Bojan Marković: National Bank of Serbia's outlook on inflation

Speech by Mr Bojan Marković, Vice Governor of the National Bank of Serbia, at the presentation of the Inflation Report, Belgrade, 16 May 2012.

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

Declining steadily over the last year, inflation fell in April to 2.7% year-on-year, its lowest level since comparable records are available from the beginning of 1980. Consistent with our projections from the previous Inflation Reports, the inflation figure is slightly below the lower bound of the target tolerance band for April. From May, however, we expect inflation to rise at a moderate pace and to move temporarily around the upper bound of the target tolerance band in late 2012 and the first half of 2013, only to return back towards the target thereafter.

Gross domestic product declined in the first quarter due to extremely cold weather, but also due to the contraction in economic activity of our key foreign trade partners. Recessionary trends in the euro area will continue to have a negative impact on the Serbian economy in the remainder of the year, but modest economic growth of 0.5% is still expected in 2012 given the start of production in the automotive industry.

The National Bank of Serbia last revised its key policy rate in January by cutting it down to 9.5%. In April, the National Bank of Serbia amended the Decision on Required Reserves, lowering the FX reserve requirement ratio and increasing the share of FX required reserves to be allocated in dinars.

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The new *Inflation Report* comes out at a time of post-election uncertainties as to how fast the future government will be formed. ***From the viewpoint of fostering macroeconomic stability and lowering the country risk premium, it is desirable that the future government is formed promptly and that it undertakes efficient fiscal consolidation measures to cut the budget deficit and contain public debt.*** This also includes the continuation of the arrangement with the International Monetary Fund, which will help improve the perception of country risk, and thus contribute to the stabilisation of financial markets.

The euro area sovereign debt crisis showed some signs of abatement following successful implementation of the debt swap agreement between Greece and private investors and expansionary measures by the European Central Bank, but in the last few days uncertainty appeared again over the formation of the new Greek government. Furthermore, as indicated by the contraction of economic activity in the past two quarters, the situation in the euro area's real sector remains challenging. Growth forecasts for the euro area for the current year remain negative, while countries in the region face muted growth prospects.

Nonetheless, Serbia's country risk premium has declined, as a result of the easing of the euro area sovereign debt crisis and expansionary measures taken by the European Central Bank, the EU's positive decision on Serbia's candidate status, and affirmation of the country's credit rating. In fact, looking at the region, the sharpest fall in EMBI this year was registered for Serbia.

The dinar nonetheless weakened against the euro. Depreciation pressures were driven by several factors: increased energy imports due to cold weather, lower exports, departure of the private owner from the Smederevo steel plant, postponed review of the arrangement with the International Monetary Fund, increased government spending, and reduced capital inflow.

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Together with a spell of extremely cold weather in February, recessionary trends in the euro area and sluggish growth of the regional economies have led to a contraction in Serbia's economic activity in early 2012. According to preliminary estimates for the first quarter, gross domestic product fell by 0.5% from the previous quarter and by 1.3% from the same period last year.

Unfavourable weather conditions in February strained and even restricted electricity supply to a large number of enterprises. Together with the suspension of operations of the Smederevo steel plant, this pushed manufacturing down by as much as 12%. However, as the production not only normalised in March, but also compensated in part for what was missed in February, manufacturing picked up by 19%.

The same factors had a decisive impact on exports, which followed a pattern similar to that of manufacturing in the first three months of 2012, while recording a mild fall at quarterly level. The steepest drop in exports was registered for base metals, chemicals and chemical products, while exports of agricultural products and electrical equipment increased.

Cold weather prompted an increase in imports of energy, and thereby, intermediate goods, pushing overall imports higher. On the other hand, imports of equipment and consumer goods recorded a decline.

Economic activity contracted in the first quarter. The negative contribution came from net exports, as well as lower private sector investment, signalled by a dip in imports of equipment and reduced construction activity, and adverse weather conditions.

Conversely, an upturn in retail trade points to a positive, though modest, contribution of household consumption to economic activity.

Economic activity is expected to increase in the upcoming quarters and reach roughly 0.5% for the entire year 2012. Over the short run, increased government expenditure in the first half of the year exerts some positive contribution to domestic demand. But, euro area recession and dented economic growth of Serbia's other foreign trade partners will reflect negatively on demand for Serbian products and the inflow of FDI in the course of this year. Despite this, past and current investments in export branches of industry, primarily in the automotive industry, will lead to increased production and exports from the second half of the current year. Past weakening of the dinar will also give impetus to exports growth. In view of high unemployment and modest economic growth, final consumption is expected to contract this year as well. Coupled with a fall in investment demand and past weakening of the dinar, this will probably result in lower imports in 2012.

With production picking up in the mostly export-oriented automotive industry, a more palpable growth of the Serbian economy of 3% could be expected in 2013. This, however, will largely hinge on the speed of the global economic recovery. Growth may turn out slower than anticipated in case stricter fiscal consolidation measures are applied. In our view, however, application of stricter consolidation measures is desirable as it would contribute to macroeconomic stability, public debt sustainability, lowering of the country risk and, consequently, of the cost of borrowing, all of which would have a positive long-term impact on the economic activity in Serbia.

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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Inflation has been on a steady decline throughout the last year, mostly as a result of weakening cost-push pressures on food prices, low aggregate demand and restrictive monetary policy measures applied at times of strongest inflationary pressures.

The fall in year-on-year inflation was particularly pronounced in the first months of the year, as substantial price hikes from early 2011 dropped out from the calculation. Inflation thus fell from 7.0% in December to 3.2% at the end of the first quarter and to 2.7% in April 2012, which is the lowest year-on-year inflation rate since records are available beginning in 1980. This is also slightly below the lower bound of the target tolerance band for that month. Such inflation movements are consistent with our projections from the previous *Inflation Report*s.

Consumer prices increased by 2.0% in the first quarter, under the influence of several diverging factors.

The rise in import prices on the back of a weaker dinar has so far produced only a minor inflationary effect, as importers, faced with low demand, abstained as much as possible from raising domestic prices. There were, however, some price increases in this respect, most notably in the case of foreign currency indexed prices such as flat rentals and cars. This is also the key reason behind the rise in market-determined prices of non-food products and services.

Excluding a substantial increase in prices of eggs, food prices continued to have a disinflationary effect in the first quarter.

By contrast, a more notable push to consumer price growth came from an increase in prices of petroleum products on the back of rising global oil prices early in the year, and prices of cigarettes following the regular adjustment of excises to consumer price growth in the prior year. In the year to date, there have been almost no increases in administered prices.

After reaching minimum level in April 2012, year-on-year inflation is expected to rise at a moderate pace from May and return towards the target. It will hover close to the upper bound of the target tolerance band in late 2012 and the first half of 2013 and thereafter fall back towards the target.

In the second quarter of 2012, with the coming of the new agricultural season, inflation growth will be driven primarily by rising prices of fruit and vegetables. Our expectations are based on the fact that these prices are currently low because of a drop in the prior season and that there will be some scope for their increase even if the new agricultural season turns out to be average.

Moreover, we expect that the absence of administered price growth in the year to date will be compensated after the formation of the future government, which will impact on growth in headline inflation in that period. Over the medium term, however, it is likely that growth in administered prices will slow down from earlier years as they come close to their economically sustainable level.

After reaching their historical high in euros early in the year, global oil prices have been vigorously declining since the beginning of April, and are likely to generate a disinflationary effect over the coming months.

In addition, given the high unemployment rate and a modest outlook for economic growth in both Serbia and its major foreign trade partners, we estimate that low aggregate demand will weigh down on price growth in the coming period. The expected fiscal consolidation measures of the future government will work in the same direction.

Another reason for deceleration in price growth are lower inflation expectations which over the last eight months have fallen by around 2 percentage points.

Growth in import prices driven by past weakening of the dinar may generate inflationary pressures. It is, however, probable that importers will react rather by cutting their margins in an environment of low demand than by raising prices. Furthermore, if the expected fiscal consolidation measures of the future government turn out to be intensive enough, they may strengthen the dinar and push down import prices in autumn.

However, overall, the coming of the new agricultural season, the past rise in import prices and sharper administered price growth after the formation of the future government will (despite low aggregate demand) lead inflation closer (at a moderate pace) to the upper bound of the target tolerance band by the end of the current and in the first half of the next year. Thereafter, inflation is expected to gradually return towards the target.

The key risks to this projection are associated with the future government's fiscal policy, developments in the international environment and movements in food and administered prices.

At a time when financial markets are highly sensitive to indicators of public debt sustainability, the absence of fast and vigorous fiscal consolidation measures of the future government may produce inflationary consequences through rising risk premium and elevated depreciation pressures.

If on the other hand, fiscal consolidation measures involve VAT hikes, this will bring about a one-off temporary rise in prices, but in the medium-run inflationary pressures would weaken owing to the strengthening of the dinar and falling risk premium.

Movements in the risk premium and the exchange rate, including the speed of Serbia's economic growth, will also be affected by developments in the euro area, which still faces numerous challenges as financial markets react vehemently to every unfavourable piece of news.

Risks acting in both directions, associated with coming of the new agricultural season, are present in this period of the year as well. Weather conditions and movements in world prices of agricultural products will have a significant impact on trends in these prices in the domestic market and therefore on cost-push pressures on food prices.

Uncertainties also prevail in terms of administered price movements, i.e. the speed at which the future government and local government authorities will remove the disparities in the pricing of services under their remit.

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Since January 2012, the Executive Board of the National Bank has not revised the key policy rate which currently stands at 9.5%. However, given the inflation projection, a decision was made in April to reduce the reserve requirement ratio from 30% to 29% on liabilities with the maturity of up to two years, and from 25% to 22% for the maturity over two years. At the same time, the dinar portion allocated against foreign exchange reserve requirements was raised by 5 percentage points for all maturities. The aim of this measure was to contribute to moderate stabilisation of inflation movements and developments in the foreign exchange market, to slightly reduce the costs of bank funding and stimulate banks to use long-term sources of funding. All of the above is likely to have a positive impact on financial stability.

The future path of the key policy rate will depend primarily on the pace and intensity of fiscal consolidation to be undertaken by the future government. ***Price and financial stability can be delivered at a lower degree of monetary restrictiveness provided fiscal consolidation and structural reforms are more intensive and effective.***

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

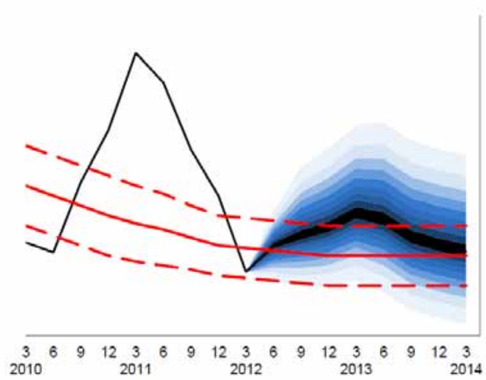


Chart 2 **GDP growth projection**
(y-o-y rates, in %)

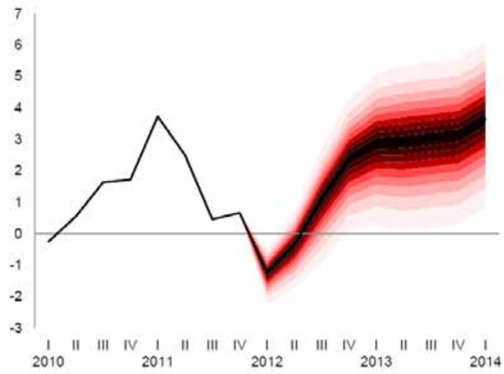


Chart 3 **Risk premium indicator – EMBI by country**
(daily, in basis points)

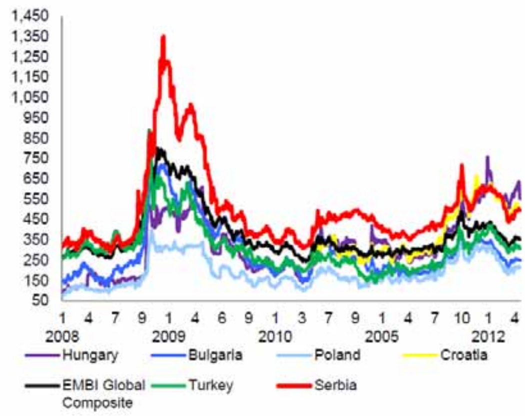
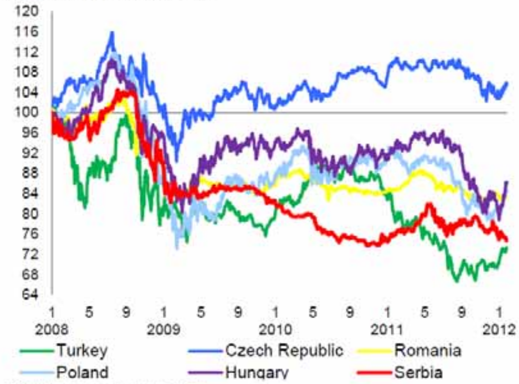
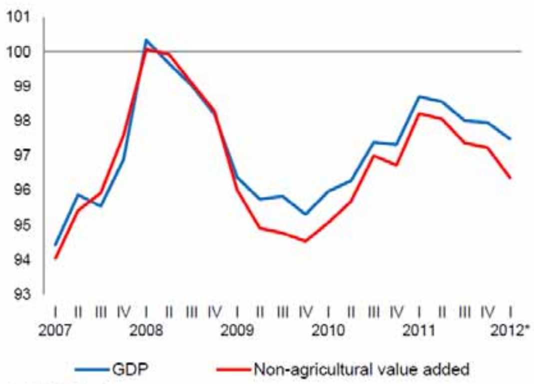


Chart 4 **Movements in exchange rates of national currencies against the euro***
(daily data, 31. 12. 2007 = 100)



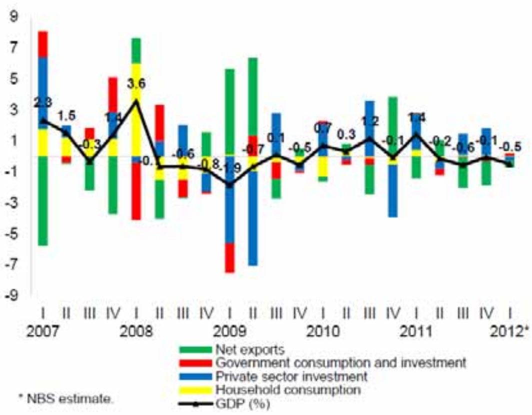
* Growth represents appreciation.

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 **Industrial production**
(s-a data, 2011 = 100)

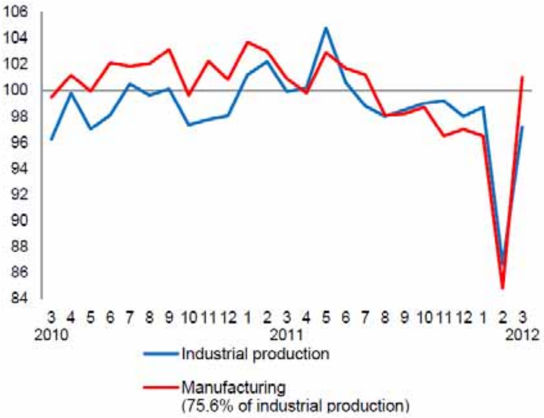


Chart 8 **Retail trade**
(seasonally-adjusted data, 2008 = 100)

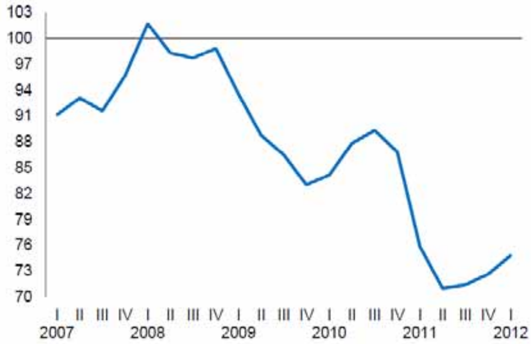


Chart 9 **Exports and imports**
(in EUR mln)

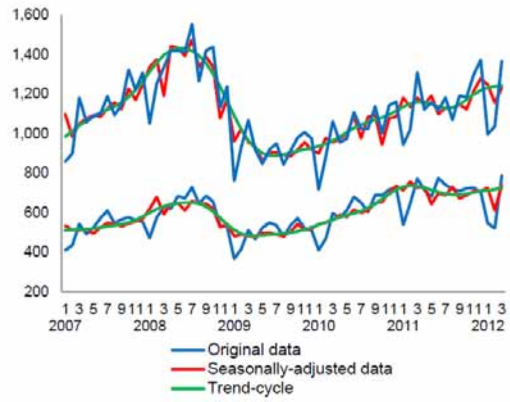


Chart 10 **Imports by key components**
(seasonally-adjusted data, 2008 = 100)

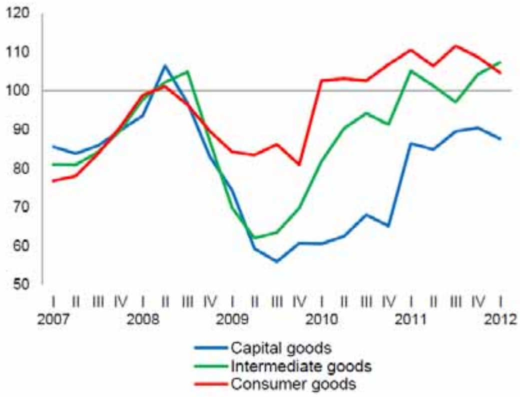


Chart 11 **GDP growth projection**
(y-o-y rates, in %)

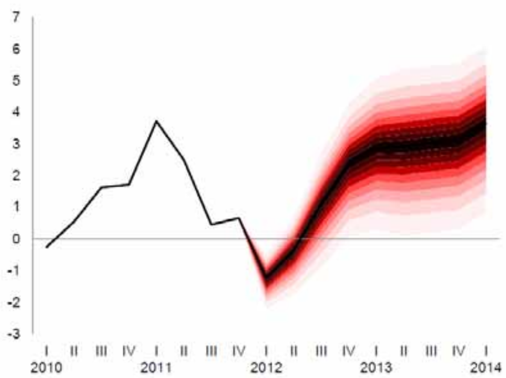
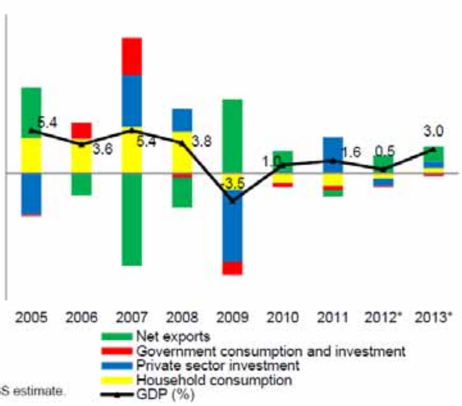


Chart 12 **Contributions to y-o-y GDP growth***
(in p.p.)



* NBS estimate.

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

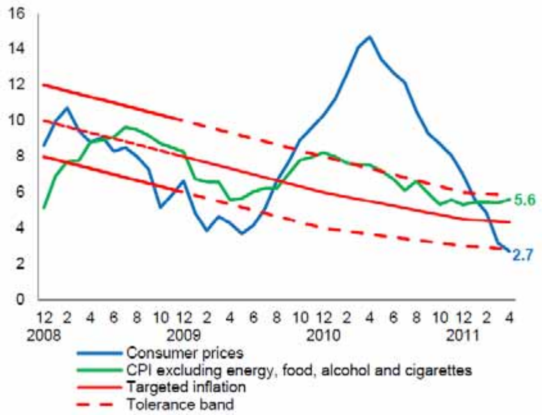


Chart 14 **Contribution to y-o-y inflation**
(in p.p.)

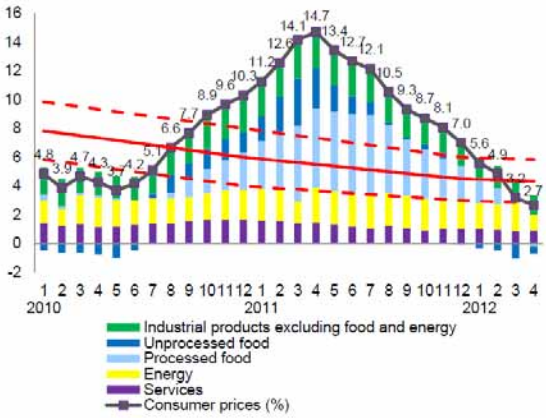


Chart 17 **Short-term inflation projection**
(y-o-y rates, in %)

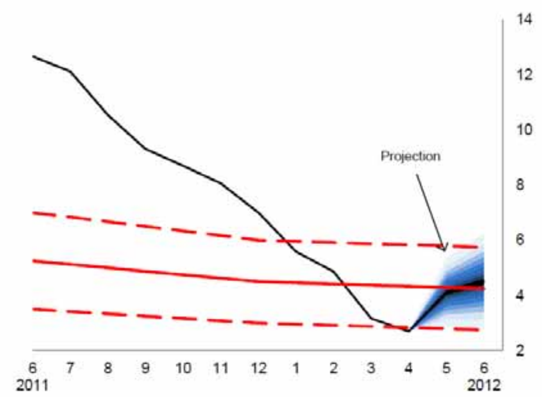


Chart 18 **Inflation projection**
(y-o-y rates, in %)