



Monetary Policy and Financial Sector of Serbia

Radovan Jelašić – Governor of the National Bank of Serbia

Subotica, 4 June 2008

**Central bank's objectives are clearly defined in the Law on the NBS
– and there are no restrictions on the means to achieving them**

Article 3

The primary objective of the National Bank of Serbia shall be **to achieve and maintain price stability.**

In addition to its primary objective, the National Bank of Serbia shall also pursue **the objective of financial stability.**

Without prejudice to its primary objective, the National Bank of Serbia shall **support the economic policy of the Government of the Republic of Serbia**, acting in accordance with the principles of a market economy.

The monetary policy can and should resolve the consequences...

- The monetary policy cannot:
 - ✓ halt excessive public spending;
 - ✓ increase exports;
 - ✓ increase employment on a sustainable basis;
 - ✓ prevent macroeconomic shocks (oil, agricultural products...)
- The monetary policy can:
 - ✓ achieve price stability;
 - ✓ control inflation at a low and stable level;
 - ✓ “iron out” fiscal policy inefficiency;
 - ✓ minimize the spill-over of macroeconomic shocks to the general level of prices.

... but it is the causes that matter most!

- Why did prices of agricultural products increase by 33.4% (April 2008/April 2007);
- Why were non-market and evidently inefficient methods for suppressing inflation used in the past?
- Why is there always enough money to raise wages, and never enough money to cut excises and contributions, i.e. to relieve the economy?
- Why is everyone convinced that higher wages are the way to better life?

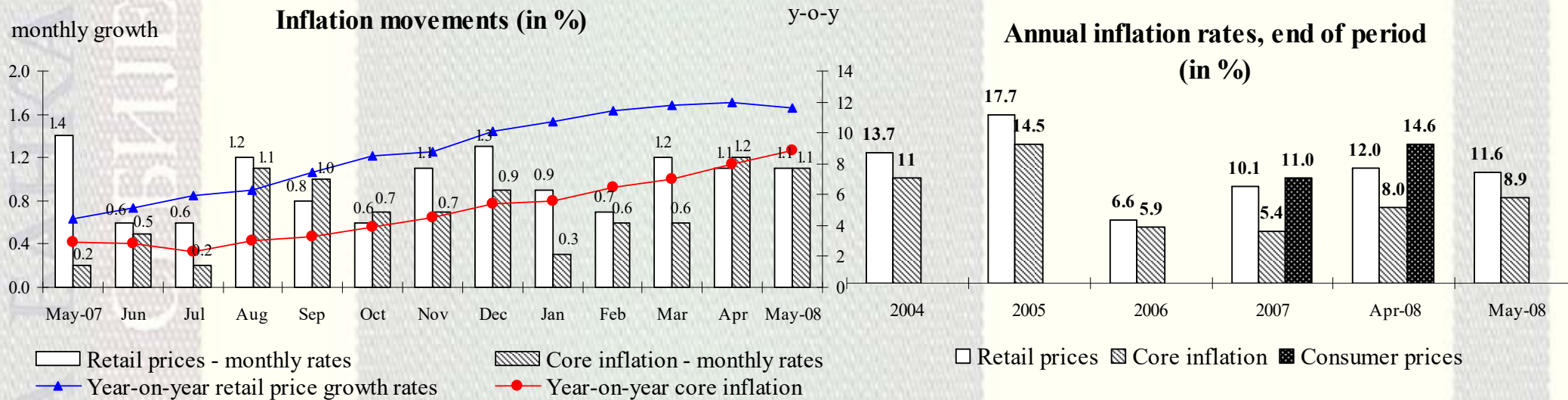
Judging by what politicians, and even some “economists”, say, Serbia still lives in the 1970s!

- “The problem is not in inflation, but in the fact that wages are not rising quickly enough”;
- As long as there is “growth and development”, inflation will not be a problem!
- “It is normal that business entities and private individuals are exposed to excessive foreign exchange risk, but it is not normal for the exchange rate to change daily”;
- In 1993, the employees of the Electric Power Company EPS requested a half-hour break after the payout of wages in order to be able to spend the money immediately!

Inflation rate and exchange rate are indicative of Serbia's circumstances

- Each change in an individual price influences not only absolute prices but also the entire relation between relative prices – monopolists and the wealthier are best off!
- Inflation means additional tax and redistribution of wealth, particularly affecting low-income individuals!
- The fact that Serbia has its own currency is a chance for us to show “who we are and what we are”!
- Foreign exchange markets – the dinar exchange rate is
 - a reflection of our overall economic and political reality – a mirror of Serbia that many would rather do without!
 - of invaluable importance for the functioning of a market economy

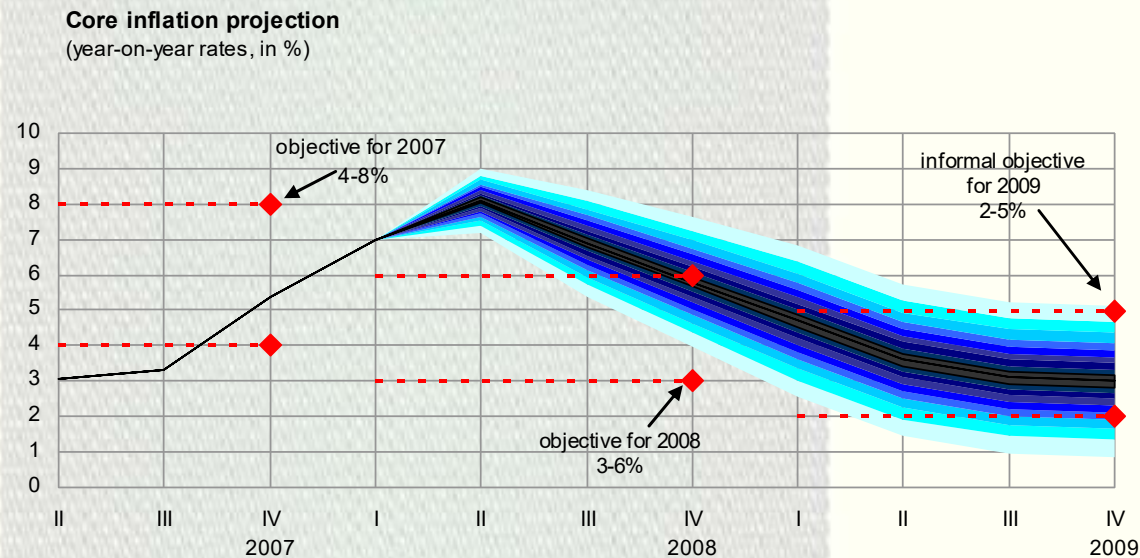
Inflation movements



May 2008:

- Year-on-year core inflation of 8.9% – above the upper bound of the target range for end-2008;
- Year-on-year retail price growth of 11.6 (of this, regulated prices – 12.7%);

Core inflation objective for 2008 will be achieved



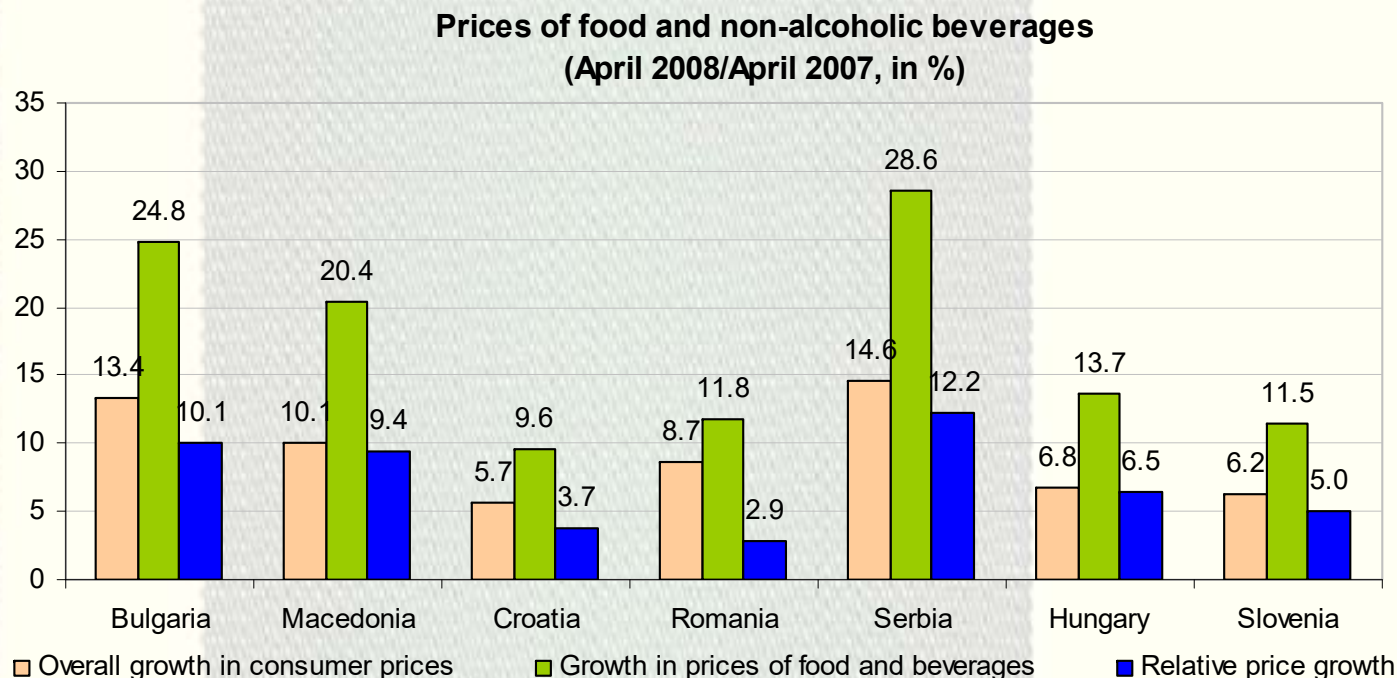
- Although monthly growth rates are expected to slow down, annual rates of core inflation will increase in H1 2008;
- The annual rate of core inflation is expected to settle within the target range (3-6%) in Q3 2008.

The NBS Monetary Policy Committee decided to raise the key policy rate from 15.25% to 15.75%

- Inflation expectations are high and rising;
- Public sector wages are increasing;
- On average, the appreciation gap has shrunk;
- The output gap is positive, and will most likely remain so for the most part of the year;
- World oil prices rose to new record highs; prices of agricultural products are not expected to decline soon – the spillover effect is still present;
- Substantial political uncertainty!

The decisions of the Monetary Policy Committee are almost exclusively based on medium- and long-term projections and not on daily movements!

Prices of food and non-alcoholic beverages



- By end-April, Serbia recorded the fastest annual growth in food prices. In Bulgaria, Macedonia and Serbia food prices are growing two times faster than the overall CPI (consumer prices);
- Whereas in mid-2006 food prices in Serbia equaled 67% of the EU average, at end-2007, according to our estimates, they reached 83%. As regards milk and milk products, Serbia is now at the EU average, compared to 75% of the average in mid-2006.

Government budget both is and is not a family budget!

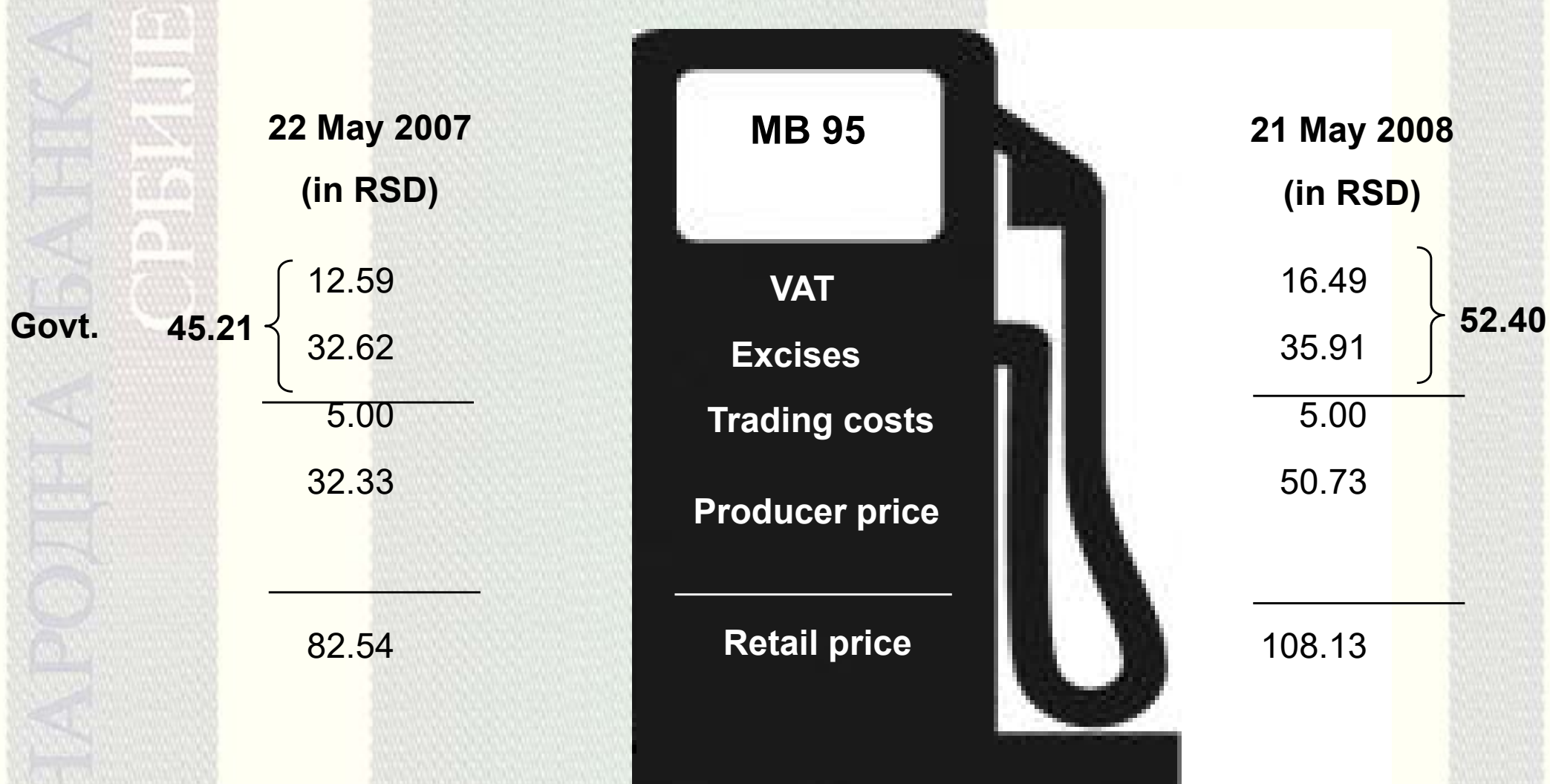
It is because...

- Lack of current revenue is easily and momentarily compensated for by means of one-off privatization receipts (“private inheritance”);
- If more is spent on pensions and wages, less will be left for investment, i.e. future pensions;
- Unlimited “shifting from above to below the line”!

It is not because ...

- Higher revenue and the resultant higher expenditure = inflation!
- Automatic indexation increases revenues – costs are irrelevant;
- There is an essential difference in the form of tax revenue (income tax or VAT)

Government earns from costlier petrol ...



“Monetary policy means managing the money supply and interest rates to preserve price stability “*

The central bank can influence movements in monetary aggregates by using the following instruments:

1. Open market operations

Definition

Issuing and withdrawing excess liquidity through securities.

Advantages

- Usual – market way – in developed economies;
- Signals the cost of money;
- Develops the money market:
- Withdrawal of excess liquidity costly for the central bank, but without consequences for clients

Disadvantages

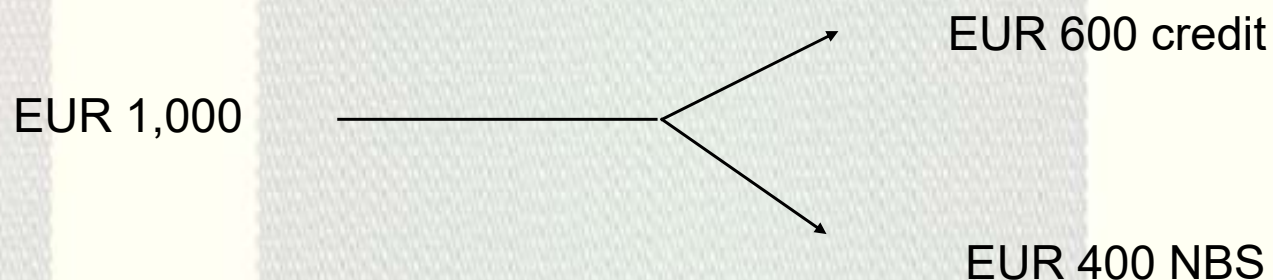
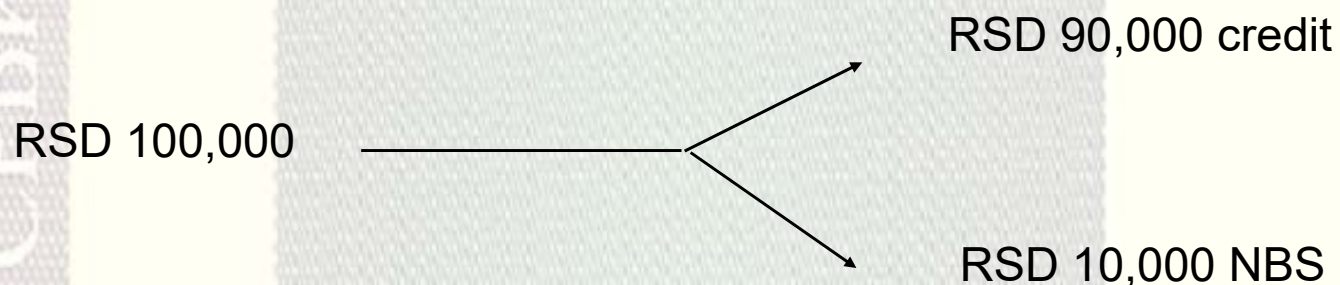
2. Required reserves

Prescribing the amount of liquidity to be deposited with the NBS.

- Quickly produces effects;
- Cheap for the central bank, but costly for clients;
- Non-market and mostly abandoned course of monetary policy
- Leads to a decline in financial intermediation

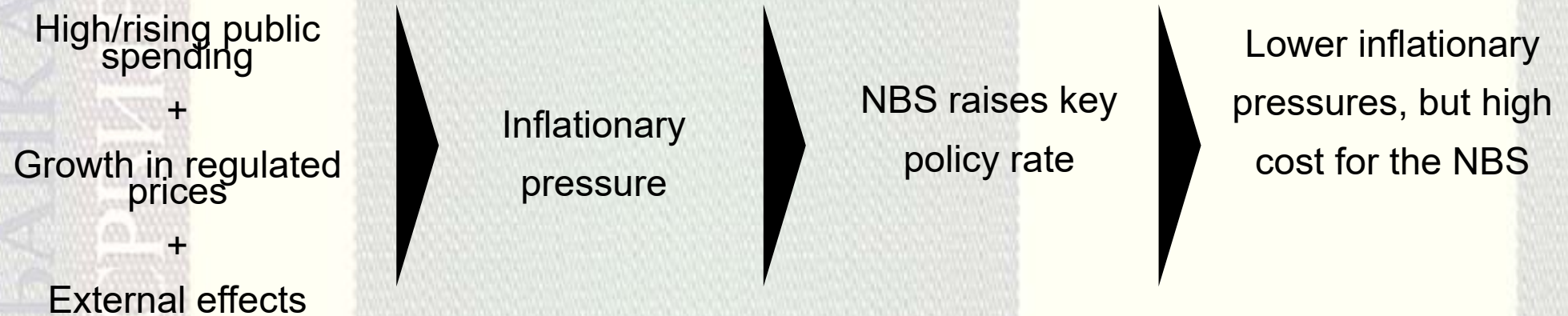
Money withdrawal against required reserves is inefficient and expensive!

Deposit in a commercial bank

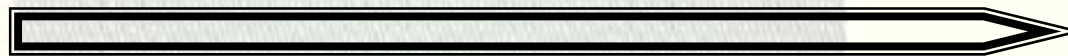


On 30 May 2008, new foreign currency savings came to EUR 5.3 billion

Maintaining price stability through open market operations is costly – but there is no alternative!



Example: RSD 1 billion injected for a year



Cost for the NBS:
RSD 157.5 million*
a year

An alternative is to raise the reserve requirement ratio further, which will result in an increased cost of borrowing!

* Based on the current key policy rate of 15.75%

Sterilization costs and stabilization gains (1/2)

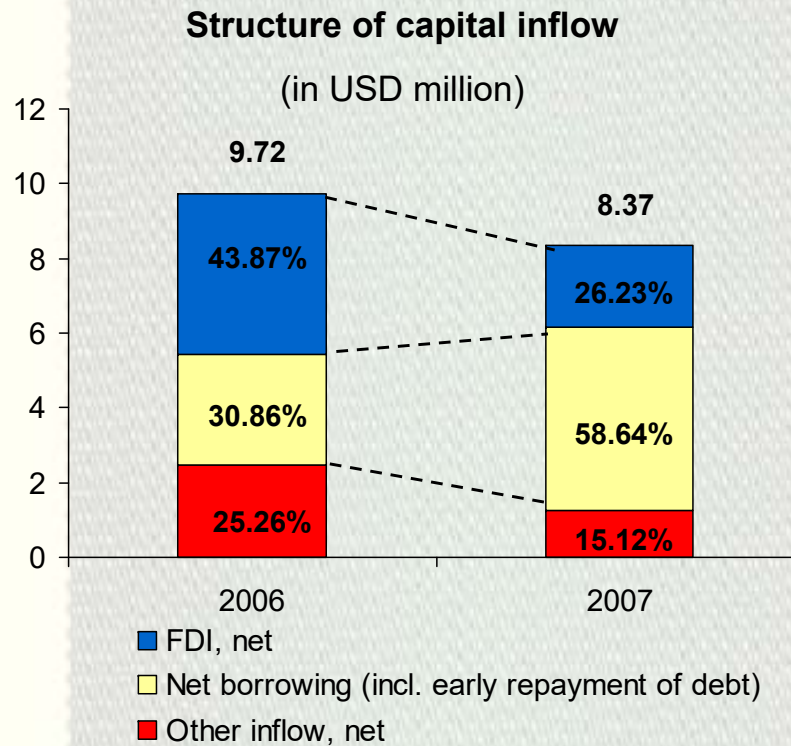
	Keeping the key policy rate at 9.5%		Current monetary policy	
	Jun	Dec	Jun	Dec
▪ Headline inflation	13.9%	17.2%	11.0%	8.6%
▪ Core inflation	10.7%	13.3%	8.1%	5.8%
▪ Difference in the RSD/EUR exchange rate	+ 7.0	+14.5	-	-

- Such a scenario would trigger an inflation spiral, create uncertainties and seriously jeopardize macroeconomic stability!
- Returning to the original level would, no doubt, cost the economy several times more than it currently costs the NBS!

Sterilization costs and stabilization gains (2/2)

- **Current monetary policy:** Inflationary pressures → Growing uncertainties → Upward revision of the key policy rate → Additional sterilization costs: around RSD 3 billion so far and around RSD 13 billion for 2008 as a whole.
- **Keeping the key policy rate unchanged:** Mounting instability → Downgrade in credit and investment rating → Weaker dinar → Additional costs:
 - ❑ In respect of external debt around RSD 5 billion so far and around RSD 22 billion for 2008 as a whole.
 - ❑ Gasoline prices would now already be 2 dinars higher.
 - ❑ With higher inflation in April, pensions would go up by an additional 2.5%, which would result in a RSD 4.5 billion cost for the government until the new inflation adjustment of pensions. In reality, however, pensioners would receive less as higher inflation would eat away at their retirement income.
 - ❑ Significant differences in the effects on investment, economic growth and standard of living.

BoP movements: credit-financial transactions



- Non-credit sources of finance (foreign investment and domestic savings) cover 73% of the current account deficit, which is around 11.8% of GDP.
- Net borrowing accounted for capital inflow of around 10.9% of GDP.

2. Credit default swap

Five-year CDS spread for Serbia in USD
(daily changes, in basis points)

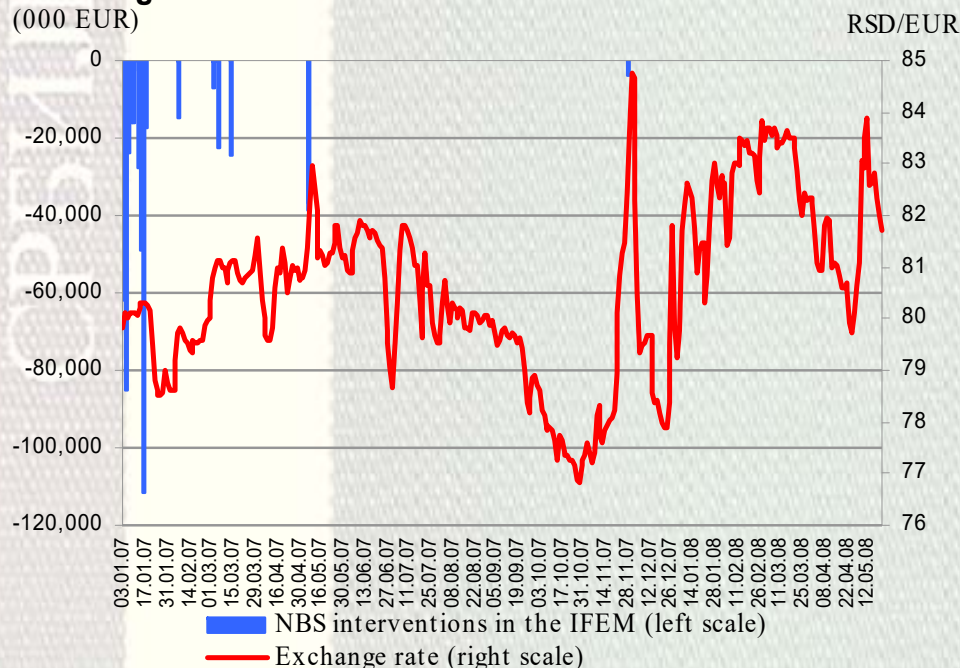


Source: Bloomberg.

- *CDS spreads* - market indicator of country risk
- Determines the level of interest rates at which banks can borrow abroad
- Corresponds to the movements of other risk premium indicators (EMBI);
- Measuring of CDS spread for Serbia began in May 2006
- Upward trend in CSD spread for Serbia is a consequence of political situation and uncertain prospects regarding the European integration processes.

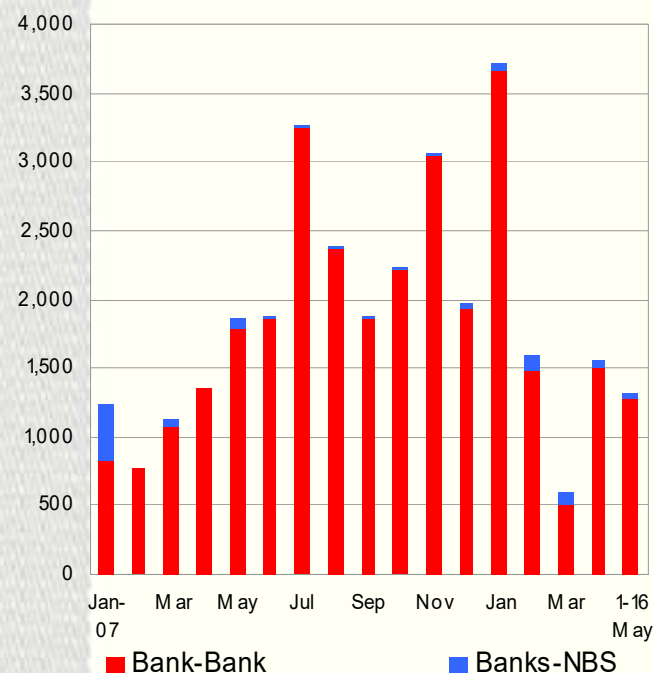
Throughout the year the NBS sold an average of EUR 4.4 million per day to boost liquidity levels in the IFEM

NBS FX trading in the the fixing session and exchange rate of the euro
(000 EUR)



Structure of banking sector

trade in the IFEM in 2007 and 2008*
in EUR million



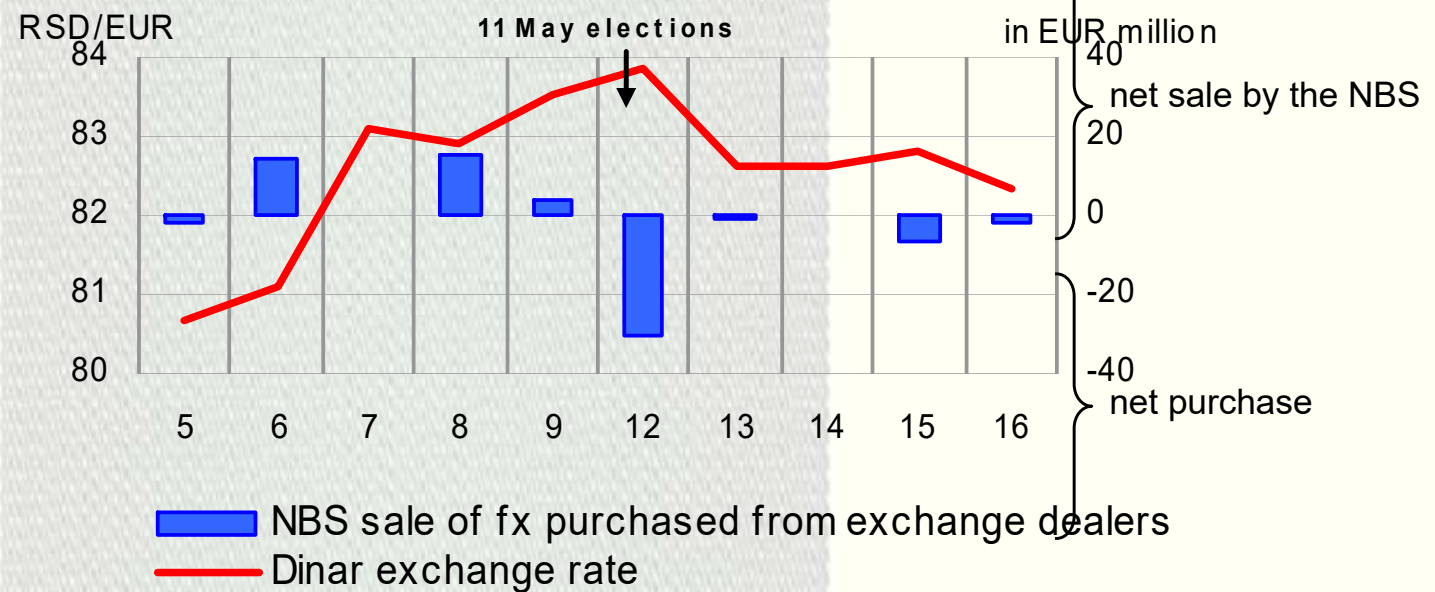
*In the IFEM the NBS sells a portion of foreign exchange

- The level of exchange rate has not been defended in the fixing session since mid-May 2007;
- From the beginning of the year to date (89 business days), the NBS sold a total of EUR 393 million (outside the fixing session), while in the same period in 2007, it sold 42% more - EUR 556.7 million (in the fixing session)!

Foreign exchange market is here also to show the effect of politics on the dinar

Exchange rate level and NBS daily net purchase from exchange dealers

(5-16 May 2008)



Even today the “fixed exchange rate” exists = forward sale of currency for exporters!

- For instance, a company is exporting goods worth EUR 1,000,000 to the EU
- Foreign currency inflow is expected after three months
- Current buying exchange rate **RSD/EUR = 81,8532 (middle rate 82,4302)***
- The exporter concludes a forward deal to sell EUR 1,000,000 after 3 months at the **RSD/EUR** exchange rate of **81,0000**
- After 3 months, if the RSD/EUR exchange rate is:
 - **79.00**, the exporter records profit on exchange rate differentials, getting instead of RSD 79.00, RSD 81.00 for EUR 1.00 * 1,000,000 = RSD **2,000,000**.
 - 81.00, the exporter breaks even – no profit, no loss
 - **82.00**, the exporter records losses on exchange rate differentials, getting instead of RSD 82.00, RSD 81.00 per EUR 1.00 * 1,000,000 = RSD - **1,000,000**.

Even today the “fixed exchange rate” exists = forward purchase of currency for importers!

- For instance, a company is importing goods worth EUR 1,000,000 from the EU
- Payment of goods is due in three months
- Current selling exchange rate **RSD/EUR=83,0072 (middle rate 82,4302)***
- The importer concludes a forward deal to buy euros in three months at the **RSD/EUR** exchange rate of **81,0000**
- After 3 months, if the RSD/EUR exchange rate is:
 - **79.00**, the importer records losses on exchange rate differentials, paying instead of RSD 79.00, RSD 81.00 for EUR 1.00 * 1,000,000 = RSD **-2,000,000**.
 - 81.00, the importer breaks even – no profit, no loss
 - **82.00**, the importer records profit on exchange rate differentials, paying instead of RSD 82.00, RSD 81.00 for EUR 1.00 * 1,000,000 = RSD **1,000,000**.

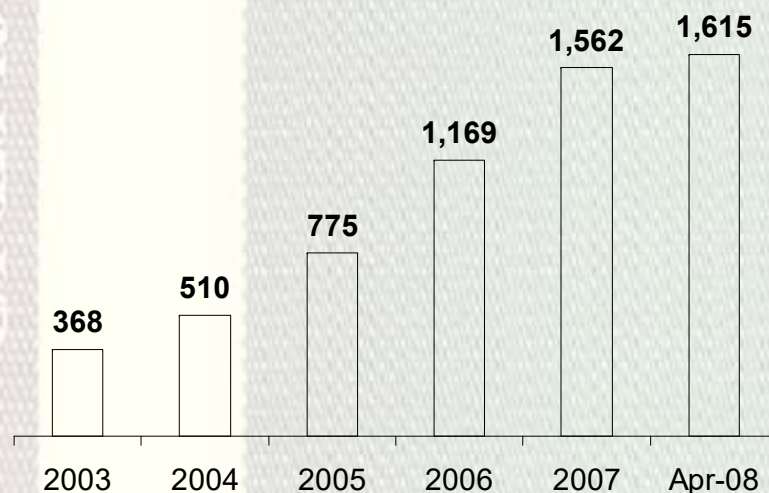
Several truths about banks!

- Banks are profit-making, not social welfare institutions;
- Banks will not and can not provide cheap loans and high deposit rates as this would be contrary to their primary objective of profit-making;
- Market-based pricing – including the pricing of banking services – means that prices are based on supply and demand, not on costs!

2007 was the year of success for the Serbian banking sector (1/2)

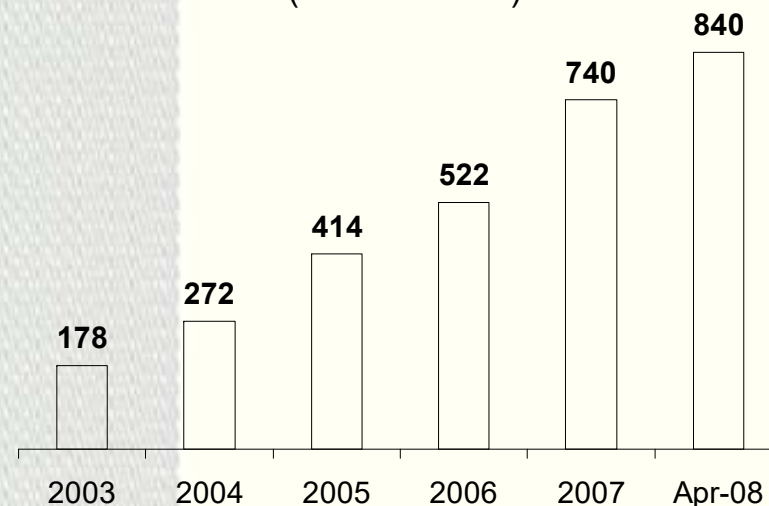
Balance sheet assets

(in RSD billion)



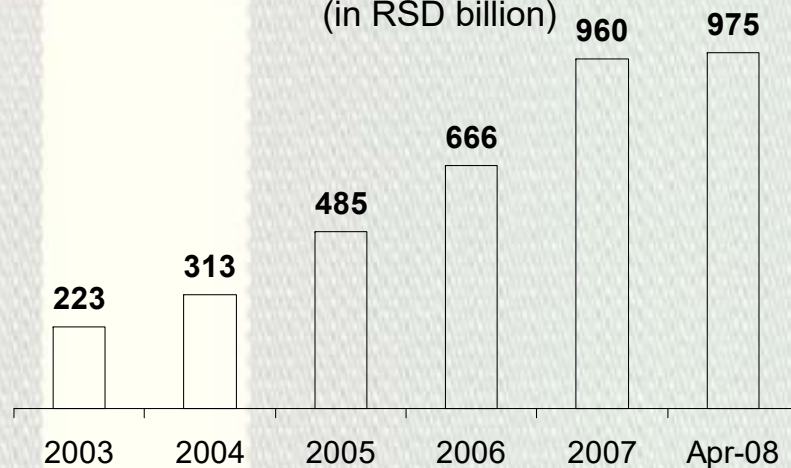
Loans

(in RSD billion)



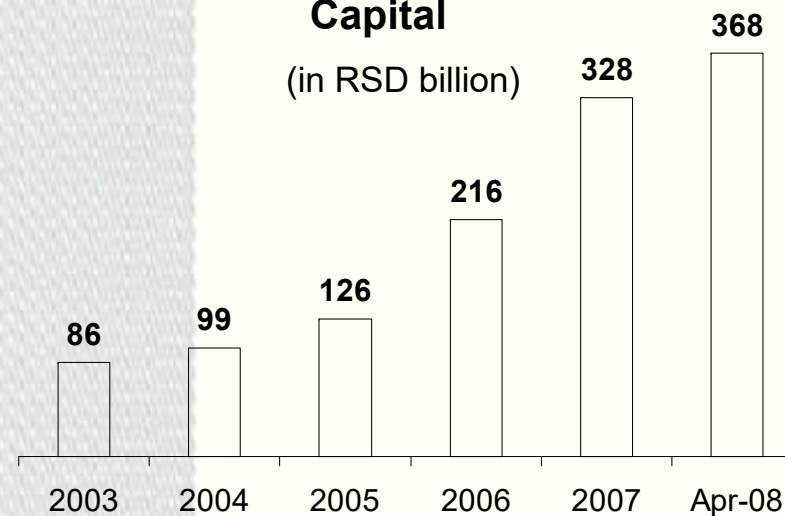
Deposits

(in RSD billion)



Capital

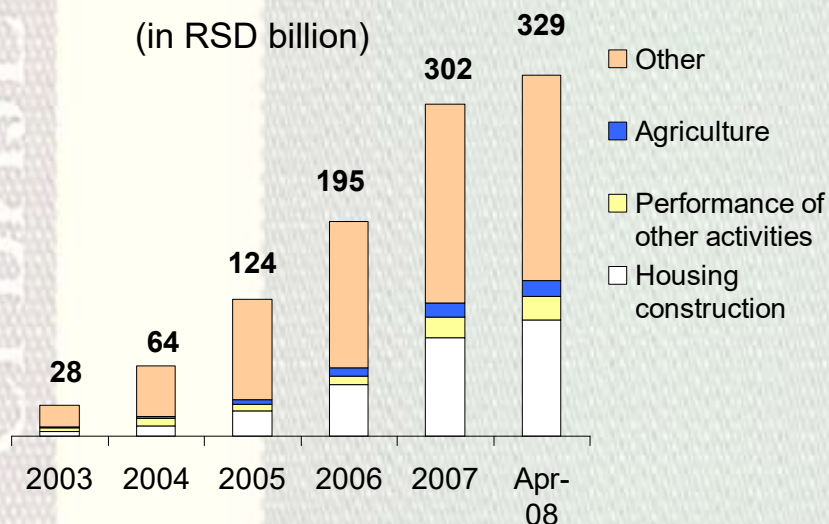
(in RSD billion)



2007 was the year of success for the Serbian banking sector (2/2)

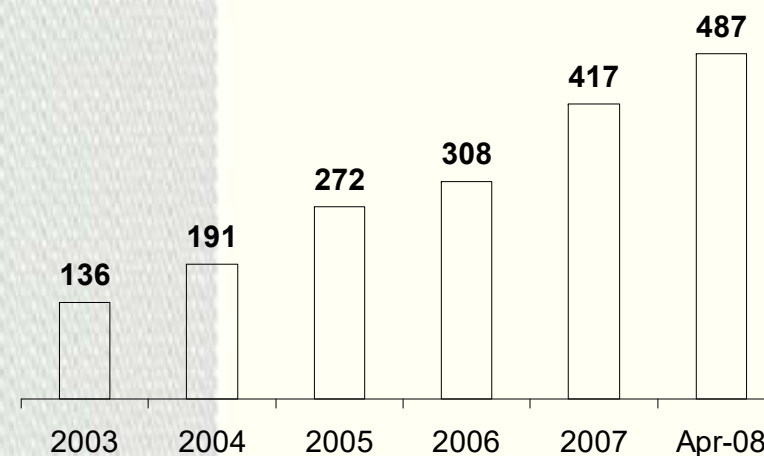
Household lending

(in RSD billion)



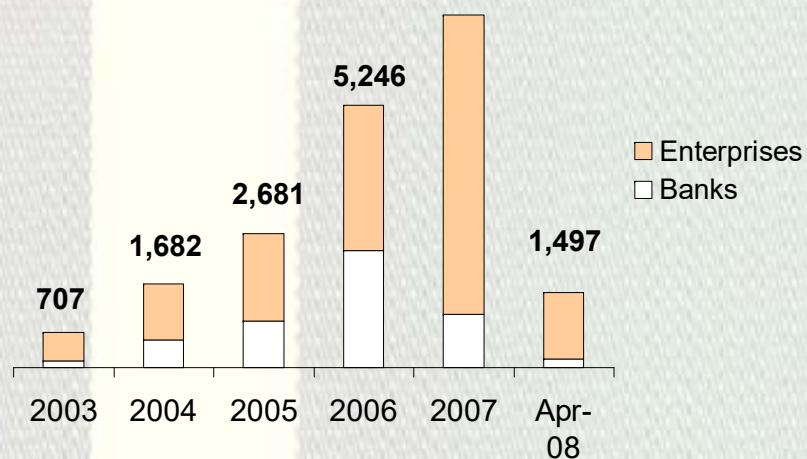
Corporate lending

(in RSD billion)



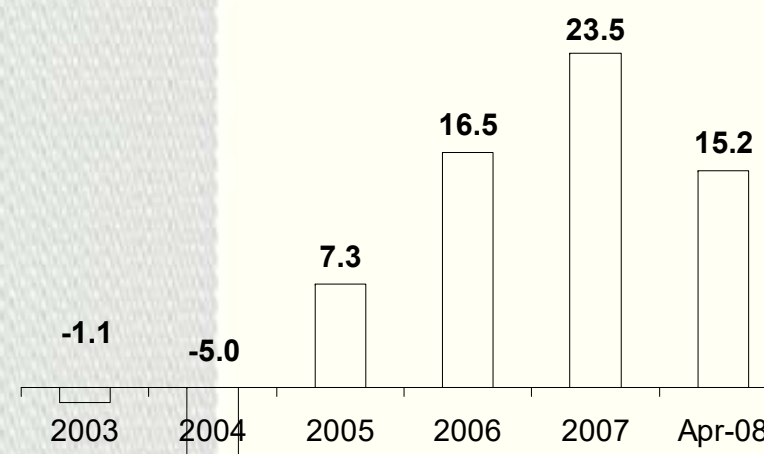
Total foreign borrowing by the private sector

(in USD million)



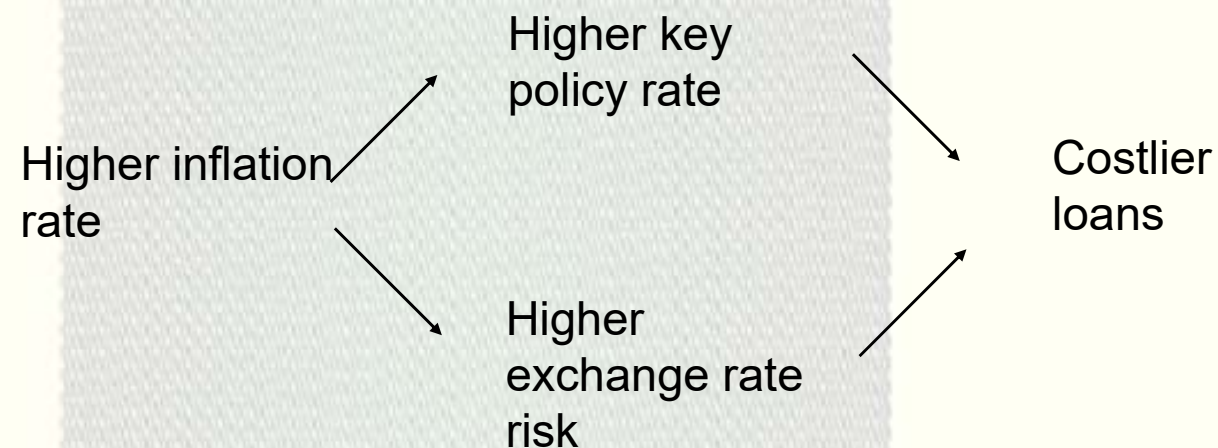
Profit

(in RSD billion)



The most recent NBS measures aim to strengthen the role of the dinar!

- Low interest rate on loans denominated in a different currency does not necessarily mean cheaper loans!
- Borrowers who take dinar loans do not have to worry about the exchange rate!



Thank you for your attention!

NBS Call Centre

Dial toll free

0800-111-110