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Prerequisites of the Passage to a Regime of Inflation Targeting

The article synthetically presents the main prerequisites of the institutional and technical order we should consider in the context of the National Bank's adopting a complex policy of inflation targeting.

1. Institutional requirements

The absolute priority of the inflation goal

The institutional commitment to price stability implies that monetary policy should have been assigned a clear mandate by which this goal might acquire a fundamental character and priority compared to other goals, such as economic growth, external competitiveness or increase of employment rate.

The independence of the Central Bank in the use of instruments

The regime of direct inflation targeting supposes an increased degree of independence of the central bank in managing the monetary policy. At the institutional level, it means the existence of a law stipulating the independence of the Board of Directors of the central bank (appointed for a long term and protected against arbitrary revocation) towards the government and granting the central bank the exclusive and complete control in the choice and application of monetary policy instruments.

Harmonizing the monetary policy with the fiscal policy

The de-facto independence of the central bank – defined by the liberty to use the instruments at its disposal in the manner it considers fit for reaching its goal – is restricted by the presence of fiscal domination, which distorts the efficiency of the monetary policy measures. As long as the monetary policy operates in an environment where the advantage of the first move is given to the fiscal policy, the action range of the central bank is considerably narrowed (Niepelt, 2001).

Its independence is complete only if the operational framework assures the precedence of the inflation target upon the goals of fiscal nature. In such a context, the fiscal policy should adjust behaviour so that it does not endanger the inflation goal, which is equivalent to the absence of any symptoms of fiscal dominance (Masson et al., 1998): (i) the financing of the direct public deficit by the central bank or the banking system should be reduced or even absent, (ii) the government should not depend on the senior age revenues, (iii) the internal financial markets should be sufficiently developed to allow the transaction of public or private credit instruments, (iv) the level of public debt should be sustainable.

Unless these conditions are met, the persistence of fiscal misbalances will generate inflation pressures, which will undermine the efficiency of the monetary policy in reaching any nominal target, imposing it an accommodating attitude. Masson et al.(1998) considers that in a country registering for a period of 3-5 years annual inflation rates of 5-20 %, the monetary and the fiscal policy are practically inseparable, the central bank not being able to accomplish all by itself the significant and sustainable reduction of inflation.

The fiscal consolidation necessary to the implementation of a regime of direct inflation targeting essentially depends however on the existence of fiscal discipline. Manifested by the failure to pay the obligations towards the State or the acceptance of a lax salary policy at the level of the state companies with losses, the fiscal indiscipline contributes to the escalation of budgetary deficits beyond sustainable limits; the imperative of financing the above exceeds the inflation goal and questions the main condition of the functioning of the inflation targeting regime.

A well-developed financial system

The underdevelopment of capital markets stresses the effects of fiscal domination. Economies with difficulties in accessing the international capital markets, with a reduced level of saving and a financial system lacking depth, limit the possibilities of the government to get loans on the internal market, the senior age and other forms of financial repression being the only options. Under these circumstances, the financial markets cannot supply information regarding the medium-term inflation forecast, necessary to the central bank in order to elaborate the strategy of direct inflation targeting, and the institutions of financial intermediation, which in general have an aversion against inflation and inflation policies, do not have the strength to exercise pressure upon authorities for the observance of the commitments made, if the implemented policies tend to deviate from the set inflation goal. The frailty of the banking system represents also a risk factor to the success of a strategy of direct inflation targeting, increasing the possibility that the central bank might sacrifice the inflation goal in order to avoid a system crisis.

Nevertheless, the recent experience of certain countries with developing or transition economies proves that the implementation of the inflation targeting is compatible also with a less advanced state of financial markets' maturation. From the perspective of these experiences, the existence of a developed financial system constitutes a factor which facilitates the implementation of the inflation targeting, without being however a sine qua non condition.

Flexible exchange rate

An additional aspect that might raise serious problems for the strategy of direct inflation targeting is the phenomenon of dollarisation, which characterizes, in many cases, the emergent markets.

The flexibility of the nominal exchange rate is a requirement of the inflation targeting regime deriving from the setting as priority goal the inflation targeting. Nevertheless the associated risks are not negligible, considering that the abrupt depreciation may trigger the increase of the burden of the denominated debt in dollars, and the appreciation of the currency may produce the deterioration of the commercial balance. In this context, the implementation of the direct inflation targeting in partially dollarised economies should be preceded by the introduction of certain strict prudential regulations and of an efficient supervision of financial institutions, which may assure the capacity of the system to absorb the shocks of the exchange rate.

Transparency and liability

The transparency of the monetary policy is extremely useful to a central bank with a firm anti-inflation orientation. If the bank is firm in the anti-inflationist behavior, the public communication of its goals, instruments, procedures, decisions and forecasts strengthens its credibility, simultaneously with the increase of the degree of liability to the public. The repeated reaching of the announced targets generates reputation gains, the public support to the independence of the central bank increasing even in the absence of a rigorous framework for assessing its performances.

The explicit announcement of a numerical inflation target diminishes the risk of dynamic inconsistency in two ways (Mishkin, 2000):

(a) on the one hand, the communication of the target is equivalent to entrusting the central bank with a mandate for the use in this purpose of the instruments of monetary policy, both the market and the political milieus being aware that the short-term goals (economic growth, unemployment reduction) will not prevail the one regarding inflation;

(b) on the other hand, the public assuming of the inflation target strengthens the capacity of the central bank to resist the possible political pressures regarding the promotion of an expansionist monetary policy.

2. Technical requirements

Beyond the institutional requirements, the adoption of a regime of direct inflation targeting supposes the solving of certain technical aspects (Debelle, 1997): the choice of an adequate price index (representative for the purchasing power of money and easily understood by the public); the explicit setting of a quantitative target, of the interval of accepted fluctuation and of the time horizon during which one will supervise the goal setting; the building by the central bank of a performant model of inflation prognosis

The choice of an adequate price index

The choice of the price index according to which the inflation target is established depends on the methodological characteristics of the calculation of the consuming prices index and of its sensitivity to shocks from the part of supply. The second criterion is more important in the transition countries aiming at implementing a regime of inflation targeting where the incidence of administered prices on the general level of prices is high. Under these circumstances, the application of a strategy of direct inflation targeting imposes either a very good communication between the monetary and the fiscal authorities as regards the moment and magnitude of the controlled prices modification, or the elimination of their effect upon the target index. In their attempt to grasp the influence of the non-monetary factors, many countries practicing the direct inflation targeting define their goal at the level of basis inflation, the excluded elements of the total IPC being different from one case to another. (Enclosure 1). The decision of establishing the goal at the level of basic inflation should nevertheless consider the fact that such a methodology is not easily understood and assimilated by the wide public; consequently, the putting into practice of the decision should be preceded by an information campaign ensuring the transparency of the goal and the public support for the new strategy.

The fluctuation range and the target horizon

a) The width of the target band. The need to specify the band width results from the imperfect control of the monetary policy upon the inflation rate. As a result of long and variable lags of the mechanism of monetary policy transmission, and of the imperfect capacity to forecast inflation, it is not possible to restrict inflation variability below certain levels.

Moreover, the band is necessary for the maintenance of a certain flexibility of the monetary policy as regards the reaction to short-term shocks. The choice of the target band dimension reflects a compromise between the announcement of a narrow band, with the risk of occasionally exceeding it, and the announcement of a width band, that can be perceived as a too relaxed attitude of the monetary policy. A narrow band reflects a firm position of the central bank in the observance of the goal of price stability, but it can become difficult to be implemented in practice, with repercussions on the credibility of monetary authority. On the other hand, adopting a narrow band has the advantage of stressing short-term liability of the central bank in reaching the inflation target , but may trigger instability at the level of monetary policy instruments – in order to obtain a given effect upon the inflation rate. The shorter the time horizon, the greater the intervention amplitude.

The width of the target band (or its very existence) represents a difference among the regimes of inflation targeting adopted in different countries (Enclosure 1). As regards the Central and Eastern Europe's countries which have adopted a direct inflation targeting, their majority defined its goal in terms of band, its size being gradually restrained along with the progress registered in the disinflation (for instance, the Czech Republic started in 1998 with a ±0,5-percent band at a 6% inflation rate, and in 2000 the fluctuation rate was narrowed to ±0 percent at a 4.5% target rate).

b) The time horizon. The establishment of the target horizon essentially depends on the initial level of inflation and on the duration of the transmission mechanism. In Canada and New Zealand, for instance, authorities benefited from an allowed delay of 8 months for the reaching of the initial target. The following targets were set at shorter intervals (2 months), but once the inflation reduced to an acceptable long-term level, both countries established that the goal will be followed by assuring the ranging within the band, at any moment, for a 5-year horizon. Similarly, the medium-term strategy of monetary policy in Poland sets at the year the horizon of inflation targets reaching, but it mentions that it will be extended in parallel with the increase of the period of economy's reaction to the central bank actions (in the context of a low inflation and of the diversifying of financial markets).

The capacity of inflation prognosis

The performance by the central bank of an inflation prognosis is essential in a regime of inflation targeting, considering the anticipating character of such a monetary policy strategy.

The elaboration of a satisfying prognosis depends however on the existence of certain consistent historic series allowing the estimation of a stable relation between inflation and the other macroeconomic variables

3. Anti-inflationist policies

It is necessary to be well aware of the existence of transmission mechanism of monetary impulses and of a financial markets able to supply, in due time, correct information to the central bank, as a response to its actions. Moreover, so that it does not become recursive, the prognosis effected within the central bank should not incorporate anticipations regarding its actions on which prognoses of other institutions rely.

Among the measures generally constituting the object of anti-inflationist governmental policies we may list:

a) Deflation, by which the state aims at blocking or tempering the price increase, as well as the increase of the purchasing power of currency by diminishing the quantity of currency in circulation.

The forms of deflation are:

1. Monetary, consisting in restraining the circulating monetary mass, this process is carried on through the annulment of the payment means or their conversion into a certain ratio, for instance: 20 to 1 (monetary reform – n.n);

2. Financial, consisting in paying the state debt to the central bank or adopting policy through budgetary exceeding, obtained by diminishing the public expenses and the increase of income taxes, respectively;

3. Of credit, consisting in increasing the level of interests or in diminishing the bank loans granting."

Although considered a radical measure, deflation is usually accompanied by a reduction of economic activity. The lack of liquidities, braking the merchandise circulation, brusquely created, the non-confirmation of inflationist anticipations regarding the evolution of prices of companies having built their supply plans from this perspective are only two aspects leading to the contradictory effects of deflation.

b) Re-valuing is the measure by which the state aims at returning the national currency to its initial, higher rate. It is an anti-inflationist measure to the extent to which it re-establishes the trust in the currency. Is also has a negative effect, as it makes exports more expensive and thus it reduces the possibility of acquiring hard currency with negative consequences upon imports.

c) De-valuing means the legal adaptation of the official, higher exchange rate of national currency, to the lower one of the market. It has a positive element the fact that it makes export cheaper. Moreover, it leads to a resettlement of prices on the basis of criteria resulting from the true value ratios indicated by practical reality. De-valuing may however generate untruth in the currency, when it is not correlated with measure of output increase, budgetary balance assurance, rigorous control of monetary issues and of their thorough coverage.

d) Manoeuvring the discount tax*, or directly, *the interest rate. As a form of interest existence, the discount may be used as an instrument of struggle against inflation. One starts from the premise that through credit one mainly feeds the channels of monetary circulation. „Strangling" this access way is possible only by making loan more expensive. As the loan price, eventually, is the very discount or interest rate, it is obvious that one will proceed to the increase of their level.

e) Reducing indirect income taxes and taxes. Since the '80s the measure has constituted, together with the increase of the interest rate and a moderate monetary issue in accordance and at the same rhythm with that of economic growth, the object of an official economic policy, known as the policy or the doctrine of supply. Its promoters, especially A. Laffer, stress the stimulation of output, of supply. In full accordance with the Say Law, they consider it normal that supply is easily created as the monetary issue is a State's monopoly; the money, irrespective of its form, once brought into economy, means potential supply. Offer, or output is more difficult to achieve. Or, a way of stimulating it means in this vision reducing fiscality. Besides the fact that high indirect taxes become a part of logically higher prices, they also suffocate the company's life. The partisans of the doctrine of supply proved that by the very company's getting rid of the burden of a high fiscality, the State has the opportunity to cash in more from this source: one considers a low taxation rate applicable to an increasingly high taxable mass, in its turn the result of an increasing turnover.

f) Prices indexing, the establishment of an interdependence ratio with that of incomes and purchasing power. One mainly considers here the effect of stability that such a measure may induce to the economic and social climate.

g) Reduction of budgetary deficits

The range of anti-inflation measures is not exhausted by those listed above. According to the place and time, the nature of inflation and especially the amplitude of the phenomenon, each state builds the strategy that best fits its situation. Although certain measures are common in almost all governmental policies, it is important to retain that the anti-inflation policy, as well as the anti-unemployment policy, by which it is usually accompanied, acquires specific characteristics, in relation with the range it circumscribes. Romania does the same. Facing a tough inflation, it searches for solutions best designed to respond its economic specific.

4. Conclusions

Under the present economic circumstances, when the impact of the interest rate on the money demand seems more reduced than in functional market economies, and at the macroeconomic level there are still weak budgetary constraints, the targeting of a certain interest rate in economy would be unoperational.

The choice of the anchor of monetary policy aims at defining an indicator able to maximize its efficiency, under the circumstances specific to market economy,. The intervention of the central bank is essentially indirect and is mainly focused on one of the monetary indicators, but also influences the behavior of the other indicators, on the principle of communicating vessels. The anchor used by the National Bank was the monetary basis, and the effect was the expected one, in the plane of inflation control. The insufficient convergence of the economic policy mix attracted unwanted evolutions, either as regards the interest rate, or the exchange rate.

Aware of the limited impact of its actions on the interest rates in the context of focusing upon the monetary basis control, the National Bank attempted however, beginning with mid-1998, to imprint a descendent trend to the interest rates. The market did not validate this attempt as it was not in accordance with the general economic framework and did not correspond to the expectations of market operators. Consequently, the market returned soon to high interest rates. This experience would allow us to draw the following conclusions:

The monetary market is functioning and its forces prevail on certain actions of the central bank that are insufficiently supported by the economic conditions.

The central bank has a limited capacity to simultaneously control several monetary variables. In the case at hand, the reduction of the interest rates is not possible if the inflationist expectations are high, the saving is poor and the financing of the public deficit is made from internal resources.

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