CONSIDERATIONS REGARDING THE MAIN MONETARY POLICY STRATEGIES PROMOTED IN CENTRAL AND SOUTH-EASTERN EUROPE

Monica-Ionelia MĂRGĂRIT

University of Craiova, margaritmonicaionelia@gmail.com

Abstract: *Worldwide, contemporary central banks have adopted different strategies and their priorities continue to change. Among the main factors that led to a change in the priorities of central banks in terms of monetary policy, can be mentioned: globalization, the innovations made in the financial field and the considerable development of the field of non-bank financial intermediation. The purpose of this paper is to identify the main monetary policy strategies existing in Central and South-Eastern Europe and how they have evolved in time. In this regard, we used a comparative analysis of the main monetary policy strategies existing in the Central and South-Eastern European countries (namely, Poland, Hungary, Romania and Bulgaria), together with a quantitative analysis, in order to systematize and present the evolution of the main macroeconomic variables, as a result of the changes made in the strategies promoted by these central banks.*

Keywords: Monetary policy; Monetary strategies, Price stability, Central and South-Eastern Europe.

JEL Classification Codes: E42, E52, E58.

1. INTRODUCTION

The monetary policy, as well as the objectives of central banks have undergone several changes. Between 1950 and 1960, the majority of central banks had paid a particular attention to economic growth stabilization, given the existence of the Bretton Woods Monetary System, a system characterized by fixed exchange rates. In the following two decades, the monetary policy was characterized by neokeynesian economic policies, known as active monetary policies, which assumed that the role of central banks was to provide sufficient liquidity in order to revive the economic activity. However, at the beginning of the 1980s, this kind of monetary policy was replaced by a new monetary policy which gave a greater importance to price stability.

Currently, worldwide, central banks have different objectives. For example, in the United States, the law that governs the organization of central bank assumes that „the mission of the Federal Reserve System is to foster the stability, integrity, and efficiency of the nation's monetary, financial, and payment systems so as to promote optimal macroeconomic performance." (Federal Reserve Board, 1994). As far as the main objective of the European Central Bank is concerned, it implies „maintaing the price stability. Without prejudice to the objective of price stability the European System of Central Banks shall support the general economic policies in the Union with a view to contribution to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union" (European Institute of Romania, 2005).

Article 3 sets out the following objectives: „The Union shall establish an internal market. It shall work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment” (European Institute of Romania, 2005).

In the European Union, we identify three important models of monetary policy, as following:

- the monetary policy promoted by the Monetary Policy Committee of United Kingdom;
- the monetary policy promoted by the Currency Board, the case of Bulgaria;
- the monetary policy promoted by the vast majority of the European central banks, which aims the inflation rate.

2. THE MAIN MONETARY POLICY STRATEGIES PROMOTED IN CENTRAL AND SOUTH-EASTERN EUROPE

With the collapse of the communist system, most of the Central and South-East European countries started to adopt the regime of fixed exchange rates. However, this regime was quickly abandoned due to the fact that these states failed to keep the inflation rate under control, which dropped significantly, leading to a strong deflation. All of these translated into a significant appreciation of the national currency, which led to a balance of payments disequilibrium.

Given the forgoing facts, these former communist countries were forced to adopt other monetary policy strategies, and they have to choose between: targeting monetary aggregates, adopting an eclectic monetary policy strategy, replacing the fixed rate regime with the one promoted by the currency board or the inflation targeting strategy.

According to Ialnazov D. and Nenovsky N. (2001), „some preliminary results suggest that Central and East European countries (CEECs) preparing to join the euro zone are faced with a trade-off between low inflation and exchange rate stability. These countries may choose either the former, by adopting inflation targeting combined with a flexible exchange rate system, or the latter, by pegging their national currencies to the euro”.

Currently, most of Central and East-European countries which are preparing to join the European Monetary Union have adopted a inflation targeting regime, the only exception is Bulgaria, which operates under the currency board.

Further, we will discuss the monetary policy strategies and objectives promoted by four Central and East-European countries which are members of the European Union but not of the European Monetary Union. These countries are Bulgaria, Poland, Hungary and Romania.

2.1. The monetary policy promoted by the Bulgarian Currency Board

Unlike other EU Member States, the implementation of monetary and fiscal policy in Bulgaria is strictly limited by the regime of the fixed exchange rate and the Currency Board.

„Currency board is a monetary regime based on rules that bring discipline in macroeconomic policy through market discipline and capital movement. It relies on two main effects: discipline effect (constraints on monetary policy) and the credibility effect stemming from the fixed exchange rate and the coverage of monetary base.” (Nenovsky, 2007).

At the beginning of this transition, Bulgaria implemented a floating exchange rate, together with an independent monetary policy. After a period characterized by numerous crises, hyperinflation and the loss of foreign exchange reserves, in November 1996, the International Monetary Fund proposed to the Bulgarian government the system of the currency board as a way of ensuring financial discipline and macroeconomic stability.

The principles of the Currency Board were established by the new law of the Bulgarian National Bank, in June 1997, according to which, the lev was fixed to the deutsche mark at a rate of 1 DM = 1000 lev and neither the central bank nor the government could voluntarily change the exchange rate. This could only be done by the vote of qualified majority from the national parliament. Moreover, the 1997 Law regarding the liabilities of Bulgarian National Bank has guaranteed the followings:

- the Bulgarian Central Bank will be guaranteed 100% of the foreign reserves of Currency Board;
- the central bank will convert national currencies and reserves on demand, without limit, at a fixed exchange rate;
- central bank loans to government, as well as refinancing of commercial banks were suspended.

This treaty limits, to some extent, the ability of the central bank to use its role as a lender of last resort, but it leaves room for interventions in the event of a liquidity risk that threatens the stability of banking system.

In Bulgaria, the central bank is divided into two departments: the money issuing department and the banking department, each one of them having its own balance sheet. The first department is directly responsible for the proper functioning of the Currency Board, while the second department is the one which acts as a lender of last resort. The third characteristic of the Currency Board is the presence o the fiscal reserve department, responsible of issuing liabilities.

According to Miller, J. (1999), „the Bulgarian currency board is designed to reduce the impact on the money supply when there are financial flows from the IMF and major debt service payments are made. This structure has the advantage of reducing the volatility of M0 which would be caused by these flows, but it also means there is no longer a direct connection between BOP disequilibria and adjustments in the money supply."

The particularities that make the Bulgarian currency board more flexible than other orthodox monetary councils, according to Dobrev, D. (1999), are:

- "the possibility to issue supplies notes, coin and deposits (the government deposits and commercial bank reserves);
- regulates commercial banks."

After the implementation of the currency board, in 1997, Bulgaria achieved remarkable macroeconomic stability, along with three successive years with economic growth. A study made by Ghosh et. al. (1998) shows that, in time, countries with currency boards recorded lower inflation on average than countries that used floating exchange rates or regular fixed exchange rates.

The currency board system also requires a better fiscal discipline from the government. Due to the fact that fiscal deficits cannot be financed by simply printing money, and loans can be prohibitively expensive, the government has a strong stimulant to maintain budgetary balance, by limiting expenditures and rising tax revenues. Furthermore, the currency board has a strong credibility effect which results from simplicity of rules and its transparency in elaborating monetary policies. The major disadvantages of the currency board include the restriction of the central bank's ability to exercise its role as a lender of last resort. Another potential threat comes from asset volatility, due to capital inflows and outflows.

In Bulgaria, the exchange rate mechanism has played a restrictive role in terms of monetary policy and, thus, on fiscal balance and public debt. The combination between the constrains that emerge from the fixed exchange rates (applied by the currency board) and the requirement from the Maastricht Treaty has led to a very high degree of fiscal discipline and, therefore, to a stronger budgetary position and to sustainable levels of sovereign debt, even in times of crises.

2.2. Monetary policy in Poland

During time, Poland has pursued three monetary policy strategies. According Pruski, J. (2002), „in 1990, at the outset of transition Poland adopted fixed exchange rate regime with the principal aim to fight hyperinflation. The initial period of stabilization took 18 months. It allowed the zloty to regain its role as a medium of exchange and a store of value in spite of the annual inflation rate still exceeding 40 per cent by the end of 1992"

The success in stabilizing the economy, on one hand, and the obvious rigidity of fixed exchange rates, on the other hand, has made necessary for Poland to change its monetary policy strategy in 1995. Obviously, at that time, Poland was not fulfilling the necessary conditions in order to adopt full-fledged inflation targeting and the Polish economy was too large and was facing a number of structural problems in order to tackle the currency board strategy. Therefore, the "eclectic approach" of monetary policy has seemed to be the most appropriate strategy for a country like Poland. Finally, in 1998, this strategy was replaced by the full-fledged inflation targeting.

Before 1998, the objectives of the "eclectic" monetary policy, as well as the tools used in order to achieve these objectives have changed several times, as follows:

- between 1990-1991, the monetary policy was based on fixed exchange rates which were pegged to the U.S. dollar or to a currency basket, as well as on the inflation targeting;
- between 1992-1995, the monetary policy had the following objectives: targeting inflation rates, annual growth of the M2 aggregate as an intermediate target, and the use of crawling pegs against a currency basket;
- between 1996-1997, the monetary policy had the same objectives from the previous period to which was added an operational objective, namely, targeting the growth of the M0 aggregate.

The "eclectic" monetary policy used between 1990-1997 can be considered a success because it has reduced inflation from 1000% to approximately 10%. However, it has led to an inconsistency in simultaneously controlling the exchange rate, interest rate and monetary growth.

According to Pruski J. (2002), "the implementation of the full-fledged inflation targeting in 1998 overcame the lack of transparency and low accountability inherently present in the inflation targeting lite system. By announcement of the short term (one year) and medium term (six year) inflation goals and introduction of main instrument of monetary policy (short term interest rate) monetary policy became subordinated to the famous principle: one instrument – one goal."

The introduction of the direct inflation targeting strategy in Poland was done in two stages:

- the first stage (1998-2003): had as a medium-term objective the reduction of the inflation rate below the level of 4% and was characterized by announcing at the end of each year an annual inflation rate objective;
- the second stage (2004-present): it is characterized by maintaining a low and stable inflation. According to the National Bank of Poland, since 2004, the inflation target continues to be 2.5%, with a fluctuation band of ± 1%. This means that, every month, the annual consumer price index should be as close as 2.5%.

2.3. Hungarian monetary policy

The monetary policy practiced by the Hungarian economy until 2000 can be characterized as unstable, the macroeconomic situation of Hungary being critical, and the vast majority of indicators suffering rapid deterioration.

According to Golinelli R. and Rovelli R. (2001) depending on the exchange rates applied, the monetary policy in Hungary between 1991-1999 can be divided into two phases:

- „ the first phase, from January 1991 to March 1995, was an adjustable peg;
- the second phase was a pre-announced crawling peg with daily devaluations."

In the first phase, between 1991 and 1995, the macroeconomic situation of Hungary was unfavorable, the gross domestic product has registered a continuous decrease, the annual rate has varied between -1% and -5%, while the budget deficit was 6-7%. In this phase „the exchange rate was the fulcrum of two conflicting central bank objectives: to promote external competitiveness and to provide a nominal anchor for price stability" (Szapary and Jakab, 1998).

During this period, targeting inflation was not the first or only objective of the central bank, since the monetary authorities were clearly concerned about the possible costs that deflation could bring. The result was not as expected: the forint was devalued 22 times, on a discretionary basis between 1990 and 1995, which led to an increased speculation against the currency and undermined the credibility of the central bank.

Under these circumstances, the Hungarian government have introduced a package of stabilizing measures in March 1995, including spending cuts, tax increases, imposing an import surcharge, liberalization of capital transactions, etc. As a result, in 1996 the deficit was reduced to 4% and there was an economic growth of 4.5%. Regarding the inflation rate, it registered a value of 10% at the end of 1999.

June 2001 marked the introduction of inflation targeting in Hungary. This measure was taken as a response to the countless unsuccessful attempts made by the National Bank of Hungary which wanted to use other nominal anchors in order to control inflation.

Regarding the implementation of this objective, considering that at the beginning of 2001 the inflation rate was around 10%, it was proposed that the inflation had to reach the level of 7% by the end of 2001. In the following years, the target was gradually reduced and was finally set in 2007 at 3%. Currently, the medium-term inflation target has been maintained at 3% with a tolerance band of ± 1%.

2.4. The monetary policy strategy of National Bank of Romania

In May 1991, the National Bank of Romania went through a reorganization, being assigned with monetary authority functions. Through art. 1 of Law no. 34/1991, the law of organization and functioning of the central bank, "the National Bank of Romania establishes and conducts the monetary and credit policy, within the economic and financial policy of the state, in order to maintain the stability of the national currency." (Law No. 34 of March 29, 1991 on the Statute of the National Bank of Romania, 1991)

With the reorganization that took place in early 1991, or in other words, after the fall of the communist regime, the National Bank of Romania implemented several monetary policy strategies. This post-communist era can be divided into three periods characterized by significant changes in terms of monetary policy, as follows:

- 1991-1997 - characterized by an alternation of restrictive policy measures with accommodative policy measures. Between 1991-1993 National Bank of Romania used credit ceilings (credit planning in a modified form). After 1993, the monetary policy promoted by the central bank aimed at targeting the monetary aggregates, together with an implicit targeting of the exchange rate, but which was abandoned in 1995;
- 1997-2005 - during this period, the economic reforms were emphasized, and the independence and credibility of the National Bank has increased. Regarding the monetary policy strategy used, it continued to be based on the targeting the monetary base, as provided in the economic program concluded in 1997 with the International Monetary Fund;
- 2005-present - with the accession to the European Union, the National Bank of Romania has changed its monetary policy strategy, adopting inflation targeting, in order to a better comply with the criteria laid down in the Maastricht Treaty, with a view to a possible adoption of the single European currency.

In view of the above, it can be considered that the main monetary policy strategies used by the National Bank of Romania were the monetary aggregates targeting and the inflation targeting.

In Romania, the monitoring of the monetary aggregate by the national authorities, between 1999-2004, was influenced by the restrictive measures taken against those banks that were outside the banking security standards, including the illegal or quasi-fiscal activities. These measures led to a change in the composition of the monetary aggregates. Also, the authorities responsible for the monetary policy faced new challenges, which is why they had to ensure:

- a better management of the M2 aggregate;
- a better control and a reduction in terms of inflation;
- a more sustainable liquidity for foreign currencies and reserves;
- a better control over the budget deficit;
- a better stability of the banking system.

It is difficult to establish which of the two approaches was more efficient and more suitable for the Romanian economy. Both strategies have more or less achieved their objectives, given the economic conditions (the implementation of the strategy in a period characterized by uncertainty, volatility and very high inflation rates, as well as the outbreak of the global financial crisis).

However, the implementation of inflation targeting was justified by two aspects. The first aspect is related to Romania's accession to the European Union in 2004. In this regard, the National Bank of Romania has modified its monetary policy strategy, adopting inflation targeting, in order to have a better compatibility with the criteria laid down in the Maastricht Treaty. On the other hand, Romania adopted the targeting of inflation during the pre-crisis period, in order to stop the growth of demand beyond the potential growth of production, which would have led to a higher inflation.

3. CONCLUSIONS

The purpose of this paper was to highlight the main monetary policy strategies that existed in Europe, and in particular in the countries of Central and South-Eastern Europe, which are part of the European Union but which have not yet met the conditions necessary for the adoption of Euro.

As mentioned, the monetary policy strategies promoted by central banks in Central and South-Eastern Europe have changed after the collapse of the communist regime. Most of these countries have adopted the fixed exchange rates regime, which was subsequently abandoned due to the fact that these countries failed to keep the inflation rate under control, which decreased significantly, leading to a strong deflation. Under these circumstances, the former communist countries were forced to adopt other monetary strategies.

As a result of the study, we identified that the monetary policy strategies differ from one country to another, as well as from one period to another. It is difficult to decide which of these monetary policy approaches are more effective because they have certain limits, which have been very well highlighted with the onset of the global financial crisis, when central banks were forced to rethink the interaction between the financial economy and the real economy, and they began to use a series of monetary policies that were considered unconventional.

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