NATIONAL BANK OF SERBIA

Press release about the publication of the *Annual Financial Stability Report for 2022*

NBS publishes Annual Financial Stability Report for 2022

The *Annual Financial Stability Report for 2022* contains an overview of trends in the financial sector, outlines the key risks from the domestic and international environment, and the regulatory measures undertaken to mitigate, remove and prevent those risks. The text boxes in the *Report* also elaborate on the most topical issues globally and at home in regard to financial stability and macroprudential policy.

In 2022, international developments were marked by mounting geopolitical tensions, the escalation of the Ukraine conflict, rising inflation worldwide, monetary policy tightening by central banks and poorer global growth prospects. Global economy slowed in 2022 to 3.4% (6.3% in 2021), while growth in the euro area, with which we foster key financial and trade links, slowed to 3.5% (5.4% in 2021). Central banks responded to elevated inflation pressures by tightening their monetary policies, which resulted in the tightening of global financial conditions.

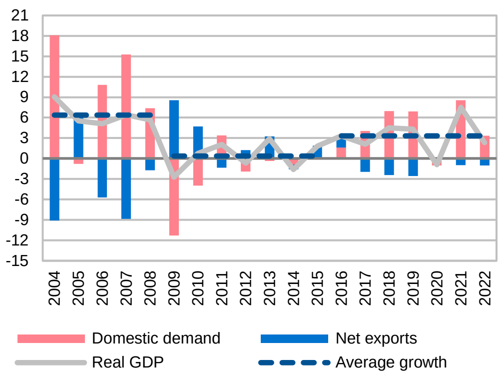
Despite the multi-dimensional crisis in place over the past three years, Serbia managed to preserve the stability of its economy and ensure smooth functioning of the domestic financial market, as a result of continuous and responsible macroeconomic and monetary policies and adequate regulatory measures.

- ✓ ***Macroeconomic stability has been preserved and strengthened despite heightened geopolitical tensions***

In 2022, Serbia’s real GDP growth measured 2.3%, and was guided by growth in industry and service sectors. Growth slackened as a result of subdued external demand, a high base and heightened global cost-push pressures caused by mounting geopolitical tensions and the Ukraine conflict, as well as a poorer agricultural season due to the drought. Global recovery as of H2 2023 and the planned implementation of investment projects are likely to speed up GDP growth and support its return to the pre-pandemic growth trajectory of around 4% in the medium run. Economic growth continued in Q1 2023, with real y-o-y GDP growth amounting to 0.7%. The growth was led by service sectors, with a positive contribution coming from industrial growth, owing primarily to the recovery of production in the electric power system. The NBS expects GDP growth to accelerate in the remainder of 2023, on account of euro area acceleration as well.

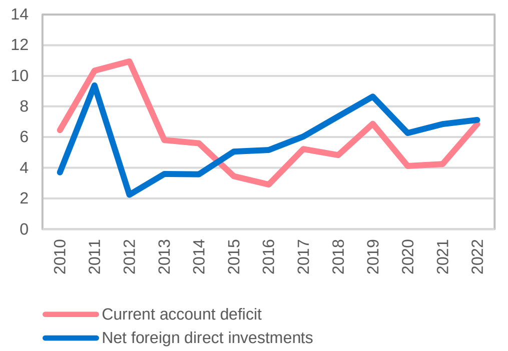
Despite the pronounced geopolitical tensions, in 2022 total FDI inflow to Serbia reached EUR 4.4 bn (EUR 4.3 bn net), the highest annual FDI inflow since data are monitored (since 1997). The net inflow of FDIs in 2022 was 17.7% higher than in the year before, and their share in GDP equalled 7.1%. The current account deficit was fully covered by FDIs for the eighth year in a row, underpinning the sustainability of the country's external position.

Real GDP growth – demand contributions
(%)



Sources: NBS and SORS.

Current account deficit financing via FDIs
(% of GDP)



Source: NBS.

Owing to preserved macroeconomic stability, in 2022 rating agencies affirmed Serbia's credit rating at the level one notch below investment grade. In February and August 2022, and February 2023, Fitch kept Serbia's credit rating at BB+, while confirming a stable outlook. In June 2022, Standard & Poor's affirmed Serbia's credit rating at BB+, changing the outlook from positive to stable. In December 2022 and April 2023, Standard & Poor's affirmed Serbia's credit rating at BB+, with a stable outlook.

✓ ***The greatest contribution to inflation came from food and energy prices. In 2022, average annual inflation equalled 11.9% and average core inflation 7.1%.***

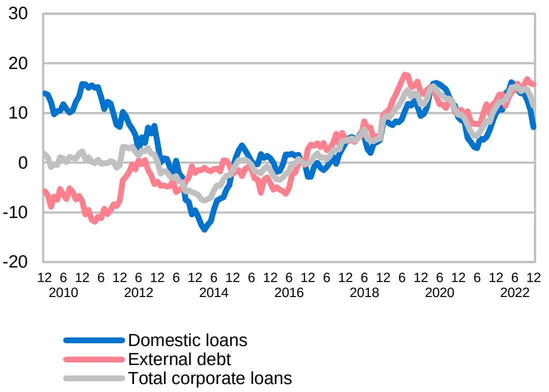
In the face of the combined effect of many negative factors, including primarily the consequences of the energy crisis and the drought which hit a large part of Europe, inflation in Serbia was lower than in its regional peers. The greatest contribution (around two-thirds of the contribution to y-o-y inflation) came from rising food and energy prices. Inflation in Serbia was largely driven by supply-side factors, on which monetary policy measures have a negligible or limited effect. The NBS responded to heightened inflationary pressures by tightening its monetary policy – first by gradually lifting the weighted average interest rate at reverse repo auctions and, as of April 2022, by key policy rate hikes. Until end-2022, it lifted the key policy rate by a total of 4 pp to 5% at year-end, with the cycle of key policy rate hikes continuing into 2023. It also increased deposit and lending facility rates, to 4.0% and 6.0% at end-2022, respectively. Monetary policy tightening translated onto rising interest rates in the domestic financial market. Y-o-y inflation began to slow as of Q2 2023, with a more sizeable drop expected in H2 2023. The downward trajectory of inflation going forward will be supported primarily by the effects of past tightening of monetary conditions, the weakening of effects of global factors which drove up energy and food prices in the past period, the slowdown in imported inflation, and the stabilisation and expected decline in inflation expectations.

In the face of escalating geopolitical tensions and mounting inflation worldwide, in 2022 the relative stability of the dinar exchange rate against the euro was preserved owing to NBS's adequate and timely interventions in the interbank FX market. In 2022, FX reserves continued up, to the record high level at the year-end, thus further strengthening the resilience of the domestic financial system to shocks from the international environment.

Domestic lending activity expanded further in 2022 (7.3% y-o-y) as a result of increased needs to ensure liquidity, restructure liabilities and purchase real estate. H2 saw a slowdown in lending growth, reflecting the high base from the previous year, the maturing of loans from the guarantee scheme and monetary policy tightening by the ECB and the NBS.

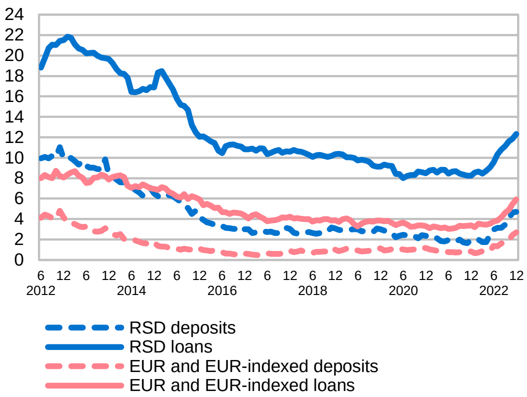
Corporate lending continued up in 2022, though losing pace in H2 and subject to tightened corporate credit standards. Nevertheless, despite key policy rate hikes due to monetary tightening of leading central banks and the NBS, the corporate NPL ratio fell further in 2022, to its lowest end-year level yet: 2.1%.

Corporate credit activity*
(y-o-y growth rates, in %)



* Excluding the exchange rate effect.
Source: NBS.

Interest rates on RSD, EUR and EUR-indexed household loans and deposits – new business
(weighted average, %)



Source: NBS.

Despite the heightened global uncertainties and a drag on economic growth, 2022 saw positive labour market trends, reflected in higher wages and employment and a lower unemployment rate. After a temporary decline, in the wake of the Ukrainian conflict, dinar savings embarked on a steady rebound path as of June, recording extremely vibrant growth in the last months of 2022, only to come at RSD 95.7 bn at year-end. At end-2022, household FX savings reached the then record amount of EUR 12.8 bn.

The real estate market witnessed an increase in prices and trading in 2022, while the lower total value of completed construction works and a decline in the number of construction permits issued may signal a potential contraction of supply in the real estate market going forward.

- ✓ ***In 2022 as well, fiscal policy measures mitigated negative economic consequences triggered by intensified global uncertainties.***

In 2022, measures were taken in the Republic of Serbia to prevent major shocks from the rising energy and food prices. These included gas price subsidies, a temporary reduction of excises on petroleum products and caps on the prices of basic foodstuffs. In 2022, the general government fiscal deficit measured 3.2% of GDP, which is considerably below the 2021 deficit, equalling 4.1% of GDP in conditions of rising fiscal revenues and expenditures relative to the year before.

Despite the impact of the international energy crisis on the rise in budgetary expenditures and purchase of energy, the public debt to GDP ratio continued to decline in 2022. The share of central government debt in GDP at end-2022 amounted to 55.1%, down by 1.4 pp compared to end-2021. By end-May 2023, the share of central government debt in GDP declined further to 51.4%. However, the high share of debt in foreign currency is an indication of FX risk, while in the course of 2022 the dinar share of public debt lost 3.3 pp and the euro share 1.9 pp, while the US dollar share gained 3.5 pp.

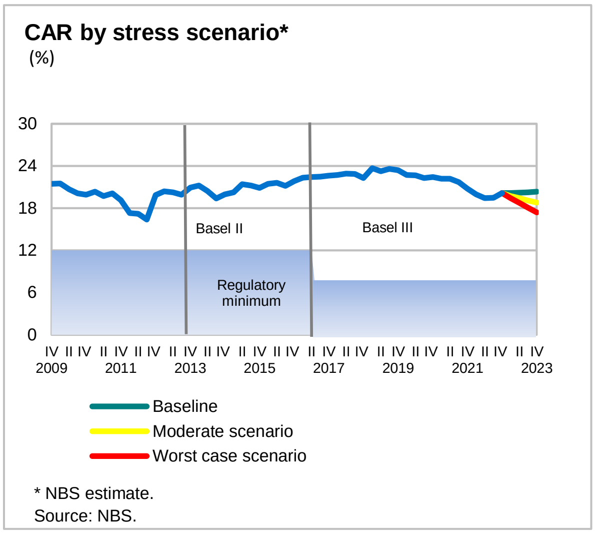
The external debt share in GDP rose to 69.4% at end-2022 (68.4% at end-2021). The current account deficit measured EUR 4.1 bn or 6.9% of GDP in 2022.

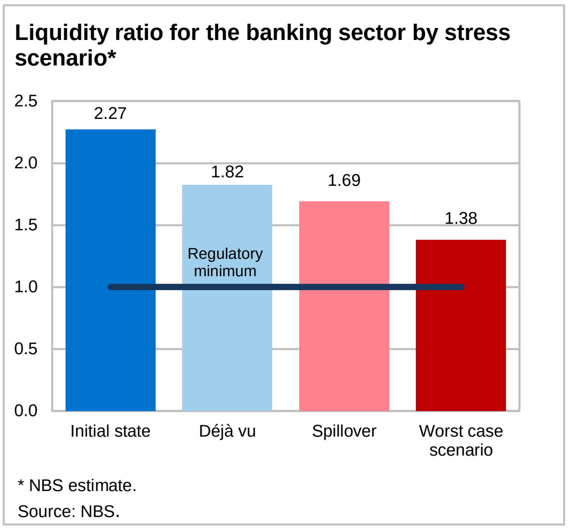
Fiscal policy sustainability, even amid pronounced global uncertainties, was also confirmed by the International Monetary Fund. At end-2022, the Republic of Serbia concluded a new arrangement with the Fund, to additionally reinforce the efforts for the preservation of macroeconomic and fiscal stability. The new arrangement replaced the previous Policy Coordination Instrument, whose implementation also received a positive review in 2022.

March 2022 saw the first-time issuance of a twenty-five-year euro government bond. This is the longest-term bond in the domestic market so far, issued at a relatively favourable interest rate (2.50%), before the rise in the costs of euro borrowing induced by ECB's monetary tightening.

- ✓ ***Serbia's banking sector is characterised by high capitalisation and liquidity, which contributed to the preservation of financial stability despite the multidimensional crisis.***

Serbia's banking sector, accounting for around 91% of financial sector assets, remained stable throughout 2022, due to adequate capitalisation and high liquidity and profitability. At end-2022 the sector's capitalisation was above the region's average and well above the prescribed minimums. Liquidity ratios also trended well above the prescribed minimums.





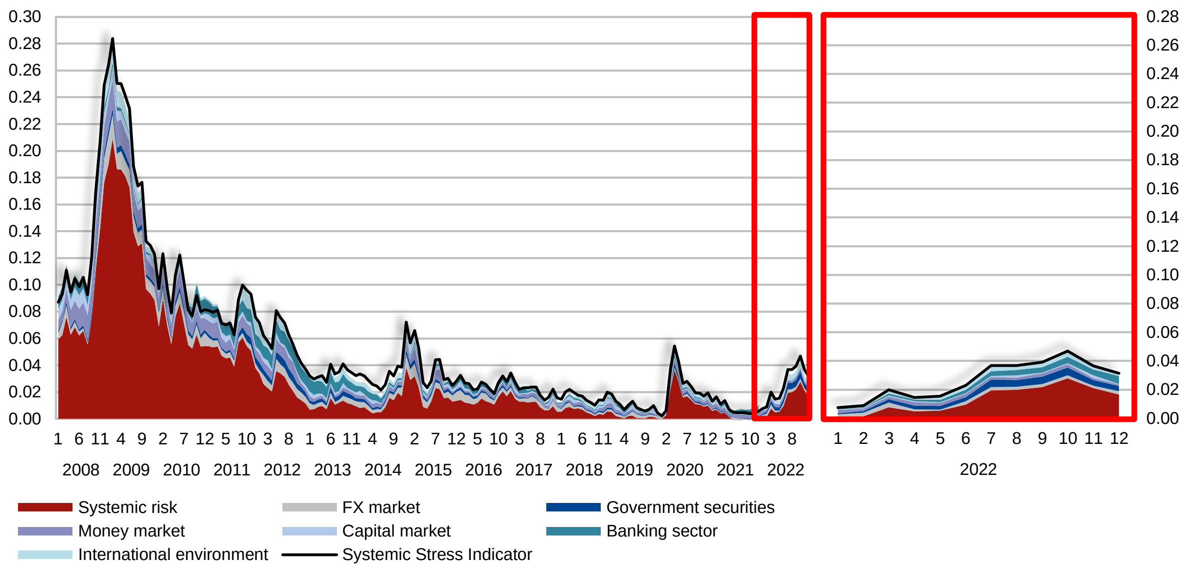
Banking sector's profitability at year-end resulted in RoA and RoE of 1.9% and 13.9%, respectively. Additionally, macroprudential stress tests confirmed that the sector would remain highly resilient even in the face of most severe shocks, and that it has sufficient capacity to alleviate the consequences of risks to which it could be exposed.

A long-term downward NPL trend extended into 2022, signalling that rising loan repayment costs did not entail deterioration in bank asset quality. The share of NPLs in total loans at end-2022 measured 3.0%, going down by 0.6 pp y-o-y and by as much as 19.2 pp relative to August 2015, when the NPL Resolution Strategy was adopted. A reduction in NPLs resulted from a systemic problem-solving approach, timely implementation of adequate measures and sustainability of the results achieved, indicating that NBS measures were timely and adequate, and that financial stability was preserved even throughout the multidimensional crisis we have been facing in the past three years.

The non-bank financial sector also remained stable. The insurance sector continued to post positive results and was adequately capitalised and profitable, recording growth in total premium. Balance sheet assets of financial lessors continued to grow, while net assets of VPFs declined. In 2022, the first alternative investment funds were set up. In December 2022, the NBS issued the first two licences to provide virtual currency services.

Despite numerous challenges in 2022, the systemic stress indicator points to a period of low risk, followed by a low and stable systemic component. After relatively low levels of the Systemic Stress Indicator, which were most pronounced in early 2022, a slight increase was recorded as of May 2022 extending until October 2022. In the period thereafter, the Systemic Stress Indicator again recorded a slight decline. The value of this indicator reflected mainly trends and risks coming from the international environment, the trends in the government securities market, as well as trends in the home markets of banks operating in Serbia.

Systemic Stress Indicator dynamics



Source: NBS.

- ✓ ***The NBS continued to mitigate the consequences of various crises we have been facing in the past three years, with a view to preserving and strengthening financial stability.***

In coordination with the Serbian Government, the NBS's timely response helped households and eased operations of corporates amid disruptions to global supply chains, thereby mitigating the spillover of high global prices of primary commodities to the domestic market.

In order to ensure permanent protection of the households' living standard in the segment of payment services needed for everyday life activities, in August 2022 the NBS adopted a decision capping the price of the payment account with basic features to RSD 150 and specifying the mandatory services under this account. In addition, it was prescribed that the NBS should be notified in due time of any planned changes to the banks' fees, which enables it to timely identify whether banks' conduct is adequate and take appropriate activities.

Given the strategic importance of agricultural production, in October 2022 the NBS adopted regulations allowing the rescheduling of current obligations for banks' and financial lessors' borrowers from the agricultural sector.

In December 2022, banks were allowed to restructure receivables under consumer, cash or similar loans from natural persons facing financial difficulties, by extending the loan maturity by three years relative to the current regulatory solution. The implementation of the measures aimed at facilitating repayment of household housing loans was also extended, which means that during the entire next year banks will be able to offer facilities to borrowers by extending the repayment term for housing loans by a maximum of five years. In current conditions of rising interest rates, the above measures could lessen the pressure on users of loans with variable interest rates and prevent a rise in NPLs.

All these decisions and measures were taken in a timely manner, preserving adequate capitalisation and high liquidity of the baking sector, and facilitating loan repayment and access to sources of funding for households and corporates. Thanks to this, even in the conditions of elevated global uncertainty, the NBS has managed to preserve and further reinforce financial system stability.