NATIONAL BANK OF SERBIA

Governor’s opening remarks at the presentation of the Inflation Report – November 2017

Dr Jorgovanka Tabaković, Governor

Belgrade, 15 November 2017

Ladies and gentlemen, dear colleagues,

Welcome to the presentation of the November *Inflation Report*. We will give you an overview of the monetary and macroeconomic trends for the period since the previous *Report* and set out our expectations for the coming period.

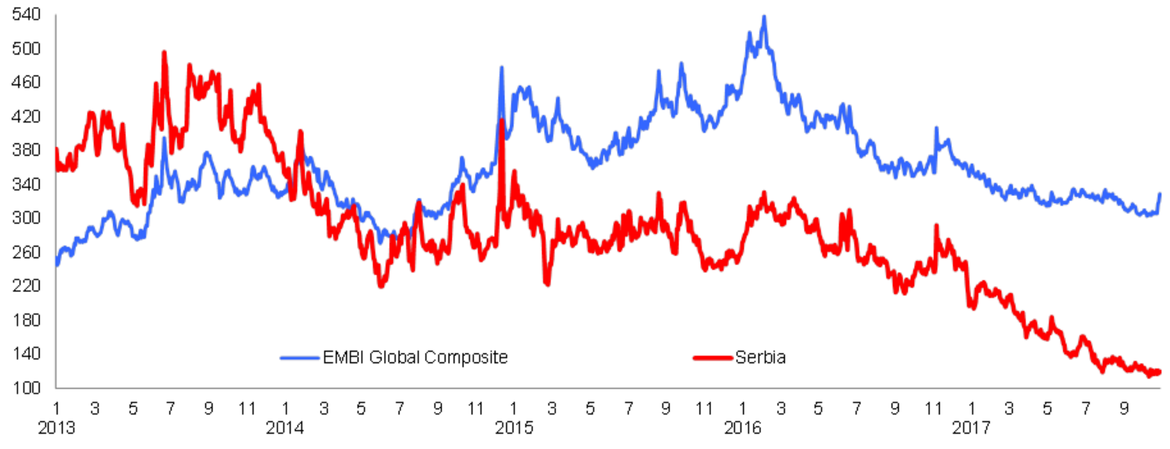
Before I give the floor to my colleagues, who will elaborate on the *Report*, allow me to reflect on several topics that were current in the period following the August *Report*.

Progress on international lists, a fall in the country risk premium, higher investment in Serbia, along with robust growth in exports

I would like to open this conference by stating the fact that Serbia has recorded progress on the World Bank Doing Business list 2018 for the third year in a row, and currently we are on the 43rd position. Furthermore, according to the latest Global Competitiveness Report of the World Economic Forum, **Serbia**, as in the past year, **made the greatest improvement on macroeconomic environment indicators, by 31 notches,** owing to low and stable inflation, a reduced budget deficit, an increase in national savings and a more favourable country credit rating. Measured by the achieved inflation level, according to the Global Competitiveness Report of the World Economic Forum, Serbia kept the first position, shared with 35 more countries.

Owing to the results achieved, Serbia's credit rating was upgraded, and the country risk premium fell to a historical low this year. Only during this year the risk premium more than halved, and since August it has been trending at a relatively stable level – around 120 basis points, its lowest levels. To us, this virtually means the possibility of using both domestic and external sources of finance under more favourable conditions.

Chart 1 **Risk premium indicator – EMBI**



The practical significance of the above stated is testified by the increased interest of foreign investors to invest in Serbia – both in the form of investment in domestic government securities, and in the form of foreign direct investment.

Despite the fact that the Federal Reserve System has raised the funds rate three times since December last year, this year we recorded an appreciably lower outflow of portfolio investment. To be specific, the outflow was down by around 85% during these nine months relative to the same period last year. And in the second and third quarter, there was in fact, a net inflow of portfolio investment despite the global ambience, where, as I have already said, the Federal Reserve System raised its funds rate.

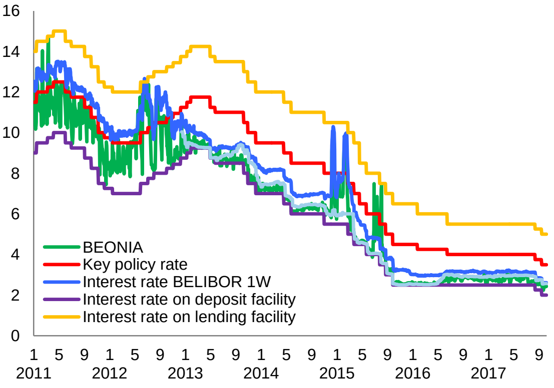
Additionally, bearing in mind the achievements made in the past nine months, we revised upwards our projection of the foreign direct investment net inflow for this year again, from 1.7 billion euros to 2.1 billion euros. That means that the expectation is that this year foreign direct investment will be at the level of around 5.5% of GDP, exceeding the current account deficit for the third year in a row. At the same time, this contributes to the rebalancing of our economy, leading to more dynamic exports, which record two-digit growth rates, owing to new projects and expansion of the exports base. Manufacturing, which is the most propulsive part of our economy, has been recording diversified exports growth of 13.6% year-on-year in the first nine months of this year. Even though exports increased in almost all areas, the most significant contribution to this growth stemmed from the production of base metals, rubber and plastic products, machinery and equipment and chemical products.

In the coming period, the emphasis should be placed on maintaining the achieved results, further improvement of the business ambience and further enhancement of the competitiveness of the domestic economy through structural reforms.

Further monetary policy easing in the conditions of low inflationary pressures, with the reduction in the cost of government borrowing

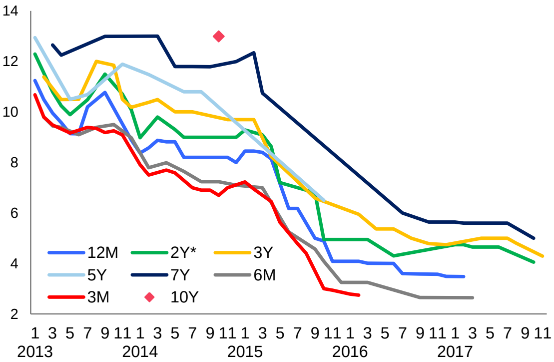
In the period following the last *Inflation Report*, we have lowered the key policy rate two times, in September and October, by 50 basis points in total. Hence, the key policy rate was lowered to 3.5%, which is its lowest level in the inflation targeting regime. **The decision to proceed with monetary policy easing was driven by additionally subdued inflationary pressures, and the fact that resilience of the domestic economy to external shocks increased, owing to favourable macroeconomic performance.** Low inflationary pressures are indicated by low and stable core inflation, moving around 1.5% year-on-year, the same as at the end of the previous year. The impact of the drought on food prices was also less pronounced and the second-round effects on other prices were absent, which is also confirmed by inflation expectations within the target tolerance band. According to our latest projection which takes into account past monetary easing and the public sector wage and pension increase, inflation will continue to trend within the target tolerance band of 3±1.5% until the end of the projection horizon.

Chart 2 **Interest rate movements**
(daily data, p.a., in %)



Sources: Thomson Reuters and NBS.

Chart 3 **Interest rates in the primary market of government securities**
(p.a., in %)



Source: Ministry of Finance.

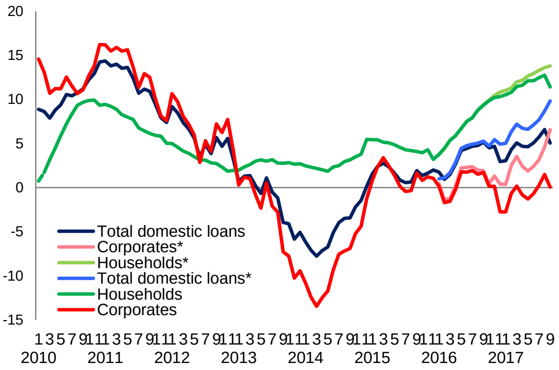
* Excluding coupon securities with the rate linked to the NBS key policy rate.

Lowering of the key policy rate expectedly reflected on a further drop in interest rates in the interbank money market and lower government costs in respect of issued dinar securities. To be specific, the achieved interest rates at the last three auctions of dinar securities with seven-, two- and three-year maturity were lower by 0.5 to 0.6 percentage points relative to the previous auctions with the same maturity, which corresponds to the lowering of the key policy rate. Hence, the full coordination of fiscal and monetary policy continues.

Acceleration of credit activity as support to economic activity and a decrease in the NPL ratio to its lowest level in the past nine years

Past monetary policy easing, a fall in the country risk premium, increased interbank competition, economic growth and labour market recovery, as well as low interest rates in the euro area, contributed to credit activity acceleration to 5% year-on-year in September. Excluding the effect of NPL write-offs, the recovery of credit activity is even more evident and equalled 9.8% year-on-year.

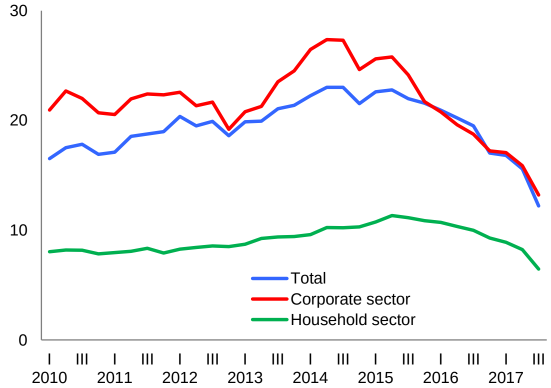
Chart 4 **Effect of NPL write-offs on lending growth**
(y-o-y growth rates at the programme exchange rate, in %)



Source: NBS.

* Excluding the effect of NPL write-offs over the last year.

Chart 5 **NPL share in total loans, gross principle**
(in %)



Source: NBS.

Also in the past two years, that is, since the adoption and implementation of the NPL Resolution Strategy, banks stepped up their efforts to resolve these loans through the write-off and sale to non-banking sector entities. The result of these measures is the **reduction** in the **NPL ratio by over 10 percentage points since the Strategy adoption, which is the lowest ratio for the past almost nine years**, to be more precise, after January 2009.

Credit activity growth, with lower interest rates, supported economic growth as well.

Continued labour market recovery and creation of the basis for growth on sustainable grounds

At the beginning of the year, economic activity was without a doubt affected by supply-side shocks, which primarily reflected on agriculture and energy. However, sectors unaffected by negative effects of these shocks continued to record good performance, particularly manufacturing. The third quarter saw accelerated growth with gradual waning of the effects of these shocks. Non-agriculture and non-energy economic activity will post 3% growth this year, and the growth of manufacturing will probably be even faster than previously expected.

Ahead of us is **the continued work on improvement of the business ambience, which will, along with a high and project-diversified inflow of foreign direct investment, implementation of infrastructure projects, past monetary policy easing and responsible fiscal policy, contribute to the**

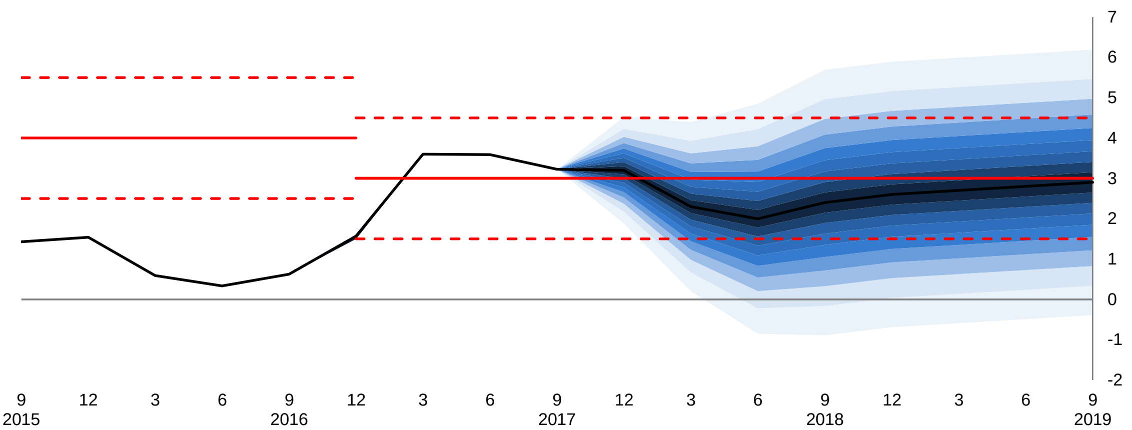
creation of the basis for acceleration of economic growth on sustainable grounds in the medium run. Accordingly, for 2018 and 2019 we expect acceleration to around 3.5%, and around 4% in the medium run. Parallel with that, we expect the continuation of labour market recovery, that is, an increase in employment and the standard of living.

Ladies and gentlemen, dear colleagues,

Finally, I would like to reflect on the just completed mission of the International Monetary Fund on the occasion of the eighth review of the stand-by arrangement of the Republic of Serbia. When it comes to the policy and results of the National Bank of Serbia, inflation is estimated to remain at the level around the target midpoint of the National Bank of Serbia. In addition, bearing in mind exchange rate movements and the expectation that inflation will trend at a low level, the monetary policy stance has been assessed as adequate. As for the financial sector, it has been assessed that the NPL Resolution Strategy continues to yield very good results, that bank credit activity is rising and contributing to economic growth, and that significant progress has been made in the area of bank supervision and alignment of the legal framework with European Union standards. All of this together contributes to the preservation of financial stability.

With this I would conclude my opening remarks and give the floor to my colleagues who will present the key messages of the November *Inflation Report* and our perception of macroeconomic trends in the coming period. You will hear from them that our projections of inflation movements indicate that we will accomplish our main statutory objective by ensuring low inflation within the target tolerance band in the future period as well.

Chart 6 **Inflation projection**
(y-o-y rates, in %)



Source: NBS.