



Southeastern European Financial Forum

**Inflation Targeting
and Financial Stability**

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Bucharest - May 25, 2006

Rationale Behind the Adoption of Inflation Targeting

- Need for sustainable disinflation, inclusive from EU convergence perspective
- Monetary targeting strategy no longer appropriate
- Exchange-rate peg based regime highly risky in light of convergence-induced appreciation trend, move towards full capital mobility

Advantages of Inflation Targeting

- Reducing time inconsistency by increasing accountability of the central bank for achieving its primary objective, i.e. price stability
- Flexible and transparent regime operational even under an unstable relationship between monetary aggregates and inflation
- Disinflation with relative minimisation of costs, a more direct impact on inflation expectations

Prerequisites

- The annual inflation rate is in the single-digit range
- The NBR has full operational independence
- The financial sector is stable and sound, although financial intermediation should increase
- Fiscal dominance is no longer a threat
- Disinflation progress has led to the strengthening of NBR credibility

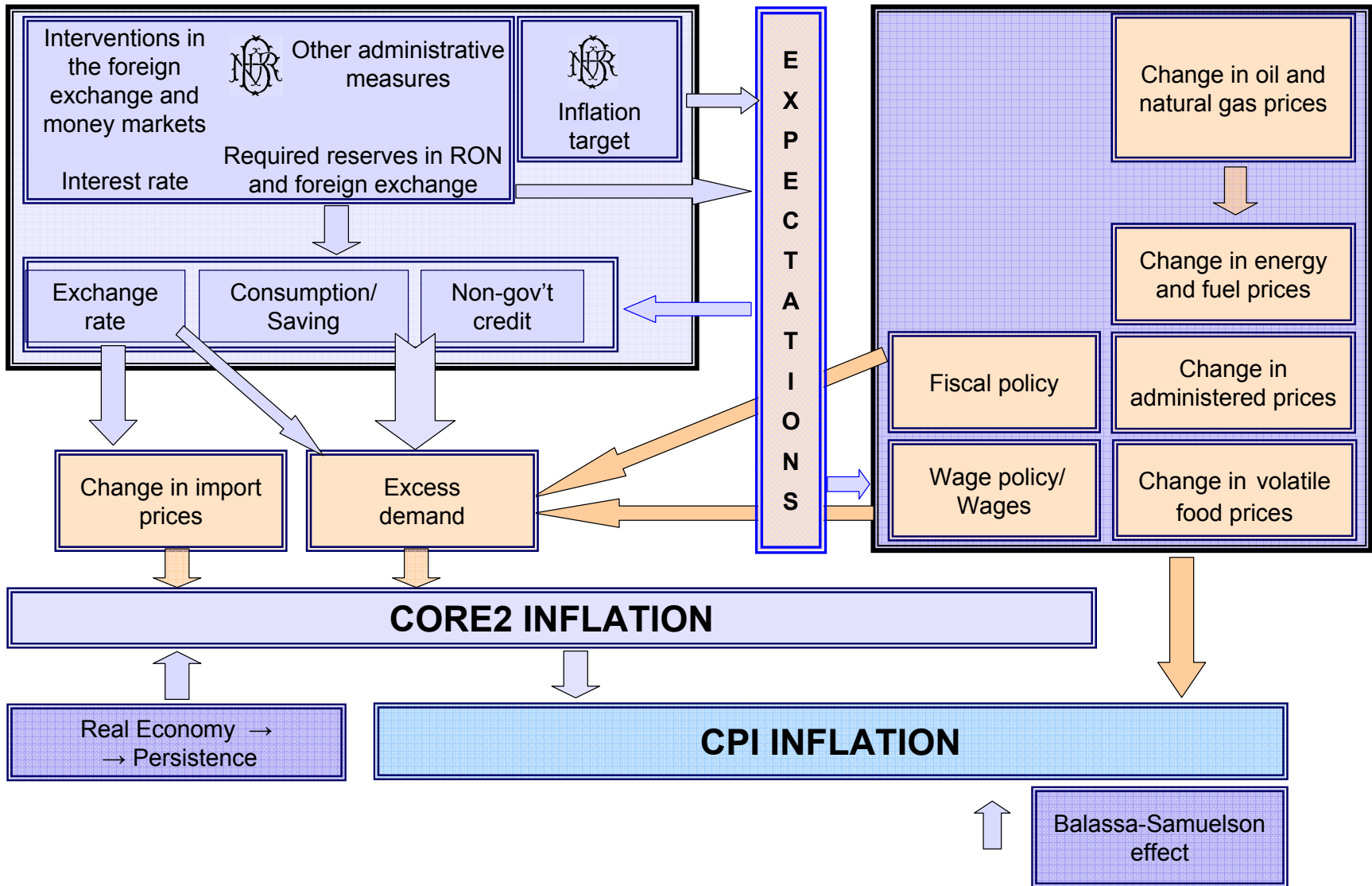
Features of Inflation Targeting Strategy in Romania

- CPI-based inflation target
- Target set as a midpoint within a band of ± 1 percentage point
- 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

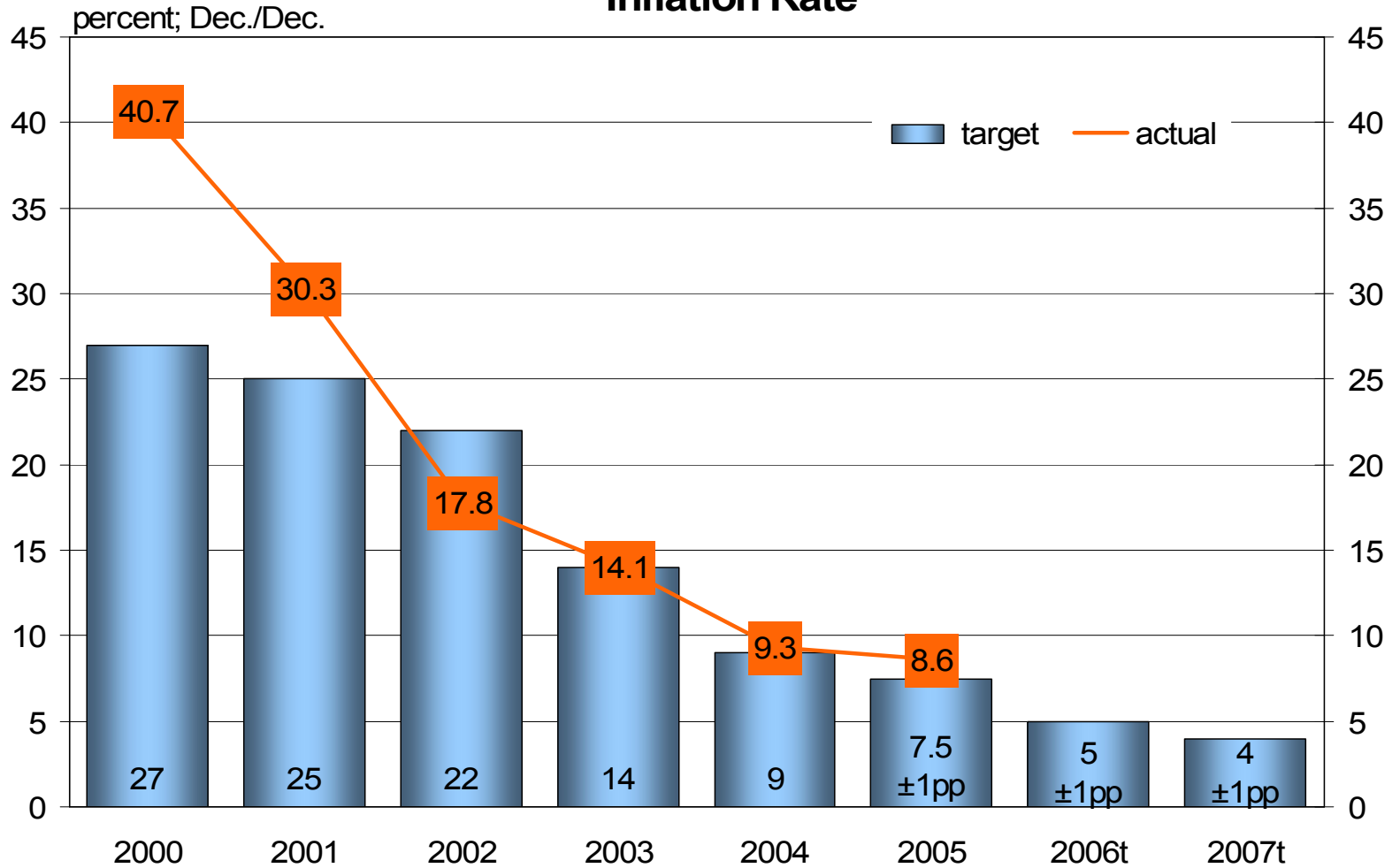
Challenges in Implementing Inflation Targeting in Romania

- Liberalisation of capital flows with large impact on forex market in the context of significant interest rate differential & perspective of more appreciation (Tošovský dilemma)
- Significant level of currency substitution, net debtor position of the central bank hinder transmission of policy signals
- Small open economy magnifies importance & visibility of exchange rate
- Persistently high current-account deficit

Disinflation Strategy



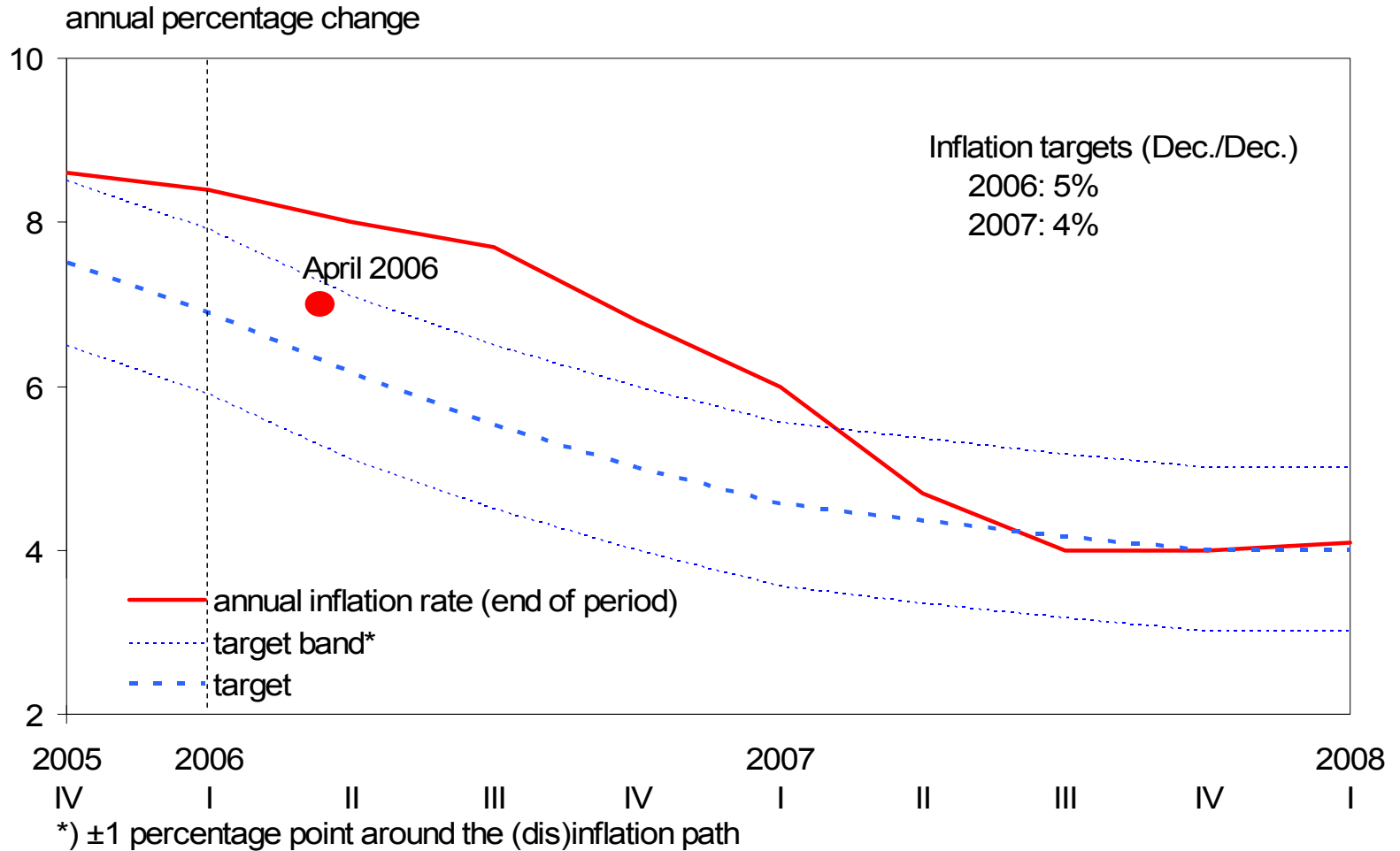
Inflation Rate



April 2006: 6.92% (yoy)

Source: National Institute of Statistics, National Bank of Romania

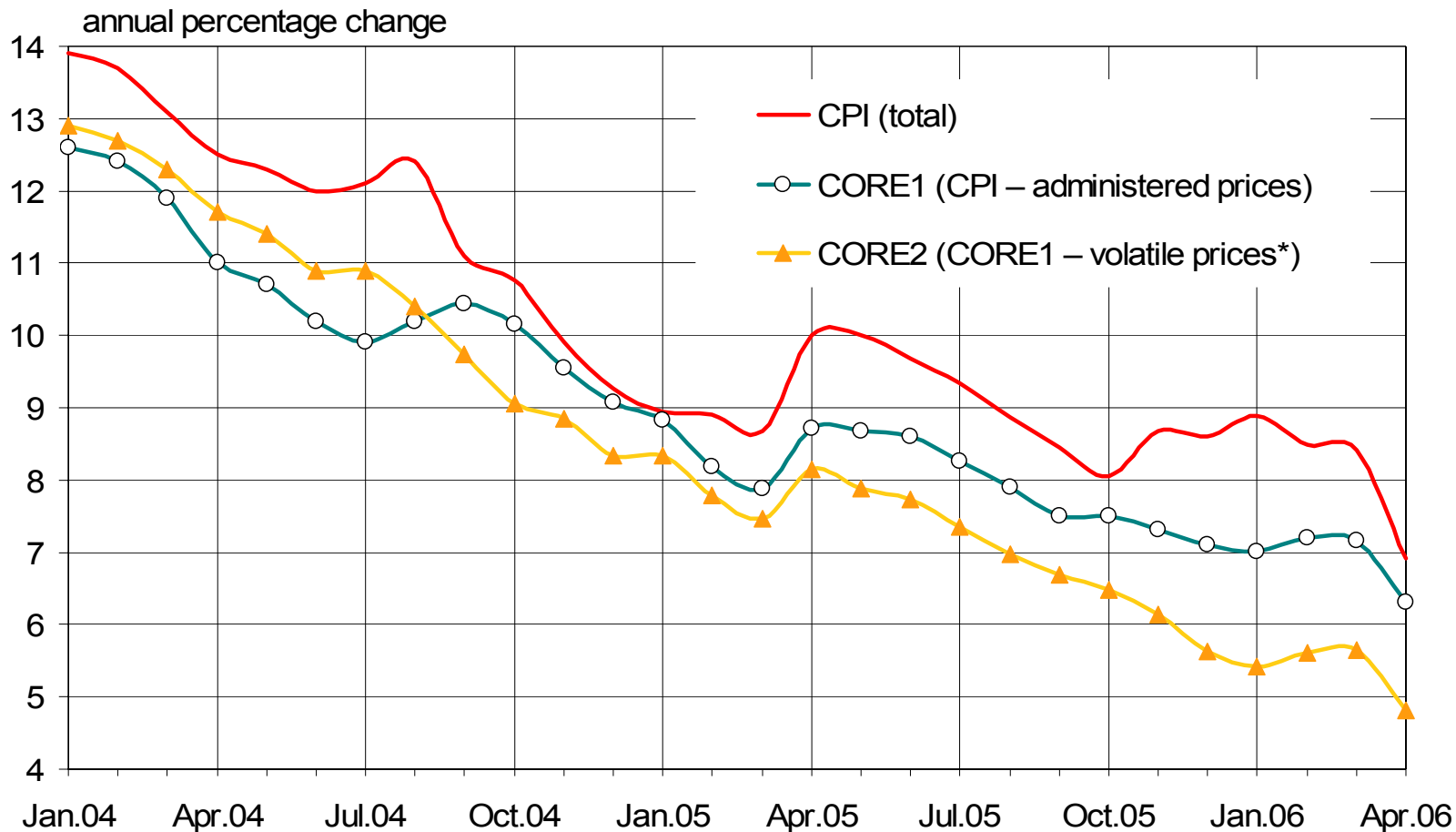
Inflation Forecast



Source: National Institute of Statistics, National Bank of Romania calculations



Headline Inflation and CORE Inflation



*) products with volatile prices: vegetables, fruit, eggs, fuels

Source: National Institute of Statistics, National Bank of Romania calculations



Challenges to Continuation of Disinflation

- Pressures exerted by movements in relative prices (due to Balassa-Samuelson effect)
- Further adjustments of administered prices (especially energy price)
- Still strong domestic demand
- External shocks (e.g.: oil price)

Definition of Financial Stability

- Unlike price stability, there is neither a broadly-accepted definition for financial stability, nor a synthetic indicator for its measurement
- Approaches:
 1. Financial instability → the cost of systemic crises
 2. Financial stability → the capacity of the financial system to:
 - Withstand systemic shocks
 - Efficiently allocate financial resources across economy
 - Effectively identify and manage risks

Financial Stability in Romania: Financial Institutions

Financial system has developed and strengthened, yet Romania lags behind all other Central and East European countries in terms of financial intermediation

- **Banking sector** is stable and capable of absorbing adverse shocks:
 - Significant bank capitalisation (over 20% against 8% worldwide)
 - Good quality of loan portfolio (overdue and doubtful loans account for less than 1% of total)
 - High liquidity, well above minimum requirements
- **Non-bank financial institutions sector** is underdeveloped, yet showing considerable growth potential; low systemic risks given the sector's small size

Financial Stability in Romania: Future Risks

- Financial stability in Romania has improved
- Risks remain benign, yet the following issues need to be tackled:
 - Capital movements
 - Inflation rate, current account deficit and exchange rate
 - Household indebtedness

Capital Account Liberalization

- **1999:** Setting the stages of total convertibility in line with EU integration
- Capital account liberalization has largely been achieved
 - **2005 stages:**
 - ✓ Non-residents' RON-denominated deposits (April 2005)
 - ✓ Residents' operations in current and deposit accounts opened abroad (July 2005)
 - **Last stage:**
 - ✓ Residents' and non-residents' operations on the money market (by September 2006)



Coping with Capital Account Liberalization

➤ Potential risks:

- Unsustainable appreciation
- Excessive credit growth
- Sudden trend reversal in capital inflows
- Worsening balance of payments

➤ Policy implications:

- Need to narrow interest rate differential and to increase exchange rate flexibility in order to reduce incentive for speculative flows
- Measures to keep in check aggregate demand:
 - ✓ tightening reserve requirements regime for foreign currency liabilities
 - ✓ tightening lending requirements, also for prudential reasons
 - ✓ fiscal policy contribution – by reducing budget deficit

The Impossible Trinity

- There can be no co-habitation of the following:
 - i. **independent monetary policy**
 - ii. fixed exchange rate
 - iii. free movement of capital

- Capital account liberalization limited the room for maneuver of monetary policy
 - Interest rate policy is constrained by the requirements related to inflation target and free movement of capital

- A flexible exchange rate is essential to avoid the impossible trinity

Features of Exchange Rate Policy

➤ **Current stance:**

- Increased exchange rate flexibility: managed floating regime maintained, but no NBR interventions in the forex market over the last seven months
- Real RON appreciation trend coexists with short-term exchange rate fluctuations, thus limiting the size of volatile capital inflows

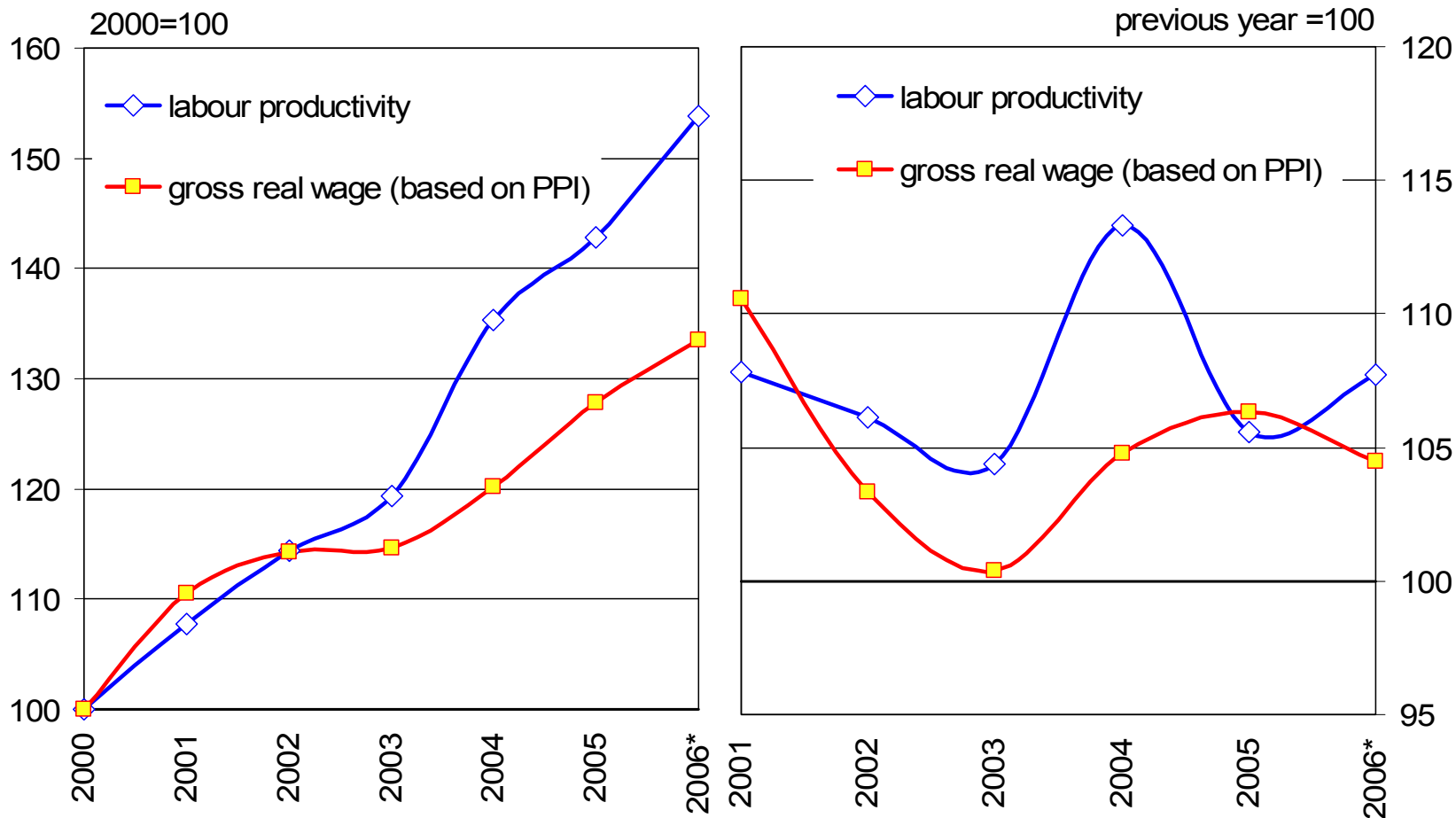
➤ **Between EU accession and ERM II entry:**

- Relative stability of RON exchange rate (against the background of full convertibility) around the long-term equilibrium level

Exchange Rate, Productivity and Wage Policy

- The golden rule: wage increases and real RON appreciation must not exceed productivity gains
- Compliance with this rule is vital to:
 - Consolidate major macroeconomic equilibria
 - Underpin disinflation trend
 - Avoid any slippages entailing difficult-to-assess effects

Real Wage, Labour Productivity in Manufacturing



Source: National Institute of Statistics, National Bank of Romania calculations

*) Jan.-Mar.

Inflation Targeting and Euro Adoption

- Inflation Targeting is to be maintained at least until ERM II entry
 - 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

Unorthodox Measures Aimed at Containing Credit Expansion

- **Increase in reserve requirement ratio on foreign currency-denominated liabilities in order to:**
 - Contain foreign exchange lending
 - Raise costs associated with foreign currency lending to underpin improvement of non-government credit

- **Prudential and administrative measures**
 - On a limited time horizon
 - **Cause:** large interest-rate differential restrains resort to interest lever
 - **Rationale:** maintaining financial stability and enhancing effectiveness of monetary policy instruments
 - **Objective:** to tighten eligibility criteria on bank credit to households and to contain banks' supply of foreign currency-denominated loans

Prudential Measures to Slow Down Credit Growth (1)

August 2005:

- Enforcement of additional prudential regulations aimed at tightening eligibility criteria for individuals:
 - Overall installments (principal + interest) associated with credit contracts (consumer and real estate), as well as with other similar liabilities resulting from other credit contracts, leasing contracts, installment purchases contracts, irrespective of the creditor, shall not exceed 40% of net incomes of the borrower and his/her family
 - Installments (principal + interest) associated with consumer credit, as well as with other contracts similar to consumer credit, irrespective of the creditor, shall not exceed 30% of net incomes of the borrower and his/her family
 - Installments (principal + interest) associated with real estate credit, as well as with other contracts similar to real estate credit, irrespective of the creditor, shall not exceed 35% of net incomes of the borrower and his/her family

Prudential Measures to Slow Down Credit Growth (2)

September 2005:

- Enforcement of new prudential regulations aimed at limiting foreign exchange credit exposure
 - Foreign exchange credit exposure of a credit institution arising from loans granted to unhedged individuals and legal persons (other than credit institutions) shall not exceed 300% of own funds
 - When determining the above mentioned exposure, hedged borrowers (i.e. individuals and legal persons who generate net positive cash flows in foreign exchange) shall not be taken into consideration
- Refining the regulations on provisioning and loan classification taking into account the foreign exchange risk of the borrower

January 2006:

- Legislation on regulating and supervising quasi-credit non-bank financial intermediaries (leasing, financial credit, etc.)