

7. Monetary Trends and Policy

Maintaining the y.o.y. inflation rate below the target framework opened room for the NBS to further relax its monetary policy in Q2. Following a series of corrections by 0.5 percentage points, the key policy rate at the end of Q2 was at the level of 6% and was lowered by the NBS in August and September to the current 5%. The monthly inflation rate which was negative in May and July with a stable exchange rate increased the profitability of REPO bonds which showed a growth in Q2. Liquidity of the banking sector which increased on the basis of growing deposits by the enterprises and the households has been transferred into REPO. This led to a reduction of the money mass. The overall money mass was still increased thanks to NBS interventions on the inter-banking foreign exchange (FX) market on which it was a net buyer of hard currency in Q2 to the amount of 120 million Euro. The placements of business banks in Q2 rose mainly on the basis of the purchase of REPO bonds and the rise in net placements to the households of 75 million Euro. This growth was almost annulled with new repayments by the enterprises of 121 million Euro to domestic banks with an additional 31 million Euro on the basis of the repayment of cross-border loans. The continuing debt repayment by the enterprises is a serious obstacle to future economic growth. Confirmation of this is visible through the NPL trend which in Q2 rose to 23% of the overall placements but because of significant oscillations in the data from the Credit Bureau on bad loans we accept this growth with the reservation that their real participation is somewhat lower.

Central Bank: Balance and Monetary Policy

NBS continues to relax monetary policy

Despite expectations by the National Bank of Serbia (NBS) from the end of last year that the y.o.y. inflation rate will fall back into the target framework in mid-2015, it dropped to the level of 1.1% in July. The monthly inflation rate, which is perhaps a better indicator for the implementation of monetary policy, was negative in May and July which suggests that we still cannot talk about the recovery of the aggregate demand in Serbia. Due to the extremely low inflation rate, the NBS acted three times in Q2 to correct the key policy rate. The rate was first lowered to 7% in early April and two more corrections of 0.5 percentage points were undertaken in mid-May and June. In July, the NBS kept the key policy rate at the level of 6% and in mid-August it was lowered to 5.5%. Finally, in first half of September another correction took place after which key policy rate stood at current 5%. This policy reflects the ex-post reactive policy by the NBS rather than an adequate pro-active approach to controlling inflation within the defined corridor. The concluding of the arrangement with the International Monetary Fund and positive trends in public finances contributed to increasing stability in the monetary sector as well. The stability of prices and the exchange rate are good results but we cannot ignore the drop in credit activities by banks since without credit activities we cannot expect a permanent recovery of the economy. Unlike the negative trend in terms of credit placement, the liquidity of the banking sector increased in Q2 due to the growth of deposits by the enterprises and the households as well as an increase of the capital of business banks. The growth of sources did not find its way to new users of credit services but thanks to low and stable inflation and a stable Dinar exchange rate it spilled over to the placements into REPO bonds. Placements in REPO bring certain yields which are relatively high in conditions of a stable Dinar exchange rate and low interest rates on the world market.

Purchase of hard currency on inter-banking FX market affects growth of net own reserves ...

There were no greater imbalances between the offer of and demand for hard currency on the inter-banking FX market in May and June, but the NBS was once again a net buy to the amount of 120 million Euro (Graph T7-2) because of appreciation pressure in April at the level of Q2. In July it had to react again with the purchase of 230 million Euro which means that in the first seven months of the year the NBS created Dinar liquidity through the net purchase of hard currency on the inter-banking FX market to the amount of 520 million Euro. Although NBS interventions in the past were mainly aimed at preventing any sudden and greater weakening of the Dinar exchange rate, we believe that the fact that despite the existence of appreciation

and indirectly growth of primary money

pressure from the start of the year, the Dinar did not strengthen significantly against the Euro is positive. The current position of the NBS in terms of exchange rate policy is unfortunately caught between a foreign trade imbalance which obviously demands an additional depreciation on the one hand and the problems in the banking sector caused by the high participation of indexed loans which are in constant danger of moving into the segment of bad loans if the Dinar weakens. Because of that the exchange rate policy which is being implemented is more of a forced compromise than it is in the function of developing the economy.

The purchase of hard currency on the inter-banking FX market caused the NBS net own reserves to record an increase in Q2 of 31 million Euro (in Q1 those net own reserves were increased by 489 million Euro, Table T7-1).

Table T7-1. NBS interventions and foreign currency reserves 2013-2015

	2013				2014				2015	
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun
Repo stock (in millions of euros)	678.86	663.82	832.03	966.40	783.96	824.19	387.39	69.48	2.85	168.72
NBS interest rate	11.75	11.00	11.00	9.50	9.50	8.50	8.50	8.00	7.50	6.00
NBS interest rate	6.95	3.31	13.24	10.38	4.38	5.09	6.78	10.63	-1.13	3.08
NBS interest rate	19.25	12.85	12.83	9.25	5.28	7.08	0.03	-1.94	11.33	5.70
NBS interventions on FX market (in millions of euros)	10.00	-215.00	-140.00	375.00	-800.00	-630.00	-855.00	-1620.00	170.00	290.00
INCREASE										
	cumulative, in % of initial M2¹⁾									
NBS own reserves ²⁾	12.5	7.1	17.9	43.2	-31.2	-4.9	2.0	-6.6	33.5	22.50
NDA	-15.3	-3.9	-16.2	-31.3	12.2	-11.4	-7.6	15.6	-28.4	-16.20
Government, dinar deposits ³⁾	1.0	-1.2	-4.7	-19.9	3.3	-14.6	-24.3	-9.5	-8.4	-0.50
Repo transactions ⁴⁾	-16.0	-14.7	-23.8	-30.7	9.2	6.5	28.9	46.0	3.7	-3.40
Other items, net ⁵⁾	-0.3	12.0	12.4	19.3	-0.3	-3.4	-12.2	-20.9	-23.8	-12.30
H	-2.8	3.3	1.7	12.0	-19.0	-16.3	-5.6	9.0	5.1	6.30
o/w: currency in circulation	-3.9	-0.7	1.0	5.4	-5.2	-3.5	0.5	3.7	-7.4	-3.40
o/w: excess liquidity	0.6	2.1	-1.4	4.4	-12.1	-11.6	-7.3	-0.6	11.6	8.10
	in millions of euros, cumulative from the beginning of the year									
NBS, net	30.01	-992.01	-1041.50	943.97	-608.63	-725.22	169.79	-778.03	-101.66	-216.59
Gross foreign reserves	-385.77	-1576.91	-1822.60	240.33	-793.11	-1090.74	-276.23	-1309.69	-671.02	-868.83
Foreign liabilities	415.78	584.90	781.10	703.63	184.49	365.52	446.02	531.66	569.35	652.24
IMF	401.14	568.40	759.83	695.60	182.35	364.90	446.72	539.97	579.34	646.52
Other liabilities	14.65	16.50	21.27	8.03	2.14	0.61	-0.70	-8.31	-9.98	5.73
NBS, NET RESERVES-STRUCTURE										
1. NBS, net	30.01	-992.01	-1041.50	943.97	-608.63	-725.22	169.79	-778.03	-101.66	-216.59
1.1 Commercial banks deposits	911.80	967.01	1058.25	240.42	-125.77	91.72	28.90	610.69	590.01	580.76
1.2 Government deposits	-811.79	47.05	209.55	-359.83	144.17	541.44	-162.64	48.59	0.60	155.71
1.3 NBS own reserves	130.02	22.06	226.30	824.56	-590.22	-92.05	36.05	-118.75	488.94	519.88
(1.3 = 1 - 1.1 - 1.2)										

Source: NBS.

1) "Initial M2" designates the state of the primary money at the start of current, ie end of previous year.

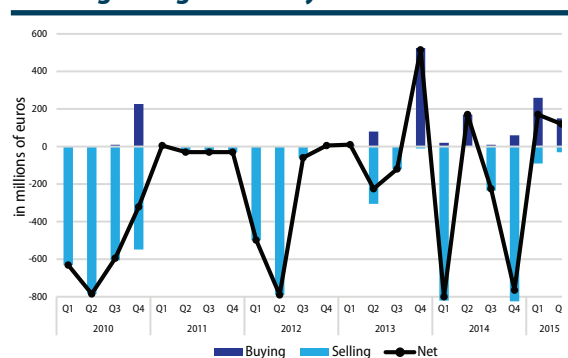
2) Definition of net own reserves NBS is given in section 8, "Monetary Trends and Policy", Frame 4, QM 5.

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

4) This category includes NBS Treasury Bonds and repo operations.

5) Other domestic assets net includes: domestic loans (net debts of banks, not including Treasury Bonds and repo transactions; net debts of economy) together with other assets (capital and reserves; and items on the balance: other assets) and is corrected by changes to exchange rate.

Graph T7-2. NBS interventions on inter-banking foreign currency market 2010-2015



Source: NBS

The increase of the net own reserves had a positive effect on the growth of primary money. At the level of Q2, primary money grew by 3.04% compared to the value at the start of the year also thanks to the growth of net domestic assets by 1.94% of the value of the initial primary money. The growth of the net domestic assets was achieved thanks to a decrease of the state deposits in the account at the NBS while business banks acted in the opposite direction by placing surplus liquidity in REPO bonds.

Monetary system: structure and trends of money mass

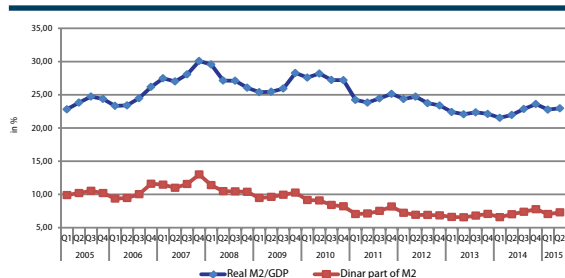
The money mass continued growing in Q2...

... mainly thanks to growth of net domestic assets

The growth of the money mass M2² continued in Q2 with a slight slowing down compared to the start of the year. The money mass recorded a nominal growth of 7.85% y.o.y. (in Q1 the money mass achieved a nominal growth of 8.5%, Table T7-4), while the growth of loans in the non-government sector stood at 4.2% y.o.y. Within this segment, loans to the households grew at a nominal rate of 4.9% y.o.y. while a y.o.y. nominal drop of -1% was recorded with the enterprises. The real y.o.y. growth rate M2 corrected by the level of inflation in the observed period in Q2 stood at 5.8% while the real rate of growth of loans in the non-government sector stood at 2.2% y.o.y. The real growth rate of loans to households in Q2 stood at 2.9% y.o.y. while a drop of -2.9% y.o.y. was recorded with the enterprises. At the quarterly level, the money mass recorded a growth of 2.2% compared to the value at the start of the year. The growth of the money mass

had a positive effect on the growth of net domestic assets of 2% compared to the level of the money mass at the start of the year while the net domestic assets had a slight effect on growth with their increase of 0.2% compared to the initial M2. The growth of the net domestic assets at the quarterly level was achieved thanks to an increase of the capital of business banks and the NBS in Q2 while loans to the government and non-government sector had a negative contribution to the overall growth of the net domestic assets.

Graph T7-3. Money mass trends as percentage of GDP, 2005-2015



Source: QM calculation

Table T7-4. Growth of money and contributing aggregates, 2013–2015

	2013				2014				2015	
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun
	y-o-y, in %									
M2 ¹⁾	8.2	4.5	6.1	4.6	4.2	4.8	6.6	8.7	8.5	7.8
Credit to the non-government sector ²⁾	1.9	-0.5	-4.4	-4.5	-6.1	-4.5	-1.2	2.9	5.8	4.2
Credit to the non-government sector ²⁾ , adjusted ³⁾	1.6	0.6	-4.1	-5.0	-8.2	-5.4	-3.7	-0.8	2.8	1.2
Households	3.0	2.9	2.9	2.6	2.0	2.5	3.0	3.6	5.5	4.9
Enterprises	0.9	-0.6	-7.6	-8.8	-13.4	-9.7	-7.3	-3.4	1.2	-1.0
	real y-o-y, in %									
M2 ¹⁾	-2.6	-5	1.2	2.3	1.9	3.5	4.3	6.7	6.4	5.8
Credit to the non-government sector ²⁾	-8.2	-9.2	-8.9	-6.5	-8.3	-5.7	-3.3	1.1	3.7	2.2
Credit to the non-government sector ²⁾ , adjusted ³⁾	-8.7	-8.2	-8.5	-7.0	-10.3	-6.7	-5.8	-2.5	0.8	-0.7
Households	-7.5	-6.1	-1.9	0.4	-0.3	1.2	0.7	1.8	3.4	2.9
Enterprises	-9.3	-9.3	-11.8	-10.7	-15.4	-10.8	-9.3	-4.9	-0.8	-2.9
	in billions of dinars, end of period									
M2 ¹⁾	1622.7	1659.8	1705.8	1719.3	1691.4	1740.2	1818.4	1864.7	1835.4	1876.1
M2 ¹⁾ dinars	478.8	492.5	519.5	547.6	516.4	555.3	587.1	614.5	567.8	595.3
Fx deposits (enterprise and households)	1143.8	1167.3	1186.3	1169.3	1175.0	1185.0	1231.3	1250.2	1267.7	1280.8
	cumulative, in % of opening M2⁴⁾									
M2 ¹⁾	-1.2	1.1	3.9	4.6	-1.5	1.4	5.9	8.6	-1.6	0.6
NFA, dinar increase	7.2	2.7	5.2	10.6	0.2	-0.1	11.7	11.1	3.2	3.4
NDA	-8.4	-1.6	-1.3	-6.0	-1.6	1.4	-5.8	-2.4	-4.7	-2.7

Source: NBS

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

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

3) Trends are corrected by changes to exchange rate. Corrections are implemented under the assumption that 70% of the loans to the non-government sector (and households and economy) are indexed in Euro.

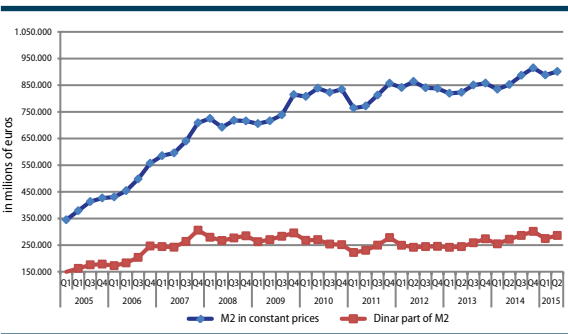
4) Initial M2 designates state of M2 at start of current, ie end of previous year.

All elements of M2 contribute positively in Q2

An analysis of the nominal growth of M2 which in Q2 stood at 7.8% y.o.y., we notice the continuation of the established trend in which all elements make a positive contribution to overall growth. As to date, the single greatest contribution is from foreign currency deposits

2 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 the M2 aggregate which we observe is equal to the M3 aggregate in NBS reports.

Graph T7-5. State of money mass in permanent prices, 2005–2015



Source: QM calculation

which participated with 5.5 percentage points in the growth of M2. Savings and timed deposits participate in the growth of M2 with 0.86 percentage points which, as in the case of foreign currency deposits, is approximately the same level as in the previous quarter. The lowest M1 aggregate participated in the growth of M2 with 1.44 percentage points which is a decrease compared to Q1 because of which the overall nominal growth in this quarter is somewhat lower (in Q1 the M1 contribution stood at 2.22 percentage points).

Banking sector: placements and sources of financing

Placements of banking sector grow in Q2 ...

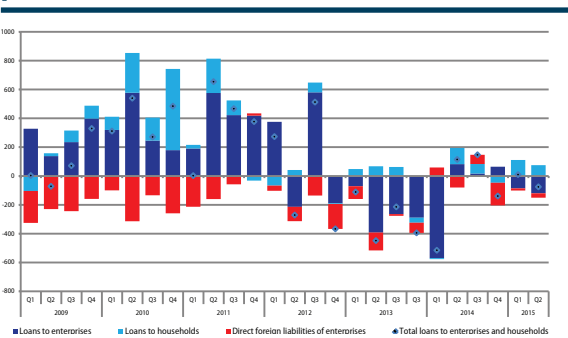
... but mostly thanks to return to REPO bonds

The enterprises are again deleveraging ...

... to domestic banks and on the basis of cross-border loans

Following the drop in Q1 business banks recorded a rise in net placements of 169 million Euro in Q2. This growth is still mainly the consequence of the return of banks to REPO placements while the negative trends continued in the economic domain. After business banks withdrew almost all their funds from REPO bonds at the start of the year, in Q2 part of the liquidity of business banks totaling 166 million Euro was once again used for REPO placements (in Q1 66 million Euro were withdrawn from REPO placements, Table T7-6). Besides that, the rise in the balance of net loans to the government of 47 million Euro made a positive contribution to the growth of overall placements in the banking sector. In Q2, the divergent trends from the start of the year continued in the enterprises and the households with the overall effect being negative because of a speedier debt repayment by the enterprises compared to the growth of the indebtedness of the households. A rise of net placements totaling 75 million Euro was recorded with the households in Q2 (in Q1 a growth of 111 million Euro was recorded), with more than half of the new placements being in the form of cash credit while housing loans continue to be at a low level. In the same period, the households repaid debts to domestic banks totaling 121 million Euro which is even more than the amount recorded at the start of the year (in Q1 the enterprises repaid a total of 86 million Euro of its debts). The greater repayment of debts by the enterprises

Graph T7-7. Growth of new loans to the enterprises and households, 2009–2015



Source: QM calculation

See footnote 1 in Table T7-5

compared to the growth of placements to the households caused the overall net placements of business banks to the non-government sector in Q2 to be negative and stand at -45 million Euro. The negative trend in the repayment of debts by the enterprises continued also in the segment of cross-border loans which recorded a decrease in net placements by 31 million Euro. If we observe the overall placements from domestic and foreign sources at the level of Q2, the non-government sector (the enterprises and the households) reduced its indebtedness by 76 million Euro (in Q1 positive net placements of 9 million Euro were recorded, Graph T7-7).

Table T7-6. Bank operations – sources and structure of placements, corrected¹⁾ trends, 2013-2015

	2013				2014				2015	
	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)	109	341	213	420	578	540	504	678	241	33
Domestic deposits	4	-56	-325	-394	240	-32	-382	-460	47	-118
Households deposits	-87	-132	-252	-423	45	-105	-149	-250	-11	-104
dinar deposits	16	-34	-110	-279	27	-51	-75	-143	96	19
fx deposits	-102	-98	-141	-144	17	-54	-74	-107	-107	-123
Enterprise deposits	91	76	-73	29	195	72	-233	-210	58	-14
dinar deposits	-11	-11	-109	-162	210	45	-159	-273	168	112
fx deposits	102	87	36	191	-15	27	-75	63	-110	-126
Foreign liabilities	357	406	588	806	358	396	610	907	36	150
Capital and reserves	-252	-9	-50	8	-20	176	276	232	158	1
Gross foreign reserves(-, decline in assets)	-278	-104	84	-304	193	215	673	1,019	-150	-115
Credits and Investment¹⁾	123	-169	-67	42	-343	66	-19	-451	-20	149
Credit to the non-government sector, total	-23	-348	-551	-875	-577	-382	-300	-296	24	-21
Enterprises	-71	-463	-728	-1,018	-570	-488	-471	-410	-86	-207
Households	48	115	177	143	-7	105	171	114	111	186
Placements with NBS (Repo transactions and treasury bills)	321	319	492	628	-176	-133	-556	-869	-66	100
Government, net ²⁾	-175	-140	-8	290	411	581	837	713	22	69
MEMORANDUM ITEMS										
Required reserves and deposits	-17	-87	-443	-134	-2	-215	-223	-730	444	605
Other net claims on NBS ³⁾	-154	-85	118	44	-136	-135	-4	110	-182	-309
o/w: Excess reserves	-151	-96	60	38	-156	-162	-9	112	-204	-317
Other items ⁴⁾	100	50	54	-22	-289	-454	-822	-592	-352	-379
Effective required reserves (in %) ⁵⁾	25	24	22	23	23	22	22	19	22	23

Source: NBS

1) Calculating growth is done under the assumption that 70% of overall placements are indexed against the Euro. Growth for original Dinar values of deposits are calculated on the basis of 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 are calculated on the basis of the exchange rate of the Euro at the ends of the period and do not include the effects of the change of the exchange rate from the calculation of the remaining balance.

2) NBS bonds include state bonds and NBS treasury bonds which are sold at repo rates and at rates which are set on the market for permanent auction sales with a due date greater than 14 days.

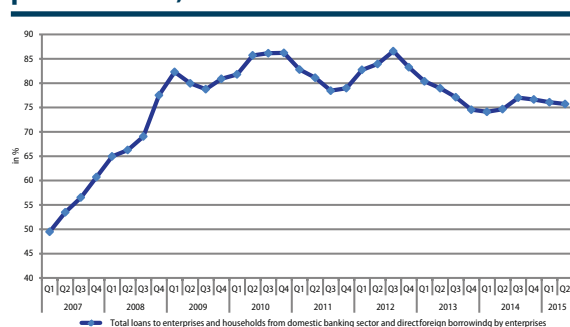
3) Net crediting of the state: loans approved to the state are decreased by the state deposits with business banks; the negative prefix designates a higher growth of deposits than of loans. State includes all levels of government: republic and local government level.

4) Other debts by the NBS (net): the difference between what the NBS owes banks on the basis of cash and free reserves and debts to the NBS.

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

6) The effective mandatory reserve represents the participation of the mandatory reserve and deposits in the total of overall deposits (households and the economy) and bank debts abroad. The basis to calculate mandatory reserves does not include subordinate debts because they are unavailable

Sources for new placements increasing in Q2

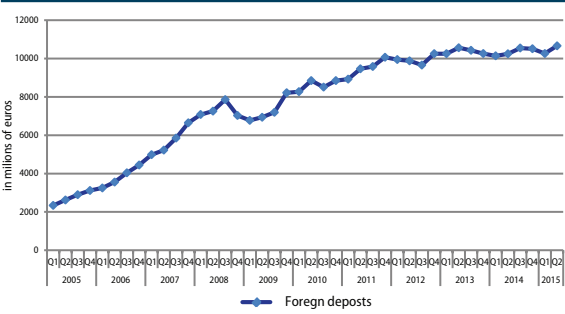
Graph T7-8. Overall credit indebtedness by private sector, 2007-2015

Source: QM calculation

The liquidity of banks in Q2, unlike the previous quarter, was increased by 208 million Euro (in Q1 the sources for new placements by bank were decreased by 241 million Euro, Table T7-6). Business banks increased their sources for new placements on the basis of the growth of domestic deposits and an increase of capital while the continuing repayment of debts outside the country neutralized a part of the growth. Following the decrease in Q1, banks recorded an increase of 165 million Euro in domestic deposit accounts with both the enterprises and the households increasing their funds

in deposit accounts. Among the households, this increase totaled 93 million Euro with more than 80% in Dinars despite the fact that the payment of this years installment of the old foreign currency savings was paid in June. Something similar was recorded in the deposit accounts of the enterprises which were increased by 72 million Euro of which around 77% was in Dinars. The decrease in the capital and reserve accounts of business banks which was recorded at the start of the year was completely neutralized in Q2 in almost the same amount of 157 million Euro which additionally increased the credit potential of banks. The repayment of borrowed funds to head offices abroad had a negative effect only on the growth of sources for new placements with banks

Graph T7-9. Level of foreign currency deposits, 2005-2015



Source: NBS

Participation of bad loans is showing unusual variations ...
...but does not drop below the level of 20%

in Q2 increased their debt repayments to 114 million Euro (in Q1 business banks repaid a total of 36 million Euro in debts outside the country).

According to data from the Credit Bureau, the participation of bad loans was additionally increased in Q2. The participation of bad loans at the end of the month of June reached the level of 23.04% (in Q1 their overall participation stood at 21.27%, Graph T7-12) despite a decrease which was recorded in the entrepreneur sector. The latest figures on bad loans from

the end of August show a drop in their participation to 20.75% which is the lowest value over the past two years. Bearing in mind that oscillations have been noticed which are extremely unusual for this time period of several months, we are expressing a reservation towards the reliability of the data on loans whose repayment is late which the Credit Bureau published. The growth of the participation of bad loans in Q2 is due to the segment of companies in which an increase of bad loans of 2.7 percentage points was recorded which had the greatest effect on the growth of the overall participation since bad loans in this segment account for around 80% of the overall bad placements. A deterioration was also recorded among the households whose participation in bad loans grew by 1.7 percentage points which represents the highest value of participation registered to date in the households segment. This deterioration can be explained in part with the delayed reaction to the rise in value of the Swiss Franc at the start of this year. The state of bad loans (stock) by segment shows that following the stabilization of the overall amount of bad loans which started in the middle of last year, a growth of the overall level was recorded once again (Graph T7-11).

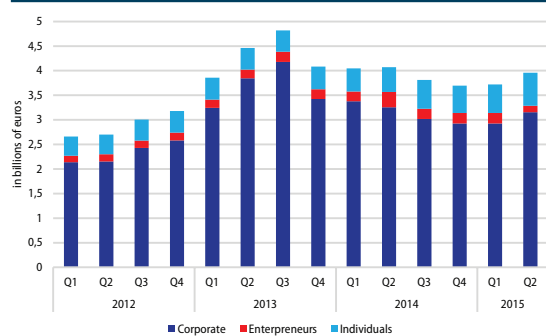
Table T7-10. Participation of bad loans according to type of debtor, 2009-2015

	2009	2010	2011	2012	2013				2014				2015	
	Dec	Dec	Dec	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Q1	Q2
	balance at the end of period													
Corporate	12.14	14.02	17.07	19.06	22.62	27.77	31.13	27.76	28.67	28.12	26.76	25.5	25.85	28.63
Entrepreneurs	11.21	15.8	17.07	15.92	16.79	18.19	20.86	20.82	21.11	29.77	43.61	43.29	45.19	34.91
Individuals	6.69	6.71	7.24	8.32	8.44	8.37	8.14	8.59	8.7	9.22	11.41	9.97	10.16	11.30
Ammount of dept by NPL (in billions of euros)	1.58	1.94	2.63	3.19	3.87	4.47	4.82	4.09	4.05	4.07	3.81	3.70	3.72	3.96

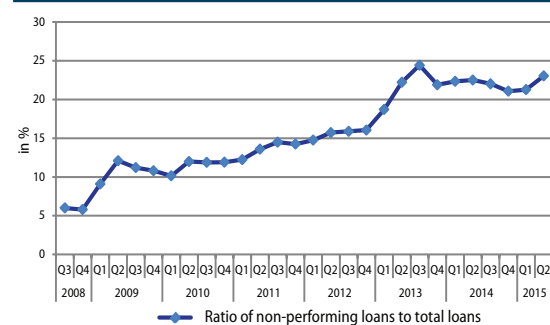
Source: QM calculation

The resolving of the problem of bad loans would remove the risks to public finances and would get credit activity moving

Even though an important part of the talks during the negotiations with the International Monetary Fund were devoted to the segment of bad loans, the set of concrete measures aimed at resolving this problem will be implemented at the start of 2016 at the earliest. Namely, on the basis of the mentioned talks, the NBS adopted its action plan for implementation of the *Strategy To Resolve Problematic Loans* in August. The adopted action plan is for the most part oriented towards creating a new system with prevention mechanisms to prevent the sudden growth of bad loans. A part of those measures are linked to the resolving of the currently high participation of bad loans but the framework for its implementation was moved further to the middle of 2016. Despite the high capitalization level of a majority of business banks in Serbia, we believe that the resolving of the problem of bad loans must not be delayed any longer. Besides the stability of the banking system, the high participation of bad loans is having a negative effect on the level of credit activity in the economy through interest rates on new loans which would be lower if banks did not have to make reserves on that basis.

Graph T7-11. Amount of remaining debt on credits running late, 2012-2015

Source: QM calculation

Graph T7-12. Participation of bad loans in overall placement, 2008-2015

Source: QM calculation