Mugur Isărescu: Unconventional monetary policies and financial stability – implications for banks and financial markets

Address by Mr Mugur Isărescu, Governor of the National Bank of Romania, at the joint CIGI (Centre for International Governance Innovation) – Oliver Wyman conference, Rome, 15 December 2015.

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The address was presented by Governor Mugur Isărescu during the panel session "Unconventional monetary policies and their impact on financial markets", which also included the following members:

- *Domenico Lombardi, Director of the Global Economy Program, CIGI*
- *Malcolm Knight, Distinguished Fellow, CIGI (former General Manager of the BIS)*
- *Lorenzo Bini-Smaghi, Chairman, Société Générale (former Vice-President of the ECB)*
- *Lorenzo Codogno – Professor in Practice European Institute, LES*
- *Pierpaolo Benigno, Professor of Economics, LUISS University*
- *Carlotta de Franceschi, Co-Founder and President, Action Institute*

Participants included, among others:

- *Robert Ophèle, Deputy Governor, Banque de France*
- *Dimitar Bogov, Governor, National Bank of the Republic of Macedonia*
- *Korbinian Ibel, Director General, Micro-Prudential Supervision IV, ECB*
- *Margarita Delgado, Deputy Director General, SSM, DG1, ECB*
- *Matthew Elderfield, Head of Compliance, Lloyds Bank*
- *Carlo Corradini, Member of the Supervisory Board, Intesa Sanpaolo*
- *Pierre Siklos, Senior Fellow, CIGI*

Ladies and Gentlemen,

It is an honour for me to address the audience during this conference on unconventional monetary policies.

In Romania, as in most other Central and Eastern European countries, monetary policy interest rates are still above the zero bound and, as such, there has been no need to venture into the uncharted waters of quantitative easing and negative nominal interest rates. Therefore, I will not approach these two already classical unconventional instruments, since Romania's experience is not illustrative from this perspective. Besides, I am sure that they will be extensively dealt with by other panellists.

In this case, you are probably wondering why I am now in front of you. The answer is that, 10 years ago, the National Bank of Romania faced an economic and financial context which could also be labelled as exceptional. It called for the use of unconventional instruments and hence the departure from the prevailing economic precepts of the time and particularly from the rules that defined the modus operandi of an inflation targeter. Some of these tools would later be referred to as "macroprudential instruments", but back then we referred to them as unorthodox monetary policy measures, the NBR responsibilities including not only monetary policy, but also financial stability, the supervision of credit institutions and the issuance of secondary legislation in the field of banking regulation.

Consequently, I have come in front of you today with the hope that at least some of the lessons we learned at the time might prove relevant for this panel's discussions.

My intervention today is structured along 4 lines, namely:

1. What made the economic context in which the NBR was operating in the run-up to the European Union exceptional?
2. How far has the NBR departed from the standard paradigm?
3. Did markets and banks react to the departure from the paradigm?
4. Was the unorthodox approach effective?

Allow me to sketch the answers to these questions:

1. What made the economic context in which the NBR was operating in the run-up to the European Union exceptional?

First of all, the banking system was dominated by foreign-owned banks. After a string of domestic bank failures (particularly in the late nineties), the lack of domestic private capital, combined with the fragile situation of the state budget, made it compulsory to privatize the existing banks by selling them to foreign entities. As a matter of fact, the dominant view at the time was that opening the banking system to foreign capital was essential for improving efficiency and expertise, alleviating the shortage of domestic capital, and increasing competition. Against this background, by facilitating a better resource allocation, the penetration of foreign capital into the Romanian banking sector was seen as a means to promote restructuring of the loss-incurring SOEs and to stimulate convergence to the EU.

Of course, such a development brought about positive effects in the economy, as it came with stronger corporate governance and modern banking practices. However, it also had the by-product of rapidly growing forex credit, undermining the effectiveness of conventional monetary policy and giving rise to risks from the financial stability perspective.

This occurred against the background of a significant interest rate differential, given the comparatively high inflation and increasingly abundant capital flows, as the removal of capital controls was proceeding rapidly due to the requirements of the forthcoming EU membership.

Such an environment naturally produced nominal appreciation of the domestic currency, providing further incentive for foreign currency lending, booming domestic demand and an unsustainable decrease in inflation, as revealed by an ever widening current account imbalance (to the tune of two-digit numbers as a percentage of GDP). To further complicate matters, the newly found prosperity lured fiscal policy into relaxing pro-cyclically.

Trying to cool down the economy through the standard recipe of policy rate hikes would have been pointless, if not outright detrimental, by prompting even more capital inflows and nominal appreciation, thus feeding the vicious circle described before.

2. How far has the NBR departed from the standard paradigm?

Quite far, I would say, if we use as a benchmark the clearly defined IT framework. Constrained in the resort to the policy rate, the NBR had to depart, at times, from monetary policy orthodoxy. Such departures from conventional practices involved full use of direct FX interventions, allowing market interest rates to fall significantly below the policy rate through liquidity management or deploying administrative measures to control credit growth. But probably the most striking unconventional feature of our monetary policy back then was the active recourse to reserve requirements, the rates of which were increased to levels exceeding by far those of any other central bank in the EU: 20 and 40 percent for lei- and forex-denominated liabilities respectively in 2006.

However, taking into account that studies published even before 2006 considered the pure IT framework as not necessarily the most suitable for an emerging economy, one might think that the NBR's departure from the mainstream was less significant. Specifically, the NBR opted for a "light" version of inflation targeting, which meant retaining the managed float feature of the exchange rate regime, which implied smoothing out excessive volatility, without defending a certain level of the exchange rate or preannouncing interventions.

The actual form inflation targeting took in Romania thus matched the "managed-floating plus" concept introduced by Goldstein in 2002, considered the most suitable choice for an emerging-market economy involved in the global capital market, as it combines the managed float part with an inflation targeting monetary policy strategy and an active pursuit of measures to limit the degree of currency mismatches in the economy.

Subsequently, this "managed-floating plus" approach gained acceptance, especially during the global crisis, and now forex interventions are part of the arsenal of many central banks, including some of those using a free floating regime before the crisis.

3. Did markets and banks react to the departure from the paradigm?

Yes, especially since we also used a number of administrative measures, controversial at the time, but which now – after the crisis has warranted their use – are considered valid macroprudential instruments. I will name some of them: enforcing maximum loan-to-value ratio, introducing debt service ceilings relative to households' monthly disposable income (the scope of which was subsequently expanded to include non-bank financial institutions engaged in lending), setting limits to banks' forex exposure vis-à-vis unhedged borrowers, using differentiated coefficients in stress tests (higher for exposures to EUR than lei, with even stricter coefficients for CHF- and USD-denominated credit).

At the time, banks perceived such measure as excessive administrative interference and I even remember a rather uncomfortable discussion with the president of a large foreign bank operating in Romania, who reproved me for the fact that, only a few years after being invited to invest in our country, banks were facing regulatory "innovations" that narrowed their scope of business.

4. Was the unorthodox approach effective?

With the benefit of the hindsight, I would say it was, at least to some extent. I see now 3 limitations and 3 benefits of the approach we took 10 years ago.

Let me start with the limitations:

First, the measures were not entirely successful in cooling off foreign currency lending, as banks found ways to circumvent the restrictions in place by externalising credit portfolios. Forex credit continued to expand, its share in total credit approaching 60 percent by the end of 2008. We are still dealing with this legacy: for instance, Swiss franc loans, even though accounting for a much lower share of total credit than in neighbouring countries, proved troublesome in the wake of the recent CHF appreciation.

Second, implementing the unorthodox measures has also proven very difficult from the communication perspective. These measures proved difficult to explain to the public at large, which saw them as preventing improvements in welfare, and also to the commercial banks themselves, which – as I said earlier – were protesting against what they saw as an uncalled for injunction into their activity. On top of that, we had a tough time explaining our policies even to the ECB. Fortunately, President Trichet understood why we had to take the unusual monetary policy approach, acknowledging that the standard policy consensus was not enough to deal with the challenges a small open economy had to face amid a flood of capital.

Third, the exit from these measures has not been easy. While the post-crisis environment provided an opportunity to gradually normalize the reserve requirements levels (thus supplying an additional counter-cyclical tool), they remain high by European standards.

However, despite all these obstacles, I think the resort to unconventional policy instruments had 3 major advantages.

I would name first the fact that they certainly managed to limit the size of the disequilibria. I have no doubt that the outcome would have been a lot worse had we been complacent and relied entirely on the self-corrective behaviour of markets. I will give here just one example: forex interventions limited significantly exchange rate fluctuations, with the appreciation during the massive capital inflows and the depreciation after the crisis outbreak not exceeding 25 percent. In the absence of such interventions, the magnitude of fluctuations could have been as high as 40 to 60 percent.

The foreign exchange purchases made before the crisis not only limited the unsustainable leu appreciation and the associated loss of export competitiveness, but supplied the ammunition for subsequent interventions to cushion the currency depreciation once the outbreak of the crisis changed the direction of the flows. And I believe this is the second benefit of the approach.

Last, but not least, thinking outside the box allowed us to avoid incurring losses after 2006. While profitability should not be a concern for a central bank, this development proved very fortunate from the perspective of the political economy. On the one hand, it allowed the NBR to preserve its independence in relation to the government by not generating quasi-fiscal deficits in a period with an increasing fiscal imbalance. On the other hand, it helped preserve institutional credibility in relation to the banks subject to NBR supervision, which were closely monitored in terms of capital adequacy. Moreover, through our actions we wanted to avoid rewarding the speculative behaviour several commercial banks were engaged in (i.e. carry trade) and instead incentivize them to focus on their core activities.