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Serbia:
Monetary policy challenges in the aftermath of the crises

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Impact of the crises on Serbia

- GDP growth rate fell from 5.4% in 2007 to -3.5% in 2009;
- Growth of unemployment – from 14.0% in 2008 to 19.2% in 2010;
- € 965 mil. FX deposits withdrawn from banking system
- Rising risk premia (EMBI, CDS);
- Depreciation of the dinar (26% cumulative since 2008);
- Slowdown of domestic credit growth;
- Scarcity of sources of funding – raised rollover risk

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Banking sector was resilient and it still remained profitable after the crisis

NBS acted preemptively:

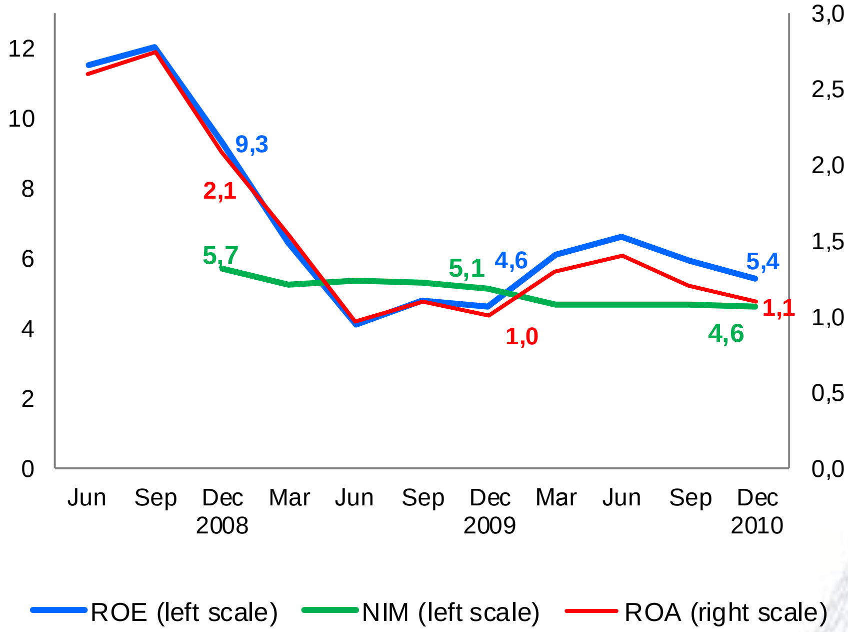
- Restrictive MP
- High policy rate
- Excess liquidity sterilization

Conservative prudential policy:

- comprehensive and conservative
- risk weights limited household borrowing
- Reduction of FX exposure
- High RR requirements of FX savings and FX borrowing by banks

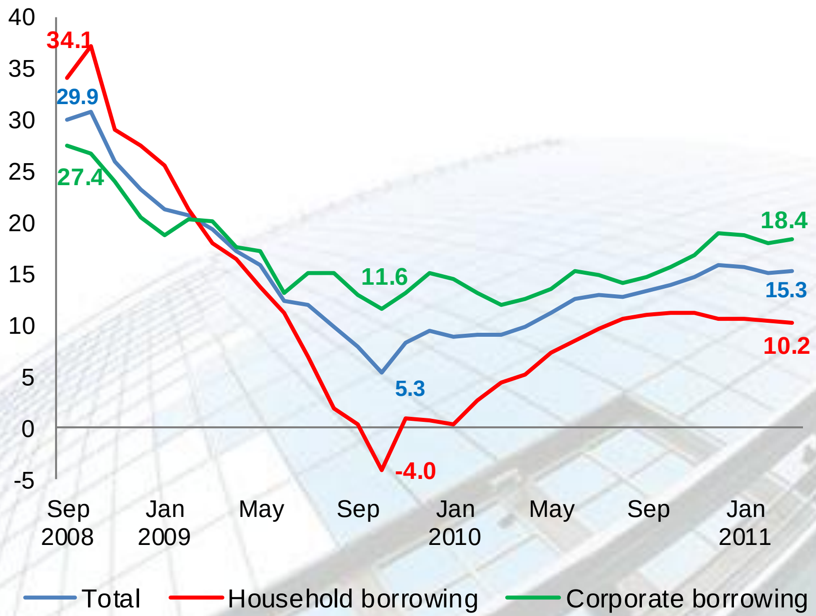
The economic crisis had effect on banks' balance sheets

Chart 1 **Banking sector profitability**
(in %)



Source: National Bank of Serbia.

Chart 2 **Real domestic borrowing***
(y-o-y growth rate in %)



*Deflated by inflation, after exchange rate adjustment
Source: National Bank of Serbia.

NBS's response to the crisis

- The Vienna initiative was introduced in order to maintain bank exposure to Serbia and to help borrowers to convert their FX loans and FX clause – index loans to dinar loans;
- RR regulations were gradually eased;
- FX risk ratio set up to 20% instead of 10% of the banks capital;
- New facilities were introduced (FX swap transactions and short term dinar loan auctions);
- Cut in the key policy rate(from 17.75% to 8.0%).

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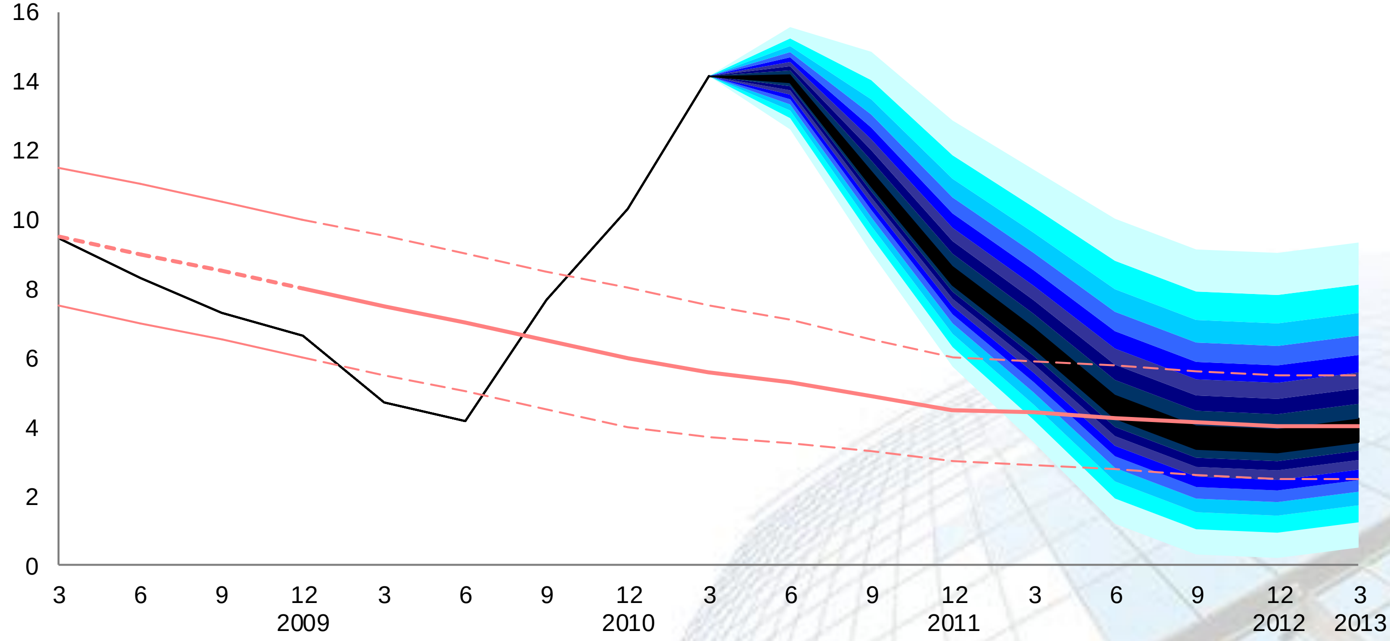
Results of imposed measures

- Inflation remained within target band in 2009
- Serbia was one of the rare countries with no financial injections in the banking sector;
- Strong BOP adjustment - CA deficit fell from 21.6% in 2008 to 7.0% of GDP in 2010,
- FX savings reached more then € 7,0 billion at the end 2010
- Banking system stable - capital adequacy around 20%
- At end 2009 S&P outlook for Serbia revised from negative to stable;
- In November 2010, Fitch rating agency changed its outlook for Serbia from negative to stable;
- S&P raised Serbia’s ratings in March 2011 from “BB-” to “BB”.

CPI projected to remain above tolerance band

Chart 3 **Inflation projection**

(y-o-y rates, in %)



Source: National Bank of Serbia and Serbian Statistical Office.

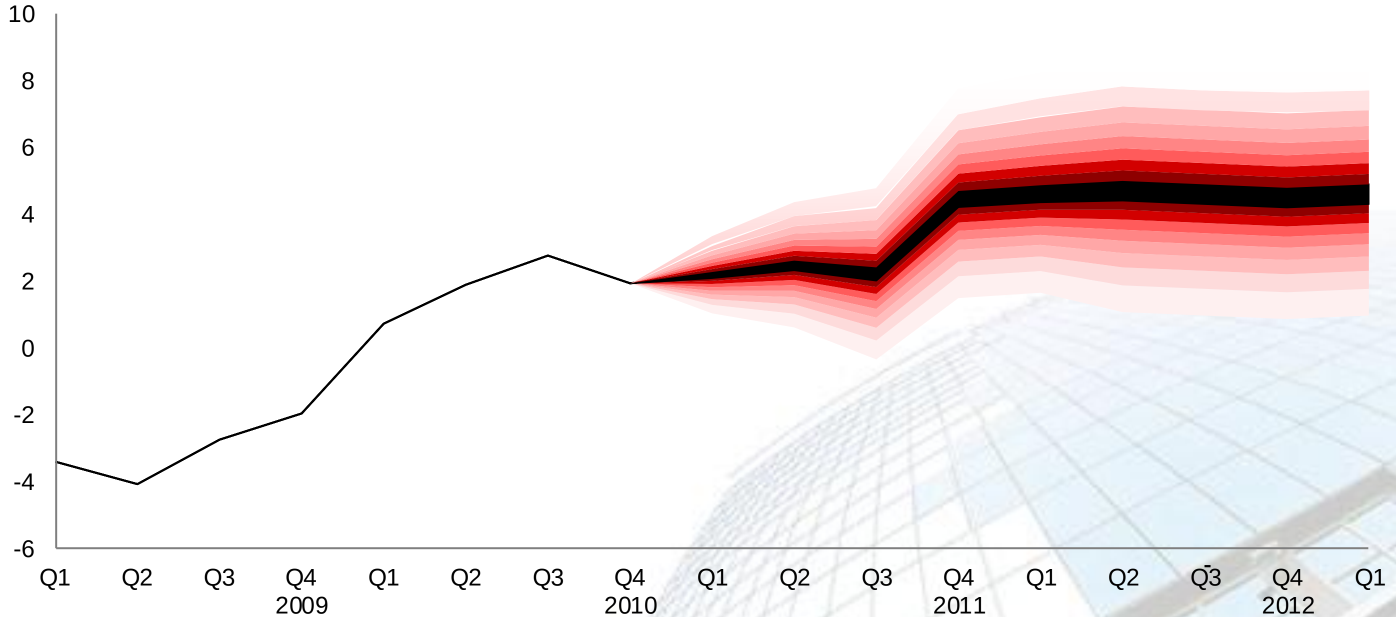
Drivers of inflation:

- Strong exchange rate depreciation since 2008 (26%)
- Rising import prices
- Domestic food supply shocks and rise of international commodities prices

Expected GDP growth of 3% in 2011 driven by net exports

Chart 4 **GDP growth projection**

(y-o-y rates, in %)

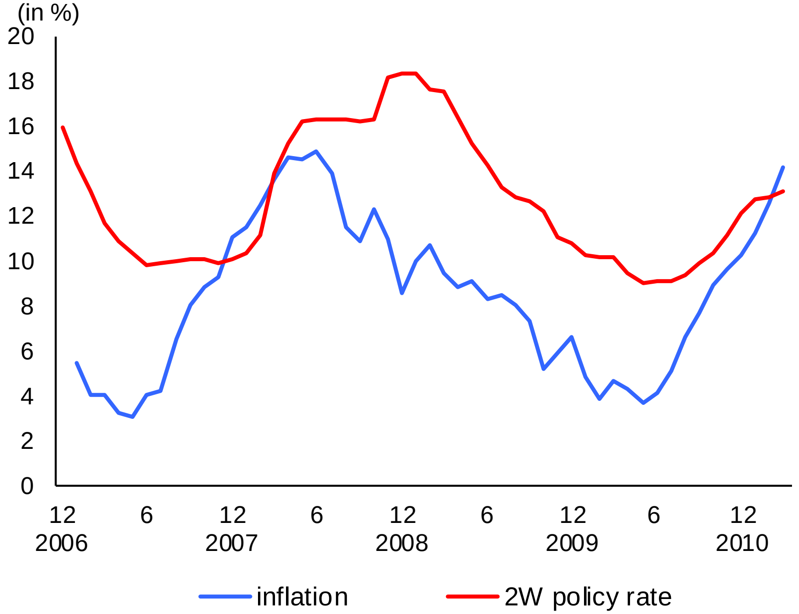


Source: National Bank of Serbia and Serbian Statistical Office.

- Domestic demand subdued
- Unemployment is still high and slackness remains in the labour market (esp. private sector)

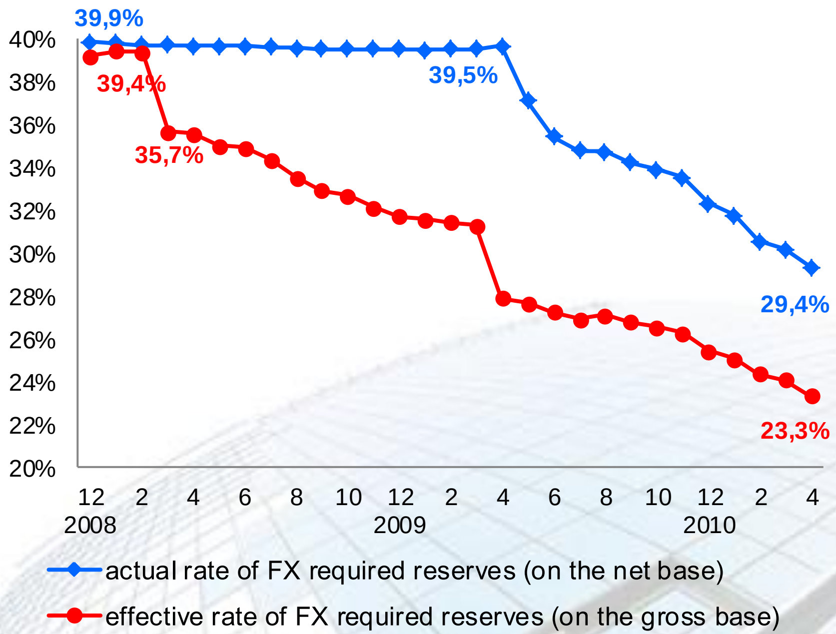
Strong monetary policy response

Chart 5 **Inflation and key policy rate**



Source: National Bank of Serbia and Serbian Statistical Office.

Chart 6 **Reserve Requirement Rates**



Source: National Bank of Serbia.

- Key policy rate raised by 450 b.p. since August 2010
- Postponed easing of reserve requirement for banks in 2011

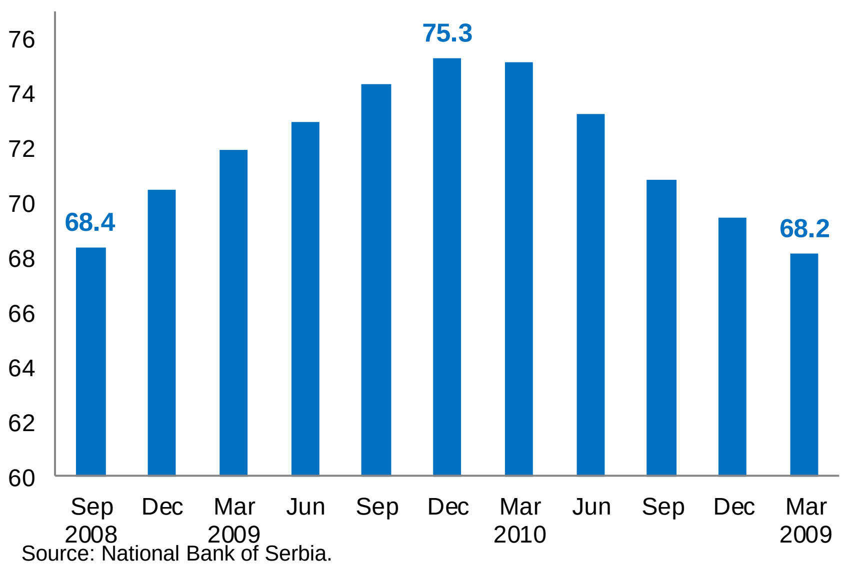
- New decision on RR rates (promoting longer maturity sources) became effective as of 17 Feb 2011.
- RR rates, with respect to source maturity, are now:

  EUR: 30% for < 2y, 25% for > 2y;

  RSD: 5% for < 2y, 0% for > 2y.
- RR is reduced by around €350 mln (instead of €700 mln as previously planned).

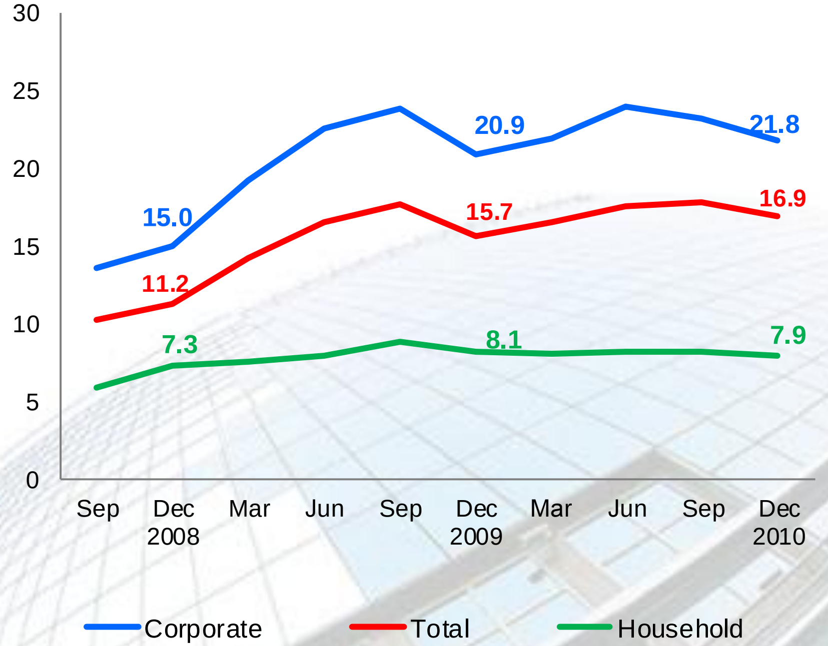
Euroization has an impact on monetary policy and financial stability

Chart 7 **Share of FX-indexed and -denominated household and corporate loans in total lending**
(in %)



Source: National Bank of Serbia.

Chart 8 **Share of Non Performing Loans***
(in % of total loans)



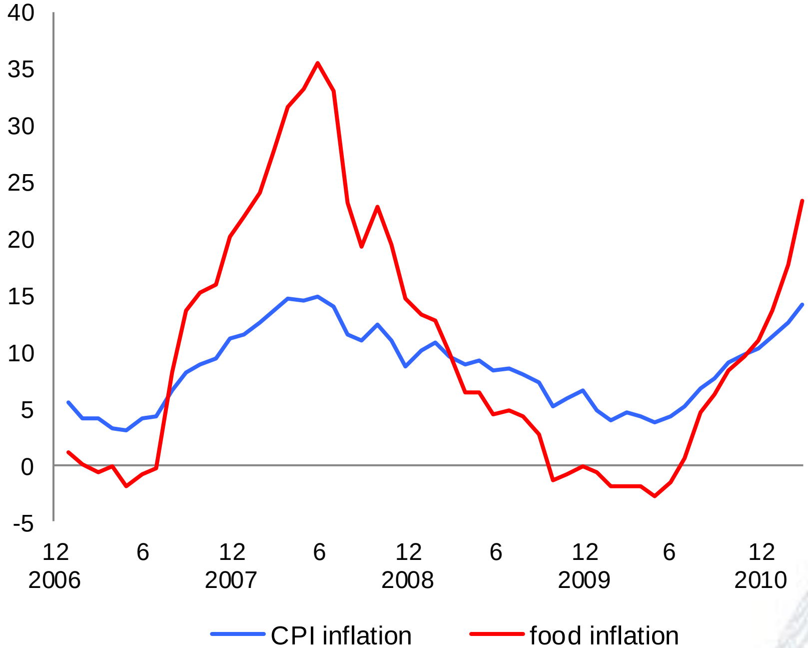
***non-performing loans are monitored on a gross basis (including value adjustments)**
Source: National Bank of Serbia.

- Strong exchange rate pass – through and constrained interest rate channel
- Required reserves used as an instrument to influence interest rate on FX indexed loans
- Exchange rate depreciation has an adverse effect on financial stability

Sensitivity to food shocks extremely high

Chart 9 **CPI and food inflation**

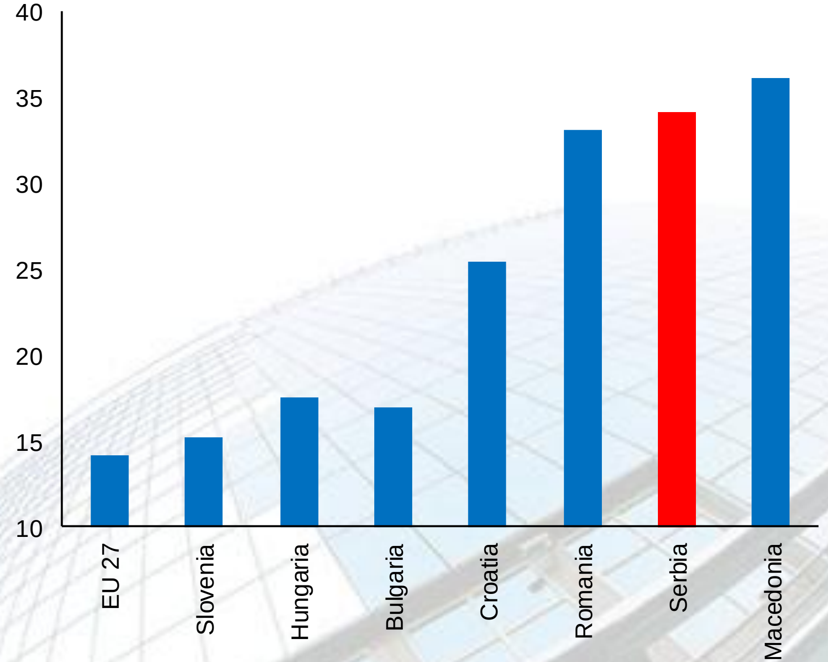
(in %, y-o-y)



Source: National Bank of Serbia and Serbian Statistical Office.

Chart 10 **Share of food in CPI**

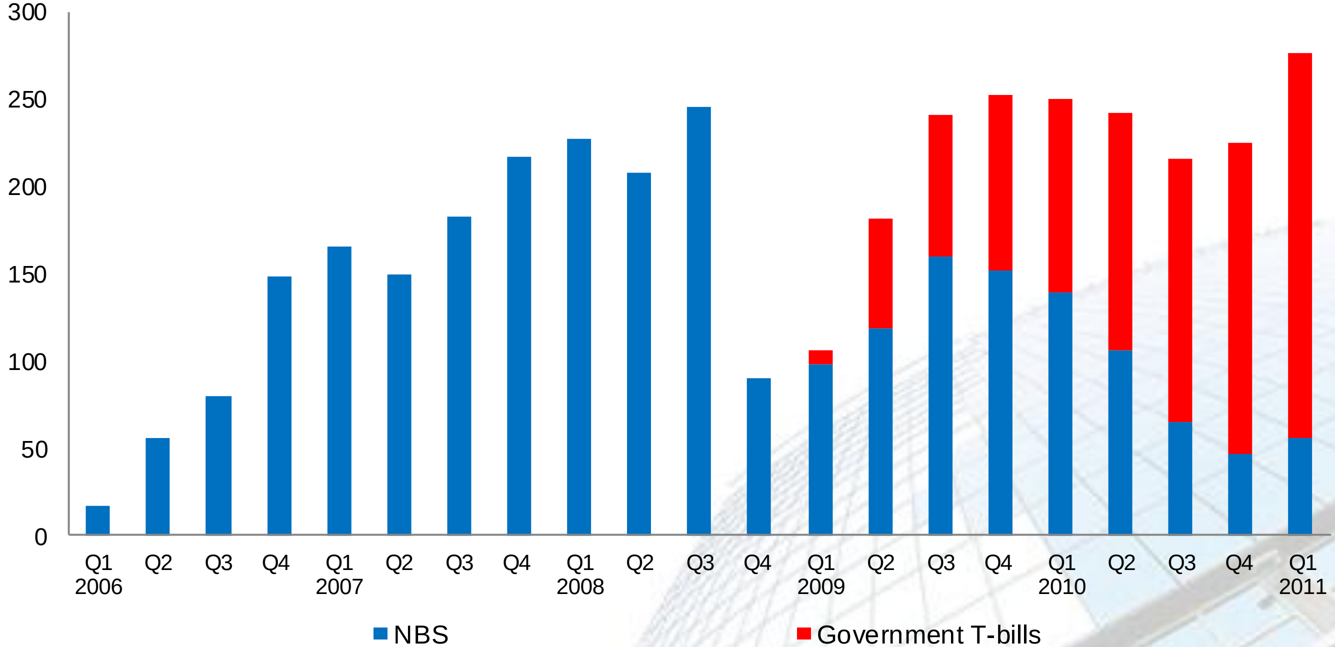
(in %)



Source: National Bank of Serbia and Eurostat.

Decreasing euroization is one of the key medium term goals

Chart 11 **Outstanding amount of securities (2W Repo and T-bills)**
(in bln RSD)



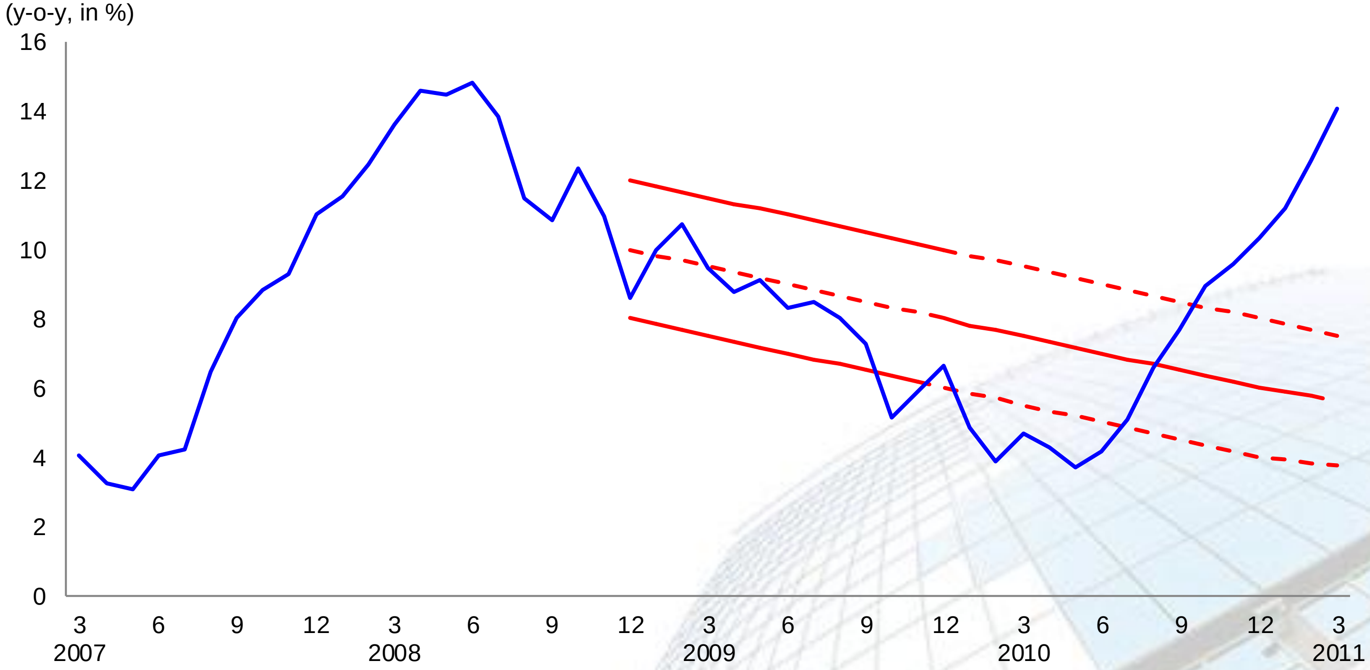
Source: National Bank of Serbia and Ministry of Finance.

A three-pillar strategy:

- Macroeconomic stability, low and stable inflation, sustainable economic growth and stable financial markets;
- Development of dinar capital market;
- Development of FX hedge instrument.

Monetary policy challenges in front of us:

Chart 12 **Inflation and inflation target**



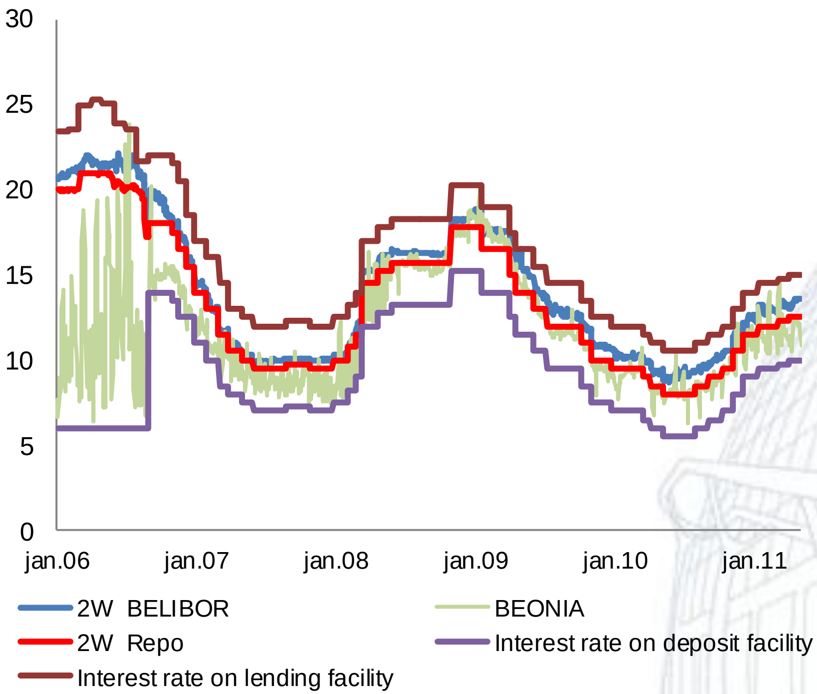
Source: National Bank of Serbia and Serbian Statistical Office.

- Structural changes in the agricultural and food market (government policy) should reduce food price volatility;
- Stabilizing inflation target at a lower level;
- Lower levels of euroization should strengthen interest rate channel;
- With this, gradual withdrawal from using instruments other than policy rate, such as required reserves and FX interventions;
- Further credibility building.

IT produced some positive results so far

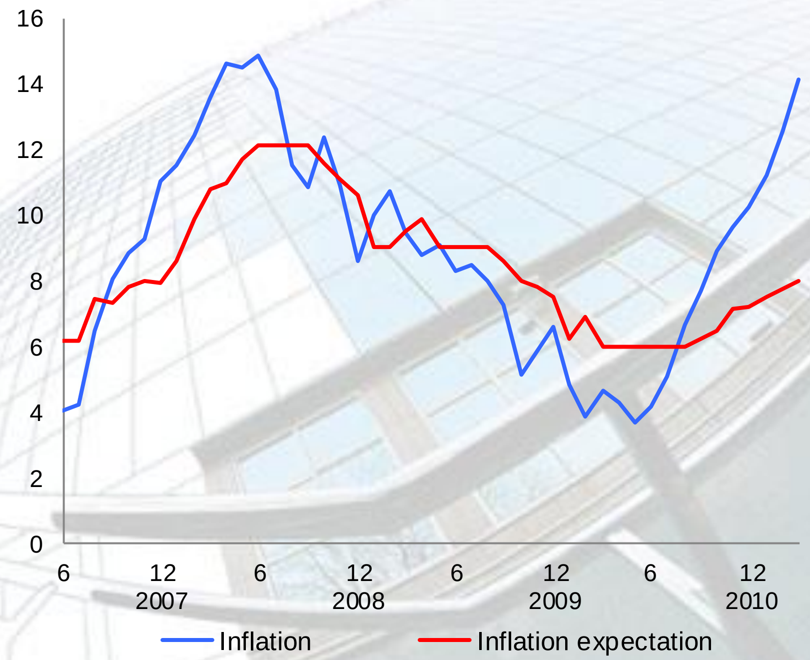
- Complete overhaul of monetary operations (policy rate became an effective tool);
- Improved transparency and credibility ;
- Inflation expectations better anchored.

Chart 13 **Interest rates on money market**
(in %)



Source: National Bank of Serbia.

Chart 14 **Inflation and inflation expectations**
(y-o-y, in %)

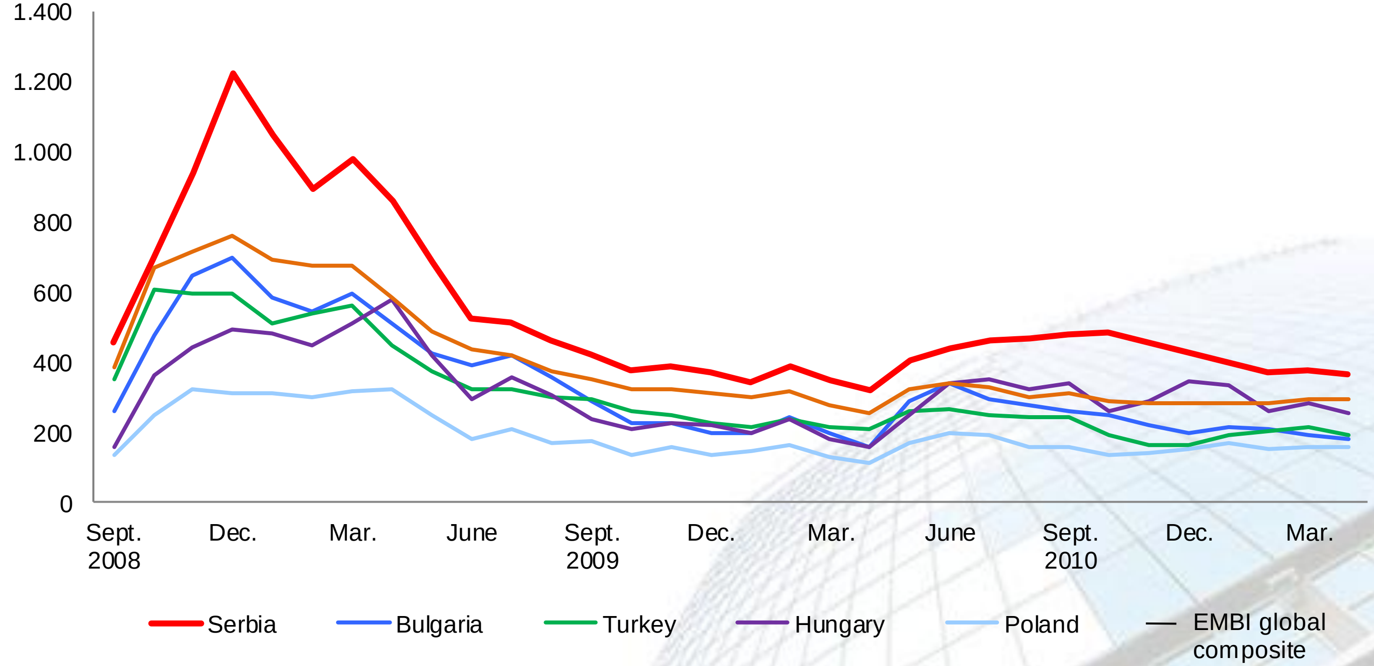


Source: Serbian Statistical Office, Agency Bloomberg and Agency Thomson Reuters.

After a period of heightened pressures, risk premium has been falling since Nov 2010

Chart 15 **Risk premium indicator − EMBI by country**

(monthly averages, in basis points)



Source: JP Morgan.

- Increased investor risk aversion during the summer sparked turbulences across CE financial markets. As a result, EMBI for Serbia was on the rise from May to Oct.
- Since November EMBI has had a downward trend and in April it stands at around 360 bp.
- In November, Fitch rating agency changed its outlook for Serbia from negative to stable. Also, S&P raised Serbia's ratings in March 2011 from "BB-" to "BB".

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THANK YOU FOR YOUR ATTENTION