NATIONAL BANK OF SERBIA

Speech at the presentation of the Inflation Report – November 2015

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

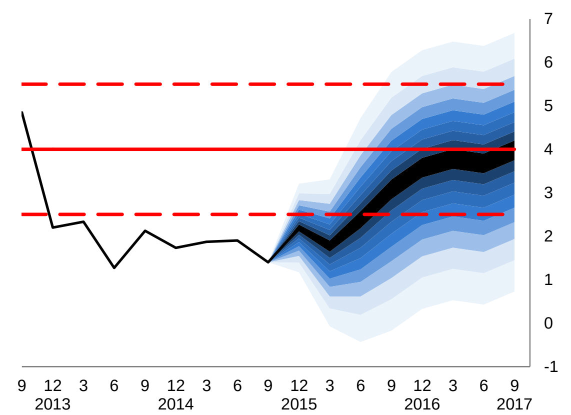
Welcome to the presentation of the November *Inflation Report*, where we will present our analyses of the current and expected economic developments and explain the decisions the National Bank of Serbia has taken based on these analyses.

Observed y-o-y, inflation continued to move below the lower bound of the target tolerance band and GDP continued rising. In line with new information and analyses, our inflation projection is revised slightly downward and the economic growth forecast upward compared to the projections from the August *Report*.

A downward revision to the inflation projection reflects a slower than expected rise in prices of primary commodities. Inflation is expected to hover around the lower bound of the target tolerance band until mid-2016 and trend steadily closer to the 4.0% target thereafter. Expectations of GDP growth rate for the current and the following year have been revised upward as investment increased more than initially estimated. Consequently, GDP is projected to grow by 0.8% in 2015 and by 1.8% in 2016.

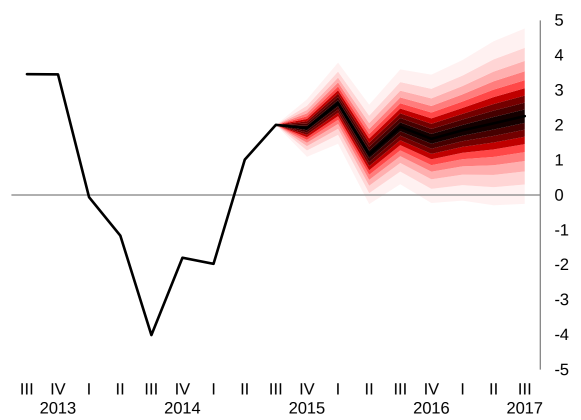
The National Bank of Serbia continued with monetary easing, which reflected on the cost of government and private sector borrowing. Subdued inflationary pressures, progress in fiscal consolidation and reduced external imbalances created room for monetary easing this year. In 2015, the fiscal deficit is expected to drop by around 40% and the current account deficit by one fourth relative to the year before. Furthermore, the latter will almost certainly be covered by foreign direct investment inflow. Coupled with fiscal adjustment, this represents a significant economic policy result, as it strengthens Serbia's resilience to external shocks. Gradual reduction of internal and external imbalances is expected to continue in the years ahead.

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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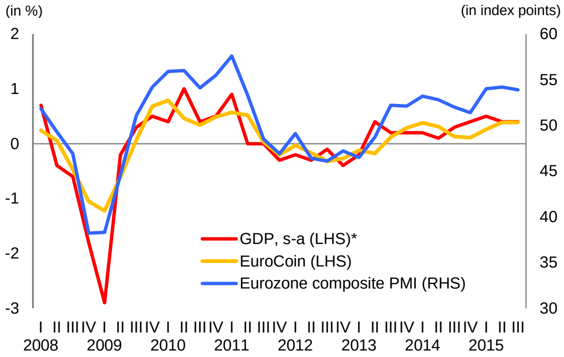
In the previous months, China found itself in the focus of world economic developments. Signals of China's economic slowdown and changes in its exchange rate policy heightened uncertainty in the international financial market in August, exerting downward pressure on financial asset prices in stock exchanges worldwide. The financial market stabilised relatively quickly though, as the Chinese central bank eased its monetary policy stance and the Fed postponed its rate hike.

However, the expected rebalancing of the Chinese economy and slowing of its growth dented global growth prospects and affected the Fed’s and ECB’s monetary policy decisions as key determinants of global liquidity. So far, the Fed has not made the decision to raise its key policy rate, while the ECB announced the possibility of additional stimulus in December, once fresh macroeconomic projections are available.

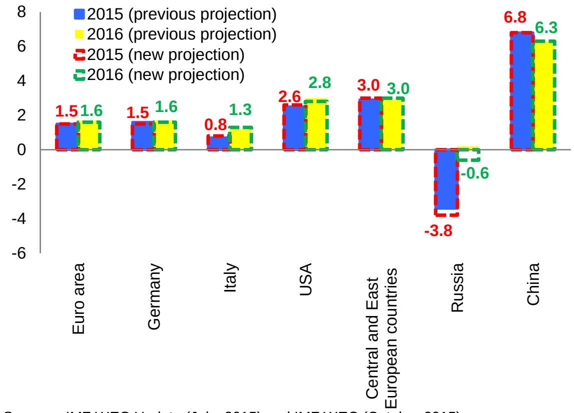
Chart 3 **Movements in GDP and economic activity indicators of the euro area**
(quarterly rates)



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

* Preliminary estimate for Q3 2015.

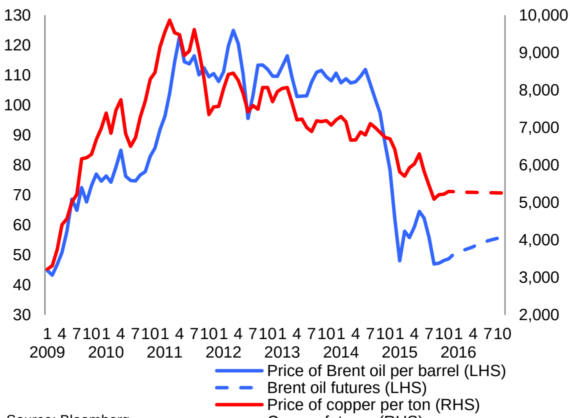
Chart 4 **Revisions of real GDP growth forecasts for 2015 and 2016 by the IMF**
(in %)



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

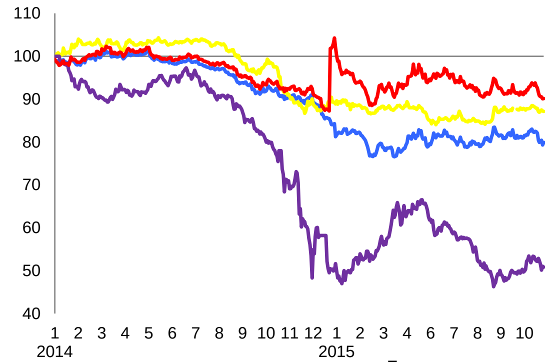
Future movements in oil prices remain a significant source of uncertainty in the international environment. Prices were pulled down by a global economic slowdown and dented demand, but also by increased oil supply, and will likely remain subdued in the period ahead. Deceleration of Chinese economy has affected markets of other primary commodities as well, primarily metals, where prices are considerably depressed. Persistent uncertainties in these markets in the coming period will be a significant factor in forming monetary policy decisions of the National Bank of Serbia and other central banks, as well as one of the determinants of inflation’s return within the target band.

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)

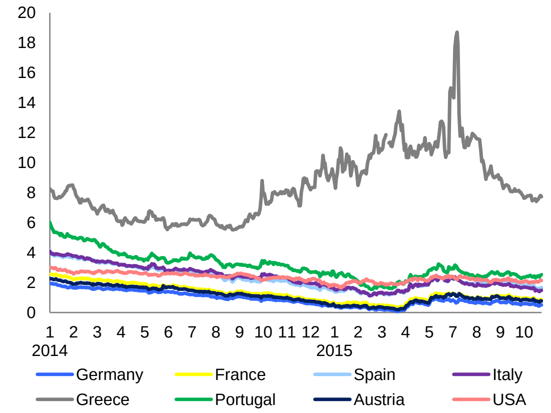


Source: NBS and websites of central banks.

* Growth indicates appreciation.

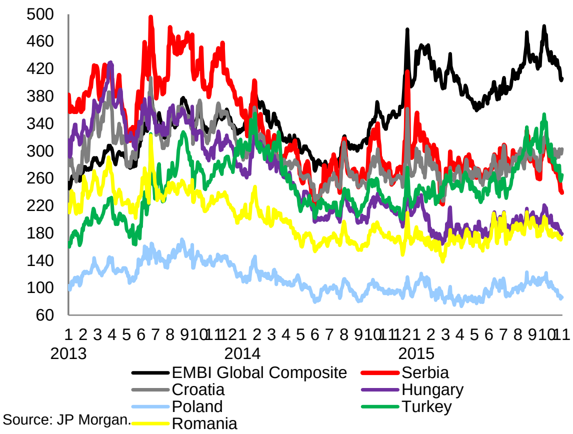
Global factors were a significant driver of volatility of risk premia of emerging economies, including Serbia, especially in the second half of August. As the situation settled, October saw a decline in risk premia, which was more pronounced for Serbia than for many other emerging economies, owing to a considerable reduction in internal and external imbalances, improvement of macroeconomic prospects and successful implementation of the arrangement with the International Monetary Fund. Serbia’s risk premium, measured by EMBI, currently equals 251 basis points, which is 46 points down from the end of the second quarter.

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



Source: Bloomberg.

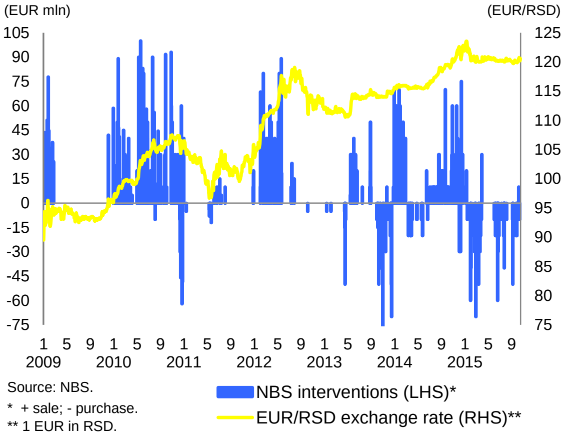
Chart 8 **Risk premium indicator − EMBI by country**
(daily, in basis points)



Source: JP Morgan.

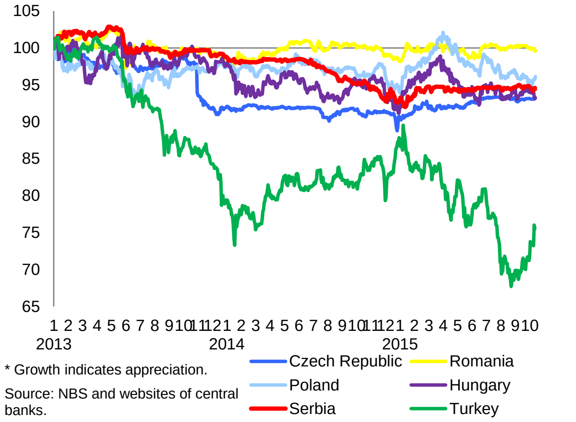
Domestic factors, hand in hand with a higher inflow of foreign direct investment, fuelled appreciation pressures on the dinar. A relatively high inflow of remittances and continued rise in banks' FX-indexed assets also worked toward boosting foreign exchange supply in the past months. In order to moderate excessive strengthening of the dinar, the National Bank of Serbia intervened in the interbank foreign exchange market to buy a total of EUR 520.0 million in the July–October period. It intervened on the sale side on two occasions (August and October), each time selling EUR 10.0 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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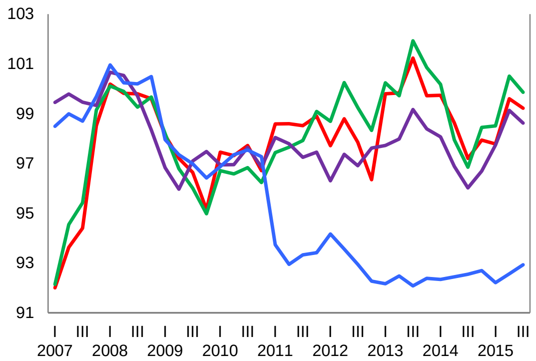
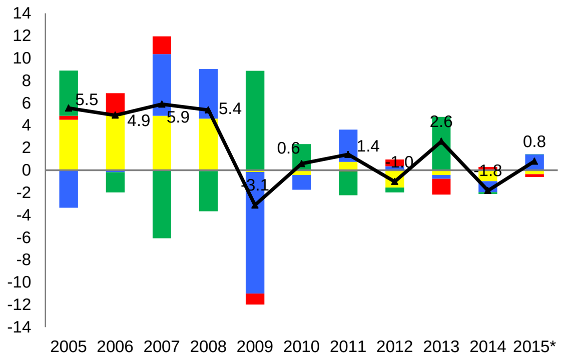
Due to the recovery of production in mining and energy sectors and continued positive trends in construction, the third quarter posted further year-on-year growth in GDP, which according to the flash estimates of the Serbian Statistical Office equalled 2.0%. Following strong growth in the previous three quarters, industrial production subsided in the third quarter as anticipated, which was a major factor behind a mild seasonally adjusted fall in GDP of 0.4%. On the expenditure side, the strongest positive contribution in the third quarter came from private investment sustained by a better financial position of corporates reflecting a drop in oil prices and lower costs of borrowing. Investment growth was also driven by the reforms of the business and investment environment taken over the last two years, as reflected in Serbia's improved international competitiveness ranking in the World Bank list.

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 is expected to grow by 0.8% in 2015 and to step up to 1.8% in 2016. GDP growth rates have been revised up by 0.3 percentage points relative to the August projection due to faster than expected growth in investment. It is favourable that, in contrast to the 2011–2012 period when investment growth was concentrated in oil and automotive industries, investments are now more dispersed. Like in August, we expect that consistent fiscal adjustment and implementation of structural reforms will lead to higher investment. At the same time, negative contribution in 2015 will originate from household and government consumption that will be weighed down by the effects of fiscal consolidation. However, the real fall in household consumption was softer than anticipated owing primarily to low and stable inflation, reduced costs of borrowing, rising remittances and private sector wages.

Economic activity growth in 2016 should be led by investment, mostly in tradable sectors, and after four years, positive contribution is also expected from household consumption. On balance, the risks to GDP projection are judged to be symmetric. Upside risks are mainly associated with stronger than anticipated positive effects of structural reforms and low oil prices, while the key downside risk is the speed of recovery of the euro area, due to a possible slowdown in global growth.

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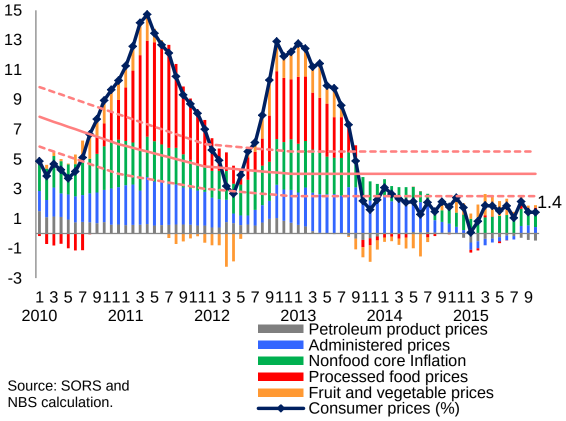
Inflationary pressures remain subdued, as a result of the majority of domestic factors, as well as of low inflation abroad and low prices of primary commodities in the international market. Year-on-year inflation continued to move below the lower bound of the target tolerance band and came at 1.4% in October. Inflation's undershooting of the target since the start of the year mostly reflects the fall in prices of petroleum products and unprocessed food, and low increase in administered prices.

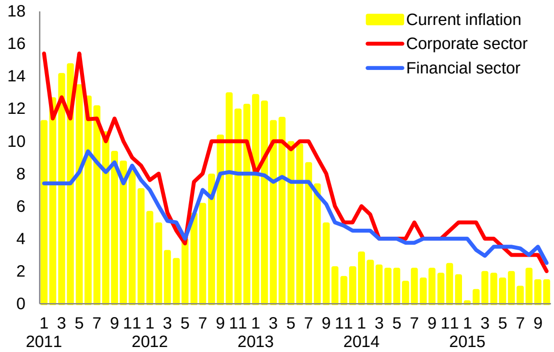
Inflation expectations fell further down due to an extended period of low inflation and anticipated weak inflationary pressures in the period ahead. The financial sector and businesses expect inflation in October 2016 and 2017 to undershoot the target midpoint (4%).

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, y-o-y inflation will be moving around the lower bound of the target tolerance band until mid-2016 and is expected to trend steadily closer to the 4.0% target in H2 2016.

In the short term, inflation will move below the lower bound of the target tolerance band and may return within the band temporarily in January due to low last year's base for petroleum product and cigarette prices which decreased notably late last and early this year. On the other hand, aggregate demand and low inflation in the international environment will continue to act as disinflationary factors, though less so than in the prior period because of the expected recovery of economic activity in Serbia, gradual increase in primary commodity prices in the international market and euro area inflation.

The anticipated gradual increase in primary commodity prices from their currently low levels may lead to a moderate increase in food prices, which have been broadly stable in the last two years due to low production input costs. Food inflation is, however, not expected to exceed the inflation target in the period ahead. Administered prices are assumed to grow by 5% in 2016, which is much lower than the average recorded in the prior years.

The new inflation projection is slightly lower than the previous one and the risks to the projection are mildly tilted to the downside. Risks are mostly associated with movements in global oil and primary agricultural commodity prices, but also with movements in administered prices. It is precisely due to these factors that in the past year inflation moved below the central projection rate from the November 2014 *Inflation Report*, though it remained within the range projected at the time.

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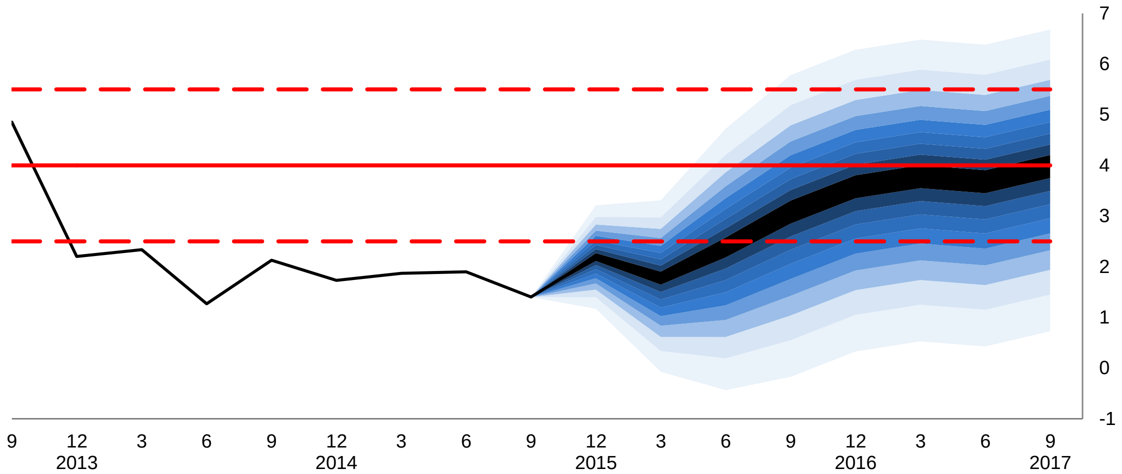
After being cut to 5.5% in August, the key policy rate was trimmed further in each of the next two months by 50 bp to 4.5%. In all, it was cut by a total of 7.25 pp since May 2013. Additionally, in September, the Executive Board decided to lower the FX reserve requirement ratio by 1 pp in each of the next six months. Together with key policy rate cuts, this is expected to lead to a further lowering of bank rates and contribute to the recovery in lending.

As inflationary pressures are likely to stay low in the period ahead, the monetary policy stance of the NBS should remain expansionary. Given the current prevalence of external risks associated with movements in the international financial and commodity markets, the degree of monetary expansion will depend primarily on the assessment of their potential inflationary effect. The NBS will, however, continue to be cautious and conduct its monetary policy so as to ensure a sustainable return of inflation to target level in the medium term.

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



Source: NBS.