

## THE DIFFICULT TASK OF MAINTAINING CREDIBILITY

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*ABSTRACT: During the past two years the main features of the Romanian economy were the strong economic growth and the presence of a relatively high surplus on the foreign exchange market. Among the direct consequences of that surplus were the gradually declining depreciation rate, the tendency towards real appreciation of the leu against the euro-USD basket as compared to 2000, the generalization of anticipations regarding that appreciation and the decreases in the interest rates. The decreases in the interest rates and elimination of the well-known costs of high and volatile inflation brought about important benefits in terms of economic growth. Indeed, the lower inflation stimulated investments by contributing to the extension of decision-making horizons. Is it possible to repeat the same trend also in 2003?*

### Introduction

During the past two years the main features of the Romanian economy were the strong economic growth and the presence of a relatively high surplus on the

foreign exchange market. As compared to 2000, the net foreign assets of the National Bank of Romania were almost twice higher in 2001 and nearly 2.8 times higher in 2002.

| Changes in the net foreign assets (mil. USD) | 1997    | 1998    | 1999   | 2000    | 2001    | 2002   |
|--|---------|---------|--------|---------|---------|--------|
| NBR  | 1.543.0 | -481.0  | 933.5  | 917.9   | 1834.4  | 2505.5 |
| Commercial Bank                              | 154.0   | 232.0   | -133.4 | 400.5   | -87.8   | -759.6 |
| Banking System                               | 1697.0  | -248.97 | 800.13 | 1318.42 | 1746.62 | 1745.9 |

Among the direct consequences of that surplus were the gradually declining depreciation rate, the tendency towards real appreciation of the leu against the euro-USD basket as compared to 2000, the generalization of anticipations regarding that appreciation and

the decreases in the interest rates. On its turn, the declining depreciation rate determined in 2002 a disinflation above expectations. Thus, inflation dropped down to 17.8% in 2002, as against the estimated 22% which represents a decrease of nearly 12 percentage points as

\* The National Bank of Romania.

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compared to the inflation recorded in 2001. The decreases in the interest rates and elimination of the well-known costs of high and volatile inflation brought about important benefits in terms of economic growth. Indeed, the lower inflation stimulated investments by contributing to the extension of decision-making horizons. Is it possible to repeat the same trend also in 2003?

#### **The economy's response to the exchange rate dynamics**

In order to answer to that question, we shall analyze the way in which the economy has adapted to the expected real appreciation of the leu and how the Central Bank responded to the over performance in diminishing inflation. Moreover, we shall analyze which are the possible responses of the monetary policy to the current state of the Romanian economy. The economy's response to the credible announcement regarding the real appreciation of the exchange rate is presented in a simplified manner in Figure 1.

We shall start from the already-mentioned finding that the balance of payments surplus has accumulated as long as the gross domestic product increased and the interest rates decreased. The decrease of the interest rates was caused by the real increase in the broad money by 12.3% in 2001 and by 13.3% in 2002. This suggests that for the past two years the Romanian economy was situated in the very rare position where the curve of balance of payments (BB) had a negative slope and was placed below the line of the aggregate investments and savings (IS), as in

Figure 1. If the balance of payments line had been placed above the aggregated plan of investments and savings IS, the already mentioned monetary relaxation would have created a balance of payments deficit, which did not occur.

Our hypothesis is that in 2001 and 2002 in Romania the improvement of the public perception regarding the country risk and the resuming of economic growth (shy in 2000 but stronger in 2001 and 2002) were strong enough to determine the slope of the balance of payments to become negative and to place itself below the IS line. On one hand, the economic growth increased the pressures in favor of the conventionally negative effect upon the current account (the trade effect). On the other hand, the increase in the real output and the credibility of the macroeconomic policies attracted new capital inflows (the income effect). The latter exceeded the former, which determined the emergence of triggered the balance of payments surplus. Therefore, a decrease in the interest rate is necessary in order to re-establish the balance of payments equilibrium. This means that when the real income increases, the interest rate decreases, namely the slope of the curve is negative.

In Romania, the interest rates were gradually diminished in line with the increases in the real output, as we have shown. However, they have not yet reached the level from where the trade and the interest rates effects matched the income effect, so that the balance had and still has a surplus.

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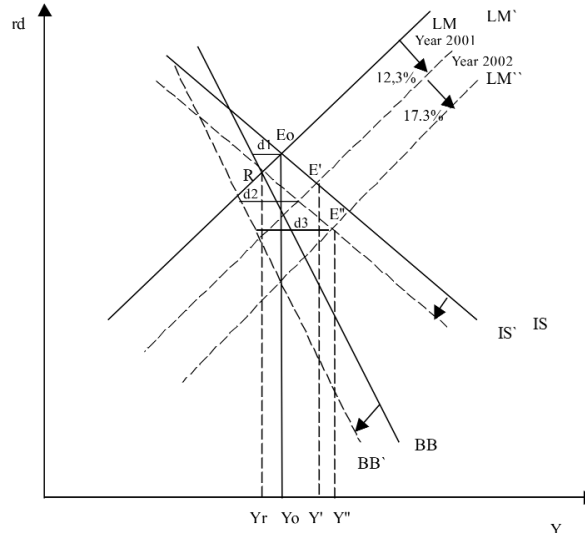


Figure 1: Adjustment of the Romanian economy in 2001 and 2002 under the hypothesis of a negatively sloped balance of payments line

Initially the economy was positioned at point  $E_0$ , above the balance of payments line (BB), indicating that the balance of payments has a surplus. That surplus is accumulated by the NBR through purchases of foreign currency reserves.

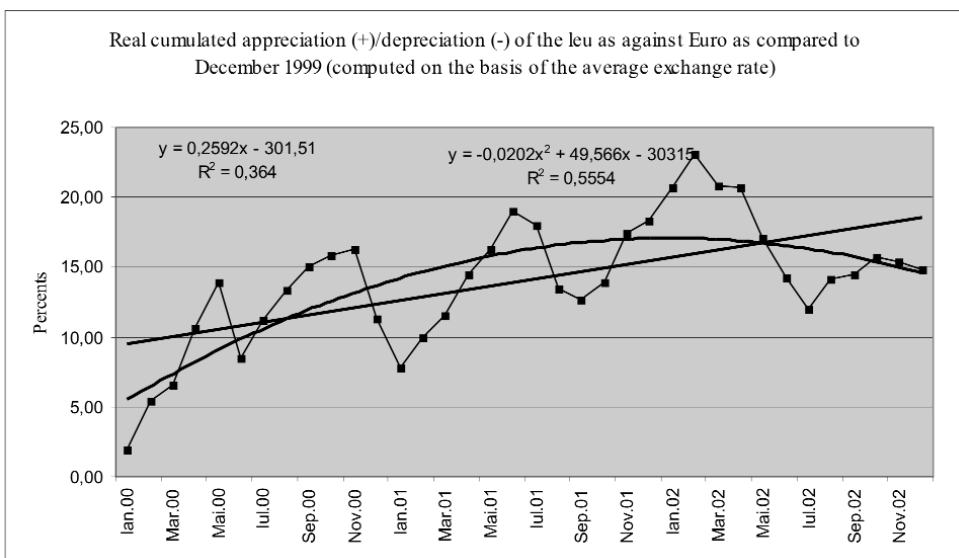
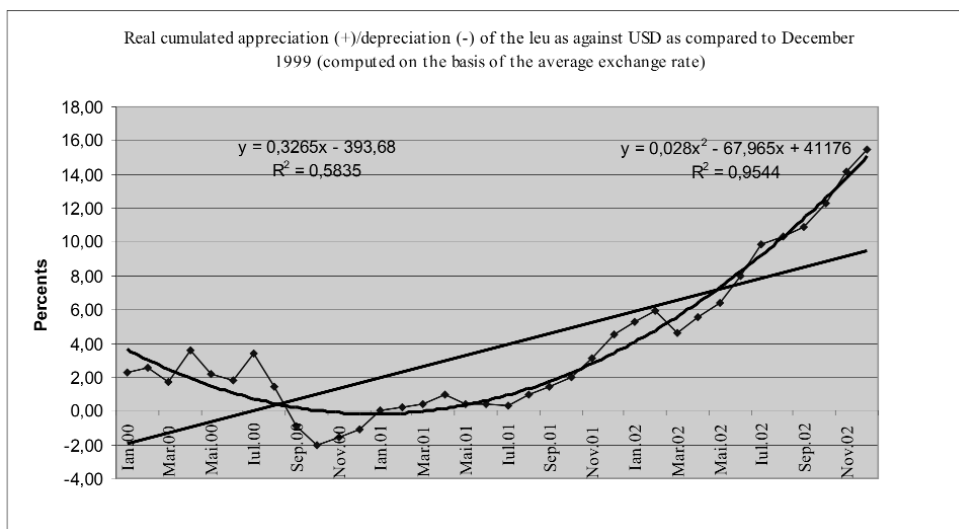
In 2001 and 2002, the expectations of a real appreciation of the national currency

determined the public to hold domestic assets for lower levels of the interest rates. In a relatively flexible exchange rate regime, that determined the achievement of the balance of payments equilibrium at lower levels of interest rate. In Figure 1 these changes in the public's intentions are presented through the downward movement of the BB line<sup>1</sup>.

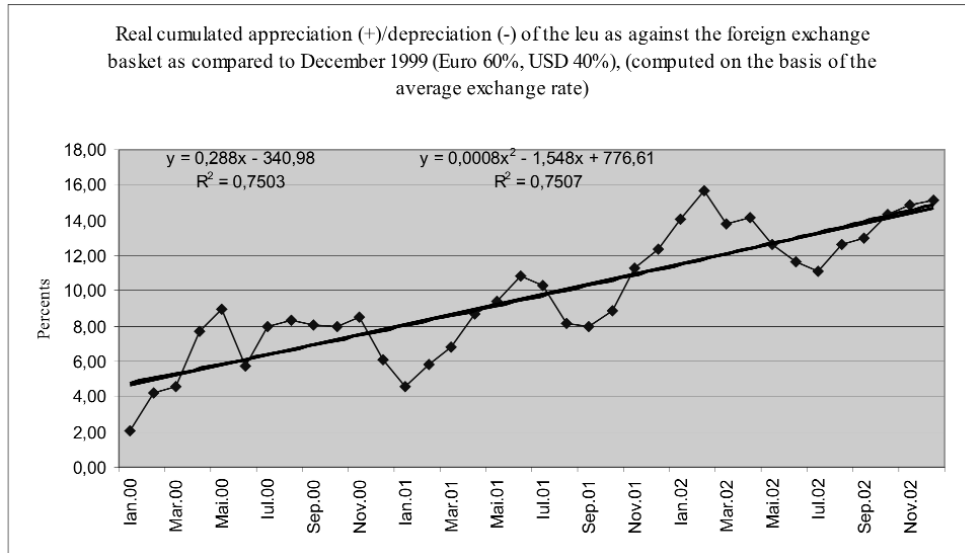
<sup>1</sup> Here we refer to the exogenous currency appreciation that emerged at the beginning of 2001. The expectations of the appreciation were consolidated in the first half of 2001 by the credible announcements of the National Bank regarding its determination and strength to sustain a real appreciation of the leu. The Ministry for Public Finance has announced, on its turn, budget deficit reductions according to the agreements of Romania with the IMF, as an integrated element of the macroeconomic policies mix, which targeted the freeing of monetary policy from the burden of adjusting the current account. Considering the volume of the forex reserves (6.7% of GDP in 2000 and 9.9% in 2001) and the good perspectives of the economy the announcement regarding the policy of real appreciation of the leu was credible and has shifted the balance of payments curve to the left, as in Figure 1. The expectations of appreciation made the public willing to keep internal assets at lower rates of interest, as, for instance, in the formula  $rd = r^* + \varepsilon$ , where  $rd$  is the domestic interest rate,  $r^*$  is the international interest rate,  $\varepsilon$  is the expected appreciation of the currency and perfect assets substitution is implied. Or we can write an equation of the balance of payments with imperfect assets substitution like:  $[\alpha_1(e-p_d) - \gamma] + \alpha_2[rd - (E_{et} + 1 - e)] + \alpha_3 y = 0$ , where  $p_d$  represents the internal prices,  $E_{et} + 1$  is the expected rate of appreciation/depreciation of the currency and all variables, except the interest rate are in logarithms. In this equation  $e$  and  $E_{et} + 1$  push the BB line in different directions, the resultant being a function also of the coefficients  $\alpha_1$  and  $\alpha_2$ . Under these circumstances, an exogenous appreciation makes it necessary for the internal interest rate to decrease in order to preserve the equilibrium of the balance. In our argument in the text, which is presented in Figure 1, we did not refer to the move of the BB curve determined by the endogenous change of the exchange rate. The endogenous appreciation moves the BB curve to the right, but the higher is the capital mobility (described by  $\alpha_2$ ), the lower is the effect of endogenous change of the exchange rate on the shift of the BB curve. In the graph we assumed that the BB curve has not shifted enough to the right in order to contribute to the reduction of the surplus of the balance of payments, which matches the data for 2001 and 2002.

The real appreciation of the leu, achieved through the slowdown of the nominal depreciation, determined adjustments of the relative prices. *Caeteris paribus* – given the interest rate – this pressed towards the achievement of the equilibrium between savings and investments only at lower levels of the gross domestic product. This is reflected by the

leftward movement of the IS curve. In the same direction pressed also the decrease of the budgetary deficit (from 4% of the GDP in 2000 to 3.3% in 2001 and 2.9% in 2002, respectively) and the adjustments occurred in the energy prices, which together with the interest rate policy tempered the increase in the domestic demand and diminished the current account deficit.



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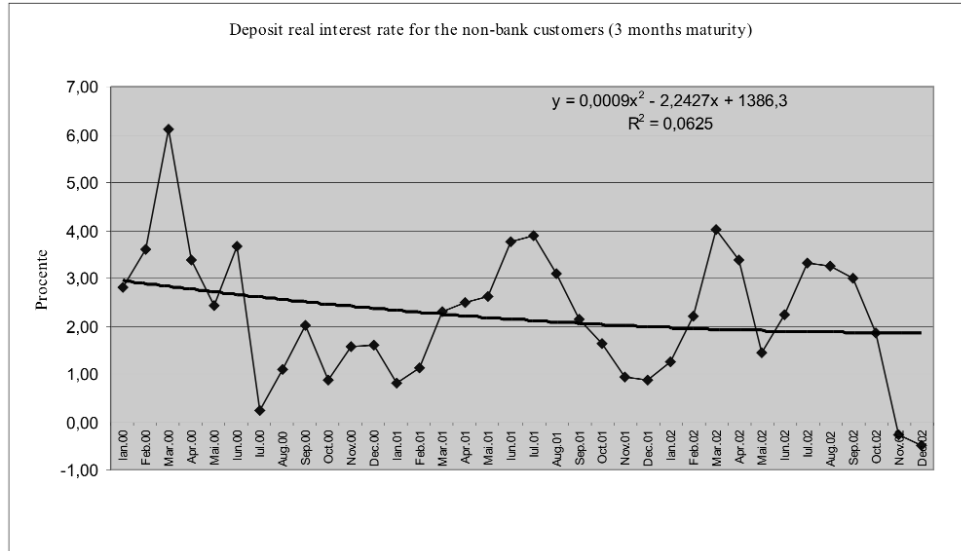


Due to these changes in the economic agents' intentions, the commodities market and the monetary market tended to be in equilibrium at point R, where the gross domestic product would have been lower in real terms and the balance of payments would have had again positive slope.

However, the changes in the aggregate intentions of the economic agents and the pressures created did not push the economy to point R (that signifies the Yr level of the gross domestic product), because the Central Bank reacted to all these movements through the

relaxation of the monetary policy<sup>2</sup>. NBR relaxed the monetary policy both in 2001 and in 2002 (M2 increased in real terms by 12.3% in 2001, and by 17.3% in 2002, respectively). With an exchange rate regime designed to decrease the pace of the nominal depreciation of the leu, the monetary relaxation stimulated the economic growth and the decrease of the interest rates. Since the income effect exceeded the cumulated interest rate and trade effect, the monetary relaxation resulted in a larger balance of payments surplus, increasing the pressures towards appreciation of the leu.

<sup>2</sup> Another solution, however unsustainable in the current circumstances, would be the increase in the budgetary deficit. That would move the equilibrium back to point E<sub>0</sub>, but without solving any problem and generating others.



The relaxation of the monetary policy and the productivity gains contributed not only to the annihilation of the contractionary pressures towards point  $Y_t$ , but also stimulated the growth of the economy with 5.3% in 2001 and almost 4.5% in 2002. With these increases, the gross domestic product of Romania was situated at the levels  $Y'$  and  $Y''$  in Figure 1.

The larger surplus of the balance of payments after the relaxation of the monetary policy in 2002 suggests the following questions: Which macroeconomic policy mixes may contribute to the preservation of the dominance of income effect over the interest rate and trade effect? Would it have been better to pursue a policy aiming to diminish the balance of payments surplus through the reduction of the volume of interventions on the forex market in order to let the exchange rate 'free' and to obtain an even faster decrease in the interest and inflation rates? Or it has to

be continued the policy aiming at gradually reducing interest rate and the pace of the leu depreciation?

#### Macroeconomic policies mixes

Our philosophy is that in the new situation (negative slope of the balance of payments line) the macroeconomic policies mix able to maintain or to increase the macroeconomic policies' credibility has to be identified. From Figure 1 it results that, potentially the relaxation of the monetary policy will generate a virtuous circle. The relaxation (through purchases of foreign currencies) will be accompanied by the increase of the balance of payments surplus ( $d_1$ ,  $d_2$  and  $d_3$  in Figure 1), which in turn will attract the appreciation of the currency that once more will require a decrease in the interest rates, and so on. In this sequence, the GDP increases despite the fact that both the BB curve (due to reduced interest

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rates) and the IS curve (due to the real appreciation) move leftwards, driving contractionary effects. When GDP is increasing, also the credibility of the macroeconomic

policies increases. With an increasing credibility of the policies, the growing economy will attract even more capital inflows, feeding the balance of payments surplus (Figure 2).

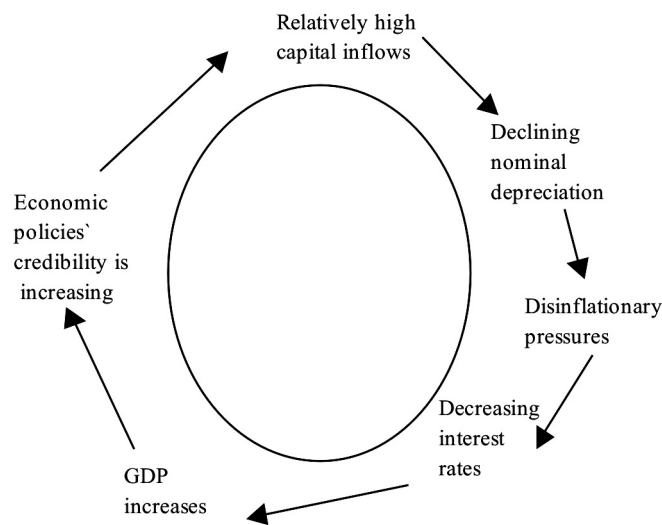


Figure 2: The virtuous circle of the Romanian economy in 2001 and 2002

Obviously, the described virtuous circle cannot continue endlessly. At a certain moment, the effect of decreasing interest rates in lowering the capital inflows and the negative conventional effect on the current account determined by economic growth will outrun the income effect. At that point, the slope of the balance of payments curve will become again positive, namely the interest rates will have to increase in order to keep the balance of payments balanced as long as the real product increases. Then, the economy can start another virtuous circle, function pending of on the (macro)economic policies mixes.

However, in the current phase, when the slope of the balance of payments line is negative, wisdom of the macroeconomic policies lies in avoiding the premature exit from the present virtuous circle.

Figure 2 reveals that the interventions of the Central Bank on the forex market in order to maintain a certain pace of the nominal depreciation of the leu are necessary for the preservation of the virtuous circle. In order to illustrate such an idea, let us first assume that the exchange rate is fixed and there is no sterilization. In this case, the money stock will continue to increase. This would only make the

things worse, while the surplus would continue to increase too. Such a situation is unsustainable. If the exchange rate is completely flexible, given the existing nominal rigidities of the Romanian economy, the surplus will determine a nominal appreciation (which makes it a bizarre result of the monetary expansion). This in turn would lead to the slowdown of the economic growth. Obviously, the balance of payments would reach equilibrium.

If the exchange rate regime is that of gradually declining targeted depreciation rate as a nominal anchor as it was the case during the interval 2001-2002, then the magnitude of the nominal depreciation is an issue of 'fine tuning'. Depreciation has to be small enough as to remain compatible with the programmed disinflation, but also high enough to prevent the steep real appreciation of the leu. Let us assume that the Central Bank would not intervene with sufficient purchases in the currency market to adjust the nominal depreciation rate. In that case, the sterilization efforts (and implicitly the Central Bank's losses) would be smaller, but the real appreciation of the leu would be higher, pushing for economic recession, lower credibility of the monetary policy and the corresponding decrease of the income effect upon the balance of payments (decrease in surplus).

The revealed virtuous circle may also be interrupted if the economy itself is not restructuring. Hence the real appreciation of the leu would erode the economy competitiveness that would lead to the slowdown of the economic growth. Once the slowdown of the economic growth occurs the

credibility of policies decreases – the one that in our view determined to a large extent the higher capital inflows in 2001 and 2002.

The economy would also exit from the above described type of virtuous circle when the IS curve (that designates the savings – investments equilibrium) would change its slope and would 'slide' below the negatively sloped line of the balance of payments (BB). This may happen, for instance, when the investments relative to interest rate elasticity decreases. Then, the monetary expansion should be stopped, because it would lead to a balance of payments deficit, in the following manner: with a lower investments to interest rate elasticity the decrease in the interest rates determined by the monetary relaxation would not drive a sufficient increase in the real product for the balance of payments to be balanced. In other words, the income effect will be lower than the interest rate effect, diminishing the capital inflows.

The fiscal policy faces certain traps when there is a significant balance of payments surplus. On one hand, given the above-mentioned hypothesis, of the negatively sloped balance of payments curve, a contractionary fiscal policy tends to add up pressures in the same direction with the real appreciation of the leu, thus diminishing the economic growth. However, its contractionary effects are mitigated by the fact that, for instance, a decrease in the budgetary deficit diminishes the balance of payments surplus. Thus a tight fiscal policy may help to the fine-tuning of the necessary depreciation of the leu of which we have previously discussed. On another hand, given the negatively sloped balance of payments curve, although it leads to the



accentuation of the economic growth, an expansionary policy is not necessarily a viable option. In the situation described, an expansionary fiscal policy would accentuate the balance of payments surplus (that presses towards the real appreciation of the leu) concomitantly with increases in the interest rates. Such a situation is unsustainable because it will attract speculative capitals and would increase the difference between the costs of credits in lei and those of the foreign currency credits. The credibility of policies would be altered and the capital inflows attracted by (until that moment) the good perspectives of the Romanian economy would be gradually replaced by the speculative capital inflows. Thus, relaxation of the fiscal policy would interrupt the virtuous circle.

To sum up, if the balance of payments line is negatively sloped, then the macroeconomic policies mix has to include a contractionary budgetary policy and the relaxation of the monetary policy. Such a mix is sustainable as long as the investments relative to interest rates elasticity is high enough for the IS line to stay above the balance of payments line, BB. By shrinking the balance of payments surplus, the decrease of the budgetary deficit may help the gradually declining targeted depreciation in the same direction as the Central Bank's purchases in the foreign exchange market. That suggests that the fine tuning would play a major part in the macroeconomic policies mix. Although the balance of payments surplus exerts a high pressure towards diminishing inflation, the latter remains to a large extent dependent upon the coherence of the macroeconomic policy. Indeed, although in 2001 and 2002 the main pressure towards diminishing inflation

came from the part of the balance of payments surplus, the coherence of policies played a major part.

#### **Circumstances at work in 2003**

To what extent would the circumstances present in 2003 allow the continuation of gradually declining targeted depreciation and diminution of the interest rates? In 2001 and 2002 the NBR's success in guiding the exchange rate toward slowing nominal depreciation was based on the coexistence of the relatively large capital inflows and of the favorable current account developments. A good correlation between the increases in labor productivity and wages preserved the competitiveness of the economy, although the exchange rate tended to appreciate. That allowed NBR to limit its purchases on the currency market, necessary to compensate the slowdown of the nominal depreciation of the leu. Even so, the Central Bank accumulated foreign net assets amounting to record levels for the past 12 years. In 2002, when the increase in the capital inflows was also accompanied by a decrease of the current account deficit (from 5.6% of the GDP in 2001 to probably 3.7%), the NBR net foreign assets increased by over 2.5 billion USD, and its net purchases on the currency market reached nearly 1.8 billion USD.

Assuming that the capital inflows would be relatively high also in 2003 too, then once more it would be necessary that the erosion of the competitiveness of the economy, generated by the real appreciation of the leu, to be at least compensated by the labor productivity increase. However, in 2003 this will be more difficult than in 2002, if we consider time lag of

the current account response to the real appreciation of the exchange rate.

In 2001 and 2002 the economy still benefited from the productivity gains generated through the real depreciation of the leu in 1999. But the cumulated appreciation of the leu in the past two years is likely to bring negative effects in the current account only this year. In such circumstances, the increase in labor productivity will have to cover not only the increase in wages, but also to compensate for the delayed influences due to the cumulated appreciation of the leu. Thus, the decrease of the budgetary deficit programmed for 2003 might become insufficient relative to the goal of preventing the current account deterioration.

If the above-mentioned requirement regarding labor productivity increase would not be fulfilled, the Central Bank might be forced to compensate the lack of competitiveness through higher purchases on the forex currency market, in order to prevent the relatively large slowdown in the pace of leu depreciation. Obviously the interventions for a

more accentuated depreciation as compared to the previous year would be even greater if it also existed a 'slide' in the wage policies able to lead to a budgetary deficit exceeding the programmed level. A relatively higher nominal depreciation as compared to the previous year would be costly in terms of a higher than programmed inflation in 2003.

With an inflation above the programmed ceiling also the interest rates will be relatively higher than those anticipated. Together with the more accentuated depreciation, they will erode the 'credibility acquisitions' of the Central Bank, and of the macroeconomic policies in general. To the extent to which the increased credibility allowed economic operators to embody in their decisions the downward trend of inflation in the past two years, the decrease in credibility will lead to an opposite effect of the same magnitude. Once eroded, the credibility is hard to rebuild. That is why the priority in 2003 is to maintain the coherence of the macroeconomic policies mix.