

Direct Inflation targeting strategy: Experience of EU Member States and perspectives for the Republic of Moldova

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Summary

In 2010, two years after stating the intention to start direct inflation targeting, the NBM adopted the respective strategy. Over the past two years of preparations Moldova registered progress in financial indices, these being currently commensurate with the ones in EU Member States with direct inflation targeting regime at the moment of the strategy adoption. A major exception concerns the very high budgetary deficit that may lead to a situation when monetary policy is dominated by budget fiscal policy. At the same time, the monetary policy promoting mechanisms remain weak, whereas in most states these evolved along with strategy adoption – prospect, expected in the Republic of Moldova as well. Thus, the direct inflation targeting strategy is welcome, given inflationary pressures expected to increase this year. This will also discipline the National Bank of Moldova (NBM) in ensuring firmness of its policies that already point to exceeding the official 5(+/-1)% inflation target by 0,5 p.p. by the year-end.

The direct inflation targeting strategy

While NBM announced its intention to start direct inflation targeting in November 2007, the institution adopted the respective strategy only two years later, in 2010. The decision was endorsed as a result of the failure to maintain over a number of years the inflation within mid-single digits, even following the approval of the amendments to the Law on the NBM of 2006 and setting the achievement and maintenance of price stability as primary objective of the National Bank of Moldova.

Initially, direct inflation targeting was associated with industrialized countries (New Zealand, Canada, Great Britain, Sweden, Australia) that adopted the relevant strategy at the beginning of the '90s. Moreover, at that time it was considered, including by the IMF, that direct inflation targeting is not an adequate strategy for developing countries, because of the technical and institutional requirements (lacking in many transition countries) in ensuring a successful outcome of the strategy. These referred to: central bank independence, central bank's analytical abilities, well-developed financial system and lack of regulated prices. However, up till now, out of the approximately 30 countries implementing the direct inflation targeting strategy, most were in transition, the strategy being for the most part effective.

The successful implementation of the inflation targeting strategy calls for the fulfillment of a series of prerequisites[1]:

1. Institutional prerequisites:

- *Maximum priority of the inflation objective.* This provision needs to be provided for in a legislative act. In some states (for example in Czech Republic) this objective is stipulated in the constitution. In the Republic of Moldova, according to the Law on the National Bank of Moldova, the central bank's primary objective is to achieve and maintain price stability[2].

- *Central bank independence.* The Central Bank needs to be independent from the Government: on a personal, institutional, operational and financial level. The NBM independence is provided for by the Law on the NBM, quoting “the National Bank shall be independent in exercising the attributions vested by this Law and shall not request, nor shall be instructed by public authorities or any other authority”.
- *Harmonizing monetary plan of action with governmental policies.* Government programs should not prevail over the country’s monetary policy. Given the current political-economic environment in the Republic of Moldova, characterized by high budgetary deficit, this could pose a problem. In 2009 the NBM acted as fiscal agent of the State in issuing state securities for covering the budget deficit. The budgetary situation in 2010 is still challenging.
- *Floating exchange rate.* For reaching its primary objective, the central bank must give up completely exchange rate targeting. Or else, interventions on the foreign exchange market are the most efficient tools used to keep inflation under control. This objective having been given up in the Republic of Moldova, both the population and economic agents are still sensitive to exchange rate fluctuations, which leads to inconveniences for the National Bank.
- *Financial system stability.* The financial system is very important in promoting monetary policies. Thus, its relatively high development level and stability are absolutely vital. Though apparently, the financial system in the Republic of Moldova withstood the pressures exerted during the crisis, a number of indices worsened (the ones for non-performing loans), whereas some – improved (the liquidity index).
- *Efficient monetary policy instruments.* In order to reach the inflation objective, central banks must have the necessary ability and skills in using existing tools, such as: the exchange rate, interest rate for REPO operations, required reserves. NBM has these instruments at its disposal and can use them, but the transmission channels differ from the point of view of efficiency of the promoted monetary policy. Up till now, NBM made less use of the base rate and resorted more to the required reserves and the exchange rate.
- *Transparency and accountability.* There has to be a PR strategy, the NBM could use to inform the public on the inflation target and the developments on the issue. The communication should be realized through monthly reports on inflation, press statements – actions already taken by the NBM.

2. Technical requirements:

- *Choosing the right price index.* The official measure estimating inflation is the Consumer Price Index (CPI), the base or net inflation rate depending on the central bank’s abilities to forecast prices for goods it has no hand in. NBM chose the CPI as inflationary target, though its prediction becomes more difficult.
- *Establishing a fluctuation framework and lapse of time for the inflation objective.* Depending on the inflationary trend in the past years, it is necessary to define the timeframe for the inflation objective and its eventual variations, as well as the fluctuations’ framework that doesn’t have to be too wide, so as not to compromise the central bank’s credibility in forecasting and reaching the inflation objective.
- *Defining exceptions.* Though the central bank should take into account all factors prone to influence inflation after the inflation target has been established and announced, the institution has to take appropriate measures against such exogenous factors as: significant changes as compared with projections of international prices for raw materials, major shifts in national currency exchange rate unrelated to the promoted monetary policy, variations in production conditions within the agricultural sector, fluctuations of regulated prices, amendments to indirect taxes. Once established, the bank could be right in not immediately reacting when such factors occur. NBM has not explicitly stipulated these provisions.
- *Central bank’s ability to forecast inflation.* The central bank must use well-defined methods for the most accurate inflation forecasting. In Moldova, the system of analysis and forecast instruments is developing, but it requires significant improvements in order to get results, closest to the real situation.

Direct inflation targeting in the Republic of Moldova

When NBM announced in 2007 about its intention to adopt the direct inflation targeting strategy, there were many pros and cons of the initiative. However, over the past two years NBM prepared for this strategy's implementation and currently, there are more arguments favouring direct inflation targeting, including:

- *The instruments, earlier used for maintaining price stability proved to be insufficient.* Thus, the annual inflation at the year-end was not single-digit from 2002 to 2008. Neither the Memorandum on economic and financial policies signed with the IMF, nor the amendment to the Law on NBM brought the expected results. Moreover, no continuous disinflationary process was registered. Consequently, a new strategy for fighting inflation was deemed necessary.
- *Current inflationary pressures.* Though inflation rate was not too high in 2008 and 2009, this was more of a consequence of the global economic crisis and namely of the price decrease for raw materials (energy resources), drop in demand and agricultural crop, rather than of some NBM actions. Thus, for reducing inflation caused by inflationary pressures resurfacing during economic recovery, direct inflation targeting is a welcome measure.
- *Republic of Moldova's preparedness to adopt the Direct Inflation Targeting Strategy improved.* During the two-year period from the moment the intention to start direct inflation targeting was announced, up to the strategy adoption, NBM had been preparing for the program implementation. As such, NBM proved its complete giving up of the exchange rate targeting, the Moldovan leu freely fluctuating during inflationary pressure periods. The evolutions within the financial system have also been positive, this sector having been given impetus, which is important for promoting the monetary policy.
- *Other countries' experience in implementing direct inflation targeting strategy.* EU countries that adopted the direct inflation targeting strategy (Czech Republic, Poland, Hungary, Slovakia, Romania) have been successful in decreasing inflation. Though these had a better situation compared to the Republic of Moldova at the moment of the strategy adoption, there are states that were in a more puzzling macroeconomic situation than Moldova (27.2% inflation rate in Chile and 18% - in Israel), but succeeded in reducing inflation in the context of the newly adopted strategy.



Despite the fact that a number of countries have positive experience and Moldova got closer to implementing direct inflation targeting during the last two years, there are challenges facing NBM, which could make the task more difficult. These are:

- *Foreign inflationary pressures.* Within the context of the global economic recovery trend, there are inflationary pressures related to price increase for energy resources in 2010. This could lead to a consequent increase of regulated prices (tariffs). The February rise in tariffs for utilities has already

started creating major impediments for the National Bank. This will bring CPI in the first months of the year at a level close to the targeted one. Thus, the National Bank will have to adequately use the monetary policy instruments at its disposal.

- *The difficulty of the exchange rate free floating.* Exchange rate free floating is a prerequisite for the inflation targeting strategy implementation. Foreign exchange market interventions are very efficient in decreasing inflation. In fact, NBM Monetary Policy Report No. 1 forecasts a moderate appreciation of the national currency, while maintaining price stability. NBM forecasts for the end of 2010 an average exchange rate between MDL 16.5-17.3 against EURO and MDL 16.2 – 17.2 [3] for 2011. However, the population and economic agents are very sensitive to exchange rate fluctuations, fact that could impel NBM to massively intervene for soothing panic on the market.
- *Interest rate as monetary policy instrument is still weak.* Up till now, the interest rate on REPO operations has not been a very productive instrument for keeping the monetary mass under control. Thus, the monetary policy transmission channel has been very weak, NBM being forced to act by means of other instruments. Medium-term, this tendency will endure.
- *Fiscal policy.* The monetary policy can be undermined by the budget fiscal policy, given a very high budget deficit and no certainties that state incomes would increase. Certain actions for increasing budgetary incomes, with impact on inflation have already been taken (excise increase for several categories of goods).
- *The difficulty of CPI targeting.* NBM aims at targeting CPI, and not the base inflation rate. Though frequently used, this is quite a difficult task and requires great efforts from the NBM, since the latter cannot control and influence all CPI component parts (tariffs, prices for energy resources and agricultural products).

Thus, though NBM prepared to embark on inflation targeting in 2008-2009, serious difficulties referring to weak channels of monetary policy promotion still persist. This is overlapped by Republic of Moldova's current situation, seriously hit by the crisis, needing a longer period of time to recover. A month after launching the implementation stage of direct inflation targeting NBM seems quite sceptical regarding the achievement of the inflation objective. It is expected that the annual inflation in March will reach 6.1%, increasing to 7.7% in August- September. NBM forecasts a 6.5% [4] inflation rate for the year-end.

EU Member States' experience in direct inflation targeting

Over the past few years more states with different development levels adopted the direct inflation targeting strategy. EU Member States are among these (Table 1).

Table 1. EU Member States with direct inflation targeting regime (ITR)

	The year of ITR strategy adoption	Inflation rate at the moment of the ITR strategy adoption	Inflation target in the year of ITR strategy adoption	Inflation rate in the year of ITR strategy adoption	Inflation target
Czech Republic	1997	10	6 (+/-0,5)	6,8	Net inflation rate
Poland	1998	9,9	6,6-7,8	9,8	CPI
Hungary	2001	10,5	7 (+/-1)	6,8	CPI
Slovakia	2005	5,9	3,5 (+/-0,5)	3,5	Harmonized CPI
Romania	2005	9,3	7,5 (+/-1)	8,6	CPI
Moldova	2010	0,4	5 (+/-1)	6,5*	CPI

Note: * estimated

Source: Central banks' web sites

Though, according to inflation data at the moment of the strategy adoption Moldova was the best positioned, the index is not 100% relevant. 2009 – a year of deep crisis has been characterized by deflation in the first 6 months, which resulted in a very low inflation by the year-end. This situation was caused by the international conjuncture and one cannot talk about a steady disinflation process. However, provided appropriate instruments are used, Republic of Moldova has great chances to succeed in reducing inflation in the context of adopting the inflation targeting strategy.

Additionally, as shown in Table 2, one can depict significant differences in Republic of Moldova’s financial indices, compared to the ones of European Union Member States at the point of the strategy adoption. These prerequisites are important for the implementation of any monetary policy, more so, within the context of the inflation targeting strategy.

Table 2. Financial indices at the moment of the direct inflation targeting strategy adoption (% of GDP)

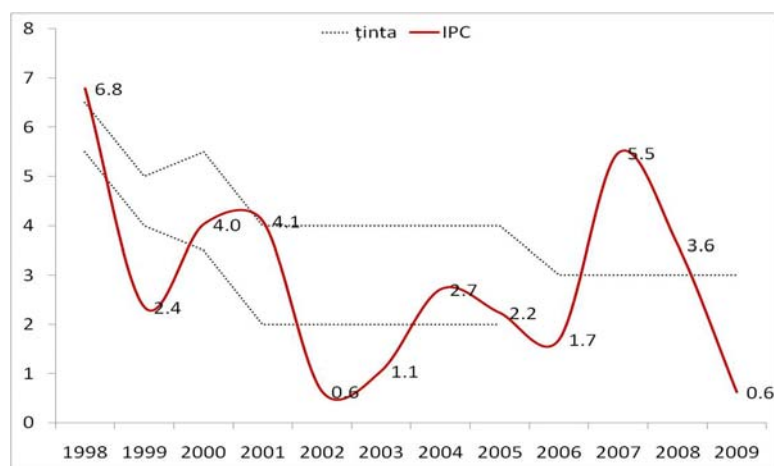
	Non-government loans	Banking system assets	Stock market capitalization	Fiscal deficit	Inflation rate at the moment of ITR strategy adoption
Czech Republic (1997)	61,5	136	24,1	-1,3	10
Poland (1998)	23,1	56,2	12,9	-2,2	9,9
Hungary (2001)	31,7	69,1	20,1	-4,4	10,5
Slovakia (2005)	-	-	-	-	5,9
Romania (2005)	17,5	38,3	17,6	-1,1	9,3
Moldova* (2009)	39,6	66,2	21,2	-6,8	0,4

Note: * 2009 GDP forecasted by the IMF, World Economic Outlook, October, 2009.

Source: Direct Inflation Targeting: between hopes and accomplishments, Mihai Nițoi, Mircea Perpelea, 2009, NBM, Ministry of Finance, EVM Group.

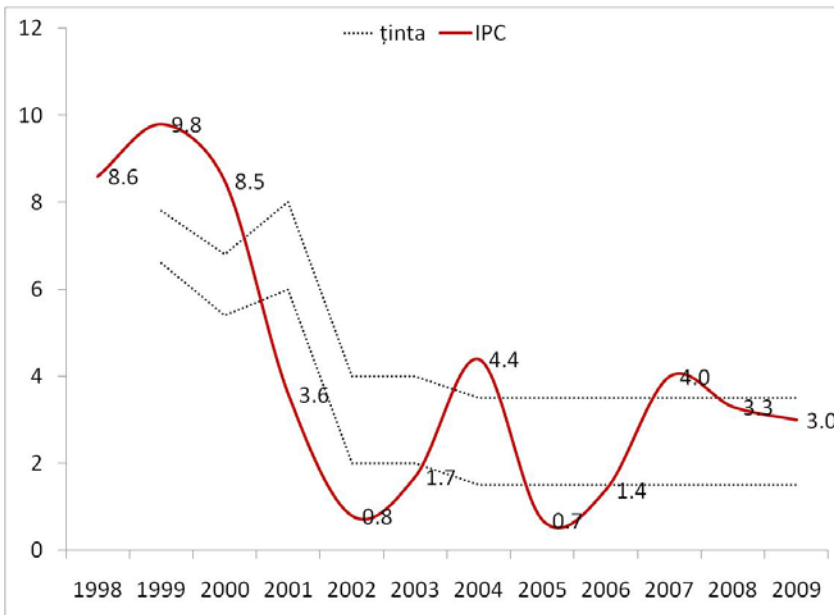
The most significant differences are certainly in the budgetary deficit of Republic of Moldova, as compared with other states, fact that could lead to difficulties. However, other countries’ experience proves that generally, the improvement of conditions for reducing inflation comes along with or upon the adoption of the direct inflation targeting strategy, and not necessarily before its implementation. Also, the international practice shows that, despite inflation decrease was successful most of the times, there were many years registering serious deviations from the inflation objective (Diagram 1-5).

Diagram 1. Inflation rate and objective in Czech Republic (%)



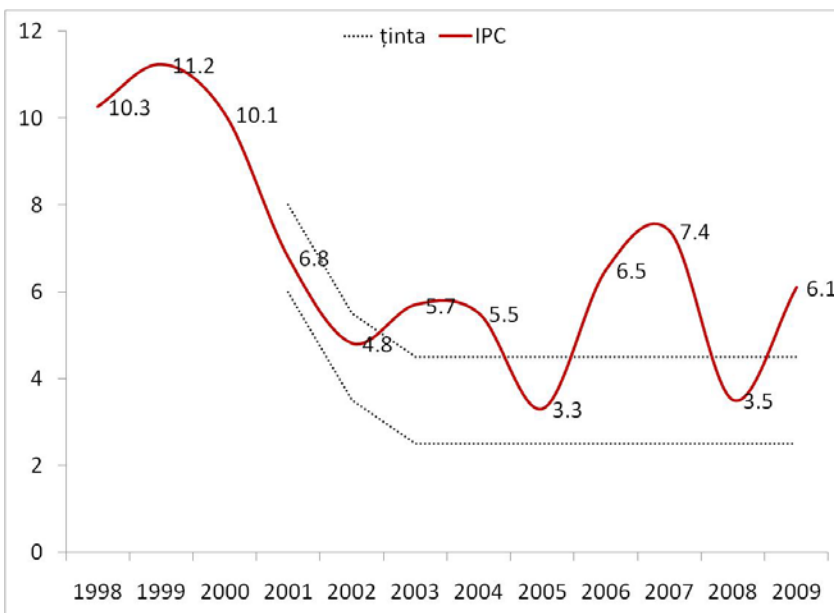
Source: Czech National Bank

Diagram 2. Inflation rate and objective in Poland (%)



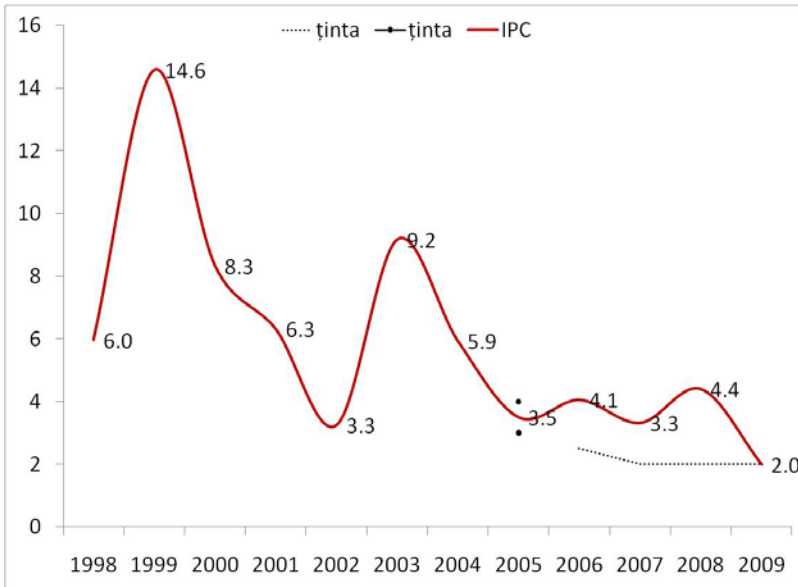
Source: National Bank of Poland

Diagram 3. Inflation rate and objective in Hungary (%)



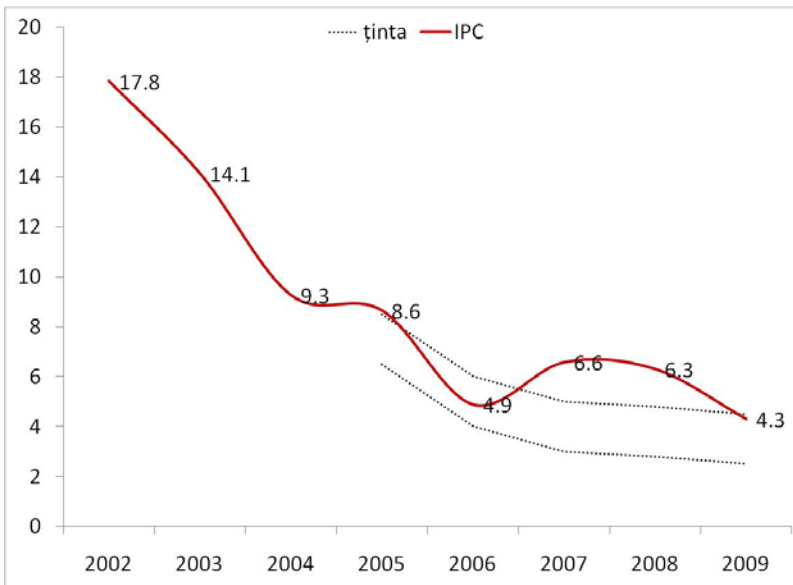
Source: National Bank of Hungary

Diagram 4. Inflation rate and objective in Slovakia (%)



Source: National Bank of Slovakia

Diagram 5. Inflation rate and objective in Romania (%)



Source: National Bank of Romania

Conclusions:

Taking into account other countries' experience, with a view of promoting the monetary policy and reaching the inflation objective, the following elements are important for the Republic of Moldova:

- Moldovan banking system has been characterized by a relatively speedy increase of bank assets. However, the total required capital is very concentrated. The largest five banks make up for 63.2% in total required capital within the banking system. This ratio decreases the speed of monetary policy implementation in Moldova.
- For the time being, the liquidity in the economy is lower than in many other states (34%). But, compared with those countries' situation at the moment of direct inflation strategy adoption, liquidity in

in the Moldovan economy is not that low. Scarce liquidity is a sign of the banking system's inefficiency, as well as of private agents' inability to appropriately use resources.

- The deposits' and loans' conversion into USD (55% and 45% respectively) can also affect the monetary policy's promotion, multiplying the effect of exchange rate fluctuations. The share of USD in the Republic of Moldova is comparable to the one in Hungary and Romania, but is higher than in Poland, Slovakia and Czech Republic.
- Lack of balance on the labor market. Over the past years, wages' increase was higher than labor productivity. Nevertheless, remittances have played (and still do) a significant role in Moldova, magnifying inflationary pressures. Short-term, given continuous effects of the economic crisis, these would not exert considerable pressure, but will resurface medium-term.

Thus, even if at the end of 2010 the inflation objective is exceeded, NBM has great chances of reducing the inflation, as against the level registered during the years prior to the global economic crisis. Though the mechanisms for monetary policy promotion are still weak, these could be improved along with the strategy adoption. Consequently, the Bank's motivation to maintain price stability will be enforced, as was the case in other countries. Exceeding the inflation target is not incidental, the phenomenon being true for all states. Nevertheless, in order to secure its trustworthiness, failures in inflation targeting should only be an exception for the National Bank.

Sources:

- [1] Direct inflation targeting in Czech Republic, Poland and Hungary: implementation and performance, National Bank of Romania, 2004.
- [2] The Law on the National Bank of Moldova No. 548-XIII as of 21.07.95.
- [3] Monetary Policy Report No.1, NBM, 2010.
- [4] Monetary Policy Report No.1, NBM, 2010.

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Strategic Objectives

- Contribute to the efficient implementation of the governmental strategies aimed at the socio-economic development and democratization of Moldova;
- Promote and consolidate the democratic institutions and procedures;
- Encourage and facilitate citizen participation in the decision-making and governance processes.