Radovan Jelašić: Achieving a stable currency for a healthy Serbian economy

Speech by Mr Radovan Jelašić, Governor of the National Bank of Serbia, at Roundtable on "Stable Currency for a Healthy Economy", Belgrade, 16 February 2007.

* * *

Ladies and gentlemen, Mr Yves Thibault de Silguy,

The role of the National Bank of Serbia is well defined by the Law adopted in mid-2003, maybe because that particular point was copied from EU Treaty provisions on the European Central Bank. The definition reads as follows:

"The primary objective of the NBS shall be to achieve and maintain price stability. In addition to its primary objective, the NBS shall also pursue the objective of financial stability. Without prejudice to its primary objective, the NBS shall support the economic policy of the Government of the Republic of Serbia, acting in accordance with the principle of a market economy."

Hence, the Law clearly defines the main objective – "to achieve and maintain price stability" – and says nothing about growth, employment, exports, wages, roads, etc... The reason why almost all developed countries adopted this law – and why we thankfully copied it – is simple enough: there is nothing that contributes more to growth and economic development, higher employment and growth in exports than stability of prices. This assertion has been proved right in all developed countries in the course of the last two decades. All other arguments remind me of stories from 1860s when Prince Mihailo reigned in Serbia and people were debating, believe it or not, whether Serbia needed railroads. The comments were like: "Foreign machines, foreign machine drivers, foreign managers, and all of it at our expense."

And, while there is a clearly defined objective that we as a central bank need to achieve, the means for achieving it are not strictly specified – though in Serbia, like in other countries of the region, it is often much more important to find a good excuse than to face reality. In simple words, the law clearly defines our assignment without delineating the means to realize it!

"Experts" in Serbia still engage in theoretical discussions about monetary policy while, at the same time, thinking in terms of exchange rate only! The facts relating to the exchange rate, however, show that the role of the NBS in setting the exchange rate was never as insignificant as in 2006 while the volume of interbank trade in foreign exchange was never more vigorous than last year – increasing by as much as 189%. Of course, we still have a long way to go to achieve a fully market-determined exchange rate, like for example Switzerland, but we are on the right track and we are getting there fast! We need a) a still deeper forex market, b) buyers and sellers who engage in forward trade and have abandoned the "euro costs what it costs" principle, c) exchange dealers who trade exclusively with banks. Moreover, after the first two weeks this year when, as we had expected, demand for foreign currency went up substantially, the NBS intervened in the Interbank Foreign Exchange Market session on one day only. Do we need another proof that the exchange rate is freely formed?

Last year's inflation of 6.5% in Serbia matches the level achieved by its neighbours. To illustrate, by applying the foreign exchange regime of the currency board, Bulgaria recorded 6.5% also, Bosnia 6.0%, while Hungary reached 6.5% and Romania 4.9%. Building on this, and primarily on the low inflation recorded in the final quarter of 2006, in 2007 the National Bank of Serbia will target the lower band of the 4-8% core inflation corridor, set already in August 2006.

Let us now note the role of the monetary policy. Last year was a key year for Serbia, as it was finally recognized that monetary policy represents a significant and powerful tool whose importance cannot be overstated! This is a very important point to make, especially in Serbia, where I can in all honesty say this is the first time a modern and proper monetary policy has been pursued! I find it quite normal and understandable that a person may come up to me in the streets of Čačak, Novi Sad or Belgrade and ask me why the National Bank of Serbia has only one objective and why this objective is "to achieve and maintain price stability" and not "to achieve growth and development, higher employment rates, exports, etc," or why it is that the NBS needs to sterilize excess money and how it finances this sterilization. But when such questions are raised by "economists" and "experts" – well, that is a cause for much concern! I get the feeling that these people are trying to ignore a very valuable experience from the 1970s and 1980s. Many experts seem to have slept through the past 20 years – but the economic science has been developing regardless! Experiences from that time were well summarized at a conference in Budapest about a month ago, on 19 January 2007, by Jacques de Larosière, former Managing Director of the IMF and EBRD President and former Governor of the Banque de France:

Stage one: Before the 1980s, governments were convinced that there was a trade off between “a little more inflation” and less unemployment. This policy eventually led to double digit inflation in advanced economies and galloping inflation in a number of developing countries. High inflation was finally recognized as inimical to growth and socially disruptive. In 1979-1980, the game of systematically seeking employment at the expense of price stability came to an end. The whole process had entailed high economic and social costs;

Stage two: In 1980s and 1990s, monetary policy managed to reduce inflation. Most central banks were gradually made independent from governments and acquired new credibility. This was the period of the triumph of central bankers. US inflation came down from 13% in 1979-1980 to 2.2% in 1999.”

Inflation has been a part of our lives for the last thirty years and it has become practically impossible to imagine living without it. It is always on our minds – when buying things or planning our future, when borrowing or giving presents – and it would feel strange not to count with the increase in prices! Because it has been with us for over 3 decades, an abnormal situation has become normal and it is now feels abnormal that there is no inflation. True, if there is inflation, it is easier to do the budgeting, to plan, to breathe, etc. because if your prices are changing all the time and your exchange rate is unstable, you will never really be comparable with the rest of the world, as today’s calculation will simply not apply tomorrow, let alone the day after. The same is true of my role as the NBS Governor: my job would be far easier if I chose to cover up my own and the institution’s inefficiency by means of inflation and currency depreciation. But times are changing, for, let me remind you, Serbia is still in the process of transition and it will take some time yet to complete! If nothing else, the stability of prices and currency has at least impelled many to come up with much more creative “explanations” for price rises. Only a year ago, the increase in prices of milk, cable TV and public transport services was blamed on the exchange rate…

In the course of the past year, the NBS created a stable economic environment and successfully slashed inflation, forcing the Government and policy makers to face the reality. And the reality is unyielding: inflation does not create jobs, it does not push GDP up, and, perhaps most importantly, inflation has not created welfare anywhere in the world! Is it then possible that, even after the devastating consequences of the 1992-1993 hyperinflation on the country’s economy, Serbia has still not grasped how damaging the effects of inflation can be?