RESTRICTED

NATIONAL BANK OF SERBIA

Governor’s opening remarks at the presentation of the Inflation Report – August 2018

Dr Jorgovanka Tabaković, Governor

Belgrade, 15 August 2018

Ladies and gentlemen, esteemed members of the press, dear colleagues,

Welcome to the presentation of the August *Inflation Report*. As always, we will give you an overview of monetary and macroeconomic trends for the period since the previous Report and set out our expectations for the period ahead. Given that on 6 August I rounded off my first term of office as the governor, allow me, before I give the floor to my colleagues, to briefly dwell on some of the results achieved over the last six years, since results are the right and only measure of success.

As you have witnessed yourself, in the past six years Serbia has been transformed into a stable and promising economy – an economy with low and predictable inflation, balanced fiscal account, reduced external imbalances, a downward trajectory of public and external debt, growing investment and recovered labour market. Today we live in a country with a significantly lower risk premium, an upgraded credit rating and a better position on the international competitiveness lists. Progress is also reflected in lower interest rates and, by all means, in the preserved value of the dinar and opened possibilities for raising our income, all of which boosts investment, exports and production.

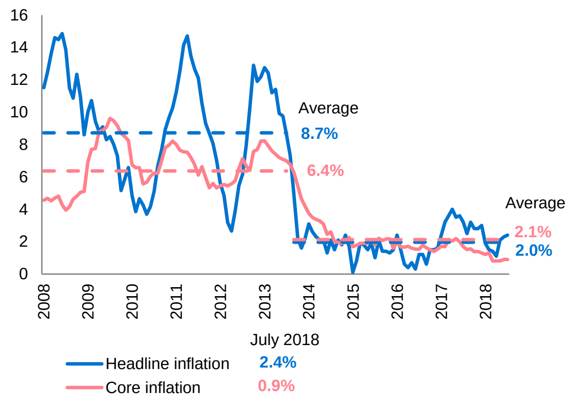
In such an ambience, Serbia's gross domestic product has been on the rise for eleven quarters in a row and, according to our latest projections, this year its growth rate is going to measure 4%. This is by 0.5 percentage points more than what was envisaged by our May projection, owing to a faster than projected growth in construction and agriculture – on the production side, and a faster pick up in investment – on the expenditure side. We expect such movements to continue in the period ahead, given that favourable conditions at home support growth in investment and exports and, by extension, higher employment and living standard of citizens. Most importantly, the results achieved are long-term and lasting.

For five years in a row, inflation has been low, stable, predictable and comparable to that in European countries, and the NBS is trusted that inflation will remain low in the future as well.

What we consider our most important result is that low inflation has become a normality in Serbia, which means that we have **succeeded in achieving our primary objective, mandated by law**. Not so long ago, in the autumn of 2012, year-on-year inflation measured 12.9%. In less than one year we brought it down to 2.2% and **preserved it at an average of 2.0% in the next five years**. Since that time inflation in Serbia **hovered at a level recorded in European countries, equalling 2.4% in July**. The intention to maintain, in the period to come, what has been achieved is also affirmed by our decision to **lower the inflation target from 4±1.5% to 3±1.5%** as of the beginning of 2017.

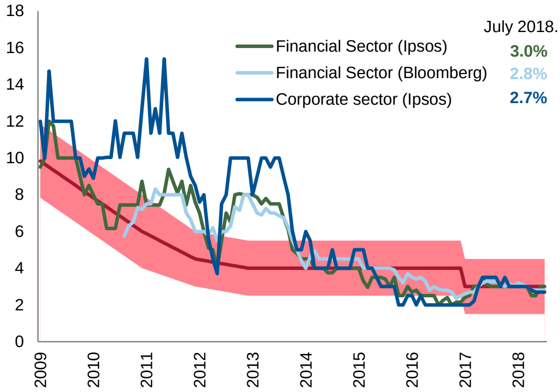
Low inflationary pressures reflected primarily adequate monetary policy measures that were fully coordinated with fiscal policy, and this was also at the core of anchoring inflation expectations. Today the financial and corporate sectors expect inflation to be maintained at a low level, as they have done for almost five years, since this brings certainty to their business and planning.

Chart 1 **Low and stable inflation**
(y-o-y rates, in %)



Sources: SORS and NBS calculation.

Chart 2 **Anchored one-year ahead inflation expectations**
(y-o-y rates, in %)

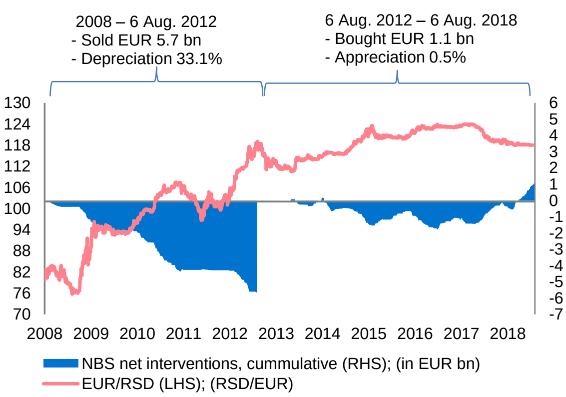


Sources: Gallup, Ipsos/Ninamedia, Bloomberg and NBS.

Relative stability of the dinar exchange rate has been preserved and the country's foreign exchange reserves have increased.

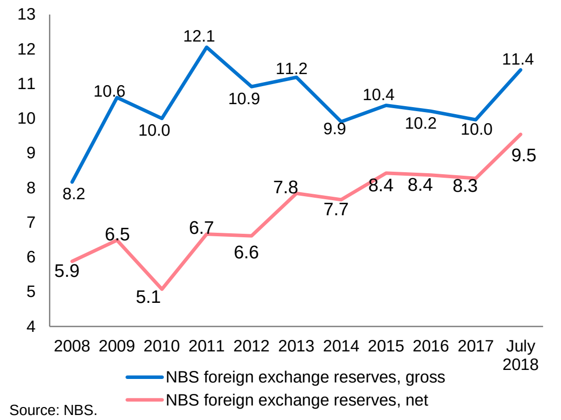
In the last six years we have also maintained relative stability of the exchange rate – **the dinar gained 0.5% against the euro**. It should be noted that relative stability has been preserved despite strong turbulences in the international environment – Brexit, Fed's monetary policy normalisation, trade and geopolitical tensions, crisis in some EU countries, Asian stock market meltdown in early 2016, etc.). We have carefully assessed the intensity and type of pressures in the foreign exchange market and **intervened impartially in both directions.** Improvement in domestic macroeconomic indicators and the strengthening of the resilience of the domestic economy to shocks from the international environment shifted the focus toward purchase side interventions, especially during the last two years. As a result, **the country's foreign exchange reserves gained EUR 1.1 billion on this account**, and now serve as a guarantee of future stability.

Chart 3 **Relative stability of the exchange rate in the past six years**



Source: NBS.

Chart 4 **Increased level of FX reserves**
(in EUR bn)



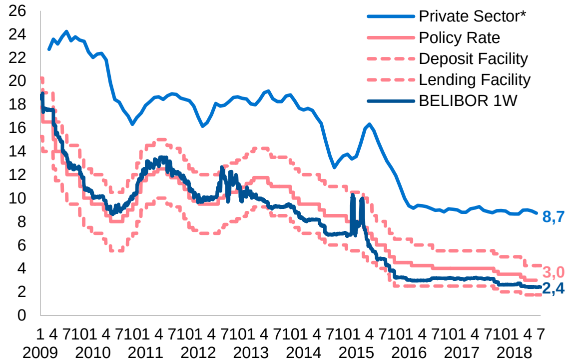
Source: NBS.

At end-July 2018, **Serbia's net foreign exchange reserves** reached their **highest level since 2000 –** EUR 9.5 billion, gaining EUR 4 billion from end-July 2012. To buttress stability, **we also increased the quantity of gold in foreign exchange reserves** – to 19.9 tonnes, which is 5.1 tonnes more than at end-July 2012.

Interest rates fell to their lowest levels.

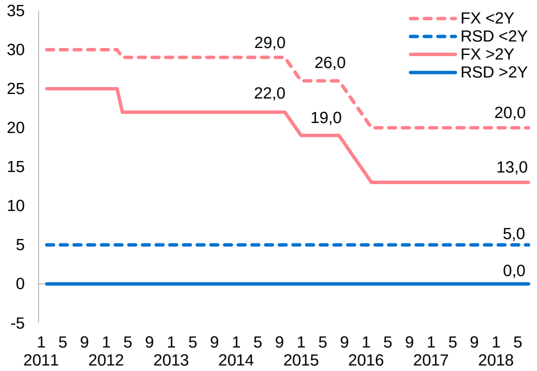
Based on the analysis of inflation factors and risks in the domestic and international environment, in May 2013 we embarked on a cycle of monetary policy easing. Since then, the **key policy rate has been reduced by 8.75 percentage points, to 3.0%**, its lowest level yet in the inflation targeting regime. The NBS gave an additional monetary incentive to the economy by **gradually lowering foreign exchange required reserve rates**, which generated around EUR 1 billion support to credit growth in 2015 and early 2016.

Chart 5 **Key policy rate at a minimum**
(annual level, in %)



Sources: Thomson Reuters and NBS.
* Weighted average interest rate on RSD loans, 3-month moving average (up to September 2010, the date were exclusively used for research purposes of the NBS).

Chart 6 **Monetary policy relaxation was also achieved through a reduction in the FX required reserves**
(in %)



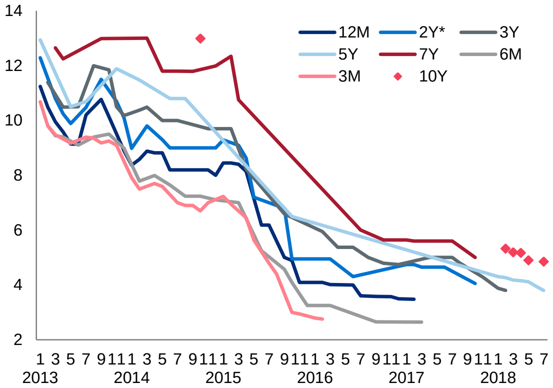
Source: NBS.

Monetary policy accommodation **fully translated into reduced costs of borrowing of corporates, households and the government.**

Since May 2013, **interest rates on new and existing dinar household loans have been halved, and those in the corporate segment turned even three times lower**, which gave an impetus to disposable income, investment and economic activity.

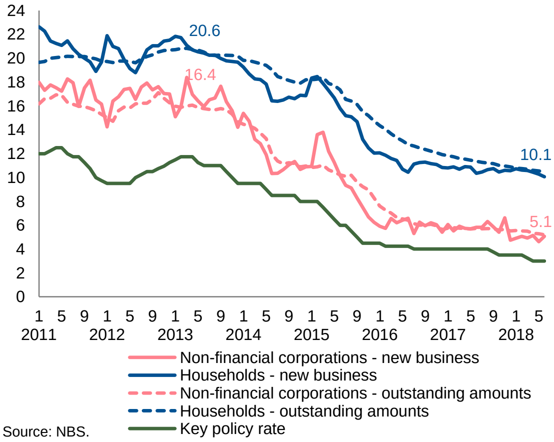
Today interest rates on dinar government securities are by around 7 percentage points lower (depending on maturity) than in May 2013 when we embarked on monetary policy easing. **The dinar yield curve was extended to 10 years**, with the interest rate of 4.80%, while in October 2014, when the ten-year dinar security was issued for the first time, it measured 13%. Today, this maturity

Chart 7 **Significantly reduced interest rates on dinar government bonds**
(annual level, in %)



Source: Ministry of Finance.
* Excluding coupon securities with the rate linked to the NBS key policy rate.

Chart 8 **Interest rates on dinar loans are at a minimum**
(annual level, in %)

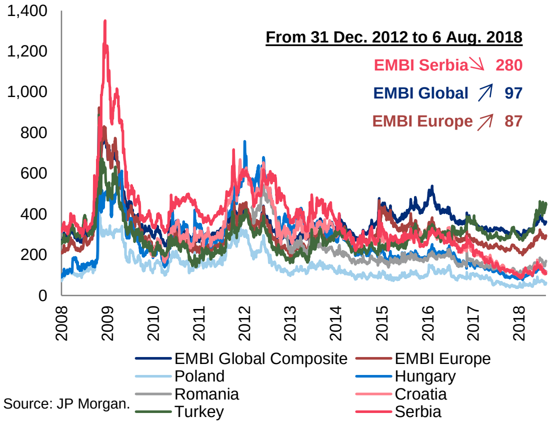


Source: NBS.

accounts for around 15% of the total portfolio of dinar government securities. Apart from the decline in the risk premium and financing needs of the country, monetary policy easing also contributed to a sizeable reduction in interest expenses and thereby to a better fiscal result. The public debt–to-gross domestic product ratio declined to below 60%, and the dinar share of public debt rose to 25%.

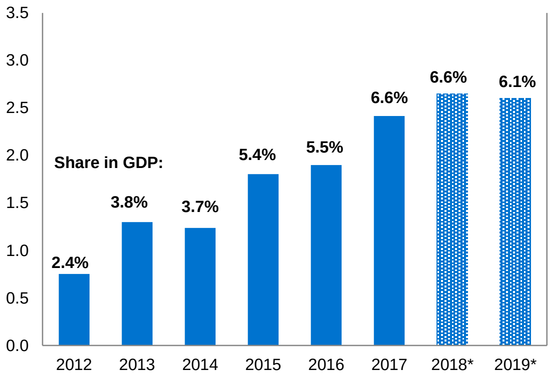
All three rating agencies monitoring our development **increased Serbia's credit rating** in 2017, assessing that the National Bank of Serbia was successful in preserving price stability and thereby rightfully earned higher credibility. The country's risk premium dropped significantly in 2017, with EMBI for Serbia moving below 100 basis points by the end of the year, only to drop to 85 basis points early this year. Serbia's risk premium is today considerably below the global and European average, and by almost 300 basis points lower than at end-2012.

Chart 9 **Sharp fall in Serbia's risk premium**
(daily data, in bp)



Source: JP Morgan.

Chart 10 **Relatively high FDI inflow, which is also expected in the coming period**
(in EUR bn)



* NBS projections.
Source: NBS.

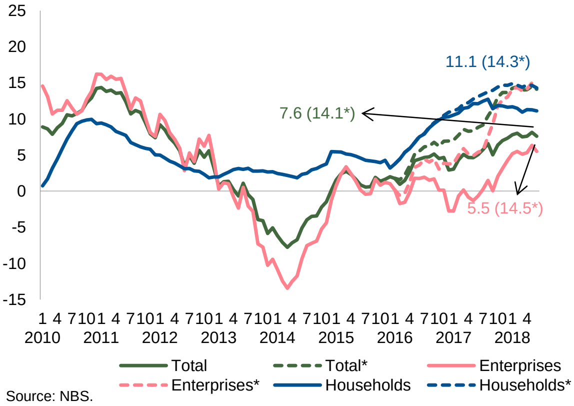
Monetary policy supported lending, and by extension, economic activity.

In conditions of accelerated lending, strongly supported by monetary policy measures, **growth in corporate investment lending** is seen as another positive development. The approval of investment loans has stepped up since 2015 and represented one of the important sources of financing in the new investment cycle, contributing to faster economic growth. **Their importance is best illustrated by the fact that in the last three years new investment loans almost equalled the inflow of foreign direct investment.**

We have reduced non-performing loans significantly and preserved financial stability.

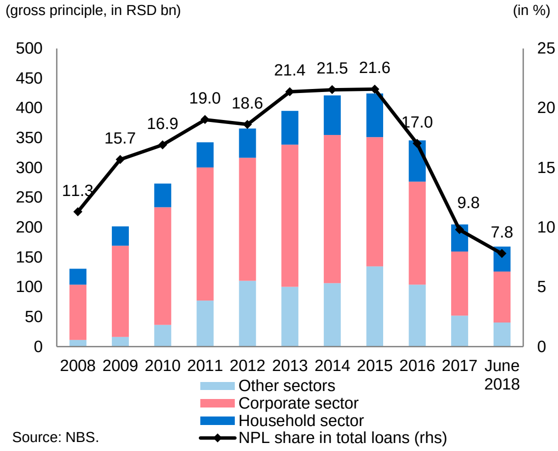
Another important result we have achieved is a considerable reduction in inherited non-performing loans (NPLs). Within three years only, **the level of NPLs was slashed by more than 60% and their share in total loans by 14.6 percentage points – from 22.4% in July 2015 to 7.8% in June 2018.** This is the lowest level of the NPL ratio since its monitoring began in late 2008. The structure of the NPL reduction was also favourable, because the greatest decreases were recorded in sectors most severely hit by the crisis (construction, manufacturing and trade).

Chart 11 **Fall in borrowing costs encouraged lending activity**
(at constant exchange rate as at 30 Sept. 2014, y-o-y rates, in %)



Source: NBS.
* Excluding the effect of NPL write-off and sale since early 2016.

Chart 12 **NPL share fell to its lowest level**



Source: NBS.

By reducing interest expenses and exchange rate losses we significantly contributed to profitability of the corporate sector.

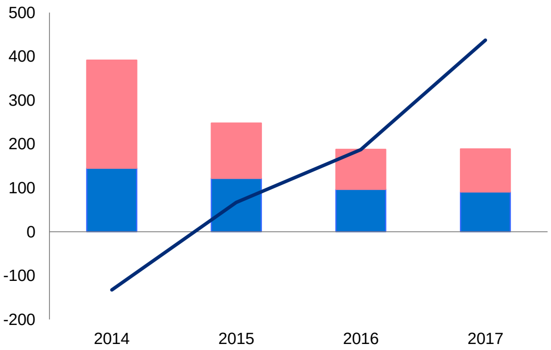
Profitability of the Serbian corporate sector increased significantly in the last three years, thanks to its higher competitiveness, and also owing to the reduction of interest expenses and exchange rate losses. In 2017, **corporate interest expenses were 37% lower** than in 2014 (down by RSD 54 billion), in the face of the rising stock of corporate loans. Thanks to the relative stability of the exchange rate, **corporate exchange rate losses went down by 60%** (or by RSD 148 billion). The end-result is higher profit, which corporates used in the right manner – to increase investment and expand their business.

A stable and predictable business ambience is conducive to strengthening investment, foreign trade and economic activity.

Positive effects of macroeconomic stability are also evidenced by the **increasing exports of our products and services**, which feeds back positively to the foreign exchange market and stabilises its movements, and by extension, inflation movements as well. Since 2016 we have exported more than half of our production, and in the second quarter this year goods and services exports reached 54.4% of gross domestic product (for the sake of comparison, in 2012 their share measured 36.2%).

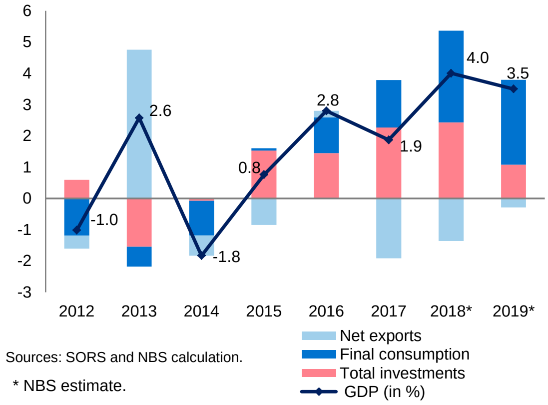
The effects of macroeconomic stability also lie at the core of **investment growth**, which additionally accelerated from the start of 2018 and, judging by all indicators, **investment share in gross domestic product is likely to exceed 22% in the year as a whole**. Apart from increased profitability of corporates and previously mentioned investment loans, a step-up in private investment growth in recent years was also spurred by foreign direct investment. All of this confirms that we are an economy that now attracts an increasing number of non-resident investors with a long-term focus. The rise in foreign direct investment has continued and this year we expect to see a net inflow of around EUR 2.6 billion.

Chart 13 **Better financial result of the corporate sector**
(in RSD bn)



Source: Business Registers Agency.

Chart 14 **Investments supported by a rise in profitability, lending and FDI gave a considerable contribution to GDP growth**
(in pp)



Sources: SORS and NBS calculation.

* NBS estimate.

Thanks above all to sizeable investment growth, **we revised our gross domestic product growth projection for this year from 3.5% to around 4.0%.** That Serbia's economic growth stands out is also confirmed by the **assessment of the European Commission, which sees Serbia as the greatest contributor to the Western Balkan economic growth in 2018.** Progress in the real sector spills over to the labour market as well, with private sector employment posting a constant rise and **the number of the unemployed plunging to its twenty-year low**.

Ladies and gentlemen, esteemed members of the press, dear colleagues,

I would like to reiterate that these are only some of the key results we have achieved since 2012 to date. However, it would be immodest to say that we are the only ones to be credited for these results. These measures yield full effects only in coordination with other government policies, and this has been achieved in Serbia. I believe that in the last six years we got to know each other very well, so you can rest assured that in the period ahead we will continue to work to the benefit of our citizens and the economy, primarily by ensuring stability, but also by facilitating everyday life of citizens and businesses – for example, by introducing the instant payment system, which is the most advanced payment system currently available.

Thank you for your attention. I will now give the floor to my colleagues, after which we remain open for your questions.