INFLATION TARGETING AND THE LEU EXCHANGE RATE AND THE INTEREST RATES IMPLICATIONS ON ECONOMIC ACTIVITY

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Abstract:
Since the early 1990s, an increasing number of central banks have adopted inflation targeting as their preferred framework for monetary policy. This has replaced frameworks involving using targets for the exchange rate or monetary aggregates. Although initially inflation targeters were industrialized countries, recently an increasing number of emerging-market economies have also adopted this framework, spurred in part by the success of inflation-targeting countries in achieving and sustaining low levels of inflation.

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JEL classification: *G01, G21*

It appeared as inflation targeting, that any escalation of a certain level of consumer price index should rise to increase key interest. Some might say that this is somewhat rudimentary, as long as key interest rate does not increase regardless of the source of inflation.

Nowadays, as Stiglitz says, inflation targeting mechanism is put to the test and, according to Nobel laureate, will certainly fail.

Countries that must deal with a rising inflation do not due the rising prices necessarily a bad management of the macroeconomic situation, but rather to some factors over which they have no control. I refer to oil prices and the supply of goods, for example.

These categories, like others in fact, belong to that category for which, in Romania, is allocated a bigger part of the budget (compared with other states). In many cases, as in that of Romania, inflation was largely imported.

With the production very low and the consumption based on imports, it is clear that the devaluation of the Leu and the price increases on international markets “brought” us inflation. The case of oil is the first example which comes into my mind.

Also, it seems obvious to me that those key interest rate increases that were operated here had no impact on the causes described above. If we take a measure to be effective, not to us should have been increased key interest for some time, nut to the Americans.

As long as emerging economies (Romania) do not take measures to limit the impact on local prices, on price increases in other states, it is clearly that inflation will transmit to us.

The adoption of inflation targeting regime takes place under conditions in which targeting of monetary aggregates, exchange rate or aggregate demand ceases to be an effective procedure to implement monetary policy. Direct inflation targeting regime beneficial influence economic situation, reducing the negative inflation effects; it serves as a benchmark for inflation expectations; reduces business cycle fluctuations.

Success of inflation targeting regime depends, largely, on the support from other policies promoted by the authorities of the state, thereby contributing to the ultimate goal of monetary policy and increasing its credibility.

There are two ways of dealing with inflation targeting regime: full and default. The difference between full inflation targeting and default inflation targeting is only implied that government public announced inflation target (and its step) on a medium term. Different countries have chosen to go its way to full inflation targeting. Some of them (ex. Australia) began from the system of default inflation targeting, moving then to the full inflation targeting, while other countries (for ex. New Zealand) went directly to full inflation targeting regime.

1. The first approach can be explained by the expression "actions speak for themselves". But this type of behavior of central banks creates difficulties in communication with the public, leaving more space to uncertainty, which does not facilitate the task of monetary authorities.
2. The second approach emphasizes transparency and open communication with the public. Clearly defined objectives and responsibility regarding achieving them, efficiency in completing tasks, etc. increase public's confidence in the authorities' actions, thereby reducing uncertainty and, in its turn, increasing the anticipation grade of market participants' actions, while easing the task of those that promote monetary policy. The most important role is played by communication skills and the way of access to relevant information.

Priority of direct inflation targeting is the possibility to react quicker in the case of shocks, while in the case of monetary aggregates targeting always has a small period of time between the two interrelated phenomena, significantly between the change of money supply and inflation response. The role of monetary policy is to provide a nominal anchor (the benchmark index) for the economy, which is the purpose for inflation.

Focusing on other objectives is essential not to create discrepancies with the primary purpose of ensuring a low level of inflation. The absence of multiple objectives for monetary policy is an important condition, which is the fact that multiple goals can undermine the achievement of the ultimate goal - to maintain price stability. Simultaneously maintaining several purposes practically never gave expected results. Therefore, monetary authorities should move away from targeting other economic indicators, such as exchange rate and employment level.

However, for successful implementation of direct inflation targeting there has to be respected the axiom: inflation do not have be sole purpose of monetary policy, but the priority compared with others, which also must be met.

In inflation targeting clearly defined objective has the role to be better perceived by the public and restore enough confidence to the authorities in achieving this objective. Inflation target should tend to a limit, which (in central banks explanations) ensure the economic performance and is understandable to the public (CPI and not core inflation index or the GDP deflator, or other indicators of price dynamics, etc.). However, establishing a inflation target- point is focusing public attention and inflationary expectations on this level, and defining the range of tolerance (+/- target - point) requires accountability and credibility of central banks.

A prerequisite for the implementation of inflation targeting is the attribution to Central Bank the autonomy in the decision making process to ensure financial stability. The absence of fiscal dominant (access to central bank credits is strictly limited or prohibited), explicit arrangements for taking decisions on numerical value of the target (inflation target is set jointly by government and central bank or delegating full responsibility to central bank for setting inflation target), etc. - all these are necessary conditions for determining an appropriate legal and institutional framework for implementation of inflation targeting regime.

Another condition necessary to achieve the inflation targeting regime is that in the country there is a well developed financial market. Instruments used by the central bank to achieve the goal of price level will only be effective under the operation of monetary transmission channels. In turn, about the effectiveness of monetary policy transmission channels can be discussed only in case of well developed money market, currency market and capital market.

A stable financial system and a developed financial market is of major importance in any monetary policy regime, it allows promoting the policy of inflation targeting without being constrained by the potential vulnerabilities of the financial sector (banks and their clients vulnerability to exchange rate fluctuations, interest rates fluctuations, etc.):

- Due to lag in the monetary transmission mechanism is impossible simultaneity between monetary instruments and keeping inflation at exactly on the intended target: in fact, inflation targeting is limited to targeting the inflation forecast. The implementation of inflation targeting central bank must have the ability to predict future developments that will influence the economic system. This factor requires monetary authorities to focus more on the future, outlining its actions on the forecasted situation (proactive mode of activity). Continuous development of economic models and deeper understanding of their results is part of the everyday activity of central banks in inflation targeting. However, in making decisions on using monetary instruments is important the role of logical reasoning.
- The promotion of monetary policy in the inflation targeting regime needs to have an effective tool under the central bank control. Usually this instrument is the interest rate on (very) short term lending resources, although other arrangements are possible. Also important is the way of perceiving the decision makers factors of monetary transmission mechanism from the instrument to target. To determine the effective tool that can be applied by monetary policy if inflation targeting regime is required to have a proper understanding of monetary transmission channels and the dissemination of economic shocks.

According to Debelle (1998)[1] one of the essential preconditions of successful adoption of an inflation targeting regime is the central bank to have an appropriate tool for forecasting inflation and assessing the impact of monetary policy actions have on inflation (magnitude of effects, transmission range etc.). To meet these conditions many central banks operating in the regime of inflation targeting is based on econometric models of inflation, although there is no explicit requirement for the use of such methods or at least call the leading indicators of inflation, like interest rate on money/ financial markets, money supply, exchange rate movements, prices of industrial production, wage dynamics, etc.

Public announcement (indicating number) of price stability as the primary goal of monetary policy contributes to greater transparency, accountability and as a results - to increase confidence in the promoted policy. The goal for inflation can be developed jointly by government and central bank and central bank should be independent of the choice of instruments necessary to achieve the ultimate goal.

Transparency and accountability are primordial factors for inflation targeting regime. Benefits of transparency are substantial: increasing understanding of the financial market of central bank actions by public announcement about the targeted (predicted) level of inflation and, respectively, anchoring inflation expectations.

[1] DEBELLE, Guy; MASSON, Paul; SAVASTANO, Miguel; SHARMA, Sunil, *Inflation targeting as a Framework for Monetary Policy, International Monetary Fund*, Economic Issues no. 15, 1998 (www.imf.org/external/pubs/ft/issues/issues15/index.htm)

For a successful promotion of inflation targeting is very important the role of central bank communication with the public[2]. Given the important role of central bank in implementing the inflation targeting regime it is necessary to build a long lasting credibility of this institution and in this context of a high level of transparency and communication. Monetary authorities have several means of communication, such as public discussion, press releases, publication of the report on inflation, press conferences, publication of minutes of monetary policy committee meetings, regular speeches of central banks senior management, prior announcements of actions to be taken in certain cases, etc.. The ultimate goal of this transparency is to create a safe landmark for inflationary expectations and reducing uncertainty.

Important to note that direct inflation targeting is an effective strategy given in the case that that inflation has a decreasing trend. The countries that record an inflation expressed by a two digit number often face the problem of accurate prediction of the rate of growth of price level. Setting numerical targets for inflation as a goal of monetary policy in such conditions leads to undermining confidence in monetary authorities and promoted economic policy. Accuracy of inflation targeting increases with increasing macro-financial credibility of the country (what implies a high country rating with low risks for investment loans).

Thus, for successful implementation of the inflation targeting regime are necessary following basic prerequisites:

- Appropriate legal and institutional framework;
- Established mechanisms for a transparent monetary policy needed to build accountability and credibility;
- Effective capacities and tools needed to promote monetary policy;
- A relatively stable financial system and developed financial market;
- Advanced methods of forecasting inflation (economic monitoring and modeling on medium term);
- Appropriate organizational arrangements.

In the fourth quarter of 2008 national currency depreciated in nominal and real terms over the previous quarter average taking into account the developments in international and regional level and the specific conditions of the Romanian economy. Risk aversion of investors deteriorated mainly due to signal of the global recession and the delay on formulating a joint response to the issues the global financial system is facing (even if after that, major central banks cut interest rates and intensified global action to improve conditions of liquidity). Also on the depreciation of Leu acted internal factors such as: salary increases of public sector perspective, the still high current account deficit of balance of payments, the negative outlook on the evolution of Romanian economy (aspects reflected also by the decrease of country rating by the main, including under the investment grade category). The rise of speculative operations of some currency operators acted in the same direction, the depreciation of the Leu.

Following the sharp depreciation of the currency in the fourth quarter, the exchange rate ceases to transmit a restrictive effect on aggregate demand through the channel of net exports, making it incentive. Moreover, the effects of wealth and balance sheet exchange rate have become stringent, Leu's depreciation leading to strong increase in the cost in Lei for loans contracted in foreign currency.

Cumulating the effects in opposite way of the real exchange rate outlined above, it is estimated that in short term its impact on aggregate demand and on inflation, will be one restrictive. This stimulus could be boosted by anticipation of adverse shocks to external demand associated with the global economic downturn and in particular the Euro area (the main commercial partner of Romania). In terms of direct impact of

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[2] ***Source: BNM of*** Marius Mihaiescu **HotNews.ro** Friday, 6th of February 2009, 11:12

exchange rate on inflation, changes in the fourth quarter of import prices has contributed to higher inflationary scale compared to that of second and third trimesters.

It is expected that on medium term, the actual exchange rates follow a path determined by fundamental factors such as capital flows and sustainable productivity differential to external partners. However, it is anticipated that, at least during the first half of the range of projection, restriction of liquidity in international markets and the persistence of very high aversion to risk will stop the trend of real appreciation of the Leu.

On the interbank money market, during the fourth quarter of 2008, the location of all commercial banks in poor net liquidity position placed the National Bank of Romania in the position of creditor to the banking system. Influenced by temporary factors, interbank interest rates increased substantially at the beginning of the quarter. Flexible management of the National Bank of Romania liquidity in the banking system has favored the return of interbank interest rates, towards the end of this period, at levels similar to those of the previous quarter. However, tensions manifested during the quarter IV on interbank money market sent increased pressure on bank interest.

Nominal interest rates charged by commercial banks in dealing with customers on loans and deposits continued to increase during the quarter IV. Increasing nominal interest rate on deposits reflect more intense competition in the banking system to attract domestic resources, in a context where access to external funding sources is increasingly limited (the international financial crisis), and interbank money market conditions have been strained during the quarter IV. At the same time, registered larger dynamics than nominal interest rates on loans reflect the incorporation of additional financing costs, and the increasing aversion of commercial banks on risk in dealing with customers. Increases in nominal interest in the context of reducing inflation expectations implies a substantial increase in real terms of interest rates on loans and deposits. Therefore, *ceteris paribus*, in the fourth quarter increased restrictive impact on the economy of the real interest rates charged by credit institutions in dealing with non-bank customers.

Overall, the cumulative impact exercised in the fourth quarter of 2008 by the real exchange rate (through the two channels mentioned above) and the interest rates charged by credit institutions in loans and deposits on aggregate demand and future inflation reduces, compared to third quarter, the restrictive feature.

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