Jorgovanka Tabaković: Financial system and economy – responses to the challenges of the crisis

Inaugural speech by Ms Jorgovanka Tabaković, Governor of the National Bank of Serbia, at the conference "Financial system and economy – responses to the challenges of the crisis", Belgrade, 2 November 2012.

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Ladies and gentlemen,

The on-going sovereign debt crisis in the euro area, most acute in Central and Eastern Europe has shown that no country can remain an isolated island in a global environment of strong economic and financial ties. The adverse effects of the sovereign debt crisis in euro area countries spilled over to the region of Central and Eastern Europe, mainly via dampened external demand, the consequent weakening of economic activity and smaller inflow of foreign direct investments. This went hand in hand with limited access to foreign sources of funding, as country risk premiums and costs of borrowing went up.

In an environment of shrinking foreign capital inflows and exports-generated inflow of foreign exchange, the first line of defence against the crisis is the maintenance and improvement of competitiveness. The price aspect of competitiveness can be improved via exchange rate or by restrictive income policy.

The managed floating exchange rate regime significantly buffered the external shock which Serbia experienced in the last quarter of 2008, when the first wave of the global financial crisis spilled over to our country. In 2009, compared to other countries in Central and Eastern Europe, Serbia's GDP shrunk the least (3.5%). At the same time, countries running the fixed exchange rate regime suffered greater economic turbulences. For example, the Baltic countries Estonia and Lithuania had to resort to adjustments through wage reductions, ending the year with a 15% fall in GDP.

As for Serbia, the flexible exchange rate regime also paved the way out of the crisis. On the one hand, the adjustment did not have to take place through sudden and drastic wage reductions and on the other, net exports gave a positive contribution to GDP growth. In this way, the dinar exchange rate was also the "engine" of Serbia's subsequent recovery, which will facilitate our shift to a new, sustainable model of investment- and exports-driven economic growth. It is true that apart from numerous positive effects, the depreciation may also have a negative bearing on financial stability, especially in countries with a substantial share of external and domestic debt in foreign currency or foreign-currency indexed, and in highly euroised economies such as Serbia. The second pillar of defence against the crisis may be a countercyclical fiscal policy, that is, the stimulation of domestic demand during the time of recession. However, the scope for implementing countercyclical fiscal policy is usually smaller in developing countries. It narrows down even further with the swelling of fiscal deficits in times of crisis, sounding alarms on public debt sustainability in many countries. That is why experts recommend fiscal consolidation instead of fiscal expansion. True, in the short run, fiscal consolidation negatively impacts GDP, but in the medium and long run it lays groundwork for sound and sustainable economic growth, which strengthens investor confidence and pushes down the country risk premium.

When there is not much room for countercyclical fiscal policy, it is expected that monetary policy should provide a boost to economic activity. However, its countercyclical potentials depend on the nature and strength of inflationary pressures. As opposed to the demand-side shocks, the supply-side shocks, such as the current food price shock in Serbia, are usually not addressed by monetary policy because these are temporary shocks with relatively short-lived effects. However, if they trigger an increase in inflation expectations and other prices and jeopardise price stability despite the strong disinflationary effect of aggregate demand,

monetary policy tightening is inevitable. In other words, such circumstances considerably narrow down the scope for boosting economic activity through monetary policy.

The efficiency of monetary policy in Serbia is most constrained by the high degree of euroisation of the domestic economy, which makes the foreign exchange risk the key risk to financial stability. Note that while banks are not exposed directly to the foreign exchange risk since the currency structure of their assets and liabilities is matched, it is the borrowers who take the major brunt of this exposure. And the exposure of the government, corporates and households to sudden and significant changes in the exchange rate may have serious implications for financial stability through the conversion of foreign exchange risk into credit risk.

As confirmed by the stress tests implemented by the National Bank of Serbia, the stability of our financial system is not under threat despite the high share of non-performing loans (NPLs). In September, Serbia's NPL ratio reached 19.9% and was the highest in the region. However, it was in Serbia too that the NPL ratio recorded the smallest increase since the beginning of the crisis. Satisfactory stability of our banking system is also confirmed by the capital adequacy ratio of over 16% and by the full coverage of NPLs by the loan loss provisions. Moreover, Serbia is one of the few countries in the region that registered a slowdown rather than a fall in lending activity. Of course, we cannot expect to see any major step-up in lending and a sharp reduction in the share of NPLs in the short term, but this will happen once the economy heals. The economic recovery is expected to start next year, which should bring investments of better quality and help repair the financial position of the corporate sector.

The current challenge for lending activity and foreign capital inflows across the region, Serbia included, is the deleveraging of EU banks and their potential withdrawal from these markets. Though deleveraging is in essence a healthy process, even for the host country as it contributes to the reduction of external debt, current account deficit and risk to financial stability, it is critical that the process is gradual, or better to say, in accordance with the adjustment capacities of the economy concerned. If otherwise, the host country could face significant threats to its financial stability. To prevent this from happening, small countries need to be proactive and involved in the adoption of international regulations, while communication and coordination need to be improved at global level. A good example in this context is the so-called Vienna Initiative.

The deleveraging of EU banks, registered in nearly all countries of the region, has not bypassed Serbia either. This comes as no surprise considering that the subsidiaries of EU banks account for around 74% of our banking sector assets. It should be noted, however, that banks in majority foreign ownership operating in the Serbian market are separate legal entities, which guarantee for their liabilities with their own capital, and are in that respect independent from their parents. Besides, the structure of the sources of funding in the Serbian banking sector is favourable – domestic deposits being the dominant source and making up over 70% of all bank liabilities. Since end-2008 household savings have gained more than EUR 3 billion, which testifies to increasing confidence in the banking system. It is exactly the high loan to deposit ratio that assured growth in lending activity during the crisis – admittedly slower than pre-crisis, but growth nonetheless. Another guarantee that there will be no abrupt withdrawals from the market is the National Bank of Serbia's regulatory framework, which aims to preclude any sudden movements which could be harmful to the liquidity and stability of the financial system.

Implementation of Basel III in the EU, planned as of the next year, will most probably bring new challenges and further reduce the exposure of EU banking groups towards countries of Central and Eastern Europe. However, encouraging banks to tap longer-term and more stable sources of funding and resorting to alternative ways of funding, chiefly in regard to domestic saving and funds of international financial organisations, may mitigate negative consequences of these processes. When it comes to Serbia, it should also be borne in mind

that deleveraging may help lower the degree of economy's euroisation as a lower volume of foreign exchange sources of funding will encourage banks to obtain and lend funds in the domestic currency to a greater extent. In the current circumstances, it is obvious that the achievement of sustainable external equilibrium and credibility of fiscal policy are paramount for the improvement of Serbia's credit rating and a stable inflow of foreign direct investment and other forms of foreign capital. As I have already underscored, depreciation helps reduce external disequilibrium, primarily over the short run, by ensuring price competitiveness of the domestic economy. However, it does not eliminate the main causes that brought about the deepening of this disequilibrium. The key to the lasting removal of external disequilibrium and ensuring sustainable economic growth are structural reforms directed at productivity growth and economic competitiveness.

A better credit rating will enable more favourable borrowing in foreign markets and a more stable inflow of foreign capital needed to finance new investment and encourage employment. This will ultimately contribute to the stability of the foreign exchange market and facilitate operation of the corporate sector. Provided the Government takes decisive steps in implementation of key reforms of the tax and pension systems, including corporatisation of the public sector, it is highly probable that Serbia's credit rating will not only be sustained but upgraded as well. In contrast, further widening of the fiscal deficit would bring about a higher public debt and deterioration in external liquidity.

Therefore, in defending the country from the current crisis, economic policy makers face numerous limitations. Some of these limitations also represent a chance to set the country's economic growth on long-term stable foundations, which should be the centrepiece of any responsible economic policy. On its part, the National Bank of Serbia will continue to stabilise inflation at a low level and maintain a sound financial system, this being the best way to help the economy in the current circumstances and contribute to the creation of a favourable business and investment environment. Nonetheless, the following must be borne in mind – the more efficient fiscal consolidation and structural changes, the more feasible will it be for the National Bank to achieve its objectives by providing a stronger monetary stimulus to economic growth! And vice versa, of course!