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Monetary Policy during Transition. How to Manage Paradigm Shifts

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Introduction

I started my career back in August ‘71, the day after President Nixon announced the suspension of gold-convertibility of the US dollar and the introduction of a 10 percent surcharge on American imports, thus marking the dismantling of the Bretton Woods System.

We all know what happened next: in an attempt to preserve a system of fixed exchange rates, the Smithsonian arrangement – which set a fluctuation band of +/-2.25 percent – was introduced in December 1971.

It only lasted for six months, so that during 1972-73 fixed exchange rates were replaced by floating regimes in most economies around the world. Exception made the countries of the European Economic Community, which decided to implement a joint floating arrangement and introduced rather funny concepts such as the “snake in the tunnel”.

Introduction (2)

Those were also years of intellectual controversy – I remember reading alternatively the Newsweek articles of Samuelson and Friedman, one preaching the virtues of Keynesian policies, while the other praised free markets and non-intervention.
I witnessed the end of an era and the dawn of another.

I also remember a conference in Salzburg in 1975, when Richard Cooper and Robert Aliber invited Friedrich Hayek – recently awarded the Nobel Prize in economics – to give a lecture on stagflation. I cannot forget the striking answer he gave: stagflation was the result of Keynesian policies.

Introduction (3)

In the decades that followed I witnessed many other policy and paradigm shifts, but I have to confess that some of them – such as quantitative easing and close to zero policy rates – I could hardly have imagined a few years ago.

However, in this paper I will deal neither with quantitative easing nor with close to zero policy rates. Instead, I will focus on those paradigm shifts that challenged the monetary policy conduct in Romania during the transition years.

Main issues

I. From monetary anchors to inflation targeting

II. Exchange rate arrangements: from managed float to corner solutions and back again

III. Capital controls vs. free capital flows

IV. Foreign-owned banks – asset or liability

V. Central bank's objective: should financial stability be added?

VI. Low vs. moderate inflation

From monetary anchors to inflation targeting

- Beginning of the ’90s: monetary strategies based on a nominal anchor still prevailed
  - ✓ Inflation targeting (IT) was still the new kid on the block
- Romania opted at the time for monetary targeting
  - ✓ Too low forex reserves to defend an exchange rate peg
  - ✓ IMF stand-by arrangements providing indicative targets for monetary aggregates
  - ✓ No precondition of inflation targeting fulfilled, nor its suitability for emerging economies proved

From monetary anchors to inflation targeting (2)

- **Late '90s – early 2000:**
  - ✓ Monetary targeting proved ineffective
    - Romania: build-up of arrears acting as substitute currency
  - ✓ Most of the Central European pegs collapsed (Czech Republic, Hungary, Poland)

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  - ✓ Inflation targeting became the regime of choice in the larger Eastern European countries
    - Small, open economies ➔ vulnerable to exchange rate shocks ➔ fear of floating ➔ **crucial question:** what approach to adopt when confronted with large exchange rate fluctuations?
- Romania switched to IT in 2005
  - ✓ Smooth transition between monetary strategies
  - ✓ Option for "IT lite" (managed float retained)

Exchange rate arrangements: from managed float to corner solutions and back again

- **Early '90s:** two thirds of the countries in the world had some form of managed float
- **2001:** "move towards corner solutions" (Fischer) against the background of free movement of capital
- **Pre-crisis:**
  - ✓ Policymaking complicated by large capital inflows
    - Conflict between inflation target and external equilibrium
      - Nominal appreciation pressures
      - Constraints to policy rate setting

Exchange rate arrangements: from managed float to corner solutions and back again (2)

- Romania kept managed floating all along
  - ✓ Thin forex market
  - ✓ Large capital inflows concentrated in a short period (2004-2008) ➔ strong appreciation pressures (risk of "Dutch disease") ➔ expansion of forex credit ➔ impaired interest rate channel
  - ✓ Interventions used to prevent overvaluation ➔ build-up of forex reserves (useful to slow down depreciation after the crisis burst)

Exchange rate arrangements: from managed float to corner solutions and back again (3)

- **Post-crisis:** even committed free floaters were forced to accept interventions on the forex market
  - ✓ When, how much and exit strategies
- **Full circle completed:** managed float is back in fashion

Capital controls vs. free capital flows

- Before the 1970s, capital controls applied, but at a high price
  - ✓ Banks innovated less, limited lending to large firms and operated less efficiently
- The ’90s: widespread capital account liberalization at the beginning of the decade; softened approach after the Asian crisis (Camdessus, 1998)
  - ✓ Romania received advice from the IMF to postpone liberalization of monetary flows, but EU entry was conditional upon full capital account liberalization
- Introducing capital controls gained support again towards end-2009, as capital flows to emerging markets seemed to rebound

Capital controls vs. free capital flows (2)

- Micro- and macro-prudential measures are effective in addressing risks associated with capital inflows
- Use macroprudential measures with precaution, since they may actually foster capital inflows and thus run counter to macroeconomic policies
- The policy mix needs to maximize the benefits of capital inflows while insulating against related risks
- Since sustainable economic growth depends on free markets, capital controls should only be considered as a measure of last resort, if at all
- Prudential measures should be designed to minimize the distortions they trigger and should be resorted to only after all macroeconomic options have been exhausted

Capital controls vs. free flows (3)

- Large capital inflows in the context of capital account liberalization in Romania
  - ✓ Including significant funding for foreign banks' subsidiaries from the parent institutions

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- Surge in credit, mainly in foreign currency

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- NBR had to innovate in order to alleviate risks to financial stability
  - ✓ High RR ratios (40% for forex liabilities, 20% for lei at end-2007)
  - ✓ "Unorthodox" prudential and administrative measures (containment of banks' exposure to currency risk, tighter lending standards for households)

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  - ✓ Short-lived effects as banks developed ways to circumvent regulations (portfolio externalization)

Foreign-owned banks – asset or liability

- Central and Eastern Europe is the only region in the world where foreign banks dominate as a share of total assets
- Presence of international banking groups used to be seen as an asset in terms of funding availability and know-how, …
- … but the crisis revealed some vulnerabilities
  - ✓ Increased risk of contagion (Greek sovereign debt crisis)
  - ✓ Downgrading of countries of origin (Austria)

Foreign-owned banks – asset or liability (2)

Romania

- Privatization of banks was deemed essential for promoting restructuring in inefficient SOEs (through hard budget constraints)
- Starting 2006, foreign-controlled banks have held around 80% of both capital and assets of the banking system

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- Deepening of financial intermediation, improved financial services (new products, know-how), but also…
- … euroization of the economy, challenges for the conduct of monetary policy and, more recently,…
- … accelerated deleveraging, arbitrage of regulations facilitated

Central bank's objective: should financial stability be added?

Economic wisdom before the crisis

- **Inflation is the main source of financial instability**

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  Safeguarding price stability seen as (almost) sufficient for promoting financial stability

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  Delivering low inflation is central banks' core contribution to preserving and strengthening financial stability and supporting sustainable economic growth

- **Net segregation of functions:**
  - ✓ **Price stability**
  - ✓ **Financial stability**

  in order to simplify policy design and implementation, by avoiding conflicting objectives

- **Markets always self-correct** ➔ ample interventions by the authorities are not required

Central bank's objective: should financial stability be added? (2)

The crisis invalidated certain elements of mainstream economics

- The global financial crisis broke out in a low inflation environment (Great Moderation) ➔ price stability does not vouch for financial stability
- The "mop up after" strategy proved much costlier than "leaning against the wind" would have been
- Inflation-induced distortions are less damaging than losses generated by financial sector distortions
- The ongoing complex challenges to financial and economic stability call for identifying and corroborating tons of information in order to articulate the adequate policies ➔ integrating the functions of price stability and financial stability in one institution appears desirable

Central bank's objective: should financial stability be added? (3)

- Early concern for financial stability in Romania
  - ✓ Supervisory function retained within the central bank
  - ✓ Threshold for capital adequacy ratio set above the 8% standard
  - ✓ Institutional arrangements reflecting increased attention to financial stability
    - Financial Stability Department created in 2004
    - Financial stability report published annually since 2006
    - National Council for Financial Stability set up in 2007; the NBR Governor acting as Chairman
  - ✓ Interventions to avoid excessive currency appreciation motivated by concern that the inherent correction could destabilize the financial system

Low vs. moderate inflation

- Over the past 20 years, low and stable inflation became the main and sometimes the only objective of monetary policy
- Nevertheless, maintaining stable inflation does not ensure a zero output gap, where the economy also faces other imperfections than the nominal ones
- Central bankers were flexible when it came to implementation:
  - ✓ The return to the inflation target after deviations was smooth rather than abrupt
  - ✓ Supply side-induced deviations from the target were allowed when expectations were well-anchored
  - ✓ Fluctuations in asset prices, especially those in the exchange rates, were considered not only in relation with their impact on inflation, but also in connection with their effects on the competitiveness of the economy and on balance sheets

Low vs. moderate inflation (2)

- The current liquidity trap dismantled the illusion that shocks capable of pushing inflation down to zero might no longer emerge
- From low levels, inflation can easily enter negative territory, triggering a decrease to zero in policy rates ➔ monetary policy must resort to quantitative easing
- Blanchard et al. (2010): raise the inflation target from 2 percent to 4 percent
- Minsky's Financial Instability Hypothesis: higher inflation is desirable when a credit-fueled asset bubble bursts
- Moderate and stable inflation is more in line with the *de facto* monetary policy conduct in emerging markets

By way of conclusion

- During periods of great transformations, while theory should guide reasoning, efficient policy action requires close contact with the shifting economic reality

- While monetary policy is normally rule-based, a certain degree of flexibility needs to be retained

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