NATIONAL BANK OF SERBIA

Speech at the Presentation on Current Developments and Challenges in the Financial System

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Ladies and gentlemen, dear colleagues, friends and members of the press,

It is a great pleasure for me to greet you today at the presentation focusing on financial stability in the Republic of Serbia. This is the second time this year that we have invited you to discuss these important issues. On the first such occasion, back in July, we used the opportunity to present our **Annual Financial Stability Report** to the general public. The assessment of financial stability presented in that Report was based on one-year data from banks' financial statements with the cut-off date of 31 December 2014. Today, we shall present to you and the public our view of the developments in the international environment and the position of the Serbian economy within the current financial cycle. Again, the assessment horizon will be a one-year period, but the assessment will be based on the banks' quarterly reports with the cut-off date of 30 June 2015.

As mentioned back in July, throughout history, crises have been the turning points that changed the tasks and practice of central banks. We can freely say that today, in the aftermath of the latest financial crisis, the National Bank of Serbia holds in check three major aspects of stability and these are: the stability of prices, stability of the national currency and stability of the financial system as a whole. These three aspects, i.e. objectives, are not independent of each other. In Serbia, the stability of the financial system is closely intertwined with the stable value of the national currency, since a bulk of lending includes a foreign currency clause. Therefore, a failure to fulfil the objective of stable national currency would lead to the failure to achieve other central bank objectives as well. The reverse, however, does not apply: the fulfilment of one objective, say price stability, is no guarantee that full financial or macroeconomic stability will be automatically at hand. That is why central bankers must juggle several balls at once, balancing the reference rate, reserve requirements and various other instruments ranging from interventions in the foreign exchange market (that have become a regular tool, even for those central banks that boasted a free float exchange rate before the financial crisis), all the way to a full arsenal of specific macroprudential measures.

Serbia is a small, open and highly euroised economy fully integrated into international financial flows – the systemically important banks in Serbia are actually subsidiaries of large European banking groups. That is why international developments can easily spill over into the Serbian banking sector and the Serbian economy. However, the risks coming from the international environment have decreased relative to the last quarter of 2014. It holds true that uncertainty over possible changes in the direction of monetary policies pursued by major central banks could add to the volatility of international financial markets, global currencies and capital flows, and that the brunt of this impact would be felt by emerging markets. However, considering the ownership structure of the Serbian banking system, what happens in the financial system of the EU is much more important for us. Following a comprehensive asset quality review in the European banking sector, the general public in the EU is again learning to trust banks as their capital and liquidity balances are beginning to improve. That is not to say that all the troubles are over: the recovery is slow, interest rates are at record lows, and this affects banks' profitability. The alarming level of private and public debt on the balance sheets of certain banks makes these banks vulnerable to yield fluctuations. Also, some banks (notably Italian, Austrian and French) are heavily exposed to Russia and Ukraine. Finally, following the approval of the third Greek bailout programme, the level of public debt risk in Greece has diminished considerably, although it can never be completely counted out. As we have already underlined, these international developments could put some pressure on international banking groups to lower their exposure to the Serbian market and that is why it is of crucial importance that the banks in Serbia maintain high levels of liquidity and capital reserves at all times.

On the domestic front, the current potential risks also show signs of abating as continued fiscal consolidation paves the way to public debt sustainability. The current monetary and fiscal policy mix supports financial stability in the country.

Although still below its long-term trend, the Serbian economy is now in the phase of the financial cycle that could easily be the beginning of a revival. The growth projection has been revised upward for the third time this year: in February the economy was expected to contract by 0.5%, in June it was expected to stagnate, in October it was expected to grow by 0.5%, whereas following the latest revision it is projected to grow by 0.8%. It should be pointed out that growth has been achieved against the backdrop of heavy fiscal consolidation measures and a relatively poor agricultural season.

Turning our attention to credits, it appears that the credit activity is stagnating. From the aspect of financial stability, however, it should be noted that banks managed to adjust their loan-to-deposit ratios and the National Bank of Serbia is determined to keep those ratios at the levels achieved. Another important thing is that there is a marked potential for credit growth, since over 52,000 enterprises showed profit in their financial statements. Also, based on results of the bank lending survey, already there are signs of favourable developments in lending reflected in the easing of credit standards and the increase in credit demand of both the household and enterprise sectors.

The level of non-performing loans is still high, but the credit risk is neutralised through heavy provisions both in accounting and macroprudential terms.

Ladies and gentlemen, dear colleagues, friends and members of the press,

Let me conclude with a few key messages, before I give the floor to the General Manager of the Financial Stability Department. The messages shall be brief but substantiated:

- The results of analyses of the key financial soundness indicators (indicators of capital adequacy, liquidity and profitability) look encouraging and show improvement compared to the last quarter of 2014.

- The analysis of indicators based on market perception and investors' expectations (prices of shares of domestic-owned banks, prices of shares of foreign-owned banks, credit risk insurance premium for five- and ten-year bonds issued by relevant European countries and bonds issued by the banking groups having subsidiaries in Serbia, yields on Serbian government bonds, etc.) shows that the investors' perception of risk has improved from the last quarter of 2014.

- The latest results of bank solvency stress-testing show that the Serbian banking sector is resilient to stress, and that it would remain solvent even under conditions of heavy depreciation shocks and a long-lasting recession.

- The results of liquidity stress-testing show that the Serbian banking sector would not be jeopardised even in case of considerable deposit flight.

- Specific liquidity stress-testing of Greek-owned banks (which account for 13.3% of the Serbian banking sector assets) indicates that banks in Greek ownership are also adequately resilient to deposit flight.

- We see no room for a domino-effect scenario, as the Serbian banking sector is simply not interconnected in a way that would make it possible for the insolvency of one bank (even if it is a systemically important bank) to spread over and directly jeopardise the stability of the system as a whole.

- Further on, although Serbian banks are indirectly interconnected in terms of providing loans to the same enterprises, the insolvency of one or more enterprises would not bring about solvency problems in any individual bank.

- Serbian systemically important banks scored better than is the average for the Serbian banking sector.

- The National Bank of Serbia closely observes developments in the field of financial stability regulation in the EU, as well as new instruments and tools used towards achieving financial stability. There is no doubt that full implementation of financial stability regulation and its instruments would bring about positive results. However, it is equally true that the implementation of new macroprudential requirements would lead to different results across European countries, depending on the size of their financial systems, their development and maturity. At first moment, the transposition of the new European regulatory framework aimed at more conservative regulation (including strengthened capital requirements both in terms of size and quality, stricter assessments of risk and vulnerability, as well as full transposition of the CRD IV package) into the domestic banking regulation would almost certainly work towards lowering the resilience of Serbian banks. However, that initial impact would soon pass and the full implementation of the regulation, from 2019 on, would bring the full positive effects to the financial stability of our country. Also, considering the current level of capital adequacy in the Serbian banking system, adjustments to EU regulations in terms of capital adequacy will not pose a problem for any bank in Serbia.

Thank you for your attention!