THE DISCOUNT RATE POLICY IN ROMANIA IN THE 20TH CENTURY

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Throughout the 20th century, economists have generally acknowledged the importance of the central bank discount rate as the reference interest rate in a country: by increasing the interest rate during economic booms that forego the busts, the Central Banks help alleviate the consequences of the crises, by deterring entrepreneurship and speculative pressures. Similarly, the discount rate is decreased during recessions, when Central Banks need to stimulate economic activity by providing cheap money and restore the optimistic spirit among entrepreneurs.
This study aims to correlate the macroeconomic evolutions in the 20th century Romanian economy with the variations in the discount rate of the National Bank. It is also meant to reveal to what extent – if any – these evolutions have been influenced by the discount rate policy. By analyzing the discount rate changes during the first half of the 20th century, we can easily notice rather abrupt changes – of about 1-1.5%, both upwards and downwards – in the discount rate. Nowadays, such changes are no longer possible, due to the intricacies and complexity of the economic, financial and banking inter-relations at the European and global level.
The discount rate evolution points out that the Central Bank has provided the cheapest capital throughout the 20th century, at an average rate of 5-6%. The evolution also reveals that the discount rate has been the cause – and not the consequence – of economic policies

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Both policy researchers and public authorities are rather divided and subjective when it comes to explaining or grounding various aspects of economic policy. In this respect, the discount rate is one of the most illustrative examples, in that the discount rate policy is subject to fierce debates and controversies. A thorough attempt to research into or to establish correlations regarding the central bank's discount rate will most certainly reveal some very interesting observations[58].
This paper is meant to establish a possible correlation between the macroeconomic evolutions in the 20th century Romanian economy and the variations in the official discount rate of the National Bank (the interest rate used to lend money to commercial banks for re-financing). It is also meant to reveal to what extent – if any – these evolutions have been influenced by the discount rate policy of the monetary authorities.
Throughout the 20th century, economists have unanimously acknowledged the importance of the discount rate as the primary interest rate within a state or group of states: by means of increasing the interest rate during economic booms that forego the busts, the Central Banks help alleviate the consequences of the crises, thus deterring entrepreneurship and speculative pressures. Similarly, the discount rate is decreased during recessions, when Central Banks need to encourage economic activity by providing cheap money and restore the optimistic spirit among entrepreneurs.
By analyzing the discount rate changes during the first half of the 20th century, we can easily notice rather abrupt variations – of about 1-1.5%, both upwards and downwards – in the discount

58 Costin C. Kiriţescu, Emilian M. Dobrescu (1998) – Moneda. Mică enciclopedie, Bucureşti, Editura enciclopedică, p. 67

rate; this reflects rather large changes in the most important economic and banking indicator. At that point, such fluctuations were afforded by the national, European and international economic situation, whereas nowadays, such changes are no longer possible, due to the intricacies and complexity of the economic, financial and banking inter-relations at the European and global level. The evolution of the official discount rate points out a sensible conclusion: the Central Bank has provided the cheapest capital throughout the 20th century, at a discount rate that fluctuated on average between 5-6%. The evolution also reveals that throughout the 20th century, the discount rate has been the cause – and not the consequence – of economic policies. All these aspects are illustrative of the decisive influence that the official discount rate has on the economic developments in Romania.

Before starting an in-depth analysis of the discount rate mechanism, we must mention two general aspects related to the concept:

-The specificity of the concept and its close connection to the banking environment have rendered it less known and rather neglected in the general economic environment; a lot of economists and, at the same time very few bankers have noticed and agreed that the different discount rates can be accounted for by the degree of development and the size of the normal official discount rate

-The utter simplicity of the influence – usually a negative correlation – of the discount rate on economic growth; (here we must note the difficulty of establishing precise mathematical correlations between the two indicators – the discount rate and the economic growth rate – due to the lack of statistical data on economic growth during the first half of the 20th century). In this respect, as early as 1915, M. Musceleanu first noted that: "There exists an inverse relationship between this degree of development (economic and financial – n.n.) and the level of the official discount rate: the more prosperous the economic situation, the lower the official discount rate"

The current conception on the discount rate policy is rooted in the "debates and inquiries that took place during the suspension of the GB pound convertibility (1797-1821), when many economists and bankers realized that a rise in the official discount rate above the market discount rate was susceptible of hindering credit expansion and of triggering deflation, together with its consequences: a decrease in prices and an improvement in the terms of exchange. The immediate conclusion: the consequences are of an economic nature. "Even during the subsequent crises of 1836, 1839, 1847, the Bank of England is believed not to have understood the utility of firmly handling the discount rate policy, because the timid attempts to lift the discount rate could not put an end to the depression"[59].

Throughout the 20th century, economists have generally acknowledged the importance of the central bank discount rate as the reference interest rate in a country: "By increasing the interest rate during vigorous economic booms that precede an imminent bust, the Central Banks contribute to alleviating the consequences of the crises, by deterring entrepreneurship and speculative pressures, in a time that the economic state requires cautiousness. By increasing the reference rate, deflation occurs. Finally, the discount rate is decreased when its purpose has been achieved or when, during recessions, the Central Bank needs to stimulate economic activity by providing cheap money and thus restore the optimistic spirit among entrepreneurs"[60].

During recent years, the discount rate policy led by the main central banks has been much more effective than 100 years ago.

The main characteristics of the discount rate are:

a. Its power is relative and it varies from country to country, and across time.

b. The low level of the reference rate lies at the bottom of the economic, banking and political edifice

59 Axenciuc, V. (2000) – Evoluţia economică a României. Cercetări statistico-istorice, 1859-1947, vol.III, p. 89

60 apud Stoenescu, Radu (1935) – Politica scontului, Bucureşti, Cartea Românească, p. 23

c. Sometimes an increase in the reference rate is not sufficient to compensate the risk incurred by the economic uncertainty

d. A decrease in the reference rate triggers an "extraordinary credit expansion", which, for the most part, generates economic depression, and not economic growth

e. A stabilization of the reference rate is possible, but not in the presence of strong opportunistic movements or on a developing capital market

f. The diversity of economic life has lead to rigid principles in what regards the reference rate

What actually happens in the economy is a rather simplistic mechanism, if understood by economic and banking authorities: if the reference rate is increased, interest rates will also increase, production costs go up, which in turn, leads to a decrease in profits and investments. "On the contrary, if the official discount rate decreases, there will be a transfer of funds from the monetary to the capital market, where the interest rate is higher, but only for a limited period of time. Production remains constant, profits increase, and the fraction of benefits which is saved will serve either for self-financing, either for a long-term investment, encouraged by the new ascending business cycle… Considered as a means of market regularization, the discount rate policy needs changing and re-orienting from time to time, both in principle and in practice, as the modern economic and financial situations require. It represents though, a classical way of guidance for the national currency, perhaps the only one to have proven its capacity so far, but the only one that the current supporters of the ``controlled currency`` do not seem to understand"[61].

The principles of the discount rate

-The official discount rate of the central bank must be lower than the market rate

-If the production costs do not rise, the discount rate must be left unchanged

-If the production costs rise, the discount rate must also be increased in order to prevent speculative pressure

-Every ascending movement in prices cannot be encumbered by an increase in the discount rate

-Accidental events, such as wars, crises, reforms, revolutions etc "can provoke a rapid increase in the discount rate in some countries, which can be conveyed to other countries" (Stoenescu 1935)

At the beginning of last century, H. Hornbostel noted that the repercussions of the discount rate fluctuations have become much more complex and that the application of the classical methods has disappointed frequently those who believed more in their efficiency.

The official discount rate is usually motivated by general economic and financial interests, by the monetary circulation and credit expansion requirements. There is no standard formula for an infallible discount rate. It is unanimously accepted that economic stability with no inflation generates ever lower discount rates.

All throughout the 20th century, the discount rate levels – denominated "reference rate" as of 1st January 2002 by the National Bank of Romania – have been as follows:

-The period (1891) – 1901 – 1918 of the gold standard: this period has generally experienced higher discount rates of 6-7% (during the agricultural crisis of 1894); 8% in 1907; 6% between 1914-1918; this points out that periods of economic upheaval usually generated higher discount rates than periods of normal activity. In this respect, dr.Radu Stoenescu (1935) observes that "Between 1901-1914, the National Bank continued to help economic development through ever larger productive investments… The

61 idem, p. 67

official discount rate was reduced to 8,7,6 and even 5% (14th August 1902), as the economic situation improved and remained at this level up to 1907 when, due to the international monetary crisis and the national social-agricultural crisis, the rate had to be raised to 8% again (27th October 1907). When the crisis ended, the discount rate turned back to its previous 5% level (28th February 1908), a level maintained until 19th October 1912, when it was again lifted to 6%. It was during 1912 that the age of prosperity and economic progress came to an end and gave way to an endless period of economic and political crises, which still goes on today… In 1914, the National Bank considerably enhanced its discount operations, in order to help eliminate the previous crises. The variations in the discount rate fluctuated between 5.5 – 7% … and the stagnation of the economic activity determined a sensible decrease in the National Bank operations

-The period 1919 – 1928: the average level of the discount rate was 6%: an official discount rate as low and stable as possible, in order to help reconstruct the national economy, by providing a cheap commercial credit… Maintaining too low a discount rate seems to have fuelled the speculative activity which was going on. Indeed, it was a most profitable business for large banks to borrow money by refinancing at the National Bank at a 6% discount rate, and then lend it to smaller banks or to other private entities at 20-25% interest rate. Not only did this hamper economic development, but it also contributed to an aggravation of the national currency depreciation, by encouraging the ascending tendency of prices

-The period 1929-1934, of the economic crisis: the discount rate varied between 8-9.5%; the 7% discount rate, although well grounded in the monetary situation, seemed too high from an economic point of view, if we take into account the low profitability of enterprises and the conventional interest rate established by law in March 1931 – at 5 percentage points above the official discount rate. Therefore, the National Bank turned back to the 6% interest rate on April 5th 1933… On December 14th 1934, the National Bank proceeded to a new decrease in the official rate, from 6% to a mere 4.5%... In this way the National Bank proved once again not only a considerable comprehension, but also its effective support, as the issuing entity, to the development of our national economy

-The period 1935-1946, the discount rate varied between 3-4%. This interval comprises both the pre-war period and World War II, with its economic and financial peculiarities

-The period 1947-1989 (the communist period) – during this age, the official discount rate varied by 1-2% from year to year up to 1955-1960; then as the centralized plans pinned down most economic evolutions and variables, the NBR official discount rate leveled off at 1%.

By analyzing the discount rate changes during the first half of the 20th century, we can easily notice rather abrupt variations – of about 1-1.5%, both upwards and downwards – in the discount rate; this reflects rather large changes in the most important economic and banking indicator. At that point, such fluctuations were afforded by the national, European and international economic situation, whereas nowadays, such changes are no longer possible, due to the intricacies and complexity of the economic, financial and banking inter-relations at the European and global level. The evolution of the official discount rate points out a sensible conclusion: the Central Bank has provided the cheapest capital throughout the 20th century, at a discount rate that fluctuated on average between 5-6%. The evolution also reveals that throughout the 20th century, the discount rate has been the cause – and not the consequence – of economic policies. All these aspects are illustrative of the decisive influence that the official discount rate has on the economic developments in Romania.

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- The National Bank is Going to Replace the Official Discount Rate with the Reference Rate –

The macroeconomic context in Romania during recent years has been characterized by structural liquidity surplus in the banking system, triggered mainly by the relative acceleration of capital inflows. The commercial banks enjoyed alternate financing sources, which led to a progressive reduction in re-financing operations, and forced the National Bank to sterilize the economy in order to prevent the inflationary pressures of the excess liquidity. Romania's case is not unique, in fact sterilization operations are a common feature for most Central and Eastern European countries acceding to the EU.
Since operations such as refinancing and discounting have gradually lost their relevance, in that they are not a particular feature of the current monetary policy orientation, the replacement of the discount rate with a rate of reference for the central bank operations seems like the natural thing, deriving from the evolution of monetary circumstances. The necessity for such a change is reassured by the fact that, for at least the next three years, the sterilization shall continue to play a predominant role among NBR operations, which is also reflected in the National Economic Development Strategy for the Medium Term, conceived in March 2000 and submitted to the European Commission.
A restoration of the discount rate is rather unlikely since, in light of the European accession process, the National Bank of Romania seeks to align its procedures to those of the European Central Bank, whose analytical kit – as that of many modern central banks – does not include the discount rate concept.
In this context, the discount rate will be replaced with the NBR reference rate and will be calculated as to reflect the prevalent conditions on the monetary market. For the forthcoming period, the new interest rate will be calculated as an arithmetic average weighted with the level of transactions, of the interest rates for deposits and reverse repo operations of the previous month. The reference interest rate will be made public through press releases of the National Bank on the first working day on a monthly basis. This information will also be published in the monthly bulletins of the central bank as well as on its website (www.bnro.ro).
The reference rate will enter into force on February 1st 2002, by regulation of the National Bank of Romania which will repeal NBR Regulation no.11/1998 and will establish the level of the reference rate for February 2002.
We must observe that the shift from the discount rate to the reference rate will not produce any shocks, the two indicators having comparable levels at present.

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