THE STRATEGY OF DIRECT INFLATION TARGETING: BETWEEN THEORY AND PRACTICE

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1. Introduction

In an interdependent global financial frame and with advanced incertitude, the ideal monetary policy should characterize itself by employment, dynamic consistency, transparency, responsibility assumption, quality assessment, avoiding excessive fluctuations and flexibility, sets of tasks which imply inevitably a certain degree of complexity. Also, central banks need to grant a special attention to the evolutions on financial markets, as a stable financial system is an essential precondition to insure an essential transmission and without monetary policy tensions, contributing in the last instance to the achievement of price stability objective on long terms.

The price stability consists in the fundamental objective of the monetary policy, as it contributes to the achievement of a substantial increase and to the macro-economic stability. According to the Economic and Monetary Union, „the main objective of the European System of Central Banks is the stability maintenance of the prices".

In order to achieve this objective, the central banks needs to promote a proactive attitude through a gradual introduction of some elements which define the targeting inflation regime:

- ✓ consequent following of the inflation target and relieving completely of monetary policy of sustenance of some other macroeconomic objectives;
- ✓ consolidation of central bank credibility through the avoidance of yearly adjustment of the inflation target initially notified;
- ✓ building up the central bank responsibility from the objective assumed through the publication of a report among the inflation which will include the prognosis of inflation.

The direct targeting regime of inflation includes the recognition of the importance of the inflationist phenomena in modern day economics and, by default, the fact that insurance of price stability represents the latest efficiencies of support route by monetary policy of the general goal of economic growth on long terms.

A targeting inflation regime allows the monetary policy to concentrate itself on the internal financial environment and to give a better response to the national economic shocks. The relation money – inflation is not the definitive element of the strategy of direct inflation targeting, but consist a favourable premise to a proper determination of monetary instruments for which the monetary authority chooses.

The strategy of direct inflation targeting presents the following definitive characteristics:

- ☞ unequivocal undertaking of the commitment from the price stability as a main objective of monetary policy and the placing of a secondary plan for the other traditional objectives (economic growth, external competitive growth, covering of fiscal deficits or decrease of unemployment);
- ☞ the transparency of monetary policy through pubic communications of

the objectives and decisions which refer to monetary policy;

☞ the responsibility growth of central bank for the inflation objective achievement;

☞ the dependence of supplying in real time of a complete set of information regarding relevant variables for all the four macroeconomic blocks (real, monetary, tax, external).

Relation between the stability of prices and the financial stability determine the inflation as being the main source of financial instability. Most of the severe financial instabilities and crisis to bank sector level have decided being with high rates periods of inflation or even advanced inflation, be it with marked intervals by the recession due to the adoption by the authorities of some inadequate measures of tempering of the inflationist phenomena.

The contemporary economic literature states out the fact that, achieving a low and stable level of inflation has the result to a new economic climate created, which needs the thorough reconsideration of the relation between prices and financial stability. However, it has been proved that a low level of inflation does not represent an efficient condition to insure financial stability on long terms[1].

2. Direct inflation targeting - theoretical aspects

In the last decades a new monetary policy strategy has taken shape and has the purpose to eliminate the intermediary targets of monetary policy: direct inflation targeting. **The direct inflation targeting** is linked to New Zeeland, which for the first time, has embraced such a strategy starting with the year 1988.

Direct inflation targeting represents that strategy of monetary policy which proposes the establishment of a target for the inflation rate level, on a certain amount of time, targeting which need to be achieved through the application of some measures of monetary policy, measures which need to insure the stability of prices (Sherwin [2000]). Even if the apparition of the concept initially started in the practical life, on the basis of the embracement of the respective strategy, it is embraced by more and more central banks.

So, Svensson[2] defines the inflation targeting through the terms of its characteristics:

- inflation targeting represents a numerical target, whether it's certain percentages which need to be insured with or without a tolerance interval, or about the stability of an interval in which the inflation is included. The numerical stability of the inflationist target is strictly linked to the price index which is taken into account; the experience of the countries which passed the inflation targeting showing the most frequent index used is the one of the consumer price index (CPI) (Sherwin [2000], Debelle [1997]).
- the decisional process at central bank level is based on a powerful independence regarding the embracement of monetary policy which can lead to inflationist targeting achievement;
- proposes a high degree of transparency and responsibility assuming for the achievement of inflation targeting.

Inflation targeting imposes at least 5 components based upon the insurance of its well implementation is done:

❖ price stability is the sole objective or main objective of monetary policy established whether by constitutional ways, or through the public engagement

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[1] Isărescu, M., *Monetary policy problems in an emerging country. Romanian Case*, Publications of The Royal Financial and Economic Sciences Academy, Barcelona, 2008

[2] SVENSSON, Lars E.O, *Inflation Targeting: Should It Be Modeled as an Instrument Rule or a Targeting Rule?,* Princeton University, December 2001.

of the central bank.

If we take into consideration the established monetary policy objectives during the inflation targeting regime, the main objective should be the goal of specified inflation rate (Debelle [1997]). The other objectives can be followed only if; through their elaboration the main objective goal is achieved. Yet many times the achievement of many monetary policy objective can generate „conflicts" between them, because the realisation of one can be done through unfulfilling the conditions of the other objective. These results two types of direct targeting strategy for the inflation: **strict targeting of the inflation**, case in which the central bank orientates its activity around the inflationist target which needs to be achieved and **flexible targeting of the inflation,** case in which the central bank takes into account other macroeconomic variables: the degree of occupation, the exchange flow, the level of economic growth. In this previous case, the central bank will follow, actually, a gradual deflation, which will not lead to real economic imbalance nor the external one (massive depreciation of own currency);

❖ this objective is quantified under an inflation rate which will be achieved in a certain amount of time;

❖ ensurance of central bank independence regarding the used instruments to achieve the stable level of inflation;

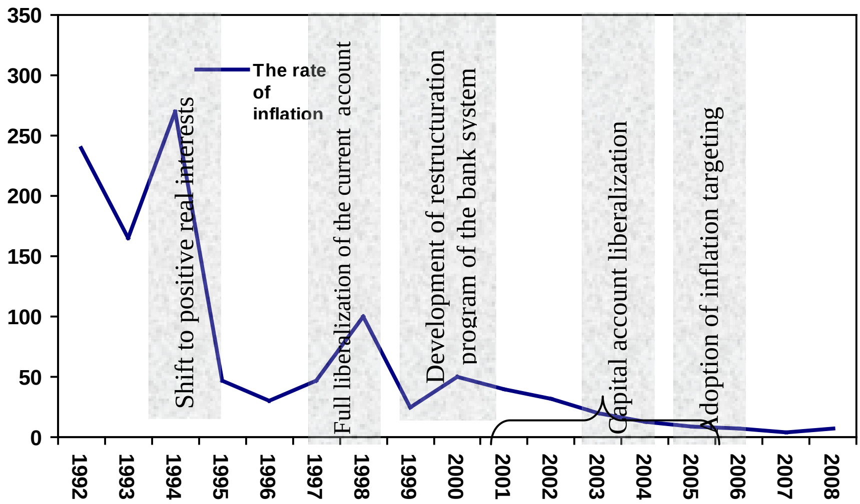
❖ elaboration and appliance of the monetary policy program in full transparent conditions;

❖ thus the monetary policy is more easily perceptible and understood by the wide public.

3. Direct inflation targeting in Romania

Romania has embraced a direct inflation targeting in the year 2005 due to some necessary insurance of a proper card implemented to this strategy (figure no. 1). In these conditions, we can say that the direct inflation targeting has become the way through which the central bank has tried to bring its contribution to the reduction effort of inflation to the levels from the countries of the European Union.

Figure no. 1 – The embraced measures by The National Bank of Romania to promote price stability



Source: information taken from reports supplied by NBR and National Institute of Statistics

Through the direct inflation targeting, National Bank of Romania (NBR) has assumed clearly the task to follow consequently the achievement of its objective fundamentally, the responsibility in the achievement of the inflation targeting being, hereinafter, more stated out, during the monetary transparency incensement.

The decision to embrace direct inflation targeting has been adopted after the specific preconditions of this change have been fulfilled, being recognised the fact that the efficiency of this strategy of monetary policy to depend on:

- the lowering of yearly inflation under the level of 10 %;
- accumulation of a win of credibility by the central bank;
- enforcing the jure independence and facto of NBR;
- restraining the tax domination, developing the tax consolidation process and lowering the coordination between tax and monetary policy;
- the relative flexibility of the exchange flow of the RON and the reduction of vulnerability degree of economy to this variable fluctuation;
- healing and enforcing the bank system and increasing the bank intermediation;
- increasing central bank transparency, as well as the area and the communication with the public by NBR and with financial markets, inclusively regarding the aspects referred to the new strategy of monetary policy and preparing to adopt it;
- clear shaping of macroeconomic components and the functioning mechanisms of the economy, necessary to identify and to increase the monetary transmission channels.

NBR Administration Council has decided to printout to this monetary policy strategy the following definitive characteristics:

- the expression of inflation targeting into headline inflation terms (the consumer index prices), taken into account that the public was familiarized with this indicator and the need to insure transparency and credibility to monetary policy decisions;
- the establishment of the target as a central point fitted by a variation interval (±1 percentage points);
- notification of some yearly targeting inflations for a longer horizon of time (2 years), which accentuates the necessary perspective on a medium term of monetary policy;
- continuing the practicability of controlled push-ups of the exchange flow;
- the stability and notification of inflation targeting by NBR together with the government.

And after adopting the strategy of direct inflation targeting, NBR has confronted with numerous problems, on one side, with the increase of inflationist pressures, and on the other side, with the amplification of volatile capitol enforcements as an effect to the liberation of the access to non-residences to the constitution of deposits in terms of RONs.

The inflationist pressures were fuelled simultaneously by the persistence of the request surplus, induced, mainly, by the relaxation of tax and salary policy, as well as powerful shocks of offer nature provoked by the substantial adjustment of administrated prices, but also by the actions of some natural factors (floods) and external ones (increase of petrol price on international markets).

Monetary policy interest is the main instrument used by NBR in the fight with inflation. In order to insure a proper finance of the Romanian economy also based on the amplification of international crisis, NBR has decided to reduce the monetary policy interest with 0,5 percentage points, from 10 to 9,5%, starting with 7th May 2009, in present the monetary policy interest being of 6,25%.

Another monetary policy instrument that NBR uses is standing facilities granted to credit institutions.

In the years 2006 and 2007 the facility of deposit was used more frequently in comparison with the credit one. In the period October 2008 – March 2009 (the hottest months of global financial crisis) credit facility was requested fully, the volume exceeding 173 billion leis.

NBR has increased in the year 2006 the reserve requirements rate both for passives in lei from 16% to 20%, and for cash deposits, from 35% to 40%, and the year 2007 these two rates were not been modified. The doubled rate for reserve requirements in cash is due to the more difficult process of monitoring and influencing of flows in cash from the ones in lei, ant the crediting in cash achieved impressive shares in our country.

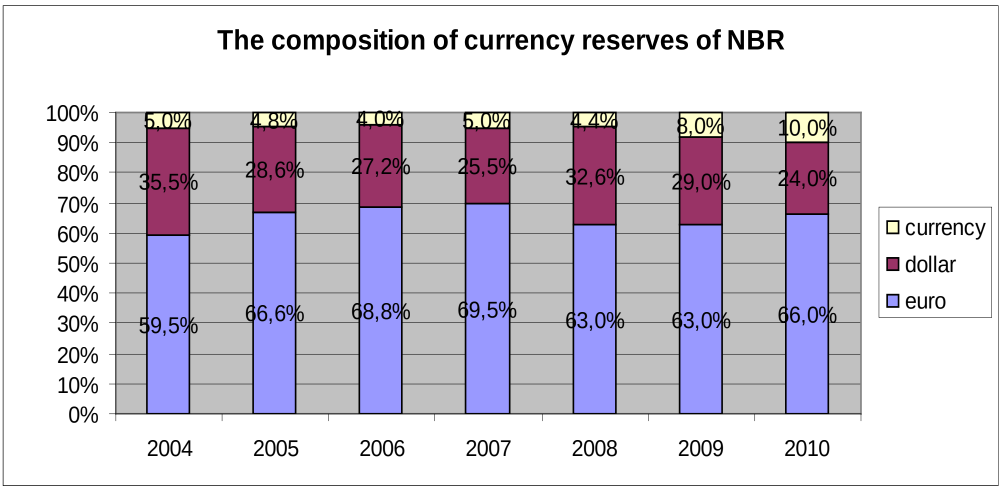
In the month of November 2008, NBR decided to reduce the reserve requirements rate to 18% for lei passives, and after that a new reduction has occurred in the month of July 2009 till the value of 15%. And for the passives with residual decrease smaller than 2 years the reserve requirements rate was reduced to 30% in August 2009 and starting with the date of 24th of May 2009 the the reserve requirements rate has become 0. This decision comes to harmonize NBR monetary policy with the one of European Central Bank (ECB).

Following monetary policy decisions at the end of the year 2010, the rate reserves from NBR were in amount of 32,4 billion euro, and increasing with 4,1 billion euro from the end of the year 2009, and with 6,2 billion euro from the end of the year 2008. If to this amount are added the counter value of the 103,7 tonnes of gold, respectively 3,5 billion euro, it is resulted that the total international reserves at 31.12.2010 were of 35,95 billion euro, and increasing with 5,1 billion euro in comparison with December 2009.

From the total reserve rate, the share of the reserves in euro were of 66%, percentage increasing easily from 2009, the dollar having a share of 24% comparatively with 29% with a year in advance.

As it is observed, the dollar share is at minimum in the last 7 years, time in which the euro share has varied between a minimum of 59,5% in 2004, and a maximum of 69,5% in 2007.

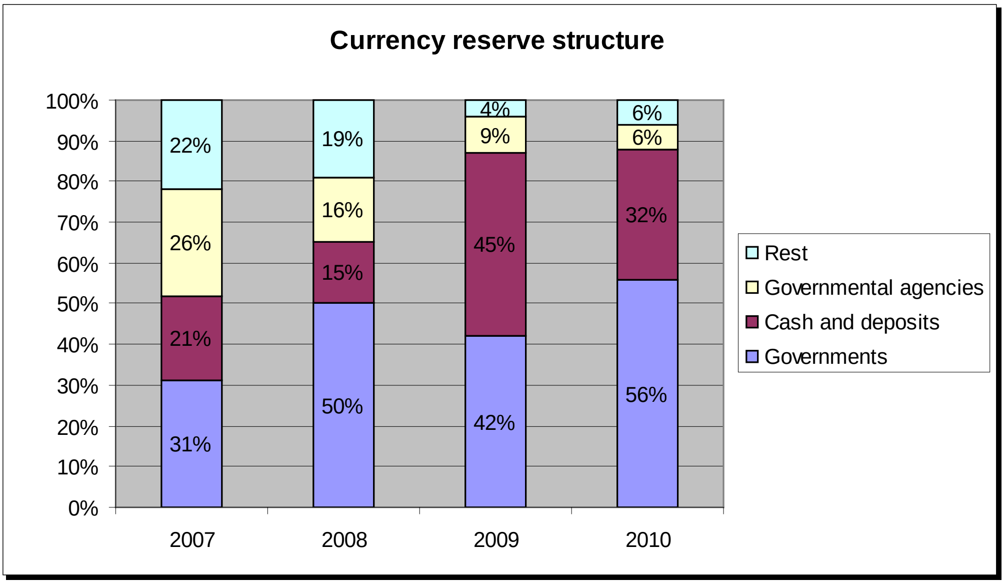
Figure no.2



Source: Processing after supplied information by the National Bank of Romania

From the total currency reserves, at 31.12.2010, a percentage of 32% was kept under cash form in deposits, the share obligations of the government being of 56%. As it is observed, in the above chart, in 2009, almost half of the reserve was kept under cash forms in deposits, percentage much higher than before the crisis. In other words, in 2009, NBR has liquidated a part of the investments considered to be risky, the paid price being the signifying reduction of yields. Although, the purpose of NBR is not the one to maximise the yields, but to obtain a better yield due to conditions of a decreased risk kept.

Figure no. 3



Source: Processing after supplied information by the National Bank of Romania

4. Conclusions

NBR will continue to monitor carefully the internal evolutions of the global economy, thus, through its adequacy of instruments, to insure the established goal achievements of prices and financial stability, in the content of established commitments realisation with the European Union, the International Monetary Fund and other international financial institutions.

Although the inflation has dropped gradually, the major vulnerabilities still persist: external balance deficit has reached a critical level, the volatility of the exchange rate creates a incertitude state, which can affect, dangerously, the financial system and can accentuate macroeconomic imbalances, plus, the process of disinflation is not consolidated. Also, the rate of inflation targeting by the National Bank of Romania rise serious credibility issues for it. In this purpose, we consider an opportune time to review the prognosis pattern used by the central bank and its correlation with the current economic situation.

I consider that an austere attitude of the tax policy and incomes, which can concretizes in the substantial reduction of budgetary deficit and by default of the deficit between the economy and investments, represents the essential condition in the minimization of economic costs and social ones in an averse global investment contexts, marked by a severe and prolonged economic and financial crisis.

Also, I appreciate that the monetary policy needs the support of the other policy, especially the tax policy and incomes as well, which need to be prudent and not pro-cyclical. I sustain the opinion whereas this monetary policy rules adopted (in certain sense, the inflation targeting is such a normative) and should be followed by a tax legislation.

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