

## **Monetary and Fiscal Policy Interaction and the Relationship between the Central Bank and the Government.**

### **(The Case of Republic of Moldova)**

**Corina Chironachi<sup>1</sup>**

**Abstract:** In this paper the author is analyzing the impact of fiscal and monetary policies on the dynamics of the exchange rate, inflation and other macroeconomic variables. The author investigates the forms of strategic interaction between the Government and the Central Bank in designing and implementing these policies. As a result, the author concludes the necessity of institutions cooperation in the development and implementation of monetary and fiscal policy measures, but also concluded that the responsible institutions must remain independent in achieving an efficient monetary and fiscal policy of the Republic of Moldova.

**Keywords:** monetary policy; fiscal policy; Central Bank; Government; exchange rate; inflation

**JEL Classification:** E52; E58; E62; E63

Interaction between the Government and the Central Bank is one of the key problems of optimal macroeconomic policy's construction. In our country the central bank has been given the mandate to preserve price stability as a primary objective, and has been granted autonomy from Government to make sure that short term political considerations do not interfere with achieving this objective. Also, the Central Bank gives accountability to the legislature and the public. Transparency is important for holding the Central Bank to account, and for making monetary policy efficient by shaping inflation expectations.

Actually, there is a clear division of responsibilities and accountabilities between the Central Bank on the one hand, and the Government and the Minister of Finance on the other hand. Information sharing, cooperation and coordination between the Central Bank and the Government are important in a number of respects. (Moser-Boehm, p. 45)

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<sup>1</sup> Senior Lecturer, State University B.P. Hasdeu" from Cahul, Republic of Moldova, Address: 1 Piața Independenței, Cahul, Republic of Moldova, Tel.: 0299 22481, Fax: 0 299 24752, Corresponding author: corinastaicu\_c@yahoo.com.

Fiscal policy is determined by the Ministry of Finance while monetary policy is made by the Central Bank. Fiscal policy involves the decisions that the Government makes regarding to collection of revenue through taxation and about spending the revenue. It is often contrasted with monetary policy, in which a Central Bank sets interest rates and determines the level of money supply. Fiscal policy and monetary policy can have dramatic effects on the economy.

According to the Law of the National Bank of Moldova No. 548-XIII from July 21, 1995, the National Bank of Moldova (NBM) is the Central Bank of the Republic of Moldova, is an autonomous public legal entity that sets up and implements the state monetary and foreign exchange policies.

The primary objective of monetary policy was to achieve and maintain the stability of national currency, which determined the NBM's monetary policy strategy and tactics. Thus, until 2006, this ultimate goal of monetary policy implied two objectives: to ensure and maintain domestic stability of the national currency, approximated by the inflation rate and measured by the consumer price index, and to achieve and maintain, additionally and in parallel, external stability of the national currency measured by the exchange rate against major foreign currencies. In 2006, following the approval of the Law No. 191-XVI dated from June 30, 2006 regarding the amendments to the Law on the National Bank of Moldova No. 548-XIII from July 21, 1995, the primary objective "to achieve and maintain the stability of the national currency: was modified and the primary objective of the National Bank of Moldova "to achieve and maintain price stability" was adopted.

The most important objective of the NBM is to achieve price stability and maintain the inflation rate at a low level so as to contribute to developing of a relatively stable macroeconomic framework that will enhance economic development and ensure a sustained growth.

During 1994 – 2008 the monetary policy objective was achieved by targeting the monetary aggregates. In 2009, the NBM has abandoned the regime of targeting monetary aggregates and set the inflation rate objective of 9.0 percent by the end of the year with a possible deviation of  $\pm 1.0$  percentage points (now, the inflation rate objective is 5.0 percent)<sup>1</sup>.

NBM achieves its primary objective through main monetary policy instrument: open market operations, as well as through auxiliary instruments: standing facilities, required reserves ratio and foreign exchange market interventions. These instruments have a direct impact on the level of nominal interest rates on the money market over the short term. The NBM will oversee the money market conditions in order to achieve the inflation objective by setting up the main short–

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<sup>1</sup> Monetary policy strategy of the National Bank of Moldova for 2010-2012 (amended by decision of the Council of Administration of the National Bank of Moldova no.267 of December 30, 2010, will be effective on January 1, 2011), accessible at: [http://bnm.md/files/attachments/2010-2012\\_0.pdf](http://bnm.md/files/attachments/2010-2012_0.pdf), p. 2

term interbank market indicator – the base rate. Due to the economic context on 1st of December 2014, NBM has initiated the process of monetary tightening, gradually raising the base rate from 3.5% to 4.5%, then 6.5%, 8.5%, 13.5% to 14.5%. By the end of January 2015, the BNM decided to raise the reserve ratio gradually from 14% to 18%.

The transmission mechanism of the monetary policy in which the interest rate plays the main role in influencing the monetary, credit and foreign exchange markets is promoted by the NBM. Changes of the NBM's base rate are expected to affect the lending and borrowing rates in the economy, as well as the exchange rate of the national currency. Thus, the base rate is expected to determine the monetary conditions under which the national economy operates<sup>1</sup>.

Due to inflationary expectations and the need to reduce aggregate demand, NBM simultaneously modified two monetary policy instruments. The transmission mechanism of the monetary policy decisions through the base rate is slow and does not respond swiftly to urgent needs of excess liquidity sterilization, therefore BNM resorted to a direct instrument of monetary policy - required reserves ratio, used less rarely, due to the immediate effects on loans and credits. By rising the base rate at the end of 2014 was pursued higher interest rates on loans and bank deposits in order to reduce consumption, attracting available resources in the economy, but also to lower price pressures. The increase of required reserves aims to sterilize excess of liquidity in the economy by limiting the monetary base multiplication process and improving monetary policy transmission mechanism. The interest rate on bank loans has increased and will have a negative impact on the volume of credits in economy. Tightening money supply causes a reduction in the growth rate of investments in economy and, respectively, the decrease of the national economy. The interest rate on bank deposits causes a price growth for refinancing resources, decreases aggregate demand and determines the stabilization of inflation expectations.

Monetary policy is flexible: it can be modified easily and rapidly. But the effects of the monetary policy changes are not immediate, nor uncontested; the effects on economic growth are often diffuse and indirect.

According to the Law on the Public finances and budgetary-fiscal responsibility No. 181 from July 25, 2014, the Ministry of Finance of Moldova is the public legal entity that develops and ensures the implementation of fiscal policy. The Ministry of Finance, the Government and the Parliament will act to ensure the budget elaboration in terms of national currency stability, stability of wages and prices and stable economic development, as well as the balance of collection of revenue and expenses. Fulfilling its responsibilities the Ministry of Finance will coordinate its activity with the National Bank of Moldova.

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<sup>1</sup> *Ibidem*, p. 7.

The main instruments of fiscal policy are: general state taxes and fees, local taxes and fees, as well as public spending. Through them, the Government can influence the country's economic development, stimulating economic growth or, on the contrary, dampening it in times of inflation. Thus, fiscal policy is a method by which the state intervenes in the economy.

The overall objectives of fiscal policy for 2013-2015 are based on:

- Ensuring equity, sustainability and fiscal transparency;
- Tax burden optimization;
- Stabilizing and simplifying tax legislation;
- Harmonization of the underlying principles of national tax legislation with the European one<sup>1</sup>.

All these objectives are based on the Tax Service Development Strategy for 2006-2010 and the particular aims of the National Development Strategy (NDS) 2008-2011 and the terms of the Medium Term Expenditure Forecast for 2009-2011. The NDS has an underlying EU integration perspective and focuses, in the tax field, on improving the fiscal administration, reducing fiscal pressures by expanding the taxation base and ensuring stability in collecting budget revenues. The recent Government Programme 2009 to 2013 provides a new focus on a comprehensive economic recovery programme centered on strengthening confidence in the ability of state institutions to manage the current crisis through prudent fiscal policies and efficient and stable cooperation with international financial institutions and Moldova's development partners. In regard to budgetary and tax policy, the Programme emphasizes the need for a stable and predictable fiscal and budgetary framework, the maintenance of the budget deficit at a reasonable level and the need to ensure fairness in the allocation of public finances and further reductions in tax burdens. (Stuart, 2010, pp. 14-15)

The Government can decide what domain of the economy to target by implementing fiscal policy; can decide in which way to spend public money or which sectors to tax in different ways. Thus, changes in fiscal policy can be applied to sectoral areas of the economy affecting some more than others, the ultimate goal being to achieve balance and macroeconomic stability. From this point of view, although fiscal policy is very flexible (any change in tax policy needs time to be approved and implemented), effects on the economy are immediate and effective.

Therefore, it is important to note that implementing a fair tax system is not only the right decision, but also a practical one. That's why an inequitable tax system

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[http://www.mf.gov.md/common/files/CCTM%202013%202015/4\\_Obiective%20politicii%20fisc%20vama.pdf](http://www.mf.gov.md/common/files/CCTM%202013%202015/4_Obiective%20politicii%20fisc%20vama.pdf), p. 1.

generates a state of resistance from taxpayers, which is achieved through rising of evasion of tax obligations.

During the last years, it became clear that the ones responsible for monetary policy and the ones responsible for tax policy often speak different languages and can follow opposite interests. For instance, higher monetary policy interest rate undermines the possibilities of the Ministry of Finance to get loans at favorable rates and, as a result, hinders the promotion of an extensive budget policy. Hence, Governments are motivated to put pressure on central banks to fund the budget deficit at a minimum cost. Hence, if the legal and institutional frameworks do not guarantee a proper level of independence for Central Banks, the last could give in to these pressures, which involves a strong and persistent inflationary effect. (Sargent & Wallace, pp. 1-17)

Often the objectives of Central Banks to maintain price stability tend to contradict, in the short run, the Governments' objectives of economic growth. Thus, in order to maximize their electoral chances, the politicians put pressure on the Central Banks to promote more relaxed monetary policies, particularly before elections. If Central Banks are vulnerable to such pressures and enter the politicians' game, they can lose control over the inflation, with adverse and long-lasting effects on the economy.

The more the monetary authorities are exposed to political pressure, the higher the inflation level is, which induces adverse effects for the economy: erosion of purchasing power of population; disincentives to the productive investment to the advantage of speculative investment; distortion of taxation system and credits becoming nominally more expensive. (Lupusor, 2013, p. 20)

Thus, monetary policy and fiscal policy can work together or against each other, canceling or amplifying their effects.

The National Bank of Moldova needs to cooperate with the Government of the Republic of Moldova and the central public authorities in order to promote the monetary policy. This cooperation requires permanent exchange of information and dialog regarding the fiscal policy, especially tax changes, budgetary wage modifications, pensions and other social benefits and other measures that may affect the price level and the Moldova's economic stability.

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