Bojan Marković: Recent economic and financial developments in Serbia

Speech by Mr Bojan Marković, Vice Governor of the National Bank of Serbia, at the presentation of the February Inflation Report, Belgrade, 13 February 2012.

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

Inflation continued to fall and settled at 7.0% in December 2011. Consistent with our projections from last year's *Inflation Reports,* inflation will return within the target tolerance band already in this quarter. Gross domestic product growth picked up mildly in the fourth quarter of 2011, but is likely to slow down in the current year to around 0.5%, mainly due to the prospect of recession in the euro area. In response to subsiding medium-term inflationary pressures, the National Bank of Serbia has cut the key policy rate over the last nine months by a total of 300 basis points, to the current level of 9.5%. The future path of the key policy rate will depend on inflation factors, and in particular on the risks stemming from the international environment and the fiscal policy stance at home.

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

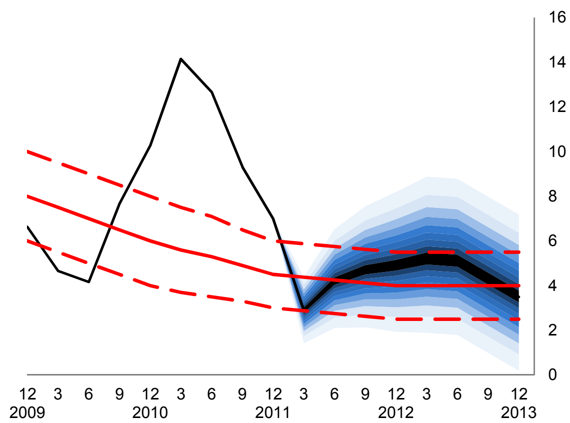
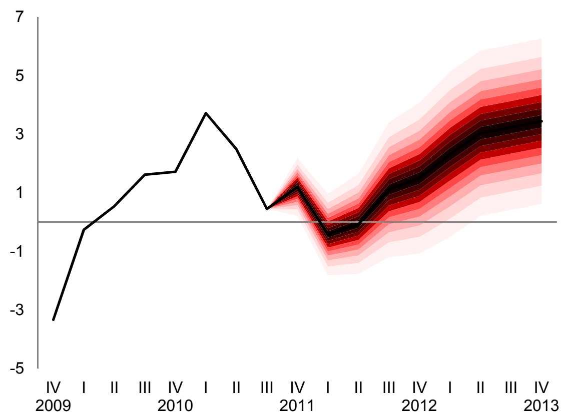


Chart 2 **GDP growth projection**
(y-o-y rates, in %)



Today we will present in more detail our view of past macroeconomic developments and our expectations for the period ahead.

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Public debt crisis in some euro area members is showing signs of abating. Still, in anticipation of a systemic solution that would reassure investors and prevent the contagion, volatility in the financial markets persists, threatening to stall the recovery of the euro area economy and to slow growth at global level.

In such an environment, international prices of most primary commodities continued to fall, moderately, with the exceptions of oil and other energy products, which edged up in the fourth quarter amid political tensions in the Persian Gulf.

Economic activity indicators point to a fall in the euro area's GDP in the fourth quarter, and based on the latest forecasts, that tendency is likely to persist in 2012. Growth forecasts for countries in the region, which are Serbia's important trade partners, have also been revised down.

These developments triggered a further rise in Serbia's risk premium in the last quarter of 2011. And though the risk premium, measured by the Emerging Markets Bond Index, receded mildly since the beginning of the year, it is currently by around 160 basis points higher than in mid-2011. As a result, at the end of January the dinar was around 5% weaker vis-à-vis the euro than at the end of the third quarter of 2011. However, compared to regional peers under a similar exchange rate regime, the dinar exchange rate was more stable during the last year, indicating that Serbia's financial resilience to external shocks is somewhat greater than in earlier years.

A recent increase in the foreign exchange market volatility was not accompanied by the drop in liquidity. To the contrary, over the last few days trading volumes at the interbank foreign exchange market averaged around EUR 130 million per day, which shows that the foreign exchange market is operating smoothly.

The National Bank of Serbia remains committed to intervening in the foreign exchange market in the event of excessive daily volatility and low trading volumes. Any central bank intervention to defend the level of the exchange rate would render foreign exchange cheaper for those with poor foreign exchange liquidity management, as well as short-term investors leaving the country, and all of this at the expense of Serbia's foreign exchange reserves. This would encourage risky short-term investors and reduce the inherent stability of the Serbian financial market, which is contrary to the objectives of the National Bank and a disincentive for long-term investors.

Nevertheless, let me reiterate that the National Bank will do everything necessary to prevent any excessive short-term fluctuations and to ensure stability of the Serbian foreign exchange market. Foreign exchange reserves in the amount of EUR 11.6 billion are more than a sufficient guarantee of our capacity to do so.

Chart 3 **Risk premium indicator – EMBI by country**
(daily, in basis points)

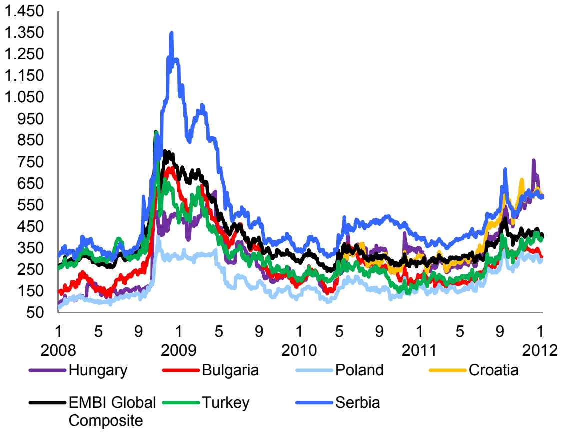
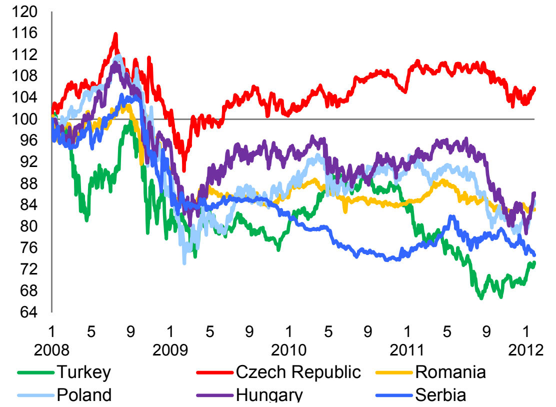


Chart 4 **Movements in exchange rates of national currencies against the euro***
(daily data, 31. 12. 2007 = 100)



* Growth represents appreciation.

Keeping the fiscal budget for 2012 within the framework agreed earlier with the International Monetary Fund would help strengthen the country's financial and macroeconomic stability. It would provide an additional assurance to foreign investors that the Serbian authorities are running a responsible and sustainable macroeconomic policy, which would lead to lower country risk premium and bring the costs of borrowing down.

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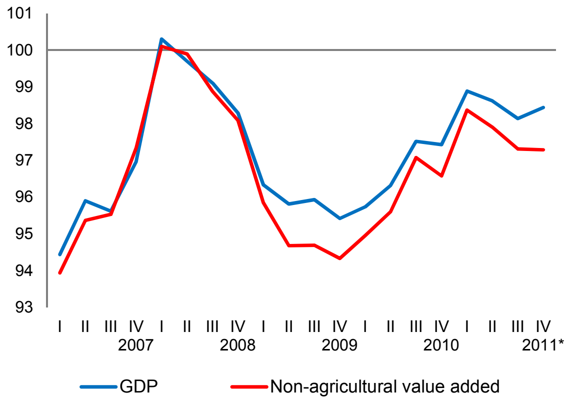
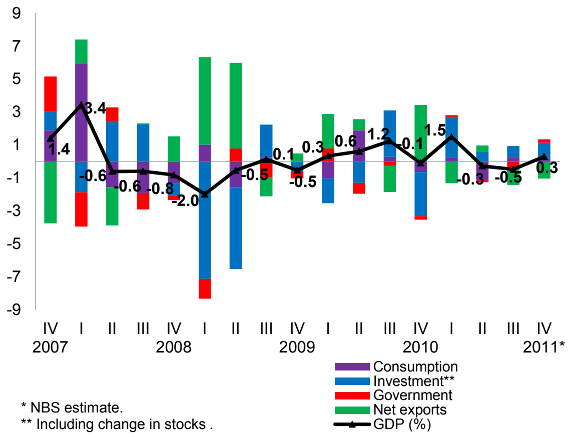
Unfavourable movements in the international environment have already reflected on the Serbian economy in the last three quarters, though a modest pick-up was registered by the end of the last year. Serbia's GDP is estimated to have increased in the fourth quarter of 2011 by 0.8% relative to the same period a year earlier, and by 0.3% relative to the quarter before.

Chart 5 **Economic activity indicators**
(seasonally-adjusted data, 2008 = 100)



* NBS estimate.

Chart 6 **Contributions to quarterly GDP growth**
(in p.p.)



* NBS estimate.
** Including change in stocks .

The most significant contribution came from investment activity, which is reflected in the robust growth in imports of equipment in the fourth quarter. Consistent with retail trade movements, final consumption rose modestly, remaining subdued compared to previous years. This is due primarily to the rise in unemployment over the past three years, which, according to the results of the last Labour Force Survey, stood at 23.7% in November 2011.

Chart 7 **Retail trade**
(seasonally-adjusted data, 2008 = 100)

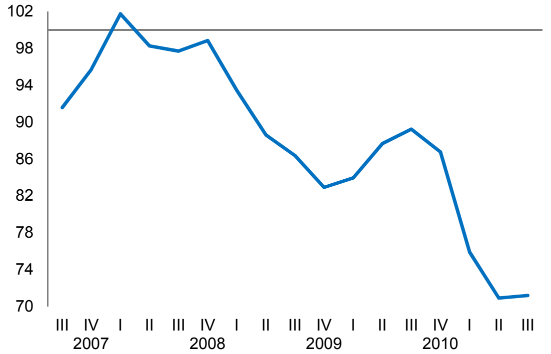
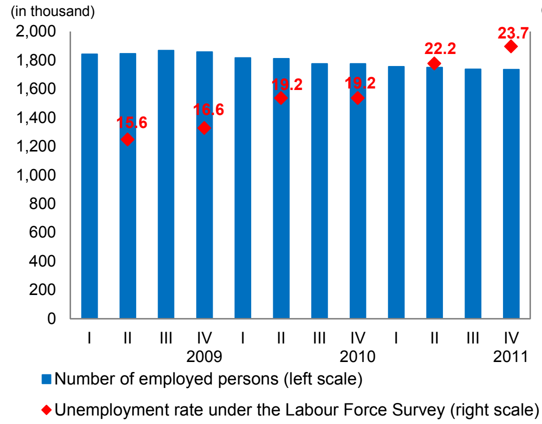


Chart 8 **Employment figure and unemployment rate**



Foreign trade expanded in late 2011, though with imports outpacing exports. Encouraging, however, is that imports of equipment and intermediate goods grew faster than imports of consumer goods. Robust growth in imports of equipment and intermediate goods in the fourth quarter was the main reason for the higher than expected current account deficit in 2011, which came at 9.1% of GDP. On the side of exports, growth was driven mainly by processed food and chemical products, while exports of agricultural products were on the decline in the fourth quarter, due primarily to low river levels, river flows being a major route for the agricultural products exports.

Chart 9 **Exports and imports**
(in EUR mln)

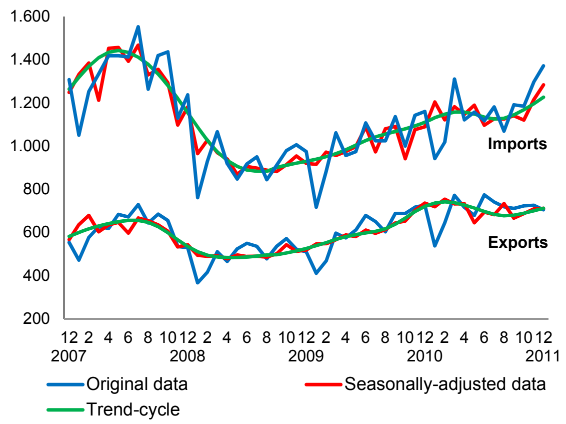
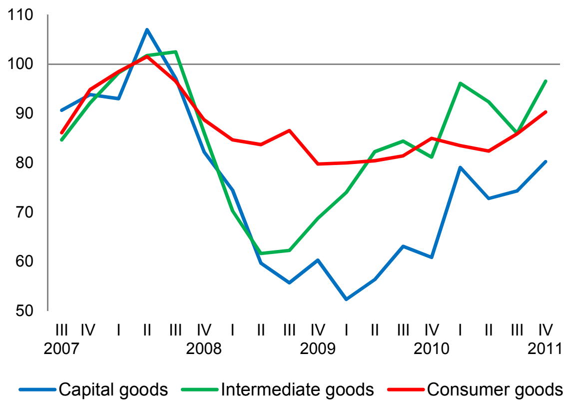


Chart 10 **Imports by key components**
(seasonally-adjusted data, 2008=100)



Private investment was the key driver of the 1.9% GDP growth in 2011. At the same time, personal consumption declined, and net exports gave a neutral contribution.

Chart 11 **GDP growth projection**
(y-o-y rates, in %)

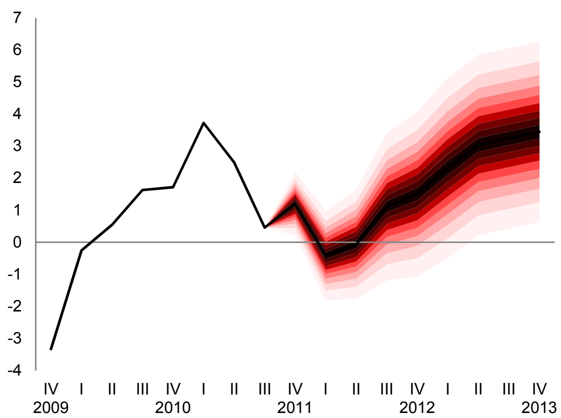
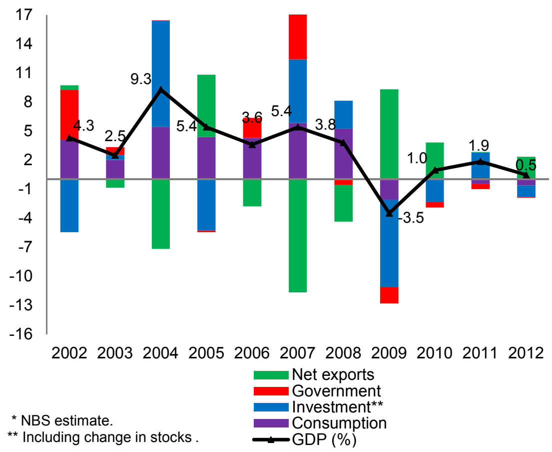


Chart 12 **Contributions to y-o-y GDP growth***
(in p.p.)



* NBS estimate.
** Including change in stocks .

The deteriorated growth outlook of our key foreign trade partners and Smederevo Steel Factory (ex US Steel) losing its private owner were the key reasons behind the National Bank of Serbia's downward revision of the GDP growth forecast for 2012 to 0.5% from 1.5%.

As a reminder, the GDP growth projection in the November *Inflation Report* assumed economic stagnation in the euro area in 2012, but implied higher downside risks due to the assessment of a significant probability of the euro area's slipping into recession. The new GDP growth projection assumes a recession, i.e. a 0.5% fall in economic activity of the euro area, but this time, the risks to the projection are evenly balanced.

Developments in the international environment will weigh primarily on demand for our export products and the inflow of foreign direct investments.

Despite the expected contraction in export demand, some of the investments made and those underway in export-oriented industries, primarily automotive, will begin to reflect on output and export figures in this and the following year. However, the departure of the private owner of Smederevo Steel Factory signals muted prospects for the exports of base metals. The economy as a whole is likely to see a modest increase in exports this year, while stronger growth may be expected only with the recovery of external demand.

Given the high unemployment rate and modest economic growth forecast, we expect that final consumption will fall this year again. This, together with lower investment demand, will reflect in a drop in imports.

A more visible recovery of Serbian economy may be expected only in 2013, conditioned largely on how the global growth dynamics plays out.

We wish to underline again that sustainability of economic growth in Serbia is more important than its pace, which assumes further shifting of the sources of growth from domestic final consumption towards net exports and investments, primarily into export-oriented industries.

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A downward trend in year-on-year inflation, in place since last May, continued, driven primarily by the weakening of the cost-push pressure of food prices and low aggregate demand. Monetary policy mitigated successfully the increase in inflation expectations, and thus the spill-over from food price growth to other prices by lifting the key policy rate in late 2010 and early 2011.

Chart 13 **Price movements**
(y-o-y growth, in %)

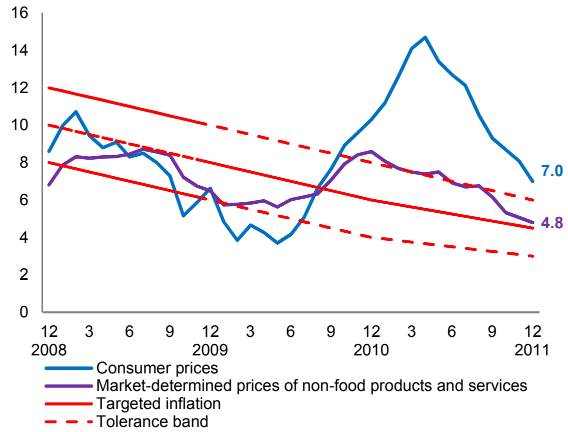
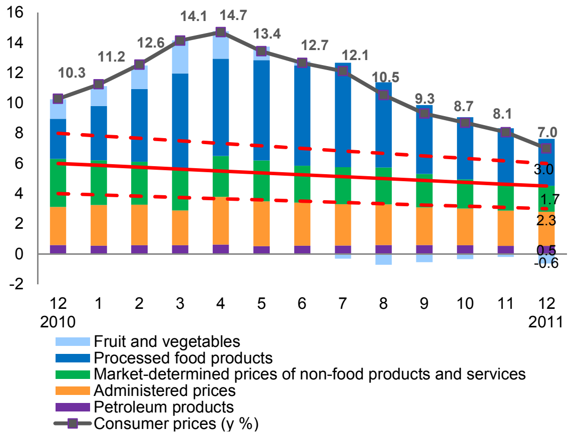


Chart 14 **Contribution to y-o-y inflation**
(in p.p.)



The fourth quarter saw consumer prices rising 0.6%, while their year-on-year growth eased down from 9.3% in September to 7.0% in December.

The key contribution to the decline in inflation in that quarter came from food prices again. Growth in fruit and vegetable prices fell short of what would be a typical hike for that time of the year, while processed food prices declined through cheapening of their inputs, such as wheat and corn.

Market-determined prices of non-food products and services also grew more moderately than in the third quarter. This component of the Consumer Price Index, which is most persistent and most responsive to monetary policy measures, has moved within the target tolerance band practically ever since the inflation targeting regime in Serbia was introduced.

As far as administered prices are concerned, the only significant hikes in the fourth quarter were recorded for natural gas and heating, but their contribution to headline inflation was modest. Nevertheless, due to the high growth in the first half of the year, administered prices exceeded the growth framework planned for 2011.

Year-on-year inflation is expected to continue down, i.e. to return within the target tolerance band already in this quarter, which confirms our projections from last year's *Inflation Reports*. Medium-term, it is expected to remain within the target tolerance band, with occasional oscillations.

The Government's decree imposing a 10% restriction on trade margins on some food products led to their cheapening in January, but as the decree expires in July, these prices could bounce back. However, provided that primary agricultural commodities see no considerable hikes in the coming period, the prices of processed food will probably rise at a somewhat slower rate than those of non-food products.

On the other hand, fruit and vegetable prices will probably outpace other prices in 2012. In view of their sharp fall in the season behind us, fruit and vegetable prices are estimated to be rather low currently, and are hence likely to rise even in the event of an average agricultural performance. We expect the contribution of fruit and vegetable prices to inflation growth to be most pronounced in the second quarter, with the onset of a new agricultural season.

Looking forward, growth in administered prices is likely to be slower than in earlier years as they have come closer to an economically sustainable level. Their growth in 2012 will probably be modest until the formation of new republic and local authorities, but could catch up thereafter, in the second half of the year.

A rise in import prices, prompted by the weakening of the dinar, may put pressure on domestic prices. We estimate, however, that real marginal costs of net importers are still relatively low, and that importers will be able to offset a major part of the growth in import costs by cutting their margins.

Given the high unemployment rate and deteriorated outlook for economic growth at home and abroad, the disinflationary pressures stemming from low aggregate demand will persist over the coming period as well.

A disinflationary effect will also be generated by inflation expectations. In the fourth quarter, they dropped to 6.0% from 8.0%. In light of a further decline in inflationary pressures, the downward tendency in inflation expectations is likely to continue this year.

Chart 15 **One-year ahead expected and targeted inflation**
(in %)

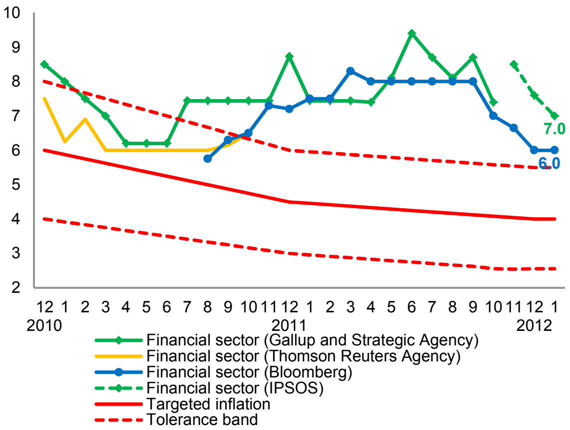
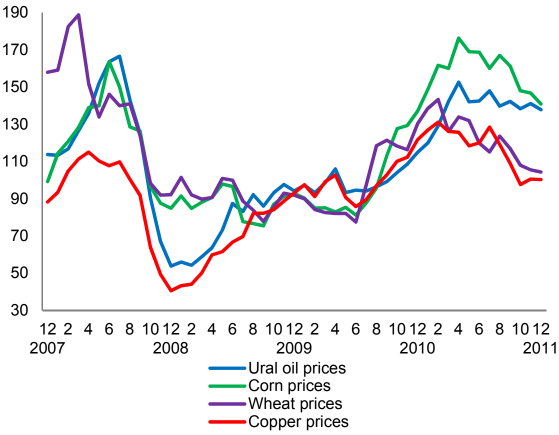


Chart 16 **World prices of primary commodities**
(2010=100)



A decline in year-on-year inflation will be pronounced in the first months of 2012 as high price hikes from early 2011 drop out of its calculation. As a result, inflation will return within the target tolerance band already in this quarter. Year-on-year inflation will reach its minimum level in March or April, when it should move around the lower bound of the target tolerance band. However, with the onset of a new agricultural season, higher growth in administered prices after elections, and the repeal of the decree limiting trade margins, inflation will return towards the target by the third quarter 2012. On account of these factors, in the first half of 2013 year-on-year inflation may temporarily stand at around the upper bound of the target tolerance band, only to return towards the 4±1.5% target thereafter.

The key risks to the presented projection relate mostly to the international environment and fiscal policy at home.

Outlook for Serbia's economic growth and pressures on inflation will largely depend on developments in the euro area given that its members, together with countries in our region, are our major foreign trade partners. The speed and way of resolving the public debt crisis in some member states, as well economic activity in the euro area may, in addition to demand for our export products, also impact the country risk premium movements. Under the latest indicators, the economic downturn in the euro area in 2012 may be softer than the assumed 0.5%, though deviations are possible in both directions.

Fiscal policy will also have a significant impact on the perception of country risk. Mounting public debt and a more significant deviation of the 2012 budget from the framework agreed earlier with the IMF may have inflationary consequences through rising risk premium, depreciation pressures and higher demand, which would leave less scope for monetary policy easing.

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In response to subsiding inflationary pressures, the National Bank of Serbia has cut the key policy rate over the last nine months by total 300 basis points to its current level of 9.5%. In February, the key policy rate was left unchanged. The future path of the key policy rate will depend on materialisation of inflation factors, while developments in the international environment and fiscal policy at home remain the key risks.

We wish to remind that the decline in inflation to around the lower bound of the target tolerance band, which may happen in some months of the first half of the year, would be only temporary and, as such, would not be the reason for monetary policy response. Given the time lag in reaction of the key policy rate on inflation, monetary policy should not respond to temporary factors, but to factors with a medium-term effect on inflation.

Chart 17 **Short-term inflation projection**
(y-o-y rates, in %)

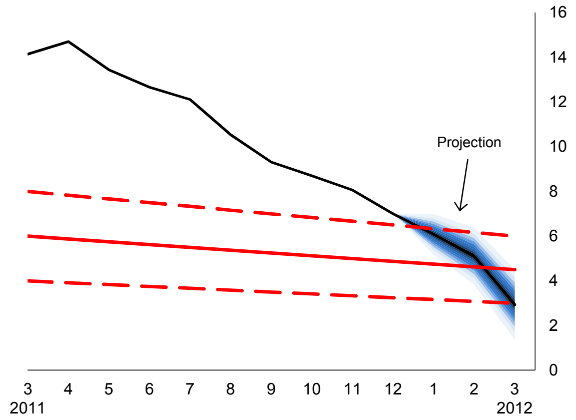
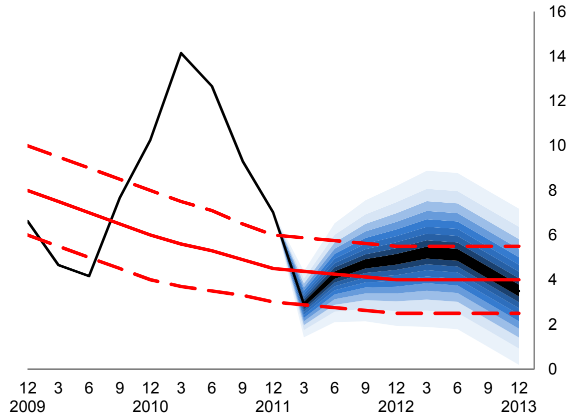


Chart 18 **Inflation projection**
(y-o-y rates, in %)



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Ladies and gentlemen, recent developments in some countries in the region show that in the current situation financial markets are highly sensitive to any disruption in macroeconomic and financial stability.

Therefore, the best way for the Government and the central bank to contribute to the improvement in the economic environment is to pursue a policy which ensures long-term macroeconomic stability. Such policy implies a sustainable level of public debt, price stability over the medium term, and a stable and resilient financial system. Any attempt at "stimulating" the economy in an unsustainable way could jeopardise the achievement of the above objectives, which would elevate the country risk and increase the costs of borrowing, exacerbate the business environment, and ultimately, inflict damage to the economy it was intended to help.

The National Bank of Serbia will therefore continue to stabilise inflation at a low level and maintain a sound financial system which, in our opinion, is the best way to help the economy in the given circumstances. The more the fiscal budget developments are aligned with the framework earlier agreed with the IMF, the more attainable will be the achievement of these objectives, with more stimulative monetary policy.