National Bank of Serbia

Consequences of ECB’s Non-Standard Monetary Policy Measures on the Western Balkan

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Key Issues and Findings

- Still to early to quantify effects of ECB measures on EME;
- Effects largely dependent on macroeconomic and financial characteristics of each country.

Key issues:

1) How external monetary conditions become a source of risk for monetary and financial stability?
2) How central banks currently react to those risks?
3) Reactions of Central banks to later exit strategies:
   - ✓ Strengthen macroeconomic fundamentals;
   - ✓ Increase financial stability in the country.

Main channels of transmission

- Non-standard measures and later exit strategies will have an effect on:
  1) External demand and trade balance;
  2) Capital flows (FDI inflow, portfolio investments, credits).

- Affecting:
  1. FX movements;
  2. Trade balance;
  3. Interest rates;
  4. Credit activity.

What Can Central Banks Do?

- Use monetary policy instruments:
  1) Key policy rate;
  2) Mandatory reserve;
  3) FX interventions;
  4) Unconventional measures.

- Together with other relevant institutions in the country:
  1) Reduce eurization in the economy;
  2) Strive to reduce macroeconomic imbalances;
  3) Seek to improve bank balance sheets through regulatory framework.

Effects of Non-Standard ECB's Monetary Policy Measures on Serbia

Impact on Economic Activity

- Non-standard measures can influence economic activity in Serbia through two main channels:

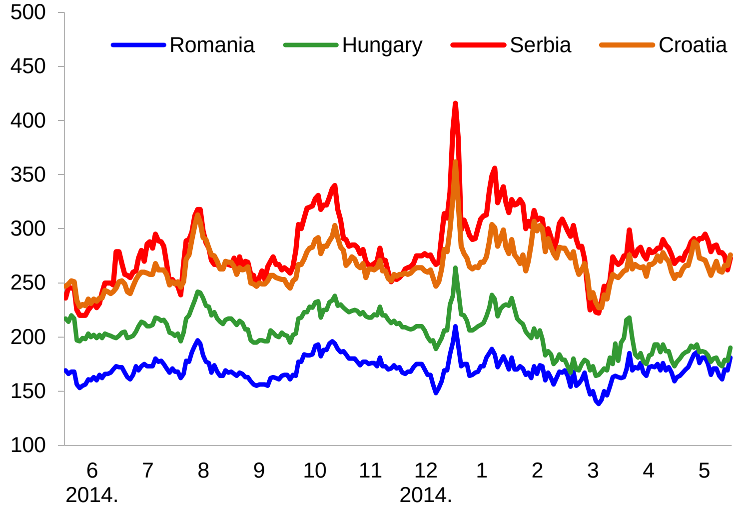
  1) Reduction in real interest rates can boost credit activity;

  2) Faster economic recovery of the Euro area enhanced by euro depreciation, spilling over to Serbia's export oriented growth.

Impact on the FX Market

Agreement with the IMF, together with non-standard measures resulted in improvement of the risk premium …

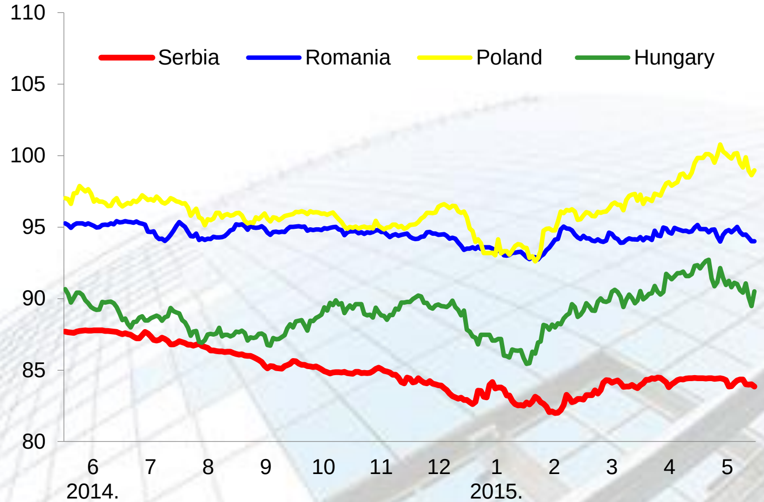
Chart 1 **Risk premium – EMBI**
(daily data, in base points)



- Since the year beginning, Serbia's risk premium has fallen the most among the countries in the region, mostly due to the conclusion of the arrangement with the IMF and positive assessment after its first revision.
- In addition to that, ECB QE helps the region as risk premia remains relatively low and stable.

… and exchange rate stability

Chart 2 **Exchage rate movements in the region**
(Q2 2010=100)



*Increase means apreciation.

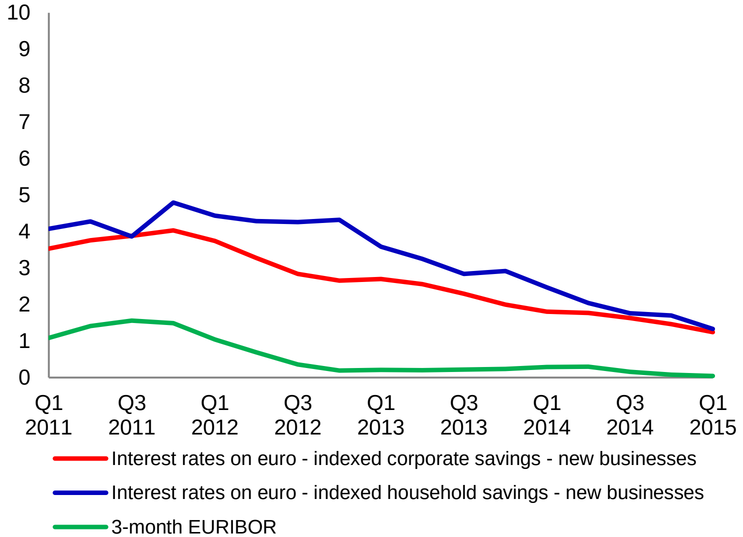
- The dinar has strengthened against the euro by 0.7% in the first four months of 2015.
- Mild appreciation came as a result of non-residents' purchase of dinar government bonds, improvement of Serbia's macroeconomic and fiscal perspectives as well as implementation of ECB's QE program.
- Since the beginning of the year described movements resulted in NBS being a net FX buyer in order to ease excessive daily volatility of the exchange rate.

Lower Interest Rates Bring Important Stimulus for Private Sector…

As a result of non-standard measures of the ECB savings interest rates have been declining…

Chart 3 **EURIBOR (3-month) and average interest rates on corporate and household euro-indexed savings**

(three - month average, in %, on annual level)

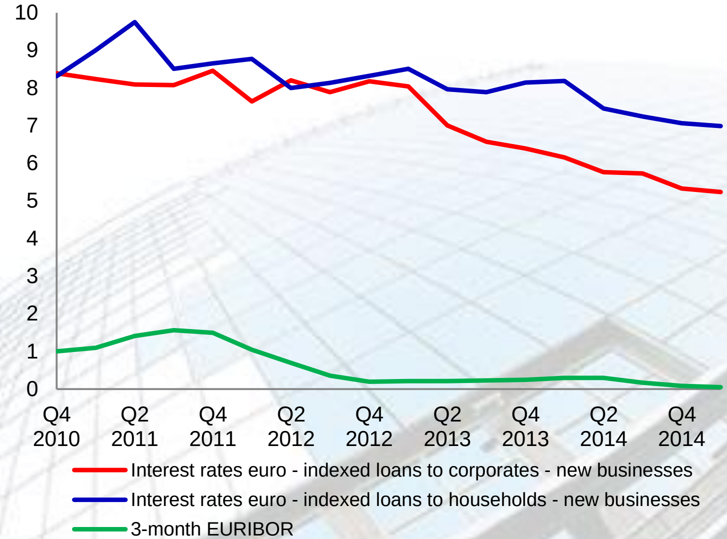


- Excessive external liquidity primarily affected savings interest rates in the Serbian banking sector.
- Reduced cost of capital for the banks gains importance as local savings are still primarily denominated in euros.
- In the conditions of excess liquidity, savings rates are expected to remain on a declining path, creating new space for further decline in interest rates on loans.

…contributing to the fall in EUR-indexed interest rates on loans

Chart 4 **EURIBOR (3-month) and average interest rates on euro-indexed credits to corporates and households**

(three - month average, in %, on annual level)

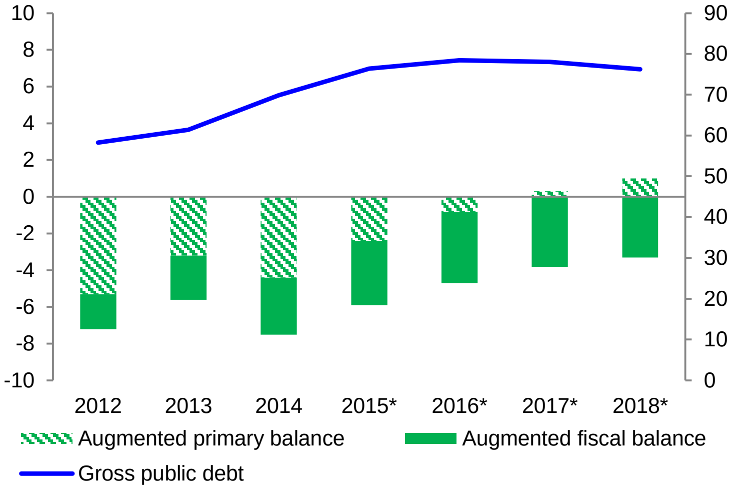


- Decline of nominal interest rates together with higher inflation expectations will help reduce real interest rates, creating a better business environment for the private sector.
- Such movements create more room for monetary easing.
- According to our estimates, decline of Euro area real interest rate of 1pp, opens up the scope for monetary easing in Serbia of around 1pp after one year.

...a Public Debt Financing Facilitation for the Government...

Countries with lower internal and external imbalances...

Chart 5 **Fiscal movements and projections**
in % of GDP)

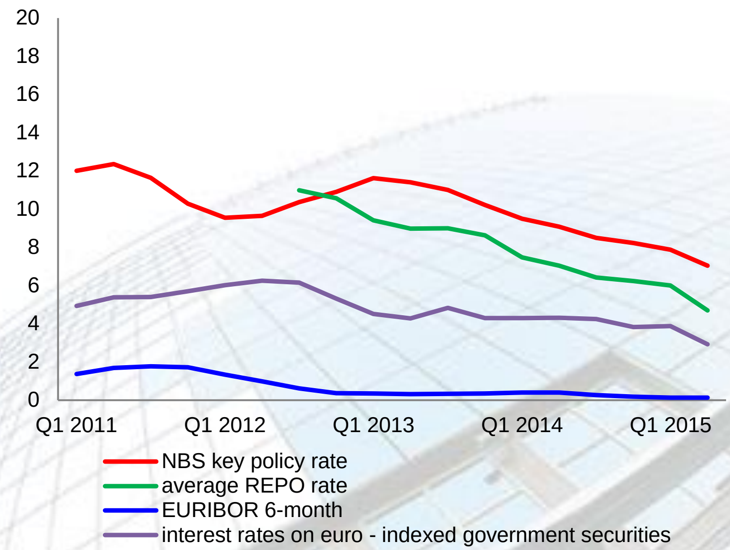


*IMF forecast - Article IV

- Measures effective since 2014 – cuts in wages and pensions and together with attrition rule have cut the deficit by around 2.0pp of GDP, while tax collection improved.
- In Q1 the fiscal deficit amounted to 2.4% of GDP despite high interest payments (4.6% of GDP), well below the program target of 6.0% of GDP.
- Additional savings in 2015 expected from structural reforms – SOE restructuring, rightsizing of General Government and increase in electricity prices (incl. new excise tax).

... are likely to benefit more from non-standard measures

Chart 6 **Interest rates**
(three-month average, in %, on annual level)



- Alongside improvement of Serbia's macroeconomic and fiscal perspectives, implementation of ECB's quantitative easing opens up the scope for reducing the debt servicing costs and for strengthening capital flows to Western Balkan economies at lower volatility.
- Continuous structural reforms in the coming period are expected to keep interest rates for government financing at a low level.

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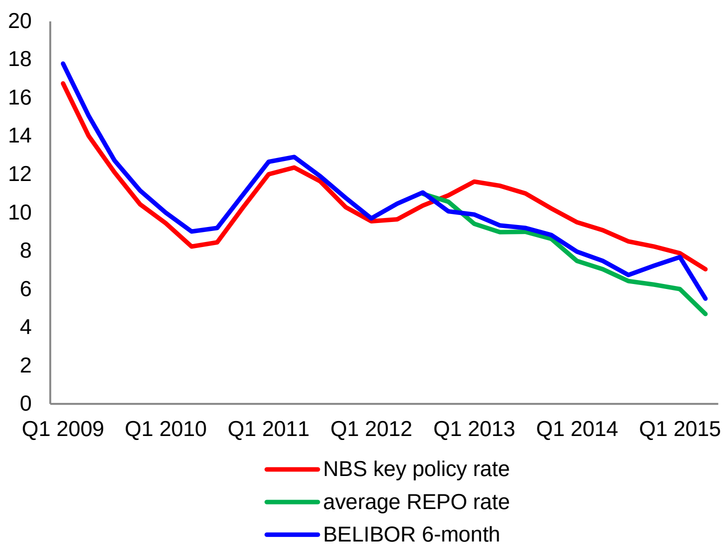
…and More Room for Monetary Easing

Conditions created by non-standard measures opened more space for monetary policy easing…

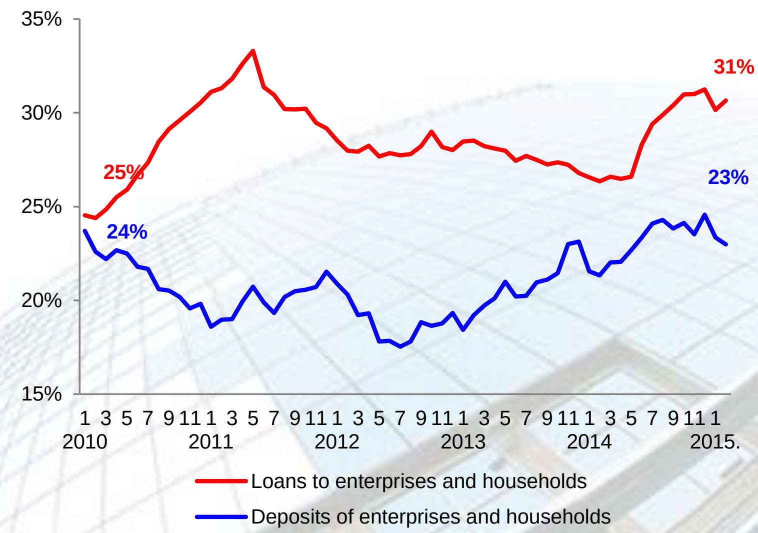
Chart 7 **NBS key policy rate and BELIBOR (6-month)**
(three-month average, in %, on annual level)



- Conditions created by non-standard measures largely determined the character of monetary policy.
- Besides QE, recent cuts were motivated by improved risk perception of Serbia following deal with the IMF, as well as credible fiscal consolidation measures and structural reforms.
- Additionally, decline in inflation expectations and persisting disinflationary pressures stemming from low aggregate demand, contributed to monetary policy easing.

…but possibilities of future QE exit strategies should be taken into account

Chart 8 **Loan and Deposit Dinarisation**
(share in total)



- To reduce volatility and limit the damage from later QE exit strategies, Western Balkan countries need to strengthen their macroeconomic fundamentals and reduce their dependence on external financing.
- Likewise, together with other relevant institutions, central banks need to seek improvement in bank balance sheets through regulatory framework, as well as, make efforts to reduce eurization and manage credit activity