



NATIONAL BANK OF SERBIA

Speech at the presentation
of the Inflation Report – February 2016

Ana Ivković, Acting General Manager
Directorate for Economic Research and Statistics

Belgrade, 19 February 2016

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

Welcome to the presentation of the February *Inflation Report*, where we will present current and expected economic developments and explain measures taken by the National Bank of Serbia.

First of all, let me note that the movements in the prior period were consistent with our expectations stated in the November *Report* – inflation stayed low and stable and GDP continued growing. As global prices of primary commodities declined in the meantime, inflation's return within the target tolerance band will be slower than expected. According to the new projection, inflation should return within the target tolerance band late this or early next year and hover around 3% thereafter. GDP is expected to accelerate from 0.8% last year to 1.8% this and 2.2% next year.

The National Bank of Serbia trimmed the key policy rate further in February, to 4.25%. Past monetary easing, begun in May 2013, greatly reduced the cost of private sector and government borrowing, while also contributing to the recovery in lending since mid-2015. It is in 2015 that interest rates on dinar loans to the private sector recorded the sharpest drop so far, of close to 5 percentage points. Their decline was also supported by the narrowing of internal and external imbalances – the budget deficit was almost halved in 2015 (from 6.6% to 3.7% of GDP), and the current account deficit was lower by a fifth and fully covered by foreign direct investment. The narrowing of internal and external imbalances increases our economy's resilience to external shocks. Similar trends are expected to continue in the years ahead.

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

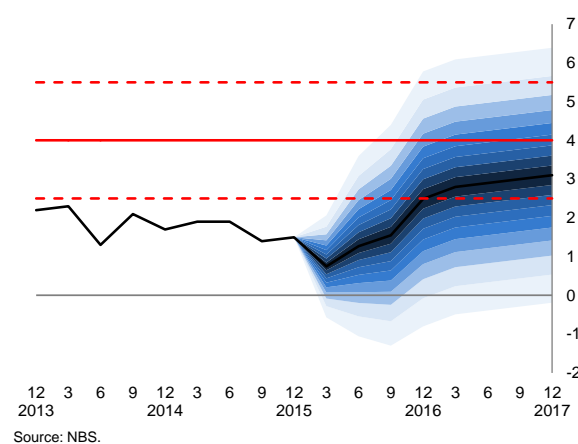
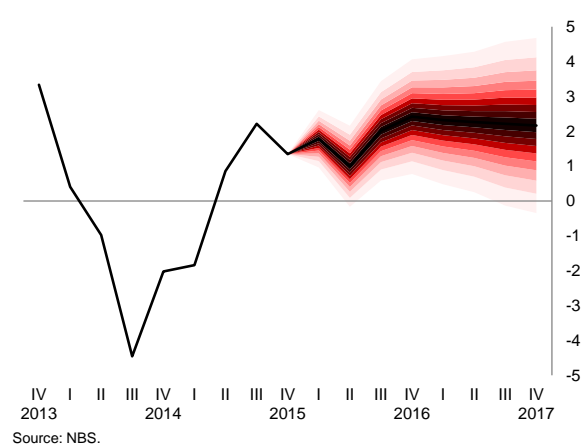


Chart 2 **GDP growth projection**
(y-o-y rates, in %)

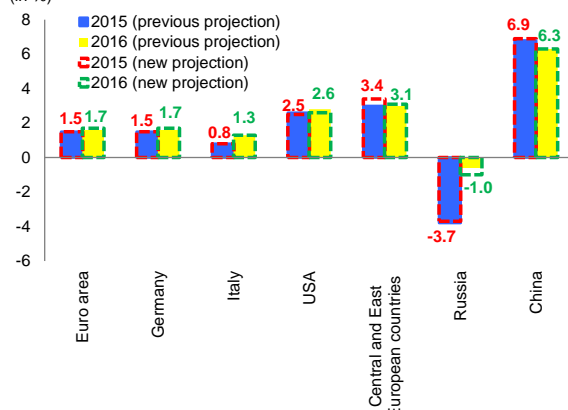


* * *

Movements in the international environment late last and early this year were marked by weaker global growth prospects, continuing slide in global prices of oil and other primary commodities and heightened uncertainty in the international financial market.

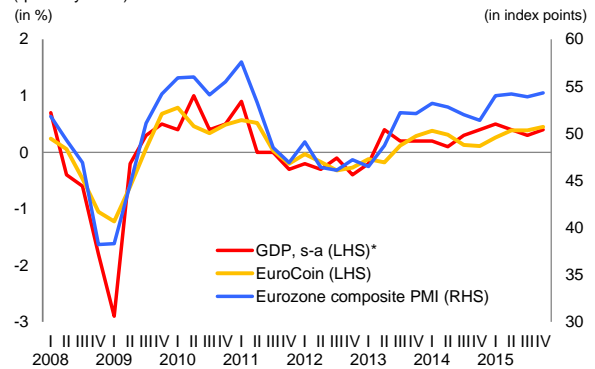
Global growth forecasts have been revised downwards. Emerging markets in particular face challenges, including increased financial vulnerability triggered by the Fed's monetary policy reversal, Chinese growth slowdown and tumbling global prices of primary commodities. Euro area growth has, by contrast, continued at a moderate pace and is expected to reach 1.7% in 2016. A deceleration in emerging markets' growth could, however, dent the recovery of the euro area by pushing down the demand for euro area exports. Given its importance as our key trading partner, any potential slowdown in euro area recovery would affect our economy as well.

Chart 3 Revisions of real GDP growth forecasts for 2015 and 2016 by the IMF
(in %)



Source: IMF WEO (October 2015) and IMF WEO Update (January 2016).

Chart 4 Movements in GDP and economic activity indicators of the euro area
(quarterly rates)

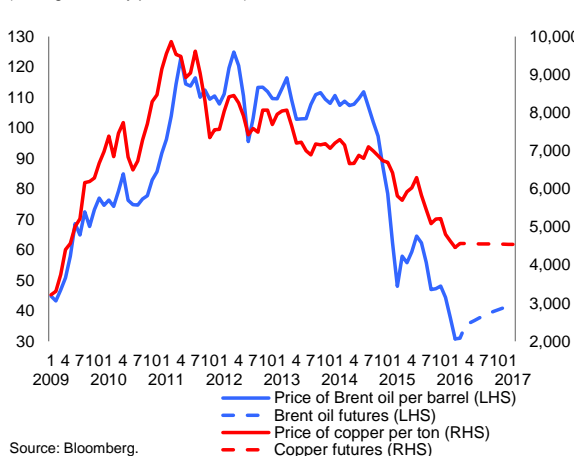


Sources: Eurostat, Markit Group and Banca d'Italia.

* Preliminary estimate for Q4 2015.

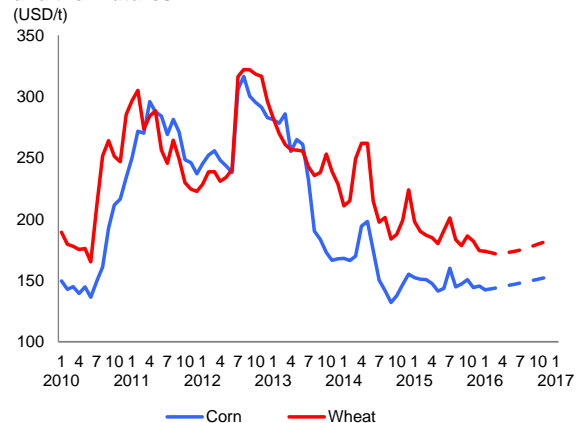
After recovering temporarily to over USD 50 per barrel in early October, oil prices tumbled again in January to their thirteen-year low. They currently stand at around USD 30 per barrel, which is more than 70% lower than a year and a half ago when their slide began. Although in our inflation projection we assumed a certain recovery of such depressed oil prices on the basis of futures, downward pressures on oil prices may persist over the short run, mostly on account of persistently high supply and inventories and weaker prospects for global growth.

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



Source: Bloomberg.

Chart 6 Prices of primary agricultural commodities and their futures
(USD/t)



Source: CBOT - Chicago Board of Trade.

In addition to oil, prices of other primary commodities also continued to decline, which made primary commodities one of the factors behind extremely low inflation worldwide. This has prompted central banks to take measures in order to bring inflation back to target. In December, the ECB decided to cut further its (already negative) interest rate on the deposit facility and to extend its quantitative easing programme at least until March 2017 in order to support the return of inflation to target and sustain economic recovery in the euro area. In January, the ECB announced the possibility of further stimulus in March this year, which could moderate the negative effects of the Fed's normalisation on capital flows to emerging markets. The pace of the Fed's rate hikes, however, may be slowed by weaker global growth prospects and the continuing slide in prices of primary commodities.

Heightened uncertainty in the international financial market reflected on the domestic foreign exchange market as well. And while appreciation pressures on the dinar prevailed during most of 2015, depreciation pressures built up late last and early this year. In the first half of December and in January, pressures stemmed from increased investor risk aversion to emerging markets, Serbia

included. To an extent, they were also generated by the interplay of seasonal factors at home. Factors working in the opposite direction included higher foreign direct investment in Serbia, which in 2015 reached EUR 1.8 bln and exceeded the current account deficit. Depreciation pressures were also moderated by the successful completion of the third review under the IMF arrangement and Serbia's improved credit rating outlook. As before, the National Bank of Serbia kept a close eye on developments and intervened in both directions – by selling and buying foreign exchange, in order to moderate excessive daily volatility of the exchange rate.

Chart 7 Current account deficit and net capital inflow (in EUR mln)

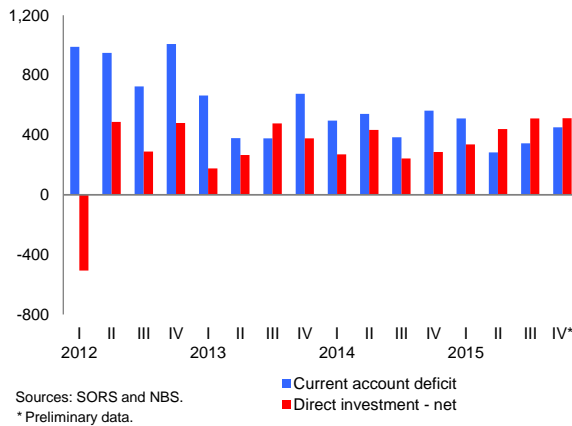
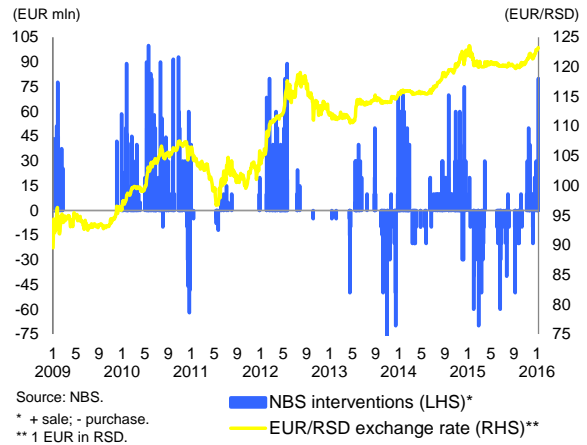


Chart 8 Movements in EUR/RSD exchange rate and NBS FX interventions



* * *

Serbia's GDP posted growth in the fourth quarter. On the back of increased domestic demand, primarily in terms of investment, GDP rose by 0.2% in seasonally-adjusted terms relative to a quarter earlier or by 1.3% compared to the same period of 2014. Investment determined GDP growth on the expenditure side throughout the entire last year, which is an important precondition to sustainable growth. On the production side, growth was led by industry and construction. At the same time, more than two-thirds of branches within manufacturing boasted increased production and almost all recorded higher exports. Such trends are expected to continue, accompanied by further acceleration in economic activity. After growing by 0.8% in 2015, GDP is expected to go up by 1.8% in 2016 and 2.2% in 2017.

Chart 9 Contributions to y-o-y GDP growth (in pp)

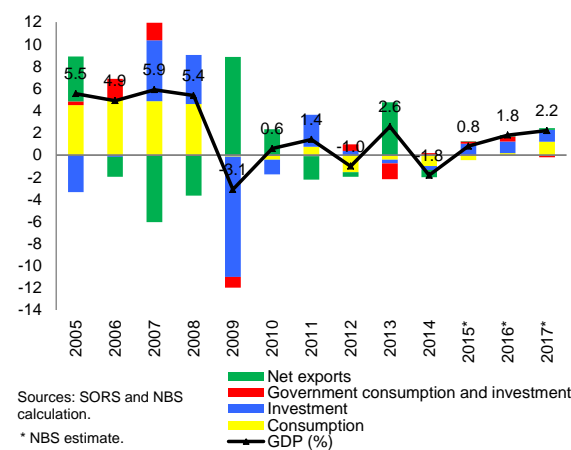
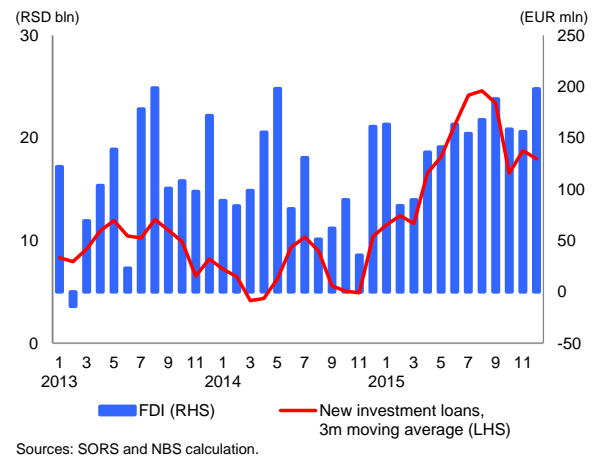


Chart 10 New investment loans and FDI



We expect growth in investment this year to result from an interplay of a number of factors, most notably lower operating expenses of businesses owing to more favourable lending terms and lower oil prices, as well as an improved investment environment. In addition, we expect that investment will also rise on the back of the recovery in the euro area which is expected to continue and stable inflow of capital from foreign direct investment. Higher investment implies higher imports of equipment and intermediate goods, which means that although we expect higher exports, the contribution of net exports to GDP growth will most likely be neutral, like it was last year.

Favourable tendencies should continue in 2017 – in all likelihood, investment will continue to drive economic growth. Household consumption will probably be an additional positive contributor to GDP, while the impact of net exports is likely to stay close to neutral. The risks to GDP projection are largely associated with the pace of economic recovery of the euro area and movements in international primary commodity prices.

* * *

Inflation has been low and stable for the last three years. Year-on-year, it continued below the lower bound of the target tolerance band in Q4 and amounted to 1.5% in December. Inflationary pressures remained subdued due to the disinflationary effect of the majority of domestic factors, continuing slide in global prices of oil and primary agricultural commodities, and generally low inflation abroad.

Looking ahead, year-on-year inflation is likely to stay low in the first half of the year owing to a further decline in global prices of primary commodities (notably oil) over the past several months. This decline is the main reason why our new projection was revised down relative to the November forecast.

Chart 11 Contribution of CPI components to y-o-y inflation (in pp)

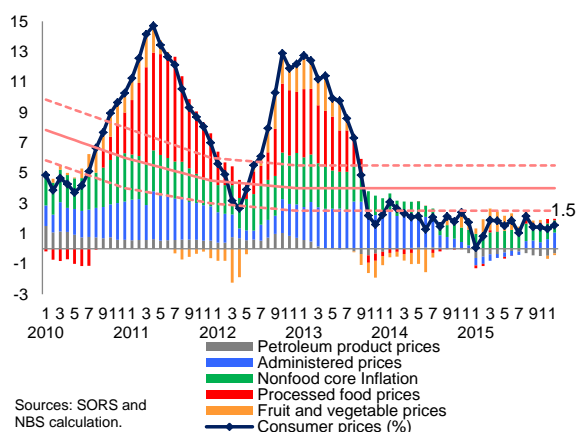
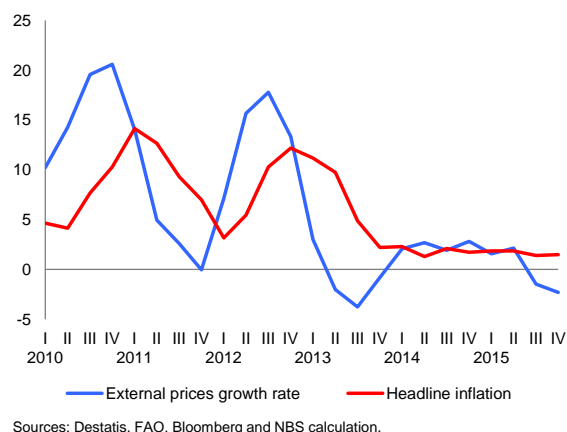


Chart 12 Domestic inflation and external prices (y-o-y rates, in %)



According to our central projection, year-on-year inflation should rise moderately from mid-year and return within the target tolerance band late this or early next year. We estimate that its growth will continue in 2017, though at a much slower pace, averaging around 3.0%.

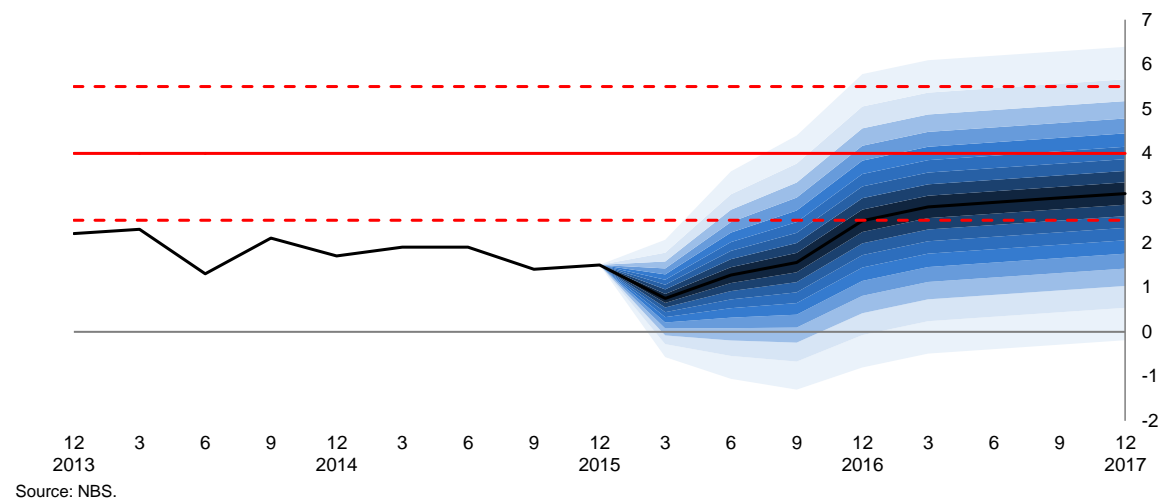
Gradual inflation growth over the projection horizon will mainly reflect the weakening of disinflationary pressures amid the assumed moderate rise in international primary commodity prices, domestic aggregate demand and inflation abroad.

The risks to the projected inflation path are mostly associated with future developments in the international commodity and financial markets and, to a degree, with the speed of recovery in the euro area.

* * *

Having kept the key policy rate unchanged for three months, the National Bank of Serbia's Executive Board decided to cut it by 0.25 pp to 4.25% in its most recent meeting. The slower pace of key policy rate trimmings over the past months is attributable to heightened uncertainty in the international environment. In the same meeting, the Executive Board also decided to narrow the interest rate corridor by 0.25 pp – from ± 2.0 pp to ± 1.75 pp relative to the key policy rate. This move should be conducive to further stabilisation of interest rates in the interbank money market and strengthening of the interest rate transmission channel. In addition, this month was the last in the six-month cycle of the FX required reserve ratio cuts which the National Bank of Serbia implemented to stimulate credit activity and, in turn, quicken the recovery of the Serbian economy. In 2015, lending activity increased by 1.8%, despite the maturing of subsidised loans. A particularly favourable development is the fact that new investment loans granted in 2015 were two and a half times higher than in 2014.

Chart 13 **Inflation projection**
(y-o-y rates, in %)



As inflationary pressures are likely to stay low in the period ahead, the monetary policy stance of the National Bank of Serbia should remain expansionary. Given the current prevalence of external risks associated with movements in the international financial and commodity markets, the degree of monetary expansion will depend primarily on the assessment of their potential inflationary effect. The National Bank of Serbia will continue to closely monitor the developments in the domestic and international environment, and its future decisions will be consistent with the commitment to return inflation within the target tolerance band in a sustainable manner while, at the same time, maintaining financial stability.

Thank you for your attention. We now open the floor for questions.