



**NATIONAL BANK OF SERBIA**

**Memorandum of the  
National Bank of Serbia  
on Inflation Targeting  
as Monetary Strategy**

December, 2008

In its meeting held on 22 December 2008, the Monetary Policy Committee of the National Bank of Serbia adopted the text of the memorandum on formal implementation of the inflation targeting regime as of 1 January 2009. This memorandum defines the main principles and workings of the new monetary policy regime of the National Bank of Serbia.

This memorandum is consistent with the *Agreement between the National Bank of Serbia and the Republic of Serbia on Inflation Targeting*, adopted in the session of the Government of the Republic of Serbia held on 19 December 2008.

Building an environment of low and stable inflation is a process which requires coordinated efforts of the National Bank of Serbia and the Government of the Republic of Serbia as inflation in Serbia is a matter of their shared responsibility. In order to ensure price stability conducive to sustainable economic growth, the National Bank of Serbia and the Government of the Republic of Serbia entered into the *Agreement on Inflation Targeting*<sup>1</sup> (hereinafter: Agreement), as a framework for achieving medium-term price stability, to announce the formal adoption of the inflation targeting regime by the National Bank of Serbia in 2009. The principles of this monetary policy regime have been gradually introduced into practice by the National Bank of Serbia pursuant to the *Memorandum on the New Monetary Policy Framework* adopted in August 2006.

## **1. Main principles of the inflation targeting regime**

The inflation target, defined in terms of the annual percentage change in the consumer price index, is the only numerical guideline for the monetary policy conducted by the National Bank of Serbia. The National Bank of Serbia will also support the conduct of the Government's economic policies to the extent that this does not threaten the achievement of its inflation targets or the stability of the financial system.

The National Bank of Serbia will achieve the inflation target by changing the interest rate applied in the conduct of its main monetary policy operations (currently, the interest rate on two-week repo operations). This interest rate will be its main monetary policy instrument. Other monetary policy instruments will have supporting roles, as they should contribute to a smooth transmission of the key policy rate to the market and balanced development of financial markets without threatening the stability of the financial system.

The National Bank of Serbia will pursue a managed floating exchange rate regime, which means that the National Bank of Serbia will have the right to intervene in order to limit excessive daily oscillations in the foreign exchange market, contain threats to financial and price stability and safeguard an adequate level of foreign exchange reserves.

The National Bank of Serbia will continue enhancing the transparency of its monetary policy and upgrading efficient communication with the public. The Monetary Policy Committee will take decisions on the monetary policy on pre-announced dates and will regularly inform the public about the achievement of the set inflation targets and measures taken in order to meet these targets in the future.

## **2. Setting inflation targets**

Inflation targets will be set by the National Bank of Serbia, in cooperation with the Government, on the basis of an analysis of current and expected macroeconomic movements and the plan of changes in prices under direct or indirect regulation of the Government.

The targets will be set for several years ahead as a continuous headline inflation band with a midpoint, and defined in terms of the annual percentage change in the consumer price index.

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<sup>1</sup> The Agreement was adopted in the session of the Government of the Republic of Serbia on 19 December 2008.

The key advantages of defining the target in the above described manner are:

- Defining the target in terms of headline inflation allows for more transparency, while measuring the target by the consumer price index ensures consistence with the international practice and comparability with a majority of other countries.
- The band indicates the comfort zone for inflation and provides for the fact that there will occasionally be smaller shocks causing short-term volatility of inflation, but not requiring a monetary policy response. Setting a midpoint will help better anchor inflation expectations.
- The target will be continuous, enabling inflation to be monitored at all times and not only at a particular point in time (end of year).
- Targets will be set for several years ahead to ensure focus on medium-term price stability, account for the lags in the transmission of the impact of monetary policy instruments on inflation and help anchor inflation expectations.

The trajectory of inflation targets will be consistent with the need to achieve and maintain medium-term price stability. Pursuant to the Agreement, the National Bank of Serbia and the Government hold that medium-term price stability should be defined as annual inflation of 2-4%. In setting inflation targets, account will also be taken of medium-term economic growth and preservation of external stability.

The setting of inflation targets will require cooperation between the National Bank of Serbia and the Government. In an environment where a large proportion of prices is under direct or indirect regulation of the Government, the National Bank of Serbia can effectively control only the part of inflation that is determined in competitive markets (the so-called core inflation). On the other hand, the Government is responsible for the part of inflation stemming from adjustments in regulated prices. The procedure of setting inflation targets will, therefore, be as follows: the Government, in cooperation with the National Bank of Serbia, will define the medium-term plan of changes in prices under direct or indirect regulation of the Government. Upon consulting with the National Bank of Serbia, the Government will announce a single range as a numerical guideline for the increase in prices of all relevant products. Thereafter, the National Bank, in coordination with the Government, will set headline inflation targets. The targets will be announced by the National Bank of Serbia in the form of a memorandum on setting medium-term inflation targets.

The Government will inform the National Bank of Serbia in a timely manner about any planned changes to its fiscal policy, including all relevant details on the plans relating to budget and deregulation of prices.

The National Bank of Serbia, in cooperation with the Government, may revise the agreed and announced inflation targets. Such revisions will be initiated only under exceptional circumstances, and the National Bank of Serbia will provide an adequate explanation of each such revision.

### **3. Achieving inflation targets**

The National Bank of Serbia will achieve inflation targets by selecting monetary policy instruments in a sustainable, consistent and predictable manner in order to avoid any unnecessary macroeconomic fluctuations. The selection of monetary policy instruments will be based on the analysis of the current economic situation, assessment of future developments and the medium-term inflation projection.

The National Bank of Serbia will use monetary policy instruments to ensure that inflation targets are met and that departures of inflation from the target are only temporary. Inflation may not be expected to equal the target level at all times. In case of serious shocks, it is not always possible or desirable to bring inflation back to the target level over a short time horizon given the

lags in the transmission mechanism and the possible effects on the overall macroeconomic and financial stability. Therefore, the National Bank of Serbia, just like other central banks, will allow such temporary departures of inflation from the set target if restoring inflation to the target level over a short time horizon calls for major changes in monetary policy that could cause added macroeconomic volatility. In particular, this refers to instances of sudden changes in prices of commodities or departures from the planned growth in prices of products that are under direct or indirect regulation of the Government.

#### *Main monetary policy instrument*

The key policy rate will be the main monetary policy instrument in the inflation targeting regime. Other monetary policy instruments, including interventions in the foreign exchange market, will only have supporting roles.

The key policy rate is the interest rate applied in the conduct of main monetary policy operations (currently, two-week repo operations). The key policy rate is an operational objective for short-term money market interest rates. Its role as an operational objective will be supported by a corridor of interest rates on lending and deposit facilities and other open market operations.

Adjustments in the key policy rate will be based on the assessment of the current economic situation, inflation developments and their projections. The key policy rate will be adjusted with a view to maintaining the projected inflation within the target range, over a time horizon deemed adequate by the Monetary Policy Committee in view of the nature of the shocks and the overall macroeconomic situation. The size and timing of such adjustments will be aligned with the mechanism of monetary transmission, respecting its lags and the currently dominant role of the foreign exchange channel. The projections will be prepared on a regular basis and updated in line with new data and assessments of future macroeconomic movements.

#### *Other monetary policy instruments*

Other monetary policy instruments, such as open market operations involving longer-term securities or the reserve requirement, will have a supporting role in achieving inflation targets. They should contribute to a smooth transmission of the key policy rate in the market and balanced development of financial markets without threatening the stability of the financial system. Some of these instruments can facilitate the monetary policy transmission through the credit channel and others (such as the reserve requirement) have an important prudential function as well.

#### *Interventions in the foreign exchange market*

In an inflation-targeting regime, foreign exchange interventions are an infrequent secondary instrument used to support the achievement of the inflation target only after the potential for influencing inflation effectively through changing the key policy rate is exhausted.

The exchange rate is an indicator of monetary policy transmission. When evaluating the impact of the key policy rate, it is important to monitor movements in the foreign exchange market as the exchange rate channel remains by far the strongest means of influencing inflation. However, no numerical objectives for the exchange rate will be set.

The National Bank of Serbia will resort to foreign exchange interventions with a view to: 1) limiting excessive daily oscillations in the exchange rate for the dinar, but without accumulating pressures in a single direction over a longer period of time, 2) containing threats to financial stability, and 3) safeguarding an adequate level of foreign exchange reserves.

### *Prudential measures*

The National Bank of Serbia will not enact prudential or administrative measures in order to support the achievement of monetary policy objectives, but only with a view to preserving financial system stability. However, as these measures may produce monetary effects, the National Bank of Serbia will make sure that they are applied in a transparent manner and that they do not hamper the efficacy of the main monetary policy instrument.

## **4. Communicating the Achievement of Inflation Targets**

In pursuing the inflation target, the National Bank of Serbia will be transparent and will continue to be accountable to the public. This means that the National Bank of Serbia will regularly inform the public, primarily through the *Inflation Report*, on the achievement of the inflation target, expected inflation outturns and the underlying macroeconomic developments, as well as monetary policy measures to be taken in order to achieve inflation targets in the future.

If the departure of inflation from the set target lasts for more than six consecutive months, the National Bank of Serbia will have the obligation to notify the Government about the reasons for such departure, measures to be taken and the time needed for inflation to return to target level.

The National Bank of Serbia will communicate with the public and specific interest groups through a series of regular publications, press conferences and press releases, as well as through irregular analytical seminars, conferences and publications on special topics.

The Monetary Policy Committee will decide on adjustments to the key policy rate at pre-announced meetings. The decisions and their reasoning will be made known to the public on the same day in press releases and/or press conferences.

The *Inflation Report* is the key tool of communication of the National Bank of Serbia with the general public. It is published quarterly and contains the assessment of the current economic situation and the monetary policy stance, as well as their future course. The *Inflation Report* contains the inflation projection and the analysis of key risks to meeting inflation targets as well as an analysis of the impact of future developments and risks on monetary policy.

Through efficient communication with the general public, the National Bank of Serbia will try to “anchor” inflation expectations, thereby contributing to the achievement of targeted inflation.

## **5. Coordination of monetary, fiscal and wage policies**

In an inflation targeting regime, the coordination between monetary and fiscal policies is of key importance as any inconsistency between the two policies may threaten not only the achievement of the target but also the credibility of the inflation targeting regime itself. The Government indisputably has a significant influence on inflation, given the relatively high proportion of products the prices of which are under its direct or indirect regulation as well as the fact that the Government plays a key role in ensuring the legal and institutional framework conducive to price stability.

In the Agreement, the Government has committed to pursuing a sustainable and predictable fiscal policy consistent with inflation targets. The Government has also committed to timely informing the public and the National Bank of Serbia about any changes in the economic policy that could threaten the achievement of the inflation targets, and, in particular, about any plans relating to market regulation and the budget. Moreover, pursuant to the Agreement, the Government and the National Bank of Serbia agree to cooperate in creating institutional

preconditions necessary for effective inflation targeting by developing regulations that ensure the independence of the National Bank of Serbia and by encouraging the development of the financial market and activities relating to the strengthening of trust in the national currency.