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Dejan Šoškić
University of Belgrade
Faculty of Economics
Department of Economic Policy and Development

MONETARY AND FINANCIAL PREREQUISITS OF HIGHER GROWTH RATES IN SERBIA*

Monetarne i finansijske pretpostavke viših stopa privrednog rasta u Srbiji

Abstract

Serbia is in a process of a fundamental shift in its economic structure. Prior growth model has ended with the global financial crisis of 2007/2008 which has revealed an unsustainable nature of import and consumption based economic growth that has been in place since the beginning of the century. A shift towards investments and exports, with higher competiveness and most of the growth coming from tradable part of the GDP is needed. Ever since 2008, however, Serbia is in, more or less, economic stagnation, with three recessionary years. Investments are still inadequate and growth is below expectations. Fiscal consolidation has started to give important results in 2016, with growth gradually recovering but still below regional average. Is there room for improvement in the domain of monetary policy and functioning of the financial system that can give additional impetus to this new growth model? This paper is attempting to shed more light on these issues and to analyze specific problems of monetary economics and financial system status quo in Serbia. Specific recommendations are given for each area of possible improvements that could lead Serbia's economic growth towards higher and sustainable rates in the following years.

Keywords: *monetary policy, financial system, sustainable economic growth, investments*.

Sažetak

Srbija je u procesu fundamentalne promene svoje privredne structure. Prethodni model privrednog rasta završio se sa globalnom finansijskom krizom 2007/2008 koja je otkrila neodrživu prirodu rasta baziranog na uvozu i potrošnji koji je bio na delu od 2000-te godine. Potreban je preokret u pravcu investicija i izvoza, uz veću konkurentnost i glavninu rasta u razmenljivom delu BDPa. Od 2008. godine, međutim, Srbija je manje-više u privrednoj stagnaciji,prošavši od tada kroz tri recesione godine. Investicije su još uvek nedovoljne i privredni rast je ispod očekivanja. Fiskalna konsolidacija je tokom 2016. godine počela da daje važne rezultate, uz postepeno oživljavanje rasta ali još uvek ispod regionalnog proseka. Postoji li prostor za unapređenja u domenu monetarne politike i funkcionisanja finansijskog sistema, koja mogu da daju dodatni podsticaj novom razvojnom modelu zemlje? Ovaj rad ima nameru da se bavi ovim pitanjima i da analizira konkretne probleme trenutnog stanja monetarne politike i finansijskog sistema u Srbiji. U radu se daju konkretne preporuke za svaku oblast mogućih unapređenja koje bi srpski privredni rast mogle podstaknudi u pravcu viših i i održivih stopa u narednim godinama.

Ključne reči: *monetarna politika, finansijski system, održivi ekonomski rast, investicije.*

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Introduction

Serbian growth model from 2000 – 2008 was inadequate and unsustainable. Predominantly it was consumption based and import led economic model backed by inflow of capital. When this capital inflow (donations, FDI from privatization, etc.) eventually started to diminish, this economic model was temporarily financed by gradual but persistent increase in debt. Growth of GDP was far too much based on non-tradable sectors, with high current account deficit, and relatively low competitiveness of the local economy additionally hampered by currency overvaluation and substantial trade liberalization. Obviously, this model had a predictable outcome: economic stagnation, unemployment and increase in indebtedness.

As a consequence, rising public debt and risk of bankruptcy, with its urgency for action, naturally came into the spotlight since Serbian public debt has risen from 28.3 % at the end of 2008, to 74.7 % [20, p.69] at the end of 2015. In 2016 important initial results in fiscal consolidation have been achieved. Public debt has stopped its continuous rise against GDP[1], partly since the growth rate was above expectations for this year[2]. It is essential to continue with fiscal consolidation in the following years, but it is equally, if not more, important to maintain and increase rate of economic growth in Serbia. This time, however, this growth needs to be sustainable in the long run, meaning that it needs to be based on competitive industries from the tradable sectors of the GDP. Serbia, finally and irreversibly, needs to shift from imports and consumption to investments and exports. But not all investments (or Gross fixed capital formation, as in Table 1) are the same.

1 And dropped from 74.7% of GDP at end 2015 to 73.5% of GDP at end of 2016 according to the estimates of Ministry of Finance (http://www.mfin.gov.rs/pages/article.php?id=12914).

2 According to the Statistical release of Statistical office of Republic of Serbia on 29/12/2016, estimated real rate of GDP growth for Serbia in 2016 was 2.7%. (http://www.stat.gov.rs/WebSite/public/PublicationView.aspx?pKey=41&pLevel=1&pubType=2&pubKey=3968).
However, According to the so called "flash estimate" of Statistical office of Republic of Serbia published on 31/01/2017 real growth rate in 4th quarter of 2016 compared to 4th quarter of 2015 was 2.5%.
(http://www.stat.gov.rs/WebSite/public/PublicationView.aspx?pKey=41&pLevel=1&pubType=2&pubKey=4010).
This might suggest decrease in economic growth in 4th quarter of 2016 compared to the average in first three quarters of the same year.

This shift towards investments needs to be biased towards investments in tradable sectors of Serbian Economy with relatively high and sustainable multiplying positive effect on future growth, investments and new employment.

If we look at investments as part of the GDP in Serbia (Gross fixed capital formation (GFCF), in Table 1), we see that they have been declining from 2012 level of 21.2% to 17.2% in 2013 and 16.7% in 2014. Modest recovery occurred in 2015 to the level of 17.7%, and for 2016 estimates are that investments are slightly above 18% of GDP. For comparison with similar countries, according to the World Bank in 2015[3] level of investments (GFCF) per GDP in Slovakia was 23.0%, Romania 24.7%, Czech Republic 26.3%, Montenegro 20.6%, Albania 26.3%, Macedonia 25.0%, Hungary 21.7%[4]. In global perspective, China invests 44% of its GDP, Australia 27%, Switzerland 24%, US about 20%. World average investments (GFCF) to GDP ratio for 2015 was 23.215%[5].

3 Data is for 2015, since final official GDP figures for 2016 were not available at the time of publishing of this paper.

4 Data taken from http://data.worldbank.org/indicator/NE.GDI.FTOT.ZS?year_high_desc=true.

5 http://data.worldbank.org/indicator/NE.GDI.FTOT.ZS?year_high_desc=true.

Table 1: GDP of Serbia 2001-2015: Growth rates, debt to GDP, and GDP exp. structure

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
GDP real growth %	5.0	7.1	4.4	9.0	5.5	4.9	5.9	5.4	-3.1	0.6	1.4	-1.0	2.6	-1.8	0.8
Debt to GDP %	97.7	68.3	61.7	52.6	50.2	35.9	29.9	28.3	32.8	41.8	45.4	56.2	59.6	70.4	74.7
structure % GDP	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Final consumption expenditure	96.1	96.9	95.5	96.6	95.2	95.3	95.2	94.7	96.5	96.5	95.3	95.7	93.1	93.4	90.9
Gross fixed capital formation	**12.9**	**16.2**	**18.3**	**20.5**	**20.1**	**22.3**	**25.3**	**24.9**	**19.7**	**18.6**	**18.4**	**21.2**	**17.2**	**16.7**	**17.7**
Changes in inventories	6.3	5.0	3.8	9.3	4.7	2.8	3.8	5.4	-0.2	-0.1	1.7	-0.2	0.4	0.8	1.2
Exports of goods and services	22.4	20.6	22.0	24.2	27.1	. 303	28.4	29.1	26.8	32.9	34.0	36.9	41.2	43.4	46.7
Imports of goods and services (-)	37.7	38.7	39.6	50.6	47.1	50.6	52.7	54.1	42.7	47.9	49.4	53.6	51.9	54.2	56.4

Source: Statistical office of Republic of Serbia, and National Bank of Serbia.

However, literature suggests that investments on their own are not a guarantee of future high levels of sustainable growth [9], [1]. As we see from Table 1. Serbia has experienced relatively higher rates of investments from 2006 to 2008, but most probably with unfavorable structure (non-tradable sectors), low efficiency [11], and limited positive multiplying effects. It is important to have in mind also that very much concerning future growth relies on the quality of investments, on availability of skilled labor and infrastructure, on overall strength of institutional framework and favorability of business environment, etc. And these important aspects should not be neglected, on the contrary. However, simple truth is hard to ignore: low investments = low (or no) growth.

This is also reflected in regional comparison of growth rates in Serbia and our immediate neighborhood (Table 2). As we can see from Table 2, it is unfortunately obvious that Serbia is, in terms of GDP growth, lagging behind regional average in past three years, and is also predicted by the IMF to be below non EU SEE[6] average in 2017[7]. At the same time projections for Serbian growth are also below projections for global growth, since IMF projects global growth rate for 2017 on the level of 3.4%[8]. Therefore, obviously for Serbia in the following years, besides fiscal consolidation, growth is job number 1.

In most successful episodes of increased GDP growth and convergence to advanced peers in various countries in past decades (Italy (1960-80), Spain (1980-09), Japan (1966-97), Korea (1988-10), and Taiwan (1968-08)) rapid growth episodes of these countries were manly based on several common factors [13], [5]:

- ambitious large scale reform package,
- increase in total factor productivity,
- initial increase in share of investments in GDP,
- financial deepening, ie. development of financial system.

In initial stages of rapid growth episodes in these countries investments as part of GDP were above 25%, and in some countries even above 30% of GDP [13, p. 20]. This initial stage needs to be followed by financial deepening, i.e. further development of financial system. Therefore, it is obvious that Serbia needs much more investments. But in addition, these investments, unlike Serbian 2001-2008 growth episode, need to be dominantly channeled to tradable GDP, to competitive companies and to products and services with better positioning within global value chains [10]. Alongside, further development of Serbia's financial system is also needed. This is, obviously, easier said than done.

Foreign Direct Investments (FDI) are currently relatively low and not easy to attract. However, FDIs should not realistically even be an expected predominant source of growth in Serbia. Growth substantially needs to be endogenous. Literature suggests that FDI alone cannot be more important for growth compared to developed institutional framework and sound economic policies. Carkovic and Levine [8] argue that sound economic policies may spur both growth and FDIs, but also conclude that FDIs do not exert a positive impact on growth that is independent of other growth determinants. In other words, relying only on FDIs, without improvements in business environment does not lead to higher sustainable rates of growth. In any case, in the near future it is unrealistic to expect substantial increase in FDIs before occurrence of robust economic recovery in developed economies of our main trading partners, most of all in Europe.

As for government investments, to a certain extent, in Serbia their potential is limited due to fiscal consolidation effort in the following years. Investments in capital infrastructure financed from the government, and with

Table 2: Growth rates in non-EU South East Europe

	Real GDP growth in %			
	2014	2015	2016	2017
Non EU SEE average	0.3	2.2	2.9	3.2
Albania	1.8	2.8	3.4	3.7
B&H	1.1	3.2	3.0	3.2
Macedonia	3.5	3.7	2.2	3.5
Montenegro	1.8	3.2	5.1	3.6
Serbia	-1.8	0.7	2.5	2.8
EU average	1.6	2.3	1.9	1.7

Source: IMF Regional Economic Issues, Nov 2016.

6 Countries of South East Europe not members of the EU.

7 IMF data for rate of growth in Serbia in 2016 of 2.5% is their estimate at the time of publishing of this report (November 2016), and is lower than 2.7% which was the estimate of Statistical Office of Republic of Serbia published on 29/12/2016.

8 According to World Economic Outlook Update of January 16th 2017 available on http://www.imf.org/external/pubs/ft/weo/2017/update/01/pdf/0117.pdf.

potential cooperation with private investors (through PPPs, risk sharing, concessions etc.), should be as high and as effective as possible, but without posing a risk to fiscal consolidation in the following years. Still worth noting, literature suggests that public investments have relatively weak influence on long term growth, especially in low income countries [26]. However, their short term impact on growth, and long term indirect impact on productivity can hardly be disputed.

Therefore, without neglecting the importance of FDIs and government investments, endogenous growth based on domestic investments and increased entrepreneurship has to be in focus of growth based reforms and economic policies in Serbia. This means that substantial improvements in business environment in all of its aspects (institutional development, corruption, rule of law, skilled productive workforce, access to finance, cost of business administration etc.) are vital for future growth in Serbia.

This paper will focus on part of the "improving business environment" agenda that has an impact on availability and cost of financing of investments for sustainable growth in Serbia. We will focus on five important reform areas, two in the domain of monetary policy improvement and three in the domain of financial system development. All of these improvements support investments (domestic, but also FDIs, portfolio investments and government investments) and economic growth.

Monetary policy improvements

For long time now it is known that monetary policy cannot do much directly for economic growth, and that its greatest contribution is to provide stable environment and prevent overheating and inflation [12]. Without structural reforms, monetary policy cannot do much for growth, and we see this in EU as we speak, where quantitative easing (monetary expansion) by ECB does not produce higher growth rates in Eurozone.

However, certain aspects in conduct of monetary policy may have an impact on elements of the risk premium in the structure of average interest rates, and therefore contribute to higher interest rates and all required rates of return, lower investments, and therefore, lower economic growth then otherwise possible. We will focus on two such elements of monetary policy conduct in Serbia that influence upward pressure in interest rates, and therefore lower investments and growth.

Decrease in euroisation

Euroisation can be defined as high use of Euros in functions of money: for payments (medium of exchange), for savings (store of value), for credits and repayments, and as a measure of value and unit of account. Serbia has one of the highest levels of euroisation among the countries that does not use Euro as an official currency[9]

Negative effects of Euroisation on investments and growth in Serbia are obviously not fully understood. Otherwise it would be hard to explain that since signing of Memorandum on Dinarization between National Bank of Serbia and Government of Serbia in April 2012, besides official mentioning of the issue, practically no active policy has been done in this respect. It seems as if there was not for the IMF to remind us, we would not bother dealing with this issue.

However, we should not forget that an important component of Serbia's active program with the IMF[10] is to increase dinarization i.e. to decrease euroisation. And it is not by chance that IMF has put this as part of the program with Serbia that fosters to increase financial sector resilience and economic growth.

Why is decrease in euroisation (dinarization) important for investments and growth in Serbia?

High level of euroisation in Serbia has a direct negative impact on effectiveness of monetary policy and on financial stability in the country. As a consequence, reference interest rate set by the central bank is, as a rule, more volatile and higher on average. In addition, due to euroisation, Serbian banking system is burdened with high risk of conversion of FX risk to credit risk [2] and creation of additional NPLs. Frequently forgotten but nevertheless true, current high level of NPLs that burdens Serbian banks

9 For detailed results in measurement of euroisation in Central, Eastern and Southeast Europe, see yearly surveys conducted by Austrian central bank - OeNB Euro Survey.

10 http://www.imf.org/external/12/images/news/serbia.jpg.

is to a large extent due to previous euroisation. This risk created by euroisation demands creation and maintenance of high loan loss provisions and high capital adequacy ratios in Serbian banks. These loss absorbing cushions are expensive and both push interest rates up. In addition, maintenance of high euroisation creates additional risks for future NPLs in banks.

Simply put, euroisation creates number of additional risks in Serbian financial system and exerts pressure to increase interest rates on loans. By doing so, euroisation decreases credit activity, investments, and current and future economic growth.

A lot can be done in decreasing euroisation in Serbia [6] , [26]. Immediate results in this area are not realistic, but gradual systematic improvements are quite feasible. There is no excuse for not trying.

Increase in credibility

Globally, Inflation targeting (IT) as a monetary policy regime was first introduced in New Zealand in 1990[11]. Officially, in Serbia Inflation targeting is in place since end of 2008[12].Since its inception Inflation targeting it has spread throughout the world among developed and emerging markets, and it has prevailed as a most widespread monetary regime around the globe.

Inflation targeting is based on five elements:

1. Anouncement of numerical goal for inflation;
2. Institucional comitment of the central bank to price stability as its primary goal to witch all other goals (exchange rate stability, employment, etc.) are subordinated;
3. Includes monitoring movements of monetary agregates (money), exchange rate and other variables in deciding on monetary policy;
4. Transparency and comunication of central bank with public and financial markets on plans, targets and decisions;
5. Credibility development based on fulfilment of inflation targets [19].

"Inflation targeting is a framework for monetary policy characterized by the public announcement of official quantitative targets (or target ranges) for the inflation rate over one or more time horizons, and by explicit acknowledgement that low, stable inflation is monetary policy's primary long-run goal" [4, p. 4].

Therefore, Inflation targeting has a long run goal of low and stable inflation, but it also has a tactical goal of achieving the inflation target. This tactical goal is clear and easy to follow by the public and financial markets. Success of monetary policy in Inflation targeting regime is easy to measure by level of achievement of its tactical goal set by inflation target. Level of success in fulfillment of inflation target is basis for credibility development by the central bank.

Let us focus on a clear causal relationship: lack of credibility pushes risk premium upward, higher interest rates (and all required rates of return) decrease investments and economic growth.

In context of monetary policy in Serbia, here we will focus on two credibility issues.

First. According to NBS [20], Inflation is outside inflation target band (4% +/- 1.5%) continuously for three years, i.e. since February 2014. In the same period, inflationary projections of NBS, stated in regular quarterly Inflation reports, unfortunately continuously prove not to be precise in predicting real movements in inflation in the following period. In truth, this is not a unique case nowadays. Many Inflation targeting central banks are facing deflationary pressures and are missing their target from the down side. Also, predicting inflation is not easy, as much as it is very important for Inflation targeting central bank. However, what is unique is that in case of continuous missing of its tactical target, inflation targeting central bank issues positive statements about success of its monetary policy to the public and international financial markets[13]. As we

11 Reserve Bank of New Zealand Act of 1989, Section 8, Public Act No. 157, December 20th 1989.

12 Unofficially it was introduced since 2006 but officially implemented by Agreement on Inflation targeting between Government of Serbia and National Bank of Serbia (adopted on the Government of Serbia session on December 19th 2008).

13 As was many times the case in press statements by NBS officials but also in official printed materials, for instance: "The three-year track record of inflation moving at around 2% indicates that Serbia is on the right path towards permanent stabilisation of inflation at a low level." [21, p. 4.].

see, this sharply contradicts above mentioned rule 4 and 5 of Inflation targeting monetary model.

Second. Certain restrictive monetary policy measures (buying dinars from FX reserves) in certain periods of time with inflation below target, low inflation expectations, and low growth, cannot be explained within Inflation targeting model. Such monetary policy conduct has led literature on this issue to conclude that Exchange rate stability is effectively a predominant goal of monetary policy in Serbia [24]. As we see, this sharply contradicts above mentioned rule 2 and 4 of Inflation targeting monetary model.

These two issues are sending wrong and unfavorable signals to international financial markets concerning credibility of our monetary policy and our central bank. As was mentioned before: lower credibility pushes risk premium upward, higher interest rates (and all required rates of return) decrease investments and economic growth.

This should be changed in one of possible two directions: full and sincere implementation of Inflation targeting, or official implementation of another monetary regime. Status quo may deter investments and lower economic growth.

Financial system development

Financial system of Serbia is predominantly based on banks. Banking sector takes 91.2% of financial sector assets, and other non-banking institutions take only 8.8%[14]. However, overall financial sector is underdeveloped. Total assets of financial assets in Serbia take 83.9% of GDP, and are lower than in 2010[15].

How does this compare to developed market economies of the EU?

Banks in Eurozone have assets which are 3,1 times larger than Eurozone GDP. Other financial intermediaries (mainly mutual funds) have assets in amount of 1,4 times Eurozone GDP. If we add Pension funds with 18% and Insurance companies with 71% of GDP, we have a total of Eurozone financial sector assets to GDP of 540%[16]. In other words, it is fair to say that Eurozone in relative terms has six and a half times more developed financial system compared to Serbia.

Therefore, financial system in Serbia is vastly underdeveloped with huge room for growth and development. In current status Serbian financial system is underdeveloped, stagnant and incapable of supporting this necessary change towards a new dynamic and sustainable growth model. There is obvious room for improvement and developing in banking and non-banking (credit and securities) institutions.

Improvements in banking institutions

Banking system improvements are possible in, at least, several areas: NPLs, credit risk guarantees, collateral valuation, regulation and supervision. Improvements in these areas would support credit growth, investments and economic growth.

Decrease in bank NPLs

Non-performing loans pose a serious obstacle for credit growth. Their high level has been addressed with stricter regulation in terms of loan loss provisioning and capital requirements. By doing so, regulation has decreased immediate risk to financial stability, but has not initiated credit growth. Problem of NPLs has not been solved.

Banks themselves are becoming more conservative in times of rising NPLs, low economic growth and strict regulation by the regulators.

This is the reason why high NPLs have to be taken very seriously in terms of their negative credit growth and economic growth.

Basic principles in dealing with this issue could be the following:

- government (and Central Bank) initiative in coordination with parent banks of local banks and their supervisors;

14 Data from NBS Quarterly Review of the Dynamics of the Financial Stability indicators of Republic of Serbia, December 2016. http://nbs.rs/internet/english/18/pregled_grafikona_e.pdf.

15 Ibidem.

16 Data from ECB, Report on Financial Structures, 2015, October. https://www.ecb.europa.eu/pub/pdf/other/reportonfinancialstructures201510.en.pdf.

- Largest banks should commence NPLs cleansing in a relatively short clearly defined time frame;
- Regulatory and tax incentives for NPL decreasing procedures conducted by banks;
- No taxpayers' money involvement, i.e. private market solution for NPL problem.
- Involvement of private equity, distressed financing and other non-traditional institutions in the process;
- Credit biro keeps records of exposures until repayment, conversion into equity or other financial transformation that eliminates obligation of the borrower.

Substantial decrease of NPLs in banks is essential for new credit growth and full support of banks in an overall effort of achieving higher and sustainable rates of economic growth.

Credit risk guaranties for new bank credit growth

Old subsidies need to die off. New, effective, targeted support frameworks for new competitive sustainable growth need to be established. Government needs to be open for risk sharing with banks, in generating sustainable economic growth. Credit risk guaranties with no initial payments from the budget, could be a cost effective way to initiate faster shift in GDP to tradable sector projects, companies and growth. Banks have the financial capacity. What they do not have is the capacity to absorb additional risks.

Credit risk guarantees issued by the government or a government agency, may be one of the models with high potential to increase sustainable growth in Serbia. Credit risk guarantees should be issued only to tradable sector projects. With these guarantees companies should approach banks and expect decrease in interest rates from three sources:

- Credit risk with a guarantee goes down, and so should the interest rate;
- Risk weight for this credit line goes down, so does the needed capital based on risk weighted assets – interest rate should go down;
- Loan loss provisions should go down even in case of default with a guarantee – interest rate should go down.

If well-organized, credit risk guarantees can substantially decrease the cost of borrowing and enable viability to many projects and companies that would otherwise stay undeveloped. They can be treated as an indirect public support to sustainable development. Important is to limit this support to entities and projects in tradable sector of GDP. This would then contribute not just to economic growth and growth in employment, but would also contribute to achievement of sustainable external macroeconomic balance. That would at the same time also be a path of increasing national economy's competitiveness.

An important element of this new credit guarantee public support should be a well-designed and effective potential post default process that could include private equity, distressed financing and other non-traditional private institutions. The aim of the post default process should be to minimize any taxpayers' loss in medium term. Therefore, this mechanism should basically allow for government balance sheet borrowing with no immediate government costs, and minimal potential costs in the future.

Improvements in collateral valuations for bank lending

Imprecise collateral valuation presents a very important issue for bank and even non-bank access to finance. Imprecise collateral valuation hampers credit growth through denial of credit lines, increase in interest rates, requirement of additional credit risk mitigants, imposition of restrictive loan-to-value (LTV) ratios, requirements of higher required loan loss reserves (LLRs) by the regulator, and lower bank interest in dealing with their NPLs based on overvalued collateral.

Therefore, more precise collateral valuation in Serbia could decrease or eliminate all of the mentioned weaknesses in collateralized lending and could improve access to finance. If combined with improvements in mortgage lending regulations and foreclosure enforcement, this could substantially improve the nature of collateral lending and open additional sources of investments in the country.

More precise and credible collateral valuation for financing purposes can increase the credit quality of borrowers and, with adequate regulatory treatment of loans with precisely-valued collateral, may further decrease the cost of borrowing. Therefore, improved collateral valuation may increase both demand and supply of bank credits and support faster economic growth in Serbia.

Improvements in bank regulation and supervision

Current regulation and supervision of banks should be reassessed on grounds of new realities. Low growth, deflationary pressures, high NPLs, procyclical behavior of banks, and dominant importance of bank activity in overall financial system operations, require new approach in regulation and supervision of banks. New impetus has to be given to bank credit growth with renewed existing and new countercyclical measures.

Supervision should be made more capable in terms of effective preventive actions, early detection of bank problems, and early intervention. In such circumstances, regulatory burden on banks could be additionally less heavy (costly). Without compromising overall financial stability, effort should be made to promote financial activity. Reserve requirements, loan loss provisioning, classification of assets, risk weights, eligible collaterals and other elements of regulation and supervision should be reassessed.

If improvements have also been made in previously mentioned areas like decrease in euroisation, NPL decrease, better collateral valuation practices and credit risk guarantees, room for additional improvements in bank regulation and supervision would be much larger since all this would substantially change the risk profile of a banking sector. So, without compromising financial stability, combined overall effect of these measures on credit growth, and therefore economic growth, could be substantial.

Creation of non-banking credit institutions

We should be realistic not to expect that non-banking credit institutions can be as important as banks or securities markets. But these institutions (savings banks, saving and loan associations, credit unions, microfinance companies etc.) could be an important missing link in retail finance supporting households and micro and small business entities. These institutions can be specifically important for individuals and business without real previous access to finance.

It is important to introduce a good legal framework for these institutions and to provide adequate regulatory and supervisory capacity on national level prior to their introduction. Since, officially Serbia does not have any of these institutions, first it would be important to define what types of institutions within this group we want to see developing in our financial system. After that, we should regulate their operations with laws and bylaws, and, finally, we should designate or develop an institutional capacity capable of regulation and supervision of these institutions.

These institutions, by its nature, cannot represent a major pillar of a financial system, but can have their modest but adequate contribution to savings, investments and growth in the country.

Development of securities (capital) markets

Securities markets and institutions have been introduced twenty or so years ago with great expectations but with very slim results so far. They represent far less than normal, and almost negligible portion, in overall gross fixed capital formation capacity of our national financial system. To put it differently, this channel of financial system almost does not generate investments. Therefore it is not really put in its role of supporting growth. It is vital to start unlocking this potential. Credibility, disclosure, competence, and institutional independence are core ingredients necessary for these markets to grow and to take their fair place and role in overall financial and economic development in Serbia. Improvements are possible, at least, in several areas.

Regulation. Existing relevant laws and bylaws should be reassessed and improved.

Institutional capacity development. Institutional capacity of market institutions, regulators and supervisors in terms of independence, competence, and overall credibility should be substantially increased. This includes Securities and Exchange Commission, Stock Exchange, but also Association of brokers and dealers. It is important to create an environment that can attract quality personnel from within the country but also from abroad. Initial government support in this effort would most probably be crucial.

Improvements in disclosure requirements. It is vital to create substantial improvement in quality of so called publicly available information on securities. This is the basis for any sound investment decision in securities, and without quality in disclosure of relevant information, securities markets cannot exist. This requires full standardization with international standards and substantial improvement in quality of financial reporting and auditing. This might also imply certain regulatory improvements. In this context it might be important to increase the existing capacity of so-called self-regulatory organizations (Association of auditors, Association of accounting professionals, Association of brokers and dealers etc.) so to understand and support this process.

Government support. At this new inception of securities market, government support could be very important in several areas.

First type of support is already going on in terms of government bond issuance and their secondary trading on Belgrade stock exchange. This should develop further with introduction of new securities with longer maturities and from municipalities as well.

Second type of support could be in tax and other regulation that could be improved to support issuance and investments in local currency denominated securities.

Third type of support could be in the form that some of the profitable government companies decide to raise part of their capital through IPOs, with subsequent listings of their shares on the Stock Exchange. This could serve as a catalyst for private sector IPOs and listings.

Finally, regulation, establishment and supervision of a national rating agencies could be very important especially for further development of local bond market and institutional investors based on this type of security (private pension funds, insurance companies, etc.).

If Serbia follows good examples of Poland and Romania, securities markets could develop significantly and support investments and growth of the economy.

Conclusion

Serbia has to pull out of the vicious circle of recession and low growth, and to start caching up with the developed countries. Higher sustainable rates of economic growth are not possible on low levels of investments in the past years. All types of investments need to be increased parallel with substantial improvements in overall business environment (institutional development, corruption, rule of law, skilled productive workforce, access to finance, cost of business administration etc.).

This paper has focused on possible improvements in monetary and financial aspects of our financial system. These improvements can have positive effect on all types of investments (foreign, domestic, and government) and can substantially contribute to the rise in future rates of economic growth in Serbia.

Improvements in monetary policy conduct can reduce risk premium in required rate on return and support investments and growth in our country. Banking system can be significantly freed from existing burdens and guided to support higher rates of sustainable growth without creation of future NPLs. Non-banking credit institutions could be ignited to do their part of savings and investments that has so far been without proper reach from existing financial institutions. And securities markets and institutions should be reset and put in place to support investments and growth as is the case in some successful post transition countries. A lot can be improved to support future growth in Serbia.

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Dejan Šoškić

is Full Professor at the Faculty of Economics (EFB), University of Belgrade. He graduated in 1989 – awarded as the best student of the generation by the University of Belgrade, received his M.A. in Monetary Economics and Banking in 1993, and Ph.D. in Finance in 1999 from EFB. He teaches undergraduate courses Financial Markets, Securities Investments, Economic Statistics as well as a graduate course Portfolio Risk Analyses. He specialized in Banking and Finance at Florida State University (1994), University of Rhode Island (1998), Swiss Central Bank (2001), Fulbright Lecturing/Research Grant – University of Nebraska (2002). He held lectures in this field on undergraduate and graduate courses at University of Nebraska at Omaha, USA (2002), Summer University of Wirtschaftsuniversität Wien (2008-2010), and on Master in Banking and Entrepreneurship organized by Unicredito Group (2005-2013), Italy. In 2002, as a Fulbright scholar, he had a series of guest lectures at University of New Heaven, University of Rhode Island, and University of California at Berkeley. Professor Šoškić headed and participated as a consultant in a number of projects of national and international scope. He served as a Member of the Economic Council of the Prime Minister of Serbia (2009-2010), Member of the Board of Scientific Association of Serbian Economists (2006-2010), President of the Council of the National bank of Serbia (2009-2010) and Governor of the National bank of Serbia (2010-2012). Professor Šoškić has authored the book "Securities: Portfolio Management and Mutual Funds" and coauthored books "Financial Markets and Institutions", "Economic Statistics" and "Stock Exchange Lexicon". He has published more than 70 papers in the fields of Financial Markets and Transition.