A THEORETICAL APPROACH TO MONETARY POLICY STRATEGIES

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Abstract

An equally important element of the new consensus is precisely the choice of the optimal one strategy that should be used to achieve the previous explanation of the ultimate goals of monetary policy. It is all due to impossibilities of the direct influence of monetary policy instruments on the ultimate goals, so that a particularly important issue that is the subject of theoretical considerations is the choice of adequate intermediate target. The target, as a link between the operational and ultimate goal of monetary policy plays a role in the leading indicator, because it registers them the changes in advance, but also the political indicator, because it reflects the intention of the central bank. Considering that monetary theory has accepted the thesis that they exist high costs of inflation due to the events that took place during the 70s years of the 20th century, an important element in achieving price stability is the existence of a nominal anchor. A nominal anchor represents a nominal variable embodied in inflation rate, money supply, exchange rate or nominal gross home product. The decision to choose an intermediate target variable depends exactly from which theory the central bank relies on when explaining it the transmission mechanism of monetary policy. Economic theory starts from several assumptions for successful application of this mode, the most significant of which refer to the necessity of the existence of constant speed of money circulation, as well as exogeneity of the money supply, that is its control by the central bank. Considering that the mentioned preconditions existed during the seventies, the strategy of the monetary target was then adopted in several developed countries, but had different results.

Key words: Central Bank, Monetary Policy Strategies, Money circulation

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Monetary targeting according to Mishkin (2006, p. 5) consists of three elements:

1. Relying on the information transmitted by the monetary aggregates for conducting monetary policy;

2. Publication of medium-term targets for monetary aggregates;

3. Mechanism of responsibility for the prevention of large and systematic deviations from monetary targets.

Several advantages of the mentioned regime are highlighted in the literature monetary policy. Namely, monetary aggregates, especially with a narrower scope, can very quickly and easily controlled by the central bank. They can especially to be accurately measured in relatively short time intervals, which in principle amount after several weeks. The use of monetary aggregates such as nominal anchor, also increases the transparency of monetary policy, having in given that very quickly the signals are sent to the interested public that influence the their inflation expectations. The transparency of monetary targeting aggregates also increases the responsibility of the central bank towards the public with intent to keep inflation at a low level.

Economic theory starts from several assumptions for successful application of this mode, the most significant of which refer to the necessity of the existence of constant speed of money circulation, as well as exogeneity of the money supply, that is its control by the central bank. Considering that the mentioned preconditions existed during the seventies, the strategy of the monetary target was then adopted in several developed countries, but had different results.

While the USA, Canada and Great Britain had bad experiences with the aforementioned regime, and above all because in those countries the mentioned strategy was not a serious one way implemented, as well as due to the absence of a solid connection between the monetary aggregates and the final goal, Germany and Switzerland had the complete opposite experiences. The success of the regime in these countries is the result of the fact that they are not relied on Friedman's rule for the constant rate of monetary growth aggregates, as well as that they paid special attention to communication with the public, in order to cause a collapse of inflationary expectations as an important factor affecting the height of the inflation rate.[2]

Although, monetary targeting in relation to other regimes has several advantages that are previously mentioned, however in practice can be valorized in case of fulfillment of numerous prerequisites. Among the most important is the existence of high the predictable links between the aggregate itself and the financial objective of monetary policy, formulated in terms of price stability or nominal income. Almost equal again important prerequisites are the existence of the stability of the demand for money, as well as the absence of significant interest rate fluctuations. As time goes by, relying on new theoretical research and empirical verifications, the key ones prerequisites for the successful application of this regime have become questionable, so many countries are decided to abandon this strategy, while looking for an adequate alternative.

A second potential nominal anchor of monetary policy is exactly that fixing, that is, tying the values of the domestic currency to the currency of the big ones countries with low inflation. The advantage of using this mode of monetary policy is reduced to eliminating or mitigating problems with time inconsistency, which certainly reduces the discretionary rights of the central bank and makes it impossible to use an excessively expansionary or restrictive monetary policy directed in the direction of devaluation or revaluation of the exchange rate. Therefore requests to fix the exchange rate are considered as a clear intention to leave the the discretionary monetary policy.[3] Apart from that, a second significant advantage is

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[2] See: Mishkin, 2000, p. 1 – 7

[3] The analysis of this phenomenon by a group of authors is interesting, which is processed in the context of the new Keynesian approach, so in that context for more information see: Laurent, Dellas and loisel, 2008.

the relations of reduction of inflationary expectations, that is, of tying them to inflation the earth's anchor, which contributes to keeping inflation under control, which is also basic reason why this strategy is aimed at defeating inflation, applied both in developed and underdeveloped countries. Among the advantages should be mentioned and the increasing integration of the countries with the neighbors, which with the application of this regime are achieves. Namely, it should be pointed out that in a large number of developing countries, which have unpleasant experiences with inflationary movements, this is practically unique a way to suppress inflation, through the currency board or completely dollarization. In recent research34 among the reasons for using this strategy the authors also add a desire to put the terms of trade in their favor.

Otherwise, with the currency peg, decision makers are faced with two choices – what is the reference currency to which the domestic currency is pegged and what is the nature of the peg in terms of commitment and firmness, that is, the choice between the currency board, and so on.

Gudmundsson (2006) suggests that countries with diversified trade fared better instead of pegging to individual currencies, to peg their currency to a weighted basket of currencies in which the currencies of those countries that have a dominant share would have tendency for low inflation. With that, on the other hand, the effects would be reduced, that is the consequences of changing the key international currency pairs on internal and external macroeconomic balance.

Some authors[4] suggest that for small countries the strategy of binding is better of its currencies for the currencies of the main trading partner, especially if integration with the partner is one of their goals. At the same time, some authors believe that pegging individual currencies is a better option than pegging to a basket of currencies for several reasons, of which the key one is that in the first case there is a lot the approach is more transparent and easier to understand by the public, which is special importance when it comes to inflation expectations.

The currency board can be powerful binding mechanism based on pegged exchange rate, especially because prescribes a strict obligation of central banks to the fixed exchange rate in relation to the classic fixed exchange rate, which is why it can be used as an effective instrument for collapse of inflation in a relatively short period.

In addition to the numerous advantages that this mode brings with it, there are also significant ones disadvantages that prevent him from using it. By accepting the exchange rate as an intermediate goal of monetary policy, the monetary authorities practically are deny the application of monetary policy that would be independent in relation to the country of origin of the targeted currency, which is a serious disadvantage which practically makes it impossible to react vigorously to the various challenges that affect them both countries. This means that the money supply in the home country is in direct dependence on the movement of the money supply in the anchor country, in order to preserve it the stable level of the exchange rate. Some authors[5] also consider it as an important drawback the impossibility of long-term targeting of any nominal variable, having in given that the monetary policy is subordinated to the objectives of the fixed exchange rate itself. More an important drawback are the significantly more serious consequences that occur for the home country in the event of a collapse of the home currency occurring as a result of the speculative attack.

Inflation targeting, which became particularly popular during the 1990s years of the minatio century, according to Mishkin (2000, p. 12) consists of five key elements:

1. Public announcement of medium-term inflation targets;

[4] For more information see for example: Ester and Monacelli, 2008, p. 721 – 750; De Paoli, 2009, p. 11 – 11.
[5] For more detailed information see: Masson, Savastano and Sharma, 1997.

2. Institutional commitment to price stability as primary long-term goal of monetary policy and commitment to achieving the the inflation target;

3. Strategy of including information in which many variables, and not only monetary aggregates have a role in making decisions about the monetary politics;

4. Increased transparency of the monetary policy strategy through communication with the public and markets related to the plans and goals of monetary policy;

5. Increased responsibility of the central bank in achieving the inflation targets.

The numerical target or the zone of can be used as an intermediate target inflation for one or more time periods. It should be emphasized that for target is often used zone in relation to a single number, while the target period which is interpreted to refer to a period of one to four years. When it comes to the zone should then be emphasized as ranging from 1 % to 4 %, which implies yes, commitment to the goal that manifests itself in price stability means nothing requirement to achieve a zero rate of inflation. All this is so because it does not exist convincing evidence pointing to the benefit of an inflation level below 2%, while on the other hand however, the cost of reduction is particularly high (Bernanke and Mishkin, 1997, pp. 97 – 116).

Like that for example Akerlof, Dickens and Perry (1996) showed that the particularly low rate of inflation reduces the flexibility of wages, thus reducing the allocative efficiency of the labor market, and even increases the level of natural unemployment rate, but the mentioned conclusions should not be exaggerated.

It is especially important to point out that it is equally binding for the creators of the targets the lower and upper limit of the zone, so on that basis it is clearly seen that instead the rules of rigidity are used the limited discretion, which is used in order to stabilization of the output, which is why the mentioned mode is often called flexible inflation targeting, taking into account that strict inflation targeting is less common though.

What particularly attracts attention in the literature is the definition of target, that is, which measure of inflation to take. Analyzing the countries that have adopted this strategy, one gets the impression that the largest number of countries are decided on a variant of the consumer price index (CPI). However, most of the time they are not takes into account the so-called public index of consumer prices, but the basic rate of inflation. For those reasons, it is necessary to emphasize that there is no single approach tied to the fact that is in charge of determining and announcing the inflation target, rather experiences are different. It can be done strictly by the Central Bank, jointly

The Central Bank and the Government, or the Government exclusively, but still prevails the practice is for the Central Bank and the Government, as holders of the monetary and fiscal policy.

It is about a strategy of the monetary policy that practically developed in strategy of monetary targeting and that in a way that accepted its own the most successful elements, of which they certainly stand out by devoting themselves to the price point stability and greater transparency of the policy itself. The main advantage of the inflation target is that full transparency has been achieved, which affects inflationary expectations of the public, taking into account that for the public the mentioned target is particularly easy to understand. Unlike targeting monetary aggregates, at them by disturbing the relationship between aggregates and inflation creates a problem at explaining to the public why it is necessary to deviate from the monetary target, with what transparency is significantly threatened, which is strongly related to the achievement of the desired level of inflation. Namely, it is irrelevant for inflation targeting the relationship between the quantity of money and inflation, which is a significant advantage over monetary targeting, where the shocks that occur in the velocity of circulation of money caused big problems in achieving the ultimate goals.

With this mode, it is possible to reduce the problems of the weather inconsistency, bearing in mind that with the clear announcements of the inflation target reduces the space for exerting various types of pressure on the Central Bank implements an inflationary monetary policy, so as not to affect other goals of economic policy, with long-term undesirable consequences. A key advantage in relation of targeting the exchange rate is that advantage that preserves the independence of the monetary policy, thus creating an opportunity for its use as a reaction to internal and external shocks that economies are not resistant to. That on the other hand means that the monetary authority on occasion other than the primary objective, which manifests itself in a stable and low inflation, takes into account other stabilization goals and uses adequate instrumentation how it could react to changes in aggregate demand.

Mishkin (2011, p. 4) argues that flexible inflation targeting implies the obligation of the Central Bank to stabilize inflation in the long term, often at an explicit numerical level, but allows the Central Bank to short term follows the policy aimed at the stabilization of the output approx. the natural rate. On the other hand, Bean (2007, p. 8) considers that objections which are attributed to inflation targeting, and who say that this strategy is too limited in the sense that it does not pay enough attention to non-inflationary targets have no real basis. All this arises because according to him all Central Banks that have accepted this regime are much more flexible, than they are rigid, so it does not mean that they will be committed to the set target at any cost, not taking into account the consequences. On the contrary, determining the target and helps the Central Bank to explain its intention, which on the other hand does not mean that no measured actions can be taken in the direction of achieving the the non-inflationary targets.

Apart from the previously mentioned numerous advantages in relation to other modes of monetary policy, the strategy of inflation targeting are also tied several flaws that stand out in the theory. One of the key arguments of its critics is that countries that have applied inflation targeting does achieve the desired inflation or output targets, but also notes that this is also the case for those countries that did not opt for such a strategy, such as the United States or Germany. Namely, in the literature it is pointed out that such strategy is not transparent enough, considering that the inflation targets are determine conditionally, because they are conditioned by the movement of other model variables.

Certain authors object to the fact that the concentration on inflation targets it can lead to a higher fluctuation of the output, which is negative in any case reflects in the economy as a whole.

However, despite the fact that there are critics of this regime, however the prevailing opinion is that inflation targeting does represent progress in in relation to other strategies of the monetary policy, which on the other hand is confirmed with the empirical evidence that supports the mentioned claims. Blanchard (2009, p.

2) concludes that the pre-crisis period (the crisis in the USA in 2007) was characterized by the growing popularity of inflation targeting not only between the creators of the monetary policy, but also within the academic circles. There are also authors, among whom Mishkin stands out, who due to the indisputable advantages of this strategy recommended by the Federal Reserve System.

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