Radovan Jelašić: Key challenges for Serbia and the surrounding region

Speech by Mr Radovan Jelašić, Governor of the National Bank of Serbia, at the Conference of Economist Media Group "Financial Services in the South East Europe", Belgrade, 5 December 2007.

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Ladies and Gentlemen,

As Serbia slowly but finally returns to Europe, the issues we face are becoming more and more "European" and even "international". Allow me to share with you today my thoughts on some of the current topics which represent key challenges not only to us in the NBS, but to almost all neighbouring countries!

Stable and efficient banking sector represents the key prerequisite and a guarantee of macroeconomic stability in Serbia today. However, no supervisory measure is more efficient in "levelling off" the margins or "convincing" institutions to cut down credit growth than a crisis situation in the financial sector. Whereas bank supervisors are constantly vigilant and keep taking measures to avert a crisis, crises still happen all the time. And they all have something in common: 1) they are never planned though risk trends are more or less common knowledge, 2) they come as a result of operations that are almost impossible to predict, 3) their initial impact is always underestimated, but soon 4) goes into the other extreme, i.e. becomes overestimated!

For seven years now, namely ever since I began attending Annual Meetings of the IMF and the World Bank in Washington, G-8 member countries and the IMF staff have been giving their semi-annual reports on "orderly winding down of global imbalances". Almost everybody seems convinced that what we have been going through in recent months is actually the beginning of orderly winding down of global imbalances, though neither the length nor the depth of the process can be predicted with any precision yet!

Strong financial sector in terms of the volume of its capital and reserves, and/or ownership structure is more than indispensable against the background of growing external and internal risks. On the eve of 2008, we are faced with many more challenges and unknowns both in Serbia and wider. Allow me to name just a few:

- Risk revaluation in the world market – while most of us remained quite unaware, only a few, like the UK-based Northern Rock Bank, realized that we had stepped from excess liquidity into the opposite extreme practically overnight. The terms on which Serbia borrowed in the world financial market only six months ago seem quite unattainable today even to some countries that recently joined the EU. Besides, the financial market is expected to be much more critical of some banks which until only recently managed to quite easily cleanse their balance sheets through securitization! In all, "seven years of fat cows, i.e. high liquidity" is already long behind us, and even if it still prevails in some isolated spots, it is exclusively due to massive support primarily from the central banks in the Euro Zone, England, Switzerland, and more recently the USA!
- Inflation challenges, primarily in the Euro Zone, seem to be ever more present, and the ECB is sailing between the Scylla and Haribda. Inflation in Germany has reached its 13 year high, M3 continues to grow fast – and these are the two main signals used by the ECB when deciding on the level of its reference rate. On the other hand, economic growth is losing its momentum, financial sector issues seem more and more complicated every day, and the currency is getting stronger with all its positive (e.g. cheaper imports of energy products) and negative effects (loss of competitiveness, primarily in the USA). It has been long since the money, i.e. cash,

was as expensive as it is in today's market notwithstanding the above injection of liquidity by central banks!

- The issue of home – host supervision comes back as a boomerang with every new crisis in the banking sector. Be it BACAG in Austria or IKB in Germany, the issue remains the same – distribution of responsibilities is being redesigned, both within the country (Austria) and at the level of the EU (e.g. Northern Rock bank).

We have been scrutinizing all of the above factors primarily from the aspect of their impact on Serbia, in which a) relatively easy and cheap borrowing abroad represents the key prerequisite to financing of the BOP deficit, b) inflationary pressures in the Euro Zone due to high level of eurization spill over into Serbia relatively quickly, and c) 80% of the banking sector is in the majority ownership of well ranked strategic owners from EU countries.

Internal factors:

- Inflationary pressures in Serbia are growing under the influence of both external and internal factors. And while the possibility to influence external factors seems quite negligible even by much bigger countries than Serbia, I am of the opinion that we should focus on issues which are exclusively under our control. Pleasant words, "stunts" from the past or delaying price increases cannot do the trick, not in the medium run, and even less in the long run. Though we in the NBS are satisfied with the core inflation result achieved in the course of the current year despite the untimely elections and the related fiscal expansion, doubling of the price of oil, and the drought, on the eve of 2008 we are more than concerned and put a question to ourselves: Should the prevailing tendencies persist, can the NBS reach its objectives with the instruments at its disposal or must there be new ones added? One thing is for sure, to achieve our objectives, we shall use all the instruments at our disposal, both old and new, but that shall not make us popular. That much I can tell in advance.
- High exposure to foreign currency risk creates additional risks to the financial sector as confirmed by the developments during last two weeks. If arguments extended by the NBS on the need to borrow in dinars do not seem plausible enough, I sincerely hope that recent developments in the market shall force many to reconsider which currency they should borrow in, namely, how to minimize their exposure to the foreign currency risk. The role of banks is of the highest importance in terms of warning against foreign currency risk exposure, if not for the sake of their clients than for the sake of their own balance sheet results!
- In the absence of adequate market competition, price signals are transferred slowly and inaccurately. This is most evident in the case of prolonged and high appreciation of the dinar which is transferred to retail prices with a significant delay. World practice points to the rigidity of prices, but it seems that they are practically "cemented" in Serbia today. I sincerely hope that something shall be done in that respect, and done exclusively for economic reasons. All in all, from the macroeconomic point of view, both internal and external challenges require that banks, unless they have already done so, reassess which way and how to proceed.

In his biography, Alan Greenspan says that market produces constant stress as in order for someone to gain, someone else has to lose. I fear that many are not yet aware that the market is not a guarantee, but a chance to make money!

And finally, allow me to go back to where I started from. Strong and stable banking sector, primarily in terms of high quality and reliable ownership structure, represents a solid foundation for macroeconomic stability. Despite all the risks, I remain optimistic that we shall be successful in overcoming all of the above challenges.