

Appendix 1: Memorandum of the National Bank of Serbia on Setting the 2008 Inflation Objective

In line with the principal objective of the central bank to achieve and preserve price stability, as defined in the Law on the National Bank of Serbia, and with respect to the Monetary Policy Framework adopted in August 2006 in which the NBS aims at specific inflation objectives, the NBS Monetary Policy Committee (MPC) has set the core inflation objective for the year 2008 as

- 3-6 % December 2008 to December 2007

The Monetary Policy Committee reiterates the main principles of the New Monetary Policy Framework:

- The declared inflation objectives are the only numerical guidelines for the monetary policy of the NBS.
- The NBS achieves the inflation objectives by changing the interest rate on its 2-week (2W) repo operations as its key policy interest rate and main instrument. Other instruments, including foreign exchange interventions, have only supportive roles.
- The NBS pursues a soft-managed floating foreign exchange regime, retaining at the same time the right to intervene in the foreign exchange market in the event of excessive daily exchange rate fluctuations, threats to financial and price stability and risk to the adequacy of the level of foreign exchange reserves;
- The Monetary Policy Committee of the NBS takes decisions on changes in the key policy rate at pre-announced dates on the basis of staff economic and inflation outlook.
- The MPC informs the public regularly about the objectives fulfilment and steps taken to meet them in the future.

The Monetary Policy Committee has decided to set the core inflation objective for end-2008 at this moment in order to help anchor inflation expectations and provide additional support to creating low-inflation environment, and a guideline for current policy actions. The MPC assesses that its policy decisions (such as changes in the key policy rate) have maximum impact on inflation not before three months following their enactment, necessitating a medium-term perspective of inflation objectives.

Compared to the 2007 core inflation objective, the level of the 2008 objective is lower and its width has been reduced on account of favourable macroeconomic developments and low inflation rates:

- The level of inflation objective for 2008 reflects the desire to achieve price stability by a process of gradual disinflation, not disrupting other macroeconomic processes taking place in the economy. The success in reducing inflation in 2006 and 2007 has paved way for lower inflation objectives and thus continuing with the disinflation process.
- Following these considerations, the level of the 2008 objective has been set below that of the 2007 objective, but high enough to allow for smooth adjustments in relative prices expected to take place during the process of restructuring of the Serbian economy. In choosing the level, the MPC has also taken into account the assessment of long-term macroeconomic trends so as to put a minimum pressure on the nominal exchange rate and thereby reduce risks of possible adverse short-term implications for competitiveness of the economy.

- The width of the 2008 objective has been reduced compared to 2007 objective in order to assist better in forming inflation expectations.

Setting of core inflation objective for end-2008 should also facilitate the process of defining the level of inflation consistent with the price stability mandate in a medium-term. In cooperation with the Government of the Republic of Serbia, within whose remit is the revision of regulated prices, the National Bank of Serbia will set the medium-term objective for headline inflation as well, and inform the public thereof.