CHALLENGES FOR ROMANIAN MONETARY POLICY

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Abstract:
The Romanian monetary policy orientation considers the commitments assumed by the Romanian authorities in the process of preparing the adaptation to EURO currency.
A challenge for the Romanian monetary policy is strengthening the pace of disinflation necessary to achieve the annual inflation targets. This involves lowering the inflation rate, over medium term, to the levels compatible with the definition of price stability. Actually, maintaining the prices is the fundamental objective of the Central Bank. The monetary policy promoted by the National Bank of Romania has a restrictive character. Direct and indirect instruments of monetary policy mainly aim: interest rate, minimum bank reserve requirements, open market operations and refinancing mechanisms.

Key words: *monetary policy, inflation targeting, policy rate, minimum bank reserves requirements.*

JEL classification: *G21*

1. INTRODUCTION

In Romanian monetary policy there have been significant changes in the period after 1990.

The staged liberalization of prices in the Romanian economy has led to a high inflation. In this context, the National Bank of Romania promoted a monetary policy with highly restrictive character. Romania's accession to the European Union has imposed increasing financial intermediation, so that the bank lending activities to support economic growth resulted in increasing the financial prosperity, living standards and banking services to European standards.

The medium-term objective of the National Bank of Romania was the integration into the European System of Central Banks in 2007, and for the years 2011-2014 integration into the Eurosystem. In order to make our central bank activity compatible with the one of the European central banks we had to make significant changes in the Romanian banking legislation. The main changes refer to:

- explicit maintaining the fundamental objective of the National Bank of Romania, namely: ensuring and maintaining price stability;
- strengthening the independence of our Central Bank, from an institutional, personal and financial point of view;
- prohibiting any form of direct financing by the Central bank of public institutions;
- elimination of privileged access of public institutions to the financial institutions' resources.

The reorganization of the banking system in Romania after 1990, on two-tier banking system, as well as credit and interest rate liberalization, have had important implications on monetary policy instruments. Direct monetary control instruments such as credit classification and determining the interest rate level have become less operational. This is because the central bank no longer holds the monopoly distribution of credits in the economy.

As a result, the National Bank of Romanian has introduced indirect monetary policy instruments to ensure the general regulation of the activity in the banking sector. Indirect instruments of monetary policy refer to: the refinancing mechanism, minimum bank reserve requirements and open market operations.

2. MONETARY POLICY STRATEGIES AND INSTRUMENTS

One of the monetary policy strategies adopted by central banks in many countries is inflation targeting. This monetary policy strategy can be materialized in a public adoption of quantitative inflation targets for one or more time horizons and express assumption of price stability as a priority objective of monetary policy. A requirement for the implementation of this strategy is the flexibility of the exchange rate. Therefore, the implementation of direct inflation targeting should be preceded by the introduction of prudential regulations. The successful implementation of this strategy depends on effective supervision of financial institutions to ensure the financial system's ability to absorb exchange rate shocks.

A successful inflation targeting strategy is also conditioned by the banking system flexibility. This risk factor increases the possibility that the central bank sacrifices the main objective to avoid a crisis in the system.

In Romania, after 2008, the Romanian banking system's structural indicators and their degree of concentration ensure the success of the inflation targeting strategy.

Structural indicators of the Romanian banking system, during the years 2008-2010, are presented in the following table:

Structural indicators of the Romanian banking system

Table 1

	2008	**2009**	**2010**
Number of credit institutions	43	42	42
Number of banks with majority private capital	41	40	40
Number of banks with majority foreign capital	37	35	35
Share in total assets of banks with majority private capital (in percent)	94,6	92,5	93,2
Share in total assets of banks with majority foreign capital (in percent)	88,2	85,3	86,1

Source: National Bank of Romania, Report on Financial Stability, 2010, p. 20

At the end of 2010, the largest market share belongs to the Austrian-owned banks (38.3%), followed by the ones with Greek capital (17.0%).

The stability of the Romanian banking system, also reflected by its structural indicators, allowed the National Bank of Romania some successful strategies in addressing inflation targeting. The successful implementation of inflation targeting strategy allows the fulfillment of one of Romania's convergence criteria imposed by the integration in the euro area, namely price stability.

In terms of aggravation and extension of the global economic and financial crisis, in Romania in late 2009, the annual inflation rate was 4.74%. It easily exceeded the upper limit of the inflation target (of 3.5 +/- 1 percentage point) but it was with 1.6 percentage points below the December 2008 inflation rate of 6.3%.

Also, an important instrument of monetary control is determining the interest rate level.

Policy rate is an indicator of monetary policy revealed by the National Bank of Romanian in the monetary transactions made. Monetary policy interest is the rate paid by the Central bank for the deposits attracted from central banks in monetary policy operations.

The evolution of monetary policy interest rate in the period 2009-frebruarie 2011, is presented in the table below:

Evolution of monetary policy interest rate

Table 2

Monetary policy indicator	2009	2010	February 2011
Monetary policy interest rate	8,00	6,25	6,25

Source: National Bank of Romania, Monthly Bulletin, no. 12/ 2010, Statistical Section, p. 24

From the table above we remark a significant decrease in the monetary policy interest rate from 8% in 2009 to 6.25% in February 2011. This reflects, on the one hand the need to counter the persistent inflation and to avoid stimulating excessive volatility of the exchange rate, and on the other hand the need to stimulate normalization of bank assets and liabilities' interest in the context of a prolonged economic contraction. The average daily volume of transactions on the monetary market decreased by almost 9% compared to the pre-crisis period, respectively from 2.3 billion lei in 2008 to 2 billion lei in January 2009 - June 2010.

The **refinancing mechanism** of commercial banks is a financial policy instrument through which the central bank exerts its function of last resort creditor.

The challenges that stood in front of Romanian monetary policy also result from the analysis of the refinancing mechanism of commercial banks, by the National Bank of Romania. Both the volume of refinancing, and related interest rate have not been established independently, by the monetary authority, in the period 1992-2000. They have been influenced by Government decisions or laws of the Romanian Parliament.

Also, another challenge that stood in front of the Romanian monetary policy was the granting of credit on the basis of laws and not based on credit worthiness of applicant customers. This favored, at the time, some state-owned banks (Bancorex and Agricultural Bank) which have benefited from cheap resources, without efforts in this regard.

Between the years 2009 - February 2011, the evolution of permanent facilities granted to credit institutions by the National Bank of Romania, it presented in the table below:

Permanent facilities granted to credit institutions by the National Bank of Romania

Table 3

Period	Credit		Deposit	
	Volume (mil. lei)	Interest rate (% per year)	Volume (mil. lei)	Interest rate (% per year)
2009	24014,2	12,00	990,0	4,00
2010	-	10,25	33503,1	2,25
February 2011	-	10,25	57838,3	2,25

Source: National Bank of Romania, Monthly Bulletin, no. 12/ 2010, Statistical Section, p. 24

From the above table we notice that interest rates, both regarding the lending facility, and deposit facility, significantly decreased between 2009 and February 2011.

The refinancing mechanism of commercial banks ensures that they have permanent access to permanent facilities. These facilities take two forms, namely: lending facility and deposit facility. The lending facility allows commercial banks to obtain from the National Bank of Romania, short term liquidity. The deposit facility is open to commercial banks by the National Bank of Romania, in order to assert their excess liquidity.

3. MONETARY POLICY AND MINIMUM BANK RESERVES REQUIREMENTS

The minimum required bank reserves represent an important monetary policy instrument used by the National Bank of Romanian. He is part of the indirect monetary policy instruments.

The minimum bank reserve requirements were established for:

- providing banking prudence;
- regulation of bank liquidity;
- control monetary creation of commercial banks; protecting the interests of bank customers,
- strengthening the credibility of banking entities.

Banking legislation requires the establishment of minimum required monetary reserves by banking companies, in accounts opened at the National Bank of Romania.

For proper management of liquidity on monetary market, the Central bank adopted a series of measures that aim including the reduction of the minimum reserve requirements' level. They have been successively reduced from 40% to 25% for foreign currency liabilities and from 18% to 15% for liabilities in lei. Foreign currency liabilities with residual maturity of over two years were eliminated from the calculation of minimum reserves requirements.

To avoid large fluctuations in bank liquidity, in the period 1992-2003, the Central bank maintained ratios for minimum reserves requirements at high levels. Then they were successively reduced, so that in the period 2009 to February 2011, they are presented as in the table below:

Evolution of ratios for minimum bank required reserves

Table 4

Period	**Ratios for minimum bank required reserves (%)**	
	lei	currency
2009	15	25
2010	15	25
February 2011	11	25

Source: National Bank of Romania, Monthly Bulletin, no. 12/ 2010, Statistical Section, p. 24

Reducing the ratios for minimum bank required reserves also enrolled in a gradual alignment of their level to the European Central Bank standards and practices.

4. CONCLUSIONS

From this research it can be concluded that one of the major challenges for the Romanian monetary policy is the proposed consolidation of disinflation in the proposed rate of annual inflation targets. Ensuring sustainability of the disinflation process must be carried out without serious injury the medium and long term potential economic growth.

Regarding the Romanian monetary policy configuration and implementation, the main difficulties are:

- ensuring an orderly progress of the adjustment process of previously accumulated extensive macroeconomic imbalances;
- maintaining global economic and financial stability.

By the prudent character of its monetary policy, the National Bank of Romania wants to create the necessary conditions for a healthy recovery of financial intermediation. Also, the Central bank intends to approach a flexible management policy of the liquidity conditions from the monetary market.

Reducing the ratios for minimum bank required reserves is a measure taken by the Central bank to gradually align their level to the standards and practices of the European Central Bank.

From the research performed and considering the complexity of economic and social conditions in which banks operate, we believe that a question is required: do golden rules exist or not in monetary policy?

The idea of rules is also generated by the fact that banks are considered the most disciplined financial entities in the economy.

To the question above, we believe that the following rules may be proposed regarding monetary policy:

- correlation rule of monetary policy interest with inflation indicators, based on the Central bank's interest on resizing money in circulation;
- resizing rule of minimum required reserve rate based on the evolution of bank risk indicators;
- correlation rule of refinancing mechanism with the financial performance of bank and with the quality of credit portfolio which they manage.

The configuration and implementation of monetary policy of central banks also have to be made depending on the conditions of economic globalization and the global financial and economic crisis.

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