INFLATION CONTROL AND OPERATIONAL RISKS OF THE MONETARY POLICY

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Introduction

Inflation is an analysis topic of great interest for specialists and the general public as it disturbs resource allocation and income distribution in society. For this reason the inflationary process often represented occasions of controversy among experts and its approach has seen frequent changes of views and/or doctrinal positions. Precisely these controversies arouse the interest of researchers and place inflation theme in a central area of economics. Because inflationary phenomenon has multiple dimensions, pragmatic emergencies spectrum of a national economy subject to system change crisis oriented the research to process finality – *inflation targeting strategy*. The balance of cognitive approach has always been approached from the economic theory area, the analysis framework being extended with the necessary technical instruments exactly for the reason of maintaining this balance.

Conceptual disjunction between causes and pre-requisites of inflationary process is necessary in order to penetrate beyond appearances and to distinguish between factors that can be influenced and altered by anti-inflationary policies and permanent substrate factors, which explain the persistence of the inflationary process even at low manageable levels. Thus, it was found that *pre-requisites of inflation reside in the very major imbalance on which economics is built*: *the mismatch between the characteristics of needs-desires and those of resources-goods.* The causes of inflationary process relate to balance factors supporting pressure on the stock of money (monetary reasons) or stocks of goods (causes in real economy). Considering the causes and pre-requisites, the inflationary process seems to be rather the result of a complex set of economic imbalances located at both microeconomic and macroeconomic level. Cognitive approach takes into account the fact that spatial-temporal and structural dimensions of the conceptualization of inflation are important for understanding and analyzing this process. In this vision the research done tries to combine microeconomic perspective with the macroeconomic one. Thus, identifying the sources of the inflationary process in microeconomic area makes us formulate the explanatory model of "contagious disease" of market imbalances, inflation being considered as an extension of the contagion effect in a critical mass of markets which can propagate macroeconomic imbalances. The trying to determine the causes of this type of imbalance leads to cognitive approach toward the susceptible interests to support the disturbing factors. It is tried to answer a formulation, often avoided, of the awkward question: who are the winners from the onset of inflationary phenomenon, namely what interests are favoured in an inflationary environment. Without debating with the Austrian school that argues the state interests in maintaining an inflationary environment, we show that there are other interests (of large producers, suppliers and bankers) in this type of economic environment. Under these circumstances the hypothesis that the Central Bank controls only the money supply, while business environment and consumers determine the velocity of money, is launched. This hypothesis would explain better the difficulties of inflationary phenomenon control or the target failures of inflation targeting strategies. Using the relative price instrument it is found that both inflation and deflation have negative effects on the economic environment due to the alienation of the price system from the optimal point and implicitly the disturbances generated in making the decisions on resource allocation. This opens the conceptual horizon of inflation analysis toward the (wider) issue of price stability.

Since inflation variability means a variability of the expression benchmark of economic variables in real terms, it is normal that these instruments have taken the form of nominal anchors: *monetary aggregates, exchange rate, implicit (combined)*. The advantages, limitations and difficulties of using these nominal anchors in terms of frequent changes in general economic framework in which different monetary policies were implemented, are reviewed. The focus is of course on the causes that have blocked the effectiveness of these monetary anchors and imposed an innovation of monetary policy instrument dedicated to ensuring price stability. Major transformations in the global economy, the extent of globalization process advocated the necessity of a monetary policy alternative that established price stability with respect to a target aimed over a time horizon as its central objective. For this reason the new direction of monetary policy strategy was called "inflation targeting" strategy and unlike other strategies that seek to "acquire" low and stable inflation by targeting intermediate variables, inflation is targeted directly.

Based on the analysis of monetary policy loss function the cognitive connection with the issue of inflation targeting strategy substantiation by means of specific macroeconomic models is achieved. These requirements pertain primarily to the *ability to forecast the dynamics of the inflationary process, respectively the simulation accuracy of the propagation forms of different inflation-generating macroeconomic shocks*. Thus, the need to switch from FPS-type models (Forecasting Policy System) to the new DSGE-type models (Dynamic Stochastic

General Equilibrium) is clarified, explaining the net advantages of the latter in improving the performance of the aforementioned criteria.

Beyond the obvious success and rapid spread of the new strategy of monetary policy to ensure price stability, the hesitations of transition period are explained by the potential risks of strategy implementation. Experts' fears resided in the abandonment and/or neglect perspective of traditional components of monetary policy due to excessive concentration on implementing the new strategy (in the case of developed countries) and the trap of the vicious circle of monetary policy in which the new strategy could slide, due to insufficient development of the instruments specific to onset period (in the case of emerging countries). In addition, due to its rigors, the new strategy of ensuring price stability seemed too rigid even in case of implementing its flexible shape. On the same line of discipline and rigor, the hesitation of political representatives, respectively the economic policy makers' anxieties related to implementing the new strategy of monetary policy can also be interpreted. However, as inflation targeting strategy was expanding internationally, the question *whether this strategy helps to improve macroeconomic performances* occurred more frequently.

Starting from the current economic climate in which inflation seems to threaten, both by effects and by causes, Romania's economic recovery chances, respectively the fulfilment of the next stages of EU integration, a thorough analysis of the connections and influences in the manifestation of the inflationary process in our country is performed. The purpose of this analysis is to try to score some landmarks in the size of the inflationary process in Romania, which are *temporary, structural, subjective (perceptions of the population), territorial and those of the connections with the labour market*.

In the manifestation of the inflationary process in Romania we can identify some specific features such as:

- The abandonment of the command economy system also meant the collapse of a national system of prices.
- Emerging markets still had no power to self-regulate and issue correct price signals.
- Correlations between markets were insufficiently formed, generating macroeconomic aggregation inconsistencies.
- Against the sharp increase in aggregate demand and collapse of aggregate supply inflationary phenomenon erupted violently.

In analysing the temporal dimension of the connections and influences in the expression of the inflationary process several stages are identified: *shock of* *transition onset to market economy (1990-1995); liberalization of some categories of prices and exchange market (1997-1998); disinflation period (2000-2005); adoption of inflation targeting strategy by the NBR (August 2005); economic crisis (2009-2011)*. Thus, it was found that inflation was high and extremely volatile, especially in the first years of transition to a market economy, making actual control measures of the monetary authority almost impossible. In general, there was a normal correlation of inflationary process dynamics with economic cycle, but there were some interesting phase-shifts on certain components of the CPI. Thus, if commodity prices had a pro-cyclical dynamics, service prices were counter-cyclical. The factors that contributed to the establishment of disinflation period favourable for adopting inflation targeting strategy by the NBR are also analyzed. However, the central bank did not have enough time to build and test the instruments specific to inflation targeting strategy because of the onset of the global financial and economic crisis that has sharply distorted the main parameters of macroeconomic equilibrium. Against this background, during the onset of the crisis in Romania, disinflation process continued supported by aggregate demand scarcity, but the increase in VAT, higher fuel and food prices, as well as worsening twin deficits caused a dangerous re-inflammation of inflationary phenomenon especially in the first half of 2011.

In the structural dimension, the inflationary process is analyzed by the dynamics CPI, Core 1, Core 2 and adjusted Core 2, respectively fuel prices, administered prices, food, alcohol and tobacco prices. Atypical trends are identified in the dynamics of these components, which indicate deep structural imbalances in the functionality of Romanian economy.

The analysis of the territorial dimension of the inflationary process is the Novelty brought by our research and consists in the manner of overcoming the obstacle given by the absence of regional price indices in Romania.

The analysis of the subjective dimension of the inflationary process is based on a significant survey at national level and aims at public perception about the prospect of rising prices. Survey results show that the quasi-majority of Romanian population is very concerned about the increase in the cost of living. Both as a whole (CPI) and on the main categories of consumer goods, inflation expectations of the population exceed the target established by the NBR. Based on these results the central bank's reaction function was revised replacing rational expectations with adaptive expectations in the sub-chapter dedicated to testing the appropriateness of adopting inflation targeting strategy by the NBR.

The connection of the size with the labour market is very important because it highlights certain specific Romanian abnormalities in relation to the main assumptions of economic theory.

The motivations of the transition from the monetary aggregate targeting strategy to inflation targeting strategy are explained. It was found that the moment for adopting inflation targeting strategy was well chosen as Romania had managed to consolidate macroeconomic balances and especially – to reduce inflation to one-figure level.

This paper conducts a test of the main econometric equations that make up the arsenal of a central bank in inflation targeting strategy: the aggregate demand equation, the aggregate supply equation (Phillips curve type) and the equation of the reaction function of the central bank. We started from the hypothesis that if such equations, econometrically consistent, can be constructed, based on official statistical data, without profiting by information support from a structural macro model or DSGE model, then there are favourable conditions for the adoption of inflation targeting strategy in Romania. The results obtained were compared with those of other studies conducted worldwide, finding parameter enclosure within the limits suggested by these studies. In addition, both rational expectations and adaptive expectations were used for the central bank's reaction function.