



DIMENSIONS OF THE MONETARY POLICY

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Rezumat

Atributele consistenței, consecvenței, coerenței, competitivității și completitudinii (exhaustivității) sunt specifice politicii monetare moderne. Acestea contribuie la asigurarea eficacității politicii monetare într-un context al incertitudinii și volatilității variabilelor și produselor monetar-financiare. Promovarea politicii monetare eficiente, într-un mediu economic globalizat și informatizat reclamă deschiderea acesteia spre un spațiu teoretic și operațional multidimensional, caracterizat prin interacțiunea puternică dintre banca centrală și public, și subiecții economici, dintre politica monetară și celelalte componente ale politicii economice și ale strategiei sociale, dintre componentele politicii monetare, dimensiunile politicii monetare moderne, eficiente și deschise fiind pe de o parte: independența, responsabilitatea și comunicarea băncii centrale, iar pe de altă parte, predictibilitatea, transparența și credibilitatea politicii monetare.

Lucrarea dorește să expună, într-o abordare explicită și interactivă, rețeaua complexă de co-determinări și interconectări dintre atributele și dimensiunile politicii monetare, prin care să se releve, adesea într-un mod implicit, capacitățile și incapacitățile potențiale ale acesteia, eficacitățile și ineficacitățile posibile ale politicii monetare.

Abstract

The attributes of consistency, purposefulness, coherency, competitiveness and completeness (exhaustivity) are specific to modern monetary policy. They contribute to ensuring the efficiency of the monetary policy in a context of uncertainty and volatility of

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monetary-financial variables and products. Promoting effective monetary policy, in a globalized and computerized economic environment requests the opening toward a theoretical and operational multidimensional space, characterized by strong interaction between the central bank and the public, and the economic subjects, between the monetary policy and the other components of economic policy and social strategy, between the components of the monetary policy, the dimensions of modern, efficient and open monetary policy being, on the one hand, the independence, responsibility and communication of the central bank, and, on the other hand, the predictability, transparency and credibility of the monetary policy.

The paper seeks to explain, in an explicit and interactive approach, the complex network of interconnections and inter-determinations between the attributes and the dimensions of monetary policy, through which it should be pointed out, often in an implicit way, the potential capabilities and incapacities, the possible effectiveness and ineffectiveness of the monetary policy.

Keywords: monetary policy, dimensions of the monetary policy, attributes of the monetary policy, central bank independence, monetary policy transparency, monetary policy efficacy.

JEL classification: E52, E58

Attributes and dimensions of the monetary policy

The paper presents the concept, characteristics, role and co-determinations of the monetary policy dimensions within the context of the elaboration and implementation of the monetary policy decisions, revealing their impact on the efficacy, feasibility and stability of the monetary policy enacted by the central bank.

The opening of the monetary policy allowed the public to better understand the monetary policy decisions and their implementation by the central bank, the economic subjects being able to anticipate these decisions adapting their behaviour accordingly.

This comprehension depends on the quality of the monetary policy, on the way it circumscribes some key attributes which define it within the area of the modern economic-social evolution; these attributes are: efficacy, uniformity, consistency, coherence, completeness and competitiveness.

1. Efficacy, which signifies the attribute of accomplishing the goals with proper instruments and in short operational time, in agreement with the demands of the targeted financial-monetary processes, involving efficiency, skilfulness, yield and utility.

The efficacy of the monetary policy is the main attribute which gathers all the other, being circumscribed to the elasticity of the results of the changes in currency offers, the maximal value being achieved if there are no unused resources and if the price level is constant.

2. Uniformity, which signifies the attribute of stability, firmness of the monetary policy, of its objectives, instruments and operations, of its flexibility and adaptability; it also signifies the promotion of non-contradictory, sustainable objectives and instruments.

3. Consistency, which signifies the constancy, stability of the characteristics of the promoted monetary policy, following the instrumental, procedural and operational logics of goal accomplishment according to the preset principles and regulations;

4. Coherence, which signifies ensuring close, adequate ties between the components of the monetary policy, particularly between the strategy, operational framework and mechanism of transmission; coherence provides the compatibility and integration of the monetary policy elements within a harmonious total, coherence being primordially linked to the consistency of the monetary policy;

5. Completeness, which signifies the fact that for a given economic, financial and monetary situation and for a known dynamics of this situation, the employed monetary policy comprehends all the elements required to influence the processes and institutions, which are set by the macroeconomic decision-makers. The monetary policy also includes the sufficient and necessary elements without creating parallelisms, distortions, adverse effects within all these elements, any of these elements completing and supporting biunivocal all the others.

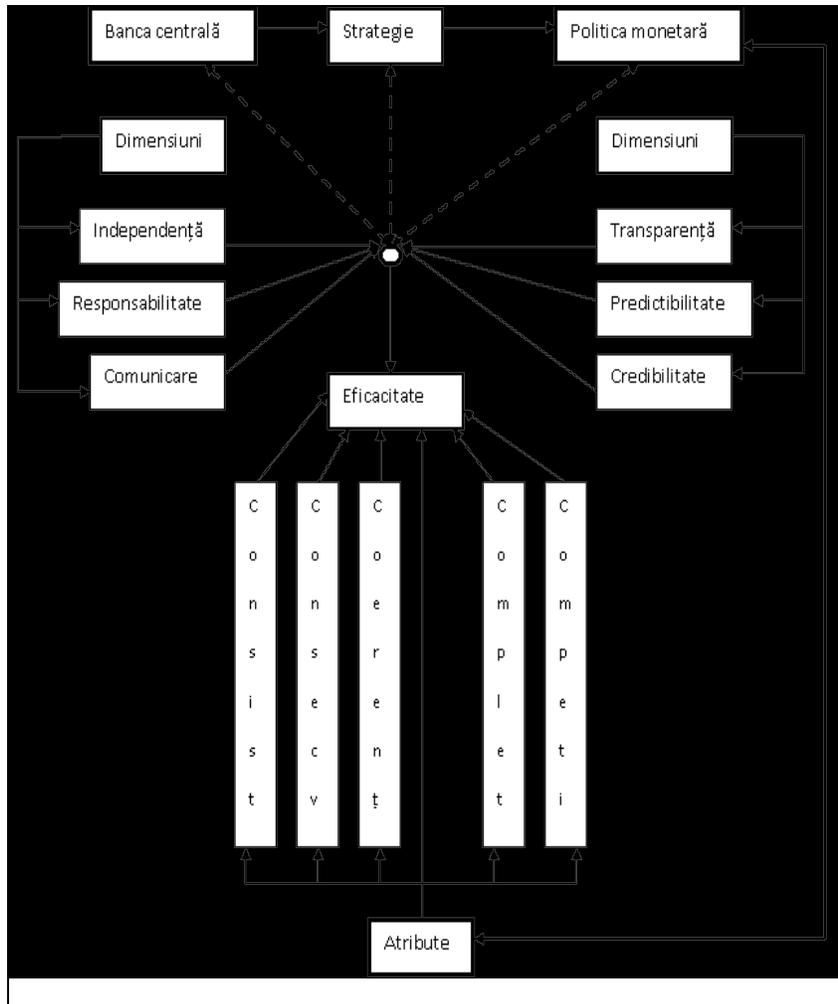
6. Competitiveness, which signifies the capacity of the central bank to promote a performing monetary policy integrated within all the other economic policies, aiming to accomplish the set goals by using an adequate operational framework, observing the preset strategy and norms and thrusting the economy on a dynamic growing trend, within the context of the evolution of the national economies and of the global economic evolution.

During the current period, the promotion of a modern monetary policy circumscribed to the above attributes requires from the central bank

and monetary policy traits that are interconnected dimensions of the monetary policy; these dimensions form the hexagon of independence, predictability, transparency, responsibility, credibility and communication.

The figure below shows briefly the relations between the attributes and dimensions of the monetary policy oriented towards the accomplishment of the promoted monetary policy. The drawing suggests that the intrinsic dimensions of the monetary policy and the specific dimensions of the central bank support the five attributes of the monetary policy in ensuring the efficacy of the monetary policy, efficacy which relates biunivocally with the activity of the central bank, with the content of the monetary policy and with the central bank strategy.

Figure 1
Relations between the attributes and dimensions of the monetary policy



Central bank independence

The central bank, in most countries, is the authority controlling the national currency, the authority responsible for the monetary policy. If this authority is not used adequately, this will invariably generate

long-term adverse effects for the economy. Price stability uncertainty which started significant economic fluctuations or the deterioration of the fiscal prudence yielded the conclusion that the distinct obligation of maintaining the value of the national currency must be entrusted to the central bank which is impartial to the short-term interests of the moment and that the professional and unbiased judgement of the central bank must be observed.

One of the reasons to increase central bank independence derives from the fact that value of the national currency can be maintained only by severing from the short-term interests with the purpose to build a basis for the life of the population and for the national economy. This independence can be also perceived as a means to control and balance the powers within the modern state.

The dimensions of central bank's independence refer to the institutional characteristics which protect the central bank from the political influences in defining the monetary policy objectives, to the aspects that allow the central bank to implement freely the monetary policy in pursuit of its objectives.

Central bank independence guarantee is one of the systems relying on the concept of power separation; central bank independence is acknowledged in most countries, not just in the countries with presidential regime, but also in those with parliamentary regime.

The empirical evidence suggests that the economic performance can be improved when the central banks are more independent, the inflation rate being lower in the countries whose central banks are more independent.

The effects of the monetary policy are transmitted through extremely complicated channels and they become visible only after a significant period of time, sometimes after several years, which implies the fact that the monetary policy must seek the long-term approach, which complicates the problem of central bank accountability.

In running its policy, the central bank is conscious of the need to explain correctly the content, objectives and basic reasons of its policy management, this approach being a mechanism which encourages the central bank to run the monetary policy in an adequate and responsible manner, clear to the public,

Central bank independence has four dimensions: functional, institutional, personnel and financial, three other aspects being

related to central bank independence: central bank involvement in the macro-prudential monitoring, the relation between independence and responsibility, cooperation and the dialogue with other economic policies.

The accountability and independence of the central bank signify that its independence is not arbitrary, the central banks being ultimately accountable for the monetary policies they promote, the accountability being another aspect of the independence, the two of them supporting and consolidating mutually.

An important aspect of central bank independence is the relation between it and central bank governance. If independence refers to the capacity of the central bank to use the momentary policy instruments without external intrusions, governance presumes three pillars: independence, accountability and transparency of the central bank. This means that a good governance of the central bank depends on its independence, both having to be achieved together.

The necessity for central bank's independence as pillar of a good governance is supported, among other, by its determinants, the main ones being: legal determinants, political determinants, price stability determinants, exchange rate policy determinants, monetary policy determinants and non-monetary deficit financing, determinants pertaining to accountability and transparency.

Over the recent decades, the trend of defining the place of the central bank was towards increasing its independence as a means to improve the long-term economic performance, even though the results of the empirical research on central bank independence and economic performance are ambiguous.

The literature defined three types of independence which circumscribe, in a way, the dimensions and determinants presented earlier: legal independence, goal independence, operational independence and managerial independence.

An independent central bank may promote a more credible monetary policy, making market expectations to be more adequate to central bank's signals, the main purpose of the independence being to prevent the political interferences in the short-term decisions of monetary policy.

Monetary policy predictability

Monetary policy predictability is often understood as the capacity of the financial markets to anticipate correctly the future decisions of

monetary policy of the central bank; this dimension of the monetary policy must be taken into consideration within a wider context and on longer periods, which doesn't mean that the central bank couldn't circumscribe the predictability of its short-term decisions.

The most performant activity of the central bank relies on a desirable high level of monetary policy predictability, a clear delimiting existing between the short-term and the long-term predictability.

The central banks have focused increasingly lately on the transparency and predictability of their actions, in close correlation with their higher independence and with the need to assume a higher responsibility.

The current central banks explain the framework of their policy and what they want to achieve in terms of monetary policy while observing the legal requirements on the assumed competencies and responsibilities.

One of the determining factors of the monetary policy predictability is transparency, which, however, is not enough to ensure a long-term impact on the formation of expectations by the participants on the financial markets. To guide the expectations on the interest rates a long-term communication is required in conjuncture with the consistency between words and facts, as well as knowledge of the decision-making procedures for monetary policy as support of central bank credibility.

Measuring predictability is not an easy task; a strong effort is required to make a long-term empirical evaluation of the central bank's monetary policy, but the participants on the financial markets are increasingly capable to anticipate correctly the monetary policy of the central bank under conditions of better transparency and communication of central bank actions.

Predictability became a relevant problem because the expectations are significant for the monetary policy efficiency, the consumption and investment decisions taking into consideration the inter-temporality which is largely influenced by the long-term interest rates. These depend on the expectations of the private sector as to the future decisions of the central bank and, as result, the efficiency of the changes in the monetary policy depends fundamentally on its impact on market expectations in terms of short-term interest rates evolution.

Essential for the understanding and anticipation of any decision of monetary policy of the central bank is the strategy of the monetary

policy. If the central bank is transparent in terms of strategy, it may supply a very systematic framework on its monetary policy decisions and it may identify clearly central bank's objectives and methods governing the monetary policy. This allows the population to evaluate in good time, central bank's behaviour, which is the essence of a high level of credibility, a necessary precondition if the central bank wants to elaborate a predictable monetary policy.

Monetary policy predictability has been often associated to a behaviour in agreement with the rules of the monetary authority; there are some attempts (such as Taylor) to formulate the governance of the monetary policy by the central bank by specifying policy rules or reaction functions. Usually, these rules are either postulated in a simple form which link the policy instruments to a small set of economic variables or indicators, or they are derived explicitly from an optimization problem, which is a particular representation of the policy objectives and economy functioning.

- If the central bank and the private agents have full information on the economy, a perfect predictability of the monetary policy can be achieved with a minimal level of transparency. Actually, however, the information available to the monetary policy decision makers is imperfect and their decisions are the result of a reason which must continuously evaluate new economic, financial and monetary information which bear on central bank's objectives.

The remarkable change in the importance of predictability in central bank's practice was significantly influenced by the role of the expectations in the economic thinking, particularly by the revolution of the reasonable expectations. If the economic agents believe in the commitment of the central bank to reduce inflation in a sustainable way, this will affect the current inflation by the adjustment of the expectations on the future prices and, hence, the importance of predictability for the efficacy of the monetary policy. Even if the central bank may influence directly, through the monetary policy, the short-term interest rates, the consumption and investment decisions and, ultimately, the medium term evolution of the prices rely on the inter-temporal conditions which are largely influenced by the long-term interest rates. These are, in turn, influenced by the private expectations on the future decisions of the central bank and, hence, by the evaluation by the economic subjects of the central bank's capacity to accomplish its medium and long-term objectives.

In conclusion, a high level of the monetary policy predictability appears if central bank's strategy is perceived by the population as being adequate and credible, if the policy makers accept the strategy in their inner debates and in the external communications, if, in consequence, the private long-term expectations are consistent with the central bank's objectives, even under the conditions of external shocks. A high predictability must be therefore regarded as a normal result of central bank's observance of its own monetary policy strategy. Thus, the predictability of the decisions on the interest rates can be regarded as an observable reflection of the general understanding by the population of the central bank's *monetary policy framework*, and of the private sector's ability to transform the change of the economic conditions into anticipations of the directions of policy, of the central bank, within a properly defined and credible strategy.

Transparency of the monetary policy

A monetary policy is transparent when all the information on it are open and freely available, transparency being an ingredient to monitor and control efficiently the monetary policy.

A higher transparency of the central bank has been achieved lately, largely determined by its higher independence and responsibility; it has been noticed that transparency, and its main instrument, communication, have a positive effect on the predictability and efficacy of the monetary policy.

By transparency, the central bank may reduce the sources of information asymmetry thus increasing the predictability of the monetary policy beyond the simple interpretation of the past regulations of the monetary policy; however, transparency must not be understood as an independent means because its efficacy is bound to have limits.

Monetary policy transparency can be regarded from two perspectives: transparency of the monetary policy strategy and transparency of the monetary policy situation.

The consequences of a higher transparency depend on the specific context, which is not necessarily positive, but generally there are two types of effects, termed as "information effects" *ex post*, which rely directly on the relevant information, and „stimulant effects" *ex ante*, which affect structurally the behaviour based on the new structure of information.

The theoretical arguments support the favourable effects of increased monetary policy transparency on the reputation and credibility of the central bank under the following aspects: transparency improves the predictability of the monetary policy actions and results; transparency strengthens the credibility and makes the long-term expectations of the private sector more stable.

The practice of the monetary policy transparency is very diverse, evolving in time. Three empirical aspects may, nevertheless, be identified: the central banks consider transparency very important for the monetary policy; monetary policy transparency increased significantly over the past two decades; monetary policy transparency shows a substantial heterogeneity of the national and regional monetary policy frameworks.

Transparency means more than information “liberalization” because it doesn’t translate by itself into a better understanding of the monetary policy. For the transparency to have a positive impact on the predictability, the type of information released by the central bank is important, as well as the way in which the information is communicated to the economic agents, to the markets. The dispersed supply of information makes the message increasingly unclear, which affects predictability. The central banks must organise and present the available information in a structured manner, maximising the relay of highly clear messages, clarity being confronted with the sources of asymmetric information presented above. Furthermore, the information disseminated by the central bank can be interpreted differently by the economic agents if the communication is ambiguous, which affects the very substance of the message perceived by the various economic agents.

Central bank’s responsibility

The guaranteed independence of the central bank is not understood as the possibility of the central bank to run its monetary policy completely outside the parliamentary democratic framework; on the contrary, the public monitoring of the central bank must be strengthened by making it liable in front of the Parliament, while its independence must be consolidated. This approach considers the independence and responsibility as indivisible, accountability meaning that the central bank has to be responsible for the correct explanation of its actions.

Operationally, in relation with the central bank, the concept of responsibility has the following features: decisions of the explicit definition and ordering the goals of the monetary policy; transparency of the current monetary policy; ultimate accountability on the monetary policy.

Transparency also is a very important element of the responsibility because, irrespective of the other arguments on the democratic responsibility, their horizon is limited without transparency because the information on behaviour is crucial in the evaluation of central bank's performance. Because transparency can not remain at the discretion of the central bank, procedures are prescribed by which the central bank explains its monetary policy by various means (conferences, minutes, reports etc.), transparency being potentially improved if the monetary authorities explain the conditions in which they are able to accomplish the final goals of the monetary policy.

Three aspects of the ultimate responsibility for the monetary policy are crucial in the relations with the parliament: existence of a monitoring mechanism; existence of a procedure to fire the governor of the central bank.

Central bank's credibility

The *expectations* for the future have an overwhelming role in the activity of the economic subjects, in their planning and decision-making and because of this their *trust in the nominal anchors*, in the nominal stability is of utmost importance. If there is not enough trust in the monetary policy the economic subjects may expect price hikes and the persistence of inflation cost, the trust in the monetary policy compensating adequately the nominal fluctuations, the production fluctuations and work utility

The monetary policy influences the prices and costs of inflation with a temporal lag of one to three years. The projections of price evolution play an important role in interest rates stability, the decisions on the interest rates impacting on the prices and inflation generating, according to the lag, disturbances that influence their evolution.

To the extent to which the monetary policy may control inflation it becomes credible, its credibility depending, among other, on two factors.

- The economic agents rely their decisions on a probable evolution of the inflation and, therefore, there is incertitude; the

monetary policy will be credible if the evolution they consider more probable is consistent with the nominal anchor;

- Trust is correlated with the pattern of reaction; if inflation is higher than the one targeted by the central bank, because of the shocks, there must be confidence that the instruments of monetary policy will reduce the inflation to the level involved by the nominal anchor, the temporal deviations having no adverse effects on credibility.

The monetary policy can not be implemented efficiently without a good interaction with the fiscal policy; the annual public budgets should be anchored in a long-term strategy, the fiscal policy shouldn't having to have pro-cyclic effects.

The higher transparency of the monetary policy contributes to a higher credibility since transparency promotes the predictability of central banks' behaviour helping the uncertainty to be narrowed.

Credibility can not be measured directly; it is reflected in the agreement between the expectations of the economic agents concerning the future nominal evolution and the nominal anchor; maintaining price stability and the evolution of the foreign currency market being indirect factors for credibility evaluation.

The banks worldwide preserve carefully their *credibility* as "fighter" against inflation and therefore seeks to preserve the *reputation* of a consistent policy to keep inflation down; there are two reasons why the banks do this:

- Fear for the consequences of the fact that the employees, businessmen and financial institutions perceive that the central bank doesn't target a low inflation and that they must expect inflation to increase;

- Fear that the central bank reputation for a consistent and credible policy is very frail because of the strong pressure on the central bank to abandon the policies to curb inflation.

If the central bank has a reputation which allows it to be at the height of its obligations, irrespective which, then it can be able to determine the economic subjects to believe its assertions that it will target the low inflation policy in order to preserve its credibility and consistency. Thus, the central banks protect carefully their reputation considering that the expectations of a low inflation is to the general advantage, but the inflationist expectations can be low only if the central bank has a strong reputation or organisation with consistent policies, with credible, trustworthy statements and announcements.

With the purpose of promoting an adequate monetary policy, the monetary policy decision makers must evaluate the current economic conditions, must understand the way economy works, must have a correct conception on the way economy should be run. Because the economic conditions are always changing, a good communication is important for the success of the monetary policy decisions; communication can help the population to evaluate the monetary policy goals, understand the decision maker's thinking on the prospects of accomplishing these objectives and to take into consideration the way in which the new information may affect the monetary policy choices.

Central bank's communication

Communication is an integral part of the monetary policy, the central banks emphasizing lately the transparency of their decisions by expanding the communication modalities and the volume of information made available to the public. Three factors contribute mainly to the higher independence accompanying the higher accountability: setting inflation targeting as the essential goal of the monetary policy, which emphasized the communication practices of the central bank; caption and manage market expectations as an important part of the monetary policy, which explains the existence of the communication channels with the participants on the market.

An aspect of communication is the perspective of the central bank on the economy materialized in the forecasts of the essential economic indicators and taking into consideration the prospective nature of the monetary economy; the publishing of these forecasts offers the economic subjects additional information on the possible course of the monetary policy. The publishing of the prospective trajectory of the monetary policy is conditioned by the projection of the evolution of the state of the economy; there is a risk that this projection is interpreted as a quasi-promise or as a firm engagement as to this trajectory, which may yield false expectations and incorrect adjustments of the interest rates expectations.

The the future path of the monetary policy is announced by the central banks either through explicitly quantitative values, or through qualitative information included in official reports or accounts; the qualitative communications are characterized by the frequency of the announcements, by the precision of the policy direction or by the time horizon. On the one hand, the central banks aim to increase the

short-term predictability by supplying indications on the monetary policy orientations, and on the other hand, the central banks have enhanced the short-term predictability of the future policy rates by the implicit use of the forecasting approach when the economic conditions are adequate.

An important aspect of the central bank's policy is the way in which bank's decisions are motivated and their clear, complete and efficient communication. A long-term communication of the central bank with the financial markets is needed and a beneficial transparency of the monetary policy, these two aspects being determined by the interactions between the monetary policy, the inflationist expectations and the challenges concerning communication and transparency generated by the mess on the financial markets.

The link between the monetary policy, communication and the financial markets acquired these past years a particular importance, the communication between the central banks and the financial markets contributing to the establishment and consolidation of the monetary policy credibility; lately, the improved communication offered advantages to the functioning of the financial markets and establishing beneficial solutions to make the economic activity more efficient.

The recent consequences of the global financial markets crisis for the prudential regulation and for the financial monitoring revealed certain possibilities to improve the design of the monetary policy which aim at the: role of the monetary authority in signalling the risks of financial instability, transparency of the overall financial system (institutions, mechanisms, markets); account by the central banks of tensions which emerged on the markets and of the lack of liquidity.

During the periods of disorder on the financial markets, of financial stress, the central banks should foster their communication with the markets and adapt their operational framework to the market conditions.

The role of communication and the benefits of the full transparency also are crucial during the periods of financial crisis, but the swift notification by the central bank of the interventions in support of the individual financial institutions may sometimes trigger flock behaviours and exacerbation of the liquidity problems, so that this communication may induce either trust, or suspicion.

In running its policy, the central bank is aware of the need to explain correctly the content, objectives and fundamental reasons of

its policy management; This approach is a mechanism used to encourage the central bank to run its policy adequate and accountable and in a way which makes the policy management clear to the public. Furthermore, such an attitude may also contribute to a better mutual understanding between the government, parliament and the central bank regarding the economic situation and the monetary policy management, thus contributing to a higher consistency of the national economic policies.

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