

7. Monetary Trends and Policy

Due to strong depreciation pressure on the exchange rate, the NBS stepped up its interventions on the inter-banking foreign currency market which resulted in the decrease of the primary issue in Q1. Despite an intervention of about 490 million Euro, the Dinar exchange rate continued to weaken which had a negative effect on a majority of economic indicators. The trend of inflation weakening continued from the start of the year leading the NBS to additionally lower the key policy rate in January to 9.5%. Along with this measure the NBS changed the Decision on mandatory reserves covering hard currency sources of financing to additionally relieve hard currency liquidity and stabilize the exchange rate in April but with no great effect on the depreciation trend. The real growth of the money mass following the correction to the exchange rate year on year stands at around 5% which is the result of the effects of a somewhat lower base and slight increase in overall credit placements with the economy. Compared to the end of last year, M2 dropped in real terms by about 4%. The placement of the banking sector in Q1 is at a somewhat higher level compared to the same period of last year. Most of the growth of the placements is in the economy which the state also increased its indebtedness. On the source side, there is a drop in Q1 because the economy withdrew deposits of some 640 million Euro which strengthened the decrease of capital in the banking sector of 80 million Euro. The negative trend of increasing unpaid loans continued in Q1 as the consequence of an increase in tardiness in collecting loan payments from companies.

Central Bank: Balance and Monetary Policy

Significant drop in primary issue in Q1...

... as consequence of NBS interventions on inter-banking foreign currency market

From the start of the year, the NBS has faced things in the Serbian economy which had divergent effects on the further implementation of monetary policy. On one hand, price stability which was established at the end of last year with year on year inflation at the lower level of the target corridor confirms that the path monetary policy took in 2011 was right. On the other hand, other indicators of macroeconomic position in Q3 deteriorated. The fast depreciation of the Dinar, recession trends in the real sector, deterioration of balance of payments trends¹ with an expected rise of inflation by the end of the year² show that low inflation in Q1 was not such a big success. If the trend continues, which is very likely, the NBS will have to introduce much more concrete (unpopular) measures to protect the basis of the monetary system. Following a year of stability on the inter-banking foreign currency market, constant pressure on the Dinar forces the NBS to step up its interventions in Q1. For that purpose, the NBS sold about 490 million Euro in Q1 (Table T7-1) which resulted in just an easing of the drop. As a consequence of the sale of the foreign currency, the net own reserves on the NBS balance recorded a drop of -17.6% of the value of the primary issue at the start of the year. This drop and slight increase of net domestic assets (NDA) the sum effect on *primary money* at the end of Q1 is negative and stands at 15.2% of the level of primary money at the start of the year.

The repo stock after almost a year of increases in Q1 recorded a drop. Following increased placements in January and no activity in February, banks withdrew some 150 million Euro in March which led to a decrease of 28 million Euro in REPO placements in Q1. An additional drop in REPO stock (Table T7-1) came about because of the effects of the depreciation of the Dinar because of which the repo rate was corrected by the changes in the exchange rate at the end of Q1 was negative and stood at -19.08%. In the same period, auctions of treasury bonds collected about 855 million Euro which is a significant growth compared to the previous quarter (in Q4 2011 bond sales at auction brought in some 340 million Euro). In Q1 the level of sales of treasury bonds at auction improved significantly compared to the end of last year when it exceeded 40% of the issue on offer in only a few cases. The increased realization came happened thanks in part to

¹ More details on growth of foreign trade deficit in section Balance of Payments and Foreign Trade

² Inflation growth can be expected because of the fact that the program of fiscal consolidation announced an increase of the VAT rate as well as the wasting of the effect of high base for calculation of year on year inflation (see section "Prices and the Exchange Rate")

the drop in the key policy rate which led banks to transfer funds placed in REPO to the purchase of treasury bonds which are more profitable.

Table T7-1. Serbia: NBS Interventions and Foreign Currency Reserves 2009-2012

	2009				2010				2011				2012
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar
Repo stock (in millions of euros)	1,050.96	1,276.77	1,721.12	1,593.79	1,406.63	1,037.51	626.87	449.00	549.77	746.09	1,000.42	1,174.84	1,055.98
NBS interest rate	16.50	13.00	12.00	9.50	9.00	8.00	9.00	11.50	12.25	12.00	11.25	9.75	9.50
NBS interest rate ¹⁾	15.08	12.00	11.18	8.91	8.60	7.68	8.36	10.44	10.74	10.65	10.29	9.11	9.21
NBS interest rate ²⁾	5.13	27.04	11.51	-31.19	-2.30	-19.45	3.20	21.90	13.99	-7.14	25.90	6.51	-19.08
NBS interventions on FX market (in millions of euros)	-513.00	46.00	18.20	-80.90	-631.50	-785.00	-595.20	-321.50	5.00	-30.00	-30.00	-30.00	-488.50
INCREASE													
	cumulative, in % of opening H³⁾												
NBS own reserves ²⁾	-1.9	-4.0	9.6	20.8	-15.3	-31.2	-57.5	-61.0	-8.9	14.0	26.8	73.9	-17.6
NDA	-13.8	-17.4	-38.4	-40.9	-0.3	4.5	30.6	33.6	-0.7	-15.5	-28.6	-51.8	2.4
Government, dinar deposits	-5.6	-2.7	1.0	-13.0	2.7	4.8	7.9	3.1	-4.6	-3.3	3.6	2.7	-5.1
Repo transactions ³⁾	-2.8	-9.4	-22.6	-19.9	4.9	14.2	35.4	42.5	-6.9	-15.3	-32.2	-47.5	2.2
Other items, net ⁴⁾	-5.4	-5.2	-16.7	-8.1	-7.9	-10.4	-8.6	-7.9	10.9	3.1	0.0	-7.0	5.3
H	-15.7	-21.4	-28.8	-20.1	-15.6	-26.7	-26.9	-27.3	-9.6	-1.5	-1.8	22.1	-15.2
o/w: currency in circulation	-3.8	-2.9	-2.3	1.8	-3.9	-3.2	-2.3	-1.5	-5.8	-4.2	1.3	12.4	-3.3
o/w: excess liquidity	-13.3	-13.4	-16.5	-16.5	-13.7	-12.5	-8.6	-6.8	-3.8	2.5	-5.5	6.3	-13.6
	in millions of euros, cumulative from the beginning of the year												
NBS, net	-37.96	23.11	681.73	1,446	-183	-389	-990	-1,059	56	282	1,374	2,203	-1,070.60
Gross foreign reserves	-25.10	732.72	1,371.41	2,477	-135	5	-637	-654	16	308	1,426	2,334	-1,138.11
Foreign liabilities	-12.86	-709.61	-689.68	-1,031	-49	-393	-353	-405	41	-26	-52	-131	67.51
IMF	-5.40	-760.71	-747.41	-1,104	-47	-386	-356	-408	37	-32	-59	-132	58.24
Other liabilities	-7.46	51.09	57.72	74	-2	-7	3	3	4	6	7	1	9.27
	0												
NBS, NET RESERVES-STRUCTURE	0												
1. NBS, net	-37.96	23.11	681.73	1,446	-183	-389	-990	-1,059	56	282	1,374	2,203	-1,070.60
1.1 Commercial banks deposits	52.72	-92.92	-280.43	-725	-115	-393	-377	-374	22	226	109	-462	459.45
1.2 Government deposits	-76.30	-61.30	-82.21	-54	-80	39	22	18	-232	-258	-1,009	-455	263.40
1.3 NBS own reserves (1.3 = 1 - 1.1 - 1.2)	-61.54	-131.11	319.09	668	-378	-743	-1,346	-1,415	-154	250	474	1,286	-347.74

Source: NBS.

1) State includes all levels of government: republic and all local government levels.

2) Definition of NBS net own reserves is provided in section 8 Monetary Trends and Policy, Frame 4, QM no. 5.

3) This category includes Treasury Bonds NBS (BZ), and repo operations.

4) Other domestic assets include: domestic loans (net bank debts not including BZ and repo transactions; net economy debts) together with other assets (capital and reserves; and items in balance: other assets and other assets and liabilities) and corrected by exchange rate differentials.

NBS additionally lowers key policy rate...

... because of weaker inflation in Q1

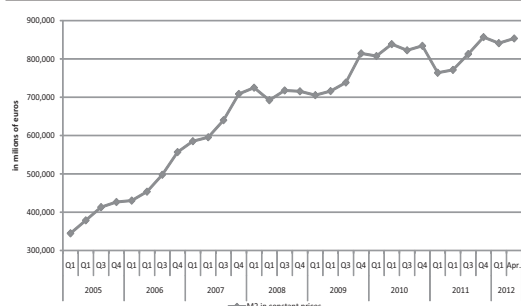
Due to a drop in the inflation rate in Q1, the NBS decided at a session of its executive board in January to correct the key policy rate by 0.25 percentage points and it now stand at 9.5%. Bearing in mind the effect this interest rate has on the interest rates of commercial banks and the low level of credit activity, the question is whether the NBS could have lowered the rate earlier to ease the conditions for new debts. Along with the change in the key interest rate, the NBS in April changed the decision on the level of mandatory reserve for hard currency sources with the rate lowered to 22% for sources of financing with a due date of more than three years and to 29% for debts with a shorter due date. The new decision raise the obligation of Dinar allocation of the mandatory hard currency reserve under differentiated rates from 20% for sources of up to two years and 15% for those with due dates of more than two years. The increase in the part of the mandatory hard currency reserve in Dinars is meant to sterilize part of the Dinar funds which, in combination with the releasing of foreign currency funds from the mandatory reserve, should ease the depreciation pressure on the exchange rate. This measure, because of large balance of payments problems and unresolved fiscal consolidation, failed to achieve any great success over the past two months.

Monetary System: Structure and Trends of the Money Mass

*Real growth of money mass at year on year level speeds up in Q1 ...
... but record dropped compared to previous quarter*

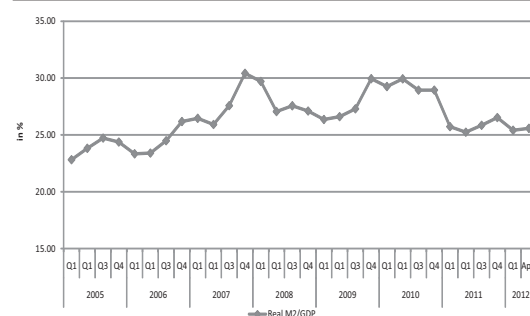
The money mass recorded a growth of 10.1% in real terms year on year in Q1 which is the result of increased credit placements in the non-state sector of 10.5% at year on year level as well as the somewhat lower base in Q1 of 2011. Following the correction in the Dinar exchange rate the real year on year credit growth rate stands at 4.9% (Table T7-4). Due to the significant effect of the Dinar depreciation in the first three months, the state of the money mass (M2) in the first three months is almost unchanged compared to the end of 2011 despite the positive effect of the increase in the NDA.

Graph T7-2. State of money mass in permanent prices, 2005–2012



Source: FREN

Graph T7-3. Serbia: trends of money mass as percentage of GDP, 2005–2012



Source: FREN

The participation of the hard currency deposit increases with the growth of the money mass...

...while other elements record drops

The year on year M2 growth rate in Q1 which stood at around 14% was dominantly affected by an increase of the hard currency deposits at a rate of 9.26% year on year (in Q4 2011 the deposit growth rate stood at 4.5% year on year). Other elements in the same period recorded drops in their contribution to the M2 growth, primarily in savings and time deposits with a rate of 1.97% year on year (in Q4 2011 the contribution of savings and time deposits stood at 2.64% year on year) and the M1 which has dropped slightly compared to the previous quarter. The noted changes within the framework of the mentioned aggregates can be explained with the effect that the constant depreciation of the Dinar in Q1 had on the currency structure of deposits. The state also contributed to the overall change by spending funds from own hard currency deposits with the NBS and new issues of treasury bonds which recorded higher realization rates compared to the previous period.

Table T7-4. Serbia: growth of money and aggregates contributing to it, 2009–2012

	2009				2010				2011				2012
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar
	y-o-y, in %												
M2 ¹⁾	6.5	12.1	10.4	21.3	19.9	22.1	20.1	13.1	8.0	3.7	8.1	10.1	14.0
Credit to the non-government sector ²⁾	33.8	27.7	22.3	16.1	14.4	25.0	27.1	27.2	19.3	11.6	8.3	7.7	14.4
Credit to the non-government sector ²⁾ , adjusted ³⁾	20.9	13.9	7.7	10.2	10.4	16.2	16.8	19.9	16.7	13.0	11.8	8.1	8.6
Households	7.4	1.5	4.4	3.7	7.9	16.1	18.7	18.9	25.1	20.6	17.8	5.7	5.7
Enterprises	28.7	20.9	9.3	13.6	11.6	16.3	15.8	20.4	12.8	9.4	8.8	9.3	10.1
	real y-o-y, in %												
M2 ¹⁾	-2.7	3.5	2.9	13.8	14.5	17.1	11.4	2.4	-5.4	-8.0	-1.2	2.7	10.1
Credit to the non-government sector ²⁾	22.2	17.9	14.0	9.0	9.1	19.9	17.9	15.0	4.5	-1.0	-1.1	0.5	10.5
Credit to the non-government sector ²⁾ , adjusted ³⁾	10.2	4.3	-0.5	3.2	5.3	11.3	7.8	7.9	1.8	0.2	2.2	0.9	4.9
Households	-2.1	-7.1	-3.6	-2.9	2.9	11.1	9.6	16.8	9.2	7.0	7.8	-1.3	2.0
Enterprises	17.3	10.7	1.0	6.4	6.5	11.3	6.9	3.7	-1.6	-3.0	-0.4	2.1	6.3
	in billions of dinars, end of period												
M2 ¹⁾	1,015.4	1,061.7	1,087.2	1,204.0	1,217.8	1,296.2	1,306.0	1,360.8	1,315.6	1,344.8	1,412.2	1,498.0	1,499.7
M2 ¹⁾ dinars	378.1	401.1	417.0	436.8	403.7	417.9	403.0	410.5	382.7	402.0	433.8	486.5	445.0
Fx deposits (enterprise and households)	637.3	660.6	670.2	767.2	814.0	878.2	903.0	950.3	932.9	942.8	978.3	1,011.5	1,054.7
	cumulative, in % of opening M2⁴⁾												
M2 ¹⁾	2.3	6.9	9.5	21.3	1.1	7.7	8.5	13.1	-3.3	-1.2	3.8	10.1	0.1
NFA dinar increase	2.2	0.4	3.6	8.9	-0.9	-0.6	-1.7	-5.3	-1.9	-1.4	9.5	11.9	-5.6
NDA	0.1	6.5	6	12.4	2.1	8.3	10.2	18.4	-1.4	8.3	-5.0	-1.8	5.7

Source: NBS

1) Money mass: components – Analytical and notation conventions QM.

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

3) Trends are corrected for exchange rate changes. Correction were conducted on assumption that 70% of loans to non-state sector (both households and economy) indexed against the Euro.

4) Initial M2 signifies state of M2 at start of respective, that is end of previous year.

Banking Sector: Placements and Sources of Financing

Credit placement from domestic sources slower...

... while slight growth of cross-border continues in Q1

Compared to the last quarter of 2011, the credit activities of the domestic banking sector slow slightly in Q1. Domestic banks placed a total of 309 million Euro with the economy and population in Q1 (in Q4 2011 386 million Euro were placed, Table T7-5). The growth of overall placement is completely the result of the increased debts of the economy by 375 million Euro, while in the same period the population continued to repay debts to banks by 67 million Euro (in Q4 2011, the population lowered its debts by 32 million Euro). A segment of the subsidized loans also continued slowing down its activities due to the fact that the only funds remaining are for subsidized housing loans. In Q1 some 90 million Euro in subsidized loans were approved, and in the coming period we cannot expect any significant growth of credit activity in this segment. As positive, we assess the increase of cross-border loans for the second quarter in a row, which rose in Q1 by 115 million Euro. On that basis, the credit placement in Serbia from domestic and foreign sources in Q1 increased by 470 million Euro. In the same period, the participation of credits in the GDP rose to 87% in Q1 (Graph T7-7). This growth came about as the result of two combined effects from the start of the year. The smaller part is the noted growth of the overall credit placement in Q1 while the larger part is the consequence of the depreciation of the Dinar bearing in mind the large-scale Euro-ization in Serbia which had an effect on the rise in the overall debts in Dinars.

Table T7-5. Serbia: bank operations – sources and structure of placements, correct¹⁾ trends, 2009-2012

	2009				2010				2011				2012
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar
<i>in millions of euros, cumulative from the beginning of the year</i>													
Funding(+, increase in liabilities)	958	61	-1,171	-2,790	7	-117	-68	-1,495	603	69	-822	-1,083	672
Domestic deposits	235	-336	-691	-1,633	131	-233	-236	-836	206	-148	-844	-1,169	589
Households deposits	-40	-270	-551	-1,314	-137	-323	-500	-1,020	-92	-295	-483	-655	-49
dinar deposits	46	-2	-30	-89	30	21	25	12	24	13	-68	-182	30
fx deposits	-87	-268	-521	-1,225	-167	-343	-525	-1,032	-116	-308	-416	-473	-79
Enterprise deposits	276	-67	-140	-319	268	89	264	184	298	147	-361	-513	638
dinar deposits	171	5	-174	-284	213	84	232	151	176	13	-128	-350	362
fx deposits	105	-72	34	-35	55	5	32	33	122	134	-233	-164	275
Foreign liabilities	299	186	-558	-1,271	-196	40	90	-563	580	634	678	545	3
Capital and reserves	424	212	78	114	72	77	78	-96	-183	-416	-656	-459	80
Gross foreign reserves(-, decline in assets)	-407	-449	-5	311	53	-120	197	430	-720	-674	-517	-923	-199
Credits and investment¹⁾	156	1,057	1,980	2,844	397	1,279	1,281	2,285	309	1,270	2,158	2,771	409
Credit to the non-government sector, total	226	381	696	1,183	411	1,264	1,669	2,434	216	1,030	1,554	1,940	309
Enterprises	331	465	700	1,097	319	897	1,142	1,756	191	766	1,189	1,607	375
Households	-104	-84	-4	86	91	368	527	678	25	263	365	333	-36
Placements with NBS (Repo transactions and treasury bills)	40	256	694	625	-125	-445	-839	-1,010	86	268	529	720	-28
Government, net ²⁾	-105	421	590	1,036	112	460	451	861	7	-28	75	111	128
MEMORANDUM ITEMS													
Required reserves and deposits	-191	-225	-185	36	54	-182	-188	-115	-157	-429	-210	391	-552
Other net claims on NBS ³⁾	-385	-380	-481	-158	-287	-272	-195	-229	17	123	2	110	-199
o/w: Excess reserves	-409	-394	-501	-177	-279	-252	-173	-220	22	123	-3	100	-187
Other items ⁴⁾	-166	-158	-254	-99	-147	-331	-692	-565	-136	-195	-246	-601	150
Effective required reserves (in %) ⁵⁾	30	28	26	25	26	24	24	23	23	21	21	24	22

1) Calculating the rise is done with the assumption that 70% of the overall placement is indexed against the Euro. The rise for original Dinar values of deposits are calculated on the average exchange rate for the period. For hard currency deposits – as the difference calculated by the exchange rates at the ends of the periods. Capital and reserves are calculated by the exchange rate at the ends of the period and do not include the effects of the changes in the exchange rate from the calculation of the remaining balance.

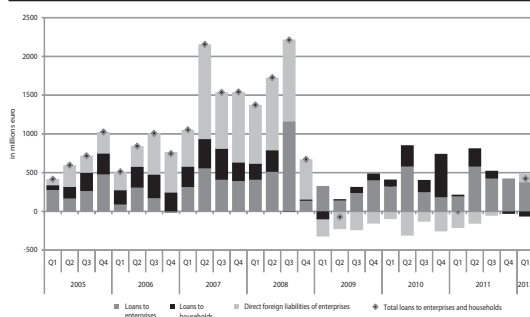
2) NBS bonds include state bonds and treasury bonds sold at the repo rate and a rate set on the market for permanent auction sales with a due date of more than 14 days.

3) Net state crediting: credits approved to the state are decreased by the state deposit in business banks; the negative prefix signifies a higher growth of deposits than loans. The state includes all levels of government: republic level and local government level.

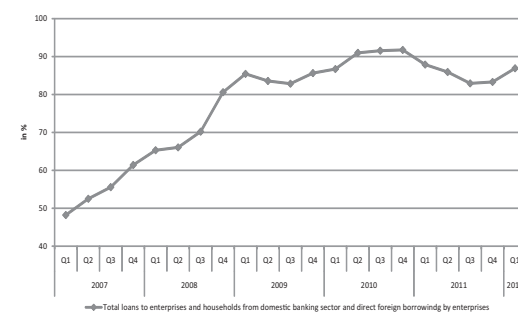
Sources for new placements of banks drop in Q1...

...due to withdrawal of economy deposits

We note on the side of the sources for new bank placements that as in previous year there is a drop in this period which in Q1 stood at 672 million Euro (Table T7-5). This decrease is in large part the product of the withdrawal of economy funds from their accounts totaling 638 million Euro, both in Dinars and in hard currency. Somewhat the drop in sources was caused by the withdrawal of 80 million Euro from the accounts of capital and bank reserves. The only element which had a positive effect in Q1 were hard currency deposits by the population which increased by some 80 million Euro which is mainly the consequence of the strengthening of the Euro while the opposite effect on the Dinar deposit side saw a reduction. Following the NBS decision to lower the rate of the mandatory hard currency reserve in April we expect the released part of the reserves to neutralize the lowering of the source for new credits which was recorded in Q1.

Graph T7-6. Serbia: economy and population debts, 2005-2012

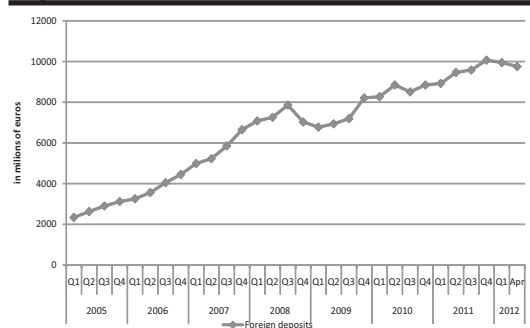
Source: FREN

Graph T7-7. Serbia: overall loan debts in % of GDP-a, 2005-2012

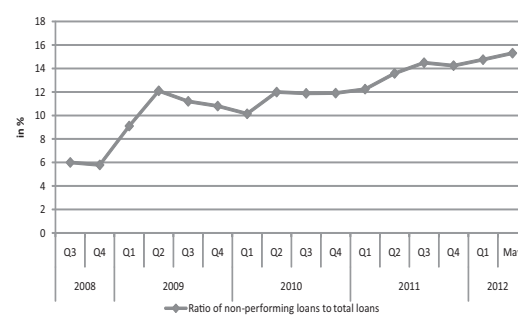
Source: FREN

No sign of improvement in segment of non-collectable loans

The trend of an increase in the participation of non-collectable loans in the overall placement continued in Q1. From the start of the year, the overall participation of non-collectable loans rose to 14.75% of the overall placement sum at the end of March (Graph T7-10). The increase of the participation is noted within the credits placed with private individuals but the growth in the participation of non-collectable loans to companies to 17.72% (in Q4 2011 that participation stood at 17.07%) had the greatest effect since these credits also have the highest level of participation in the overall mass of approved loans. The bad situation in the banking sector is reflected by the fact that despite the introduction of receivership in the Agrobanka A.D. since May when its operating license was revoked because it had insufficient capital for risk insurance in credit operations. At present there are several other banks which are at high risk in their credit operations and are under NBS scrutiny and there is a possibility that they could face the same scenario as the Agrobanka unless they introduce significant changes in their operations.

Graph T7-8. Serbia: level of hard currency deposits, 2005-2012

Source: NBS

Table T7-9. Serbia: participation of non-collectable debts by type of debtor, 2008-2012

Source: FREN

Graph T7-10. Serbia: participation on non-collectable loans in overall placement, 2008-2012

	2008		2009				2010				2011				2012	
	Dec.	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	May	
	balance at the end of period															
Corporate	6.86	11.05	14.86	13.24	12.14	11.62	14.18	13.83	14.02	14.39	16.23	17.44	17.07	17.72	19.07	
Entrepreneurs	3.66	5.28	8.93	10.21	11.21	12.19	13.73	15.7	15.8	15.66	15.75	16.99	17.07	16.05	17.86	
Individuals	3.78	5.36	6.19	6.63	6.69	6.37	6.79	7.04	6.71	6.79	7.1	7.4	7.24	7.57	7.45	

Source: FREN