Fiscal and Monetaty Policy Measures to Ensure Price Stability

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The study aims to offer a clear and suggestive view of the stage in which we can find the Romanian economy in terms of performance of the main objective of the macroeconomic policy–ensuring the price stability
In the context of an unstable economic environment, one of the reasons for choosing this theme is the need to understand and acquire the mechanisms related to monetary and fiscal policy measures to be taken to ensure price stability. Economic and financial crisis has stressed more concerns on the sustainability of the tax system and monetary policy to answer of the economic pulse. The maintenance of a favorable economic environment is the key to a sustainable economic growth eventually leading to the convergence of revenues towards the levels attained by the other European Member States.
An optimal mix between fiscal-budgetary policy and monetary policy may contribute to restore the macroeconomic equilibrium capable of managing financial turbulences from the international market. Sustaining a favorable economic environment is the key to robust economic growth.

Key words: *fiscal policy, monetary policy strategy, direct inflation targeting, price stability, policy mix*
JEL classification: *E52, E62, E63, E66*

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1. Introduction

In the last decade, the problem facing the world economy was the generalized increase in prices, which generated pressures in the plan of monetary, fiscal, political, social. This imbalance affects economically powerful private sector decisions regarding investments, savings and even increasing production, the final effect materialized as reducing production levels. This is why, in recent years economies have shifted towards achieving macroeconomic fundamental objective of macroeconomic policy represented by price stability.

This objective can be based on different strategies of monetary policy and fiscal policy strategy as highlighting their contribution to creating favorable conditions for reducing inflation and ensuring financial stability.

The paper is organized as follows:

In the first paragraph are included theoretical monetary and fiscal policies. In the 2nd paragraph presents aspects of the literature on the stability of prices, inflation, monetary and fiscal policy strategies. 3rd paragraph presents the main macroeconomic developments in Romania during 1990-2009. In the 4th paragraph are conclusions derived from synthesizing information presented in this paper

2. Economic literature

Even if international disputes occurred over many fiscal and monetary policy measures to be taken, the consensus was expressed regarding the ultimate objective of macroeconomic policy and hence monetary policy - price stability.

Experience in recent years has shown that this objective can be based on various monetary policy strategies, strategies that are geared towards the establishment of intermediate objectives:

- monetary aggregates targeting (such as monetary base, M1, M2 or

M3);

- exchange rate targeting

These intermediate targets are links between the actions performed by the operational tools of monetary policy and the real economic activity and inflation.

Regarding the use of monetary aggregates as intermediate target of monetary policy, they require the application of restrictive monetary policy to consider controlling the growth rate of monetary aggregates in order to eliminate excess liquidity in the economy.

With the adoption is going on based on targeting the exchange rate regime, the central bank tries to ensure the nominal exchange rate stability through the use of its instruments aimed, on the one hand, changes in interest rates, and secondly based on direct interventions on the forex market interventions designed to support the exchange rate.

The theoretical and practical debates in recent years, inflation targeting monetary policy strategy that has proved most effective strategy in achieving the ultimate objective of monetary policy. This approach requires a commitment that inflation targeting is the main objective and mission of the institution.

The concept emerged from the theoretical point of view through the '80s and the first country to implement this scheme was New Zealand. Widely used in industrialized countries in the 90s, the strategy of direct inflation targeting became an attractive alternative for emerging economies.

Strict inflation targeting implies that the central bank pursues the objective of minimizing inflation and inflation deviation from target only, without taking into account the effects this may have on gross domestic product and economic growth.

Inflation targeting strategy has the following defining characteristics:

- Price stability (understood in the form of low and stable inflation rates) as a single objective or priority of monetary policy either by constitutional or by public commitment of monetary authorities.

-Quantifying the objective of monetary policy as inflation rate to be achieved over a time interval, the target being set by government and empowered the central bank, established jointly or independently indicated by the monetary authority.

-Central-bank independence in the instruments used to achieve the targeted rate of inflation, implying a greater degree of central bank independence in monetary policy management

-Transparency and accountability of the central bank configuration process development and implementation of monetary policy

Romania has adopted an explicit monetary policy of inflation targeting in August 2005. National Bank is the 19th world central bank to adopt such a policy. Excess demand, fueled by fiscal and wage policy combined booming and strong and intense promotion of lending products carried by most commercial banks in the period 2007-2008 forced the national bank to strengthen monetary policy significantly, through growth rate of monetary policy and maintaining high levels of minimum reserve requirement ratios. The result was such an optimal mix defined by loose fiscal and wage policy and a restrictive monetary policy. In these circumstances, the central bank for monetary policy made efforts to ensure a balance between the restrictiveness imposed target of inflation in the medium and prudence necessary to avoid undue costs in terms of economic growth.

National Bank of Romania considers that inflation targeting strategy is appropriate macroeconomic conditions that are Romania. Father points out that the criteria were satisfied and that makes the effectiveness of this strategy: lowering the annual inflation rate below 10 percent, fiscal dominance to restrict, the conduct of fiscal consolidation and improving coordination between fiscal and monetary policy, the relative flexibility of leu exchange rate and reducing the vulnerability of the economy to fluctuations in this variable; clearer shape macroeconomic behavior and functioning of economic mechanisms necessary to identify and increase the efficiency of monetary transmission channels.

According to Isărescu[1] ”setting a proper policy mix is of higher importance than each policy taken independently” because “without the support of other economic policies, the risk of achieving price stability in the detriment of other macroeconomic equilibriums arises, which can finally prove to be an auto reversible process”. Therefore, a sub-optimal mix in recent years (loose budgetary and wages policies, and a very “tight” monetary policy) could be replaced with an optimal mix in which all policies (budgetary, wages and monetary) will have a similar restrictiveness rate and will focus the economic activity on labor and productivity. “A highly restrictive monetary policy can compensate only on short term the lack of support from structural reforms, fiscal-budgetary policy and revenues policy.

Fiscal-budgetary policy holds a key role in maintaining external disequilibrium at a sustainable level.” As regards the effects of fiscal policy, Philip R. Lane and Roberto Perotti state that domestic fiscal policy has a significant influence on the economy by modifying the cost of labor force and of profitability. Moreover, they state that real wage and profitability are more receptive to the innovations of fiscal policies than quantities (labor force participation and output). A close complementarity relation lies between fiscal and monetary policy as they both are core components of economic policy and aim to ensure a suitable environment for achieving specific objectives, such as: prices stability and economic growth or economic cycle stabilization, respectively.

Between 2007 and 2008, the pro-cyclic character of fiscal policy reduced the area for the actions of the new government aiming to counteract the economic recession from the beginning of 2009. The de-

[1] Isărescu Mugur, „ *Rolul politicii monetare in mix-ul de politici macroeconomice*”, August 2007

mand surplus, resulting from loose wages and fiscal-budgetary policy, was amplified by the excessive growth rate of bank credit in the first three quarters, followed by a sudden deceleration in the first months of 2008, which led to a conflict between restrictive monetary policy and the expansionist fiscal policy, for the first time in latest years, while the NBR restricted monetary conditions, and fiscal policy seems to be out of control following the decision to increase pensions. It is imperious that the monetary policy is sustained by a fiscal policy that responds to the needs of the economy, otherwise the national bank will be in the difficulty if left alone to manage this situation, and in this case Romania will face high costs.

The current crisis appears to compromise the delicate issue of monetary policy objectives: price stability and financial stability. Romania's experience shows that financial stability is of particular importance to price stability. Rightly, Romania has been criticized for delays in disinflation. They were due to structural reforms should be substituted NBR insufficient. NBR would be substituted if this lack of reform by steep rises in interest rates the financial situation of firms and households would be damaged. And so would damage the financial stability of the banking sector. Finally, the very pace of disinflation would be probably less than that achieved. Lesson to be learned is that the long term, failure to maintain financial stability may not only lead to a higher inflation (Isarescu, 2009).

An important role in mitigating the effects of economic and financial crisis is policy makers, to find those ways to ensure that complementarity between fiscal policy and monetary policy through the efficient use of their specific instruments can influence the economy. When the government reduces its spending, aggregate demand falls, leading to a reduction in production and employment in the short term. However, if, simultaneously, monetary policy is used, then by increasing the money supply, aggregate demand can be expanded. An appropriate mix between monetary policy and can leave fiscal aggregate demand unchanged.

We can say that a macro precise diagnosis - an emotional approach to the crisis may lead to inappropriate action, given the increase in domestic demand stimuli unsecured. A coherent policy mix is essential for restoring calm macroeconomic equilibrium.

3. Analysis of macroeconomic indicators for determining inflationary process

Chapter examines the evolution of the indicators used in analysis in the economic context of Romania from 1990 to 2009.Romania's transition to a competitive market economy was a slow process, characterized by low growth and high inflation rates and unstable.\

After 1990, price liberalization has been extended. Most prices were liberalized in November 1990, in April 1991 and July 1991, but the last major round of liberalization has been delayed until 1997

Since 1991 inflation has been on an upward slope. Maximum being reached in 1993 when consumer prices were 256.1 percent annual variation from other countries (Hungary, Czech Republic, Bulgaria) the inflation rate was below 50%. Rising prices in this period was due to their gradual liberalization, but also other measures (fiscal reform or exchange rate).

In 1994, amid the resumption of growth and timing of price increases, inflation was calm, immediately after registering a downward trend.

In 1995 he passed the first 3-digit level in a two-digit level, so that in 1995 there was an inflation of 32.3%.

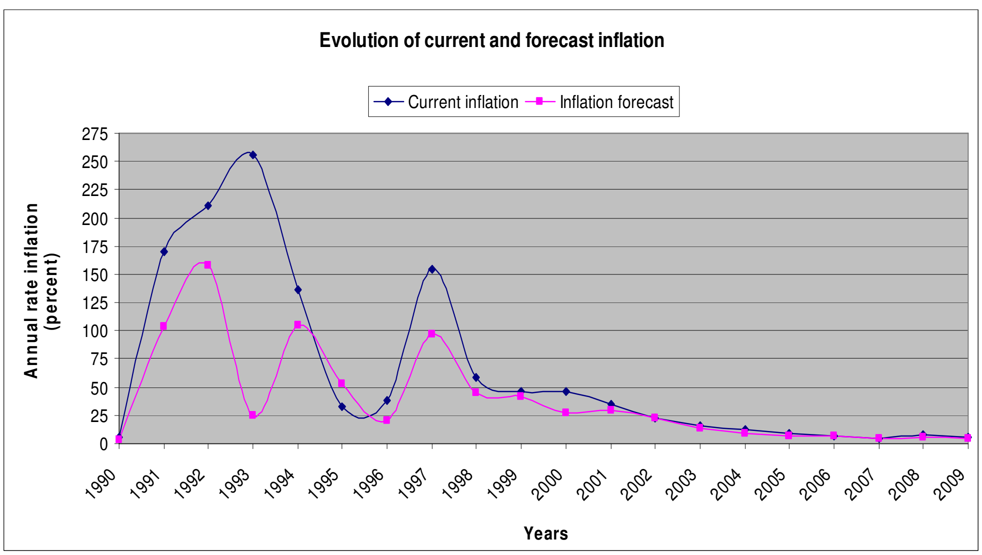
In 1997, following the latest round of price liberalization (in sectors agriculture and energy), average annual inflation increased again, reaching a value of 154.8%. Since then, inflation was in a downward trend, dropping below 10% in 2005 (when annual average inflation was 9%) and 5% in 2007 when annual average inflation was 4.84%).

In 2008, following the global economic crisis the annual inflation rate rose to 7.85%, following that in 2009, to register a decrease in its value by 5.59%.

Crisis started in late 2008 required the adoption of a vision of fiscal policy has been accompanied permanently of a restrictive monetary policy, whose effects were reflected both in lower income population adversely influenced consumption and production, and a non-governmental credit loss as a result of active interest rates increase leading to a reduction in the level of investment, all these reflected a sharp contraction of economic growth.

Figure 1 contains a comparison of expected inflation, that is forecast in the draft State Budget Law and actual inflation. Expected inflation data was collected editions of the newspaper "Romania Libera" from the period 1990-2009, the month of adopting the State Budget Law.

Figure 1: Current inflation and forecast inflation in Romania from.1990 to 2009



Great differences are observed up to 70 percent in 1990-2000, when price liberalization and economic situation had resulted in an unstable inflation rate and major fluctuations. Differences between the two inflation rates have decreased in recent years as inflation has become more stable.

No inflation dynamics can be analyzed without taking into account exchange rate and its effects. Figure 2 presents the real exchange rate ROL / USD and GBP / EUR in period 1990-2009. Recent data on the actual rate registered in Romania were collected from the site of the National Bank of Romania, excluding the value of 1990, which was used for the recorded value of the ECU. Figure 3 is noted that exchange rate was similar to inflation but not so fluctuating. Exchange rate depreciation had a maximum in 1992. In the period 1996-1997 has been depreciated since early 1997 has been the liberalization of the exchange rate, with the last price liberalization. In 1998 we wanted to avoid depreciation of the leu to reduce inflation. In late 1998 and in 1999 to restore external competitiveness followed by a depreciation of currency. Since 1999 the lion entered a process of real appreciation against major currencies, while registering and low inflation. The two phenomena may be related, low inflation can be explained by currency appreciation.

Figure 2: Evolution of the real exchange in Romania From 1990 to 2009

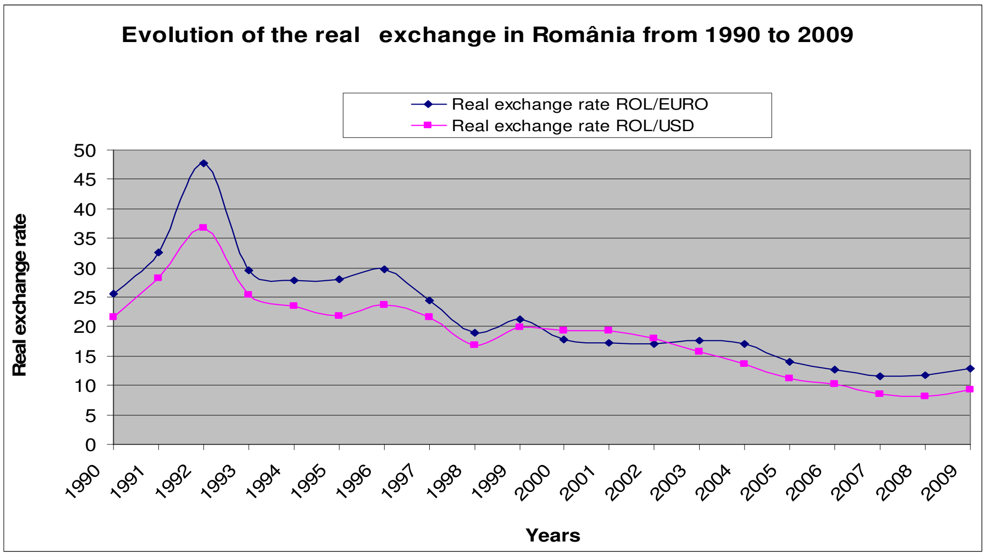


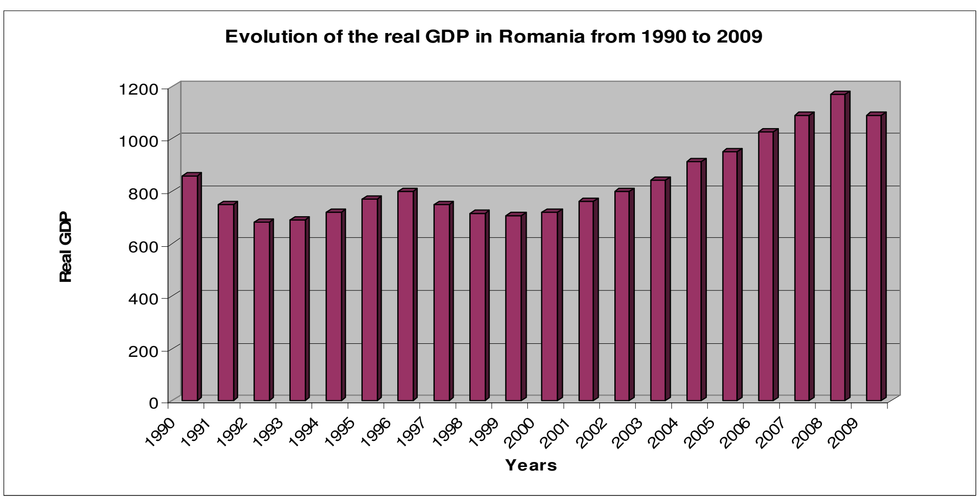
Figure 3 presents the evolution of real wages in our country during 1990-2009. Calculations were made in comparable prices.

Figure 3: Evolution of real wage in Romania from 1990 to 2009

It may be noted that in the early years of transition real wages increased fluctuations presented, with peaks around the years 1996 and 2008. Value of real wage in 1990 was exceeded only in 2005, when Romania adopted the strategy of monetary policy, inflation targeting. In recent years, real wages showed obvious upward trend, reaching a value of 5642.36 GBP in 2008. In 2009 there was a decrease in net salary, this value reached 5137.3 ROL.

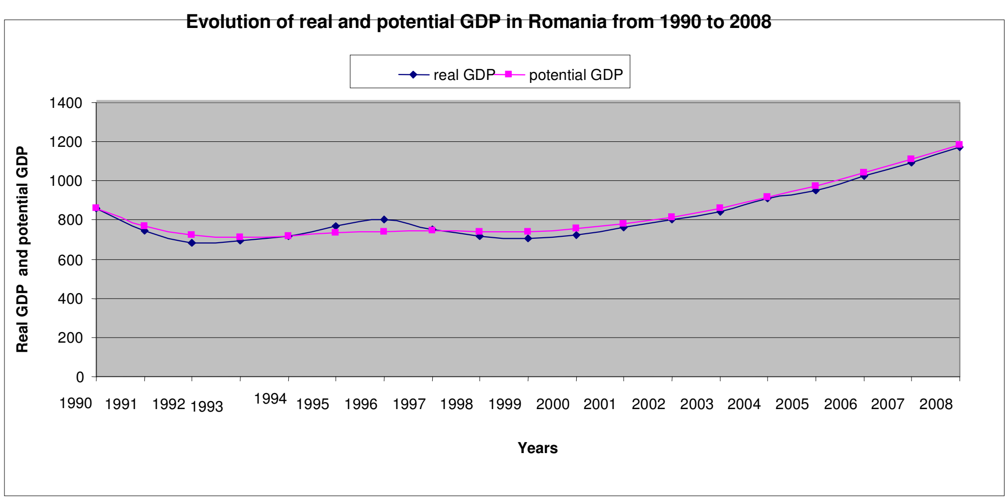
Fig.4 shows the evolution of gross domestic product of Romania during 1990-2009. GDP is expressed in comparable prices in 1990. Data on GDP are taken from the Statistical Yearbook, during 1990-2009, National Statistical Institute. We can see that the evolution of real GDP has a slightly upward trend, with an average of 793.332 billion ROL. Minimum was reached in 1992 when it registered a real GDP 681.1726 ROL billion and the maximum was reached in 2006, reaching a figure is at 1031.099 billion ROL. Since 1999 real GDP shows a steady upward trend.

Figure 4: Evolution of real GDP in Romania from 1990 to 2009



Central banks to apply inflation targeting strategy, as is the case of Romania, are concerned with growth and development especially of GDP deviation from the potential. In Fig 5 is presented the comparative evolution of real GDP and the potential during 1990-2008.

Figure 5: Comparative evolution of the real and potential GDP from 1990 to 2008

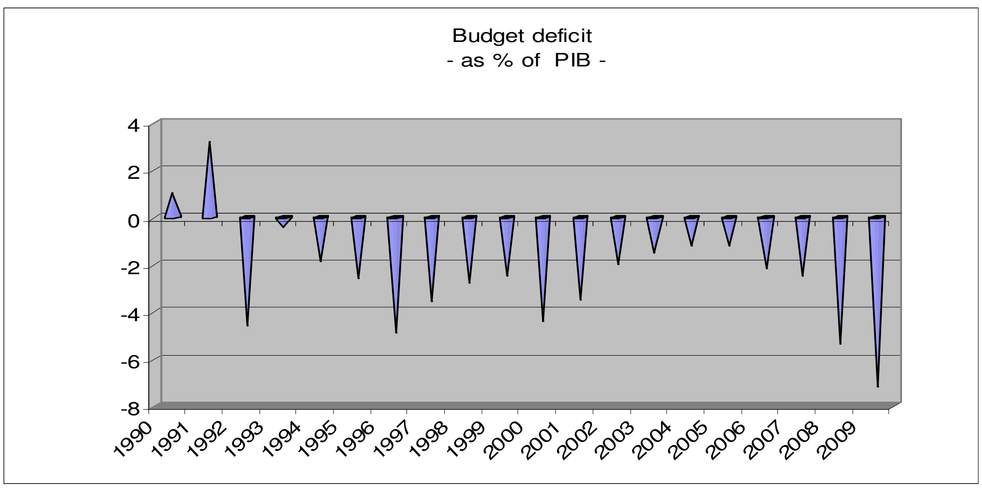


Based on the data obtained we can see that the values of the two outputs are similar, with small fluctuations around the years 1992, 1996 and 2000. This is due to two economic cycles: the years 1990-1991 was a recession, after which, around the year 1992 was a period of depression. The period 1993-1996 was characterized by an economic pick-up, followed by a recession for the next two years. 1999 was characterized by economic depression, and then the next year we are dealing with a period of economic expansion, with the peak in 2008. In

2009, amid sharp global economic crisis, real GDP registered a decline, hovering around the value of 2007

Romania strictly followed the budget deficit criteria from 2001 to 2007, keeping it under the limit of 3 percentage points of GDP, but the expansionist fiscal-budgetary policies of 2008 led to an increase of budget deficit (5.4 % of GDP) according to European standards (SEC 1995). As a result of exceeding the 3% of GDP, the excessive deficit procedure was initiated. Romania was not sanctioned financially, and it could only be after 2011, in case it does not implement the recommendations on the deficit.

Figure 6: Evolution of budget deficit from 1990 to 2009



In the context of current economic crisis, the assessment of European Commission is highly straightforward. Romania needs to implement its structural reforms program, mainly focused on macroeconomic stability through strict control of fiscal measures, of inflation, reduction of bureaucracy and a more efficient administration. Moreover, a global policy concerning the labor market correlated with education reform is needed.

Setting a favorable environment in Romania, among others, the implementation of a sustainable and credible strategy for fiscal consolidation can contribute to diminishing the demand-side inflation pressures and macroeconomic disequilibria. Concurrently, credit expansion, current account significant deficit, and its funding need to be closely monitored. Although creating new workplaces needs to be stimulated by adjusting fiscal systems and of aid allocation, it is required that a decrease of taxes to be accompanied by constrained expenditures, and this process needs to be sustained by higher efficiency of budgetary expenditures, among others. Adopted measures to increase quantity and quality of labor force supply needs to include adjustment based on the needs of economy.

Conclusions

In the new context of the financial and economic crisis it is imperious to implement a policy mix that responds to Romanian economy's vulnerabilities related to financial turbulences from the international market. For that matter, in order to ensure the equilibrium in the economy the monetary policy needs to be accompanied by a similar behavior of the fiscal policy, by a prudent revenues policy, as well as by continuous structural reforms for creating the conditions to decrease budgetary deficit, current account deficit, external disequilibrium, and to ensure stability of prices and, implicitly, for the process of economic development.

In order to sustain the growth trend of macroeconomic stability, the measures to strengthen the restrictive character of the monetary policy need to be supplemented by prudent fiscal and wages policies, as well as by further reducing quasi-fiscal deficit. The conditions needed to revitalize the economy can only be ensured through an adequate policy mix so designed that the fiscal and budgetary policy, wages and monetary policy complement each other and that their interaction reflects upon the economy. A highly restrictive monetary policy can compensate only on short term the lack of support from structural reforms, fiscal-budgetary policy and revenues policy. For that matter, in order to achieve the equilibrium that provides an adequate environment, the inter-correlations between economic policies need to be considered so that their effects lead to achieve specific objectives, such as: prices stability and economic growth or stabilization of economic cycle, respectively.

A solid fundament of the fiscal policy that comprises the actual conditions of social and economic activity, and the prerequisites of present time and the imperatives of future time, can prove to be beneficial to progress. In case these factors are not taken into consideration, the fiscal policy can slow down economic development, lead to involution or even to social tensions

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