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Monetary policy targets the general price level

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A consensus among central banks, academia and the general public has been created over time that price stability is good and it shall be ensured by monetary policy.

Price stability can be defined as a situation where the price increase is small and stable enough, so that it does not significantly influence the society's economic decisions. Thus, price stability and keeping inflation at a relatively low level is the most important objective of a central bank, since it leads to maintaining over time the value and rate of erosion of the purchasing power of money and contributes to a relatively stable macroeconomic framework allowing economic development and providing a sustained level of economic growth.

This consensus is valid for both advanced and emerging economies. Although in the latter case, the central bank may face **a more difficult task that is to respond to real and nominal shocks**, as financial markets are insufficiently mature and operate with less diverse tools. Such shocks may be generated both by the changes in capital flows and by changes in food prices, fuel prices, etc. due to domestic and foreign supply or demand shocks, causes of which are wholly or largely outside of the monetary policy's competence and are not under the direct control of the monetary authorities (e.g., international prices of food, fuels, weather conditions, fluctuations in exchange rates of currencies of major trading partners, international economic and financial shocks, etc.). These limitations to the effectiveness of monetary policy increase the need to implement a coherent policy mix in order to maintain price stability.

In order to achieve the objective of **ensuring the stability of the general price level**, it should be taken into account that the notion of stability of the general level of prices does not mean that all prices are stable or fixed. On a pragmatic level, the focus is on maintaining stability in the average level of prices, aiming ultimately to their relative stability and not the absolute one.

Monetary policy in essence, through its instruments, cannot influence the price development of an individual product or service in part, which means that in the CPI basket there may be products or groups of products or services whose individual increases or decreases in prices may evolve differently, and in some cases may exceed the variation range of the inflation target. In response, through the management of its instruments, the central bank tends to dampen the average volatility of prices and their effects on other products and services and maintains the growth rate of the general price index in target.

The transmission mechanism of monetary policy is the ability of monetary policy instruments (open market operations, standing facilities, required reserves, foreign exchange interventions, etc.) to influence money market conditions (interest rates, excess liquidity, exchange rate, etc.) that affect the demand for goods and services in society (by influencing the lending, saving, consumption or investment processes), which in turn exert influence on the prices of all goods and services, and which underlies the mechanism of monetary policy's influence on the increase of average general price level in an economy.

The transmission of impulses generated by monetary policy instruments to inflation is propagated through complex chains of cause and effect, which represent the decisions of the economic agents and households with regard to monetary policy measures. This leads to the extension of the effects of monetary policy on the economy. The complexity of this mechanism varies both geographically and temporally, each economy having its own specific mode of propagation of monetary impulses, which change over time. This is caused, in particular, by structural and behavioral changes in the economy.

The complexity of the transmission mechanism is affected by the persistence of a plurality of shocks, which occur simultaneously and which are unexpected and unforeseeable events causing fluctuations in the economy. Thus, the objective of the monetary policy in this case is to stabilize the system by absorbing in a greater or lesser extend the effects of exogenous disturbance thereof. Without the support of other economic policies, monetary policy may have difficulties in ensuring a sustainable price stability. In other words, it is possible that price stability is achieved at the expense of other macroeconomic balances, which ultimately may prove to be an auto reversible process. If macroeconomic policies applied are not intended or fail to dampen economic fluctuations and to ensure the smooth adjustment of macroeconomic imbalances, the risk of "forced landing" is increasing. This means that the likelihood that the authorities will suddenly react increases, by imposing policies that cause the rapid return of macroeconomic indicators to equilibrium.

Therefore, adopting a monetary policy rule needs the support of other macroeconomic policies, in particular should be accompanied by a fiscal rule, which should be prudent and countercyclical. Such promotion of discipline at the level of macroeconomic policies allows the stabilization of existing economic fluctuations.

Since 2013, in order to achieve and maintain price stability, the NBM has implemented the direct inflation targeting regime, calculated based on the consumer price index published monthly by the National Bureau of Statistics and fixed at 5.0 percent annually with a possible deviation of ± 1.5 points percentage. To achieve this objective and to ensure a better efficiency of monetary policy shocks, the NBM has implemented the inflation targeting regime and, also in line with the inflation target, implemented a managed floating regime of the exchange rate without having a default target of the exchange rate of the MDL.

The inflation target is considered optimal for growth and sustainable economic development of the Republic of Moldova in the medium term and is the benchmark that guides monetary policy **regarding the increase in the general price level.** The general price level is used in the communication to the public, aimed at anchoring inflation expectations at the level of the inflation target.

The results of the NBM in this sense are distinguishable. Since February 2012, the annual inflation rate was always within the target range of variation. According to the recent data of the National Bureau of Statistics of the Republic of Moldova, the annual inflation rate in June 2014 was 5.0 percent, which does not exclude that price changes of some goods and services in annual terms have exceeded on average the target range of variation (e.g., exceeded the upper limit of the range of variation: cucumbers - annual growth of 39.7 percent, exotic fruits - growth of 19.0 percent, yogurt - annual growth of 13.8 percent, air transport services - increased by 11.9 percent, payment for nurseries and kindergartens - growth of 9.4 percent, etc.; exceeded the lower limit of the range of variation: melons and water melons – down by 48.5 percent from June 2013, garden objects (flowers) - 12.2 percent annual decrease, potatoes - 10.1 percent decrease, vegetable oil - 9.0 percent annual decrease, health services - annual growth of 1.0 percent, printed editions - 1.7 percent increase, furniture - annual growth of 2.3 percent, etc.). However, the weighted average of these developments of prices of goods and services included in the CPI basket are within the target range.

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[1] http://www.bnm.md/en/content/inflation-report-no3-august-2014 [2] http://www.bnm.md/ro/search?hashtags[0]=price [3] http://www.bnm.md/ro/search?hashtags[0]=Monetary Policy [4] http://www.bnm.md/ro/search?hashtags[0]=real shock [5] http://www.bnm.md/ro/search?hashtags[0]=nominal shock [6] http://www.bnm.md/ro/search?hashtags[0]=shock [7] http://www.bnm.md/ro/search?hashtags[0]=price stability [8] http://www.bnm.md/ro/search?hashtags[0]=transmission mechanism [9] http://www.bnm.md/ro/search?hashtags[0]=transmision