CHALLENGES OF THE NATIONAL BANK OF ROMANIA'S MONETARY POLICY ON THE ROAD TO EURO AREA

FULL PAPER

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Abstract
Romania's accession to the European Union implies adopting the euro currency, which is conditioned by the participation in the Exchange Rate Mechanism II for at least two years.

The participation in the ERM II has implications upon the monetary policy: on the one hand, the exchange rate variation must fit the ± 15% fluctuation band around the central parity, while on the other hand, the fulfilment of the inflation criteria is necessary.

The first part of the paper focuses on the challenges of the National Bank of Romania's monetary policy which issue from the Maastricht convergence criteria.

The mandatory compliance of the fluctuation band at ± 15% implies the change of the monetary policy strategy during the ERM II participation period. Accordingly ,it is necessary a more flexible direct inflation targeting strategy that will ensure the fulfilment of two criteria: price stability and exchange rate stability.

In the second part of the paper we highlighted the necessity of coordination of monetary and fiscal policy in the ERM II period, being essential for achieving inflation criteria and government deficit criteria.

Key words: *Exchange Rate Mechanism II, convergence criteria, monetary policy*
JEL Classification: E52, E31, E58

1. Introduction

The countries which acceded to the European Union in the years 2004 and 2007 have become members of the Economic and Monetary Union with derogation regarding the adoption of the euro currency, the moment of acceding the euro area not being explicitly specified. Among these, only five countries have adopted the European currency (Slovenia - 2007, Malta and Cyprus - 2008, Slovakia - 2009, Estonia - 2011), currently being a number of seventeen countries which form the euro area. The other states, including

Romania, have committed to adopt the euro currency in the moment of the fulfilment of the sustainable convergence criteria.
The fulfilment of these criteria implies a series of challenges for the mix of macroeconomic policies, as a result of the existence of the conflict between them. In reality, we observe a heterogeneousness in the choosing of the monetary regime in the accession countries. Some countries have opted for the currency board (Bulgaria, Estonia, Lithuania), while others have chosen the inflation targeting and a more flexible exchange rate (the Czech Republic, Hungary, Poland, Romania).

This heterogeneousness is explained through the fact that economies of these countries are different, the choosing of the monetary policy being based on its capacity to fulfil the nominal convergence and, especially, the monetary criteria. The monetary criteria (the inflation, the exchange rate and long term interest rate) represent the primary preoccupation of the central banks in the countries on the road to euro area. But the main challenge which the monetary authorities of the countries which apply a flexible exchange rate will face is the simultaneous assurance of the price stability and exchange rate stability in the period of the participation to the Exchange Rate Mechanism II (ERM II).

Thus, an essential role in the fulfilment of the convergence process will fall on the policy of the National Bank of Romania, the paper concentrating itself upon *the challenges of the monetary policy of the NBR* which result from the Maastricht convergence criteria.

2. Romania's participation to the Exchange Rate Mechanism II and the implication upon the monetary policy

The adoption of the euro currency by Romania is conditioned by the participation to the Exchange Rate Mechanism II for at least two years, being considered the anti-chamber of the integration to the euro area.

According to the European Union's Treaty, during the Exchange Rate Mechanism II a country can not adopt the following monetary regimes: the fully floating exchange rates, the crawling and anchored pegs, other than the euro.

During the participation to the Exchange Rate Mechanism II, Romania is obliged, according to the Maastricht Treaty, to respect the exchange rate fluctuation band of ± 15%. Consequently, the strict inflation targeting is no longer viable, but a more flexible form is necessary to ensure the fulfilment of the two criteria: the price stability and exchange rate criteria.

This flexible variant of the inflation targeting includes a strategy based on a single instrument, examined by Jonas (2004) and a strategy with two instruments, proposed by Orlowski and Rybinski (2006).The first strategy is based on the use of the interest rate for the realization of the two objectives, while Orlowski and Rybinski (2006) propose the realization of the inflation target through the adjustment of the interest rate and the stabilization of the exchange rate through interventions on the foreign exchange market.

According to the European Council's Resolution in 1997, during the ERM II the exchange rate stability is subordinated to the primary objective of the monetary policy, the price stability being a condition prior for the currency stability. Thus, the necessity of the

realization of a inflation rate compatible with the Maastricht price stability criteria is being imposed, so that fluctuation margins provided in the Exchange Rate Mechanism II are respected. In this sense, the conflict between the two objectives represents a challenge for the monetary policy of the NBR.

The increase of the nominal interest rate in order to calm the inflationary pressures can determine an increase of the interest rate differential upon the euro area which encourages the speculative capital inflow and, therefore, the leu currency is appreciated against the European currency.

Figure 1 highlights the trend of the domestic interest rate in accordance with the inflation rate trend, regardless of the necessity of the decrease of the gap between the internal and external interest rate, which maintained itself at a high level (4-8%).Therefore, in the pre-ERM II period, the NBR's objective is to reduce the inflation rate, so that after the entry in the ERM II its main objective to be the reduction of the interest differential in order to assure the national currency stability. Although the nominal appreciation has a positive impact upon the inflation rate, taking into consideration that the goods import with the highest average in the consumer's basket (foods) is very large, the capital inflow have negative effects upon the inflation target through the liquidities increase. Also, a nominal appreciation too lage on a short–term leads to losing the competitiveness on the international markets and therefore, to the increase of the current account deficit.

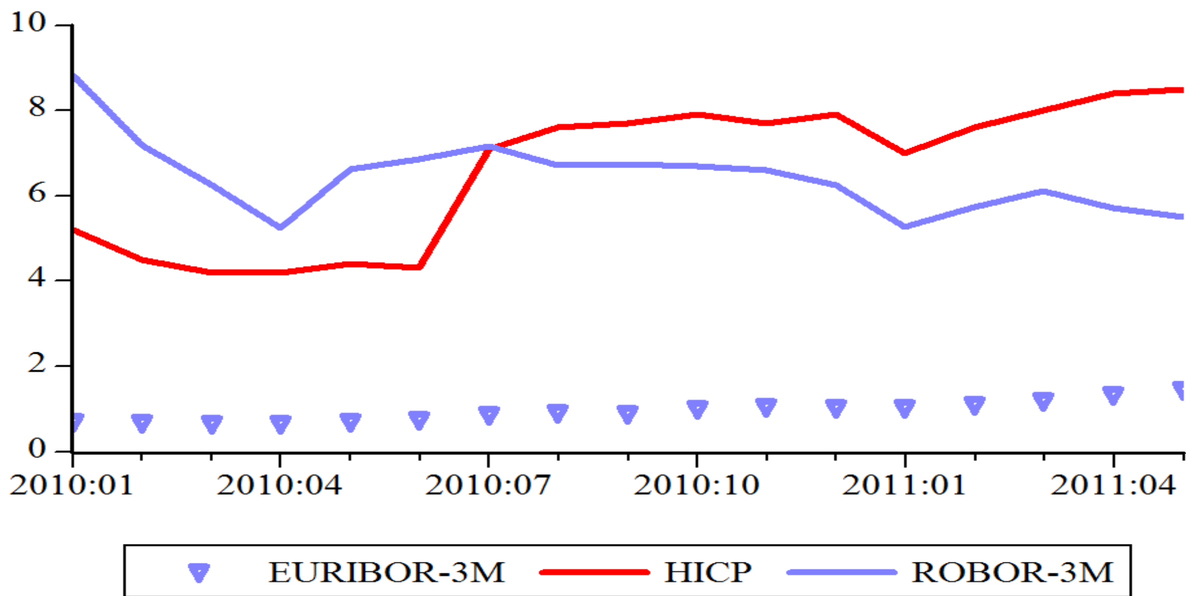

Figure 1. The trend of the interest rate differential, inflation rate in Romania in the 2010:01-2011:05 period

Source: European Central Bank, monthly Bulletins 2010 - 2011, National Bank of Romanian, http://www.bnr.ro/Ratele-medii-ale-dobanzilor-pe-piata-monetara-interbancara-5612.aspx

In the June 2009 - May 2011 period, the leu exchange rate against the euro has fluctuated between -1.94% and 2.98% compared to the reference level (the month of May 2009), indicating a high stability of the national currency, facilitating the fixation of the central parity in the ERM II entry moment.

The nominal appreciation of the national currency during the ERM II can also be the result of the manifestation of the Balassa-Samuelson effect, the real appreciation realizing itself through the exchange rate and, less through the inflation differential.

The interventions on the foreign exchange market (currency purchases and the sterilization of the liquidity in the national currency) can be used for the prevention of the appreciation of the national currency, but this option is considered to be inefficient, because it does not permit the diminishment of the interest rate, being an incentive for the capital inflow. In case the exchange rate isn't in line with the equilibrium exchange rate, despite the effectuated interventions, the central parity will be revalued according with the state of the economy.

In our opinion, *in order to realize the exchange rate stability objective, a combination of the two methods aforementioned is necessary, using with priority the interest rate. We consider that the appeal to the intervention operations on the foreing exchange market should be effectuated in case the reduction of the interest rate has not been sufficient to calm the appreciation of national currency.*

A second situation which might appear during the ERM II refers to the depreciation of the leu and the risk of breaking the inferior limit of the variation interval, an increase of the interest rate being necessary then. In this case the exchange rate stability is in concordance with the inflation target, but the restrictiveness of the monetary policy reduces the aggregate demand with negative effect on the economic growth.

The low level of the interest rates is not a sufficient condition to maintain the exchange rate stability. For instance, the stability of the Czech koruna in the recent years isn’t only due to the low interest rate level, but also because of national bank’s credibility to maintain the inflation rate at a low level.

Thus, the credibility of the national bank is a necessary condition for the fulfilment of the two nominal convergence criteria: the inflation and the exchange rate. We consider that the National Bank of Romania must strive in order to win the credibility through the fulfilment of the proposed inflation targets.

In the opinion of the governor of the NBR, after the ERM II entry it is possible to maintain the direct inflation targeting or the adoption of the exchange rate targeting, the second variant being used as to not generate conflicts between objectives considering the increase of the degree of openness (approximately 66% in the year 2010), the exchange rate becoming the main monetary transmission channel. His opinion is backed up by Hungary’s experience, which in the year 2001 it has adopted the direct inflation targeting strategy and a mechanism similar with the ERM II (with a fluctuation band of ±15% around the central parity). In order to protect the rate’s fluctuation band, the National Bank of Hungary had to sacrifice the inflation target in the years 2003 – 2004 (Isarescu, 2004, p.22).

We consider *that the exchange rate targeting isn't viable for the ERM II entry,* if the catching-up process will also continue after this moment, which means that in order to fulfil the inflation criteria, the nominal appreciation of the leu is necessary. On the other hand, in the condition of the liberalization of the capital flows, an exchange rate requires the loss of the monetary autonomy and, implicitly, the control of the inflation.

Borowski et.al. (2003) has examined two ways to reduce the inflation rate during the participation at the Exchange Rate Mechanism II in Poland: the increase of the interest rate and the nominal appreciation. The results of the simulation show that the impact of a shock of the exchange rate is produced after eight months, while in the case of a shock of the interest rate the effect appears after sixteen months. The reduction of the of the exchange rate with 0.5 percentage points can be realized either through the increase of the interest rate with 1% or through the appreciation of the national currency with 2.5%. The author concludes that the interest rate policy is less efficient during the ERM II.

In our opinion, the reduction the inflation rate during the ERM II will be done in **three ways**. Thus, in case there are inflationary pressures provoked by external factors (the price of oil and food on the international markets) their moderation will be realised through the increase of the interest rate in the same rhythm as that if the euro area, so that the interest differential won't increase. If the causes of the price increase are internal (unfavourable climate conditions) the inflation reduction will be realized through the restrictiveness of the fiscal policy, because the increase of the interest rate determines the increase of the gap against the external interest and implicitly, speculative capital inflow. Although the depreciation of the leu with 15% is permitted, we consider that the nominal appreciation is necessary for the fulfilment of the inflation criteria. This necessity is imposed, on the one hand by the real appreciation of the national currency as a result of the real convergence process and on the other hand, the exchange rate variations reflect themselves faster on the prices, compared with the interest rate, in which case the monetary impulses transmit themselves with a certain delay. In the case of the appearance of the too strong appreciation or depreciation of the leu, the NBR will intervene on the foreign exchange market, so that the national currency to be appreciated by a few percentage points, a favourable situation for the two nominal convergence criteria.

3. The coordination of the monetary policy with the fiscal policy in the context of the fulfilment of the convergence criteria

The accession to the euro area implies a mix of economic policies which will ensure the fulfilment of the five nominal convergence criteria provided in the Maastricht Treaty. The monetary policy can not ensure the price stability without the support of the other components of the macroeconomic policy – the fiscal policy and the income policy. In the period prior to the entry in the euro area, the fiscal policy will have a crucial role in the maintenance of the economic stability.

The Maastricht Treaty imposes the necessity of a sustainable fiscal position which is defined as a share of the budget deficit and the public debt in the GDP.

Empirical studies demonstrate the relationship between the fiscal deficit and inflation. Thus, Catão and Terrones (2005), Fisher, Sahay and Vegh (2002) have shown that there's a strong relationship between the fiscal deficit and inflation in the countries with a high inflation and developing countries, and it rules out this relationship in the case of developed countries and countries with a low inflation. This link is explained through the fact that the budget deficit is financed through monetary creation – seigniorage. According to the Maastricht Treaty, the monetary finance of the budget deficit is forbidden. In case the finance is realized through loans, the budget deficit does not have an inflationary character. On the contrary, the loans from commercial banks restrict the liquidity in the bank system and, therefore, determine the increase of the interest rate.

The negative impact of the fiscal deficit upon the inflation rate highlights the necessity of the fiscal consolidation, as it is presented in the convergence criteria of the Maastricht Treaty. But Vierra (2000) investigating the inflationary effects of the budget deficit in six countries of the European Union suggests that the relationship between the two variables is inverted in the case of a majority of studied countries, meaning that the inflation leads to the increase of the deficit. The lack of empirical evidence concerning the monetisation of the fiscal deficit is explained by the change of objectives of the monetary policies in the beginning of the eighties (the entry in the European Monetary System) towards the price stability and the fiscal consolidation and the higher independence of the central banks.

The reduction of the budgetary deficit is realised through the application of a restrictive monetary policy, through the increase of fiscality and/or the reduction of public expenditure, with effect upon the aggregate demand, in the sense of its reduction and, implicitly, upon the inflation rate. But we must specify that the increase of the indirect taxes (VAT, excises), as a measurement for the reduction of the budget deficit, have a negative influence upon the price consumer and, as a consequence, the impossibility of the fulfilment of the inflation criteria.

In the opposition, the direct tax increase reduces the income and decreases, as a result, the inflationary pressures, but this measure isn't always efficient. In case the population doesn't pay its fiscal obligations, the sums which represent unpaid taxes can be destined for consumption.

In our opinion, for the fulfilment of the two aforementioned objectives, the *adjustment of the budget deficit must be based on the reduction of budget expenditure*, because the tax increase can have an inflationary character.

A successful fiscal consolidation must be based on the reduction of the public consumption and not on the diminishment of public investments which can beneficial for the long term economic growth. The experience of the new member states of the EMU shows that the decrease of the inflation rate through the promotion of a restrictive fiscal policy has permitted the relaxation of the monetary policy and consequently, the convergence of the interest rates.

The reduction of the aggregate demand, as a result of the tightening of the fiscal policy, determines the diminishment of the demand for money and, therefore, the decrease of the interest rates, thus eliminating the incentive for the capital inflow (von Hagen, 2004, p.17). In the author's opinion, the restrictiveness of the fiscal policy through the increase of income can determine the extension of the fiscal expenditure, the effect being null. On the other hand, the decrease of expenditure in a strong economy isn't a very popular measure.

The empirical studies highlight the bi-univocal relationship between inflation and the increase of public expenditure, Ezirim et. el. (2008) suggesting the fact that the fiscal policy is an appropriate instrument for combating inflation in the United States. In order to reduce the inflation, the government should properly reduce the level of public expenditure.

The majority of interest rates amid the inflationary expectations exercise negative influences upon the budget deficit through the increase of expenditure with the interest afferent to the public debt.

Thus, *during the ERM II the monetary policy must reduce the interest rate, necessary for the reduction of the budget deficit and the stability of the exchange rate, the inflationary shocks being absorbed by the fiscal policy.*

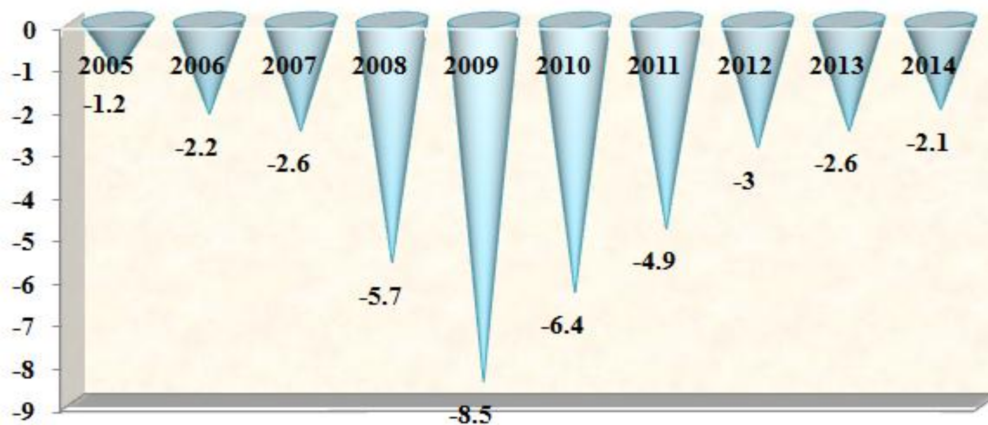

Figure 2. The budget deficit share in the GDP in Romania (%, 2005-2014) *

Source: The 2011 – 2014 Convergence Program, Eurostat, http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/data/main_tables,
*according to the methodology of ESA 95

If in the 2005 – 2007 period the fiscal criteria didn't constitute a problem for Romania, maintaining itself within the limit imposed through the Maastricht Treaty, starting with the year 2008, the share of the budget deficit in the GDP has far exceeded the accepted 3%

threshold, which means that fiscal consolidation measure are necessary for the fulfilment of the budget objective. The budget deficit increase between the years 2008 and 2009 is due to the increase of the budget expenditure in the first part of the year 2008 and the negative GDP dynamic starting with the fourth trimester of the same year.

The public debt share in the GDP in Romania was 30.8% in 2010 and it is estimated that for the 2011 – 2014 period it won't go over 33.2%, being inferior to the 60% reference level.

According to the *2011- 2014 Convergence Program*, the objective of the budget policy is the adjustment of the budget deficit, the target for the year 2004 being 1.8% of the GDP (according to the cash methodology). In this sense, a decrease of the share of public expenditure in the GDP to 35.68% is expected in the year 2013. The result of the restrictive fiscal policy will be a deficitary demand which creates deflationary pressures, the output gap registering negative values for the next years, according to the estimations realized by the Prognosis National Commission.

In our opinion, the *degree of restrictiveness of the fiscal policy must seek the elimination of the demand excess and not a strong contraction which would place it at a level inferior to that of the supply*, because in this case the price increase rate will be negative, and Romania must reach a level of the inflation rate compatible with the price stability definition adopted by the European Central Bank.

Borowski and Brzoza-Brzezina (2004) suggest as an optimal moment for the restrictiveness of the fiscal policy – the period prior to the entry in the ERM II. In this case, the fulfilment of the budget deficit criteria, the credibility of the exchange rate policy and the reduction of the inflation rate at the proper moment (in the middle of the ERM II period) are being assured. The author specifies that the early application of a restrictive fiscal policy does not assure the fulfilment of the inflation criteria, because the disinflationary effect can disappear in the moment of the evaluation of the convergence criteria. We consider *that the restrictive fiscal policy can be applied in any given moment before the ERM II entry*, because the reduction of the inflation is done in a sustainable way, according to the Maastricht Treaty, which means that if the level of the inflation rate was reduced before the moment of the evaluation, it will be maintained even after that moment.
In our opinion, the role of the monetary authority in the price stability during the participation to the ERM II, consists in the application of a preventive credit policy in the case of consumption credits, because the control of liquidity in the economy (the main task of the central bank) through the limiting of the credit volume is not accompanied by the interest rate increase. Their maintenance at a low level is necessary for the fulfilment of the other convergence criteria.

For the fulfilment of the inflation target, a balanced income policy is also necessary to ensure the correlation between the wages in the public sector with the ones in the private sector and with the labour productivity evolution.The increase of earnings in a rhythm superior to labour productivity generates the unit labour costs increase, which will have effects on consumer prices.

We consider that the *coordination of the monetary policy with the fiscal policy is essential for the fulfilment of both the inflation criteria and the deficit criteria*. The objective of the

fiscal policy is to reduce the budget expenditure in order to reduce the budget deficit and to calm the aggregate demand, while the objective of the monetary policy is represented by the reduction of the interest rate with the purpose of fulfilling the fiscal and exchange rate stability criteria.

4. Conclusion

The monetary policy strategy which will be lead by the NBR during the participation to the ERM II will be directed towards price stability, as a main objective, with the simultaneously maintenance of the exchange rate stability.

Romania’s participation to the Exchange Rate Mechanism II has implications on the monetary policy: on the one hand it must reduce the inflation rate, while on the other hand it must respect the provided fluctuation band. Thus, the reduction of the interest differential is imposed in order to ensure the exchange rate stability, but this measure isn’t in concordance with the inflation criteria. Thus, the diminishment of the interest rate will be done by monitoring the approximately constant maintenance of its real level. In case the interest differential maintains itself at a high level, stimulating, thus, the speculative capital inflow, the central bank intervenes in order to avoid a strong appreciation of the leu.

In this period, the fiscal policy holds an essential role, due to the requirement to respect the fluctuation margin limits the use of the monetary policy in the realization of a low inflation. But the Maastricht treaty imposes the necessity of a sustainable fiscal position. If Romania fulfils the public debt criteria, its share in the GDP being inferior to the 60% reference value, the second fiscal criteria, the share of the budget deficit in the GDP exceeds the 3% threshold, which means that measures to reduce the budget deficit are necessary. Thus, the fiscal policy must strive, simultaneously, the budget deficit and inflation decrease. In this sense, the fiscal policy must be based on the decrease of the share of budget expenditure in the GDP. But this reduction should aim the current expenditure, making possible the maintenance of an ascending trend of capital expenditure, necessary for the assurance of the economic growth.

On the other hand, the framing of the budget deficit in the limit provided in the Maastricht Treaty imposes the reduction of costs with interest rate afferent to the public debt. In this case, the liquidity control in the economy is realised through the limiting of consumer credits, which is not accompanied by the increase of the interest rate.

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