

ECONOMICS

## POLICY CHALLENGES FOR THE SECOND HALF OF 2002

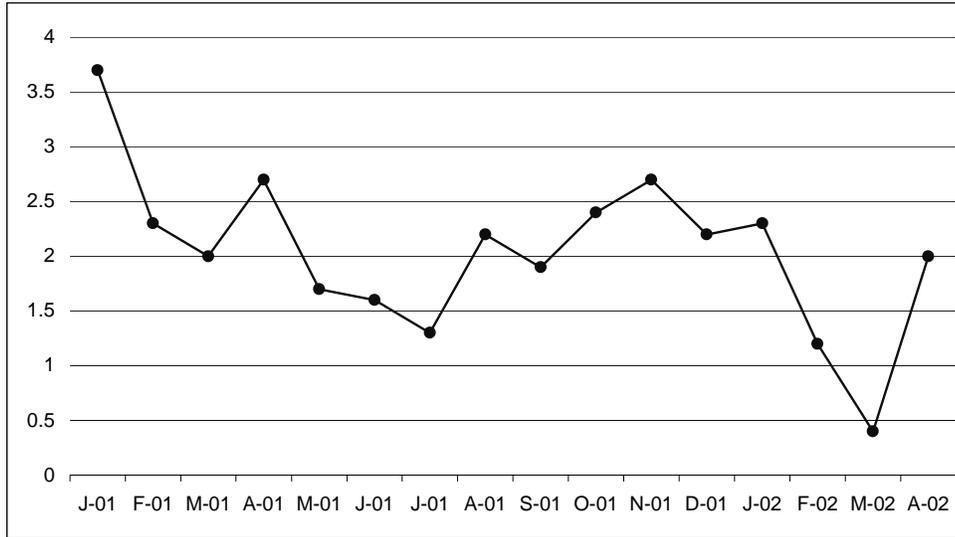
*By Daniel Daianu***The good news**

Economic recovery has been under way in Romania for the last couple of years; after a rise of 1.6% in 2000, the Gross Domestic Product grew by 5.4% in 2001. The latter was enhanced by a good agricultural year, but the growth tendency was indisputable. Moreover, GDP growth has continued in the first quarter of 2002, alongside continued increase in industrial output, although both at a slower pace than in 2001 (Fig. 1). Further good news is the continuing disinflation – it is worth reminding in this context that persistently high inflation has been a scourge of the Romanian transition in the past decade, and that a serious policy of disinflation has only begun in 2000.

As matter of fact, the pace of disinflation has puzzled many observers, in view of the big rise in the price of energy, which has started in the last quarter of 2001; this rise should have entailed, presumably, a significant corrective inflationary bout. Surprisingly, however, the cumulated inflation was only 8% in the first four months of this year (Fig. 2), against the backdrop of an official 22% inflation target for the whole year. Consequently, both the National Bank and the Ministry of Finance are considering a revision of the target, to about 20%. It is not the purpose of this article to investigate what lies behind the more rapid than expected disinflation, but, aside from some methodological problems, one can submit that, following the drastic increase in the relative price of energy,

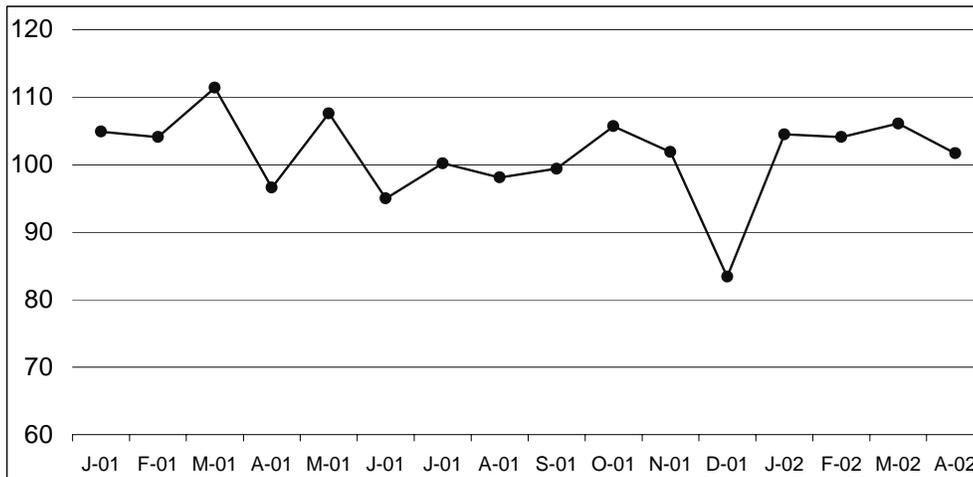
significant changes have occurred in the consumption structure of many citizens, which have affected price dynamics.

**Fig. 1. Monthly inflation rate, January 2001 - April 2002**



Source: INSSE

**Fig. 2. Industrial production dynamics, January 2001 - April 2002**



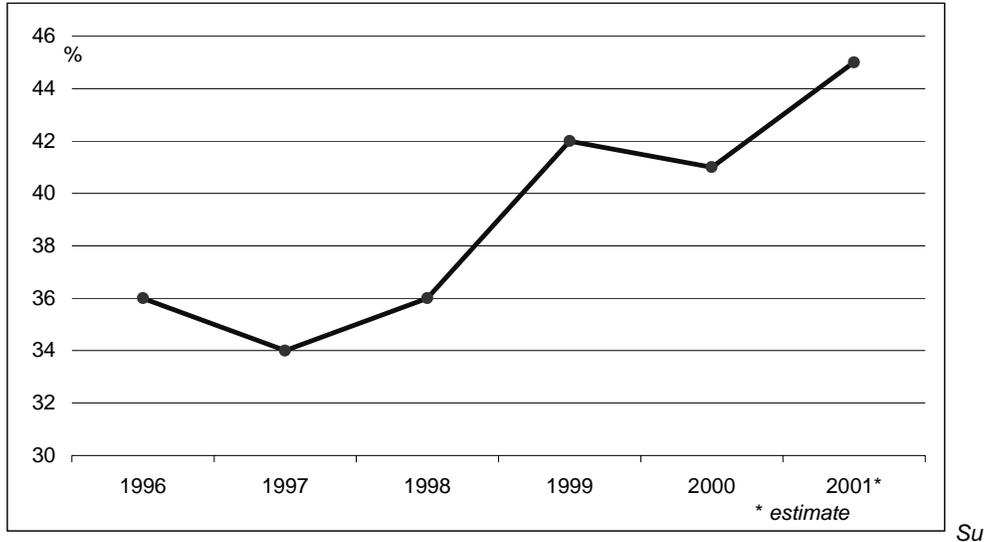
Source: INSSE

Overall, continuing economic recovery together with the decline of inflation and the bulging foreign reserves of the Central Bank (which went beyond US\$6.5 billion at the end of May, gold included) provide an appealing economic picture; to these features one can add the much sounder banking system (as compared to the late '90s) and an easy financing of the trade and current account deficits.

All this prompted rating agencies to upgrade Romania's sovereign risk and has eased the country's access to international financial markets. But there is also a less bright side of the story, which raises a series of policy challenges.

## The less bright side of the picture: arrears and disinflation

**Fig. 3. Arrears evolution, % GDP**



rsa: INSSE

Although statistics are not yet available for the whole of 2001 (nor are they for the elapsed months of 2002), the available information – which covers the first half of 2001 – suggests that financial indiscipline has hardly improved (Fig. 3). Thus, financial indiscipline remains the Achille's heel of the Romanian economy, which also reflects a slow pace of restructuring. The sharp rise in the relative price of energy has been a sort of a “shock” to both consumers (households) and companies; for the latter, it means the disappearance of a general subsidy and a big pressure towards restructuring. How this restructuring takes place will be indicated by the financial statements of public (energy) utilities – with due allowance for those households, which cannot pay their additional bills.

The growth of arrears can be quite disturbing at a time of disinflation, when inflation can no longer operate as a *sui-generis* mechanism for stabilizing arrears in real terms.

Unless debtors are forced to pay their dues, more and more gridlocks would emerge in the economy and threaten its stability and growth. Hopefully, the ordinance adopted by the government to encourage the payment of current debts will have the expected effects, albeit its highly complex set of provisions may cause headaches.

### The pace of economic activity, disinflation and the budget deficit

At the beginning of this year, the EWR warned that the government's target for GDP growth in 2002 may be over-optimistic, in view of the need to pursue disinflation and

control the budget deficit and the current account deficit. Our opinion was that the 5.1% official forecast was unrealistic, and that even 4.5% would be a pretty ambitious target. The data for the first months of 2002, the drought of this year, the less favorable external circumstances, all point to a pace of economic growth that is unlikely to exceed 4%. Under such circumstances, one is forced to think about various policy implications of a slower economic expansion. One such implication regards the execution of the public budget, which is made even more complicated by the more rapid than planned disinflation.

Without better tax collection, lower economic growth and more rapid disinflation will bring fewer revenues to the budget, and this will force the government to either undertake a painful budget rectification (reduce expenditure), or increase the budget deficit.

### **Disinflation and interest rates**

At a time of disinflation it is not surprising to see real interest rates linger at high levels, which hinders the expansion of credit and, consequently, investment. Lately, government officials have demanded the National Bank (NBR) to do something about it, since consumption and net exports are less likely to drive the economy as they did last year. But relaxing the reins of monetary policy is not risk-free; the very goal of disinflation could be at stake when one overestimates the extent to which the monetary authority can ease its control of liquidity.

The spreads practiced by commercial banks are linked with several factors, which diminish NBR's ability to influence them; such factors are the degree of competition in the banking system, the efficiency of the banking activity, the size of obligatory reserves and their remuneration, the financing needs of the budget deficit, and, not least, the monetary sterilization operations of the Central Bank. Actually, the stock of deposits attracted by the NBR – in order to stem the rise in liquidity entailed by its purchase of hard currency in the forex market – soared from 24,835 billion ROL at the end of December 2001 at over 37,654 billion ROL at the end of April 2002. This increase illustrates the difficulties that NBR has encountered in controlling liquidity, because of the low monetisation (the size of the money supply as a share of GDP – Fig. 5) of the Romanian economy and of the heavy inflows of foreign capital (not necessarily FDI) lately.

**Fig. 4. Average interest rates practiced by commercial banks vis-à-vis non-bank clients**

	Lending rates	Deposit rates
1997	63.70	51.60
1998	56.90	38.30
1999	65.90	45.40
2000	53.48	32.74
2001	45.13	26.40
January	40.42	23.31
Febr.	39.12	22.75
March	39.55	23.48

Source: National Bank of Romania Bulletin, No.3, 2002, p.38

**Fig. 5. Monetization in the Romanian economy**

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
M2/GDP	27.4	20.1	13.8	13.3	18.1	20.5	18.1	24.9	24.8	23.2	22.4

Source: NBR

It is worth mentioning that bank lending to the non-government sector expanded quite rapidly in the first quarter of 2002, which should mitigate the concern about the impact of high interest rates on economic activity. But hard currency-denominated lending grew much more rapidly than lending in domestic currency, which, probably, is also a consequence of NBR's policy of ROL real appreciation. And the sharp appreciation of the Euro vs. the USD in May and June dramatically changed "the ball game" for those companies, which are not export oriented and borrowed heavily in Euros. Thence the rising concern of the NBR with the overexposure of some banks and firms to such lending (and borrowing, respectively).

### Policy options

- The government is bound to revise its GDP forecast for this year and this should prompt a reexamination of budget revenues and expenditure; an option for averting a cut in expenditure is better tax collection, which should become a top priority for economic policy. Should interest rates decline more than what is expected, the smaller service of the public debt could release additional resources as a means for avoiding cutting expenditure. A slightly higher budget deficit is also an option, to the extent that monetary (credit) conditions allow it and the financing of the current account deficit is unproblematic.
- The government should lend top attention to financial discipline/arrears; unless arrears decrease in real terms, disinflation is likely to choke the economy; the financial situation of public (energy) utilities should be closely monitored in this regard.

- Should the NBR revise its inflation target to 20%? Probably not, in view of the leeway that the higher inflation target (22%) permits for a more flexible conduct of monetary policy; a lower target would entail a more restrictive stance of monetary policy, at a time when there is concern about the level of real interest rates. Likewise, the 22% target (assuming that the actual inflation will evolve towards an yearly rate of 20%) would allow a lesser real appreciation of the ROL; this would make the sterilization operations by the NBR easier and less costly.
  
- The NBR should monitor more closely the hard currency-denominated lending of the banking system, so that both firms and banks do not incur excessive risks. It would be good for banks and firms to encourage the introduction (expansion) of hedging operations for reducing exchange rate risks.
  
- The government and the NBR should opt for the introduction of the “hard ROL” in late 2003; such a timing would not affect the 2004 elections. Early euro-ization is a very risky option and should be discarded.

## FOCUS: DISINFLATION -- SMALL IS BEAUTIFUL, BUT HOW DO WE MEASURE IT?

In recent months, the disinflation process seems to score success after success. Inflation is within target, but many question the methodology by which CPI (Consumer Price Index) is calculated. This material is not an academic study, and we are first to admit that more thorough research is needed. This is, however, a warning on two major issues: that the current methodology may underestimate inflation, and that further inflationary pressures are to be expected as the Romanian economy develops.

### Components of inflation

What triggers inflation in emerging economies? Inflation sources can be grouped as follows<sup>6</sup>:

- fiscal imbalances (money growth, fiscal deficits, exchange rate)
- real economy structural problems (lack of restructuring or overheating)
- supply-side shocks (surging prices of specific items, either imported or previously subsidized)
- inflationary expectations.

### Have these factors been active in Romania?

Contrary to what theory says, there is only a very weak correlation between fiscal deficits and inflation rate (CORREL=0.34), which is also consistent with other recent findings for developing economies. In transition economies like Romania's, the quasi-fiscal deficit is more relevant. Indeed, a very strong correlation appears between quasi-fiscal deficits (calculated as the algebraic sum of public debt flows and consolidated budget deficit) and inflation rate (CORREL=0.88). The quasi-fiscal deficit is a good indicator of back-door money creation. Nevertheless, in the last years, there seems to be a consistent trend of

decrease in the quasi-fiscal deficit, which can help explaining the decreasing inflation rate.

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<sup>6</sup> Prakash Loungani, Philip Swagel (2001) "Sources of Inflation in Developing Countries", IMF Working Paper pp.198.

Until recently, net domestic assets were preponderant in the composition of the monetary aggregate M2 (except for year 1997). The National Bank had to sterilize only what it had created itself. In 2001, and in 2002 alike, significant liquidity injections from foreign capital (direct investment, portfolio investment, remittances, unrecorded flows under 'errors and omissions') have induced inflationary risks. This phenomenon is illustrated by the fact that the deposits attracted by NBR, by the end of April 2002, were more than half of the monetary base M0 in the economy. Inflationary pressures appear nowadays less through the excessive creation of local money (often accompanied by quasi-fiscal deficits), than through foreign capital inflows. The NBR has to sterilize a lot, in order to prevent the real appreciation of the ROL.

**Fig. 6. Correlation coefficients for the inflation rate**

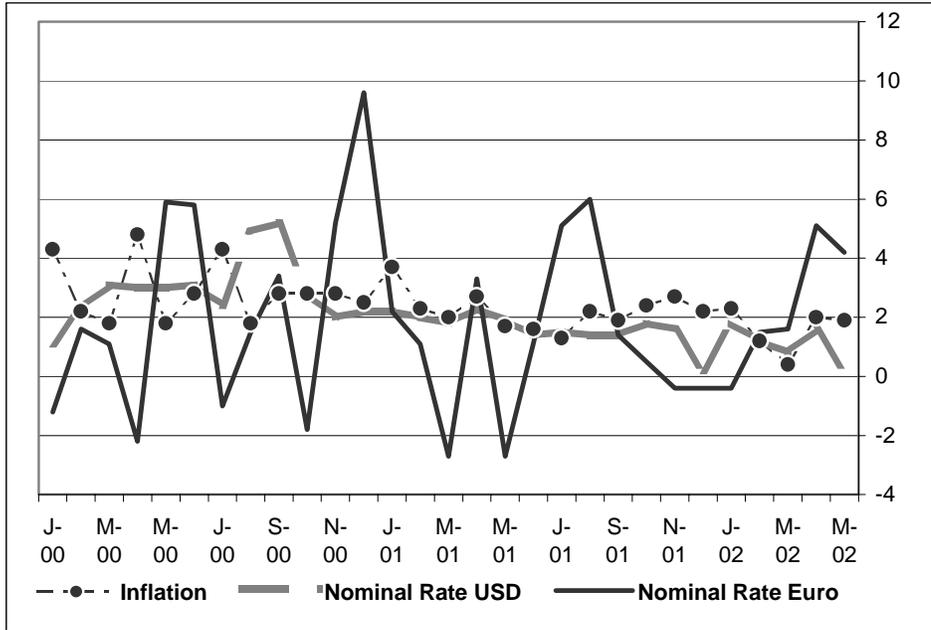
	Fiscal deficit	Quasi-fiscal deficit	M2 growth	ROL-USD nominal rate	ROL-EURO nominal rate	Unemployment
Pearson coefficient	0.43	0.88	0.67	0.43 (1 month lag)	0.31 (1 month lag)	- 0.17
Number of observations	11	10	11	29	29	11

*Source: author's calculations*

Real appreciation occurred nevertheless over the last two years, as nominal depreciation stayed below the inflation rate. The structural-driven inflation is, however, decreasing much slower than the monetary inflation. On the one hand, there is no correlation between inflation and unemployment, which is normal as hidden unemployment is thought to be large, pointing therefore to the delayed restructuring in real economy. On the other hand, the risk of overheating should not be underestimated, as part of the growth in recent years comes with the accumulation of stocks.

The cost-push inflation, through supply-side shocks, is deemed to play an increasing role in the composition of inflation, as relative prices in Romania are still far from the EU average. Substantial pressures are likely to appear, therefore, in the direction of reducing this gap in relative prices.

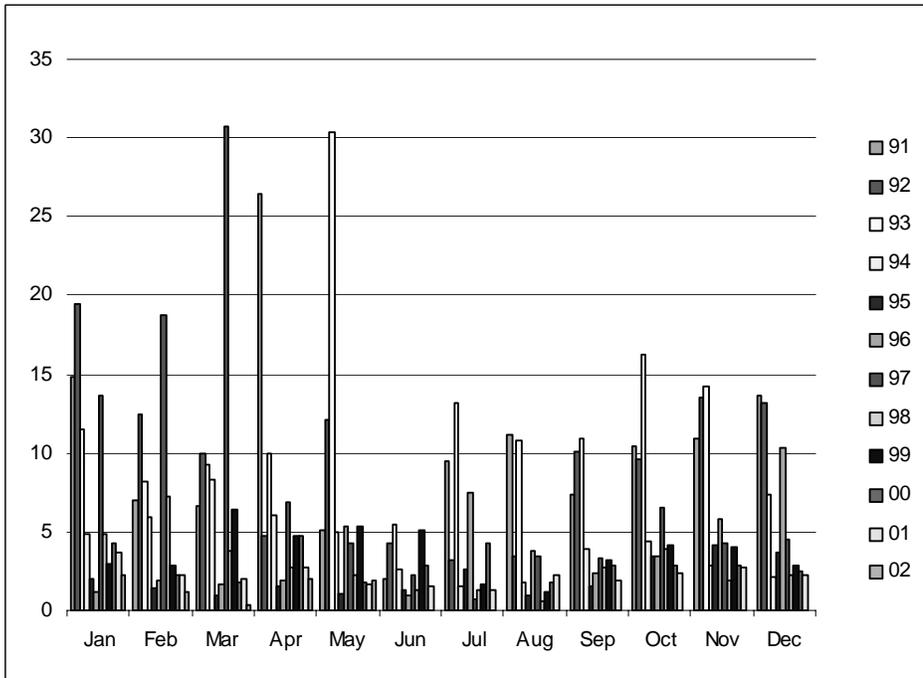
**Fig. 7. Inflation and exchange rate, monthly data, 1999- 2002**



So

Source: NBR data

**Fig. 8. Inflation, monthly rate, 1991- 2002**



Sou

Source: based on INSSE data

Most of the future movements in prices will reflect an adjustment process toward a new equilibrium set of relative prices; and this adjustment will be upward, as there is very limited downward flexibility of nominal prices in transition economies<sup>7</sup>.

There is also a structural element in the inflationary expectations. What some call a seasonal feature of inflation in Romania, actually reflects the insufficient change in the structure of production, in the mix of goods and services that are produced over one year. Fig. 8 shows a seasonal pattern of inflation, which is still visible after 11 years of transition (although the magnitude of seasonal fluctuations has been decreasing).

### **Remarks on the CPI composition**

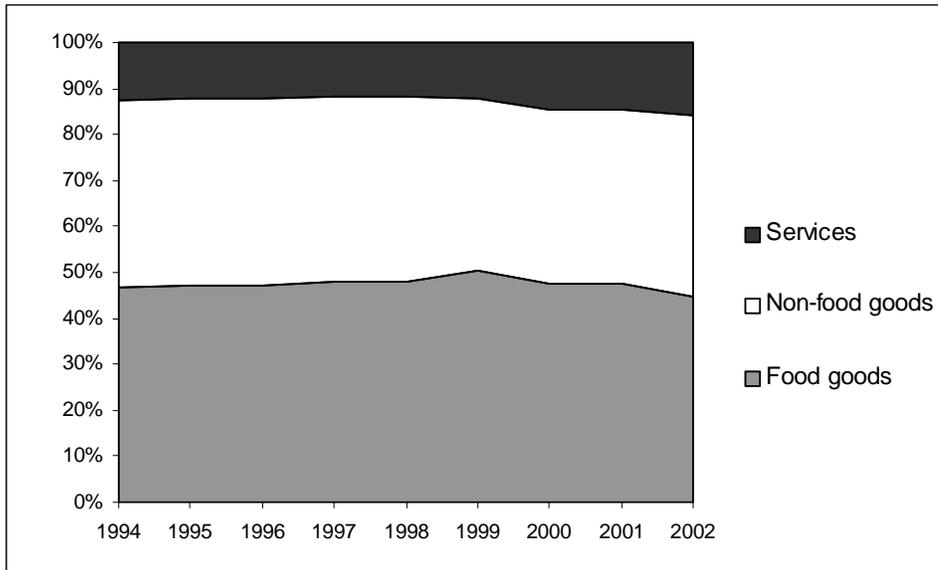
The Consumer Price Index (CPI) is computed by the official bureau of statistics (INSSE) as follows: prices are recorded by a selective survey comprising 68 centers, and then they are weighted based on the structure of direct consumption resulted from an annual households survey. To the best of our knowledge, there is no independent comprehensive survey of households' consumption, which could offer a basis for an alternative calculation of CPI.

The first striking thing when looking at CPI composition over time is that it varied in a very narrow band (Fig. 9). The fact that CPI composition suffered only marginal changes over time, as far as major groups are concerned, seems at least surprising. Over the period analyzed (composition is based on households' surveys of two years before, so that the period 1994-2002 in Fig. 9 actually reflects surveys carried out between 1992-2000), the country went through recession and growth, and, therefore, one would expect more significant changes in the consumption behavior. However, the only two significant changes that can be noticed in CPI composition are not between groups, but within them.

In food goods, there is a tradeoff between meat and bread (meat decreased its weight in CPI from 13.1% in 1995 to 9.6% in 2002, while bread increased its weight from 3.7% in 1994 to 8.4% in 2002). This substitution occurred as meat prices rose faster than those of bread, and people reoriented towards the cheapest product.

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<sup>7</sup> Martin Cihak, Tomas Holub (2001) "Convergence of Relative Prices and Inflation in Central and Eastern Europe", IMF Working Paper 124.

**Fig. 9. CPI composition, 1994 - 2002**

Source: based on INSSE data

In the non-food section, there is a tradeoff between clothing and energy, the latter including electric power, gas, and thermal energy (clothing's weight decreased from 9.1% in the CPI basket in 1995 to 4.4% in 2002, while energy's weight went up from 3.8% in 1994 to 8.6% in 2002). This substitution occurred because of households' budget constraints, as energy prices skyrocketed.

The current method of calculating CPI has a series of pitfalls, which risk isolating CPI figures from a more complex economic reality. The main questions that may be raised regarding CPI calculation are the following:

- 1. The CPI weighting does not make the difference between various times of the year, although consumption behavior changes a lot from one season to another.**

In particular, the case of energy is illustrative. Energy consumption during winter may represent around 40% of a household's expenditures. If it is weighted based on a monthly average, and prices skyrocket, as it happened last winter, then CPI fails to cover for a significant increase in prices, and substitutes it with another item whose weight is over-rated for that time of the year. Electric energy alone recorded a 15% price increase in the first five months (according to INSSE data), double than the total consumption basket. The result is an underestimation of the inflation rate.

The argument that this underestimation is subsequently balanced by an overestimation in other months of the year does not hold true, mainly because the initial underestimation of the inflation rate induces a bias in the inflationary expectations (helping them to converge towards a lower than normal level).

**2. The CPI weighting does not make the difference between various income groups. The annual households' survey separates, indeed, between such groups, although these are defined based on their social status (i.e. employees, employers, retired, unemployed), but this is not perfectly consistent with the weights in the CPI.**

As an example, the households' survey includes consumption from own resources (taking this into account, food goods represent about 60% of the basket), while the CPI leaves it aside; the survey considers energy in the services group, and weights it within it, while the CPI considers energy in the non-food goods group (and weights it within this group).

Particularly in transition economies, with raising inequalities, the consumption patterns vary a lot between different income groups; and even if similar products are consumed, different quality preferences exist, which in turn lead to different prices. An aggregated, uniform index may not capture these differences.

**3. The CPI weighting is based on two-years-old household surveys (e.g., the CPI weighting in 2002 is based on a survey in the year 2000).**

In a transition environment, that is still to undergo numerous price adjustments, product preferences may change significantly. Accounting for them two years later already induces a bias against the current year price changes, whose impact is likely not be fully recorded by a two-years-old CPI structure.

### **Warnings and suggestions**

The downward trend of the inflation rate cannot be denied; for one, this is consistent with the decreasing quasi-fiscal deficits. Indeed, the CPI weighting contains a number of disputable aspects; by its nature, the official inflation rate may not capture all inflationary inputs, but it measures the same thing it measured before, hence the comparability of data is secured.

A cynical leader once said that it doesn't matter who votes, it only matters who counts the votes. In an economy, things are more complex: it matters both what causes inflation, and how you measure it. Keeping this in mind, we issue the following warnings.

**First warning: the current methodology of CPI weighting may induce a bias towards underreporting inflation.**

As detailed above, the CPI weighting is indifferent to season, income group, and time gaps. Therefore, it may be biased against seasonal consumption patterns, underestimating ex-post the inflationary component of a sudden price adjustment in a specific product (such as energy), while the amplitude of price increases in substitute products (in terms of basket weighting) may not fully compensate for the initial underestimation. By doing so, it also induces a bias in inflationary expectations, taming them down. Furthermore, it does not consistently account for the different consumption behaviors of different income groups. Last, but not least, it is also biased against the current year price changes, whose impact is likely not be fully recorded by a two-years-old CPI structure.

To address these methodological problems, we suggest that:

- the CPI weighting should vary on a quarterly (seasonal) basis.
- different CPIs should be reported for different income groups, and only then these separate indexes should be aggregated in an average index.
- the time gap between the moment when the households' survey is conducted and the moment when its results are applied should be reduced (one possibility would be to carry out two surveys each year).

These suggestions are consistent with the need to accurately record inflation in a fast changing environment with regard to price structures and levels.

**Second warning: the disinflation process will have to face new challenges, arising from embarking on a pace of sustained growth.**

As the economy is growing, and capital account is being liberalized, capital inflows will increase the inflationary pressures, and therefore the NBR will have to sterilize more. Also, relative prices are expected to converge in the medium and long run, further inducing inflationary pressures.

**Third warning: underestimating inflation is not helping the disinflation process, because:**

- it can raise social tensions, as wages will be compensated for a lower than actual inflation rate.

- it reduces budgetary expenses, risking to reduce consumption, hence reducing the instruments of growth.
- it induces inflationary expectations to converge to lower levels, leading to the appreciation of the local currency. This may attract large capital inflows, easily reversible in the context of liberalization of the capital account.
- the real interest rate may actually decrease. The effects are twofold. On the one hand, active nominal interest rates prove higher rigidity (to keep real interest rates from decreasing) – which actually happens. This may explain why interest rates do not follow fast enough the inflation rate – simply because the inflation rate is underestimated. On the other hand, people's deposits are remunerated at lower real rates.