Mugur Isărescu: Transition – how to secure a stronger economic future for the constituency?

Speech by Mr Mugur Isărescu, Governor of the National Bank of Romania, in the panel on "Transition: How to Secure a Stronger Economic Future for the Constituency?", during the annual meeting of the IMF and World Bank Constituency, Kyiv, Ukraine, 4 June 2016.

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Ladies and Gentlemen,

In my address I would like to focus on the challenges in conducting monetary policy in a way that will contribute to securing a stronger economic future for countries in our constituency. Obviously, my account is shaped by Romania's experience, but I hope it will still keep you interested, as it may be relevant for other small to medium-sized emerging economies.

1. Brief account of monetary policy regimes in Romania

At the time when the National Bank of Romania had to choose a strategy for conducting its monetary policy, i.e. in the early nineties, monetary targeting was actually the only feasible option. Not only did the low forex reserves preclude a fixed exchange rate arrangement, but, even if possible, the alternative was not suitable given the widening external imbalance. However, by the end of the decade, monetary targeting had reached its operational limits given the break in the relation between monetary aggregates and inflation, a phenomenon which matched developments elsewhere in the world.

At that point, we took into account pegging the exchange rate, but neither the hard nor the soft version was deemed appropriate. On one hand, a crawling peg helps control inflation when it is brought down from 30%–40%, but it is less useful when a lower level is envisaged, since the crawl incorporates inflation expectations. On the other hand, exchange rate flexibility was seen as an asset for an economy as big and rigid as Romania was at the time, especially given the upcoming stages of capital flow liberalisation.

Against this background, Romania opted for inflation targeting as early as 2002, even though it took several years of preparations until the actual adoption, in August 2005. The NBR chose the "light" version of the strategy, which meant retaining the managed float feature of the exchange rate regime. The actual form that inflation targeting took in Romania matched the "managed-floating plus" concept, considered the most suitable choice for an emerging-market economy involved in the global capital market. This concept, introduced by Goldstein in 2002, combines the managed float part, allowing for FX market interventions in order to smooth out excessive volatility, with inflation targeting as a monetary policy strategy and an active pursuit of measures to limit the degree of currency mismatches in the economy. As a matter of fact, in an IMF paper published in 2003, the light version of inflation targeting is found to be widely spread among emerging economies, where fiscal dominance continues to weigh and monetary policy cannot set aside concerns over financial stability and external equilibria.

2. Light inflation targeting in Romania

Drawing the line after more than a decade of inflation targeting, I would say that we have managed to deliver steady disinflation and anchor expectations, even though the frequent occurrence of exogenous shocks led to high volatility in inflation and the occasional missing of annual targets. All central banks are familiar with supply-side shocks related to a surge or fall in commodity prices, but in Romania we have also had to deal with large (and not necessarily predictable) adjustments in administered prices and frequent changes in indirect taxation. Some of the latter were inherent to EU membership (i.e. alignment of some excise

duties), but others were related to an erratic tax legislation. In such an environment, two features of the inflation targeting framework as implemented in Romania appear as particularly relevant:

- First, the focus on the medium-term achievement of the inflation objective, rather than hitting the target all the time. This approach allows for sustainable price stability without incurring the cost of excessive volatility in output and employment.
- Second, the ex-ante definition of a set of escape clauses that limit the central bank's responsibility in attaining the annual target:
  1. Marked increases/decreases in commodity prices
  2. Natural disasters and other similar exceptional events that induce cost-push or demand-pull inflationary effects
  3. Large fluctuations of the exchange rate of the leu that are decoupled from domestic economic fundamentals, as well as from the monetary policy pursued by the National Bank of Romania
  4. Major deviations from the administered price adjustment programme announced by the Government, in terms of both magnitude and proposed calendar
  5. Divergence of the fiscal and income policies, in terms of implementation and outcomes, from the programmed coordinates

3. Case in point: monetary policy under a string of VAT changes

To give you a flavour of the environment the monetary policy has had to operate in lately, we had three VAT rate cuts from 2013 to 2016, after a hike in 2010, and another cut is scheduled for 2017. Currently, the annual inflation rate stands at –3.25 percent, the most negative value in the EU. Excluding the first-round effects of the VAT cuts in mid-2015 and early 2016, headline inflation would have hovered around +1 percent. Consequently, the negative inflation we are dealing with now is not at all a condition brought about by a persistent lack of demand, as economic activity, employment and wages are actually buoyant. This is just a transitory development, induced by the aforementioned indirect tax cuts.

The textbook policy choice would be to accommodate the temporary deviation from the inflation target and focus on the VAT-adjusted inflation developments – especially since the latter paint a quite different picture.

If I may be allowed a short digression, the very recourse to a VAT-adjusted inflation measure in our analysis and communication came under fire. This is by no means different in nature than the Eurostat's HICP at constant taxes – just more refined, in the sense that we take into account the fact that the pass-through of a VAT change is below 100% for most CPI items.

Coming back to the current economic context, it should be pointed out that behind the "perfect storm" of deflationary exogenous shocks (low energy, food and metal prices, successive VAT rate cuts), demand-side inflationary pressures are looming: a positive output gap is emerging, unit labour cost pressures are building up, fiscal policy is taking a strongly expansionary turn.

As such, while medium-term prospects appear to call for a tightening bias of monetary policy, the short-term context of deeply negative inflation makes communication with the public rather challenging. Specifically, we have to contend with the idea that the central bank should lower interest rates in response to VAT rate cuts. It proves more difficult than we thought to make people understand that the current negative readings in inflation are just transitory and reflect neither postponed consumption, nor sluggish wage growth one would associate with

negative inflation expectations – these actually remained anchored to the target. Therefore, none of the ingredients which make for a scary deflationary trap are present.

Frankly, I understand that the general public is not familiar with concepts like overheating or positive output gap, but I believe that annual growth rates to the tune of 20% for retail sales and in excess of 10% for wages are more than self-explanatory. Still, with all the obvious signs – even for non-economists – that the economy is growing fast, we are criticised for not fighting deflation.

The recent experience has made us painfully aware that – despite the large amount of information provided through a wide range of communication vehicles – our messages get through to a much lesser extent than we had thought. Therefore, we should enhance our efforts in escaping the professional jargon and trying to be as accessible as possible when explaining to the public the rationale behind our monetary policy decisions.

If I were to conclude on Romania's experience with inflation targeting, I would say that it worked quite well, even though the concept of inflation targeting has not been immune to criticism, especially in the post-crisis period. I would mention here Axel Weber, who suggested in 2015 that inflation targeting is a simplistic framework that could not stabilise the value of money in a complex and constantly evolving economic environment.

However, his opinion is not shared by other well-known economists. For instance, in 2013 Charles Wyplosz stressed that even though there are times when inflation targeting seems inconvenient and possibly counter-productive, the alternatives – monetary targeting, nominal-GDP targeting or no explicit strategy at all – would probably not have done a better job. Along the same lines, Lucrezia Reichlin and Richard Baldwin concluded that inflation targeting should continue to be refined, not replaced. Of course, since I come from a central bank practicing inflation targeting, I tend to agree with the latter line of thought, as I believe that, whatever its faults, the strategy has enough intrinsic flexibility to enable it to address them.