NATIONAL BANK OF SERBIA

Press release about the publication of the Annual Financial Stability Report for 2020

NBS publishes Annual Financial Stability Report for 2020

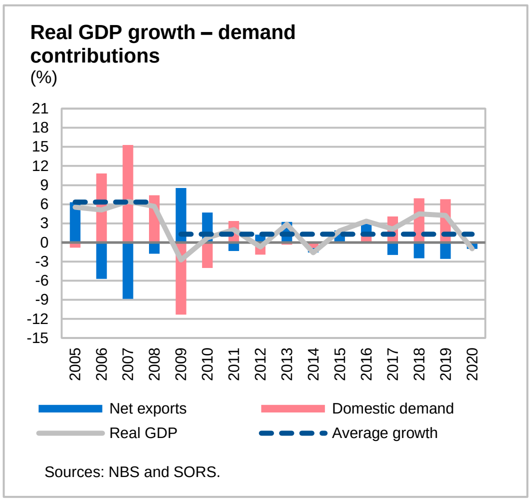
The Annual Financial Stability Report aims to inform the public about the situation and risks in the financial system and to timely alert of the potential systemic risks. This Report gives an overview of the key systemic risks and developments in the domestic and international environments, as well as regulatory measures undertaken to prevent, mitigate or eliminate those risks. Developments in the banking and non-bank sectors are also presented, as well as movements in different segments of the financial market. Numerous text boxes in the Report cover in particular the most current topics in the areas of financial stability and macroprudential policy at national and global level.

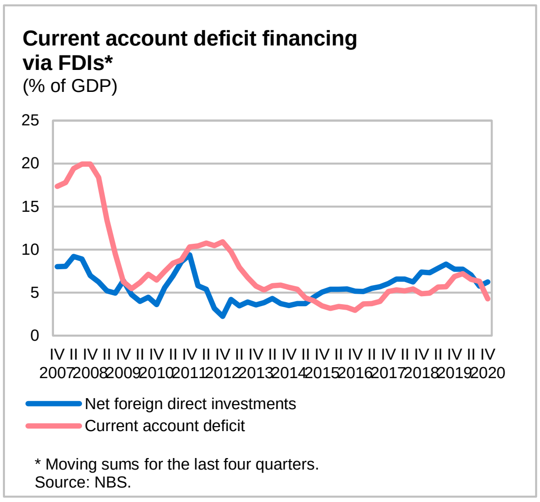
The coronavirus pandemic caused a sharp contraction in global economic activity in 2020. To mitigate the negative effects of the pandemic, governments and leading central banks responded by easing their monetary policies and by applying a number of conventional and unconventional measures. Growth of the euro area, Serbia's most important trade and financial partner, slowed down in 2020 relative to 2019. The news on progress in vaccine development and availability rekindled investor optimism in late 2020, leading to an upward revision of global growth projections for 2021. However, uncertainty remains as to the further course of the pandemic, partly also due to the emergence of new virus variants.

- ✓ ***Macroeconomic stability was maintained and strengthened despite the challenges brought by the pandemic***

In the conditions of pandemic-induced global uncertainty, Serbia's economic activity contracted by only 1.0% in 2020, which is one of the best outcomes in Europe. Thanks to the successfully implemented fiscal consolidation, initiated structural reforms and improved investment environment in prior years, the grounds were laid for accelerated economic growth over the medium-term. In addition, sound macroeconomic fundamentals and robust monetary and fiscal policy measures enabled Serbia to weather the COVID-19 crisis more easily than most European countries. FDI inflow to Serbia stayed relatively high despite the pandemic. Namely, gross FDI inflow reached EUR 3 bn in 2020 and was the highest in the region. It covered the current account deficit fully for the sixth year in a row, the coverage equalling 146.5% at end-2020.

The achieved macroeconomic and fiscal stability and the timeliness of monetary and fiscal policy measures were confirmed by the fact that Fitch and Standard & Poor's affirmed Serbia's ratings in 2020, despite the global pandemic-induced crisis. Furthermore, in 2021 Moody's upgraded Serbia's rating to Ba2, with a stable outlook, while Fitch and Standard & Poor's affirmed their ratings at BB+, a step away from investment grade.



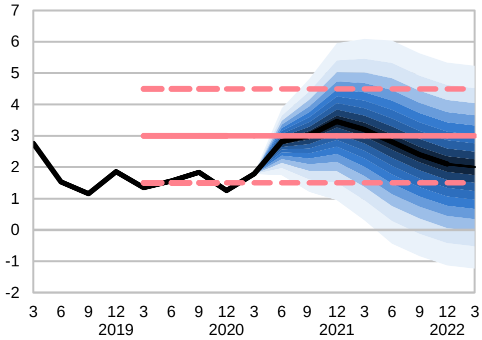


Owing to the maintained price and financial stability and sound public finances in recent years, Serbia was in a better position to face the coronavirus crisis and to implement a large package of monetary and fiscal policy measures to minimise its economic fallout and preserve jobs. This helped maintain favourable financing conditions for corporates and citizens and contributed to the rise in their disposable income. Already in Q1 this year, Serbia reached the pre-crisis level of economic activity. Real GDP growth in Q1 2021 measured 1.7% y-o-y, exceeding the preliminary estimate (1.2% y-o-y). The NBS estimates that GDP growth will amount to 6% this year, or even exceed this figure, as a result of continued implementation of infrastructure projects and sustained FDI inflow. An additional impetus to growth will come from the third package of measures for corporates and households to be implemented in the course of this year.

- ✓ ***Inflation remained low and stable and inflation expectations of the financial and corporate sectors firmly anchored.***

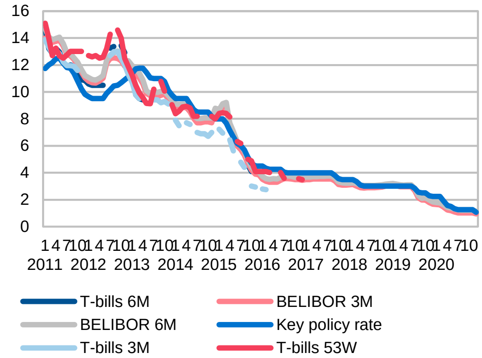
Inflation remained low and stable, averaging 1.6% in 2020. An important pillar of low and stable inflation over the previous years has been the relative stability of the exchange rate of the dinar against the euro. Low inflationary pressures are also signalled by the one- and two-year ahead inflation expectations of the financial and corporate sectors which are firmly anchored and remain below the inflation target midpoint. The NBS continued to pursue a cautious monetary policy stance in 2020, trimming the key policy rate four times by 1.25 pp in total, to 1.0% at end-2020, its new lowest level in the inflation targeting regime. Monetary policy easing decisions reflected primarily the NBS's effort to provide additional support to the domestic corporates and households, in view of the scale of the pandemic-induced global crisis, worsening of the epidemiological situation and slowing of economic recovery at global level, particularly in Europe.

Inflation projection*
(y-o-y growth rates, %)



* May 2021.
Source: NBS.

Interest rates in the money market and auctions of dinar T-bills
(monthly averages, %)



Sources: Ministry of Finance and NBS.

By lowering the key policy rate, the NBS propped up domestic lending activity, which – supported by an accommodative monetary policy and loans under the Guarantee Scheme, recorded an almost double-digit growth (9.9% y-o-y in December 2020) even in the conditions of the crisis caused by the coronavirus. Key policy rate cuts translated also onto interest rates in the interbank money market. Besides, during 2020 the NBS narrowed the corridor of main interest rates relative to the key policy rate on two occasions – in March and December.

- ✓ ***Coordinated fiscal and monetary policies successfully responded to the challenges posed by the coronavirus pandemic***

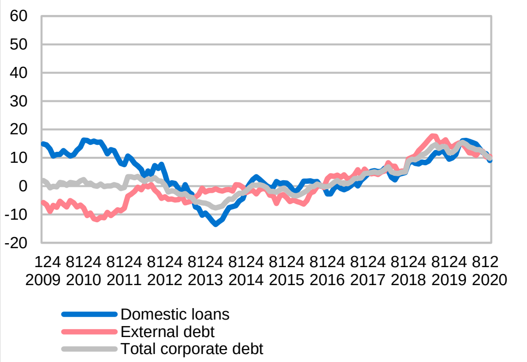
Due to the robust package of economic measures for mitigating the negative consequences of the pandemic, Serbia's fiscal deficit reached 8.1% of GDP in 2020. The declining trend of public debt-to-GDP ratio was temporarily halted in 2020. The share of central government debt in GDP increased by 5.4 pp from end-2019, to 57.4% at end-2020. Nevertheless, this increase was among the smallest in Europe. Already in 2021 this share resumed its downward trend, so that in May 2021 the central government public debt measured 55.6% of GDP. The currency structure of public debt improved significantly, as the dinar portion of debt gained 2.8 pp, while the US dollar share slid by as much as 6.9 pp from the year before. A considerable decrease in the US dollar portion of public debt resulted from the early redemption of costly dollar eurobonds issued in 2011 and the first FX hedging swap transaction, whereby dollar liabilities under the eurobond were converted to euro.

The achieved economic policy results were also confirmed in February 2021 when it was announced that Serbia’s dinar bonds will be included in J. P. Morgan’s GBI-EM family of indices, which came to fruition in June 2021. The inclusion of government bonds in the reputed index is the result of strengthening the macroeconomic environment in Serbia and years-long efforts to develop the domestic financial market. The IMF Executive Board concluded the final review of Serbia’s economic programme supported by the Policy Coordination Instrument in January 2021, assessing that the programme was implemented successfully throughout its duration and that the adopted measures and the ample fiscal package played an important role in supporting the domestic economy and accelerating recovery from the consequences of the coronavirus pandemic. In June 2021 the IMF Executive Board concluded regular Article IV consultation with the Republic of Serbia and approved a new 30-month programme of cooperation supported by the Policy Coordination Instrument, which is, same as the previous one, advisory in nature and does not envisage any use of financial resources.

- ✓ ***Despite the challenges, the trend of corporate profitability has been preserved and positive movements in the household sector sustained***

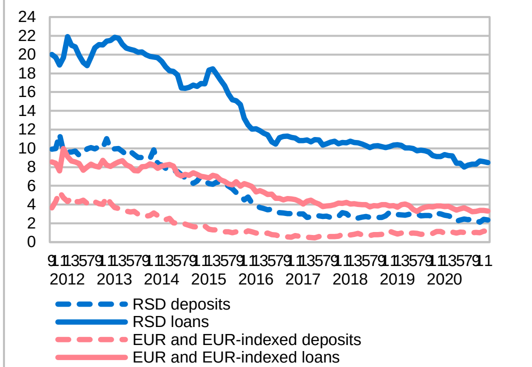
Against the background of implemented economic measures of support to the economy, corporates managed to record an increase in employment and profitability in 2020, despite the aggravated conditions of doing business amid the pandemic. Monetary policy accommodation, approval of loans under the Guarantee Scheme, low interest rates in the euro area money market and other NBS support measures boosted corporate lending growth.

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



* Excluding the exchange rate effect.
Source: NBS.

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



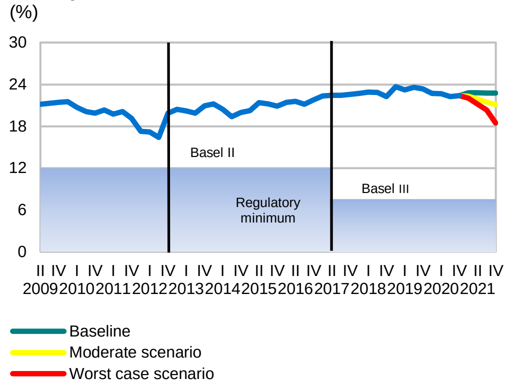
Source: NBS.

In the face of extraordinary conditions in the labour market caused by the coronavirus spread, the unemployment rate edged up only slightly compared to the year before. Excluding the exchange rate effect, total household lending rose by 11.4% y-o-y, driven mainly by cash and housing loans. The NBS adopted a series of measures to facilitate the repayment of existing liabilities and access to sources of financing for households. Same as in previous years, dinar savings posted growth, testifying to continuous strengthening of citizens' confidence in the domestic currency. At end-2020 dinar savings reached RSD 92.5 bn, up by RSD 13.5 bn from the end of the previous year.

✓ ***The Serbian banking sector is stable, capitalised and liquid, contributing to the stability of the overall financial system***

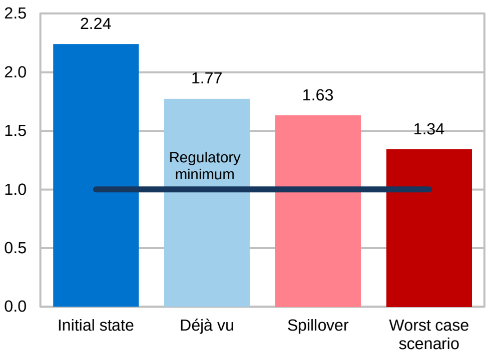
Even during the coronavirus pandemic, the Serbian banking sector, accounting for over 90% of financial sector assets, remained stable thanks to adequate capitalisation, high liquidity and profitability. Throughout 2020, banking sector capital adequacy and liquidity ratios stood well above the prescribed minimums. The achieved profitability of the banking sector at year-end resulted in a 1.1% ROA and a 6.5% ROE. Also, the results of macroprudential stress tests confirm that Serbia's banking sector as a whole would remain highly resilient even to the most severe shocks, and that it has sufficient capacity to absorb the consequences of the risks it might be exposed to.

CAR by stress scenario*



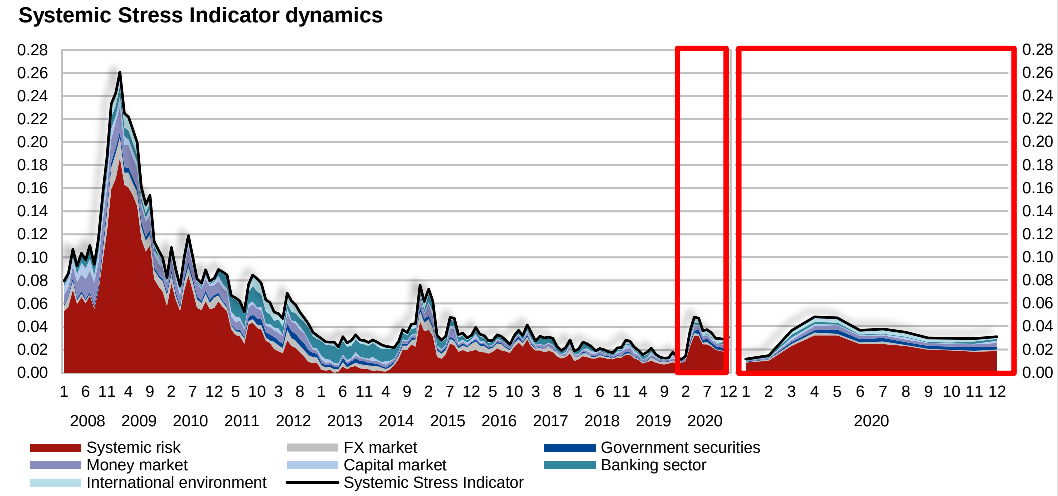
* NBS estimate.
Source: NBS.

Liquidity ratio for the banking sector by stress scenario*



* NBS estimate.
Source: NBS.

The growth in lending, systemic NPL resolution and measures for mitigating the negative effects of the coronavirus pandemic contributed to a continued decline in the NPL ratio, which at end-2020 measured 3.7%, dropping by 0.4 pp y-o-y and by as much as by 18.5 pp relative to August 2015, when the NPL Resolution Strategy was adopted.



Source: NBS.

The overall financial stability was assessed based on the composite systemic stress indicator and other financial soundness indicators. The analysis of the systemic stress indicator in 2020 reveals an increase in systemic risk due to the negative impacts from the COVID-19 pandemic on financial markets in the first half of the year. After that, systemic risk declined and levelled off, which was supported by the implemented fiscal, monetary and macroprudential policy measures aimed at strengthening Serbia's financial system stability.

✓ ***NBS measures to mitigate the negative effects of the coronavirus pandemic were timely and comprehensive***

The NBS was one of the first central banks in Europe which responded to the coronavirus pandemic by a series of concrete measures aimed at supporting the domestic economy and citizens. The NBS's response was timely and comprehensive.

It enabled the domestic financial sector to obtain additional dinar and FX liquidity via direct repo operations, swap auctions and bilateral purchases of dinar government bonds from banks – in order to ensure uninterrupted lending to domestic corporates and households. Also, a precautionary repo line was established with the ECB in order to secure additional liquidity in euros for the domestic financial system in case of need, but this line has not been used thus far. Together with the effects of the moratorium on repayment of credit and leasing liabilities of corporates and households and incentives offered under the Guarantee Scheme for dinar lending to micro, small and medium-sized enterprises and entrepreneurs, this supported further growth in lending and the recovery of our economy from the consequences of the coronavirus-induced crisis.

In order to support construction industry growth and facilitate access to housing loans, the NBS also lowered the mandatory downpayment for first-time home buyers. It also reduced the minimum degree of completion of an object eligible for housing loan financing. The repayment term for housing loans and other household loans was also extended.

Thanks to the responsible conduct of economic policy in the previous period and coordinated and timely measures of the Serbian Government and the NBS, Serbia managed to evade more severe economic consequences and preserve full macroeconomic and financial stability.