NATIONAL BANK OF SERBIA

Governor's opening remarks at the presentation of the Inflation Report – August 2017

Dr Jorgovanka Tabaković, Governor

Belgrade, 16 August 2017

Ladies and gentlemen, dear colleagues,

Welcome to the presentation of the August *Inflation Report*. As always, we will give you an overview of monetary and macroeconomic trends for the period since the previous *Report* and set out our expectations for 2017 and 2018. However, before we move on to this, allow me to briefly venture outside the usual timeframe covered by this *Report* and look back at the results which the National Bank of Serbia achieved in the past five years, that is, in the period since my appointment as Governor. This period is long enough to allow us to take stock of what we have accomplished and of the challenges that are still ahead of us.

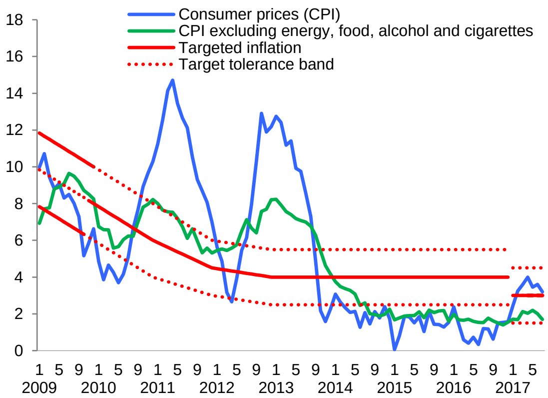
The presence of strong challenges emanating from the international environment, which heightened uncertainties in all markets, did not work in our favour, but also did not prevent us from achieving and maintaining price and financial stability in the five years behind us.

I would like to use this opportunity to highlight some of our key achievements as well as their significance for all of us.

Inflation has been low, stable and predictable for four years in a row.

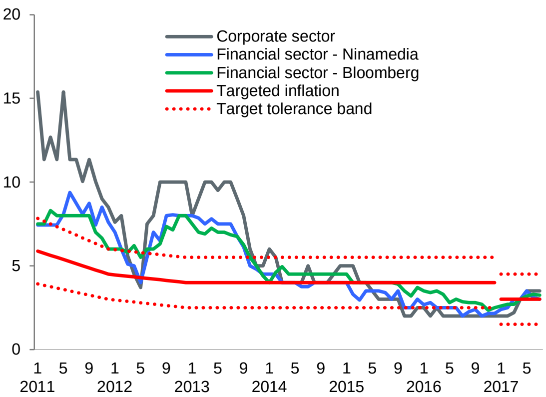
From nearly 13% in autumn 2012, inflation was brought down to 2.2% in less than one year. After that, we have kept it at a low level. Low inflationary pressures from 2013 onwards were partly attributable to low cost-push pressures from the international environment; however, they are mostly a result of the effects of domestic factors – relative stability of the exchange rate, more anchored inflation expectations and the effects of fiscal consolidation. ***With the price stability it has achieved, Serbia is now comparable to other European countries – since the start of the year, inflation has moved within the new, lower target tolerance band and measured 3.2% y-o-y in July***. Core inflation moved at around 2% during the year and equalled 1.7% y-o-y in July. This is also a confirmation of the adequacy of the monetary policy that we conducted in the prior period, as well as of the legitimacy of our decision to lower the inflation target by 1 percentage point to 3±1.5%. According to our latest projection, we expect inflation to remain within the new, lower target tolerance band for the following two years.

Chart 1 **Price movements**
(y-o-y rates, in %)



Source: SORS and NBS calculation.

Chart 2 **One-year ahead inflation expectations**
(y-o-y rates, in %)



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

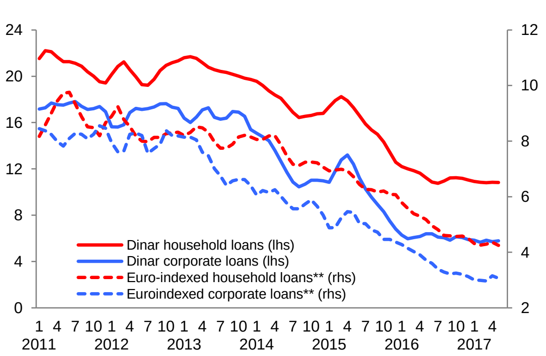
Over the past four years, interest rates on corporate, household and government borrowing have decreased considerably. This is reflected in higher disposable income, a rise in lending and economic activity and more successful fiscal consolidation.

Inflation was first lowered and then maintained at a low level, thereby enabling significant monetary policy easing through the key policy rate, which we initiated in May 2013. By July 2016, through 17 iterations, the key policy rate was lowered by a total of 7.75 percentage points to 4%. Owing to this, ***interest rates on new dinar loans to corporates and households were lowered during the past four years by more than 10 percentage points.***

Within four years, interest rates on euro-indexed loans were also decreased – by 3.5 percentage points for corporates and 3.8 percentage points for households. The decline was partly a result of lower interest rates in the euro money market and partly attributable to the country's lower risk premium and interbank competition. Our efforts to create a more stable business environment, as well as the significant fall in the country's risk premium and Serbia's improved credit rating, were the dominant factors leading to the lowering of interest rates on euro-indexed loans and the greater availability of cross-border borrowing at lower costs.

The fall in rates on private sector borrowing provided an impetus to the rise in disposable income on account of lower interest rates on current and new loans, with the possibility of refinancing under more favourable terms.

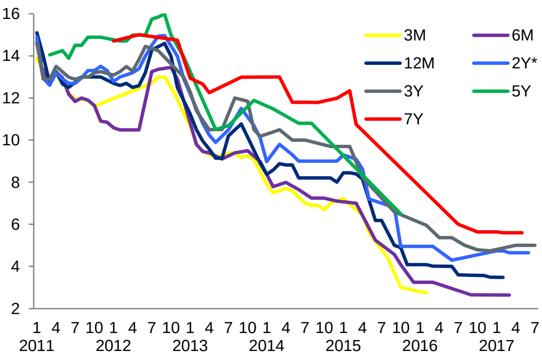
Chart 3 **Interest rates on new dinar and euro-indexed loans to corporates and households***
(3m moving averages, in %)



Source: NBS.

* Excluding revolving loans, current account overdrafts and credit card debt.

Chart 4 **Interest rates in the primary market of government securities**
(p.a., in %)



Source: Ministry of Finance.

* Excluding coupon securities with the rate linked to the NBS key policy rate.

Fiscal policy was also immensely helpful in preserving price and financial stability, however, it caused some feedback effect as well. As monetary policy was eased, interest rates on dinar government bonds were lowered by more than 7 percentage points, depending on maturity. This significantly lowered the costs of dinar government borrowing, which, together with a more favourable economic environment and in conditions of low inflation and a relatively stable exchange rate of the dinar to the euro, rendered fiscal consolidation more successful.

Lower interest rates meant lower costs for everyone – the corporate sector, citizens and the government.

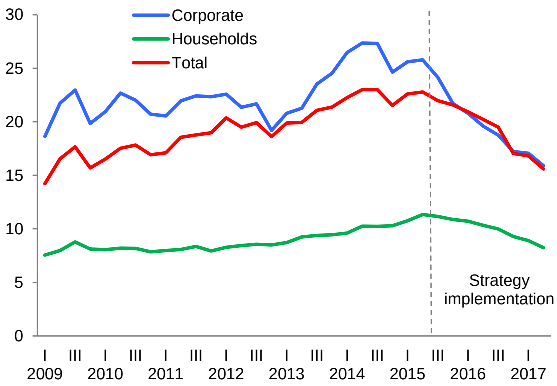
Significantly lower interest rates, accelerated economic activity and labour market recovery led to a rise in loan demand. On this account, lending recorded positive y-o-y growth rates since the second half of 2015, despite the maturing of considerable amounts of subsidised loans and increased efforts of banks to resolve the issue of non-performing loans. Since the start of 2015, new investment loans were approved at a significantly faster pace, their total volume over the past two years equalling the level of total new investment loans in the four years before that. Investment loans were one of the sources for funding investment in the new investment cycle, thereby contributing to a pick-up in economic growth. During 2017, the y-o-y rise in loans accelerated and arrived at 4.5% in June, or 6.7% excluding the effect of NPL write-offs.

In the prior period, financial stability has been preserved, the share of NPLs in total loans dropped significantly and the regulatory framework has been improved.

Owing to the appropriate combination of measures of monetary and fiscal policies, Serbia arrived at a more favourable macroeconomic position which, coupled with the NBS's regulatory policy, also contributed to the stability of the financial system – our system is more stable than before!

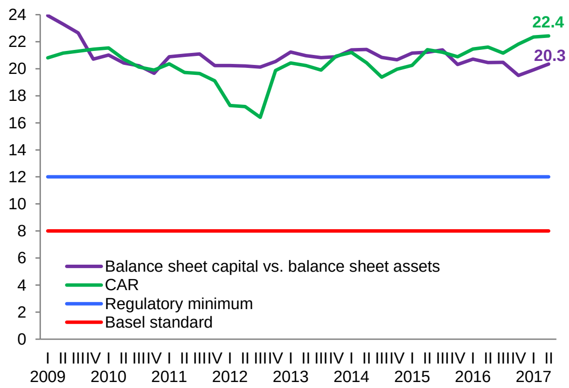
One of the key results in this area is the resolution of NPLs, an issue that accompanied Serbia into the financial crisis, after which it only deepened further. To resolve the NPL issue in a systemic way, in cooperation with the Government, the NBS prepared the NPL Resolution Strategy and the accompanying Action Plans, and adopted them in August 2015. The NBS carried out all the activities within the deadline set by its Action Plan and, as a result, ***since the adoption of the Strategy – which means within a period of less than two years – the NPL share has decreased by close to 7 percentage points***. Moreover, corporate NPLs are now at their lowest level in nine years.

Chart 5 **Share of NPLs in total loans, gross principle**
(in %)



Source: NBS.

Chart 6 **Capitalisation of the Serbian banking sector**
(in %)



Source: NBS.

As a result of numerous measures and activities that were undertaken in the area of macro and microprudential policy, the Serbian banking sector features a high degree of capitalisation and liquidity, which are above regulatory requirements, and resilience to various macroeconomic shocks. High capital adequacy has been confirmed by special diagnostic studies of the quality of banks' assets which, until then, had never been conducted in the domestic banking system. The stability of the sector is further substantiated by the fact that banks operating in Serbia mostly rely on domestic sources of funding, which increased in the previous period. This reduces banks' exposure to risks stemming from the international environment, as well as to the risk of sudden withdrawal of funds by the parent bank, which was one of the challenges countries in the region faced during the crisis.

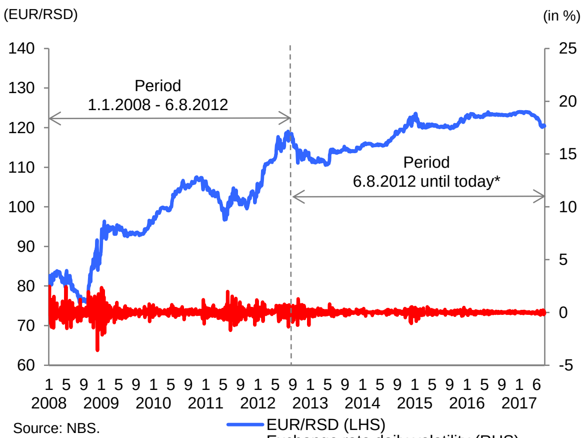
Additional contribution to the sector's stability came from our strategic commitment to continuously improve the legal framework, in accordance with international standards and EU regulations, taking into account the specificities of the domestic market. Let me remind you that we have composed and adopted a set of secondary legislation introducing Basel III in Serbia as one of the important reforms aligning Serbia's regulatory framework in this area almost entirely with the applicable framework in EU countries.

Since August 2012, we have ensured the relative stability of the exchange rate, which is one of the factors of overall stability.

The international environment in the prior period was marked by uncertainty arising from the diverging monetary policies of leading central banks, but also from the so-called Greek crisis, the Asian stock market crisis, shifting outlooks for global and Chinese growth, the effects of Brexit, geopolitical tensions, etc. ***To these challenges we responded adequately, owing to greater resilience of the Serbian economy and the financial system, cautious monetary policy, as well as interventions in the foreign exchange market which were timely, fine-tuned and well-balanced in terms of the reaction to short-term pressures towards both the depreciation and appreciation of the dinar.*** Expressed in numbers, in the last five years until July, the NBS intervened in the foreign exchange market by net selling EUR 765 million, with the nominal depreciation of the dinar against the euro of 1.5%. This is significantly less than the net sale of EUR 5.7 billion in the five years before that, when the nominal depreciation of the dinar was 33.2%.

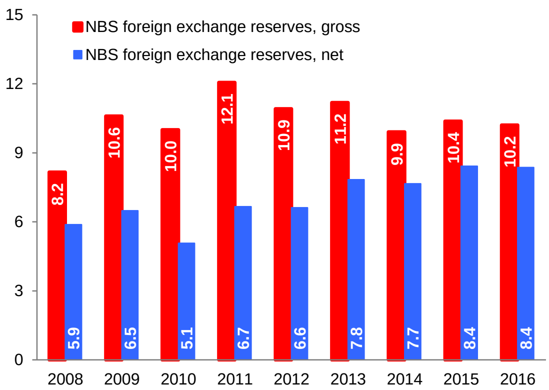
Bracing for the coming pressures by preparing a defence system at peaceful times and investing in stability during turmoil, the country's gross foreign exchange reserves were preserved at an adequate level, measured by all criteria, while in net terms, they increased from EUR 6.6 billion at end-2012 to EUR 8.4 billion at end-2016.

Chart 7 **Dinar exchange rate**



Source: NBS.
*As at 31/07/2017.

Chart 8 **Level of foreign exchange reserves**
(in EUR bn)



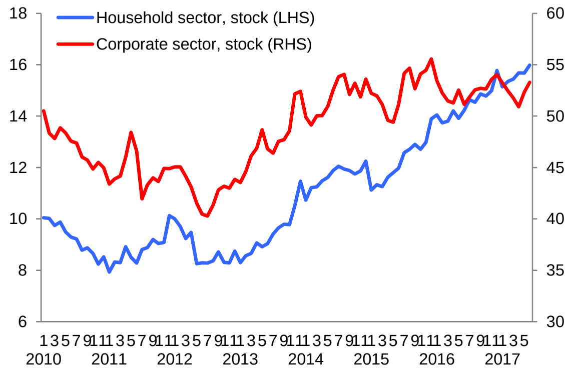
Source: NBS.

Confidence in the dinar is also returning slowly, as evidenced by the rising degree of dinarisation.

Macroeconomic stabilisation, significantly lower dinar loan rates and measures promoting saving and borrowing in dinars provided a contribution to the increase in the degree of dinarisation. ***Consequently, the share of dinar loans of households rose from 35% at end-2012 to almost 50%, where it now stands, while at the same time the share of dinar deposits in total deposits also rose from less than 20% to around 30%.*** As of last year, banks introduced dinar housing loans approved at interest rates below 5% and for the period of up to 30 years. Last year, a top-rated international financial organisation issued the first dinar securities and the proceeds were used for dinar lending.

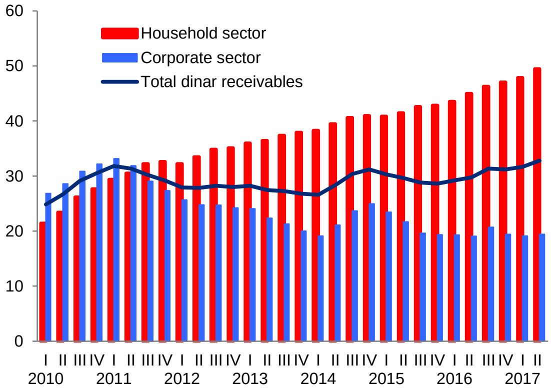
Bearing in mind how deep the roots of euroisation go, we are aware that dinarisation will be a gradual process, but the important thing is that it has begun and that it will remain one of our strategic priorities.

Chart 9 **Dinar share in total bank deposits of corporates and households**
(in %)



Source: NBS.

Chart 10 **Share of dinar in total bank receivables from corporate and household sectors**
(in %)

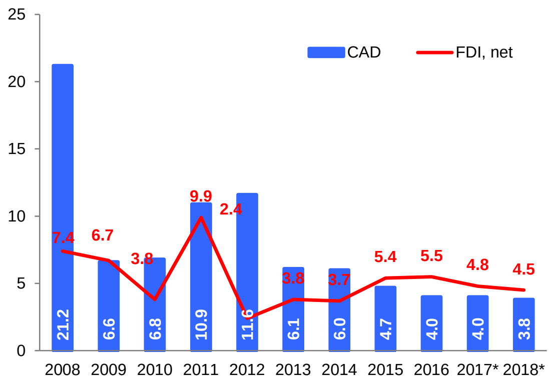


Source: NBS.

The business and investment environment is more stable.

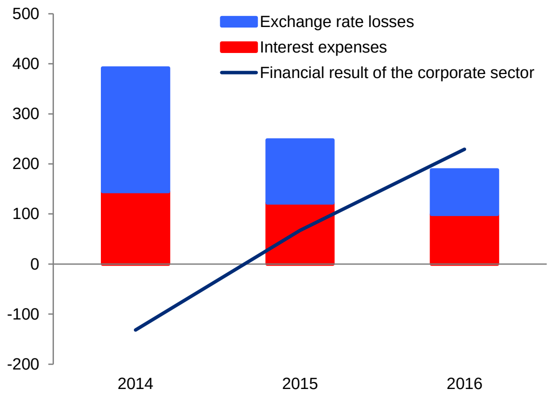
Over the past five years, the NBS managed to achieve and maintain price and financial stability, thereby meeting its statutory objectives and contributing to the creation of a more encouraging business environment, a fall in the risk premium to its lowest level and improvement in the country's credit rating, progress on the Doing Business list and prospects for the coming period. The practical

Chart 11 **Current account deficit and FDI**
(in % of GDP)



Source: NBS
* NBS projection.

Chart 12 **Financial result of the corporate sector**
(in RSD bn)



Source: Business Registers Agency.

importance of this is substantiated by the inflow of foreign direct investment, which measured 5.5% of GDP in each of the past two years, and was more than sufficient to cover the current account deficit. *Moreover,* ***better business results, supported by lower costs of corporate borrowing and relative stability of the dinar, provided the funds that pushed investment growth up***. Owing to this, private investment – directed mainly to export projects – has become one of the pillars of economic growth and we expect it to remain so in the coming years.

Ladies and gentlemen, dear colleagues,

I would like to reiterate that these are only some of the key results we have achieved over the past five years. I must point out that this is a pleasant though rare opportunity to look back into the past in order to learn lessons for the future – the future which we create by overcoming challenges, armed with knowledge and a sense of responsibility about the importance of what we do. In the period ahead, you may count on the National Bank of Serbia to use all of its available instruments to maintain the achieved price and financial stability and give its contribution to economic growth and the preservation of the standard of living.

Thank you for your attention. I now give the floor to my colleagues.