MONETARY POLICY PROGRAMME OF THE NATIONAL BANK OF SERBIA IN 2007

1. The key objective of the National Bank of Serbia, as defined in Article 3, paragraph 1 of the Law on the National Bank of Serbia, "is to achieve and maintain price stability". The same Article sets out that, "without prejudice to its key objective, the National Bank of Serbia shall support the pursuit of the economic policy of the Government of the Republic of Serbia".

It is principally by ensuring stability of prices defined as the rate of inflation that has no negative impact on investment, savings and other decisions of economic players that the National Bank aims to contribute to the achievement of sustainable economic growth.

2. Monetary policy of the National Bank of Serbia is formulated in the *Memorandum of the National Bank of Serbia on the Principles of the New Monetary Policy Framework Aiming at Low Inflation Objectives* (hereinafter: Memorandum). This document defines monetary policy principles in the transitional period until the adoption of the inflation targeting regime.

The *Memorandum,* adopted by the Monetary Policy Committee of the National Bank of Serbia on 30 August 2006, sets out that inflation will be contained "within a defined inflation corridor, with the key policy rate as the main instrument and other monetary policy measures as supporting instruments".

The *Memorandum* outlines the new monetary policy framework and the manner of its implementation:

– Core inflation corridor for a calendar year is defined as a numerical interval (December-on-December). Projections of the annual retail price growth will be prepared in cooperation with the Government of the Republic of Serbia, based on planned adjustments in administered prices.

– The Republic Statistical Office collects data and publishes information on movements in prices. Monthly changes in prices over a year earlier represent a very important point of reference for the Monetary Policy Committee decisions, as they enable an assessment of any deviation of inflation from the projected inflation corridor. Application of annual indices enables justification of short-term, unsystematic and seasonal deviations.

– Maintaining inflation within the projected corridor enhances credibility of the monetary policy and enables anchoring of inflation expectations.

– The purpose of defining inflation corridor is to ensure that inflation objective is met regardless of shocks and changes to the economic environment. The NBS anticipates a neutral impact of economic shocks that will not call for a change in the monetary policy stance.

– The National Bank of Serbia will counter sudden and powerful shocks to the economy to prevent departure from the projected inflation corridor band. Monetary policy response to such shocks will depend on their strength and nature, as well as on the level of inertia of inflation expectations. It should be noted that a response to demand shocks is easier to accomplish, as changes in inflation and economic activity move in the same direction. Rises in interest rates and inertia of inflation expectations weaken economic activity and dampen inflationary pressures. Adequate response to supply shocks, however, is a much more complicated matter, as economic activity and inflation move in opposite directions. Efforts to offset supply shocks on inflation by means of monetary policy alone can lead to unnecessary restraints on economic activity. On the other hand, any attempt to fully offset a supply shock by raising prices shall speed up inflation. This would call for monetary policy tightening in the immediate future and would induce a slowdown in economic growth.

– In case of supply shocks, monetary policy aims to prevent emergence of secondary effects. The risk of such effects is particularly strong in countries with a relatively short history of low inflation. When analysing the effects of supply shocks, the National Bank of Serbia attempts to properly quantify headline and core inflation to facilitate differentiation between temporary and permanent shocks.

– Due to a time lag customarily implicated in monetary regulation its effect on current movements in inflation is relatively insignificant. Duration of such lags is not predetermined and depends on structural and institutional changes involved. Any change in the transmission mechanism will entail a careful evaluation of the timing of the effect of inflation-related decisions.

– Monetary policy is implemented in the environment of high uncertainty, which, inter alia, means that the inflation projection model used by the National Bank of Serbia could cease to reflect fairly the actual economic developments, as a result of ongoing structural changes in the economy. Hence, in its decision making, the National Bank will take into account all available information, in addition to deviations from the inflation projection. Besides, monetary policy will be communicated to the public in an effort to balance the risk factors implied by the inflation corridor.

– Any assessment of the degree of monetary policy restrictiveness should take into account not only real interest rates but the real exchange rate as well.

3. Monetary policy of the National Bank of Serbia is forward looking and its decisions will be based on inflation projections. When the projected rate of inflation falls short of or exceeds the objective range, both the level of interest rates and the monetary policy stance are reviewed.

Core inflation (i.e. inflation of retail prices under the influence of NBS instruments) in 2007 is set at 6±2% (December-on-December). The National Bank of Serbia will pursue other goals only to the extent that the fulfilment of the inflation objective is not threatened.

4. To achieve its objectives, the National Bank of Serbia will use all available information and apply adequate mix of monetary policy instruments. The key policy rate of the National Bank of Serbia – two-week repo rate – will stand out as the main monetary policy instrument.

5. Based on monetary developments and inflation projection, the National Bank of Serbia can decide to change the key policy rate to a level compatible with the maintenance of core inflation within the projected range.

6. The exchange rate of the dinar will be formed freely, with reference to supply and demand in the foreign exchange market.

7. The National Bank of Serbia will try to use its interest rate policy to influence foreign exchange supply and demand in the foreign exchange market. It will channel changes in the exchange rate of the dinar towards accomplishment of the set objective, while retaining the right to intervene in the event of significant oscillations in the foreign exchange market that could threaten medium-term sustainability of the country's external position. The new framework defines the following three instances in which the National Bank of Serbia may intervene in the foreign exchange market: (1) to limit daily oscillations, but not resisting cumulative pressure over a longer period, (2) to contain potential threats to financial and price stability (after the potential of influencing inflation through changing the key policy rate is exhausted) or to prevent inflation from being lower than planned, and (3) to safeguard an adequate level of international reserves. In addition, during the transitional period which encompasses the year 2007 (when performance of exchange transactions will be transferred to the scope of commercial bank operations), the National Bank of Serbia will intervene in the process of interaction with exchange offices.

8. In 2007, the National Bank of Serbia will continue to develop and strengthen market instruments of monetary regulation and to support development of the interbank money market, in order to upgrade banking sector liquidity management.

9. To regulate liquidity of the banking system in 2007, the National Bank of Serbia will enable banks to resort more efficiently to its lending and deposit facilities, while using interest rate corridor as a mechanism for managing money market interest rates.

10. Use of reserve requirement as an instrument of monetary regulation shall depend on the effects produced by market instruments of monetary regulation.

11. The National Bank of Serbia shall closely observe lending activity of banks and take adequate prudential and other measures of monetary regulation to prevent any threat to the achievement of the key monetary policy objective.