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Inflation Targeting-Fundamental Objective of the Monetary Policy of Romanian National Bank (BNR)

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Abstract

After the 80's, a lot of central banks have shifted from the evolution of the monetary aggregates towards inflation targeting, case in which have been eliminated the intermediate objectives of the monetary policy. Hereby, in the 90's, the growing preoccupation for ensuring price stability as a premise for long-term economic growth has materialized in the adoption of the central banks from many countries of a new monetary policy strategy. Direct inflation targeting

Initially, the strategy has been adopted by some countries with a developed economy. Direct inflation targeting has become after the crises from Latin America and Asia, an attractive alternative also for the emerging economies. Romania is the 22nd country that has adopted the direct inflation targeting strategy..

For now, NBR considers the inflation targeting as being the adequate medium-term monetary policy framework, leading in the same time at the increase of independence and credibility. This monetary policy strategy is applied in Romania starting from 2005, until, introducing the Exchange rate mechanism (ERM II) The exchange rate policy will still remain the controlled floating. Although the exchange rate will play a stronger role in reducing inflation, NBR has reduced its interventions, leaving the foreign currency market to find the equilibrium level for the exchange rate. After the moment of introducing the ERM II, the maintaining of the direct inflation targeting strategy is probable or is possible to pass at an exchange rate targeting strategy.

Keywords: *Monetary policy, the direct inflation targeting, open-market operations, Minimum Obligatory Reserves mechanism.*

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1. Introduction

In Romania, the long-term fundamental objective of the monetary policy of NBR has been represented by ensuring the price stability in order to contribute at the stability of the national currency. NBR has pursued the realization of this objective implicitly with the help of intermediary targets. Starting 2004, according to the new statute of NBR; the unique objective of the monetary policy is represented by ensuring and maintaining the price stability. On short-term, the Central Bank can establish intermediary objectives as *the monetary aggregates, interest rates and exchange rate*, so that these cand lead to reaching the objective of limiting the inflation. On long-term, the intermediate targets for monetary policy is represented by *maintaining the control on the monetary aggregates, maintaining the positive real interest rate, exchange rate predictions.*

The main intermediate target of the monetary policy in Romania has been constituted by the maintaing of the monetary aggregates as non-inflation targeter. Targeting the monetary aggregates has faced certain limits, pursuant to the instable relationship and difficulty of prediction between the monetary base and monetary mass, represented by the monetary multiplier. The connection between M2 and the inflation rate has presented the same characteristics. The money demand instability – accentuated by the recession of the financial non-mediation – and unpredictability evolution of the credit, monetary base and of the M2 have dimmed the role of the monetary aggregates in administrating the monetary policy. In these conditions, the exchange rate and interest rate of the Central Bank have become the best indicators for monetary policy decisions.

2. The Monetary Policy of National Bank of Romania: Evolutions and Perspectives

Starting from 1999, NBR has followed two objectives that have mutually potentated, namely a gradual non-inflation together with maintaining a sustainable external position, by using the exchange rate as nominal anchor. Starting July 2005, NBR has shifted from a monetary policy frame based on the exchange rate towads the direct inflation targeting.The modification of monetary policy implementation has been imposed due to the following economic causes:

- Continuous deduction of the annual inflation rate;
- Stimulate the expansion of the currency credits and relative decreasing the channel of monetary transmission of the interest rate as a result of a significant deceleration of the growth of the credits in lei.
- Amplify the currency market excess by increasing the autonomous capital inputs, together with the risk of progressive increasement of volatile potential capital inputs, on the basis of maintaining the high differential of the interest rate and of the appropriation of the liberalization moment of the

non-residence access to making term deposits in lei.

The monetary policy has pursued to reach in time an inflation rate and then of an interest structure on the monetay market compatible with the provisions of the Maastricht Treaty - the inflation rate has represented the essential objective of the monetary policy, and it's completion depended of the result of the policies ensemble followed by the Romanian authorities. Constructing the *operational framework*, NBR had in view the last period and the objective of its gradual harmonization with the ones of the ECB, so that the monetary policy instruments that NBR disposes are almost identical with the ones of ECB. The nature, functions, characteristics and efficiency in transmitting the monetary policy impulses of the instruments used by NBR are still partially different by those specific to the ECB instruments.

In the period 2000-2004, the instruments of the monetary policy have been developped to ensure an increased efficiency to the monetary policy depending on the increasement of the degree of compatibility with the market economy. For this purpose, it has been ensured the predominance of the *open-market operations* in administrating the liquidities and implementing the monetary policy to the detriment of the Minimum Obligatory Reserves that remains in the second plan. *The MOR mechanism* reflects the constraints to which has been and is submitted in the operational framework of the monetary policy in the last years. NBR has attributed to the MOR the functions of monetary control and liquidity management, the mechanism having the role of partially absorbing the structural excess of liquidity.

The *open-market operations* have represented the main instrument used by NBR for sterilizing the liquidity excess, an important share having the deposit withdrawal and public reverse-repos security operations. Credit and deposit facilities have been granted by the Central Bank, and the MOR has represented an active instrument. In 2003, the deposit drawn up has represented the only method used for liquidity excess absorption, and from 2004 NBR has acted at launching the deposit certificates. *Deposit attraction* with a month due date has continued to represent the most important monetary policy instrument, these representing approximately 90% from the medium daily flow of the sterilization operations.

The NBR' interventions on the currency market has constituted its main instrument of monetary creation. Although in the last period the exchange rate has substantially contributed at the inflation reduction, NBR has reduced its interventions on the currency market. The monetary policy framework of NBR has been determined by the interest rate policy, this is being used as a background for system liquidity excess sterilization, together with the administration instruments of the liquidities.

In the last period, NBR has counted also on the intense use of its *administrative instruments.* For decelerating the rapid expansion rhythm of the foreign exchange credits - considered to be a factor of excessive stimulation of an aggregate demand and, also a risk element in the financial stability – NBR has called again for *activating the MOR mechanism,* for provoking a relative increase of the foreign currency credit cost. Hereby, the MOR rate afferent to the foreign currency deposits has been increased for counteracting the worrying expansion of the foreign currency credit, while the MOR rate has been diminished in the first half of 2005 in order to encourage the credit given in the national currency.

3. Adopting the Direct Inflation Targeting Strategy in Romania

After the 80's, a lot of central banks have shifted from the evolution of the monetary aggregates towards inflation targeting, case in which have been eliminated the intermediate objectives of the monetary policy. Hereby, in the 90's, the growing preoccupation for ensuring price stability as a premise for long-term economic growth has materialized in the adoption of the central banks from many countries of a new monetary policy strategy. *Direct inflation targeting*

The direct inflation targeting strategy is characterized by the following *elements:*

- Assuming the unequivocal commitment for price stability as a main objective of the monetary policy and placing on a second base of the other objectives of economic policy (economic growth, external competitive growth
- Quantifying the objective of monetary policy under the form of an inflation rate which must be reached along a long time period (annual);
- Central Bank's independence regarding the used instruments in reaching the inflation rate, leading to a reduction of the role of intermediate targets;
- Transparency of the monetary policy strategy by public communication of the monetary policy objectives and decisions;
- Raising the responsibility of the Central Bank for reaching the inflation rate and assuming the failure in reaching the established targets;
- Dependence upon providing in good time of a complete set of information regarding the relevant macroeconomic variables (real, monetary, fiscal, external).

The *advantages* in using the inflation target as *nominal anchor* for the monetary policy are the following:

- the use of inflation target as a nominal anchor leads to the improvement of monetary policy discipline;
- limiting the dynamic inconsistency by growing the responsibility of the Central Bank towards accomplishing the fundamental objective for price stability;

- realizing some smaller inflation rate with smaller inflation expectancies;
- non-inflation with a relative price reduction;
- increase the understandment degree of the monetary policy towards the public;
- improving the degree of quantification of the monetary policy;
- transparent and flexible regime, operational even in the conditions of instability between monetary aggregates - inflation;
- transparency to growth leads to a coherent formulation of inflationary anticipations and increase the credibility of the Central Bank.

A regime of inflation targeting permits the monetary policy to concentrate upon aspects of the internal financial medium and respond better to the economic shocks. Initially, the strategy has been adopted by some countries with a developed economy. Direct inflation targeting has become after the crises from Latin America and Asia, an attractive alternative also for the emerging economies. Until the present, 21 countries have adopted the inflation targeting regime, even though have existed different technical details from one country to another. The pioneers have been New Zeeland (1990), Canada (1991), Chile (1991), Israel (1992), Great Britain (1992), Australia (1993), Sweden (1993), Finland, Spain, Brasil. Many of the inflation targeting procedures are present in the monetary policy of Germany and Switzerland. In Central and Eastern Europe, Czech Republic (1998), Poland (1999) and Hungary (2001) have adopted this system.

A common characteristic is that these countries have eliminated the disequilibrium from the economy before adopting the new monetary policy strategies, disposing of a solid fiscal position, a stable financial system and a reduced vulnerability towards foreign currency shocks. Direct inflation targeting can give results only for making some fine adjustments in relative equilibrated economies.

A direct inflation targeting system permits the monetary policy to concentrate on aspects of the internal financial medium and respond better to the economic shocks, NBR maneuvering the monetary policy instrument with the direct purpose of limiting the medium-term inflation. The proposed and accomplished objectives of NBR for 2005 consist of: liberating the capital account, official adoption of direct inflation targeting and national currency denomination.

The strategy adopted by the NBR has included up to this year elements as: orientation of the noninflation, exchange rate flexibility and the important role of monetary aggregates, which are found in a direct inflation targeting regime. The exchange rate has been used as nominal anchor for noninflation until November 2004, NBR following the inflation target and moderating the real effective appreciation of the leu currency. The intervention on the foreign currency market have been limited, NBR adopting the measure of prudent reduction of the monetary policy interest rate, feeling the implicit anti-inflational effects of the exchange rate. These objectives have facilitated the pass, from 2005, at the *inflation targeting strategy*, Romania completing the preconditions asked for implementing such a regime. Implementing the direct inflation targeting strategy creates a transparency degree of the monetary policy strategy by public communication of the objectives, adopted measures, determining rationality and its risks and uncertainties. Also, will lead to a medium-term increased efficiency of the monetary policy.

The transit to a new monetary policy strategy is not simple, and the success in obtaining the established objectives depend by the nature of the political and economic factors, and not in the end by the public support. The transit to the direct inflation targeting increases the public responsibility of NBR and obligates at a close co-operation between all the factors influencing the evolution of economic phenomena.

Romania is the 22nd country that has adopted the direct inflation targeting strategy. Inflation targeting means to previously bring this to an established and announced level, NBR having for this operation instruments as: reserve policy, exchange and interest rate. The intervention regime on the exchange rate should be maintained for a couple of years, even though the Central Bank has began the inflation targeting. When the inflation percentage will be of 2—3% the main instrument in reaching it will be the interest rate.

The NBR policy supposes the establishment of some annual inflation targets, that will be communicated by the Central Bank with an advance period of two years. The variation interval of the inflation level is established at ± 1 percentage point. Advance inflation targeting communication represents an act through which it increases the policy transparency practiced by NBR. NBR's interventions for straightening the exchange rate will be very rare, only in absolutely necessary situations, fact demonstrated from November 2004 when the monetary authority renounced at a strict control policy of the exchange rate of the national currency. So, the newness consists in the predictable character of the monetary policy and in its transparency, by publictating the estimations of NBR regarding the inflation for the next two years, together with an analysis presenting the risks and benefits. In the following years the floating regime of the exchange rate will continue, based on using some flexible parameters established starting from November 2004.

4. Conclusions

Inflation targeting process represent the passing from the monetary policy rules, characterized by a partial mobility of the capital and achoring the exchange rate at the rules of the new developing system, supposing a capital mobility, together with a clear inflation targeting. NBR has adopted a flexible inflation target, in which the monetary policy answers at the deviations from the established inflation target, intervening upon the exchange rate of the national currency. The second strict inflation targeting approach would lead to a free floating of the exchange rate of the national currency. The majority of the analists consider that Romania is not ready yet for a freefloating exchange rate regime, due to the current account deficit and risks regarding the fund entrance with a speculative character. As a consequence, NBR will operate any deviation of the established exchange rate of the inflation by two instruments: intervention upon the interest rate and rare interventions upon the exchange rate of the national currency. Although a strict inflation targeting, with a free exchange rate would bring benefits to the economy, is indicated so that NBR would accumulate some years of experience in inflation targeting before leaving the exchange rate to be free.

The inflation forecasts *are based* on the inflation econometric models or call for relevant indicators of the inflation *(leading indicators)* as are the following: interest, monetary mass, exchange rate, industrial production prices, salaries, etc. In Romania is difficil to construct a macroeconomic model that could establish sufficiently precise the correlations between the nominal and the real variables in order to permit the Central Bank to have a clear image about the efficiency of the transmitting mechanism of the monetary policy and its decisions upon the inflation. The unexistence of the viable information regarding inflation anticipations increases the risk that the inflation projections done by NBR could not materialize, finaly leading to missing the inflation targeting.

In a direct inflation targeting strategy, when the inflation projections digress from the established objective, the monetary policy reacts by using some anchors as interest rate, MOR, exchange rate. For now, NBR considers the inflation targeting as being the adequate medium-term monetary policy framework, leading in the same time at the increase of independence and credibility. This monetary policy strategy is applied in Romania starting from 2005, until, introducing the Exchange rate mechanism (ERM II) The exchange rate policy will still remain the controlled floating. Although the exchange rate will play a stronger role in reducing inflation, NBR has reduced its interventions, leaving the foreign currency market to find the equilibrium level for the exchange rate. After the moment of introducing the ERM II, the maintaining of the direct inflation targeting strategy is probable or is possible to pass at an exchange rate targeting strategy.

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