CONSIDERATIONS ON MONETARY POLICY HELD BY THE CENTRAL BANK TO ADOPT THE EURO

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The current paper presents some considerations regarding the monetary policy held by the central bank in order to obtain the declared goal of joining the European Monetary Union. The paper refers to the strategies included in the National Accession Plan, and in the Convergence Program established by the National Bank of Romania. Furthermore, the paper presents some of the recent developments and the technical developments.

Keywords: Monetary policy, National Bank of Romania, convergence

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1.Introduction.

The Romanian National Bank has been subjected to a transformation process over the last few years, that manifested itself under the influence of 3 factors: the reorganization of the central bank by transitioning from the monobank, centralized system to a more descentralized model, more adept for a market economy; adopting the communitary acquis and the efforts made to reach the real and nominal convergence criteria in light of the future integration process and the adoption of the single european currency.

Along with the communist regime removal, the transition to a market economy has involved extensive changes at institutional level. Two-tier banking system reorganization involved the NBR to regain the traditional functions typical of a genuine central bank. Thus, its commercial bank specific activities have been abandoned, which were taken over by another newly created entity - Romanian Commercial Bank.

The new status of NBR in June 30th, 1998, provides price stability as basic objective and seeks to standardize legislation. Since 1999, the main objective of monetary policy, target inflation's reduction to gain competitive advantage to the devaluation of the leu against the euro. long with this, we wanted to stabilize the leu exchange rate, given its importance as a nominal anchor.

Since 2001, NBR announced that it abandoned to disperse efforts to multiple targets, and focus on reducing inflation, leaving the Government, through various means, especially in budgetary policy, to deal with maintaining the foreign payment's balance equilibrium. This means not only a major change in the monetary authority's practice, but also a distribution of tasks and concern for the trade balance situation.

EU integration process has been a stimulating factor in speeding up reforms, real and nominal convergence criteria become important landmarks in efforts to maximize the degree of functionality of the Romanian economy. Priorities and objectives in line with Romania's intention to join the European Union were addressed in the National Program for Accession of Romania to

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the European Union (PNAR). It provides: strong reducing inflation, ensuring a sustainable external position, maintaining the budget deficit under control, improve and reform its banking system stability.

Also, one of the main factors leading to repeated update of the Romanian banking legislation was the need to adopt the acquis communautaire. Legislative changes have mainly focused on issues such as: central bank independence, the adaptation of central bank's regulations to modernizing the payments system, prudential requirements on commercial banks' lending activity, bank accounts coding standardization, gradual liberalization of currency transfers, adaptation regulations to combat money laundering requirements.

NBR status in June 2004 contributed to the harmonization of Romanian legislation with the EU. News had in mind primarily the strengthening of central bank independence, price stability as a fundamental objective, prohibition of direct financing of public institutions by the Central Bank, harmonization of the NBR's procedures and instruments with the ECB's.

Strengthening NBR's independence is a prerequisite to achieve nominal convergence criteria, established by the Maastricht Treaty. In the literature, central bank's independence is defined as a series of restrictions regarding monetary policy, aiming government loans, the method of economic policies and the relationship between government and central bank, restrictions which favors the price stability objective.

Central bank's independence refers to a certain degree of independence in the choice of specific instruments for achieving objectives, not setting targets itself for monetary policy[388].

Hayo and Hefeker argues that central bank independence is not a necessary and sufficient condition for price stability, citing as an alternative, a possible agreement between central banks and governments on this objective, or setting up a fixed rate regime, by linking the national currency of another currency[389].

Both versions cannot be valid in the case of the CEB and at the same time, are unverifiable in the case of the NBR. Therefore, in the first instance, it could occur that both the Central Bank and the Government tacitly agree on the failure to comply with the price stability objective, at a certain time. This scenario could only turn out if the partners cannot call each other into account or be called upon by a third party. Also, judging by the way the European Central Bank System is organized each Central Bank should be in close contact with the Government, which could favor cartel behavior for certain members of the area.

The second alternative has been embraced in various forms by several transitioning countries, some of which have become members of the European Union in the meantime. Yet, it has been proven that there is no correlation between price stability and the fixed exchange rate system, the government's temptation to use exchange policy as a foreign commerce competitive edge could constitute an argument in this sense.

A certain practical miscorrelation between the NBR and the Government is easily visible, in so far as the independence of the Central Bank infers the joint setting of economic policy objectives. In certain instances, the Central Bank will try to patch up the Government's decisions.

The absence of a long term fiscal and budgetary strategy renders much more difficult NBR's attempt to reach its objectives regarding inflation rates, fact proven in later years by the repeated recalculation and failure to reach the set inflation target, due in most part to unilateral Government decisions regarding the enactment of a sole tollage rate. This measure has caused an increase in consumption rates which manifests itself by the augmentation of the non-

388 Debelle, G., Fischer, S., *How Independent Should a Central Bank* Se?, in: Jeffrey C. Fuhrer (ed.) *Goals, Guidelines, and Constraints, Facing Monetaiy Policymakers,* The Federal Reserve Bank of Boston, Boston, 1995. p. 195-221.

389 Hayo. B., Hefeker, C., "Reconsidering central bank independence", *European Journal of Politica! Economy,* no. 18(4)72002, p. 653-674.

governmental credit especially the consumption allocated one, thence increasing the inflationist pressure on the economy.

In the attempt to better the decision-making process between the NBR and the Government, the inflation targeted regime adopted in the summer of 2005 by the Central Bank should find its correspondent in the multiannual budgetary scheduling strategy.

The NBR reform has also brought with itself a set of measures pointed at the betterment of the Romanian banking system, taking into consideration – in this sense – passing resolutions in regards to the minimum limit. As the disinflation, in Romania, entails drastic fiscal deficit diminution measures and a cautious income policy, economic specialists think it unwise to only keep the current deficit under control through budgetary and commercial policies.

NBR and the Government should choose to correct the entire setting of the economic policy to encourage durable economic growth, even though in the context of the current economic crisis [390] achieving this would be a difficult task.

Basel II, completed in June 2004 after a series of changes, is structured on three pillars: minimum capital requirements, capital adequacy supervision, strengthening the supervisor's role, and the third concerns market discipline, changing the central bank's reporting requirements.

The objectives of Basel II aims to provide a flexible framework for determining capital requirements, adequate risk profile of credit institutions and strengthen financial system stability assumptions. In this sense, the central bank set a clear calendar for adoption of the new Capital Accord in the national banking system, including four phases of implementation: initiating dialogue with the banking sector, development of means for banking supervision in the Basel II standards, internal rating model's validation by NBR used by credit institutions to assess clients and existing loan portfolio, provisions application's verification of the Agreement in whole banking system.

Since August 2005, central's bank monetary policy strategy pursued inflation targeting.

It was adopted after completing a training process, whose final stage was the development and functional testing framework for economic analysis and monetary policy decision specifically direct inflation targeting.

Were simultaneously satisfied and other requirements and criterias which determine the effectiveness of this strategy: lowering the annual inflation rate below 10 percent; building the central's bank credibility and consolidating it; strengthening the independence of jure (by the entry into force on July 30, 2004 of the new Statute of the BNR) and the *de facto* of the central bank; the restriction of fiscal dominance, the course of fiscal consolidation and improving coordination between fiscal and monetary policy; the relative flexibility of the exchange rate of MDL and reducing the vulnerability of the economy to fluctuations to this variable; healing and strengthening the banking system and the relative increase in banking brokerage; increasing the transparency and responsibility of the central bank as well as the intensity of central's bank communication with the public and financial markets, including issues new regarding monetary policy strategy and the preparation of its adoption; clearer outline of macroeconomic behavior and of economic function mechanisms necessary to identify and increase the efficiency of monetary transmission channels.

In the relationship between commercial banks and the real economy, central's bank monetary policy impulses are transmitted rather imperfectly and after a time that depends on the structural features of the national economy.

Although the central bank can control short-term interest rates, the real economy is influenced by *medium and long-term interest rates practiced by commercial banks for deposits and for loans*

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[390] Anghel, Lucian , Sinteze macroeconomice trimestriale Aprilie 2009, BCR p. 34

offered to their customers. The level of the later depends on the monetary policy interest rate, but also on a number of other determinants (expectations on inflation, the outlook for economic growth, etc..) and is crucial for investment decisions, consumption or saving. Generally, lower interest rates stimulate investments and consumption over saving, while higher interest rates stimulate saving, inhibiting short-term consumption and investments. Thus aggregate demand is influenced by the economy.

The aggregate supply has a capacity for adjustment to the level of aggregated demand limited to a short time horizon. On a long term, the supply mainly depends on the dynamic of some fundamental factors such as basic production capacity, employment and level of technological endowment, and therefore it adjusts more slowly and longer-term it cannot be influenced by monetary policy. Under these conditions, on the short / medium term monetary policy can affect only the gap between the actual level of economic activity and the one that is long-term sustainable (real GDP deviation from its potential level, or, excess demand).

The set of instruments and procedures by which the central bank implements monetary policy to achieve its primary objective forms the operational framework of the monetary policy.

The main instruments of monetary policy that the central bank (BNR) has at its disposal aims: open market operations; standing facilities granted to credit institutions; minimal reserves (RMO). On the medium term, the main problem that arises for BNR is to design a monetary policy that will enable the participation in "II European Monetary System (EMS II) and respectively, the entry into EMU (U.E.M).

2.The Strategy of the National Bank of Romania (NBR) regarding the adoption of Euro

Before the entry into the EMS II phase and then in the participatory phase, the inflation targeting strategy would continue to function, given that it is consistent with exchange rate flexibility and ensures the gradual fulfilment of all the Maastricht criteria.

Romanian financial sector is substantially integrated into the broader EU sector, mainly due to a high participation of foreign investors to the social capital of financial intermediation firms. Taking into account the Commission's evaluations on legal compatibility and convergence criteria plus additional factors, Romania does not meet the requirements for adopting the Euro.

The date mentioned for admission into EMS II was chosen considering that an early admission could prolong the waiting period before Euro adoption, and excessive delay could weaken the incentives for sustained reforms. Thus, the mentioned instalments can keep - for a limited period - some flexibility in terms of monetary policy and exchange rate. That flexibility is needed to make some additional structural reforms, which must be undertaken to give greater flexibility to the Romanian economy that might improve its ability to cope with "asymmetric" shocks.

Also, the reminded planning has the advantage to maintain the motivation for further reforms and reinforcement of the macroeconomic discipline. The transitional period creates the possibility of determining the "pivot rate" (the central parity) based on a fair estimate of the exchange rate's level of equilibrium after surpassing the top of capital inflows caused by favourable expectations of entering the EU.

Among the arguments that advocate possible reduction of the period of participation in EMS II, we remember the following: increased reliability - performance afforded by the latest phases of the process - is absolutely necessary for the passage to the next stage (adopting the Euro), but cannot be maintained indefinitely if the process is not completed; possibility of volatile capital movements around the time of Euro adoption, which requires greater exchange rate flexibility; this involves a transitional period even between the participation in EMS II and entering into the Euro zone, period that, by nature of its purpose, can only be very short; monetary policy applied in the meantime (inflation targeting) implies an obvious subordination of exchange rate movements to the inflation objective; or the requirements of exchange rate stability, specific to EMS II, may become incompatible with the inflation targeting.

As regards the NBR's strategy of adopting the Euro, by June 2009, NBR has not published such a strategy. Furthermore, the Board of National Bank of Romania decided to maintain the same monetary policy for 2009, the same interest rate and the current level of mandatory minimum reserve ratios applicable to liabilities in Lei (18%) and currency (40%) of credit institutions[391].

In this context, the consolidation of the disinflation process and ensuring sustainable financing of the Romanian economy amid the international crisis requires keeping the current conduct of monetary policy in order to support the formulation and implementation of a balanced mix of macroeconomic policies. NBR continues to monitor developments in domestic and global economic environment, so by using adequate instruments it would achieve the objectives of price stability and financial stability through the applied monetary policy. Valentin Lazea, NBR chief economist, said that the national bank intervened in three ways in an attempt to control inflation and exchange rates: "It intervened verbally, and this is a weapon that all central banks use; it intervened using the interest, which grew cumulative until now with one percentage, and intervened in the money market, sterilizing Lei, meaning drawing on central bank deposits the Lei excess on the market"[392]. Also, Valentin Lazea considers that NBR should get involved in the currency market, meaning to sell foreign reserves in order to stem the exchange rate, to meddle with the minimum reserve required, and to continue increasing Lei's interest that, together with reducing interest to other international currencies, like the dollar, will grant new desirability.

To act on inflation, in 2009, the National Bank has imposed (as a crisis situation) to commercial banks especially high minimum required reserves: 40% for liabilities in foreign currency and 18% for the ones in Lei. Reserves are at these levels in order to prevent the entering in economy of a massive amount of money that could not be absorbed and thus generate inflation, as lower consumption converts in an abrupt disinflation. During the first part of 2010, NBR lowered the minimum reserve requirements to relaxation which is meant to bring money in the market and restart crediting.

The main implications for monetary policy in EMU accession are: alignment of monetary policy in the Euro area to avoid shocks caused by sudden changes in monetary policy position; maintaining the efforts to reduce inflation in a realistic tempo; it is necessary the preservation of "direct targeting of inflation", i.e. both in the period up to the entry into EMS II and during this phase; currency policy should allow the adjustment of the Leu's real exchange rate; in the period up to the entry into the EMS II, it is necessary to find the equilibrium level of exchange rate, which is then used as a *pivot point;* complete adoption of the acquis communautaire in the following two areas - banking and supervisory procedures and improving the institutional framework, strengthening the central bank's independence and ensuring its status compatibility with the *"European System of Central Banks"*; developing the banking system and the overall financial system, in order to increase the rationality of resource allocation and ensure monetary policy with adequate transmission channels; modernizing the payment system and connecting it to the European system TARGET; full harmonization of monetary statistics.

It is impossible to define precisely the policy after entering the EMU, but some general features can be stated as of now with pretty much certainty. First, there will not be an independent national monetary policy, but the participation of NBR representatives to the

[391] Anghel, Lucian , Sinteze macroeconomice trimestriale Aprilie 2009, BCR.

[392] Medrega, Claudia, *Inflaţia coboara in aprilie la 6,45%, ajutata si de intarirea leului.* Ziarul Financiar, 13.05.2009.

elaboration of the common monetary policy will be possible. In other words, the monetary policy will be subordinated to the common interest and therefore could not be used exclusively for solving specific problems of the Romanian economy. Secondly, we can make the assumption that until then, the national law which constitutes the framework for the adoption of monetary policy decisions would fully match the "European System of Central Banks" regulations.

3.NBR's Technical Preparation for the Euro Adoption in Romania

Preparation of Euro banknotes (denominations, graphics, technical features, safety features) will be conducted by Romania's Central Bank and European Central Bank. The manufacture of coins will be provided by the Ministry of Finance, as the legal issuer of currency will be the National Treasury, and NBR will adjust the amount of Euro coins that will enter the market. All coins of the same value will have the same size, colour, technical features, in all countries. At the moment, Romania provides harmonized statistical information, but some corrections are still necessary. For example, by the end of 2006, NBR used specific definitions of monetary aggregates (monetary base - M_0, narrow money – M_1, broad money – M_2 and quasi-money), but recently (March 2007) was decided to adopt the monetary aggregates definitions used by the ECB.

Furthermore, it would be indicated the realization of public information campaigns before the introduction of Euro. The NBR campaign will have to follow the mediatisation of the specific safety features graphics, and the fixed exchange rate[393].

The channels used by the NBR to transmit information can be the classical ones, used in any media campaign: the periodic publication of articles in high-circulation newspapers, conducting press conferences and symposiums, making posters and presentation folders, interviews with experts from the NBR and of course, publishing any information on the NBR website.

Especially for rural areas, banknote designs posters, identification elements and other essential information of this process may be displayed in postal offices, bank branches and subsidiaries. The presentation brochures could be made available inside the banks. For areas less connected to the mass media, local administration can be co-opted to publicise this process.

Problems that can increase the amplitude of the banknotes conversion process must be avoided, like the possibility of queues at bank counters, automatic vending machines or shops, and the problem of insufficient supply of cash in banks, the necessary of banknotes being difficult to estimate due to the psychological component - the novelty associated with this process.

4.Conclusions

The specialists' macroeconomic analysis found that Romania meets only one criterion for convergence, i.e. the public debt criterion, and that relatively, given the fast pace of Romania's indebtedness to overcome the economic and financial crisis. Consequently, in order to follow the established schedule, namely entering ERM II in 2012, and adopting the Euro in 2015, it is necessary to employ an appropriate monetary strategy, and developing economic policies that lead to fulfilment of all the convergence criteria.

As regards the monetary policy, it appears not to have changed so NBR will continue the same trend as in 2008 and 2009. However, alarming is that the NBR has not made public a strategy of monetary policy for adopting the Euro in 2015.

Central Bank's independence, reinforced by the latest status of NBR in June 2004, has not always as a support the collaboration with government authorities. A solution in linking monetary policy with the fiscal and financial plans would be the adoption of the strategy of multiannual budgetary

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[393] Chiru Liviu, Popa, BNR: Adoptarea unilaterala a euro nu este o opţiune pentru Romania, Ziarul Financiar, 01.05.2009

programming that would ensure the premises for the Central Bank to meet the inflation targets. Thus, good collaboration between NBR and the Government should create favourable conditions for the performance of both nominal convergence criteria, as well as those of real convergence.

Prospects for introducing Basel II involves an active collaboration with the banking community, an accurate assessment of internal rating models of credit institutions and strict surveillance conducted by the NBR.

Also, cooperation with monetary authorities, of supervision and regulation from other countries, especially those in the Economic and Monetary Union, is necessary.

In addition, it is recommended that, in 2014, NBR develops an information campaign for the Romanians to prepare them for the actual introduction of the Euro.

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