Annals of "Dunarea de Jos" University of Galati
Fascicle I. Economics and Applied Informatics
Years XXI – nº2/2015
ISSN-L 1584-0409 ISSN-Online 2344-441X
www.eia.feaa.ugal.ro

A Statement of the Reaching Inflation Target upon Price Stability in Romania

Larisa PREDA*, Elena Violeta DRAGOI**, Lucretia Mariana CONSTANTINESCU***

ARTICLE INFO

Article history:
Accepted June 2015
Available online September 2015
JEL Classification
G12

Keywords:
Monetary policy, Price stability, Inflation, Interest rate, Productivity

ABSTRACT

Price stability contributes to financial stability because it eliminates the market distortions and uncertainties which may occur at the markets' level as a result of the price instability. Price stability can reduce the level of risk premiums in interest rates because it lowers the degree of uncertainty that is associated with future inflation.

1. Introduction

Inflationary phenomenon is considered a sign of an imbalance in economy, so it's necessary to control inflation and avoid inflationary process and by this reason in most contemporary states the primary objective of economic policy is to combat or at least to limit inflation.

Global experience and the whole spectrum of economic theory shows that a sustainable and healthy economic growth can be achieved only in a non-inflationary environment. Monetary policy and its instruments have evolved according to the historical conditions of each period but price stability remained his main objective. Monetary equilibrium is a process which involves the action of several economic and monetary levers that lead to the achievement a balance between the money supply and demand of goods and services, and between solvable demand and the capacity of economy to ensure the relative stability of prices.

The events which have been determined at the beginning of the transition from centralized totalitarian economy before the Revolution of December to market economy caused a major monetary disequilibrium as happened with other countries in Central and Eastern Europe, which followed the same path. In the years before 1989 occurred deep and profound imbalances such as economic decline while inflation took the most dangerous form that was manifested by widespread shortages of goods and forced saving.

Our country has faced a long-term inflationary process and a higher magnitude than other countries in transition due to several causes such as: the rigid price system inherited from the old regime, the prices that are administratively controlled, the major imbalances which belong the real economy, the external shocks that led the authorities to decide for cautious and gradual liberalization of prices. The initial prudence had solid political and social reasons and it proved to be an acceptable short-term measure but very difficult to be supported on medium-term. Trying to treat the effects and not the causes of phenomena, it has led to increasing inflationary pressures and increasing cost inflation measures.

The inflation in 1993 (256.1%) determined that the National Bank of Romania (NBR) to adopt anti-inflationary policy that led to the relative stability of the national currency, part of the reform process initiated by our country.

It can be appreciated that inflation control and its reduction as the levels recorded in the countries with mature market economy is not only a key-objective and a measure of performance which belongs the economic policy of the Romanian authorities. Price stability leads to better quality of life because it leads to the decrease of the uncertainty which is related to the overall evolution of prices and, in consequence, it increases the transparency of relative prices. Maintaining a certain level of price stability can avoid certain problems related to the economy, social life and policy, problems about the redistribution of wealth and the cleanup, which is evident during the periods of inflation and deflation.

This aspect is more obvious in the case of the changes that occur about the price level, if they are difficult to forecast, and in the situation of those social categories which are experiencing difficulties in

*, **, *** Valahia University of Targoviste, Romania, E-mail addressess: larisapreda@yahoo.com (L. Preda), violeta_dragoi@yahoo.com (V. Dragoi), maractinescu@gmail.com (L. M. Constantinescu)

protecting the nominal value of the assets. For example, if there is an unexpected increase in the rate of inflation, all those who hold nominal assets, such as long term employment contracts, bank deposits or bonds, report losses in the fair value of the nominal assets. Thus, this income is randomly transferred from lenders to borrowers, because with the money obtained from the repayment of a loan you can buy fewer goods than it was expected when it was granted. If there is an unexpected episode of deflation, those who hold nominal assets (such as salaries or deposits) can record earnings, because their value is increased. Of course, in conditions of deflation, it may happen that, sometimes, borrowers may not be able to pay their debts or they may declare insolvency.

The pronounced connection of the Romanian economy with the world economic real and capital flows, has favored the process of catching up in the last period, reflected by the evolution of the growth rate between 2000 -2008 years.

The emerging economies marked by structural stiffness but open to the foreign market can be highly affected by unfavorable economic conjuncture as the economic and financial crisis spread of the United States of America and United Kingdom which affected the Romanian economy to significantly reduce the pace and it made it decrease the GDP during the years after 2008.

2. Literature review

Traditionally speaking, monetary policy is represented by the action of the monetary authorities which are designed to monitor the changes in the total amount of money in time, including interest and exchange rates, in order to collaborate with other elements of economic policy and control inflation, reduce unemployment, record greater growth rates of income or production and improve the balance of payments.

Monetary policy aims to make changes about the economic variables. In accordance with the traditional Keynesian concept, the permanent growth of the nominal money supply leads to lower nominal interest rate as a result of the effect of liquidity.

Reduction of interest rates, in turn, stimulates the growth of investment and consumption, which determines the growth of the actual revenue and the change of the nominal GDP. The transmission mechanism of the effects of monetary policy adopted by the Keynesian model (fig. 1) is designed an empirical analysis of the various transmission channels of influence of offered currency **(C)** - interest rates **(ir)** - investment expenses **(I).**

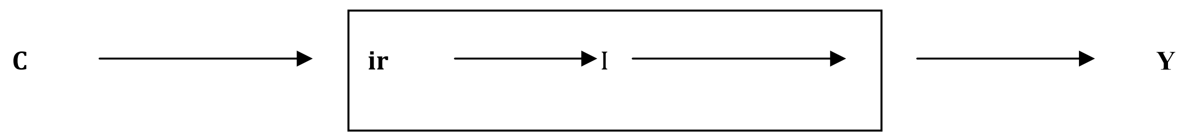
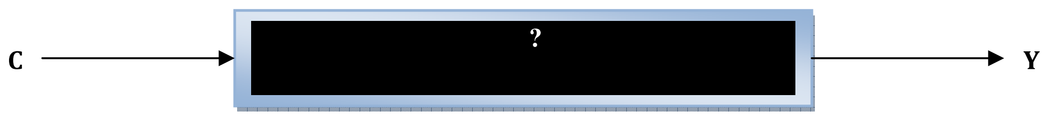


Figure 1. Keynesian model of the monetary policy transmission

The empirical model highlights, if the movements of C are accompanied by the movements of Y, and determines the correlation between the two variables. Specialists did not specify the various channels through which money affects global demand. Instead, they examined the effect of money on economic activity where Y is strongly connected (for example, in a strong correlation) to the evolution of C. Using this model, specialists analyzed the effect exerted on C and Y, assuming that the economy is a "black box" where no one can see and the figure 2 where the economy is represented by a black box containing a question mark, illustrates this specialists' approach.



C→?→Y

Figure 2.The monetary transmission model of monetary policy

The monetarism adepts believed that the decisive element for growth and price trends is the money quantity in circulation and that responsible for inflation is excessive monetary growth.

In contradiction with the Keynesian theory adepts, money does not play a very important role in the evolution of economic activity.

M. Friedman proved that every time in history when economic activity decreased, it was preceded by a robust monetary contraction, generated by the decisions of the monetary authorities. Starting from the idea that real economic growth's variation is determined by the evolution of the rate of growth of the money supply, the adepts of the monetarism established the relationship between monetary impulses given by the growth rate of the amount of money and of the further development of the economic activity and they observed that this relationship is neither linear nor immediate, but it is a relationship that works on "long and variable intervals". By this reason they support the necessity and the utility of a slow and steady growth in the money supply, by proposing the so-called "rule of constant growth of money". Under present conditions, in the status of the majority of the central banks, the insurance and the maintenance of the price stability aims a fundamental objective.

3. The National Bank of Romania role to ensure an adequate set-up the price stability

The price level stability design an important gap of the economic stabilization policy because its manifests mainly in the form of inflation and may provide a negative influence on the national economy. The bad side of this effect starting from an increase of the inflation provides a reduction of the economic efficiency, an unfair distortion about the distribution of the income and a worsening of the position of the international balance of payments".

Given that the inflation rate in the case of an economy is situated on a high level (over 2 digits), economic inefficiency manifests acutely, the most commonly encountered phenomenon is that of the growth of the aggregate demand, while the offer remains the same. If the demand increases, prices change again, a fact that leads to an increase of the demand for the change that occurs about wages, which is often satisfied just to a lesser extent, because it represents an expenditure that generates new price hikes. Regardless of the sector of the productivity of the activity sector, demand for increased wages is the same, which is why the effectiveness of certain sectors is incurred by other sectors. On the other hand, a high rate of inflation and an arbitrary distribution generates income to the economy; so those who record the variable income will automatically benefit from the salary increases much faster than those who have a fixed income. In this situation the Central Bank reduces the inflation (fig.3).

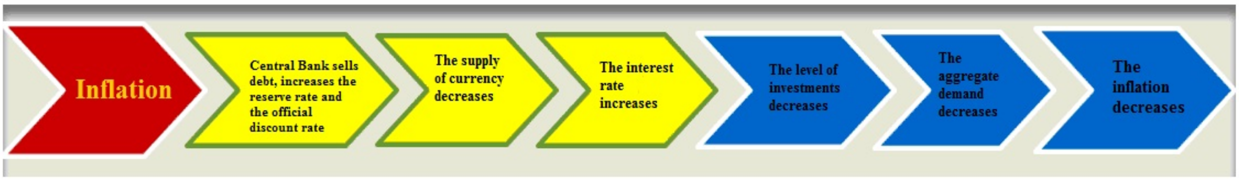


Figure 3.The mechanism of the inflation rate decreasing of Romania

This method called the restrictive monetary policy, because it decreses the amount of currency in circulation. If we think about the external economy, it should not be forgotten the impact of price instability of this work highlighted by the balance of payments. The decrease of the efficiency of the economy leads to a decrease of the competitiveness of exported products, which is why on the foreign market outlets can collapse. On the other hand, the increase of the prices of production, makes possible that on the foreign market more competitive producers may exist. A high inflation rate may lead to the devaluation of the national currency, which can lead to an inhibition of the exports. On the other hand, if domestic production is dependent, to some extent, on imported raw materials, th continuation of the activity is equivalent to an increase of production prices, which leads to a change of prices in the economy, fact that leads to an inflationary spiral with high costs of disposal.

Price stability is shaping up as one of the most important objectives of economic policy. In order to fulfil this objective, it must be taken into account the fact that the notion of price stability does not mean that all prices should be stable or fixed. At the pragmatic level, the focus is on maintaining the stability in the general level of prices, the main pupose being represented by the relative stability of the prices and not the absolute one. Economists believe that the relative stability of prices that exists when the annual rate of prices increase resulting from a representative price index, is not more than 2%.

If, the price stability is currently one of the main strands of the authorities, we must keep in mind that one of the problems of inflation is represented by the economic stagnation. There are cases in which the main purpose of the economic policy of the state is to ensure sustainable growth.

In Romania, the monetary policy strategy of the National Bank of Romania ensures an adequate set-up to the inflation targeting. This strategy was adopted in august 2005, after completion of a process of preparation, whose last stage was the creation and testing of the functioning of the economic analysis and monetary policy decision specific to direct inflation targeting and in the same time there were satisfied the other requirements and criteria which determines the effectiveness of this strategy:

(1) the relative flexibility of the exchange rate of the leu and the decrease of the vulnerability degree of the economy to the fluctuations of this variable;
(2) the strengthening the independence „de jure" (by entering into force on 30th July 2004 of the new status of the NBR and „de facto" of the NBR;
(3) the decrease of the annual inflation rate below 10 percents;
(4) the accumulation of a gain of credibility by the Central Bank and its consolidation;

(5) the fiscal domination restrictions, the development of the consolidation process and the improvement of the coordination between fiscal and monetary policy;
(6) the rehabilitation and strengthening of the banking system and the relative growth of banking intermediation;
(7) a clearer outline of the macroeconomic behaviors and of the mechanisms of functioning of necessary economy in order to identify and increase the efficiency of the channels of monetary transmission;
(8) enhancing the transparency and the responsability of the Central Bank, as well as to the area and intensity of the comunication of the NBR with the public and financial markets, including the aspects regarding to the new strategy of monetary policy and the preparation of its adoption.

While fundamental factors further contributed, as forecasted, to consolidating inflation rate dynamics in line with the price stability definition adopted by the NBR, the temporarily very low inflation levels are the result of the recent overlapping of favorable supply-side shocks, part of which were manifest, at the same time, across the region. NBR attempts to create organizational and technical framework required by the implementation of the new strategy of monetary policy have lasted 16 months and have received technical assistance from the International Monetary Fund and the National Bank of the Czech Republic.

Inflation targets are expressed in terms of the annual variation of the „Consumer Price Index (CPI)" and are established as central point framed by a variation of +/-1 percentage point.

Table 1 aims the inflation targets established by NBR during the 2007-2013 years in according the AnnualInflation Reports publishings by BNR.

Table 1.The inflation target of Romania between 2007-2014 years

Reference year	Inflation target
2007	4,0% ±1 %
2008	3,8% ±1 %
2009	3,5% ±1 %
2010	3,5% ±1 %
2011	3,0% ±1 %
2012	3,0% ±1 %
2013	2,5% ±1 %
2014	2,5% ±1 %

Source: NBR Inflation Reports

Starting with 2000, inflation rate had a generally decreasing trend (from 45.7% in 2000 to 6.06% in 2010). In 2008 there was an increase in inflation to 3.01% over the previous year, and in 2010 the average rate of inflation was 0.5 percent points from 2009, to 6.06%. Between 2012 and 2013 the inflation rate has a downward trend and it reached the value of 3.21% as shown figure 4. In consolidate data in figure 4 all these objectives didn't reached.

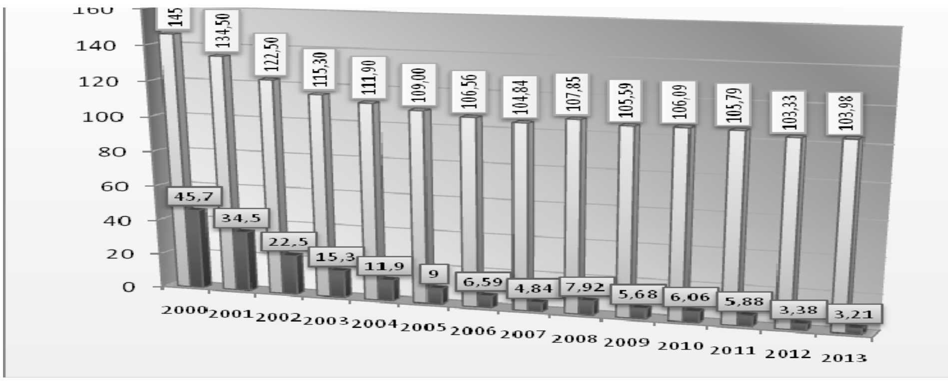


Figure 4.The difference between the inflation rate and the actual rate of the targeted inflation

The macroeconomic forecast envisages economic activity to consolidate over the reference period, amid the gradual rebound in domestic demand as the major driver of growth starting 2014. Similarly to the previous projection, the anticipated contributors to this evolution are: the rise in households' real disposable income, also due to the projected inflation rate staying at levels consistent with the inflation target, consolidation of productive capital inflows (EU structural and cohesion funds and foreign direct investment flows), as well as the phased adjustment of lending conditions, also as a result of the projected configuration of real broad monetary conditions. While fundamental factors further contributed, as forecasted, to consolidating inflation rate dynamics in line with the price stability definition adopted by the NBR the temporarily very low inflation levels are the result of the recent overlapping of favorable supply-side shocks, part of which were manifest at the same time across the region.

4. Inflation Trend of Romania in 2014

The decrease in the inflation rate below the levels projected in the May 2014 Inflation Report is accounted for by the impact of some developments that occurred or were confirmed after its publication: the appreciation of the leu in Q2, the good supply of vegetables, favored by the weather conditions in the first half of the year, as well as the persistence of subdued inflation in the euro area, which fed partly through into the dynamics of aggregate domestic prices via developments in import prices.

The rebound in domestic demand will chiefly be led by the consolidation of household consumption growth in 2014, whereas investment is expected to recover no sooner than the latter half of this year. Hence, gross fixed capital formation is foreseen to make a positive contribution to growth starting 2015. The advance in domestic demand will also induce a relatively faster rise in imports, entailing a slightly negative contribution of net exports to growth over the projection interval, despite the further favorable performance of exports. Therefore, the share of the current account deficit in GDP is expected to stabilize below 2 percent from 2014 onwards, significantly lower than the pre-2013 levels. These assumptions of the baseline scenario entail the lack of any significant corrective pressure on the leu exchange rate arising from the external position until the projection horizon.

Payments Balance, price stability, economic growth and the full utilization of economic factors represent the final objectives of monetary policy that coincides with the Romanian general economic policy.

In August 2015 NBR adopted the strategy of inflation targeting, under which aimed to achieve the fundamental objective namely price stability. According to statute, the National Bank of Romania has as primary objective to ensure and maintain price stability.

While fundamental factors further contributed, as forecasted, to consolidating inflation rate dynamics in line with the price stability definition adopted by the NBR, the temporarily very low inflation levels are the result of the recent overlapping of favorable supply-side shocks, part of which were manifest, at the same time, across the region. NBR attempts to create organizational and technical framework required by the implementation of the new strategy of monetary policy have lasted 16 months and have received technical assistance from the International Monetary Fund and the National Bank of the Czech Republic. Inflation targets are expressed in terms of the annual variation of the „Consumer Price Index (CPI)" and are established as central point framed by a variation of +/-1 percentage point. Table 1 aims the inflation targets established by NBR during the 2007-2013 years in according the Annual Inflation Reports publishings by BNR.

The macroeconomic forecast envisages economic activity to consolidate over the reference period, amid the gradual rebound in domestic demand as the major driver of growth starting 2014. Similarly to the previous projection, the anticipated contributors to this evolution are: the rise in households' real disposable income, also due to the projected inflation rate staying at levels consistent with the inflation target, consolidation of productive capital inflows (EU structural and cohesion funds and foreign direct investment flows), as well as the phased adjustment of lending conditions, also as a result of the projected configuration of real broad monetary conditions.

While fundamental factors further contributed, as forecasted, to consolidating inflation rate dynamics in line with the price stability definition adopted by the NBR the temporarily very low inflation levels are the result of the recent overlapping of favorable supply-side shocks, part of which were manifest at the same time across the EU countries' area.

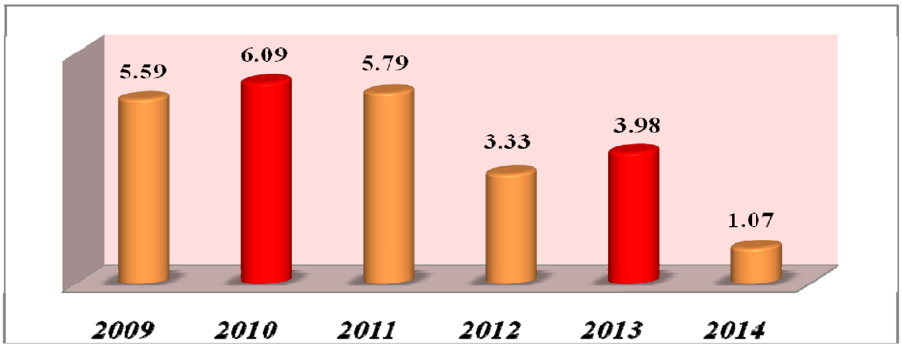


Figure 5.Inflation rate evolution in Romania during 2009-2014

The decrease in the inflation rate below the levels projected in the May 2014 Inflation Report is accounted for by the impact of some developments that occurred or were confirmed after its publication: the appreciation of the leu in Q2, the good supply of vegetables, favored by the weather conditions in the first half of the year, as well as the persistence of subdued inflation in the euro area, which fed partly through into the dynamics of aggregate domestic prices via developments in import prices.

The rebound in domestic demand will chiefly be led by the consolidation of household consumption growth in 2014, whereas investment is expected to recover no sooner than the latter half of this year. Hence, gross fixed capital formation is foreseen to make a positive contribution to growth starting 2015. The advance in domestic demand will also induce a relatively faster rise in imports, entailing a slightly negative contribution of net exports to growth over the projection interval, despite the further favorable performance of exports. Therefore, the share of the current account deficit in GDP is expected to stabilize below 2 percent from 2014 onwards, significantly lower than the pre-2013 levels. These assumptions of the baseline scenario entail the lack of any significant corrective pressure on the leu exchange rate arising from the external position until the projection horizon.

The baseline scenario of the macroeconomic projection places the annual CPI inflation rate in the lower half of the variation band of the target (at 2.2 percent) at end-2014 and at 3.0 percent at end-2015.

The individual final consumption of households is expected to rise further in quarterly terms in the quarter 2/2014 (Q2) . This assessment is supported by the 1 percent real increase in net wages in April-May 2014 versus the Q1 average and by the 1.7 points improvement in the consumer confidence indicator in 2014 Q2 compared with the previous quarter. However, the growth rate of this GDP component may slow down slightly from Q1, as illustrated by the developments in the consumer loan stock in real terms (total lei and foreign currency), which dropped 2.5 percent in 2014 Q2 versus the Q1 average and in retail trade turnover volume, except for motor vehicles and motorcycles, which fell by 0.6 percent in April-May 2014 versus the Q1 average. In this context, in 2014 Q2, the negative deviation of the actual individual final consumption of households from its medium-term trend is foreseen to narrow compared with the preceding quarter. The actual collective consumption of general government is expected to go up moderately in 2014 Q2, in line with the fiscal consolidation process29, the deviation from its medium-term trend remaining in negative territory, albeit on a decrease.

The dynamics of the actual individual consumption of households are foreseen to consolidate during the projection interval, supported by the further easing of lending conditions and the expected increase, albeit moderate, in employment in the private sector. The absorption rate of EU structural and cohesion funds, which is expected to rise given the previously mentioned overlapping of the multi-annual financial absorption cycles (2007-2013, extended until 2015, and 2014-2020), also creates favorable conditions for future consumption developments. In this context, a favorable contribution to the rise in consumption is expected particularly from funds channeled to the operational programmers aimed at improving labour productivity, with a positive impact, inter alia, on the wage dynamics in the private sector.

Lending conditions are expected to ease gradually, also as a result of the lagged pass-through of the NBR policy rate cuts onto credit institutions' interest rates applicable to their non-bank clients. This process is also influenced by the constraints on the total volume of household demand for new loans, which were imposed in the context of the ongoing consolidation of household balance sheets. A favorable impact on the actual individual consumption of households stems from the anticipated increase in real disposable income, underpinned, particularly in the first part of the projection interval, by the relatively low projected CPI inflation rates. In 2014, an additional positive effect on consumption is expected to be exerted by the agricultural output. The actual collective consumption of general government is foreseen to increase moderately throughout the forecast interval.

In the context of recent regional and geopolitical uncertainties, the forecasted quarterly growth rate is, however, slightly slower than in past quarters. The expected performance of this component is upheld by the ongoing favorable dynamics of the economic sentiment indicator at EU level (up 1.4 points in 2014 Q2), whereas the euro area industrial production went down by 0.1 percent in April-May 2014 versus the Q1 average. Albeit on a decline versus the previous quarter, the quarterly dynamics of imports of goods and services are expected to be positive in 2014 Q2, due to the anticipated rebound in domestic demand and the spillover effect of the forecasted favorable performance of exports. In this context, the deviations of exports and imports from the medium-term trends are assessed to remain positive, of a similar magnitude compared with the prior quarter in the case of the former, and larger in the case of the latter.

The goods and services exports are anticipated to maintain their positive dynamics throughout the projection interval, supported by the expected uptrend in the effective external demand and the persistent favorable developments seen in recent periods by "machinery, equipment and transport means" and "agro-food products" (the latter being spurred by the increasingly active presence of grain traders on the Romanian market). The exports of goods and services following further reporting positive dynamics in 2014 up 3.1 percent Vs. 2013 Q4.

The dynamics of goods and services imports is expecting to remain in positive territory for the last quarters, amid the forecasted increase in domestic demand, supported by the faster dynamics of final consumption and the recovery of gross fixed capital formation.

Compared to the May 2014 Inflation Report, the projected inflation rates are considerably lower, i.e. by 1.1 percentage points and 0.3 percentage points, respectively, at the end of 2014 and 2015. For the end of

2014 year, the only basket item whose contribution was revised upwards was tobacco product prices, while all other components are assumed to have more favorable contributions to the annual inflation rate. Particularly as a result of favorable incidental influences in the period that elapsed since the release of the previous Inflation Report, stemming from the appreciation of the leu versus the euro and the reduction in certain regulated prices, especially prices of electricity delivered to household end-users.

As a cumulated result of the recent appreciation of the leu versus the euro and the US dollar, as well as the downward revision of the projection on movements in "effective" external prices (a composite indicator quantifying the impact of euro area and US price dynamics on domestic inflation, according to the shares held by these regions in Romania's foreign trade).

The annual economic growth rate in 2014 is foreseen to stand slightly below the level in the previous year. The projected Gross Domestic Product (GDP) dynamics will be supported by the consolidation of domestic demand in positive territory (also due to the forecasted above-average agricultural output in 2014), which will also entail a relatively faster growth of imports and hence a slightly negative contribution of net exports to economic growth throughout the projection interval, the expectations of further good export performance notwithstanding. The gradual revival of domestic demand in 2014 is foreseen especially on account of the rise in the actual individual final consumption of households, bolstered by their higher real disposable income27, the gradual adjustment of lending conditions (also following the successive monetary policy rate cuts and the projected configuration of real.

Real broad monetary conditions in 2014/Quarter 2, with an impact on economic activity in the following quarter, are assessed to be relatively simulative, leading, ceteris paribus, to the alleviation of disinflationary pressures generated by the aggregate demand deficit. In the structure of the real broad monetary conditions, amid the marginally simulative impact of the real lending rate deviation, the cumulative simulative impact exerted by the deviation of the real deposit rate and the wealth and balance sheet effect is mitigated (via the net export channel) by the negative deviation of the real effective exchange rate.

According Inflation Report of the National Bank of Romania (august 2014), in the context of the new quarterly forecast, the expected annual inflation rate stays further below the midpoint of the flat target until mid-2015 – entailing a 2.2 percent level in December 2014 – despite the upward correction in September 2014 triggered by the fading of the transitory influence of the cut in the VAT rate for some bakery products. Furthermore, even though it subsequently returns more rapidly to the upper half of the variation band of the flat target, inflation rate remains, also on a longer-time horizon, at lower-than-previously-projected levels, i.e. 3.0 percent in December 2015 and 3.1 percent over the following two quarters (3.3 percent and 3.5 percent respectively in the previous forecast).

Consequently, the forecasted average annual inflation rate posts a decline versus the previous projection, falling to 1.4 percent in 2014 (from 2 percent) and to 2.4 percent in 2015 (from 3.1 percent) as stipulate the same Inflation Report of NBR (fig.5).

5. Closing remarks

The significant change in the short and medium term inflation outlook is the result of the downward revision of the forecasts for almost all inflation components, with the major contributions being, however, made by core inflation and, to a lesser extent, by administered price inflation, the forecasted annual dynamics of which post substantial downward adjustments throughout the projection interval compared to the previous forecast. Thus, in spite of a marked upward inflection in September 2014 and a subsequent tendency to go up slowly, the trajectory of the forecasted annual adjusted CORE2 inflation rate stays way below the path pointed out by the previous forecast throughout the projection horizon.

One of the determinants of this change in the core inflation outlook is the disinflationary impact that the slower dynamics of import prices are anticipated to generate. However, the main driver of such a development is thestronger disinflationary pressure assumed to be exerted by the fundamentals, given the downward adjustment in inflation expectations, and especially the revision of the forecasted aggregate demand deficit to more negative values. The premises of the latter include the revision of the historical data series on GDP, the return of fiscal policy to a slightly countercyclical stance, the persistence of the relatively slow economic growth rate in the euro area/EU, as well as the maintenance of stimulative real monetary conditions.

The economic downturn is already a reality for Romania, economic uncertainties concerning financial stability, monetary policy implemented and the precarious political situation leading the state in a direction which isn't granted to the prospects for a quick recovery. A major source of such uncertainty, but also of risks to the inflation outlook refers to the regional and geopolitical tensions that have recently intensified, with the conflict in the Ukraine being particularly relevant to Romania's economy. Thus, depending on its duration, intensity and implications, this conflict might induce – especially through portfolio reallocations that it could trigger across the region – upward/downward fluctuations in the leu exchange rate, and implicitly both-way deviations from the anticipated coordinates, with a temporary impact on inflation and on short-term inflation expectations as well. Similar influences, particularly on the USD/RON exchange rate, would arise also from the potential intensification of portfolio reallocations – most likely depending on the quality of fundamentals, correlated with the relative attractiveness of investments in various financial markets – amid the divergent monetary policy decisions that major central banks worldwide have recently adopted and could adopt in the future.

The recent escalation of geopolitical conflicts/tensions adds to the uncertainty surrounding the pace of economic growth globally, and particularly in the EU countries, conditional also upon the speed of implementing structural reforms and of the deleveraging and restructuring of some banking systems in the euro area/EU. These developments may induce, directly or through the variations in the global risk appetite, changes in the economic growth rate and inflation dynamics in the euro area and, consequently, in the demand for exports, including exports from Romania, in the developments of import prices alongside both ‑way movements in the capital flows to the Romanian economy, all of which could implicitly entail temporary, yet possibly significant, fluctuations in the leu exchange rate.

Arising from a potential relative deterioration of economic and financial developments in the euro area, also as a result of the implications of the conflict in the Ukraine, the impact on CPI dynamics is expected to be counterbalanced in the medium run by the relative intensification of the disinflationary pressures stemming from the negative output gap, given the very likely slowing, under the circumstances, in the recovery of the Romanian economy, under the adverse impact exerted by external developments.

As well as the potential developments on the political scene in the context of this year's elections, that could have either a favourable or adverse bearing on foreign investors' perception towards the risk associated with the local economy and financial market.

Also, another category of uncertainty stemming from the domestic environment could be enhanced by a possible future hike in the international agri-food commodity prices that could occur following a severe or protracted worsening of weather conditions in various world regions.

By contrast, the likelihood that the dynamics of administered prices may deviate from the coordinates of the present forecast – using further as major landmarks the specific measures/calendar agreed under the arrangement concluded with the EU, the International Monetary Found and the World Bank – is viewed as relatively low.

Furthermore medium‑term inflation expectations are seen to be further resilient to a possible short-lived upward deviation of these categories of prices from the projected coordinates, in the context of the persistence of the negative output gap, albeit on a decrease, over the medium term.

It's the reason by which its can be said that only a colaboration of all monetary policy can restore the imbalance, the implemented actions on one direction proving to be not only ineffective, but also capable of generating unexpected negative effects.

The NBR supports the general economic policy of the state without prejudicing the primar objective of achieving and maintaining price stability. Reaching the target of the inflation, requires a balanced mix of economic policies, especially the monetary policy, tax and revenue, which ensures lower inflation while maintaining economic growth. Such an evolution towards the target is usually achieved on behalf of the foreign direct investments that increase the productive capacity of the economy and finance a sustainable external deficit.

Considering the outlook for the annual inflation rate to run at markedly lower readings than previously forecasted, i.e. below the midpoint of the flat target until mid-2015 and in the upper half of the variation band in the latter part of the medium-term projection horizon, given the anticipated overlapping of the impact of one-off factors with the persistent effects of the negative output gap and the downward adjustment in inflation expectations, the Board of the National Bank of Romania decided in its meeting of 4 August 2014 to lower the monetary policy rate by 0.25 percentage points to 3.25 percent per annum.

The NBR Board also decided to continue to pursue adequate liquidity management in the banking system and to maintain the existing levels of minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions.

Reaching the target of the inflation, requires a balanced mix of economic policies, especially the monetary policy, tax and revenue provide a lower inflation while maintaining economic growth. Such an evolution towards the target is usually achieved on behalf of the foreign direct investments that increase the productive capacity of the economy and finance a sustainable external deficit.

References

1. *Adam, K. (2003), Optimal monetary policy with imperfect common knowledge, European Central Bank, Working Paper Series No. 223.*
2. *Antohi, D., Udrea, I., Braun, H. (2003), Mecanismul de transmisie a politicii monetare în România, Caiet de studii nr.13, p.42 available on http://www.bnro.ro/Caiete-de-studii-484.aspx open June 2015 open June 2015.*
3. *Băcescu, M., Băcescu-Cărbunaru, A. (1998), Macroeconomie și politici macroeconomice, ALL Educational publisher, Bucarest, p. 894.*
4. *Constantinescu, L.M., Tănăsescu, D. (2014), Binomial Inseparable Of The Emerging Countries Between The Financial Development Level And Their Economic Growth, 5th International Conference LUMEN2014-Transdisciplinary and Communicative Actions, Moduzzi Editore International Division Proceedings publisher, Bologna, pp.211-213.*
5. *Ekanayake, H. K.J. (2012), The Link between Fiscal Deficit and Inflation: Do Public Sector Wages Matter?, ASARC Working Paper 14.11.*
6. *Isărescu, M. (2003), Spre o nouă strategie de politică monetară: țintirea directă a inflației", disertație cu ocazia decernării titlului de Doctor Honoris Causa al Universității din Craiova, Craiova, October 17.*
7. *Mishkin, F., Bordes, C., Hautcœur, P-C. , Lacoue-Labarthe, D. (2007), Currency, banks and financial markets.8th edition, Pearson Education publisher.*
8. *National Bank of Romania, Inflation Report 2014, 2015 available on http://bnr.ro/Regular-publications-2504.aspx open June 2015.*