



**UNIVERSITY OF
STIRLING**

**Monetary Policy Processes
in
Postcommunist Romania**

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By

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DECLARATION

In accordance with the Regulations for Higher Degrees by Research, I hereby declare that the whole thesis now submitted for the candidature of Doctor of Philosophy is a result of my own research and independent work except where reference is made to published literature. I also hereby certify that the work embodied in this thesis has not already been submitted in any substance for any degree and is not being concurrently submitted in candidature for any degree from any other institute of higher learning. I am responsible for any errors and omissions present in the thesis.

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ABSTRACT

This thesis has a twofold aim. It first argues that monetary policy is inherently political because it involves struggles over meaning. It modifies Niebyl's (1946) conceptual approach with an explicit attention to meaning, advancing a theory/ policy discourse/institutional practices nexus for exploring central banking. It shows that the emergence of leading representations of monetary processes (in Ricardo, Keynes and Friedman) involved discursive struggles during periods of crisis to assign meaning to problems and establish dominant interpretations. Politics and power were not grafted onto policy but were ontologically constitutive of it, shaping specific institutional configurations and practices.

Second, this conceptualization is taken to a case study: a critical scrutiny of the role played by the central bank of Romania (NBR) in the reconstitution of the postcommunist Romanian economy as neoliberal economy from 1990 to 2008. The thesis asks what does the central bank do when the state, defined through its central planning legacy, 'retreats' from the market?

The usual account explains policy success as direct result of commitments to neoliberal (monetarist) principles prescribed by international policy advice. Before 1997, neocommunist governments politically validated a communist legacy: soft budget constraints in the (state) productive sector. Politicized monetary policy decisions produced repeated crises. Afterwards, neoliberal governments gradually institutionalized an autonomous economic sphere, allowing an objective formulation and implementation of stability-orientated monetarist policies.

The thesis challenges this orthodoxy. It argues against the attempts to erase politics from monetary policy processes that the above account articulates. Instead, drawing on critical conceptualizations of neoliberalism in its shifting forms, the period under analysis will be

(re)interpreted as an ongoing process of neoliberalization, with the central bank an important actor in it.

Indeed, the narration of crises identified the NBR as an essential instrument of institutional change and neoliberal ‘policy-making’. Monetarist narratives (ideologically) legitimized neoliberalism and effectively enacted neoliberal principles of monetary governance in the central bank. Thus, before 1997, the central bank functioned as a key vehicle of the neoliberal attack on the state’s capacity to craft economic reform. Since neoliberal institutions (also) take time to build, expanding policy repertoires outside the monetarist range invested the central bank with increasing powers to respond to structural and institutional resistance to neoliberal logics, arising from both communist legacies and ongoing political struggles. After 1997, the central bank’s rationality gradually changed to a constructive phase, normalizing an extralocal mode of economic governance whose distinguishing features will be identified. Institutional practices reconstructed the relationship between money, foreign exchange and treasury markets, subjugating liquidity management to the requirements of financialized accumulation. With financial stability increasingly tied into transnational actors’ choices, the NBR adopted inflation targeting. Nevertheless, inflation-targeting’s promise of stability operated to sideline the destabilizing nature of normalized neoliberal practices of monetary management, clearly evoked by the 2008 crisis. The thesis concludes with policy implications and an agenda for future research.

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Chapter 1. Introduction

At a congressional hearing on the deep financial turmoil unfolding in the United States in late October 2008, Alan Greenspan, the ex-chairman of the Federal Reserve, was faced with an extraordinary question (Bloomberg, 2008). The chairman of the committee, Representative Henry Waxman, asked ‘Do you feel that your ideology pushed you to make decisions that you wish you had not made?’.

The question (and a positive answer) was extraordinary not only because the ‘maestro’ had had a near mythical status in financial markets, but also because it challenged a fundamental premise in monetary policy: the objectivity of technocratic policy-makers. It suggested that, under that cloak of objectivity surrounding monetary policy, lurk questions of power, ideology, and politics.

Indeed, this thesis will argue in agreement with Rep. Waxman that monetary policy is inherently political. However, monetary policy is not political because governments might impose their political agenda onto an otherwise objective field of policy formulation, a problem solvable by ensuring adequate central bank independence. Milton Friedman, that anti-government man, saw political interference, usually although not exclusively at the stage of implementation, as the greatest threat to rational monetary policy, essentially transgressing a necessary separation between the economic and political spheres. Instead, this thesis argues for transcending the dichotomy economics-politics usually deployed in monetary policy analysis. Politics and power are not grafted onto policy, but ontologically constitutive of it, through processes with actors that mobilize and pursue competing agendas and interests. Monetary policy works through struggles over meaning, concepts and interpretation.

The journey to this argument started with my interest in central banking in post-communist Romania. A first important question my research tackled was how to approach the analysis of monetary policy in a context so profoundly marked by system dislocation. What initially appeared to be a methodological question quickly acquired epistemological and ontological dimensions. The challenge was that monetary policy analysis for Romania resisted the methods deployed in typical economic policy analysis: causal relations between relevant variables were difficult to establish empirically since the attempts to construct a capitalist system of production had resulted in repeated economic crisis. That the country itself appeared to be somewhat an outlier is illustrated well by its lengthy relationship with the International Monetary Fund (IMF), the international institution that provides policy advice for member countries experiencing balance of payment problems. From 1990 to 2008, the period on which this research focuses, Romania signed no less than eight Stand-By Agreements (SBA) with the IMF, of which only one was completed. The rest went off-track usually in less than a year after signing. While through these agreements monetary policy was assigned an essential role in tackling the crisis, the general explanation of failure contrasted a reform-orientated central bank with vested (political) interests capturing policy implementation (Dragulin and Radulescu, 1999).

I was thus searching for an approach that could shed some understanding on these recurrent episodes of crisis and the role monetary policy had played before, during and after; particularly against the wider processes of reorganizing the logic of economic production once the Central Plan, the mechanism for allocating resources in communism, disappeared.

Encountering the work of Karl Niebyl on theories of money provided a first guiding step. An (unjustly) all-but-forgotten economist, in his 1946 *Studies on the Classical Theories of Money* he suggested an interesting and innovative historical approach. Any account of central banking should involve three necessary dimensions: monetary theorizing, policy-

making and reality. In a capitalist system of production, he claimed, monetary theories and policies are embedded in particular institutional structures of the productive and financial sectors. The continuity of an economic doctrine depends on its capacity to anchor itself in the ‘continuity of reality’, in satisfactorily representing and explaining this reality. However he did not imply that a dominant theory at any one time would necessarily best represent those particular economic conditions: interests and power had to be considered in the process of doctrine formation. In other words, specific configurations of power and interest groups, rather than some objective criteria, might shape the theory and policy prescriptions applied to an economic problem¹.

In his methodological approach, Karl Niebyl was a pioneer not only in economics (Chick, 1999), but also in policy studies. Indeed, it would be another forty years until questions of interests and power would be systematically addressed in policy analysis. Traditionally, an instrumental view represented policy as a rational problem-solving exercise and attributed to policy makers control over other policy actors (Mosse, 2005). Policy implementation follows the policy model in a linear fashion. Two alternative conceptualizations emerged to question this rationalist representation (Keely and Scoones, 1999). The incrementalist perspective depicts policy as the ‘science of muddling through’ through a continuous process of negotiation and bargaining, a perspective which retains the central role of models, but acknowledges that implementation might be more complex than initially assumed. A third, more radical view, explicitly links policies with hegemonic struggles over meaning and interpretation. Drawing on French poststructuralism, deconstruction, Western Marxism, ethnography and several other interpretative and critical traditions of analysis, this

¹ In the preface to the book, Niebyl put it as follows: ‘Inadequate theories lead to inadequate policies, and inadequate policies are ‘inadequate’ for the welfare of society as a whole, while at the same time they are ‘adequate’ – over the short run – for vested and functionally past economic interests.’

epistemological stance thus argues for locating social (and policy) inquiry in a broader interpretative framework (Fischer, 1998).

Indeed, what Fischer called the argumentative turn in policy analysis emerged in the 1980s against the growing discontent with the rationality project in policy analysis and its ‘common mission of rescuing public policy from the irrationalities and indignities of politics’ (Stone, 1988: 12). Under the positivist banner, policy was understood as a ‘science’ concerned with generating predictive generalization and working according to a universal logic of scientific enquiry. Thus policy interventions, ‘based on causal laws of society and verified by neutral empirical observation’ (Dyrzek, 1982:310), would consist of manipulating an array of variables towards achieving certain ends. To ensure a genuine ‘scientific’ approach, empirical enquiry should be stripped of all normative dimensions and rigorously conducted according to the ‘fact-value dichotomy’ by hypothesis testing, data collection, statistical analysis and value-neutrality (Hawkesworth, 1988). Rational policy engineers, technocrats, thus anchor policy knowledge in the confirmation of empirical experience, achieving what Habermas (1989) called the ‘scientization of politics’ or the depoliticization of politics.

This depoliticization operation works to disguise the importance of discursive struggles in producing policies. Discourse is defined here as ‘an ensemble of ideas, concepts and categories through which meaning is given to phenomena’ (Hajer, 1995:45), continuously evolving historical constructs that shape and are shaped by social practices and institutions. A dominant interpretation requires a system of inclusion and exclusion: ‘discourses frame certain problems; that is to say, they distinguish some aspects of the situation rather than others’ (Hajer, 1995:45). Framing is the result of struggles over the production of meanings, a ‘core discursive activity’ where the rational, sensible and beyond doubt is defined to mediate the exercise of power (Foucault, 1976 in Lemke, 2001).

That policy is the product of discursive struggles is most apparent during times of crisis. Indeed, crises, the Slovenian philosopher Slavoj Žižek (2009) once said, are moments of extraordinary politics. Existing cognitive mappings are disrupted, leaving instead an ideological struggle over how to interpret events and think about solutions. In other words, policy responses do not develop out of technical, objective analysis of options, but are the result of a political struggle over representing the crisis. A Kuhnian analogy can be drawn between periods of ‘exceptional’ policy-making, when the parameters of what previously defined rational policy change, followed by periods of ‘normal’ policy-making, when a dominant interpretation draws the boundaries of what is possible in policy (Hay, 1999).

Crisis is thus useful as a conceptual category to map how a dominant construction of the ‘problem’ is stabilized and becomes hegemonic. As the interpretative framework that identifies legitimate policy issues comes under increased contestation, it becomes increasingly apparent that policies are ‘shaped by competing narratives, informed by divergent interests’ (Scoones, 2003:1). Indeed, narratives, defined as vehicles ‘for transmitting and making accessible a framework of meaning, that is discourse’ (Hajer, 1995: 23) have long been advocated as a valuable analytical tool for exploring moments of dislocation (Roe, 1991). Framing is essential in all policy-making, providing the tools with which narratives are constructed and ‘cannot be settled by instrumental rationality precisely because it frames that’ (Apthorpe and Gasper, 1996:6). By imposing a certain meaning and order onto a series of disjointed events, policy narratives provide a method for creating categories and spaces amenable for interventions, stabilizing the assumptions needed for policy making while marginalizing competing approaches and closing down policy spaces (Keely, 1997). Essential to any policy narrative is its complicity with politics, what Currie (1998) called the ideological function: not what it includes, but what it leaves out of the story.

Thus Niebyl's (1946) approach will be modified to retrieve the politics of central banking from rationalist representations. Indeed, there is an interesting connection between Karl Niebyl's method of triangulating theory/policy/reality and discursive approaches to policy analysis. Both view policy as contingent, consolidating through processes that reflect particular institutional configurations, rather than the inevitable product of a rational exercise. Where they differ is in the ontological status accorded to 'reality', a discrepancy essentially arising from the different role accorded to language and meaning. Indeed, Niebyl did not consider the politics of meaning in either theorising or policy discourse, an understandable omission since the foundations of the language turn in philosophy had just been laid by Wittgenstein (Fischer, 1998) when Niebyl published his book. For Wittgenstein, language functions as a structuring agent, in other words it constitutes 'reality' rather than describes it. From this perspective, Niebyl's claim that 'reality' represents the institutions of finance and production existing at any particular point in time is problematic because it presumes 'an objective reality' and 'disengaged spectators' as policy makers and analysts (Howarth, 2000). Instead, critical approaches argue for a more complex relationship between discourses and 'reality', where policy discourses have important institutional effects – (re)configuring relations of power or institutional practices – and ideological effects – privileging a particular understanding and excluding others by casting policy in the neutral language of science (Mosse, 2005).

However, Mosse warns, this does not imply that the implementation 'black box' of instrumentalist approaches can be unpacked by an approach that reduces explanations to the all-powerful operation of a hegemonic discourse. In fact, while a particular policy discourse might offer control over the interpretation of events, it is not necessary that this policy will be fully translated in practice. An important implication of allowing for the influence of institutional structures is that no one-to-one relationships can be presumed between theory, policy discourse and practices of monetary management, as Niebyl would probably have

written today. In other words, *pace* Niebyl, policy models (informed by a particular theoretical conceptualization) might not shape practice in the way they claim, nor provide a guide to policy action. Thus, Mosse argued, the causality might be completely reversed: the endurance of certain policy models and discourses arises precisely from their capacity to legitimize certain practices. Central banks, from this perspective, then have to be understood through both what they say (the policy narratives) and what they do (practices of monetary management). And here ‘traditional tools’ for the economist – empirical analysis – are essential in producing an account of practices (and their reconfiguration) in the policy space.

To trace these effects, the thesis will focus on the emergence of three leading historical representations of monetary processes, as constituted through the work and policy advocacy of David Ricardo, John Maynard Keynes and Milton Friedman. It seeks to substantiate claims that central banking is an inherently political process, involving discursive struggles during periods of crisis to assign meaning to problems and establish dominant narratives.

The attention to the three narratives of crisis is not exhaustive. While it serves to map monetary policy’s ‘argumentative texture’, the thesis will turn to postcommunist Romania for a detailed case study. It seeks to scrutinize critically the role of the central bank in the reconstitution of the postcommunist Romanian economy as neoliberal economy from 1990 to 2008. It reformulates O’Neill’s (1997) question to ask: what does the central bank do when the state, defined through its central planning legacy, ‘retreats’ from the market?

The Romanian case offers a good case study of the politics of monetary policy processes precisely because policy argumentation linked policy success to depoliticization and consistency with ‘objective’ monetarist principles prescribed by international policy advice and conditionality. Indeed, the dominant account of the National Bank of Romania’s (NBR) role in transition, or as it came to be known later, transformation, went as follows. Successful market reform has been the direct result of policy commitments to neoliberal recipes for reform (Pop,

2006). The neo-communist governments of 1990-1996 failed to uphold these commitments, politically validating a communist economic legacy, the soft budget constraint. Vested industrial interests were allowed to capture policy implementation against the rational policies agreed in repeated programs with the IMF, in two essential domains of economic reform: monetary policy and exchange rate policy (IMF, 1997). Politicized economic decisions prevented the NBR, despite its best efforts, from ensuring the macroeconomic stability necessary for a successful marketization. The 1997 election of a right-wing government with established neoliberal credentials, applauded as such by international institutions, radically modified the approach to reform. Increasingly, though not consistently, the new government succeeded in separating the economic and political spheres. This allowed an objective formulation and implementation of stability-orientated monetarist policies. The success of such policies was more marked after 2000 and picked up impressively after 2004. Indeed, the adoption of inflation targeting in August 2005 saw Romania becoming a European growth star, and finally succeeding in its bid to join the European Union in January 2007. Such commitments to sound economic principles also contributed to sheltering Romania from the initial manifestations of the financial crisis affecting developed economies starting with 2007. While eventually the crisis hit Romania towards the end of 2008, it was an unavoidable consequence of the increasing interdependencies in the world economy. The central bank governor confidently stated that Romania was in a good position, better than ever before, to weather the crisis, because of its record of careful monetary management and the credibility conferred by the inflation targeting regime² (Isarescu, 2008a).

The thesis aims to challenge this orthodoxy. It first contests the suggestion that neoliberalism gained ground only after the 1997 shift in the political will to reform. Instead, it

² His personal experience, for he was at the time the longest-serving central banker in the world, having been at the helm of the institution since the fall of communism, would lend confidence to crisis policies. But fundamentally, the underlying health of the Romanian economy, constructed through a careful monetary management, provided the necessary space for manoeuvre for a swift course out of the crisis.

will be argued, the entire period under analysis can be mapped as an ongoing process of reconstituting the economic space through neoliberal rationalities. The argument will draw on critical conceptualizations of the shifting character of neoliberalism. Hay (2004) or Peck and Tickell (2002) have convincingly argued that neoliberalism(s), while variegated in their localized manifestations, have shared an underlying logic of change: from the destructive attack on the Keynesian state (Peck and Tickell, 2002) during years of exceptional politics (Hay, 2004) to a constructive mode of normalized neoliberalism characterized by the political construction of markets and modes of self-governance, with financialized accumulation as the hegemonic economic imperative. This logic of change has also been at play in Romania, and it is the contribution of this thesis to the growing critical literature to map how the central bank, through its discourse and practices, has become increasingly embedded in the political operations of shifting neoliberal rationalities.

That the NBR would play a key role in reconstituting the economic space through neoliberal logics of economic management was a consequence of the very logic of neoliberal discourse. The superiority of neoliberalism as an economic paradigm has been predicated on the superiority of the market in producing economic and socially-efficient outcomes. For this to be achieved, neoliberal discourses prescribed depoliticization of economic decisions and the institutionalization of a technical set of devices for managing increasingly interdependent economies (Hay, 2004). This has naturalized the central bank as the institution *par excellence* fit to design, and ensure the deployment of, such devices. Indeed, neoliberal international policy advice, instrumental in scripting the Romanian marketization, identified the NBR as essential instrument of institutional change and neoliberal ‘policy-making’. Monetarist narratives ideologically legitimated neoliberalism and effectively enacted neoliberal principles of economic governance in the central bank.

The argument is put forward in several parts. It begins by mapping over time, dominant narratives of monetary management, to argue that their consolidation arose from struggles over the interpretation of crisis. It will show how the hegemony of monetarism and its ascendance in the international development discourse, particularly in the operations of the IMF, have been instrumental in the neoliberal scripting of postcommunist transformations. It will argue that the institutionalization of the Romanian central bank cannot be discussed outside the increasingly hegemonic position of the neoliberal economic paradigm in international policy discourse.

The thesis then focuses its analytical attention on the Romanian policy processes. It will argue that the periodization offered by the orthodox account reflects in fact the shifting character of the neoliberal project and the different roles this constructs for the central bank. Thus, during the 1990 to 1996 period, the NBR, rather than being an institution subdued to vested industrial interests that delayed necessary processes of marketization, functioned as a key vehicle of the neoliberal attack on the state's capacity to craft reform. Since neoliberal institutions (also) take time to build, expanding policy repertoires outside the traditional monetarist range invested the central bank with increasing powers to respond to structural and institutional resistance to neoliberal logics, arising from both communist legacies and ongoing political struggles. From 1997 onwards, the NBR rationality changed towards a constructive phase, with practices of monetary management increasingly structured to facilitate processes of financialized accumulation. However, the project has not delivered on its promise of stability, as embodied in the ultimate neoliberal expression of monetary policy discourse: the inflation targeting regime adopted in August 2005. The promise of stability, it is argued, operates to sideline the destabilizing nature of the increasingly normalized neoliberal practices of monetary management.

The chapters develop this argument as follows. The second chapter maps the constitution of three dominant narratives of monetary policy during times of economic

dislocation or 'crisis'. It seeks to open up the conceptual space underlying monetary policy argumentation and simultaneously point out the political nature of its constitutive processes. The Ricardian narrative of automatic adjustments emerging out of the 19th century British Bullionist controversy provided a powerful explanation of excess money as the root of imbalances and discretionary policy as its cause. Through the Peel Act, it assigned the Bank of England a passive role at odds with the increasingly complex link between its discount rate, gold movements and domestic money markets. The 1930s Great Depression saw Keynes constructing a counter-narrative which linked discretionary monetary management to the recovery in investment and growth. While this narrative put forward the concept of a monetary rate of interest and recognized the institutional practices Bank of England had developed throughout the 19th century, for strategic reasons related to the politics of the Gold Standard, Keynes defined policy discretion around open-market operations, thus remaining within the Ricardian quantity framing. This line of continuity would be fundamental to the consolidation of Chicago School monetarism. An updated version of the automatic adjustment case against policy discretion, monetarist discourses argued that excess demand, financed through central bank money, was a primary if not exclusive source of inflationary pressures in the economy, and sought to reconfigure practices of monetary management around control of high-powered money.

The monetarist representation of inflation as the ugly creature of irresponsible politics, articulated well, chapter three will argue, with the political mood at a time of crisis of the Keynesian state. It opened up the discursive field to the increasing domination of a new discursive system, neoliberalism, committed to market mechanisms, deregulation and financialized accumulation. Thus the chapter provides a detailed account of the consolidation of neoliberalism as hegemonic discourse and its institutionalization in international policy discourse, a process fundamental to its extension from the initial locus of its discursive

production, western capitalist countries, to developing countries. It will show that the political economy of the IMF's crisis interventions, as embodied in program relationships, is key to understanding processes of neoliberalization in formerly planned economies. Indeed, the institution's privileged role in designing and financially supporting 'transition' produced a well-defined map for neoliberalizing the monetary policy space. To establish monetarism as the legitimate policy narrative, the IMF's policy discourse drew on Western academic conceptualizations of the macroeconomics of socialism. Excess-demand narratives naturalized a set of planned system 'features' that constructed a generic socialist economy as an object amenable to standard stabilization intervention³.

Chapter four turns to the 'gradualist years' of the Romanian transformation: 1990 to 1996. It argues that through the extensive program relationship with the IMF, excess demand narratives assigned the central bank the fundamental mission of the neoliberal transformation: a sustained attack on state-owned enterprises, which neoliberal discourses constructed as the antithesis of the logic of allocative efficiency. It argues against viewing the repeated failures to uphold commitments to the IMF during this period as an indication that Romanian politics were singularly ill-equipped to deal with the discipline of austerity. It suggests instead that the representation 'good policies' vs. 'bad politics', and its underlying construction of a subdued central bank, has functioned to minimize the role monetary policy decisions have played in the ongoing reconfiguration of economic relations through neoliberal logics. Policy was neither static nor stable, and its inherently political character is most obvious here. It required sustained discursive struggle to remain within the boundaries set by neoliberal discourses, against structural and institutional resistance. Neoliberal institutions take time to build, requiring institutional reflexivity, reform and flexibility. Consequently, policy and practice

³ A paper building on this chapter received a conditional acceptance from the *Cambridge Journal of Economics*. At the time the thesis was finished, a modified version incorporating the referees' comments had been resubmitted for consideration for publication.

were open to constant reconfigurations and expanding repertoires to reconcile repeated liquidity crunches with the excess demand policy narrative.

Chapter five focuses on the 1997-2005 period, narrated as the dawn of a new era in policy-making. Finally the vested interests that had captured policy implementation during the gradualist years lost their power to obstruct marketization. With the official shift to targeting high-powered money, monetary policy is generally acknowledged, and by some applauded, as the instrumental factor in stabilizing the economy (Gabor⁴, 2008). While addressing the legacies of gradualism entailed an unavoidable recession, an autonomously formulated monetary policy saw Romania becoming Eastern Europe's growth leader by 2005. Against this account, the chapter will argue that this period marks the increasing normalization of neoliberalism, as neoliberal monetary policy met with substantially less contestation. The institutional effects of normalized neoliberalism clearly surface here, operating to restructure money, foreign exchange and Treasury markets and subjugate liquidity management to the requirements of financialized accumulation.

With financial stability increasingly tied into transnational actors' choices, in August 2005 the NBR switched to inflation targeting, a policy regime that promised stability in a world of liberalized capital accounts. The last chapter provides a critical reflection on the regime-switch. It links the neoliberal enthusiasm for inflation targeting optimality with its strongly depoliticizing discourse and its suitability in legitimizing institutional practices where monetarist discourses lost both political legitimacy and discursive strength to explain them. It thus maps the mechanisms through which the central bank institutionalizes new forms of policy intelligibility, knowledge and argumentation. It argues that efforts to establish interpretive communities should be understood against the new forms of exclusion from argumentative terrains which inflation targeting regimes produce. It further considers the

⁴ An early version of this chapter was published in *Comparative Economic Studies* (2008).

institutionalization of the new policy regime against the increasing global instability of neoliberal rationalities under destabilizing processes of financial innovation. It argues that the unfolding crisis, as reflected in the Romanian policy space until the end of 2008, has seen a reconfiguration in policy practices that appears to be diluting the central bank's commitments to private finance.

In short, this thesis argues monetary policy choices are inevitably political. Central banks cannot vanish from 'technocratic' policy processes, as either automatic adjustment narratives or the rhetoric of free markets triumphantly suggest. Instead, the central bank functions within, and works to reproduce, broader political rationalities of economic management.

To hold true to my epistemological commitments, I believe it necessary to state that my political views have inevitably coloured my analysis. In my case, to raise questions of power and politics in policy formulation is not solely an interesting academic exercise but also a necessary political act of challenging the hegemony of neoliberal logics, particularly in the NBR's policy discourse. Since there is nothing natural about the domination of the neoliberal way of imagining and performing policy, as the 2008 crisis suggests, opening up the discursive field might be a step towards articulating alternatives.

Indeed, my partisan interests reject neoliberal capitalism and claim that other economies are possible. My economy, as it were, is discursively constituted through similar processes of inclusion/exclusion, and is defined through an explicit emphasis on industrialization. Hence the thesis allows for the possibility of a different set of policies that reflect my subjective position on post-communist reform. This insists on re-organizing, rather than bankrupting, socialist production after the fall of communism and conceptualizes a monetary policy process subordinated to the needs of the productive sector, an approach I believe would have avoided the unprecedented growth in poverty and inequality post-communist capitalism has brought to

Romania. Nevertheless, the alternative is not explored in detail, as this thesis aims primarily to deconstruct dominant accounts given the dearth of critical conceptualizations of Romanian monetary policy processes. The next step is to build on Gibson-Graham's (2006) advice that research can move from the critical to the constructive and transformative: imagining economic alternatives to (neoliberal) capitalism.

Chapter 2. Narratives of crisis

The aim of this chapter is twofold. It focuses on moments of crisis to retrieve the political nature of monetary policy processes. A dominant construction of the crisis, arising from discursive struggles, initiates a decisive intervention in the process of theoretical and institutional change. Change, it will argue, is neither linear nor ‘rational’.

It aims to show that integrating the politics of meaning with Niebyl’s conceptual framework offers a useful analytical tool for approaching moments of dislocation in the existing hegemonic configurations. The chapter will focus on three turning points in the monetary history of capitalist countries, when dramatic dislocations opened up the discursive terrain for contesting the dominant paradigm and articulating new perspectives. Theory formation does not necessarily reflect existing practices of monetary management or changing institutional configurations, but might instead seek to reconfigure them (Niebyl, 1946). Thus, an important implication of allowing for the influence of institutional structures is that no one-to-one relationships can be presumed between theory, policy discourse and practices. The question in times of ‘extraordinary’ policy making is how policy discourse mediates the gaps between the emerging monetary theory and the ‘reality’ it purports to address.

The chapter does not seek to provide an extensive account of either the wealth of monetary theories developed since early capitalism or the complex discursive struggles involved in the consolidation of these three narratives. Its purpose is to map the ‘argumentative texture’ underlying dominant policy discourses and the political processes underlying its constitution, as developed until the fall of the Berlin Wall. Subsequent developments in the conceptual arena (as for instance the consolidation of inflation targeting regimes) will be discussed in the chapters on Romania.

The first episode to be examined revolves around the Bullionist controversies in 19th century Britain. This controversy was instrumental in the consolidation of a narrative of automatic quantitative adjustments, most forcefully articulated by David Ricardo, that dominated monetary thinking for the century, a theory that has been obstinately resurfacing in some cosmeticized version ever since. As formally enacted into legislation, this narrative sought to narrow practices of monetary management to the logic of the automatic adjustment to equilibrium. The third suspension of the Gold Standard in Britain in 1931 will be analysed next. This saw the emergence of a counter-narrative of monetary policy which advocated discretionary monetary management as a solution to the economic problems of the time, as embedded in Keynes's powerful policy advocacy. Pragmatic imperatives led to the construction of policy discretion through a quantity-driven framing, a logic not easily accommodated either by Keynes's monetary theory or by the Bank of England's liquidity management practices. The third narrative, Chicago school monetarism, an updated version of the automatic adjustment case against policy discretion, became dominant during the high inflation period of the 1970s. While attempts to translate it into practice were sporadic and short-lived in developed financial systems, its appeal for, and contribution to, the ideological struggles of the time gave it a foundational status. When mainstreamed into the IMF's stabilization approach, the next chapter will argue, it became instrumental in the extension of the neoliberal paradigm of economic management to developing countries. This had profound implications for the scripting of Eastern European postcommunist transformations.

2.1 The Ricardian automatic adjustment mechanism

The Ricardian narrative of monetary processes emerged during the Bullionist controversies, against dramatic economic and social changes of the Industrial Revolution.

In the run-up to the Bullionist Controversies in the second half of the 18th century, the transition from a mercantile to an industrial system was accompanied by a rapid change in the British economic and financial landscape, which altered the trade patterns of the era of trade capitalism. Thus, while early mercantile exchange was built upon an export of raw materials and import of finished goods, expanding industrial production reversed these patterns. Increased input requirements for industrial production and the uprooting of the labour force from subsistence agriculture into cities led to a structural shift in imports towards raw materials and food. Simultaneously, new export markets for industrially produced goods were opened up, predominantly in Europe.

This had two implications for monetary issues. First, it led to the establishment of gold as a monetary standard of value. While both silver and gold had been full legal tender up to the beginning of the 18th century, by the end of the same century silver coins virtually disappeared from circulation. As the search for raw materials intensified trade with India through the East India Company, the attending trade deficit had to be financed by an outflow of silver to India. Manufactured exports to Europe became the main source of export earnings, in the form of gold (Cameron, 1967).

Second, processes of industrialization played a key role in the increasing sophistication of the credit system (Niebyl, 1946). While bimetallism was thought to offer a broader currency base for the expansion of the system, England's changing pattern of integration in world trade produced a mismatch between the financing needs of the system and metallic currency growth. It also changed the patterns of external vulnerability, as any substantial drain of gold would immediately affect import capacity, industrial production and consequently exports.

The quick pace of industrial change greatly amplified the need for larger capital investments and labour, increasingly difficult to satisfy under a metallic currency standard exposed to the vagaries of international gold movements. Financial innovation would provide

an answer. Since gold coins were both too large and too scarce for retail trade or wage payments, the dramatic shortage of money of small denominations attending the establishment of the gold standard saw the issuing of private token money, laying the foundations for the emergence of country banking (Ashton, 1955). The consolidation of private banks outside London led to the establishment of two separate systems of paper currency and conflicting interests between centres of economic power. This would come to the fore and deeply influence the theoretical positions of the Bullion Controversies (Niebyl, 1946).

Traditionally, London had been the dominant centre of finance as the residence of most major merchants⁵. The Bank of England was set up in 1694, both as a bank to the government and an institution to cater to the financial affairs of trade capitalism. It provided loans and discounted bills of exchange and promissory notes for London merchants. By the end of the 18th century, the Bank of England increased its strategic importance by becoming a *de facto* monopoly issuer of paper means of payment in the London area. The competitive advantage of its position as the banker of the government had driven all London private banks to cease paper issuing by 1750, and as a consequence all large transactions were settled in Bank of England banknotes. Despite holding the country's gold reserves, the Bank had not assumed, however, what would later be identified as the distinguishing features of a Central Bank: neither did it engage in discounting operations with private banks nor did it allow all banks to hold deposit accounts (reserves).

Initially, geographic barriers provided a stimulus to the mushrooming country banking. As communications and transportation were not yet available on a significant scale, country industries' access to London finance was limited. What started as a response to the dearth of low-denomination means of exchange rapidly shifted to financing production. Local merchants became local bankers, increasingly engaged in issuing notes and granting credit to the growing

⁵ It was in London that various means of payment were developed. For instance, both banknotes and cheques (drawn on bank deposits) spread outside London only well into the 19th century (Cameron, 1967).

industry, with whom they were in close contact. The new banks, which the literature places at around 1750, acted as financing institutions, building industrial credit on bills of exchange, with expansion of notes depending on the demand for credit and limited to a certain extent by the ability to rediscount them (Silberling, 1924). This further strengthened links with London banks, where capital was more readily available or could be put to use (Mathias, 2001).

Thus, a picture of an increasingly complex, dual financial system emerged. Financial institutions in the industrializing counties expanded the range of credit instruments, innovating forms and functions of money so as to meet the liquidity needs of an increasingly large industrial production. For instance, bills of exchange, traditionally deployed to facilitate exchange, become fully fledged instruments of credit (Niebyl, 1946), with their price directly linked to bank interest rates, as businesses used them in times when other forms of credit were less available (Tooke and Newmarch, 1857).

Soon this climate of intense change would come under additional pressure from the wars with France between 1793 and 1818. Apart from the considerable concerns about the possible spread of French revolutionary ideas, Britain's ruling classes worried about its domination of world trade in industrial goods. The French Revolution could have created the necessary conditions for a mass industrialization of the type Britain was experiencing at the time.

The strains on the country's gold reserves were further aggravated by a commercial crisis and the attending drain of gold through international trade. In these circumstances, the suspension of the convertibility of bank notes into gold was deemed unavoidable if a major financial crisis was to be avoided (Viner, 1965). While formally it applied only to Bank of England notes and kept other issuing financial institutions under obligation to redeem notes in gold, in practice the suspension acquired a general character.

Thus, the first major debate concerning monetary issues in Britain arose and revolved around the suspension of specie payments by the Bank of England. In a climate of high and rising prices, it stirred up intense controversies which would provide fertile ground for an unprecedented development in monetary thought and the consolidation of the Quantity Theory of Money as the dominant explanation of inflationary processes. Furthermore, it had important policy implications, raising questions of the necessity of a central bank in an economy faced with complex domestic productive/financial structures and international monetary relations. It opened up the discursive field for formulating and debating basic principles of monetary policy.

2.1.1 The Bullionist Controversies

Soon after the suspension act, depreciating paper money attended a rise in commodity prices. The Bullionists narrated these as a crisis of excess money: any note issue above what would be sustained by the metallic standard was excessive; the premium bullion commanded over paper was the measure of such excess. The imperative remedy was to restore convertibility. On the other side, the anti-bullionists pointed to the extraordinary circumstances of war affecting international gold movements and increasing pressures on domestic bullion prices (Niebyl, 1946).

In what follows, the focus of the analysis will be the consolidation of the Bullionist arguments around its most forceful advocate, David Ricardo. Anti-Bullionist arguments will be presented to contextualize the emergence of a hegemonic explanation of monetary processes. The analysis of the controversy and its influence on monetary theorising will be conducted by investigating the major lines of argumentation to frame the debate, identifying which particular complex political and economic dimensions were excluded.

It would be a mistake to present the Bullionists as a homogenous group. In fact, between the 1796 Bank Restriction and the 1810 publication of the findings of the Bullion Committee which outlined the main theoretical arguments of the bullionist position, there is a fascinating diversity of opinion, not so much in ‘pure theorising’ but with respect to the arguments excluded in the process. Against this diversity, the crisis narrative as articulated by the Bullionist was built on the frames outlined below:

Money as commodity money

Arguably, the underlying foundation of the Bullionist theoretical arguments was the treatment of money as commodity money, subject to the same laws and principles as any other commodity. While the first large-scale investigations into monetary matters were triggered by developments linked to the extensive use of paper money, theorising was by and large structured by applying the laws of commodity circulation to money.

Indeed a commodity-money account constructed monetary disturbances around the depreciation of the value of paper money with respect to gold, with paper money treated as simple certificates for gold. This depreciation, defined through the relationship between paper money and the standard metal rather than the value of goods and services, signalled the ‘City’s interest in the rise of the price of gold’ (Sayers, 1960). Since Britain had virtually been on a gold standard since the middle of the 18th century, the suitable measure for depreciation was the premium on bullion⁶.

The Bullionist explanation for the depreciation was simple: excess issue of paper money, an argument powerfully developed in Ricardo’s (1810) *The High Price of Bullion*. The understanding of monetary processes underlying Ricardo’s theory of money is a reinterpretation of Hume’s monetary theory (Marx, 1859). Hume, building on Locke’s

⁶ Bullionists accepted that some of the premium arose from the war-driven increase in costs of transportation between London and the Continent.

pioneering work, had already established the concept of an equilibrium level of money in an economy engaged in international trading. Any increase in money over the optimum level would create a trade deficit and an outflow of gold. Thus, international trade would provide an automatic correction mechanism to bring the quantity of money back to its equilibrium level (Hollander, 1911).

This representation Ricardo articulated with a labour theory of value, an approach in line with theorising at the time. He dismissed any concept of an aggregate price level, framing his analysis in terms of exchange ratios between commodities, a function of the quantity of labour required in their production (Ricardo, 1821: 4). To paraphrase Schumpeter (1954), implicit in his theory of commodity money is that what really matters is exchange ratios between market goods: money prices are only a reflection of these. Thus, the value of gold in relation to other commodities is derived from the quantity of labour time necessary to produce it. With given exchange values of commodities, there is a ‘proper’, natural level of monetary circulation given by the labour cost of producing gold in relation to other commodities. In equilibrium there would be no transfers of gold from one country to another, since its value is determined by the cost of production, as ‘nationality does not affect general economic laws’ (Marx, 1859: 12).

Thus any excess of gold, brought about by a general fall in aggregate exchange value of commodities or the discovery of new mines, would drive its price below this metallic value and increase commodity prices. The ensuing export of gold and the accompanying fall in commodity-prices would restore money to its equilibrium level.

Ricardo took such issue with inconvertibility because paper issue without gold backing invalidated the automatic adjustment. The argument, Marx (1859) noticed, was rather circular: paper money was depreciated, therefore too much money was issued, and therefore too much money caused the depreciation. Nevertheless, the claim of having discovered the laws

governing the circulation of gold brought with it a very powerful explanation of monetary disequilibria and a hopeful message for the future. The root of all trouble was the issue of paper money above the existing gold in circulation. While paper money facilitated exchange, only a one-to-one relationship to gold reserves would preserve the automatic adjustment mechanism.

The Bank of England mis-managing currency: reserve-constrained credit

Having identified the mechanism through which monetary equilibrium was disturbed, Bullionists went on to identify the culprit. The excess issue was clearly a problem of currency mismanagement, attributed to the Bank of England as holder of the country's gold reserves and issuer of paper money without gold backing⁷.

Policy discretion, Ricardo argued, produced a positive discrepancy between the rate at which the Bank of England would lend and 'the rate of profit which can be made by the employment of capital'. Against these circumstances, there was an unlimited demand for banknotes that undermined the strict correspondence to gold: 'If profits be high, and the Bank is willing to lend at low interest, can there be any conceivable number of bank notes which may not be applied for?' (Ricardo, 1821: 363).

However, the question arose, could country banks equally overissue? The general Bullionist answer was a qualified no, as these were governed by a different set of laws. (Silberling, 1924). Boyd was reportedly one of the first to outline a theory of reserve-constrained credit creation in his attempts to unburden country banking from accusations of inflationary credit creation. As suppliers of business capital, country banking satisfied a

⁷ Blaming the Bank of England for currency mismanagement seems to have been a favourite pastime of the moment, and then later periods of inflation. As Schumpeter (1954: 706) put it: 'from Ricardo to the most unsophisticated man (sic!) in the street, everybody loved to make a whipping boy of the Central Bank, a habit economists retained until today'

demand for money that reflected increased production or trade (a Real Bills reasoning), so that credit could not be in excess of local demands (Schumpeter, 1954).

Walter Thornton's applauded contribution to the understanding of monetary theory and banking practices constructed a far more sophisticated explanation (Viner, 1965). Assuming that commercially-connected areas were bound by an equilibrium of currency value (a forerunner of Ricardo's gold adjustment mechanism), excess issue in the country would spill over into prices and shift local demand to London, thus affecting country profits and ultimately leading to a currency contraction. He further formulated a reserve-constrained reasoning: the Bank of England, by expanding credit to London money markets, expanded the reserve basis for country circulation and thus inflationary pressures (Thornton, 1802). Nevertheless, Thornton held that pure theory could not always provide a pragmatic basis for policy. Sympathetic to the extreme pressures faced by Bank of England during the Napoleonic wars, he acknowledged that this 'merely theoretic idea' of excess issue and its attending policy implication – the necessity of a monetary contraction - would be a serious threat to an already-strained economy.

To this rather balanced position Ricardo would give little attention. He ignored Thornton's explanations of the credit mechanism, and kept his message simple: 'Diminish the currency by calling in the excess of Bank notes: make a partial void...and what can prevent...an importation of gold and consequently a favourable exchange' (Ricardo quoted in Silberling, 1924: 34)

This quotation touched on the other essential characteristic of the British financial system conveniently sidelined in Bullionist argumentation: balance of payment movements other than those occasioned by trade flows, then commonly referred to as foreign remittances. The most extreme positions, in Ricardo and Wheatley, simply held that in conditions of convertibility, the automatic adjustment mechanism would regulate the quantity of money in

the economy to the equilibrium level: a contraction of the gold reserves would, with exchange values un-altered, simply reduce prices and increasing export competitiveness, thus restoring the gold balances to equilibrium. This is more puzzling since Bullionists with considerable experience in the working of international financial flows, such as Boyd and Ricardo, refused to acknowledge that foreign remittances could have an impact on the price of foreign bills and specie⁸.

Indeed, Ricardo held that gold movements between countries were essentially corrective, always connected to commodity trading and essentially, only occurring because metallic currency moved away from its equilibrium level (Marx, 1859)⁹. Thus, he argued, under conditions of convertibility not even military remittances would affect exchanges (between paper and bullion) as lower prices following the monetary contraction would automatically ensure an improvement in the balance of trade. This dogmatic commitment to the principles of an equilibrium quantity of (gold) money forced Ricardo into some rather curious assertions following the application of the principle of comparative advantage to gold movements. For instance, he rejected the idea that gold exports during periods of crop failure, frequent around the time of the Bullionist Controversies, arose from international trade payments. Instead, the fall of the commodities in circulation had altered the equilibrium quantity of money, leaving gold in excess. The depreciation in relation to other national currencies rendered it comparatively more advantageous to export. This led to a paradoxical conclusion. During episodes of supply shocks the upshot in commodity prices was usually accompanied by liquidity shortages, especially since the increased uncertainty prompted hoarding (Marx, 1859). However, the automatic adjustment logic narrated these instances as moments of excess

⁸ Thornton however admitted that international gold speculations or war subsidies could be a significant source of upward pressures on the domestic price of the bullion and thus produce depreciation.

⁹ 'The temptation to export money in exchange for goods, or what is termed an unfavourable balance of trade, never arises but from redundant currency' (Ricardo, quoted in Marx, 1859).

liquidity, restored by exports of gold. This reinterpretation, it will be shown later, has since been characteristic to equilibrium explanations of inflationary episodes.

Against the background of Niebyl's (1946) critical assessment of the Ricardian theory as a mere, if clever, recycling of older theories formulated under mercantile conditions, its influence in narrating the crisis arose from a combination of rhetorical appeal and ability to mobilize various interests. Indeed, the Ricardian theory successfully simplified complex monetary processes while paying little analytical attention to the implications of the fast industrial expansion. It first imposed a strict definition of money as a commodity and thus refused to accept that the laws governing its circulation might follow a different logic. Aside from gold, it defined bank notes as the only legitimate form of money, as gold certificates rather than instruments of credit. The implications of either the widespread use of bills of exchange, which tended to adjust to the financing needs of the system in times of liquidity shortages, or the bank deposits had not been addressed because of the challenges these raised to the automatic adjustment mechanism.

Furthermore, the narrative premised that monetary circulation was entirely and exclusively built upon the gold reserves before the Suspension Act. Hence Ricardo refused any growth measures of paper money as proof of over-issuance. Comparisons could only be formulated between the prices under the metallic standard and the prices in conditions of suspension. Nevertheless, the rapid pace of development in country banking suggests that the increasing financing needs of the productive system rapidly outpaced the movements in gold reserves.

Lastly, by treating money as mere medium of circulation, Ricardo assumed that international gold movements will be immediately translated into one-to-one changes in the volume of money in circulation, glossing over the possibility of hoarding, driven by either uncertainty or speculation in domestic markets.

However, the hegemony of the Ricardian narrative of adjustment during the 19th century must be understood in that particular historical context. At the heart of Bullionist theoretical formulation stood an unabated commitment to the laissez-faire principles embodied in the Gold Standard (Schumpeter, 1954). Such a commitment did not sit well with any ideas of monetary management or credit control that the Suspension Act inevitably raised.

The normative aspects of the Ricardian monetary theory constructed a sound financial system based upon and restrained by gold reserves. To preserve the static conditions of equilibrium, (paper) money ought to behave like gold. Crisis arose from mistaken policy choices (initially the suspension of convertibility, then Bank of England's discount activity at rates lower than the rate of return on capital¹⁰), altering the automatically equilibrating mechanism of international trade which otherwise would ensure a smooth functioning of the economy. Since a metallic currency provided a necessary and sufficient base of the financial and productive system, other means of payment had to be constrained to work as commodity-money. Any departure from this elementary principle of monetary management would automatically create excess money, inflation (in terms of relative exchange ratios) and a premium on gold. Underlying this Quantity Theory representation of monetary processes was a passive central bank, allowing the movements in the gold reserves to set liquidity conditions. The next sections will ask how this account structured policy discourse and practice once convertibility restored.

2.1.2 Monetary developments post-convertibility

The hegemony of Ricardo's narrative of excess money consolidated in the subsequent monetary crises. Indeed, the 1825 return to convertibility failed to bring the Bullionist serenity

¹⁰ Ricardo refused to accept that the quantity of money had any bearing on the rate of interest: 'the rate of interest for money is totally independent of the nominal amount of money in circulation. It is regulated solely by the competition of capital, not consisting of money' (Ricardo 1810 quoted in Sayers 1960: 47). Later he accepted that additional notes might reduce interest rates in the short term, but he regarded this as a side point to his interest in long-run tendencies.

of equilibrium. Instead, sharp financial crises, depressions and unemployment dominated the 19th century. These repeated convulsions in the monetary system¹¹ did not diminish the appeal of the Ricardian account but instead prompted animated reflections on how to bring the institutional ‘reality’ in line with its conceptual foundations, or to follow the public opinion at the time, how to address the problem of currency mismanagement.

The Ricardian narrative shaped the argumentative terrain. Against a deflationary environment¹², crises were narrated as consequence of an excess issue of paper money¹³. This was, it is worth remembering, a theory developed in response to the inflationary environment of the Napoleonic wars. Ricardo’s insistence that all paper money should be made to behave as commodity money (gold) was incorporated into the ‘currency principle’¹⁴, which held that a mixed currency (paper and metallic) could only function properly if it behaved like metallic currency (Niebyl, 1946).

The Bank of England’s position was rather ambiguous. It had temporarily subscribed to the excess money account during 1825, to discover that its refusal to discount threatened to turn concerns about liquidity into panics. It subsequently, (if rather reluctantly) accepted its lender of last resort position.

However, the simple Ricardian narrative of crises was complicated by the fact that convertibility had been fully restored by 1825. This necessitated a re-interpretation where over issue was possible even under conditions of full convertibility. Convertibility was no longer sufficient to guarantee the absolute correspondence between gold reserves and paper money.

¹¹ Such as in 1826, 1836 and 1839.

¹² After the high levels of the Napoleonic wars, English prices entered a downward trend that would last, without significant reversals, from 1815 to 1850.

¹³ During the 1825 crisis, Bank of England’s initial refusal to continue discounting turned worries into panic, and the decision had to be reversed. Under the spell of Ricardian narratives of crisis, it attributed the liquidity crisis to over issue.

¹⁴ The currency school advocated controlling paper money issue by tightly tying it to species movements, while the Banking School, fervent adherents of free market ideas, held that the market mechanism would certainly be better at regulating matters, with any issue in excess of what banks were willing to accept corrected by a one-off inflationary bout.

Consequently, paper issuing had to be firmly tied to gold reserves, so that ‘a paper circulation, by this system, would dilate and contract precisely in the same manner as a metallic currency’ (Joplin, 1820 quoted in Viner, 1965 :224).

The Ricardian narrative thus constructed the policy problem to be the break-up in the one-to-one relationship between paper and bullion, caused by Bank of England’s lending, particularly as lender of last resort. Subsequent monetary legislation sought to eliminate this possibility.

2.1.3 Monetary policy rules: quantitative constraints

Various attempts at limiting and eliminating the lender of last resort function were put into law in the second quarter of the 19th century. First, the 1827 Palmer Rule explicitly aimed to make paper money behave as ‘purely metallic currency’ by maintaining the Bank of England’s security holdings (including discounted paper) constant. This sought to maintain internal circulation constant unless gold reserves changed. However, between 1836 and 1839, gold reserves positions were altered through deposits, breaking the paper-specie link and the search for the automatic mechanism (Schumpeter, 1954).

The currency school suggested separating securities held for paper issuing from those held against deposits. Thus, the 1844 Peel Bank Act was designed to improve radically where the Palmer Rule had failed: it separated the Bank of England’s Banking and Issuing departments, and established a fixed maximum note-issue covered by securities¹⁵, the rest to be necessarily backed by bullion (Bagehot, 1876).

The Peel Act was grounded in excess money reasoning. It gave legal standing to Ricardo’s idea that bank notes had to be forced to act as legitimate gold-money and sought to curtail discretionary monetary management. It technically prevented the Bank of England to

¹⁵ The provisions of the Peel Act set at 15.000.000 the maximum of notes issued against government securities

act as lender of last resort by asking the Banking Department to act as any other private banking institution and turning the Issue Department into an automatic exchange 'bureau' from paper to gold and vice-versa¹⁶. Moreover, by restricting access to the gold reserves in the Issue department for external payments, it left the Banking Department with little resources to deal with situations of crisis.

While the 1844 Act finally translated the currency principle into policy, sectional interests struggled over its articulation. Although the currency school managed to fashion policy rules to a large extent, it could not completely dismiss the influence of country banks, greatly opposed to both the Palmer Rule and the Peel Act. Thus, while theoretical consistency required a complete withdrawal of the right of note issue from the country banks, in actual fact the question was by and large eluded, a move which Viner (1955) identified as a strategic choice, a trade-off for passing the Peel Act¹⁷. Furthermore, the Bank of England endorsed the excess money narrative because it diminished its responsibility for currency management and served its interests in two ways. First, it sanctioned its reluctance to unproductively maintain high gold reserves as protection against crisis. Second, by separating the two departments, the Peel Act conveniently overlooked the key role the discount rate played in the financial system. This would allow the Bank to offer competitive discount rates in an attempt to revive its banking operations, significantly affected by the expansion of joint stock banks in the London area and increased competition in the commercial discounting business segment¹⁸ (Viner, 1955).

¹⁶ The Issue department took the function of changing bullion for notes and inversely. Practically, any gold transactions with the Bank of England would be effected by the Issue Department. The Banking Department had as reserves only the Issue Department notes.

¹⁷ Torrens, one of the main figures behind the currency school, held that the note issues by country banks was ultimately under the control of the Bank of England, echoing Thornton's reserve constrained credit creation idea.

¹⁸ The 1833 financial legislation opened up the London scene for joint stock banks, with a dynamic that saw by 1850 three joint stock banks with deposits in excess of those with the Bank of England (Viner, 1954)

There appeared thus a difference of purpose behind the different supporters of the Peel Act. Building on the gold reserve constrained credit doctrine, the currency school envisaged the Act as the best means to keep in check the Bank's discount activity, while the Bank of England saw in the Peel Act an opportunity to defend its discount business operations from the ever stronger competition of the joint-stock banks¹⁹ (Niebyl, 1946).

2.1.4 The Peel Act and practices of monetary management

However, whilst monetary theorizing (and subsequently legislation) in the 19th century faithfully reproduced Ricardian monetary theory, practices of monetary management shifted to respond to the increasingly complex relationship between the financial and the productive systems. Indeed, money market actors argued that the processes involving the Bank of England and the quickly-expanding money market went far beyond the reach of the Peel Act:

‘Of course, if the Act of 1844 really were, as it is commonly thought, the *primum mobile* of the English Money Market [...], the extreme irritation excited by an opinion on it would be no reason for not giving a free opinion. [...] But in my judgment, the Act of 1844 is only a subordinate matter in the Money Market’ (Walter Bagehot, 1876:10).

At first sight, the Peel Act did reach its goal. It did succeed in making the Bank of England's paper issue simply stand for gold certificates, although at the expense of its diminishing relevance. Thus, the most notable consequence of the Peel Act was to remove the bank note from the sphere of commercial transactions and substitute it with cheques drawn on deposits (Withers, 1910). Banks economized on the means of payment the law was seeking to restrict, while innovating new instruments of credit. The bank note, under the Peel Act a mere gold

¹⁹ As Niebyl put it, the Banking Department was used by Bank of England as an ‘Instrument of attack upon the country banks to establish its predominance, by increasing the discounts at a rate very low for that time’ (p. 152)

certificate and thus part of the cash reserve along with metallic currency, became largely irrelevant as an instrument of credit, so that by 1910, the note issuing of banks others than the Bank of England had consistently been below the amount allowed in the Peel Act. Thus, in practice the English credit structure was built on a very low gold reserve base²⁰, a remarkably narrow base for the metallic currency of the excess money story²¹ and a clear indication of the insufficiency of the gold reserves for the increasingly large liquidity needs of industrial production (Viner, 1955).

This was not the only unexpected outcome of the Peel Act. It had to be suspended several times²² to allow the Bank of England to prevent the collapse of the financial system by exercising its lender of last resort function. The centrality of the interest rate to the Bank's operation became apparent and created a dilemma for policy practice.

With the extension of markets and capitalist production to other countries, international gold movements became increasingly elastic to the interest rate differentials, against the assumptions of the automatic adjustment mechanism. Volatile gold flows saw monetary management increasingly centred on defending gold reserves, mainly through interest rates manipulation²³. Bank of England had at its disposal a potentially powerful instrument for dealing with external imbalances in the form of speculative gold flows²⁴, which however depended on the constantly changing relationship with money markets.

²⁰ Between 1850 and 1890 the average ratio revolved around 2 to 4% of gold reserves to domestic bank liabilities.

²¹ Sir Robert Peel admitted that this level was extraordinarily low, but could see no solution under which the Bank could bear the expense of extending it (Viner, 1955).

²² In 1847, 1857, 1866 and again in 1914.

²³ The 1833 exemption of Bank of England operations from usury laws with short-term paper sanctioned the role of the interest rate as a policy instrument, allowing it to be raised above the 5% threshold.

²⁴ Such as in 1836, when a change in the US coinage laws which practically imposed a gold standard led to a drainage of gold to the US to which the Bank of England responded by increasing rates by more than 200 percentage points.

The Discount Market

The increasing monetization attending industrialization saw the London Discount Market gradually emerging as a central point to issues of monetary management²⁵. An increasingly integrated banking sector could mobilize capital more easily, so that the practice of trading bills was extended to lending money on call on the security of bills, an innovation that would greatly simplify the process of obtaining liquidity in a system somewhat constrained by the rigid time-consuming process of trading bills or holding large cash reserves (Niebyl, 1946).

The growing magnitude of funds traded on the Discount Market had conflictive implications for the Bank of England operations. While the remarkable expansion in joint-stock banking threatened Bank of England discount business, its interest rate decisions (the rate at which it would discount fine bills) were increasingly tied to, and therefore constrained by, rates on the discount market. The Bank of England's dilemmas were rooted in the centrality of its interest rate to the functioning of the gold standard. It affected the Bank's competitiveness and profits, and thus the successive changes in its strategy towards the Discount Market and ultimately its approach to monetary management were shaped by the search to maintain its profit margins in its banking (discount) operations.

At first the Bank of England understood the Peel Act as releasing it from its imposed duties of monetary management and quickly tried to expand its banking business. However, the separation of the two departments created a paradoxical situation: while the Bank of England and its interest rate policy was the cornerstone of the stability of the financial system (given the interest elasticity of international gold movements), its banking operations were

²⁵ Initially the Bank of England benefited from the brakes imposed on country banking expansion by the limitation of the capital base to six partners. It lost some of this monopoly in 1826 when legislation allowed joint stock banks outside London. The 1833 Act through which non-issuing joint-stock banks were allowed inside London finally set the framework for the subsequent development of the London Discount Market. Very rapidly joint stock banks outnumbered country banks. While the Bank of England still maintained exclusive rights of joint-stock banking within the London area, country banks held a portion of their bills of exchange with London discount houses (bill traders).

subjected to private-banking rules²⁶. Thus, attempts to expand the banking business of the Bank of England by reducing the discount rate to competitive levels²⁷ repeatedly saw a drain of reserves from the Banking Department which under the Peel Act could not be accommodated by the Issuing Department.

Bagehot, the voice who gave prominence to the necessity of the lender of last resort function for the Bank of England after the Peel Act, argued that when it came to panics, a distinction must be made between an internal panic (a run on banks) and a foreign drain occasioned by the vagaries of foreign trade or international speculations. External imbalances should be prioritized by raising the bank rate (to attract gold inflows) but making sure that all internal demand for liquidity is satisfied at the going rate: ‘What is wanted and what is necessary to stop a panic is to diffuse the impression that, though money may be dear, still money is to be had. [...]Unless you can stop the foreign export, you cannot allay the domestic alarm’ Bagehot, (1876: 9).

There is an implicit association between an outflow of gold and uncertainty; expectations of a possible liquidity shortage would increase the demand for liquidity and hoarding, and potentially transform a panic into a fully-blown crisis. Moreover, in times of liquidity crisis/uncertainty, demand for liquidity proved largely inelastic to interest rate movements, as the largest borrowers, usually businesses, would be reluctant to cease payments.

Nonetheless, the question turned out to be more complex than that. Against the institutional changes the Peel Act produced, international gold movements were sensitive to rates on the Discount Market, while the Bank Rate was used as a benchmark for setting lending rates and thus affected first business activity. While it was understood that raising the bank rate could potentially harm business by raising the cost of borrowing, its desired impact on gold

²⁶ This was Sir Robert Peel’s overt intention. He declared in the House of Commons that ‘the banking business of the Bank should be governed on precisely the same principles as [...] any other body dealing with the Bank of England notes’ (in Viner, 1955: 221).

²⁷ Shortly after the Peel Act the Bank of England lowered its discount interest rate from 4% to 2.5%.

movements required market rates to follow consistently. The problem would be made worse by international competition for gold reserves. In other words, the Bank of England needed to ensure control over the money market in order to control external developments by forcing the market rate to track the bank rate, a monetary policy practice that has not lost validity ever since. With the rapid development of money markets, this process changed rapidly.

At the time of the Peel Act, the Bank of England controlled the market by being the ultimate source of cash (Bagehot, 1876), so that the market rate traced the Bank rate. However, the increased ability to mobilize liquidity reduced banks' dependence on the Bank of England, a tendency to be reinforced by its continuous competitive pressures against bill brokers. By the late 1890's the Bank had serious difficulties in influencing market rates. On several occasions, it raised the bank rate without attracting gold, largely as it failed to affect the London market. It thus became clear that a strategy for recovering its influence in the money market was necessary.

In 1890 new methods to bring the market into the Bank were adopted: open-market operations (OMOs) or direct borrowing from the market to make its rate effective by reducing the flow of funds available for financing bill purchases (Sayers, 1976). Monetary management was focused on maintaining the Gold Standard, a policy objective with a pronounced asymmetric character: OMOs were mainly undertaken to raise interest rates and prevent a gold outflow. The Bank of England changed its discount market strategy by establishing a new willingness to lend under any circumstances, rather than only during crisis. Practices of bill discounting were replaced with two-week advances, requiring bills as collateral.

Inspired by a monetary theory that constructed the economy as naturally in equilibrium and crisis arising from excess money issuing, 19th century monetary legislation sought to prevent discretionary monetary management. However, the increasing sophistication of national and international financial systems, driven by the spread of industrialization, saw the

consolidation of the interest rate on Bank of England operations and its relationship with the rates on money markets as central to the maintenance of the gold standard. Thus, while the Bank accepted and promoted the narratives framed through the dominant monetary theory while congruent with its own interests, policy practice could not be further away from the story of the automatic adjustment mechanism. In fact, the Bank struggled throughout the 19th century to balance the conflicting outcomes of its interest rate decisions on financial stability, and maintain some degree of control over money markets. Finally, it became apparent that legislation aimed at imposing some type of quantity constraint on credit expansion would quickly generate financial innovations and that the Bank's willingness to assume the lender of last resort role was essential for the smooth functioning of the financial system.

In sum, the 19th century theoretical dominance of commodity-money conceptualizations was rooted in a desire to curb the central bank's discretionary power. A (gold) commodity-money would insure that the Ricardian automatic adjustment worked successfully to maintain the economy, and particularly the value of gold, in equilibrium. While practices of monetary management were quite distinct from the theoretical foundations of the Peel Act, most theoretical innovations after 1850 failed to move away significantly from the commodity money story. For instance, Menger's famous integration of money in the marginalist revolution was entirely based on commodity money (Ingham, 1999)²⁸. However, Knut Wicksell, a disgruntled quantity theorist of the late 19th century, proposed an analytical angle that would prove instrumental in the consolidation of Keynesian narratives of monetary policy.

²⁸ According to Menger, money is simply the most 'saleable' of a set of commodities. It emerges as means of exchange resulting from spontaneous market process driven by rational economic decisions to solve the 'double coincidence of wants' (Ingham, 1999).

2.2 The Keynesian narrative of monetary adjustments

Wicksell's (1962) approach, emphasizing the central role played by interest rates and credit, would provide the foundational basis for most non-monetarist conceptualizations developed ever since (Leijonhufvud, 1981), particularly popular in policy circles in the 1990s through its re-articulation in New Keynesian monetary theory (Woodford, 2003).

2.2.1 A theoretical detour: Wicksell

While Wicksell (ibid) accepted the Ricardian connection between the quantity of money and the Bank of England's discount policy, he identified one important contradiction in the Ricardian narrative. Against its prediction, the rate of interest had been low during times of falling prices, and vice versa (Ohlin, 1936). To explain this contradiction, Wicksell turned to the widespread use of instruments of credit as means of payment, which he thought the single most important development that not only freed the banking system from the scarcity constraints of the gold reserves but broke down the Quantity theory relationship between quantity of money and prices (Wicksell, 1962: 76).

Having established that institutional circumstances necessitate a different analysis, the next question was what determined the price level in an economy. He framed the question differently from Ricardo. While the Ricardian automatic adjustment premised a monetary system where the only means of payment were (gold) coins and paper money automatically linked to gold, Wicksell started by eliminating any possible interference from cash (both coin and paper) governed by Quantity Theory logic. Wicksell's account constructed a credit-only economy, where transactions were settled through bank deposits. Gold no longer represented the reserve base of the system, but was held only for international transactions or industrial use.

The reason for this choice becomes immediately apparent: at the centre of the Wicksellian story are two interest rates: a (bank) monetary and a natural one (real, governed by

the productivity of capital). The deviation of one rate from the other triggers a cumulative process of price movements. While the narrative premises a pure credit system, only the money rate is the outcome of processes within it.

Thus, the money rate, i.e. the rate charged on loans to entrepreneurs, is set within the credit-economy by the banking system²⁹. On the contrary, the natural rate of interest is determined in equilibrium by the supply and demand for capital in a system without money or credit where all lending is done in the form of real capital goods³⁰. The natural rate equates savings and investment.

When the bank rate is equal to the natural one, there is no credit creation in the economy. This only occurs when the bank rate falls below the natural rate, ultimately resulting in an increase in prices. Essentially, it is not the mere modification of the bank rate that brings about the change in prices, but rather that the banking system has it in its power to maintain the short-term rate at a level low enough and for long enough to influence the nominal long-term rate (i.e. bond rate) upwards. The transmission mechanism, later echoed by New Keynesian theories, links long-term interest rates with spending and investment decisions, an aggregate demand explanation of inflationary pressures³¹.

The movement of the long-term rate ‘in sympathy’, *ceteris paribus*, will lead to sudden price rises and ‘the whole world knows that the upward phase has started’. There is a further cumulative element in the upward price movement, as bank rates below equilibrium levels

²⁹ Furthermore, the long-term (bond) rate will necessarily move in tandem with the short-rate.

³⁰ There is ambiguity in what Wicksell held the ‘natural’ rate to be, Marget (1938) for instance identified eight different meanings assigned to the concept.

³¹ ‘...the excess of demand (brought about by easier credit) over the supply of raw materials, labour, land and the like, and directly and indirectly of consumption goods, is the decisive factor in pushing up prices....’ (Wicksell, 1962: 90)

induce business to repeatedly set their production plans higher and thus increase the demand for factors of production, adding to inflationary pressures³².

Thus the movement in prices provides the link, the ‘spiral spring’ between the two rates, as ultimately the monetary rate adjusts to its equilibrium level. The explanation of adjustment brings to the fore the complications of switching from the pure credit economy setting to one where gold is essential for the return on equilibrium. Ultimately the pure credit economy is regulated by commodity money.

Indeed, the question of whether the banking system can maintain a rate below the natural rate and, through the cumulative process push prices higher, fails to receive an unambiguous answer. On the one hand, with the extensive development of credit instruments the demand and supply for money are no longer independent, with ‘the supply of money more and more inclined to accommodate itself to the level of demand’ (Wicksell, 1962: 56). Credit creation is no longer reserve-constrained. The implication, that banks could maintain the money rate under the natural rate indefinitely, is nevertheless dismissed by making recourse to Ricardo’s currency of preference, gold. The monetary interest rate can be maintained below equilibrium while banks have sufficient gold reserves. The (public’s) demand for cash (gold) contracts bank reserves, eventually forcing them to push up the money rate to the level of the natural rate where prices stabilize. While departing from the Ricardian analysis in both its assumptions and its framing of the problem, replacing quantity with the price (of money) as key monetary variable, the Wicksellian story is still one of an automatic adjustment. However, the adjustment is not necessarily immediate: Wicksell argued that, historically, banks maintained excess reserves for substantial periods of time, particularly in a system where demand for gold had fallen consistently (Leijonhufvud, 2007).

³² Speculation is not an important factor in driving up prices, as the differential required by a speculator is so significant that he would not respond to a small change (or deviation) of the monetary rate of interest.

The Wicksellian account has important policy implications. At a first glance, the Ricardian approach is maintained: a self-regulating system. Nevertheless, Wicksell ascribes an important role to policy interventions for two reasons. First, since the natural rate of interest would change with evolving circumstances, its measurement subsequently subject to considerable uncertainties, it has limited policy usefulness. Second, precisely because adjustment is not immediate, inflationary pressures provide signal that the system moves away from equilibrium, allowing banks to react and mitigate the cumulative process. Echoing Ricardo's message, the attending policy recommendation is disarmingly simple:

So long as the prices remain altered the banks' rate of interest is to remain unaltered. If prices rise, the interest rate is to be raised; and if prices fall, the interest rate is to be lowered; and the rate of interest is henceforth to be maintained at its new level until a further movement of prices calls for a further change in a direction or other (Wicksell, 1962: 189).

The banking system, and the central bank's discount rate, are assigned an important role. The willingness to factor price movements into interest rate decisions is essential in reducing the price volatility which would otherwise accompany the longer automatic adjustment. The importance of the institutional characteristics of the banking system is two-fold: it first justifies the setting of a pure credit economy, and second, by delaying automatic adjustment, it justifies policy interventions. Nevertheless, policy discretion in this case is of a rather constrained type, with policy decisions reacting to price movements, a theoretical conceptualization which would later provide the cornerstone for New Keynesian monetary theories.

Thus, the conceptual importance Wicksell assigned to the natural rate of interest and the commodity-money adjustment mechanism reflected little in his policy analysis. Although Laidler (2004: 25) rightly argued that the discrepancy between the two rates (which caused

prices to move away from equilibrium) ‘would be removed eventually, though, because a commodity currency usually lay in the background of Wicksell’s analysis’, policy argumentation pushed the commodity-money story underlying automatic adjustment in the background. The natural rate of interest received a similar treatment, remaining a theoretical construction, a concept around which the system gravitates.

Further reflecting on the policy implications, Wicksell (ibid, p. 191) noted an essential challenge to the applicability of his theory: the Gold Standard, which required discount policy decisions be tailored to balance-of-payment requirements rather than domestic price dynamics. This was not a shortcoming of the theory, Wicksell argued, but evidence that the Gold Standard was no longer suitable for an increasingly interdependent world economy. He recommended a fundamental overhaul that replaced the obsolete arrangement with an international paper standard and institutionalized international cooperation between central banks to maintain the stability of prices.

These rather visionary reflections would provide theoretical foundations for another important moment in British monetary history: the Keynesian narrative of discretionary monetary management.

2.2.2 Britain in the 1920s and the Macmillan Report

The next point of analysis focuses on the 1931 suspension of the Gold Standard in Britain. Against the backdrop of difficult economic conditions, the orthodoxy of free market economics was increasingly questioned, thus opening up a new space for discourses advocating activist policies. This saw the emergence of a new narrative of monetary policy, an account of a Central Bank that can control credit conditions in the economy by manipulating its liabilities side. It brought open-market operations into the theoretical realm as an active instrument for managing bank reserves.

The analysis of theoretical developments will concentrate on Keynes's (1930) *Treatise on Money* and the reflection of his ideas in the policy report drawn by the Macmillan Committee on Finance and Industry, as the author's place in British policy circles arguably created the single most important instance of theory and policy advice interacting to respond to what he perceived to be the urgencies of his time.

Key to understanding the new conceptualization of monetary processes is the rather unusual historical circumstances of the time: a prolonged post-war slump and the growing importance given to unemployment both by economic theory and by policy makers. A new-found international awareness of the global implications of gold as reserve assets could not be translated into coordinated action³³. In 1925 Britain unilaterally reinstated the Gold Standard at the pre-war parity³⁴, a measure hailed by the financial community as the cornerstone of return to stability. However, this failed to provide the necessary impetus for post-war recovery, a result many, most vocally Keynes in his *The Economic Consequences of Mr. Churchill* (1925), attributed to the damages to industry and trade caused by the defence of an overvalued pound. The Bank of England, the institution most intimately connected with the Gold Standard, was again placed at the centre of the controversy, and an increasingly loud public voice demanded an inquiry into the workings of the institution (Sayers, 1976).

Finally a Macmillan Committee on Finance and Industry was set up in 1929, seeking to come up with policy recommendations to tackle the depression. As the title suggests, monetary issues (coined as finance for industry) were framed to be the crux of the matter. Keynes, whose expertise on monetary matters was widely acknowledged by then, was one of the two academic economists on the Committee³⁵. Although his appointment was intended, in Skidelsky's words,

³³ The 1922 Genoa Conference called for international cooperation between monetary authorities to avoid the destabilizing effects competition for gold reserves would have on the post-war reconstruction efforts.

³⁴ At the rate of 113 grains to the pound.

³⁵ Along with T.E. Gregory from the London School of Economics

‘to give the appearance, not the reality, of radical movement’ (2005:419), he was to have an essential role in shaping its findings.

The final Report was the result of an intense process of negotiation and compromise³⁶ (Stamp, 1931). In going to great length to carefully avoid making the Bank of England the scapegoat, while still maintaining that monetary phenomena were the main factor behind the depression, it conformed to the rather ambiguous language of public policy papers: the monetary system was found to have failed ‘to solve successfully a problem of unprecedented difficulty and complexity set it by a conjunction of highly intractable phenomena’ (Macmillan Report, 1930:93).

The politics of the report created a tension between theoretical considerations and the policy implications it put forward. Thus, the revolutionary ideas about the monetary system, mostly attributed to Keynes (Gordon, 1972), were watered down to very general policy recommendations. The economic recession was framed as a consequence of price deflation, and to inflate the economy the Macmillan Committee recommended discretionary monetary policy while maintaining the Gold Standard. The first important step in constructing a case for discretion was to question the gold automatic adjustment mechanism (Stamp, 1931). The story of automatic adjustment, the Report warned, neglected the connection between the Bank Rate and the domestic economy. The Report thus brought the Bank Rate for the first time into public policy discourse as ‘a delicate and beautiful instrument’ of monetary policy, delicate because its use involves two conflicting policy objectives: the maintenance of the Gold Standard and internal credit conditions. Although due consideration was given to the contractionary implications of an exclusive focus on maintaining the gold value of sterling, the Report held that the Bank Rate was still better adapted to target the stability of the exchange rate rather than that of business. But it shied away from detailing the possible policy

³⁶ All but one members signed it, but added various addenda and reservations.

implications of this statement. It instead stated the main policy objective: with long-term price stability in mind, everything possible had to be done to raise prices. Thus the bank rate as a possible instrument of monetary policy performed a mysterious disappearing act: first rescued from the theoretical obscurity to which the Ricardian narrative had condemned it, to be quickly dropped for lack of a better instrument for preserving the Gold Standard.

Still, the Report hinted at the need for a new instrument of monetary policy: ‘the monetary authority is not as powerless as is sometimes supposed’, a sentence widely attributed to Keynes (Stamp, 1931). Nevertheless, the report was rather vague on detailing this room for manoeuvre. The answer, I suggest, can be found in the original source of most of the revolutionary ideas the Report contained, Keynes’s *Treatise on Money*.

2.2.3 The *Treatise on Money*

Keynes had already advocated in his 1923 *Tract on Monetary Reform* a set of policies that would allow monetary authorities control over domestic credit creation. Unlike most economists he accused of dozing away, he harboured no illusions about the claim that gold was regulating the credit system. He still he deemed it necessary, for international considerations, to maintain the Gold Standard, but under a new policy framework: replacing the Bank Rate with direct interventions for regulating the gold market (establishing a buying and selling price for gold), an innovative policy he saw at work during his civil service period in the India office. Like Wicksell, Keynes sought solutions for instituting the Bank Rate as an instrument adequate for influencing economic activity, prices and the labour market. The *Treatise* was intended to provide theoretical grounding for his early policy recommendations³⁷.

However, the *Treatise* was in fact giving theoretical grounding not to ‘the dogmas’ of the *Tract*, but to a different policy narrative, a change of ideas connected to Keynes’s

³⁷ ‘The new book on Monetary Theory which I have in preparation will, I am hopeful, throw much new light on my fundamental arguments in favour of the dogmas to which I have rashly given utterance without sufficiently substantiating them.’ (Keynes in Skidelsky, 1992:27).

recognized flexibility in dealing with policy issues (Skidelsky, 2005). The new policy narrative redefined policy room for manoeuvre by framing open market operations rather than the Bank Rate as the instrument and bank reserves as the operational target of monetary policy. In what appears to be a clear case of theory formation driven by policy considerations, I will argue that this was a strategic choice emerging from his interactions with the policy discourse of the leading figures at the Bank of England during the Macmillan hearings.

The Money Multiplier and the changing understanding of open market operations

OMOs had entered policy discourse as a discretionary policy instrument in the US after the November 1919 crisis that saw massive hikes in interest rates to defend the Gold Standard. Bindseil (2004) explained it as a discursive device to shift away from responsibility for the contractionary impact of short-term interest rate decisions³⁸.

In British policy practice, OMOs were nothing new at the time: they were understood as a mere method of making the Bank Rate effective³⁹ to attract inflows of gold. Nevertheless, the Phillips 1920's theoretical formulation of the money multiplier paved the way for a conceptual shift, from OMOs as passive instrument of monetary policy subordinated to interest rate decisions to an active tool of credit control through control of bank reserve positions. This suited perfectly Keynes's attempt to move away from money market rates as a policy target.

The money multiplier story's appealing simplicity is, in a similar fashion to the Ricardian excess money story, rooted in an automatic adjustment mechanism. Through its open market operations, the Central Bank determines the desired level of bank reserves. With a policy intervention directed at increasing the money stock, open market operations would create excess reserves - banks' current account holdings with the Central Bank over the

³⁸ Even OMOs enthusiasts like Friedman and Schwarz (1963) are surprised to note that the 1921 annual report of the Board of Governors of the Fed failed to mention the discount rates.

³⁹ Though not in the common understanding, after the 1890s new approach to policy making the Bank of England used direct borrowing to make the Bank Rate effective when it wanted to attract gold inflows as the portfolio of Treasury bills was very limited.

required reserves. These would automatically set off an increased lending activity (i.e. the multiplier mechanism). The asset adjustment would trigger liabilities adjustment, bringing the reserves to the required level and the money stock to the level desired by the policy intervention.

This new adjustment mechanism Keynes thought to integrate with the Wicksellian theoretical framework. From the Wicksellian connection the *Treatise* retained the explanation of price level changes on account of the difference between the natural and the monetary rates of interest, and the emphasis on the importance of long-term rates for investment (Leijonhufvud, 1981). The criterion for stability was defined as ‘the equilibrium between savings and investment’ (ibid: 222), while the ultimate condition of non-inflationary credit is the preservation of equilibrium between the rate of savings and the volume of new investment.

As explored earlier, Wicksell (1962) had developed a narrative where the money rate would (eventually) adjust to the natural rate through a (gold) reserves-constraint process, subject to the qualification that institutional characteristics of the banking system made the process rather lengthy. In other words, the excess (gold) reserves he empirically found to be dominating the British banking system at the time would allow for the monetary rate to be maintained below the natural one for long enough to trigger substantial price increases. The policy implication of a framework where the divergence between the two rates (and consequently inflation) was rooted in credit creation: active monetary management for credit control.

This is where Keynes enlarged and modified the Wicksellian framework to support the essential policy recommendation of the Macmillan Report, the desirability of discretionary policy making. The adjustment process is nevertheless quite different in the Keynesian narrative; OMOs are constructed as an instrument of a much more interventionist nature than the interest rate. This sets the frame for enquiring into the process of monetary management:

the focus is set first on the mechanics of the money multiplier, assuming the monetary authority is fully in charge of reserve positions. He then addresses the issue of whether banks have any significant control over reserve positions. Open market operations are essential to both narrative stages.

2.2.4 Fixed reserves: Chapter 25 'Ratio of Bank Money to Reserves'

Keynes (1930) starts his analysis of monetary policy by asking 'how the quantity of money is related to reserve money', an enquiry into the stability of the multiplier. For policy purposes and despite the inadequacy of the crude Quantity Theory of Money: 'the quantity of money remains [...] of exceptional practical significance because it is the most controllable factor' (ibid, p. 49). The underlying policy question is what would happen to a reserves injection through open market operations?

The crux of the matter was the possibility of excess reserves. With the qualification that there must be interest, yielding assets available, he maintained excess reserves would be unlikely under normal circumstances, a clear indication that he understood the importance of the call (wholesale) money market as explained by Bagehot (1876) in *Lombard Street*: 'That the member banks should wish to work as close as possible to their legal minima is explained by the natural incentive to keep down the assets not earning interest' (Keynes, 1930: 64). He thus established that excess reserves were not likely to exist as a rule⁴⁰, 'the aggregate of bank deposits (represented by M in our monetary equation), is a multiple, as nearly as possible constant, of the reserves of the member banks' (ibid. p. 64).

Nevertheless, articulating the monetary process through the multiplier, while still considering the call market, required an interesting argumentative turn. Banks turned to the call

⁴⁰ This had been the case for both England and the US. While England had no legal reserve requirements, the practice of 'window dressing' was in a sense similar to the US case where legal requirements see banks making recourse to the discount window or the call market to manage reserve positions.

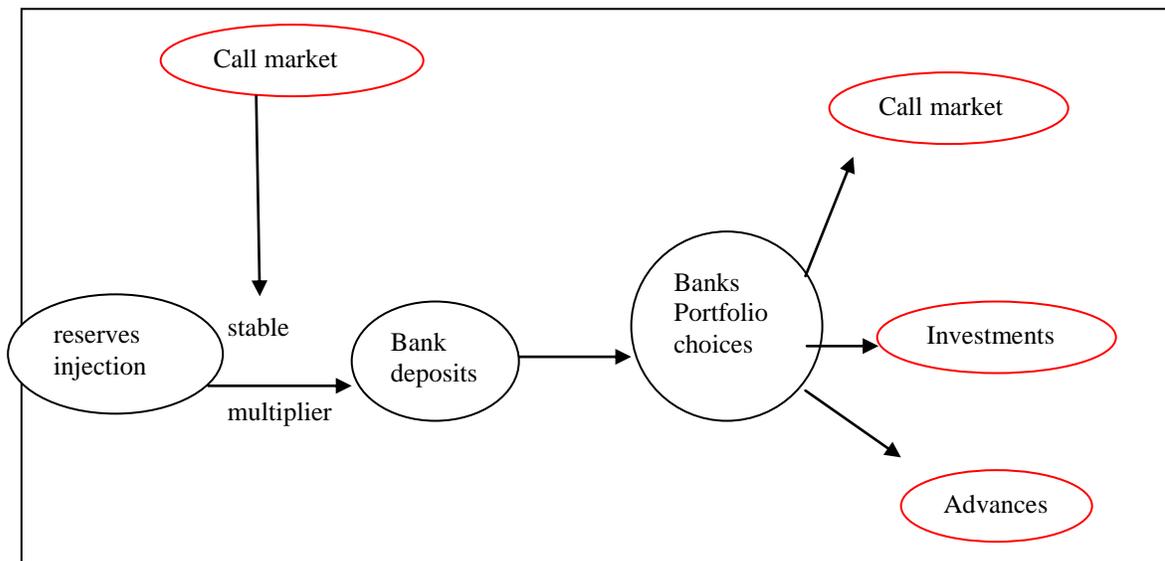
market⁴¹ twice within this process (see Figure 1): after a reserve injection to dispose of any excess reserves left from their asset decisions, and second, once the stock of money is settled, as portfolio option. Yet somehow the first stage is irrelevant in terms of banks' control over their reserves position - choice is only exercised over the second stage and within the constraints of the reserves-determined bank deposits:

what bankers are ordinarily deciding is, not how much they will lend in the aggregate – this is mainly settled for them by the state of their reserves- but in what forms they will lend - in what proportion they will divide their resources between the different kinds of investment which are open to them (ibid, p. 67)

Portfolio preferences are then exercised between the call money market, investments, and advances, in this order of liquidity, depending on expectations. While advances to customers (for working capital purposes) can fluctuate over time, there is no change in the aggregate. Aggregate credit activity is constrained by reserve positions.

⁴¹ Along with the discount window, though this is not central to the argument since the problem is framed as a question of reserves injection.

Figure 1 The Money Multiplier Process in the *Treatise on Money*



Source: produced by author from the *Treatise on Money* (Keynes, 1930)

Thus, under the assumption of given reserves, the chapter suggests that an injection of reserves would indeed set, via the money multiplier, credit and monetary expansion. However, framing the stability of the multiplier around the issue of excess reserves is problematic as in fact Keynes is not arguing for a stable multiplier, but a stable relationship between reserves and the stock of money once excess reserves are disposed. The basis for refuting the possibility of excess reserves, the call market, is at the same time the source of an inconsistency with the stable multiplier story, which assumes all reserves injections have to be converted into credit expansion for policy interventions to have a predictable (stable) effect. Still, the inconsistency is inconsequential when bearing in mind that Keynes's rationale behind this policy framework was the need to induce increased business investment to reflate the economy. This becomes clearer in the discussion of bank-reserve control.

Control of Bank Reserves

For the purpose of Keynes's argument, Chapter 32, The Control of the Member Banks, could give only one answer to the question of who has control over bank reserves. Framing discretion

as a question of employing OMOs as an instrument of monetary policy is theoretically only consistent with a view of reserves being controlled by the Central Bank. And Keynes did not hide his enthusiasm for OMOs as a method that allowed the Bank of England an absolute control over the creation of credit by the member banks' (ibid., p. 225).

In policy terms this is a rather revolutionary statement. It attempts to forge a theoretical connection between open market operations and credit control through the control of reserves. Discretionary policy-making means in fact discretionary open market operations. However, to integrate OMOs into monetary policy as *the instrument* of domestic credit control required the construction of a dichotomy between the bank rate and OMOs, a polarization built on the need to abandon the Bank Rate as the key variable of discretionary monetary management.

What accounts for this conceptual shift from the *Tract* to the *Treatise*? His advocacy of using Indian-style direct interventions on the gold market would have significantly helped isolate interest rate decisions from balance-of-payments considerations. And indeed he began the Macmillan hearings enthusiastically criticising the Bank for having neglected the contractionary consequences of imposing high rates to defend the Gold Standard. But the response of the Bank, though partly driven by the desire to avoid responsibility for depression, forced him to revise his narrative: Bank officials denied the link between the bank rate and overall credit conditions, a revival of the Real Bills doctrine where credit is demand-driven (Sayers, 1976; Skidelsky, 2005). The policy implications were immediately clear to Keynes: it amounted to saying that 'there is always the right amount of credit'. The agenda for monetary management could not be built on an instrument the Bank rejected up front as giving little domain over credit creation. The Bank Rate, as the Macmillan Report asserted, was better suited to target the stability of the exchange rate than that of business.

To establish OMOs as a viable policy alternative required addressing the long-standing understanding, 'the orthodox doctrine', that OMOs were a mere instrument for bringing the

market into the Bank. Indeed, Bank of England had by then well-established practices, with a pronounced asymmetric character (Sayers, 1976), of making the Bank Rate effective upwards when there was a glut of funds on the money market (a liquidity mopping-up operation).

The first step for constructing the dichotomy focuses on the source of expansion in the liabilities side of the Central Bank's balance sheet: gold, investments in assets (OMOs) at Bank of England's initiative and advances (the discount window⁴²). There is an essential difference between investments and advances in what concerns control: OMOs are entirely at the discretion of the Central Bank, while advances, though regulated through bank rate, ultimately depend on commercial banks' demand for liquidity and 'much wider complex of consequences which a change in the Bank Rate sets up' (Keynes, 1930: 165).

But could open market policy work independently of the Bank Rate? The orthodoxy's claim was that OMOs would produce an offsetting movement in advances unless accompanied by a change in Bank Rate, so that ultimately overall assets (and hence liabilities) would be a function of the Bank Rate. With this Keynes disagreed on the grounds that the 'kinds of effects produced by the two methods are materially different' (ibid, p. ?). In fact, he argued, the substantial difference, manifested in their effects on the sources of high-powered money expansion, is that OMOs produce:

- a) A direct effect on bank reserves and hence credit (the multiplier).
- b) Probably more important, since they involve long-term instruments, OMOs affect long interest rates and hence investment activity.

Reserve injections would increase bank reserves and loans. While this might put downward pressure on market rates, the effect is not sizeable (rates would fall 'later a little lower') and most often there need not even be a material weakening of rates. This essentially presumes that banks' loan policy reacts faster than money market rates (Bindseil, 2004), a claim questioned

⁴² In today's central banking terminology this is known as standing facilities, including both the discount window and the deposit-taking facility.

since Bagehot (1876). Similarly he held liquidity mopping-up operations to be entirely efficient only while the Bank Rate was kept above the market rate. Indeed, liquidity tightening through OMOs, which would see money-market rates increasing, ultimately required the Bank of England to prevent access to the discount window (advances in his terminology) by raising the Bank Rate.

Thus, in between the lines the *Treatise* recognized that OMOs cannot be separated from Bank Rate decisions because of the operating principles of the call market. This implied that banks did influence their reserve positions. The discretionary power he held OMOs to give Bank of England in its relation with the call market and independently from the Bank Rate functioned as a discursive device for advocating a policy focused on the link between OMOs and long-term rates. Although he framed OMOs in terms of the money multiplier, the *Treatise* narrates discretionary monetary policy ultimately grounded in open market operations as instrumental in reviving investment activity.

Keynes appeared to have understood that a critique of a dominant narrative of policy making is effective to the extent that it manages to construct its own story. Just as Ricardo had promised to those unhappy with the first gold standard suspension a world of automatic adjustments and equilibrium free of the ‘dangerous’ intervention of the monetary authority, Keynes offered the equilibrium sceptics a central bank that could engineer a successful post-war economic recovery.

This required the development of an equally straightforward counter-narrative, and in this Keynes could not escape the simplistic nature of the narrative he was trying to displace. The Macmillan hearings made him realize that a narrative built around the Bank Rate would not be powerful enough to change policy, as the Bank officials’ Real Bills doctrine would have caused lengthy controversies unsuited for his sense of urgency. His answer was to advocate what he perceived as a new technique: OMOs as the instrument of monetary policy to

manipulate interest rates at the long end of the yield curve. By trying to put it on equal footing with the Bank Rate he was forced to frame OMOs into the theory of the money multiplier. This was the source of a series of inconsistencies, which nevertheless did not affect his main message: discretionary monetary management in the form of reserve injections would trigger increased investment activity, if not by an increase credit activity, most definitely by lowering long-term rates.

Indeed, in the *Treatise*, the signal of the divergence between the natural and the monetary rates of interest is a rise or fall in investment that would further trigger price adjustments (Leijonhufvud, 1981). A monetary effect requires a monetary treatment, hence it is the role of the monetary authorities to correct the market rate, by interventions at the long end of the market through an extraordinary dosage of open market purchases ‘to the point of satisfying to saturation the desire of the public to hold savings deposits’ (p. 370). This amounted to an extreme intervention for extreme circumstances, best suited to bring long-rates down when the ‘bearishness of the public’ was not very strong.

2.2.5 The suspension of the Gold Standard and the *General Theory*

Keynes’s rhetorical efforts to construct an alternative to the interest rate policy under the constraints of the Gold Standard were however neutralized by a deepening crisis in the world and British economies. The instability following the 1929 US stock market crash increased the difficulties of maintaining the Gold Standard. In 1931 strong pressures on the gold market forced Britain to go off the Gold Standard only 6 years after reinstating it. Nevertheless, the *Treatise*’s policy argument that driving down long-term rates would revitalize industry was becoming increasingly attractive. The conversion of the 1917 5% War loan rate, commonly understood to have been an essential factor in maintaining long rates on securities at an unnecessarily high level, was the beginning of a long period of cheap money policy.

However, the cheap money policy failed to affect significantly long-term rates and stimulate economic activities. The next major work Keynes published in 1936, the *General Theory of Employment, Interest and Money*, signalled his scepticism that monetary policy could efficiently respond to the extraordinary depressionary conditions of the moment. Indeed, the focus shifted to the short-term stabilization potential of fiscal policy grown out of his increasing conviction that the time lag for monetary policy to bring down long-term rates was excessive compared to the economic conditions of the time, because of the power of the Bear army. In the famous IS-LM framework later developed by Hicks, this was subsequently taken by ‘orthodox’ Keynesians to mean that monetary policy was ineffective due to the low interest elasticity of investment (Leijonhufvud, 1981).

The new focus of the *General Theory* on liquidity preference retained the Keynesian narrative of monetary policy articulated in the *Treatise*. Open market operations remained the instrument for arriving at a ‘given’ stock of money, through the money multiplier. Short-term interest rates are either not affected or the impact is secondary; long-term rates are set at the level where the desire to hold liquidity matches the given stock of money.

Thus, in the theoretical realm, the displacement of the Ricardian automatic adjustment mechanism was only apparent. There is a line of continuity between excess money and the OMO narrative, replacing gold with reserves as a constraint for credit creation. This would constitute the basis for the next important change in monetary policy thinking, a narrative widely recognized as monetarism.

2.3 Monetarism

The third major narrative of monetary policy consolidated its dominance during the 1970s years of high inflation. Monetarism, the narrative of the dangers associated with discretionary

monetary policy, had been around since the 1950s. It had however little influence against dominant Keynesian accounts that denied that monetary policy had much short-run stabilization potential, given the time-lags involved in responses to policy measures.

The ‘orthodox’ view of monetary policy which Milton Friedman, the leading character of the monetarist camp, challenged was well represented by the 1959 Radcliffe Report. The report argued that a long-term view rather than fine-tuning ought to guide the central bank’s actions, and identified the structure of the interest rates rather than the quantity of money as key to the transmission mechanism (Gordon, 1972). It rejected any relevance of whatever definition of money stock for aggregate demand dynamics, taking a broader view of the overall level of liquidity in the economy. This shifted analytical focus from the liabilities to the assets position of the financial sector (Laidler, 2004). A framework which conceptualized banks as ‘lenders’ rather than ‘creators of money’ thus necessarily positioned the interest rate at the centre of both policy discourse and practice.

2.3.1 Theoretical foundations of Monetarism

Writing in 1967, Hicks identified two strands in monetary theory, divided by their attitude towards monetary management. One of them, going back to Ricardo, held that disturbances to the economy would be eliminated if any monetary innovation would be made to behave like commodity-money. And at the time, he claimed, there was one notable ‘Ricardian among us’: Milton Friedman.

Monetarism conceptualized a system whose equilibrium would be disrupted by monetary phenomena, and a theory of the business cycle that assigned monetary origins to both inflation and output fluctuations (Laidler, 1991). Money is a very powerful source of disturbance only if it gets out of order, and it can only do so because of a mistaken policy stance. In a Ricardian fashion, maintaining money at a neutral level by constraining the

discretionary power of the monetary authority would seriously limit the possibility of major disturbances.

The monetarist narrative of inflation further reformulated the Quantity Theory of Money in terms of a stable demand for money. Built around Friedman's (1956) empirical claim that monetary processes in the United States supported a consistent relationship between the changes in money supply and money income, monetarism put forward a stable demand for real cash balances determined as a function of social and institutional factors ultimately reducible to real income (Laidler, 1991). With output determined by productivity and individual preferences, it implied that the quantity of money moved in tandem with prices.

Once a stable demand for money was postulated, monetarism redefined the equation of exchange as a causal relationship. While a stable demand for money *per se* could not logically establish a causal relationship from the quantity of money to money-income (Laidler, 1991), the neutral money assumption dictated the direction of causality: a central bank fully in command of the money stock determines price dynamics. Against the Keynesian narration of inflation arising from labour market dynamics, monetarism once again forged a theoretical conceptualization of monetary policy as instrumental in managing aggregate demand and prices.

Once inflation was framed as a problem of discretionary monetary management, the adjustment process echoed the Ricardian excess money narrative. Any excess expansion in the supply of money over the level of desired balances would create additional purchasing power, automatically setting off an inflationary process.

2.3.2 Monetary Policy Framing

Defining policy through the neutral-money assumptions further provided a well-defined array of policy instruments. Making fiat money behave like commodity money premised reserve-

constrained credit and a quantitative approach to monetary policy implementation argued in a strict money multiplier framework. Open market operations are the necessary and sufficient instrument for controlling bank reserves and hence movements in the money stock. The representation of the central bank also changes: no longer solely in control, but the key initiator of monetary change (Chick, 2005) through its decisions to alter reserve positions.

To construct the case for quantitative targeting Friedman similarly deployed the Keynesian strategy of constructing a dichotomy between the interest rate and OMOs. However, this was not a strategic choice, as in the Keynesian story, of which instruments and targets would be politically feasible to advocate, but it claimed strong theoretical foundations (Friedman, 1968): the use of interest rate as policy variable is simply difficult to justify theoretically. The monetarist quantity-price dichotomy is framed in terms of the long-term rate, sidelining questions of relevant short-term money market rates, an omission neither accidental nor erroneous, but vital for making the case against interest rates. The reasons that the interest rate makes a poor operational target are three-fold, as Friedman explained in his 1968 address to the American Economic Association, unsurprisingly entitled the *Role of Monetary Policy*:

- **Investment and consumption have low interest-rate elasticity.** This is a standard reinterpretation of Keynes's scepticism about the time-lag with which long rates respond to a cheap money policy (Leijonhufvud, 1981), which shifted orthodox Keynesian policy recommendations to fiscal policy measures. But Friedman turns an argument against the short-term stabilizing potential of monetary policy into one about the appropriateness of the policy framework chosen.
- **The central bank cannot control interest rates,** as cheap-money policies can only have a temporary effect on interest rates. This argument is entirely built on the assumption of an exogenously determined (or 'given') money stock. OMOs aimed at increasing the reserve base would, through a money multiplier effect, trigger a

monetary expansion. This is claimed to put downward pressure on interest rates, not as Keynes argued in the *Treatise* through OMOs operating at the long end of the market, but through a downward sloping liquidity preference schedule: people can be induced to hold a larger quantity of money only by bidding down interest rates. However, for the same liquidity preference considerations, the increased spending (excess purchasing power over the real balances desired) would see rising income and a rising liquidity preference schedule pushing rates back up towards the initial level. Friedman even ventures a time frame for the adjustment: ‘in say, something less than a year’.

- **An uncertain impact of interest rate decisions.** This logically follows from the framing of interest rate management as an issue of long-term rates, which takes Friedman’s argument into a logical inconsistency. In this framework interest rates are determined in a demand/supply space, with demand depending on liquidity preference and supply set by the Central Bank through OMOs. The policy instrument is clearly not the interest rate, and the Central Bank has little control over the outcomes. Nevertheless, this uncertainty, in Friedman’s words, renders the interest rate as a rather insane policy objective: it amounts to guiding a space vehicle towards the wrong star (and implicitly with the wrong board instruments).

The criteria used to construct the case against an interest rate policy produced an account of ‘good’ monetary policy: first and foremost ‘to prevent itself from being a major source of economic disturbance’ (Friedman 1968: 13). Discretionary measures ought to be applied only in extreme cases, when the disturbance is ‘a clear and present danger’ to check monetary growth. The case against discretion rests on predictability: anchoring inflationary expectations is essential, through a quantity-driven approach with a money growth rule as a built-in stabilizer:

My own prescription is still that the monetary authority go all the way in avoiding [...] swings by adopting publicly the policy of achieving a steady rate of growth in a specified monetary total [...] a rate that would achieve rough stability in the level of prices of final products, which I have estimated would call for something like a 3 to 5 per cent per year growth in currency plus all commercial bank deposits (Friedman (1968: 16).

And this is where monetarism fundamentally departs from the Keynesian OMOs narrative: quantitative targeting is not essential to an activist stabilization but to a neutral money policy. Monetary policy implementation is argued in a strict money multiplier framework, where OMOs alone are sufficient to steer the monetary base (Bindseil, 2004), rendering unnecessary a policy of changing either reserve requirements or standing facilities:

The elimination of discounting and of variable reserve requirements would leave open market operations as the instrument of monetary policy proper. This is by all odds the most efficient instrument and has few of the defects of the other [...] The amounts of purchases and hence the amount of high-powered money to be created thereby determined precisely [...] and render the connection between Federal Reserve action and the changes in the money supply more direct and more predictable and eliminate extraneous influences on reserve policy (Friedman, 1960: 50-51).

Essentially for arguing policy, this framing sees a reinterpretation of monetary policy stances. Fixing explanations of monetary processes through quantity measures leads to the paradoxical claim that the observed empirical correlation between low interest rates and low money growth is a sign of tight policy and vice versa. This engenders an implicit contractionary bias: even a tight interest rate policy in times of high and rising cost-push inflation with working capital

needs feeding into higher money growth would be interpreted as expansionary, leading to a spiral of deflationary measures.

2.3.3 Critiques of monetarism

Monetarism was contested on both conceptual and methodological grounds. Conceptually, Post Keynesians argued that monetarist narratives essentially depended on the exclusion of institutional characteristics. Kaldor (1982), Moore (1988) or Dow (1996) forcefully rejected the Ricardian argument that credit creation could be constrained by controlling reserves positions. While internally polarized on the precise working of the transmission mechanism, Post Keynesians argued that the control of high-powered money and a stable money multiplier, assumptions essential to the exogenous control of the money supply, ignored institutional and historical features at different stages in the development of the banking sector (Chick, 1986). Money's particular functions and attributes greatly increased the risks of systemic effects in the banking sector and required central banks to assume lender-of-last-resort functions to maintain confidence. Furthermore, financial innovation, either through growing wholesale markets or liability management practices, reduced the scope for controlling (a specific) quantity of money, a lesson the Ricardo-inspired Peel Act taught the Bank of England during the 18th century, and Goodhart (1994) later popularized as a common-sense 'law' .

Indeed, as Keynes (1930) forcefully argued, the effectiveness of any reserve targeting strategy depends on the institutional characteristics of the market where banks trade liquidity with each other. Where banking operates under reserve requirements, the demand for liquidity on the wholesale market comes from banks that need to supplement their reserve positions, while supply comes from banks with excess liquidity. Technically, the Central Bank does not operate on this market, unless it chooses to do so by using a third party. Rather, the Central Bank conducts open market operations with counterparts from the banking sector (not all banks are counterparties), usually by means of repurchase agreements (repos) or reverse repos.

A salient feature characteristic of the interbank market is its inherent instability (Bagehot, 1876). Not only are both the supply and the demand side of the interbank market subject to transitory shocks linked to the so-called autonomous liquidity factors (cash in circulation, the Treasury's deposits with the Central Bank, excess/deficient reserves) but the demand for reserves is highly interest-inelastic (Bindseil, 2004). Largely unpredictable changes in the liquidity positions of the market players carry two implications.

First, it makes it virtually impossible to target a certain level of reserves (Moore, 1988). OMOs conducted within an operational framework of quantity-constrained reserves create excess/deficient reserves, for which the banks will quickly search the most profitable placements. Banks that find themselves with excess reserves that receive no or at best below-market interest rates will not engage in time-consuming hunts for credit-worthy borrowers, but turn to the money market for alternative placements with higher yields (Goodhart, 1994). Similarly, banks that need to supplement their reserves to the required level will rather pay punitive rates on the money market than cancel loans. In other words, short-term demand for liquidity is largely interest-inelastic.

Furthermore, reserve targeting engenders volatility in interbank rates. The magnitude of the volatility depends however on the period of calculation for compliance with reserve requirements, the maintenance period. The highest volatility is registered with a daily maintenance period, as excess reserves push overnight interbank rates downward to zero or to the level of the deposit facility, while deficient reserves would have to be accommodated at a penal rate either by the market or the Central Bank. Averaging reserve requirements over a longer period than one day create a more stable pattern of overnight rates only up to the end of the calculation period, when excess/deficient reserves would produce similar effects as in the daily calculation regime (Bindseil, 2004). This point, it will be later argued, was of particular relevance for the Romanian central bank's reserve-money targeting strategy.

Even if monetary control worked according to monetarist premises, the assumption of a stable (and predictable) demand for money proved difficult to reconcile with empirical evidence. A second critical question referred to separating the impact of money growth on the two components of money income: prices and real income, particularly for short-term considerations (Laidler, 2004). Ultimately it was admitted that monetary causes can have real effects even in the short-run, but this failed to alter the narrative: for policy purposes, a money-supply growth rule would ensure price stability.

The relevant definition of the money supply was again a matter of contention even within the monetarist camp. Defining money only as means of exchange, neutral for the real economy, has bearing on the choice of relevant monetary aggregates in testing the monetarist propositions. Thus, it is only the narrow money (M1, i.e. the currency plus non-interest-bearing demand deposits held by the public) that confers direct purchasing power. Hence, strictly speaking, only excess increases in the narrow money supply will induce an increase in spending and the attending inflationary pressures. This distinction between money as a medium of exchange (M1) and money as a store of wealth (M2 or any broader aggregate) tended to get blurred within the monetarist empirical analysis. Methodologically ‘anything goes’ as long as it has predictive power (Ouanes and Takur, 1997).

2.3.4 Policy Practice

Holding that inflation is a purely monetary phenomenon generated by excessive growth of the money supply in relation to output leads to a crucial conclusion. Nothing will stop inflation but a stop in the undue rise of the money supply. Since the money supply is controlled by the Central Bank (hence its exogeneity), inflationary pressures can be subdued through informed action. The movements in the money supply can be analysed by looking at the structure of the assets and liabilities of either the entire banking system - the flow of funds approach - or just

that of the Central Bank - the money-base approach (Nicholas, 2003). The first locates the source of inflationary pressures in the movements in the liabilities of the banking system (broad money stock). It first disaggregates the broad money stock into its corresponding assets – net foreign assets, net credit to government, credit to private sector and other net assets, to then identify which is the most likely generator of pure purchasing power. The increases generated by net foreign assets are held to spill over into import expenditure, while traditionally the credit to the private sector is tacitly accepted to be non-inflationary due to its potential contribution to output increase (though this contradicts the quantity theory requirements that output is fixed in the short run). Thus, the obvious suspect left is credit to government, viewed as the major source of expansion in the money stock (Friedman, 1960). Within the monetary base approach, the central bank's asset side is disaggregated. The policy message is simple: refrain from monetizing budget deficits to avoid inflationary pressures.

This message embodied a paradigmatic shift in the conceptualization of economic policy during the 1970s crisis of stagflation. The combination of high and rising inflation with high and rising unemployment, was narrated as a crisis of the Keynesian state. The monetarist articulation of the 'economic problem' arising from the state's incapacity to perform as an efficient economic actor fitted well with the right's political diagnostic: a state overloaded and overburdened by the hegemony of Keynesianism and corporatism (Hay, 2004). The solution was obvious in its simplicity: predicate economic policy on monetarist foundations, a solution greatly appealing to the electorate of both the UK and the US. Thus began the rise to hegemony of a new paradigm of economic management: neoliberalism.

The remarkable thing about monetarism in this phase of the neoliberal project was its increasing strength against its failure to structure practices of monetary management as predicted. Indeed, Friedman's unabated insistence on the essential role excessive money creation plays in setting off inflationary processes was eventually rewarded: policy in the US

shifted to quantitative targeting, a shift constructed as the only available method for fighting the inflationary spiral of the 1970s. Monetarist thinking at the Federal Reserve had been in place since 1970, when M1 was established as an intermediate target. Still, the adjustment was enacted through the federal funds rate: the Fed would respond to deviations from the quantitative target by varying the federal funds rate. A new Fed governor, Paul Volker, sought to bring policy further in line with monetarist rhetoric: between 1979 and 1982⁴³ growth rates for reserves subsequently were derived from a three month M1 growth rate. Nonetheless, in policy practice the federal rates could not be dismissed completely, hence a corridor was set to complement quantitative operational targets.

Since M1 dynamics shaped expectations of further rate movements, this approach not only increased volatility in short-term rates but also in monetary aggregates. The rationalization of this volatility was entirely Friedmanite: the incapacity of the monetary authority to enforce the money growth rule. Several changes to the operating procedure followed, but without much success in consolidating the claimed monetarist causal relationships. Eventually federal funds rate targeting became again the official policy stance in the 1990s (Bindseil, 2004). Similarly, the Thatcher government's monetarist credentials were not translated into policy practice. Instead, monetary targets came to be understood as 'a convenient, pragmatic and largely 'presentational' device, behind which to conduct a familiar Keynesian deflation of the economy, without having the inconvenience of having to specify the likely real output and employment consequences' (Thompson, 1986:30).

Nevertheless, monetarism and money neutrality retained its foundational status for economic theorising well into the 1990s (Mishkin, 2004)⁴⁴. While quietly abandoned for

⁴³ Consequently an intense debate was sparked whether the Fed was doing quantitative targeting or not. Some claimed it was a simple rhetorical exercise designed to protect the Fed from the public disagreement with the contractionary implications of a high rate policy (Bindseil 2004).

⁴⁴ The quantity of money versus interest rate debates was for long treated by most academic macroeconomists as an empirical question, and the money multiplier still dominates textbooks explanations.

guiding policy decisions in western countries, the narrative was mainstreamed into the stabilization policies of the International Monetary Fund. Monetary targeting became standard policy advice, with quantitative performance criteria specified either on base money or its sources targets with a view to achieve a certain rate of expansion of the money stock and thereby a certain target for the price level (Keller and Richardson, 2003). This development was connected to the increasing hegemony of neoliberalism in international development discourses, which the next chapter will argue, has been essential in the process of transforming socialist economic relations.

2.4 Conclusion

This chapter opened up questions of power and politics in the formulation of monetary theory and policies. It modified Niebyl's conceptual apparatus to show how, historically, narratives of monetary crisis and policy solutions consolidate through political processes of assigning meaning and establishing relevant concepts for analysing monetary processes. While the Ricardian narrative of excess money and crisis was incorporated into British legislation with the tacit approval of a Bank of England keen to revive its banking business, practices of monetary management reflected the increasing importance of interest rates in an institutional context marked by rapid innovation attending industrialization. Throughout the 19th century, the struggle to reconfigure the relationship between the Bank of England and money markets involved policy innovation, reform and flexibility to negotiate conflicting imperatives.

Keynes's contribution to monetary theory further reflected the challenges involved in tailoring policy to existing institutional configurations and dominant interpretations. His theoretical conceptualization and policy argumentation incorporated, unlike Ricardo, a rich institutional component. The operating principles of the call money market were essential for

framing monetary policy as pivotal for tackling the crisis. The apparent commitment to an automatic adjustment mechanism, despite the implicit Wicksellian foundations of his analysis, grounded a pragmatic search for constructing a convincing narrative of discretionary policy making against the Bank of England's Real Bills doctrine. This sought to modify not only the theoretical status of open market operations, but also the practices of liquidity management, which Keynes hoped would positively affect the long-term interest rates relevant for investment and recovery. The power of the bear army discouraged Keynes' emphasis on monetary policy, which gradually evolved into a widely held idea of an impotent monetary policy (Woodford, 2006).

Friedman modified this narrative to argue that quantitative targeting strategies, operated through open market operations alone, would provide the necessary curtailment of monetary policy discretion to which he assigned the inflationary episodes of the 1970s. While pleading for eliminating policy discretion, monetarism articulated the image of a powerful central bank as key originator of monetary change, and monetary policy as key to controlling inflation. This representation, the next chapter will argue, played an important role in positioning monetarism at the centre of an increasingly powerful paradigm of economic management (and political ideology): neoliberalism. Indeed, while monetarism turned out to be of little consequence for modifying policy practices, its consolidation as foundational monetary theory has to be understood through the consolidation, normalization and institutionalization of neoliberalism (Hay 2004). The increasing hegemony of neoliberalism towards the end of the 1980s permeated international development interventions: monetarist narratives were parlayed into IMF's technocratic discourses, structuring the institution's policy interventions in countries experiencing economic crisis around the question of stabilization. In this context, the Berlin Wall fell, and former communist countries turned to the West for advice on how to transform the crisis of communism into a successful transition to capitalism. The next chapter will argue

that international policy advice, and the rationalities of monetary policy these constructed, was instrumental in designing reform through neoliberal logics.

Chapter 3. Repoliticizing ‘transition’: neoliberalism, monetarism and the IMF

Monetary policy, the last chapter argued, is inherently political because it involves struggles over meaning and representation. Hegemonic narratives are contingent and contested, requiring discursive strategies and institutional flexibility to reconcile gaps between policy models and institutional practice. These claims will be substantiated in the rest of the thesis by focusing the analytical attention on the consolidation of the National Bank of Romania. A first step in this process is to redefine transition as transformation, a process whose roots must be traced to historical conditions outside national borders. Indeed, there is a historical dimension to the policy choices in post-communist Eastern Europe: had change occurred in the 1960s or 70s, policy priorities would have been different. Through a historical coincidence, the dismantling of the Eastern European socialist system began as neoliberalism consolidated its hegemonic position in global agencies and discourses. Neoliberalism is defined as a discursive structure that constitutes a powerful model of economic development predicated on the optimality of markets in producing the most efficient outcomes.

Indeed, Pop (2006) describes the Eastern European mood after the fall of communism as one of enthusiastic willingness to embrace the unquestionable Western norms of a liberal democracy and a market economy, the opposite of the plan and the monopoly of the communist party. The mood was confident, as were the promises: a quick transition to a market paradise of consumer well-being and efficient production. Against this optimism that the development gap could be bridged quickly, postcommunist transformations were scripted as naturalized processes of neoliberal marketizations (Smith, 2002). Neoliberal discourses presented system-wide change as a fundamentally simple process if policies were consistent

with market efficiency assumptions. A successful reconstitution of economic processes as market-driven processes required in the first instance an irreversible decision to break up the politico-economic nexus of the central plan: economic decisions, the experience of planned socialism clearly showed, would result in an efficient allocation of resources only under market conditions.

International institutions, including the IMF, the World Bank or the European Bank for Reconstruction and Development, played a critical, threefold role in this process (Zecchini, 1995). They (i) were instrumental in catalyzing financial support from multilateral sources, (ii) provided economic policy advice, and (iii) ensured that this advice was complied with. For a substantial time, however, the IMF had a more immediate and relevant presence (Portes, 1994), so that deviation from IMF policy advice has been the exception rather than the rule (Sachs, 1996).

Indeed, while the IMF has always emphasised national ownership of transition policies, its role in post-communist policy-making has gone well beyond an impartial provider of technical advice. The IMF's leading financing role reflected the mechanism of aid assistance: through cross-conditionality, both bilateral and multilateral financing was made conditional upon securing its approval of the economic strategy. This configuration of international interventions was not accidental, but had been structured by neoliberal discourses of reform. Commitments to market processes produced a well-defined sequencing of the system-wide change towards marketized relations: price liberalization and stabilization first, privatization and liberalization of other economic fields later.

Thus, the chapter will argue, the hegemony of neoliberal rationalities in international development discourse placed the IMF in a unique position to influence, and where necessary dictate, domestic macroeconomic policies. Getting prices right, the IMF held, raised two immediate policy concerns: to identify what would obstruct this adjustment, and once these

obstacles were removed, how to ensure that prices remained there. The answer to these questions the IMF constructed through a monetarist narrative of excess aggregate demand that legitimized its standard stabilization interventions. Its analytical framework drew on Western research on the macroeconomics of central planning, for the IMF's policy discourse was careful to state that the Eastern European challenge was unprecedented, and thus required careful consideration of the specific legacy of central planning (Lane, 1991).

The chapter will first provide an account of shifting neoliberal rationalities and their reflection in critical conceptualizations, to then focus on the political economy of the IMF's crisis interventions. It will argue that the IMF's standard narration of crisis identified central banks as essential instruments of institutional change and neoliberal 'policy-making'. Monetarist narratives (ideologically) legitimated neoliberalism and effectively enacted neoliberal principles of economic governance in the central bank. The IMF's entry on the domestic policy scene changed the dynamics of policy processes and initiated discursive renegotiations of the relationship between various policy actors, imposing new strategic trajectory for (state) institutions. The chapter then goes on to map the articulation of the IMF's standard stabilization narrative in the formerly planned context, tracing the discursive operations through which monetarism both came to construct, and promised to tackle, the socialist macroeconomic problem.

3.1 Neoliberalism and its phases

The 1970s marked a paradigmatic shift in international discourses of economic development, replacing Keynesian optimism with Chicago School neoliberalism. With neoliberalism came an epistemological shift engendering a new form of intelligibility: the market (Lemke, 2001). It expanded the object of economic efficiency from the economic domain to all forms of human

action, instating the market as ‘a kind of permanent economic tribunal’ (Foucault, 1978, in Lemke, 2001).

Neoliberalism, rather than a monolithic and static project, has seen three historical shifts (Peck and Tickell, 2002). What began as a philosophical moment of the early 1970 (a proto neoliberalism) in the Chicago school mode of free market economics was transformed by the Reagan and Thatcher governments (and various dictatorships in Latin America and Asia) into a specific economic-political project militating against the Keynesian state: the extension of market logics into state domains. From its roll-back or normative stage, neoliberalism increasingly crystallized in a roll-out (Peck and Tickell, 2002) or normalized and necessitarian stage during the 1990s (Hay, 2004). These shifts occurred against neoliberalism’s resilience and impressive capacity to redefine itself, a resilience which Bourdieu (1998) assigned to its successful alignment with the dominant configurations of political-economic power.

Critical conceptualizations changed to reflect these shifts: neoliberalism has been increasingly understood as the transformation, rather than the end of politics (Foucault in Lemke, 2000: 11). Thus the increasingly hegemonic discourses of neoliberalism evolved from a destructive and discrediting mode to the construction of neoliberalized modes of (self) governance and regulatory relations. In its latest phase, neoliberalism was explicitly linked to the political construction of markets and practices of economic management that favoured financialized accumulation (Dumenil and Levy, 2001; Palley, 2007). For instance, a paradigmatic example of the increasing financialisation of global capitalism has been the growth in derivative instruments, as financial market deregulation opened up spaces for speculative gains from betting on volatility (in interest rates and exchange rates). The Bank for International Settlements (2000) statistics are edifying in this respect: in December 1998,

derivative instruments⁴⁵ amounted to US\$ 80 trillion, over four times the world GDP. Ten years later, the total reached US\$ 684 trillion, over twelve times the world GDP.

Furthermore, it became increasingly accepted that analytical attention had to be expanded beyond the heartlands of neoliberal discursive production: North America and Western Europe (Larner, 2000). Conceptualizing neoliberalism as an extralocal project contributed to a fast expansion in the research on the consolidation of the 1990s deep neoliberalism in the developing world (see DeMartino, 2000 for an overview).

Instrumental in this process was the parlaying of deeply political decisions into the technocratic discourses of the 'Washington Consensus' type (Peck and Tickell, 2002). A standardized package of policy measures underlying international development interventions, the Washington Consensus aimed at establishing the fundamental principle of neoliberal economic doctrine: getting prices right to ensure an efficient allocation of resources. Subsequently, the 'division of labour' in international development assigned stabilization to the IMF, while the World Bank, along with various regional organizations, would insist on structural change through privatization and liberalization (Onis and Senses, 2005).

The ascendance of macroeconomic stability on the IMF's policy agenda instated Chicago school monetarism as policy discourse and changed policy practice. It established financial programming as standard policy analysis and conditionality as the disciplinary technique for ensuring compliance with Fund-designed performance criteria. Reflecting the hegemony of the monetarist discourse, financial programming identified the quantity of money as policy instrument for influencing macroeconomic developments (Mussa and Savastano, 1999). As a narrative of money above a natural level fuelling excess demand, monetarism constructed policy discretion as a powerful source of disturbance. Since under a series of restrictive assumptions financial programming linked money supply expansions to government

⁴⁵ Over 65 per cent of these were interest rate contracts, and 10 per cent foreign exchange rate contracts

spending and thus naturalized the idea that both inflation and external imbalances were the ugly creatures of irresponsible politics, macroeconomic stability became a question of enforcing macroeconomic austerity (Friedman, 1969). This further reflected in the IMF's approach to crisis: 'rational economic policy' can only be formulated without the intervention of politics, an approach which consequently identified the central bank as the institution most likely to share this rationality ethos (Krueger, 2003, in Woods, 2006).

3.2 The political economy of austerity

The aptly named shock therapies thus became standard advice for countries experiencing balance-of-payment problems. There are two essential dimensions to a standard IMF crisis intervention: the economics of the programs and the change in the politics of the policy process. The discussion will focus on the IMF's policy discourses around the fall of the Berlin Wall, while later chapters will map changes in IMF's theoretical conceptualizations as they reflected in the policy advice it gave to Romania.

3.2.1 The economics of stabilization

The design of a financial-programming-based stabilization package, as Killick (1995) explained in detail, builds on a series of identities and constructs causal relationships through a monetarist logic. It sees excess demand, driven by excessive domestic credit creation mostly orientated to financing government deficits, as the primary driver of inflation and/or balance-of-payment imbalances. Assigning monetary causes to the crisis thus leads to a crucial conclusion: inflation, and external imbalances, can be contained by adequate control of the money supply.

Thus the analytical core of the IMF approach, as it consolidated in its Latin American programs during the 1980s, focused on the sources of growth in the money supply, either

through a flow of funds or monetary base approach. The typical format for crisis interventions, a Stand-By Agreement (SBA), established a money supply growth rate consistent with the desired level of inflation (and foreign reserves accumulation), and consequently derived a growth rate for the sources of the money supply. To ensure government compliance, these projections would be instituted as quantitative performance criteria: ceilings on domestic credit (or central bank credit to commercial banks), complemented with floors for international reserve and contractionary targets for fiscal spending. A money neutrality approach underlined the monetarist expectation that credit constraints would have few negative consequences for output. ‘Heterodox’ income policies, that reflected IMF’s experience in Israel (1985) and Mexico (1989), later amended orthodox fiscal and monetary policy prescriptions with a restrictive income policy, aimed at containing wage growth (Bofinger *et al*, 1997).

Another important component of stabilization programs referred to exchange rate policy advice, which addressed two interconnected concerns: the immediate policy response to balance of payments crisis, and the optimal regime choice for avoiding future imbalances.

During the 1980s, the IMF tended to favour exchange rate flexibility, legitimized through equilibrium discourses. It however accepted that particular circumstances, such as the Latin American inflationary episodes, warranted the use of the exchange rate as nominal anchor to add credibility to an anti-inflationary stance (Edwards, 1994). Whatever the policy regime choice, IMF interpreted a balance-of-payment crisis as a sign of exchange rate misalignment and invariably recommended devaluation. This was expected to increase competitiveness by moving the real exchange rate closer to its equilibrium level. Two policy questions arose here: how to decide the magnitude of misalignment, and what measures would be necessary to ensure that the nominal devaluations would ‘stick’ in real terms. Both were addressed through the monetary approach to the balance of payments, a theory that constructed external imbalances as monetary problems. An extension of the traditional purchasing power parity

(PPP) which requires money-market clearing (MacDonald, 2000), the monetary approach explained nominal exchange rates dynamics through excess money supply growth (under a constant equilibrium real exchange rate).

Thus, the answer to the second question, the IMF held, was simple. For nominal devaluations to work in real terms, policy coordination required monetary tightening to keep in check monetary aggregates and thus prices. Nevertheless, (neo)structuralist critiques pointed out that such a policy prescription might have perverse effects if the productive system is taken into account (Katseli, 1983; Taylor, 1983). A shift in emphasis to costs of production and mark-up pricing altered the expected outcome: where intermediary imports were substantially used in the export sector and the country could not substantially influence its terms of trade, devaluations would increase production costs and reduce profitability, with little effect on real exchange rates. Nominal devaluations would not be effective in altering real exchange rates, but set off an inflationary process. Against this background, domestic currency overvaluation might be necessary to support a policy of capital accumulation.

The structuralist critique brought to light the theoretical and methodological complications that assessments of misalignment involve, usually glossed over in the IMF's policy discourse. At the time, the magnitude of misalignment would be typically assessed through a PPP approach. An equilibrium theory of exchange rate determination, PPP holds that, over the long run, exchange rates are determined by relative prices,⁴⁶ and will converge towards an equilibrium level due to arbitrage in international goods trade (Cassel, 1928 in Rogoff, 1996). It builds upon the Law of One Price, the argument that competitive markets will equalize prices for tradable goods once converted to a common currency. For PPP to hold as an equilibrium condition, the long-run real exchange rate must be constant. When empirical testing rejected

⁴⁶ Later equilibrium theories specified other variables influencing real exchange rates: net foreign asset positions, productivity (the Balassa-Samuelson effect) and capital flows (MacDonald, 2000).

this assumption⁴⁷ (Rogoff, 1996), attention turned to its weak form, the relative PPP. This requires that the rate of growth in the nominal exchange rate offset the differential between the rate of growth in home and foreign price indices. Thus, for policy purposes, relative PPP normativity implied that an inflation differential rising faster than the nominal exchange rate depreciation appreciated the real exchange rate, moving it further away from its constant equilibrium level.

The crucial conclusion: PPP-guided policy-making prescribed nominal adjustments in line with price inflation and price liberalization. The appealing simplicity of such a policy narrative however hides a series of significant policy ‘uncertainties’. Which price indices are relevant for computing real rates, and which base year? What is the mechanism to obtain equilibrium? Is there a causal relationship between variables, and is PPP a theory of nominal or real exchange rate determination? Under which conditions can it be assumed that the real equilibrium level remains constant?

First, misalignment is defined as a sustained departure of the real exchange rate from its equilibrium value. For policy purposes, this requires the computation of this equilibrium value in order to establish whether the exchange rate is undervalued or not. Relative PPP measurements that employ government computed price indices, such as CPI or PPI, assume full comparability across countries. The use of consumer price indices ignores the presence of non-tradable goods in the basket, an important point for formerly planned economies where the price of services has been lower than in countries at higher levels of income per capita. Furthermore, interpreting deviations of relative PPP depends on the base year taken for

⁴⁷ Rogoff (1996) attributed the failure to confirm PPP empirically as a long-run condition to the following factors short-run, high and volatile deviations from PPP, very slow long-run adjustments (on the account of interest rate differentials, transportation costs or foreign market interventions) and serious measurements problems (difficulties in finding homogeneous tradable goods for comparison and the wide differences in calculating price indices across countries).

comparison, for it requires a specification of the relationship between the value of the real exchange rate in that year and its equilibrium value.

In sum, measuring misalignment through a relative PPP discourse defines a strict causality from prices to exchange rate movements. Its static foundations imply that equilibrium exchange rate would not change with fundamentals. In policy practice it involves the following process: a benchmark year is identified, for which the (real) exchange rate is assumed to be in equilibrium. Using the price differential, the accompanying nominal exchange rates are derived, and by comparing it with the actual nominal level, the magnitude of the misalignment can be judged. Essential for this computation is the assumption that the equilibrium exchange rate remains constant, so that only nominal magnitudes are affected by price movements.

These questions, the following chapters will argue, have been fundamental to the macroeconomics of the Romanian transformation, challenging the superficial depoliticization that exchange rate flexibility underlying equilibrium discourses premised. Policy ‘uncertainties’ are not simple methodological challenges, but an essential constituent of the political nature of the exchange rate decisions wherever PPP is used as a yardstick for devaluation.

Another important component of this political process arises from the reconfigurations that a program relationship produces on the domestic policy scene.

3.2.2 IMF program relationships and the changing politics of policy processes

Wood’s (2006) study of the political economy of IMF operations suggested that, aside from US mercantilism, institutional politics and the nature of the relationship with borrowing countries are equally important in shaping IMF policies. Thus, she argued, institutional politics, connected to the preferences of the IMF’s resident economists and the limited resources available, have been instrumental in the development of the infamous one-size-fits

all standardized economic analysis such as financial programming. Furthermore, the national political landscape is fundamental for the outcomes of IMF interventions, requiring the Fund to forge alliances with domestic institutions with power over the policy agenda. And this, I argue, is why the central bank becomes essential to reconstructing policy along neoliberal lines.

The definition of the policy problem through a narrative that privileged monetary policy in tackling the crisis served to construct the monetary authority as a point of entry for normalizing a neoliberal rationality. Indeed, while governments might cooperate with the IMF because it provides legitimacy to unpopular measures, it is the ‘technocratic’ elite of the central bank that shares most affinities with the ‘technocratic’ rationale of stabilization packages. The emergence of central bank independence as the main institutional feature of the neoliberal conceptualization of the stability marked a move in this direction: embedding ‘rational’ economic policy into ‘depoliticized’ economic expertise.

SBAAs have been structured according to this logic. Programs are designed to restrict room for manoeuvre and institute a careful and detailed monitoring mechanism that seeks to maintain policy within its 'rational' boundaries. Three broad components are designed to mobilize policy shifts before the official signing, and then closely monitor compliance. The SBA process first sets a list of prior actions upon which agreement of the IMF Executive Board is conditional. Once these prior actions are satisfactorily undertaken, the official agreement is signed. This further specifies the quarterly quantitative performance criteria, structured, as explained above, through a monetarist discourse. Depending on the particular context of the program, negotiations can identify other quantitative benchmarks which are deemed important for stabilization. Thirdly, the SBA envisages a mid-term review where policy slippages that could potentially threaten compliance are identified, and targets are updated according to the developments in monitored indicators. The performance criteria function as a straitjacket: the loan is divided into four equal tranches that can be drawn if the criteria are met. However, the

IMF claimed (Mussa and Savastano, 1999), this straitjacket is not as mechanical as critics suggests.

Indeed, of the battery of criticism directed to the IMF's crisis interventions (see Killick, 1995; Easterly, 2004; Onis and Senses, 2005), the only criticism the Fund acknowledged as legitimate referred to the 'quantitative character of the IMF's approach to stabilization' (Mussa and Savastano, 1999). While it admitted that the predominance of unstable relationships (particularly the assumption of a stable demand for money) and unreliable data affected monetary conditionality, Fund economists refused to accept these as radically undermining its principles. Financial programming's usefulness built on its flexibility, rather than the accuracy of forecasts/quantitative targets. Financial programming was viable because it managed to strike a balance between ensuring short-run adjustments and the revisions of targets in light of new data (Mussa and Savastano, 1999: 4).

Casting the shortcomings of the monetary policy framework as informational problems which can be accommodated through inbuilt flexibility is another instance of what Gasper (1986) called prescriptive essentialism in policy-making. The focus on contingent weaknesses in implementation allowed the IMF to address both claims of rigid blueprint interventions and issues of country ownership of targets. Flexibility, the IMF claimed, augmented statistical estimations of performance criteria with a process of negotiated 'educated guesses' involving national authorities (Mussa and Savastano, 1999). Such a representation of fraternal expertise sharing glosses over two issues connected to the politics of stabilizations programs. First, it sidelines the extent to which 'staff judgement' would have primacy in target updating where poor countries' technical dependency on IMF 'expertise' reproduced rather than eliminated unequal relationships in negotiations (Bolnick, 1999). Second, it fails to acknowledge that a program relationship redefines the dynamics of the domestic policy process.

Indeed, program relationships require both government and monetary authorities to mobilize around a commonly-defined set of policy measures. This essentially political process is not without its contradictions. Rather than a linear, objective response to specific economic circumstances, the policy process involves struggles over policy priorities both in the formulation of the policy ‘problem’ and the implementation of the attending policy measures. The apparent unity of interests between policy actors created through negotiations is challenged during program implementation, particularly considering what Gomulka (1995) described as IMF’s institutional bias towards low inflation projections that translate into overly contractionary quantitative targets. While central banks are constructed to ensure that governments do what they are told to do, the IMF’s record of conditionality shows that governments are seldom willing to comply with overly-contractionary targets for very long (Woods, 2006).

The question to address then is how this struggle unfolds, and how the discourses at play maintain the privileged status of monetarism as foundational policy orientation. First, the next section will map the process through which monetarism came to structure policy discussions in Eastern Europe, asking how the IMF’s standard stabilization narrative was articulated in the formerly planned-economy context.

3.3 Stabilizing ‘transition’: policies and politics

After 1990, the efforts to reorganize Eastern European economic systems along market principles, while variegated in outcomes, had a common starting point: to address first the macroeconomic disequilibria produced by years of planning. The IMF, a key source of policy advice in the region, drew an essential lesson from the previous Polish flirtations with limited marketization (Wolf, 1991). Policies conducive to macroeconomic stabilization were crucial

for the sustainability of wider market reforms, a principle to which most academic economists subscribed (Fischer and Gelb, 1992).

And essential to macroeconomic stabilization, the IMF argued, were the following systemic features of formerly planned economies: a) the soft-budget constraint; b) excess household liquidity and c) the price equalization mechanism which isolated domestic production from exchange rate volatility (Wolf, 1990; IMF et al, 1991; Bruno, 1992). The first two required aggregate demand contraction and the last devaluations to align domestic production to international relative prices. Of course, policy responses had to be tailored to specific country circumstances, for previous attempts to implement market reform implied that disequilibrium, while similar in nature given the common economic legacy, was different in magnitude.

The argument went as follows. The establishment of market mechanisms required price liberalization in the first instance, for free markets would offer the most efficient allocation of resources if governed by relative scarcity, a principle which the quantity-driven logic of socialism violated. Thus relative prices were to be removed from the dominion of the Central Plan and subjected to market forces. While across-the-board price liberalization would result in a one-off surge in prices, the magnitude of this jump depended on the monetary overhang prevailing in individual economies. The monetary overhang, or involuntarily-held liquid balances, represented pent-up demand stemming from chronic shortages and rationing, a form of repressed inflation under price controls. Since money supply exceeded what would be demanded if existing prices were market-clearing, monetary restraint was required to prevent inflationary spirals once prices decontrolled (Lin and Osband, 1992). A second reason for monetary restraint arose from the state-owned enterprise behaviour: while standard stabilization policies premised profit-maximising firms, the soft-budget constraints pervasive

in planned production implied government-backed ‘soft’ credits would further feed aggregate demand and reproduce allocative inefficiencies (Lane, 1991; Fischer and Gelb, 1991).

Excess aggregate demand was thus defined as the policy problem and monetary contractions as the policy solution (IMF et al, 1991; Winiecki, 1993). Given powerful wage pressure on costs, monetary and fiscal rectitude needed to be accompanied by tight income policies. How and why this narrative of excess aggregate demand became the single most powerful explanation of macroeconomic processes to shape economic policy decisions is one of the least researched areas in transition studies. It is perhaps a sign of its enduring hegemony that it has been subjected to such little critical scrutiny. To begin filling in this void, the chapter will trace its intellectual roots to a 1980’s controversy in (western) academic research on socialist economies and its articulation in the IMF’s policy discourse. It will argue that the narrative was fundamental in making sense of the problematic dislocations produced by the disintegration of communist regimes because it provided a platform for naturalizing a series of truth-claims necessary to legitimise policy interventions drawn from the IMF’s monetarist policy discourse.

While doing little justice to the variety of research programs, the analysis below will focus on the production of a systematic body of knowledge addressing the macroeconomics of central planning.

3.3.1 Towards an (or rather two) economics of planning

In the context of the 1970s price volatility in capitalist economies, western research set out to investigate the possibility of inflation under central planning. Little systematic attention had previously been devoted to the issue beyond the broad agreement that, by prioritizing capital accumulation at the expense of consumption, the planned economy suffered from severe excess

demand, termed as repressed inflation, manifesting itself in queues, shortages and black market activity.

This account of inflation faced mainstream macroeconomics with a conundrum. The ‘scientific’ mind detected a fundamental epistemological shortcoming arising from the lack of methods to formalize anecdotal evidence and attributed it to weak theoretical foundations: the dominance of Walrasian models with instantly-adjusting prices could not provide a coherent framework for integrating across-the-board price controls prevailing in planned economies (Portes, 1986).

Disequilibrium models grounded in quantity-constrained markets would change this. Disequilibrium analysis attempted to reconcile Keynesian macroeconomic insights with general equilibrium microeconomic foundations by allowing temporal rigidities that prevent markets from always clearing, thus positioning the economy in a state of rest away from the Walrasian market-clearing price vector (Barro and Grossman, 1971). With an exogenously-set money supply, consumer market rationing would initially force households to save parts of their money balances and eventually substitute leisure for consumption. Frustrated commodity demand produced lower employment, output, and repressed inflation, defined as: ‘Rising excess liquid balances in the hands of the population with respect to what they would wish to hold if markets cleared at official prices’ (Nuti, 1986:38). Should rationing be eliminated, it would automatically trigger demand-side, corrective adjustments in prices.

Thus the conceptualization of ‘repressed inflation’ under quantity rationing rendered disequilibrium analysis attractive for questioning, in an empirically rigorous manner, the official figures that suggested planned economies successfully avoided the 1970s inflationary spirals in capitalist economies.

However, the application of disequilibrium analysis to a context so markedly different from capitalist economies required a highly controversial framing of monetary processes. It

triggered an intense debate around the claims of an a-historical, a-institutional fitting to the socialist context between two approaches to socialist economics: the disequilibrium and shortage schools (Van Brabant, 1991).

Disequilibrium vs. shortage in CPEs

The late 1970s saw the first attempts to harness disequilibrium analysis to the macroeconomics of central planning (Portes and Winter, 1977). The basic model specified two types of agents, households and planners (conflated with the productive sector) each acting on labour and consumption goods markets respectively. Since enterprises operate with planner's consent to procure intermediary inputs and dispose of output, inter-enterprise money is 'passive'. Money circulates in the household sector and cannot be spent on any parallel informal market with flexible prices.

The articulation in a planned context required two controversial assumptions. First, to maintain equilibrium as a governing principle, the disequilibrium narrative fundamentally assumed no systematic tendency towards imbalances under central planning. Previous imbalances, arising from unintended error in planning or production, could be corrected in the new planning period.

Second, the analysis of disequilibrium was confined to consumer markets. The productive sector entered analysis if its excess demand spilled over into consumer markets either directly through demand for consumption goods or indirectly through the demand for labour and wage bills in excess of planned/actual consumer goods output (Portes, 1986). Demand for investment and intermediary goods, while duly acknowledged as a potential source of disequilibrium, was left aside.

This further validated the idea that money only had policy relevance in the household circuit, an idea that would come to shape post-socialist stabilization programs. Exogenously

established through the wage plan, it consisted of cash and cash-convertible accounts either used for the purchase of consumer goods and services or saved. Furthermore, quantity rationing in the consumer goods market created savings in excess of the desired level of wealth, a wealth overhang (Cottarelli and Blejer, 1992). As portfolio options were limited to very liquid assets, a wealth overhang translated into a monetary overhang - purchasing power in excess of the total supply of goods and services.

Thus disequilibrium was conceptualized as an essentially quantitative question. Empirical investigations for various socialist countries and time periods spanning between 1960 and 1985 suggested periods of both excess demand and excess supply (Portes *et al*, 1987). Thus, the disequilibrium narrative argued, empirically testable macroeconomic models challenged the common wisdom of either excess demand or repressed inflation as systemic features of central planning.

Such conclusions were met with scepticism. Criticism sought to challenge the two premises behind disequilibrium theory by linking the practice of Soviet industrial production to a narrative of chronic shortages as developed by the Hungarian economist Janos Kornai. Under his leadership, the shortage school disputed the fundamental assumption that disequilibrium was a temporary state of the consumer market arising from the inability of central planners to fulfil targets. One of the salient characteristics of any planned economy was the pervasiveness of chronic shortage (Kornai, 1982; Kemme, 1989), not a consequence of erratic planner's mistakes but a systematic feature arising from the system of incentives at enterprise level. To understand a planned economy, one needed to explore its logic of production.

The shortage narrative constructed the state-owned Soviet-type firm in direct contrast with the textbook description of a firm operating in a neoclassical competitive market structure. The latter is driven by profit, constrained by demand and disciplined by market competition into efficiency. In contrast, the former operates in an institutional environment

involving political decisions all along the production process, as resources are allocated by a hierarchical bargaining structure. Production is quantity rather than profit-driven while prices, determined in the context of the plan as a mark-up on labour and intermediary products costs, play no allocative role. Viability is not a matter of success in obtaining profits, but of responding to shortages by short-term substitutions, queuing for inputs and outputs and long term negotiations for investment resources with the central planners (Burawoy and Lukacs, 1992). With no price constraints, plan targets and an overfulfilment incentive system generate an environment where state-owned enterprises continuously bid against each other for resources. Instrumental in this process was what Kornai (1982) coined as enterprises' *soft budget constraint*: a situation where cost (and profit) considerations have little impact on production decisions, as costs above the plan are 'validated' by central planners to stimulate output and over fulfil the plan. On the contrary, households face a hard-budget constraint as income arises solely from labour market participation.

The main objection to disequilibrium arose from its neoclassical treatment of firms as profit maximizers operating under a hard budget constraint. Disequilibrium simply subsumed the socialist firm to the general equilibrium competitive firm with planners substituting for the allocative role of the market. However, once micro-level imbalances are allowed to enter the analysis, the disequilibrium assumption of discrete switching from excess supply to excess demand regimes needs to be discarded. The soft budget constraint perpetuates shortages as enterprises' excess demand for all factors of production systematically creates an imbalance between demand and supply on the consumer markets, driving wage bills above initial targets. Inefficiencies in planning/production and planners' bias towards the investment-goods sector will necessarily result in lower-than-projected production of consumer goods (Winiecki, 1985). Defining imbalances at micro level further grounded a methodological critique. The continuous quest for resources creates both positive and negative excess demands, shortages and slack at

micro level, thus invalidating the possibility of identifying an aggregate excess demand using traditional western measurements (Kornai, 1982).

Thus the point of contention in the shortage vs. disequilibrium debate was not the existence of disequilibrium but its nature and measurement. Disequilibrium narratives positioned disequilibrium at a macro level, its existence an empirical question. Shortage narratives conceptualized disequilibrium as a long-term systematic feature arising from enterprise managerial decisions. Both rejected the claim of sustained excess aggregate demand or repressed inflation, one on empirical grounds and the other all-together as a valid concept (Kornai, 1982: 278). As Kemme (1989: 345), a shortage school economist, put it ‘There are few tenets of the economics of centrally planned economies (CPEs) which are more likely to cause disagreement than the notion that CPEs suffer from chronic excess demand or shortages of goods and services’.

3.3.2 From academia to policy: the role of international institutions

How then did this intense debate collapse into a homogenous policy narrative that constituted excess demand at the stabilization policy problem? By 1990 even Kornai was discussing the policy implications of repressed inflation (p. 143). The leading role that the IMF occupied in designing and financially supporting stabilization packages is an important part of the answer.

Clearly both the soft budget constraint and monetary overhang suited the IMF’s institutional interests well by couching the policy problem in monetarist terms and thus rendering the post-communist countries as objects amenable to standard IMF stabilization interventions. That both were privileged into constituting the policy problem is clear from IMF research at the outset of transition (Wolf, 1990). Furthermore, this framing was deployed to interpret the 1980s Polish experience with reform as supportive of IMF’s approach to stabilization. Undertaken against increasingly difficulties to service external debt, ‘neither plan

nor market' piecemeal reforms had produced what Kolodko and McMahon (1987) described as shortageflation: rising prices along with widespread shortages, and simultaneously reinforced enterprises' soft budget constraints (Lane, 1991). Particular circumstances aside, the Polish experience illustrated well the dangers embedded in sidelining the macroeconomic implications of central planning: excess liquidity holdings and soft budget constraints (Wolf, 1991).

Thus, the key to constructing excess aggregate demand as the threat to post-socialist macroeconomic stability was to minimize theoretical complexities by dovetailing the less controversial parts of the debate, the disequilibrium treatment of money and the shortage treatment of the productive sector.

Money

Disequilibrium models conceptualized money as neutral, while shortage models tended to exclude it altogether, narrowing the discussion to real values (Kornai, 1982). To the shortage economist, the specification of an exogenously-given money supply manifesting itself through the wage channel appeared to be disequilibrium theory's closest approximation of socialist reality. It reproduced the clear delimitation between enterprise and household monetary circuits established in socialist planning, designed to counteract the inherently destabilizing role Marx identified for money in capitalism (Ellman, 1989). Thus, enterprise financial flows were endogenized through the central plan to eliminate the volatility of uncoordinated, profit-driven production. In the productive sector circuit, bank deposits were adjusted to physical flows (settling interenterprise transactions) but not for payment of personal income: money functioned as a unit of account (Dow et al, 2008).

Further, disequilibrium models validated the idea that money had policy relevance only in the household circuit. Exogenously established through the wage plan⁴⁸, it consisted of cash and cash-convertible accounts either used for the purchase of consumer goods/services or saved (McKinnon, 1991). Indeed, the only flaw that the shortage school later identified in the disequilibrium treatment referred to the passivity of enterprise money (Van Brabant, 1991). Indeed, if under soft-budget constraints, enterprises were overbidding for all types of resources, then wage bills would always tend to exceed planned targets. Given that portfolio options in planned economy consisted by and large of very liquid assets, the ensuing forced savings implied higher monetary balances (Kempe, 1989).

Thus policy discourse was able to argue for the existence of excess household liquidity even in the absence of aggregate excess demand à la Portes, by attributing it to micro level imbalances (Wolf, 1990). In the aggregate, for policy must always refer to the aggregate, the systemic nature of shortages implied that the household sector had been bottling up unspent purchasing power. A further step in naturalizing the monetary overhang was to emphasise the empirical difficulties in estimation and to sideline conceptual considerations. Once a policy problem, measurement caveats allowed policy makers to estimate magnitudes from the exchange equation, approximating the overhang as the difference between the current and equilibrium broad money-to-income ratios proxied through a historical average, with little critical appraisal of the validity of such indicators. If the macroeconomic challenge of transition depended on the size of excess demand, as Wolf (1990) argued, then the IMF estimates suggested most CPEs were facing a strikingly similar policy problem: around 40-50% of liquid balances were involuntarily held (Nordhaus, 1990; IMF, 1992; IMF et al, 1991).

⁴⁸ State banks carefully monitored enterprise wage payments to complement the system of wage controls and limit the impact on aggregate demand.

The productive sector and its soft budget constraint

Excess liquidity alone did not warrant macroausterity measures. Releasing the liquidity overhang would translate into a one-off price increase absorbed through price liberalization. To legitimize contractionary monetary targets, policy argumentation was structured around the behavioural characteristics of the managerial process.

Thus, in policy discussions, the soft budget constraint was infused with normativity, privileging an understanding of enterprise behaviour which simultaneously constructed the policy problem and its solution. State-owned enterprises were fashioned as threats to stability, ‘old mammoths’ reluctant to change practices or be subjected to market pressures. To contain the impact of the soft budget constraint on aggregate demand growth, policy-making had to curtail access to liquidity. Influential neoliberal policy advisors went as far as to suggest temporarily prohibiting bank lending to state-owned enterprises, confining them to self-finance and non-bank capital markets (McKinnon, 1991: 118). A further step in the disciplining process was to expose the state-owned sector to the rigours of international competition. Devaluations, complemented by trade and foreign exchange market liberalization would increase responsiveness to changing price signals (Wolf, 1990). Furthermore, the IMF urged the adoption of floating exchange rates, a move that would adjust exchange rates to equilibrium levels.

Thus estimating and eliminating excess liquidity in an ‘orderly’ fashion, together with disciplining state-owned enterprises into a hard-budget constraint became hallmarks of policy thinking (Kornai et al, 2003).

3.3.3 My narrative or yours? Policy implications

If all policy narratives are constituted through exclusion, does it matter which narrative becomes dominant? The answer to this, I hold, is unequivocally yes. The deployment of the

excess demand narrative structured policy options on three inter-related levels, excluding characteristics of the productive system that would have radically undermined its policy prescriptions.

The source of inflationary pressures: demand vs. cost-push pressures

Reflecting both disequilibrium and shortage approaches, inflationary pressures were discursively placed in the consumer markets, with considerations of cost-push pressures removed from policy considerations. Privileging the monetary overhang and the soft-budget constraint in the construction of the policy problem thus narrowed policy solutions to one option. Monetary restraint would ensure that prices, once brought to market-clearing levels through liberalization and the elimination of the monetary overhang, remained at that level. Monetary restraint would contain soft-budget behaviour, which otherwise would result in inefficient allocation of resources (Lane, 1991).

Thus policy measures were predicated on two assumptions: that excess liquidity existed and would be spent, and further that a monetary policy designed according to monetarist principles could spontaneously invalidate the traditional cost-plus mark-up pricing and replace it with the neoclassical marginal pricing strategy (Allen and Haas⁴⁹, 2001).

To legitimize the first assumption, policy discourse sidelined several theoretical and methodological considerations. For instance, it was not entirely clear that liquidity (and savings) were forcibly held. Secondary (black) markets provided alternative spending

⁴⁹ Allen and Haas (2001: 11), both working for the IMF at the time, explained the challenges facing representatives of the IMF engaged in negotiations with domestic authorities:

‘There were few monetarists in transitional economies, at least in the beginning [...] The idea that prices were related to money was often not intuitive. Rather, the price formation process was viewed as a complex process that involved many technical elements and many factors outside the authorities’ control, especially external factors. In fact, tight monetary policy was precisely designed to make the traditional cost-plus-mark up pricing policy impossible. This meant that the same situation IMF economists would see as inflationary would often be viewed as too tight a monetary policy setting by the local authorities. They frequently argued that the “monetary coefficient” (that is, the reciprocal of velocity) was too low, and the level of activity required more—not less—money to support it [...] there was always a local variant of the real bills doctrine—namely, credit expansion is not inflationary if it is issued for productive purposes, typically construction or agriculture.’

opportunities (Alexeev, 1988). Furthermore, the trend increases in broad money-to-GDP ratio, used to proxy the monetary overhang, need not represent forced savings, but rather higher voluntary savings to maintain available purchasing power for acquiring consumable goods entering the markets in a random fashion (Cottarelli and Blejer, 1992). In other words, treating (household) money as a store of wealth, as the concept of forced savings implies, would render broad money-to-income irrelevant as a proxy for unspent purchasing power. It further brings into discussion fundamental Keynesian insights relating to behaviour under uncertainty. Indeed the monetarist treatment of money grounding the concept of monetary overhang ignored the Keynesian liquidity preference link between money and uncertainty (Dow, 2004). With little confidence in expectations, money would be demanded and held as an asset to deal with fundamental (unquantifiable) uncertainty. Thus placing household monetary holdings in a Keynesian narrative changes policy implications as households confronted with the extreme uncertainty of a collapsed political and economic system would have demanded precautionary balances rather than disposed of the extra-purchasing power. Uncertainty, rather than pent-up demand, could function as a guiding concept for households' economic behaviour.

Second, the logic of socialist production premised a cost-plus mark-up pricing that contrasted the IMF's account of inflationary pressures from forced savings to demand pressures and then inflation. The 'economist's case for socialism', as Oscar Lange put it, was built around capitalism's tendency to concentration and centralization associated with the economies and efficiencies of scale required by innovation (Persky, 1991). Accepting that monopolization was capitalism's inevitable economic destiny implied that socialism could handle large-scale production better by allowing the socialist planner to undertake the tasks of the Walrasian auctioneer.

Even where political and social considerations accounted for country variations in the Central Plan's flexibility and reach, socialist industry was organised around vertically-

integrated sectors concentrated in the production of capital-intensive goods. Considerations of economies of scale grounded the economic structure. Thus, most segments along any production chain were dominated by monopolistic or oligopolistic structures, with highly specialized production: most enterprises produced a small range of specific intermediary inputs. Geopolitical considerations saw an increasing share of production concentrated in the military sector, particularly in the Soviet Union (Shlykov, 1997).

Not only industries but also countries were carefully located along the production chains corresponding to their resource endowments. Accordingly, import plans reflected domestic demand for unavailable raw materials and fuels, finished products not manufactured at home (mainly investment goods) and intermediary products unavailable domestically in the quantities demanded. Except for a few resource-intensive countries, domestically produced raw inputs were reserved for internal use. Furthermore, international trade within the communist block was based on production requirements rather than considerations of competitiveness (Winiacki, 1988). Limited diversification to preserve economies of scale implied limited scope for substitution of intermediary inputs, reducing the scope for devaluation strategies aimed at correcting current account deficits.

Therefore the complex network of established relationships between large, vertically-integrated firms would see policy decisions propagating through a domino effect. Price increases would quickly spread throughout the system as both demand and production costs depended on companies up and downstream in the production chain. This further rendered cost-push pressures essential for inflationary dynamics. Where production depended on imports, cost-push pressures would be intimately linked to developments in exchange rates. Price stability required a stable exchange rate.

Such a possibility had been explored in detail by neostructuralist critiques of the IMF's policies in Latin America. Taylor (1988: 148-9) argued that the devaluations and exchange rate

flexibility typically favoured in monetarist narratives would set-off inflationary spirals in economic systems where mark-up pricing (and supply bottlenecks) prevailed. Later IMF research indeed recognized that its policy advice in Latin America had been successful where it recommended the deployment of the exchange rate as nominal anchor, in contrast to a well-documented weakness of the Fund's money based strategy in curbing money growth and inflation where exchange rates were allowed to float (Schadler, 1995). Nevertheless, in formerly planned countries the institution ignored calls for a similar approach and refused to contemplate currency stabilization funds, Poland being a notable exception⁵⁰ (Sachs, 1996; Bofinger, 1996). It instead advocated price liberalizations, currency devaluations and floating exchange rates. Defending a particular level of the exchange rate made little sense not solely because of the difficulties in estimating equilibrium levels where economic processes had been little marketized, but would have required international reserves that formerly planned economies simply did not have, and the IMF would not provide. Market processes would ensure a faster, more effective method of bringing exchange rates to equilibrium levels.

Wage-led system

The IMF's discourse of stabilization conceptualized cost-push pressures primarily in relation to wages. The emphasis on the cost of labour can again be traced to the disequilibrium-shortage controversy: the disequilibrium model specification of labour as the main productive input constructed the CPE as wage-led. Cost-push pressures were only considered in relation to incomes policies. The disequilibrium models' emphasis on labour as the main input in the production process constructed the generic CPE as wage-led. It grounded a restrictive incomes policy of inflationary wage cuts that would cut demand while maintaining enterprise costs under control, reflecting the IMF's 'heterodox' stabilization programs in 1985 in Israel and

⁵⁰ Western governments joined to provide a \$1 billion Zloty Stabilization Fund which allowed authorities to manage the currency.

1988-89 in Mexico (Winiecki, 1993). Anti-inflationary wage cuts, in other words nominal wages rising slower than the rate of change in prices, would achieve a double effect: reduce demand while simultaneously keeping enterprise costs under control. However, the fundamental difference to developing countries in the capitalist world resided in the relative magnitude of workers' wages. Capital (or raw material) intensive production techniques and a social security system that guaranteed free access to basic social services (education, housing, health), implied that productive sector wages were maintained at a minimum. For instance, several studies quoted in Amsden et al (1994) placed wage costs between 10 and 25% of production costs for various Eastern European manufacturing sectors. This further challenges not only the large magnitude of excess household liquidity estimated by the IMF, but the relevance of income policies for containing production costs. Indeed, the wage bill represented a small and decreasing proportion of total production costs, as the cost of imported intermediate goods increased with repeated devaluations. The rhetoric of belt tightening, oddly required for ensuring the victory of both socialism and free market capitalism, rather played the ideological function of marginalizing considerations of cost pressures other than wages, such as intermediate imports, in policy discussions.

Liquidity

The normativity of soft budget constraints labelled monetary stability as the potential victim of lax enterprise behaviour, ultimately ruling out considerations of productive sector financing needs. Liquidity tightening was constructed as the only viable policy option and required a fundamental reform of the financial sector.

The typical planned financial sector consisted of a Central Bank, a few specialised credit institutions that channelled credit from the Central Bank to different sectors of the economy and a savings bank that attracted deposits from population but did not engage in

credit operations (Amsden et al, 1994). Credit activity was subordinated to the requirements of the physical plan (Sundararajan, 1990), financing inter-entreprise transactions according to output targets. Further, this implied that state-owned enterprises were highly dependant on bank credit for financing working capital requirements (Dow et al, 2008). The volume of currency (cash money) was determined by planned wage payments. The only domestic financial assets were bank deposits and currency, while access to foreign exchange holdings was severely restricted for companies and forbidden for individuals (Demekas and Khan, 1991).

Policy advice envisaged the creation of a two-tier banking system made up of a Central Bank and commercial banks. Private ownership, it was held, either through privatization or greenfield investments, would function to harden budget constraints in the first instance, and gradually ensure the financial deepening characteristic of market economies (Ruziev and Ghosh, 2008). However, since the institutionalization of market-driven bank behaviour took time, policy discourse argued that credit ceilings were necessary to enforce monetary discipline. While working capital financing required bank credit, McKinnon (1991) argued (a policy recommendation later inscribed in IMF's programs) that the higher the share of state-owned enterprises in total production, the stronger the need for curtailing access to credit and a generally prudent monetary policy stance. This, the next chapter will argue, was an essential discursive component in the process of institutionalizing (normative) neoliberalism in Romania.

3.4 Conclusion

This chapter argued that critical to understanding what the central bank does when the formerly planned state 'retreats' from the markets is to set first the wider reform processes against

historical conditions outside national borders. The hegemony of neoliberalism in international policy discourse, it showed, was instrumental in scripting postcommunist transitions. A discursive system that instituted the market as the ‘tribunal’ against which all economic (as well as social) activities must be judged, neoliberalism insists on ensuring an efficient allocation of resources, i.e. without state interventions, as key to reconstituting economic relations along rational principles.

Drawing on critical conceptualizations of neoliberalism in its shifting forms, the chapter questioned its state-markets dualism. States do not vanish from neoliberal processes as the rhetoric of free markets triumphantly suggests. Instead, neoliberal restructuring is a process of re-regulation that institutionalizes a new rationality of economic governance. Nevertheless, this process is neither spontaneous nor straightforward. Neoliberalism does not simply happen. It requires institutions to articulate and consolidate its hegemony. For developing countries, it was argued, the IMF has been the neoliberal institution *par excellence* charged with introducing and policing neoliberal policy-making through its conditionality and practices of crisis intervention. The IMF’s approach to crisis constructs the central bank as key instrument of neoliberal institutional change, drawing on monetarism (and equilibrium discourses of exchange rate determination) as legitimating narrative. Indeed, the IMF’s interventions redefine the politics of the policy process and assign monetary policy the fundamental mission of the neoliberal transformation: to discipline all economic actors into the allocative efficiency logic. To legitimize this approach in formerly planned economies, policy discourse constructed an excess-demand narrative of post-socialist crisis and stabilization. This narrative integrated the less contested elements of an ongoing debate in western conceptualizations of macroeconomics of socialism: the disequilibrium assumption of money neutrality and the chronic shortage treatment of the productive sector. The monetary overhang allowed the discursive placement of inflationary pressures in the household sector and constructed inflation

as a demand phenomenon, while assigning a normative dimension to the soft-budget constraint sanctioned neoliberal austerity policies: monetary and fiscal contractions.

The next chapters turn to the specific dynamics on the Romanian policy scene to explore the political economy of central banking under neoliberal rationalities. It will discuss the 1990-2008 years through a post Niebylian perspective, comparing and contrasting the theoretical frameworks deployed by the National Bank of Romania with policy discourses and the practices of monetary management throughout the successive neoliberal phases. Table 1 thus provides a snapshot of the theory/policy discourse/practices nexus for the period under analysis.

The following chapter focuses on the 1990 to 1996 period, described in policy texts as ‘the gradualist years’: the NBR’s ‘rational’ monetary targeting strategy, with money-growth rules derived from the quantitative criteria established through repeated IMF agreements, is contrasted with the political involvement in the implementation phase that validated a communist legacy - the soft budget constraint.

Table 1 The National Bank of Romania from a post Niebylian perspective

Periods		Theoretical foundations	Policy discourse	Practices of monetary management	
Normative (roll-back) neoliberalism (1990-1996) <i>The central bank key to dismantling state-owned production</i>		Monetarism (four IMF stabilization packages) 1. contractionary broad money growth targets 2. flexible exchange rates central to market-determined competitiveness	The gradualist years - ‘rational’ policies vs. ‘bad’ politics of implementation 1. excess liquidity produced by monetization of soft-budget constraints feeding inflationary pressures 2. relative PPP approach to rationalize exchange rate devaluation	Expanding policy repertoires under conflicting demands: 1. liquidity shortages through credit ceilings, then restricted access to the discount window and prohibitively high discount rates 2. directed credit to priority sectors at <i>ex-ante</i> positive real interest rates 3. switching from attempts to stabilize exchange rates given the high pass-through to complying with IMF demands for flexibility	
Normalized (roll-out) neoliberalism (1997-2008) <i>Central bank key to reconstituting policy fields (and markets) through a logic of financialization</i>	1997-2005 partly liberalized capital account	Monetarism 1. reserve money targeting 2. exchange rate as nominal anchor, central to fast disinflation	1997-1999 austerity and crisis 1. aggregate demand contraction 2. separating economics from politics: money market financing of budget deficits 2000-2005 recovery and growth Encouraging sustainable real appreciations to ensure disinflation, under a tight control of liquidity	Sterilized forex interventions produce a structural excess of liquidity on the money market. Sterilizations not monetary targeting <i>stricto sensu</i> but as vehicle for attracting speculative capital channelled through the banking sector, and engineering exchange rate appreciations	1. asymmetric distribution of excess liquidity 2. liquidity tightening through forex sales, increasing reserve requirements and limited lender-of-last-resort financing 1+2 => crisis opening up banking sector to foreign ownership and neoliberal logics
	2005 – 2008 fully liberalized capital account	Inflation targeting 1. commitment to inflation target 2. short-term interest rate central to aggregate demand control 3. flexible exchange rate regime	Internal and external credibility 1. output gap and broad monetary conditions 2. adequate liquidity management to redefine policy instrument as cost and signal for spending decisions	1. forex interventions formally abandoned 2. after failed attempts to divorce practice from speculative capital, sterilizations resumed without eliminating excess interbank liquidity 3. policy rate little relevant for spending, instead tailored to stabilizing forex dynamics dominated by non-resident carry-trades 4. currency appreciations tying financial stability into transnational actors’ choices as growing borrowing from mother banks/ companies increased exposure to short-term, foreign-currency liabilities 5. limited crisis options: reluctance to stabilize interbank rates during the October 2008 speculative attack as extra liquidity feeding speculative pressures on forex markets	

Chapter 4. The 'Gradualist' Years: 1990-1996

The previous chapters pleaded for treating monetary policy as inherently political. It explored the processes through which dominant narratives of monetary processes have consolidated, to then narrow the focus on the specific politics of central banking under the IMF's neoliberal interventions. This chapter now turns to the policy processes in Romania, seeking to trace how the NBR has been increasingly embedded in the political operations of a neoliberal rationality. It argues, following Krippner (2007), that the relationship between the ideological force of neoliberalism (manifested in the monetary policy domain through the depoliticizing discourses of monetarism) and its strength in redefining institutional practices is key to understanding the phenomenon.

Indeed, through repeated agreements with the IMF, policy discourse has sought to institutionalize a central banking logic that is essential in normalizing a neoliberal mode of economic governance with its commitment to market mechanisms. The discourses at play have aimed to depoliticize monetary policy by invoking government intervention into an essentially 'technocratic domain', and thus increasingly strengthened the dominance of 'gradualist' narratives. The discursive dichotomy politics/rational policy, I will argue, operated to structure the central bank as an important vehicle for the sustained neoliberal attack on the state's capacity to craft economic reform.

Further, it will be argued that neoliberal institutions take time to build, requiring institutional reflexivity, reform and flexibility. Expanding policy repertoires outside the traditional monetarist range invested the central bank with increasing powers to respond to structural and institutional resistance to neoliberal logics, arising from both communist legacies and ongoing political struggles. Indeed, the speed and particularities of the process of

normalizing a neoliberal mode of economic management depend on the national political landscape, a point particularly relevant considering the mainstream account of the 1990 to 1996 years. Botel (2002) or the IMF (2001) describe this period as 'gradualist' years of persistent efforts and short-lived successes, of timid price liberalization, stop and go macroeconomic policies politicized by 'neocommunist' governments afraid or unwilling to restructure. In contrast, the election of a centre-right government in 1997 is represented as the dawn of a new era in policy-making: a new momentum for reform materialized in a much faster withdrawal of the state from economic domains.

The most scathing appraisal of this period's economic policy strategy appeared in the 1997 IMF country report (IMF, 1997a). At the time, Romania's unenviable record showed four successive SBAs cancelled a few months after signing. By the IMF's standards, these were lost years: a series of failed stabilization attempts punctuated by temporary revivals, inflation rates substantially higher than other formerly-planned economies and large external imbalances that systematically depleted foreign reserves and threatened balance-of-payment crisis. This, the IMF held, was not a problem of policy design but of policy implementation. Whereas the SBA negotiations committed national authorities to a series of policy measures that would have ensured a quick and painless transformation, the intervention of politics during policy implementation reproduced the imbalances inherited from communism. State-owned industrial interests emerged as a powerful political force that resisted restructuring and transformed the 'rational economic policy' advice into a gradualist approach to reform. The report identified two policy domains where vested interest captured policy implementation: both exchange rate and monetary policy, the main anchor for stabilization, acquired a quasi-fiscal objective, at the expense of external balance and inflation control.

This narrative of the period, which the National Bank of Romania repeatedly endorsed and reproduced (NBR, 1997a; 1998a), conceptualizes economic policy as a solution to

prevailing economic problems (Hall, 1986). It further serves to portray the IMF and the NBR as technocratic institutions whose success in promoting 'appropriate' stabilization policies was always short-lived against the government's preference for promoting employment. This research however claims that there is nothing ontologically inherent in a policy narrative that lends it primacy in 'solving' the crisis. Instead a dominant narrative requires discursive strategies to fix a particular explanation and to reconcile it with policy practice and unexpected policy outcomes.

To analyse these effects, the chapter will focus on the discursive constructions of crisis during each of the four SBAs, mapping how the IMF discourse produced Romania as an object of intervention. I will analyse the shifts that the IMF's presence produced in the politics of policy making, to then turn to the dynamics of discursive adjustment to rationalize repeated SBA failures and critically interrogate the political operations of 'gradualism' narratives against these failures.

The research will avoid claims that IMF policy advice has been all-powerful, in other words that policy agendas have been constructed with little participation, or indeed resistance, from domestic policy actors. Instead, it will question the assumption of a linear relationship between policy (models) and practices, and attempt to open the 'implementation black box' (Mosse, 2005). Where these diverged, policy learning and institutional reflexivity expanded the policy repertoire in order to (re)produce and legitimize continuously the neoliberal approach to reform.

4.1 A historical perspective

At the time of the fall of the communist block in the early 1990's, Romania was a particular case of a planned economy. Its peculiarity derived from specific historical and geographical

circumstances: once the Soviet Union ended the short occupation after the Second World War, the country went from being just another soviet satellite in the first two decades to taking a more nationalistic, self-sustainable approach that sought independence from outside influence.

Most oral accounts of Romanian history begin with ‘Our country is at a crossroads’, an indication of how much geography has mattered for Romania. Being at crossroads has meant exposure to invasions and territorial ambitions from neighbouring empires. Thus, territories of what is now known as the Romanian state have been parts of the Hun, Roman, Polish, Tatar, Ottoman, Tsarist, Austro-Hungarian and more recently, the Soviet empires.

The ambiguous position of the country in the Second World War⁵¹ weighed heavily on the post-war settlements. Romania had to pay the Soviet Union war compensations⁵², and after the Yalta 1945 treat, it was assigned to the Soviet sphere of influence. The Soviet-backed Romanian Communist Party seized power in 1945 and set out to construct a centrally planned economy. During the 1950s the Romanian communists gradually loosened their links with Moscow.

4.1.1 Economic conditions before Communism

At the end of the 19th century, Romania had most of the characteristics of a colonial society. A small landowning elite concentrated power and controlled the state bureaucracy, while the small industrial sector was, in its large majority, foreign owned. Highly dependent economically on international markets and without conditions for industrial growth in place, Romania specialized in cereal exports, while importing industrial goods.

⁵¹ For geopolitical considerations, the military dictator in power at the onset of the Second World War decided to join the German invasion of the Soviet Union in June 1941. During the Red Army’s advance in Romania in 1944, the King staged an overthrow of the wartime military dictatorship, and brought Romania into the anti-fascist camp.

⁵² Attempts to recover lost territories were partly frustrated: the 1947 peace treaty only restored control over northern Transylvania, but awarded Basarabia and northern Bukovina (now in Moldova and Ukraine respectively) to the Soviet Union.

By the First World War, oil became an increasingly important export product, its share rising to 10% of total foreign earnings. The 1917 Russian Revolution forced massive reforms that fundamentally changed agrarian relations. The Romanian army, largely made up of peasants, had been fighting alongside the Russian army. For fear of ideological infection, the king proclaimed an agrarian reform and granted universal suffrage in 1919. However, the fragmentation of agricultural production⁵³ was further aggravated by the Great Depression. As protectionist policies reduced foreign demand for Balkan agricultural products, Romanian grain exports (70% of total exports) fell by 73 % from 1929 to 1934. The shocks to the agricultural sector could not be absorbed by an industrial sector specializing in low-technology, labour-intensive production (textiles and food processing), employing barely 7% of the labour force in 1935⁵⁴ (Chirot, 1976).

Moreover, the agricultural reform, though progressive in intention, failed to solve social problems. With rapid population growth, the average peasant family still had too little land. As most of the region, Romania was sitting on a social time bomb. This led to a wide policy consensus that massive industrialization was needed to drain ‘excess’ rural population (Tismaneanu, 2003). This was very much in the spirit of the 1940-50 international problematization of economic ‘backwardness’ which was to be treated by ‘big-push’ industrialization (Gerschenkron, 1966) and stave off communism.

4.1.2 Romania under Communism

Romanian’s geopolitical positioning after the Second World War saw a fast change in the industrialization pace. Under the Soviet occupation of the 1950’s and 60’s, the country underwent the standard industrialisation strategy characteristic to all planned economies, aimed

⁵³ Large land ownership (above 100 hectares) declined from over 50% of total land before the war to about 10% in 1935.

⁵⁴ Reflecting the low income produced by light industrial goods, Romania had the lowest industrial output per capita in the Balkans, less than half of Hungary’s.

at creating an industrial structure advanced enough to manufacture means of production (implying a pronounced bias towards capital-goods production).

However, in the beginning of the 1960's Nikita Khrushchev shifted the Soviet discourse from 'simultaneous transition' to socialism to specialization within the Soviet trading block, the so called Council for Mutual Economic Assistance (CMEA). This established the Soviet Union as key producer of heavy industry, while the Eastern European block would focus on supplying consumer goods and primary products (Spulber and Gehrels, 1958).

Romanian leaders objected heavily to a division of labour that positioned the country as producer of primary goods⁵⁵ and some light industry. After the 1964 "Declaration" stressing Romanian sovereignty, Nicolae Ceausescu's election as president a year later intensified the attempts to escape Soviet influence. It marked the beginning of a new vision for national development: an industrial economy producing capital goods (Linden, 1986), as industrial development and national sovereignty were mutually dependent.

Consequently, Romania redefined itself as a 'socialist developing country' in 1972, seeking preferential treatment both from its more developed socialist neighbours and non-socialist organisations such as the European Economic Community (EEC). It was the first CMEA country to join the GATT in 1971, the IMF and World Bank in 1972, to receive EEC generalized trade preferences, and to allow Western companies to operate joint ventures within its borders. Simultaneously, it resisted the CMEA 1971 'comprehensive programme' which delegated planning authority to a supra-national level, rejecting the idea of a dominant 'leading centre' of the communist world. It instead centralized economic activity through a planning logic that established a five year horizon to the economic development strategy.

⁵⁵ Oil, ores and cereals.

The 1970-1975 five year plan

In this period the orientation of Romanian foreign trade reflected foreign policy shifts. By 1974, the country was trading more with capitalist states than with the Soviet block. Essential to the industrialization strategy, investment grew at a rapid pace (14% annual average), most concentrated in industry (57%) and transport and communication (18%), with little attention paid to agriculture (16%). Economic growth was the fastest in the region, with net material product growing at an annual average of 11% and industry at 14% (INS, 1980). The rapid expansion was mainly financed from domestic resources, by heavily drawing labour from the agricultural sector⁵⁶ and restricting consumption. Machinery and raw-material imports, the bulk of imports from capitalist countries, were financed by oil and gas exports.

The 1976-1980 five year plan

The apparent success in self-sufficient industrialization had important repercussions for the new five year plan. While both capitalist and Soviet countries struggled against recessionary pressures, Romania followed unabated with its rapid investment strategy, particularly in energy-intensive heavy industries⁵⁷. However, the quest for heavy industrialization quickly proved elusive. The investment in oil refineries turned out to be a particularly unfortunate choice, as refining capacity increased while domestic oil production peaked. The ensuing oil imports reflected in rising current account imbalances, mainly financed by foreign loans.

Time for adjustments: the 1980s

The growing debt became unserviceable by 1981. Creditors agreed to a rescheduling conditional on a structural adjustment agreement with the IMF. Initially approving the agreement, Ceausescu abandoned it when realising it would have forced him to soften his iron

⁵⁶ The sectoral shifts in employment show more than 20% of the labour force moving from agriculture to industry and services, thus closing the gap with CMEA members.

⁵⁷ The targeted sectors were steel, chemicals and petrochemical refining.

grip on economic decisions, as was all too clearly happening in Poland. Instead, he embarked on a nationally-owned 'structural adjustment' plan, aimed at repaying the external debt. The emphasis shifted from fast capital accumulation to campaigns for efficiency, frugality and personal sacrifice, all with the explicit purpose of reducing external imbalances.

State-owned enterprises bore the brunt of the adjustment. The IMF-sponsored program had brought attempts to make enterprises less dependant on the state budget for investment financing. The emphasis on self financing, reduced budgetary outlays for investment (on which a capital charge was levied) and interest rates hikes on bank credit had already affected industrial production. While some of these tight measures were relaxed⁵⁸ after the suspension of the IMF agreement, the emphasis on debt repayment maintained this underinvestment tendency. Indeed, towards the end of the 1980s, unrealistic plan targets, on which the tax liability of each enterprise was based, resulted in heavy taxation and large enterprise losses financed by bank credit and interenterprise arrears. At the end of 1989, the IMF (1991) estimated these arrears at ROL⁵⁹ 300 billion (almost 40 percent of GDP in 1989). Official figures show industrial production decreased by an average of 1.5% throughout the last five years of communism, a larger contraction when taking into account tendencies to overstate production (see Table 2). Ceausescu's structural adjustment program did achieve what it set out to do: the previous trade deficits were transformed into trade surpluses, and the outstanding foreign debt was reduced from around US\$ 7000 million in 1985 to US\$ 170 million in 1989, at the expense of a serious contractionary blow.

⁵⁸ Interest rates on bank credit were reduced to pre-agreement levels.

⁵⁹ As of July 1st, 2005, Romania's legal tender, the leu, previously coded as ROL, has been redenominated so that ROL 10.000 were exchanged for 1 new leu (RON). The thesis will mirror this change, referring to the currency as ROL until June 2005.

Table 2 Macroeconomic performance, Romania, 1985-1989.

	1985	1986	1987	1988	1989
Foreign debt (US\$ mil.)	6,830	6,875	6,272	2,106	174
Industrial production (% change)	-0.3	2.2	-2.3	-0.7	-5.3
real GDP (% change)	-0.1	2.4	0.8	-0.5	-5.8

Source: Daianu (1994)

Thus, the fall of the Berlin Wall found in Romania a social climate favourable to unrest and public protest. Ultimately, economic austerity brought down the communist regime in December 1989, but only after bloodshed and the public execution of the Ceausescu couple, by far the most extreme dissolution of a socialist system in Eastern Europe.

One of the immediate priorities of the provisional government after the disappearance of the tightly controlled system of resource allocation was to define a policy agenda for reform. A Commission for Transition was set up. It drew on a wide participation of various social actors in society (economists, governmental bodies, industry, trade unions and international organizations), seeking to mark an epistemological shift from the central-planning years and render policy deliberations participatory and consensual.

4.2 The post-communist macroeconomic problem

This sub-chapter briefly describes the 'transformation problem' as identified by the Romanian Commission for Transition in May 1990 and its redefinition during the negotiations for the first SBA with the IMF towards the end of 1990.

4.2.1 Redefining transition: from industrial upgrading to stabilization first

The report (Government Commission, 1990) advanced an economic reform strategy which crucially premised industrial development as the basis for a rapid catch-up with capitalist economies. It recognized that state intervention was required to support capital investments in order to rebuild the technological capabilities of the Romanian industry, particularly since the last years of socialism had been so detrimental to industrial production⁶⁰. Second-order priorities included the traditional Washington Consensus measures of price, trade and capital account liberalization, to be spread over a period of two to three years. The report rejected a quick price liberalization, for the monopoly/oligopoly structures prevailing in the Romanian economy warranted price controls while a more competitive setting emerged.

The report conceptualized a financial system subordinated to restructuring the productive sector. While it drew attention to the problem of the soft budget constraint (not surprising since Thomas Wolf, the IMF Director for Europe, was consulted in its drafting), the report contained an endogenous money argument: the money supply was to be managed in line with the requirements of the productive sector, prioritizing its technological upgrading. The Central Bank would channel credit through commercial banks, who would be assigned a more active role in setting interest rates, while the establishment of new private commercial banks would be authorized. The report further discussed the conditions and time horizon for introducing exchange rate convertibility⁶¹, and recommended a devaluation to bring the exchange rate to a more realistic level.

However domestic and international developments produced a dramatic reformulation of reform priorities by November 1990. Internally, politics was increasingly polarized between

⁶⁰The report stated that: ‘The state will provide financial support – subsidies, preferential credit, export incentives – to sectors mostly needing structural reconversion. However it is imperious that these measures be short term, enabling these enterprises to play by market rules’ Government Commission (1990:3, own translation).

⁶¹ The earliest date for introducing full convertibility was set for early 1992, conditional on the existence of foreign reserves and of mechanisms to defend the national currency from excessive fluctuations.

the Frontul Salvării Naționale (FSN), a party positioning itself on the left of the ideological spectrum, and the formerly-outlawed ‘historical parties’ of the right which returned to politics with a promise of democratic values. This polarization had immediate consequences for the program of economic reform. During the summer of 1990, violent confrontations between the newly-elected government headed by the FSN and opposition forces⁶² reinforced the perceptions of a volatile political climate. Furthermore, it appeared to confirm the anti-democratic, neo-communist credentials of the governing party and instituted the historical parties as ‘true’ democrats, with the corresponding different representations of political will to reform. While the FSN was generally accused of colliding with conservative industrial interests associated with the dominance of large, state-owned monopolies in the industrial sector, the international media and international organizations conferred on the ‘true’ democrats the position of ‘true’ reformers, better positioned to create capitalism (Pop, 2006).

Economic problems added to this sense of political instability. The delays in creating viable alternatives for allocating resources to state-owned enterprises following the collapse of the State Planning Committee saw industrial production quickly contracting. The 1991 crisis in the Middle East, Romania’s main source of imports for the energy-intensive productive sector, not only pushed up oil prices but led to the freezing of Romanian assets in the region⁶³. Together with a policy of favouring imports of consumer goods to satisfy some of the pent-up demand, these events concurred to produce a sharp deterioration in the foreign trade balance. In the absence of international assistance, the NBR’s foreign reserves were diminishing at such a rapid pace that national authorities were left with little choice but to seek assistance from the international organization in charge of balance-of-payments problems.

⁶²Known as the first *mineriada*, it saw miners descending on Bucharest to ‘assist’ the police in dealing with the protestors occupying a public square, which quickly led to a violent backlash against the opposition parties and their intellectuals.

⁶³At the time, Iraq debt amounted to around US\$1.7 bn (1991 figures), the equivalent of the 1990-1993 IMF loans to Romania (Demekas and Khan, 1991).

Negotiations with the IMF started late 1990, and the first SBA was signed in April 1991. This would be the first of four stabilization programs designed under IMF guidance throughout the period: a second SBA in May 1992, a third in May 1994 and an extension of the May 1994 one signed in December 1995. All went off-track within less than a year.

The 1991 SBA radically redefined the policy ‘problem’ and its attending measures. Indeed, the Demekas and Khan⁶⁴ (1991) commended the national pedigree of the May 1990 strategy, but traced the origin of the ongoing balance-of-payments crisis in the report’s approach to policy reforms. The May 1990 strategy had fundamentally underestimated the ‘degree of price distortion and the disequilibrium between aggregate demand and supply inherent in the existing monetary overhang and its inflationary potential’ (ibid. p. 16). Consequently, it failed to appreciate the ‘true’ extent of the necessary structural reforms and it envisaged unrealistic policy measures given the existing monetary overhang. The ‘timid’ price liberalization timetable would maintain price distortions and harm ambitious privatization plans while reducing the capacity to attract foreign direct investment. Furthermore, the social protection scheme would undermine stabilization efforts by generating additional demand and adding to the monetary overhang.

Thus macroeconomic stabilization, and no longer industrial competitiveness, was identified as the essential policy priority. Framing the policy problem in terms of excess aggregate demand thus reconstituted policy discourse along monetarist lines: ‘Correcting relative prices and eliminating the monetary overhang in an orderly way are pre-requisites for achieving the other objectives of economic reform’ (ibid, p.19).

With the economic policy space constructed through an excess demand narrative, the monetary overhang became the metric for formulating other macroeconomic policies. Indeed, while national authorities generally supported a real bills doctrine (Allen and Haas, 2001), the

⁶⁴ The authors were heading the IMF team negotiating the 1991 Stand By Agreement, and published an account of their experience as an IMF Working Paper.

IMF's monetarist discourse linked prices to money, inflationary pressures to excess demand arising from the monetary overhang rather than cost factors, and recommended a tight monetary policy to ensure the adequate absorption of the monetary overhang through price liberalization. Where national authorities would have preferred to extend credit to production and thus mediate an industrial recovery after the break-up of both the Central Plan and traditional trade linkages, the IMF re-orientated policy discussions to aggregate demand dynamics and tight credit policies to harden enterprises' budget constraints.

Had policy discourse encompassed a wider conceptualization of cost-push pressures in the context of vertically integrated, monopolistic productive structures, the strategy towards price and exchange rate liberalization would have necessarily required a 'gradual' approach, as the May 1990 Commission suggested. Without even reframing the policy problem along some state developmentalist line, to achieve the declared IMF objectives of containing inflationary pressures and reducing external imbalances would have warranted a complex 'multifaceted price system', setting different prices and rationing in certain markets (Zhukov and Vorobyov, 1991) rather than across-the-board liberalization (Amsden et al, 1994). Furthermore, it would have warranted active currency management. Nevertheless the IMF discouraged any 'gradualist' measures that would undermine its radical marketization strategy. It also refused to support international stabilization funds necessary to defend pegged rates despite evidence that high inflation stabilization under pegged regimes was far more effective and less contractionary (Sachs, 1996).

Thus the treatment of cost pressures and exchange rate policy prescriptions (devaluations combined with a flexible exchange rate regime) that, as I later show, exacerbated inflationary pressures, were not a consequence of IMF ignorance (or misunderstanding) of the socialist economies, as many have chosen to understand it (Winiiecki, 1993). On the contrary, these were part of a systematic program to reconstitute the economic space along neoclassical

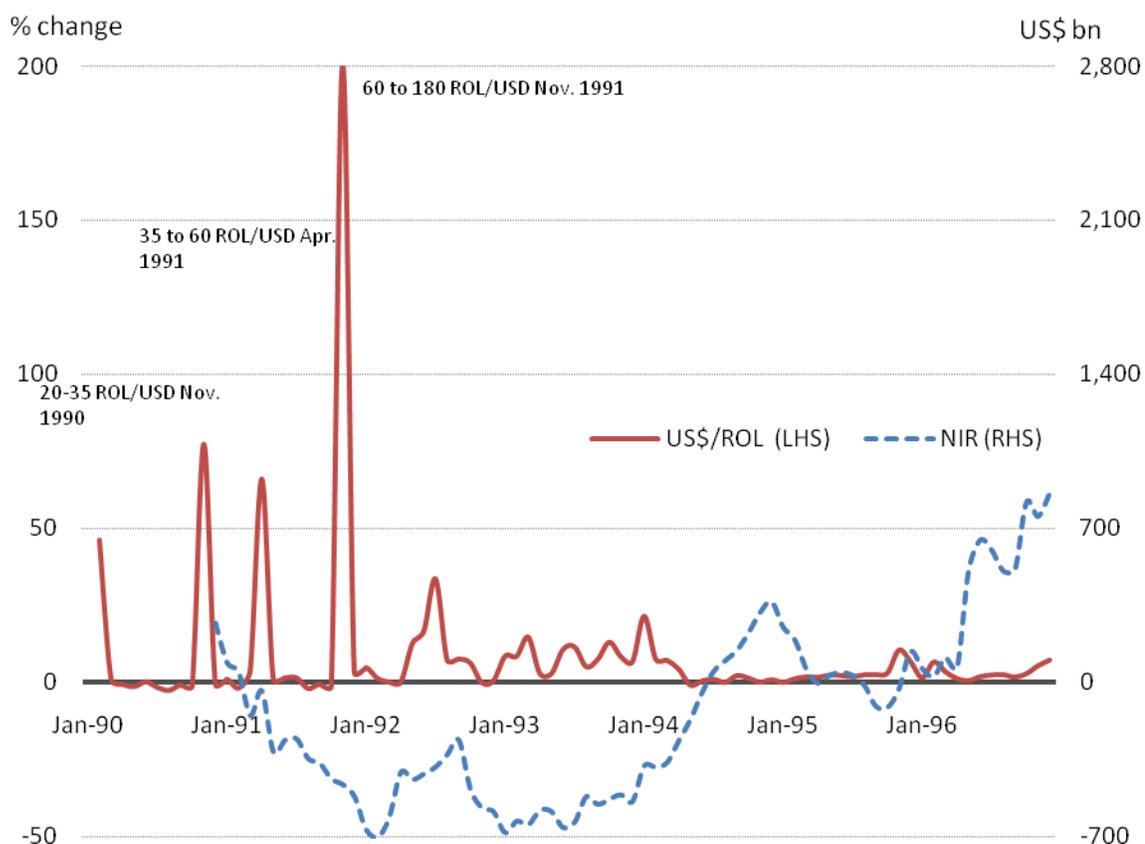
lines, a broader agenda for naturalizing the perfect competitive market behaviour with its marginal pricing logic. This also required a series of discursive operations for framing optimal exchange rate policy through a discourse of equilibrium.

The exchange rate was at the forefront of policy discussions because Romania experienced repeated difficulties in financing its current account deficit. Indeed, after the fall of the communist regime, a significant loss of export markets, trade liberalization, a structural trade deficit and very limited access to foreign capital resulted in highly volatile foreign reserve positions (Gabor, 2008). Initial conditions appeared favourable, as Romania entered its transformation process with no foreign debt. The lack of foreign liabilities however contributed little to endearing Romania to foreign investors after the regime change.

Neither did IMF agreements, usually perceived in international markets as a guarantee of credible policies. Indeed, the NBR managed to secure its first commercial bank international loan for the dismal sum of US\$ 60 million only in late 1993. For most of the period international organizations remained Romania's main source of foreign capital⁶⁵, thus increasing the leverage of international policy advice. However international official lending functioned more like a life line. The NBR's convertible currency position was negative for the first four years, despite massive devaluations advised by the IMF as method for restoring international reserves (see Figure 2). It gradually strengthened up to 1994, and then reversed during 1995 as both the trade and the current account deficit widened. Reserves position improved again in 1996, as the NBR managed to mobilize short-term foreign debt. As the reserve position improved, exchange rate volatility diminished.

⁶⁵ For instance, at the end of 1992, of the US\$1.3 bn short-term debt, US\$1.07 bn was owed to the IMF alone (NBR, 1993).

Figure 2 Exchange rate (ROL/US\$) and foreign reserves (US\$ billions), Romania, 1990-1996.



Source: computed from the Statistical section of the *National Bank of Romania Annual Report 1995* (p. 14 and 26-29) and *2000* (p. 580 and 90).

Against this background, IMF’s policy discourse in Romania consistently emphasized a free float, a requirement inscribed in the Stand-By Agreement. Its refusal to endorse a peg combined arguments of sustainability and measurements difficulties. With little foreign reserves, domestic authorities would not be able to credibly defend a peg. Even with international endorsement, empirical difficulties in assessing the magnitude of misalignment raised serious doubts about its policy effectiveness. Under these circumstances, the market, rather than policy makers, would be better placed to find the equilibrium level.

The NBR (1993b) subscribed to this equilibrium discourse. It further deplored the government’s interference with exchange rate decisions, which it represented as the most

politicized economic space. Indeed, while the NBR accepted a possible trade-off between external stability and inflation, it argued that the politicization of exchange rate decisions inherent to a pegged regime would prevent the necessary adjustments to equilibrium and reproduce external imbalances. The use of the exchange rate as a nominal anchor to stabilize inflationary dynamics would appreciate the real exchange rate, divorcing its dynamics from its fundamental determinants, and eventually forcing large devaluations.

Consequently, the IMF's presence on the Romanian policy scene redefined the policy problem in line with its preferred policy narrative, and its conditionality changed the politics of the policy process. Since monetary policy was identified as the fundamental anchor in all four stabilization episodes, the next sections will argue that policy discourse assigned the central bank an instrumental role in establishing and policing neoliberal rules of governing the economic space.

Thus the next part of the analysis turns to the discursive production of crises, paying particular attention to the exchange rate and monetary policy narratives and their deployment in policy practice.

4.3 Welcome to crisis: SBA 1991

The 1991 Stand-By Agreement was the outcome of a process entirely consistent with a *modus operandi* perfected since the Chilean experiment of the Pinochet regime's Chicago boys (Klein, 2007). It used the political and economic crisis unfolding in the second part of 1990 to push forward a package of policy measures that would have found little support under democratic conditions. The prime minister addressed the Parliament in October requesting exceptional powers to implement what Demekas and Khan (1991) termed a 'substantially more realistic' approach to reform. Invoking extraordinary politics, the government refused to

submit the package for discussion or approval in the Parliament, and instead pushed the reforms through an emergency ordinance. A series of measures targeting price and trade liberalization were implemented in November 1990, responding to the prior actions required for the SBA approval. The timetable for price liberalization deserves particular attention, as it became an important discursive operation for explaining policy failures or unexpected outcomes of the stabilization process.

4.3.1 Price Liberalization

There are different, and at times contradictory, accounts of the timetable of liberalization. These share the claim that a gradual, politicized timetable reproduced the ‘rigidities’ of the planned system by distorting the signalling role of prices and wider market mechanisms.

The strategy towards prices (liberalization) was first discussed in the May 1990 report. The report rejected a sudden liberalization, suggesting that the monopoly/oligopoly structures prevailing in the Romanian economy warranted price controls in certain sectors until a more competitive setting emerged. It further identified a set of key intermediate and final products that would remain under administrative control, reflecting the industrial policy concerns of the report.⁶⁶ However, the turn to a neoliberal economic agenda in the second half of 1990 redefined price reform, seeking to eliminate the early industrial ‘bias’. Three successive rounds of price liberalization, in November 1990, April 1991 and July 1991 left only 14 categories of consumer goods critical for social reasons under an administered regime⁶⁷. Price controls on strategic intermediate imports were quietly abandoned a few months after their institutionalization, prompting the IMF to commend Romania on the speed of its price

⁶⁶ Products of the mining, fuel and energy sectors; metallurgy; the chemical industry; forestry; basic branches of the machine building industry; the main products of the food industry; transportation, postal and telecommunication services.

⁶⁷ The first stage in November 1990, followed by the Stand-By Agreement in April 1991, up to which point 80% of all prices were ‘freed’ from administrative control (Demekas and Khan, 1991). After the third round, in July 1991, only 14 categories, including a few basic food items and public services – home heating, public transportation and rents, retained their administered regime.

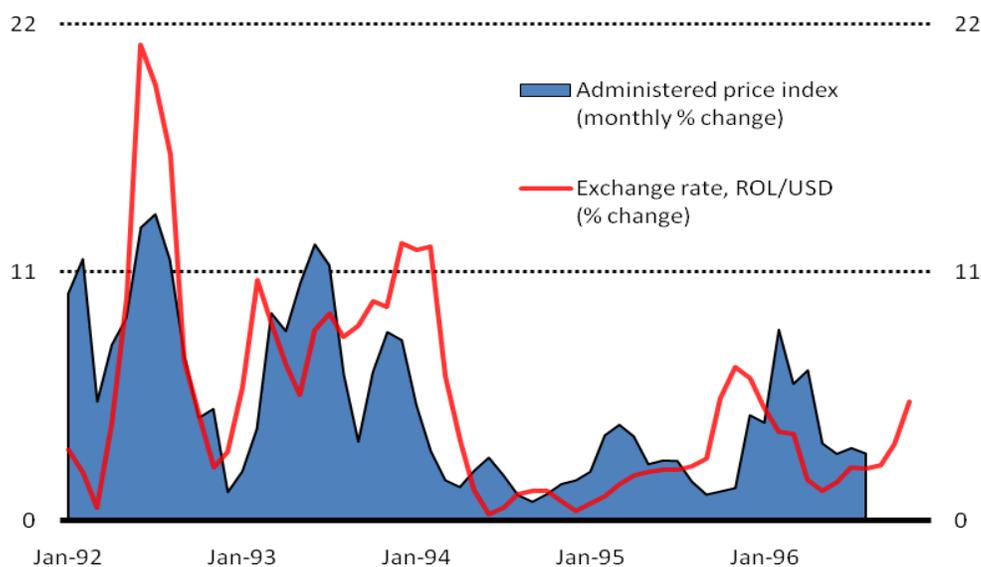
liberalization, as 'in only eight months Romania went from a system of complete price controls to one that compares favourably with many market economies' (Demekas and Khan, 1991: 21).

This pace of price reform has not been recognized in gradualist discourses. On the contrary, these picture price liberalization as a long and cumbersome process (OECD, 1998; IMF, 1996; Dragulin and Radulescu, 1999), with harmful consequences for the establishment of much needed allocative efficiency⁶⁸ (NBR, 1992a).

To maintain a gradualist representation, the discussion was framed around administrative control of consumer prices. Indeed, by 1993, prices of around 50% of the consumer basket were administered control, a share reduced, through successive liberalization rounds, to 15% in 2000 (Budina *et al*, 2002). While indeed the weight of administered prices in the consumer basket has been higher than in other Eastern European countries, in practice successive governments retained far less control over administered prices than is commonly recognized. Under the provisions of the successive SBAs, administered prices were periodically adjusted in line with exchange rate devaluations, and generally absorbed devaluations with a lag no longer than four months (see figure 3). This inscribed administered prices a trend similar to those determined 'freely'.

⁶⁸ The literature identifies gradual price liberalization as the root cause for unexpected, negative outcomes: explained delays in structural reforms (OECD 1993), inflationary spirals through inflationary expectations (NBR, 1992); limited institutional reform (Ibrahim and Galt, 2002); a sectoral segmentation of real interest rates that subsidized state-owned enterprises (NBR, 1994) and reduced efficiency of monetary policy (Dragulin and Radulescu, 1999: 6).

Figure 3 ROL/US\$ exchange rate and administered prices index changes (four-month lag), Romania, 1992-1996.



Source: computed from the Statistical section of *the National Bank of Romania Annual Report 1997* (p. 14) for exchange rate data and Budina et al (2002) for administered price index data.

Articulating gradualism around consumer price decontrol had two discursive effects. It first structured discussions around the speed of consumer price liberalization, thus removing from the argumentative terrain the very issue that the 1990 Commission report emphasized: that the structure of the Romanian economy required a careful consideration of whether and when to liberalize, particularly for intermediary inputs and raw materials unavailable domestically.

It further suggested that gradualism functioned to protect state-owned enterprises from the disciplining hand of the market by ‘distorting’ price signals, when by July 1991 only certain consumer prices were controlled. SOEs received little if any direct subsidy through price controls. Furthermore, since energy imports formed the bulk of intermediary imports due to the high energy intensity of industrial production, energy pricing was identified as essential to both restructuring and tackling widening external imbalances. The government committed, at the IMF’s specific request, to maintain domestic prices of crude petroleum and related products at or above international market levels, and to adjust them monthly in line with

exchange rate movements. Retail prices would be adjusted to fully reflect costs and allow for a profit margin. Thus, by February 1991, domestic energy prices (at official exchange rates) were above international market levels (IMF, 1991a). Moreover, cross-subsidization from industrial consumers to households was a current practice until energy-sector liberalization began in 2001 (IMF, 2001).

In other words, state-owned enterprises were operating under the same cost conditions as private ones and faced the same caps in the consumer goods sectors targeted by administrative price control, while policy discourse insisted on the distortions to allocative efficiencies engendered by price controls. This discursive operation, I will further argue, was important for constructing the state-owned sector through a narrative of soft budget constraints.

4.3.2 Tackling excess demand

The April 1991 SBA articulated the policy problem according to the IMF's policy priorities. It identified the monetary overhang as the main 'problem' for stabilization. Consistent with the neoclassical flow of funds approach that locates the source of inflationary pressures in excessive bank liabilities (here the monetary overhang), the first stabilization plan aimed to reduce the inflation rate to a 15% annualized rate for December 1991, for which it envisaged an annual 15% target in broad money growth and 26% in credit to the non-government (i.e. productive) sector growth. The logic of the programme was purely monetarist. It assumed a constant velocity of circulation, no short-term impact on output, and a one-for-one relationship between broad-money supply growth and price increases. Furthermore, the Fund estimated that up to 50% of the money stock was involuntarily held at the end of 1990, by comparing the income velocity of money at that time with the 1970s and early 1980s' average (Demekas and Khan, 1991). Given the size of the monetary overhang, the combined impact of price

liberalization and the attending exchange rate devaluation was expected to push inflation levels to about 100% year-on-year, a one-off corrective episode (IMF, 1991a).

The monetary program thus aimed at transferring money holdings from the household sector, where most of the monetary overhang was assumed to be located, to the enterprise sector. The data seemed to support this policy proposition. At the end of 1990, time deposits amounted to 60% of broad money stock, of which 84% were household ROL savings. The ratio of cash to broad money (19%) was similar to other CPE at the time (Ruziev and Ghosh, 2008). Enterprise deposits amounted to only 16% of total deposits, a consequence of the Ceausescu era policy of limiting access to bank credit for working capital purposes only, as capital investment would be financed from own resources.

In other words, the IMF held, a tight credit policy would not affect output, but merely redistribute excess money. Price liberalization and exchange rate devaluation would absorb excess monetary holding without creating liquidity shortages for the state-owned productive sector. Further, the IMF (1991a: 46) stabilization plan explained, the fall in real credit would be mitigated by the removal of existing restrictions on enterprise deposits in the banking system. Eliminating the segmentation between household and enterprise money, and thus the different degrees of liquidity and moneyness, would foster financial development⁶⁹.

Moreover, it was widely agreed that exchange rate devaluations were required to correct the communist legacy of substantial misalignment (Demekas and Khan, 1991; NBR, 1992a), particularly since the differential to the level on the newly created foreign exchange market signalled that official exchange rates were well overvalued⁷⁰. Relative PPP normativity

⁶⁹ This has not been the case in all formerly planned economies. Dow et al (2008) examine the case of Uzbekistan, where specific institutional characteristics and the overall development strategy resulted in restrictions on the free convertibility of bank deposits into cash money.

⁷⁰ The institutionalization of a foreign exchange market was made a prior requirement of the 1991 SBA. It began operations in February 1991, with small volumes and substantial volatility. Thus the economy operated with a double set of exchange rates to the dollar up to November 1991: an official rate for imports of raw materials and energy (financed through a 50% surrender requirement on hard-currency exports) and a parallel rate set 'freely' in

guided the magnitude of the adjustments: devaluations would offset the price increases associated with price liberalizations so that real depreciation would move the exchange rate closer to its equilibrium level. Perversely, the phasing of price liberalizations legitimated repeated ‘corrective’ devaluations⁷¹, so that within a year of the first SBA, the exchange rate weakened by around 900% (see Figure 2).

Subsequent developments challenged the claim that monetary tightening would transfer excess household liquidity to the state-owned sector. Faithful to its SBA commitments, the NBR proceeded to tighten credit at the beginning of 1991. Bank-by-bank credit ceilings were used in the absence of indirect instruments of money control. This created a severe liquidity shortage: while credit to non-government (largely to state-owned enterprises) kept pace with the IMF benchmark target, expanding by around 30% April to December 1991, inter-enterprise arrears quadrupled throughout the same period, from ROL 480 mil. to ROL 1.7 bn. (see Table 3). Industrial production contracted by more than 25%, a development which Calvo and Coricelli (1992) attributed to widespread credit crunches rather than demand-side factors. Romanian developments thus confirmed a well-documented tendency of IMF’s stabilization programs to produce liquidity crunches (Schadler, 1995).

the interbank market. Supply shortages on the interbank market produced a significant differential to the official rate, a differential which was further deployed in policy argumentation to legitimize sharp devaluations.

⁷¹ The devaluation timetable went as follows: from Lei/US\$ 20 to Lei/US\$ 35 in November 1990, to Lei/US\$ 60 in April 1991 and Lei/US\$ 180 in November 1991, when the NBR unified the two exchange rates and instituted internal convertibility on the current account operations. It further committed to a flexible regime with rates established in the interbank market.

Table 3 Credit, arrears and industrial production, Romania, 1991 .

	Credit to non-government (ROL million)	Inter-enterprise arrears (ROL million)	Industrial production (Dec. 1990=100)
1990 Dec.	683	100	100
1991 Jan	703	206	79.8
Feb.	731	307	79.8
Mar.	756	400	86.1
Apr.	765	482	90
May	788	550	90
Jun.	811	600	92.6
Jul.	839	637	83.8
Aug.	806	691	80.9
Sep.	749	800	81.3
Oct.	839	1000	77.9
Nov.	899	1317	70.1
Dec.	954	1777	68.2

Source: Demekas and Khan 1991, NBR, 1991a

Indeed, as companies' working capital needs were pushed up by price liberalization and exchange rate movements, the increase in money demand was frustrated by the tight monetary/credit policy, leading to a credit crunch. In a market-based system, a policy of credit rationing adopted by banks would push unsatisfied borrowers willing to pay going rates to other financial institutions. In a formerly-planned-economy setting, where these were absent, the credit crunch produced inter-enterprise credits. In the absence of credit, the complex networks of vertically-integrated chains of production and trade laid the basis for spontaneously emerging networks of credit liaisons, what Post Keynesians would recognize as the transition equivalent of a money-endogenizing process.

Thus the neoliberal policy discourse ushered in a relationship between finance and production that fundamentally sidelined the role of money in capitalist production. Historical accounts of capitalism in both Marx and later Keynes emphasise the role of money capital as a vital institution of capitalism: production, and realizing gains, is about converting output into money values (Dillard, 1980). Money is no longer the veil over atomistic individually-owned

competitive units, but the oil that runs the machine, particularly one dominated by large-scale production. Since money is the motivator for production, when the state-owned enterprise is forced into capitalist relations of production, it needs to find money to buy now, produce and pay later. The embryonic nature of the Romanian financial system of the time constituted a serious constraint. More sophisticated forms towards which market reformers pointed as desirable market-driven mechanisms, such as equity issues or long-term debt instrument issues, were simply not available. Financing choices were limited to either retained earnings (highly volatile given the demand collapse) or bank loans. However, market-driven resource allocation was conditional on the establishment of institutional mechanisms enabling banks to deal with information asymmetries, particularly regarding the state-owned productive sector. In the meantime and consistent with monetarist policy prescriptions, creditor/debtor relations were to be controlled through credit ceilings.

Such a contractionary macroeconomic programme could not be upheld for very long. After the government had ignored trade unions' increasingly vocal contestations of the economic strategy, at the end of September 1991 several trainloads of miners descended on the capital⁷². Following several days of protest, the Prime Minister was forced to resign. A new government of 'apolitical technocrats' vowed to continue with (neoliberal) economic reform.

It soon became apparent that social unrest was only a manifestation of the upheaval the country was experiencing. From the 'job for everyone' socialist doctrine, unemployment increased quickly to around 7.7% by the end of 1991. The difficulties in accessing international financial markets curtailed available hard currency for essential imports of raw materials and energy, further affecting industrial production. The SOEs were asked to surrender all export earnings, a highly controversial measure in place until May 1992. Furthermore, price developments were contradicting the monetarist logic: while broad money increased by 19%

⁷² Most analysis portrays the miners' strike as a political manipulation rather than legitimate workers' grievance (Pop, 2006).

up to October 1991, consumer price inflation reached 156% (producer price inflation 103%), clearly tracking exchange rate devaluations.

By December 1991, the government recognized the obvious danger of economic collapse if contractionary monetary policies were to be further pursued. Indeed, the attempts to institutionalize 'market relationships' produced a severe (financial) payments blockage: arrears reached 40% of enterprises' turnover (World Bank, 1992) as unpaid firms were unable to pay in turn. We find here at play what Bourdieu (1998:95) recognized as one of neoliberalism's sources of strength: the ability to 'make itself true'. The policy discourse that had naturalized the soft budget constraint despite little empirical support (Amsden et al, 1994), ultimately produced it in the form of inter-enterprise arrears.

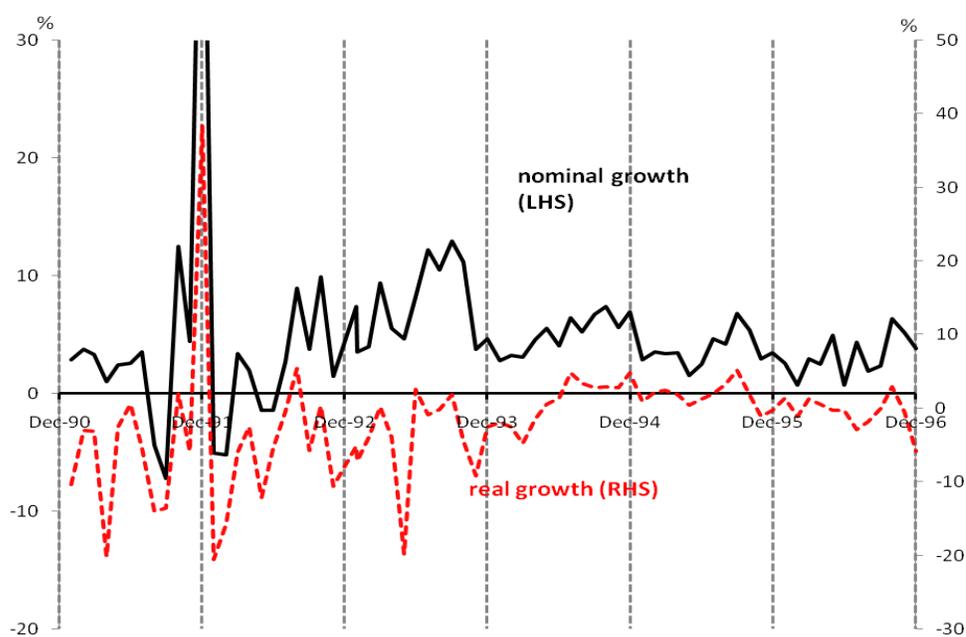
While the government advocated a selective bailout, the Parliament passed legislation for a Global Compensation Scheme (GCS), a one-off credit injection that would clear arrears across the board. Rather than a 'gift' to enterprises as most analyses claimed (NBR, 1992a), the GCS was designed on a commercial basis. It required collateral (government guarantees or debtors' assets of six-month maturity or less), while the interest rates it charged reflected the prohibitive credit conditions in the economy (at around 70%).

However, the credit injection breached the SBA performance criteria on credit to nongovernment. The monetization of interenterprise arrears brought the actual figure five times above its target⁷³. In response, the IMF suspended the program, portraying the global compensation scheme as a politicized solution subordinated to industrial interests (IMF, 1991b). This functioned to depoliticize monetary policy choices. It sidelined any questioning of the economics of stabilization predicated on the assumption of excess liquidity, although the magnitude of the deviation from target suggested a massive liquidity crunch. Instead, the IMF attributed interenterprise arrears to weak financial discipline caused by the soft budget

⁷³ ROL 522 bn compared with a target of ROL 96 bn.

constraint. Consistent with this explanation of crisis, the NBR took measures to minimize the net GCS liquidity effects. It enforced credit repayments before maturity and introduced reserve requirements on bank liabilities, so that the liquidity injection was largely sterilized in the first months of 1992 (IMF, 1992a): credit contracted in both nominal and real terms (see Figure 4). The system was again starved of liquidity.

Figure 4 Total credit dynamics, Romania, 1990-97.



Source: computed from the Statistical section of *the National Bank of Romania Annual Reports 1995* (p. 60 and 61) and 2000 (p.618-9)

4.4 Expanding the policy repertoire: SBA 1992

Negotiations for a second SBA resumed immediately. A new set of policy commitments was agreed by May 1992, essentially recommitting the national authorities to the principles of the first stabilization plan. In the letter of intent, the Romanian authorities pointed out that external shocks had worsened an already difficult economic environment, and that further discipline was required to tackle the crisis. While income policies had remained consistent with the SBA

prescriptions (real wages had declined by 22% since Nov. 1990), further monetary tightening was envisaged to signal commitment to economic restructuring and to reconstruct policy credibility after the GCS episode. The authorities also acknowledged that exchange rate policy practice during February-May 1992 had deviated from its discourse of flexibility. It portrayed it as a temporary episode aimed to contain wage demands and again vowed to entrust exchange rate to the market's self-regulating forces.

The new SBA identified the soft budget constraint as the main policy challenge. Indeed, the IMF (1992a:55) drew a valuable lesson from the GCS episode: price stabilization was conditional on micro restructuring efforts to enforce hard budget constraints⁷⁴, so that 'to obtain the desired reduction of inflation, stringent credit policies are needed'. The second stabilization plan set an 88% money growth target and a 70% limit on cumulative changes in bank credit. The difference of magnitude between the money growth targets in the two stabilization programs reflected a more pessimistic outlook for inflation and the alleged absorption of the monetary overhang⁷⁵.

However, the policy repertoire had to be expanded to legitimize and enforce the monetarist excess liquidity narratives. A new round of credit ceilings could have hardly mobilized political support given the 1991 debacle. In response, policy argumentation turned to interest rates and indirect policy instruments (required reserves and the refinancing facility) to ensure monetary restraint. The 1992 SBA demanded a substantial increase in interest rates; the NBR (1992a) agreed that this would signal the end of abundant credit at negative real interest rates as if credit decisions in 1991 had not been entirely determined by credit ceilings⁷⁶.

⁷⁴The 1992 SBA required Parliament to pass legislation strengthening financial discipline.

⁷⁵ The 15% broad-money growth established in the first SBA premised a monetary overhang that would allow the absorption of price jumps without additional monetary growth. The substantial overshooting in consumer price inflation (223%, compared with a target of 120%) implied that, whatever the magnitude of the monetary overhang, such substantial price inflation had absorbed it.

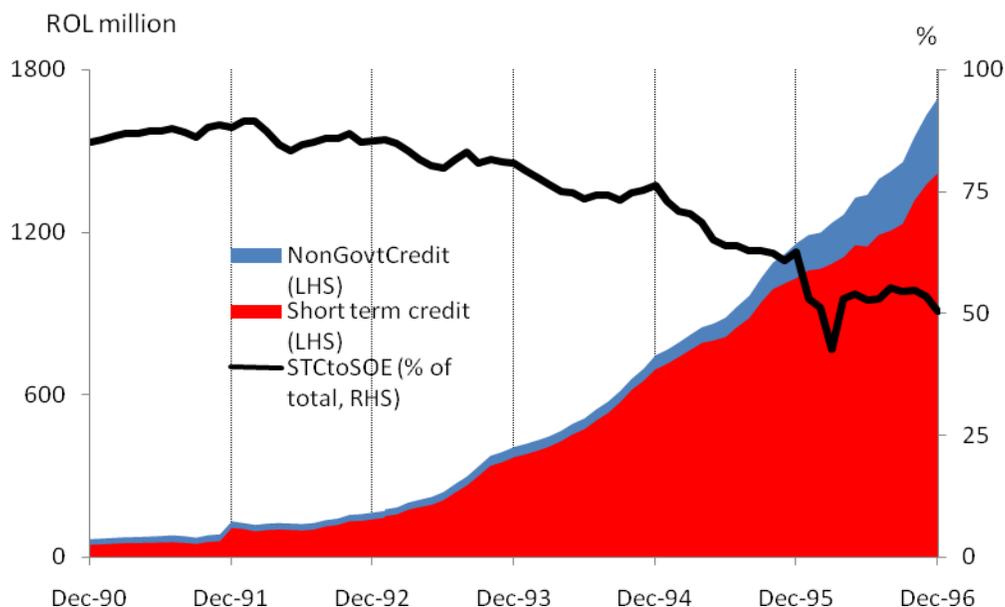
⁷⁶ 'The often invoked policy to stimulate investments through interest rates again proved illusory: during 1991, the year with the highest negative real rates, investment fell to 12% of GDP the lowest since the second world war' (NBR, 1992:27).

Instead, the emergence of the interest rate as a 'viable' policy instrument sought to give the appearance that market mechanisms, rather than policy-makers, were behind highly contractionary policies. The NBR raised its refinancing rate to 80% in May 1992, positive in real terms. While in policy practice the institutionalization of the interest rate as policy instrument is conditional on its effectiveness for controlling aggregate demand, no questions of a functioning transmission mechanism were explored in this case.

The new monetary tightening programme again produced unexpected results. The IMF's October 1992 SBA review noted with dismay that enterprises' demand for credit was growing at an unexpectedly slow pace'. While some of the subdued demand for credit was partly explained as a substitution effect to cheaper arrears, even so, the increase in total credit, including arrears, was only at half the programmed level (IMF, 1992b: 15). Indeed, for most of 1992 non-government credit grew at a slow pace in nominal terms, and contracted in real terms, interpreted as evidence that enterprises' demand for credit reflected lower financing needs.

The IMF's narrative failed however to consider whether and how the highly uncertain climate combined with the NBR's non-accommodative stance would affect willingness to lend or borrow in domestic currency. The term structure of the banking sector's assets suggested that the productive sector found it increasingly difficult to raise long-term finance: the share of short-term credit in total non-government credit increased rapidly from around 65% at the end of 1990 to around 90% up to the middle of 1995 (see figure 5). Initially SOEs were worse affected: only after 1994 did their share in short-term credit fall below 80%.

Figure 5 Credit dynamics and share of short-term credit to SOEs in short-term credit, 1990-96, Romania



Source: computed from the Statistical section of the *National Bank of Romania Annual Reports 1995* (p. 60 and 61) and 2000 (p.618-9)

The central bank faced a new conundrum to explain. If the SBA monetary targets were too generous, how come Romania was experiencing, in the words of the NBR director of monetary policy (Radulescu, 1993), the third payments blockage in so many years and rampant inflation by the end of 1992, along with a spectacular 13% contraction in output and a 22% contraction in industrial output?

While policy discourse attributed the economic chaos to political interference that perpetuated financial indiscipline, the government was forced out of office in September 1992 on accusations of an overblown predisposition towards ‘shock therapy’ (Pop, 2006). The NBR’s 1992 annual report further clarified the policy ‘failure’. Preferential credit, extended under governmental pressure, had produced an excess of liquidity in the system (Radulescu, 1993). It further fed into speculative pressures on the exchange rate, since the loss of the domestic currency’s ‘moneyness’ shifted portfolio preferences to foreign currency and

complicated monetary control. Indeed, in early 1992 the government had decided to open two special credit lines for agriculture and energy producers⁷⁷, extended by a state-owned commercial bank⁷⁸ at subsidized rates. Underlying this ‘non-market’ measure was not an industrial revival strategy, but rather an attempt to cover the large losses enterprises were incurring due to the asymmetry between administered prices (for food and household energy) and liberalized costs (NBR, 1995:55).

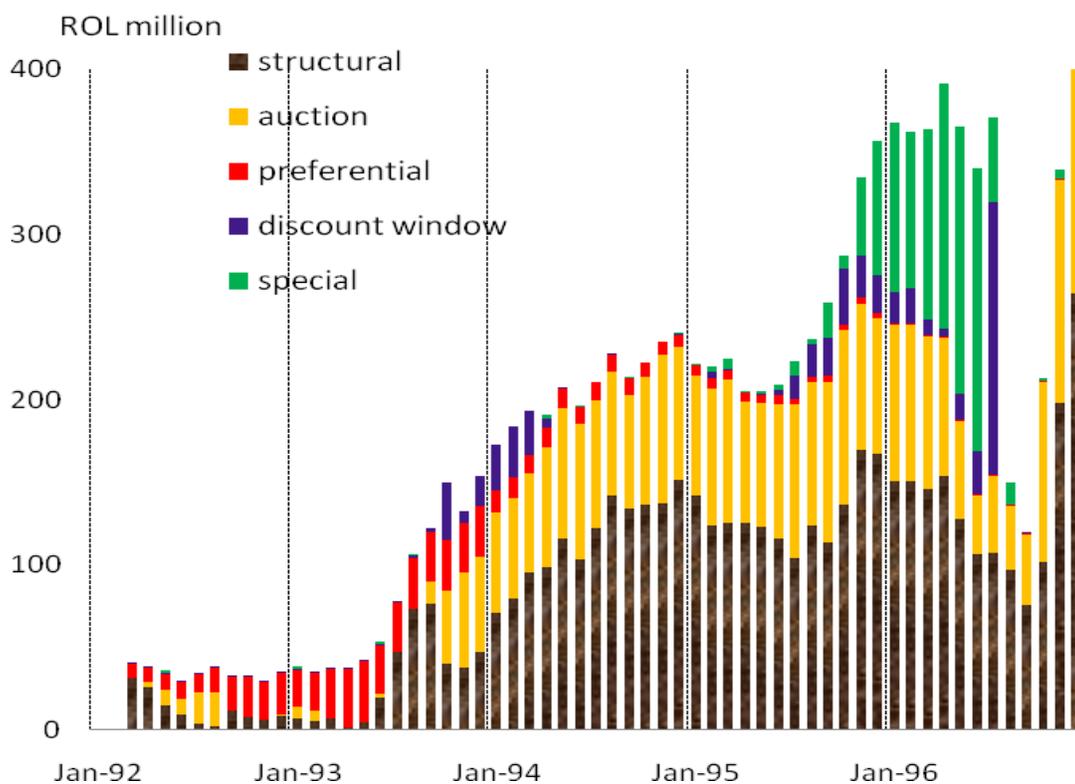
Notwithstanding these claims, the dynamics of NBR credit facilities suggest that, throughout 1992 and up to the middle of 1993, the central bank had maintained a tight policy stance. Indeed, in this period, preferential credit rose to amount to over 80% of total high-powered money available in the system (see Fig. 6). However, the change in the high-powered money structural composition alone is misleading, for it fails to take into account nominal dynamics. As Figure 6 shows, against mounting inflationary pressures (consumer price inflation rose to 200% that year), average daily refinancing from the NBR decreased in nominal terms⁷⁹. In order to comply with the NDA performance criterion, and in line with the excess liquidity discourse, the NBR significantly reduced access to the discount window (through either the structural or auction facilities) to offset growth in preferential credit.

⁷⁷ Lei 75 bn, of which only half used for the energy sector, and lei 105 bn for the agricultural sector, all used.

⁷⁸ The Romanian Commercial Bank, BCR.

⁷⁹ From ROL 40bn in March 1992 to RL 35bn in December 1992.

Figure 6 NBR's credit facilities (million ROL), Romania, 1992-96.



Source: computed from the Statistical sections of the *National Bank of Romania Annual Reports 1995* (p. 64) and *2000* (p.622)

The industrial sector, supported by some government officials, mounted a substantial challenge to the excess-money narrative. It argued that the bank's credit behaviour, rather than financial indiscipline, was posing unprecedented challenges to economy-wide payment operations, short of sabotage in the words of a Ministry of Industries official (Adevarul, 1993a). Since the NBR had raised its refinancing rate, and was set to impose regulation that would approximate market outcomes by administratively raising loan rates, state-owned banks had discovered their capitalist instincts and were damaging productive activity. The following quotation captures well the outrage:

‘[We are] a state-owned enterprise that succeeded in both increasing production and mobilizing demand. Whatever we have achieved through restructuring production, banks are destroying, through extremely high interest rates and a very slow payment mechanism. We have ROL 200 mil with CEC⁸⁰, which requires thirty days for access [...]. While the essence of restructuring, money, is at banks discretion, there is a silent war going on’ Priescu (1993).

The language deployed here to describe the relationship between production and finance suggests that the economic space was showing signs of reconstitution along neoliberal lines: a world where finance is no longer circumscribed by a logic of production, but is redefined as a separate ‘entity’ with divergent interests. Indeed, against the increasing reluctance of the industrial sector to draw credit at prohibitive interest rates, banks were purposefully delaying payment transfers (Adevarul, 1993b; Priescu, 1993b). Such reports further questioned the common wisdom of banking development in transition: state-owned banks, unaccustomed to market practices, functioned to validate the state’s populist credit subsidies for its productive system.

Indeed, the productive sector questioned its capacity to withstand such operational blockages. Without access to its bank deposits, financing options were narrowed to either accepting payment delays, with the attending slowdown in activity, or playing into banks’ game by contracting credit at penal rates. The first choice would result in arrears while the second implied either a contraction of profits or prices increases to reflect increasing costs.

A temporary solution saw enterprises turning to large-value cash payments⁸¹ which the NBR subsequently recognized as a consequence of banks’ deliberate delays in settling interbank payments (NBR, 1993a). To circumvent banks’ reluctance and reduce

⁸⁰The largest savings bank at that time.

⁸¹ Large cash transactions were illegal, but enterprises preferred to incur the penalties associated with breaching the law while banks refused to settle payments rather than demand credit at penalty rates.

the payment cycle, the NBR decided to create fixed-sum cheques, paid on sight⁸². Furthermore, the government took additional measures to tackle the payments blockage. The four big state-owned banks were mandated to implement a subsidized three-month credit programme⁸³ aimed at alleviating the temporary liquidity problems among exporting SOE with good economic performance.

The shifting relationship between production and finance opened up a new field of policy contestation: NBR's interest rate policy. Policy argumentation framed interest rate decisions through a discourse of financial liberalization (McKinnon, 1973; Shaw 1973), in line with the IMF's own position. Indeed, once the corrective component of inflation was absorbed, tackling structural inflationary pressures required the fast marketization of the two relevant financial variables: the exchange rate and the interest rate (NBR, 1992b). Market-driven financial intermediation is more productive at channelling saved resources into productive use, while simultaneously 'discriminating' against investments with lower returns. This last point was of particular importance, for it implied that, under a liberalized financial sector, state-owned enterprises would no longer benefit from subsidized interest rates. Removing loan rate ceilings would increase the average efficiency of investment, and thus accelerate restructuring and the re-orientation of resources towards more efficient activity. Furthermore, financial liberalization would positively influence growth as higher (deposit) real interest rates could mobilize savings at the expense of consumption and thus increase the productive capacity of a country.

However, the episode described above, where additional regulation was necessary for the banking sector to behave according to basic 'market rules' (such as timely payments), questioned the optimistic promises financial liberalization discourses made to the productive

⁸² This central-bank driven financial innovation is the opposite of the 19th century changes in the English financial systems, when banks substituted cheques for banknotes in order to avoid the Peel Act quantitative constraints.

⁸³ Credit was to be extended for three months at a 25% preferential interest rate.

sector. Against this background, the NBR proceeded to reconstruct the legitimacy of its interest rate policy (NBR, 1993a). It dismissed the Keynesian argument that an increase in the marginal propensity to save reduces consumption, aggregate demand, the rate of profit and therefore investment (Arestis and Caner, 2004). The 1991 collapse in investment, it argued, when interest rates were highly negative in real terms, indicated that interest rates were not a viable avenue for stimulating investment. Again the discursive operation of narrowing policy argumentation to interest rate behaviour sidelined the credit ceilings that substantially reduced access to financing. The NBR further maintained that Keynesian-informed interest rate policy would undermine its emphasis on contracting excess demand. Besides, increases in real interest rates could not generate either cost driven inflationary pressures or affect the rate of profit because interest payments represented a small share of enterprises' operating costs.

This last claim was quite controversial, particularly when the logic of socialist production translated into a dependency on bank credit for financing working capital (Dow et al, 2008). Indeed, for an annual 80% interest rate in 1992, the Ministry of Industries (1993) estimated interest rate repayments at around 30% of enterprises' operating costs, significantly higher than the 5% produced by the NBR (1993a). Elsewhere however NBR admitted that the lack of capitalization affecting the state-owned sector after the collapse of communism implied that enterprises' own resources for working capital needs amounted to 35%, compared to a necessary average of 80% (Radulescu, 1995). The rest had to be covered through bank loans. If the Ministry of Industry's estimation was closer to the actual value, than high interest rates would be detrimental to capital investment, particularly where SOEs responded to payments blockage by contracting credit⁸⁴.

While the NBR maintained liquidity operations in line with the excess demand narrative, its exchange rate policy practice again departed from the commitments to flexibility.

⁸⁴ For instance a large car manufacturer (ARO) reported that the debt service throughout 1992 had exceeded the wage costs for 12.000 employees (Romania Libera, February 23, 1993).

Mounting inflationary pressures triggered interventions to reduce currency volatility after June 1992. These suggested a different explanation of the 1992 SBA developments: inflationary pressures arising from massive exchange rate devaluations⁸⁵, and the financial blockages produced through a combination of banks' attempts to coerce SOEs into demanding expensive credit combined with NBR's discount window policies.

The IMF however paid little attention to the possibility of alternative policy narratives, and instead cancelled the second SBA in April 1993. New negotiations began in July 1993, as the NBR (1993a) promised a fresh beginning in monetary policy.

4.5 The dawn of a new era: SBA 1994

Negotiations extended for nearly a year (the SBA was approved in May 1994), amidst a difficult economic environment. Inflation rates remained stubbornly high while industrial production was contracting at an alarming rate. Increasing policy contestations required a series of discursive adjustments to maintain the coherence of excess liquidity narratives and to explain the divergence between the discursive commitment to exchange rate flexibility and the repeated attempts to stabilize the currency. The NBR produced two reports explaining monetary policy (NBR, 1992b) and exchange rate policy (NBR, 1993b).

The 1993 exchange rate report contained an interesting instance of discursive ambiguity. On the one hand, it insisted on the PPP causality from prices to nominal exchange rates⁸⁶, and deployed the monetary approach to the balance of payments to argue that, rather

⁸⁵ November 1992 year-on-year figures showed a 300% depreciation in the ROL/US\$ exchange rate.

⁸⁶'The external depreciation of the ROL has followed the internal inflationary dynamics.' (NBR, 1993b: 31).

than devaluations feeding into price increases, excess liquidity caused inflation. On the other hand, the report recognized some pass-through to prices⁸⁷.

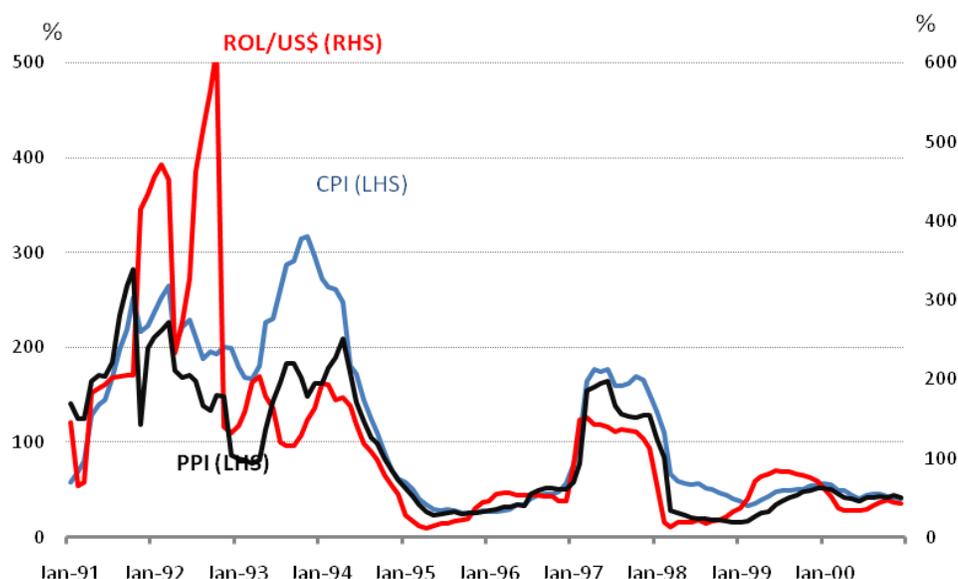
The report used a relative PPP method to estimate equilibrium levels and the magnitude of misalignment (NBR, 1993b). It situated the equilibrium exchange rates at ROL/US\$ 33 for 1990, and calculated subsequent equilibrium levels and deviations using the retail price difference between Romania and the US. Such estimation was clearly subject to relative PPP shortcomings explored in the previous chapter. It took no account of the comparability of price indices, the base-year equilibrium was derived on the questionable assumption that it would have equilibrated the external balance during the last years of communism, and it subsequently produced highly volatile equilibrium levels for the 1991-1992 period. Essentially, it assumed that the real equilibrium level remained constant throughout the period under analysis, a strong assumption in light of the significant structural changes the economy was experiencing. Furthermore, the report used two ‘common sense’ arguments for the discursive production of misalignment: the persistence of trade deficits despite successive devaluations and the differentials between the interbank/black market levels and the official interest rate. It glossed over the possibility of either structural trade deficits arising from the permanent loss of export markets or the persistent foreign reserves shortages that translated into interbank exchange rate volatility.

In policy practice this ambiguity translated into shifts between stabilizing the currency and withdrawing from the foreign exchange market (forex). What explains the apparent inconsistency of exchange rate decisions? Was it political interference into market processes, as the IMF alleged? While indeed forex interventions did involve political decisions to sidestep commitments to equilibrium, focus on politics again glosses over the economics underlying

⁸⁷ ‘The external equilibrium is vital for the economic independence of a country, and could thus be more important than subduing inflation; it has to be maintained even with the painful cost of internal price increases’ (NBR 1993?: 8)

equilibrium discourses. Indeed, equilibrium-seeking devaluations have perverse effects in the presence of an exchange rate pass-through. Where nominal devaluations were reflected in prices (with a lag), as Figure 7 suggests for both consumer and producer prices, then the PPP discourse shaping policy practice produced inflationary spirals. In fact, relative PPP logic dictated that price liberalizations required devaluations, but these would quickly push into increased prices, further requiring *ex post* adjustments in exchange rates. Under these circumstances, commitment to equilibrium could not be upheld for too long unless policy makers were prepared to accept the instability associated with highly volatile inflation rates. While forex interventions did require political validation, the PPP logic itself contributed significantly to the erratic policy-making.

Figure 7 Price indices and exchange rate dynamics (% change), end of period, Romania, 1991-2000.



Source: computed from the Statistical Section of *the National Bank of Romania Annual Report 1995* (p. 21) and *2000* (p. 576).

NBR's policy discourse reflected this dilemma. While it acknowledged that arresting the speed of devaluation did slow down price movements, the NBR (1994a: 10) rejected what it called

the ‘disproportionate emphasis’ on cost-push inflation. It discussed monetary policy options as a trade-off between aggregate demand and cost-push explanations of inflation, and argued that an undue emphasis on the latter had two essential shortfalls. First, the conditions for employing the exchange rate as a nominal anchor were simply not in place (Radulescu, 1993). The NBR lacked the foreign reserves for credibly defending an established target, while the IMF refused to support such a policy strategy. Furthermore, the politicization of exchange rate decisions disqualified it as a policy instrument. Inflation could not be tackled through exchange rate policies because its origins had to be located in the politics of gradualism delaying micro-restructuring. Once prices were liberalized, the government’s insistence on maintaining an overvalued currency constituted another instance of protectionism of the state-owned enterprises, an implicit and indirect subsidy of the imports of raw materials and intermediary imports that undermined the critical link between exchange rates and competitiveness and thus reproduced external trade disequilibria.

By insisting that exchange rate management represented the best example of technocratic policy-making frustrated by government pressures, the NBR was aiming to orchestrate policy consensus by discursively depoliticizing its policy-making. This was a difficult operation, for various policy actors challenged its economics. Industrial interests, the ‘big winners’ of the insistence on nominal stability, rejected the claim that the exchange rate decisions were functioning to allow it to recover its export competitiveness (Adevarul, 1994). The 1991 decision to ‘confiscate’ exporters’ foreign exchange earnings, a measure commonly employed throughout Eastern Europe to eliminate some of the volatility in foreign exchange rate reserves, is a good example of the institutional disorder that affected industrial exporters. Production depended on imports of intermediary goods and raw materials revenue, so that the surrender mechanism left exporters dependent on the NBR or the interbank market for mobilizing these resources. The active encouragement of consumer goods imports as an anti-

inflationary measure, a feature present in IMF supported stabilization plans (Amsden *et al*, 1994), saw industrial producers competing for scarce foreign resources with retail importers, or having the option of a greatly depreciated exchange rate. Thus, rather than receiving a subsidy through appreciating real exchange rates, the lack of a well-functioning mechanism for redistributing foreign currency greatly limited the ability to produce and export, and compelled SOEs to innovate payment procedures in order to avoid the retention mechanism. Equally controversial were devaluation decisions when placed in the context of enterprises' dependency on imports of intermediary goods (Oana, 1993). In theory, competitive devaluations function by changing relative prices and shifting consumption from more expensive imports to locally-produced goods, while simultaneously improving export competitiveness. However, a significant pass-through effect to production costs, caused by the absence of domestically produced intermediary substitutes, not only increased domestic prices but diminished the scope for correcting the current account imbalances and exchange rate flexibility. PPP-driven ex-post adjustments aimed at preserving competitiveness would produce persistent inflationary pressures (Coricelli et al, 2004).

The existence of such an effect was later acknowledged in IMF research (2001, 2003), which estimated a substantial pass-through from exchange rate to prices for the period 1997-2001. Undoubtedly the magnitude was higher before 1997, as domestic production depended to a greater extent on intermediary imports. Thus the existence of a large pass-through limits the scope for exchange rates flexibility.

Notwithstanding policy contestations, the NBR rejected the idea that cost-push considerations could guide its policy. This would amount, in its words, to a negation of the central bank's *raison d'etre* (NBR, 1994a: 36): to control aggregate demand. What emerges here is a dichotomized discursive construction of policy choices: politicized exchange rate management versus 'objective' aggregate demand control, arising from the increasing

colonialization of the policy imaginary by neoliberal monetarist discourses. Fixing politics as a yardstick shaped the rationality underpinning the central bank's functioning: policy must stay out of politics, even if it involves disregarding empirical evidence (of the relationship between exchange rates and prices) and requires complicated discursive operations to reconstruct continuously the legitimacy of a policy discourse underpinned by 'objectivity' but undermined by failure to achieve stated outcomes.

Indeed, attempts to frame inflation through an excess liquidity narrative were difficult to maintain in the policy space. During the 1993 discussions with the IMF, the negotiators on both sides recognized that Romania was confronted with a peculiar type of inflation, for neither arrears nor monetary aggregates (and credit behaviour) could explain inflationary pressures (Adevarul, 1993b). Monetarist policy measures, such as restricting access to NBR's liquidity facilities, seemed to have little impact on prices, while the crucial role of the exchange rate was barely recognized in policy discourse. For instance the 1992 NBR (1992b) report on monetary policy in transition failed to mention the exchange rate as a possible cause of inflation, and instead insisted on the usual suspects: gradual price liberalization and excess liquidity driven by gradualism in micro restructuring.

Furthermore, the shift in portfolio preferences further debilitated the scope for monetary control: by the end of 1993 forex liabilities amounted to around 30% of broad money, also reflected in a substantially lower share of ROL long-term household deposits⁸⁸ (see Table 4). The cash-to-broad-money ratio remained broadly similar through the first four years of transition, a trend different from other formerly planned countries that witnessed a

⁸⁸ This carried implications for what the NBR described the 'monetary overhang' policy puzzle. The first stabilization episode was predicated on the existence of a substantial household excess liquidity. However, throughout the first three years of transition, household ROL deposits did not fall in nominal terms. This the NBR (1993) explained as money illusion - instances when economic units overestimate the purchasing power of their nominal wealth (Kane and Klevorich, 1967), failing to consider whether the collapse in real money balances could have been explained by an increased preference for liquidity in times of high uncertainty. Whether explained as economic irrationality or Keynesian liquidity preference, household behaviour invalidated the essential premise of the 1991 SBA: that household excess liquidity would be redistributed to the productive sector.

period of growing reliance on cash transactions (Ruziev and Ghosh, 2008). With the exception of 1991, when the GCS monetization of interenterprise arrears increased end-of-year enterprises sight deposits, the overall broad money supply composition changed little. However, SOEs share in total sight deposits declined substantially (from 70% in 1990 to around 34% in 1993), both because of an increasing importance of the private sector and banks' continued reluctance to finance state-owned production (manifested for instance in high interest rates).

Table 4 Broad Money composition, Romania, 1990 – 1993.

	% cash	% sight deposits		% time deposits	
			of which SOE	of which household RON savings	
1990	19%	25%	68%	60%	84%
1991	18%	52%	91%	34%	78%
1992	22%	33%	39%	45%	49%
1993	23%	26%	34%	50%	29%

Source: computed from the *National Bank of Romania Annual Report 1995* (p.62)

In this increasingly complicated argumentative terrain, the NBR decided that a policy shift was needed to stabilize its excess liquidity narrative. To enforce this change, it proceeded to reinterpret its policy record up to 1993. Its concerted efforts to curb access to liquidity by any means possible, even at the expense of payment blockages, were now represented as unfortunate instances of policy relaxation. Indeed, the NBR argued, a new IMF agreement depended on its ability, government permitting, to make a break with its past accommodative stance (NBR, 1994a). A new era of commitment to monetary restraint⁸⁹ would be accompanied

⁸⁹The 1993 NBR annual report (1995: 12) explained that the policy shift would be underpinned by four objectives, all constructed through an excess liquidity discourse. These sought to a) eliminate the excess liquidity arising from the government's deposits with the commercial banks by transferring a consolidated Treasury account into NBR management. b) commit to avoid new preferential credit or the rollover of existing outstanding loans, with most directed credit phased out by the end of 1993. c) ensure tighter liquidity control to keep money supply

by structural reforms that recognized the fundamental role SOEs played in delaying, or even obstructing, stabilization efforts (IMF, 1994a).

However, negotiations with the IMF had reached a stumbling block: full liberalization of exchange rate transactions (including NBR's interbank auctions). Eventually the Fund accepted a gradual move towards a floating regime, but leveraged the 'exchange rate gradualism' to pressure authorities towards faster liberalization in other policy domains. The IMF's Executive Board recommendations stressed two necessary policy actions in September 1993: positive real interest rates (to complement a tighter control of the money supply) and the termination of concessional-credit programs⁹⁰.

The NBR responded to these demands with a fundamental overhaul of policy practice: *the effective deployment of indirect instruments for a tighter liquidity control*. It thus instituted reserve money as an operational objective and instruments for forecasting liquidity requirements in August 1993. The new policy framework, it argued, would reinforce monetary control because of the central bank's monopoly position in supplying high-powered money.

This monetarist rhetoric was however qualified by uncertainties in estimating the demand for money. Hence, the NBR maintained, an unusual mix of policy instruments was required to tackle inflationary pressures. The NBR would target both the interest rate and the (broad) money supply (NBR, 1995: 190). Thus efforts to distance policy-making from its previous 'ambiguity' produced a new form of ambiguity. The simultaneous use of the two instruments is in fact theoretically inconsistent. Instating high-powered money as an operational objective precludes any interventionist interest rate policies. Instead the market sets interest rates at a level consistent with the demand for broad money, given a certain level of

growth on path and thus ensure compliance with future NDA targets. d) raise real interest rates to positive levels. The increase in the cost of liquidity was intended to work both as a signal of the anti-inflationary stance and to force commercial banks to mobilize alternative funding sources.

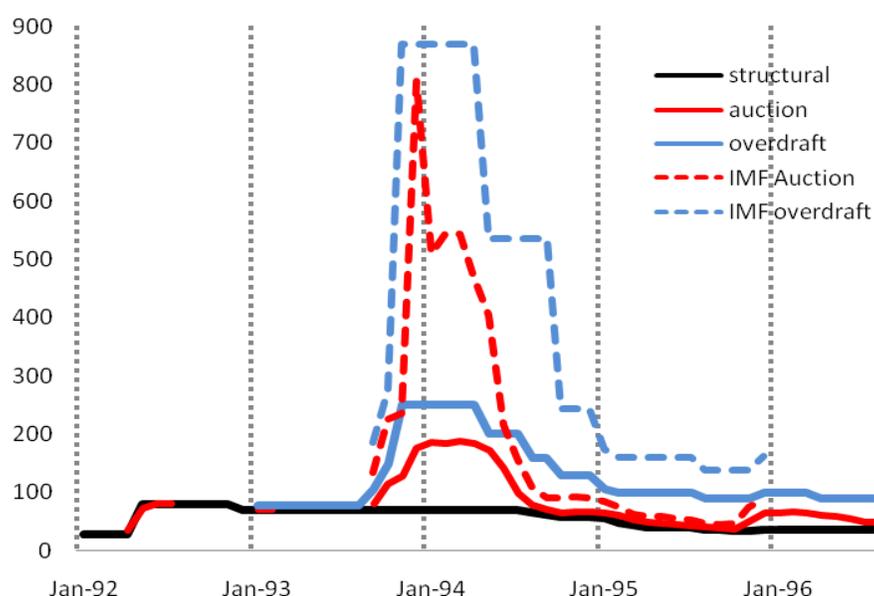
⁹⁰The IMF also requested the government to downsize the imports of primary commodities (especially energy) for the special reserves and a faster closing down of inefficient state-owned enterprises (Adevarul, 1994b).

broad money (Friedman, 1969). In other words, for exogeneity (in a policy sense) to hold, an essential condition for the quantity-theory causality, the demand for money has to be independent of its supply. This independence works to set the interest rate.

Thus policy discourse articulated a tight stance. Nevertheless, in practice the NBR stepped up liquidity injections, with total refinancing increasing substantially after June 1993: daily average refinancing from the central bank doubled between July 1993 and April 1994 (see Figure 6). If liquidity operations were driven by forecasts in line with projected price increases, then the significant increase in average daily liquidity made available to the banking sector challenged the representation of the monetary stance as accommodating before July 1993 and tightening afterwards. Indeed, it would seem that up to 1993 the system suffered from a systematic shortage, rather than an excess of liquidity.

While the NBR appeared to have finally accepted that the system could not function without liquidity, it nevertheless sought to maintain policy tightness by raising its refinancing rates to historically high levels (see Figure 8).

Figure 8 Interest rates on NBR credit lines (% , annual), Romania, 1992-1996.



Source: computed from the Statistical Section of *the National Bank of Romania Annual Reports 1995* (p. 34), 1999 (p. 29) and IMF 1995a (p. 9)

As explained earlier, the IMF had made the third SBA conditional on positive real interest rates (IMF, 1995a). Previous attempts to impose real interest rates had been obstructed by failures to predict inflation rates: *ex post* values moved real rates into negative territory. These failures reflected the challenges monetarism produced for either controlling or forecasting price developments. While exchange rate volatility (and price liberalizations) drove price movements, and with little room for a longer, administratively-induced, exchange rate stability, forecasts tended to underestimate the magnitude of price inflation. Under these circumstances, the NBR could have either changed its approach to forecasting to explicitly account for exchange rate dynamics, or raise its interest rates enough to contain any unexpected price surges. The NBR chose the second option.

Here a curious contradiction appears between IMF and NBR data, a difference difficult to account for given that the NBR was the source of IMF statistics. In discussing the turn to tightening after mid 1993, the NBR (1994a) advanced interest rates on its refinancing

operations of a far lower magnitude than the IMF's. For instance the NBR quoted a rise in overdraft (Lombard) rates at around 250% p.a. between November 1993 and April 1994, while the IMF (1995a) placed it at 860% for the same period. The same holds for the auction facility, where IMF figures show the rate rising to 800% in December 1993, then gradually decreased to 159% in August 1994. The discrepancy in the reported figures then has to be understood as an attempt to minimize the contestations in the domestic policy space, for it would have been difficult to defend such high interest rates in an environment where industrial interests were already casting the monetary authority, and the banking system, as detrimental to productive activity. It is important to note here that during the period where both the overdraft and the auction rates were hovering at extremely high levels, between 40 and 50% of total refinancing (see Figure 6) was granted through these facilities. Furthermore, the NBR charged positive interest rates for the structural credit lines through which the government extended preferential credit to the agricultural and energy sectors. The NBR structured this selective allocation of credit so that it would not conflict with allowing market mechanisms to allocate liquidity. It maintained refinancing volumes at levels consistent with the quantitative targets for reserve money growth. In other words, the directed credit which the government intended to target priority sectors was neither creating excess liquidity nor providing an indirect subsidy through negative real interest rates.

Following these policy measures, the third SBA was signed in May 1994. Reflecting lower inflation projections, it set lower broad-money growth targets⁹¹ and indicative targets for reserve money. It further specified a quantitative benchmark for the stock of enterprise arrears, envisaging a gradual reduction towards the end of 1994. The national authorities renewed their commitment to exchange rate flexibility, and pledged to restrict forex market interventions to instances of substantial volatility. Interbank forex auction sessions were liberalized in April

⁹¹ The SBA broad money target specified 54% for the first half of 1994, 35% in the second half.

1994 and a fully fledged forex market was fully operating from August 1994⁹², replacing auctions with direct negotiations between dealers. The income policy remained geared towards real wage cuts, setting a forward-looking indexation coefficient so that it only partly compensated for price increases. State-owned enterprises faced a punitive charge for excess wage increases (IMF, 1994a).

The September SBA review (IMF, 1994b) noted significant progress, with all quantitative criteria in line with projections, and recommended that Romania be allowed to make the second SBA purchase. Indeed, NBR (1995a: 15) identified 1994 as the best year in terms of the success of macroeconomic stabilization, ‘reflecting both authorities’ learning curve and a better response of the productive sector to macro policy measures’. It pointed to the substantial fall in the inflation rate (62% compared with 295% at the end of 1993), the pick-up in GDP growth (3.9%) and industrial production (3.3% annual growth). The improved export performance, on the back of increased stability in exchange rates, reduced the current account deficit. Such positive developments were attributed to a better control of liquidity, when in fact data showed substantial reserve-money growth.

Indeed, despite extremely high refinancing interest rates, credit growth was for the first time positive in real terms since the 1991 Global Compensation Scheme (see Figure 4). The NBR seemed more inclined to make liquidity available, even if at high prices, while money supply developments invalidated the monetarist link between monetary aggregates and prices. M2 grew at a similar pace in both 1993 and 1994 (around 135%) while inflation fell to 62% from 295% in 1993, confirming difficulties of forecasting money demand, and thus employing a strict monetarist logic. It suggested that the inflationary implications of an increase in the demand for money were not always clear. If for instance M2 growth reflected a structural or

⁹²The IMF (1994a) established the creation of a foreign exchange interbank market by June 30, 1994 as a structural performance criterion.

portfolio shift in demand, driven by increase confidence in the domestic currency, the inflationary impact is limited.

However, by February 1995 the IMF's endorsement of the macroeconomic policy package disappeared. The SBA review concluded that Romania had failed to comply with the program's conditionality. The review (IMF, 1995a) listed three main policy slippages:

- Accommodating policy practice which prioritized preferential credit to agriculture.
- Interference with the forex market: state-owned banks reportedly quoted overvalued rates, impeding market clearance, producing expectations of future devaluations and a rapid extension in foreign currency credit for stockpiling intermediary inputs.
- Delays in enterprise reform that produced a fast increase in payment arrears.

However, the share of concessional loans to agriculture⁹³ in total financing did not change from the 37% registered in September 1994, when program continuation was approved. The IMF's decision to interrupt program relationships was apparently driven by the last two policy 'slippages', both performance criteria.

4.6 Last but not least: SBA 1995

These policy domains would reappear in negotiations during October-November 1995, when Romania turned to the IMF again as NBR foreign reserves were again contracting at an alarming pace (see figure 2), and its plans to tap international markets depended on the IMF's seal of approval. The IMF (1995b) identified two policy problems undermining liquidity control: government-preferential credit policies⁹⁴ and inter-enterprise arrears, substantially above the 1994 performance criteria targets. A third 'policy challenge' was also noted:

⁹³ The IMF (1995a) argued that over two thirds of total refinancing was channelled through the Banca Agricola (the Agriculture Bank), nevertheless only half of this (amounting to 37% of total refinancing) was concessional credit. The remainder was extended under normal credit procedures.

⁹⁴ Directed at the agricultural, energy and exporting sectors.

monetary control was debilitated by the explosive increase in foreign currency loans, from 4% of total non-governmental credit at the end of 1991 to 30% at the end of 1995. Predictably, NBR's high interest rate policy switched credit demand to foreign-currency credit. The IMF's policy prescriptions did not go as far as the NBR's, who at one point contemplated the possibility of prohibiting the banking sector from lending in foreign currency (and failed to mobilize enough political support). Since this would have interfered with market mechanisms, the IMF (1995b) instead recommended the typical regulatory measure for containing credit growth: increased reserve requirements. The NBR consequently raised required reserve ratio on forex deposits to 40% by the end of 1995.

However, the IMF (1995b) recognized that the monetary authority had behaved according to its expected mandate. Domestic currency interest rates had remained positive in real terms on both refinancing credit and commercial bank loans throughout 1994 and 1995. What the monetary authorities faced now was a typical capitalist banking affliction: information problems. Since demand for credit had a low price elasticity, a combination of moral hazard and adverse selection was keeping problematic state-owned enterprises afloat. By now structural reforms, and not macroeconomic policy per se, delayed stabilization.

Despite a dismal SBA record, the IMF did not, at any point, question the usefulness of its quantitative targets, even when the process of re-monetization rendered the demand for money unstable. The fourth stabilization plan, signed in December 1995, again set a 30% upper limit on broad money growth. Furthermore, interest rates on refinancing facilities were raised while the government committed to reduce preferential credit to the agricultural sector. The national authorities asked the IMF to consider the possibility that the exchange rate could receive 'greater explicit emphasis' as nominal anchor (IMF, 1995b). Again the staff refused to support such a policy stance, arguing that the NBR lacked both foreign reserves and credibility

in the light of previous unsuccessful attempts to stabilize forex market volatility. Subsequently, the NBR vowed to refrain from further interference.

However, this last year of the ‘gradualist’ period would prove particularly challenging for implementing monetarist policy measures. The government, attempting to shore up political support in an electoral year, and instructed the NBR to provide concessional credit (Pop,2006). Preferential credit to agriculture rose to around 30% of total NBR refinancing credit in the first months of 1996. Under its monetarist impulse, the NBR sought to minimize access to other liquidity facilities while simultaneously raising the rate on its auction facility, so that the net effect was a contraction in daily average liquidity released to banks (see Figure 6). Two private banks were experiencing liquidity problems, and in the absence of any deposit guarantees, the NBR was forced to assume the lender-of-last-resort function at the end of 1995 and throughout 1996.

Thus discourses at play suggested that Romania was again on the brink of a crisis. Indeed a widening current account deficit triggered faster exchange rate depreciation in 1995, which the NBR failed to arrest. Inflation was again rising, driving ex-post real interest rates into negative territory. Through financial liberalization discourses, this signalled an expansionary policy, although the NBR had tightened up liquidity to September 1996. New forex regulation again broke IMF requirements: early 1996 the NBR revoked all foreign banks’ licenses, leaving only four state-owned banks to deal in the market.

The IMF suspended its fourth SBA in June 1996, four month before the general election. While the decision was accounted by the breaching of the performance criteria on net bank credit to the government, the overall NDA target was well within limits (IMF, 1996) and could thus not be inflationary. Nevertheless, the institution refused to contemplate a waiver, alleging that the NBR had lost control over reserve money, which indeed was above the indicative target in June 1996 because of the emergency liquidity provided to the two ailing

banks. Compliance with the IMF target would have required the NBR to refuse its lender-of-last resort function, and accept the systemic-risk implications of such a policy decision.

Was the IMF's decision the outcome of a quiet gamble for political change and a government of a more neoliberal disposition? In election politics, the failure of the fourth attempt to comply with IMF conditionality was explained as another failure of nostalgic socialism. The alternative explanation, linking failure to the IMF's economics of stabilization, never gained much currency in public politics. Predictably, the right wing 'historical coalition' won the general election on a platform of change that promised a quick and painless shift in the roadmap to reform. Negotiations with the IMF resumed, setting the country on course for its fifth shock therapy in seven years, this time under the leadership of a political party with much greater appeal in neoliberal circles. The IMF's Managing Director visited Romania in December 1996 to salute the new momentum for reform.

4.7 A pause for reflection: the state-owned enterprises

The IMF's record of engagement in the Romanian policy space suggests that state-owned enterprises, rather than aggregate demand, were its main policy concern. Indeed, the ideological function of the hegemonic narrative of excess aggregate demand is revealed through its treatment of the productive sector. At play in the IMF's discourse was a sort of complicity between the exclusion of state-owned enterprises as economically viable and the wider systematic exclusion of supply-side discussions from the neoliberal discourse embedded in blue-print IMF stabilization packages and international economic advice to Eastern Europe.

The policy narrative constructed the stabilization problem as follows: state-owned enterprises are no longer productive units capable of generating economic growth but problematic entities whose functioning is governed by politics instead of market principles.

This construction deployed the ‘soft budget constraint’ and ‘restructuring’ as structuring metaphors. Policy analysis has shown how policy discourse produces mobilizing metaphors, whose ambiguity is required to conceal ideological differences so as to allow the enrolment of various interests (Mosse, 2005). In the Romanian economic discourses, restructuring is an example *par excellence* of a lack of conceptual precision. Restructuring, in the IMF’s and NBR’s discourse, required closures and privatization, while the unwillingness to restructure, validated through pervasive arrears, called for ever tighter liquidity policies. On the other hand, domestic industrial interests defined restructuring as a strategic intervention, through an industrial policy, that prioritized credit for capital formation and competitive exchange rate management. In this framing, the systematic attempt to starve the system of liquidity underlying policy practice sought to transform liquidity problems into solvency problems and delayed restructuring. This homogeneous treatment of state-owned firms rendered them all susceptible to blockages in the payment system, and ultimately required government-orchestrated rescue packages, such as the Global Compensation Scheme.

Clearly governments could have contemplated restructuring through bankruptcies, as the IMF suggested. Political preferences influenced economic outcomes, and perhaps a coalition of ‘historical’ parties would have been more prepared to uphold commitments to neoliberal prescriptions. However, such a claim, underlying the neoliberal argument that shock therapy could displace industrial interests and thus push a quick restructuring, glosses over substantial structural bottlenecks while simultaneously downplaying the extent to which ‘neocommunist’ government did in fact implement contractionary measures.

Indeed, closing down state-owned enterprises implied massive unemployment when the emerging private sector was hardly generating significant employment opportunities. The temporary commitment to IMF targets tested the government’s willingness to accept the political consequences of highly contractionary policies, and found they were reluctant to do so

for very long. But this reluctance was not entirely the outcome of political calculations and communist reminiscing about the beauty of full employment. It partly reflected a stark consequence of the liquidity crunches and prohibitively high interest rates: a privately owned productive sector with little possibilities of financing capital investment and thus operating mainly in the services sector. State-owned industrial production was the only source of much-needed export earnings.

Furthermore, the excess-demand narrative involved an attempt to redefine the organization of the productive system along competitive market lines, an economic engineering that the free market discourse refused to acknowledge but inherently contained. For processes to function under the disciplining hand of the market, production required a radically different logic. However, as Karl Polanyi (1944) convincingly showed, markets do not emerge spontaneously, but are human and contingent entities that have to be produced. And this is what the IMF's discourse of stabilization and its structuring of the central bank, sought: a radical engineering of the economic space to exclude state-owned monopolies and oligopolies. If power was to be exercised in the market, then it should be private rather than state-owned industrial interests attempting to influence policy-making.

Thus economic reform was shaped by an economic discourse that portrayed monopolies and oligopolies as unfortunate market structures that ought to be eliminated to achieve efficient market outcomes. However, the narrative that emphasized market efficiency generated through small-scale production in a competitive setting was built on a discourse disengaged from capitalist 'realities': that capitalism engendered an inherent tendency to concentration and centralization. Hence innovation, rather than price, underlines competitiveness (Schumpeter, 1951), and the bulk of innovative activity is generated by large, oligopolistic firms (Baumol, 2004). While free-market discourse vilified large-scale production for its power to obstruct the market, it is tacitly accepted, as Galbraith (1967) convincingly

argued, that the greatest productivity is achieved precisely through technologically-intensive processes that require increased commitments of both time and capital.

The implication is that socialist and capitalist production shared a similar logic of planning despite the neoliberal ideological rejection of monopolization. The capitalist industrial system fundamentally depends on firms' ability to circumvent the market (Galbraith, 1967). While neoclassical economic discourse obscures the central role that technology played in industrial production, where production involved capital and technology, capitalist firms do not simply respond to spontaneously generated demand. The ubiquitous large-scale, technology-intensive, capitalist firm, needs to reduce uncertainty in order to be commercially viable. Planning is an essential constituent of business activity, for the market is too unreliable to generate spontaneously either sophisticated technological inputs or the appropriate consumer preferences. Thus size is not everything, but nearly everything. As Galbraith showed, it requires and allows firms to contain to a significant extent market uncertainties through one of the following mechanisms:

- (1) Eliminating the market by vertical integration. This is aimed to control production chains and the price and supply of particularly important intermediary inputs who otherwise would be subjected to market volatility and threaten profits.
- (2) Suppliers or buyers can control both prices and quantities by exercising market power (monopsony/monopoly).
- (3) The market can be temporarily or indefinitely suspended when large firms mutually protect each other from price fluctuations by entering into contracts that specify both price and quantity for substantial periods of time.

Planning under socialism similarly sought to inscribe these principles in the logic of industrial production. Once the Central Plan disappeared, policy discourse constructed the state-owned sector exactly as Galbraith (1967) described the neoclassical depiction of monopolies: wasteful

and inefficient in employing resources, exploitative in the price it charges, and challenging in its need for reform.

SBA policy prescriptions aimed to invalidate the mechanisms that large-scale production, be it under socialism or capitalism, deployed for circumventing the market. The soft-budget constraint was deployed to articulate the SOEs' problem as one of solvency rather than liquidity, an important discursive operation that lent support to the argument that the paternalistic hand of the state had to be replaced by the efficient hand of the market. The sole survival strategy had to be the ability to generate profit under competitive conditions.

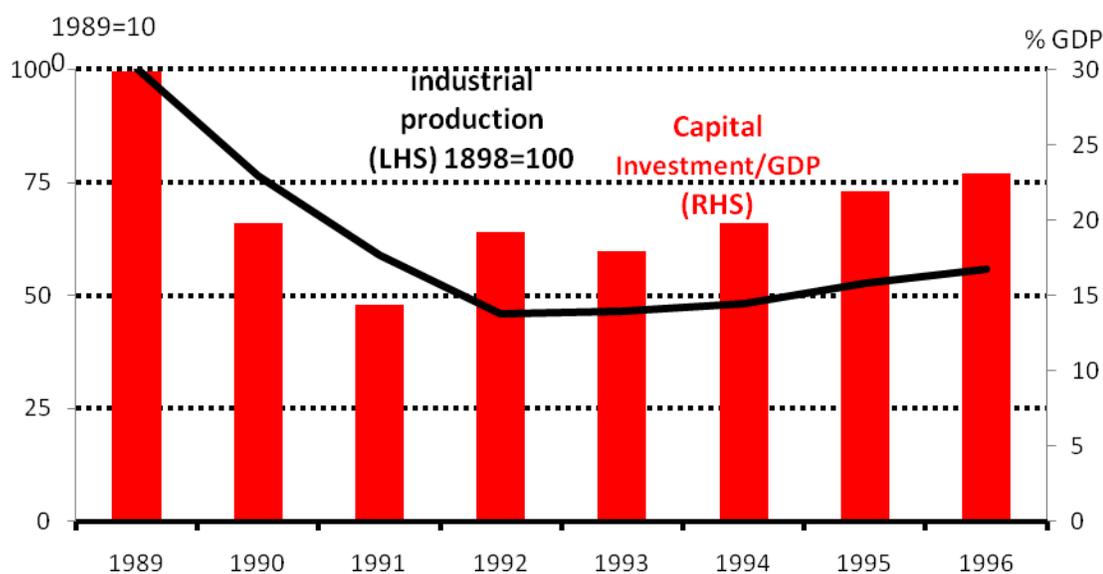
SBA measures worked to systematically minimize state-owned enterprises' profit-making by reducing the means of protection against market uncertainties. Through IMF interventions, highly strategic cost factors (energy in particular and other intermediary imports) came to be dictated by international volatility and exchange rate devaluations rather than strategic planning. SBA conditionality forced local energy prices for the productive sector above international market levels, and social concerns institutionalized cross subsidization from industry to households. Compliance with this requirement was carefully monitored, and corrections of any deviations from commitments were regarded as a policy priority. Second, the scope for exercising market power was reduced through administrated prices: for instance the agricultural sector had to absorb market-determined costs while facing price caps.

Furthermore, the central bank was instrumental in this neoliberal attack on state production. Monetary policy, consistent with an interpretation of money as a means of exchange de-linked from production, added the final nail in the coffin: credit crunches, or, when liquidity was made available, extremely high interest rates. Curtailing access to working capital accelerated the decapitalization of the productive sector and debilitated the essential driver of competitiveness in large-scale production: technological upgrading. The payments blockages and arrears also functioned to curtail the space for the third practice Galbraith

described: temporary or indefinite suspension of the market through long-term contracts between large firms. With no means to distinguish between liquidity and solvency in such an environment, firms became more reluctant to enter long-term commitments.

Thus restructuring according to the neoliberal roadmap created a perfect storm scenario for industrial producers, who were faced with massive contractions in sales revenue resulting from domestic/foreign demand contraction and increased competition following trade liberalization; rocketing input prices induced by exchange rate devaluations and reduced foreign exchange availability for imported intermediary inputs; little or very expensive access to working capital needs, and uncertainty in buyer/seller contracts arising from repeated blockages in the payment system (Gabor, 2008). Undoubtedly industrial interests succeeded in exercising some degree of influence in economic policy decisions, as the government sought to alleviate liquidity shortages and provide preferential credit. Even so, under conditionality pressures, preferential credit was granted at positive interest rates, requiring profit margins impossible to achieve in that particular economic context. That industrial interests were not quite so successful at capturing policy implementation is apparent from the collapse in industrial production, which at the end of 1996 stood at around 55% of the level achieved in 1989 (and this given that the 1980s had seen Ceausescu's attack on socialist production as method for repaying foreign debt), and a contraction in capital investment that by the end of 1996 had failed to return to 1989 levels (see Fig.9).

Figure 9 Industrial production (1989=100) and capital investment/GDP (%), Romania, 1989-1996.



Source: computed from the Statistical section of the *National Bank of Romania Annual Report 1999* (p 7 and 8).

This ideological manifestation had serious implications for the development of formerly-planned economies, pointing to the excess demand narrative as a technique aimed at inserting them into capitalist product markets with diminished industrial competitiveness. Despite promises of a consumer paradise, it resulted in a prolonged deindustrialization process with long-term economic and social consequences. The massive contractions in manufacturing not only ‘levelled’ the field for international competitors (a process complimented by privatization discourses), but shifted competitiveness drivers from technology intensive processes to labour costs. It further resulted in massive social upheaval, at times reversing rural-urban migration patterns, and increasing inequality at pre Second-World-War levels.

Had industrial interests shaped the policy agenda, the narrative of reform would have privileged industrial recovery as the main anchor for stabilization, and prioritized manufacturing and capital accumulation as drivers of growth. Inflationary pressures, external instability and competitiveness would have been better addressed by:

- A partial price liberalization allowing market mechanisms in the consumer sector and maintaining price controls for resources vital to production.
- A cost-push approach to inflationary pressures which fundamentally required managed exchange rates.
- The provision of liquidity to the productive sector to offset temporarily the loss of revenue from collapsing export markets, complemented with a mechanism for inscribing a medium-term profitability logic into the behaviour of enterprises.

4.8 Conclusion

This chapter traced how international economic advice ushered in neoliberalism as the rationalization for state and economic reform in the Romanian setting. Indeed, if the metric for IMF policy success is a central bank functioning according to an underlying neoliberal rationality, then the IMF's policies have been particularly successful in Romania. Discursively, the NBR internalized the neoliberal logic and engaged in a continuous struggle to stabilize a dominant system of interpretation grounded in monetarist theories.

Policy discourses operated to structure the argumentative terrain around the two policy domains under the dominion of the monetary authority: the exchange rate and monetary management. Thus, a relative PPP and its monetarist extension, the monetary approach to the balance of payments, sanctioned a causality running from prices to nominal exchange rates. This legitimized a free floating exchange rate and constituted the various devaluation episodes as consequences of internal price dynamics. It further implied that price and hence exchange rate stability (together with external balance) required a tight monetary policy. Through an excess demand narrative, policy practice targeted excess liquidity control, to be enforced through SBA quantitative criteria on credit.

Notwithstanding discursive commitments, monetarism was ‘translated’ in different degrees into policy practice. The NBR explained differences between policy commitments and institutional practices through a discourse of gradualism constructed around price liberalization, exchange rate liberalizations and restructuring of state-owned enterprises. The government’s intervention in these essentially economic domains was held to reproduce inherited communist rigidities and create damaging obstacles to ‘rational economic policy’. As the IMF argued, and the NBR concurred, both the exchange rate and monetary policy functioned with a quasi-fiscal objective, through administratively-induced stability of the exchange rate and preferential credit to ‘strategic’ sectors.

It was again argued that the monetary policy space is a discursive space where various interests struggle over policy priorities. Through the SBA agreements, a temporary communion of interests was established between the monetary authority and the government. This dissolved, not because policy implementation was necessarily captured by state-owned industrial interests, but because ‘reality’ failed to produce the outcomes projected through monetarist discourses. Policy practice created liquidity shortages where policy discourse saw excess liquidity, produced repeated payment blockages where it was supposed to liberate a ‘repressed’ financial system, contracted industrial production instead of producing growth, and fed exchange rate devaluations into inflationary pressures.

Whether Romania’s economic policy was gradualist, or governments lacked will to reform, are more complex questions than either the NBR or the IMF recognized. While the NBR was usually prepared to accept a monetarist explanation of policy failures and continue with contractionary measures, governments eventually refused to do so. This was not nostalgia for full-employment, but rather reflected a stark political choice: governments, neoliberal credentials or not, will find it difficult to comply with the highly contractionary requirements

the IMF imposes through its SBAs. The worldwide poor record of compliance with IMF conditionality testifies accordingly.

Nevertheless, the lack of foreign exchange reserves required Romania to continue its program relationship with the IMF. Policy reflexivity saw every new stabilization plan seeking to further colonize the policy imaginary. Remarkably, a discourse that cherishes the theoretical rigour underlying the perfect world of competitive markets made little attempt to ground policy decisions firmly in empirical evidence. Instead, it insisted on expanding the policy repertoire with little, if any, (empirical) proof that policy innovations were consistent with theoretical requirements. For instance, volatility in the forecast demand for money was never accepted to undermine fundamentally the quantity theory framework. Interest rates were institutionalized as a policy instrument with little concern for a functioning transmission mechanism.

These audacious approximations required a continuous re-writing of the past. The technique was similar in every new instance of stabilization: portray past monetary policy measures as accommodative and formulate the future through a commitment to eliminate excess demand. For instance, policy argumentation surrounding the 1992 SBA articulated the previous policy stance as accommodative, sidelining the fast liquidity absorption that sterilized the GSC credit injection. The turn to tightening in mid-1993, when high-powered money had been identified as the operational objective of monetary policy, saw a substantial increase in the liquidity made available to the banking sector compared to the previous period. Discursively this was presented as a policy success in ensuring a tighter control of liquidity.

Deploying a policy narrative that confines enquiry and policy evaluation to a narrow set of criteria achieved a double discursive operation. It allowed the NBR to marginalize, dismiss and deny links between exchange rates and cost pressures. Indeed missing from the NBR's narrative was a critical interrogation of whether its focus on containing inflation was consistent with a 'freely' determined exchange rate. Second, rather than contemplating critical

interrogations of the economic principles underlying stabilization, the NBR sought to develop new practices for tightening its grip on liquidity. For instance, complying with the prior requirements of the second SBA, the NBR raised the interest rate on its refinancing facilities. While this brought the interest rate in the policy space through a financial liberalization discourse that required positive interest rates, it also increased the scope for policy contestations. While the monetary overhang claim was framed through a technicist discourse that minimized competing claims, it was more obvious that high interest rates could be detrimental to investment. Both government officials and the industrial sector voiced concerns about the contractionary policy stance - rightly so, for the monetary policy measures guided by the positive interest rate discourse drove the NBR, in the absence of credible projections about future price rises, to hike interest rates on its two facilities to extremely high levels (800% in the last month of 1993).

The NBR's monetarist practices met with structural and institutional resistance to neoliberal logics, arising from both communist legacies and ongoing political struggles. While government pressures pushed practices of monetary management outside neoliberal boundaries, particularly when it instructed it to extend preferential credit, a coherent industrial strategy that recognized the crucial role of the exchange rate and of a financial system orientated towards recapitalizing the productive system never emerged. Rather, policy discourse and practices throughout the period sought to subject large-scale state-owned industries to the disciplining hand of the market, when in fact business practices of large-scale capitalist production, as Galbraith documented, consisted of eliminating the market. Liquidity problems were transformed into solvency problems as policy systematically targeted every avenue available for protecting profits. The neoliberal structuring of the central bank achieved, in this respect, what it set out to do: it played a major part (along with the neoliberalization of

other policy domains, such as price liberalization) in the systematic, if not always coherent or consistent, reconfiguration of economic relations.

The 1997 shock therapy marked a new move in this direction. Indeed, the next chapter will argue that the 1997 SBA was instrumental in the transition to a second stage of neoliberal logic of economic governance, normalizing practices of monetary management tied into the requirements of financialized accumulation.

Chapter 5. The dawn of a new era: 1997-2005

Policy, the previous chapters showed, is political. Neoliberal policy has both ideological effects (depoliticization) and institutional effects (reconfiguring institutional practices). Furthermore, policy modifies with the broader logic of shifts in neoliberalism. Indeed, this chapter argues, the NBR's rationality gradually changed to a constructive phase after 1997, normalizing a neoliberal mode of economic governance whose distinguishing features it goes to identify. Institutional practices reconstructed the relationship between money, foreign exchange, treasury markets and the central bank through a logic of financialized accumulation. These tied financial stability considerations into the choices of transnational market actors, and faced the central bank with contradictory imperatives: inflation control vs. financial stability.

In public discourse, 1997 is identified as the crucial moment when politics finally got in tune with the economic reforms repeatedly demanded by the IMF. Before 1997, the reconstruction of economic relations along market principles suffered from a mismatch between 'good policies' agreed and negotiated with the IMF (in the first instance) and 'vicious politics' that surrendered policy implementation to vested industrial interests. The political willingness to reform changed however with the election of a centre-right coalition with recognized neoliberal sympathies at the end of 1996. While subsequent policy measures triggered a three year recession and a near default on foreign debt service, it is argued that such developments were the unavoidable consequences of seven years of delayed reforms and a singularly unfavourable communist legacy (Daianu, 1999; IMF, 2001). The improved macroeconomic performance since 2000 has been interpreted as a clear indication that commitment to reform, unwavering in the face of inevitable social and economic costs, would eventually clear the field for a dynamic and efficient privately owned economy.

Monetary policy discourse broadly echoes this triumphalist tone. It points to a successful, if somewhat sluggish disinflation process. Such positive developments are attributed to an independent monetary policy, as opposed to the 'gradualist years'. Where slippages and pace were not consistent with the NBR's commitments, these are explained away by appealing to international shocks and domestic political imperatives. Indeed, the narrative goes, international volatility, particularly around the 1997 Asian and 1998 Russian crisis, together with requirements of the export sector, have at times imposed upon the NBR competing objectives: external vs. domestic stability. Notwithstanding these, monetary policy is generally acknowledged, and by some applauded, as the instrumental factor in stabilizing the economy and an overall positive economic climate. By 2005 Romania was one of the growth leaders in Eastern Europe.

However, this chapter will argue that the discursive emphasis on 'right politics' finally allowing the implementation of 'right policies' operates on two levels. It glosses over the political character of monetary policies and discursively articulates the neoliberal distinction between states and markets, with central banks as guardians of the border. Secondly, it functions to downplay the extent to which policy discourse and practices changed after 1997. Various discursive operations have been at play to suggest that the monetarist reasoning informing policy decisions succeeded in reducing inflation, thus legitimizing the excess demand (and liquidity) narrative deployed during the 1990-1997 period. Notwithstanding this apparent continuity, the changes inscribed in the 1997 IMF SBA altered fundamentally the process of reconstructing the policy space. Since 1997, and against all previous discourses, the IMF sanctioned and legitimated a managed exchange rate, while simultaneously pushing the government into the disciplining arms of the market: it demanded, and obtained, confining budget deficit financing to domestic or international money markets.

These two policy changes set the stage for the second step in the normalization of a neoliberal logic of economic governance. From the early 'destructive' emphasis on the incapacity of the state to generate efficient economic outcomes, the neoliberal rationality moved to an increasingly 'constructive' phase that would cement the growing importance of and dependency on speculative capital in policy practice. Its ultimate manifestation, I will show in the following chapter, found its vehicle in the adoption of inflation targeting as policy strategy.

Thus, this chapter will argue that the monetarist narrative during the 1997 to 2005 period, rather than informing policy, functioned to legitimize practices of monetary management increasingly structured through a neoliberal logic. The chapter is structured as follows. It first explores the changes brought into the economic policy space by the 1997 SBA. It then describes the economic dynamics throughout the period to set the context for discussing monetary policy choices. The analysis then turns to the Romanian policy scene to map the new stage in the reconstitution of the monetary policy space as a neoliberal space. It will explore how speculative capital, channelled through the banking sector, redefined the rules of the game for monetary policy practice by focusing on the NBR's management of liquidity. It will contrast the difficult 1997-1999 years to the recovery after 2000, tracing the increasing institutionalization of a series of practices tailored to tapping international markets and the shifts in policy discourse aimed at legitimizing the shift to inflation targeting in August 2005.

5.1 The 1997 shock therapy

As explored in the previous chapter, the IMF's (1997a) appraisal of its record of engagement in Romania up to 1997 identified two 'problematic' policy areas, monetary control and exchange rate management, where implementation was captured by vested interest groups. The narrative

of policy failures, grounded in excess demand explanations of inflationary pressures, ran as follows: monetary policy attempts to drain excess liquidity were systematically compromised by pressures for directed credit to agriculture and energy, while commitments to exchange rate flexibility gave way to demands for an overvalued currency to support inefficient, energy-intensive production. Thus the 1997 SBA established three 'priority' areas that would address inconsistencies between policy and practice:

- Refocus monetary policy by narrowing liquidity management to inflation control. The success of these efforts would be conditional on a commitment to reduce to a minimum subsidies for restructuring state-owned enterprises, and where absolutely necessary (as closure would be, to some extent, inevitably constrained by social considerations), to include them directly in the budget⁹⁵. In other words, all preferential credit would be switched from the central bank's to the government's balance sheet.
- Allow the exchange rate to foster external equilibrium by refraining from any exchange rate market intervention⁹⁶. To emphasize the overall importance of this requirement for the stabilization plan, the IMF made every SBA purchase subject to an exchange rate policy review and warned that any sign of exchange market interference, or even a minor backtracking on the commitment to unburden the NBR would be perceived as the beginning of a return to accommodating policies (IMF, 1997a: 25).
- Immediately undertake a comprehensive, up-front reform of the energy-intensive and agricultural sectors, building upon the authorities' willingness for reform. Thus the 1997 SBA expanded structural conditionality to specify a detailed timetable for closing down 'fundamentally unviable' state-owned enterprises.

⁹⁵ This explains the 4.7% of GDP budget deficit specified in the SBA.

⁹⁶ By February 1997 the NBR reinstated the interbank forex market by re-issuing licenses to all banks, and further issued a directive suggesting/demanding that interbank quotes be made so as to clear the market.

Macroeconomic conditionality changed to establish high-powered money targets as the SBA quantitative performance criteria. Similar to previous programs, the 1997 SBA identified a considerable build-up of excess liquidity, a legacy of the 1996 political populism targeting the agricultural sector, as the main monetary policy challenge to be addressed. Simultaneously the program specified a new round of price liberalisation, hikes in prices remaining under administration and an exchange rate devaluation.

The three-month review (IMF, 1997b) confirmed the centre-right government's commitments to the principles and policies embedded in the 1997 SBA. It further applauded the faster-than-expected fall in inflation, the improvement in international reserves position and substantial capital inflows. While it drew attention to delays in structural reform that threatened this improvement in monetary control, the overall assessment found the reform program on-track.

The review recognized that national authorities had finally understood and wholeheartedly subscribed to the policy measures the Fund had long advocated. However, rather than 'policy advice as usual', the 1997 SBA brought two policy changes that would fundamentally overhaul institutional practices. First, by August 1997, the NBR had institutionalized, and the IMF endorsed, the active use of the exchange rate as an anchor for stabilization. Against previous requirements of, and commitments to, flexibility⁹⁷, from this point onwards forex interventions would be systematically deployed in policy practice. The threats of exchange rate 'politicization' that drove the IMF and NBR to reject suggestions of managed rates before 1997 disappeared from policy argumentation.

A second, complementary, 'innovation' required the government to shift its financing to market-based instruments and further 'depoliticize' monetary policy. The IMF's wide experience with conditionality confirmed that governments seldom do what they are told.

⁹⁷ For instance, the 1995 SBA was suspended because the NBR had broken its commitment not to interfere in the foreign exchange market.

Nevertheless, if it was impossible to prevent the repetition of past mistakes, it was within reach to alter the outcomes of 'unconstructive' policy choices, to redefine and circumscribe them to a market logic. Thus deliberate delays in structural reforms would no longer be monetized, with the attending increases in liquidity and overall 'disequilibrium'. Instead politicized economic decisions would be subjected to the unforgiving discipline of the market: market financing of budget deficits required governments to convince markets, the ultimate instance, of their credibility.

Indeed, by June 1997 a primary dealer system was set in place for auctioning government securities, a prior SBA requirement that aimed at replacing the previous subscription method for government securities issuance with a market mechanism. The first T-bill auction took place in late April 1997, followed by a 'smooth and competitive' working of the system (IMF, 1997b). This opened up (substantial) profit opportunities for foreign capital: capital inflows for the first semester of 1997 amounted to US\$ 1.8 bn as foreign investors took advantage of what the IMF termed exceptional yields: 400% return on three-month government paper. It also marked the beginning of a substantive change in money market liquidity conditions: forex interventions, undertaken to limit the exchange rate overvaluations, produced a structural excess of liquidity (NBR, 1998a).

The formalization of high-powered-money targeting as the new policy strategy was essential to this shift, for it allowed the IMF to sanction exchange rate management. A reserve-targeting strategy with an implicit exchange rate anchor would require the central bank to isolate reserves (and thus monetary aggregates) from exchange rate decisions. Indeed, high-powered money targeting rests on the assumption that Central Bank-induced quantitative adjustments in the reserves of the banking sector will prompt, via the money multiplier mechanism, immediate adjustments in the liabilities side of the banking system to the level of required reserves. How do these quantitative adjustments function? Changes in the monetary

base are driven by either net foreign assets (NFA) or net domestic assets (NDA) of the monetary authorities. Thus any balance of payments or exchange rate policy induced changes in the NFA component of the monetary base must be sterilized by an offsetting NDA movement.

The NBR institutionalized sterilized forex interventions when academic circles were debating their role in the 1997 Asian crisis. Indeed, sterilizations of forex interventions have not been a localized, specific Romanian policy practice but a common policy response to capital inflows (Caballero and Krishnamurthy, 2001). By the early 1990s a flourishing literature discussed the effects of sterilizations under fixed exchange rate regime, as monetarist structuring of policy decisions had prompted central banks in Latin America to sterilize the capital inflows (Calvo et al, 1993). The traditional view at the time, derived from the standard Mundell-Fleming model (Mundell, 1962), conceptualized the effectiveness of sterilization in close relationship to the degree of capital mobility. Under perfectly mobile capital and a fixed exchange rate, sterilizations are undone by the exploitation of arbitrage opportunities, an extension of the Ricardian narrative of automatic adjustments in an international context. Hence discretionary attempts at either easing or tightening the policy stance are ineffective: the famous impossible trinity of a fixed exchange rate, autonomous monetary policy and capital mobility. The uncovered interest rate parity holds and the domestic interest rate is entirely determined by international markets. The Mundell-Fleming theory thus sanctioned sterilizations as an instrument for protecting the money supply from the undesirable side effects of the managed exchange rate regime, i.e. the monetary expansion triggered by forex interventions.

Calvo's (1991) influential challenge of this traditional understanding grounded an emerging consensus that sterilizations could be counterproductive. Under a stabilization program designed along traditional IMF targets of monetary growth, he argued, sterilizations

involve an increase in domestic interest rates and nominal debt. Higher debt service levels threaten commitments to stabilization, as the government prefers to devalue/increase inflation in order to reduce the public debt burden. This critique was further substantiated in Calvo, Leiderman and Reinhart's (1993: 10) conclusion that sterilized inflows 'perpetuate a high domestic-foreign interest rate differential and that gives rise to an increased fiscal burden'. By late 1990s, while theoretical developments saw Mundell-Fleming models replaced by intertemporal approaches to balance of payment analysis (Obstfeld, 2001), common wisdom rejected Mundell-Fleming analysis as a satisfactory framework for exploring policy responses to sustained capital inflows. Sterilizations were not only difficult to operate, particularly in illiquid markets characteristic of emerging economies, but could prove self-defeating: an apparently successful operation could raise domestic interest rates and stimulate even greater capital inflows (Lee, 1997), as the uncovered interest parity did not hold. The 1997 Asian crisis was a paradigmatic example: Montiel and Reinhart (1999) argued that domestic policy responses to early capital inflows were responsible for the crisis, at a moment when conventional wisdom identified Latin America as the most likely next victim of 'hot money' reversals. Sterilized interventions in Asia had altered the term composition, shortening the maturity of capital inflows while simultaneously increasing the volume. In other words, sterilizations increased exposure to short-term liabilities and vulnerability to reversals.

Nevertheless, this emerging consensus never amounted to a serious threat to the IMF's neoliberal logic of increased financialization of capitalist relations underlying its push for capital account liberalization. Notwithstanding Calvo's employment with the IMF at the time his two papers were published (as IMF staff papers), the IMF retained its standard monetarist approach and refused to contemplate capital controls. Instead of undermining financial liberalization discourses, vulnerability to short-term flows was attributed to the choice of exchange rate regimes. The IMF drew an important lesson from the Asian crisis: under

liberalized capital flows, soft pegs and the attending sterilized interventions could no longer be defended as a viable policy option. Emerging markets would benefit from greater flexibility (Eichengreen, 2006).

The changing politics of exchange rate management produced a conundrum for developing countries: a discursive emphasis on flexibility along with an increased dependency on exchange rate stability for containing inflationary pressures. Indeed, the Washington Consensus push for balance-of-payments liberalization strengthened the link between exchange rates and prices, for a larger share of imports in consumption (and sometimes production) increased the impact of exchange rate movements on prices. It also expanded the scope for exchange rate volatility, no longer solely a matter of vulnerability to terms-of-trade shocks, but also to speculative flows. Developing countries' 'fear of floating', cast by the IMF as a political rejection of market forces' potential to balance international positions, merely represented the changing importance of exchange rate policies for both price and external stability. A market-determined currency exposed prices to exchange rate volatility; however currency management required substantial foreign reserves. I will show, in the next chapter, how inflation targeting dovetailed perfectly with this dilemma: a credibility-enhancing regime that would stabilize prices while guaranteeing access to international finance.

The debate on sterilizations and exchange rate regimes reverberated little on the Romanian policy scene. Despite its substantial involvement in designing and endorsing policy decisions, the IMF failed to issue one single warning of the destabilizing nature of sterilized forex interventions, let alone explore alternative policy choices. Instead it focused its attention on the speed of the disinflation process and the ever-present concerns with the state-owned enterprises. The next sections will briefly describe overall developments in selected economic indicators, to then map NBR's policy discourse and practices in a policy space increasingly structured through a neoliberal logic.

5.2 Macroeconomic trends

This subchapter identifies two (broadly) distinct sub-periods in terms of economic performance: 1997 to 1999 and 2000 to 2005. The 1997 IMF-sponsored SBA dealt a serious contractionary blow to the economy. To make matters yet worse, the NBR was faced with a peak in foreign-debt servicing (amounting to around 30% of export earnings) after the 1996 Samurai and Eurobond issues. Rollover possibilities were uncertain as the Asian and Russian financial crises reduced the international markets appetite for emerging economies.

The SBA prescribed tight credit policies, an exchange rate devaluation, price liberalizations and a well-defined timetable for closing down or privatizing state-owned enterprises⁹⁸. Further real wage cuts were implemented, without a corresponding increase in government spending, investment or net exports to offset its contractionary effect on aggregate demand (Kalecki, 1971). The attack on ‘excess demand’ contracted the economy by 4% on average throughout 1997-1999 (see Table 5), replicating the earlier SBAs outcomes. The industrial sector bore the brunt of the ‘adjustment’, contracting at a staggering annual average of 7.7%. Romania went through a second transformational shock (Daianu, 1999), an explanation that underplays the role highly contractionary macroeconomic policies played. Afterwards economic growth resumed, reaching a 5.1% average annual growth rate.

⁹⁸ In a law reminiscent of the communist ‘performance targets’, the State Ownership Fund, the entity in charge of privatization, was mandated to identify at least 50 companies per week for privatization (Meydroff and Takhor, 1997).

Table 5 Annual Average Growth Rates (% change), Romania. 1990-2005

	1990-1993	1994-1996	1997-1999	2000-2005
GDP	-6.45	4.97	-4	5.1
Industry	-10.55	5.30	-7.7	5.2

Source: computed from the Statistical Section of *the National Bank of Romania Annual Reports 1999* (p 10) and *2005* (p.8)

The sectoral composition of GDP reflects the sectoral growth trends portrayed above: a move away from industry, whose share declines from 51.7% in 1990 to 24.6% in 2005, towards services. Agriculture's share increased in the early 1990s, to decline to less than 10% of GDP in 2005. The sectoral shift in income shares was not completely reflected in changes in employment composition⁹⁹, as the labour force shed from industry moved to the agricultural sector. From this perspective, the small increase in the income share of agriculture compared to the increase in the share of employment can be explained by low value-added agricultural production: the 1991 land reform¹⁰⁰ caused the dismantling of the large state-owned collective farms and a subsequent return to small-scale subsistence farming. Subsequently the share of production retained within households¹⁰¹ increased significantly while simultaneously debilitating food security as it augmented the dependency on imports of food in the case of bad weather conditions.

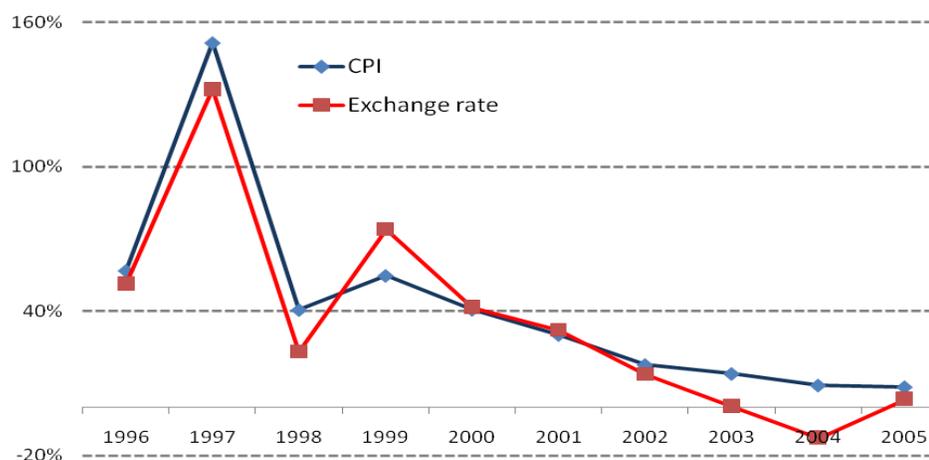
Disinflation proceeded at a sluggish pace, in line with exchange rate developments. The 1997 SBA imposed price liberalization and devaluation pushed the consumer price inflation to around 150% (see Figure 10).

⁹⁹ Industry's income share declined by around 26 percentage points, while employment in industry fell by 22 percentage points. Furthermore, although the value added of services increased by around 30% throughout the period.

¹⁰⁰ Restitution of land previously confiscated by the communist regime for collective farms.

¹⁰¹ For instance in 1990 this rose above 50% (Tesliuc, 1999).

Figure 10 Price and exchange rate (US\$/ROL) dynamics, Romania, 1996-2005.

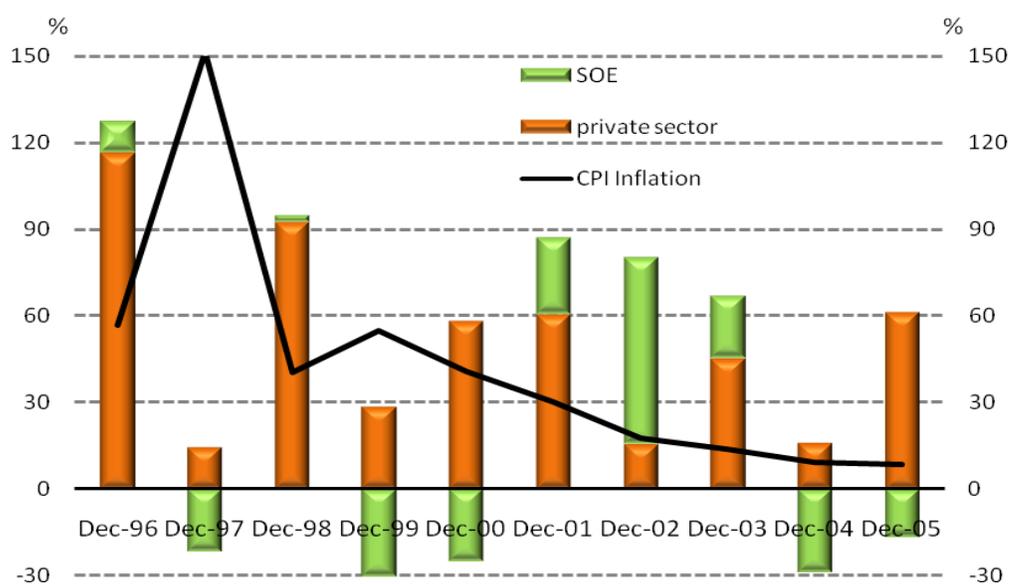


Source: computed from the Statistical section of *the National Bank of Romania Annual Report 2005* (p4).

Inflation slowed down in 1998, to increase again in 1999 when the NBR allowed the exchange rate to devalue by more than 60% in order to contract imports as sources of financing the external debt became scarce. Starting with 2000, price inflation entered a fast downward trend as exchange rate volatility diminished. When the inflation-targeting regime was introduced in August 2005, inflationary pressures were contained to one-digit levels as the exchange rate appreciated in real (and often nominal terms) in the latter part of the period.

The SBA standard monetary tightening prescriptions saw a substantial reduction in willingness to lend. Credit to the private sector slimmed down, contracting in real terms in both 1997 and 1999, to gradually recover afterwards (see figure 11). Reflecting a structural shift in the ownership of the productive sector and the neoliberal reluctance to finance state industries, credit to the state-owned productive sector was significantly worse affected: in four of the eight years of the period it decreased in nominal terms - by a staggering 21% in 1997 and 30% in 1999 - and expanded at rates well-below inflation in the remaining years.

Figure 11 Growth rates, credit to private sector, SOE and consumer prices, Romania, 1997-2005.

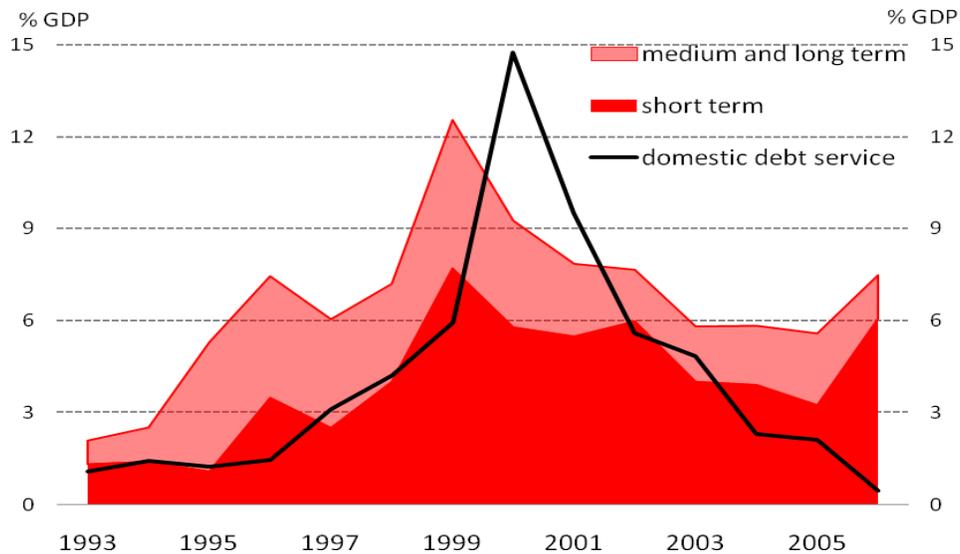


Source: computed from the Statistical section of *the National Bank of Romania Annual Report 2000* (p. 588) and *2005* (p4)

The drive to money-market financing saw domestic public debt increasing substantially throughout the period. For the first few post-communist years the government not only ran a budget surplus, but was also a net creditor to the banking sector (NBR, 1998a). With the introduction of government treasury bills in 1993, domestic debt rose as a percentage of GDP, and reached significant proportions after 1997 (see figure 12). It peaked at over 12% of GDP in 1999, as Romania could not access foreign loans from either private or official sources, to reduce gradually afterwards. The structural composition changed after 1997, the first year that the short-term debt share increased above medium and long-term debt, a trend that was maintained afterwards (reaching almost 80% in 2003). The debt service reflects both the short-term nature and the penal rates at which the government was financing its deficit on domestic money markets: debt service increased to as much as 14% of GDP in 2000, higher than the outstanding stock at that time. As the government recovered its access to foreign markets, the

terms at which it borrowed domestically improved markedly, with debt service declining to 2.1% of GDP in 2005.

Figure 12 Public domestic debt, as % of GDP, Romania, 1993-2005.

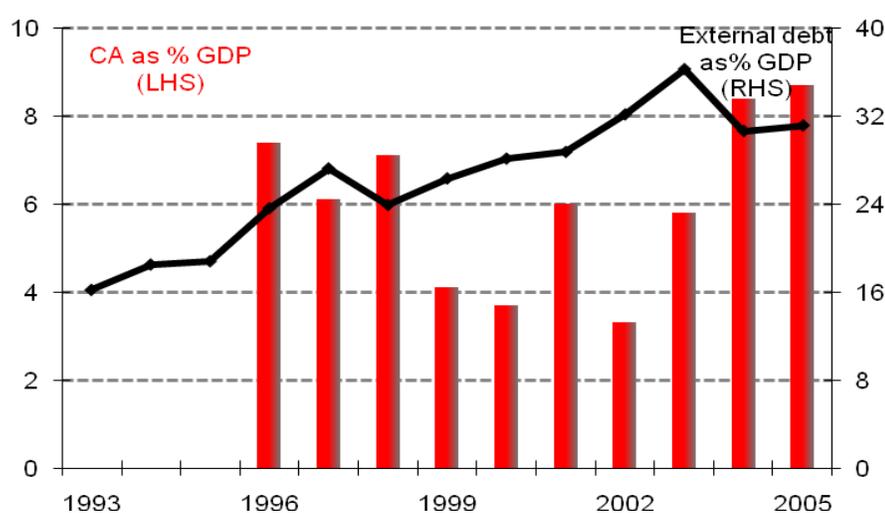


Source: computed from the Statistical section of *the National Bank of Romania Annual Report 2005* (p. 4 and 33)

The improved growth pattern after 2000 was accompanied by an increasing vulnerability to international volatility, for neoliberal economic policies failed to correct the structural trade deficits (and the accompanying current account deficit) inherited from central planning. Indeed, none of the massive devaluations undertaken throughout the entire post-communist period corrected Romania's net importer position. This vulnerability was never more obvious than in 1999, a peak year of foreign debt service, when the IMF introduced the concept of burden sharing as a pre-requisite for its balance of payment assistance. The IMF refused to grant funds through a new SBA agreement unless access to private international financial markets was secured independently (NBR, 1999a). This was a recipe for cornering countries into the highly predatory behaviour of speculative money markets which the IMF (2004) later recognized as thoroughly mistaken; it nearly cost Romania a default on its debt service. Default

was finally avoided by a highly contractionary policy aimed at narrowing the trade deficit, bringing the current account deficit below 4% of GDP (see Fig. 13). Since 2000, stimulated by exchange rate appreciations, the current account deficit entered again an expansionary trend, reaching above 8% of the GDP in 2005. While privatization-linked FDIs and foreign remittances became increasingly important in financing the current account deficit, debt-creating capital inflows played a major part in this new expansion: the external debt increased to 32% of GDP in 2005.

Figure 13 Current Account and External Debt, Romania, 1996-2005.

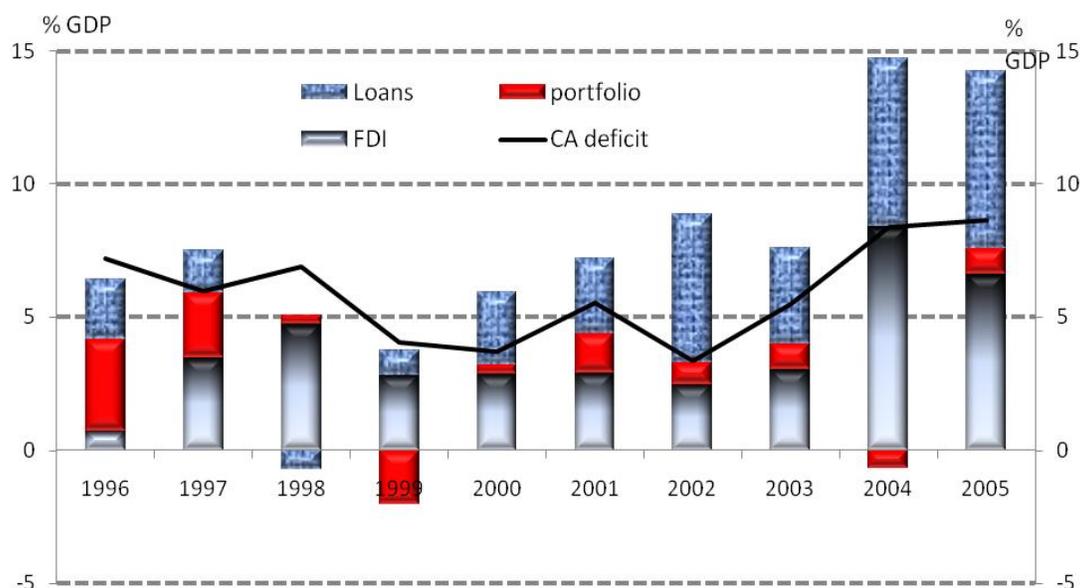


Source: computed from the Economist Intelligence Unit *Romania Country Report 2006* (p. 55) statistics and Statistical Section of the *National Bank of Romania Annual Report 2006* (p. 12)

Indeed, capital account developments throughout the period suggest substantial volatility in non-debt-generating inflows. FDIs contribution to financing the current account deficit fluctuated, rising above 5% of GDP only in 2004 and 2005 (see figure 14). FDI has been mainly privatization-related, stemming from the constant pressure on the government to privatize, or rather fire-sell assets, when it had little access to foreign borrowing. The year 1998 is a typical case, when the privatization of the telecommunications state-owned monopoly and a large state-owned bank accounted for the bulk of FDI inflows. The reliance on portfolio

inflows, arising from international debt issuance (bonds or other financial instruments), throughout 1996 and 1997 produced a peak in debt service in 1999. Starting with 2000, Romania accumulated large balance of payment surpluses, driven by both FDIs and foreign loans.

Figure 14 Capital Account developments, %GDP, Romania, 1996-2005.



Source: computed from *the National Bank of Romania Balance of Payment Reports* (2000: 63) and (2006: 61-2) and Eurostat data

5.3 Policy narratives: competing objectives

Once the IMF's 1997 SBA sanctioned forex interventions as legitimate if subordinated to the overall base-money targeting strategy¹⁰², policy discourse acknowledged that the close relationship between exchange rates and inflation, driven by a substantial pass-through,

¹⁰²The IMF endorsed this position, for its August 1997 SBA review recommended a waiver for non-compliance with the benchmark on arrears and did not identify exchange rate practice of interventions as contradicting its flexibility requirement. The endorsement of this policy stance is clear:

'The NBR at times also pursued an implicit exchange rate target as it undertook large interventions when foreign capital threatened to cause a nominal appreciation of the ROL, but interventions were fully sterilized or ceased when they threatened the reserve money target' (IMF, 1997a: 4).

rendered developments in the external position essential for its anti-inflationary strategy. The NBR recognized a gap between its policy discourse and what it termed ‘eclectic’ institutional practices (Antohti et al, 2003). This involved deploying the exchange rate as an anti-inflationary anchor; a consistent policy stance under the prolonged capital control policy. However, such eclecticism engendered competing policy objectives¹⁰³, i.e. internal vs. external stability, with the attending uncertainty and confusing signals to the economy.

Indeed, throughout this period policy argumentation maintained the discursive ambiguity that characterized exchange rate discussions during 1990-1997. Then, the NBR went to great lengths to justify its equilibrium discourse (and the PPP approach to devaluations) and downplay the extent to which prices were responsive to exchange rate movements. This time, the pass-through acknowledged, the ambiguity shifted to explaining exchange rate decisions. The previous insistence of market-determined equilibrium levels was discarded by arguments that interventions no longer amounted to political interference, for the interbank forex market operated freely and the central bank intervened like any other trader (Daianu and Vranceanu, 2001). Clearly the 1997 SBA altered the political logic of exchange rate policy: previous NBR interventions were ‘political’ because exchange rate dynamics were crucially linked to state production. The new government’s commitment to reform, which the IMF held to signify a commitment to push through with contractionary policies regardless of the impact on state-owned production (a commitment previous governments were reluctant to maintain for very long), would increasingly sever this link.

This depoliticization of exchange rate decisions nevertheless embedded an unavoidable contradiction: how to rationalize the central bank’s systematic presence in the forex market

¹⁰³ ‘The fundamental objective of the NBR’s monetary policy is to maintain price stability. In order to reach this goal, the central bank uses money supply as intermediate target and the monetary base as its operation target. In recent years, however, this analytical framework has cohabited with a strongly managed float exchange rate regime aiming to reconcile the objective of disinflation with that of preventing the deterioration of the economy’s external position, which might have occurred in the case of an excessive real appreciation of the ROL’ (Antohti et al,2003: 7).

against the neoliberal presentation as a regime of self-regulating markets. To negotiate this contradiction, the NBR explained its interventions either through a narrative of competitiveness or a monetarist discourse.

Exchange rate and competitiveness

The narrative of competitiveness appeared during 1997, when the NBR institutionalized (large) forex interventions to stem ‘unsustainable’ appreciations associated with large capital inflows. Ever since, the gradual disinflation process has been explained as a ‘policy of encouraging moderate, sustainable real appreciations’ (Popa, 2004:5), a policy stance constrained by the productivity pace in the exports sector (Vasilescu, 2005). Indeed, the NBR (2002a) argued, the slow pace of export productivity growth forced it to strike a delicate balance between its inflation objective and the sustainability of the country’s external position. It prompted policy interventions to slow down the pace of appreciation, and consequently the pace of disinflation, in order to mitigate the negative impact on competitiveness.

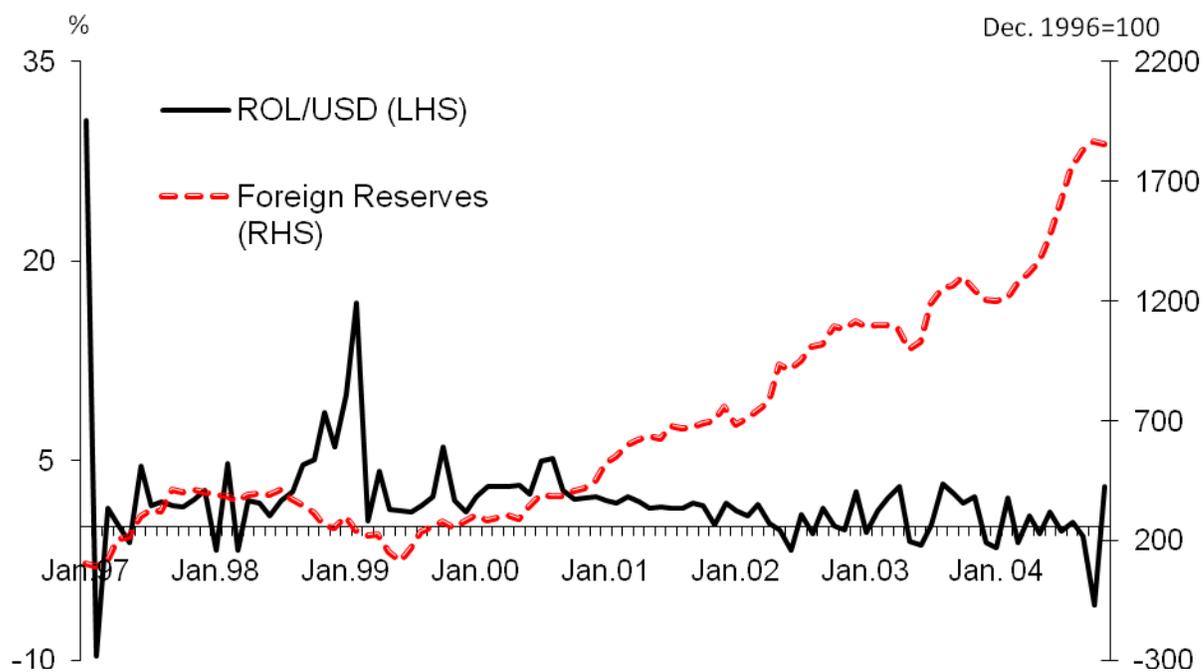
Nonetheless, exchange rate appreciations required balance of payment surpluses. The NBR’s foreign reserves could only function in the short term as an instrument for manipulating currency movements. Against a structural account deficit, balance of payment surpluses were conditional on capital account surpluses. Indeed, as the SBAs greatly reduced the scope for an active industrial strategy, export-orientated production never emerged as a sustainable mechanism for redressing trade imbalances. Policy discourse thus encouraged FDI (to which the privatization of existing state assets would be a substantial contribution) and borrowing from abroad. Neoliberal colonialization of policy domains worked to subject policy to the discipline of foreign ‘investment sentiment’: a loss of confidence would trigger devaluations, price increases and tighter IMF conditionality.

Indeed, exchange rate dynamics throughout the period suggest an increasing vulnerability to external volatility. Without access to foreign financing, the exchange rate fluctuated considerable (see Figure 15). A policy practice orientated at smoothing exchange rate fluctuations was faced with significant challenges during 1997 to 1999: the Asian and Russian crisis, coupled with the peaks in the foreign debt service. The NBR intervened heavily during these three years, first to contain strong appreciation pressures (throughout 1997) and then to contain depreciations triggered by substantial capital outflows. The loss of foreign reserves during 1998 and the first months of 1999c came at a moment when Romania could not access foreign markets while the IMF refused to provide support without private-sector burden sharing. Eventually the moratorium on debt payment was avoided through a massive contraction of domestic demand.

Riding on a tide of large foreign inflows, foreign reserves picked up after June 2000, with brief reversals¹⁰⁴. The exchange rate movements mark a substantial departure from the early patterns of volatility, with foreign inflows supportive of the NBR's policy of sustainable real appreciations. Critical voices questioned this stance, pointing to the increasing deterioration of the current account position (Paun, 2002; Serbanescu, 2005) and questioned the 'sustainability' of a policy that relied on short-term, debt-creating flows for producing stability.

¹⁰⁴ Such as in the first semester of 2002 and 2003.

Figure 15 Exchange rate (ROL/USD, % change) vs. and foreign reserves (Dec. 1996=100), Romania, 1997-2005.



Source: computed from *the National Bank of Romania Balance of Payment Reports* (2000: 49) and (2006: 58)

It was not entirely clear how a policy of real appreciation was beneficial to exporters, since strategies of export promotion usually entailed a competitive (read undervalued) exchange rate. The NBR however rejected the criticism, arguing that without its forex interventions and an increasingly liberalized capital account¹⁰⁵, exporters would have been worse off. In fact, the NBR constructed its forex interventions as an implicit subsidy for exporters; a policy stance that removed the rules-based approach of its monetary-targeting strategy. This further required discursive operations to stabilize its monetarist narrative.

The monetarist narrative

As discussed in the previous chapter, much of the NBR's argumentative efforts during 1990 to 1997 focused on stabilizing the excess liquidity narrative which grounded its monetarist

¹⁰⁵ The timetable for capital account liberalization will be explored in further detail when discussing the shift to inflation targeting.

discourse. It faced a different challenge now: how to legitimize a base-money targeting strategy, with its emphasis on excess-demand control, when institutional practices of exchange rate management suggested a cost-push explanation of inflationary pressures.

To resolve this contradiction, the NBR explained its exchange rate decisions through a monetarist frame. Forex interventions were represented as instruments in the overall management of liquidity: exchange rate dynamics conveyed important signals about liquidity positions in the money markets, of crucial importance for evaluating the monetary policy stance¹⁰⁶ (NBR, 1998a). A depreciating exchange rate implied an excess demand for foreign currency arising from excess money market liquidity. Accordingly, the practice of base-money targeting produced an asymmetric effect. Downward pressures on the currency, interpreted as a signal of excess liquidity, would trigger a sale of foreign currency to drain liquidity. On the contrary, interventions to counter appreciations increased money-market liquidity and require sterilizations in order to maintain reserve money within targets. This asymmetry, I will show, was instrumental in consolidating speculative capital, primarily channelled through commercial banks, as the driving force for policy practice.

Indeed, the NBR's presence on the forex market was not akin to any other trader, for its participation affected the overall liquidity in the system, and thus money-market dynamics. The next section explores in detail policy practice under a monetary-targeting regime with exchange rate constraints.

¹⁰⁶The NBR (1997c: 23) argued that:

'Developments in the exchange market will provide an important indicator of the stance of monetary policy. Any tendency to depreciate faster than expected will initially trigger a reduction in reserve money below target in an attempt to slow the rate of depreciation.'

5.4 Challenges to policy and practice: excess liquidity

The deployment of the exchange rate as nominal anchor changed the nature of the ‘policy problem’: excess liquidity produced by forex interventions, a challenge for both policy discourse and practice. Indeed, the existence of structural excess liquidity belied the NBR’s discursive anchoring of its policy successes in ‘tight monetary control’¹⁰⁷ (NBR, 1998a). A monetarist discourse linked excess money to an expansion in reserve base of the system, increased credit activity and pushed monetary growth above the neutral rate. Commitment to price stability required the central bank to sterilize the liquidity effects of its forex activity and maintain reserve positions within the targets established for money supply growth.

Forex interventions, aimed at anchoring the currency within a given band, change the international reserves component of the monetary base. For instance upward pressures on the exchange rate arising from balance of payment deficits will trigger a sale of foreign currency, reducing NFA and overall liquidity in the system. The counterbalancing sterilization operation would require an increase in liquidity by increasing NDA through open market operations. In the opposite case, increases in NFA arising from an oversupply on the forex market would be sterilized by reducing NDA.

Table 6 presents the evolution in the sources of the monetary base in Romania between 1996 and 2004. Up to 2000, the NFA contribution changes from negative in 1996, when it registered a net liability position amounting to 30% of the monetary base, to positive but fluctuating levels. It picks up at a significant pace after 2000, reaching a more than double coverage of high-powered money from 2003 onwards, levels close to those under a currency

¹⁰⁷ The NBR (1998a:6) report described policy in the following terms:

The tight monetary policy stance in 1998 was instrumental in lowering inflation markedly,[...] Monetary policy was successful in alleviating substantially the inflation expectations and reducing the impact on prices of both tax adjustments and administered price increases through a severe control over monetary variables; maintaining a tight monetary policy stance, the monetary authority curbed the accelerated depreciation of the exchange rate of the ROL and cushioned its effect on inflation in the latter half of 1998.

board arrangement. Such dynamics confirm that the variations in banks' liquidity positions were mainly stemming from the NBR's massive interventions on the foreign exchange market to avoid the appreciations attending large capital inflows. Since the Treasury was forced to turn to domestic or external money markets for deficit financing, the credit to government's negative contribution since 2002 reflects the Treasury's net depositor position with the NBR. The corresponding sterilisation operations have been mainly operated by modifying the net credit to banks (NCB) position that registered an increasing negative contribution (net liability position) throughout the period. The table also suggests the magnitude of the structural excess of liquidity on the money market: beginning with 2002 the banking sector had no outstanding loans from the NBR. Forex market interventions remained the only channel through which liquidity was made available in the system.

Table 6 Sources of growth in the monetary base, 1995-2005

	Money Base	Net Foreign Assets (%)	Credit to Government (%)	Credit to Banks (%)	Other Net Assets (%)	Refinancing from NBR (outstanding ROL bn.)
1995	4690	-13	108	50	-44	N/A
1996	7877	-29	3	98	28	8822
1997	10587	108	25	-69	37	3367
1998	19090	40	48	-16	28	3618
1999	35982	82	52	-39	5	2433
2000	51485	128	26	-44	-9	2296
2001	67791	204	0	-79	-25	1148
2002	80190	289	-9	-136	-44	0
2003	98415	295	-12	-131	-52	0
2004	12403	331	-37	-186	-18	0
2005	17342	374	-23	-229	-17	0

Source: computed from the Statistical Section of the *National Bank of Romania Annual Reports 1999* (p. 35) and *2005* (p.38)

In policy practice, this brought up questions of how to manage money-market liquidity effectively. Exchange-rate stabilization tied money market dynamics and the NBR's management of liquidity to foreign currency positions. Reconciling the two competing policy objectives (base money targeting and exchange rate management), the NBR (2002a) claimed, required policy innovations, particularly since its portfolio of open market paper (government securities and Treasury bills), historically amounting to a very small proportion of domestic assets, which by and large consisted of loans to the banking sector. Aside from changes in reserve requirements, the NBR developed deposit-taking operations from commercial banks as the main instrument for mopping up liquidity.

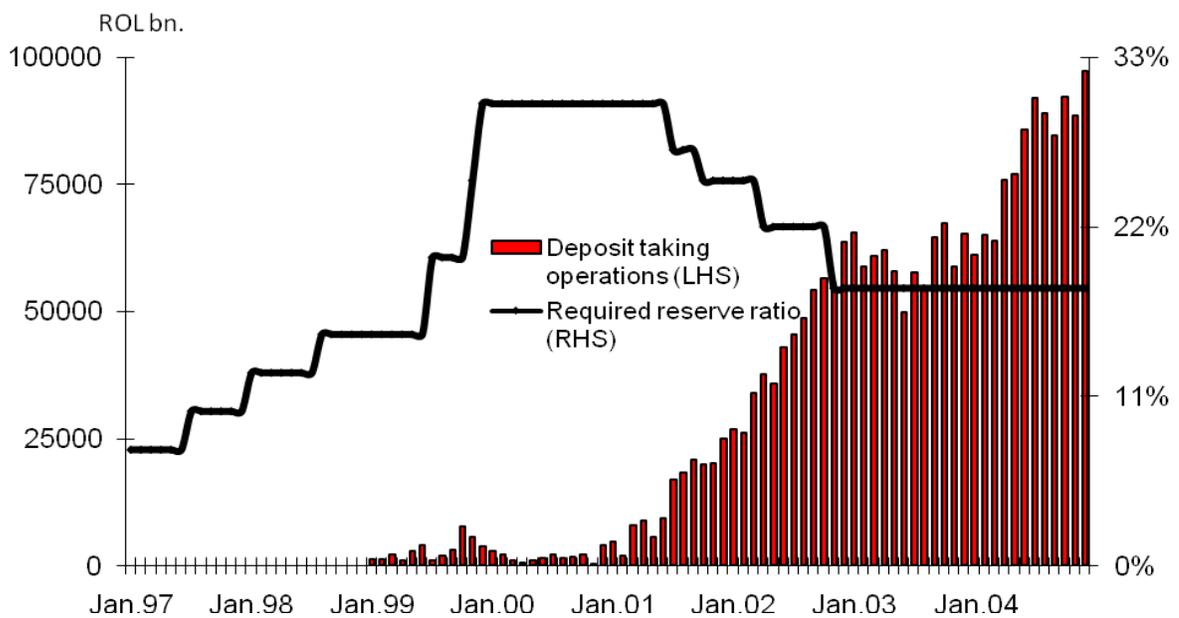
As restrictions on refinancing were insufficient to ensure quick liquidity drainage, reserve requirements were deemed to be a better instrument for 'confirming the toughness of monetary policy' (NBR, 1997a: 12). By triggering immediate credit and monetary adjustments via the money multiplier, changes in reserve requirements are advocated as a powerful, albeit rudimentary, instrument for controlling high-powered money (Ritter et al, 1993). The mechanism is straightforward: lower/higher required reserves create/reduce additional reserves for banks, enabling the banking system to expand/reduce their loans, which in turn changes the money stock without modifying the monetary base.

The second instrument, deposit-taking operations, was deployed against downward pressures on the exchange rate that induced the NBR to take a buying position on the forex market. The ensuing liquidity increased the commercial banks' excess reserves. To bring these back to the required level, the NBR would mop up liquidity by taking fixed-term deposits with maturity ranging from two weeks to three months (NBR, 2001a). The magnitude and frequency with which the NBR deployed these varied according to the international reserve position (see Figure 16). Up to 2000, with foreign reserves dwindling and little access to foreign capital, the NBR made intensive use of all mechanisms available to reduce the current account gap by

practically stifling economic activity. Not only did it drastically reduce access to its refinancing facility (see last column in Table 6) but increased reserve requirements from 7.5% to 30%. Choking the system of liquidity was expected to reduce aggregate demand and imports to thus minimize the current account gap.

Once foreign inflows were restored after 2000, the NBR resumed its sterilisations of forex interventions by deposit-taking operations, complemented with a reduction in reserve requirements. Thus deposit-taking operations replaced the discount window as instrument for managing liquidity, particularly after 2001. The NBR used reductions in its outstanding loans to the commercial banks as a contractionary instrument in the 1997-2000 period, and for sterilising forex interventions up to the end 2002. Ever since, discount window lending disappeared from the NBR's balance sheet.

Figure 16 Deposit taking operations (outstanding daily average) and Required Reserves, Romania, 1997-2004.



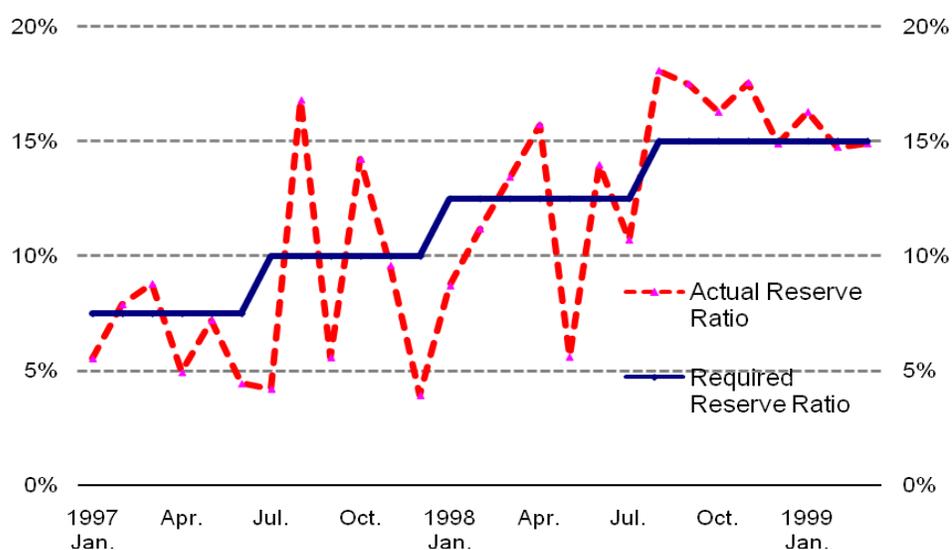
Source: computed from the Statistical Section of the *National Bank of Romania Monthly Report* (December) (2000, p. 26), (2001:27), (2002:27), (2003:26), (2004:29), (2005:27).

The reserve accounting mechanism was amended three times during the regime of high-powered money targeting in an effort to improve monetary control. It changed from averaging over a month (January 1997 to March 1999) to daily reserve requirements (April 1999 to July 2002) to again averaging over a month (since August 2002). For each of the three methods of reserve maintenance, before and after the introduction of the overnight interbank market (April 1999), actual reserves consistently diverge from the required ratios, pointing to the difficulties the NBR in reconciling its sterilization practices with monetarist policy narratives.

5.4.1 The recession years: 1997 – 1999

Despite repeated manipulations of required reserve ratios, the NBR's management of liquidity failed to fall in line with its monetarist premises. Indeed, the plot of required against actual reserve ratios from January 1997 to April 1999 (when the accounting mechanism was changed) suggests that the actual reserve ratio consistently diverged from its mandatory values (see figure 17). With no overnight market to turn to and restrictions in refinancing from the discount window, reserves followed a volatile pattern, depending on the liquidity positions of the banking sector. It would seem that for this period commercial banks endogenously determined both their reserves positions and broader monetary aggregates, with limited if any control from the NBR.

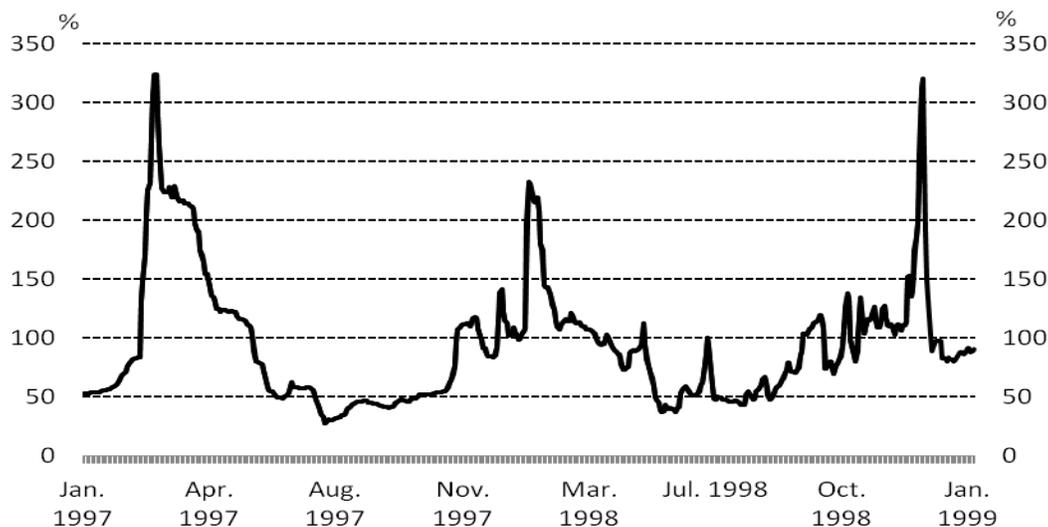
Figure 17 Actual and Required Reserve ratios (percentage), Romania, January 1997 – April 1999.



Source: computed from the Statistical section of the *National Bank of Romania Quarterly Bulletin 2/1999* (p. 55 and 57)

Furthermore, throughout these three years, policy makers were confronted with a paradoxical situation: a structural excess of liquidity co-existed with high interbank interest rates. The one week money market (ROBOR) rate fluctuated heavily throughout the period, a predictable outcome of the monetary targeting strategy. It increased above 200% on three occasions, reaching highly positive real values (see figure 18). The NBR denied that the quantity-targeting strategy was ultimately the source of such substantial volatility on the interbank market, and instead advanced two explanations: excessive government expenditure and the speculative behaviour of the banking sector. Indeed, Antohi et al (2003) described speculative attacks on the national currency as a method of putting pressure on the interest rates on central bank and government securities, an argument Borc (2002) further linked to the changing institutional characteristics of the treasury and interbank markets.

Figure 18 Interbank (ask) 1week Interest Rates (%), Romania, 1997-1999.



Source: computed from the National Bank of Romania statistics (<http://www.bnro.ro/StatisticsReportHTML.aspx?icid=801&table=642&column=>, accessed December 2008)

Borc attributed the high interest rates throughout 1997-1999 to a combination of the following factors: the deployment of the exchange rate as nominal anchor, the historically high inflation after the fall of communism and, thirdly, the commercial banks' monopoly position in the interbank and Treasury markets. The first two arguments reflect the (rather Western-centric) claim that emerging countries' central banks are more likely to deviate from commitments to price stability and that investors require higher risk premiums to factor in deteriorating inflationary expectations (Mishkin, 1999). These arguments fail to consider, however, that speculative activity responds to (expected) nominal returns rather than real returns on investments, as the short-term nature of speculation renders nominal values central to investment decisions (UNCTAD, 2004).

Indeed, starting with 1997, speculative activity would become a central element in the policy process, reflecting a wider, global neoliberal logic of structuring economic processes, 'the hegemony of financial capital under neoliberalism' (Dumenil and Levy, 2001). A

hegemonic policy discourse that dismantled controls on short-term capital and produced an international financial system where exchange rates are no longer linked to a common anchor¹⁰⁸ has created new investment opportunities: betting on volatility in exchange rates or interest rates. Against this background, the commercial banks' behaviour in both the wholesale and Treasury markets increasingly reflected wider neoliberal logics in a world economy dominated by financial capital.

Traditionally, exchange rate dynamics would primarily be linked to export and growth performance. However, with the increasingly liberalized capital account, capital flows would become the primary determinant of exchange rate movements in most developing countries (Jalan, 2003). While negotiations with the European Union projected a sequencing of the capital account liberalization to end in 2004 (see Appendix 1), by 1998 the Romanian forex market was replicating these neoliberal dynamics. Whereas historically, non-bank transactions dominated forex trading, in 1998 the interbank forex market outpaced non-bank transactions, a tendency maintained ever since (NBR, 1999a). Volumes traded on the forex interbank market reached a monthly US\$1 bn from August 1998, compared with US\$ 500 million in non-bank transactions and against a US\$ 2.6 bn trade deficit for the entire year.

Thus banks' ability to access foreign currency, particularly those under foreign ownership, had important consequences. It 'prompted speculative behaviour of some banks holding large amounts of foreign currency' (NBR, 1998a). The implications for policy practice came into sharper focus during 1999.

¹⁰⁸ Such as the Bretton Woods gold convertible dollar in place before 1973.

The crisis that never was: 1999

The second half of 1998 saw an emerging consensus that proclaimed an imminent default on Romania's foreign debt service (Isarescu, 2008b¹⁰⁹). Rating agencies¹¹⁰ downgraded Romania's rating by two or three notches, questioning its ability to finance a foreign debt service double the amount of the NBR's foreign reserves¹¹¹, with payments concentrated in the first half of the year. The timing of the foreign-debt service peak could not have more unfortunate. The Asian and Russian crisis reduced the availability of lending to emerging countries, and the embargo imposed during the Yugoslav conflict affected Romanian exporters. Designation to participate in an IMF pilot program of burden sharing further compounded the predicament, as balance of payments assistance was conditioned on securing privately contracted debt¹¹². The IMF had decided, after sustained criticism of its handling of the 1997 Asian crisis, to modify the nature of contractual obligations between sovereign borrowers and lenders that required Romania to convince holders of two 1996 bond issues to agree to a 80% rollover of the debt (Pop, 2006). After extended negotiations, the government rejected what it deemed highly unacceptable terms for borrowing abroad and instead chose to satisfy its contractual obligations without IMF assistance by implementing a severe adjustment of the current account. Consequently during 1998, the exchange rate exhibited substantial volatility. Concerned about capital outflows that would have threatened its inflation objective; the NBR took a net sale position on the forex market throughout most of the second semester and then the beginning of 1999, seeking to offset threats of a massive depreciation.

¹⁰⁹ The NBR governor (Isarescu, 2008c:1) described it in the following terms: 'according to the headlines disseminated obsessively by international agencies for over a year, Romania would have faced an imminent payment default'.

¹¹⁰ Including Moody's, Thomson Bankwatch, Fitch IBCA and Standard & Poor's,

¹¹¹ The debt service for 1999 rose to US\$ 2.8bn, equivalent to the entire banking systems foreign reserves at the end of 1998.

¹¹² For Romania, the terms of this arrangement envisaged a US\$ 600 million privately-financed loan.

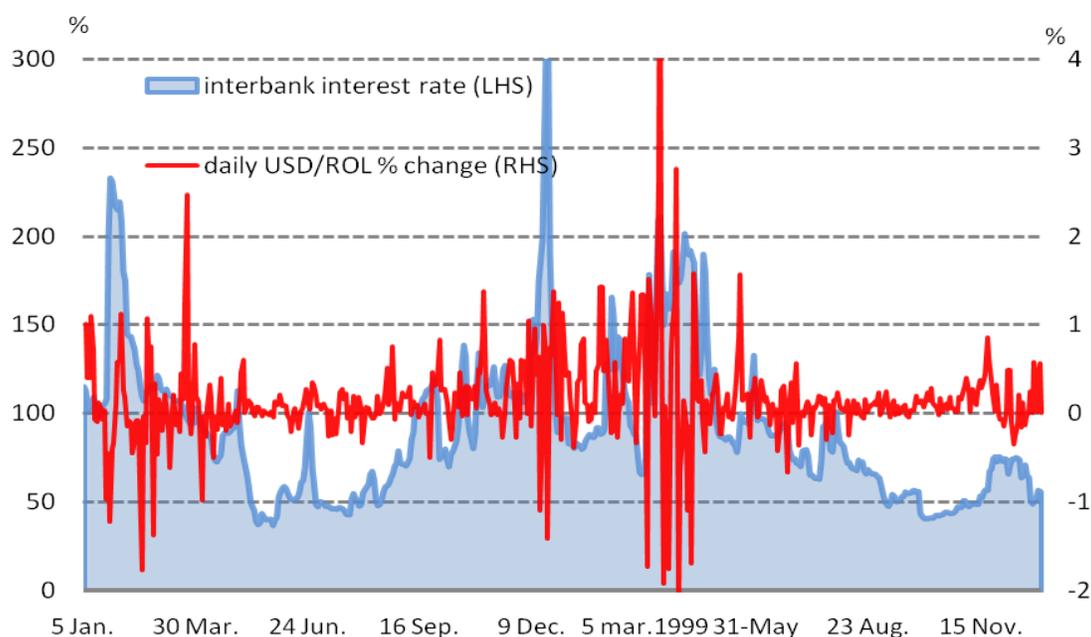
The NBR interpreted forex pressures as a signal of excess liquidity on the interbank market. On this market, banks were playing what Borc (2002) termed a bilateral bargaining game: on one side were banks with excess liquidity from the NBR's forex operations and on the other two state-owned banks (Bancorex and Banca Agricola), with severe liquidity problems. As the NBR downsized substantially its lender-of-last-resort function, complying with IMF's demands, the sole source of liquidity remained the interbank market, where the asymmetric distribution of liquidity had produced a divide between banks with access to foreign capital and those (mainly state-owned banks) confined to local savers and international trade activity. With rising reserve requirements and a deteriorating loan portfolio (partly due to the contractionary policies imposed during 1997), the two state-owned banks were compelled to accept bids at very high returns. Interbank lending became a very profitable activity for banks with excess liquidity. Once demand from these two banks was satisfied, excess-reserve banks turned to the forex market as the second source of speculative returns, using excess liquidity to open forex positions.

Under these circumstances, the NBR had several possible courses of action. It could allow the exchange rate to depreciate, with the attendant increase in inflation rates. A second option, using 'moral suasion' to stabilize expectations, signalled a disposition to defend the currency, which the NBR expected would discourage speculation without requiring actual interventions. Finally, the NBR could choose to intervene directly on the forex market, simultaneously absorbing money market liquidity and bringing the Bank into the market, as Bagehot would put it, by sterilizing at high interest rate.

The first option reflected negatively on commitments to price stability, while the second could not withstand repeated speculative attacks. Consequently, to narrow the wild swings in exchange rate movements throughout December 1998, and again in March-April 1999, the NBR resorted to both forex sales and very high interest rate sterilizations. Indeed,

increasing daily volatility in exchange rates since July 1998 went hand-in-hand with a trend increase in interbank short-term rates (see figure 19). The critical moment of debt service once overcome, the NBR allowed the exchange rate to depreciate at a slow pace while simultaneously proceeding to rebuild its forex reserves. The additional liquidity injected through forex operations set the interbank rate on a decreasing trend.

Figure 19 Daily forex and overnight rates dynamics, Romania, 1998-1999.



Source: computed from the National Bank of Romania statistics
<http://www.bnro.ro/StatisticsReportHTML.aspx?icid=801&table=642&column=> for interbank data, and
<http://www.bnro.ro/StatisticsReportHTML.aspx?icid=801&table=702&column=>, accessed December 20, 2008

Forex sales functioned to a certain extent as an anti-speculative instrument, but at the expense of overnight-rate spikes. The NBR would ask banks that were betting on a currency depreciation to buy a large volume of forex at the quoted rate. Since regulations required banks to engage in transactions with the NBR at the quoted rate, the matching liquidity had to be raised on the interbank market, pushing overnight rates to record levels (March 1999 is a prime

example of the NBR's anti-speculative tactic). The NBR would not intervene to smooth such fluctuations, since the success of its anti-speculation tactic depended on restricting banks' access to domestic liquidity for matching the forex buying orders.

This 'market mechanism' for discouraging speculation inflicted liquidity shortages and expensive refinancing on other banks in the system, so that by the end of 1999 Romania avoided a default on its foreign debt service at the expense of a banking crisis. The state budget absorbed the costs of restructuring two state-owned banks, while the NBR revoked the licence of several small private banks (NBR, 1999a), successfully calming a series of incipient bank runs¹¹³.

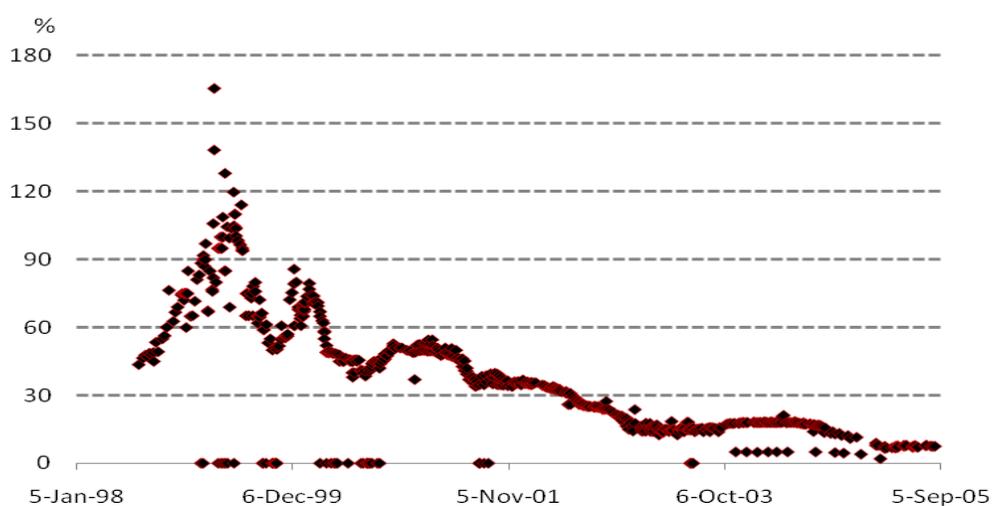
The dynamics of interbank rates and a pattern of lending rate movements that showed little sensitivity to short-term rate fluctuations (and thus to the NBR's liquidity policies) raised questions of what governed interest rate movements. The NBR (1999a) pointed to the lack of confidence and uncertainty generated by conflicting policy objectives, a depoliticizing exercise that aimed to sideline the grip that speculative behaviour exercised on the money market. It also deployed that neoliberal argument *par excellence*, that irresponsible expenditure crowded out private investment¹¹⁴. Indeed, since the 1997 SBA, the government had been increasingly forced to finance its deficits on the domestic money markets, which, the NBR argued, kept interbank rates high. An IMF intermediated process saw T-bill yields rising to a staggering 400% during 1997, and public debt service increasing significantly. The cost of bank restructuring increased the burden on the expenditure side, and opened up another source of speculative returns for the banking sector when the government's access to foreign borrowing all but disappeared towards the end of 1998. Since the NBR was legally forbidden to engage in

¹¹³ A more detailed account of the banking sector developments is provided at the end of this chapter.

¹¹⁴ 'Moreover, apart from the unfavourable influence on the conduct of monetary policy and the additional efforts of the National Bank of Romania to control liquidity, coverage of the budget deficit from domestic sources had a crowding-out effect on non-government sector and maintained or even increased interest rates because of the gap between demand and supply on the interbank market.' (NBR, 1998a: 56)

purchases of government paper on the primary market, a Treasury desperate for liquidity was forced, on several occasions, to accept extremely high interest rates at very short maturities. For instance, throughout the first trimester of 1999 the government could only borrow at three months, above 120% yield (see figure 20). Several high-volume auctions were not concluded as the Treasury deemed the commercial banks' offers unacceptable. Such a pattern of financing brought the 2000 public debt service up to a staggering 14% of GDP.

Figure 20 Yields on domestic debt, Romania, 1998-2005.



Source: computed from the Ministry of Finance data and the statistical section of the *National Bank of Romania monthly report* (December 2003).

Debt-related interest payments expanded substantially, forcing the government to downsize social expenditure to achieve a significant primary surplus in both 1998 and 1999. Starting with April 1999 the Treasury decided to eliminate such costly intermediation, issuing bonds directly to individual rather than institutional savers, so that the share of government paper held by banks fell from the near 100% throughout 1997 and 1998 to 63.1% at the end of 2000 and

18% at the end of 2005. This decision triggered a competition for savings that saw banks immediately responding with deposit rate increases.

The relationship between commercial banks, the NBR and the Treasury came to be described as a 'guerrilla war' or 'ambush' and the money market as the 'cemetery of public money' (Capital, 1999), as if the field of monetary management contained well defined, antagonistic interests between different policy-actors. The Central Bank, in this representation, struggled to formulate policy in a captive position vis-à-vis the money market. Nevertheless, the neoliberal reconfiguration of the policy space entails a much more fluid, shifting set of alliances. To describe the relationship between the NBR and speculative finance, manifested primarily through the banking sector, as antagonistic downplays the extent to which both were structured through a neoliberal logic into a sort of symbiotic co-existence. Hence tapping international markets became a justification for the institutionalization of new central banking practices that fostered speculative behaviour, including that of the state-owned banks, while at the same time the IMF accused these banks of sluggish adjustment to market behaviour!

Furthermore, the NBR's claims that fiscal domination hindered monetary policy implementation must be assessed against its practices of sterilization. In a circle of mutual dependency, the high interest rates attending sterilized interventions were increased the debt burden and forced fiscal policy into a procyclical pattern of primary surpluses accumulation during periods of economic recession. Debt management, on the other hand, was exposed to the procyclical nature of capital inflows (Kaminsky et al, 2004), which Togo (2007) further connected to the cyclical nature of the risk premium on public debt. The implication, Togo suggested, was that, under pro-cyclical risk premium and capital flows, the government ought to refrain from contracting short-term debt or minimize the concentration of maturing debt in one period. This technical expression of the policy trade-offs obscures the extent to which policy decisions were shaped by the priorities of the central bank. Indeed, to analyse the pattern

of capital flows through a pro-cyclical frame engenders a discursive operation that suggests a separation between domestic policies and the international context. This representation constructed capital flows as an exogenous force that might exacerbate or contain an ultimately domestic process, when in fact domestic dynamics and policies have been structured through neoliberal logics similar to these that govern international financial markets. To argue that the government had not managed correctly either its debt or its fiscal stance sidelines the critical role in narrowing policy options played by both the IMF's push for money-market financing and the speculative behaviour of the banking sector. It also questions the extent to which policy coordination would have been possible, when the NBR's attempts to legitimize its policy stance generally involved a dichotomised representation that placed fiscal misbehaviour at the root of macroeconomic problems. The terms of agreement on a common goal, a process that indeed premises negotiation, have been constructed by neoliberal discourses such that they inevitably require fiscal restraint.

Thus the 1999 moment revealed how in fact policy success translated into a successful compliance with the rules of neoliberal global finance. It entailed a 'purging' of the banking sector that further narrowed the potential (and policy instruments) for a different economic paradigm and legitimized a policy practice increasingly dependent upon speculative capital, where adjustment to the international rules of the game justified a deep recession and a further deterioration of the state's capacity for social provisioning.

5.4.2 The recovery years: 2000-2005

After the tumultuous late 1990s, the re-configuration of the policy space reflects the stabilization of an extra-local mode of rules and practices characteristic of neoliberal financialization processes. This period, I will argue, saw the Romanian economy increasingly resembling, in its fundamentals, other policy spaces structured through a neoliberal mode of

management: where policy practice is conditioned by and fosters speculative behaviour through sterilized interventions. Policy ‘success’ depends essentially on the ability to attract capital inflows through the practice of sterilized interventions, but at the expense of sustained appreciation of the local currency, a worsening of the current account position, and increased vulnerability to sudden reversals - an outlook familiar to many Latin American and Eastern European countries (Massad, 1997).

The NBR (2003a) heralded 2000 as the year when it regained its dominion of the money markets and began recovering its credibility as inflation tempered gradually, aided by a favourable international environment that saw global finance increasing its appetite for emerging markets investment. Foreign capital flows increased substantially, supporting the NBR’s practice of gradual real appreciations. Accordingly, the magnitude of structural excess liquidity on the money market, and the attending sterilization operations expanded considerably.

However, as I will argue in the following sections, the NBR was not entirely able to eschew the ambiguity of its policy discourse. The monetarist foundations of its policy framework projected a clearly-defined set of policy practices and outcomes. These involved maintaining monetary targets within the SBA-defined targets and deploying its policy instruments accordingly. On the other hand, by 2003 the NBR recognized, and the IMF (2004) concurred, that in fact monetary aggregates had little if any relevance for policy practices, while the exchange rate and gradually, the policy rate, were better indicators of its policy stance¹¹⁵. And this is where the political character of the policy strategy reveals itself. Monetarism is predicated on the ontological assumption that markets are the only viable mechanism for regulating activity, financial markets included. A rules-based policy removes

¹¹⁵ The IMF (2004:25) country report explained that: ‘Monetary policy works mostly through the exchange rate, while the direct impact of the policy interest rate on inflation is modest. As continuing reliance on the exchange rate for disinflation seems unavoidable, it is imperative that monetary policy be relieved from current account considerations by wage restraint and a tight fiscal stance.’

discretion and allows markets to distribute resources efficiently. However, the increasing consolidation of the neoliberal rules-of-the-game depended on a deeply discretionary policy practice that produced the necessary incentives for speculative capital.

The first challenge was to articulate a practice of tight monetary control, for how otherwise could the NBR explain the disinflation process? Maintaining a legitimizing representation required considerable work, for money-market dynamics rendered the impact of policy decisions on the intermediate target (broad money) unpredictable. To bring money-market dynamics in line with claims of tight liquidity control, the NBR altered its reserve requirements mechanism. Accordingly, the maintenance period was reduced to 15 days in the first quarter of 1999. A daily floor and ceiling for reserves, practically amounting to a daily reserve requirement, was set simultaneously with the creation of an overnight interbank market. The change did little to improve control. Indeed, the new overnight market provided commercial banks with an outlet for the excess or deficient reserves resulting from own financing needs and the NBR's interventions. Under the quantity-targeting strategy, this translated into significant volatility of overnight rates (see Figure 21). In August 2002 the *de facto* daily reserves requirement was replaced with one month averaging, from the 23rd of the month to the 23rd of the next month. The NBR hoped that this move would increase the flexibility of the policy instrument as much as its efficiency in stabilizing money market rates. Clearly the length of the accounting period changed overnight rates patterns, as averaging over a period reduced volatility (see Figure 22). Still, on the last working day before the end of the maintenance period, the interest rate either fell dramatically to the level of the standing deposit facility, indicating excess reserves, or increased sharply as commercial banks attempt to restore deficient reserves (as in January and March 2003). Wholesale markets remained volatile in the absence of an interest- rate smoothing policy (Bagehot, 1910).

Clearly, the monetarist assumptions underlying the policy strategy were invalidated by money-market dynamics, rendering not only the demand for money but also the money multiplier unstable. Against monetarist premises, the transmission mechanism functioned through excess/deficient reserves, creating volatility in overnight rates.

Commercial banks chose their liquidity position given NBR's sterilization operations and the demand from the productive sector, supporting the endogenous money argument that 'bank earning asset decisions are largely independent of their reserve position' (Moore, 1984: 106).

Figure 21 Overnight money market rates (bid), Romania, April 1999-July 2002.

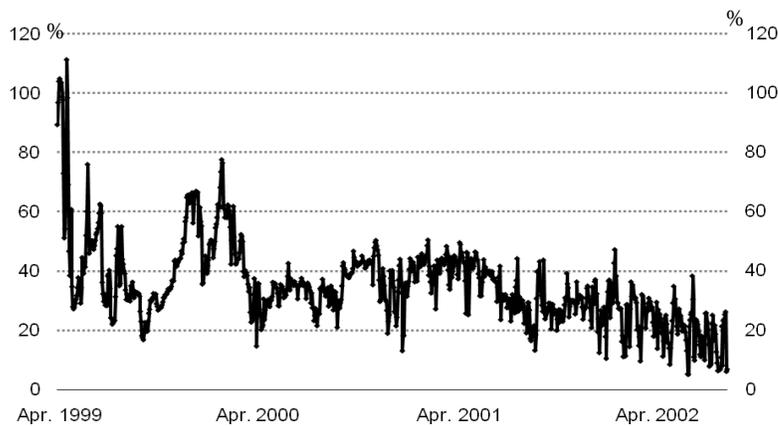
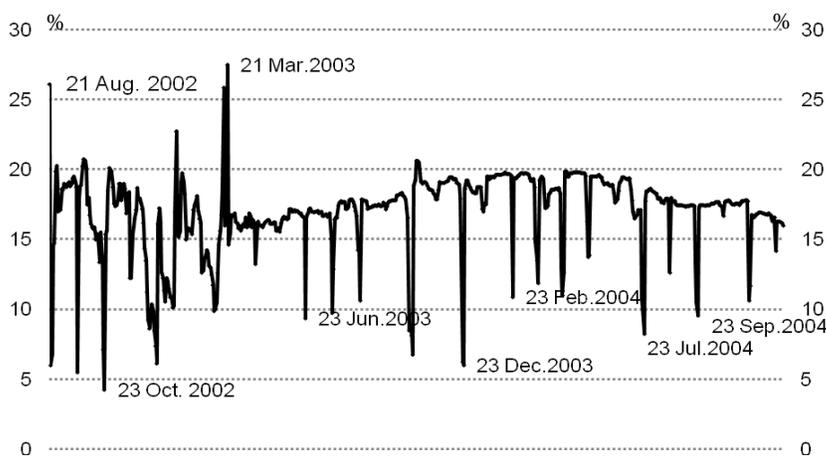


Figure 22 Overnight money market rates (bid), Romania, August 2002-August 2005.



Source: Source: computed from the National Bank of Romania statistics
<http://www.bnro.ro/StatisticsReportHTML.aspx?icid=801&table=642&column=> accessed December 20, 2008

Should we take the failure of monetarism as self-evident? The question, again, is not whether monetarism worked or why the NBR did not accept an endogenous theory of money, but how and why ‘success’ was produced and sustained in the policy space. Here David Mosse’s (2005) research on development practices and policies is useful in exploring the NBR’s policy. Mosse argues that the more interests are tied up within a particular interpretation, the more stable and dominant the policy model becomes. The need to sustain the relationship with the IMF, whose approval sanctioned Romania’s access to international finance, partly explains the endurance of monetary targeting against NBR’s open admission that the implementation of a pure monetary targeting regime was not within its reach. Nevertheless, the IMF’s country reports contain little if any reference to the monetary targeting strategy, while acknowledging that inflation control involved exchange rate targeting. So what explains the resilience of this policy model, which the NBR’s logic of practice routinely contradicted? Here, Mosse’s warning against a linear conceptualization that represents practice as the result of the policy model is particularly relevant. Instead, he argues, policy models (and discourses) serve to mobilize and maintain political support, thus legitimizing rather than orientating practices (Mosse, 2005: 14).

Indeed, the NBR was constrained to promote the view that its activities were the result of the implementation of official policy, when in fact practices of monetary management were increasingly subordinated to logics of financialized accumulation. Remarkable in this period is the rapid expansion in the volume of liquidity sterilized through deposit-taking operations: from ROL 300 million in 1999 to ROL 10 bn by 2004 (see figure 16). Increasingly large forex inflows arising from balance-of-payment surpluses (on account of privatization-driven foreign direct investments, foreign remittances and foreign loans) involved exchange-rate appreciations that the NBR saw necessary to prevent, with the attending explosion in money-market liquidity. Thus a fundamental component of the monetary transmission mechanism, the

money market, assumed to transmit the signals of the central bank through a competitive process, was in fact dependent upon the overwhelming participation of the NBR: the volume of liquidity deposited with the NBR reached 90% of the overall interbank market by the end of 2002 (NBR, 2002a).

Notwithstanding the policy discourse, sterilizations were not undertaken in the strict sense of monetary targeting to isolate reserve positions from forex interventions (since sterilizations failed to eliminate the massive excess liquidity in the system) but as the complementary instrument of the managed float: a vehicle for providing high returns to foreign capital. Thus monetary targeting stabilized and made coherent a forex practice engendering an inherent contradiction: interventions to prevent excessive appreciations produced the policy ‘problem’ - excess liquidity - and ‘the solution’ - sterilization. Still, abandoning forex interventions and sterilization would have reduced arbitrage opportunities and narrowed the inflow of capital that produced the exchange rate appreciations and disinflation. This inherent contradiction further questioned the narration of conflicting objectives: that policy practice produced confusing signals by gravitating from external stability concerns tailored to the exporter’s interests to internal stability that would have justified less or no interventions to prevent currency appreciations. In fact, forex interventions, along with sterilizations, were a necessary policy practice for curtailing inflation, rather than a strategy of export promotion.

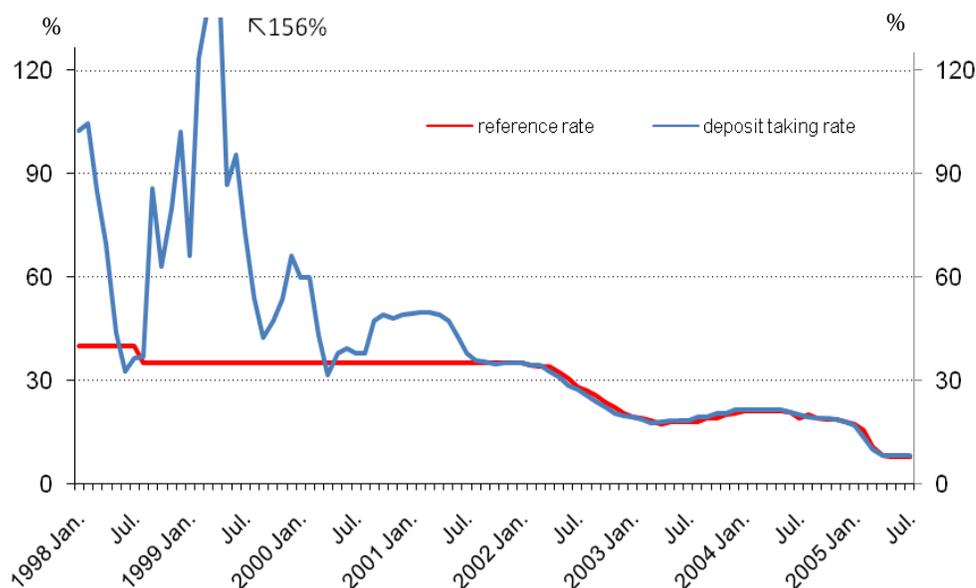
However, by 2003 the NBR accepted that it was defending the indefensible (NBR, 2003a). Open market operations were difficult to rationalize through a monetarist discourse in the presence of a structural excess of liquidity. Similarly, representation of reserve money as operational target were complicated by the discretion banks exercised in choosing their reserve position. Seeking to adopt the conceptual apparatus of ‘modern banking’ with its emphasis on signalling as a tool for stabilizing expectations, the NBR gradually switched policy argumentation to interest rates. Such a formulation overlooked the conditions under which the

interest rate that determined the NBR's relationship with money markets could function as a signal.

Indeed, interest-rate policy argumentation points to the power the central bank holds through its position of monopoly supplier of high-powered money. A day-to-day practice orientated at offsetting the volatility of autonomous liquidity factors allows it to maintain short-term rates within a corridor closely correlated to its policy rate (for instance the Bank of England maintains a 50-percentage-point fluctuation corridor for the overnight rate). In this manner, the central bank controls the price of liquidity in the system, and the short-term money market rate functions as signal for the entire structure of the interest rates, aggregate demand and inflationary pressures. As longer term rates incorporate an additional expectations factor, an interest rate policy strategy requires the central bank to influence expectations about future policy moves and thus strengthen the link between short and long-term interest rates.

Hence the claim that the interest rate policy functioned better as an indicator of the monetary policy stance has to be considered against the practice of sterilized interventions. Clearly, the only variable relevant for money market dynamics was the rate at which the NBR mopped up money-market liquidity and not the reference rate in its statistical releases, which for most of the period remained consistently below the sterilization rate (see Figure 23).

Figure 23 Official and sterilization interest rates, Romania, 1998-2005.



Source: computed from the National Bank of Romania statistics <http://www.bnro.ro/Interest-Rates-on-Monetary-Policy-and-Standing-Facilities.-history-3337.aspx>, accessed December 20, 2008 and NBR internal data

However, the NBR admitted, the sterilization rate did not function as a policy rate in the traditional understanding (i.e. as the cost of liquidity in the system), but rather as an opportunity cost for banks constantly searching for the best arbitrage opportunities. Thus, the interbank market had ‘an insignificant role’ in propagating monetary policy impulses (Antohei et al., 2003: 8). The neoliberal management of the monetary policy space thus produced a paradoxical representation of policy practice: an interbank market largely dominated by the central bank, but with little relevance in the monetary transmission mechanism. While this representation functioned to construct a central bank in control of monetary conditions, albeit through rather unorthodox means, it conveniently sidelined the extent to which the ‘policy’ rate was conditioned by forex/money-market dynamics. This appeared nowhere more clearly than in the evolution of the deposit-taking rate throughout this interval. After the extended volatility registered during 1997-99, sterilization rates entered a rapidly-descending trend. Nonetheless, these rate cuts were not autonomous policy decisions constructed through rigorous analysis of

aggregate demand developments. In fact the NBR admitted that the quasi-permanent excess supply on the forex market and the Treasury's success in reducing the costs of financing on the primary T-bill market were instrumental in its decisions to reduce sterilization rates¹¹⁶.

The policy reversal during the second half of 2003 further confirmed this trend. After having reduced the policy rate by around 1000 basis points since June 2002, the NBR decided to 'tighten' monetary conditions by ending the easing cycle and increasing the sterilization rate in three steps, each of one percentage point. Two interrelated developments explained this move. First, the NBR (2003a) attributed its decision to balance of payments developments. It interpreted a reversal of capital inflows as evidence of an overshooting in its interest rate cuts that depreciated the currency¹¹⁷ and threatened disinflation.

Second, it argued, the policies in place had unduly supported an expansion in demand, on the back of a fast increase in forex-denominated consumer credit. Indeed, between January 2000 and June 2003 domestic non-bank credit nearly tripled, albeit from a low base. In the first six months of 2003 alone it increased by 80%. The currency composition shifted towards forex-denominated credit: while at the end of 1996, around 35% of the banking sector's assets were in foreign currency, by April 2003 this share had risen to 60%, reflecting expectations of a trend appreciation in the domestic currency and the interest rate differential caused by high domestic interest rates. A Post Keynesian positioning would have described this process as the endogenization of the monetary transmission mechanism, where the productive sector's demand for credit and the banking sector's liquidity preference, based on the risk assessment of the credit worthiness of the borrowers and the level of perceived risk the banks are willing to assume, drive credit creation (Dow, 2004). The Central Bank's control, in this scenario,

¹¹⁶ 'As a result of lower resort by the Ministry of Public Finance to domestic resources amid substantial foreign financing in H1 2002, the need to correlate the rapidly decreasing yields on Treasury certificates with the central bank's rates was another factor underlying the monetary authority's move' (NBR, 2002a: 13).

¹¹⁷ The reference currency shifted from the US\$ to the EUR as of 3 March 2003, reflecting the large share of trade with the European Union.

narrows to influencing the cost of credit in the system (by setting the price of liquidity). Nevertheless, in the particular circumstances of a banking system awash with liquidity and a substantially euroized asset side, there was little scope for monetary control either on monetarist terms (reserves control) or Post Keynesian lines (interest rate control).

Under these circumstances, the attempts to contract aggregate demand by raising sterilization rates would achieve the very opposite: shifting demand towards foreign-denominated credit. Clearly, explaining credit dynamics as the outcome of a monetary easing, as the NBR did during 2003, would have required a rather more substantial control of monetary conditions than the structural excess of liquidity allowed. Nevertheless, such a claim served a different discursive purpose: to articulate policy through interest rates and aggregate demand control. These discursive efforts reflected NBR's decision to shift its policy regime from (it claimed, an obsolete) monetary targeting towards inflation targeting, whose adoption date was set for August 2005.

The regime shift has to be understood in the context of capital account liberalization (see Annex 1). Indeed, EU accession negotiations required Romania to open access to bank accounts denominated in domestic currency for non-residents by early 2004, a move the monetary authorities feared would reverberate in the speculative transactions segment. A postponement to April 2005 was negotiated, a breathing space the NBR (2005a) demanded in order to adopt containing measures. On the one hand, it undertook a series of aggressive policy rate cuts to reduce the interest rate differential: the sterilization rate decreased from 21.25% in January 2004 to 8% by August 2005, a decrease of almost 1400 basis point in 18 months. Viewed from a different angle, NBR's expectations of higher (speculative) capital inflows allowed it to substantially lower its sterilization rates, a move suggestive enough of the fundamental role that speculative capital played in structuring policy decisions. On the other hand, the NBR decided simultaneously to allow inflation-curbing nominal appreciations in the

domestic currency by gradually withdrawing from the forex market, which it would abandon by the fourth quarter of 2005. This stance, the NBR claimed, would offset the potential inflationary consequences of its monetary easing.

5.5 A second pause for reflection: the banking sector

The OECD (2002: 43) described 1999 as the moment when financial sector reform gained momentum in Romania. The restructuring process redefined the banking sector through the closure of one of the largest state-owned banks, privatizations and several bank failures.

This, international institutions held, was highly overdue. Indeed, while the 1997 SBA committed the government to speed up the pace of bank privatization, by December 1998 state-owned banks still amounted to over 70% of banking activity. The politics of gradualism had maintained Romania on the dark side of the great divide, as a famous Berglof and Bolton (2003) article described an opening gulf between successful and laggard formerly planned economies. What opened the divide, they argued, was governments' failure (Romania unequivocally one of them) to break the cycle of unpaid enterprise debt, arrears and pressures for monetization that was reflected in increasingly deteriorated state-owned banks' balance sheets. The large presence of the state in the banking sector continued unfortunately to mirror the communist inheritance. The 'gradualist' years' commitments to change the ownership structure and thus stimulate market driven processes of financial intermediation failed to materialize. This articulation of the banking sector problem simultaneously identified the solution: privatization and private ownership as necessary conditions for crossing the divide.

Neoliberal accounts of the changes in the banking system narrowed the explanations of the 1999 bank failures to serious governance problems and political pressure to extend credit to vested industrial interest, thus validating soft-budget constraints. Notwithstanding the many

high-profile corruption cases which involved banks' top management, particularly in the state-owned sector¹¹⁸, this narration of the success of bank restructuring as a natural and necessary progress towards private ownership had two discursive effects. It first sidelined over the NBR's institutional practices during the years of normative neoliberalism. Its policies of maintaining historically high refinancing rates and limited access to the discount window had a negative impact on the banking sector as a whole: the NBR had to provide lender-of-last-resort assistance to two private banks in 1996. Furthermore, NBR's attempts to enforce neoliberal recipes for 'restructuring' state-owned enterprises transformed liquidity problems into solvency problems, with the attendant deterioration on the asset side of the state-owned banks.

Second, it premises a state-owned bank behaviour systematically tailored to the requirements of state-owned production, sidelining the increasing reconfiguration of the relationship between finance and production through a neoliberal logic. While indeed state-owned banks were repeatedly instructed to extend preferential credit, would this constitute conclusive evidence of their functioning (only) as a validation mechanism for soft-budget constraints? This representation simply cannot be reconciled with liquidity shortages and the three payment blockages described in the last chapter nor the industrial sector's repeatedly voiced concerns that state-owned banks were deliberately engineering operational blockages to 'stimulate' demand for expensive credit.

However, the 1990-96 banking dynamics also suggested that neoliberalizing state-owned banks entailed more efforts than neoliberalizing private ones. The 1997-99 years provided a perfect opportunity to do so. With the peak in debt service looming at the end of 1998, the IMF most helpfully advised Romanian authorities that a faster privatization of important state-owned assets could partially offset the foreign financing gap (Pop, 2006). Pressed for foreign currency, the government initiated a fire sale of two large state-owned

¹¹⁸ Bancorex is a paradigmatic example.

banks¹¹⁹ (along with several other high-profile privatizations), further opening up the banking sector to international ownership. Simultaneously, the asymmetric distribution of liquidity on the interbank market, coupled with serious governance problems (Economist Intelligence Unit, 1998) had immediate consequences for the liquidity and solvency of several state-owned and private banks. Thus the two state-owned banks which had channelled preferential credit to the energy and agricultural sectors during 1995 and 1996 (Bancorex and Banca Agricola) found it increasingly difficult to finance on the wholesale market a stream of non-performing loans (amounting to 253% of the capital in the banking system in December 1998). Under the IMF and World Bank's specific requests, one state-owned bank was closed, and two other restructured for privatization¹²⁰. The state budget absorbed all costs of clearing state-owned banks' balance sheets of non-performing loans.

Neoliberalism's impressive capacity to redefine itself is obvious here. Critical voices saw the 1997 Asian crisis and its spread elsewhere as a fundamental crisis in the neoliberal logics of financialized accumulation, when it quickly became clear that the dislocation was instead used as a platform for extending neoliberal logics (Peck and Tickell, 2002). A similarly impressive operation was achieved in Romania: international volatility opened up the banking sector in an unprecedented manner, marking a substantial reconfiguration of banking activity. By the end of 1999, the state-banks had lost 25% of market share, while foreign-owned banks extended their influence further at the expense of private banks with domestic capital (see Table 7), a tendency that would further strengthen over the following years.

¹¹⁹ The state development bank, BRD, and the state savings bank, Bancpost, were privatized at the end of 1998 and May 1999.

¹²⁰ Bancorex was closed, its assets transferred to an asset recovering agency, Banca Agricola was restructured for privatization while another state-owned bank, Bankcoop was placed under special administration.

Table 7 Banking sector structure, Romania, various years.

	Number				% Total Credits		
	1990	1998	1999	2005	1998	1999	2005
State-Owned	5	7	4	2	75%	50%	6%
Domestic private capital	2	13	11	7	9.5%	6.1%	31%
Foreign private capital	0	16	19	30	15%	43.6%	62%
TOTAL	7	36	34	39	100	100	100

Source: computed from *National Bank of Romania Annual Reports* 1992 (p.37), 1999 (p.45) and the *Financial Stability Report 2006* (p.8)

But this was not the only achievement: the government absorbed restructuring costs. The elimination of state-owned banks thus further increased the scope for speculative returns on the Treasury markets, functioning to increasingly structure banking behaviour through neoliberal logics. Indeed, during 1999 it became evident that the neoliberal policy-making punished credit activities and rewarded speculation what the NBR (2000a) called a paradoxical situation: banks obtaining higher returns on the interbank market than through long-term financing of productive activities. That commercial banks' willingness to lend for productive activity diminished considerably throughout the period is an important explanatory factor for another 'challenge' of the transformation process: the culture of non-payment and arrears (IMF, 2004), affecting both the state-owned enterprises and private firms. Aside from political considerations (rent-seeking behaviour for instance), the IMF recognized that the systematic liquidity squeeze produced by a curtailing of directed credit contributed substantially to the consolidation of such behaviour. Nevertheless, the disappearance of directed credit cannot account for another interesting statistic the IMF (2004) report produced: enterprises financed around 8% of total requirements through bank credit, while arrears financing rose to 35%. Diminished willingness to lend to productive activity was a consequence of both the restructuring of the banking sector through neoliberal logics and the NBR's new practices of

monetary management that offered high returns from speculative operations on the money markets.

Indeed, after 2000, the NBR's institutional practices further consolidated the neoliberal reconfiguration of the relationship between the money, forex and Treasury market, with the foreign-owned banks' speculative behaviour playing a central role on all three. While the NBR (2004a) acknowledged that the money market played an insignificant role in propagating monetary policy impulses, it refused to recognize that this was the consequence of its practices of liquidity management, increasingly subjugated to the requirements of financialized accumulation and transnational market actors.

5.6 Conclusion

This chapter mapped the further reconfiguration of the monetary policy space between 1997 and 2005, a period when the NBR formally adopted high-powered money targeting as its policy strategy. It argued that the macroconstitution of the neoliberal economic space saw a shift (or perhaps a cumulative change) from the 1990-1997 destructive emphasis that structured monetary policy as the primary instrument of neoliberal destruction, to a constructive phase where markets relevant to monetary management are politically constructed through neoliberal logics. As Peck and Tickell (2002) so persuasively argued, the hegemony of neoliberal discourses cannot be reduced simply to an after-Keynesian, or in this case post-communist, outcome of spontaneously emerging market forces in the spaces opened up by the state's withdrawal. Instead, neoliberalism's ascendancy has been associated with the political construction of markets and processes of reregulation.

The usual account of the period attributes policy success to the increasingly technocratic mode of policy-making and congratulates the 1997 right-wing coalition's wisdom

to withdraw (albeit hesitantly) from the process of policy implementation. It was argued however, that such a narrative glosses over the politics of monetary policy while simultaneously understating the global forces that shaped and defined domestic policy choices. Indeed, while one could argue that the structural and institutional resistance to neoliberalism during the ‘gradualist years’ produced localized outcomes (such as a uniquely intense relationship with the IMF), the post-1997 developments resist such narrow confinement. Instead, this period saw the normalization of an extra-local regime of rules and practices grounded in a neoliberal mode of economic governance present across geographic boundaries. Its main features are the following:

- the transformation of the relationship between wholesale banking and the central bank, where management of liquidity is subjugated to the exigencies of private actors and an increasing reconfiguration of banking-sector activity through neoliberal logics of financialized accumulation;
- discourses and practices that rewarded speculation and punished credit for productive purposes. The asymmetric distribution of liquidity on the wholesale market, coupled with high interest rates, produced in a banking crisis that all but terminated the dominance of the state-owned banks;
- the changing configuration of credit and debt, with an increased euroization of the assets side of the banking sector that belied claims of tight monetary control.
- an increasing vulnerability to international sentiment, produced through practices of sterilized interventions, currency appreciations and expanding current account deficits;
- a monetarist policy discourse engaged in feigning control over the uncontrollable, of legitimizing and normalizing practices tailored to attracting speculative capital, while simultaneously tying financial stability considerations into the choices of transnational market actors.

Against the sustained efforts to clean up and systematize policy discourse, one of its defining, and I argued, necessary characteristics remained its ambiguity, whose source can be traced in the shift in policy rationalities operated by the 1997 SBA: sterilized forex interventions and a fiscal policy disciplined by the market. In the first instance, the redefinition of the relationship between policy discourse and practices is revealing. Thus the economics of stabilization predicated on the existence of excess liquidity translated into extended and highly detrimental liquidity shortages before 1997; afterwards a policy discourse that ascribed success in the disinflation process to a tight monetary control in fact saw policy practice and success dependant on a structural excess of liquidity on the money market.

The exchange rate constituted a second site of narrative ambiguity. The NBR claimed that its decisions were embedded in two conflicting objectives: export competitiveness, implicitly recognizing that export performance hinged on a competitive exchange rate as much as on productivity, and internal stability, sanctioning a pass-through from exchange rate to prices that it had refused to discuss, minimized or rejected altogether before 1997. This translated into a policy goal of sustainable real appreciations, which allowed the NBR to deny policy responsibility for a widening current account gap. Notwithstanding the NBR's claims, the intimate connection between the governance of the money markets and exchange rate movements point to a symbiotic rather than competing relationship, familiar to other countries dependent on capital inflows: sterilizations as a vehicle for speculative returns.

The claims surrounding the interest rate policy constituted a third space of ambiguity. The massive sterilization volumes and the managed exchange rate contradicted the discursive anchoring of success in the monetary targeting strategy, so that by 2003 the NBR shifted its policy argumentation to interest rates. The successive cuts in sterilization rates, facilitated by the availability of foreign inflows and lower Treasury yields, ushered in an argumentation linking interest rates to aggregate demand control. Nevertheless, the NBR's dominance on the

wholesale market, and the little relevance of its sterilization rates for the cost of liquidity in the system simultaneously invalidated a monetary transmission mechanism rooted in the control of short-term interest rates. Once set in the context of the further liberalization of the capital account, this discursive operation permitted the NBR to bring considerations of speculative inflows and financial stability into its policy rates and begin the process of shifting to inflation targeting.

The next chapter will explore the politics of the regime shift and the re-articulation of practices in terms of inflation-targeting models. It argues that the shift represented a further step in the neoliberal structuring of the monetary policy domain.

Chapter 6. Inflation Targeting (under crisis)

The last chapter argued that after 1997, policy discourse enacted in the NBR principles of monetary management corresponding to a normalized neoliberalism, with institutional practices increasingly tailored to the requirements of financialized accumulation and transnational market actors. However, this faced the central bank with contradictory imperatives: inflation control or financial stability. Negotiating these, the central bank argued, required a policy regime that transferred the prerogatives of policy-makers to markets: inflation targeting. Nevertheless, it will be shown that inflation targeting's promise of stability operates to sideline the destabilizing nature of normalized neoliberal practices of monetary management, clearly evoked by the 2008 crisis as it unfolded in the Romanian policy space.

This chapter will explore the institutionalization of inflation targeting as the new policy regime since its adoption in August 2005. The NBR narrative explaining this policy shift stressed two driving factors (NBR, 2005a). First, it recognized the ineffectiveness of its formal policy strategy, setting monetary targets at both intermediate and operational levels. Instead, the NBR would join a growing consensus seeking to align the theoretical underpinnings of monetary policy strategies with developments in general equilibrium monetary theory. Second, it maintained that its practices of exchange rate manipulation would no longer be sustainable under further capital account liberalization that allowed non-residents to purchase of treasury bills and hold bank deposits starting with April 2005 (Isarescu, 2005). Tackling the increased vulnerability to speculative capital movements required interest rate manipulation (NBR, 2005c).

Shifts in policy paradigms cannot be understood without reference to the historical context in which they emerged. The question that arises then is how did inflation targeting

function within (or outside) neoliberal logics? What discursive operations did it require to sustain, challenge or change policy practices tailored to the requirements of speculative capital? Furthermore, the period under analysis, August 2005 to December 2008, had seen the unfolding of a fully blown global financial crisis that started as a meltdown in the US securitized markets in 2007. The chapter will ask to what extent inflation targeting functioned to increase vulnerabilities to financial turmoil elsewhere, and whether the crisis as it unfolded by the end of 2008 changed the parameters that had previously circumscribed practices of monetary management.

The chapter will begin by situating the regime shift within international discourses of optimal monetary policy frameworks. It maps the politics of modelling inflation, linking these with neoliberal ideology and institutional practices of monetary management. It will explore the discursive dynamics produced on the policy scene, tracing change and continuity in policy discourse. Indeed, while inflation targeting constructs a new conceptual space for policy making, a shared ontological foundation with monetarist thinking blurs the clear distinction between the former and the present policy discourses, so that the new policy argumentation retains some of the structuring concepts of the monetarist narrative, such as the emphasis on excess liquidity as driver of inflationary dynamics. Furthermore, it will ask how the new policy discourse re-articulates practices of monetary management, and explore the ongoing reconstitution of policy spaces in a period marked by the increasing dislocation, and contestation, of neoliberal hegemonies.

6.1 The inflation targeting regime in Romania

The advocates of inflation targeting point to a series of distinguishing features: the primacy of monetary policy for managing demand; the virtues of central bank independence; and the

importance of managing expectations (Woodford, 2007). Indeed, this policy strategy requires the central bank publicly to commit to an inflation target and a policy rule that details how the policy instrument would be changed to ensure inflation moves towards the target over a specified time horizon.

At the time of adopting inflation targeting, the NBR (2005c) argued that it had fulfilled the institutional criteria fundamental to a successful regime switch: it was both operationally and legally independent from any political pressures, fiscal dominance had disappeared as a threat to inflation and, very importantly, its credibility had been reinforced through a continuous process of disinflation bringing inflation into single-digit territory.

The policy framework specified a CPI-based inflation target (7% for 2005 and 5% for 2006), set as a midpoint within a target band of +/-1 percentage point and a forward-looking policy rule. This demanded that the policy instrument, the short-term interest rate, respond to forecast, rather than current deviations from the target. Annual targets would be set for a longer time horizon, in a joint announcement with the government, and a clear set of escape clauses was specified to detail the circumstances under which the NBR would not assume responsibility for missing the target. Furthermore, the NBR (2005e) explained that while it preferred market mechanisms in the forex market, it reserved the right to interfere occasionally when the exchange rate moved into undesirable territory.

The next sections will detail the theoretical conceptualization behind inflation targeting regimes and discuss how and why a consensus on its optimality emerged.

6.2 The Consolidation of the New Keynesian Consensus

The increasing influence of this policy regime before the 2008 crisis was reflected in its wide endorsement by academics, international financial institutions and policy-makers alike. Its appeal built on three (related) features.

Inflation targeting safely squared with neoliberal approaches to financial development. The World Bank applauded its consistency with the claim that financial markets provide the best allocation of resources if and when the government's role is of a regulatory nature, aimed at fostering systemic stability. It has been advocated as the new mechanism for building international consensus on optimal policies, thus guaranteeing safe integration into global financial markets. The inflation-targeting land was all rosy: with credible macroeconomic policies, states no longer need worry about exchange rate regimes, but could allow markets to decide the most competitive level of a national currency (de la Torre et al, 2007).

Furthermore, inflation targeting echoes international development discourses on the centrality of knowledge in the policy process. The marriage of technocratic expertise and policy credibility necessitates 'knowledge institutions'. For policies to be credible, policy-makers must have adequate knowledge of how policy decisions impact on macroeconomic variables and how expectations are formed. Furthermore, policy decisions need to be transparent enough for agents to form knowledge of the dynamics of the process and thus stabilize expectations (Gaspar and Kasyhap, 2006).

Last, inflation targeting policy discourse depoliticizes policy-making while fundamentally reinforcing the focus of the PostWashington Consensus on institutions that facilitate market processes. It articulates a version of monetary control where scientific expertise is instrumental in monitoring and carefully correcting any deviations of the economic machine from its natural path. Thus inflation targeting emphasizes the shift from the political character of multiple policy objectives under previous policy regimes to the depoliticizing

effect of scientifically-sound rules underlying optimal policy (Woodford, 2003). As its economic theory builds upon forward-looking individual decisions made under rational expectations, policy credibility rests on stabilizing inflationary expectations through a systematic commitment to low inflation. Policy is thus devolved to the market.

Inflation targeting finally succeeded, advocates argue, in making monetary theory relevant for monetary policy, and thus bridged the historical divide between academic research, policy discourse and central banking practices (Walsh, 2006). The existing mainstream macroeconomic theory, with its emphasis on nonmonetary factors for explaining business cycles, had allowed no room for systematic policy, while monetarist policy discourses emphasizing the necessity of targeting monetary aggregates within a quantity theory logic increasingly lost their political legitimacy. I will look at each in turn.

Real business cycle models a la Lucas-Sargent (1978)¹²¹ specified a fully flexible equilibrium setting temporarily disturbed by exogenous stochastic shocks. Under rational expectations, DSGE real business cycle analysis implied that monetary policy was effective only if it produces unexpected results. Subsuming monetary processes under a rational expectations frame reinforced the Chicago school money neutrality, and denied any room for systematic policy. While such results did little justice to the historically complex practices of monetary management, the turn to rational expectations raised a serious challenge for policy-makers. Lucas's (1976) famous critique argued that the large-scale (dynamic IS-LM) econometric models used by central banks suffered from one essential flaw. Estimated model coefficients, assumed policy-invariant, depended on past policy measures. If such was the case, then the impact of future policy decisions could not be simulated by deploying policy-specific historical relationships. This, Lucas argued, resulted from the models that lacked microfoundations, and opened up a new research agenda. The frontier of mainstream

¹²¹ The real refers to money neutrality engendering a monetary-real dichotomy.

macroeconomic research moved to constructing models where relations are not sensitive to policy changes, but grounded in interactions between agents with rational expectations operating in a well-specified economic environment, with all decision problems accounted for in the model.

The new research agenda dovetailed with a related debate on the monetary targeting regimes advocated by monetarist discourses and embraced by various central banks in Western Europe and the US. Monetarist strategies, on which the monetary side of DSGE models were built, specified a quantity variable as policy instrument¹²², and thus failed to recognize an essential principle of money market management famously explained by Bagehot (1910): policy practice in developed financial systems involved interest-rate manipulation. This principle further underpinned a critique of the monetarist assumption of money supply exogeneity and money neutrality forcefully initiated by Kaldor (1982) and strengthened by Post Keynesian economic thought (Dow, 1996; Moore, 1988).

Endogenous money theories, while presenting a far more accurate picture of central banking practices, failed to displace rational-expectations monetary models. Portrayed as too scholastic or philosophical, mainstream economists dismissed Post Keynesianism as of little relevance for theoretical developments in monetary economics (Gale, 1982:183). Instead, a New Keynesian ‘paradigm’ of monetary theorising emerged, integrating rational expectations micro foundations with Keynesian notions of nominal price rigidities and short-term money non-neutrality. This, New Keynesians held, brought back ‘normativity’ into macroeconomic policy research, while simultaneously closing the gap between mainstream theorising and central banking. New Keynesian models answered Lucas’s call for incorporating individual

¹²² The DSGE literature is fraught with confusions between instruments and operational targets, arguably due to the little attention paid to policy practice by mainstream modelling. Policy practice consists of choosing an operational target, be it the high powered money (reserves of banks with the central bank+cash) or a short-term market interest rate. The instruments used to achieve the target are open market operations and standing facilities. The confusion between targets and instruments, dating back as long as Poole (Bindseil, 2004), is present in the New Keynesian literature as well, particularly in the specification of the policy rule.

decision making into general equilibrium models. By introducing nominal rigidities, accounted for by government contracts, these acknowledged short-term money non-neutrality and thus opened up considerations of optimal policy design. Furthermore, New Keynesianism discarded the monetarist insistence on monetary targeting, and recognized (short-term) interest rates as operational targets in monetary policy practice. Monetary theory, New Keynesians proclaimed, regained its relevance for monetary policy (Walsh, 2006).

Did inflation targeting mark a radical break from the principles of monetarism? Woodford (2007) traced two shared fundamental principles: the recognition that monetary policy can control inflation - against the Keynesian focus on labour market dynamics as primary in inflationary developments - and the importance of a verifiable commitment to price stability. The next sections will explore these questions in detail, focusing not only on the changes and continuities in the conceptual framework underlying this new policy strategy, but also on the reconstitution of argumentative terrains and practices of monetary management.

6.2.1 The Basic Model

Inflation targeting models constructed a new conceptual space for policy-making. The basic New Keynesian dynamic general equilibrium model used for policy analysis specified an aggregate demand curve, a Philips curve and a loss function for the Central Bank (Clarida et al, 1999). The incorporation of nominal price rigidities changed the real business cycle models in two respects: monetary policy decisions with non-neutral effects and aggregate behavioural equations derived explicitly from optimizations by households and firms. Optimization was derived either from backward- or forward-looking behaviour, or a hybrid of the two. Incorporating expectations into the model was often argued to offer a better grounding for policy-making as policy decisions reverberate throughout the economy with a lag (Woodford, 2003). Since the NBR's inflation targeting strategy stresses the essential role of the

expectations channel, the discussion will focus on the forward-looking class of models¹²³. It will also follow the common presentation of the model in its closed-economy setting, to later identify the issues attending open-economy considerations.

Aggregate demand function

Under forward-looking expectations, output and prices depend on current and future expectations of private agents. The aggregate demand function sums individual spending decisions for household consumption and firms' investment. Both present and (expected) future interest rates are important, as they influence long-term interest rates and asset prices, a specification which Woodford (2003) argued is consistent with the Wicksellian approach. For instance, if the interest rate is above its natural level, households will choose to save more now (substituting consumption), while firms will invest less, opening a gap between the current level of output and its natural level. The concepts of a natural level of output and interest rate¹²⁴ reflected the neoclassical emphasis on preferences and technology under perfectly flexible wages and prices, so that the forces of productivity and thrift bring the economy to full employment. Since both preferences and technology are subject to sudden changes, New Keynesian theories accept a degree in volatility in natural output. The current output gap (x_t) depends on the expected output gap (x_{t+1}), the real interest rate determined ex-ante from expectations of price movement and the nominal interest rate (i_t), and a demand shock (g_t).

$$(1) \quad x_t = -\varphi(i_t - E_t \pi_{t+1}) + \theta E_t x_{t+1} + g_t$$

¹²³ For backward-looking models see Ball (1999).

¹²⁴ Some of the NewKeynesian modelling, particularly in Woodford (2003), is explicitly Wicksellian in using a natural level of the interest rate in the policy rule.

Most New Keynesian literature conventionally equates i_t with the policy rate. Such a specification critically premises a perfect transmission mechanism to the interest rate relevant for spending decisions (Gaspar and Kashyap, 2006). While this simplification has been justified by the expectations theory of the term-structure determination, a wealth of empirical studies challenged this assumption (Cochrane and Piazzesi, 2005).

Aggregate supply function

The specification of the aggregate supply function is a variant of the standard expectations-augmented Phillips curve, an equivalent of NAIRU (Sawyer and Arestis, 2002). Firms set nominal prices depending on past and expected inflation, the output gap and cost-push shocks (u_t). The supply function aggregates individual firms pricing decisions, assumed to change on a staggered basis: in each period, a subset of firms sets prices for multiple periods, usually specified a la Calvo (1983), with a fixed probability independent of particular historical circumstances. As Gali and Gertler (2007) pointed out, the u_t term has a strict theoretical interpretation, essentially dependent on the existence of nominal (price) rigidities. It represents variations in marginal costs other than due to excess aggregate demand. Only under wage rigidities do ‘cost shocks’ capture variations in oil prices or productivity. This is fundamental to policy making. It implies that cost-push shocks face the central bank with a short-run trade-off between inflation and output.

$$(2) \pi_t = \gamma\pi_{t-1} + \beta E_t \pi_{t+1} + \kappa x_t + u_t$$

Policy rule

To close the model, the central bank is assumed to operate with a forward-looking loss function (3). The central bank has constrained discretion in as far as it is not only concerned about achieving its inflation target but also with stabilizing economic activity (z_t), usually the

output gap. The degree to which there is policy flexibility, captured by the coefficient λ , is known in the literature as the ‘stabilization bias’ (Walsh, 2006).

$$(3) L_t = \frac{1}{2} \left[(E_t \pi_{t+1} - \pi_{t+1}^*)^2 + \lambda E_t z_{t+1}^2 \right]$$

Since expectations of the future are endogenous and influence the current state of the economy, expenditure decisions fundamentally depend on expectations of future policy movements (through the aggregate demand function). Influencing expenditure through policy therefore requires the Central Bank to shape market expectations about the future path of its instrument (Woodford, 2003). Transparency in communicating the policy rule becomes essential.

While this approach does not intend for policy to account transparently for any future contingency, it requires a systematic rule that private agents understand. In other words, with inflation on target and no excess demand, the central bank adjusts the interest rate to track movements in the equilibrium interest rate. The policy response to deviation from target requires that the inflation coefficient exceed unity so that increasing real interest rates will contract expenditure (known in the literature as the Taylor Principle¹²⁵). Concerns of excessive output volatility justify its presence in the policy rule, implying a gradual adjustment towards the inflation target.

$$(4) i_t = i_n + \alpha (E_t \pi_{t+1} - \pi_{t+1}^*) + \delta E_t z_{t+1}$$

¹²⁵ The policy rule is known as the Taylor rule. Taylor (1993) contributed substantially to the shift away from money growth rules by arguing that an interest rate policy rule (with a constant natural interest rate and a detrended output as measure of potential out) described well policy practices in the 1980s.

In sum, the policy narrative underlying this monetary theory runs as follows. Under perfectly flexible wages and prices, economic activity would be at a natural level and prices on a trend consistent with it. Aggregate demand or cost-push shocks, not large enough to shift the steady state, produce a deviation of output from its potential or change marginal costs. Subsequently, firms adjust prices in a staggered fashion creating an inflation gap¹²⁶. The central bank responds to any deviations from natural (neutral) levels included into its policy rule by adjusting its instrument, thus changing the term structure of the interest rate and closing the gaps.

Thus inflation targeting embeds two formal requirements: the formal announcement of a target for inflation and a policy rule that explains how the policy instrument would be adjusted in a manner consistent with achieving that target over a certain time horizon (Walsh, 2006).

6.2.2 Credibility, Expectations and Policy Knowledge

Since inflationary expectations and the future path of the policy instrument are central to the price-setting mechanism, monetary policy must credibly establish an anchor for inflation¹²⁷. Because agents are assumed to factor inconsistent policies into their behaviour, anchoring expectations is an essential mediator of the adjustment process. As a two-step process, it involves a discursive construction of credibility and a systematic rule that private agents understand. It requires the Central Bank to shape market expectations about the future path of its instrument and assigns transparency in communicating the policy rule a central role in the new policy framework.

Central banking as an exercise in expectations management has a performative dimension. It institutionalizes a set of practices to usher in the new policy concepts: quarterly

¹²⁶ Different models of how individual firms adjust prices have been suggested (see Calvo, 1983).

¹²⁷ Blinder (2001) provides an overview of the growing importance central banks attach to stabilizing expectations.

inflation reports, press conferences explaining the inflation reports, a policy committee setting policy rates in response to economic developments. Formal policy spaces are complemented by press interviews and interventions further explaining the policy stance, all under the banner of transparency for credibility. This further shapes the representation of policy knowledge.

The inflation targeting narrative stresses the articulation of academic knowledge and policy making to construct policy as a technocratic process grounded in neutral scientific enquiry. While the academic and the policy discourse each approach questions of knowledge somewhat differently, argumentation is narrowed through a positivist epistemology.

First, the methodological individualism embedded in modelling specifies a representative agent operating with rational expectations. Indeed, the strong version of rational expectations¹²⁸ premises economic agents with full knowledge of the underlying ‘true’ model of the economy and its structural parameters. Furthermore, central bankers know as much as the representative agent, a highly questionable assumption (Orphanides and Williams, 2005:2¹²⁹). The current advances in incorporating these objections have been shaped by the positivist epistemology defining rationality and knowledge in terms of technique (Fischer, 1998). A (small) step back from rational expectations to allow for imperfect information now depicts agents as being in a process of learning (Honkapohja and Mitra, 2006). Yet this approach does not yet mark a departure from canonical specifications¹³⁰, since it equates learning with the accumulation of (better) information: correcting estimation errors brings the system back to equilibrium.

¹²⁸ Rational in the sense that the agent’s expectations regarding any variable correspond to the mathematical expectations of that variable in the economy model.

¹²⁹ Orphanides and Williams approvingly quote Sargent’s (1993) critique of rational expectations: ‘Rational models impute much more knowledge to the agents within the model...than is possessed by an econometrician, who faces estimation and inference problems that the agents have somehow solved’

¹³⁰ The representative agent retains some of the magical capabilities she possessed under rational expectations: not only does she know the correct specification of the model and the nature of the exogenous shocks, but has econometric skills to estimate the no-longer-known true value of the coefficients. Though imperfect information leads to errors in estimation (small enough not to affect equilibrium values), learning ensures convergence towards equilibrium values.

Second, policy discourses allude to a more nuanced treatment of knowledge. It considers uncertainty, defined either as limited knowledge of how the economy works (Issing, 2002), or in its fundamental, Knightian version where the future cannot be statistically derived from the past. However, this recognition of model uncertainty does not undermine objectivity claims: policy discourse maintains its depoliticizing effect by invoking technocratic judgement. The neutral technocratic experience will offer guidance when policy cannot be anchored in the objectivity of models.

Thus a tension arises between the theoretical emphasis on the need for a transparent policy rule, and questions of model uncertainty. In practice, it translates into a certain reluctance on the side of the central bank publicly to formulate a policy rule. Nevertheless, inflation targeting draws a divide between knowing and unknowing subjects in terms of use of formal methods. It defines legitimate knowledge claims and significant policy ‘evidence’, rendering policy participation highly exclusive. For instance, while under monetarism it was fairly easy to question contractionary credit targets, under inflation targeting policy contestation requires estimative capacity to generate equilibrium levels, to forecast future developments and scenarios for policy responses. This operation thus discloses the political nature of modelling inflation, which the next sections seek to retrieve.

6.3 Politics of modelling inflation

Assigning a more prominent role to models in policy discourses produced a new array of institutional practices of modelling which were absent in monetarist regimes. Constructing scenarios to be deployed in policy argumentation has three components: identifying where the economy is in relation to its equilibrium (a gaps model), what accounts for this move (‘shocks’ or changes in expectations) and how to address it (the policy rule). As explained above,

scenarios for policy action are built once gaps are calculated, ‘shocks’ identified and coefficients attached to variables in the model, particularly in the policy rule. In each of these fields, a cloak of objectivity obscures the political nature of the policy choices involved.

First, the gap model underpinning policy does not explain equilibrium values, but they are given by the analyst. However, ‘natural’ variables are unobservable. They cannot be directly measured but have to be estimated. While the underlying naturalist ontology frames these complications out of aesthetic exercises in theoretical modelling, policy-making aimed at correcting deviations needs to attach some values to current and forecast potential output, the natural rate of interest and equilibrium exchange rates. Policy discourse then requires negotiating the narrative emphasis on output gaps with the uncertainties surrounding natural output estimations.

Second, conflicting views can arise over what type of ‘shock’ explains the deviation from the target. Clarida et al (1999) argue that optimal policy calls for offsetting demand shocks and accommodating shocks to potential output¹³¹. A cost-push shock however faces policy-makers with a trade-off between inflation and output: an interest rate rise would contract the economy.

Third, policy argumentation is structured by the choice of model coefficients. Model builders assign weights to each variable of the gap equations, seeking to capture how these drive the economy away from equilibrium. A trial-and-error principle is used to derive these. An iterative calibration modifies an initial set constructed on what assumptions ‘seem reasonable based on economic principles, available econometric evidence, and an understanding of the functioning of the economy’ (Begg et al, 2006: 20). Once the model

¹³¹ Essentially, a productivity ‘shock’ requires no change in the policy stance since it also changes natural output., whereas a demand shock (an increase in government spending) calls for an interest rate rise to offset the increase in prices, or vice versa.

behaves ‘appropriately’ and fits past data, a base scenario and various other policy options are derived for a ‘structured and consistent discussion’ (Begg et al, 2006: 20).

The policy rule is another site for struggles over policy priorities because monetary authorities, rather than econometric techniques, choose how and to what exactly they should respond. A ‘pure’ inflation-targeter only includes the inflation’s deviation from target in its policy rule: the policy response is very aggressive. An increase in forecast inflation would trigger a corresponding interest rate increase. However, if policy-makers are concerned by excessive output volatility, then interest rate changes would be paced to ensure a gradual adjustment towards the inflationary target. Lastly, the monetary authority needs to decide whether exchange rate dynamics should be directly taken into account.

In theoretical models of inflation targeting, the presence of the exchange rate in the policy rule is still an unresolved issue. At its roots, inflation targeting is a theory developed for industrialized countries in the early 1990s. It assumes competitive financial markets and ascribes little importance to exchange rate dynamics (Edwards, 2006). Where these are included, exchange rate dynamics are rationalized through an equilibrium approach that assumes that the uncovered interest parity assumption holds. However, as development practice has shown over and over again, transposing a theoretical model and its policy discourse to developing countries is problematic if it ignores the different mechanisms of economic and financial integration at play.

And here, policy models neglect the characteristics of financial markets. The underlying logic links the policy interest rate with expectations and prices, a transmission mechanism modelled through a single interest rate. However, as Gaspar and Kashyap (2006) pointed out, policy (also) operates by affecting bank and market rates. This embodies an implicit recognition that financial volatility and asset prices can be important for monetary

policy, a point that gained prominence in policy discussions in the wake of the 2008 global financial crisis.

6.4 Critiques of inflation targeting

Inflation targeting regimes have been generally contested through technicist discourses for having departed too much, or not enough, from monetarism. A third and rather incipient line of critique explicitly positioned this paradigm shift within the political economy of neoliberalism.

Indeed, inflation targeting departed markedly from monetarism in the role it ascribes to monetary aggregates, at least until the 2008 return to quantitative easing. The movements in monetary aggregates are no longer a criterion in judging the soundness of a policy stance, for many a substantial loss of important informational content (Issing, 2006). The ECB approach embodies well this ambivalence towards quantity variables, as its policy discourse still assigns an important role to monetary aggregates exploiting the long-run link between money and prices (Woodford, 2007).

This ambivalence, Post Keynesians repeatedly pointed out, reflects shared theoretical foundations (Kriesler and Lavoie, 2005). Similar to monetarism, NewKeyensian economics retains long-term money neutrality and the proposition that fiscal expansions have inflationary effects, while insisting on the importance of low inflation rates, for only under such conditions are relative prices functioning as signals for resource-allocation decisions. Unlike aggregate demand dynamics, high inflation affects productivity and thus the potential level of output (Fontana and Palacio Vera, 2004).

Furthermore, the onset of the financial crisis in 2007-8 substantiated critiques that the equilibrium framework underlying inflation targeting models sidelined important questions of financial stability. The little analytical attention paid to the structure and role of the financial

sector in the propagation of policy decisions could no longer be accepted as a minor modelling problem settled by the efficient market hypothesis (Buiter, 2009), but was now suspected of playing an essential role in the production of the crisis. This sidelining arises from the neoclassical treatment of the monetary transmission mechanism: it is assumed that the targeting of a short-term interest rate changes the system of incentives by modifying the prices of assets that enter the spending decision. Policy decisions propagate smoothly. The only substantial contribution monetary policy decisions can make to financial stability is to ensure a low inflation environment. Under assumptions of complete markets, no detailed analytical attention to financial market characteristics is necessary, as illiquidity, both funding and market, is impossible unless imposed on the model as an additional constraint that makes ‘money’ more liquid than other types of assets. Nevertheless, in a generalized financial debacle, the theoretical premises that uncertainty is exogenous and additive rather than Knightian and that asset prices reflect fundamentals, were no longer tenable. Despite inflation targeting’s promises of stability in a low-inflation environment, the unravelling crisis had clearly damaged one of its underlying premises, Alan Greenspan’s approach to asset bubbles: that cleaning up after a burst bubble was more cost-effective than preventing it from forming.

The third line of critique explicitly described inflation targeting as the new facade of neoliberal conditionality (Epstein and Yeldan, 2006) that reproduced an environment favourable to unregulated finance and its associated volatilities. That this policy regime fitted well with the neoliberal policy advice to developing countries was nowhere clearer than in its exchange rates regime normativity and the specification of the policy rule.

The presence of the exchange rate in the policy rule is important because it reflects the changing politics of exchange rate management in developing countries under the Washington Consensus, as explained in the previous chapter. The repeated international crisis throughout the 1990s seemed to confirm the assumption that soft currency regimes were more vulnerable

and that emerging markets would benefit from greater flexibility (Eichengreen, 2006). Inflation targeting promised the ideal solution: a credible policy regime that would stabilize prices and guarantee access to international finance necessary for exchange rate stability.

Nevertheless, inflation targeting still engenders a conundrum: should interest rates respond directly to exchange rate volatility? Advocates of pure inflation targeting, including the IMF, define 'sound' monetary policy through a 'sound trinity': flexible exchange rates, an inflation target and a monetary policy rule (Taylor, 2000). Unless volatility affects expectations, the Central Bank should refrain from stabilizing foreign exchange markets. Mishkin and Savastano (2001) disputed this position. For developing countries where exchange rate 'shocks' are of higher magnitude, with a potentially higher impact on both aggregate demand and price movements, inflation targeting regimes should care for exchange rate fluctuations in the same manner that they should care about stabilizing output. Vernengo (2008) further substantiated these claims by arguing that in developing countries, inflation targeting regimes amount to hard pegs, for central banks are reluctant to allow exchange rate volatility to feed into either inflationary pressures or worsen balance sheets denominated in foreign currency. Furthermore, there is an asymmetric effect at play, with upward (depreciating) pressures on exchange rates more likely to trigger contractionary policy responses in order to maintain policy credibility.

Even where policy incorporates exchange rate concerns, inflation targeting redefines policy practice: exchange rate volatility is to be addressed through interest rates rather than direct interventions in the foreign exchange (forex) markets. Traditionally, a currency would be managed through direct purchases or sales on the forex market. Only under a sustained speculative attack on the currency would the Central Bank be forced to raise interest rates in order to avoid depleting its foreign reserves. Yet under inflation targeting, currency

management is justified as long as it is strictly aimed at minimizing the impact that volatility might have on the central bank's forecasting ability, or prices.

In other words, inflation targeting discourses reject exchange rates as a legitimate policy objective aimed at fostering competitiveness, as advocated by structuralists (Chang and Grabel, 2004). Inflation targeting central banks would not allow exchange rate concerns in the policy rule above and beyond its effects on inflation. However, such a reliance on market driven competitiveness glosses over the extent to which exchange rate dynamics are tied into speculative behaviour where capital accounts followed standard neoliberal processes of liberalization. Indeed, a hegemonic policy discourse that rejected controls on short-term capital has tremendously increased developing countries exposure to volatility and market sentiment. As Epstein and Yeldan (2006) argued, a vicious cycle developed, periodically subjecting developing countries to crisis after episodes of real exchange rate appreciations driven by hot money. These further required contractionary adjustments and austerity to rebuild 'healthy macroeconomic fundamentals' required by neoliberal accumulation strategies: low inflation rates that allow speculative returns from high interest rate policies.

So far these three approaches operate under the assumption that policy models do and can shape actual practice in the way the claim. Instead, the next sections will critically explore the assumption of a linear relationship from policy models to practice. It seeks to map in detail how (or whether) the institutionalization of a new policy regime has changed policy practice in Romania, and ask how the gap between policy and practice is negotiated.

These questions will be first set in the specific context of European Union membership, which Romania joined in January 2007, comparing macroeconomic dynamics in five inflation-targeting New Member States (hereafter IT5¹³²: Romania, Hungary, Slovakia, Poland and the Czech Republic) in the run-up to the 2008 crisis. The following sections argue that the underlying commonalities, particularly in the constitution of the monetary policy domain, should be interpreted as evidence of the extralocal neoliberal modes of economic governance. A detailed account of the policy process is only provided for Romania, as a similar focus on each individual country is beyond the scope of this thesis.

6.5 An Eastern European perspective on inflation targeting regimes

The negotiations for EU accession carried two immediate consequences for macroeconomic policy: capital account liberalization was demanded while the scope for regulatory measures aimed at fostering financial stability narrowed (NBR, 2005b). Furthermore, EU membership entailed an unconditional commitment to join the Eurozone upon fulfilment of the Maastricht criteria. New Member states are expected to define a time horizon for joining ERMII, an exchange rate mechanism that specifies a formal 15% fluctuation band around a fixed parity. This implies identifying an ‘equilibrium’ level that combines competitiveness with price stability. For inflation-targeting New Member States, research on the optimal policy regime before the managed float of ERMII membership generally recommended flexible exchange rates. Orłowski (2005) suggested a stages approach, from a strict regime and floating exchange rates to a hybrid combination of well-specified inflation targets supported by exchange rate

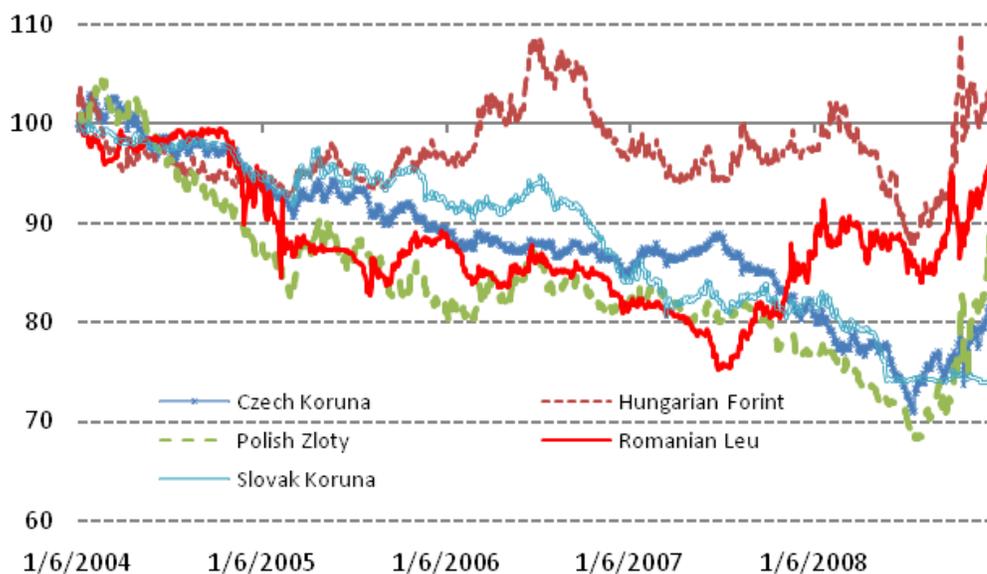
¹³² The timetable of adoption:

	Hungary	Slovakia	Romania	Poland	Czech Republic
Date of adoption	June 2001	Jan. 2005, ERMII from Nov. 2005	August 2005	Jan. 1999	Jan. 1998
Previous regime	Exchange rate as nominal anchor	Monetary targeting with exchange rate constraints			

targets. Diev and Kurtz (2006) mapped a trade-off between either nominal interest/exchange rates volatility under a free float or current account disequilibrium under a fixed exchange rate. Given the emphasis on price stability in the Maastricht criteria, the obvious strategic choice is a flexible exchange rate regime.

These arguments have to be considered in the particular context of post-socialist exchange rate dynamics. Indeed, one common trend before 2008 was the pattern of nominal and real exchange rate appreciation, a development independent of the choice of exchange rate regime (figure 24). Thus Slovakia, in the ERMII since November 2005, and two floaters, Poland and the Czech Republic, have seen substantial and systematic strengthening of their currency after joining the EU. Despite its managed float policy that specified a ERMII type of fluctuating band until February 2008, volatility has been most pronounced in Hungary. In Romania, which abandoned the managed float with the adoption of inflation targeting in August 2005, the trend appreciation reversed after August 2007, a shift I will later connect to the particular policy choices of the inflation targeting regime. Trend appreciations have subsequently been reversed by the global deleveraging and the associated uncertainties that saw substantial capital flight from emerging markets.

Figure 24 Nominal Exchange rate trends, Eastern Europe, 2004=100



Source: computed from European Central Bank data
(<http://sdw.ecb.europa.eu/browse.do?node=2018794>, accessed February 12th 2009)

The above movements have been narrated as a natural outcome of the catching-up process. For instance the IMF (2006) attributed it to corrections in relative prices through increasing marketization and productivity gains, described in the literature as the Balassa-Samuelson effect. The significance of this concept for discussing convergence and Eurozone entry cannot be understated, for it has been used in policy argumentation in connection to two of the Maastricht criteria: inflation and exchange rate stability in the ERMII. The Balassa-Samuelson effect explains cumulative appreciation as an equilibrium process¹³³ (Egert et al, 2002).

Thus theoretical reflections on exchange rate movements focus on real rather than nominal trends, naturalizing real appreciation as an inevitable component of convergence. For instance the IMF's inflation-targeting models for formerly-planned economies specify a long-run real exchange rate equilibrium which incorporates an appreciation trend (IMF, 2007a). I

¹³³ The Balassa Samuelson model builds upon a two-sector economy producing tradable and non-tradable goods. Assuming wage equalization across sectors, productivity increases in the traded sector would trigger upward adjustments in both sectors, and thus higher relative prices for the non-traded sector and overall higher inflation. Since real magnitudes are derived with consumer price indices, the faster productivity growth arising from the catching-up process impacts calculations of the real exchange rate.

argue however that this representation has an ideological function within policy narratives, for it offers a naturalist rather than policy driven explanation of exchange rate movements. Indeed, underlying Balassa-Samuelson models is the idea that exchange rates in formerly-planned economies move according to the logic of adjustment to equilibrium. Essentially models do not seek to explain exchange rate movements, but rather price movements which affect real values, including that of the exchange rate¹³⁴. While the magnitude of the Balassa Samuelson phenomenon in Eastern Europe has been the object of much research and controversy (see Egert et al, 2002 for a survey), this focus on productivity differentials has marginalized considerations of macroeconomic policy and nominal magnitudes in discussing exchange rate movements.

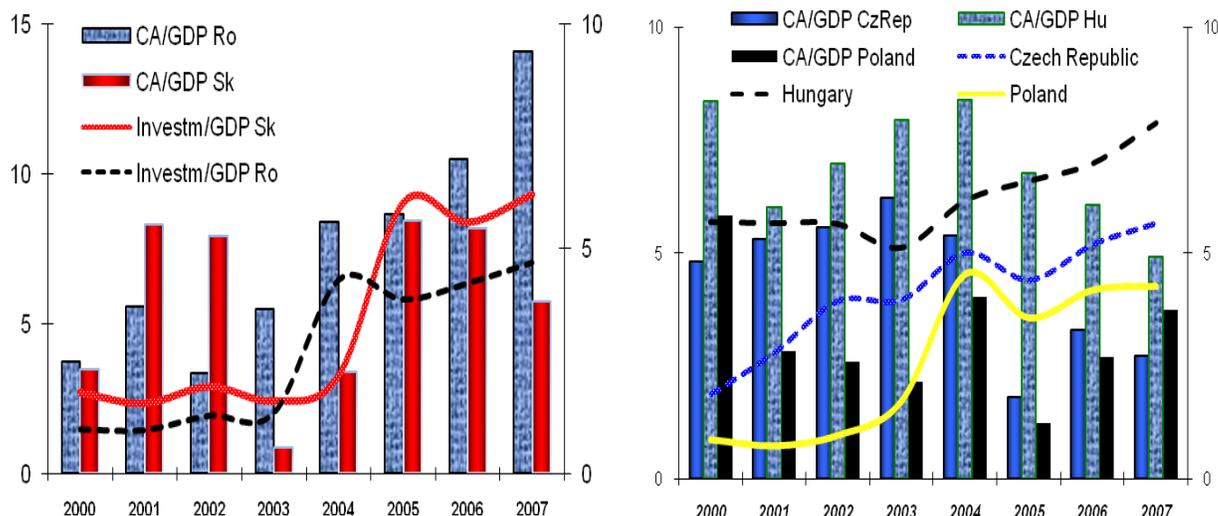
Nominal magnitudes matter for two reasons. First, they bring into policy discussions developments on the capital account, questioning the above narrative of adjustment to equilibrium. Second, taking these into account opens the argumentative field for discussions of neoliberal logics at play in the monetary policy domains.

Catching-up narratives gloss over broader balance of payments considerations. Indeed a cursory look at the current account position for IT-5 reveals that the trend appreciations have been accompanied by systematic current account deficits (Figure 25). For Romania, whose currency strengthened at a fast pace up until the middle of 2007, the current account deficit expanded to 14% of GDP, a level that raised concerns of sustainability. Furthermore, the structural composition contrasts the Balassa-Samuelson emphasis on the goods trade account with the increasingly important role played by the income and transfers account. For instance, the deficit on the income account has outpaced the overall deficit in all IT5s except Romania, reflecting an underlying structural and increasing deficit caused not only by external debt

¹³⁴ One result suggests that domestic demand does not affect real exchange rates, for prices depend on interest rates fixed on international markets under perfect capital mobility and total factor productivity while wage levels depend simply on labour market dynamics.

service, but also by foreign businesses profit remittances. This is more remarkable for Hungary and Czech Republic, which recorded trade surpluses in 2006 and 2007.

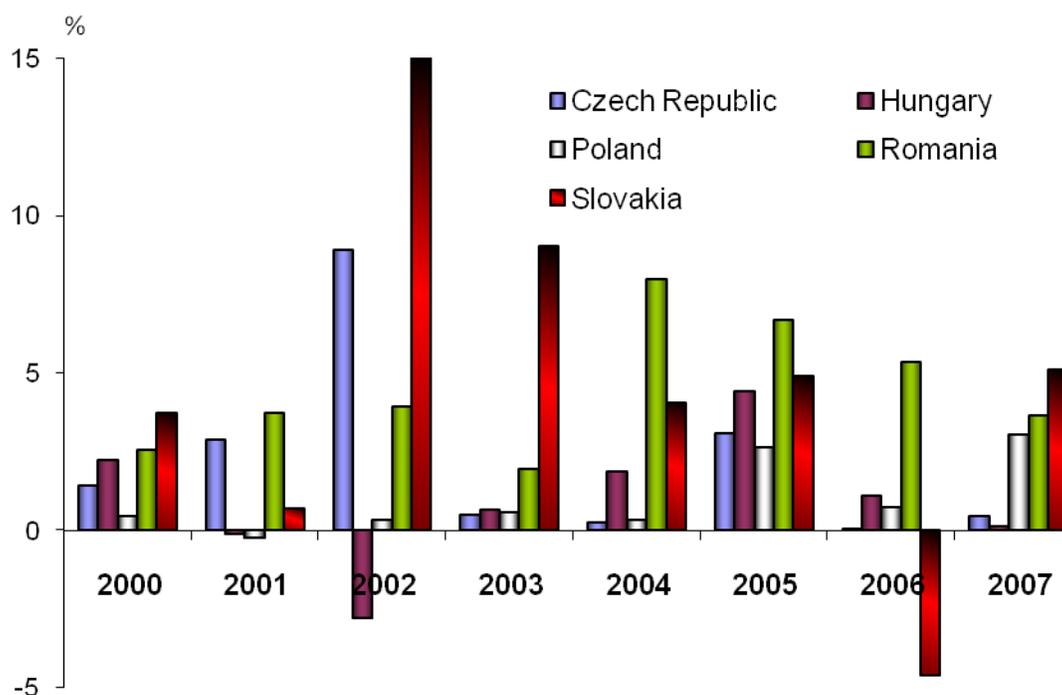
Figure 25 Current account and income account as % of GDP, selected New Member States, 2000-2007



Source: computed from Eurostat data
http://nui.epp.eurostat.ec.europa.eu/nui/show.do?dataset=bop_q_c&lang=en, accessed July 12th 2008)

Thus current account deficits are not solely capturing the patterns of competitiveness but also foreign capital movements. While a long-run adjustment to equilibrium driven by productivity considerations falls short of explaining exchange rate movements in this context, the question to ask next is why do economies with large current account deficits experience a strengthening of their domestic currency? The answer points to balance of payment surpluses: between 2000 and 2007, Eastern European countries have been accumulating significant foreign reserves, despite systematic current account deficits (see Figure 26).

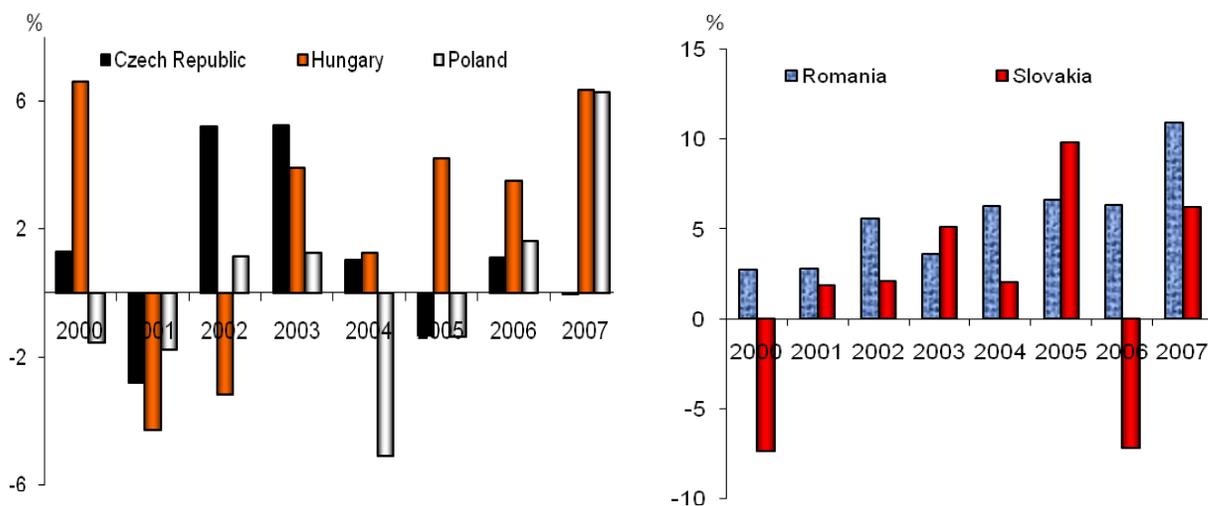
Figure 26 Foreign Reserves, IT5, (- increase, as % of GDP), 2000-2007



Source: computed from Eurostat data
 (<http://nui.epp.eurostat.ec.europa.eu/nui/setupModifyTableLayout.do>, accessed July 12th 2008)

The large surpluses on the capital and financial account were driven by a combination of foreign direct investments and debt-generating inflows. While FDIs, often targeting the privatization schemes of large state-owned monopolies, have traditionally financed current account deficits, their recent levelling-off is expected to continue in the future. Debt-generating flows experienced the opposite dynamic, accumulating at a rapid pace (see Fig. 27). This pattern of indebtedness is partly explained by the increasing presence of Western European banks in the domestic banking sectors. At the end of 2008, BIS (2008) estimated that European banks held over US\$600 billion of cross-border claims on emerging European economies, around 90% of the reported total of around \$700 billion. The increased exposure to short-term, foreign currency liabilities occurred as foreign owned banks sought to avoid domestic regulation (for instance reserve requirements) by borrowing from mother banks in Western Europe.

Figure 27 Foreign Loans/GDP, (- an outflow), selected EU member states, 2000-2007.



Source: computed from Eurostat data
 (http://nui.epp.eurostat.ec.europa.eu/nui/setupModifyTableLayout.do, accessed July 12th 2008)
 Note: a negative value represents an outflow.

This constitutes an essential aspect of the transmission mechanism: before 2008, money-market liquidity management was intimately linked to foreign capital flows and exchange rate policies. Indeed, for these five countries, institutional practice before 2008 mirrored the ECB's strategy for liquidity management: interventions at the very short end of the maturity structure. However, unlike the ECB, institutional practices in all five countries produced, and had to address, a structural excess of liquidity on domestic money markets, arising from forex interventions addressing sustained capital inflows and EU structural funds (National Bank of Hungary, 2007). Liquidity management sought to sterilize partly the structural excess of liquidity¹³⁵.

To sum up, inflation targeters in Eastern Europe have exhibited remarkably similar macroeconomic characteristics in the run-up to the 2008 crisis, suggesting that the monetary

¹³⁵ The instruments used had a maturity of one-week for the Czech Republic and Slovakia, and two-week for Poland and Hungary.

policy domain had been increasingly constituted through a common neoliberal logic¹³⁶. The next sections will take a closer look at the dynamics in the Romanian policy space after the adoption of inflation targeting.

6.6 Institutionalizing a new policy regime

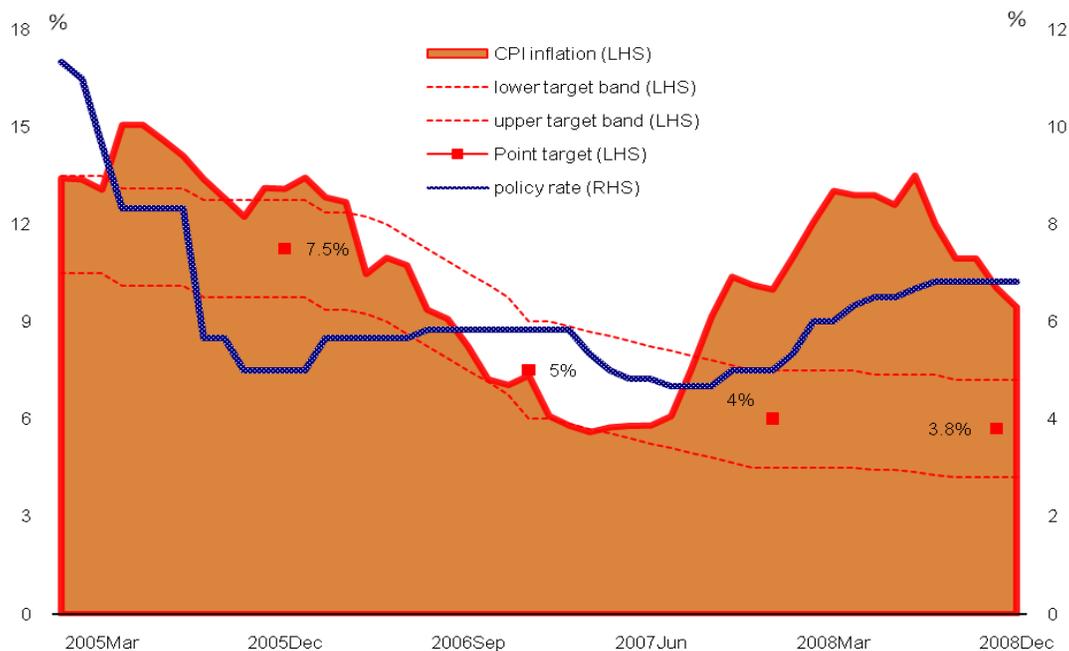
The NBR's decision to switch to inflation targeting was designed to address the increasing vulnerability to speculative capital movements produced by the last step of capital account liberalization in April 2005. Containing speculative pressures required a redefinition of the policy framework, replacing the monetary targeting under a managed float with an explicit focus on interest rate manipulation (NBR, 2005e). The NBR simultaneously committed to abandoning the managed exchange rate, under the qualification that it retained the right to intervene in forex markets if and when it considered that exchange rate volatility would be detrimental. This, to a certain extent, is consistent with inflation targeting discourses, for intervention is (albeit reluctantly) sanctioned as a temporary practice if exchange rate volatility threatens the inflation target, but interventions should not be a constant practice since they could distort expectations. As the next sections will show, NBR's presence on the forex market became one of the most contested policy arenas, particularly when its underlying reasons contradicted the neoliberal structuring of the relationship between the forex and money markets.

The record of the inflation-targeting regime shows a rather poor performance: only in one of the first four years did the NBR comply with its inflation target, an experience not uncommon to Eastern European inflation targeters (Daianu and Lungu, 2007). Indeed, the 2005 level nearly missed the interval (8.6% annual increase compared to the 7.5% upper limit),

¹³⁶ This underlying common logic arguably explains why Eastern Europe became known as the subprime region once the financial crisis extended from developed financial markets.

while inflation in both 2007 and 2008 recorded levels substantially above the upper limit of the target interval.

Figure 28 CPI inflation vs. Inflation target and the policy rate, Romania. 2005-2008



Source: computed from National Bank of Romania data (<http://www.bnro.ro/StatisticsReportHTML.aspx?icid=801&table=665&column=3800,3801,3802>, accessed January 23rd 2009 and NBR, 2009:24 for the inflation data)

The monthly developments show an accelerated disinflation during 2006 and until September 2007, after which consumer price inflation moved systematically above the targeted band (see figure 28). Policy responses saw an aggressive easing during 2005, a tightening cycle throughout 2006 to be followed by a cycle of fast easing that brought policy rates down by 150 basis points until September 2007. Subsequently, the NBR hiked its interest rate at every meeting until August 2008, bringing it to 10.25%, the highest level in the European Union at the end of 2008.

The inflation reports have constructed the policy stance around two driving factors: broad monetary conditions and liquidity management. A focus on broad monetary conditions,

the NBR (2005f) claimed, would provide a broader mapping of aggregate demand pressures over the forecast horizon, by accounting for both policy instrument and exchange-rates influences. Second, the NBR (2006c) recognized that an adequate management of liquidity is required to improve the transmission mechanism from short to long-term interest rates, and provide the appropriate signalling role for individual decisions.

Hence the use of these two factors in policy argumentation brings together policy models and institutional practices (describing the central bank's operations on money and forex markets). The next sections will explore how policy discourse negotiated the relationship between the two.

6.6.1 Model(s) and policy rules

Inflation targeting regimes are appealing for their promise of a scientific foundation for policy decisions. Nevertheless, while the process of modelling is essential for producing projections of future trends, the central bank's perceptions of model uncertainty might limit the extent to which these projections structure policy decisions, a point to which the following analysis of the Romanian policy process turns. It will address one central question: what role do policy models play in policy discourse and what is their relationship to practice. This will be done by exploring the importance assigned to model uncertainty, forward looking orientation, and the narration of different types of shocks in policy decisions.

While the narratives explaining policy reactions were grounded in inflation targeting concepts, the NBR provided no explicit information on the models deployed for policy formulation, a first indication of the complications that model uncertainty raise for claims of transparent policy-making. While the IMF (2007a) produced the only fully specified New Keynesian model for Romania, various NBR presentations offered a narrative explanation of the model specifications (NBR, 2006c,d) as follows. A Monetary Policy Committee prepares

near and medium-term forecast and qualifies model-based policy scenarios with ‘expert judgement’. The near-term model forecasts two quarters inflation and GDP trajectories, which are further fed into a New Keynesian medium-term model¹³⁷. Initially the forecast horizon extended to six quarters, modified in February 2006 to eight quarters to better reflect the time frame of the transmission mechanism.

The short-term forecasting produces monthly projections for main components of CPI¹³⁸: food items, non-food, and services, excluding those with administered prices. The near-term forecasting model reflects statistical relationships rather than standard New Keynesian economic theory, since it incorporates no forward-looking behaviour.

Price dynamics were explained by exchange rates, net average wages, imported price inflation and administered prices. Policy discourse acknowledged various sources of uncertainty arising from difficulties in forecasting the dynamics of exchange rates in the short term and unpredictable wage and administered prices policies. These projections are then fed into the medium-term model, which incorporates New Keynesian foundations.

The policy rule specified reactions to deviations from targeted inflation and the output gap, while simultaneously seeking to smooth interest rate volatility. The NBR (2006c) considered the interest rate channel to be relatively weak, reflecting sluggish bank and deposit rates, a point to which I will return in the discussion of practices of monetary management. Exchange rate concerns were not present in the policy rule, although the NBR (2006c) identified exchange rate dynamics, along with the expectations, as the two critical channels in the monetary transmission mechanism. The following sections map the argumentative field

¹³⁷ The gaps model contains a neutral interest rate and an equilibrium exchange rate (subject to the uncovered interest parity), but the NBR has not publically disclosed where it believes these to be.

¹³⁸ While the official inflation target is specified on CPI growth, policy documents (NBR, 2006) suggested that the price index which monetary policy can best control should exclude both volatile prices (energy, food) and administered prices - a measure of inflation usually referred to as ‘core inflation’.

around the main concepts underlying inflation targeting discourses: expectations, the output gap and the broad monetary conditions.

Expectations

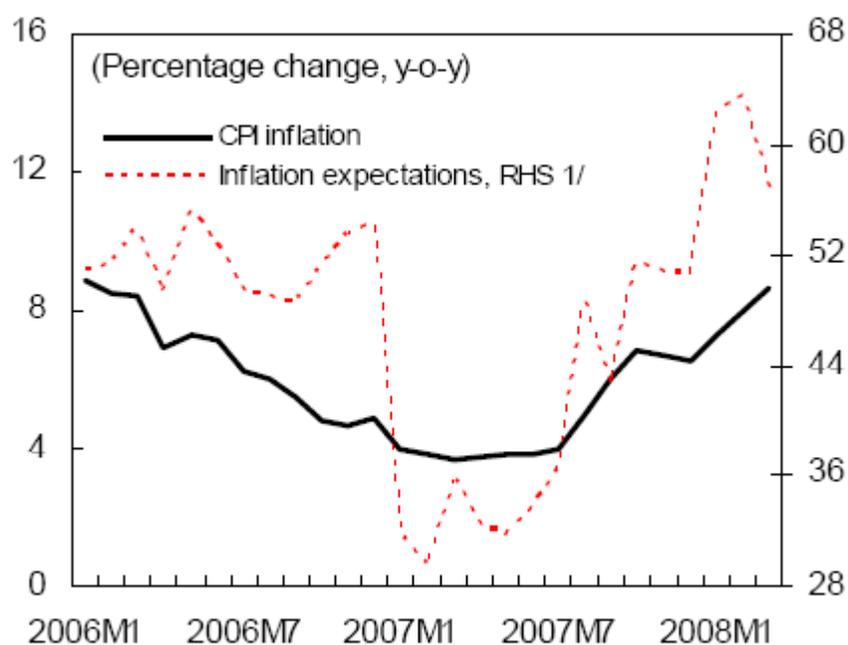
While the narration of policy models suggested that expectations were modelled as a combination of backward-looking and forward-looking expectations, policy decisions were articulated around the current policy rate. Policy discourse did not, at least publicly, assign much relevance to the importance of publishing a forecast of the path of the instrument, a decision contested in the inflation-targeting literature (Svensson, 2006). Indeed, inflation targeting models assume that the ability of the central bank to influence expenditure critically depends on influencing expectations regarding the future path of the overnight instrument. In other words, current interest rate decisions matter very little for private sector decisions, and only matter in as much as they influence expectations of the future path of the instrument rate. While the interest rate assumptions are crucial to model projections¹³⁹, the NBRs policy argumentation involves what Svensson (ibid) termed the paradox of forward-looking inflation-targeting regimes: most policy discussions focus on current instrument settings and levels, while statements provided little qualitative guidance about the likely future path of policy.

Furthermore, the possibilities of capturing forward-looking expectations from the yield curve were limited by the relatively underdeveloped nature of bond markets and consequently the small range of maturities. Despite the discursive emphasis on expectations, incorporating this in modelling exercises proved a complex, an unresolved issue by the end of 2008. The

¹³⁹ If forecasting is not done on the common assumption of a constant rate over the targeted horizon, modellers will derive the interest rate path either from market expectations of future interest rates, a Taylor rule or an optimal instrument rate projection that best reflects the central bank's preferences (Svensson, 2006). The literature converges towards supporting the last alternative (as for instance deployed in Norway), conditional on a clear communication that seeks to prevent long-term asset prices building in a more rapid tightening pace than the central bank would have wished for, and thus minimizes unnecessary volatility while increasing effectiveness of monetary policy.

available statistics on consumer expectations confirmed this claim: surveys suggested, despite a common trend, wide nominal deviations between expectations and actual values (see figure 29). For instance, for January 2008, consumer price inflation was expected to rise above 50%, ten times higher than the level registered. Nevertheless, the NBR refused to accept these patterns as either evidence of its failure to anchor expectations, or indication of the uselessness of the concept of expectations in this particular context. It instead interpreted it as a lack of ‘economic culture and sufficient knowledge’ rather than a failure of its communication strategy (Isarescu, 2008c), and chose to proxy overall inflationary expectations through the analyst community.

Figure 29 Price trends and inflationary expectations, Romania, 2006-08.



Source: the International Monetary Fund *Romania Country Report* (2008:7).

Indeed, the establishment and consolidation of an interpretative community, a body that constructs and interprets the meaning of policy measures, is essential for a policy discourse that assigns an essential role to expectations formation and credibility. The relationship between the

central bank and the interpretive community can be cast as a power relationship, but also as a struggle over determining meaning particularly when considering the various positionings of policy actors. Thus international institutions, particularly the IMF, engaged in policy argumentation through ‘objective’ models. Commercial bank analysts articulated a different set of policy priorities, focused on institutional practices rather than models. The influence that these different interests played in the policy process, framed in inflation-targeting language as the importance of anchoring market expectations, produced a complex interaction mechanism to which the chapter will return later.

The Output Gap

Policy narratives stressed the crucial role of the output gap. The deployment of output gaps to substantiate policy decisions required efforts to narrow the argumentative field and command credibility, to re-frame policy to conceal signs of ambiguity or inconsistency regarding either empirical estimations, questions of spare capacity or policy responses to projections.

Indeed, the narrative emphasis on excess demand and potential output has nowhere been matched by methodological certainty. On the contrary, the NBR (2008c) recognized that the methodology for computing the potential output suffered from a series of shortcomings arising from the short time-period and the massive structural changes since 1990. Uncertainties would particularly affect recent period estimations, as GDP data were usually subjected to substantial revisions¹⁴⁰. The reliability, or indeed significance, of output gap data could be further questioned by the volatility of agricultural output, where production patterns, broadly

¹⁴⁰ According to one of the members of the Modelling Department of the NBR (personal communication, July 14th, 2008), the GDP data used for computing the past, current and projected values of the output gap are usually subjected to revisions outside the NBR’s control, as they are produced by the National Institute of Statistics. While this constitutes a source of some frustration within the Modeling Department, policy discourse has glossed over the implications of these revisions for the deployment of output gap in assessing policy stances. The thesis will consequently use the output gap projections as they were produced by the NBR on the basis of available data, as these projections, rather than the ‘true’ values, were deployed in policy argumentation. Furthermore, the graphs and tables of this chapter use GDP data available at the end of 2008/beginning of 2009, when most data previous to 2008 had been already revised.

involving small-scale or subsistence techniques, implied a high vulnerability to weather conditions. IMF (2007a) chose to exclude agricultural fluctuations from output gap estimations.

Furthermore, the NBR's argumentation of the output gap displayed inconsistencies with NewKeyensian assumptions. For instance, it linked the investment component of aggregate demand to potential output dynamics (NBR, 2008d), when the underlying theory assumes that aggregate demand does not shift potential output (Fontana and Palacio Vera, 2004). Furthermore, estimating natural levels from historical data assumed businesses operating at full capacity, when even IMF statistics suggest that capacity utilization gradually increased from 72% in 2003 to 80% in 2007 (IMF, 2008). The existence of spare capacity in the manufacturing sector was not surprising against a context of accelerated capital formation attending high levels of foreign direct investment in the run-up and aftermath of the EU membership.

Notwithstanding these complications, the NBR held that expert judgement and comparison with IMF's assessments would complement econometric techniques, so that output gap forecasts could provide a useful guide to policy formulation. The NBR (2008c) research thus sanctioned a 6% level for the potential output growth between 2006 to 2008, obtained by averaging estimates based on no less than twenty different estimation techniques. Financial analysts expressed disbelief at this estimate (Paun, 2007:1), but the legitimacy of the challenge was denied, on epistemological grounds, by the very actor articulating it: 'I'm saying that I suspect the IMF is wrong in defining potential growth - but of course, I can't prove it - it's just a sneaking suspicion based on casual observations (very bad economics - I know!)' .

Such a circumspect attitude reflected an empirical puzzle: on several occasions, the NBR's projections suggested that substantial excess demand co-existed with a fast disinflation process, as for instance between the end of 2006 to mid 2007 (see Figures 30 to 35). Indeed,

the graphical representations of the output gap produced by the NBR contradicted somewhat the discursive insistence the persistence of demand-pull inflationary pressures. For instance, the February and November projections for each year were strikingly similar, describing a positive output gap during the current period and the following few quarters, followed by a negative output gap towards the end of the forecasting horizon. Of course projections should not be expected to depict future outcomes perfectly, as unpredictable ‘shocks’ imply a significant likelihood that forecasts would be incorrect. Nevertheless, for policy to be consistent with the underlying model, instruments should be adjusted to the projections constructed given all information available. Thus if policy takes into account the lags in the transmission mechanism, as implied by forward-looking strategies, then policy responses would have consistently required monetary easing or at least no change in the policy stance in the case of a very low stabilization ‘bias’. This was not the case in February 2006, when a tightening cycle started against a projection of a large negative output gap towards the end of the forecasting horizon, unlike February 2007, the start of an easing cycle against a similar outlook for the forecast output gap.

To reconcile these conflicting accounts, policy argumentation sought to redefine the representation of policy stances. This would no longer reflect interest rate movements, but had to be judged against developments in broad monetary conditions. In this representation, excessive aggregate demand is consistent with a fall in price inflation if real exchange rate appreciates, tightening monetary conditions. For instance, the August 2005 inflation report explained how the substantial interest rate cut operated since the beginning of the year (of 800 basis points) should not be constructed as signalling an expansionary policy stance, for the substantial real currency appreciation rendered policy contractionary¹⁴¹.

¹⁴¹ ‘The expansionary effect of the interest rates only partially offsets the tightness induced by the real appreciation of the domestic currency against the euro, as a result the development in real interest rates and real exchange rate have been exerting a net contractionary effect on excess demand’ (NBR, 2006:21)

Figure 30 Output gap. NBR Inflation Report Feb 2006

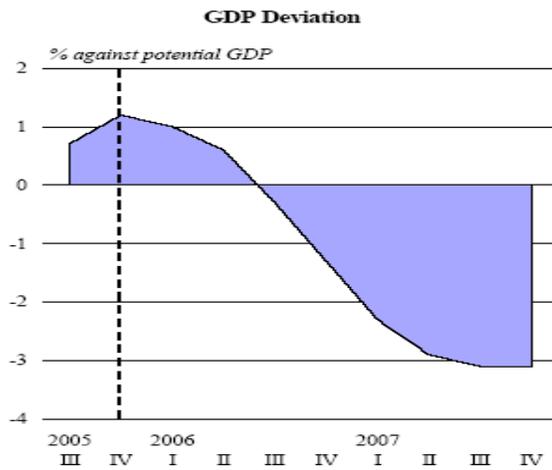


Figure 31 Output gap. NBR Inflation Report Nov 2006

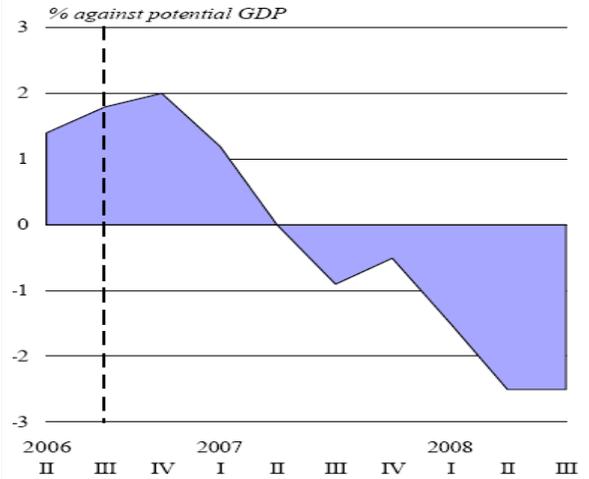


Figure 32 Output gap. NBR Inflation Report Feb 2007

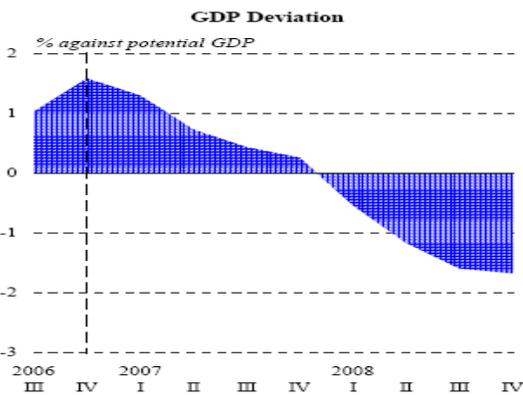


Figure 33 Output gap. NBR Inflation Report Nov 2007

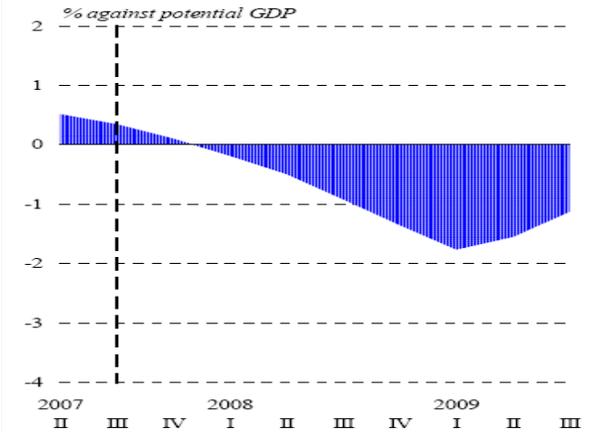


Figure 34 Output gap. NBR Inflation Report Feb 2008

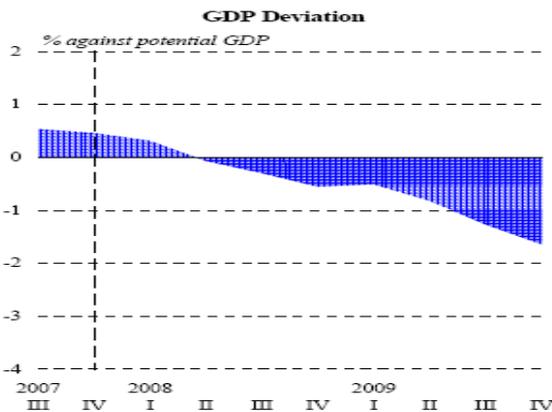
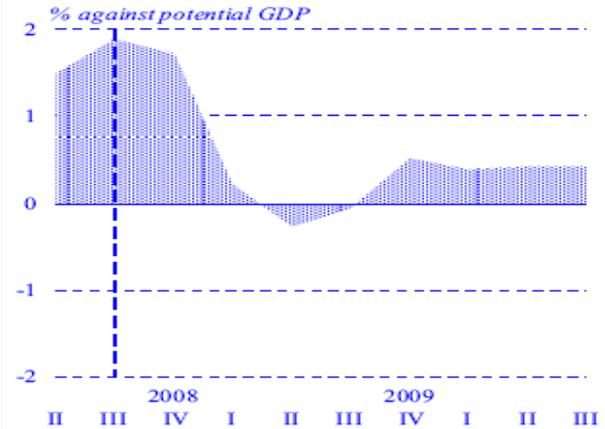


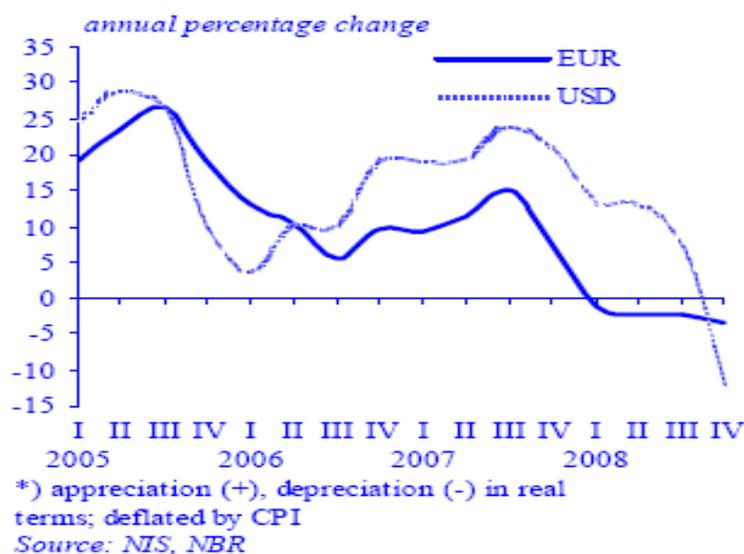
Figure 35 Output gap. NBR Inflation Report Nov 2008



Source: the *National Bank of Romania Inflation Report*, February 2006 (p. 46), November 2006 (p. 13), February 2007 (p. 45), November 2007 (p. 46), February 2008 (p. 45), November 2008 (p. 44)

As Figure 36 shows the real exchange rates (CPI deflated) appreciated systematically between 2005 and 2007, a tendency which the NBR (2006, 2007) interpreted as exercising a contractionary effect on excess demand. Starting with 2008, a trend reversal saw the strong nominal depreciation contributing to aggregate demand pressures.

Figure 36 Real exchange rate dynamics, Romania, 2005-08.



source: *the National Bank of Romania Monthly Report* (March 2009, p.12)

Nevertheless, the NBR's account premised causality from real exchange rate dynamics to aggregate demand that denied the opposite effect was equally possible. For instance, in a context of confident expectations and low perceived risk, an appreciation of the exchange rate could positively affect domestic demand by stimulating foreign currency loans. This possibility would suggest some caution in deploying the monetary conditions index as a reliable indicator of policy stances, and indeed, of producing forecasts of future output gaps. However, rather than economic rigour, this line of argumentation had two strategic functions:

1. It suggested that policy formulation accounted for exchange rate dynamics mainly through the aggregate demand, rather than the cost-push channel.

2. It worked to legitimize policy decisions, particularly at the beginning of an easing cycle.

While policy narratives accepted that the exchange rate could be a significant source of cost-push inflationary pressures, cost-push discussions were articulated around income policies, a tendency shared by the IMF policy argumentation. The privileging of wage dynamics in explaining inflationary dynamics was endorsed by empirical claims that wage policy in the public sector appears to have influenced wage settlement in the private sector (NBR, 2007a,c; IMF, 2007b), so that, by 2007, both the IMF and the NBR were claiming that wage increases in the public sector were behind inflationary dynamics, and threatened the target. While for most of the inflation-targeting period productivity gains outpaced industry wage growth (NBR, 2008d), the labour-market tightening following large-scale labour emigration (after the EU membership) saw industry wages tracking public sector increases. While fast wage increases could indeed translate into a wage-price spiral, the NBR's forecasting models were in fact ill-equipped to account for such dynamics. Indeed the near-term model specified net average wage dynamics as a measure of aggregate demand pressures, with no wage-productivity differential incorporated to account for cost-push pressures. The medium-term structural model, on the other hand, had yet to incorporate labour market dynamics at the end of 2008¹⁴². In other words, the narrative insistence on wage dynamics as a source of cost-push pressures, with little foundation in the NBR's empirical estimations and forecasting, functioned to marginalize considerations of other cost-push pressures affecting price dynamics.

The second operation related to the NBR's tendency to connect policy instrument adjustments to current or near-term projections rather than projections over the forecast horizon, an approach common to most inflation targeters (Goodhart, 2005). For instance, the August 2007 inflation report explains the decisions to cut the policy rate by 150 percentage

¹⁴² Personal communication with a member of the NBR modelling department during July 2008.

points during the first two quarters as an outcome of improving short-term projections for inflation (to the end of 2007). Such an approach is partially conditioned by analysts' narratives, which tend to explain changes in the policy instrument or construct expectations of near-term instrument path in connection with past price developments or near-term projections¹⁴³. Against such a framing, policy decisions are contestable, and might appear inconsistent, when the change in the policy instrument contradicts the inflation targeting normativity: for instance analysts questioned the decision to substantially reduce policy rates at the beginning of 2005 while inflation was accelerating (Ziarul Financiar, 2005). It would appear that policy models derive legitimacy from success in enrolling certain interests, of the interpretive community in this instance. The central bank's decisions are somewhat constrained by the meaning attached to policy decisions by market players. However, there are tensions in this process, for policy decisions are interpreted differently by different policy actors. A good example was the summer of 2007, when a resurgence in inflationary pressures pitted the IMF's model against the NBR's and financial analysts' interpretation, revealing how the politics of modelling inflation played out in policy argumentation involving actors with (relatively) similar estimative capacity.

My model or yours?

The IMF inflation-targeting model for Romania was published in the June 2007 country report. The coefficients of the model, arrived at through what is claimed to be a sophisticated calibration process, were similar to those in the standard model developed for Canada (Begg et al, 2006), suggesting that universalism remains the *modus operandi* in IMF's policy advice.

¹⁴³ In 2005, Daniel Daianu, an influential policy analyst and former minister of finance, termed as 'strange the situation in which we decrease interest rates against an acceleration of inflationary pressures during the first month of 2005' (Ziarul Financiar, 12/03/2005). In another instance, the chief economist of the second largest bank in Romania, BRD, a subsidiary of the French Societe Generale, was arguing at the end of 2007: 'The easing cycle in early 2007 occurred against a fall in inflation. Since new inflationary pressures on the economy, it is time for the NBR to reassess its policy stance'. (Ziarul Financiar, 18/09/2007)

The report outlined two possible policy scenarios in a highly essentializing narrative that overlooked the complexities of model uncertainty. It assigned excess demand and potential output a primary role in explaining a forecasted acceleration in prices:

- In the baseline scenario, the NBR maintained rates at current levels, and the government its fiscal deficit at 2.8% of GDP. The additional excess demand would drive output above its potential, and inflation above its target, requiring substantial interest rate increases in the following year, 2008.
- In the adjusted scenario, the NBR would take firm action by raising interest rates by 50 percentage points, while the government reduced current spending to contain the deficit 1% of GDP and kept wage demands under control. This would contract the excess demand and bring growth nearer to its potential. In other words, even if the monetary authorities were rejecting an immediate adjustment, they were in fact postponing and thus magnifying disequilibria that would require stronger, and thus more contractionary, future policy responses.

The importance assigned to aggregate demand factors in explaining inflation in Romania is not merely a sign of lingering monetarist rhetoric, but a systematic feature of the IMF's policy discourse which further structured the model treatment of excess demand and exchange rates. In the output gap equation, the interest rate coefficient is quite low, implying that the transmission channel from interest rates is weak and that a forecast excess demand would require massive hikes in the interest rate to correct it. Combined with the high weight placed on the past output gap, it pushes policy into a straightjacket: further massive deviations from potential output can only be avoided through immediate, strong corrective action. The inflation equation replicates the emphasis assigned to aggregate demand. Despite the emphasis placed in the 2001 to 2004 IMF country reports on the primacy of exchange rate movements for price developments, the exchange rate coefficient in the inflation equation is so low (0.06) that it

suggests a very weak impact on prices. For comparison purposes, the excess demand impact on prices is weighed at 0.4, and price/wage rigidities at 0.25. Within the space of three years, the IMF changed its representation of the exchange rate from the key driver of inflation to a rather negligible side-factor.

To explain its forecasts of excess aggregate demand, the IMF (2007a) pointed to the government's wage policies although data for the first nine months showed that the execution of the budget was substantially lower than projected. Fund policy analysis failed to consider how to tailor policy responses to different types of shock, and recommended, in usual fashion, fiscal tightening and interest rate increases. Considerations of cost-push shocks were sidelined, although there were important cost-push factors at play: a bad agricultural season, rising international commodity prices and massive labour emigration attending EU membership (January 2007) tightening the labour market and creating wage pressures. Furthermore, the international liquidity squeeze driven by the difficulties in the US sub-prime market and investor concerns about the sustainability of the two-digit Romanian current account deficit saw higher exchange rate volatility. These developments combined to push inflation above the target.

The NBR policy response appeared to have factored in a broader range of inflationary pressures than the IMF's emphasis on excess aggregate demand. It thus resisted the calls for interest rate increases until September 2007, when it became clear that they would be missed (again suggesting that policy responded to current or very near forecasts).

Some of the analysts' narratives acknowledged that the assessment of the type of shock, and its projected impact on the target at the end of the targeting horizon, would warrant different policy responses (Dumitru, 2007). Furthermore, narratives focused on current and short-term future developments, implicitly recognizing that practices of monetary management were not structured through inflation targeting discourses. Indeed, analysts assigned little

importance to models, more ‘radical’ ones denying that the monetary policy regime could be described as an inflation targeting regime (Catu, 2008). Instead, it was argued that NBR’s institutional practices were related to forex market dynamics.

6.7 Practices of monetary management

The new policy framework, built on an explicit commitment to a single credible inflation target, is rooted in the use of a short-term interest rate (NBR, 2005e), usually the overnight interbank rate, as the operational target of the new policy rule. Against this requirement, the 2005 policy shift has been accompanied by sustained attempts to consolidate the overnight rate as an operational target, and inscribe policy practice within the logic of inflation targeting: the control over short-term market rates, through open market operations, as the avenue for influencing long-term interest rates relevant for spending and saving decisions.

Policy practice during the monetarist targeting period sought to induce exchange rate appreciations. Under a structural current account deficit, the NBR developed a series of practices for achieving capital account surpluses. While foreign direct investment played an increasingly important role in supporting exchange rate appreciations, liquidity management techniques provided a second channel for attracting foreign capital. As the last chapter argued, the bulk of NBR money market operations were focused on the speculative segment, inducing real appreciation through sterilization operations and an attractive interest rate differential. It created excess of liquidity on the interbank market, limiting the relevance that the policy instrument could have for as a cost of liquidity, and hence for aggregate demand control.

This placed the NBR in a rather uncomfortable relationship with the foreign-owned commercial banking sector, the main players on the forex market and thus source of

speculative capital. It produced a vicious circle where banks reaped profits not only from expectations of exchange rate appreciations but essentially from the risk-free high returns NBR offered on its sterilization operations. Thus, similar to other eastern European countries, the central bank became a net debtor to the banking sector. This severed the link between the short and long-term interest rates and reduced the scope for controlling aggregate demand, for the NBR's net debtor reduced its control over money markets.

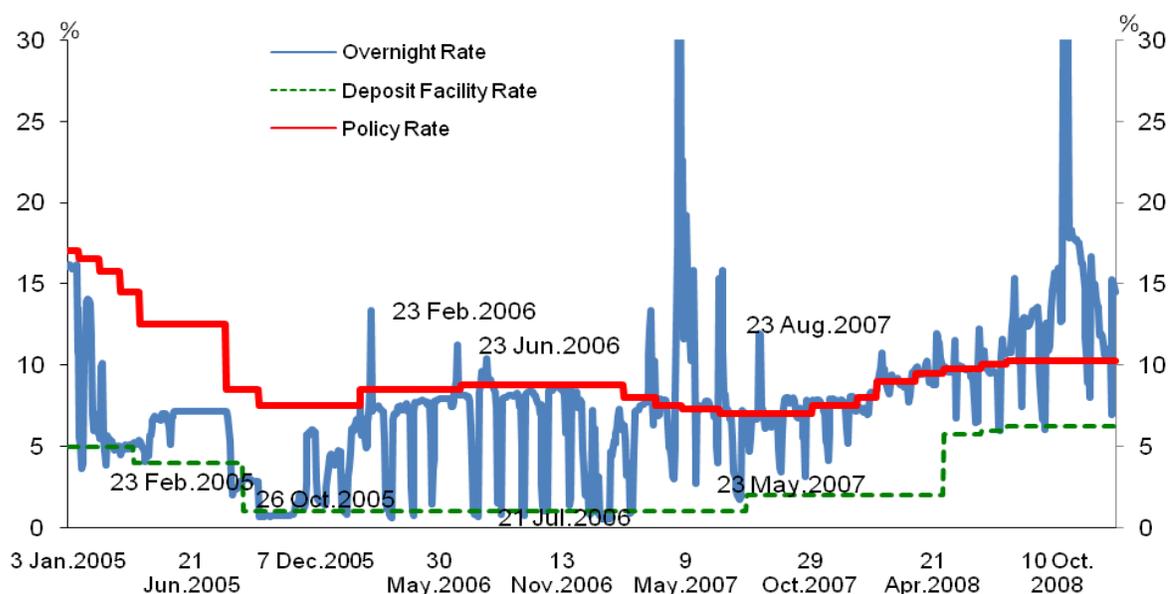
Despite rhetorical commitments, liquidity management practices under the new policy regime failed to forge a closer relationship between the policy rate (on sterilizations) and short-term money market rates. However, while overnight-rate volatility has been a systematic feature of the period, the patterns of volatility have shifted, mirroring changes in money market liquidity (see Figure 37). The adoption of the new policy strategy saw wholesale rates falling to the level of the deposit facility for most of 2005, a sign of excess liquidity that further characterised market dynamics in 2006, when overnight rates would fall to, or even below, the deposit facility rate towards the end of the maintenance period (the 24th of the month).

Indeed, the first inflation report, in August 2005, outlined the necessity of devising appropriate tools to cope with capital account liberalization (NBR, 2005e). Without questioning, or differentiating, the impact of various types of capital inflow, the NBR discourse referred to a 'sustainable rate of capital inflows', and acknowledged a trade-off, to which it referred as the Tosovski dilemma: the policy instrument, a signal for inflationary expectations, also functioned to attract speculative capital.

Consequently, the NBR attempted to decouple policy practice from speculative inflows and bring it in line with inflation targeting specifications. In order to strengthen the policy rate's signalling role for the overall interest rate structure, the monetary authority sought to break the vicious cycle of speculative capital inflows, excessive liquidity, sterilizations and the attending

volatility on the overnight market. Indeed, immediately after the August 2005 regime switch, the NBR decided to downsize sterilization operations significantly, and simultaneously reduced both the intervention rate (i.e. the sterilization rate) and the rates at which commercial banks could deposit extra liquidity with the NBR overnight through the standing facilities.

Figure 37 Policy and money market rates, Romania, 2005-2008.



source: computed from <http://www.bnro.ro/Interest-Rates-on-Monetary-Policy-and-Standing-Facilities,-history-3337.aspx>, for NBR interest rate data and <http://www.bnro.ro/StatisticsReportHTML.aspx?icid=801&table=642&column=> for money market data, accessed December 22, 2008.

NBR's refusal to continue offering vehicles for speculative returns forced commercial banks to deposit excess liquidity at the standing deposit facility, at a dismal 1% return. This signalled the substantial presence of speculative capital on Romanian money markets: in September and October 2005 commercial banks took around Euro 60bn. to the NBR's deposit facility, forty times the amount registered in August 2005 and 200 times higher than July 2005.

Policy rhetoric toughened considerably as the governor explicitly linked the decision to speculative flow considerations and announced that sterilizations would be resumed when excess liquidity originated from normal banking activity (i.e. deposit-taking) rather than forex participation. A cursory look at the banks' balance sheets, he maintained, sufficed to identify speculators, so that the NBR would refuse to validate speculative activity from banks with a low deposit base¹⁴⁴ (Chiru, 2005).

This change of attitude triggered intense policy contestations, framed by both commercial banks and the IMF through the inflation-targeting discourse. The collapse in short-term interest rates, they argued, was both stimulating excess aggregate demand and feeding inflationary expectations (IMF, 2006; Adevarul, 2005). This argument, in typical New Keynesian fashion, failed to take into account that the net debtor position of the NBR implied that policy rate was not the marginal cost of liquidity for the banking sector (Antohei et al, 2003) and could not have substantial influence on spending decisions. Furthermore, both analysts and the IMF pointed to the growing differential between the official policy rate and what the NBR called the effective rate: the average rate at which the NBR sterilizes liquidity in the system. During the first months of 2005, the effective rate fell faster than the official rate, reflecting an approach to liquidity management constrained by forex developments on the one hand, and the normativity of the inflation targeting regime on the other. This solution was interpreted as subverting the signalling role of the policy instrument, the IMF (2007a) urging a reunification of the two rates.

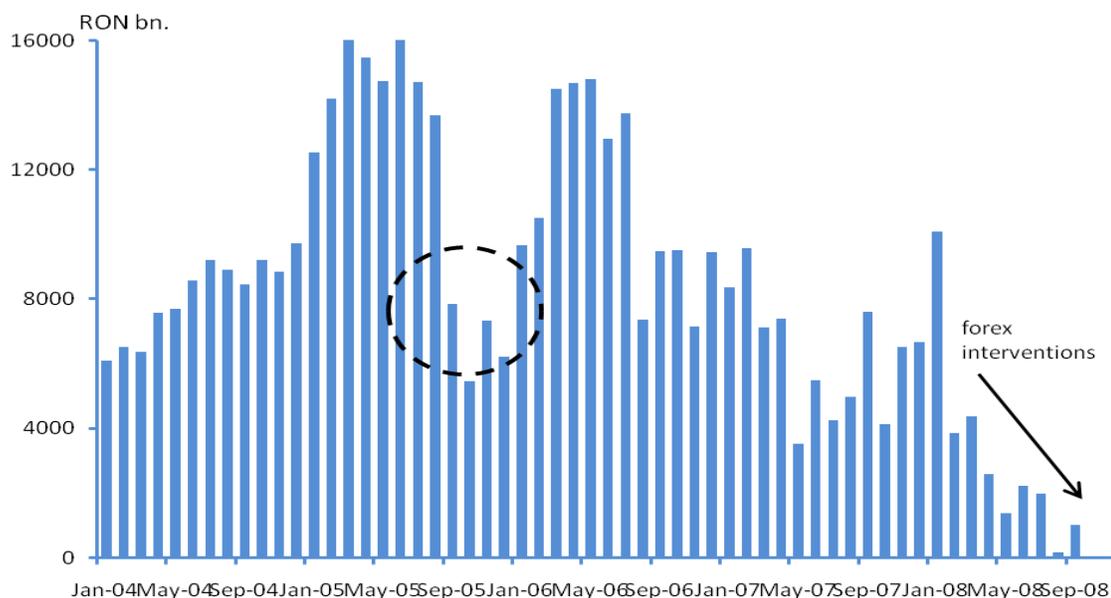
Nevertheless, the efforts to institutionalize some degree of policy autonomy were short lived. Money market rates collapsed under the level of the deposit facility (see figure 37), while the outflow of speculative capital quickly translated into currency depreciations which

¹⁴⁴ 'We will resume sterilizations when placements will reflect deposit-taking activity rather than forex sales. When I sterilize, I check three elements of the balance sheet: liabilities, assets and volumes bid for sterilization – and I cant accept sterilizations bids from a banks with a very low deposit base' (Mugur Isaescu in *Ziarul Financiar*, october 5, 2005).

threatened the inflation target. Concerned about the credibility of its newly-adopted policy regime, the central bank resumed its liquidity management practices: by November 2005 business as usual on the interbank market, with the NBR increasingly sterilizing liquidity through deposit-taking operations and speculative flows were restored. By the end of 2005, overnight rates resumed the familiar pattern of the previous policy regime, fluctuating and most often dropping to the level of the deposit facility towards the end of the maintenance period. The attempt to escape neoliberal logics by decoupling institutional practices from volatile capital inflows failed, partly due to a discourse structuring policy action through its emphasis on expectations.

Up to the 2008 crisis, policy practice confronted the same predicament: interest rate decisions tied into exchange rates and speculative flows. After the 2005 episode, the NBR was reluctant to adopt measures that would alter the structural characteristics of the money market. However, the crisis quickly engulfing the world economy from 2007 onwards marked another substantive change in money-market liquidity, redefining the monetary policy space and NBR's practices. The global deleveraging and diminishing risk appetite saw excess liquidity disappearing from the Romanian money market. Indeed, sterilization volumes decreased systematically to virtually disappear in September 2008 (see figure 38).

Figure 38 Sterilization operations, RON bn, , Romanian, 2004-08



Source: computed from the statistics section of *the National Bank of Romania Monthly Report* - December (2008:20; 2007:22; 2006: 21; 2005: 23, 2004:22)

The reverse repo rates, an additional sterilization method through three month instruments, further suggested that banks were increasingly reluctant to deposit liquidity with the NBR, demanding returns between 300 to 500 basis points higher than the policy rate. At the last auction for which data are available, in June 2008, there were only two banks bidding for the NBR’s offered volume, a number substantially lower than the twelve banks that participated in the January bid (see figure 39). This, the next section will argue, resulted not only from increased liquidity preference in the banking sector against a very uncertain economic outlook, but had a structural dimension. As the NBR changed its approach to forex markets, liquidity began disappearing from money markets.

Figure 39 Certificates of deposit, volume and yield, Romania, 2004-2008.



Source: computed from the National Bank of Romania data, (<http://www.bnro.ro/StatisticsReportHTML.aspx?icid=800&table=805&column=>, accessed March 26, 2009)

The exchange rate as a site of narrative ambiguity

The common theoretical positioning underlying inflation targeting regimes requires central banks to abandon the exchange rate as a policy objective in order to preserve the credibility of a single objective: price stability. Such a policy stance is however complicated in circumstances where the exchange rate exercises a systematic influence on costs and prices, and the extent to which policy rate decisions can be freed from exchange rate considerations, as premised by inflation targeting discourses, is not entirely straightforward. The NBR's policy discourse implicitly acknowledged the complexities surrounding exchange rate dynamics, and uncertainties of how these would play out in policy practice. While it vowed to abandon direct forex interventions, it identified its exchange rate regime as a 'managed float', a 'flexible' inflation targeting regime that would allow exchange rate considerations in policy decisions in cases of unacceptable volatility. As Epstein and Yeldan (2006) pointed out, there is a very clear

distinction to be made between what warrants an intervention and what does not. The ‘strict’ interpretation of inflation targeting, as put forward by Bernanke et al (1999) or Fischer (2001), restricts interventions to cases where volatility affects the ability to forecast and target price inflation. Any concerns about levels, or in other words, any central-bank preferences about the path of the exchange rate, implies multiple policy objectives, and would undermine efforts to stabilize expectations. An inflation targeting central bank ought to leave competitiveness to the market, a discourse to which the NBR subscribed, despite its emphasis on a ‘flexible’ policy regime.

Once inflation targeting was adopted, policy discourse rejected responsibility for external competitiveness. Exchange rate movements were framed in terms of national productivity (i.e. export performance), sidelining the impact of speculative inflows on short-term exchange rate dynamics. Nevertheless, the exchange rate still entered policy rate decisions, which both the NBR and the IMF constructed as a trade-off between internal (fuelling aggregate demand) and external (moderating real appreciations) considerations. Indeed, the IMF accused the monetary authority on several occasions of allowing exchange rate concerns to interfere with its inflation targeting objective (IMF, 2007b), and thus endangering inflationary expectations. This is precisely where the ideological function of the inflation targeting model lies: it suggests that exchange rate considerations, and speculative activity, are best addressed through market mechanisms rather than explicit policy interventions.

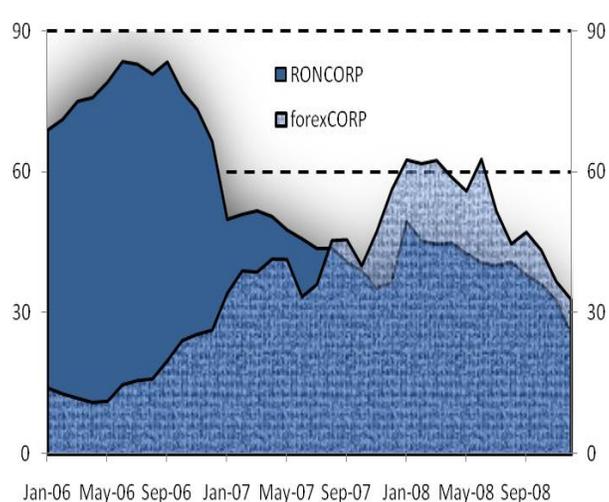
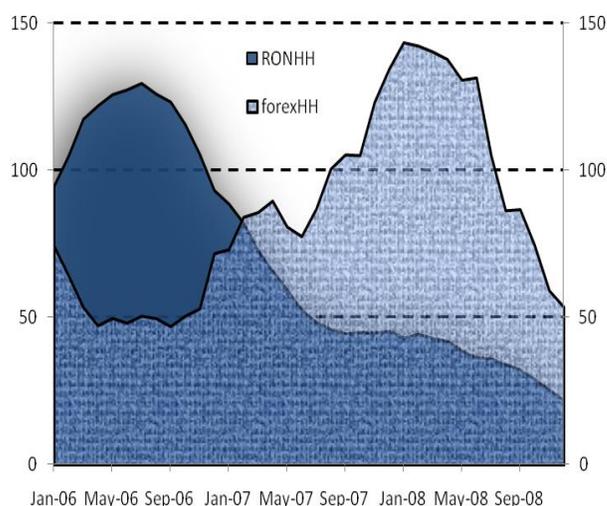
This was particularly pertinent for the Romanian policy scene. Indeed, the capital account liberalization saw both banks and non-financial business diversifying financing resources away from domestic credit and deposit markets. The ownership patterns were instrumental in this process, for the large majority of banks and businesses were foreign-

owned, and thus had access to funds from mother banks or companies. Still, the effect of this was different across institutional actors. Businesses borrowing from abroad implied little dependency on domestic bank credit, hence little responsiveness to policy instrument decisions: throughout 2005 to 2008, the share of bank loans in corporate liabilities remained modest, under 10% (NBR, 2008b). Such a share suggests that bank loans were by and large used to finance working-capital needs, rather than capital investment. However, bank's decision to borrow capital from abroad raised more serious policy implications. The NBR chose to interpret the increasing share of long-term foreign liabilities in total bank liabilities as a positive development: it reduced the threat of asset-liability maturity mismatches in the domestic banking sector. Such an interpretation, however, separates the financial stability concerns from monetary policy issues, a discursive dichotomization that could not be translated into policy practice.

First, a banking system increasingly decoupled from domestic market dynamics weakened the effectiveness of the NBR's attempts at monetary control, while simultaneously increasing vulnerability to the mother-banks portfolio decisions. Second, easy access to foreign borrowing could potentially translate into credit bubbles. By the middle of 2008, policy discourse expressed serious concern at bank credit growth, and set to reverse the February 2007 regulatory decision, when free market discourses had been deployed to explain that a deregulated banking system would increase the efficiency of lending. Indeed, growth patterns in the credit market, with businesses reduced borrowing propensity, implied that credit bubbles concentrated on the consumer sector. Household credit had grown at a substantial 115% annual average (82.4% in real terms) during 2000-2005, against a low starting base. The inflation targeting regime failed to modify this trend. Year-on-year figures for credit growth show a shared tendency across households and companies to switch from domestic to foreign currency credit starting with the middle of 2006, reflecting expectations of exchange rate appreciation

(see Figures 40 and 41). Thus foreign currency credit to households, extended at increasingly longer maturities, was growing at above 100% year-on-year during the first half of 2008. Furthermore, neoliberal logics changed the configuration of credit and debt, producing financial subjects increasingly engaged in the exploitation of arbitrage opportunities: households were actively seeking carry-trade activities by borrowing in low-yielding currencies to invest in the housing market, or even for financing consumption. For instance, the share of exotic currency credits (predominantly denominated in Swiss francs), in total foreign currency credits expanded from 8% to 23% from the end of 2006 to the end of 2008. The policy response, focused on altering reserve ratios on foreign-currency-denominated liabilities, to 35 % (January 2006) and to 40 % (March 2006), where it stayed until the end of 2008, had little effect in restraining forex credit, instead prompting banks to borrow from mother banks.

Figure 40 Credit to household, year on year % change, Romania, 2006-2008 **Figure 41 Credit to business, year on year % change, Romania, 2006-2008**



Source: computed from the National Bank of Romania data (<http://www.bnro.ro/StatisticsReportHTML.aspx?icid=800&table=571&column=>, accessed January 25th 2009)

Against this background, instrument manipulations structured through inflation targeting discourses would create an asymmetry that contributes to financial instability. If the central bank seeks to maintain the incentives for capital inflows, interest rate hikes would have a perverse effect: instead of contracting demand, as premised by the broad monetary conditions narrative, these would further reinforce expectations of a trend appreciation and carry trade behaviour. However, lowering interest rate to avoid nominal appreciations would be discouraged because it might stimulate demand, inflation and the credibility of the policy regime, despite NBR's recognition that neither the interest rate channel nor the credit channel functioned as described in inflation targeting theories (NBR, 2007f, 2008c).

The NBR's policy discourse reflected this dilemma. On the one hand, its framing of policy decisions changed with the site of policy contestation. During periods of sustained exchange rate appreciations (such as 2006), increasingly vocal policy contestation pointed to NBR's obsession with inflation at the expense of the productive sector (Serbanescu, 2006), as suggested by expanding current account deficits. The idea that the exchange rate appreciation was an equilibrium process driven by the Balassa Samuelson effect, as both the IMF (2007a) and NBR (2007f) suggested, had to be judged against a documented tendency for industrial sector wages to have systematically grown at a slower pace than productivity throughout most of the period, and to track public sector (i.e. services) for the rest. Such dynamics invalidated the underlying assumptions of the Balassa-Samuelson logic that constructed wages as driven by productivity increases in the tradable sector and exchange rate appreciation as a consequence of non-tradable sector wages rising above productivity due to wage equalization. On the contrary, critics argued, these arguments served to deny policy responsibility for exchange rate dynamics, when in fact the NBR had repeatedly sacrificed competitiveness to accelerate the pace of disinflation (Serbanescu, 2006).

The NBR maintained that export performance was driven by productivity, and a worsening of the current account performance reflected the exporting sectors' failure at technological upgrading. Nevertheless, policy argumentation turned to financial stability concerns, and credit markets dynamics, to counteract IMF's charges that its policy decisions reflected exchange rate concerns.

Indeed, in policy practice the NBR's attitude was far more nuanced than the inflation targeting discourse would have suggested. The shift to inflation targeting was accompanied by a public commitment to withdraw from the forex market as required by the inflation targeting framework, a qualified withdrawal conditional on NBR's perceptions of 'unsustainable trends'. Even where such circumstances arose, policy makers were required to decide what type of interventions to undertake. The literature on emerging market inflation targeters acknowledges that it is possible, and at times unavoidable, for inflation targeting to coexist with exchange rate management (Benes et al, 2008). Such a choice can be played out in two institutionally different ways. The central bank can first chose to affect the exchange rate by incorporating it in the policy rule. It would target a certain level through interest rate manipulation, rationalizing exchange rate dynamics through the interest rate parity arbitrage condition, a fundamental assumption underlying open economy general equilibrium models. Alternatively, it could opt to conduct interventions independently of interest rate management, a choice generally rejected by theoretical conceptualizations because it violates the uncovered interest rate parity condition, and the forecasting properties of the model.

The first choice is by definition of a more systematic nature, for it explicitly recognizes certain preferences for exchange rate levels. Direct interventions are less preferable as these could exacerbate short-term volatility, if market players can anticipate interventions and take

speculative positions. Thus, infrequent, unannounced interventions are generally intended as a signal rather than market-making.

Analysts suggested that the NBR had been deploying both (Ziarul Financiar, 2008). Indeed, after the October 2005 episode, (at least) twice throughout the period analysts speculated that the NBR had interfered directly in the market, during July 2007 and then in October 2008. Except for two short depreciation episodes (one in late 2005, produced by NBR's attempts to deflect speculative inflows, and the other in May/June 2006, when foreign investors sold short all Eastern European currencies), the exchange rate had experienced a sustained trend appreciation (see Figure 42). By the middle of 2007 it had gained 25% in nominal terms, despite the repeated cuts in the interest rate that analysts contextualized with the sustained trend appreciation. If policy concerns were entirely focused on inflationary developments, the trend appreciation would have translated into a tightening of monetary condition, thus offsetting inflationary pressures reappearing through July/August 2007. Whether driven by an expanding trade deficit or concerns of excessive credit growth, analysts suggested that the NBR was interfering indirectly through the trading desk of a major domestic bank.

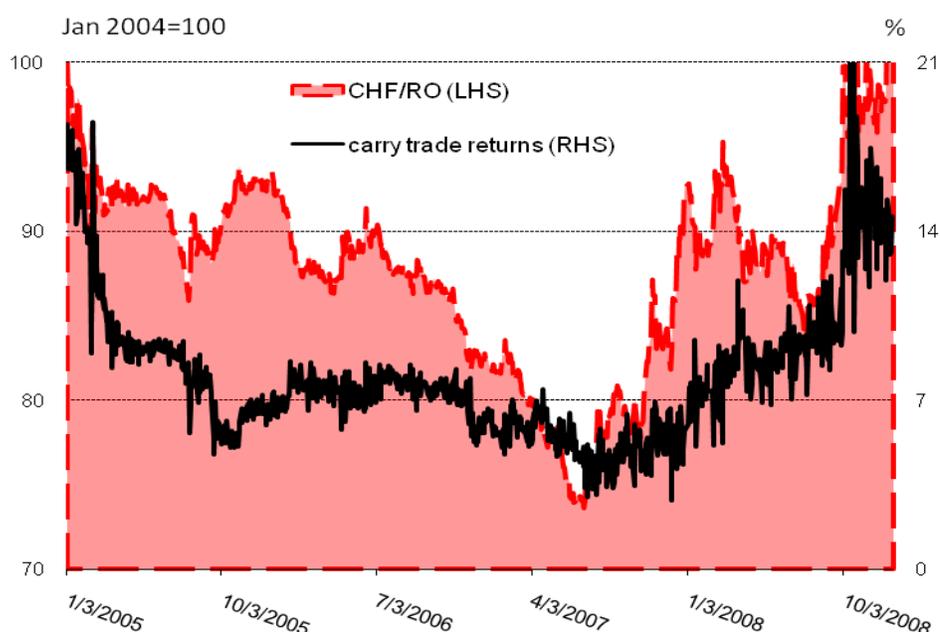
Figure 42 Foreign exchange dynamics, Romania, June 2004=100



Source: computed from European Central Bank data
(<http://sdw.ecb.europa.eu/browse.do?node=2018794>, accessed February 12th 2009)

The 2007 interventions reflected the new policy challenges produced by structural shifts in the forex market. The last steps in capital account liberalization, that allowed non-resident investors to participate on domestic money markets, marked an increasingly heterogeneous trader community, with different investment behaviour patterns. This tendency was first manifested during 2006, when non-resident forex transactions grew four times year-on-year, driven by substantial carry trade returns. As Figure 43 suggests, leveraged cross-country positions that speculate on interest rate differentials provided a profitable source of carry trade returns, above 5% for most of the period.

Figure 43 Carry trade returns vs. RON/Swiss francs exchange rate, Romania, Jan 2004=100.



Source: computed from Swiss Central Bank statistics for CHF exchange rate and 3 month Libor data (http://www.snb.ch/en/iabout/stat/statpub/zidea/id/current_interest_exchange_rates, accessed May 26, 2008 and April 12, 2009) and National Bank of Romania statistics for 3month ROBOR and exchange rate statistics (<http://www.bnro.ro/Raport-statistic-606.aspx>, accessed January 23, 2009)

While there are a variety of ways to implement carry trades, each with different implications for market dynamics, the one predominant in emerging markets involves exchanging borrowed funds in the target currency in the spot market (Galati et al, 2007). These can be held until maturity in some short-term asset (bank deposit or government paper), or through derivative contracts, such as forex swaps. In this process banks participate either as primary market intermediaries, providing loans in funding currency and deposits in target currency; as direct players through the proprietary trading desks or counterparts in derivatives with carry trade investors.

By 2007, a substantial share of transactions on the Romanian forex market originated from carry-trade activity. BIS reported that the derivative segment amounted to 60% of transactions, of which 90% were carried by non-residents on very short-term instruments, the highest share and shortest maturities in the region (see Table 8).

Table 8 Foreign exchange market structural characteristics, April 2007

	Volume (daily avg.)	Derivatives		of which non- residents		Instruments with maturity <7 days	
	US\$ mil	US\$ mil	%	US\$ mil	%	US\$ mil	%
Romania	2510	1508	60	1351	90	1224	81
Poland	8813	6820	77	5404	79	5274	77
Hungary	6715	4658	69	3945	85	3632	78
Czech Republic	4947	3631	73	2995	82	2110	58

Source: adapted from the National Bank of Romania *Financial Stability Report*, 2007

Carry-trade activity in the Romanian market altered the patterns of vulnerability. Indeed, unlike household carry trades, financial institutions' foreign currency exposure is more likely to unwind quickly against market turbulence, particularly where non-residents occupy such an important position. It also created new policy challenges. This was never clearer than during October 2008, in an unprecedented episode in policy-making, which the developments in the preceding months could not have signalled.

The first months of 2008 saw again a trend reversal in exchange rate dynamics, with the RON reaching a new high (3.47 to the EUR) after the fast depreciation during the second half of 2007. An appreciating currency signalled increased investor confidence, a sign policy-makers interpreted as evidence of the 'decoupling' thesis, a popular theory arguing that emerging markets, having grown increasingly more self-reliant, would not be severely affected by the subprime mortgage crisis in the US (Helbling et al, 2007). Indeed, the NBR governor claimed that Romania would not suffer, but benefit from the crisis given its strong underlying fundamentals (Isarescu, 2008a). Throughout June 2008, the main policy concern focused on containing the excessive credit growth fuelling a consumption boom, a policy problem diametrically opposed to developed markets where willingness to lend had been substantially affected by the US subprime market debacle. While the NBR's internal research contemplated

the prospects of a hard landing (a combination of substantial corrections of large current account deficits and an economic contraction), its public position was to point to the record economic growth in the third semester¹⁴⁵ as proof that misgivings about the Romanian economy were misplaced.

Accordingly, in September 2008, the governor criticized analysis that bundled Romania with the Baltic countries as the likely victims of a hard landing in Eastern Europe (Isarescu, 2008a). Despite similar characteristics, such as booming construction and housing sectors, a credit-driven consumption boom and large current account deficits, he maintained that there was one essentially different macroeconomic feature that would prevent Romania from repeating the Baltic story: the monetary policy regime, relatively autonomous compared to the currency board of the Baltic countries that had transformed their central banks into statistics institutes. Monetary policy, he implied, would be instrumental in sheltering Romania from global volatility, particularly since the Romanian banking sector had not indulged in profit-making along the ‘originate and distribute’ paradigm. In fact, the banking sector was adequately capitalized, with insignificant exposure to ‘toxic assets’ as it held the assets it originated on its balance sheets. Developed financial markets might have been experiencing a ‘Minsky moment’, but not Romania.

The first signs of the wishful thinking behind the NBR’s arguments emerged in October, only one month later, when volatility in money and forex market rose substantially. In the preceding four months, large short positions had set the domestic currency again on a depreciating trend, a tendency the NBR sanctioned as a market mechanism for a soft landing, and increased export competitiveness when demand in export markets, predominantly in Western Europe, was tightening. This benign attitude towards exchange-rate dynamics changed radically in the third week of October 2008, when policy makers publicly announced

¹⁴⁵ The first in the post-communist period to register double digits growth, partly driven by a very good agricultural year.

that they had successfully defeated a speculative attack (Ziarul Financiar, 2008). In no uncertain terms, the governor claimed victory over offshore investors' speculative attack on the domestic currency.

The attack had begun on October 15, when a series of hedge funds and foreign banks sought to speculate on an expected depreciation of the domestic currency, expectations partly arising from Standard and Poor's downgrade to sub-investment grade status (BB+), the only EU member with such a low profile. Around EUR 2 billion RON short positions were opened, to be settled two days later (ING, 2008). While the success of such operations depends on realized expectations of depreciation, offshore investors required access to domestic liquidity in order to close positions. These could be obtained either from wholesale markets or through currency swaps. And this is where the central bank intervened: between the 15 and 17th of October the NBR drained liquidity from money markets by selling Euros, so that on the 17 of October no domestic liquidity was to be had. Interest rates on the overnight market climbed to above 50%, while swap rates went as high as 500% (ING, 2008), as speculators attempted (and some failed) to close positions. Ironically, the RON strengthened as offshore players resorted to forex sales as a desperate measure to obtain domestic liquidity. Short-term interbank rates remained high for the rest of the month, as the NBR would only provide liquidity through the discount window, where access was restricted by collateral requirements.

The significance of this episode is twofold. First, it brought into the public domain the question of adequate practices of liquidity management, particularly during times of crisis. And here two conflicting interpretations emerged, pitting the central bank against most players in the money markets. Indeed, sustained criticisms of the NBR's approach consolidated around the claim that its refusal to stabilize interbank rates by providing the necessary liquidity was symptomatic of its heavy-handed approach, particularly ill-judged when central banks around the world were engaging in aggressive liquidization of wholesale and securitized markets as a

first necessary response to a fast-spreading crisis (Catu, 2008). High interbank rates would have a damaging effect on economic activities as these increases would be transmitted to loan rates. By refusing to address interbank liquidity shortages, the NBR was effectively engineering a recession (Paun, 2008). Such a suggestion the NBR rejected in no uncertain terms. Liquidity injections were not necessary simply because there was no shortage of liquidity in the market, but a hoarding of liquidity driven by the same speculative intentions behind the October attack. True to its position, the NBR publicly identified three big commercial banks where liquidity positions did not justify the high quotes on the interbank market and hikes in loan rates and threatened administrative sanctions (*Ziarul Financiar*, 2008).

Second, such an unexpected shift in the previously cosy relationship between market players and the central bank reveals the tensions a neoliberal logic of monetary management engenders. The investigation of practices after 1997 suggested that these were increasingly subjugated to the requirements of financialized accumulation, with short-lived attempts at decoupling policy decisions from speculative capital dynamics on the forex and money markets. Nevertheless, during 2008 it became increasingly apparent that such a representation does little justice to the complex dynamics produced by neoliberal articulations of the relationship between various transnational actors and central banks. Practices changed in response to a multiplicity of interests, and when confronted with the possibility of a massive depreciation, the NBR hesitated little to reverse its strategy towards speculative capital and exchange rate dynamics. The medium and long-term implications of these decisions will be the object of future research, but clearly the unfolding crisis, and the shifts in practices of monetary management that it brought about, have redefined policy spaces, while simultaneously opening up space for reconstituting techniques of monetary governance. Whether this will indeed amount to an ‘imminent’ demise of neoliberal rationalities under destabilizing processes of

financial innovation is not entirely clear. The compromises, inconsistencies and contradictions that characterize neoliberal projects have yet to amount to a substantial challenge. After all, the 1990s Anglo-American recession or the Asian crisis transformed, rather than subverted, neoliberal macrogovernance regimes (Peck and Tickell, 2002).

6.8 Conclusion

This chapter aimed to interrogate critically the institutionalization of inflation targeting as the new monetary policy regime in August 2005. It opened up questions of power and politics in inflation targeting discourses, asking how this regime shift has changed the neoliberal articulations of monetary management practices from the days of monetary targeting. It argued that the critiques of inflation targeting regimes, questioning either its normativity or the political economy of its functioning within neoliberal regimes of governance, essentially assumed policy models provide a (not necessarily good) guide to practice.

It appeared instead that, while models cannot easily be turned into practice, they function according to a political logic to mobilize support and enlisting different interests – particularly from policy actors in the banking sector. Indeed, policy documents, analysts from commercial banks and the IMF acknowledges, with different degrees of openness, that the theoretical centrality accorded to interest rates in influencing domestic demand was nowhere matched by a transmission mechanism that functioned as described by inflation targeting models. Aside from a few short-lived attempts, the NBR has not taken control of money markets consistent with the premises of the model.

Nevertheless, interest rate decisions were systematically, though not solely, interpreted through an aggregate-demand frame. Interpretive communities in monetary policy spaces functioned, as Sayer (1994, in Li 1999: 298-9) observed them in development policies: to enrol

supporting actors with reasons ‘to participate in the established order as if representations were reality’. Still, interpretations were not entirely fixed, as the interests they were tied up with had at times been antagonistic to the policy measures announced by the central bank. Hence instrument decisions were also linked to foreign exchange dynamics, interpreted to signal the central bank’s (excessive) concern for competitiveness.

The policy model(s), or the assumptions and concepts it underpins, were not the most contested policy space, despite numerous inconsistencies: (a) the incoherencies in responses to output gap estimations, (b) the expected impact of broad monetary conditions, (c) the responses to current rather than future variables and (d) the unresolved question of how expectations are formed and to what extent they affect price dynamics. Instead, policy contestations were strongest where practices of liquidity management deviated from the role assigned by neoliberal logics of financialized accumulation. While, for most of the period, sterilization operations confirmed to this role, during September/October 2005 and then in October 2008 policy makers changed the approach. Indeed, the NBR’s interventions on money and forex markets signalled that it would refuse to validate speculative returns, and triggered intense contestations, unlike in periods of excess liquidity that were equally inconsistent in terms of aggregate demand control.

These interventions arguably arose from the inherent contradictions of deploying inflation-targeting models to legitimize neoliberal techniques of monetary management, particularly in emerging countries’ money markets. Where price stability crucially depends on exchange rate dynamics, it will require practices that encourage appreciations, and, against a liberalized capital account, an increased financial instability. Targeting inflation, in Romania’s case, has further inflated an absorption boom, propelled by a surge in capital inflows and household borrowing patterns highly vulnerable to exchange rate depreciations. How such contradictions will be played out remains to be seen, but clearly the central bank is facing

uncomfortable trade-offs since structural liquidity conditions on money markets have changed. While inflation targeting continues to guide policy discourse, price dynamics will be prioritized, and the early neoliberal marginalization of issues of industrialization and competitiveness reproduced.

Chapter 7. Conclusion and implications

In conclusion, monetary policy is political, under any economic or political paradigm and policy regime. Its politics arises from what postpositivist policy analysis refers to as the politics of meaning, the struggles over definitions, interpretations and concepts.

Critical to substantiating this claim, it was shown, was to integrate conventional economic analysis with a discursive approach that treats policies as contested and contingent, linking struggles over the construction of the ‘crisis’ and its ‘solutions’ to configurations of power and interest groups in policy spaces. For this the thesis modified Karl Niebyl’s (1946) methodological approach to studying central banking as a three-dimensional process: theorizing, policy and the reality of institutions of finance and production. Instead it suggested a nexus of theory/policy discourse/practices-of-monetary-management. Such a redefinition allows conceptual precision, by acknowledging that policy and ‘reality’ are mutually constitutive, while retaining Niebyl’s fundamental insight that policy, and its underlying theory, are not the outcome of rational choices between various scenarios. As a methodological tool to this epistemological position, the thesis suggested a narrative approach, which allows mapping the discursive frames involved in the production of a ‘crisis’. Narratives have homogenizing effects, imposing a certain order of interpretation over a collection of events. Its ideological function, then, resides not in what it includes but what it leaves out of the story, a point well illustrated by the consolidation of three fundamental paradigms of monetary policy through Ricardo, Keynes, and Friedman’s policy advocacy.

An emphasis on power and discursive struggles in the policy space prompted a different set of reflections on the process of institutionalizing a central bank after the fall of the Romanian communist regime. Standard monetary policy analysis, described as an

instrumentalist approach in policy studies, would have produced an account of the successes or failures of the three policy strategies deployed in Romania and subsequently assessed the validity of the underlying theoretical conceptualizations. It would have attempted to elucidate whether the shifts in policy regimes - from broad money targeting (1990 to 1997) to high powered money targeting (1997 to 2005) to inflation targeting (2005 to 2008) could be constructed as attempts to improve policy.

However, the thesis took a different (epistemological) route. While this could be justified on the grounds of serious methodological challenges to formalizing economic dynamics in formerly-planned economies, it instead argued that monetary policies have a necessary political dimension, more apparent during times of exceptional politics and better disguised during periods of 'normal' policy making. Romania, it further maintained, provided a fertile case for a critical scrutiny of the role played by its central bank in the reconstitution of the postcommunist economy as neoliberal economy from 1990 to 2008.

Consequently, it showed how the historical changes in the dominant narratives of monetary processes, underlying changes in economic paradigms along Kuhnian lines, saw that the Romanian transformation began while monetarism dominated international policy discourse. Its equilibrium ontological foundations and advocacy of rules-bound monetary policy dovetailed well with, and legitimized neoliberalism, a discursive system committed to market mechanisms, deregulated economies and private finance.

Critical conceptualizations distinguish between various phases in neoliberalism: an initial normative (Hay, 2004) or roll-back stage (Peck and Tickell, 2002) focused on dismantling the foundations of the Keynesian state and economic paradigm, to a roll-out stage that normalizes neoliberal rationalities and constructs practices of economic (and social) management which further reflect in institutional reconfigurations. In the second stage neoliberal rationalities transcend the initial Western sites of discursive production, expanding

their reach to developing countries through the apparatus of international development interventions and the technically-oriented expert discourses of the Washington Consensus type. Further instrumental in this process was the IMF's strategic positioning in developing countries' crisis management. Indeed, IMF's (in) famous blue-print stabilization programs changed the politics of domestic policy processes in crisis ridden countries. Its neoliberal doctrine and monetarist policy advice constructed the central bank as a point of entry for normalizing neoliberal rationalities, for it has been the IMF's motto that 'rational' policies will prevail where they can be formulated without the intervention of politics (Krueger, 2003). Central bank independence has served this depoliticizing operation well, substantiating claims of depoliticized economic expertise underlying monetary policy decisions against the politics of government expenditure and taxation.

Nevertheless, it appeared that the hegemony of neoliberal discourses in the Romanian policy space cannot simply be reduced to an after-planned product of spontaneously emerging market forces. While taking seriously Smith's (2002) claim that international policy advice has been instrumental in scripting post-communist transformations as naturalized processes of neoliberal marketization, the thesis sought to avoid the deliberate distancing from 'messy process of implementation' characteristic to critical studies of neoliberalism as rule of governance and move beyond the notion that policy action (or practices) arise from policy intention (Mosse, 2005). Instead the ascendancy of neoliberalism in Romanian was treated, as Hart (2006) suggested, as an exercise of power in multiple, interconnected areas, with analytical attention mainly, yet not exclusively, devoted to the monetary policy space. Such an analytical approach recast the policy narratives of the period as follows.

(1) **The 1990-97** period of broad money targeting, narrated as the 'gradualist' years when the reconstitution of economic relations through market principles suffered from a mismatch between 'rational policy', designed through repeated IMF agreements, and 'vicious politics'

that surrendered policy implementation to vested industrial interests groups. The problems of implementation were primarily manifested in the two policy domains relevant to monetary control: (i) the exchange rate, where policy discourse argued that the only viable solution to the fundamental disequilibrium inherited from communism was a freely-floating exchange rate that would allow market mechanisms to find equilibrium levels and (ii) monetary policy, structured through a monetarist narrative as necessarily contractionary.

Instead, it has been argued that the 1990 to 1997 period could be broadly read as the era of normative, roll-back neoliberalism. The National Bank of Romania was structured as an important, arguably the primary, vehicle for the sustained neoliberal attack on the state's capacity to craft economic reform. Policy measures engendered concerted efforts to deconstruct and discredit the idea that any form of planned economic activity, as embodied in the state-owned enterprises, could function under market principles. Indeed, in policy discourse, state-owned enterprises emerged as a powerful political force that resisted restructuring and ascribed a quasi-fiscal objective to exchange rate and monetary policy choices.

A first step in this direction was to redefine the 'transition macroeconomic problem' through an excess aggregate demand narrative. This constituted a generic, centrally-planned economy through two theoretical concepts: *the monetary overhang* that premised an excess of liquidity arising from pent-up demand in consumer markets, and the *soft budget constraint*, that would have reproduced such excess liquidity even after price liberalizations unless the appropriate contractionary monetary policy was firmly in place. These legitimized the austerity discourse underlying the IMF's policy advice, and translated into tight monetary targets specified as quantitative performance criteria in the four IMF Stand-By Agreements.

Throughout the period, the NBR engaged in a continuous struggle to stabilize monetarist narratives as the dominant system of interpreting macroeconomic dynamics. This was a complex task, for notwithstanding discursive commitments, monetarism was translated to

policy practice in different degrees. Indeed, while monetarist-informed practices of monetary management created liquidity shortages where policy discourse saw excess liquidity, produced repeated payment blockages instead of liberating a ‘repressed’ financial system, contracted industrial production instead of producing growth and fed exchange rate devaluations into inflationary pressures, the repeated failure to conclude IMF agreements was interpreted as evidence of insufficient commitment to monetarist principles.

However, it was argued that governments throughout this period showed a remarkable initial willingness to comply with IMF conditionality. That such commitments vanished has to be understood against the IMF’s well-documented tendency for overly-contractionary targets, so that program completion is the exception rather than the rule in Fund programs. Indeed, there comes a point, as the Romanian experience has shown, where no rhetoric of discipline or the desirability of markets can rationalize, or indeed legitimize, the profound economic (along with social and political) dislocations produced by neoliberal austerity policies. However, measuring policy performance in terms of compliance with IMF conditionality is instrumental in the construction of the ‘good’ policies/‘bad’ politics dichotomy. It is not only a necessary argumentative technique against policy contestations but also essential for re-articulating the necessity of neoliberal reform. Dislocations are thus attributed to micro ‘distortions’ and domestic politics rather than the economics of the policy advice.

The NBR’s reactions to repeated SBA failures were twofold. Policy learning and institutional reflexivity expanded the policy repertoire in order to continuously (re)produce and legitimize the monetarist narratives. On the one hand, its policy argumentation focused on interpreting the past measures as accommodative, and formulating the future policy stances as necessarily tightening. The dynamics of high-powered money, for instance, brought into question such an articulation, for they suggest accommodative liquidity practices and tight-money discourses and vice versa. On the other hand, every SBA expanded policy repertoires,

not always in accordance to monetarist logics and sometimes rather against them, a sign that not the monetarist model per se, but the overall logic of neoliberal normativity, was structuring policy action. Nevertheless, these extensions outside the monetarist discourses opened policy to contestation. For instance, when the interest rates on NBR refinancing were raised to levels unusual even in very high-inflation environments, it prompted strong criticism from government, industry and policy analysts.

The ambiguity characterizing the relationship between policy discourse and practices was even more evident in exchange rate decisions. Policy texts went to great lengths to dismiss, deny or marginalize the extent and speed to which exchange rate devaluations were transmitted to prices, without questioning whether the search for price stability was consistent with a market determined exchange rate or devaluation decisions structured through equilibrium discourses. However, the NBR repeatedly intervened to prevent a fast depreciation of the exchange rate, its practices constrained by conflicting demands: the control of inflation, which required exchange rate stabilization against a structural trade deficit, and the IMF pressures for complying with commitments to flexibility.

While the thesis acknowledged that industrial interests were important, and at times powerful, policy actors, it showed that a coherent industrial strategy that recognized the crucial role of the exchange rate and of a financial system orientated towards recapitalizing the productive system never emerged. Instead, monetarist discourses and practices sought to subject large-scale state-owned industries to the disciplining hand of the market, against Galbraith's (1967) well documented argument that large-scale capitalist production necessarily requires minimizing market uncertainties. A policy package systematically targeting every avenue for protecting profits not only contributed to the decapitalization of large state production, but transformed liquidity problems into solvency problems. Ultimately, neoliberal attacks succeeded in what they set out to do.

(2) **The 1997-2005 period** when the ‘right politics’ allowed ‘right policies’ to be implemented. The account of policy success went as follows: the NBR’s substantial improvement in its management of liquidity, deployed in support of its strategy of high powered money targeting, ensured the tight monetary policies necessary for reducing inflation. Policy success was thus attributed to an increasingly technocratic mode of policy-making, enabled by the 1997 right-wing coalition’s wisdom to withdraw (albeit hesitatingly) from the implementation of monetary policy.

Instead, it was argued that the 1997 SBA was instrumental in producing the shift to neoliberalism’s constructive phase. Redefined policy rationalities sanctioned a managed exchange rate policy, albeit confined to the requirements of high powered money targeting, and a fiscal policy disciplined by the market. The economics of stabilization predicated on the existence of excess liquidity before 1997 instead resulted in liquidity shortages; afterwards policy discourse articulated claims of tight monetary control to explain policy successes against an increasingly significant structural excess of liquidity on wholesale money markets which the new practices of sterilized forex interventions produced.

Essentially, starting with 1997, the banking sector’s speculative activity would become central to monetary policy processes. Underlying this was a reconstitution of the relationship between wholesale, forex and the treasury market, shaped by the NBR’s practices of monetary management and the increasing role played by global finance (present in this stage primarily in the banking sector) in defining domestic policy choices. Sterilizations consolidated as the primary vehicle for speculative returns, locking forex and money market interventions into a logic of engineering exchange rate appreciations.

Indeed, this period saw the normalization of an extra-local regime of rules and practices grounded in a neoliberal mode of economic governance. First, the exchange-rate strategy aimed at ensuring real appreciations reproduced neoliberal dynamics on the forex market:

capital flows would become the primary driver of exchange rate movements, a trend reflected in the growing importance (and volume traded) of the interbank foreign currency market. Practices of sterilized interventions combined with currency appreciations and expanding current account deficits increased vulnerability to international sentiment. Second, banking rationality shifted towards financialized accumulation. During the years of normative neoliberalism, the activity of the state-owned banking sector was constrained on the one hand by the NBR's attempts to tighten liquidity, and the government's attempts to revive the agricultural and productive sector through directed credit on the other hand. Coupled with a low confidence in the domestic currency and consequently a low monetization of the economy, banks were dependant on central bank refinancing, and the Bank's willingness to assume the lender-of-last-resort function. After 1997, the discourses and practices that rewarded speculation and punished credit for productive purposes produced an asymmetric distribution of liquidity on the wholesale market that would further consolidate the logic of financialized accumulation. Access to foreign capital became fundamental to profit making and even survival, as the 1998-99 episode suggested. The narration of 1998-99 as a moment of crisis not only hinted to the vulnerability associated with the increased exposure to global forces that neoliberalism engenders, but revealed how practices of monetary management addressing speculative pressures contributed to further subjugating the management of liquidity to the exigencies of private actors. The NBR's 'market driven' solution for discouraging speculation inflicted liquidity shortages and expensive refinancing on money markets, producing a banking crisis, and the associated privatizations, that opened up the banking sector to transnational actors. Practices of monetary management further contributed to the changing configuration of credit and debt, with an increased euroization of the assets side of the banking sector that belied claims of tight monetary control, and bubbles in consumer credit and housing markets.

In sum, this period saw a monetarist policy discourse engaged in feigning control over the uncontrollable, that legitimized and normalized practices tailored to attracting speculative capital and thus tied financial stability considerations into the choices of transnational market actors. Normalized neoliberalism consolidated its institutional effects, producing institutional configurations where practices of macroeconomic management respond to the exigencies of financialized accumulation, and its ideological effects: a normalized neoliberalism depicted as a technical set of devices for managing an open economy, to find its further expression in the consolidation of inflation targeting as a ‘consensus’ on optimal policy strategy.

A global normalization of roll-out neoliberalism was simultaneously changing discursive regimes in international financial markets. Inflation targeting, the monetary policy regime that explicitly incorporates interest rate management as a technique for managing aggregate demand, promised a new mechanism for building international consensus on optimal policies, guaranteeing safe integration into global financial markets if credible policies were implemented. The NBR, faced with the further liberalization of the capital account and acknowledging the potentially destabilizing character of the ensuing capital inflows, decided to switch to inflation targeting in August 2005.

Exploring the shifts in policy discourses and practices produced by the new policy regime suggested that, as in the period of high-powered money targeting, policy models function at best to legitimize rather than provide a consistent guide to policy actions. As elsewhere, the NBR now couches its policy rhetoric to a considerable extent in terms inflation targeting discourse. It clearly articulates policy preferences in terms of inflation control, underlying what it sees as the non-negotiable character of inflation targeting imperatives. Its discourse recognizes that policy success is contingent upon external circumstances: ‘shocks’ in the global economy or in the domestic productive system.

Furthermore, efforts to bring institutional ‘reality’ in line with theoretical conceptualizations had a limited success before the onset of the global crisis of financialized accumulation. Prior to 2008, the NBR failed in its few attempts to reconstitute liquidity management, and its logic of money market intervention, according to inflation targeting requirements. However, despite the contradictions inherent in the rhetorical deployment of inflation targeting models, these function to enlist interpretations and stabilize the discursive system. These further function to substantiate contestations where practices of liquidity management deviate from the role assigned through neoliberal logics, as for instance in September 2005 and, more pronounced, in October 2008.

Indeed, everything changed in 2008. Global financial dynamics showed the inherent contradictions and vulnerabilities engendered by neoliberal accumulation strategies, but manifested differently on the Romanian policy scene.

The last stages of capital account liberalization had opened up the forex market to non-resident players and again reconfigured financial market relations. The banking sector lost its primacy in channelling speculative activities on money and forex markets, as an increasingly heterogeneous trader community produced different patterns of investment behaviour. By 2007 carry trade activity dominated forex trading, increasing the likelihood of unwinding in periods of market turbulence. On the back of substantial carry-trade returns, the domestic currency appreciated systematically until the summer of 2008. However, increasing speculative pressures against the domestic currency produced patterns of volatility unseen since the 1999 episode. Short-selling evolved into a fully-blown speculative attack in October 2008, and the NBR response echoed its 1998/99 tactics. It took buying positions on the forex market, and simultaneously drained liquidity from wholesale markets, with the attendant substantial increases in overnight and swap rates. The contradictions embedded in neoliberal rationalities of financialized accumulation became apparent during this episode: while neoliberal

structuring of liquidity-management practices contributed substantially to increased financial instability in times of steady speculative inflows, in October 2008 the NBR refused to validate speculative returns precisely because these would have endangered financial stability. Thus, while central banks in developed financial systems were engaging in aggressive liquidization of wholesale and securitized markets, the Romanian central bank presented liquidity tightening and the attending hikes in the cost of liquidity as the only solution to tackle speculative attacks.

This episode marked a new beginning on money markets: the structural excess of liquidity disappeared, while the appetite for Romanian assets diminished. How such contradictions will play out in both discourse and practice is the subject of future research: by February 2009 the NBR and the government radically reformulated the appraisal of the Romanian macroeconomic outlook. Twenty years after the fall of communism, a period when the central bank became increasingly embedded in the political operations of shifting neoliberal logics, Romania's policy-makers recognized that the country was again in times of exceptional politics and crisis. The dangers to financial stability associated with the uncertainties of high short-term private debts forced it to request the IMF's assistance. Only six months before the central bank governor had declared that the crisis was an opportunity for Romania, given that its fundamentals were in line with inflation targeting conceptualizations.

In conclusion, opening up questions of power and politics underlying monetary policy has a two-fold contribution. First it expands the range of epistemologies deployed in economic policy analysis, and thus subjects policy discourses to the type of critical scrutiny that other social sciences are routinely engaged in. This, I argue, is particularly important for monetary policy analysis, the field less exposed to critical exploration when understanding its politics is essential. This is particularly relevant at a moment when destabilizing processes of financial innovation have seen the macroconstitution of neoliberal economic spaces being increasingly contested. Nevertheless, the 'imminent' demise of neoliberal processes of economic

management cannot be taken for granted. Instead, the extent to which responses to crisis might confirm or contest the dominant rationalities of global finance depends on discursive struggles in national policy spaces.

From this perspective, the research is valuable to policy-making and development processes at large. Once technocratic, instrumentalist representations are replaced with an analysis of historical conditions and hegemonic discourses, the contingent nature of policies becomes apparent so that it is worthwhile to explore means of escape from these structuring forces. It could also serve to render policy formulation more participatory/democratic, and redefine policy accountability, away from neoliberal 'market tribunals' and standards of inflation/austerity to questions of inequality, employment and poverty. Now could be a most propitious moment to explore alternatives to neoliberalism.

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Annex 1. The timetable for capital account liberalization, Romania.

Liberalizing foreign currency operations for residents and non-residents	
<p>Liberalization of medium and long term inflows</p>	<p>1999</p> <ul style="list-style-type: none"> ▪ Medium and long term international trade loans extended by non-residents to residents ▪ Medium and long term financial loans extended by non-residents to residents
<p>Liberalization of capital inflows with limited balance of payment impact</p>	<p>2001-02</p> <ul style="list-style-type: none"> ▪ resident's real estate and direct investments abroad; ▪ Romanian financial instruments* on international capital markets ▪ non-resident collaterals extended to residents; ▪ personal capital transfers (donations, inheritances, non resident short term loans extended to residents); ▪ Medium and long term international trade loans extended by residents to non-residents. ▪ Capital transfers linked to life and credit insurance contracts
<p>Liberalisation of capital movements related to insurance contracts and other capital flows with a significant impact on the real sector</p>	<p>2003</p> <ul style="list-style-type: none"> ▪ resident transactions with foreign financial instruments*; ▪ Financial loans with less than a year maturity extended by non-residents to residents; ▪ Financial and personal loans extended by residents to non residents; ▪ resident collaterals extended to non residents.
	<p>2004</p> <ul style="list-style-type: none"> ▪ foreign financial instruments* on the domestic capital market
	<p>11.04.2005</p> <ul style="list-style-type: none"> ▪ non residents domestic currency deposit account operations, held with domestic credit institutions.
<p>Liberalization of capital inflows with a substantial balance of payment impact</p>	<p>20.07.2005</p> <ul style="list-style-type: none"> ▪ current account and deposit operations of entities residing outside Romania.
	<p>01.09.2006</p> <ul style="list-style-type: none"> ▪ trading financial instruments on the money market; <p><small>*) including mutual funds instruments (OPC)</small></p>

Source: NBR (translated by author)