7. Monetary trends and policy

The fourth quarter of 2013 saw the continuing of the trend of extremely low inflation which was temporarily stopped with a single leap of prices in January 2014. The foreign currency market saw depreciation and appreciation pressure from mid-2013 but the Dinar exchange rate was relatively stable because of the strong interventions by the National Bank of Serbia (NBS) on that market. Following the lowering of the key policy rate by 1.5 percentage points in Q4 , there were no additional drops in NBS interest rates at the start of 2014. That fact that the key policy rate was kept at the level of 9.5% with a y.o.y. inflation rate of about 3% reflects the intention of the NBS to ease the strong depreciation pressure on the foreign currency market, which has been in place since early 2014, through the REPO rate. The NBS policy of high interest rates in conditions of low inflation shows that the pure model of target inflation is not being implemented in Serbia – instead of through interest rates, the NBS influences inflation predominantly through the exchange rate. As part of the existing model of monetary policy, the NBS does not have an opportunity to stimulate the credit activities of banks, even in periods when it drops significantly, and the question that is raised legitimately is whether the existing model of monetary policy is optimal for Serbia. The high drop in the real value of loans to the economy of about 10% y.o.y. increases the problem of lack of liquidity of companies and deepens recession tendencies in a significant part of the economy. Financial problems in a group of large private companies carries over to banks and the NBS revoked the licenses of two small banks late last year and early this year. The drop in the participation of bad loans in Q4 is the consequence of the revoking of the licenses of problematic banks and we believe it is temporary. If the state does not create the appropriate mechanisms to solve the lack of liquidity and insolvency problems more efficiently we expect the trend of growth of bad loans to continue and that will result in a drop in production and employment as well as serious problems in the banking sector. Financial problems in companies will have a negative effect on public finances because insolvent companies do not pay taxes and when the problems are carried over to banks, the state will have significantly expenses on the basis of payment of insured deposits.

Central Bank: Balance and Monetary Policy

Low inflation rates in Q4 allowed easing of monetary policy …

The positive trends in lowering inflation continued in Q4 causing a gradual relaxation of monetary policy in the form of lower NBS key reference rates. The combination of a good agriculture season at home and abroad, lower domestic demand and a drop in the price of crude oil in Q4 brought y.o.y. inflation rates to levels below the target of 4±1.5% by the end of the year. That caused the NBS to correct the key policy rate three times for a total of 1.5 percentage points (PP) after which it was at the level of 9.5% at the end of the year (Table Tabela T7-1). Although inflation at the start of 2014 was closer to the lower target framework value, NBS did not continue relaxing its monetary policy. The restrictive policy can be explained with the intention of the NBS to redirect the excess liquidity of banks from demand for hard currency to REPO NBS bonds. By keeping the key policy rate at a relatively high level, the NBS de facto controls the exchange rate at its current level by sterilizing a part of the liquidity of the banking sector which would otherwise by used to buy foreign currency. If we bear in mind the fact that a large part of the transactions in the economy are Euro-based (more than 70%) we get the impression that the NBS started implementing its key policy rate to support the target exchange rate rather than the target inflation. That is confirmed by the state of the REPO stock which was increased by 134 million Euro in Q4. The Dinar exchange rate in Q4 moved towards strengthening which led the NBS to intervene by purchasing hard currency to the value of 525 million Euro with one intervention when it sold 10 million Euro which was in December. We feel that the preventing of the strengthening of the Dinar in a situation when the population supports its strengthening is responsible behavior by the NBS since the Dinar exchange rate would otherwise have additionally distanced itself from its balanced value and would endanger the long-term position of

… but the NBS indirectly targeted the course level which meant that there was no great lowering of the key policy rate

the economy. Interventions on the inter-banking foreign currency market in Q4 led the NBS to become a net buyer of hard currency to the value of 180 million Euro over the entire year for the first time in the previous five years although the NBS intervened on that market selling 610 million Euro in January and February because of significantly stronger depreciation pressure (Graph T7-2). The high variation in demand on the foreign currency market in part reflect the changes on the inter-banking capital market while at the same time reflecting the specificity of Serbia – a high deficit in the current accounts balance combined with a very high inflow of capital, uncertainty over the kind of economic policy which will conducted after the elections etc.

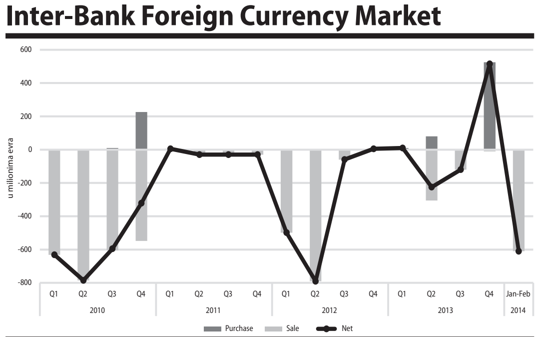
Table T7-1. Serbia: NBS Interventions and Foreign Currency Reserves 2011-2013

	2011				2012				2013			
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec
Repo stock (in milions of euros)	549.77	746.09	1,000.42	1,174.84	1,055.98	111.98	2.29	354.16	678.86	663.82	832.03	966.40
NBS interest rate	12.25	12.00	11.25	9.75	9.50	10.00	10.50	11.25	11.75	11.00	11.00	9.50
NBS interest rate	-9.74	6.76	12.59	7.15	1.11	-2.77	-5.74	1.11	6.95	3.31	13.24	10.38
NBS interest rate	25.66	28.86	5.17	2.61	-18.43	-7.27	-6.50	-3.99	19.25	12.85	12.83	9.25
NBS interventions on FX market (in milions of euros)	5.00	-30.00	-30.00	-30.00	-498.50	-1,288.80	-1,348.30	-1,343.30	10.00	-215.00	-140.00	375.00
INCREASE					**cumulative, in % of initial M2[1]**							
NBS own resreves[2]	-8.9	14.0	26.8	73.9	-17.6	-45.4	-35.6	-6.0	12.5	7.1	17.9	43.2
NDA	-0.7	-15.5	-28.6	-51.8	2.4	61.3	65.8	41.3	-15.3	-3.9	-16.2	-31.3
Government, dinar deposits[3]	-4.6	-3.3	3.6	2.7	-5.1	6.1	4.3	-4.3	1.0	-1.2	-4.7	-19.9
Repo transactions[4]	-6.9	-15.3	-32.2	-47.5	2.2	53.7	59.3	40.2	-16.0	-14.7	-23.8	-30.7
Other items , net[5]	10.9	3.1	0.0	-7.0	5.3	1.5	2.3	5.4	-0.3	12.0	12.4	19.3
H	-9.6	-1.5	-1.8	22.1	-15.2	15.9	30.2	35.3	-2.8	3.3	1.7	12.0
o/w: currency in circulation	-5.8	-4.2	1.3	12.4	-3.3	-4.0	-1.4	-1.6	-3.9	-0.7	1.0	5.4
o/w: excess liquidity	-3.8	2.5	-5.5	6.3	-13.6	-1.6	-1.1	5.4	0.6	2.1	-1.4	4.4
					in millions of euros, cumulative from the beginning of the year							
NBS, net	56.41	281.69	1,374.46	2,203.13	-1,070.60	-2,087.45	-2,383.97	-1,050.95	30.01	-992.01	-1,041.50	-106.98
Gross foreign reserves	15.50	308.18	1,426.15	2,333.77	-1,138.11	-2,090.09	-2,536.57	-1,324.15	-385.77	-1,576.91	-1,822.60	-1,083.82
Foreign liabilities	40.91	-26.49	-51.69	-130.63	67.51	2.64	152.60	273.20	415.78	584.90	781.10	976.83
IMF	36.90	-32.40	-58.53	-131.88	58.24	-6.44	138.99	258.95	401.14	568.40	759.83	954.55
Other liabilities	4.01	5.90	6.85	1.24	9.27	9.07	13.61	14.25	14.65	16.50	21.27	22.28
NBS, NET RESERVES-STRUCTURE												
1. NBS, net	56.41	281.69	1,374.46	2,203.13	-1,070.60	-2,087.45	-2,383.97	-1,050.95	30.01	-992.01	-1,041.50	-106.98
1.1 Commercial banks deposits	21.84	226.33	108.59	-461.78	459.45	740.45	1,030.19	907.59	911.80	967.01	1,058.25	1,148.01
1.2 Government deposits	-232.50	-257.55	-1,009.24	-455.09	263.40	488.43	683.75	28.63	-811.79	47.05	209.55	-331.19
1.3 **NBS own reserves** (1.3 = 1 - 1.1 - 1.2)	-154.25	250.47	473.81	1,286.27	-347.74	-858.58	-670.03	-114.73	130.02	22.06	226.30	709.84

Source: NBS.
1) "Initial M2" is used to designate the state of primary money at the start of the year, or the end of the previous year.
2) Definition of net own reserves NBS given in section 8 „Monetary Trends and Policy", Frame 4, *QM* no. 5.
3) State includes all levels of government: republici and other levels.
4) This category includes NBS (BZ) Treasury Bonds and REPO operations.
5) Other domestic net assets include: domestic loans (net debts of banks including BZ and REPO transactions; net debts by the economy) along with other assets (capital and reserves; and balance items: other assets) and corrected by changes in the exchange rate.

NBS own reserves rise in Q4 because of foreign currency purchases, ..., but drop from start of 2014

Graph T7-2. Serbia: NBS Interventions on Inter-Bank Foreign Currency Market



Source: NBS

The purchase of foreign currency on the inter-bank foreign currency market had a positive effect on the level of NBS own reserves which rose by 484 million Euro in Q4 (in Q3 the net own reserves increased by 104 million Euro). The NBS foreign currency reserves have decreased since the start of the year. On the other hand, the state has kept most of the money collected from the sale of treasury bonds and Euro bonds in NBS accounts which led to an increase in the state deposits by some 540 million Euro. The growth of the state deposit combined with added placement by business banks in REPO had a negative effect on net domestic assets which recorded a drop of 15.1% of the value of primary money at the start of the year. The overall effect in creating primary money in Q4 was positive due to a higher growth of net own reserves which led to the level of primary money at the end of the year growing by 12% of its value at the start of the year.

Monetary System: Structure and Trends of the Money Mass

The money mass recorded a slight growth at the end of the year...

The money mass M2 increased in Q4 by 0.8% compared to the level at the start of the year (in Q3 a growth of 2.8% was recorded, Table T7-4). The overall growth of the money was generated on the basis of the growth of net foreign assets which also recorded a quarterly growth of 5.4% at

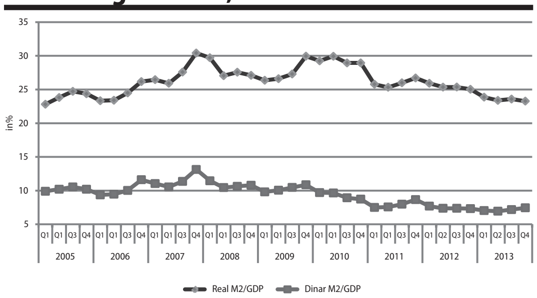
… thanks solely to an increase in NSA

the end of the year and 10.6% at the level of the entire year. On the other hand, the net domestic assets recorded a significant drop which stood at –4.6% in Q4.

A growth of the money mass at y.o.y. level was registered in Q4 …

… but the loans to the private sector dropped constantly and significantly

Graph T7-3. Serbia: Money Mass Trends as Percentage of GDP, 2005-2013



Source: *QM* calculation

The y.o.y. nominal growth rate of the money mass M2[1] stood at 4.7% in Q4 despite the fact that loans to the private (non-state) sector in Q4 saw a drop of –5% compared to the same period a year earlier (Table 7-4). Take into account the level of inflation in Q4 and the real M2 growth rate is 2.5% y.o.y. while in credits to the non--state sector it recorded a drop of –6.5%. The overall drop in credit activity covers the credit placements to the economy which recorded a drop of 10.7% y.o.y. in Q4 with the situation remaining unchanged with the population. The drop in credit to the private sector in Q4 is a continued trend from early 2012 with no indications yet that it will end soon if we know that the 2014 budget does not include funds to continue the program of subsidized interest on new loans.

Table T7-4. Serbia: growth of money and contributing aggregates, 2011–2013

	2011				2012				2013			
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec
					y-o-y, in %							
M2[1)]	8.0	3.7	8.1	10.1	14.0	18.1	13.8	9.6	8.2	4.5	6.1	4.7
Credit to the non-government sector[2)]	19.3	11.6	8.3	7.7	14.4	14.0	16.6	9.8	1.9	-0.5	-4.4	-4.5
Credit to the non-government sector[2)], adjusted[3)]	16.7	13.0	11.7	8.1	8.6	4.6	7.0	3.8	1.6	0.6	-4.1	-5.0
Households	25.1	20.6	17.8	5.7	5.7	3.3	3.0	2.5	3.0	2.9	2.9	2.6
Enterprises	12.8	9.4	8.8	9.3	10.1	5.3	9.1	4.4	0.9	-0.6	-7.6	-8.8
					real y-o-y, in %							
M2[1)]	-5.4	-8.0	-1.2	2.7	10.1	12.0	3.4	-2.2	-2.6	-4.7	1.2	2.5
Credit to the non-government sector[2)]	4.5	-1.0	-1.1	0.5	10.5	8.1	5.9	-2.0	-8.2	-9.2	-8.9	-6.5
Credit to the non-government sector[2)], adjusted[3)]	1.8	0.2	2.2	0.9	4.9	-1.2	-3.6	-8.1	-8.7	-8.2	-8.5	-7.0
Households	9.2	7.0	7.8	-1.3	2.0	-2.4	-7.2	-9.2	-7.5	-6.1	-1.9	0.4
Enterprises	-1.6	-3.0	-0.5	2.1	6.3	-0.5	-1.7	-7.5	-9.3	-9.3	-11.8	-10.7
					in bilions of dinars, end of period							
M2[1)]	1,315.6	1,344.8	1,412.2	1,498.0	1,499.7	1,588.6	1,607.6	1,641.7	1,622.7	1,659.8	1,705.8	1,719.3
M2[1)] dinars	382.7	402.0	433.8	486.5	445.0	444.6	467.4	480.6	478.8	492.5	519.5	550.0
Fx deposits (enterprise and housholds)	932.9	942.8	978.3	1,011.5	1,054.7	1,144.0	1,140.2	1,161.1	1,143.8	1,167.3	1,186.3	1,169.3
					cumulative, in % of opening M2[4)]							
M2[1)]	-3.3	-1.2	3.8	10.1	0.1	6.1	7.3	9.6	-1.2	1.1	3.9	4.7
NFA, dinar increase	-1.9	-1.4	9.5	11.9	-5.6	-4.5	-7.9	0.2	7.2	2.7	5.2	10.6
NDA	-1.4	0.2	-5.7	-1.8	5.7	10.5	15.2	9.4	-8.4	-1.6	-1.3	-5.9

Source: NBS

1) Money mass: components – see Analytical and Notation Conventions *QM*.

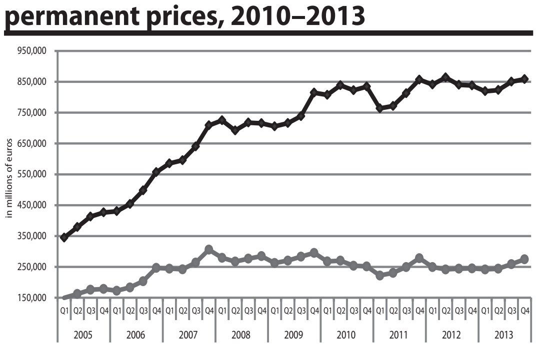
2) Credits to non-state sector – credit to the economy (including local government) and households.

3) Trends are corrected by exchange rate changes. Corrections are done with the assumption that 70% of credits to the non-state sector (households and the economy) are indexed in Euro.

4) Initial M2 designates the state of the M2 at the start of this ie the end of the previous year.

The greatest contribution to the growth of the nominal M2 at y.o.y. level of 4.72% came from the growth of M1 which in Q4 stood at 4.87 percentage points. The growth of the M1 was caused by an intervention of the NBS which bought foreign currency on the inter-banking foreign currency market in Q4 due to the appreciation of pressure on the Dinar exchange rate and the increased demand for cash which is characteristic for the end of the year. On the other hand there was no rise in the foreign currency deposits which could have been expected during savings week which led to this element contributing to the growth of M2 by just 0.5 percentage points while Dinar savings and timed savings had a negative effect on the growth of M2 of –0.65 percentage points.

Graph T7-5. State of money mass in permanent prices, 2010–2013



Source: *QM* calculation

1 Monetary aggregate M2 in section Monetary Trends and Policy includes the lesser aggregate M1, savings and timed deposits as well as foreign currency deposits in business banks. Because of that, aggregate M2 which we are observing is equal to monetary aggregaeu M3 in NBS reports.

Banking Sector: Placements and Sources of Financing

Debt repayment by the economy continues …

… with record 312 million Euro in Q4

The placements by the banking sector in Q4 recorded a slight rise of 87 million Euro which is just under the amount which business banks placed in the previous quarter (in Q3 they placed 102 million Euro, Table T7-6). The structure of the bank placements continues to be unfavorable because the economy is continuing to get rid of its debts and bank placements are growing solely on the basis of investments in REPO bonds and treasury bonds. The negative trend of debt repayment by companies which started in 2012 continued in 2013 with companies getting rid of 1,040 million Euro of debts including 312 million Euro in Q4 which is also a quarterly record. The high drop in credit in Q4 is owed partly to the fact that the Privredna Banka Beograd lost its licence in October which means that its placements were not included in the balance of the banking sector but the continued debt repayment is present even when we observe the other banks in the system. According to figures for October and November, there was a debt repayment by the economy on the basis of cross-border credits to the amount of 64 million Euro. An analysis of the domestic banking sector in Q4 shows that besides the economy, the population also got rid of 34 million Euro of its debts which can be explained partly with the seasonal effect while the placement at annual level is positive and stands at 143 million Euro.

Table T7-6. Serbia: bank operations – sources and structure of placements, corrected[1)] trends, 2011-2013

	2011				2012				2013			
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec
	in millions of euros, cumulative from the beginning of the year											
Funding(-, increase in liabilities)	603	69	-822	-1,083	672	692	472	-384	109	341	213	420
Domestic deposits	206	-148	-844	-1,169	589	146	15	-459	4	-56	-325	-394
Households deposits	-92	-295	-483	-655	-49	-189	-296	-578	-87	-132	-252	-423
dinar deposits	24	13	-68	-182	30	69	36	11	16	-34	-110	-279
fx deposits	-116	-308	-416	-473	-79	-258	-332	-589	-102	-98	-141	-144
Enterprise deposits	298	147	-361	-513	638	336	311	120	91	76	-73	29
dinar deposits	176	13	-128	-350	362	304	230	99	-11	-11	-109	-162
fx deposits	122	134	-233	-164	275	31	81	21	102	87	36	191
Foreign liabilities	580	634	678	545	3	345	335	127	357	406	588	806
Capital and reserves	-183	-416	-656	-459	80	200	123	-52	-252	-9	-50	8
Gross foreign reserves(-,decline in assets)	-720	-674	-517	-923	-199	371	164	284	-278	-104	84	-304
Credits and Investment[1)]	309	1,270	2,158	2,771	409	-424	201	521	123	-169	-67	20
Credit to the non-government sector, total	216	1,030	1,554	1,940	309	136	784	589	-23	-348	-551	-897
Enterprises	191	766	1,189	1,607	375	161	741	552	-71	-463	-728	-1,040
Households	25	263	365	333	-67	-25	42	37	48	115	177	143
Placements with NBS (Repo transactions and treasury bills)[2)]	86	268	529	720	-28	-944	-1,052	-701	321	319	492	628
Government, net[3)]	7	-28	75	111	128	385	470	632	-175	-140	-8	290
MEMORANDUM ITEMS												
Required reserves and deposits	-157	-429	-210	391	-552	-418	-451	-265	-17	-87	-443	-399
Other net claims on NBS[4)]	17	123	2	110	-199	-20	-42	58	-154	-85	118	102
o/w: Excess reserves	22	123	-3	100	-187	45	54	*10*	-151	-96	60	48
Other items[5)]	-136	-195	-246	-601	150	222	56	146	100	50	54	124
Effective required reserves (in %)[6)]	23	21	21	24	22	23	23	23	25	24	22	23

Source: NBS

1) Calculating revenue is done with the assumption that 70% if the overall placements are indexed in Euro. Revenu for original Dinar values of deposits is calculated using the average exchange rate for the period. For foreign currency deposits – as the difference in the state calculated by the exchange rate at the ends of the period. Capital and reserves calculated by Euro exchange rate at ends of period and do not include effects of exchange rate changes after calculation of remainder of balance.

2) NBS bonds include state bonds and NBS treasury bonds which are sold at repo rates and rates set by the market in regard to permanent auction sales with a due date of 14 days.

3) Net crediting of state: credit approved to state decreased by state deposits in business banks; negative prefix designates higher growth of deposits over credit. State includes all levels of government: republic and local.

4) Other debts to NBS (net): difference between NBS debts to banks on the basis of cash and dues to the NBS.

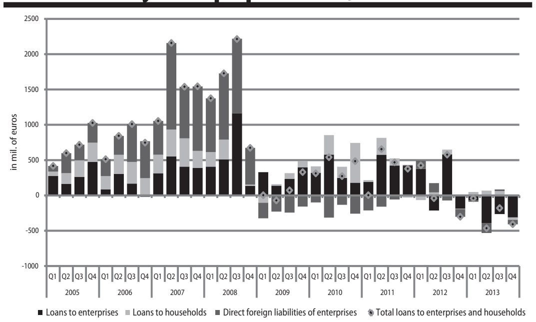
5) Items in bank balances: other assets, deposits by companies in bankruptcy, inter-banking relations (net) and other assets not including capital and reserves.

6) Effective mandatory reserve designates participation of mandatory reserves and deposits in overall deposits (population and economy) and bank debts abroad. The basis for mandatory reserves does not include subordinate debts which are not available.

Stability of the exchange rate and prices in Q4, in combination with the bad state of the economy motivated banks to increase their placement in REPO and treasury bonds

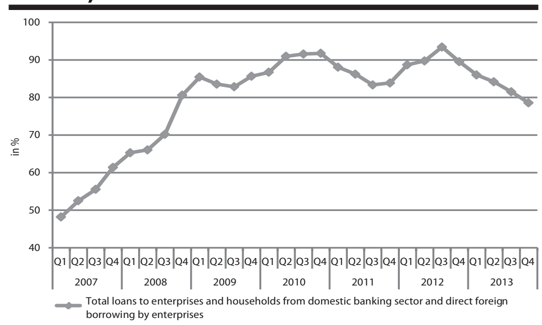
The increased liquidity was placed in Q4 in REPO to the amount of 136 million Euro which means that the REPO stock increased at annual level by 628 million Euro. Using strong interventions on the foreign currency market in the third quarter the NBS sent investors the message that it would prevent a sudden depreciation of the Dinar. The announced stability of the Dinar in combination with high Dinar interest rates made the placement in REPO bonds and treasury bonds risk-free (in relation to the changes of the exchange rate) and very profitable. We feel that the maintaining of the key policy rate at 9.5%, in combination with strong interventions on the foreign currency market, sends a signal to investors that the Dinar exchange rate will be stable at least in the short term. Also, a part of the liquidity of banks spilled over into the purchase of treasury bonds – in Q4 the value of sold treasury bonds issued in Dinars stood at 1.052 billion Euro including 600 million which is income from investments in treasury bonds. Also, bonds were issued in the same period denominated in Euro amounting to 334.7 million Euro, including some 247 million Euro used to pay earlier issue Euro bonds while the revenue from investments in treasury bonds stood at 88 million Euro. Add all that up and the conclusion is that banks in Q4 of last year increased their investments in Dinar and foreign currency treasury bonds by about 700 million Euro.

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



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

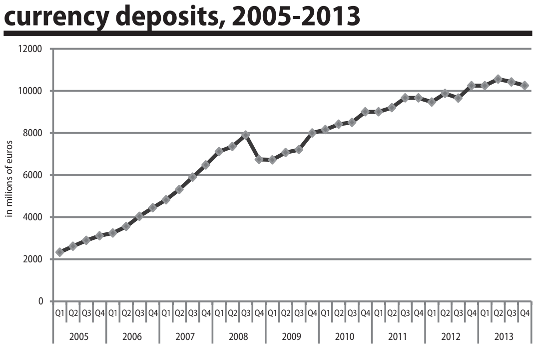
Graph T7-8. Serbia: overall credit debt in % of GDP, 2007-2013



Source: *QM* calculation

Business banks recorded a drop in foreign sources for new placements in Q4 besides the drop in placement to the economy and the population. In the last three months of 2013, sources for new placement were reduced by 207 million Euro and by 420 million Euro for the entire year, Table T7-6. Sources for placement were reduced because domestic banks reduced their dues in foreign currency on the basis of loans taken from their head offices abroad by 218 million Euro and also reduced the capital and reserves of banks by 58 million Euro. In regard to domestic sources, deposits by the population increased in Q4 by 171 million Euro which were almost entirely in Dinars while just three million were deposited in foreign currency. Although that period, because of savings week in previous years, was characterized by a growth of foreign currency deposits, interest rates on savings in Euro were significantly lower than savings in Dinars which, along with the expected stability of the exchange rate and high interest on Dinar savings, caused the population to choose savings in Dinars. We feel that this is a positive change in the behavior of the population which up until now regularly laid their trust in foreign currency savings despite the fact that Dinar savings were more profitable over the past five years. The reduction in new placements was also caused by the withdrawal of deposits by the economy which appears regularly at the end of the year and which stood at 102 million Euro in Q4. If we consider the data on sources and placements in 2013, we can conclude that the high growth in REPO and state bonds, combined with the bad financial situation in companies, turned business banks towards crediting of the state and not the economy. This situation in which the state takes out loans and the economy reduces its debts is not tenable for long. That is why measures are needed to reduce the fiscal deficit so that the state will take out less loans in future and measures to resolve the financial problems in the company sector to stimulate growth in banks crediting companies and subsequently see a growth in investments and employment.

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



Source: NBS

If we know that, based on current performances, most of the Serbian economy still has not pulled out of the recession and is late in repay-

Active state participation is necessary in resolving the problem of excessive debts in big companies

ing loans, the question that arises is whether there is room for new credit lines with the existing level of debt at current interest rates. The answer to that question is negative and was given by banks over the past two years. On the other hand, if the state does not participate actively in resolving the financial problems of large private companies, much deeper problems will be generated and that will result in much higher losses for the state in the future. Also, interventions by the state should be focused on improving regulations (bankruptcy and other) with the aim of motivating company owners and banks as creditors to take timely measures to restructure companies or launch receivership if that is not possible. The state as a creditor on the basis of unpaid taxes should play a significant role in the process of restructuring or company receivership.

Table T7-10. Serbia: particpation of bad loans according to debt or type, 2009-2013

	2009	2010	2011				2012				2013				
	Dec	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Feb
	balance at the end of period														
Corporate	12,14	14,02	14,39	16,23	17,44	17,07	17,72	19.26	19,04	19.06	22.62	27.77	31.13	27.76	29.08
Entrepreneurs	11,21	15,8	15,66	15,75	16,99	17,07	16,05	18.47	17,56	15.92	16.79	18.19	20.86	20.82	21.47
Individuals	6,69	6,71	6,79	7,1	7,4	7,24	7,57	7,69	8,05	8.32	8.44	8.37	8.14	8.59	8.77
Ammount of dept by NPL (in milions of euros)	1.58	1.94	2.09	2.46	2.64	2.63	2.67	2.71	2.97	3.19	3.87	4.47	4.82	4.09	4.20

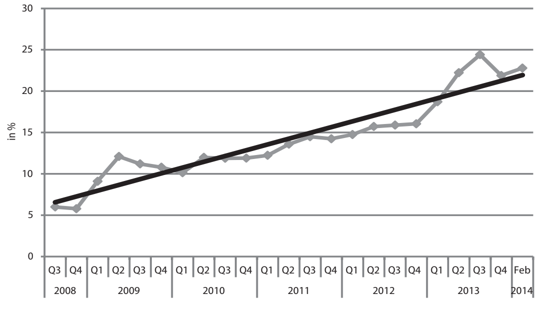
Source: *QM* calculation

Revoking the licence of the UBB caused a drop in the participation of bad loans …

… but the negative trend was not stopped according to figures for January and February

Following the strong increase in bad loans in Q3, an improvement was recorded in this segment to the end of 2013 in the form of a decrease in the overall participation to 21.89% (participation in Q3 stood at 24.41%, Graph T7-11). This is also the first time since 2010 that a significant reduction in participation in this segment was recorded but data from January and February 2014 showed that there were just short-term changes in level but not in the trend. The drop in the participation of bad loans was not the consequence of an improvement of the situation in the economy but of the fact that in October 2013, a third foreign-owned bank the Privredna Banka Beograd (PBB) lost its license following the Agrobanka and Razvojna Banka Vojvodina (RBV). The revoking of the license meant that the PBB balance position was excluded from the balance of the banking sector which gives us a clear picture of the level of bad loans in this bank even though we are bearing in mind the fact that the participation of bad loans in the entire banking sector was reduced by some 2.5 percentage points following the exclusion of this bank. The biggest individual reduction was recorded in bad loans to companies which stood at 27.76% at the end of Q4 (at the end of Q3 the participation of bad loans with companies stood at 31.13%, Table T7-10), while the participation of bad loans placed with private individuals continued to rise following a drop in Q3 and stood at 8.59% at the end of Q4. In January, the Univerzal Bank Beograd (UBB) also lost its license which shows the gravity of the problem of bad management in domestic banks and the danger of negative effects spilling over to the rest of the banking sector. The NBS revoked the UBB license as a measure of prevention to avoid a repeat of the scenario with the first three banks whose recovery cost some 800 million Euro but despite that public finances will continue to be exposed because of the fact that deposits of up to 50,000 Euro are guaranteed by the state. Despite the fact that the UBB lost its license in January, figures from the end of February back up our view expressed in previous issues that bad loans are a problem for the entire banking sector and that the real situation is probably even worse than statistics are showing. Although the NBS has taken certain measures to reduce the participation of bad loans[2], the effects to date are far below the level that would indicate that we could expect significant reductions in the amount of bad loans in the Serbian banking sector in the medium term. On the basis of the stable trend of growth of bad loans, it seems that an active engagement by the state as regulator and creditor is needed to resolve problems in companies whether by restructuring or by change of owner.

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



Source: *QM* calculation

2 By changing regulations in December 2012, the NBS enabled the passing of debts due to banks to persons outside the financial sector with the consequence of increasing the credit ability of banks thanks to the freeing of previously formed reservations for credit losses.