MONETARY POLICY WHERE TO?

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1. Introduction

On today's background of economic and financial globalization emerges a new concept, different from the one which characterized the ’80s and gave priority to the fight against inflation. It aims financial stability, in addition to monetary stability.

In the years 1990-2000 the macroeconomic conditions were characterized by a low and stable inflation, but in background of the outbreak of the global economic and financial crisis the inflation volatility accentuated. The period 1990-2000 was considered by B. Bernanke as the period of "the great moderation" [1] but monetary policy was not the only determinant of the low inflation, the real and structural factors of economy (overproduction, competition, markets dominated by buyers) also had an important role in this matter. This period had repercussions on the behavior of economic agents and the stability of the currency of the years 1990-2000 was unfavorable to the financial stability. It follows that monetary stability is not always a necessary and sufficient condition for ensuring financial stability. The recent crisis through which the global economy passes shows that financial stability can no longer be regarded as a secondary objective. In this context it is necessary to modify the operational framework of central banks, modification which refers to both objectives and instruments. Central banks should consider financial stability a priority objective alongside economic growth and labor employment without sacrificing monetary stability.

Tinbergen[2] by the rule that bears his name suggested that monetary authorities should use a wider range of tools (dynamic provisioning, pro-cyclical capital requirements, minimum reserves, selective refinancing). It is important that central banks cooperate closely between themselves and with the authorities of prudential supervision[3]. This new collaboration could be the missing link between the monetary policy and the micro-prudential supervision of banks.

2. The implications of the crisis on the monetary policy

The assumption from which the central banks started when they substantiated their monetary policy strategies was that monetary stability leads to financial stability and both of them lead to economic growth are. After the crisis was triggered, this assumption was dismantled by showing that the monetary stabilization can lead to the emergence of speculative bubbles and financial imbalances. The countries with emerging economies tried to achieve also the stability of the exchange rates claiming that they did not follow a precise target in connection with these and they were concerned about the exchange rates only to the extent that they

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[1] Bernanke, B., The great moderation, speech in 2004 (www.federalreserve.gov).

[2] Tinbergen, J., On the Theory of Economic Policy, Amsterdam, North-Holland, 1952.

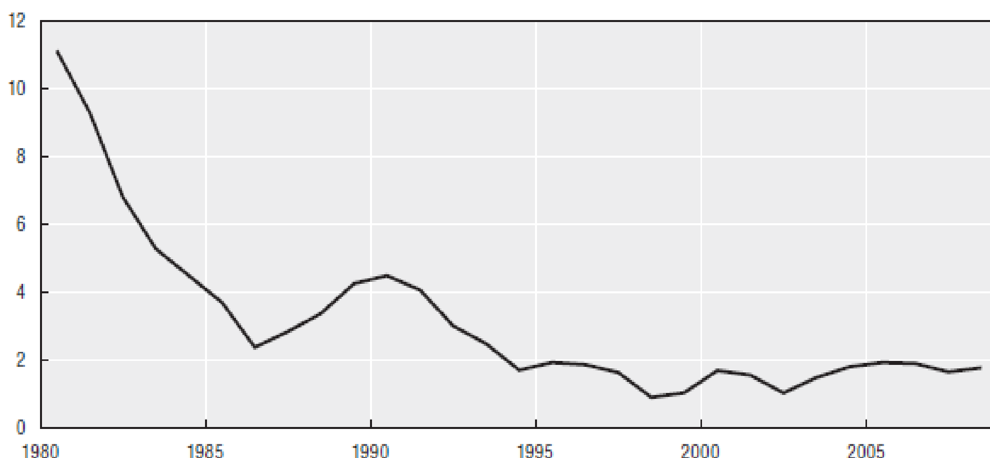
[3] Larosiere, J., The High Level Group of Supervision in the EU, Report, Brussels, 2009.

influence inflation. In reality, however, they paid on the exchange rates much more attention than it was justified by the influence on inflation.

We consider it appropriate an overview of the situation prior to the crisis in terms of the evolution of inflation. We present below a parallel between the inflation **in the G7 countries** to the level of January 2011 in Figure 1 and Figure 2 respectively, and the situation **in Romania**, in Figure 3.

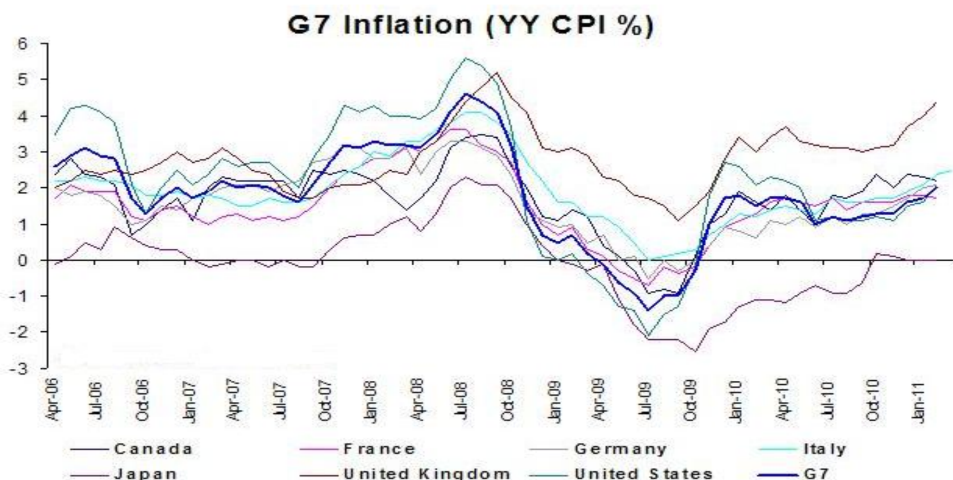
In G7 countries the situation is as follows:

Figure 1. The evolution of inflation in G7 countries during the period 1980-2005



Source: Pain, N., Koske, I., Sollie, M., *Globalization and OECD Consumer price inflation,* OECD Economic Studies, no. 44, 1, 2008, page 3.

Figure 2. The evolution of inflation in G7 countries during the period 2006-2011



Source: www.econgrapher.com

Of the G7 Nations, Canada has adopted the strategy of direct inflation targeting in 1991, having at the moment of the adoption an inflation rate of 6.9%, and currently a target of 2 +/-1%. United Kingdom adopted the strategy in 1992 with an inflation rate of 4%, and currently has a target of 2%. The Bank of Japan

does not present any numerical target for inflation or any index of monetary conditions. France, Germany and Italy are part of the euro zone, having an inflation target between 0-2%. The Federal Reserve has set a target of inflation rate of 2%.

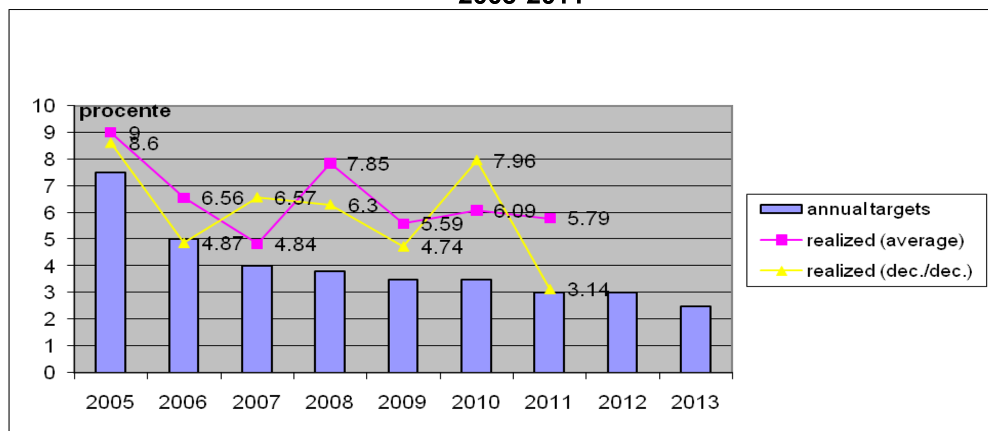
The period between the late '80s and up to the crisis of 2007 was characterized by a low and stable inflation (approximately 2%). The monetary policy taken by the main central banks around the world has not been the only factor which has led to the low inflation in that period, thus validating Friedman's allegation that "inflation is not always and everywhere a monetary phenomenon". Another extremely important factor was the credibility proven by the central banks in the fight against inflation.

As it results from the data presented above inflation has been reduced from a level of 11% in 1980 to almost 2% in the mid '80s. In the period between the late '80s and early '90s the inflation was between 4% to 6%, and since the mid '90s and up to the triggering of the crisis the inflation remained around 2%.

Since the triggering of the crisis the inflation has seen a greater volatility only in 2008, with the peak of the financial crisis, but in the next period it was stabilized at the level before the crisis. This invalidates the hypothesis according to which monetary stability leads to financial stability. Although the monetary stability was achieved in the countries analyzed, the same thing cannot be said about the financial stability, as the effects and the magnitude of the crisis was unprecedented. The international financial crisis has led to a rise in the cost of capital, a lack of confidence in the financial system, the decrease in the global GDP, declining of wealth, bankruptcies on the international market, etc.

In Romania the evolution of inflation are presented as it follows:

Figure 3. The evolution of inflation in Romania during the period 2005-2011



Source: NBR, INS

In contradistinction to the G7 countries, the evolution of inflation in Romania has seen a high volatility. Romania adopted the strategy of direct inflation targeting in 2005 when inflation recorded a level of 9.3%, having now a target of 3 +/-1%. The data presented above show that in none of the years analyzed the rate of inflation has not been within the range proposed by the NBR, but it can be seen a downtrend from one year to the next up to a

minimum of 3.14% by the end of 2011. The exception is the year 2010 when the crisis reached its peak in our country.

The impact of the implementation of the process of fiscal consolidation and of structural reforms in accordance with the objectives of the economic program set out in the framework of the agreements with the EU, the IMF and the World Bank is favorable to the context of implementation of the monetary policy. Thus the process of disinflation has resumed and has sped up down to level 3.14% located in the immediate vicinity of the center point of the inflation target (3% ±1 percentage point).

At the origin of unfulfillment of the inflation target proposed by the NBR lies the accelerate growth of food raw materials prices and oil prices on the international market, low elasticity of the demand and structural failures of the local agricultural market. The global crisis has affected our country too, with direct effects in the decline in exports and imports, as Romanian exports are strongly dependent on the euro zone, in the reduction of the flow of foreign capital, the depreciation and volatility of the national currency. In terms of indirect effects we can talk about a halt in crediting, heavily affected by the cost of funding and by the increase of uncertainty, the rise of unemployment, the decline in consumption, the decline in budget revenues, the postponing of investments. Thus, Romania continues to be avoided by foreign investors, and the funds raised continue to be used for consumption and not for stimulation of investment.

As said before, during the period of "the moderation" the monetary stability was not exclusively determined by the monetary policy taken by the central banks, and neither by the structural factors related to the globalization of trade and the growth of the major emerging economies (and here we're speaking about China, India, Brazil), but only by the result of the intertwining of these two categories of factors.

The monetary stability that followed in the period 1990-2000 was the result of three categories of factors: an increased effectiveness of the monetary policy in fighting inflation, a concurrence of favorable circumstances and structural factors linked to globalization and to the development of big countries. The application of the anti-inflationary monetary policy coincided with the reforms on the labor market and with new ways of establishing salaries. Countries such as Germany and France abandoned the indexation of salaries according to inflation and the productivity gains derived from the application of new technologies were the main factors of the deflation. In this way, the monetary policy and the wage policy have disadvantaged the rise of wages which has softened the inflationary "prices-wages" spiral. Another factor with important role in reducing the inflation has been the liberalization of international commercial and financial transactions and the process of globalization, so that price formation mechanism has changed from a price formation mode dominated by sellers to one dominated by buyers[4].

The economists' current opinion is that the financial stability of the '90s could not be performed as the banks and the authorities responsible for drawing up the economic policy and the prudential settlement were stimulated to assume increased risks. By anchoring the expectations of the businesses at a low level of inflation, the central banks contributed to the emergence of an exaggerated sense of safety and trust which lead to assuming increased risks and contracting of excessive debts. "The paradox of silence" mentioned in the '90s by Minsky[5] emphasized the fact that exactly at the time when things are going

[4] Aglieta, M., Berrebi, L., Cohen, A., *Banques centrales et globalisation,* Groupama Expertises, 7, 2009.
[5] Minsky, H., *Cum stabilizăm o economie instabilă,* Editura Publica, Bucureşti, 2011.

well debt crisis arises, as businesses benefit from the economic growth and the low interest rates, borrowing more than necessary and in a contagious manner. In a situation where the interests increase as a result of the tightening of the monetary policy, the debts that once seemed bearable become unsustainable.

Studies of Borio and White[6] in terms of credibility of the central banks showed that when the Central Bank is credible the inflation expectations are anchored on the official long-term objective, making that the abundant liquidity does not turn immediately into inflation. We can conclude that the monetary stability affects the financial stability, and vice versa. There are cases when the monetary stability favor the financial stability, as there are cases when the monetary stability disfavor the financial stability. In the case of a positive shock of demand, of an inflationary shock, the necessary measure in order to ensure monetary stability and financial stability is the increase of the interest rate. However, sometimes, ensuring monetary stability may require higher interest rates and increasing the cost of credit increases financial instability. To restore the financial stability, injections of liquidity are required but in this way the monetary stability is hindered.

Monetary stability and financial stability have been strictly separated during the "great moderation", this principle of separation leading to the conclusion that central banks should not react to financial tensions unless the prices stability is threatened.

Rudebush[7] studied the model according to which when monetary stability is provided, financial instability reabsorbs by itself. He came to the conclusion that this model is only partially in balance, so that, for the prices of financial assets to influence the conduct of the monetary policy, the following conditions are necessary:

- the existence of a speculative bubble.
- the breaking of this bubble may have important macroeconomic consequences;
- the effects of an increase in the interest rate on the bubble are certain and little expensive.

Monetary stability in the 2000s has favored the financial instability that has caused an economic and social crisis of huge proportions. Central banks had to deal with many forms of financial and monetary instability, and the principle of separation of monetary stability from financial stability was no longer required. Some economists believe that the monetary stability can be an objective and the financial stability a task to which central banks contribute without considering it a priority.

3. New challenges in the stabilization of the monetary policy

A challenge of the monetary policy that economists have analyzed is the issue of taking risks. They concluded that a low level of interest rates tempts banks to take greater risks. As a consequence to this issue, Borio's work [8] evidences a new transmission channel of the monetary policy (*Risk-Taking Channel*), a channel which has been underestimated before the triggering of the crisis but which has amplified its importance as a result of the financial innovations and of the development of non-banking financial brokerage and securitization. The conclusion from this work is that in addition to the traditional

[6] Borio, C., White, W., *Whither Monetary and Financial Stability? The implications of Evolving Policy Regimes*, BIS Working Papers, 147, 2003.

[7] Rudebush, G., *Monetary Policy Inertia: Fact or Fiction?*, Working Papers in Applied Economic Theory, Federal Reserve Bank of San Francisco, 19, 2005.

[8] Borio, C., Zhu, H., *Capital Regulation, Risk-Taking and Monetary Policy: A Missing Link in the Transmission Mechanism?,* Bank for International Settlements, Working Papers no. 268, December 2008

transmission channels of the monetary policy (the interest rate channel and the loan channel) the risk-taking channel should also be included. However, to do this, banks would need to equip themselves with the tools likely to allow the identification of the financial imbalances which are about to occur. The risk-taking channel is the channel which confirms the close ties that exist between the monetary stability and the financial stability.

A second challenge in the stability of the monetary policy aims the situation of the monetary policy, the micro-prudential policy and the macro-prudential policy on the same level as limiting individual risk is no longer a sufficient condition to ensure the stability of the financial system. In order to be able to contribute to financial stability monetary policy should not be restricted to the control of inflation, but also to take into account also the growth of the credit and the evolution of the prices of financial assets. Either with regard to the prudential policy, the monetary policy should not be limited to the control of the individual risks but should tend towards the stability of the financial system as a whole. Supervision for a long time did not take into account the systemic risk, considering that limiting individual risk was a sufficient condition for ensuring the stability of the financial system. The main goal of micro-prudential and macro-prudential policies is to promote the resistance of the financial system so that it provides financial services tailored to the current needs of the economy as a whole.

Proposals to improve the prudential mechanism are different and they depend on the different financial systems in the United States and in Europe, as market brokerage is more extensive in the United States. In Europe the focus is on contra-cyclic regulations applied by the banks supervisory authorities, while in the United States the focus is on market measures capable to solve the problems that arise from moral hazard and from the size of the banks. Thus, as a consequence which results from the systemic risk, in Europe, the Basel III Agreement discusses the introduction of new requirements for own funds, the so-called systemic risk capital for limitation of leverage effect. The crisis has also highlighted the poor attention paid to liquidity risk, requiring the stimulation of banks to resort to longer term financing. Basel III Agreement also proposes measures to increase the level of solvency.

In order to complete the monetary policy and the action on bank liquidity it is recommended to adopt measures to supervise the settlement of the loan. The credit settlement can be achieved by setting the level of the "*loan to value*" coefficient, through the establishment of mandatory reserves related to credits in parallel with those related to deposits. In the euro zone, the mandatory reserves relating to credits are to be established, most likely as a progressive values according to the growth rate of the loans and to their destination. It is necessary to rethink the single monetary policy lead by the ECB in the euro zone since the crisis exposed a divergence in which the economies of the member countries evolved in the years 2009-2012.

There are also other macro-prudential tools, among which we mention the dynamic provisioning, the use of resistance tests and the taxation of the financial system.

In addition, also as a consequence of the crisis, it has also been imposed a reform of the institutions involved in the prudential regulation. There were established the European Systemic Risk Board - an authority in charge with macro-prudential supervision - and a European system of financial supervision, which brings together the European Banking Authority, the European Securities and Markets Authority, the European Insurance and

Occupational Pensions Authority - authorities in charge with microprudential supervision. The Financial Stability Board has been established so that macro-prudential supervision constitute the subject to global cooperation.

There also are arguments against expanding the role of the Central Bank in the prudential supervision as a conflict may occur between the monetary policy and the prudential policy. It is the situation in which a strong growth of the director interest, measure taken in order to limit inflation, complicates the financial situation of the businesses in debt, or in which the Central Bank injects liquidity causing inflation. In these examples, there is a conflict between the monetary stability and the financial stability.

A third challenge that seeks to stabilize the monetary policy aims the attempts to take some measures aimed at a better budgetary discipline (The Tax Pact), the coordination of policies to mitigate the macroeconomic imbalances (the six pack) and the creation of a Banking Union at the level of the EU Member States. With the launch of the idea of Banking Union, the European Mechanism for Stability would be able to directly capitalize banks at risk of insolvency, and here we may refer to the case of Spain. However, a Banking Union cannot operate without tax arrangements, which means common resources for intervention and sharing the burden. There are many controversies on whether all banks should fall under the new system of regulation and supervision, and Germany and France diverged on the subject.

Because of the adverse effects of the crisis of debts in the European Union there are attempts to establish this bank union from several considerations. The first is that between central banks there is no longer sufficient coordination, as the risks to which a country is subjected can affect the entire Monetary Union. So, a supervision of the entire banking system by a single institution would be required to consolidate confidence in the community block. Secondly, the new mechanism will be built around the European Central Bank, so that the monitoring of the European banking system would be a rigorous, high-quality and reliable process.

4. Conclusions

A major conclusion arisen from the lessons of the recent crisis aims to the rethinking the tasks of the Central Bank and the reconsideration of financial stability alongside the monetary stability because once the monetary stability is reached it doesn't mean that the financial stability is automatically reached too. It is also required a closer link between the Central Bank and the other supervisors and an increase in its exchange of information with all financial actors.

To the same extent, the success of the central banks will depend on the methods of management and communication that they will adopt. Another conclusion which emerges from the increase of the role and power of the central banks aims at taking responsibility for their decisions and the promotion of a culture of cooperation with all prudential and political authorities and with the representatives of the beneficiaries of financial services.

So the modalities of management of the crisis bring up issues that go far beyond pure economics and reach the relationships linking the citizens to their representatives in representative democracies. Preserving financial stability is a measure which is necessary and which must be recognized as such. The effervescence and dynamism of studies and proposals on macro-prudential matter seem to go in this direction and mark the return of the countries and the central banks to the control of the financial sector. Indeed, the common denominator of these macroprudential measures be is the recognition of failure of self

regulation and of failure of market discipline in finance. But this revival of the involvement of the countries in the supervision and control of finances is likely to face the conflicts of national interests. Globalized finances are in essence international, the macro-prudential policy must integrate itself in this dimension, which implies a high level of coordination and convergence between countries.

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