BOX

Operational framework of the NBR monetary policy

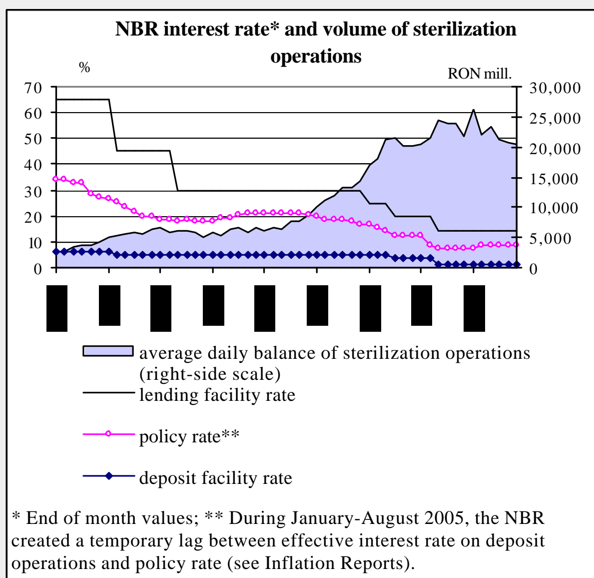
The monetary policy operational framework is made up of instruments and procedures whereby the central bank implements its monetary policy with a view to achieving its primary objective. The NBR's current operational framework is the result of successive changes to the monetary policy instruments with the aim of adjusting them vis-a-vis the new developments in financial market, first and foremost in the interbank market, as well as in the economy. Moreover, the changes were aimed at incorporating into the operational framework the guiding principles, the most important of them being: (i) the principle of operational efficiency of the central bank; and (ii) the principles of simplicity, transparency and cost efficiency of monetary policy instruments. Recently, the main changes to monetary policy instruments were meant to:

- make the most and enhance the role of interest rate within the monetary policy transmission mechanism, against the backdrop of the progress in resumption of financial intermediation and deepening of money market;
- harmonise the instruments with the ECB's set of instruments, although the persistence of structural liquidity surplus requires adjustment of instruments used by the NBR to the specific conditions of domestic money market;
- increase the transparency and predictability of monetary policy instruments in the context of inflation targeting adopted by the NBR in August 2005.

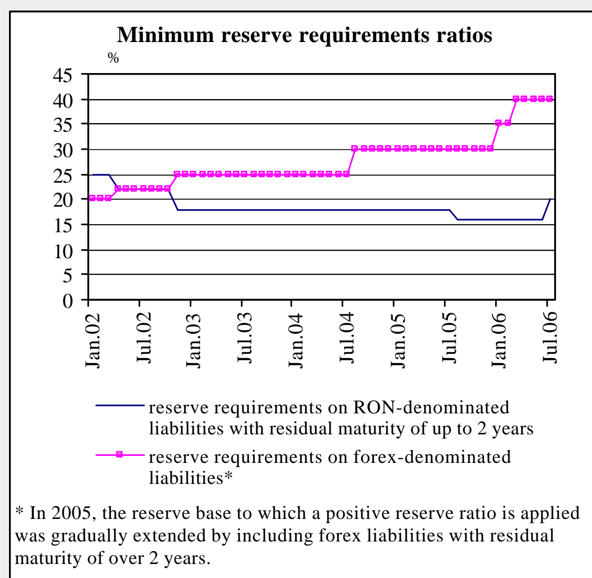
At present, the set of instruments used *de facto* by the NBR encompasses the following:

1. Open market operations, which are the most important monetary policy instruments of the NBR; they play a role in steering interest rates, managing the liquidity conditions in the money market and signalling the stance of monetary policy. Although the array of market instruments *de jure* available to the central bank is wide, the net debtor position of the NBR vis-a-vis the banking system called for almost exclusively *de facto* use of liquidity-absorbing instruments. At present, they include:

- One-month deposit-taking operations - the key monetary policy instrument. Deposit-taking operations have been used since June 1997, being executed in the form of multiple rate auctions. These operations were performed until 2003 for maturities that varied between one day and three months. Starting with May 2003, deposit-taking operations have been performed exclusively for one-month deposits. The ceiling of interest rates accepted at deposit-taking operations, as established by the NBR Board (pre-announced since August 2003), was the policy rate (see chart below); starting August 2005, the central bank switched to volume auctions; in the new context, the policy rate is the **fixed interest rate on one-month deposits**. The last change occurred in the latter half of February 2006, when the NBR Board decided to set a timetable of auctions for deposits on a weekly basis.



* End of month values; ** During January-August 2005, the NBR created a temporary lag between effective interest rate on deposit operations and policy rate (see Inflation Reports).



* In 2005, the reserve base to which a positive reserve ratio is applied was gradually extended by including forex liabilities with residual maturity of over 2 years.

(continued)

- issuance of certificates of deposits. This instrument was introduced in June 2004 in order to mop up the mounting excess liquidity. Certificates of deposit were issued for a three-month maturity, being traded between banks on the secondary market; this instrument is used for longer-term sterilization, against the backdrop of a relatively lower liquidity premium. The NBR operations in certificates of deposit have a higher level of standardisation than deposit-taking operations; CDs are issued exclusively by auctions conducted through multiple rate procedure, on a monthly basis, and the rate of allotment accepted by the NBR may vary within ±25 percent of the pre-announced volume.

2. The NBR standing facilities. These instruments were introduced in 2000 in order to (i) absorb (deposit facility) or provide (lending facility) liquidity with overnight maturity (one day); (ii) signal the general monetary policy stance through the interest rates applied to them; and (iii) stabilise overnight interbank market rates through the corridor defined by the interest rates on standing facilities. Unlike open market operations, standing facilities are available to credit institutions at their own initiative; the use of standing facilities is larger at the end of the reserve maintenance period.

3. Minimum reserve requirements. This mechanism was introduced in 1992, being subject to gradual changes in order to adjust it to the specific framework of monetary policy implementation. In 2002, minimum reserve requirements underwent a major change, the central bank assigning this instrument the function of controlling liquidity (which is closely interlinked with management of liquidity, more specifically with sterilization of structural liquidity surplus) and that of stabilising interbank market rates. The main features of the current reserve requirements mechanism are the following:

(i) reserve base is calculated as the daily average of balances (over the observance period) of foreign currency-denominated and leu-denominated liabilities on banks' balance sheet items (except interbank liabilities, and liabilities to the NBR and core capital);

(ii) observance period and maintenance period are of one month each (the observance period starts on the 24th of previous month and ends on the 23rd of the current month);

(iii) reserve ratios may be differentiated depending on both currency-denomination of the reserves (see chart in Box) and the residual maturity of items included in the reserve base (residual maturity of up to two years or over two years);

(iv) minimum reserve requirements are set up as daily average of banks' holdings on current accounts with the NBR during the maintenance period;

(v) reserve deficit is sanctioned by penal interest rate and repeated failure to comply with reserve requirements is sanctioned by written warning, fines or restrictions imposed on the operations performed by the credit institution.

4. Interventions in foreign exchange market. Unlike the other categories of instruments used by the NBR, interventions in the foreign exchange market are not standardised. During 1997-2005, the central bank's operations on the foreign exchange market consisted mainly in foreign exchange purchases. Starting November 2004, when the central bank adjusted its foreign exchange policy in order to increase the flexibility and unpredictability of the RON exchange rate, frequency of foreign exchange purchases declined significantly. However, in the summer of 2005, the NBR had to resort to sizable intervention in the foreign exchange market in an attempt to depress large inflows of volatile capital by discouraging expectations of nominal appreciation of the domestic currency and by increasing unpredictability of the RON exchange rate; starting with the latter half of October 2005, the central bank refrained from intervening in the foreign exchange market.