NATIONAL BANK OF SERBIA

Speech at the presentation of the *Inflation Report* – August 2021

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Economic Research and Statistics Department

Belgrade, 18 August 2021

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

We shall now present in more detail our latest macroeconomic projections, assessments of current macroeconomic developments and key underlying domestic and international factors.

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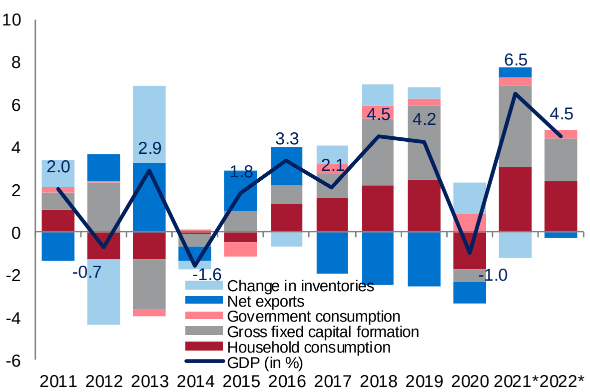
As highlighted by Governor Tabaković in her introductory speech, we have revised up our real GDP growth projection for 2021 from 6.0% to 6.5% taking into account favourable trends in the first six months and the anticipated developments in key sectors of the economy in the second half of the year. Growth could be even higher in case of stronger FDI inflows and further acceleration of government investment in infrastructure. This would bring us closer to having an average annual economic growth of 3% during the two years of the pandemic, an outturn likely to be recorded by only few other economies in Europe. It should also be noted that the above projection includes highly conservative growth assumptions for Q3 and Q4 of this year. Namely, we have assumed another spike in coronavirus infections during autumn both at home and abroad. If this wave of the pandemic proves to be weaker, implying no major economic consequences, our growth could exceed 6.5%.

According to our assessment, fixed investment will increase by around 17% this year, accounting for more than a half of this year's economic growth of 6.5% and contributing 3.8 pp to GDP growth.

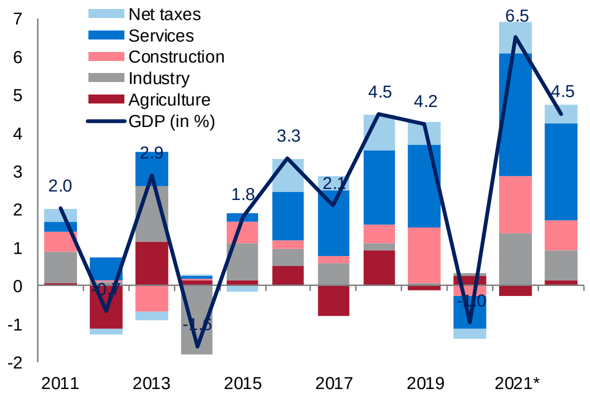
We expect personal consumption to go up by 4.5%. Net export is also anticipated to provide a positive contribution, with export rising more quickly than import of goods and services.

Chart 1 **Contributions to real GDP growth, expenditure side**
(in pp)



Sources: SORS and NBS.
* NBS estimate for 2021 and 2022.

Chart 2 **Contributions to real GDP growth, production side**
(in pp)

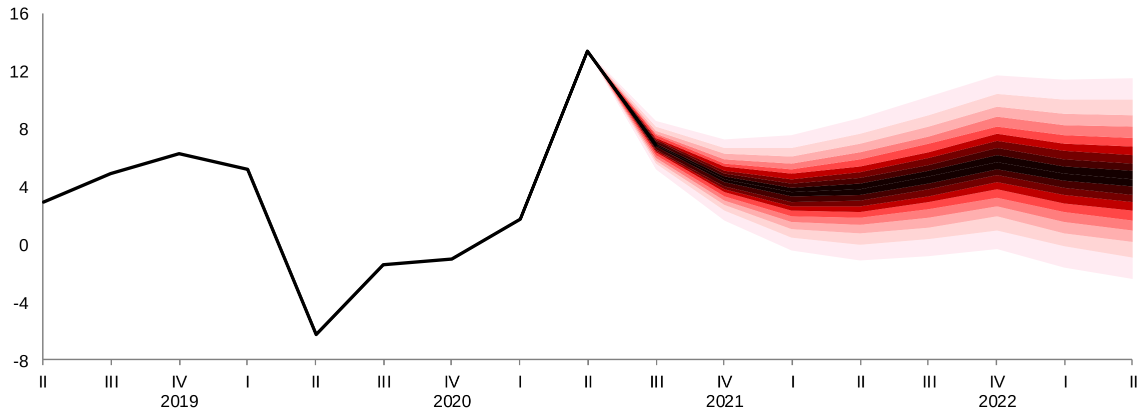


Sources: SORS and NBS.
* NBS estimate for 2021 and 2022.

The only negative contribution will come from changes in inventories, due to the anticipated gradual decline in inventories of industrial products and the agricultural season, which we assume to be somewhat weaker than last year. On the **production side,** in addition to robust growth in construction, this year we also expect a full recovery of activity in most service sectors and continued growth in manufacturing. The rebound in service sectors will be buttressed by the rise in consumption as the epidemiological situation improves and disposable income goes up. These expectations are also supported by favourable trends in the labour market, and growth in private sector wages. Industrial production growth will be propped up by the activation of new and expansion of existing capacities and the gradual removal of bottlenecks in global supply chains on the supply side, and by the expected acceleration of economic growth of our main foreign trade partners and increased absorption of the domestic market on the demand side.

With regard to medium-term economic growth, we judge that conditions have been met for us to revise up our medium-term GDP growth projection for the first time, from 4.0% as we previously anticipated to a range of 4% to 5%, having in mind the announced infrastructure projects in rail, road, energy and utility infrastructure, and their direct and indirect effects on GDP. Details relating to the new GDP projection and the impact of construction on economic growth and other macroeconomic indicators are available in a special text box we prepared as part of this *Report.* Our key expectation is that the share of construction in GDP will touch around 7% next year and remain at a high level over a longer time period, whereas the share of fixed investment ought to reach and exceed 26% of nominal GDP.

Chart 3 **GDP growth projection**
(y-o-y rates, in %)



Source: NBS.

According to our estimate, higher investment in infrastructure will have a positive impact on other segments of construction and the rest of the economy – most of all, on growth in industry, trade, transport, tourism and catering, but also on sectors such as finance and real estate business. Overall, the risks to the GDP projection are judged to be symmetric, while uncertainty in the short-term remains associated mostly with the global course of the pandemic and its impact on economic activity. Risks are also associated with future movements in prices of primary commodities and metals, and the duration of bottlenecks in production and transport which have to some degree been present almost all the time since the outbreak of the pandemic. Moreover, the speed of global recovery and the character of inflationary pressures will also determine movements in the international financial market, global financial conditions and, by extension, capital flows to emerging economies. We judge the risks from the domestic environment to be mildly tilted to the upside, primarily on account of potentially higher than expected FDI inflows.

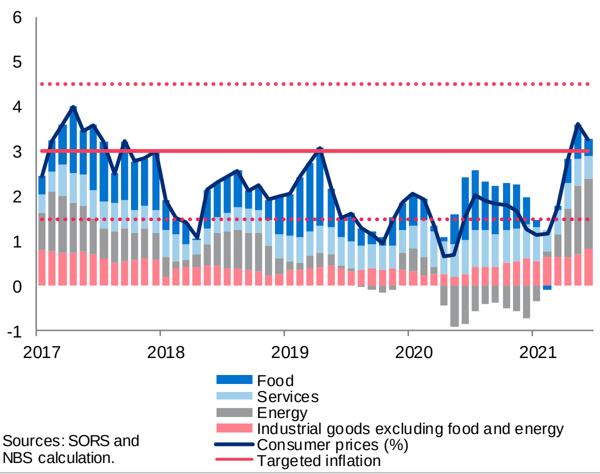
On the other hand, as higher investment and faster GDP growth will entail substantial imports of equipment and intermediate goods, **we have revised our current account deficit projection in the medium term from 4.0% of GDP as we previously anticipated to a range of 4% to 5% of GDP. The current account deficit will remain fully covered by the net inflow of FDI.** The rise in export capacities, together with high product and geographical diversification, as well the anticipated global economic recovery will continue to work towards improving the external position.

When it comes to the impact of economic growth on inflation, **we estimate that faster GDP growth will not have an inflationary character** as the improved quality of infrastructure raises the economy's productivity. As the quality of infrastructure also has a decisive significance in stimulating private sector investment and growth in production capacities, the effect of demand on inflation ought to remain unchanged. Improvement of infrastructure quality could also work towards alleviating potential inflationary pressures as it will quite probably also lead to lower operating costs in the economy.

After the GDP projection, I will now touch upon some of the details from the inflation projection, a particularly current topic these days.

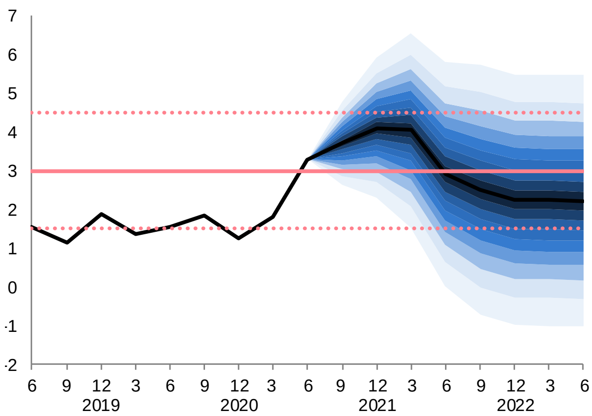
After moving at around 1% in the first two months, in March y-o-y inflation returned within the bounds of the target tolerance band. Inflation thereafter hovered around the target midpoint (measuring 3.3% y-o-y in June and July), which is consistent with our expectations set out in the May *Inflation Report.* Higher inflation than at the start of the year resulted primarily from a low base from the same period last year, particularly for petroleum product prices. Moreover, elevated global prices of oil and other primary commodities in the past months resulted in higher cost-push pressures in the global and domestic market, primarily in food and energy production. A special text box we prepared for this edition of the *Report* presents an overview of the impact of the base effect on inflation, as well as of the impact of global prices of primary commodities through producer prices. On the other hand, despite robust economic growth, there have been no major demand-side inflationary pressures that are more persistent in character.

Chart 4 **Contribution to y-o-y consumer price growth**
(in pp)



Sources: SORS and NBS calculation.

Chart 5 **Inflation projection**
(y-o-y rates, in %)



Source: NBS.

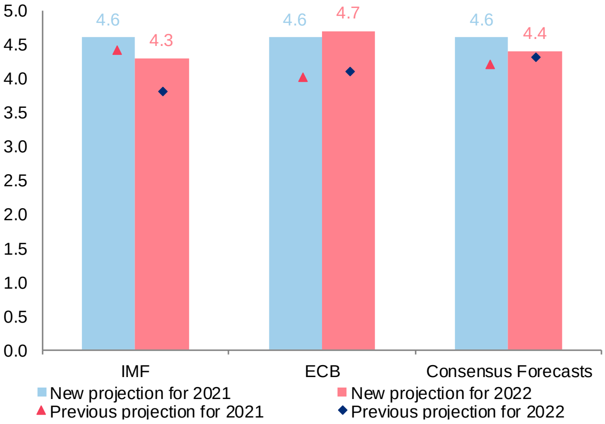
When it comes to inflation in the coming period, under our projection it will remain within the upper part of the target tolerance band of 3±1.5% for some time to come. With the waning of the effects of this year's rise in global prices of primary commodities and cost-push pressures in production and transport, as of Q2 2022 we expect inflation to slow gradually towards the target midpoint of 3% and move within the lower part of the target tolerance band in the latter half of 2022 until the end of the projection horizon.

That these are temporary inflationary pressures, which is the stance of leading central banks as well, is also supported by the fact that y-o-y core inflation in Serbia is still around 2%. Our projections show that core inflation should continue to move around 2% in the coming period as well and record mild growth only at the end of the projection horizon. Given the anticipated movement of inflation within the bounds of the target tolerance band going forward and the relatively stable exchange rate, which is the underlying factor of price stability, we expect inflation expectations to remain stable until the end of the projection horizon. The risks to the inflation projection are judged to be symmetric. For the most part, they remain associated with the international environment and pertain primarily to the speed of global economic recovery, which will also affect the global prices of primary commodities and capital flows to emerging economies. To a lesser degree, there are also risks in the domestic market, primarily associated with the outcome of the new agricultural season and further dynamics of domestic demand.

All macroeconomic projections – and this one is no exception – have to be based on certain assumptions. One of the important assumptions included in all of our projections pertains to movement in external demand. We expect it to recover significantly this year, owing primarily to progress in vaccine rollout. We assumed that real GDP growth in the euro area this and the following year will be 4.6% and 4.4%, respectively, which is in accordance with the projections of leading international financial institutions. Full recovery in the euro area is expected during next year, whereafter euro area economic growth should normalise in 2023 and equal around 2%.

Chart 6 **Revisions of euro area GDP growth projections for 2021 and 2022**

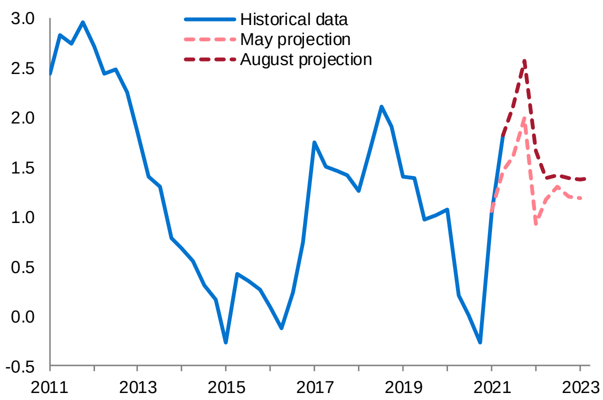
(in %)



Sources: IMF, ECB and Consensus Forecasts.

Chart 7 **Assumption for euro area inflation**

(y-o-y growth, in %)



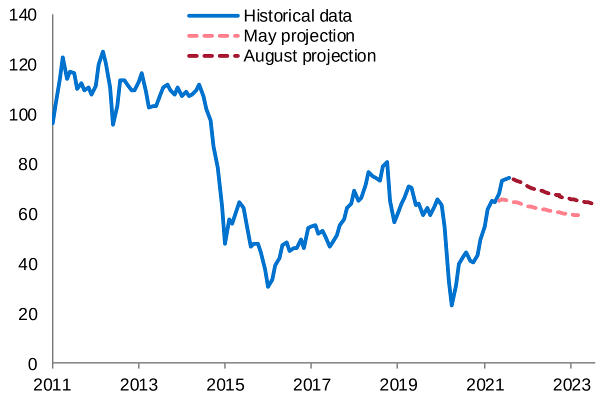
Source: NBS calculation based on projections of relevant institutions.

When talking about inflation in the international environment, projection for this and the following year assumes the average annual euro area inflation of 1.9% and 1.5%, respectively, which is in line with the latest projection by the ECB. Also, macroeconomic projections presented to you today were prepared under the assumption that favourable conditions in the international financial market will be maintained.

Leading central banks in the world, the Fed and the ECB, continued to pursue an accommodative monetary policy to ensure faster recovery from last year's recession. According to the new Guideline issued by the ECB in July, interest rates will remain at their present or lower levels until inflation reaches 2% well ahead of the end of its projection horizon and durably for the rest of the projection horizon. The Fed's latest projections envisage an increase of the federal funds rate slightly sooner than previously expected, but not before 2023. On this account we expect continued high liquidity and favourable financial conditions in the international environment, which should reflect on capital inflow to Serbia and favourable price of euro-indexed loans in the domestic market.

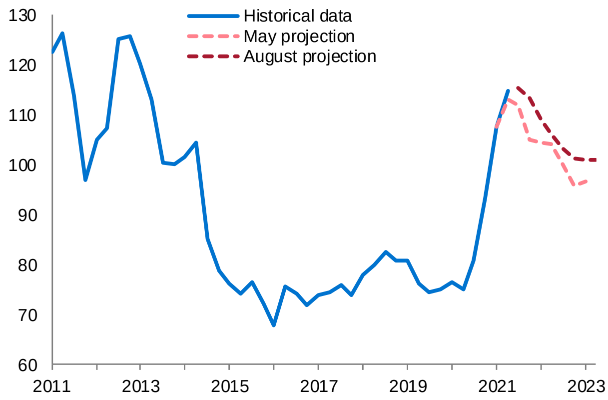
Uncertainty in the international financial market primarily pertains to how much future moves by leading central banks will differ. It is also important to which extent these moves will deviate from market expectations, which mandates caution due to the possible impact on global capital flows and, by extension, capital flows to emerging economies, including Serbia.

Chart 8 **Assumption for Brent oil prices**
(USD/barrel)



Source: Bloomberg.

Chart 9 **Assumption for international prices of primary agricultural commodities**
(Q4 2013 = 100)



Sources: CBOT, Euronext and NBS calculation.

As for the international commodity market, in addition to the global price of oil, uncertainty also pertains to movement in the global prices of agricultural commodities on which prices of processed food greatly depend. After trending extremely low in March, April and May 2020, just after the pandemic broke out, the price of oil struck an upward path, with occasional halts, and currently stands at around USD 70 per barrel. Based on the results since the start of the year and movements in futures for the coming period, we assumed that the price of oil will be USD 71 per barrel at the end of the year and USD 66 per barrel at end-2022. As for the global prices of primary agricultural commodities, in our current projections we assumed their growth to measure around 39% annualised, though it should be noted that growth in these prices is in all likelihood over. The prices of these products mostly reached their maximum in May, levelling off and starting to decline gradually with the arrival of the new agricultural season at the global level. This is also confirmed by the FAO food price index which, after a longer period, decreased in June and July.

Ladies and gentlemen, dear colleagues,

To conclude today's speech, I would like to point out that the August *Inflation Report* includes four text boxes covering current topics:

1. The first text box is focused on the assessment of the impact of rising producer prices in Serbia on consumer prices;

2. In the second, we analysed the contribution of the construction sector to GDP, and we will present it in more detail later on in the conference;
3. The third text box explains the key changes in the Labour Force Survey, which has been conducted under a new methodology in the EU as well as of the start of this year, and how this reflects on key labour market indicators – employment, unemployment and participation rates;
4. Text box four assesses the impact of the base effect, i.e. the low prices of petroleum products and unprocessed food, on movement in y-o-y inflation in Q2 and going forward, which significantly dictates the inflation profile as well.