

Monetary Policy in the Context of the Macroeconomic Policy Mix

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Abstract

This paper presents the measures and methods used by the monetary authority and the National Bank of Romania (NBR) in order to influence macroeconomic conditions through monetary and financial policy mix. An integral part of the economic policy of a state, monetary policy acts with the fiscal and budgetary policy in order to influence the aggregate demand. The instruments with which monetary policy operates are: supply and demand of credit, interest rates, exchange rates and reserve. The main target of the NBR is the determination of the annual rate of growth of the money supply, in order to maintain price stability, stimulate investment and employment growth.

The analysis focuses on how the National Bank of Romania used the instruments of monetary policy in the period 2010-2014 in order to ensure the overall balance and to achieve the stated objective, i.e. to keep inflation level by anticipating the adoption of the single European currency. Experience has shown that monetary policy cannot act alone, but together with fiscal-budgetary policy.

Keywords: *monetary policy, monetary mass, rate of interest, inflation, the mix of macroeconomic policies*

JEL Classification: *E52*

Introduction

The economic development of a country is closely linked with the policies used by the state. It is involved in the economic field in order to achieve certain structural or circumstantial objectives, their implementation in practice returning to the executive given that the role of the public authorities is not limited to providing the legislative-institutional frame, on the contrary to seeking the general balance. Realization of general economic equilibrium must start from the major objectives of economic policy, such as: the dynamics of real economic growth, changes in inflation and maintaining external credibility by keeping the current balance of the balance of payments in financeable limits.

According to the Romanian economist Iulian Văcărel, financial programming model requires "the need for materialisation of the correlations that exist between the general consolidated budget (expression of financial equilibrium), balance of payments (reflection of external equilibrium) and the size of the cash flows (delivering monetary equilibrium)"¹

¹ Văcărel, I., et.al., *Finanțe publice*, Ediția a VI-a, Didactic and Pedagogic Publishing House, Bucharest, 2007, pp. 667

In order to achieve the objectives of economic policy the following are used as tools of intervention: financial policy with its two components, respectively budgetary and fiscal policy, as well as monetary policy.

Monetary policy is in close correlation with the tax policy and budgetary policy, aimed at adopting measures to achieve the adjustment of money supply and interest rates in the economy, with impact on national income and the level of prices. The link between the financial and the monetary policy is the mode of action of the central bank. Drawing up monetary policy lies with the National Bank of Romania.

The fulfilment of the fundamental objectives of general economic policy lies in its interdependence with the monetary policy report, taking into account the fact that, nowadays, the government uses a mix of policies, aimed at stimulating aggregate demand. As part of the policy mix, specific objectives are established; the role of public authorities is their harmonization. The interaction of the financial policy with monetary policy must lead to "combining money market model with aggregate supply and demand model."²

Appearance of imbalances implies the application of corrections which take into account the conjectural fluctuations in the economic plan in order to ensure market balance via demand-supply mechanism, in order to capitalize on financial and monetary flows of real resources, in a continuous process of interconnection.

A monetary policy that targets inflation demonstrates its effectiveness in case the prices of goods and services are stable, a fact that contributes to the growth and well-being of the population. Monetary policy exerts influence on aggregate demand and inflation through the interest and exchange rate. A priority objective of monetary policy is the stability of the exchange rate of the national currency. Monetary authorities act on the currency exchange rate and the balance of external payments through interest rate variation and through the purchase or sale of foreign currency on the forex market.

Monetary Policy - Concept and Transmission Tools

Monetary policy, an integral part of the economic policy of a state, is defined as: "all the measures and the methods by which public authorities seek to influence macroeconomic conditions by increasing or decreasing the money supply"³.

According to some specialists in the field, the monetary policy means "the interventions of the central bank or monetary authority which shall be carried out on the liquidity of the economy, in order to contribute, through the use of monetary instruments, or techniques to achieve the objectives of economic policy"⁴. This requires action by the Central Bank on monetary currency.

Monetary policy is a lever of indirect intervention upon economic processes, using tools like the offer of currency and interest rate.

Implementation in practice of the monetary policy objectives is achieved through tools that are meant to influence the credit and liquidity of banks.

According to the legal regulations in force, the main instruments of monetary policy that National Bank of Romania uses to act upon the application or offer credits are:

² Crețoiu, C., Cornescu, V., Bucur, I., *Economie*, Ediția a III-a, C.H. Beck Publishing House, Bucharest, 2011, pp. 423

³ Angelescu, C., et.al., *Dictionar de Economie*, Ediția a doua, Economic Publishing House, Bucharest, 2001, pp. 338

⁴ Basno, C., Dardac, N., Floricel, C., *Monedă, credit, bănci*, Didactic and Pedagogic Publishing House, Bucharest, 2003, pp. 324

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- money market operations plus interest rate monetary policy;
 - permanent facilities granted to credit institutions;
 - minimum reserves (MR);

Through *money market operations*, the National Bank of Romania follows the conditions of reserve requirements and interest rates on the market, facilitating banks the establishment of reserve in order to ensure liquidity. Interest rates, monetary indicator, which allows assessing, quantifying the monetary expansion as well as the connections between money and economic processes it sets up daily on the basis of supply and demand for credit, negotiated between banks. The level of interest is based on liquidity. Reducing credit liquidity leads to increased interest. Money market operations involve primarily deals with debt instruments which influence the amount of the reserve assets held by the banks and the flow of loans from financial institutions with interest rate level consequences. The purpose of this type of operation is changing the money supply in the economy.

In the category of money market operations used by the National Bank of Romania are included:

- repo and reverse repo operation;
- the acceptance of deposits;
- the issuance certificates of deposit;
- granting of loans collateralised with assets eligible for guarantee;
- selling/buying of assets eligible for trading;
- currency swaps;

Permanent facilities granted to credit institutions are the marginal lending and deposit, which allows the contracting or awarding of borrowings, or the formation of deposits in exceptional circumstances. Sub-loans achieved by marginal lending must be offset by eligible collateral.

Reserve system influences the costs of financing, acting on the demand and supply of credit. It contributes to enhancing the liquidity of banks requirement, calculated as a monthly average, thereby reducing the volatility of short-term interest rates. Increasing the reserve contributes to reducing the funds available for lending, with an impact on the growth of interest rates, while reducing the reserves entails the reduction of interest rates.

The manner in which the Central Bank uses these tools to influence the money supply in the economy provides an insight into the type of promoted monetary policy (expansionary or restrictive).

In the first case it acts on monetary expansion by reducing interest rates, easing restrictions in granting loans, the acquisition of securities on the open market, reducing reserve requirements and boosting demand for credit from banks. A low cost of financing has the effect of increasing investment with multiplicative effect on the income made by taxpayers, and default on tax revenues raised to the unitary system of budgets on account of revenues from the tax on income or wealth supported by individuals and legal entities, as well as the usage charges (VAT, excise tax) as a result of an increased consumption of goods and services. At the same time, the increasing employment of the population is leading to a decrease in expenditure on unemployment, and those concerning labour market reintegration and professional reconversion.

Contraction of the monetary policy causes the decline of the aggregate demand in the economy and decreasing the gross domestic product. A restrictive monetary policy involves raising reserve requirements, interest rates on the money market, the sale of money market securities, which in turn leads to higher cost of funds, with implications on aggregate demand in the economy and the dynamics of consumption and investment will be reduced, due to a slowdown in economic growth, while ensuring economic stability and a financial system.

The central bank option concerning the two types of policy is influenced by the economic situation at the time, of a surface. Each policy must make adjustments in a timely manner so as to avoid overburdening of the other policies.

Although monetary policy does not act directly on the dynamics of incomes and expenses of the budget, its effects on aggregate demand, inflation and unemployment affect the decisions of fiscal-budgetary nature adopted by the government.

The literature distinguishes two conceptions of the role played by monetary policy in the framework of macroeconomic policy mix:

- Keynesian theory;
- monetary theory;

In the Keynesian theory, the interest rate affects the amount of currency in circulation, with an impact on investments and consumption of government and private sector. Followers of the Keynesian theory, Paul Krugman, Joseph Stiglitz and Nouriel Roubini are supporting an expansionary monetary policy during the crisis in order to stimulate aggregate demand even as amplifying inflation pressures. According to Krugman a high inflation leads to increasing production and lowering unemployment, for which he proposes raising the inflation target and the adoption of incentive policies.

The economist Robert Lucas formulates “rational expectations theory” according to which economic decisions must be taken on an individual basis on the basis of market relations and not by the state mixture, contrary to the Keynesian theory. This theory relies on two important ideas:

- prices and wages adjust quickly to changes in market, thus settling a balance;
- the people know and use all the information and economic theories which support economic policy measures.

The second theory argues that action of the money in the economy is more extensive. They take into account the monetary mass and rotational velocity of money as factors determining the dynamics of macroeconomic indicators and prices.

Romania’s accession to the European Union meant aligning macroeconomic policy of our country to the requirements imposed by the nominal and real convergence towards the euro area, which involved the adoption of a monetary policy aimed at maintaining price stability with a view to maintaining sustainable economic growth.

The Stability and Growth Pact aims to ensure budgetary discipline in the Member States in order to avoid the occurrence of excessive deficits, thereby contributing to the stability of the currency.

Of the four economic stability criteria relating to the situation of public finances, price stability and exchange rate, the convergence of long-term interest rates Romania meets only two: those concerning public finance and the convergence of interest rates.

Amid the finalisation of the European monetary unification by creating a single currency, monetary policy strategy promoted by the National Bank of Romania aimed at ensuring price stability through direct inflation targeting as it is stated in the law 312/2004 on the NBR statute.

The main developments in monetary policy in Romania show the direction to be followed for the adoption of euro in the context of the current economic crisis.

Monetary policy causes significant effects on inflation, either all or only the one corresponding to the index CORE2 and over exchange rates, for the purposes of its assessment and inflation diminution.

The analysis of general economic framework of Romanian economy shows positive results in the evolution of the main macroeconomic indicators.

The onset of the economic crisis was favored by the lack of coordination between monetary policy and fiscal policy, which impacted upon the financial stability. Financial stability in the euro area is measured on the basis of an index of aggregate stability developed via IMF methodology, which is used to provide the financial stress index.

Monetary Policy in Romania - Evolution and Prospects

Within the framework of macroeconomic policy mix, the monetary and exchange rate policy will take into account the implementation of the priority objective, namely the reduction of inflation, while fiscal-budgetary policy will ensure the continuation of the budgetary consolidation process.

Inflation is an imbalance of economy manifested by increased discrepancy between the monetary mass and offer of goods in relation to the previously existing situation, manifested by two trends: on the one hand, generalised increase in prices and on the other hand, the decreasing purchasing power. Money consists of all means of payment, existing liquidity in a determined period within an economy. The size of the inflation is evidenced by the increase of prices and index of the decreasing purchasing power index, manifested through the gap between the absolute nominal aggregate demand and aggregate supply of real property.

The long-term goal of monetary policy should be to achieve a low and stable inflation as a foundation for sustainable growth over the long term.

Inflation targeting as a monetary policy strategy is based on the need to achieve financial stability with a view to adopting the single currency.

Measures taken by the National Bank of Romania have led to a decrease in the average rate of inflation by 6.41 percentage points during the period 2010-2013, whilst maintaining the stability of the financial system.

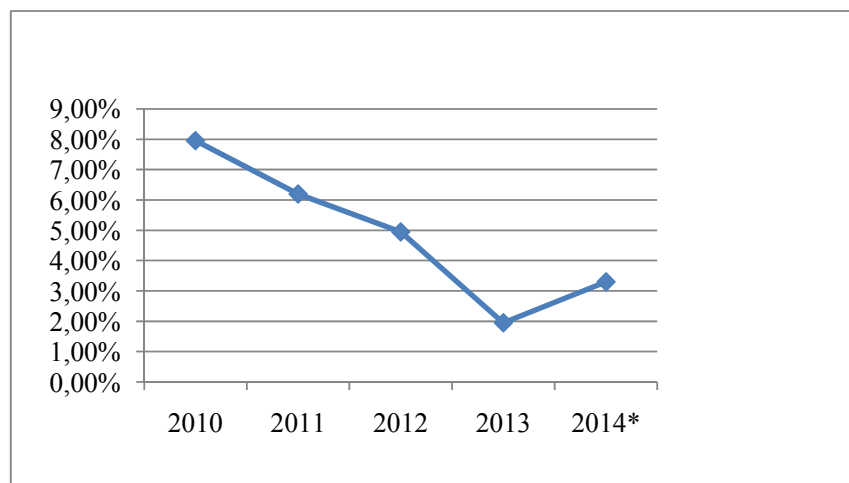


Fig. 1. Evolution of the rate of inflation during the period 2010-2014

*forecast for the end of the year 2014

Source: Own processing on the basis of the reports on inflation drawn up by NBR in the period 2010-2014

Reducing the level of inflation rate at 1.55% at the end of 2013 was due to an excess of supply of agricultural products as a result of the rich harvest obtained during the year and also to the government decision on 1 September 2013 to decrease VAT from 24 percent to 9 percent for

bakery products, but also to the strong decrease in income, including purchase power of the population in the period 2009-2011. Also the strict measures of control of monetary expansion adopted by NBR, the reduction of the reference interest and the stability of exchange rates contributed to the decline in inflation.

The annual inflation rate foreseen for the end of 2014 will be increased, approaching the upper limit of the target range, as a result of rising prices for tobacco products and alcoholic beverages, as well as fuel prices with increasing specific excise duty on these products but also to the exchange rate converted to RON. Inflationary pressures in the year 2014 are also due to ruling on the liberalization of prices of energy products.

Easing monetary policy stance adopted by the NBR is similar to that adopted by the European Central Bank. The measures adopted were aimed at reducing the rate of monetary interest and currency reserve in order to stimulate the economy by encouraging lending. Romanian National Bank realized early in 2014 the sixth consecutive drop of the interest rate with 0.25 percentage points over the last eight months, accumulating 1.75 percentage points, because currently its level is 3.50%.

Table 1. The evolution of monetary policy interest rate

| Starting date | The rate of interest | Lending facility | Deposit facility |
|------------------|----------------------|------------------|------------------|
| February 5, 2014 | 3,50 | 6,50 | 0,50 |
| 9 January 2014 | 3,75 | 6,75 | 0,75 |
| 6 November 2013 | 4,00 | 7,00 | 1,00 |
| 1 October 2013 | 4,25 | 7,25 | 1,25 |
| 6 august 2013 | 4,50 | 7,50 | 1,50 |
| 2 July 2013 | 5,00 | 8,00 | 2,00 |
| May 3, 2013 | 5,25 | 8,25 | 2,25 |
| 30 March 2012 | 5,25 | 9,25 | 1,25 |
| 3 February 2012 | 5,50 | 9,50 | 1,50 |
| January 6, 2012 | 5,75 | 9,75 | 1,75 |

Source: NBR

The standing facilities interest rates granted by the National Bank of Romania (deposit facility and credit facility) vary from 2013 with ± 3 percentage points compared to the monetary policy interest rate.

Reducing the interest rate from 3.75% to 3.50% was possible due to the fall in the annual inflation rate at the end of 2013 at 1.55% which was the minimum of the last 24 years. This decision taken by the National Bank of Romania has led to the reduction of the interest rate that commercial banks pay to their depositors, their level hovering just below the rate of inflation at a time (a negative real interest rate), given that the client also supports a 16% tax on the interest income, somewhere around 2%, but also to a fall in commodity prices and bank lending to companies and households.

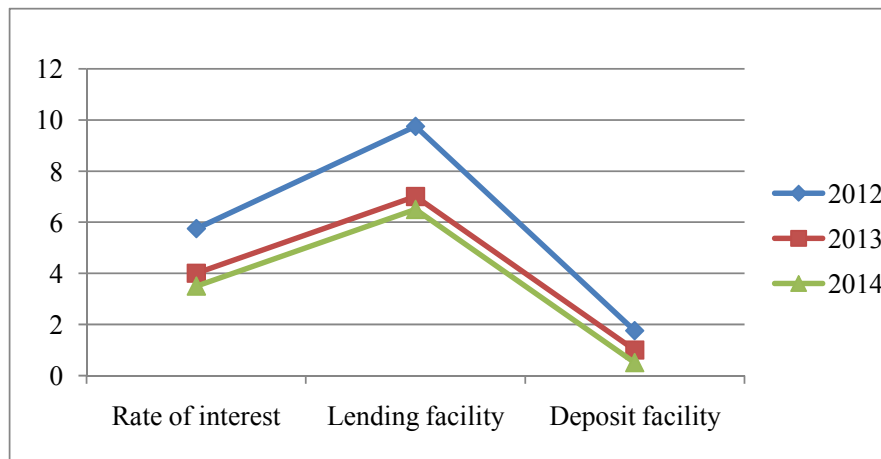


Fig. 2. Dynamics of monetary policy interest rates and of the permanent facilities during 2012-2014

Source: Own processing based on data presented in table number 1

As for the reserves, NBR decided to maintain them at 12% for liabilities in Ron, respectively to 18% for foreign currency liabilities. The National Bank of Romania intends to continue easing reserve requirements for banks, even if it ended the cycle of interest-rate reduction.

Short and medium term monetary policy will continue in the direction of strengthening the process of disinflation and price stability in order to achieve the target of 2.5 percent plus or minus 1 percentage point, while stimulating lending and investment, likely to contribute to the economic recovery.

Conclusions

The current economic and financial instability involved major challenges for monetary policy. The objectives of monetary policy must be harmonized with the general economic objectives proposed by the executive, namely economic growth, internal and external stability of the currency, varying from one country to another and from one period to another.

Knowledge of the role of monetary policy, reported at the objective of macroeconomic stabilisation, as well as its interdependence with specific measures of financial policy allows the understanding of its implications in terms of economic balance, in general, and of the financial one in particular. Macroeconomic policy mix has an impact on budgetary revenues, on the dynamics of the G.D.P. and prices, taking into account the fiscal pressure.

The way in which public authorities make use of budgetary, monetary and fiscal policy, influences aggregate demand and investments.

The budget deficit and inflation rate constitute the link between financial policy and financial balance, on the one hand, and monetary policy, on the other.

Taking into account the risks associated with domestic and international macroeconomic trends in the period ahead, the Romanian National Bank will promote a prudent monetary policy, oriented towards strengthening the process of reducing inflation and ensuring price stability. The effectiveness of monetary policy depends on the implementation of the objectives agreed with the EU, IMF, WB, in the sphere of fiscal consolidation, structural reforms and attraction of European funds.

The essential problem is not to choose between monetary policy and the fiscal-budgetary policy, but to coordinate them in order to increase their efficiency.

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