MONETARY POLICY OF ROMANIA: A CRITICAL REVIEW

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Abstract: *The monetary policy is the backbone of economic system. It is equally important instrument of regulating inflation with or without inflation target. Romania has rightfully adopted to price stability despite the fact that European Union and European Commercial Bank preferred price stability. JM Keynes in his General theory suggested that the monetary policy would be associated with interest rates for credit expansion and contraction for employment and growth. John B Taylor and other economists have opted for other measures including sacrifice of economic growth for inflation targets. The policy mix does play important role in this regard among other options. There are different views on price stability and financial stability while deciding the monetary policy options*.

Keywords: *Monetary Policy: Financial Statistics; Interest Rates; Central Bank; ECB*

JEL Classification: *E50, E51, E52, E58, E59, E63*

I. KEYNES: CRITICISM OF MONETARY-FISCAL POLICY MIX

Keynes criticized the policy of Roosevelt on the monetary-fiscal policy mix (Keynes (1934). Roosevelt had successfully achieved 57% growth in four months of implementing monetary –fiscal policy mix in March 1933. Unfortunately, the industrial production had dropped by 25% in the next six months. During this period National Industrial Recovery Act (NIRA) through the negotiations of National Recovery Administration (NRA) with the leaders of major industries decided to reduce production so that the scarcity is created resulting in increasing price rather than by virtue of increasing in demand. Keynes (1938) advised the President Roosevelt to follow independent monetary policy than fiscal activism. Clark Johnson (2012) mentioned that Lawrence Summers, who was the Chief Economist to the President Obama during 2009-2010, critiqued JM Keynes.

II. KEYNES: GENERAL THEORY

Among all other arguments Keynes (1936) has stressed that, in zero interest rate, there is no growth and development. Secondly he has pointed that the intervention of government is important for regulating 'fiscal activism'. In fact, it is claimed that Keynes has abandoned his criticism of policy-mix (Robert Mundell (1971). The general theory suggests that the demand and supply decides the deficit and it may be alternatively. The monetary expansion promotes employment and the monetary contraction creates unemployment but it is identified in terms of wages. This is explained in monetary policy in terms of interest rates (Robert Mundell (1971). In 1968-70 American depression both monetary policy and fiscal policy failed. A successful policy mix was found in 1964-65 as the President Johnson adopted the tax cut and interest rise (Robert Mundell (1971). According to Keynesian monetary policy there three principles: (1) the investment multiplier, (2) the marginal efficiency of capital and (3) the interest rate. The interest rate is the most important aspect of monetary policy. The most important factor is the interest rate. The main principle of monetary policy is attributed maximum to the interest rate.

III. MONETARY POLICY IRRELEVANT

The monetary policy is irrelevant in real economic activity (Sargent and Wallace (1975). The International Monetary Fund stipulates importance to monetary policy in sub-Saharan Africa in its programmes in order to control inflation and stabilize exchange rates. The successful implementation of monetary policy depends upon two factors such as open market operations for private credit and regulation of borrowing rates. Where there is no bond market the Central banks regulate interest rates through commercial banks for private investment. In Sub-Saharan region there are no open market operations due to the absence of securities trading except in South Africa (John Weeks (2010). The monetary policy has no impact in Sub-Saharan region.

Surjit.S Bhalla (2014) examined closely the inflation of the last 78 months data and three measures of monetary policy initiated by the Reserve Bank of India and concluded that the monetary policy was irrelevant. The table is given below:

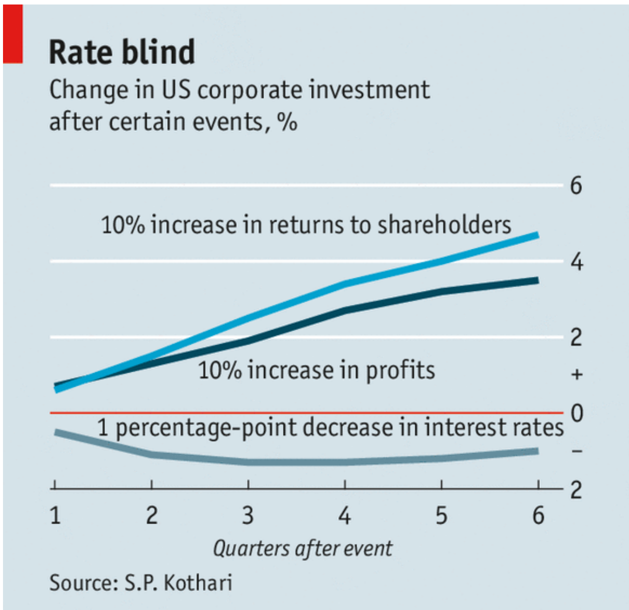
Indian inflation: It's the MSP, stupid

Year	CPI inflation (%)	CPI (IW) inflation (%)	Lagged procurement price inflation (%)	Predicted CPI (IW) inflation (%)	Model prediction error (%)
2005	3.7	4.2	2.4	5.8	-1.6
2006	6.5	6.2	2.4	5.8	0.4
2007	7.4	6.4	3.7	6.3	0.1
2008	8.9	8.3	12.3	9.0	-0.7
2009	11.8	10.9	25.5	13.2	-2.3
2010	11.9	12.0	9.9	8.2	3.8
2011	9.6	8.9	5.7	6.9	2.0
2012	9.7	9.3	11.5	8.8	0.5
2013	10.1	10.7	16.2	10.3	0.4
2014	8.2	6.9	6.0	7.0	-0.1
2015	–	–	2.4	5.8	–

Notes: (1) The regression uses CPI (IW) instead of the new CPI since the latter was only introduced in 2010.
(2) The model has CPI (IW) inflation as the dependent variable and (lagged) weighted average of minimum support prices (or procurement prices) of 25 crops as the independent variable.
(3) Time dummies are used for the years 1981, 1991, 1998 and 1999.
(4) The time period of the regression is 1978 to 2004. The estimated equation is: CPI (IW) = 5.075 + 0.32*Lagged procurement price inflation.
(5) See 'Indian Inflation: Populism, Politics and Procurement Prices, Developing Trends', July 2011 (goo.gl/b7VBs5) for specifications of the model.
Source: Oxus database

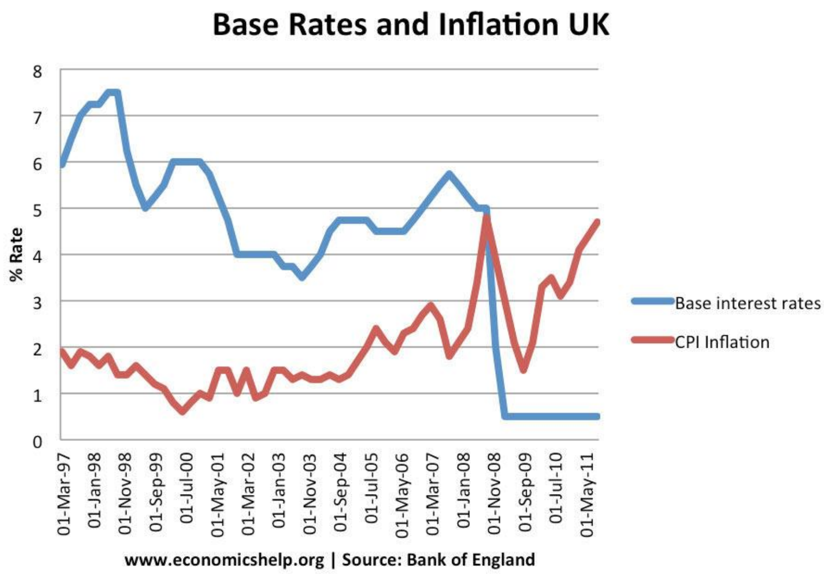
Alan Greenpan (2015), former Federal Reserve Bank of America, said that monetary policy was irrelevant without solving fiscal problems. The State of Kansas has invoked the monetary policy measures of reduction of interest rates and stability of economic environment to attract investment but failed. It used fiscal policy measures also like tax cut and less regulation but failed. In this case the policy-mix is also found failure. There are other views like non-neutrality of monetary policy may be effective in short run (Nicola Acocella (2004). FA Hayek, Austrian economist, introduced the concept of neutrality of money in 1931and it was adopted by the later classical and neo-Keynesian economists. Now there is superneutrality of money indicating that the change in interest rates does not affect economic output. John Maynard Keynes, Ludwig von Mises, Paul Davidson, the post-Keynesian School and Austrian School of Economics rejected the neutrality of money even though some studies found it relevant in long term. Valentina Mera and Monica Pop Silachi (2015) have wrongfully mentioned that National Bank of Romania preferred financial stability to price stability despite the fact IMF, European Commercial Bank and Article 127 (1) of Treaty of European Union which preferred price stability as an instrument of monetary policy. The particular decision has saved Romania while all other members of European Union reeled under recession in 2008. Similarly they wrongfully interpreted the neutrality of money in reference to the monetary policy pursued by National Bank of Romania. National Bank of Romania has aimed to achieve liquidity of money and has never suffered from the syndrome of neutrality of money. Despite these shortcomings their consistent arguments on the economic growth and monetary policy of Romania are welcome. The price stability is for long term which instills confidence on monetary stand of a nation (Mervyn King (2000). In order to regularize the deviation of target inflation the modified Taylor Rule offers the mechanism adjusting it from its desired inflation and output. The Philips Curve analysis helps in this regard.

SP Kothari (2014), Solan School of Management, in his new study, held that the practice of monetary policy is wrong after examining the data from 1952 onward. He established being one of the authors that the expansion or contraction of money does not influence inflation. He has shown it in the diagram given below:

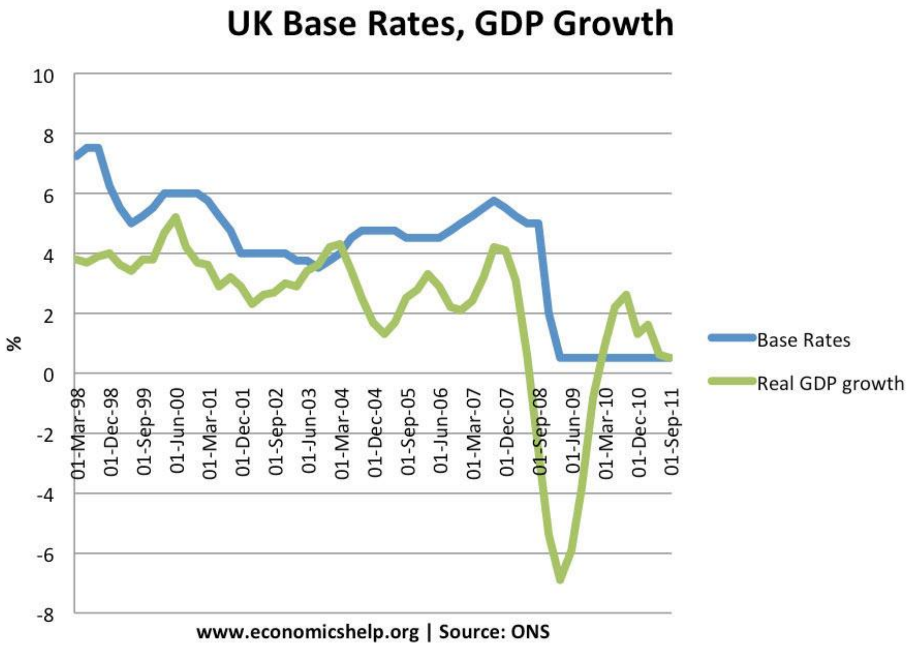


IV. EUROPEAN UNION AND EUROPEAN CENTRAL BANK: MONETARY POLICY

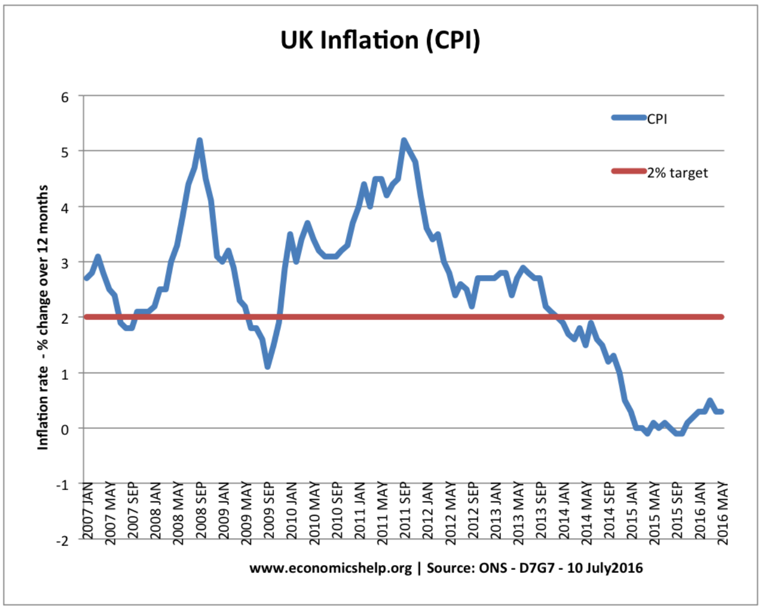
The ECB has promoted the price stability in its monetary policy. It aims to control inflation under 2% in the medium term. The ECB has preferred price stability to financial stability. NBR has given priority to financial stability to price stability (Mugur Isărescu (2016). During the recession in Europe Romania is not much affected. The Eurosystem has the main objective of price stability and it is laid down in the Europe Union Treaty (Article 127 (1), EU). The euro area is the main concern of Europe Union and European Commercial Bank because of its size and vulnerability. Unfortunately due to various economic collapses in various member countries the recession 2007-2008 had affected them severely. The monetary policy of the European Union and European Commercial Bank has failed to achieve the desired results. The UK is one of the worst affected economies as the data explains given below:



The change in interest rate has not affected inflation. During the period of 2008 the inflation increased despite high interest rate and subsequently base interest rate has remained stable but the inflation steadily increased from September 2009 to May 2011. This trend has proved that the monetary policy is irrelevant.



Reduction of interest rate pushed to negative growth from 2008 to 2010 during the recession. When the interest rate has remained stable there is real GDP growth. Again the relevance of monetary policy is questioned. The inflation target is 2% as per the monetary policy option but it is found that the inflation has been higher or extremely lower. It reflects the ineffectiveness of monetary policy as shown in the diagram below:



The euro area economy is the third largest economy next to USA and China. The following economic data establishes it:

-	Unit	Euro area	United States	Japan	China
Population 1	millions	339.0	321.7	126.8	1,374.6
GDP (share of world GDP in PPP)	%	12.0	15.8	4.2	17.3
GDP per capita 2	€ thousands	30.8	42.0	28.8	10.2[*)]
Value added by economic activity	-	-	-	-	-

Agriculture, fishing, forestry	% of total	1.6	1.3*)	1.2*)	8.9
Industry (including constructions)	% of total	25.0	20.7*)	26.9*)	40.0
Services (including non-market services)	% of total	73.3	78.0*)	72.0*)	49.8
Unemployment rate (share of the labour force)	%	10.9	5.3	3.4	4.0
Labour force participation rate 3	%	72.4	72.6	76.0	-
Employment rate 4	%	64.5	68.1*)	72.8*)	-
General government 5	-	-	-	-	-
Surplus (+) or deficit (-)	% of GDP	-2.1	-4.2	-6.2*)	-2.7
Gross debt 6	% of GDP	90.4	97.2	233.4	42.9
Revenue	% of GDP	46.5	33.5	35.8*)	28.6
of which direct taxes	% of GDP	12.6	13.1	9.5*)	4.7
of which indirect taxes	% of GDP	13.1	6.9	9.0*)	13.2
of which social contributions	% of GDP	15.3	6.7	13.2*)	-
Expenditure 7	% of GDP	48.5	37.7	42.0*)	31.3
of which final consumption	% of GDP	20.7	14.4	20.6*)	-
of which social payments	% of GDP	23.8	14.7	22.7*)	-
External 8	-	-	-	-	-
Exports of goods	% of GDP	20.2	8.4	14.2	21.6*)
Exports of goods and services	% of GDP	27.5	12.5	17.9	24.3*)
Import of goods	% of GDP	16.8	12.6	14.3	17.4*)
Import of goods and services	% of GDP	23.6	15.3	18.3	21.7*)
Exports (share of world exports, including intra-euro area trade)	%	25.2	9.2	3.8	13.9
Exports (share of world exports, excluding intra-euro area trade)	%	15.5	10.3	4.3	15.7
Current account balance	% of GDP	3.0	-2.6	3.1	2.7*)

Source: Euro areas (2015), Chapter 2, The Monetary Policy of the ECB) 2015

The ECB has a bigger role to play as guide to all members European Union on monetary policy due to its largest area. Despite the better data shown above the monetary has failed to control inflation during recession and after.

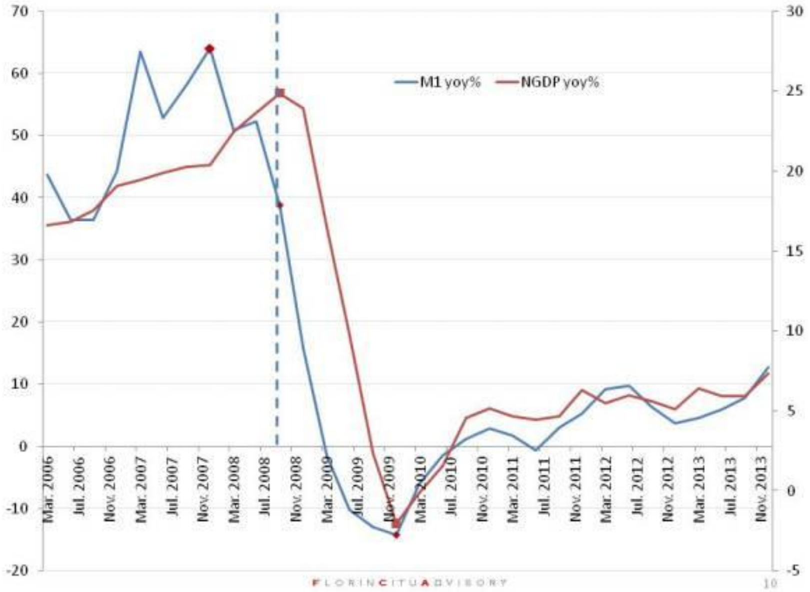
Inflation rate (consumer prices) (%)

Country	2004	2005	2006	2008	2009	2010	2011	2012	2013
European Union	2.1	2.2	1.8	3.5	0.8	1.8	3	2.6	1.5

Source: CIA World Fact book

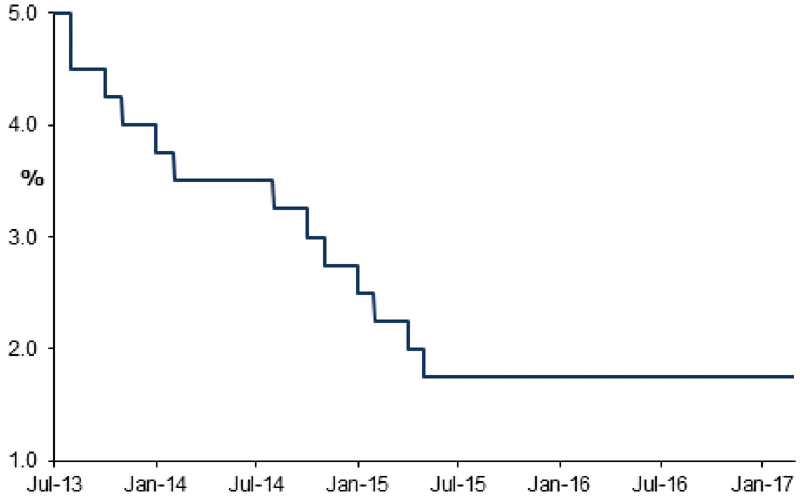
V. Monetary Policy of Romania

It was considered that Romanian monetary policy was failure (Florine Citu (2014) as depicted in the diagram below:



The criticism is that the National Bank of Romania has failed in its monetary policy (Florin Citu (2014). The arguments of him are absolutely incorrect as he has followed the general views of book knowledge. He has failed to appreciate that the monetary policy is irrelevant under certain conditions. Thus the monetary policy of Romania is not failure but a successful application of monetary policy under the given circumstances. There are less private investments and purely inadequate open market operations. Failing to appreciate it is unfortunate. Therefore following tight monetary policy of interest rates during the period from March 2006 to March 2009 has proved to be sound application of monetary policy.

Since May 2015 National Bank of Romania has not changed the interest rate from 1.75%., after its review of monetary policy in February 2017. The inflation rate of annual consumer price has declined from 3% in March to 0.7% in June 2016 (National Bank of Romania (2016).



Source: National Bank of Romania, Romania Monetary Policy (Feb 2017) -Focus Economics

During the period of March 2016 to February 2017, the unemployment has declined to 5.5%. It establishes that the General Theory of Keynesian on monetary policy is less accurate. The higher rate and expenditure would improve employment as per JM Keynes but it is seen otherwise.

VI. PRICE STABILITY VERSUS FINANCIAL STABILITY

The interest rate plays an important role both in price stability and financial stability. The price stability is the main purpose of monetary policy. It does not mean that the financial stability is antithesis of monetary policy. There are several factors that require for price stability. In the case of financial stability some of the factors which are important to price stability are not required in the case of price stability. According to the Bank for international Settlements (BIS), the monetary policy should use the interest rate for financial stability even though it may be needed to compromise the inflation target (Axel Weber (2014). This is not sacrifice or sacrifice ratio of monetary policy of Romania towards economic growth as discussed (Axel Weber (2014); Valentina Mera and Monica Pop Silachi (2015). The price stability provides confidence to make economic decisions and financial stability ensures the implementation of economic decisions. Thus the price stability and financial stability are complementary to each other towards economic growth and development (David C. Wheelock (1998). Economic growth is neither available in book shelves of economist nor in the market. Let us not be over enthusiastic about the economic discovery of economists in isolation. Economy is an institution of socio-political decisions in terms of economic value additions. Society resembles intelligent mostly but succumbs to failure without reason and relevance. A man is successful not because of his talents alone but also because of comparative advantage of given time in the society. It is difficult to predict which prevails over other. Arithmetic calculation is excellent while the values of numbers are stable and static but it is different when the values are dynamic. Economy is complex and it has no explanation always to poverty. The poverty is not economic deprivation alone but there are several reasons associated with poverty. The eradication of poverty is not mere economic solution but it is more than it. The monetary policy is not the solution to inflation and neither the inflation results in employment and growth. It does not mean that the monetary policy is irrelevant.

VII. CONCLUSION

Since the National Bank of Romania has preferred financial stability it has taken extraordinary measures to monetary policy by reorganizing the Deputy Governors for solving problems under one roof. It has brought institutional changes by creating a separate Financial Stability department in 2004 and half yearly Financial Stability Report has been published form 2006.The national Committee for Financial Stability came into function with effect from 2007. The National Committee consists of the Governor, National Bank of Romania, the Minister of Public Finance, the President, the Financial Supervisory Authority and the Chairman, Bank Deposit Guarantee Fund (Mugur Isărescu (2016).

Inflation rate (consumer prices) (%)

Country	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Romania	44	45.7	34.5	22.5	15.3	9.6	9	6.8	4.8	7.8	5.6	6	5.8	3.3	3.2

Source: CIA World Fact book - Unless otherwise noted, information in this page is accurate as of June 30, 2015

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Country	2004	2005	2006	2008	2009	2010	2011	2012	2013
European Union	2.1	2.2	1.8	3.5	0.8	1.8	3	2.6	1.5

Source: CIA World Fact book

While the inflation of Romania and European Union, Romania has achieved better price stability and inflation rate even though Romania has preferred financial stability unlike European Union.

VIII. ENDNOTES

1. Keynes (1934), "Roosevelt's Economic Experiments," The Listener, 17 January, 1934.
2. Keynes said: One half of [Roosevelt's] programme has consisted in abandoning the gold standard, which was probably wise, and in taking various measures … to depreciate the gold value of the dollar… [But it is not easy to bring about business expansion merely by monetary manipulation. The other half of his programme, however, is infinitely more important and offers in my opinion much greater hopes. I mean the effort to cure unemployment by large-scale expenditure on public works and similar purposes.
3. Robert Mundell (1971), The Dollar and the Policy Mix: 1971, Essays in International Finance, No. 85, May 1971, Department of Economics, Princeton University, Princeton, New Jersey, p.10: "Interest rates rise when there is ( ) an increased shortage of capital, (2) a strengthening of the domestic economy, (3) expectations of accelerated monetary expansion and inflation, and (4) monetary restriction caused by open-market sales of securities with unchanged expectations."
4. Article 127(1), (EU Treaty): The twin objectives of the Treaty are price stability and natural role of monetary policy for "full employment" and "balanced growth of economy".

5. Mugur Isărescu (2016), "Central Bank and Supervisory Governance" Conference, Recent developments in central bank governance, Amsterdam, 12 February, 2016.
6. Mugur Isărescu said : "For quite a long time, at least in Europe, "price stability" enjoyed the position of overriding objective, but since the outbreak of the crisis it became obvious that the "inflation first" approach may turn counterproductive in an environment of financial instability. Therefore, financial stability concerns made their way up on central bankers' agenda". BIS central bankers' speeches, p1, 2016

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