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Monetary Policy, Inflation and the Causal Relation between the Inflation Rate and Some of the Macroeconomic Variables

Zîna Cioran[a,*]

[a]*Faculty of Economics and Business Administration / Deparment of Economics, "Alexandru Ioan Cuza" University, Iasi, Romania*

Abstract

Both monetary policy and inflation are issues of great interest and importance, thus studying them and their impact on the evolution of the macroeconomic variables is a constant concern for our society. The purpose of this article is focused on identifying the existing connections between the inflation rate and some important macroeconomic indicators and also on the dynamics of inflation at a national and European level. The main objective of this study is to reveal the causal relation between the inflation rate and the interest rate of the monetary policy and also between the inflation rate and the unemployment rate, using regression methods.

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Keywords: monetary policy, inflation, interest rate, unemployment rate

1. Introduction

The monetary area is an important component of the economic system, which has always been uncertain. The currency may be considered a measure of recording, promptly and with great accuracy, the oscillations of a country's economy. Also, the main issues are mainly expressed in monetary terms.

Economic growth, GDP or the budgetary deficit cannot be analyzed without considering governmental policies (monetary and budgetary) and their implications in promoting economic reforms. The monetary policy is a component of economic policy and can be defined as a set of actions, such as adjusting the quantity and cost of money, undertaken by the monetary authority of a country in order to influence the evolution of the national economy and to keep price

* Corresponding author.
E-mail address: cioranzina@gmail.com (C. Zîna)

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stability. It represents an instrument of macroeconomic policy, which attempts to regulate the money supply, credit volume and interest rate in order to provide a good orientation for the economy.

Our analysis has focused on the dynamics of inflation in Romania and in the European Union. Most of the current papers that approach monetary issues have an econometric character. Both theory, as well as empirical studies indicate that the monetary policy may influence for a significant period of time not only prices, but also the employment rate, the GDP, the investments, economic growth and other important aspects of nonfinancial economic activities. Econometrics has an essential role in this area, because it represents an approach between theory and facts, thus the econometric analysis allows testing the hypothesis, verifying mathematical functions based on a variety of theories and building models to reflect reality.

Macroeconomic analyses enforces a view of the economic field as a whole, including its emergent or recession periods, with a total level of production and services of the market, without neglecting price levels and their cyclicity, of employment levels that ensure a certain level for production. The final objective of it all is to provide, in the long run, economic growth.

2. Literature review

Keynesians (1936) claimed that the monetary policy may influence the aggregate demand, by modifying the money supply, which may lead to full employment, without generating inflation. Later, at the beginning of the '80s, the Keynesian theories lose credibility and to the monetary ones, held high by economists such as Milton Friedman, Karl Brunner and Alton Meltzer, who suggest that monetary regulation can stabilize economy. The neoclassic economy brings in the rational expectations theory (Cerna, 2012, p. 59).

In Gherman and Adam's study, the monetary policy aims at guaranteeing a high employment rate, as well as price stability. This double purpose, which is known and reviewed through literature as dual mandate of the monetary policy, may oppose the declared purpose of many central banks, which aim primarily, and sometimes exclusively, at price stability (Gherman, 2010, p.90).

Gherman also considers that today few economists and businessmen, market investors or otherwise, concerned about the evolution of the economy and the business opportunities, still believe that the actions of central banks have no impact on the evolution of the GDP and other important economic variables that have been in the public's attention. The fact that monetary policies do not ensure a natural growth in employment or do not reach its correspondent GDP cannot be an excuse for lack of effort in sustaining these variables on an optimal level during business disturbances.

In a situation of dependency between global finances and high uncertainty, the ideal monetary policy should be highly comprehensive, it should be consistent, dynamic, transparent and responsible and it should avoid excessive fluctuation and flexibility (Solans, 2002).

The reduced inflation of the last years is the result of a mixture of economic policies, favorable to disinflation, followed by restrictive monetary and fiscal policies and an almost neutral budgetary policy. The monetary policy was mainly characterized by high interest rate and mandatory reserves and currency appreciation (Pop, 2011).

The economic literature highlights that, the contemporary economies, reaching a low and steady inflation creates a new economic climate, which requires a stringent reconsideration of the price stability and financial stability dependency.

3. Price stability- the main objective of a monetary policy

Price stability emerges as one of the most important objectives of the monetary policy. In pursuing the achievment of this objective there must by taken into consideration that the notion itself does not involve that all prices are stable or fixed. Pragmatically, the focus is on maintaining a steady mid-level, a relative stability and not an absolute one.

The definitions of price stability vary through literature: some authors consider inflation expectances, while others use quantity terms to explain it. The American economist Alan Blinder (1998) stated: price stability is established when people stop debating and worrying about inflation.

Castelnuovo et.al.(2003, p.12) notice that the countries that practice inflation targeting regime do not use an explanatory definition of price stability, but this is characterized by the announcement of the inflation target. These