Radovan Jelašić: Macroeconomic policy and export sector

Speech by Mr Radovan Jelašić, Governor of the National Bank of Serbia, a the First Summit of Serbian Exporters, Belgrade, 8 November 2007.

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Ladies and Gentlemen,

Recent debates on macroeconomic policy mainly focused on assessment of its export-related effects. Basically, macroeconomic policy incorporates monetary policy (MPC decisions related to interest rates) and fiscal policy (government decisions related to taxes and public spending). In my comments, I shall concentrate on monetary policy related issues (and defend our own back yard) first, because the NBS is responsible for implementation of monetary policy and second, because it is the monetary policy that has been the subject of numerous debates and criticism, especially by exporters. On this occasion, I wish to give out six main messages to exporters in order to differentiate what can from what cannot be accomplished for their purposes by monetary policy.

However, before I proceed, let me remind you of the events during last forty years in Yugoslavia, and subsequently in Serbia, when our currency was losing value almost on a daily basis resulting in an automatic growth in inflation, while exports were gradually, but inevitably, declining. Is there a lesson to be learned from those events, and who are those who have not had enough of that experiment?

My first message is in fact the answer to that question. I really think that there is no need for another déjà vu, another failed experiment. Unfortunately, not even forty years of failed experimentation are sufficient evidence to some that weak dinar cannot help support certain business activities and that the outcome is inevitable inflation and chaos, i.e. unpredictable and dangerous environment! The main role of **monetary policy is, first and foremost, to maintain stability of prices as stated explicitly in the Law on the National Bank of Serbia adopted in mid-2003**. There are at least two possible explanations as to why exactly is monetary policy expected to do just that. First, it has been widely accepted by economic theory and practice that monetary policy can not be employed to achieve either economic growth or sustainable growth in employment. It, however, can be employed to control movements in inflation. Second, low inflation is conducive to an improvement in exports sector. Why is it so? Because it helps improve competitiveness. However, appreciation of the exchange rate neutralizes positive effects of low inflation. What is the point then of low inflation? The point is that low inflation is beneficial to everybody, including exports sector, and such beneficial effect has two aspects. First, it increases efficiency of operations of economic entities. When inflation is low, changes in prices give an important signal to producers when taking decisions on what to produce, what to buy, how much to put aside for savings, etc. because changes in prices represent something concrete, a change in either demand or supply. On the other hand, when inflation is high, it is difficult to interpret changes in prices – we cannot know whether demand for such product is increasing or a change in price is actually a result of the general increase in prices. Investment decisions taken in the environment of low inflation are almost always better than those taken in the environment of high and variable inflation. For that particular reason, most economists believe that economies operating at a lower level of inflation have a higher average growth rate than those in which the rate of inflation is higher. Second, low inflation is beneficial to the exports sector as well as to the economy in general as it induces lowering of interest rates.

I can safely say today that, despite all the shocks to which our economy (and not only ours) is exposed, inflation is under control. Many may ask: If inflation is under control, why are interest rates still high in real terms? There is not much enthusiasm in Serbia today for saving money even though interest rates are quite high, but people are very enthusiastic when it comes to borrowing at such rates. Thus, regardless of the fact that we assess current interest rates as high in real terms, we borrow more and save less.

Therefore, my second message reads as follows: the best option for the NBS is to persist in its attempts to attain low and stable rate of inflation in order to ensure low interest rates in real terms.

But what about the exchange rate? Is it true that appreciation of the exchange rate keeps inflation under control by putting an enormous burden on the exports sector? I wish to underline that the monetary policy implemented by the NBS aimed to accomplish only the main objective which is defined by the law – „to achieve and maintain price stability“. During the period when we were raising the key policy rate because of increased inflationary pressures at end-August, we managed to strengthen the dinar. Tight monetary policy was indispensable in order to keep inflation within the announced target range, which in this year is closer to the lower bound of the projected range, and at the same time, making sure that we will stay on targets announced for the next year as well! However, we could not estimate the effect of tighter monetary policy on: (1) increase in interest rates, without affecting the exchange rate, or (2) appreciation of the exchange rate, without affecting interest rates, or (3) appreciation, if at the same time interest rates are declining, or (4) depreciation, if at the same time interest rates are increasing. The policy mix to be applied depends on the perception and reaction of many people, large number of economic entities in the country and abroad. Such fine tuning has proved to be too much even for the European Central Bank!

However, it is beyond doubt that appreciation of the exchange rate has reduced gross income of many exporters below the level that would otherwise have been achieved if there were no appreciation, assuming of course, that they have not protected themselves from currency risk by entering into forward trade agreements. At the same time, reduction in net income was much lower. The question is why is it so. Because strengthening of the dinar reduced not only gross income, but many costs as well – had there been no appreciation of the exchange rate for the dinar, price of fuel would have been much higher as well as the price of transport vehicles, transport services, computers and various chemicals, while wage levels would have been lower. Of course, in the short run, life would have been much less complicated to exporters if there were no appreciation of the exchange rate for the dinar. However, the following should also be taken into account:

- Inflation has been under control in the course of several recent years despite strong inflationary pressures, both external (drought, price of oil, etc.), and internal (increase in public spending and wages, credit expansion, still high inflation expectations, etc.);
- Combating strong inflationary pressures requires high interest rate in real terms, which affects the exchange rate, namely discrepancy of the real exchange rate from its equilibrium long-term level;
- Many countries were and still are faced with appreciation and what is happening to us is only part of the usual process – both in terms of duration and intensity.

It is also true that in the course of the last two years countries with currency board arrangements experienced almost 50% higher inflation and lower economic growth than countries that were implementing active monetary policy and the floating exchange rate (check what Jürgen Stark said on this issue). **For that particular reason my third message would be that the NBS has a limited impact on the real exchange rate in the longer run, and can have a significant influence only in the short run. Adoption of alternative exchange rate regimes cannot resolve the problem of the real exchange rate.**

It is, of course, my intention to also tackle on this occasion the other aspect of macroeconomic policy – fiscal policy. It deals with tax revenue which the state can extract from the economy and the amount of money it must spend. I do not wish to debate here the optimum size of the public sector, though it is only natural that I should have an opinion on that matter. I wish to underline, however, that changes in fiscal policy have very important implications on monetary policy, real interest rate and the real exchange rate as specified by the government in both the budget and the Memorandum on economic policy for 2008-2010.

Hence comes my fourth message that monetary policy can be applied to keep inflation under control at low and stable level, but how tight should such policy be to achieve its aim, depends to a large extent on fiscal policy, too. The increase in public spending that is not covered by an increase in regular public receipts, or a significant reduction in tax receipts without comparable reduction in public spending, shall have its implications on the level of interest rates and the exchange rate for the dinar. I think that many exporters are aware of the significance of this dependence.

My fifth message is that an exporter-friendly macroeconomic environment assumes low rate of inflation, gradual decrease in real interest rates and implementation of responsible fiscal policy. However, these can provide only indirect help in view of the reality facing the ever increasing number of exporters. The fact is that, in the longer run, world prices are falling in real terms. It is a long-term trend, of course, and has nothing to do with macroeconomic policy. Improvement in productivity, product quality adjustments to market requirements and better marketing are at least as important as macroeconomic policy. **These are the real challenges facing the exports sector worldwide!**

My sixth and final message is that the role of the NBS is not to hermetically isolate Serbia from exchange rate changes coming from abroad but to secure conditions that would protect the economy from such risks. The price of oil has been continually increasing since the beginning of the year, prices of metals are several times higher now than few years ago, electricity prices are three times higher now than on the onset of transition. “Market is merciless place and carries a lot of stress” said Alan Greenspan in his autobiography, as “each produces both winners and losers”. Are we fully market-oriented or are we still feeling nostalgic for various subsidies, incentives and agreements? Unfortunately, the market and the economy at large have no sympathy for our past or future challenges, Serbian market reacts like any other market in the world would!

Conclusions

I am aware that some of you and maybe even many of you – I sincerely hope not all of you – are disappointed since I can not promise a simple and fast solution in the form of stimulative, **adequate and stable exchange rate that would suit all exporters. Few days ago I discussed this topic with some economists and we remembered mistakes made when “monetary policy of associated labour” was implemented. Should we now invent “monetary policy of exporters”!?**

As for exchange rate fluctuations, they are simply a part of the regular market mechanism (oil, gold, dollar....). But, if these fluctuations are not to somebody’s liking, there is a solution! First, nowadays it is possible for exporters to fix several months in advance the exchange rate at which they will convert their export proceeds! By doing so they are protecting themselves from the strengthening of the dinar, but at the same time, they forsake the chance of profiting from possible weakening of the dinar. Of course, exporters may opt not to avail themselves of this chance and decide to gamble hoping for a much more favourable exchange rate in the future. They are free to make their own choices. What is important is to know that in such case they are assuming the whole of the foreign exchange risk as they have decided to step out of the body of their professional knowledge. Assumption of the foreign exchange risk by exporters is an example of irresponsible behaviour. It is a job of banks, just like payment operations, granting of credits, etc.

What about the real exchange rate trends? Real appreciation is something that many countries in the region and wider are currently faced with. It is quite possible that the exchange rate of RSD 77 for EUR1 is as unacceptable as RSD 83 or RSD 100 for EUR 1. None represents the equilibrium rate. But stronger dinar is an encouragement to exporters and forces them to restructure and specialize in exports of specific products which would reward them with a higher price (mark up). Stronger dinar also means easier restructuring, as import of high technology is cheaper and thereby more accessible.

Most often asked questions

I am sure some of you think that MPC members do not care much about exporters – I must prove you wrong. The real issue here, however, is something quite different. Can monetary policy help and what it is that monetary policy cannot do? Let me reply to three most often asked questions.

1. If the MPC were to relax its monetary policy and set higher target for inflation, would that help exporters?

   The answer is: No. The problem that many exporters are faced with is that prices of products and profit margins are too low relative to input costs which, to a certain extent, reflects the strength of the dinar. Higher inflation can induce an increase in prices of products but it would also induce higher costs as higher prices are the outcome of higher wages and higher costs of intermediate goods. High inflation in earlier years did not result in higher profitability of exports sector. Quite the contrary, it led to a cycle of „boom and crashes“ which made life much more difficult for exporters.

2. Would it help exporters if MPC were to set the target in respect of something else instead of inflation?

   The answer is: No. I hope that everybody now understands that the MPC sets the level of its key policy rate with respect to achieving core inflation within the 2-8% range. That should help anchor inflationary expectations. If the level of the key policy rate were specified with respect to achievement of some other objective, for example a certain level of the exchange rate, the rate of inflation would overshoot the target. Inflation expectations would increase, we would loose our anchor and we would be back battling inflationary cycles of the past.

3. Should the MPC try to depreciate the exchange rate for the dinar?

   The answer is again: No. The value of the dinar is determined in the market and reflects expectations with regard to future steps by the NBS. The only way the MPC could depreciate the exchange rate for the dinar is by giving up inflation targeting. Who can trust a central bank which erodes the value of its own currency and denounces its "main objective"? Let me remind you that currency depreciation increases exporters' income only if all else – all inputs needed to manufacture a product or render an export-oriented service, such as wages, energy prices, credits, intermediate goods, etc. – were to remain unchanged. And we all know, and our history confirms, that such a thing is impossible! In the light of our own and world experience, we in the NBS appeal to all of you to renounce taking drugs called inflation, to renounce short term effects, the so-called "better export performance" for the sake of long term sustainability and stability. By the way, if the exchange rate of the dinar were to be changed, would you, the exporters, be prepared to promise that you will achieve a significant increase in exports? Is the government prepared to promise to substantially cut public spending and not give in to the requests of trade unions regardless of the effects of depreciation? The answer is NO! We have already seen all of that and, in my view, transition is not going back to the past but a way to the future!

There is a latent pressure on the MPC members to involve themselves with current problems and to act fast. However, the task of the MPC is to look ahead into the future and to secure stability in the long run. The support for low inflation will weaken if it is based only on memories of consequences of high and unstable inflation of the past. There is a need for understanding of the essence of positive features of low inflation and long-term stability particularly by those who seem not to remember our inflationary past. Hence, the main task of the MPC is to explain the significance of stability of prices and to gradually shape public attitude towards low rate of inflation.