Jorgovanka Tabaković: Serbia reform programme – what can we learn from past mistakes

Introductory speech by Dr Jorgovanka Tabaković, Governor of the National Bank of Serbia, at the Kopaonik Business Forum 2017 "Reform agenda for Serbia – what can we learn from the past and the way forward", Kopaonik, 7 March 2017.

* * *

Accompanying slides

Esteemed representatives of the diplomatic corps, esteemed members of the Government, fellow economists, businesspeople, ladies and gentlemen,

(*Slide 1*) I would like to begin today's presentation by saying that the difficulty lies not so much in developing new ideas as in escaping from old ones. How did I earn the right, privilege and credit to open today's event? Allow me to answer this question myself.

If one successful year could be attributed to coincidence, two successive years to fortuitous circumstances, then three such years in a row, or an entire "Olympic cycle" of good results, are an indicator of undisputable quality, commitment and knowledge. All that we, at the National Bank of Serbia (NBS), have achieved reminds us only too well that we have struck a path of sustainable progress which we must maintain and improve.

The great John Maynard Keynes said: "The difficulty lies not so much in developing new ideas as in escaping from old ones." To which I would add: the problems lie in the inability to sense the right moment, the inability to sense the final moment. In underestimating the resistance to change, in overestimating the results we expect, and in impatience. A sense of measure is above all a key to success.

Those who cannot remember the past are condemned to repeat it. This is what we are talking about today. There is too much negative experience behind us cautioning us, mistakes that must not be repeated. For the price is much too high.

At this event, where I am pleased to present the results of my work, back in 2014 I spoke about Serbia's problems reflected in temporariness, dissent and a lack of continuity. I spoke about a historic desire, which persisted throughout Serbia's long history, to create a man who pays his taxes regularly, is subject to courts, and acquires knowledge. About the need to create a lasting order and system.

In the Balkans, however, this task is much more difficult to carry out than elsewhere. Isidora Sekulić noted this accurately: "Many fought for the freedom and beauty of this land, yet everyone pillaged it and hated it. There is nobody who would make it his homeland and farmland to be cultivated for its own sake. The Balkans is one vast cemetery of different lordships and civilisations." The very same history is cautioning us today, and it is speaking to us in a loud voice.

That is why stability is the key word for all decision-bearers and decision-makers, and stakeholders in the public, economic, political and any other life. For years we were witnesses to short-sighted illusions of positive movements – unrealistic wage increases and growing debts with no grounds or footholds. The situation in public finances was becoming critical. Individual gain outweighed the common, state interests. It was up to us to make sure that this is never repeated.

In economies which are not experiencing growth, spending in advance and projecting an improvement in the standard of living is not sustainable, yet reforms are implemented because of people, therefore we must also take into account the social dimension and sustainability of reforms.

We realised that the long-standing irrational focus of the domestic economy on consumption had to be replaced by an investment and export-oriented use of financing sources, both domestic and foreign. Today, it is investment and net exports, broadly dispersed across economic sectors, that drive the growth of Serbia's GDP.

I am pleased that we have managed to regain the confidence in institutions, in the bearers of economic policy, in the domestic currency. This is attested by the results we achieve within our arrangement with the IMF. It is also attested by the number of investors interested in dinar securities. Yet another proof of that is Serbia's advance on the World Bank's Doing Business list.

What we have achieved commits us to persevere in this.

What was one of the major problems we faced? Over the last decade, the relationship between monetary and executive authorities could be defined by the phenomenon of "competitive decadence between the West and Russia." It was a relationship of superiors and subordinates, a relationship where everyone wanted to have the victors and the defeated, where everyone took part in the tug-of-war. You may be familiar with this phenomenon in practice as the "prisoner's dilemma" – the larger the personal contribution, the lower the potential for cooperation. We had competitions, instead of coordinating activities to try and find the best solutions. Solutions which would be the best for society and for the majority of citizens.

What were the consequences – high interest rates, high and volatile inflation and an unstable exchange rate. This is why a relationship which implies coordination and cooperation between the monetary and executive authorities, with strictly divided competencies, is of such importance today.

Cooperation of the NBS with the Government and all ministries has been at its highest level for several years now. At the same time, each institution has retained independence in its operation. We are working together to improve the composition of investors in government bonds. We do not want to depend on individual investors who come here, make a quick and easy profit and leave. Investors are now many; they are sound, and they are here for longer periods – this is the future. Equally so, we do not want to be unprotected from external impacts. Public debt will be safe from fluctuations in foreign currencies and the exchange rate more resilient to shocks from abroad.

(Slide 2) Since August 2012, the NBS has made a considerable shift in its approach to monetary policy and to establishing and maintaining financial system stability. And now we have the results. The year 2016 ended with y-o-y inflation at 1.6%, a stable exchange rate, lower interest rates and the lowest level of non-performing loans (NPLs) in six years. As a result of all that, the inflation target was revised down to 3±1.5%. Thus, we have come closer to developed economies.

Let us go back and touch on continuity. In order to maintain continuity, and turn these results into a good starting point for the continuation and conclusion of transition, we must not give up on such results because it would take us more than ten or twenty years to return to where we are now, and perhaps even longer than that to build credibility.

(Slides 3 and 4) During 2016, inflation remained low and stable, and stood at 1.6% y-o-y. Average annual inflation in 2016 was 1.2%. In January 2017, it equalled 2.4% y-o-y and was within the bounds of the new target tolerance band.

As for factors arising from the domestic environment, a contribution to low inflationary pressures came from the effects of fiscal consolidation, relative stability of the exchange rate and a successful agricultural season, as well as low and stable inflation expectations of the financial and corporate sectors which are within the tolerance band. In terms of external factors, as in prior years, low inflation was maintained owing to low prices of primary products, as well as to generally low headline inflation in the international environment.

The greatest contribution to inflation came from petroleum products, fresh meat, travel packages and administered prices (chiefly cigarettes and electricity).

We expect inflation to move within the target tolerance band over the projection horizon. In the short run, a rise in inflation will be primarily driven by the low base effect from prices of petroleum products and the January increase in cigarette prices. In the medium run, a rise in inflation will be driven by an increase in aggregate demand and inflation abroad.

The risks to the projection are judged to be symmetric and primarily relate to trends in the international financial and commodity markets, and the spill-over effect of global oil prices on the prices of petroleum products at home. Also, the price trajectory will be shaped by the degree of success of this year’s agricultural season.

(Slide 5) Ladies and gentlemen, when all think likewise in the market, no one actually does any thinking. When the market consensus is achieved, markets grow more vulnerable than ever. We were not swayed by persuasions of many that Brexit would not take place, or that surveys in the USA hinted at an unambiguous outcome of the presidential election. We were prepared for the “unexpected” and not for a moment did we let the turbulences roil the domestic market and reflect on the exchange rate. In times of tranquillity we were honing our defence system for the upcoming pressures, while in the times of turbulences we invested wisely in stability.

From January 2008 to August 2012, the dinar lost 33.2% against the euro. Since then, it has weakened seven and a half times less. At the same time, four times less FX reserves have been spent. I call this commitment, efficiency and conscientiousness, dedication to the general interest!

(Slide 6) In 2016, the dinar depreciated by 1.5% against the euro. Depreciation pressures mostly came from turbulences in the world financial markets which affected non-resident activity. Appreciation pressures followed in July, aided by increased interest of foreign investors who wished to invest in dinar government securities, and these pressures lasted into the following months (until November 2016). Appreciation pressures were fuelled by a significant recovery of domestic macroeconomic indicators, positive IMF reviews of the implementation of the stand-by arrangement and greater investor confidence in Serbia, which was confirmed by the improvement in credit rating by Fitch (on 17 June 2016 the rating was raised from B+(p) to BB-(s)).

Depreciation pressures at the turn of the year came from stepped-up sale of dinar government securities by non-residents in the secondary market, payout of profit to non-residents through dividends, a seasonal increase in FX demand of domestic energy importers and a reduction in net indexed bank assets. The key risk from abroad emanates from the Fed’s rate hike and the resulting withdrawal of international portfolio investors from capital markets of emerging countries, which spurs depreciation pressures on currencies of those countries.

To moderate excessive daily exchange rate volatility, in 2015 the NBS intervened in the IFEM by buying EUR 970 million and selling EUR 450 million (net purchase of EUR 520 million), thus creating a buffer to subdue depreciation pressures that prevailed in the first half of 2016. In 2016, the NBS sold EUR 980 million and bought EUR 820 million in the IFEM (net sale of EUR 160 million), intervening mostly on the purchase side from July till November. The first half of 2016 saw depreciation pressures, while the latter half was primarily characterised by appreciation pressures. Since the start of 2017 (as at 28 February), the NBS sold EUR 330 million in the

IFEM. Since the start of 2017 (until 28 February), the dinar lost 0.4% against the euro.

(Slide 7) How much is the domestic currency used nowadays? What is the level of interest rates? In 2008, only a fifth of total household loans were in dinars. Today, they account for nearly 50% and you must admit that this is a significant result. The cost of new dinar borrowing has been cut by over 10 pp.

(Slide 8) Interest rates in the dinar segment of the market mirror the trends in the key policy rate. Since May 2013, when the easing cycle began, the NBS has trimmed the key policy rate by 7.75 pp, and interest rates on dinar loans have dropped by over 10 pp, both in the corporate and household sectors.

From 2012 to 2016, interest rates on newly approved dinar loans to corporates were cut by 11.6 pp, while interest rates on newly approved dinar loans to households were trimmed by 10.7 pp.

Total loans to corporates and households rose by 1.9% y-o-y in December 2016, led by the rise in household lending (10.1% y-o-y). Excluding the effect of corporate loans write-off and early loan repayment by a public enterprise to domestic banks in October, covered by a cross-border loan, the y-o-y rise in corporate lending equalled around 1.5% in December.

(Slide 9) In 2016, internal imbalance continued to narrow, as shown by the general government deficit of 1.4% of GDP (vs. 3.7% in 2015 and 6.6% in 2014), mostly on account of improved collection of all categories of tax revenue. Favourable fiscal movements persisted in January, according to preliminary data at Republic level.

As regards the projection of fiscal movements, in 2017 consolidated deficit is expected to be at a level similar to that in 2016, despite the wage and pension increase and higher capital expenditures, mainly due to the continued rise in tax revenues.

In late 2016 public debt was lower than in late 2015 (a year prior relative to the initial projection). It will stay on a downward path in 2017, and I believe in the coming years as well.

We all tend to be impressed with the achievements of physics and information technologies and often disregard the importance of economic theory and its most direct and unfaltering impact on our everyday lives. A bad reform or wrong economic moves can have devastating consequences. They can pauperise and make jobless people across the social strata.

Wrong theories suggest wrong reforms, but the responsibility has never been with theoreticians and advisers. The responsibility lies with decision-makers. We shall therefore listen to what everyone has to say at this event, but we shall work in a way that will help us come here before you next year with the best possible results. And I am referring to fiscal consolidation and structural reforms.

(Slide 10) Dear colleagues, while improving our macro- and investment environment, we have preserved the necessary stability of the financial sector. Though the objectives in this area are hard to measure, the results achieved by the NBS are indisputable. It is enough to look behind and remember 2012 and the challenges we faced at the time. The presence of a number of weak banks called for an urgent solution. We have today a banking sector with higher capital adequacy and a significantly lower level of NPLs. We have come a long way – we have preserved both financial stability and citizens' trust in the Republic of Serbia's banking sector. This is corroborated also by household foreign exchange savings exceeding EUR 9 billion in January this year for the first time on record.

With the exception of several smaller banks, Serbia's banking sector remained stable during the crisis. The capital adequacy ratio is much above the regulatory threshold of 12% – at end-September 2016 it equalled 21.2% (end-June 2016: 21.6%), owing mainly to a 3.1% rise in risk-weighted assets (reflecting primarily growth in credit risk-weighted assets).

According to preliminary data, the profitability of the banking sector improved in 2016 compared to 2015. Net pre-tax profit was around EUR 217 million.

(Slides 11 and 12) What remains to be tackled is the amount, level and structure of NPLs. Credit risk reflected in a relatively high share of NPLs in total loans poses the greatest problem for us. However, it should be borne in mind that a considerable portion of NPLs was inherited from the pre-crisis period. At the same time, during the crisis the NPL growth in Serbia was lower than in other countries of the region. Since end-May 2015, when it reached its peak, the NPL ratio has been on a downward path, though remaining relatively high (17% at end-December 2016, down by 4.6 pp relative to the same period the year before).

As regards the NPL structure, the corporate sector still accounts for the largest share. It accounted for around 45% of total NPLs in December 2016. At the same time, the NPL ratio has been on a decline (17.5% at end-December 2016).

The gross NPL ratio for the household sector is much lower than for corporates (it equalled 10% at end-December 2016). In late December 2016, the NPL ratio for housing loans was 8.7%, followed by 7.5% for cash loans.

It is noteworthy that gross NPLs remain fully covered by loan loss reserves. At end-December 2016, loan loss reserves covered 131% of gross NPLs, while allowances for impairment (under the IFRS) covered 67% of gross NPLs.

Movements in NPLs in the coming period will depend primarily on the situation in the real sector, but also on the domestic legal framework and its efficiency. Confirming the commitment of competent government authorities to tackling NPLs in a systematic and comprehensive way, in August 2015 the Government of the Republic of Serbia adopted the National NPL Resolution Strategy. The Strategy is being implemented by experts from the NBS, ministries of finance, justice, economy and construction, the Deposit Insurance Agency and other competent authorities and institutions. The NBS has implemented all activities envisaged by the Action Plan. The results are already visible as NPLs fell by 4.6 pp in 2016 to their lowest since January 2011.

It is high time we dedicated a part of our future endeavours to increasing efficiency, availability and quality of services of the financial sector, particularly to ensuring further growth in sound credit activity. There are no perfect, competitive markets anywhere in the world, Serbia included. From a social viewpoint, it is important that profit be at least partly transferred from companies to consumers, from banks to clients – in the form of lower prices and better services. We are confident that banks will be led by the objectives of long-term sound and sustainable operation, while at the same time mindful of the interests of financial services consumers.

Dear colleagues and friends, some people examine the past to define the future. I believe that we need to glance at the past only occasionally, just to be reminded of what we have learned and experienced, and look around us to see what we have accomplished, but that we must constantly look towards future challenges. This is the only recipe for success! And maybe, using the example of the NBS, in a part where we are similar to the economy, I could comment on it with Mr [Group Executive of Market Development for Europe, Jason] Lane, and invite him to help Serbia, using the reputation of the large and well-known company such as MasterCard, to preserve a domestic card called “Dina” by co-branding, because until we value ourselves, we will not be valued by others. And I value the opinion of each and every one of you. Thank you for your attention.