FINANCIAL STABILITY - MAJOR OBJECTIVE OF THE CENTRAL BANKS

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1. Introduction

The relationships between monetary stability and financial stability are more complex than what assumed monetary policy strategies of central banks until the outbreak of the crisis. Monetary stability and financial stability lies in interdependence, and bilateral influences can act both positively, and negatively..

National Bank of Romania defines widely the financial stability, "as the feature of the financial system to cope with systemic shocks on a sustainable basis and without major disruptions, to allocate efficiently financial resources in the economy and to identify and manage effectively the risks"[1].

The financial stability is more difficult to define and quantify than monetary stability [2], but the costs of financial crises are too high, so that the central banks in the future, not to prevent them. We believe that the major objective of central banks is to control monetary stability and ensure financial stability, through the use, by monetary authorities, of a number of tools and through a closer cooperation between central banks and supervisors[3]. In general, the main link between Central bank and supervisors should be exchange of information. Charles Goodhart[4] has formulated a general argument in favor of a close realtionship between the Central Bank and the supervisor, pointing out the huge dependence of the capacity of the Central Bank - to achieve the objective of monetary stability, based on the financial stability of the banking institutions at the microeconomic level.

2. Regulation of bank loan and other macro-potential tools

Most economists today agree that monetary stability of the ' 90-s was unfavorable financial stability, since it has stimulated businesses, especially banks, to take greater risks.

It is known that the excessive increase of the loans has had an essential role in the current crisis. Therefore, it is advisable to supplement the monetary policy of central banks through the adoption of measures to regulate the loan.

As Hyman Minsky states, the debts' crisis is born just in the period in which all things are going well, and businesses take advantage of economic growth and low interest rates to borrow very much and in a contagious manner. When interest rates rise because of tighter monetary policy, the debts, which at a previous level of interests seemed bearable, become unsustainable [5]. This explanation is relevant to the period

[1] BNR, *Raport asupra stabilității financiare*, 2006, pag. 7

[2] Cerna, S., *Stabilitatea financiară*, Editura Universității de Vest, Timişoara, 2008

[3] Larosière, J., *The High Level Group on Supervision in the EU Report*, Brussels, February, 2009

[4] Goodhart, C., *The Organisational Structure of Banking Supervision*, FSI Occasional Papers, 2000

[5] Minsky, H., *Cum stabilizăm o economie instabilă*, Editura Publică, Bucureşti, 2011

preceding the global financial crisis of 2007-2008: monetary stability in the 2000-s has favoured the financial instability of 2007-2010, and the latter has caused an economic and social crisis of large proportions, allowing us to appreciate that the central banks have underestimated the dangers that financial instability might create to the overall macro-economic situation.

In the near future there will be reforms of the organization of prudential supervision, and the role of central banks will increase: they have to assume the task of macro-prudential supervision .

The macro-prudential regularization aims to stabilize the monetary system and financial system. Its objectives are: to reduce the probability of occurrence of systemic financial crises, limiting their intensity and costs when they occur.

Studies of Claudio Borio and his team at the Bank for International Settlements have focused on signs prior to the serious financial crisis, pointing out that among the factors that announce the crisis is the strong expansion of bank loan. In this context, the loan - whose excessive growth is the factor that triggered the most severe financial crises – should be subject to rigorous surveillance

The Bank loan adjustment can be done using several tools, such as, for example, the imposition of minimum reserves on loans, parallel to the reserves related to deposits, reserves which would affect the ability of banks to grant new loans and their liquidity. There is the opinion that these reserves for loans will have to be progressive, depending on the growth rate of loans and their destination.

In emerging countries, the adjustment of required reserve on short-term financing in foreign currencies of financial institutions may be used for the purposes of financial stability.

The reality of recent years, has shown that particularly serious are the crises when the pro-cyclical nature of the evolution of the volume of loan interferes with the pro-cyclical nature of the evolution of other assets [6].

The idea of introducing of counter-cyclicity in banking regulation appears in Basel III Agreement. Thus, the depreciation of counter-cyclical capital, (which is directly proportional to the systemic risk and is calculated by the credit/GDP relationship), the „conservation” capital , the minimum leverage ratio and dynamic reserve, fall to all means of struggle against pro-cyclicity prudential rules.

The principle of dynamic reserve is to recognize that the likelihood of future losses is measurable and covered from loans granted. The ex-ante reserve of expected losses allows the attenuation of the incidence of depreciating claims on the the financial results of banks, which should alleviate the pro-cyclicality of bank behaviors. In other words, the dynamic reserve obliges banks to make provisions in the good times, which help them to absorb the losses during periods of recession.

Also, appyling maximum or variable rates during the cycle for price/value ratios or debt/revenue service can fight effectively against the accumulation of loan risks in the boom phase of the economic cycle.

„Conservation” capital represents another macro-prudential tool that seems to be the best solution to reduce systemic risk.

Macro-prudential policies aiming the problem of the systemic financial institutions are still under construction, three major types of economic policy options are possible in this area. The first option is to prohibit, which aims to impose a maximum size to the institutions and/or separation of activities.

[6] Boyer, R., Dehore, M., Plihon, D., *Les crises financiers: analyse et propositions, în: Les crises financiers*, Rapport du CAE, La Documentation française, pg. 50, 2004

The second option is to act in advance to discourage financial institutions to become too big to go bankrupt. This option depends on the extent of the contribution of each financial institution to the systemic risk and can degrade by several instruments, including the establishment of additional capital and eventually excess of liquidity proportionally to the systemic potential of the institutions.

Each country should draw up a list of systemically important institutions depending on the size, degree of interconnection with other financial institutions, the degree to which services they provide can be secured by substitutes. Moreover, the systemic potential is not constant over time and depends on the situation of the global financial system at the time of the crisis.

Additional capital may increase the marginal cost of lending and thus, tends to reduce the effect of multiplication of debts.

The Central Bank determines the size of the additional capital that the systemically important banks should hold, so as to limit excessive loans. Since the structure of the banking system and economic situation differ from one country to another, the mode of application of the rules of establishing additional capital may differ from country to country. For example, in Switzerland, in 2011, a Committee of experts had expected for Credit Suisse a rate of total capital per weighted assets by risk of 19%: 10% of the weighted assets by risk in ordinary shares and 9% in convertible contingent capital in ordinary shares at a predefined threshold of degradation of capitalization.

As regards the introduction of the obligation for financial institutions to hold extra cash, the amount will be determined by a procedure similar to that used in the case of additional capital, applying the two liquidity coefficients recommended by the Basel III[7].

The third option, on the issue of "too big to go bankrupt", is to create a legal framework that allows all financial intermediaries to give bankruptcy without creating a systemic financial instability. This option covers two types of proposals: requiring rehabilitation plans on the one hand, and the legal instruments which allow an orderly failure of financial groups, on the other hand, thus minimizing the systemic implications.

Of all macro-prudential instruments that are proposed is part of them also the use of stress tests – measure which aims verifying of the ability of banks to react to exogenous shocks — as well as taxation of financial system (tax incentives, tax on financial transactions, etc.). Objectives covered through these taxes are different, but in essence it is about banking ethics, in the sense of changing the behaviour of banks for the compliance with the principle of caution in banking.

3. Conclusions

The international financial crisis has demonstrated the need of the states and central banks to return to the financial sector. The problems that arose in the management of the current crisis go beyond the economy and affect the relationships that are established between the citizens and their representatives. Therefore, the Central Bank's success will depend a lot on the new methods of communication that they will adopt. At the same time, increasing the power of central banks means that they are responsible for their decisions.

In an internationalized and globalised financial world , macro-prudential policy should be designed and implemented at the international level, which implies a

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[7] Basel Committee on Banking Supervision, *Report and recommendations of the cross-border bank resolution group*, BIS, Basel, March, 2010

high level of coordination and convergence amoung countries.

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