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DIRECT INFLATION TARGETING IN ROMANIA

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Abstract: *The article proposes to offer a clear and suggestive image of the stage the economy of Romania is from the prospective of the policy of direct inflation targeting, to outline the main achievements of the Romanian economy and to emphasize the unbalances existing at the macroeconomic level, by studying the interaction between the National Bank and the private sector, offering solutions concerning economic stability. In the context of an unstable economic environment, one of the reasons for choosing this theme is the need to understand and acquire the mechanisms related to monetary and fiscal policy measures to be taken to ensure price stability. The subject proposed is framing into an extremely actual field of research and with large perspective of analysis in the future too, regarding the role that National Bank plays in keeping the inflation under control and implicitly in assuring the macroeconomic balance.*

Key words: direct inflation targeting, monetary policy, macroeconomic equilibrium

1. INTRODUCTION

In the last decade, the problem facing the world economy was the generalized increase in prices, which generated pressures in the plan of monetary. This imbalance affects economically powerful private sector decisions regarding investments, savings and even increasing production, the final effect materialized as reducing production levels. This is why, in recent years economies have shifted towards achieving macroeconomic fundamental objective of macroeconomic policy represented by price stability.

This objective can be based on different strategies of monetary policy strategy as highlighting their contribution to creating favorable conditions for reducing inflation and ensuring financial stability.

The paper is organized as follows:

First paragraph include theoretical monetary policies, the 2nd one presents aspects of the literature on the stability of inflation and monetary policy strategies, 3rd paragraph presents the main macroeconomic developments in Romania during 1990-2010 and into the 4th paragraph we present conclusions derived from synthesizing information presented in this paper.

2. LITERATURE SURVEY

The ultimate objective of macroeconomic policy and hence monetary policy is the price stability. This objective can be based on various monetary policy strategies, strategies that are geared towards the establishment of intermediate objectives: monetary aggregates targeting (such as monetary base, M1, M2 or M3) or exchange rate targeting.

These intermediate targets are links between the actions performed by the operational tools of monetary policy and the real economic activity and inflation. Regarding the use of monetary aggregates as intermediate target of monetary policy, they require the application of restrictive monetary policy to consider controlling the growth rate of monetary aggregates in order to eliminate excess liquidity in the economy.

With the adoption is going on based on targeting the exchange rate regime, the central bank tries to ensure the nominal exchange rate stability through the use of its instruments aimed, on the one hand, changes in interest rates, and secondly based on direct interventions on the FOREX market interventions designed to support the exchange rate.

The theoretical and practical debates in recent years, inflation targeting monetary policy strategy that has proved most effective strategy in achieving the ultimate objective of monetary policy. This approach requires a commitment that inflation targeting is the main objective and mission of the institution.

The concept emerged from the theoretical point of view through the '80s and the first country to implement this scheme was New Zealand. Widely used in industrialized countries in the 90s, the strategy of direct inflation targeting became an attractive alternative for emerging economies.

Strict inflation targeting implies that the central bank pursues the objective of minimizing inflation and inflation deviation from target only, without taking into account the effects this may have on gross domestic product and economic growth.

Inflation targeting strategy has the following defining characteristics:

- Price stability (understood in the form of low and stable inflation rates) as a single objective or priority of monetary policy either by constitutional or by public commitment of monetary authorities.

-Quantifying the objective of monetary policy as inflation rate to be achieved over a time interval, the target being set by government and empowered the central bank, established jointly or independently indicated by the monetary authority.

-Central-bank independence in the instruments used to achieve the targeted rate of inflation, implying a greater degree of central bank independence in monetary policy management

-Transparency and accountability of the central bank configuration process development and implementation of monetary policy

Romania has adopted an explicit monetary policy of inflation targeting in August 2005. Popa and Isarescu (2005)[1] underlines the fact the requirements and criteria which condition the effectiveness of this strategy are satisfied:

- bringing the annual inflation rate to single-digit levels;
- earning and strengthening central bank credibility;
- a relatively more flexible exchange rate of the domestic currency and diminishing the Romanian economy's vulnerability to exchange rate movements;
- the soundness and strengthening of the banking system and a relatively higher degree of banking mediation;
- greater transparency and accountability of the central bank and more effective communication with the public and financial markets, including the presentation of various aspects related to the inflation targeting approach and the preparatory steps for its adoption;
- better insight into macroeconomic behavior patterns and economic mechanisms in order to identify and enhance the effectiveness of monetary policy transmission channels

National Bank of Romania considers that inflation targeting strategy is appropriate macroeconomic conditions that are Romania. Father points out that the criteria were satisfied and that makes the effectiveness of

[1] Isarescu. M., Preparations and Prerequisites for the Introduction of Inflation Targeting in Romania, Conference “Inflation Targeting: International Experience and Romania’s Prospects”, Bucharest, 2005

this strategy: lowering the annual inflation rate below 10 percent, the relative flexibility of leu exchange rate and reducing the vulnerability of the economy to fluctuations in this variable; clearer shape macroeconomic behavior and functioning of economic mechanisms necessary to identify and increase the efficiency of monetary transmission channels.

Constantinescu C. (2007) presents six basic inflation measures (core measures), built as being those components expressing the persistent sources of the inflationary pressures in an economy (three measures obtained by the method of exclusion of certain components from the Consumer Price Index Basket, trimmed mean optimum (19 per cent), median and Edgeworth index). All these measures present a lower volatility in comparison with the total inflation, but the most representative inflation measure, according to the tests carried out in this work, was proven to be the 19% trimmed mean. The inconvenient of using this measure is however given buy the complexity of the determination method, becoming difficult to be accessed by the large public.

Aristide O.[2](2007) carries out an empirical assessment of the following aspects: determinants of the salaries evolution, interdependence among the salaries in the private and public sector and the incidence of the labour force cost upon the inflation and commercial deficit. The results presented show that despite the high increase rate of salaries in the economy coexisted with a sustained process of disinflation, these increases involved however macroeconomic costs. For the entire period, the empiric analysis of the impact of gross salaries upon the inflation and the commercial deficit emphasizes that these exercised an influence on both variables, the appreciation of the exchange rate being the one determining the occurrence of more visible effects upon the commercial deficit, at the same time improving the negative effect upon the inflation.

Isărescu (2008)[3] the need of approaching of a flexible manner the inflation targeting, having in view the following aspects: perspective of a feasible disinflationary trajectory on medium term; sustainability of the disinflationary earnings achieved; accentuating upon the risk management at macroeconomic level and of the financial stability when implementing inflation targeting; avoiding worsening the existing unbalances without transforming the related macroeconomic variables in monetary policy targets; monitoring the effective fastening of the inflationary anticipations without changing the disinflationary trajectory announced; the role needed played by the other components of the policies mix in managing the aggregate request and assuring the macroeconomic stability.

Thus, a sub-optimum combination existing in the last few years (a lax budgetary and salary policies, or a very "tighten" monetary policy, respectively) will be possible to be replaced with an optimum combination where all the policies (budgetary, salary and monetary) have a similar restriction degree and to straighten the economic activity towards work and productivity. The enhanced restrictiveness of the monetary policy cant compensate on short term the lack of support of the structural reforms, of the fiscal – budgetary policy and of the income policy only, and the situation resulting would be sub-

[2] Aristide O- Occasional Paper no.24 , BNR, December 2007

[3] Isărescu M. "Evolutions and Challenges. Monetary Policy in the new Global Economic Context", The Seminar on Monetary Policy ,April 2008

optimum from the perspective of the real convergence. The fiscal-budgetary policy holds a key-role in assuring keeping the external unbalance at a sustainable level. It is also recommended, according to his assertion, to restrain the public sector, in order to offer a more extended handling space to the private sector, avoiding thus a pro-cyclic conduit also. At the same time, the policy of revenues must remain cautious from similar considerations and to transmit not improper signals for setting up the salaries in private sector.

The important role of the direct inflation targeting policy in keeping the economic stability is underlined by Patrik Artu (2008) that suggest the combat against inflation is efficient, under the conditions of globalization, by a coordination of the Central Banks actions.

The global financial crisis implies new approaches of the direct inflation targeting policy.

Dăianu (2008) asserts that at the origin of the crisis one can count also the finding that one did not learn enough from the crisis episodes of the last two decades: and these crises were exulting periods, of massive (forming the so-called "bubbles"), of relaxing cautiousness and greedy standards without measure.. These warning regarded especially a certain type of financial innovations- on the ground of loans securing (that is their transforming in transactional bonds) – creating a huge uncertainty and accentuated the systemic risks. „The causes of the financial crisis are deeper" appreciates Isărescu (2009), they being „both of macroeconomic and of microeconomic type". These two types of causes inter-conditioned the start of crisis. The deep cause of the financial crisis was the plentiful liquidity created by the main central banks of the world (FED, BOJ) and the desire of the petrol and gas exporting countries of limiting the appreciation of the currency.

In the context of the actual crisis, Isărescu (2009) draws the attention upon the occurrence of the delicate problem of the compromise between the objectives of the monetary policy: assuring monetary stability and assuring financial stability. The experience of Romania shows that financial stability presents a special importance for the prices stability. With good reason, Romania was criticized for delays in disinflation. These were due to insufficient structural reforms. Our country achieved a 5.8% average rate of disinflation during 2000-2007, in parallel with keeping the stability of the financial system. If the National Bank of Romania (BNR) would replace this deficit of reforms by more abrupt increases of the interest rate, the financial status of the companies and of the households had been deteriorated. Thus, the financial stability of the banking sector would be deteriorated. At the end, the rhythm of disinflation itself would probably have been lowest than the achieved one. The lesson to be learn is therefore, on long term, the inability of keeping financial stability can lead only to a re-inflammation of the inflation (Isărescu, 2009). Concluding, we can affirm that an accurate macroeconomic diagnosis is needed – an emotional approach of the crisis may lead to proper measures given the increase of the non-guaranteed stimuli in the internal demand. A mix of coherent policy is essential for a calm restoration of the macroeconomic balance. Romania must maintain its calendar announced previously for EURO adoption as national currency, specifying that the entry on 1 January 2012 in the ERM-II mechanism of the exchange rate and crossing the minimum mandatory period of two years in the interior of this mechanism is conditioned by the need to make many reforms, proper and competent reforms, until 2012, in Romania.

3. 3. ANALYSIS OF MACROECONOMIC INDICATORS FOR DETERMINING INFLATIONARY PROCESS

Romania's transition to a competitive market economy was a slow process, characterized by low growth and high inflation rates and unstable. After 1990, price liberalization has been extended. Most prices were liberalized in November 1990, in April 1991 and July 1991, but the last major round of liberalization has been delayed until 1997Since 1991 inflation has been on an upward slope. Maximum being reached in 1993 when consumer prices were 256.1

percent annual variation from other countries (Hungary, Czech Republic, Bulgaria) the inflation rate was below 50%. Rising prices in this period was due to their gradual liberalization, but also other measures (fiscal reform or exchange rate). In 1994, amid the resumption of growth and timing of price increases, inflation was calm, immediately after registering a downward trend. In 1995 he passed the first 3-digit level in a two-digit level, so that in 1995 there was an inflation of 32.3%. In 1997, following the latest round of price liberalization (especially in sectors agriculture and energy) average annual inflation increased again, reaching a value of 154.8%. Since then, inflation was in a downward trend, dropping below 10% in 2005 (when annual average inflation was 9%) and 5% in 2007 when annual average inflation was 4.84%).In 2008, following the global economic crisis the annual inflation rate rose to 7.85%, following that in 2009, to register a decrease in its value by 5.59%. Crisis started in late 2008 required the adoption of a vision of fiscal policy has been accompanied permanently of a restrictive monetary policy, whose effects were reflected both in lower income population adversely influenced consumption and production, and a non-governmental credit loss as a result of active interest rates increase leading to a reduction in the level of investment, all these reflected a sharp contraction of economic growth.

Figure 1 contains a comparison of expected inflation, that is forecast in the draft State Budget Law and actual inflation.

Great differences are observed up to 70 percent in 1990-2000, when price liberalization and economic situation had resulted in an unstable inflation rate and major fluctuations. Differences between the two inflation rates have decreased in recent years as inflation has become more stable.

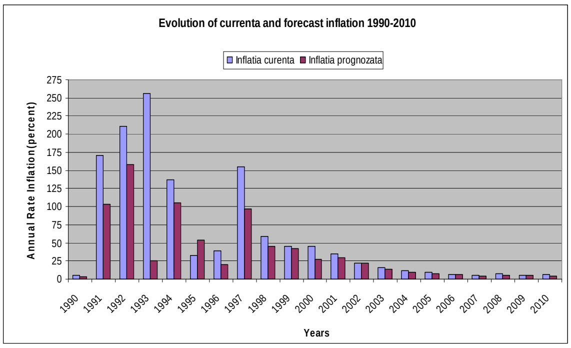

Fig 1: Current inflation and forecast inflation in Romania from.1990 to 2010

No inflation dynamics can be analyzed without taking into account exchange rate and its effects.

Figure 2 presents the real exchange rate ROL / USD and GBP / EUR in period 1990-2009. Recent data on the actual rate registered in Romania were collected from the site of the National Bank of Romania, excluding the value of 1990, which was used for the recorded value of the ECU. Figure 3 is noted that exchange rate was similar to inflation but not so fluctuating. Exchange rate depreciation had a maximum in 1992. In the period 1996-1997 has been depreciated since early 1997 has been the liberalization of the exchange rate, with the last price liberalization. In 1998 we wanted to avoid depreciation of the leu to reduce inflation. In late 1998 and in 1999 to restore external competitiveness followed by a depreciation of currency. Since 1999 the lion entered a process of real appreciation against major currencies, while registering and low inflation. The two phenomena may be related, low inflation can be explained by currency appreciation.

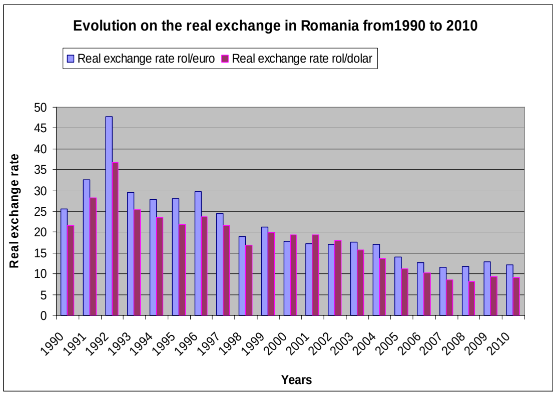

Fig 2: Real exchange rate in Romania in 1990- 2009 period

In Fig. 3 we present the evolution of real wages in our country during 1990-2009. Calculations were made in comparable prices.

It may be noted that in the early years of transition real wages increased fluctuations presented, with peaks around the years 1996 and 2008. Value of real wage in 1990 was exceeded only in 2005, when Romania adopted the strategy of monetary policy, inflation targeting. In recent years, real wages showed obvious upward trend, reaching a value of 5642.36 GBP in 2008. In 2009 there was a decrease in net salary, this value reached 5137.3 ROL.

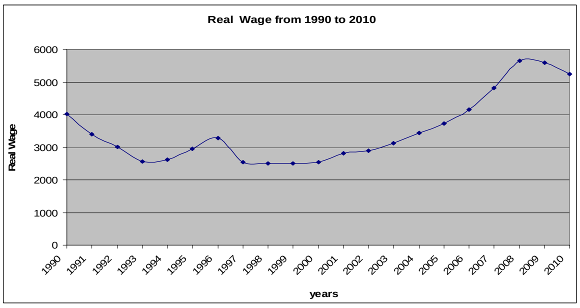

Fig. 3: Evolution of real wage in Romania in 1990-2009 period

Fig.4 shows the evolution of gross domestic product of Romania during 1990-2009. GDP is expressed in comparable prices in 1990. Data on GDP are taken from the Statistical Yearbook, during 1990-2009, National Statistical Institute. We can see that the evolution of real GDP has a slightly upward trend, with an average of 793.332 billion ROL. Minimum was reached in 1992 when it registered a real GDP 681.1726 ROL billion and the maximum was reached in 2006, reaching a figure is at 1031.099 billion ROL. Since 1999 real GDP shows a steady upward trend.

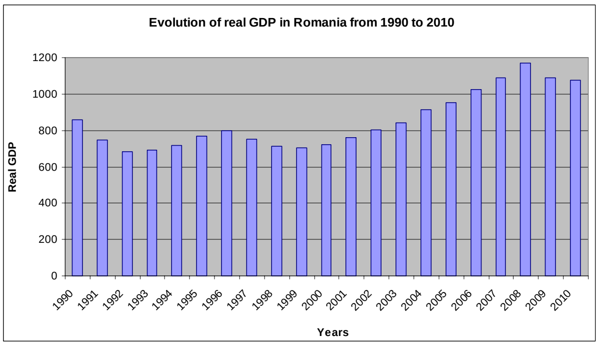

Fig. 4: Evolution of real GDP in Romania in 1990-2009 period

Central banks to apply inflation targeting strategy, as is the case of Romania, are concerned with growth and development especially of GDP deviation from the potential. In Fig 5 is presented the comparative evolution of real GDP and the potential during 1990-2008

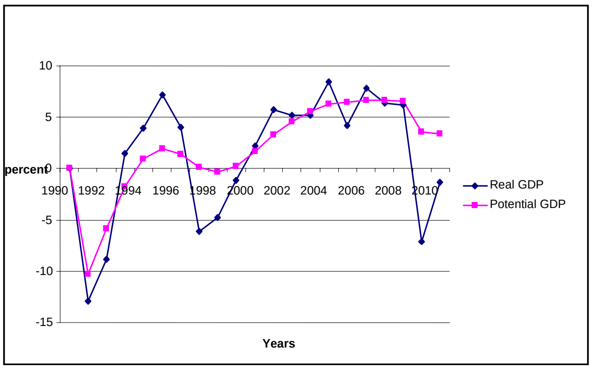

Fig. 5: Comparative evolution of the real and potential GDP from 1990 to 2008

Based on the data obtained we can see that the values of the two outputs are similar, with small fluctuations around the years 1992, 1996 and 2000. This is due to two economic cycles: the years 1990-1991 was a recession, after which, around the year 1992 was a period of depression. The period 1993-1996 was characterized by an economic pick-up, followed by a recession for the next two years. 1999 was characterized by economic depression, and then the next year we are dealing with a period of economic expansion, with the peak in 2008. In 2009, amid sharp global economic crisis, real GDP registered a decline, hovering around the value of 2007.

In the context of current economic crisis, the assessment of European Commission is highly straightforward. Romania needs to implement its structural reforms program, mainly focused on macroeconomic stability through strict control, of inflation, reduction of bureaucracy and a more efficient administration. Moreover, a global policy concerning the labor market correlated with education reform is needed.

Setting a favorable environment in Romania, among others, the implementation of a sustainable and credible strategy for fiscal consolidation can contribute to diminishing the demand-side inflation pressures and macroeconomic disequilibria. Concurrently, credit expansion, current account significant deficit, and its funding need to be closely monitored. Although creating new workplaces needs to be stimulated by adjusting fiscal systems and of aid allocation, it is required that a decrease of taxes to be accompanied by constrained expenditures, and this process needs to be sustained by higher efficiency of budgetary expenditures, among others. Adopted measures to increase quantity and quality of labor force supply needs to include adjustment based on the needs of economy.

5. CONCLUSIONS

In the new context of the financial and economic crisis it is imperious to implement a policy mix that responds to Romanian economy's vulnerabilities related to financial turbulences from the international market. For that matter, in order to ensure the equilibrium in the economy the monetary policy needs to be accompanied by a similar behavior of the fiscal policy, by a prudent revenues policy, as well as by continuous structural reforms for creating the conditions to decrease budgetary deficit, current account deficit, external disequilibrium, and to ensure stability of prices and, implicitly, for the process of economic development.

In order to sustain the growth trend of macroeconomic stability, the measures to strengthen the restrictive character of the monetary policy need to be supplemented by prudent fiscal and wages policies, as well as by further reducing quasi-fiscal deficit. The conditions needed to revitalize the economy can only be ensured through an adequate policy mix so designed that the fiscal and budgetary policy, wages and monetary policy complement each other and that their interaction reflects upon the economy. A highly restrictive monetary policy can compensate only on short term the lack of support from structural reforms, fiscal-budgetary policy and revenues policy. For that matter, in order to achieve the equilibrium that provides an adequate environment, the inter-correlations between economic policies need to be considered so that their effects lead to achieve specific objectives, such as: prices stability and economic growth or stabilization of economic cycle, respectively.

A solid fundament of the fiscal policy that comprises the actual conditions of social and economic activity, and the prerequisites of present time and the imperatives of future time, can prove to be beneficial to progress. In case these factors are not taken into consideration, the fiscal policy can slow down economic development, lead to involution or even to social tensions

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