

Strategies for Developing Monetary Policy in Emerging Countries

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Abstract

Monetary policy is a primary element of economic policy, as with its help central banks can act and influence both the demand and supply of money in the economy. The main purpose of monetary policy measures is to ensure price stability, effective control over inflation, as well as the stability of the national currency. A very important aspect to highlight about the European Central Bank is that the objective of monetary policy aims at the strategy of maintaining price stability and the inflation rate at lower levels. Any decision is the product of a procedure that involves the assembly of a large number of primary information. The monetary policy decision is also subordinated to these procedures, but simple information, regardless of its degree of organization and hierarchical processing, does not seem to be sufficient to be able to make a decision.

Keywords: monetary policy, European monetary integration, financial stability, price stability, inflation targeting, emerging economy, European Central Bank (ECB), convergence process.

JEL Classification: K22, K34

1. Introduction

An infallible monetary policy should be supported by appropriate monetary policies, since, at least in emerging economies, due to real and nominal shocks that cause imbalances in financial markets and implicitly cause unpredictable price variations, inflation control is of paramount importance². In other words, 'economic policy is a deliberate state intervention in the economic field in order to achieve certain structural or conjunctural objectives'³.

The particularities of economies in transition determine considerable inflows of direct investments, either independent or through the process of transferring some assets from the state's patrimony to the patrimony of private entities, or portfolio investments, which have been generated by the higher interest that made these markets extremely attractive.

These aspects can generate two relevant consequences at macroeconomic level: the first would be an appreciation of the exchange rate, which would reduce inflationary pressure in the short term, the second consequence would essentially be generated by the appreciation of the national currency which would implicitly disfavor exports and generate an external imbalance; the boomerang effect would continue with currency depreciation, high inflation and a vulnerability of the economy associated with changes in foreign markets⁴.

2. In monetary theory and particularly in monetary practice

In monetary theory and particularly in monetary practice, there are three monetary policy strategies that have generated an effective nominal anchor, namely: targeting monetary aggregates, targeting the exchange rate and targeting inflation. An alternative to these strategies would be the nominal income strategy, which however is a purely theoretical strategy, not yet applied in real monetary policy.

Currently, in the emerging economies of Central and Eastern Europe, exchange rate targeting policies and inflation targeting policies are used, while the policy of targeting monetary aggregates loses its importance due to the disintegration of the relationship between monetary aggregates and inflation, against the background of liberalization of capital flows and a reduced inflation and

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² Isărescu, Mugur, *Probleme ale politicii monetare într-o țară emergentă. Cazul României*, 2008, p. 27, (https://www.bnr.ro/files/d/Noutati/Prezentari%20si%20interviuri/Probleme_PM_tara_emergenta.pdf).

³ Basno, Cezar and Dardac, Nicolae, *Currency, Credit, Banks*, Didactic and Pedagogical Publishing House, Bucharest, 1999.

⁴ Isărescu, Mugur, *op. cit*, 2008, p. 28.

implicitly an accelerated remonetisation⁵.

In the approach of the European Central Bank there is a strategy that takes into account the rhythm of the monetary mass, structured into 2 pillars:

a) economic analysis - carried out by analyzing short- and medium-term price determinants, focused on the evolution of the economy and financial conditions

b) monetary analysis - carried out by capitalizing on the long-term connection between money and prices; thus, by analyzing the evolution of the monetary mass, the authorities can make forecasts on inflation

However, monetary policies differ from state to state, depending on its size and the specifics of the economy; therefore, monetary practice shows us with the following types of monetary policies related to the exchange rate: 'monetary council' regime (Bulgaria, Estonia, Lithuania), hard peg regime (Latvia), freely floating exchange rate regime (Poland), managed floating exchange rate regime (Czech Republic, Romania).

Regarding an inflation targeting approach, the central banks of the states that adopt such a strategy must pay more attention to loss functions, through complex measures adopted in order to minimize them⁶.

Emerging economies present certain specific characteristics which, combined with the criteria for joining the euro zone, generate difficulties in the elaboration of monetary policy.

Thus, the shocks on the supply side, the expansion of the monetary substitution phenomenon, the fragility of fiscal institutions, the shallow financial markets, the vulnerability to the sudden interruption of capital inflows and labor migration generate a high degree of complexity in the development of price stability.

Based on the above, we can say that price stability is the fundamental objective of an effective monetary policy.

The main reason would be that, in addition to the inflationary balance it determines, price stability also allows the regulation of other macroeconomic imbalances and thus this policy becomes the best measure that can be taken in order to ensure a state of social welfare and an increasing standard of living.

This idea is supported by the Treaty on European Union, according to which 'the primary objective of the European System of Central Banks (ESCB) is to maintain price stability'. Despite these facts, the effectiveness of monetary policy is constrained in the absence of a viable and stable financial system. The efficient operation of the interest rate and credit channel is hindered by shallow financial markets, therefore a fine-tuning operation by the European Central Bank is limited and an excessive dependence on the exchange rate channel in the aggregate demand management process may be generated.⁷

The independence of the Central Bank is reflected by its ability to ensure the achievement of the macroeconomic policy objective established by the government.

Therefore, the Central Bank does not have the independence in establishing the objective of monetary policy, but it does have the independence regarding the choice of the instruments used to achieve such an objective.⁸

Appreciating the exchange rate of the national currency has an extremely relevant contribution regarding the process of reducing inflation. In the context in which it presents imbalances, combined with a considerable current account deficit, long-term price stability shall be compromised.

Thus, in order to achieve the objective of long-term price stability and to take advantage of the gains from disinflation, the European Central Bank must apply a prudential monetary policy, with increased attention given to financial stability and macroeconomic indicators⁹.

In the last two decades, price stability has become the primary objective of monetary policy.

⁵ Idem.

⁶ Ibid.

⁷ Ibid.

⁸ Fraser, B.W. *Central Bank Independence: What does it mean?*, Reserve Bank of Australia Bulletin, December 1994.

⁹ Isărescu, Mugur, *op. cit.*, 2008, p. 30.

In this sense, Marshall & Swanson emphasized that 'price stability represents an important objective for monetary policy because price instability, manifested as inflation, can have long and intense consequences on a national economy. The unfavourable side, starting from increased inflation, resides in the reduction of economic efficiency, in an unfair and whimsical distortion regarding the income distribution and in a downgrade of the international balance of payments'.¹⁰

Two of the reasons behind this concept are: firstly, monetary policy can stimulate long-term economic growth by controlling inflation, and secondly, the traditional strategy of controlling inflation through intermediate alternatives such as monetary aggregates was starting to lose its credibility.

Furthermore, this inflation targeting strategy assumes a direct approach to achieving the objective of long-term price stability, without resorting to the manipulation of intermediaries in order to achieve it.

Inflation targeting can be defined as the framework of monetary policy characterized by the public commitment of the central bank to achieve quantitative inflation targets announced for one or more time horizons and the explicit recognition of the fact that a low level of inflation is the long-term priority objective of monetary policy.

As a result, direct inflation targeting represents the monetary policy strategy that involves setting a target for the level of the inflation rate, over a certain period of time, target that must be reached by applying monetary policy measures, so as to ensure price stability¹¹.

Waivering intermediate objectives in order to directly target inflation has been done to ease the central banks' mission; however, national monetary authorities must pay more attention to the factors that could jeopardize price stability.

Under these circumstances, fiscal policy needs to be adjusted according to the actions taken at the central bank level, 'so as not to jeopardize the inflation objective, which is equivalent to the absence of any symptoms of fiscal dominance, namely:

- the financing of the public deficit directly by the central bank or by the banking system should be reduced or even non-existent;
- government should not depend on seniority earnings;
- financial markets should be sufficiently developed to allow the trading of public or private debt instruments;
- the level of public debt should be sustainable.'¹²

By setting the medium-term inflation target and making its levels public, investors can make a clearer forecast on the real value of the cash flows generated by their investments in the markets of the states whose national monetary authorities have adopted this strategy.

At the same time, 'the money supply control is the most important monetary instrument for stopping inflation. That is why interventions to increase liquidity in economic circuits must be carried out with great caution'.¹³

This strategy offers the central bank considerable room for maneuver in the implementation of monetary policy, preserving its ability to respond to unexpected shocks through an appropriate adjustment of the level of monetary policy instruments, safeguarding the fundamental objective of price stability.

Inflation targeting, as a strategy, has the following characteristics:

a) the main objective is price stability; the other objectives stepping out of the spotlight into the background (economic growth, covering fiscal deficits, reducing the unemployment rate etc.) Many economists consider that the optimal level of the unemployment rate is that which, in

¹⁰ Marshall, Robert & Swanson, Rodney, *The Monetary Process: Essentials of Money and Banking*, Houghton Mifflin Company Boston, 1974.

¹¹ Sherwin, Murray, *Institutional Framework for Inflation Targeting*, Reserve Bank of New Zealand, October 2000 (www.rbnz.govt.nz/speeches/009759.html).

¹² National Bank of Romania, *Direct Inflation Targeting: A New Monetary Policy Strategy*, Occasional Papers, Bucharest, 2002.

¹³ Isărescu, Mugur, *Inflation and Fundamental Balances of the Romanian Economy*, National Bank of Romania, Occasional Papers, no. 3/ June 1996, www.bnr.ro.

correlation with the inflation rate, does not generate accelerated growth;¹⁴

- b) transparency in the decisions and objectives of the national monetary authorities;
- c) increasing the responsibility of the central bank by attaining the achievement of certain goals.

The Central Bank shall have to be better informed on macroeconomic variables and indicators than in the case of traditional strategies; this is explained by the fact that all these variables are interdependent and can to some extent influence price stability.

Therefore, the attention of the national monetary authority must be directed to the following variables: the level of wages, the level of labour productivity, the level of import prices, the level of production prices, the level of the interest rate, the level of the real and nominal exchange rate, as well as the level of the budget deficit.

The strategy of direct inflation targeting has been adopted in many industrialized economies, but it is beginning to make its presence felt in emerging economies as well, because, by ensuring price stability, it facilitates the achievement of nominal and real convergence with the European Union in view of the monetary integration process.

The first reason would be empirical studies, that led to the conclusion that high inflation cannot support economic development, external competitiveness or employment. In the long term, inflation inhibits investment and reduces real income.

That is why it was concluded that keeping inflation as low as possible is the primary objective for ensuring economic growth.

The second reason would be the decrease in the credibility of monetary aggregates in determining inflation. This equation instability led many countries in the '90s to adopt the inflation targeting strategy. The strategy was seen as a more practical and less risky solution than those based on targeting inflation through intermediaries.

Thirdly, monetary policy has been subjected to important changes under the impact of the increasing international integration of financial and goods markets. In the context of capital account liberalization, a floating exchange rate regime can better protect the economy against real or nominal shocks in foreign markets than a fixed exchange rate regime.

The fourth reason can be considered the credibility associated with monetary policy, upon the adoption of the inflation targeting strategy through the transparency specific to this strategy, generating better results of the evolution of inflation and production, at the same time increasing the possibility of economy to adapt to shocks. The success experienced by industrialized economies has given emerging economies more confidence to adopt this strategy as well.

The successful implementation of direct inflation targeting strategy depends on the following pre-requisites:

- a) ensuring the independence of the central bank from the point of view of monetary policy instruments used in order to achieve the established nominal objectives;
- b) the government should not be involved in the development and implementation of monetary policy, and the public sector should be financed to a small extent by the central bank;
- c) the European Central Bank must avoid targeting other variables, such as the exchange rate, because the inflation targeting strategy generates effectiveness only in the case of considerable flexibility of the exchange rate;
- d) the European Central Bank needs a strictly market-based monetary policy instrument, such as the short-term interest rate;
- e) transparency and responsibility of the central bank in view of inflation expectations;
- f) high forecasting potential of the central bank;
- g) selecting a relevant and conclusive price index;
- h) the central bank's strategy must be long-term because any monetary policy decision has a delayed effect.

¹⁴ Mayer, Thomas, Duesenberry, James S. and Aliber, Robert Z., *Money, Banking and the Economic*, W.W. Norton & Company, Inc, 1984.

The main advantage of inflation targeting is represented by maintaining price stability which gives an impetus to economic growth.

Therefore, having this as the main objective of the monetary policy, the forecasts made about inflation, wage increases and prices in the economy become more plausible.

The best definition of price stability is given by that rate of inflation which is low enough for private individuals and entrepreneurs not to take it into account when making their daily decisions.

The use of an appropriate mix of policies has a fundamental role in achieving the primary objective of monetary policy, namely ensuring price stability, because prices in the economy are subject to both internal and external influences, acting on aggregate demand and supply.

In a framework of global financial interdependence and increased uncertainty, the ideal monetary policy should be characterized by commitment, consistency, dynamic, transparency, accountability, qualitative assessment, avoidance of excessive fluctuations and flexibility, a set of attributes that inevitably involve a certain degree of complexity.

Since a stable financial system is a necessity for the effective transmission of monetary policy, central banks must pay more attention to financial market activities, contributing to the objective of long-term price stability.

3. Conclusions

Thus, it is necessary to determine the main sources of risks and vulnerabilities of financial systems, through a systemic monitoring and an assessment of the requirements of financial stability. However, it must be taken into account that these risks and vulnerabilities are also related to the events registered at macroeconomic level.

On the way to achieving real and nominal convergence with the European Union, the emerging economies of Central and Eastern Europe encounter difficulties from the point of view of monetary policies. One of the most relevant is represented by the establishment of a balance regarding the establishment of the interest rate policy, so that inflation targets are reached without additionally stimulating capital inflows that could erode the external competitiveness of the economy and the long-term growth prospects.

To achieve this goal, the European Central Bank must be guided by a fundamental principle, according to which there is no possibility of achieving a long-term compromise between inflation and economic growth and the only solution for achieving sustainable economic growth is a long-term commitment to the objective of price stability.

In the event of a conflict between these two objectives, it is preferable to safeguard financial stability and not a rapid disinflation.

Countries that have adopted a disinflationary process must choose an appropriate pace of disinflation in order not to endanger the objective of financial stability. Failure to achieve financial stability can only lead to re-entry into the inflationary process.

One of the essential objectives of economic policy is, in the case of most contemporary states, combating or at least limiting inflation and implicitly price stability.

The inflationary phenomenon is considered a sign of an imbalance in the economy, which is why it is necessary to control inflation and avoid the inflationary process.

The convergence process must be constantly analysed and monitored at least from the point of view of its risks and sustainability; only in this way can the role and conduct of monetary policy be correctly determined in order to achieve macroeconomic stability.

Moreover, for this universal purpose, monetary policy must be supported by an optimal fiscal policy, implicitly prudent, and it is necessary to avoid their procyclical nature.

Considering the international context that will be less favourable in the coming years, the absence of an adequate mix of macroeconomic policies increases the risk of macroeconomic imbalances.

Therefore, the economic policies implemented by authorities must temper the warming of the economy and implicitly reduce the risk of a 'forced landing' following years of economic growth,

through a smooth adjustment of existing imbalances.

The process of convergence in the emerging economies located in Central and Eastern Europe was supported by the liberalization of capital flows, however, the flip side of the coin was the increased vulnerability of these economies to external financial shocks.

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