



NATIONAL BANK OF SERBIA

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

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Directorate for Economic Research and Statistics

Belgrade, 21 November 2016

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

Welcome to the presentation of the November *Inflation Report*, which has just been published on our website. Today we will present a summary of the key information from the *Report*, most notably, information about current economic trends, new macroeconomic projections and monetary policy decisions.

As the Governor has already pointed out, the key monetary policy decision taken in the period since the August *Inflation Report* is the lowering of the inflation target down to $3.0\% \pm 1.5$ pp, effective as of next year. The decision to lower the target was made in cooperation with the Government, based on a significant improvement in Serbia's macroeconomic fundamentals and prospects and the achieved and maintained price stability. According to our new projection, which is slightly lower than the previous one, y-o-y inflation will enter the new target band early next year, and continue to move within the band in the period thereafter. Speaking of economic activity, an excellent agricultural season prompted us into yet another upward revision of GDP, the third one this year – this time to 2.7%. For the time being, GDP growth projection for 2017 remains unchanged at 3%.

Consistent with the expectations stated in the August *Report*, a further narrowing has been recorded in internal and external imbalances. Owing to successful fiscal consolidation and structural reforms, a particularly sharp fall was recorded in the **fiscal deficit**, which should amount to 2.1% of GDP this year. Public debt is also expected to decrease, for the first time since 2008 and one year earlier than anticipated. Owing to exports rising faster than imports, **current account deficit** is going further down and its share in GDP should shrink to 4.1% in 2016. This year again, at EUR 1.8 billion or 5.2% of GDP, foreign direct investment will be more than sufficient to cover the current account deficit.

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

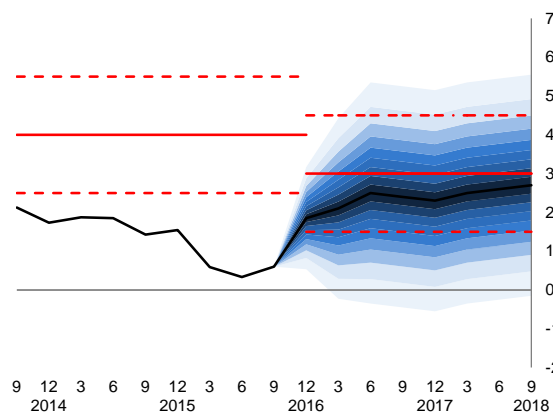
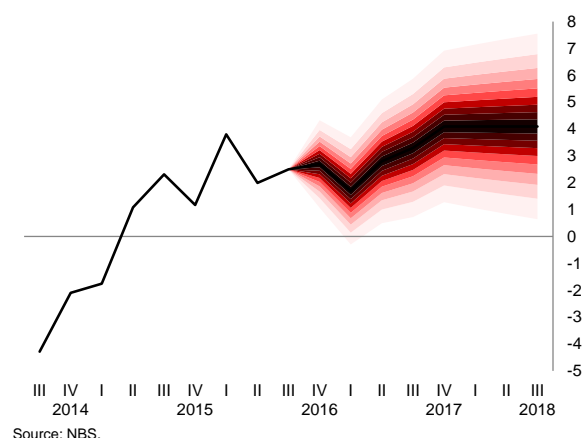


Chart 2 **GDP growth projection**
(y-o-y rates, in %)

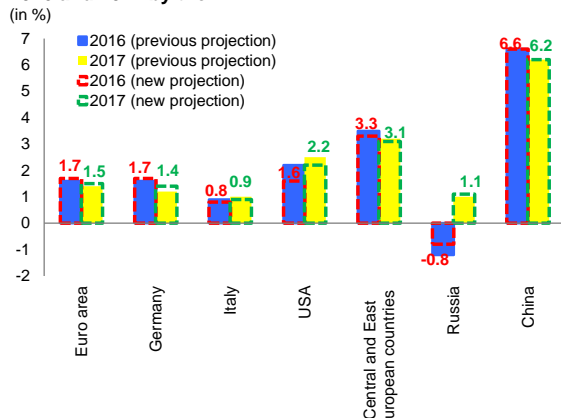


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Esteemed members of the press, fellow economists,

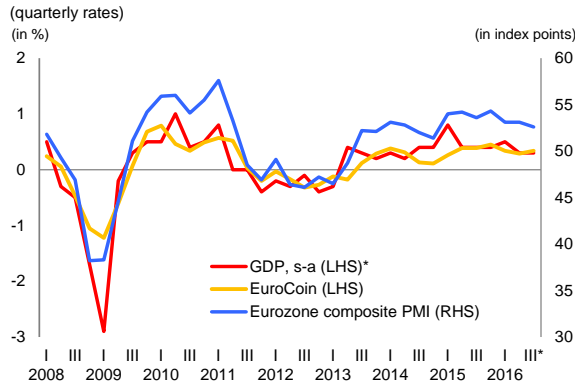
From the standpoint of monetary policy, the main uncertainties in the international environment remain associated with future measures of leading central banks – the Fed and the ECB. While generally satisfied with the progress of the US economy, the Fed has not yet decided to raise the policy rate further. The ECB has also kept its rate on hold, along with its asset purchase programme, pointing out that the undertaken monetary policy measures have efficiently underpinned the economic recovery of the euro area. Growth prospects of the euro area, our main trade partner, have improved to a degree from three months ago, as Brexit repercussions turned out softer than feared. Thus, the IMF expects that the euro area GDP will grow 1.5% this year, which is 0.1 pp more than projected in July and similar to the ECB's estimate of 1.6%.

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



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

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

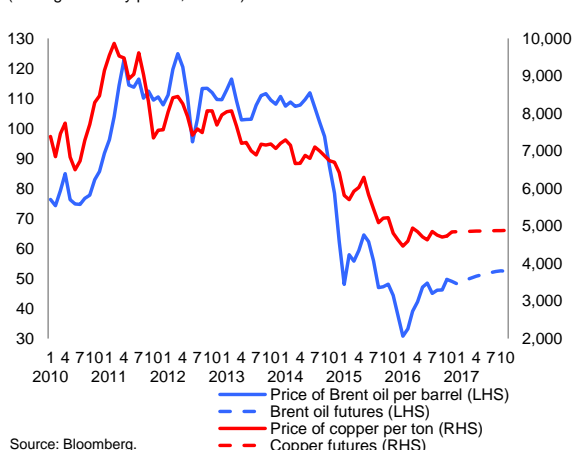


Sources: Eurostat, Markit Group and Banca d'Italia.

* Eurostat preliminary estimate.

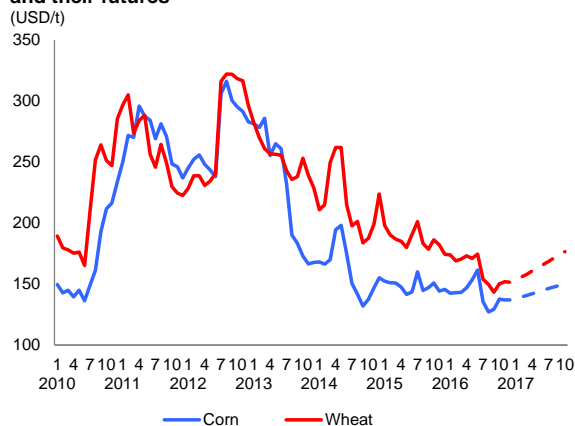
Another major uncertainty concerned the movement of global oil prices, which started to bounce back in the third quarter, but still ended the quarter 1.5% lower than at its beginning. The announcements of the world's leading producers that they would reach a deal to limit production, sent global oil prices rising early in October, but the upward trend could not be sustained due to the record supply in that month. Consistent with oil futures, our projections assume relatively low oil prices in the period ahead – USD 46 per barrel at the end of this year and USD 51 per barrel in December 2017.

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.

Despite the uncertainties in the international environment, which may produce either positive or negative effects, the resilience of our economy to potential unfavourable developments in the international environment has increased owing to the narrowing of internal and external imbalances. This is reflected in the fall of the country risk premium. Measured by EMBI, Serbia's risk premium dropped by 59 basis points in the third quarter to reach 225 basis points. Its fall was also supported by the IMF's positive assessment of Serbia's performance under the stand-by arrangement and a relatively quick stabilisation of the international financial markets in the wake of Brexit. In October and early November, emerging countries' risk premia have edged up somewhat due to the global factors, but still remained lower than early in the year. Serbia's risk premium currently stands at 263 basis points.

Chart 7 Current account deficit and net capital inflow
(in EUR mln)

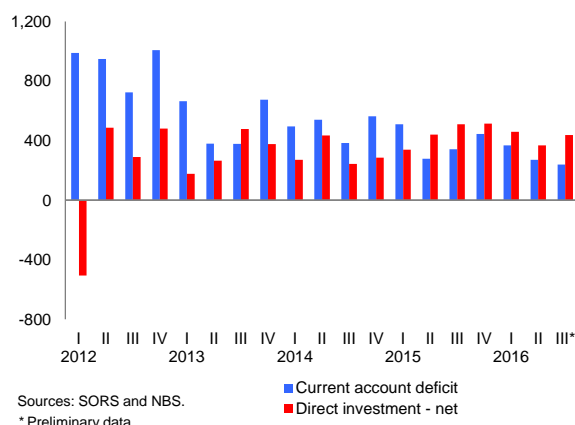
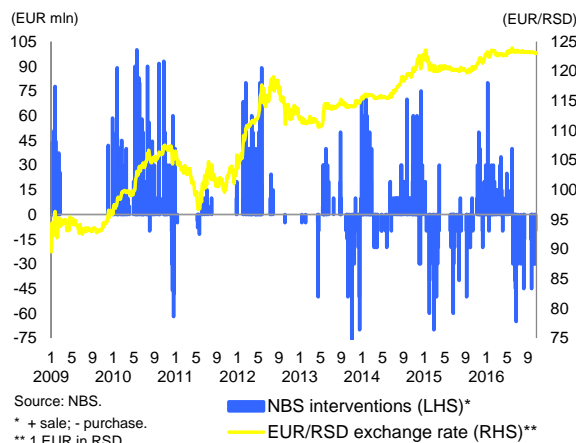


Chart 8 Movements in EUR/RSD exchange rate and NBS FX interventions



Reflecting the success of fiscal consolidation and structural reforms, fiscal imbalances have narrowed down sharply since the beginning of the year. In the first nine months of 2016 general government deficit amounted to 0.1% of GDP, compared to 1.8% of GDP in the same period last year. At the same time, the current account deficit dropped by more than 20% year-on-year and was fully (by 144%) covered by the inflow of foreign direct investment.

The reduction of macroeconomic imbalances and the drop in the country risk premium sparked non-resident interest in buying long-term government dinar securities. This added to appreciation pressures on the dinar, especially early in the third quarter. In order to ease excessive short-term volatility of the exchange rate, the National Bank of Serbia intervened in the Interbank Foreign Exchange Market by buying EUR 680.0 million since July.

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Economic recovery has continued. As a result of an excellent agricultural season and sustained favourable trends in manufacturing and construction, economic growth in the third quarter exceeded our expectations. According to our estimates, GDP rose by 0.5% from a quarter earlier and 2.5% relative to the same period last year. The growth in industrial production continued thanks to the activation of earlier investments, lower operating costs and economic recovery of the euro area. Also, construction grew further owing to the continued intensive implementation of infrastructure projects. Growth in most service sectors continued, while mining and electricity began to recover amid gradual completion of overhauls in electric energy plants. On the expenditure side, GDP growth in the third quarter was led by investment, with a positive contribution also coming from net exports.

According to our estimate, GDP will rise by around 2.7% this year owing to favourable trends in agriculture, manufacturing, construction and some service sectors. GDP growth will speed up to around 3%, led by investment on the expenditure side. In 2017, final consumption is also expected to provide a positive contribution amid expected rise in employment and private sector wages, higher disposable income based on lower cost of borrowing and, to a degree, the announced increase in minimum wages, as well as in public sector wages and pensions. The contribution of net exports will remain positive in 2017 as well.

Chart 9 **Contributions to y-o-y GDP growth**
(in pp)

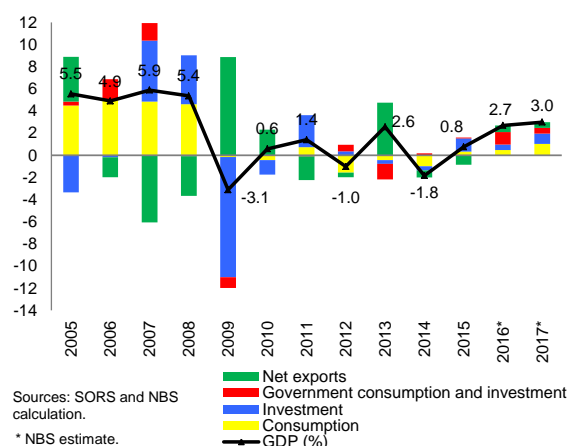
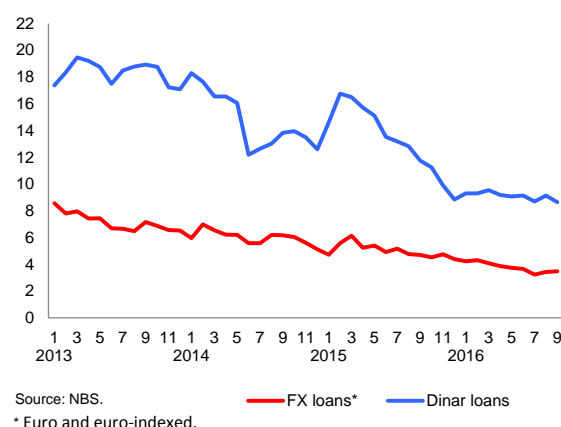


Chart 10 **Interest rates on new loans to private sector**
(weighted average values, p.a., in %)



A reduction in the cost of private sector borrowing continued in the third quarter. Interest rates on new dinar loans to corporates and households went down by an average 0.5 percentage points to 8.7%. In the same period, interest rates on new euro-indexed loans to corporates and households inched down by 0.2 percentage points to 3.5%. The decline is primarily a result of past monetary easing, lower risk premium, increased interbank competition and low euro area rates. The above factors and the acceleration in economic activity propped up lending activity, which grew 4.3% year-on-year in September.

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Inflationary pressures remained low under the influence of the majority of domestic factors, low global prices of oil and primary agricultural commodities, and low inflation abroad. In the third quarter, consumer prices increased by 0.2% (0.6% in year-on-year terms in September), undershooting our expectations stated in the previous *Report*, mainly due to depressed prices of unprocessed food.

Chart 11 **Contribution of CPI components to y-o-y inflation**
(in pp)

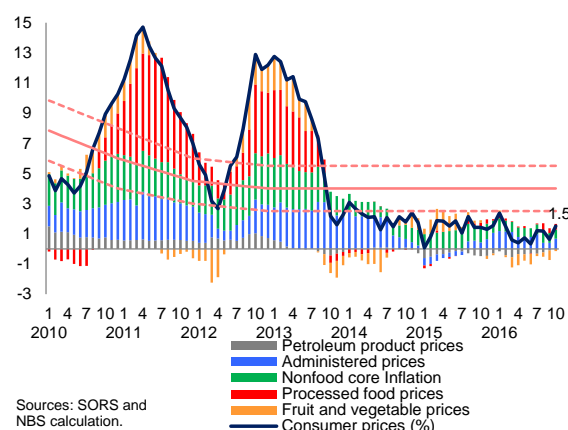
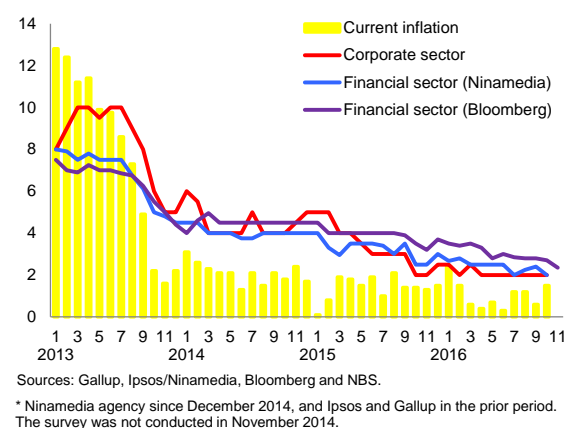


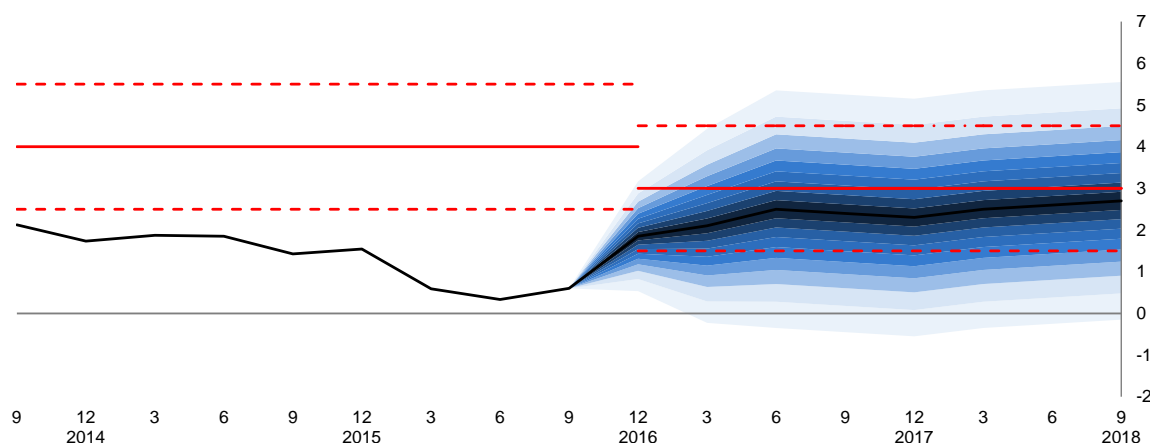
Chart 12 **Current inflation and one-year ahead inflation expectations***
(y-o-y rates, in %)



Year-on-year inflation rose to 1.5% in October as a result of the low-base effect of some components and the increase in electricity prices. We expect that the low base of petroleum product prices, the recovery in demand and inflation in the international environment, above all in the euro area, will drive inflation up in the following months. On the other hand, a good agricultural season drove the prices of primary agricultural commodities down both at home and abroad, resulting in lower food production costs, which will hold inflation back for some time to come.

According to our central projection, year-on-year inflation will stay low and stable, and will move within the new target tolerance band (3.0% ± 1.5 pp) from the beginning of next year until the end of the projection horizon.

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



The new inflation projection for 2017 is lower than the one published in the *August Report*, primarily due to the downward revision of assumptions regarding global prices of primary agricultural commodities and lower than assumed administered price growth this year. The risks to the projected inflation path are symmetric, relating primarily to future developments in international commodity and financial markets and, to a certain degree, to administered price growth at home next year.

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In consideration of the inflation outlook, the expected effects of past monetary easing and uncertainties in the international environment, the Executive Board has kept the key policy rate unchanged at 4.0% since July. In making the decision in November, the Board also took account of the new, lower inflation target starting from 2017.

In the coming period, the National Bank of Serbia will continue to closely monitor domestic and international economic movements, in particular trends in the international financial market and global prices of primary commodities. It will then accordingly calibrate its decisions, staying committed to maintaining low and stable inflation, preserving financial stability and supporting the implementation of economic policy of the Government.

Esteemed members of the press, fellow economists,

Inflation Report text boxes always reflect on the most topical issues. The November *Report* contains four text boxes that look into interesting topics: the first one gives an in-depth elaboration of the lowering of the inflation target; the second deals with the automobile industry and its contribution to Serbia's industrial and exports growth; the third tackles the effect of the new agricultural season on GDP growth, and the fourth looks into the recorded fiscal movements, which have exceeded all of our expectations during the year. We strongly recommend these analyses, as they address topics significant for our economy.

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