Bojan Markovic: FX volatility and market stability

Speech by Mr Bojan Markovic, Vice Governor of the National Bank of Serbia, at the Annual ACI Conference, Zlatibor, 17 September 2011.

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Ladies and Gentlemen,

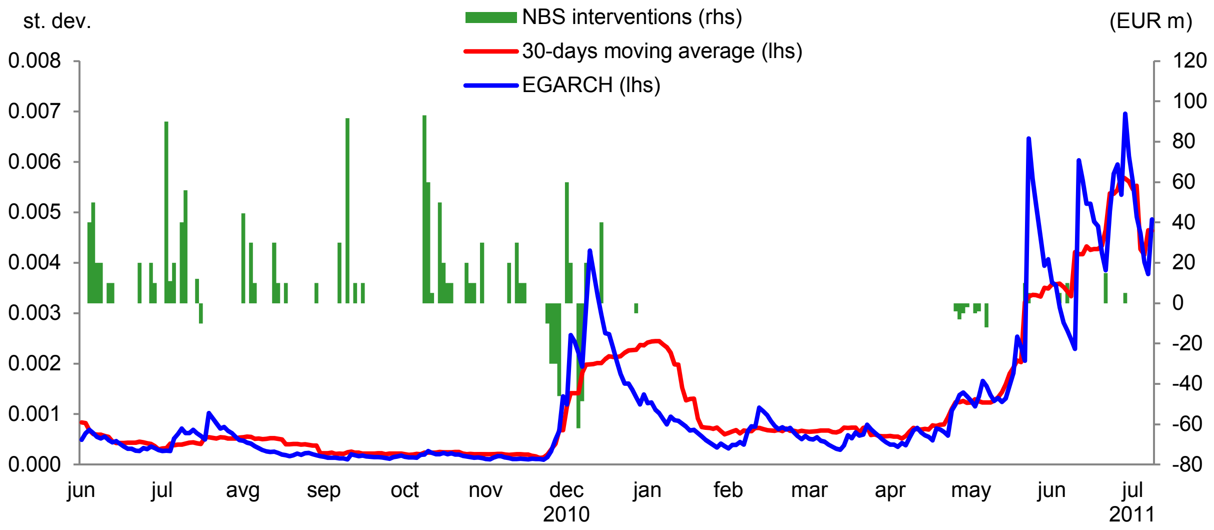
A year ago, I was standing here in front of the very much the same audience, expounding on the benefits of exchange rate flexibility. I argued that exchange rate flexibility is a necessary backbone of stable and low inflation, and as such it must stay with us in the foreseeable future. I reasoned that movements in the exchange rate absorb shocks that otherwise would have gone to inflation or output and applauded the role the flexible exchange rate played in sheltering our economy from the impacts of the crisis.

At the same time, however, I called for a greater use of hedging instruments and sheltering the financially less literate sectors of our society from unwarranted exchange rate exposure. The way forward, I argued, is not through limiting exchange rate volatility, but rather through expanding on the use of dinar based and hedging instruments. Accordingly, monetary policy based on a flexible exchange rate has become a cornerstone of our efforts to increase the use of dinars in the economy.

A year on, some of the effects of exchange rate volatility are already visible. The daily exchange rate has certainly become more volatile. According to some measures[1], the daily volatility increased threefold in the past year, although it still remains lower compared to, for instance, volatility in similar countries with flexible exchange rate, such as Poland, Hungary or Romania. And we expect that to remain the case in the period ahead.

Chart 1.

NBS interventions and short-term FX volatility



[1] Charts 1 and 2 report 30-days moving average and EGARCH measures of daily volatility.

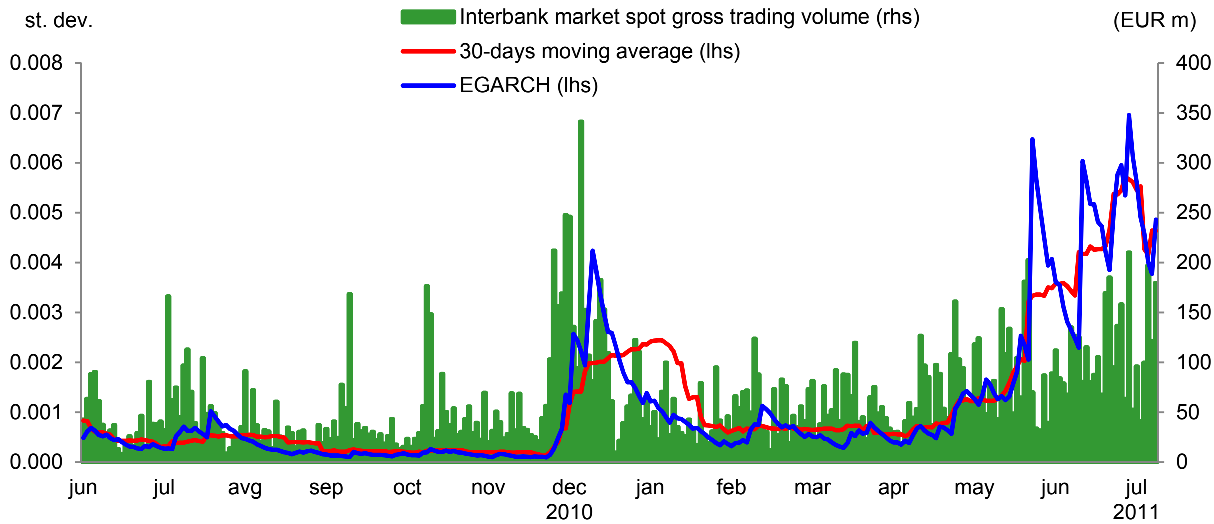
The increase in exchange rate volatility was taking place against a declining presence of the National Bank of Serbia (NBS)in the FX market. With more than 100meuros volume a day, continuous quoting and low spreads, the market has recently been able to absorb larger orders from both sides of the market than before, within only moderate exchange rate movements, and without an excessive central bank's assistance. Indeed, the interbank market volumes and the central bank's presence have been inversely correlated, and this behavior is in line with the experience some other countries, for example the Czech Republic, had at this stage of market development in transition.

In Serbia, the daily FX volatility increased at the beginning of the year, following the discontinuation of NBS interventions in the final months of 2010. After calming down during the first months of 2011, the volatility started rising once more in May this year – again after the NBS stopped intervening.

While the stronger NBS interventions would successfully calm the markets, they would also delay market development by stifling genuine market making of private banks. Some of our evidence points out that the short-term exchange rate volatility increases gross trading volumes in the interbank market and thus strengthens the arbitraging behavior of market participants.

Chart 2.

Short-term FX volatility and spot trading volumes in the interbank market



Our recent experience thus gives a fairly straightforward answer to a notorious chicken-and-egg problem. Less central bank presence in the market increases short-term exchange rate volatility, which in turn strengthens market making and volumes, making the market more resilient to shocks and thus decreasing the need for NBS interventions.

In addition to supporting market making, higher short-term volatility should also help market development by discouraging short-term speculative behavior. Arguably, a 1% daily volatility in the exchange rate presents a problem for an investor seeking an immediate profit from its FX position, but is less of an issue for a longer-term investor in Treasury securities. In this manner, the higher short-term volatility may have also strengthened the stability of financial system in Serbia.

In the NBS, we are also looking into the effects higher exchange rate flexibility has on the degree of financial dinarisation. The NBS has started publishing a quarterly report on the progress in its dinarisation efforts. While there are some encouraging developments already, the process is a long-term phenomenon and overall trends are not yet clearly visible in the data. Nevertheless, we can observe that the bank credit market is becoming increasingly dinarised. An increase in the level of dinarisation can partially be related to the increased monthly volatility of the exchange rate. Portfolio models of financial intermediation[2] suggest that the combination of inflation targeting and increased exchange rate volatility should foster the use of the local currency and discourage the use of the foreign currency. Preliminary econometric analysis of the Serbian data for the past three-years suggests that indeed there exists a relatively fast link between higher exchange rate volatility and a higher degree of dinarisation. In particular, higher monthly exchange rate volatility appears to increase the loan dinarisation with a delay of around two months.

Also, increased exchange rate flexibility might be contributing to the somewhat weakening link between domestic prices and the exchange rate. A recent NBS analysis suggests that the pass-through of the exchange rate to prices has declined over the past several years, since the Lehman Brothers episode.

In summarizing my short speech: plain data, the experience of other countries, as well as more sophisticated analysis suggest that somewhat greater short-term FX volatility has been beneficial for market development. Indirectly, it has allowed for lower National Bank of Serbia presence in the market and contributed to making the market more resilient by attracting longer-term and discouraging short-term hot inflows. We have also observed that dinarisation might be reacting positively to somewhat higher exchange rate flexibility and so does an increased use of hedging instruments.

That said, although in the long run our goal remains full flexibility of the exchange rate, until the FX market in Serbia becomes deep enough and fully efficient, the National Bank of Serbia stands ready to react with its large stock of FX reserves and ensure normal functioning of the market, should it be needed. But we shall carefully measure our actions so to avoid endangering the now dynamic process of structural market development in Serbia.

On that note I thank you for your attention, and wish you a successful annual meeting.

[2] For example, A. Ize and E. Levy-Yeyati (2003), Financial Dollarization, Journal of International Economics, Vol. 59, pp. 323–347.