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Challenges in the introductory phase of inflation targeting

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Every country is specific – but our own is always the most specific one!

- Since 1981 the lowest inflation rate was 6.6% year on year rate in 2006!
- 97.2% of private individuals' savings are in foreign currency;
- Less than EUR 50mn citizens' savings at the end of 2000, no loans for a time period of over 12 months;
- Closure of 66% of the banking sector's balance sheet within 6 months in 2001, lost old frozen currency savings of EUR 4bn, pyramid banks...
- Only one economic term is known by every citizen of Serbia – the “Phillips curve” - citizens complain more about moderate increases in salaries than high inflation rates – they think this is the way to beat inflation;
- Memories of hyperinflation disappeared rather fast - as people prefer to forget bad times;
- Continued political turmoil...

Passage of the central bank law by the Parliament does not mean that politicians or the public understand it!

- “Achieve and maintain price stability” – except us, central bankers, hardly anybody understands why other, “more important” categories e.g. stability of the currency, unemployment, GDP growth etc., are not even mentioned;
- I do not spend a single day in the central bank without reminding people about the role of the central bank – to politicians, journalists, business people, passersby on the street and even my own central bank colleagues!

Conditions for implementing inflation targeting are never perfect

- Lack of credibility – National Bank of Serbia, Government / Public institutions;
- Hyperinflation - just 15 years ago;
- Fear of floating the exchange rate – firstly among the central bank employees;
- Traditionally high inflation expectations;
- Targeting of CPI excluded due to high impact of government regulated prices...

Serbia became an implicit inflation targeting country in August 2006!

Alternative regimes

- Exchange rate targeting

- Money aggregates targeting

- Inflation targeting

- CPI

- Core inflation

- Point

- Range

Reasons

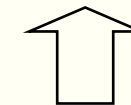


- Exchange rate targeting does not provide the necessary flexibility in the long run;

- Money aggregates targeting proved to be unreliable for the last 5 years;



- Only 50% of the prices determined by the market;



- Provides more credibility;

Inflation targeting was implemented in August 2006...

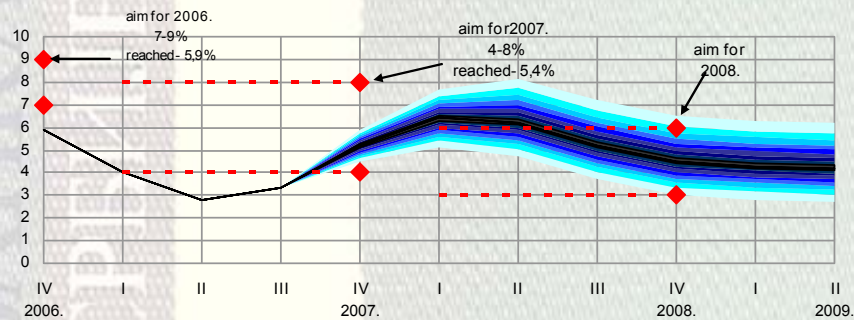
- Specific numeric inflation objectives

	Target	Final result
▪ 2006	7-9%	5.9%
▪ 2007	4-8%	5.4%
▪ 2008	3-6%	?

- Transparency about and accountability for reaching the objectives;
- Changes in interest rates on 2W repo as the main NBS instrument;
- More flexible exchange rate as an indicator of monetary policy transmission.

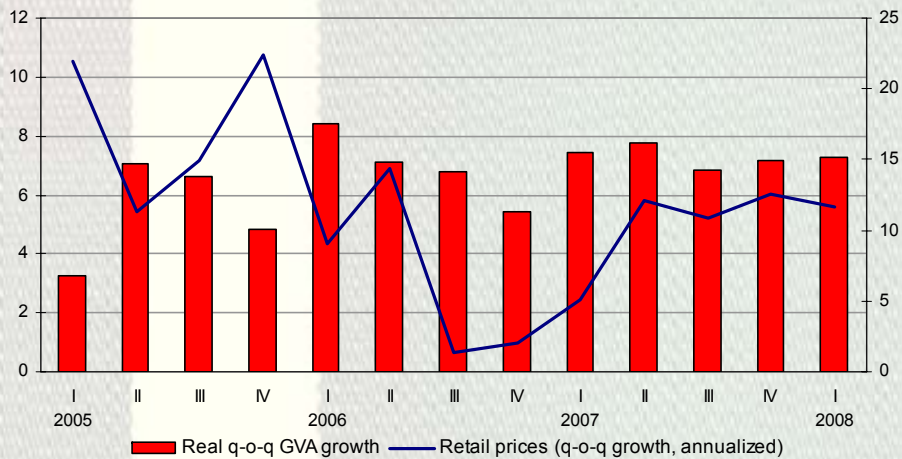
... and it does show positive results

Projected core inflation
(year on year inflation in %)



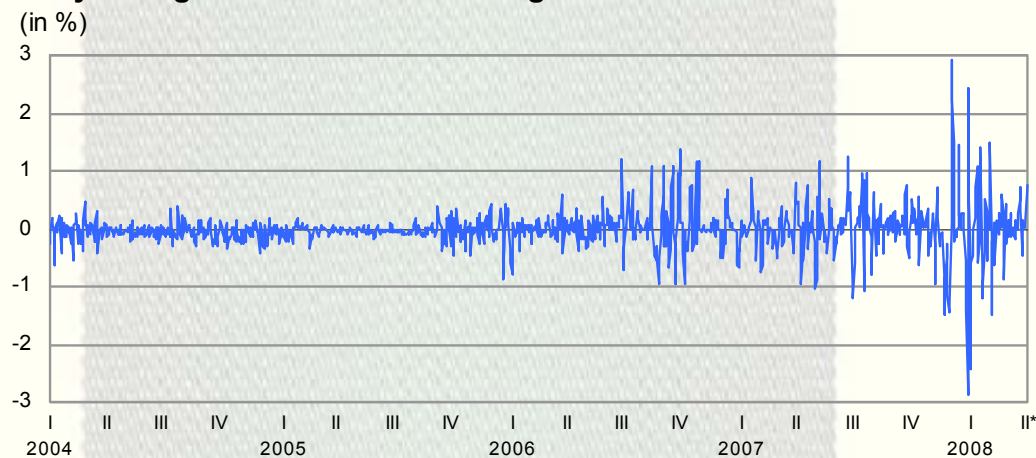
- Inflation decreased
- Inflation expectations more stable
- Core inflation on the target
- Strong growth continued

Economic Activity and Inflation



“Less management” meant more “floating” of the exchange rate

Daily changes in RSD/EUR exchange rate¹⁾

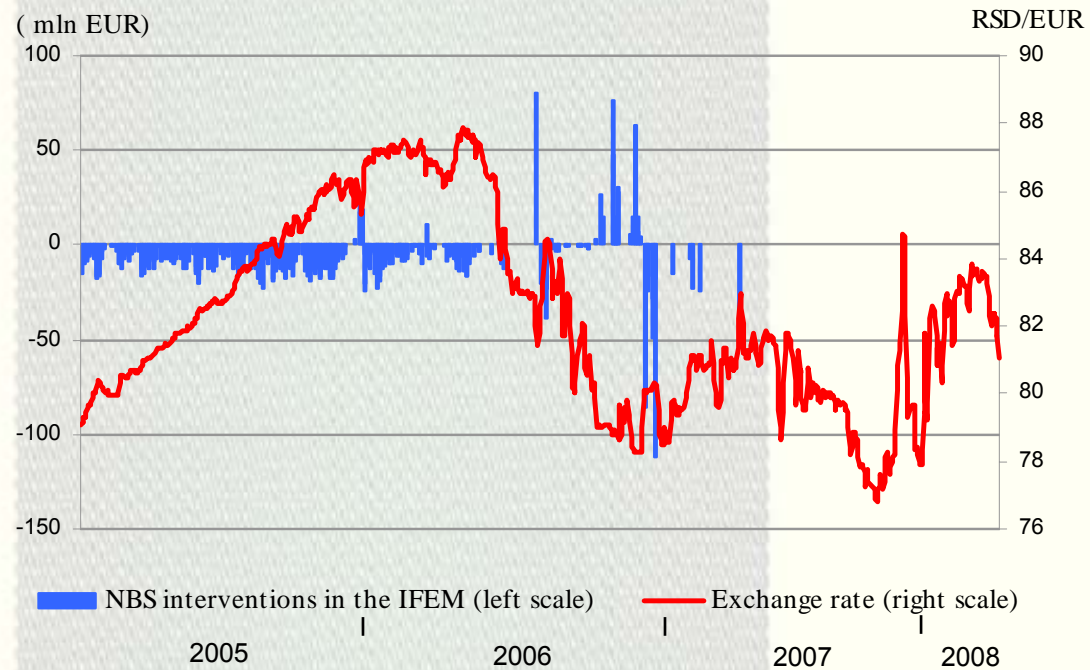


¹⁾ Negative rates indicate depreciation and positive rates appreciation of the dinar.

- Economic agents, instead of hedging their FX position, prefer to blame whomever they know;
- Every citizen of Serbia considers himself/herself to be a successful carry trader - banks have no problems financing it!

NBS is gradually withdrawing from the FX market – fixing sessions are the past

Foreign exchange purchase/sale by the NBS in the fixing session and the euro exchange rate



- Only 3 fixing sessions took place since March 2007!

NBS is particularly criticized regarding the following issues!

- Monetary policy can not and should not compensate for the lack of fiscal restrictiveness – NBS should lay back, criticize the government and watch the inflation rising!
- NBS is spending taxpayers money and even showing losses due to high costs of sterilization – that money used for sterilization could have been used to build up x number of schools, y km of roads, several hospitals...
- High reference rate increases the cost of capital and contributes to even higher inflation;
- NBS supports only importers and makes the life of exporters impossible!

NBS faces several challenges today !

- Core inflation targets not fully understood and therefore not fully credible
- High share of regulated prices in CPI makes achieving price stability a shared responsibility between government and NBS
- Inefficient coordination of policies and strategies between the NBS and the government reduces IT credibility and undermines the NBS independence
- Inflation highly sensitive to exchange rate, oil and commodity prices
- Interest rate transmission only partially effective - High degree of financial and real dollarization
- Underdeveloped financial markets no yield curve on T-bills or other benchmark instruments, no derivative instruments

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Thank you for your attention!