MONEY POLICY IMPLEMENTATION AT NATIONAL LEVEL

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Abstract:

Article aims to highlight the effectiveness of inflation targeting strategy in Romania during the crisis. Thus, we present inflation in Romania in the period 2008 - 2012 and the strategy adopted inflation targeting in Romania during the crisis.

Working method used is to show the importance of inflation in the economy, the importance of targeting its strategies, especially their efficiency impact on the Romanian economy during the crisis.

The authors also try to highlight the relationship between inflation and economic imbalance condition where existing money supply in the economy overcomes real money demand, leading to a general rise in prices and declining purchasing power.

Keywords: economic strategy; inflation targeting; economic imbalance; economic crisis.

JEL Classification: P24; L12; B22; E60.

1. Introduction

Pressures generated by rising prices accentuate further pressure in monetary, economic, political, social levels. Thus, in addition to distorting the price level, inflation generates a sharp erosion of savings, discourages investors favoring the migration of capital to assets that generate real additional income, most often in unproductive assets. This misalignment strongly affects the decisions of private economic sector in terms of investments, savings and even the development of production, the final effect materializing in lowering production[1].

During inflation there are important structural changes in the national economy caused either by inflationary phenomena itself or some measure of economic policy led to inflationary process itself and its dimensions.

Since the central bank can not act directly on the inflation or on the real economy activity level, through these intermediate targets they are trying to connect between the action exerted by monetary policy instruments regarding short term objectives of monetary policy - i.e. operational objectives, objectives that can be achieved directly by the monetary authority - and the real economy activity and inflation[2].

Whatever the form of inflation, it is mainly caused by the phenomenon of disparity. The phenomenon of inflation is caused not by the fact that a certain element - money supply - increases in absolute size, but that the change occurs inconsistent with other elements of monetary exchange, (i.e. the faster growth of the amount of money compared to growth of other economic variables). What matters is not the fact itself that the money supply increases, but that the money supply grows faster than the other elements with which it is normally correlated (monetary speed is exceeding the speed of real development).

Although inflation is always present to some extent, it does not mean it negatively affects the prosperity of the citizens. Increased welfare due to economic growth generally balances the declining purchasing power caused by inflation. Products may cost more, but the people can afford to spend more. However, people may find differences in the actual rates of inflation in everyday life.[3] It is caused by many factors, often complex, such as household type, differences in consumer paradigms of each country and region, national tax policies.

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[1] Croce, E., Khan, M., *Monetary Regimes and Inflation Targeting*, International Monetary Fund, Finance and Development Magazine, vol.37, no. 3/September 2000

[2] Walsh, C., E., *Monetary theory and policy*, Massachusetts Institute of Technology, 1998, pag. 86

[3] Burghelea, C., *Modelul dezvoltarii durabile*, Theoretical and Applied Economics, Bucharest, 2012, pp. 96-107

2. Research methodology

Romania has an open economy, small investments are funded mainly through the banking system rather than through the capital market. These features, without giving the ideal profile for the adoption of Romanian economy inflation targeting, have been shown to be compatible with this system.[1]

Inflation targets set by the central bank and the acceptable range for the change in the inflation rate in the next period are as follows (see Figure 1):

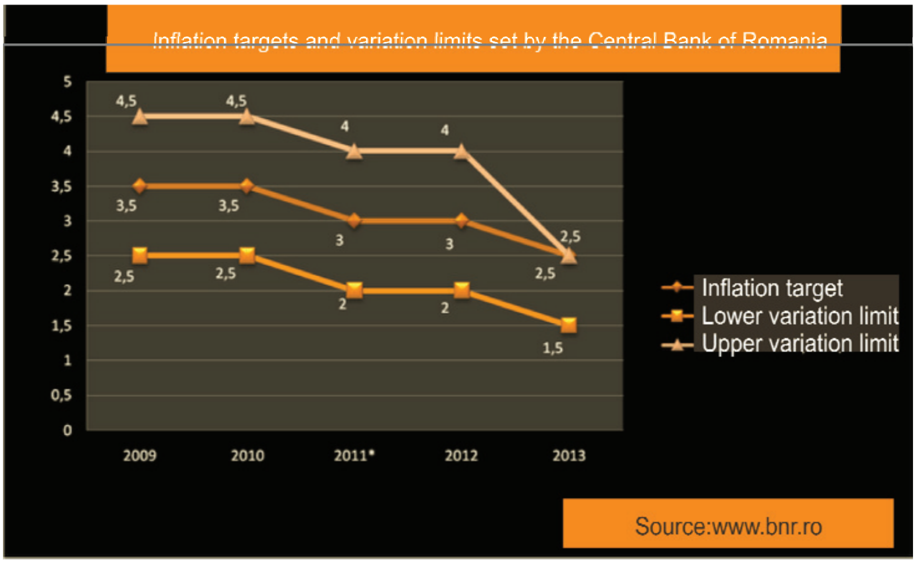

Figure 1. Inflation targets

Annual inflation targets were placed in recent years on a downward path, their level falling from 7.5 percent ± 1 percentage point in 2005 to 3.5 percent ± 1 percentage point in 2009 and 2010. The inflation target for the end of 2011 was lowered to 3 percent ± 1 percentage point. The option to emphasize in 2011 the downward trend of annual inflation targets was justified mainly by the prospect of sustained deceleration in inflation in the coming years, with the resort severe contraction suffered in 2009 by Romanian economy under the impact of global economic and financial crisis and the anticipated slow recovery in the post-crisis global economy and the national default.

[1] Craciun, L., *Viitorul si noua fata a economiei*, Theoretical and Applied Economics, Economic Publishing, Bucharest, 2012, pp. 65-72

For this option also pleaded this target capacity to meet the requirement to consolidate disinflation and to achieve level of inflation consistent with the inflation criterion of the Maastricht Treaty, in accordance with the timetable for euro adoption, and, subsequently, quantitative definition of price stability adopted by the ECB. At the same time, the option on the inflation target for 2011 reflected the central bank's concern for establishing realistic goals, achieving them being essential to the credibility of the central bank and thus the effective anchoring of inflation expectations in the medium term.[1] In this context, maintaining a prudent approach to the inflation target reduction stepping for 2011 was justified by the risks and uncertainties related to the magnitude of the direct inflationary effects that will continue to be exercised by factors beyond the reach of the bank, the most important being: adjustment of administered prices, resumption of economic convergence, including convergence of price levels, after the synchronized economic downturn, maintaining asymmetric nominal rigidities[2].

Inflation targeting for 2007-2009 proved correct and effective. Central bank should continue its efforts to reduce inflation to a realistic pace, it is necessary to apply "direct inflation targeting", it must align with monetary policy of the euro area to avoid sudden shocks to changes of monetary policy, and the exchange rate policy must allow real exchange rate of the Romanian leu. The Central Bank must complete adjustment acquis and procedures for banking supervision and strengthening the independence of the central bank must develop the banking and financial system as a whole to increase the rationality of resource allocation and ensure appropriate monetary policy transmission channels, need to modernize the payments system and connect it to the European T.A.R.G.E.T.[3].

The implementation of the inflation targeting strategy was not easy either before the financial crisis and fiscal dominance, massive capital inflows, net debtor to the banking system and the central bank of the monetary policy transmission mechanism were combined. Financial crisis has increased the monetary and exchange rate volatility and tends to amplify the economic slowdown. On the one hand, the reduction of external financing and the existence of large external imbalances triggered the depreciation of the leu, which feeds inflation and requires a relatively high interest rate.

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[1] Molanescu, A., G., Aceleanu, M., I., *Consequences of the Budget Deficit in the Current Crisis in Romania. Implications on the Labor Market*, Theoretical and Applied Economics, Economic Publishing, Bucharest, 2011, pp. 59-74

[2] www.am.ro

[3] www.ziare.com

A successful policy that includes a credible disinflation trajectory can be implemented provided the Romanian financial system to continue the modernization and structural reforms to become more profound. In the financial sector, this implies additional measures to reform the banking sector and the establishment of corporate financial discipline (especially arrears should be reduced in real terms).

Effective monetary policy leading to disinflation requires not only a good financial system and good coordination between fiscal and monetary policy, but also between exchange rate policy and monetary policy.

In order to strengthen the credibility and autonomy of central bank, quasi-fiscal deficits should significantly be reduced (debt contracted by NGOs but guaranteed by the State), in particular, a solution to the crisis of the social system has to be found, in a similar way, the public utilities must improve their efficiency in economic terms.

One of the medium term priority of Romania's central bank and the government is to reverse the credit relationship between the central bank (BNR) and commercial banks, which means getting a structure specific to all developed countries, the central bank's net creditor position banking sector and not vice versa. This would be possible if the central bank would waive the increase in deposits from banks and then would try to reduce them gradually. The gradual reduction would be accompanied by an increase in money supply that could be of economic inflation if output growth is not high enough and the speed of money supply movement does not decrease.

An important feature of inflation targeting strategy represents its transparency. This requires communication to the public of the objectives and policy decisions (including the rationale which led) and projected evolution of inflation and the risks and uncertainties associated with it. Transparent public communication facilitates performance evaluation of monetary policy, thereby increasing the central bank's responsibility.

The annual inflation rate fell below the central target of 3 percent ± 1pp for 2012 (see Figure 2):

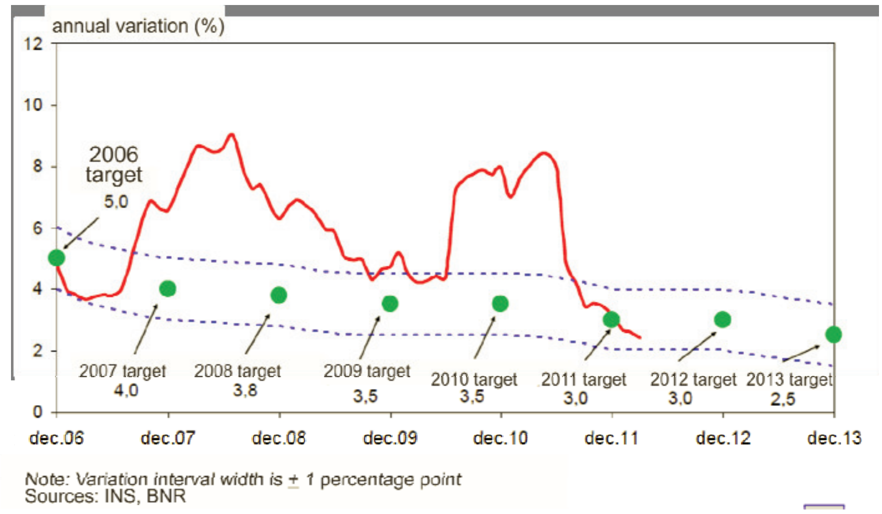
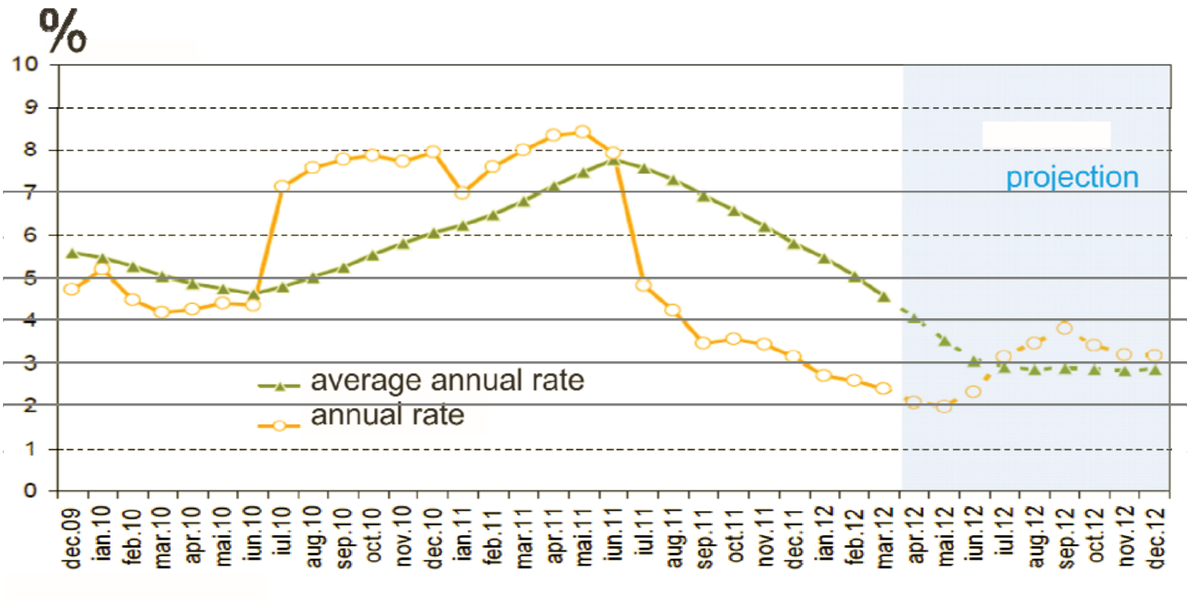


Figure 2. Annual inflation targeting variation

Despite unfavorable base effect, the average annual inflation forecast was set at about 3 percent in the second half (see Figure 3).



Source: www.insse.ro

Figure 3. Projected average annual inflation rate

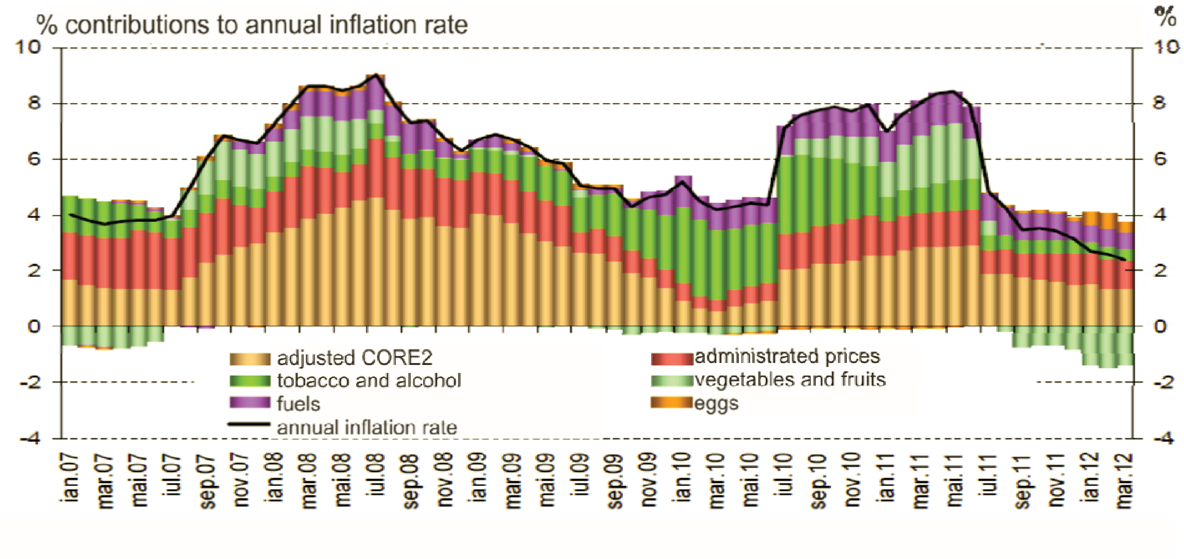
In conclusion, the economic situation in Romania is currently benefiting from a favorable environment: economic growth in an environment where inflation decreases rapidly. It is true that the future growth will depend on continued structural reforms, reducing inefficiency in the economy and fiscal deficits. There are favorable prerequisites for attracting foreign investment, in this context, to support effectiveness of management of monetary policy, exchange rate should be flexible and direct central bank interventions in the foreign exchange market should be low as possible.However, this requires the gradual liberalization of the capital account. Special attention should be paid to capital inflows and short-term loans in foreign currency, especially in the non-exportable.

To support economic development in a general sense, the central bank needs to accelerate the modernization of both the banking system and the management of its own monetary policy. It should be based more on general market practices with strengthened independence and autonomy.[1]

Determinants of inflation in the first quarter of 2012 were: persistent demand shortfall; manifestation of favorable base effects associated with increasing food and fuel prices in the first part of 2011, keeping consumer inflation expectations to decline, although less pronounced, the upward trend in international oil prices, moderate depreciation of the leu against the euro and against the U.S. dollar, the negative influence exerted on the fruit and vegetables prices due to adverse weather conditions in the first months of the year.

Disinflation was supported by most CPI components (see Figure 4):

[1] Vasile, V., Balan, M., *Impact Of Greenhouse Effect Gases On Climatic Changes. Measurement Indicators And Forecast Models*, articol publicat in Faculty of Sciences, "1 Decembrie 1918" University, Alba Iulia, Annales Universitatis Apulensis Series Oeconomica



Source: www.insse.ro

Figure 4. Contributions to annual inflation rate

The annual inflation rate in March 2012 compared to February 2012 remained unchanged in both the EU (2.9%) and the euro area (2.7%), according to data from the European Statistical Office (Eurostat).

In March 2012, the countries with the highest inflation rate were: Hungary (5.5%), Estonia (4.7%) and Czech Republic (4.2%). At the opposite pole Sweden (1.1%), Greece (1.4%) and Bulgaria (1.7%). Romania is both below the EU average and below average euro area inflation rate of 2.5%, according to Eurostat.

Compared to February 2012, annual inflation fell in 14 member states (including Romania), remained stable in four states and has grown in eight countries. However, Romania is still on top in the EU when it comes to the average increase in prices in the past 12 months, with an advance of 4.6%, a larger increase was recorded only by Estonia (4, 9%). At the opposite pole Sweden (1.3%) and Ireland (1.6%).

According to data from the National Statistics Institute (INS), the annual inflation rate fell to 2.4% in March 2012 from 2.59% rate recorded in February 2012, registering a new record low of the last 23 years. In March, prices rose by