

Monetary policy normalisation

I believe that first we have to define what the normalisation of monetary policy implies. I would say that it is incorrect to consider that it is only an increase in reference interest rate; instead, it should involve another two conditions where the first restoring a central bank's balance sheet as well as its maturity and structure to the pre-crisis level.

The FED is already far ahead in normalizing its monetary policy, but I believe that it is far more important for both Montenegro and all countries in the region to see what the ECB will do since our real and financial sectors are mainly connected with the euro currency movement. I think that all of us will agree on two things: the first is that unconventional monetary policy measures cannot last for an unlimited period of time, and the second is that the normalisation of monetary policy must be carried out gradually to avoid potential shocks. It is certain that the ECB will not change its policy by September this year.

However, if we look at the euro area situation, there are numerous arguments that speak in favour of delaying the normalisation, that is, that it should be very lenient. To wit, the expected inflation rate is still below the target level (below, but close to 2%), and there are no announcements that it may reach the target level in the following couple of years. Output gap in the euro area is still evident, with still high unemployment of around 9%. However, a certain level of uncertainty lies in the fact that the continuation of such policy is not acceptable for the strongest euro area economy, Germany, that has been growing faster than the average and where employment has picked up pace, whereas unemployment fell to the level of 4%.

I believe that the normalisation should be based on the following principles to avoid financial market distress. First, public communication is necessary, i.e. the ECB announcements of all planned measures, allowing for a certain timeline before their implementation, as was done by the FED, so that the financial markets would have sufficient time to prepare themselves. The balance sheet of the ECB should be reduced gradually over a longer period to avoid jeopardizing financial markets. Increase in the reference interest rate should also be gradual and it should be kept at a lower level for some time compared to the one from the pre-crisis period.

I would refer here to the President of the ECB's statement made at the end of the last year who emphasised that although euro area economies are recovering they still need the support. I think that this simple statement announced the policy of the ECB in the following period (very gradual normalisation).

Finally, bearing in mind a high level of public debt in Montenegro, normalisation could have negative effects on its financing. In the euroisation conditions, there are no available instruments which could be used by the central bank to influence mitigation of such policies. Therefore, it is of extreme importance to carry out fiscal consolidation measures now when we have relatively favourable conditions in the financial markets. I believe that the effects of monetary policy

normalisation on the banking sector in Montenegro will be that of less severe impact because banks are well-capitalised, extremely liquid, and with significantly fewer vulnerabilities compared to several years ago.

Challenges in NPL workout

I think that I won't be wrong if I say the Montenegro was twice a champion – once regarding the level of NPLs that exceeded 25% in the third quarter 2011, and then in the case of speed of their reduction. Namely, the latest available data show that the level of NPLs in Montenegro fell to 7.18%, which is close to the pre-crisis level. Of course, we are not satisfied with this level and we will continue with implementing measures aimed at mitigating this problem, as NPLs' current level influences banks' balance sheets and both their investments and credit activities.

The Central Bank of Montenegro has undertaken several measures to address this issue. First, banks are required to prepare three-year NPL resolution strategies, which are submitted and examined by the Central Bank. We prohibited the purchase of doubtful receivables by banks without our prior approval. In this manner, we prevented the intention of a number of banks to disclose again in their balance sheets a portion of non-performing loans previously sold to parent banks or factoring companies, and all machinations that followed these transactions. The support of parent banks for NPL resolution was also important during the first post-crisis years.

I would like to highlight here that we adopted a special law in cooperation with the World Bank, the Law on Voluntary Financial Restructuring of Debts towards Financial Institutions, which is known as the "Podgorica Approach". It basically refers to providing incentives for restructuring loans to companies that are experiencing a currently shortfall of liquidity but have market perspective. I think that the thing that was of key importance for the successfulness of this model was that it envisaged incentives for both banks (in terms of more favourable classification of restructured loans), and clients (in terms of longer repayment periods, the possibility of write-offs of a portion of credit obligations, reduction in interest rate, tax debt restructuring, and the like). The validity of this law is limited and it expires in several months. However, we are currently considering the possibility of its extension.

Nevertheless, I have to admit that NPL resolution cannot be successful if the economic activity has not revived and earning possibilities of the economy have not improved. This is exactly what happened in Montenegro – the economy picked up and estimated growth in the last year was over 4%, while the growth of about 3% is expected in the current year. Recently adopted regulations put the supervision of factoring companies under the Central Bank competence. Therefore, we will have a better insight in NPL developments.

Finally, the key issue that remains is what needs to be done to prevent something like this from happening again in the future. It is obvious that banks easily granted loans in pre-crisis period,

without having adequate risk management practices in place, while on the other hand, taking into account experiences from socialism and the first years of transition, clients did not take loans seriously and did not believe that they must be repaid. I think that both sides learned this lesson. However, this will not be enough. It is very important to strengthen the part of the supervision that controls risk management in banks. Furthermore, the implementation of all international standards is required, from the IFRS 9 to a gradual implementation of Basel III that strengthen capital and liquidity of banks. It is particularly important that supervisors prevent over excessive growth of portfolios and individual banks, as well as the system. I would also like to point to a novelty that has not been generally accepted yet, but which I believe is important and this is that central banks should monitor potential occurrence of price bubbles in any segment of the market and take prompt actions to restrict activities of banks in that segment.