NATIONAL BANK OF SERBIA

Speech at the presentation of the Annual Financial Stability Report for 2015

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

Welcome to today's press conference where we will present our *Annual Financial Stability Report***.**

Exactly one year ago (at a very sensitive time – before special diagnostic studies were completed and in the midst of the Greek crisis), we held the first public presentation of the *Report.* At that time, we not only provided an assessment of the situation in the financial system, but also made an estimate of its resilience over a one-year time horizon under conditions of stress.

We have the same task today, set in a very complex international environment. And though our last year's assessments were proven correct (we said at the time that the overall system was stable and that Greek-owned banks were resilient to large shocks), it is a rather challenging task to communicate to the public the extent to which we have fulfilled our objective of preserving and strengthening the stability of the financial system. That is to say, although there are many measurement tools (which I mentioned last year and which are presented in our *Report)*, resilience cannot be quantified as a monetary policy objective can, nor is it possible to disclose data on individual institutions in the way that we publish data on movements in different product prices. This is why it is difficult for the public (including the professional community) to fully appreciate the progress made towards financial stability.

The role of central banks has changed globally relative to the pre-crisis period. Their scope of competence has widened, mostly in the area of financial stability, though the hierarchy of objectives has been retained, with price stability as the first and foremost. At the same time, eight years of financial crisis have weighed heavily on the conduct of monetary policy. It is common knowledge that the effectiveness of monetary policy diminishes in the conditions of low interest rates and high public and private sector debts. For this reason, non-conventional instruments, such as quantitative easing, are becoming something of a standard, while central banks which before the crises boasted fully flexible exchange rate regimes are now resorting even to foreign exchange market interventions.

Similarly as that of other central banks, the NBS's scope of competence in the area of financial stability has increased. Note that the NBS has traditionally held competences in this area. The **supervision of financial institutions** has always been within the NBS's remit. Also, the NBS has always had the possibility to **perform the lender-of-last-resort function** by approving collateralised liquidity loans to banks facing temporary difficulties in maintaining liquidity. New competences in the area of financial stability mean that the NBS is **responsible for the overall last-resort policy,** through incorporation of the Bank Recovery and Resolution Directive into our regulations. Without denying the significance of bank recovery and resolution instruments, the primary objective of the NBS – as banking system regulator and supervisor – is to prevent banks from becoming distressed. And whereas it is true that the so-called "orderly" exit of a bank from a market (without the spending of taxpayers' money) is certainly better than a disorderly one (which is the whole purpose of the Directive), the best approach is the one that ensures prevention of a distress situation or a new crisis. For this reason, the NBS's remit in the area of financial stability has been extended to include **responsibility for identifying and assessing systemic risk and the conduct of macroprudential policy.** The new international regulatory package (Capital Requirements Regulation/Capital Requirements Directive IV) has set up prudential standards for credit institutions and investment firms in the EU. It became effective in January 2014, with full implementation starting in January 2019. This framework introduces new instruments to prevent a new crisis from occurring: countercyclical capital buffer, capital buffer for systemically important institutions and systemic risk buffer, as well as measures to control leverage, liquidity and large exposures.

In accordance with the new international regulatory package, in March 2015 the NBS made it known to the public that it would have the same instruments at its disposal and that they would be used to preserve and strengthen financial stability at large.

When deciding on monetary policy measures (and the return of inflation within the target tolerance band), the NBS also takes into consideration other economic factors, including in particular external stability and the stability of the financial system. Ignoring the impact of monetary policy on financial stability could come at a high price, given the specific economic conditions and characteristics of our economy.

By contrast to large economies and monetary areas, Serbia is a small and open economy. This means that the share of imports and exports in GDP is high, reflecting the country's high dependence on international flows of goods and capital. At the same time, being a small country, Serbia has no influence over these flows or over the way global prices are formed – for Serbia, they remain as set. As a small economy, it can borrow abroad in foreign currency only. Foreign debt of all sectors is around 80% of GDP. High financial euroisation, however, further complicates the pursuit of an orthodox monetary policy. The high level of deposit euroisation can be associated with a long history of macroeconomic instability in the course of final three decades of the last century. The high degree of credit euroisation comes only as a consequence of deposit euroisation. In such circumstances (which differ greatly from the conditions prevailing in large monetary areas where countries borrow in local currency only), depreciation raises the level of debt and has a recessionary effect, instead of having an expansionary effect on a rise in production due to the impact of increased demand for domestic goods at home and abroad.

By trimming its key policy rate, the NBS triggered a decline in the cost of borrowing in dinars. At the same time, by maintaining exchange rate stability (and keeping its foreign exchange reserves at an adequate level), the NBS has stabilised the repayment burden for those who borrow abroad and in the domestic market subject to a euro currency clause, thus contributing to the achievement of financial stability which is within its remit as defined by the Law on the National Bank of Serbia.

This is confirmed by the fact that, after rising for eight years, NPLs remained unchanged in nominal, dinar terms in 2015 relative to 2014. As a result of a stable exchange rate, fewer new NPLs were generated. Additionally, regulatory measures of the NBS encourage banks to ensure:

- increased coverage of NPLs with IFRS provisions, and
- faster clean-up of NPLs from balance sheets of banks (through increased loan write-offs or selling to other legal persons).

Positive trends continued into 2016 as well. In the first five months, NPLs decreased in nominal terms by RSD 23.3 bln, while the NPL ratio fell from 21.6% to 20.3%.

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

I now give the floor to the General Manager of the Financial Stability Department to explain in more detail our assessment of the progress achieved in the area of financial stability. Thank you for your attention!