NATIONAL BANK OF SERBIA

Speech at the presentation of the Inflation Report – November 2017

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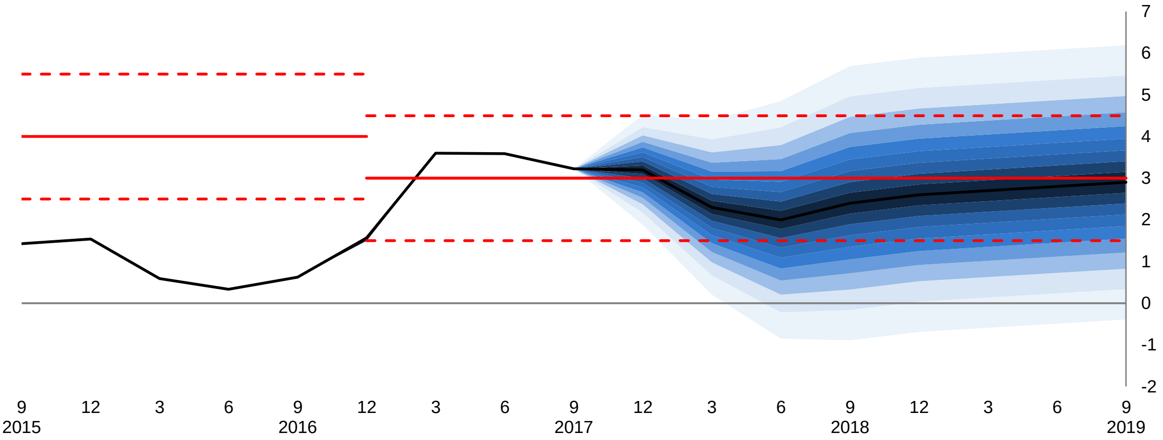
Ladies and gentlemen, esteemed members of the press, dear colleagues,

Welcome to the presentation of the November *Inflation Report*. We will present the key information from this *Report*, primarily the current economic developments, our new macroeconomic projections and the adopted monetary policy decisions.

Since early 2017, inflation has been moving within the target tolerance band (3.0±1.5%) and has slowed over the past months. In addition to headline inflation, core inflation slowed as well, which indicates – along with inflation expectations that are anchored within the target band of the National Bank of Serbia – that inflationary pressures are still low. Inflation slowed somewhat more than expected, notably due to the weaker than estimated effects of the drought on food prices. This, along with lower import prices compared to the previous projection, is the main reason why we revised downward this inflation projection as well.

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

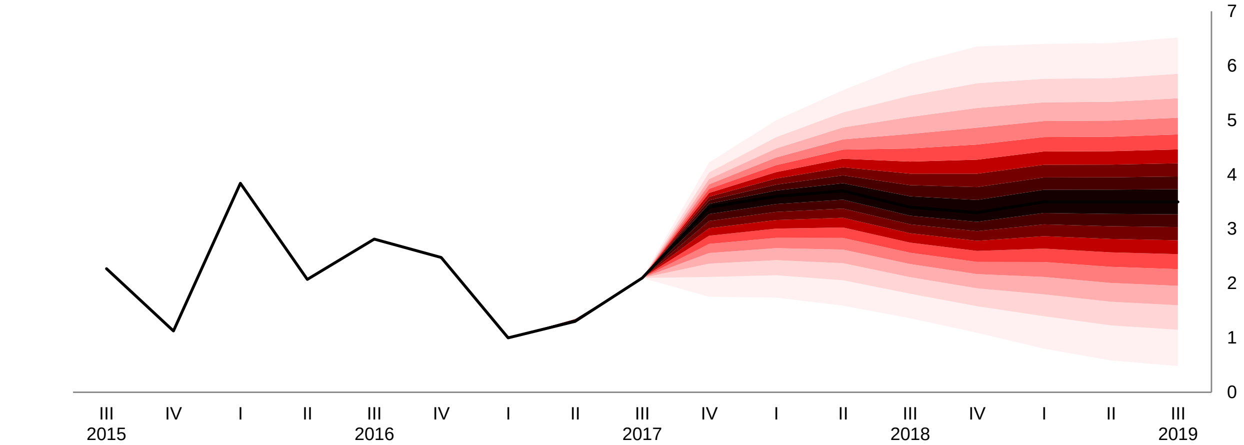


Source: NBS.

At the same time, after measuring 2.0% this year, GDP is expected to step up to around 3.5% in 2018 and 2019. The basis for sustainable acceleration of growth includes, first of all, a further upgrade of the business environment, a high and project-diversified inflow of foreign direct investment, implementation of infrastructure projects, past monetary policy easing and acceleration of global economic growth.

Commodity exports have witnessed robust growth this year as well, while keeping broad product and geographical dispersion. Imports also increased, notably on account of the effects of cold weather early in the year and higher industry needs for equipment and intermediate goods.

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



Source: NBS.

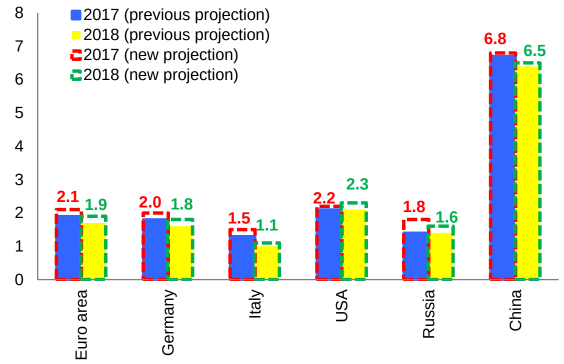
The current account deficit is estimated at 4.6% of GDP and will be more than fully covered by the net foreign direct investment inflow, which was higher by 12.6% in the year so far compared to the same period of 2016.

Fiscal trends are still exceeding expectations, primarily due to the significant growth in fiscal revenue. Instead of a deficit, expected until recently, a surplus was achieved, measuring 2.6% in the first nine months, or 5.8% of GDP excluding interest expenses. The share of central government public debt in GDP, whose rising trajectory was reversed last year, continued down this year as well.

* * *

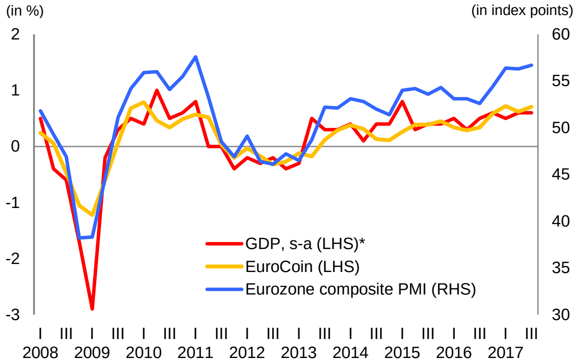
In the year to date, global economic growth has been unfolding at a faster pace than expected, primarily in the euro area. This resulted in an improved growth outlook of the euro area, and thus the growth outlook of Serbia's other important foreign trade partners.

Chart 3 **Revisions of real GDP growth forecasts for 2017 and 2018 by the IMF**
(in %)



Sources: IMF WEO (October 2017) and IMF WEO Update (July 2017).

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

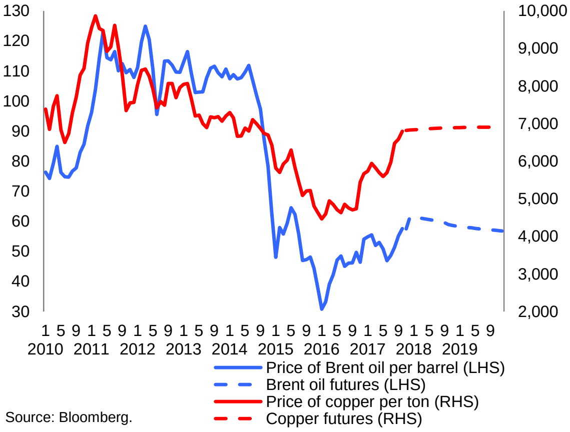


Sources: Eurostat, Markit Group and Banca d'Italia.

* Eurostat preliminary estimate for Q3 2017.

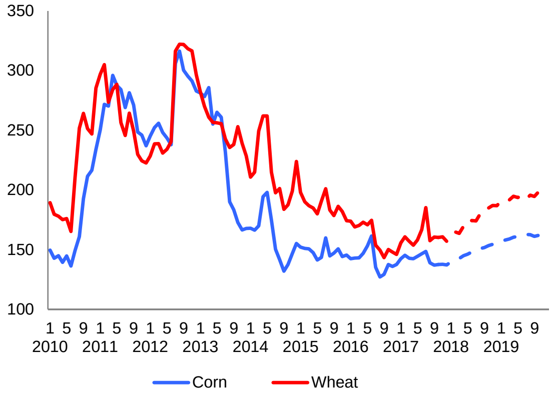
The global market of primary commodities is still fraught with uncertainty. Oil prices have been volatile over the past months, but with an upward tendency. They have been led by supply-side factors, such as capping production, hurricanes, geopolitical tensions, and expectations that oil demand will rise with acceleration of global growth. Thus, in early November, Brent oil prices reached 64 dollars per barrel, which is their highest level since June 2015. However, based on futures, which we use in our projection like other central banks, oil prices will remain relatively stable and in the next two years are likely to move below 60 dollars per barrel. Significant deviations are certainly possible, both due to supply-side and demand-side factors.

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.

In terms of the prices of primary agricultural commodities, a much better than expected global agricultural season restricted their growth, which will therefore be lower this year than previously assessed. We expect that the prices of these products in the domestic market will mirror their counterparts in the world, given their connectedness, and that their growth will continue next year as well, though at a somewhat more moderate pace.

Despite the step-up in growth, most countries still show no credible signs of rising inflation. Moreover, due to euro's appreciation against the dollar, the euro area inflation projection was revised slightly down, while the European Central Bank extended the quantitative easing programme at least until September 2018, reducing the monthly amount to 30 billion euros. The continuation of the quantitative easing programme should contribute to the preservation of favourable terms of funding in the euro area and inflation's return to the target. On the other hand, the Federal Reserve System began unwinding its balance sheet in October and is expected to make the decision on a new increase in its fed funds rate in December.

While the divergence of monetary policies of leading central banks breeds uncertainty over global capital flows to emerging economies, Serbia included, improved economic outlook reflected positively on the readiness of investors to invest in the Central and Eastern Europe region. Along with the improvement of domestic macroeconomic fundamentals on account of the further narrowing in macroeconomic imbalances, this resulted in the fall in Serbia's risk premium and its movement around the lowest level since records began (April 2005). Measured by EMBI, Serbia's risk premium currently stands at 118 basis points.

Greater readiness of investors to invest in Serbia is reflected also in the capital inflow which was high above the current account deficit in the third quarter, contributing to appreciation pressures. Apart from the capital inflow, appreciation pressures were also fuelled by better export results, increased household demand for dinars and an increase in foreign currency-indexed assets of banks. In the third quarter, the dinar strengthened by 1.2% against the euro and by 4.3% against the dollar, primarily due to significant strengthening of the euro against the US currency. In order to alleviate excessive short-term strengthening of the dinar, in the third quarter the National Bank of Serbia intervened in the interbank foreign exchange market by buying 605.0 million euros. Appreciation pressures continued into the current quarter and the National Bank of Serbia intervened by buying additional 155.0 million euros.

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

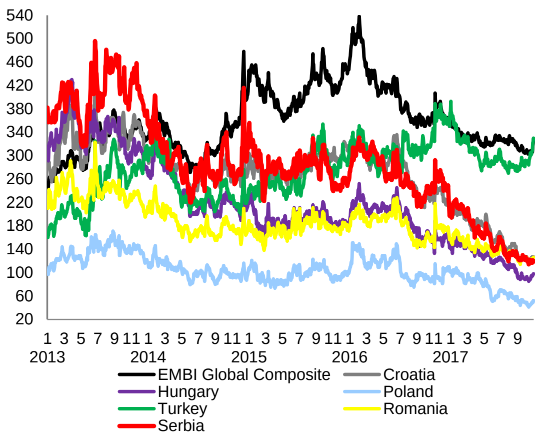
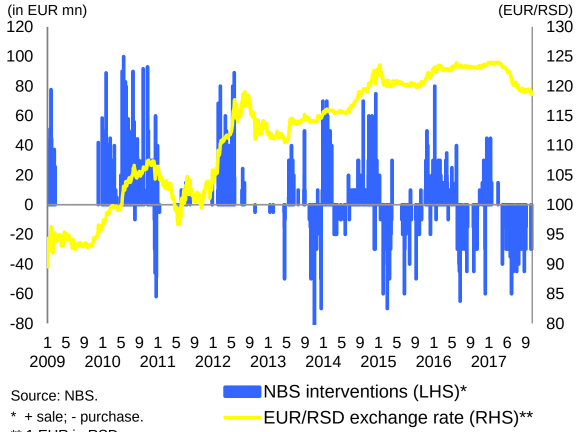


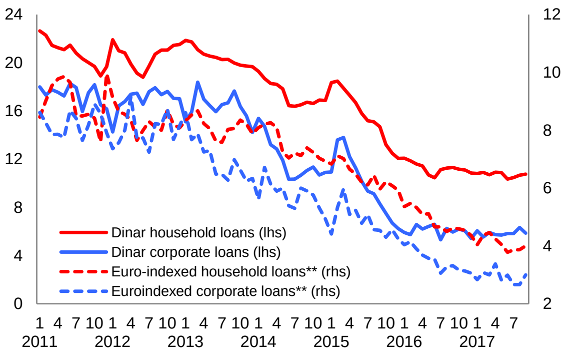
Chart 8 **Movements in EUR/RSD exchange rate and NBS FX interventions**



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

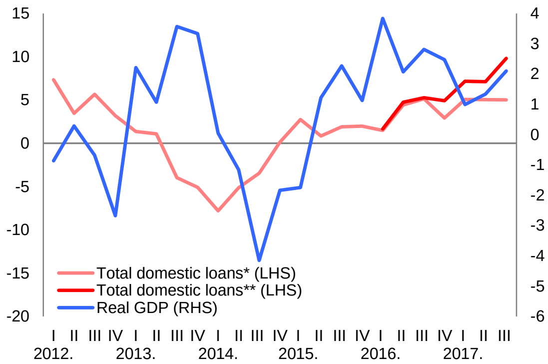
Past monetary easing of the National Bank of Serbia, a fall in the risk premium, increased interbank competition, growth of economic activity and recovery in the labour market, as well as low interest rates in the euro area, all contributed to acceleration of lending growth. In September, that growth came at 5.0% year-on-year (excluding the exchange rate effect), despite the sizeable write-offs of non-performing loans (NPLs). Excluding the effect of NPL write-offs over the last year, lending growth reached 9.8%, with the increased contribution of corporate loans. We expect that NPL resolution will provide additional support to lending and, by extension, to economic growth in the period ahead.

Chart 9 **Interest rates on new dinar and euro-indexed loans to corporates and households***
(weighted average values, p.a., in %)



Source: NBS.
* Excluding revolving loans, current account overdrafts and credit card debt.

Chart 10 **Lending activity and GDP**
(y-o-y rates, in %)

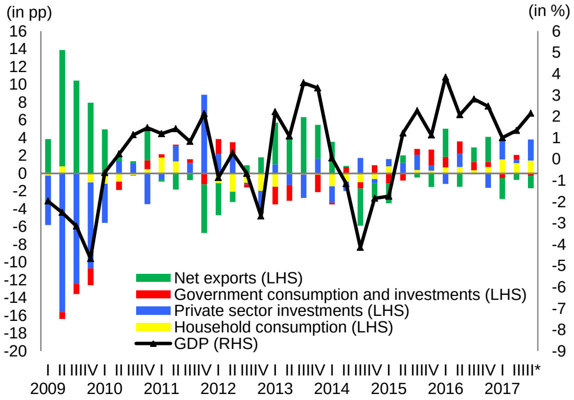


Sources: NBS and SORS.
* Excluding the exchange rate effect.
** Excluding the effect of NPL write-off in the past year.

* * *

Economic activity accelerated in the third quarter. Namely, with the gradual waning of effects of the supply-side shocks which mainly hit agriculture and energy, and given the good performance of the remaining part of the economy, manufacturing in particular, GDP rose by 2.1% year-on-year. With the further acceleration until the end of the year, GDP growth in 2017 will amount to around 2%. Economic activity outside agriculture and energy will grow at a rate of 3%, while manufacturing is likely to experience even considerably faster growth.

Chart 11 **Contributions to y-o-y GDP growth rate – expenditure side***

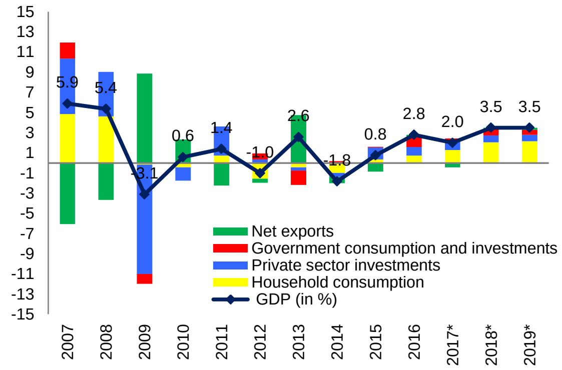


Sources: SORS and NBS calculation.

* NBS estimate.

Chart 12 **Contributions to real GDP growth**

(in pp)



Sources: SORS and NBS calculation.

* NBS estimate.

In 2018 and 2019, GDP growth is expected to accelerate to around 3.5%. One of the drivers of economic growth should be private investment, owing to further improvement in the business environment, a high inflow of foreign direct investment, infrastructure projects and past monetary policy easing. In addition, a rising positive contribution is also expected from household consumption, on account of an increase in employment and wages. We also expect further growth in exports, owing to investment and higher external demand. On the production side, GDP growth should be led by industry and services, with the positive contribution of construction.

The risks to the projection for this year are mildly asymmetric downward and are primarily associated with performance in the agriculture, mining and energy sectors. With the normalisation of conditions in these sectors, risks are asymmetric upward for the next year on the same grounds.

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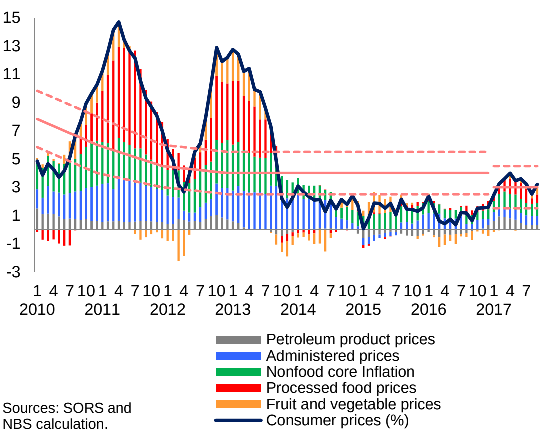
Year-on-year inflation has been slowing down as of May, to 2.8% in October. The slowdown was prompted by lower year-on-year growth of energy and food prices, reflecting the base effect of prices of petroleum products and meat, as well as lower imported inflation. Also, inflation was lower than expected in the previous *Inflation Report*, since the effects of drought on movements in fruit and vegetable prices turned out to be smaller than initially estimated. That inflationary pressures remained low is evidenced also by the movement of core inflation, which slowed down to 1.4% in October, as well as by inflation expectations anchored within the National Bank of Serbia’s target band.

Chart 13 **Contribution of CPI components to y-o-y inflation**

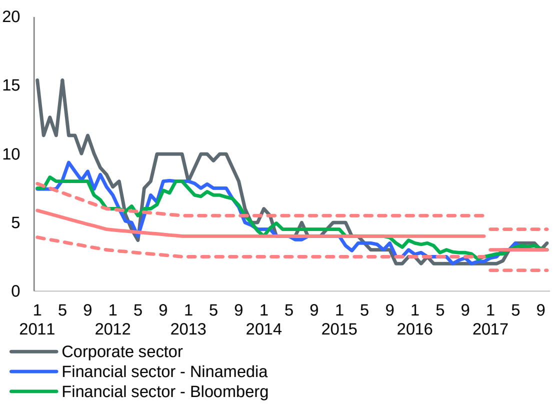
(in pp)



Sources: SORS and NBS calculation.

Chart 14 **One-year ahead inflation expectations**

(y-o-y rates, in %)



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

Under the short-term projection, inflation until the end of the year will be stable and hover around the National Bank of Serbia’s target midpoint.

As for medium-term inflation, our new central projection again confirmed that until the end of the projection horizon, i.e. in the next two years, year-on-year inflation will continue to move within the target tolerance band of 3.0±1.5%.

In the first half of the next year, inflation is likely to move below the target midpoint, due to the high base in prices of petroleum products and other products which recorded one-off price hikes early this year. The expected rise in prices of primary agricultural commodities and aggregate demand will work in the opposite direction.

This inflation projection is lower than the previous one, both for 2017 and the first half of the next year. The reason for the downward revision is that increases in consumer prices in the third quarter and in import and administered prices this year were lower than expected under the August projection.

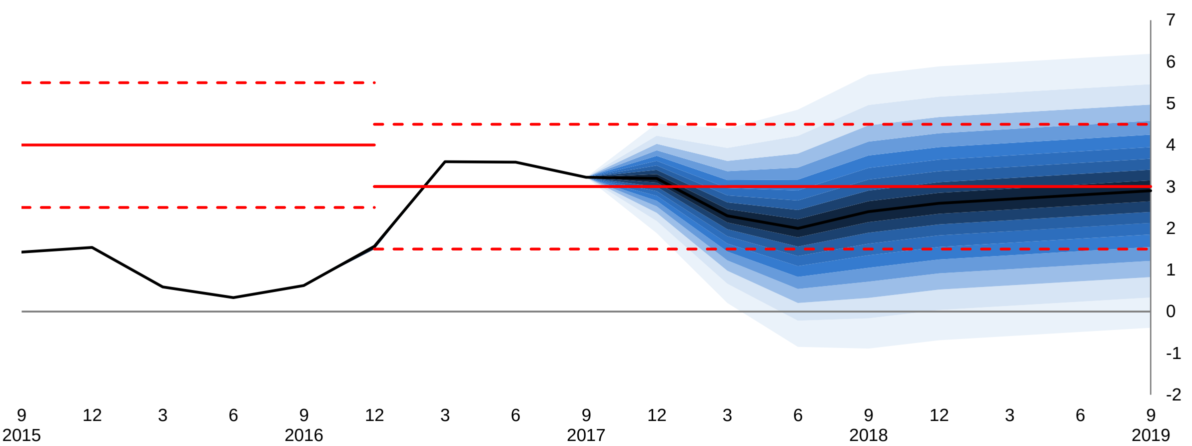
The risks to the projected inflation path are symmetric and relate primarily to future developments in the international commodity and financial markets and, to a degree, administered price growth.

* * *

In the period since the last *Inflation Report*, the Executive Board trimmed the key policy rate in September and October, by 25 basis points each. At 3.5%, it touched its lowest level since the introduction of the inflation targeting regime. The Executive Board decided to continue with monetary policy easing bearing in mind the medium-term inflation projection from August and the additional weakening of inflationary pressures on account of factors from the domestic and international environment.

The reduction in the key policy rate gave an additional boost to credit activity and economic growth. Taking into account past monetary policy easing and the new inflation projection from November, the movements in key inflation factors, better economic performance in the third quarter and outlook for the period ahead, in November the Executive Board decided to keep the key policy rate unchanged.

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



Source: NBS.

As so far, the National Bank of Serbia will carefully monitor economic developments at home and in the international environment and take timely action in order to maintain the achieved price and financial stability, thus also contributing to general macroeconomic stability.

Esteemed members of the press, dear colleagues,

Please note that the November *Inflation Report* contains three text boxes. In the first, we analysed movements of different inflation indicators in 2017, in the second – credit growth and the results achieved in NPL resolution and in the third – indicators of Serbia's competitiveness.

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