Macroeconomic Developments in Serbia

December 2020
Sustained Macroeconomic Stability

- COVID-19 and global slowdown will have a less severe impact than in 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 favorable structure of the economy.
- On the back of “V shape” recovery in many sectors, we revised upwards our GDP projection for 2020 from -1.5% to -1.0%. Projection for 2021 has been kept at +6%, with symmetrical risks.
- In seven years, Serbia has transformed to a low inflation and stable growing economy, with a balanced fiscal position, declining public debt, significantly reduced external imbalances and labour market recovery, which helped our economy to respond readily to ongoing challenges.
- The adopted economic measures (EUR 5.8 bn, around 12.5% of GDP) should allow GDP to return to pre-crisis level early next 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 and a de facto coupon rate of 1.066%) most of which will be used for the early redemption of the Eurobond from 2011, so that the level of public debt will not change significantly and almost certainly will remain below Maastricht criteria of 60% of GDP.
- Inflation has moved in accordance with our expectations, and in November it measured 1.7% y/y. Low inflationary pressures are also confirmed by the core inflation of 2.0%, as well as by anchored inflation expectations. Inflation is expected to average 1.6% and 1.9% in 2020 and 2021, respectively.
- External imbalances will be reduced this year with CAD set to decline to around 5% of GDP or below. On the other hand, macroeconomic stability and improved business environment that led to high FDI inflows of EUR 7.3 bn in 2018–19, enabled FDI inflow to continue in Jan-Oct 2020 (gross inflow EUR 2.0 bn).
- Despite global value chains disruption and the decline of external demand, exports remained relatively resilient on the back of increased product and geographic diversification and activation of export oriented investments.
- 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. In 2018, a PCI arrangement with the IMF has been approved, with successfully completed 4th review.
- In December, NBS decided to cut the key policy rate by 0.25 pp to 1.0%, as well as to narrow its main interest rate corridor, from ±1.0 pp to ±0.9 pp relative to the key policy rate.
- Banking sector stability has been preserved and further reinforced. Encouraged by the NBS measures, the share of NPLs in total loans declined to 3.4% at end-October 2020.
Inflation Has Been Stable Around 2%; Inflationary Pressures Still Remain Low

Inflation profile similar to advanced economies…

- Average core inflation in the last seven years stood at 1.7%, confirming price stability.
- Core inflation stood at 2.0% y/y in November. Its growth since the beginning of the year has been driven by a one-off price increase of telephone services and travel packages.
- According to Bloomberg’s December survey, one year ahead inflation expectations of the financial sector stood at 2.3%.

• Inflation is kept firmly in check, moving around 2% on average in the past seven years.
• After low level in April and May, inflation returned within the target band in June and measured 1.7 y/y in November.
• Inflation movement since the beginning of 2020 was a result of fruit and vegetables, and oil derivatives prices.
• The biggest positive contribution to inflation came from services prices (0.7 pp), processed food (0.6 pp), fruits and vegetables prices (0.4 pp) and cigarettes (0.3 pp).
• The biggest negative contribution came from prices of oil derivatives (-0.7 pp)

… same stands for core inflation
Inflation Stable Within the Target in the Medium Term

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

• Inflation returned to the target in the middle of this year. By the end of 2021, we expect it to continue to move closer to the lower bound of target tolerance band.

• Disinflationary pressures, that prevail in the medium run, will come from low aggregate demand, as well as low imported inflation, while the disinflation effect from the oil prices drop in the previous period will gradually wane.

…and will gradually approach the target midpoint, though remaining below it in 2022

• With the expected recovery of demand, supported by the adopted accommodative monetary and fiscal policy measures, inflation will gradually move towards the target midpoint in 2022.

• 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 and administered prices.
GDP Forecast for 2020 Stands at -1.0%, Growth of +6.0% and Total Recovery in 2021

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

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

- For the sixth month in a row, the recovery of real sector indicators was stronger than expected, where most of them already reached the pre-crisis level.
- In Q3 2020 GDP growth stood at -1.4% (+7.5% s-a) and around 2/3 of recovery has been completed.
- The estimated GDP growth for Q4 amounts -1.3% y/y, which includes growing uncertainty generated by the new wave of pandemic and partial lockdown in Europe.
- Serbia will record one of the best results in Europe in 2020, owing to the achieved and preserved macroeconomic, financial and fiscal stability in previous years and due to comprehensive and timely economic relief package.

- Despite the uncertainty regarding pandemic, we revised upward our GDP growth projection for 2020 as a result of:
  - Faster recovery of industrial production,
  - Good performance of investments,
  - Better performance of certain services sectors,
  - Better agricultural season.
- 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, GDP growth will fully recover and will be a mirror figure of this year GDP quarterly dynamics.
- Preserved favourable medium-term outlook for Serbia will enable a return to a stable growth path of about 4% in the coming years.
## NBS Response to COVID-19

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<th>Monetary policy measures</th>
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<td>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</td>
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<td><strong>Measures for adequate credit risk management</strong></td>
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<td>Reduction of the minimum degree of completion of a building eligible for financing via bank housing loans</td>
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<td>Until end-2021 banks allowed to extend household dinar loans (up to 90,000 dinars) only based on signed statement on employment/pension</td>
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<td>A precautionary repo line with the ECB established to supply additional euro liquidity to local banks in case of need</td>
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Source: NBS.
**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.

<table>
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<th>Group – Tax policy measures</th>
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<tr>
<td>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)</td>
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<td>2. Deferred payment on taxes and contributions on salaries for one month</td>
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<td>3. Exemption of donors from the obligation to pay VAT</td>
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<th>Group – Direct assistance to the private sector</th>
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<td>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</td>
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<td>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</td>
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<th>Group – Measures to preserve liquidity</th>
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<td>6. Financial support to the corporate sector through the Development Fund</td>
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<td>7. Corporate support guarantee scheme</td>
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<th>Group – Other measures</th>
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<td>8. Moratorium on dividend payments until the end of 2020, except for public companies</td>
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<td>9. Wage increase measures and other direct financial assistance</td>
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<td>10. Direct assistance to all adult Serbian citizens in the dinar equivalent of EUR 100</td>
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<th>Group – Additional package of measures (July/August 2020)</th>
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<tr>
<td>1. Payment of 60% of minimal wages to entrepreneurs, and to micro-, small- and medium-sized enterprises in the private sector</td>
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<td>2. Deferred payment of income tax advances for one month</td>
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<td>3. Direct support to the hotel sector - 350 € per bed, 150 € per room</td>
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Source: Ministry of Finance.
The Ongoing Investment Cycle

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

- In 2015-2019, fixed investments grew at an average annual rate of about 10%, while their cumulative growth was about 64%.
- The fastest growth was made in 2018 and 2019, when fixed investments increased in real terms by 17.5% and 17.2%.
- 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.
- Despite pandemic, government investments continued to grow and are projected to reach 5.5% of GDP in 2021.

...supported by diversified financing sources

- 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...

...which are diversified by sector and origin and contributing to the country’s export potential

- Out of a gross inflow of EUR 7.3 bn (EUR 6.7bn net) in 2018 and 2019, EUR 4.1 bn has been directed into tradable sectors, most notably manufacturing (EUR 1.9 bn).
- Manufacturing sectors with the highest FDI inflows (metals, autos, food, tyres) recorded a high growth in employment, output and exports.
- During Jan-Oct 2020 FDI remained robust despite the corona virus pandemic, with gross inflow of EUR 2.0 bn (net inflow EUR 1.9 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.
Current Account Deficit Set to Decline to 5.0% of GDP in 2020 – October Surplus Indicates Possible Better Outcome

In recent years, CAD has been driven by the investment cycle and high growth in equipment imports.

From a savings-investments perspective CAD increase in 2019 was driven by higher investments.

- **Key factors behind CAD improvement in 2020** are a contraction in domestic demand, lower oil prices and resilience of exports on account of their structure, diversification and investment in exporting industries in the previous period.
- In Jan-Oct 2020 CAD amounted to EUR 1.7bn, down by 29.0% from a year earlier, having a surplus in October, indicating that CAD in 2020 could be even lower than projected 5% of GDP.
- Since 2015 Serbia’s current account deficit has been fully financed by net FDI, which we expect to be continued in the coming period.

- In 2020 the decline in the S-I gap will be driven by a faster reduction of private and public investments than in public sector savings.
- Private sector savings will increase in 2020 due to reduced domestic demand and lower energy prices.
- During 2019 the share of gross domestic investments in GDP increased from 22.6% to 24.9% broadly in line with the CAD increase.
- 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 are Expected to Remain Relatively Resilient in 2020 and to Rebound Strongly in 2021

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

Exports of goods and services

Imports decline will be deeper and recovery slower due to combined effect of domestic demand and energy prices

Charts 13 and 14: Exports and Imports

- Small decline in overall exports of goods and services in 2020 will be driven by decrease manufacturing exports due to reduced external demand and disruption in global value chains.
- Net services exports are expected to show more resilience due to limited share of tourism and high pre-crisis growth of less affected sectors – IT and business services.
- After contraction in Mar/Apr (-35% s-a cumulative), exports recovered during May/Oct (+56% s-a cumulative), driven by a rebound in exports of manufactured goods (+53% s-a) - in particular those that were hardest hit in April, such as auto-industry.
- The greatest reduction in imports in 2020 is expected in energy and other industrial inputs, as well as in services.
- Oil price decline will have a delayed additional effect on lower natural gas prices throughout 2021.
- As of 2017 Serbia saw a faster growth in imports on account of capital and intermediate goods related to investment and industrial activity as well as growth in domestic demand.
- After falling 37% s-a in Mar/Apr, goods imports also increased during May/Oct (+43% s-a) driven mainly by intermediate and capital goods, as well as consumer goods.
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 H1 2019/ H1 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 H1 2020, most of Serbian exports went to the EU, followed by CEFTA and CIS.
- By country, the largest share of exports went to Germany (12.8%), followed by Italy (8.4%), Bosnia and Herzegovina (7.3%), Romania (6.2%) and Russia (5.2%).
- In H1 2020 compared to H1 2019, the total volume of exports has decreased in all top 10 countries.
- Unlike the top 10 countries, exports to China continued to grow in H1 2020 compared to H1 2019.

Chart 16 Goods imports by country in H1 2019/ H1 2020
(EUR mn and % of total)

- Majority of imports (around 58%) come from the EU, followed by CIS and CEFTA.
- By country, the largest shares of imports are from Germany (13.1%), whereas the share of imports from China increased from 8.6% in H1 2019 to 11.8% in H1 2020, mostly due to imports of medical equipment. Following Germany and China, third is Russia (8.3%) and then Italy (8.1%).
Good Performance of Labour Market Indicators Despite the Pandemic

**Unemployment rate in Q3 2020 retained the single-digit level**

- 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 people, of which around 92 thousand people joined the contingent of employees.

**Increasing contribution of total factor productivity to Serbian GDP growth**

- 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.
Favourable Labour Market Developments and Productivity Growth

The average wage in the period January - September 2020 amounted 504 euros

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

- The average net wage in the period January - September 2020 amounted 59,286 RSD (EUR 504) and is higher by 9.4% y/y.
- Wages increased in both the private (8.8% y/y) and public sectors (11.2% y/y) in the same period.
- Wage growth continued at a relatively high growth rate despite a slowdown in economic activity in Q2, owing to comprehensive economic measures.
- The largest growth of wages since the beginning of 2020 was recorded in the sector of information and communication and health care.

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)

- The total formal employment in the period January-October 2020 is on average increased by about 42 thousand persons (2.0% y/y), despite the pandemic and thanks to state measures, of which almost overall growth relates to private sector (41 thousand persons).
- Observed by activities, the growth of employment stands out in the manufacturing, construction and the ICT.
- When it comes to the registered unemployment, in October, for the second month in a raw, it was below the level of 500 thousand people.
Temporary Increase in Fiscal Deficit in 2020 Due to Covid-19, Public Debt Below 60% of GDP at the End of the Year

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

- During previous years, Serbia eliminated fiscal deficit, with government investments reaching near 5% of GDP.
- Deficit in March and during Q2 2020 was a consequence of pandemic effect, and a result of direct tax relief and double-digit increase in expenditures for support measures to private sector companies, as well as for medical equipment procurement.
- Increased spending continued in Q3, but at a lower rate enabling fiscal deficit to decline to 3.6% of GDP along with revenue recovery.
- According to Revised Budget for 2020, projected fiscal deficit for this year stands at 8.9% of GDP, and should decline thereafter.

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

- During ten months of 2020 public debt increased to 56.9% 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.
- According to Revised Budget, public debt is projected to remain below 60% of GDP this year, and return to decreasing trend in the following years.
- Public debt dinarisation picked up from 20.9% (end-2016) to 29.6% in October 2020.
- In the medium-term deficit should return to around 1.0% of GDP, enabling sustainable level of public debt.
Key Policy Rate Trimmed by 0.25 pp to 1.0%, the New Lowest Level in the Inflation Targeting Regime

In December, the key policy rate was cut to 1.0%, while the main interest rate corridor was narrowed from ±1.0 pp to ±0.9 pp relative to key policy rate

The decision takes into account the following factors:

• Provision of the additional support to the domestic economy, having in mind the scale of the pandemic-induced crisis worldwide, renewed worsening of the epidemiological situation and economic slowdown globally, and especially in Europe.
• Responsible conduction of economic policy in the prior period, which ensured the capacity of monetary policy and public finance to fight the current crisis without jeopardising the achieved low and stable inflation and other indicators of macroeconomic stability.

FX required reserve ratio has remained unchanged since early 2016

• 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 November 2020 RR amounted to EUR 2.2 bn and RSD 220.7 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 %)

- The dinar yield rate curve is extended up to 12 years in February, with great interest of investors for this kind of bond.
- The share of long-term securities (5+ year maturity), increased from 2% in December 2012 to 75% in 2020.
- In November, Serbia issued a 10y Eurobond (USD 1.2 bn), at the coupon rate of 2.125% and the yield rate of 2.35% - so far the best conditions our country has achieved in terms of financing in dollars. At the same time, after hedging via swap operations, whereby we swapped liabilities under this Eurobond from the dollar into the euro, we achieved a de facto 1.066% coupon rate for financing in euros (the lowest financing rate our country has ever had).

... 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 October they amounted to:
  - 3.4% for corporates (down by 13.0 pp),
  - 8.6% for households (down by 11.9 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.
Lower costs of financing support domestic lending …

... as Well as to Growth of Credit Activity

• Domestic lending activity continued to record double-digit y/y growth rates in 2020 due to excellent loan disbursement at the beginning of the year, expansionary monetary policy, the effects of the moratorium and disbursement of Guarantee Scheme loans.

• In October, total domestic loans were higher by 12.1% in y-o-y terms, keeping a favourable structure in terms of the contribution to economic recovery.

• We expect continuation of positive trends in lending activity in upcoming period, as a result of the effects of undertaken measures, monetary policy relaxation, low interest rates, as well as of the recovery of economic activity.

... and the positive tendencies are also reflected in corporate loans market

• Corporate loans provide significant impetus to economic activity and for more than a year have been providing the biggest positive contribution to total credit activity growth in y/y terms.

• Investment loans continued to be the most dominant category of corporate loans, with a share of 43.4% in October, followed by liquidity and current assets loans with a share of 43.3%.

• Micro, small and medium-size enterprises loans amounted to 68% of total corporate loans in October, whereby this market segment records double-digit y/y growth rates for more than a year (10.6% in October).
Increased Resilience of the Serbian Economy Confirmed by Rating Agencies

Unprecedented stimulus of leading central banks contributed to the fall in EM risk premia since May

- Under the impact of global factors, Serbia’s risk premium for euro-denominated debt rose in March and April, as was the case with other emerging economies. Since May, EURO EMBIG for Serbia is on the downward path, driven by large-scale measures of leading central banks, the relaxation of restrictions and signals of gradual recovery of the global economy, as well as by Serbia’s measures adopted in response to the crisis and better than expected results of economic activity at home.

- Both S&P and Fitch affirmed Serbia’s rating at BB+ during the year, 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

- In the previous three years the dinar cumulatively appreciated by 5% against the euro in nominal terms. Strengthening of the dinar was stimulated by better Serbia’s macroeconomic fundamentals, good performance and favorable growth prospects, which contributed to FX inflow of FDI and elevated non-resident investment in long-term dinar government securities, resulted in bolstering the FX reserves.

- Since the beginning of 2020, the dinar stayed broadly unchanged against the euro, despite the rise in global uncertainty, as NBS has provided 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.
Indicators of Dinarisation are on the rise

Macroeconomic stability contributing to dinarisation process

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

- 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 29.6% in October 2020.
- Dinarisation of corporate and household sector deposits rose by 19.3 pp compared to end-2012 to 38.6% (October 2020). Dinarisation of corporate and household sector claims reached new maximum of 36.8% in October (up by 8.8 pp compared to end-2012).
- 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 56.3% (October 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 (in ten months it increased by RSD 10.5 bn or 13.3%).
- Such savings trends testify to the household confidence in the banking system and the domestic currency, which gains particular importance amid the rising uncertainty fueled by the pandemic of corona virus.
Traditional Banking
Mostly Financed by Domestic Deposits

Adequate structure of banking sector assets
Chart 33 Structure of banking sector assets (RSD bn)

- 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 (17.0% at the end of October 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 October 2020.
- Despite high loan portfolio euroization, currency matching of assets and liabilities is present, with net open position of 2% of regulatory capital at end of October 2020.

Improving the quality of the banking sector assets
Chart 34 Asset quality – Non-performing loans (NPL) (RSD bn, %)

- 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-October 2020, the NPL ratio was 3.45%, with the maintenance of relatively high coverage by IFRS provisions (62.1%).
- 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

- 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

- Liquidity ratios are constantly at levels significantly higher than the regulatory minimum.
- Liquid assets account for around 36.5% of the total assets of the banking sector in October 2020.
- The loan to deposit ratio that at the end of October 2020 amounted 88.1%, 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

Key reform areas in the last four years:

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

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

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


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

- Aggregate decrease of NPL level in August 2015 – October 2020 amounts to RSD 332.2 bn, while the effect of the NPL Strategy is mostly reflected through the historically lowest level of NPL ratio of 3.45% at end-October 2020. Compared with NPL ratio before the NPL Strategy entered into the force (22.25%) the decrease is clearly impressive at 18.80 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.

Effect of strategy on NPL ratio

Chart 39 Gross NPL (RSD bn)

- Stock at end of period
- Reduction during period

Chart 40 NPL Ratio (in %)

- Stock at end of period
- Shift during period
• 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 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 slowed down 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.

### NPL data, October 2020

<table>
<thead>
<tr>
<th></th>
<th>Gross loans (EUR bn)</th>
<th>Gross NPL (EUR bn)</th>
<th>NPL ratio (%)</th>
</tr>
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<tr>
<td>Corporates</td>
<td>10.4</td>
<td>0.3</td>
<td>2.8</td>
</tr>
<tr>
<td>Natural persons</td>
<td>10.6</td>
<td>0.4</td>
<td>3.6</td>
</tr>
<tr>
<td>of which: households</td>
<td>9.5</td>
<td>0.3</td>
<td>3.6</td>
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<tr>
<td>Corporates in</td>
<td>0.1</td>
<td>0.1</td>
<td>98.3</td>
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<tr>
<td>bankruptcy proceedings</td>
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<td></td>
<td></td>
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<tr>
<td>Other</td>
<td>2.4</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Total</td>
<td>23.5</td>
<td>0.8</td>
<td>3.45</td>
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</table>
## Serbia’s Economic Outlook

### Serbia

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<tbody>
<tr>
<td><strong>Real GDP, y-o-y %</strong></td>
<td>5.7</td>
<td>-2.7</td>
<td>0.7</td>
<td>2.0</td>
<td>-0.7</td>
<td>2.9</td>
<td>-1.6</td>
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<tr>
<td><strong>Private consumption, in %</strong></td>
<td>4.5</td>
<td>-3.3</td>
<td>-0.6</td>
<td>1.4</td>
<td>-1.7</td>
<td>-1.7</td>
<td>-0.1</td>
<td>-0.6</td>
<td>1.9</td>
<td>2.2</td>
<td>3.1</td>
<td>3.6</td>
<td>-2.8</td>
<td>4.5</td>
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<tr>
<td><strong>Private investment,¹ in %</strong></td>
<td>13.2</td>
<td>-23.4</td>
<td>-7.6</td>
<td>6.9</td>
<td>14.9</td>
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<td>5.2</td>
<td>2.8</td>
<td>8.7</td>
<td>14.0</td>
<td>14.9</td>
<td>-6.6</td>
<td>13.1</td>
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<td><strong>Government consumption, in %</strong></td>
<td>3.5</td>
<td>-1.7</td>
<td>-0.1</td>
<td>1.6</td>
<td>0.4</td>
<td>-2.1</td>
<td>0.9</td>
<td>-3.7</td>
<td>0.0</td>
<td>2.9</td>
<td>3.8</td>
<td>2.9</td>
<td>7.0</td>
<td>3.0</td>
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<tr>
<td><strong>Government investment, in %</strong></td>
<td>-16.4</td>
<td>-16.6</td>
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<td>-7.8</td>
<td>7.6</td>
<td>-35.8</td>
<td>13.6</td>
<td>14.0</td>
<td>22.0</td>
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<td>43.1</td>
<td>30.4</td>
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<td><strong>Exports, in %</strong></td>
<td>12.6</td>
<td>-11.5</td>
<td>16.9</td>
<td>5.6</td>
<td>2.9</td>
<td>18.0</td>
<td>4.3</td>
<td>9.3</td>
<td>12.0</td>
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<td><strong>Imports, in %</strong></td>
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<td>-21.9</td>
<td>-0.1</td>
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<td>10.7</td>
<td>-7.6</td>
<td>10.9</td>
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<tr>
<td><strong>Unemployment Rate, in %⁴</strong></td>
<td>13.6</td>
<td>16.1</td>
<td>19.2</td>
<td>23.0</td>
<td>23.9</td>
<td>22.1</td>
<td>19.2</td>
<td>17.7</td>
<td>15.3</td>
<td>13.5</td>
<td>12.7</td>
<td>10.4</td>
<td>8.7</td>
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<tr>
<td><strong>Nominal Wages, in %⁵</strong></td>
<td>18.0</td>
<td>9.0</td>
<td>7.6</td>
<td>11.2</td>
<td>9.0</td>
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<td>10.6</td>
<td>9.4</td>
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<tr>
<td><strong>Money Supply (M3), in %</strong></td>
<td>9.8</td>
<td>21.5</td>
<td>12.9</td>
<td>10.3</td>
<td>9.4</td>
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<td>3.6</td>
<td>14.5</td>
<td>8.4</td>
<td>-</td>
<td>-</td>
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<td><strong>CPI,² in %</strong></td>
<td>8.6</td>
<td>6.6</td>
<td>10.3</td>
<td>7.0</td>
<td>12.2</td>
<td>2.2</td>
<td>1.7</td>
<td>1.5</td>
<td>1.6</td>
<td>3.0</td>
<td>2.0</td>
<td>1.9</td>
<td>1.6</td>
<td>1.9</td>
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<tr>
<td><strong>National Bank of Serbia Key Policy Rate,³ in %</strong></td>
<td>17.8</td>
<td>9.5</td>
<td>11.5</td>
<td>9.8</td>
<td>11.3</td>
<td>9.5</td>
<td>8.0</td>
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<td>4.0</td>
<td>3.5</td>
<td>3.0</td>
<td>2.25</td>
<td>1.00</td>
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<td><strong>Current Account Deficit BPM-6 (% of GDP)</strong></td>
<td>20.0</td>
<td>6.3</td>
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</table>

¹ Excluding the effect of change in inventories
² Inflation figures in the table represent Dec on Dec inflation: \((P_t/P_{t-12})\times100-100\)
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 2017, nominal wages published according to the new methodology. January-September 2020 data.
### Banking Sector Overview

#### Serbia

<table>
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<td>Number of banks¹</td>
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<td>32</td>
<td>30</td>
<td>29</td>
<td>30</td>
<td>31</td>
<td>29</td>
<td>27</td>
<td>26</td>
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<td>Employees</td>
<td>29,228</td>
<td>28,394</td>
<td>26,380</td>
<td>25,106</td>
<td>24,257</td>
<td>23,847</td>
<td>21,627</td>
<td>1,598</td>
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<td>1,577</td>
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<td>Branches</td>
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<td>1,730</td>
<td>1,671</td>
<td>1,627</td>
<td>1,598</td>
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<td>1,577</td>
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<td>HHI Assets</td>
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<td>741</td>
<td>794</td>
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<td>779</td>
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<td>Share of foreign banks, %</td>
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<td>75.2</td>
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<td>74.5</td>
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<td>76.9</td>
<td>75.4</td>
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<td>76.6</td>
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<td>Assets (net), EUR m</td>
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<td>25,322</td>
<td>24,827</td>
<td>24,545</td>
<td>25,059</td>
<td>26,253</td>
<td>28,440</td>
<td>31,931</td>
<td>34,731</td>
<td>38,412</td>
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<tr>
<td>Capital, EUR m</td>
<td>5,104</td>
<td>5,198</td>
<td>5,186</td>
<td>5,074</td>
<td>5,090</td>
<td>5,122</td>
<td>5,631</td>
<td>5,725</td>
<td>6,002</td>
<td>6,116</td>
</tr>
<tr>
<td>Loans (gross), EUR m</td>
<td>17,204</td>
<td>17,273</td>
<td>16,140</td>
<td>16,170</td>
<td>16,175</td>
<td>16,442</td>
<td>17,565</td>
<td>19,406</td>
<td>21,111</td>
<td>23,467</td>
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<tr>
<td>Of which gross NPL, EUR m</td>
<td>3,275</td>
<td>3,217</td>
<td>3,448</td>
<td>3,483</td>
<td>3,491</td>
<td>2,800</td>
<td>1,730</td>
<td>1,105</td>
<td>862</td>
<td>809</td>
</tr>
<tr>
<td>GROSS NPL ratio, %</td>
<td>19.0</td>
<td>18.6</td>
<td>21.4</td>
<td>21.5</td>
<td>21.6</td>
<td>17.0</td>
<td>9.8</td>
<td>5.7</td>
<td>4.1</td>
<td>3.45</td>
</tr>
<tr>
<td>IFRS impairment of NPLs</td>
<td>51.0</td>
<td>50.0</td>
<td>50.9</td>
<td>54.9</td>
<td>62.3</td>
<td>67.8</td>
<td>58.1</td>
<td>60.2</td>
<td>61.5</td>
<td>62.1</td>
</tr>
<tr>
<td>Deposits, EUR m</td>
<td>14,584</td>
<td>14,936</td>
<td>15,067</td>
<td>15,637</td>
<td>16,523</td>
<td>18,242</td>
<td>19,926</td>
<td>23,115</td>
<td>25,197</td>
<td>28,330</td>
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<tr>
<td>Pretax income², EUR m</td>
<td>12.0</td>
<td>102.5</td>
<td>-18.0</td>
<td>29.0</td>
<td>80.0</td>
<td>172.0</td>
<td>579.8</td>
<td>640.6</td>
<td>575.5</td>
<td>389.9</td>
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<tr>
<td>CAR³, %</td>
<td>19.1</td>
<td>19.9</td>
<td>20.9</td>
<td>20.0</td>
<td>20.9</td>
<td>21.8</td>
<td>22.6</td>
<td>22.3</td>
<td>23.4</td>
<td>22.4</td>
</tr>
<tr>
<td>CET1 ratio %³,⁴</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>21.5</td>
<td>21.1</td>
<td>22.3</td>
<td>21.4</td>
</tr>
<tr>
<td>Leverage %³,⁴</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>11.1</td>
<td>12.6</td>
<td>13.6</td>
<td>12.6</td>
</tr>
<tr>
<td>Liquidity ratio</td>
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<td>2.1</td>
<td>2.4</td>
<td>2.2</td>
<td>2.1</td>
<td>2.1</td>
<td>2.0</td>
<td>2.0</td>
<td>2.2</td>
<td>2.1</td>
</tr>
<tr>
<td>Liquidity coverage ratio⁴, %</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>239.5</td>
<td>213.3</td>
<td>199.3</td>
<td>210.3</td>
</tr>
<tr>
<td>FX ratio, %</td>
<td>6.2</td>
<td>5.5</td>
<td>4.4</td>
<td>3.9</td>
<td>4.4</td>
<td>2.7</td>
<td>2.9</td>
<td>4.5</td>
<td>1.5</td>
<td>2.0</td>
</tr>
<tr>
<td>ROA⁵, %</td>
<td>0.0</td>
<td>0.4</td>
<td>-0.1</td>
<td>0.1</td>
<td>0.3</td>
<td>0.7</td>
<td>2.1</td>
<td>2.1</td>
<td>1.7</td>
<td>1.3</td>
</tr>
<tr>
<td>ROE⁵, %</td>
<td>0.2</td>
<td>2.0</td>
<td>-0.4</td>
<td>0.6</td>
<td>1.6</td>
<td>3.4</td>
<td>10.6</td>
<td>11.3</td>
<td>9.8</td>
<td>7.7</td>
</tr>
<tr>
<td>Net interest margin⁶, %</td>
<td>4.6</td>
<td>4.3</td>
<td>4.2</td>
<td>4.3</td>
<td>4.3</td>
<td>3.9</td>
<td>3.7</td>
<td>3.6</td>
<td>3.3</td>
<td>3.0</td>
</tr>
</tbody>
</table>

¹ The NBS revoked operating licence from Nova Agrobanka on 27 October 2012, from Razvojna banka Vojvodina 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 December, 2017. Pireaus bank was merged to Direktna bank on 26 October, 2018. Vojvodanska bank was merged to OTP bank 25. April 2019 (consolidated under Vojvodanska 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

⁶ Net interest margin to average total asset