NATIONAL BANK OF SERBIA

Speech at the presentation of the Inflation Report – May 2015

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

Welcome to the presentation of the May *Inflation Report*, where we will set out our views of the current and expected economic developments and explain the decisions the National Bank of Serbia has taken since we last met in February.

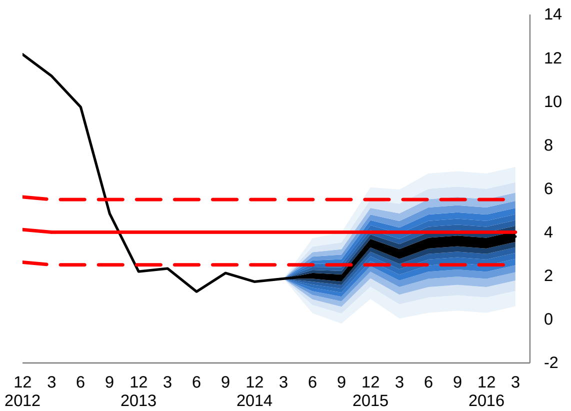
Currently, inflation is undershooting the target. However, after touching its minimum level in January, inflation has been rising steadily since February and is expected to return within the target tolerance band in the second half of the year. The new inflation projection is slightly lower than the one published in the February *Inflation Report*, chiefly due to the expectation of weaker growth in administered prices.

In contrast to the February projection of a slight decline in economic activity this year, economic activity is now expected to stagnate. The projection for 2015 has been revised up owing to a somewhat faster recovery of the euro area, our key trade partner, and a smaller-than-expected decline in final consumption, supported by lower oil prices. GDP growth projection for 2016 has been kept unchanged at 1.5%.

Fiscal performance in the first quarter of this year was quite satisfactory. Consolidated fiscal deficit amounted to 2.4% of estimated GDP, and assuming further consistent implementation of fiscal consolidation measures, it is likely to stay below the level envisaged by the Fiscal Strategy for this year – 5.9% of GDP. We expect not only a reduction in internal, but also in external imbalances. According to our estimates, the current account deficit will narrow to 4.2% of GDP this year (from 6.0% of GDP last year) thanks to the recovery of our main foreign trade partners, lower prices of oil and revitalisation of energy and mining sectors.

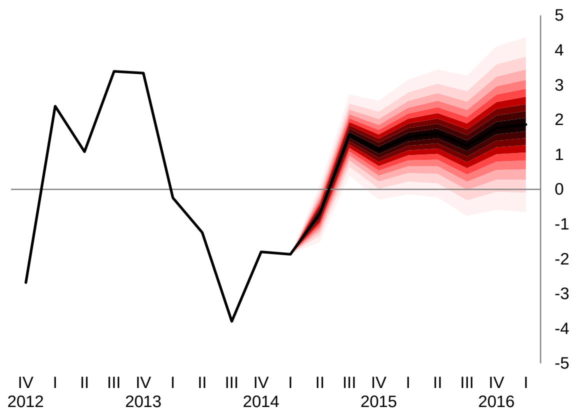
We proceeded with monetary policy relaxation, hence contributing to economic recovery in an environment of reduced fiscal accommodation. Guided by the assessment that there will be no major inflationary pressures in the coming period, and bearing in mind the recently concluded arrangement with the IMF and buoyant liquidity in the international financial market, we decided to cut the key policy rate to its lowest level since the introduction of the inflation targeting regime.

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



Source: NBS.

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



Source: NBS.

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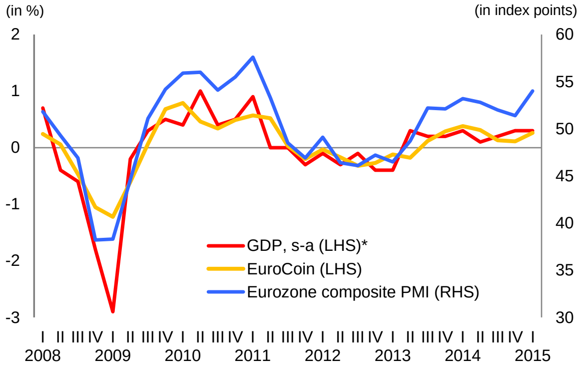
In the period under review, the international environment was plagued by uncertainties over several key issues: the effects of the ECB's quantitative easing on the economy, the start of the Fed's policy rate increases and the outlook for oil prices.

In early March, the ECB started buying government securities issued by member states. The initial results of the new monetary policy measures appear to be encouraging – real interest rates are going down and the euro is weakening, which together with low oil prices serves as a catalyst to the economy. The expected effects of the ECB's measures and positive movements of economic indicators in the first quarter have led to an upward revision of the euro area's GDP growth. According to the IMF and Consensus Forecast, the euro area economy is set to grow 1.5% in 2015.

The recovery of the euro area has started spreading to the region of Central and East Europe. The ECB's quantitative easing and low oil prices have opened up the room for regional central banks to ease their monetary policies further. This, along with the necessary structural adjustment, should help the countries of the region improve their competitiveness in the global market and step up economic growth, despite persistent geopolitical tensions.

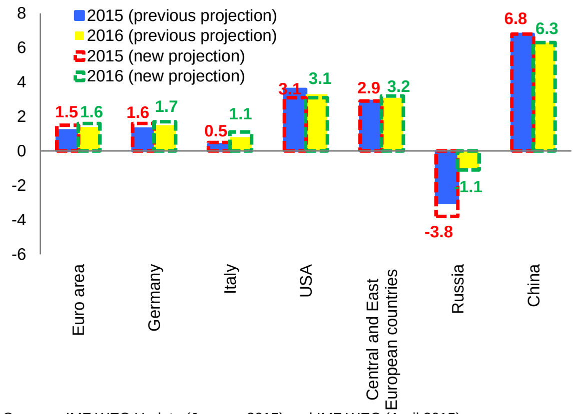
Chart 3 **Movements in GDP and economic activity indicators of the euro area**
(quarterly rates)



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

* Preliminary estimate for Q1 2015.

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

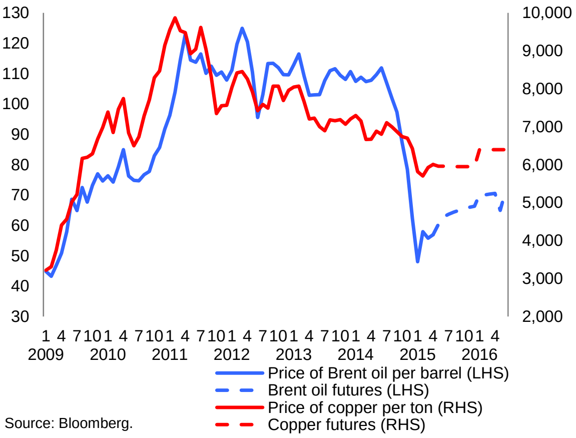


Source: : IMF WEO Update (January 2015) and IMF WEO (April 2015).

By contrast to the ECB and other central banks, the Fed is preparing to initiate a cycle of interest rate increases. In its March meeting the Fed suggested it could start increasing the policy rate in summer, but then failed to make any specific announcements in the April meeting about when this was likely, as the readings from the labour market and the economy turned out to be less favourable. Analysts estimate that the Fed's first policy rate increase could take place in the third quarter, while interest rate futures indicate that the Fed will wait until December.

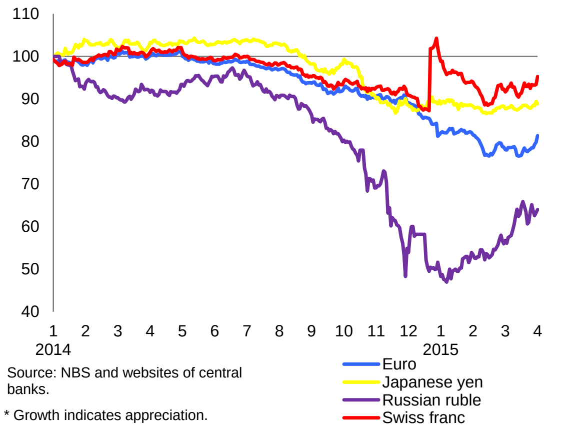
After plummeting to their lowest level since early 2009, global oil prices began to rise, remaining however significantly below the levels recorded in the past. As the main factors behind low oil prices are more on the supply than on the demand side, these prices are expected to give a positive contribution to global economic growth. As stated in February, a positive impact on the foreign trade balance and economic activity of Serbia may be expected if oil prices stay entrenched at low levels over an extended period of time. This is also one of the reasons for the upward revision of our GDP growth projection for this year.

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)

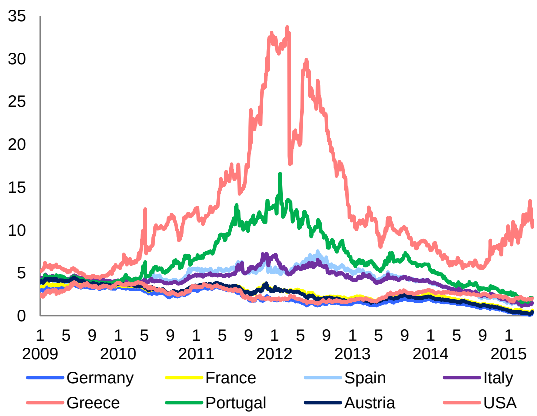


Source: NBS and websites of central banks.

* Growth indicates appreciation.

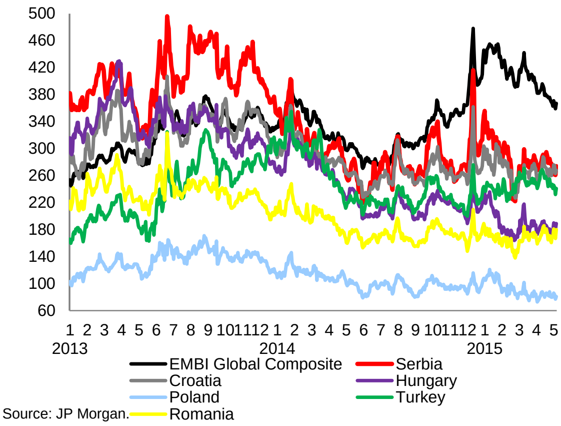
Serbia's risk premium, measured by the Emerging Markets Bond Index, currently stands at 267 basis points. Its decline from the beginning of the year is attributable primarily to the agreement with the IMF and implementation of fiscal consolidation, as well as to the affirmation of the country's credit rating. It should be noted, however, that changes in the Emerging Markets Bond Index, were also due to the volatility in yields on the ten-year US Treasury note caused by uncertainties over the start of the Fed's interest rate increases.

Chart 7 **Yield on 10-year bonds of selected countries**
(daily data, in %)



Source: Bloomberg.

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

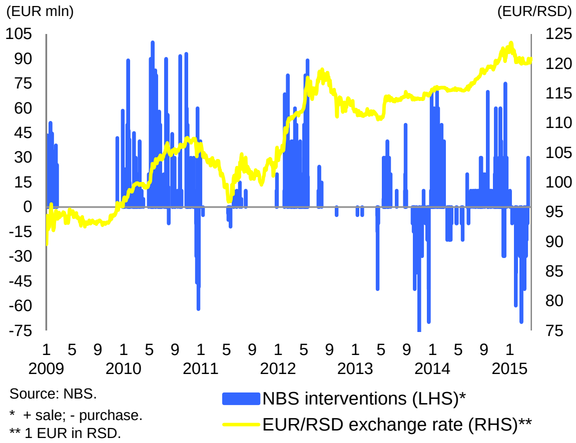


Source: JP Morgan.

Ample liquidity in the international financial market and low and in an increasing number of cases negative yields on government securities of advanced economies have helped re-channel capital flows towards emerging markets, ours included. An important stimulus in this respect came from fiscal adjustment and the conclusion of the arrangement with the IMF. This is evidenced by the high non-residents' investment in dinar government securities in February and March, which fed through into stronger demand for the dinar. An additional boost to appreciation pressures on the dinar came from the reduction in energy importers' demand for foreign exchange, relatively low deficit on the balance of goods and services and comparatively high net purchase of foreign cash from exchange offices in March.

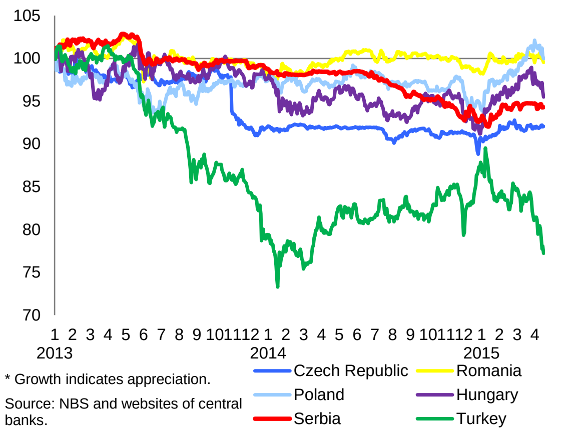
To ease excessive short-term volatility of the exchange rate, without seeking to influence the exchange rate trend, the National Bank of Serbia intervened in the interbank foreign exchange market by both selling and buying foreign exchange. After selling EUR 90 million in January, the National Bank of Serbia intervened mainly on the purchase side (EUR 400 million) and much less on the sale side (EUR 30 million).

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



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

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.

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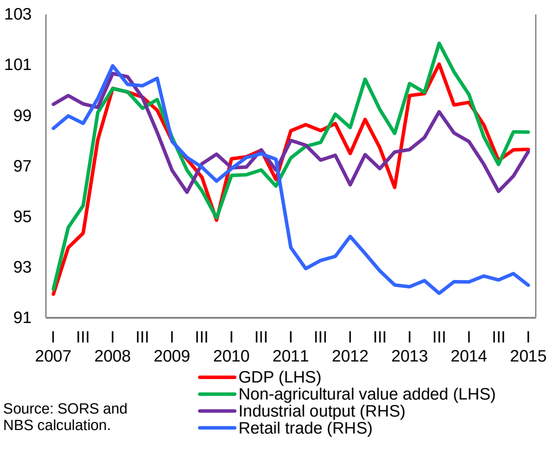
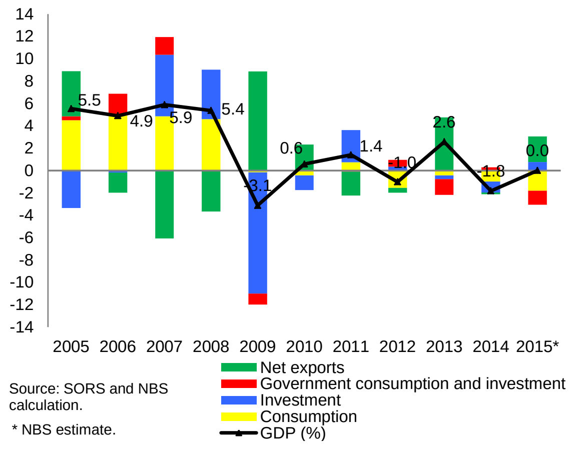
The recovery in manufacturing and continued rehabilitation of the mining-energy complex, driven by the rising external demand, counterbalanced the negative trends in the service sectors in the first quarter. As a result, GDP stayed unchanged relative to the previous quarter. Promisingly, recovery was recorded for a larger number of export-oriented sectors, laying a sound foundation for growth in the coming quarters. As estimated by the Statistical Office, GDP fell by 1.9% in the first quarter relative to the same period last year. Still, manufacturing experienced positive trends and its physical volume entered a year-on-year rise, following three consecutive quarters of decline.

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



Source: SORS and NBS calculation.

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



Source: SORS and NBS calculation.
* NBS estimate.

Owing to faster recovery of the euro area and lower oil prices, the growth in net exports is likely to be somewhat stronger this year and the fall in household consumption softer than expected earlier. We have therefore revised upward the GDP projection for 2015, expecting economic stagnation instead of a moderate decline. On the expenditure side, a positive contribution is likely from net exports and to a lesser extent from private investment, whereas final household and government consumption will provide a negative contribution. On the production side, the contribution of industrial production is likely to be positive and higher than expected owing to manufacturing. An impetus is also likely to come from the recovery of production in the mining and energy sectors after the damage to their capacities caused by last year's floods. In contrast, dampened final consumption will negatively affect the activity of service sectors, which will probably be the main negative contributor to GDP growth. A negative contribution is also likely from agricultural production given the high last year's base when agricultural performance was very good.

Uncertainties surrounding the GDP projection concern primarily the speed of economic recovery of the euro area and the pace of fiscal consolidation and structural reforms at home, but also this year's agricultural performance. The projection does not include potential positive effects associated with the Smederevo steel plant.

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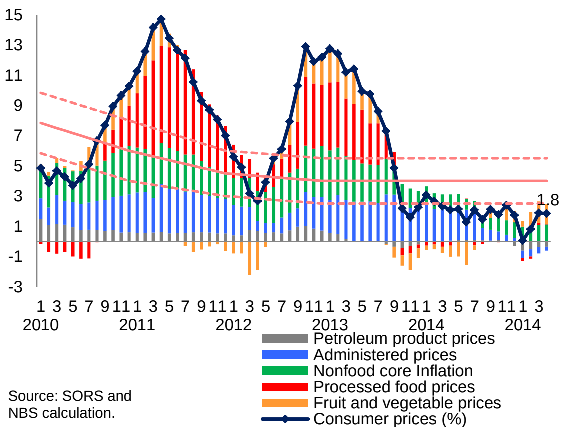
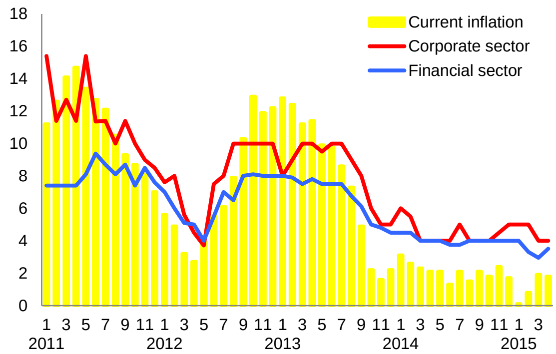
Consistent with expectations expressed in the February *Inflation Report*, year-on-year inflation continued to move below the lower bound of the target tolerance band in the first quarter. After falling to a 0.1% low in January, inflation began to rise in February towards the target. It touched 1.8% in April. Low inflation rates are a result of the interplay of several factors – muted aggregate demand, low inflation in the international environment, low prices of primary commodities, notably oil, and the absence of the expected administered price adjustment.

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 will return within the target tolerance band (4.0±1.5%) in the second half of the year and stay within the band until the end of the projection horizon.

The expected growth in inflation over the coming period will be led by a rise in only a few CPI items (cigarettes, petroleum products and electricity), which contributed significantly to the undershooting of the inflation target band in the past year, but also by the effects of low last year's base. The risks to the projected inflation path relate to developments in the international environment, including prices of primary commodities, and to the movement of administered prices at home. To a certain degree, the risks are also associated with the outcome of this year's agricultural season.

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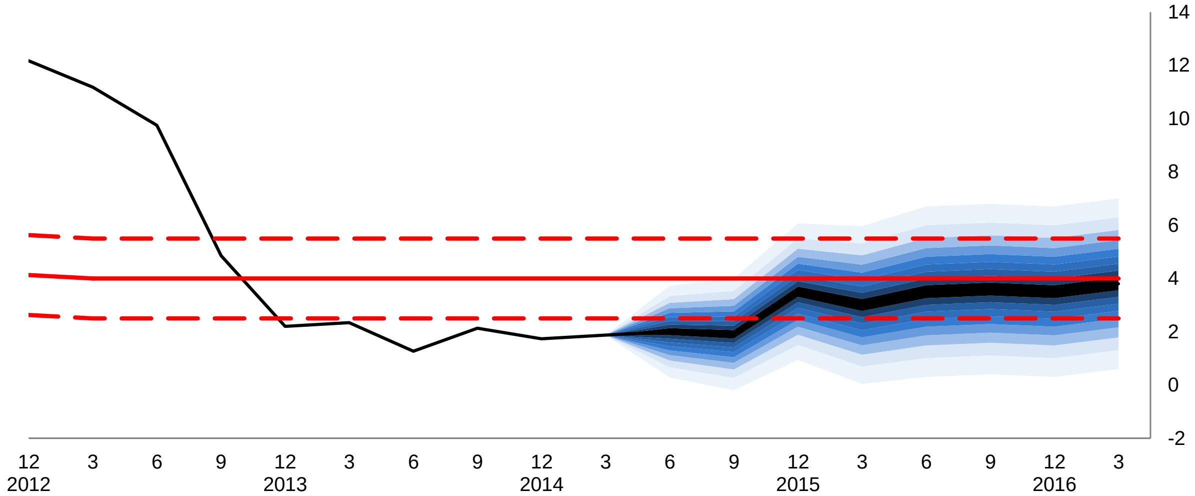
Assessing that no major inflationary pressures are likely in the coming period, the National Bank of Serbia's Executive Board decided to further ease the monetary policy stance. The Board also took into account the stabilisation of inflation expectations within the target band, increased investor interest in Serbia owing to fiscal consolidation and the arrangement with the IMF, as well as more favourable developments in the international environment. In the March–May period, the key policy rate was cut by a total of 150 basis points to 6.5% – its lowest level since the introduction of the inflation targeting regime. In addition, in its May meeting, the Executive Board narrowed the corridor of interest rates set in reference to the key policy rate from ±2.5% to ±2.0%. This measure aims to further stabilise interest rates in the interbank money market.

Looking ahead, the monetary policy stance 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 oil and agricultural commodity prices. In addition, further consistent implementation of fiscal consolidation and structural reforms should open up additional room for monetary policy easing. At the same time, we wish to emphasise the importance of the arrangement with the IMF and express our satisfaction that all quantitative programme criteria have so far been met. Net foreign exchange reserves of the National Bank of Serbia at end-March were much above the floor defined by the programme and year-on-year inflation moved within the bounds of the agreed band. Furthermore, fiscal developments went in line with the programme objectives and most fiscal consolidation measures were implemented according to the plan. We expect this trend to continue in the coming period, with structural policies featuring as exceptionally prominent, notably in regard to the restructuring of state-owned enterprises and improved environment for new investments, which are the key prerequisite for economic and employment growth in the long run.

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



Source: NBS.