10. A CENTRAL BANK'S DILEMMAS IN HIGHLY UNCERTAIN TIMES - A ROMANIAN VIEW

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Abstract

This paper looks at policy dilemmas the National Bank of Romania has faced over the years, with the analysis framed in a European and historical context. Some of these dilemmas are of an older vintage, such as how to deal with massive capital flows, how to combat high inflation when resource misallocation is a very burdensome legacy and expectations of high inflation are well entrenched. Other dilemmas are pretty new, or have got salience during the Great Recession. Romania has had to undertake a painful correction of its large macroeconomic imbalances. "Light" inflation targeting has provided leeway for mitigating the fallout from the financial crisis, although high euroization has dented its efficacy. The specter of stagnation in the Euro Area, financial deleveraging, unconventional policies which are pursued by key central banks, the ongoing reform of banking regulation and supervision, a growing shadow banking, how will the Banking Union evolve, etc, make up a very complicated European context and pose a range of big challenges for the central banks of New Member States (NMSs).

Keywords: central bank, credit, deflation, dilemma, Euro Area, European Union, financial cycle, financial stability, macro prudential policy, stagnation

JEL Classification: E44, E51, E58, F36, F45, G01, G28

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Introduction

This paper looks at policy dilemmas the Romanian central bank (the National Bank of Romania/NBR) has faced over the years, with the analysis framed in a European and historical context. Some of these dilemmas are of an older vintage, such as how to deal with massive capital in- and outflows, how to combat high inflation when resource misallocation is a very burdensome legacy and expectations of high inflation are well entrenched. Other dilemmas are pretty new, or have got more salience during the *Great Recession*. Romania has had to undertake a painful correction of its large macroeconomic imbalances, under very unfavorable international circumstances. Its macroeconomic situation is much better now, than when the financial crisis hit during 2008/2009, but a highly uncertain European environment is a major source of concern. The NBR's monetary policy arrangements ("light" inflation targeting) have provided leeway for mitigating the fallout from the financial crisis, although high euroization has dented their efficacy. For the easing of monetary policy cannot underestimate the wealth effect and the balance sheet impact which a significant exchange rate depreciation it entails. The specter of stagnation in the Euro Area, financial deleveraging, unconventional policies which are pursued by key central banks, the ongoing reform of banking regulation and supervision, a growing shadow banking, how will the Banking Union evolve, etc., make up a very complicated European context and pose a range of big challenges for the central banks of New Member States (NMSs).

Section 1 highlights a major correction of imbalances in an economy that was with the back against the wall in late 2008, when financial markets froze. Section 2 deals with older age dilemmas which confronted the NBR. Section 3 tackles "new age" dilemmas and makes observations on the highly uncertain environment, the age of disruptions, in which policy-makers, central bankers operate.

1. Romania: Huge Correction of Imbalances in a Highly Unfavorable Environment

The Romanian economy cannot extricate itself from the goods and bads of the EU economies. The financial crisis hit the Romanian economy very severely, as it did other economies that had boomed owing to massive credit expansion and external borrowing. The freeze of financial markets compelled the Romanian policy-makers to ask for external assistance in order to fend off the prospects of a liquidity crisis turning into a solvency crisis, in spite of a quite low public debt. The correction of external and domestic imbalances which has been achieved is quite remarkable and is matched by similar adjustment processes in other NMSs. But while the Baltic economies had to undertake internal devaluation (because of their currency boards), Romania could use the exchange rate, too, as an adjustment tool. It needs to be said that the external borrowing, which took place during 2005-2008, was primarily done by the private sector and was driven by foreign banks' operations in Romania. The current account deficit went down to 0.9 % of GDP in 2013, from a double digit level during 2007-2008 (Table 1). The upsurge of exports and the very freeze of financial markets, with the ensuing forced compression of imports, explain this turnaround. In 2014 the deficit it is estimated to be a close number.

There was also a massive correction of fiscal imbalance during 2010-2013 (Figure 1), which was enabled by the agreements with the EU and IFIs. Inflation stood at 1.6% at the end of 2013 and in 2014 inflation has gone further down at about 0.8%. Economic growth is estimated at about 2.8% in 2014, from 3.5% in 2013 (figure 2). It is worthy to notice that the economy bounced back in positive territory in spite of a *fiscal impulse being* negative in the crisis years and interest rates that did not ease as some might have expected. We will get back to this issue in section three. The negative, pro-cyclical, fiscal impulse was entailed by the need to correct very large structural budget deficits.

Public debt trebled, but it is stabilizing around 40% of GDP (Figure 3). Fed's tapering of its stimulus will arguably find Romania much better prepared than during 2008/2009 turbulences, owing to a major correction of imbalances and the "buffers" it has created (the forex reserves of the NBR and the buffers available at the State Treasury, with the latter amounting to about 5 months of imports at the end of 2014). Table 2 shows the size of Romania's overall external debt, as against other NMSs.

Table 1

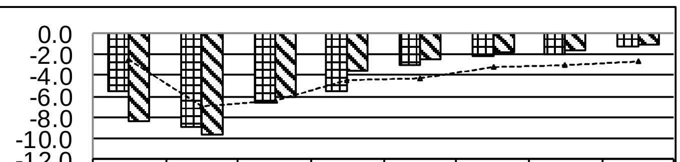
Current Account Balance (% of GDP, 2007-2014)

	2007	2008	2009	2010	2011	2012	2013	2014E	2015F
Romania	-13.4	-11.5	-4.5	-4.6	-4.6	-4.5	-0.8	-0.6	-1.2
Bulgaria	-24.3	-22.4	-8.6	-1.5	0.1	-0.8	2.6	2.1	2.3
Poland	-6.1	-6.5	-3.9	-5.0	-5.2	-3.5	-1.3	-2.0	-2.4
Hungary	-7.2	-7.0	-0.8	0.3	0.8	1.9	4.1	4.3	4.3

Source: Eurostat, European Commission, Autumn forecast 2014; BPM6 methodology: Romania, Poland (2011 – 2015), Hungary GDP – ESA2010.

Figure 1

Fiscal Consolidation in Romania (2008-2015)

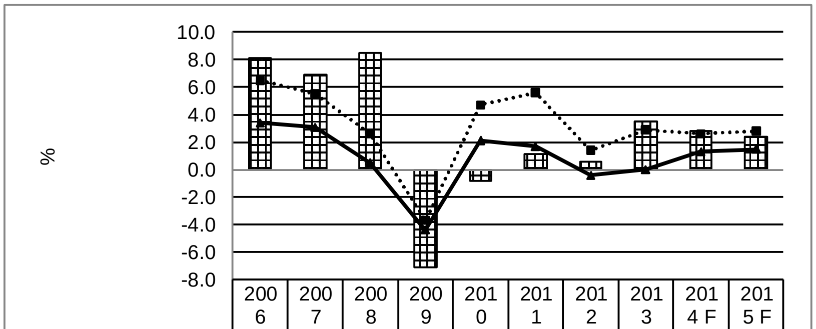


	2008	2009	2010	2011	2012	2013	2014 F	2015 F
Ro ESA95	-5.6	-8.9	-6.6	-5.5	-3.0	-2.2	-2.0	-1.2
Ro Structural	-8.3	-9.6	-6.0	-3.6	-2.5	-1.7	-1.6	-1.0
EU28 ESA95	-2.4	-6.9	-6.4	-4.5	-4.2	-3.2	-3.0	-2.7

Note: RO, EU28 (Net lending (+)/borrowing (-); Ro (Structural budget balance)
Source: European Commission, Autumn forecast 2014; ESA 2010 methodology, Official estimates from the Budget Law Report of 2015.

Figure 2

Real GDP Growth Rates (%yoy, 2006-2015))

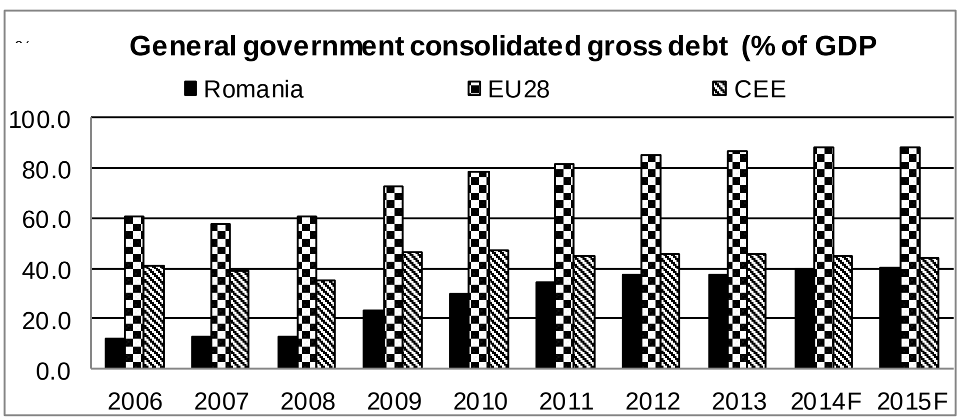


	2006	2007	2008	2009	2010	2011	2012	2013	2014 F	2015 F
GDP RO	8.1	6.9	8.5	-7.1	-0.8	1.1	0.6	3.5	2.8	2.4
CEE	6.5	5.5	2.6	-3.7	4.7	5.6	1.4	2.9	2.6	2.8
GDP EU28	3.4	3.1	0.5	-4.4	2.1	1.7	-0.4	0.0	1.3	1.5

Source: CEE; RO; EU 28; Source: European Commission (AMECO), own calculations (Bulgaria, Croatia, Hungary, Latvia, Lithuania, Former Yugoslav Republic of Macedonia, Montenegro, Poland, Romania, Serbia, Turkey) 2014 – 2015, European Commission, Autumn forecast 2014
ESA 2010 methodology.

Figure 3

Romania's Public Debt



Source: European Commission (AMECO), own calculations (Bulgaria, Croatia, Hungary, Latvia, Lithuania, Former Yugoslav Republic of Macedonia, Montenegro, Poland, Romania, Serbia, Turkey)
2014-2015, European Commission, Autumn forecast 2014; ESA 2010 methodology (data for EU28 is calculated on non-consolidated basis).

Table 2

Gross External Debt* (% of GDP)

	2009	2010	2011	2012	2013	2014Q2
Romania	68.2	75.1	76.4	74.9	68.8	64.1
Bulgaria	104.8	100.7	90.5	92.1	91.0	89.9
Czech Republic	49.9	54.7	57.5	60.2	66.3	68.3
Hungary**	174.2	162.1	184.5	160.5	144.9	148.6
Poland	58.7	65.9	71.8	70.1	69.4	69.8
Slovakia	72.9	74.3	76.7	74.9	81.2	87.3

Source: NCBs, own calculations, ESA 2010 methodology.
**Romania, the Czech Republic, Hungary, Poland: according to BPM6 methodology.*
***including SPE's.*

2. Older Vintage Policy Issues/Dilemmas

Several policy issues have deeply concerned the Romanian policy makers and the NBR, in particular, in the pre-crisis years: "structural strain" (how to deal with massive resource misallocation when prices are freed overnight); the pace of financial liberalization; the persistence of high inflation (expectations, moral hazard, the exchange rate pass-through, etc); and, relatedly, the move to "inflation targeting" in 2005.

"Structural Strain"

"Structural strain" (Dăianu, 1994, 1997) can provide an analogy with overburdened monetary policy during the current financial and economic crisis in the advanced economies. When the command system collapsed and there was a dramatic change in relative prices, many enterprises revealed themselves as unprofitable and facing increasingly hard budget constraints. The system, due to its rigidities, more or less structural, was incapable of undergoing massive resource reallocation rapidly. Hence, the need to subsidize firms, and even sectors, which involved monetization of quasi-fiscal deficits. Moreover, firms themselves created an own pseudo-money via inter-enterprise arrears. This quasi-fiscal task of central banks during the initial stage of post-command transition resembles the QEs practiced by major central banks in advanced economies during the current crisis –a similar fiscal dominance takes the center stage and blends two policy tools together. Why the fiscal dominance now? Because, during the Great Moderation period, resources were misallocated on a large scale (Caruana, 2013, p.1). There are two differences, nonetheless, as compared to resource misallocation under the command system: in the free economies market mechanisms are not emasculated and, second, people and firms are free to make their own choices, which allow incentives and entrepreneurship to drive decisions. Another difference regards monetary aspects: money printing after price liberalization in post-command economies did create high inflation (owing to years of suppressed inflation and considerable money balances[2]), while inflation is very low in the

[2] *Kornai, with his masterpiece (1980), and Kolodko and MacMahon (1987) analyze repressed inflation in a command system.*

economies afflicted by the current crisis. This is because a liquidity trap is overwhelming and inflation expectations are quite low, or are even declining. This difference explains why tolerating high inflation, in the initial years of transition, entailed the threat of entrenched high inflation expectations. This proved a handicap for the Romanian central bank in its efforts to subdue inflation later on and forced a rethinking of its monetary policy regime during the past decade.

Pace of Financial Liberalization

There was an intense domestic debate on the pace of financial (capital account) liberalization, which went beyond the implications of the "Tosowsky dilemma"[3]. There were proponents of fast financial liberalization, in tune with the "Washington Consensus", which extolled the virtues of quick financial integration with the outer economy. And there was a more cautious approach that considered structural features of emerging economies, the threats posed by hot money and the need to sequence financial liberalization (Dăianu and Vrânceanu, 2002). The Asian crisis of 1997-1998 should have given plenty of food for thought during those years regarding the pace of capital account/financial liberalization. But, the IFIs continued to prod quick financial liberalization in spite of Asian crisis and similar episodes of crisis in Latin American economies. The Romanian policy-makers did try to sequence the opening of the capital account, but the EU rules of the game (the single market) forced a faster pace which, ultimately, enhanced a boom and bust cycle. The National Bank of Romania (NBR) made an attempt to stem the skyrocketing pace of credits, but of little avail due to euroization and bank parent funding, and possibly due also to inexperience with what currently are named macro-prudential tools and the sheer size of capital inflows. One easily detects here Helen Rey's insight that the *impossible trinity* (trilemma) is, when a global financial cycle operates, basically a "dilemma" (2013), and that capital controls could play a useful role in mitigating the destabilizing features of massive capital flows. An ensuing inference is that major central banks, the Fed in particular, have a key responsibility in considering their monetary policies and ensuing externalities. Rey's "dilemma" compounds the "Tosowsky dilemma", both indicating how hard it is to conduct an effective monetary policy in small open economies and when facing substantial capital flows.

But not only the Romanian economy was caught in the ample boom and bust cycle of the past decade. The latter did occur in large parts of the EU (Figure 4). Downhill flows did make sense, but they did not move into tradable sectors in the main. Romania, the Baltic economies, Bulgaria, and Euro Zone economies like Spain and Ireland, received enormous amounts of private capital that showed up in rising external imbalances. One wonders whether a European financial cycle[4] was at play in the EU after the introduction of the euro and against the backdrop of the myopia of financial markets regarding the performance differences among various economies. Much of the inflows were private borrowing and, like in the Asian crisis of 1997-1998, it shows that financial markets care, in the end, about the overall external indebtedness of an

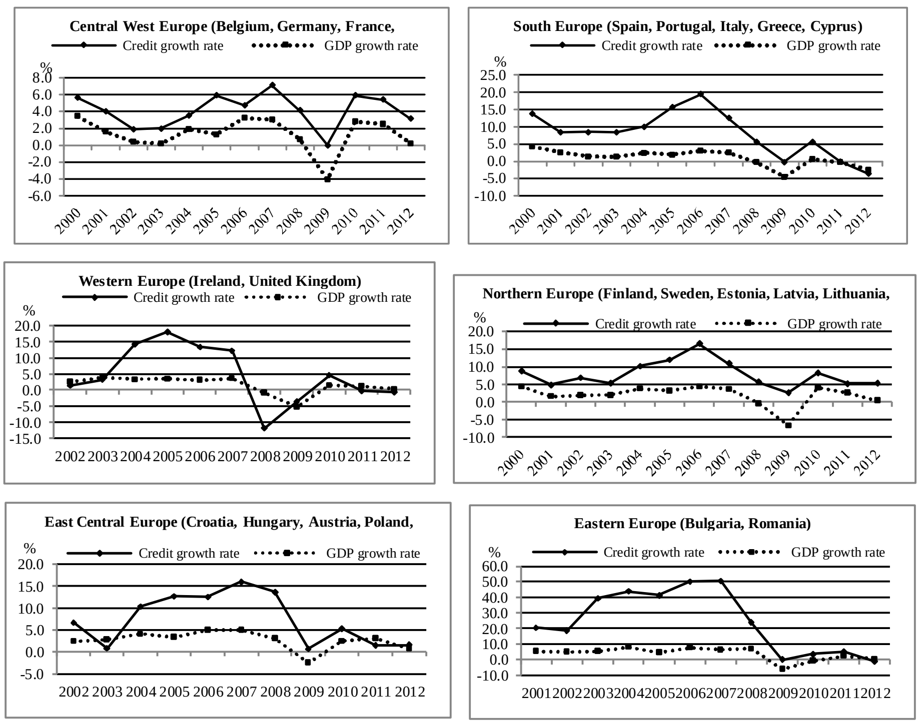
[3] *For the Tosowsky dilemma and the way IMF viewed its significance see Lipshitz et al., 2002.*

[4] *Were it applicable, a European financial cycle would mix with what BIS experts (Borio, 2012, 2014) call the global financial cycle.*

economy, be it driven by the private sector. One can draw an inference here about the importance of private borrowing in judging resilience to shocks and the triggering of balance of payments crises. Like other NMSs, Romania faced a liquidity crisis due to markets' freeze and, as mentioned already, external financial support and the Vienna Initiative were instrumental in averting a worst scenario.

Figure 4

Bank Lending and GDP Growth (2002-2012)



Source for all graphs: Eurostat, European sector accounts (central bank; other monetary financial institutions), own calculations.

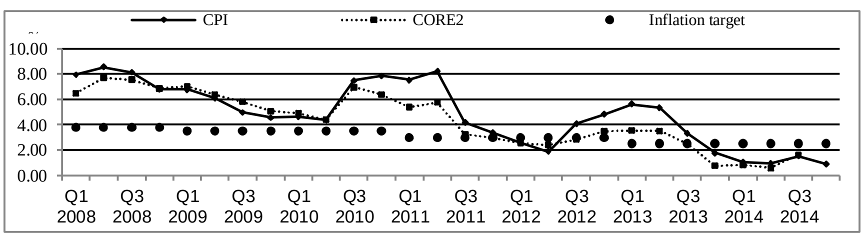
Which Type of Inflation Targeting?

For a long period of time Romania was an outlier when it comes to bringing inflation down to a reasonable (one digit) level. A protracted transition, with many loss making enterprises weighing heavily on budget deficits and entrenched high inflation expectations made the mission of the NBR more difficult. The perspective of joining the EU prompted a more determined effort to combat high inflation and the choice made was to adopt a flexible inflation targeting (IT) as a means to achieve it (Popa *et* *al*., 2002; Daianu and Kallai, 2004)[5]. This is what the Governor of the NBR, Mugur Isărescu, names a "light" version of inflation targeting. The option for a "light" IT acknowledged the reality a small open economy, which is heavily euroized and for which wild gyrations of the exchange rate pose significant risks. This is why; de facto, managed floating was part and parcel of the practiced IT. As a sharp and persistent nominal appreciation (following massive capital inflows) can be highly detrimental to resource allocation (to the creation of comparative advantages[6]), likewise, brutal depreciations cause heavy losses via balance-sheet and wealth effects. The NBR could not be complacent about erratic, wide exchange rate fluctuations and, arguably, this stance has merits.

Disinflation has occurred during the past decade (Figure 5), but with large deviations from target, due to various shocks. Disinflation around the world also helped in this regard, as did the large GDP gap after the crisis hit[7]. Inflation targeting relied also on administrative tools –such as substantial reserve requirements for both euro and leu funds. As mentioned, macro-prudential tools (restraints on credit growth) operated during 2006-2008, but with little efficiency. The transmission mechanism has improved over the years, with smaller margins between the policy rate and lending rates, but it is still quite cumbersome. In addition, once the crisis erupted, supply and demand constraints have taken their toll, not unlike what can be seen in all economies where deleveraging and risk aversion have been ubiquitous.

Figure 5

Disinflation in Romania (yoy, %)



Note: CORE2 (CPI less administered prices, volatile prices, as well as tobacco and alcohol prices)
Source: NIS, NBR.

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[5] *"The characteristics of the Romanian economy do not favor the "divine coincidence" if hard inflation targeting is implemented. The economy still needs substantial relative price adjustments, wages have to be more flexible, the economic structure shows too much power and the tax system is still pretty distorting….Since the NBR has announced to introduce IT a "soft" form is arguable a better choice than a hard version"" (Dăianu and Kallai, 2004, published in Liebschauer et al., pp.138)*

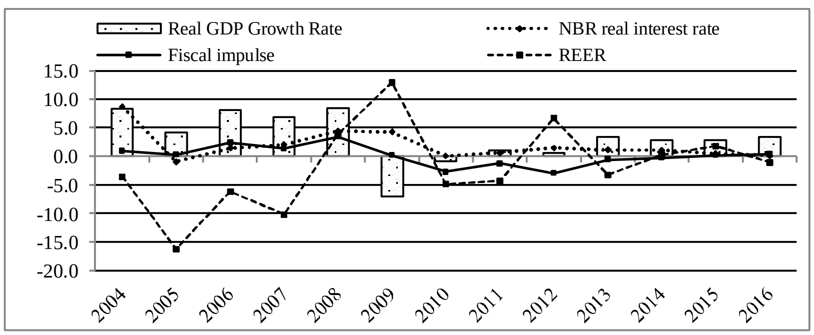
[6] *Dynamic comparative advantages lied behind Asian economies' rejection of real appreciation of their currencies. There was another reason as well: the build up of forex reserves as buffers against an unfavorable international environment. The crisis 1997-1998 taught them a very painful lesson.*

[7] *The GDP gap ante- and post-crisis is quite controversial. The Basel (BIS) view would see the gap substantially lower in view of the need to consider the financial cycle.*

Fiscal policy was pro-cyclical after 2009 due to the forex constraint and the big structural budget deficit. Why output bounced back starting with 2011 is a legitimate question that will be tackled in section four –as a recent vintage dilemma. A monetary policy easing has taken place during 2014, but it was restrained because of the worrisome balance-sheet and wealth effects. In order to judge the working of NBR's monetary policy, its version of inflation targeting, two inferences stand out: first, the stimulus entailed by an easing of monetary policy is counteracted by the wealth and balance-sheet effects induced by an exchange rate depreciation; second, when the transmission mechanism breaks down, lower policy rates are less effective due to credit demand and supply constraints. There is an asymmetry at work here, for rises in policy rates can prolong, deepen a recession[8]. In a heavily euroized economy, monetary conditions (the policy stance) are to be assessed by examining both the dynamics of the policy rate (real policy rates) and the dynamics of the real effective exchange rate (Figure 6).

Figure 6

REER, GDP Growth, Policy Rate, Fiscal Impulse



Source: National Institute of Statistics, NBR; REER – European Central Bank.

3. Recent Vintage Dilemmas: A New Age?

After what the Great Recession has entailed paradigm-wise, policy wise and as an overall mood, a gripping new "age of uncertainty"[9], of disruptions, would be a proper term to capture people's sentiments and changes. Let's sum up what appears to make up the dramatically changed environment in which policy-makers (central bankers included) operate.

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[8] *This is Svensson's argument when he discourages the use of the policy rate as a means to forestall a bubble when the economy is weak. Instead, he asks for the use of macro-prudential tools (2014). On the other hand, there is the view that emphasizes the use of the policy rate as a means to mitigate the amplitude of financial cycles (Borio, Caruana). Woodford seems to take a mixed position on this matter (2012).*

[9] *This concept was used by the Harvard economist John Kenneth Galbraith in a 1977 TV series, in which he tried to portray the world the way he saw it at that time.*

3.1. The Overall Environment: Cognition And Policies

The *Great Recession* has questioned cognitive and operational models with which policy-makers operate. Therefore, they need to consider, inter alia:

- An oversized financial sector (Ugo Pagano *et al*.), with destabilizing features (Stiglitz, 2010; Blanchard and Ostry) and a derailed institutional culture[10], in spite of major efforts to reform its regulation and supervision;
- How to model non-linearities (tail events) is a big challenge, as it is the integration of finance in macroeconomic models (Brunermeier *et al*.; Borio, 2012[11])[12];
- A paradigm shift: price stability is not sufficient for economic stability[13];
- Proliferation of conventional and non-conventional shocks (including cyber attacks), and a decline in robustness and resilience (rising fragility);
- Complexity on the rise and inability to understand it frequently; thence the need to have simpler, more transparent and more robust financial sectors;
- An over-burdening of central banks' functions'; central banks can no longer rely on simple rules (like the Taylor's rule). This makes central bankers' life much more complicated and obfuscates the delimitations between monetary policy and other policies, especially when financial stability gets into the center stage;
- The development of capital markets brings about new systemic risks. Regulators and supervisors of these markets will arguably think increasingly like central bankers to the extent shadow banking creates new systemic risks (think just about the role central counterparties are asked to play, the volume of funds moved by hedge funds and money market funds worldwide, and sudden stops that can occur in these markets);
- The specter of much lower growth in the industrialized world (a balance-sheet recession, secular stagnation) due to demographics, income inequality(Piketty; Saenz, IMF and OECD), technical change and zero-sum games in the world economy, etc (Summers; Gordon; Crafts; Eichengreen; Koo; Jimeno, Smets and Yiangou);

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[10] *As Mark Carney, the head of the Financial Stability Board and Vice-Chairman of the ESRB says, by echoing William Dudley and Minouche Safik, "the succession of scandals mean it is simply untenable to argue that the problem is one of a few bad apples. The issue is with the barrels in which they are stored" (2014).*

[11] *As Borio (2012) puts it, "macroeconomics without the financial cycle is like Hamlet without the prince".11 Monetary policy regimes, inflation targeting, are going to be influenced by this new outlook regarding financial stability.*

[12] *Buch and Holtenmoeller (2014), while examining dynamic stochastic general equilibrium (DSGE) models, acknowledge their weaknesses in explaining crises in developed economies and allude to the modeling of balance of payments crises in emerging economies (Calvo, 1995; Krugman; Velasco). BIS experts favor a financial cycle based, a disequilibrium (Minsky-type) approach. For an explanation of crises in the eurozone see Stein (2014).*

[13] *Rajan quotes Andrew Crockett, the former General Manager of BIS, who, in a speech of 13 February 2001, said that "the combination of a liberalized financial system and a fiat standard with monetary rules based exclusively in terms of inflation is not sufficient to secure financial stability" (2013, p.2).*

- Social and political implications of economic slowdown/recession;
- Ineffective international policy coordination.

As far as Europe is concerned several observations can be made, which are relevant for our discussion.

- The Euro Zone is, arguably, no longer menaced by a collapse owing to ECB's extraordinary operations and large macro-imbalance corrections in its periphery. The stress tests and the Asset Quality Reviews have revealed better capitalization of banks. But other threats are looming;
- A specter of debt deflation in the Euro Zone is real; debt deflation could rekindle the menace of a Euro Zone break up;
- The link between sovereign debt and bank balance-sheets has not been severed; and it may be quite unrealistic to think that a total delinking is feasible. At the end of the day the only entity which has taxation power, irrespective of how financial markets deem its reputation, are governments;
- Market fragmentation has continued, although the periphery (except Greece) pays much less currently for issuing its debt due to ECB's special operations.
- Internal demand in most of the Euro Zone is very weak and suffering from the negative loops between weak activity, fragile banks, weak firms, diminished incomes, and the need for fiscal consolidation;
- The bottom line question in the Euro Zone is: how to foster economic growth, avoid debt deflation? Unless this is achieved the seeds of a new crisis are planted, which would impair the state of the banking sector again (in spite of its efforts to increase own capital, reduce leverage);
- The fragility of the growth model that relies on debt; this is particularly relevant for NMS (CESEE) economies, which need to reinvent their growth model, enhance domestic savings, orient more resources toward tradables;
- The fallout from the Ukraine crisis on economic recovery in Europe, the return of major geopolitical risks; this development is especially relevant in an environment which is already very severely influenced by risk aversion. The fall of the price of oil and gas hardly offsets the economic impact of the additional uncertainty on CESEE economies;
- Capital flows reversals are a significant threat in view of the disconnect between booming asset markets worldwide and the very slow economic growth rates in most of Europe. The search for yield would quickly be arrested were the Fed to taper its stimulus in a significant way.

3.2. Dilemmas of Recent Vintage: The Domestic Context

Observations are made next on a range of policy issues and dilemmas which confront the NBR.

The Policy Space Issue

Economists are fond of extolling the virtues of fiscal space and the European Commission and the IMF keep prodding governments to build it up through buffers and counter-cyclical measures. But there is another, broader and not least important concept, e.g., the policy space. For economies to adjust smoothly to shocks they need to rely on highly flexible markets and be able to resort to an array of adjustment tools – Jan Tinbergen got his Nobel Prize for highlighting just this tenet decades ago. In a single currency area, where the monetary policy and exchange rate policy are gone, the tasks for policy makers can easily turn into a mission impossible unless local markets are sufficiently flexible and productivity gains in the local economy match those of neighboring economies.

When to Join the Banking Union and the Euro Zone

The policy space issue and the pains the single currency area is going through make joining the Euro Zone (which is a must according to the accession treaties) a more complicated journey. There is caution among NMSs in this regard. For key lessons of the Euro Zone crisis is that real convergence and a better functioning of the single currency area are badly needed in order to make accession successful. Solid fiscal underpinnings are badly needed in the Euro Zone while fiscal rectitude is not sufficient in this regard. It should be said that the Ukraine crisis has brought geopolitical concerns into the pros of joining the Euro Zone (the case of Baltic economies in particular).

The Banking Union project might provide a solution to enhancing the cohesiveness of the Euro Zone. But there are important technicalities, of a fiscal nature in particular, and sequencing problems that need clarification. And there is hardly any talk about a collective deposit insurance scheme, which would make sense in a monetary union. National budgets will essentially be the main financial backstops in case of emergencies, although the ECB will hover as the ultimate lender of last resort in case of dire need, and there is also the ESM as a possible instrument. Since member states' financial fortunes are very different, inferences are not hard to make. The bailing-in procedures are likely to increase funding costs, in the short term at least. There is also the need for a strong and timely financial backstop (the 55 billion common resolution fund is pretty small and its time of coming into being, 2024, is pretty remote)[14]. There are other needed policy arrangements, which go beyond the operations of a banking union, in order to make the euro zone, the EU, function properly. This said, however, one needs to consider that banking sectors in the NMSs are heavily controlled by European groups and that participating in the working of the Single Supervisor Mechanism and the Single Resolution Fund presents benefits.

A Threat of the Zero Lower Bound?

Diminishing inflation has allowed an easing of monetary policy lately; the policy rate moved from 5.25 policy rate in December 2013 to 2.75% in December 2014 and reserve requirements were also brought down several times. In January 2015 the policy rate was cut further to 2.5%. If inflation continues to be considerably below forecasts (not least due to the oil price fall) the NBR has the leeway to lower its policy rate further. It is telling that 2014 ended with an inflation rate of 0.8% (considerably below 1.5%, which is the lower bound of the band around the target of 2.5%). A

[14] *All this implies that national budgets would have to step in in order to deal with banks' failure.*

caution note for moving drastically further down would be linked with the balance-sheet effect and the rising global risk aversion. One can infer that a threat of the zero lower bound in Romania is highly improbable in the near future.

Financial Stability

Financial stability is a concern not quite of recent vintage. High euroization has always suffused NBR's monetary policy with a concern for the balance-sheet effect and for financial stability (apart from the concern to avoid bank failures as did happen in the late 90s). The thinking at the NBR, which is shared more widely in the local policy-making community, is that financial stability policy should be a preserve of the central bank. This is due to the need to have thorough information and be able to respond quickly to a crisis. The Cyprus crisis vindicated this approach, for there are outfits of Cypriot banks in Romania. The NBR had to act swiftly in coordination with European Authorities (ECB) and the central bank of Cyprus. How can one avoid conflicts of interest in formulating monetary policy and financial stability policy is not a trivial issue, but the experience available and the need to act coherently when things go awry would arguably support the choice made until now. Concern for financial stability implies measures to diminish the degree of euroization, be accession in the Euro Zone an ultimate goal. And it is good that there is a tendency for the level of euro-denominated credits to come down simultaneously with the relative rise in the share of leu-denominated credits lately. One can submit that a more active presence of local banks would be a favorable evolution by considering the deleveraging undertaken by banks that operate EU-wide and which, sometimes, cater less to the needs of local markets. Having said this one should not underestimate the lessons from the collapse of Santo Espirito in Portugal and the failure of a couple of domestic banks in neighboring Bulgaria. It may be good to have more domestic capital in local banking, but how banks are managed is the key issue in the end.

A Credit Puzzle?

In CESEES (Central, Eastern, and South-Eastern Europe), public debts and private debts are much lower than in most of the EU: is there a puzzle with credit?[15] In spite of deleveraging and the importance of general external funding requirements (GEFR) for the way financial markets judge sovereign creditworthiness, there is fact: the EU mature economies have public and private sector debt much higher than the NMSs of Central and Eastern Europe[16]. One explanation could be that NMSs, CESEES in general, enjoyed the "benefits" of the Great Moderation (rising indebtedness) later. But there could be other explanations as well, such as: boom and bust dynamics took

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[15] *Borio argues that a main indicator for the financial cycle is credit (2012, p. 29). In the CESEES it is probably the speed of credit expansion (and less its stock) together with poor resource allocation that lie behind the boom and bust dynamic.*

[16] *In 2012, according to Eurostat , the public debt and the private debt (except financial institutions) were, as a share of GDP, in Germany 81% and 107%, respectively ; in the Netherlands, 71,3% and 219%, respectively; in the UK, 89% and 178% respectively; in Italy, 127% and 126,4%, respectively. Whereas the similar numbers, in the same year, were in Poland, 55,6% and 74,8%, respectively; in Slovakia, 52,7% and 73%, respectively; in the Czech Republic, 46,2% and 72,4%, respectively; in Romania, 38% and 73%, respectively.*

place in NMSs too; there was substantial resource misallocation, with much investment in non-tradables (which shows up in the volume of NPLs); trade and finance, FDI link, CESEES organically with the rest of the EU (deleveraging is a facet of this financial integration); local market sentiment hinges on EU-wide dynamics; banks have tightened credit conditions and many firms are reluctant to borrow more because of their debts; household debt must be judged in conjunction with people's incomes and their wealth (lending takes into account the assets of individuals and firms)[17].

Although local banks rely increasingly on deposits domestic savings are still low. Therefore, mother banks policies and overall credit conditions in the EU will continue to shape bank landing in CESEES in the years to come. There is at work here a powerful size effect, for these are small economies and their growth prospects depend on what happens in the hard core of the Euro Zone.

A Creditless Recovery?

Why GDP bounced back after 2011 though, in spite of the fall of the stock of credit? Is there a "credit-less recovery" in Romania[18]. Several thoughts can be submitted in this respect: one should distinguish between the stock and credit flow (especially when massive write-offs are made); new credits condition economic recovery; big recessions are followed by recoveries that may not involve credit expansion, for there is already much liquidity in the system (when dormant liquidity wakes up, it may make new lending redundant); there is much fragmentation in our credit markets, with SMEs being under much pain and some of them being priced out of markets for the wrong reasons; there is a substantial underground economy that is not captured by statistics and which can lubricate a financial system that has partially broken down; commercial credit can be a substitute for bank lending and arrears, too, can play a role in this regard. Not least, EU funds can bring in additional liquidity, funding, to the tune of several percentage points of GDP, which is a very substantial injection of base money in the domestic economy). To notice is that export growth was the key in driving economic recovery in recent years; productivity gains were also important. A distinction was made between credit stock and credit flow. It is possible that deleveraging (which shows up in the decrease of the stock) should not preclude new bank lending, especially in an economy in which capital markets play a minor role.

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[17] *According to Eurostat, in 2012, salaries in the EU15 (the better off countries) had an average share of the GDP of over 50%, as against 33% in Romania. In the same year, this share was 51,6% in Germany, 52% in Finland, 54% in Sweden, 53% in France, 45% in Hungary, 38.6% in Bulgaria. In 2012, the share of profits in GDP was 38.4% in the EU15, while it was 54.5% in Romania, 48.4% in Bulgaria and cca. 40% in Hungary.*

[18] *The stock of credit, as a share of GDP, went down in Romania during the crisis years. This tendency would validate a delinking between credit and economic activity after episodes of crisis and when access to external finance is pretty difficult - so called "creditless recoveries" (Calvo et.al, 2006; Takats and Upper, 2013).*

Macro-prudential Policy

One has to consider that much of the macro-prudential tools which are recommended by the ESRB, the FSB, etc., are poorly tested, and in some instances, the experience gained is not highly relevant. Spain's poor record in spite of its dynamic provisioning and prudent fiscal policy is quite telling in this respect. Romania's own experience with trying to stem massive capital inflows indicates the limited room of maneuver in the context of the "single market". Likewise, the current crisis compels at revisiting the pluses and minuses of deep financial markets in relation to the size of economy. In addition, one wonders whether the use of highly sophisticated financial products is warranted when markets can be so erratic, volatile.

Capital markets dynamics are linked with financial cycles. What drives a European financial cycle (if there is any) is of utmost importance for the EMs of Europe, whose macroeconomic policies are heavily influenced by what happens in the core economies. A European cycle depends on crisis management policies at the EU level and its intrinsic drivers. The latter also depend on the paradigms policy-makers embrace. It appears that there is, currently, a clash of visions in this regard. "The Basel view" takes a long term perspective and stresses factors and policies which have made economies drift from sustainable trajectories (have amplified boom and bust dynamics) and resources be misallocated. By not delaying rises in the policy rates would be a means to combat future boom and bust, new big crises. Another view highlights the threat of debt deflation, especially in Europe, of being stuck in a very bad equilibrium with intense hysteresis phenomena that may invite social and political troubles[19]. Income inequality and highly skewed wealth distribution, which would impair economic growth, is a factor that should be factored in both visions; it can bring them closer and reconcile policies that can bolster aggregate demand (for the sake of avoiding debt deflation) with measures that take into account resource misallocation.

When it comes to world capital markets, we seem to be at the beginning of a bumpy ride, at a time when the crisis is not yet over (in Europe, the impact of the financial crisis blends with the crisis of the Euro Zone). It is never futile to stress how much important for global markets is the international policy regime, what big players in the global economy do.

The Euro Zone

Economic recovery in the Euro Zone conditions the very sustainability of economic growth in NMSs via many channels, including finance. Were debt deflation to happen on wide stretches of the Euro Zone, this would quite likely bring the Romanian economy again to a halt. Economic recovery in the Euro Zone depends not only on national economic policies, but on Euro Zone level policies: on whether there is a significant bolstering of aggregate demand at the Euro Zone level which should help avoid debt deflation (is the Juncker plan sufficient in this regard?), the operations of the ECB[20] and, not least, structural reforms in various countries.[21] More debt restructuring may be needed to help the private sector be reignited (Borio, 2012).

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[19] See Posen and Ubide (ed) (2014).

[20] A problem for the ECB to replicate the Fed' and the Bank of England's experience with QEs is that capital markets play a much smaller role in finance in Europe; this limits the room for repairing a broken transmission mechanism.

A Middle Income Trap?

This is a concern rooted in the need for a catching up economy to haven a mix of policies which favor education, innovation, and constant upgrading of the value-added in the economy. It is not an easy task for policy-makers when in the economy is small, deeply integrated in outer markets and with local markets dominated by international groups. Why should a central bank have this concern? Since its policies are increasingly under pressure due to the need to protect financial stability, which ultimately, is linked with internal and imbalances, the robustness and resilience of the economy. A huge challenge for policy-makers here is how to mobilize substantial efficiency reserves, which, in the Romanian case, are ubiquitous at micro and macro levels.

3.3. The Wider Context

A Trade-off between Economic Growth and Financial Stability?

The possible trade-off mentioned above is, probably, the most profound "Grosse Frage" for academic economists and policy-makers nowadays. One could say that this question sets a Basel view against a view that is more concerned with the level of resources used in the economy, with the need to combat high unemployment and avoid poor equillibria. One view takes a longer term perspective; the other pays attention to what may push an economy toward a bad equilibrium and keep it stuck there because of *hysteresis* phenomena. A related question is the growth potential of mature economies. Gordon would say that it is lower than in the past owing to a range of structural factors including demographics, education, etc. Other voices would argue that this growth potential may be eroded by not adopting the right policies now, in the wake of the current crisis. Others fear that attempts to foster short term growth may sow the seeds of future crises by enhancing the search for yield and risky behavior (Borio, 2014; Rajan). Is a way out of this conundrum? Summers (2014) seem to be quite pessimistic in this regard. One would have to consider also the relationship between economic growth and income distribution. It is quite an amazing change to hear top officials of major central banks voicing concerns in this regard, their worries that income distribution may hurt economic growth (Yellen, Mersch, Haldane); IMF and OECD experts voice similar concerns[22]. The debate encompassing these issues is of enormous importance to central banks, for their mission cannot be divorced from what policy makers do in order to resuscitate their economies.

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[21] *Mario Draghi's speech in Jackson Hole, in August 2014, in which he highlighted these three components, is quite indicative in this regard. Giavazzi and Tabellini consider that there is need for a much larger boost to aggregate demand than what the Juncker plan suggests (2014). See also Butiglione et al. (2014) and Wolff (2014) in this respect.*

[22] *Korinek and Kreamer, from the BIS, observe that financial deregulation favors Wall Street (as against Main Street), that it has important redistributive effects (2014). Market imperfections would ask for regulatory interventions would increase risk-sharing between finance and the rest of society on both the upside and the downside. For the linkage between economc growth and income distribution see also Piketty (2014), Piketty and Saez (2013), Ostry, Berg and Tsangarides (2014).*

The Governance of the Euro Zone and its Fiscal Underpinnings

Fiscal rectitude is not sufficient for rescuing the euro zone. There is need of elements of fiscal integration (the issue of common bonds, eventually), of tools for dealing with asymmetric shocks (such as insurance for unemployed people) and of stronger means for fostering economic convergence. *Fiscal capacity*, as put forward by former president Herman van Rompuy, encapsulates such requirements[23]. It is justified to decry, as some do, the insufficient size of resources the EU budget assigns to R&D based activities, to innovation, as a means to help EU members states cope with the challenges posed by the emerging economic powers. But it is also wrong to underestimate the impact on the euro zone, on the EU in general, of growing economic cleavages among member states.

The Reform of Finance: Size, Content, Shadow Banking

The Larosiere and Liikanen reports, which were worked out at the behest of the European Commission, the Turner, Vickers and the Tyrie reports in the UK, the Dodd-Franck legislation and the Volcker's proposals in the US, what the FSB and the BIS do, indicate a logic and action of overall reform[24]. Measures have been taken in order to bolster capital and liquidity requirements, reduce leverage, limit pay, enhance transparency and discourage excessive risk-taking, etc. But, arguably, more has to be done. For example, dealing with the "too big to fail" syndrome requires the application of anti-trust legislation, as it does happen in various industrial sectors; this would imply splitting big financial entities. A sort of Glass-Steagall legislation should be restored, as after *the Great Depression*. Ring-fencing retail from trading activities is, arguably, not sufficient for protecting tax-payers[25]. More own capital and less reliance on debt (as against the Modiglian-Miller theorem which implies that where capital comes from does not matter)[26], rules that prohibit the use of depositors' money for the own trading of banks would also contribute to making systems more robust.

The robustness and resilience of financial systems has been much diminished by inter-connectedness and the spreading use of derivatives. In order to reduce its fragility, make it more robust, the financial (banking) system needs to be "modularized", as Andrew Haldane remarks (2012). And there are ways to achieve it, in spite of stern opposition from the financial industry: by promoting more simple

[23] Studies made for the European Commission, more than three decades ago, highlighted the need for a Eurozone budget, which should go over 5% of the cumulated GDP of the member states (the MacDougall report). There is talk nowadays, too, about the need to create a Eurozone budget (see, inter alia, the Glienicker group report in Germany and the Eiffel group report in France).

[24] One of the legislative pieces of the European Parliament dealing with the need to reform the regulation and supervision of financial markets is a report by Ieke van den Burg and Daniel Daianu and the related resolution of the European Parliament of 9 October 2008.

[25] The proposal made by the US senators John McCain and Elisabeth Warren does make sense and should be considered in Europe too. As a Financial Times editorial stresses "it would eradicate the testosterone-charged culture of investment banking from retail activities" ("Split the Banks", 13 July, 2013). See also Laven, Ratnovski, and Tong (2014), and Gapper (2015).

[26] See Admati and Hellwig in particular (2013).

banking (finance), downsizing large groups, separating activities, prohibiting the use of certain financial products, regulation of the shadow banking sector (hedge funds and private equity funds included), forcing transactions on open venues and mandating reporting and transparency standards, punishing frauds and market rigging severely. More should be done when it comes to diminishing the casino like activities and regulating shadow baking, enforcing ethical standards, tackling the threats posed by rising electronic (algorithmic) trading, cyber attacks.

Trilemma or "Dilemma"

Borio and BIS experts consider that the "financial cycle" has much lower frequency than business cycles and is much more ample time wise (2012). In this context, the observation that the financial cycle depends critically on policy regimes is of exceptional relevance. For, although cycles can hardly be precluded the amplitude of boom and bust dynamics is influenced by policies, as it is the size of the financial industry –which is oversized in not a few advanced economies.

A New Bretton Woods?

The future international economic system will, quite likely, be carved out amongst three major currency blocs, with the US, the EU and China providing the lynchpins. A reshaped international regime would involve rules for the realignment of major currencies and measures in order to mitigate destabilizing capital flows, including financial transactions taxes; rules for preserving an open trade regime, but that should consider the needs of the poorest countries at a time when ecological degradation and food safety are a rising global concern. The functioning of the IFIs would have to keep in mind the shifting power redistribution in the world and lessons of economic modernization. G20 has not been effective enough in this respect. A new international regime would have to combat tax evasion and avoidance, not least because of the heavy burden bank rescues operations have put on public budgets, on tax payers. In this respect, a legislation that should limit tax havens to the utmost would make sense economically, socially, and ethically. In domestic finance the restoration of a sort of Glass Steagall legislation would be more than welcome, together with measures that deal with the too big to fail syndrome, limit over-risky activities (trading), downsize finance and bring it back to reason, make it more simple. The EU and the US have the key role in promoting uniform norms in the regulation and supervision of finance. The Financial Stability Board could help enforce this new framework. The main aim herein is not the avoidance of arbitrage attempts by firms, but the very function of finance in the service of economies. The US and the EU have the key role in reinventing the logic and spirit of Bretton Woods, in taming finance, for the sake of regaining economic stability and avoiding "dark corners"(Blanchard, 2014), in order to defend democratic order.

4. Final Remarks

Central bankers have a much more complicated and difficult job nowadays. Not only that the impact of the financial crisis combines with a persistent Euro Zone crisis, but cognitive and operational models have been questioned. It is a period of increasing uncertainty, when central banks navigate in uncharted territory, which is well illustrated by the diplomatic euphemism of "un-conventional policies". Furthermore, a threat of "secular stagnation" and the menace of debt deflation in the Euro Zone are pointing at years of painstaking efforts to keep the boats afloat. Central banks in NMSs have their tasks shaped by membership, or not in the Euro Zone, size of domestic macroeconomic imbalances and of public and private debts, degree of euroization, intensity of deleveraging, etc. Preserving financial stability is crucial and this mission hinges enormously on the health of the banking sector in Europe, on the effectiveness of macro-prudential tools. This goal will influence monetary policy, inflation targeting regimes too. Joining the Banking Union is an option under consideration in view of the heavy presence of international banks on local financial markets. But the deep interest and concern of any lucid policy makers is to see the functioning of a "complete" banking union, which should help achieve a proper design of the Euro Zone. An adequate design and better policies in the Euro Zone would help prevent debt deflation become a reality and threaten the very existence of the EU. Romania has gone through a very painful process of macroeconomic adjustment after 2009. Its "new age" dilemmas are linked to a large extent with challenges that face all EU member states.

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