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MONETARY POLICY AND THE INFLATION TARGETING STRATEGY

Literature review

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Abstract

The monetary policy is a basic component of the economic policy. It has an important role in fulfilling the main objectives of the economic politics, which is: price stability, insurance of a balanced economic raise, full occupancy of human resources and the external payment balance stability insurance. Inflation is a negative thing affecting the economy both on short and long term. On short term, it erodes the purchasing power of currency and thus, it mostly affects the retirees and those with fixed incomes. On long term, inflation discourages the investments and the economic growth. The purpose of this paper consists in the revision and presentation of the specialized literature concerning the impact the monetary policy has on the main macro-economical variables, especially on inflation, in terms of influence of the monetary authority decision on economic and financial conjunction. It was found that the monetary authorities of any country can evaluate exactly the rhythm and the effects of their actions on the economy by understanding the mechanisms which the monetary policy uses to influence the economy.

1. INTRODUCTION

Within the economical increase policies the analysts include the monetary policy, because it represents an instrument of the macroeconomic policy which attempts the adjustment of the money supply, credits capacity and interest rate in order to direct the economy. To this effect, the monetary policy has as main mission the adjustment of the coin quantity available in economy, so that it disposes of sufficient liquidities to insure its normal functioning and balanced development.

The monetary policy has an important role within the economy as a whole. The monetary policy ensures a balanced economic increase, full occupancy of the human resources, insurance of payment balanced stability as well as the correlation between the capacity of the available means of payment and the needs of the economy through the specific monetary instruments.

By means of the adopted monetary policy, against globalization, BNR (Romanian National Bank) adapted its monetary policy regime according to the fundamental objective, on one side, and on the other tried to ensure the bank departments and, the financial system's normal functioning, implicitly.

Decades of practical experience and various economic studies suggest the fact that a monetary policy directed towards maintaining the long term price stability will contribute the most to the improvement of the economic perspectives and the increase of the citizen's living standards.

Being one of the major instruments that the state uses to balance the economy, the monetary politics has long been a subject of interest for the economists.

2. MONETARY POLICY AND THE INFLATION EXPECTATIONS

The keynesists(1936) advocated that the monetary policy, modifying the money offer, could influence the aggregate demand and could, thus, lead to the full use of the human resources without inflation. Later on, in the beginning of the 8th decade of the last century the keynesist theories start losing credibility as opposed to the monetarist ones, advocated by famous economists such as Milton Friedman, Karl Brunner and Alton Meltzer who recommend monetary rules that can lead to the establishment of the economy. The neoclassic economy proposes the rational expectations theory. [6, p. 59;21, p.131].

There is a rich literature showing that between the increase of money supply and inflation there is a correlation. The increase in money supply and inflation were associated with the monetary and bank policy in the first papers during the modern times at the University of Chicago (Friedman 1956). Anderson and Jordan (1968), in trimestrial reports for the US, clearly showed that there was a strong connection between the money supply and inflation during 1952-1968[11,p.1].

In the research study made by Gherman and Adam (2010), the monetary policy wants to ensure both a bigger occupancy and price stability. This double purpose, known and analysed by the specialised literature as monetary policy „dual commission" can be seen in contrast with the declared purpose of several central banks that are mainly, and sometimes exclusively, dealing with price stability. Both theory and the empirical part indicate the fact that the monetary policy can influence, for a significant period of time, not just the prices, but also the GDB, the occupancy and other important aspects of the non-financial economy's activity. [12,p.90].

The transmission mechanism estimation was traditionally considered one of many macroeconomic major objectives. Therefore, the empirical researchers effectuated two major things: the first one, the fact that the transmission mechanism varies through time and the second one consist in the modification of the exogenous shocks in time [12,p.92].

In Romania, the monetary policy was elaborated accordingly to the orientations comprised in the Romanian medium-term economic strategy, whose implementation started in the beginning of 2000. The aim was to inscribe the variables with which the central bank acts on a course compatible with the Strategy's major objectives, that points both to a medium annual economic increase ad to reaching a one-number inflation rate. [21, p.132].

The monetary policy has an essential contribution concerning the inflationist expectations [7,p.197]. The central bank is considered a serious institution by the Romanian people, but they are also concerned of the inflation context. A lot of studies nowadays consider that a viable and stable financial system represents an essential condition to base a durable economic increase by realising a raised efficiency associated to the inflation's reduced levels. [5,p.31;4, p.74].

Consulting the specialized literature one can observe that the inflation is characterised as being a bad thing affecting economy both on short term, as well as on the long-term, On short-term it erodes the coin's purchasing power, therefore affecting especially the most vulnerable citizens – retirees, scholars, people with fixed income. On long-term, the inflation discourages the investments and inhibits the economic increase. For a while, the economists believed that the inflation also has a good size, meaning that, it would be possible to ”buy” a better occupancy of the human resource with a rather more increased inflation. In time, this assertion also proved to be wrong, because the positive effect on the unemployment does not last long, preponderant on long-term being the effect of discouraging the savings and the investments, as a consequence of the uncertainties raised by an increased inflation. [22, p.5].

Generally, inflation is defined as a messy increase in the general level of prices, that is, as a purchasing power of money erosion. The classical theory, represented by David Hume (1751), explains inflation by increasing prices due to increased supply of money. Keynesian theory argues, by its very founder John Maynard Keynes (1936), that inflation occurs when the demand for goods and services is greater than the supply itself (thesis resumed among others by Richard Lipsey (1995) showing that inflation has extra-monetary causes). Monetarist approach repeats David Hume's thesis arguing that "inflation is always and everywhere a monetary phenomenon" even if it makes valuable nuances between the temporal dimension of the process: short-term versus long-term. [1, p.6].

Even in the inflation synthesis definitions proposed by Frisch (1983), the characteristic features are part of the same conceptual area described above: inflation is the excess demand generalized condition where "too much money pursue too few goods"; inflation - an increase reserve money or income, total or per capital; inflation - an increase in the price level characterized by the following elements: forecasted with some degree of error, it leads (through costs) to new price increases, it is measured by net prices (of which taxes were deducted) and it is irreversible; inflation - a depreciation of the value of money in relation to other currencies, as measured by exchange rate or the price of gold, or indicated by an excess of demand in gold or other currencies.[1, p.6].

The macro-stability process, started in 1990 in Romania (23, 2008) was a dimensional one, devoted, on the one hand to the readjustment of the economic structure from a command economy in the matrix of a functioning market economy and on the other hand, to the insurance of the economic and social convergence of the Romanian economy to that of the European Union. Thus, the elaboration of a monetary policy correlated to specific conditions of an open, small, emergent economy, placed in a specific economic space and context that of Central and Eastern Europe, has become a priority of the National Romanian Bank.

The specialized literature considers that central banks have a key role in ensuring financial stability, although there are no rules or models that provide means of achieving this process and when analyzing it, the economic science must always be supplemented with intuition. The adoption of the law 312/2004 established the main purpose of the National Romanian Bank, which is "to achieve and maintain price stability." This goal depends on the exact measure of the future inflation rate level and, especially, on the components that are sensitive to monetary policy measures [19,p.135].

Paun C. (2012) believes that central banks were not created to bring more order into the system through the policies they promote. He believes that since their creation, central banks have forgotten to think about the "national wellbeing". Ardently embracing Keynes (who destroyed the last smattering of free market and capitalism existent in the collective mind) they went to what they can do best: print money to help the state and help "the system" get out of the impasse that they shepherd [17, p.10].

Numerous recent articles believe that central banks have greatly contributed to the global crisis and the collapse of real estate markets during 2007-2009 due to low interest monetary policy and inadequate regulation and supervision. Dedu V. and Stoica T. (2011) consider that the generalization of this idea, however, is an error because some central banks such as the National Romanian Bank (BNR), adopted prudent policies during the pre-crisis.[9, p.5].

3. INFLATION TARGETTING STRATEGY

Lack of uniformity of points of view is not only defining the concept of inflation. Economic fluctuations in recent years around world represented a challenge in terms of effectiveness of monetary policy objectives and in identifying the objective decision transmission modality at the level of real economy. Thus, the need to develop complex and judgmental models that can comprise accurately the changes of exogenous shocks and time varying parameters arose [12, p.90].

Over the past decades there were three standard monetary policy strategies that have been successful in terms of providing an effective nominal anchor, that is, monetary targeting, exchange rate targeting and inflation targeting. Frankel (1995) suggested an alternative strategy that is best suited to semi-open economies, namely nominal income targeting, however, a major issue raised by this strategy is the fact that it has never been implemented neither in the industrialized countries, nor in the emerging ones (Mishkin and Savastano, 2000).

Introduced in 1990 by the Central Bank of New Zealand, as an innovation of the monetary policy instruments, the direct inflation targeting strategy is considered by specialized theory and by the practitioners as a framework, allowing a central bank to exercise a "constrained discretionism", where the role of the nominal anchor is fulfilled by the inflation targets [2, p.20]. Since the early 1990s, an increasing number of central banks have adopted the inflation targeting monetary policy framework. Although initially, inflation targeting was introduced in industrialized countries, recently an increasing number of countries with emerging market economies have also adopted this framework, partly stimulated by the success of achieving and maintaining a low inflation [20, p.505; 16, p.217, 24, p.2]. Public perception tends to associate macroeconomic forecasts published by the government with the area of accuracy, having no prospect of uncertainty [3,p.28].

In Romania, the central bank officially adopted the direct inflation targeting strategy in August 2005. The conceptual framework and practical problems of this strategy have been widely discussed in academic and financial-banking publications (Bernanke, 2003; Snowdon and Vane, 2005; Abel, Bernanke, and Croushore, 2008; Roger, 2009) [10, p.252]. Although they were prepared in advance, the implementation conditions amidst a medium-term disinflation process, the National Romanian Bank (BNR) has only succeeded in 2006 and 2011 to achieve the inflation target. Beyond the inherent difficulties specific for emerging countries, the implementation of this strategy, which has proved effective even in times of crisis, was blocked by an unfavourable economic and political environment [2, p.22].

The decision to move to the inflation targeting was adopted only after this specific precondition changes have been accomplished. The main preconditions considered were: lowering the annual inflation rate below the 10% level, strengthening the National Bank's *de jure* independence, restraining the fiscal dominance and a better coordination between fiscal and monetary policy, healing and strengthening the banking system and increasing bank intermediation [2, p.22].

The central bank must adjust its monetary policy instrument in order to stabilize inflation around the central target without generating excessive fluctuations in the economic activity. In practice, central banks must consider objectives other than price stability. In Mervyn King's formulation the „central bank governors are not some people <<obsessed>>with inflation"[23,p.15].

The inflation expectations play a key role in the conduct of monetary policy. Because various central banks have explicitly or implicitly adopted an inflation targeting regime, insuring the inflation expectations' stability has become one of the main political objectives. Since there is a lag between the monetary policy actions and the latter's impact on the central banks' target, the monetary authorities are guided by forecasts. These make the inflation forecasts essential for an effective monetary policy. Although the monetary authorities seek to stabilize long-term inflation expectations, monitoring short and medium term inflation is equally important. Whenever inflation is inert, the well made short-term forecasts are translated into more accurate long-term projections[7,p.204].

As the Romanian reform has gained more substance and structural imbalances have diminished appreciably, it became possible to gradually reduce the inflation rate. A challenge for monetary policy in Romania is to strengthen the pace of disinflation required to achieve annual inflation targeting objectives. This implies decreasing the inflation rate on the medium term at a level consistent with price stability. In fact, price stability is the primary objective of the central bank and monetary policy pursued by the National Romanian Bank has a restrictive character [13, p.416].

Disinflation has been deployed successfully in Romania in 2000-2012. The less than 40% inflation in 2001 reached 3.2% in 2012. In 2007, when Romania joined the EU, inflation was over 6.5% because of adverse internal and external shocks [8,p.60].

Central banks should pay special attention to developments in the financial markets because a stable financial system is an essential precondition for ensuring an effective transmission without monetary policy tensions, ultimately contributing to the achievement of long-term price stability. In this respect, the systematic monitoring and evaluation of financial stability conditions is imposed in order to identify the financial systems' main sources of risk and vulnerability. But these risks and vulnerabilities are not only related to developments in the financial sector, but also of changes in the macroeconomic environment.[23,p.47]

4. CONCLUSIONS

In reviewing the specialised literature, we have seen that the monetary authorities of any country may assess as accurately as possible, the pace and impact of their action on the economy, understanding the mechanisms by which monetary policy affects the economy, one of the most important ones being the transmission mechanism of monetary policy. In the last 5 years have seen a great interest of research on the importance and role of monetary policy and its impact on the inflationary process, and the review of this specialized literature is the purpose of this paper.

In conclusion we can say that progress in the science of monetary policy makes art and judgment essential to lead the monetary policy. Monetary policy approaches take into account the current macroeconomic context. In other words, monetary policy cannot be conducted solely on the results of patterns or rules. As sophisticated as they may be, the models are vulnerable to changes in the economy structure and it is usually discovered late. Moreover, models use only a small part of the data and statistical available information.

There is a lot of information on the complexity of economy structure and it has relevancy to the elaboration of the monetary policy, but is not the result of the algorithmic methods.

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