

NATIONAL BANK OF SERBIA

R E P O R T
ON DINARISATION OF THE SERBIAN FINANCIAL SYSTEM
September 2011

Belgrade, December 2011

Introductory note

More extensive use of the dinar in the financial system and better currency matching of assets and liabilities of the non-bank sector would improve the country's financial stability, lessen the risk of exchange rate volatility in the most vulnerable sectors of the economy, and reinforce the efficiency of monetary policy.

To inform the public about changes in the degree of dinarisation, the National Bank of Serbia (NBS) prepares and publishes the quarterly *Report on Dinarisation of the Serbian Financial System* as one of its supporting communication tools. The *Report* provides key information about developments in the dinar market and highlights measures and activities (to be) taken by market players and regulatory authorities with a view to supporting the process of dinarisation. Access to this information will help raise public understanding of the necessity to hedge against changes in the exchange rate, as well as of the measures and activities to be taken in order to encourage the process of dinarisation of the Serbian financial system.

Reports on Dinarisation of the Serbian Financial System are available on the National Bank of Serbia's website (www.nbs.rs).

DINARISATION STRATEGY

The dinarisation strategy rests on three inter-connected pillars.

The first pillar is the most general, but also the most important. It calls for strengthening the macroeconomic environment by delivering low and stable inflation through a flexible exchange rate, alongside durable economic growth and a stable financial system.

The second pillar consists of measures geared at promoting dinar-denominated instruments and markets, with a special emphasis on the development of the dinar bond market. Development of an actively traded dinar yield curve is an important milestone of this pillar.

The third pillar aims to promote hedging of the existing foreign currency risks in the non-bank sector and to discourage the further build-up of those risks. The NBS has been leading the efforts in this field, working together with the banking sector on introducing and developing basic hedging instruments both in the interbank market and in client transactions.

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I. Dinarisation of the Serbian financial system

The share of dinar lending in total corporate and household lending is the key indicator the National Bank of Serbia uses to monitor and communicate the degree of dinarisation of the Serbian financial system.

1. Corporate and household lending

The degree of dinarisation, as the share of dinar lending in total corporate and household lending, came at 30.2% at end-September, down by 1.2 pp q-o-q, but up 1.1 pp y-o-y.

The degree of dinarisation contracted in Q3 as a result of lower dinar lending (RSD 16.6 bln) and higher FX and FX-indexed lending (RSD 25.8 bln). By end-Q3, total corporate and household lending amounted to RSD 1,648.6 bln.

Dinar lending declined in the corporate and expanded in the household sector. Though the degree of dinarisation in the previous period was higher in the corporate sector, dinar lending to households has been growing constantly in 2011 and since end-August, the degree of dinarisation exceeds that in the corporate sector.

In Q3, the degree of dinarisation rose by 1.7 pp to 32.2% in the household sector and declined by 2.8 pp to 29.1% in the corporate sector. A rise in dinar household loans was also, among other factors, prompted by the NBS measures from June this year, stipulating mandatory minimum downpayment for FX and FX-indexed household loans, excluding dinar loans. Apart from suspension of the subsidised dinar liquidity loans, decrease in the dinarisation degree in the corporate sector was also a result of the approval of an FX-indexed loan to the public enterprise “Srbijagas”.

To monitor the degree of dinarisation of the financial system, the NBS also uses the following *supplementary indicators*:

- share of dinar loans in total newly granted corporate and household loans,
- share of dinar deposits in total corporate and household deposits,
- share of dinar debt in total public debt, with a special emphasis on the currency and maturity structure of government securities.

Chart I.1.1. Share of dinar lending in total corporate and household lending

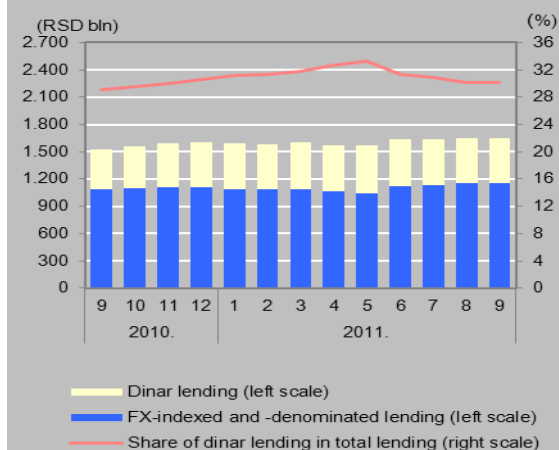
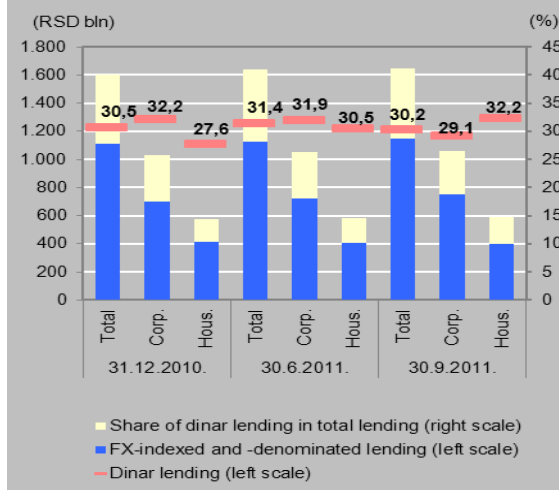


Chart I.1.2. Lending by sector



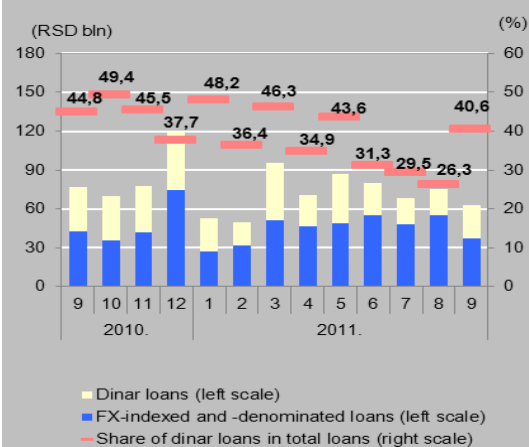
2. Newly granted corporate and household loans

The share of dinar in total newly granted loans continued to oscillate significantly throughout Q3 – it increased by 9.3 pp q-o-q to 40.6% at end-Q3.

Higher proportion of lending in dinars reflected higher fresh dinar lending to households and fewer approvals of new FX and FX-indexed loans. On the other hand, new corporate dinar loans contracted mainly because subsidised dinar liquidity loans were no longer available.

Throughout Q3, interest rates on newly granted dinar loans mirrored the movements in the NBS key policy rate, with a sharper decline noted for household loans. Such interest rate trends lent a further boost to a rise in new dinar loans.

Chart I.2.1. Share of dinar loans in total newly granted corporate and household loans



3. Corporate and household deposits

The degree of dinarisation measured by the share of dinar in total corporate and household deposits was 20.5% at end-Q3. Relative to end-Q2, this share rose by 0.6 pp.

A rise was recorded both for dinar (RSD 17.4 bln) and FX and FX-indexed deposits (RSD 34.2 bln).

Dinar deposits rose both in the corporate (RSD 9 bln) and household sectors (RSD 8.4 bln).

At end-Q3, the share of dinar in total deposits remained significantly higher in the corporate (44.0%) than in the household sector (9.2%). From end-Q2, however, the share of dinar deposits in the corporate sector fell by 2.6 pp, while rising by 0.9 pp in the household sector. Such movements were due to lower quarterly growth in dinar deposits in the corporate sector (RSD 5.4 bln) and higher growth in the household sector (RSD 7.4 bln). Q3 saw more robust growth in FX and FX-indexed corporate deposits, due mainly to the sale of “Delta Maxi Group” and approval of an FX-indexed loan to the public enterprise “Srbijagas”.

Chart I.3.1. Share of dinar deposits in total corporate and household deposits

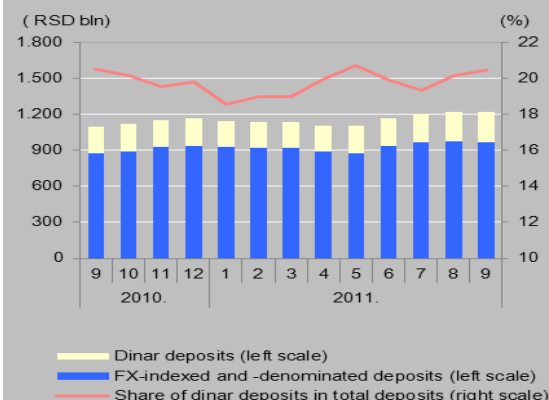
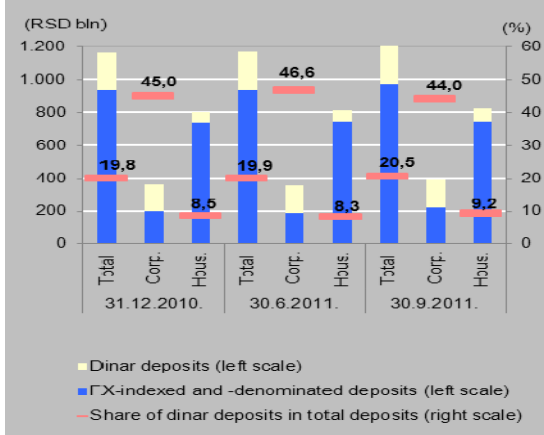


Chart I.3.2. Deposits by sector



At end-Q3, short-term deposits still accounted for the majority of total corporate and household deposits (87.7%). Their share stayed broadly flat in q-o-q terms, but declined by 4.4 pp y-o-y.

The share of short-term dinar deposits in total dinar corporate and household deposits remained elevated, reaching 97.3% at end-September. This share, however, dropped by 1.2 pp in y-o-y terms. FX deposits were also predominantly short-term (85.2%) and were down 5.2 pp y-o-y.

4. Dinar and FX savings

At end-Q3, At end-September, dinar savings rose 14.2% and FX savings 1.5% from end-June. The rise in dinar savings may be related to their profitability. On the other hand, slower growth in FX savings relative to Q2 is seasonally-induced.

Despite a 16.0% rise in 2011 and 35.1% y-o-y, dinar savings remain modest compared to FX savings.

The maturity structure of overall household savings stayed unfavourable as short-term deposits were dominant both in dinar and FX savings.

Deposits up to 3 months continued to prevail in dinar savings (48.1%). The share of these deposits rose by 5 pp from end-Q2, while the share of 3-6 month deposits stayed flat.

Chart I.3.3. Currency and maturity structure of corporate and household deposits

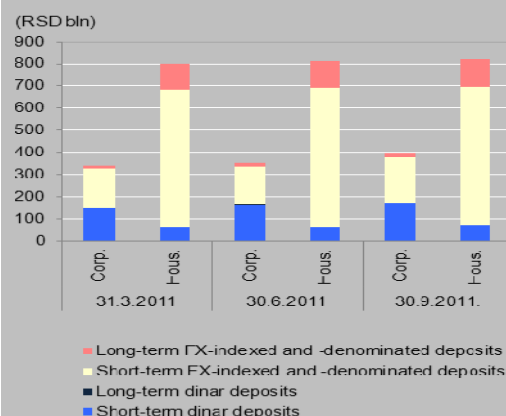


Chart I.4.1. Dinar and FX savings

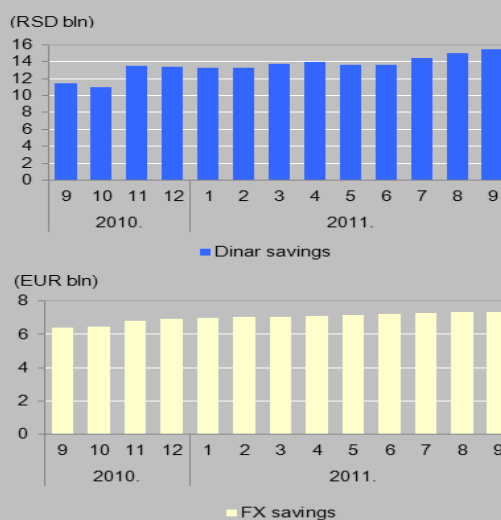
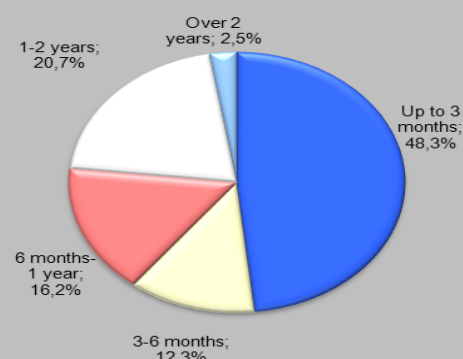


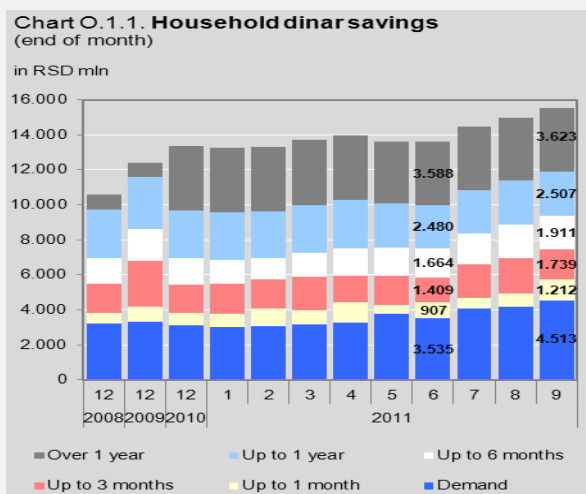
Chart I.4.2. Maturity structure of dinar savings (30 September 2011)



Text box 1: Growth in household dinar savings

Rising month-on-month during Q3, household dinar savings reached RSD 15,505 mln at end-September, while increasing by RSD 1,924 mln (14.2%) from end-June and by RSD 4,028 mln (35.1%) relative to September last year.

A breakdown by maturity reveals the strongest growth in demand deposits (RSD 978 mln), followed by up to 3-month deposits (RSD 635 mln) and 3–6 month deposits (RSD 247 mln). Time dinar savings over 6 months also rose, though only marginally. The largest increase in the share in total dinar savings relative to end-June was recorded for demand deposits (up from 26.0% to 29.1%) and up to 3-month deposits (up from 17.1% to 19%).



Banks that registered an increase in household dinar savings have attributed it to higher interest rates on savings in dinars relative to savings in FX*. They pointed out that in most cases households opted for dinar savings up to 6 months, which is also confirmed by figures. On the other hand, only few banks offered the possibility of terming dinar savings for a period of 24 and 36 months.

The interest rates on household dinar savings offered during Q3 2011 varied across banks, moving on balance mostly within the following bands*: 0–6% for demand savings, 6–9% for up to 1-month, 8–10% for 1–3 months, 9–11% for 3–6 months, and 10–12% for 6–12 month savings.

The profitability of saving in dinars was also underpinned by a more favourable tax treatment, considering that interest earnings on dinar savings are exempt from taxation, while those on FX savings are subject to 10% tax.

Even though no new types of dinar savings were introduced in Q3 2011, a number of banks showed readiness to do so in the future. And the current offer of dinar products is not in want of diversity either. Some banks offer specially tailored products, i.e. saving models, such as:

- *Step by step saving* – terming a deposit for a period of up to 12 months at a fixed interest rate. With this type of savings, interest is calculated at annual level but increased at the end of each quarter;
- *Phased saving* – terming a deposit for a period of up to 36 months at an interest rate linked to the NBS key policy rate. The client decides on the amount of monthly deposit, and may terminate the deposit term after 12 months.

As 3-month and 1-year dinar deposits proved to be more profitable than FX deposits of the same term in a greater number of periods observed from January 2001 to October 2011**, the growth in household dinar savings may be expected to continue.

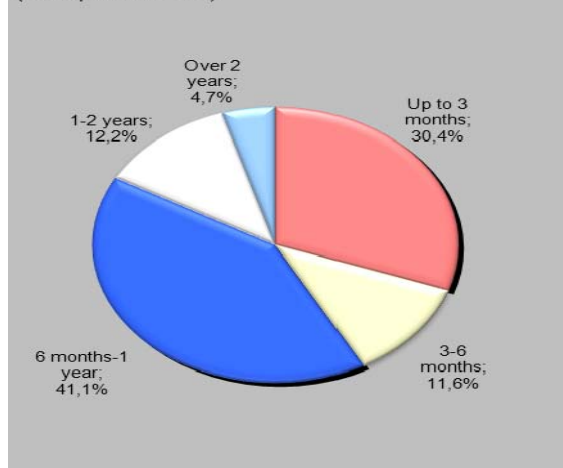
* For the purposes of the *Report on the Dinarisation of the Serbia Financial System*, banks were surveyed in October about household interest in savings in dinars and about the introduction of new types of dinar savings in Q3 2011.

** Analysis of profitability of dinar and FX savings, National Bank of Serbia, October 2011.

http://www.nbs.rs/export/sites/default/internet/english/90/analyze/Analysis_dinar_and_FX_savings_2011.pdf

At end-Q3, most of FX savings were fixed-term from 6 months to 1 year (41.1%), their share in total FX savings contracting by 1.9 pp from end-Q2. At the same time, the share of deposits termed up to 3 months expanded by 3.0 pp. An increase was also noted for 1-2 years deposits. At end-Q3, deposits over 2 years accounted for 4.7% of total FX deposits.

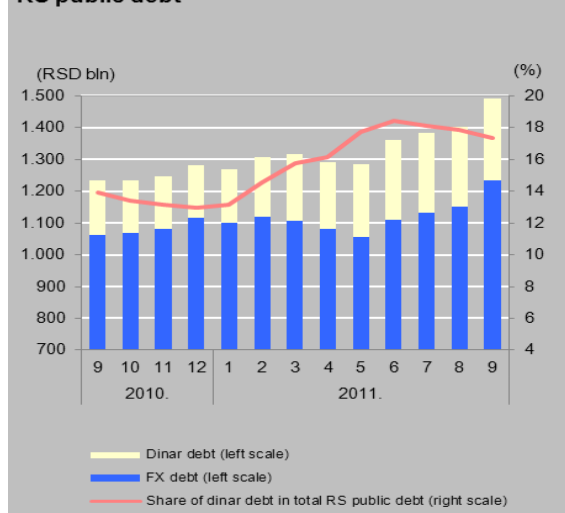
Chart I.4.3. Maturity structure of FX savings
(30 September 2011)



5. Public debt

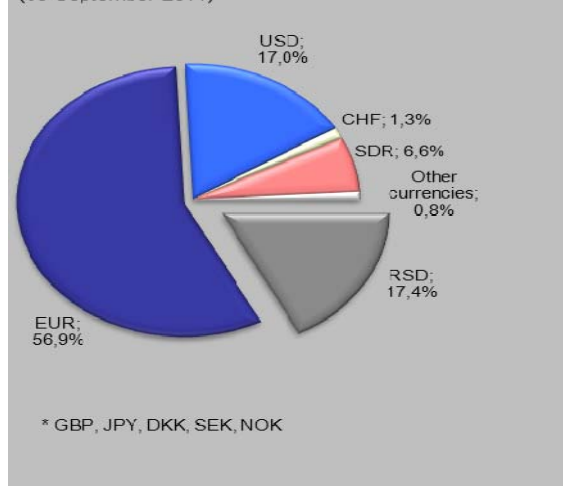
At end-September, dinar debt accounted for 17.4% of the total. Though the stock of dinar debt increased by RSD 7.6 bln on end-Q2, its share in total public debt declined by 1.1 pp due to a sharper rise in FX debt (by RSD 122.8 bln). Rise in FX debt, above all, is the result of the successful sale of the Republic of Serbia dollar eurobond in the international financial market. Relative to end-2010, the share of dinar debt was up 4.4 pp.

Chart I.5.1. Share of dinar debt in total RS public debt



The bulk of public debt remained in foreign currency, mainly in euros (56.9%). The dollar component increased most in Q3 – from 12.2% to 17.0%.

Chart I.5.2. Currency structure of RS public debt
(30 September 2011)



Public debt under securities issued by the government fell in Q3 by RSD 14.4 bln nominally, chiefly in response to the redemption of 6-month euro-indexed government bills (RSD 21.0 bln). In contrast, the stock of dinar government securities was up RSD 7.1 bln.

Positive changes in the maturity structure of government securities were observed in Q3 as well. The stock of long-term securities (initial maturity over 12 months) rose in Q3 by RSD 36.7 bln and their share in the total portfolio of government securities was up from 65.2% to 81.0%. Such an increase also reflected a RSD 51.1 bln reduction in the stock of short-term dinar government securities and 6-month euro-indexed government bills.

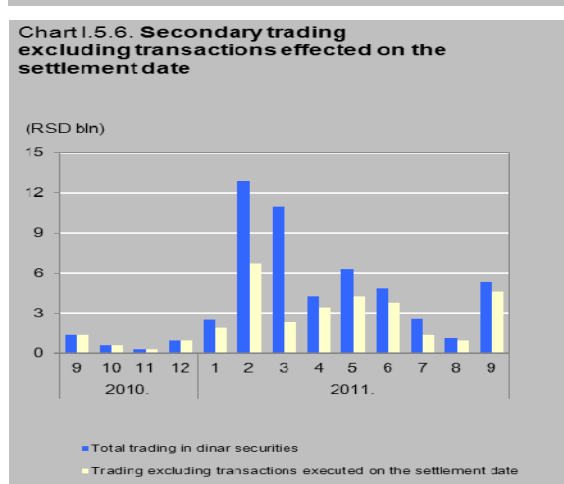
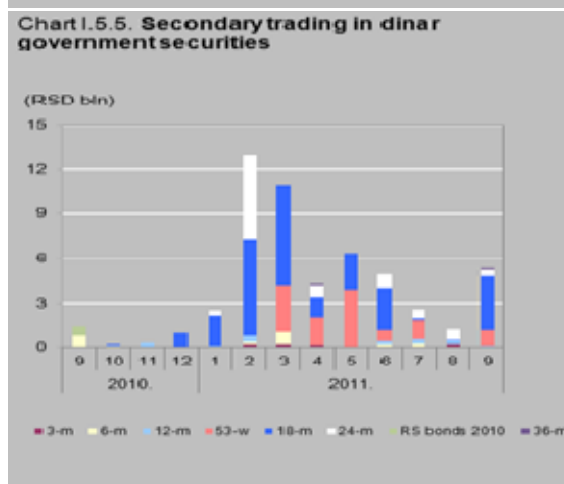
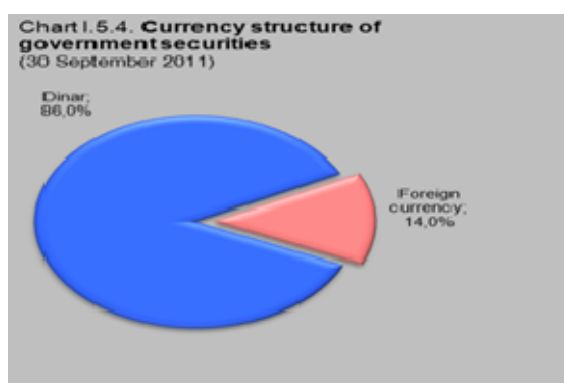
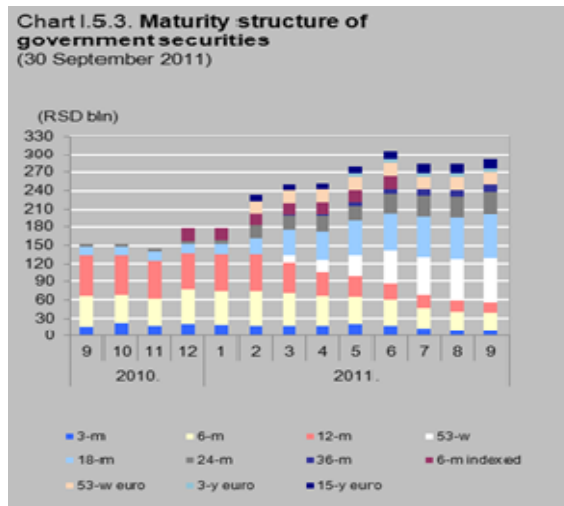
At end-Q3, long-term securities maturing in 53 weeks (25.7%) and 18 months (24.2%) continued to account for the majority of the portfolio of dinar government securities.

The currency structure of government securities also improved in Q3. Dinar government securities made up 86.0% of the total at end-September, implying a 6.4 pp rise relative to Q2.

Secondary trading in dinar government securities came at RSD 9.1 bln in Q3, down by RSD 6.4 bln on Q2. The lowest trading volumes were recorded in August.

In terms of the maturity structure, the largest volume of secondary trading in dinar government securities (RSD 6.1 bln or 67%) was recorded for longer maturities (18 months and 53 weeks).

Excluding secondary trading in long-term dinar government securities executed on the settlement date (two days after primary trading), “true” secondary trading volumes in Q3 were lower by RSD 2.1 bln and stood at RSD 7.0 bln.



Text box 2: FX risk hedging instruments

High FX risk exposure of the economy and population in developing countries poses a significant threat to the financial stability of their respective national economies. Hence the NBS advises domestic transactors to avoid or to minimize their FX risk exposure. The NBS has been carrying out an intensive campaign since 2010 to promote the use of market instruments for protection against the risk of exchange rate changes by domestic companies. The campaign offers detailed information about the features and functions of instruments currently available in the Serbian market – forward contracts to buy/sell foreign currency, covered forward contracts to buy foreign currency and FX swaps.

The NBS activities for enhanced use of FX risk hedging instruments may be classified into three categories: (1) promotional and educational activities, (2) regulatory activities, and (3) market activities.

Promotional and educational activities include conferences on FX hedging with representatives of businesses and banks in Serbia, distribution of publications and brochures and ongoing media campaign with a view to enhancing the use of instruments for protection against FX risk. These conferences cast light on incentives and limitations to the development of the hedging market and provide a forum for sharing experiences on the use of FX hedging instruments. The NBS has to date organised conferences and meetings on this topic in Belgrade, Novi Sad, Užice, Niš and Kragujevac.

The NBS has also created a web page on its website dedicated to FX hedging. In addition to the description of the main FX hedging instruments, the “FX hedging” link also contains a list of banks offering these instruments. The page features two financial calculators – the first displays the basic model of forward price calculation in forward purchase/sale of foreign currency, and the second one compares forward contract terms currently on offer.

The NBS regulatory efforts in this domain are aimed at enhancement and simplification of laws and regulations governing operations with FX hedging instruments. To this aim, the new Decision on Performance of Financial Derivative Transactions will be applied from early December 2011 to enable foreign currency payments and collections under deliverable financial derivatives as a protection against the FX risk and other market risks.

As part of its *market-focused activities*, the NBS regularly monitors the development of this market segment based on banks’ reports and the range of FX hedging instruments offered in the domestic market. Occasional surveys have also been conducted to evaluate enhancement of hedging instruments by banks and their attractiveness to companies. Finally, with a view to stimulating the development of the interbank foreign exchange swaps market, the NBS organizes foreign exchange swap auctions featuring three-month swap transactions.

Despite the evident need for FX hedging instruments, their use is still quite limited. Since the beginning of 2010 banks recorded almost no forward purchases of foreign currency from clients, while only few foreign currency forward sale transactions have taken place (banks sold EUR 795.5 mln at over 7 days maturity by end-September 2011, which is a 4.3% of the total sale of foreign currency to clients since the beginning of 2010 to date). However, we expect a more active participation of domestic businesses in this segment of the market over the period to come, given that the domestic FX market, apart from better liquidity, also features significant oscillations of the RSD/EUR exchange rate in both directions. In particular, we expect more interest for foreign currency forward sale transactions from exporters (who have not used this instrument so far), because of the greater attractiveness of this instrument when the RSD is appreciating.

Methodological notes

1. Lending implies dinar and FX (including FX-indexed) loans, advances, securities, corporate shares and claims on interest and charges. Dinar loans are extended in dinars without an FX-clause. An FX-clause is a currency clause as defined by the Law on Foreign Exchange Operations and any other clause stipulating a hedge against the risk of dinar exchange rate changes.
2. Lending is expressed by the gross principle, i.e. it is not deduced by value adjustment. When excluding the exchange rate effects, the exchange rate of the dinar against the euro, Swiss franc and US dollar is taken into account.
3. In line with the ECB methodology, the category of newly granted loans also includes re-scheduled loans.
4. In line with the ECB methodology, the household sector includes entrepreneurs and non-profit institutions serving households.
5. Deposits include dinar and FX (including FX-indexed) deposits.

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