

# THE INFLUENCES OF INFLATION ON THE MONETARY POLICY INTEREST

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*In the context of sovereign debt crisis in Europe, a crisis entirely felt also in the direct relation between credit institutions, the National Bank of Romania (NBR) adopted a monetary policy strategy meant to determine the reinforcement of its image, by initiating in the autumn of 2011 a new series of reduction of the monetary policy interest rate and implicitly the appropriate resizing of liquidity conditions. By increasing the role of liquidity adjustment, the European Central Bank (ECB) succeeded to determine in the money market the decrease of interbank rate interests under the interest rate level of monetary policy. The direct inflation targeting strategy used by the European Central Bank in applying its monetary policy has the first criterion of implementation the expression of inflation target in terms of „headline inflation” (consumer price index - CPI) given that the economic market in Romania is familiar with this indicator. Also, the main criterion considered by the investment segment of the market to achieve capital infusions in economic transactions is represented by the consumer price index, this one ensuring the necessary transparency related to the effects of inflation phenomenon. A strong argument supporting the use of consumer price index in monetary policy is represented by its upward flexibility towards the limited effectiveness of monetary aggregates in sizing inflationary anticipations.*

*The downward slope of inflation phenomenon, in whose depreciation the evolution of consumer price index, whose positive trend surprised the European Central Bank, played a significant role, determined adjustments in the monetary policy strategy of the National Bank of Romania and at the same time the achievement of the inflationary target proposed with a direct effect on the monetary policy interest rate.*

*The same measure to reduce the key interest rate is outlined in the monetary policy of the European Central Bank and it is mainly due to the decrease of inflation phenomenon, although at the end of 2011 important quantities of liquidities were introduced in the financial system. It remains to be analysed to what extent the inflation phenomenon will be possible to manage under the conditions of the renewal of economic instability in the euro area and to which direction this aspect will influence the monetary policy of the National Bank of Romania.*

*Keywords: inflation, monetary policy, interest rate, monetary policy strategy, CPI*

*JEL Codes: E31, E42, E52, E58, E63*

## **Introduction**

The formal nature of the subject proposed should lead us to a strict analysis of the result of the National Bank of Romania monetary policy after getting over a year, respectively 2011, which exceeded positively the inflation forecast.

In other words, the monetary policy strategy of NBR, respectively targeting inflation had the expected efficiency while the positive response of the real economy, even unexpected in relation to the forecast came to support this strategy.

To what extent the tendency to respect the inflation forecast is sustainable, NBR explains us in the *Inflation Report in February 2012* which includes a more or less relevant analysis of the evolution of inflation in the last year, but synthetic, instead, effective leverages of the analysis of forecast compliance are given only in terms of monetary policy proposals, although as we can see the trend rate of monetary policy is in decline.

On the other hand, with reference to the NBR arguments we are somehow prompted to analyse this decrease, starting with 2<sup>nd</sup> November 2011 from 6,25% to 6,00% of monetary policy rate and compared to the consumer price index evolution which at the beginning of 2012, respectively until March enrolled to a slightly descendent trend.

The credibility of NBR forecasts was slightly shaken by the positive evolution of real economy, but not on the downside, only anticipatively, which determined an immediate reaction of the

European Central Bank in the sense of decreasing the monetary policy rate. We can see thus in the NBR reaction a decisive influence generated by the inflationary phenomenon.

The risks to which we submit in terms of actual inflation need to be treated in the light of euro area, an area where intermediate forecasts are in terms of a moderate recession with signs of stabilization given that the inflation weighted 2, 3% in European Union (EU) and 2,1% in the euro area. It is not insignificant that in this area the forecast was scaled upward due to higher energy prices.

Regarding this matter and the strategy of monetary policy in the euro area the Commission Vice President responsible for Economic and Monetary Affairs, Olli Rehn (2012) declared: *„Although the growth observed recently is stagnating, the European Economy gives signs of stabilization. The overall economic sentiment indicator remains low, but the tension in financial markets began to decline. Many of the key measures were taken to ensure the financial stability and to establish the necessary conditions for the sustainable growth and the creation of jobs. If we take decision actions, we can overcome the situation and move from stabilization to economic growth and employment.”*

### **Highlights of monetary policy strategy in view of National Bank of Romania and The European Central Bank**

The monetary policy practiced over the last seven years by NBR starting with 2005 was based on the declared strategy of inflation targeting. This strategy aims clearly the consumer price stability by respecting a proposed inflation target.

Although the final objective of monetary policy under this approach is the consumer price stability, the intermediate or operational objective is to meet the inflation target in the amount self-imposed or imposed by the government, a key element of this strategy representing the specification of target inflation.

Basically the purpose of monetary policy is to stabilize consumer prices regardless the monetary mass in circulation, the target being the level proposed and accepted of inflation, taking into account the fact that the presentation of inflation forecast allows the controlling of tendencies and inflation expectations and, on the other hand, the real situation of a significant time lag between increasing the amount of money in circulation and accelerating inflationary trends. NBR adopted and maintained a relatively distinct condition in the European Central Bank strategy basically to apply its monetary policy, both before and after Romania entered the EU and which firstly gives a central role to its coin when applying its policy, considering that by controlling monetary mass we can avoid the long-term inflationary phenomenon and secondly, a secondary role in stabilizing prices in the euro area through an assessment of their progress.

It is true that the markets where the two banks perform their duties – NBR and ECB – are differentiated by not using the same monetary standard and the forecasts about the phenomenon of inflation are apparently inconsistent, however, due to the possibility of free movement of goods and services in the European Union, the consumer price index connects the policies practiced by the two institutions.

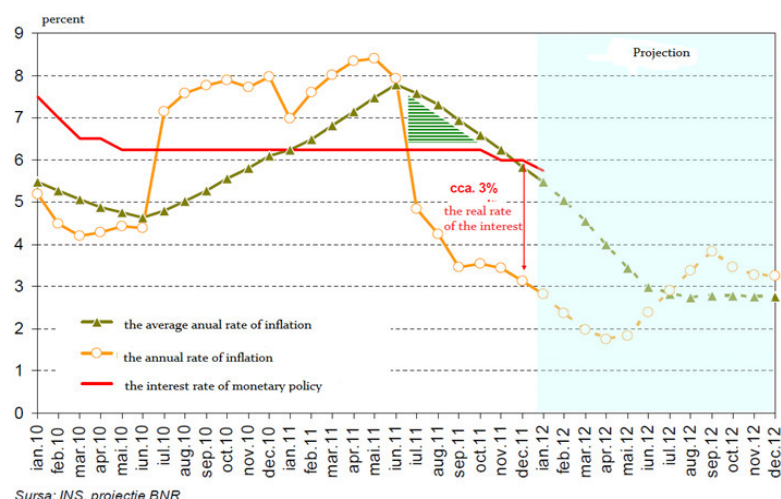
As we can observe from the evolution of the consumer price indexes, these are used as significant benchmarks in determining the development of inflationary phenomenon while the control policy of inflation and achievement of inflationary threshold in NBR determined the correlation of interest rate with the trends identified in real economy.

The inflation target projected in NBR is to maintain the inflation rate at 3% for 2012 and 2, 5 % for 2013 while the European Commission report estimated that in 2012 the inflation rate of Harmonized Consumer Price Consumer (HCPI) will be of 2, 3% in UE and 2, 1% in euro area.

### **The evolution of monetary policy interest rate and consumer price index in inflation report**

Coming back to monetary policy instruments used by NBR in the strategy that aims to achieve its forecasted inflation threshold we can clearly notice that the monetary policy rate plays a

significant role, its reporting to the inflation being the decision support in the operations used by NBR on the money market.



**Chart no 1. Forecasted inflation and interest rate of monetary policy (projection 2012)**

Source: National Institute of Statistics (INSSE), projection of NBR in the speech “Targeting the inflation. Quarterly inflation”, report – February 2012, Mugur Isărescu - NBR Governor

Also this comparative report of the interest rate of monetary policy to inflation determines the inflation target proposed by the European Central Bank.

For the main open market operations of the National Bank of Romania, which are currently one week repo operations, conducted by fixed rate tender interest, the interest rate is the interest rate of monetary policy.

Also, starting with May 2008 the amount of interest of permanent facilities – deposit facility and credit facility – granted by the National Bank of Romania is circumscribed a margin of +/- 4% with the interest rate of the monetary policy.

It is obviously that the repo operations should be carried within a week because they create the early intervention of the European Central Bank over the level of the interest rate of monetary policy in case the interventions in meetings establishing the exchange rate does not produce the desired effect.

**Table no 1. Interest rates of monetary policy and permanent facilities**

(% p. a.)			
Valid from:	Monetary policy	Credit facility	Deposit facility
30 March 2012	5.25	9.25	1.25
3 Februarv 2012	5.50	9.50	1.50
6. Januarv 2012	5.75	9.75	1.75
3 November 2011	6.00	10.00	2.00
5 Mav 2010	6.25	10.25	2.25
30 March 2010	6.50	10.50	2.50
4 Februarv 2010	7.00	11.00	3.00

(% p. a.)			
Valid from:	Monetary policy	Credit facility	Deposit facility
6 January 2010	7.50	11.50	3.50
30 September 2009	8.00	12.00	4.00
5 August 2009	8.50	12.50	4.50
1 July 2009	9.00	13.00	5.00
7 May 2009	9.50	13.50	5.50
5 February 2009	10.00	14.00	6.00

Source: National Bank of Romania

Also as we have shown the inflation impact is given by the evolution of CPI in the same extent that the sizing of ECB is done in relation to the *Harmonised Index of Consumer Prices*.

**Table no. 2. Consumer price index for March 2012 totally and on groups of goods and services and the interest rate of inflation**

	March 2012 towards:			The average rate of inflation between 11- 31III	
	February 2012	December 2011	March 2011	2012	2011
Total	100,42	101,42	102,40	0,5	0,7
Food goods	100,64	102,18	99,06	0,7	1,4
Non food goods	100,32	101,12	103,93	0,4	0,5
Services	100,20	100,70	105,40	0,2	-0,1

Source: INSSE Press release no 85/10.04.2012



**Chart no 2. The average unfixed rate of CPI on 12 months**

Source: INSSE Press release no 85/10.04.2012

So CPI inflation is closely connected to the evolution of the interest rate of monetary policy used by the European Central Bank in its monetary policy strategy.

**Table no 3. Harmonized consumer price consumer historic and projection**

	2006	2007	2008	2009	2010	2011	2012
Belgium	2.3	1.8	4.5	0.0	2.3	3.5	2.7
Germany	1.8	2.3	2.8	0.2	1.2	2.5	1.9
Estonia	4.4	6.7	10.6	0.2	2.7	5.1	3.1
Ireland	2.7	2.9	3.1	-1.7	-1.6	1.2	1.6
Greece	3.3	3.0	4.2	1.3	4.7	3.1	-0.5
Spain	3.6	2.8	4.1	-0.2	2.0	3.1	1.3
France	1.9	1.6	3.2	0.1	1.7	2.3	2.2
Italy	2.2	2.0	3.5	0.8	1.6	2.9	2.9
Cyprus	2.2	2.2	4.4	0.2	2.6	3.5	2.8
Luxembourg	3.0	2.7	4.1	0.0	2.8	3.7	2.7
Malta	2.6	0.7	4.7	1.8	2.0	2.4	2.1
Netherlands	1.7	1.6	2.2	1.0	0.9	2.5	2.0
Austria	1.7	2.2	3.2	0.4	1.7	3.6	2.4
Portugal	3.0	2.4	2.7	-0.9	1.4	3.6	3.3
Slovenia	2.5	3.8	5.5	0.9	2.1	2.1	1.6
Slovakia	4.3	1.9	3.9	0.9	0.7	4.1	1.9
Finland	1.3	1.6	3.9	1.6	1.7	3.3	3.0
Euro area	2.2	2.1	3.3	0.3	1.6	2.7	2.1
Bulgaria	7.4	7.6	12.0	2.5	3.0	3.4	3.0
Czech Republic	2.1	3.0	6.3	0.6	1.2	2.1	3.0
Denmark	1.9	1.7	3.6	1.1	2.2	2.7	1.8
Latvia	6.6	10.1	15.3	3.3	-1.2	4.2	2.5
Lithuania	3.8	5.8	11.1	4.2	1.2	4.1	2.6
Hungary	4.0	7.9	6.0	4.0	4.7	3.9	5.1
Poland	1.3	2.6	4.2	4.0	2.7	3.9	3.5
Romania	6.6	4.9	7.9	5.6	6.1	5.8	3.0
Sweden	1.5	1.7	3.3	1.9	1.9	1.4	0.9
United Kingdom	2.3	2.3	3.6	2.2	3.3	4.5	2.7
EU	2.3	2.4	3.7	1.0	2.1	3.1	2.3

Source: The press release of the European Commission: “Intermediate forecasts for the euro area: a moderate recession with stabilizing signs”, Brussels, 23.01.2012

## Conclusions

*The behaviour of the evolution of the interest rate of monetary policy relative to inflation and the fact that the European Central Bank applied a significant correction of this rate following the economy reaction and resizing the real inflation positively led us to realize this analysis.*

*It must thus consolidate the credibility of the NBR as through the signals of the market, inclusively through establishing an interest rate of monetary policy related to an inflation target strictly forecasted, we can determine the reinforcement of the image of real economy and the development of investment sector.*

*Through his messages and his goals the NBR will be able to create an accurate picture over the inflationary trends and also over the viability of long-term investment.*

*The enlargement of investments due to the accurate determination of inflationary expectations generates successive increases in consumption of goods and services and also relocation of available manpower.*

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