EFFICIENCY AND LIMITS OF MONETARY POLICY IN THE FINANCIAL INSTABILITY. ROMANIA'S CASE

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1. Introduction

The world has evolved from closed and dogmatically economies toward open and flexible actual economies, in the same time adjusting concepts regarding general objectives of economic policy. It is recognized more and more the role of monetary policy as a tool of indirect intervention, most often used by modern authorities, initially as an intervention through the currency on the currency and then toward the entire economic system.

Through its sphere of action monetary policy aims to achieve monetary equilibrium both in internal and international relationships.

Central banks and regional monetary authorities as European Central Bank aim to ensure price stability appealing to a fiscal-monetary mix. The current global financial crisis that has propagated rapidly created great difficulties to all countries regardless their degree of development. The fall of real estate markets drew after itself the banking system contamination and disturbance of economic policy strategies.

Even the political world doesn't seem to be alerted by current recession, banks and monetary authorities look desperately for quick economical solutions but they delay to appear.

Romania is far from an exception to this situation. National Bank requires government support in creating of a fiscal-monetary measures mix ready to adapt the Romanian reality to the European economic recovery mechanism.

2. Monetary policy today

Today, monetary policy strategies related to the intermediary objectives that means monetary aggregates, interest rate linked to inflation and exchange rates.

International Monetary Fund-IMF-classified monetary policy strategies in 4 categories and presented their development in industrialized and unindustrialized countries the last twenty years (1985 to 2005).

- *Inflation targets*
- *Monetary targets*
- *Managed floats &Multiple targets*
- *Exchange rate targets*

In an IMF's analysis in 2006 following issues are emphasized:

- *Inflation targets* are approached for about 15 years by the developed countries, representing in 2005 about 25% from all developed countries, while the undeveloped countries approached this strategy after 1995, with a share below 10%;
- *Monetary targets* in developed countries experienced a reduction from about 20% during 1985, up to a near abandonment around 2000, about 10% from undeveloped countries have maintained these strategies throughout this period;
- *Managed floats &Multiple targets* had a great expansion in developed countries, from about 20% to 70% of the developed countries as an expression of all economic policies pragmatism and,

therefore, of the monetary policies, the less developed countries could not achieve these strategies than the proportion of 25%;

- *Exchange rate targets* were reduced rom 55% to less than 5% for developed countries, existing a trend to abandon this targets, in contrast, the undeveloped continues to target the exchange rate strategies being used in 2005, yet over 55% of the undeveloped countries, but lower compared to 75% in 1985.

The basic objective of actual monetary policies is to ensure and maintain price stability, that meaning a positive, low and stable inflation.

► Countries with developed economies have experienced many strategies, but now believes that they reached the objective of price stability, so that in recent decades led to a stabilized inflation around 3%. Their central banks, however, monitor any possible disturbances factors and, according to Taylor, arrogate its right to take appropriate measures.

► Countries with less developed economies and emerging economies, as considered countries in transition, use different strategies of monetary policy to achieve that final goal. As noted, countries with developing and emerging economies put a big emphasis on the objective of the exchange rate (exchange rate).

According to the IMF classification, there are following types of exchange rates arrangements (ordered from extreme situations with serious economic and political situation toward democratic economies and economically developed):

- *without national currency* (the currency of another country circulates as the only official currency and give up completely to the independence of internal monetary policy ; this system is for special political circumstances);
- *monetary board* (fixing the exchange rate at a certain rate comparing to a strong currency for which exists economic interests or big restrictions for domestic monetary policy);
- *fixed conventional exchange rate* (link the national currency at a fixed exchange rate to another currency or basket of currencies, but the traditional functions of the central bank are exercised, the monetary authority can adjust the exchange rate, even through further devaluation);
- *horizontal fluctuation band* (that means setting an administrative fluctuation band with an upper limit and a lower limit of a central rate, as the mechanism of the European Monetary System called "monetary snake", starting since 1 January 1999, the current mechanism for exchange currency is Exchange Rates Mechanism II or ERM II; the central rate is the exchange rate between the national currency and the benchmark currency or currency basket, fixed for 2 years in ERM II;); central bank aims to set the central rate, width of the fluctuation band and to support and maintain the exchange rate within the band through purchase/sale foreign currency but currency reserves of the central bank must have an appropriate level);
- *adjustable fixed exchange rate or crawling peg* (currency is adjusted periodically by small amounts at a fixed course or in response to changing select quantitative indicators such as inflation differential against trading and financial partners, the differential between target inflation and their expectations);
- *fluctuation adjustable band or crawling band* (the currency is maintained within the limits of maximum and minimum fluctuation of + / - 1% compared to the central rate, as horizontal fluctuation band, but is more flexible width of the fluctuation band, depending on the constraints of monetary policy);
- *managed flotation* (the monetary authority is involved for short periods to influence the exchange rate, but without having a certain objective (target), by direct or indirect interventions; for

instance, through sales of foreign currency in case of a sudden depreciation of currency or by purchasing foreign currency in case of sudden appreciation; central bank should have a considerable foreign exchange reserves);
- *free flotation* (the monetary authority is not involved anymore in the formation mechanism of exchange rate, but has responsibilities for conduct surveillance of operations in the foreign market and the in the survey of institutions involved in this market; it is specific to the developed economies, able to support any possible imbalances, in the first place of the balance of payments).

Of course, to the strategies regarding the exchange rate should be added the strategies regarding targeting the monetary aggregates and aiming the inflation.

Specifically, in 2006, the IMF published the following data, summarized in the following table:

Monetary policy strategies in developing countries and emerging countries

Monetary policies strategies	Usage degree-%
1. Free or controlled flotation under IMF programs or other programs	20
2. Peg with one foreign currency	20
3. Currency basket	12
4. Targeting inflation	7
5. Currency of another country as a legal currency (without currency)	6
6. Monetary Board	4
7. Crawling peg	4
8. Peg composite	4
9. Horizontal band	4
10.Aiming monetary aggregates	2
11. Other policies	17

Each of these strategies have positive effects and adverse effects, requiring their rigorous analysis on the example of each country where was applied, taking into account certain factors from that period of time.

Closing chain of elements of monetary policy should allow classification into a *particular type of policy*.

Practice shows that in developed economies, based on mechanisms of real and financial market, has overcame choosing phase between keynesian (which considers as primary the fiscal policy) and monetarism (based on monetary policy). In fact, there is a mix, which combines an expansionary policy with an expansionary fiscal policy, stimulating or restricting expenditure adjustment process and inflation expectations, with effects in the short term or long, which can be explained simply in steps in the short term and long term.

A. Short-term effect of a currency supply's changing

a) If money supply increases (the LM curve) takes place the following steps:➔ people want to buy bonds, so their exchange rate increases, reducing the interest rate ➔ low interest rates lead to the investment increasing and spending money (the IS curve), taking into account a number of multipliers ➔ when expenses exceed the initial production appears inflation, with rising prices ➔ higher prices reduce real wealth, but reduce the real money supply, defending the inversion process from initial offer big money.

The overall effect created by increased supply of money is a stimulus for aggregate demand, increasing production, but prices and inflation also.

b) If money supply decreases, the effects have reverse steps, such as:➔ decrease in demand for buying securities reduces their course, but the interest rate increase ➔ decreases production and prices ➔ demand reduce to the offer

level until the point of inversion, because if all people sell bonds, raise money, and so increase the supply of money.

The overall effect created by reduced supply of money is a brake on the aggregate demand by reducing production, and also prices and inflation.

B. Long-term effect of a change in the currency supply's changing

a) If the supply of currency increase (in LM) follow the 4 steps outlined on the short term with the addition of the 5th step, as follows:➔ adjustment on the long term through reducing aggregate supply, so that although the current actual production is higher than the potential production continues to be an upward pressure on final prices of goods. Nominal price increase, but the actual remains unchanged, so the balance is achieved. In this way money will express the same quantities of real goods, coming back to the point of balance between aggregate supply and demand.

b) Reducing the supply of money on the long term effect would be reversed, but it is not practiced in real life, because it would dramatically restrict the economy.

In conclusion, on the long-term, an initial growth of money supply leads to a temporary increase of actual real production, but comes a phase of contraction, because of the relationship between real income, interest rate and inflation rate in a situation of excess demand, restoring the balance at the level of the potential employment of production factors.

C. Short-term effect of a fiscal changes

a) Increasing tax leads to the rising of government expenses, which has 4 steps of changes: ➔ increase the demand for final production ➔ increase the prices level and nominal money demand, but decreases the real money supply, thus increase the interest rate ➔ decrease investment, negating some of the initial increase in aggregate demand ➔ reach a point that shows the same effect as the supply of money increased.

So, the effect is an interest rate that remains high and investments are lower than in the initial phase.

b) Reducing taxes effects have inverse effects, but it depends on the performance where public economy expenditure are not essential, since the reduction of public funds can seriously affect economic and social mechanisms.

D. Long-term effect of a tax changes

It is considered that the effects on the short-term are extended on long term.

Essential difference between the effects of monetary policy and fiscal policy shows that if a policy of monetary expansion, the economy returns to the same level of real balance, with all variables unchanged, but the expansionary fiscal policy results are contradictory, as following: real national income come back to the real potential, but increasing government spending seriously affect long-term investments and consumption and growth rate.

Therefore, even monetary and fiscal policies appear to have the same mechanisms, they have different consequences on the structure of aggregate demand, disturbing expectations and forecasts of the companies and population.

The effects of the two policies are more complex and enhanced in an open economy, in which occurs the exchange rate evolution and capital mobility. Application and effects of the two policies depend on the quality of governance act at the intern and international level.

Money in the modern economy varies depending on the budget deficit net of public and private sectors, plus net exports, and internal and external deficits have opposite effects money in an open economy in which capital movements are rapid and complex on the short and long term. The effect is releasing the central banks is issuing the conceptual

monetarist programs in order to reduce interest rates and boosting real keynesian investment against stagflation.

In conclusion, economic pragmatism has focused new targets for economic growth with inflation tolerable because of artificially declining of interest rates stimulates speculations instead of real investment, by appropriate ***monetary-fiscal mix and a reconsideration of the role of authorities to manage the banking deregulation and the effective exercise of the state's role.*** The problem of inflation is always combined with the problem of unemployment and known dilemma (fiscal policy or monetary policy) is already exceeded.

3. Feedback on the monetary policy effectiveness in Romania during the current financial crisis

The effectiveness of monetary policy is analyzed on two levels:

a) Monetary policy has effects in steps, more exactly, if the at the macroeconomic level can be a restrictive or expansive policy, it acts first on economic activity and second on price. For example, an increase in money on 2 years create on the first year an effect - volume, and on the second effect - price. So, by injecting additional liquidity increases the activity of economic agents, but subsequently increases prices too, leading to a new imbalance.

b) Monetary policy is an effective tool, preferred by the authorities, because it has a reduced period of time between deciding and when it is acting and effects are obtained by different instruments of intervention. It is composed of discrete steps, usually avoiding confrontation with parliament, the unions and the vast mass of the population. Intervention is very rapid and may take several hours, days or weeks, compared to fiscal and budgetary policy, which goes quite a long time between decision and implementation and effective achievement effects.

Simplified approached, the monetary authorities *attempt to target a "convenient" level of monetary growth, a "reasonable" level of interest rate, exchange rate, aiming that all to facilitate the optimal allocation of national financial resources.*

■ The effectiveness of monetary policy is influenced by the **transmission channels**, which allow monetary instruments to interfere on monetary quantities.

Efficacy is exercised by three effects with different channels of transmission:

1. Effect-price or cost of capital, which uses as channel transmission the exchange rate.
2. The effects of wealth, which is transmitted through economic assets, and through their cash and consumption, involving expectations of the economy.
3. Reporting effects generated by monetary policy, which is transmitted through forecast channel on subsequent developments.

The effectiveness of monetary policy depends on a number of factors related to the nature of economic and financial system on the degree of effective control exercised by the monetary authorities, the quality of coordination with other instruments of economic policy or the behavior of economic agents and their ability to adapt to the public authorities decisions

In terms of BNR attitude regarding current economic crisis effects, there are opinions that believe we should adopt a prudential policy and to avoid aggressive decreasing of interest rate, when fiscal policy "raises some questions."

However the strong contraction of the economy, disinflation trend and the LEU stability in the last period of time have determined National Bank to reduce the key interest (8.5% in August 2009, **up 8% until the end of this year**).

Another argument for reducing key interest it would be also the **disinflation trend**. Analysis of the most recent statistical data reveals the continuation of disinflation process, the annual inflation rate lowering at the level of 5.95% in May 2009 comparing to 6.45% in April, taking into account reducing of price dynamics and to the volatile ones Inflation basis of adjusted Core2 - calculated by removing the impact of administered prices, of the volatile (vegetables, fruits, eggs and fuels) and vice tax – decrease at a low level of 5.04% in May, compared to 5.51% in previous month, reflecting the decreasing of aggregate demand.

There are opinions that expected achievement will be minimum in July of this year, below 5%.

Minimum reserves are maintained at a constant level but decreases are expected in the next monetary policy meeting, depending on how will be accomplished the external funding agreement with the IMF and EC.

Dropping the minimum reserves for liabilities in foreign currency has surprised the market.

On the other hand, the NBR will continue to use active market operations to implement adequate liquidity in the banking system.

Mentioned developments, coupled with continued disinflation process in the following months, highlights the need for calibration of monetary policy in order to ensure a range of real monetary conditions appropriate to both the convergence rate of inflation targets set in the medium term, and for sustainable revitalization of the Romanian credit economy These decisions will contribute to ensuring an adequate level of liquidity and a gradual return to the interest rates. Board of administration of the NBR considers that this strategy will contribute to ensuring an adequate level of liquidity and the gradual return of interest rates charged by commercial banks, both to deposits and credit, to natural functional position in relation with interest rate of monetary policy.

Financial crisis in the Romanian banking system should not be removed from the context. Specialists of the European Bank for Reconstruction and Development (EBRD) has warned that current economic crisis threatens to cancel almost two decades of economic reforms in East and Central Europe.

The conclusion is that it is necessary of an international support because the issues facing the region are strongly intertwined with those of the entire continent, and viable solution to this situation would be a coordinated response from the public and the international financial institutions.

4. Conclusions

- Transmission mechanism of monetary policy of the NBR is the “result” of combination of the general characteristics of the economy (size, degree of openness) on the one hand, and rhythm and depth of institutional and structural reforms and macro stabilization in transition period of time, on the other hand.

- Strategy of monetary policy and its operational framework - determining for the effectiveness of monetary policy - have the constraints exerted by this combination of factors. Both are adapted continuously to the concrete implementation conditions.

- Monetary control exercised by the central bank and monetary quantitative variables has attenuated their relevance in the monetary transmission mechanism, the role of interest rate in sterilization operations becoming increasingly important, including their ability to signal the monetary policy.

- NBR interest rate has a direct influence on interest rate deposits. Instead, the interest rate bank loans do

not appear to be sensitive direct to rate of absorption operations performed by the central bank, but to the interest rate deposits. Both financial retail prices are affected by the minimum reserves.

- Exchange rate and foreign currency purchases by the NBR represented for many years the most important ways that the central bank has exerted influence on economic behavior.

- Traditional channels of monetary transmission mechanism of NBR are still at an early stage of formation, but their restoration began in 2000, with the cessation of the Banking disintermediation.

- Although located in a restorative process, the credit channel continues to be undermined by the existence of structural excess liquidity, the phenomenon of substitution of credits in lei with the ones denominated in foreign currency and the exercise of *moral hazard.* (Exemptions or discretional special regimes, including delays and cancellations of debt have contributed in the past to increase arrears in the public and the private sector and the installation of a moral hazard behavior. Moreover, moral hazard comes from a close connection between government and financial institutions, which induces to the creditors idea of existing an implicit government guarantees, generating, on the one hand, a foreign overdue- external in particular-and on the other hand, suboptimal investment decisions).

- Although some of these phenomena affect the interest rate channel, its role in transmitting monetary policy impulses are in continuous progress. It seems that he still acts through nominal rates of interest rates, their real level seems to be less relevant.

- The distortional character of some transmission mechanism channels and the lack of effectiveness of others, reduces the moving margin of monetary policy in combating inflation, monetary policy effectiveness being undermined by the origin predominantly structural of the inflation.

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