Bojan Marković: The use of hedging instruments by the National Bank of Serbia

Speech by Mr Bojan Marković, Vice Governor of the National Bank of Serbia, at the FX Hedging Conference, Belgrade, 20 July 2010.

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Let me start by quoting a few newspaper headlines from 2000: "S čekom po kilo mesa" ("Signing cheque for two pounds of meat"), "Vrednost marke na crno i dalje raste" ("The value of deutsche mark in the black market still rising"), "Marka obuzdana kineskim parama" ("Deutsche mark restrained with Chinese money"). I guess they are very telling about the main concerns of the population at the time. For most people monetary policy means only two things: inflation and exchange rate. And as far as I could remember both had always been a cause for concern in the past.

Fortunately, things are changing. Inflation is no longer the main pre-occupation of the public. Since the end of 2008 it has been below 10% – firmly anchored around the NBS targets. The word inflation has all but disappeared from today's headlines.

Not so for the exchange rate. The exchange rate fluctuations still remain a major concern for the public and businesses. The purpose of my talk today is to explain that such fluctuations are a necessary backbone of stable and low inflation, and as such they must stay with us in the foreseeable future (until Serbia enters the eurozone following the harmonization of business cycles). Nevertheless, limiting the negative implications of these fluctuations on households and businesses is possible through the use of financial derivatives and I would like to encourage a greater use of these techniques by banks and businesses.

The flexible exchange rate brings many advantages for the economy as a whole. Today, the level of the exchange rate is not determined by the NBS anymore – it is the product of market forces. Movements in the exchange rate absorb the shocks that otherwise would have gone to inflation or output. Not surprisingly therefore we are now enjoying a period of the lowest inflation volatility in our recent history. Moreover, the flexible exchange rate played a major role in sheltering our economy from the impacts of the crisis. Thanks to dinar depreciation during the crisis, Serbia has performed much better in terms of output than most other countries in the Eastern Europe or the EU. In other words, the flexible exchange rate meant more business, more jobs.

However, for ordinary households and businesses it is difficult to see these advantages. What people see is that fluctuations in the exchange rate are affecting their income – profits, payments for goods or a mortgage. And people don't like this persistent reason for concern.

Yet, a flexible exchange rate is the lesser of the two evils and we will need to learn to live with it without such concerns. These concerns arise, when incomes and expenditures of households and businesses are not in the same currency. For instance, a car importer has to pay in euros for the cars, but will receive dinars from the buyers. An exporter of local meat products receives euros, while most of its costs are in dinars. A household receiving wages and pensions in dinars has to pay in euros for a mortgage. Unless a balance is restored between the currencies of these incomes and payments, people will always watch exchange rate movements with anxiety.

There are several ways of restoring the balance between the currencies of incomes and expenditures – in other words hedging against the risks of exchange rate fluctuations. Some businesses or households are so called "naturally hedged". An exporter who is importing lots of materials from abroad is not really concerned about the exchange rate. Nor is a household that is paying a mortgage in euros, but that is receiving enough income in FX from relatives abroad to cover for these mortgage payments.

Others who are not that fortunate are trying other ways of hedging against the currency fluctuations. The most common way consists of quoting the price in euros and receiving dinars according to the exchange rate valid at the payment day. Such an approach is understandable, but from the perspective of the NBS and macroeconomic policy is not welcome. Such behavior makes our economy and its financial system vulnerable.

Instead, we would like to encourage businesses to seek hedging of currency risks through their banks and their specialized hedging instruments. These instruments allow fixing future payments in any given currency as of today. For instance, with a simple forward contract concluded today one can buy or sell the euro in December 2010 for about 108 dinars with certainty – irrespective of what the actual dinar exchange rate is going to be in December. Sure, with such a contract buyers of Euros will be disappointed, if the actual exchange rate in December turns out to be 104 and delighted when it is 112. But the contract gives them certainty.

Such contracts greatly facilitate cash flow and liquidity management. At the same time, their price is very easy to compute – the future exchange rate depends on today's exchange rate plus the differential between interest rates – the key policy rate of the NBS and refinancing rates of the foreign currency – over the duration of the forward contract.

These simple contracts may be amalgamated into more complicated derivative instruments – such as currency or interest rate swaps, or options – tailored to the needs of particular businesses. Although these products are less straightforward to think about, the banks should be working closely with their clients in providing adequate advice on how to use them as a means of effective hedging rather than speculation.

Expanding on the use of hedging instruments is therefore a big challenge for the commercial banks. Although the situation is improving, only 14 out of 34 banks offer derivative instruments to their clients today. Account managers in banks often do not understand how the derivative instruments could be used in helping the clients. Also the share of inter-bank FX forward trading remains very small – less than 5% of the overall market. This is surely less than the hedging needs of our economy. The lack of competition in providing hedging instruments among banks sometimes also implies that even the simple instruments such as forwards are overpriced, discouraging businesses from using them more often.

And this is the challenge for the National Bank of Serbia too. We are committed to provide for a greater use of FX forward and derivative product both in the interbank market as well as by the corporate sector. The recently introduced FX swap operations of the NBS are an example. We will also work with the banks in standardizing their offer of forward contracts to the clients. Our aim is that every bank offers such a standardized product so that the prices can easily be compared. We will set up a call center advising businesses on such products, provide a simple calculator of forward prices on our website and conduct other promotional and educational activities. Besides, we will be actively encouraging banks' account managers to develop and offer hedging strategies tailored to the needs of their clients.

A greater use of hedging instruments will have many benefits. With most of the foreign currency needs covered by hedging instruments, companies will be able to construct their financial plans irrespective of currency movements. Higher demand for such instruments from businesses will stimulate more competition and lower prices among banks. And a greater use of forward instruments among banks will also reduce exchange rate volatility in the interbank market.

But most importantly, by promoting the use of FX hedging instruments the NBS is hoping to contribute to a situation when businesses and households are no longer scared of the exchange rate fluctuations. Situation when prices are quoted in dinars and not in euros. Admittedly, it is a far reaching ambition, but expanding the use of financial hedging is the first important step.