7. Monetary trends and policy

Inflation has stood at the lower end of the target corridor since March but we expect it to draw close to the middle of the target corridor in the fourth quarter. The main movers of the moderate increase of inflation in the coming period are the depreciation of the Dinar and expected rise in fuel prices. Monetary policy remains restrictive but an easing of that restrictive nature is possible only once macro-economic risks are lowered and that primarily means once a credible plan of fiscal consolidation is adopted. Following a lengthy period when credit activity dropped, that activity increased at the end of the second and start of the third quarter with the launching of the program of subsidized credits was launched. The rise in the number of bad loans continued but at a slower pace. The extent of bad loans reached a level which made in necessary for the government and National Bank of Serbia (NBS) to announce a program to resolve the problem.

Central Bank: Balance and Monetary Policy

Monetary policy demands a balance between extremely low inflation and high macro-economic risks

In Q2 the annual rate of growth of consumer prices continued to stand below the lower level of the target corridor. Viewed at monthly level, inflation was extremely low with deflation registered in March and July. Contrary to the expectations of the NBS, inflation at the end of July was under the lower level of the target corridor for four consecutive months. The policy of very cautious and gradual lowering of the key policy rate continued in Q2 with the NBS lowering the key policy rate by 0.5 percentage points in May and again in June. The key policy rate now stands at 8.5% and it is significantly higher than the y.o.y. inflation which stands at around 2%. The high key policy rate has the basic goal of redirecting the surplus Dinar liquidity of banks to NBS REPO bonds. In that way, the NBS is preventing greater fluctuations of the exchange rate since they affect inflation to a great degree in the highly Euro-ized economy but with some tardiness. However, the high NBS interest rates in conditions of low inflation carry a price which is the lowering of bank credit activity and a rise in the cost of loans.

NBS easing depreciation pressure through high interest rates

Despite that we do not expect any significant correction of the key policy rate downwards to the end of the year because of the stronger depreciation pressure in July and August. By keeping the rate at this level, the NBS is trying to prevent business banks from drawing funds out of REPO placement and converting them to foreign currency which exerts pressure on the exchange rate. This is confirmed by data on REPO placements in July when business banks withdraw from REPO placement 215 million Euro which was felt quickly as the Dinar weakened. A significant weakening of the Dinar, although justified from the point of view of the competitiveness of the economy would seriously shake the financial position of the state, companies and the population.

Easing of restrictive monetary policy requires reduced macro-economic risks

Although inflation this year was low with deflation occasionally present, macro-economic risks were extremely high. The postponing of fiscal consolidation, replacement of the finance minister, delay in the arrival of the IMF mission and other things caused doubts among investors in the government economic policy which is manifested through a withdrawal of Dinar placements, rise in demand for foreign currency and withdrawal of capital from Serbia. As a result of those processes, strong depreciation pressure appeared mid-year and the NBS intervened on the foreign currency market to prevent a depreciation of the Dinar. The maintaining NBS interest rates at high level is aimed at preventing a high depreciation of the Dinar because it would affect inflation. Besides internal risks, Serbia, like other countries in the region, is facing the negative effects of the Ukrainian crisis. We feel that a significant easing of the restrictive monetary policy is possible only once macro-economic risks are reduced.

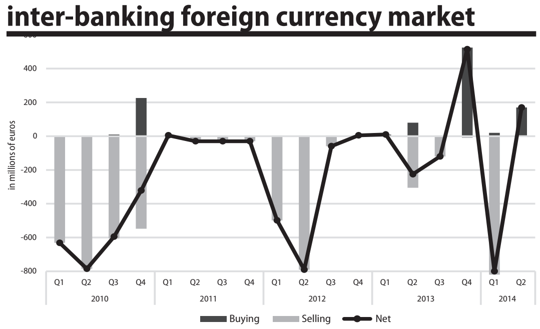
Table T7-1. Serbia: NBS interventions and foreign currency reserves 2012-2014

	2012				2013				2014	
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun
Repo stock (in milions of euros)	1,055.98	111.98	2.29	354.16	678.86	663.82	832.03	966.40	783.96	824.18
NBS interest rate	9.50	10.00	10.50	11.25	11.75	11.00	11.00	9.50	9.50	8.50
NBS interest rate	1.11	-2.77	-5.74	1.11	6.95	3.31	13.24	10.38	4.38	5.09
NBS interest rate	-18.43	-7.27	-6.50	-3.99	19.25	12.85	12.83	9.25	5.28	7.08
NBS interventions on FX market (in milions of euros)	-498.50	-1288.80	-1348.30	-1343.30	10.00	-215.00	-140.00	375.00	-800.00	-630.00
INCREASE					cumulative, in % of initial M2[1]					
NBS own resreves[2]	-17.6	-45.4	-35.6	-6.0	12.5	7.1	17.9	43.2	-21.4	-13.3
NDA	2.4	61.3	65.8	41.3	-15.3	-3.9	-16.2	-31.3	1.9	6.4
Government, dinar deposits[3]	-5.1	6.1	4.3	-4.3	1.0	-1.2	-4.7	-19.9	-0.3	5.0
Repo transactions[4]	2.2	53.7	59.3	40.2	-16.0	-14.7	-23.8	-30.7	4.2	4.4
Other items , net[5]	5.3	1.5	2.3	5.4	-0.3	12.0	12.4	19.3	-2.1	-3.0
H	-15.2	15.9	30.2	35.3	-2.8	3.3	1.7	12.0	-19.5	-6.9
o/w: currency in circulation	-3.3	-4.0	-1.4	-1.6	-3.9	-0.7	1.0	5.4	-3.6	-2.8
o/w: excess liquidity	-13.6	-1.6	-1.1	5.4	0.6	2.1	-1.4	4.4	-14.3	-2.8
					in millions of euros, cumulative from the beginning of the year					
NBS, net	-1070.60	-2087.45	-2383.97	-1050.95	30.01	-992.01	-1041.50	943.97	-230.19	-497.57
Gross foreign reserves	-1138.11	-2090.09	-2536.57	-1324.15	-385.77	-1576.91	-1822.60	240.33	-344.35	-797.81
Foreign liabilities	67.51	2.64	152.60	273.20	415.78	584.90	781.10	703.63	114.16	300.24
IMF	58.24	-6.44	138.99	258.95	401.14	568.40	759.83	695.60	112.50	298.78
Other liabilities	9.27	9.07	13.61	14.25	14.65	16.50	21.27	8.03	1.66	1.45
NBS, NET RESERVES-STRUCTURE										
1. NBS, net	-1070.60	-2087.45	-2389.97	-1050.95	30.01	-992.01	-1041.50	943.97	-230.19	-497.57
1.1 Commercial banks deposits	459.45	740.45	1030.19	907.59	911.80	967.01	1058.25	240.42	-132.58	-18.15
1.2 Government deposits	263.40	488.43	683.75	28.63	-811.79	47.05	209.55	-359.83	-41.34	264.53
1.3 NBS own reserves (1.3 = 1 - 1.1 - 1.2)	-347.74	-858.58	-670.03	-114.73	130.02	22.06	226.30	824.56	-404.10	-251.20

Source: NBS.
1) "Initial M2" designates the state of primary money at the start of the current or the end of the previous year.
2) The definition of NBS own reserves is given in section 8 „Monetary trends and policy", Frame 4, *QM* no. 5.
3) „State" includes all levels of power: republic level and local government level.
4) This category includes NBS Treasury Bonds (BZ), and repo operations.
5) Other domestic net assets includes: domestic credits (net bank debts excluding BZ and repo transactions; net debts by the economy) together with other assets (capital and reserves; and items in the balance: other assets) and corrected by changes in the exchange rate.

During Q2 the NBS prevented the appreciation of the Dinar and in Q3 it eased its depreciation

Graph T7-2. Serbia: NBS interventions on inter-banking foreign currency market



Source: NBS

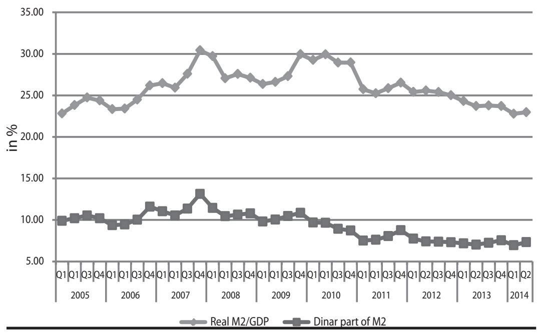
Due to the greately more stable Dinar exchange rate, NBS interventions in Q2 were significantly lower compared to the first quarter. Since appreciation pressure was dominant in this period, the NBS bought foreign currency on the inter-banking foreign currency market to the value of 170 million Euro (Graph T7-2). That caused an increase in the level of NBS net own reserves in Q2 to the value of 150 million Euro which partly neutralized the significant drop in the first quarter (in Q1 those net own reserves decreased by 404 million Euro). By buying foreign currency the NBS positively affected an increase in Dinar liquidity in the system and the primary money in Q2 increased by 12.7% of its value at the start of the year (Table T7-1). Part of the primary money growth is due to the conversion of state foreign currency deposits which led to an increase of 5.36% of the primary money level at the start of the year. On the other hand, business banks in Q2 increased their REPO placements by some 45 million Euro which, along with the drop in account of other domestic assets, led to a decrease in Dinar liquidity. The NBS changed the direction of its interventions from mid-year, selling foreign currency on the foreign currency market to slow down the depreciation of the Dinar.

The Monetary System: Money Mass Structure and Trends

M2 money mass growth of 2.9% of value at start of year in Q2

The M2[1] registered a slight increase in the y.o.y. growth rate in Q2 which nominally stood at 4.8%. The trend of decreasing credits in the private sector continued with credits standing nominally lower by 4.5% y.o.y. while, following a correction by changes in the exchange rate, the drop rate stood higher at –5.4% (Table T7-4). Thanks to low and stable inflation, the real y.o.y. growth rate stood at 3,5% but the greatest cause for concern are loans to the economy which registered a drop of –10.8% y.o.y. Compared to the level at the start of the year, the M2 money mass in Q2 recorded a growth of 2.9% (in Q1 the drop was 1.5%, Table T7-4). The increase in the money mass in this period was solely thanks to the growth of the net domestic assets of 3% compared to the value of M2 at the start of the year while the net side of the net foreign assets was slightly lower in the same period.

Graph T7-3. Serbia: money mass trends as percentage of GDP, 2005-2014



Spurce: *QM* calculation

Real growth of money mass increases in Q2 ...

... while loans to the private sector continue to drop

The drop in loans to the private sector, primarily to the economy, was partly reduced in June and July thanks to the launching of a new cycle of measures to stimulate credit activities in the form of subsidized loans to maintain liquidity and finance permanent turnover funds. As part of the new program of subsidized loans, a limit was imposed of 15% of the total loans being used to refinance loans with the loan issuing bank. In that way the state tried to affect the system of distributing loans so that they would dominantly be used to finance production and not cover debts based on earlier loans which would profit only banks. Also, a limit was imposed of 20% on total approved credits on loans to large companies which is a positive movement of focus to financing small and medium sized companies which proved to have the most problems in financing production in the previous period.

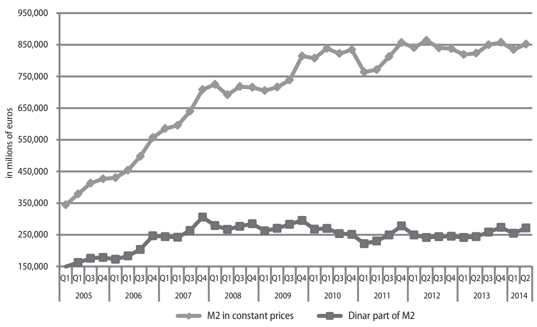
Table T7-4. Serbia: growth of money and contributing aggregates, 2012–2014

	2012				2013				2014	
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun
					y-o-y, in %					
M2[1)]	14.0	18.1	13.8	9.6	8.2	4.5	6.1	4.6	4.2	4.8
Credit to the non-government sector[2)]	14.4	14.0	16.6	9.8	1.9	-0.5	-4.4	-4.5	-6.1	-4.5
Credit to the non-government sector[2)], adjusted[3)]	8.6	4.6	7	3.8	1.6	0.6	-4.1	-5.0	-8.2	-5.4
Households	5.7	3.3	3	2.5	3.0	2.9	2.9	2.6	2.0	2.5
Enterprises	10.1	5.3	9.1	4.4	0.9	-0.6	-7.6	-8.8	-13.4	-9.7
					real y-o-y, in %					
M2[1)]	10.1	12.0	3.4	-2.2	-2.6	-5	1.2	2.3	1.9	3.5
Credit to the non-government sector[2)]	10.5	8.1	5.9	-2.0	-8.2	-9.2	-8.9	-6.5	-8.3	-5.7
Credit to the non-government sector[2)], adjusted[3)]	4.9	-1.2	-3.6	-8.1	-8.7	-8.2	-8.5	-7.0	-10.3	-6.7
Households	2.0	-2.4	-7.2	-9.2	-7.5	-6.1	-1.9	0.4	-0.3	1.2
Enterprises	6.3	-0.5	-1.7	-7.5	-9.3	-9.3	-11.8	-10.7	-15.4	-10.8
					in bilions of dinars, end of period					
M2[1)]	1,499.7	1,588.6	1,607.6	1,641.7	1622.7	1659.8	1705.8	1719.3	1691.4	1740.2
M2[1)] dinars	445.0	444.6	467.4	480.6	478.8	492.5	519.5	547.6	516.4	555.3
Fx deposits (enterprise and housholds)	1,054.7	1,144.0	1,140.2	1,161.1	1143.8	1167.3	1186.3	1169.3	1175.0	1185.0
					cumulative, in % of opening M2[4)]					
M2[1)]	0.1	6.1	7.3	9.6	-1.2	1.1	3.9	4.6	-1.5	1.4
NFA, dinar increase	-5.6	-4.5	-7.9	0.2	7.2	2.7	5.2	10.6	0.2	-0.1
NDA	5.7	10.5	15.2	9.4	-8.4	-1.6	-1.3	-6.0	-1.6	1.4

Source: NBS
1) Money mass: components – see Analytical and Notation Conventions QM.
2) Credits to private sector – credits to the economy (including local government) and households.
3) Trends are corrected by exchange rate changes. Corrections are undertaken under assumption that 70% of loans in private sector (both households and the economy) are indexed against the Euro.
4) Initial M2 designates state of M2 at start of current and end of previous year.

1 Monetary aggregate M2 in section Monetary Trends and Policy includes less aggregate M1, savings and timed deposits in business banks. Because of that the M2 aggregate which we observe is equal to M3 aggregate in NBS reports.

Graph T7-5. State of the money mass in permanent prices, 2010–2014



Source: *QM* calculation

The greatest contribution to the 4.8% nominal growth of the M2 is owed to the growth of the narrowest monetary aggregate M1 which in Q2 contributed 4.33 percentage points to the growth of the M2. The remainder of the growth was achieved thanks to an increase in foreign currency deposits which participated with 1.06 percentage points in the overall growth of the M2 bearing in mind that this was one of the lowest contributions recorded in the past two years. Savings and timed deposits in Q2 made a negative contribution to the growth of the M2 of –0.55 percentage points but that was not enough to endanger the overall y.o.y. growth rate of the M2.

Banking sector: placements and sources of financing

Placements to economy positive again...

The placements of business banks following the significant drop at the start of the year, recorded an increase of 409 million Euro in Q2 (in Q1 the bank placements were negative to the amount of –343 million Euro, Table T7-6). That growth is the result of the combined effect of the growth of placements to the economy and the populaton and increased state crediting in Q2. The negative trend in repaying the debts of the economy recorded over a period of more than one year was ended late in Q2 thanks to the new program of subsidized loans. The placements to the economy at Q2 level increased by 88 million Euro with business banks increasing their placement by 230 million in July when the subsidized loans began. A growth of credit placements of 98 million Euro was recorded among the population in Q2 even though the new program of subsidized loans did not include funds for housing loans which were dominant for the population in previous cycles. The fact that the state increased its debts to business banks in Q2 contributed to the rise in overall credit placements and led to a rise in the net crediting of the state by 170 million Euro. Besides the fact that the crediting of the state and private sector in Q2 increased, the rise in the placement of business banks was also caused by the positive effects of the rise in purchase of REPO NBS bonds with REPO stock in Q2 increasing by 43 million Euro. In July, banks once again withdrew funds from REPO bonds to the value of 215 million Euro. Following the positive increase in cross-border credits in the previous quarter, business banks in Q2 once again lowered their foreign debts by 9 million Euro (in Q1 the increase in cross-border loans stood at 68 million Euro, Table T7-6).

... thanks to launching of new program of subsidized credit

Table T7-6. Serbia: bank operations – source and structure of placement, corrected[1)] trends, 2011-2014

	2012				2013				2014	
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun
	in millions of euros, cumulative from the beginning of the year									
Funding(-, increase in liabilities)	672	692	472	-384	109	341	213	420	578	540
Domestic deposits	589	146	15	-459	4	-56	-325	-394	240	-32
Households deposits	-49	-189	-296	-578	-87	-132	-252	-423	45	-105
dinar deposits	30	69	36	11	16	-34	-110	-279	27	-51
fx deposits	-79	-258	-332	-589	-102	-98	-141	-144	17	-54
Enterprise deposits	638	336	311	120	91	76	-73	29	195	72
dinar deposits	362	304	230	99	-11	-11	-109	-162	210	45
fx deposits	275	31	81	21	102	87	36	191	-15	27
Foreign liabilities	3	345	335	127	357	406	588	806	358	396
Capital and reserves	80	200	123	-52	-252	-9	-50	8	-20	176
Gross foreign reserves(-,decline in assets)	-199	371	164	284	-278	-104	84	-304	193	215
Credits and Investment[1)]	409	-424	201	521	123	-169	-67	42	-343	66
Credit to the non-government sector, total	309	136	784	589	-23	-348	-551	-875	-577	-382
Enterprises	375	161	741	552	-71	-463	-728	-1,018	-570	-488
Households	-36	-25	42	37	48	115	177	143	-7	105
Placements with NBS (Repo transactions and treasury bills)	-28	-944	-1,052	-701	321	319	492	628	-176	-133
Government, net[2)]	128	385	470	632	-175	-140	-8	290	411	581
MEMORANDUM ITEMS										
Required reserves and deposits	-552	-418	-451	-265	-17	-87	-443	-134	-2	-215
Other net claims on NBS[3)]	-199	-20	-42	58	-154	-85	118	44	-136	-135
o/w: Excess reserves	-187	45	54	10	-151	-96	60	38	-156	-162
Other items[4)]	150	222	56	146	100	50	54	-22	-289	-454
Effective required reserves (in %)[5)]	22	23	23	23	25	24	22	23	23	22

Source: NBS

1) Calucalting increase is done under the assumption that 70% of overall placements are indexed in Euro. Increases for original Dinar values of deposits are calculated based on the average exchange rate for the period. For foreign currency deposits – as the difference of the state calculated based on the exchange rate at the ends of the period. Capital and reserves calculated based on exchange rate of Euro at the ends of the period and do not include the effects of the exchange rate calculated for remainder of balance.

2) NBS bonds includes state bonds and NBS treasury bonds sold at repo rate and at rate set by market for permanent auction sales with a due date of more than 14 days.

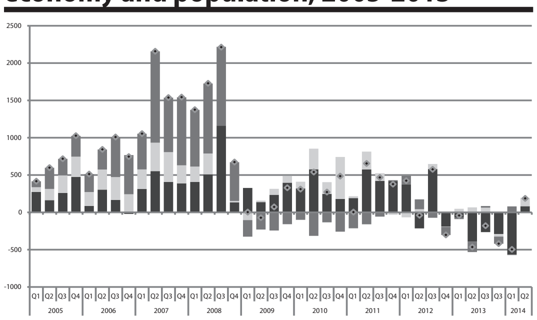
3) Net crediting of the state: credits approved to the state lowered by the state deposits in business banks; the negative prefix designates a higher growth of deposits over credits. The state includes all levels of power: republic and local government level.

4) Other NBS debts (net): difference between NBS debts to banks based on cash and free reserves and debts to the NBS.

5) Items in bank balance: other assets, deposits by companies in receivership, inter-banking relations (net) and other assets not including capital and reserves.

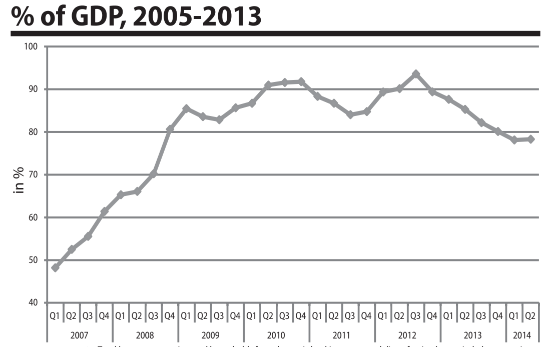
6) Effective mandatory reserves represents the participation of mandatory reserves and deposits in the total overall deposits (for the economy and population) and bank debts abroad. The basis for calculating mandatory reserves does not include subordinate debts because that data is not available.

Graph T7-7. Serbia: growth of new loans to economy and population, 2005-2013



Source: QM calculation
See footnote 1 in Table T7-5.

Graph T7-8. Serbia: overall credit debts in % of GDP, 2005-2013



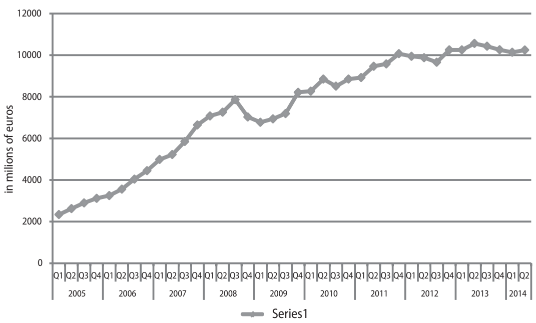
Source: *QM* calculation

Sources for new placements increased in Q2 ...

... but surplus liquidity redirecte into REPO and treasury bonds

In terms of sources of financing for new placements, business banks recorded a slight increase of 38 million Euro in Q2 which is several times lower than the recorded drop at the start of the year (in Q1 sources for new placements dropped by 578 million Euro, Table T7-6). Unlike the previous quarter, domestic deposits contributed to the growth of sources for new placements with 272 million Euro. Within the growth of domestic deposits, a rise was recorded in Q2 in both the economy sector and the population sector with the population contributing to the overall growth with 150 million Euro while the economy increased its deposits by 120 million Euro. Due to the low inflation rate, the population increased its participation in Dinar deposits

Graph T7-9. Serbia: level of foreign currency deposits, 2005-2013



Source: NBS

in Q2 which is a continuing of the trend from the previous year. In the same period, business banks lowered their foreign debts by 38 million Euro (in Q1 business banks repaid 358 million Euro of debts abroad) which, along with the reduction on the capital and reserves accounts of 196 million Euro, helped neutralize to a great extent the positive effect of the growth on the side of domestic deposits. The surplus liquidity freed in Q2 was redirected by business banks to the purchase of treasury bonds to the value of 505 million Euro of which 2/3 represents a rise in debts on the basis of Dinar bonds while the rest was tied to bonds issued in Euro.

Table T7-10. Serbia: participation of bad loans according to type of debtors, 2008-2013

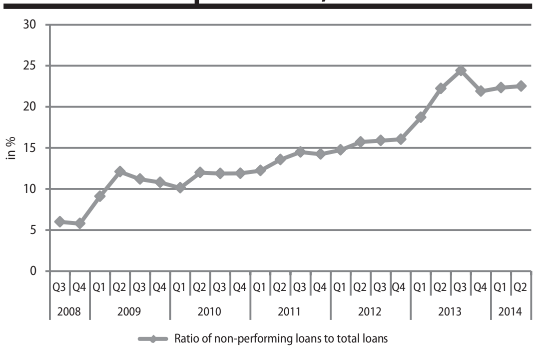
	2009	2010	2011	2012				2013				2014	
	Dec	Dec	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun
	balance at the end of period												
Corporate	12.14	14.02	17.07	17.72	19.26	19.04	19.06	22.62	27.77	31.13	27.76	28.67	28.12
Entrepreneurs	11.21	15.80	17.07	16.05	18.47	17.56	15.92	16.79	18.19	20.86	20.82	21.11	29.77
Individuals	6.69	6.71	7.24	7.57	7.69	8.05	8.32	8.44	8.37	8.14	8.59	8.70	9.22
Ammount of dept by NPL (in bilions of euros)	1.58	1.94	2.63	2.67	2.71	2.97	3.19	3.87	4.47	4.82	4.09	4.05	4.07

Source: QM calculation

The rise of bad loans continued in Q2 …

… primarily because of a deterioration of the situation among entrepreneurs and private individuals

Graph T7-11. Serbia: participation of bad loans in overall placement, 2008-2014



Source: *QM* calculation

Q2 saw a slight rise in the participation of NPLs in the overall placement which stood at 22.5% in June (Graph T7-11). The percentage of bad loans in the private individual segment which participated with some 65% in the overall sum of placed credit dropped slightly and in Q2 the bad loans placed with private individuals stood at 28.1% of the sum placed. Unlike them, the credits placed with entrepreneurs saw a slight deterioration at quarterly level and a rise in bad loans to 29.8%. There was also a rise in the participation of bad loans among private individuals which is slightly lower and stood at 9.2% of the overall placement at the end of Q2 but was relatively more dangerous bearing in mind that this segment accounts for about 30% of the overall funds placed.