

The Operational Framework of National Bank of Romania's Monetary Policy

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Abstract: *The Central Bank often intervenes on money market, both to take over the net surplus of liquidities, and to inject liquidities in order to cover the net deficit as a result of the interbank operations of commercial banks. The refinancing mechanism represents a monetary policy instrument through which the central bank exercises the function of „lender of the last resort”, in the last few years the operational framework of the monetary policy being represented by the open-market operations, the mechanism of minimum reserve requirements and lending and deposit facilities to commercial banks. The open-market operations can be used in all the phases of the process of ensuring financial stability (prevention, remediation and elimination of the consequences). The efficiency of monetary policy is limited at macroeconomic level by the necessity to fulfill other objectives of the economic policy, such as economic growth or ensuring external balance.*

Keywords: *monetary policy, refinancing mechanism, open-market operations, liquidity, minimum reserve requirements, eligible assets*

Introduction

Traditionally, the analysis of monetary policy must be approached on many levels in order to highlight the interaction between objectives and instruments, but also the transmission channels of the monetary policy's measures. In this context, the followings should take into account:

1. the final objective of the most of the central banks' monetary policy is price stability. The achievement of this objective is conditioned by the way of connection between the banking financial sector and the real economy.
2. the intermediate and operational objectives of monetary policy are represented by certain monetary variables (monetary base, monetary aggregates, M_1 and M_2 , etc., the volume of loans, the level of the interest rate, the level of the exchange rate) that the monetary authorities can influence more or less with the help of the instruments that are at their disposal.

The instruments of the monetary policy are processes that allow the authorities to act on the monetary variables, some of these being direct (credit control, administrative fixing of some interest rates, exchange rate control), others are indirect, meaning that are based on compatible mechanisms with the laws of the market (refinancing policy, open-market operations, the minimum reserve requirements).

For each type of instrument it can be followed some objectives, so that monetary policy' instruments can be presented as being grouped as it follows [1, 381]:

- a. instruments by which the central bank favors and withdraws central currency, category that includes the following types of operations and measures:
 - open-market operations and lending operations with variable interest rate on money or financial market;
 - discount operations: limiting the funds for discount operations and setting the discount operations costs;
 - establishing the minimum reserve requirements.
- b. instruments that directly affect the assets and liabilities of the banks, that aim the global quantitative objectives and selective objectives, including following:
 - framing or limiting loans or financing ;
 - balance sheet's ratios (the ratio between loans and own funds);
 - control of securities issues on the financial market;
 - setting of the interest rate.

- c. instruments that allow the control of the transactions with foreign countries and that refer to:
- exchange transactions control (authorized external loans, the regulation of foreign exchange banks' position);
 - the regulations applied to the interest rate paid for the non-residents' deposits and the level of the interest rate;
 - the minimum reserve requirements for non-residents' deposits;
 - the central bank interventions on the foreign exchange market.

1. The Evolution of the Operational Framework of the Monetary Policy in Postdecember Romania

Characteristic for the implementation of the postdecember monetary policy in Romania is the fact that amid the macroeconomic variables (prices, wages) liberalization and in the conditions of the lack of functional money and capital markets, the National Bank of Romania proceeded to replace the direct instruments with market ones, even before preparing an appropriate institutional framework.

The specific conditions of the transition imposed the National Bank of Romania to take into account the behavior at micro and macroeconomic level, the concrete conditions of the real economy, the necessity of achieving a balance between the long term monetary policy's objectives and short term restrictions.

The passage to indirect instruments, specific to market economy was a complex process due to objective factors at that time such as: the rigidity of the real economy, the fragility of the banking system, the predominance of state ownership in banking sector and economy, social constraints and others.

For these reasons, although the new monetary policy instruments have been shaped since 1991 (refinancing interest rate) and 1992 (the system of minimum reserve requirements) their effectiveness was manifested later, towards the end of 1993. For these considerations there were periods of control over money supply and balancing money and foreign exchange market with periods when money supply considerable increased due to overvaluation of the exchange rate.

Thus, 1991 was materialized in a monetary policy control regarding the increase of money supply by measures of limiting the non-government loan that generate (in the conditions of the predominance of state property) the phenomenon of nonpayment of debts, the increasing of financial indiscipline and therefore financial blockage (that became in time a scourge hard to control and annihilate).

In 1992, the monetary policy was fluctuating, so the next year the inflationary phenomenon became chronically due to the persistent difficulties in the real economy.

The analysis of the monetary policy used in Romania should start from the concrete realities, and over its evolution we can make the following considerations:

a. the refinancing mechanism of commercial banks, using the refinancing interest rate represented in a first stage (1992-1997) an active factor to support monetary policy, helping to provide necessary liquidities for banking system, although the interest rates were established in an administrative way and sometimes induced some distortions in the economy.

Amid the strong depreciation of the national currency, not a few times the interest rates for tender loans recorded significant changes on short intervals, for example 58.8% in January 1997, 266.7% in March and 184.9% in April of the same year.

Subsequently, during 1998-1999, the refinancing mechanism played a passive role; in this period the central bank bought massive foreign currency and thus injected liquidities in the economy.

In this period, the interbank money market became operational, the banks were procuring resources from this market with priority; the National Bank wasn't in the position of net creditor of the banking system. However, it was the period of the appearance of "problem banks", so to support them central

bank was forced to resume during 1999-2002 the refinancing policy as an instrument of monetary injection.

The refinancing loan was guaranteed more with government securities and less with trade effects, with coverage in goods. However, the refinancing from the National Bank represented the most important instrument of the monetary policy, the evolution in total and in structure of loan categories is the following:

Daily average values – mil. Lei

Table 1.

	1992	1993	1995	1997	1998
Total refinancing, of which:	35,1	154,2	248,6	239,8	53,0
Structural loan	8,9	47,4	130,8	121,2	-
Preferential interest rate loan	25,5	30,7	4,7	0,3	0,1
Tender loan	0,5	57,3	85,5	22,3	-
Special loan	-	-	15,3	8,1	-
Lombard loan	0,2	18,8	12,3	2,6	0,6
Loan granted with derogation from regulation	-	-	-	75,3	52,3

Source: NBR – Annual report 1998

1998 was the moment when the interbank money market knew a significant boosting, the volume of interbank deposits increased by 78.8%, the discount fee was gradually unused and since February 2002 it has become the reference interest rate.

b. the liquidity control by the minimum reserve requirements – is a much more effective instrument than the refinancing policy, because the minimum reserve requirements policy applies to all commercial banks not only to those that are constrained to appeal to the central bank refinancing.

The commercial banks that bring deposits from its clients have to keep at central bank a certain percent of these deposits. In this way, a part of the money supply is no longer available to commercial banks for lending, therefore by this instrument is controlled not only the banks' liquidity, but the increase of the volume of loans in economy, so the minimum reserve requirements have a prudential role.

In Romania, the requirement for banks to keep reserves on accounts at the National Bank was provided by the legislation adopted in 1991, and in January 1992 the first implementing regulation was issued [2], by which it was covered the basis for calculating the minimum reserve requirements only for national currency deposits of companies.

Then, in the next years, the basis for calculating was expanded by including the households' savings in lei, the companies' deposits in foreign currency and the amounts in transit between banks headquarters, and since March 1995 by including households' deposits in foreign currency.

In order to achieve a better management of resources of the commercial banks, the National Bank of Romania established increases of the minimum reserve requirements ratios for deposits in lei (from 10% in 1998 to 20% in 2000).

Since 2002 the central bank has moved to a more restrictive policy of the minimum reserve requirements in order to discourage lending in foreign currency, first by increasing the ratio to 25%, then to 30% (in 2004), and to 40% starting with March 2006, together with a gradual decrease of the minimum reserve requirements in lei to 25% in 2001 and 16% starting with March 2006.

Amid the financial crisis that global economy has been passing through, since 2008, with implication also for Romania, the liquidity funds have become fewer and more expensive, the National Bank has proceeded to a gradual decrease of the minimum reserve requirements to 20% at present.

In the conditions of a gradual decrease of monetary policy interest rate since November 2011 from 6.25% to 5.25% at present (starting with 1st of April 2012), and this "signal" wasn't resulted in an

appropriate reduction of the interest rate for the loans of banks' clients, we can predict that the continue decrease of minimum reserve requirements both in lei but also in foreign currency could be the National Bank's alternative for the next years, to ensure more liquidity in the economy, but also to decrease the loan costs and by default to boost the economic growth.

The Central Bank's caution in applying these reductions is motivated by the fact that the indicated volume of the minimum reserve requirements that banks have to keep in accounts at the monetary authority (and which represents 10% of gross domestic product of the country) provides the necessary liquidity support to be used in significant stress conditions that may occur on the market, amid the sovereign debt crisis that are faced by a part of the European Union members.

Although, since the 80's the minimum reserve requirements mechanism has begun to show a relative decline, amid boosting the pace of diversification and innovation of the bank products and services, for Romania it is proved to be an effective instrument in the actual context.

c. Open-market policy was conditioned by the government securities issue, the first one being made by the Ministry of Finance in 1994. The lack of clear regulations in the field, the absence of secondary markets that allow current transactions with securities, the low level of attractiveness of these were factors that made that until 1997 the issue of government securities had a sporadic character, with short maturity. For the National Bank it wasn't create, until that time, the necessary legal framework in order to intervene on the market, placing the government securities by public subscription.

Together with enforcing the Regulation no. 2/April 1997, the using of the government securities boosted, in order to inject liquidity or to create the necessary portfolio for future operations.

Therefore, the first open-market operations were done in April 1997, in the immediately next period, in this way an important volume of liquidities from the market was absorbed (578 million lei at the end of 1997), and the banking sector owned 95% of government securities, taking account of the auction mechanism established for their trading. The government's securities portfolio purchased by the central bank was at the 31th of December 1998 of 936.1 million lei, being the main way of liquidity injection in economy, so that in the next year its value gradually decreased, and in 2001 such as operations became insignificant.

This aspect is explained by the fact that beginning with August 2000 new open market instruments were introduced on the market, closed to those that are used by the Central European Bank, such as:

- **reversible purchases/sales (repo/reverse repo) of eligible assets** are operations that allow the National Bank to buy from commercial banks eligible assets to inject liquidity, upon their commitment to repurchase the assets at the date and the price agreed on the date of the transaction was concluded. The evolution of repo/reverse operations in 2000 shows a daily average stock of 267.3 million lei at an interest rate level of 47.8 %, while in 2001 it increased to 430.4 million lei at an interest rate of 42.9 %, while in 2002 its volume decreased to 258.7 million lei at an interest rate of 29.3 %. It is mentioned that by the introduction of these operations, although with a delay than other countries in transition to market economy, monetary policy has gained more credibility by limiting the growth of the volume of liquidity.
- **outright sales/purchases of eligible assets**, meaning purchases/sales of eligible assets, in order to absorb/provide liquidity by the central bank. Unlike repo and reverse operations these operations involve the transfer of ownership of these assets from seller to buyer;
- **issuance of certificates of deposit** – represents a way through that the National Bank of Romania sells to commercial banks certificates of deposits with the purpose of absorption of liquidity, the first issues took place in June 2004, and except for 2 months (January and May 2005), in next period the using of this instrument recorded a continuity (in 2004 as a daily average stock of 2890 million lei, and in 2005 between 3821 million lei and 15040 million lei);
- **deposits taking operations with fixed maturity**, method used since 1997, in order to absorb the surplus of liquidities from the market, the deposits having a pre-specified maturity and a negotiable interest rate. During 1998-1999 the National Bank of Romania faced with a massive excess of liquidity, situation that continued in the next years, the daily average stock increased from 167.1 million lei in 2000 to 8098.5 million lei in 2004. This context meant a

change in the position of the central bank's net creditor to net debtor, involving high operational costs and negative impact on monetary authority's profitability;

- **refinancing and deposit facilities granted to commercial banks by the National Bank**, are available to commercial banks by lombard loan. Thus, banks can access at any time of the banking day the refinancing facility offered by central bank, the interest rate being established according to the monetary policy's objectives. Also, this instrument was used both as refinancing facility and deposit facility.

In recent years, 2010 and 2011, the National Bank of Romania's monetary operations have resulted in repo transactions (with one week maturity), deposits taking operations and standing facilities, amid the measures of cutting the monetary policy interest rate and minimum reserve requirements ratios, as:

Period	Monetary policy interest rate (%)	Repo transactions Daily average stock (million lei)	Deposit facility (million lei)	Minimum reserve requirements ratios	
				Lei (%)	Foreign currency (%)
December 2010	6.25	1 145.6	33 503.1	15	25
March 2011	6.25	524.6	14 157.8	15	25
June 2011	6.25	1.3	45 638.7	15	20
September 2011	6.25	706.9	11 509.6	15	20
December 2011	6.00	4 396.9	8 958.7	15	20
January 2012	5.75	3 644.0	66 318.3	15	20

Source: NBR, Monthly report no.1/2012

The monetary authority's latest decisions to continue the cycle of a cautious cutting of monetary policy interest rate (initiate in November 2011 from 6.25 % to 6.0 % and the last reduction from 5.50 % la 5.25 % beginning with the 1st of April 2011) were motivated by the strengthening of the disinflation forecasted previously by central bank.

In this context, short term interest rates of interbank money market recorded a strong decline, reaching close to the level of deposit facility interest rate.

From the evolution of the operational framework of the National Bank of Romania's monetary policy during the entire postdecember period, it is noted that:

- the enforcing of the monetary policy instruments was an ongoing process, in close causal relationship with the development level of financial markets, and with the development and diversification of banking products, but also with the progress in the field of information technology;
- open-market instruments became operational since liberalization and development of the financial system, and the secondary market securities became active. The flexibility of open-market operations amid financial globalization had positive effect, the central bank using these instruments to control liquidities and interest rate, whenever it is necessary, with the possibility of a large volume of transactions with access facilities for a large number of participants.

2. The Specific Problems of the Monetary Policy in Transition Period

The operational framework of monetary policy instruments used in European System of Central Banks is materialized mainly in open-market operations used by all member countries and also in minimum reserve requirements.

The general trend is to increase the volume and to diversify the range of negotiated and traded securities, that leads to the expansion of the open money market and to the development of the open-market operations. The opening of the money market provides the opportunity to all capital suppliers to alternate between long term or short term placement options, according to what each of them estimates, regarding the evolution of the interest rate level.

In this way, the open-market instruments have a quantitative effect on money supply in circulation and a price effect on the prevalent interest rate in economy.

In Romania, even if progresses in enforcing the monetary policy instruments are recorded, there are some problems that were not solved or that were delayed and might rekindle inflationary trend:

- contractual financial discipline including the fiscal one is not consistently imposed, companies and groups of companies politically supported gains delays or even deletion of debts to the state;
- the application of legislation and the corruption remain concerning problems for business environment;
- although partially privatized, electricity and natural gas companies further maintain monopoly prices, with a negative impact on the proper functioning of markets;
- the technical level of agriculture continues to be reduced, an important potential of human and material resources of country side isn't highlight, and whose inhabitants live far away from european standards.

In the conditions mentioned below, Romania was the last one that obtained the status of a functional market economy, but with conditions related to poor functioning of the institutional structures for ensuring financial discipline and compliance with contractual obligations, protection the property and implementation of an appropriate system of effective mechanisms to prevent and mitigate shocks.

However the National Bank of Romania announced that, since 2005, the assuming the objective of inflation targeting and proceeded to the national currency denomination. These are daring measures comparing with the economic situation much more improved from the other countries in transition, taking account also other difficulties (such as the high value of the assets in USD and EUR from Romanian economy, the NBR net debtor position toward the banking system and that limited the interest rate control).

The delays produced comparing with other states of European Union in introduction, expansion and the proper functioning of the market principles and mechanisms from our economy postponed the process of establishing the traditional connections between operational framework of the monetary policy and real economy. The transmission mechanism of monetary policy has been more clear, while the connection with the real economy began to function relatively late, starting with 2000, but still presents syncope that depend on real economy characteristics (unfinished privatization process and less beneficial privatizations, reduced competitiveness, rigidities in the adoption of the supply to the domestic and external market demand).

However the decisional autonomy of the central bank, in formulating and implementing the operational framework of the monetary policy, it can't solve by itself the problems that refer to purchase power stability and "The politics with all the pride that the fact of being the expression of the society general interests gives to, will return ashamed every time, in his rush, forgetting behind the economics. There, where on the Government desk next to Constitution there isn't the Economics, society train will consume more steam for the siren, than for moving to a reasonable future" [4]. It is an expression, but also a requirement, which shows that price stability and therefore economic stability depends on a multitude of factors, for some of them the Government is in charge.

3. Final Considerations

The ensure of the monetary policy's fundamental objective of the National Bank of Romania, price stability, is conditioned not only by the success of the application of the monetary policy instruments, but also the success of the restructuring and privatization government policy, Executive's fiscal and budget policy.

Regarding to the effectiveness and the application of the central bank's monetary policy instruments it is to emphasize the following conclusions:

- The choice of the monetary policy's mix of instruments depends on the central bank's position in the financial system, its independency, monetary policy's objectives. It is not recommended to use direct interventions, of credit capping, in a market economy the central bank is an active

player on the money, foreign exchange, financial market, the central bank sells and purchases lei, foreign currency, government securities, and others, in accordance with its monetary policy.

- By an effective using of the monetary policy instruments it has to take account of an objective closely related to the economic growth, namely a good allocation of financial resources, a selective credit politics, the boosting of the economic financial performance by competitive lending techniques.
- To enforce the operational framework of the monetary policy it has to pursue continuously objectives targeting and the prevention of the appearance of any conflict between the level of the money supply growth and foreign exchange rate growth, that are not independent each other.

The success and the effectiveness of the instruments that are used by the National Bank of Romania depends on the maintaining public confidence in the banking system, its ability to manage crisis situations, protection of depositors' money, the standard of quality of banking services. For this, the monetary authority must enjoy a good credibility, to convey clear messages to the public, realistic, and its predictions to be confirmed by practice.

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