National Bank of Serbia

2020

January-June

SEMI-ANNUAL

MONETARY POLICY REPORT

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Introductory note

The National Bank of Serbia submits to the Parliament its annual and semi-annual monetary policy reports, explaining the factors influencing the implementation of monetary policy in the period under review. The annual report is 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], these reports present and analyse the monetary policy strategy, macroeconomic developments (international environment, balance of payments, the country's international investment position, monetary aggregates, prices, wages and employment, and other macroeconomic trends), monetary policy defined and implemented (defined vs. achieved monetary policy objectives, monetary policy instruments and measures, and other monetary policy-related issues), and outline the planned monetary policy.

The *Semi-Annual Monetary Policy Report – January–June 2020* was reviewed and adopted by the NBS Executive Board at its meeting of 10 September 2020.

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

Executive Board of the National Bank of Serbia:

Jorgovanka Tabaković, PhD, Governor

Željko Jović, PhD, Vice Governor

Ana Ivković, PhD, Vice Governor

Dragana Stanić, MA, Vice Governor

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[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.

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Overview

In 2020 the world faced the health and economic crisis triggered by the coronavirus pandemic. This unprecedented crisis brought about a drastic **contraction of the global economy and recession for the majority of countries**, and strongly affected the global commodity and financial markets. In the initial phase of the pandemic, the global commodity market saw falling prices of primary commodities, particularly oil, and the global financial market was marked by uncertainty as investor risk aversion picked up. As the economies gradually opened, containment measures were eased and expansionary fiscal and monetary policy measures were adopted by many countries, the global economy began to recover. Still, its growth prospects were revised down and uncertainty concerning the speed of recovery remained high.

Favourable economic trends in the domestic market **continued in early 2020**. However, as of March, the Serbian economy, just like other European economies, was hit by the coronavirus pandemic. The NBS and the Serbian Government responded by robust monetary and fiscal stimuli to help the economy overcome the negative effects of the pandemic. Responsible running of the economy in the past period, the undertaken structural reforms, maintained price and strengthened financial stability, narrowed fiscal and external imbalances and record high FX reserves made possible the adoption of comprehensive measures and acceleration of economic recovery.

Even before the state of emergency was introduced, at its extraordinary meeting of 11 March the NBS Executive Board **cut the key policy rate** by 50 bp to 1.75%, and narrowed the corridor of the main interest rates from ±1.25% to ±1.0%. Judging by the speed at which it responded to the outbreak of the pandemic, the NBS was among the first institutions in the country and among the first central banks in the world. As the magnitude of the global crisis entailed additional monetary policy support, at the Executive Board's meetings in April and June, the key policy rate was cut by 25 bp each time, to 1.25%. The rate was thus trimmed by an entire percentage point from the pre-crisis level, which translated onto a further fall in interest rates in the interbank money market and a record drop in rates on dinar loans.

The NBS also undertook **additional measures to support the real sector** – it provided **significant dinar and FX liquidity to banks through direct repo operations, swap auctions and bilateral purchases of dinar government securities from banks**. It introduced a **moratorium on the repayment of loan and financial lease debt** for all debtors who wished to apply it, over 90 days, with a 60-day extension, easing the burden of the crisis for our citizens and businesses. In July, the NBS Executive Board introduced **stimuli within the Government's Guarantee Scheme, which contributed to even better conditions of dinar corporate lending**, a rise in dinarisation and further strengthening of financial stability. All this helped soften the first wave of the crisis, support smooth functioning of the credit channel and encourage recovery.

In H1, **total domestic lending recorded two-digit y-o-y growth rates** (13.9% in June). The structure of loans remained favourable in terms of supporting economic activity, with y-o-y growth in corporate and household loans standing at 15.9% and 12.6% in June, respectively. In addition to lower borrowing costs in the domestic market, the stock of loans was on an increase from end-March also thanks to the moratorium, while a positive contribution as of May came from the Guarantee Scheme loans for micro, small and medium-sized enterprises and entrepreneurs. Until end-June, over EUR 630 mn worth of loans were approved through the Guarantee Scheme, with over a half in dinars, which helped increase the dinarisation of receivables to the record high level of 34.6%. Also, the **results of implementation of the dinarisation strategy** pursued by the NBS and the Government are reflected in the share of dinar in total deposits, which reached record 38.5% in June, and in the dinar share of public debt rising to 28.4% at end-June.

Owing to the significantly improved macroeconomic position of the country, room was created for a **robust fiscal response** to the pandemic, and the government budget withstood shrinking revenue and rising costs of the healthcare system. In late March, the Government adopted the Programme of Economic Measures to Mitigate the Negative Effects Caused by the COVID-19 Pandemic and Support the Serbian Economy worth around 11.0% of GDP and expanded in July by additional 1.2% of GDP. The bulk of the planned tax policy measures and measures of direct support to the private sector were implemented already in Q2, creating a consolidated fiscal deficit of RSD 311.5 bn in H1 (with over 4/5 pertaining to Q2). The strongest effect on revenue which declined by 7.5% in real, y-o-y terms came from deferred payments of advance profit tax in Q2, lower social insurance contributions and lower non-tax revenue, while other categories almost stagnated. Public expenditure was up by 23.2% in real, y-o-y terms, mainly due to minimum wage payments to businesses and one-off payments to adult citizens. Goods and services purchases also rose somewhat (reflecting primarily the procurement of medical supplies), as did wage expenses and capital expenditure. Interest expenses declined thanks to NBS monetary policy easing and the country's credit rating one step away from investment grade.

According to the Ministry of Finance's estimates, the **general government fiscal deficit** will reach around 8.2% of GDP this year. However, in our opinion, such one-off deficit is fully justified as, otherwise, the economic contraction could be much sharper this year, followed by reduced production capacities, a declining number of jobs and much slower recovery next year. As estimated by the Ministry of Finance, **central government public debt** would temporarily rise to around 60% of GDP this year (from 57.3% at end-June), only to continue down next year.

Despite the current crisis, inflation remained low, owing to relative stability of the exchange rate, enhanced monetary policy credibility which reflected on anchored inflation expectations, and the market being fully supplied. In line with NBS expectations, **y-o-y inflation** decelerated from 2.0% in January. It moved below the lower bound of the target band in March, April and May, and returned within the target band in June, touching 1.6%. **Core inflation** (excluding the prices of food, petroleum products, alcohol and cigarettes) also confirms low inflationary pressures – it remained stable in the first six months of 2020 and came at 1.4% y-o-y in June.

According to the August medium-term projection, the NBS expects **y-o-y inflation to continue to move in the lower half of the target band, closer to the lower bound, until the end of this and during next year**, mainly due to weaker cost-push pressures and dented aggregate demand in the current pandemic. As the economy and demand pick up, inflation is expected to move towards the midpoint in 2022, remaining below it until the end of the projection horizon.

The dinar's stable movement vis-à-vis the euro continued in H1 even amidst heightened uncertainty over the pandemic, owing to the NBS which provided banks with necessary FX liquidity as the supply of foreign currency and foreign cash declined. End-of-period, the dinar was stable against the euro, but gained 0.3% against the dollar which lost ground on the euro. To maintain relative stability in the domestic FX market, in January–June, the NBS sold EUR 1,030.0 mn net in the interbank FX market. April saw the largest net sale (EUR 440.0 mn) and the strongest effects of heightened uncertainty in the international financial market.

In an environment of lower external demand, economic shutdowns and containment measures, **Serbia's foreign trade** declined in Q2 in line with expectations, with goods and services imports falling faster than exports. Along with a lower primary income deficit, this led to an 11.6% y-o-y reduction in the current account deficit – to EUR 1.3 bn since early 2020. The current account deficit was more than fully covered by net FDI inflows, which exceeded EUR 1.4 bn in H1. Portfolio investment inflows were by EUR 0.1 bn higher than FDIs, reflecting chiefly the successful issue of the seven-year eurobond worth EUR 2 bn in the international financial market. Even amid the globally heightened risk aversion, investor demand exceeded multiple times the planned and realised amount of the issue, with the rate of return at 3.375% (coupon rate: 3.125%). The proceeds were used to finance the programme of support to the real sector to mitigate the consequences of the corona crisis.

At end-June, **NBS gross FX reserves** equalled almost EUR 14 bn, up by EUR 578 mn from end-2019. The level of Serbia's FX reserves is adequate and protects from external shocks as it covers close to six months' worth of goods and services imports, twice higher than the standard defining the adequacy of FX reserves. In accordance with the principles of safety and liquidity, reserves were invested in highly liquid securities issued by the most advanced countries in the world and international financial institutions, and top-tier institutions (central banks, international financial institutions and top-tier foreign banks).

According to our estimate, at the year-level, falling external demand and supply-side restrictions will drag down exports, though imports will contract more sharply due to dented domestic demand. This will – along with favourable terms of trade reflecting lower oil prices – bring about a **reduction in the current account deficit to around 5% of GDP** this year. In the medium run, based on increased export capacity and expected global recovery, we can expect a slight decline in the share of the current account deficit in GDP, with the pace of the reduction depending on the investment cycle dynamics.

In early 2020, **economic activity indicators suggested continued positive tendencies**, with some of them even exceeding our expectations, which implies that if the coronavirus pandemic had not taken place, the economy would have almost certainly risen at an even higher rate than projected (around 4%) this year, supported primarily by investment. Still, the pandemic triggered a standstill and, in some service sectors, suspension of activity in the second half of March. This did not largely negatively affect the GDP growth dynamics in Q1, of around 5.1% y-o-y, which was the highest growth in the region of Central and South-East Europe. On the expenditure side, GDP growth was led by rising investment and household consumption, and, on the production side, by higher activity in the sectors of services, construction and industry. Falling external demand and containment measures weighed down on domestic demand and economic activity in Q2. According to SORS estimates, GDP lost 6.4% y-o-y in Q2, less than in other countries in the region, consistent with the estimates of international financial institutions that Serbia's GDP outturn will be most favourable at the year-level. The strongest negative effects of the pandemic were felt in April. Recovery ensued as of May, encouraged by the undertaken monetary and fiscal policy measures, and faster than expected in most production and service sectors.

The negative effects of the pandemic on the labour market were largely mitigated by the adopted economic policy measures – formal employment and wages were preserved in the majority of service sectors, and, according to the Labour Force Survey, the unemployment rate of 7.3% in Q2 was at a record low level. Employment in the formal segment of the labour market was not only preserved, but even increased by 1.6% y-o-y.

According to our August projection, **recovery will continue in the rest of the year**. Real GDP is expected to decline by 1.5% in 2020, and to accelerate already next year. On the production side, a negative contribution will be provided by service and production sectors, save for agriculture as this year's agricultural season will be better than last year's, which was also above average. On the expenditure side, dented domestic demand will be a negative contributor. Net exports will give a positive impetus owing to the expected sharper drop in imports than exports. Economic recovery will accelerate next year and GDP will grow by around 6%, led by domestic demand and exports, reflecting the timely and adequate response of economic policy makers in Serbia and the preserved favourable medium-term prospects of our country, which will ensure a return to the stable medium-term growth trajectory of around 4% p.a.

Full coordination of monetary and fiscal policy measures will continue, allowing for a reduction in potential further negative effects from the international environment. The NBS will continue to follow global trends and their impact on the domestic economy and inflation, and will timely respond to preserve price and financial stability and contribute to sustainable economic growth. Monetary policy decisions will depend on the estimate of effects of past monetary policy easing and the expected movement in the key factors from the domestic and international environment and their impact on inflation, financial stability and the speed of economic recovery. The Executive Board highlights that the NBS is ready to respond to potential additional effects of the pandemic on economic developments in the domestic and international environment.

I Strategic monetary policy framework

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

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

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

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

The width of the target tolerance band was kept at ±1.5 pp, to diminish the need for frequent monetary policy interventions and contribute to higher predictability of monetary conditions. Being a small and open economy, Serbia is exposed to developments in the international commodity and financial markets, which may cause **temporary** volatility of headline inflation. The target tolerance band leaves to the NBS more room to work on

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

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

[3] The National Bank of Serbia'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, i.e. the inflation outturn may diverge from the target in the short run due to exogenous shocks. The NBS will allow temporary deviations from the target if bringing inflation back to the target in the short term implies monetary policy changes that would cause macroeconomic disruptions. 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 inflation target by **changing its key policy rate, applied in main open market operations**. This interest rate is the key monetary policy instrument and the decisions on its level are based on the analysis of economic circumstances, assessment of future developments and the medium-term inflation projection. Other monetary policy instruments play a supporting role – they contribute to the smooth transmission of the impact of the key policy rate on the market, as well as to the development of the financial market, without jeopardising financial stability.

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

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

II Monetary policy and achievement of the inflation target

1 Monetary policy since early 2020

In H1 2020, monetary policy was pursued in accordance with the **Monetary Policy Programme of the National Bank of Serbia in 2020[4], in an environment of the coronavirus pandemic**. The Programme, adopted in December 2019, envisaged that the NBS would aim to achieve the inflation target through consistent and predictable changes in the key policy rate, taking into account the inflation projection, economic developments in the domestic and international environment, and the impact on financial stability. Vigorous fiscal adjustment, implementation of structural reforms and full coordination of monetary and fiscal policy measures helped strengthen macroeconomic stability and increase the resilience of the domestic economy to potentially adverse effects from the international environment, making the economic outlook more favourable. According to the Programme, in 2020 the NBS would maintain the necessary caution in making monetary policy decisions in light of uncertainties from the international environment.

In January and February 2020, the key policy rate was kept on hold, at 2.25%, its lowest level in the inflation targeting regime at the time. In making the decision, the Executive Board took into account domestic factors which continued to contribute to low and stable inflation, and external developments which mandated caution in the conduct of monetary policy. It also had in mind the effects of past monetary policy easing, i.e. the key policy rate cuts in July, August and November 2019, by 75 bp in total, to 2.25%. The effects of these cuts were expected going forward as well.

The start of 2020 was marked by a favourable macroeconomic environment in which the NBS pursued monetary policy. For the seventh year in a row, inflation was low and was expected to remain low in the coming period. Under the then projection, y-o-y inflation would hover around the lower bound of the target tolerance band until mid-2020, and gradually move towards the midpoint thereafter. The low base for vegetable prices and regulated prices was forecast as a short-term contributor and rising aggregate demand as a medium-term contributor.

As in the previous projections, the main factor expected to help inflation approach the midpoint in the medium run was rising domestic demand, which, as assessed by the Executive Board, was to fully compensate for the negative effects of expected softer external demand in 2020. It was anticipated that domestic demand would be encouraged by economic growth and positive labour market trends – reflected in rising wages and employment and a reduction in the unemployment rate to a single-digit level – and NBS past monetary policy easing, which translated onto favourable conditions of financing and a higher disposable income of citizens and businesses. Also expected were the effects of new regulations, adopted by the NBS in December to encourage dinar corporate lending, primarily lending to micro, small and medium-sized enterprises, entrepreneurs and farmers. Moreover, interest rates on euro-indexed loans remained low, supported by further monetary accommodation by the ECB, higher interbank competition and a further fall in Serbia's risk premium.

In the first two months of 2020, high-frequency indicators of economic activity showed vigorous GDP growth, led

[4] RS Official Gazette, No 88/2019.

by investment, consumption and exports. The Executive Board expected GDP growth at around 4% in 2020, with similar dynamics maintained in the medium run as well. Owing to investment in tradable sectors, the strong growth in goods and services exports continued, despite the economic slowdown in the euro area, quotas on steel exports to the EU and 100% taxes on the delivery of goods and services to Kosovo and Metohija.

Contrary to favourable macroeconomic conditions at home, developments in the international environment continued to mandate caution in the conduct of monetary policy. Although tensions concerning trade policies of leading world economies abated to a degree, uncertainty in the international financial and commodity markets originated largely from geopolitical tensions. The monetary policies of leading central banks provided support to the global economy, which was expected to further positively influence the conditions in the international financial market and capital flows to emerging economies, including Serbia. However, it was uncertain to what extent the monetary policies of leading central banks would diverge from market expectations, which could impact capital flows to emerging economies. In addition, in making decisions on monetary policy, the NBS Executive Board exercised caution also due to the uncertain movement in the prices of oil and primary agricultural commodities in the world market, given the complex interplay of numerous demand- and supply-side factors.

However, as of March the NBS eased its monetary policy much more vigorously than before, in light of the unprecedented challenge in recent history. **On 11 March 2020, the World Health Organization declared a global pandemic caused by the coronavirus. On the same day, at its extraordinary meeting, the NBS Executive Board responded by reducing the key policy rate by 50 bp. It also narrowed the corridor of the main interest rates, from ±1.25 pp to ±1 pp** relative to the key policy rate. In terms of the speed at which it responded to the outbreak of the pandemic, the NBS was one of the first institutions in the country and among the first central banks in the world. At its meetings **in April and June, the Executive Board cut again the key policy rate, by 25 bp each time, to 1.25%**, given that the magnitude of the crisis which engulfed the world required additional monetary policy support to mitigate the negative effects of the pandemic and encourage economic recovery, without prejudice to price and financial stability. The key policy rate was reduced by an entire percentage point from the pre-crisis period, which reflected on a further decline in interest rates in the interbank money market and on dinar loans, whereby continued growth in lending was encouraged.

The NBS also undertook **additional measures to support the real sector** – it provided significant dinar and FX liquidity to banks through direct repo operations, swap auctions and bilateral purchases of dinar government securities from banks. It introduced a **moratorium on the repayment of loan and financial lease debt** for all debtors who wished to apply it, over 90 days, with a 60-day extension, easing the burden of the crisis for our citizens and businesses. In July, the NBS Executive Board introduced **stimuli within the Government's Guarantee Scheme, which contributed to even better conditions of dinar corporate lending**, a rise in dinarisation and further strengthening of financial stability. The NBS made a decision to pay to banks which approve dinar loans under the Guarantee Scheme at rates lower by at least 50 bp than the maximum rate (one-month BELIBOR + 2.5 pp) a 50 bp higher remuneration rate on the amount of dinar required reserve allocations equivalent to the amount of loans approved at lower rates. All this softened the first wave of the crisis for banks, businesses and citizens, supported smooth functioning of the credit channel and encouraged the incipient recovery.

In conditions of global uncertainty caused by the pandemic, the NBS set up a **precautionary repo line with the ECB**, for the provision of additional euro liquidity to the domestic financial system, in case of need. It should be noted that neither dinar nor FX liquidity of the domestic banking sector is jeopardised and the country's high FX reserves are more than sufficient to ensure a response to any potential FX liquidity shocks. The precautionary repo line is yet another assurance, showing that the NBS acts proactively and takes all possible measures to support the domestic economy and preserve macroeconomic stability amidst the heightened global uncertainty due to the pandemic.

Responsible running of the economy in the past eight years made it possible for the NBS to respond by the above measures and to contribute, on its part and in coordination with the Government, to the mitigation of the negative effects of the pandemic and provide full support to the country's economic recovery. **Serbia faced this crisis in a much more favourable macroeconomic position than the previous crises** – with the average growth rate of 4.3% in the past two years, low and stable inflation for the seventh year in a row, a strong banking sector, lowered public debt, eliminated fiscal and significantly reduced external imbalances and record high FX reserves.

Table II.1.1 **Key monetary policy measures aimed at mitigating negative effects caused by the COVID-19 pandemic and supporting the Serbian economy**

Measure	Objective
1. The key policy rate lowered by an entire percentage point – to 1.25%, its new lowest level in the inflation targeting regime.	A further decline in interest rates in the interbank money market and on dinar loans, aimed at encouraging lending growth and faster recovery of economic activity.
2. The corridor of main NBS interest rate narrowed from ±1.25 pp to ±1 pp relative to the key policy rate.	Enhanced monetary policy efficiency through the interest rate channel.
3. Increased dinar and FX liquidity of banks, through direct repo operations, swap auctions and bilateral purchase of dinar government securities from banks.	Efficient functioning of the banking system and even more favourable conditions of corporate and household lending.
4. Introduced moratorium on the repayment of loan and financial lease debt, for all debtors who wish to apply it, over 90-days and additional 60 days.	Facilities to ease the burden of the crisis for our citizens and businesses, increasing their disposable income and mitigating the negative effect of the pandemic on domestic demand and economic activity.
5. Introduced stimulating measures within the Republic of Serbia's Guarantee Scheme – the NBS will pay to banks which approve dinar loans under the Guarantee Scheme at rates lower by at least 50 bp than the maximum rate (one-month BELIBOR + 2.5 pp) a 50 bp higher remuneration rate on the amount of dinar required reserve allocations equivalent to the amount of loans approved at lower rates.	Even more favourable conditions of dinar lending to micro, small and medium-sized enterprises and entrepreneurs, a higher degree of dinarisation and further strengthening of financial stability.
6. Introduced precautionary repo line with the ECB to ensure, in case of need, additional euro liquidity to the domestic financial system.	Ensuring another form of security amid pronounced uncertainty in the international financial market.

Source: NBS.

Owing to such position of the country, it was possible to **respond vigorously both by monetary and fiscal measures, in accordance with the best world practice, without prejudice to macroeconomic stability and the country's fiscal position**. The robust package of measures, worth over 12% of GDP, ensured support to the private sector and helped preserve jobs, ensure the operation of enterprises and speed up economic recovery. Owing to fiscal consolidation implemented in the past period, Serbia's public finances have the capacity to tackle the current crisis without jeopardising the achieved low and stable inflation and other indicators of macroeconomic stability.

The timely and coordinated measures of the Government and the NBS prevented a sharper economic contraction in the initial phase of the pandemic. It was certain that the strongest effects of the crisis would be felt in April, just like in the majority of other European countries, with recovery ensuing in the following months – encouraged by the undertaken monetary and fiscal policy measures, aimed at stimulating growth, through favourable conditions of financing for businesses and citizens, and at preserving favourable medium-term prospects of the country. More than complete recovery was expected already next year, without prejudice to price and financial stability and the country's fiscal position.

The Executive Board decided to further lower the key policy rate in an environment of low and stable inflation. As expected, the inflation slowdown continued, primarily due to the high base effect for vegetable prices and lower current prices of petroleum products reflecting a decline in global oil prices. The Executive Board stated that inflation should move around the lower bound of the target tolerance band until the end of the year (3±1.5%) amid weaker aggregate demand and lower import prices. It will gradually move to the target midpoint in the medium term, owing to the recovery of demand, supported by monetary and fiscal policy measures.

The decisions to lower the key policy rate were made as it was becoming increasingly evident that the opening, i.e. recovery of the global economy would be gradual, which is why economic growth projections for many advanced and emerging economies were revised down dramatically. The economy contracted as many service sectors faced difficulties in operation, i.e. standstills and, in some cases, disruptions of global supply chains, and receding consumer and business confidence. This fuelled uncertainty in the international financial market, with investors opting for save assets, which precipitated a fall in global stock exchange indices and a rise in prices of gold and sovereign bonds of advanced economies.

To mitigate the negative effects of the crisis, many central banks in the world responded by further easing their monetary policies and introducing large-scale unconventional measures. The Fed narrowed its federal funds target range effectively to zero and launched quantitative easing, unlimited in time and scope and unprecedented in this more than 100-years-old central bank. Particularly important for us is the euro area recovery, which should be encouraged, among other things, by the ECB's monetary accommodation and gradual easing of containment measures which, after the initial phase of the pandemic, took place as of May. The governments of many countries responded by robust fiscal packages. Measures were taken at the EU level as well. In deciding on monetary policy easing, the NBS Executive Board stated that monetary and fiscal policy coordination in the largest world economies should ease the negative effects on global economic growth and maintain favourable conditions of financing in the international environment in the new circumstances. The Board also noted that due to bleaker global growth prospects, the prices of primary commodities in the world market, notably oil prices, would remain relatively low going forward.

The NBS Executive Board highlighted it would continue to carefully monitor and analyse developments in the international financial market and the market of primary commodities, notably of crude oil and primary agricultural commodities, and that the NBS stands ready to respond to any further effects of the pandemic. As so far, full coordination of monetary and fiscal policy measures will continue, diminishing potential further negative shocks from the international environment and the economic fallout from the spread of the coronavirus. In coordination with the Government, the NBS implemented all necessary measures to preserve the achieved price and financial stability and ease the position of citizens and businesses in the current extreme circumstances. In case of need, additional measures will be implemented in the coming period as well, depending on the further course of the pandemic and the recovery of our economy.

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 were again **one-week reverse repo transactions**, i.e. repo sale of securities (liquidity absorbing).

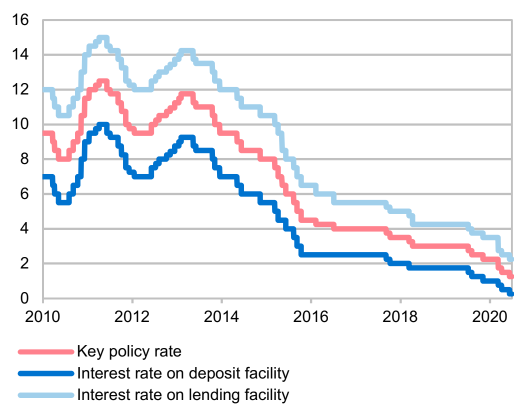
The NBS implemented repo transactions through own securities. For the needs of repo sale, one series of T-bills issued in late 2019 was used, in the total nominal value of RSD 500 bn. This is consistent with practice from earlier years which enables more adequate management of securities within the same series and facilitates liquidity management for banks.

In H1 2020, twenty-five 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 1,120.0 bn, which was lower than in H2 2019 (RSD 1,790.0 bn).

The stock of NBS securities in banks' portfolios averaged RSD 45.8 bn in H1 2020, down by RSD 20.1 bn from H2 2019. Relative to end-2019, the stock of these securities decreased by RSD 30.0 bn, to RSD 40 bn at end-June.

In order to support the domestic financial system and overall economic flows amid the coronavirus pandemic, the NBS provided the banking sector with additional

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



Source: NBS.

dinar liquidity in the total amount of RSD 26.2 bn at end-March 2020, by organising three auctions of repo purchase of dinar government securities with seven-day and three-month maturities, at a favourable interest rate of 0.75% for both maturities, i.e. at the deposit facility rate.

During April and May 2020, the NBS continued to provide support to the banking system through outright purchase of dinar government securities from banks, thus providing them with additional liquidity in the amount of RSD 97.0 bn.

In order to support the domestic economy amid the pandemic, by amending the Decision on the Conditions and Manner of Implementing Open Market Operations, the NBS allowed for dinar securities without a foreign exchange clause, issued by domestic companies (corporate bonds), to be purchased and sold in outright and repo transactions of banks with the NBS.

Deposit and lending facilities

In H1 2020, banks continued to place overnight deposits with the NBS, which averaged RSD 135.1 bn, up by RSD 83.9 bn from H2 2019. The highest average daily stock was recorded in June (RSD 209.4 bn) and the lowest in March (RSD 75.7 bn).

The Decision on the Conditions and Manner of Extending Daily Liquidity Loans to Banks against the Collateral of Securities, which regulates NBS lending facilities, was amended to include more securities which can be the subject of the collateral of dinar securities, without a currency clause, issued by domestic companies. In H1 2020, banks used lending facilities as intraday loans (one bank in the total amount of RSD 1.0 bn). Overnight loans were not used.

Required reserves

In H1 2020, the amount of calculated required reserves allocated in dinars increased by RSD 14.6 bn, to RSD 206.1 bn in June. This increase reflects growth in dinar required reserves (by RSD 7.9 bn) and FX required reserves allocated in dinars (by RSD 6.7 bn).

In the same period, the amount of calculated required reserves allocated in foreign currency increased by EUR 97.9 mn and came at EUR 2,136.8 mn in June. This was driven by the increase in the FX base by EUR 824.6 mn, mostly due to greater foreign borrowing of banks and FX savings of citizens.

Interest rates

In H1 2020, the NBS key policy rate was trimmed three times – in March from 2.25% to 1.75%, in April to 1.50% and in June to 1.25%, whereby in March the interest rate corridor was narrowed from ±1.25 pp to ±1.00 pp relative to the key policy rate. As a result of these changes, the rates on lending and deposit facilities were also lowered from 3.5% and 1.0% in January, to 2.25% and 0.25% in June, respectively.

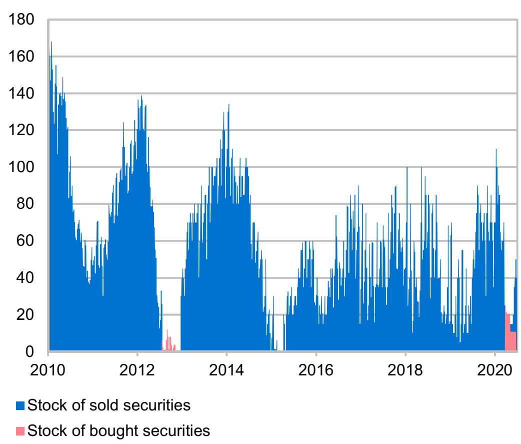
Furthermore, in the same period, the interest rate used by the NBS to charge and pay interest on the amount of actual average daily balance of allocated dinar required reserves was reduced in March from 0.75% to 0.50%, in April to 0.25% and in June to 0.10%.

Foreign exchange market operations

Under the 2020 Monetary Policy Programme, the NBS continued implementing the managed float exchange rate regime, with the possibility to intervene in the FX market with a view to easing excessive short-term volatility of the dinar against the euro, maintaining price and financial stability and an adequate level of FX reserves.

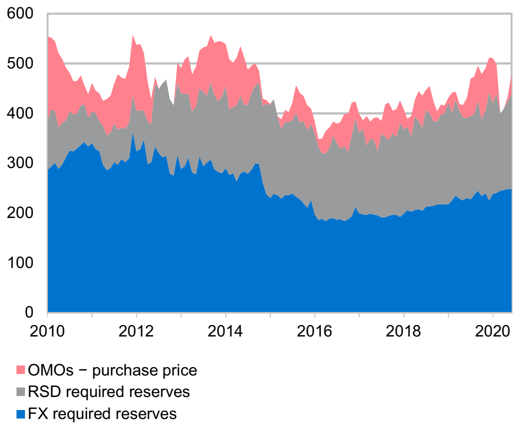
In H1 2020, the dinar's value against the euro remained almost unchanged. Despite the turbulences in the international markets caused by the coronavirus, the value of the dinar against the euro remained almost unchanged, with the NBS intervening in the FX market mainly on the sale side. The depreciation pressures in Q1 were triggered primarily by usually heightened FX demand of domestic

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



Source: NBS.

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



Source: NBS.

enterprises – energy importers, while only April saw somewhat greater demand by non-residents due to growing uncertainty in the international markets amid the coronavirus pandemic.

In H1 2020, the NBS intervened in the IFEM as a net seller of EUR 1,030 mn (selling EUR 1,205 mn and buying EUR 175 mn). The NBS intervened as a price taker, strictly under market conditions.

The presence of structural appreciation pressures from April 2017 to the end of 2019 (prompted by macroeconomic stability, strong export activity, a significant FDI inflow and portfolio investments) enabled the NBS to significantly increase its FX reserves in that period (to the historical high), based on its interventions in the IFEM too. In that period, the NBS net bought EUR 5,345 mn, creating additional security in case of potential shocks, especially from the international environment, which manifested themselves in H1 2020, due to the spread of the coronavirus.

FX supply in H1 2020 was influenced by the increase in net indexed bank assets (reflecting the stepped-up bank lending), the longer FX positions of banks on account of use of payment cards by non-residents, as well as FX supply by some residents, which eased depreciation pressures, and in some periods generated milder appreciation pressures. In January and February 2020, banks were net buyers of foreign cash, while in the following months they were net sellers, contributing to depreciation pressures caused by higher FX demand by residents and, in some periods, by non-residents.

At end-H1, relatively stable movements in the FX market continued. The elevated FX supply of non-residents recorded in June reflects a currently more positive sentiment in global markets concerning investments in emerging economies, i.e. foreign investors expect the relative stability of the dinar exchange rate to be preserved in the coming period.

FX swap auctions of the National Bank of Serbia

In H1 2020, the NBS continued to hold its regular three-month and two-week auctions of FX swap purchase and sale (EUR/RSD), in order to encourage the development of interbank swap trading and facilitate more efficient liquidity management for banks.

In H1 2020, 48 two-week swap auctions were held, at which the NBS swap bought EUR 148 mn and sold EUR 284.5 mn, as well as 50 three-month swap auctions, at which it swap bought EUR 259 mn and sold EUR301 mn.

In order to support domestic financial system and economy, on 23 March 2020, the NBS organised an additional swap auction of purchase of foreign currency (euros) for dinars, providing dinar liquidity for banks in the equivalent of EUR 127 mn for a three month term at a favourable dinar interest rate of 0.85% (the NBS deposit facility rate increased by 10 bp) and at the rate of 0% for euros.

As part of the package of measures aiming to facilitate continuous management of dinar and foreign currency liquidity by banks amid the coronavirus pandemic, the NBS adopted changes in the conduct of regular swap auctions of purchase and sale of foreign currency (euros) for dinars. In the period from 31 March to 31 May 2020, the regular three-month and two-week FX swap auctions were organised at fixed swap points, instead of variable multiple swap points applied previously. Also, the execution principle at FX swap purchase and sale auctions was also changed, so swap purchase and sale of foreign currency did not have to be identical in the executed amount. In such circumstances, the NBS's role was not solely mediatory, but also involved the provision of sufficient amount of dinar and FX liquidity to banks, at favourable interest rates, in order to prevent potential disturbances in the domestic money and financial markets. The interest rates at which regular fixed swap auctions were executed were the deposit facility rate increased by 10 bp[5] for dinars and 0% for euros. The net effect of regular FX swap auctions at a fixed method, executed in the period 31 March – 31 May 2020 provided banks with FX liquidity in the amount of EUR 96 mn. Since June, after the abolition of the state of emergency in our country and the assessment that there was no longer a need to apply the changed practice when it comes to regular FX swap auctions, the NBS organised these auctions by the method of variable multiple swap points, based on the application of the usual principle of identical executed amounts at FX swap purchase and sale auctions.

At end-H1 2020, the stock of NBS FX receivables and liabilities in respect of three-month and two-week swap auctions equalled EUR 243 mn and EUR 201 mn, respectively.

Table II.3.1 **Growth and contribution of components to consumer price growth in H1 2020**

	Growth rates (in %)	Contribution (in pp)
Consumer prices (CPI)	**1.4**	**1.4**
Unprocessed food	12.9	1.3
Processed food	2.2	0.5
Industrial products excluding food and energy	0.5	0.1
Energy	-6.7	-1.0
Services	2.4	0.6
Core inflation indicators		
CPI excluding energy	3.0	2.5
CPI excluding energy and unprocessed food	1.6	1.2
CPI excluding energy, food, alcohol and cigarettes	1.2	0.6
Administered prices	2.3	0.4

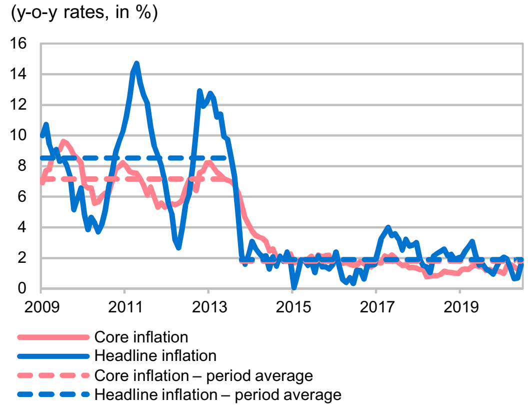
Sources: SORS and NBS calculation.

3 Achievement of inflation target in the period January–June 2020

Despite the crisis caused by the coronavirus pandemic, **inflation was maintained at a low level in H1 2020 as well**. After standing at 2.0% in January, in line with the NBS expectations, **y-o-y inflation** slowed down and moved below the lower bound of the target tolerance band in March, April and May, only to **return within the target band**, **measuring 1.6% in June**. The initial inflation slowdown was mostly influenced by the higher base effect from vegetable prices, whose negative contribution to y-o-y inflation dissipated by June. A considerable decrease in the prices of petroleum products worked in the same direction, reflecting a drastic fall in global oil prices in the first four months of 2020. Conversely, in H1 the prices of fruit and other food categories increased, giving a positive contribution to y-o-y inflation, together with administered prices and prices of non-food products and services.

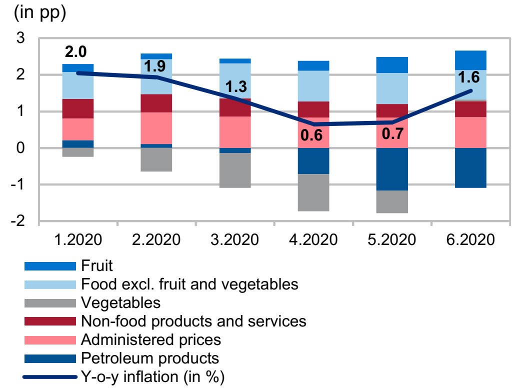
The y-o-y inflation dynamics in H1 indicate that even in the conditions of the changed structure of demand caused by the pandemic, the market was fully supplied with goods, and inflationary pressures did not intensify. This was also facilitated by the **decision of the Serbian Government to limit the price increase of certain products** to a period of 60 days (since the introduction of the state of emergency) to prevent disruptions in the

Chart II.3.1 **Headline and core inflation**
(y-o-y rates, in %)



Sources: SORS and NBS calculation.

Chart III.3.2 **Contribution of CPI components to y-o-y inflation**
(in pp)



Sources: SORS and NBS calculation.

[5] Following the reduction in main interest rates by 25 bp, on 13 April, the NBS decided to cut the interest rate on dinars that banks can obtain through regular FX swap auctions from 0.85% to 0.60%.

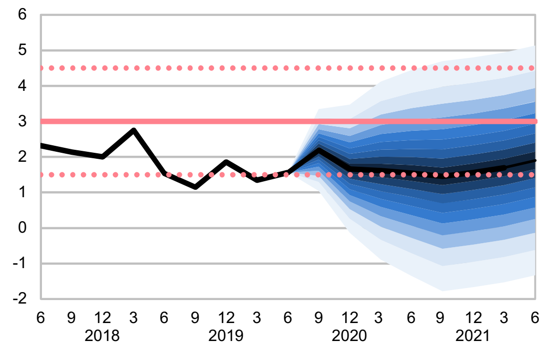
supply of the market with essential food. Low inflationary pressures are also confirmed by **core inflation** (measured by CPI excluding the prices of food, petroleum products, alcohol and cigarettes), which **remained stable in H1, and measured 1.4% y-o-y in June**.

In H1, consumer prices recorded 1.4% growth, led by the increase in prices of **unprocessed food** (12.9%), primarily fresh fruit and vegetables, contributing 1.3 pp to semi-annual inflation. In addition, **processed food** prices also grew, as well as the prices of **services and industrial product prices excluding food and energy** (with a 1.2 pp cumulative contribution to inflation). On the other hand, a negative contribution in H1 came from the drop in **energy** prices (contribution: -1.0 pp), almost entirely attributable to a significant decrease in petroleum product prices (-17.7).

Prices within core inflation (measured by CPI excluding the prices of food, energy, alcohol and cigarettes) increased in H1 by 1.2% (contributing 0.6 pp to inflation), predominantly driven by the seasonal hike in prices of travel packages. At the same time, **administered prices** grew by 2.3% (contribution: 0.4 pp) on account of the February increase in the prices of landline telephony services and the regular annual cigarette excise adjustment.

Bearing in mind the projection assumptions, **the NBS expects that y-o-y inflation will continue to move around the lower bound of the target band until the end of this and in the course of next year, closer to the lower bound**, primarily due to lower cost-push pressures

Chart II.3.3 **Inflation projection**
(y-o-y rates, in %)



Source: NBS.

The fan chart depicts the probability of various inflation outcomes in the next eight quarters. The central projection is within the darkest central band and the probability that inflation would lie in it is 10%. Each following shade includes 10% probability, which means that outturns of inflation somewhere within the entire fan chart are expected with probability of 90%. In other words, the probability that inflation in the next eight quarters would lie somewhere outside the band in the chart is 10%.

and aggregate demand amid the current coronavirus pandemic. As economic activity strengthens and demand picks up, y-o-y inflation in 2022 is expected to approach the target midpoint, but remain below it until the end of the projection horizon. Uncertainties surrounding the inflation projection are still mostly associated with movements in the international environment, including primarily the pace of global economic growth and trade, capital flows to emerging economies and prices of oil and other primary commodities. The risks to the projection also relate to the speed of recovery in domestic demand and movement in administered prices at home. Overall, risks to the inflation projection are judged to be symmetric.

III Macroeconomic environment

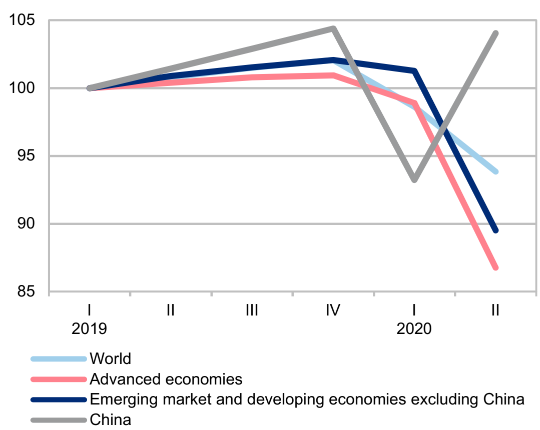
1 International environment

Economic activity and inflation

During H1 2020, the world faced a health and economic crisis caused by the coronavirus pandemic, the consequences of which are estimated by leading international organisations to be much graver than initially anticipated, and recovery uncertain. The unprecedented crisis led to **an unparalleled fall in global economic activity in H1** and pushed most of the countries into recession. Hence, in June the IMF made significant downward revisions to its global growth projection for 2020 (by 1.9 pp to -4.9%), predicting a slower economic recovery in 2021 than previously projected. The bleak prognosis is mostly attributable to the weaker private consumption, under the impact of the introduced containment measures and increased precautionary savings, as well as a fall in capital investments amid heightened uncertainty. Despite China's economic resurgence in Q2 and early signs of recovery in the euro area and the USA at end-Q2, **risks to global growth remain pronounced and skewed to the downside**, as it is still not possible to grasp the full effects of the new crisis, given the continued spread of the virus in many countries across the globe.

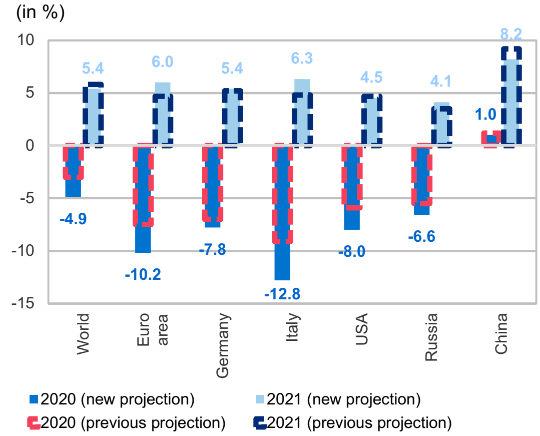
In the circumstances of implemented anti-crisis measures, **the euro area economy posted a sharp fall in H1** – first by -3.6% s-a in Q1, and then by -12.1% s-a in Q2 (preliminary), mostly as a consequence of subdued household consumption and fixed investments. Such dynamics is present with our key foreign trade partners in the euro area – **Italy and Germany, where GDP dropped drastically in Q2**, by -12.8% s-a and -9.7% s-a, respectively, whereby both economies entered recession.

Chart III.1.1 **Quarterly GDP dynamics**
(Q1 2019 = 100)



Source: IMF WEO Update (June 2020).

Chart III.1.2 **Revisions of real GDP growth forecasts for 2020 and 2021 by the IMF**
(in %)



Sources: IMF WEO (April 2020) and IMF WEO Update (June 2020).

The negative effects of the new crisis in euro area countries were mostly felt in April, when business activity was forced down, and even completely suspended in some sectors, only to start recovering gradually as of May. The nascent recovery is also signalled by the leading economic indicators for the euro area – Eurozone Composite PMI and Economic Sentiment Indicator – which suggest that the euro area economy will leave the economic contraction stage at end-Q2.

Assuming the loosening of restrictive measures going forward, in June the **ECB** assessed that **the euro area will see a gradual economic recovery in H2**, propped by favourable financial conditions and an accommodative fiscal policy, as well as the renewed activity in Europe and elsewhere. However, the pace of the recovery will still remain uncertain amid the new global spread of the virus. Given the depth of the crisis, the **ECB made significant downward revisions to its euro area 2020 growth projections in June** (by 9.5 pp to -8.7%). Whether the projection materialises will depend on the duration of the pandemic and efficiency of containment measures, the impact on supply and demand, and the success of economic policies in preserving jobs and wages. Over the past months, this was greatly facilitated by the so-called **short-time work scheme,** which was introduced to prevent layoffs and it helped avoid a major impact of the crisis on the labour market – the unemployment rate equalled 7.7% in June.

After **euro area inflation** stepped-up slightly, by 0.1 pp to 1.4% y-o-y in January, a sharp fall in energy prices led to it slowing down to 0.1% y-o-y in May, its lowest level since June 2016. On the other hand, a positive contribution to inflation came from food prices, which accelerated their y-o-y growth until May, most likely due to the increased demand for basic foodstuffs and panic caused by the coronavirus. As the global oil prices recovered, the negative contribution of energy prices to inflation decreased. Thus, in June, inflation edged up to 0.3% y-o-y, but still remained significantly below the inflation target of below, but close to 2%. Excluding the volatile components, i.e. the prices of food, energy, alcohol and cigarettes, inflation continued to slow down until the end of H1, coming down from 1.3% y-o-y at end-2019 to 0.8% in June, against the backdrop of the significant contraction in economic activity caused by the pandemic. As for Serbia's key foreign trade partners, y-o-y inflation in **Germany**, measured by the HICP, mirrored the dynamics of the euro area – after slowing down to 0.5% in May, it rose mildly to 0.8% in June due to the slower y-o-y fall in energy prices. On the other hand, **Italy's** y-o-y inflation slowed down until end-H1, with y-o-y prices striking a downward path as of May (-0.4% in June).

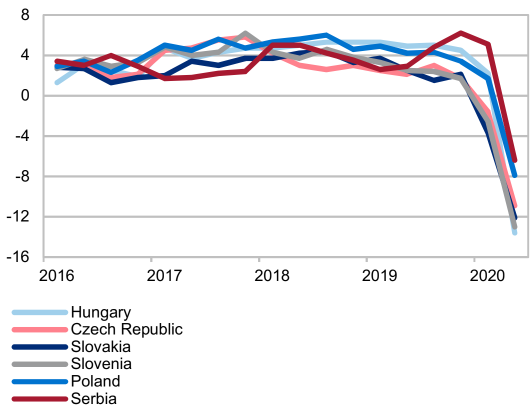
Having declined -5.0% annualised in Q1, the **US economic activity contracted further in Q2**, by -31.7% annualised, as a consequence of stay-at-home measures and suspended business operations in March and April, which remained in force in the majority of states during May and June. The sharp fall in economic activity is the result of the inevitable slump in personal consumption and fixed investments in contrast to increased government consumption and goods and services import. To hedge against any lasting deterioration of economic conditions, the USA adopted a comprehensive fiscal programme, with direct aid payments to households and corporates, parallel with monetary policy measures for supporting liquidity and lending. Based on this, the **Fed** in its baseline scenario **forecast a gradual recovery of the US economy in H2**, though not to the full scope, therefore a 6.5% fall of GDP is expected at the year level. In addition, May and June saw somewhat improved conditions in the labour market, as attested by the fall in the number of submitted claims for compensation in the event of job loss, the unemployment rate declining to 11.1% in June (from the record high 14.7% in April), and the number of non-farm payrolls increasing by around 4.8 mn persons, especially in the services sector.

Measured by the personal consumption expenditures index, headline y-o-y inflation in the **USA** decelerated significantly during H1, from 1.6% at end-2019 to 0.5% in May, due to low aggregate demand and low energy prices, only to perk up mildly to 0.8% in June owing to a recovery in the prices of energy. Inflation excluding energy and food prices – as the Fed's preferred measure – declined from 1.6% y-o-y in December 2019 to 0.9% in June, thus moving further from the 2% inflation target.

Unlike the euro area, with which it has strong trade relations, the **Central and Southeast European region**[6] **posted growth** of 0.7% y-o-y **in Q1**, owing to a positive contribution of final consumption, in contrast to the negative contribution of net exports and investments. Most countries in the region recorded y-o-y growth in Q1. In the forefront of these countries was Serbia with the GDP growth of 5.0% y-o-y. However, during Q2, economic activity plummeted across the region, reflecting on lower

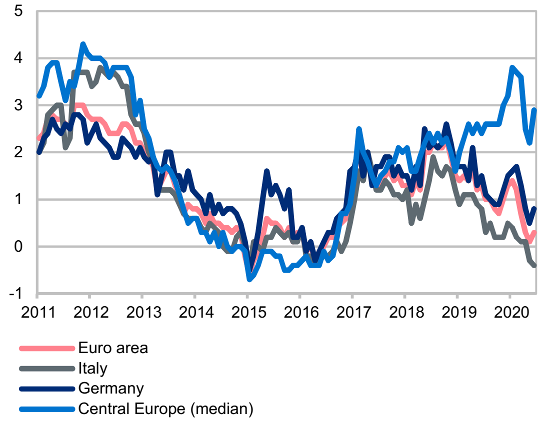
[6] The region includes Romania, Hungary, the Czech Republic, Slovenia, Bulgaria, Croatia, Slovakia and Poland.

Chart III.1.3 **Y-o-y GDP growth rates in CESEE countries**
(in %)



Source: Eurostat.

Chart III.1.4 **HICP across selected countries**
(y-o-y rates, in %)



Source: Eurostat.

consumption and investments, which was then followed by deterioration in the labour market. In regard to this, in June the IMF forecast an economic fall of 5.8% in **Europe's emerging and developing countries**. The pace of the recovery in the remainder of the year will depend on the degree to which physical distancing measures are loosened and on measures taken by economic policy makers based on the previously secured fiscal space.

Inflation in the majority of observed **Central and Southeast European countries** rose in January, driven by energy prices and last year's low base, as well as by the rising food prices, and in Hungary, Poland and the Czech Republic it reached record high levels in eight years. It continued up in Poland and the Czech Republic in February amid rising domestic demand, while slowing down in Hungary and Romania, and then decelerating in all observed countries over the following three months. Such inflation movements are mostly attributable to the lower prices of categories that were most affected by containment measures aimed at mitigating the spread of the coronavirus (petroleum products, prices of services, etc.). June saw inflation accelerate in these countries: in the Czech Republic it overshot the upper bound of the target tolerance band (3.3%), in Poland it came close to the upper bound (3.3%), while in Hungary (2.9%) and Romania (2.6%) it was close to the target midpoint. In addition to the rise in the prices of petroleum products, a contribution to this also came from the rise in the prices of some categories of services and products as economies gradually opened up and some producers and service providers sought to transfer the higher costs caused by the pandemic onto consumers. Still, the June acceleration of inflation is assessed as temporary and there are currently no fears that inflation might pose a major problem in those countries going forward.

Upon the outbreak of the coronavirus pandemic, favourable **economic developments in Russia** at the onset of the year (with GDP growth of 1.6% y-o-y in Q1) were disrupted, mostly due to the plummeting global oil prices as of February, caused by dampened demand in the crisis period, and the failure of Russia and Saudi Arabia to reach an agreement on capping production. Due to the decrease in oil export revenue, the introduced containment measures and stricter financial conditions, the IMF's June projection included a downward revision of Russia's growth of 6.6% in 2020.

With global oil prices declining, **inflation in Russia** continued down in January and February, when it reached the lowest level in more than a year and a half (2.3% y-o-y), with depreciation of the rouble triggering its rise again in March. Inflation continued up in April, on the back of the rising food prices, and despite its slowdown, inflation continued up over the following two months (3.2% y-o-y in June), notably due to the low base from last year, while inflationary pressures remained low.

Compared to the rest of the world, **the Chinese economy** bore the brunt of the crisis during Q1 (with a 6.8% y-o-y fall in GDP), after which China took comprehensive fiscal and monetary policy measures which helped achieve the GDP growth of 3.2% y-o-y in Q2, whereby the economy practically left the contraction stage. The economic recovery begun already in H1 is indicated by the return of leading activity indicators in the production and services sectors to pre-crisis levels in June, as well as by a solid agricultural season and the rising profits in industry. Therefore, in June the IMF forecast the growth of 1.0% for the Chinese economy in 2020, propped by government support to troubled corporates and households via a welfare programme and the further development of medical and digital services.

Monetary policy

Though it kept its main refinancing rates unchanged, during H1 the **ECB** adopted a comprehensive package of other stimuli with a view to providing support to the real sector and increasing the availability of loans to households and corporates. The ECB continued with the asset purchase programme (APP) at a monthly pace of EUR 20 bn, and launched the additional asset purchases in the total amount of EUR 120 bn until end-2020 to limit the tightening of financial conditions in the euro area. In addition, a Pandemic Emergency Purchase Programme (PEPP) was introduced in March and expanded in the June meeting by an additional EUR 600 bn to EUR 1,350 bn, and its implementation was extended – instead of end-2020 until at least end-June 2021, and in any case until the ECB estimates that the crisis caused by the pandemic has ended. The ECB will reinvest the maturing principal payments from securities purchased under the PEPP at least until end-2022. It eased the conditions relating to the volume and interest rate for targeted longer-term refinancing operations (TLTROs III), and the interest rate for these loans, for banks meeting certain conditions, can be as low as -1.0%. It also expanded the eligible collateral base within the corporate sector purchase programme (CSPP), and mitigated the collateral criteria for refinancing operations (main refinancing operations, LTROs, TLTROs). As of May, banks can make use of new pandemic emergency longer-term refinancing operations (PELTROs), introduced to secure a sufficient liquidity level and further ease the financial conditions in the euro area during the pandemic. At end-June, it also announced the introduction of repo auctions to provide euro liquidity to central banks outside of the euro area, to be carried out until end-June 2021. Thus, in July, the ECB and the NBS set up a pre-emptive repo line to ensure additional euro liquidity to the domestic financial system should such a need arise amid disturbances in the market caused by the coronavirus pandemic.

In March, the **Fed** lowered its federal funds target range twice, by a total of 150 bp, to 0–0.25%, and kept it unchanged until the end of H1, noting that interest rates are expected to remain very low until there is confidence that the US economy is on the path of achieving maximum employment and price stability. Considering the potential negative effects on funds in the money market and the banking system, the federal funds rate is not expected to descend into the negative zone, and projections indicate it will remain at the current level during this and the following two years. The Fed relaunched the quantitative easing programme based on the purchase of Treasury bonds and mortgage-backed securities, and launched large repo operations in order to sustain the smooth functioning of markets and efficient monetary policy transmission. It also introduced temporary international repo transactions which ensure dollar liquidity to foreign central banks and other monetary institutions, and activated dollar swap lines with central banks of other developed countries (ECB included) and several central banks in emerging markets. The Fed also launched support programmes, such as the Commercial Paper Funding Facility (CPFF), the more favourable Primary Dealer Credit Facility (PDCF), facilities to support the corporate bond market in the USA (PMCCF and SMCCF), the Money Market Mutual Fund Liquidity Facility (MMLF), support lending to small and medium-sized businesses (MSLP), and many others.

Central banks in countries of the Central and Southeast European region also responded to the newly-emerged situation caused by the pandemic by easing their monetary policies in H1. After lifting its key policy rate by 25 bp in February, the central bank of the **Czech Republic** trimmed it twice in March, by a total of 125 bp, and then once again in May by an additional 75 bp, to 0.25%, against a backdrop of aggravated prospects for economic activity at home. In an emergency meeting in March, the central bank of **Poland** first cut its policy rate by 50 bp – its first change since March 2015 – and then twice more, in April and May, by a total of 90 bp to the record-low 0.1%. In addition, in April it launched an asset purchase programme in the secondary market. The **Romanian** central bank also embarked on a programme of government bond purchase in the secondary market in April, and after trimming the policy rate by 50 bp in an emergency meeting in March, it cut the rate by another 25 bp to 1.75% at end-May. The central bank of **Hungary** did not change its policy rate during Q1 (0.9%), but it secured unlimited liquidity to banks by introducing a new instrument of collateralised loan with a fixed interest rate. It drove liquidity up by abolishing the required reserve for domestic banks and increasing the volume of FX swap transactions. In June, for the first time since May 2016, the central bank of Hungary reacted via the policy rate, trimming it by 15 bp and then by another 15 bp in July, to 0.6%.

During H1, the central bank of **Turkey** continued trimming its policy rate by a total of 375 bp to 8.75%, in conditions of dampened demand and cost-push pressures, despite the lira depreciating in the prior period. Against the backdrop of rising disinflationary pressures due to decreased domestic and external demand, the central bank of **Russia** also lowered its policy rate in H1. In its February, April, June and July meetings, it trimmed the key rate by a total of 200 bp to its lowest level on record in the inflation targeting regime (4.25%), i.e. since early 2014.

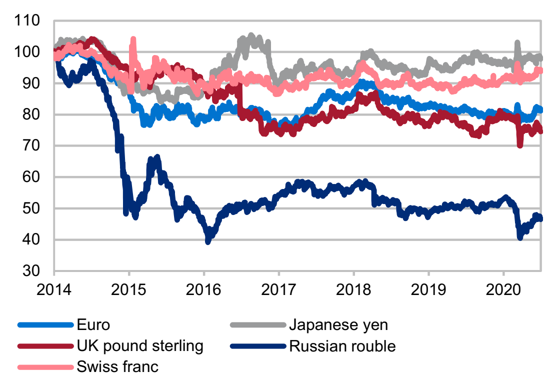
Financial and commodity markets

In H1, financial markets were under the dominant sway of news and developments related to the coronavirus spread. When the pandemic broke out, investors fled from shares and corporate bonds in order to buy safer assets, as well as due to the need for more liquid assets, hence leading stock exchanges recorded the sharpest slumps since the global financial crisis, while the implicit measure of **financial market volatility** (VIX) reached its historic maximum in mid-March. After leading central banks managed to stabilise the financial system with their measures and helped calm financial markets with comprehensive measures undertaken by governments across the world, adopted with the aim of mitigating the consequences of the pandemic, volatility in global financial markets subsided considerably. Yet, at end-H1, VIX (30.4%) was still much higher than at end-2019 (13.8%), the same as the volatility of currencies of emerging countries, measured by EM–VXY (10.5% compared to 6.6%), due to the ongoing uncertainty as to the speed of the global economic recovery.

As the virus continued to spread, leading to a rise in risk aversion, investors increasingly sought security in government bonds of developed countries, therefore **yields on ten-year** US and German **sovereign bonds** posted record-low values in early March. The whole yield curve of US Treasuries went below 1% for the first time ever, and the yield curve on German government bonds went deeper into the negative territory. The drop was largely prompted by the launch of the new asset purchase programme (PEPP), with the lifting of some restrictions previously applied in asset purchases. As H1 unfolded, the volatility of the yield on government bonds of emerging countries declined, hence at end-H1 yields on ten-year US and German bonds stood at levels similar to those from end-Q1, i.e. 0.7% and -0.5%, respectively. The upward pressure on yields stemmed from the gradual opening of economies and the data which hinted at a certain stabilisation in the labour market, while working in the opposite direction were rising apprehension as to the new spread of the coronavirus and fears that this could lead to a reinstatement of restrictions, leading to a slower economic recovery. Apart from German bonds, negative yields at end-H1 were also recorded by the ten-year French (-0.1%) and Austrian bonds (-0.2%). The Q1 rise in the yields on comparable bonds of countries in the euro area periphery was annulled during Q2, mostly due to the agreement on the establishment of an EU-level fund for assistance to the hardest hit member states, and in the case of Italy and Greece, the yields were even lower than at end-2019.

Movements in FX markets also reflected higher risk aversion, with the leading world currencies turning highly volatile against the dollar in H1. In the second half of February, **the dollar** reached its highest value **against the euro** since April 2017 (1.08 EUR/USD), only to touch the lowest value in more than 12 months in early March (1.15 EUR/USD), reflecting the concerns about the coronavirus impact on the US economy. A global pandemic ensued, and the dollar, as the most liquid and the world's primary reserve currency, gained strength again, reaching its new peak since April 2017 (1.07 EUR/USD). Additional measures of leading central banks, aimed at boosting dollar liquidity, to some degree satisfied a huge demand for this currency, therefore the dollar again lost steam. During April and nearly until end-May, the USD/EUR exchange rate oscillated around 1.09. On the other hand, hints at the epidemic stabilising in the hardest hit euro area countries and the measures taken to mitigate its effects worked towards strengthening the euro. The euro's strongest rise against the dollar was recorded after the

Chart III.1.5 **Exchange rates of selected national currencies against the dollar***
(daily data, 31 December 2013 = 100)



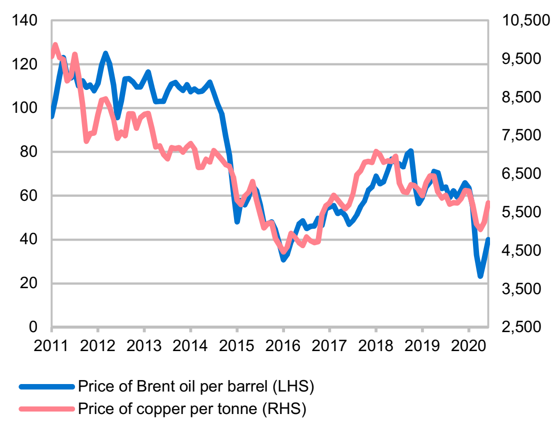
Source: IMF database.
* Growth indicates appreciation.

European Commission presented the details of the EU recovery plan (Next Generation EU), which implies assistance to the most vulnerable member states. During June, the euro continued to appreciate (the average monthly exchange rate was 1.13 dollars per euro) amid hints of economic recovery in the leading economies, the ECB's decision to step up asset purchases within the PEPP, and Germany's decision to support the economy by an additional package worth EUR 130 bn. However, fears over the potential second wave of the pandemic and a slower exit from recession of leading world economies contained the euro's further rise, hence at the level of H1 the euro gained mildly on the dollar – a mere 0.1%. During the observed period, other leading world currencies also recorded significant volatility vis-à-vis the dollar. Thus, besides the euro, also appreciating against the dollar were the Swiss franc (2.2%) and Japanese yen (1.3%), while the pound sterling weakened by 6.5% and the Russian rouble by 12.1%.

The **global oil price** plummeted, coming down from USD 66.4 per barrel at end-2019 to USD 17.3 per barrel in the second half of April, when oil futures entered the negative territory for the first time in history. The drop in the oil price was prompted by the lower demand due to the newly introduced counter-pandemic measures which directly affected the transport sector. In the ensuing period, oil prices recovered, mainly owing to the unprecedented cut in production by OPEC members – to the lowest level in almost 30 years, applied as of 1 May with a view to alleviating market saturation. The oil price was also driven up by the optimism that the demand might start recovering with the opening of economies, as well as by a significantly stronger import demand from China during May, the rebound in global demand in June, and sharper than expected depletion of US oil inventories. At end-H1, the price of oil equalled USD 40.9 per barrel, still lower (by almost 40%) than at end-2019.

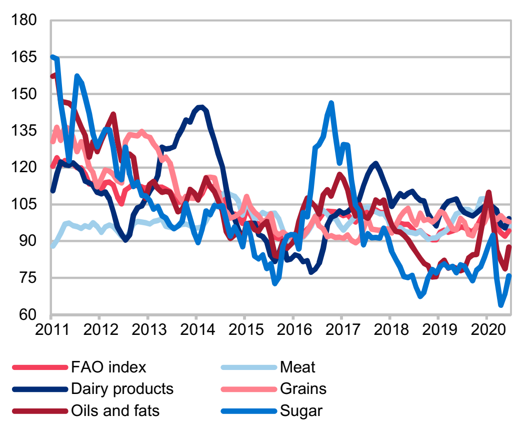
Global food prices, measured by the **FAO index**, decreased by 7.2% in H1, recovering slightly only in June. The prices of all types of vegetable oil were reduced the most, by 14.2%, mainly due to the fall in the price of palm oil. After dropping in May to their lowest level in ten months, they perked up slightly in June, driven by the recovery in global palm oil demand, amid the relaxation of containment measures in many countries. The rise in these prices is attributable to concerns over potential halts in production due to the lack and restricted movements of the workforce. Meat prices were 10.3% lower than at end-2019, first due to China's decreased import of ovine and bovine meat, caused by disruptions in transport and the consequent piling up of inventories in exporting countries during Q1, and then by the lower import of meat from other regions, as well as increased export capacities of leading producers. The price of sugar also declined in H1, initially because of the measures adopted by some countries, which dampened import demand, and then because of a sharp fall in energy prices, when sugar cane was redirected from biofuel to sugar production. The recovery of energy prices in May and June worked in the opposite direction, which, together with the disruptions in sugar supply from Brazil, led to a mild recovery in the price of sugar, though it was still 9.1% lower than at end-2019. In H1, the prices of dairy declined by 4.7%, in conditions of lower demand and growing export capacities and inventories, while still mildly recovering in June, as Middle East and Eastern Asia demand expanded.

Chart III.1.6 **Oil and copper price movements**
(average monthly prices, in USD)



Source: Bloomberg.

Chart III.1.7 **World food price index**
(in real terms, 2014−2016 = 100)



Source: FAO, UN.

The prices of cereals were the only ones to record a slight increase at the level of H1 (0.1%). The prices of wheat and corn, the key agricultural commodities for Serbia, rose in January amid stepped-up demand, only to decline in the remainder of the quarter due to large global inventories combined with good prospects for the wheat harvest and diminished demand for corn as biofuel. After the April increase, cereal prices headed down again for the rest of the quarter. Wheat harvest in the Northern Hemisphere in June drove the price of wheat further down, as did the good production prospects in countries which are the main wheat exporters, primarily in the Black Sea Region. On the other hand, after several months of decline, the corn price edged up in June, influenced by a partial rebound of demand and unfavourable weather conditions in the USA.

2 International transactions

Balance of payments and FX reserves

During H1 and in Q2 in particular, current account dynamics were under a powerful sway of the coronavirus pandemic and the containment measures put in place. According to preliminary data, the **current account deficit** measured EUR 1.3 bn in H1 2020, down by 11.6% y-o-y. At the same time, the current account deficit contracted from EUR 973.1 mn in Q1 to EUR 366.5 mn in Q2 (down by 47.3% relative to Q2 2019), due to a narrowing of the trade deficit as imports fell more than exports, contraction of the primary income account deficit and a slight improvement in the balance of services. A smaller inflow of remittances worked in the opposite direction. Even in the conditions of the pandemic-induced global crisis, the current account deficit was more than fully covered by net FDI inflow which measured over EUR 1.4 bn in the six months this year. Net inflow in respect of portfolio investments equalled EUR 1.5 bn and resulted primarily from the eurobond issue in the international financial market. This led to a rise in FX reserves, further increasing our economy's resilience to shocks from the international environment.

In the first two months, Serbia's foreign trade recorded growth, but entered a decline as the new crisis unravelled. The adverse effects of the crisis were particularly felt in April. With the relaxation of containment measures and the gradual opening of economies, both exports and imports began to rally as of May. Despite the recovery, the y-o-y fall in goods exports (-9.3%) in H1 was somewhat more pronounced than the y-o-y drop in imports (-5.8%), leading to a slight increase in the **deficit on trade in goods** (by EUR 134.7 mn), to EUR 2.7 bn. **Goods exports** (EUR 7.3 bn) were subdued in H1, which was almost entirely due to manufacturing, whose exports lost 10.0% y-o-y, while agricultural exports increased even in the conditions of the crisis (10.5% y-o-y). At the same time, measured by s-a growth rates, most key export areas began to recover in May (electrical equipment, automotive cluster, rubber and plastic), while in June growth was supported also by exports of metals and metal products. **Goods imports** (which decreased to EUR 9.9 bn) depended on movements in economic activity too – imports of intermediate and capital goods for industry purposes were lower, as were energy imports due to weaker industry needs and a subdued price of oil. With the rallying of production from May onwards, imports also picked up, led mainly by stronger imports of intermediate and capital goods. Though imports of consumer goods also decreased with the escalation of the crisis, at the level of H1 their contribution to imports was positive. By SITC group, the decline in imports relative to the same period last year was mainly due to lower imports of energy (25.9% y-o-y), road vehicles (32.5% y-o-y), metal ores (51.5% y-o-y) and iron and steel (22.0% y-o-y), while stronger imports of chemical products

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

	H1 2019	H1 2020
I CURRENT ACCOUNT	-1,514.6	-1,339.6
1. Goods	-2,518.8	-2,653.6
1.1. Credit	8,054.1	7,306.2
1.2. Debit	-10,572.9	-9,959.8
2. Services	387.1	541.1
2.1. Credit	3,109.8	2,940.5
2.2. Debit	-2,722.8	-2,399.4
3.Goods and services	-2,131.7	-2,112.4
3.1. Credit	11,163.9	10,246.7
3.2. Debit	-13,295.6	-12,359.2
4. Primary income	-1,199.4	-752.1
5. Secondary income	1,816.6	1,524.9
II CAPITAL ACCOUNT	-43.4	-10.9
III FINANCIAL ACCOUNT (excluding reserve assets)	2,498.5	2,122.1
1. Direct investment, net	1,809.2	1,449.6
2. Portfolio investment, net	152.2	1,508.6
3. Financial derivates, net	4.8	-3.3
4. Other investment, net	532.2	-832.8
4.1. Trade credit and advances, net	9.3	-1,077.2
4.2. Financial loans, net	217.7	529.8
4.3.Currency and deposits, net	305.2	-285.1
4.4. Other, net	0.0	-0.3
IV Reserve assets	-763.8	-363.2
V NET ERRORS AND OMISSIONS	-176.8	-408.3
VI OVERALL BALANCE	763.8	363.2

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

(4.7% y-o-y), most notably pharmaceutical products, worked in the opposite direction.

External **trade in services** was also powerfully affected by the pandemic. The sharper fall in services imports (-11.9% y-o-y) than exports (-5.4% y-o-y) led to a rise in the surplus on trade in services to EUR 541.1 mn in H1 (y-o-y growth of 39.8%). Tourism and transport provided the largest negative contribution to both services exports and imports, but imports were more affected. On the other hand, ICT and business services provided a positive contribution to export growth, and business and other services – to import growth.

At the same time, the deficit in the **primary income account** decreased by 37.3% y-o-y to EUR 752.1 mn in H1. This was due primarily to lower expenditures in respect of FDI (by 38.5% y-o-y) and portfolio investments (by 16.5% y-o-y).

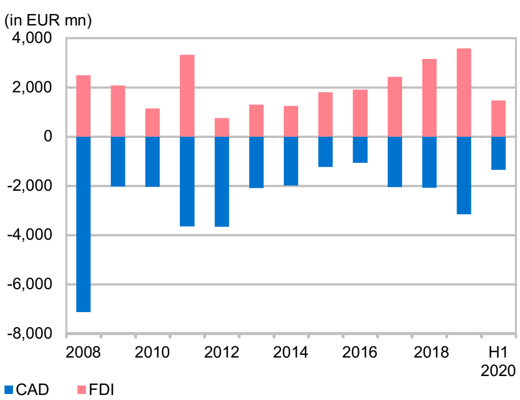
The surplus in the **secondary income account** contracted in H1 to EUR 1.5 bn (by 16.1% y-o-y). This was mostly due to subdued inflow of foreign remittances, which was expected given the global economic slowdown and reduced labour mobility, and was also recorded by other countries which traditionally have this type of inflows. Relative to H1 2019, the inflow of remittances decreased by 22.5%, and measured EUR 1.2 bn.

The inflow to the **balance of payments financial account** in H1 2020 equalled EUR 2.1 bn,[7] down by 15.1% relative to the same period a year earlier. Portfolio investments and FDI made up the bulk of capital inflows. Inflow was also recorded in respect of higher foreign borrowing by banks and corporates. Outflow was, on the other hand, recorded in respect of trade loans and higher amounts of currency and deposits held by banks abroad.

Despite increased uncertainty in the international financial market, **FDI** inflow to Serbia continued and, according to preliminary data, measured EUR 1.4 bn, net in H1 (6.7% of GDP). In H1 2020, FDI inflow was EUR 359.6 mn, or 19.9%, lower relative to the same period last year. The difference refers mainly to reinvested earnings, which for the most part did not accrue in Q2, as expected due to the coronavirus pandemic. It should also be noted that comparison is made with 2019, a year which saw record high FDI inflows. In H1 as well, FDI was primarily directed to tradable sectors, with the highest amounts invested in manufacturing (32%), transportation and warehousing (24%), construction (13%), financial activities (8%) and trade (7%). As usual, the bulk of investments came from European countries (80%), but investments from Asian countries also went up, accounting for 17% of FDI inflows.

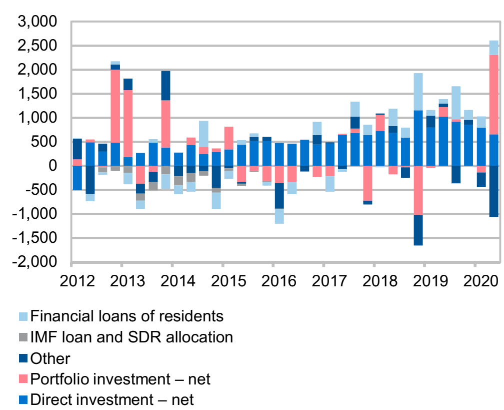
The net inflow of **portfolio investments** came at EUR 1.5 bn. It was the result of a successful, EUR 2 bn-worth issue of seven-year eurobonds in May. In the conditions of the global economic crisis caused by the coronavirus pandemic, Serbia issued these bonds at the coupon rate of 3.125%. Investors' demand exceeded severalfold the issue amount planned and realised in the auction.

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



Sources: SORS and NBS.
* Preliminary data.

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



Source: NBS.
* Preliminary data.

[7] Excluding change in FX reserves.

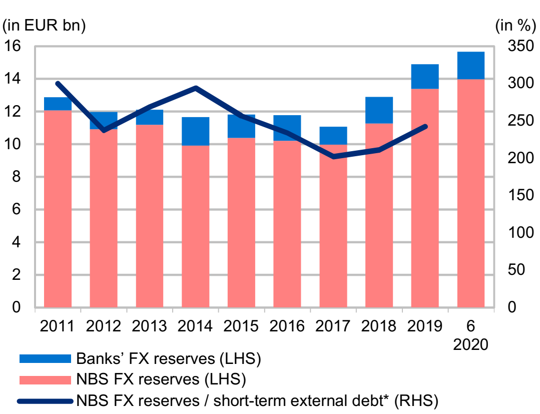
Previously, the matured remaining eurobonds issued in 2013 were paid out early in the year. The bulk of these bonds were bought back before maturity in 2019. On the other hand, foreign investors cut down on their investment in government securities in the domestic market amid global risk aversion.

By contrast to H1 2019, when inflow of EUR 532.2 mn was recorded, H1 2020 saw an outflow of EUR 832.8 mn in respect of **other investment**. This was due to net outflow in respect of trade loans (EUR 1.1 bn), and net outflow due to higher currency and deposits held by banks abroad (EUR 285.1 mn). Net inflow of EUR 529.8 mn was recorded in respect of **financial loans** in H1, supported by higher borrowing by banks (EUR 367.0 mn) and corporates (EUR 185.8 mn). By contrast, the Government reduced its obligations by EUR 18.8 mn, net, and the NBS by EUR 4.2 mn.

The above flows in the current and financial account pushed up **Serbia's FX reserves** (according to the balance of payments methodology)[8] in H1 by EUR 363.2 mn.

As at 30 June 2020, **gross FX reserves of the NBS** measured EUR 13,956.2 mn, up by EUR 577.7 mn from end-2019. End-June 2020 FX reserves covered 147% of money supply M1 and six months of imports of goods and services, almost twice the standard on the adequate level of FX reserves. At the same time, **net FX reserves** equalled EUR 11,807 mn, and were EUR 366 mn higher than at end-2019.

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



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

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). As at 30 June 2020, foreign securities accounted for the bulk of FX reserves (52.2%), followed by FX balances in accounts abroad (23.0%), foreign cash (12.9%), gold (11.4%) and SDRs with the IMF (0.5%).

The highest FX inflow in H1 came from the sale of euro-denominated government securities in the international and domestic financial market (EUR 2,334.8 mn). In respect of the issue of the seven-year bond in the international financial market in May, inflow of EUR 1,968.6 mn was recorded and used for implementing the *Programme of Economic Measures to Mitigate the Effects of the COVID-19 Pandemic*. FX inflow of EUR 366.2 mn was recorded from the sale of euro-denominated government securities in the domestic financial market. Inflow also came from the disbursement of loans for the Republic of Serbia in the amount of EUR 137.5 mn, FX required reserves of banks (EUR 129.3 mn, net), temporary payment operations with Kosovo and Metohija[9] (EUR 94.9 mn) and grants (EUR 68.1 mn). In H1, the NBS also earned income from investment in foreign securities and interest rates on FX funds in the total amount of EUR 21.9 mn net.

In respect of NBS activities in the IFEM, net FX outflow of EUR 1,042.0 mn was recorded, on account of a net outflow of EUR 1,000.00 mn under spot transactions and EUR 42.0 mn under FX swap auctions. Government obligations to foreign creditors (principal and interest) were settled regularly, measuring EUR 539.2 mn. In respect of matured FX-denominated government securities in the international and domestic financial market, EUR 525.5 mn was paid from FX reserves, including EUR 326.9 mn in the domestic financial market, and EUR 198.6 mn in the international financial market, in respect of repayment of the remaining part of the dollar eurobond issued in 2013. Pursuant to the Law on the Settlement of the Public Debt of the RS Arising from Unpaid Foreign Exchange Savings of Citizens, EUR 12.2 mn was paid out (including the first series of amortised bonds in respect of unpaid FX savings of citizens of former SFRY republics in the amount of EUR 10.9 mn).

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

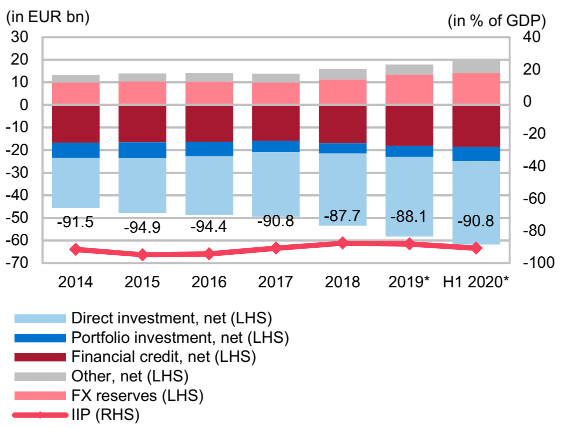
[9] Under the Law on Temporary Execution of Certain Payment Operations in the FRY (FRY Official Gazette, No 9/01).

International investment position

At end-H1 2020, Serbia's international investment position of a net debtor equalled EUR 41.9 bn, up by EUR 1.5 bn from end-2019. This was due to **the further growth in the most desirable investment from abroad – FDI, the net stock of which at end-H1 reached 87.8% of the net international investment position**. Low inflation and the relative stability of the exchange rate, together with the country's favourable economic outlook, created an environment conducive to investment and, by extension, high FDI inflow, which is significant for the sustainability of Serbia's external position. **Portfolio investment also increased to a significant degree** in H1, as the Government successfully issued eurobonds in the international financial market amid the global economic crisis induced by the coronavirus pandemic. **The high inflow of FDI and portfolio investment reflected on an increase in the share of Serbia's net international investment position in estimated GDP to 90.8% in H1**, up by 2.8 pp from end-2019.

Serbia's foreign financial assets gained EUR 1.5 bn in H1 to EUR 28.2 bn. Balance of payments transactions contributed EUR 1.2 bn to this increase, while the rest referred to currency and other changes. Within financial assets, other resident investment abroad increased the most (by EUR 829.5 mn to EUR 10.1 bn), owing to a rise in trade loans and advance payments to non-residents (by EUR 423.0 mn) and resident currency and deposits abroad (by EUR 381.3 mn). **FX reserves continue to account for the bulk, i.e. almost a half, of total assets (49.6%)**. Resident FDI and portfolio investment abroad increased to a smaller degree, so claims on this account measured EUR 3.7 bn and EUR 339.9 mn, respectively.

Chart III.2.4 **International investment position**



Source: NBS.
* Preliminary data.

Serbia's foreign financial liabilities rose in H1 to EUR 70.2 bn, mostly as a result of executed transactions worth EUR 2.9 bn, and in part also of currency and other changes (EUR 79.1 mn). The composition of financial liabilities reveals a continuation of a positive trend from prior years – in H1 as well, the rise in foreign liabilities of residents resulted to a significant degree from an increase in **FDI**, which gained EUR 1.5 bn to reach EUR 40.5 bn. Thanks to continued growth in FDI, resident liabilities in this respect continue to exceed a half of total foreign liabilities (57.7% at end-H1). The rise in total liabilities was also facilitated by the EUR 1.6 bn increase in **portfolio investments** in H1, to EUR 6.7 bn; as a result, resident liabilities in this respect came at 9.6% of total foreign liabilities. Resident liabilities in respect of **other investments** contracted by EUR 118.6 mn to EUR 22.3 bn or 31.8% of total liabilities at end-H1. Within other investments, resident liabilities in respect of trade loans and advance payments decreased the most (by EUR 654.3 mn), while liabilities in respect of financial loans increased (by EUR 452.8 mn).

3 Financial market trends

Interest rates

To mitigate the negative effects of the crisis caused by the coronavirus, the NBS trimmed its key policy rate three times in H1 by a total of 1 pp to 1.25%, its new record low in the inflation targeting regime. The corridor of NBS interest rates was also narrowed in March from ±1.25 pp to ±1 pp relative to the key policy rate. As a result, end-June interest rates on deposit and lending facilities equalled 0.25% and 2.25%, respectively. The average repo rate was almost equal to the deposit facility rate in all auctions in H1 (departure of up to 1 bp), measuring 0.25% in late June, which is 0.75 pp lower than at end-2019.

From March onwards, the NBS implemented other measures aimed at increasing FX and dinar liquidity – direct repo purchases of dinar government securities, extraordinary swap auctions and bilateral purchase of dinar government securities from banks, which also influenced developments in the domestic financial market.

The rise in excess dinar liquidity reflected on developments in the **interbank money market**, where turnover in the overnight market contracted from RSD 3.2 bn in H2 2019 to RSD 2.5 bn in H1 2020. BEONIA decreased more than the average repo rate (by 0.8 pp), to 0.26% at end-June. BELIBOR rates of all maturities also decreased in H1, but to a smaller degree (by around 0.6 pp), ranging between 0.45% and 1.2% in late June.

In the **primary market of dinar securities**, early in the year the government for the first time issued 12-year dinar bonds, with the coupon rate of 4.5%. In the first two auctions held in February and early March, demand was severalfold higher than the planned sale, resulting in an effective rate of 3.35%. As of April, uncertainty in financial markets increased due to the coronavirus crisis, pushing up the interest rate on 12-year bonds to 3.85% in June.

Early in the year, there was a new issue of five-year bonds, which were realised at a rate of 2.6% in January, and this rate was kept until June. After the coronavirus epidemic broke out, as of April the government, in order to raise additional funds to support the real sector, issued treasury bills with 53-week maturity (for the first time since 2017) and bonds with the maturity of two and three years. The achieved rates ranged between 1.79% and 2.15% and were confirmed at repeated auctions in May and June.

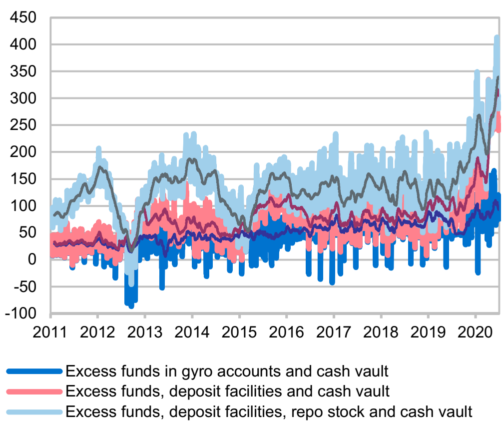
In H1, dinar securities in the nominal amount of RSD 211.8 bn were sold. Amid heightened uncertainty in financial markets, from April onwards securities in the nominal amount of RSD 158.5 bn were sold. This offset the maturing of three-year benchmark bonds issued in 2017. As a result, the stock of sold securities in H1 gained RSD 115.2 bn, rising to RSD 889.3 bn in June.

Though non-residents showed great interest in 12-year dinar bonds, their investment in dinar securities subsided on account of rising uncertainty globally and the resulting higher risk aversion. Hence, the stock of sold securities owned by non-residents slid by RSD 25.2 bn to RSD 215.8 bn in late June.

In mid-May, Serbia was among the first European countries to successfully realise a **new issue of eurobonds in the international financial market**. Namely, in the conditions of heightened risk in the international financial market, Serbia sold seven-year bonds in the nominal amount of EUR 2 bn, at a rate of 3.375% (coupon rate of 3.125%). The proceeds of this sale were used to finance the programme of support to the real sector to mitigate the consequences of the economic crisis caused by the coronavirus.

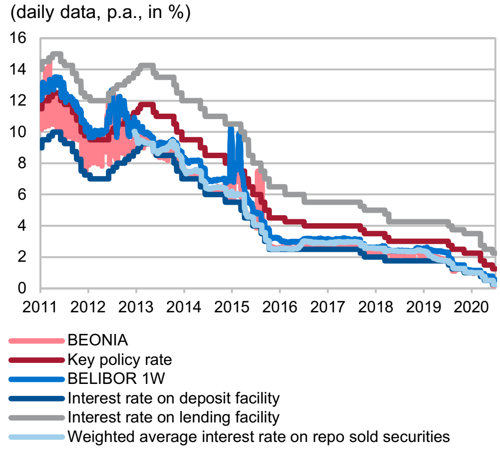
As the issue of eurobonds in the international financial market greatly diminished the government's need to borrow, no auctions of sale of **euro-denominated securities in the domestic market** were held in May and June. Previously, 20-year securities were issued in January for the first time, and the total issue in the nominal amount of EUR 150 mn was sold, at a rate of 3%

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



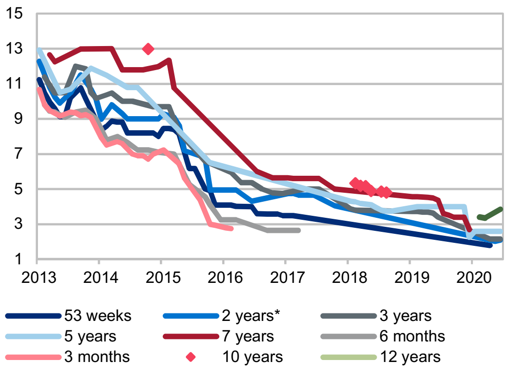
Source: NBS.

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



Sources: Thomson Reuters and NBS.

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



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

(coupon rate of 3.5%), with significant participation of non-residents. From January to April, euro-denominated securities with two-, five- and 12-year maturity were also issued, at effective rates of 0.5%, 1.1% and 1.9%, respectively. In H1, securities in the nominal amount of EUR 353.8 mn were sold, which was mostly used to cover the maturing of previously sold securities. Hence, the stock of sold euro-denominated securities in H1 rose by EUR 36.8 mn to EUR 2.8 bn at end-June.

In the secondary market, yield-to-maturity rates mirrored movements in effective rates. Thus, yield rates saw a mild increase relative to December and in June ranged between 1.7% for 11-month remaining maturity and 3.8% for 12-year remaining maturity. In H1, total trade measured RSD 235.9 bn, which is almost unchanged from H2 2019 when it equalled RSD 238.4 bn.

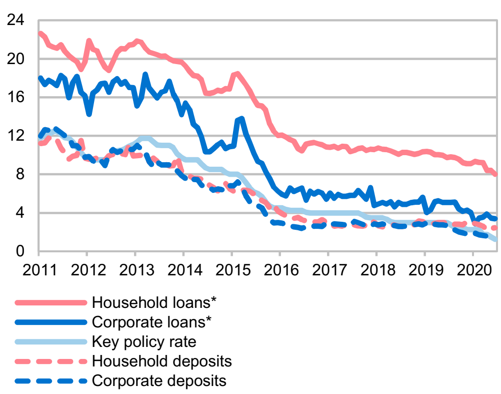
Interest rates on new dinar loans subsided in H1 to 8% on household loans and 3.4% on corporate loans in June. Relative to December, interest rates decreased more on dinar household loans – by 1.1 pp, while rates on dinar corporate loans fell by 0.6 pp.

The decrease in interest rates on new dinar household loans resulted not only from key policy rate cuts, but also from the drop in interest rates on other unclassified loans from 7.6% in December 2019 to 5.5% in June, which can be attributed to lending to entrepreneurs at the prescribed maximum interest rate (1M BELIBOR + 2.5 pp), pursuant to the Decree Establishing the Guarantee Scheme as a Measure of Support to the Economy to Mitigate the Impact of the Pandemic. Interest rates on consumer loans also decreased by 0.5 pp to 2.9% in June, while the average interest rate on cash loans, as the most dominant category of new dinar household loans, remained almost unchanged from December 2019, measuring 9.3% in June.

Within new dinar loans to enterprises, the fall in interest rates on working capital loans was notable, by 1.1 pp to 3.3% in June, while interest rates on investment and other unclassified loans remained unchanged from December 2019 when they equalled 4.4% and 3.4%, respectively.

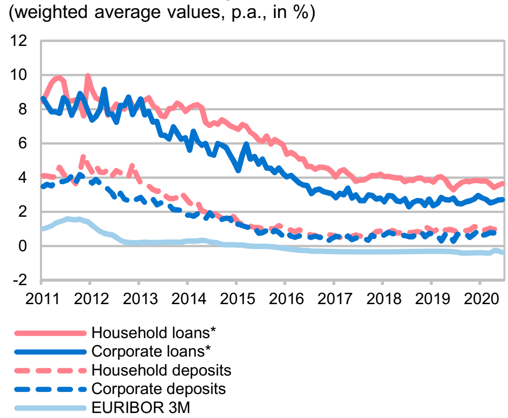
The weighted average **interest rate on new euro-indexed loans** to households decreased in H1 by 0.2 pp to 3.7%. The interest rate on housing loans dipped marginally to 2.7% in June.

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



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

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



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

The weighted average interest rate on new euro-indexed loans to corporates also decreased in H1 by 0.2 pp to 2.7% in June. This was mostly due to a decline in interest rates on working capital loans and investment loans, which fell by 0.25 pp each in H1 to 2.4% and 3.2%, respectively, while interest rates on other loans increased by 0.25 pp to 2.6% in June.

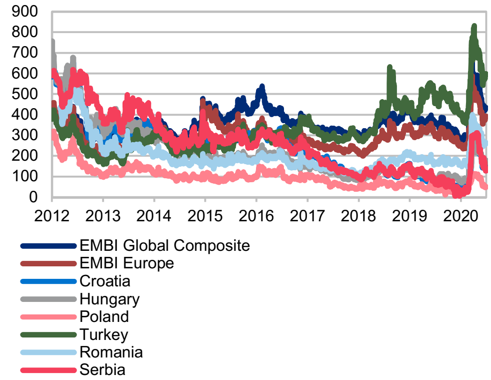
Average **interest rates on time deposits** of corporates and households were also on a decline in H1, which was somewhat more pronounced for dinar deposits. Namely, rates on time dinar deposits of corporates and households decreased by 0.6 pp relative to December 2019 and measured 2.45% for household savings and 1.3% for corporate deposits in June. On the other hand, interest rates on household savings in euros decreased in the same period by 0.1 pp to 1.1% in June, while interest rates on time corporate deposits in euros subsided by 0.25 pp to 0.65% in June.

Risk premium

Serbia's risk premium for dollar-denominated debt was relatively stable early in the year, but, similarly as in other countries of the region, increased in late February and March amid global uncertainty caused by the coronavirus pandemic and consequently higher global risk aversion and flight to safe assets. In April, Serbia's risk premium for dollar-denominated debt stayed at around 300 bp but began to fall as of early May. This fall was guided by investors' increased readiness to invest in emerging economies again, led mostly by central banks' measures which pumped in substantial liquidity in response to the crisis, but also by the relaxation of containment measures. Hence in late H1, EMBI Serbia was 137 bp which, though higher than the extremely low end-2019 level (19 bp), is still well below EMBI Global Composite (433 bp) and among the lowest risk premia for dollar-denominated debt in the region.

After relatively stable movement in the first two months of 2020, Serbia's risk premium for euro-denominated debt began to rise in March and April due to global factors, reaching 344 bp in early May. After this, EURO EMBIG[10] for Serbia began to decline which was led, in addition to large-scale measures of leading central banks, also by the relaxation of containment measures and the first signals of an incipient global recovery. In late H1,

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



Source: JP Morgan.

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

	2017	2018	2019	2020
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)]	

Source: NBS.

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

Serbia's risk premium for euro-denominated debt was 148 bp higher than at end-2019, measuring 257 bp.

In March 2020, Fitch retained Serbia's credit rating at BB+ with a stable outlook, despite the current crisis caused by the coronavirus pandemic. In its press release, Fitch underscored that the affirmed rating reflects Serbia's increased resilience to the crisis caused by the pandemic, underpinned by increased NBS FX reserves, low external government debt, maintained fiscal discipline and sound public finances. As part of the extraordinary rating review conducted globally amid the crisis caused by the pandemic, in May Standard&Poor's affirmed Serbia's credit rating at BB+, with a stable outlook. The outlook was revised to stable from positive in the previous review due to the outbreak of the coronavirus and its impact on the world economy and financial flows. In June, as part of its regular rating activities, Standard&Poor's maintained Serbia's rating at BB+, affirming a stable outlook going forward.

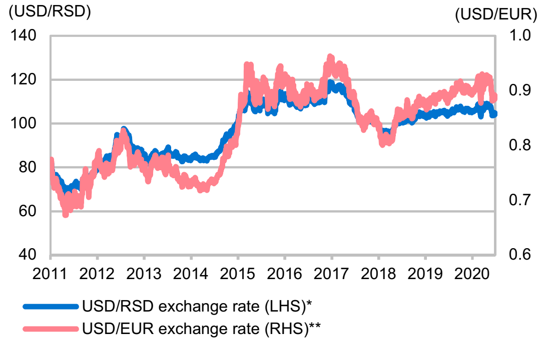
[10] For more on EURO EMBIG, see the February 2020 *Inflation Report*.

Trends in the FX market and exchange rate

Owing to the NBS, which provided necessary FX liquidity to banks in the face of reduced foreign currency and foreign cash supply, the dinar remained stable against the euro in H1 despite the heightened uncertainty caused by the coronavirus pandemic. At period-end, the dinar was unchanged vis-à-vis the euro, while it strengthened against the dollar by 0.3% due to the weakening of the dollar against the euro.

In H1, domestic companies were a significant factor on the FX demand side. Early in the year the reason was the increased import of energy and later the reduced supply of energy due to the economic slowdown caused by the global pandemic. Uncertainty in the international financial market reflected on the purchase of foreign currency by non-residents, particularly in March and April. In addition, net sale of foreign cash to citizens and exchange dealers has been recorded since March, owing to the reduced inflow of remittances and absence of tourist visits in pandemic conditions. On the other hand, what worked on the supply side was the FX-indexed lending to corporates and households, i.e. increase in FX-indexed bank assets,[11] and, to a lesser degree, the lengthening of banks' positions on account of payment card use by non-residents. Furthermore, in June, non-residents were the net sellers of foreign currency as a result of increased investment in dinar government securities in the domestic market.

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



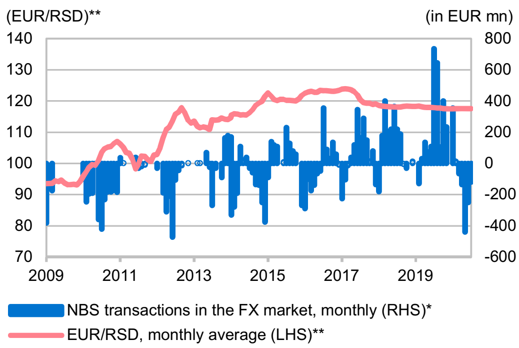
Source: NBS.
* 1 USD in RSD.
** 1 USD in EUR.

To maintain relative stability in the domestic FX market, the NBS net sold EUR 1,030.0 mn in its IFEM activities in H1. The highest net sale was recorded in April (EUR 440.0 mn), when the effects of heightened uncertainty in the international financial market were the most pronounced.

The average daily trading volumes in the IFEM in H1[12] reached EUR 27.9 mn, up by EUR 4.9 mn from the same period last year. The highest turnover was recorded in March (daily average of EUR 35.2 mn).

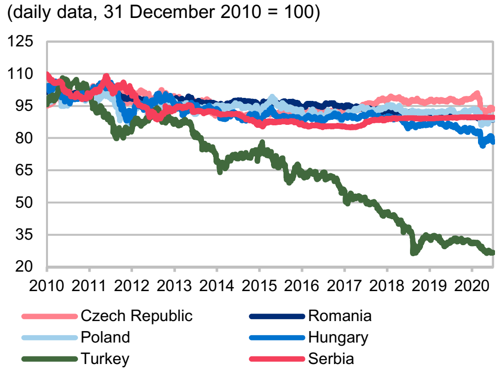
Unlike the dinar, the currencies of other countries in the region running inflation targeting regime weakened

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



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

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



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

[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.

during H1. End-of-period, a more significant weakening against the euro was recorded by the Turkish lira (13.7%), Hungarian forint (7.3%), Czech koruna (5.0%) and Polish zloty (4.6%), while the Romanian leu lost 1.3%.

Stock exchange trends

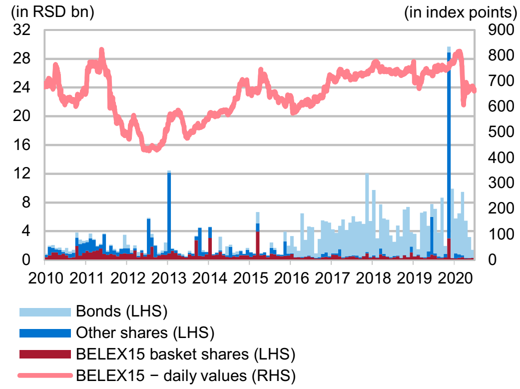
Both BELEX15 and BELEXline decreased in H1 2020. A gradual rise marked the beginning of the year. However, late February and early March brought uncertainty to the global economy. Global stock exchanges headed down and the BSE indices followed suit. Hence, BELEX15 fell by 200 index points in March (in less than a month) and BELEXline by around 300 index points. By end-June both indices recovered slightly; BELEX15 reached 665.9 index points, down by 16.9% from end-2019, while the general index BELEXline lost 13.3%, measuring 1,497.6 index points in June. The majority of regional stock exchange indices exhibited similar trends. At end-H1 they had lower values than at the beginning of the year, with Sofia and Zagreb stock exchange indices recording the sharpest fall (20.2% and 19.6%, respectively).

The total shares trading from the beginning of the year until end-June was around 13% higher than in H2 2019 (excluding block transactions of a single issuer in November 2019), reaching RSD 3.1 bn. In H1, foreign investors were the net sellers of shares and they participated with around 31.7% in total trading. Trading of shares from the BELEX 15 basket accounted for 47.2% of trading.

In H1 2020, trading in long-term RS bonds accounted for the entire bond trading, dropping by 3.2% from H2 2019, to RSD 28.5 bn.

In H1, the BSE market capitalisation contracted by RSD 67.1 bn, coming to RSD 502.6 bn or 9.2% of estimated GDP. Market capitalisation contracted mainly in the regulated market segment, whose market value decreased by RSD 64.1 bn, to RSD 280.8 bn in H1. Market capitalisation of the MTP[13] segment also decreased, to RSD 243.6 bn in June, down by RSD 2.9 bn from December 2019.

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



Source: Belgrade Stock Exchange.

4 Money and loans

Monetary aggregates M1, M2 and M3

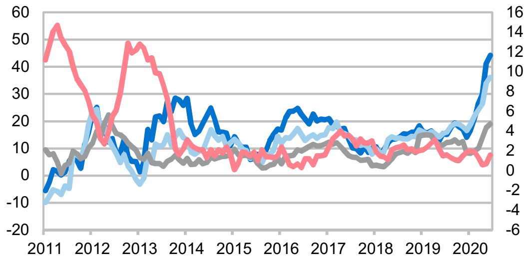
Stable growth in lending and increased government spending in line with the *Programme of Economic Measures to Mitigate the Negative Effects Caused by the COVID-19 Pandemic and Support the Serbian Economy*, along with a positive contribution of economic activity in Q1, were the key drivers of money supply trends in H1 2020. Monetary aggregate M1 expanded by 23.5%, M2 by 18.3%, and M3 by 10.0%.

By individual category, **sight deposits** rose by RSD 173.0 bn (of which RSD 149.3 bn in Q2). Government measures for boosting corporate liquidity (deferral of tax liabilities, subsidised minimum wages for employees, Guarantee Scheme loans, etc.) and moratorium on loan repayment for corporates and households boosted the money supply of non-monetary sectors, especially its more liquid components. In this regard, in H1 corporate and household transaction deposits increased by RSD 112.7 bn and RSD 58.9 bn, respectively. All other sectors also recorded an increase in account balances.

Term dinar deposits rose by RSD 4.8 bn in H1 with the entire increase recorded in Q2 (RSD 9.9 bn). Household account balances rose the most indicating that citizens' trust in the banking system and the domestic currency was

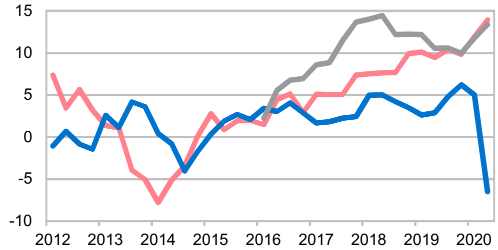
[13] MTP is a multilateral trading platform. It is set up by the Belgrade Stock Exchange and incorporates shares of companies that are currently not eligible for regulated market listing.

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



Sources: SORS and NBS.

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



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

preserved even in the face of increased uncertainty caused by the coronavirus pandemic. Dinar household savings expanded by RSD 6.0 bn in H1, reaching their new maximum in June – RSD 85.0 bn.[14] Dinar savings are more attractive than FX savings thanks to higher interest rates and more favourable tax treatment in addition to preserved price stability and relative stability of the exchange rate.

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

	Dec. 2019	June 2020	Changes in H1 2020
Net foreign assets	**1,287,399**	**1,361,690**	**74,292**
Bank net foreign assets	-295,486	-289,833	5,652
Net domestic assets of the banking sector	**1,536,147**	**1,743,026**	**206,879**
Net domestic loans	2,692,633	2,954,451	261,818
Net claims on government	225,087	317,910	92,823
Government loans	677,272	800,698	123,426
Government deposits	-452,185	-482,788	-30,603
Loans to other resident sectors	2,467,546	2,636,541	168,995
Loans to households	1,112,000	1,184,375	72,375
Loans to the corporate sector	1,291,149	1,389,767	98,618
Loans to other financial corporations	31,471	31,144	-327
Loans to local authorities	30,961	30,539	-422
Loans to non-profit and other organisations	1,964	716	-1,248
Other net assets	-1,156,486	-1,211,425	-54,939
Money supply M3	**2,823,546**	**3,104,716**	**281,171**
Money supply M2	1,186,596	1,403,657	217,060
Money supply M1	903,603	1,115,859	212,256
Currency in circulation	209,568	248,833	39,265
Sight deposits	694,035	867,026	172,991
Dinar savings and term deposits	282,994	287,798	4,804
FX deposits	1,636,949	1,701,060	64,110

Source: NBS.

FX deposits increased by EUR 547.3 mn in H1, primarily thanks to rising corporate FX deposits (by EUR 376.8 mn), driven by the FX inflows on account of exports, FDI and corporate borrowing abroad, as well as government measures taken during the pandemic. At the same time, household FX savings also increased to EUR 10.6 bn in June (by EUR 172.7 mn in six months), i.e. to EUR 11.0 bn including non-residents' funds.

In y-o-y terms, monetary aggregates M1, M2 and M3 accelerated to 44.3%, 36.1% and 19.0% in June, respectively, driven by the dinar component. As this rise in money is temporary and connected with increased corporate liquidity (resulting from the government measures) and households' reluctance to spend in the face of the coronavirus pandemic, our estimate is that it will not fuel inflationary pressures. In addition, the link between money and inflation has generally weakened and is present mainly in the long run – not in the short. Also, we expect that money supply will contract in the coming period owing to the payment of tax liabilities (deferred during the pandemic thanks to the government measures) and the expected rise in investments and spending, but this will not cause any major inflationary pressures.

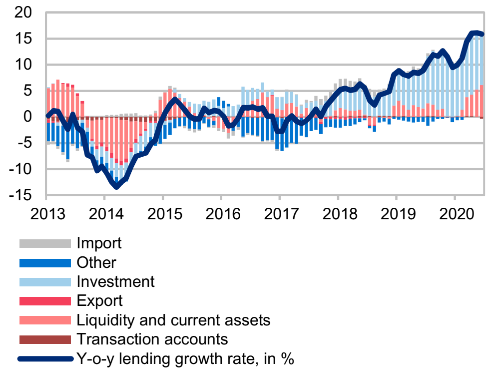
[14] Money supply includes only resident funds. With non-resident funds included, dinar savings equalled RSD 85.5 bn at end-June.

Bank loans

Total domestic loans continued to post two-digit y-o-y growth rates in H1 (13.9% in June). Loan composition remained favourable in terms of support to the economy with y-o-y growth in corporate and household lending at 15.9% and 12.6% in June, respectively. Lending growth in 2020 resulted from good loan performance in Q1, atypical for the season, and the effects of moratorium since end-March, as well as from the positive contribution of the Guarantee Scheme Loans since May.

In 2020 banks continued their NPL efforts but at a more balanced pace owing to the results achieved so far in this area. H1 saw the write-off of RSD 4.6 bn worth of NPLs and the sale of another RSD 0.6 bn worth of NPLs to non-banking sector entities.

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



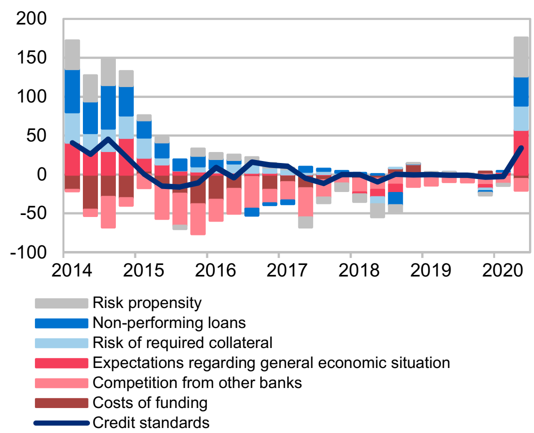
Source: NBS.

Excluding the exchange rate effect, **corporate loans** went up by 8.2%, or RSD 103.5 bn in H1 (with 56% of increment in Q1). **By purpose**, investment loans have been the most dominant type of corporate loans for longer than a year now (since May 2019). Their share in total corporate loans equalled 44.4% and their stock increased by RSD 34.9 bn since the beginning of the year. Next come loans for working capital,[15] accounting for 40.7% in June. Their share in total corporate loans has been on the rise in the past several months, owing to the increasing need for liquid assets. **Sector-wise**, corporate loans posted growth across all sectors (save agricultural companies), most notably in transport, trade, real estate and manufacturing.

The volume of new corporate loans in H1 (RSD 433.3 bn) dropped by 15.0% from the same period last year, or by 7.3% excluding the loans refinanced with the same bank. In view of the rising liquidity needs of companies amid the pandemic, as well as favourable lending conditions under the Guarantee Scheme, working capital loans accounted for the bulk of new corporate loans (RSD 247.6 bn or 57.1% of total new corporate loans in H1). Almost 65% of these loans were granted to micro, small and medium-sized enterprises. Investment loans accounted for 26.8% of new corporate loans in H1, with micro, and small and medium-sized enterprises using almost 70% of that amount. Companies' interest in dinar loans rose, owing to the lowering of the NBS key policy rate and favourable financing conditions under the Guarantee Scheme. In H1, dinar loans accounted for 33.2% of new loans, almost double the share from the previous year.

Excluding the exchange rate effect, **household loans** increased by 6.3% or RSD 69.6 bn in H1. Cash and housing loans made up the largest shares in total household loans with 44.2% and 36.2% in June, respectively. Wishing to be proactive and to further mitigate the negative effects of the crisis, in June the NBS made the decision to reduce the minimum downpayment for first-time home buyers from 20% to 10%. It also

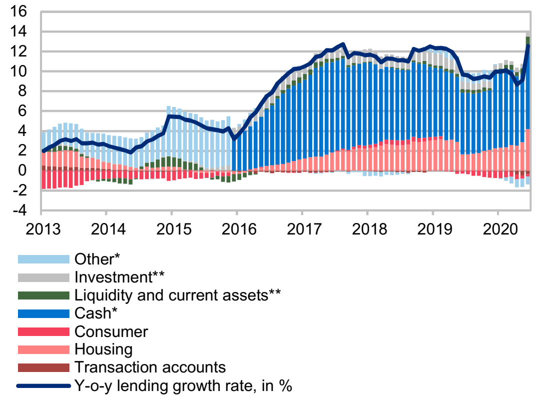
Chart III.4.4 **Change in corporate credit standards and contributing factors**
(in net %)



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

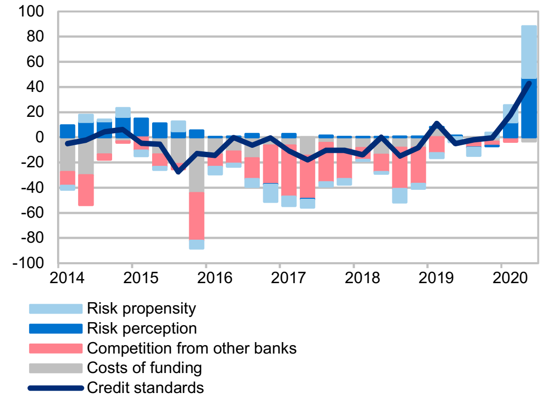
[16] In H1, increase by RSD 62.6 bn.

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 %)



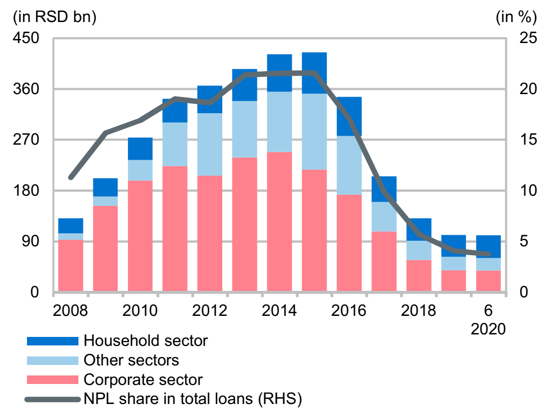
Source: NBS.
Note: Growth indicates the tightening, and decline indicates the easing of credit standards.

adopted new regulations in July to facilitate the conditions for the repayment of cash, consumer and other types of loans (other than housing loans and current account overdrafts) for citizens. More specifically, once these regulations enter into force, banks will be encouraged to offer refinancing to borrowers or extension of maturity date of the last instalment for consumer, cash and other loans (other than housing loans and current account overdrafts) approved until 18 March 2020 for additional two years relative to the current repayment term (payment term up to seven years this year, up to six years in 2021 and up to eight years for consumer loans granted for the purchase of motor vehicles regardless of the year).

The volume of new household loans in H1 amounted to RSD 178.4 bn, down by 32.4% from the same period last year or by 22.2% excluding the loans refinanced with the same bank – considering the containment and distancing measures. Cash and housing loans were the most dominant category, accounting for 56.4% and 20.5%, respectively, of total new household loans in H1.

The results of the NBS bank lending survey[16] were largely affected by the coronavirus pandemic. In line with expectations reported in the April survey, banks tightened corporate and household credit standards in Q2, because of rising risk aversion in most banks amid uncertainty caused by the coronavirus pandemic. On the other hand,

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



Source: NBS.

banks singled out interbank competition and dinar sources of financing as the factors of standard easing, largely because of the lowering of the NBS key policy rate. Banks estimate that corporate loan demand increased in Q2, i.e. the demand for loans for working capital and restructuring of current liabilities. At the same time, household loan demand went down in Q2, which can be also associated with containment measures.

Owing primarily to the past results of the NPL Resolution Strategy and stable lending growth, and

[16] The NBS implements the survey since the start of 2014.

partly to moratorium since Q2, **the gross NPL ratio** went down to a new low since the introduction of this asset quality indicator – 3.7% in June, down by 0.3 pp from the end of the last year. At the same time, NPL ratios of corporate and household sectors dropped in H1, by 0.3 pp and 0.1 pp, to 2.8%[17] and 3.8%[18] in June, respectively.

NPL coverage remained high – allowances for impairment of total loans measured 91.6% of NPLs in June, while allowances for impairment of NPLs stood at 62.6% of NPLs. High capitalisation and resilience of the banking sector are confirmed by the **capital adequacy ratio**[19] which equalled 22.7% at end-H1 (regulatory minimum at 8.0%) .

5 Dinarisation

In H1 2020, 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 so far helped preserve price stability, relative stability of the EUR/RSD exchange rate and stability of the financial system, this being the key precondition for further building up of confidence in the dinar.

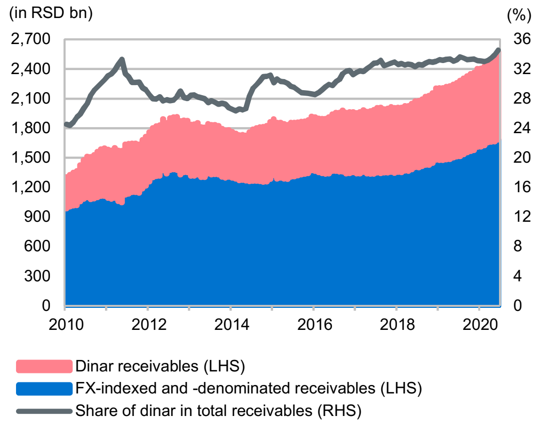
The reserve requirement policy was used to further encourage banks to rely more on dinar sources of funding. Namely, the required reserve ratios on dinar sources of funding are still significantly lower than those on FX sources, and the NBS continues to remunerate allocated required reserves in dinars,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

The NBS continued to work on the development of basic FX hedging instruments. In H1 2020, regular two-week and three-month FX swap auctions were organised, encouraging interbank swap trading and the development of instruments for liquidity management and FX hedging.

The degree of dinarisation, **measured as the share of dinar receivables in total corporate and household receivables**, increased by 1.4 pp in H1 2020, to 34.6% at end-June. At the same time, this is the highest level of this indicator since its monitoring began.

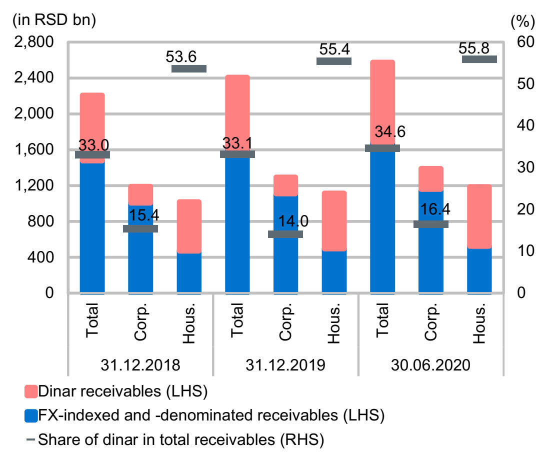
Increased dinarisation of receivables in H1 2020 reflects the rise in dinar corporate lending which accelerated

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



Source: NBS.

Chart III.5.2 **Receivables by sector**



Source: NBS.

particularly after the approval of loans under the RS Guarantee Scheme adopted to support lending in the face of the pandemic. Corporate FX-indexed and FX loans, also covered by the Guarantee Scheme, expanded to a smaller extent, so the degree of dinarisation of corporate receivables increased by 2.5 pp, to 16.4% in H1.

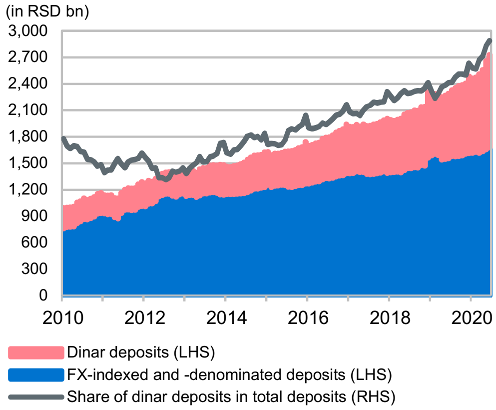
In terms of loan purpose, all loan categories went up, but liquidity and working capital loans the most and these categories exhibit the highest degree of dinarisation

[17] Includes companies and public enterprises. Looking only at companies, the share of NPLs in total loans came at 3.1% in June, down by 0.3 pp from end-2019.

[18] With entrepreneurs and private households included, the share also decreased - by 0.1 pp, to 3.8%.

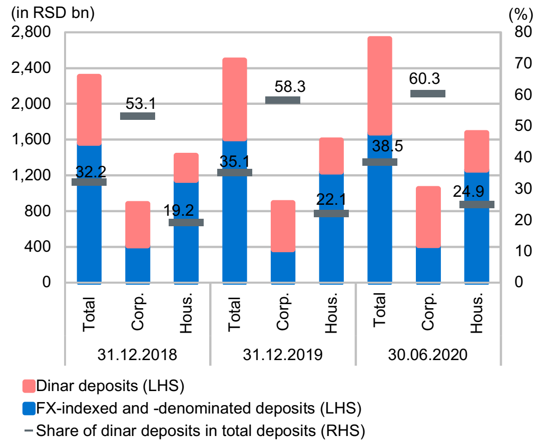
[19] The regulatory framework of Basel III standard came into force on 30 June 2017.

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



Source: NBS.

Chart III.5.4 **Deposits by sector**



Source: NBS.

(41.3% for loans approved in H1 2020.) Investment loans also went up considerably.

The dinarisation of household receivables continued up in 2020. At end-June, this indicator measured 55.8%, 0.4 pp higher than at end-2019 and the highest level so far. The rise in dinar loans continued to drive the dinarisation of household receivables. Among them, the sharpest increase continued to be recorded by cash loans and partly by liquidity loans and working capital loans granted to agricultural estates and entrepreneurs under the Guarantee Scheme. FX-indexed household loans were also on the rise, driven by housing loans dominantly, as well as loans belonging to the "other" category, of which a portion are loans to agricultural estates and entrepreneurs approved with a government guarantee.

The degree of dinarisation of deposits, measured as **the share of dinar in total corporate and household deposits with banks**, continued to increase, reaching the highest level on record at end-H1 – 38.5%, up by 3.4 pp relative to end-2019.

Sector-wise, **the degree of dinarisation of deposits is still on the rise, both among corporates and households**. At end-H1 2020 these indicators posted the highest levels so far (60.3% and 24.9%, respectively). This increase is largely a result of the rise in dinar transaction accounts of corporates and households aided by the government measures for boosting corporate liquidity (deferral of tax liabilities, subsidised minimum wages for employees, Guarantee Scheme loans, etc.), as well as moratorium on loan repayment for corporates and households.

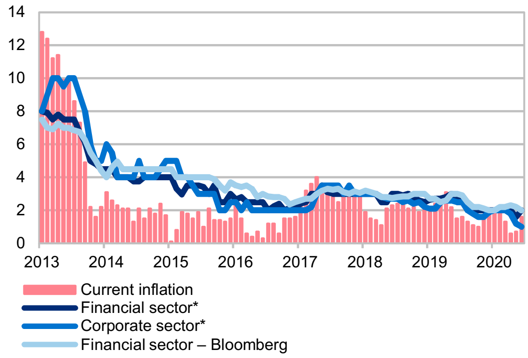
The increase in dinarisation remains underpinned by the sustained rise in dinar savings. Despite the emergency circumstances caused by the coronavirus pandemic, dinar savings continued to record vibrant growth and record high levels which is a proof of the confidence gained in the dinar and financial system stability. At end-June, household dinar savings, including deposits of non-residents, reached RSD 85.5 bn, up by RSD 5.9 bn (7.4%) from end-2019.

6 Inflation expectations

Inflation expectations of the financial and corporate sectors continued to move at a low and stable level in H1. **The expected preservation of price stability amid the global coronavirus pandemic indicates the confidence of market participants in the measures taken by the NBS and enhances its credibility and the efficiency of the monetary policy**.

According to the results of the Ipsos survey, **one-year ahead inflation expectations of the financial sector** moved within the target band (3±1.5%) in H1. Short-term inflation expectations of the financial sector were stable at 2.0% in the whole of H1, except in May, when they temporarily edged down to 1.6%, most likely due to the actual inflation slowdown. The results of the Bloomberg survey point to similar conclusions, stating that one-year ahead inflation expectations of the financial sector moved in the range 2.0–2.3% in H1. Looking at a longer time interval, one-year ahead inflation expectations of the financial sector have been

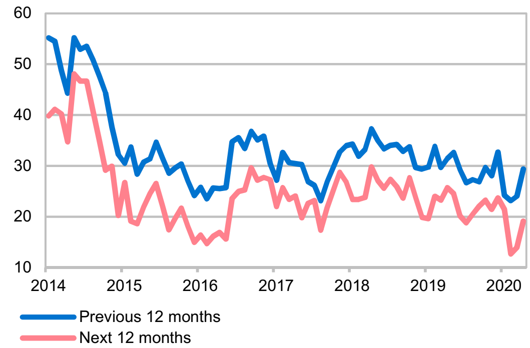
Chart III.6.1 **Current inflation and one-year ahead inflation expectations***
(y-o-y rates, in %)



Sources: Gallup, Ipsos/Ninamedia, Bloomberg and NBS.

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

Chart III.6.2 **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.

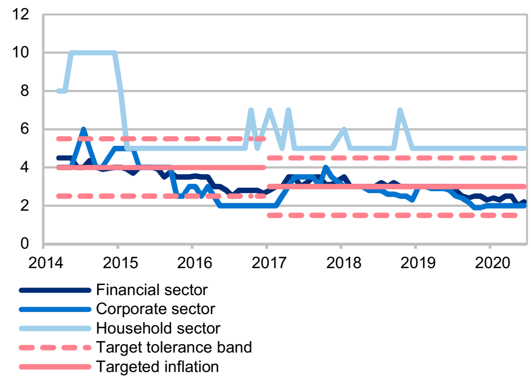
anchored within the NBS target band for almost seven years, more precisely since October 2013.

One-year ahead inflation expectations of corporates were stable at 2.0% in Q1. Short-term inflation expectations of corporates in Q2 were probably under the impact of the fear that the coronavirus pandemic would reduce consumer demand, and the fall in global oil prices certainly reflected on lower expectations. In this respect, they were gradually lowered from 1.8% in April to 1.0% in June. At the same time, more than 70% of surveyed corporates expect that the prices of production inputs will not change over the next twelve months.

One-year ahead inflation expectations of the household sector were typically higher than those of other sectors, standing at 5.0%[20] in almost entire H1. Price stability is expected in the following year, as indicated by the results of the qualitative survey of household inflation expectations[21]. They show that the index of expected inflation continued to record lower values than the index of perceived inflation, indicating that households expected inflation to be lower in the next 12 months than in the past year.

Medium-term inflation expectations of the financial sector are anchored within the NBS target tolerance band since their monitoring began (March 2014), moving in the range 2.0–2.5% in H1. Two-year ahead inflation expectations of the **corporate sector** were stable at 2.0%

Chart III.6.3 **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.

in H1, while the expectations of **households** have been unchanged at 5% for the past nineteen months.

7 Fiscal trends

A much improved macroeconomic position of the country – including an average economic growth rate of 4.3% in the past two years, low and stable inflation for seven years in a row, improved tax collection, eliminated fiscal imbalance and reduced external imbalances – created scope for a powerful fiscal policy response to the

[21] The temporary increase to 8.0% in March can be attributed to the spread of the coronavirus and fears of citizens that there would be a shortage of basic foodstuffs.

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

coronavirus pandemic, and the state budget was able to sustain a period of lower revenues and increased healthcare spending.

The Programme of Economic Measures to Mitigate the Negative Effects Caused by the COVID-19 Pandemic and Support the Economy of Serbia was adopted in late March. It set two priorities: 1) providing assistance to corporates facing difficulties in doing business and 2) preserving jobs and wages. The economic support package contained **a total of nine measures, classified into four groups, worth an estimated RSD 5.1 bn (around 11.0% of GDP). They involved tax policy measures, direct assistance to the private sector, preservation of liquidity of the economy and other measures** (moratorium on dividend payments until end-2020 and one-off assistance to all RS citizens over 18 years old). Its implementation began on 13 April, with the elaboration of the legal framework and the enactment of the relevant decrees by the Government. An important part of the programme were **loans to enterprises based on the Guarantee Scheme (around EUR 2 bn), with government guarantee of around EUR 480 mn**, which does not represent a budgetary expense unless activated.

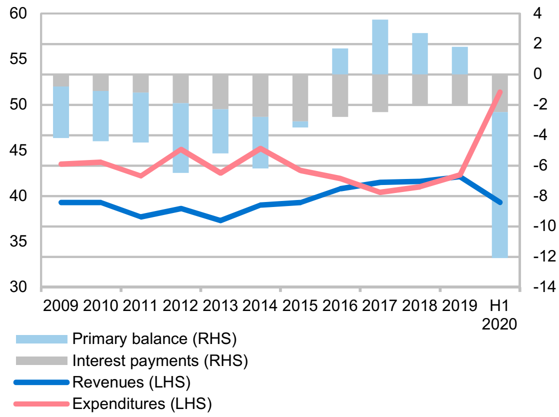
According to the programme of measures adopted by the Government in late March and the Decree on Budget

Table III.7.1 **Programme of Economic Measures to Mitigate the Negative Effects Caused by the COVID-19 Pandemic and Support the Serbian Economy**

I Group – Tax policy measures
1. Deferred payment of payroll taxes and contributions in the private sector with subsequent repayment of liabilities in instalments (starting from 2021 at the earliest)
2. Deferred payment of income tax advances in Q2 2020
3. Exemption of donors from the obligation to pay VAT
II Group – Direct assistance to the private sector
4. Payment of three minimum wages to entrepreneurs that are subject to the flat rate tax and pay tax on actual income, and to micro-, small- and medium-sized enterprises in the private sector
5. Payment of assistance to large private sector enterprises in the amount of 50% of net minimum wage for employees on paid temporary leave on employer's decision
III Group – Measures to preserve liquidity
6. Financial support to the corporate sector through the Development Fund
7. Corporate support guarantee scheme
IV Group – Other measures
8. Moratorium on dividend payments until the end of 2020, except for public enterprises
9. Direct assistance to all adult Serbian citizens in the dinar equivalent of EUR 100

Source: Ministry of Finance.

Chart III.7.1 **Fiscal revenues, expenditures and result**
(in % of GDP)



Source: Ministry of Finance.

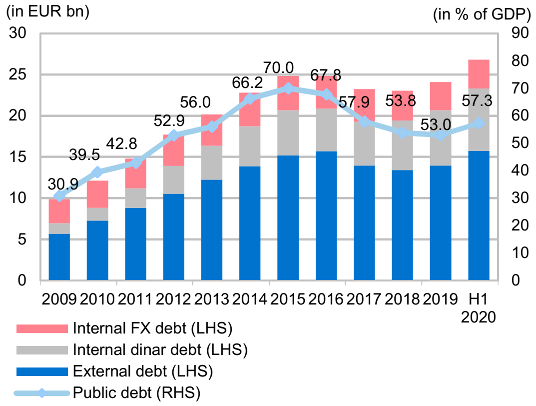
Revision for 2020, **the consolidated fiscal deficit** will come at around 7% of GDP in 2020. The bulk of the planned assistance measures, directly reflecting on the RS budget, was already implemented in Q2. This resulted in a consolidated fiscal deficit of RSD 311.5 bn in six months (more than four-fifths of which referred to Q2).

Relative to the same period of 2019, **public revenue** lost 7.5% in real terms in H1 2020 as a result of subdued economic activity in Q2 and the enacted anti-crisis measures involving deferred collection of direct taxes. Revenues were lower than in H1 2019 mostly on account of deferred profit tax advance payments in Q2 (-2.7 pp), reduced social insurance contributions (-2.4 pp), and lower non-tax revenues (-1.5 pp), while other revenue categories were broadly stagnant.

Public expenditure in H1 2020 gained 23.2% in real terms relative to the same period of 2019, mostly due to the one-off payment to citizens over 18 years old (contribution of 7 pp to total expenditure growth), and minimum wage subsidies for corporates (6.4 pp). To a smaller extent, procurement of goods and services also increased (contribution of 4.0 pp), mostly on account of purchases of medical supplies, followed by wage expenses (2.5 pp), and capital expenditures (2.4 pp). By contrast, interest expenses subsided (-0.7 pp), due among other things to NBS monetary policy easing and the country's improved credit rating.

The programme of support to the real sector to moderate the negative effects of the coronavirus-induced economic crisis was financed from the sale of dinar bonds in the

Chart III.7.2 **Public debt***



Source: Ministry of Finance.
* Central government.

domestic market and the issue of eurobonds in the international financial market. In mid-May, Serbia was among the first European countries **to successfully realise a new issue of seven-year eurobonds**, in the nominal amount of EUR 2 bn. Investors' demand exceeded severalfold the issue amount planned and realised in the auction. As a result, the cost of borrowing decreased by 50 bp in the course of the auction.

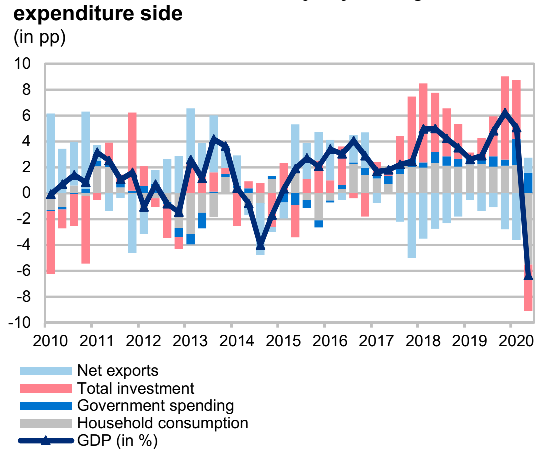
End-June **central government public debt** came at EUR 26.8 bn, and its share of projected GDP reached 57.3% (compared with 52.0% in late 2019). Debt rose on account of higher debt in original currencies (6.3 pp), most notably the euro due to the issue of the seven-year eurobond, followed by dinar debt (RSD 115.2 bn). The projected nominal GDP growth led to a decrease in the share of debt by 1.0 pp. The currency risk declined due to a higher share of dinar debt, which reached 28.4% in late June, close to the maximum recorded in March (28.9%).

In late July 2020, the second package of fiscal policy measures worth around RSD 66 bn was adopted, extending the payment of employee wage subsidies to SMEs by further two months. In addition, the deferral of payroll taxes and social insurance contributions for all private companies was extended by further 30 days. With this, total fiscal support this year will come to around 12.2% of GDP. According to the Ministry of Finance, this will result in a **general government fiscal deficit** of around 8.2% of GDP this year. In our view, such one-off deficit is fully justified, as economic activity decline would otherwise be much sharper this year, followed by reduced production capacities and lower employment. Also, economic recovery next year would be much slower if these measures had not been taken. According to the Ministry of Finance, public debt will rise temporarily this year to around 60% of GDP, but it will resume a downward path from 2021.

8 Aggregate demand

In early 2020, economic indicators continued to record positive tendencies, with some of them even exceeding our expectations. But for the coronavirus pandemic, the economy would have almost certainly risen this year at a pace higher than projected last year – by around 4%, led primarily by investment. However, the pandemic dragged down private consumption and investment in Q2, neutralising their growth from the start of the year. On the other hand, a positive contribution to economic activity in Q2 came from higher government consumption which, due to the crisis, was channelled mainly to the procurement of medical supplies, as well as from rising government investment underpinned by the implementation of infrastructure projects. An impulse in Q2 also came from net exports, as imports of goods and services declined more than exports, in contrast to Q1 when imports recorded high growth rates owing to a continued rise in investment, wherefore the contribution of net exports was positive. In H1, the economy contracted by 0.8 y-o-y, reflecting a 6.4% y-o-y drop in Q2. Such outturn in Q2 was one of the best in Europe, exceeding our expectations from the May *Inflation Report*, when we forecast an 8% y-o-y decline in GDP in Q2.

Chart III.8.1 **Contributions to y-o-y GDP growth rate – expenditure side**



Sources: SORS and NBS calculation.

Domestic demand

Household consumption remained on a stable upward path in early 2020. It picked up by 3.2% y-o-y in Q1, but after the state of emergency was declared and containment measures were adopted, in H1 private consumption declined by 2.6% y-o-y. Containment measured restricted citizen mobility and halted the activity in most service sectors in April. As of May, after most lockdown measures were abolished, consumption began to recover and retail trade, the least hit by the crisis, started up in y-o-y terms already from May. Due to lingering uncertainty, other service sectors were recovering more slowly, notably transport and tourism sectors. Air transport, suspended in April, recovered only partially as of May, and the fall in the number of overnight stays of domestic tourists slowed from 94.0% y-o-y in April to 17.2% y-o-y in June.

Owing to Government and NBS measures geared toward mitigating the negative effects of the crisis, domestic sources of consumption were preserved. Government measures aimed at preserving jobs by subsidising wages up to the minimum wage in a three-month period helped maintain positive labour market dynamics, as seen in a 10.8% y-o-y real rise in wage bill from January to May. Household disposable income went up thanks to the NBS decision to introduce a three-month moratorium on loan repayments, used by around 90% of debtors. Household lending recovered as of May after the NBS cut the key policy rate – by 1 pp from March to June. H1 saw a reduction in remittances inflows (-22.5% y-o-y), reflecting the economic downturn in European countries. Remittances inflows also declined in other remittances-recipient countries. They went down also on the back of restrictive rules for cross-border travel, which significantly reduced labour force mobility during the pandemic.

The purchase of goods and services needed in the pandemic propped up **government consumption**, by around 10.3% y-o-y in H1. This fully neutralised the decline in private consumption and, as a result, total consumption in H1 stayed unchanged y-o-y.

The investment cycle continued into early 2020, as evidenced by a 12.6% y-o-y rise in **private sector investment** in Q1. However, as it became difficult to operate in the crisis and uncertainty over the recovery of some sectors increased, private sector investment declined in Q2 – by 2.7% y-o-y in H1. Good performance of the corporate sector in 2019 pushed up investment, but as operating conditions deteriorated in the crisis and uncertainty as to future results went up, the investment funded from own sourced decelerated in Q2. The global rise in risk aversion partly slowed non-resident investment in Q2, and FDI inflows fell by 24.2% y-o-y in H1. Q2 saw a smaller y-o-y increase in investment loans.

The implementation of government-funded capital projects continued in H1. Works on infrastructure projects in transport and energy were not suspended even during the emergency state, and **government investment** was up by 3.6% y-o-y in H1.

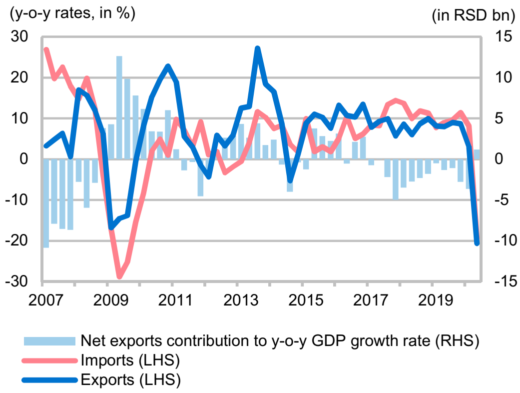
Inventories grew more in Q1 than they were consumed in Q2, owing to partial disruptions in supply chains during the pandemic – H1 saw a positive contribution based on a change in **inventories**, driving up GDP by 0.7 pp in H1.

Net external demand

The continued rise in investment in early 2020 reflected on rising imports of intermediate goods and equipment, and elevated household consumption reflected on higher imports of consumer goods, whilst exports decelerated due to dented external demand. As a result, net exports were a negative contributor to GDP growth in Q1. However – through falling demand and standstills and, in some cases, disruptions of global supply chains and the closing of borders – the pandemic-induced crisis dragged down foreign trade as of mid-March, with goods and services imports falling more sharply than exports in Q2. At the H1 level, goods and services exports declined (by 9.3% in real y-o-y terms) more than imports (by 6.2% y-o-y), and the contribution of net exports to GDP was negative in H1, at 1.2 pp.

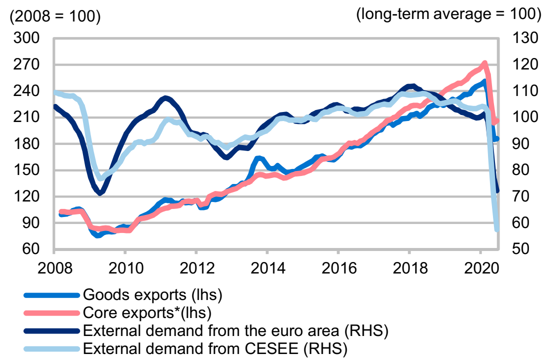
Containment measures and a sharp drop in external demand triggered by the pandemic led to a 9.3% y-o-y decline in euro exports of goods in H1, according to balance of payments data. The drop in exports fully pertained to manufacturing – down by 10.0% y-o-y in H1, while agricultural exports were up even in the crisis (10.5% y-o-y). Negative effects of the crisis on exports, which began to show in March, were the most pronounced in April. With the gradual easing of containment measures and the opening of economies, recovery began in May, as confirmed by positive s-a growth rates, recorded in 16 of 23 manufacturing sectors. Of the key export branches, the growth in exports of electrical equipment, rubber and plastic and cars, car

Chart III.8.2 **Exports and imports of goods and services**
(in previous-year constant prices, ref. 2010)



Sources: SORS and NBS calculation.

Chart III.8.3 **Movement of indicators of external demand for Serbian exports**
(3m moving avarage, s-a)



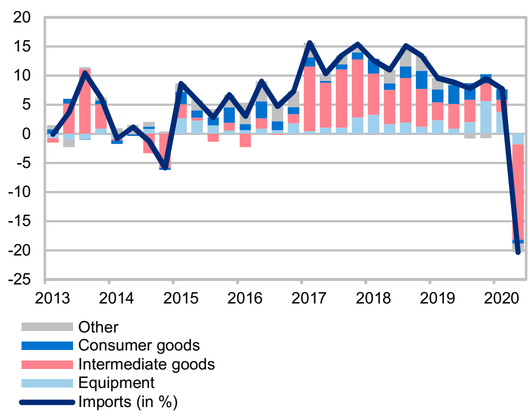
Sources: European Commission, SORS and NBS.
* Core exports are exports excluding the exports of agricultural products, base metals, motor vehicles, petroleum products and electricity.

parts and accessories began in May and continued into June, when the exports of base metals and metal products also went up.[22]

As the economy contracted, euro goods imports declined by 5.8% y-o-y in H1. According to the EU classification, this was due primarily to the reduced imports of intermediate goods (-9.0% y-o-y), capital goods (-4.6% y-o-y) and energy products (-25.9% y-o-y), reflecting both reduced industry needs and lower oil prices. On the other hand, although they declined in April and May, the imports of consumer goods in H1 positively affected the growth in imports. Similar movements are suggested by the BEC classification of imports – imports declined primarily on account of lower imports of intermediate goods (-13.3% y-o-y), while higher imports of equipment (6.6% y-o-y) and consumer goods (2.7% y-o-y) worked in the opposite direction. The recovery of production helped imports to start to recover in May, led by more robust imports of equipment and intermediate goods, which continued in June.

The pandemic also bore down on foreign trade in services, and owing to somewhat faster recovery, prompted by the easing of containment measures, the decline in exports in H1 (5.4% y-o-y) was smaller than in imports (11.9% y-o-y). The crisis hit most strongly tourist and transport services, with a negative impact in the case of Serbia being more pronounced on the import side. In H1, ICT and business services contributed to rising exports, and business and other services to rising imports of services.

Chart III.8.4 **Movement of key import components**
(contributions to y-o-y growth, in pp)



Sources: SORS and NBS calculation.

The coverage of goods imports by exports[23] was 73.6% in June, or 83.5% including services, which is close to the end-2019 coverage.

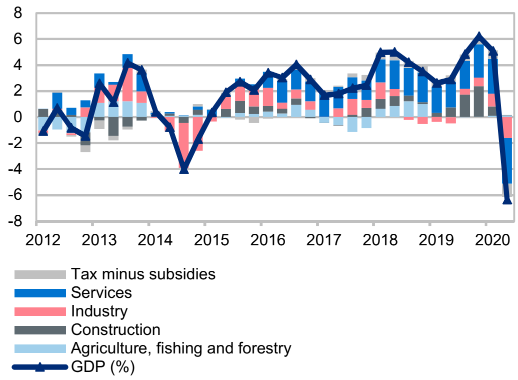
9 Economic activity

Following the robust 5.1% y-o-y GDP growth in Q1, the global spread of the coronavirus pandemic significantly slowed down the Serbian economy and in H1 GDP dropped by 0.8% y-o-y. The coronavirus crisis caused the shutting down of economies, lowering in external demand and disruptions to supply chains. This, along with the reduced utilisation of production capacities, considerably slackened the performance of the Serbian economy.

[22] More information is available in the August 2020 *Inflation Report*, Text box 3, p. 37.

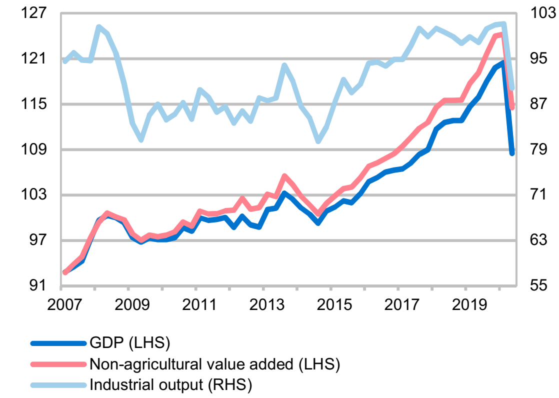
[23] Measured by 12-month moving average.

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



Sources: SORS and NBS calculation.

Chart III.9.2 **Economic activity indicators**
(s-a, H1 2008 = 100)



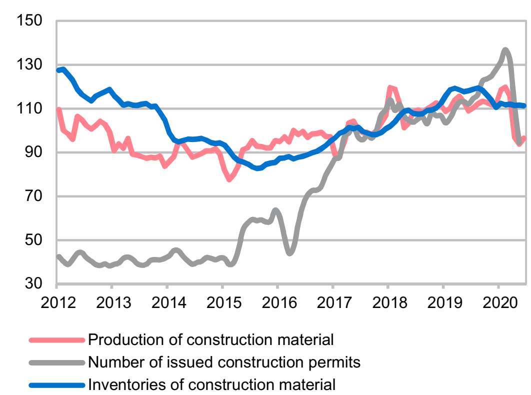
Sources: SORS and NBS calculation.

To mitigate the negative effects of the crisis, the Government adopted a package of measures which, inter alia, entail the deferral of corporate tax liabilities and subsidising of minimum wages for small and medium-sized enterprises for the duration of three months whereby **net taxes** were brought down by 1.2% y-o-y with a negative GDP contribution (-0.2pp). Gross value added was also reduced in the crisis, by 0.7% y-o-y in H1, primarily due to the slump in services, by 1.0% y-o-y and industrial production by 1.7% y-o-y. On the other hand, construction posted robust growth in Q1, which was followed by stagnation in Q2. Hence, 8.3% y-o-y growth was recorded in construction in H1. After above-average season in 2019, agriculture recorded growth (2.0% y-o-y) in H1 as well. **Industrial** slack is indicated by the reduced volume of industrial production of 1.8% y-o-y with the volume of production in manufacturing declining by 1.5% y-o-y and electric energy supply by 5.6% y-o-y. On the other hand, mining, which was hit by the crisis the least, recorded 3.8% y-o-y growth in H1.

In manufacturing, export-oriented activities were hit the most by the crisis. Lower external demand affected automobile industry the most, as confirmed by the 41.7% y-o-y drop in the production of motor vehicles, while the volume of production of rubber and plastic products lost 13.7%. The volume of production of base metals also contracted (17.8% y-o-y), as did the production of textile, clothing and leather products. On the other hand, food industry posted 1.2% y-o-y growth, on account of inelastic demand for food staples, while increasing demand for medical products drove up the volume of production of pharmaceutical products by 15.8% y-o-y. In H1, the production of petroleum and chemical products also went up by 33.5% and 8.9% y-o-y respectively, this being mainly attributable to the low base caused by the overhaul of oil and chemical plants in H1 2019.

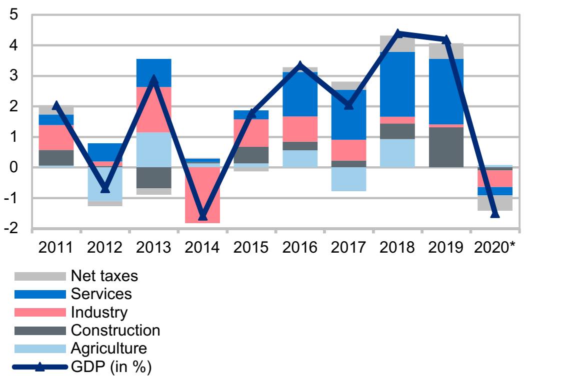
Continued intense implementation of infrastructure projects along with rising activity in the real estate market were the drivers of growth in **construction**. It is necessary to emphasise that the emergency situation caused by the coronavirus only slowed down the launch of new construction projects, as testified by the fall in the number of issued construction permits in April–May (31.1% y-o-y). The ongoing construction projects continued at an unaltered pace in Q2, as evidenced by the value of executed construction works, which was almost unchanged compared to Q2 2019 (-0.8% y-o-y), while it rose by 9.3% y-o-y in H1.

Chart III.9.3 **Construction activity indicators**
(quarterly averages s-a, 2017 = 100)



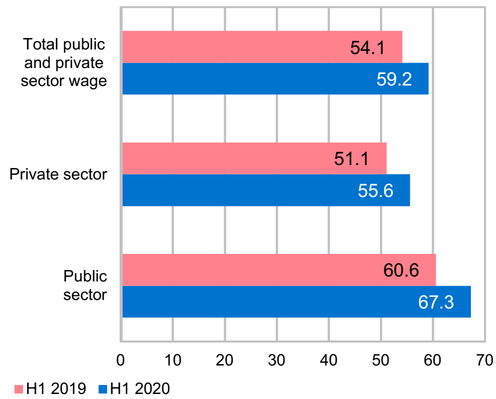
Sources: SORS and NBS calculation.

Chart III.9.4 **Contributions to annual GDP growth rate – production side**
(in pp)



Sources: SORS and NBS calculation.

Chart III.10.1 **Average nominal net wage**
(in RSD thousand)



Source: SORS.

Services aggregately, recorded a 1.0% y-o-y drop in activity in H1 and gave a 0.5 pp negative contribution to GDP, which can primarily be linked to the situation in Q2 when services recorded a fall of 6.6% y-o-y. The emergency state and implementation of containment measures completely suspended the activity in tourism, catering and transport. However, after the lifting of the emergency state a gradual recovery ensued amid still present uncertainty caused by the pandemic. On the other hand, trade was affected much less by the crisis, as indicated by the real turnover which did not go up in y-o-y terms only in April – in H1 as a whole it increased by 3.4% y-o-y.

Preliminary data about wheat production and yield of certain fruits indicate the rise in **agriculture** in 2020 even though last year an above-average agricultural season was recorded. This is also confirmed by the increase in surface areas under corn, sunflower and soya bean (up to 5%) compared to the last year. Bearing this in mind, agricultural production in 2020 is estimated to grow 1.3%, while SORS preliminary data suggest 2.0% y-o-y growth in H1.

10 Wages and employment

The domestic labour market kept posting good results in early 2020. A more serious effect of the pandemic on the labour market in H1 was avoided owing to the timely implementation of economic measures of the NBS and the Government aimed at preserving the business activity and adequate level of employment and thus wages. Nevertheless, compared to Q1 and the pre-pandemic period, in Q2 a slight deceleration of y-o-y wages and employment growth was noticeable, as well as a drop in unemployment in y-o-y terms.

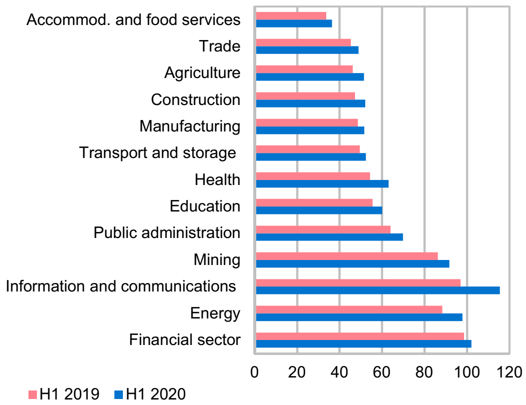
Nominal net wage in the period January-June 2020 was on average 9.4% higher than in the same period of 2019. At the same time, the y-o-y rise in the average wage in H1 was recorded both in the **private** (8.8%) and **public sector** (11.1%), partly on account of the revocation of the regulation on temporary reduction of wages in a part of the public sector[24] owing to excellent fiscal results and stabilisation of public finance in the past years. Unlike the public sector[25], the private sector saw a deceleration in the y-o-y wage growth in Q2 compared to the pre-pandemic period due to the enforced economic shutdown in April and May because of the spread of the coronavirus, as well as a slight s-a decrease at the monthly level. However, as early as in June private sector wages returned to the pre-crisis level, which only indicates the effectiveness of economic measures aimed at offsetting the negative effects of the pandemic.

By sector, average wages in H1 were higher than a year before, even though their y-o-y rise was somewhat slower than in the period before the pandemic – it equalled 11.2% in agriculture, 9.2% in industry, and 8.8% in services. The deceleration of y-o-y wage growth was first felt in private sector activity - catering, transport,

[24] The Law Repealing the Law on temporary regulation of salary i.e. wages and other steady income calculation and payment bases of public fund users (RS Official Gazette, No 86/2019).

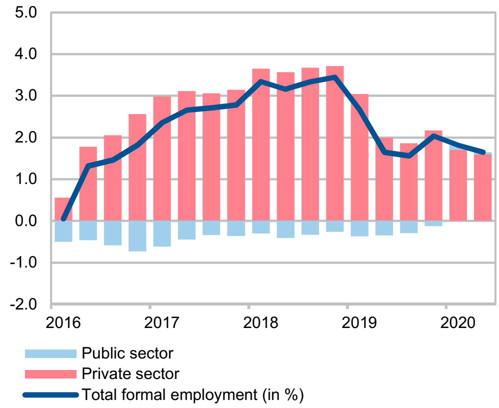
[25] For the purposes of average wage calculation, the Statistical Office classifies the following under the public sector: public enterprises, public local utilities, all levels of administration, public institutions performing health and social protection, educational and cultural activity.

Chart III.10.2 **Nominal net wage by economic sector**
(in RSD thousand)



Source: SORS.

Chart III.10.3 **Composition of y-o-y growth in formal employment**
(in pp, average for the period)



Source: SORS and NBS calculation.

trade and manufacturing, branches which were affected the most by containment measures. As opposed to that, H1 saw the acceleration of y-o-y average wage growth in ICT[26] (19.2%) and health and social protection (15.9%) dominantly on account of the rise in health workers' wages in April.

As a dominant source of consumer demand, **total nominal net wage bill** grew by 13.0% y-o-y in H1 – rising 14.3% y-o-y in the private sector and 10.6% y-o-y in the public sector.

Owing to robust economic growth in Q1, **overall economic productivity** went up by 3.2% y-o-y, while, according to the preliminary estimate, it fell by 7.9% y-o-y in Q2 due to the expected economic slack caused by containment measures.

Despite the pandemic, formal employment recorded average growth of 1.7% y-o-y in H1, driven by continued employment with legal entities and entrepreneurs, along with a less pronounced fall in the number of individual farmers since the beginning of the year. H1 saw somewhat weaker employment growth than the year before as **the private sector** employed less people under non-standard employment arrangements[27] due to the pandemic (by around 4.5 thousand people). On the other hand, standard employment arrangements, which have made up more than 70% of total formal employment in Serbia for a while now, grew by almost 46 thousand people in H1. At the same time, **public sector** employment also went up (by around 1.6 thousand) for the first time since 2015, when the right-sizing process began.

In H1, **the highest number of new recruits was recorded on average in manufacturing** (by close to 16 thousand people) and in the majority of services (by around 22 thousand), which are the greatest drivers of economic growth. At the same time, agriculture recorded a drop in employment, as did the energy and water supply sectors (by around two thousand persons aggregately) partly on account of control of employment in public fund users.[28]

According to the National Employment Service, **total unemployment measured 525,987 in June**, or around 1.2 thousand unemployed people less than a year ago and almost 216 thousand less than at end-2014 when labour market reforms were initiated. Along with the deceleration of y-o-y employment growth, upon the outbreak of the pandemic, the y-o-y fall in registered unemployment also slowed down, from 9.8% in March to 0.2% in June. Though at a slower pace than before the pandemic, **unemployment continued to drop in all occupation groups in H1** – primarily in those related to manufacturing (by around 11 thousand persons on average), followed by occupations in trade, catering and tourism, as well as construction, transport and agriculture (by around seven thousand persons aggregately). This is

[26] In early 2020 labour law was amended in the area of formal hiring of entrepreneurs with flat rate taxation.

[27] Non-standard employment arrangements include mainly temporary and occasional work, while standard employment arrangements cover permanent or fixed-term employment contracts.

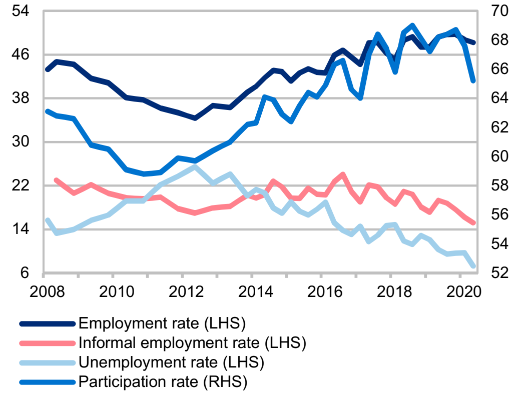
[28] Pursuant to the Decree on the Procedure for Obtaining Consent for New Employment and Additional Engagement in Public Fund Users. Late in 2019 the Law Setting the Maximum Number of Employees in the Public Sector was repealed.

Table III.10.1 **Formal employment and unemployment**
(y-o-y growth rates, period average)

	2019		2020	
	Q3	Q4	Q1	Q2
Total number of formally employed	1.6	2.0	1.8	1.6
Employed with legal persons	1.7	2.2	2.4	2.2
Entrepreneurs and their employees	3.0	3.4	1.0	1.1
Individual farmers	-8.6	-8.4	-7.4	-7.8
Unemployed	-9.5	-8.9	-9.1	-3.3
First-time job seekers	26.1	32.9	26.3	11.3
Used to be employed	-27.2	-29.4	-28.5	-14.8

Sources: SORS and National Employment Service.

Chart III.10.4 **Labour market indicators under the Labour Force Survey**
(in %)



Source: SORS.

indicative of the success of implemented reforms supported by active labour market policies[29] which benefit from the improved business and investment climate in Serbia. Favourable trends in formal and informal labour market segments in early 2020 were also confirmed by the **Labour Force Survey** for Q1. Just before the outbreak of the pandemic, in Q1 the participation rate of working age population (15–64) and the employment rate remained relatively high at 67.6% and 48.7%, while, at the same time, the informal employment rate dropped to the lowest level since comparable data are available (16.2%). In addition, the unemployment rate remained at a single-digit level (9.7%) in Q1, while the long-term unemployment rate[30] almost touched its historic low again (5.5%). Despite the pandemic, labour market indicators remained favourable in Q2, with record low unemployment rate of 7.3%. At the same time, data indicate that adverse effects on the formal labour market have been avoided owing to the undertaken economic policy measures. Negative effects of the pandemic, when Q2 is compared to Q1, are visible only in the informal labour market segment due to which 15+ employment shrank. Unemployment was cut, but at the same time the inactivity increased due to the impossibility to seek a job in Q2. The employment rate was reduced by 0.5 pp, measuring 48.2%, while the unemployment rate was cut by 2.5 pp, to 7.3% which is its lowest level under the comparable methodology. The inactivity rate increased by 2.8 pp, to 48%.

The uncertainty as to the duration of the new crisis and the speed of economic recovery in H2 might affect the labour market, but, according to our estimate, these effects will be reduced to the minimum owing to the undertaken economic policy measures and retained favourable medium-term prospects of the country.

[29] Active labour market policies and programmes encompass, inter alia: job matching services, career guidance and counselling, support to self-employment, further education and training, special programmes for youth in transition from the education system to the labour market.

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

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