PROS AND CONS OF INFLATION TARGETING STRATEGY

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Abstract

The purpose of this paper is to define the inflation targeting strategy and its characteristics. Inflation targeting is a monetary policy strategy in which the central bank projected estimates and makes public, or "target" inflation rate and then, attempts to steer actual inflation towards the target through the use of interest rate changes and other monetary tools. Early proposals of monetary systems targeting the price level or the inflation rate, rather then exchange rate, followed the general crisis of the gold standard after the World War I. Inflation is usually measured as the change of prices for consumer goods, called Consumer Price Index (CPI). Inflation targeting assumes that this figure accurately represents growth or money supply, but is not always the case. The most serious exception occurs when factors external to the national economy are the cause of the price increase. A more essential objection to the strategy of inflation targeting is that it does not really comprise a specific set of monetary policy recommendation would traditional monetarism did, but just constitutes an explicit statement of the aims of the monetary authority.

Keywords: *inflation targeting, monetary policy, central bank, monetary strategy*

Introduction

Monetary policy is the process by which the government, central bank, or monetary authority of a country controls (i) the supply of money, (ii) availability of money, and (iii) cost of money or rate of interest to attain a set of objectives oriented towards the growth and stability of the economy[1]. Monetary policy plays a central role in each country which participates in the international financial system and inflation targeting has become a leading concept for management of monetary policy.

The definition of inflation targeting given by Ben Bernanke is the appropriate one. Accordingly, inflation targeting is "a framework for monetary policy characterised by the public announcement of official quantitative targets […] for the inflation rate over one or more time horizons, and by explicit acknowledgement that low, stable inflation is monetary policy's primary long-run goal. Among other important features of inflation targeting are vigorous efforts to communicate with the public about the plans and objectives of the monetary authorities, and, in many cases, mechanisms that strengthen the central bank's accountability for attaining these objectives." The definition can be wrapped up by adding instrument independence for the Central Bank and the lack of an explicit intermediate target, as all factors affecting inflation are taken into consideration.

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[1] Federal Reserve Board. January 3, 2006.

Inflation targeting as a monetary policy strategy

Inflation targeting is a monetary policy strategy based on periodical setting of inflation rate target for attaining price stability.[2]Inflation targeting as a framework for the conduct and evaluation of monetary policy has a short history of less than 25 years.

First countries that have shifted to the new monetary policy regime, *Inflation targeting,* were New Zealand, United Kingdom, Sweden and Australia, during the 1990's.

In New Zealand inflation targeting has been a success and monetary authority has been able to maintain the price stability, to reduce the long – term inflation below the levels that it should attained in the absence of inflation targeting and to gets the economic growth. That was the reason for which other countries adopted inflation target strategy. For example, Central and Eastern European countries have abandoned the different variants of fixed exchange rate regime (from currency boards to adjustable pegs) in favor of more flexible arrangements, such as inflation targeting. The Czech Republic (in 1998), Poland (in 1999) and Hungary (in 2001) introduced this monetary policy strategy, giving up the solution they had opted for in the first stage of transition, i.e. use of the exchange rate as a nominal anchor.

Theoretically, inflation targeting can, by its simplicity and grace to a better channeling of inflation expectations to strengthen the credibility and transparency of the central bank. It assumes, however, that the authorities put in place the institutional arrangements necessary to meet the target.

In contrast to monetary targeting, another possible monetary policy strategy, inflation targeting has the advantage that does not depend on relationship between money and inflation and also has the advantage that it is easily understood by the public.

Unstable relationship between monetary aggregates and inflation rate, on the one hand, and economic activity, on the other hand, made the central bank to abandon the old monetary strategy and choosing inflation targeting.

An inflation targeting regime allows monetary policy to focus on issues relating to the domestic financial environment and to better respond to shocks in the domestic economy. The money inflation relation is not the characteristic element of the direct inflation targeting, but represents a favourable prerequisite for the adequate determination of the monetary tools chosen by the monetary authority.

To enjoy the benefits of inflation without suffering too many ill effects, governments try to maintain a low level of inflation, typically below 5 percent. A government's central banks can help moderate inflation by regulating interest and lending rates. Higher interest rates reduce the money supply and slow inflation. Alternately, governments can fix wages or the costs of goods in order to prevent prices from rapidly rising. Other methods involve manipulating the supply and demands of goods through import and export regulations[3]

First, inflation targeting was mentioned in Romania's Medium – Term Strategy for Economic Development, in 2000, and then Romanian National Bank officially adopted it since 2005. Adopting inflation targeting was not just a matter of choice, but also of fulfilling a number of key requirements:

- by year end 2004, inflation was brought down to single digit levels for the first time from 1990 onwards;
- since 2004, the National Bank of Romania has benefited from full operational independence, as stipulated by Law No. 312 of June 28, 2004;
- the success in disinflation over the last years until adopting inflation targeting regime has strengthened the NBR's credibility;

[2] Sherwin, Murray – "Institutional Framework for Inflation Targeting", Reserve Bank of New Zeeland, 2000
[3] How Does Inflation Affect Monetary Policy? | eHow.com

The adoption of Inflation targeting regime was judged as a means to bring major benefits for Romanian monetary policy[4]. First of all, by enlarging the projection period in which an inflation target is pursued, the central bank would escape from the trap of time inconsistency. Second, by adopting a single publicly acknowledged goal, such as an inflation target pursued over the medium term, the central bank could manage inflation expectations so that the required short-run deviation from the target does not jeopardize the final goal. Third, the central bank might benefit from a kind of 'demonstration effect' by using a method adopted in some of the EU's newest members.

The inflation targeting strategy adopted by the National Bank of Romania has the following characteristics[5]:

1. a CPI-based inflation target, i.e. headline inflation, taking into account the general public's awareness and the need to ensure transparency and credibility of monetary policy decisions; CPI is the weighted of prices of a basket of goods and services, that in Romanian economy, currently consisting in 37% food goods, 45% non-food goods and 18% services.
2. target set as a midpoint within a target band of ±1 percentage point aimed at better anchoring inflation expectations;
3. announcement of annual inflation targets for longer time horizons (initially two years), thereby emphasizing the focus of monetary policy on medium-term developments;
4. maintenance of a managed float exchange rate regime;
5. ex ante definition of a narrow set of circumstances ("exceptional circumstances") that are beyond the control of monetary policy and therefore circumscribe the responsibility of the National Bank of Romania for achieving the announced inflation targets;
6. Joint formulation and announcement of inflation targets by the NBR and the government.
7. Given the ongoing disinflation process in the domestic economy - a sustainable inflation rate over the medium term in line with the quantitative definition of price stability has yet to be attained - inflation targets are formulated on an annual basis (December/December) and are set over a two-year horizon.

	Inflation target	**Variation band**
2005	7.5	6.5-8.5
2006	5.0	4.0-6.0
2007	4.0	3.0-5.0
2008	3.8	2.8-4.8
2009	3.5	2.5-4.5
2010	3.5	2.5-4.5
2011	3.0	2.0-4.0

Source: NBR, Inflation Report, November 2011

[4] Daianu, Daniel; Kallai Ella - *Disinflation and Inflation Targeting in Romania*, Romanian Journal of Economic Forecasting – 1/2008

[5] www.bnro.ro

Romania's monetary policy is based on an inflation targeting framework. Inflation is currently running within the range of target rate. In these circumstances, the NBR has needed to maintain a firm policy stance, dampening downward pressure on the exchange rate, in order to ensure that inflation returns to the target range. Other measures have also been introduced to discourage unhinged foreign currency borrowing, especially by households, as well as to constrain household debt exposures, especially with regard to mortgage debt. In November 2008, as the financial crisis worsened and the liquidity position of the banking system shifted to a deficit, MRR on Leu deposits was cut from 20 percent to 15 percent. More recently, MRR on foreign currency deposits with over 2 years residual maturity was reduced to zero. Although the NBR recognizes that high MRR is no longer needed to contain credit expansion, it also recognizes that a significant easing could lead to substantial capital outflows. Consequently, any easing of MRR is likely to be gradual. The NBR also acted to counter adverse spillover effects from the global crisis on domestic money market liquidity conditions and interbank interest rates. Romania also followed the EU lead in raising household deposit insurance coverage.

Lars Svensson[6] defines inflation targeting strategy using its characteristics:

(1) there is a numerical inflation target, in the form of either a point target, with or without a tolerance interval, or a target range. This numerical target refers to a specific price index, such as Consume Price Index (CPI);

(2) there is a high degree of transparency and accountability, the central bank being accountable for achieving the inflation target;

(3) The decision – making process can be described as "inflation – forecast targeting", which means that the central bank can choose the monetary instrument for achieving the inflation target.

The institutional commitment towards price stability implies that monetary policy should be given a clear mandate whereby this objective is considered fundamental and thus takes priority over other objectives such as economic growth, external competitiveness or increase in employment.

Major advantages offered by direct inflation targeting strategy, provided by its specific characteristics are:

1. ensuring and maintaining price stability, with the lack of an explicit intermediate target. But, the adoption of inflation targeting as a monetary policy framework does not guarantee exchange rate stability. On the margin, if inflation targeting contributes to better economic performance, including reduced inflation variability, it should make a small contribution to enhanced exchange rate stability.

2. increase in the central bank's accountability for attaining the inflation target;

3. requires an increased independence of the central bank in conducting monetary policy, which means independence from the government and grant to the central bank full and exclusive control over the choice and implementation of the monetary policy rules;

4. Transparency of the monetary policy strategy by communicating the monetary policy objectives and decisions to the public;

5. independence on having in due time a whole set of information on relevant variables concerning the four macroeconomic areas (real, monetary, fiscal and external areas)

Critics of inflation targeting have noted a few major disadvantages of this monetary policy strategy[7]:

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[6] Svensson, Lars E.O – "*Inflation Targeting: Should It Be Modeled as an Instrument Rule or a Targeting Rule?",* Princeton University, December 2001

[7] Mishkin, Frederic; Posen, Adam – "*Inflation Targeting: Lessons from Four Countries"*, Federal Reserve Bank of New York, FRBNY Economic Policy Review, august 1997

- The inflation targeting is too rigid;
- Inflation targeting allows too much discretion;
- Inflation targeting has the potential to increase output instability;
- Inflation targeting will lower economic growth;
- Inflation targeting cannot prevent fiscal dominance;
- Exchange rate flexibility required by inflation targeting might cause financial instability;
- In contrast to exchange rates and monetary aggregates, the inflation rate cannot be easily controlled by monetary authorities.

Adopting the direct inflation targeting regime suppose to fulfill some preconditions, classified in two categories: institutional prerequisites and technical prerequisites.

Institutional prerequisites are: consider price stability like a fundamental objective, the independence of the central bank in conducting monetary policy, harmonization of monetary policy with fiscal policy, a well-developed financial system, flexible exchange rate, transparency and accountability.

Consider price stability like a fundamental objective and with priority over other objectives, such as economic growth or increase in employment is first condition for adopting inflation targeting.

The second one consists in *the independence of the central bank in conducting monetary policy*.

Harmonization of monetary policy with fiscal policy is the third institutional condition. The *de facto* independence of central bank, defined as the discretion to use the available instruments in the way the central bank deems appropriate for attaining its objective is constrained by fiscal dominance which reduce the efficiency of the monetary policy measures. Therefore, the independence of central bank is fully only when the operational framework ensures that the inflation target overrides the fiscal objectives.

A well-developed financial system. If the capital market doesn't function, then the government possibilities to borrow on the domestic market are limited and financial markets cannot provide information on medium – term inflationary expectations, which the central bank needs to prepare the direct inflation targeting strategy.

Flexible exchange rate. The flexibility of the nominal exchange rate is a condition of the inflation targeting regime, but the related risks are important. Thus, the sharp depreciation of exchange rate involves the rise of currency debt, while an appreciation of the local currency may lead to trade balance worsening. That's why, before adopting targeting inflation regime, must been adopted prudential settlements which should ensure the system capacity to absorb exchange rate shocks. The central bank's policy on forex market intervention wasfurther steered in this new environment by the philosophy that a high volatility of the exchange rate is detrimental to the inflation target as well as to thefinancial soundness of the real and financial sectors. A small emerging economy with a significant openness is exposed on an ongoing basis to the threat of capital movements likely to adversely affect the stability of the financial market, the foreign exchange market in particular. Firstly, the NBR's interventions in the foreign exchange market were meant to avoid an excessive weakening of the domestic currency, while also linking the level and the pace of the depreciation to the progress in the current account adjustment. With this goal in mind, the central bank monitored the developments in the real effective exchange rate of the domestic currency, along with the pressures on external competitiveness stemming from wage bargaining.

Transparency and accountability. Monetary policy transparency is extremely useful to a central bank, enhancing its credibility and its accountability towards the general public. Monetary policy needs to be conducted in an open and forward-looking way. A forward-looking focus is essential as policy adjustments affect activity and inflation with a lag and because of the crucial role of inflation expectations in shaping actual inflation outcomes. In addition, with a clearly defined inflation objective, it is important that the central bank continues to report on how it sees developments in the economy, currently and in prospect, affecting expected inflation outcomes. These considerations point to the need for effective transparency and accountability arrangements

Technical prerequisites refers to:

- choosing an adequate price index, representative for the purchasing power of money and easily understandable by the public, in relation to which the inflation target is set;
- explicit setting of a quantitative target, of the accepted fluctuation band and of the time horizon over which the target is pursued. Because of the imperfect control of monetary policy over the inflation rate appears the need to specify a bandwidth.

A narrow band indicates a strong commitment of the central bank to pursue the price stability objective, but may undermine the credibility of the monetary authority and may induce instability in the instruments of the monetary policy, for achieving a given movement in inflation rate.

Regarding on setting the time horizon of the target, this depends on the initial inflation rate and the duration of the transmission mechanism.

- the central bank's forecast of inflation. This means that the central bank must respond to the gap between the inflation forecast and the target, before the inflationary pressures become visible.

In the case of the ECB, the primary objective, as assigned by the Treaty on the Functioning of the European Union, is to maintain price stability. Thus, the Governing Council of the ECB assesses whether the impact that monetary policy is having on the economy and ultimately price stability – i.e. its monetary policy stance – is appropriate in order to achieve its primary objective, taking into account all the factors that affect the medium-term inflation outlook. The stance deemed appropriate at the previous monetary policy meeting may require adjustment, with new information having become available. The Governing Council then decides on the monetary policy course that will realign its stance with the price stability objective.

The severity of the financial crisis since the autumn of 2008 and its spillover to the real economy, together with the resulting high levels of uncertainty, have complicated both the assessment of risks to price stability and the way in which monetary policy is able to influence the euro area economy in order to ensure price stability. In such circumstances, the maintenance of price stability over the medium term has required both the rapid lowering of the key ECB interest rates and the introduction of temporary measures to ensure their effective transmission to the economy, with a view to tackling the financial crisis and cushioning its impact on the real economy. As economic and financial conditions have now improved, not all exceptional measures are needed to the same extent as in the past. Indeed, continuing them could even have adverse economic and financial effects[8].

In Romania, the central bank will seek to calibrate the path of the monetary policy rate so as to adjust real broad monetary conditions, aiming at consolidating the prospects of keeping the inflation rate inside the target band and achieving a sustainable recovery of lending to the economy. The balance of risks to the inflation rate projected in the baseline scenario appears to be

[8] ECB, Monthly Bulletin, January 2010

broadly balanced in the short term. Over the medium term however, the overall balance of risks is still significantly tilted to the upside, albeit to a lower extent than in the previous round. Potential sources of risk relate to external developments, the fiscal policy stance, and administered price adjustments. Major external risks are associated with a possible heightening of tensions on global financial markets following the delay in resolving the sovereign debt crisis. Such a scenario cannot be entirely ruled out, despite the recent scaling-up of the rescue fund for the countries facing such difficulties. Thus, the stronger risk aversion of increasingly jittery investors could lead to higher financing costs and scarcer funding sources also for non-euro zone economies, Romania included. Such effects becoming manifest would tighten financing of both the fiscal deficit and the private sector, translating into higher interest rates, as well as depreciation pressures on the leu[9].

Conclusions

The inflation target is defined as a medium-term average rather than as a rate (or band of rates) that must be held at all times. This formulation allows for the inevitable uncertainties that are involved in forecasting, and lags in the effects of monetary policy on the economy. Experience has shown that inflation is difficult to fine-tune within a narrow band. The inflation target is also, necessarily, forward-looking. This approach allows a role for monetary policy in dampening the fluctuations in output over the course of the cycle. When aggregate demand in the economy is weak, for example, inflationary pressures are likely to be diminishing and monetary policy can be eased, which will give a short-term stimulus to economic activity.

Regarding the perspectives of inflation targeting in Romania , this monetary strategy would be maintained, according to NBR strategy at least till ERM 2[10].

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[9] NBR, Inflation Report, November 2011

[10] The **European Exchange Rate Mechanism**, **ERM**, was a system introduced by the European Community in March 1979, as part of the European Monetary System (EMS), to reduce exchange rate variability and achieve monetary stability in Europe, in preparation for Economic and Monetary Union and the introduction of a single currency, the euro, which took place on 1 January 1999. After the adoption of the euro, policy changed to linking currencies of countries outside the Eurozone to the euro (having the common currency as a central point). The goal was to improve stability of those currencies, as well as to gain an evaluation mechanism for potential Eurozone members. (according of www.wikipedia.com)

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