ANNUAL MONETARY POLICY REPORT

2019

National Bank of Serbia

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Introductory note

The National Bank of Serbia is required to submit to the Parliament its annual and semi-annual monetary policy reports, explaining all the factors that affected the implementation of monetary policy in the period under review. The annual report must be submitted by 30 June of the following year and the semi-annual by 30 September of the year under review.[1]

Pursuant to the Statute of the National Bank of Serbia[2] the above reports must present and analyse the monetary policy strategy, macroeconomic developments (international environment, balance of payments, the country's international investment position, movements in monetary aggregates, prices, wages and employment, and other macroeconomic movements), monetary policy defined and monetary policy implemented (defined vs. achieved monetary policy objectives, monetary policy instruments and measures applied, and other monetary policy-related issues), as well as outline the monetary policy planned.

The *Annual Monetary Policy Report for 2019* was reviewed and adopted by the NBS Executive Board at its meeting of 11 June 2020.

Monetary policy reports are available on the National Bank of Serbia's website (http://www.nbs.rs).

Executive Board of the National Bank of Serbia:

Jorgovanka Tabaković, Governor

Željko Jović, Vice Governor

Ana Ivković, Vice Governor

Dragana Stanić, Vice Governor

[1] Law on the National Bank of Serbia, RS Official Gazette, Nos 72/2003, 55/2004, 85/2005 – other law, 44/2010, 76/2012, 106/2012, 14/2015 – CC decision and 44/2018.

[2] RS Official Gazette, Nos 12/2013, 18/2015, 72/2015 and 50/2018.

ABBREVIATIONS

bn – billion
bp – basis point
CEFTA – Central European Free Trade Agreement
CPI – Consumer Price Index
ECB – European Central Bank
EMBI – Emerging Markets Bond Index
FAO – Food and Agriculture Organization
FDI – foreign direct investment
Fed – Federal Reserve System
FOMC – Federal Open Market Committee
GDP – Gross Domestic Product
H – half-year
IFEM – Interbank Foreign Exchange Market
IMF – International Monetary Fund
mn – million
NPL – non-performing loan
OPEC – Organization of the Petroleum Exporting Countries
pp – percentage point
Q – quarter
q-o-q – quarter-on-quarter
s-a – seasonally-adjusted
SORS – Statistical Office of the Republic of Serbia
y-o-y – year-on-year

Other generally accepted abbreviations are not cited.

Contents

Overview

In 2019, the NBS continued to pursue a **responsible monetary policy, consistent with maintaining low and stable inflation within the target tolerance band of 3±1.5% in the medium run**. Inflationary pressures at home remained muted both on the supply and demand side, while uncertainty from the international environment, concerning mainly trade and geopolitical tensions and volatile primary commodity prices, was the main reason why the key policy rate was kept on hold at 3.0% in H1. The announcements and consequent easing of monetary policies of leading central banks – the Fed and ECB, against the background of weaker global growth prospects, coupled with continued low inflationary pressures at home, enabled further monetary policy easing by the NBS in H2. The key policy rate was cut in July, August and November by 75 bp in total, to 2.25%, its lowest level thus far in the inflation targeting regime. The NBS thus provided additional support to credit and economic growth, and enabled the government to borrow at more favourable terms.

Even in conditions of faster than expected growth in domestic demand and positive labour market trends, **inflation remained low and stable in 2019**, averaging 2% for the sixth year in a row. Its movement in 2019 was determined mainly by food and energy prices. In the January–April period, similarly as in other countries in the region, y-o-y inflation was led by rising vegetable prices due to poor yields in the previous agricultural season, and reached the target midpoint in April. With the onset of the new agricultural season, in May–October inflation decelerated significantly, also on account of lower petroleum product prices as the global oil price declined. After falling temporarily below the lower bound of the target in August, September and October, inflation returned within the target band in November and stood at 1.9% at year end, reflecting rising food and petroleum product prices given last year's low base. That inflationary pressures were low was also indicated by low and stable core inflation, which moved in the 1.1–1.5% range y-o-y, and short- and medium-term inflation expectations of the financial and corporate sectors which were anchored close to, but below the NBS target midpoint.

Monetary policy easing by the NBS translated fully to the lower cost of government and private sector borrowing. **Interest rates on new dinar loans to the private sector** decreased by over 1.2 pp from end-2018 to 4.0% and 9.1% at end-2019 for corporate and household sectors respectively, touching the **new lowest levels in the inflation targeting regime**. Rates on euro loans remained low, supported by strong monetary accommodation by the ECB, stepped-up interbank competition and a lower country risk premium.

The **country risk premium** was among the lowest in the region. In 2019, it fell by 140 bp to 19 bp at year end. The fall was prompted by global and, more significantly, domestic factors, favourable macroeconomic prospects of the country, narrowed internal and external imbalances and bolstered financial stability. Another confirmation of increased investor appetite and the success of Serbia's economic policy is the credit rating upgrade by Fitch and Standard & Poor's to the level only one step away from investment grade. These two agencies stated that the demonstrated operational independence of the NBS and enhanced monetary policy credibility were the factors supporting the rating upgrade and favourable prospects.

The lower costs of borrowing in the domestic market sustained **further credit growth** at an almost two-digit rate, which was among the highest in the region. The fact that total growth in corporate lending concerned investment loans, which increased by over 25% at the year-level, suggests that credit activity has a favourable structure and that it provides important support to economic growth, without jeopardising price and financial stability. The efforts to resolve the NPL issue continued and credit growth ensured **a further drop in the NPL ratio to the lowest level on record – 4.1% in December**, down by over 18 pp since the adoption of the NPL Resolution Strategy.

Economic growth exceeded 4% for the second year in a row as domestic factors compensated for the slowdown in external demand. According to SORS data, real GDP growth was 4.2% in 2019. The main boost came from investment owing to accelerated implementation of infrastructure projects, the upgrade of the business environment, as testified by Serbia's improved score on the World Bank's Doing Business list, and favourable financing sources. Sustainable consumption growth also continued, most notably thanks to favourable labour market trends and lower borrowing costs. In contrast, as external demand slowed and the investment cycle at home continued, net exports were a negative contributor, though to a lesser extent than in 2018. On the production side, the major contribution to growth came from the overperformance in the construction sector and the growth in most service sectors, supported by elevated personal consumption. Industrial production gave a moderate positive impulse, despite the effects of the external demand slowdown, 100% taxes on products delivered to Kosovo and Metohija, and the overhauls in the oil and chemical industries in H1.

Despite the slowdown in external demand, the implementation of past investment helped **maintain a high growth rate of goods and services exports** in 2019, which exceeded the last year's figure (10.5% vs. 9.6%). **Investment largely determined the pace and structure of goods and services imports**, which were up by 10.7% at the year-level, led by increased corporate needs for intermediate goods and equipment, and, to a lesser extent, by rising consumer demand. Although the current account deficit increased on these grounds in 2019, the imported equipment will boost the export capacities of the Serbian economy, which will most likely help reduce the deficit share in GDP in the medium run, with the pace of this reduction depending on future investment cycle dynamics.

For the fifth consecutive year, **the current account deficit** was fully covered by the net FDI inflow. According to preliminary data, the net FDI inflow of around EUR 3.6 bn (8% of GDP) was the highest in the Western Balkans region, diversified by project and channelled mainly to tradable sectors for some time already, which contributes to the country's external sustainability and sustainable economic growth. Owing to foreign investors' increased interest in government securities in the domestic market, the net inflow of portfolio investment came close to EUR 200 mn. Moreover, in 2019 Serbia issued the new ten-year eurobond in the international financial market, at the most favourable terms thus far – **the rate is among the lowest rates on ten-year euro-denominated eurobonds issued by countries in the region**, even those with ratings higher than Serbia's. Thus, the markets demonstrated that the risk of investment in our country has decreased significantly and that the yield rates are comparable to those of countries already enjoying investment grade. The proceeds (EUR 1.55 bn) were used for the early repayment of a portion of bonds issued in dollars which mature in 2020 and 2021.

Non-residents' stepped-up investment in Serbia fuelled further appreciation pressures in the FX market. Moderate depreciation pressures were recorded in January, reflecting primarily the seasonally stronger FX demand of energy importers. In February, however, appreciation pressures – which prevailed in the previous two years – re-emerged. To mitigate excessive short-term volatility of the dinar against the euro, in 2019 the NBS intervened in the interbank FX market by purchasing EUR 2,695.0 mn net. This gave the strongest **boost to gross NBS FX reserves, which rose to EUR 13.4 bn at end-2019 and were at their highest end-year level since 2000,** when records began. **The level of Serbia's FX reserves is adequate and serves as a safeguard from external shocks**, given that it covers close to six months' worth of goods and services imports and over 260% of debt maturing in the next year.

The **fiscal result** was better than planned in 2019 as well – the general government deficit stood at RSD 11.1 bn or 0.2% of GDP, vs. 0.5% envisaged by the Fiscal Strategy. Excluding interest expenses, the surplus equalled RSD 97.2 bn. Continued positive fiscal trends in 2019 were supported primarily by economic growth and the resulting higher corporate profitability, positive labour market trends, and lower government borrowing costs, achieved owing to the effects of NBS monetary policy easing, a more favourable country risk premium and credit rating. At the same time, the overperformance in H1 created room for a further increase in government capital expenditure and public sector wages as of November.

This contributed to rising investment and consumption, but not to the extent that would jeopardise the main medium-term fiscal policy objectives and trigger any major inflationary pressures. The narrowing in fiscal imbalances and reduced currency and refinancing risks helped bring public finances within sustainable bounds – at end-2019, central government **public debt** was 52.0% of GDP. The share of dinar debt rose to 27% and the dollar debt declined to 20%.

Owing to the favourable macroeconomic environment, as of mid-2014 the **labour market** has been continuously recording positive trends, reflected primarily in an over 230,000 increase in the number of formally employed persons in the private sector, contraction in registered unemployment by as much as a third, and a reduction in the unemployment rate to a single-digit level. In December 2019, the nominal net wage reached RSD 59,772 (EUR 510), which is its highest level since comparable data are available.

Positive macroeconomic trends in the domestic market continued into early 2020. However, as of March, similarly to other European countries, the Serbian economy was under the strong sway of the coronavirus pandemic. This called for significant monetary and fiscal stimuli of the NBS and the Government, aimed at supporting the economy and overcoming the negative effects of the pandemic. Though economic activity has contracted in the short run due to the halt and, in some cases, complete suspension of production, medium-term growth prospects remain positive, as indicated by the assessments of the IMF, rating agencies and other relevant international institutions. It is worth emphasizing that the measures undertaken in the past period, the preserved price and strengthened financial stability, narrowed fiscal and external imbalances and the country's FX reserves standing at their highest level on record, enabled the authorities to undertake sweeping measures to recover the economy from the crisis caused by the coronavirus. The NBS will continue to closely monitor the developments in the domestic and international environment and will undertake coordinated measures together with the Government, in order to mitigate the negative effects of the crisis to the greatest extent possible.

I Strategic monetary policy framework

The NBS has been implementing **a fully-fledged inflation targeting** regime since 2009, with elements of the regime gradually introduced into practice since 2006. In December 2008, the NBS Monetary Policy Committee[1] adopted the Memorandum on Inflation Targeting as a Monetary Strategy, defining formal implementation of the inflation targeting regime from 1 January 2009. The Memorandum was drafted in accordance with the Agreement on Inflation Targeting between the NBS and the Government of the Republic of Serbia, adopted at the Government session of 19 December 2008. In the best collective judgment of the NBS and the Government, this was the most appropriate monetary policy regime under the circumstances prevailing at the time.

The inflation targeting regime is pursued by a large number of central banks worldwide as a pragmatic response to the deficiencies of other monetary policy regimes. The choice of the regime was strengthened by the awareness that high inflation rates dampen economic growth and employment and that the monetary policy focus should therefore be shifted from short-term demand management to medium-term price stability which lies at the core of inflation targeting. The inflation targeting regime is a framework rather than a set of rigid monetary policy rules. It is based on a numerical target for inflation in the medium term and a discretionary right to respond to economic shocks in the short term.

The NBS inflation target is defined in terms of the headline inflation rate (with a tolerance band) measured as the annual percentage change in the Consumer Price Index (CPI). In order to define the framework for medium-term monetary policy decision-making and to anchor and stabilise inflation expectations, the decision on the level of the inflation target is always made for the period ahead. In the case of Serbia, this decision is made for three years ahead and this will remain so until the process of nominal, real and structural convergence to the EU is completed. As the process is ongoing, the inflation target is slightly above the level of the quantitative definition of price stability and the level of the inflation target in advanced economies (2.0% or 2.5%). In late 2019, **the inflation target until December 2022 was set at 3.0%, with a tolerance band of ±1.5 pp**.[2]

For the sake of reminder, as of 2017 the inflation target was lowered by 1 pp to 3.0±1.5%[3], confirming the economic policy makers' determination to keep medium-term inflation low, stable and predictable. In cooperation with the Government, the NBS made such decision owing to the achieved and maintained low and stable inflation, for three consecutive years at the time, significantly improved macroeconomic fundamentals and prospects for our economy, which reflected successful coordination of monetary and fiscal policies and excellent results of fiscal consolidation. Inflation expectations of the financial and corporate sectors for both one and two years ahead were low and relatively stable for quite some time, testifying to increased credibility of the NBS monetary policy.

The width of the target tolerance band was kept at ±1.5 pp, to diminish the need for frequent monetary policy interventions and contribute to higher predictability of

[1] In line with the Law Amending the Law on the National Bank of Serbia (RS Official Gazette, No 44/2010), the Executive Board assumed all powers of the Monetary Policy Committee.

[2] National Bank of Serbia's Memorandum on Inflation Targets until 2022 was adopted at the meeting of the NBS Executive Board of 12 December 2019.

[3] National Bank of Serbia's Memorandum on Inflation Targets until 2019.

monetary conditions. Being a small and open economy, Serbia is exposed to developments in the international commodity and financial markets, which may cause **temporary** volatility of headline inflation. The target tolerance band leaves to the NBS more room to work on the achievement of its second objective – financial stability, and to support the Government's economic policy which encourages sustainable economic growth.

It should be borne in mind that the inflation target is a medium-term objective, i.e. that the inflation outturn may diverge from the target in the short run due to exogenous shocks. The NBS will allow temporary deviations from the target if bringing inflation back to the target in the short term warrants monetary policy changes that would cause disruptions to macroeconomic processes. This also applies to sudden shocks in primary commodity prices or deviations from the planned growth in commodity prices under direct or indirect government regulation.

The NBS strives to achieve the inflation target by **changing its key policy rate, applied in main open market operations**. This interest rate is the key monetary policy instrument and the decisions on its level are based on the analysis of economic circumstances, assessment of future developments and the medium-term inflation projection. Other monetary policy instruments play a supporting role – they contribute to the smooth transmission of the impact of the key policy rate on the market, as well as to the development of the financial market, without jeopardising financial stability.

The NBS implements a **managed float exchange rate regime**, which implies the right to intervene in the FX market in case of excessive short-term volatility of the exchange rate, threats to financial and price stability, and risks to the adequate level of FX reserves.

To strengthen the transparency of its monetary policy and the effectiveness of communication with the public, the NBS Executive Board makes monetary policy decisions in line with the agreed schedule of meetings and regularly informs the public about the implementation of inflation targets and measures undertaken to achieve them. At *Inflation Report* press conferences, NBS representatives explain in detail the macroeconomic projections and monetary policy decisions, and answer all questions of the public.

II Monetary policy and achievement of the inflation target

1 Monetary policy in 2019

In 2019, the NBS eased its monetary policy further, cutting the key policy rate by total 75 bp, to 2.25%, its lowest level in the inflation targeting regime. The NBS thus provided further support to credit and economic growth.

Monetary policy was pursued in accordance with the **Monetary Policy Programme of the National Bank of Serbia in 2019**.[4] The Programme envisaged that the NBS would aim to achieve the inflation target through consistent and predictable changes in the key policy rate, taking into account the inflation projection, economic developments in the domestic and international environment, and the impact on financial stability. The vigorous fiscal adjustment, implementation of structural reforms and full coordination of monetary and fiscal policy measures helped strengthen macroeconomic stability and increase the resilience of the domestic economy to potentially adverse effects from the international environment, making the economic outlook more favourable. According to the Programme, in 2019 the NBS would continue to maintain the necessary caution in making monetary policy decisions in light of uncertainties from the international environment.

Uncertainty from the international environment was the main reason why the key policy rate was kept at 3.0% in H1, while inflationary pressures at home remained low both on the supply and demand side. The announcements and consequent easing of monetary policies of leading central banks – the Fed and ECB, against the background of a bleaker global growth outlook, enabled further monetary policy easing by the NBS in H2.

Inflation was kept firmly under control for the seventh year in a row and, in accordance with Executive Board announcements, after reaching the target midpoint in April, it began to decline, moving around the lower bound of the target tolerance band. The main underlying factor was the reduced contribution of vegetable prices with the onset of the new agricultural season. Inflation projections indicated that inflation would continue to move in the lower part of the target band until the end of the projection horizon. That inflationary pressures were low was also indicated by core inflation, moving in the 1.1–1.5% y-o-y range during 2019, and one- and two-year ahead inflation expectations of the financial and corporate sectors which were anchored somewhat below the 3.0% target.

The Executive Board underscored that inflation would get closer to the target midpoint in the medium run owing to a **further rise in domestic demand**, bearing in mind positive labour market trends and rising public sector wages and pensions. It also noted that household disposable income was under a positive influence of lower interest rates, and, by extension, lower loan repayment costs, achieved through past monetary policy easing of the NBS. Moreover, the room for further credit and economic growth was created thanks to the achieved and maintained financial stability and relative stability of the domestic currency, with the NPL ratio being the lowest on record. A positive effect was also expected from low interest rates on euro-indexed loans, which should remain low longer than initially expected, and from the reduced country risk premium and enhanced interbank competition.

[4] RS Official Gazette, No 96/2018.

Positive fiscal trends also contributed to overall macroeconomic stability and the country's development prospects. Robust growth in government capital expenditure and the planned increase in public sector wages and pensions provided for the sources to finance investment and consumption, but not to the extent that would trigger major inflationary pressures and halt the downward trajectory of the public debt share in GDP. As in 2017 and 2018, fiscal discipline resulted in the almost balanced general government budget in 2019 and a reduction in the public debt share in GDP. Positive fiscal trends were also supported by economic growth and rising corporate profitability, and positive labour market trends.

Favourable fiscal trends continued to positively impact the **country risk premium and credit rating**. Serbia's risk premium fell to its lowest level on record, signalling investors' rising confidence in growth sustainability of the Serbian economy. Rating agencies also confirmed the progress achieved and favourable growth prospects. By maintaining stability and transforming its economy, Serbia is for the first time a step away from investment grade, typical for economies offering high security of investments. This is not only a confirmation of economic progress and the results achieved by the Republic of Serbia, but also contributes to the further improvement of financing conditions and investment growth in Serbia.

The high FDI inflow, which fully covers the current account deficit, contributes to the **sustainability of the country's external position**. Stable and low inflation and the relatively stable exchange rate supported FDI growth, which is among the highest in the region. In addition, non-residents stepped up investment in dinar government securities, fuelling further appreciation pressures in the FX market. As assessed by the Executive Board, the narrowed internal and external imbalances and favourable macroeconomic prospects of the country are of key importance for the more favourable treatment and financial conditions that the country can obtain in the financial market. This is best confirmed by data on Serbia's eurobonds issued in the global market, and primarily the lowest interest rate that Serbia has ever achieved in the international market, which is among the lowest rates on ten-year eurobonds issued by countries of the region, even those with credit ratings higher than Serbia's.

FDIs continued to fully cover the current account deficit, which remained under the impact of elevated investment in the country and weaker external demand. However, despite the slowdown in external demand, export growth remained relatively high owing to new production capacities and the placement of agricultural inventories from the previous season. The Executive Board expected that the share of the current account deficit in GDP would be reduced in the medium run, given the continued robust FDI inflows to tradable sectors. The Board emphasised that the current account deficit would remain more than fully covered by the FDI inflow in the coming years, continuing to contribute to relative stability in the FX market.

Factors from the international environment mandated caution in the conduct of monetary policy, particularly in H1. Caution was needed primarily given the trade tensions among leading world economies, which not only aggravated the global growth outlook, through reduced investors' risk propensity, but also increased uncertainty in the international commodity and financial markets. The Executive Board expected the recovery of external demand, while at the same time pointing out that the slowdown in global trade and economy could be stronger than expected. It particularly looked at the growth prospects of the euro area, our most important trade partner which, among other things, faced the Brexit challenges. On the other hand, though slower, economic growth remained vibrant in most Central and South-East European countries, which are also our important trade partners – thanks to domestic demand, which continued to drive economic growth, while a negative contribution was provided by net exports due to the slowdown in external demand.

In making monetary policy decisions, since early 2019 the Executive Board stated that rising protectionism in international trade could negatively affect both financial and commodity markets, through uncertainties as to monetary policies of leading central banks, the dollar/euro exchange rate and capital flows to emerging economies. Tensions tightened particularly in May and early June, mainly due to new US tariffs on Chinese imports. New protectionist measures and trade tensions continued to undermine business confidence, deepening concerns regarding a possible negative impact on investment and economic growth.

Given the mounting uncertainty as to the global growth outlook, leading central banks gradually changed the rhetoric about their future monetary policies. After raising the federal funds rate in December 2018, the Fed first stated it would be patient with future adjustments to the rate, in line with movements of economic indicators, only to face by end-June 2019 the dilemma of whether to keep on hold or cut the rate; it then made a turnabout by launching a new round of quantitative easing. The ECB stated it would extend the period during which it did not expect changes in its key rates. In March, it announced it would launch the third series of targeted longer-term refinancing operations (TLTRO III), to be implemented from September 2019 to March 2021 in order to preserve favourable borrowing conditions for banks. The NBS Executive Board said it was uncertain as to what extent the monetary policies of leading central banks, notably the ECB and Fed, would differ from market expectations, which could impact capital flows to emerging economies.

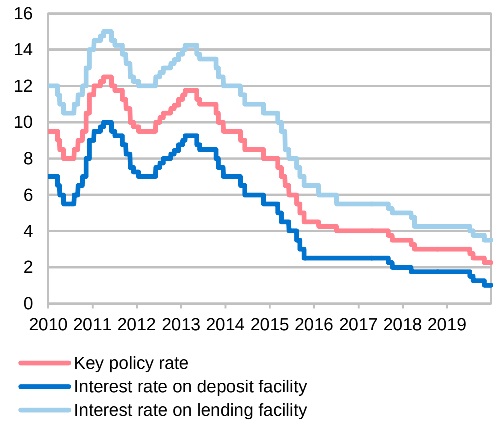
The NBS Executive Board was cautious when making monetary policy decisions also due to global prices of primary commodities, notably of oil. The global oil price first soared by almost 40% from January to mid-May, mainly because of a further scale-down of production in OPEC countries, the UAE's announcement to limit output in order to draw down inventories, and the volatile situation in Venezuela. As trade and geopolitical tensions were mounting, and the global slowdown was increasingly certain, the oil price was reduced. Although no significant changes in the global oil price were expected according to futures, its movement was uncertain due to a number of factors, both on the supply and demand side. Also uncertain was the movement in other global prices of primary commodities, notably of primary agricultural commodities, which affect agricultural commodity prices at home, and this also mandated caution in the conduct of monetary policy.

The increasingly certain further monetary accommodation by leading central banks – the Fed and ECB, against the background of continued favourable macroeconomic trends at home without triggering inflationary pressures, enabled further monetary policy easing by the NBS **in July and August by 25 bp on each occasion, to 2.5%**. As inflationary pressures weakened further, at its meeting **in November** the Executive Board **decided to cut further the key policy rate by 25 bp to 2.25%**. With each of these cuts, the key policy rate reached a new minimum in the inflation targeting regime.

2 Monetary policy instruments

The main monetary policy instrument of the NBS is the **key policy rate, i.e. the interest rate on the main open market operations**. The role of the key policy rate is supported by the **corridor of interest rates on deposit and lending facilities and by other open market operations**. In addition to the key policy rate, the NBS uses other instruments of monetary regulation, notably **reserve requirements and operations in the FX market**.

Chart II.2.1 **Key policy rate and interest rate corridor**
(daily data, p.a, %)



Source: NBS.

The main open market operations of the NBS in 2019 were one-week reverse repo transactions, i.e. repo sale of securities (liquidity absorbing).

The NBS implemented repo transactions through own securities. For the needs of repo sale, one series of T-bills was issued in 2019 in the total nominal value of RSD 500.0 bn. This is consistent with practice from earlier years which enables more adequate management of securities within the same series and facilitates liquidity management for banks.

In 2019, fifty-three repo sale auctions were organised, upon the model of the variable multiple interest rate. The total securities sales amounted to RSD 2,521.0 bn, which was somewhat higher than in 2018 (RSD 2,488.4 bn).

The stock of NBS securities in banks' portfolios averaged RSD 46.9 bn in 2019, down by RSD 0.9 bn from 2018. Relative to end-2018, the stock of these securities increased by RSD 53.5 bn, to RSD 70.0 bn at end-December.

Deposit and lending facilities

In 2019, banks continued to place overnight deposits with the NBS (deposit facilities). The average daily stock of such deposits came at RSD 39.6 bn, which is RSD 25.0 bn more than in 2018. The highest average monthly stock was recorded in December (RSD 66.4 bn) and the lowest in January (RSD 21.5 bn).

The Decision on the Conditions and Manner of Extending Daily Liquidity Loans to Banks against the Collateral of Securities, which regulates NBS lending facilities, was amended in February 2019. This created conditions for the efficient settlement of NBS receivables in respect of these loans against the pledged collateral, in accordance with the Law on Financial Collateral (RS Official Gazette, No 44/2018).

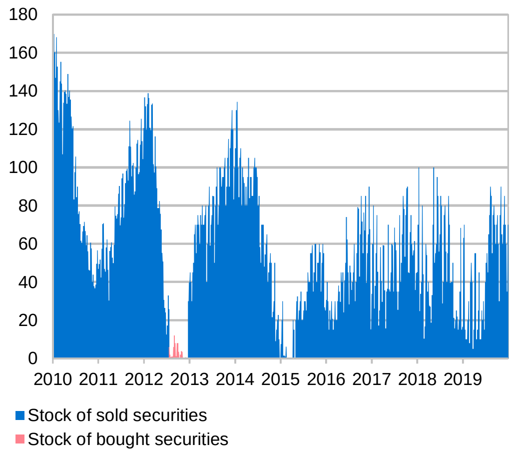
In the observed period, banks used lending facilities only as intraday loans (eight banks). Intraday loans were worth a total of RSD 40.5 bn and the peak was recorded in January (RSD 23.3 bn).

Interest rates

In August 2019, the NBS Executive Board adopted the new Decision on Interest Rates Applied by the National Bank of Serbia in the Implementation of Monetary Policy.

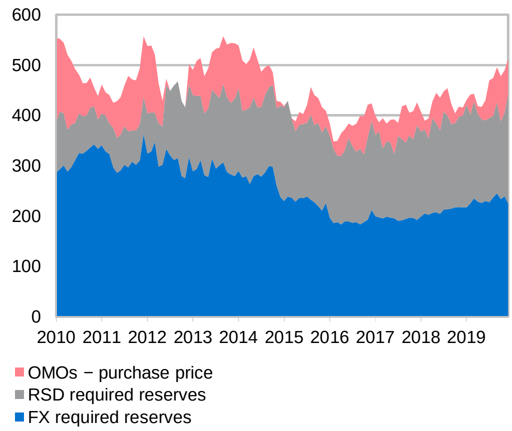
Under the new Decision, starting from the maintenance period of 18 August – 17 September 2019, the interest rate used by the NBS to charge and pay interest on the amount of actual average daily balance of allocated dinar required reserves was reduced from 1.25% (the percentage defined by the previous Decision) to 1.00%. Pursuant to the amendments from November 2019, the rate was reduced to 0.75%, starting from the maintenance period of 18 November – 17 December 2019.

Chart II.2.2 **Stock of sold/bought NBS securities**
(in RSD bn)



Source: NBS.

Chart II.2.3 **Volume of sterilisation by monetary policy instruments**
(in RSD bn)



Source: NBS.

Required reserves

At end-2019, **calculated required reserves allocated in dinars** increased by RSD 20.3 bn relative to end-2018, reaching RSD 191.5 bn. This increase reflects growth in dinar required reserves (by RSD 9.4 bn) and FX required reserves allocated in dinars (by RSD 10.9 bn).

In the same period, the amount of **calculated required reserves allocated in foreign currency** increased by EUR 175.1 mn and came at EUR 2.0 bn. This was driven by the increase in the FX base by EUR 1.5 bn, of which EUR 1.1 bn relates to FX liabilities with the maturity of up to two years and EUR 0.4 bn to liabilities with the maturity of over two years. Given the FX base composition, most of the increase relates to FX savings (EUR 0.8 bn) and FX deposits of corporates (EUR 0.5 bn).

Foreign exchange market operations

Under the 2019 Monetary Policy Programme, the NBS continued implementing the managed float exchange rate regime, with the possibility to intervene in the FX market with a view to easing excessive short-term volatility of the dinar against the euro, and maintaining price and financial stability and an adequate level of FX reserves.

In 2019, the dinar gained 0.5% against the euro in nominal terms, continuing the appreciation trend present since April 2017. Appreciation pressures reflect improved indicators of the domestic economy and its good prospects going forward. Solid macroeconomic performance and positive prospects boosted FX inflows from different sources, primarily FDIs, whose net inflow was more than sufficient to cover the current account deficit. In addition, FX inflows came from foreign investments in long-term dinar securities, primarily seven-year benchmark government securities, as well as remittances and net foreign cash purchases. Appreciation pressures were also fuelled by stepped-up bank lending (an increase in net indexed bank assets).[5]

In 2019, the NBS net bought EUR 2,695.0 mn in the IFEM (buying EUR 3,100.0 mn and selling EUR 405.0 mn).

By quarter, the dinar gained 0.2% against the euro in nominal terms in Q1. Milder depreciation pressures in January were triggered by temporary seasonal factors (heightened FX demand of domestic enterprises – energy importers). In January, the NBS intervened in the IFEM by selling EUR 130.0 mn and buying the total of EUR 165.0 mn in February and March. In Q2, the dinar kept appreciating (by 0.1%) and the NBS intervened only on the buying side (EUR 920.0 mn). In Q3, the dinar gained 0.3% against the euro in nominal terms, with the NBS net buying EUR 1,150.0 mn (buying EUR 1,210.0 mn and selling EUR 60.0 mn). In Q3, the NBS sold FX in late August, when depreciation pressures emerged on the back of heightened uncertainties in the international environment due to persisting trade tensions, slowdown in global economic growth and renewed inversion of the yield curve in the USA (in the 2–10Y segment), and amid seasonally weaker activity in the domestic FX market. In Q4, the dinar weakened 0.1% against the euro in nominal terms due to the emergence of milder, seasonal depreciation pressures. The NBS net bought EUR 590.0 mn (buying EUR 805.0 mn and selling EUR 215.0 mn).

FX swap auctions

In 2019, the NBS continued to hold its **regular three-month and two-week auctions of FX swap purchase and sale** (EUR/RSD), in order to encourage the development of interbank swap trading and facilitate more efficient liquidity management for banks. During 2019, 104 regular three-month swap auctions were held, at which the NBS swap sold and bought EUR 67.0 mn each, as well as 100 regular two-week swap auctions, at which it swap sold and bought EUR 446.5 mn each. The strongest performance in 2019 was recorded in January, when the NBS swap sold and bought EUR 82.0 mn. At end-2019, the stock of NBS FX receivables and liabilities from/to banks in respect of three-month and two-week swap auctions equalled EUR 20.0 mn and EUR 14.0 mn, respectively.

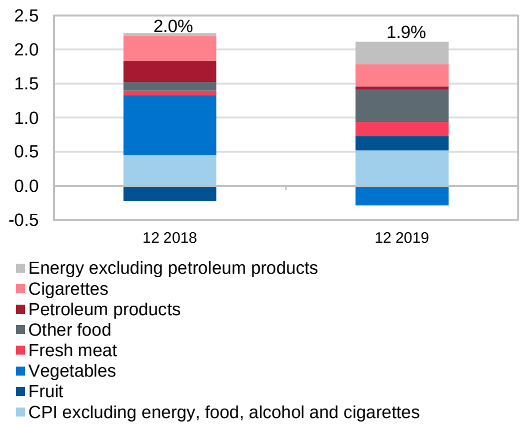
Working proactively in an environment of temporarily reduced excess liquidity in the banking sector (particularly in Q1) and **with the aim to ensure further unimpeded functioning of the money market and maintain relative stability of short-term market interest rates, the NBS organised seven additional FX swap purchase auctions**, which are one of the instruments at its disposal for the regulation of dinar and FX liquidity of the banking sector. In exchange for foreign currency (euros), the NBS provided banks with two-week dinar liquidity in the total amount of RSD 67.0 bn.

3 Achievement of inflation target in 2019

Although domestic demand rose faster than expected and the labour market ex0perienced positive trends, inflation remained low and stable in 2019, averaging around 2% for the sixth year in a row.

Such movements in y-o-y inflation in 2019 were largely determined by food and energy prices. In the period January–April 2019, just like in other countries in the

Chart II.3.1 **Contribution to y-o-y inflation in December 2018 and 2019**
(in pp)



Sources: SORS and NBS calculation.

[5] Aiming to balance their FX positions, thus reducing exposure to FX risk, banks sell foreign currency, which results in the strengthening of the dinar.

region, y-o-y inflation was driven by the increase in vegetable prices due to weak yields from the previous agricultural season, and reached 3.1% in April. With the onset of a new agricultural season, from May to October, it decelerated significantly, on account of lower vegetable prices (their contribution fell from 1.6 pp in April to -0.5 pp in October) and a decrease in petroleum product prices reflecting a fall in global oil prices. After temporarily falling below the lower bound of the target tolerance band in August, September and October, inflation returned within the target band in November and equalled 1.9% at year end, led by the increase in the prices of food and petroleum products.

In terms of inflation components, an almost even contribution to December y-o-y inflation came from food, services and industrial products excluding food and energy.

As for the prices of food, **unprocessed food** prices grew by 1.1% and **processed food** prices by 2.4%, contributing 0.6 pp to headline inflation in 2019. Within unprocessed food, vegetable prices were 6.5% lower and fruit prices 11.3% higher y-o-y. Prices of pork also increased (almost 20%) in conditions of global market disruptions, due to the emergence of African swine fever and elevated demand for pork in China. Higher prices of fresh pork spilled over to the prices of meat products. This excluded, processed food production costs remained low, primarily owing to low prices of primary agricultural commodities.

Industrial product prices excluding food and energy picked up by 1.3% y-o-y in December, contributing 0.4 pp to inflation. The increase in these prices was largely determined by the 7.6% cigarette price hike (contribution to inflation: 0.4 pp) on account of the regular annual adjustment of excise prices. A positive contribution also came from pharmaceutical and household cleaning products, while the largest negative contribution stemmed from the prices of cars and clothes and footwear.

At annual level, the **prices of services** went up by 2.1% (contribution to inflation: 0.5 pp), driven largely by the rising prices of travel packages, food and accommodation and transport services.

Energy prices gained 2.4% in 2019 (contribution to headline inflation: 0.4 pp in December). In this category, the highest positive contribution came from electricity prices, which picked up by 4.1%. A positive contribution also stemmed from the prices of solid fuels. As regards petroleum products, their contribution to y-o-y inflation varied throughout the year, turning almost neutral at year end.

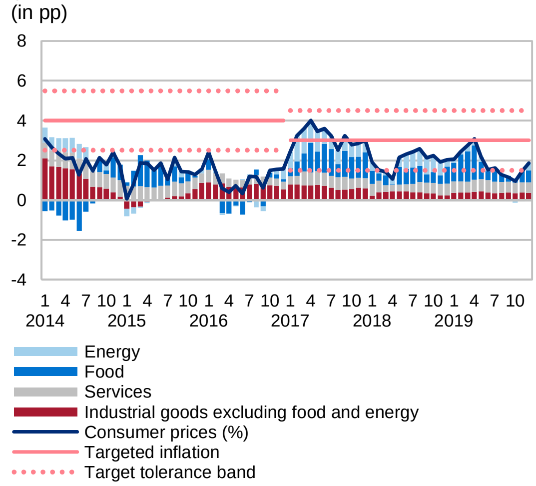
Administered prices, i.e. prices under direct or indirect government regulation, grew by 3.4% in 2019, contributing 0.6 pp to headline inflation. The growth in this price group was largely due to cigarette price hikes and the December electricity price increase.

Table II.3.1 **Growth and contribution of components to consumer price growth in 2019**

	Growth rates (in %)	Contribution (in pp)
Consumer prices (CPI)	**1.9**	**1.9**
Unprocessed food	1.1	0.1
Processed food	2.4	0.5
Industrial products excluding food and energy	1.3	0.4
Energy	2.4	0.4
Services	2.1	0.5
Core inflation indicators		
CPI excluding energy	1.8	1.5
CPI excluding energy and unprocessed food	1.9	1.4
CPI excluding energy, food, alcohol and cigarettes	1.1	0.5
Administered prices	3.4	0.6

Sources: SORS and NBS calculation.

Chart II.3.2 **Contribution to y-o-y consumer price growth**
(in pp)



Sources: SORS and NBS calculation.

Core inflation[6], the part of the CPI most affected by monetary policy, remained low and stable in 2019, ranging between 1.0 and 1.5% y-o-y. In December, it measured 1.1% y-o-y, contributing 0.5 pp to headline inflation. An almost entire contribution to core inflation came from services, while product prices within core inflation stayed broadly unchanged on average. Such developments in core inflation indicate that low inflationary pressures are of more durable character and largely the result of relative stability of the dinar exchange rate, low and anchored inflation expectations, low inflation abroad and a sustainable rise in domestic demand.

[6] CPI excluding the prices of food, energy, alcohol and cigarettes, which is the most frequently used measure of core inflation.

III Macroeconomic environment

1 International environment

Economic activity and inflation

In 2019, the global economy slowed down to the lowest level of growth since the world economic crisis, and the same trend was recorded in both developed countries and emerging economies. According to the IMF's report from January 2020, global growth in 2019 decelerated to 2.9% (from 3.6% in 2018) mainly due to lower global output and dampened trade and investment activity. Amid trade and geopolitical tensions, instability in financial markets and natural disasters, early signs of a gradual economic recovery emerged at the end of the year, supported mostly by monetary and fiscal stimuli. Not long after, the coronavirus was registered in China, the economic effects of which are most likely going to be substantial, pushing many economies worldwide into recession. Though growth projections for 2020 and 2021 were initially optimistic, they suffered major downward revisions in light of the new circumstances.

Euro area economic growth slowed down to 1.2% in 2019 (from 1.9% in 2018). Domestic demand remained the main driver of GDP growth, with a positive contribution of household and government consumption (1.1 pp) and investment in fixed assets (0.7 pp). On the other hand, a negative contribution came from net exports (-0.6 pp) under the impact of a further weakening in external demand. Due to the presence of global uncertainties, slower-paced growth was predicted for the euro area in the short-term, as indicated by leading economic activity indicators. With regard to this, in December the ECB came out with a forecast of slower euro area growth in 2020, which would then gain speed in the medium term, propped by favourable financing conditions, the recovery of external demand and the fiscal stimulus, with Brexit unfolding according to the deal. The unemployment rate equalled 7.3% in December, which is its lowest level since May 2008.

Despite the good data from the labour market, core **inflation in the euro area** remained at the 2018 level of 1.0%. Headline inflation in the euro area went down by 0.6 pp to 1.2% in 2019, thereby moving further from the inflation target of below, but close to 2%. According to the ECB, the strengthened cost-push pressures, against the backdrop of high utilisation of capacities and declining unemployment, did not translate into core inflation because corporates absorbed the rising costs by trimming their profit margins in order to remain competitive. The slowdown in external demand was particularly reflected on industry, hence there were no cost-push pressures on account of the prices of industrial products (excluding energy prices) to push inflation up. Unlike in industry, profit in the services sector is less dependent on the phase of the business cycle, therefore the greatest positive contribution to inflation in 2019 again came from the prices of services (0.7 pp on average, the same as in 2018). The fall in headline inflation is mainly attributable to the declining prices of energy. Inflation expectations also declined due to lower-than-expected inflation and poorer prospects of euro area economic growth.

Our key euro area trade partners, **Germany and Italy**, recorded significantly lower economic growth last year. Germany's economy had a close shave with recession, posting 0.6% GDP growth in 2019 (compared to 1.5% in 2018), largely in response to subdued activity in export-oriented sectors. In this period, the Italian economy posted growth of 0.3% (compared to 0.8%

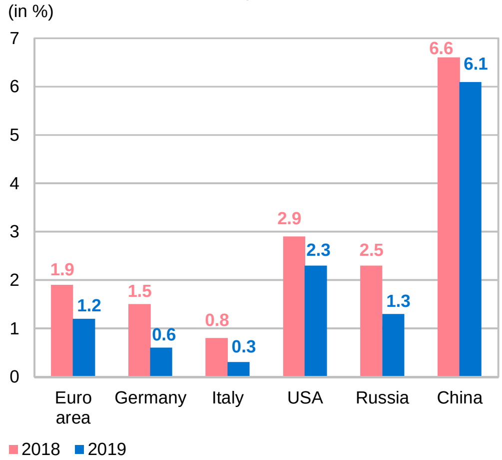
in 2018), mostly because of the slumped activity in the production sector.

Measured by the Harmonised Index of Consumer Prices, in 2019 inflation in Germany slowed down by 0.5 pp to 1.4%, and in Italy by 0.6 pp to 0.6%.

US economic growth decelerated to 2.3% in 2019 (from 2.9% in 2018), mostly in response to weaker investment dynamics, with a negative contribution to GDP growth of -0.3 pp annualised. By contrast, personal consumption gave a major positive push to economic growth (1.8 pp). The rising government consumption acted in the same direction, as did the recovery of export in Q4, owing to the fact that Phase One of the trade agreement with China was achieved. The labour market also provided support to growth, considering that the participation and employment rates were relatively high (63.2% and 61.0% in December), and that unemployment rate dropped to its lowest level in half a century (3.5% in December).

Measured by the personal consumption expenditures price index, headline **inflation in the USA** also slowed down – from 2.1% in 2018 to 1.4% in 2019. Excluding food and energy prices, inflation edged down from 1.9% to 1.6% in this period, which is below the 2% target, the same as headline inflation. Inflationary pressures at home remained low, given that wages did not increase at a pace that would drive inflation up, despite the low unemployment rate. Some FOMC members feel that an explanation for the moderate wage rise lies in technological changes that represent an alternative to the labour force, the fact that workers tend to prefer safe jobs to higher wages, other contributions and perks not included in the wage, etc. In addition to domestic factors, the prolonged global disinflationary pressures are another factor contributing to the relatively low inflation in the USA.

Chart III.1.1 **Real GDP growth in 2018 and 2019**
(in %)



Source: IMF WEO (April 2020).

According to the IMF's April report, economic growth in **emerging and developing European countries**[7] slowed down from 3.2% in 2018 to 2.1% in 2019. However, countries in **Central and Eastern Europe** continued to post solid GDP growth, while Turkey embarked on a path of economic recovery. After Hungary, whose GDP rose 4.9%, Serbia posted the highest economic growth in 2019 (4.2%), whereby it came ahead of Poland and Romania (4.1%), Croatia (2.9%), the Czech Republic (2.6%), and Slovenia and Slovakia (2.4% each). The European Commission affirmed this in its January report, noting that Serbia achieved the best results in the Western Balkans, and gave the highest contribution to the acceleration of growth across the region, based on robust investment growth.

Inflation in Central and Southeast Europe had an upward trajectory in H1 2019, driven bythe rising prices of food and energy, whereas the drop in the price of oil and lower contributions of these same categories dictated its slowdown in the majority of countries in Q3. In almost all countries in the region inflation picked up in Q4, and at end-2019 it trended above the upper bound of the target tolerance band in some countries, such as Romania and the Czech Republic, while in Hungary it reached its seven-year maximum – right on the upper bound. Energy prices and their low base from last year stand out as the main factors behind growth in y-o-y inflation. As for food, the price of meat (notably pork) continued to increase; in addition to petroleum products, these prices drove Bulgaria's y-o-y inflation in December to its highest level since January 2013. Y-o-y inflation in Poland also reached its several-year maximum due to the key contribution of the minimum wage increase. Growth in wages and domestic demand continued to generate moderate inflationary pressures in these countries, while lower import inflation acted in the opposite direction.

After rising by 2.5% in 2018, the **Russian economy** slowed down to 1.3% in 2019. This is primarily attributable to two main factors – exports, on the one

[7] Serbia, Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Hungary, Montenegro, North Macedonia, Poland, Romania and Turkey.

hand, which contracted under the impact of OPEC members capping their oil production, and lower household consumption on the other, mostly under the impact of the VAT increase in early 2019. The achieved GDP growth was facilitated by investment in fixed assets on account of the launched implementation of capital projects, as well as the accumulation of inventories in conditions of a relatively good agricultural season.

Due to rising food prices, the previous weakening of the rouble and the VAT increase as of 1 January 2019, **y-o-y inflation in Russia** went up at the start of the year and in March reached its maximum in more than two years (5.3%). In the remainder of the year, inflation decreased on account of the fall in food prices, stronger rouble and weak domestic and external demand. At year end, y-o-y inflation was 3.0%, its lowest level since July 2018.

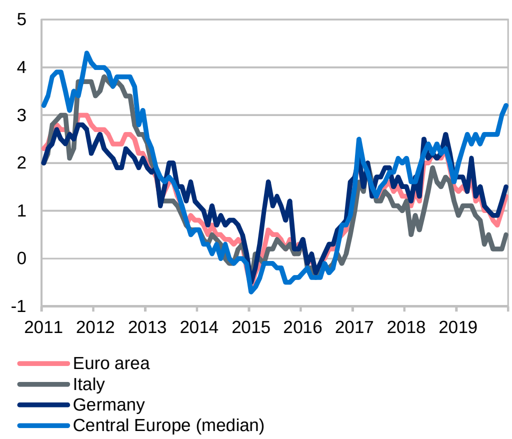
According to a preliminary estimate, the **Chinese economy** also decelerated – from 6.7% in 2018 to 6.1% in 2019, with the major contribution to the achieved growth coming from the services sector, followed by industry and agriculture. Weaker economic growth in 2019 is not only attributable to a slump in external demand due to unresolved relations with the USA, but also to a slowdown in domestic demand under the impact of suspended tax facilities for car purchase and introduction of new regulations on harmful gas emission. After 18 months of trade tensions, December saw China and the USA reach a deal (called Phase One) on avoiding the introduction of new protectionist measures. Also, it was concluded on several occasions that the strengthening of the regulatory framework should continue in order to hold public debt rise in check.

Monetary policy

At the start of the year, leading central banks took a somewhat cautious stance with regard to monetary policy normalisation, only to announce new stimuli in conditions of low inflation and heightened risks of additional global slowdown, which they began to implement in H2.

In order to ensure the sustained convergence of inflation to the target of below, but close to 2% over the medium term, the **ECB** changed its forward guidance. After initial expectations that, instead of through summer 2019, ECB interest rates would remain at their present levels through the end of 2019, it was announced in June that they would remain record-low at least until the end of H1 2020. As previously announced, in September the ECB launched a new series of quarterly targeted long-term refinancing operations (TLTRO III), each with a maturity of two years, to be implemented until March 2021. These operations will help preserve favourable bank lending conditions and the smooth transmission of the effects of monetary policy measures onto the real sector. At the September meeting, the ECB trimmed the interest rate on the deposit facility from -0.4% to -0.5%, and kept the rate on the main refinancing operations and the rate on the marginal lending facility at their current levels of 0% and 0.25% respectively. Also, it changed its forward guidance again, stating that, instead of at least through H1 2020, it now expects its key rates to remain at their present or lower levels until the ECB's projections forecast inflation at the target level. Further, it decided to restart net asset purchases at a monthly pace of EUR 20 bn as of November, which will end shortly before the ECB starts raising its key interest rates. Reinvestments of the principal payments from maturing securities purchased under the asset purchases programme will continue past the date when the key interest rates are raised, and in any case for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation. Also, the ECB further eased the conditions for disbursing TLTRO III, as well as decided to introduce a two-tier system for reserve remuneration of banks, enforced as of 30 October 2019. It was stressed that the highly accommodative monetary policy will be needed for an extended period of time in order to ensure the achievement of the inflation target. The remainder of the year saw no changes in the ECB's monetary policy.

Chart III.1.2 **HICP across selected countries**
(y-o-y rates, in %)



Source: Eurostat.

After raising the target range for the federal funds rate four times in 2018, at the start of 2019 the **Fed** changed its communication with respect to monetary policy going forward, underscoring that it will be patient and flexible in the pursuit of its policy. A more cautious monetary policy is also reflected in the more flexible approach to the normalisation of the Fed's balance sheet. According to the new plan on balance sheet normalisation, published in March, reductions in reinvestments of matured principal payments will be slowed from the then USD 50 bn per month to USD 35 bn as of May, only to be concluded at the end of September, and reinvestments will be continued primarily in favour of US Treasuries. During H1, the target range for the federal funds rate remained 2.25–2.50%, however, heightened uncertainty over growth prospects and muted inflationary pressures led to an increase in expectations that the federal funds rate will be cut. In July, for the first time since 2008, the Fed trimmed its federal funds rate target range (by 25 bp) amid concerns over trade tensions, Brexit, dampened growth in developed countries and the spill-over effects on the US economy and inflation. It also decided to end its balance sheet roll-off two months earlier than originally planned. The target range for the federal funds rate was trimmed on two more occasions, in September and October, each time by 25 bp, to 1.50–1.75%, where it remained until end-2019.

Stronger disinflationary pressures from the external environment, together with new measures of the ECB and Fed, helped most of the central banks in the region to maintain favourable monetary conditions.

After raising its overnight deposit facility rate from -0.15% to -0.05% in March and keeping its key policy rate at 0.9%, the central bank of **Hungary** kept the rates on hold until end-2019. However, the amount of excess liquidity provided to the financial system increased in September, which partly offset its reduction in March and June 2019. Though increased domestic demand and good performance in the labour market exerted pressure on inflation growth, weaker economic performance in the euro area resulted in a build-up of external disinflationary pressures and increased prospects of inflation being lower than projected. At year end, there was a rise in headline, but not in core inflation, which dampened market expectations of an increase in the key policy rate. The central bank of **Romania** kept its benchmark rate at 2.50% during 2019. Despite the anticipated overshooting of the target, the central bank estimated that this was an adequate level to ensure the return of inflation within the target tolerance band amid favourable external monetary conditions. Monetary policy makers were also apprehensive that an increase in the key policy rate could attract speculative capital. During 2019, the central bank of **Poland** maintained its key policy rate at 1.5%, where it has stood since March 2015. Officials emphasized that they saw no need to change it any time soon, despite stronger inflationary pressures, that is, the December increase in inflation to its highest level in seven years. In contrast, the central bank of the **Czech Republic** raised its policy rate by 25 bp to 2.00% in May, in accordance with analysts' expectations. In the second half of the year, there were no changes in the benchmark rate, despite rising inflationary pressures. Though the central bank of **Turkey** kept its policy rate unchanged during H1 amid the still high inflation, on two occasions it temporarily suspended one-week repo operations at the rate of 24%, redirecting banks to more costly lending facilities at the rate of 25.5%. Then, in Q3, it trimmed its policy rate by a total of 750 bp in conditions of weaker cost-push pressures and a global slowdown, and by an additional 450 bp in Q4 – to 12.0%, noting that that was in line with the projected downward trajectory of inflation.

In June, for the first time since March 2018, the central bank of **Russia** lowered its policy rate from 7.75% to 7.50%. Monetary policy relaxation continued in upcoming meetings due to lower than anticipated economic growth and heightened risks of a global slowdown. At the end of the year, the key policy rate equalled 6.25%, its lowest level since January 2014.

Financial and commodity markets

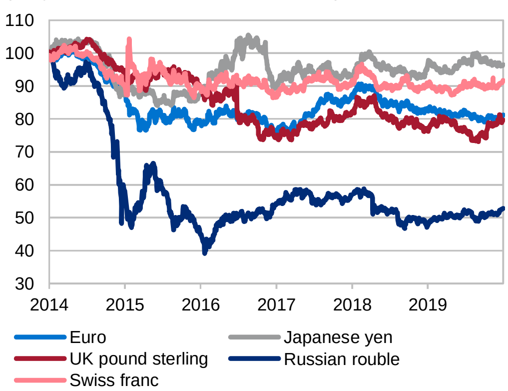
The upward trend of the value of shares, present since the start of the year, was disrupted in May due to new protectionist measures of leading world economies. Still, after clearer signals by the Fed that its federal funds rate might be trimmed before the year ends, global stock markets recovered in June, which was additionally supported by lower yields on bonds as an alternative form of investment. Heightened trade tensions between the USA and China in August reflected on the increase in **financial market volatility**, though monetary policy accommodation by leading central banks, progress in Brexit talks, and optimistic news regarding US-China trade talks around the end of the year contributed to its gradual reduction thereafter. The prices of shares continued up, with S&P 500 reaching a record-high value at the end of the year. The implicit measure of financial market volatility (VIX) declined in 2019 by 11.6 pp to 13.8%, and the volatility measured by the EM–VXY, which tracks the volatility of currencies in emerging markets, by 3.2 pp to 6.6%.

Another consequence of heightened trade tensions during H1 was the fall in the **yields on ten-year government bonds of developed countries**. Yields on ten-year US Treasuries reached their multiple-year maximum in H1, and yields on German bonds, which are also considered safe assets, entered the negative zone, as did yields on benchmark French and Austrian bonds. Looking to make profit, investors purchased bonds of peripheral euro area countries, thus causing a fall in their yields too. The US announcement about new tariffs on Chinese imports in August and poorer prospects for global growth on this account led to a further decline in the yields on government bonds of developed countries. In August, for the first time, the entire German yield curve was in the negative territory. Rising investor optimism at year end reflected on the increase in the yields on ten-year government bonds of developed countries, which ranged from -0.2% on German bonds to 1.9% on US Treasuries at end-2019. Yields on French and Austrian ten-year bonds returned to the positive territory, while the entire yield curve on German government bonds remained in the negative territory, though at a somewhat higher level.

In H1, the **euro** weakened **against the dollar** in response to relatively poorer prospects of euro area's economic growth and increased investment in the dollar as a safe-haven currency. After the Fed's June meeting, when monetary policy accommodation was hinted at, the euro started gaining on the dollar, though only temporarily, as it turned out. In light of a somewhat better inflation outlook in the USA and the Fed avoiding to announce an extended period of greater monetary policy accommodation, the euro continued to weaken against the dollar in Q3. The alleviated trade tensions, progress in Brexit talks, slightly better economic indicators in the euro area, as well as signs of a slowdown in the US production sector helped the euro regain some of its value relative to the dollar at end-2019, though it was still 2.3% weaker than at end-2018. Thanks to the progress achieved in Brexit talks around the end of the year, the British pound gained 3.4% against the dollar in 2019. The Swiss franc, the Japanese yen and the Russian rouble also appreciated against the dollar (1.0%, 1.6% and 12.3% respectively).

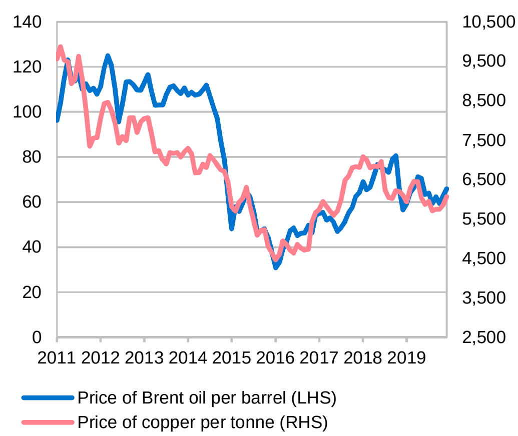
The price of oil in the global market was volatile during 2019. It rose in early 2019, mainly on account of contracted production in OPEC members, as well as the decreased production in Venezuela and Iran due to US sanctions. After reaching USD 74 per barrel in May, its highest level since October 2018, the price of oil declined to USD 57 per barrel in August in response to bleak prospects for global growth and the record-high production in the USA. After the attack on oil facilities in Saudi Arabia, the price of oil went up to nearly USD 70 per barrel in mid-September, but once it turned out that the effect on this account was of short breath, concerns over global economic growth and the consequently poorer outlook in terms of oil demand regained dominance. During Q4, the global oil price started rising again in response to geopolitical tensions in the Middle East, which spurred concerns over possible disruptions in oil supply, the contraction of US oil inventories and the announced production cuts in OPEC members and other oil exporters. In addition, optimism in terms of trade talks and the dollar's weakening in Q4 drove the price of oil up. Around end-2019, the price of oil equalled USD 66.4 per barrel, up by 25% from end-2018.

Chart III.1.3 **Exchange rates of selected national currencies against the dollar***
(daily data, 31 December 2013 = 100)



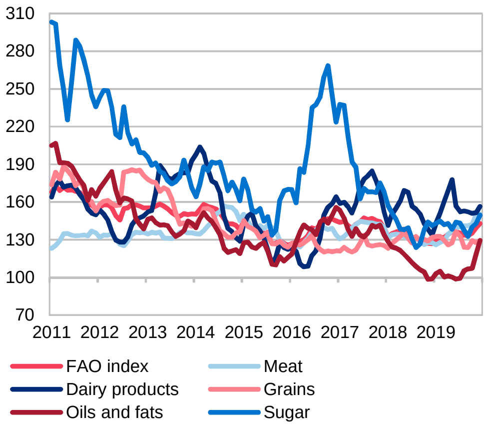
Source: IMF database.
* Growth indicates appreciation.

Chart III.1.4 **Oil and copper price movements**
(average monthly prices, in USD)



Source: Bloomberg.

Chart III.1.5 **World food price index**
(in real terms, 2002–2004 = 100)



Source: FAO, UN.

Table III.2.1 **Serbia's balance of payments**
(in EUR mn)

	2018	2019
I CURRENT ACCOUNT	-2,076.1	-3,159.9
1. Goods	-5,085.4	-5,615.9
1.1. Credit	15,105.8	16,427.8
1.2. Debit	-20,191.2	-22,043.7
2. Services	994.9	1,048.6
2.1. Credit	6,060.5	6,970.5
2.2. Debit	-5,065.6	-5,921.9
3.Goods and services	-4,090.6	-4,567.3
3.1. Credit	21,166.3	23,398.3
3.2. Debit	-25,256.9	-27,965.6
4. Primary income	-2,182.3	-2,476.9
5. Secondary income	4,196.8	3,884.4
II CAPITAL ACCOUNT	-6.6	-112.1
III FINANCIAL ACCOUNT (excluding reserve assets)	2,866.6	4,933.1
1. Direct investment, net	3,156.5	3,583.1
2. Portfolio investment, net	-913.0	188.4
3. Financial derivates, net	-21.0	-0.5
4. Other investment, net	644.1	1,162.1
4.1. Trade credit and advances, net	-200.7	-222.0
4.2. Financial loans, net	1,302.9	1,106.1
4.3.Currency and deposits, net	-464.2	277.7
4.4. Other, net	6.1	0.3
IV Reserve assets	-1,123.2	-1,872.8
V NET ERRORS AND OMISSIONS	339.3	211.6
VI OVERALL BALANCE	1,123.2	1,872.8

Source: NBS.
Note: Preliminary data.
[1)] BPM6 methodology, except sign convention.

Measured by the FAO index, at end-2019 **global food prices** were 12.4% higher relative to end-2018. Vegetable oil prices rose the most (30.9%), reaching their two-year maximum in December in response to a growing demand for palm oil. Meat prices increased by 17.5%, mainly due to the rising import demand in East Asia in order to compensate for the decrease in domestic production of pork, which slumped because of the African plague. The prices of dairy also rose (17.0%), facilitated by the weaker supply from the EU and Oceania, as did the price of sugar (6.0%), due to the contracted supply from Brazil. Of the food products in the FAO index, only the price of cereals declined in 2019 (-2.0%), mainly because of the better-than-expected corn harvest in the USA, the world's largest corn producer and exporter.

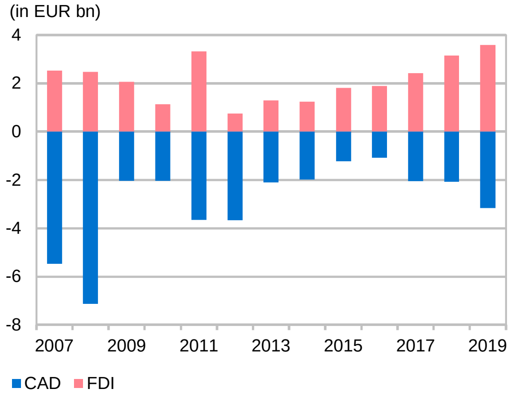
2 International transactions

Balance of payments and FX reserves

In 2019 as well, balance of payments trends were under the sway of the domestic investment cycle, the slowdown of external demand and taxes on products delivered to Kosovo and Metohija. The **current account deficit** was EUR 3.2 bn in 2019 (6.9% of GDP), up by EUR 1.1 bn from 2018. In terms of its main components, the current account deficit widened due to a higher commodity deficit, a higher primary income account deficit and a smaller surplus in the secondary income account, while the surplus in external services trade continued to go up and work in the opposite direction. At the same time, as positive trends in the financial account continued, the current account deficit was fully covered by net FDI inflow for the fifth year in a row, which helped strengthen appreciation pressures. Such movements led to an expansion in FX reserves, further increasing the resilience of our economy to shocks from the international environment.

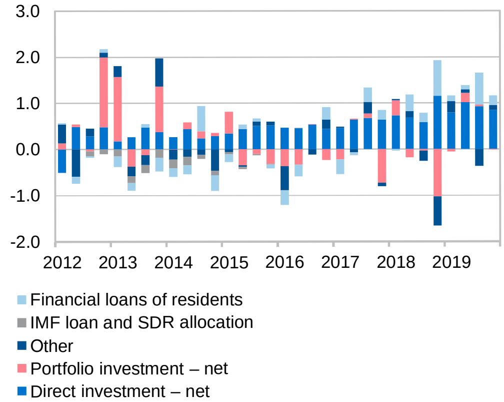
The deficit on **trade in goods** increased by EUR 530.5 mn to EUR 5.6 bn. In euro terms, goods exports gained 8.8% y-o-y and imports – 9.2% y-o-y. Though euro area demand slackened, **goods exports** climbed to RSD 16.4 bn, led by higher exports of the manufacturing industry (7.2% y-o-y) which remained broad-based. The greatest contribution to growth came from the export of electrical equipment and machinery which gained 23.6% and 21.8%, respectively, as well as rubber and plastic products which went up by 10.7%. The export of motor vehicles decreased, but this was fully offset by rising exports of other producers in the automobile industry. The overhauls in the Pančevo refinery and Petrohemija in H1 had a temporary dampening impact on the export of petroleum and chemical products, while the adjustment to the application of EU steel import quotas led to somewhat lower export of base metals, which was largely compensated for by higher copper exports and, partially,

Chart III.2.1 **FDI/CAD coverage***
(in %)



Sources: SORS and NBS.
* Preliminary data.

Chart III.2.2 **Structure of the financial account***
(in EUR bn)



Source: NBS.
* Preliminary data.

steel exports to other markets. Thanks to good results during two consecutive agricultural seasons, there was a powerful upswing in the export of food (8.3% y-o-y) and agricultural products (21.7% y-o-y), while a further positive effect came from the deferral of a part of exports from the 2017–2018 season due to low water levels on the Danube in late 2018. **Goods import** went up (to EUR 22.0 bn) primarily on account of rising production and investment, as confirmed by the fact that 74% of the growth (EUR 1.4 bn)[8] pertained to intermediate goods and equipment, whose imports went up by 6.5% and 20.4% y-o-y, respectively (equipment imports exceeded EUR 3.3 bn in 2019). Within intermediate goods, particularly vigorous was the rise in the import of steel pipes (by EUR 230 mn) for the construction of the TurkStream pipeline, which had a one-off effect on import growth.

Due to strong growth of both the export and import of services, the surplus in external **trade in services** rose further (by 5.4% to EUR 1.0 bn). Export growth was spurred mainly by ICT and business services, while import growth was mostly led by business and tourism services.

The deficit in the **primary income account** widened (by EUR 294.6 mn) mostly on the back of higher expenditure for FDI-related dividend payments (by EUR 306.2 mn), which is consistent with the continued rise in the FDI stock, while the level of reinvested earnings was somewhat higher than in 2018, indicating foreign investors' readiness to step up investment in Serbia. At the same time, expenditures on account of portfolio investments were lower, due to the maturing and replacement of securities issued earlier at higher interest rates, and more favourable terms of new borrowing.

The surplus in the **secondary income account** decreased by EUR 312.3 mn, due to a smaller inflow of other transfers (by EUR 277.5 mn) – notably dampened inflow on account of temporary payment operations with Kosovo and Metohija following the introduction of taxes on goods from Serbia – and, to a significantly lesser extent, a somewhat weaker net remittances inflow (by 1.3%).

In 2019, inflow to the balance of payments **financial account** (EUR 4.9 bn[9]) was 72.1% higher than in 2018. FDIs accounted for the bulk of capital inflow from abroad and were more than sufficient to fully cover the current account deficit, for the fifth year in a row. At the same time, capital inflow was also recorded on account of portfolio investment, and increased foreign borrowing by corporates, banks and the government.

Net **FDI** inflow equalled EUR 3.6 bn in 2019, the highest since comparable statistics are available. Gross FDI inflow amounted to EUR 3.8 bn. Based on preliminary data, almost a half of this amount was invested in tradable sectors, of which EUR 1 bn in manufacturing alone. As before, investments were distributed to a large number of other sectors, with the highest amounts invested in construction and real estate business (27.9%) and transportation (15.5%), while investors were mostly from European countries (84.0%).

[8] BEC classification.

[9] Excluding change in FX reserves.

In 2019, **portfolio investment** amounted to EUR 188.4 mn net, reflecting mainly stepped-up non-resident investment in long-term dinar government securities, though the government, facing smaller borrowing needs, organised fewer auctions and achieved lower yield rates. Moreover, a new ten-year eurobond was issued in 2019, at the most favourable terms so far, and the funds raised (EUR 1.55 bn) were used for the early repayment of a portion of bonds issued in dollars in 2011 and 2013 at much higher rates. In addition to investors' readiness to accept lower rates of return against the background of monetary policy easing by leading central banks, such developments also reflect the fact that Serbia, owing to macroeconomic stability, is a favourable investment destination, as confirmed by the upgrade in Serbia's credit rating by Standard & Poor's and Fitch in H2.

The inflow from **other investments** in 2019 equalled EUR 1.2 bn, up by 80.4% from 2018. Of this, resident borrowing under **financial loans** increased by EUR 1.1 bn net, led by a rise in borrowing by corporates (EUR 500.9 mn), banks (EUR 321.8 mn) and government (EUR 291.8 mn), while the NBS trimmed its obligations by EUR 8.3 mn. In the same period, net inflow from **cash and deposits** came at EUR 277.7 mn. Exporters approved more trade loans than were used by our importers, resulting in a net outflow of EUR 222.0 mn for **trade loans**.

Owing to the above movements in the current and financial accounts, **Serbia's FX reserves** (according to the balance of payments methodology[10]) expanded in 2019 by EUR 1.9 bn.

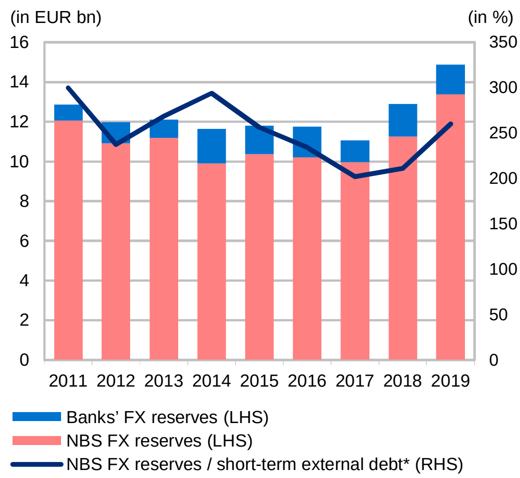
At end-December 2019, gross and net FX reserves of the NBS were at their highest end-year level on record (since 2000). Gross FX reserves of the NBS came at EUR 13,378.5 mn at end-2019, up by EUR 2,116.7 mn from end-2018. Such level ensured the coverage of 174% of money supply (M1) and around six months' worth of the import of goods and services, almost twice the standard on the adequate level of FX reserves.

Net FX reserves were EUR 11,441 mn, up by EUR 2,587 mn from end-2018.

Consistent with fundamental principles of security and liquidity, funds were invested in highly liquid securities issued by the world's most advanced countries and international financial institutions, as well as placed with prime institutions (central banks, international financial institutions and top tier foreign banks). In regard to this, as at 31 December 2019, foreign securities accounted for the bulk of FX reserves (55.5%), followed by FX balances in accounts abroad (21.5%), foreign cash (12.5%), gold (10.0%) and SDRs with the IMF (0.5%).

In 2019, the NBS saw record high foreign exchange inflow from NBS interventions in the IFEM, amounting to EUR 2,680.0 mn net.[11] In respect of the issuance of long-term euro-denominated government securities in the international financial market in June (EUR 1.0 bn) and November (EUR 550.0 mn), inflow of EUR 1,541.7 mn was earned and used for the early buyback of dollar-denominated eurobonds issued in the international financial market in 2011 and 2013 at higher interest rates, and maturing in 2020 and 2021. An inflow of EUR 653.7 mn was recorded in respect of sale of euro-denominated government securities in the domestic financial market. In addition, inflows were also recorded on account of the disbursement of loans for the Republic of Serbia (EUR 671.5 mn), grants (EUR 255.4 mn) and temporary payment operations with Kosovo and Metohija[12] (EUR 150.3 mn). In 2019, the NBS earned income from investment in foreign securities and interest rates on FX funds in the amount of EUR 89.0 mn net.

Chart III.2.3 **FX reserves and coverage of short-term external debt**



Source: NBS.
* Short-term debt by remaining maturity.

[10] Excluding currency changes, changes in the market value of securities and the price of gold.

[11] In accordance with accounting rules, transactions in respect of NBS interventions in the IFEM are disclosed on the execution day and not on the trading day.

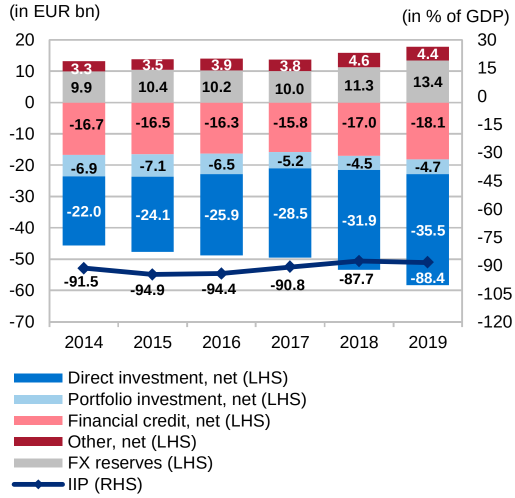
[12] Under the Law on Temporary Execution of Certain Payment Operations in the FRY (FRY Official Gazette, No 9/01).

An outflow from FX reserves in the amount of EUR 1,577.6 mn was recorded in respect of the above early buyback of dollar-denominated eurobonds. Obligations to foreign creditors (principal and interest) were settled regularly, amounting to EUR 1,221.9 mn. An amount of EUR 837.2 mn was paid from FX reserves in respect of maturing euro-denominated government securities in the domestic market. In the observed period, banks drew FX required reserves in the net amount of EUR 191.0 mn. The amount of EUR 7.2 mn was paid pursuant to the Law on the Settlement of the Public Debt of the Republic of Serbia Arising from Unpaid Foreign Exchange Savings of Citizens.

International investment position

At end-2019, Serbia's international investment position of a net debtor equalled EUR 40.6 bn, up by EUR 3.0 bn compared to end-2018. As in the prior period, the increase is mostly due to the **rise in the most desirable investment from abroad – FDI, whose net stock at year end reached 87.4% of the net international investment position**. Low inflation and the relative stability of the exchange rate, together with the country's improved macroeconomic outlook, contributed to the high inflow of FDI, which is significant for sustainability of Serbia's external position. **The high FDI inflow reflected on the increase in the share of Serbia's net international investment position in estimated GDP** to 88.4% at end-2019, up by 0.8 pp from end-2018.

Chart III.2.4 **International investment position***



Source: NBS.
* Preliminary data.

Serbia's foreign financial assets increased by EUR 2.7 bn in 2019, to EUR 26.7 bn. The increase is driven by balance of payment transactions (EUR 2.4 bn) and currency and other changes (EUR 306.9 mn). FX reserves increased the most (EUR 2.1 bn), with their share exceeding a half of total assets, followed by other resident investment abroad which gained EUR 215.9 mn, mainly owing to a rise in trade loans and advance payments to non-residents. As resident FDI abroad increased by EUR 308.2 mn, claims on this account amounted to EUR 3.6 bn. Portfolio investment of residents abroad also went up, though to a smaller extent (by EUR 41.4 mn) to EUR 290.0 mn.

Serbia's foreign financial liabilities gained EUR 67.3 bn in 2019. This increase was mostly a result of executed transactions, worth EUR 5.4 bn, and to a lesser extent also of currency and other changes (EUR 275.9 mn). Like in prior years, the rise in foreign liabilities of residents in 2019 resulted to a significant extent from a rise in FDI which increased to EUR 39.2 bn. Relative to end-2018, **FDI** growth mainly related to the increase in equity capital (EUR 3.1 bn), while foreign investments in debt instruments were lower (EUR 848.7 mn). The rise in total liabilities was also facilitated by the increase in **other investments** (financial loans, trade loans and advance payments) by EUR 1.4 bn, which equalled EUR 23.0 bn at end-2019. **Portfolio investments** gained EUR 377.2 mn, reaching EUR 5.1 bn late in the year.

3 Financial market trends

Interest rates

During the year, the NBS trimmed the **key policy rate** three times,[13] by 0.25 pp each, to 2.25%. The **average repo rate**[14] mirrored the decrease in the key policy rate and equalled 1.0% at year end, down by 1.4 pp from end-2018.

The average daily turnover in the **overnight interbank money market** amounted to RSD 3.5 bn in 2019, up by 20% from 2018. BEONIA mirrored movements in the average repo rate and also declined during the year by 1.4 pp to 1.1%. BELIBOR rates of all maturities decreased slightly in H1, only to see a sharper drop in H2, reflecting

[13] In July, August and November meetings.

[14] The rate achieved at repo auctions weighted by the amount of securities sold.

key policy rate cuts (by around 1.2 pp on average). In December, BELIBOR rates moved within the range of 1.1% for shortest maturities to 1.8% for the six-month maturity.

The NBS's monetary policy accommodation, improved fiscal position and preserved macroeconomic stability contributed to a further fall in interest rates in the **primary market of dinar government securities in 2019** to their new all-time lows. In 2019, the government issued new benchmark dinar bonds with the maturity of three and seven years, the interest rates on which decreased during the year from 3.7% and 4.6% in January to 3.4% and 2.7%, respectively.[15] In addition, during the year the government also sold five-year dinar securities whose interest rate decreased from 4.0% in the February auction to 2.3% in December. The government also organised five early buyback auctions for dinar three-year securities due for payment in April 2020. A total of RSD 30.1 bn of these bonds was bought back, and the effective rate decreased from 3.0% in the April auction to 1.75% in the December auction. In addition, there was also the early buyback of RSD 5.0 bn of seven-year dinar bonds due in April 2022 (effective rate of 3.51%).

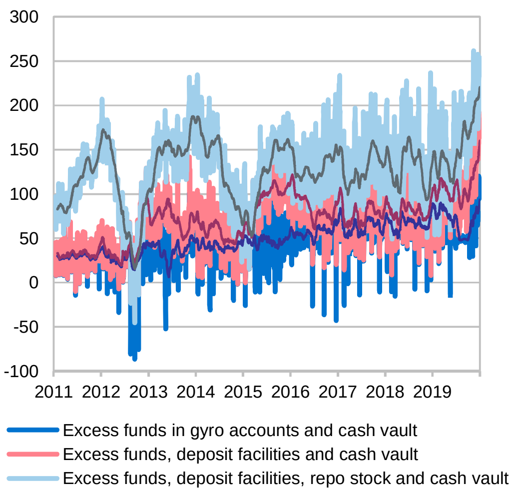
In 2019, the government organised **auctions of euro-denominated government securities**, whose interest rates were also on a decline, with the rates on the majority of maturities falling to their all-time lows, amid strong investor interest. The sharpest fall was recorded for the ten-year maturity – the interest rate decreased from 3.5% in March 2018 to 1.9% in October 2019. Interest rates on two-year bonds moved at 0.8%, while interest rates for three- to five-year maturities decreased to 0.6% and 1.5%, respectively. Strong demand also marked the auction of fifteen-year securities held in February at the effective yield rate of 3.6%, which was 0.6 pp lower than at the auction held in September 2017.

In 2019, the government also successfully issued ten-year **eurobonds in the international financial market**, amid strong investor interest and at lowest interest rates so far. In the June auction, EUR 1.0 bn of eurobonds was sold at the rate of 1.62%, while an additional EUR 550 mn was sold in November at the rate of 1.25%.

Consistent with movements in the primary market, **yield rates in the secondary market** were also on a decline, ranging from 1.7% for three-month maturity to 3.0% for eight-year (98 months) maturity. Total trade in the secondary market in 2019 was RSD 431.2 bn, or 14% more than in 2018.

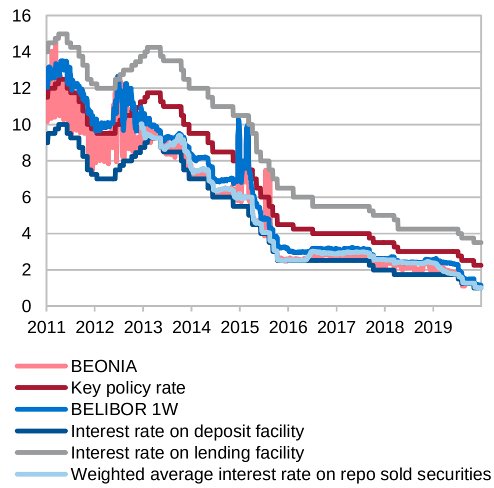
The trimming of the key policy rate also reflected on lower costs of private sector financing. The average weighted interest rates on new dinar bank loans to

Chart III.3.1 **Dinar liquidity**
(daily stock and moving averages, in RSD bn)



Source: NBS.

Chart III.3.2 **Interest rate movements**
(daily data, p.a., in %)



Sources: Thomson Reuters and NBS.

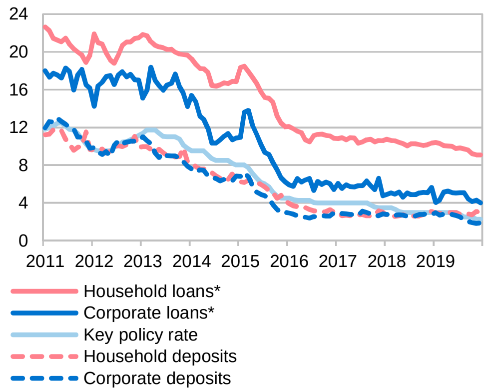
[15] The latest auction of three-year bonds was in June, and of seven-year bonds in November.

households decreased during 2019 by 1.2 pp to a new minimum of 9.1% in December. In terms of loan purpose, cash loans were approved at the rate of 9.4% in December, down by 1.4 pp from a year earlier. Interest rates on consumer loans also decreased (from 7.0% to 3.4%), as did the rates on other unclassified loans (by 1.6 pp to 7.6%). The weighted average interest rate on dinar corporate loans decreased in 2019 by 1.6 pp to 4.0% in December, its lowest level on record. Decrease was recorded for loans of all purposes, but it was the sharpest for the dominant loan categories – current assets loans (by 1.5 pp to 4.4% in December) and investment loans (by 1.8 pp to 4.4% in December).

Interest rates on euro-indexed loans to households oscillated mildly during the year, but remained broadly unchanged in December from end-2018 – at 3.8%. In late 2019, euro-indexed housing loans were approved at the rate of 2.8%, and consumer loans at the rate of 4.8%, which is almost the same as in 2018. Rates on cash loans decreased (by 0.8 pp to 2.6%), while interest rates on unclassified loans increased slightly (by 0.2 pp to 5.9%). New euro-indexed loans to corporates saw a mild increase compared to 2018. In December, they were approved at the rate of 3.0% (2.8% in December 2018) – 2.7% for current assets loans (2.4% in late 2018) and 3.4% for investment loans (3.2% in late 2018).

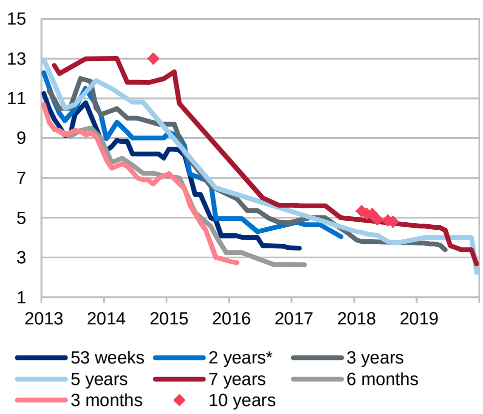
Interest rates on **dinar** household **savings** dipped slightly in December 2019 (by 0.1 pp) relative to end-2018, measuring 3.0%, while interest rates on **euro savings** gained 0.1 pp in the same period, and equalled 1.1%. At the same time, interest rates on corporate time deposits in dinars fell by 0.9 pp to 1.9% in December, while rates on euro deposits increased by 0.2 pp to 0.9%.

Chart III.3.4 **Interest rates on new dinar loans and deposits**
(weighted average values, p.a., in %)



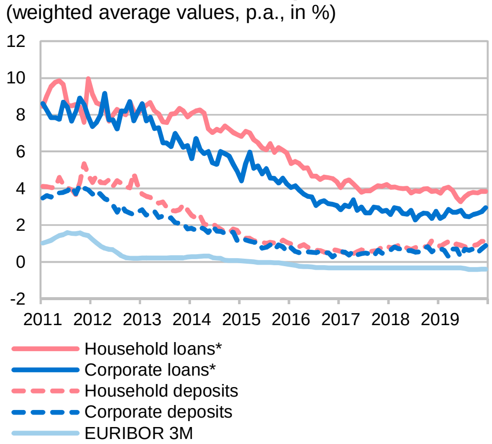
Source: NBS.
* Excluding revolving loans, current account overdrafts and credit card debt.

Chart III.3.3 **Interest rates in the primary market of government securities**
(p.a., in %)



Source: Ministry of Finance.
* Excluding coupon securities with the rate linked to the NBS key policy rate.

Chart III.3.5 **Interest rates on new euro and euro-indexed loans and deposits**
(weighted average values, p.a., in %)



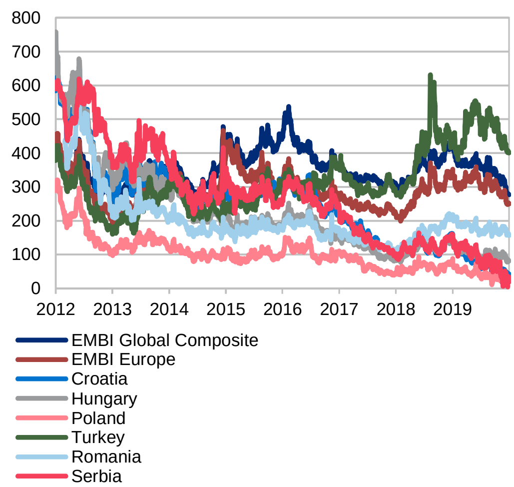
Sources: NBS and European Banking Federation.
* Excluding revolving loans, current account overdrafts and credit card debt.

Risk premium

Movements in emerging markets' risk premia in 2019 were mostly determined by the developments in trade negotiations, expectations of global economic growth and monetary policies of leading central banks, but also domestic factors. During the year, there was an alternation of periods of tightening and easing of trade tensions between the US and China, which also reflected on movements in the risk premia of emerging markets. Already early in the year, leading central banks announced that the process of monetary policy normalisation would be slower than signalled earlier, which gave rise to expectations of a new cycle of monetary accommodation which indeed took place in H2. This enhanced investors' risk propensity and pushed down emerging markets' risk premia, which was supported additionally late in the year by the reaching of the Phase One trade deal between the US and China. The composite measure, EMBI Global Composite, lost 158 bp in 2019 to 277 bp, while the risk premium indicator for European emerging markets, EMBI Europe, decreased by 90 bp to 249 bp.

The risk premia of most regional peers moved well below EMBI Global Composite and EMBI Europe. Among these, Serbia's risk premium saw the sharpest drop in

Chart III.3.6 **Risk premium indicator – EMBI by country**
(daily data, in bp)



Source: JP Morgan.

Table III.3.1 **Credit rating**
(change of rating and outlook)

	2016	2017	2018	2019
S&P	BB- /stable[1] /positive[5]	BB /stable[5]	BB /positive[5]	BB+ /positive[5]
Fitch	BB- /stable[3]	BB /stable[5]		BB+ /stable[4]
Moody's	B1 /positive[2]	Ba3 /stable[2]		Ba3 /positive[4]

Source: NBS.
[1]January, [2]March, [3]June, [4]September, [5]December.

2019, by 140 bp to 19 bp, which is among the lowest risk premia in the region and slightly higher than the minimum recorded on 23 December (5 bp). This indicates that the fall in Serbia's risk premium was not only due to global factors, but to domestic factors as well,[16] and confirms investors' growing confidence regarding Serbia's macroeconomic outlook.

After Moody's improved Serbia's outlook from "stable" to "positive" and confirmed its credit rating at Ba3, while Fitch increased Serbia's credit rating in September, another recognition of Serbia's successful economic policy came in December 2019 from Standard & Poor's, sending a positive signal to investors. Just as Fitch, Standard & Poor's increased Serbia's credit rating from BB to BB+ with a positive outlook, bringing it only a step away from investment grade, according to the standards of this agency. The upgrade reflects the Serbian economy's proven resilience to external shocks and a favourable medium-term outlook, firm fiscal discipline, and the demonstrated operational independence and adequate monetary and prudential policy of the NBS. Standard & Poor's assessed the outlook as positive, which is a strong signal that further rating upgrades are possible in the coming period.

Trends in the FX market and exchange rate

End-of-period, the dinar strengthened vis-à-vis the euro by 0.5% in 2019, continuing the multiannual trend of relative stability. At the same time, as the euro weakened against the dollar end-of-period, the dinar weakened against the dollar by 1.5%.

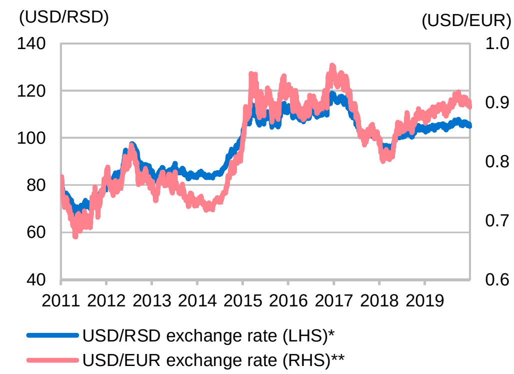
[16] Analysis done in February 2020 confirms that the decline in Serbia's risk premium since end-2012 was due to lower inflation, NPL resolution, acceleration of economic growth, narrowing of fiscal and external imbalances (as measured by the ratio of public debt and current account to GDP) (NBS, *Inflation Report – February 2020*).

After moderate depreciation pressures in January, caused primarily by the seasonally heightened FX demand of energy importers, appreciation pressures which prevailed in the past three years, re-emerged from February onwards. Appreciation pressures reflected primarily stronger exports and FDIs, owing to which the net sale of foreign currency to companies dropped significantly as of February. From March onwards, appreciation pressures were also fuelled by the rise in FX-indexed corporate loans, i.e. increased FX-indexed bank assets.[17] Higher purchase of foreign cash worked in the same direction, as well as card payments by non-residents in Serbia, seasonally the highest during summer months. In June and July, increased non-residents' investments in long-term dinar government securities also played a role in the dinar's strengthening. Such trends accounted for the full coverage of FX demand by FX supply in almost every month, the supply being exceptionally buoyant during Q2 and Q3. To ease excessive short-term volatility of the exchange rate of the dinar against the euro, in 2019 the NBS intervened in the IFEM by buying EUR 3.1 bn and selling EUR 405.0 mn. The country's FX reserves rose on this account by EUR 2,695.0 mn at the annual level.

Daily trading volumes in the IFEM[18] averaged EUR 25.0 mn in 2019, down by EUR 2.6 mn from 2018. The highest turnover was recorded in October (daily average of EUR 35.0 mn).

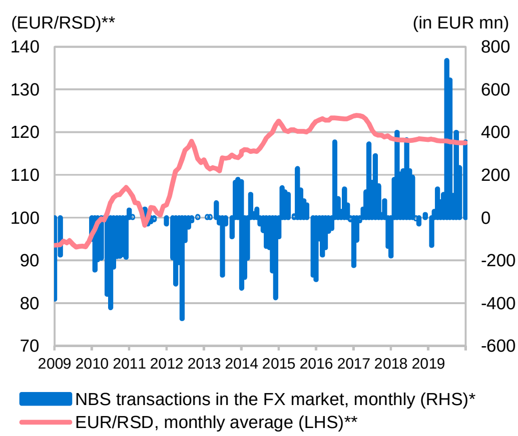
The currencies of other countries in the region running similar exchange rate regimes exhibited different trends in 2019. At period end, the Czech koruna and the Polish zloty strengthened by 1.2% and 1.0%, respectively, while the Romanian leu weakened by 2.4%, the Hungarian forint by 2.7% and the Turkish lira by 9.4%.

Chart III.3.8 **Movements in RSD/USD and EUR/USD exchange rates**



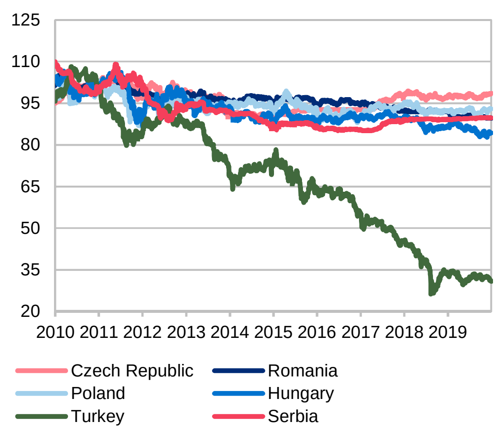
Source: NBS.
* USD 1 in RSD.
** USD 1 in EUR.

Chart III.3.7 **Movements in EUR/RSD exchange rate and NBS FX interventions**



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

Chart III.3.9 **Movements in exchange rates of national currencies against the euro***
(daily data, 31 December 2010 = 100)



Sources: NBS and websites of central banks.
* Growth indicates appreciation.

[17] Aiming to balance their open long FX position thus reducing FX risk exposure, the banks sell foreign currency which results in the dinar's appreciation.

[18] Excluding the NBS.

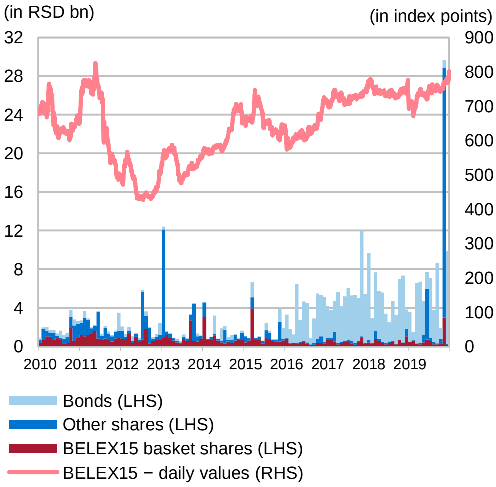
Stock exchange trends

Though the prices of shares were falling at the beginning of the year, by end-2019 they were on the rise. At end-2019 BELEX15 measured 801.7 index points, up by 5.3% from end-2018, while the general index BELEXline went up by 8.6%, reaching 1,726.8 index points in December. The Belgrade Stock Exchange indices reflected most of stock exchange indices in the region which were higher in December 2019 than at end-2018. The Skopje and Sarajevo stock exchanges recorded the strongest rise in indices (34.0% and 29.0%, respectively), whereas only the Sofia stock exchange index declined (4.4%).

The total shares trading of RSD 40.7 bn was more than five times higher than in 2018. However, block transactions of a single issuer in November accounted for around 71% of the trading. Excluding those transactions, shares trading almost doubled in 2019. Foreign investors participated in total trading of shares with around 43.1% as net sellers of shares. Trading of shares from the BELEX15 basket accounted for 18% of trading.

The entire bond turnover in 2019 is attributable to trading in long-term RS bonds. Relative to 2018, bond turnover dropped by RSD 4.2 bn, to RSD 51.2 bn.

Chart III.3.10 **BELEX15 and Belgrade Stock Exchange turnover**



Source: Belgrade Stock Exchange.

In 2019 the BSE market capitalisation rose by RSD 46.9 bn, to RSD 569.6 bn, or 10.5% of annual GDP. This increase was supported by the higher value of shares in the open market segment (up by RSD 19.4 bn) and stronger capitalisation of the MTP[19] segment (up by RSD 23.3 bn).

4 Money and loans

Monetary aggregates M1, M2 and M3

Monetary aggregates recorded relatively high y-o-y growth rates[20] throughout the year with positive contributions from economic and credit activity growth. Higher government deposits in the banking system, on account of a responsible fiscal policy and fiscal surplus, worked in the opposite direction.

The broadest monetary aggregate, M3, was higher by 8.4% in 2019 with more than three quarters of growth stemming from the dinar component.[21] The achieved macroeconomic stability reflected in low and stable inflation, anchored inflation expectations and relative exchange rate stability resulted in a higher degree of dinarisation of corporate and household deposits in 2019 (by 2.9 pp, to 35.1%).

In terms of components, sight deposits recorded the highest growth (by RSD 84.3 bn). Positive labour market trends (rise in wages and employment) brought about higher transaction household deposits (by RSD 55.3 bn). At the same time, economic acceleration in the second half of the year boosted corporate deposits (by RSD 38.3 bn) with the most striking rise in deposits of companies operating in construction, trade and real estate business.

Dinar term deposits went up by RSD 57.5 bn owing largely to the growth in dinar household savings (by RSD 18.5 bn to maximum RSD 79.0 bn[22]). Increased confidence in the domestic currency reflected in dynamic growth in dinar household savings for the second year in a row (22.2% in 2018 and 30.7% in 2019) is a result of the stable macroeconomic environment, more favourable interest rates and a better tax treatment of dinar relative to FX savings. Dinar term deposits of the corporate sector also increased, by RSD 13.3 bn, owing mainly to manufacturing and construction companies. An increase was also recorded in all other sectors.

[19] MTP is a multilateral trading platform. It is set up by the Belgrade Stock Exchange and incorporates shares of companies that are currently not eligible for regulated market listing.

[20] In December M1, M2 and M3 increased by 14.0%, 16.6% and 8.4% y-o-y, respectively.

[21] Partly also owing to the high base in FX deposits.

[22] Including only resident assets. Dinar savings (non residents' assets included also) reached RSD 79.6 bn at end-2019.

Table III.4.1 **Monetary survey**
(in RSD bn)

	Dec. 2018	Dec. 2019	Changes in 2019
Net foreign assets	**1,115,637**	**1,287,399**	**171,762**
Bank net foreign assets	-223,347	-295,486	-72,139
Net domestic assets of the banking sector	**1,490,216**	**1,536,147**	**45,931**
Net domestic loans	2,607,225	2,692,633	85,408
Net claims on government	345,646	225,087	-120,559
Government loans	646,691	677,272	30,581
Government deposits	-301,045	-452,185	-151,140
Loans to other resident sectors	2,261,579	2,467,546	205,967
Loans to households	1,017,998	1,112,000	94,002
Loans to the corporate sector	1,188,180	1,291,149	102,969
Loans to other financial corporations	27,068	31,471	4,403
Loans to local authorities	26,730	30,961	4,231
Loans to non-profit and other organisations	1,603	1,964	362
Other net assets	-1,117,009	-1,156,486	-39,477
Money supply M3	**2,605,853**	**2,823,546**	**217,693**
Money supply M2	1,017,826	1,186,596	168,770
Money supply M1	792,332	903,603	111,271
Currency in circulation	182,615	209,568	26,953
Sight deposits	609,717	694,035	84,318
Dinar savings and term deposits	225,494	282,994	57,499
FX deposits	1,588,027	1,636,949	48,923

Source: NBS.

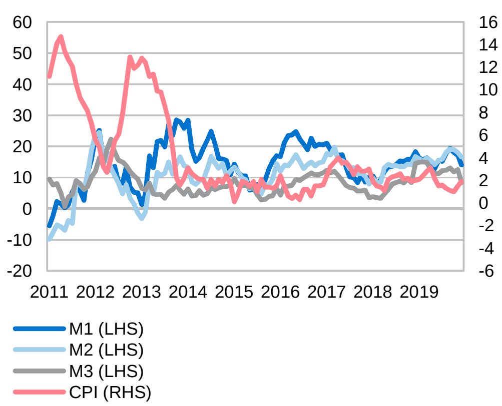
FX deposits rallied by EUR 484.8 mn, driven by the growth in FX household savings (by EUR 825.6 mn), to the maximum EUR 10.5 bn.[23] FX deposits of corporates were reduced by EUR 321.5 mn as a result of the transfer of funds to the government in April, for the Nikola Tesla Airport concession, while FX inflows from exports, FDIs and external borrowing of companies worked in the opposite direction.

Bank loans

Stable and sustainable growth in total domestic loans continued in 2019. Excluding the exchange rate effect,[24] it equalled 9.8% (9.2% in nominal terms) and was among the highest in the region. Almost two-digit growth rate of credit activity was achieved despite a relatively high base in 2018. Unlike 2018, in 2019 growth was boosted more by corporate than household lending (4.9 pp vs. 4.6 pp contribution). The structure of loans remained favourable and supportive of sustainable growth, owing primarily to increased loans for investments of companies and the rise in housing loans of households.

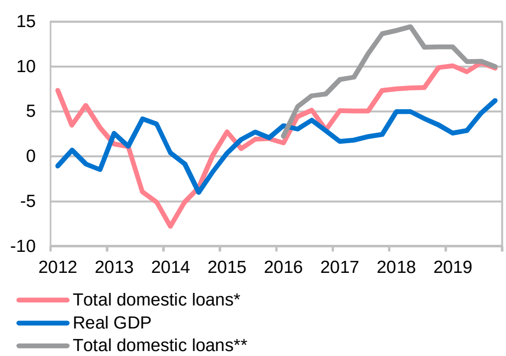
Lending was mostly financed from domestic sources. Banks' credit potential received the greatest positive contribution from higher non-monetary sector deposits[25] and capital increases, along with the rise in net external liabilities (due to an increase in external liabilities and a decrease in external receivables).

Chart III.4.1 **Monetary aggregates and CPI**
(y-o-y rates, in %)



Sources: SORS and NBS.

Chart III.4.2 **Lending activity and GDP**
(y-o-y rates, in %)



Sources: NBS and SORS.
* Excluding the exchange rate effect.
** Excluding the effect of NPL write-off and sale since early 2016.

[23] To EUR 10.8 bn (including non-residents' assets),

[24] Calculated at the dinar exchange rate against the euro, Swiss franc, US dollar, as at 30 September 2014, taking into account the currency structure of loan receivables.

[25] Nevertheless, in 2019 the LtD ratio increased by 0.7 pp., to 93.1% owing to a faster rise in loans than in deposits.

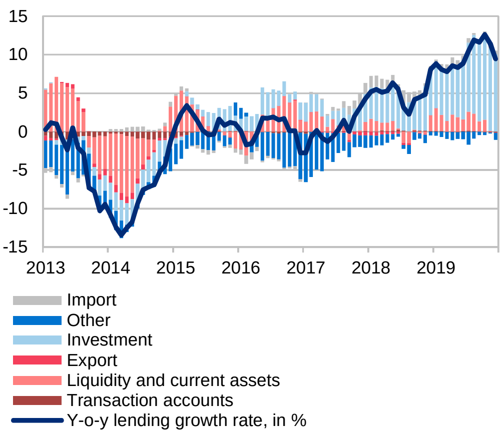
Excluding the exchange rate effect, corporate loans went up by RSD 108.9 bn or 9.5% in 2019. The entire rise in corporate loans in 2019 is attributable to investment loans, which have been one of the more important sources of financing investments ever since 2015, i.e. since the start of the investment cycle. At the level of the year, these loans went up by 25.6% and their share in total corporate loans reached 45.2%. On the other hand, current assets loans stagnated, while their share in total corporate loans contracted to 39.1%. Lending to corporates operating in almost all sectors increased, and the sharpest rise was recorded in construction and real estate business, transport and trade.

The volume of new corporate loans in 2019 (RSD 1,076.0 bn) increased by 15.1% relative to 2018. Of this, the amount of new investment loans (RSD 360.6 bn) was 48.6% higher than in 2018, with almost 70% of loans granted to micro, small and medium-sized enterprises. The disbursement of current assets loans (RSD 497.7 bn) went up by 2.0% and the highest amounts were disbursed by large and medium-sized enterprises.

The NBS bank lending survey[26] indicates that banks further eased their corporate credit standards in 2019, affected largely by the competition in the banking sector, positive expectations regarding the general economic situation, greater risk appetite and lower required collateral risk. In 2019, banks extended maximum loan maturity. In Q2, they eased collateral requirements, while price conditions for loans were tightened. More favourable borrowing conditions primarily concerned SMEs, the main drivers of the growth of corporate demand for loans. The growth in demand was driven primarily by the need to finance current assets and capital investment, and to a lesser degree by the activities associated with company acquisitions/mergers and debt restructuring.

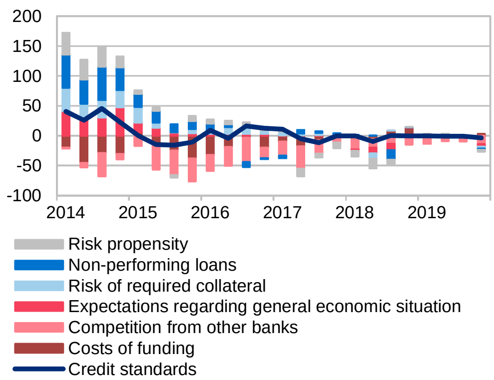
Excluding the exchange rate effect, household loans increased by RSD 100.8 bn or 10.0% in 2019, driven by cash and housing loans. Cash loans went up by RSD 75.4 bn in 2019. With the share of 43.9% in December, this category remained the dominant category of household loans. Owing to NBS measures aimed at limiting unsecured household loans with unreasonably long maturities, applied since early 2019, during the year the maturity of non-purpose loans intended for consumption, primarily cash loans, was reduced to less than eight years[27]. At the same time, positive labour market trends and the recovery of the real estate market contributed to the growth in housing loans, which was higher than in 2018 if we exclude the effect of the write-off of 38% of the value of loans indexed to Swiss francs on conversion to euro-indexed loans.[28] In December 2019, housing loans accounted for 36.2% of total household loans. On

Chart III.4.3. **Contributions to y-o-y corporate lending growth**
(in pp, excluding the exchange rate effect)



Source: NBS.

Chart III.4.4 **Change in corporate credit standards and contributing factors**
(in net %)



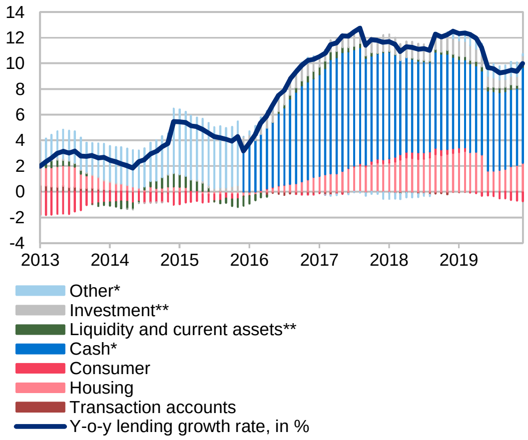
Source: NBS.
Note: Growth indicates the tightening, and decline indicates the easing of credit standards.

[26] The NBS conducts the survey since early 2014 on a quarterly basis. Participation is voluntary and the response rate almost 100%.

[27] The share of loans with maturity over eight years was reduced from over 30% in early 2019, to 19.6% in December.

[28] In accordance with the Law on the Conversion of Housing Loans Indexed to Swiss Francs (RS Official Gazette, No 31/2019).

Chart III.4.5 **Contributions to y-o-y household lending growth**
(in pp, excluding the exchange rate effect)



Source: NBS.
* Until December 2015, the contribution of cash loans is shown within the contribution of other loans.
** Loans extended to entrepreneurs.

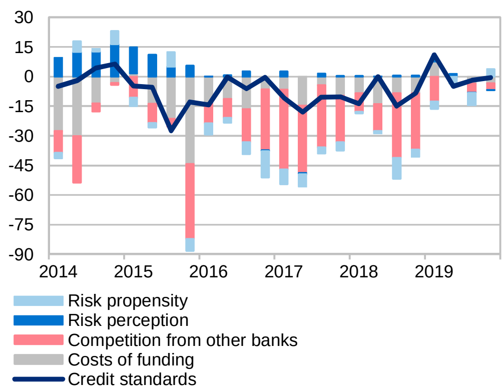
the other hand, receivables from consumer loans, current account overdrafts and credit card borrowing went down.

The volume of new household loans in 2019 (RSD 535.2 bn) expanded by 13.1% relative to 2018, with the maintained dominance of cash loans (55.6%), though somewhat less pronounced than in 2018. At the same time, positive labour market trends and the recovery of the real estate market reflected on the disbursement of new housing loans, whose amount, excluding refinancing loans with the same bank, was 23% higher in 2019 than in 2018.

Bank lending surveys indicate that household credit standards were eased in Q2 and Q3, after tightening in Q1 under the impact of the reduced maximum maturity of unsecured loans intended for consumption. The standards were eased primarily owing to interbank competition and increased risk propensity, and in H2 due to less expensive sources of funding, and positive expectations regarding economic growth. Borrowing terms for households were more favourable due to lower interest margins and associated costs, and relaxation of collateral requirements. According to survey results, household demand continued to expand, and the greatest demand was registered for dinar cash loans and refinancing loans, as well as FX-indexed housing loans. The need for real estate purchases and refinancing of existing liabilities, along with rising wages, employment and positive developments in the real estate market also contributed to higher loan demand.

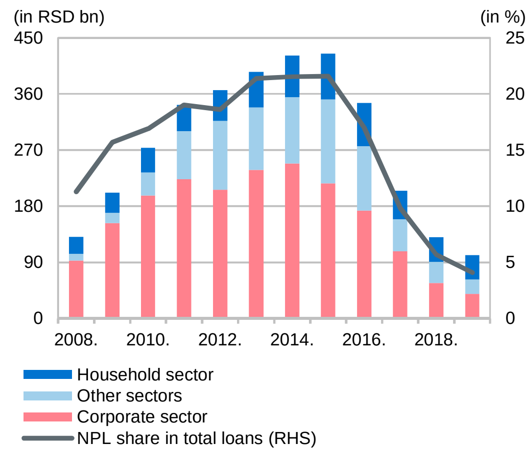
In late 2019, the share of NPLs in total loans declined to the lowest level since this indicator of asset quality is monitored, which additionally strengthens financial stability and creates room for further credit growth. Namely, the share of NPLs in total loans came at 4.1% in

Chart III.4.6 **Change in household credit standards and contributing factors**
(in net %)



Source: NBS.
Note: Growth indicates the tightening, and decline indicates the easing of credit standards.

Chart III.4.7 **NPL share in total loans, gross principle**



Source: NBS.

December, down by 1.6 pp from end-2018.[29] The drop was a result of stronger economic and credit growth, on the one hand, and on the other, of the successful implementation of the NPL Resolution Strategy owing to which the amount of write-offs and sales of these loans was several times lower in 2019 than in previous years. The NPL share in corporate loans declined by 1.8 pp, to 3.2%[30] and in household loans by 0.4 pp, to 3.9%.[31] NPL coverage remained high. In December, total allowances for loan impairment came at 84.2% of NPLs, while allowances for impairment of NPLs equalled 61.5% of NPLs. High capitalisation and resilience of the banking sector (8.0% regulatory minimum) are confirmed by the **capital adequacy ratio**[32] which, according to the latest available data as at end-2019 equalled 23.4%.

5 Dinarisation

In 2019, the NBS continued to implement activities aimed at bolstering the use of the dinar in the Serbian financial system.

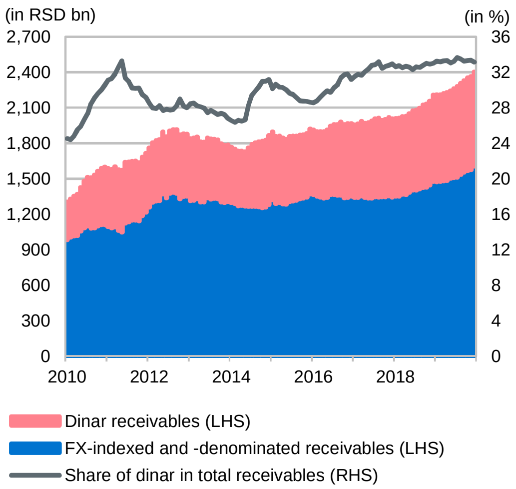
Monetary policy measures implemented by the NBS helped preserve price stability, relative stability of the EUR/RSD exchange rate and the stability of the financial system, this being the key precondition for building up confidence in the dinar.

The reserve requirement policy was used to further encourage banks to rely more on dinar sources of funding. The required reserve ratios on dinar sources of funding remained significantly lower than those on FX and the NBS offers remuneration on required reserves in dinars only, and not in foreign currency.

The NBS continued to develop basic FX risk hedging instruments. In 2019, regular two-week and three-month FX swap auctions were organised, encouraging interbank swap trading and the development of instruments for liquidity management and FX risk hedging.

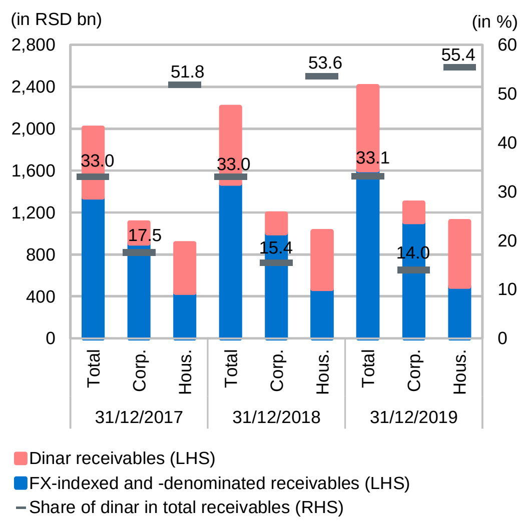
At end-2019 the NBS adopted a series of prudential measures in the area of capital adequacy and risk management, aimed at reducing the currency risk and increasing the dinarisation of the financial system. Namely, as of 1 July 2020 banks will allocate fewer resources for covering the risk on account of dinar receivables approved to SMEs and entrepreneurs than on account of FX and FX-indexed receivables. In parallel, a possibility for a bank capital decrease is envisaged if the share of new non-purpose and non-investment, FX-

Chart III.5.1 **Share of dinar receivables in total corporate and household receivables**



Source: NBS.

Chart III.5.2 **Receivables by sector**



Source: NBS.

[29] By 18.3 pp lower than in July 2015, i.e. just before the start of implementation of the NPL Resolution Strategy.
[30] Includes companies and public enterprises. Looking only at companies, the share of NPLs in total loans came at 3.3% in December, down by 1.9 pp from December 2018.
[31] With entrepreneurs and private households included, the share decreased by 0.5 pp to 4.0%.
[32] The regulatory framework of Basel III standard came into force on 30 June 2017.

indexed loans and loans in foreign currency granted to certain client categories exceeds the defined level, which will discourage the approval of FX loans.[33]

The degree of dinarisation, **measured as the share of dinar in total corporate and household receivables**, increased by 0.1 pp in 2019, to 33.1% at end-December.

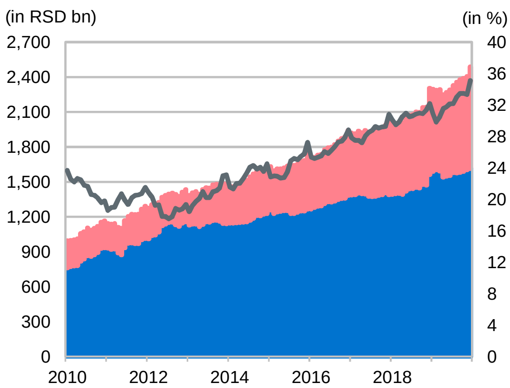
Increased dinarisation of receivables in 2019 reflects a rise in household loans, which are still typically approved in dinars. FX-indexed household loans also rose, owing to more frequent approval of housing loans, underpinned by positive labour market trends, favourable real estate market developments and relatively favourable borrowing conditions amid rising interbank competition. A more prominent rise in dinar than in FX-indexed receivables led to the continued growth in the dinarisation of household receivables in 2019. At the end of the year this indicator measured 55.4%, up by 1.8 pp from end-2018. This is the highest level of this indicator since its monitoring began in June 2008.

The degree of dinarisation of corporate receivables measured 14.0% at end-2019, down by 1.4 pp from end-2018. The degree of dinarisation of corporate receivables declined due to the rise in FX-indexed and FX loans, driven particularly by a striking increase in investment loans in the current investment cycle (primarily granted with a currency clause). As of May 2019, investment loans became the most dominant loan category, with a 45.2% share in total corporate receivables at end-2019. At the same time, the stock of liquidity and current assets loans, which continue to record a higher degree of dinarisation compared to loans for other purposes, is almost unchanged relative to end-2018. Furthermore, the degree of dinarisation of corporate receivables in 2019 continued to be dampened on account of bank activities aimed at NPL resolution such as write-off of receivables from companies in bankruptcy which are mainly in dinars.

Regarding the degree of dinarisation of deposits, **the share of dinar in total corporate and household deposits with banks** in 2019, continued to rise, reaching the highest level on record at the end of the year: 35.1%, up by 2.9 pp from end-2018.

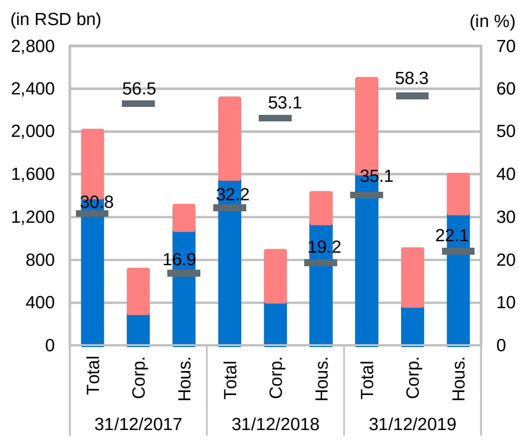
Sector-wise, the share of dinar in total household deposits equalled 22.1% at end-2019, the highest level on record. In 2019, this indicator increased by 2.8 pp, owing to the rise in dinar transaction deposits of households, as well as to continued dynamic growth in dinar savings. Relative to

Chart III.5.3 **Share of dinar deposits in total corporate and household deposits**



Source: NBS.

Chart III.5.4 **Deposits by sector**



Source: NBS.

[33] For more details see https://www.nbs.rs/internet/english/scripts/showContent.html?id=15075&konverzija=no

end-2018, growth in dinar savings equalled RSD 18.5 bn (30.3%), which is the most vibrant growth since 2013.

The degree of dinarisation of corporate deposits also went up in 2019 (by 5.2 pp) to 58.3% as a result of the rise in dinar deposits, unlike FX deposits which shrank.

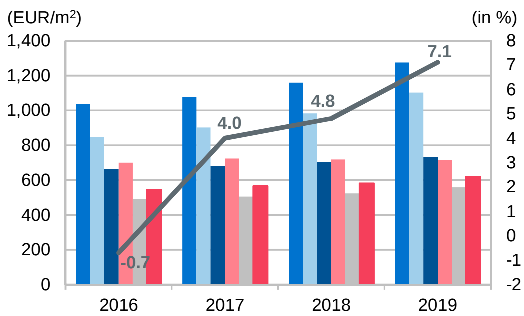
6 Real estate market

According to the Republic Geodetic Authority, the value of turnover in the Serbian real estate market totalled EUR 4.1 bn (up by 12%) in 2019, even though the number of sales contracts edged up only slightly (by 1.2% to 104,919) and this mostly owing to the boosted sale of newly constructed apartments (up by 16%).

A look at apartment prices in the largest Serbian towns[34] in 2019 reveals an average price of EUR 745 per square metre, which is by around 7% higher than a year earlier. As before, the average apartment price was the highest in Belgrade (EUR 1,274 per square metre). SORS data indicate that newly constructed apartments were sold at the average price of RSD 163,520 per square metre (EUR 1,387).

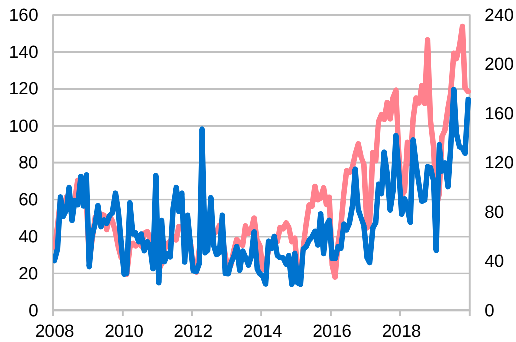
The number of issued construction permits in 2019 also points to continued recovery of the real estate market. Namely, relative to 2018 this number for residential construction increased by 27.9%.

Chart III.6.1 **Average prices of apartments by town**



Source: Republic Geodetic Authority.

Chart III.6.2 **Indices of the number of issued construction permits for new construction**
(quarterly averages s-a, 2018 = 100)



Sources: SORS and NBS calculation.

The demand for housing loans increased in response to positive labour market trends, eased credit standards for households and more favourable borrowing terms. According to the Republic Geodetic Authority, the number of loan-financed apartment purchases went up from around 25% in 2018 to around 30% in 2019.

7 Inflation expectations

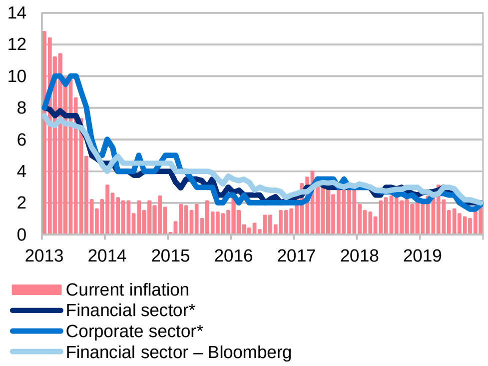
As a result of the maintained macroeconomic, fiscal and financial stability, as well as of the continuously increasing credibility of the Serbian central bank, inflation expectations of the financial and corporate sectors moved within the inflation target band in 2019. Anchored inflation expectations contribute to monetary policy efficiency and indicate market participants' confidence in the measures taken by the NBS.

According to the results of surveys carried out by Ipsos and Bloomberg, **one-year ahead inflation expectations of the financial sector moved within the target band** (3±1.5%) **in the whole of 2019.** Ipsos results indicate that these expectations edged up mildly in H1, peaking at 3.0% in May[35], receding gradually thereafter to the level of 2.0% in September and in Q4. Similar dynamics is suggested also by Bloomberg results – from 2.7% in January, inflation expectations of the financial sector declined to 2.0% in December. Looking at a longer time interval, one-year ahead inflation expectations of the financial sector have been within the NBS target band

[34] Belgrade, Novi Sad, Niš, Kragujevac, Subotica and Čačak.

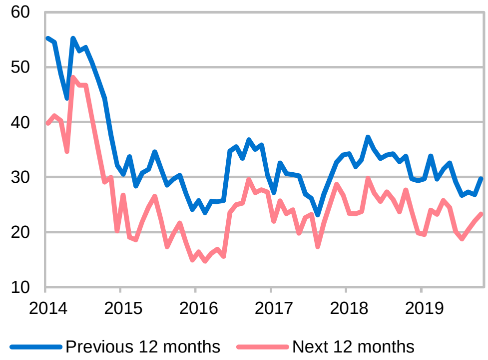
[35] 2.7% in January.

Chart III.7.1 **Current inflation and one-year ahead inflation expectations***
(y-o-y rates, in %)



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

Chart III.7.2 **Inflation perceived and expected by households***
(in index points)



Sources: Ipsos/Ninamedia and NBS.
* Ipsos until December 2014, Ninamedia since December 2014, and Ipsos since January 2018.

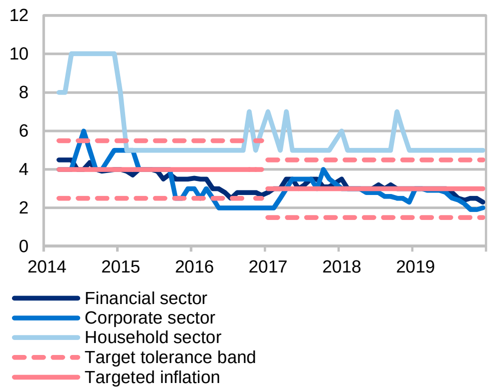
since October 2013. The confidence of the financial sector that price stability will be maintained is also reflected in much lower dispersion of individual expectations of financial sector representatives.

Short-term inflation expectations of the corporate sector indicated somewhat lower inflationary pressures, as they followed the dynamics of financial sector expectations, as well as the current inflation profile. During the year corporate one-year ahead inflation expectations ranged between 1.6% and 2.6%. In December they touched 1.9%.

Usually higher than those of other sectors, **inflation expectations of households** were stable at 5.0% for the major part of the year[36]. At the same time, the **results of the qualitative survey of household inflation expectations**[37] show that the index of perceived inflation continued to record higher values than the index of expected inflation, indicating that households expect inflation to be lower in the next 12 months than in the past year.

Medium-term inflation expectations of the financial and corporate sectors continued to move within the NBS target band in 2019. In H1, two-year ahead inflation expectations of the financial sector were stable at 3.0%, but then receded gradually in H2, to 2.3% in December. Corporate expectations also moved in the lower part of the target band – retreating steadily from 3.0% in January to 2.0% in December. At the same time,

Chart III.7.3 **Two-year ahead inflation expectations***
(y-o-y rates, in %)



Sources: Ipsos/Ninamedia and NBS.
* Ipsos until December 2014, Ninamedia since December 2014, and Ipsos since January 2018.

medium-term inflation expectations of households were stable at 5.0% throughout the year.

8 Fiscal trends

In 2019 as well, the **fiscal result** was better than planned – general government deficit amounted to RSD 11.1 bn or 0.2% of GDP compared to the 0.5% of GDP envisaged by the Fiscal Strategy. Excluding interest expenses, public finances recorded a surplus of RSD 97.2 bn (1.8% of GDP).

[36] Except in January, April and June when they equalled 6.0%

[37] For more information on qualitative inflation expectations of households, see *Inflation Report – February 2016*, Text box 2, p. 15.

Positive fiscal trends continued in 2019 on the back of growing economic activity and the consequently increased profitability of the corporate sector, favourable developments in the labour market, as well as a lower cost of government borrowing achieved owing to the NBS's monetary policy easing, a lower country risk premium and improved credit rating. Fiscal overperformance in H1 created room for an additional increase in government capital expenditure and an increase in public sector wages starting from November, which buoyed investment and consumption, though not to the extent that would threaten the main medium-term fiscal policy objectives or give rise to any major inflationary pressures.

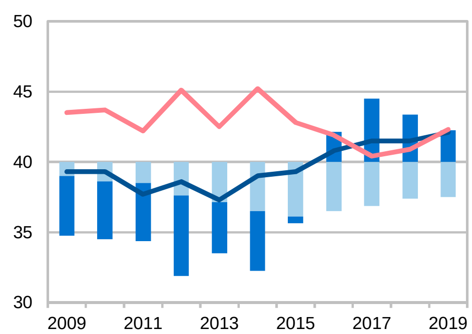
Consolidated revenue in 2019 (42.1% of GDP) was by 6.2% higher in real terms than in 2018, as a result of higher tax receipts. The largest boost to the growth in tax receipts came from mandatory social insurance contributions (2.1 pp) and income tax (1.0 pp) due to rising wages and employment, and from VAT receipts (1.9 pp) amid higher final consumption. Growth was recorded also for receipts from profit tax (0.6 pp) owing to higher corporate profitability in 2019, as well as for excise tax revenue (0.5 pp) amid a concurrent increase in the consumption of petroleum products and stabilisation of tobacco trade, following a slump in 2018, and the regular excise tax adjustment. Only non-tax revenue recorded a fall in real terms (by 1.2%), attributable in part to the reduced payment requirement on account of the wage cut in public enterprises.

Consolidated expenditure in 2019 amounted to 42.3% of GDP and was up by 8.4% in real terms relative to 2018. Its growth (more than one third) can be put down to capital expenditure which rose by 31.2% in real terms to 4.9% of GDP. A part of the fiscal space was used for a targeted increase in public sector wages and pensions (contributing to total expenditure growth 1.8 pp and 1.2 pp respectively). At end-2019, employee expenses accounted for 9.5% and budget allocations for pensions for 10.3% of GDP. Growth was registered also for outlays for the purchase of goods and services (1.4 pp) and subsidies (0.4 pp), while a real decline was seen in called guarantees and interest expenses. Interest expenses declined by 1.6% in real terms as a result of smaller government borrowing needs and lower cost of borrowing, underpinned by the NBS's monetary policy easing and the fall in the country risk premium.

Investor confidence in the reforms implemented over the past years, reflected in greater interest in government securities, was confirmed also in the international financial market by the successful **issue of ten-year eurobonds** in June in the nominal amount of EUR 1 bn, at the rate of 1.619% (1.5% coupon rate). On the November re-opening of the issue, additional EUR 550 mn worth of bonds was sold at even more favourable conditions than in June – at the rate of 1.25%. The funds raised were used for the early repayment of a portion of eurobonds maturing in 2020 and 2021, which means that public debt did not increase on this account.

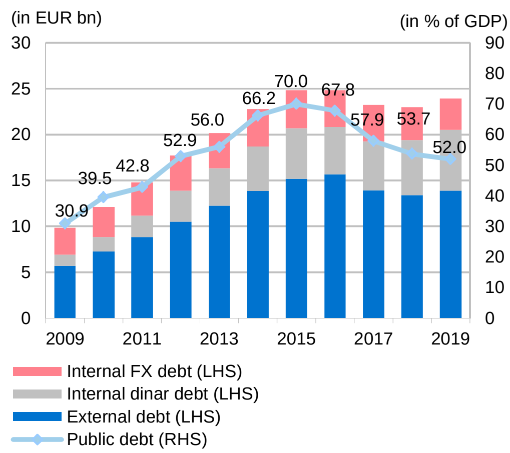
Owing to narrowed fiscal imbalances, the **share of** central government **public debt** in GDP contracted by 1.7 pp to 52.0% at end-2019. Of total public debt, 72.3% was in foreign currency. The share of US dollar-denominated debt was scaled down to 20.1%, which helped ease the urency and refinancing risks further.

Chart III.8.1 **Fiscal revenues, expenditures and result**
(in % of GDP)



Source: Ministry of Finance.

Chart III.8.2 **Public debt***



Source: Ministry of Finance.
* Central government.

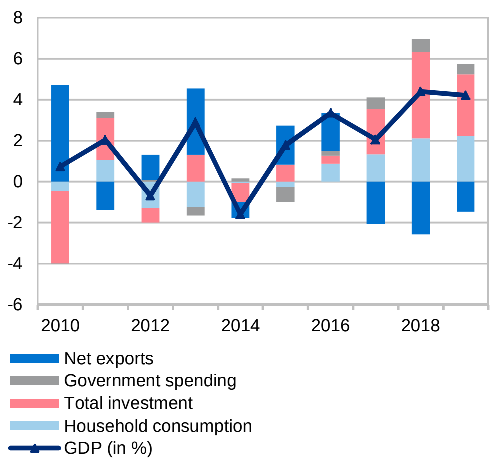
9 Aggregate demand

In 2019, economic growth of 4.2% was fully led by domestic demand, primarily by investment, as domestic factors successfully compensated for the lower external demand. Due to the high share of the imports of equipment and intermediate goods, net exports provided a negative contribution despite continued vibrant export growth.

Domestic demand

Thanks to intensive implementation of infrastructure projects, favourable investment environment and financial conditions, for the second year in a row **fixed investment** rose at a two-digit rate, which reached 16.4% in 2019 (adding 3.6 pp to GDP growth). Fixed investment thus largely compensated for the effects of decelerating external demand. Its share in GDP, in 2019 alone, edged up by 2.5 pp to 24.3%. One third of investment growth in 2019 referred to government investment, which increased around 30% in real terms, primarily owing to faster implementation of transport infrastructure projects. Private investment posted robust growth, almost to the same extent as in the year before (13.4%), supported by the favourable macroeconomic environment and low cost of borrowing. This is confirmed by the higher production of machinery and equipment (3.3%), growth in equipment imports of around 20%, and construction indicators. The value of construction works performed increased by around 35% at the annual level, supported by the construction of the TurkStream, while the number of issued construction permits rose by 12.1%. Positive movements in the construction sector are also signalled by the rise in the production of construction material, employment, effective hours worked and the number of completed apartments.

Chart III.9.1 **Contributions to annual GDP growth rate – expenditure side**
(in pp)



Sources: SORS and NBS calculation.

According to NBS estimate, investment was mainly financed from own sources, above all higher profitability of companies and rising FDI inflow (by 13.5%, to EUR 3.6 bn), thanks to favourable macroeconomic environment and investment climate. Also, more and more investment was financed from credit sources, as evidenced by the rise in the volume of investment loans with domestic banks of over 25% (RSD 115.9 bn) in 2019. The fourth important source of investment was government capital expenditure which increased in 2019, reaching 4.7% of real GDP (4.9% of nominal GDP).

Inventories worked in the opposite direction, giving a negative 0.6 pp contribution to GDP. It was mainly inventories of finished products in industry that declined, going down by 3.7% relative to end-2018.

Sustainable growth in **household consumption** extended into 2019, reaching 3.2% at the annual level and adding 2.2 pp to GDP growth. Household consumption expanded mainly on the back of continued positive trends in the labour market, reflected in the rising employment and higher average wages. This is confirmed by the real increase in the private sector wagebill of 15.6%, and in pension expenditure of 4.5%. Another source of the rising consumption were cash loans, going up by 18.4% at the annual level, reflecting more favourable terms of borrowing, supported by the NBS's monetary policy easing. On the other hand, net inflow of remittances from abroad was slightly lower than in the year before (by 1.3%).

The rise in household consumption is also indicated by the movement of key service sector indicators. In 2019, retail trade turnover increased by 9.7%, catering by 9.1%, and arrivals and overnight stays of domestic tourists by 7.2% and 6.8%, respectively.

GDP growth also received an impetus from **government consumption** (0.5 pp), which rose 3.0% in real terms in 2019. The rise in government consumption resulted from higher outlays for the purchase of goods and services and public sector wage expenditure. This was enabled by the elimination of fiscal imbalance and reduction of the public-debt-to-GDP ratio within sustainable boundaries.

Net external demand

In 2019, Serbia's commodity and services exports rose by 8.5% in real terms, driven by the growing exports in services, manufacturing and agriculture. However, the ongoing investment cycle and partly also the recovery of private consumption pushed the real growth in commodity and service imports (9.5%) above exports growth, hence net exports contribution to GDP movements in 2019 remained negative, albeit weaker than in 2018 (-1.5 pp vs. -2.6 pp).

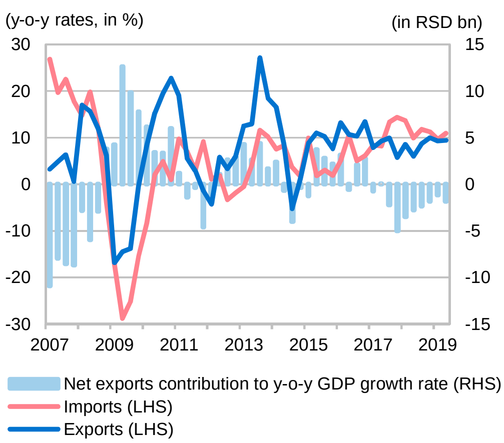
According to balance of payments data, commodity exports in euro terms posted relatively high growth in 2019 as well (8.8%), despite the slowdown in external demand and the working of specific factors, such as quotas on steel exports to the EU. External trade data suggest that the main contributor to exports growth was manufacturing, whose exports rose 7.2% y-o-y in 2019. Manufacturing exports growth remained widely dispersed (in 17 of the 23 areas), receiving a key impetus from the export of electrical equipment, machinery and equipment, and rubber and plastic products. The automobile industry remained a positive contributor, since lower export of automobiles was fully offset by the rising export of other manufacturers in the sector (by 13.1%), which pushed the automobile industry share in total exports in 2019 to 11.7%. Set against that, overhauls in the oil refinery in Pančevo and Petrohemija chemical industry in H1 dampened the export of petroleum and chemical products. Lower base metals exports compared to 2018 resulted from adjustment to the steel import quotas applied by the EU, which were largely offset by higher copper exports and partly also by steel exports to other markets. Thanks to a good agricultural season, robust growth was recorded for the export of both agricultural (21.9%) and food products (8.4%).

Commodity exports in euro terms rose by 9.2% in 2019, mostly owing to intermediate goods and equipment, whose import, consistent with investment growth, expanded by 6.0% and 21.8%, respectively. The import of consumer goods went up by 12.9%, signalling a recovery in household consumption. Similar trends are confirmed by the imports structure according to the EU classification into end-use categories, which shows that the greatest contributions to imports came from intermediate and capital goods, followed by non-durable consumer goods, while durable consumer goods and energy products gave a much lower contribution.

According to balance of payments data, the surplus in trade in services expanded further in 2019 (5.4%). Services exports was 15.0% higher, mostly spurred by the exports of business and ICT services, while services imports increased by 16.9%.

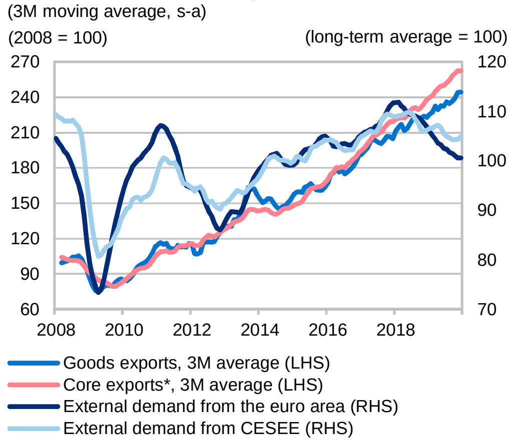
In 2019, the commodity exports-to-imports ratio measured 74.8%, or 83.9% if services are included, similar as at end-2018.

Chart III.9.2 **Export and import of goods and services**
(in previous-year constant prices, ref. 2010)



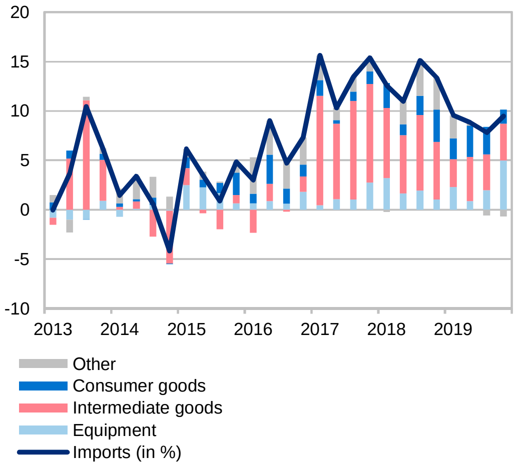
Sources: SORS and NBS calculation.
Note: NBS estimate for Q4 2019.

Chart III.9.3 **Movement of indicators of external demand for Serbian exports**
(3M moving average, s-a)



Sources: European Commission, SORS and NBS.
* Core exports are exports excluding the exports of agricultural products, base metals, motor vehicles, petroleum products and electricity.

Chart III.9.4 **Movement of key import components**
(contributions to y-o-y growth, in pp)



Sources: SORS and NBS calculation.

10 Economic activity

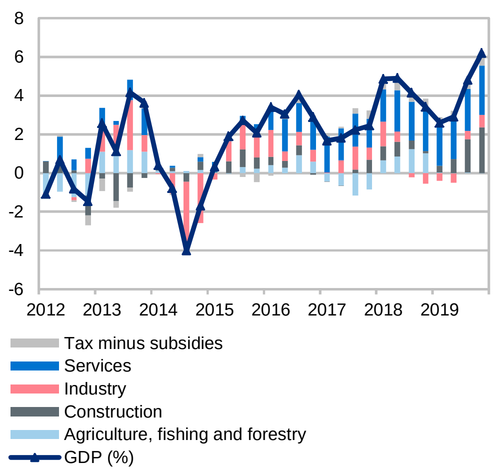
For the second year in a row, economic growth exceeded 4%, reaching 4.2% in 2019 according to SORS. The greatest impetus to growth came from above-average results in construction, as well as the expansion in the majority of service sectors, supported by positive labour market trends. A mild positive contribution also came from industrial production, despite the effects of decelerating external demand, 100% taxes on products delivered to Kosovo and Metohija, and the overhauls in the oil and chemical industries in H1.

In terms of growth dynamics throughout the year, H1 growth averaged 2.8%, while the expansion of production capacities in manufacturing and implementation of infrastructure projects led to a significant acceleration of economic activity in H2 – to 4.8% y-o-y in Q3 and 6.2% y-o-y in Q4. Thus, economic activity was on the rise for twenty consecutive quarters, approaching its potential in H2 2019.

At the annual level, **industrial production** recorded a 0.4% increase in gross value added, contributing to GDP growth by 0.1 pp. Slower growth compared to previous years is a consequence of deceleration of economic activity in the euro area, our most important foreign trade partner. The overhauls in the oil and chemical industries, as well as taxes on products delivered to Kosovo and Metohija reflected on industrial production in H1, primarily the food industry.

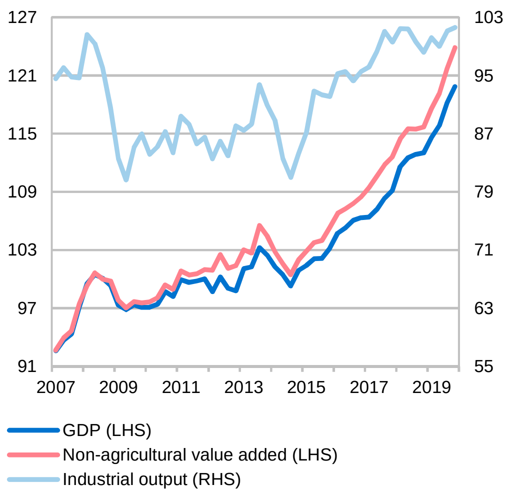
The physical volume of manufacturing edged up by 0.2% at the annual level, with one half of the 24 manufacturing branches posting growth. The greatest positive contributions came from the production of pharmaceutical and metal products (0.4 pp each), followed by rubber and plastic products and base metals (0.2 pp each). On the other hand, the greatest contraction was recorded in the production of food, as well as petroleum and chemical products.

Chart III.10.1 **Contributions to y-o-y GDP growth rate – production side**
(in pp)



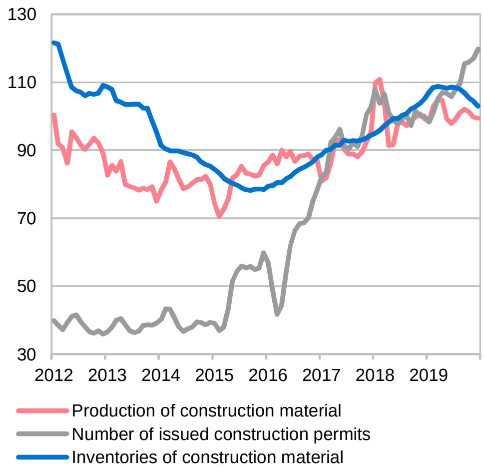
Sources: SORS and NBS calculation.

Chart IV.10.2 **Economic activity indicators**
(s-a, H1 2008 = 100)



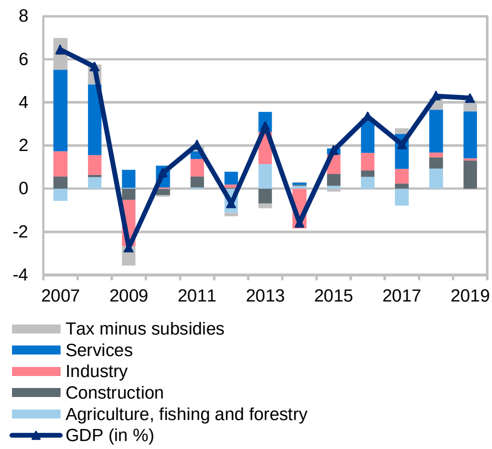
Sources: SORS and NBS calculation.

Chart III.10.3 **Construction activity indicators**
(quarterly averages s-a, 2018 = 100)



Sources: SORS and NBS calculation.

Chart III.10.4 **Contributions to annual GDP growth rate – production side**
(in pp)



Sources: SORS and NBS calculation.

The physical volume of production in the mining sector increased by 1.2%, despite the lower exploitation of metal ores and crude oil, while the volume of production in electricity, gas and steam supply edged up by 0.5%.

Faster implementation of infrastructure projects in the area of transport and energy, as well as the rise in residential construction, led to a 30.2% growth in **construction** in 2019, which added 1.3 pp to GDP growth. Strong growth is also confirmed by construction indicators – in 2019 the value of construction works performed went up by around 35%, while the number of issued construction permits increased by 12.1%. The production of construction material expanded by 2.7% and formal employment in construction by 13.4%, reaching the highest level in the last five years.

Favourable labour market trends, reflected in lower unemployment and higher employment and wages, led to stable growth in consumption, which in turn supported activity in the **service sectors**. They aggregately expanded by 4.2%, giving a 2.2 pp contribution to GDP growth. Sector-wise, the greatest contribution to GDP growth came from trade (0.6 pp), as confirmed by the real growth in retail trade turnover of 9.7%. Speaking of tourism indicators, catering turnover increased by 9.1% and the number of tourist arrivals and overnight stays by 7.6% and 7.9%, respectively.

Given the above-average **agricultural output** for the second consecutive year, the contribution of agriculture to economic growth is estimated to have remained neutral in 2019.

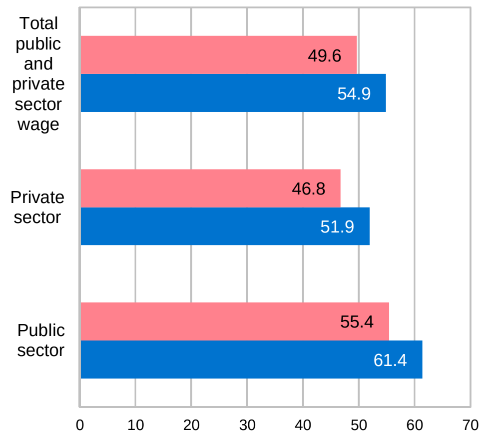
11 Wages and employment

In 2019, the domestic labour market continued to support economic growth through a **further rise in wages and employment, as well as a fall in the unemployment rate** to a single-digit level. Since the labour market reform in 2014, formal employment in the private sector increased by over 230 thousand, while registered unemployment shrunk by as much as one third. In addition, total nominal net wage in December 2019 reached RSD 59,772 or EUR 510, its highest level since comparable data are available.

Increase in the minimum wage early last year and accelerated economic growth in H2 contributed to a significant rise in the average nominal net wage, which in 2019 equalled RSD 54,919, up by 10.6% compared to the 2018 average. This was primarily a result of further **growth in wages in the private sector, as well as the increase in public sector wages**. Against the backdrop of continued economic growth and created fiscal room, in late 2019 the Serbian Government decided to raise the minimum wage once again, from RSD 155.3 to RSD 172.5 per hour, effective as of early 2020.

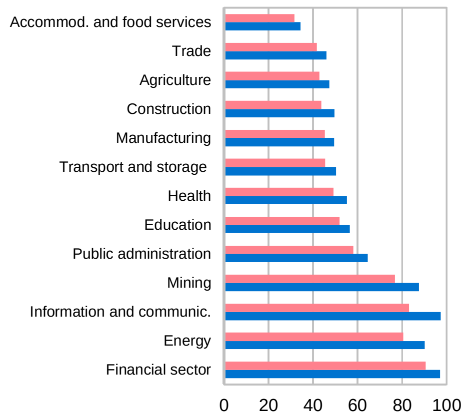
Wage growth remained widely dispersed in 2019 as well, as confirmed by **higher wages in all economic sectors**, primarily in industry (mining, energy and manufacturing) and services (information and communications, construction, transport and trade). Apart from activities dominated by the private sector, in 2019 wages also increased in public administration, health and education,

Chart III.11.1 **Average nominal net wage**
(in RSD thousand)



Source: SORS.

Chart III.11.2 **Nominal net wage by economic sector**
(in RSD thousand)



Source: SORS.

dominated by the public sector, which was supported by the Government's decision to raise public sector wages by 8–15% (as of November).

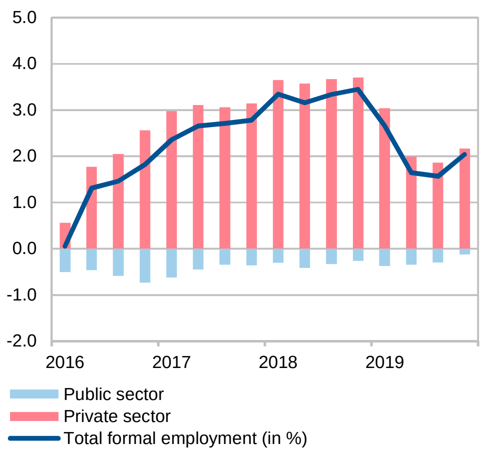
As a dominant source of consumer demand, the total nominal net wagebill rose 14.6% in 2019, thanks to the nominal wage growth in all sectors and higher formal employment in the private sector. With economic activity rising faster than employment, the overall economic productivity increased by 2.2% in 2019.

Apart from wage growth, **overall formal employment also went up**, on average by 2.0% in 2019, i.e. around 42 thousand of newly employed persons. According to the SORS data obtained from the Central Registry of Compulsory Social Insurance, the increase in formal employment was mostly spurred by the further hiring by legal persons and private entrepreneurs. On the other hand, a smaller number of individual agricultural producers and employees in agriculture was recorded.

For an extended period of time, **the rise in private sector employment** (by 3.2% in 2019) **has been the main source of growth of overall formal employment**, primarily in manufacturing and construction, as well as in the rest of the services sector (accommodation and food, information and communications, wholesale and retail trade), which have been the key driver of economic growth. Conversely, activities which predominantly belong to the public sector recorded employment cuts (by 1.0% in 2019), due to the continued downsizing.

In parallel with employment growth, **a years-long trend of decline in registered unemployment also continued**.

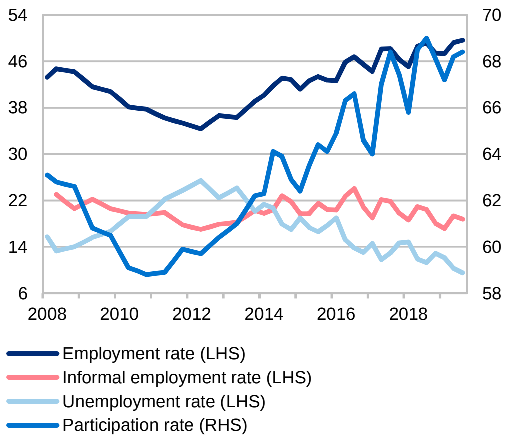
Chart III.11.3 **Composition of y-o-y growth in formal employment**
(in pp, average for the period)



Sources: SORS and NBS calculation.

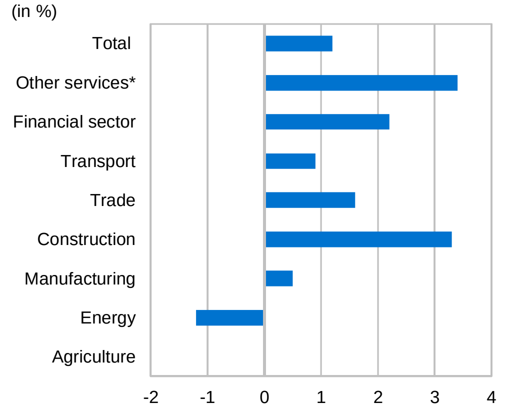
According to the National Employment Service data, the overall unemployment in December 2019 equalled 506,865, which is almost 46 thousand unemployed persons fewer than a year before. This was aided by **a smaller number of the unemployed in all groups of occupations**, from the sector of industry (mechanical engineering and metal processing, electrical engineering, chemicals and non-metals, etc.), to occupations related to trade, catering and tourism, and finally agriculture and food production, construction and transport. Compared to 2014, when labour market reforms were initiated, the number of unemployed persons on average decreased by one third, or close to 240 thousand persons, which was

Chart III.11.4 **Labour market indicators under the Labour Force Survey**
(in %)



Source: SORS.

Chart III.11.5 **Realized net job creation rates in 2019**
(in %)



Sources: Central Registry of Mandatory Social Insurance, Employer Survey (NES).
* Other services include: professional activities, administration, health and art.

supported by the improvement in the business and investment environment in Serbia, and the implementation of active employment measures and programmes in the labour market.[38]

The results of the **Labour Force Survey**, which covers the formal and informal segment of the labour market, also indicate the continuation of favourable labour market trends. Hence, compared to 2018, the rate of participation of the working-age population (15–64 years) on average edged up by 0.3 pp to 68.1% in 2019, while in the same period the average employment rate went up by 1.4 pp to 49.0%. Previously, the **employment rate in Q4 reached the record level of 49.7%**. At the same time, the rate of informal employment in 2019 dropped by 1.3 pp to 18.2% on average, indicating lower engagement of employees outside formal employment contracts. At the level of 2019, the average unemployment rate measured 10.4% (down by 2.3 pp relative to 2018), dropping to a **single-digit level in Q3 (9.5%), for the first time since comparable data are available**. The rate of long-term unemployment[39] edged down by 1.5 pp to 6.1% on average, and the rate of youth unemployment by 2.3 pp to 27.6% on average, which confirms that unemployment decreased in all structures, including among the most vulnerable groups.

Table III.11.1 **Formal employment and unemployment**
(y-o-y growth rates, period average)

	2019			
	Q1	Q2	Q3	Q4
Total number of formally employed	2.7	1.6	1.6	2.0
Employed with legal persons	2.6	1.9	1.7	2.2
Entrepreneurs and their employees	5.3	2.8	3.0	3.4
Individual farmers	-8.3	-8.7	-8.6	-8.4
Unemployed	-9.1	-9.3	-9.5	-8.9
First-time job seekers	-1.6	21.1	26.1	32.9
Used to be employed	-12.7	-24.3	-27.2	-29.4

Sources: SORS and National Employment Service.

These results aro also supported by the data derived from the **Employers Survey**. Namely, in 2019 the gross job creation rate (17.0%) exceeded the gross job destruction rate[40] (15.8%), driven mainly by the opening of new jobs in services. On the other hand, it is difficult to predict the dynamics of job creation/destruction in 2020, given the anticipated consequences of the pandemic on the domestic labour market.

[38] Active employment measures and programmes among other include: job matching services, career guidance and counselling, support to self-employment, further education and training, special programmes for youth in transition from the education system to the labour market.

[39] The long-term unemployment rate is the percentage of persons who have been unemployed for one year and longer in the total active population.

[40] The gross job creation/destruction rate is the ratio of the number of newly employed/dismissed persons and the total establishment employment observed at the beginning of a year. The net job creation rate is the difference between the gross job creation and gross job destruction rates.

List of charts and tables

Charts

Tables

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