



NATIONAL BANK OF SERBIA

Speech at the presentation of  
the Inflation Report – November 2014

---

Branko Hinić, General Manager  
Directorate for Economic Research and Statistics

Belgrade, 19 November 2014

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

Since we last met at the presentation of the August *Inflation Report*, inflationary pressures have stayed low. Y-o-y inflation continued to move below the lower bound of the target tolerance band and measured 1.8% in October. Under our central projection, which is lower than the one from the August *Report*, until end-2014 and in the first quarter of the next year inflation is expected to continue moving below the lower bound of the target tolerance band, though it might temporarily return within the target band in November. As of the second quarter next year we expect to see it trending up, only to return within the target band by mid-2015.

Low inflationary pressures are sustained by weak aggregate demand, absence of the usual administered price adjustment, low cost-push pressures in the production of food and movements of import prices. Note particularly that the prices of primary agricultural commodities (corn, wheat and soybeans), important food production inputs, dropped by around 25% over the last six months.

Economic activity in the third quarter fell more than expected. On the production side, this was induced primarily by the May flooding which placed greater strains on mining and energy sectors than initially assessed. On the expenditure side, the fall in economic activity ensued as the recovery of the euro area, i.e. our main trade partners, started to lose steam. These are also the reasons why economic activity will contract this year and probably next year as well. The recovery of economic activity is expected starting from 2016.

The same reasons – flooding and contraction in external demand – are behind the temporary slowdown in the reduction of the current account deficit which should reach some 6.0% of GDP, same as last year. The expected rise in exports in 2015 should be aided by the recovery of our main trade partners, while the contraction of domestic demand amid fiscal consolidation measures will hold back imports, thus likely leading to the lowering of the deficit below 5% of GDP.

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

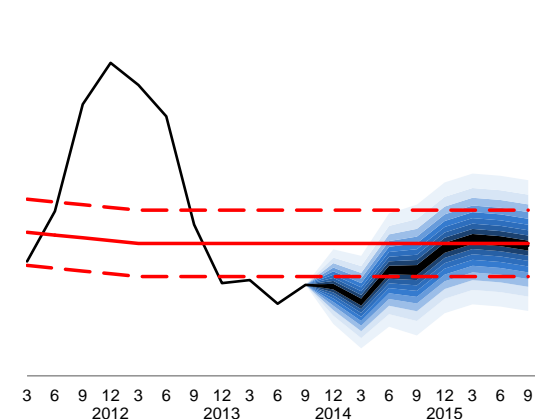
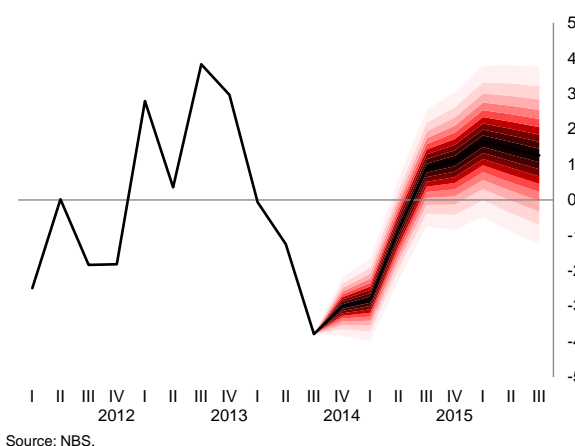


Chart 2 **GDP growth projection**  
(y-o-y rates, in %)

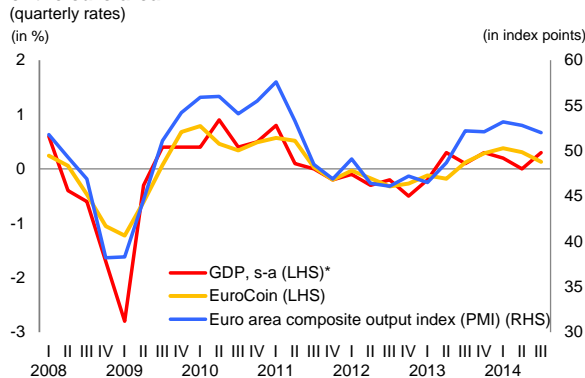


\* \* \*

Over the past period, international environment witnessed not only an uninterrupted decline in prices of primary agricultural commodities but also the cheapening of the majority of raw materials in industry. Particularly strong was the drop in crude oil dollar prices, amounting to as much as 30% from mid-year. Increased oil supply and the strengthening of the dollar triggered a fall in oil prices, despite the geopolitical tensions.

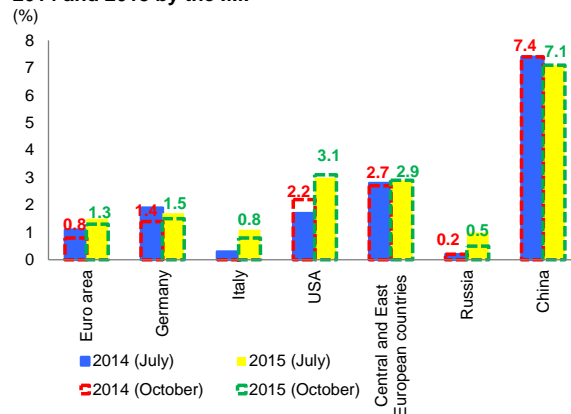
The Ukraine crisis continues to pose a risk to Europe's economic movements. As for the euro area, its growth prospects were revised down – in 2014 GDP is likely to grow by 0.8% and in 2015 by 1.2%. As the risk of an extended period of low inflation persisted, the European Central Bank lowered its policy rate in September to a new historical minimum (0.05%) and cut further the interest rate on deposit facilities which was already negative. Furthermore, as of last month, the European Central Bank resorted to additional unconventional liquidity boosting measures. Contrary to the European Central Bank, in its October meeting, the Fed put an end to its programme of buying treasury notes and mortgage-backed securities, and the markets expect to see it embark on key policy rate increases as of mid-next year.

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



Sources: Eurostat, Markit Group and Banca d'Italia.  
\* Consensus Forecast estimate for Q3 2014.

**Chart 4 Revisions of real GDP growth forecasts for 2014 and 2015 by the IMF\***  
(%)



\* Revision compared to July WEO Update.  
Source: IMF WEO Update (July 2014) and IMF WEO (October 2014).

Uncertainties in the international capital market, reflecting the Fed's QE tapering and geopolitical tensions over Ukraine, brought about somewhat more modest capital inflows and, as a consequence, fuelled depreciation pressures in the emerging market economies, Serbia included. Since the beginning of the third quarter, the depreciation pressures on the dinar have been generated not only by global factors, but also by elevated energy imports and weaker export results, including the delay in the start of implementation of additional fiscal consolidation measures and structural reforms. From July to October, the National Bank of Serbia intervened in the interbank foreign exchange market by selling EUR 365.0 million net. Consistent with the practice so far, the interventions were aimed at easing excessive short-term volatility of the exchange rate, without any intention to influence the exchange rate trend.

Though increasing twice in the period observed, by late October Serbia's risk premium measured by EMBI touched almost the same level as in late June, equalling 270 basis points. Currently, Serbia's EMBI measures around 250 basis points.

Chart 5 Risk premium indicator – EMBI by country (daily, in basis points)

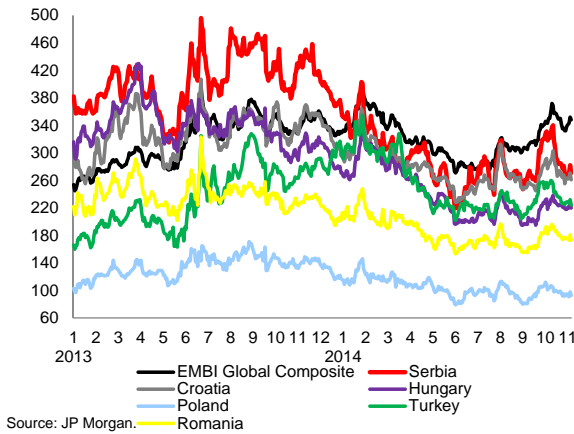
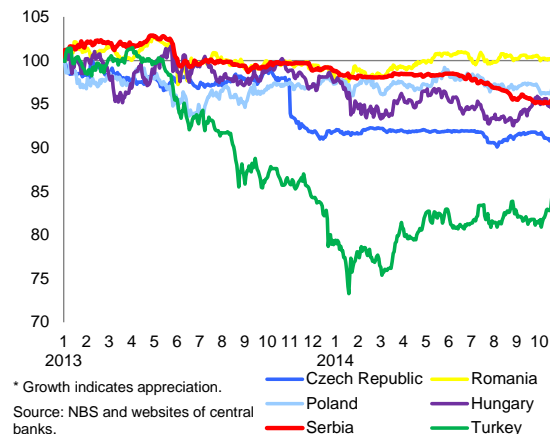


Chart 6 Movements in exchange rates of national currencies against the euro\* (daily data, January 2, 2013 = 100)



\* \* \*

Based on our estimates, GDP contracted in the third quarter by 1.0% s-a, driven chiefly by the sharp downturn in industrial production. The downturn in industrial production was precipitated by the flood damage to the sectors of energy and mining and by the slowing pace of the euro area recovery. On the expenditure side, the largest negative contribution to quarterly GDP stemmed from net exports, given that automobile industry and agricultural product exports decreased and energy imports increased.

Chart 7 Exports and imports of goods and services (in constant prices 2010)

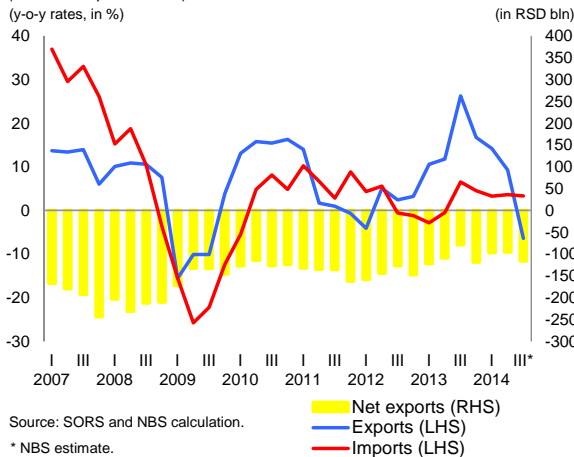
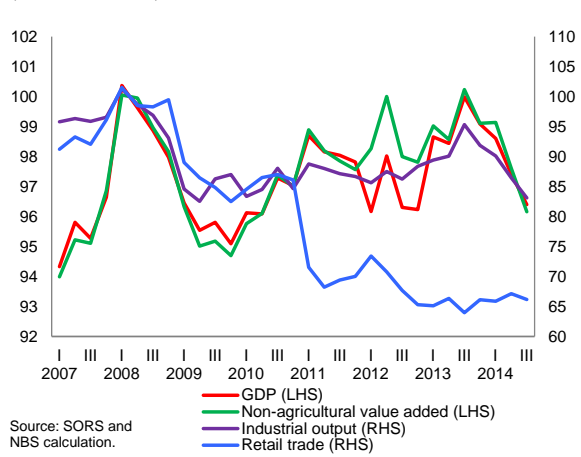


Chart 8 Economic activity indicators (s-a, H1 2008 = 100)



As already noted, economic activity will contract this year and probably next year as well. On the expenditure side, the largest negative contribution to this year's GDP will come from household consumption, weighed down by the taken fiscal consolidation measures, and from private investments. Due to the weakening of external demand over the past several months, the contribution of net exports to GDP in 2014 is estimated to be neutral, rather than positive as expected earlier.

Like in previous projections, the contribution of household consumption to GDP will stay negative in 2015, given the cut in pensions and public sector wages starting from this month. Still the drop in household consumption should be largely offset by the expected rise in net exports and investments. Net exports are expected to generate a positive contribution as a result of the euro area recovery, but

also lower imports against the backdrop of falling final consumption. Investments are expected to gather pace not only as a result of the efforts to restore flood damage, but still more so as a result of the implementation of structural reforms.

\* \* \*

Persistently subdued inflationary pressures reflect chiefly low aggregate demand, unusually weak administered price growth and the absence of major cost-push pressures in food production and pressures from import prices. Year-on-year inflation continued to move below the lower bound of the target tolerance band in the third quarter, and was joined from August by core inflation as well.

Looking at inflation components, the inflation movements described were mostly due to food prices which fell amid a drop in international and domestic prices of primary agricultural commodities since mid-May. In addition to this, administered price growth turned out to be rather low compared to the previous years. Namely, in the first ten months of the year, it measured mere 2.8% compared to the 10.4% in the same period last year, largely owing to the absence of electricity price adjustment.

Chart 9 Contribution of CPI components to y-o-y inflation (in pp)

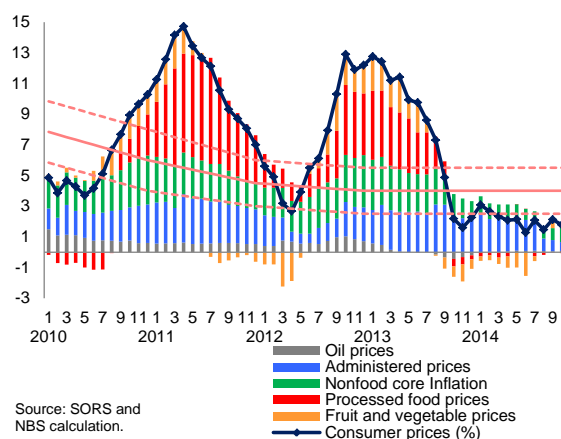
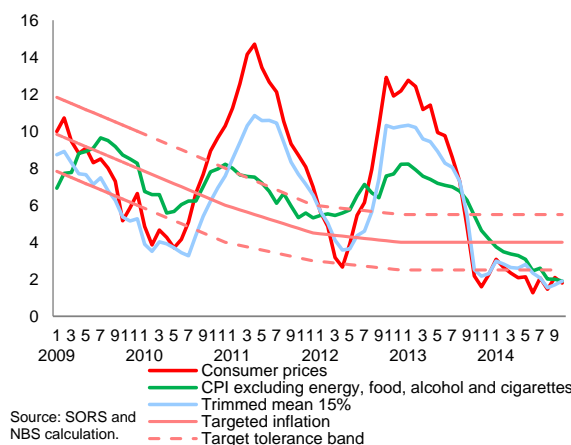


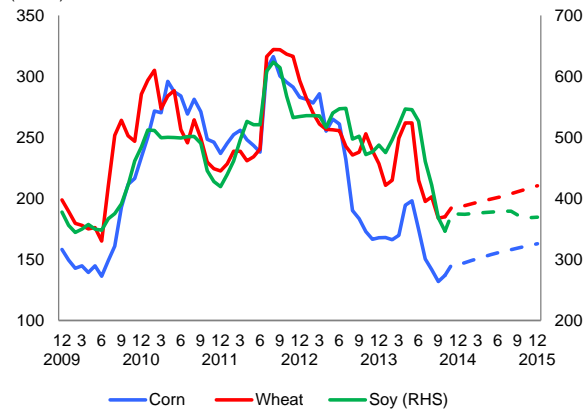
Chart 10 Price movements (y-o-y growth, in %)



***Under our central projection, year-on-year inflation will stay below the lower bound of the target in the current and the coming quarter, possibly re-entering the target tolerance band temporarily in November. Based on our estimates, inflation will start rising from the second quarter of 2015 and will return within the target tolerance band (4.0 ± 1.5%) around mid-year. In the remainder of the forecast period, inflation is expected to move within the bounds of the target tolerance band.***

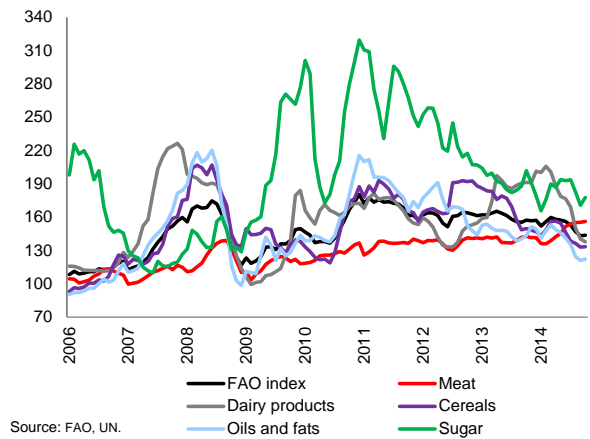
Inflation's return to the target in the course of 2015 will be led primarily by administered prices, most of all by electricity prices, which are expected to rise in the second quarter. Past depreciation of the dinar will put pressure on the prices of import products, but also on the prices of domestic products depending on their import content. Still, the intensity of this pressure will depend on the importers/producers' ability to command higher prices against the backdrop of depressed aggregate demand which remains the key disinflationary factor in the medium term. The upward pressure on import prices in Serbia should be additionally constrained by the rather low inflation in the international environment, notably in the euro area which is our main foreign trade partner.

Chart 11 **Prices of primary agricultural commodities and their futures**  
(USD/t)



Source: CBOT - Chicago Board of Trade.

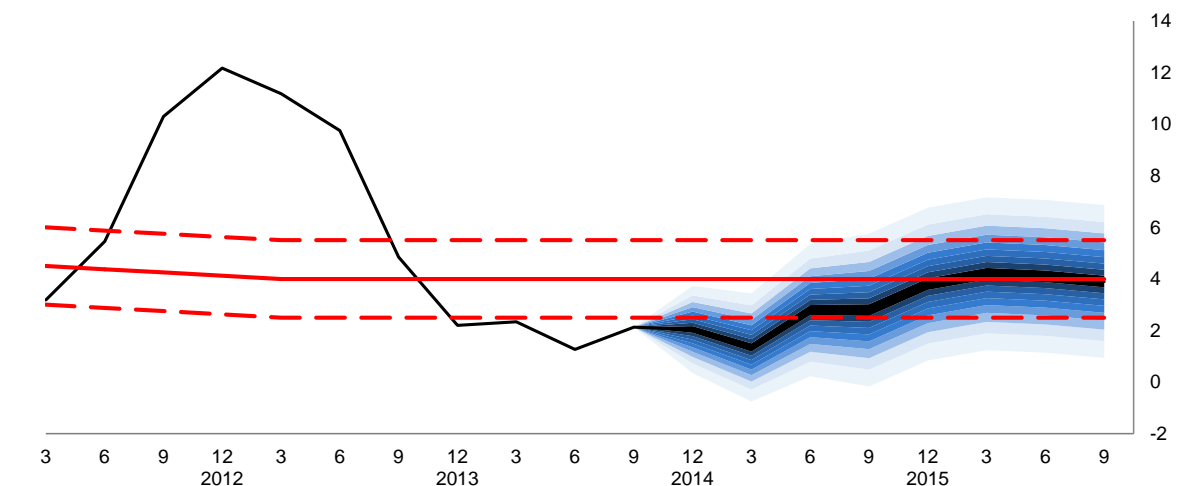
Chart 12 **World food price index**  
(in real terms, 2002 – 2004 = 100)



Source: FAO, UN.

The risks to the projected inflation path are associated primarily with fiscal movements, administered prices, and the impact of developments in the international environment on domestic economic and financial flows and on the prices of primary commodities.

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



Source: NBS.

\* \* \*

Due to uncertainties in the international environment and persistent geopolitical tensions and their possible impact on the country risk premium and the exchange rate, monetary policy is eased at a cautious pace in order to stabilise inflation permanently at low levels. Taking into account the new lower projection of inflation and GDP, the Executive Board of the National Bank of Serbia decided in its last meeting to cut the key policy rate by 50 basis points to 8.0%. To support credit activity, the Executive Board also lowered the foreign exchange reserve requirements and raised the dinar share of

allocations of foreign exchange required reserves. Credit activity remains in the negative zone, even though its real year-on-year fall slowed down to 1.8% in September thanks to the subsidised loan programme for the corporate sector.

Looking ahead, monetary policy easing will depend on the effects of past monetary policy measures, the effects of fiscal consolidation and structural reforms, as well as on the assessment of the potential inflationary impact of developments in the international environment.

At this point, the international environment is plagued by uncertainties over the effects of normalisation of the US monetary policy on the financial markets, further evolution of the geopolitical situation and the pace of recovery of the euro area. Continued consistent implementation of fiscal consolidation and structural reforms is essential in order to increase the resilience of the domestic economy to potential external shocks. At the same time, consistent implementation of fiscal consolidation and structural reforms will help improve foreign investors' perception of Serbia as an investment destination. Agreement with the International Monetary Fund on a new arrangement will stand an additional assurance of the credibility of the Serbian economic policy.