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## AN EVALUATION OF THE MONETARY POLICY DURING 2006-2008

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### Rezumat

Aderarea României la zona euro presupune și adoptarea Programului strategic de convergență.

În conformitate cu primul Program Național de Convergență elaborat de Guvernul României împreună cu BNR (2006)<sup>1</sup>, adoptarea monedei unice este prevăzută pentru anul 2014.<sup>2</sup> Acest orizont de timp a fost considerat necesar pentru realizarea convergenței nominale, dar și pentru asigurarea sustenabilității acesteia prin avansarea suficientă a convergenței reale.

Programul Național de Convergență schițează atât cadrul macroeconomic cât și pașii ce urmează a fi întreprinși până când România va adopta moneda euro.

Dacă anul 2014 este ținta oficială pentru adoptarea euro, atunci România trebuie să îndeplinească, până în anul 2012, criteriile de convergență nominale de la Maastricht, după care va intra, pentru o perioadă de cel puțin doi ani, în mecanismul european al ratelor de schimb ERM II.

Asupra procesului de adoptare a monedei euro un impact deosebit de important îl are politica monetară și de curs de schimb. De la momentul aderării la Uniunea Economică și Monetară (UEM) se renunță la

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<sup>1</sup> EU Council has published its agreement for the updated Program of convergence for Romania during 2007-2010

<sup>2</sup> (NBR-Annual Report 2006, p. 9).

independența politicii monetare ca și la mecanismul cursului de schimb ca mijloc de ajustare a dezechilibrelor economice.

**Abstract**

The accession of Romania to the euro zone presupposes the adoption of the strategic program of convergence.

In agreement with the first National Program of Convergence approved by the Government of Romania together with NBR (2006), the adoption of the single currency is set for 2014. This interval has been considered necessary to achieve the nominal convergence and to provide for its sustainability by the sufficient progress of the real convergence.

The National Program of Convergence draws both the economic framework, and the steps to be taken until Romania adopts the euro.

If 2014 is the official target for the adoption of euro, then Romania must meet by 2012 the Maastricht criteria of nominal convergence, after it will join for at least two years ERM II.

The monetary and the exchange rate policies have a very strong impact on the process of adopting the euro. After the accession to the Economic and Monetary Union (EMU), the independence of the monetary policy and the exchange rate mechanism will no longer be used as means of adjusting the economic imbalances.

**Keywords:** monetary policy; inflation rate; interest rate

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**1. Monetary policy objective**

After the accession of Romania to the European Union (EU), considering the institutional structure of the European System of Central Banks (ESCB), the monetary and exchange rate policy of the NBR becomes object of the joint interest of the EU.

To meet the criteria for nominal convergence with the view to adopt the euro, it is necessary to avoid the premature abandonment of the own monetary policy, as long as it will be necessary, to finalise the reforms which will potentially generate more benefits than costs. It is, therefore, necessary to have a permanent correlation between the calendar of shifting to euro and the process of inter-temporal optimisation of the cost-benefit ratio which is submitted to constraints (sustainable accomplishment of the criteria of nominal convergence, reaching a

satisfactory level of the criteria of real convergence and shorten the interval spent within ERM II, at the legal minimum of two years).

The conception and implementation of the monetary and foreign currency policy is the main attribution of the monetary authority.

According to its statute, NBR has the fundamental purpose to ensure and maintain price stability. This is the single goal of the monetary policy. By this objective, the monetary strategy of NBR closes to that of the European Central Bank (ECB). Even from its establishment (June 1, 1998), ECB had the main goal of price stability by keeping a low inflation rate in the euro zone.<sup>3</sup> The option for the fundamental NBR goal (price stability) and the way in which its statute has been conceived, to acquire a real independence of NBR from the national government (a central bank must not be under pressure from the outside), prove the concern to achieve EMU requirements for Romania. Also, after the accession to the European Union, in choosing the monetary and exchange rate strategy, Romania assumed those responsibilities in agreement with its prerogatives of independence in the respective policies until the adoption of euro.

## **2. An analysis of the monetary policy during 2006-2008**

Within an economic context marked by considerable inflationist risks, the major challenge of the monetary policy in 2006-2008 was deflation and keeping it sustainable.

One of the economic problems of Romania on its way to the European Union and to the integration within the European structures was and is the high rate of inflation. Its permanent reduction stands out within the process of misbalance improvement.

Inflation rate was 2, 3 percent points above the level demanded by the Maastricht Treaty criterion, and the main causes of this situation can be found both in the late finalisation of price liberalization (incoherent action) and of the exchange rate (1997), and in the low initial price of the administered prices, overlapped by the international price increases for energy or the deliberate adoption of a strategy for the gradual reduction of inflation, with the attached costs and benefits.

Thus, in 2006, the average annual inflation (taken into consideration by the European Union) was 6.6%, after it reached 9% in 2005 (it was the

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<sup>3</sup> ECB has adopted even from its establishment, the aim of 2% annual inflation rate, to the detriment of a monetary policy oriented towards the stimulation of economic growth by credit expansion (monetary policy based on Keynesian premises).

first year when the average inflation rate was expressed in a number with just one digit).

The next year, inflation rate was just 4.8%, and inflation expressed Dec/Dec. was 6.6%, higher than the reference level of 2.8%. In the year 2007, Romania has been outrun, in accomplishing this indicator, by countries such as Bulgaria, Lithuania, Estonia, if we refer just to the Eastern Europe countries. Worldwide, among the emergent countries, only Brazil and Thailand managed not to exceed the inflation limit.

In 2008, the inflation rate was close to NBR prognosis, i.e. 6.7%.

As it is known, starting with August 2005, the monetary policy was inflation targeting.<sup>4</sup> (until 2004, NBR used the strategy of targeting the monetary aggregates, considering that up to that moment, the macroeconomic conditions in Romania didn't allow the orientation towards the new strategy). By this new framework, NBR assumed more clearly the task of an abiding pursuit of its fundamental goal – price stability.

NBR goal, within the specific context of 2006, resulted from the values assigned to the annual targets of inflation corresponding to the two-year time horizon targeted by the monetary policy in its new framework.

The annual inflation targets on which NBR established to focus were set at  $5\% \pm 1$  percent point for the end of 2006<sup>5</sup> and  $4\% \pm 1$  percent point for the end of 2007.

For December 2005, the inflation target adopted in September 2005 was set to  $7.5\% \pm 1$  percent point (the target has been announced in the November 2005 Report on inflation) and for 2008, the inflation target (adopted in August 2006) was set to 3.8% Dec/Dec., with a margin of  $\pm 1$  percent point. On the medium term, the inflation targets will be set in agreement with the trajectory required to maintain deflation in a direction in agreement with the convergence criteria.

These targets resulted from the engagements assumed by the Romanian authorities during the negotiations for accession to the EU.

In setting the annual inflation targets, NBR followed a way quite similar to the Central and Eastern Europe countries, whose Central Banks implement the monetary policy with direct inflation targeting (Hungary, Czechia, Slovakia, Poland).

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<sup>4</sup> This strategy has been taken into consideration for the first time in 2001, when it has been mentioned in the Pre-accession economic Program, as major NBR option.

<sup>5</sup> Confirmation of the PEP inflation targets announced in the February 2006 Report on inflation.

The Central Banks from these countries, undergoing a process of deflation, passed from the stage of setting and announcing descending annual inflation targets for a two year horizon, to the stage of setting and announcing a stationary inflation target (on the medium term), after reaching low, sustainable, inflation targets.

For the end of 2009, in the case of Romania, the Report on inflation (May 2008) projects the inflation 0.4 pp below the previous forecast (3.5% vs. 3.9%).

The assimilation of the practice implemented by the other Central Banks has been delayed, because the Romanian economy didn't reach a sustainable rate of inflation on the medium term, still being during a process of deflation.

Starting with 2005, annual inflation targets have been clearly formulated, the inflation targeting system supporting the monetary policy.

In 2006, the mix of macroeconomic policies accomplished the inflation target set at 5% Dec/Dec<sup>6</sup>.

Starting with the summer of 2007, the inflation rate increased fast, reaching 6.6% in December, much above the higher limit of NBR target, of 4% ±1pp.

After seven years of continuous deflation, 2007 witnessed a sensitive increase of the prices compared to 2006. The deflation process, which slowed down starting with 2005, took place under adverse conditions, among which the large increase of the aggregate demand, the unfavourable agricultural year, wage raises in the budgetary sector, continuous increase of the short-term foreign debt, continuous increase of the budget deficit, incapacity of the Romanian economy to absorb in projects a large amount of received funds.

In 2008, in March, for instance, the annual inflation rate increased to 8.63% compared to 6.6% in December 2007. This was an evolution outside the ±1pp interval corresponding to the inflation target set for 2008, 3.8% ±1pp, which was, obviously, not accomplished.

Among the risk factors for the accomplishment of the 2008 inflation target, one may identify, for instance, the higher percent increase of the administrated prices, persistence of the excessive demand and of a positive output gap, inertia of the inflationist anticipations etc.

As it is known, the existence of a nominal anchor is essential for an efficient implementation of the monetary policy within the context of direct inflation targeting. The full capacity of this nominal anchor strategy can be

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<sup>6</sup> According to NSI data, 4.87% Dec.%Dec.

obtained, according to a rigorous empirical evaluation<sup>7</sup>, only after the inflation target becomes stationary.

The implementation of a coherent assembly of macroeconomic policies and the acceleration of the structural reforms are compulsory if the 2009 annual inflation rate is to be brought on a trajectory compatible with the medium-term inflation target.

In order to make sure that Romania doesn't miss the target of joining the euro zone in 2014, we consider it is imperative that the 2009 inflation is reduced, so that in 2010 it ranges within the limits set by the Maastricht criteria.

### **3. Implementation and utilisation of the monetary policy instruments**

It is known that the participation of Romania to the euro zone depends on the success of the structural transformations which may support reaching the convergence criteria.

The inflation rate indicator proves to be sensitive during this period of preparation of the national economy for the adoption of the single currency.

The increased inflation and the lower rate of economic growth may stress the economic misbalances already existing in Romania.

The only solution, on the long-term, known since the 90s, to solve the inflation problem is the revival of production. Of course, there also is the possibility of a frontal attack on the inflation (such as Brasilia, in 1986, for instance) which can be done by freezing both the prices and wages, by setting an exchange rate and by the significant modification of the fiscal policy.

There is a quite large number of destabilising factors which support inflation. Thus, among the major risks for the continuation of deflation are the increase of the current account deficit, the large increase of the short-term foreign debt; the wage raises in the budgetary sector; the evolution of the credit, taking into consideration that after the capital account has been completely liberalized, the monetary policy lost momentum in influencing this aspect; the exchange rate movements; the international prices for the crude oil and natural gas; increase of the price for some raw materials etc.

Considering these risks, NBR can maintain or strengthen the restrictive character of the monetary policy making use of all the instruments available to it, instruments characterised by simplicity and transparency.

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<sup>7</sup> F.S. Mishkin, Klaus Schmidt- Hebbel- Does Inflation targeting make a difference NBER WP 12876, Jan. 2007.

As example, we can cite the monetary policy interest rate, the mandatory minimal reserves rate etc., or the prudential and administrative measures.

*Monetary policy interest rate*

The interest rate, in general, is the instrument of monetary policy most used at the present moment. But the "liquidity trap" (Keynes), which says that levels close to zero of the nominal interest rate may bring the monetary policy in incapacity of action, shows that this instrument is not difficulty-free.

According to the Program of convergence 2006-2009, the role of the interest rate policy will consolidate. Thus, this measure on monetary policy improves, by its role of signal, the process of anchoring the expectations concerning the inflation.

This variable can be calibrated so that the deflation process continues in a sustainable way by maintaining an adequate increase of the credit and by stimulating saving.

In 2006, NBR continued the process to strengthen the monetary policy. The monetary policy interest rate was increased twice, on February 8 and June 27 2006. After that, the 8.75% interest rate was maintained to the end of the year, despite the fair improvement of perspectives for the short-term inflation rate.

The restrictive character of the monetary policy has been given, during the last three quarters by the strong control on liquidity, NBR sterilizing substantially the surplus of liquidity using monetary market operations and additional measures to limit the credit risk for the population.

Towards the end of the fourth quarter, NBR has initiated the gradual relaxation of the control on liquidity, as reaction to the excessively high pressure of the speculative capital on the exchange rate of the national currency, the leu.

The large appreciation of the national currency, which started in December 2006, determined the monetary authority to reduce, during the first quarter 2007, in two stages, the monetary policy interest rate, while maintaining the restriction of the mandatory minimal reserves (MMR). After that, in the second quarter of 2007, the monetary authority has decided to reduce, also in two stages, the monetary policy interest rate, but the leu has continued its nominal appreciation vs. the euro and dollar. MMR restrictions are still preserved, however. Thus, the level of restriction of the monetary conditions in the broad meaning remained adequate to

maintaining deflation on a path compatible with accomplishing the medium term inflation targets.

At the same time, NBR exercised a firm control of liquidity on the financial markets.

During the last quarter, the consumer prices index has been influenced beyond expectations by the pressure of increased prices for food and natural gas, by the exchange rate volatility and by the international context.

The measures taken by NBR included an increase of the monetary policy interest rate in October 2007.

This increase of interest rate is aimed to potentiate the interest of the foreign capitals for the monetary market, which involved a correction of the national currency.

Considered strictly in terms of the impact on inflation, this measure had a low effect in 2007, but its effect propagated in 2008.

Considering that the inflation target for 2008 was difficult to attain, given the evolution from the first part of 2008, the macroeconomic prospects and the need to anchor the inflationist expectations, NBR, in pursuit of its main goal, increased the monetary policy interest rate on several occasions. The effects of this decision can be observed in the slight effect of leu strengthening, because the fundaments of the Romanian economy are quite feeble (a stronger monetary policy to appreciate the leu would be harmful for deflation, if a correction is to be done, at a subsequent moment), being possible to notice an increase of the interest rates for national currency loans and for deposits, as well as an increased cost for liquidity sterilization.

Because the aggregate demand is quite high in Romania, then the effect of this measure of NBR on the credit and consumption is reduced.

Another effect of NBR decisions to increase the monetary policy interest rate was the lower rate of GDP increase.

#### *Rate of the mandatory minimal reserves (MMR)*

In the case of NBR, MMR fulfils, at the same time, the function of liquidity management, with the component of liquidity excess sterilization, and of interbanking interest rate stabilizer.

NBR increased the restrictiveness of MMR mechanisms starting with 2005.

In February 2006, NBR Board decided to increase by 5 pp the MMR for bank liabilities in foreign currency, while in June the same year, for the first

time in the past 6 and a half years, it decided a 4 pp increase of the MMR for liabilities in lei.

The major NBR goal intended by these measures, and by increasing the monetary policy interest rate, was to temper the rate of increase of the loans in lei. The secondary objective was to stop the erosion of the leu and to stimulate saving in the national currency.

The use of MMR helped to avoid an excessive increase, from the perspective of the financial stability, of the monetary policy interest rate.

#### *Administrative and prudential measures*

During these years, several administrative and prudential measures have been taken and updated regularly, such as harder conditions to grant credits to natural persons; limiting the degree of concentration of the exposures from credits to a maximum of 300% in relation to the own funds; implementation of the legislation on the activity of the non-banking financial institutions; supplementing the measures to limit the risks of credits for natural persons, etc.

On the one hand, the eligibility conditions for the natural persons get stricter while, on the other hand, the exposure from the credits in foreign currency taken by banks is limited.

These measures, concomitantly with the actions for bank persuasion and with the measures for increasing the public awareness on the exchange rate risks, aimed to complete the traditional instruments of monetary policy used to temper the aggregate demand.

They also played the role of reducing the lack of correlation between the resources and placements within the banking system in terms of the denomination currency.

#### **Some conclusions**

By all these measures, NBR shows that it is worried by the increased inflation. In 2008, the most problematic criterion of convergence was that of inflation.

We consider that the monetary authority should be assisted by the Government in its struggle for price stability. As a matter of fact, one of the main causes of the critical situation which developed after 1990 (the increased inflation and continuous depreciation of the national currency were the standards of transition in Romania) was exactly the lack or insufficient correlation between the governmental and NBR policies (maybe due to the apology of the monetarist policies).

The accomplishment of NBR fundamental goal depends largely on other macroeconomic policies too.

“...inflation in Romania has been maintained and favoured by the so-called policies of macrostabilization and by the monetarist nominal convergence, which neglected the real economy and provided a sustainable character to the economic recession. ...The use of restrictive monetary and budgetary policies blocks the domestic demand and consumption ....”<sup>8</sup>

Romanian is preparing to join the euro zone in the situation of an uncertain future and when the international financial market witnesses strong disturbances. In such situation, ECB and FED use different policies: ECB has a single goal, to maintain price stability in the euro zone (at the beginning of 2008, for instance, inflation increased to 3.2% in the countries which adopted the euro, being the fastest increase since 1997), while FED is accountable both for inflation control and for supporting the economic growth.

ECB modified the reference interest rate until July 2008, while FED reduced the reference interest rate in order to restore the balance in the economy.

We consider that the adoption of the euro by Romania might have been done at the moment set by the authorities, if the Romanian economy would have done significant economic and institutional reforms and if there was no disaster on the world financial market.

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<sup>8</sup> Mircea Ciumara, Constantin Ciutacu (coord. ), *Inflation in Romania*, Expert, 2003, Bucharest, p236-237.