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MONETARY POLICY IN ROMANIA: CHALLENGES AND OPTIONS

ION DRAGULIN
Romania Representative, International Monetary Fund

EUGEN RADULESCU

CONTENTS

-- ABSTRACT –

The paper is aimed at analyzing the extent to which monetary policy has fulfilled its function of ensuring price stability in Romania since 1990, as well as the medium-term outlook with a view to harmonization with The European Union (EU) standards. From the quantitative viewpoint, the central bank's performance in controlling inflation in Romania was less than modest. However, the key reason behind this state of affairs is the delay in implementing the other elements of the reform process, most notably those related to property and the proper mechanism which enables a performing market economy to function. During most of the transition period, the authorities' policy mix maintained an expansionary stance and the major imbalances in the economy were treated inconsistently; consequently, monetary policy only averted a drive into hyperinflation and contained price increases to the moderate range. Under the circumstances, monetary policy was shunted onto a branch line and the central bank agreed on a great deal of compromises that hampered control over inflation.

Meanwhile, the authors end up in identifying an already existing institutional framework that should pave the way for making good progress at bringing the price level on course to meet the target for integration with the EU. Making all this a success is critically conditional on finalization of reform as regards the other components of the macroeconomic and structural policy mix, on the one hand, and on central bank's capability to enhance credibility and catalyze the necessary political consensus on the other.

I. INTRODUCTION

1. Monetary policy has captured the attention of both public and political circles in Romania. Both the role and the performance of monetary policy were seen, to some extent, through a distorted mirror for endogenous or exogenous reasons related to the monetary authority. In the absence of profit-oriented economic management (driven by the state proprietor), enterprises have further regarded monetary policy as an automatic supplier of financial resources during a well-managed tradition from the socialist economic system. Any attempt to tighten the monetary conditions was considered to be an anti-economic action. The behavior exhibited by enterprises was often backed by the double-dealing stance of the government and the political class – who for most of the past decade failed to put together public commitments (stabilization and structural reform) – and the evident pattern of their policies.

2. The exceedingly critical reaction – of the government in particular – to the quality of monetary policy was also prompted by the institutional autonomy of the monetary authority that hindered the government's unconditional access to the central bank's resources. Ultimately, the government proceeded to decisive interventions, in effect canceling the autonomy of the central bank. At the same time, the limited success of monetary policy in preventing inflation was attributed to the central bank's feebleness, as demonstrated during the long race toward macroeconomic stabilization. The instances of a firm stance on monetary and foreign exchange policy have been short-lived and therefore insufficient to bear fruit.

3. Considering the relatively insubstantial track record of monetary policy, the following major question is legitimate: to what extent can the present monetary and exchange rate regime in Romania achieve the much-needed macroeconomic stabilization and disinflation in accordance with a reasonable agenda for integration with the economic structures of the European Union? Despite the non-convincing performance to date, the authors give credit to the present monetary regime based on an autonomous central bank and managed floating. In their analysis, the authors are encouraged by the obvious potential of these monetary and exchange arrangements to achieve macroeconomic stabilization, and to guide economic policy in Romania towards the resolution of the chief drawbacks that the economy have faced in the last couple of years.

4. Chapter II analyzes the institutional framework of monetary policy in particular, and of the economy in general. The authors conclude that a proper framework was put in place for the banking system and the central bank. The poor performance of bank privatization and privatization overall is seen as an obstacle to strengthening monetary policy. Chapter III deals with the pillars of stabilization. The authors underscore the fact that, poor effectiveness notwithstanding, monetary policy has remained the main pillar of Romania's (unfortunately excessive) macroeconomic stabilization programs. Other potential pillars of stabilization, such as fiscal, income, or exchange rate policy, are considered as well.

5. Implementation of the proper operational framework increased, to a large extent, the capacity of monetary policy to react to the challenge posed by the task of stabilization. This framework, which includes monetary policy tools, is analyzed in Chapter IV. Assessment of the performance of monetary policy, covered in Chapter V, reveals both its intrinsic value and the value to the economic environment and policy coordination. The authors reach the conclusion that monetary policy proved effective every time it withstood political pressures, but that this success could not be consolidated.

6. Finally, Chapter VI deals with the medium-term outlook of monetary policy. The authors conclude that the favorable foundations already in place and the current momentum of macroeconomic and structural policies makes it easier for the central bank to achieve the anti-inflationary goal of monetary policy based on a flexible exchange rate.

II. The institutional framework

7. Banking legislation (i.e., the law on the statute of the National Bank of Romania (NBR) and the Banking Law) has been enforced since the first half of 1991. By and large, the laws were largely in accordance with the requirements extant in fully-fledged market economies. The laws lay down the two-tier banking system, the independence of the central bank, and that the main goal of the latter is price stability. This effectively contains the possibility of the central bank financing the budget deficit. Moreover, the central bank is in charge of elaborating the foreign exchange policy, and regulating and supervising of the banking system. The first NBR Board, appointed with an 8-year mandate, comprised unaffiliated personalities that have in time proved to be reform-minded. It is intriguing that, shortly after being appointed, the Board decided to abolish interest and credit ceilings, thus clearing the central bank to use indirect mechanisms.

8. The new banking legislation enacted in 1998 – the revised laws on the statute of the National Bank of Romania and on banking, as well as the new law regarding bank insolvency – does not bring very many changes. The new statute of the NBR stipulates the following: Board members are formally required to be unaffiliated; the levers available to the central bank for supervision of the banking system are strengthened; bankruptcy proceedings for banks are simplified and enforced. In fact, the present banking laws are almost completely in line with EU-wide standards and only minor adjustments are needed to render them fully compatible.

9. However, this favorable institutional framework did little to help monetary policy play its role successfully. The greatest challenge was the *de facto* limited support of public authorities to the mechanisms and institutions that enable the smooth functioning of a market economy. For most of the time, the common attitude assumed, in practice, by many of the political parties was the gradual approach to reform, with its alleged purpose of ensuring its social supportability. Thus, price liberalization – the cornerstone of smooth functioning of any market economy – began in late 1990 but just 80 percent of goods and services witnessed free prices three years later; the whole process ended no earlier than 1999.

10. Privatization in turn was poorly drafted and developed at a snail's pace. A voucher mechanism, similar to the one implemented by the Czech Republic, was adopted in Romania as well. As in the Czech Republic, the outcome of voucher-based privatization was disappointing as far as corporate governance is concerned (Nellis, 1999): in Romania it took more than three years to be completed. As for privatization based on selling the assets officially held by the State Ownership Fund (SOF), the performance is rather modest; barely one quarter of such assets were sold by 1999 (*Romania – Memorandum of the Government of Romania on Economic Policies, August 1999*).

11. By 1999 restitution of property seized by the communist regime was not concluded. The farming land was partly reconveyed in the early 1990's. Subsequently, part of real property was also reconveyed. The retrocession of industrial property, as well as some other agricultural and real property, remains a point of contention between political parties and can no longer be handled by mere procedure. Romania took a one-off position among the former socialist countries, since it did not settle properly the question of legal redress once and for all. Aside from moral issues, the current state of affairs adds to the confusion and, if anything, delays the reform process.

12. Legislation on market functioning has several important flaws. The first law on bankruptcy was enforced only in 1995; the fact that it avoids usage of the word bankruptcy is

puzzling, given the overall direction of economic policy. Moreover, the provisions of the law are bureaucratic and hamper *de facto* the process of forcing bankrupt companies out of the system. Generally speaking, the way in which the economic legislation and the specific jurisprudence were drafted shows that quite frequently the debtor is defended to the detriment of the creditor (*Annual Report of the National Bank of Romania – 1998*). The above-mentioned state of affairs was favorable to the emergence of moral hazard and adverse selection.

13. In turn, labor legislation has not been harmonized with market-economy standards. Staff cuts, albeit economically justified, are difficult to enforce due to legislative rigidities. All this led to the emergence of a double standard. On one hand, unions in the state-controlled enterprises took advantage of the already outdated legal provisions to block restructuring, and one the other hand some of the newly-established private enterprises would violate laws on a large scale.

14. The institutional structure of the banking system, though built on correct principles, also accommodated the overall orientation of the authorities. Thus, the leading state-owned banks fulfilled quasi-fiscal functions, while some of the private banks evinced major weaknesses in corporate governance. All this resulted in a fragile banking system that failed to perform its resource allocation function properly.

15. The performance of the stock exchange and of other financial institutions was even poorer than that of the banking system. The Bucharest Stock Exchange started operations no earlier than 1995 and, except for a short-lived boom in 1997, it played only a marginal part in resource allocation, since the volume of trades and market capitalization were extremely low. Nor did the over-the-counter market, the RASDAQ (established similarly to the NASDAQ), succeed in living up to expectations. Operators seem to take little interest in the prospective advantages of commodity markets that were established here and there across the country. It should be pointed out that Romania, which used to be (and could become again) a large grain exporter, has yet to establish a grain exchange. The aforesaid phenomenon brought about market segmentation and lack of transparency in setting prices, and therefore deterred production in spite of Romania's bountiful natural assets. The government has granted subsidies for outdated farming methods instead of boosting a competition-driven agricultural policy.

16. Therefore, the institutional framework remained less favorable, if not hostile, to reform in the economy in general and to an anti-inflationary stance of monetary policy in particular. Besides, the public – lacking a historic memory of a painful inflation-plagued period, such as Germany's memory of inflation in the early 1920's – were not very willing to suffer the constraints required for an anti-inflationary policy, thereby depressing the central bank's capacity to pursue such a policy. In time, the institutional framework was partially improved, but these changes came in a stop-and-go pattern. This inconsistency actually hampered progress at times, generating a general perception that the costs of the reform appear to be higher than its benefits and inducing a crisis of confidence in the authorities' policies. For instance, slow price liberalization entailed a persistently high inflation rate and severely undermined the performance of the transmission mechanism of monetary policy.

17. Good progress in each of the previously mentioned areas was not made until this year. Price liberalization was eventually concluded, the first drastic measures were taken to improve the health of the banking system, privatization was put on a fast track, and economic legislation became less favorable to debtors, thereby helping to strengthen corporate

governance. It remains to be seen whether, when put into practice, the improved institutional framework will provide the foundation needed not only to step up reform but to yield positive results in the economy, thus enhancing public support for advancing the process.

III. Anchors of stabilization

18. The above-mentioned institutional framework has seriously limited the central bank's discretion in elaborating monetary policy. The poor adherence to the institutional structures and to the policies with steadfast anti-inflationary orientations forced the central bank to choose between two second-best solutions: either to stick to its mandate or agree on tradeoffs. Although the first option appears to be the optimal one, the lack of support from other policies diluted the central bank's credibility and ended in failure. This emerged strikingly in Romania in 1991. Following conclusion of the first arrangement with the International Monetary Fund (IMF), the central bank had followed exactly, for nine months, the agreed monetary program aimed at containing price increases. Unfortunately, the lack of other economic measures backing this objective actually detached the monetary mechanisms from the evolution of the economy as a whole. Monetary tightening was circumvented by a dramatic increase in money velocity and by the mechanism of arrears (Dãianu, 1994, UN/EEC, 1999), both of them accelerating the rise in prices throughout 1991 without affecting wage and salary payment. In time, the belief grew more firm that the monetary policy is not viable and that its restrictive stance will eventually be abandoned. In the long run, it is less important that monetary loosening was the follow-up to a law enacted by Parliament, which stipulated the complete and unconditional monetization of arrears, rather than the result of a decision made by the central bank. In the absence of support from other policies, the limitations of monetary policy were brought to the fore[1].

19. The alternative is to avoid major disruptions relative to the other components of economic policy. Such an approach translates into setting less ambitious targets or, frankly speaking, translates into tradeoffs in setting the objectives and their attainment. After its failure in the fall of 1991, monetary policy embarked on the aforesaid path until 1999. This was the main driver of large swings in inflation rates, highlighting the stop-and-go pattern of macroeconomic policies. The central bank's tradeoffs gradually sapped its credibility and contributed to a much higher inflation rate than that of other Central European countries. However, the central bank progressively ushered in mechanisms and working procedures to gear monetary policy, signaling beyond any doubt its reform-oriented approach. The public at large understood the message and eventually gave the central bank credit for a better performance than that justified by the actual result of monetary policy, i.e., the inflation rate.

20. In assessing the performance in controlling inflation we should not lose sight of the fact that the anchors used to this end proved insufficient or even misleading. Thus, the use of broad money (M2) appeared to be more reliable as an intermediary target than, say, the monetary base, owing to weaknesses in the transmission mechanism, at the outset of transition at least. Admittedly, between 1991 and 1994, the NBR used M2 as an intermediary objective, aiming at a money supply growth lower than that of nominal GDP in an effort to stifle inflationary pressures. As a matter of fact, money velocity posted a swift increase because of the lack of credibility of the authorities' policy mix, decline in money illusion, and persistence

[1] The Republic of Moldova in another case in which monetary policy attempted to pursue its objectives by making no tradeoffs, and Moldova succeeded in doing so for a longer period than Romania. The National Bank of Moldova enjoyed a legal framework much the same as the one in Romania while, in retrospect, reform in the economy proceeded even more slowly than it did in Romania. However, inflation was kept under control by using almost exclusively monetary levers. But soon enough arrears took hold of wage and salary payments and reached endemic proportions – it was just one of the reasons behind moderate inflation rates. The central bank's stance alone was not enough to improve the policy mix and the lack of structural reforms materialized in a fragile external position and subsequently in high inflation.

of pseudo-liquidity in the form of arrears. Although money supply growth lagged behind nominal GDP growth, the previously noted factors prevented system liquidity from stoking price increases (Table 1). Moreover, starting in 1992, preferential and directed credits were granted by resorting to money creation; as a result, liquidity was running high. Excess money creation crimped household saving. Usually, in times of financial repression, mushrooming banks chase cheap funds from households (McKinnon, 1973, Show, 1973). This did not occur in Romania. Therefore, at the end of 1993 (the year to see the highest inflation rate ever, combined with the least convincing performance as far as reform is concerned), household savings at banks, other than CEC (the Savings House), covered barely 0.7 percent of the credit to the non-government sector, while refinancing from the NBR accounted for 46.3 percent of these credits (Rãdulescu, 1999).

Table 1. Money velocity, 1991 - 98

	M.U.	1991	1992	1993	1994	1995	1996	1997	1998
M2 (annual average)	lei bn.	604	1,210	2,764	6,652	13,108	22,219	45,116	70,212
Nominal GDP	lei bn.	2,204	6,029	20,036	49,773	72,136	108,920	250,480	338,670
Money velocity	rotations	4	5	7	7	6	5	6	5

21. The exchange rate lamentably failed as an anti-inflationary anchor in Romania. Several attempts were made in this respect, with some intermissions, throughout the period 1990-1996. The reasons behind this state of affairs were ultimately linked to the lack of both monetary and extra-monetary conditions to render such an anchor credible and therefore effective. First, the exchange rate target was from the very start unrealistic, much overvalued in comparison to the market-determined level. Second, the monetary conditions – high liquidity, low interest rates – were the opposite of those deemed compatible when using the said anchor. Consequently, the nominal stability of the exchange rate – achieved anyway through rather "unorthodox" methods – was rightly perceived as unsustainable by operators who upped prices in order to make up for the losses likely to be caused by future depreciation. Thus, the direct effect induced by the nominal stability of costs of imported components was annihilated by the indirect effect of inflation expectations. The result of administratively induced stability of the exchange rate was the worsening balance of payments, protraction of market segmentation, and lack of transparency. The relatively long period during which these phenomena were discernible engendered a marked hysteria: even if the authorities had fulfilled every condition for the successful use of the exchange rate as an anti-inflationary anchor, its dismal performance prior to 1996 severely eroded its credibility for the next few years at least.

22. The National Bank of Romania did not use the interest rate as an anchor between 1990 and 1999. The money illusion that lasted until 1992-1993, the lack of political support, and the extremely uncertain transmission mechanism against the backdrop of soft budget constraints warranted this approach. Nor did other countries in transition use this anchor because there was not enough theoretical support for its use under the given circumstances.

23. Other macroeconomic policies failed as anti-inflationary anchors, even when they appeared to be satisfactory. Thus, fiscal policy definitely fell short of standards of transparency and proceeded at a snail's pace. While the consolidated public deficit recorded low values (an annual average of 1.8 percent during 1990-1998), the quasi-fiscal deficit was very high, mirroring the expansionary fiscal policy. Several authors studied the mechanisms underlying the quasi-fiscal deficit and made quantitative appraisals of this phenomenon (Dãianu, 1999, Croitoru, Rãdulescu, 1999). Even though the appraisal methods were different, the

conclusions were similar: the deficits widened to as much as 20 percent of GDP in 1991 and 1992, and progressively narrowed to 5-10 percent of GDP in most of the subsequent years. The quasi-fiscal deficit was nothing but the symptom of delay in implementing reform at the microeconomic level and the main buffer for the repeated attempts of monetary policy to grow tighter.

24. Fiscal policy was also slack from the operational viewpoint. No government securities were issued until 1993 as the deficit was financed from extra-budgetary funds (such as the supplementary pension fund, the unemployment compensation fund, etc.). Public debt instruments developed slowly even afterwards. In 1999, there is still no liquid and deep secondary market for government securities, and financing of public debt uses almost solely T-bills or foreign borrowings. This state of affairs added more uncertainty to the interest rate mechanism in the market and increased the cost of financing the public debt whenever monetary policy tightened, especially in 1997 and in 1999.

25. To put an end to the list of inflationary policies, we will briefly refer to income policy. The overall impact should have been favorable to disinflation, since wage indexation was below par and based on forward-looking inflation. Instead, wage policy stood out as one of the most powerful inflationary factors until late 1998. First, unlike most of the countries in transition, in Romania wage and salary payment was viewed as taboo and represented the key function of state-controlled enterprises. Second, collective bargaining took the performance of output into consideration only marginally, and unions across industry seemed to have great influence. This explains why some of the most inefficient state-owned sectors, such as mining and metallurgy, paid some of the highest wages at the expense of either subsidies or arrears. These developments led to higher resistance to reform mechanisms and helped perpetuate inefficient resource allocation. At the macroeconomic level, the signals conveyed by income policy are somewhat less clear. Real average wage per person declined until 1994, and again in 1997, but increased in the other years under review. Nonetheless, the unit labor cost that rose every year until 1994 moved slightly lower in 1995-1996 and soared in 1998. The wage indexation policy was eventually abandoned starting in the fall of 1998; thus, provided that budget constraints became effective, income policy could entail anti-inflationary effects.

26. Hence, the potential anchors of a stabilization program frequently led to opposite results. If we consider the knock-on effect, which also impacted credibility as a result of prevalently inflationary policies pursued by the authorities, one would have expected that the inflation rate, which had been in the three-digit range for many years now, might turn into hyperinflation. Several factors prevented this. First was the external imbalance, which was likely to have a certain impact during the entire period. The external current account deficit triggered by the considerable trade deficit widened to as much as 5 percent of GDP during most of the transition period. Real foreign resources boosted aggregate supply and produced anti-inflationary effects.

27. Another factor detectable in the first years of transition was the persistence of a relatively strong money illusion fueled by decades of fixed prices. Households, the main holder of liquidity in 1990, were therefore slow to react to the weakening of the currency and incurred tremendously high losses through inflation tax. Thus, in 1990, during the first stage of price liberalization, the losses suffered by households virtually overnight was equivalent to 10.2 percent of GDP. In 1991, value transfer accounted for 11.4 percent of GDP, while in 1992 it equaled 5.3 percent of GDP due to a much lower level of monetization of the economy (Rãdulescu, 1999). The fact that individuals could not identify more readily the means to deal with inflation provided the authorities with some room for maneuver and cushioned

substantially the inflationary pressures likely to be induced by an all-round money flight in the early stages of price liberalization.

28. The third factor that helped avoid hyperinflation consisted in the improvement of economic policies, although this process was uneven and unfolded much more slowly than in most of the other countries in transition. Monetary policy, to which we shall refer below, played an essential part. Fiscal policy also improved. Thus, 1993 saw the introduction of value added tax, which replaced the former turnover tax. The State Treasury was also commissioned in 1993, thereby putting a halt to the financing of public expenditures via issues by the central bank. Later on, the spread in which quasi-fiscal deficits were created narrowed considerably, so that, overall, fiscal policy became less expansionary. Income policy developed in a rather expansionary fashion, with relatively few anti-inflationary episodes, the most significant being that of 1997.

29. Finally, enterprise restructuring also played its part, due mostly to privatization and enhanced corporate governance in the private sector (which accounted for 62 percent of GDP in 1998). At the same time, even the not-yet-privatized sectors were subject to adjustment (Hunya, 1999), which occurred chiefly spontaneously, under the pressure of market mechanisms and exhaustion of the available financing resources.

30. Even if, in retrospect, the improvement of both policies and the institutional framework is clear, it occurred rather unevenly, hesitantly and even took a few steps backward, thereby dampening its credibility as well as the overall economic picture. It is worth mentioning that, in 1998, the GDP in Romania equaled a mere 76 percent of the 1989 figure, while the countries that implemented the reform earlier and more thoroughly achieved a gross domestic product higher than that of 1989.

IV. Monetary policy tools

31. The National Bank of Romania abolished direct control over credit and interest rates for good. Ceilings on credits were removed and interest rates liberalized as early as September 1991. Control over monetary expansion was subsequently exercised by means of the refinance credit and reserve requirements. Ever since 1997, refinance credits have lost their active role, so the National Bank of Romania proceeded to make use of open market operations.

32. The NBR sought to render monetary policy tools more flexible and therefore reduce progressively the maturity of credits granted, from three months for structural credits to (usually) one week for auction credits and overnight for Lombard credits. However, although a mechanism to control liquidity relying on structural, auction, and Lombard credits was put in place back in 1991, both standardization and the impact on the development of a genuine money market remained unsatisfactory. In addition, open market operations, which were first applied in 1997, are taking place on an ad hoc basis, and the market continues to be scarcely liquid and is less efficient.

Table 2. Composition of refinancing, 1992-99*

- daily average -

	M.U.	1992	1993	1994	1995	1996	1997	1998	1999*
Structural credit 1)	lei bn.	121.9	306.2	1,156.5	1,308.1	1,398.0	1,211.9	–	–
	%	34.9	37.2	55.6	52.6	34.2	50.6	–	–
Preferential credit 2)	lei bn.	162.7	303.4	108.0	47.3	6.8	3.4	1.0	0.2
	%	46.6	36.9	5.2	1.9	0.2	0.1	0.2	0.0
Auction credit	lei bn.	61.8	156.6	734.9	855.1	823.6	223.0	–	–
	%	17.7	19.0	35.3	34.4	20.1	9.3	–	–
Special credit 3)	lei bn.	1.2	2.7	2.3	153.3	728.7	80.7	–	4,381.3
	%	0.3	0.3	0.1	6.2	17.8	3.4	–	88.8
Lombard credit 4)	lei bn.	1.4	54.3	77.8	122.5	217.8	26.0	5.8	–
	%	0.4	6.6	3.7	4.9	5.3	1.1	1.0	–
Credit granted with a derogation	lei bn.	–	–	–	–	914.5	752.7	521.2	503.1
	%	–	–	–	–	22.4	31.4	89.9	10.2
Non-directed structural credit	lei bn.	–	–	–	–	–	56.0	–	–
	%	–	–	–	–	–	2.3	–	–
Credit granted according to Law 135/1996	lei bn.	–	–	–	–	–	43.6	52.0	52.0
	%	–	–	–	–	–	1.8	9.0	1.1
Total refinancing	lei bn.	349.0	823.1	2,079.4	2,486.2	4,089.4	2,397.3	579.9	4,936.6

Note: Percentage as weight of total refinancing.

1) Credit lines until July 31, 1995. 2) Special credit until July 31, 1995. Credits extended at interest rate lower than the refinancing interest rate or credits on which the interest is not encashed at least once a month.

3) Fixed-term credit until July 31, 1995. 4) Overdraft credit until July 31, 1995. *) June.

33. The emergence of direct credits, with or without preferential interest rates, hindered the construction of monetary policy tools in line with European standards. Such credits emerged in late 1992, shortly after the NBR's first attempt to bring interest rates to real positive levels in order to achieve stabilization of the economy. Such credits were further granted until the end of 1996, leading to grave consequences for reform in general and for the sound development of the banking system in particular. The volume of direct credits and the size of the implicit subsidies posted ups and downs that mirrored precisely the trends in reform. The very existence of directed credits brought to the fore the *de facto* limitations on the central bank's independence in elaborating monetary policy.

34. Economic literature examines at length the confinancing of subsidization, notably through directed credits, which have an adverse impact on the basic equilibria across the economy. In addition, another effect of directed credits in Romania is the high direct costs, while the potential favorable effects are practically non-existent. Most likely, this state of affairs was at least partly due to widespread diversion of directed credits from their original destination. Actually, the sectors that benefited most from directed credits in dubious circumstances, agriculture and the energy sector, saw their performance worsen steadily and just delayed the restructuring, thereby rendering their inevitable shake-up more and more difficult. In addition, the two main state-owned banks involved in preferential lending to the aforesaid sectors, Bancorex and Banca Agricolã, were severely "contaminated" by the implications of directed credits both due to the large share of these credits, which became non-performing, and the dramatic deterioration of corporate governance of these banks.

35. Nevertheless, it should be pointed out that the central bank voiced publicly its reservations about the efficiency of directed credits, but neither the political parties nor the public at large listened to it. In order to contain the effects of directed credits, the NBR resorted to the reserve requirement mechanism and made more extensive use of auction credits. The latter stood out as a fine-tuning mechanism – its use smoothed the way for the change of the operational objective of monetary policy (in 1997, broad money was replaced by reserve money).

Table 3. Directed credits and subsidies

M.U.	1992	1993	1994	1995	1996	1997	1998
lei bn.	284.6	609.6	1,264.5	1,355.3	2,319.4	2,011.6	574.1
as % in total refinancing	81.6	74.1	60.8	54.5	56.7	83.9	99.0
as % in total credit to non-gov't	14.9	12.4	13.3	8.2	8.6	5.6	1.0
as % in GDP	4.7	3.0	2.5	1.9	2.1	0.8	0.2

36. Open market operations were initiated later and played a merely marginal role until 1999, due to the confluence of several factors, the most important being the low domestic public debt. The government was a net creditor to the banking system until 1992. From that point on the accumulation of public debt slowed down, due to both low fiscal deficits (as the quasi-fiscal was definitely not reflected by government accounts) and high inflation rates, which whittled down the stock of public debt as long as interest rates remained negative in real

terms. Another factor was the Finance Ministry's poor appetite for financing the deficit by using standardized market tools (government securities) that might have driven, at least in the beginning, a rise in costs linked to domestic public debt. Moreover, the quasi-permanent excess liquidity on the money market limited the central bank's capacity to purchase government securities from the secondary market, although they had begun trading on the primary market.

37. Interest rates played a relatively modest part among the NBR's tools and in the allocation of resources to the real economy. Maintenance of a marked money illusion in the first years of transition, and protraction of the habit to allot resources directly by means of directed credits in the next few years, both contributed to this state of affairs. Interest rates stayed highly negative in real terms until the end of 1993, but turned to real positive levels thereafter, and began to play their own part in the economic operators' decisions on resource allocation. All the same, the signaling role of interest rates was not coherent enough during the period under review, mostly due to Romania's unpredictable inflation rate and the fledgling money market. Therefore both lending and deposit rates varied within a large spread. For instance, in the last quarter of 1993, lending rates ranged from 15 percent *per annum* on directed credits destined to agriculture to 250 percent on overnight Lombard credits granted by the NBR to commercial banks.

38. Interest rate developments suffered the adverse impact of protraction of directed credits until 1996. They have since remained very sensitive because of the repeated stop-and-go experiments during reform implementation in Romania in general, and the fluctuating inflation rate in particular. In fact, there were three moments in which disruptions in reform implementation led to inflation flare-ups: in the summer of 1992 (when the success of reform was short-lived), in 1996 (during the run-up to the elections), and between October 1997 and August 1998. Each time, lack of coordination of economic policies triggered the subsequent acceptance of increasingly high real rates, which otherwise stood for the premium for lost credibility. This was the main driver of extremely high real rates throughout 1999, thereby impeding resumption of economic growth because of prohibitive lending costs. This is yet more proof of the high price that has to be paid for the half-hearted reform process of the past decade.

39. Under the present circumstances, the National Bank of Romania was not in the position to consider interest rates as an anchor of monetary policy. It took a long time and plenty of effort on behalf of the central bank to make the public understand the importance of having real-positive interest rates, since under central planning interest rates were assigned no part at all, and at the start of the transition period their sole effect was on production costs, while the impact on aggregate demand was simply ignored.

40. The use of the exchange rate as a monetary policy tool was severely hampered by political interests despite the fact that, formally, elaboration of foreign exchange policy was the prerogative of the National Bank of Romania. As a matter of fact, the successive failures in implementing the economic policy were soon reflected by depreciation of the home currency on the free market, regardless of the authorities' voluntary options. For most of the 1991-1996 period, the exchange rate was seen as a political objective instead of a monetary policy tool. In time, despite the inauspicious conditions, the NBR successfully completed a series of ground-breaking reforms: abolition of multiple rates on the regulated market controlled by the authorities (in November 1991), adoption of the full retention mechanism (in May 1992), *de facto* liberalization of the interbank auction sessions (in April 1994), and commissioning of the full-fledged forex market (in August 1994). However, the forex market remained largely

segmented until the end of 1996, with an overvalued official rate, virtually not recognized by the market. Over the years, the instances when reform was frozen concurred with blockage of the exchange rate under the government's relentless pressures, thereby highlighting the *de facto* limitations on the central bank's independence. The forex market has been operating free of constraints ever since 1997, the exchange rate has been determined consistent with the demand/supply mechanism, market segmentation ceased to exist and so did the multiple exchange rates. The latest momentous achievement in this respect was the official acceptance of the provisions of Article VIII in the IMF's Articles of Agreement (March 1998). In light of political constraints and the relatively recent negative experience of the public at large, the National Bank of Romania could not contemplate the use of the exchange rate as a tool of monetary policy, and has used it solely as the means to confirm the consistency of monetary policy.

V. Assessment of monetary policy

41. A mere black-and-white assessment of the behavior of monetary policy would be, in our opinion, both inaccurate and useless in the attempt to draft an outlook for the future. Monetary policy cannot be analyzed separately from the other elements of the macroeconomic policy mix, for viable accomplishment of the final goal of monetary policy is critically conditional on the basic equilibria in the economy. From this angle, it would have been more important that the policy mix pursued by the authorities firmly addressed the major imbalances confronting the economy. For many years, the targets were unrealistic and their means conflicting.

Table 4. Composition of broad money, 1991-99*

- percent -

	1991	1992	1993	1994	1995	1996	1997	1998	1999*
M2	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
M1	67.4	55.4	49.9	42.6	38.8	36.8	30.1	23.9	21.7
Currency outside banks	17.3	22.2	23.4	20.7	20.6	17.7	14.8	12.5	13.4
Demand deposits [1)]	50.2	33.2	26.4	21.9	18.2	19.1	15.3	11.4	8.3
QUASI-MONEY	32.6	44.6	50.1	57.4	61.2	63.2	69.9	76.1	78.3
Household savings	25.3	22.0	14.4	25.6	28.1	29.0	32.4	33.5	29.2
Time and restricted deposits (lei)	3.3	4.7	6.7	9.7	10.5	10.8	9.0	10.0	11.5
Residents' deposits in hard currency	3.9	17.9	29.0	22.1	22.6	23.4	28.5	32.6	37.6
Pro memoria: Money velocity (based on annual average) - rotations -									
M1	7.1	8.3	13.8	17.6	14.6	13.9	20.2	19.4	...
M2	3.7	5.0	7.3	7.5	5.5	4.9	5.6	4.8	...

Note: Since December 1992, foreign banks' branches have been included.
1) Until December 1991, it also included corporate deposits. *) August.

42. It is difficult to make a hierarchy of the factors seen as major obstacles to rendering monetary policy efficient. Although the only available anchor was the monetary one, its efficient use was hurt by the ever-changing, unpredictable developments of the demand for money. The trends developed by the latter were the following: decline in times of confused policies, and slow recovery following improved policies. Owing to the prevalence of stop-and-go policies in Romania, the demand for money fluctuated and attempts at econometric formalization of money demand developments failed to yield conclusive results (Bo_el, 1996; Popa, 1997).

43. From another viewpoint, commencing in 1991 broad money composition underwent a relatively significant shift from the liquid components such as M1 to less liquid ones that provide better protection against the effects of inflation. On one hand this evolution points to a maturation of market operators. On the other hand, it leaves open the discussion on monetary indicators that are closely linked to inflation. Furthermore, it is to be noted that the growth rate of narrow money lagged behind the annual inflation rate, pinpointing that monetary policy was tighter than the analysis of broad money shows.

44. The transmission mechanism of monetary policy was affected by several factors in turn, the most important of which appear to be the following: price liberalization, enterprise

restructuring, and financial sector problems (Begg, 1998). The chief constraint was the major difficulty of achieving price liberalization and economic stabilization simultaneously, since the supply-side shock induced by the former concurs with disinflation measures affecting mainly the demand and sows confusion (Blanchard, 1998, quoted in Begg, 1998). Most notably, price liberalization in Romania covered more than eight years and protracted the period of conflict between stabilization and liberalization. In addition, the lingering price liberalization sparked inflation expectations that impeded the effectiveness of disinflationary efforts.

45. Snail's-pace enterprise restructuring produced an adverse selection effect, however paradoxical it may appear. Monetary policy tightening had an asymmetric effect on the enterprises' behavior. While small-sized enterprises, private ones as well, were hit by the crowding-out effect on the credit market, large enterprises, primarily state-owned enterprises, made increased resort to resources. Popa (1996) identifies, by using empirical means, a positive correlation between mounting rates and the resort to credit of large enterprises, confirming the non-existence of budget constraints on these enterprises. In addition, access to resources by industries that were granted directed credits helped strengthen the effect of resource allocation on less efficient sectors. With this in view, the central bank faced a major dilemma: either promote stabilization through monetary stimuli evenly sent to the economy but heavily distorted by the above-mentioned mechanism, or follow a rather accommodating policy, which does not generate adverse selection, but definitely leads to rampant inflation.

46. The third important factor that distorted the transmission mechanism of monetary policy was the functioning of the financial system itself. The quality of the inherited portfolio plagued the old state-owned banks, and some of them even became victims of their debtors. In addition, the quasi-fiscal activities imposed by the authorities through the policy of preferential lending made things worse. The newly-incorporated banks suffered from an insufficiently consolidated institutional culture, and the quality of their portfolios worsened following the dismal performance of the economy as a whole and, in some cases, inadequate corporate governance. Above all, the repeated attempts to achieve macro-stabilization had a negative impact particularly on the quality of banks' loan portfolios. Until 1998, the Ministry of Finance had not certified the right to tax rebates on risk provisions set up by banks, thereby increasing the taxation burden; this illustrates the conflict of interest between short-term objectives of fiscal policy and the long-term objectives of macroeconomic policy. The relatively weak financial position of most banks stymied both financial deepening due to large interest rate spreads and the overall operation of the interbank market.

47. The government's incessant intervention in foreign exchange policy limited the *de facto* decision-making capability of the National Bank of Romania. However, the headway made during the past years – see paragraph 32 – succeeded in achieving a rational and sustainable foreign exchange policy in 1997. Nonetheless, the tradeoffs made for so long and the setbacks in forex market liberalization had serious consequences both for the overall effectiveness of macroeconomic policies and Romania's credibility *vis-à-vis* prospective foreign investors. Acceptance of multiple rates and overvaluation of the official exchange rate worsened the balance of payments and perpetuated the lack of transparency in the interface between Romania and the world, causing *inter alia* further dysfunction of the price mechanism and implicitly an unjust allocation of resources. It is therefore impossible to use the exchange rate as an anchor for disinflation at least for several years to come. The National Bank of Romania's stance in building up the foreign exchange policy, though justified by exogenous factors, represents irrefutable proof of mismanagement.

48. All the above bring us to the conclusion that monetary policy operated in a hostile environment and, frankly speaking, the performance it might have achieved in curbing inflation could not have been too impressive. The central bank has quite resolutely sought to create the tools to use once a more favorable institutional and macroeconomic framework is in place. For every time restructuring programs were initiated, monetary policy measures led the way not only because they were naturally in the forefront of macroeconomic stabilization but also because the central bank already had adequate tools in store. However, the reform-oriented approach of monetary policy remained solitary several times, since every other measure included in the program could not be implemented either due to political constraints or to the feeble support of public authorities.

49. One of the major disturbing factors was the almost permanent discrepancy between fiscal and monetary policy. Such behavior is the more so regrettable as it brings about an overall weaker economic performance. Thus, a lax fiscal policy would require a tighter monetary policy, even though the latter cannot fully make up for the taxation shortfall. Moreover, the lack of credibility stemming from the long-term inconsistency of such a policy mix can only dampen the effectiveness of monetary policy. Efficient coordination requires that each of the two policies be sustainable. For the stabilization of anticipation on monetary policy to be successful, fiscal policy should support the same. On the contrary, a tight monetary policy leads to sky-high interest rates, undermining from the very start the credibility attached to the central bank’s capability to pursue such a policy in the long run. Admittedly, coordination should allow for the fact that adjustments to fiscal policy operate on a different timetable than that of monetary policy. The latter can be adjusted virtually on a daily basis, which is why it bears the burden of fine-tuning stabilization policies (Laurens and De la Piedra, 1998).

50. Romania did not fulfill the above-mentioned requirements in the least. Although the government aimed to keep the public deficit under control, at the same time it indulged in and even encouraged massive quasi-fiscal deficits to be borne largely by some state-owned banks or the central bank itself. The construction of monetary policy has been overburdened by quasi-fiscal activities imposed on the central bank in basically every year since 1991. These activities resulted in net credits from monetization of arrears, accounting for more than one-half of the monetary base in December 1991 – i.e. subsidized-credits (between 1992 and 1996, topping 80 percent of total refinancing in the spring of 1993) and structural credits extended to cash-strapped banks (Dacia Felix and Credit Bank in 1996, Banca Agricolã and Bancorex in 1997 and 1999). In most of these cases, the related quasi-fiscal costs were eventually accounted for as fiscal costs. All the same, fiscal policy had by then transferred the burden onto monetary policy in a non-transparent manner. The central bank did not take a firm enough stand against this behavior, so the real source of these challenges remains questionable and efforts to reach a lasting solution were delayed.

51. The impact of trade policy on the macroeconomic policy mix in general and on monetary policy in particular was less discussed publicly, though, as shown below, it was not negligible. For most of the reviewed period, trade policy in Romania achieved weaker-than-expected results. The policy of imports was overly protectionist; Romania’s customs policy was, if anything, one of the most ineffectual among the transition countries, and its managers can be blamed *inter alia* for a risky lack of transparency verging on hazard. Calculations show that during 1991-1998 the average value of customs duties applied in Romania reached nearly 4.65 percent (CIF) of total imports. Meanwhile, bureaucracy and lack of stimulation mechanisms plagued export policy. Boosting imports and hindering exports is a less common trade policy elsewhere in the world. However, the Romanian authorities have clung to such a

policy under the impression, not always admitted, that cheap imports cushion inflationary pressures and leave room for restructuring the economy (Rãdulescu, 1996a and 1996b). Trade policy therefore worsened the most menacing imbalance of the economy, the external imbalance, the recovery of which ultimately depended on the NBR's foreign exchange policy.

VI. Monetary policy options

52. Construction of a framework for the monetary policy in the medium term should be grounded on the restrictions imposed by the developments to date, on the one hand, and on the stated target of the Romanian authorities of integration with the EU approved by all political parties, on the other. Continuation of the disinflationary process should be maintained as the key objective of monetary policy, aimed at curbing the inflation rate to the mid-single digit range (5-6 percent) on an annual basis in the next five to seven years. Both the use of monetary tools and the elaboration of a policy mix backed by the attendant institutional development should help achieve this objective. Such a stance rests on the authors' belief, similar to that of other authors (see Cottarelli a. o., 1998, Coorey a. o., 1996, Dãianu, 1994) that in Romania, like in other transition countries, the inflationary process has not only monetary causes, therefore it cannot be addressed by using monetary policy alone. Besides, the time horizon suggested by the authors hinges chiefly on the fact that lasting success in curbing and keeping inflation at bay is critically dependent on components other than monetary policy, the structural ones in particular, whose construction takes time.

53. The first and, most likely, utmost issue the central bank must dwell on is to ensure the support of both the public at large and policy makers for the implementation of consistent anti-inflationary policies. It should be mentioned that apparently viable sectoral policies ignored the restrictions on available resources, so the macroeconomic environment was ultimately plagued by either inflation or external imbalance, or by a combination of the two. In order to be successful, the central bank should take a more firm public stand and refuse tradeoffs, which not only delay the reform process, but also tarnish the credibility of monetary policy.

54. Construction of the policy mix should start with improvement of fiscal policy. First and foremost, this implies preclusion by any means of quasi-fiscal deficits and containment of the fiscal deficit to a level that can be financed without stoking inflation. In view of the low monetization of the economy and the still fledgling financial markets, the authorities should aim to maintain a primary surplus and reduce the total deficit to about 2 percent of GDP or less next year. This behavior could annihilate the crowding out effect of the private sector and could enable a lowering of interest rates to a level that may induce resumption of a sound economic recovery. Without going into details outside the scope of this paper, we think that improvement of fiscal performance can be achieved by means of the following: eliminating red tape in central and local government; phasing out subsidies to unviable sectors such as mining; broadening the taxation base by introducing the personal income tax and removing the numerous tax exemptions, most of which are dubious. The social security system should also be reshaped, since it has been draining far more resources than the Romanian economy can accommodate both at present and in the medium term. Similarly, public-debt-related costs can be cut down sizably through better management.

55. Income policy can play in turn a major part in the achievement of disinflationary economic policy. Above all, a more transparent correlation between earnings and output performance is required. It is highly unlikely that unions will come to terms with privatization as long as state-run industries offer at the same time a secure job, above-average earnings, and lavish fringe benefits. Although the authorities seem to be getting the message, a decision has not been made yet. The experience so far shows that a lasting solution for this challenge cannot be reached in the absence of privatization.

56. This is where we come to the crucial point of economic stabilization, enterprise reform. Performance of the state-owned enterprises has worsened steadily, as the target-function of profit maximization receded to the background and was taken over by maximization of earnings by the rank and file (Dãianu, 1994, Croitoru, 1998). Over and above that, in time, a perverse mechanism was put in place, through which the substance, i.e., the profit achieved in the public sector, goes into private hands with the support of managers against the backdrop of the owner's feebleness, while losses are borne by taxpayers. In our opinion, a mere improvement of management in the current status of ownership is not enough to break the gridlock. The only lasting solution is to accelerate privatization. The success of both economic stabilization and efforts to prevent inflation require stopping the "bleeding" of the public sector in the economy. The authors deem that the proponents of restructuring before privatization are the representatives of vested interests, taking advantage of circumstances.

57. An essential condition of successful reform in Romania is to improve the functioning of the financial system. Thus far, one of the chief weaknesses was the operators' impression that there are only a few rules of the game, the observance of which is optional. This impression ought to be suppressed, and regulation and supervision of financial institutions must be enhanced considerably. Parallel to market globalization, the aforesaid effort becomes crucial to pre-empt turmoil that may end in full-scale crisis. Romania has no choice but to buck the trend in both banking and other financial institutions as far as they keep developing. Since the "lion's share" of the financial market in Romania is currently held by the banks, the previously mentioned requirements refer, first of all, to them, while the central bank is bound to fulfill these requirements.

58. Assuming that good progress will be made in the above-mentioned areas, monetary policy should further identify the ways for disinflation to meet with success. The authors are of the opinion that the medium-term target can be accomplished more successfully within the institutional framework provided by an independent central bank empowered to freely draw up and adjust monetary policy, thus spelling a bias toward discretion rather than precise rules. It does not mean that the central bank executives aim to provide a legal basis for voluntary decisions meant to accommodate the inconsistencies of economic policy with monetary policy measures, but just the possibility to react to expected developments of the monetary parameters. Hence, once the functioning of the economy has improved and the financial markets consolidated, a steep increase in the demand for money and financial deepening is likely to emerge. It takes a proper monetary policy to accommodate this trend.

59. A very fine line exists between voluntary, politically-driven decisions and necessary monetary accommodation of mounting demand for money. This distinction is more delicate now, since the initial process of improving economic conditions is about to suffer from the bias toward premature monetary accommodation. A mechanism that makes the central bank accountable for the fashion in which it achieves its main goal – control over inflation – can obviate the menace of voluntarism in the decision-making process. In our opinion, such a stance will not entail changes to the existing regulatory framework. All it takes is the mere decision by the NBR Board of Directors to start issuing, on a half-yearly or even quarterly basis, an inflation report. This measure is expected to strengthen accountability in the central bank, to render it less vulnerable to political pressures, and to pave the way for assuming an inflation target in case the European Central Bank opts for such a target.

60. Moreover, the authorities assert that using of the exchange rate as an explicit anchor by way of a peg cannot be successful in the next few years. The assertion is based on

lack of credibility, given the recent track record. Two other reasons render the exchange-rate anchor non-viable: first, prices should stay flexible enough to allow further adjustment of their relative level; and second, a fixed or pegged rate deprives monetary policy from playing an active part. In particular, we join Dãianu and Croitoru (1999) in their argument against the introduction of the Currency Board in Romania; the successful implementation of such a mechanism is conditional on fulfillment of other conditions than those directly linked to the parity of the exchange rate. Once all these conditions have been met, a less rigid exchange rate can serve better a sound, long-lasting economic growth.

61. Construction of monetary policy can be made more successful within the existing framework, aiming primarily at a monetary target, i.e., the monetary base, which is adjustable in relation to other essential economic developments. Using the monetary base as an intermediate target is feasible, since the monetary base multiplier is relatively stable or at least predictable, and the central bank has nearly real-time information on this aggregate. Thus, it can intervene promptly to correct unanticipated deviations. In assessing the quantitative targets of monetary base growth, the central bank should consider the following: the change in currency in circulation (which stays on a downward trend in relation both to other monetary aggregates and to the nominal GDP); the rise in the monetary base multiplier; and the rise in demand for money. To confirm the appropriateness of the base money level, the NBR can resort to interest rates on the interbank market, as well as to forex market developments, both available in real time. These developments, at least in the last six months, look set to provide more accurate information on the consistency of monetary policy.

62. The above-described scenario should represent an optimal formula for sustaining the progress of reform and for expediting integration with the European Union. Nonetheless one may ask, "Which should be the most adequate monetary policy stance in case of a less supportive policy mix applied by the authorities?" Should these deviations be relatively narrow, and pose no threat to the overall macroeconomic environment, monetary policy can be built on the same basic principles, and it must only answer the question of whether the disinflation process can be continued at the same pace as envisaged in the best-case scenario. An answer in the affirmative would imply a monetary tightening that obviates the slower recovery of the demand for money. Pursuant to this scenario, economic growth is also expected to be more moderate, owing to reform slowdown rather than a monetary tightening. Should the central bank estimate that the quantitative anti-inflationary target might lose credibility, even amid tighter monetary conditions, it is much more important to fend off the swings that occurred so far than to pursue and ultimately miss an overly ambitious target. It is worth mentioning that the central bank has adequate tools to adjust monetary policy according to the actual circumstances.

63. It is our belief that over a time horizon of five to seven years the objective of lowering annual inflation to the mid-low digit area is within reach. Consequently, the issue of putting the spotlight on exchange rate stabilization may arise. Such a change is unavoidable once an advanced stage in the process of European integration has been reached. The success of this process and the pace to be set hinge critically on the government's capability to implement decisive structural reforms now.

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