NATIONAL BANK OF SERBIA

Speech at the presentation of the Inflation Report – February 2018

Dr Jorgovanka Tabaković, Governor

Belgrade, 14 February 2018

Ladies and gentlemen, dear media representatives, esteemed colleagues,

Welcome to the presentation of the February *Inflation Report*. We will present to you the current macroeconomic developments, our new projections and monetary policy decisions.

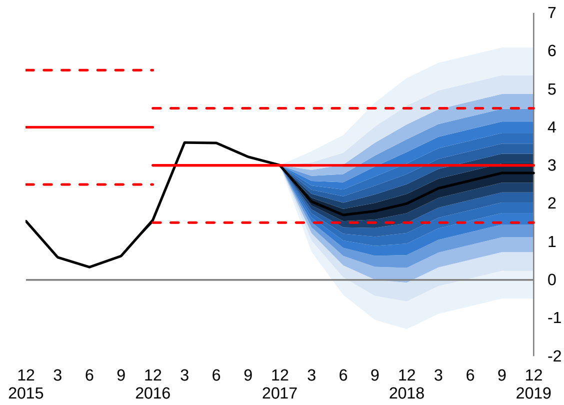
Inflation is on target, credit rating was upgraded, the country risk premium declined, the government budget is in a surplus, the cost of dinar lending is going down, and non-performing loans are on a sharp downward trajectory

At the start, I wish to give a brief overview of last year, i.e. I will present the domestic macroeconomic developments that we believe marked 2017 and that are important from the aspect of the corporate sector, citizens, the government, all of us.

I would like to open this conference by reminding us of an important decision from late 2016 – to lower the inflation target by 1 percentage point, to 3±1.5%, starting from January 2017. That we were realistic in setting the target and consistent in its implementation is confirmed by the fact that inflation moved within the bounds of the lower target corridor throughout the year, and stood at the 3% target both on average and in December. In 2017, three rating agencies upgraded Serbia's credit rating and the country risk premium fell below 100 basis points, to its lowest level. Concretely, for all of us, this means the possibility of using both domestic and external sources of funding under more favourable conditions. The government budget recorded a surplus of 1.2% of GDP, for the first time since 2005. The share of public debt in GDP fell by 10.4 percentage points, thus speedily getting closer to the 60% boundary. The eighth review of the arrangement with the International Monetary Fund was successfully concluded, with the assessment that progress achieved in numerous fields outperformed the defined criteria. Interest rates on dinar corporate and household borrowing declined further in 2017, as did the rates on government borrowing. Lower interest expenses certainly contributed, among other factors, to an improved fiscal performance, which continues into this year as well. I wish to remind you that at the auction of ten-year dinar securities of the Republic of Serbia held on 6 February, demand outstripped supply almost five and a half times. Securities were sold at a 5.35% rate, down by 7.64 percentage points relative to the same-maturity auction of October 2014. These data speak volumes about investors' perception of our economy's prospects. What makes us particularly happy is that the government borrows in dinars, over a ten-year period, at rates that are much lower today. This is another concrete example of savings made based on everything done in the past period, with full coordination of monetary and fiscal policy measures. Last but not least, we have lowered the share of non-performing loans, which was particularly high, below the pre-crisis levels. Their stock has been more than halved in the previous two years.

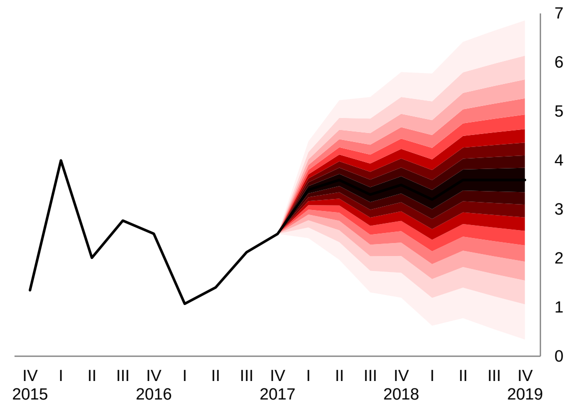
A good year is behind us, and we expect positive trends to continue into this year as well. This is also confirmed by our new projections, under which inflation will move within the bounds of the new, lower target band in the next two years as well. In regard to the economic growth projection, we believe that economic policy measures are well-calibrated, and have created the basis for sustainable acceleration of GDP growth of around 3.5% in 2018 and 2019.

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



Source: NBS.

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



Source: NBS.

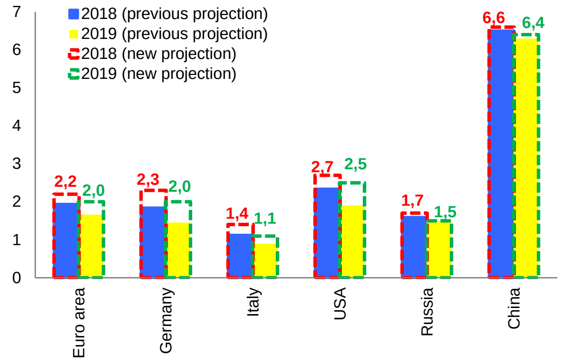
International environment – outlook and risks

Last year saw volatile trends in the international market, which will continue, by all odds, into this year as well. Given the openness of our economy, we carefully monitored and analysed movements in the international environment.

The period from the previous *Report* was marked by a brighter global growth outlook. Particularly important for us is the improvement of the growth outlook of the euro area and countries in the region, which are our important foreign trade partners. On this basis as well, we expect positive effects on further growth in our exports, which was robust last year as well, recording a two-digit rate and maintaining a broad dispersion by product and geographical area.

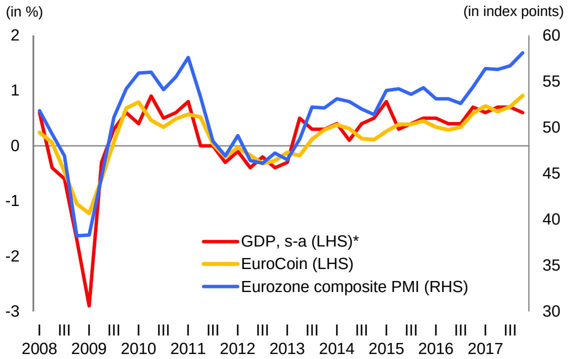
While global growth prospects are favourable, trends in some markets are still marked with uncertainty. In commodity markets, oil prices increased further compared to the previous *Inflation Report*, reflecting

Chart 3 **Revisions of real GDP growth forecasts for 2018 and 2019 by the IMF**
(in %)



Sources: IMF WEO (October 2017) and IMF WEO Update (January 2018).

Chart 4 **Movements in GDP and economic activity indicators of the euro area**
(quarterly rates)

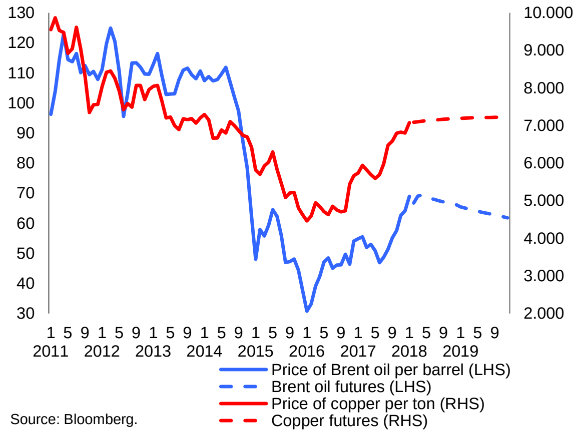


Sources: Eurostat, Markit Group and Banca d'Italia.

* Eurostat preliminary estimate for Q4 2017.

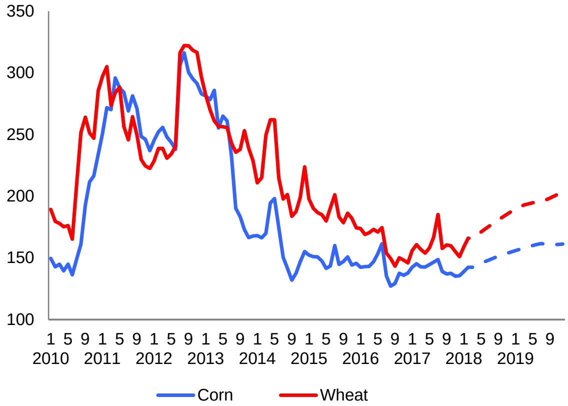
both supply-side factors and expectations that demand will rise more rapidly with global growth acceleration. In January, the Brent oil price exceeded USD 70 per barrel, which is its highest level since December 2014. Owing to higher energy prices, global inflation is somewhat higher than in the earlier period, but still no stronger inflationary pressures are expected in the majority of countries. In addition, based on oil futures that we use in our projection, we do not expect further growth in global oil prices. Of course, deviations are possible both for oil prices and prices of other primary commodities.

Chart 5 **Oil and copper price movements**
(average monthly prices, in USD)



Source: Bloomberg.

Chart 6 **Prices of primary agricultural commodities and their futures**
(USD/t)



Source: CBOT - Chicago Board of Trade.

Also, the leading central banks continue to pursue diverging monetary policies due to different economic cycle phases of their economies, while financial conditions remain favourable. Thus, the international environment is still marked with uncertainty as to the speed of Fed's monetary policy normalisation. Another question concerns the duration of monetary accommodation of the European Central Bank due to faster than expected growth in the euro area.

Strengthening of domestic fundamentals – as a response to external challenges

It is indisputable that external challenges have existed and will exist. However, what is important in the context of analysing overall developments is the fact that our economy's resilience to shocks increased in the past period, including the readiness to respond to these shocks in a timely and adequate manner.

A contribution certainly also came from fiscal performance, which was more favourable than initially expected – the surplus of 1.2% of GDP at the consolidated level was achieved in 2017 for the first time since 2005. Positive fiscal trends continued largely on account of rising domestic demand and corporate profitability, labour market recovery and enhanced efficiency of tax collection. Indubitably, a better fiscal result was achieved also on account of lower interest expenses both owing to the government's diminished needs to borrow and monetary policy easing by the National Bank of Serbia. Lesser government needs for funding were one of the factors leading to the sharp decline in the share of public debt in GDP of 10.4 percentage points in 2017. The end of the year also saw the repayment of the due eurobond, issued in the international market in 2012, in the amount of USD 750 million, which reduced the level of debt and its dollar component.

In the course of 2017, the country risk premium measured by EMBI declined considerably. Given that EMBI Global fell by 54 basis points last year and that EMBI for Serbia fell by 147 basis points, it is clear that a portion of the decline in our risk premium was due to global factors, though to a larger degree it was determined by domestic factors as well. The preservation of macroeconomic stability, strengthening of domestic fundamentals and Serbia's more favourable growth outlook resulted in Serbia's risk premium falling below 100 basis points, for the first time on record. Late last year, two rating agencies – Standard & Poor's and Fitch, upgraded Serbia's credit rating, with a stable outlook. The eighth review of the arrangement with the International Monetary Fund was also successfully concluded. In January, Serbia's risk premium fell to its lowest level on record (85 basis points).

A fall in the risk premium and upgraded credit rating of the country contribute to rising foreign investor confidence as to long-term investment in Serbia. The opposite is also true. In 2017, this also resulted in a considerably higher net external capital inflow, notably foreign direct investment, which exceeded the previous projection and reached EUR 2.4 billion, i.e. 6.6% of GDP. Thus, for the third year in a row, it ensured full coverage of the current account deficit. In gross terms, the foreign direct investment inflow to Serbia came at EUR 2.55 billion. On these grounds as well, in 2017 appreciation pressures prevailed in the foreign exchange market and the dinar gained 4.2% against the euro. To ease excessive short-term strengthening of the dinar, in 2017 we intervened in the interbank foreign exchange market by purchasing foreign currency worth EUR 725.0 million net, which further bolstered the country's foreign exchange reserves.

Chart 7 **Risk premium indicator − EMBI by country**
(daily, in basis points)

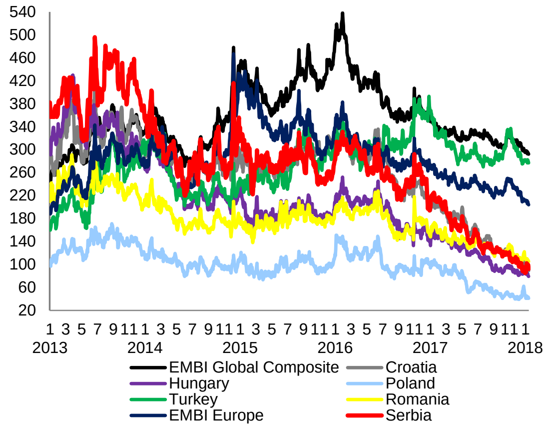
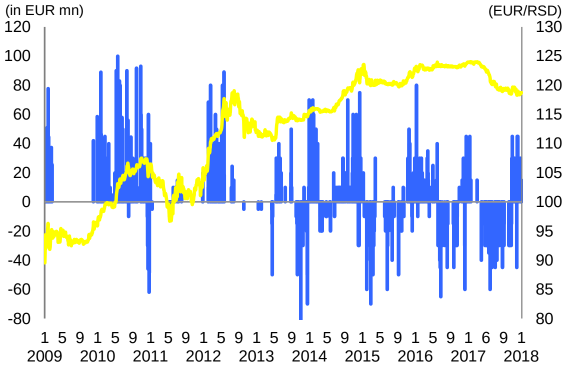


Chart 8 **Movements in EUR/RSD exchange rate and NBS FX interventions**



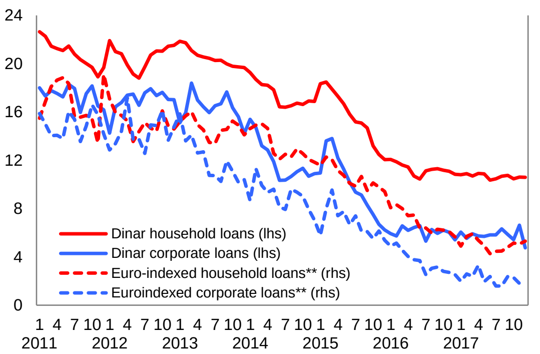
Source: NBS.
* + sale; - purchase.
** 1 EUR in RSD.

A further decline in interest rates on dinar corporate loans and acceleration of lending in the function of supporting economic activity, with the share of non-performing loans falling below the pre-crisis level

In an environment of low inflationary pressures, past monetary policy easing by the National Bank of Serbia led to a further decline in the costs of dinar borrowing, while interest rates on all types of dinar corporate loans fell to new lows in December. This, together with a falling country risk premium, enhanced interbank competition, economic growth and labour market recovery, as well as low interest rates in the euro area, contributed to acceleration of lending activity. A rise in total loans (excluding the exchange rate effect) equalled 7.4% in 2017, with corporate lending rising by 4.3% year-on-year. Excluding the effect of the write-off of non-performing loans in the past year, the recovery of lending activity is even more evident – it rose by 10.2% year-on-year, with corporate loans up by 7.4%.

In addition, the resolution of the issue of non-performing loans was stepped up. Their share in total loans fell below the pre-crisis level and their stock in the past two years more than halved (a drop of 53%). This provides additional support to lending activity and economic growth going forward.

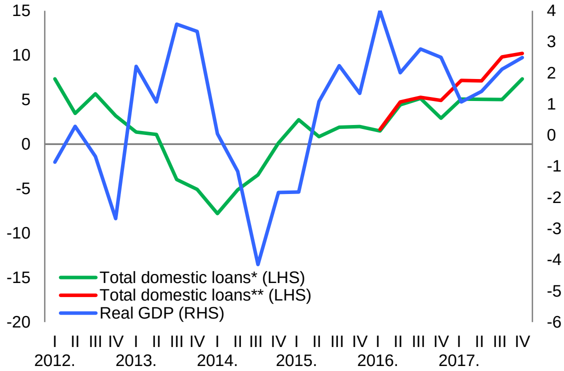
Chart 9 **Interest rates on new dinar and euro-indexed loans to corporates and households***
(weighted average values, p.a., in %)



Source: NBS.

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

Chart 10 **Lending activity and GDP**
(y-o-y rates, in %)



Sources: NBS and SORS.

* Excluding the exchange rate effect.

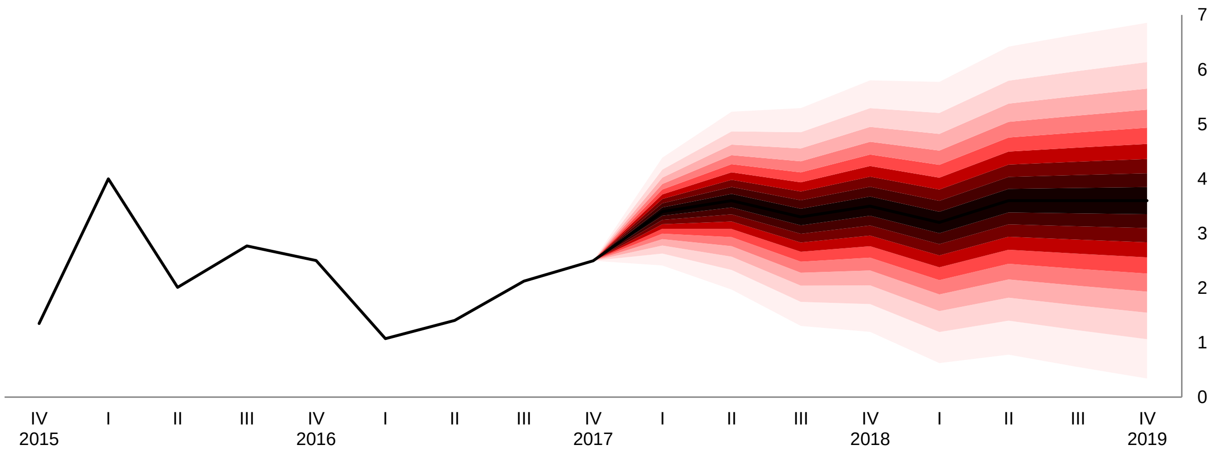
** Excluding the effect of NPL write-off in the past year.

* * *

Consistent with our estimates, GDP growth has gained ground with the gradual waning of supply-side shocks. In the fourth quarter, it accelerated to 2.5% year-on-year, underpinned by faster growth in construction and the majority of service sectors. Manufacturing continued to provide a positive contribution, while agriculture, due to a bad agricultural season, recorded an expected slump. On the expenditure side, growth accelerated the most on the back of private investment, supported, among other things, by the high inflow of foreign direct investment.

Our new projection also confirms that in 2018 and 2019 GDP growth will accelerate to around 3.5%. Investment is expected to remain one of the drivers of economic growth, bearing in mind further improvement in the business ambience, a high foreign direct investment inflow, infrastructure projects and past monetary policy easing. An increasing positive contribution should also come from household consumption amid a further recovery in the labour market. We also expect further growth in exports, particularly in manufacturing, whose exports continued up in 2017, reaching 13.6%, thanks to investment in the past period and expansion of external demand. Imports are also likely to increase, particularly imports of equipment, with the continuation of the investment cycle.

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



Source: NBS.

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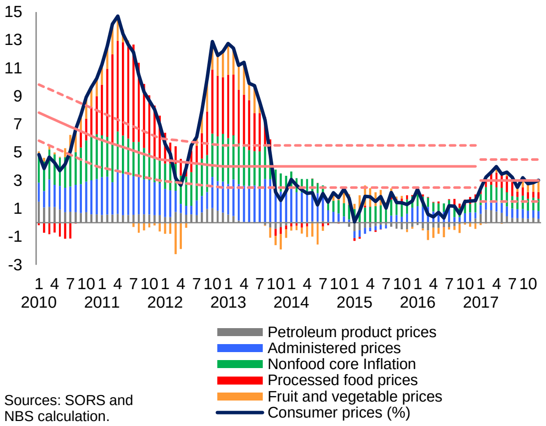
Ladies and gentlemen, dear colleagues,

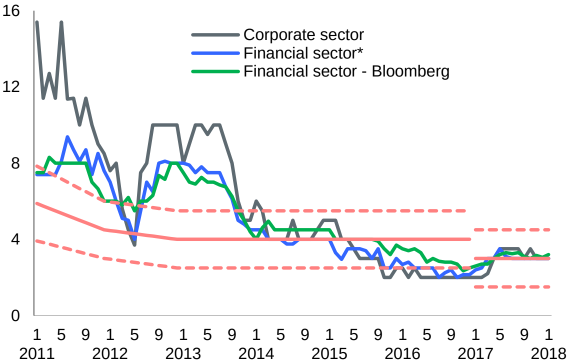
Allow me to conclude the first part of the conference by presenting the data on inflation movements. Owing to well-calibrated monetary policy measures and full coordination with fiscal policy, in the course of 2017 inflation moved within the target (3±1.5%) and in December, as well as at the level of the annual average, it measured the targeted 3.0%. That inflation pressures remained low is indicated also by core

Chart 12 **Contribution of CPI components to y-o-y inflation**
(in pp)



Sources: SORS and NBS calculation.

Chart 13 **One-year ahead inflation expectations**
(y-o-y rates, in %)



Source: Gallup, Ipsos/Ninamedia, Bloomberg and NBS.
* Ipsos and Gallup agencies until December 2014, Ninamedia agency since December 2014, and Ipsos agency since January 2018.

inflation, which in December hit the lowest level since the introduction of consumer price measurement (1.3% year-on-year), as well as by inflation expectations of the financial and corporate sectors, which have been anchored within the target.

As of the beginning of this year, inflation is expected to slow down and move closer to the lower bound of the target tolerance band. In an environment of low inflationary pressures, this will also be supported by the drop-out of last year's one-off price hikes of certain products and services from the year-on-year calculation.

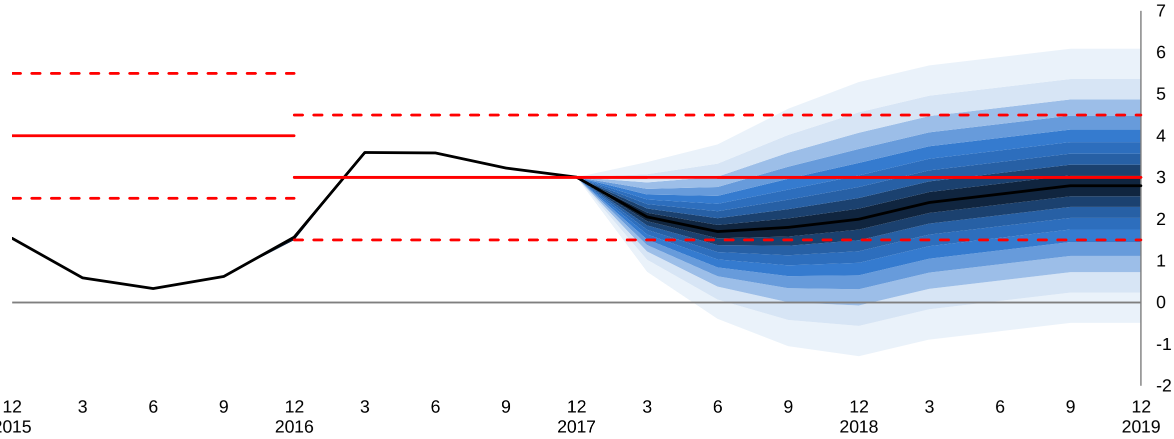
In the medium-term, according to our new central projection, year-on-year inflation will continue to move within the target tolerance band of 3.0±1.5% until the end of the projection horizon, that is in the following two years, which will also be supported by the gradual recovery of domestic demand.

* * *

Taking into account primarily the expected movement of inflation and its key factors in the period ahead, as well as the effects of past monetary policy easing in the period since the last *Inflation Report*, we kept the key policy rate at 3.5%.

In the coming period as well, monetary policy decisions will depend on our estimate of the impact of domestic factors and factors from the international environment on inflation movements in Serbia. In our judgement, the major risks come from the international environment, and thus we will continue to closely monitor and analyse movements in the international financial market and the market of primary commodities, and to assess their impact on economic movements in Serbia.

Chart 14 **Inflation projection**
(y-o-y rates, in %)



Source: NBS.

Of course, same as before, the National Bank of Serbia will use all available instruments in order to keep inflation in Serbia low and stable in the medium term. I believe that this, together with preserving financial stability, is the best way for a central bank to contribute to sustainable economic growth and to strengthen resilience to challenges from the environment.

I will finish my introductory address with these words and give the floor to my colleagues from the Directorate for Economic Research and Statistics, who will briefly present the latest projections and text boxes from the *Report*. What you will also hear from them is that our projections of inflation movements indicate that in the coming period we will continue to fulfil our primary legal mandate of keeping inflation within the target, while well-calibrated measures of economic policy set the groundwork for sustainable acceleration of GDP growth, which we estimate at around 3.5% in 2018 and 2019, and at around 4% in the medium term.