NATIONAL BANK OF SERBIA

Speech at the presentation of the Inflation Report – August 2019

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Economic Research and Statistics Department

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

We shall now present the current macroeconomic developments in the domestic and international environment, our new inflation and economic activity projections, as well as monetary policy decisions.

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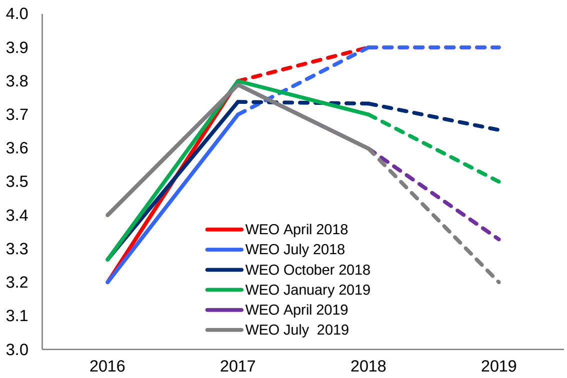
I would like to begin with an overview of developments in the international environment, as they are still one of the more relevant challenges to the monetary policy of the National Bank of Serbia, as well as to that of other central banks in emerging market economies. Concerns over global growth, which emerged in mid-2018, turned out to be justified – trade, investment and industrial production at the global level slowed down since the start of the year, and trade tensions remain the main risk going forward. Recently, the International Monetary Fund again revised its global growth projection down, anticipating a slowdown to 3.2% this year and a pick-up to 3.5% next year. Presently, support to the global economy is coming in the form of a shift in the monetary policies of leading central banks, which should ensure more favourable financial conditions and give an incentive to global investment activity.

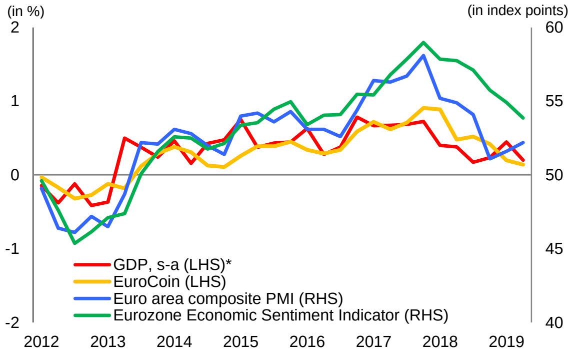
For the euro area, our key trade partner, we expect a slower growth dynamics for the remainder of the year, while the positive impact of domestic macroeconomic fundamentals will prevail in the medium term, supported by the ECB's announced monetary stimulus. As for countries in our region, which are also our important trade partners, expectations are more favourable than three months ago owing to domestic demand, though their growth in this and the following year is estimated to be lower than in 2018.

Chart 1 **IMF global growth projections for 2018 and 2019**
(in %)



Source: IMF WEO.

Chart 2 **Movements in euro area GDP and economic activity indicators**
(quarterly rates)

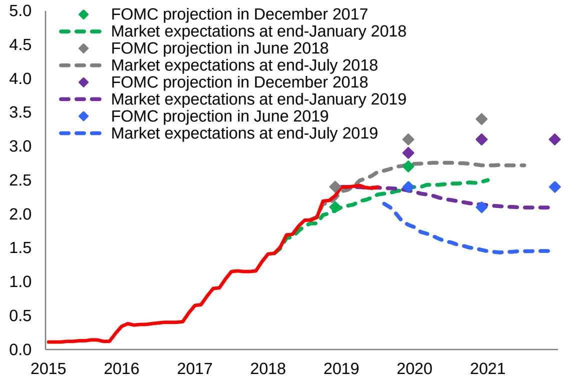


Sources: Eurostat, Markit Group, Banca d'Italia and European Commission.

* Eurostat preliminary estimate for Q2 2019.
** ESI is standardised relative to PMI.

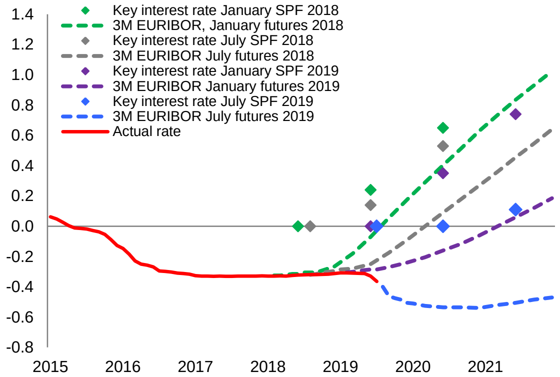
Against the backdrop of global slowdown and low inflation, the expected trajectories of leading central banks' policy rates have been revised down. The Federal Reserve System trimmed its policy rate at end-July, offering no clear explanations as to whether this is a one-off adjustment or whether the rate will be trimmed further. The European Central Bank announced an unchanged or even lower level of its key interest rates at least through mid-2020, with a new programme of longer-term financing as of September. This should have a positive effect on conditions in the international financial market and capital flows towards emerging countries. Even so, it remains to be seen to which degree such moves of leading central banks will deviate from market expectations, which requires caution because of the possible impact on global capital flows.

Chart 3 **Expected Fed funds rate***
(p.a, in %)



Sources: Fed and Bloomberg.
* Market expectations based on futures.

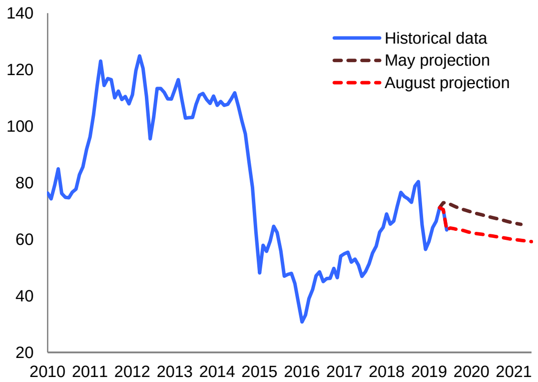
Chart 4 **Expected ECB key interest rate* and futures for three-month EURIBOR**
(p.a., in %)



Sources: ECB and Bloomberg.
* ECB Survey of Professional Forecasters (SPF).

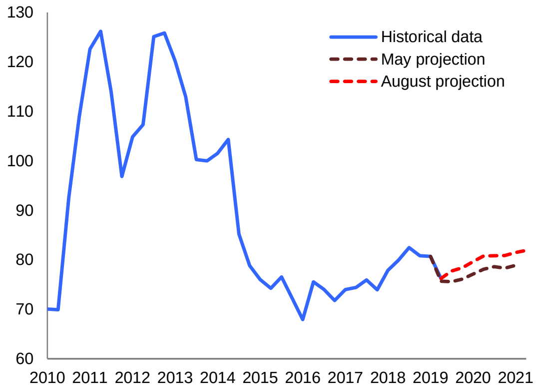
Uncertainty with regard to the future developments in the international environment is also associated with the global prices of primary commodities. There is uncertainty regarding the global oil price, which reached USD 74 per barrel in May and then declined to around USD 60 per barrel amid dampened global demand and stepped-up production in the USA. According to futures, no major changes in the global oil price are expected until the end of the year, or in the two years beyond. As suggested by futures, no significant changes in the prices of primary agricultural commodities in the world market are expected either.

Chart 5 **Assumption for Brent oil prices**
(USD/barrel)



Source: Bloomberg.

Chart 6 **Assumption for international prices of primary agricultural commodities**
(Q4 2013 = 100)



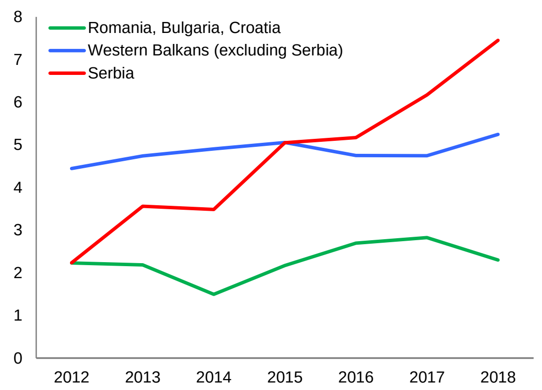
Sources: CBOT, Euronext and NBS calculation.

In contrast to uncertainties in the international environment, the domestic macroeconomic conditions of monetary policy conduct remain favourable. The trend of good fiscal results was maintained in the first half of the year, with the fiscal surplus of 0.7% of GDP. The favourable fiscal developments are underpinned by the rising economic activity and profitability of corporates, as well as positive labour market developments. The significant increase in government capital expenditures and higher public sector wages and pensions represent sources of financing investment and consumption, though not to the extent that would cause major inflationary pressures and disrupt the downward trajectory of the share of public debt in GDP, which declined to 51.4% at end-June. At the same time, the currency and refinancing risks were lowered, given that the dinar share of public debt increased to 27%, and the dollar share declined to 22%, owing to the early repayment of a portion of the debt on account of the eurobond maturing within the next two years.

The share of external debt in GDP is also declining – coupled with the FDI inflow which is among the highest in the region, this contributes to the sustainability of the country's external position. With a 9% share in GDP in the first six months of the year, FDI continues to fully cover the current account deficit, which remains under the impact of rising investment and weaker external demand. Despite the slowdown in external demand, export growth stayed relatively high thanks to new production capacities, as well as the sale of agricultural inventories from the previous season. The import of goods rose slightly faster than export and, as in the prior period, it was dictated by the higher import of raw materials and equipment. In conditions of higher consumer demand, we also recorded a rise in the import of consumer goods.

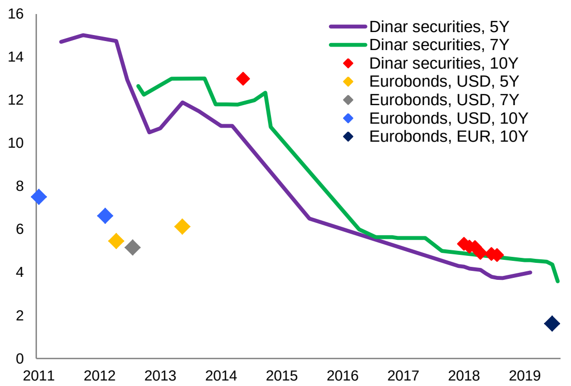
At the annual level, we estimate that the share of the current account deficit in GDP will be similar to last year's, while in the medium term it is expected to decline further, considering the investments that were channelled to tradable sectors. In the coming years, the current deficit is expected to remain more than fully covered by FDI.

Chart 7 **Net FDI inflow to Serbia and the region**
(in % GDP)



Sources: NBS, websites of central banks and Eurostat, NVBS calculation.

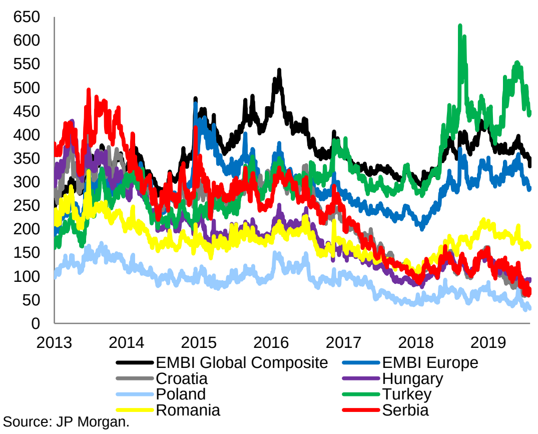
Chart 8 **Interest rates in the primary market of dinar government securities and eurobonds**
(p.a., in %)



Source: Ministry of Finance.

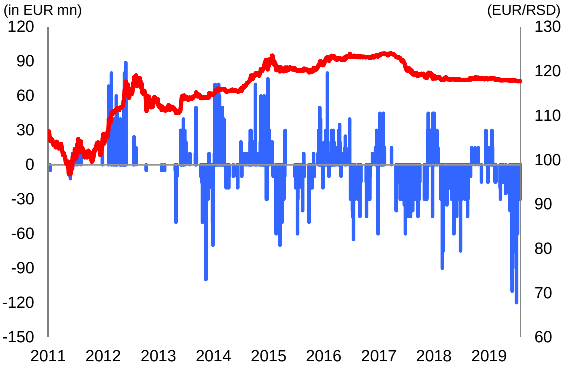
The improved internal and external position of the country, along with sustainable economic growth, provides the basis for further improvements in our country's outlook. This is confirmed by a number of indicators, notably investors' readiness to make long-term investments in Serbia at yield rates that are constantly declining. Also, Serbia's risk premium is among the lowest in the region – in July it fell below 60 bp, its lowest level on record. Appreciation pressures, which remained dominant in the past period as well, intensified as of June, and the National Bank of Serbia intervened in order to mitigate excessive short-term volatility of the dinar to the euro. Since the start of the year, the National Bank purchased EUR 1.8 bn net in the FX market, thus increasing the country's FX reserves.

Chart 9 **Risk premium indicator – EMBI by country**
(daily, in basis points)



Source: JP Morgan.

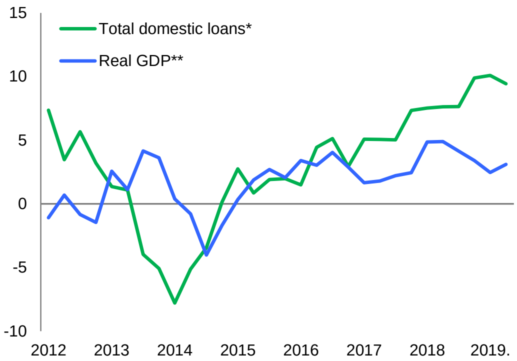
Chart 10 **Movements in EUR/RSD exchange rate and NBS FX interventions**



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

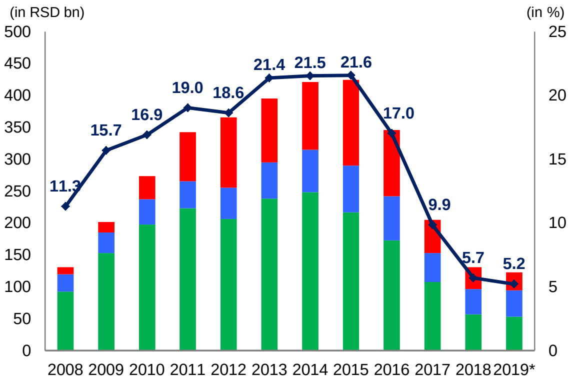
The sustainability of narrowed imbalances, inflation kept firmly under control for the sixth consecutive year, and the increasingly certain monetary accommodation by leading central banks prompted the Executive Board to cut the key policy rate by 25 bp both in July and August, to the new lowest level in the inflation targeting regime (2.5%). This should reflect positively on financing conditions and a further reduction in interest rates on dinar loans. Along with growth in economic activity, wages and employment, lower interest rates will contribute to further stable growth in private sector loans, which in June picked up by 9.4% y-o-y. As NPL resolution efforts continued, growth in lending contributed to the further fall in the NPL share in total loans to the new lowest level on record – 5.2% in June, down by 17.2 pp since the adoption of the NPL Resolution Strategy.

Chart 11 **Lending activity and GDP**
(y-o-y rates, in %)



Sources: NBS and SORS.
* Excluding the exchange rate effect.
** NBS estimate for Q2 2019.

Chart 12 **NPL share in total loans, gross principle**



Source: NBS.
* June 2019.

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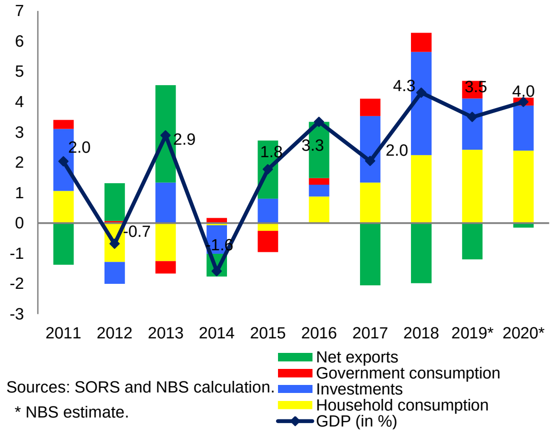
The domestic drivers of economic growth compensated for the negative impact of external factors, so the economic activity continued to rise in the second quarter for the nineteenth consecutive quarter. The growth was faster than in the first quarter and, according to our estimate, led by acceleration in the construction sector, and a further rise in service sectors. On the expenditure side, GDP growth was led by investment in the second quarter as well, owing to the continued implementation of infrastructure projects, improvement of the business environment and favourable sources of private sector financing. GDP growth is also affected by household consumption, on account of rising wages and employment and lower loan-related costs.

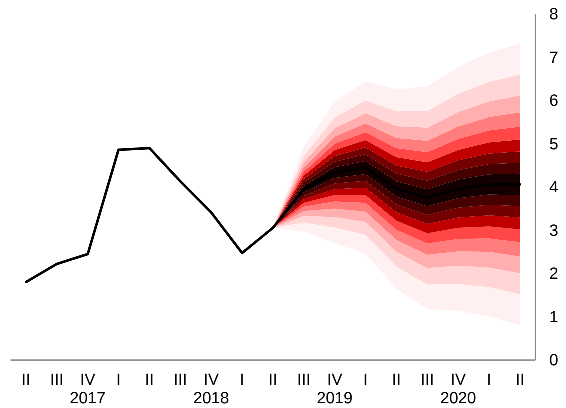
We kept the GDP growth forecast for 2019 at 3.5% and, as in the previous projection, we expect it to be led by domestic demand, whose positive contribution is greater owing to faster growth in investment and final consumption since the start of the year. On the other hand, the contribution of net exports is negative due to lower external demand. In the medium run, we expect economic growth to accelerate to around 4%, led by a sustainable rise in investment, exports and household consumption. The medium-term risks to the GDP projection are assessed as symmetric. In the short run, the risks emanating from the international environment are tilted to the downside, mirroring the potentially greater than expected slowdown in external demand. The risks at home are tilted to the upside, over the potentially faster than estimated growth in investment.

Chart 13 **Contributions to annual GDP growth**
(in pp)



Sources: SORS and NBS calculation.
* NBS estimate.

Chart 14 **GDP growth projection**
(y-o-y rates, in %)

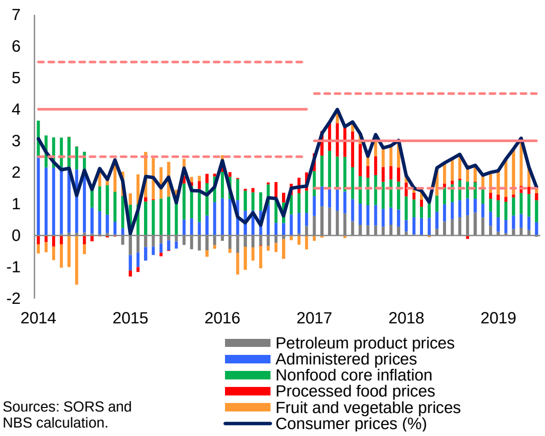


Source: NBS.

* * *

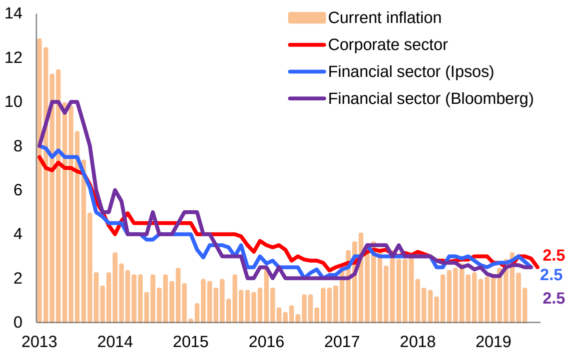
Inflation is moving with the target tolerance band (3±1.5%) this year as well. After reaching 3.1% in April, which is estimated to be its maximum this year, y-o-y inflation decelerated and touched 1.6% in July. That inflationary pressures are low is confirmed by low and stable core inflation, which measured 1.5% y-o-y in July, as well as financial and corporate sector inflation expectations, which declined in July and are moving below the target midpoint.

Chart 15 **Contribution of CPI components to y-o-y inflation**
(in pp)



Sources: SORS and NBS calculation.

Chart 16 **Current inflation and one-year ahead inflation expectations***
(y-o-y rates, in %)



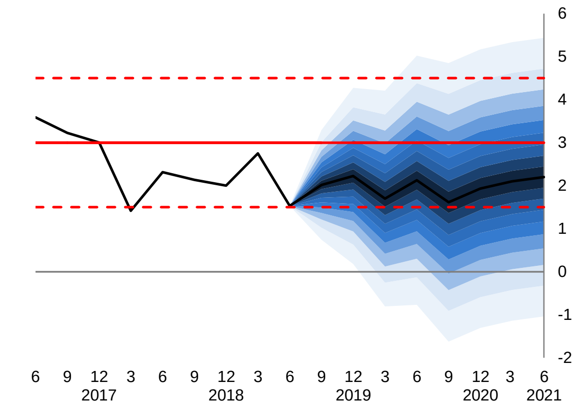
Sources: Gallup, Ipsos/Ninamedia, Bloomberg and NBS.

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

Under the August central projection as well, y-o-y inflation is expected to continue to move within the target tolerance band until the end of the projection horizon – most probably in the lower part of the target band.

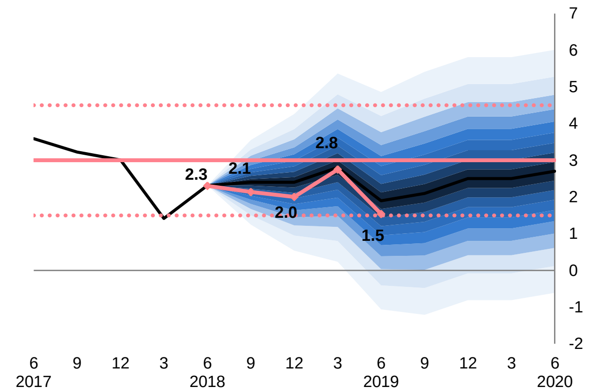
Projected low and stable inflation is supported by low cost-push pressures and sustainable growth in aggregate demand. The current inflation projection until the end of this year is slightly lower compared to the May projection, most notably over the deceleration in y-o-y growth in vegetable prices and lower petroleum product prices. Uncertainties surrounding the inflation projection are associated primarily with developments in the international commodity and financial markets.

Chart 17 **Inflation projection**
(y-o-y rates, in %)



Source: NBS.

Chart 18 **Achievement of August 2018 inflation projection**
(y-o-y rates, in %)



Source: NBS.

Allow me to briefly reflect on our projection presented in August last year, that being the monetary policy horizon within which the policy's full effect on inflation comes to the fore. As you can see, in the last year inflation moved fully in line with the path projected in August 2018, which contributes to the strengthening of trust in the National Bank of Serbia and anchored inflation expectations. That the National Bank of Serbia efficiently controls inflation and that inflation will remain low and stable in the coming period is also confirmed by the assessments and projections of relevant international institutions. The confidence in monetary policy, both at home and abroad, enhances its efficiency and strengthens the resilience of our economy to potential adverse effects of developments in the international environment.

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Ladies and gentlemen, dear colleagues,

At the end of my presentation, I would like to emphasise once again that the August *Inflation Report* contains four text boxes on topical issues:

1. The first text box elaborates on Serbia's economic prospects in terms of the foreign capital inflow;
2. The second text box analyses Serbia's increasingly better position in the global services market;
3. The third text box focuses on total factor productivity and its contribution to Serbia's GDP growth;
4. The fourth text box looks into changes to the global growth outlook and possible effects on Serbia.

Thank you for your attention.