REGIONAL SUMMIT OF FINANCE MINISTERS, GOVERNORS AND TAX ADMINISTRATION DIRECTORS

Stability of Prices and the Banking System in Uncertain Times

Traditional central banking theory and practice consider that price stability is the central goal of central banks. Also, it has accepted the general paradigm of price stability achieved with a target inflation rate of 2%, which provides sufficient incentives for the dynamic development of the economy and financial flows. On the other hand, economic theory has not given a unified position on the definition of financial stability. The prevailing opinion is that financial stability means the stability of the constituent components of the country's financial system – financial institutions, financial market and financial infrastructure (ECB). This concept implies monitoring and controlling systemic risk as the risk of disruption in providing necessary products and services to the financial system.

In an underdeveloped financial system, such as the Montenegrin one, which is strongly bank-centric, the banking sector's stability is a prerequisite to ensuring financial stability. In Montenegro's case, the aforesaid implies that we can put the equals sign between these two terms. Moreover, considering that the euro is the legal tender, the objectives of the Central Bank of Montenegro (CBCG) until Montenegro joins the European Union are fostering and maintaining the stability of the financial system, including fostering and maintaining a sound banking system and safe and efficient payment systems as well as contributing to achieving and maintaining price stability. After Montenegro enters the European Union, the CBCG's main objective will be maintaining price stability.

In the long run, price stability fosters economic and financial stability

When discussing the relationship between price stability and financial stability, there is no single position in economic theory about price stability's impact on the financial system's stability. From the initial conventional position that price stability is a guarantor and a sufficient condition for financial stability, through the position that price stability fosters financial stability and, in the long term, boosts the synergistic impact, we came to the position that too low inflation in combination with low interest rates can stimulate vulnerabilities in the financial system and thereby shake the foundations of its stability. Such conditions can encourage unrealistic optimistic expectations regarding economic development in the future, which can lead to the creation of price bubbles and the undermining of financial stability. In the long run, price stability fosters economic and financial stability.

The great financial crisis of 2007, generated in the USA and spilt through financial flows globally, characterised banks as part of the problem, not the solution. The onset of the 2007 financial crisis demonstrated that bank stocks and other financial factors can intensify economic fluctuations and even cause long-lasting, deep recessions. The expansive growth of prices on the real estate and capital markets, followed by the expansive banks' credit portfolio growth, resulted in the price bubble bursting, the extreme growth of NPLs in the banks' balance sheets, and a liquidity crisis. The leading central banks responded with an expansionary monetary policy and applied non-standard monetary policy measures to stimulate economic growth. One of the critical solutions for preserving financial stability was strengthening prudential micro and macro regulation and "launching" a new concept of macroprudential policy aimed at preventing systemic risks and encouraging and preserving financial stability. The tailor-made instruments of this policy, with a particular focus on introducing capital buffers (capital preservation buffer, countercyclical buffer, buffer for structural systemic risk, and buffer for global and other systemically important institutions) and defining macroprudential indicators created the missing puzzle in the mosaic of the financial stability concept.

The recent crises fuelled by unforeseen circumstances, such as the COVID-19 pandemic in 2020 and the start of the war in Ukraine in February 2022, which, inter alia, led to disruptions in global supply chains, continued with expansionary policies aimed at preserving macroeconomic stability. These policies resulted in double-digit inflationary growth in many countries in the following two years. In such conditions, central banks acted by tightening monetary policy and sharply increasing reference interest rates, consciously balancing the risk of recessionary trends. On the other hand, stimulated by inflation adjustments and short-term expectations, private consumption led to higher prices in the real estate sector. However, in these crises, banks were part of the solution instead of generating the problem. It turned out that we have a new reality in which the conventional monetary policy model with the premise of "one instrument - one goal" is no longer relevant. Central banks are now balancing the price stability, financial stability, and macroeconomic stability triangle. New empirical research suggests that the conditions seem ripe for rethinking the prevailing central bank monetary policy model.

The CBCG closely monitors the ECB's policy following the existing monetary regime and the strategic commitment of the State of Montenegro to join the EU as soon as possible.

The overall inflation in the EU is trending down due to the reduction of disruptions in global value chains on the one hand and the central banks' restrictive monetary policy on the other. Montenegro is an open and euroised economy, and macroeconomic trends in the EU and globally impact its inflation. Montenegro is closely connected through global value chains with the EU, and it is one of the essential transmitters of EU inflation to Montenegro.

The CBCG studies confirm this - inflation in Montenegro is predominantly influenced by global factors related to raw materials, food and oil prices. One of the study's conclusions is that a short-term inflation increase of 1% in the EU can lead to a rise of 0.77 pp in Montenegro. Therefore, the decrease in EU inflation due to the application of restrictive monetary policy also affects the inflation decline in Montenegro. Average inflation in 2023 was high and amounted to 8.6%. Although it is high, it has a distinct downward trend. Thus, in January 2023, inflation amounted to 16.2%, to amount to 5.4% in April 2024. The CBCG forecasts that inflation will continue to trend down in the current year but will still be above the optimal inflation of 2%. Limited prices on some food products have been in force since March as an additional measure to control inflation in the coming months.

Montenegro's financing conditions also reflect the impact of the tightening of the ECB's monetary policy. In April 2024, the average weighted effective interest rate on newly approved loans was 6.89%, while it was 4.83%at the end of December 2021, representing a 2.67 pp increase. One of the primary causes of the growth was undoubtedly the growth of the ECB reference interest rates, which consequently affected the rise of Euribor as a critical component in the variable interest rate structure and the tightening of lending conditions. A favourable circumstance for the Montenegrin banking system in the past is reflected in excess liquidity and primary reliance on financing from domestic sources, which are calculated at meagre deposit interest rates. Due to the aforementioned reference interest rate growth, the ECB did not reflect the effective interest rate growth in Montenegro as in most European countries. To a certain extent, the CBCG contributed to reducing interest rates for households through an initiative to lower average effective interest rates on new loans, which began to be implemented in March of this year.

At the same time, the amount of approved loans grew. During the first four months of 2024, 33.61% more new loans were approved in terms of value compared year-on-year. Continuous supervision and applying a regulatory framework, mainly in line with the EU acquis, resulted in the banking system's high liquidity and solvency, while NPLs are declining. The share of NPLs in total loans was 4.75% at the end of April 2024 and decreased by 0.78 pp compared year-on-year.

The CBCG actively applies macroprudential instruments - capital buffers, namely: countercyclical buffer (currently 0%, i.e. 0.5% from April 1, 2025), buffer for structural systemic risk (currently 1.5%) and buffer for other systemically important credit institutions (currently 1.25-2%), while the capital preservation buffer is determined by the Law on Credit Institutions (currently 1.875%, i.e. 2.5% from 1.1.2025). In addition to capital buffers, the CBCG is currently implementing macroprudential measures to limit the credit growth of cash unsecured loans and non-performing loans among those loans. Currently, the CBCG does not have the so-called macroprudential measures related to borrowers (borrower-based measures), such as DSTI ratios, LTV ratios, etc. In this matter, banks are only obliged to internally establish an acceptable level of these ratios for the loans they provide to natural persons. However, if the risk increases, the CBCG will not hesitate to apply these macroprudential measures.