National Bank of Serbia

2021

January-June

SEMI-ANNUAL

MONETARY POLICY REPORT

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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 Semi-Annual Monetary Policy Report January–June 2021 was reviewed and adopted by the National Bank of Serbia's Executive Board on 9 September 2021.

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, PhD, Governor

Željko Jović, PhD, Vice Governor

Ana Ivković, PhD, Vice Governor

Dragana Stanić, MA, 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

The domestic macroeconomic conditions of monetary policy implementation were favourable since the start of the year despite the extended COVID-19 pandemic. This was supported primarily by successful vaccine rollout and the effects of robust monetary and fiscal stimuli in 2020 which sustained investment and consumer confidence, production capacities and jobs. A key role was also played by the macroeconomic, financial and fiscal stability achieved and maintained in the years preceding the pandemic.

Economic activity indicators outstripped expectations already from the second half of 2020. As a result, Serbia exceeded its pre-crisis economic activity level in the first quarter of 2021 already, sooner than most European countries and a quarter earlier than we anticipated. In the second quarter of the year, GDP was roughly 3% above its pre-crisis level. In y-o-y terms, GDP growth measured 7.6% in the first half of the year, according to SORS estimate. Robust growth was led by recovery in the service sectors, hit particularly hard by the crisis last year, as well as by an upturn in industry and construction. On the expenditure side, growth was guided by domestic demand, i.e. investment and consumption.

Annual GDP is expected to grow by 6.5%, led mostly by domestic demand. A key contribution to this ought to come from continued implementation of infrastructure projects, timely and adequate response of economic policy makers in Serbia and the resulting favourable terms of financing and preserved production capacities and jobs. In addition, higher export supply, together with a normalisation of global economic flows amid continued vaccination and the expected rebound in external demand, ought to lead to double-digit export growth and an improvement in the foreign trade deficit. In our judgement, the same factors, coupled with the expected further acceleration of implementation of new planned infrastructure projects (underground, railway construction and modernisation, motorways, fast roads, utility infrastructure) will contribute to a more favourable medium-term growth outlook. At this point, we therefore expect economic growth to move between 4% and 5% p.a. in the coming years, instead of 4% as we previously anticipated.

Thanks to the undertaken economic policy measures, the labour market averted major fallout from the pandemic. This is signalled by the total number of formally employed persons of 2.27 million in June, which represents a six-year high and is by 66 thousand persons more than in the same period last year. The average nominal net wage in the first half of the year increased by 8.6% y-o-y, with growth more pronounced in the private sector.

Despite the implementation of the third assistance package worth around 4.5% of GDP, fiscal trends in the first six months of the year were more favourable than expected, mostly because of better revenue performance thanks to a faster economic activity rebound. The share of general government deficit in GDP measured 1.3% in the first half of the year, while the Fiscal Strategy for 2022 with Projections for 2023 and 2024 puts it at 6.9% at the annual level. The third package of economic measures was tailored so as to provide maximum assistance to hardest affected sectors. The Fiscal Strategy plans a further increase in the share of capital expenditure to around 7% of GDP this year, supporting a rise in investment and potential output. Central government public debt measured 55% of GDP at end-June and is not expected to exceed the Maastricht criterion of 60% at the annual level. Though substantial money will be directed into infrastructure projects going forward as well, the

fiscal deficit is anticipated to contract gradually in the medium run and turn into a primary surplus, sustaining a return of public debt to a downward trajectory.

Goods and services export (27.3%) recovered faster than import (20.4%), mostly as a result of higher export supply thanks to earlier investment in tradable sectors and a rebound in external demand. Such trends, together with a recovery in foreign remittances inflow, led to a **further improvement of the external position and a narrowing of the current account deficit in the first half of 2021 compared to the same period in 2020.** The current account deficit measured EUR 518.4 mn (2.1% of GDP), down by EUR 728 mn from the same period last year. According to our projection, the current account deficit this year will measure around 4% of GDP, which is better than we anticipated, and there is a possibility of an even better outturn. In the medium term, as the investment cycle and related purchases of equipment from abroad continue, we expect the current account deficit to range between 4% and 5% of GDP, while remaining, as in the past six years, fully covered by net FDI inflow which will be additionally bolstered by large-scale investments in infrastructure. The rise in export capacities and the anticipated global economic recovery will continue to work towards improving the external position.

Capital inflow to Serbia remained relatively high, pushing up the country's FX reserves and strengthening its resilience to external risks. This was mostly due to FDI inflow which measured EUR 1.8 bn in the first six months, up by around 21% relative to the same period last year. FDI not only remained high but also diversified by product and geographical area. In the same period, inflow in respect of portfolio investment reached close to EUR 800 mn, resulting primarily from a successful issue of eurobonds with the longest maturity so far (12- year maturity) in the international financial market. The inclusion of dinar government bonds in the renowned J.P. Morgan index in late June, resulting from several years' committed efforts of the NBS and the Government of the Republic of Serbia, will help expand the base of foreign investors investing in dinar government bonds and deepen the domestic financial market, thereby ensuring higher capital inflows from abroad.

As a result of favourable balance-of-payments movements, appreciation pressures on the dinar prevailed from February. To ease excessive short-term oscillations of the dinar, the NBS bought EUR 320.0 mn, net, in the interbank foreign exchange market during six months, which additionally bolstered the country's FX reserves. As at 30 June 2021, gross FX reserves of the NBS measured EUR 14.1 bn, up by EUR 600 mn from end-2020. Such level is adequate and protects against external shocks, since it covers more than six months of import of goods and services, almost twice the standard on the adequate level of FX reserves. Consistent with the principles of security and liquidity, funds were invested in highly liquid securities issued by 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). At end of period, the dinar/euro exchange rate was unchanged (RSD 117.6 for EUR 1). The dinar weakened against the dollar by 3.1% due to the euro's slide against the dollar (to RSD 98.7 for USD 1 at end-June).

After measuring around 1.1% in the first two months of 2021, **y-o-y inflation returned within the bounds of the target tolerance band in March (1.8%)**. Like in other coutries of the region, under the impact of a low base for petroleum product prices and elevated global prices of oil and other primary commodities, y-o-y inflation accelerated during the second quarter and moved around the target midpoint. By contrast to cost-push pressures, demand-side inflationary pressures remained low as signalled by stable core inflation of around 2% since the start of the year.

Under the central August projection, y-o-y inflation will move within the upper part of the target tolerance band in the second half of this and the first quarter of next year. As the effect of transitory factors wanes (elevated global prices of primary commodities and cost-push pressures amid halts in global supply chains), inflation is expected to slow first from the second quarter of 2022 and then move within the lower part of the target tolerance band until the end of the projection horizon. That no major inflationary pressures are anticipated in the medium-run and that factors behind current inflation growth are temporary is **also confirmed by short and medium-term inflation expectations, as the financial sector anticipates inflation to be around the target midpoint, while the corporate sector expects it to be even lower.**

By contrast to some central banks in the region which in the second quarter began to reduce their monetary accommodation amid inflationary effects and factors from the domestic environment, **the NBS continued to pursue an accommodative monetary policy** and to be an equal partner of the Government of the Republic of Serbia in supporting corporates and households, against a background of preserved relative stability of the exchange rate and anchored inflation expectations. In the first half of 2021, the key policy rate was kept unchanged at 1.0%,

its level since December 2020. This is the lowest key policy rate level in the inflation targeting regime and 1.25 pp below its pre-pandemic level. In making this decision, the NBS Executive Board took into account the fact that most domestic factors still contribute to low and stable inflation, while international developments warrant caution in the conduct of monetary policy.

Thanks to the effects of past monetary policy easing, **the terms of borrowing in the domestic market remained favourable in the six months of 2021 as well**, continuing to bolster lending activity. Growth in lending to the non-monetary sector slowed as of early 2021 to 6.3% y-o-y in June, but this was expected and reflects the high base from last year, primarily due to the loan repayment moratorium. This is also indicated by the amount of new corporate and household loans, which in the first six months of 2021 was similar to the same period of 2019, and was by more than a fourth higher than in 2020. Such trends are also borne out by the results of the July Bank Lending Survey – loan demand continued up both in the corporate and household sectors, with banks easing standards for dinar loans. The NPL share in total loans equalled 3.6% in June. It was below the pre-pandemic level, suggesting that – owing to the timely and adequate measures of the NBS and the Government aimed at easing the pandemic's negative effects on corporate and household sectors – the quality of bank assets has been preserved and further reinforced.

The degree of dinarisation, **measured by the share of dinar in total bank receivables from corporates and households,** increased by 1.3 pp in the first half of 2021 to 38.6% in late June, its highest level on record. Dinarisation increased primarily as a result of elevated dinar corporate lending. Results in terms of the dinarisation strategy, implemented by the NBS and the Serbian Government, are also reflected in a growth of the share of dinar household deposits in total deposits to around 26.9% in June, and in the increase of the dinar share of public debt to 30.6% in late June.

In making the decision to keep the key policy rate unchanged, **the Executive Board was aware of the fact that developments in the international environment are still largely dependent on the course of the pandemic.** Though economic recovery remains uneven across countries, with a risk that it might undergo a slowdown due to new virus strains, the global economy's medium-term outlook is favourable thanks to the vaccination process. Potential risks to global economic growth may include disruptions in supply chains and imbalances in the labour market, as they increase production costs and lead to global concerns that inflationary pressures might rise. For the time being, accelerated growth in the euro area in the second quarter, coupled with higher inflation from the start of the year, is not driving the ECB towards a decision to reduce the level of monetary policy accommodation, because higher inflation factors are assessed as temporary. Also, the Fed believes that developments in the US economy still do not call for the withdrawal of central bank's support measures. Good prospects for global economic growth and announcements by leading central banks that their rates will remain low going forward have alleviated uncertainty in the international financial market to some degree, therefore financing conditions for emerging countries are still favourable. Uncertainty persists in the global commodity market, notably in terms of movements in the global oil price, which went up by more than 45% in the first half of the year. Other primary commodity prices also recorded an upward trend in the first half of the year, as did global food prices.

The NBS Executive Board will continue to closely monitor and analyse movements in the domestic and international market **in order to preserve the achieved price and financial stability, while providing support to further economic growth.** As so far, the full coordination of monetary and fiscal policy measures will continue going forward, which will mitigate any further negative impacts from the international environment and ensure dynamic economic growth in Serbia in the period ahead.

I Strategic monetary policy framework

The NBS has been implementing a **fully-fledged inflation targeting regime** since early 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 along the lines of 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 judgement 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 significant number of central banks worldwide as a pragmatic response to deficiencies of other monetary policy regimes. The choice of the regime was strengthened by the awareness that high rates of inflation 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. More of a framework than a set of rigid monetary policy rules, this regime 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, inflation target is set in advance. In the case of Serbia, inflation target is set for three years ahead until the process of nominal, real and structural convergence to the EU is completed. As the process is ongoing, inflation target is slightly above the quantitative definition of price stability and the target inflation level in advanced countries (2.0% or 2.5%). Thus, at end-2020, **inflation target was set at 3.0% until December 2023, with the tolerance band of ±1.5 pp.**[2]

For the sake of reminder, inflation target was trimmed since 2017 by 1 pp to 3.0±1.5%,[3] confirming the commitment of economic policy makers to keeping inflation low, stable and predictable in the medium term. In cooperation with the Government, the NBS made this decision thanks to the achieved and maintained low and stable inflation – at the time, for three years in a row – and the significantly improved macroeconomic fundamentals and our economy's prospects, underpinned by the successful coordination of monetary and fiscal policies and excellent results of the fiscal consolidation. Inflation expectations of the financial sector and corporates for one and two years ahead have been low and relatively stable for a longer period already, confirming the higher credibility of the NBS's monetary policy.

The width of the target tolerance band was kept at ±1.5 pp, which diminishes the need for frequent monetary policy interventions and contributes to higher predictability of 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 band leaves to the NBS broader room to work on

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

[2] The NBS's Memorandum on Inflation Targets until 2023 was adopted at the meeting of the NBS Executive Board of 10 December 2020.

[3] The NBS's Memorandum on Inflation Targets until 2018.

the achievement of its second objective – financial stability, and to support the Government's economic policy which encourages sustainable economic growth.

The inflation target is a medium-term objective, which means that inflation can deviate from the target in the short term 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 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 prices under direct or indirect government regulation.

The NBS strives to achieve the targeted rate of inflation by **changing its key policy rate, i.e. the interest rate applied in the 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.** Interventions in the FX market aim to ease excessive short-term volatility of the exchange rate, safeguard price and financial stability, and maintain an 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 taken to achieve them. Also, when publishing the *Inflation Report*, monetary policy decisions and macroeconomic projections are explained in detail.

II Monetary policy and achievement of the inflation target

1 Monetary policy since early 2021

In H1 2021, monetary policy was pursued in accordance with **the NBS Monetary Policy Programme in 2021**.[4] The Monetary Policy Programme, adopted in December 2020, envisaged that the NBS would aim to achieve the inflation target through consistent changes in the key policy rate, taking into account the inflation projection and anticipated movements in its key factors from the domestic and international environment, and their impact on financial stability. As highlighted in the Programme, in 2021 the NBS would also maintain the necessary flexibility when using monetary policy instruments in order to preserve an appropriate level of bank liquidity and ensure efficient functioning of the monetary policy transmission mechanism, but also support the economy's recovery from the negative effects of the pandemic.

In H1 2021, the key policy rate was kept on hold at 1.0%, same as in December 2020. This is its lowest level in the inflation targeting regime, **by 1.25 pp lower than before the pandemic**. In making such decision, the NBS Executive Board took into account the fact that majority of domestic factors continued to contribute to low and stable inflation, while developments in the international environment warranted caution in the conduct of monetary policy. It also had in mind the effects of past robust monetary and fiscal policy measures aimed at providing support to corporates and citizens amid the pandemic. The effects of these measures were also expected going forward. In addition, the decision was influenced by the third package of economic measures implemented this year.

Early 2021 was characterised by a deteriorating epidemiological situation globally and at home, but the negative effects of the pandemic were much weaker than in the first wave, thanks to the adjustment of consumer habits and companies' operations to altered conditions, as well as to robust monetary and fiscal stimuli in Serbia and many other countries worldwide. It was especially important that the vaccination process began, which gave rise to optimism, as well as the fact that **Serbia was among the leading countries in the world to provide vaccines and ranked at the very top of the list in terms of the number of vaccinated people relative to the total population**.

In many countries, notably in Europe, containment measures were tightened during the winter, which was the basis for expectations that the economic recovery of the euro area, our main economic partner, could slow down, especially in Q1 2021. However, the fall in the euro area service sector was moderated by solid industrial production results, which was important for Serbia's exports. With advances in the vaccination process and the expected gradual relaxing of restrictive measures, the Executive Board expected a stronger economic recovery of our main trading partners and, hence, a positive impact on our exports.

The Executive Board also had in mind that the speed of global economic recovery largely determined the movements in the international financial market and capital flows to emerging economies, including Serbia, increasing the importance of a cautious monetary policy conduct. The adoption of a new package of fiscal stimuli in the USA fuelled expectations that US economic growth

[4] RS Official Gazette, No 149/2020.

would be stronger than previously expected, leading to higher long-term interest rates. At the start of the year, interest rates grew somewhat in the euro area as well, before the ECB additionally eased its monetary policy.

Uncertainty in the global commodity market also mandated caution due to the upward trend in the prices of oil, primary agricultural commodities and food. The global Brent oil price exceeded USD 60 per barrel in February, mostly due to the expected global economic growth. Also, the decision of OPEC+ members from early March to extend their agreement to cap the oil production until April surprised market participants and contributed to a further global oil price hike. Global food price index (FAO index) rose as well. It increased in March for the tenth consecutive month to its highest level since June 2014. It was estimated that this would contribute to inflation going up in the international environment this year more than in the previous year, which was marked by extremely low inflation and even deflation in some countries due to the pandemic.

Inflation in Serbia has been firmly under control for the past eight years. Despite many shocks from the international environment, the NBS continued to meet its primary objective – securing low and stable inflation. After standing at 1.1% and 1.2% in the first two months of 2021, in line with NBS expectations, y-o-y inflation returned within the target band, measuring 1.8% in March. Core inflation (inflation excluding the prices of food, energy, alcohol and cigarettes) was the same in March and remained stable. Low and stable inflation was buttressed by the relative stability of the exchange rate and anchored inflation expectations of the financial and corporate sectors, which illustrate the credibility of monetary policy.

In deciding to keep the rate on hold, the Executive Board pointed out that **the domestic economic performance is better than expected even amid globally deteriorating epidemiological situation in early 2021**. This was signalled by available monthly economic, foreign trade and labour market indicators. Production growth in manufacturing particularly stood out, underpinned by the activation of new production capacities owing to investments from the previous period, by the undertaken robust monetary and fiscal policy measures, implementation of one of the most successful vaccination strategies worldwide, and the gradual recovery of external demand. It was estimated that industrial production, retail trade turnover and exports had already exceeded pre-crisis levels, and as advances were made in the vaccination process, the Executive Board expected a full recovery in other service sectors as well.

With the onset of spring, the epidemiological situation in Serbia and abroad was getting better, and the continuation of successful vaccination gave rise to optimism that economic growth could be faster than hoped for. In early April, for the second time this year, the IMF made an upward revision to its global growth projection, in anticipation of the effects of additional fiscal measures in several large economies and the stimulus that the vaccination process would give to global growth in the second half of the year. It was expected that the euro area would post stronger growth, as well as our key trade partners – Germany and Italy, which would reflect positively on our exports. The Executive Board highlighted that caution in monetary policy conduct was mandated because of uncertainties in the global commodity market, primarily due to the upward trend in oil prices, primary agricultural commodities and food, which exceeded their pre-pandemic levels and touched their multiple-year maximums. Global cost-push pressures also increased on account of higher prices of transport due to halts in supply chains, shortage of some raw materials, as well as the mismatch of supply and demand for labour force in certain market segments, etc.

Still, core inflation remained relatively stable in the leading world economies, and y-o-y headline inflation rate went up mainly as a result of extremely low base effect from energy prices from the previous year, notably in April and May. Assessing that the factors behind the higher y-o-y inflation rates this year are primarily temporary, the leading central banks, the Fed and the ECB signalled that they would strive to maintain an accommodative monetary policy for as long as possible to ensure an accelerated recovery from the last year's recession. It was expected that global financial conditions would remain very favourable on this account, while the improved outlook for global economic growth reflected on greater readiness to invest in emerging markets.

Unlike certain central banks in the region, which began to reduce the degree of policy accommodation in Q2 due to the inflationary effects and factors from the domestic environment, **the NBS continued to pursue an accommodative monetary policy and to act as an equal partner to the Government in providing support to businesses and citizens.** This was possible owing to the fact that somewhat higher y-o-y inflation rates since April had moved around the target midpoint (3±1.5%), reflecting mostly the low base from petroleum product prices from the same period last year, as well as higher cost-push pressures on account of rising global oil prices and the prices of other primary commodities in the prior months. A negative output gap indicated that there were

no signs of any major inflationary pressures on the demand side. This was also indicated by the low and stable core inflation (around 2%), as well as short- and medium-term inflation expectations, which were around the target midpoint in the financial sector and somewhat lower in the corporate sector. The Executive Board expected inflation to remain within the tolerance band in the period ahead.

Owing to the NBS's accommodative monetary policy, **borrowing terms in the domestic market remained favourable even in Q2**, encouraging lending activity, with the continued increase in the dinar share of total loans. Although since early 2021, y-o-y loan growth to the non-monetary sector decelerated to 6.3% in June, this was anticipated due to the high base from the past year, primarily on account of the moratorium on loan repayment. Namely, considering that there was no maturing of loans during the moratorium, the stock of total loans was higher than it would have been had the moratorium not been introduced, which translated onto lower y-o-y lending growth rates in Q2 through the high base. The dynamics of lending activity was still relatively accelerated, as indicated by the trend in new corporate and household loans, which in the first six months this year resembled that recorded in the same period of 2019, and up by more than a quarter compared to 2020. Such developments are in accordance with the results of the July bank lending survey, which indicate that banks eased credit standards for dinar loans and that corporate and household demand continued up. **The share of NPLs in total loans (3.6% in June), which is below its pre-pandemic level**, indicates that the quality of bank assets improved further, thanks to the timely and adequate measures of the NBS and the Government aimed at mitigating the negative effects of the pandemic on corporates and households.

In addition to the NBS measures, fiscal measures were also comprehensive and strong, contributing to the preservation of production capacities and employment, as well as business and consumer confidence, thereby yielding results regarding economic growth. **As in 2020, economic activity indicators since early 2021 exceeded expectations.** Data indicated that Serbia was among the few countries **to have exceeded the pre-crisis level of economic activity already in Q1 this year**. According to the SORS estimate, GDP growth continued up in Q2, at the rate of 13.7% y-o-y, as a result of further positive trends in domestic economy, but also low last year's base, when containment measures were the strictest. In quarterly terms, excluding the effects of seasonal factors, GDP growth was at 1.3%, under the NBS estimate. On the production side, the strongest positive impetus to GDP growth in Q2 came from service sector, which was hit the hardest by the pandemic last year, but manufacturing and construction also contributed significantly, as in the previous quarter. On the expenditure side, growth was led by consumption and investment in fixed funds, owing to the advances made in vaccination, preserved investment and consumer confidence, as well as the implementation of infrastructure projects.

The Executive Board underscored the importance of **the upward trend of the domestic economy's export supply, which, together with the normalisation of global economic flows, led to further improvement of country's external position**. In the first six months of the year, the current account deficit measured 2.1% of GDP, down by EUR 728 mn y-o-y, owing to a higher surplus on trade in services and recovery of remittances from abroad. Despite notable import growth in Q2, primarily import of equipment and intermediate goods due to the continued investment cycle, which was temporarily slowed down by the pandemic, since the start of the year the export of goods and services grew at a faster pace (27.3% vs. 20.4% y-o-y) thanks to prior investment in tradable sectors and external demand recovery.

In deciding to keep the key policy rate unchanged, the NBS Executive Board had in mind that **capital flows to Serbia remained relatively high, thus contributing to an increase in FX reserves and strengthening the country's resilience to external risks. FDI** inflows were especially high, **equalling EUR 1.8 bn in the first six months**, which is by around 21% higher in y-o-y terms and **several times higher than the current account deficit**. As a significant inflow from portfolio investments was recorded in the same period, the country's FX reserves continued up – to EUR 14.1 bn at end-June. In conditions of high capital inflows, appreciation pressures on the dinar prevailed in Q2 and strengthened further after dinar government bonds were included in J. P. Morgan's renowned index at end-June, reflecting higher demand and expansion of the foreign investor base. A further reduction in the cost of public debt servicing can be expected on this account in the period ahead, which testifies to the significance of yearslong efforts of the NBS and the Government to include dinar government bonds in this renowned index.

The Executive Board stressed that it would continue to closely monitor and analyse the trends in the domestic and international market, and, **if necessary, take appropriate measures and activities to preserve the achieved price and financial stability, supporting**

further economic growth. As so far, full coordination of monetary and fiscal policy measures will be maintained, easing possible further negative effects from the international environment and ensuring vibrant growth of the Serbian economy looking ahead.

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**.

Open market operations

The main open market operations of the NBS in H1 2021 were again **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 issued in late 2020 was used, in the total nominal value of RSD 500.0 bn. This is consistent with the practice from earlier years which enables more adequate management of securities within the same series and facilitates liquidity management for banks.

In H1 2021, twenty-six repo sale auctions were organised. Auctions were organised once a week, **upon the model of the variable multiple interest rate**. The total securities sales amounted to RSD 1,086.0 bn, which was higher than in H2 2020 (RSD 628.5 bn).

The average stock of NBS securities in banks' portfolios reached RSD 41.8 bn in H1 2021, up by RSD 18.7 bn from H2 2020. Relative to end-2020, the stock of these securities remained unchanged, measuring RSD 30.0 bn at end-June.

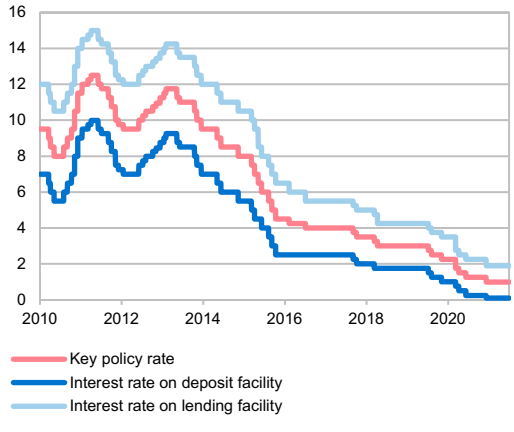
In H1, the NBS continued to support the domestic financial system and overall economic flows by providing the banking sector with additional dinar liquidity in the total amount of RSD 32.6 bn. Namely, the NBS organised 24 auctions of repo purchase of dinar government and corporate securities (once a week), with three-month maturity, at a favourable interest rate of 0.10%, i.e. at the deposit facility rate.

Deposit and lending facilities

In H1 2021, banks continued to place overnight deposits within the NBS, which averaged RSD 101.3 bn, down by RSD 32.7 bn from H2 2020. The highest average daily stock was recorded in January (RSD 135.7 bn) and the lowest in June (RSD 87.9 bn).

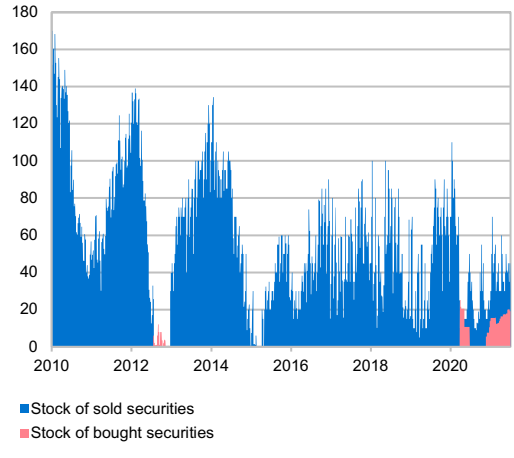
In H1 2021, banks did not use lending facilities, neither as intraday nor overnight loans.

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



Source: NBS.

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



Source: NBS.

Required reserves

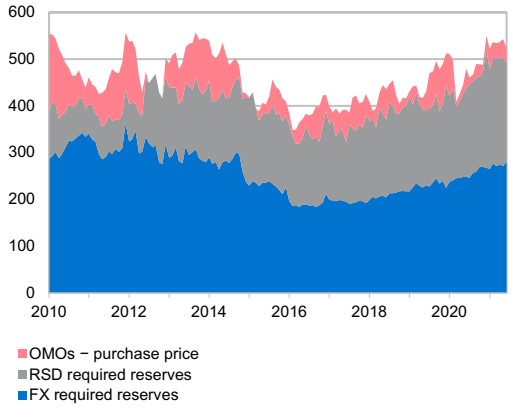
In H1 2021, the amount of calculated required reserves allocated in dinars increased by RSD 11.7 bn, to RSD 232.2 bn in June. This increase reflects growth in FX required reserves allocated in dinars (by RSD 6.8 bn) and dinar required reserves (by RSD 4.9 bn).

In the same period, the amount of calculated required reserves allocated in foreign currency increased by EUR 88.4 mn and came at EUR 2,329.0 mn in June. This was driven by the increase in the FX reserve base by EUR 692.6 mn, mostly due to greater FX savings of citizens and FX deposits of corporates.

Interest rates

In H1 2021, interest rates applied by the NBS in the conduct of monetary policy remained unchanged. The NBS key policy rate was kept at 1.00%, while the rates on lending and deposit facilities stood at 1.90% and 0.10%, respectively. The interest rate used by the NBS to charge and pay interest on the amount of average daily balance of allocated dinar required reserves was also unchanged, at 0.10%.

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



Source: NBS.

Foreign exchange market operations

Under the 2021 Monetary Policy Programme, the NBS continued implementing the managed float exchange rate regime, with the possibility to intervene in the FX market in order to ease excessive short-term volatility of the dinar against the euro and maintain price and financial stability and an adequate level of FX reserves.

In H1 2021, the value of the dinar vis-à-vis the euro was almost unchanged. After short-term depreciation pressures in early 2021, caused mainly by the seasonal hike in FX demand of domestic enterprises – energy importers, appreciation pressures prevailed for most of H1. Upward pressures on the domestic currency reflect a renewed effect of factors which created structural appreciation pressures even before the pandemic and boosted FX inflows from different sources. The common denominator of these factors is the improvement of the country's macroeconomic performance.

In H1 2021, the NBS net bought EUR 320.0 mn in the IFEM (buying EUR 580.0 mn and selling EUR 260.0 mn).

FX supply in H1 2021 was influenced by net foreign cash purchases, which were the highest in May, partly as a result of the increased purchase of the eighth-series Swiss franc banknotes, which were withdrawn from circulation by the decision of the Swiss National Bank. FX supply in H1 2021 was also influenced by the longer FX positions of banks on account of the use of payment cards and the increase in net indexed bank assets, as well as elevated FX supply of residents and non-residents in some periods.

FX swap auctions of the National Bank of Serbia

In H1 2021, the NBS continued to hold its regular three-month and two-week auctions of FX swap purchase and sale in order to encourage the development of interbank swap trading and facilitate more efficient liquidity management for banks.

In the period observed, 48 regular three-month swap auctions were held, at which the NBS swap sold and bought EUR 44.0 mn each, as well as 48 regular two-week auctions, at which it swap sold and bought EUR 46.0 mn each.

In order to provide banks with additional cheap dinar liquidity (dinar interest rate equals deposit facility rate increased by 10 bp), in H1 2021, until 8 March, the NBS continued to hold additional three-month swap auctions of purchase of foreign currency for dinars, which were introduced in mid-November 2020. Thus, in an environment characterised by a faster than expected rebound of the domestic economy, the NBS sought to maintain a sufficiently high level of available and cheap liquidity in the banking sector and, in turn, in the corporate sector, in order to ensure the continuation of such stimulating effect. In additional swap auctions in

H1 2021, until 8 March, the NBS swap bought EUR 165.0 mn, providing additional dinar liquidity to banks for a three-month term in the equivalent of RSD 19.4 bn.

At end-H1 2021, the stock of NBS FX receivables and liabilities in respect of regular three-month and two-week swap auctions equalled EUR 21.0 mn and EUR 13.0 mn, respectively.

3 Achievement of inflation target in the period January–June 2021

The y-o-y inflation dynamics in H1 2021 was dominantly dictated by the prices of petroleum products and food, which mostly stayed abreast with movements of these prices in the global market.

After standing at around 1% in the first two months of 2021, **y-o-y inflation** returned within the target band at end-Q1 (1.8%). As in most other countries, y-o-y inflation accelerated in Q2, moving around the target midpoint. The inflation hike was mostly influenced by the low base effect from the prices of petroleum products from the previous year, as well as higher cost-push pressures on account of rising global oil prices and primary agricultural commodities in the previous months.

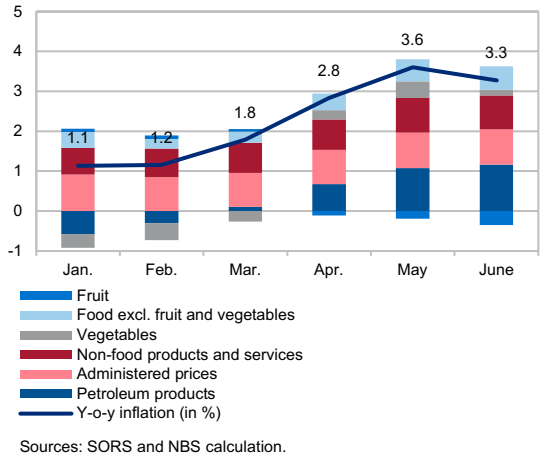
Despite stronger consumer demand due to the opening of economy, **core inflation** (measured by CPI excluding the prices of energy, food, alcohol and cigarettes) remained stable in H1, at around 2% y-o-y, indicating the absence of any major inflationary pressures on the demand side.

By CPI components, consumer price hike of 3.3% y-o-y in June was led primarily by the increase in **prices of energy** (by 10.7%, with a 1.6 pp contribution), dominantly reflecting much higher prices of **petroleum products** (22.7%, with a 1.2 pp contribution), amid the rising global oil prices since the start of the year. In addition, **electricity prices** increased as well (4.8% in June, contributing 0.4 pp to y-o-y inflation).

The prices of food and non-alcoholic beverages recorded 1.2% growth in June in y-o-y terms (with a 0.4 pp contribution to inflation), led by the increase in **the prices of processed food** (2.8%, with a 0.6 pp contribution), in contrast to lower **prices of unprocessed food** (-1.9%, with a -0.2 pp contribution to inflation).**Vegetable prices** grew by 2.6% y-o-y in June, while **fruit prices** decreased by 11.8% y-o-y due to the high last year's base, giving a negative aggregate contribution to the June y-o-y inflation. On the other hand, a positive contribution came from higher **prices of other food** (excluding fruit and vegetables) amid the rising prices of primary agricultural commodities in the global market since the start of the year.

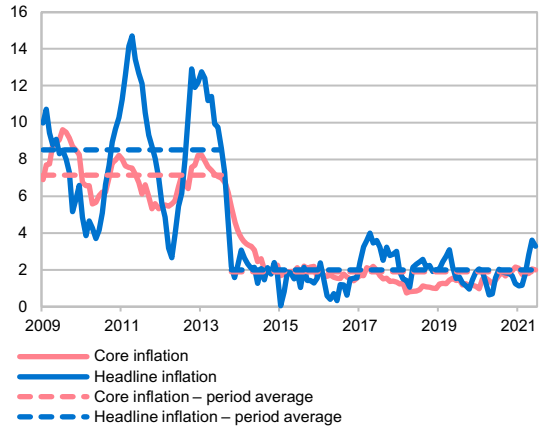
The prices of industrial products excluding food and energy were 2.9% higher in June in y-o-y terms (with a 0.8 pp contribution to inflation), which is mostly attributable to the regular annual adjustment of the excise tax on cigarettes (6.8%, 0.3 pp contribution to y-o-y inflation). Working in the same direction were also higher prices of computer equipment and audio devices, alcoholic beverages, furniture and apartment maintenance materials, as well as medical and pharmaceutical products (with a 0.4 pp aggregate contribution to y-o-y inflation in June).

Chart II.3.1 **Contribution of CPI components to y-o-y inflation during H1 2021**
(in pp)



Sources: SORS and NBS calculation.

Chart II.3.2 **Headline and core inflation**
(y-o-y rates, in %)



Sources: SORS and NBS calculation.

Table II.3.1 **Growth and contribution of components to consumer price growth in H1 2021**

	Growth rates (in %)	Contribution (in pp)
Consumer prices (CPI)	**3.5**	**3.5**
Unprocessed food	11.7	1.2
Processed food	1.7	0.4
Industrial products excluding food and energy	1.2	0.4
Energy	8.2	1.2
Services	1.5	0.4
CPI excluding energy, food, alcohol and cigarettes	**1.1**	**0.5**
Administered prices	**3.8**	**0.7**

Sources: SORS and NBS calculation.

The prices of services in June rose by 2.1% y-o-y (with a 0.5 pp contribution to inflation), primarily driven by the increase in the prices of utility services (9.1%, with a 0.2 pp contribution). Higher prices were also registered in other service categories, reflecting the relaxation of restrictive containment measures.

Administered prices rose 4.8% y-o-y in June (contributing 0.9 pp to inflation) due to the said hike in the prices of electricity, utility services and cigarettes.

Within the regular annual review of CPI weights, SORS made certain adjustments to weights for inflation calculation in 2021 acknowledging the pandemic effects. The most important change refers to the reduced share of services (by 1.0 pp) on account of lower weights for transport, restaurant and hotel services, as well as travel packages, which were most affected by the pandemic. This pushed down the weights for core inflation, while the share of weights for food inflation went slightly up. The said adjustments are in line with Eurostat guidance on honouring the changes in the habits of consumers brought about by new circumstances.

According to the August central projection, y-o-y inflation is expected to move within the upper half of the target band in H2 2021 and Q1 2022. As of Q2 2022, with the waning of the effects of temporary factors (rising prices of primary commodities and cost-push pressures due to halts in global supply chains), inflation is expected to first slow down and then to move in the lower part of the target band until the end of the projection horizon.

III Macroeconomic environment

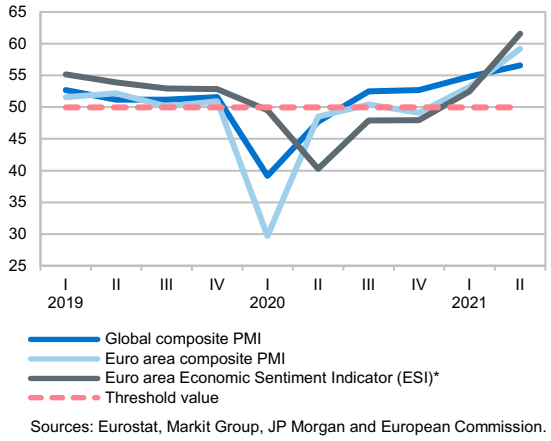
1 International environment

Economic activity and inflation

Despite the new wave of the pandemic and the introduction of containment measures, late in 2020 and early this year the global economy struck a path of recovery supported by additional economic measures in leading world economies and progress in vaccine development. Q2 saw a loosening of measures and accelerated vaccine rollout which, together with comprehensive fiscal packages in developed countries, gave **stronger wind in the back of economic recovery**. This is confirmed by several months of growth in industrial activity and recovery of the service sector during Q2, which helped keep the leading global economic activity index in the expansion zone. According to assessments by leading international institutions, the pace of global economic rebound will largely depend on the availability of vaccines, therefore it can be divided into two blocks on this account – advanced countries are expected to see a further stabilisation of economic conditions, while a large number of emerging and developing countries are experiencing vaccine shortage, witnessing the spread of new virus strains and narrowing the room for new fiscal incentives. In June, the World Bank projected global growth at 5.6% in 2021, with the assessment that **global economic recovery is still uneven** and concentrated in large economies (notably China and the USA). In July, the IMF came out with a slightly higher global growth estimate of 6.0% in 2021, with risks to the projection still skewed to the downside in the short term.

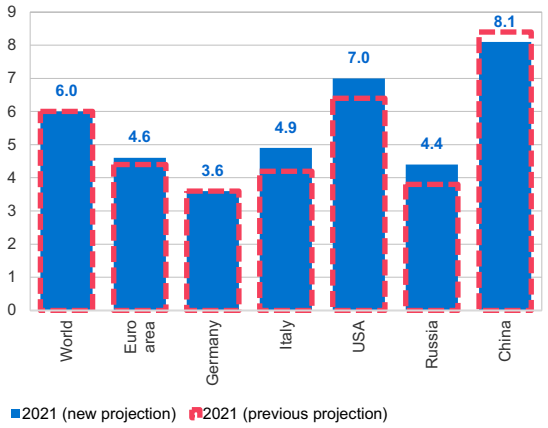
Euro area GDP dipped slightly in Q1, by 0.3% s-a, while Q2 saw a positive economic growth rate of 2.0% s-a (Eurostat preliminary flash estimate) on account of the recovery of domestic and external demand amid progress in vaccine rollout and removal of strict containment

Chart III.1.1. **Leading economic activity indicators in the world and the euro area**
(in index points)



Sources: Eurostat, Markit Group, JP Morgan and European Commission.
* ESI is standardised relative to PMI.

Chart III.1.2 **Revisions of real GDP growth forecasts for 2021 by the IMF**
(in %)



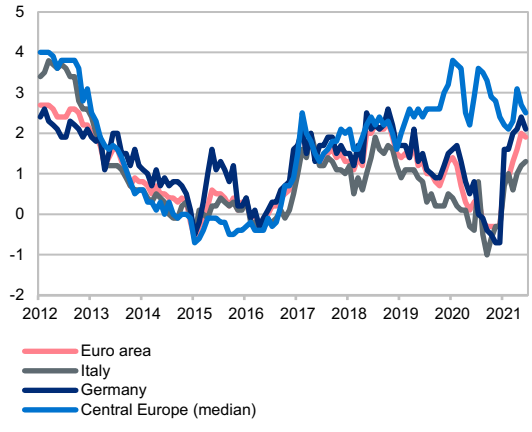
Sources: IMF WEO Update (July 2021) and IMF WEO (April 2021).

measures. This was also indicated by movements in the leading Economic Sentiment Indicator (ESI) for the euro area, which in June reached its record level in two decades (117.9 points), while in the same month the level of the PMI Composite for the euro area was the highest in 15 years (59.5 points). S-a growth in GDP in Q2 was recorded in Germany (1.5%) and Italy (2.7%), our key trade partners in the euro area. Despite halts in global supply chains in H1, economic activity in the euro area was driven by growth in industrial production and export, as well as the recovery of the service sector amid the opening of European economies. With strong economic support, the euro area labour market continued to recover, and the June unemployment rate of 7.7% came close to the pre-crisis level (7.4% in February 2020). In June, the ECB forecast economic growth of 4.6% for the euro area in 2021, which will largely depend on the further course of the pandemic and the response of European countries.

In early H1, y-o-y **inflation in the euro area** again entered the positive territory and continued up, primarily as a result of temporary factors, such as the cessation of the temporary VAT reduction in Germany, belated sales in some countries, as well as the rise in energy prices and their extremely low base from the previous year. In May, when the effect of the low base with energy prices was the most pronounced, y-o-y inflation in the euro area reached its highest level since October 2018 (2.0%), and then slightly edged down in June, to 1.9%, under the impact of the slowdown in the y-o-y rise in the prices of energy, as well as services. Though production prices went up amid the rising cost-push pressures due to the higher prices of primary commodities and disruptions in production and value chains during the pandemic, so far this has spilled over onto the rise in the prices of industrial products excluding energy only to a smaller extent. Bearing in mind that, after rising from 0.2% in December to 1.4% in January, y-o-y **core inflation** continued to move close to 1.0% of GDP, the ECB estimated that inflation growth since the start of the year is temporary. As for Serbia's key foreign trade partners, y-o-y inflation in **Germany**, measured by the change in HICP, rose from -0.7% in December to 2.1% in June, and in **Italy** from -0.3% to 1.3% in the same period.

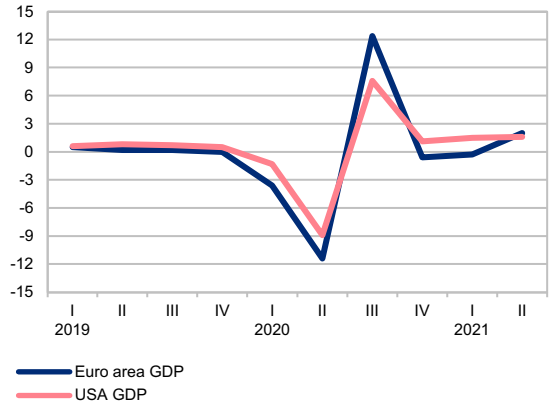
US economy posted growth of 1.5% s-a in Q1, which picked up to 1.6% s-a in Q2, on account of growth in private consumption and fixed investments. Major drivers behind this were the further loosening of physical distancing measures in Q2, favourable financial conditions and positive effects of previously implemented fiscal measures. Leading indices – ISM Manufacturing PMI and Consumer Confidence Index (CCI), which have been in the expansion zone for an extended period – also suggest accelerated GDP growth. At the same time, H1 saw further improvements in labour market developments, given that the unemployment rate of 5.9% in June was far below its record level from last April (14.8%), though it is still above the pre-crisis level (3.5% in February 2020). In June, the Fed came out with a 7.0% growth forecast for the US economy in 2021.

Chart III.1.3 **HICP across selected countries**
(y-o-y rates, in %)



Source: Eurostat.

Chart III.1.4 **Quarterly GDP dynamics in the euro area and the USA**
(s-a growth rates, in %)



Sources: Eurostat and U.S. Bureau of Economic Analysis.

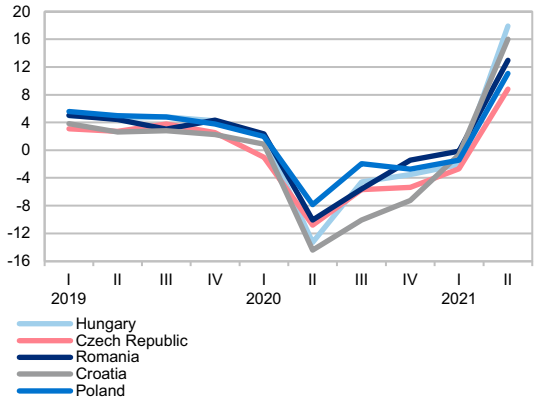
Demand growth in the wake of the opening of economies and comprehensive fiscal measures, as well as cost-push pressures on account of the rise in the prices of primary commodities and short-term restrictions on the supply side due to bottlenecks in production and supply chains, led to an acceleration of inflation in the USA. Headline y-o-y inflation, measured by the CPI, rose from 1.4% in December to 5.4% in June, its highest level since August 2008. Inflation excluding the prices of food and energy – to which the Fed attributes particular importance – reached 3.5% y-o-y in June and thus overshot the inflation target (average 2%).

In the **region of Central and Southeast Europe**[5] Q1 saw a lower fall in GDP than anticipated (-1.25% y-o-y), after which GDP rose 11.8% y-o-y in Q2 (preliminary), as a result of stepped-up household consumption and total investments, as well as low last year's base. Propped by accelerated vaccine rollout, the achieved economic growth in Q2 was broadly dispersed across geographies, given that it was recorded in all countries of the region. Still, leading analysts estimate that short-term economic prospects are divergent by country in the region, especially bearing in mind the new virus strains and travel restrictions. Hence, some countries decided to extend support measures for corporates and households, counting on the funds from the Next Generation EU.

The Chinese economy returned to the growth trajectory sooner than others – its growth in Q1 was at a high level of 18.3% y-o-y, and in Q2 it rose by an additional 7.9% y-o-y owing to the robust growth of the production sector and, to a lesser degree, the service sector as well. According to the Bank of Russia, after a fall in Q1 (-0.7% y-o-y), **the Russian economy** rebounded to the pre-crisis level in Q2, thanks to the recovery of domestic demand and net exports against a backdrop of the rising global prices of primary commodities, of which Russia is a net exporter.

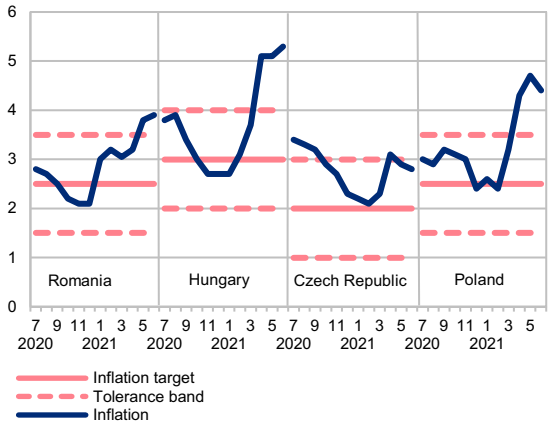
The prices of petroleum products and their extremely low last year's base led to inflation growth in all observed **Central and Southeast European countries**, therefore in many of them it overshot the inflation target during H1. The most pronounced inflation growth was recorded in Hungary, where y-o-y inflation reached 5.3% in June, a contribution to which came from growth in core inflation and food prices, in addition to petroleum product prices. After reaching 4.7% in May, y-o-y inflation in Poland came down to 4.4% in June, primarily under the impact of a slowdown in core inflation due to the base effect. Inflation in the Czech Republic slightly overshot the target in April, only to slow down afterwards under the impact of lower food prices and move until end-H1 just shy of the upper bound of the target tolerance band (2.8% y-o-y in June). The hike in electricity prices, which are no longer included in administered prices as of the start of 2021, growth in the prices of petroleum products and the unexpectedly higher vegetable prices in May and June, which is unusual for the season, contributed to inflation in Romania reaching 3.9% y-o-y.

Chart III.1.5 **Y-o-y real GDP growth rates in CESEE countries**
(quarterly, in %)



Source: Eurostat.

Chart III.1.6 **Movement in CPI for selected CESEE countries**
(y-o-y rates, in %)



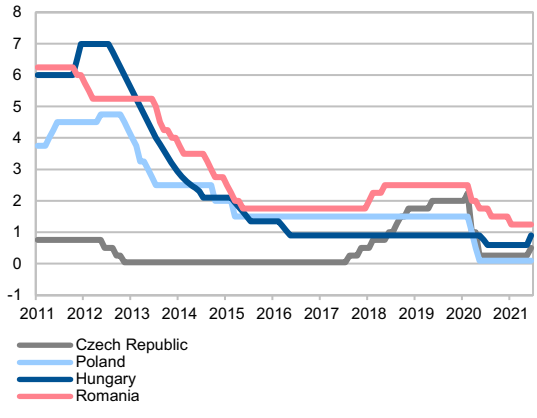
Sources: Central banks of selected countries.

[5] The region includes Romania, Hungary, the Czech Republic, Slovenia, Bulgaria, Croatia, Slovakia and Poland.

Monetary policy

During H1, the **ECB** kept its interest rates unchanged – the main refinancing operations rate at 0%, and the rates on lending and deposit facilities at 0.25% and -0.50%, respectively. Though it kept the volume of asset purchases unchanged, in Q2 – as previously announced – the ECB significantly accelerated the pace of purchases within the Pandemic Emergency Purchase Programme (PEPP) relative to the beginning of the year. Also, it reiterated the programme's flexibility, hence the stated amount does not need to be used entirely if favourable financing conditions can be maintained by a smaller purchase volume, though in the opposite scenario it may even be increased. In early July, the ECB announced the results of its monetary policy strategy review that began in January 2020. According to the new strategy, instead of the previous target of below, but close to 2%, the symmetrical inflation target is now 2% in the medium term. The ECB stated that when making monetary policy decisions, it would also take climate change into account. The next review of the adequacy of monetary policy strategy has been announced for 2025. In accordance with the new strategy, in its July meeting the ECB revised its forward guidance on interest rates. The new guidance envisages that the rates would remain at their current or lower levels until the ECB in its projections starts expecting the inflation within the projection horizon to reach 2% and stay there until the end of the projection period, as well as until the ECB estimates that core inflation movements are consistent with inflation target achievement. Due to this, in the transition period, inflation might be moderately above the target. For the time being, the ECB announces further monetary policy support to economic growth and, accordingly, expects higher inflation in the medium-term, though it believes it will remain below 2%.

Chart III.1.7 **Policy rates across selected CESEE countries**
(p.a., in %)



Sources: Central banks of selected countries.

In H1, the **Fed** also kept its federal funds target range at the current level (0–0.25%), where it will remain until the Fed estimates that maximum employment has been achieved, with inflation reaching 2% and a tendency to slightly overshoot that level for a while. It also kept the current dynamics of asset purchases within the quantitative easing programme (monthly purchase of Treasury bonds in the amount of USD 80 bn and agency mortgage-backed securities in the amount of USD 40 bn), and the guidance that the purchases will not slow down until substantial further progress has been made toward the achievement of the Committee's goals. However, the Fed's June projections of the federal funds rate for the first time envisage the rate going up in 2023, indicating that the majority of Fed members is more optimistic that goals will be achieved faster than initially expected.

Of the observed Central and Southeast European countries, only the **Romanian** central bank responded by trimming the policy rate early in the year, to 1.25% in January, which is its lowest level, while other central banks kept their policy rates on hold. Amid rising inflationary pressures, stemming not only from the higher global prices of primary commodities, but from domestic factors as well, some of the observed central banks later reacted by tightening their monetary policies. In the June meetings, for the first time since February 2020, the central bank of the **Czech Republic** raised its interest rate by 25 bp to 0.50%, and the **Hungarian** central bank by 30 bp to 0.90%, with both banks underlining that they would continue with monetary policy tightening going forward. The central bank of **Poland** kept its policy rate at 0.1%, and the **Romanian** central bank also did not change its policy rate after January, until end-H1.

Amid heightened inflationary pressures, preceded by a sharp depreciation of the Turkish lira, the central bank of **Turkey** raised its policy rate in March by 200 bp to 19%, thus significantly exceeding analysts' expectations, and then kept it unchanged until end-H1.

Financial and commodity markets

After the implicit measure of **financial market volatility** (VIX) surged above 37% at end-January as a consequence of speculative trade in certain shares in the US stock market, it struck a downward trajectory, primarily due to the optimism that the coronavirus

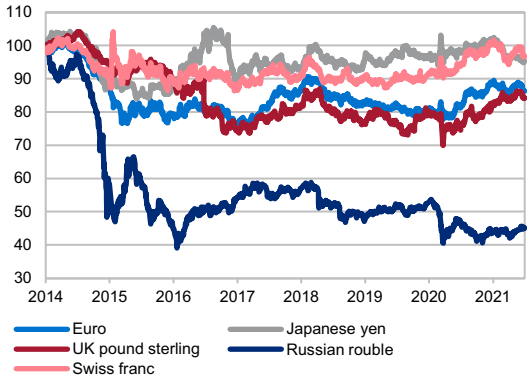
vaccine and the planned USD 1,900 bn fiscal aid package in the USA would trigger global recovery. Thus, VIX was 6.9 pp lower at end-H1 compared to end-2020 and measured 15.8%, which means it returned to the pre-pandemic level. The volatility of the currencies of emerging markets, measured by EM–VXY, dipped by 2.2 pp to 8.6% in H1.

Yields on **ten-year government bonds** of advanced countries rose during H1. Yields on ten-year US Treasury bonds rose the most – by 0.6 pp to 1.5% – amid investor optimism that 2021 will be the year of robust economic recovery and accelerated inflation due to the successful vaccine rollout in the USA and comprehensive monetary and fiscal stimuli, as well as indicators of labour market recovery. The opening of economies and loosening of containment measures also reflected on a rise in the yields on ten-year government securities of advanced European countries in H1 (by around 0.4 pp on average), with yields on ten-year German bonds still remaining negative (-0.2% at end June).

In early January, the **USD/EUR exchange rate** reached the highest level since April 2018 (1.23), after which the value of the dollar recovered gradually. The strengthening of the dollar not only against the euro, but against other global currencies as well, was under the impact of the rise in the yields on ten-year US Treasuries and the anticipated faster economic recovery, as well as greater progress in vaccination in the USA compared to the majority of other countries. However, as investors increasingly expected that the Fed – despite rising inflationary pressures – would keep the rates unchanged for an extended period of time, the dollar again weakened against the euro during April and May, to EUR/USD 1.23 at end-May. Afterwards, amid rising expectations that already in Q3 the Fed might announce the contraction in the asset purchase volume within the quantitative easing programme, the dollar started to appreciate again, reaching EUR/USD 1.19 at end-H1, and was therefore 3.1% stronger vis-à-vis the euro than at end-2020.

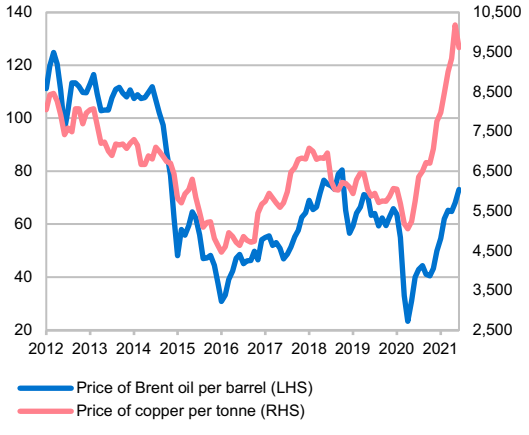
In January, Saudi Arabia decided to unilaterally cut oil production by 1 mn barrels a day during February and March, which reflected on the rising **oil price** at the very start of the year. Afterwards, the price of oil continued up on the back of the anticipated recovery in oil demand, as well as the reports on depleting oil inventories in the USA, the suspension of oil wells and closure of many refineries due to bad weather conditions in the southern USA. The price of oil continued up in March, on the back of the decision by OPEC+ not to step up production until demand growth is proven to be long-term, as well as because of Saudi Arabia's decision to extend the further production cut for another month. A further fall in crude oil inventories in the USA and the recovery of oil demand in the wake of the opening of euro area and US economies, as well as the strong rise in China's oil demand, led to a continued increase in the price of oil, therefore it reached USD 75.1 per barrel at end-H1, up by 47% from end-2020. Working in the same direction was the decision by OPEC+, made in the meeting in early June, to continue to adhere to production caps, as well as the projections of the International Energy Agency (IEA) that oil demand would grow faster than the supply.

Chart III.1.8 **Exchange rates of selected national currencies against the dollar***
(daily data, 31 December 2013 = 100)



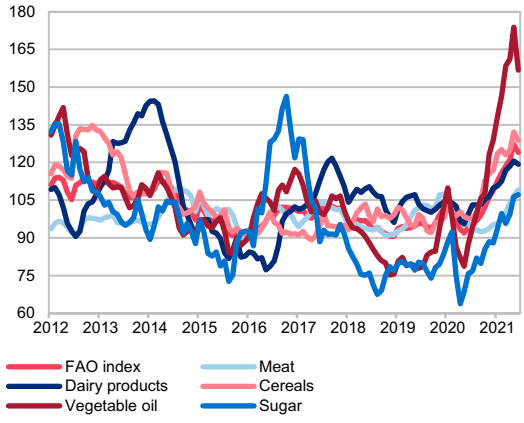
Source: IMF database.
* Growth indicates appreciation.

Chart III.1.9 **Oil and copper price movements**
(average monthly prices, in USD)



Source: Bloomberg.

Chart III.1.10 **World food price index**
(in real terms, 2014−2016 = 100)



Source: FAO, UN.

Global food prices, measured by the **FAO index**, also continued up and, due to the strong growth in the prices of vegetable oils, sugar and cereals, reached their maximum in May after more than ten years. Still, June saw them edge down slightly after 12 consecutive months of growth, therefore at end-H1, in real terms, they were 13.1% higher than at end-2020. In May, the prices of vegetable oils reached their highest level on record as a consequence of concerns over the level of inventories in exporting countries, which coincided with the rising global demand and was also under the impact of increased demand in the biodiesel sector. Then, these prices declined slightly in June and were 18.3% higher at end-H1 compared to end-2020. Concerns over global inventories, coupled with unfavourable weather conditions in Brazil, the world's biggest sugar exporter, impacted the price of sugar, driving it up by 21.7% in H1, to its new multi-year record. Due to dampened global supply and the rising demand in China, the prices of cereals in the global market, which are of particular importance for Serbia, rose by 9.8% in H1 and reached their multi-year maximum in May, while their dip in June is attributable to corn yields in Argentina which exceeded expectations. The price of wheat dipped only slightly. Meat prices rose 13.8% in H1, driven by demand from Eastern Asia, which was also the reason behind the 8.1% rise in the prices of dairy products in H1.

2 International transactions

Balance of payments and FX reserves

According to preliminary data, **the current account deficit** measured EUR 518.4 mn in H1 2021 (2.1% of GDP), down by EUR 727.9 mn relative to H1 2020. The y-o-y contraction in the current account deficit in H1 2021 resulted from an improvement in the balance of services and the secondary income account, while the mild rise in the primary income deficit worked in the opposite direction. The balance of trade in goods remained broadly unchanged in y-o-y terms. Gross FDI inflow in H1 (EUR 1.8 bn or 7.2% of GDP) outstripped the inflow recorded on this account in the same period last year, while net FDI inflow (EUR 1.6 bn) covered the current account deficit several times over (306.5%). Net inflow in respect of portfolio investment equalled EUR 782.6 mn and resulted from the eurobond issue in the international financial market in February. This led to a rise in FX reserves, further bolstering our economy's resilience to potential shocks from the international environment.

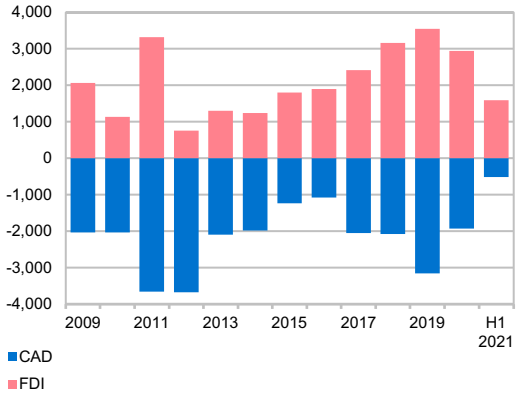
Table III.2.1 **Serbia's balance of payments**
(in EUR mn)

	H1 2020	H1 2021
I CURRENT ACCOUNT	-1,246.3	-518.4
1. Goods	-2,580.2	-2,602.1
1.1. Credit	7,342.5	9,620.2
1.2. Debit	-9,922.7	-12,222.2
2. Services	498.5	809.2
2.1. Credit	2,926.1	3,456.0
2.2. Debit	-2,427.6	-2,646.8
3.Goods and services	-2,081.7	-1,792.9
3.1. Credit	10,268.6	13,076.2
3.2. Debit	-12,350.3	-14,869.1
4. Primary income	-692.9	-701.0
5. Secondary income	1,528.3	1,975.6
II CAPITAL ACCOUNT	-10.9	-13.7
III FINANCIAL ACCOUNT (excluding reserve assets)	1,994.0	802.1
1. Direct investment, net	1,419.4	1,589.0
2. Portfolio investment, net	1,508.6	782.6
3. Financial derivates, net	-3.3	-43.6
4. Other investment, net	-930.7	-1,525.8
4.1. Trade credit	-1,125.6	-380.8
4.2. Financial loans	482.6	-160.0
4.3.Currency and deposits, net	-285.1	-985.1
4.4. Other, net	-2.7	0.1
IV Reserve assets	-363.2	-581.9
V NET ERRORS AND OMISSIONS	-373.5	311.8
VI OVERALL BALANCE	363.2	581.9

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

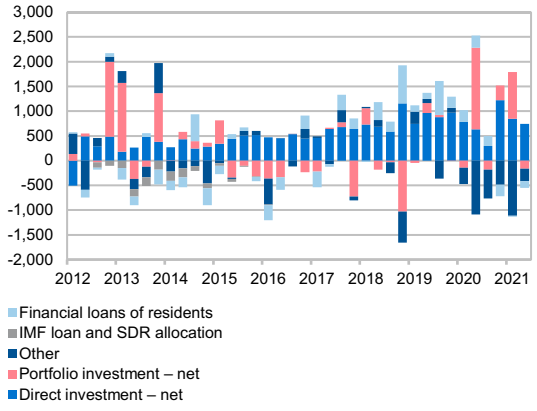
The deficit on trade in goods came at EUR 2.6 bn in H1, almost the same as in H1 2020, with both export and import growing at double-digit rates – by 31.0%, y-o-y and 23.2% y-o-y, respectively. The rise in **goods export** (to EUR 9.6 bn) was guided by manufacturing export which gained 26.9% y-o-y. Export increased y-o-y in almost all branches of manufacturing (20 out of 23), including in particular export of electrical equipment, motor vehicles, rubber and plastic products, chemical products, base metals, food and metal products. Export

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



Sources: SORS and NBS.
* Preliminary data.

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



Source: NBS.
* Preliminary data.

growth was also supported by agricultural, mining and electricity exports. The rise in **goods import** (to EUR 12.2 bn) was led by a further economic activity rebound. By broad economic category (BEC), the main contribution to import came from higher import of intermediate goods (27.1% y-o-y), followed by import of equipment (15.0% y-o-y) and consumer goods (12.8% y-o-y). Such movements are also confirmed by the EU classification, according to which import growth was led by the import of intermediate and capital goods, and was supported by the higher import of consumer goods and, to a smaller degree, of energy.

The surplus on external **trade in services** expanded in H1 to EUR 809.2 mn (by 62.3% y-o-y) as services export recovered faster than import. Services export and import gained 18.1% y-o-y and 9.0% y-o-y, respectively, in H1. The rise in the surplus on trade in services was supported in particular by continued growth in ICT services export (by 17.6% y-o-y to EUR 826.1 mn) and the surplus on tourism services which increased from EUR 4.1 mn in H1 2020 to EUR 160.2 mn in H1 2021.

The deficit in the **primary income account** increased by 1.2% y-o-y to EUR 701.0 mn, under the impact of subdued revenues in respect of FDI abroad and employee salaries. Though expenditures in respect of portfolio investment increased, since the first coupon on eurobonds issued last year was paid out in May, this was offset by smaller expenditures in respect of FDI.

The surplus in the **secondary income account** increased in H1 by 29.3% y-o-y to almost EUR 2.0 bn, mostly on account of stronger inflow of foreign remittances which measured EUR 1.5 bn in H1, up by almost a quarter relative to the same period last year. Surplus growth was also supported by higher grants to the public sector and net transfers in respect of trade with Kosovo and Metohija.

Net inflow to the **balance of payments financial account** equalled EUR 802.1 mn[6] in H1 2021. Capital inflows referred to FDI and portfolio investments, while outflow was recorded in respect of higher amounts of currency and deposits held by banks abroad, trade loans and increased bank deleveraging to foreign creditors.

According to preliminary data, **FDI inflow to Serbia** measured EUR 1.8 bn in H1, up by 21.0% from the same period last year, with almost two-thirds of investment in the form of equity capital. The bulk of investment came from the EU and Asian countries and was directed to manufacturing (23.7%), followed by mining, transport, construction, financial activities and information. In this way, FDI continues to be mostly oriented towards tradable sectors. Net FDI inflow measured EUR 1.6 bn in the same period.

The successful issue of 12-year eurobonds in the international market in February resulted in net inflow of EUR 782.6 mn in respect of **portfolio investment** in H1. Serbia issued eurobonds worth EUR 1.0 bn in the international financial market. In the domestic market, non-residents stepped up their investment in the primary market of dinar government securities, especially in longest-term securities, which for a major part covered

[6] Excluding change in FX reserves.

outflows in respect of maturing and net sale of securities in the secondary market. As of end-June, after dinar government securities were included in J.P. Morgan indices, foreign investors' demand for these securities expanded.

An outflow of EUR 1.5 bn was recorded in respect of **other investments** in H1. The bulk of this outflow related to higher amounts of **currency and deposits** held by banks abroad (EUR 985.1 mn). Outflow was also recorded in respect of **trade loans** of corporates (EUR 380.8 mn) due to an increase in residents' receivables from foreign buyers. Net outflow was also recorded in H1 in respect of **financial loans** (EUR 160.0 mn) because of net deleveraging by banks (EUR 294.7 mn) and regular servicing of the NBS's liabilities to the IMF in respect of earlier borrowing (EUR 3.9 mn). At the same time, the government borrowed EUR 133.5 mn, net, and corporates – EUR 5.1 mn, net.

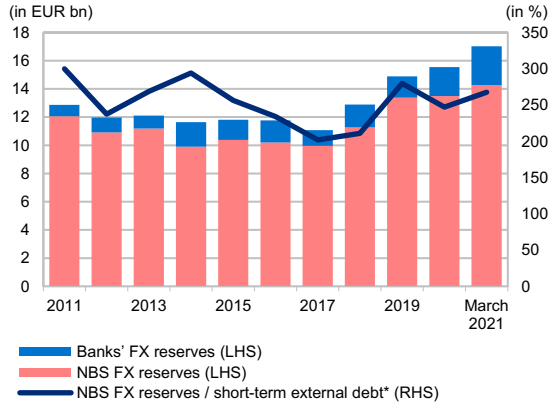
The above flows in the current and financial account pushed up **Serbia's FX reserves** (according to balance of payments methodology)[7] in H1 by EUR 581.9 mn.

As at 30 June 2021, gross FX reserves of the NBS measured EUR 14,091.8 mn, up by EUR 600.1 mn from end-2020. Such level covered 132% of money supply M1 and more than six months of import of goods and services, almost twice the standard on the adequate level of FX reserves. At the same time, net FX reserves equalled EUR 11,597.0 mn, and were EUR 466.3 mn higher than at end-2020.

Consistent with the 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). As at 30 June 2021, foreign securities accounted for the bulk of FX reserves (50.2%), followed by FX balances in accounts abroad (21.3%), foreign cash (15.7%), gold (12.3%) and SDRs with the IMF (0.5%).

The highest FX inflow in 2021 came from the sale of long-term RS securities (eurobonds) worth EUR 970.9 mn in the international financial market in March. Inflow from the sale of euro-denominated RS securities in the domestic financial market equalled EUR 110.1 mn.

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



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

Inflow also came from the disbursement of loans for the RS (EUR 236.4 mn), temporary payment operations with Kosovo and Metohija[8] (EUR 191.1 mn), grants (EUR 143.9 mn) and FX required reserves of banks (EUR 96.7 mn, net). In respect of NBS activities in the IFEM[9], a net FX inflow (the effect of spot and swap transactions) of EUR 53.0 mn was recorded, as was the inflow in respect of investment in foreign securities and interest rates on FX funds in the amount of EUR 35.4 mn, net.

The largest outflow from NBS FX reserves was driven by the regular settlement of obligations to foreign creditors (principal and interest) in the amount of EUR 554.9 mn and the maturing of euro-denominated RS securities in the domestic financial market worth EUR 352.0 mn. Pursuant to the Law on the Settlement of the Public Debt of the RS Arising from Unpaid Foreign Exchange Savings of Citizens, EUR 12.1 mn was paid out (including unpaid FX savings of citizens of former SFRY republics in the amount of EUR 10.9 mn).

International investment position

At end-H1, Serbia's international investment position of a net debtor equalled EUR 42.8 bn, and its share in GDP measured 87.1%, down by 3.9 pp relative to end-2020.

The increase in Serbian residents' foreign liabilities, primarily in respect of the most desirable form of

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

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

[9] 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.

foreign investment – FDI, was to a large extent accompanied by an increase in assets abroad, primarily FX reserves of banks and the NBS. As a result, Serbia's net international investment position of a net debtor increased by only EUR 489.2 mn.

Foreign financial assets (Serbian residents' assets abroad) continued to increase in H1. They gained EUR 2.5 bn as a result of balance of payments transactions worth EUR 2.46 bn, while the remainder of EUR 62.4 mn referred to currency and other changes. Within financial assets, other resident investment abroad increased the most (to EUR 12.4 bn) owing to a rise in resident currency and deposits abroad, as well as in trade loans and advance payments to non-residents. Also, FX reserves increased notably within financial assets as a result of balance of payments transactions, but also, to a considerably smaller degree, of currency and other changes. **FX reserves continued to account for the bulk, i.e. 45.4%, of total assets.** FDI measured EUR 3.9 bn or 12.6% of total resident assets abroad at end-H1 2021.

Foreign financial liabilities (Serbian residents' foreign liabilities) increased in H1 as a result of executed transactions worth EUR 2.7 bn, but also of currency and other changes worth EUR 331.3 mn.

The composition of financial liabilities reveals a continuation of a positive trend from prior years – an increase in the stock of **FDI** to EUR 44.4 bn. In this way, the share of the most desirable form of residents' foreign liabilities climbed to 60.1% of total foreign liabilities of residents. The rise in total liabilities in H1 was also facilitated by an increase in **portfolio investment**, as the government successfully issued the 12-year bond in euros in the international financial market. As the stock of portfolio investments climbed to EUR 7.9 bn, resident liabilities in this respect measured 10.7% of total foreign liabilities.

Resident liabilities in respect of **other investments** equalled EUR 21.6 bn at end-H1 or 29.2% of total liabilities. Within other investments, resident liabilities in respect of financial loans decreased, while those in respect of trade loans and advance payments, as well as currency and deposits, increased.

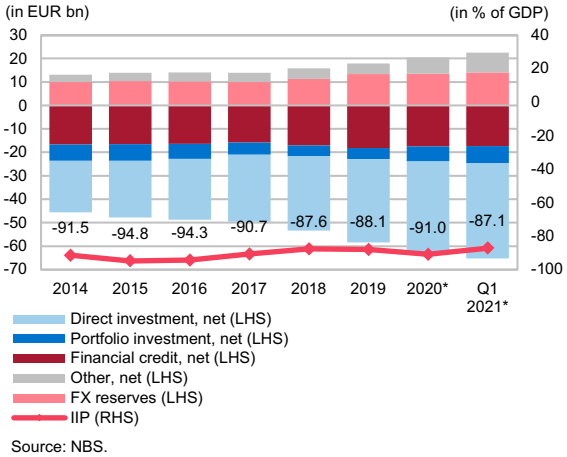
3 Financial market trends

Interest rates

In all auctions for the sale of securities during H1 the average repo rate was almost equal to the deposit facility rate (deviation up to 1 bp), which determined movement in money market interest rates and, by extension, in rates on bank dinar loans.

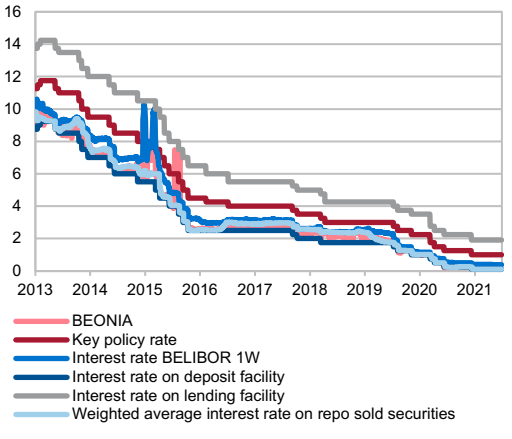
On the back of a mild dip in excess dinar liquidity, turnover in the overnight interbank money market expanded from RSD 3.4 bn in December 2020 to RSD 11.4 bn in June 2021. This did not reflect on the BEONIA interest rate, however, and in H1 it ranged between 0.10% and 0.14%. BELIBOR rates of all maturities also oscillated minimally in H1. At end-June,

Chart III.2.4 **International investment position**



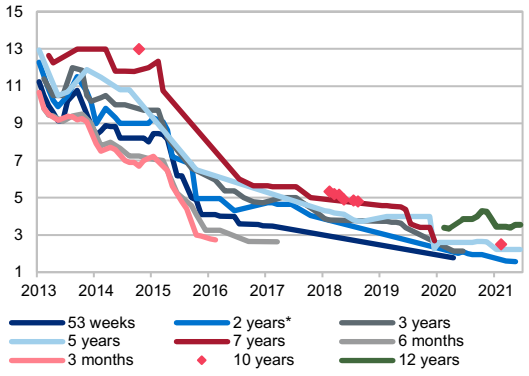
Source: NBS.
* Preliminary data.

Chart III.3.1 **Interest rate movements**
(daily data, p.a., in %)



Sources: Thomson Reuters and NBS.

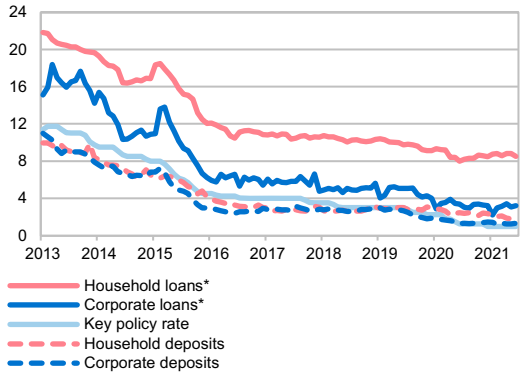
Chart III.3.2 **Interest rates in the primary market of government securities**
(p.a., in %)



Source: Ministry of Finance.

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

Chart III.3.3 **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.

like at end-December 2020, they ranged between 0.3% for the shortest maturity and 1.1% for the six-month maturity.

In the **primary market of dinar securities**, in 2021 the government continued to hold auction sales of 5.5-year and 12.5-year benchmark dinar bonds issued in early 2020. The effective rate for the 12.5-year maturity lost 0.3 pp during H1 to 3.55%. The nominal amount of these securities sold in five auctions measured RSD 52.7 bn. In the auction sales of securities with the initial maturity of 5.5 years, the effective rate decreased by 0.4 pp to 2.2%, while the nominal amount of securities sold in three auctions measured RSD 22.8 bn. A new two-year bond was issued in March 2021. The effective rate on this bond was 1.6%, but declined by 3 bp to 1.57% in a new auction held in May. A reopening of the issue of 10-year bonds issued in 2018 was organised as well, at an effective rate of 2.5% (for the 7-year remaining maturity).

In H1, dinar securities in the total nominal amount of RSD 115.5 bn were sold. After the maturing of previously sold securities in the nominal amount of RSD 56.4 bn, the stock of sold dinar securities climbed to RSD 1,006.8 bn in late June.

Similarly as in 2020, in primary auctions non-residents invested most in 12.5-year dinar government bonds. In the secondary market, however, non-residents were somewhat more active on the selling side. As a result, the stock of sold securities owned by non-residents declined by RSD 7.7 bn in H1 to RSD 227.5 bn in late June, or 24% of the total stock of sold dinar securities.

In Q1, two **auctions for the sale of 20-year euro-denominated securities** and one auction for the sale of 12-year euro-denominated securities were held. The effective rates were on a decline. The effective rate for the 20-year maturity decreased by 0.75 pp (the previous auction was held in January 2020) to 2.25%, its level in March and May auctions, while the rate on the 12-year maturity dipped by 0.15 pp to 1.74% in March 2021 (previous auctions were held in February and March 2020). Securities in the nominal amount of EUR 110.5 mn were sold, but as maturities of previously sold euro-denominated securities were higher, the stock of sold securities in euros decreased in H1 by EUR 236.3 mn to EUR 2,394.0 mn.

In the **international financial market**, in February Serbia issued a new 12-year euro-denominated eurobond in the nominal amount of EUR 1 bn, at a rate of 1.92% (coupon rate 1.65%). This was the third successful bond issue in the international capital market since the outbreak of the COVID-19 crisis, which once again confirmed investors' confidence. As in the previous auctions, demand was several times higher than supply.

In the secondary market, investor activity gained momentum, as evident from trade worth RSD 275.8 bn in H1 2021, up by 52.6% relative to H2 2020. Yield-to-maturity rates were slightly lower than in December 2020, ranging on average between 1.0% for 8-month remaining maturity and 3.55% for 11-year remaining maturity in June. It should also be noted that trade intensified somewhat in late June after 7-, 10- and 12.5-year dinar government securities were included in J.P. Morgan indices.

In H1, interest rates on new dinar loans were close to their all-time lows – in June they equalled 8.4% on household loans and 3.2% on corporate loans.

Within dinar loans to households, the interest rate on the most dominant household loan category – cash loans – was mildly revised down (0.1 pp) to 9.1% in June, while interest rates on other unclassified loans gained 0.4 pp to 5.7%.

Within new dinar loans to corporates, interest rates on working capital loans and other unclassified loans decreased in H1 by 0.1 pp each to 3.3% and 2.8%, respectively, while the interest rate on dinar investment loans increased, reaching 4.4% in June.

The average interest rate on euro-indexed household loans decreased by 0.3 pp to 3.0%, largely due to a continued fall in interest rates on housing loans which touched a new trough of 2.5%.

The average interest rate on new euro-indexed corporate loans also subsided in H1 by 0.5 pp to 2.5%, across all corporate loan categories. Interest rates on working capital, investment and other unclassified loans decreased by 0.2 pp, 0.4 pp and 0.9 pp to 2.5%, 2.7% and 2.5%, respectively, in June.

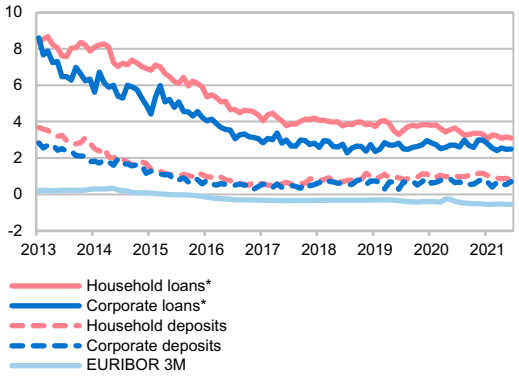
During H1, interest rates on time corporate and household deposits recorded a decline, which was slightly more pronounced for dinar deposits. Interest rates on dinar deposits lost 0.4 pp each relative to December 2020 – to 1.95% for household savings and 0.8% for corporate time deposits in June. In the same period, interest rates on time deposits in euros decreased by 0.2 pp each to 0.7% for corporate deposits and 0.8% for household savings.

Risk premium

Similarly as in many other European emerging economies, Serbia's risk premium for euro-denominated debt, EURO EMBIG, initially saw a mild increase in Q1 (by 19 bp to 163 bp), reflecting diminished investor appetite for emerging economies amid higher long-term yields on US sovereign securities. After decreasing in Q2 (by 18 bp), it remained broadly unchanged at the level of H1. In late June, it measured 144 bp, which is lower than EURO EMBIG Composite (147 bp). Serbia's dollar risk premium was stable in H1. In late June, similarly as at end-2020, it measured 128 bp and remained well below EMBI Composite, which equalled 312 bp at end-H1. A positive impact on Serbia's risk premium in H1 continued to come from domestic factors – favourable macroeconomic outlook and continued vaccine rollout.

As a result of strengthening of the domestic macroeconomic environment and the activities taken in order to develop the domestic financial market in prior years, in late June Serbia's dinar bonds were included in J.P. Morgan's GBI–EM Global Diversified Index, one of the most frequently watched indices of emerging economies' bonds in local currencies. This reflects global confidence in Serbia and confirms its attractiveness as an investment destination. The above index will include three benchmark issues of dinar bonds, of 7-, 10- and 12.5-year original maturity, falling due in 2026, 2028 and 2032 and having a 0.3% weight in the index. The Serbian dinar

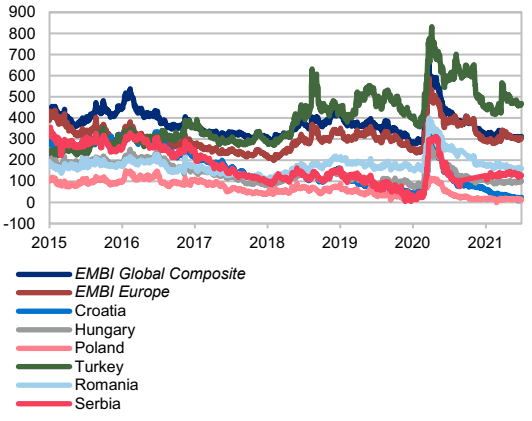
Chart III.3.4 **Interest rates on new euro and euro-indexed loans and deposits**
(weighted average values, p.a., in %)



Sources: NBS and European Banking Federation.

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

Chart III.3.5 **Risk premium indicator on the dollar debt – EMBI**
(daily data, in bp)



Source: JP Morgan.

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

	2017	2018	2019	2020	2021
S&P	BB /stable[4)]	BB /positive[4)]	BB+ /positive[4)]	BB+ /stable[2)]	
Fitch	BB /stable[4)]		BB+ /stable[3)]		
Moody's	Ba3 /stable[1)]		Ba3 /positive[3)]		Ba2 /stable[1)]

Source: NBS.
[1)] March, [2)] May, [3)] September, [4)] December.

bonds are also included in GBI–Aggregate (GBI–AGG) and GBI–AGG Diversified indices, as well as in J.P. Morgan's ESG (JESG) GBI–EM index.

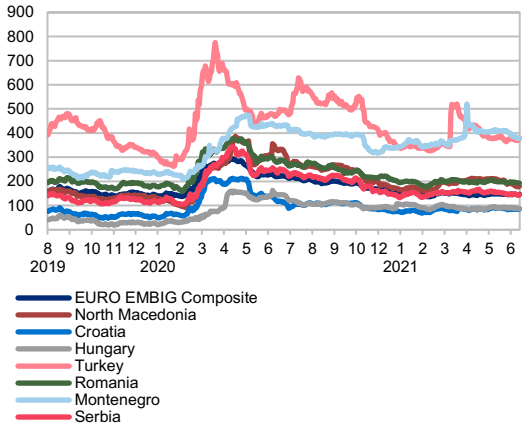
Despite the global crisis and the extended pandemic, Moody's upgraded Serbia's credit rating in March from Ba3 to Ba2, with a stable outlook, while Fitch (in March) and Standard & Poor's (in June) affirmed Serbia's rating at BB+, with a stable outlook for further upgrade to investment-grade rating. Agencies highlight substantial resilience of the Serbian economy achieved in prior years, and the fact that Serbia faced the COVID-19 crisis with much reduced macroeconomic imbalances compared to a decade ago. This created scope for prompt and adequate measures as soon as the crisis broke out. As key factors of resilience and favourable economic outlook, the agencies highlighted low and stable inflation, relative stability of the exchange rate, reduced external imbalances and a current account deficit fully covered by FDI, adequate FX reserves, increased economic diversification and lower fiscal risks. Political stability and successful reform implementation, as well as Serbia's stable banking system, are cited as important factors bringing Serbia closer to investment-grade rating.

Trends in the FX market and the exchange rate

The dinar/euro movements were stable in H1. In late June, the dinar/euro exchange rate was almost unchanged (RSD 117.6 for EUR 1) relative to the start of the year. On the other hand, the dinar weakened against the dollar by 3.1% to RSD 98.7 for USD 1 in late June, reflecting the euro's slide against the dollar.

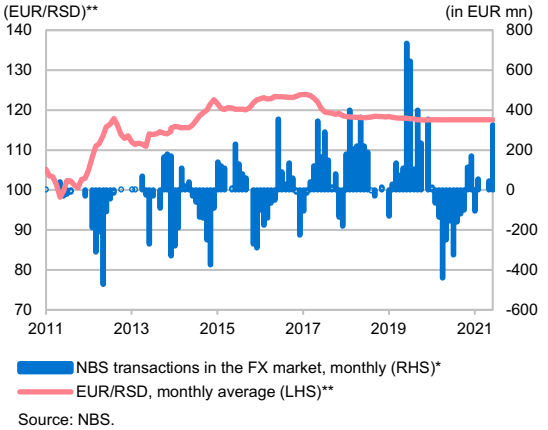
Depreciation pressures prevailed in January, mostly due to seasonally higher FX demand of domestic companies, energy importers, and net sale of foreign cash to households and exchange dealers and reduced FX-indexed assets of banks.[10] These pressures were moderated by FX sales by non-residents, which were majority buyers in auctions of 12-year dinar securities in January as well. In the coming months, appreciation pressures gained ground, supported in February also by FX sales by some domestic companies, mostly net exporters. In addition, February saw renewed net purchases of foreign cash from households and exchange dealers, the quarterly amount of which came close to the pre-pandemic level in Q2. The

Chart III.3.6 **Risk premium indicator – EURO EMBIG**
(daily data, in bp)



Source: J.P. Morgan.

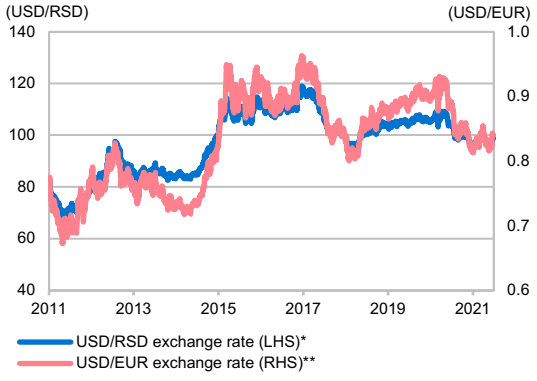
Chart III.3.7 **Dinar exchange rate and NBS transactions in the FX market**



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

[10] Aiming to balance their short open foreign currency positions, and reduce their exposure to foreign exchange risk, banks buy foreign currency, which results in the weakening of the dinar.

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



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

dinar's strengthening during entire H1 was supported by a lengthening of the banks' foreign currency position in respect of payment card use. Appreciation pressures intensified in June, propped up by higher FX-indexed lending to corporates and households, i.e. a rise in FX-indexed bank assets,[11] and, late in the month, also by increased demand of foreign investors for dinar government securities, after RS dinar bonds were included in J.P. Morgan indices.

In H1, the NBS bought EUR 320.0 mn, net, in the IFEM, further strengthening the country's FX reserves. To maintain relative FX market stability, the NBS intervened only on the FX buying side in June, and only on the FX selling side in January, while in other months it intervened on both the buying and the selling side.

The average daily interbank trading volumes[12] in the IFEM in H1 2021 reached EUR 25.4 mn, up by EUR 1.5 mn from H2 2020. The highest turnover was recorded in January (daily average of EUR 30.4 mn).

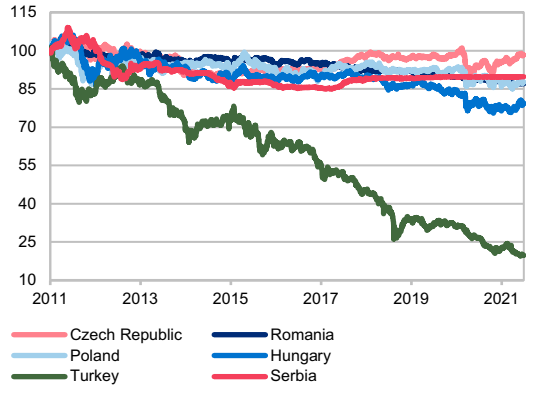
Whereas the dinar remained unchanged against the euro in H1, currencies of other inflation targeting countries of the region recorded divergent movements. The Hungarian forint, Czech koruna and Polish zloty strengthened (by 3.8%, 3.0% and 2.1%, respectively) and the Romanian leu and the Turkish lira weakened vis-à-vis the euro (by 1.2% and 13.1%, respectively).

4 Money and loans

Monetary aggregates M1, M2 and M3

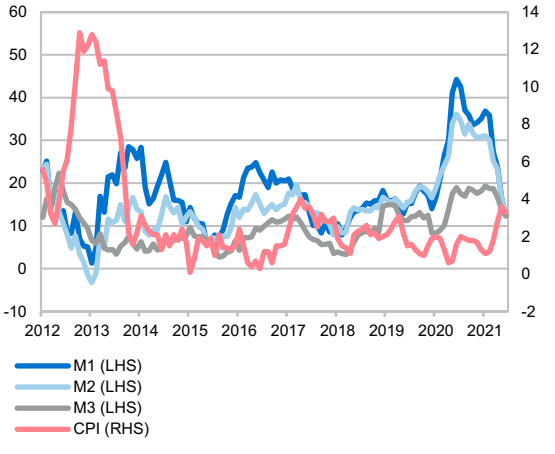
A lower volume of direct government assistance and the lifting of the moratorium on corporate and household loan repayment contributed to a slowdown in money supply growth during H1, as expected. Dinar monetary aggregates, M1 and M2, increased in six months by 2.8% and 2.2%, while growth in M3, additionally supported by FX deposits, equalled 4.6%.

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



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

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



Sources: SORS and NBS.

[11] Aiming to balance their long open foreign currency positions, and reduce their exposure to foreign exchange risk, banks sell foreign currency, which results in the strengthening of the dinar.

[12] Excluding the NBS.

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

	Dec. 2020	June 2021	Changes in H1 2021
Net foreign assets	**1,347,165**	**1,545,739**	**198,574**
Bank net foreign assets	-250,497	-227,098	23,399
Net domestic assets of the banking sector	**1,987,585**	**1,943,518**	**-44,066**
Net domestic loans	3,139,611	3,141,100	1,489
Net claims on government	379,203	292,566	-86,637
Government loans	840,014	865,428	25,414
Government deposits	-460,811	-572,862	-112,050
Loans to other resident sectors	2,760,408	2,848,534	88,126
Loans to households	1,243,622	1,309,923	66,301
Loans to the corporate sector	1,452,691	1,478,694	26,003
Loans to other financial corporations	33,656	33,299	-357
Loans to local authorities	29,857	26,123	-3,734
Loans to non-profit and other organisations	582	495	-87
Other net assets	-1,152,027	-1,197,582	-45,555
Money supply M3	**3,334,749**	**3,489,257**	**154,508**
Money supply M2	1,553,797	1,587,764	33,966
Money supply M1	1,220,082	1,253,985	33,903
Currency in circulation	266,725	264,546	-2,179
Sight deposits	953,357	989,439	36,082
Dinar savings and term deposits	333,715	333,779	64
FX deposits	1,780,952	1,901,493	120,541

Source: NBS.

In terms of individual categories, **sight deposits** rose by RSD 36.1 bn, mostly owing to the increase in household and corporate deposits. Households increased their transaction account balances by RSD 19.8 bn, and the entire growth was achieved in Q2. At the same time, the rise in transaction deposits of corporates equalled RSD 1.8 bn in H1 – during Q2, corporates compensated quite well for the seasonally usual decrease in deposits at the start of the year. The balance of transaction accounts of other sectors recorded relatively smaller changes compared to end-2020.

Time dinar deposits in H1 were almost unchanged from end-2020. The decrease in corporate deposits measured RSD 25.5 bn (declining almost evenly in quarterly terms). On the other hand, growth was recorded in accounts of other financial organisations (by RSD 11.0 bn) and local government units (by RSD 6.9 bn). Dinar savings of households upheld the stable growth trend from the previous three years, having risen by RSD 5.8 bn during H1 (i.e. 6.3%), thus recording the new maximum of RSD 98.3 bn in June.[13] The continued growth in dinar savings illustrates citizens' confidence in the local currency and the banking system, which was preserved even in the crisis conditions that emerged due to the coronavirus pandemic. In addition to the preserved price stability and the relative stability of the exchange rate, the increased appeal of dinar savings compared to FX savings is also attributable to higher interest rates, as well as the more favourable tax treatment of dinar savings.

FX deposits rose EUR 1.0 bn in H1, mostly owing to the increase in household and corporate deposits. Household FX savings increased EUR 666.9 mn in six months, to EUR 11.7 bn in June,[14] which is their highest level to date. At the same time, corporate deposits increased by EUR 388.6 mn, mainly thanks to FX inflows on account of exports, FDI and corporate borrowing abroad.

In y-o-y terms, according to our expectations, monetary aggregates gradually decelerated during H1 – M1, M2 and M3 posted y-o-y growth of 12.4%, 13.1% and 12.4%[15] in June, respectively, practically returning to their 2019 levels. The slowdown in money supply growth is mostly attributable to the high last year's base, when the pronounced growth in money supply was connected with government and NBS measures aimed at boosting liquidity and disposable income of corporates and households, and with the change in certain consumer habits amid the pandemic and the rise in precautionary savings. On the other hand, going forward, we can expect the third package of economic measures, approval of loans under the Guarantee Scheme (the first and the second), and the recovery of economic activity to act towards driving money supply up.

Bank loans

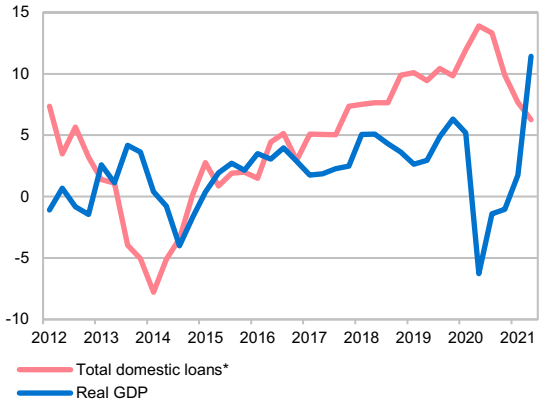
Domestic lending continued the stable growth trend during H1 as well, which, in accordance with our expectations, gradually slowed down y-o-y, to 6.3% in June, excluding the exchange rate effect. The slowdown is mostly a result of the high base from last year (especially in the corporate sector) due to the moratorium on loan repayment, as well as the consequently higher maturities after the lifting of the second moratorium. At the same time, growth in **total domestic receivables** (which, apart

[13] Money supplies include only resident assets. Including the assets of non-residents, dinar savings amounted to RSD 98.8 bn at end-June.

[14] Including non-resident assets, FX savings equalled EUR 12.1 bn at end-June.

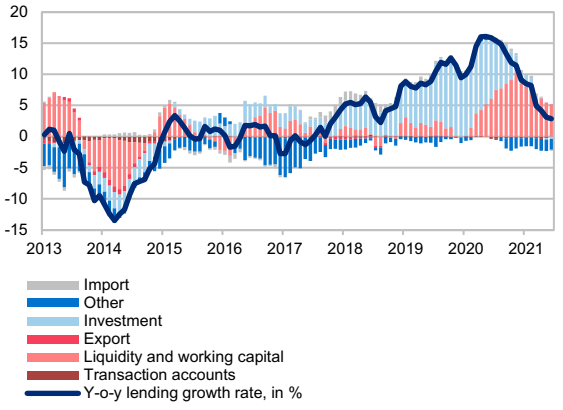
[15] Compared to 35.0%, 30.9% and 18.1%, respectively, in December 2020.

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



Sources: NBS and SORS.
* Excluding the exchange rate effect.

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



Source: NBS.

from loan receivables, also include receivables arising from investment in securities, interests and fees, and other receivables) amounted to 7.0% y-o-y in June.

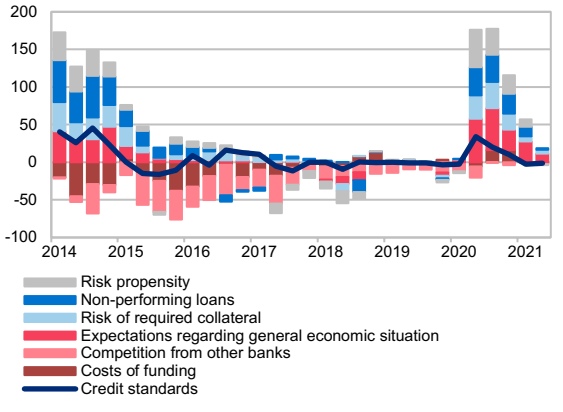
In 2021, banks continued with NPL resolution activities, though at a more moderate dynamics considering the current results achieved in this field. During H1, banks wrote off RSD 6.9 bn in NPLs, and sold RSD 2.9 bn in NPLs to non-bank entities directly from their balance sheets.

Excluding the exchange rate effect, **corporate loans** increased by RSD 28.4 bn in H1. The growth is entirely attributable to dinar loans, which is a result of the NBS's monetary policy easing and favourable lending conditions within the Guarantee Scheme, thanks to which interest rates on new dinar loans to corporates came close to the rates on euro-indexed loans. By purpose, growth was driven by liquidity and working capital loans, which are the dominant corporate loan types, and accounted for 44.6% in June. Next are investment loans, with a 42.8% share. Sector-wise, the biggest increase in borrowing in H1 was recorded by transport, trade and construction companies, while a decrease was recorded only by agricultural companies. In terms of company size, growth was spurred by the market segment of micro, small and medium-sized enterprises to a somewhat greater extent (RSD 15.6 bn), while large enterprises increased their loan stock by RSD 12.9 bn.

The volume of new corporate loans in H1 (RSD 495.0 bn) was 14.2% higher than in the corresponding period a year earlier. The bulk of new loans to corporates were liquidity and working capital loans (52.3%). Investment loans accounted for 29.2% of approved loans, and their amount of RSD 144.7 bn was almost by a quarter higher than in the same period last year. Micro, small and medium-sized enterprises used 62% of the approved liquidity and working capital loans, and 68% of investment loans.

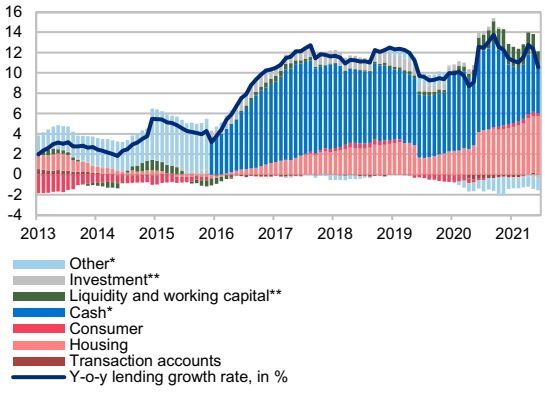
Excluding the exchange rate effect, **loans to households** rose 5.4%, or RSD 67.3 bn, in H1. Almost 60% of this growth referred to housing loans, which recorded a y-o-y growth of 15.7% in June. Next were cash loans, which gained RSD 26.9 bn, and liquidity and working capital

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



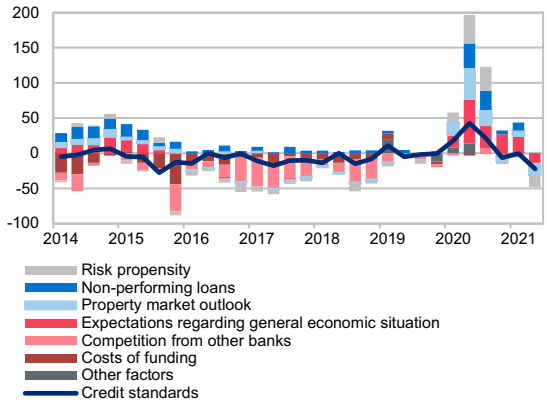
Source: NBS.
Note: Growth indicates the tightening, and decline indicates the easing of credit standards.

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.

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.

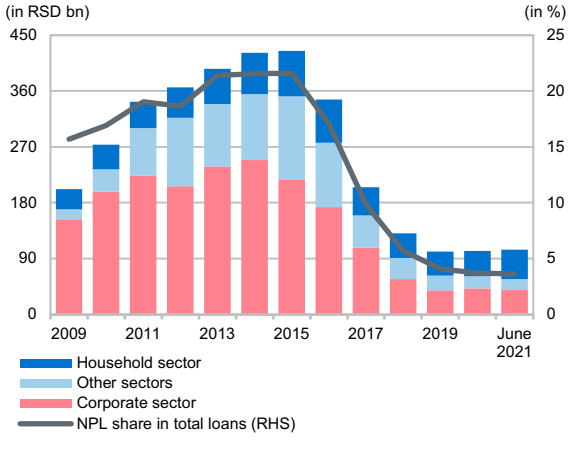
loans approved to entrepreneurs, which rose RSD 8.1 bn. In the composition of household loans in June, the dominant categories were cash loans (44.2%) and housing loans (37.8%).

The volume of new household loans in H1 equalled RSD 277.9 bn, up by 55.8% from the same period last year, though it must be noted that containment and physical distancing measures were in place at the time. Cash loans made up 57.5% of new loans in H1, and housing loans 25.8%, while the amount of new housing loans in H1 (RSD 71.7 bn) more than doubled y-o-y. Positive trends in the real estate market, a continuous rise in the number of completed apartments since 2016 and favourable borrowing terms have boosted household demand for housing loans.

Results of the NBS bank lending survey[16] show that in H1, banks embarked on a moderate loosening of corporate credit standards, which mostly pertained to dinar loans. Household credit standards were unchanged in Q1, and then mitigated in Q2, mostly for the dominant loan categories – FX-indexed housing and dinar cash loans. Banks estimate that corporate and household loan demand increased during H1. Corporate demand was driven by small and medium-sized enterprises and was largely directed toward long-term loans. Another contributor since the start of the year has been capital investment. At the same time, households were mostly interested in dinar cash loans and FX-indexed housing loans.

Gross NPL ratio is still below its pre-crisis level, measuring 3.6% in June, which indicates that the NBS and Government measures were timely, thus preventing stronger negative effects on corporates and households, and in turn on financial stability as well. Also, compared to end-2020, the share of NPLs in total loans dropped (by 0.1 pp), with the corporate sector[17] recording a decrease of 0.2 pp to 2.9% in June and the household sector[18] by 0.4 pp to 4.0% in June. **The NPL coverage still remained high** – allowances for impairment of total loans came at 92.1%

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



Source: NBS.

[16] The NBS conducts the survey since the beginning of 2014.

[17] It includes companies and public enterprises. Looking at companies alone, the NPL share in total loans in June also equalled 2.9%.

[18] Including entrepreneurs and private households, the share also equalled 4.0%.

of NPLs in June, while allowances for impairment of NPLs stood at 58.2% of NPLs.

The capital adequacy ratio[19] at end-Q2 2021 equalled 22.2%, indicating high capitalisation (regulatory minimum – 8.0%) and resilience of the banking sector to external and domestic risks.

5 Dinarisation

In H1 2021, the NBS continued to implement activities aimed at promoting 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 stability of the financial system, this being the key precondition for strengthening confidence in the dinar.

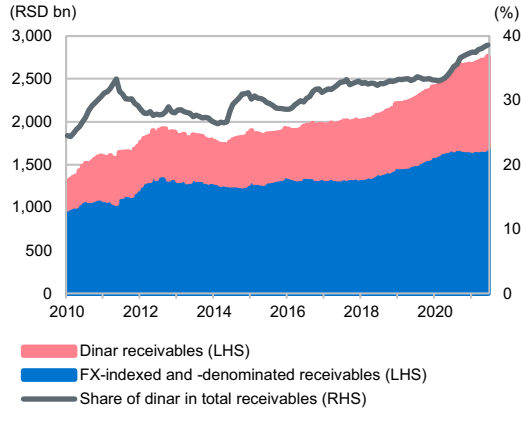
The reserve requirement policy continued to stimulate banks to rely more on dinar sources of funding. Namely, the required reserve ratios on dinar sources of funding are still significantly lower than those on FX sources, and the NBS continues to remunerate allocated required reserves in dinars, and not in foreign currency.

With regard to prudential measures that help mitigate the FX risk and bolster dinarisation of the financial system, banks approving dinar loans under the first and the second Guarantee Scheme,[20] at interest rates at least 50 bp lower than the maximum rate prescribed by the relevant laws, will be paid by the NBS a remuneration rate 50 bp higher than the standard remuneration rate on allocated dinar required reserves in the amount of such loans.[21] In this way, within the existing required reserves system, the NBS supported the anti-crisis measures of the Serbian Government and further encouraged the approval of dinar corporate loans, at more favourable interest rates, which are closer to interest rates on euro loans. As at end-June, the amount of corporate loans approved under more favourable terms on account of the remuneration rate on required reserves reached RSD 22.1 bn, at an average interest rate of 2.4%.

The NBS continued to support the development of FX hedging instruments. In H1 2021, regular two-week and three-month FX swap auctions were also organised, encouraging interbank swap trading and the development of instruments for liquidity management and FX hedging.

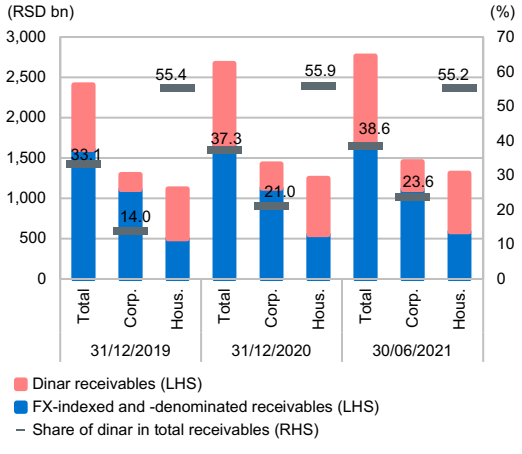
Within other activities which contribute to higher dinarisation, the NBS actively participated in the adjustment of the regulatory framework and the implementation of measures and activities supporting the development of the financial market. **The inclusion of dinar government securities in the renowned J. P. Morgan index family** contributes to the development of

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



Source: NBS.

Chart III.5.2 **Bank receivables by sector**



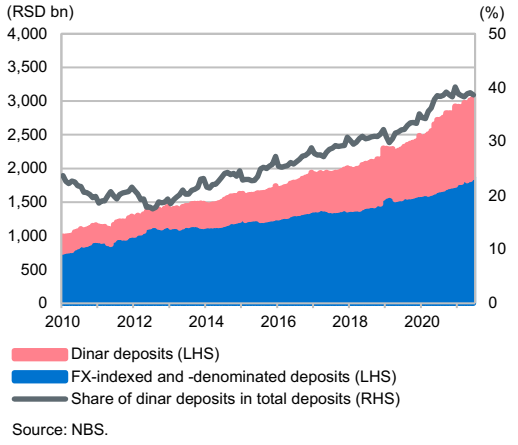
Source: NBS.

[19] The regulatory framework of Basel III is applied since 30 June 2017.

[20] Law on Establishing a Guarantee Scheme as a Measure of Support to the Economy for Mitigating the Effects of the COVID-19 Pandemic Caused by the SARS-CoV-2 Virus (RS Official Gazette, Nos 153/20 and 40/21) and the Law on Establishing the Second Guarantee Scheme as a Measure of Additional Support to the Economy due to the Prolonged Negative Impact of the COVID-19 Pandemic Caused by the SARS-CoV-2 Virus (RS Official Gazette, No 40/21).

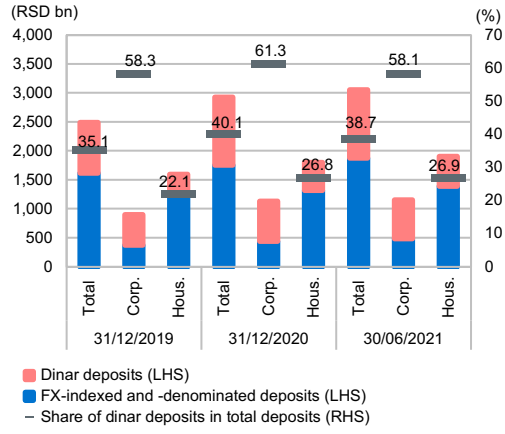
[21] The standard remuneration rate on allocated required reserves currently equals 0.10%

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



Source: NBS.

Chart III.5.4 **Bank deposits by sector**



Source: NBS.

the local capital market, its better functioning and higher liquidity.

The degree of dinarisation, **measured as the share of dinar receivables in total corporate and household receivables**, increased by 1.3 pp in H1 2021, to 38.6% at end-June.

Increased dinarisation of receivables in H1 reflects primarily the rise in dinar corporate lending, mostly under the RS Guarantee Scheme. The Guarantee Scheme provided for lending on relatively favourable terms to entrepreneurs as well as micro, small and medium-sized enterprises, and loans were largely disbursed in dinars.

Unlike dinar receivables, corporate FX-indexed and FX receivables decreased, so the degree of dinarisation of corporate receivables increased by 2.6 pp in H1 2021, to 23.6% at end-June.

The degree of dinarisation of household receivables edged down slightly in H1 2021, mostly on account of further upswing in FX-indexed housing loans, which besides positive trends in the real estate market, benefited from favourable terms of borrowing and higher disposable income. Stronger growth in FX-indexed than in dinar household receivables led to a decrease in the dinarisation of household receivables in H1 2021 (by 0.7 pp) to 55.2% at end-June.

During **H1 2021, the degree of dinarisation of corporate and household deposits fell from its record high level at end-2020** (40.1%) to 38.7% at end-June 2021. The decrease in this indicator mainly resulted from intensified depositing of FX funds to corporates' accounts, which is why the degree of dinarisation of corporate deposits went down in H1 (by 3.2 pp, to 58.1%).

Household deposits being an extremely important source of funding for the banking sector, it is noteworthy that **the degree of dinarisation of household deposits in H1 2021 continued to increase**. At end-June, this indicator measured 26.9%, up by 0.1 pp from end-2020. The increase in dinarisation of household deposits remains underpinned by the **dynamic rise in dinar savings**.

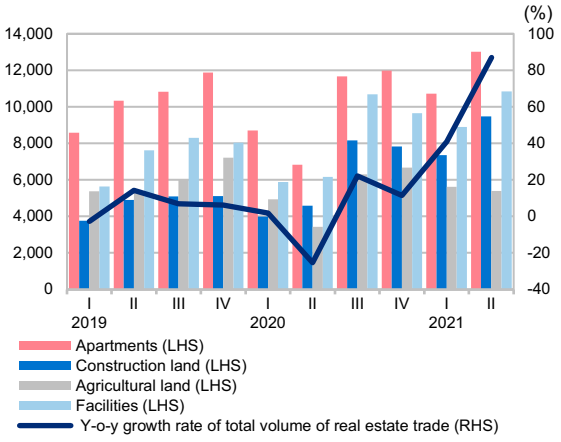
6 Real estate market

According to the Republic Geodetic Authority, **the number of real estate transactions** reached 83,515 in H1 2021, which is significantly higher than in the same period last year (by 62.5%). Flats accounted for most of real estate transactions in H1 (28.4%), followed by development land (20.1%), residential buildings (13.7%), and farmland (13.2%).

The average price of flats in old buildings in cities (Belgrade, Novi Sad, Niš and Kragujevac) measured EUR 1,099 per square metre in H1 2021, which is an 8.5% y-o-y rise. **The average price of flats in newly constructed real estate** reached EUR 1,331 per square metre in the same period (a 10.2% y-o-y increase).

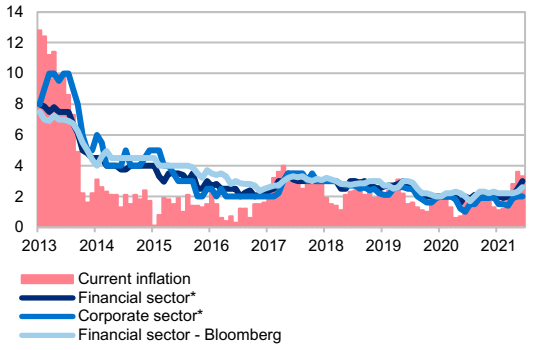
Of the total number of registered contracts in the overall real estate market in H1, 84% were paid by **cash**, while the remaining 16% were financed from **loans**. Cash was used to pay for land in most cases (99% of turnover), while the purchase of flats was mostly financed from loans – 35% in Q2 and 38% in Q1, a mild increase from 2020, when 33% of the turnover was financed in this manner.

Chart III.6.1 **Volume of trade by type of real estate**



Source: Republic Geodetic Authority.

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.

As for the supply-side factors in the real estate market, according to the Statistical Office, 6,571 **construction permits were issued for residential buildings** in H1 2021, which is a 58.5% y-o-y increase. The number of flats for which construction permits were issued continued up in H1 2021, reaching 17,608 (12.9% y-o-y increase). The rise in the number of issued construction permits for residential buildings and flats present in previous years as well, boosted the supply in the real estate market. Higher supply is also indicated by the fact that 25.3 thousand flats were finished in 2020 despite the pandemic, 2.1% more than a year earlier.

Even though the supply is constantly growing, robust demand for real estate, driven by the rising disposable income, pushes the prices of real estate up. The increase in household disposable income reflects the employment and wage growth, as well as favourable terms of new borrowing and lower cost of repayment for already disbursed loans.

7 Inflation expectations

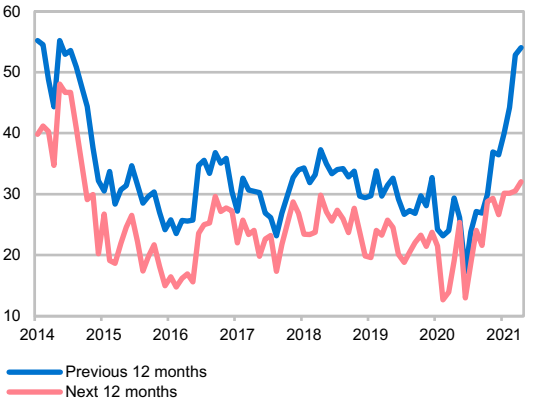
Inflation expectations of the financial and corporate sectors moved in the lower half of the target tolerance band in H1. **Anchored inflation expectations of market participants even in the face of the crisis caused by the coronavirus pandemic, confirm the credibility and adequacy of NBS monetary policy and are one of the factors that drove Serbia's credit rating closer to investment grade.**

According to the Ipsos survey, in H1, **one-year ahead inflation expectations of the financial sector** ranged between 1.9% and 3.0% (in June). According to the Bloomberg survey, short-term expectations of the financial sector were stable at 2.2% in the first four months of 2021, only to rise in May and June to 2.3% and 2.6%, respectively, most probably as a result of the current inflation.

One-year ahead inflation expectations of corporates moved in the lower half of the target tolerance band in H1 – in Q1 they averaged 1.5%, but under the influence of higher cost-push pressures they went up to 2.0% in Q2.

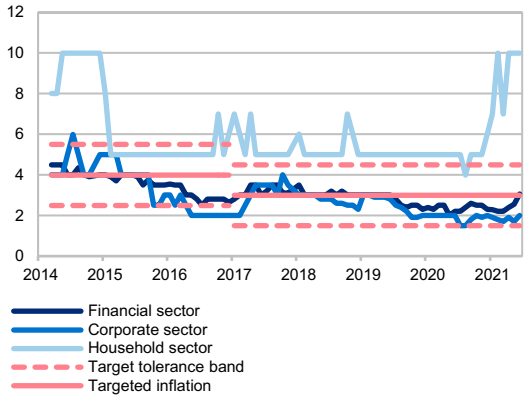
As usual, **short-term household inflation expectations** were higher than those of other sectors. Since February they have stood at 10.0%. Increased household inflation expectations can be associated with the price hikes at the

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.

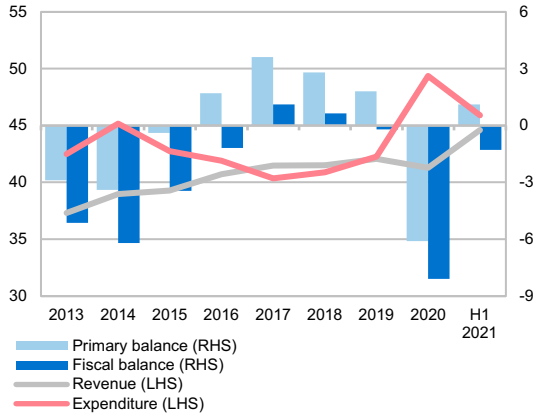
Chart III.7.3 **Two-year ahead inflation expectations***
(y-o-y rates, in %)



Sources: Ipsos/Ninamedia and NBS.

* Ipsos until December 2014, Ninamedia since December 2014, and Ipsos since January 2018.

Chart III.8.1 **Fiscal and primary balance of general government budget**
(% of GDP)



Source: Ministry of Finance.

beginning of the year – of energy (fuel and electricity), utilities and cigarettes. Nevertheless, the results of the qualitative survey[22] of household inflation expectations speak in favour of the preservation of price stability as the bulk of respondents (around two-thirds) still believe that consumer prices will go moderately or mildly up in the coming 12 months. Also, the expected inflation index stayed lower than the perceived inflation index, indicating that households anticipate inflation in the coming twelve months to be lower than a year earlier.

As of February 2021, the NBS is also monitoring three-year ahead inflation expectations, which additionally point to anchored inflation expectations and preservation of price stability in the medium term. **Two-year ahead inflation expectations of the financial sector** have been anchored within the NBS target tolerance band since their monitoring began (March 2014), moving in the range of 2.2–3.1% in H1, while three-year ahead expectations ranged between 2.3% and 3.0%. **Medium-term corporate expectations for both two and three years ahead** averaged 1.8% in H1, while household expectations stood at 9% for two years and 8.4% for three years ahead.

8 Fiscal trends

Despite the delivery of the third aid package worth around 4.5% of GDP, fiscal trends in the first six months of the year were more favourable than expected. This was primarily a result of better-than-expected revenue performance owing to a faster economic growth. The share of the general government deficit in GDP measured 1.3% in the first six months of 2021, while the Fiscal Strategy for 2022 with Projections for 2023 and 2024 envisages 6.9% for the year as a whole.

The bulk of the package (2.5% of GDP) is direct fiscal support to corporates and households, and it entails the payment of three halves of the minimum wage, aid to businesses in sectors hit by the pandemic (catering, tourism, and transport), as well as payment of cash to citizens (citizens of age, retired citizens and the unemployed). The remaining portion of the package (around RSD 120 bn) falls under the Guarantee Scheme and a half of that amount is the expansion of the 2020 Guarantee Scheme, while the rest of the funds are intended for the new Guarantee Scheme targeting companies in the affected sectors and all other companies with the fall in income of over 20% in 2020. In addition to the support package, further fiscal room gained by budget revision was used for higher capital investments in transport infrastructure, health, and environment through communal infrastructure. The share of capital expenditure should reach around 7% of GDP this year and remain at a similar level over the medium run as well, thereby sustaining faster growth in investments and production potential.

Relative to the same period last year, in H1 2021, **public revenues** rose by 24.1% in real terms, as a reflection of faster than expected economic growth. The most

[22] For more details on qualitative household expectations see the February 2016 *Inflation Report*, Text box 2, p. 15.

significant boost to revenues growth came from social insurance contributions (10.1 pp), whose robust increase in H1 2021 resulted from the low base due to the anti-crisis measure of deferral of private sector's payment of contributions. To a smaller extent, the sharp real rise in public revenues was also supported by corporate profit tax (4.1 pp), VAT (4.0 pp) and income tax (2.8 pp), indicating economic recovery. Non-tax revenues also went up in the same period, providing a 1.4 pp contribution to the overall revenue increase.

In H1 2021, **public expenditures** were lower by 2.1% y-o-y in real terms. As in H1 2020, the largest drag came from other current expenditures (-3.8 pp), amid payment of EUR 100 to adult citizens. An equally negative contribution to total expenditures stemmed from outlays for the procurement of goods and services, as well as from subsidies (-0.8 pp each). Higher employee expenditures worked in the opposite direction (7.5% y-o-y, with a 1.6 pp contribution to the rise in total expenditures), due to the January and April wage increase in the public sector. Capital expenditures (which were higher by over 12% in real terms, with a 1.1 pp contribution to total expenditures) also pushed public expenditures up.

In H1, funds for deficit financing and payment of due liabilities were provided by the sale of government bonds in the domestic market and issue of euro bonds in the international financial market. The inclusion of dinar bonds into J.P. Morgan index family increased the attractiveness of Serbian government bonds and broadened the investor base. Additional reduction in the cost of public debt servicing on this account may be expected in the coming period, which speaks in favour of the significance of the NBS and government's perennial efforts to include dinar government bonds in this reputable index.

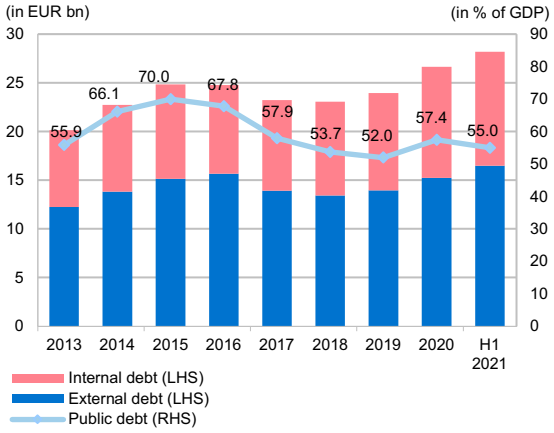
At end-June 2021, **central government public debt** stood at EUR 28.3 bn, or 55% of GDP, down by 2.4 pp from end-2020, as a result of the projected nominal GDP growth in this year. As for the debt currency composition, compared to end-2020, the euro and dinar shares of the debt increased (to 51.1% and 30.6%, respectively at end-June). On the other hand, the dollar portion of the debt decreased by 1 pp measuring 12.2% at end-June, additionally reducing the public debt currency risk. The new Fiscal Strategy envisages that the share of central government debt in GDP will remain below the Maastricht criterion of 60% of GDP this year, and that it will resume a downward path next year as the fiscal deficit falls.

9 Aggregate demand

As the recovery of economic activity, which started in Q1, accelerated in Q2, GDP growth in H1 measured 7.6% y-o-y, reflecting entirely the rebound in domestic demand (7.5% y-o-y, with 8.4 pp contribution), while net exports provided a negative contribution to GDP growth (-0.8 pp).

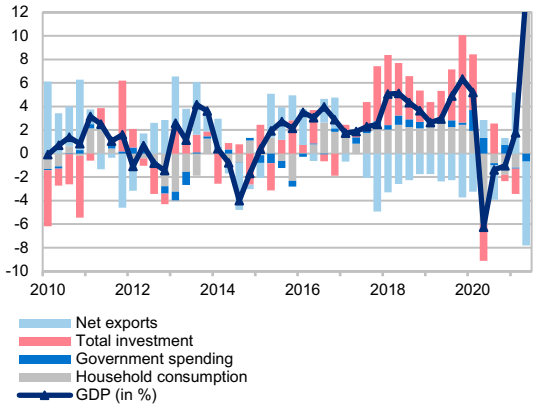
Even though containment measures were still in force at the beginning of the year and they affected adversely the

Chart III.8.2 **Public debt***



Source: Ministry of Finance.
* Central government.

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



Sources: SORS and NBS calculation.

consumption in some service activities (tourism, catering, entertainment and recreation, transport), intensive vaccination process contributed to a better epidemiological situation and consequently to the recovery of services, as indicated by the increase in the number of overnight stays of domestic tourists by 28.4% y-o-y in H1 and the rise in real turnover in catering by 24.5% y-o-y in the January–May period. In addition, positive trends in the trade sector continued in H1, as testified by the rise in the real turnover of 12.1% y-o-y and import of consumer goods of 12.8% y-o-y. The estimate is that household consumption went up by 7.7% y-o-y in H1, adding 5.3 pp to GDP growth.

The measures taken to prevent the spread of the coronavirus-induced crisis and aimed primarily at employment preservation, boosted the private consumption to a great extent. In this way, a further rise in the wage bill (12.5% y-o-y), as the main source of consumption, was enabled in H1, with other sources of consumption recording growth since the beginning of the year. The average stock of loans intended for consumption went up by 12.0% y-o-y in H1, while the inflow of remittances increased by 23.7% y-o-y owing to higher labour force mobility after the relaxation of restrictive health-related measures in other countries. Consumption was also boosted by the payout of EUR 30 government assistance to all citizens of age, as part of the measures of support to economic recovery.

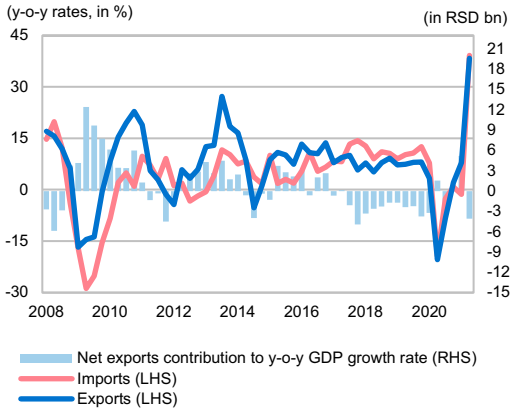
After H1 last year, when the government extraordinarily increased its consumption primarily to procure medical supplies, in H1 this year, with improved epidemiological situation, government consumption declined by 2.2% y-o-y, dragging GDP growth down by 0.4 pp.

Improved global epidemiological situation and the consequently reduced risk aversion gave a boost to private investment in fixed funds (15.3% y-o-y) in H1. This was largely a result of government measures to overcome the effects of the coronavirus-induced crisis, as testified by the positive business result recorded in most companies during the previous, crisis year which, in our estimate, provided a strong contribution to the rise in investment of companies already operating in Serbia. On the other hand, timely and adequate measures of economic policy makers helped preserve a favourable investment environment, thanks to which FDI inflow in H1 went up by 21.0% y-o-y, to EUR 1.8 bn. In addition to private investment growth, government investment also recorded a robust increase in H1 (16.6% y-o-y), primarily owing to the continued implementation of infrastructure projects.

That investments were on the rise is also suggested by numerous indicators in this area. Thus, in manufacturing, the production of machinery and equipment went up by 15.7% y-o-y, while the import of equipment increased by 15.0% y-o-y. Investment growth reflected on the construction, too, as testified by the higher value of construction works performed in H1 (19.2% y-o-y), accompanied by the rise in the production of construction materials (21.1% y-o-y).

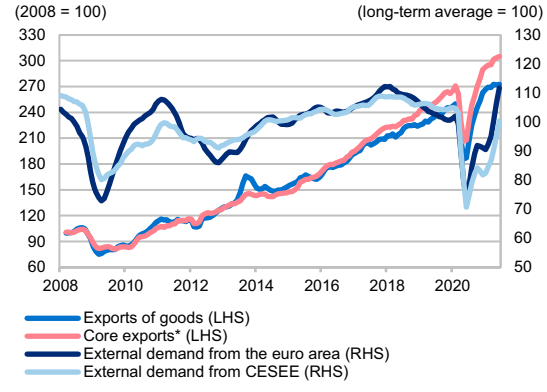
In H1, industrial growth also pushed the inventories of final products up, which contributed 0.3 pp to GDP growth, in our estimate.

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



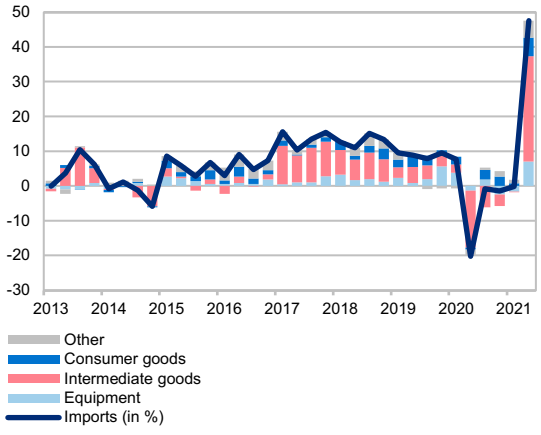
Sources: SORS and NBS calculation.

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



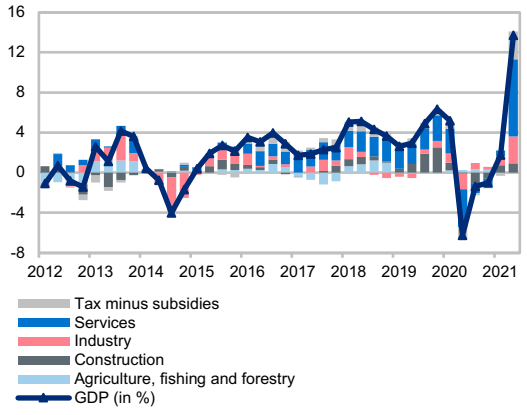
Sources: European Commission, SORS and NBS.
* Core exports are exports excluding the exports of agricultural products, base metals, motor vehicles, petroleum products and electricity.

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



Sources: SORS and NBS calculation.

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



Sources: SORS and NBS calculation.

Foreign trade continued to rebound in H1. Goods and services exports and imports increased by 21.2% and 18.7%, respectively, in real terms, relative to H1 2020, when, due to the lockdowns, foreign trade suffered the most severe negative effects. Yet, due to the higher share of imports than of exports, the contribution of net exports to GDP movements was negative (-0.8 pp) in H1.

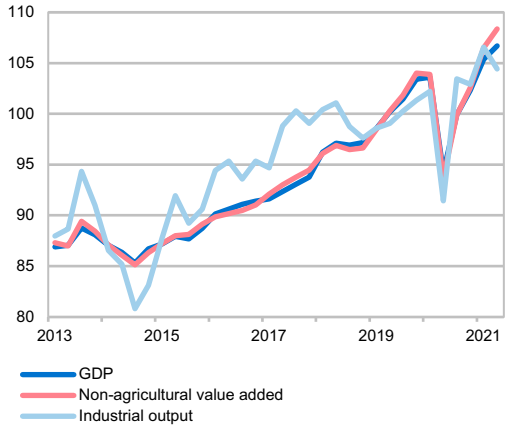
At the level of the year, instead of the 6.0% (earlier projections), we now expect GDP growth to reach 6.5%, driven mainly by domestic demand, with a major contribution from continued implementation of infrastructure projects and timely and adequate response of the Serbian economic policy makers and the resulting favourable conditions of financing and preserved production capacities and jobs. In addition, higher export supply, together with the normalisation of global economic flows amid continued vaccination and the expected rebound in external demand, will lead to double-digit export growth and improvement in the foreign trade deficit. The same factors and the expected additional acceleration of implementation of infrastructure projects in line with the new planned projects underpin a more favourable medium-term growth outlook, in our estimate, which is why we now expect economic growth in the coming years to range between 4% and 5% p.a. instead of the previously expected 4%.

10 Economic activity

Owing to the measures taken to mitigate the impact of the crisis and preserve production capacities and employment, GDP exceeded the pre-crisis level in Q1, a quarter earlier than expected, while in Q2 it was around 3% above the pre-crisis level. This was also a result of the intensive vaccination process, which started at the beginning of the year, and the improved epidemiological situation. In y-o-y terms, GDP growth measured 1.8% in Q1, according to the Statistical Office. It accelerated to 13.7% in Q2 and measured 7.6% in H1 overall. Robust growth was driven by the recovery of service sectors, which were hit the most by the crisis. A contribution to growth also came from industry and construction, even though the construction activity was maintained at a high level during the crisis. On the other hand, on the assumption of average agricultural season, we estimate that agriculture provided a mildly negative contribution to the economic activity in H1 due to the high base from the previous year.

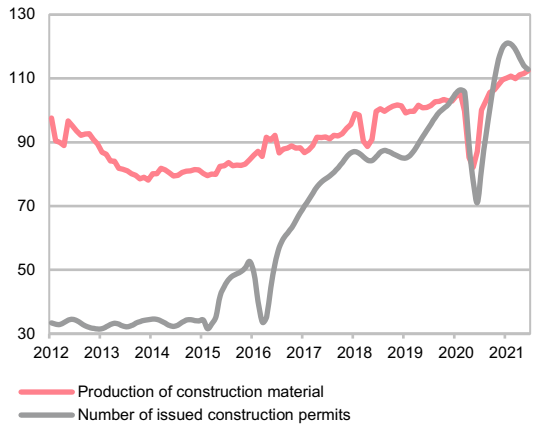
A gradual recovery of external demand resulted in 8.5% y-o-y **industrial growth** in H1. This is confirmed by the volume of industrial production, which increased by 8.9% y-o-y, based primarily on the growth in manufacturing (10.0% y-o-y), while mining which was least hit by the crisis, recorded a mild drop (-0.4% y-o-y). In manufacturing, an increase in the volume of production was registered in almost all sectors (21 out of 24), with the highest rise in activity recorded in export-oriented sectors, particularly in the automobile industry as the production of motor vehicles increased by 37.6% y-o-y, while the volume of production of rubber and plastic products went up by 16.2% y-o-y. Further, the production of electrical equipment (38.8%) and machinery and equipment also recorded solid y-o-y growth (15.7%). On the other hand, the production of pharmaceuticals and tobacco products dropped (by 4.8% and 9.9% y-o-y, respectively).

Chart III.10.2 **Economic activity indicators**
(s-a data, 2020 = 100)



Sources: SORS and NBS calculation.

Chart III.10.3 **Construction activity indicators**
(quarterly averages s-a, 2020 = 100)



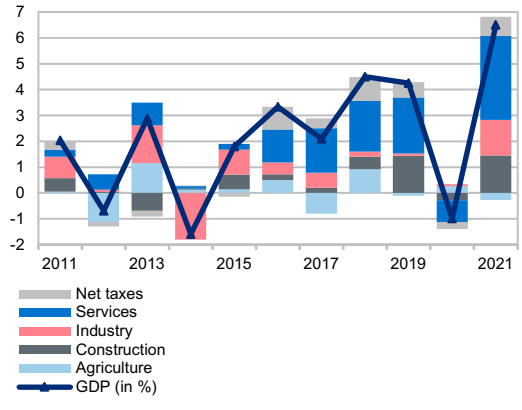
Sources: SORS and NBS calculation.

Continued intensive implementation of government-financed infrastructure projects and the acceleration of private investments, owing to the preserved investment confidence and favourable financing conditions, resulted in the 17.7% y-o-y **rise in construction** in H1, evident in almost all relevant indicators. Namely, in H1 the total number of issued construction permits went up by 33.9% y-o-y. The increase in housing construction is also suggested by the rise in apartment usable area based on the permits issued (15.8% y-o-y). The production of construction materials also recorded a strong rise in H1 (21.1% y-o-y), while employment in the construction sector went up by 5.7% y-o-y.

The highest contribution to GDP growth stemmed from the recovery in **services** (4.1 pp), which picked up by 7.9% y-o-y in H1. This is indicated by the increase in real retail trade turnover, which reached its pre-crisis level already in mid-2020 and continued up in H1, settling at 12.1% y-o-y. It needs to be emphasised that the rise in services in H1 was recorded despite the tightening of containment measures in Q1 with the new wave of the pandemic, some of them affecting services. Even though containment measures were relaxed in Q2, the consequences of the coronavirus crisis remain visible in the areas of tourism, recreation, and entertainment, where the recovery is noticeable, but not yet at the pre-crisis level. This is also testified by the number of tourist arrivals and overnight stays, which increased in H1 by over 20% y-o-y, but decreased by around 40% compared to 2019.

A faster than expected rise in economic activity since mid-last year led to an upward adjustment of GDP growth for this year, to 6.5%. On the production side, this growth will be driven by the expected full recovery of activity in service sectors and a continued rise in production sectors, excluding agriculture. The pick-up in service sectors, first and foremost in those that were hardest hit by the pandemic, will be supported by the anticipated rebound in consumption as the epidemiological situation improves, higher disposable income and living standard, as well as reduced propensity to save. Manufacturing growth will be propped up by the activation of new and expansion of existing capacities on the supply side, and by the expected acceleration of economic growth of our main foreign trade partners on the demand side. A positive contribution to GDP growth should also come from the

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



Sources: SORS and NBS calculation.

construction sector, given the planned further increase in government capital expenditures, most notably the current and planned projects in transport infrastructure, and favourable trends in the real estate market.

11 Wages and employment

In early 2021, the **Serbian labour market** faced a new wave of the pandemic, which, together with the announcement of additional unemployment benefit by the National Employment Service, led to a mild rise in registered unemployment. However, amid the accelerated vaccination and easing of containment measures in Q2, unemployment dropped again in May and June, with a further rise in employment and average wages, whereby favourable labour market trends were preserved.

In H1 2021, the **average nominal net wage recorded 8.6% y-o-y growth**, driven by the faster rise in private sector wages (9.4%) relative to those in the public sector (7.5%). Industry-wise, the highest y-o-y growth in average wages was recorded in information and communications (14.5%), and health and social protection sectors (16.3%), on account of the January wage increase in health and other public sector niches, as well as the higher average minimum wage (RSD 183.93 per hour). In the same period, wages went up in y-o-y terms in all service sectors, manufacturing (8.7%) and construction (6.3%), dropping only in the energy sector (-1.6%).

The **total nominal net wage bill** grew by 12.5% y-o-y in H1. It was higher by 15.0% y-o-y in the private sector and by 8.0% y-o-y in the public sector.

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

	2020		2021	
	Q3	Q4	Q1	Q2
Total number of formally employed	2.0	2.3	2.8	3.3
Employed with legal persons	2.3	2.5	3.1	3.5
Entrepreneurs and their employees	2.7	3.2	3.6	4.6
Individual farmers	-7.6	-7.8	-8.6	-8.0
Unemployed	-0.4	-1.9	1.0	4.9
First-time job seekers	12.3	8.9	10.9	14.2
Used to be employed	-11.4	-12.0	-8.7	-4.7

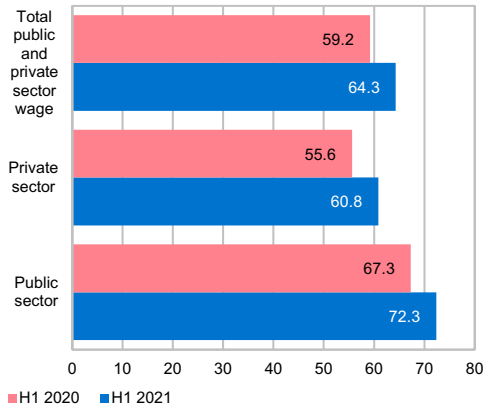
Sources: SORS and NES.

Overall economic productivity fell in Q1 (-1.0% y-o-y), only to record a sharp rise in Q2 (10.0% y-o-y) on account of the low base from the previous year, as well as positive economic trends.

Total formal employment reached 2.27 mn in June, which is the highest level in the past six years, since monitored using the comparable methodology. Compared to the same period last year, formal employment increased by around 66 thousand in June, led by employment with legal persons (around 58.0 thousand) and entrepreneurs (around 13.0 thousand), while the number of individual farmers went down (by around 5 thousand).

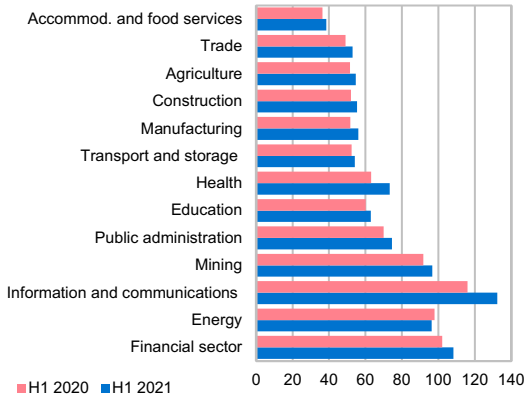
Over 95% of new jobs in June, in y-o-y terms, were created in the private sector, primarily in manufacturing (around 22 thousand) and wholesale and retail trade

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



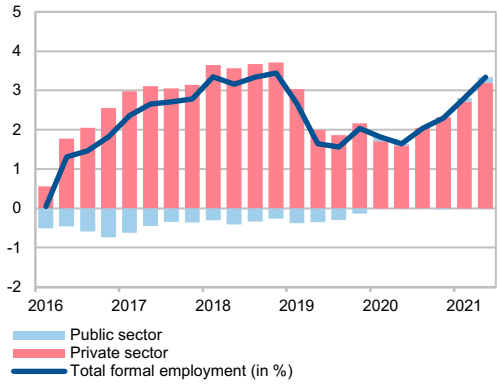
Source: SORS.

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



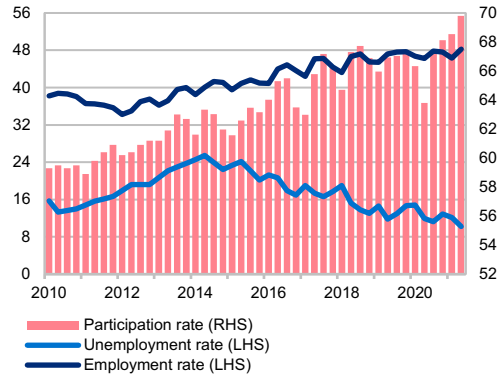
Source: SORS.

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



Sources: SORS and NBS calculation.

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



Source: SORS.

(around 12 thousand). In addition, construction (around 6 thousand) and almost all service sector activities recorded a y-o-y rise in employment, with the most prominent increase in information and communications (around 9 thousand) and professional, scientific, innovation and technical industries (around 7 thousand). At the same time, higher employment was also recorded in transport and storage sectors, as well as accommodation and food services (close to 4 thousand), affected by containment measures the most. **Public sector** employment also recorded a y-o-y rise (around 3 thousand in June), greatly on account of more flexible restrictions on employment in public fund beneficiaries. On the other hand, employment in agriculture and mining was lower in June by almost 2 thousand than a year ago.

Compared to the beginning of the year, when it went slightly up, **total registered unemployment equalled 540,739 in June**, dropping for the second consecutive month. This mitigated its y-o-y rise considerably (to 2.8% in June) compared to previous months.

In line with the new EU regulation, since January 2021, the Statistical Office conducts **Labour Force Surveys** using the amended methodology with data on the employment and unemployment rates adjusted for the Q1 2010 – Q4 2020 period. **The main methodological change refers to the employed population, which no longer includes persons that produce agricultural goods and render services for self-consumption** (who previously belonged to the informally employed category). What can be observed from the adjusted data is that from 2010 until 2012 the employment rate was dropping and the unemployment rate rising and after that the trend reversed, so in all years until 2020 the employment rate was on the rise and the unemployment rate on the decline. In the 2012–2020 period the employment rate went up from 36.0% to 47.1% on average, with the unemployment rate cut at the same time, from 26.0% to 9.7%. The available survey results for H1 2021 indicate that the **employment rate measured 48.3% in Q2**, up by 2.0 pp from Q1 and by 1.6 pp y-o-y. The **unemployment rate equalled 11.1% in Q2**, down by 1.7 pp from Q1 and somewhat above the level recorded in the same period last year (by 0.6 pp). In addition, the participation rate of the working age population (15–64) was on the rise, on average, in all years for which data were adjusted, and continued up in H1 2021. In Q2 it reached 69.8%, up by 1.3 pp from Q1 and by 3.5 pp above the last year's level.

Index of charts and tables

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