Conference on European Economic Integration
REGAINING FINANCIAL MARKET STABILITY IN CESEE

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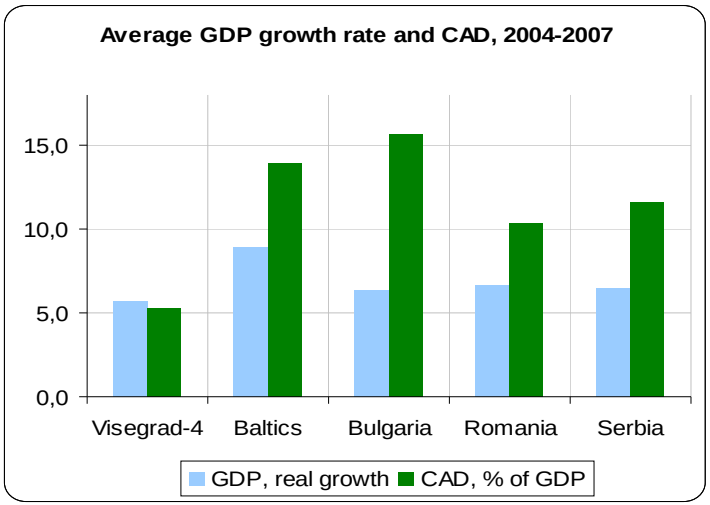
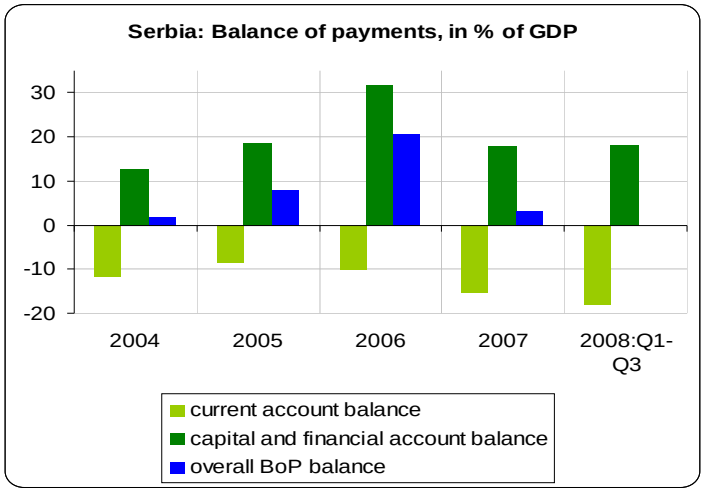
Before the crisis/1

- High growth, but also high CAD
- Easily financed by large capital inflows
  - donor support (2001 -2003)
  - FDIs, mainly privatization
  - bank privatization and recapitalization from abroad
  - cross - border lending



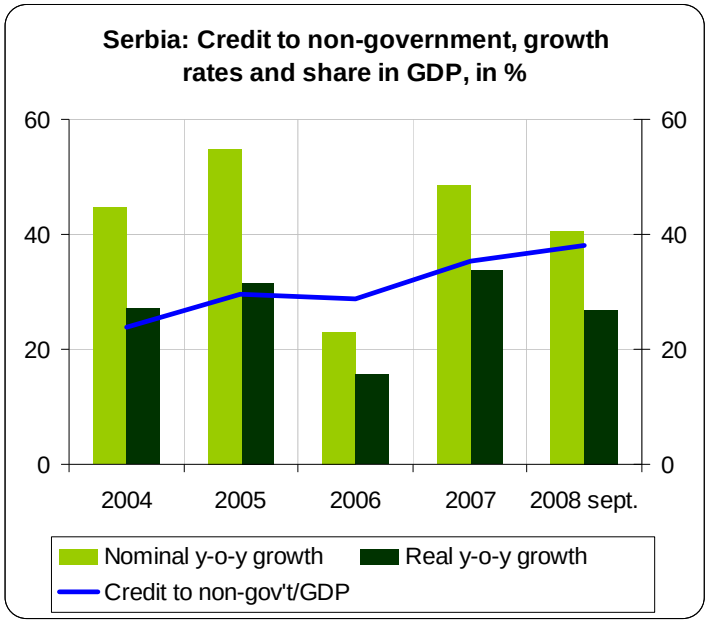
Source: IMF WEO database



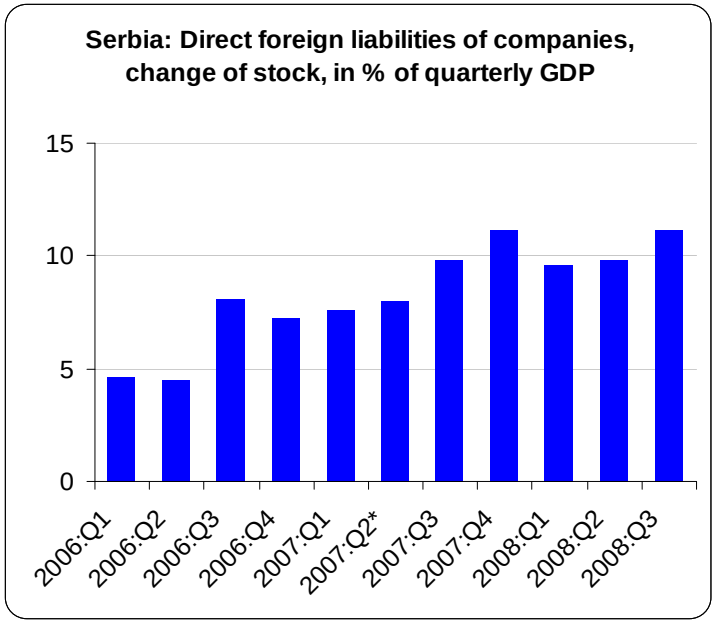
Source: National Bank of Serbia

Before the crisis/2

- Strong growth of credit
  - Through domestic system
  - Cross border lending (because of high reserve requirements on domestic banks)



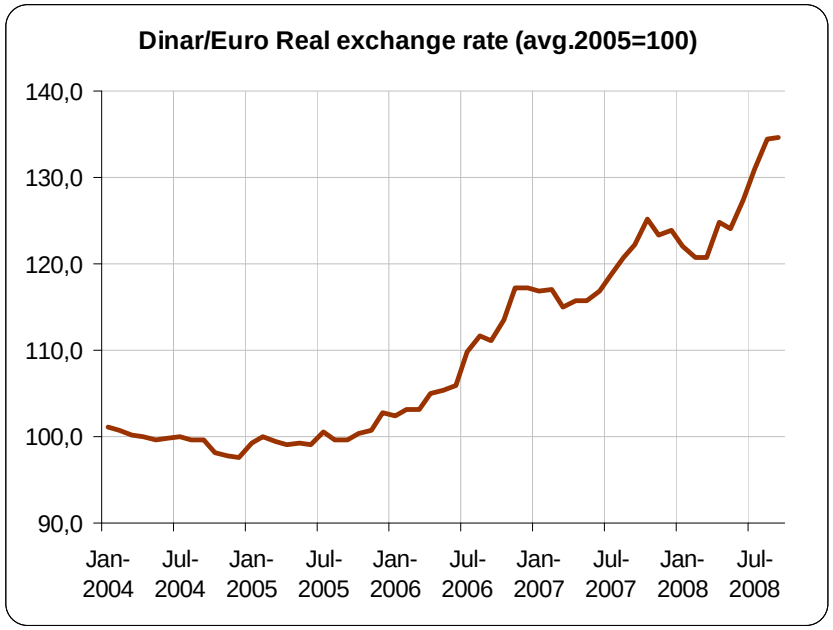
Source: National Bank of Serbia



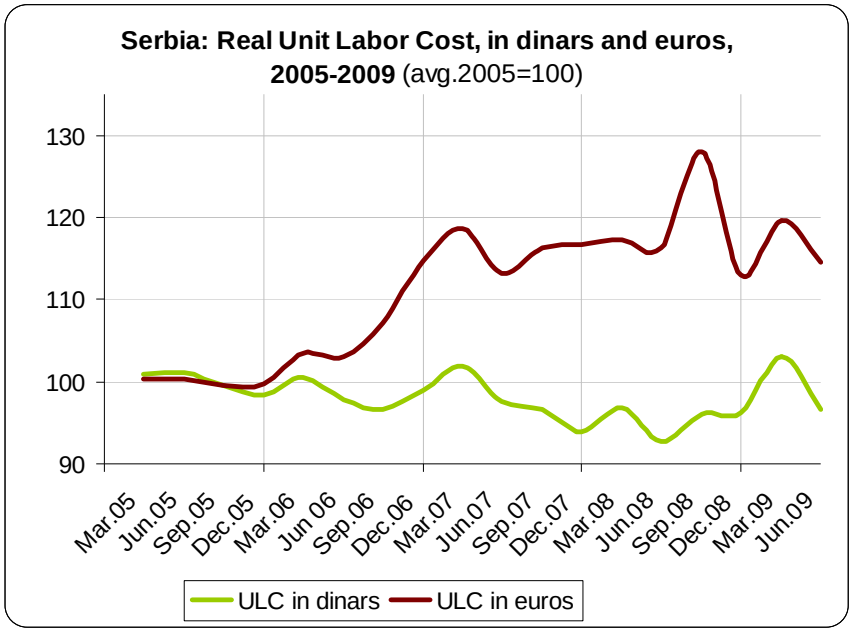
Source: National Bank of Serbia

Before the crisis/3

- Capital inflows – real appreciation of currency
- Labor costs expressed in euros increase – loss of competitiveness



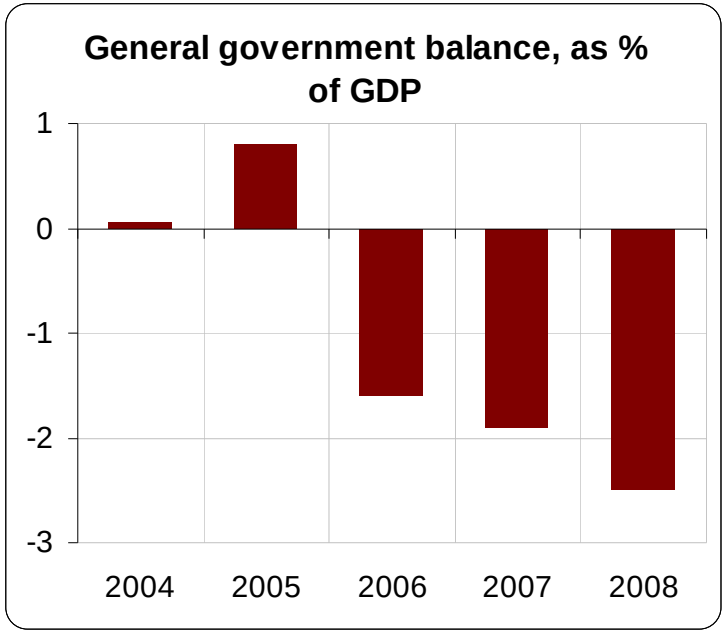
Source: National Bank of Serbia



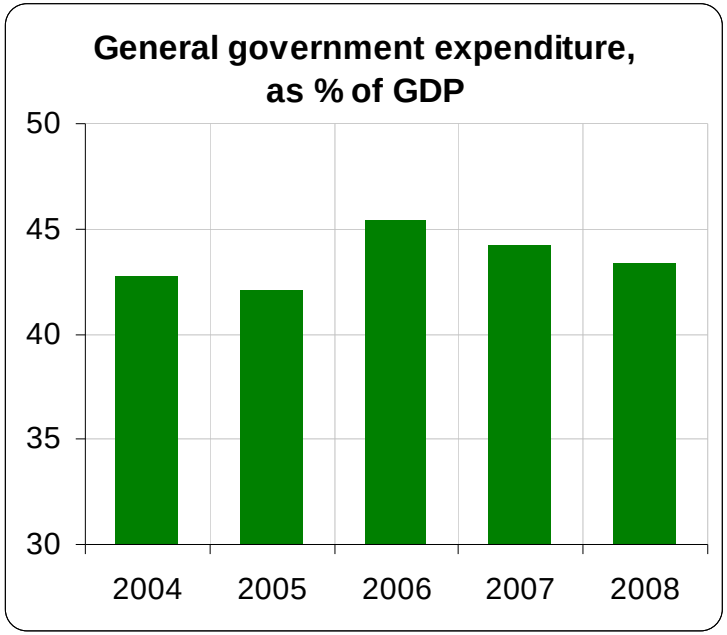
Source: Quarterly Monitor of Economic Trends and Policies in Serbia

Fiscal policy was procyclical

- Frequent elections led to loose fiscal policy
- It had a procyclical effect on the economy



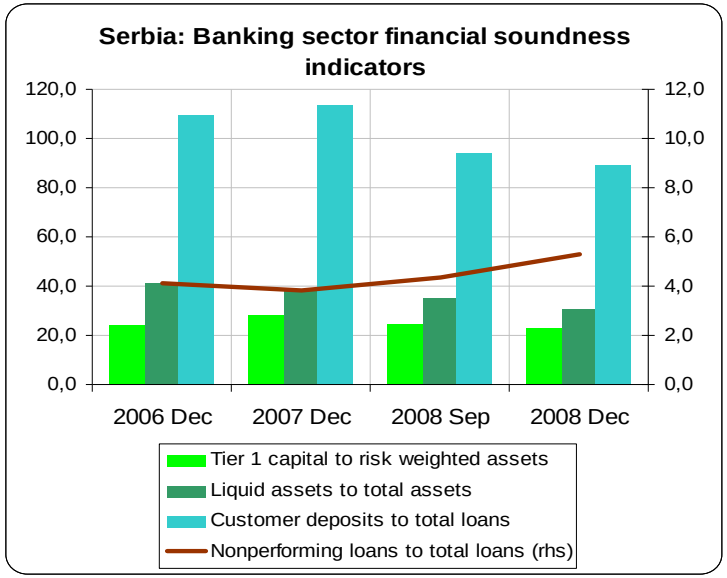
Source: Ministry of Finance



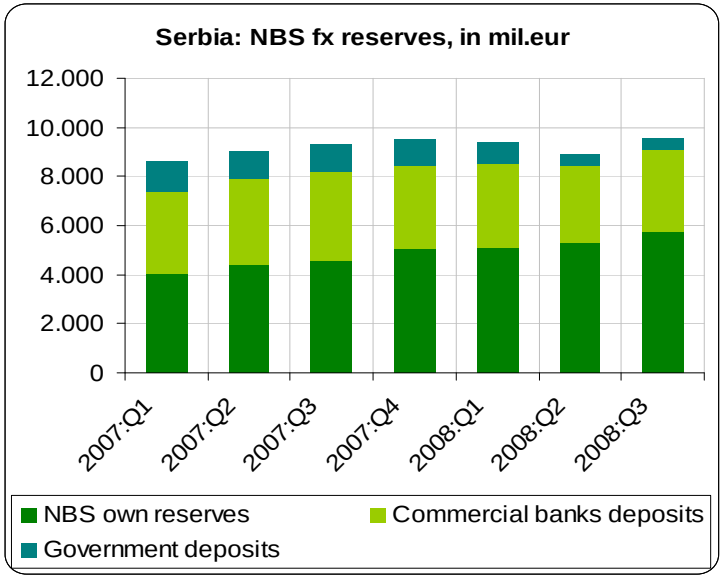
Source: Ministry of Finance

Prudent monetary policy

- On the other hand, monetary policy was very tight in relation to the credit expansion
- Very strong prudential ratios
- Solid f/x reserves



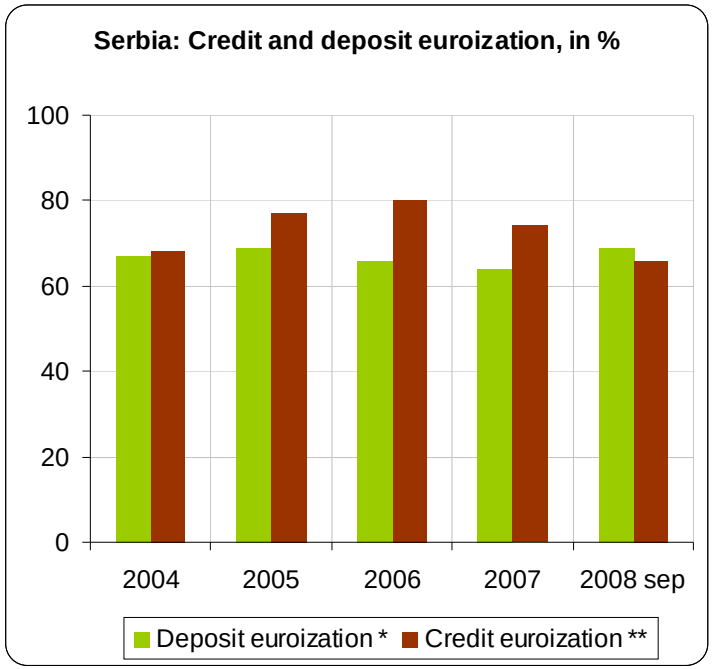
Source: National Bank of Serbia



Source: National Bank of Serbia

Highly euroized economy

- Banking system is highly euroized
- Vast majority of both deposits and credits are in foreign currency
- Vulnerable to balance sheet risk as a consequence of quick depreciation



Source: National Bank of Serbia and IMF
* Share of non-gov't f/x deposits in total non-gov't deposits
** Share of net (excl. provisions) fx-indexed and fx-denominated bank credit in total bank credit to non-government

Financial system was relatively robust before the crisis…

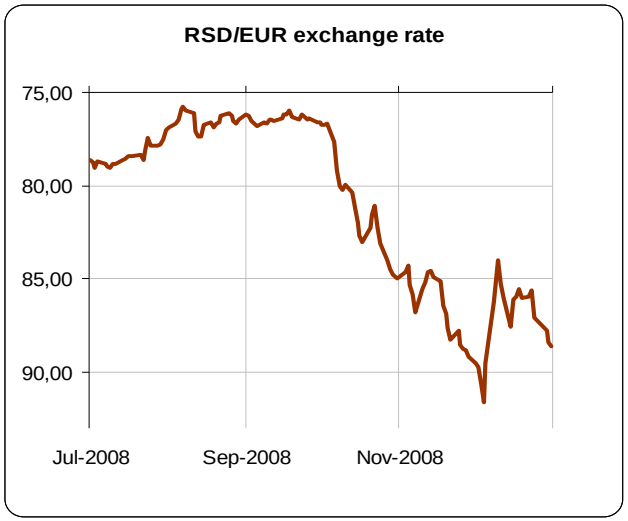
- Because of tough prudential measures by the NBS, financial system had a relatively favorable pre-crisis starting position
  - Banks well capitalized
  - Low share of risky assets
  - Solid f/x reserves

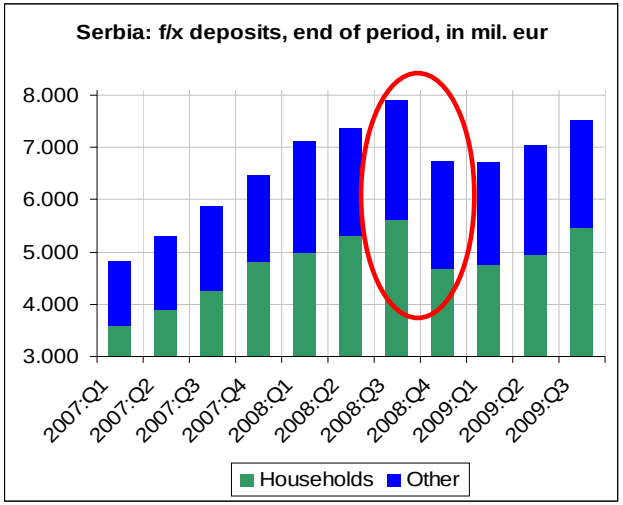
..but there are also some weaknesses

- Key risks to the financial stability before the crisis were:
  - Large current account deficit
  - Highly dependent on capital inflows
  - Roll over risks for direct cross border lending
  - High euroization of the economy, balance sheet risks

First effects of the crisis

- At the begining of the crisis, dinar started to depreciate sharply
- Anxious reaction of households – deposit withdrawals
  - Almost 1 billion euros (about 20% of total HH deposits) withdrawn by households just after the crisis started

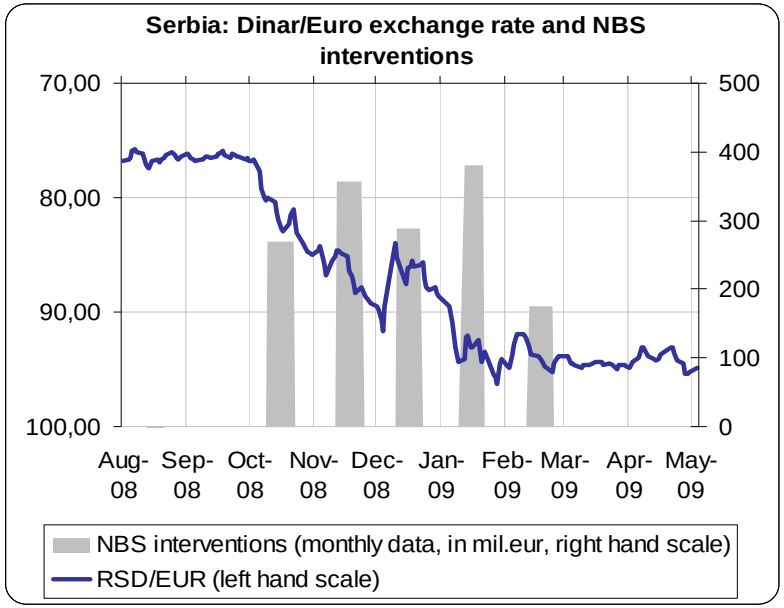




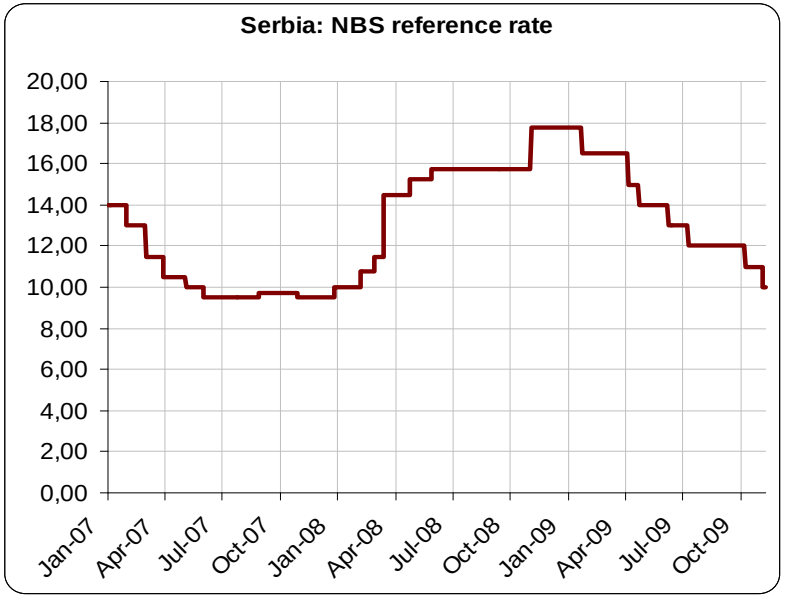
Source: National Bank of Serbia

NBS reacts quickly to the crisis…

- Aggressive direct NBS interventions at f/x market provided floor for exchange rate
  - At the expense of decreasing f/x reserves
- Interest rate increased to defend exchange rate



Source: National Bank of Serbia



Source: National Bank of Serbia

…followed by the Ministry of Finance and the IMF

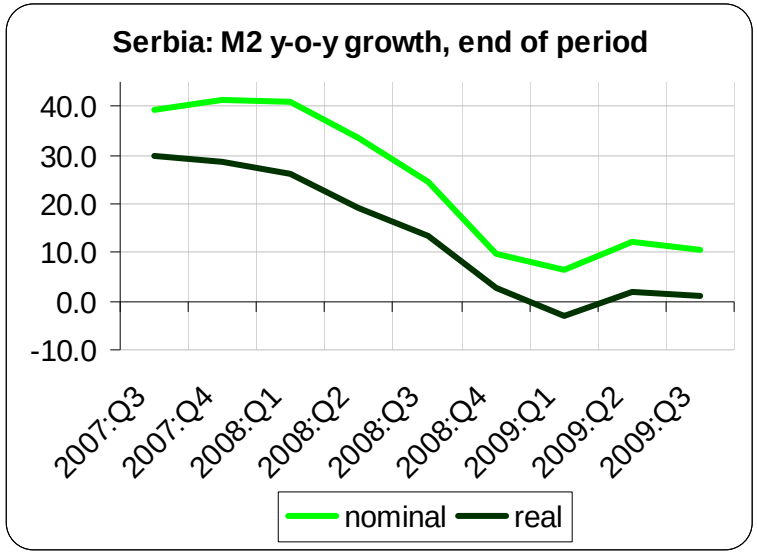
- Vienna accord
  - Foreign banks agree not to decrease their exposure to Serbia – risk of capital reversal averted
- IMF stand-by agreement provided contingency support for f/x reserves
- Ministry of Finance eliminated tax on savings and introduced subsidized loans to provide necessary liquidity

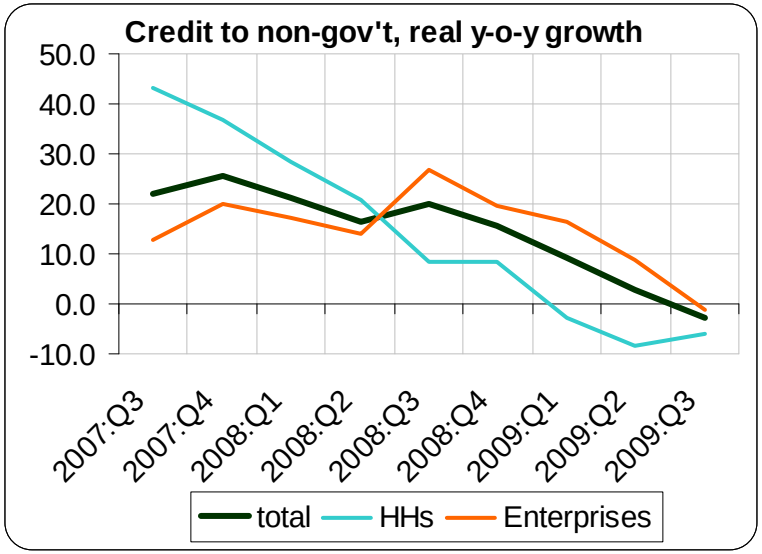
IMF support very important

- When the crisis was at its peak, IMF support gave credibility to policies
- Based on 3 pillars:
  1. Fiscal adjustment in Serbia – lower domestic demand, easing pressures to the CAD
  2. Commitment of the foreign banks to continue supporting Serbia (Vienna accord – prevents potential capital outflows, and eases pressures to corporate BS)
  3. Role of the IFI's – project loans and budget support, provides Fx inflows, liquidity to the budget and infrastructure projects that stimulates the economy

Further policy response/1

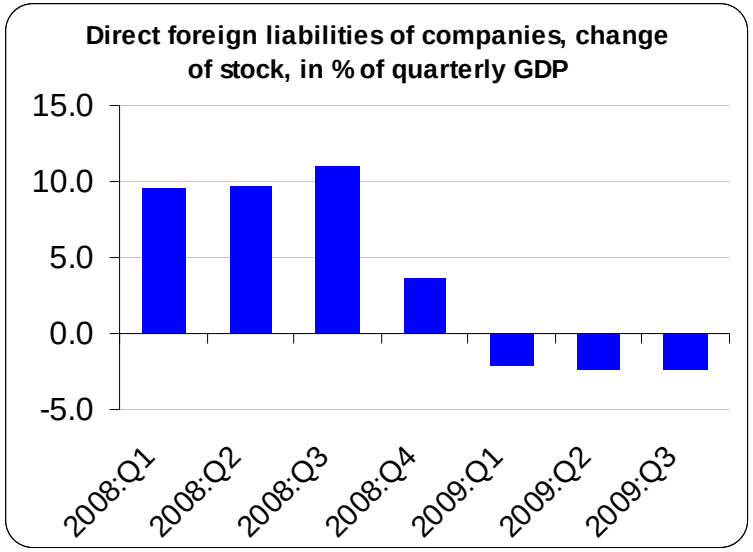
- Credit activity almost frozen
- First hit was taken by credit to households, credit to enterprises also freezes

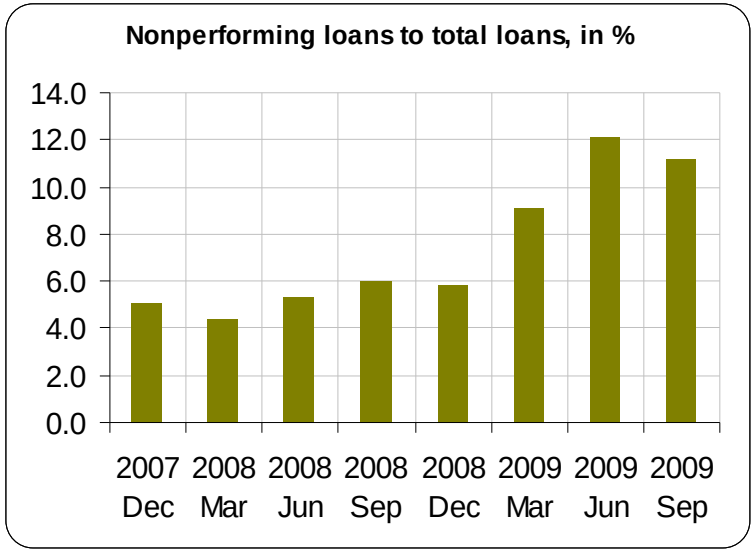




Further policy response/2

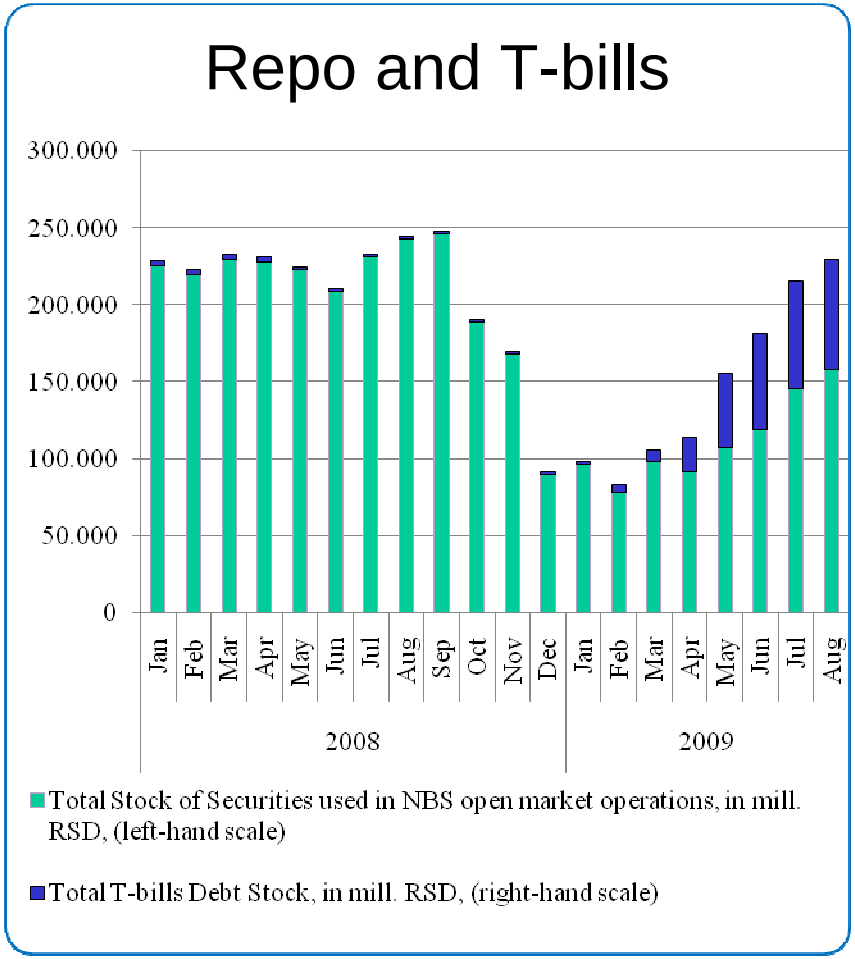
- Net cross border lending is now negative
- NPLs increased, but seem to have leveled off





Further policy response/3

- Crowding out effects?
  - Government debt increasing, NBS repo stock high
- Interest rate on T-bills determined by NBS reference rate, which is relatively high (12% until mid-October)



Further policy response/4

- Monetary policy still relatively tight
  - Slow response to changing circumstances?
- Too backward looking?
  - Inflation very high in first half of 2009, but due to administrative price increases
  - Inflation in second half of 2009 almost zero, but reference rate remained high (for too long?)

Policy challenges

- Financial system seems to have stabilized
  - Exchange rate very stable, NPLs level off
- Challenges remain:
  - Fiscal adjustment
  - Public debt management
  - Revive lending to companies
  - Monetary policy adjustment (reference rate)

Thank you for the attention!

Government of the Republic of Serbia, Ministry of Finance

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