NATIONAL BANK OF SERBIA

Speech at the presentation of the Inflation Report – May 2017

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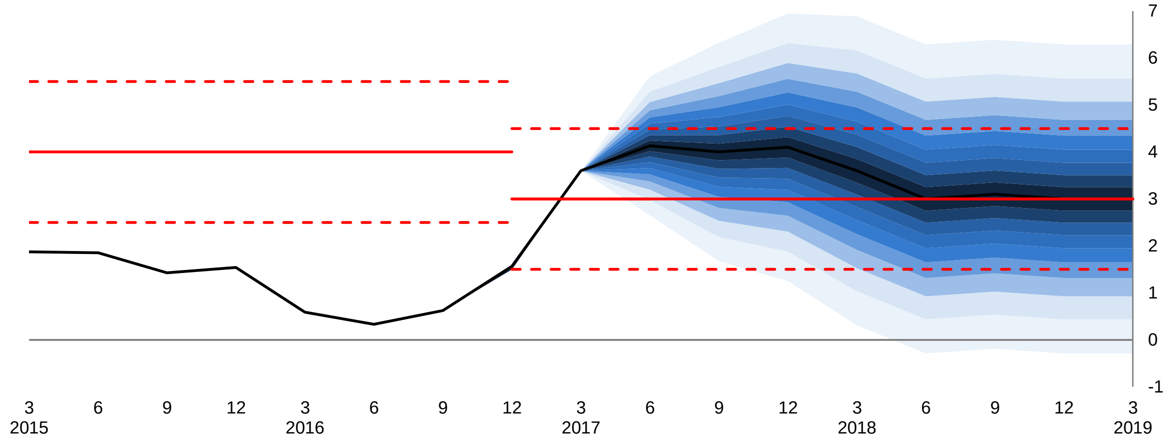
Ladies and gentlemen, esteemed members of the press, fellow economists,

Welcome to the presentation of the May *Inflation Report.* As usual, we will present key information from the *Report*, most notably information about current economic trends, new macroeconomic projections and monetary policy decisions.

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

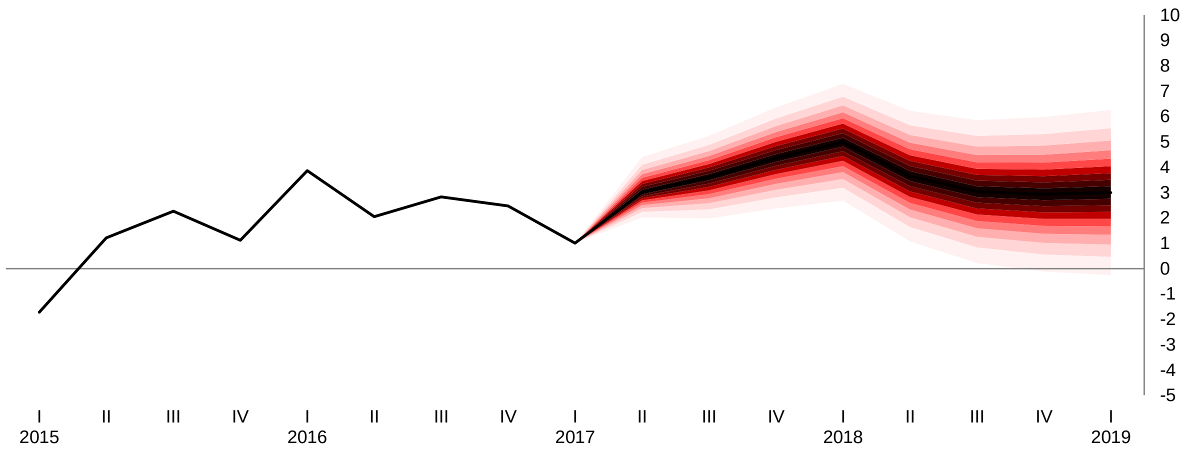


Source: NBS.

Consistent with our expectations, inflation has been moving within the target tolerance band of 3±1.5% since early 2017. As in other countries and in line with our expectations, inflation movements in this period were determined by the impact of primary commodity prices, while fruit and vegetable prices recorded an unexpectedly robust rise. Thus, the impact of the recovery of global oil prices on inflation growth was consistent with earlier projections and expectations. On the other hand, a stronger than expected impact came from the rise in prices of fruit, vegetables and solid fuels, which was higher than usual for the season due to cold weather in January and February. Given that these are one-off price hikes, our inflation projection was adjusted for this year only and is somewhat higher than the February projection, but remains almost unchanged for the next year. We expect inflation to move within the target tolerance band until the end of the projection horizon, i.e. in the upper half of the corridor this year, and around the 3% target thereafter. That inflation movements in early 2017 are mainly due to one-off factors is signalled by low and relatively stable core inflation, which hovers at around 2% year-on-year.

Cold weather early in the year also reflected on economic and foreign trade activity. However, as over 80% of manufacturing, which is mainly export-oriented, continued to provide a positive impulse to growth, whereas exports increased considerably in March and the global growth outlook was improved –

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



Source: NBS.

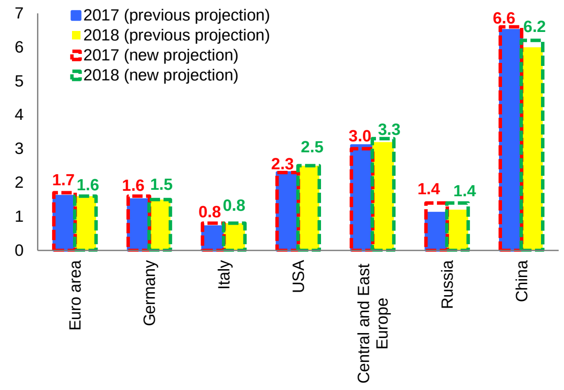
we did not change our projection of GDP growth and the balance of payments current account. As in February, we expect economic growth to accelerate to around 3% this year and around 3.5% next year. Positive tendencies are expected to continue in foreign trade as well. The current account deficit is anticipated at around 4% of GDP this year and will be fully covered by foreign direct investment.

Furthermore, owing to the results of fiscal consolidation, the three-year objectives for the fiscal deficit and the public debt to GDP ratio were achieved in 2016 – one year ahead of schedule. Positive trends continued into the first quarter of 2017, with a consolidated budget surplus of RSD 11.8 bln (1.2% of GDP) and a reduction in public debt of EUR 274 mln.

* * *

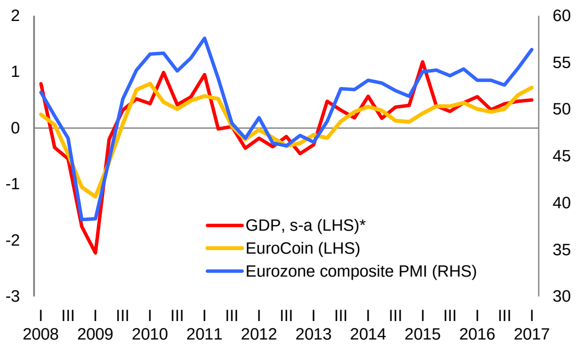
The international environment was marked with positive macroeconomic developments and prospects for somewhat faster global economic growth. In the euro area, our most important foreign trade partner, the economic growth projection was revised upwards. Economic growth is expected to be dispersed by sector and country. Faster growth in the euro area should also positively affect the countries in the region, which are also our important foreign trade partners, and thus Serbia's economic growth as well.

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



Sources: IMF WEO Update (January 2017) and IMF WEO (April 2017).

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

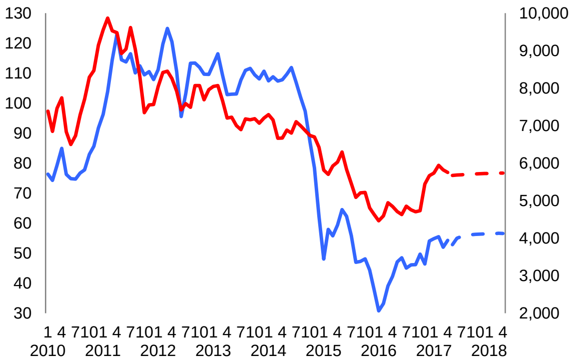


Sources: Eurostat, Markit Group and Banca d'Italia.

* Eurostat preliminary estimate.

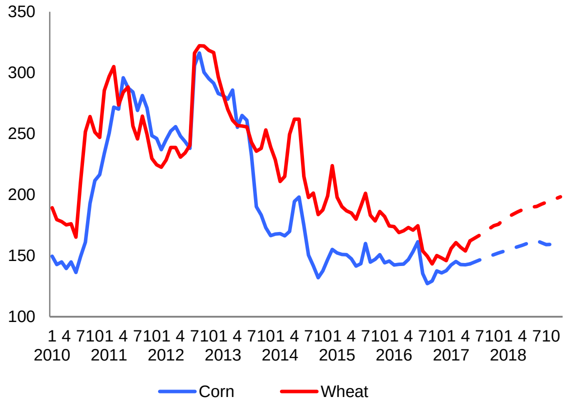
After hitting their lowest in January 2016, global oil prices rallied in the second half of the year. Since early 2017, they have moved between USD 48 and USD 56 per barrel. Based on the latest available futures, oil prices will stand at around USD 50 per barrel this and the next year. This is close to their current level and lower than we assumed in the February projection. In addition to oil, prices of other primary commodities increased as well, notably of base metals and primary agricultural commodities. Due to adverse weather conditions which affected the production of main agricultural crops, world food prices increased early this year as well, but entered a decline in March as the conditions improved. An exception are world meat prices, particularly in the European Union.

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)

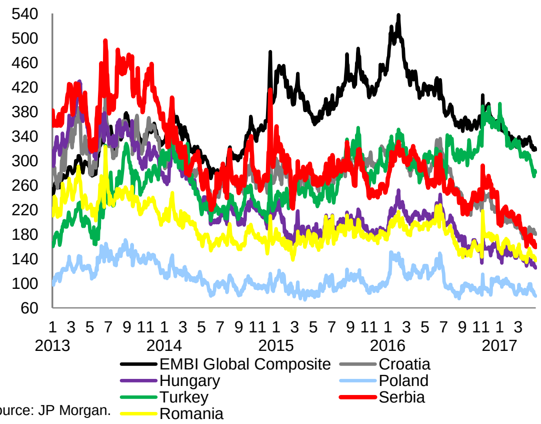


Source: CBOT - Chicago Board of Trade.

The rising prices of oil and other primary commodities in the global market were the key drivers of global inflation growth since early 2017. Euro area inflation came close to the target, supported by rising prices of energy and food. However, still relatively low demand in the majority of countries, including the euro area and the countries of our region, hinders a more substantial rise in prices, as confirmed by core inflation trending below the multiannual average. That is why the central banks of these countries still pursue accommodative monetary policies. On the other hand, following December, the Fed raised its fed funds rate in March again. The pace of rate hikes in the coming period, in combination with future moves of the European Central Bank, will largely determine movements in the international financial market.

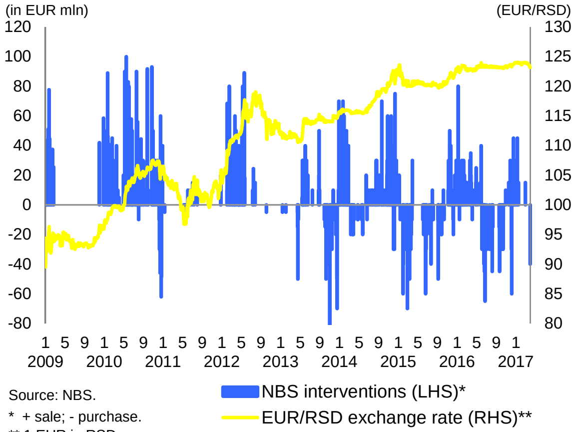
As the majority of countries in the region, Serbia adapted pretty well to the Fed's rate hikes so far. This is also indicated by the country risk premium, which fell by 91 bp from early 2017 to its ten-year low of 158 bp in mid-May. In addition to global factors and higher yields on benchmark US treasures, the fall in Serbia's risk premium was also aided by improved macroeconomic fundamentals, as confirmed by the Moody's upgrade of Serbia's credit rating in March.

Chart 7 **Risk premium indicator – EMBI by country**
(daily, in basis points)



Source: JP Morgan.

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

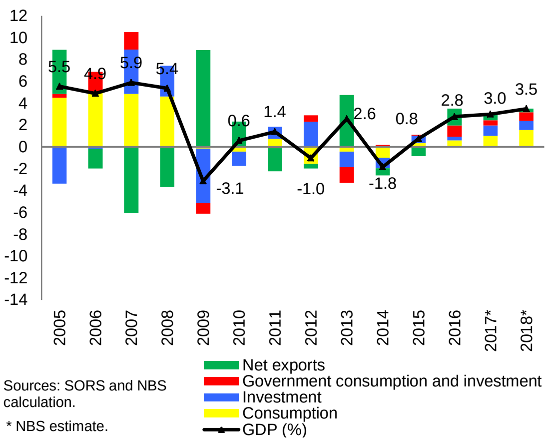


Source: NBS.
* + sale; - purchase.
** 1 EUR in RSD.

Depreciation pressures from the start of this year waned in time. In April, the dinar strengthened against the euro. Movements in the FX market early in the year were largely influenced by further normalisation of Fed's monetary policy, which affected the behaviour of foreign investors in the domestic market and the seasonally higher FX demand of domestic energy importers. Working in the opposite direction were inflows from exports, foreign direct investment and exchange transactions, as well as a rise in FX-indexed bank assets. Relative stability of the exchange rate was also supported by the National Bank of Serbia's interventions aimed at easing excessive short-term volatility. In the first quarter, the National Bank intervened on the sale side. Since April, it has been intervening on the purchase side.

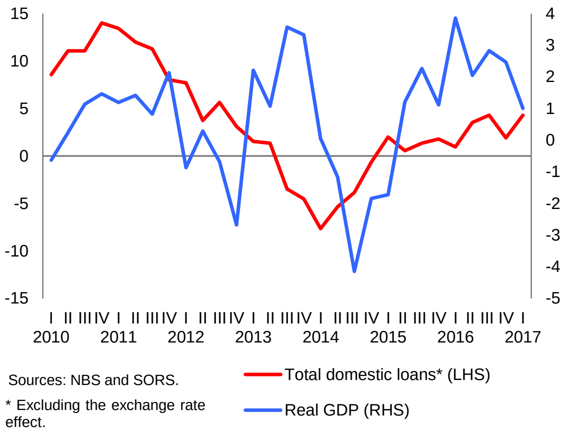
Past monetary policy easing by the National Bank of Serbia, low interest rates in the euro area, narrowing in internal and external imbalances, increased interbank competition, as well as acceleration of economic activity, all contributed to growth in lending, which sped up to 4.3% year-on-year in March. In addition, as banks intensified their efforts to resolve the issue of non-performing loans as of the beginning of 2016, the share of non-performing loans in total loans dropped to its lowest level in seven years (16.8% in March). Compared to August 2015, when the NPL Resolution Strategy was adopted, the NPL share fell by 5.4 percentage points.

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



Sources: SORS and NBS calculation.
* NBS estimate.

Chart 10 **Lending activity and GDP**
(y-o-y rates, in %)



Sources: NBS and SORS.
* Excluding the exchange rate effect.

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According to the preliminary estimate of the Serbian Statistical Office, GDP increased by 1.0% year-on-year in Q1, and we estimate that it rose by 0.2% from the previous quarter. Manufacturing continued to provide a positive contribution, recording growth in over 80% of primarily export-oriented areas, owing to investment in the past period and the recovery of external and domestic demand. Domestic demand also had a positive impact on growth in the majority of service sectors. On the other hand, construction, agriculture and energy contributed negatively, mostly due to negative effects of cold weather early in the year. On the expenditure side, a positive contribution to quarterly GDP growth came from household consumption and inventories, while net exports were a negative contributor because imports, primarily those of energy, grew faster than exports aggravated by cold weather.

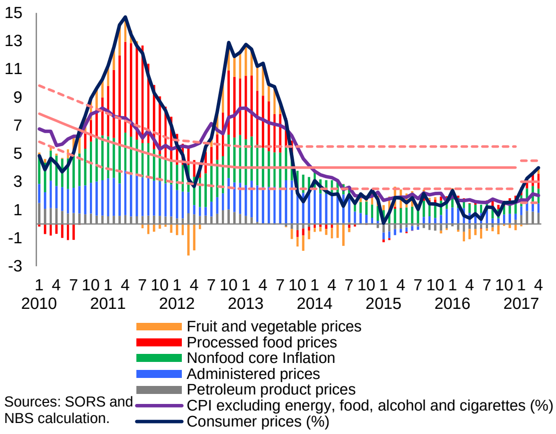
Given that the negative effect of cold weather was temporary, that manufacturing continued to record high growth rates and that growth prospects in the euro area improved, we kept our projection of economic growth unchanged. We expect that GDP growth will accelerate to around 3% in 2017, and around 3.5% in 2018. This year, growth should be investment- and export-driven, with an increasing contribution of household consumption, while the next year domestic demand is expected to have the leading role.

Investment and further improvement of the business ambience, coupled with faster recovery of external demand, should support further growth of industry and construction, while the continued recovery of final consumption should contribute to growth in service sectors. On the other hand, we expect, as we did in February, that this year's agricultural output will reach a ten-year's average. This implies its negative contribution to GDP growth because of the above-average agricultural output last year.

* * *

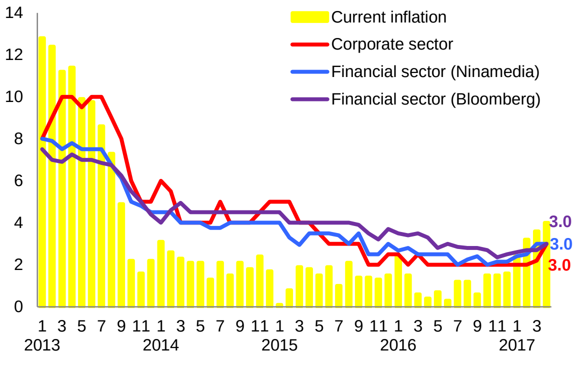
Since the start of the year, inflation has moved within the target tolerance band, equalling 4.0 % year-on-year in April. As expected, inflation movements early in the year were determined by the recovery of global oil prices which began in the second half of 2016. Expectedly, due to the low base from the last year, this price was one of the generators of inflation movements globally. On the other hand, the increase in fruit, vegetable and firewood prices caused by adverse weather conditions early this year and the rise in fresh meat prices in April were higher than seasonally expected. These effects are estimated to be one-off in nature. That this is the case, i.e. that inflation movements since the start of the year were largely determined by one-off factors, is also suggested by stable movement of core inflation at around 2.0% year-on-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 %)



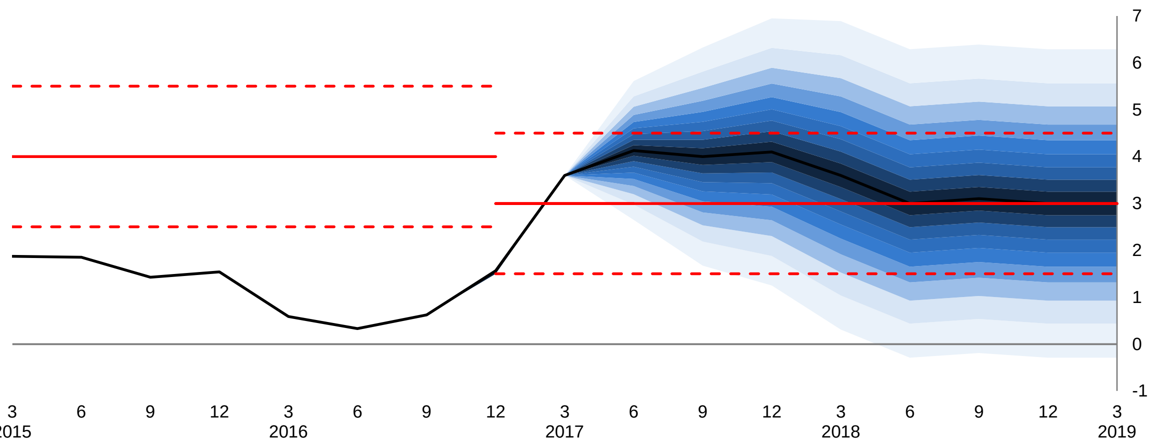
Sources: Gallup, Ipsos/Ninamedia, Bloomberg and NBS.

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

According to our central projection, year-on-year inflation will continue to move within the target tolerance band of 3.0%±1.5 percentage points in the next two years, i.e. by the end of the projection horizon.

We expect that inflation movements in the coming period will be determined by several key factors. A more inflationary impact should originate from the recovery of inflation in the international environment and an increase in aggregate demand, which has been supported by our monetary policy for quite a while now. On the other hand, the high base in prices of petroleum products and fruits and vegetables is likely to slow down inflation until the first quarter of the next year.

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



Source: NBS.

Our latest inflation projection for 2017 is somewhat higher than in February, while the projection for 2018 is almost unchanged. Compared to February, we assumed a higher increase in prices of agricultural commodities in the global and domestic markets and slightly higher euro area inflation. However, the deviation from the initial inflation projection for this year is mainly the result of the growth in prices of fruit, vegetables and solid fuels early this year, which turned out faster than seasonally expected. As these one-off price increases will be dropping out from the annual comparison in the beginning of 2018, we expect inflation to decrease and to continue to move around the 3% target until the end of the projection horizon.

The risks to the projected inflation path are symmetric and are mainly associated with movements in world commodity and financial markets and to some extent also to the rise in administered prices and the performance of the agricultural season.

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Taking into account the projected inflation movements, the new inflation target and the expected effects of the monetary policy easing implemented thus far, the Executive Board kept the key policy rate unchanged from 4.0% set in July.

Factors that mandated caution in the conduct of monetary policy were uncertainties in the international financial and commodity markets, primarily with regard to the pace of normalisation of the Fed's monetary policy and movements in primary commodity prices. Risks from the international environment were mitigated by better macroeconomic prospects at home, supported by the implementation of fiscal consolidation and structural reforms, full coordination of monetary and fiscal policies, the narrowing in external imbalances and, to a degree, the European Central Bank's monetary accommodation. In the coming period the NBS will continue to carefully monitor and assess movements in the domestic and international markets and use all available instruments to make sure inflation remains low and stable over the medium term.

Esteemed media representatives, dear colleagues,

The May *Inflation Report* contains three text boxes covering topical issues. The first text box provides a detailed analysis of the impact of extremely cold weather early this year on inflation, and the second examines its impact on economic and foreign trade activity. The third text box elaborates on the importance of the international environment for economic growth in Serbia and other emerging economies.

Thank you for your attention. We are here for your questions.