



Monetary Policy in the Shadow of the Euro

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Policy Regime Choices & Constraints: Romania

- **Need for further sustainable disinflation, incl. from EU convergence perspective; move from 8.5% to around 2-3% difficult, fraught with costs (non-linear sacrifice ratio, etc.)**
- **Status quo (mix of monetary targeting with exchange rate interventions) no longer appropriate: weakening relationship between monetary aggregates and inflation**
- **Exchange-rate peg based regime highly risky in light of convergence-induced appreciation trend, move towards full capital mobility**
- **Inflation targeting provides CB transparency & accountability, constrained discretion, should help anchor expectations, dominates above options in terms of robustness to shocks; but requires time for full effectiveness**

Policy Regime Choices & Constraints: Other Countries

Other countries followed different paths:

- currency board – Bulgaria (only option available in aftermath of severe financial crisis & hyperinflation)
- implicit euroization (quasi-currency board) – Croatia (small open economy, resident inflows & savings, aftermath of war period, widespread euroization from beginning of statehood)
- Czech Republic, Hungary, Poland moved to IT and away from exchange rate-based configurations

Romania: Foregone Policy Regime Choices (1)

- The market perception of risk of a crisis in 1998-99 raised the issue of introducing a currency board arrangement
- Authorities decided to preserve an independent monetary policy as:
 - quasi-fiscal deficits (not apt to be influenced by regime switch) were larger than the fiscal ones
 - the level of official foreign exchange reserves was insufficient
 - no crisis meant lack of basis for a large initial devaluation (in order to preserve sustainability of fixed rate with prospect of future appreciation), with substantial inflationary effects, also hitting real incomes
 - the banking sector was unrestructured and fragile

Romania: Foregone Policy Regime Choices (2)

- The option was even less substantiated in early 2000s, considering that:
 - it does not allow monetary policy to react to asymmetric shocks
 - currency board arrangement incompatible with choice of gradual liberalisation of the capital account
 - given the fixed nominal exchange rate, real exchange rate appreciation due to capital inflows and Balassa-Samuelson entirely reflected by inflation rate, thereby slowing down disinflation under strong catching-up in incomes (Bulgaria at 8.8% 12-month CPI inflation in Feb. 2006)

- Monetary policy evolved gradually towards inflation targeting
 - first Inflation Report published in 2002
 - implicit inflation targeting for about 3 years, with two dry runs of the quarterly forecasting exercise

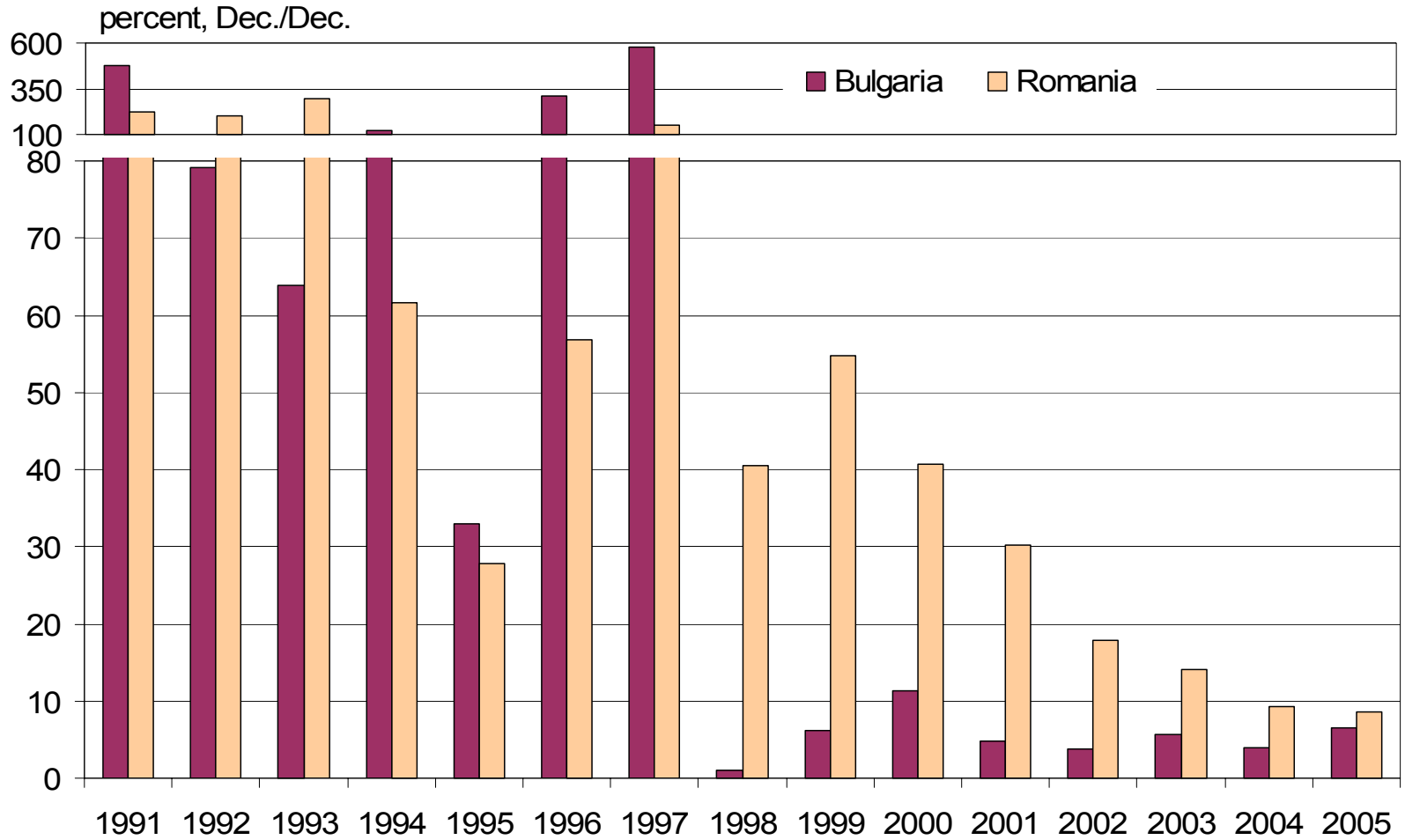
Macroeconomic Context of Proposed Currency Board Arrangement

percent

Country	Year	GDP growth	Inflation rate (annual average)	Overall budget balance/GDP
Bulgaria	1996	-9.4	121	-15.4
	1997	-5.4	1,058	2.1
Romania	1998	-4.8	59.1	-3.6
	1999	-1.2	45.8	-1.8

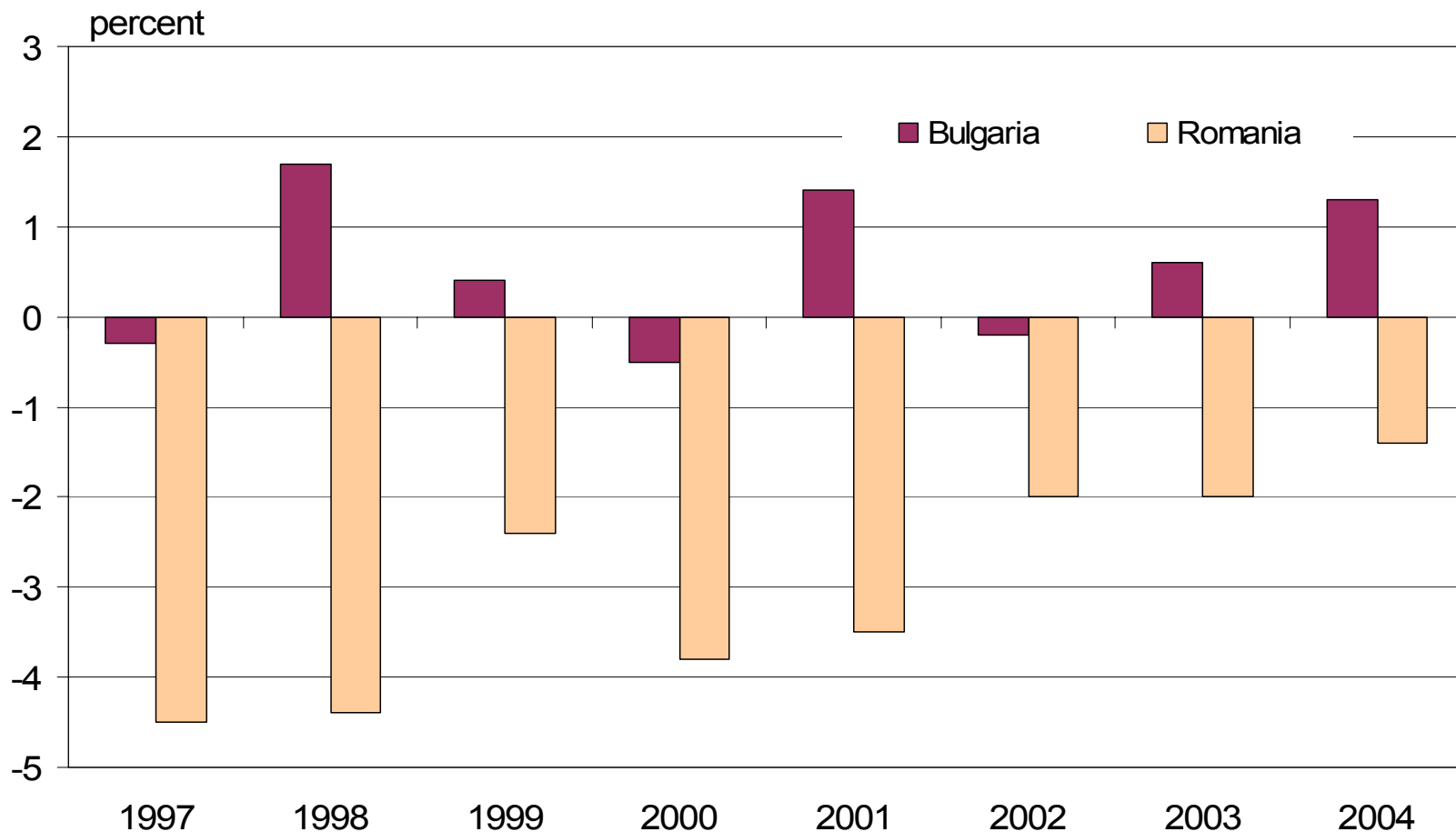
Source: World Bank, EUROSTAT, NIS, NBR

Inflation Rate



Source: BNB, NBR

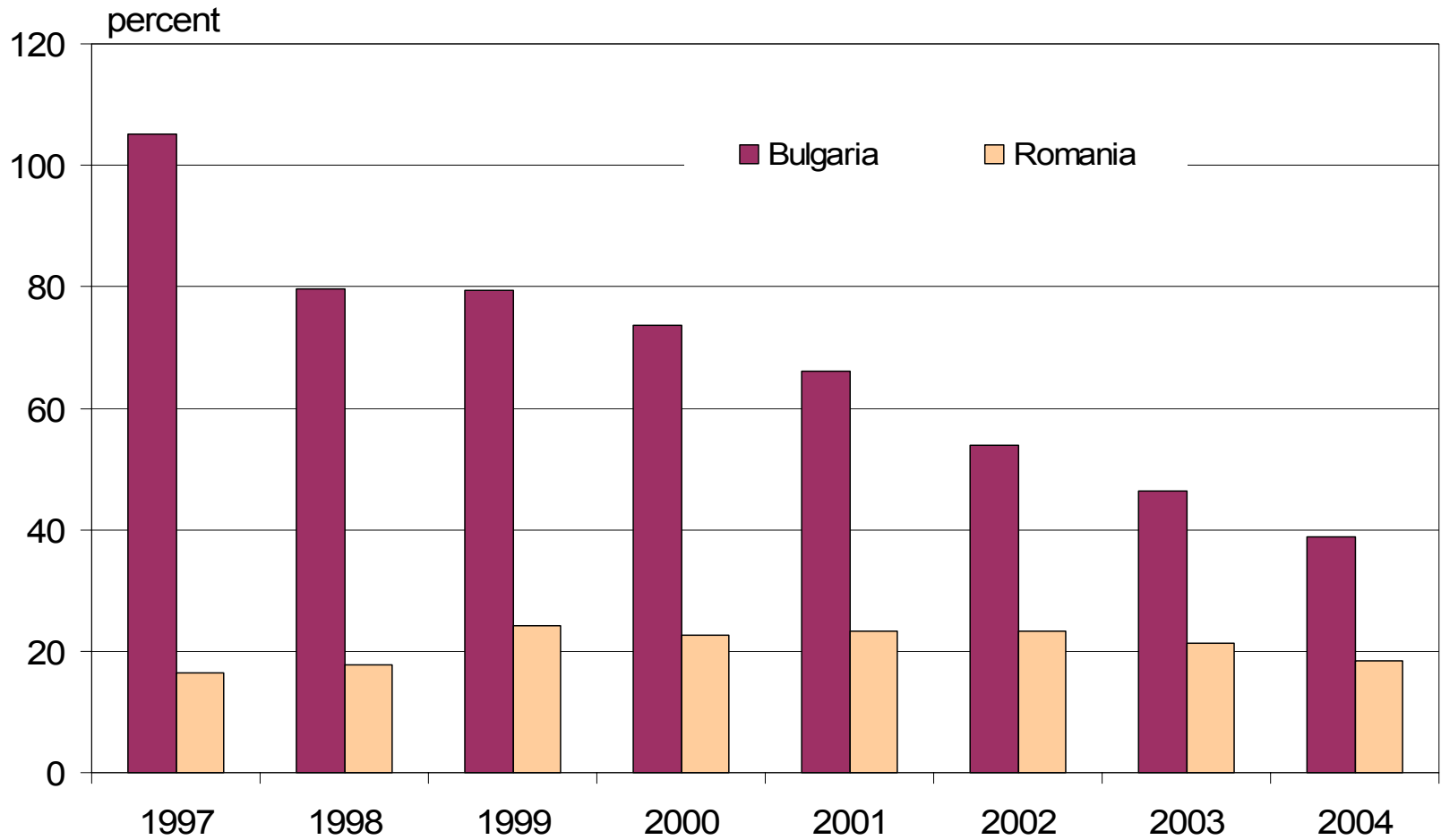
Public Balance*/GDP



* Net borrowing/lending of consolidated general government, according to ESA95 methodology

Source: EUROSTAT

General Government Debt/GDP*



Source: EUROSTAT

* ESA95 methodology

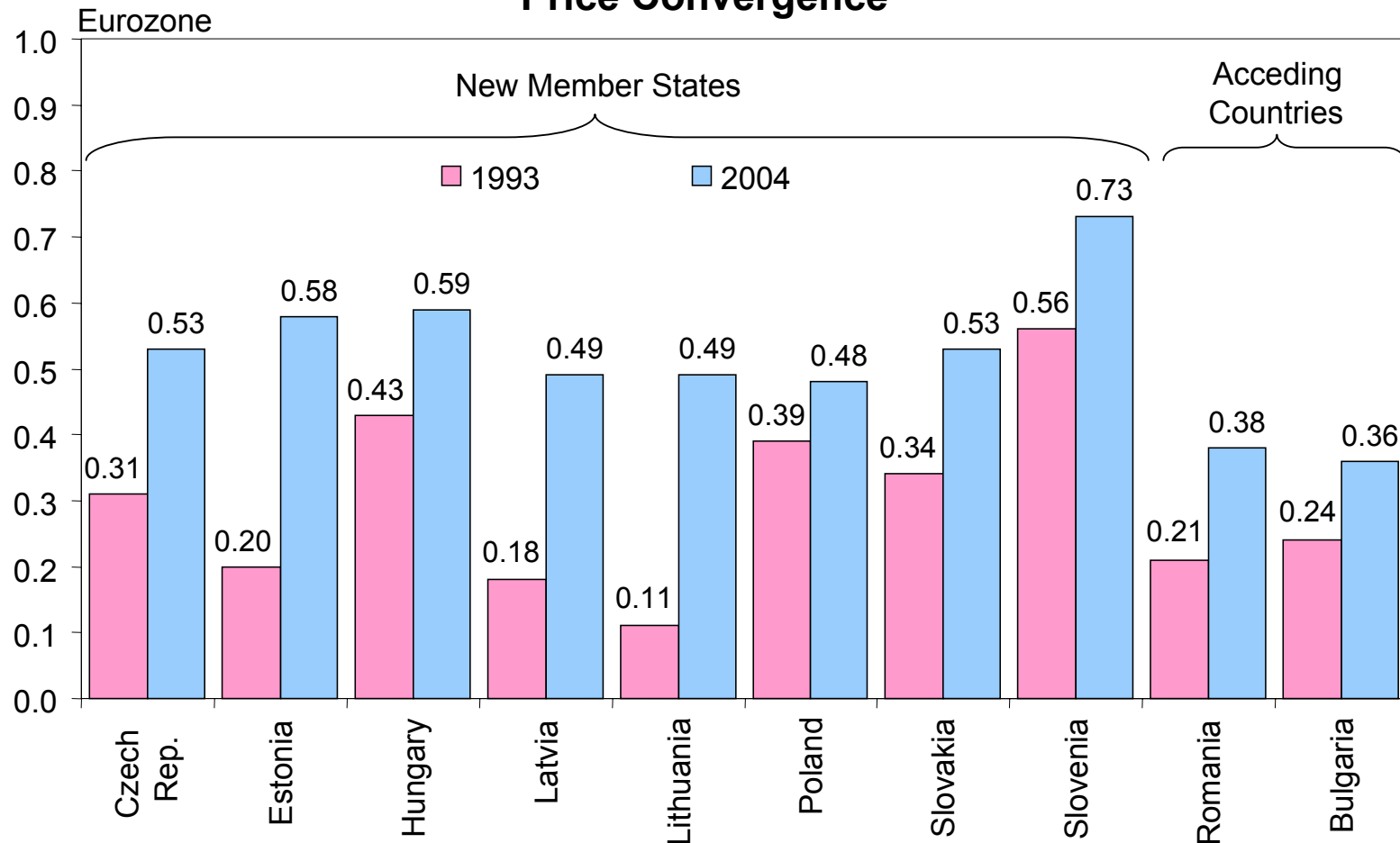
Forex Deposits/Total Deposits

percent

Year	Croatia	Romania
2000	86.0	47.0
2001	87.6	49.3
2002	84.7	44.7
2003	80.5	42.5
2004	78.4	41.2
2005	75.6	34.5

Source: National Bank of Romania, Croatian National Bank

Price Convergence*



*) ratio of GDP per capita using the exchange rate to GDP per capita in PPP/PPS

Source: European Commission, national central banks and statistics offices

Macroeconomic Performance Before and After IT Adoption

percent

	Average annual inflation rate		Average annual growth rate	
	3 years prior to IT adoption	After IT adoption	3 years prior to IT adoption	After IT adoption
Czech Rep.	8.8	3.5	5.2	2.7
Hungary	23.3	5.9	2.4	4.1
Poland	20.9	4.41	10.0	3.35

Source: IFS; EUROSTAT

Prerequisites for Inflation Targeting

- Annual inflation rate in the single-digit range
- NBR has full operational independence
- Financial sector stable and sound, but exhibits low financial depth
- Fiscal dominance no longer a problem
- Inflation targets for the years to come have been agreed on together with government
- Central bank improved its inflation-forecasting capacity
- Disinflation progress pre-2005 has led to the strengthening of NBR credibility

Challenges in Implementing Inflation Targeting in Romania

- Liberalisation of capital flows with large impact on forex market in the context of significant interest rate differential & perspective of more appreciation (Tosovsky dilemma)
- Significant level of currency substitution, net debtor position of CB hinder transmission of policy signals
- Small open economy magnifies importance & visibility of exchange rate (risk of future unwinding of unsustainable appreciation with asymmetric pass-through of exchange rate movements to inflation)
- Persistently high current-account deficit

Features of Inflation Targeting in Romania

- CPI-based inflation target
- Target set as a midpoint within a band of ± 1 percentage points; annual targets set for a longer time horizon (initially 2 years)
- Flexible interpretation of inflation targeting (mainly its co-existence with managed float)
- Joint announcement of inflation targets by the NBR and the government
- NBR pro-active stance & transparency: decisions based on 8 quarters ahead inflation forecasts, detailed risk analysis in quarterly inflation reports, pre-announced policy meetings followed by statements, analyst meetings, press conferences

Inflation Targeting and Euro Adoption

- Inflation Targeting is to be maintained at least until ERM2 entry
 - the co-existence of Inflation Targeting with an explicit exchange rate objective might be problematic (Hungary)

- The strategy ensures a gradual fulfilment of the Maastricht criteria while supporting the real convergence process

A Post-Accession Perspective

- Timing of ERM2 entry (3-4 years after EU accession) should be chosen so as to:
 - provide some monetary and exchange rate flexibility (for a limited time period) in order to further necessary and substantial structural adjustment
 - maintain motivation to carry out reforms in a timely manner and consolidate macro discipline
 - provide the possibility of setting the central parity based on a more accurate estimate of the equilibrium exchange rate after overcoming the peak in capital inflows (expected to stay high even subsequent to EU accession)
- Timing configured to ensure *ex ante* likelihood of shorter necessary stay in ERM2 (2-3 years), considering:
 - credibility provided by final stage of the process (adoption of the euro) and attendant spurring of adjustment
 - possible volatile capital movements amid restricted exchange rate flexibility during interim period
 - the inflation targeting framework, to which exchange rate movements should be clearly subordinated
- Euro adoption expected in 2012-2014