

**FOR
INFORMATION**

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To: Members of the Executive Board

From: The Secretary

Subject: **Republic of Serbia—Statement by the European Central Bank Representative**

Board Action: Executive Directors' **information**

Additional Information: For the Executive Board discussion on the Republic of Serbia to be held on Friday, June 18, 2021.

16 June 2021

**Statement by Rasmus Ruffer (ECB Representative) and Dimitrios Rakitzis on
Serbia – 2021 Article IV Consultation and Thirty-Month Policy Coordination Instrument (PCI)
IMF Executive Board Meeting**

18 June 2021

We would like to thank Messrs. Trabinski and Djokovic for their Buff statement and Staff for their report. We commend the Serbian authorities for maintaining macroeconomic and financial stability during the Covid-19 crisis while supporting the economy through swift and determined fiscal, monetary and financial sector policy action. The request for a new Policy Coordination Instrument (PCI) demonstrates a strong commitment to fiscal discipline and structural reforms and to deliver more inclusive and sustainable growth. Serbia built a good track record under previous IMF programmes. However, pandemic-related uncertainty is still elevated and there are a number of remaining structural challenges to be addressed. We broadly share many of the main findings in the Staff Report and would like to highlight a few items.

We concur with Staff that the Serbian authorities' substantial and prompt policy response provided a cushion against contractionary forces in 2020. Serbia's economy contracted comparatively mildly in 2020 in the wake of the COVID-19 pandemic. Real GDP declined by 1.0% in 2020, the least severe GDP decline in the Western Balkans. The comparatively smaller decline of Serbia's output was due to the substantial and prompt monetary, financial and fiscal policy response to the pandemic, which cushioned its impact. An additional factor that mitigated the impact of the pandemic consists in the structure of the economy; contact intensive service activity also severely contracted in Serbia, but some of these sectors such as tourism account for a much smaller share of overall output than in some neighbouring economies. To a smaller extent, the modest contraction was also facilitated by developments in the agricultural sector, which saw its output grow strongly in 2020.

Like Staff, looking ahead, we believe that the growth outlook for Serbia will be mainly determined by the evolution of the pandemic both at home and abroad. In 2021, Serbia's vaccination programme has started well ahead of many neighbouring countries and could potentially lead to a faster reduction in infections and possibly quicker removal of remaining containment measures. The labor market has been relatively resilient in 2020 and wage growth has been robust. This could boost confidence and support a further recovery in consumption and investment. Externally, recovery in foreign demand will primarily depend on developments in Serbia's most important trade partners in Europe.

While continued fiscal support remains essential in the recovery phase, looking beyond this it will be important to rebuild fiscal buffers and manage fiscal risks. Fiscal support in 2020 amounted to 12.5% of GDP, the highest in the region, enabled by policy space thanks to a strong fiscal position, prior fiscal consolidation and prudent policies during past years. We welcome the authorities' commitment to narrow the fiscal deficit and adopt a new fiscal rule by 2023, which would imply a significant reduction of public debt over the medium term, thereby restoring fiscal buffers. The case of Serbia is a good example of the benefits of generating fiscal space when the economic environment is benign, which can then be

used for a strong countercyclical fiscal response to an economic downturn, as was done during the pandemic. We encourage the authorities to closely monitor fiscal risks stemming from contingent liabilities of state-owned enterprises (SOEs). In this context it is welcome that authorities adopted a new ownership and governance strategy for SOEs and that strengthening SOE governance is identified as a key pillar of the proposed new PCI.

In the wake of the pandemic-related economic downturn, the National Bank of Serbia (NBS) appropriately took a series of monetary policy and financial sector measures. The easing of the monetary policy stance was appropriate given subdued inflation and helped by further monetary accommodation provided by major central banks. The NBS also acted swiftly at the onset of the pandemic to support both dinar and euro liquidity, including by establishing a repo line with the ECB to counter possible market dysfunctions. Furthermore, the NBS conducted outright purchases of domestic government securities as well as corporate bonds in the secondary market, which in combination with the previously mentioned monetary policy measures helped to maintain the functioning of the financial system and lowered the cost of credit for firms and households.

We positively note the authorities' efforts to promote dinarisation amid challenging conditions, and concur with Staff that it should remain a medium-term objective. The use of the local currency has continued to increase in 2020, which is a significant achievement given pandemic-related uncertainties. However, the level of currency substitution is still elevated, presenting a tail risk for financial stability and constraining monetary policy choices. The existing measures to foster dinarisation in the banking sector, such as higher reserve requirements on foreign exchange (FX) denominated deposits, mandatory down-payment ratios for FX-denominated loans and systemic risk buffers, should remain in place and potentially be expanded. Furthermore, developing the dinar bond market would not only enable firms to obtain financing with longer maturity than offered by the banking sector but also contribute to further dinarisation of the economy. We also encourage continued public communication about the benefits of dinar savings and the risks associated with unhedged FX-denominated borrowing. Finally, we take note of the NBS's interventions in both directions to stabilise the dinar since the advent of the pandemic. On that note, we concur with Staff that in the medium term more exchange rate flexibility could help dinarisation, by exposing unhedged borrowers to FX risk, and, in case of appreciation, demonstrating to depositors that they are not always better off with forex savings. This needs to be carefully balanced with avoiding excessive exchange rate volatility and combined with developing hedging instruments.

We share the views that the Serbian banking sector remains stable, liquid and well capitalised, as well as that the potential build-up of credit risks should be closely monitored. Thanks to its strong position at the onset of the crisis and the extensive policy support, the Serbian banking sector remained resilient in 2020. However, the full impact of the economic downturn on asset quality will only become visible once support measures are lifted. We therefore concur with Staff that risks in the banking sector need to be closely monitored. It will be important to actively monitor problematic loans and ensure proper loan classification and adequate provisioning going forward. In addition, strong regulatory definitions

should continue to be maintained in line with international and EU practices to ensure transparency. Given the likely increase in non-performing loans (NPLs) in the wake of the pandemic reducing remaining structural obstacles to effective NPL resolution would also be welcome. Building on considerable past progress in this area - for instance as regards analysing corporate indebtedness, problem loan prevention, resolving the legacy NPL portfolio and some improvements to the insolvency framework - improving the effectiveness of the judiciary and further developing the NPL market would be helpful to this end.