NATIONAL BANK OF SERBIA

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

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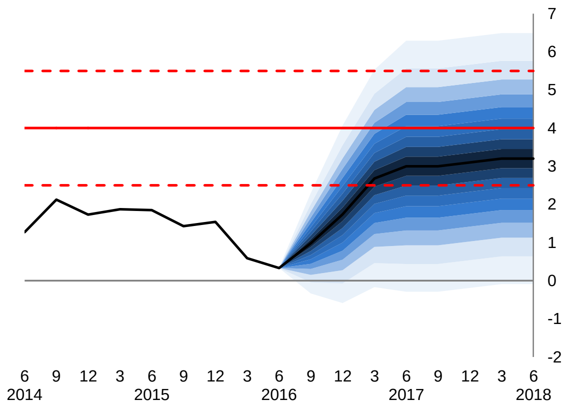
Ladies and gentlemen, esteemed members of the press and fellow economists,

Welcome to the presentation of the August *Inflation Report* where we will give an overview of recent economic developments in Serbia and explain the latest macroeconomic projections and monetary policy measures of the National Bank of Serbia.

According to our latest projection, year-on-year inflation will increase gradually towards the target tolerance band and return within it in the first half of 2017. It will continue to move within the target band thereafter until the end of the projection horizon. With regard to economic activity, GDP growth is expected to accelerate to 2.5% this year, which is the upper bound of our projection range from May. In 2017, GDP growth is expected to step up to around 3%.

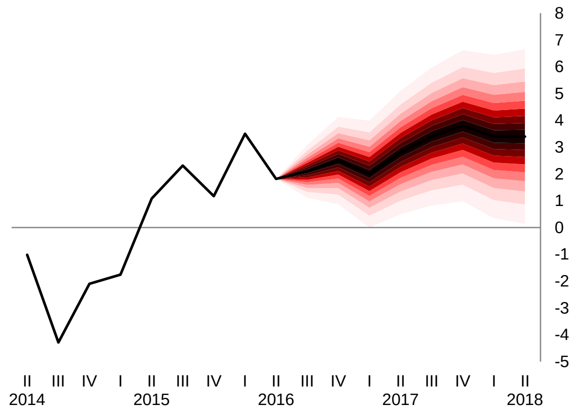
Fiscal developments in the first half of the year signal a further lowering of the **general government budget deficit** to 2.5% of GDP, according to our estimate. For the sake of reminder, this is well below the ceiling originally agreed as part of the arrangement with the IMF (4.0%). The share of the **current account deficit** in GDP is also expected to decline this year to 4.2%, which is a decrease by around 0.6 pp from 2015. This decline will result from an improvement not only in the balance of goods, but also in the balance of services. No less importantly, this deficit will continue to be fully covered by foreign direct investment.

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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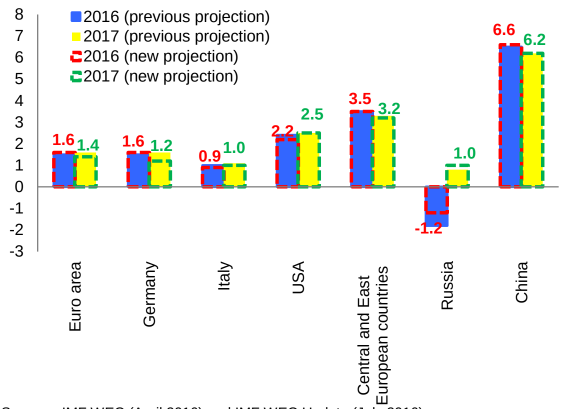
Esteemed members of the press, fellow economists,

Circumstances in the international environment continue to pose a challenge to central banks' monetary policies. Less than two months ago, the United Kingdom decided to leave the EU, amplifying the already prevailing uncertainties in the international financial and commodity markets. A day after the referendum, financial markets worldwide were in turmoil which affected all their segments, foreign exchange markets in particular. Thanks to a timely reaction of the National Bank of Serbia, our foreign exchange market calmed down quickly. In the course of July, the National Bank of Serbia intervened on the buying side only, purchasing a total of EUR 355 mln.

Increased global uncertainty spurred investors to channel their portfolios to traditional safe havens. Still, the likelihood that monetary policies of leading central banks would be more accommodative than previously thought could have a positive impact on capital flows to emerging market economies, Serbia included, particularly in view of our country's steadily improving macroeconomic fundamentals. The Fed is expected to slow down the pace of its monetary policy normalisation and raise the federal funds rate in December. Caution is advised in the conduct of monetary policy, however, as positive trends in the US economy could easily revive investor expectations that the Fed will increase the federal funds rate even before the year is out.

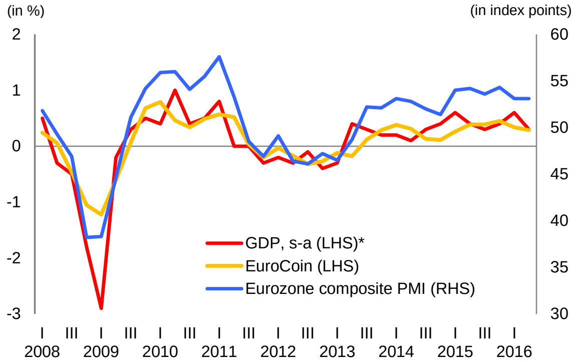
Additionally, despite sound economic performances early in the year, global growth prospects for the period ahead have been revised downwards, primarily because of Brexit. Growth in the euro area, our main foreign trade partner, is expected to slow down by 0.2 pp in 2017 relative to 2016 (according to the IMF, from 1.6% this to 1.4% next year, and according to Consensus Forecast, from 1.5% this to 1.3% next year).

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



Sources: IMF WEO (April 2016) and IMF WEO Update (July 2016).

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

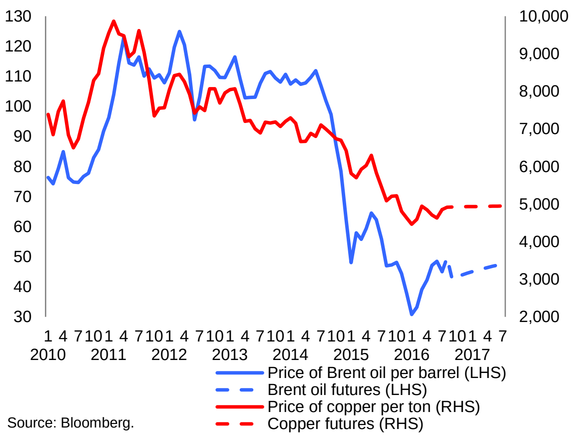


Sources: Eurostat, Markit Group and Banca d'Italia.

* Eurostat preliminary estimate.

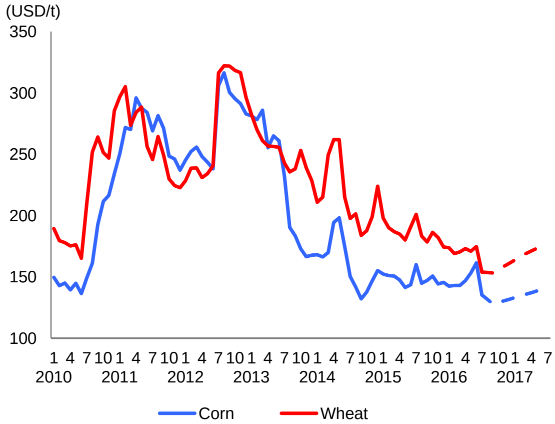
Turbulences in the international financial market and weaker global growth prospects reflected on commodity markets as well. The recovery in global oil prices was halted in the wake of Brexit: after rising by 25% in the second quarter, oil prices fell by over 15% in July. Based on oil futures, we assumed in our projections that the price of oil will remain relatively low going forward – it is expected to amount to USD 45 per barrel at end-2016 and USD 49 per barrel at end-2017. The market of primary agricultural commodities was also marked by pronounced volatility. Substantial volatility in the above markets is expected to continue 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)



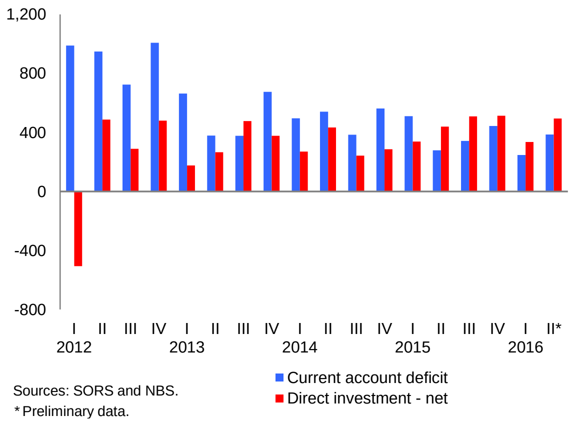
Source: CBOT - Chicago Board of Trade.

The UK referendum had a dominant impact on oscillations in risk premia of all emerging economies, particularly as the month of June drew closer. Markets rallied relatively swiftly, however, and a number of emerging economies, Serbia included, recorded a lower risk premium at the close than at the start of the second quarter. Serbia's risk premium, as measured by EMBI, decreased by 40 bp in the second quarter and by a further 15 bp in the course of July. In August, it continued down to 245 bp at the moment.

Domestic factors were also behind the sharp reduction in Serbia's risk premium – most notably the narrowing of internal and external imbalances. The results of fiscal consolidation have so far proved to be considerably better than planned and, in the first half of 2016, the consolidated budget deficit was down by almost a half relative to the same period last year. At the same time, the current account deficit was around 20% lower than in the first half of 2015. Net inflow of foreign direct investment in Serbia in the first half of 2016 was 7.7% higher than in the same period last year and more than fully covered the current account deficit.

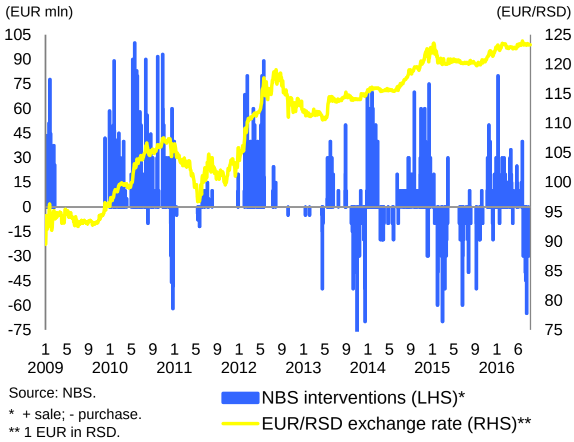
Macroeconomic performances and the overshooting of fiscal targets were assessed positively by IMF representatives during their June mission, as well as by rating agencies. In June, Fitch Ratings raised Serbia's credit rating, owing to the country's political stability, successful fiscal consolidation, banking sector stability and implementation of reforms.

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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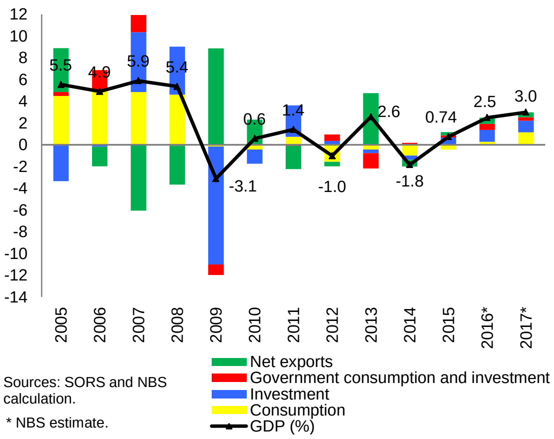
According to our estimate, after exceptionally strong seasonally-adjusted growth in the first quarter (1.8%), economic activity stagnated in the second quarter, though still recording a relatively high year-on-year growth rate (1.8%). All components of domestic demand made a positive contribution. By contrast, the contribution of net exports was negative in the second quarter. Export growth extended into the second quarter as well, but imports, mostly of equipment and intermediate goods for industrial production and construction purposes, grew at a faster pace.

According to our estimate, GDP growth will accelerate to 2.5% in 2016 and 3% in 2017, reflecting more favourable developments in the manufacturing, construction and some services sectors. Assuming an average agricultural season, positive contribution of agriculture is also expected this year, but could in fact be even higher than anticipated given the performances in the year so far. Conversely, activity in the mining and energy sector this year will be lower than previously expected on account of major overhauls in the electric-energy system.

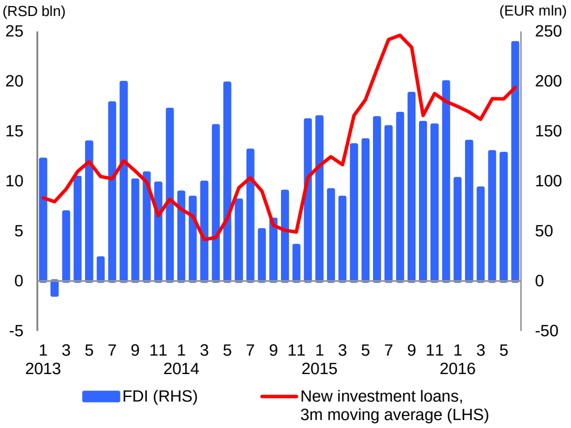
On the expenditure side, robust growth in investment is expected to continue owing to more effective implementation of infrastructure projects and a favourable investment environment, supported by lower loan costs. Positive trends in foreign trade activity from the start of the year are expected to result in a positive contribution of net exports. A positive contribution is also expected from household consumption on account of higher disposable income underpinned by a rise in employment and private sector wages, but also due to lower loan costs and energy prices.

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**



Source: NBS.

The cost of borrowing for the private sector decreased further thanks to monetary policy easing. The average interest rate on new dinar loans to corporates and households was 9.1% in June, down by 0.4 pp relative to March. Lending activity accelerated during the second quarter, and year-on-year loan growth came at 3.5% in June. Lending activity is expected to increase further in the period ahead due to the expected acceleration of economic activity and past monetary easing. This is consistent with the expectations of commercial banks stated in the July bank lending survey.

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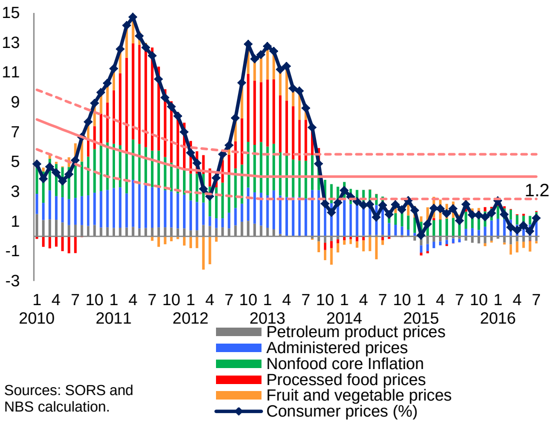
In July, year-on-year inflation was 1.2%, while core inflation also continued to move below the lower bound of the target tolerance band and came at 1.5%. Inflationary pressures remained low on account of domestic factors, but also due to falling prices of oil and primary agricultural commodities and low inflation abroad. Food and petroleum product prices continued to give a negative contribution to year-on-year inflation, while a positive contribution came from non-food products and services and administered prices.

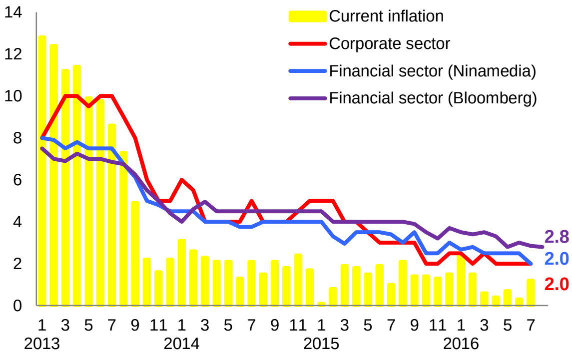
As inflation has been low and stable for three years already, inflation expectations of market participants headed further down. Hence, the financial sector and corporates expect inflation to range between 2.0% and 2.8% in the summer of 2017.

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.

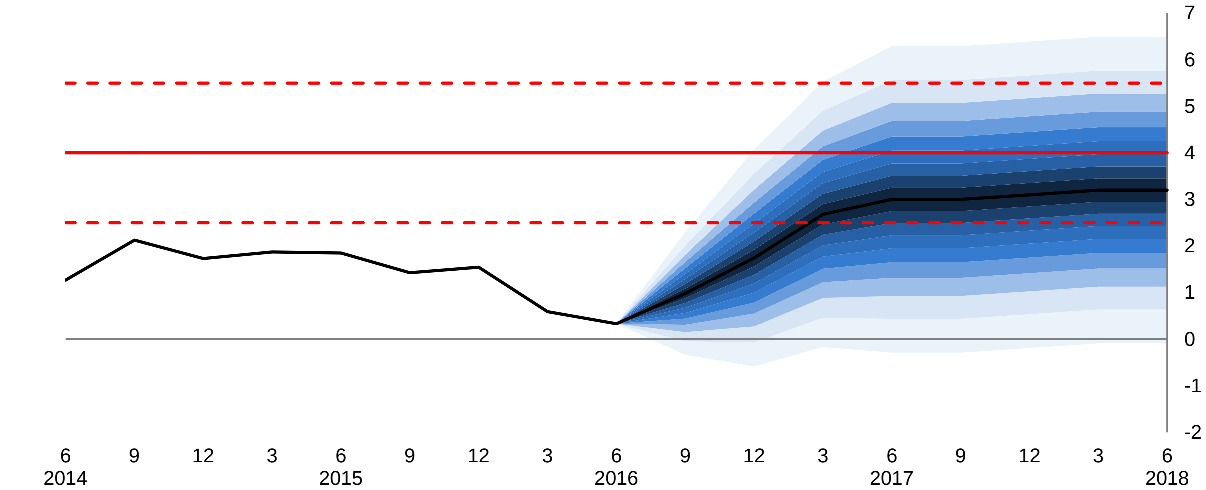
* Ninamedia agency since December 2014, and Ipsos and Gallup in the prior period. The survey was not conducted in November 2014.

According to our expectations, inflation will continue to move below the lower bound of the target tolerance band in the months ahead. In the third quarter, administered prices will give the largest positive contribution to inflation (most notably, the July increase in cigarette prices), while the contribution of prices of food and non-food products and services will be somewhat smaller.

The new inflation projection is lower than the one published in the May *Inflation Report*, due primarily to the downward revision of assumptions regarding global prices of oil and primary agricultural commodities. As a result, the return of inflation within the target tolerance band will be slower than expected in the May *Report.*

Under our central projection, year-on-year inflation will increase gradually towards the target tolerance band and return within it in the first half of 2017. It will continue to move within the target band until the end of the projection horizon, i.e. June 2018.

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



Source: NBS.

Inflation's return within the target tolerance band will be driven primarily by the low base effect from the prices of petroleum products and the gradual increase in demand at home and inflation abroad, while low costs of raw materials in food production will continue to hold inflation back for some time yet. The risks to the projection are symmetric and relate primarily to future developments in global prices of primary commodities and financial market developments, and to a certain degree, administered price growth at home.

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As regards monetary policy measures, the projection assumes an active monetary policy which seeks to keep inflation within the target tolerance band in the medium run. For this reason, the Executive Board decided to trim the key policy rate by 25 bp to 4.0% in July. As a result, the key policy rate was cut by a total of 7.75 pp in the current round of monetary policy easing begun in May 2013.

The Executive Board's July decision on further monetary easing was based on the assessment that low inflationary pressures would persist in the period ahead in view of the renewed decline in global prices of oil and primary agricultural commodities. The Executive Board also assessed that external risks could be moderated by possible further monetary accommodation by the ECB and a slower than initially expected monetary tightening by the Fed. Still, the Executive Board stated that elevated uncertainties in the international environment warranted caution in the conduct of monetary policy. In the August meeting, the key policy rate was kept unchanged at 4.0% in consideration of the expected effects of past monetary easing and the inflation outlook for the period ahead.

The National Bank of Serbia will continue to closely monitor and analyse the developments in the international financial and commodity markets, and make decisions on the basis thereof in order to maintain the achieved level of stability.

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