NATIONAL BANK OF SERBIA

Speech at the presentation of the *Inflation Report – May 2016*

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Directorate for Economic Research and Statistics

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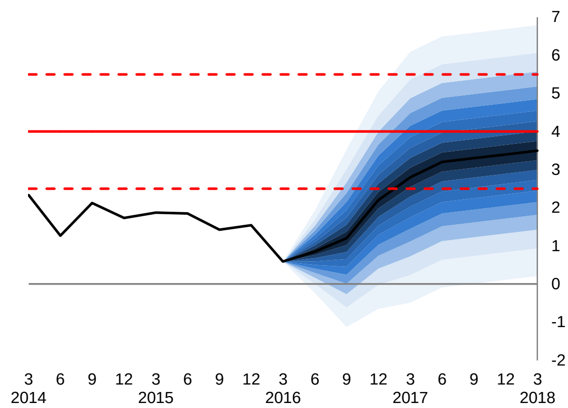
Ladies and gentlemen, esteemed members of the press and fellow economists,

Welcome to the presentation of the May *Inflation Report* during which we will present current economic developments in Serbia and explain new macroeconomic projections as well as monetary policy measures of the National Bank of Serbia.

Since our last meeting in February, inflation has stayed low, economic recovery has accelerated and our expectations for the period ahead have improved. According to the latest projection, year-on-year inflation will rise from May onward and make its way back within the target tolerance band early next year, stabilising thereafter at slightly above 3.0%. Our GDP projection for 2016 has been revised upwards from 1.8% in February to 2.3–2.5%.

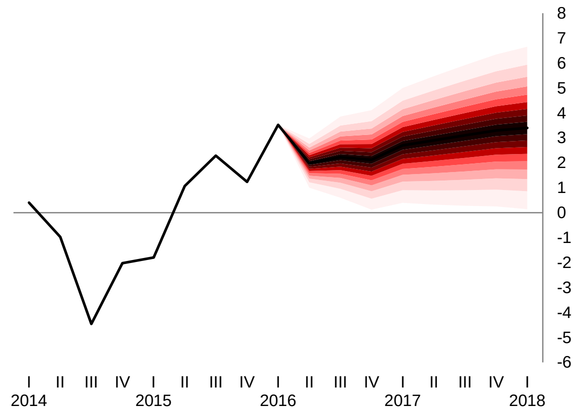
It is particularly important that both internal and external imbalances have narrowed further, increasing Serbia's resilience to challenges from the international environment. Our expectations that both fiscal and current account deficits will be lower in 2016 than last year are confirmed by favourable fiscal and balance of payments movements since the start of the year. At 1.7% of GDP, the consolidated fiscal deficit was almost a quarter lower than in the same period a year earlier, which is also well below the ceiling under the agreement with the International Monetary Fund (5.8% of GDP). In addition, the current account deficit has been more than halved relative to the same period a year earlier and stands at 3.3% of GDP. With FDI coverage of the current account deficit at 133%, the deficit remains fully covered by FDI.

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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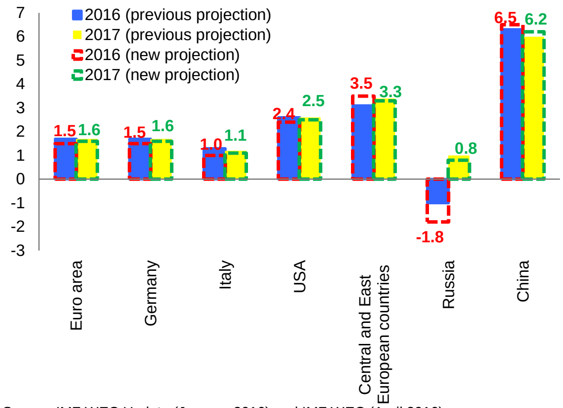
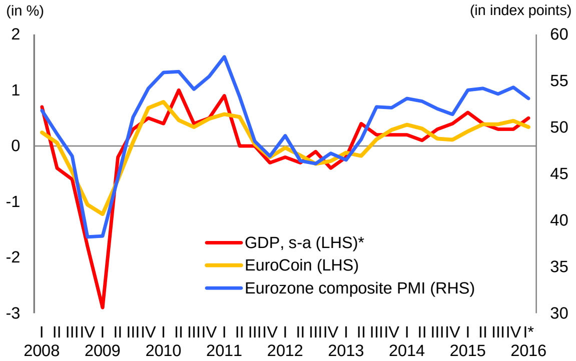
For quite some time, developments in the international environment have posed a challenge to monetary policies of central banks worldwide and, in particular, to small and open economies such as ours. They are, therefore, a good starting point for a more detailed analysis of macroeconomic movements and prospects for the period ahead. Rising uncertainty late last and early this year was triggered by weaker global growth prospects, continued slide in global prices of primary commodities and the start of normalisation of the Fed's monetary policy. In response, leading central banks have taken fresh measures and announced more monetary accommodation than previously expected. In March, the ECB adopted a set of measures to ease its monetary policy further. The Fed, on the other hand, announced a slower dynamics of policy rate hikes, somewhat appeasing financial and commodity markets. Further, China's monetary policy measures mitigated the risk of a sudden slowdown in Chinese, and consequently, in global growth.

Chart 3 **Revisions of real GDP growth forecasts for 2016 and 2017 by the IMF**
(in %)



Source: IMF WEO Update (January 2016) and IMF WEO (April 2016).

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

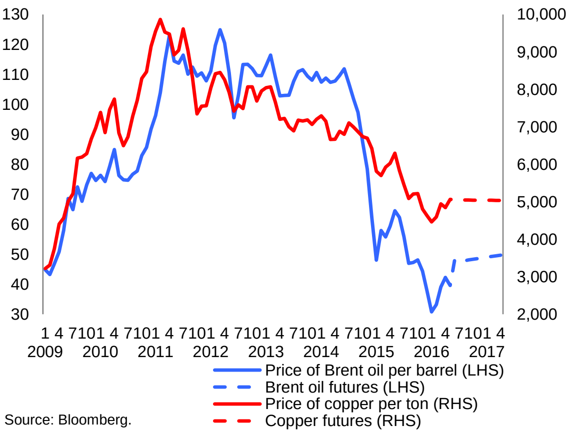


Sources: Eurostat, Markit Group and Banca d'Italia.

* Eurostat preliminary estimate.

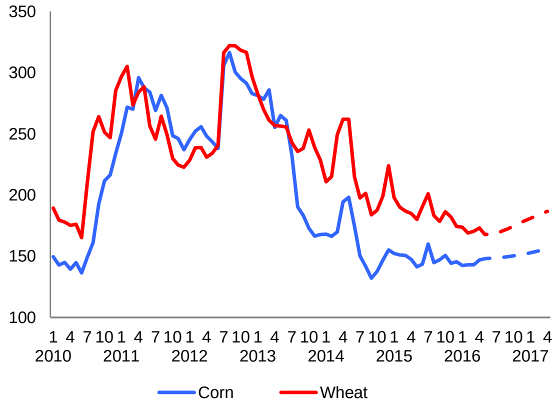
Diminished concerns over sudden slowdown of global growth and expectations of lower oil supply gave impulse to the recovery of global prices of oil and other primary commodities. Though global oil prices increased from USD 26 per barrel in January to the present level of USD 48 per barrel, they are still roughly 60% lower than in June 2014. Global prices of other primary commodities increased as well, most notably prices of metal and agricultural commodities. Substantial volatility in these markets is expected in the period ahead.

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)



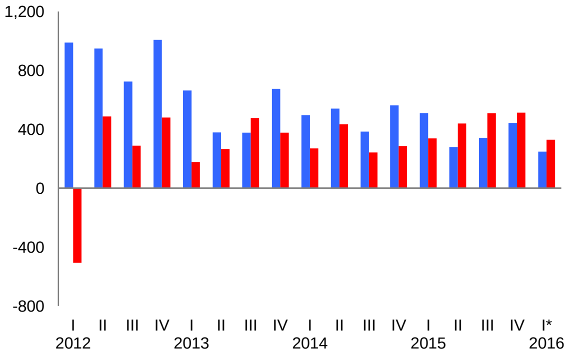
Source: CBOT - Chicago Board of Trade.

Depreciation pressures on the dinar have been present since late last year, when uncertainty in the international financial market increased. Relatively high demand for foreign exchange in the domestic market was caused by seasonally higher payments for energy imports, but also by servicing of foreign liabilities. On the other hand, a much improved export performance and FDI inflow helped moderate pressures on the dinar. We expect these pressures to be further alleviated by current developments in the international financial market that also reflected on Serbia's risk premium, which, measured by the Emerging Markets Bond Index, fell by 64 basis points to 267 basis points over the past three months.

Stability in the foreign exchange market is also sustained by the continued narrowing of external and internal imbalances. Foreign trade imbalances narrowed further this year, mostly on account of investment in tradable sectors, lower global oil prices and recovery in external demand. As exports of goods and services grew at a much faster pace, the first-quarter current account deficit was more than halved relative to the same period a year earlier. Fiscal prospects improved further in early 2016 as well, guided mainly by higher VAT and excise revenue. The consolidated budget deficit was RSD 16 bln in the first quarter, or almost a quarter less than in the same period a year earlier.

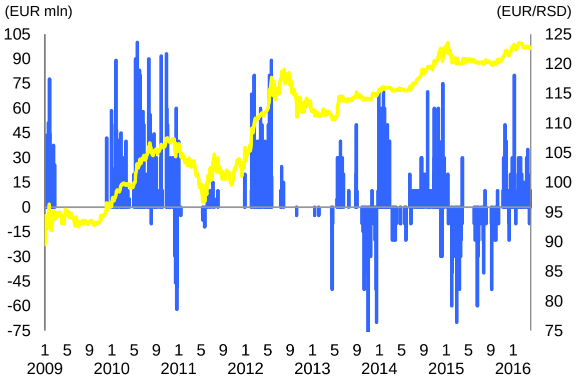
According to Moody's, which raised Serbia's credit rating outlook in March, further narrowing of these imbalances could support a credit rating upgrade in the period ahead. Coupled with continued structural reforms and acceleration of the EU accession process, this should make Serbia more attractive for foreign investment. As before, the National Bank of Serbia will keep a close eye on developments in the foreign exchange market and intervene without bias in either direction – buying and selling foreign exchange – in order to ease excessive short-term oscillations of the exchange rate. In addition, the expected further narrowing of the current account deficit in 2016, which will be more than covered by FDI, ought to contribute to greater stability of the foreign exchange market.

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



Sources: SORS and NBS.
* Preliminary data.

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



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

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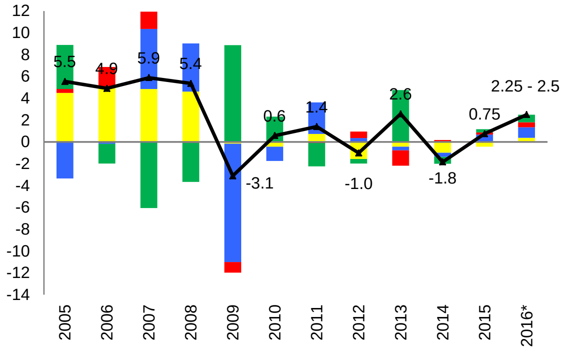
In addition to a strong reduction of the fiscal and current account deficits, the start of the year has also been marked by accelerated exports and economic activity. This was due to euro area recovery and favourable terms of trade, but also to high investment in tradable sectors. Quarter-on-quarter, our GDP gained 1.7% in seasonally-adjusted terms, while according to the preliminary estimate of the Serbian Statistical Office, year-on-year GDP growth was 3.5%. Production and exports increased further in more than three-quarters of the manufacturing branches. Together with continued growth in construction, this has contributed most to the acceleration of GDP growth.

As actual developments have been more favourable than our expectations stated in the February projection, we have revised our GDP growth projection for 2016 from 1.8% three months ago to 2.3–2.5%. We expect that growth will be led by investment, thanks to continued implementation of infrastructure projects, improved investment environment, lower operating expenses on account of interest rates on loans and lower energy prices, as well as by exports. The contribution of net exports is expected to be positive, instead of neutral as was projected in February. This is without doubt shown by foreign trade developments which are more favourable than expected – real export growth accelerated to 13.0% year-on-year in the first quarter, while imports slowed to 4.0%. This can be attributed to past FDI, which involved a large number of smaller projects in various manufacturing branches which are now recording growth in both production and exports.

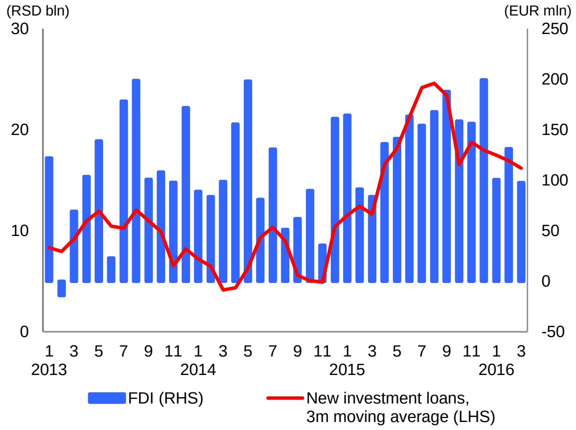
Chart 9 **Contributions to y-o-y GDP growth**
(in pp)



Sources: SORS and NBS calculation.

* NBS estimate.

Chart 10 **New investment loans and FDI**



Sources: NBS.

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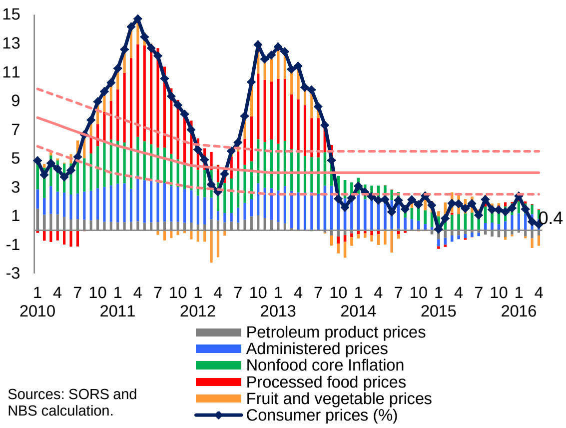
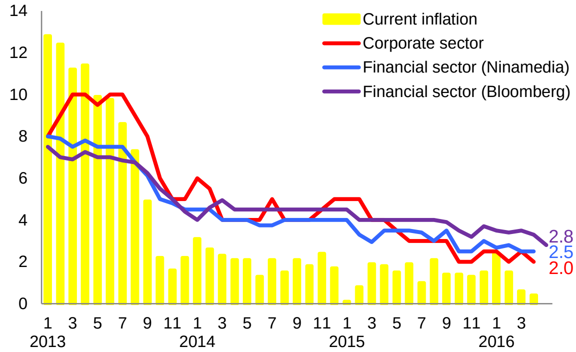
Inflationary pressures remained low under the impact of the majority of domestic factors, relatively low global prices of primary commodities and generally low inflation abroad. Consistent with expectations stated in the February *Report*, year-on-year inflation continued to run below the lower bound of the target tolerance band. Though rising to 2.4% in January, mostly on account of the low prior-year base, inflation decreased from February onwards to 0.4% in April. According to our estimate, this will be its lowest level this year.

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



Sources: SORS and NBS calculation.

Chart 12 **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.

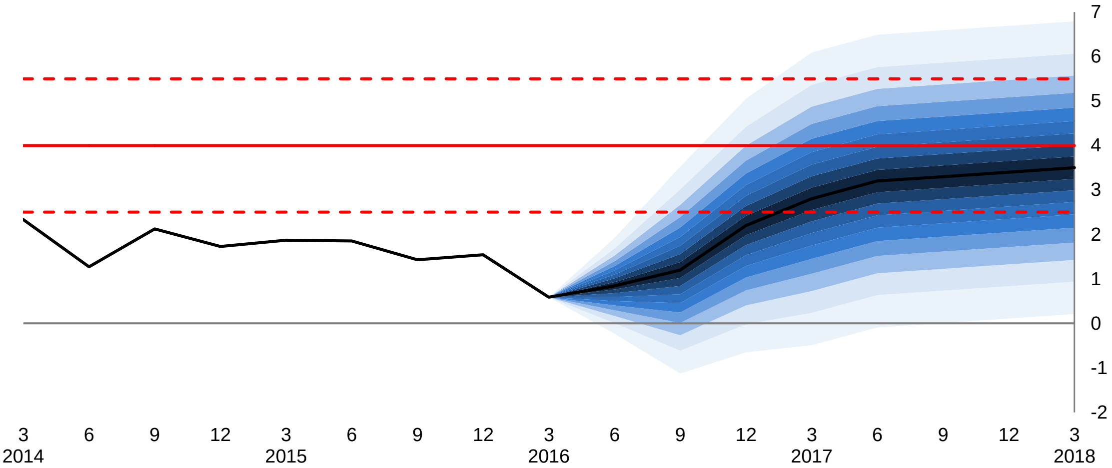
Inflation’s movement below the lower bound of the target band was led primarily by low global prices of oil and primary agricultural commodities, as indicated by falling prices of petroleum products over the past year and stagnating prices of industrial-food products. In addition, year-on-year inflation was dragged down early in the year by fruit and vegetable prices. Furthermore, disinflationary pressures in that period were generated by euro area inflation and aggregate demand, as reflected in the relatively low core inflation (1.7% y-o-y).

Short- and medium-term inflation expectations of market participants headed further down, mostly owing to low inflation for almost three years. One-year ahead expectations of the financial sector are between 2.5% and 2.8%, while corporates expect somewhat lower inflation (of 2.0%). Though inflation expectations of households are as a rule somewhat higher, they stabilised at 5.0% from October last year and are running within the target tolerance band.

Under our central projection, year-on-year inflation will start rising in May. It will make its way back within the target band early next year, and stabilise thereafter at slightly over 3.0%.

Such inflation path will reflect the low base effect from prices of petroleum products and fruit and vegetables, the expected further recovery of international primary commodity prices, the strengthening of aggregate demand in Serbia, as well as a gradual rise in inflation abroad. The risks to the projected inflation path are symmetric and associated primarily with future movements in global primary commodity prices and developments in the international financial market. To a certain degree, they also relate to the outcome of this year's agricultural season and administered price growth at home.

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



Source: NBS.

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The projection assumes an active monetary policy which seeks to keep inflation within the target tolerance band in the medium run. After cutting the key policy rate to 4.25% in February, we have kept it on hold in the months that followed. The decision to keep the rate unchanged was mostly due to developments in the international environment and the expected effects of past monetary easing.

Further monetary easing will depend on the assessment of the intensity of inflationary pressures, conditioned primarily by developments in the international financial and commodity markets. Monetary policy decisions will continue to be guided by efforts to keep inflation low and stable, while maintaining financial stability and supporting faster-paced economic activity.

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