Bojan Marković: Macroeconomic developments in Serbia

Speech by Mr Bojan Marković, Vice Governor of the National Bank of Serbia, at the presentation of the November 2011 *Inflation Report*, Belgrade, 16 November 2011.

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

Despite repeated media announcements about the “waves of price hikes”, inflation continued down over the past several months and settled at 8.7% in October. We expect this downward trend to persist and inflation to retreat within the target tolerance band in the first quarter of 2012. At the same time, pessimism over global growth prospects intensified, particularly in the euro area prompting us to revise the economic growth forecast for Serbia down to around 2.0% in 2011 and 1.5% in 2012. In response to subsiding inflationary pressures, the National Bank of Serbia cut the key policy rate during the last six months. The key policy rate currently stands at 10%, and its further cautious lowering is likely in the coming period.

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

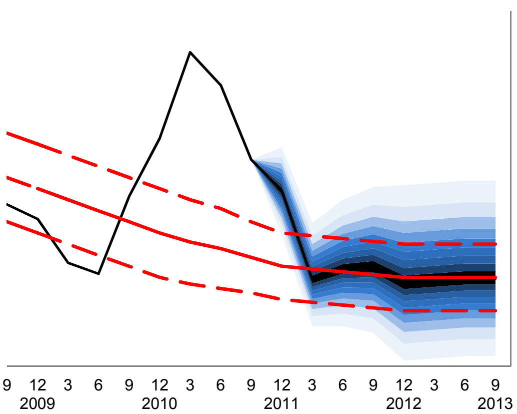
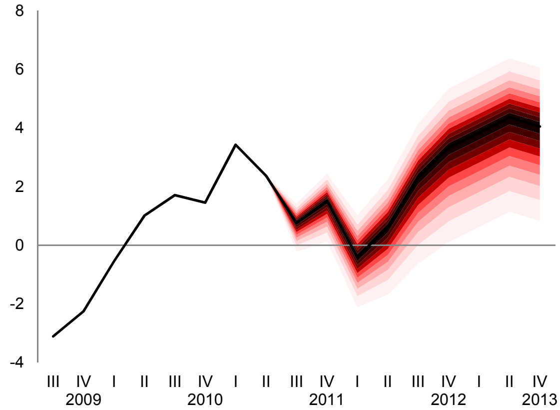


Chart 2 **GDP growth projection**
(y-o-y rates, in %)



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

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Mounting doubts about the sustainability of public debt in advanced economies and unfavourable growth indicators for the second and third quarters have led to a downward revision of the global economy growth forecasts, particularly that of the euro area. The third quarter witnessed a drop in share prices and a rise in interest rates on public debt in a number of countries. The prices of primary commodities, such as oil, base metals and agricultural products, also declined in the third quarter. Though financial markets showed some recovery in October, global economic growth will no doubt be slower than expected until recently. Also, the governments might not be able to respond with fiscal stimuli as they did during the first wave of the crisis, primarily due to high public debt.

Turbulences in the global financial market led to an increase in Serbia’s risk premium (measured by EMBI), albeit smaller than those of other countries in the region. As a result, the dinar was more stable during this period than the currencies of other East European countries with flexible exchange rate, even without the National Bank of Serbia’s interventions in the foreign exchange market. Together with high demand for the first issue of the Republic of Serbia’s Eurobonds, the prior indicates that Serbia’s financial resilience to external shocks of this kind is greater than in previous years. The stability of the dinar was underpinned largely by the inflow of foreign direct investments, as well as by the conclusion of a precautionary arrangement with the International Monetary Fund.

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

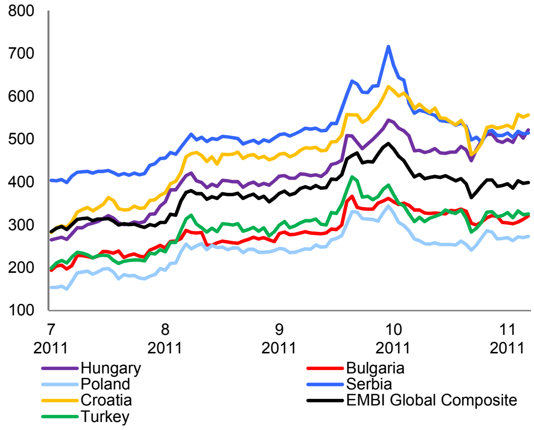
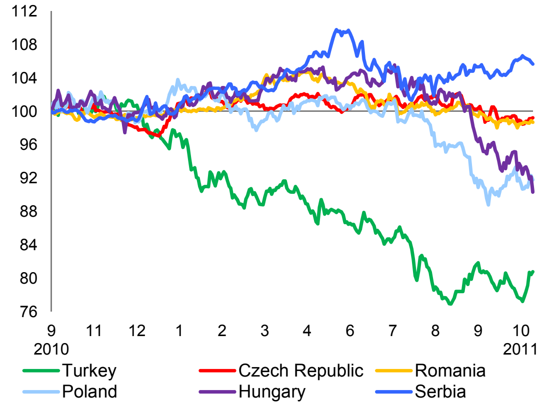


Chart 4 **Movements in exchange rates of national currencies against the euro***
(September 30, 2010 = 100)



* Growth indicates appreciation.

The government’s commitment under the arrangement to run a sustainable fiscal policy lessens the risk of a public debt crisis in Serbia, which is of paramount importance in light of the forthcoming parliamentary and local elections. In an environment of a global collapse of confidence in public finance sustainability, the perception of Serbia’s risk will depend most on the sustainability of its budgetary framework.

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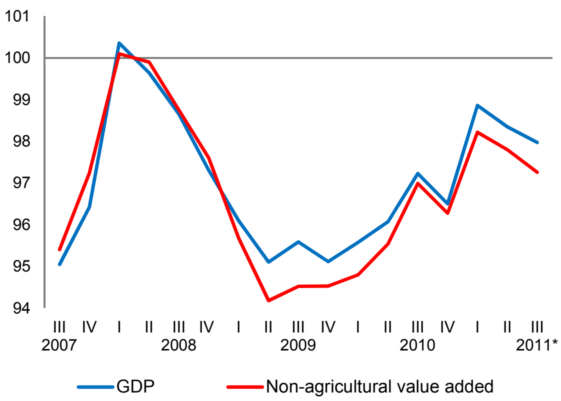
The slowing of global growth over the previous two quarters, and notably that of the euro area, has already reflected on the Serbian economy. According to preliminary estimates, in the third quarter GDP rose 0.7% year-on-year and fell 0.4% quarter-on-quarter.

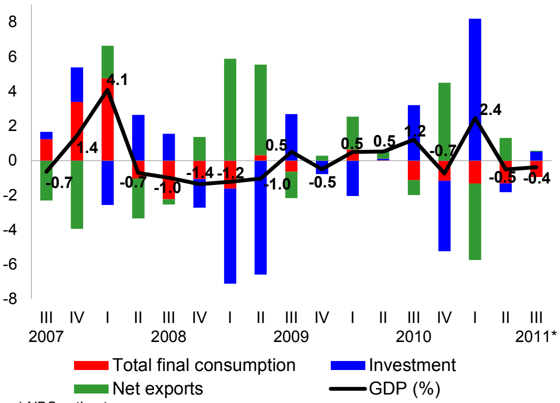
The fall in economic activity in the third quarter is for its major part due to the reduced final consumption of households.

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



* NBS estimate.

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



* NBS estimate.

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

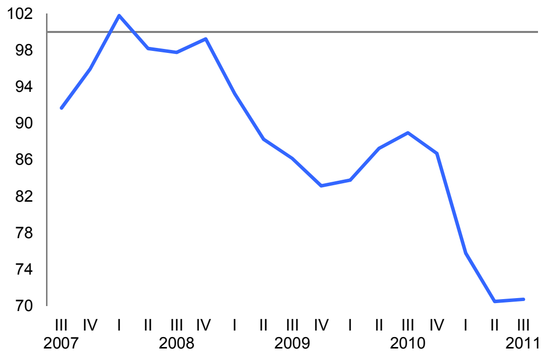
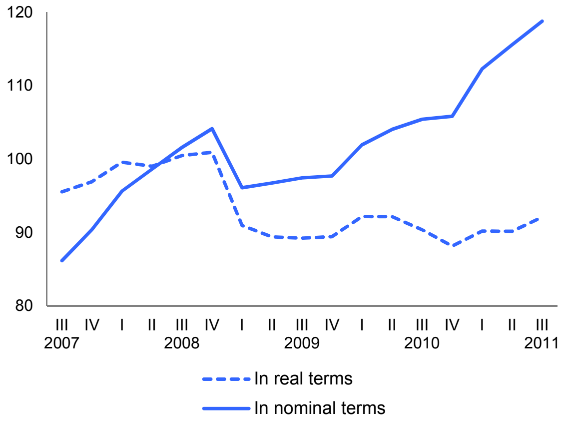


Chart 8 **Average net wages**
(2008=100)



With exports and imports increasing only modestly in real terms, the contribution of net exports to GDP growth in the third quarter was neutral. Once again, exports failed to record stronger growth due to the drop in exports of base metals, caused by weaker export demand, especially from the euro area countries. On the side of imports, a decrease was registered for intermediate goods and an increase for equipment and consumer goods.

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

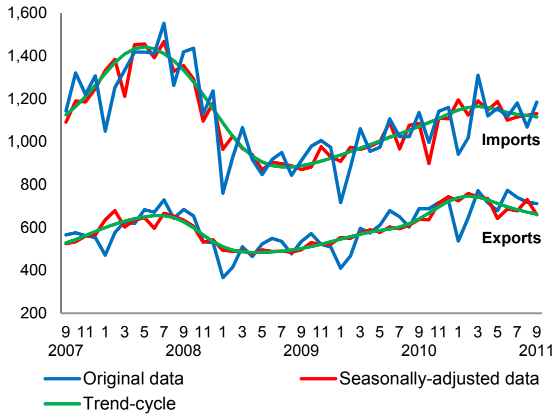
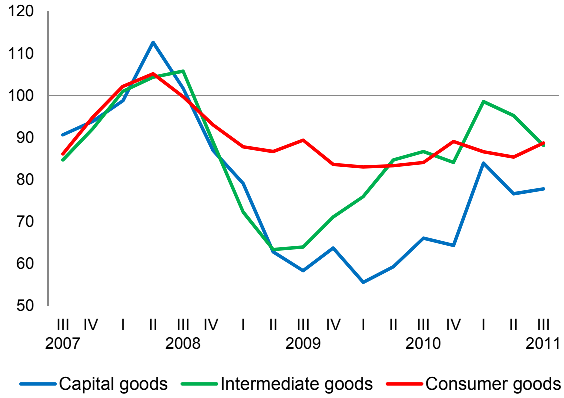


Chart 10 **Imports by key components**
(seasonally-adjusted data, 2008=100)



Imports of equipment are the key indicator of an upturn in fixed investment in the third quarter, fixed investment being the only component with an estimated positive contribution to GDP growth.

With downward revisions to growth forecasts for our key trading partners, the National Bank of Serbia revised down its GDP growth projection for Serbia to around 2.0% in 2011 and around 1.5% in 2012. The National Bank of Serbia's projection is based on the expected stagnant economic activity in the euro area in 2012 and a decline in some of our important export partners.

Global growth deceleration, particularly in the EU and CEFTA countries, could feed through to the Serbian economy along the following channels: (1) lower export demand for our products, (2) a decline in direct and portfolio investments, (3) higher interest rates due to rising country risk premium, and (4) more limited access to foreign sources of funding. The channels of impact of the global slow-down on the Serbian economy are discussed in more detail in a separate text box of this *Inflation Report*. However, let me reiterate: despite the inevitable consequences of the slowdown which we have thoroughly analysed, we see it as encouraging that risk premium movements so far indicate higher financial resilience of Serbia to this kind of external shocks than in earlier years.

On the whole, we estimate that in 2011, the greatest contribution to the growth of economic activity will come from investments. A positive contribution is also expected from net exports, whereas that of final consumption will be negative this year.

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

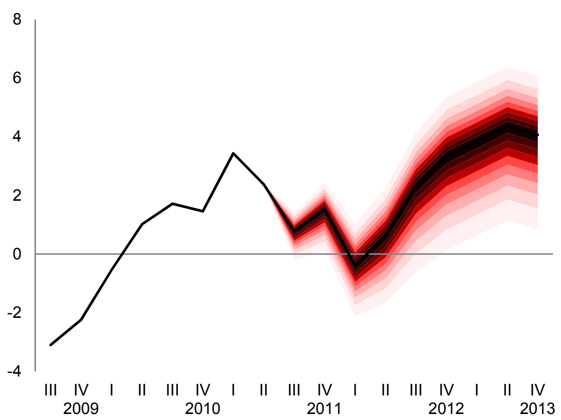
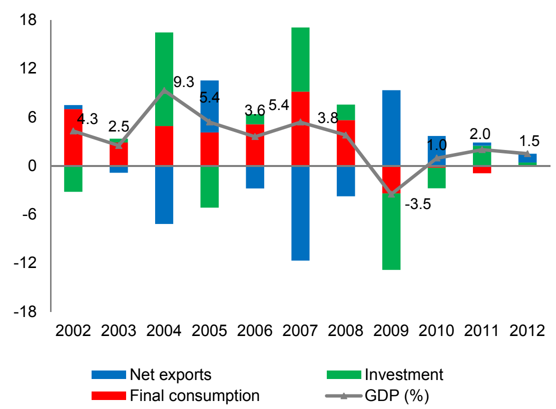


Chart 12 **Contributions to y-o-y GDP growth***
(in p.p.)



* NBS estimate for 2011 and 2012.

Although we anticipate slower investment in the coming year, the effects of some investments already underway, notably those in the automotive and oil industry, will begin to reflect in output and export figures only next year. However, their impact will however be lessened by the weakening global demand, including that of our export partners. Given the still modest growth forecast for the next year, final domestic consumption and, by extension, imports should also show moderate growth.

We wish to underline again that sustainability of economic growth is more important than its pace, which assumes further shifting of sources of growth from domestic demand towards net export demand, with a greater contribution of investments within domestic demand.

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Inflation has been declining steadily since May this year. The third quarter saw deflation of 0.4%, i.e. a drop in year-on-year inflation from 12.7% in June to 9.3% in September, consistent with our expectations from the August *Inflation Report*.

Consumer prices in the third quarter were pushed down by seasonal decreases of fruit and vegetable prices. A sharp decline in these prices since April was due to a more abundant fruit and vegetable harvest this year.

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

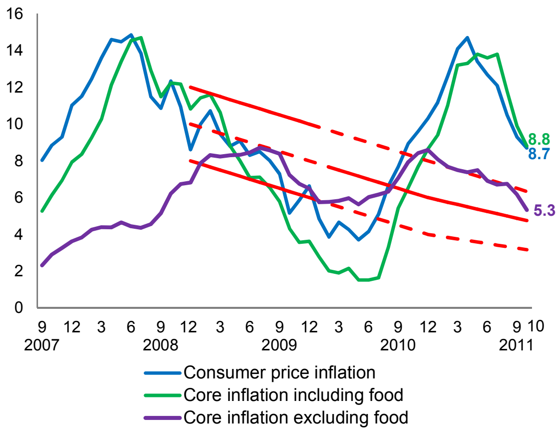
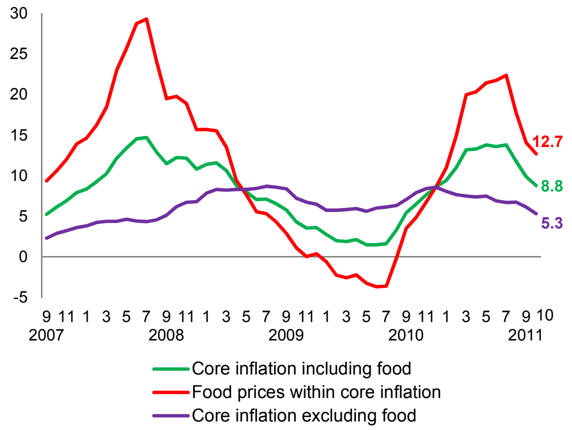


Chart 14 **Core inflation incl. and excl.food prices**
(y-o-y growth, in %)



Processed food prices grew at a slower rate compared to the quarter before, primarily on account of a decline in prices of primary agricultural products.

Conversely, market-determined non-food product prices grew faster than in Q2, prompted by several larger seasonal price increases, rather than reflecting a general tendency in movement of these prices.

Chart 15 **Core inflation by component**
(monthly growth, in %)

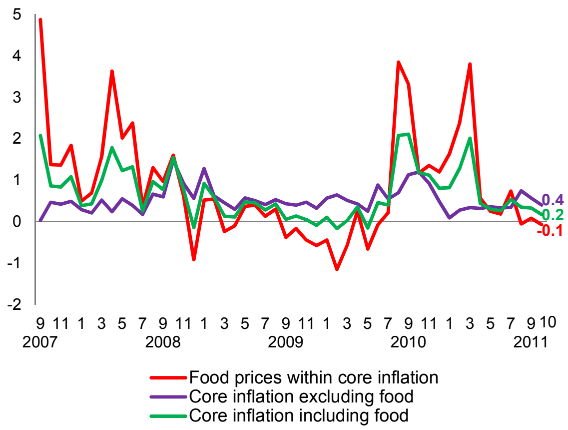
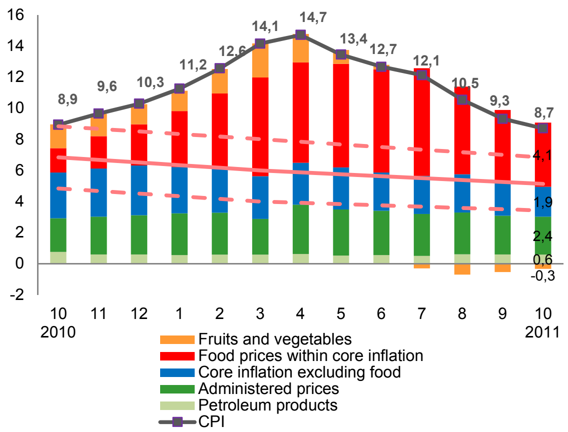


Chart 16 **Contribution to y-o-y inflation**
(in p.p.)



Contrary to the first half of the year, administered prices grew modestly in the third quarter. The only significant increase was recorded for landline telephony services. The overall increase in the year to September however came at 9.5%, extending beyond the 7±2% framework planned for the whole of 2011.

According to last week's data, consumer prices rose in October by 0.4% month-on-month or 8.7% year-on-year, which shows continuation of a downward trend in inflation.

We expect year-on-year inflation to decline further and to return within the target band in the first quarter of 2012.

Disinflationary pressures stemming from low aggregate demand will be strong in the coming period reflecting lower growth expectations for Serbia.

The lowering fruit and vegetable prices over the previous two quarters will be factored into year-on-year inflation rates until the next season. However, being currently at a low level, these prices could rise faster next year than other prices, even if the 2012 agricultural season turns average.

Given the developments on the global markets and the lowering of wheat and corn prices, a rise in processed food prices in the coming period will probably be modest.

Chart 17 **World prices of primary commodities**
(2010=100)

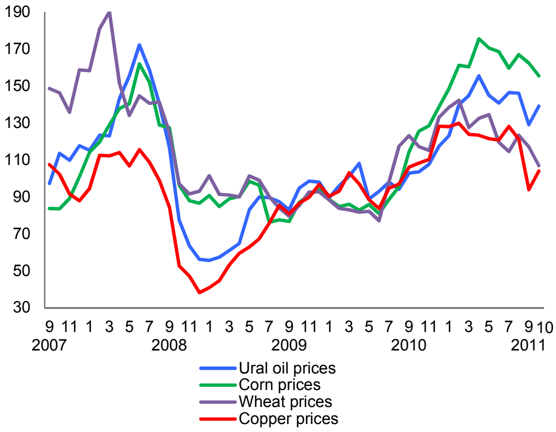
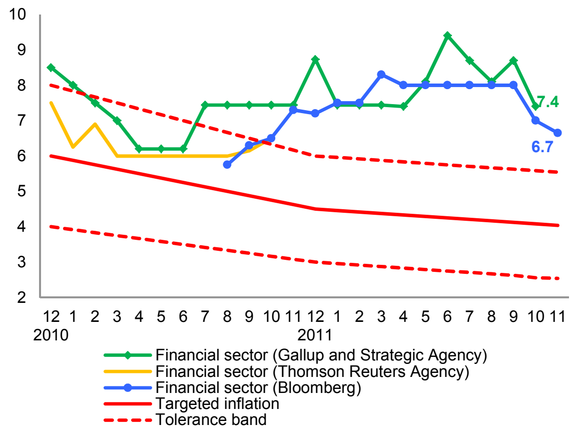


Chart 18 **One-year ahead expected and targeted inflation**
(in %)



Declining world prices of other primary commodities, such as oil and base metals will also work towards the disinflatory effect.

Furthermore, we expect administered price growth to be slower in 2012 than in this and earlier years, though we may see another departure from the planned level.

The disinflation process will be further fuelled by declining inflation expectations. Inflation expectations declined from some 8.0% to 6.7% in the last two months, and we expect this tendency to continue.

A fall in year-on-year inflation will be particularly pronounced until March–April next year as a result of the base effect. Namely, although monthly inflation rates have decreased over the last six months to levels consistent with the target, the year-on-year rate remains above the target as price hikes from late 2010 and early 2011 are still included in its calculation. As these price hikes phase out of the year-on-year calculation and new, lower monthly inflation rates are taken in, year-on-year inflation will decline and return within the target band.

Chart 19 **Short-term inflation projection**
(y-o-y rates, in %)

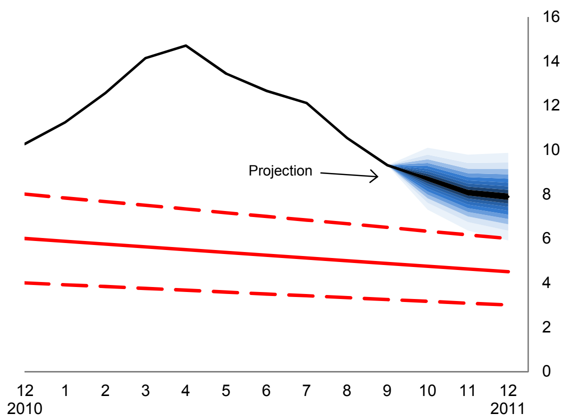
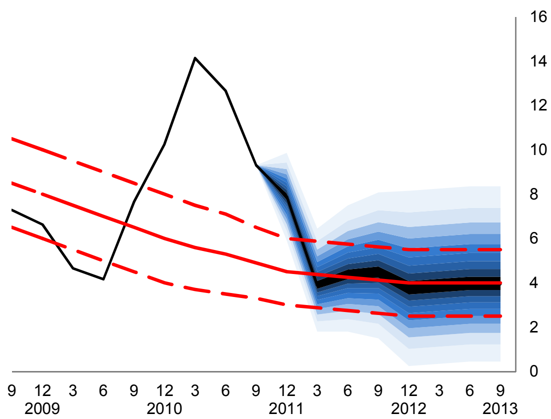


Chart 20 **Inflation projection**
(y-o-y rates, in %)



The key risks to the presented inflation projection are largely associated with movements in the international environment and fiscal policy at home.

World analysts agree in the assessment that global growth will be slower than expected until recently, but there is a large difference across individual forecasts. If, contrary to the currently prevailing expectations, the world economy is swept by a new wave of recession, negative repercussions for the Serbian economy, and the disinflationary effects arising from aggregate demand, would be more pronounced than envisaged in our projection.

As regards developments in the international environment, uncertainty remains regarding risk premium movements, which may affect capital flows and exchange rate trends. Movements in risk premium will also be largely affected by future compliance with the budgetary framework. In this regard, conclusion of a precautionary arrangement with the International Monetary Fund is a step in the right direction as it contributes to macroeconomic stability. If fiscal policy adheres to the planned framework, there will be scope for monetary policy to respond more strongly to the disinflationary impact of slackening economic activity.

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Over the last six months, responding to diminishing inflationary pressures, the National Bank of Serbia lowered the key policy rate, by a total of 2.5 percentage points to its current level of 10.0%.

Based on the inflation projection presented today and its underlying risks, the Executive Board of the National Bank of Serbia judges that the key policy rate is more likely to be lowered further in the coming period than raised or kept on hold.

The Executive Board confirms its previously expressed confidence that year-on-year inflation will continue to fall and that its return within the target tolerance band is likely in the first quarter of the next year.