NATIONAL BANK OF SERBIA

Speech at the presentation of the Inflation Report – February 2015

Branko Hinić, General Manager
Directorate for Economic Research and Statistics

Belgrade, 19 February 2015

Ladies and gentlemen, esteemed members of the press and fellow economists,

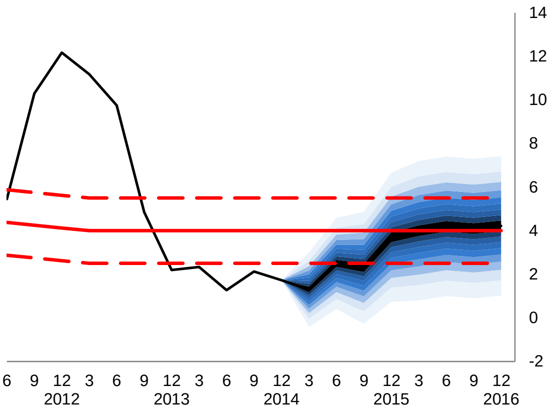
I wish you all welcome to the presentation of the February *Inflation Report*. This is the first time we meet in 2015 and I will use the opportunity to wish you success in your work and reporting on the National Bank of Serbia's activities.

The prospects for inflation and economic activity have not changed from the time of our previous *Inflation Report*. Under the impact of temporary factors, year-on-year inflation continued to move below the lower bound of the target tolerance band. In fact, due to the high last year's base caused by the increase in the VAT rate, inflation is likely to have recorded a new historical low in January this year. However, it is expected to return within the target tolerance band around mid-year and to continue moving within the band thereafter.

It is most likely that GDP will record a mild fall this year under the impact of additional fiscal consolidation measures, and hence, weaker final consumption of the household and government sectors. According to our estimates, the recovery of economic activity will start from 2016, given that consistent implementation of fiscal consolidation and structural reforms is expected to result in higher investment and net exports.

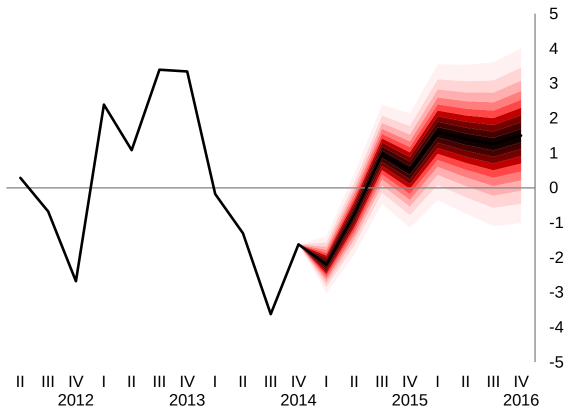
Despite the negative effects of the flooding, the current account deficit continued to narrow down – from 6.1% in 2013 to 5.9% of GDP in 2014. In 2015, the current account deficit is expected to fall to 4.3% of GDP, led primarily by the effects of fiscal consolidation, the recovery of the energy sector and lower import prices of energy.

Chart 1 **Inflation projection**
(y-o-y rates, in %)



Source: NBS.

Chart 2 **GDP growth projection**
(y-o-y rates, in %)



Source: NBS.

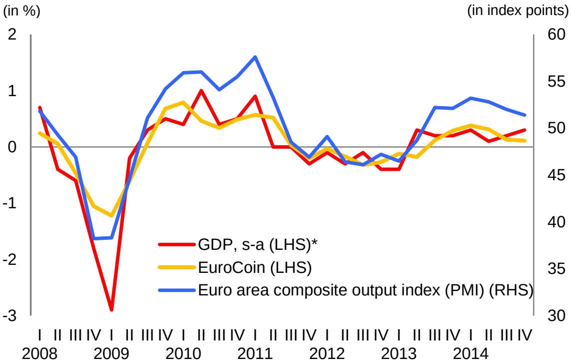
* * *

Developments in the international environment have been plagued by uncertainties associated with the pace of economic recovery, the effects of divergent monetary policies and unexpected moves of leading central banks, the movement in global oil prices and the on-going geopolitical tensions.

Despite the sharp drop in oil prices, global growth is proceeding at a sluggish pace. An exception in this respect are the United States that have experienced an economic rebound. Positive developments in the real sector encouraged the Fed to end the quantitative easing programme and to announce the start of interest rate increases this year.

Faced with strong deflationary pressures and languid economic recovery, the ECB increased to the utmost its reliance on unconventional monetary policy measures. It first expanded the programme of purchasing private securities and then made a decision to engage in purchasing sovereign bonds of the euro area member states as well, thus coming close to the quantitative easing programme implemented by the Fed. The ECB's asset purchase programme aims to pump into the system over EUR 1,100 billion by September 2016. The financial markets responded to the news by pushing down the yields on sovereign bonds of all member states of the euro area, except Greece.

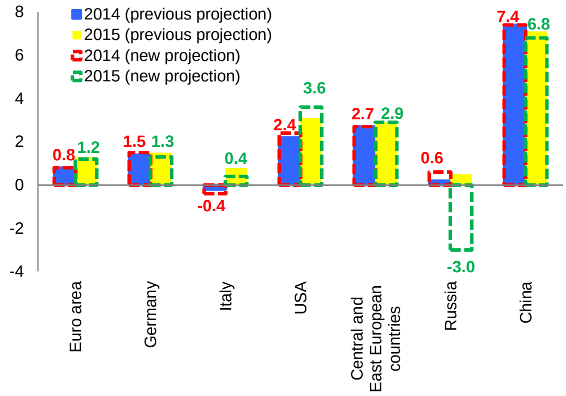
Chart 3 **Movements in GDP and economic activity indicators of the euro area**
(quarterly rates)



Sources: Eurostat, Markit Group и Banca d'Italia.

* Preliminary estimate for Q4 2014.

Chart 4 **Revisions of real GDP growth forecasts for 2014 and 2015 by the IMF**
(in %)

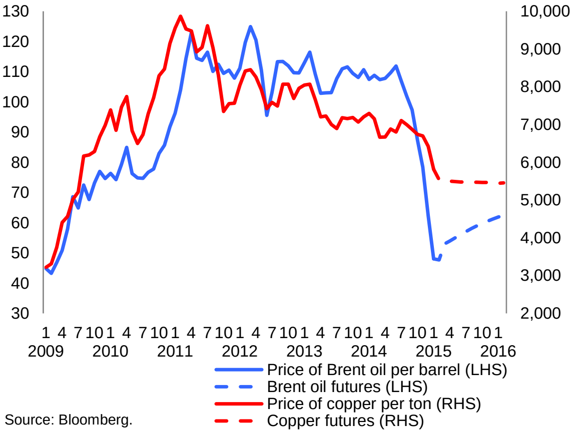


Source: IMF WEO (October 2014) and IMF WEO Update (January 2015).

Looking ahead, the divergence between the monetary policy implemented by the ECB and that implemented by the Fed is likely to extend the weakening of the euro. Faced with such outlook, after more than three years the Swiss National Bank decided to remove the minimum exchange rate of the Swiss franc against the euro. The decision shook the financial markets globally, and in particular the credit markets of some Central and East European countries where a part of bank credit portfolios is denominated in the Swiss franc. The regulatory authorities in the affected countries are now looking for ways to relieve the borrowers' debt servicing burden caused by the franc's strengthening. In Serbia, Swiss franc loans account for around 3% of GDP, which is much less than in Poland (around 8%) and Croatia (around 7%) or formerly in Hungary (around 25%).

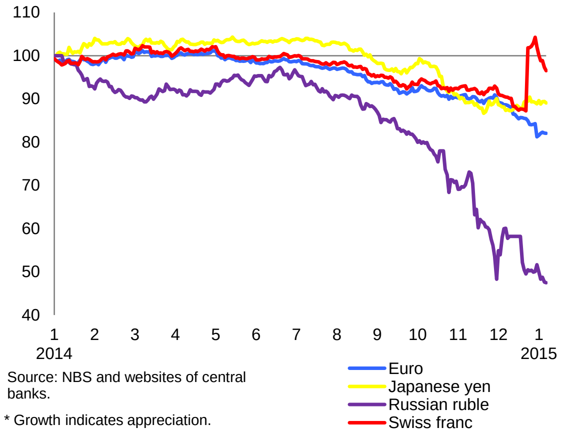
As regards commodity markets, the decline in oil prices continued in the fourth quarter at an even faster pace than a quarter earlier. The price of oil plummeted in January to below USD 50 per barrel, which is less than half the price recorded in mid-2014. Considering that Serbia is a net importer of crude oil, a significant impact on foreign trade, inflation and economic activity may be expected if oil prices stay entrenched at low levels over an extended period of time.

Chart 5 **Oil and copper price movements**
(average monthly prices, in USD)



Source: Bloomberg.

Chart 6 **Movements in exchange rates of national currencies against the dollar***
(daily data, December 31, 2013 = 100)

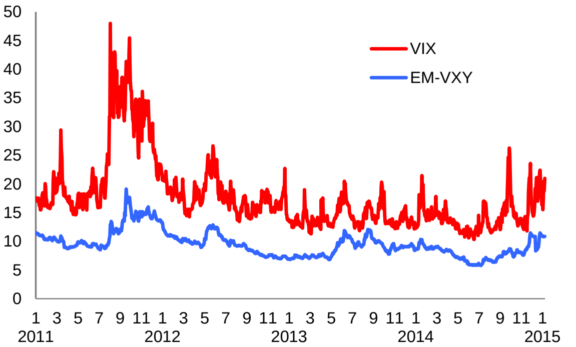


Source: NBS and websites of central banks.

* Growth indicates appreciation.

The above developments fed through into higher volatility in the international financial market and prompted investors to re-visit their risk assessments. This dampened the capital inflows and increased the pressure on most emerging market currencies, the dinar included. Serbia's risk premium followed the regional dynamics and currently stands at around 300 basis points.

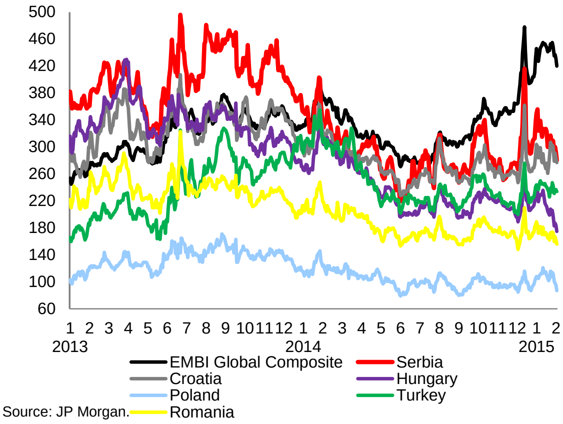
Chart 7 **Implied volatility of the global financial market***
(in %)



Source: Bloomberg.

* VIX (Chicago Board Options Exchange Market Volatility Index) measures implied volatility of the S&P 500 index; EM-VXY (JPMorgan emerging markets implied volatility index) measures aggregate volatility of emerging market currencies based on three-month forward options.

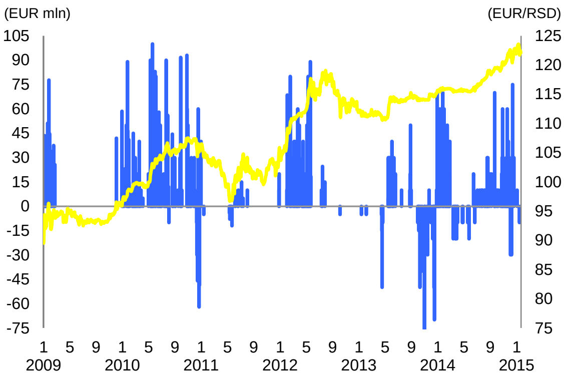
Chart 8 **Risk premium indicator – EMBI by country**
(daily, in basis points)



Source: JP Morgan.

The demand for foreign exchange in the domestic market gathered pace in the fourth quarter, partly on account of increased payments of energy imports. The demand was also fuelled by dividend payments to foreign owners, balancing of bank foreign currency positions and net repayment of foreign debt by enterprises. All of this resulted in the prevalence of depreciation pressures. To ease excessive short-term volatility of the exchange rate, but without seeking to influence the exchange rate trend, the National Bank of Serbia intervened in the foreign exchange market by selling EUR 765.0 million net in the fourth quarter of 2014 and EUR 80.0 million net in the year to date.

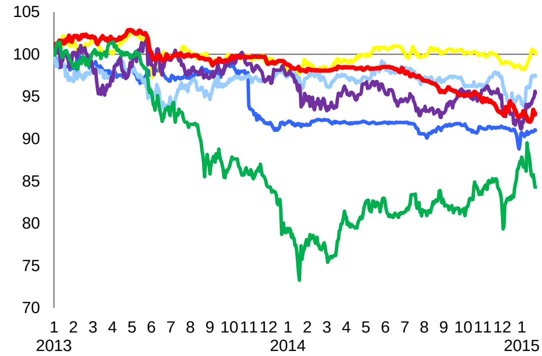
Chart 9 **Movements in EUR/RSD exchange rate and NBS FX interventions**



Source: NBS.
* + sale; - purchase.
** 1 EUR in RSD.

NBS interventions (LHS)*
EUR/RSD exchange rate (RHS)**

Chart 10 **Movements in exchange rates of national currencies against the euro***
(daily data, January 2, 2013 = 100)



* Growth indicates appreciation.

Source: NBS and websites of central banks.

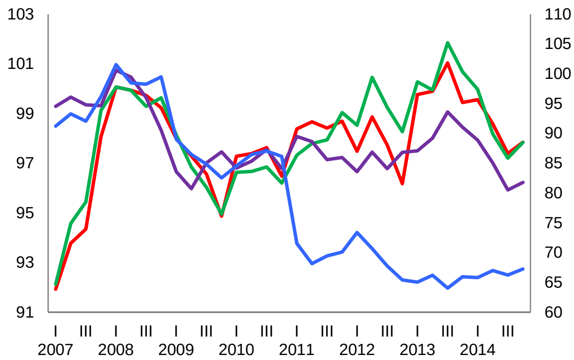
Czech Republic
Romania
Poland
Hungary
Serbia
Turkey

Though inflationary pressures were low, caution in monetary policy easing was commanded by heightened uncertainties in the international financial market in view of their impact on capital flows and the risk premium. The key policy rate was last cut in November by 50 basis points, to 8.0%. Credit activity continued up in the fourth quarter on the back of the programme of subsidised corporate lending, but at a weaker pace than in the previous quarter. However, as the programme came to an end, credit activity will most likely continue to slow down this year, prompting the National Bank of Serbia to lower its foreign exchange reserve requirement ratios.

* * *

The negative effects of the May floods on Serbia's economic activity are gradually fading. Despite the last year's decline triggered mainly by the flood damage to the energy and mining sectors, the industrial production recovered in the fourth quarter partly due to increased production in these sectors. This reflected on GDP growth in the fourth quarter, which, according to the National Bank of Serbia's estimate, equals 0.5% in seasonally-adjusted terms. On the expenditure side, GDP growth was driven by more favourable trends in foreign trade. Domestic demand stagnated – the fall in investment and household consumption was offset by higher government consumption. In year-on-year terms, GDP fell by 1.6% in the fourth quarter, which is a significant slowdown relative to the previous quarter. In light of this, GDP is estimated to have fallen by around 1.8% in 2014. This year, GDP is expected to decline moderately, by 0.5%.

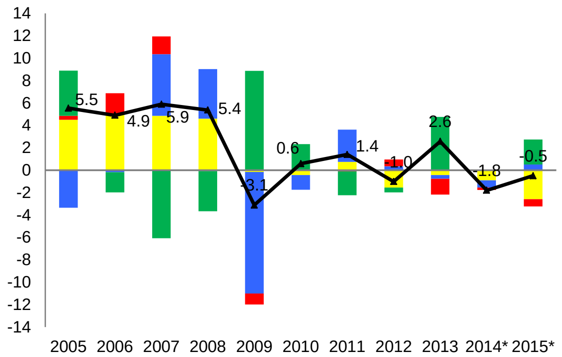
Chart 11 **Economic activity indicators**
(s-a, H1 2008 = 100)



Source: SORS and NBS calculation.

GDP (LHS)
Non-agricultural value added (LHS)
Industrial output (RHS)
Retail trade (RHS)

Chart 12 **Contributions to y-o-y GDP growth**
(in pp)



Source: SORS and NBS calculation.

* NBS estimate.

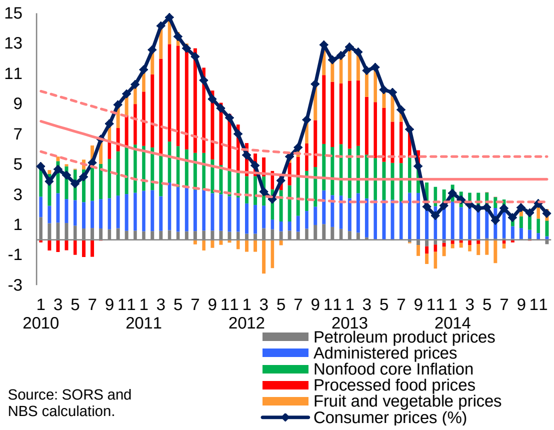
Net exports
Government consumption and investment
Investment
Consumption
GDP (%)

According to the Labour Force Survey, the labour market continues to recover. The unemployment rate declined further, ending 2014 at 16.8%. A gradual rise in employment and real income of households, in an environment of low inflation, should contribute to growth in economic activity as of 2016. However, the strongest impetus to growth is expected from higher investment and net exports, owing primarily to progress in fiscal adjustment and structural reforms, as well as positive effects of external demand.

* * *

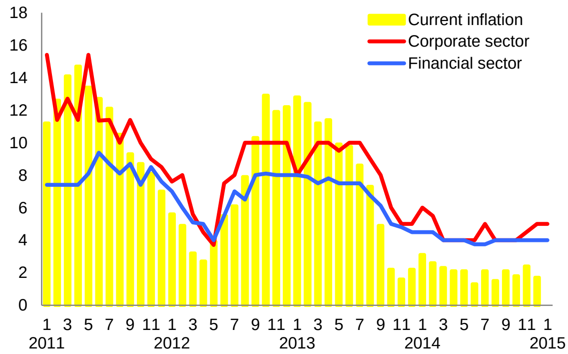
Consistent with our expectations from the November *Inflation Report*, year-on-year inflation continued to move below the lower bound of the target tolerance band and reached 1.7% in December. At the same time, core inflation rose moderately and trended closer to the lower bound of the target tolerance band in December, aided, *inter alia*, by the past depreciation of the dinar. The undershooting of the target band during most of 2014 is largely attributable to factors with a temporary effect – the unexpectedly weak administered price growth and a sharp fall in primary agricultural commodity prices and global oil prices. On the other hand, the disinflationary pressures from low aggregate demand and low inflation in the international environment matched our earlier expectations.

Chart 13 **Contribution of CPI components to y-o-y inflation**
(in pp)



Source: SORS and NBS calculation.

Chart 14 **Current inflation and one-year ahead inflation expectations***
(y-o-y rates, in %)



Sources: Gallup, Ipsos, Ninamedia and NBS.

* Ninamedia agency since December 2014, and Ipsos and Gallup in the prior period. The survey was not conducted in November 2014.

Under our central projection, year-on-year inflation is likely to return within the target tolerance band (4.0±1.5%) around mid-year and then move around the target until the end of the year.

In addition to monetary policy measures already taken, such movements in inflation will be driven by the expected administered price adjustments, the effects of past depreciation of the dinar and the gradual waning of the disinflationary pressures generated by primary agricultural commodity prices. On the other hand, price growth will be slowed down by low aggregate demand, its disinflationary effects reinforced by fiscal adjustment measures, and by inflation in the international environment which continues to run low irrespective of accommodative monetary policy measures.

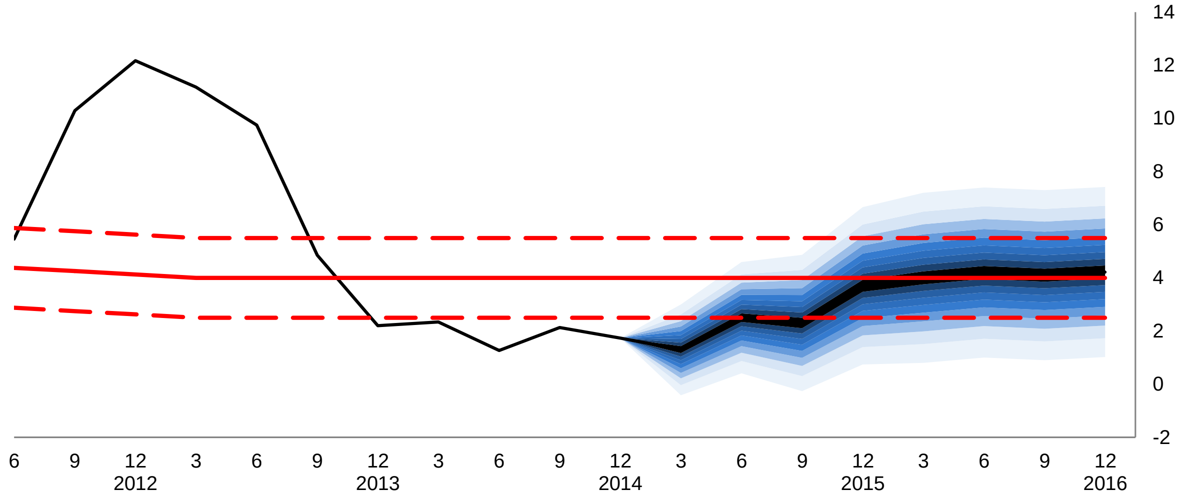
Inflation will stabilise within the target band also thanks to anchored inflation expectations. Owing to an extended period of low inflation and anticipation of weak inflationary pressures, both one-year and two-year ahead inflation expectations of financial and corporate sectors have been moving within the target band, for the longest period on record.

* * *

At its last meeting, the Executive Board of the National Bank of Serbia kept the key policy rate at 8.0%. In order to stabilise inflation at low levels in the long run, caution was exercised in the conduct of monetary policy, particularly in the light of heightened geopolitical tensions and volatility in the international commodity and financial markets. These factors may result in increased investors' risk aversion, slower capital flows and a more uncertain effect of monetary policy measures of advanced economies, notably those of the ECB, on the economic recovery of our key trade partners.

Looking ahead, monetary policy easing will depend primarily on the assessment of the potential impact of developments in the international environment on capital flows and Serbia's risk premium, as well as on the movement in international and domestic prices of primary commodities and their effect on other prices. Fiscal consolidation measures, both taken and announced, have lessened the risks associated with fiscal policy. The initiated structural reforms and fiscal consolidation will reduce the external imbalance and facilitate the conduct of monetary policy, which is likely to contribute to long-term sustainable economic growth.

Chart 15 **Inflation projection**
(y-o-y rates, in %)



Source: NBS.