NATIONAL BANK OF SERBIA

Speech at the presentation of the Inflation Report – August 2015

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

Welcome to the presentation of the August *Inflation Report*, where we will set out our analyses of the current and expected economic developments and explain the decisions the National Bank of Serbia has taken in accordance with these analyses.

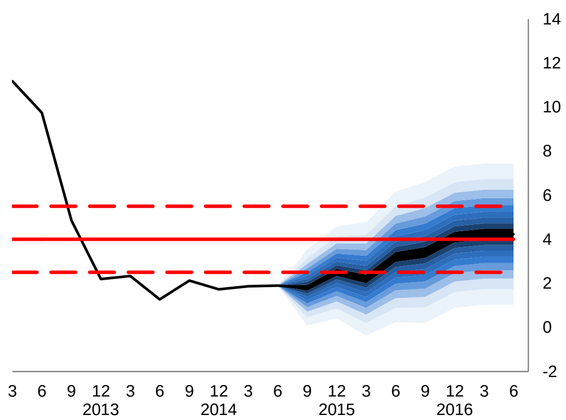
Since we last met in May, year-on-year inflation has continued moving below the lower bound of the target tolerance band, while GDP turned out to be higher in the second quarter than expected earlier. The current inflation projection is lower than the one released in May because primary commodity prices were lower than anticipated before. In accordance with this, inflation is projected to revolve around the lower bound of the target tolerance band until mid-2016, whereafter it will gradually trend closer to the 4.0% target.

The projection of GDP growth in 2015 has been revised up, from 0.0% to 0.5%, as it appears that the decline in domestic consumption will be smaller than previously expected. Like in May, we expect GDP growth to amount to 1.5% in 2016, led by investment and net exports and to a lesser degree by household consumption.

As favourable fiscal developments continue, we expect a lower budget deficit this year than initially projected. The reduction in internal imbalances goes in parallel with further narrowing of external imbalances – in the first half of the year the current account deficit contracted by around 30% relative to the same period a year earlier and is expected to amount to slightly over 4% of GDP in the year as a whole.

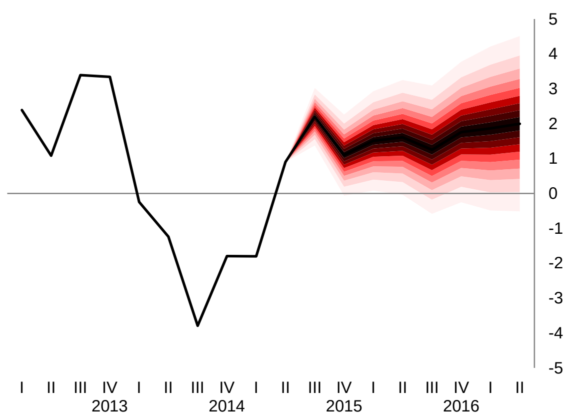
Responding to lower inflationary pressures, the National Bank of Serbia proceeded with monetary policy easing and lowered the key policy rate to 5.5%. We expect the markets will react accordingly, i.e. that we will see a further fall in dinar interest rates in the money and credit markets, which should contribute to the recovery of the domestic economy.

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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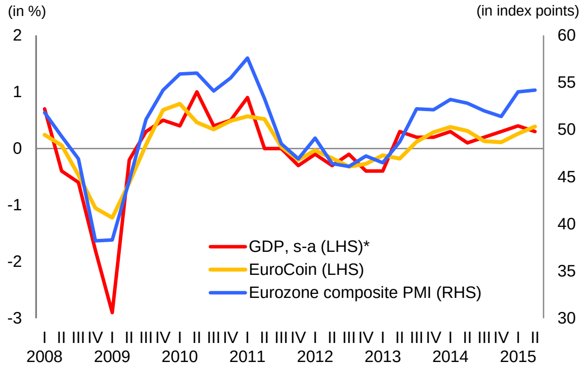
Monetary policies implemented by leading central banks remain accommodative, which together with low international oil prices, creates favourable conditions for global economic recovery. Looking ahead, the European Central Bank will be implementing increasingly accommodative monetary policy, while the Fed is nearing the decision to start raising its policy rate. As it largely determines global liquidity, the future monetary policy stance of the Fed is one of the key factors of uncertainty in the international environment. The markets expect the Fed will start raising its rate before the year ends, but there are some views that the Fed's decision could be postponed after last week's devaluation of the Chinese yuan.

Economic activity of the euro area has been gathering pace steadily since the end of last year, aided by the European Central Bank's monetary policy measures, low oil prices and the weakening of the euro. Positive effects of the euro area growth are spreading to Central and East European countries. High global liquidity remains conducive to capital inflows into these countries, which coupled with low oil prices and low inflation enables their central banks to ease their monetary policies further and thus contribute to economic recovery.

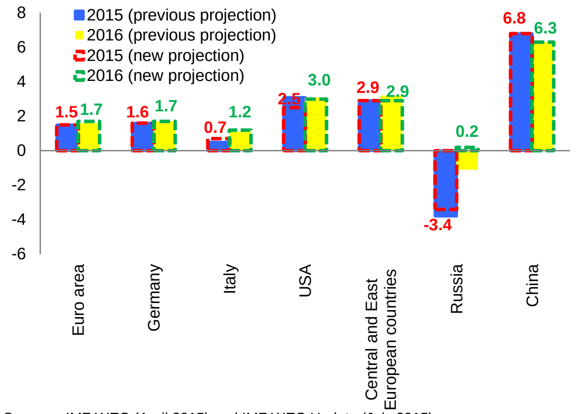
Chart 3 **Movements in GDP and economic activity indicators of the euro area**
(quarterly rates)



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

* Preliminary estimate for Q2 2015.

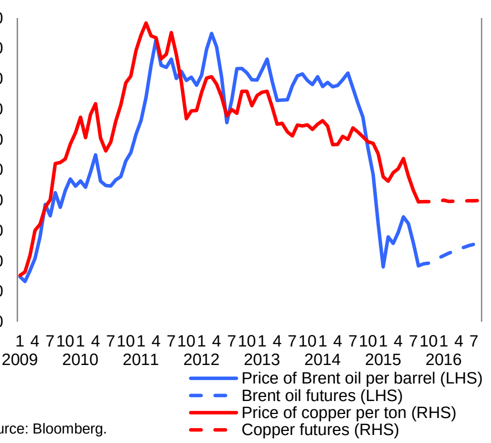
Chart 4 **Revisions of real GDP growth forecasts for 2015 and 2016 by the IMF**



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

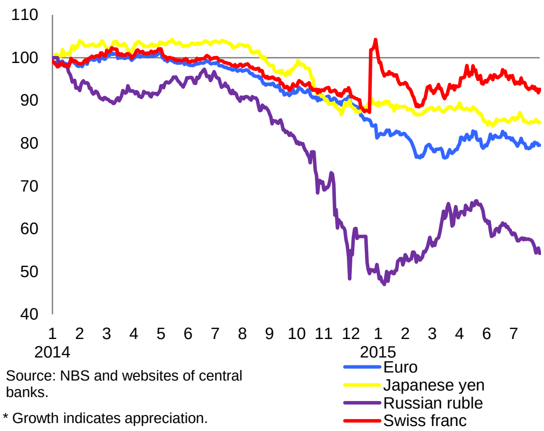
Significant for this region, Serbia included, is the easing of uncertainties over the Greek crisis, not so much because of the direct effects of that crisis, but because of its indirect effects through the impact on the international financial market and the euro area economy. So far, the Greek crisis has not caused any major turmoil in the international financial market or investors' exit from riskier assets. It seems that the more important question is whether the Greek crisis will constrain growth of the euro area economy which absorbs around 45% of our exports. For the time being, the majority of leading institutions and analysts have kept their growth projections for the euro area unchanged.

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)



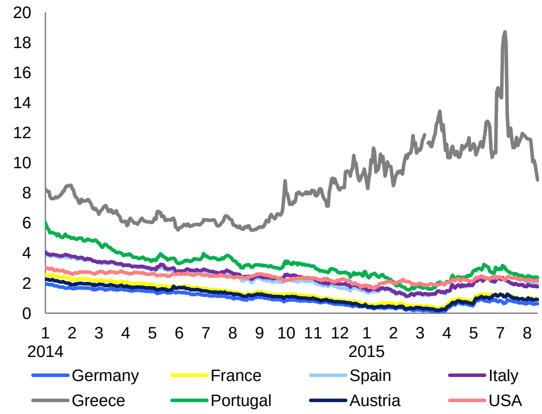
Source: NBS and websites of central banks.

* Growth indicates appreciation.

Oil price movements represent another significant source of uncertainty in the international environment. The expectation that the Fed's rate hike will be delayed led to a temporary weakening of the US dollar, which supported the recovery of oil prices in the second quarter. However, oil prices resumed a decline in

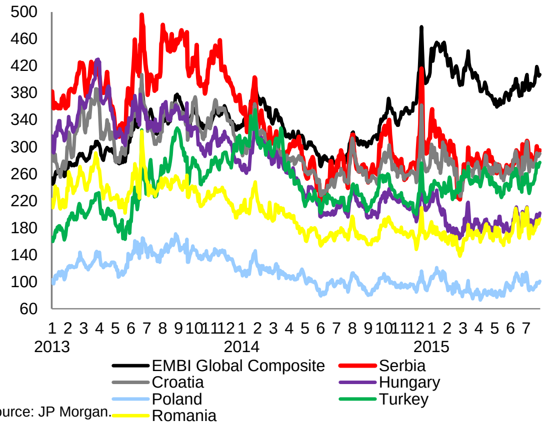
July, falling to below USD 50 per barrel. There should be no major increase in oil prices until the end of the year, given the still high global inventories, Iran's return to the market and an uncertain pace of global recovery.

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



Source: Bloomberg.

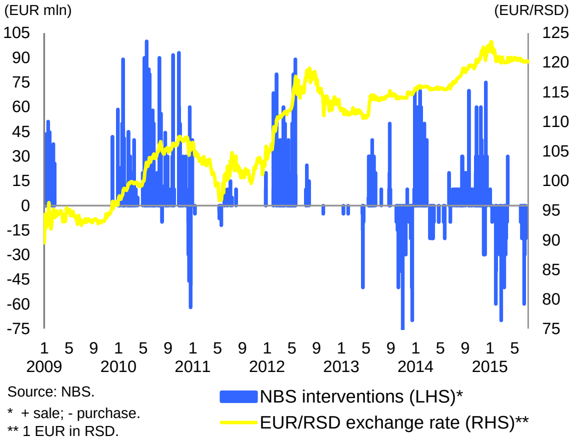
Chart 8 **Risk premium indicator − EMBI by country**
(daily, in basis points)



Source: JP Morgan.

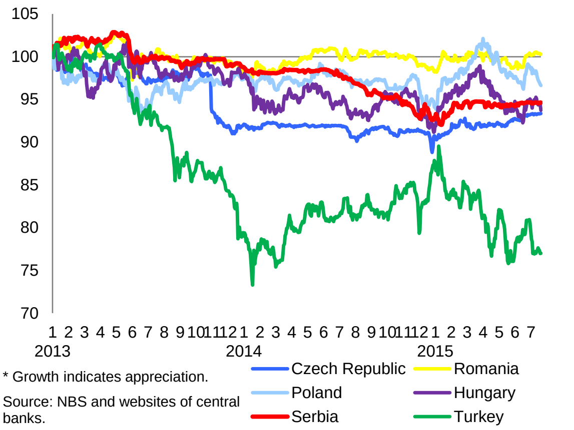
Despite persistent uncertainty in the international environment, Serbia's risk premium, measured by EMBI, was relatively stable at around 290 basis points over the past several months owing to domestic factors, notably improved fiscal and external position of the country and successfully completed first review of the arrangement with the International Monetary Fund. These movements also contributed to stronger appreciation pressures. In order to ease excessive short-term volatility of the exchange rate, but without any intention to influence its trend, the National Bank of Serbia intervened in the interbank foreign exchange market from April to end-July by buying EUR 380 million and selling 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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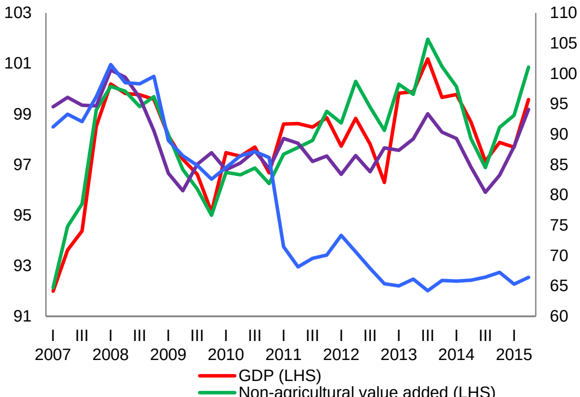
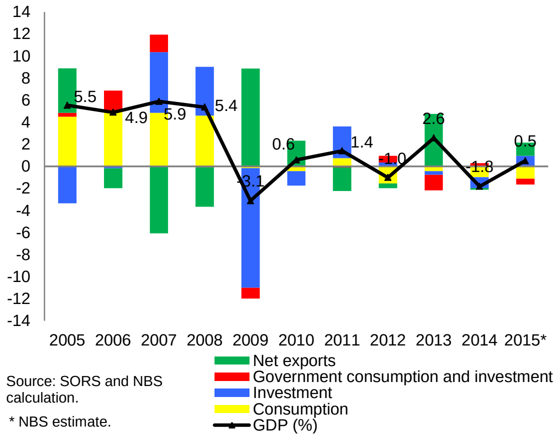
GDP growth exceeded our expectations in the second quarter and amounted to 1.9% seasonally-adjusted, thanks to good results in industry and construction. The upturn in industrial production was supported by low energy prices on the cost side and by the recovery of the euro area on the demand side. The recovery of the construction industry was aided by the stepped up implementation of capital projects and new legal solutions in that area. On the expenditure side, the business environment reforms, along with the improvement in the financial position of enterprises attributable primarily to the fall in oil prices, exerted a positive impact on private investment. The resulting rise in private investment and smaller than expected negative effects of fiscal consolidation on final consumption were the main reason behind the positive contribution of domestic demand to GDP growth in the second quarter.

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.

GDP grew in year-on-year terms as well (0.9%), owing chiefly to the recovery of mining and energy sectors from last year's floods. We expect GDP to grow by 0.5% this year, in contrast to the May projection when we expected stagnation. These expectations are underpinned by better performances of the industry and construction sector, although a drop in agricultural production will be steeper than expected due to the drought. On the expenditure side, consistent fiscal adjustment, followed by the implementation of structural reforms, is likely to result in higher investments and net exports. A negative contribution to GDP this year is expected from final consumption. Still, this contribution will be smaller than earlier expected, which was the main reason for the revision of GDP growth projection for 2015. A smaller drop in consumption is expected owing to several factors: higher disposable income of households owing to a decline in petroleum product prices, rising remittances and an increase in private sector wage bill, but also owing to low inflation. Although the recovery of external demand positively affects our exports, the contribution of net exports will be lower as imports will go up on account of elevated investments and a more moderate decline in consumption.

GDP growth in 2016 should be led by investments and net exports, while a positive contribution is likely also from household consumption. Consistent with further fiscal adjustment, government consumption is expected to decline next year as well. Uncertainties associated with the GDP projection relate to the outcome of this year's agricultural season, the speed of economic recovery of the euro area and effects of fiscal consolidation and structural reforms.

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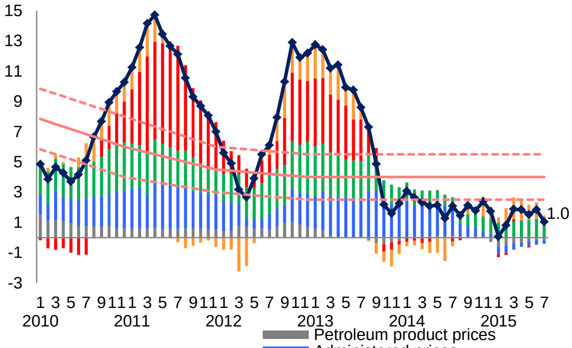
Inflationary pressures remained low in the second quarter, as a result of the majority of domestic factors, subdued inflation in the international environment and low prices of primary commodities in the world market. Year-on-year inflation continued to move below the lower bound of the target tolerance band. It reached 1.0% in July on account of a vigorous decline in vegetable prices. Inflation moved below the target reflecting primarily the absence of expected administered price adjustments over the past year and a fall in petroleum product prices triggered by tumbling global oil prices late last year and early this year.

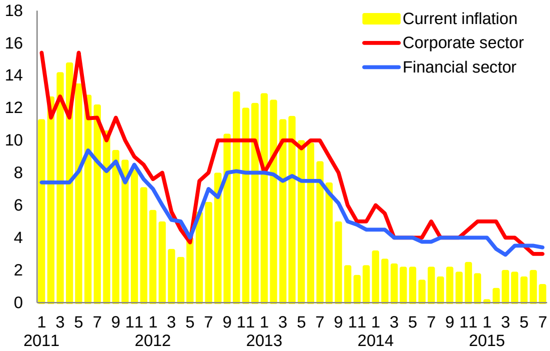
As a result of low inflation and muted inflationary pressures, both one-year ahead and medium-term inflation expectations stabilised within the target band, which is the key prerequisite for stabilisation of inflation and greater efficiency of monetary policy measures.

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 move around the lower bound of the target tolerance band over the coming twelve months, possibly entering the target band late this year or early next year. Inflation is expected to trend closer to the 4.0% target in the second half of 2016.

In contrast to the prior period, administered prices will also give a positive contribution to inflation in the coming period, notably the August electricity price increase. Another inflationary factor will be low last year's base resulting primarily from a reduction in prices of cigarettes and petroleum products in 2014. Disinflationary pressures will be generated by low global oil prices, weak aggregate demand, low inflation in the international environment and tight fiscal policy at home.

In respect of food, we expect a moderate increase in prices of industrial food products, due to rising prices of raw materials in their production, i.e. prices of individual primary agricultural commodities hit by the drought. In the first half of the year, fruit and vegetable prices were at a high level. Therefore, despite the drought, these prices are expected to record – because of the base effect, lower year-on-year growth in the remainder of the year.

The risks to the projected inflation path relate to movements in prices of primary agricultural commodities and their impact on food prices. Other risks concern the impact of developments in the international environment on the country's risk premium and capital inflow, and to a certain extent the movement in administered prices in 2016.

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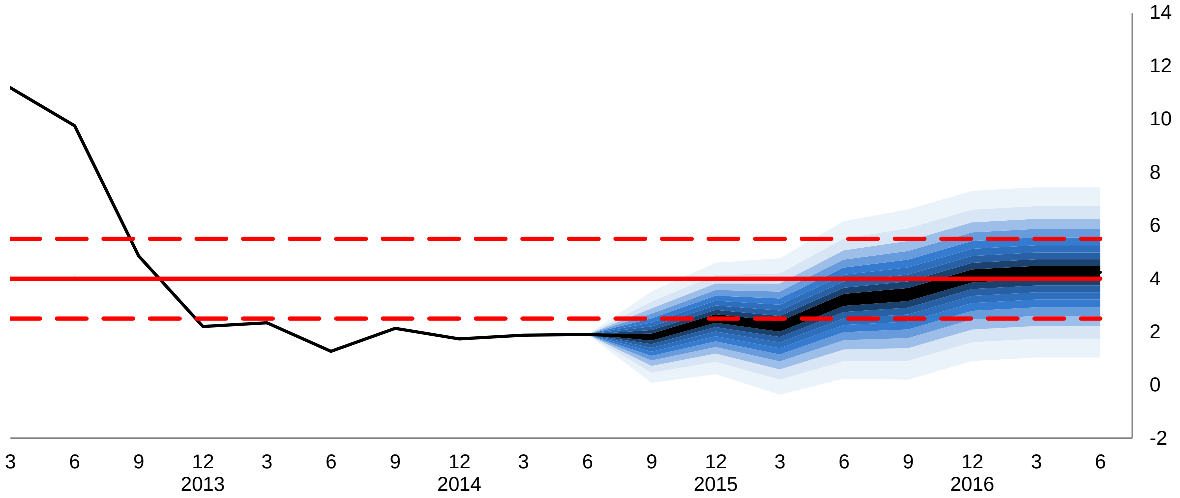
Consistent with low inflationary pressures, the key policy rate was lowered in June for the fourth month in a row, by 50 basis points to 6.0%. In July, the key policy rate was kept unchanged, only to be cut in August, again by 50 basis points to 5.5%. External risks have lessened after Greece reached an agreement with international creditors, which, along with Serbia's arrangement with the International Monetary Fund and more favourable than expected economic and balance of payments performances, contributes to relative stability of the foreign exchange market and improved investor perception. Having this in mind, as well as the disinflationary effect of the majority of domestic factors, low inflation abroad and stabilisation of inflation expectations within the target tolerance band, the Executive Board decided to continue with monetary policy easing in August.

As external risks persist, the character of monetary policy will depend primarily on the assessment of their potential inflationary effect. An important factor will also be this year's agricultural season, i.e. movement in primary agricultural prices in the domestic and international markets. We expect that further successful implementation of fiscal consolidation measures and structural reforms, along with the arrangement with the International Monetary Fund, will contribute to the sustainability of public finances and further improvement of macroeconomic prospects of the country. This will diminish the exposure of the domestic economy to adverse external shocks and further improve the conditions for economic growth.

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



Source: NBS.