National Bank of Serbia

Macroeconomic Developments in Serbia

February 2021

Sustained Macroeconomic Stability

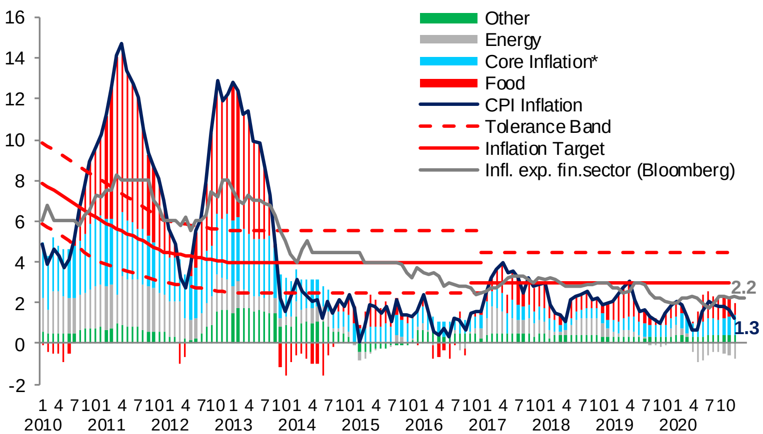
- COVID-19 and global slowdown, according to available data, had a less severe impact on Serbia compared to other European countries, due to achieved macroeconomic and financial stability, growth momentum, fiscal space created in previous years, large and timely monetary and fiscal package, and structure of the economy.
- According to SORS preliminary estimate, GDP declined in 2020 by 1.1%. According to NBS projection, GDP growth in 2021 will range from 5.0% to 6.0%, with symmetrical risks.
- The adopted economic measures (EUR 5.8 bn, around 12.5% of GDP) managed to mitigate the effect of the crisis and minimize economic downturn, which should allow GDP to return to pre-crisis level during this year and to sustainable growth of around 4% in the medium term.
- After Eurobond in May, Government issued in November a 10Y Eurobond USD 1.2 bln at an interest rate of 2.35% (coupon rate 2.125% - with the first time ever hedging to euro and a de facto coupon rate of 1.066% on EUR) most of which have been used for the early redemption of the Eurobond from 2011, so that the level of public debt did not change significantly and remained below Maastricht criteria of 60% of GDP.
- According to our new projection, inflation will continue to move in the lower part of the target band in 2021 and 2022, as indicated by inflation expectations, which are stable and anchored at around 2%.
- External imbalances are reduced in 2020 with CAD declined to 4.2% of GDP. On the other hand, macroeconomic stability and improved business environment that led to high FDI inflows of EUR 10.3 bn in 2018–20, of which in 2020 FDI inflow stood at Eur 3.0 bln.
- Despite global value chains disruption and the decline of external demand, goods export remained relatively resilient and owing to increased product and geographic diversification and activation of export oriented investments declined only 2.5% in 2020.
- Unemployment rate at single digit level in Q3 2020 (9.0%), with significant growth in activity rate and employment levels.
- Results were acknowledged by confirmed credit ratings in 2020 (Fitch and S&P) despite global crisis caused by COVID-19 pandemic. PCI arrangement with the IMF has been successfully completed at end-2020.
- As of June 30, 2021, RSD bonds of the Republic of Serbia will be included in the renowned bonds index - J.P. Morgan GBI-EM index.
- In February 2021, the NBS decided to keep the key policy rate unchanged at 1.0%, the lowest level in inflation targeting regime.
- Banking sector stability has been preserved and further reinforced. Encouraged by the NBS measures, the share of NPLs in total loans declined to 3.7% at end-December 2020.

National Bank of Serbia

Inflationary Pressures Still Remain Low

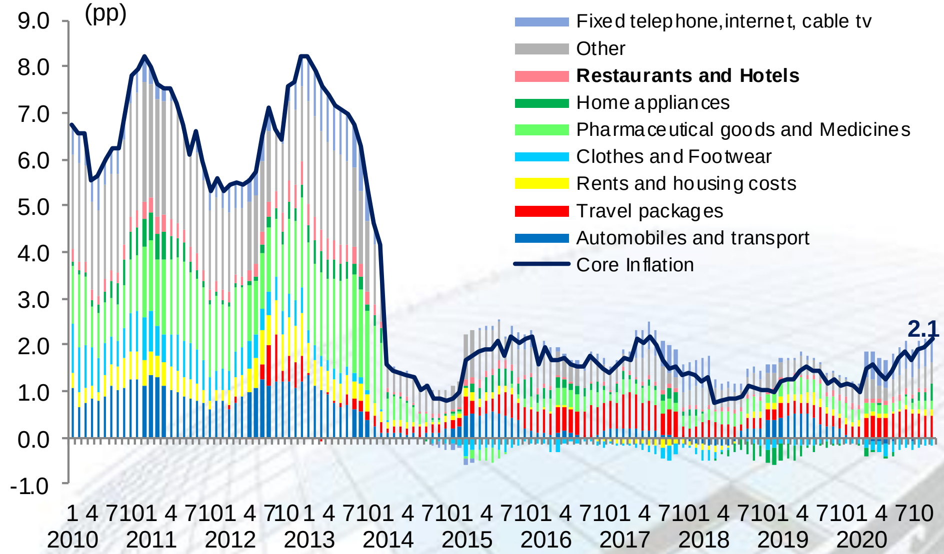
Inflation profile similar to advanced economies…

Chart 1 **CPI developments**
(y/y rates, %) and contributions (pp)



… same stands for core inflation

Chart 2 **Contributions to y/y core inflation**
(pp)



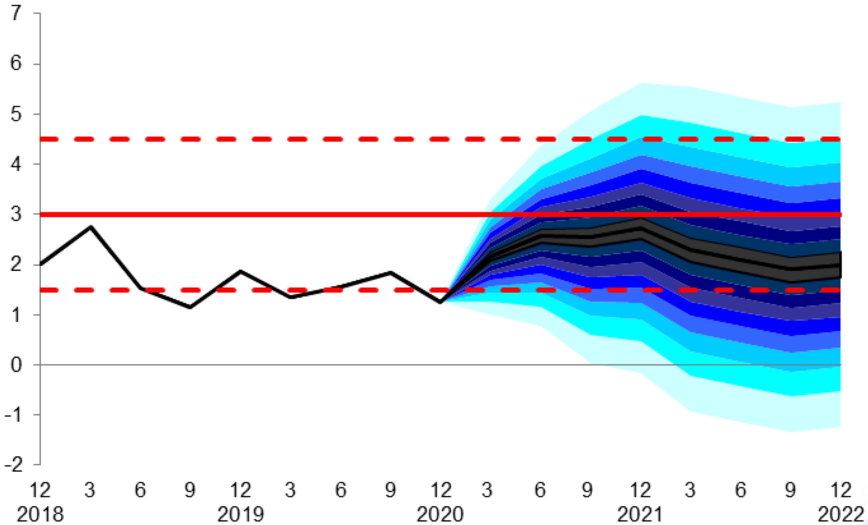
- Inflation is kept firmly in check, moving around 2% on average in the past seven years.
- Inflation remained low and stable during 2020, averaging 1.6%.
- The dynamic of inflation in 2020 were mainly led by fruit and vegetable prices as well as oil derivatives prices
- The biggest positive contribution to inflation in December (1.3%) came from services prices (0.8 pp), processed food (0.7 pp) and cigarettes (0.3 pp).
- The biggest negative contribution came from prices of oil derivatives (-0.7 pp)

- Average core inflation in the last seven years stood at 1.5%, confirming price stability.
- Average core inflation in 2020 stood at 1.6%, and ended the year at 2.1%.
- Its growth in H2 2020 was a result of rapid recovery of domestic demand and the growth of demand for certain products that enable work from home.
- According to Bloomberg's February survey, one year ahead inflation expectations of the financial sector stood at 2.2% (unchanged relative to January survey)..

Inflation Stable Within the Target Until End of Projection Horizon

Inflation will move within the lower half of the target tolerance band in the period ahead,…

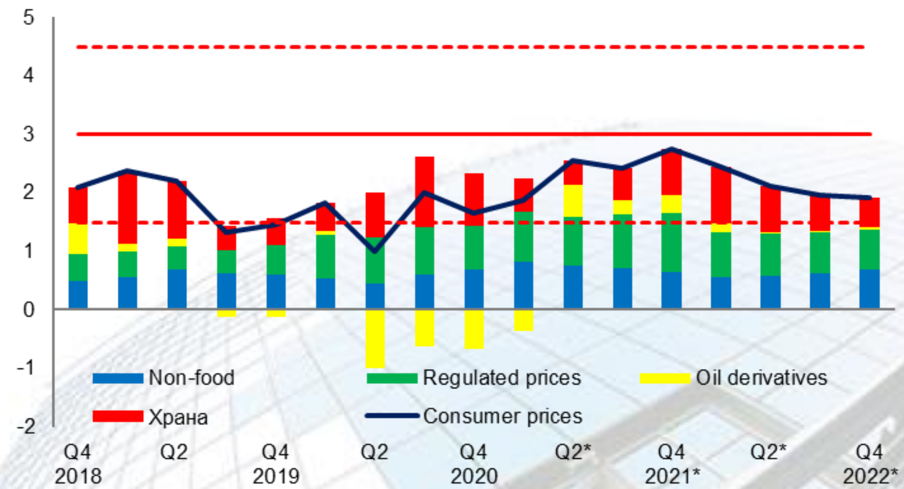
Chart 3 **Inflation projection** (from February 2021 IR)
(y/y rates, in %)



- We see an increase of y-o-y inflation in 2021 as temporary, resulting from the increase in the prices of electricity and the growth in global oil prices, that will lead to the increase in petroleum product prices.
- Effects of these temporary factors will weaken by the end of the year, so in 2022 we expect average inflation to be lower.
- Disinflationary pressures, that prevail in the medium run, will come from open negative output gap, as well as low imported inflation, but their impact will gradually weaken from the second half of 2021.

…and it is expected to be at somewhat higher level in 2021 than the previous year.

Chart 4 **Inflation projection** (from February 2021 IR)
(y/y rates in % and contributions in pp)



*NBS Forecast

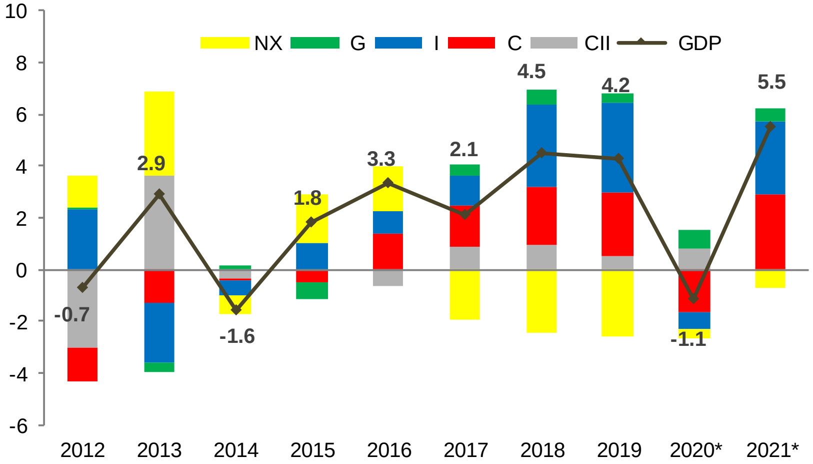
- Risks of the projection are judged to be symmetrical and related mainly with trends in the international environment, global trade and economic growth, primarily growth of the euro area, capital flows to emerging economies and the global prices of oil and other primary commodities.
- The movement of inflation will also depend on the pace of recovery of domestic demand, domestic food prices and administered prices.
- Risks of the inflation projection, alltogether, are assessed as symmetrical.

Real GDP Decline in 2020 Stands at -1.1%; Growth Range From +5.0% To +6.0% in 2021

Economic recovery is driven by domestic, and to a lesser extent by external demand

Chart 5 **GDP developments**

(y/y growth rates in % and contributions in pp)



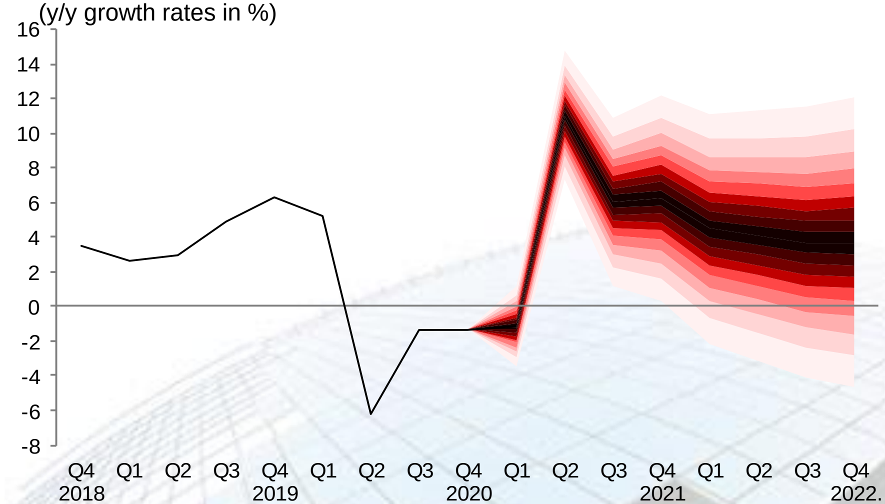
*NBS forecast

- SORS estimate of Serbia's growth in 2020 is at the level of -1.1%, which is one of the best results in Europe, with the possibility of being -1.0%, as indicated by the flash estimate for Q4.
- In 2020, Serbia managed to avoid a decline in both total industry and manufacturing, with a decline in goods exports of only -2.3%.
- A decline in exports of ICT services was also avoided, while a decline in construction and fixed investment, despite a very high base in 2019, was kept to a minimum.
- According to SORS flash estimate, GDP growth for Q4 amounts -1.3% y/y and increased by 1.3% s-a on a quarterly basis (carry over effect of about 1.5 pp in 2021).

In the coming years Serbia will maintain a strong, sustainable and broad-based growth

Chart 6 **GDP growth projection** (from February IR)

(y/y growth rates in %)



- Thanks to the economic measures taken, a greater decline in investment and consumer confidence has been prevented, and production capacities, labor force and favourable macroeconomic outlook have been preserved.
- In 2021, we expect GDP growth between 5.0% and 6.0%, with symmetrical risks, while in the coming years the growth should stabilize at around 4.0%.
- We assess the overall risks as symmetric: risks from international environment as asymmetric downwards (Eurozone recovery, vaccination pace, normalization of economic flows), and domestic risks as asymmetric upwards (new package of economic measures).

NBS Response to Covid-19

NBS response to COVID-19

	2020									2021
	March	April	May	June	July	August	September	November	December	January
Monetary policy measures										
Key policy rate										
	Cut by 0.5 pp, to 1.75%	Cut by 0.25 pp, to 1.5%		Cut by 0.25 pp, to 1.25%					Cut by 0.25 pp, to 1.0%	
	Rate corridor narrowed from ±1.25 pp to ±1 pp								Rate corridor narrowed from ±1.00 pp to ±0.90 pp	
Support to dinar liquidity										
	Additional swap auctions, 3M maturity							Additional swap auctions on a weekly basis (Mondays), 3M maturity		
		Lower interest rate on FX swaps								
	Auctions of repo purchase of government securities 7D maturity									
	Auctions of repo purchase of government securities 3M maturity							Additional repo auctions of securities purchase on a weekly basis (Thursdays), 3M maturity		
		Outright purchase of government securities in the secondary market								
			Corporate bonds included in the list of eligible in NBS monetary operations							
More favourable conditions for Guarantee Scheme loans										
					Approval of dinar loans under the Guarantee Scheme at lower interest rates – minimum 50 bp reduction is compensated by the NBS through the higher remuneration rate on allocated required reserves					
Additional NBS measures										
Moratorium										
		Moratorium on debt payments				Moratorium on debt payments				
Measures for adequate credit risk management										
									Measures to facilitate loan repayments for debtors who have difficulties in settling their obligations	
Housing loans										
				Reduction of mandatory downpayment for first-time home buyers from 20% to 10%						
						Reduction of the minimum degree of completion of a building eligible for financing via bank housing loans				
						Extension of repayment term for housing loans by up to five years				
Other loans										
					Extension of repayment term for household loans (except for housing) by up to eight years					
						Until end-2021 banks allowed to extend household dinar loans (up to 90,000 dinars) only based on signed statement on employment/pension				
Precautionary repo line with the ECB										
					A precautionary repo line with the ECB established to supply additional euro liquidity to local banks in case of need					

Programme of Economic Measures to Mitigate the Negative Effects Caused by the COVID-19 Pandemic and Support the Serbian Economy

- Total value of economic measures is estimated at 12.5% of GDP.

Programme of Economic Measures to Mitigate the Negative Effects Caused by the COVID-19 Pandemic and Support the Serbian Economy

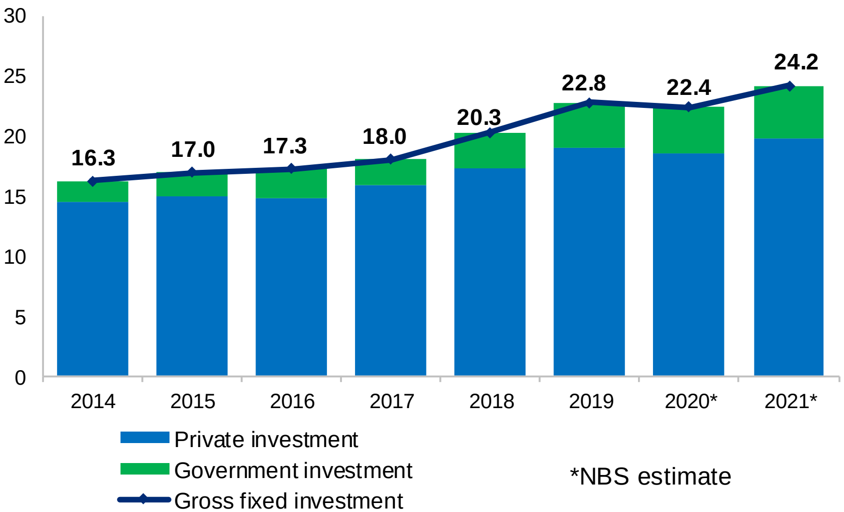
I Group – Tax policy measures
1. Deferred payment of payroll taxes and contributions in the private sector (during the state of emergency) with subsequent repayment of liabilities in instalments (starting from 2021 at the earliest)
2. Deferred payment on taxes and contributions on salaries for one month
3. Exemption of donors from the obligation to pay VAT
II Group – Direct assistance to the private sector
4. Payment of three minimum wages to entrepreneurs that are subject to the flat rate tax and pay tax on actual income, and to micro-, small- and medium-sized enterprises in the private sector
5. Payment of assistance to large private sector enterprises in the amount of 50% of net minimum wage for employees on paid temporary leave on employer's decision
III Group – Measures to preserve liquidity
6. Financial support to the corporate sector through the Development Fund
7. Corporate support guarantee scheme
IV Group – Other measures
8. Moratorium on dividend payments until the end of 2020, except for public companies
9. Wage increase measures and other direct financial assistance
10. Direct assistance to all adult Serbian citizens in the dinar equivalent of EUR 100
V Group – Additional package of measures (July/August 2020)
1. Payment od 60% of minimal wages to enterpreneurs, and to micro-,small- and medium-sized enterpises in the private sector
2. Deferred payment of income tax advances for one month
3. Direct support to the hotel sector - 350 € per bed, 150 € per room

Source: Ministry of Finance.

The Ongoing Investment Cycle

Preceded by achieved macroeconomic stability, new investment cycle began in 2015…

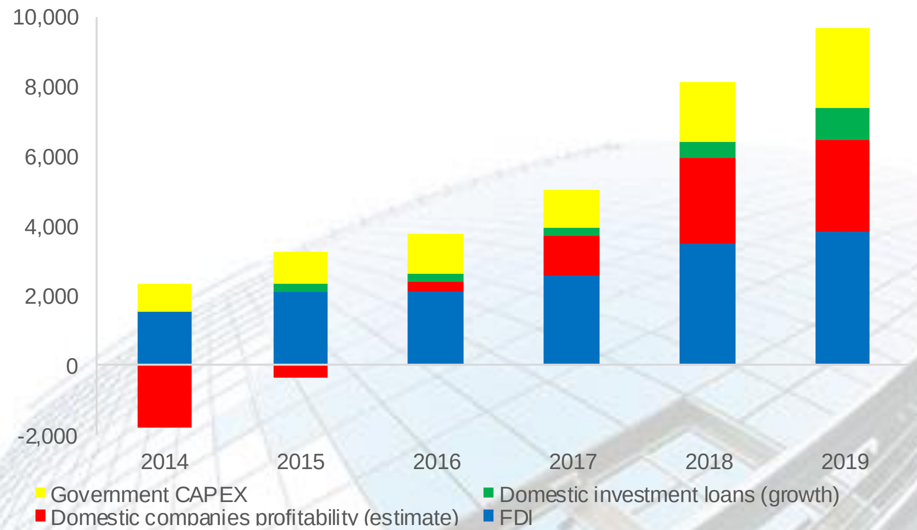
Chart 7 **Fixed investment share in GDP**
(real terms, in % of GDP)



- In 2015-2019, fixed investments grew at an average annual rate of about 10%, while their cumulative growth was about 64%.
- Despite pandemic, fixed investments declined in 2020 by only 2.8% .
- The share of fixed investment in real GDP increased from 16.3% in 2014 to 22.8% in 2019, and it is expected to continue to rise, after a temporary decline in 2020 due to negative effects of the Covid-19 pandemic.
- Government investments continued to grow in 2020 and are projected to reach 5.5% of GDP in 2021.

…supported by diversified financing sources

Chart 8 **Key sources of investment financing**
(in EUR mln)



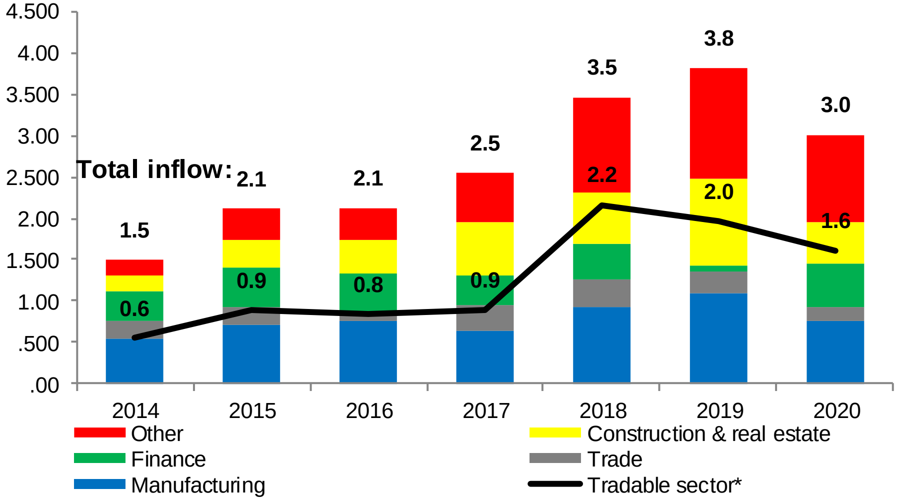
- In earlier years, investments have largely relied on FDI.
- Owing to maintained macroeconomic and financial stability, exchange rate stability, as well as fiscal consolidation, in recent years three more strong pillars for financing investments have been established: multiplied profitability of the economy, investment loans and doubled government investments.
- On top of that, FDI inflow reached record levels of around 8% of GDP.

Macroeconomic and Financial Stability Supported High FDI Inflow

Macroeconomic and financial stability combined with structural reforms has created a favourable climate for FDIs…

Chart 9 **FDI composition by sector**

(EUR bn)



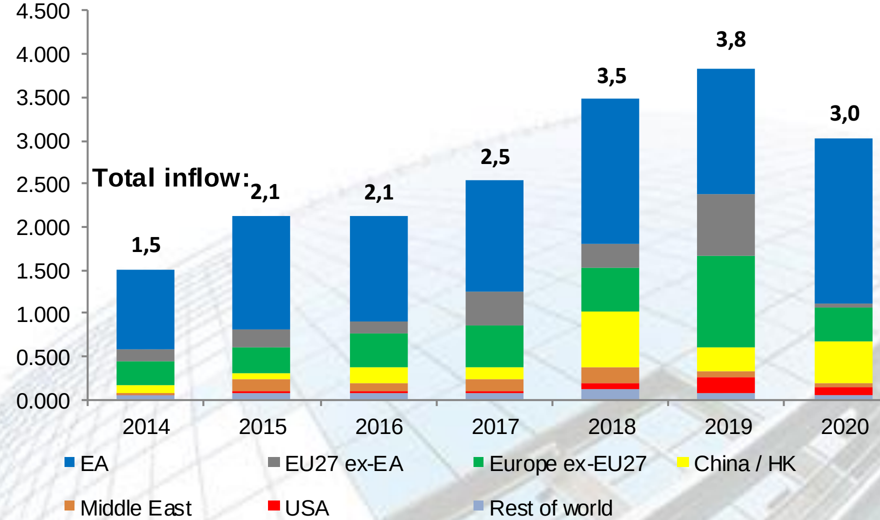
*industry, agriculture, transport & storage, accomodation and food svc.

- Out of a gross inflow of EUR 10.3 bn in past three years, EUR 5.6 bn has been directed into tradable sectors, most notably manufacturing (EUR 2.8 bn).
- Manufacturing sectors with the highest FDI inflows (metals, autos, food, tyres) recorded a high growth in employment, output and exports.
- Serbia has attracted about 60% of total FDI to the Western Balkans region.
- **During 2020 FDI remained robust despite the corona virus pandemic, with inflow of EUR 3.0 bn (net inflow EUR 2.9 bn).**

…which are diversified by sector and origin and contributing to the country's export potential

Chart 10 **FDI composition by geographic origin**

(EUR bn)

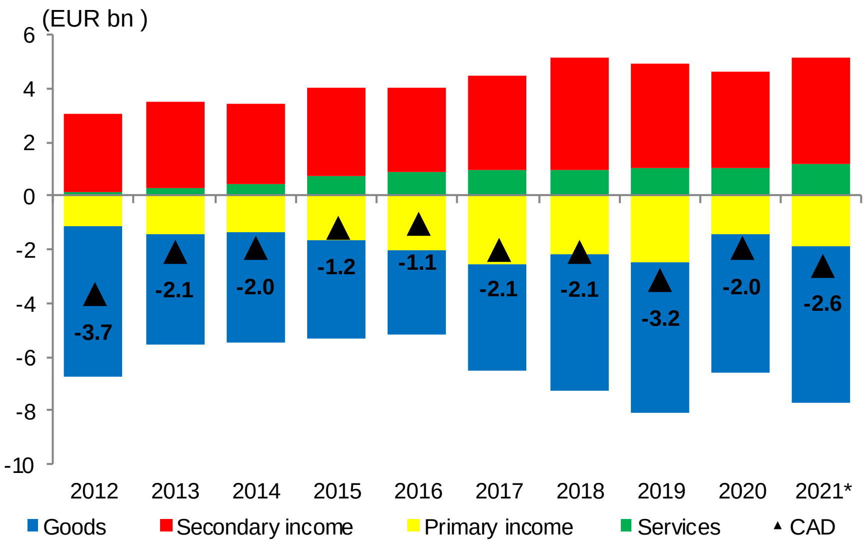


- FDI inflows are diversified by region of origin as well, with a greater share of countries from the Asia Pacific and Middle East regions, alongside Serbia's major investment partner - the European Union.
- During 2017 – 2019, the bulk of FDI inflows still came from Euro area countries (45.1%), but with an increasing share of Asian countries (16.4%) such as China/HK and the UAE, as well as non-EU European countries (20.8%) such as Russia, Turkey and Switzerland.
- In 2020, the participation of Eurozone countries increased (63%), with decreased participation of other European countries, and a stable participation of Asian countries.

Current Account Deficit Amounted to -4.2% of GDP in 2020, Lower Than Projected -5,0% of GDP

CAD improvement in 2020 is a result of a smaller decline in exports than imports and a lower primary income deficit

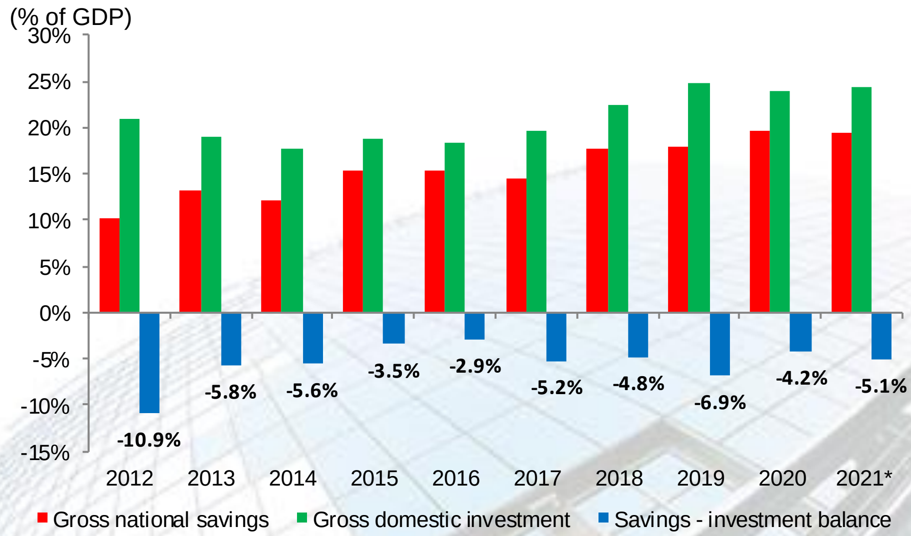
Chart 11 **Current account balance by component**



- **Key factors behind CAD improvement in 2020** are a contraction in domestic demand, great agricultural season, lower oil prices and resilience of exports on account of their structure, diversification and export/oriented investments in the previous period.
- In 2020 CAD amounted to EUR 2.0 bn, down by 37.3% y/y, while the December deficit is the lowest since comparable data exist. The temporary CAD increase in 2021 to -5.1% of GDP will be the result of a recovery in personal consumption and investment, as well as a rise in world oil prices.
- Since 2015 Serbia's current account deficit has been fully financed by net FDI, which we expect to be continued in the coming period.

From a savings-investments perspective CAD decrease in 2020 was driven by lower investments and higher savings

Chart 12 **Savings and investment balance**



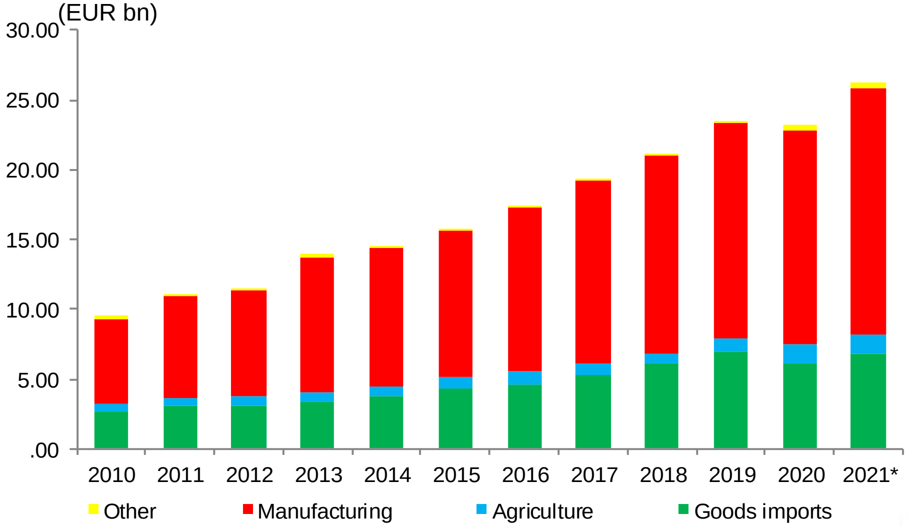
- In 2020 the decline in the S-I gap was driven by a faster reduction of private gap than public SI gap.
- Private sector savings increased in 2020 due to reduced domestic demand and lower energy prices.
- During 2020, the share of gross domestic investment in GDP decreased only slightly compared to 2019, due to the growing share of gross public sector investment.
- The S-I gap since 2017 is driven by the private sector, while government savings and investments were mainly neutral (a result of the fiscal consolidation) until the pandemic.

Exports Remaind Relatively Resilient in 2020 and Will Rebound Strongly in 2021

Exports declined slightly in 2020 due to global recession, with return to previous growth path already in 2021

Chart 13 **Exports of goods and services**

(EUR bn)



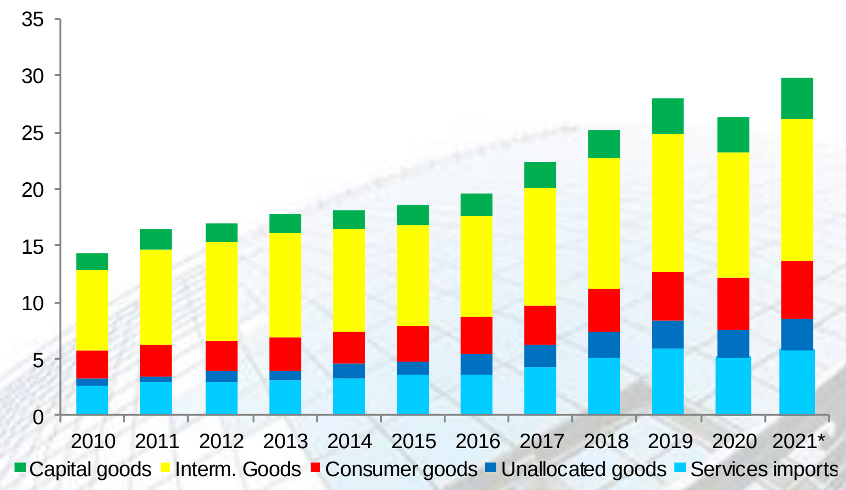
*NBS Forecast

- The slight decrease in exports of goods in 2020 of 2.3% was driven by a decrease in exports of the manufacturing industry due to deterioration external demand and disruptions in global value chains.
- Net exports of services were more resilient to the effects of the crisis due to a smaller share of tourism services and high growth in the ICT sector.
- This year we expect a complete recovery in exports of goods and services with a growth of 13.4%, driven by exports of manufacturing and exports of ICT and business services.

Import decline was deeper and this year we expect its recovery driven by investments and private consumption

Chart 14 **Imports of goods and services**

(EUR bn)



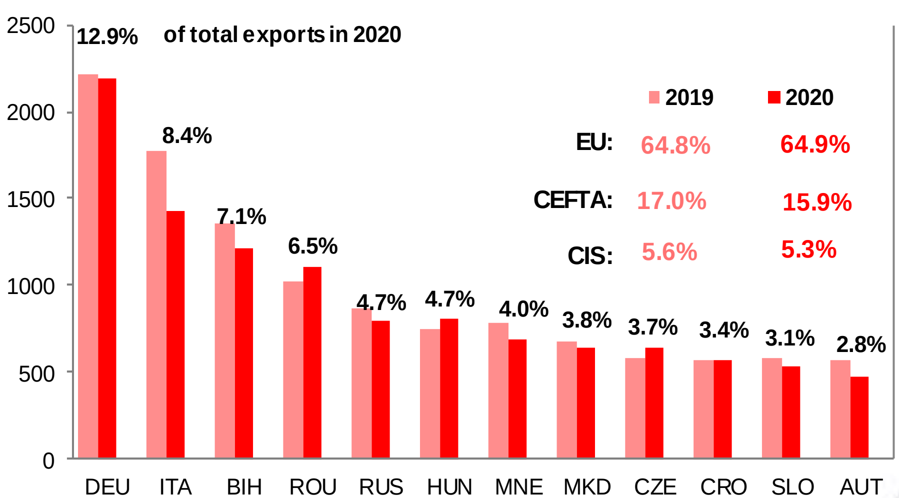
*NBS Forecastt

- Imports of goods decreased by 3.5% in 2020. The largest decrease in imports was recorded within the reproduction, of which more than half of that decrease was related to lower energy imports. On the other hand, imports of equipment and consumables continued to grow.
- The fall in oil prices in 2020 will have an additional delayed effect on the lower import price of gas during 2021.
- In 2021, we project a growth of imports of goods and services of 13.3%, which will be driven by the growth of domestic demand, and almost certainly the continuation of imports of medical equipment

Geographic Diversification Helped Foreign Trade Resilience During Pandemic

Except towards Italy, exports to other partners remained relatively stable despite pandemic

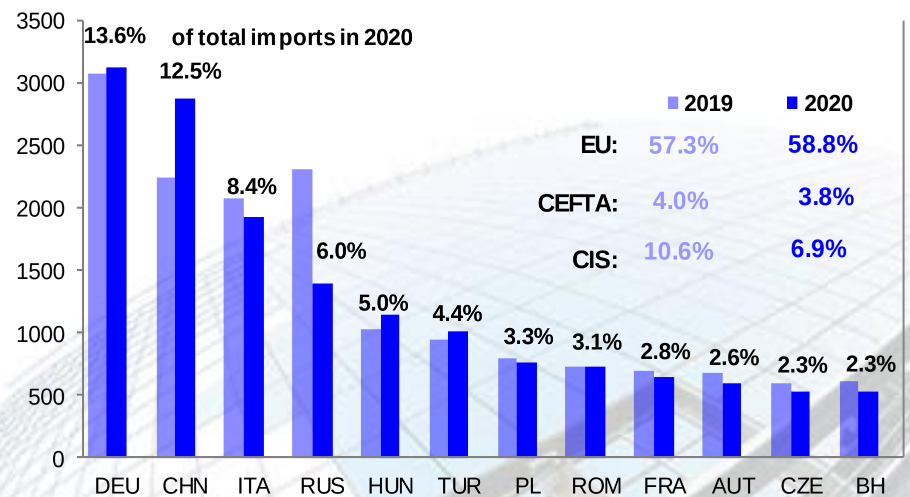
Chart 15 **Goods exports by country in 2019 / 2020**
(EUR mn and % of total)



- Serbia's exports are largely directed towards EU and countries of the region, and reliant on demand in those countries which is currently lacking. In 2020, most of Serbian exports went to the EU, followed by CEFTA and CIS.
- By country, the largest share of exports went to Germany (12.9%), followed by Italy (8.4%), Bosnia and Herzegovina (7.1%), Romania (6.5%) and Russia and Hungary (4.7%).
- In 2020 compared to 2019, the total volume of exports has decreased in most of the countries.
- Unlike the top 10 countries, exports to China continued to grow in 2020 compared to 2019.

China catches up to Germany in 2020 as the most important import partner

Chart 16 **Goods imports by country in 2019 / 2020**
(EUR mn and % of total)

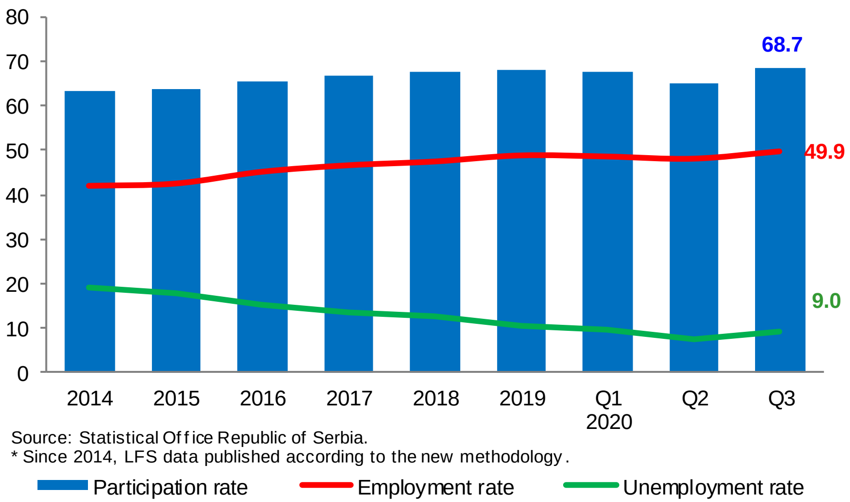


- Majority of imports (around 59%) come from the EU, followed by CIS and CEFTA.
- By country, the largest shares of imports are from Germany (13.6%), whereas the share of imports from China increased from 9.0% in 2019 to 12.5% in 2020, mostly due to imports of medical equipment. Following Germany and China, third is Italy (8.4%) and then Russia (6.0%).

Good Performance of Labour Market Indicators Despite the Pandemic

Unemployment rate in Q3 2020 retained the single-digit level

Chart 17 **Labour market indicators according to the LFS*,** (in %)

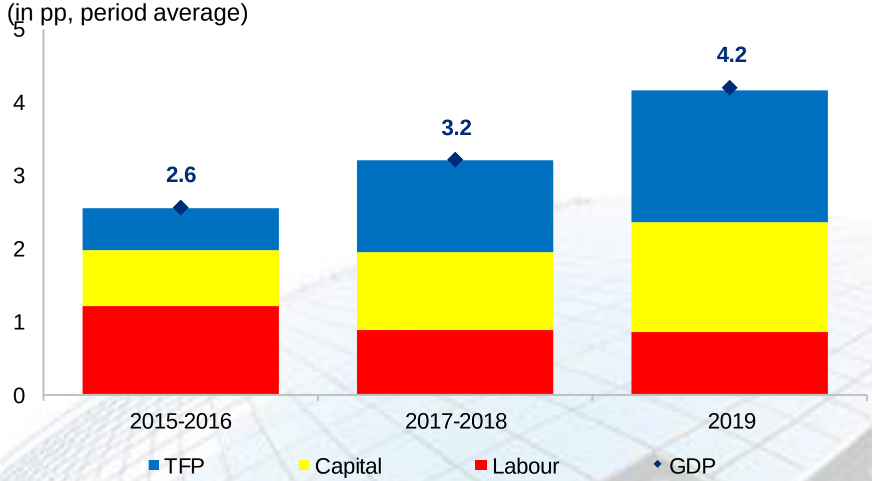


Source: Statistical Office Republic of Serbia.
* Since 2014, LFS data published according to the new methodology.

- The unemployment rate in Q3 2020 was 9.0%, which is lower by 0.5 pp compared to the same period last year and remained at the single-digit level.
- The employment rate in Q3 was at the level of 49.9% (y/y growth of 0.3 pp), and the growth was driven by employment growth in the formal segment of the labour market.
- The participation rate in the same period among working age population was 68.7% and was y/y higher by 0.3 pp, thus returning to pre-pandemic levels.
- Compared to Q2, the activity rate in Q3 increased by 161.5 thousand persons, of which around 92 thousand persons joined the contingent of employees.

Increasing contribution of total factor productivity to Serbian GDP growth

Chart 18 **Contribution of factors of production to GDP***
(in pp, period average)



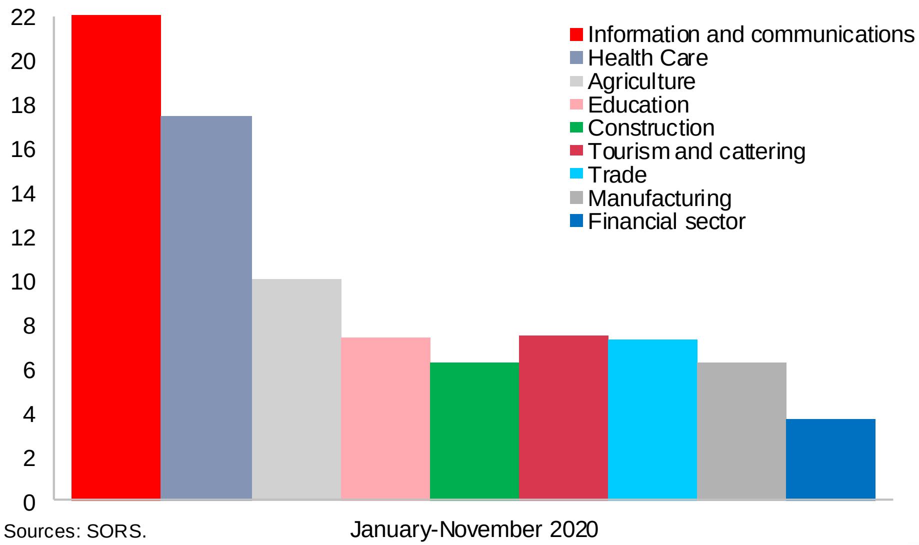
Sources: SORS, NBS calculation.
* NBS estimate.

- In the period as of 2015, a positive contribution to GDP growth came from capital, labour and TFP.
- Growth acceleration in 2017-2018 was driven mainly by faster TFP growth. Labour contribution to growth declined compared to 2015-2016, compensated by a faster growth of the capital stock.
- In 2019, we estimate that contribution from labour was still lower, a higher capital contribution due to structural reforms, while TFP contribution increased further to 2 pp supporting income convergence to developed countries.

Preserved Wages and Increased Employment During 2020

The average wage in the period January - November 2020 amounted 506 euros

Chart 19 **Nominal net wages by economic sector** (y/y growth, in %)

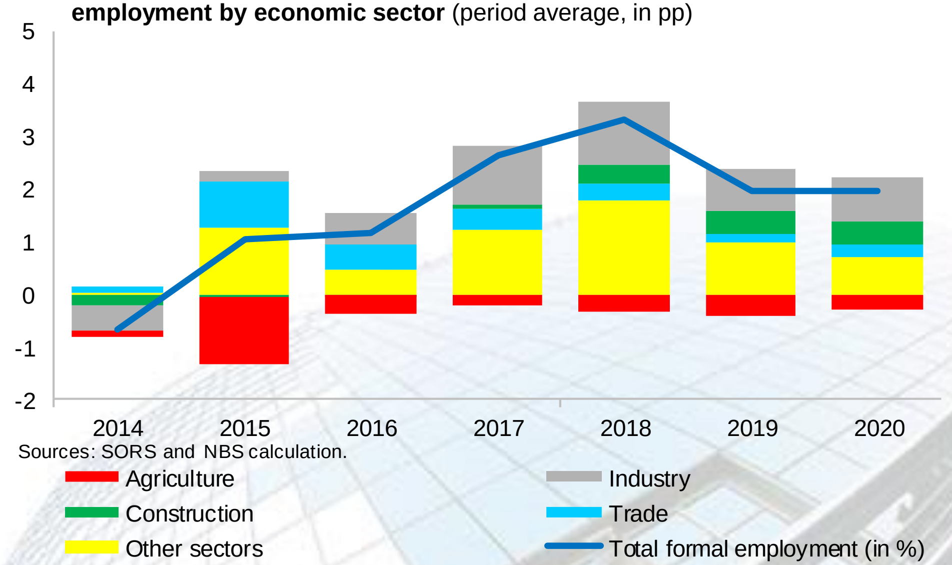


Sources: SORS.

- The average net wage in the period January - November 2020 amounted 59,515 RSD (EUR 506) and is higher by 9.3% y/y.
- Wages increased in both the private (8.8% y/y) and public sectors (10.8% y/y) in the same period.
- Wage growth continued at a relatively high growth rate despite a slowdown in economic activity, owing to comprehensive economic measures.
- The largest growth of wages since the beginning of 2020 was recorded in the ICT sector and health care sector.

Dominant contribution of industry in formal employment

Chart 20 **Contribution to y-o-y growth in total formal employment by economic sector** (period average, in pp)



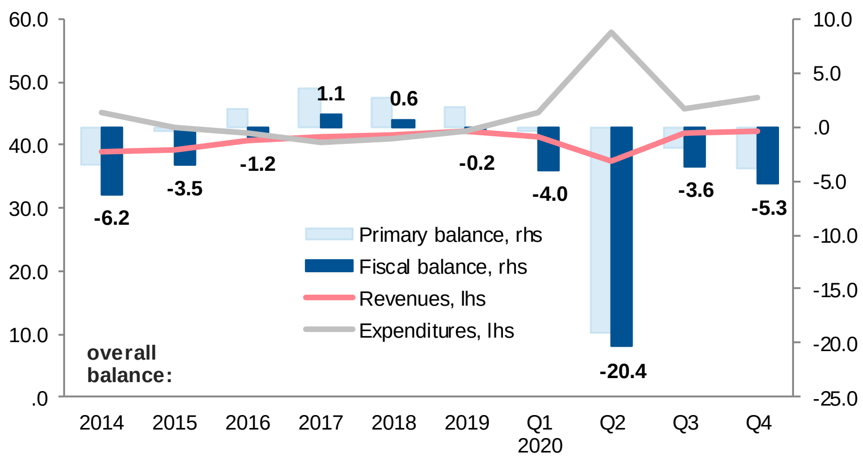
Sources: SORS and NBS calculation.

- The total formal employment in 2020 increased by about 42 thousand persons (1.9% y/y), despite the pandemic and thanks to state measures.
- Almost overall growth relates to private sector (somewhat less than 42 thousand persons, 2.7% y/y).
- Employment in public sector grew by about 600 persons (0.1% y/y) and mainly comes from health care sector.
- Observed by activities, the growth of employment stands out in the manufacturing, construction and the ICT.
- When it comes to the registered unemployment, in January, for the fifth consecutive month, it was below the level of 500 thousand persons.

Temporary Increase in Fiscal Deficit in 2020 Due to Covid-19, Public Debt Below 60% of GDP at the End of 2020

Largest share of the fiscal deficit was in Q2 as result of support measures

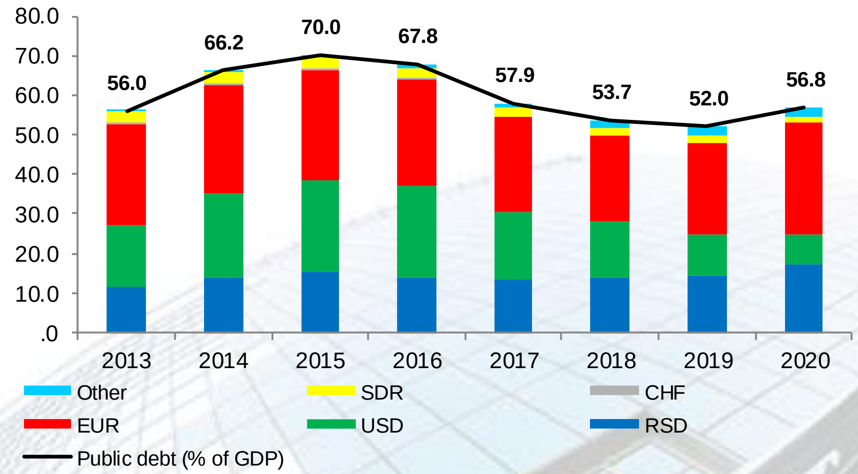
Chart 21 **Fiscal revenues, expenditures and outcome**
(% share in GDP)



- During previous years, Serbia eliminated fiscal deficit, with government investments reaching near 5% of GDP.
- High deficit in Q2 2020 (8.0% of GDP) was a consequence of pandemic, which resulted in direct tax relief and double-digit increase in expenditures for support measures to private sector companies, as well as for medical equipment procurement.
- Despite increased current expenditures in 2020 CAPEX continued to rise, reaching the level of 5.3% of GDP and surpassing projections from the Fiscal strategy .
- Fiscal strategy projects the deficit of 3,0% of GDP in 2021, and further decrease to around 1% in the medium term.

Increase of public debt due to economic relief package is much smaller compared to most of the European Union countries

Chart 22 **Public debt (central government)**
(% share in GDP)

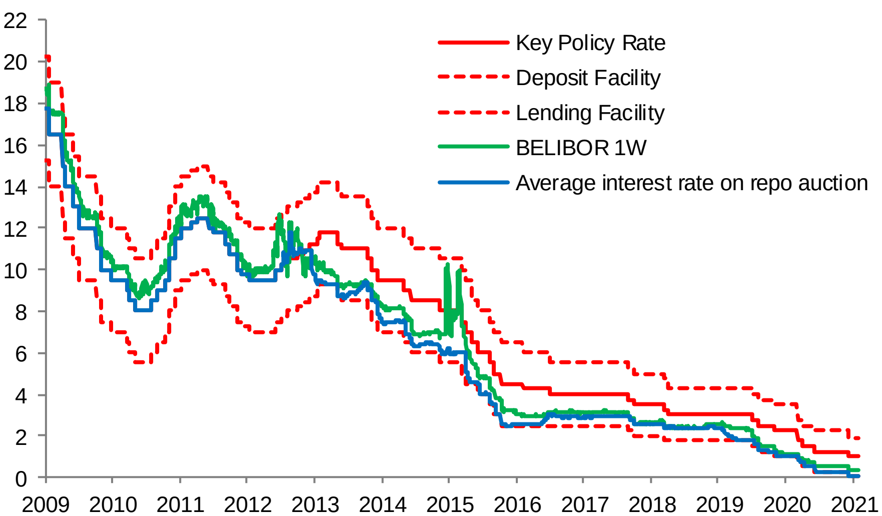


- In 2020 public debt increased to 56.8% of GDP (from 52,0% at the end of 2019), mainly due to a 7y Eurobond of EUR 2 bn, issued in May, at a rate of 3.375 % (coupon rate of 3.125%), for covering increasing financing needs in light of the pandemic.
- Additional Eurobond of USD 1.2 bn was issued in November, with the first time ever hedging and a de facto coupon rate of 1.066% denominated in euros. The funds were used for partial early repayment of USD Eurobond issued in 2021, which significantly reduced USD debt, and thus the exchange rate risk.
- Public debt dinarisation picked up from 20.9% (end-2016) to 30.5% in 2020.

The Key Policy Rate kept unchanged at the Lowest Level in the Inflation Targeting Regime

In February 2021, the key policy rate remained unchanged at the level of 1.0%

Chart 23 **Interest rates**
(in %)

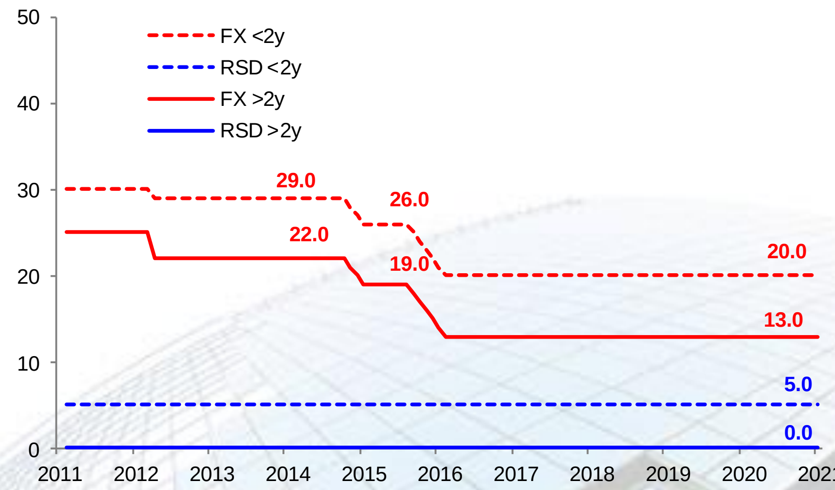


The decision takes into account the following factors:

- continued stimulating effect of the previously adopted monetary and fiscal policy measures and by the announcement of an additional package of fiscal measures.
- coordinated monetary and fiscal policy measures that will continue to have a positive effect on the financing conditions for corporates and households and on their disposable income.

FX required reserve ratio has remained unchanged since early 2016

Chart 24 **Reserve requirement ratios**
(in %)



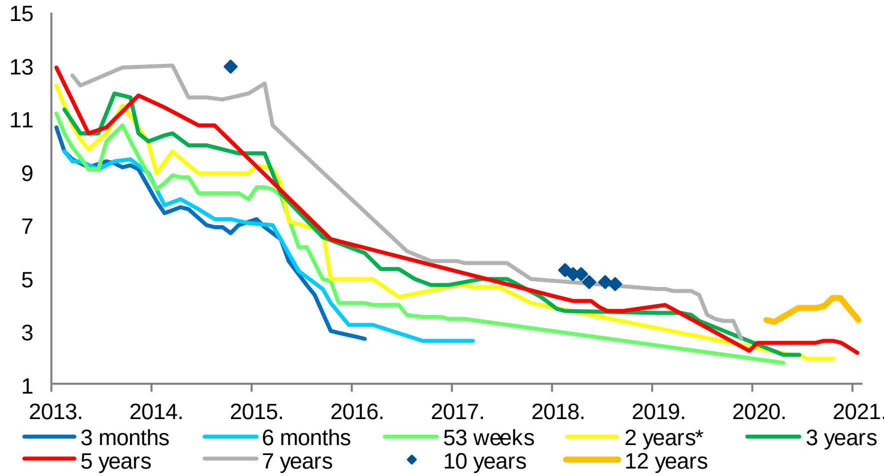
- Last time FX RR ratio was cut in 2016 aiming to support lending activity (to 20%/13%, for liabilities up to/over 2Y).
- RR is an important monetary policy tool (in January 2021 RR amounted to EUR 2.3 bn and RSD 224.0 bn).
- NBS uses RR as an important macroprudential tool within dinarisation strategy:
  - by applying lower RR ratio on dinar vs FX sources,
  - by applying remuneration on dinar RR (i.e. „standard“ rate 0.10% and „beneficial“ rate of 0.60% under predefined conditions, on amount on dinar lending in line with State Loan Guarantee Scheme), while no remuneration is applied on FX RR.

The Effects of Monetary Policy Easing are Reflected in Lower Costs of Government and Private Sector Financing…

Interest rates on dinar government securities are moving around their minimum levels…

Chart 25 **Interest rates in the primary market of government securities**

(p.a. in %)



Source: Ministry of Finance.

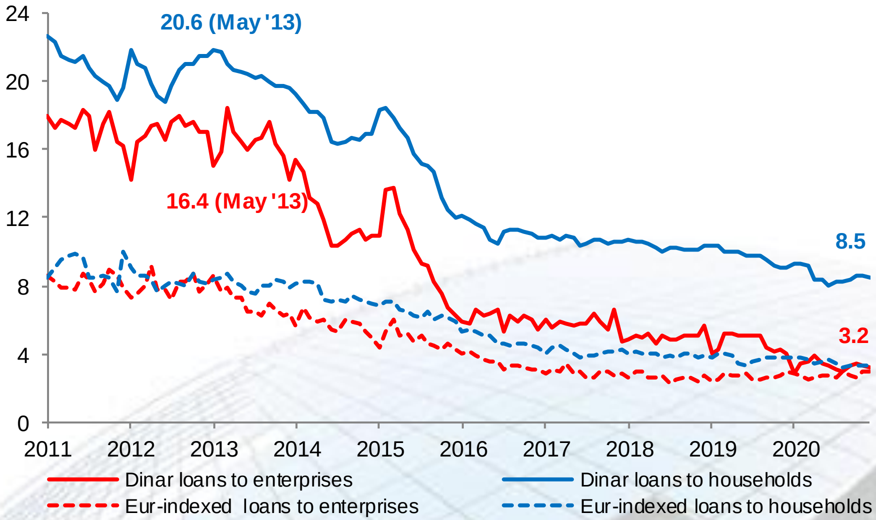
* Excluding coupon securities with the rate linked to the NBS key policy rate.

- The share of long-term securities (5+ year maturity) increased from 2% in December 2012 to over 75% in 2020, accompanied by the extension of the dinar yield rate curve up to 12 years in February 2020.
- J.P. Morgan announced its decision to include Serbia's dinar-denominated bonds in its renowned GBI-EM family of indices as of 30 June 2021, which should contribute to even greater recognition of Serbia as a safe and favorable investment destination.
- In December 2020, yield rates on 5y and 12y dinar bonds fell to 2.2% and 3.4%, respectively.

… as well as interest rates on private sector loans

Chart 26 **Interest rates on loans – new business**

(p.a. in %)



- The key policy rate reduction is fully reflected in **dinar lending interest rates** which fell sharply since the beginning of monetary policy relaxation cycle (May 2013), and in December they amounted to:

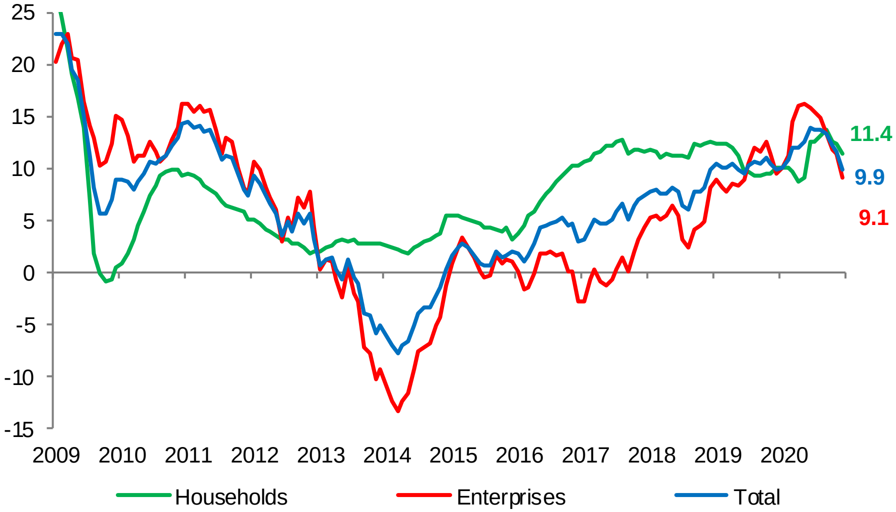
  - 3.2% for corporates (down by 13.2 pp),

  - 8.5% for households (down by 12.1 pp).
- The servicing costs of outstanding credit amounts have also been reduced, leading to higher disposable income for consumption and investments, of both households and corporates.
- In the observed period, a sharp fall in the country risk premium and the country's credit rating upgrade, as well as monetary easing by the ECB contributed to the fall in EUR-indexed lending rates.

… as Well as to Growth of Credit Activity

Lower costs of financing support domestic lending …

Chart 27. **Bank lending to enterprises and households**
(y/y rates, constant exchange rate 30 Sept 2014, in %)

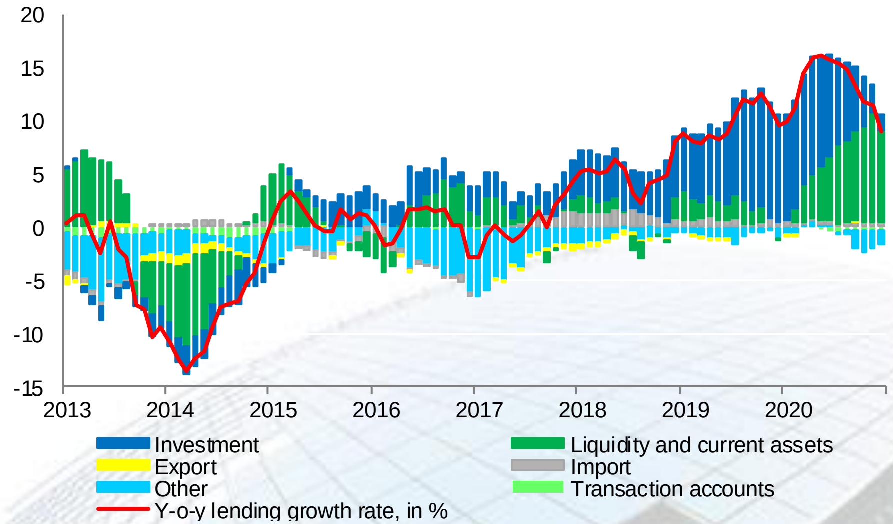


- NBS monetary policy easing, along with the effects of measures stimulating sustainable household lending, approval of Guarantee Scheme loans, as well as the maintained low interest rates in the euro area money market, enabled the **continuation of lending growth**.

- In December 2020, **total domestic loans**, for a third year in a row, recorded almost double digit growth rate – 9.9% in y/y terms, excluding the effect of exchange rate changes, **keeping a favourable structure in terms of the contribution to economic recovery.**

… which supports the recovery of the economy from crisis caused by COVID-19 pandemic

Chart 28. **Contributions to y-o-y corporate lending growth**
(in pp, constant exchange rate 30 Sept 2014)



- **Corporate loans** provide significant support to domestic credit activity and impetus to the recovery of economic activity.

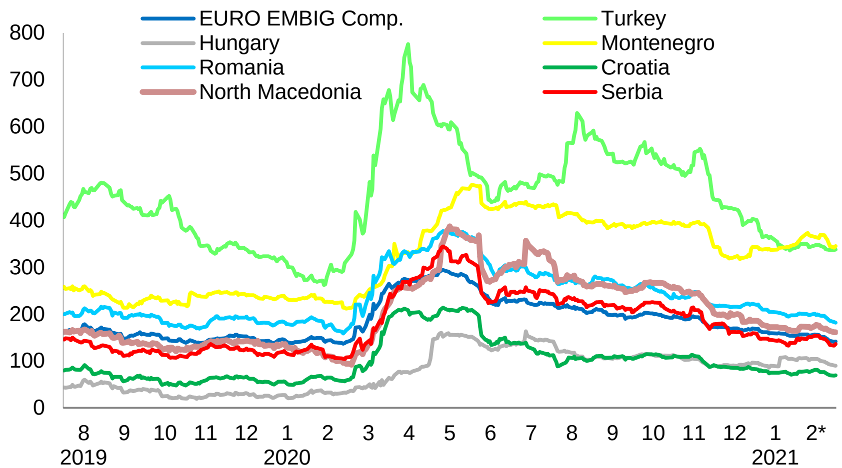
- **Liquidity and current assets loans** represented the dominant category of corporate loans in December, with a share of 43.7%, reflecting growing corporate liquidity needs and approval of Guarantee Scheme loans. **Investment loans** followed them, with a share of 43.0% in December.

- **Micro, small and medium-size enterprises loans** amounted to 69% of total corporate loans in December, whereby this market segment recorded 9.4 y/y growth rate in December.

Increased Resilience of the Serbian Economy Confirmed by Rating Agencies

Serbia's risk premium is falling and below the composite measure for European emerging markets

Chart 29 **Risk premium indicator for euro-denominated debt - EURO EMBIG**
(basis points, daily values)

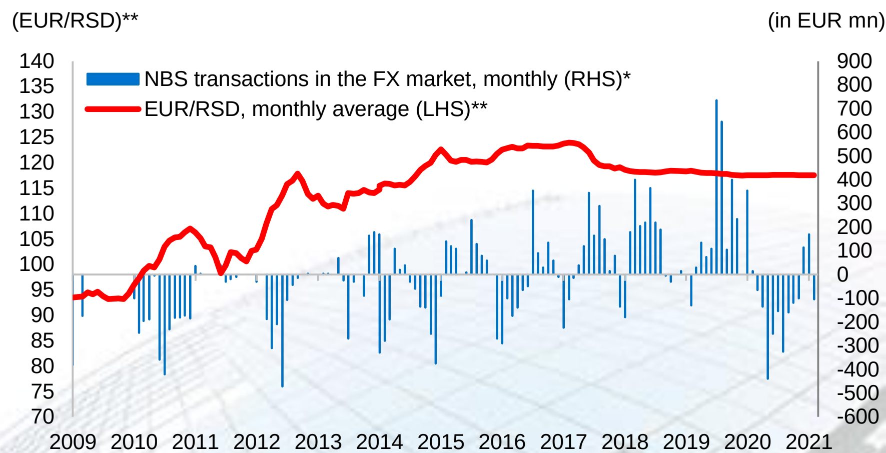


*Until February 9, 2021

- The decline in Serbia's risk premium for euro-denominated debt, which began in May, continued during T4 and from the beginning of 2021. In addition to global factors (optimism regarding the coronavirus vaccines), this was also underpinned by Serbia's economic policy measures in response to the crisis, the recovery of economic activity at home since May, as well as the expected more than full recovery from the crisis in 2021.
- **Both S&P and Fitch affirmed Serbia's rating at BB+ during 2020**, despite global crisis caused by COVID-19 pandemic, emphasizing increased resilience of the Serbian economy as a result of responsible economic policy pursuit in the past years and an adequate response to the crisis by economic policy-makers in Serbia.

Despite global uncertainty dinar stayed broadly unchanged

Chart 30 **Exchange rate developments and NBS transactions in the FX market**



* + net purchase; - net sale.
** EUR 1 in RSD.

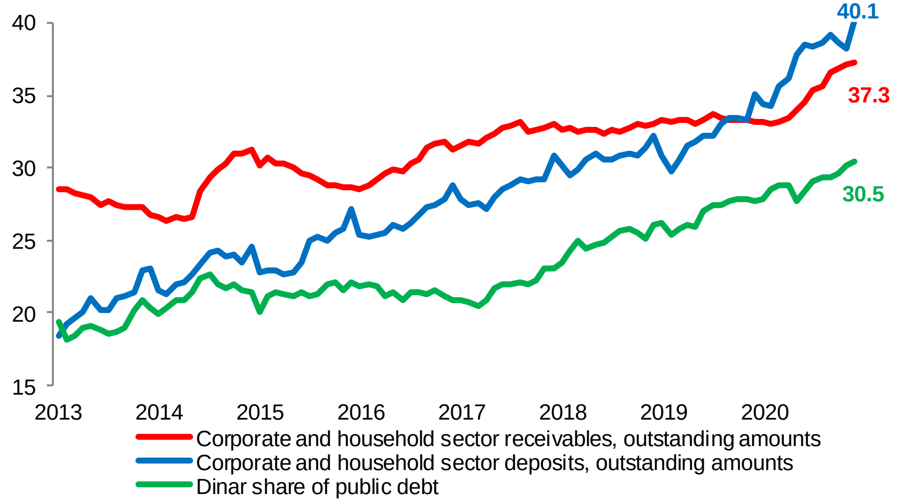
- Dinar cumulatively strengthened by 5% against the euro in the period 2017-2019, as a result of better Serbia's macroeconomic fundamentals which contributed to FX inflow of FDI and elevated non-resident investment in long-term dinar government securities, and resulted in bolstering the FX reserves.
- The dinar stayed broadly unchanged against the euro in 2020, despite the rise in global uncertainty. The National Bank of Serbia contributed to this by providing needed FX liquidity to banks against the background of limited supply of foreign exchange and cash. After a gradual weakening of depreciation pressures in previous months, appreciation pressures on the dinar reemerged in November and December.
- The stable movement of the dinar against the euro has continued since the beginning of 2021.

Indicators of Dinarisation are on the rise

Macroeconomic stability contributing to dinarisation process

Chart 31 **Dinarisation of the corporate and household sector receivables and deposits, and dinar share of public debt**

(in %)

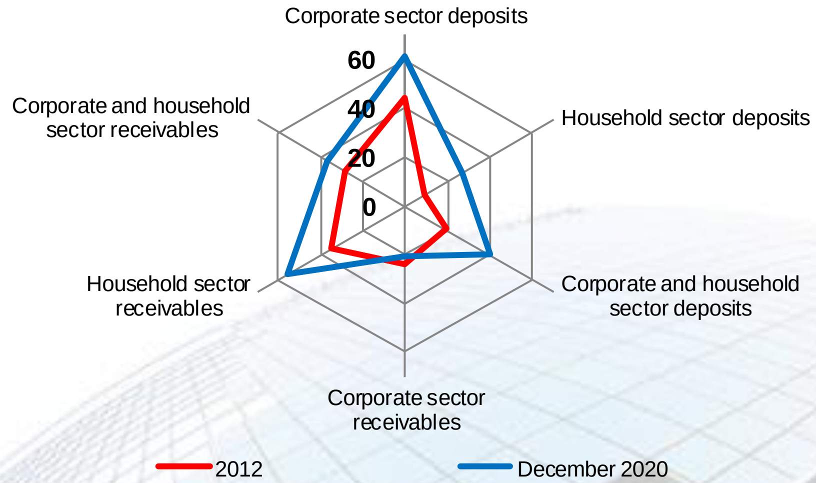


- NBS stimulates the dinarisation process by delivering low and stable inflation, preserving relative exchange rate stability, enhancing management of FX risks and exposures in the private sector, and using other measures.
- The Government contributes to dinarisation through tax policy, by developing the dinar securities market - dinar debt share rose from 2.5% in 2008 to 30.5% in December 2020.
- Dinarisation of corporate and household sector deposits rose by 20.8 pp compared to end-2012 to 40.1% (December 2020). Dinarisation of corporate and household sector claims reached new maximum of 37.3% in December (up by 9.3 pp compared to end-2012).

The growth of dinar loans to households accompanied by higher dinar savings

Chart 32 **Dinarisation of corporate and household sector**

(outstanding amounts, in %)

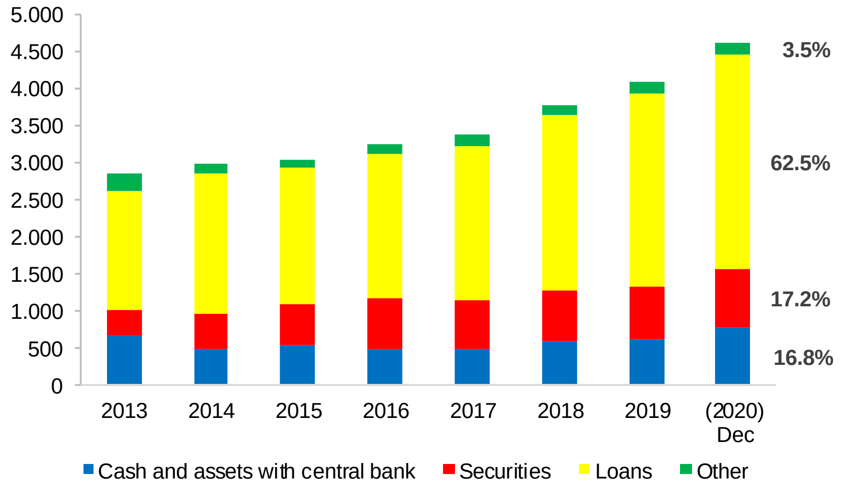


- Over the past years, dinarisation of household receivables had a firm upward trend as a result of a sharp drop in dinar interest rates, low and stable inflation as well as NBS measures aimed to support dinarisation – an upsurge from 35.1% (2012) to 55.9% (December 2020).
- Dinar savings of households (residents) recorded strong growth in past two years (22% in 2018 and 31% in 2019), which is also continued in 2020 when it increased by RSD 13.5 bn or 17.1%.
- This reflects citizens' confidence in financial and price stability, given that savings growth was realised even in conditions of pandemic-induced crisis and increased risk aversion.

Traditional Banking Mostly Financed by Domestic Deposits

Adequate structure of banking sector assets

Chart 33 **Structure of banking sector assets**
(RSD bn)

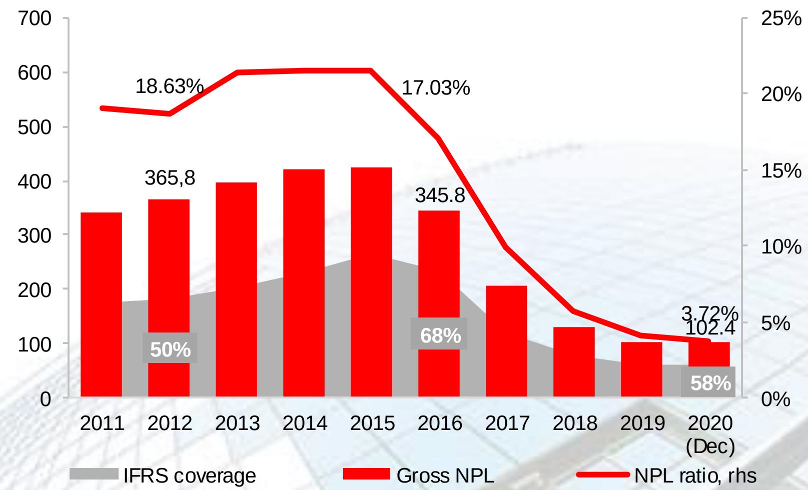


Source: NBS

- Risk aversion during the crisis led to more intensive investments in low-risk state securities, which after 2015 stabilized at around of one-fifth of the total banking sector net assets (17.2% at the end of December 2020).
- Despite historical low levels of deposit rates, stability of retail and corporate deposits in funding mix is present, with share in total liabilities of 45% and 30%, respectively at the end of December 2020.
- Despite high loan portfolio euroization, currency matching of assets and liabilities is present, with net open position of 1.1% of regulatory capital at end of December 2020.

Improving the quality of the banking sector assets

Chart 34 **Asset quality – Non-performing loans (NPL)**
(RSD bn, %)



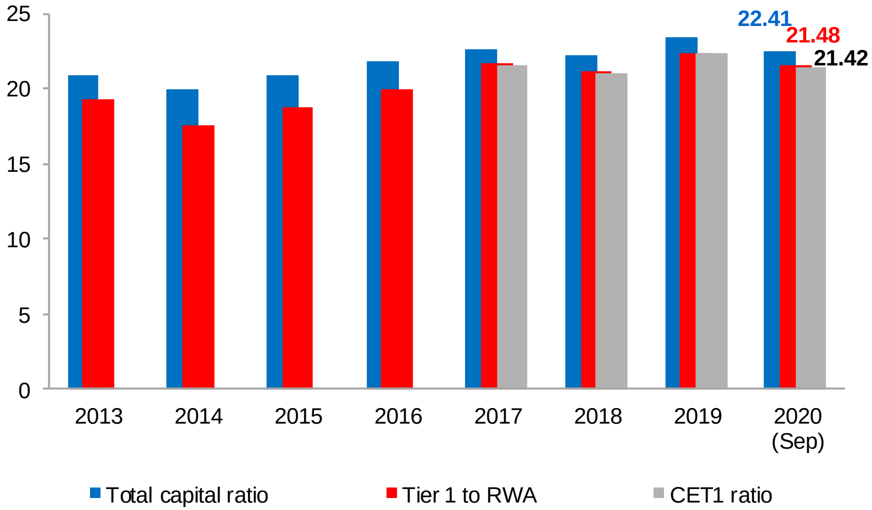
Source: NBS

- Implementation of NPLs resolution measures together with the growth of credit activity led to a significant improvement of banks portfolio quality. The share of NPLs decreased to the lowest level since the 2008 when the definition and reporting requirements were introduced.
- At end-December 2020, the NPL ratio was 3.7%, with the maintenance of relatively high coverage by IFRS provisions (58.5%).
- The main channels for the NPLs reduction remained the write-off and transfer (sale) to third parties, with increasing contribution of repayment.

Conservative Framework Contributed to the Banking Sector Resilience to Shocks

High banking sector capitalisation as a result of strong prudential measures

Chart 35 **Capitalization of the Serbian banking sector**
(%)

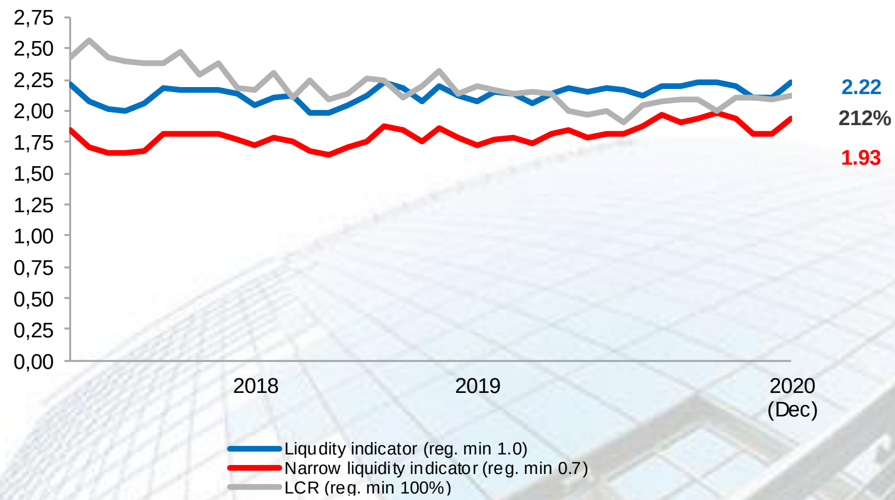


Source: NBS

- Banks possess significant capital reserves, which enable them to successfully deal with credit risk even in the case of worst-case stress scenario.
- In addition to the high level, the capitalization of the banking sector is characterized by a strong structure, with CET1 around 95% of total capital.
- The high solvency of the banking sector is also indicated by the leverage ratio, introduced in regulatory framework of the Republic of Serbia with Basel III implementation, which at the end of September 2020 amounted to 12.6%.

Serbian banking sector is highly liquid

Chart 36 **Liquidity indicators of the Serbian banking sector**



Source: NBS

- Liquidity ratios are constantly at levels significantly higher than the regulatory minimum.
- Liquid assets account for around 37.2% of the total assets of the banking sector in December 2020.
- The loan to deposit ratio that at the end of December 2020 amounted 85.7%, indicates stability of funding and in general the liquidity of the banking sector.

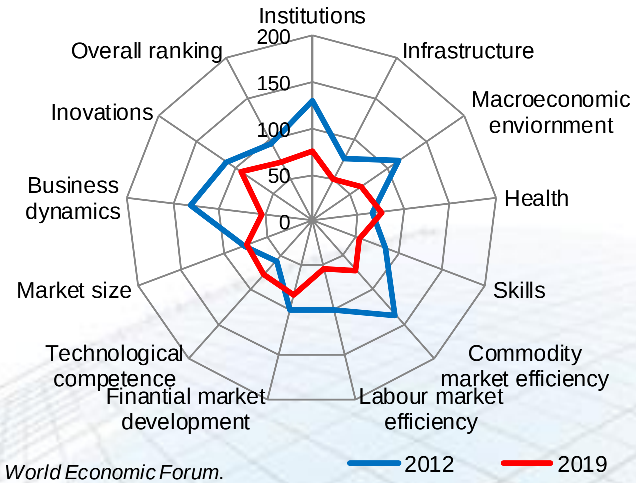
Structural slides

Improved Structural Competitiveness Provided Additional Boost to Overall Macroeconomic Performance

Chart 37 **Indicators on business regulation, Doing Business**
(rank, lower value means rank improvement)

Source: World bank, *Doing Business Report*.

Chart 38 **Global competitiveness indicators, WEF**
(rank, lower value means rank improvement)



Source: *World Economic Forum*.

<u>Key reform areas in the last four years:</u>

- Construction sector;
- Labor market;
- Tax administration;
- Financial sector;
- Contract enforcement and resolving insolvency.

Legal Framework for Banking Supervision

- **Domestic regulatory framework for banking supervision is based on Basel III standards:**
  - ✓ Set of by-laws implementing these standards on individual and consolidated level are applied as of 30 June 2017;
  - ✓ Since July 2017 further steps on harmonization of domestic legal framework with Basel III were made;
  - ✓ The main goals of implementing these standards are to increase the resilience of the banking sector by enhancing the quality of capital and introducing capital buffers, to increase the efficiency of monitoring and controlling banks' exposure to liquidity risk, further strengthening of the market discipline and transparency of banks' operation in the Republic of Serbia by publishing all relevant information on bank operation, as well as to bring the reporting system in line with the new regulatory arrangements
  - ✓ So far, no issues have been identified in the application of Basel III standards;
  - ✓ NBS will continue to take regulatory activities in order to ensure alignment with EU acquis.

- In December 2017 **regulation governing risk management by banks was amended** with aim to improve the way bank deals with risks and enhance its Internal Capital Adequacy Assessment Process (ICAAP).

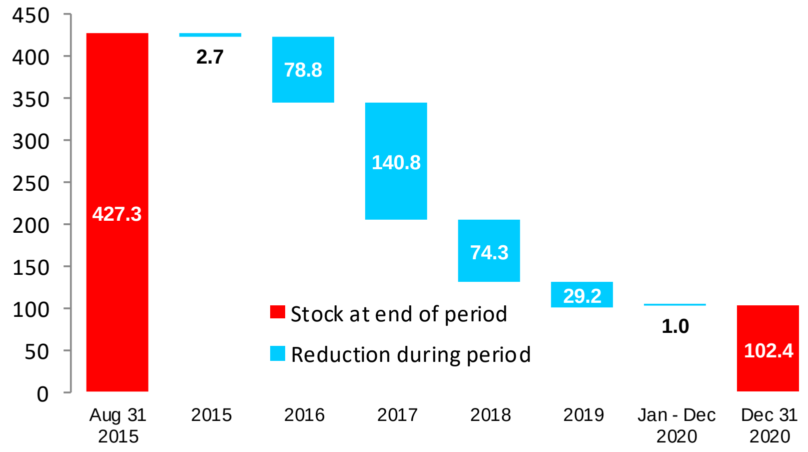
- Accounting and prudential regulations were timely adjusted in order to **enable the implementation of IFRS 9 in banks from 1st of January 2018.**

- Additionally, cooperation with supervisors of the home countries of banks present in Serbia is continuously developing and strengthening and regular communication with the ECB and EBA is maintained.

The Amendment of NPL Resolution Strategy by Adoption of NPL Program for Period 2018 - 2020

Effect of strategy on NPL stock

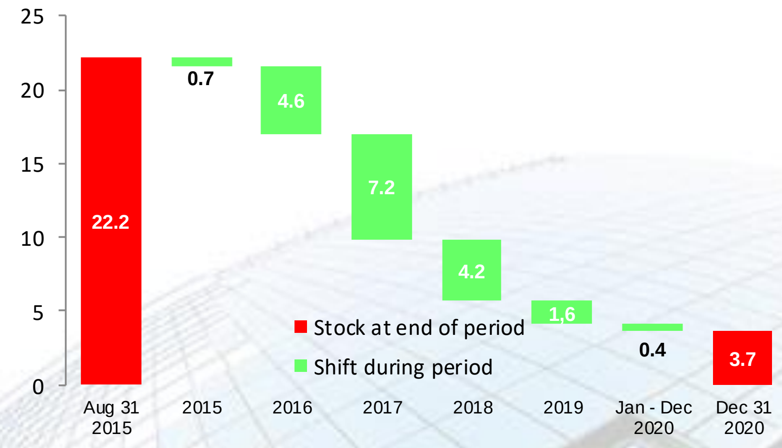
Chart 39 Gross NPL
(RSD bn)



Source: NBS

Effect of strategy on NPL ratio

Chart 40 **NPL Ratio**
(in %)



Source: NBS

- Aggregate decrease of NPL level in August 2015 – December 2020 amounts to RSD 324.9 bn, while the effect of the NPL Strategy is mostly reflected through the historically lowest level of NPL ratio of 3.7% at end-December 2020. Compared with NPL ratio before the NPL Strategy entered into the force (22.25%) the decrease is clearly impressive at 18.53 p.p.
- Beside successful implementation of NPL Strategy, it is necessary to perform activities intended for resolution of remaining problems in order to provide the sustainability of achieved results. For that purpose, it is very important to create the ambient, which strives for early detection of sources and causes of NPLs, as well as, upgrading of existing institutes directed toward resolution of potentially new NPLs. Bearing that in mind, the Government of the Republic of Serbia on the December 27th, 2018 implemented a Program for NPL resolution for period of 2018 – 2020 (Program for NPL).
- As an integral part of Program for NPL, Action plan focuses on subjects of:
  - resolution of non-performing claims of state-owned financial creditors, through assignment of claims and eventually write-off of remaining part of portfolio;
  - improving bankruptcy framework, i.e. it`s upgrade as institute in non-performing claims resolution;
  - series of activities that are directed to the prevention of emerging and accumulating of new NPLs.

Capital Buffers – Implementation of Macroprudential Policy Measures

- Capital buffers increase the resilience of banks to losses, reduce excessive or underestimated exposures and restrict the distribution of capital.
- These macroprudential instruments should limit systemic risks in the financial system, which can be cyclical (capital conservation buffer and countercyclical capital buffer) or structural (capital buffer for a systemically important bank and systemic risk buffer).
- The following capital buffers are used in the Republic of Serbia:
  - Capital conservation buffer;
  - Countercyclical capital buffer, in order to mitigate and prevent excessive credit growth;
  - Capital buffer for a systemically important bank, with the objective to limit the systemic impact of misaligned incentives in terms of favoring certain financial institutions;
  - Systemic risk buffer, introduced to limit the risk of euroisation, one of the key structural non-cyclical systemic risks to the stability of the financial system of the Republic of Serbia.
- The capital conservation buffers may consist only of Common Equity Tier 1 capital equal to 2.5% risk-weighted assets for capital conservation buffer, 1% or 2% risk-weighted assets for capital buffer for systemically important banks, depending on the systemic importance level and 3% of total foreign currency and foreign currency-indexed placements of a bank approved to corporates and households in the Republic of Serbia for systemic risk buffer. Countercyclical buffer rate is set at 0%.
- Capital buffers apply as of 30 June 2017.

NPL Resolution Required a Systemic Approach – and, as Such, Gave Results

NPL data, December 2020	Gross loans (EUR bn)	Gross NPL (EUR bn)	NPL ratio (%)
Corporates	10.4	0.3	3.1
Natural persons	10.6	0.4	3.6
of which: households	*9.5*	*0.3*	*3.6*
Corporates in bankruptcy proceedings	0.1	0.1	97.9
Other	2.3	0.1	4.3
Total	23.4	0.9	3.7

- NPL development after the adoption of the NPL Resolution Strategy, especially in 2017, 2018 and 2019, confirmed the soundness of the inter-institutional and coordinated approach envisaged by the Strategy.
- After 2019 drop in share of NPLs of 1.61 pp, noticeable downward trend had slow downed in 2020, resulting with four times lower NPL ratio than it was at the time of Strategy adoption.
- Fall was widespread and recorded in all sectors, of which most prominent was within construction.
- The continuation of NPL resolution efforts by banks together with the recovery of credit activity, should further stimulate the decrease in the share of NPLs.

National Bank of Serbia

Serbia's Economic Outlook

Serbia	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Real GDP, y-o-y %	5,7	-2,7	0,7	2,0	-0,7	2,9	-1,6	1,8	3,3	2,1	4,5	4,2	-1,1	5,5
Private consumption, in %	4,5	-3,3	-0,6	1,4	-1,7	-1,7	-0,1	-0,6	1,9	2,2	3,1	3,6	-2,4	4,2
Private investment,[1] in %	13,2	-23,4	-7,6	6,9	14,9	-8,4	-5,2	5,2	2,8	8,7	14,0	14,9	-4,8	11,8
Government consumption, in %	3,5	-1,7	-0,1	1,6	0,4	-2,1	0,9	-3,7	0,0	2,9	3,8	2,0	4,8	3,2
Government investment, in %	-16,4	-16,6	0,0	-7,8	7,6	-35,8	13,6	14,0	22,0	-6,4	43,1	30,4	7,4	16,0
Exports, in %	12,6	-11,5	16,9	5,6	2,9	18,0	4,3	9,3	12,0	8,2	7,5	7,7	-5,5	12,4
Imports, in %	10,1	-21,9	-0,1	7,2	-0,6	6,5	5,1	4,0	7,0	11,1	10,8	10,7	-4,0	11,3
Unemployment Rate, in %[4]	13,6	16,1	19,2	23.0	23.9	22.1	19,2	17,7	15,3	13,5	12,7	10,4	8,7	-
Nominal Wages, in %[5]	18,0	9,0	7,6	11,2	9,0	6,2	1,4	-0,2	3,7	3,9	6,5	10,6	9,3	-
Money Supply (M3), in %	9,8	21,5	12,9	10,3	9,4	4,6	7,6	6,6	11,6	3,6	14,5	8,4	18,1	-
CPI,[2] in %	8,6	6,6	10,3	7	12,2	2,2	1,7	1,5	1,6	3,0	2,0	1,9	1,6	2,4
National Bank of Serbia Key Policy Rate,[3] in %	17,8	9,5	11,5	9,8	11,3	9.5	8,0	4,5	4,0	3,5	3,0	2,25	1,00	1,00
Current Account Deficit BPM-6 (% of GDP)	20,0	6,3	6,5	10,3	10,9	5,8	5,6	3,5	2,9	5,2	4,8	6,9	4,2	5,1

[1] Excluding the effect of change in inventories

[2] Inflation figures in the table represent Dec on Dec inflation: (Pt/Pt-12)*100-100

[3] Latest data

[4] Labour Force Survey. Since 2014, data are revised according to the new LFS methodology. The data for 2020 is the average of three quarters of 2020.

[5] Since 2018, nominal w ages published according to the new methodology. January-November 2020 data.

Banking Sector Overview

Serbia	2011	2012	2013	2014	2015	2016	2017	2018	2019	December 2020
Number of banks[1]	33	32	30	29	30	31	29	27	26	26
Employees	29,228	28,394	26,380	25,106	24,257	23,847	23,055	22,830	23,087	22,823
Branches	2,383	2,243	1,989	1,787	1,730	1,719	1,627	1,598	1,598	1,576
HHI Assets	664	678	741	794	796	813	813	779	800	786
Share of foreign banks, %	74.1	75.2	74.3	74.5	76.1	76.7	76.9	75.4	75.7	86.0
Assets (net), EUR m	25,211	25,322	24,827	24,545	25,059	26,253	28,440	31,931	34,731	39,177
Capital, EUR m	5,104	5,198	5,186	5,074	5,090	5,122	5,631	5,725	6,002	6,130
Loans (gross), EUR m	17,204	17,273	16,140	16,170	16,175	16,442	17,565	19,406	21,111	23,439
Of which gross NPL, EUR m	3,275	3,217	3,448	3,483	3,491	2,800	1,730	1,105	862	871
Gross NPL ratio, %	19.0	18.6	21.4	21.5	21.6	17.0	9.8	5.7	4.1	3.7
IFRS impairment of NPLs	51.0	50.0	50.9	54.9	62.3	67.8	58.1	60.2	61.5	58.5
Deposits, EUR m	14,584	14,936	15,067	15,637	16,523	18,242	19,926	23,115	25,197	28,984
Pretax Income[2], EUR m	12.0	102.5	-18.0	29.0	80.0	172.0	579.8	640.6	575.5	391.5
CAR[3], %	19.1	19.9	20.9	20.0	20.9	21.8	22.6	22.3	23.4	22.4
CET1 ratio %[3,4]	-	-	-	-	-	-	21.5	21.1	22.3	21.4
Leverage%[3,4]	-	-	-	-	-	-	11.1	12.6	13.6	12.6
Liquidity ratio	2.2	2.1	2.4	2.2	2.1	2.1	2.0	2.0	2.2	2.2
Liquidity coverage ratio[4], %	-	-	-	-	-	-	239.5	213.3	199.3	211.6
FX ratio, %	6.2	5.5	4.4	3.9	4.4	2.7	2.9	4.5	1.5	1.1
ROA[2], %	0.0	0.4	-0.1	0.1	0.3	0.7	2.1	2.1	1.7	1.1
ROE[2], %	0.2	2.0	-0.4	0.6	1.6	3.4	10.6	11.3	9.8	6.5
Net interest margin[5], %	4.6	4.3	4.2	4.3	4.3	3.9	3.7	3.6	3.3	3.0

[1] The NBS revoked operating licence from Nova Agrobanka on 27 October 2012, from Razvojna banka Vojvodine on 6 April 2013, from Privredna banka Beograd on 26 October 2013, from Univerzal banka Beograd on 31 January 2014 and from Jugobank Jugbank Kosovska Mitrovica on 2 April 2018. The NBS issued operating licence to Mirabank on 16 December 2014 and the bank started its operations in April 2015. The NBS issued operating licence to Bank of China Srbija on 20 December 2016. The Findomestic bank was merged to Direktna bank on 1 July, 2017. Jubanka ad Beograd was merged to AIK bank on 23 Decembar, 2017. Pireaus bank was merged to Direktna bank on 26 October, 2018. Vojvođanska bank was merged to OTP bank 25. April 2019 (consolidated under Vojvođanska brand).

[2] Without Agrobanka at the end of 2011: Pretax profit € 296m; ROA 1.2; ROE 6.0. Without Razvojna banka Vojvodina at the end of 2012: Pretax profit € 230m; ROA 1.0; ROE 4.7

[3] The last available data of 30.09.2020

[4] Introduced by the implementation of Basel 3 and monitored from 30 June 2017

[5] Net interest margin to average total asset