THE MANAGEMENT OF INTEREST RATE IN THE CONTEXT OF THE MONETARY POLICY PROMOTED BY THE NATIONAL BANK OF ROMANIA

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1. Introduction

The monetary policy framework is represented by the institutional arrangements through which the monetary policy decisions are approved and implemented. Choosing this framework depends on a series of factors inside and outside the central bank, as well as the characteristics of financial system together with institutional aspects. At the level of central banks, general public and academic environment, there was an appropriate agreement according to which the stability of prices is favourable to development and economic progress, the National Bank of Romania assuming the task of ensuring its achievement through the monetary policy. Therefore, the price stability represents the main objective of monetary policy. It is both an end in itself and a means for monetary policy, since it contributes to the achievement of a sustainable economic growth and macroeconomic stability (Bernanke, 2006)[1].

The recommendation is generally valid for all economies whether we speak of emergent or developed economies. For central banks belonging to emerging economies such as the case of Romania, the task is more difficult to achieve, because in their case, the poor development of instruments on the financial markets cannot efficiently answer to possible inflationary shocks which may occur anytime. Thus, these shortcomings of emergent economies impose the use of a mixture of both instruments and monetary policies, in order to achieve the desired objective of the monetary policy, ensuring in a sustainable manner a low inflation. If the economic policy does not help the monetary policy, NBR might encounter difficulties in achieving its goal, as well as the use of a single monetary instrument, without considering that the evolutions of the other indicators could lead only to short-term favourable results.

The monetary policy interest rate is a valuable instrument in the policy promoted by NBR, together with monetary aggregates and exchange rate. In this article, I will stop, as outlined in the title, to the management of interest rate in the context of monetary policy of National Bank of Romania, trying also to emphasize the usefulness of using this indicator in a mix of monetary instruments, which come to substitute its limits. Stabilizing inflation around a well-established target area must be realised by NBR, without destabilizing economy by generating some excessive fluctuations.

The characteristics of emergent economies, such as supply-side shocks, the expansion of monetary substitution phenomenon, the fragility of fiscal institutions, shallow financial markets, vulnerability to sudden withdrawal of

[1] Bernanke, B. - *The Benefits of Price Stability,* discourse sustained at „The Center for Economic Policy Studies" and on occasion of „Seventy-Fifth Anniversary of the Woodrow Wilson School of Public and International Affairs", Princeton University, Princeton, New Jersey, 24th February 2006

cash inflows and labour force migration contributes to the amplification of complexity of monetary policy decisions designed to achieve the price stability goal (Isărescu, 2008)[2].

2. Monetary aggregates or interest rate

Both empirical evidence and literature have revealed the importance of knowing the transmission instruments of the policy promoted by the monetary authorities. The achievement of the final objective of monetary policy involves several stages and implicitly, establishing intermediate objectives, through which the National Bank of Romania may determine ways of action, as well as operational objectives by means of which we can track the status of the objective proposed.

Among the intermediate objectives we include the use of monetary aggregates, interest rate and exchange rate. The question that arises is which of these objectives serves the best to achieve the final objective of monetary policy within a defined time interval. The economy is an unpredictable phenomenon, which may, at any time, depending on the stage in which it resides, turn the ultimate objective of monetary policy into intermediate objective and vice versa. This is the case of monetary aggregates, which until 2000 were considered the main central pillar to achieve economic stability.

Ever since the mid-90s, appeared recommendations of some illustrious academicians who considered that the monetary anchor is an objective which no longer corresponds to requirements and changes of economy. Mishkin and Estrella (1996)[3] were wondering in a title that raised many controversies „ Is there a role for monetary aggregates in the conduct of monetary policy?" question that has a clear answer in the conclusions of the famous article, the monetary aggregates may successfully meet three roles in monetary policy : informative variables, indicators of monetary policy and instruments within it. For Romania, but it was still too early, the replacement of monetary aggregates as an objective of monetary policy of NBR with inflation targeting, although it would have taken the audacious decision to make this change, our country did not meet any of the mandatory criteria to access this objective, at that time the annual inflation rate was still expressed in two digits.

The domination of monetary aggregates couldn't last much in our country because the instability of money velocity led to a low connection between money and inflation. The formation of arrears at the level of state enterprises acting as money substitutes was another reason for which the role and importance of monetary aggregates began to decline in the monetary policy stance. The passage of monetary aggregates to intermediate objectives together with interest and exchange raises new dilemma in establishing the importance of each indicator in targeting inflation, the main objective of monetary policy starting August 2005.

Thus, the overshadowing of monetary aggregates doesn't mean that they have lost their importance in the monetary policy objective established by NBR. In the lines that follow I will try to capture the contribution they have along with the monetary policy interest rate, in the monetary policy promoted by the central bank.

[2] Isărescu, M., - Monetary policy issues in an emerging economy. The case of Romania", discourse sustained at the Royal Academy of Economic and Financial Sciences , 21st February 2008, Barcelona, Spain,

[3] Estrella, A., Mishkin, F. - "Is There a Role for Monetary Aggregates in the Conduct of Monetary Policy?", NBER Working Papers 5845, 1996

Table no. 1 Monetary aggregates * and annual inflation rate

INDICATORS	31/12/2008 (mil. lei)	31/12/2009 (mil. lei)	31/12/2010 (mil. lei)	31/12/2011 (mil. lei)
M1 (Narrow money)	**92 605,3**	**79 369,3**	**81 604,8**	**85 835,0**
Currency in circulation	25 313,8	23 973,0	26 792,9	30 608,7
Overnight deposits	67 291,5	55 396,3	54 811,9	55 226,3
M2 (Intermediate money)	**173 736,5**	**188 017,3**	**199 586,4**	**212 059,3**
M1	92 605,3	79 369,3	81 604,8	85 835,0
Deposits with an agreed maturity up to 2 years(Deposits redeemable at a period of notice up to 3 months here included)	81 131,2	108 648,0	117 981,6	126 224,3
M3 (Broad money)	**174 135,5**	**189 634,5**	**202 763,4**	**216 208,1**
M2	173 736,5	188 017,3	199 586,4	212 059,3
Other financial instruments	399,0	1 617,2	3 177,0	4 148,8
INFLATION RATE (% - annual average level)	**7,30**	**5,59**	**6,09**	**5,79**

* Provisory data;
Source: NBR, Press release – *Monetary aggregates: December 2009, 2010, 2011*, Inflation report, 2012

The interpretation of the data presented in the table above allows us the evaluation of positive effects of monetary aggregates use, as well as their inherent limitations. Among the positive effects, we firstly mention, the appearance of a new monetary aggregate - M3, starting with 2007, an aggregate which represents broad money and together with the evolution of macroeconomic indicators led to the restoration of confidence in national currency. This led to the decrease of inflation rate at a quite distant level from the proposed level by the National Bank of Romania in the monetary policy promoted.

Regarding the connection between monetary policy interest rate and inflation rate, the data presented in table no 2 suggest us a stable monetary policy, which was understood and was adapted to chaotic fluctuations of inflation rate. However, analysing the two indicators, we observe that the decrease of monetary policy interest rate to historical minimum of 5.25%, on March 2012, was correctly received by the market, which answered to the central bank through a very low level of inflation. Practically, we may say that monetary policy has managed to anticipate inflationary shocks through its indicators.

Table no. 2 Monetary policy interest rate and annual inflation rate (% per year)

Date	Monetary policy interest rate	Lending facility rate	Deposit facility rate	Annual inflation rate
30 Mar 2012	5,25	9,25	1,25	2,40
03 Feb.2012	5,50	9,50	1,50	2,59
06 Jan.2012	5,75	9,75	1,75	2,72

03 Nov.2011	6,00	10,00	2,00	3,44
05 May2010	6,25	10,25	2,25	4,4
30 Mar.2010	6,50	10,50	2,50	4,2
04 Feb.2010	7,00	11,00	3,00	4,5
06 Jan.2010	7,50	11,50	3,50	5,2
30 Sep.2009	8,00	12,00	4,00	4,94
05 Aug.2009	8,50	12,50	4,50	4,96
01 Jul.2009	9,00	13,00	5,00	5,06
07 Mai.2009	9,50	13,50	5,50	5,95

Source: NBR, Data sets – Monetary policy indicators, Inflation Report, 2012

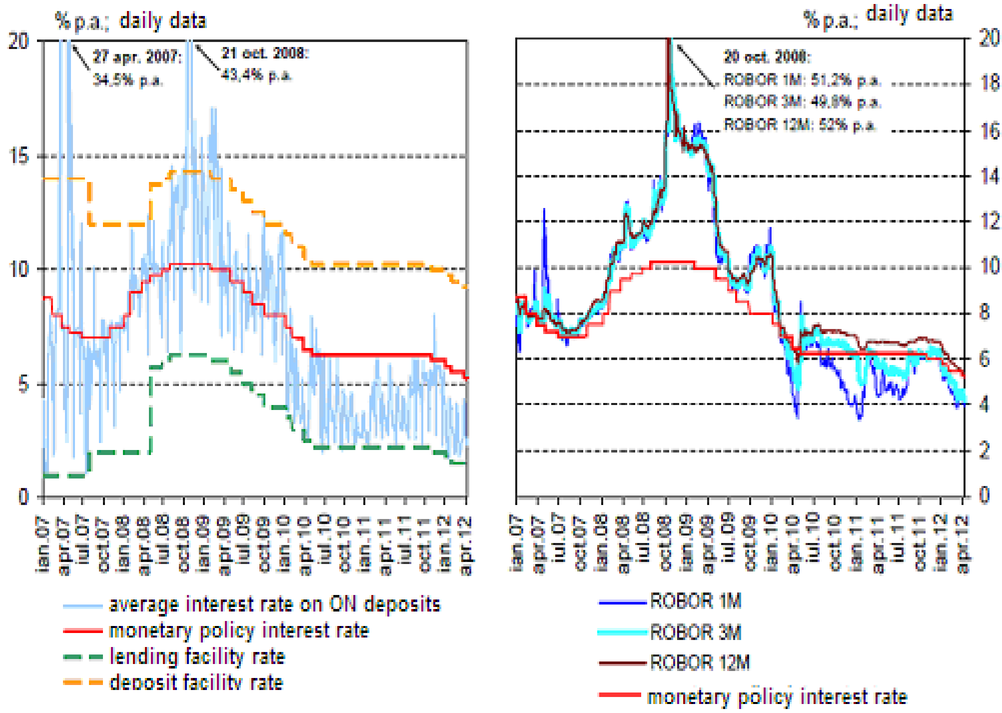
As we can see, any of the two instruments do not always respond in an effective manner to monetary policy requirements. Thus, we share those opinions that consider that, when interest is targeted, money must necessarily be included in the set of informative indicators and vice versa. This is due to the fact that Romania has always been marked by serious imbalances both on goods and services market and the money market, so that the quantification of their intensity and selecting the best variables are very difficult.

3. Interest policy promoted by the National Bank of Romania

The monetary policy of the National Bank of Romania in recent decades has focused on three standard strategies, both in emerging countries and in developed countries: monetary aggregates targeting, exchange rate targeting and inflation targeting. Within the policy promoted, the central bank agreed the control of monetary aggregates as intermediate leading objective. The question that arises and to which I will try to answer in this last part of the present article concerns the effectiveness of the use of interest rate by NBR, considering that this doesn't fulfil the role of main intermediate objective. NBR tried to use for 2007 – 2012 the framework operational components of monetary policy to an effective adequacy of liquidity to all the challenges arising in this period.

The suitability of real monetary conditions in a broad sense, in terms of the objective of monetary policy was realised through the interest rate policy, sustained by the appropriate management of liquidity by the central bank; in the latter, the monetary market operations, NBR facilities and minimum reserve system continued to hold the main role. Against relative growth of restrictiveness of liquidity conditions, in the second part of the first quarter of 2011, the average interest rates on short-term in the interbank money market, but also the average quotations of ROBOR 1M and ROBOR 3M increased, positioning themselves to close value to the monetary policy interest rate; but in the same time, the average quotations of maturities that are at the high end of the maturities spectrum of monetary market (ROBOR 6M, ROBOR 12M) have reduced the positive gap they had towards it.

Graphic no 1 The Behaviour of interest rate on the interbanking money market



Source: NBR, Report on Financial stability 2007, 2008, 2009, 2010, 2011, 2012

Against this background, the resumption of the cycle of decreasing the monetary policy interest rate had the effect of returning the interbanking monetary policy interest rates on a downward trend, including quotations ROBOR 1M and ROBOR 12M, their adjustment – interrupted only temporarily, in mid-November by an episodic growth which has been fully corrected in the next – sensitively emphasised by the end of the year, thus creating the premises of descent in the next period of interest rates on loans and deposits of non-banking clients.

The manner in which NBR managed liquidity continued to be adapted to liquidity conditions particularities of the banking system and those of functioning in the different segments of the financial domestic market. Therefore, in the context of emphasizing the downward correction of excessive high interest rates of loans and deposits in lei of non-banking customers, in the last part of 2010, the management of liquidity of the central bank was appropriate in the first quarter of 2011, from the point of view of sustaining the return of interbanking monetary policy interest rates from the lower and lower values they reached during December 2008 – January 2011.

Table no 3 The average rates of interests practiced by commercial banks for new loans (% per year)

Year	Loans granted to households with agreed maturity			Loans granted to non-financial corporations with an agreed maturity		
	Up to 1year inclusively	between1 year and 5 years	over 5 years	Up to 1year inclusively	between1 year and 5 years	over 5 years
2007	10,65	14,08	11,35	11,60	11,81	11,55
2008	18,37	20,38	15,38	19,73	18,43	18,58
2009	14,16	19,14	14,92	15,35	16,48	14,50
2010	12,03	12,19	11,34	9,50	9,36	9,28
2011	11,72	13,40	12,37	9,73	9,38	10,53

Source: NBR, Monthly bulletin no. 12/ 2011
Note: Starting June 2010, the average interest rate is determined according to Norms No.11/2009 issued by NBR which replaced Norms No.14/2006, Annual Data refer to December.

Since during this time the net position of bank liquidities had frequent, but relatively modest sign changes – associated with amplification of volatility of autonomous liquidity factors – the central bank acted alternately from debtor position, respectively creditor of banking system.

In most of the first quarter of 2011, the monetary policy operations were designed to drain the liquidity excess of banks, only at the end of February and first days of March the central bank provided liquidities to banking system, performing repo operations with one week maturity.

4. Conclusions

The management of interest rate in the context of monetary policy promoted by the National Bank of Romania was and will always be a topical subject, because the direction in which the monetary policy interest evolves represents a signal, sometimes of alarm for the entire economic life.

The use of this indicator, but only singular in achieving the monetary policy objective, cannot lead to desired results, because the unpredictability of economic environment requires a special attention on a large number of economic reactions. Therefore, an efficient monetary policy involves choosing and using a mixture of economic indicators, which through their variety may answer to all modifications of the market. Not only the path of key interest rate gives the monetary policy stance, in some cases the elements of influence may be represented by operational decisions of the central bank.

The economic thought was and will always be influenced by major crises. Before 2008 crisis, the analysts and academicians considered that the great challenges wherewith monetary policy was facing were overtaken, a thought which became obsolete due to the economic events of the year mentioned. Thus, only recognizing the existent interconnections between financial stability and prices stability implies the possibility of achieving an optimum monetary policy.

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