National Bank of Serbia

Macroeconomic Developments in Serbia

February 2019

Sustained Macroeconomic Stability

- In six years, Serbia has transformed to a low inflation and stable growing economy, with fiscal surplus, declining public debt, significantly reduced external imbalances and labour market recovery.
- GDP growth significantly surpassed expectations in 2018, growing at an estimated 4.4% on the back of robust investment activity, supported by consumption and exports (despite headwinds from the Eurozone).
- In 2018, y/y inflation remained low and stable, moving at the average level of 2.0% and finishing the year at the exact same level. Throughout the year, core inflation hovered around 1.0%, confirming low inflationary pressures. Until the end of the forecast horizon, inflation is expected to move within the target tolerance band, more likely in its lower half. Inflation expectations are anchored around the central target point (3%).
- Government budget turned to a surplus in 2017 (1.1% of GDP), and this trend continued in Q1-Q3 2018 (1.5% of GDP). As a result public debt declined by over 14pp of GDP (cumulative) in 2017-18, with an improved currency composition after repayment of two Eurobonds (USD 1.75 bn).
- These results were acknowledged by improved credit ratings (S&P, Fitch and Moody’s) during 2017 and additionally improved outlook in 2018 (S&P), by successful completion of a precautionary SBA with the IMF and a sharp decline in the country risk premium (historic low in January 2018). In 2018 a 30-month Policy Coordination Instrument with the IMF has been approved.
- Macroeconomic stabilization and improvements to the business environment contributed to further FDI growth (EUR 3.2 bn net in 2018), focused on the tradable sectors.
- Manufacturing exports retained their growth momentum in 2018 (9.1 % y/y) with 21 of 23 branches posting growth. Services expansion continues, with exports growing at 14.4% y/y, driven by ICT services.
- The policy rate was cut in March and April 2018, both times by 25bp, to its current level of 3.0%. Led by demand and supply factors, lending activity increased by 9.9% y/y in December 2018 (12.2% excluding the effects of NPLs write-offs and sales since 2016).
- Banking sector stability has been preserved and further reinforced. Encouraged by the NBS measures, the share of NPLs in total loans declined to 5.7% at end-December 2018 (preliminary data), which is the lowest level since 2008 when this indicator of portfolio quality was introduced. Capital adequacy indicators are even stronger after the application of Basel III standards in Serbia.

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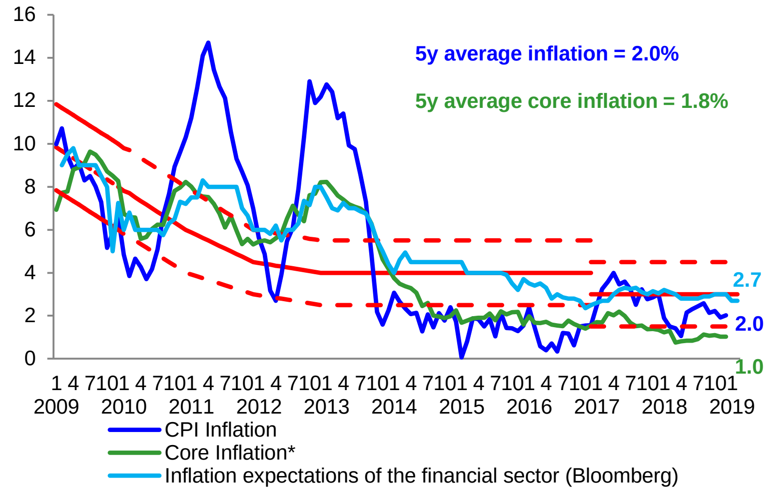
Low Inflationary Pressures

Inflation profile similar to advanced economies

Chart 1 **CPI and inflation expectations developments**
(y/y rates, in %)

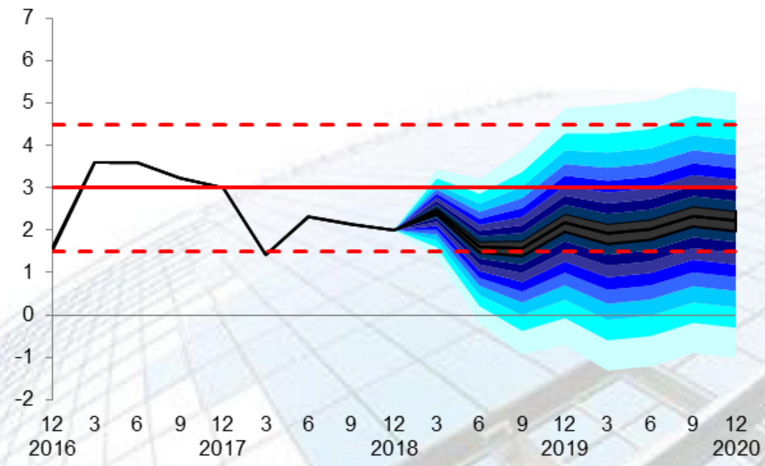


*CPI excl. Food, Energy, Alcohol and Tobacco

- Inflation is kept firmly in check, moving around 2% on average in the past five years.
- After ending 2017 at 3%, headline inflation bottomed out in early 2018 (high base effect) but recovered since May.
- Inflation in 2018 amounted to 2.0% y/y (both average and year-end), and was driven by food and services prices.
- Underlying price pressures remain subdued: core inflation has been moving around 1% y/y during 2018.

Inflation will continue to move in the lower half of the target band…

Chart 2 **Inflation projection** (from February 2019 IR)
(y/y rates, in %)



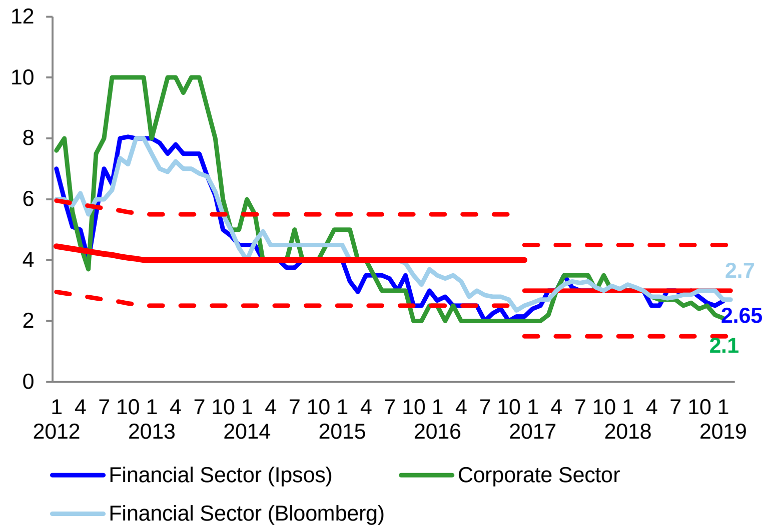
- ... though it will be trending temporarily closer to the target midpoint at the beginning of 2019, due to low base effect.
- Inflation movements in the coming period will be determined by growth of aggregate demand, faster growth of administered prices in 2019 and waning of the effects of past appreciation. On the other side, high base effect for fruits and vegetables and petroleum products prices will act as a damper.
- Risks are slightly skewed to the downside and related to developments in the global commodity and financial markets and, to some extent, to administered prices.

Inflation Expectations Well Anchored Around the Inflation Target

Short-term inflation expectations of financial institutions and corporates are moving close to the central inflation target …

Chart 3 **One year ahead Inflation Expectations**

(in %)

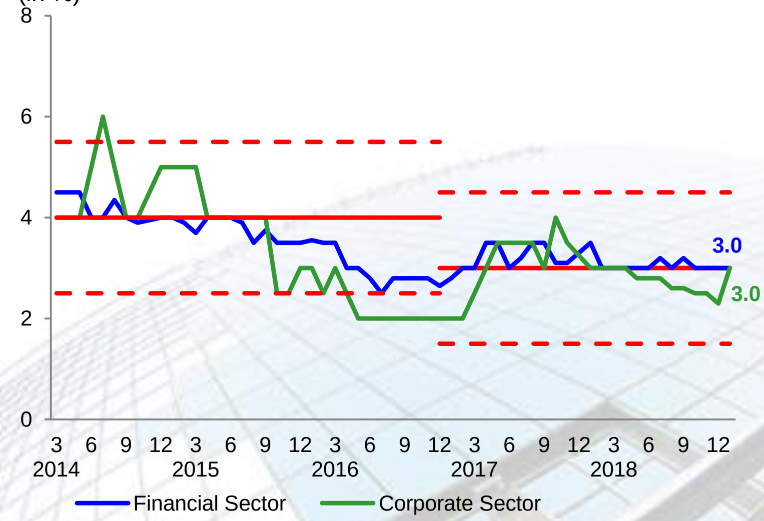


- Short-term expectations of the financial sector and corporates have been moving within the target band for five years.
- According to Ipsos' survey, short-term inflation expectations of the financial sector edged up from 2.5% in December 2018 to 2.65% in January 2019.
- According to Bloomberg's February survey, the financial sector expects inflation one year ahead at 2.7% (same as the month before).

…same as medium-term inflation expectations

Chart 4 **Two year ahead Inflation Expectations**

(in %)

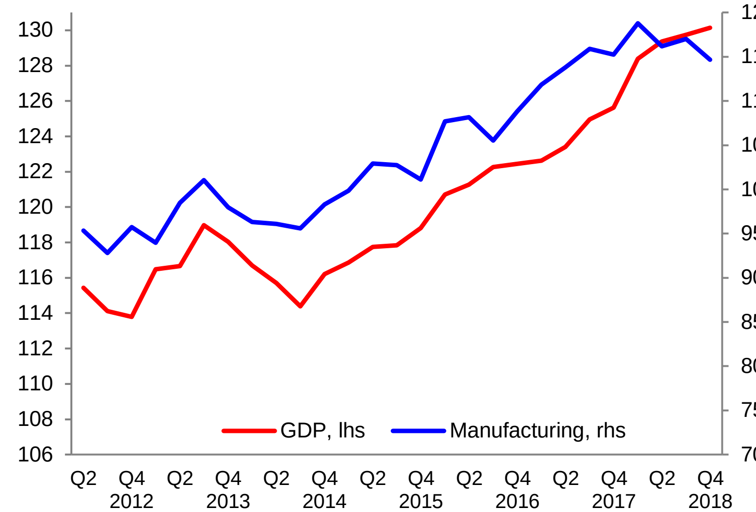


- Medium-term expectations of the financial sector are firmly anchored on target, indicating a high level of trust in the commitment and ability of the NBS to achieve its primary goal.
- Financial sector and corporates' two-year ahead inflation expectations in January 2019 are at the central inflation target of 3.0%.
- Medium-term expectations of the financial sector have been moving within the target tolerance band since their monitoring began.

Strong GDP Growth in 2018 on the Back of Robust Investment Activity and Labour Market Recovery

GDP growth in 2018 picked-up to 4.4% on the back of robust investment growth

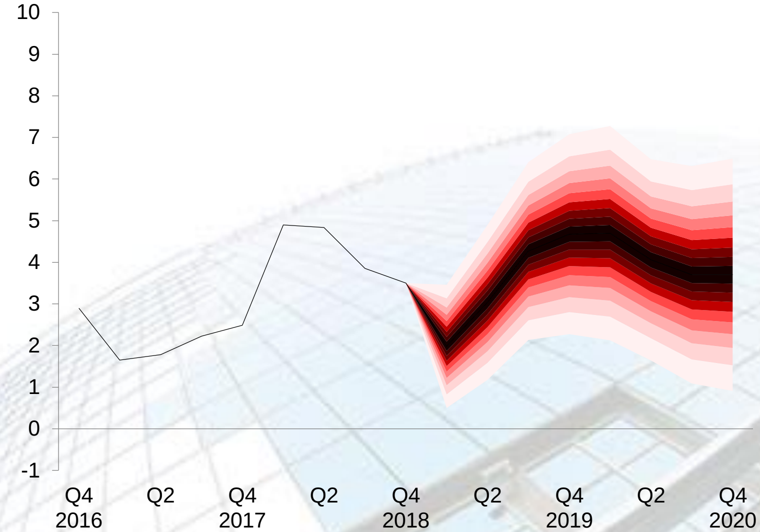
Chart 5 **GDP developments**
(seasonally adjusted, Q1 2006=100)



- Higher than expected 2018 growth (4.4%, the highest in a decade) came from robust investments, as well as sustainable consumption growth, supported by continuance of strong export growth despite Eurozone slowdown.
- On the production side, growth remained diversified, with positive contributions coming from all sectors, mainly services, agriculture and construction.
- Strong private and public investments, continuous expansion in exports and sustainable rise in consumption will be the main drivers of GDP in the coming years.

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

Chart 6 **GDP growth projection** (from February 2019 IR)
(y/y rates, in %)



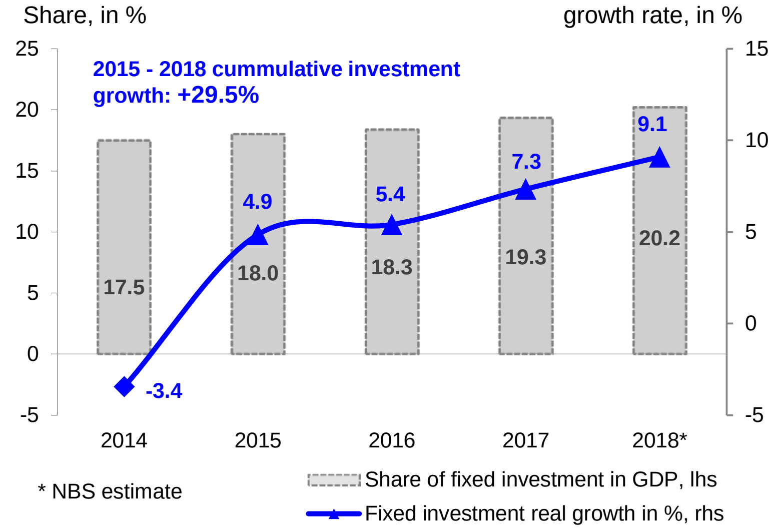
- We keep the GDP growth forecast for 2019 at 3.5%, while In the medium run, we expect to accelerate to around 4%.
- Risks to GDP growth are mostly related to global economic activity slowdown, as well as monetary policies of leading CB and commodity prices. On the other hand, domestic factors will continue to provide strong support to economic growth.
- Factors to support sustainable medium-term growth of around 4% include macroeconomic stability, improved business environment, strong private and public investment and effects of past monetary easing.

The New Investment Cycle

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

Chart 7 **Fixed investment dynamics**

(growth rates in %, share in %)



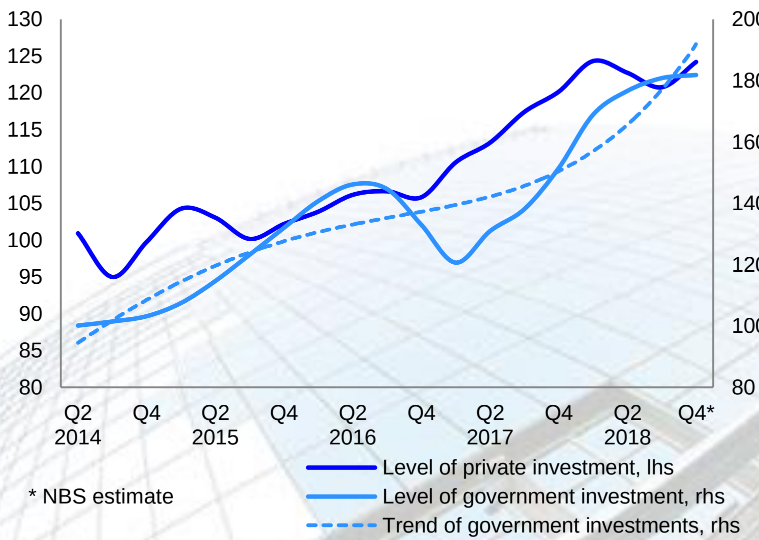
* NBS estimate

- In the past four years, fixed investments grew at an avg. rate of around 7%, with cumulative growth of 29.5%.
- In 2018 investment growth picked up to 9.1% providing a key contribution to higher-than-expected GDP growth.
- Investments will reach 20.2% of GDP in 2018, and their share will continue to grow in the medium term.
- Key indicators (equipment imports, construction activity, production of capital goods) are performing exceptionally.
- In the medium-run, investments will contribute to further rebalancing of the economy.

…in both private and government sector

Chart 8 **Private and government investment dynamics**

(seasonally adjusted data, indices 2014=100)



* NBS estimate

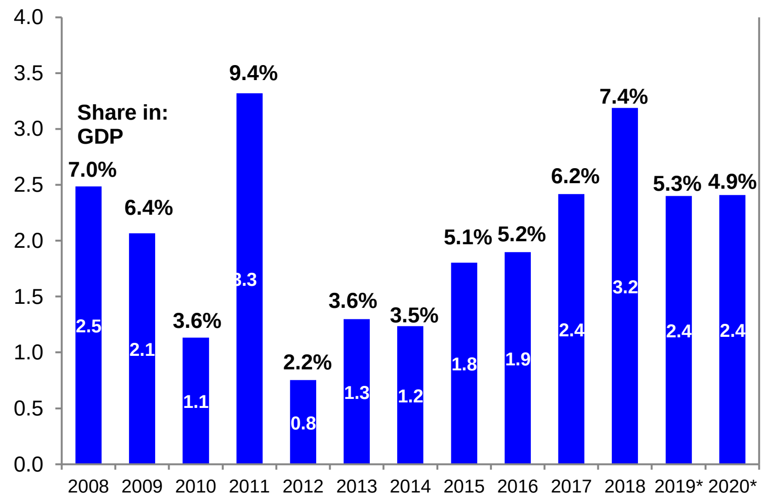
- Sustained macroeconomic stability, improvement in the overall business environment, rising profitability and EU accession process will work in favour of private investments in the coming years.
- Aside from private investments, public sector investments recovered as of 2015 and picked up particularly in 2018.
- A growing economy, combined with improved tax collection and responsible public spending policies, will enable the government to increase investment activity and further develop the country's infrastructure.

Improved Business Environment Supporting High FDI Inflow

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

Chart 9 **Net FDI**

(EUR bn)



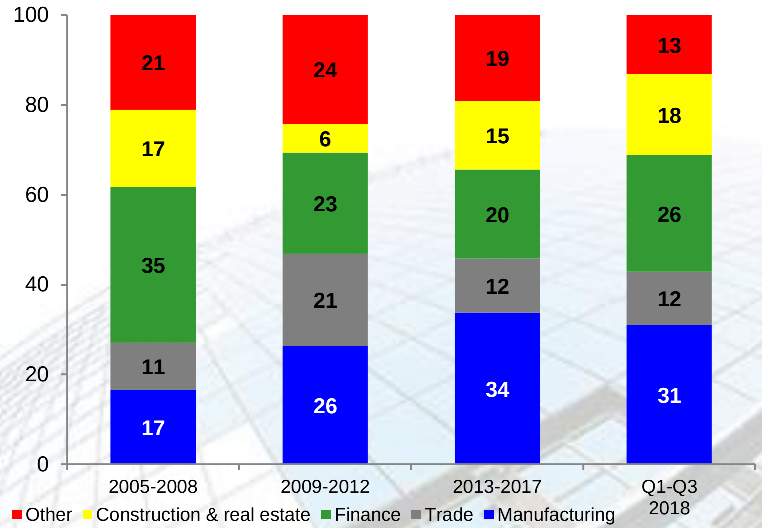
*NBS projection

- In 2018 net FDI inflow covered the current account deficit for the fourth year in a row.
- The net FDIs amounted to EUR 3.2bn in 2018, marking one of the best years on record and outperforming the projection.
- The largest part of net FDIs were outright equity transactions (EUR 1.2bn); reinvested earnings accounted for EUR 1.1bn and the remainder were debt transactions.
- CAD/FDI coverage stood at 143.4% in the same period.
- We expect a continuance of strong performance in 2019, with net FDI inflows projected at 5.3% of GDP (EUR 2.4 bn).

…which are well-diversified and contributing to the country's export potential

Chart 10 **FDI composition by sector**

(% of inflow)

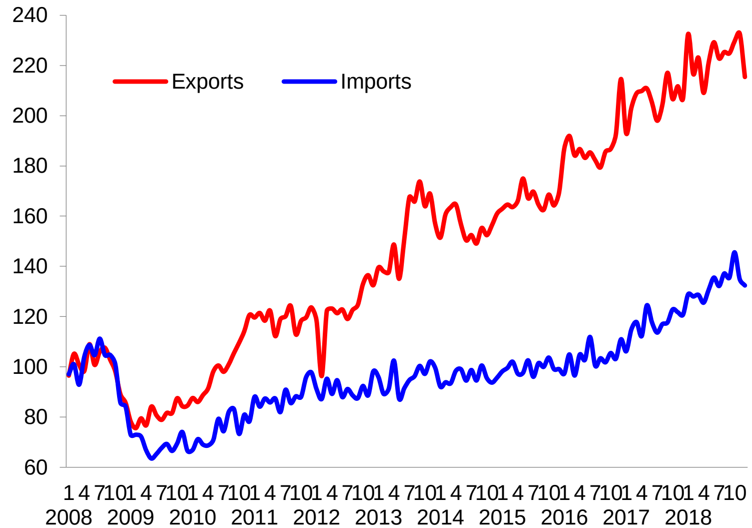


- During 2013 – Q3 2018 a large share of FDI inflows has been directed to export-oriented sectors.
- Within manufacturing, most FDI inflows are directed to the automobile, base metals, food/beverage and chemical industries. This resulted in high growth of manufacturing employment, output and exports.
- 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.

External Position Stable

Export growth largely continues despite Eurozone slowdown…

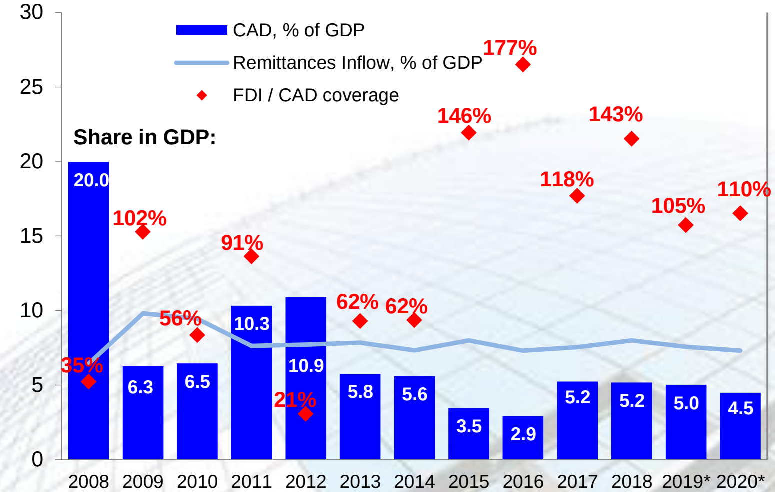
Chart 11 **Exports and imports**
(seasonally adjusted, 2008=100)



- During 2018 CAD amounted to EUR 2.2bn (5.2% of GDP– unchanged from the previous year).
- Goods exports grew 8.3% y/y (manufactured goods +9.1% y/y). Eurozone demand moderation was largely compensated by increasing exports to CEE markets.
- Goods imports grew 13.4% y/y, over 80% of which is accounted for by growth in imports of capital and intermediate goods (oil & gas – related imports up 30% y/y).
- Exports of services grew 14.4% in 2018, driven by ICT and business services.

…but investment and oil-related imports temporarily raised the deficit in 2017 and 2018

Chart 12 **Current account deficit, FDI and remittances**
(% share in GDP)



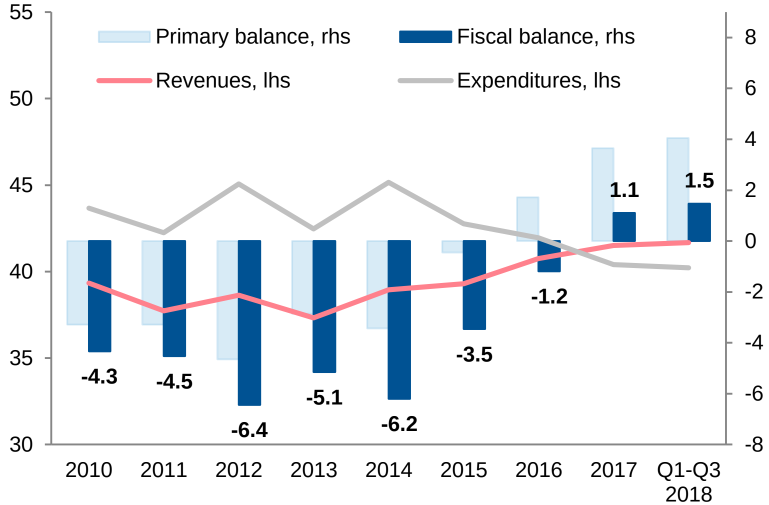
*NBS projection

- In 2017-2018 an increase in CAD / GDP ratio was recorded due to higher imports of capital and intermediate goods related to investment and industrial activity, as well as higher oil prices.
- In 2018 CAD share in GDP has remained on a similar level as in 2017, which is in line with a higher oil price, ongoing investment cycle, further growth in consumption and exports.
- In the medium term, we expect CAD to be around 4-5% of GDP, while FDI inflows will remain more than sufficient to finance the CAD.

Favourable Fiscal Performance Continues

Strong fiscal adjustment since 2015 of around 8pp of GDP…

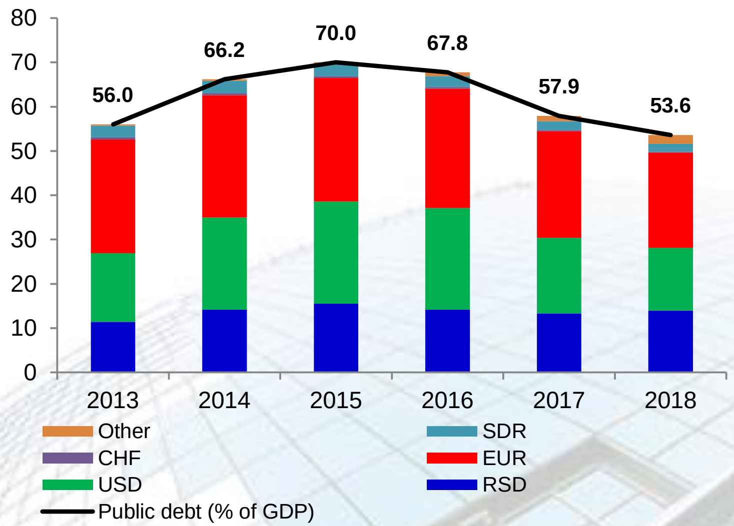
Chart 13 **Fiscal revenues, expenditures and outcome**
(% share in GDP)



- Improvement of the fiscal outlook in last four years was led by fiscal consolidation on expenditure side, and robust growth in revenues on account of GDP growth and improved tax collection.
- Fiscal balance switched to a surplus of 1.1% of GDP in 2017 (the first on record since 2005), with a primary surplus around 4% of GDP.
- A surplus of 1.5% of GDP was posted for Q1-Q3 2018 on the back of continued growth in tax revenues, and the trend continued in Q4.
- Public investments growth in 2018 is estimated at around 50% y/y, and their further increase remains a top priority of fiscal policy.

…resulted in a decline in the public debt-to-GDP ratio and its sustainability

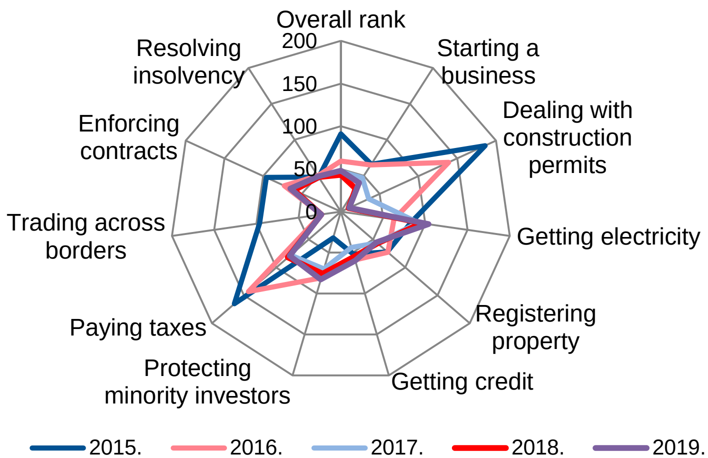
Chart 14 **Public debt (central government)**



- The declining trend of public debt continued in 2018 – 53.6% of GDP at the end of the year.
- The declining debt share is driven both by lower government financing needs and faster GDP growth.
- The Government's Fiscal Strategy entails a medium-term deficit target of 0.5% of GDP, consistent with steady debt reduction and sustainability.
- Public debt dinarisation picked up from 23.0% (end-2017) to 26.0% in December due to Eurobond repayment (USD 1 bn) as well as government choice to rely more on dinar denominated debt.

Improved Structural Competitiveness Provided Additional Boost to Overall Macroeconomic Performance

Chart 15 **Indicators on business regulation**
(rank, lower value means rank improvement)



Source: World Bank, *Doing Business Report*

- <u>**Key reform areas in the last four years:**</u>
- ❑ Construction sector;
- ❑ Labor market;
- ❑ Tax administration;
- ❑ Financial sector;
- ❑ Contract enforcement and resolving insolvency.

<u>Key deliverables:</u>

✓Law on Planning and Construction (2014) and Law on Investment (2015) – streamlined construction permit procedures (one-stop-shop and electronic construction permits), doubling the number of construction permits and increasing the share of construction in GDP.

✓New Labor Law (2014) – improved flexibility and job creation. On top of that, the National Employment Strategy & Reform Program improved job matching services and training and provided subsidies to disadvantaged people and self-employment. Reforms contributed to an increase in private sector employment by more than 200 thousand people (16,3%), almost half of which in manufacturing industry, followed by private sector services and the construction sector.

✓Tax Administration reform – led to a significant increase in revenue collection and better than planned fiscal results.

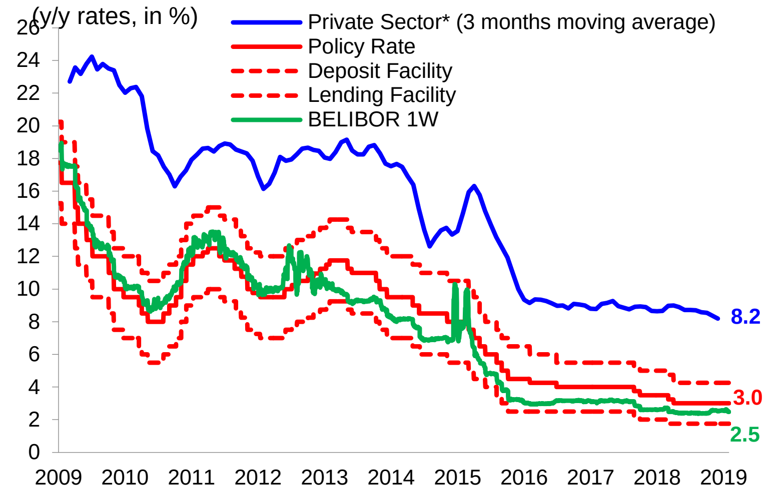
✓NPL Resolution Strategy (NBS and government action plans) – the share of NPLs declined more than 70% (from 22.2% in August 2015 to 5.7% in December 2018, preliminary data). Narrowing was most evident with corporates – the share of NPLs was reduced from 25.9% to 5.2% (preliminary data) in the same period.

✓ Private bailiff system (2013) and New Bankruptcy Law (2014).

Key Policy Rate Kept on the Lowest Level of 3.0%

The key policy rate kept on hold in February

Chart 16 **Interest rates**



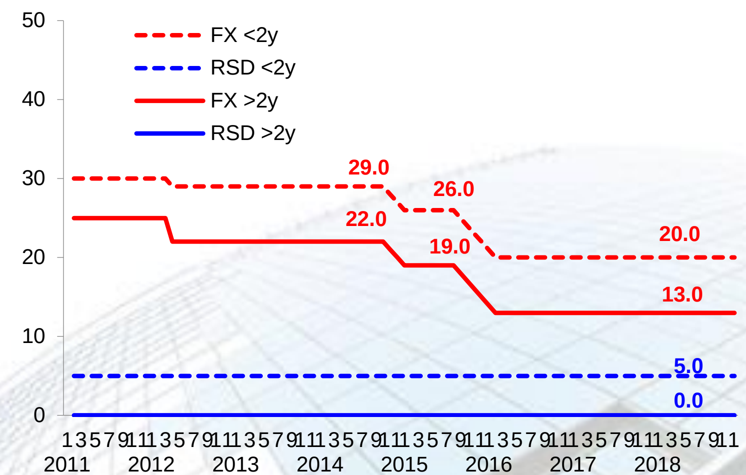
*weighted interest rate on non-indexed RSD loans (up to September 2010 the data was exclusively used for research purposes of NBS)

- NBS kept the key policy rate unchanged at 3%, taking into account the expected movement in inflation and its underlying factors going forward, as well as the effects of past monetary policy easing.
- Caution in monetary policy conduct is still mandated primarily due to developments in the international environment – weakened global growth outlook, uncertainty regarding the monetary policies normalization dynamics of leading central banks, potential escalation of tensions in international trade and oil price volatility.
- Nevertheless, NBS points out the resilience of the Serbian economy to potential negative effects from the international environment has increased, owing to improved macroeconomic indicators and outlook going forward.

FX required reserve ratio has remained unchanged since early 2016

Chart 17 **Reserve requirement ratios**

(in %)



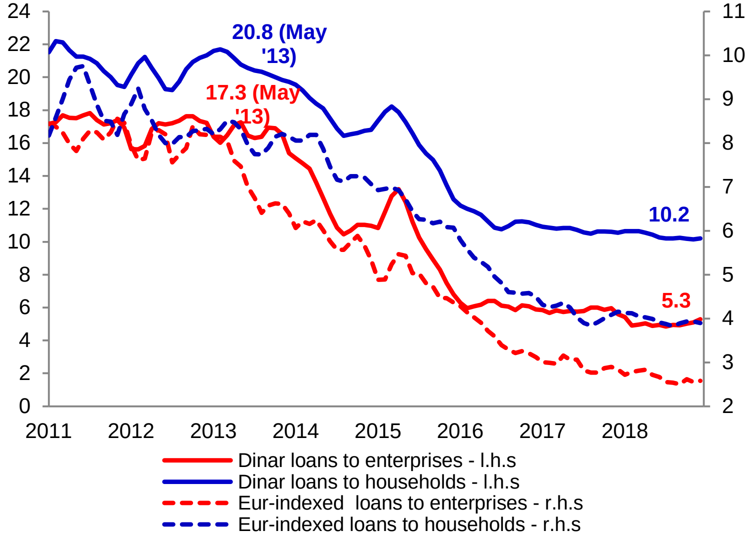
- Last time FX RR ratio was reduced in early 2016 aiming to support lending activity (to 20%/13%, for liabilities up to/over 2Y).
- RR is important monetary policy tool (in December 2018 RR amounted to EUR 1.9 bn and RSD 171.2bn).
- NBS uses RR as an important macroprudential tool within dinarisation strategy:
  - by applying lower RR ratio on dinar vs FX sources,
  - by applying remuneration at higher rate on dinar RR vs FX RR (i.e. 1.25% on RSD RR, while no remuneration is applied on FX RR).

The Effects of the NBS Monetary Policy are Reflected in Lower Costs of Financing and Credit Growth

Interest rates on dinar loans have declined significantly over the last five and a half years

Chart 18 **Interest rates on loans – new business**

(3 months moving average, in %)

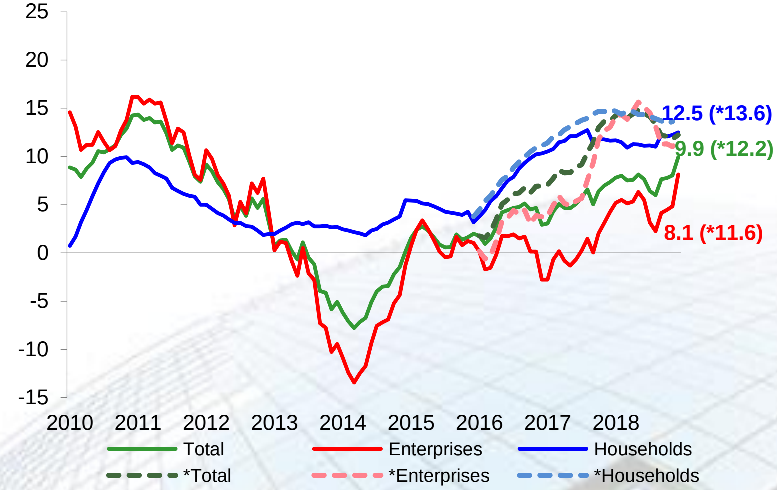


- Monetary policy easing from May 2013 was the key determinant of the significant fall in dinar lending rates (more than 10 pp), to the level of 5.6% for corporates and 10.3% for households (December 2018).
- In parallel to new business, interest rates on outstanding loans also fell sharply, leading to higher disposable income of both households and corporates.
- In the observed period, a sharp fall in the country risk premium and monetary easing by the ECB contributed to the fall in EUR-indexed lending rates.

Lower costs of financing and sustainable economic growth support domestic lending

Chart 19 **Bank lending to enterprises and households**

(y/y rates, constant exchange rate 30 Sept 2014, in %)



* Excluding the effect of NPL write-offs and sales since 2016.

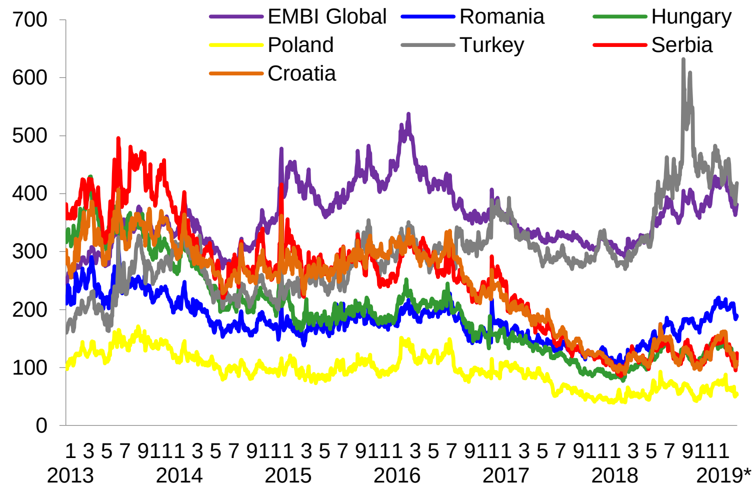
- Total lending growth accelerated to 9.9% y/y in December 2018, primarily due to acceleration of corporate loans to 8.1% y/y, and households lending to 12.5% y/y.
- Excluding the effect of NPL write-offs and sales, total lending growth reached 12.2% y/y in December, of which lending to enterprises reached 11.6% y/y and lending to households 13.6% y/y.
- Further growth of lending activity is expected in the coming period, as a result of economic growth, improved conditions in the labor market, effects of past monetary policy easing by the NBS, low interest rates in the euro area, interbank competition and reduced NPLs.

Rating Outlook for Serbia Improved

After reaching its all-time low in early 2018, Serbia's risk premium remains among the lowest in the region

Chart 20 **EMBI risk premium**

(basis points, daily values)



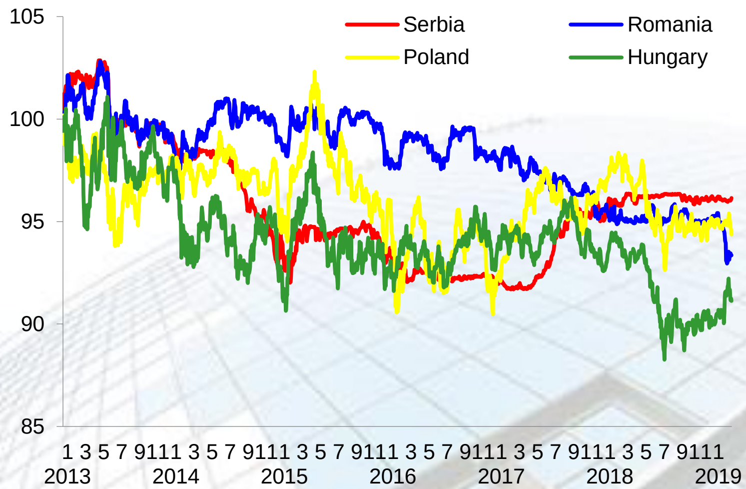
*Until February 11, 2019

- The rise in emerging markets' risk premia from Q4 2018, which was due to the trade and geopolitical tensions and consequent global financial markets volatility, was largely offset since the beginning of 2019. EMBI Serbia is for quite some time relatively low, as a result of domestic factors, such as multi-year narrowing in internal and external imbalances, and a favorable growth outlook.
- In December 2018 **S&P improved outlook from stable to positive** and affirmed rating at BB, on the back of strong economic growth and maintenance of price and financial stability.

The dinar remained relatively stable against the euro in 2018 and since the start of 2019

Chart 21 **Exchange rate developments**

(31 December 2012 = 100)



*Until February 11, 2019

- Appreciation pressures that were prevalent in 2017 and 2018 were due to favourable developments and outlook of domestic economy which contributed to FX inflow on several grounds, such as FDI and investment in long term dinar government bonds by foreign investors.
- In order to maintain the relative stability of domestic currency, the NBS was buying FX in the periods of strong and concentrated appreciation pressures on the dinar, thus acting proactively and bolstering the FX reserves and increasing resilience of the domestic financial system to potential external shocks.

S&P Revised Serbia's Rating Outlook from Stable to Positive; Rating Affirmed at BB

- **The upward revision of Serbia's rating outlook resulted from strong economic growth and results of monetary policy in maintaining price and financial stability. The improved outlook also reflects prudent fiscal stance confirmed also through new PCI arrangement with IMF.**

- Key drivers of the outlook upward revision:
  - GDP growth in 2018 highest in a decade and positive medium-term growth outlook supported by strong investment, high exports and sustainable private consumption growth;
  - NBS credibility and effectiveness of its inflation targeting regime and relatively flexible FX regime, which resulted in low and stable inflation and anchored inflation expectations, while at the same time allowing the economy to adjust to changing international environment and possible external shocks
  - Stable, adequately capitalized, liquid and resilient banking system, with sustained progress in NPL reduction, whose amount is more than halved since adoption of NPL resolution Strategy and share in total loans dropped to historically low level in November 2018 (6.1%);
  - Stronger lending activity supporting economic growth;
  - Shrinking external imbalances and improvement of current account financing structure;
  - Prudent fiscal policy ensuring the downward trajectory of public debt;

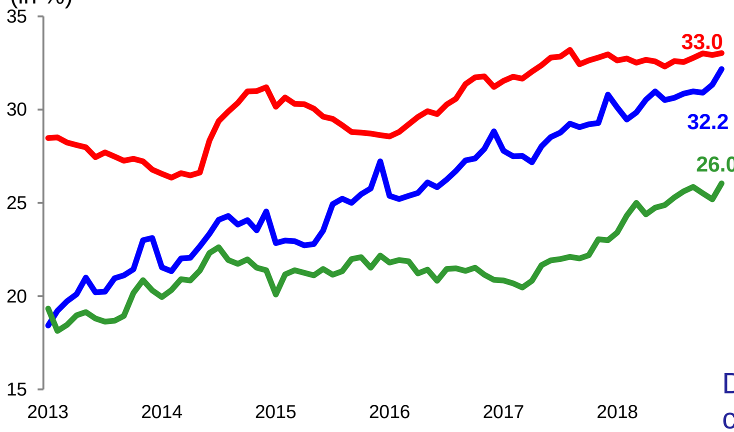
- Agency highlights that the continuation of strong growth, declining public debt and contained external imbalances could result in raising Serbia's credit rating.

Indicators of Dinarisation of Corporate and Household Sector are on the Rise

Macroeconomic stability contributing to dinarisation process

Chart 22 **Dinarisation of the corporate and household sector receivables and deposits, and dinar share of public debt**

(in %)



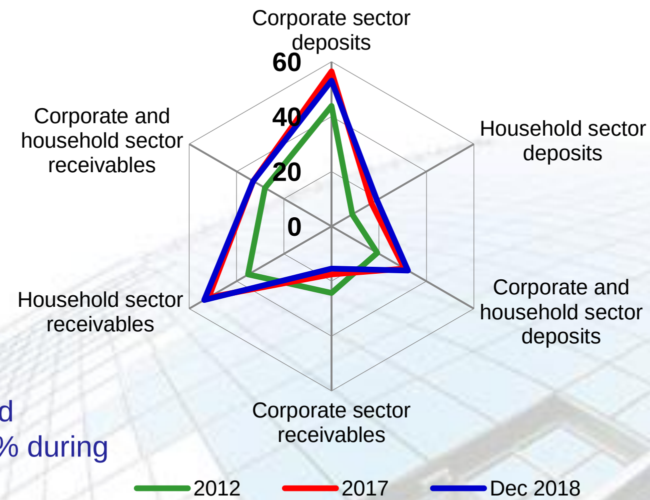
- NBS stimulates the dinarisation process by delivering low and stable inflation, preserving relative exchange rate stability, enhancing management of FX risks and exposures in the private sector, and using other measures.
- The Government contributes to dinarisation through tax policy, by developing the dinar securities market (dinar debt share rose from 2.5% in 2008 to 26.0% in December 2018). Maturity of dinar yield curve is extended to 10 years.
- Dinarisation of the corporate and household sector deposits rose by 12.9 pp compared to end-2012 and currently stands at 32.2%(December 2018), while dinarisation of corporate and household sector receivables rose by 5.0 pp to 33.0% (December 2018).

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

Dinar savings have continued to grow and increased around 22% during 2018.

Chart 23 **Dinarisation of corporate and household sector**

(outstanding amounts in %)

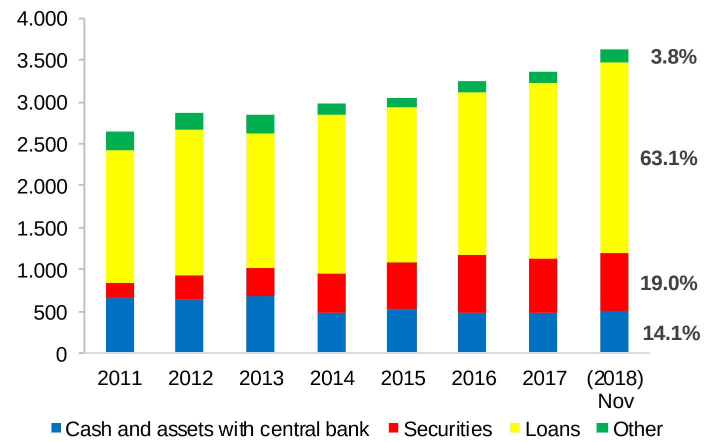


- Over the past years, dinarisation of household receivables had a firm upward trend – an upsurge from 35.1% (2012) to the maximum of 53.6% (December 2018). This positive trend is a result of a sharp drop in dinar interest rates, low and stable inflation, as well as NBS measures aimed to support dinarisation.
- Since the beginning of 2018 dinar savings of households (residents) increased by around 22% and amounted to RSD 60.5bn in December 2018, the highest level so far.
- Dinarisation process is additionally supported by the issuance of the first dinar bond by EBRD (December 2016).

Traditional Banking Mostly Financed by Domestic Deposits

Adequate structure of banking sector assets

Chart 24 **Structure of banking sector assets**
(RSD bn)

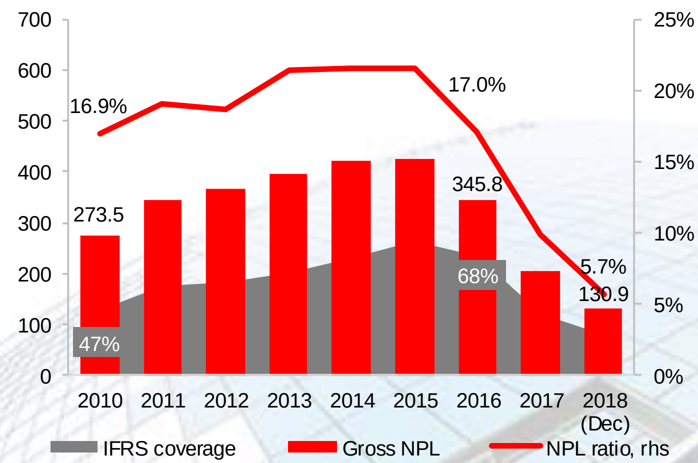


Source: NBS

- 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 (19.0% at the end of November 2018).
- 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 29%, respectively at the end of Decembar 2018 (preliminary data).
- Despite high loan portfolio euroization, currency matching of assets and liabilities is present, with net open position of 4.8% of regulatory capital at end-2018 (preliminary data).

Improving the quality of the banking sector assets

Chart 25 **Asset quality – Non-performing loans (NPL)**
(RSD bn, %)



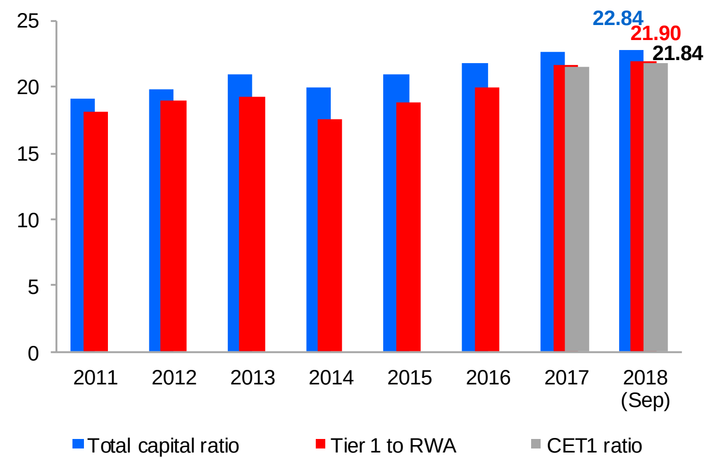
Source: NBS * December 2018 data are preliminary

- 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 2018, the NPL ratio was 5.7% (preliminary data), with the maintenance of relatively high coverage by both, IFRS provisions (61.5%, November data) and regulatory reserves (162.2%, preliminary data).
- 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 26 **Capitalization of the Serbian banking sector**
(%)

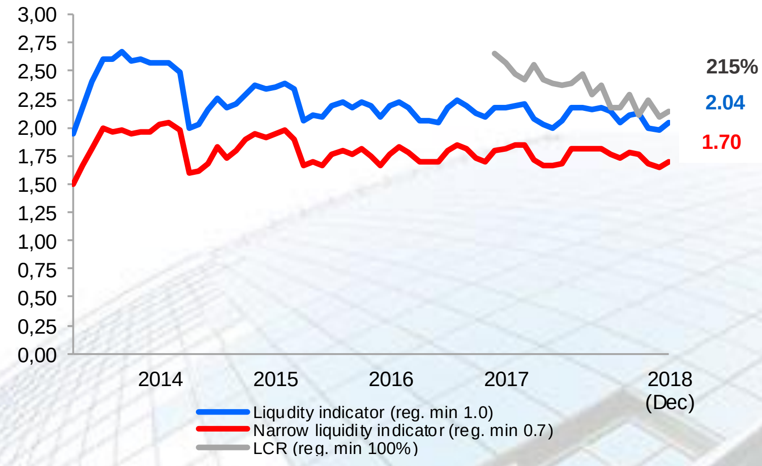


Source: NBS

- 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 over 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 2018 amounted to 12.4%.

Serbian banking sector is highly liquid

Chart 27 **Liquidity indicators of the Serbian banking sector**



Source: NBS

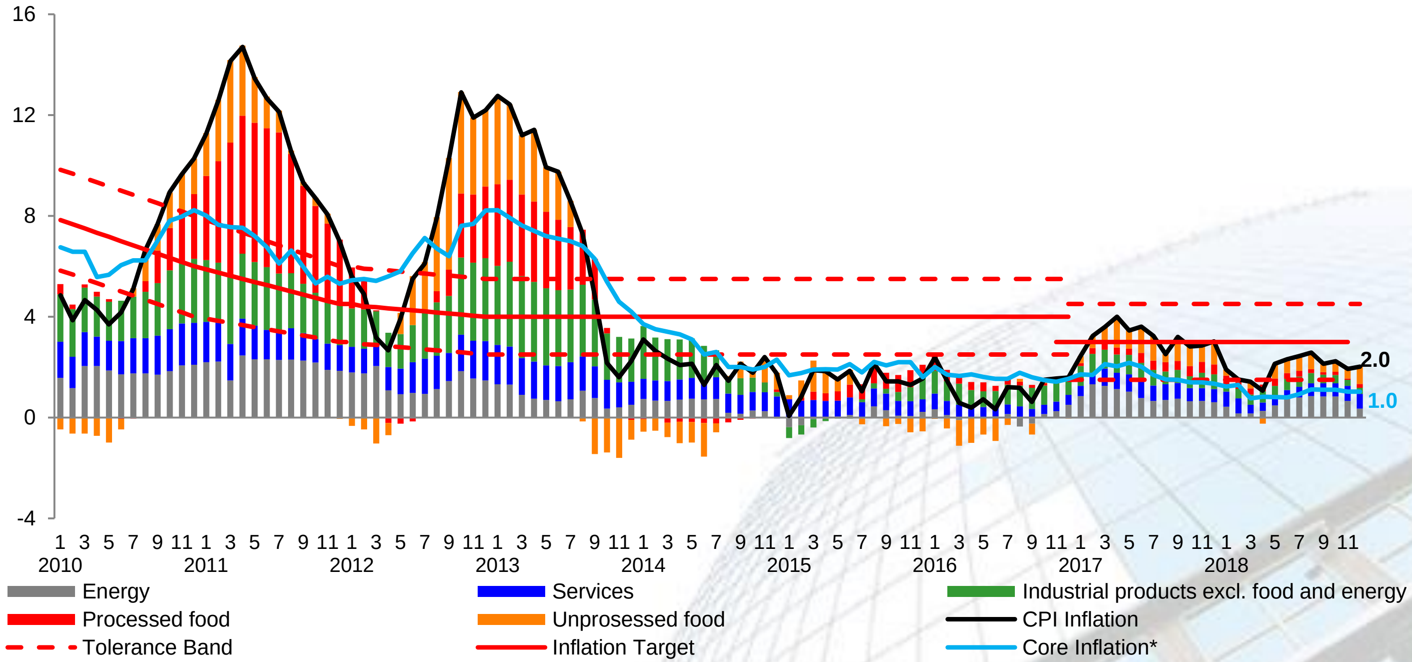
* December 2018 data are preliminary

- Liquidity ratios are constantly at levels significantly higher than the regulatory minimum.
- Liquid assets account for around 37.3% (preliminary data) of the total assets of the banking sector in December 2018.
- The loan to deposit ratio that at the end of December 2018 amounted 90% (preliminary data), indicates stability of funding and in general the liquidity of the banking sector.

Structural slides

Fall in the Headline Inflation in 2018 Driven Mainly by High-Base Effect in Food Prices

Chart 28 **Contributions of CPI components to y/y inflation**
(y/y rates, pp)



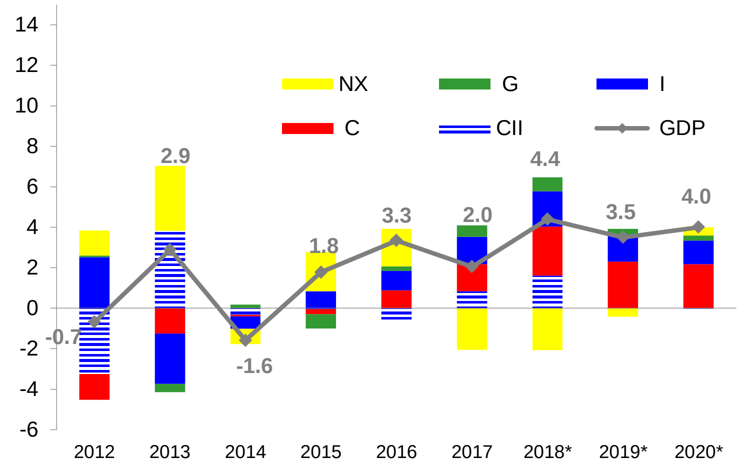
- Historically, short-term volatility of headline inflation was mainly driven by food prices.
- Core inflation remained low and stable hovering around 1% in 2018, confirming low inflationary pressures.

Growth Structure more Favourable than Pre-Crisis

Pre-crisis GDP growth was driven by consumption, the trend reversed after the crisis in favour of investments and exports

Chart 29 **Contributions to real GDP growth**

(y/y rates, pp)



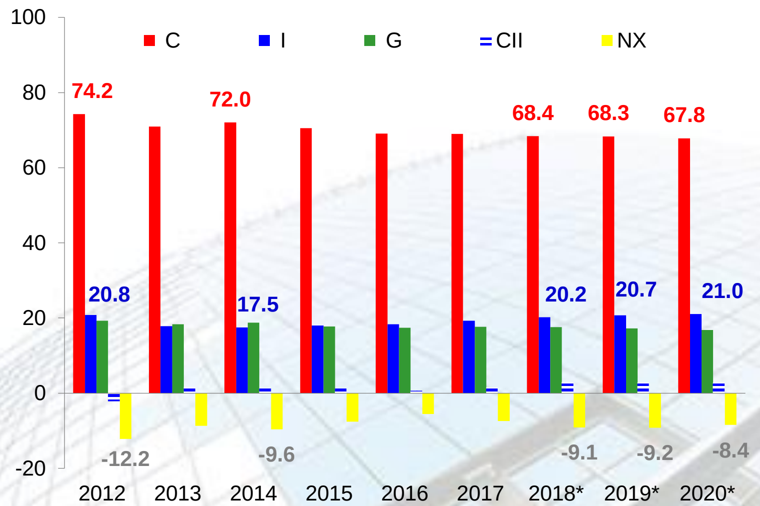
*NBS forecast

- Prior to the crisis, high capital inflows led to consumption-based growth which resulted in increased external imbalances. With the first wave of the crisis, this trend reversed. Growth was slower, but more sustainable and driven by net exports and investments.
- Large-scale investments in the automobile and oil industries (2011–2012) have helped the economy to rebalance.
- The new investment cycle that began in 2015 is more diversified, and is leading to further rebalancing of the economy and sustainable growth.

In the next five years, Serbia will gradually converge towards more developed countries in terms of GDP composition

Chart 30 **GDP composition**

(share in GDP)



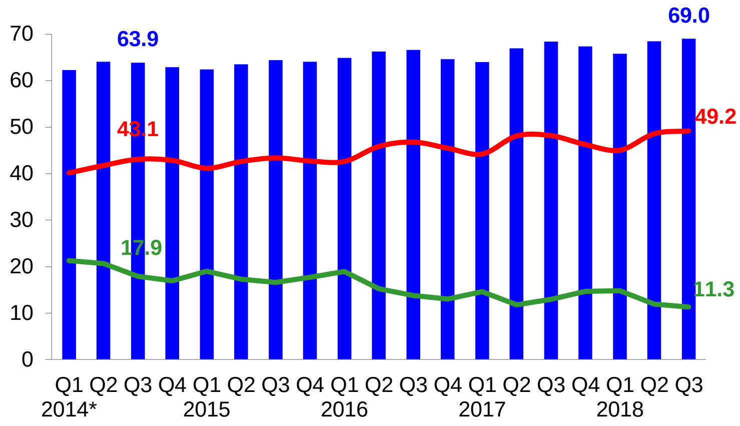
*NBS forecast

- As a result of adequate policy mix, GDP growth will remain broad-based and sustainable.
- Consumption will continue to grow, but slower than the total GDP, creating space for more investment.
- In the medium-run, fixed investments will increase their share in GDP, while exports of goods and services are likely to approach 70% of GDP.
- Implementation of structural reforms, improvement in the investment climate and the EU accession process created a foundation for healthy growth.

Sustainable Recovery of the Labour Market

In Q3 2018, the unemployment rate recorded the lowest level since there are comparable data

Chart 31 **Labour market indicators according to the Labour Force Survey,** (in %)

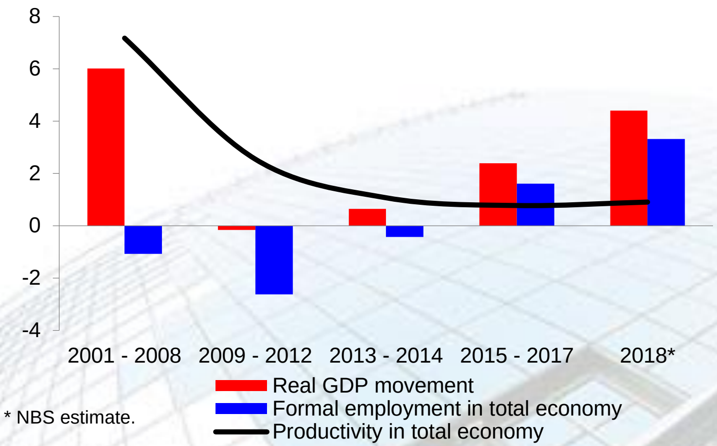


Source: Statistical Office Republic of Serbia.
* Since 2014, LFS data published according to the new methodology.

- According to the Labour Force Survey for Q3 2018, the unemployment rate was 11.3% (-1.6 pp. y/y), which is its lowest comparable level.
- The employment rate in Q3 reached 49.2% (+1.0 pp y/y) and positive movements are also confirmed by the participation rate growth to highest level so far (69.0%, +0.6 pp y/y).
- Favourable trends in the formal labour market come from the private sector, where employment increased by 15.0% (December 2018/December 2014) - mainly in manufacturing, private sector services and construction.

Stable growth in productivity of the Serbian economy

Chart 32 **Developments of productivity in total economy** (growth rates, in %)



* NBS estimate.

Source: Statistical Office Republic of Serbia, Central Registry of Compulsory Social Insurance, NBS calculation.

- Estimated growth in productivity of the Serbian economy is result of a faster growth of GDP (4.4% y/y) than increase in employment during 2018.
- In the last three years, the highest growth of productivity has been recorded in manufacturing branches with the largest FDI inflows - steel, chemical and pharmaceutical industries, as well as in rubber and plastics industry.
- Productivity growth in the same period is also noticeable in production of machinery and equipment, as well as in production of beverages.

Trading Partners and External Demand

Chart 33 **Imports by country 2018**
(EUR mn)

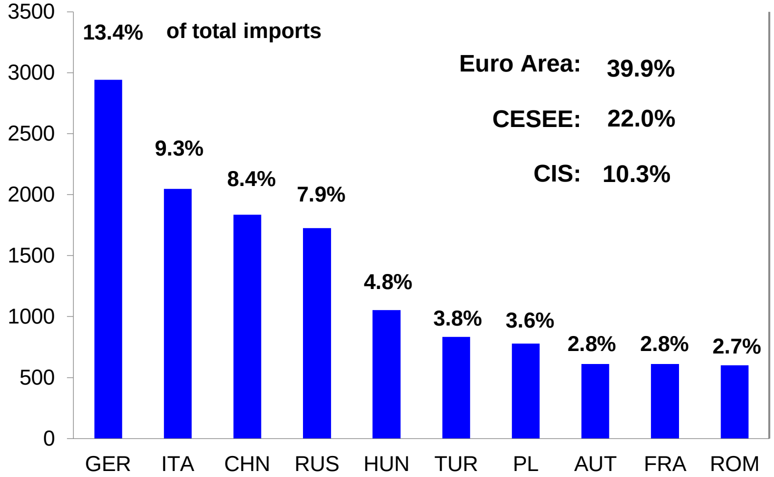


Chart 34 **Exports by country in2018**
(EUR mn)

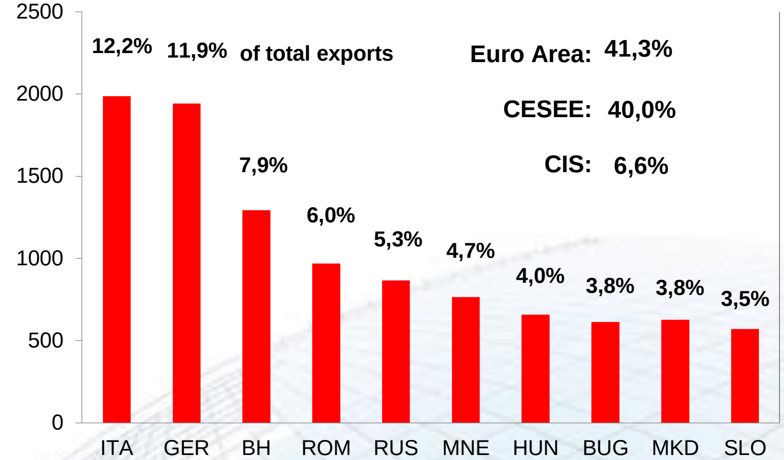


Chart 35 **External Demand Indicator**
(long-term average = 100)

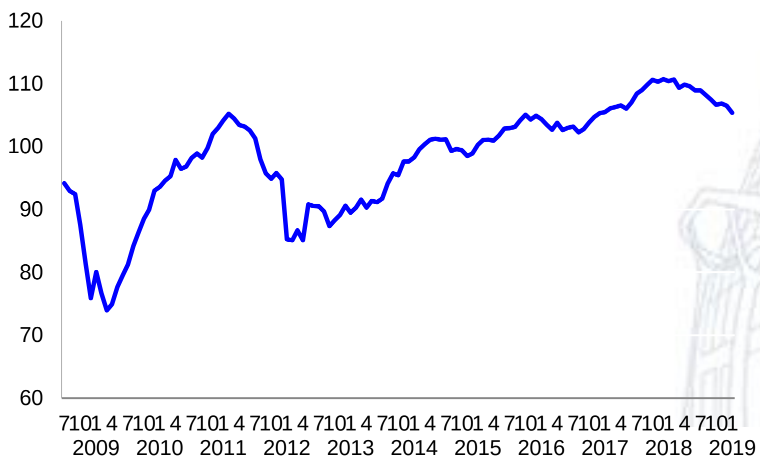
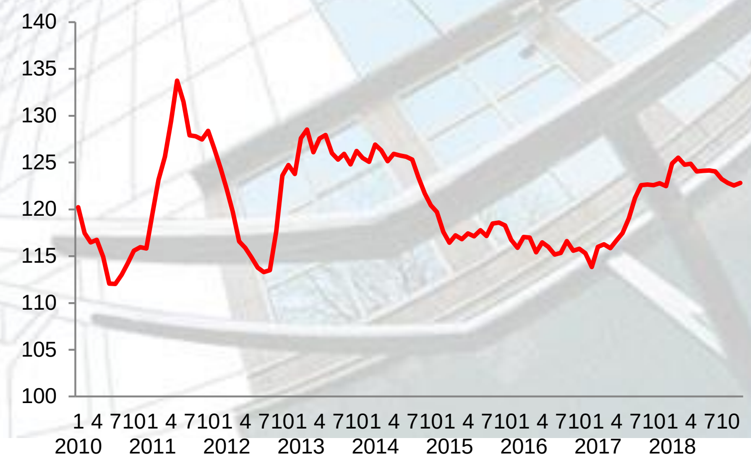


Chart 36 **Real Effective Exchange Rate**
(2005=100)



Source: European Commission,NBS

*Growth indicates appreciation.

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.

Efforts on NPL Resolution

- On 13 August 2015, the Government adopted the national NPL Resolution Strategy. In addition, both the Government and the National Bank of Serbia adopted action plans in order to fulfil strategic objectives
- In the previous period, the NBS carried out **all** activities envisaged by its Action Plan aimed primarily at the enhancement of banks' capacities to resolve NPLs. In line with this plan, the NBS:
  - ✓ Published the Guidelines for implementation of IAS 39;
  - ✓ Enhanced the reporting of NPLs by banks;
  - ✓ Conducted an analysis regarding NPL market obstacles and limitations;
  - ✓ Established a database on real estate collateral valuations and loans approved based on reported collateral;
  - ✓ Introduced additional requests for banks regarding monitoring of collateral and engagement of persons that evaluate that collateral;
  - ✓ Strengthened the regulatory treatment of restructured receivables in order to encourage sustainable restructuring practices and prevent the unsustainable refinancing practices (evergreening);
  - ✓ The distressed asset management in banks has been improved by introducing additional requirements for banks in the context of strategic planning;
  - ✓ Published the Guidelines for Disclosure of Bank Data and Information Related to the Quality of Assets for Banks
- Other activities envisaged by the Strategy are under the competence of ministries (finance, economy, justice and construction), as well as the Deposit Insurance Agency.
- Although NBS Action Plan was accomplished, NBS undertakes additional regulatory steps aiming to encourage the banks to resolve NPLs more efficiently and to establish a system that will prevent the accumulation of NPLs:
  - ✓ Introducing the obligatory write-offs of NPLs which are fully impaired;
  - ✓ Prescribing regulatory treatment of particular undesirable transactions related to NPLs.
- Taking in account specificities of the domestic market and carefully considering activities of EU bodies and institutions in this field NBS will continue to make regulatory efforts on NPL resolution.

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

NPL data, December 2018			
	Gross loans (EUR bn)	**Gross NPL (EUR bn)**	**NPL ratio (%)**
Corporates	8.7	0.5	5.2
Natural persons	8.6	0.4	4.4
of which: households	*7.7*	*0.3*	*4.4*
Corporates in bankruptcy proceedings	0.2	0.2	98.9
Other	1.9	0.0	0.0
Total	19.4	1.1	5.7

** preliminary data*

- NPL development after the adoption of the NPL Resolution Strategy, especially in 2017 and 2018, confirmed the soundness of the inter-institutional and coordinated approach envisaged by the Strategy.
- After 2017 record drop in share of NPLs of 7.2 pp, noticeable downward trend continued in 2018, resulting with three and a half 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.

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.

National Bank of Serbia

Serbia's Economic Outlook

Serbia	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018*	2019*
											*NBS forecast	
Real GDP, y-o-y %	5.7	-2.7	0.7	2.0	-0.7	2.9	-1.6	1.8	3.3	2.0	4.4	3.5
Private consumption, in %	4.5	-3.3	-0.6	1.4	-1.7	-1.7	-0.1	-0.3	1.3	1.9	3.5	3.4
Private investment,[1] in %	14.4	-23.6	-7.9	7.5	15.1	-7.7	-5.6	3.5	2.7	10.1	5.0	4.4
Government consumption, in %	3.5	-1.7	0.0	1.6	0.4	-2.1	0.9	-3.7	1.2	3.3	3.9	1.9
Government investment, in %	-16.4	-16.6	0.0	-7.8	7.6	-35.8	13.6	14.0	22.0	-6.4	33.6	15.7
Exports, in %	12.6	-11.5	16.9	5.6	2.9	18.0	4.3	9.4	11.9	8.2	8.8	8.3
Imports, in %	10.1	-21.9	-0.1	7.2	-0.6	6.5	5.1	4.0	6.7	11.1	11.2	7.7
Unemployment Rate, in %[4]	13.6	16.1	19.2	23.0	23.9	22.1	19.2	17.7	15.3	13.5	11.3	n/a
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	n/a
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	n/a
CPI,[2] in %	8.6	6.6	10.3	7	12.2	2.2	1.7	1.5	1.6	3.0	2.0	chart 2
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	3.0
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	5.2	5.0

[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. Data for 2018 is for Q3.

[5] Nominal w ages by the old methodology (Survey RAD-1). Data for 2018 cover the period January-November.

National Bank of Serbia

Banking Sector Overview

Serbia	2010	2011	2012	2013	2014	2015	2016	2017	December 2018
Number of banks[1]	33	33	32	30	29	30	31	29	27
Employees	29,887	29,228	28,394	26,380	25,106	24,257	23,847	23,055	22,830
Branches	2,487	2,383	2,243	1,989	1,787	1,730	1,719	1,627	1,598
HHI Assets	629	664	678	741	794	796	813	813	779
Share of foreign banks, %	73.5	74.1	75.2	74.3	74.5	76.1	76.7	76.9	75,4
Assets (net), EUR m	24,015	25,211	25,322	24,827	24,545	25,059	26,253	27,993	30,610*
Capital, EUR m	4,720	5,104	5,198	5,186	5,074	5,090	5,122	5,631	5,757*
Loans (gross), EUR m	15,324	17,204	17,273	16,140	16,170	16,175	16,442	17,565	19,408
Of which gross NPL, EUR m	2,592	3,275	3,217	3,448	3,483	3,491	2,800	1,730	1,108
Gross NPL ratio, %	16.9	19.0	18.6	21.4	21.5	21.6	17.0	9.8	5.7
IFRS impairment of NPLs	47.2	51.0	50.0	50.9	54.9	62.3	67.8	58.1	61.5*
Deposits, EUR m	14,263	14,584	14,936	15,067	15,637	16,523	18,242	19,926	23,110
Pretax Income[2], EUR m	241.0	12.0	102.5	-18.0	29.0	80.0	172.0	579.8	587.9*
CAR[3], %	19.9	19.1	19.9	20.9	20.0	20.9	21.8	22.6	22.8
CET1 ratio[3,4], %	-	-	-	-	-	-	-	21.5	21.8
Leverage[3,4], %	-	-	-	-	-	-	-	10.1	12.4
Liquidity ratio	1.0	2.2	2.1	2.4	2.2	2.1	2.1	2.0	2.0
Liquidity coverage ratio[4], %	-	-	-	-	-	-	-	239.5	214.6
FX ratio, %	3.9	6.2	5.5	4.4	3.9	4.4	2.7	2.9	4.8
ROA[2], %	1.1	0.0	0.4	-0.1	0.1	0.3	0.7	2.1	2.2*
ROE[2], %	5.4	0.2	2.0	-0.4	0.6	1.6	3.4	10.6	11.3*
Net interest margin[5], %	4.6	4.6	4.3	4.2	4.3	4.3	3.9	3.7	3.6

[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 w as merged to Direktna bank on 1 July, 2017. Jubanka ad Beograd w as merged to AIK bank on 23 Decembar, 2017. Pireaus bank w as merged to Direktna bank on 26 October, 2018.

[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 30.09.2018

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

[5] Net interest margin to average total asset

[5] Net interest margin to average total asset

* data as of Novermber 30, 2018;
December 2018 data are preliminary