NATIONAL BANK OF SERBIA

Speech at the presentation of the Inflation Report – August 2018

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for Economic Research and Statistics

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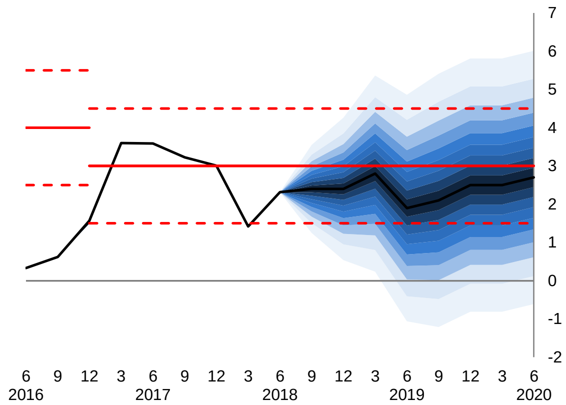
Ladies and gentlemen, esteemed members of the press, dear colleagues,

Let us now give a brief overview of current macroeconomic developments, our new projections and monetary policy decisions.

We would first like to reiterate that gross domestic product growth of 4.5% year-on-year in the first half of the year surpassed our expectations stated in May. This means that the positive risks we emphasised in May now materialised, leading us to **raise the gross domestic product growth projection for this year from 3.5% to 4.0%**. The upward revision was a result of higher than forecast construction and agriculture growth on the production side, and faster investment growth on the expenditure side. We expect that **fixed investment** growth will remain high in the remainder of the year, and it seems that its share in gross domestic product will exceed **22%**.

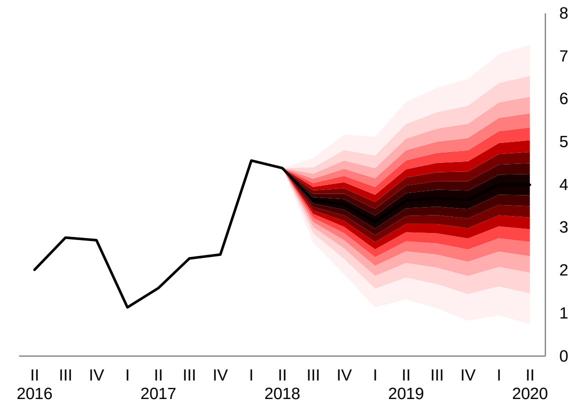
After reaching this year's low in April, in line with our expectations, inflation stabilised from May at somewhat above 2%. The new projection also indicates that inflation will remain low and stable and continue to move within the target band (3±1.5%) in the next two years.

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



Source: NBS.

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



Source: NBS.

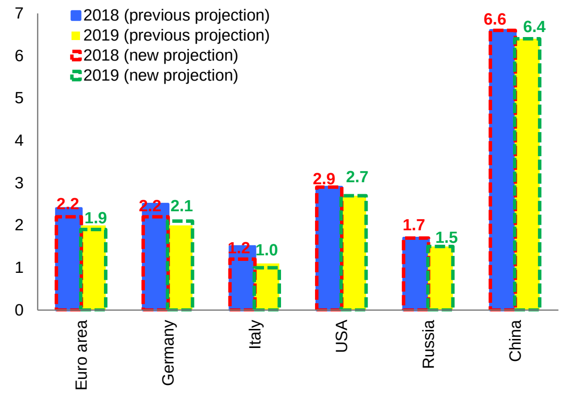
Positive fiscal trends also continued in the period since the previous *Inflation Report*. In the span of five months of 2018, consolidated budget recorded a surplus of RSD 9.3 billion, suggesting that this year as well **fiscal result will be better than planned** by the Fiscal Strategy. We also favourably assess the considerable increase in government capital expenditure, which contributes to investment and economic growth. **The share of public debt** in gross domestic product, which has moved **below 60%** since the start of the year, is another important indicator of the country's improving fiscal position.

In the first half of the year, **manufacturing exports continued their strong growth of 10.7% year-on-year**, with a positive contribution from all of its sectors. Imports grew in parallel, mainly of equipment and intermediate goods, owing to increased business and investment needs of the economy, and in part to higher global oil prices. Imports of consumer goods were also rose, though to a lesser extent, in line with growing household consumption. On the other hand, due to more favourable developments in trade in services and in the primary and secondary income accounts, **in the first half of 2018 the current account deficit declined by 0.7 percentage points** year-on-year to 5.4% of gross domestic product.

* * *

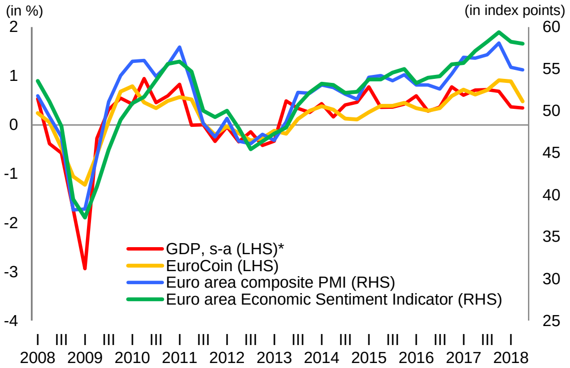
Global economic growth outlook remains favourable, though trade tensions between leading global economies give rise to risks that growth could be slower than expected. Growth in the euro area, our key trade partner, was dampened in the first half of the year, leading the European Central Bank to revise down the euro area growth projection for 2018 by 0.3 percentage points to 2.1%, while keeping the 2019 and 2020 projections unchanged. Still, it assesses that economic growth in the medium run will remain stable and broadly distributed, both sector-wise and geographically. It is reassuring that an agreement on cooperation to remove trade barriers was reached in late July between the European Union and the United States of America.

Chart 3 **IMF's revised forecast of real GDP growth for 2018 and 2019**
(in %)



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

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



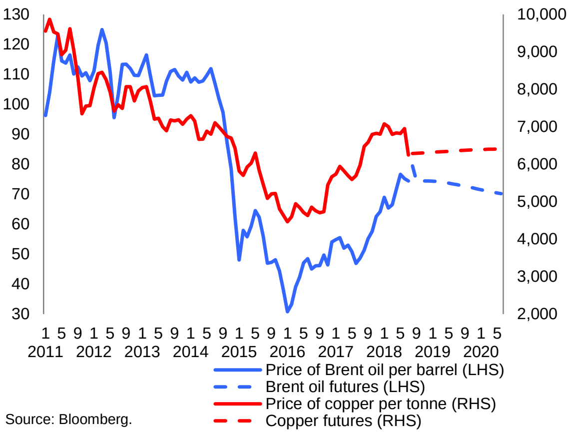
Sources: Eurostat, Markit Group, Banca d'Italia and European Commission.

* Eurostat preliminary estimate for Q2 2018.

Uncertainty in the international environment arises from volatile movements of global primary commodity prices. This mainly relates to oil prices, which have been on an upward path in the past year. Reaching even USD 79 per barrel on some days, oil prices were on average 11.2% higher in the second than in the first quarter, as a result of geopolitical tensions and other supply-side factors. Despite this, early August oil futures that we used in the projection suggest that oil prices will measure USD 74 per barrel by the end of this year, and fall to USD 71 and 68 per barrel in the next two years, levels somewhat higher than those assumed three months ago.

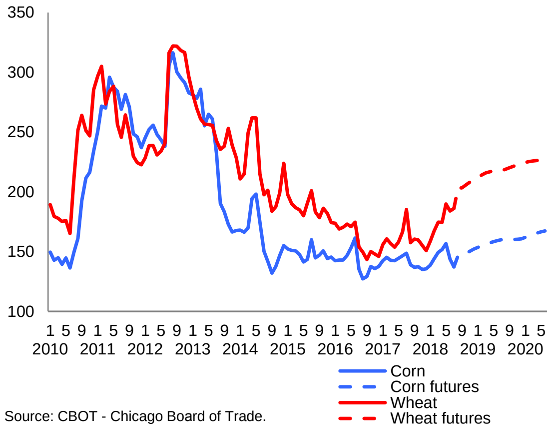
Uncertainties also surround global primary agricultural commodity prices, particularly taking into account their volatility in recent months, and the potential adverse weather effects in some regions and trade tensions between leading global economies. Bearing in mind the movement of futures, we lowered the assumption of their growth for this year compared to the previous projection (from 15.9% to 11.3%), while we revised upward the next year's projection (from 2.0% to 6.0%).

Chart 5 **Oil and copper price movements**
(average monthly prices, in USD)



Source: Bloomberg.

Chart 6 **Primary agricultural commodities' price movements**
(USD/t)



Source: CBOT - Chicago Board of Trade.

The above rise in oil prices in the global market was the primary reason for somewhat higher inflation in the international environment from the start of the year, and for higher inflation projections in most countries for this year. The European Central Bank raised its euro area inflation projection for 2018 and

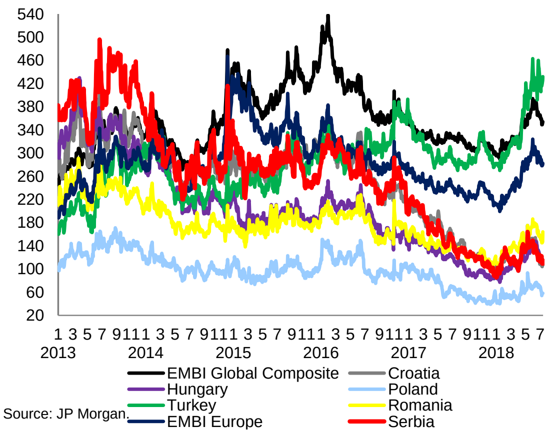
2019 and did not change it for 2020, so inflation is expected to measure 1.7% during the entire projection horizon.

With inflation gradually approaching the 2% target, the European Central Bank will most probably conclude the asset purchase programme late this year. However, it will continue reinvesting principal payments from maturing securities for some time thereafter, and keep its key interest rates unchanged at least through the summer of 2019. On that basis, we estimate that the conditions in the international financial market remain favourable for Serbia.

Also, thanks to narrowed internal and external imbalances, Serbia is now more resilient to changes in the international environment. This is also indicated by the risk premium, which was slightly lower at end-July than at end-March, while for other emerging economies at the global and European level it gained 28 and 36 basis points, respectively. Investors' perception of Serbia is favourable, as also shown by the achieved capital inflow in the first half of this year of EUR 1.8 billion, mostly made up of foreign direct investment (EUR 1.3 billion). Foreign direct investment gained 8.6% from the same period last year and more than fully covered the current account deficit (128.5%), which contributed to continued appreciation pressures in the foreign exchange market. The expected net foreign direct investment inflow for the year as a whole of around EUR 2.6 billion will ensure full coverage of the current account deficit. We expect this trend also in the coming period, which will be one of the factors of external sustainability in the medium run.

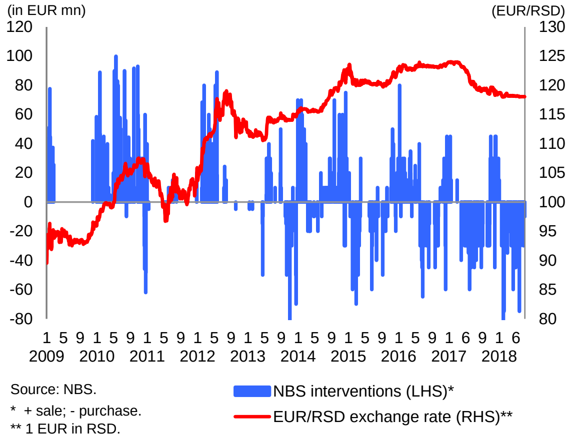
To ease excessive short-term volatility of the exchange rate, since the start of the year the National Bank of Serbia has intervened in the foreign exchange market by purchasing EUR 1.48 billion net, while the dinar strengthened by 0.4% against the euro.

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



Source: JP Morgan.

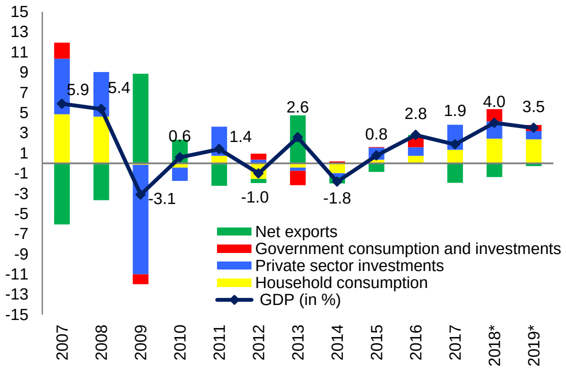
Chart 8 **Movements in EUR/RSD exchange rate and NBS FX interventions**



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

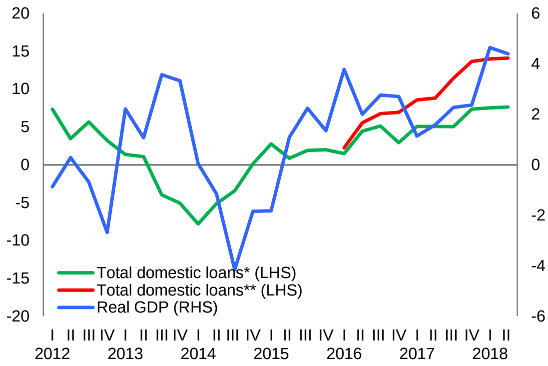
Past monetary policy easing drove down interest rates on dinar loans to new lows in the second quarter. Along with economic growth, labour market recovery, increased interbank competition, a relatively low country risk premium and low euro area interest rates, this contributed to the recovery in lending. Despite significant write-offs of non-performing loans, year-on-year growth in total loans (excluding the exchange rate effect) picked up since the start of the year to 7.6% in June, while it was even greater (14.1%) excluding the effect of the write-off and assignment of non-performing loans. The share of non-performing loans in total loans fell drastically, to 7.8% in June, the lowest level since 2008, when this indicator of bank asset quality was introduced.

Chart 9 **Contributions to annual 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.
** Excluding the effect of NPL write-off in the past year.

* * *

Robust gross domestic product growth diversified across sectors continued in the second quarter. According to the preliminary estimate of the Statistical Office, second-quarter growth equalled 4.4% year-on-year, surpassing our expectations. The highest contribution to growth continued to come from service sectors, which were positively affected by the recovery of domestic demand, and construction, mainly owing to faster implementation of infrastructure projects and a gradual recovery of the real estate market. Industry and agriculture were also positive contributors. Thus, growth in the first half of the year reached 4.5% year-on-year, the highest figure in ten years.

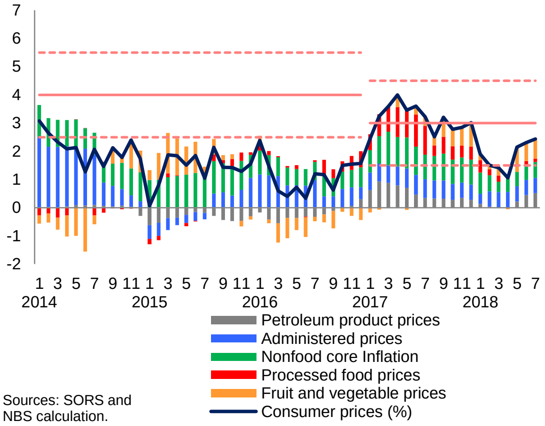
Based on developments in the first half of the year, we revised the gross domestic product growth forecast for 2018 to around 4%, or 0.5 percentage points higher than in the May projection. The upward revision was a result of faster than expected construction and agriculture growth on the production side, and faster investment growth on the expenditure side, which we mentioned as positive risks in the May projection. We did not change the gross domestic product growth forecast for 2019 (3.5%), in part due to the high base on account of faster growth this year.

We estimate that this and next year's economic growth will be driven by domestic demand, i.e. investment and household consumption. A basis for further growth in private investment is the favourable macroeconomic environment and growth outlook, supported also by favourable financial conditions. Along with an increase in government capital expenditure, this should increase the share of investment in gross domestic product to 22% this year, ensuring preconditions for sustainable medium-term growth of around 4%. Also, favourable terms of borrowing, further growth of disposable income of households on account of the achieved and expected increase in wages and employment, and gradual recovery of consumer confidence, will lead to further expansion of household consumption. We also expect that exports, particularly of manufacturing, will continue to grow at two-digit rates, supported by external demand, above all investment, on which account we expect imports of equipment and intermediate goods to grow.

* * *

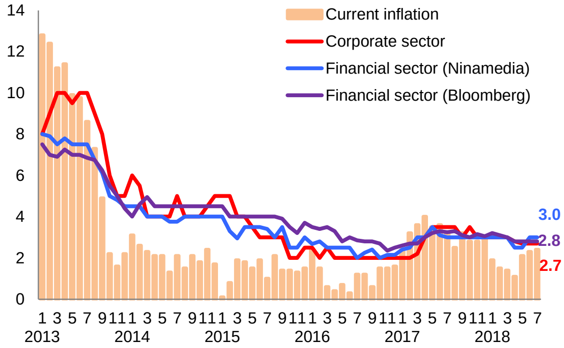
Inflationary pressures on account of the majority of factors remain low. Consistent with the expectations we stated in May, after reaching this year's lowest point in April, year-on-year inflation has moved within the target tolerance band (3.0±1.5%), measuring 2.4% in July. Prices of fresh vegetables recorded somewhat elevated growth, as did the prices of petroleum products, due to a continued increase in global oil prices. On the other hand, a quarter of the prices in the consumer basket increased in the targeted band of 1.5–4.5%, and a half by less than 1.5%, confirming that inflationary pressures remain low. If we were to exclude volatile categories from the consumer basket, such as the prices of

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.

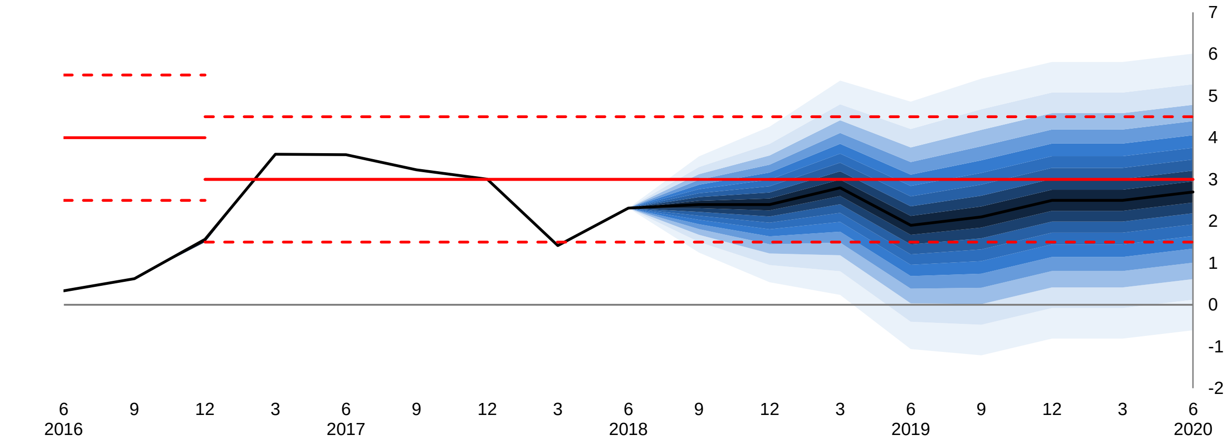
* Ipsos and Gallup agencies until December 2014, Ninamedia agency since December 2014, and Ipsos agency since January 2018.

food, energy, alcohol and cigarettes, we would get core inflation, which has moved in the range of 0.8% to 0.9% year-on-year since March. Subdued inflationary pressures are also reflected in the inflation expectations of financial and corporate sectors which are anchored around the target midpoint of 3%.

Under our central projection, year-on-year inflation will continue to move within the target tolerance band in the next two years – below the target midpoint (3.0±1.5%) by late 2019, though it will temporarily approach it in the first months of next year owing to the low base effect from the start of this year.

In the short term, low costs of food production will have a disinflationary effect, and next year inflation will be dragged down by this year's high base of fruit and vegetables and petroleum products. The main drivers of inflation in the medium run will be the gradual waning of disinflationary pressures on account of the dinar's appreciation in the previous period, and the rise in aggregate demand.

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



Source: NBS.

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Having cut the key policy rate by a total of 50 basis points in March and April to 3%, the Executive Board kept it unchanged. The Executive Board made decisions in consideration of the projected movement of inflation and its underlying factors, and the expected effects of past key policy rate cuts. Caution was also mandated by the uncertainty in the international financial market and the market of primary commodities, particularly crude oil and primary agricultural commodities.

In the coming period, the National Bank of Serbia will continue to closely monitor and assess developments in the domestic and international markets and use all available instruments to keep inflation low and stable in the medium term.

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

The August *Inflation Report* contains four text boxes concerning current topics. The first one provides an overview of the key measures and results of the National Bank of Serbia in the past six years, i.e. during the Governor's first term. In the second text box, we analysed the impact of foreign direct investment on production, exports and employment in manufacturing. The third one analyses the factors that contributed to financial results of domestic corporates in 2017 as well. The fourth text box assesses this year's agricultural season and its impact on economic and foreign trade activity.

We thank you for your attention and remain at your disposal for any questions.