Bojan Marković: Desirable capital inflows in Serbia

Speech by Mr Bojan Marković, Vice-Governor of the National Bank of Serbia, to dealers at the Bloomberg conference, Belgrade, 27 April 2010.

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Deliberating consequences and policies of capital inflows seems perhaps inappropriate against the backdrop of recession and depreciation pressure on dinar. Yet, the situation may change rapidly, as the recent experience of the emerging Europe attests. Just a year ago Poland, Czech Republic and Romania were concerned about capital outflows and weakening exchange rate – as was Serbia. Now there are increasing signs that capital starts flowing again into the emerging Europe and these countries are finding it difficult to cope with the consequences.

A similar turnaround in capital flows can happen in Serbia anytime soon too – we are not doing worse than these countries as regards the macroeconomic performance or financial system stability. One such trigger could be the planned issue of medium-term T-bonds that are likely to attract much attention of international investors.

It is perhaps wise to use this occasion and review the thinking about capital flows from the perspective of the National Bank of Serbia. We feel it is important for traders and other players in the financial markets to understand the central bank's attitudes so that they could anticipate our policies and feel comfortable in their activities.

Capital inflows are welcome! They have been a necessary backbone of our growth model, helping the Serbian economy to realize its catch-up potential in the absence of domestic savings. Before the crisis foreign savings financed most of our investments (the investment share was 28% of GDP and domestic savings around 8%). Hand in hand went large productivity gains and terms of trade improvements, which were mostly associated with foreign direct investments (share in GDP of 7% was relatively high). Capital flows also contributed to improving financial sector infrastructure, increasing the resilience of the financial system to shocks, and allowing for a smoother and efficient allocation of resources.

However, by drawing on foreign savings capital inflows also allowed our consumers and government keeping high consumption levels. Practically the entire Serbian income was consumed in the period before the crisis. Such a model of growth was therefore socially attractive, but economically unsustainable. The prospects of repaying the ballooning external debts were dim against the backdrop of low competitiveness and exports of our economy. And although the investment ratios looked high, even higher were necessary, especially given that the investment structure did not support stronger growth in our competitiveness.

Regardless of their structure, capital inflows have complicated the life of a policy maker in many ways. On a macroeconomic level, the reliance on foreign savings, especially when channeled into consumption, manifested in large current account deficits. They reached as much as 18% of GDP before the crisis and their long-term viability was rightly questioned. The influx of capital into nascent financial markets with a low absorption capacity has led to periods of sharp appreciation and contributed to unnecessary large exchange rate volatility. Such appreciation spells – such as the one in 2006 – also encouraged excessive foreign currency borrowing.

But these macroeconomic phenomena were not the major problems per se. After all, exchange rate volatility is a key element of the Inflation Targeting regime, it prompts the development of hedging instruments, and facilitates de-euroization of the financial system. The moderate current account deficits could be partly just a flip side of high investment ratios that are needed for our catch-up process. There is no doubt large capital inflows are needed for growth to resume in the coming period. If the inflows are used wisely to increase the productive capacity – and especially so in manufacturing, the current account deficits should be self-corrective over long horizons, as many examples – also from the Eastern Europe – attest. Investments in infrastructure are an example of how capital inflows can help increase the productivity capacity and raise long-term growth prospects.

Before the crisis, the major problem with capital inflows in Serbia was the unbalanced risk sharing and mismatches involved, potentially jeopardizing the stability of our financial system. The catch-up potential is a long-term process requiring long-term financing. But a part of the financing was short-term, requiring a regular roll-over. Furthermore, most of the financing came in a foreign currency, while most revenues are denominated in the local currency.

Unlike the popular wisdom, it is not a reckless risk behavior of foreign investors that put our economy at risk – it is the lack of it.

The risks involved in the currency and maturity mismatches were not born by foreign investors, but by domestic businesses and partly by households. They suffered the most, when the capital flows dried up and the currency depreciated. Many blame the fragility of the financial systems in emerging Europe on the “so called” speculation or carry traders. But who was the most important carry trader in Serbia? A large number of households – not a shrewd financier from London. And who bore most of the currency and maturity risk? Again domestic entrepreneurs and partly households – not the foreign investors.

It is because of this unbalanced risk sharing that policy makers have to remain cautious about capital inflows. Our macroeconomic and financial stability was put in danger during the crisis not because we had been borrowing abroad to finance growth, but because foreign investors did not carry adequate share of the risks involved in these activities. Those businesses that were financed by foreign direct investment did not suffer so much from the lack of financing during the crisis, nor did those who borrowed in dinars, when the currency depreciated. In both these cases the foreign investors ventured into the future prospects of our economy – hoping to enjoy benefits but also sharing the risks. Those foreign investors who bought into dinar denominated financial instruments took the fair burden on their shoulders, while those who had a stop-loss deposit with a local bank left the damage here.

This discussion gives a background for our thinking about capital inflows in the future. We welcome all kinds of inflows, but as long as the financing risks involved rest fairly with the investor and not only with the local economy. That of course favors long-term flows to short-term, because most investment projects require long-term financing. Foreign direct investments or joint ventures are the most preferred examples here – also because they bring other positive externalities in terms of know-how and technology. Such investors clearly demonstrate their long-term commitment to the prospects of Serbian economy.

But we also encourage pure financial flows – even short-term, if they match the financing needs. For many reasons explained earlier, they contribute to financial market development and help risk diversification.

In particular, we are hoping the issue of dinar-denominated T-bonds will attract much attention of foreign investors, and the program will be success, eventually allowing the government to reduce the FX part of its debt. We are also hoping that higher volumes will help spur secondary trading and develop a dinar yield curve for benchmarking of other dinar-based instruments.

For all these reasons we encourage foreign investors’ involvement in local currency T-bonds – but we have clear preferences as regards specific forms of such an involvement. We prefer the forms in which the foreign investors take most of the credit and FX risks, such as direct purchases into buy&hold or trading portfolios. On the other hand, participation in T-bonds through deposits and/or swaps with local banks is less welcome, because a substantial part of the market, credit or FX risk remains with the local banking sector. An example of a least favored involvement is a deposit with a local bank combined with a stop-loss that keeps all the risks in the domestic financial system. Such involvements we would like to discourage.

As regards practical policy consequences, we believe that what is good for the stability of the economy is also good for the market participants individually in the long term. We therefore prefer corrective self-regulation to regulatory action. We understand that it may be difficult for individual players to internalize all consequences for the entire financial system, but we are here to provide enough guidance through speeches and regular discussions.

That being said, we stand ready to act swiftly, should we see that the imbalances from unequal risk sharing accumulate in a way dangerous to the financial system. We have enough tools for that purpose, including punitive reserve requirement and remuneration policies, as well as prudential measures aimed at liquidity, capital or open positions.

In summarizing, by no means we would like to see lower volumes of capital inflows. We would only prefer to see a different structure than in the past. Structure, in which foreign investors adequately share the risks involved in investing into the local economy. This does not imply only foreign direct investments and joint ventures – we also encourage pure financial flows as long as the credit, maturity and FX risks are not left entirely with the domestic financial system.

The upcoming dinar T-bonds issues are going to be a good occasion for a renewed foreign investors' interest in the local financial market. We are hoping to see more trading, larger volumes, more market development, and more risk taking. It will also be a good occasion to test how the financial market players understand our preferences about risk needed for the balance of our financial system.