THE REFERENCE INTEREST RATE AND IT'S ROLE IN ECONOMY

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Abstract: The National Bank of Romania (NBR) as a monetary authority sends the objectives of the forward policy through some monetary indicators, among them detaching the reference interest rate, as the main element in determining the direction in which the rates applied by the other banking institutions involved in the economic life, will evolve. The interest rate has successfully assumed the role of an adjuster of the relationship between supply and demand on the credit market. The influence of reference interest rate is not only exerted on banks, the entire economical world revolves around its upward or downward evolution. The economy, through its main components: credit, savings, investment, GDP, exchange rate, export and import of goods and services, inflation etc., is tempered or brightened by the burst or fear that NBR expresses through the reference interest rate. The purpose of this article is to highlight the importance that reference interest rate has on economic life, concerned both as a whole and through its main elements. At the same time, I will try to present the evolution of interest rate in the last years, an evolution correlated with the main macroeconomic indicators. The oscillations of inter and intra bank interest rates exert a very important impact on both credit and savings, no matter whether we have a natural person or a legal entity. Consequently, the interest rate changes determine and establish the stages of economic development.

JEL classification: E43, E52

Key words: reference interest rate, The National Bank of Romania, monetary policy

1. INTRODUCTION

In the economy of many developed countries there have been periods when monetary policy interest rates were close to zero with major implications in all areas of the economy. Romania is on a downward trend of monetary policy rate following the developed countries and therefore I consider it is very important to debate the relationship between monetary policy interest rate and the economic life in this context. The impact of interest rate reduction over the entire economy is someway limited due to a pluralism of internal and external factors, among which we can mention the increased volatility of the domestic currency and the context of international financial markets that have an increasingly high correlation with the financial market in Romania. A key interest rate on the decrease will positively influence investment growth, reduce unemployment and an economic increase at least in the short term, but we should also consider the reverse side of this measure that may be manifested in an increased risk of inflation and even if the International Monetary Fund is recommending a cautious use of the leverage key rate, drawing attention to the excessive increase of the administrative prices and volatility of exchange rate, we also have to mention that the state has access to cheaper loans from the

domestic market because the banks from the Romanian banking system invest in state bonds.

The inflation trend also downward will give the possibility to the National Bank of Romania to lower the key rate even below the present record low of 5,25%, which will not be immediately felt in a cheaper crediting and investment growth, being a lot of examples in the last 3 years when a reduction of key interest rate motivated by encouraging economic growth didn't also lead to a decrease of interest rates applied by banks for loans extended to enterprises, the reducing of key interest rate in 2009 was followed by an increase of average rates applied by banks for loans.The reduction of key interest rate is influenced by the economic reality but we must take into account the inflation expected for the next period of time as otherwise in periods of inflation the growth of key interest rate is an efficient leverage to stop the inflationary phenomenon through reducing crediting and hence the liquidities or, by increasing the return of investment in local currency.

2. THEORETICAL CONSIDERATIONS ON THE EVOLUTION OF MONETARY POLICY INTEREST RATE

The early stage of interest practised by NBR in order to achieve its objectives in monetary policy is the discount rate. This one along with monetary and credit policies used by NBR may influence monetary supply in circulation at a given time. Basically the discount rate is the fee paid by commercial banks to NBR for liquidities received. In fact, we can speak of a rediscount because bills sold by commercial banks are also being obtained through a primary discount transaction. Being considered a penalty rate, the discount rate is bigger than the rate practised on credits market. Through the influence that exerts on the economic life in its whole, the discount rate was used by NBR for a long time in achieving the monetary objectives reported. A high discount rate can lead to the decrease of monetary supply in circulation, and hence the volume of credits offered by commercial banks with major implications over the level of inflation and unemployment, while a low discount rate relaunches the economy through monetary supply growth and implicitly of loans for economic life participants.

Thus we can notice a close connection between the level of discount rate and average interest rate, any modification in a positive or negative way entails a modification of the average interest rate in the same direction, but with a different intensity. This inevitable connection between average interest rate and discount rate affects the entire economic life, both internal and external, and in the last case we can speak about visible effects on foreign capital, on realising equilibrium of balance of payments. But, because this invasion of foreign capital cannot be controlled, it can be harmful both to the economic development at that time, and the monetary policy objectives promoted by the central bank.

The Central Bank was using the discount rate to achieve its monetary objectives, but due to the growth of liquidity level in the banking system, they had to give it up and introduce a new notion: reference interest rate, a normal approach considering the evolution of monetary conditions. A possible reactivation of the discount rate is very unlikely, because NBR tried and is continually trying to align its procedures to those of ECB, and the discount rate is not included through the instruments used. The macroeconomic framework of Romania of the 2000s can be described by a liquidity surplus in the banking system due to the increased capital inflows. Therefore, to avoid a possible growth of inflation due to excessive liquidity on the market, the central bank used

sterilization operations, operations used by most countries on the brink of joining the European Union of Eastern and Central Europe. Therefore the discount rate has a new name and a new formula, thus becoming: NBR reference interest rate that will try to efficiently outline the aim of central bank, as well as the economic situation of the country in key moments. As a formula, this one is determined like a weighted arithmetic average of the volume of transactions, the interest rates on deposits and reverse repo operations of the previous month for which the announcement is made.

This shift to the reference rate didn't have major influences over the economy because their values were relatively close. Thus, starting 1 February 2002, the National Bank Circular does no longer contain elements referring to the official discount rate. From this moment, the reference interest rate was calculated and communicated monthly, through the Circulars of the Central Bank. At the same time its value is going to be published in the monthly bulletins of NBR. Therefore, the reference interest rate comes into force on 1 February 2002, through Circular no.3 of National Bank of Romania which will repeal the NBR Circular no.11/1998 and that will set the reference interest rate for February 2002. Because of NBR net debtor position towards the banking system, this rate cannot be confused with reference interest rate of central banks in mature markets. Usually, it is a benchmark interest rate whose value is based on floating rates of interbank interest rates and those on bond markets and deposit certificates. It can be also seen as sign for inflation movements or as one of economic healthy.

Depending on the NBR reference interest rate level, it is established the legal interest rate, an interest rate that is taken into account by courts in commercial litigations and in accountancy, thus: – the one in the first working day of the year, for legal interest due on the first semester of the current year**;** and – the one in the first working day of July, for legal interest due on the first semester of the current year. The period October 2008 – January 2009 brought modifications to NBR position, this one moves from the debtor position of banking system to creditor of the same system. This element explains the NBR Board decision to modify the structure of reference rate starting with February 2009. Therefore, this becomes the arithmetic average, weighted with the volume of transactions, interest rates of deposits, reverse repo operations of previous month for which the announcement is made. September 2011 brings new modifications over reference rate calculated by NBR, so it acquires a new name, becoming the monetary policy interest rate, established through a decision of the Board of Directors of National Bank of Romania.

3. THE IMPACT OF MONETARY POLICY RATE OVER ECONOMIC RELATIONS

The monetary policy interest rate practised by NBR showed significant jumps from 2009 until 2012, as it is shown in table no 1. The level of the interest rate promoted by the National Bank of Romania has shown a permanent decrease starting August 2009 and reaching the historic record 5.25% in March 2012. The most spectacular jump of reference interest rate was in March 2012, when the rate reaches 5, 25 percentage points, 4, 25 percentage points less than in the same period in 2009. Therefore, we can say that, interest rate can enter a decreasing trend, the decrease being constant and significant. As far as the interest rate for lending facility and deposit facility are concerned, the decrease is felt with a similar intensity as in monetary policy interest rate.

Table no.1 The NBR monetary policy rates and permanent facilities

(% p.a.)

Date	Monetary policy rate	Lending facility rate (lombard)	Deposit rate
30 Mar.2012	5,25	9,25	1,25
03 Feb.2012	5,50	9,50	1,50
06 Jan.2012	5,75	9,75	1,75
03 Nov.2011	6,00	10,00	2,00
05 May 2010	6,25	10,25	2,25
30 Mar.2010	6,50	10,50	2,50
04 Feb.2010	7,00	11,00	3,00
06 Jan. 2010	7,50	11,50	3,50
30 Sep.2009	8,00	12,00	4,00
05 Aug.2009	8,50	12,50	4,50
01 Jul. 2009	9,00	13,00	5,00
07 May2009	9,50	13,50	5,50

Source: www.bnr.ro /info finaciar/monetary market

The decreasing variation of monetary policy interest rate was also reflected in economy, through its influences on indicators in table no.2

Table no.2 The evolution of the main macroeconomic indicators

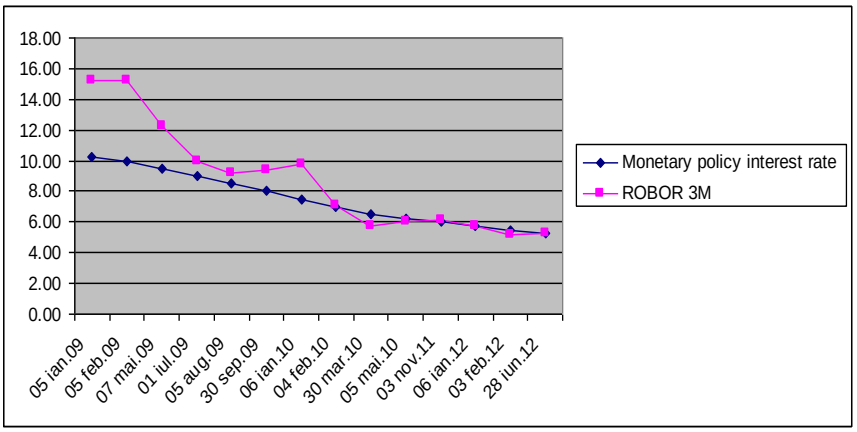
Name indicator/ Year	December 2008	December 2009	December 2010	December 2011	July 2012
Export (FOB) - Mil. EUR	33.725	29.116	37.368	45.041	26.091
Import (FOB) - Mil. EUR	52.834	35.903	44.968	52.563	30.122
BALANCE	**-19.109**	**- 6.787**	**-7.600**	**- 7.522**	**- 4.031**
Domestic credit (mil. RON)	215.260,9	246.697,9	270.668,0	292.848,9	310.415,3
Broad Money (M3, mil. RON)	174.027,8	189.630,3	202.772,6	216.208,1	221.463,8
Interbank transactions: Daily average (mil. RON)	2.018,2	2.769,6	1.694,5	1.600,9	1.509,3
Average interest rate (%p.a.)	**11,54**	**10,06**	**3,28**	**5,04**	**4,04**

Sources: data from NBR monthly bulletins, December 2008 - July 2012

The monetary policy sets the tone to all rates practised in economy, while its fluctuations in one way or another, have consequences on prices in economy, balance of payments, the volume of credits in economy, reviving or moderating the economic life. Handling this interest by the National Bank of Romania directs also the level of the other rates in economy with a particularly important role in adjusting the report between demand

and supply on the credit market. Following the decrease of the reference rate, the volume of monetary supply increased, commercial banks pleading for rediscounting bills at a lower rate. Also the growth of money supply in circulation led to the growth of credits, which records the amount of 310.415,3 million Lei at 31.07.2012. The reference rate recorded a decreasing trend in the analysed period, which attracted foreign capital and influenced the balance of payment. Therefore, at the end of each year the balance recorded a deficit decreasing from one period to another.

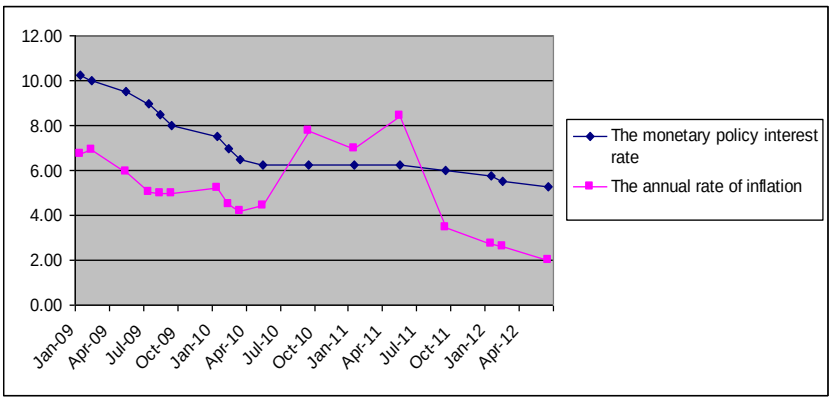
Graphic no.1 Monetary policy interest rate and ROBOR 3M



Sources: data from NBR monthly bulletins, December 2009 - July 2012

We notice that, in the entire period analysed the mechanisms of transmission of monetary policy to the real economy were operating at optimal parameters. Therefore, the downward trend of the reference rate didn't shake the monetary market because the level of interest rate at interbank loans on 3 months was pretty close, which means that in the banking system were enough liquidities. Also, this alignment of the two parameters communicates that the monetary market understood and applied correctly the signals of NBR.

Graphic no.2 The monetary policy interest rate and the annual rate of inflation



Sources: data from NBR monthly bulletins, December 2009 - July 2012

The analysed period reflects a strong period of monetary policy which successfully coped with the irregular evolutions of inflation. As we notice from the graphics the inflexion points recorded on the interest rate curves are situated before those recorded on the curve of interest rate therefore a sign that monetary policy anticipated the inflationary shocks.

4. CONCLUSIONS

When the Central Bank establishes the monetary policy interest rate as an objective of its monetary policy promoted, it also should be able to control it, because its level influences directly both the option of capital owners between investments and placements as also the behaviour of non-financial agents between investments and placements. The level that NBR establishes should be quite attractive to stimulate savings, but without heavily slowing down the economic development. The monetary policy interest rate is a very important instrument, applicable both internally and externally: externally, the interest rate has an important impact on short-term capital flows and internally, influences the demand for loans, the volume of investments, employment, the global demand.

The variation of interest rate may have different effects on the monetary supply according to the period of time referred to, so in case of a superficial analysis it may create the impression of a contradiction between the two objectives of the monetary policy. Romania will have to cope with challenges in order to meet its 2015 target to join euro area with direct implications over monetary policy interest rate and inflation. According to the Treaty of Maastricht regarding the conditions of economic convergence for Member States that would participate to the Economic and Monetary Union, Romania should reach the targets related to inflation, public finances, exchange rate stability and long-term interest rate. The inflation rate must not exceed more than 1, 5% the average of inflation rates of the three best performing Member States in terms of inflation and also Romania will have to reach a long-term nominal interest rate that does not exceed more than 2 percentage points interest rate of three best performing Member States, in terms of inflation besides observing the conditions of public finances, the stability of exchange rate.

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