A BRIEF ASSESMENT OF THE MONETARY SITUATION IN ROMANIA DURING THE FINANCIAL CRISES AND FACING THE EURO ADOPTION*

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Abstract*:* What is the lesson this financial crises has taught us, from a monetary perspective? One of the basic causes for this crisis has been abundant liquidity. Another cause has been non-performant loans granted and extended by banks to an unreliable clientele known for not being able to return these debts. Finally, these credits have amplified exponentially without many restrictions all around the globe and have been commercialized at unprecedented volumes. These are, briefly, the causes of the actual financial crises. All these can also be located in the area of monetary economics. From this perspective, the analysis of the effects and efficiency of the monetary policy strategy and instruments is essential. This paper aims to briefly present the efficiency of the monetary policy conduct in Romania. The context of the financial crisis is not the only one affecting the monetary segment of the Romanian economy. Thus, analysis is performed from the perspective of the Euro adoption, of the monetary convergence process and achievements.

JEL classification: E50, E52, E58

Key words: monetary integration, real convergence, economic crises, monetary policy

1. Introduction

Romania's economic aims and performance have been focused, at least during the previous twenty years on achieving the economic and monetary convergence needed for the EU accession. This has been mostly the reason for never-ending comparisons, setting benchmarks and targets. Envisaging these aspects and the recent economic and financial crises, we considered appropriate to briefly capture an accurate glimpse of the monetary situation in Romania confronted with the crises, with the inflation threat and massive capital inflow consequences. Monetary evolutions are analyzed in an inter-connected manner considering also the debut of the actual monetary regime – inflation targeting, and pointing out an inflationary projection on a short term.

* Paper achieved as part of the CNCSIS Contract - Human Resources – Postdoctoral research Code_110 „Romania and the Euro Adoption – a Complex Model of Monetary Integration"

2. Objectives

Essential aims of this paper are to point out recent monetary evolutions in Romania based on the monetary policy regime, its timing and implementing. These evolutions are to be analyzed by respect to recent developments of the financial crises, from the perspective of its determinants – in the monetary area, and not least by the perspective on the monetary integration and Euro adoption processes. Finally, we envisage pointing out the real performance of monetary policy instruments, measures and transmission mechanism. All this is based on a strong theoretical base in the field of monetary convergence provided by recent literature and described below, but also on statistic data provided by the Romanian National Bank and the National Institute for Statistics.

3. Methodology

In analyzing monetary convergence, we must consider the debate developed in the mid-1990s, when the first "wave" of EMU was in the making. At that time, most of the debate focused on three questions (see Angeloni and Dedola (1999)): (1) whether the prospective members constituted an "optimum currency area", in the sense defined by Mundell, Kenen and McKinnon in the 1960s; (2) if and how their monetary policy transmission differed; and (3) whether the diversity existing in the prospective currency area would permit a cohesive and efficient monetary policy decision-making process. We shall be using this as main methodological hypothesis. There may be a new path in investigating monetary integration and the efficiency of the monetary policy application. Does the convergence affect or reflect in any way on the aggregate income and living standards? An empirical model of real income convergence across countries has been used by Sala-i-Martin (1997) and it is also suitable for actual developments in NMS. Several other studies raised new questions on the convergence matter: Haan et al. (2004), an analysis of business cycle correlation analyses has been conducted by Fidrmuc and Korhonen (2005), Frenkel and Nickel (2002) set up a structural vector auto-regression model to identify and compare demand and supply shocks – as well as the speed with which economies adjust to shocks – between euro area countries and central and eastern European countries etc.

In emphasizing determinations between monetary aspects in Romania and the financial crises, we use the hypothesis of Reinhart and Rogoff (2008), according to whom, there may be a relationship between these synchronous, large capital inflows and external sovereign defaults, currency crashes, inflation crises and banking crises.

4. Analysis

As there is no centralized strategy for Romania's accession to the single European currency, and as the Nice Council recommended the candidate countries to adopt the most suitable monetary policy according to the specific condition in each country and in accordance to the rest of the economic condition, this project aims to offer certain orientation instruments. The choice of monetary policy in Romania has also been a rather debated and controversial subject as far as the inflation targeting strategy is concerned but also its timing and results. Since 2005 the Romanian National Bank chose the inflation targeting as strategy of the monetary policy after several years of targeting monetary aggregates. The recent economic developments generated by the financial and economic crisis, raised new question and challenges for the monetary approach in the Romanian economy. Monetary integration means foregoing the use of

monetary and exchange rate policies for national purposes alone. In signing the Maastricht Treaty – that contains the institutional arrangements for the conduct of monetary policy in the European Economic and Monetary Union (EMU) – these countries agreed to immediately start taking into account the implications of such policies for other EU members; in the longer run, monetary integration means adopting the euro. Most NMS (new member states) have undergone a very rapid and deep transformation in all economic and institutional areas. First, all NMS have been able to achieve a high pace of nominal convergence in recent years. As far as real convergence is concerned, however, the record is more mixed and differentiated. Second, looking at more structural factors we find that, while trade integration with the other 15 EU Member States (EU15) has progressed quickly in recent years and is now quite advanced, convergence in output specialization to EU standards has been slow, especially if measured in real terms (excluding changes in relative prices). This may influence negatively the pace of real convergence. Third, there is also some evidence that a few NMS have a higher degree of business-cycle synchronization with the euro area. Hence, they may become less likely to be affected by radically different economic shocks. This, however, is not true for all NMS. Many NMS are quite advanced relative to the euro area in the process of labour market and institutional reform. Looking at central bank statutes, objectives, strategies and instruments, we find that good progress has recently been made in developing sound central banking structures. Our view is that the conditions for full monetary integration have still not been reached. A case-by-case approach to adopting the euro – based on country-specific conditions – seems natural.

In analyzing monetary convergence, we must consider the debate developed in the mid-1990s, when the first "wave" of EMU was in the making. At that time, most of the debate focused on three questions (see Angeloni and Dedola (1999)): (1) whether the prospective members constituted an "optimum currency area", in the sense defined by Mundell, Kenen and McKinnon in the 1960s; (2) if and how their monetary policy transmission differed; and (3) whether the diversity existing in the prospective currency area would permit a cohesive and efficient monetary policy decision-making process. The debate on European economic and monetary integration in the late 1980s and 1990s devoted a lot of attention to the convergence criteria which countries had to meet if they wanted to join EMU. Two important projects in this area are the Global Economic Model (GEM) maintained at the IMF (Laxton and Pesenti, 2003) and the New Area-Wide Model (NAWM) constructed at the ECB (Coenen et al., 2008a). These models and their offspring have been used in a variety of applications, including scenarios of global current account rebalancing (Faruqee et al., 2005), labour tax reforms (Coenen et al., 2008a), fiscal consolidation (Coenen et al., 2008b), structural reforms (Everaert and Schule, 2006) or globalization (Jacquinot and Straub, 2008).

The monetary policy analysis for an acceding country should go even further – to a new set of real convergence indicators for Romania on the basis of an appropriate monetary integration model (schedule and timing, monetary policy model, sets of criteria etc.). According to the ECB, the real convergence set of indicators used for the quantification of the progress of the candidates is based on growth, productivity and price level convergence. Also, the composition of the output is taken into account from this perspective – if the output composition differs internationally, sectorial disturbances tend to generate asymmetric country disturbances and asynchronous national cycles, since sectors have different cyclical properties and may even respond

differently to monetary policy (Dedola and Lippi (2000)). The composition of output and employment tends to be closely related to the stage of economic development. International comparisons have shown that a higher level of development tends to be associated with a smaller share of agriculture in aggregate output and a larger share of services, whereas the share of industry typically has an inverted U-shaped relationship to per capita output, increasing first and declining later (Chenery and Taylor, 1968). The output shares can then be used to "benchmark" the degree of economic development, as recently done for central European countries by Raiser et al. (2003).

An empirical model of real income convergence across countries has been used by Sala-i-Martin (1997) and it is also suitable for actual developments in NMS. Several other studies raised new questions on the convergence matter: Haan et al. (2004), an analysis of business cycle correlation analyses has been conducted by Fidrmuc and Korhonen (2005), Frenkel and Nickel (2002) set up a structural vector auto-regression model to identify and compare demand and supply shocks – as well as the speed with which economies adjust to shocks – between euro area countries and central and eastern European countries etc.

The Romanian National Bank officially adopted the inflation targeting monetary strategy in august 2005. This is considered by literature as a flexible framework capable to offer the Central Bank a „constricted discretionarism" in performing a role where the nominal anchor is the inflation target. Also, this has been seen as the strategy where the monetary policy is connected to the long and medium time horizon without siminishing its ability of reacting to short term developments. Thus, inflation achieves conciliation between the responsibility imposed by the rigid rules, on one hand, and the flexibility allowed by the discretionary approach, on the other hand. These are the essential hypothesis of the Romanian National Bank in instating and applying the actual monetary policy strategy.

Policy regime choices & constraints for Romania could have been resumed as following1:

The need for further sustainable disinflation, incl. from EU convergence perspective; move from 8.5% to around 2-3% difficult, fraught with costs (non-linear sacrifice ratio, etc.)

Status quo (mix of monetary targeting with exchange rate interventions) no longer appropriate: weakening relationship between monetary aggregates and inflation

Exchange-rate peg based regime highly risky in light of convergence induced appreciation trend, move towards full capital mobility

Inflation targeting provides CB transparency & accountability, constrained discretion, should help anchor expectations, dominates above options in terms of robustness to shocks; but requires time for full effectiveness

The essential arguments in this respect can be summarized as efficiency in price stability. The previous lack of success of the monetary anchor has been mostly due to the instability and unpredictability of the money demand. Now, the main objective is price stability, the money mass is the intermediary objective, and the monetary base represents the operational aim of this strategy.

Previously, the Romanian National Bank used the disinflationary trends of the foreign exchange rate of the Romanian Leu in order to compensate the limited

[1] According to the Romanian National Bank

efficiency of monetary aggregates in stabilizing inflation. Still, the choice has also been based on the other transition countries experience in this field.

From the point of view of the monetary policy strategy choice, Romania had to follow theoretical aspects and considered the experience of neighboring countries such as Bulgaria who followed a different path - the currency board – only option available in aftermath of severe financial crisis & hyperinflation. Croatia in turn, chose implicit euroization (quasi-currency board), but we must not forget that it is the case of a small size economy, with resident inflows & savings, aftermath of war period, widespread euroization from beginning of statehood etc. The other new members - the Czech Republic, Hungary, Poland moved to inflation targetting and away from exchange rate-based configurations.

The final choice in inflation targeting regime in Romania has the folowing features2:

- CPI-based inflation target
- Target set as a midpoint within a band of ±1 percentage points- annual targets set for a longer time horizon (initially 2 years)
- Flexible interpretation of inflation targeting (mainly its co-existence with managed float)
- Joint announcement of inflation targets by the NBR and the government

NBR pro-active stance & transparency: decisions based on 8 quarters ahead inflation forecasts, detailed risk analysis in quarterly inflation reports, pre-announced policy meetings followed by statements, analyst meetings, press conferences.

This particular tailloring of the monetray policy stance has been accompanied by the capital account liberalization and has proved efficient during both increase and recession periods. Even thought, it can not be demanded to suprass the lack of macroeconomic stabilisation durring different periods, inconsistencies in the macroeconomic mix or the lack o economic growth. One must always remember that the monetray policy is merely an instrument and its transmission process and channels, even if sutable and performant can not replace a non-functioning economic mechanism.

Theoretical aspects and the economic reality have not been the only constraints of the transition to infaltion targetting. Further constraints came from a new perspective – the Euro accession process. Under these circumstances, the monetary policy had to be maintained at least until ERM2 entry and it must co-exist with an explicit exchange rate objective. That had already had proven itself rather problematic if we consdier the former Hungarian experience. This strategy was also meant to ensure a gradual fulfilment of the Maastricht criteria while supporting the real convergence process.

Apart from constraints the monetary policy stance has been envisaged by the Romanian Central Bank as to provide some monetary and exchange rate flexibility (for a limited time period) in order to further necessary and substantial structural adjustment and maintain motivation to carry out reforms in a timely manner and consolidate macro discipline. (Popa 2006)

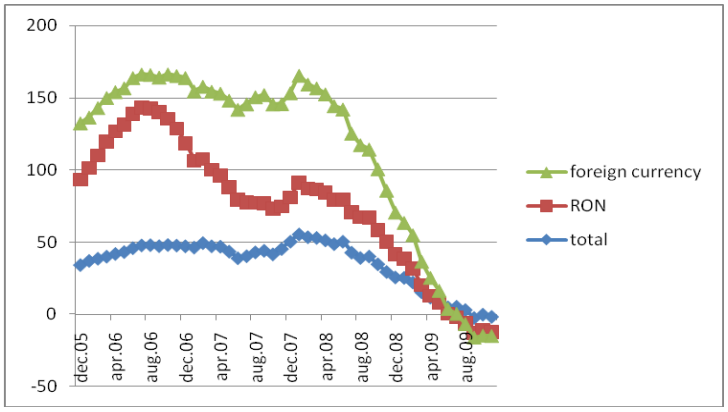
The issue of the equilibrium exchange rate has been a different problem and aim for the monetary regime capable to provide the possibility of setting the central parity based on a more accurate estimate after overcoming the peak in capital inflows.

The circumstances of the financial crises in Romania should be analyzed and considered in conjunction with the large capital inflows experienced by Romania since

[2] Also according to the Romanian National Bank

2005 – the year of the capital account liberalization. This has been an immediate and strict requirement of the Euro accession process, unlike the choice of the monetary policy. It has been a constraint and, somehow the monetary policy should have been the instrument generating equilibrium or compensation.

Generally, global adjustments are characterized by synchronous, large capital inflows in a great number of countries, followed by their relative reduction for the entire group. Usually, the number of countries facing large capital inflows simultaneously is relatively small. However, from time to time, simultaneous episodes of massive capital inflows occur in a relatively great deal of countries. Over the past few years, very many countries, Romania included, were faced with the capital inflows problem.



Source: computing based on INS and BNR data

Figure no.1 Credit inflow towards the private sector in Romania – annual real variation

As recently pointed out by Reinhart and Rogoff (2008), there may be a relationship between these synchronous, large capital inflows and external sovereign defaults, currency crashes, inflation crises and banking crises. The authors defined the crises for each of the above-mentioned components and constructed specific probabilities of crisis emergence for the 1960-2007 periods in 66 countries. The probabilities were defined both conditional and unconditional on the episodes of heavy capital inflows. The final outcome is that, for low- or middle-income countries, the conditional probabilities for a crisis to emerge are significantly higher than unconditional ones.

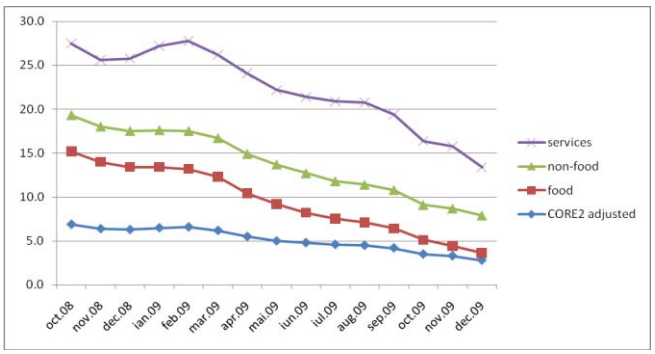
The number of crises is higher around the episodes of large capital inflows. One may conclude, in practice, the ensuing magnitude of adjustments and financings is different from that seen in quasi-individual episodes of substantial capital inflows for a given period, followed by their reduction. This owes to the fact that, if synchronized crises occur in any of the cited components – sovereign debt, exchange rate, inflation and banking system –, synchronized recession episodes are likely to follow. Certainly, simultaneous resorting to external financing with a view to underpinning a great many anti-crisis programmes makes the resources to each country relatively less available and costlier than in the case where only a small number of countries use a given amount of resources. In addition, synchronized recession episodes could translate into greater individual recessions for the economies in which the export-oriented sector holds a

sizeable share in GDP. Against this background, the difficulty in adopting a package of reforms and in securing external funding is bigger in the context of the quasi-singular episodes when a large capital inflow cycle ends. Romania took this into account at the time of asking for financial assistance from the EU, the IMF and other international financial institutions to cover the financing gap estimated for 2009 and 2010. (Isarescu, 2009).

Modern globalised economies have experienced such cyclic episodes before during the 1970's, '80s and even '90s. Nevertheless they have been more or less accompanied by deep recessions and finally generalized economic crises.

One of the basic causes for this crisis has been abundant liquidity. Another cause has been non-performant loans granted and extended by banks to an unreliable clientele known for not being able to return these debts. Finally, these credits have amplified exponentially without many restrictions all around the globe and have been commercialized at unprecedented volumes. These are, briefly, the causes of the actual financial crises. All these can also be located in the area of monetary economics. From this perspective, the analysis of the effects and efficiency of the monetary policy strategy and instruments is essential. This paper aims to briefly present the efficiency of the monetary policy conduct in Romania. The context of the financial crisis is not the only one affecting the monetary segment of the Romanian economy.

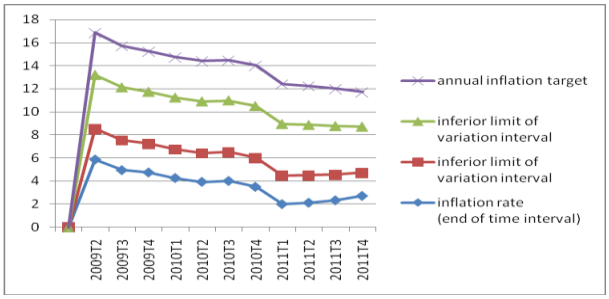
Many analysts believe that the monetary policy still owes a certain due in respect of the recession diminution. The out-put gap still over -7% seemed slightly bring justice to that idea. Even more, in its definition that is not influence by supply factors, inflation has decreased from 6.3% in December 2008 to 2.8% in December 2009 (Croitoru, 2010). This decrease is due both to the recession, but also to the prudence of the Romanian Central Bank in reducing the monetary policy interest rate.



Source: computing based on INS and BNR data

Figure no.2 Inflation based on CORE2 components

Even if many say that inflation is no longer a threat, 2010 has already brought new developments and new constraints for the monetary policy that has done so well so far. The expected economic growth foreseen under the influence of external factors and external economic recovery proves not to be as expected. Still inflation and interest rates have decreased and it is probable for new factors acting in diverting to show up. Under these circumstances, reaching the inflation aims of 3.5% for 2010 and 3% for 2011 remains a rather sensible issue.



Note: the width of the variation interval is 1 percentage point.
Source: computing based on INS and BNR data

Figure no.3 Inflation forecast

Once the global economy recovers, chances are that capital inflows increase. Globally, the economic and financial crises have corrected disequilibrium in a brutal way and correction to the countries current accounts have been only due to cyclical factors and most probable not stable or enduring. Even more, there have been no reforms aiming to prevent a re-built in un-sustainable deficits. The crises' factors are still present and for countries experiencing current account deficit, savings increase might generate a reversal. The liquidity has been also raised by banks injecting money on the market.

Inside the Euro area – our convergence aim – structural rigidities still prevent economic growth. This existed before. The new and yet unpredictable aspect is the financial crises in Greece. That could trigger the contagion effect through means of monetary policy. The EU, IMF and World Bank would hopefully produce enough trust in order to maintain stability, even if it is already known that the 146 bln. Euros that Greece needs would not be enough unless structural reform is undertaken.

Another implication of crises development can be depicted in the ROL exchange rate evolution. From this point of view, predictable effects could be found in an increase in inflation, accumulation of debt in foreign currency and a depreciation of international competitiveness.

As far as the interest rate is concerned, the key constraint and challenge for the actual stage of the monetary policy is achieving the inflation target while minimizing risks threatening financial stability. Thus, the actual monetary policy strategy is not all about reducing interest rates. Taking into account all these, the most likely scenario for the Euro adoption could be positioned in time for 2015.

5. Conclusions

Even confronted with rather difficult economic conditions and with an unstable and even un-coherent macroeconomic mix, the monetary policy has performed rather well, both in terms of real targets, but also in terms of substitution and prevention. The cautionary monetary policy strategy in the area of inflation targeting but also in exchange rate stabilization, have had positive results, even beyond expectations and beyond the general economic evolution. In other words, monetary performances have surpassed economic ones. All these can be depicted from statistical analysis, but also from the ever challenging convergence process with the Euro-zone. Facing the imminent Euro adoption, the monetary policy in Romania has been confronted with supplementary constraints. Accession timing is yet another. In real terms, a rather soon

Euro accession would mean giving up monetary policy before having ensured the necessary convergence and its sustainability, and the ECB monetary policy might prove inadequate for the actual status of the Romanian economy.

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