Mugur Isărescu: Inflation targeting - international experience and Romania's prospects

Speech by Mr Mugur Isărescu, Governor of the National Bank of Romania, at the Conference on Inflation Targeting, Bucharest, 30 March 2005.

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Ladies and gentlemen,

I would like to begin by extending a very warm welcome to you to the National Bank of Romania. It is a great honor for me to open the conference "Inflation Targeting: International Experience and Romania's Prospects". I would like to add that I am particularly pleased that such distinguished guests agreed to join us today and share some of their insights regarding inflation targeting.

This spring marks an important moment in our history: in April 1880, the National Bank of Romania was established, and became the 19th central bank in the world; now, 125 years later, our central bank is getting ready to become the 19th (plus 3) inflation targeter. For a few years now, the National Bank of Romania considered inflation targeting to be the monetary policy framework suitable for the timeframe between achieving single digit inflation and joining the ERM II.

My confidence in inflation targeting stems from my belief that price stability should be the primary goal of monetary policy and that there is full long run compatibility between this objective and economic growth. This has been proved by successful inflation targeting experiences of numerous countries, regardless of the level of economic development.

Although I see why it is difficult to define inflation targeting, I consider the definition given by Ben Bernanke as being the appropriate one. Accordingly, inflation targeting is "a framework for monetary policy characterised by the public announcement of official quantitative targets […] for the inflation rate over one or more time horizons, and by explicit acknowledgement that low, stable inflation is monetary policy's primary long-run goal. Among other important features of inflation targeting are vigorous efforts to communicate with the public about the plans and objectives of the monetary authorities, and, in many cases, mechanisms that strengthen the central bank's accountability for attaining these objectives." The definition can be wrapped up by adding instrument independence for the Central Bank and the lack of an explicit intermediate target, as all factors affecting inflation are taken into consideration.

An important feature of inflation targeting is the need for accountability of the central bank. Within the inflation targeting framework, this is enhanced by the public announcement and commitment to attain an inflation target. The explicit target and the public and transparent nature of inflation targeting also enable the central bank to withstand political pressures more easily and to overcome the so-called time inconsistency problem. In this sense, as Frederic Mishkin[1] argues, central bank independence and inflation targeting are mutually reinforcing.

Adopting inflation targeting is not just a matter of choice, but also of fulfilling a number of key requirements. Having these in mind, I believe that Romania is in a good position to pursue disinflation by implementing such a framework.

Most of the conditions required for a successful implementation of the inflation targeting framework in Romania have already been met:

- by year end 2004, inflation was brought down to single digit levels for the first time from 1990 onwards;
- since 2004, the National Bank of Romania has benefited from full operational independence, as stipulated by Law No. 312 of June 28, 2004;
- the success in disinflation over the recent years has strengthened the NBR's credibility;

[1] Frederic S. Mishkin, "What Should Central Banks Do?" Federal Reserve Bank of St. Louis Review, vol. 82, #6 (November/December 2000): 1-13.

- after five years of continuous development and adequate supervision, the financial sector can undoubtedly be considered sound and stable;
- fiscal dominance is no longer an issue, witness the afore-mentioned legal independence of the National Bank, a relatively low public debt, as well as the increasingly consistent financial policies mix;
- inflation targets have been set for the following years in cooperation with the government. The Pre-Accession Economic Programmes underline the commitment to attain these targets;
- since 2002, an inflation report has been published on a half-yearly basis. Following the implementation of inflation targeting, the report will be published quarterly; - a model calibrated by the Bank's staff is currently being tested and will be used for forecasting purposes.

Instead of going into the details related to the Inflation Targeting framework, I will let my fellow speakers tackle the most important issues. Shortly after this, Deputy Governor Ms. Rachel Lomax will present a compelling account of UK's experience and, may I add, success as a benchmark inflation targeter. After the lunch break, Gill Hammond, Deputy Director of CCBS, will give you an excellent presentation dealing with specific issues and challenges faced by emerging market economies when adopting inflation targeting. Later on, we will have our guests from the Czech National Bank and the National Bank of Hungary giving you a purposeful insight of such challenges and of their countries' experiences with the IT framework. Mr. Ludek Niedermayer, Deputy Governor of the Czech National Bank, will first explain to you "why and how" inflation targeting was adopted in the Czech Republic – the first country to embrace this regime in our region. Then, it will be for Ms Csermely Agnes, Director with the National Bank of Hungary, to share with us the "Lessons and Challenges" put forth by the Hungarian experience with inflation targeting. Our last speech for this event will be held by Mr. Cristian Popa, Deputy Governor of the National Bank of Romania, showing you just where we, as central bank and as economy, stand in the preparation of the introduction of inflation targeting.

What I do want to mention is the current debate on the appropriateness of adopting inflation targeting in Romania. I am very happy that monetary policy steals the spotlight from football, at least temporarily. Some acknowledged Romanian economists claim that inflation targeting is not needed since future euro adoption requires fulfilling the grueling conditions of the ERM-II framework. In line with this argument, the exchange rate might prove to be a better choice for a nominal anchor.

Given the soon to be completed capital account liberalization, I believe that exchange rate management would be very difficult outside a currency board. Although I am confident about our option, I respect all disagreeing opinions. For those retaining their doubts about the benefits of inflation targeting, there is one more argument, courtesy not of a renowned economist, but of the Danish physicist Niels Bohr. When asked why he, an enlightened scientist, kept a horse-shoe on display in his house, his prompt answer was that "it helps non-believers too". Likewise, provided that the National Bank of Romania has convinced enough people of its commitments, non-believers should also enjoy the benefits of this policy change.

Ladies and gentlemen, let me now introduce Rachel Lomax, Deputy Governor of Bank of England and member of the Monetary Policy Committee. Before passing on the floor, I would just like to mention that Mrs. Lomax has previously visited Romania. Ten years ago Mrs. Lomax was negotiating development programs in Romania on behalf of the World Bank with a team including myself and some other people in this audience. She is now here again to assist us in preparing to achieve another goal related to Romania's development, that of lasting price stability.