

MODERN CHALLENGES OF THE MONETARY POLICY

Prof. Constantin IONETE, PhD
Member of the Romanian Academy

August 2008 has marked one year since the manifestation of the sub prime mortgage credit crisis, from USA, a crisis which could spread all over the world. The event concurred with the adhesion of our country to European Union (1st of January 2007), and it was seen as an international unique event. In the first part of the last year we couldn't feel the effects of the severe drought, because of the food provisions from the past year. Even more, in February and March the prices of three food products have dropped, and after July the monthly prices have grown.

In the same time, the statute of the country, as a member of the European Union, has brought new perspectives on the international financial markets, as well as freedom of the capital account, opened for external funds with effects on the appreciation of the national currency.

In the next semester, when USA was evaluating the decline of the economy, caused by the mortgage credits, in Romania, the prices of the food products, as well as the oil price, began to grow as a drought result.

The annual average prices had an instalment of 4,84%, which corresponded to the level of targeting inflation by the National Bank of Romania.

In the first trimester of the year 2008, the consumption price index jumped to an installment rate of 8,56%.

The inflation reduction was a long process, started from a high level, in 2000 had an installment of 40,7%, so that the monetary policy of NBR, supported by the method of targeting the inflation, has reduced the inflation by 4,84%, at the end of 2007.

According to NBR sources, between 2005–2008 the consumption

price index (CPI) had the following declining phase: 2005- installment of CPI 9%, 2006- installment of CPI 5,16%, 2007- average annual rate 4,84%. In January 2008, the CPI jumped to 7,26% and in June to 8,61%.

The devastating drought from 2007 or the incredible growth of the oil barrel is not the only cause of the ascending trend of the Romanian inflation. Together with the drought the mortgage credit crisis had expensive pressures over the entire global economy. In the first trimester of 2007 it was a depreciation of the currency exchange of the national currency.

This was in fact the effect of the financial disorder which characterized the international markets.

According to the report made by NBR, about the financial stability from 2008, disorder means: "The changes which characterize the international financial systems starting from the second part of 2007 weren't a surprise. Many international institutions (such as IMF, BIS, and ECB) have showed that the risk is underestimated and probably an involution may occur. Some of the causes of the problems of financial systems from developed countries may be: 1) the significant excess of liquidities in the context of low interest rates, fact which promoted high risks in order to achieve low productivity; 2) the development of financial innovations was done without a proper understanding of the assumed risks and without proper methods of administering the risks and 3) the transparency of the investments in innovative products, as well as the regulation limits, which were insufficient.

The central banks have reacted promptly. Immediate measures were

taken: urgent delivering of liquidities, the use of new financial facilities, different from the ones offered through the operations of the current monetary policy, and in some situations the reduction (an aggressive reduction, as in the case of FED) of the monetary policy rates.”

However in the first 6 months of 2008, some sectors of the Romanian economy have registered growth, capable to sustain the financial stability, as results from the following indexes:

**Table no 1. Macroeconomic indexes
(percentage variations: 6 months 2008/6 months 2007)**

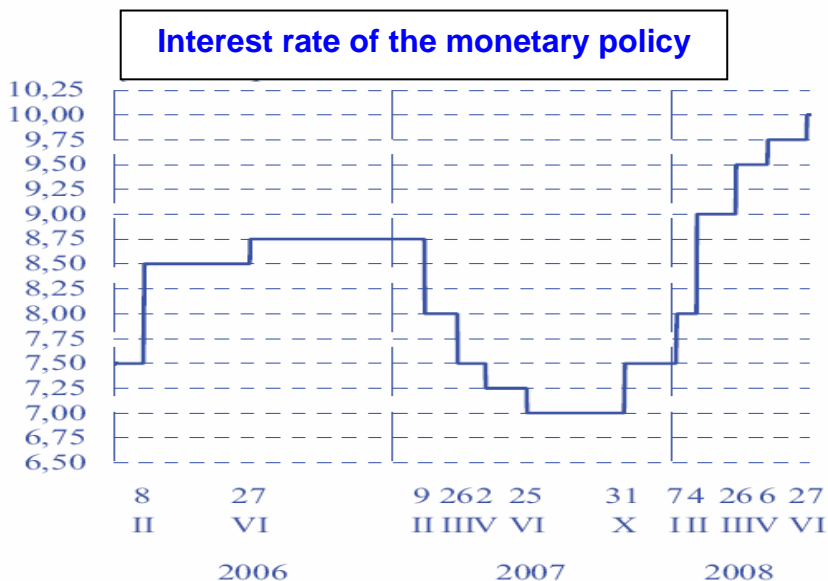
1	Industrial production	5,9	6	Monthly average net wage	
2	Labor productivity in industry	9,3	6.1	- nominal	23,5
3	Retail trade	¹⁾ 16,0	6.2	- real	14,1
4	Population services	²⁾ 11,0	7	Consumption population prices	8,3
5	1. Foreign trade		8	Industrial production prices	³⁾ 15,8
5.1	- export	18,1	9	Average rate exchange RON/EURO	⁴⁾ -9,2
5.2	- import	15,3	-		

Source: NBR, monthly bulletin.

In monetary policy, the interest rate and the currency exchange are vital elements for obtaining the financial stability. The interest, according to the first graphic, had a contradictory evolution between 2006–2008. In February 2006 it was 7,50%, then it

increased up to 8,50% (one percentage point increase) and in the sixth month it was 8,75%, a rate which could be maintained till February 2007, when reached 7% and remained this way.

Graphic no 1.



Source: NBR, monthly bulletin, June 2008

At the end of October 2007 the reference interest rate increased rapidly till June 2008, when it reached the point of 10,25%. A cause for this could be the growing tendencies of the inflation, as a result of the offer pressures, price increase but also of the demand's inflationary pressures.

Supporting the calculations of the inflation aggressiveness, NBR administered the liquidities on the market, by maintaining the mandatory minimum reserves at the point of 20% in RON and 40% in foreign currency. An important role in maintaining the financial stability was represented by the growing of the GDP (Growth Domestic Product), which at a real level had increasing rates – 4,2% in 2005, 7,9% in 2006, 6,0% in 2007 and 8,8% in the first semester of 2008.

Every country has its own options when it comes to directing the targets of the increasing and decreasing interest. Taking into consideration the danger of the economic recession, Ben Bernanke chose to reduce the interest to the minimum limit of possibilities, as the danger of a crisis were imminent.

In Romania, since the beginning of inflation, the interest preserved and will preserve the growth tendency till new stability signals will appear.

The European Central Bank applied the same option by maintaining an interest rate of 4% and adding 0, 25%.

The rate exchange had important variations during 2005-2007, as well as in the first part of 2008. By the end of the year 2005 the rate exchange followed a depreciation trend of 3,6771 RON/EURO. At the end of 2006 the trend changed – 3,3817 RON/EURO.

At the end of 2007 the rate exchange was 3,6102 RON/EURO. In January 2008 the important depreciations have begun – 3,70 in the first three months, with a slight diminution of 3,64 in the next trimester.

The main prudential indexes are followed and analyzed. The general risk rate evolved as follows: 47, 6% for 2005, rise up to 53,01% in 2006 and up to

26,94% in 2007. In 2008 the risk rate decreased to 51,14% for March, but in June was bigger: 52,41%.

In 2005, the amounts owed were 68.240 million RON, for 2006 these amounts raised up to 102,189 million RON and in 2007 up to 167.707 millions RON. In January 2008 global risk raised at a level of 173.172 million RON and for June had a level of 200.053 million RON. The unpaid amounts, expressed in millions of RON, were in 2005 of about 1.752 million RON, for 2006 the amounts decreased to 1.667 million RON and for 2007 these amounts were 2.009 millions RON. In June 2008 total unpaid amounts raised up to 2.350 millions RON.

During the implementation of the monetary policy, the National Bank of Romania took great care for the activity of giving loans. Analyzing USA crisis, IMF pointed out the importance of regulations for this sector, which practically don't exist in some cases, especially in the case of innovative banking instruments, such as sub prime, derivatives and others. In full financial crisis the National Bank of Romania revised rules applied for provisions for commercial banks, and it also added a new category for credit rating called "standard" and increased the provisions for 4 from the 5 existing categories. The most important initiative for sustaining the same objective was a complex and profound support of regulation regarding credit activity through the NBR regulation number 3 / 2007 regarding the limitation of credit process for private persons. The importance of this regulation made us to reproduce, only for example at least the chapter 1:

"f) Establishing the maximum level permitted for the aggregate level of debts differentiated on customer categories, on credit destination (e.g. consumption credit, mortgage), on credit type (depending on currency, or in same cases on index), on interest type, fix or mobile, on credit life duration and the client behavior regarding payments for the debts determined by the quality of guaranties and taking into consideration

the exchange risk, the interest rate risk, as well as the possibility to have any modification in time for the credit price from commissions and other expenses regarding credit administration as it was stipulated in the contract.”

The decision in credit activity includes all factors which are involved, with complex functions adjustable to changes and especially the final moment of payment of all debts determined by the guaranty quality.