Bojan Marković: Dinarization strategy in Serbia

Speech by Mr Bojan Marković, Vice Governor of the National Bank of Serbia, at The Financial Markets Association (ACI) Serbia Annual Assembly, Zlatibor, 18 September 2010.

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Judging by the experience of many other countries, Serbia has gone through the crisis well. The decline of the country's output was among the lowest in Europe, inflation was on target, the rise in unemployment was contained. The banking system, well capitalized, came from the crisis largely unscathed.

Yet, rather than boasting about successes, my purpose here is to speak about what could have gone better and what the key stakeholders – the central bank, government and the banking sector – should work on to increase the resilience of our economy and its financial system against potential future shocks.

In contrast to the banking sector, the financial system on the whole, was hardly the source of strength during the crisis. Money market existed only on the shortest maturities. Spot FX market almost disappeared during the crisis, and only recently started to recover higher volumes of trade. Market making initiatives of the banking sector and the ACI – the drivers of the markets development in the past – have been scarce in recent times. And the few existing initiatives – such as the one on the development of basic hedging instruments – are stifled by low trust and credit limits among the market participants.

These are important but small problems. What requires more attention and concerted efforts is to prevent a potential vulnerability of our financial system to the exchange rate risk in any potential future crisis. It is not the toxic assets such as ABSs that were the risk for our financial sector stability during the crisis, it was the sheer quantity of FX indexed or denominated loans to households and businesses who were often unhedged against FX risks.

And I think we will all agree that if there was one single important problem for management of the crisis in Serbia, it would be the high level of financial euroization and, related to it, excessive reliance on foreign resources.

For us at the central bank – and also I believe for yourselves – it was a wary experience to watch the exchange rate swings during the crisis. On one side, depreciation was welcome since it was sheltering the economy from the world crisis. On the other, the consequences for the unhedged private and public sector balance sheets were potentially risky, especially in case of individuals who (although in minority) were quite vocal.

Policy mix on occasions had to act as a compromise in steering the economy through the turbulent waters.

Now, with these memories still fresh and vivid, it is a good time to think how we could reduce the level of euroization and thus improve our capacity to deal with such situations in the future. Indeed, the post-crisis environment provides a genuine window of opportunity to speed up our efforts towards a greater use of dinar and building dinar based financial markets.[1] Rather than de-euroization, I therefore call this – ***the agenda of dinarization***.

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[1] The post-crisis period offers a fairly predictable macro-environment with low inflation. Many bank clients are now acutely aware of the FX risk and so are the banks of the implied indirect credit risk to their balance sheets. The dinar balance sheet may also be a prospective way of expanding the retail banking business in the future, as the FX financing may be more constrained in terms of quality and price than in the past.

One should not be naive – the size of the problem is large. Serbia is one of the most financially euroized countries in Eastern Europe. More than 70% of both assets and liabilities in the banking system are either held in a foreign currency or indexed to it. The high level of euroization in Serbia reflects a history of macroeconomic instability (hence a dearth of local currency deposits), as well as abundant availability of foreign currency funding pre-crisis, and underdeveloped financial markets.

Dinarization will therefore be a long-term process to gradually transform both sides of the balance sheets of both banks and nonbanks. This long-term process will consist of a series of small steps that must be well coordinated. Some of these steps are already being taken, but there is no time to waste.

What gives me hope is the fact that reducing the level of euroization is certainly possible. Several countries have achieved sustained reductions in euroization or dollarization levels in the recent past. In our vicinity, it was Turkey or Poland. Turkey, for instance, has reduced the share of FX deposits from 60 to 30% and the FX loans from 40 to 10% in the decade preceding the crisis. Several Latin American countries have been successful too.

Another good thing is that we are not alone in this process. The development of local currency markets has become a priority item in the global agenda of creating a new world financial infrastructure., This is reflected in a number of initiatives by the G20, IMF or the World Bank. In our region, the EBRD is playing a key role in coordinating these efforts under the Vienna plus initiative.

So, what should be the key requirement on our dinarization strategy? The strategy needs to have realistic objectives, and be technically feasible. It also has to involve all key stakeholders and to minimize the risks of adverse side-effects on the economic recovery or other segments of the economy.

Next, what extent of dinarization is achievable? I believe increasing the share of dinar corporate loans in the banking sector from the current 28 to around 45% in the period of 2–4 years is a simple and appropriately ambitious objective.[2] Under plausible assumptions, such an objective implies a net addition of circa 800 bn of new dinar denominated loans in the next 4 years compared to the existing stock of almost 300 bn.[3] Although ambitious, this objective still provides enough room for the expansion of the FX credits – they could continue growing at 20% in nominal terms, which was the rate of growth of corporate credits in 2009.[4]

Now, are there enough dinar sources for such dinar credit expansion? Yes, and the central bank is ready to supply as much as needed (as long as collateralized by dinar T-bonds), should there be a structural dinar liquidity shortage in the future. Our analysis (based on an average multiplier from the recent years) shows that the current stock of repos and dinar part of FX required reserves should comfortably support the needed dinar credit growth in the next 2 years. However, I would like to send a strong signal that the NBS is ready to start liquidity providing repo operations, if need be, so that the banking sector is not worried about the sufficient sources of dinars in the future. Also, we have already prepared all the necessary infrastructure for such potential move, although we do not expect the need for such a move to arise this year.

The dinarization strategy must involve all the key stakeholders – the NBS, banking sector government, and the public. Most activities will inevitably be done by the NBS and the banking sector. However, increasing the public awareness and receiving an active support of

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2 I am assuming the cross-border loans are granted only to entities with FX denominated revenues and will not be a focus of dinarization campaign.

3 Assuming that the real credit volume in the corporate sector will grow at an average annual rate of 20% (the average between 2007 and 2009). For simplicity we also assume a full roll-over of the existing stocks.

4 With declining inflation along the targets, this implies rising real rates of FX credit growth.

the government are also key conditions for success. For instance, government policies in the past had sometimes prioritized euro over dinar, not really providing a good example to the public. Subsidies extended to FX-based financial products until last year is yet another example. Also, a vast majority of government debt is in foreign currency, making fiscal policy exposed to FX risks. Some public companies continue to make FX deposits and take FX loans regardless of the nature of their hedging needs. Fortunately, the situation is changing rapidly and the government started actively to prioritize the use of dinars.

The dinarization strategy we have in mind has three interconnected pillars. Although activities in each pillar can be pursued independently, the progress is mutually reinforcing. However, careful coordination is needed to minimize potential adverse effects on other economic activities.

The first pillar is the most general but also the most important. It calls for strengthening the macroeconomic environment by delivering low and stable inflation through a flexible exchange rate, alongside durable economic growth and stable financial system.[5]

Understandably, the NBS should continue and further reinforce its flexible exchange rate IT policies under this pillar. Similarly, we should be strengthening our capacity to provide for stability in financial markets. Structural reforms in the real economy and sustainable fiscal policies delivering long-term growth are equally important. Although they rest outside of the monetary policy control, the NBS will support the government efforts in this area.

We should also bear in mind that the real success in this pillar will come only over a long period, requiring prolonged efforts. We are positive that targeted measures, subsidies and campaigns will increase short-term dinar savings and loans. However, a sustained period of macroeconomic stability will be needed before the trust in dinar as a means of storing wealth is re-established.

The second pillar in our dinarization strategy should consist of measures creating favorable conditions for the development of the dinar bond market. The measures should facilitate expansion of the dinar credit activity of banks through promoting dinar denominated instruments and markets. Development of an actively traded dinar yield curve is an important milestone of this pillar.

In this sense, much activity is already taking place. Several commercial banks have started programs offering longer-term dinar credits under both flexible and fixed terms. The government has been raising the local currency share in government debt, trying to extend the yield up to 2Y. Several initiatives under the Vienna plus are taking place focusing on the secondary market for government bonds. Also some IFIs expressed an interest in issuing dinar bonds locally.

However, more still needs to be done before we can see tangible results. The secondary government bond market remains illiquid and the Treasury has been struggling lately with its T-bill program.

The third pillar of our dinarization strategy aims to promote hedging of the existing foreign currency risks in the nonbank sector and to discourage further buildup of these risks. The NBS has been taking a leading role in this field. It has worked with the banking sector on introducing basic hedging instruments both in the inter-bank market and in client transactions. It has also introduced regular FX swap auctions to ease the liquidity management of banks.

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5 An analysis undertaken by experts from the EBRD and IMF has identified the macroeconomic environment – low volatility of exchange rate relative to volatility of inflation – combined with hysteresis and bad memory as the main source of high euroization in Serbia. (See the forthcoming EBRD Working Paper by Chailloux, Ohnsorge, and Vavra.)

In the coming months even more attention will be paid to consumer protection. Our goal is to increase the risk awareness of banks' clients and to improve basic financial literacy. The NBS has launched a public educational campaign through a series of FX hedging conferences and a page at our website.[6] We encourage the banks to take an active role by marketing dinar based and hedging instruments, and building FX risk awareness with their clients.

Finally, further regulation remains an option, but the one we would not like to use as a main means. The regulatory measures should be used to restrict the most vulnerable segments from FX risk exposure, and to ensure that a banking model based on a blunt pass-on of exchange rate risk to clients is not viable.

The NBS has been making regulatory changes gradually always careful that potential side effects do not jeopardize the still fragile economic recovery. We reduced dinar reserve requirement to 5% from 10%, with 2.5% remuneration. We have also amended the prudential debt service-to-income ratios to differentiate by currency matching with borrower income. Also, the compulsory deposit for loans taken in dinars has been abolished, whereas for loans indexed to foreign currency it is still 30%. Government has been on board too, and from May 2010, state-subsided cash and liquidity loans are extended in dinars only.

The NBS is cooperating and intends to further intensify its interactions with the banking sector and ACI in all of these pillars. We would very much wish this to be a two-way process with the banking sector taking a lead in many areas. For instance, we welcomed the decision of the domestic banks to discontinue entirely their small lending programs in Swiss francs. We would be happy to see further voluntary restrictions to target consumer loans to unhedged retail customers. We are ready to discuss and encourage any well meant initiative to help with dinarizing the economy. For example, formal market making or primary dealership arrangements could be considered if there is consensus that such arrangements could help.

All in all, strengthening the resilience of our financial system must be based on increasing the use of dinars. The aim of the dinarization agenda is to discourage the buildup of foreign currency risk in the nonbank sector, to hedge any remaining risks, and to develop the market for local currency financial instruments. It involves a number of very different activities – from pursuing an Inflation Targeting regime to educating borrowers about the FX risk. And it also requires a good coordination among the banking sector, government and the NBS.

A lot has already been done in the past 18 months, but more rests ahead of us. In the period from March to June this year the share of dinar denominated bank assets increased from 24.6% to 27.4% and more than 40% of the newly granted credits were in dinars. True, much of it drew on the government subsidy programs, but several banks have started offering fixed-term dinar credits with a maturity of several years. However, we are not seeing any movements in the currency composition of savings so far. This is despite the fact that saving in dinars has been a more profitable strategy than saving in Euros in the past several years (see charts).[7] But as I said earlier – changes in savers' behavior require years of sustained macroeconomic and financial stability, and they will come gradually.

The NBS is assuming the leading role in the dinarization agenda, but will cooperate closely with the other stakeholders – most notably the banking sector. We therefore welcome your initiatives and encourage an active approach to our common task.

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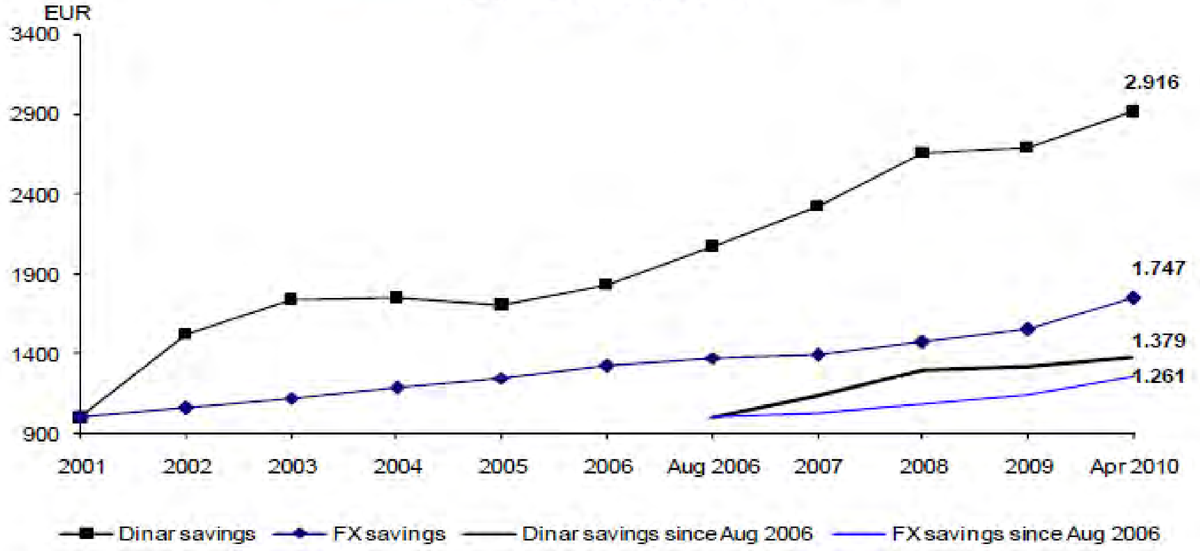
[6] NBS-FX Hedging (http://www.nbs.rs/internet/english/64/index.html).

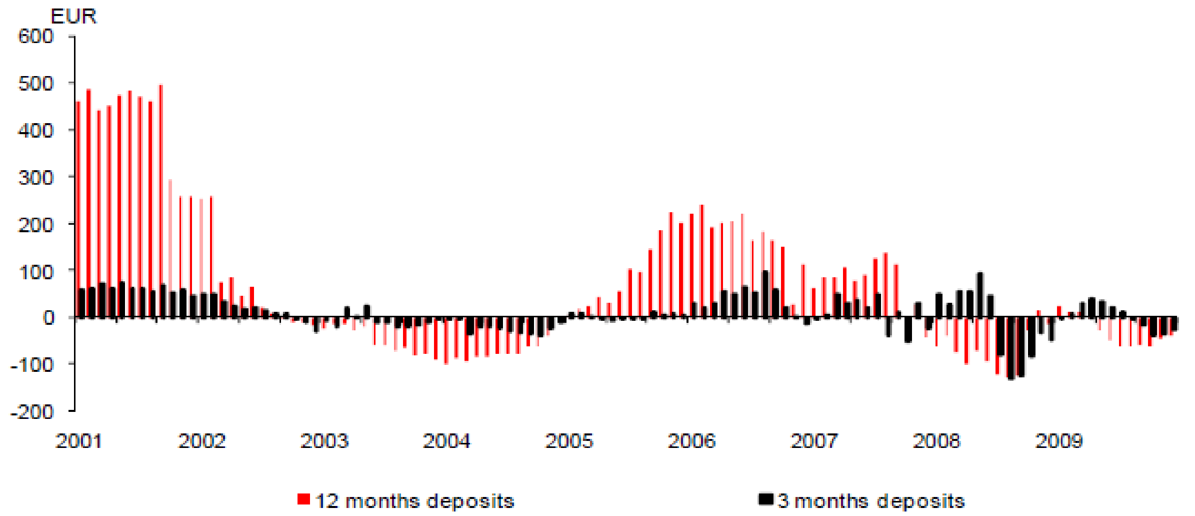
[7] Among others, the NBS has conducted recently two studies on this topic.

Chart 1 Roll-Over of Dinar and FX Savings
(2001 through April 2010)



Exercise 1) Deposits worth EUR1000 in a) dinars and b) euros, are deposited on saving accounts in January 2001 and August 2006 for the period of year. Every year at the end of the term, the deposits increased by interest are rolled over, until April 2010.

Chart 2 Profitability of Savings in Dinars Relative to FX: Net Profit (+) or Loss (-)
(2001 through end 2009)



Exercise 2) Between 2001–2010, EUR1000 worth of deposits, in euros and dinars, are placed each month on saving accounts for a) one year and b) three-month periods. At the end of the term period, the yield on dinar saving deposits were compared to the yield on euro saving deposits (without rollover, interest calculated at the end of the period).