NATIONAL BANK OF SERBIA

Speech at the presentation of the Inflation Report – May 2018

Dr Jorgovanka Tabaković, Governor

Belgrade, 17 May 2018

Ladies and gentlemen, representatives of the press, dear colleagues,

Welcome to the presentation of the May *Inflation Report.* We will give you an overview of the current macroeconomic developments, our new projections and monetary policy decisions.

Low inflationary pressures, with anchored inflation expectations, a sustained fiscal surplus in conditions of high growth of domestic GDP, and credit growth, with an extended fall in the share of non-performing loans

To begin with, I would like to share with you our overall assessment that economic developments in the past months of 2018 have been favourable and that the positive trends are expected to continue for the remainder of the year. **GDP growth** particularly stands out given that, according to the preliminary estimate of the Serbian Statistical Office, it accelerated considerably in the first quarter of 2018, to 4.5% year-on-year. The favourable structure of its sources is indicated by stepped-up growth in investment and activity in production sectors, primarily construction and manufacturing.

In accordance with our expectations, during the first four months of this year, year-on-year inflation decelerated significantly, largely due to the base effect, that is, the drop-out of early-2017 one-off price hikes of certain products and services from the calculation. Consumer prices rose 1.1% year-on-year in April, with core inflation of 0.8% year-on-year, which is below our expectations stated in the February *Inflation Report*. The reasons for this are primarily lower-than-expected import prices and low costs in food production. Coupled with lower inflation expectations, this confirms that inflationary pressures have additionally abated since the beginning of the year.

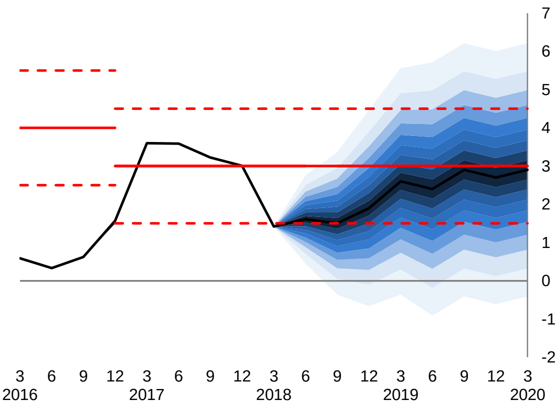
Positive fiscal movements continued in the first quarter, with a **fiscal surplus** of 0.4% of GDP recorded in conditions of accelerated growth, higher corporate profitability, positive tendencies in the labour market and more efficient tax collection. By structure, revenues increased mostly on account of excise taxes, allocated social insurance contributions and profit tax, while on the expenditure side, the rise in capital expenditures is assessed as highly positive. Also conducive to the favourable fiscal result was the reduction in interest expenses in conditions of the government's subdued need for borrowing, monetary policy easing by the National Bank of Serbia and a low country risk premium.

As regards external economic relations, the **current account deficit** has been lowered by 6.3% year-on-year, amid two-digit growth of goods and services exports, as well as two-digit imports growth due to the economy's increased need for equipment and intermediate goods. In terms of structure, the financial account still recorded a high net inflow of foreign direct investment, which was higher by around 2% year-on-year and boosted by the net inflow of portfolio investment. We estimate that the net inflow of foreign direct investment for the entire year will be around EUR 2.6 billion.

Since the start of the year, **lending** also posted **accelerated growth** – to 7.5% year-on-year in March, sustained by the effects of past monetary policy easing, growing economic activity and labour market recovery. Coupled with the activities on the resolution of non-performing loans, this was conducive to the continued reduction in the share of non-performing loans in total loans to 9.2% in March.

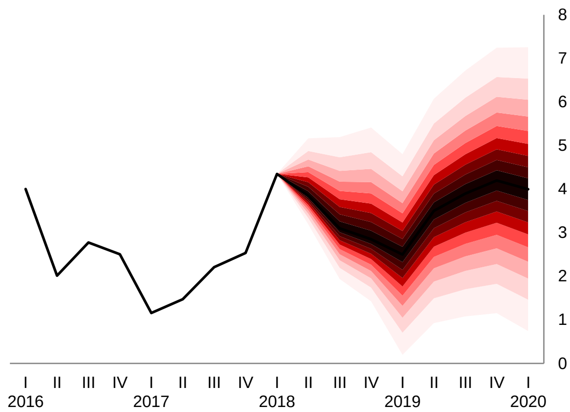
This is a brief overview of developments in the first quarter. In the remainder of the year, we expect positive trends to continue. This is also indicated by our latest projections, according to which we will maintain low inflation in the next two years as well, under current assumptions. As for the economic growth forecast, we believe that economic policy measures are well-calibrated and that they have created the basis for sustainable acceleration of GDP growth of around 3.5% in 2018 and in 2019. We also believe that there are grounds for growth to be even faster this year.

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



Source: NBS.

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

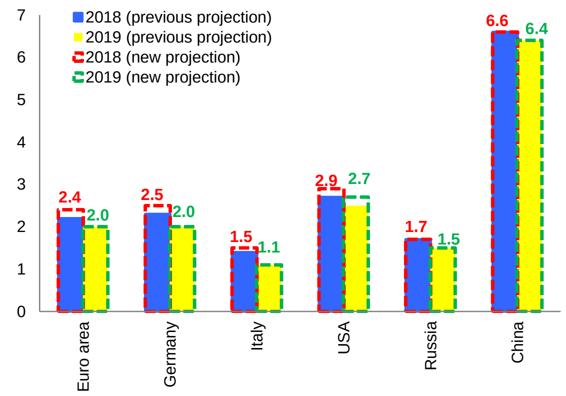


Source: NBS.

Uncertainty in the international environment emanates primarily from the commodity and financial markets

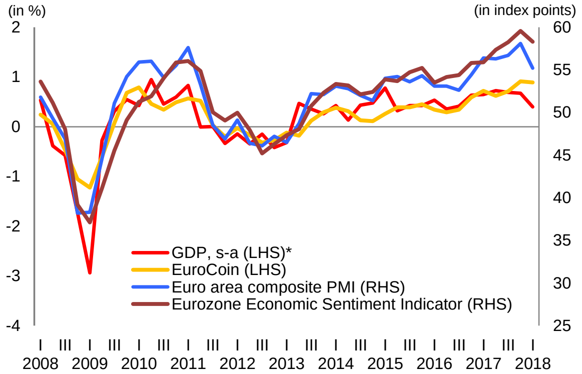
In the period since the previous *Report,* developments in the **international environment** were marked by additionally improved prospects of global economic upturn, maintenance of low inflationary pressures despite the hike in the prices of primary commodities, notably oil, as well as increasingly diverging monetary policies of leading central banks. Although the recently published data indicate that growth in the euro area slowed down in the first quarter, dominant estimates suggest that the deceleration is temporary and that growth will resume this year at a similar pace as in 2017. In addition to favourable growth prospects of Serbia's other important trade partners, this should contribute to further growth in Serbia's exports.

Chart 3 **Revisions of real GDP growth forecasts for 2018 and 2019 by the IMF**
(in %)



Sources: IMF WEO Update (January 2018) and IMF WEO (April 2018).

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



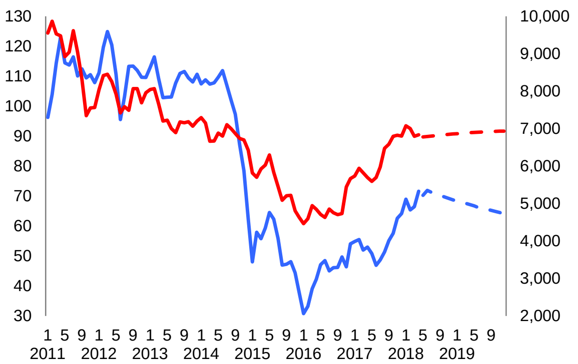
Sources: Eurostat, Markit Group, Banca d'Italia and European Commission.

* Eurostat preliminary estimate for Q1 2018.

While global growth forecasts are looking up, developments in certain markets are still veiled in uncertainty. The global commodity market recorded a continued rise in the prices of primary commodities, notably oil, whose price came at USD 78 per barrel in May, the highest since November 2014. The price of oil rose on the back of a sharp pick-up in demand, triggered by accelerated global growth, as well as supply factors, primarily the leading oil exporters capping the production and geopolitical tension. In addition, since the start of the year, the prices of primary agricultural commodities also increased, though to a lower extent.

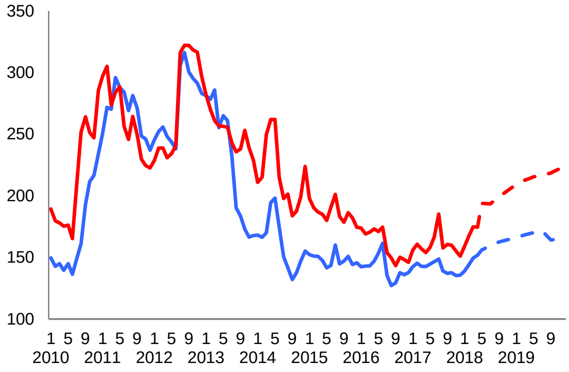
However, the futures and current projections by the relevant institutions indicate that, after this year's growth, we can expect global prices of primary commodities to stabilise and then decline in 2019 and 2020. Using that as a starting point, we do not expect any major inflationary pressures on this account over the medium term. However, bearing in mind the high volatility of oil prices in the prior period, as well as the fact that these prices are currently around 50% higher in year-on-year terms, it is our estimate that their movements require caution in making monetary policy decisions in the coming period as well.

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.

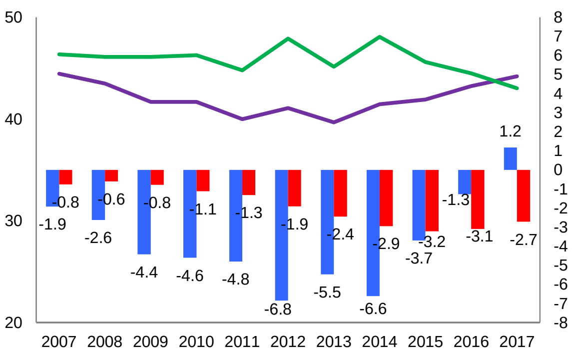
During the first quarter, uncertainty and volatility in the international financial market also increased. The character of monetary policies of leading central banks diverged further amid the still present uncertainty in terms of the pace of their normalisation in the coming period and, in turn, movements in the dollar/euro relationship, as well as capital flows towards emerging economies. Despite this, global financial conditions are still favourable.

Strengthening domestic fundamentals – a response to external challenges

It is a fact that there have been and there still will be external challenges going forward. We cannot impact them, but only mitigate their effects. Therefore structural improvements of our economy and the narrowed internal and external imbalances have been of particular importance as they boosted our resilience to negative effects of global factors.

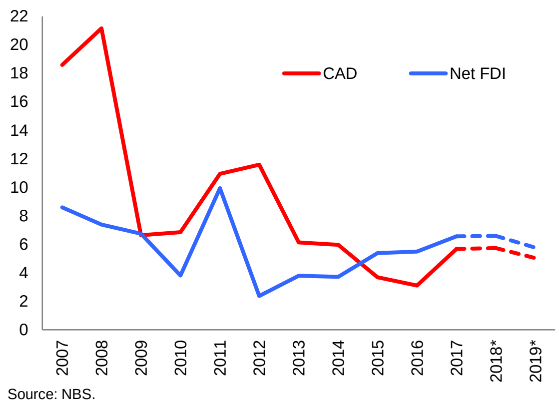
In conditions of rising corporate profitability, positive tendencies in the labour market and higher efficiency of tax collection, favourable fiscal movements continued in 2018 as well, with a surplus of around 0.4% of GDP in the first quarter.

Chart 7. **Fiscal trends**
(in % of GDP)



Source: Ministry of Finance.

Chart 8 **Current account deficit and net FDI inflow**
(in % of GDP)



Source: NBS.

* NBS projection.

The competitiveness of the Serbian economy also increased, reflected in the rise in exports of all areas of manufacturing (12.4% year-on-year), except the food industry, which was adversely affected by the diminished agricultural production in the wake of last year's drought. As many as 14 of the 23 areas of manufacturing recorded a high two-digit growth rate in exports in the first quarter. At the same time, the stepped-up pace of investment growth reflected on the higher imports of equipment and intermediate goods, which played a key role in total imports growth (11.9% year-on-year).

In addition, the net inflow of capital in the first quarter fully covered the current account deficit, contributing to the continuation of appreciation pressures in the foreign exchange market. As for the composition of inflows, foreign direct investment maintained a high inflow, posting growth of around 2% year-on-year and still channelled to export-oriented sectors. The foreign direct investment inflow was additionally boosted by portfolio investment in conditions of non-residents' investment in five- and ten-year dinar government securities.

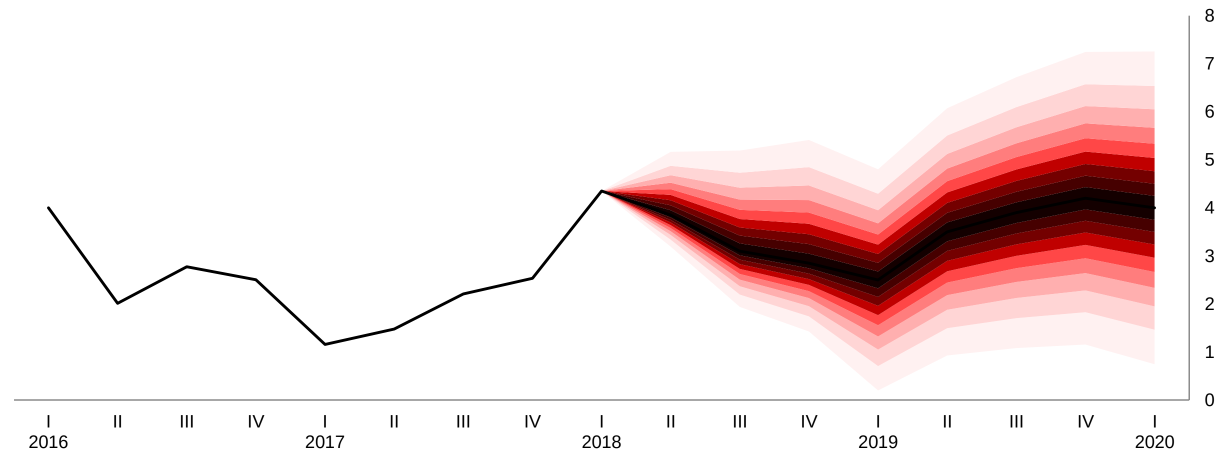
The net inflow of foreign direct investment, which is estimated at around EUR 2.6 billion this year, will ensure the full coverage of the current account deficit for the fourth year straight. In the years ahead, we expect to maintain the full coverage of the current account deficit by long-term external sources of finance, which would support dynamic exports growth in the medium-term. With this in mind, our assessment is that Serbia has remained on the path of lowering external imbalances over the medium run.

Economic activity grew for the tenth consecutive quarter, exceeding our early-year expectations in the first quarter

In such conditions, GDP growth accelerated in the first quarter, even more so than we expected in the February *Inflation Report*. According to our estimate, a key contribution to the pick-up in growth to 4.5% year-on-year in the first quarter came from fixed investment. If the rise in **total fixed investment** continues at a similar pace for the remainder of the year, we estimate its share in GDP to reach around 22%. This is an important assumption for creating a basis for the acceleration of economic growth to around 4% in the medium run.

Taking into account the further improvement in the business environment, favourable monetary conditions, faster implementation of infrastructure projects and positive labour market trends, we estimate that growth will be driven by domestic demand, investment and household consumption. We also expect that exports will retain double-digit growth rates on the back of earlier investment and the rise in external demand. We expect higher investment to also push up imports of equipment and intermediate goods.

Chart 9 **GDP growth projection**
(y-o-y rates, in %)



Source: NBS.

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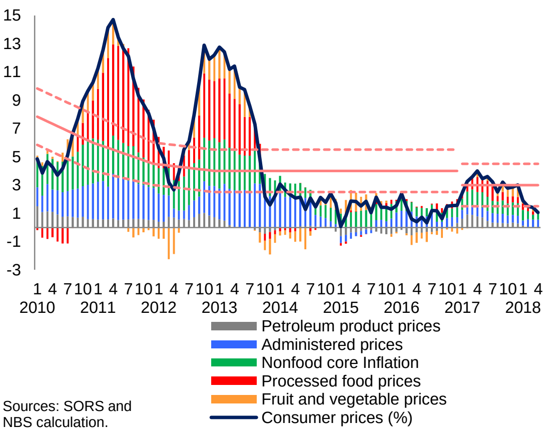
Ladies and gentlemen, dear colleagues,

I would like to conclude the first part of the conference with the actual and expected movement of inflation and the monetary policy measures adopted.

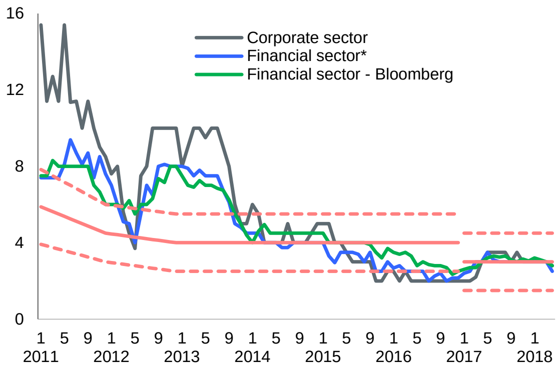
In year-on-year terms, inflation has slowed down since the start of the year. The slowdown was anticipated and stated in the previous issues of the *Report*, though it was stronger than expected. This resulted from lower dinar-denominated import prices due to low inflation in the international environment and the dinar's appreciation in the previous period, and from the still low food production costs. That inflationary pressures are still low is suggested also by core inflation, which declined to 0.8% year-on-year in March and April, its lowest level since changes in consumer prices have been used as a measure of inflation. Compared to the previous *Inflation Report*, short-term inflation expectations fell even more – to 2.5% for the financial and 2.8% for the corporate sector, remaining anchored within the target corridor. These are the main reasons why the new medium-term inflation projection is somewhat lower than the previous one.

Chart 10 **Contribution of CPI components to y-o-y inflation**
(in pp)



Sources: SORS and NBS calculation.

Chart 11 **One-year ahead inflation expectations**
(y-o-y rates, in %)



Source: Gallup, Ipsos/Ninamedia, Bloomberg and NBS.
* Ipsos and Gallup agencies until December 2014, Ninamedia agency since December 2014, and Ipsos agency since January 2018.

After reaching this year's low in April, we expect inflation to gradually approach the target in the coming period, though this year it will remain close to the lower bound of the target tolerance band. We expect inflation to approach the 3.0% midpoint in the second half of 2019, and to remain stable around that level until the end of the projection horizon.

In view of this, we expect inflation to remain low and stable in the coming period as well. In other words, in the medium term, year-on-year inflation will move within the target tolerance band (3.0%±1.5%) until the end of the projection horizon, i.e. in the next two years, also owing to a gradual recovery in domestic demand. Medium-term inflation expectations of the financial and corporate sectors are also anchored at the target midpoint of the National Bank of Serbia.

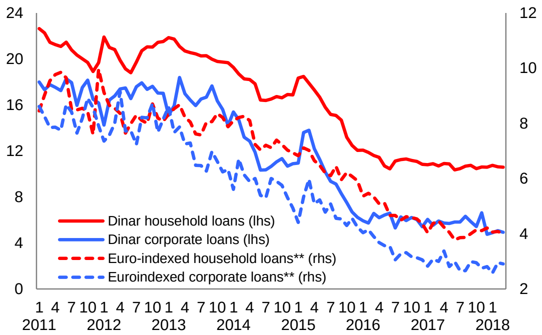
* * *

Monetary policy easing amid low inflationary pressures helps speed up lending and economic activity, which, along with the efforts to resolve non-performing loans, made the share of these loans fall below the pre-crisis level.

By carefully monitoring and analysing the developments in the domestic and international environment, we assessed that the expected movement in inflation and its underlying factors going forward, along with the further strengthening of macroeconomic fundamentals, allow for additional monetary policy easing. Accordingly, we decided to further cut the key policy rate in both March and April by 25 basis points to 3%, its lowest level in the inflation targeting regime. Its sharp drop in the period since the monetary easing cycle began (May 2013) had a strong impact on the rise in disposable income, thus contributing to a faster recovery of domestic demand. We made the decisions on further monetary policy easing taking into consideration not only that the February medium-term inflation projection was lower than the previous one, both for this and next year, but also that inflationary pressures weakened further after the February projection. On the other hand, monetary policy caution was mandated by pronounced uncertainty in the international commodity market, mainly regarding the movements in oil prices. Caution was also required due to diverging monetary policies of the Federal Reserve System and European Central Bank.

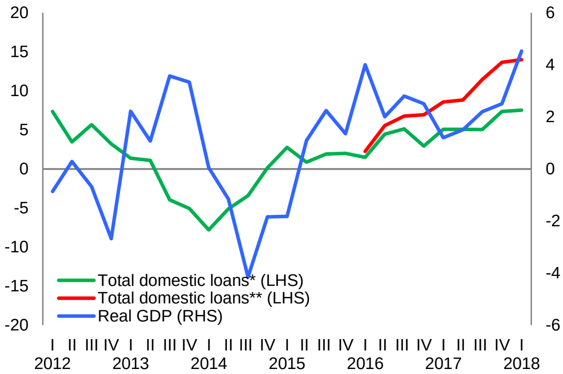
Monetary policy easing in the previous period significantly drove down interest rates on dinar loans in the past several years, and created more favourable financing conditions. This and the effects of economic growth, positive labour market trends, increased interbank competition, a decline in the country risk premium, and low interest rates in the euro area – contributed to further growth in lending activity, which, excluding the exchange rate effect, measured 7.5% year-on-year in March. Since the beginning of the year, year-on-year growth in loans to corporates has accelerated further (to 5.1%), while growth in loans to households slowed down slightly (to 10.9%). In the conditions of stepped-up efforts to resolve non-performing loans and the rise in lending activity, the share of non-performing loans in total loans declined considerably since the Strategy was implemented, by 13.2 percentage points to 9.2% in March, below the pre-crisis level. Thus, the stock of these loans has been more than halved since the start of implementation of the Strategy (down by 55%), undeniably pointing to intensified efforts made to resolve this issue.

Chart 12 **Interest rates on new dinar and euro-indexed loans to corporates and households***
(weighted average values, p.a., in %)



Source: NBS.
* Excluding revolving loans, current account overdrafts and credit card debt.

Chart 13 **Lending activity and GDP**
(y-o-y rates, in %)

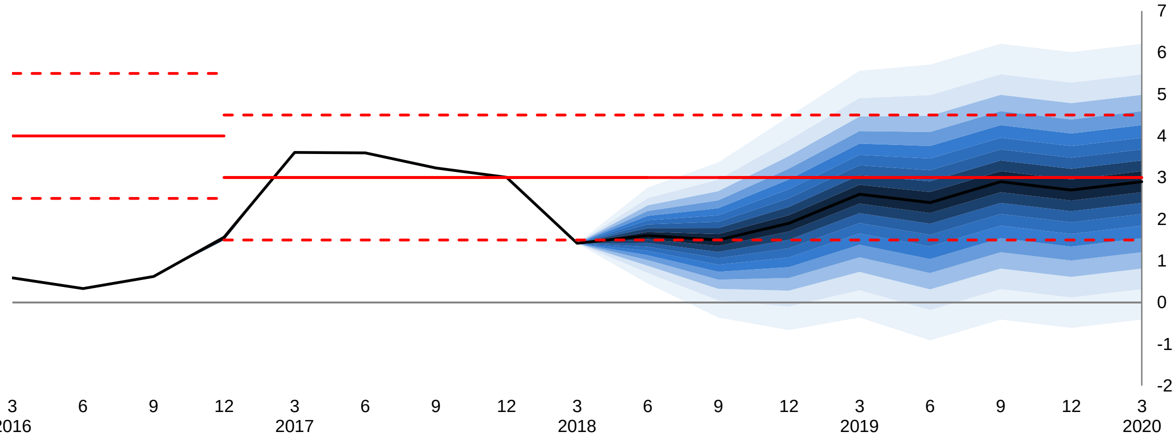


Sources: NBS and SORS.
* Excluding the exchange rate effect.
** Excluding the effect of NPL write-off in the past year.

Looking ahead, in the coming period monetary policy decisions will continue to depend on our assessment of the impact of inflation factors from the domestic and international environment. According to our estimate, key risks emanate from the international environment, which is why we will continue to closely monitor and analyse developments in the international financial market and the market of primary commodities, and to assess their impact on economic developments in Serbia.

As so far, we will use all our instruments to ensure low and stable inflation in the medium term. I believe that this, with the preservation of financial stability, is the best way for the central bank to contribute to sustainable economic growth and stronger resilience to external challenges.

Chart 14 **Inflation projection**
(y-o-y rates, in %)



Source: NBS.

With this, I would like to conclude my introductory address and give the floor to my colleagues from the Directorate for Economic Research and Statistics, who will briefly present the latest inflation and GDP growth projections. What you will also hear from them is that, according to the new projections as well, in the coming period we expect to fulfil our primary legal mandate – price stability – by ensuring low inflation within the target tolerance band, against the backdrop of faster GDP growth, which we estimate at around 3.5% in 2018 and 2019, and at around 4% in the medium run.