NBS: Current developments and challenges

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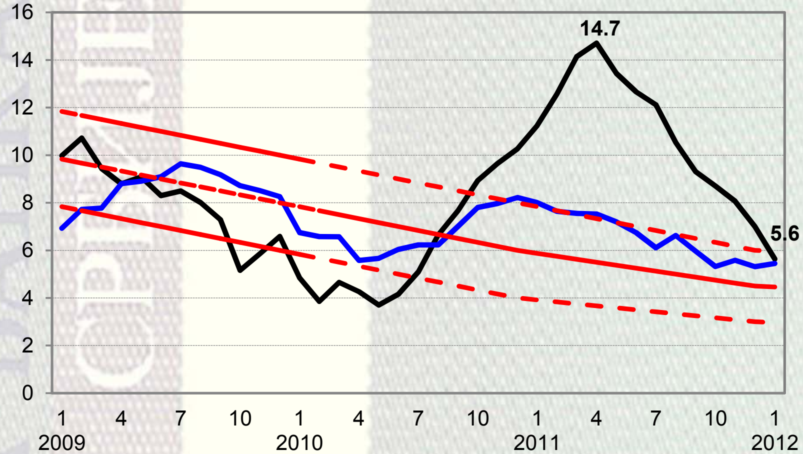
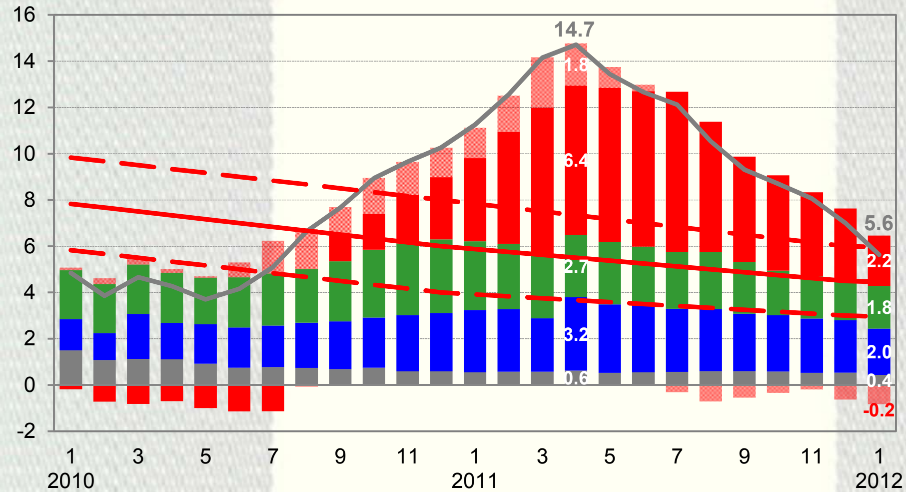
Kopaonik, 7 March 2012

Inflation eased back within the target tolerance band

Inflation movements
(y-o-y rates, in %)



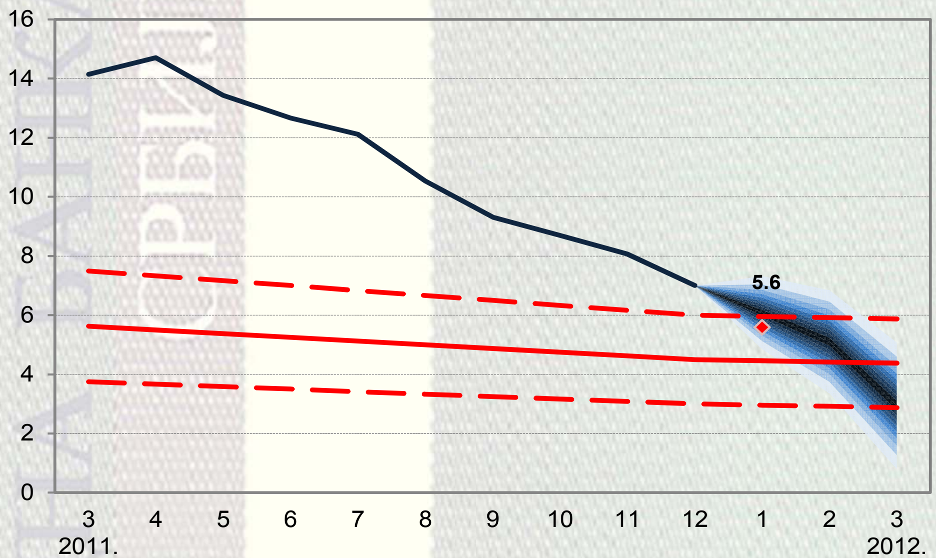
Contributions of CPI components to y-o-y inflation
(y-o-y rates, in pp)



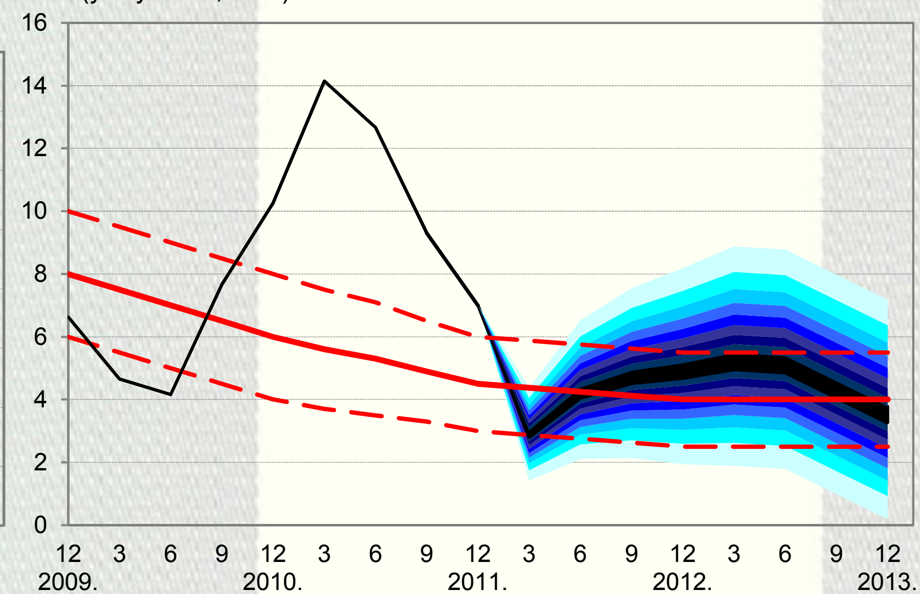
- In January 2012, **y-o-y inflation** returned within the target tolerance band (4.5±15%) and settled at **5.6%.**
- The key contribution to disinflation came from dissipation of cost-push pressures on processed food prices, subsiding inflation expectations and low aggregate demand.
- **CPI excluding food, energy, alcohol and tobacco prices** (internationally accepted measure of core inflation) has practically stayed within the target band since the introduction of inflation targeting regime in December 2008.

Y-o-y inflation will continue to decline over the coming months

Short-term inflation projection (IR February 2012)
(y-o-y rates, in %)



Mid-term inflation projection (IR February 2012)
(y-o-y rates, in %)



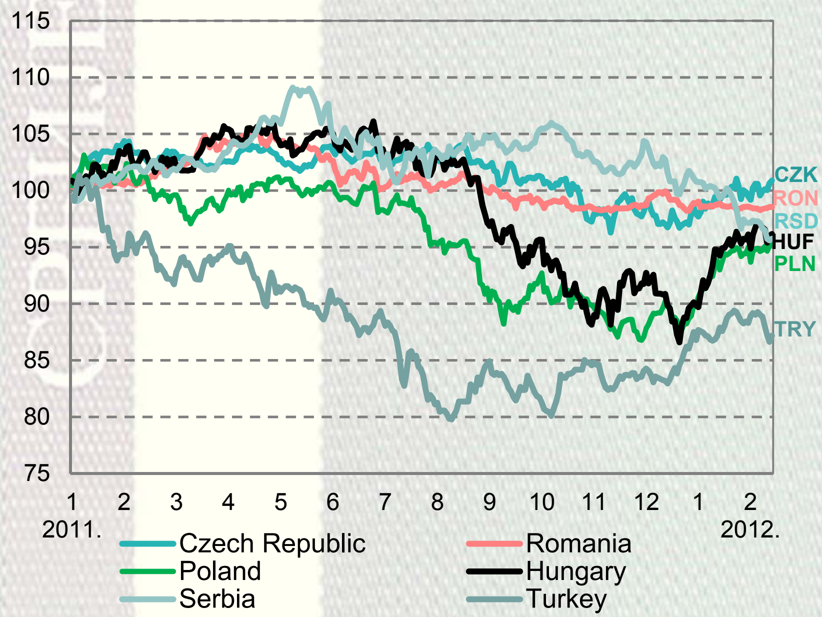
- Y-o-y inflation will continue to fall over the coming 2-3 months (mainly due to the **base effect** of high monthly inflation rates from early 2011 and the **administrative cap** on trade margins).
- Y-o-y inflation will fall to its lowest level in March or April and move around the lower bound of the target tolerance band.
- However, with the new agricultural season, a sharper rise in administered prices after the elections and the lapse of the decree restricting trade margins, inflation will return towards the target by Q3 2012. In H1 2013 y-o-y inflation may temporarily move around the upper bound of the target tolerance band, only to return towards the 4±1.5% target thereafter.

Financial stability of the banking sector

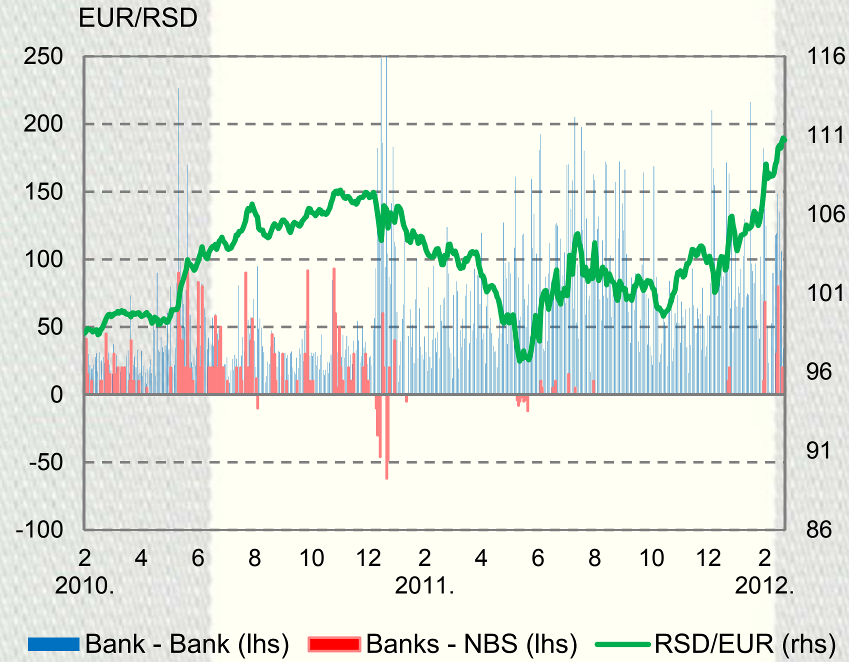
- Capital adequacy ratio → 19.7% (end-2011);
- Liquidity ratio → 2.16 (end-2011);
- Loan loss reserves to NPL ratio → 121% (end-2011);
- Over the past two years, NBS regulations led to a decline in the share of short-term financing in banks' external financing – from 47% to below 23%;
- Basel II was introduced;
- In 2011, the banking sector was recapitalised with more than EUR 300 mln;
- FX reserves → over EUR 11.5 bln;
- Household savings → EUR 7.6 bln;
- The new Decision on the Classification of Bank Balance Sheet Assets and Off-Balance Sheet Items was adopted, which is a countercyclical measure aimed at easing the existing regulatory provisions for banks and facilitating enterprise debt restructuring.

FX market operates smoothly

Movements in exchange rates of national currencies against euro
(31/12/ 2010 = 100, increase represents appreciation)



IFEM turnover and exchange rate (in EUR mln)



- Depreciation pressures were fuelled by increased government **spending** in late 2011, **negative news** (halted negotiations with the IMF and leaving of US Steel), which worsened the outlook for financing of the current account, as well as a **step-up in energy imports** due to cold weather, and the **flight of short-term capital** (activation of stop-loss clauses).
- To mitigate excessive daily oscillations of the exchange rate, since early 2012 the NBS has **intervened in the IFEM** by selling **EUR 208.5 mln**.
- The accession to candidate status makes Serbia more attractive for foreign investment, which may influence trends in the FX market.

The current pace and dynamics of exchange rate fluctuations are not uncommon for the type of currency regime run by Serbia

- Compared to the dinar's change in value since the beginning of the year, **currencies of other countries in the region saw even more drastic fluctuations** on a bimonthly and quarterly basis!

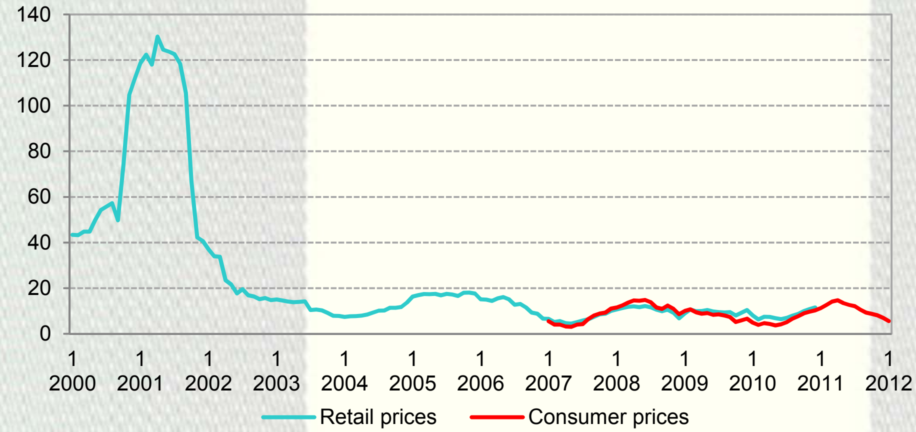
- From the beginning of the year **the dinar** weakened **4.4%** altogether.

  - **Polish zloty** (*PLN*) → **July to September 2011 → weakened 12.4%**
  - **Hungarian forint** (*HUF*) → **October to December 2011 → weakened 9.5%**
  - **Turkish lira** (*TRY*) → **June to August 2011→ weakened 12.5%**

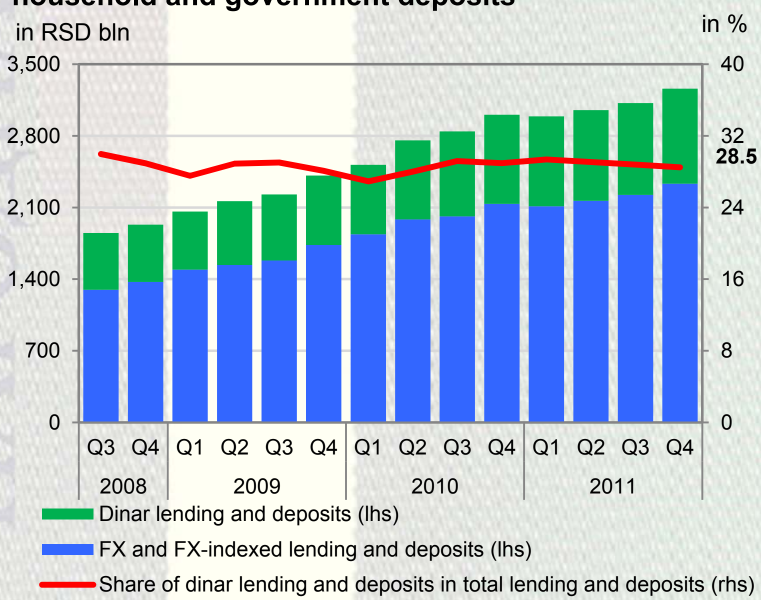
What brought on the current situation : Key problems in the last decade

- ❑ **High inflation**
- ❑ **Relatively stable exchange rate**
- ❑ **High level of euroization**

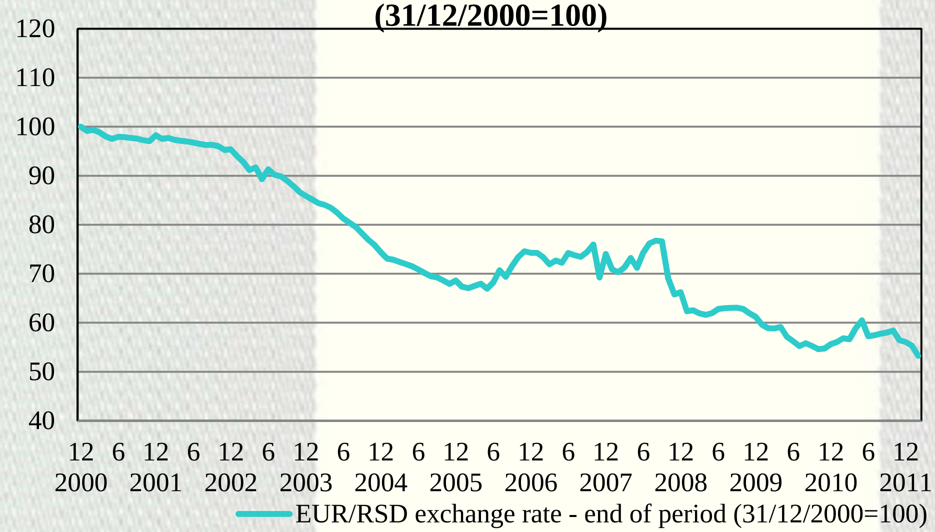
Inflation movements
(y-o-y rates, in %)



Dinarization: Bank lending and corporate, household and government deposits



EUR/RSD exchange rate - end of period (31/12/2000=100)



* Growth represents appreciation.

What we did and did not do:

- **We did not** find a sufficient number of high quality strategic partners for the privatisation programs.
- **We did not** increase the share of tradable sectors in GDP (industry, agriculture, export services etc.)
- **We did not** enhance the competitiveness of domestic economy sufficiently.

- **We did** have GDP growth, but it was fuelled by growth in services and consumption.
- **We did** have continuous real appreciation of the dinar, i.e. inflation remained relatively high and the exchange rate relatively stable (some years even saw nominal appreciation of the dinar). However, without sufficient boost in labour productivity, this led to a deterioration of the terms of trade in the international market, i.e. reduced competitiveness of the tradable sectors of domestic economy;

o **Result:** current account deficit of **21.6%** in 2008

- **We did** allow high euroization of domestic financial system.

o **Result:** any exchange rate depreciation results in lower repayment ability of borrowers; currency risk entails high NPLs and regulatory costs; limited effectiveness of monetary policy with high REPO rates.

Exchange rate regime in Serbia

- The exchange rate regime is adopted by the Council of the Governor of the National Bank of Serbia (as a supervisory body elected by the National Assembly of the Republic of Serbia). The exchange rate regime proposal is prepared by the NBS Executive Board, with the consent of the Government of the Republic of Serbia.
- The current exchange rate regime of our country is an integral part of the Agreement on Inflation Targeting concluded between the Government of the Republic of Serbia and NBS and was adopted at the Government's session on 19 December 2008. Article 5 of this Agreement reads as follows: "*Consistent with the agreed monetary policy framework, the Government and the National Bank of Serbia agree that the National Bank of Serbia shall implement a managed floating exchange rate regime,* ***but that no numerical targets for the exchange rate shall be set.***"
- Based on the Agreement on Inflation Targeting adopted by the Government, in December 2008 the National Bank of Serbia adopted the Memorandum on Inflation Targeting which says in Section 3 that interventions in the foreign exchange market are *"a secondary instrument used to support the achievement of the inflation target"* and that "*the National Bank of Serbia will resort to foreign exchange interventions with a view to: 1) limiting excessive daily oscillations in the exchange rate for the dinar, but without accumulating pressures in a single direction over a longer period of time, 2) containing threats to financial stability, and 3) safeguarding an adequate level of foreign exchange reserves.*"

Is a fixed exchange rate a better solution? Let us remind ourselves….

- **All attempts of pegging the dinar to a foreign currency over the past 50 years have utterly failed.**
- **If a balanced current account is not sustainable in the long run (as is the case of Serbia), a fixed exchange rate invariably leads to:**
  - **higher spending of FX reserves;**
  - **higher risk of a financial crisis and bankruptcy of households, businesses, banks and the state;**
  - **increased probability of capital flight as a fixed exchange rate eliminates losses for those taking the capital out of the country for as long at there are FX reserves on hand.**
- **Maintaining a fixed exchange rate may call for rather painful measures and give rise to serious economic consequences:**

<u>Examples:</u>

- Estonian government→ **cut public sector wages** by **20%** in order to preserve fixed exchange rate regime relative to the euro.
- Lithuania, Latvia and Estonia → most severely hit economies after 2008. In 2009 they recorded a **real GDP drop** of **14.8%, 17.7%** and **14.3%,** respectively.

Let us remind ourselves further…..

- **Argentina** → operated a fixed exchange rate regime (Currency Board) and recorded a mounting fiscal deficit from 1991 to January 2002, when it was forced to switch to a floating exchange rate regime.
    - Attempted defence of the local currency **failed despite a 50% loss in FX reserves.**
    - **Interest rates on local currency** ranged from **40%** to as much as **60%.**
    - **Cumulative devaluation** of the peso **over the following six months** (January-June 2002) measured **265%**.

- **Mexico** → operated a crawling peg exchange rate adjustment regime until 1995. The exchange rate against the US dollar was maintained within the bounds of a narrowly targeted band through interventions.
    - Due to a yawning fiscal deficit that induced an increase in **real interest rates and the balance of payments deficit,** a financial crisis broke out in 1994.
    - **From around USD 29 bln** in early 1994, **FX reserves tumbled down to around USD 7 bln** at the end of the year.
    - **The currency lost** around **50%.**

Principal and interest repayments (Stand-by Arrangement with the IMF)

PROJECTION OF PRINCIPAL AND INTEREST REPAYMENTS IN RESPECT OF DISBURSEMENTS UNDER THE 2009 STAND-BY ARRANGEMENT WITH THE IMF

(DEBT BALANCE AS AT 31 DECEMBER 2011)

-in EUR

	2012	2013	2014	2015	2016	Total
Principal	207,428,798	671,807,783	587,570,050	136,998,953	13,807,889	1,617,613,473
Interest	17,837,705	13,396,424	5,729,749	1,063,035	61,162	38,088,074
Total	225,266,502	685,204,207	593,299,799	138,061,988	13,869,051	1,655,701,547

Notes:

- Applicable exchange rate as at 31 December 2011 SDR 1 = EUR 1,182689.
- Total funds made available under the SBA concluded in January 2009 equal SDR 2,619,120,000 (EUR 3,097,603,400).
- Given the country's balance of payments position and the level of FX reserves, the authorities decided to disburse SDR 1,367,742,500 (EUR 1,617,616,547).
- The amount of principal will be repaid in eight equal quarterly instalments.
- Repayments are made in the period beginning 3¼ years and ending 5 years after each disbursement.
- Interest will be repaid on a quarterly basis at a variable interest rate determined by the IMF (changes on a weekly basis).
- The above projections were made based on a **1.11% per annum interest** applicable in the period 26 December 2011 – 1 January 2012.

Finally, let us remind ourselves of a few simple truths….

Q: Who benefits most from a stronger dinar?

A: All households and businesses with liabilities in FX and income in dinars (net importers and foreign exchange debtors).

Q: Who benefits most from a weaker dinar?

A: All net importers who rely primarily or entirely on domestic intermediate goods. It is they who should be the key drivers of the new economic growth model based on exports, and who should, as a rule, create the greatest number of jobs per unit of GDP.

Q: Is it possible to eliminate the risk of currency changes in a floating exchange rate regime?

A: YES, by using FX hedging instruments.

Q: Is it possible to have a relatively stable exchange rate in the medium and long run if you have an insufficiently competitive and import-oriented economy, if you have for years been spending more than you produced, delaying structural reforms, failing to attract enough FDI and not demonstrating the reform effort (such as an active arrangement with the IMF)?

A: NO, and there is no central bank and no amount of FX reserves that could change that.