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Basic Inflation Corridor towards Full Implementation of Inflation Targeting Stategy

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Abstract

This paper focuses on the institutional prerequisites and basic terms concerning implementation of inflation targeting strategy and its positive and negative characteristics. The particular accent has been set on results and experiences in selected developed and transition countries with special overview on implementation in Serbia. The purpose of this study is to analyze the efficiency of projected base inflation rate as the part of the New frame of monetary policy. In 2007, National bank of Serbia has successfully realised its goal in spite of high inflation pressures, which have been passed on in the first quarter of 2008, thereby causing the impossibility of achieving the projected corridors of basic inflation, due to retail prices up-growth of agricultural, alimentary, energy-generated, non agricultural products and influences of political factors.

Key words: *inflation targeting, base inflation, referent interest rate, retail prices*

JEL Classification: *E50, E52, E58*

Introduction

A growing number of countries at the global level, regardless of their position on economic development scale (developed or transition countries) who aimed to sustain independence of monetary policy, have adopted special inflation targeting strategy as the circumstance of termination in relations between monetary aggregates and targeted variables, in this case – inflation.

Although there is no clear consensus in professional literature, inflation targeting is often defined as a framework of monetary policy, whose characteristics are periodical public reports of official numeric targets (or target zone) of inflation rate, for one or more time horizons, and an explicit statement that low, stable inflation represents the primary long term objective of monetary policy.

Other important features of inflation targeting regard great efforts towards public awareness and public communication about the plans and objectives of monetary policy. In the last few years, IMF and ECB highly recommended this regime within their arrangements.

Institutional Foundations of Inflation Targeting Strategy Implementation

Implementation of Inflation targeting regime implies defining the assessment of expected inflation. Real assessment of expected inflation is achieved by the most objective way - index selection, most commonly known in general public as the indexes which represent ratios of price relative of key products prices with a purpose to providing the accountability of NBS. It is very important to eliminate indexes which have no effect on inflation. Implementation of inflation targeting regime in many countries is based on Consumer price index, using the concept of base inflation at the starting period, in order to avoid negative effects and possible shocks, due to price growth of food, energy generated products, indirect taxes and so on. The main argument for accepting Consumer price index occurs from its long-term implementation easily recognized and approachable to broad public opinion[1]. Besides that, it is important to emphasize that this Index includes some of the elements which are not typical for monetary policy, although it sometimes effects fluctuation and dynamics of inflation, which in final instance influence the making of the monetary policy and the defining of the estimated expected inflation. Therefore, drafting of inflation targeting regime uses so called modified CPI as targeted index.

Further implementation of IT strategy is related to determination of targeted variables. Among monetary experts there is no unique stand or opinion when the choice of targeted variabiles is concerned. The large number of lively discussions with arguments and counter-arguments which have been debated mostly around the fact whether it is a better solution to target inflation rate or price levels.

The choice between targeting of price level or inflation involves compromises between lower frequency of variability price level and lower inflation rate frequency and employment variability[2].

Targeting inflation includes higher insecurities in long-term price anticipations (than price level targeting which indirectly influences high level of price variations). Long-term targeting of price levels contributes to the lower price level oscillations. In fact, targeting the price levels could lead to short-term oscillations of inflation rate and outputs. In case of inflation targeting there are no oscillations.

Apart from this, targeting of price levels has one more disadvantage. Higher inflation rate in observed period of time should be repressed by the monetary policy measures in upcoming period in order to maintain expected price levels. It is not possible to use exchange rate as a nominal anchor under this regime, although this does not imply interventions of Monetary authorities on Foreign exchange market in a case of suppressing consequences which occurred due to temporally shocks induced on the market.

If nominal interest rate equals lower zero margin level, Parkin indicates that targeted stability of prices would be in collision with lower zero margin, which would limit creators of monetary policy in transacting more efficient measures and enable faster exit from recession period. Besides that, he indicates that inflation positively affects and anticipates Labor market, making it more efficient. Despite many counter-arguments the number of countries that settled for implementation of inflation targeting measures is growing and, among them Serbia is too. For monetary authorities, level of Inflation targeting is the most important issue and a subject of examination. Dealing with this matter, economic theory and practice isolated two different approaches.

[1] P e t u r s s o n , T. G., *Exchange rate or inflation targeting in monetary policy?*, Bank of Iceland, 2000.
[2] S w e n s s o n , L. O. E., *Price - Level Targeting vs Inflation Targeting: A Free Lunch?*, NBER, Working Paper No. 5719, Cambridge, 1996.

The first approach, whose prominent mediator is Poole[3] (1999) points out three reasons for implementing inflation targeting, which are:

1. Inflatory uncertainty makes it difficult for enerprises and independent enterprenuers, as to distinguish modifications in relative prices of goods and services towards fluctuation in aggregate level of prices;
2. It is harder to politically maintain constant but positive inflation rates rather than to maintain inflation trends at point zero;
3. Violations are caused by interaction of inflation and tax laws, because indexation of inflation is necessary, especially in the matter of investment incomes, due to imposing the taxes of nominal rates and capital gain incomes.

Therefore, counter-arguments for the above mentioned arguments for inflation targeting strategy implementation are referred to as CPI index, mostly overestimating real inflation rate for 1.5%, which issues the conclusion that inflation targeting on zero level could lead to deflation, depending on the economic situation of the observed country. Miškin also contributed to deflation problem, emphasizing the high expenses during deflation suppressing, which were supposed to be avoided. According to provided arguments the larger number of central banks are targeting the value of inflation above zero rate. Suppressing deflation is noticeable in ECB inflation strategy targeting around 2% level.

While deflation implies similar costs to economy as inflation, avoiding deflation is also important because, once it occurs, it may become entrenched as a result of the fact that nominal interest rate cannot fall below zero.

In a deflationary environment, monetary policy may thus not be able to sufficiently stimulate aggregate demand by using its interest rate instrument. Any attempt to bring the nominal interest rate below zero would fail, as the public would prefer to hold cash rather than to lend or hold deposits at a negative rate. Although various monetary policy actions are possible even when nominal interest rates are at zero, the effectiveness of these alternative policies is not certain. (ECB, 2004: 51-54)

Another problem of monetary policy makers, regards defining the subject of targeting – exact number or range of numbers.

Proponents of fixed numbers as their argument, are alleging that targeting of the expected ranges of inflation trends, especially in broader range, could bring to uncertainty of inflation expectations, which would inevitably jeopardize the credibility of the Central bank. On the other hand, inflation targeting in defined ranges, enables flexibility of central bank in creation of monetary policy. Therefore in most of the countries, central banks are rather targeting range of numbers then fixed numbers, when defining the corridors of trends of expected inflation.

Inflation targeting could be implemented through one or more time horizons. There are various solutions on this issue in the practice, due to the fact that inflation target could not be established once for all. Inflation is always under influences of unpredictable swings, shocks and time lags. If interest rate affects the inflation rate, then it is no use setting the goal in the next year.

The reason for preventing short term targeting lies in the fact that inflation phenomena is not influenced by monetary policy in a period shorter than a year. Targeted horizon as the long term strategy is supported by few theoreticians.

Batini and Nelson 2000 supports the view that, in practice, inflation targeting should be designed in such a form that the target is achieved over the medium term. In other words,

[3] P o o l e , W., „Is Inflation too Low?”, *Federal Reserve Bank of St. Louis Economic Review,* 81 (4), St. Louis, 1999.

central banks wishing to act optimally should not attempt to neutralize inflationary shocks immediately, but respond gradually to them.

Optimum (per example, Canada and New Zealand accepted the period of 18 months, Australia defined that period as the period of business cycle, while in Great Britain, Government has the right to modify the target each year or adjust it to cycle phases.) of time horizon could be observed as time period which is necessary to economic policy to give some practical results. Theoretical background of this theory could be found in Freedman's key propositions of monetarism.

Conditions for Implementation of Inflation Targeting Strategy

The experience of long-term users of this strategy emphasizes certain conditions which are supposed to be fullfilled in order to get a successful implementation of inflation targeting strategy. The *conditions* for the implementation of inflation targeting are the following:

- Central bank should have sufficient level of independence and thus it can fully bear responsibility for achieved results;
- Central bank has to give up other nominal anchors in order to avoid a conflict between previous nominal anchors and price stability as a new anchor and new final goal. That is the reason why fixed exchange rate system usually is not compatible with inflation targeting.
- Declaration of price stability as a final goal itself does not express precisely what does it mean in fact. It is necessary to determinate an explicit numeric inflation target.
- Inflation targeting is characterised by dependence of goals and by independence of instruments. Inflation targeting should be announced together both by central bank and by government. That would mean indirect commitment of government to fortify inflation targeting by its fiscal policy.
- Fiscal policy should not be the dominating policy in an economy. That is a very common feature of transition countries. Consequently, there is a higher risk of increased inflation because of direct and indirect financing of state budget deficit. Thus, pumping of central bank finance by government should be restricted (restrictions of so called credit links). Monetary and fiscal policy should be coordinated. It means that fiscal inflation pressure should be eliminated in practise Accountancy, transparency and comprehension of monetary strategy.
- There should be certain assumptions for financial stability, financial system and institutional development in the economy. It enables independency in monetary instrument application. More developed financial markets enable better functions of the channels of monetary transmission and thus, more effective application of monetary policy.
- Central bank should be able to predict future evolution of macroeconomic indicators to aim an inflation goal in a more realistic way. The more precisely is evolution predicted, the more adequate monetary instrument is chosen. Correct predictions require sufficient understanding of effects of monetary transmission channels; sufficiently long time ranks of macroeconomic variables and above all low sensitivity of economy to different external and transformation chocks.
- External stability, i.e. limited fluctuations of exchange rate is important as well[4]. Stone[5] favors the stand that four preconditions are necessary for targeting to be implemented.

[4] Neupauerová, M., Vravec, J., "Monetary Strategies from the Perspective of Intermediate Objectives", *PANOECONOMICUS*, No 2/2007, pp. 219-233.

The first one referes to reducing inflation – as an objective of a central bank. The second relates to avoiding a situation where reducing inflation is subordinated to some other objectives, while the third one concerns a well developed financial system. The last precondition entails the utilization of monetary policy instruments aimed at reducing or sustaning the inflation rate.

Positive and Negative Characteristcs of Inflation Targeting

This strategy has its bad and good effects on economy. In accordance with economic practise, defenders of this theory singled out some positive characteristics:

1. Inflation targeting, unlike some explicite monetary anchors, is the type of strategy, where activities of central bank are oriented to domestic economy, so eventual potential impacts from the outside could be neutralized;
2. Number of available variabiles which influence the monetary policy is unlimited, all available information in the moment of creation should be considered;
3. Inflation targeting is positivly accepted by the public, which means that transparency and communication are generally at the good level of satisfaction of public opinion;
4. Quantitatively established variabiles (inflation rate), high level of transparency and regular communication boost the level of liability of the central bank, acting with caution, preventively against possible problems and time consistency.

Very positive practical experiences, are registered in the countries implementing strategy of inflation targeting, which have been reflected as downsizing the inflation rate, as well as inflation expectations. Additional postitive effects are based on the fact that after initial downsizing, inflation rate remains at low level.

On the other side, there are also negative sides of inflation targeting. Opponents of this strategy consider that those features are very outstanded to be marginalized, in fact those are the reasons for suspending the strategy. Numerous economists support the thesis that targeting is introducing significant rigidity in creation of monetary policy, but it also limits the possibilites for reaction in conditions of unplanned strokes. According to opponents, negative characteristics of inflation targeting are:

1. The influence of the monetary policy on targeted variable in conditions of inflation targeting can be observed with a certain time delay. Taking into account these delayed indicators it is not possible to estimate the effect of central bank measures promptly.
2. The key argument against inflation targeting is represented by the stronger fluctuations in terms of income, which are, in many opinions, caused by this strategy. Namely, when the inflation rate is above its targeted level, the central bank is implementing restrictive monetary policy measures, and vice versa. Changes in the monetary policy trend lead to fluctuations in the income level.
3. Relating to the delayed effects of the central bank actions and its unpredictable results, inflation targeting finally leads to the low responsibility of the central bank, which is especially dangerous in the developing countries.
4. Inflation targeting can not prevent fiscal dominance.

[5] Stone, M., Challenges to Central Banking from Globalized Financial System, IMF, Washington, 2003, pp 111 – 142.

5. The flexibility of the foreign exchange rate, necessary for the inflation targeting implementation, under some circumstances can result in financial instability[6].
6. Monetary policy influences on targeted variabiles in terms of inflation targeting, could be observed with certain time delay. Considering these postponed perfomances, it is not possible to accurately estimate the effect of the Central bank. Key arguments against inflation targeting are the strong fluctuations of income, which are by many opinions caused exclusively by targeting. In fact, when inflation rate is above targeting level, the central bank will apply the measures of restrictive monetary policy and vice versa. Changes of monetary policy lead to income fluctuations.

Besides the postoponed effects of central bank actions, or unpredictable results, targeting inflation ultimately leads to low level of central bank accountability, which could be reflected as dangerous in developing and transition countries. Moreover, inflation targeting can not prevent dominace of fiscal system policy. Furthermore, exchange rate flexibility, indispensable for targeting inflation on certain conditions can provoke financial instability.

Examples of Inflation Targeting Application

The first positive experiences in inflation targeting application had been in New Zealand, where the implementation started in 1989, and then the other contries followed – Canada in 1991, Great Britain 1992, Sweden and Finland 1993

Different versions of inflation targeting proliferated in emerging- market economies as Brazil, Israel, Korea, Mexico, South Africa and the like. Recently, this policy has been also adopted by some transition countries such as Poland, Czech Republic, Hungary and Slovakia (Table 1).

Table 1. Countries with formal inflation targeting

Country	Adoption year	Target band
New Zealand	1990	0-2% (until 1996) 0-3%
Israel	1991	8-11 (until 1998) 7-10%
Canada	1991	1-3%
G.Britain	1992	1-4% (until 1997) 0-2.5%
Australia	1993	2-3%
Sweden	1993	1-3%
Czech Republic	1997	5.5-6.5% u 1998, 4-5% u 1999, 3.5-4.5% u 2000
Switzerland	1999	0-2%

Source: Petursson (2000), according to Bernanke, Mishkin (1997), Bernanke, Laubach, Mishkin & Posen (1999), and centralbanks web-sites

Until the adoption of Reserve Bank of New Zealand Act in 1989, Central Bank of New Zealand had the highest level of dependency. The Act gave the Bank great independence and set price stability as the single objective of monetary policy. The Governor and Finance Minister were in charge of determination and public presentation of Agreement on monetary policy objectives, numerical specification of estimated targeted ranges, i.e. frameworks for inflation trends and time period for achieving monetary policy objectives.

After Inflation targeting adoption in Canada, inflation has dramatically dropped down from 5% in 1991 to 0 % in 1995 and moved up to 1%-2% at in the last decade of 90-ties. Inflation downfall affected higher unemployment rates, from 10% in the period from 1991 – 1994 and afterwards unemployment rate significantly fell down.

[6] M i s h k i n , F. S., "Issues in Inflation Targeting", in *Price Stability and the Long-Run Target for Monetary Policy,* Bank of Canada: Ottawa, Canada, 2001.

Great Britain also adopted the regime of inflation targeting after implementing specific procedure. Before adopting the strategy, inflation rate already fell from 9% at the start of 1991 to 4%. After the weak growth at the start in 1993, at the end of third term in 2004 it fell to 2.2% and fluctuated around projected corridor. Until 2006 inflation gradually increased above the level of 2.5 % and stabilized within projected range. Afterwards, Great Britain recorded strong economy growth which consequently lowered unemployment rate.

European Central bank adopted hybrid strategy of monetary policy, combining monetary targeting previously used by Bundesbank and some instruments of inflation targeting, including involvement of monetary aggregate M3 as ‘’referent value’’ for growth rate and price stability which was supposed to move in range from 0% – 2%. The objective was to sustain price stability and keep controlling inflation rate below 2%, (which failed in the last six years), also to increase employment rate and open new workplaces.

Experiences of Transition Counties

In September 2006 Serbia has joined the group of transition countries such as Czech republic, Hungary, Slovakia, Poland and Romania, which trade off fluctuating exchange rate policies for inflation targeting as the main objective of monetary policy in its decision to suppress inflation in mid-term period.

Table 2. *Effect of inflation control in developed and transition countries*

Country	Adoption year	Targeted band	Inflation		
			Before adoption	After 1 year	After 2 year
N Zealand	1990	3-5%	7%	4.5%	0.8%
Canada	1991	1-3%	6.9%	1.7%	2.3%
G. Britan	1992	1-4%	3.6%	1.4%	2.4%
Sweden	1993	1-3%	1.8%	1.7%	2.5%
Czech Republic	1997	5.5-6.5%	10%	3.5%	3.4%
Poland	1998	<=9.5%	10.4%	8.8%	9.9%
Hungary	2001	7% (±1%)	10.8%	4.9%	4.3%
Serbia	2006	7-9%		5.4%	10.1%

Source: IMF-IFS, European Central Bank, http://www.ecb.int/

The table shows that the Czech Republic, Hungary and Serbia (first year) managed to control inflation in much shorter period of time, as compared to Poland. Also, the significant difference between developed and transition countries is noticeable. Economies of developed countries have more higher standards and regulated institutions with long term practice and therefore they are much more successfull in implementing and maintaining monetary policy of targeting inflation comparing to newly established countries. It could be concluded that timing is the key factor in building credible and respectful institutions. Measures of central banks in transition countries should be substantially consistent for reasons originating from the nearer past where individual economic subjects had not much respect and confidence in CB. So, Central bank should defray expenses of building confindentiality at the same time as decrease possible inflatory pressure which supervenes from low credibility.

When comparing inflation trends to other transition countries under different exchange rate regimes indicators show, that there are no important deviations within achieved results measured by inflation volatility and output.

Table 3. *Inflation volatility and output volatility in period of 1998-2002*

Country	Inflation Volatility	Output Volatility
Czech republic	3.49	2.00
Poland	3.60	1.82
Hungary	3.08	0.72
Estony	3.08	3.07
Letony	1.34	2.52
Litvania	2.18	3.50
Bulgaria	49.7	3.97
Slovakia	3.88	1.39
Slovenia	1.34	0.82
Romania	18.37	4.83

Source: Jonas i Mishkin (2003)

Achieved results in suppressing inflation in all, do not indicate superiority of economic performances of countries which have been implementing the IT strategy from 1998 (Poland, Czech republic, Hungary, Serbia) rather than other transition countries. Calvo and Mishkin came to the same conclusion, due to the fact that adoption of IT regime of monetary policy in exact period of time was less important from the quality level in institutions of transition countries.

Transition countries that joined EU, proved that the policy of targeting inflation gives results. Especially if success of the policy is scaled specifically by the level of the reached projected objectives of real inflation thanks to measures of the Central bank. The other indicators as production gap, money growth or exchange rate are less important for the central bank.

Experiences of Serbia

Accepting the experiences drawn from the contries which implemented IT and existing practice, in September 2006, NBS adopted objectives concerning projected inflation – base inflation on the grounds of retail prices index modification which are not the result of correction of regulated prices and tariffes. Framework of base inflation corridor is determined in ranges from 7% – 9% in 2006, 4% – 8% in 2007,and 3% - 6% in 2008.

Using referent interest rate as the main instrument of monetary policy of inflation targeting, implementing all other monetary policy instruments, in 2007 NBS announced defined goal of inflation targeting in projected ranges from 4% – 8% , was of 5.4 %.

During 2007, NBS using corections of two-*week repo rate* operations, six times decreased and two times increased referent interest rate, with a sole purpose of mitigating the effects of price shocks of agricultural-alimentary goods as the consequence of reduced yield on agricultural products and increased growth on demand at the Global markets. Strong influence of egsogenic factors, record prices of crude oil at the Global markets, made an impact as inflation pressures. Outstanding effects of price growth of agricultural-alimentary products along with oil prices growth, synergetically were stronger than the effects of nominal appreciation of RSD and increased appreciation gap of real exchange rate during the second half of 2007.

In the first semester of 2008, unfavourable tendencies of inflation acceleration continued, as the consequence of conveyed negative trends manifested in the last quarter of 2007. In the first half of 2008, total inflation equalled 12.1%. Higher and growing inflation, especially from the start of the second quarter of ongoing year, exceeded projected range of base inflation between 3%–5 %, and recorded growth of 10%, which was above the projected upper limit. Countries of the Euro – zone simultaneously with other countries in the observed period, recorded an increase in inflation too. In June, Great Britan recorded the highest inflation growth since the introduction of inflation targeting of 3.6%. In Euro-zone inflation rate in May reached above expected 3.5% to 3.6%, which was the highest level in the last 16 years, therewith the lowest inflation rate in Jully this year registered, was in Holland, about 3%, Portugal 3.1% and Germany 3.5%.

Inflation growth was mostly affected by regulated prices, with growth of 6.6% which contributed indirectly, participating with approximately 50 % in retail prices growth (3.1 percent point). Prices of agrocultural-alimentary products increased by 32% and are among the highest in the region. High growth of agricultural-alimentary products which had an impact on inflation growth was recorded in Bulgaria and Macedonia, but other countries of the world, calculated in USD $ in last several years recorded growth of 44.4%.

Prices of non-agricultural products, above all industry product prices in the first half of 2008 increased by 8.5%, whereby significantly influenced retail price growth. Prices of energy products, capital products, permanent and unpermanent consumer goods and intermediate products, recorded the highest growth up to 16.1 %. Growing prices of oil derivates on the World market, Serbia and other countries, led to an increase in production prices combining high level of inflation, which negatively affected the consumption and directly slowed down the economy.

We should not ignore postponed actions of fiscal expansion introduced at the end of 2007, as well as higher level of political and economic uncertainty, and depreciation which will have effects on the growth of domestic prices.

Besides that, high level of growth in domestic demand at the end of 2007 induced by high growth of public consumption and significant growth of credit debts, carried on in 2008 and instigated high inflation rate in the first half of 2008. Nominal depreciation of RSD also on larger scale effected the reduction of appreciation gap and directly contributed to downsizing of deflation factors.

Conclusion

At the moment Serbia has been implementing the strategy that still does not represent Inflation targeting. Unlike the regime of IT, objectives are relatively broadly set up, the main *monetary policy* instrument is *two-week repo* rate (2W *repo* rate), and decisions are made on the bases of macroeconomic projection indicators. Inflation report is the basic instrument in public communication and the official system of intervention in the foreign exchange market has been improved.

Flexible foreign-exchange rate is the key factor for this strategy regime, although indicated certain flaws towards exchange rate trends, especially under conditions of high deficit of current payments.

According to the first impressions about inflation targeting as well as the analysis of implementation of the new framework of monetary policy, the results have overall positive effects, considering the short period of implementation time and lack of relevant information.

Yet, for ultimate and optimal results, monetary policy has to find out new, stable and permanent solutions for new challenges and inconsistencies.

Due to increasing inflation rate in Serbia or base inflation trends above the limits of projected corridors, specificities of inflation targeting are characterized as very interesting and contradictory. As a matter of fact, unlike most of the countries where lower inflation trends are expected, monetary policy makers in Serbia expect inflatory pressure, i.e. inflation growth.

Due to unfavorable experiences from the past, in Serbia there still exists the constant fear of high inflation or inflatory expectations.

Contributions for this thesis are eurosation, exchange rate clauses on RSD landings, indexation of real estate prices and other values and indexations of incomes.

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Coridorul fundamental al inflației - către implementarea completă a strategiei de urmărire a inflației

Rezumat

Acest articol urmăreşte condițiile instituționale şi termenii de bază privind implementarea strategiei de urmărire a inflației şi a caracteristicilor sale pozitive şi negative. Un deosebit accent se pune pe rezultatele şi experiențele anumitor țări dezvoltate sau aflate în tranziție, cu o prezentare specială a procesului de implementare în Serbia. Scopul acestui studiu este de a analiza eficacitatea ratei de inflației proiectate ca parte a Noului cadru de politică monetară. În 2007, Banca Națională a Serbiei şi-a atins cu succes scopul, în ciuda presiunilor accentuate ale inflației care au fost depăşite în primul trimestru al anului 2008, cauzând astfel imposibilitatea realizării coridoarelor de inflație, datorită prețurilor en detail crescânde în cazul produselor agricole, alimentare, energetice şi non-agricole, precum şi a influenței factorilor politici.