The Monetary Policy Promoted by Romania's Central Bank: Where To?

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Abstract. *In Romania, the National Bank (BNR) is responsible for the monetary policy, and its objectives are harmonized with those set by the European Central Bank (ECB) in order to put in practice a correlation of the Romanian economy with that of the Eurozone, given the fact that 70% of Romania's exports are made towards it. We should keep in mind that both BNR and ECB are aiming at assuring financial stability, and the fulfillment of this goal is only possible by correlating Romania's monetary policy with those implemented by the central banks of the states in our region (Central and Eastern Europe). Romania is a direct competitor of Poland, Hungary or Czechia in terms of economic activity, and the monetary policy has to be correlated. These states had a similar course with that of our country, having had a centralized economy, and needed reforms similar to those implemented by Romania, and to compare them makes sense in most of the cases and in most of the economic sectors. It is unanimously accepted that the last decade's events had a significant impact on the manner in which the classic monetary policy was realized, as well as on the way it was implemented, and these mutations will be taken into account and discussed in this paper. In the same time, we will separately take in consideration the various strategies the central banks can implement in order to assure financial stability and achieve monetary policy goals, irrespective of their nature. It is known that most of the central banks have a determinant role in assuring the financial stability of the states in which they are active. However, the manner in which they define and reach their objectives vary from case to case, and the focus of the present paper will be Romania, more precisely the case of the Romanian National Bank and its monetary policy over the last years.*

Keywords: monetary policy, financial stability, central bank, inflation, price stability, monetary policy interest rate

JEL Classification: G14, G21

1. Introduction

The National Bank of Romania, by its statue[2], has as a central monetary policy objective ensuring and maintaining price stability. In this regard, BNR used the channel variation method as the main monetary policy for inflation targeting, which generates the possibility of a flexible approach of this policy (for instance, the inflation targeting for 2018 was of 2.8%, with a channel variation of +/- 1 percentage point). Before this policy, BNR used monetary aggregates targeting as a method of monetary policy. Thus, we can

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[2] Law No 312/2004 on the Statute of the BNR.

argue that the monetary policy implemented by BNR is different from a classic monetary policy strategy, the central bank aiming in the same time to intervene on the currency market for maintaining the EUR/RON conversion rate stability. Hence, we can speak of a *managed floating exchange rate*. Although this approach is seldom used in central banks' monetary policy, it was necessary given the impact the abrupt changes of EUR/RON conversion rate have on the Romanian economy. This situation is doubled by the high degree of foreign currency indebtedness of the population, but also by the fact that some of the prices are expressed in the single European currency.

Likewise, we should mention that Romania, a member state of the European Union, has committed through the Accession Treaty to ensure free capital movement, which limits BNR's capacity to intervene in order to achieve its goals. Taking into consideration the concept of Impossible Trinity, we have to emphasize a central bank's incapacity to maintain a fixed foreign exchange rate, the free capital movement, and an independent monetary policy at the same time. Romania has to ensure the free capital movement and is thus forced to choose between a higher stability (higher control) of the interest rates and the intervention on the foreign exchange rate for a controlled currency depreciation/appreciation. In this context, an intervention in the currency market to support RON may lead to an increase of the interest rates in the interbank market.

During the EU post-accession period, BNR had chosen an exchange rate support strategy, which consequently led to a higher volatility of the interest rates in the interbank market over this period of time. On the other hand, it tried to support the banks and ensure the required liquidity during tense periods via market facilities. We can summarize BNR's monetary policy over the last 15 years in this one sentence, yet questions arise about its future evolution and the direction in which it will go in the next period. Thus, in which direction will the monetary policy in Romania go in the coming years? Will there be a change in the BNR's approach, given the recently declared goal of joining the Eurozone in 2024? How will monetary policy influence Romanians' lives in the coming years? Therefore, taking into account the above, I set out to find the answers to these questions, which I consider particularly important for identifying the direction of the monetary policy that will be implemented in the future by the central bank of Romania, monetary policy on which will depend Romania's financial stability.

2. The evolution of the main monetary variables that influence monetary policy

It is well known that the National Bank of Romania has managed in recent years to ensure financial stability in our country, using different channels and different instruments. The directions on which it has focused were represented by the sensitive points of the economy, as well as those that exposed the population the most:

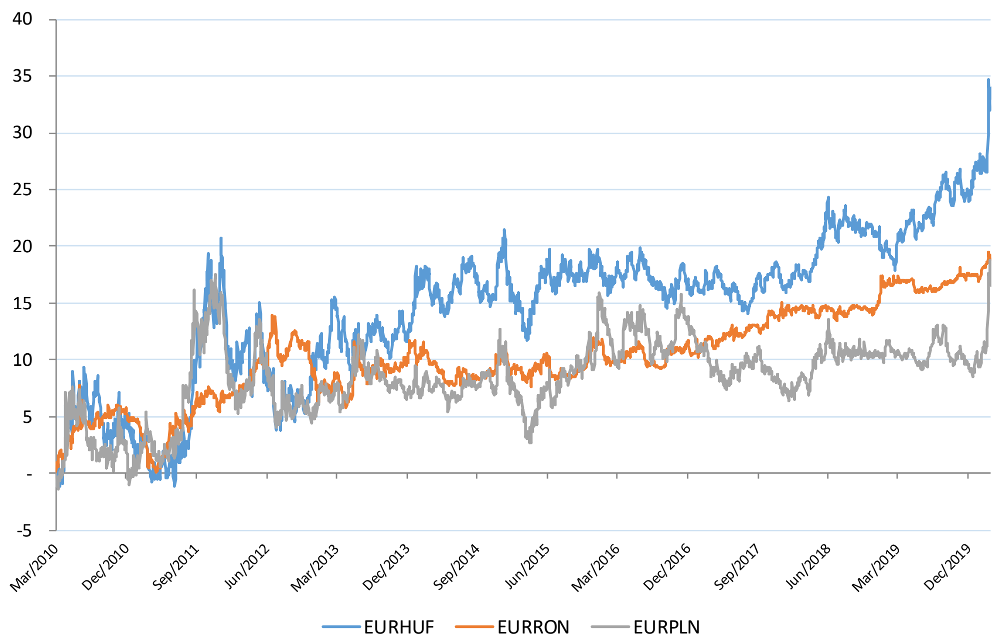
- The exposure of the Romanian economy to the euro, given that the prices for a significant part of the goods and services in our country are expressed in euros. I am referring here to telecommunication services, private medical services, real estate, automobiles, etc.
- A significant amount of food is imported into Romania, and the payment is made in euros, which leads to the exposure of Romanians to increases in food prices if RON depreciates sharply against the euro. Thus, we can also talk about a pressure on the inflation side if the EUR/RON exchange rate increases, i.e. if the RON depreciates, which can lead to the impossibility of achieving the most important objective that the

BNR sets, that of ensuring price stability. Therefore, the depreciation of the RON can lead to price increases in Romania via the exchange rate channel.

• Given that a large part of Romanians have taken out loans in euros, and their income is in RON, they could face problems with paying installments or repaying the loan if there is a significant depreciation of the RON against the euro. Thus, in the previous years, the BNR tried to keep the exchange rate as volatile as possible and to ensure that there are no shocks in the economy in this direction, shocks that could have led to non-performing loans, rising inflation and, overall, to the decrease of the quality of life in Romania. In fact, the negative effects would not be limited to the impact on the population.

Starting from these past events, we will go further and try to analyze the direction in which the monetary policy in Romania could go in the coming years, taking into account the economic context and, at the same time, what happened in the countries in the region of Romania, i.e. in Poland and Hungary. Thus, we will start by building the general context, and then I will focus on the possible decisions that the BNR could take.

Chart no. 1: EUR/RON, EUR/HUF, EUR/PLN exchange rate evolution in the last 10 years



Source**:** Bloomberg, own processing

Thus, we can observe that during the analyzed period the RON was the most stable and the least volatile currency. This was mainly due to the policy promoted by the BNR of implementing a managed floating exchange rate. The other two currencies were much more volatile, the HUF having a significant depreciation against the euro of about 35% in the analyzed period, while the PLN and RON being somewhere around 20%, with a more accelerated trend in the last months of the analyzed period for both currencies, this being the effect of the crisis caused on the financial markets by the Covid-19 pandemic.

Having presented these developments, we can conclude that the BNR has pursued a much more restrictive exchange rate policy compared to Hungary and Poland, the two countries allowing the exchange rate to fluctuate much more (which can sometimes be helpful to the economy, as the exchange rate can be a valve used to adjust it and a depreciation can stimulate the exports of that country).

The next aspect that will be analyzed is the one related to the interest rates in these countries, being known that a central bank cannot control both the exchange rate and the interest rates in the interbank market and, at the same time, to ensure the free movement of capital (this condition is essential under the Treaty of Accession to the European Union). We appreciate that, in the case of Romania, the interest rates would have been much more volatile, considering that the BNR focused more on the stability of the exchange rate.

Chat no. 2: The evolution of interbank interest rates in Romania, Poland and Hungary in the last 10 years

Source**:** Bloomberg, own processing

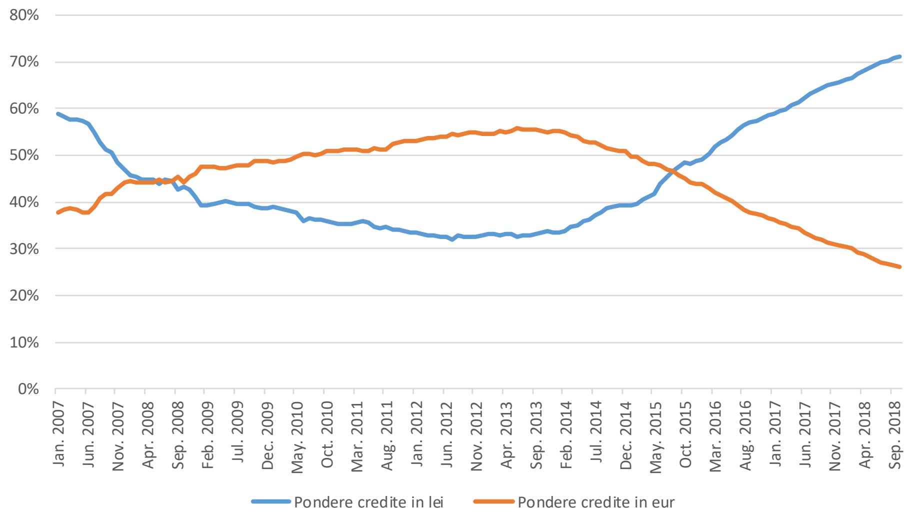
Therefore, the assumptions that I previously formulated were confirmed and, thus, I noticed that interest rates on the Romanian interbank market were much more volatile than those in Poland or Hungary, showing that the central bank put more much emphasis on exchange rate control to the detriment of the stability of interest rates in the banking market. It is known that, for the exchange rate stability, the central bank must intervene by selling or buying foreign currency against RON, and in this way changes the money supply in the interbank market by increasing or decreasing the volume of RON. The change in the amount of RON will then be translated into a change of interbank interest rates in the market. It should be noted that these rates are used as a reference for many variable interest rate loans, and a very high fluctuation could cause problems for those loans. However, insofar as we know, lending has been done mostly in foreign currency, Romanians being less attentive and less exposed to interest rates fluctuations in the interbank market.

3. Considerations regarding the trajectory of the monetary policy promoted by the BNR

Following the presentation of the evolution of the main monetary variables employed by the central bank, we can say that BNR's approach in the case of Romania is slightly different from the approach of the central banks of Poland and Hungary. The BNR pursued a higher stability of the EUR/ RON exchange rate, to the detriment of a higher volatility of interest rates in the interbank market, and this was justified by a series of arguments that I presented in the beginning of this paper. Thus, BNR stroke a discordant note in the region, regarding the approach of the exchange and interest rates, trying to adapt the monetary policy to the context of our country, knowing that we had a euroized economy, an economy strongly dependent on the exchange rate. Now, the question naturally arises as to the direction in which monetary policy will move in the coming years.

In order to be able to issue opinions related to this direction, as well as regarding the approach that monetary policy makers and political factors might have, we should first analyze the current situation of the Romanian economy and the level of vulnerability to the exchange rate, which is the variable to which public opinion is very sensitive. In this regard, I will present the evolution of the balance structure for the loans granted in Romania in recent years, depending on the two important currencies: RON and EURO. Starting from this credit situation radiography, a series of conclusions can be drawn as to the direction in which the sensitivity of the Romanian economy has changed, from exchange rate fluctuations to interest rate fluctuations on the interbank market.

Chart no. 3: The evolution of the EUR loans percentage v. RON loans percentage



Source**:** Own processing of BNR data

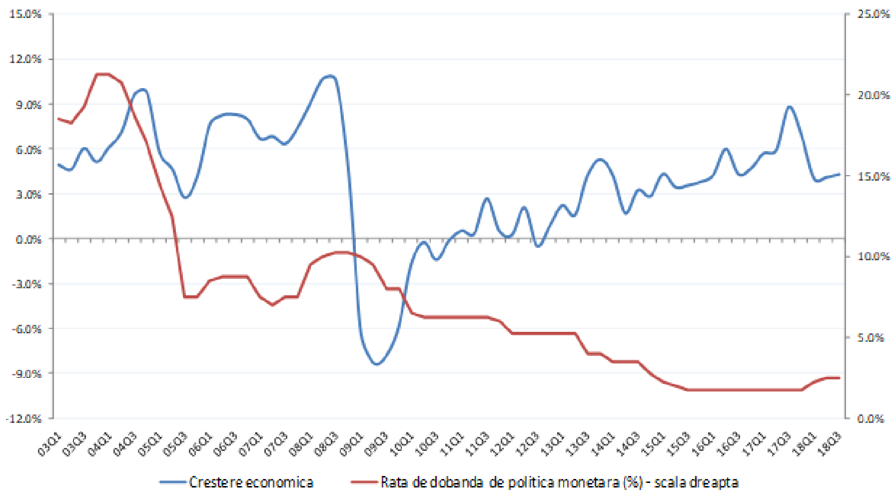
First of all, the vulnerability that euro borrowers faced in the 2009-2014 period is obvious; the share of loans in this currency reached 58% of the total loan balance in Romania, and this clearly justifies Romanians' sensitivity and that of the central bank towards exchange rate fluctuations and the consequent monetary policy makers choice to implement a managed floating exchange rate approach. An increase of the EUR/RON exchange rate could have created payment difficulties, could have led to a decrease in disposable income and, implicitly, could have been an obstacle to economic growth. On the other hand, it could have generated a significant increase in non-performing loans and, in the end, this would have been a vulnerability for the Romanian banking system.

We can easily observe that, starting with 2013, the share of loans in euros begins to decrease at the expense of loans in RON, the most important element that supported this change being BNR's decision by which loans offered through the First House program to be granted only in RON. These types of loans represented the main mortgages contracted during that period, having had a significant impact. Subsequently, BNR regulations went as well in this direction, supporting loans in the national currency and making it increasingly difficult to access a loan in euros, even when it comes to a mortgage secured by a property. Currently, BNR has intervened by modifying the maximum degrees of indebtedness accepted for individuals; thus, the maximum accepted degree of indebtedness for a mortgage loan in euro is half of that in RON, further restricting the appetite of Romanians for loans in euro.

Consequently, in recent years lending has been mainly in RON, greatly reducing the borrowers' sensitivity to exchange rate fluctuations, as well as the risks they take. On the other hand, a significant part of these loans were granted with variable interest rates, which depend on one of the interest rates in the interbank market (ROBOR 1 month, ROBOR 3 months, ROBOR 6 months, etc.), increasing borrowers' sensitivity to interest rates fluctuations.

Additionally, I consider that in order to analyze Romania's monetary policy we have to analyze as well the manner in which this has been implemented in recent years, and the graph below, in which I overlapped the evolution of economic growth in Romania over the last 17 years on the monetary policy interest rate evolution, I consider to be relevant in this regard.

Chart no. 4 Economic growth in Romania v. monetary policy interest rate during 2001-2018



Source**:** Own processing of BNR data

Between 2003 and 2005, the BNR promoted a slightly pro-cyclical policy (see the previous chart), lowering interest rates in a period of strong economic growth. However, interest rates came had very high levels initially and, as we approached the accession to the European Union, they were to be reduced in order to get closer to the levels the countries in this community were practicing, being a necessity for partial convergence at the level of financial markets. After 2005, the BNR maintained a stable interest rate until 2007, when it started increasing it in order to try a slowdown of the economic growth and avoid overheating the economy. Thus, we can talk about a countercyclical monetary policy promoted by the BNR between 2005 and 2007.

The 2007 interest rates increase was followed by the 2008 global economic crisis and, implicitly, by Romania's entry into recession in 2009, which can be easily noticed in the previous graph by the collapse of the economic growth rate to a level of approximately -8.5% in 2009. In order to reduce the effects of this deep recession in which our country was thrown, the BNR started a process of lowering the monetary policy interest rate, promoting a lax monetary policy in a period of recession; we are talking again of an anti-cyclical monetary policy. This type of approach seems to have been beneficial to the Romanian economy and the private sector, which led to a slight recovery, but on a more solid basis, following a period in which BNR kept the monetary policy interest rate at a constant level of 1.75% for a longer period, until the beginning of 2018, when the BNR took again the decision to increase the monetary policy interest rate, gradually reaching 2.5%. Once again, this decision of the Romanian central bank came to stop the economy overheating, being a period in which lending accelerated sharply and drops began to appear in the economy, which translated into an increasing of the current account deficit, representing a higher rate of imports than that of exports.

After 2018, the BNR kept the monetary policy interest rate unchanged, and at the beginning of 2020 it decided to reduce it by 0.5 pp, amid the crisis caused by the Covid-19 pandemic. Thus, in order to prevent a deeper crisis, the BNR reduced the interest rate and decided to take a series of other easing monetary measures, including the launch of a government securities acquisition program, for the first time in Romania. Therefore, the central bank has again promoted an anti-cyclical monetary policy meant to support the economy and those in need of funding in the coming period.

Analyzing the moments when BNR changed the monetary policy interest rate level, we found that in those periods, in order to emphasize the expansionary or restrictive effect of a monetary policy measure, decisions were taken related to the minimum reserve rate, of regulations, of issuing money, of carrying out *repo* operations or of attracting deposits for the sterilization of liquidity. Therefore, the BNR came up with a series of complementary measures to make the monetary policy applied more effective.

In this regard, two concrete examples can be brought for the monetary policy implemented by the BNR in recent years:

- At the beginning of 2019, in order to streamline its restrictive monetary policy, BNR decided to tighten lending conditions, reducing the maximum degree of indebtedness that banks could accept (40% for loans in RON and 20% for loans in euro). As a result, a number of customers were no longer eligible and loans demand fell.
- In March 2020, in the context of the Covid-19 pandemic crisis, BNR decided to reduce the monetary policy interest rate by 0.5 pp., together with the decrease of the minimum reserve ratio for RON and, at the same time, with the announcement of the first bond purchase program on the secondary market together with BNR's firm

commitment to constantly provide liquidity in the interbank market when needed, in order to maintain this market functional. All these decisions came to support an expansionary monetary policy meant to help the economic environment digest the shock caused by the activities' closure during quarantine.

4. Conclusions

Taking into account the facts presented in the first part of this paper and considering the approaches related to the monetary policy of the countries in the region, as well as the global economic crisis caused by the Covid-19 virus which all countries is currently facing, I tend to believe that BNR will try to change its perspective in the near future, being forced to pay more attention to interest rate fluctuations in the interbank market, to which Romania's population has become more sensitive. On the other hand, the exchange rate is no longer of much interest to borrowers, yet it continues to be a channel for importing inflation, and a RON depreciation could lead to an increase of the imported products prices, which in turn would generate an increase in inflation, putting at risk BNR's price stability objective. Therefore, we can expect a higher flexibility of the exchange rate, at higher fluctuations than in the past, but with concise interventions of the BNR in tense moments, so that no strong deviation occurs. On the other hand, the BNR will permanently try to intervene through liquidity injections in the interbank market in order to maintain interest rates stability, as their fluctuation can be a negative factor for the population's income and, implicitly, for the consumption in the economy and for the economic growth.

Economic theory teaches us that monetary policy must be correlated with other segments of economic policy promoted by a state and should often be anti-cyclical, in order to avoid imbalances and excesses. Moreover, monetary policy must be adapted to the economic context of the country, the level of development and investment needs, yet the regional and global context must also be taken into account in order to achieve a correlation between the monetary policy pursued by a state and those applied by other states with which it has trade relations.

The last part of the paper highlighted the fact that the monetary policy interest rate is an economic indicator that provides sufficient information which can reflect the type of monetary policy implemented, or promoted, by the National Bank of Romania, which can be expansionist or restrictive. However, it should be noted that there are a number of other instruments and decisions that can provide indications as to the type of monetary policy that a central bank can pursue, such as:

- The changes of the minimum required reserves rates.
- The injection of liquidity into the system, through various mechanisms.
- The acquisition of bonds on the secondary market, by monetary issue.
- The decrease in capital requirements and regulations for banks in the system (deregulation at the level of the banking system).
- The increase of the maximum levels of indebtedness accepted for individuals or legal entities.

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