FINANCIAL STABILITY - COORDINATE OF CONTEMPORARY MONETARY POLICY

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1. Introduction

All monetary authorities are facing with problems regarding immediate control and forecast issues of some interventions effects through monetary objectives and tools.

These problems become more complicated if we take into consideration savings through globalization phenomenon and intersection between monetary and financial market. It is unanimous accepted that economical stabilization mechanisms becomes impossible without using a proper mix of macroeconomic policies where monetary policy has a recognized place.

Specific objectives of monetary policy are different from one country to another, and in recent years all states, regardless their degree of development, faced numerous difficulties and economic uncertainties due to several new phenomena, such as:

-deteriorating financial position of domestic enterprises and the existence of a external debt crisis;

-the existence of some unfinished contradictions between economical stimulation and inflation;

- interdependencies of monetary and financial markets, having as background a instability of funds flows, especially capital movement;

-financial innovations that have created a series of new financial products, which involves great difficulties in defining the monetary aggregates and in establishing their influence on monetary policy

2. About inflation and price stability

In 1998, the Government Council announced this definition of price stability, as following: "price stability is an annual variation of the Harmonized Index of Consumer Prices (HICP) more than 2% and maintaining this price stability on the medium term". Later, in 2003, the same Council has made further clarifications on this definition by specifying that prices should vary by more than 2% annually but changes must be very close to that amount;

Inflation targeting aims the ensuring of Inflation targeting that will contribute to the achievement of a sustainable economical growth, macroeconomic stability and finally to ensure a high level of social welfare.

Following this judgment we find an excuse to the fact that "the main objective of the European System of Central Banks is to maintain price stability" as recorded in Establishing Treaty of the European Community.

Theoretically, there are several ideas about what means price stability. Realizing this concept is based on the following assumptions:

a. Price stability refers to the aggregate price level measured by indices (CPIs in the case of Romania, HICP in case of EU)

b. Price stability is achieved when the money keeps their value over time or their speed erosion of purchasing power is very slow;

c. The monetary stability concept overlaps the price stability concept

3. Financial stability

Unlike price stability, there is no universally valid definition of financial stability. According to Jaime Caruana (2005), "although we benefit from a well structured framework for discussing and applying monetary policy, our judgment concerning financial stability is less advanced". The approach of financial stability can be broadly made, if we refer to the situation in which the financial system can ensure the efficient allocation of savings towards investment opportunities and can face shocks without major perturbations or, in restricted sense, specific to the banking system, if we refer to the situation characterized by the absence of banking collapse and by the existence of a certain stability level of the assets' prices, including the interest rates. Central banks are demonstrated to hold an important role in ensuring financial stability, although there have not been established patterns which would define the realization of this process, and in its analysis, economics uses intuition.

Both approaches involve an active role of monetary politics, but the relative importance associated to it is different. The first of the above-mentioned definitions, which presents the general functioning of the financial system, suggests that the prudential surveillance occupies the main role in the promotion of financial stability; the monetary policy is important from the perspective of the efficient allocation of resources in the way they contribute to the price stability. BCE and Eurosystem systematically monitories the cyclical and structural evolutions of the banking sector of euro/EU area, as well as of other financial sectors. The purpose of this activity is to evaluate the possible vulnerabilities of the financial sector and its resistance to possible shocks.

The evaluation is made in collaboration with the surveillance agencies and national central banks in the EU, which have representatives in the banking surveillance Committee of SEBC. Inside of the BCE, the monitoring of financial stability needs the significant implication of more departments (Financial stability - as a coordinating department, Economy, Operations, Foreign and European Relations and Systems of payment). The result of this action is annually published, for example, in the reports named *EU banking sector stability, Structural analysis of the EU banking sector* and in the annual reports of BCE.

On the other hand, if we define financial stability as being "the smooth" trajectory of interests' rates, according to the second definition, monetary policy has a more important role, and the maneuver space concerning its instrument use (the monetary policy interest rate) may be the object of a limitation – thus, we could assist a conflict between price and financial stability.

Practically, the level of the increase of monetary mass, that of interest rate and the exchange currency may independently evolve, but are difficult to administrate at the same time. They are permanently involved in economy mechanisms, and the effects may be transitory or definitive, these effects depending on the intervention degree and its efficacy, as well as by the influence of the anticipation of different participants in economy.

The conflict between the growth of monetary mass and the level of the interest rate is a classic conflict also demonstrated in the modal IS-LM, so that the effects of the interest rate variation on monetary mass in manifested according to the period of time taken into consideration, and that is:

- *on short-term*, the fluctuation of the interest rates allows arbitrary actions between certificates and currency, since a growth of interest accelerates the growth of monetary mass, and a decrease slows it down. In short, the growth of interests stimulates the speculative demand of currency, while the decrease of interests diminishes this demand. This effect does not last forever and when interests stabilize themselves at a certain level, the anticipations which lay at the basis of speculative demand of currency, stabilize in their turn and the arbitrary actions stop. The transitory effect of the variation of the interest rate disappears under these conditions.

- *on medium term,* an increase of the interest slows the increase of the monetary mass and the other way round. Thus, the level of the interest rate affects the demand of currency for transactions, but the effect is permanent.

In a functional economy, the reverse sense of variations of the monetary mass and of the interest rates doesn't reflect a conflict of objectives. But, the transitory effect of the interest variations can hide its permanent effects. In case of incoherence in the behavior of the monetary authorities, intern disagreements by which it is settled on the one hand the increase of the monetary mass, and on the other hand a certain level of the interest rate. In this case, the conflict cannot end unless one of the two objectives or both of them are modified directly or hidden at the same time.

4. How capital inputs influence price stability and financial stability

The capital inputs are mainly determined by the liberalization of the capital account and by the high interest differential. The greatest advantages are given by the banking sector. The presence of foreign operators on the banking market determines a more stable financial environment and the improvement of the capacity to manage risks. At the same time, the rapid expansion of the credit may exceed the capacity of the banks to evaluate risks, thus leading to the increase of informational asymmetry which may result in a greater non-reimbursement rate. At the macroeconomic level, the rapid expansion of the credit stimulates the aggregated request, thus generating inflationist pressures and contributing to the accentuation of the external disequilibria. If the inflationist pressures have been generally successfully counteracted by the monetary policy in all the regional countries, on the other hand, the external disequilibria have significantly increased in the Baltic States, Bulgaria and Romania, countries which have registered the most rapid increase in credit in the last five years. In spite of all these, the central banks have difficulties in trying to restrict the credit expansion, both because of the fact that the moderation of the increase of the credit in national currency throughout a restrictive monetary policy may lead to its replacement with the foreign currency loans, and because of the fact that the administrative measures meant to limit the exposure capacity of the banks may determine the externalization of their exposure towards the "mother" banks.

The large current account deficits are dangerous because they are associated with a greater risk of producing an abrupt adjustment of the exchange rate and the high volatility of the exchange rate has major implications in the monetary and macroeconomic stability, in general.

Table no. 1A Prudent indicators

	non-performing credits/total of credits		the capital adequacy rate	
	2002	2006	2002	2006
Bulgaria	2,6	2,2	25,2	14,5
Croația	10,2	5,2	17,4	13,6
Republica Cehă	8,1	4,1	14,2	11,4
Ungaria	2,9	2,5	13,0	11,3
Polonia	21,1	9,4	13,8	14,0
România	1,1	2,8	25,0	18,1
Slovacia	7,9	3,7	21,3	13,0
Slovenia	3,9	2,5	11,9	11,1

The evaluation of the sustainability of current account deficits of the countries from Central and Eastern Europe is difficult, while the presence of the external disequilibria is absolutely natural in the case of countries which find themselves amidst the process of real convergence.

Despite all, there is the possibility for the excessive external deficits registered by some countries to continue generating risks over the macroeconomic stability.

Regarding the risks over the financial stability, the specialized literature confirms the fact that the accelerated expansion of the credit is one of the warnings regarding the appearance of financial turbulences but without leading to the materialization of these crises. The standard warning thresholds of the specialists, as well as the annual increase rhythm of the financial brokering with more than 5 percentage points from the GDP over a period of 5 years (Demirgüç-Kunt and Detragiache, 1997), beyond which the probability of generating a crisis increases significantly, have been exceeded by the evolutions registered in Bulgaria, Croatia, the Baltic States and Slovenia.

Table no. 1B Prudent indicators

	ROE		ROA	
	2002	2006	2002	2006
Bulgaria	14,9	24,4	2,1	2,2
Croația	13,7	13,0	1,6	1,5
Republica Cehă	27,4	19,4	1,2	1,2
Ungaria	19,8	29,0	1,4	1,9
Polonia	5,5	22,2	0,5	2,1
România	18,3	10,2	2,6	1,3
Slovacia	11,5	16,6	1,2	1,3
Slovenia	12,6	15,1	1,1	1,3

At first sight, the banking prudence indicators from the countries in Central and Eastern Europe, such as the capital adequacy rates and the non-performing credits weight of the total loans have maintained at comfortable levels and, regarding the second situation they even improved in the last years. However one must bear in mind the high volume of new credits which may artificially decrease the non-performing credits weight and thus mask the quality problems of the credit portfolio.

5. The relation between price stability and financial stability: Romania's situation

Romania's economy shows "clear signs" of overheating and estimated GDP growth for 2008 and 2009 is" somewhat optimistic"

In the Notice of the EU Council regarding the updated convergence programme of Romania for the period 2007-2010 is stated that "Romania has registered a strong economical growth, meaning 6.5% in average annually between 2003 and 2006.

However, its very performing economy gives very clear signs of overheating, presenting a high external deficit and still growing (estimated at nearly 13% of GDP in 2007) and a reduction in financing from FDI (foreign direct investment), despite the high investments other than those relating to privatizations, but still attenuated due to higher proportions of capital's contributions on medium and long term, according to information available at present for 2007 ", it says in the opinion of the Council.

The deficit of employment, still high, strong wages growth and fast development of credits are other signs of overheating. EU document also shows that the magnitude and quick worsening of the external imbalance are alarming, as it proves a trend of depreciation of the leu since the middle of 2007, in the context of a general reassessment of the risks on international financial markets.

Also, the programme forecasts regarding inflation seems also to be very pessimistic. "Strong inflationary pressure due to wage growth (including the salaries of public functions), quickly growth of international prices of foodstuffs and consumer goods, as well as the lower exchange rate (after a long period of appreciation) suggest a more pronounced slowdown of the disinflation process. Thus, it is estimated that the inflation differential (HICP) against EU-27 will stabilize or will not be reduced only slightly during the analyzed period.

Generally, there is the possibility that the combination of policies set in the program will not determine the progress towards nominal convergence, it says in the evaluation of the EU Council.

It is unacceptable to ensure price stability, the most important objective of central banks, sacrificing financial stability or allowing an excessive external imbalance. “Between a quick disinflation, but unsupported, and a stable macroeconomic and financial consistency, it is wise to choose the second variant. In this way we will get for sure to the price stability "said Isarescu (2008) the Governor of National Bank of Romania. Central Bank estimated recently, an inflation of eight per cent to end of the first quarter of 2008, respectively 3.8 percent for the full year 2008. Isarescu has given assurance that, after the first quarter of the year, will go on a downward trend as regards inflation, which will continue in the second half of the year.

"We do not forecast a major increase of the oil’s price on international markets, but no major decline," said Isarescu (2008), who mentioned among the causes of high inflation, registered starting at the end of the third quarter of last year, the continued effect of weak agricultural production in 2007, and the fact that we had a more pronounced depreciation of the national currency, a higher level of international oil prices and persistent excess demand.

"Current account deficit remains an important issue. In view of the central bank, correcting the external deficit has become anavoidable. And an increase of 1 per cent of the current account deficit is costly, because one of the criteria of that corrections is a plus of inflation”, has warned Isarescu (2008).

Annual inflation rate was at 6.57 percent at the end of last year, compared to 4.87 per cent in December 2006.

6. Conclusion

In this paper we tried to show that the theoretical argumentation according that the two types of stability sustain and mutually potentates on long-term, is against by the reality of the fact that starting with the inflation stabilization at low levels, it is creating a new economic environment in which monetary policy has a greater role, and using its tool (interest rate of monetary policy) may be subject to limitation - so we could see a conflict between price stability and financial stability.

Price stability contributes to:

- Price stability take into account limitation of price increasing or decreasing on the Single Market;
- Price stability allows to the companies and consumers to substantiate much better their consumption or investment decisions;
- Marketing resources will be allocated more efficiently (lower risks, higher productivity);
- Thus, price stability increases the productive capacity of the European economy;
- Price stability makes the risk premium included in the interest rate to be very low, which significantly decreases the cost of financing;
- The absence of a higher inflation rate makes investment in real assets (stocks of goods) to be much lower, investments in real assets are not the best investment decision;
- Price stability decrease the twisted effect on taxes and social contributions;
- Price stability decrease demand for cash on the market;
- Price stability decreases the differential redistribution of income and wealth in the economy.

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