A BRIEF EVALUATION OF INFLATION TARGETING IN ROMANIA ENVISAGING THE EURO ADOPTION*

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Abstract: This paper aims to present a clear, pertinent and realistic description of the actual results and perspectives of the application of inflation targeting in Romania, in the context of two major events – the financial crises and the Euro adoption process.
The paper is structured based on the following elements: - the implementation of the inflation targeting monetary strategy – arguments, advantages, technical elements; -the institutional changes; - the decisional and operational framework of the monetary policy; - a brief assessments of the results of implementing the new monetary policy strategy – inflation targeting.

JEL classification: E52, E58, F33,

Key words: monetary policy, inflation targeting euro, monetary convergence

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1. INTRODUCTION

The Romanian National Bank officially adopted the inflation targeting monetary strategy in august 2005. This is considered by litearture as a flexible framework capable to offer the Central Bank a „constricted discretionarism" in performing a role where the nominal anchor is the inflation target. Also, this has been seen as the strategy where the monetary policy is connected to the long and medium time horizon without siminishing its ability of reacting to short term developments. Thus, inflation achieves a conciliation between the responsability imposed by the reigide rules, on one and, and the flexibility allowed by the discretionary aproach, on the other hand. These are the essential hypothesis of the Romanian National Bank in instating and applying the actual monetary policy strategy. vThe choice and guiding of the monetary policy regime depends on few basic principles. Two of these principles refer to money neutrality and, further more to the independence in policy making decisions. The core concept launched by Friedman (1968) is that, on a long term, there is no compromise between inflation and un-employment, due to the fact that money is neutral. The second principle states the fact that monetary policy strategy and management could, on the other hand, exploit the inverse short term relation between the inflation rate and the un-employment rate. These are the basic priciples apliable by any national bank. Further constraints for Romania come from the EMU enlargement process under the restrictions of the „no-opt-out clause”, and the recent economic and financial crises. The questiones raised by this study is whether the monetary regime choice is performing, not only under normal economic circumstances, but also under the monetary preasures of the crises.

2. Analysis

From the EMU enlargement point of view, the choice of the monetary regime has been free as long as convergence is considered an aim for monetary evolutions. At the same time, the Euro accession timetable is envisaged due to the evolution in the fulfilment of the convergence criteria. Aspiring EMU candidates have used very different monetary and exchange rate regimes, covering practically the whole spectrum from rigidly fixed to free floating exchange rate arrangements, from currency boards to inflation targetting. Among the Central and East European accession candidates, three have a currency board (Bulgaria and Estonia with respect to the euro, Lithuania originally with respect to the USD, changed to the euro on February 2, 2002), Latvia has a conventional fixed exchange rate regime with a peg, Hungary a target zone with a central rate fixed against the euro and a 15% fluctuation band plus an inflation target. The remaining five countries have a managed float. Managed floats cover a wide spectrum of possibilities as regards the ultimate nominal anchor. Among the five managed floaters, the Slovak Republic has a core inflation target, Poland and the Czech Republic have headline inflation targets. The Romanian central bank had price stability as its primary mandate, and has converted it into an inflation target.

Since 2005 the Romanian National Bank chose the inflation targeting as strategy of the monetary policy after several years of targeting monetary aggregates.

The broadest definition of inflation targeting is a monetary policy framework that accords overriding importance to the maintenance of price stability. The narrower definition says that inflation targeting is a monetary policy framework based on the adoption of a monetary policy rule in which forecasts of future inflation play a central role, either in the form of instrument rules or of target rules. An instrument rule expresses the monetary policy instrument as a simple and usually linear function of deviation of a few key macroeconomic variables from their target level. A target rule expresses the monetary policy instrument as the solution to an optimization problem defined by a loss function describing the costs associated with deviations of specific goal variables from their target levels subject to the constraints imposed by the model of the economy’s structure (Daianu 2008).

The strongest logic of the inflation targeting regime is that under some reasonable conditions stabilization of prices is equivalent to the stabilization of output around its natural level – that is, the level of output that would prevail if there were no nominal rigidities (Blanchard, 2003). Nevertheless, inflation targeting is faced with several restrictions. At least three of them have been depicted from specialized literature, and treated as basic assumptions (Daianu 2008).

The first one is according to Aoki (2001) is the assumption of no schocks that would require the relative price of any good to vary over time in an efficient equilibrium. Price stability maintenance is not optimal under the conditions of relative price change in an efficient resource allocation due to asymmetric shock effects.

The second one, comes from the sticky price area (Christiano et al., 2001), but refering to the flexibility of wages. In real economy, that might not be valid, due to the fact that if both wages and prices are sticky with price stabilization, the real wage will be frequently misaligned, as will be the relative wages of different types of labor if these are not set in perfect synchronization.

The third assumption is the lack of market power and distorting taxes, meaning, as a consequence, that it will not be possible to simultaneously stabilize inflation and the welfare relevant output gap (Daianu 2008).

All these strengthen the controversy around inflation targeting as the ideal monetary policy strategy. Even as far as price stability is concerned there are no success guarantees for neither of the options. Close attention and good track of actual economic conditions could provide a correct and suitable connection to monetary aims.

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One certain aspect is that, as previously demonstrated by other central and eastern European countries implementing inflation targeting, this choice moves inflation expectations down gradually. Also, during last few years since its implementation and to the economic crises, inflation targetting has provided a smooth transition, even disinflationary. Implementing inflation targeting is a rather challenging job and requires a very solid approach and understanding of the monetary policy transmission mechanism based on the monetary structure of an economy. The monetary economy in Romania has been characterized by certain features of its main components:

- The banking sector holds a rater low rate of the GDP compared to other economies even if it ranges beyond 50% of GDP; there a few large banks operating and thus, their market power actions in a different direction upon the monetary power of the NBR over the banking liquidity. This is rather an oligopoly state for the Romanian Banking system.
- The level of monetization has been low, both before and during the financial crises
- An increasing euroization of the Romanian economy due to the eve-lasting inflationary issue in Romania. Recent literature on financial crises focuses on the other side of private agents' balance sheets and puts forward financial risks associated with liability dollarization, for example a situation where private and public debts are denominated in a foreign currency. As compared to currency substitution (asset dollarization), this is quite a

different perspective on dollarization (euroization) and must be explicitly dealt with (Reinhart et al., 2003). Various risks indeed may be connected to a significant dollar debt, in particular if the international value of the local currency can slide down. (Daianu 2008).

- The illegal sector is yet another constraint of the monetary policy choice regime for Romania due to the lack of control power. The larger the so-called "informal sector" the larger the money demand.
- Literature has denominated the size of the economy as another element to be considering when discussing monetary regimes. Romania is a rather small economy, an open one, where the exchange rate is by far the most important channel for monetary policy transmission. The openness degree depicted in the share of trade in the GDP has ranged from around 28% to 40% with certain variation from the beginning of the economic crises.
- Timing of the capital account liberalization – which the NBR has been forced to postpone due to the fact that a premature opening of the capital account could translate into a financial turmoil if other macroeconomic criteria are not met first (Daianu and Vranceanu, 2003). That turn has been even though taken and capital account liberalization and significant capital inflows further potentiated the effects of the economic crises.

Policy regime choices & constraints for Romania could have been resumed as following (According to the National Bank of Romania):

- The need for further sustainable disinflation, including from EU convergence perspective; move from 8.5% to around 2-3% difficult, fraught with costs (non-linear sacrifice ratio, etc.)
- Status quo (mix of monetary targeting with exchange rate interventions) no longer appropriate: weakening relationship between monetary aggregates and inflation
- Exchange-rate peg based regime highly risky in light of convergence induced appreciation trend, move towards full capital mobility
- Inflation targeting provides CB transparency & accountability, constrained discretion, should help anchor expectations, dominates above options in terms of robustness to shocks; but requires time for full effectiveness

As these and other more represent the constrains for Romania in dealing with inflation targeting regime,

The final choice in inflation targeting regime in Romania has the folowing features (according to the NBR):

- CPI-based inflation target
- Target set as a midpoint within a band of ±1 percentage points- annual targets set for a longer time horizon (initially 2 years)
- Flexible interpretation of inflation targeting (mainly its co-existence with managed float)
- Joint announcement of inflation targets by the NBR and the government

NBR pro-active stance & transparency: decisions based on 8 quarters ahead inflation forecasts, detailed risk analysis in quarterly inflation reports, pre-announced policy meetings followed by statements, analyst meetings, press conferences.

In terms of actual performance of inflation targeting regime in Romania, data provided by the National Bank of Romania concerning inflation evolution and forecast represent a starting point for discussion.

At end-2009, the 12-month CPI inflation rate went down to 4.74 percent, i.e. 0.24 percentage points above the upper limit of the 3.5±1 percent variation band and 0.2 percentage points below the September reading of 4.94 percent. The persistent negative GDP gap and the leu exchange rate dynamics were conducive to the decline in consumer price inflation. Nevertheless, their contribution was largely offset by the adverse impact of supply-side factors, and particularly by the hikes in excise duties on tobacco products. Throughout 2009, the prices of tobacco products contributed by more than one third to the annual expansion in consumer prices, following the successive increases in excise duties. In 2009 Q4, the rapid rise in such prices was generated by producers' earlier incorporation into prices of the new exchange rate that was to be used, starting January 2010, for calculating excise duties (the increase in the EUR-denominated excise duty is estimated to be incorporated in consumer prices at the beginning of 2010). By contrast, the annual dynamics of adjusted CORE2 inflation, which responds more accurately to aggregate demand management, decreased September through December 2009 by 1.4 percentage points to 2.8 percent2. Behind the deceleration in adjusted CORE2 inflation stood the disinflationary pressures arising from falling demand, softer depreciation of the domestic currency in annual terms, absence of negative supply-side shocks from the agricultural sector in 2009 and diminishing inflationary pressures from wage costs. (NBR - Inflation Report , February 2010).

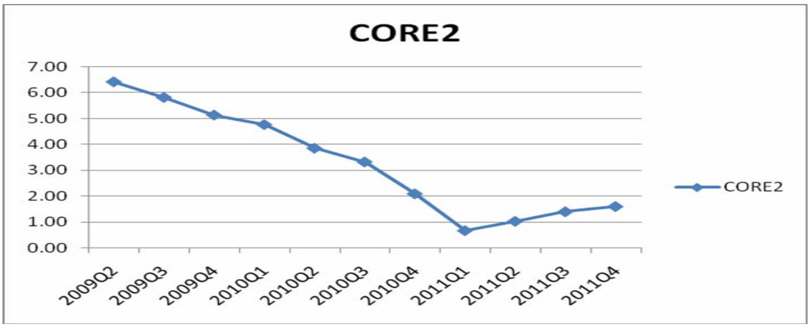

Chart no.1.

CORE2 Annual inflation (procentage change)

For 2011, the current projection anticipates a consumer price inflation trajectory largely in line with that presented in the previous Inflation Report. A marginally unfavorable contribution will be generated towards the end of the projection horizon by the incorporation of higher increases in administered prices into the current baseline scenario. (NBR - Inflation Report , February 2010).

Actually, the major challenge is to both settle the need to consolidate disinflation and, on the other hand, to limit the actual ever-growing budget deficit. Once the capital acount has been opened, this task becomes even more difficult. Even if the actual one is not an acurately tailored one, a real reforme of public expenditure is necessaryand mush needed by the monetary economy in Romania, and by the economy as a whole. This would help settleing the confrontation between a restrictive monetary policy and the budget deficit. The policy-mix including the monetary policy, the budget policy and furthermore should also be able to overcome the international financial crisis. These financial turbulences ask for more prudence on the part of national policy makers, especially where external deficits are pretty large and inflation is still high.

Romanian budget policy would be imprudent were it to target larger budget deficits in the years to come –under the circumstances of still strong tensions on world financial markets.

One must not forget, once more, of the restrictions imposed by the multilateral external financing arrangement signed by Romania with the EU, the IMF and other international financial institutions, on the one hand, and the absence of any significant deviations from the forecast assumptions regarding the impact of exogenous factors and external developments, on the other hand.

3. CONCLUSIONS

No monetary policy choice guarantees success or the fulfillment of monetary objectives unless correctly implemented and timed, according to the structure of the monetary economy. Romania's actual inflation targeting monetary strategies has performed rather well on a monetary level, anyway better than the rest of the economic policies. The economic and financial crisis has pointed out the vulnerabilities of the Romanian economy, and of the monetary side in particular. Even more challenges are to come as part of the external financing granted to Romania by the IMF and other monetary institutions envisaging supporting the budget deficit. These financial turbulences ask for more prudence on the part of national policy makers, especially where external deficits are pretty large and inflation is still high. The monetary policy stance is expected to remain prudent, aiming to avoid potential second-round effects of adverse exogenous shocks expected for 2010 Q1. Even more, a balanced adjustment of real monetary conditions is needed in order to stabilize inflation around the initial targets and also to support lending.

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