Inflation Targeting as Monetary Policy Strategy in View of Romania's Adopting Euro as National Currency

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Abstract: *On its way towards the European Union accession, Romania had undertaken a multitude of economic transformations that made the transit from the ineffective system of central planning to an institutional framework created to facilitate the functionality of a competitive market economy. Linked to these economic developments, the monetary authority represented by the National Bank of Romania chose some models of monetary policy in order to achieve its fundamental objectives: price stability and financial stability. Nowadays the monetary policy adopted is based on inflation targeting as a main frame of decision and action to reach the objective of adopting euro as national currency in Romania. This paper attempts to focus on the rationale behind the adoption of inflation targeting, the key features, the international experience and the prerequisites on this subject. As a conclusion there are presented the advantages of choosing this type of monetary policy on the further developments towards euro adopting in Romania.*

Keywords: inflation, monetary policy, exchange rate, Balassa-Samuelson effect

As a set of measures and tools used by the central bank in order to ensure that the legally provided objectives are achieved (under Law no. 312/2004 on the Statute of the National Bank of Romania, the fundamental objectives of the monetary authority are to ensure price stability and financial stability), the monetary policy is a part of the set of policies by which the economic evolution is influenced, along with the other types of policies: fiscal, budgetary and salary related.

On its way towards the European Union accession at January 1, 2007, Romania had undertaken a multitude of economic transformations that made the transit from the ineffective system of central planning to an institutional framework created to facilitate the functionality of a competitive market economy. Under these circumstances, the monetary policy framework represents the institutional system by which monetary policy decisions are made and implemented.

According to the social and economic evolutions of that time, the monetary authority represented by the National Bank of Romania approached a series of monetary policy strategies which, by specific use of monetary policy tools (interest rate, the policy of mandatory minimum reserve funds, open market policy) would lead to the achievement of its fundamental objectives.

The last decade of the 20 th century and the beginning of the 21 st century have been marked in the Romanian monetary policy by targeting monetary aggregates as basic strategy implying that in order to achieve the fundamental objective of prices stability an intermediary objective should be used, namely the control of monetary aggregates, by using the monetary basis as operational objective. This modality of implementing the monetary policy was adopted following the preeminence of the monetarist model in the economic thinking of that period.

In order for this monetary basis control policy to be efficient, it is necessary for two conditions to be complied with: the monetary authority should be effectively capable to set out the limits of its own primary currency creation and the multiplier making the connection between the monetary basis and the monetary mass in a larger sense should be a constant measure

Targeting monetary aggregates was applied in Romania in parallel with a strongly administered floating regime of the leu exchange rate, as this was necessary in order to achieve concordance between the objective of decreasing the inflation and the objective of maintaining the external deficit within sustainable limits.

In August 2005, the National Bank of Romania adopted a new monetary policy strategy – **direct inflation targeting**. An essential part in the functioning of this regime is played by anchoring inflation forecasts in the level of the inflation objective set out by the central bank and consequently by efficient communication with the population.

The rationale behind adopting this monetary policy model was a fundamental one, considering the specificity and actual stage of the Romanian economy, grounded on the following aspects: the firm commitment in supporting un-inflationist processes following European Union adhesion; the decreasing connection between the volume of monetary aggregates and the level of the inflation consequent to financial innovation and the increased gap between the real economy and the real one; the need of focusing all efforts rather on the inflation rate than on the intermediary targets and the fact that once the capital account is liberalized, the stability of the exchange rate could no longer represent a viable alternative, because the still high inflation and the Balassa-Samuelson effect could slow down the un-inflation process.

In the same time, the international experience and practice have proven the undeniable advantages of adopting this sort of strategy which, although initially undertaken by only some developed countries, has now been adopted by central banks in approximately 21 countries, and it has also proven to be an attractive alternative for emerging countries given the fact that by implementing such some important nation wide economic disequilibrium have been solved.

Regarding this answer, it is relevant to mention that the changes in the monetary policy occurring over two decades in the new member states of the European Union have been closely connected to the strategies shaped by the model named "the Washington Consensus" based on the simple principles of the market economy system: stability, privatization and liberalization. This type of policies was adopted especially in Central European countries recently coming out of communism and has been achieved by disciplined budgetary policies, commercial and fiscal liberalization, privatization of state owned companies and financial institutions, by de-regulation and monetary policies based on fixed currency exchange rates, which were favorable at that time in achieving prices stability.

Consequently, the financial crises faced worldwide – the one in Asia in 1997-1998 and the one in Russia in 1998 – proved that monetary policies based on exchange rate could not be effectively used in order to reduce inflation, as the decrease in the appreciation of the currency exchange rate led to increased current account deficits, which made it necessary for efficient monetary policy "anchors" to be searched for. Alternatives were limited to targeting monetary aggregates – as their increase could lead to the increase of inflation, to incomes targeting – which also led to the increase of inflation by nominal indexation of salaries and prices or to direct inflation targeting, objective which was actually decided upon, as it prevented both inflation increases and the danger of currency exchange rate appreciation.

In a general definition, inflation targeting represents a monetary policy framework created in order to achieve a predetermined inflation level. Inflation targeting combines two distinctive elements of successful monetary policy: a medium term inflation target on which inflationist expectations would depend and enough freedom of action within such policy for the purpose of attenuating the shocks over financial stability.

In this respect, grounded on the fundamental monetary policy objective, namely of ensuring and maintaining price stability, the National Bank of Romania grounded the strategy of inflation targeting by emphasizing the following as its main features: using the entire set of monetary policy tools in order to achieve the inflation objective; supporting a proactive monetary strategy grounded on communicating to the public the objectives, the decisions and reasons behind such monetary decisions, as well as afferent risks; increasing the efficiency of medium term monetary policy actions.

In order to perform this undertaking, a series of premises should exist, namely: annual inflation rate is expressed as having a decimal expressed value; by its Statute adopted by law, the National Bank of Romania is fully independent on a decisional and operational level; the Romanian financial sector is characterized by stability and robustness, nonetheless the financial intermediation level should increase; excessive taxation is no longer a threat; objectives regarding the level of inflation for the next years have been mutually agreed upon with the Government; the Romanian monetary authority has improved its forecasting capacity regarding the inflation evolutions; the successes in the un-inflationist process since the year 2000 have lead to increased credibility for the National Bank and for its actions.

Along with designing this strategy, the National Bank of Romania has also established that the inflationist target will be expressed based on the consume price index (CPI) and that such should be within the limits of a fluctuation interval of ± 1 percentage point. The annual inflation targets would be established for a larger time horizon (initially 2 years). Also, a flexible interpretation would be considered of the inflation rate objective, especially in respect to its consistency with the regime of the exchange rate flotation. The Governor of the National Bank of Romania, Correspondent Member of the Romanian Academy Mugur Isarescu said in his speech at the Royal Academy for Economic and Financial Sciences of Barcelona, at February 21, 2008 that: "the central bank should adjust its monetary policy tool, so that to stabilize inflation around the central target, without generating excessive fluctuations on the level of economic activity. […] In the formulation of Mervyn King, the "governors of central banks are not *obsessed* with inflation". The gradual approach determined by the concern for stabilizing the GDP deviance around its potential level is usually accompanied by the need of avoiding sudden evolutions of the interest rates […], as well as of the currency exchange rates, which could endanger the stability of financial markets and external equilibriums".

Thus, regarding the currency exchange policy, the main determinants will consist in: continuing the controlled flotation regime for the currency exchange rate considering that the market will have an increasing role in determining the exchange rate; the less frequent intervention of the central monetary authority, as well as unpredictability on a short term of the currency exchange rate for the purpose of discouraging speculative capital flows consequent to the liberalization of the capital account.

A particularly important aspect in applying the inflation targeting monetary policy is represented by creating a decisional framework adequate to such strategy, including the establishment and use of inflation measures that are relevant for the monetary policy decisions. On a general level, it is accepted that the consume price index – the indicator used by most central banks as a measure of inflation – reflects the impact of some factors of transitory nature, which can send false signals, making the decisional process more difficult on the level of monetary authority. On the level of the Romanian central monetary authority six core measures of the basic inflation have been analyzed, designed as those components which express the persistent sources of the inflationist pressures in an economy (three measures obtained by the method of excluding certain components from the consume prices index basket, ***optimal trimmed mean (19 percent), median*** and ***Edgeworth index***). All those measures present a more reduced volatility compared to total inflation, however the most representative measure of inflation, according to the tests performed in this paper, has proven to be ***trimmed mean 19 percent***. The inconvenient of using this measure arises from the complexity of the determination method, as such becomes inaccessible to the public. That is why, as mentioned above, the measure by which inflation will be expressed is the consume prices index (CPI).

The modality for reporting the level reached by inflation in Romania would represent the main tool of communication of the central bank with the public for the purpose of anchoring the inflationist expectations and that is why starting with August 2005 it was decided for such to be made on a trimester basis by means of a Report on inflation. The sections of this Report refer to: the assessment of the current economic developments; motivations grounding the monetary policy decisions made during that period; previsions of the Romanian Bank of Romania on the evolutions of the inflation rate for a time horizon of eight trimesters (3 years); emphasis on the uncertainty and risk associated to such predictions; implications over the future attitude regarding monetary policy measures.

By this, communication between the monetary authority in Romania and the public would be based on: a more transparent policy; official annunciation of adopting the inflation targeting regime, along with details on the inflation fluctuation limits etc; communication with the public based on publishing the trimester Reports on inflation and press conferences organized upon releasing such Reports; press releases regarding the meetings of the monetary policy Committee and its decisions.

The advantages of adopting the inflation targeting strategy as a strategy of monetary policy for Romania consist in: reduced contradictions on a temporal level by increased responsibility of the central bank in achieving its primordial objective – prices stability; applying a flexible and transparent policy which is operation even in case of instable relations between monetary aggregates and inflation; achieving an un-inflationist trend upon relatively minimum costs, of direct impact over inflationist expectations.

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