INTRODUCTORY NOTES

Central banks have never been more powerful as they are today. Monetary policy has become the primary instrument of macroeconomic stability, and in a growing number of countries monetary policy is in the hands of independent central banks.

Richard Layard, 2005

Central banks have monopolies on money issuing. Since money plays a great role in every country`s economy, the significant role of central banks arises naturally. A large number of individuals believe that economics is actually the study of money. Mervin King`s paradox shows that when price stability has been accepted as the main objective of a central bank, the focus on money decreased. During the period of „Great inflation", most economists ignored money although it was the culprit of inflation. The counterrevolution came in the late 1970`s with the concept that money has an effect on inflation in the long-term, but it does not affect economic performance volume, which brought money back to the focal study point. From the logical conclusion that money was the cause of inflation came the conclusion that money control is the way to control inflation, which consequently led to the popularity of monetary targeting. However, the process of reducing inflation was not painless, and the control of monetary aggregates proved to be very complicated. The more central banks were focused on price stability, the less attention was paid to the movement of monetary aggregates, and the monetary policy focus shifted towards regulating short-term interest rates. Such a strategy implies that a central bank regulates short rates of interest, and then economic subjects determine the money supply for the interest rate. Maybe the best description of this situation has been given by the former Governor of the Bank of Canada, Mr. G. Bouey: „*We didn`t abandon monetary aggregates, they abandoned us.*" However, this should not be regarded as a recommendation for central banks to ignore money, but as Mr. A. Chrystal (2003) pointed out:

„Inflation is inevitably about one thing: the value of money.“ The concept that has become more and more popular in the last few years is inflation targeting. It has raised many dilemmas and questions, such as whether the intermediary target is at the same time the ultimate objective, and whether this concept is based on a rule or discretion, and many others. Nevertheless, the number of countries that are accepting this concept has been continuously increasing and has often been included by the International Monetary Fund as a part of their recommendations.

The problem many central banks face is how to achieve the targeted inflation rate after an inflationary or a deflationary shock. Two main issues arise here: the problem that the knowledge of the channels through which monetary policy affects the real sector is imperfect and the speed, i.e. time lags of monetary policy are uncertain and volatile.

Many books and papers have been published on monetary policy and central banking. Some of them are more theoretical in analysing the effects of certain monetary policy measures and instruments in various hypothetical scenarios or in analysing different monetary policy regimes, while others are focused on certain central bank functions. However, there is practically no book that deals with all the activities a central bank performs and in which manner, or what problems it could encounter while trying to achieve its objectives. The aim of this book is to fill this void by pointing to all the functions a central bank carries out, as well as to the various modalities of central banking functions, providing numerous practical examples.

The book shows two dimensions: the theoretical, in which central bank operations are analysed from the theoretical aspect, and the empirical, which shows how the relevant functions are performed in some of the selected central banks. Therefore, the book contains many practical examples, charts, boxes, and the like. It also covers numerous findings, conclusions, and observations I have learned while working in the Central Bank of Montenegro.

The book is the result of my theoretical observations that I have come to while working at the Faculty of Economics and the Economic Institute in Belgrade. The practical dimension of the book is presented through my work at the Central Bank of Montenegro, as well as through specialised courses and visits to numerous reputable central banks, such as the FED, the European Central Bank, the Deutsche Bundesbank, the Swiss National Bank, the National Bank of Austria, and many others.

The book is comprised of four parts. The first part discusses the basic notions of central banking, such as its history, central bank objectives, governance, independence, transparency, responsibilities, and the like. The second part deals with the functions performed by a central bank, and the third analyses alternative monetary policy regimes that are at a central bank's disposal. The last part discusses the actual functioning of central banks in practise.

Professional books on economics are often incomprehensible to non-economists as they are full of professional terms, mathematical models which require an advanced knowledge of econometrics, as well as numerous assumptions of wide economic foreknowledge. What I tried to show with this book is that economic books can be written in a clear, simple, and comprehensible language that does not require so much foreknowledge of economics. I leave the readers to conclude whether I have succeeded in this intention.

In the end, it is very difficult to single out all those who have helped me during the writing of this book. I owe special thanks to the editors of this book, Professor Mr. Miomir Jakšić, the President of the Council of the Faculty of Economics in Belgrade, and Mr. Ljubiša Krgović, the President of the Central Bank of Montenegro Council. I also owe special thanks to the BIS Bank from Basel that allowed me to use and publish numerous data they had obtained in their research on central banking. Great help in the form of useful suggestions was provided by Mr. Goran Knežević, Mr. Pero Drakić, and Mr. Goran Bakić, as well as the Research and Statistics Department of the Central Bank of Montenegro that assisted me in the collection of data for this book.

N.F.