Romania: From the quantitative monetary aggregates to inflation targeting

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June 2006

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I. Once the Romania moved toward market economy, the presence of a free central banking institution started being necessary in, at least, two decision areas:

- First: the last resort lender or banker for all Romanian banks,
- Second: the monetary policy management.

It can be noticed that since its establishment, Romanian National Bank (RNB) has been constrained to adjust its monetary initiatives to several urgent main objectives: maintaining a healthy foreign currency position or liquidity, and improving the low level of M2-aggregate participation to GDP (e.g. the last one being around 30-33% of GDP – almost two times lower than the performance of other Central European democratic countries like Hungary, Poland, Czech Republic).

The lack of historic capitalism experience, the delays of governmental legislative and economic reforms, the ownership changes of the former state-own banks, the existence of the real negative interest rates on banking deposits, the regional crises (e.g. former Yugoslavia Republic, Kosovo situation), the high costs of financial intermediation, the alternative of financing by arrears, and the lack of legislation in by-law forced recovery of receivables, all that together were challenges affecting the health of banking system. On such a non-favorable premises' structure including both periodic major macroeconomic disequilibrium and a partial national currency crises during 90's, we were witnesses at the lowering significance for those monetary aggregates chosen as intermediate targets (e.g. the phenomenon of artificially sustaining the currency exchange rate having as consequence a deterioration of foreign reserves) and at the necessity of periodic replacement of those without significance in order to maintain a valid macroeconomic analysis.

Historically, Romanian macroeconomics could be characterized by the followings:

- Inconsistence of favorable influences coming from the price liberalization, increasing participations of services revenue to GDP, or higher direct foreign investment, that were often counterbalanced by the excessive increase of wages and arrears, or by a lack of fiscal stability.
- Long term-effects limitation of monetary aggregates-based policy in the absence of structural reforms, reality that generated a trend of choosing either the less ambitious objectives or the costly compromises. The results manifested as downtrends of credibility and higher levels of annual inflation compared to European Union new-entered economies.

II. Based on the previous circumstances:

- The monetary aggregate management of central Romanian authorities was under the impact of punitive measures against those banks being out of the banking security standards including non-legal or quasi-fiscal activities (e.g. roll-over nonperforming loans). It was a moment when, as a result of inflation erosion of banking assets, there started a modification inside the components of monetary aggregates used as reference targets (a swift of importance from the monetary base aggregate toward quasi-money aggregate).
- The new challenges for the authorities being in charge of monetary policy consisted of:
    1. M2 aggregate management,
    2. Inflation control and reduction,
    3. Sustainable foreign currency liquidity and international reserves,
    4. Control of budgetary deficit,
    5. Better stability for the banking system.
- The regular NBR objectives consisted in the fulfillment of commitments related to EU integration, better efficiency of domestic institutional mechanism, better supervisory and payment system, higher degree of M2 participation into GDP.

- The monetary policy instruments were dynamically adapted and the consequence/performance was an inflationary neutrality in the end (or an inflation rate with one digit) - recorded into a monetary context characterized by liquidity excess and amplified sterilization operations. Unfortunately the distortions generated by the stage of administrative money control has continued to be present on quite important scale. NBR has recently adopted restrictive decisions related to the indebtedness size limitation on retail market, and also to the authorized banks' capacity for lending in foreign currency.
- Open market operations have continued to be used as an essential instrument toward money sterilization. Among such operations a central role was played by the state-securities repo reverse activity and the drawing of deposits.

III. As a consequence of the fact that NBR was forced to accommodate high fiscal and quasi-fiscal deficits, doubled by the loses recorded among the state companies and in agriculture area, the monetary aggregates recorded amplified fluctuations:

- Econometric analysis according to the monthly NBR statistics, proved a high significant correlation on long term between M2, industrial output, and Romanian currency deposits drawn by NBR. Additionally excessive role of M2 upon inflation has proved that in case of Romania the price dynamics is not an exclusive monetary phenomenon. Besides, NBR has used M2 as monetary anchor because that indicator had a better significance compared to monetary base, looking to increase the availability of money offer in the same direction with GDP's dinamics but at a slower slope.
- Due to M2's accelerated increase, back by the increasing commercial deficit and the dynamics of loans and arrears, there was identified a hidden latent inflation well-administrated by the central bank through monetary sterilization interventions. Thus, the low linear slope of the monetary base was mainly a response at the high interest rate policy.

IV. It is ought to be mentioned, that the existence of a continuous dynamics and innovation among the banks' management instruments of liquidity and financial investments, did not allow NBR to apply exclusively a monetary policy based on a single interventionist instrument.

- As a particularity for Romania, during 2000-2005 period, it was noticed the absence of statistical correlation between the interest rate spread and the values of M1 or M2 monetary aggregates. Thus, the overall economic environment was characterized by the presence of targeting the monetary aggregates instead of inflation.
- Also, due to excessive liquidity on the capital market, the banks started to have important deposits at NBR that were far above the minimum reserve requirements, and thus the monetary policy interest rate has acted more as an opportunity cost instruments instead of being a marginal cost of last resort financing. So, the influence of interest rate was smaller than the one of monetary aggregates.
- Additionally, we consider that the relation between NBR interventional instruments and monetary aggregates was more powerful than that between the same interventional instruments and inflation, due to the fact that the monetary aggregates include in their contents the most of banks liabilities.

V. It is sure, that up to the end of year 2004, NBR's monetary policy strategy had wear the particularities' "suit" of monetary targeting that had meant the use of monetary base as operational objective, and M2 as intermediate objective. Then, the strategy turned step-by-step toward inflation targeting. It is ought to pinpoint the fact that monetary policy appealed quantitative targets both at operational and intermediary levels. The major attempts of using extensively the exchange rate as anti-inflation anchor failed during 90's, while the exchange rate strategy was not proper for such interventions due to overall adverse monetary conditions and costs. Thus, the inflation successfully slowed down from extreme levels of almost 300% (1993 year) to almost 9% (year 2005). Such performance is still away or below compared to the performance of new-entered European Union members, but it is a trend that should continue. At the same time, the disinflation's move was not linear during that period, as there were moments when new inflation peaks were recorded (in 1997 and 1999).

- For the last three years (2004,2005,2006), Central Bank has adopted a gradually intensified monetary policy as a result of a high dynamic investment and consumer demand. The danger of exceeding the sustainable commercial deficit was a real issue for each of last years.
- By its deposits interventions, NBR looked for controlling the inflationary expectations under incertitude conditions especially on inter-banks market.
- Adopting an official inflation targeting since 2005, NBR strategy has also been sustained by a favorable free exchange rate environment. The viability of that interdependence relied on the maturity-reach effects of previous structural reforms that allowed an export competitive advantage.

VI. Concluding, the shift from monetary targeting toward inflation targeting was done under the influences of following events:

- The existing pressure coming from refinancing the public debt and from the necessity to remain in certain boundary with the budgetary deficit. Thus, the governmental deficit financing was done mainly from foreign markets in order to slow down the interest expenses. That move affected the liquidity of the domestic stock exchange and money market in case of government securities, and led to high difference between yields offered by NBR and Public Finance Ministry.
- NBR assigned monetary control and liquidity management functions on the mechanism of minimum required reserves. The differences among the interest rates paid on domestic currency reserves and those on foreign currency reserves were justified as a measure to discourage both the excessive lending in foreign currency, and also the speculative orders upon the domestic currency exchange rate. Thus, the minimum required reserves mechanism reflected the constrains existing in the operational environment of the last years monetary policy.

- Romanian strategy was deeply hurt by the low development of its financial markets, and the low level of monetization (e.g. % M2 in GDP).
- A precondition of potential success in the case of inflation targeting was fulfilled - the improvement of taxes collection and the reduction of money laundry.
- The important amounts of quantitative increases in Foreign Direct Investment (yearly Euro 4 billion), and also in the rest of M2's components, forced the necessity of a new strategy based mainly on non-monetary aggregates.

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