TEN YEARS OF INFLATION TARGETING IN SERBIA

On 1 January 2019 the NBS will mark the tenth anniversary of implementing the inflation targeting strategy. This important jubilee serves as a reminder that the NBS has achieved and preserved price stability and that it will remain committed to this objective in the years to come. Transparent in communication and open to cooperation, we have worked and will continue to work to the benefit of all, making a consistent and ongoing contribution to positive social and economic changes in the country. Low and stable inflation for five years in a row, anchored inflation expectations, relative stability of the exchange rate, and preserved and reinforced financial stability – are the palpable results of the NBS, which help us strengthen monetary policy credibility and contribute to sustainable economic growth and, by extension, to a better standard of living of our citizens.

Inflation targeting as a monetary strategy has been applied as of early 2009. The strategy was chosen after earlier monetary policy strategies (targeting of the exchange rate and monetary aggregates) failed as they produced high and volatile inflation and pronounced internal and external imbalances. The analyses of the strengths and weaknesses of various monetary strategies showed that the inflation targeting regime was the most appropriate to our circumstances as it supported the achievement of the desired results:

- an environment featuring low and stable inflation, in accordance with the criteria defined within the EU accession process,
- stronger confidence in the national currency and, consequently, its greater use,
- increased resilience of the economy to shocks from the domestic and international environment, as well as to changes in the business environment expected during the EU accession process.

Positive experiences of other central banks and the fact that they were increasingly embracing this monetary strategy supported the switch to inflation targeting.

Main principles of inflation targeting

Inflation targeting is a monetary policy strategy with the following main principles:

1. Achieving and maintaining low and stable inflation as an explicitly defined monetary policy objective

Pursuant to the Law on the National Bank of Serbia, the principal objective of the NBS is to achieve and maintain price stability. Without prejudice to its main objective, the NBS contributes to the preservation and strengthening of financial stability. It also supports the Government's economic policy, without jeopardising the achievement of price and financial stability.

2. Medium-term inflation target is set as the only numerical monetary policy guide

Measured by the annual consumer price changes, the inflation target is determined as a point value with a tolerance band, for several years ahead. The NBS determines the inflation target in cooperation with the Government, based on the analysis of current and expected macroeconomic developments and the medium-term plan of adjusting prices under direct or indirect influence of the Government. The numerical target facilitates the guiding of inflation expectations, while the central bank's aim is to anchor them, i.e. link them to the inflation target. *The National Bank of Serbia's Memorandum on Inflation Targets until 2021*, adopted in December 2018, defines the inflation target at 3±1.5% until end-2021.

3. Monetary policy decision making is based on comprehensive economic analyses and forecasting

Inflation targeting requires a forward-looking approach. The starting point is the analysis of current economic developments, though the decisions on the key policy rate and other monetary policy instruments are made primarily based on future developments, i.e. the medium-term inflation projection and inflation factors such as GDP growth and other macroeconomic categories. Bearing this in mind, the NBS focuses its efforts on understanding the monetary policy transmission mechanism and development of a consistent analytical framework and forecasting process.

4. Monetary policy is transparent and accountable to the public

The inflation targeting strategy implies efficient communication with the public. Acting in a transparent and accountable way towards the public, in line with the defined and published schedule of meetings, the NBS adopts decisions on monetary policy and regularly informs the public about the achievement of the set inflation targets and the measures it undertakes to achieve them in the future. Through efficient communication with the public, relying primarily on the Inflation Report, the NBS aims to stabilise inflation expectations and, thus, contribute to the achievement of the inflation target.

Overview of the introduction of inflation targeting as the NBS monetary strategy

The preparations to switch to the new monetary policy regime began in 2006. Its elements, defined by the *Memorandum of the National Bank of Serbia on the Principles of the New Monetary Policy Framework – Aiming at Low Inflation Objectives*, were gradually introduced into practice. The years 2006–2009 were the transition period of the informal (implicit) inflation targeting, whereafter a switch was made to formal, fully-fledged (explicit) inflation targeting.

The *Agreement on Inflation Targeting* was concluded in December 2008, with the NBS and the Government agreeing that inflation targeting was the most adequate monetary regime to ensure price stability in Serbia. In the same month, *the Memorandum on Inflation Targeting as Monetary Strategy* was adopted, defining the formal application of the inflation targeting regime as of 1 January 2009.

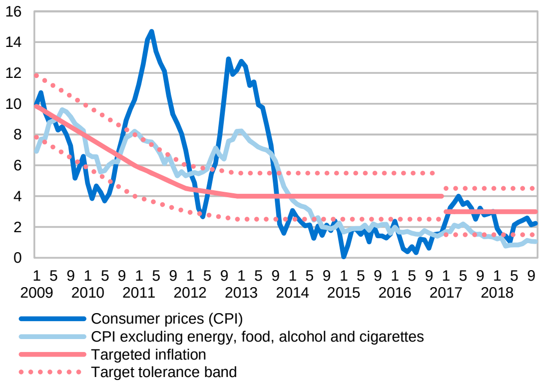
I Initial years of inflation targeting (2009–2012)

The first year of fully-fledged inflation targeting was marked by the global economic crisis. It started with a high key policy rate of 17.75%, which was trimmed to 9.5% until the end of the year. Monetary policy easing was made possible by the falling GDP and low aggregate demand, resulting in a decline in inflation from 10% to 6.6% that year.

The downward inflation path continued into H1 2010, when the key policy rate was cut to 8.0%. However, a bad agricultural season and a significant rise in global primary agricultural prices, spilled over to rising food prices and inflation expectations. This, together with exchange rate depreciation and insufficient coordination between monetary and fiscal policies had a decisive influence on the rise in inflation and its movement above the upper bound of the target band as of October. To curb inflationary pressures, in August 2010 the NBS initiated the cycle of monetary policy tightening, which ended in April 2011, with the key policy rate raised to 12.5%. In the same month, inflation reached 14.7% y-o-y, its highest level in the inflation targeting regime. Thereafter, it fell to a single-digit level by December, on account of a slowdown in food price growth and past monetary policy measures.

The weakening of inflationary pressures in mid-2011 led to monetary policy easing. However, the monetary policy stance had to be reversed again in H2 2012. The reason was vigorous depreciation of the exchange rate in H1, caused, among other things, by unsustainable fiscal policy and the widening of external imbalances. Inflation moved above the upper bound of the target tolerance band. Until end-2012, the key policy rate was raised to 11.25%. In addition to being high, inflation was also rather volatile.

Chart 1 **Headline and core inflation**
(y-o-y rates, in %)



Sources: SORS and NBS calculation.

The experience of inflation targeting in this period (2009–2012), with frequent changes in the monetary policy stance, showed that inflationary pressures could not be curbed on a durable basis without strengthening the credibility of monetary policy and fully coordinating it with fiscal policy measures. In addition, this period was marked by pronounced short-term exchange rate volatility, which triggered not only the volatility of inflation, but also had an adverse effect on the certainty of doing business, consumer confidence and financial stability. This conclusion is confirmed by the results achieved in the period 2013–2018.

II Achieving and maintaining low and stable inflation and anchoring inflation expectations (2013–2018)

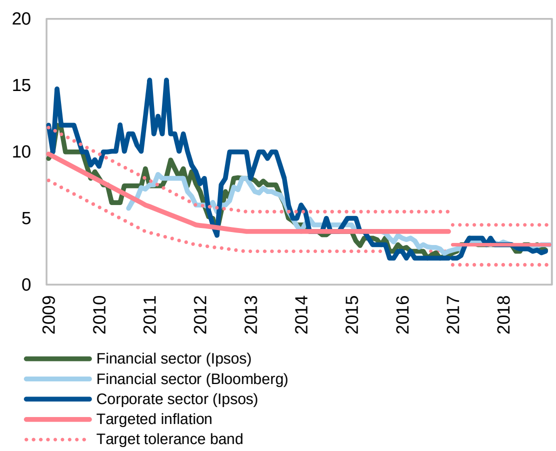
The period since governor Tabaković took office was marked by a number of adequate and timely monetary policy measures. Among other things, there was a shift in the approach to FX interventions and greater importance was attached to developments in the FX market, which helped to achieve and subsequently maintain a relative stability of the exchange rate.

Monetary policy measures such as the key policy rate hikes at end-2012 and early 2013, the fall in inflation expectations, prompted by intensive NBS's communication with the public conveying the message that all the necessary measures and activities would be taken in order to achieve and maintain price stability, as well as the relative stability of the exchange rate, produced full effects in 2013, when inflationary pressures were curbed on a more durable basis. Y-o-y inflation dropped from 12.2% at end-2012 to 2.2% in December 2013 and remained low and stable to this day.

In the period 2014–2016 inflationary pressures were maintained at low levels also owing to the consistent and well-calibrated monetary policy measures, reduced cost-push pressures in food production and lower aggregate demand amid a more restrictive fiscal policy. In the period observed, inflation averaged around 2% and its undershooting of the target tolerance band for the greater part of this period was mainly prompted by the unusually sharp fall in global prices of primary agricultural commodities and oil.

As a result of adequate monetary policy measures, fully coordinated with fiscal policy, almost the whole time since the beginning of 2017 inflation has moved within the bounds of the new, lower target of 3±1.5%. Low inflationary pressures are confirmed also by the movement of core inflation at around 1% y-o-y and inflation expectations of the financial and corporate sectors anchored around the target mid-point.

Chart 2 **One-year ahead inflation expectations**
(y-o-y rates, in %)



Sources: Gallup, Ninamedia, Ipsos and Bloomberg.

The path toward price stability was paved by adequate and well-timed monetary policy measures:

- in early 2013 monetary policy needed to be further tightened by raising the key policy rate to 11.75%;
- in the period thereafter, a considerable fall in inflation and curbing of inflation expectations laid

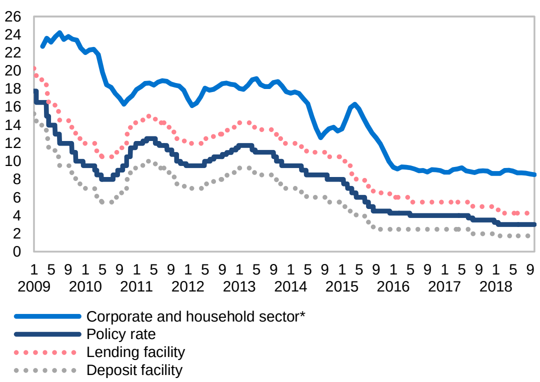
the groundwork for a cycle of monetary policy relaxation, during which the key policy rate was lowered from 11.75% to 3.00%, where it stands today;

- the NBS embarked on a cycle of monetary policy easing in May 2013, while the adoption and consistent implementation of the fiscal consolidation programme since end-2014 allowed for a significant acceleration in monetary policy relexation in 2015. In 2015 alone, the key policy rate was lowered by 3.5 percentage points.

- The NBS proceeded with monetary policy easing in the years to come, but at a more cautious pace, taking into account the effects of the sizeable easing in the preceding years and the risks stemming from the international environment.

Since April 2018 the key policy rate has measured 3%, its lowest level in the inflation targeting regime.

Chart 3 **NBS key police rate and lending rates**
(p.a., in %)

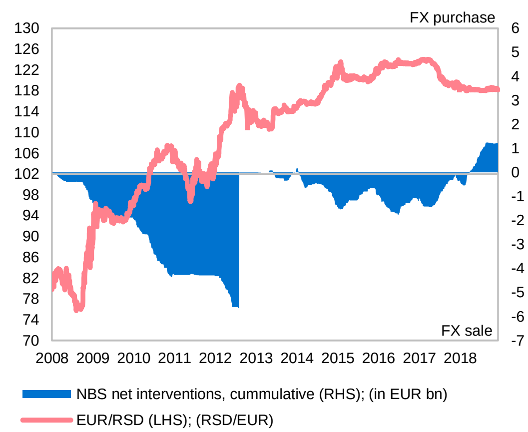


Source: NBS.
* Average interest rate on dinar loans, three-month moving average.

Monetary policy easing was one of the main drivers behind a strong fall in interest rates in the interbank money market and hence in lending rates to the private sector, which lost over 10 percentage points since mid-2013. The fall in interest rates in the money market reflected not only on lower price of new loans and higher loan availability, but also pushed down the cost of repayment of existing loans. This reduced the operating expenses of corporates, freed up the funds for new investments, and boosted disposable income of households, giving a further impetus to economic growth.

A strong decline in money market interest rates and dinar loan rates in the period observed clearly demonstrates successful workings of the interest rate channel in the dinar segment of the market. The interest rate channel is further strengthened by the higher degree of dinarisation, which reflects the achieved price and overall macroeconomic stability, as well as the relative stability of the exchange rate. At the same time, strengthening of the interest rate channel in turn increases monetary policy efficiency and thereby the NBS's effectiveness in running the inflation targeting regime and influencing the overall macroeconomic developments.

Chart 4 **Dinar exchange rate and NBS interventions in the interbank FX market**



Source: NBS.

In conditions of a relatively high pass-through effect of the exchange rate on inflation and the concurrent turbulences in the international financial market and volatile capital flows, the ensuring of a relative stability of the exchange rate in the period 2013–2018 was decisive not only for securing low and stable inflation, but also for maintaining and strengthening financial stability. The relative stability of the exchange rate increased certainty in doing business, which helped to set in motion a vibrant investment cycle, whose results are fully visible today, in the form of dynamic economic growth. What is equally important, the stability of the exchange rate and inflation, with considerably lower interest rates contributed to higher efficiency of fiscal consolidation measures and minimised the negative effects on the household living standard. The relative stability of the exchange rate was also underpinned by enhanced monitoring of FX market developments and establishment of intensive communication with commercial banks, which enabled timely and well-calibrated interventions in the FX market in both directions. A surely important contribution to the relative stability of the dinar exchange rate in the period observed came from reduced external and internal imbalances and implemented structural reforms, which also helped to increase the resilience of the domestic economy to potential shocks from the international environment.

In the period under review the NBS paid special attention to the development of the operational monetary policy framework which is adjusted to the postulates of inflation targeting as a monetary strategy, but also to the specificities of the domestic financial market. In addition, analytical support to the process of monetary policy decision making was continuously improved and bolstered, including further development of models used for medium-term macroeconomic projections. Also, in view of the important impact of higher monetary policy transparency on the formation of inflation expectations, communication with the public was constantly upgraded, in order to bring closer to the wider public the manner of conduct and mechanism of functioning of monetary policy, as well as the decisions taken.

Successful performance of the National Bank of Serbia in the inflation targeting regime

Over the last five years, inflation in Serbia has been low and stable and comparable to inflation in other European countries. The inflation targeting strategy proved to have played the key role in ensuring sustainable price stability and anchoring of inflation expectations. Being sufficiently flexible, the strategy allowed for tailoring of monetary policy in line with the specificities of the domestic economy and for increasing policy efficiency. Such integral approach increased the certainty of doing business and investment which, along with the rising confidence, boosted the sustainability of economic growth and the prospects for its acceleration.

The NBS will remain committed to preserving price and financial stability in years to come. Being aware that the success of policies depends also on the commitment to their implementation, we will continue to carefully analyse monetary policy efficiency and best international practices in this field, keep track of and further develop new ideas, discuss them and ask questions. In these efforts, we will remain mindful of the specificities of the domestic economy in order to ensure and maintain the best framework for monetary policy implementation in the period ahead.