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THE IMPACT OF MONETARY POLICY ON OTHER MACROECONOMIC POLICIES AND THE FINANCIAL SYSTEM

C O N T E N T

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Spillover effects of non-standard monetary policy measures and of future monetary policy normalisation on Serbia

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Unconventional monetary policy in the EU and other advanced economies has had no negative impact on Serbia so far. With respect to its inevitable consequences, especially on interest rates, it is assessed that the key risks in the period ahead will emanate from the international environment and, as such, may affect the monetary policy stance. These risks far outweigh the expected monetary normalisation. Hence, as so far, monetary policy will be predictable and consistent in delivering low and stable inflation in the medium run, which will, along with the preservation of financial stability, contribute to sustainable economic growth and strengthening of resilience to external uncertainties.

Over the past years, the country has fully transformed its economy for the better. Foreign investors have shown huge interest there. We point out the important development potential in the medium run and the unique opportunities resulting from Serbia's accession to the EU, issues strongly dependent on the acceleration of the structural reforms.

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1. Introduction

After a long period of applying unconventional monetary policy tools such as direct loans to banks, quantitative easing, forward guidance and negative policy rates, major central banks embarked on the process of policy normalisation in the middle of this decade. First of all, the U.S. Federal Reserve ended its asset purchase programme in 2014, then increased its key rates in December 2015 and embarked on the plan to shrink its balance sheet in 2017. The benchmark rate was raised three more times in 2017 to 1.25-1.50% and normalisation continued into 2018 when the rate was raised on four more occasions to 2.25 -2.50% at the end of 2018. However, due to weaker global growth prospects this process is interrupted. At the very beginning of 2019, the FED emphasised that its monetary policy would be more flexible in the coming period and did not indicate which direction it expected the policy rate to take. The final U-turn happened at the end of July 2019 when the FED has cut interest rates for the first time in more than a decade and signalled its readiness to provide more support as growth slows in the world's largest economy. The US Federal Reserve has cut interest rates by a quarter of a percentage point for the first time in more than a decade and signalled its readiness to provide more support as growth slows in the world's largest economy.

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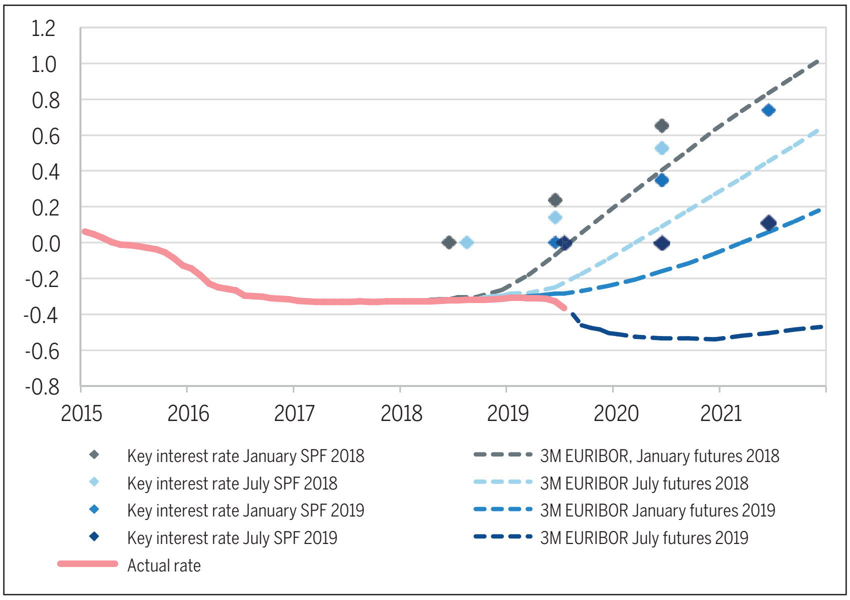
Figure 1. Expected ECB key interest rate* and futures for three-month EURIBOR (p.a., in %)



Source: ECB, Bloomberg and NBS

The aforementioned policy has been followed by the ECB, it seems, in a slightly milder variant. Firstly, in April 2017, the ECB began to gradually reduced the pace of its asset purchases, but the first indication of monetary policy normalisation appeared in June 2018 after an additional decrease the pace of its asset purchases to EUR 15 billion per month beginning from October and announcement that the asset purchase programme would be closed by the end of 2018 after running for almost four years. However, things got complicated in the early 2019. Economic activity in the euro area and EU28 slows down. For example, during the second quarter of 2019, GDP in the EU28 increased by 0.2 % compared with the previous quarter (after +0.5% in the first quarter of 2019). Slowdowns and recessionary pressures are more pronounced in the largest countries – decreases were observed in the UK (-0.2%), Germany and Sweden (both -0.1%), while Italy stagnates (which is a good result, as activity has been declining for two consecutive quarters on an annual basis, see EUROSTAT). At the beginning of September 2019, the eurozone's biggest economy, Germany, is widely thought to be on the brink of recession.

Consequently, the ECB estimated that interest rates (the interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility are 0.00%, 0.25% and -0.40%, respectively) will remain at their present or lower levels at least through the first half of 2020, and in any case for as long as necessary to ensure the continued sustained convergence of inflation to its aim over the medium term. Furthermore, the ECB also underlined the need for a highly accommodative stance of monetary policy for a prolonged period of time, as inflation rates, both realised and projected, have been persistently below levels that are in line with its aim.

Practically on the day this text was submitted (mid-September) The ECB has unveiled fresh stimulus measures to bolster the eurozone, including cutting the key interest rate. The deposit facility rate, paid by banks on reserves parked at the ECB will be cut from minus 0.4% to minus 0.5%. The ECB also said it was re-starting quantitative easing. It will buy 20bn of debt a month from 1 November.

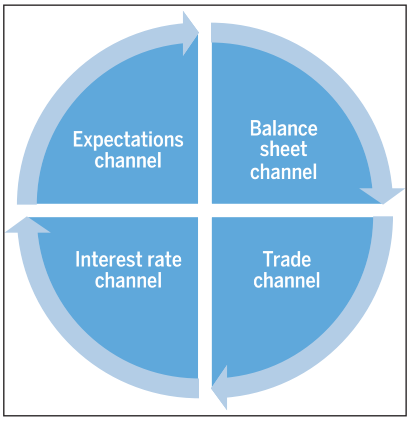
2. Ongoing Challenges and Future Prospects

One of the most significant questions for monetary policy makers in small open economies, including the National Bank of Serbia, is the question of the nature and magnitude of potential effects of leading banks' policy normalisation on their economies. Overall, these effect can work their way primarily through the channel given in the figure 2.

(a) Expectations channel - monetary policy normalisation of leading central banks may induce investors to expect that yields in developed countries will increase, leading to higher expected yields in emerging markets and/or capital outflow from emerging markets;

(b) Balance sheet channel - asset purchases by central banks pushed liquidity levels up, resulting in higher portfolio investment in emerging markets. On the other hand, the shrinking of central banks' balance sheets might reverse capital flows;

Figure 2. The key channels of effecting leading bank normalisation on the Serbian economy



Source: Author's creations

(c) Interest rate channel - policy rate increases in the euro area money market would push up the cost of new corporate and household borrowing in euros, lifting also the costs of the repayment of existing euro and euro-indexed loans;

(d) Trade channel - economic growth of developed countries, which is a precondition for monetary policy normalisation, has a positive impact on emerging markets' exports.

The magnitude of the potential effect through these channels will depend primarily on the pace of monetary policy normalisation of leading central banks and on the extend of its consistency with market expectations. However, by all indicators, it will be slower than initially expected in the case of both the FED and the ECB considering the global economic growth deceleration.

Given Serbia's strong economic and financial linkages with the euro area (the EU Member States account for around two-thirds of external trade; the first two major export destinations are Germany and Italy (see: Nikolic, et al. 2016), with the total export share of 13% and 11%, respectively in the first six mouths of 2019), with over 60% of FDI inflows to Serbia originating from these countries, it is inevitable that macroeconomic developments in the euro area have a significant impact on the economic and credit activity in Serbia.

The results of the analysis carried out at the National Bank of Serbia in 2019 show that the movements of the cyclical component of Serbia's and euro area's economic activity significantly overlap, as measured by the real GDP in the period from 2004 until Q1 2019. The value of the index which measures the degree of synchronisation of cycles in Serbia and the euro area at 0.52 shows that Serbia and the euro area's economic cycle phases were in a synchronized regime for more than half of the quarters in the period observed (see NBS - Inflation report, may 2019, p. 28-30).

The synchronised cyclical dynamics of the economic activity in Serbia and the euro area becomes even more pronounced if gross value added is used as a measure of economic activity (the synchronisation index for the period observed is 0,62; see *ibidem*). That way eliminates the impact of agriculture, as a sector most vulnerable to seasonal factors and weather conditions.

It makes it difficult to analyse much of it part of domestic economic policy, primarily relatively massive subsidised lending programmes and the NBS's monetary policy easing. It is just a credit activity entered into the expansion phase soon after the subsidised lending programmes, but as of May 2013, credit activity was additionally encouraged by the NBS's monetary policy easing, which led to a fall in interest rates on dinar-denominated loans.

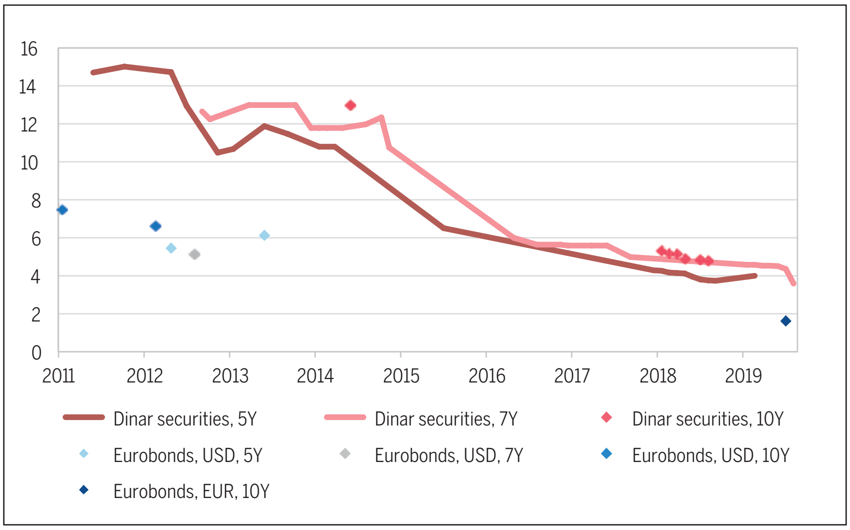
In addition, low interest rates in the euro area, together with the low country risk premium, further boosted credit activity in Serbia, in expansion since the beginning of 2018.

In this regard, there is no dilemma that the ECB announced slower montary policy normalisation, the expected prolongation of the period of lox interest rates in the euro area shoul continue to positively impact credit activity in Serbia.

The effects of monetary policy normalisation of leading banks on emerging markets largely depend on the specific characteristics of individual economies, too. In case of Serbia, the negative impact of global factors has been broadly offset by considerable improvement of macroeconomic indicators and increased resilience of the domestic economy to potential shocks from the international environment.

It should be emphasised that growth in Serbia is today more balanced and that domestic factors are a much stronger driver of growth, while export potential has strengthened further through increasingly higher investment in tradeable sectors. Fiscal discipline has taken root, with the general government budget recording a surplus for three consecutive years – both on the back of strict control of current

Figure 3. Interest rates in the primary market of dinar government securities and eurobonds (p.a., in %)



Source: Ministry of Finance, Republic of Serbia expenditure and economic growth and strong tax revenue generation. Public debt falling by about 15 percent of GDP since the beginning of 2017.

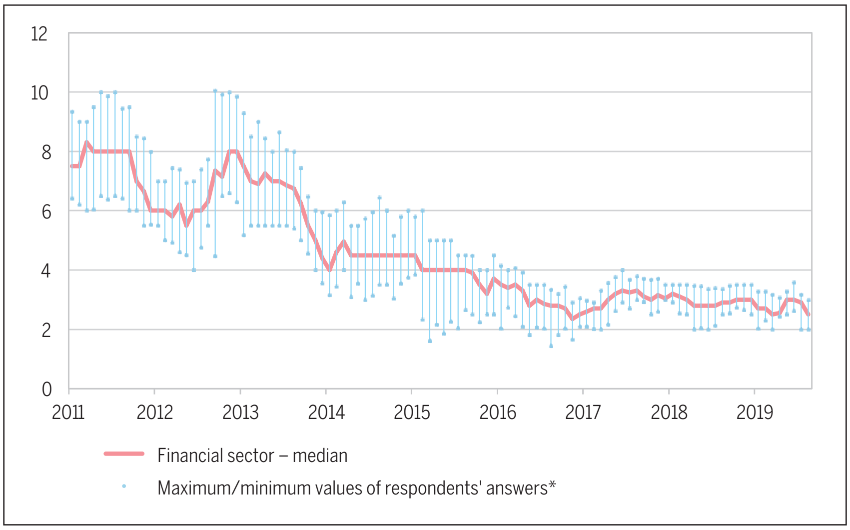
Stronger resilience of the domestic economy primarily stems from the reduced internal and external imbalances – net FDI flows more than fully covering the BOP current account deficit in last four years, which, by the way, has been lowered since 2013 to close to 5% of GDP. Inflation expectations anchored within the target tolerance band, stable and robust financial sector and an adequate level of FX reserves. The government's needs for external financing have been significantly reduced. Diversifying exports by product and market, Serbia has also decreased its exposure to disruptions in certain segments of external demand in the last couple of years. Inflation expectations of the financial and corporate sectors anchored within the target tolerance band suggest monetary policy credibility. This is particularly important in view of the IMF's analysis which suggests that anchored inflation expectations limit the pass-through effect of the potential depreciation of the national currency on the domestic prices and provide more leeway to the monetary policy of emerging markets for mitigation of potential negative effects of monetary policy normalisation of developed countries.

The reduction of the non-performing loans (NPLs) to record low level (5.2% in June 2019, which is a reduction of 17.2 pp from July 2015), high capital adequacy ratios (despite the decreased regulatory minimum by the introduction of Basel III standards) and greater availability of domestic sources of funding at lower cost in conditions of sustainable economic growth have considerably strengthened the resilience of the domestic banking sector to potential shocks from the international environment. That the domestic banking sector is resilient to shocks from the domestic and international environment despite the numerous challenges it faced during and after the crisis is confirmed by the macroprudential stress-tests conducted by the National Bank of Serbia on a regular basis.

In the period ahead, the NBS will also carefully watch and analyse the decisions of central banks of developed countries and assess their potential effects on Serbia, while simultaneously continuing to boost the resilience of the financial sector and the economy to external uncertainties through its monetary, macroprudential and micropurudential policy.

Unlike volatile monetary policy of major central banks and its apparently limited negative effects Serbia, like other small-open economies, remains vulnerable to spillovers from external developments, including weaker-than-expected growth in key trading partners. At the moment, external demand conditions and terms of trade seem to be more important for Serbia's economic growth than external financial conditions.

Figure 4. One-year ahead inflation expectations of the financial sector (y-o-y rates, in %)



Source: Bloomberg; NBS

3. Conclusion

A non-standard monetary policy measures has been going on for too long. They proved their worth during the crisis but accumulated risks of uncertainty, at the same time (Neri and Siviero, 2019). We cannot know what lies in store for monetary policy once non-standard measures have been cut back. But now it doesn't seem to matter... Apparently these measures have become the "new normal", and therefore, they should remain in the monetary policy toolbox and be applied under normal conditions as well. This condition should be accepted (Weidmann, 2019). The fact is that unconventional monetary policy in EU and other advanced economies had no negative impact on Serbia so far. With respect to inevitable consequences, especially on interest rates, it is assessed that the key risks in the period ahead will emanate from the international environment and, as such, may affect the monetary policy stance. These risks far outweigh the expected monetary normalisation. Hence, as so far, monetary policy will be predictable and consistent in delivering low and stable inflation in the medium run, which will, along with the preservation of financial stability, contribute to sustainable economic growth and strengthening of resilience to external uncertainties.

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