Monetary Policy Challenges - Inflation Targeting Strategy and the Process of Euro Adoption

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Abstract. This paper is a review of some of the challenges for the monetary authorities in countries which adopted an inflation targeting strategy, and which are also intending to adopt Euro. Both the increasing mobility of capital flows and the preparations for entering ERM II are constraints for such a monetary strategy. Since September 2008, the financial crisis, having burst into the developed countries, has also affected the Central and Eastern Europe countries, and this phenomenon represents another challenge for the monetary authorities.

Keywords: European integration, capital mobility, exchange rate flexibility, ERM II, financial crisis.

1 Introduction

The macroeconomics debate on the effectiveness or ineffectiveness of monetary policy along with empirical evidence from many countries lead policy makers and economists to come to a general consensus suggesting that monetary policy can exert some real effects on the economy, but only in the short run. The same policy becomes ineffective to change the level of output in the long run and has a negative effect on the central bank's credibility and could lead to a loss of public confidence. These empirical findings based on theoretical models lead many central banks to look for a credible nominal anchor. Inflation could serve as one of these nominal anchors. The main objective of inflation targeting is to achieve low and stable inflation in an economy. Other benefits of inflation targeting include increased accountability of the central bank (or the monetary authority) and transparency of their operating procedures. Hence, many emerging economies as well as some industrialized countries have recently switched to 'inflation targeting' as their monetary policy regime.

Early proposals of monetary systems targeting the price level or the inflation rate, rather than the exchange rate, followed the general crisis of the gold standard after World War I. Interest in inflation targeting schemes diminished during the Bretton Woods system (1944-1971), as they are normally inconsistent with exchange rate pegs such as those prevailing during three decades after World War II. New Zealand was the first country to adopt an inflation-targeting regime in 1990. Since then, many countries have adopted this strategy including both industrialized countries (such as Australia, Sweden, Switzerland, and the United Kingdom) and emerging economies (such as Brazil, Chile, Columbia, Czech Republic, Iceland, Israel, Mexico, Peru, the Philippines, Poland, Hungary, Romania and South Africa). Some discussion has also taken place in the Federal Reserve (the United States) and the Bank of Japan to switch to an inflation-targeting regime. The European Central Bank (ECB) already has a two-pillar system in place with inflation being one of the policy targets (along with monetary targets).

Countries that have adopted the inflation targeting strategy aim at reducing inflation and inflation expectations based on an independent national monetary policy, using a nominal anchor (low inflation), as a rule of behavior to avoid or limit the problem of temporal inconsistencies.

Among the *general (and theoretical) reasons* that underpin the adoption of an inflation targeting strategy (ITS), we can mention the following: *its viability* as the central bank is independent, the *possibility* of monetary policy *to focus on domestic variables* and the ability to allow the monetary authorities to use all available information to establish the optimal variant of the monetary policy, the central bank's *posibility to respond to domestic shocks*. Also, this type of strategy is also an institutional commitment concerning long term stability of prices, as a primary objective of the monetary policy.

For the new EU member states that have such a strategy (Poland, Hungary, Romania and the Czech Republic), the changeover to the euro (commitment which involves fulfillment of the criteria set by the Maastricht Treaty) is a complex and delicate process, because it involves a radical change of the monetary strategy - going from the flexible exchange rate regime to a fixed exchange rate regime (but with exchange rates variable within the established margins).

2 Inflation Targeting Strategy in the Process of Euro Adoption – challenges on focus

The main challenges, that the monetary authority has to face in these countries, regard the limitation of the benefits of independent monetary policy (by increasing international mobility of capital) and the establishment of a proper central parity allowing the central bank to reduce speculative pressure on the national currency. To these problems are added the financial crisis effects, which have clearly complicated the process of euro adoption.

Monetary policy independence is ensured by the fact that inflation targeting is based on all instruments that the central bank has at its disposal, in the situations of a flexible nominal exchange rate against the euro. It should be noted however that, in the current conditions of increasing international mobility of capital flows, the capability of an independent monetary policy is reduced, even if there is a flexible currency regime. In general, emerging economies'central banks are taking into account the effect that may be induced on exchange rate fluctuations by the variation of the official interest rate. The risk of triggering such fluctuations of exchange rates increase with the widening of the *carry trade*[1] global speculative phenomenon, due not only to financial liberalization, but also to technological information progress. To reduce inflation, the central bank may rise the official interest rate, which attracts speculative capital flows (*carry trade* profitable monetary operations), increasing substantially banks' deposits. This could increase the supply of banks' loans, with an impact on economy heating. If this heating is excessive, the central bank is forced to increase interest rates again above the appropriate level for maintaining the inflation expectations, generating excessive appreciation of the national currency. The circuit also shows the difficulty of the monetary policy management through interest rates. *In other words, increased mobility of the capital, with a flexible currency regime, is limiting the scope of an independent monetary policy (the experience of Poland in the period 2000-2001).*

Preparation for entry into ERM II, the precondition for adopting euro, is an important analysable issue for inflation targeting countries. This preparation influences the national monetary policy, by the fact that the flexibility of the exchange rate, an important instrument of the central bank for correcting certain imbalances, is now limited to the ± 15% fluctuation band around the central parity. Central parity should be established as correctly as possible, otherwise it creates speculative pressures, either

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[1] Carry trade operations are done in the forex market and consist of the purchase of the currency which has a bigger interest rate and of the sale of the currency that has a lower interest rate. Anyone who uses this strategy seeks to gain profit from the interest rates differential. Through these speculative operations, liquidity can be „exported" from one country to another.

by its increase or decrease. The experience of countries such as Slovakia[2], Hungary or the Czech Republic, in this direction, shows that the central bank should conduct monetary policy in a certain way that would offer the necessary space of action. Thus, Slovakia, which joined ERM II having a high level of inflation, suffered revaluations of the central parity, financial markets starting from the premise that the Slovak currency will need reassessment to ensure the fulfillment of the inflation criterion. This hypothesis was the basis of speculation in the forex market in Slovakia, which led the National Bank to revalue Slovak koruna against the euro. Also in Hungary, in 2003, having a ERM II type of exchange rate (with the constraints of exchange rate fluctuations within ± 15% band from central parity), the National Bank was forced to increase interest rates, following the pressure from national currency speculations. This shows that the target of speculation in the forex market may be not only the exchange rate.s level, but the level of interest rates, too. In the same framework of analysis, it has been often stated that the Czech national currency has been relatively stable in recent years due to low levels of interest rates which have provided some protection against speculative capital flows. But a low level of interest rates is not a sufficient condition to maintain stability of the Czech koruna. The reason of this currency’s stability should be sought elsewhere: in the credibility of the Czech National Bank concerning its firm commitment to keep inflation at low levels.

Lack or limitation of the margin of maneuver of official interest rates may be due to speculative capital flows, when the financial markets perceive this vulnerability.

From the experience of these countries, it could be concluded that the National Bank which adopted a strategy of inflation targeting, with a flexible exchange rate regime in a ± 15% band of fluctuation, should establish a level of central parity which could enable also a stable currency evolution in ERM II. In this sense, *the credibility* of the National Bank concerning inflation targeting is a prerequisite for this institution to be able to act for the prevention or elimination of any eventual speculative pressures, but it must be "built" on a solid and stable macroeconomic foundation. Otherwise, the credibility of the central bank will be affected sooner or later.

From the experience of the analyzed countries, it could be observed that the exchange rate instrument has not been fully used for this purpose from fear of flotation[3]. The monetary authorities of these countries have tried to avoid in this manner the possibility that such an increase in interest rates (meant to reduce domestic demand pressure) should determine too much capital inflows, which could lead to excessive volatility of exchange rate, compromising the basic objective of monetary policy (price stability).

The main problem with regard to flexible exchange rates is that it can not be removed the risk of diversion of the exchange rate from its equilibrium level. This risk can not be neutralized by the interventions of the central bank on the foreign exchange market, because these intervensions are costly and with short-term effects.

In the context of current global financial crisis, the new Member States may be the target of speculative attacks from foreign "investors" (non-financial and financial institutions), which are aiming at obtaining liquidity in these markets, trying to solve the lack of liquidity by transferring it to other countries. By the end of 2008, with such a situation was faced the National Bank of Hungary, which was unable to avoid or absorb the speculative shock, and also the National Bank of Romania, which in turn was able to manage and to eliminate the pressures on the exchange rate.

The financial crisis has reduced investors' appetite for risk and generated a reverse phenomenon to that of attracting foreign capital. The analyzed countries are characterized by a high level of domestic

[2] Slovakia is a member of the euro area since January 1st, 2009. The mixed strategy, which was adopted, in the last years, by this country was a preparation for entering into the monetary union: inflation targeting in the ERM II conditions.
[3] Although monetary policy in these countries provides a flexible exchange rate, the only concern of the central bank is inflation, fear of flotation is justified by the possible negative consequences of a too high volatility of the exchange rate and its effects over the economic growth and over the development of the current account balance.

investments financed by capital inflows, which put them in a vulnerable position, by the increase of the risk that these inflows to be reduced substantially in the next period. Such a phenomenon of diminuished foreign capital causes the depreciation of national currencies, which may exert inflationary pressures, thus making the task of the National Bank much harder. In fact, any country that is not sitting on her own "feet", which strongly depends on external environment and whose macroeconomic performance is built on a conjunctional base (foreign investments attracted by the EU accession and which are not reflected in increases in the supply of domestic products, economic growth based on final consumption, less on productive consumption as a result of global economic conditions in the past), a country which has no national strategy for sustainable development in the long term, driven by a realistic mix of macroeconomic policies, risks to be rapidly and dramatically affected by a change of situation from abroad.

In addition to drawbacks, the financial and economic crisis could offer also some advantages. Among the advantages we can mention the process of revising the status of national economies. At the macroeconomic level, it could be translated into a structural analysis and an elimination of those unfunctional or ineffective items. Inefficiency should not be viewed strictly in the light of missing the target, but rather in the light of non-alignment in a sustainable position to achieve the primary objective. Financial crisis, triggered in the summer of 2007 and extended in NMS, in the autumn of 2008, has generated debates on a possible quickening of the euro adoption by NMS. However, in the conditions of pretty high structural internal imbalances, premature adoption of the euro can not be a positive review of the monetary strategy as IMF suggests, but rather a strategy of growing the shortcomings. Thus, the strategy of monetary policy should focus on a better management of the monetary indicators' structure, on a better coordination with the fiscal-budgetary policy, and last but not least on a real encouragement of the economy on a sustainable base (encouraging private and public productive consumption), through all channels that are available.

3 Conclusions

Establishing an accurate and reliable central parity, the development of the *carry trade* operations, possible speculative attacks on the currency to cover the needs for liquidity of the investors, caused by the global financial crisis, are just some of the challenges that monetary authorities in the new Member States which have adopted a strategy of inflation targeting have to face. Responding to these challenges can be done by formulating a mix of macroeconomic policies that are directed primarily towards the achievement of the internal macroeconomic stability and the development of economic activities with long-term perspective, and not only the fulfilling strictly of the nominal convergence, an important role in this direction having the credibility of the monetary and the fiscal authorities.

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