Radovan Jelašić: Dinar products and declining interest rates in Serbia

Speech by Mr Radovan Jelašić, Governor of the National Bank of Serbia, at the promotion of "Pure" Dinar Credit of HVB Bank, Belgrade, 18 October 2006.

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Dear ladies and gentlemen,

My participation in this conference is motivated by two reasons: dinar products and decline in interest rates! I am happy to say that today we are all able to conclude that the National Bank of Serbia was right when it announced that interest rates will subside and that banks will expand their credit offer so as for it to include "pure" dinar credits. HVB bank has recently cut its effective interest rates on foreign currency credits and has now launched a new product – an authentic dinar cash credit, with no revaluation. Some other banks have also announced their intention to reduce interest rates on credits in euros. Present developments only go to confirm what the NBS has claimed, in response to criticisms purporting that the restrictive measures of the National Bank are entirely to blame for the high cost of credits in Serbia: inflation needs to decline first, and only then can we count on a gradual decline in interest rates. And also, a drop in inflation is an essential precondition to increasing trust in the domestic currency and its use. Serbia is on the right track to achieving both these objectives!

It is precisely the restrictive monetary policy of the NBS that gave a decisive contribution to a decline in inflation, and to the fact that, now that the policy interest rate on two-week repo operations amounts to 18 percent, with annual inflation dropping to 11.6% in September, banks are starting to reduce their interest rates on credits, even though the much criticized measure of the central bank – increase in the reserve requirement on short-term external borrowing of banks – introduced as far back as May this year, is still in force. At the same time, the share of reserve requirement on external credits with maturity of up to two years, the ratio on which was raised from 40 to 60 percent, in total calculated reserve requirement is only 17.5%. When this measure was first introduced, this share was 30.3 percent.

In the first eight months this year, the sum of total credits increased by over CSD 100 billion, which plainly shows that measures that the NBS enacted with the aim of bringing down inflation did not have a negative effect on either lending activity of banks or country's economic growth. Neither the corporate nor the household sectors were left without credits, which only disproves the "forecasts" put forward by opponents of central bank's measures. Profit interest of banks appears not to have been affected by these measures either, since August data put interest rate margin in Serbia at approximately 11 percentage points (weighted average interest rates on total credits and total deposits were 16.43 % and 5.55%, respectively). In Romania, which is on the point of EU accession, this same margin is still around 9 percent! Those who wonder why interest rate margins range between 4 and 7 percentage points in a majority of transition countries, and between 4 to 5% in EU countries, i.e. why they are lower than in Serbia, ought to have in mind the following facts: 1) our country rating is still BB-, almost exclusively because of high political risk, 2) until only few months ago, we had double-digit annual inflation, 3) a large part of the corporate sector is still waiting to be restructured, with monopolies maintained or created in several branches of economy! But let us go back to our starting point – bringing down inflation, although it entails costs that are not insignificant for the NBS, for banks or the Government, is a priority, because low inflation creates real scope for lower interest rates. With the decline in inflation that occurred over the past five months, we can already see the beginning of this process in practice, and all that the NBS can now do is "promise" that monetary policy will be as restrictive as necessary in order to accomplish the set inflation objectives.

High inflation is an additional tax affecting the poorest of the population, first by directly reducing the value of their income, and then also because it leads to a decline in foreign direct investments, which in turn narrows down opportunities for new and productive employment. The dinar is our currency, and I am surprised that the Government nominally advocates its use, while at the same time calculating all important things in euros – credits extended by the Government are in euros, national investment program is expressed in euros, country debt is disclosed in euros only – as if the Government has left Serbia and now lives in another country.

I firmly believe that our citizens are ready to pay a certain cost of credit, but that they are not ready to buy a "pig in a poke" or take credits on imprecise terms or terms they do not fully understand, for which at a later time they would have to pay a "tax on naiveté." That is why we introduced the effective interest rate, so that citizens should know how much each borrowing costs and so that they should be able to estimate whether they are able to meet the obligations they have assumed. The fact that our people have accumulated high credit appetite over the past decade or so, and that, when they borrow, they do not respond adequately to the level of interest rates, does not relieve banks from the responsibility to be real partners and financial advisors to their clients – from being responsible not only for what they do, but also for what they tell their clients. The NBS and I, as its Governor, are being reproached for warning citizens of the risks of foreign currency clause indexation or borrowing in Swiss francs because Serbia will one day enter the EU, but certainly not a monetary union with Switzerland. We are also being reproached for advocating full transparency in banks' operations, and for requiring observance of the ethical code which would obligate bankers to fair competition. The NBS will intensify its efforts on educating citizens as users of financial and banking services, and I hope that in this it will be joined by an increasing number of banks.

The immediate task that the NBS has set itself is to restore public trust in the dinar not only as a transaction currency, but also as a savings instrument. Although dinar savings have grown significantly over the past two years despite high inflation, their present level of around CSD 4.7 billion is still not satisfactory, even though all calculations show that dinar savings are much more profitable than foreign currency ones. This is due primarily to negative past experiences citizens have had with dinar savings, which, as opposed to foreign currency savings, completely lost their value in the years of hyper-inflation. However, with low inflation rate and higher exchange rate fluctuations, citizens will be increasingly interested in saving in dinars, especially when they realize that this is not a short-term trend, as it most certainly is not (!), while the increase in interest rates in the euro area will provide banks with an additional motive for a more active approach to collecting and increasing dinar savings. The NBS has offered citizens its savings bills, whereas banks are expected to diversify their offer of dinar products, both deposit and credit ones. At this point, when external borrowing is the principal source of banks' credit potential, it is quite understandable for me that banks are not overly interested in a more active approach to boosting dinar savings. However, I am also convinced that in the near future this will became a significant factor of competition among banks, as Serbian citizens get their salaries in dinars. Therefore – if the NBS is successful in its fight against inflation, and it most certainly will be successful, just as has been the case with all other challenges so far – it is quite logical that Serbian people will want to save in dinars, if this yields a higher rate of return, and that they will want to borrow in dinars and not have to worry about foreign currency risk from which banks are now protected, but citizens are not. Competition in the Serbian banking market is strong enough to ensure success for all those who first understand the needs of the market and of their potential clients.