FINANCIAL SYSTEM AND MODERN MONETARY MECHANISM

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Abstract

This study determines the modern approaches to the implementation of monetary policy and regulation of financial systems. Set of measures to prevent and overcome the financial crisis is grounded taking into consideration different areas of research and the IMF (Poole W., 2010; Roger S., 2010).

New tasks of monetary policy in central banks are specified and they are intended to ensure the financial stability of the state (within the common financial policy).

The main directions of elaboration and implementation of new monetary policy mechanism, which is intended to ensure the effective solution of problems in macro prudential supervision and financial stability, are examined.

Keywords: Monetary policy, financial stability, macroprudential analysis, flexible inflation targeting, liquidity risk.

JEL Classification: E52, G15, G18.

Introduction

The financial system can be described as a combination of different mechanisms and relations, each of which is characterized by the specific features in the formation and usage of the financial resources and different role in social redistribution.

The presence of common features at the base of all financial relations does not exclude certain differences among them, which leads to the development of relatively specific areas of these relations in the framework of a single economic category of finance. In developed countries the financial system includes the following categories of financial relations:

- state budget system;
- extra-budgetary special state funds;
- public credit;
- private funds with different forms of ownerships;
- capital market.

Delimitation of the financial system into separate units is due to differences in the tasks and roles of each unit, as well as to methods of formation and distribution of centralized and decentralized funds of financial recourses. Mainly, the centralized budget funds are established by redistribution of a part of Gross National Product.

The important role played by the state in the field of economic and social development, leads to the necessity of centralization at its disposal of significant amount of financial resources.

Forms of their usage are budgetary and extra-budgetary funds, which are dictated by the state's needs in economic, political and social problems. Decentralized financial funds are formed from companies' income and savings.

Despite the separation of economic activities and relations, the financial system can be considered as a single mechanism, giving the fact that it rests on a unique base of accumulation and redistribution of the financial resources among the different parts of its system.

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Taking into account the instability of the world financial markets and national financial systems, the role of the monetary and credit policy pursued by the central banks increases essentially. It is caused by a sharp reduction of the financial cycle duration, high volatility of the markets which all, in turn, demand high level of efficiency and a good coordination of actions carried out by all subjects of the financial market in order to assess any situation and take a corresponding decision. However, as the practice has shown, traditional approaches do not always correspond to requirements of post crisis development of the world economy and need certain modernization or updating on the basis of transition to some new monetary conditions. The problem does not consist simply in working out some additional measures or new instruments of the monetary policy in order to counteract the crisis, but in the monetary policy substantiation that will be capable to warn about any appearance of any systemic financial crises or to neutralize their negative consequences in case of any need.

Description of the problem

The regulation of the financial system can be carried out by the public sector, but as well by the corporate self-regulation, too. Mechanism of state regulation of the financial system comprises a set of tools and methods with a financial impact on the national economy. By manipulation of its revenues and spending, addressing different economic priorities, the government can influence different economic processes. Among these tools and methods we can mention the following: taxes, budget expenditures, depreciation methods, forms of public credit, etc.

In the mechanism of state regulation are important both revenues and expenditures. The private capital formation is based on enterprises income. At its turn, the structure of the expenditure distribution changes the amount of the available financial resources of the companies, influencing the expansion of the economic activity at branch and territorial levels.

Government financial funds play a key role in ensuring certain rates of development of all sectors of the economy, the redistribution of financial resources between economic sectors and regions of the country, between the productive and non-productive areas, and between the forms of property, individual groups and segments of the population. Effective use of financial resources can be ensured by a proactive fiscal policy.

Corporate self-regulation is determined by the methods of constitution of private capital. These methods are selected and used by the business entities within the given state law. Self-regulation is used for internal redistribution of own resources or for attraction of capital from financial market.

Self-regulation is provided by the market mechanism. Through the price setting system the impulses are transmitted from consumption to production, setting the framework of the Gross National Product distribution and redistribution. The monopoly and the degree of market development limit the freedom of movement of economic resources, in this case the equilibrium being very difficult to achieve.

Methodology and data sources

The combination of centralized and market-based regulation of the financial system takes account both of private and government interests. But, the absolute priority belongs to the state, which at his own can make certain decisions. At the same time, the government forms the legal framework within which the enterprise must activate. Nevertheless, as evidenced the recent financial crises, the government regulation is not always perfect. Because of this followed a period of large reforms in the regulation systems after the financial shock, both at regional and global levels. The main lessons of the global financial crisis and mentioned by the majority of scientists and experts are the following.

The first: The banking sector served as the source of the crisis, because it has become a poorly regulated part of the overall financial system due to the fact that it accumulated considerable volumes of individual risks. Based on the experience of the financial crises of the past decades, the least regulated sectors, activities or even individual financial instruments became the main sources of these crises. Therefore the next financial crisis should be expected in the least controlled sector of the financial system, group of financial products or monetary institutions. Besides this, the theory of 'risk dispersion', which has been carried out by many financiers for many years who believed that it is possible to avoid any system shocks by hedging individual risks, has not been confirmed.

The second: The methodology and instruments used for system risks and crises forecasting have proven to be insufficiently developed or in some cases even were not applied at all. In many countries regulatory systems have not considered the real problems of the financial sector development, and the regulators themselves failed to anticipate crises events and to respond instantly to any banking panics and financial shocks. Besides this it has appeared that in many countries there is no any uniform approach (and corresponding mechanisms) ready to form and realize the state financial policy; thus, it all has complicated the overall process of crisis consequences overcoming.

The third: Crisis consequences were eliminated based on the use of the monetary policy instruments carried out by central banks, as well as on active actions taken by the governments that had to use considerable amounts of budgetary funds. However, the practice has shown that this method appeared to be less efficient for many countries, especially from the social and economic point of view; it has led to social and economic crises and to the strengthening of social tension.

The fourth: The economic model based on advanced development of the financial sector being compared to the real sector of the economy, has once again aggravated the contradiction between the production of real cost and the movement of its monetary and financial forms that promoted the strengthening of inflationary processes and macroeconomic instability.

However, if in an estimation of consequences and lessons of the crisis experts were more unanimous, then in justification of actions intended for prevention and overcome of financial crises there was a huge variation in their opinions. Generalization of all the proposed measures can identify several areas, some of which, in our opinion, are not particularly new, and the use of the others can unlikely be sufficiently effective in the future.

1. The strengthening of the state regulation and supervision of banking activity, financial markets, financial institutions and even financial products is offered traditionally. Although it is a really important task, in our opinion, the addenda to the Agreements on capital (Basel III) offered by Basel Committee on Banking Supervision do not introduce any cardinal changes either in methodology, or in the whole process of regulation and supervision. They can be considered only as cosmetic additions that reflect the current situation; and the extension in time of all innovations implementation (until 2019) only confirms this.

2. The active involvement of governments to address the problems of the financial sector by increasing budget expenditures (including the maintenance of solvency and liquidity of the institutions from the financial sector and the realization of capital expenditures in specific areas or sectors of the national economy).

3. The request from politicians and the public addressed to central banks with the aim to pursue a policy directed on stimulation of the real sector development, the development of separate branches or even certain corporations. In some cases, there were proposals to increase the share of state ownership in the structure of the financial sector.

4. The introduction of macro-prudential analysis systems in the central banks or independent mega-regulators in order to monitor the macroeconomic situation, identify imbalances and develop measures to prevent the systemic risks. Although this approach is also not essentially new, since prior to the crisis most of the central banks around the world had units in their organizational structure whose main responsibility was to ensure financial stability, it deserves attention as a prospective direction towards the extension of financial analysis methodology.

5. The complex of proposals having global character: the world monetary system change, the creation of new world and regional financial institutions and supranational regulatory and supervision bodies, the expansion of the regional currencies spectrum, the change of principles referring to the national currencies issue, return to the 'gold standard' and many other.

Most clearly the new tasks of monetary policy and principles of financial markets regulation for the post-crisis period were defined by IMF. Analyzing the impact of the global financial crisis, IMF experts have identified the following three priorities for the central banks' policy, which are designed to promote financial stability:

- To use the results of macro-prudential analysis and to expand the authority of the central banks as main regulators of the financial market in the process of the monetary policy elaboration and implementation;

- To provide the priority to price stability measures as the primary objective of the monetary policy;

- To improve the liquidity management within the banking system by increasing the flexibility of procedures used by the central banks, as well as to increase the activity control and regulation of the financial institutions and markets that are potential recipients of any liquidity support.

Appreciating the IMF proposals positively, it is necessary to notice anyway that, despite the high level of their overall theoretical development of the monetary theory and their huge practical experience in the monetary policy implementation, there is no any uniform recipe which is equally suitable for all countries and which is capable to eliminate any consequences and moreover to foresee any major systemic financial crises. Despite the generality of some problems, the ways to overcome crisis and to ensure the post-crisis development of national financial systems can be different in some countries.

Today the general approach to elaborate and implement the monetary and credit policy of the central banks is to direct the attention of the central banks to the maintenance of national monetary units stability and realization of monetary regimes which will be based on the maintenance of price stability. According to experts, the maintenance of the overall price level stability in economy should become a main objective for any central bank; thus this approach will offer the possibility to conduct an anti-cyclic monetary and credit policy as well as to ensure a high level of employment [5; 6; 7].

At present a complete revision of the monetary and credit policy objectives and goals occurs in many countries. There is a function of financial and macroeconomic stability maintenance included in the mandate of the central banks which requires expansion of the monetary and credit policy instruments, the broadening of the central bank's powers in order to fulfill this function, as well as the strengthening of the central bank's operational and institutional independence. Today the dominant approach is the one that declares the main objective of the central bank's monetary policy as being the maintenance of the national monetary unit stability, which should include both the stability of exchange rates and prices; the rest of the central bank's objectives should be subordinated to this one being classified by the degree of their importance.

In particular, the achievement of the price stability should contribute to the financial and macroeconomic stability within the framework of the state uniform financial policy realization.

In practice, during the last years, especially during the world crisis period, the central banks of many countries have constantly been facing the necessity to find a reasonable compromise when choosing the corresponding instruments for price and financial stability maintenance. The point is that the central banks do not have special instruments for a direct impact on the level of the financial stability, for which the source of imbalance is often out of any possible direct influence of the central bank. Besides, there are some discussions concerning any possibility for the central bank to prevent any sharp changes in assets price (for example, in real estate and securities prices) via the central bank's active interest rates adjustment policy. There is still also another debatable question on the possibility to solve the conflict between the maintenance of financial stability and the guarantee of price stability. In our opinion, these and some other problems should be solved within the framework of the general realization of the state financial policy strategy, as well as within the framework of the new monetary regime carried out by the central bank.

At present the most effective monetary regime that promotes the price stability is the one dedicated to the inflation targeting. This regime has become a preferable basis of the monetary and credit policy realization for many central banks; although in its classical form it has been already applied in 26 countries only. Some central banks (in particular ECB, FRS, Bank of Japan, Swiss National Bank) have not passed on to a practical realization of this monetary regime completely yet; they use some of its individual elements only. According to the research done by IMF, within the framework of this regime in developed countries the inflation is maintained at the target level of 1-3 %, and in developing countries - at the level of 3-6 % [8, p. 46-49].

The inflation targeting, being one of effective ways for price stability maintenance and for inflationary expectations fixation, is of great importance for the countries with emerging markets. Since 2000's these countries has been consistently passing to use individual elements of the inflation targeting regime, or to its more flexible alternative, because there are multiple objectives standing before the central banks which cannot be achieved in long-term outlook in case if the inflation is maintained within a certain range. Besides that, the presence of the rate of inflation over 7-8 % significantly inhibits the transition to this new monetary regime. Nevertheless, since 2010 the National bank of Moldova (NBM) has practically gone to the monetary mode based on the inflation targeting. The Strategy of monetary policy of the National Bank of Moldova for 2010-2012 states that to achieve and maintain the price stability the NBM will establish the inflation target measured by the consumer price index published by the National Bureau of Statistics, at the level of 5.0 % for the year 2010 with the possible deviation of ± 1.0 percentage points [3].

According to the standard approach the basic elements of the inflation targeting are:

1) The determination of the price stability done by the central bank as the primary goal of the monetary policy and the establishment of accurate quantitative indicators of inflation;

2) The high level of operational independence of the central bank;

3) The central bank accountability for the achievement of the established target indicators of inflation;

4) To carry out the monetary policy based on the assessment of the inflationary pressure and inflationary expectations.

Thus, the monetary regime, based on inflation targeting, is considered mainly as a function or a task of the central bank, as well as a component part of its monetary policy. Hence, the list of the instruments used to achieve the objectives of this regime is limited to the instruments of the monetary policy; this fact creates natural barriers in possibilities of the effective use of this regime in order to achieve other objectives established for the central bank.

In recent years within the limits of the inflation targeting regime and taking into consideration the overall slowdown in economic growth in developed countries, the central banks conducted a soft monetary and credit policy in order to stimulate the economy, which resulted in a gradual reduction of the basic interest rate. This has contributed to increased demand for money that has led to an unjustified growth in lending. In turn, the financial and credit institutions have reduced their requirements towards the size and quality of collateral, have eased their credit conditions, and have expanded the circle of potential borrowers. It was supposed that such measures will increase the volume of lending and stimulate the economic growth.

It should also be noted that due to lack of effectiveness of the inflation targeting regime to adequately respond to the manifestations of the financial crisis, to take into account the sharp fluctuations of the exchange rate and the value of financial assets due to non-monetary factors, as well as to reduce the negative impacts and promote financial stability, the central banks of several countries began to revise their attitude towards the inflation targeting regime. Thus, the crisis has called into question the effectiveness of inflation targeting as the sustainability framework for a monetary policy. This is due to the fact that, despite the strong economic growth and low inflation in the pre-crisis period, many developed countries have failed to provide a sound basis for financial stability and to reduce the tension on the financial markets. Once again the practice has questioned the thesis of the possibility to achieve both high economic growth and stability of the financial and economic systems simultaneously.

Therefore, in recent years in many countries there is a transition to a flexible targeting regime, in which the main effort of the central banks was concentrated on achieving the inflation target in the medium term of 2-3 years. This allows the central banks to combine their primary objective with the other tasks, particularly in the post-crisis period a special attention is paid to ensure macroeconomic and financial stability.

That is why the main tool of the monetary policy under the inflation targeting regime is still the interest rate which today should be considered not as the tool of the monetary policy only, but as one of the key macroeconomic indicators. However, according to many experts, the use of short-term instruments cannot provide long-term and sustainable management and moreover the achievement of any long-term goals. If short-term instruments of the monetary policy can be successfully used to manage the current opportunities of financial markets and inflationary expectations, then in order to prevent imbalances in the financial system there is a need of instruments that can ensure not only their stable use, but also their long-lasting action, which should also include the system of the state regulation.

Results obtained

Lessons from the crisis suggest that the practice has delivered more than a challenge for the central banks to not only ensure the price stability, but also to achieve the overall stability of the financial system as part of the overall state financial policy. Firstly, it means that the monetary policy emphasis should be shifted from one-sided consideration of the value of money in terms of its purchasing power to an integrated assessment based on the value of money as capital. That is why the modern monetary policy of the central banks as part of a flexible inflation targeting regime, in our opinion, should be based on a combination of the effective interest rate policy with the advanced approach towards targeting of monetary aggregates, with a focus on optimizing their structure.

Secondly, the implementation of the new monetary regime must take into account the need for coordination of monetary and fiscal policy under a single state financial policy. This is due to the fact that in emerging markets the interaction between external factors and internal economic processes carries out a complex and often ambiguous nature, making it difficult to perform any macro-prudential analysis. In addition, there is a domination of market-based incentives over the regulatory constraints, which is specific for modern financial systems [4, p.7-15]. Therefore, in our view, within the framework of the macro-prudential analysis the analysis of systemic risks must be integrated with the objectives of both price and financial stability.

Thus, the foundation of the new monetary policy regime should be based on goals of price and financial stability as well as on the possibility to influence the macroeconomic stability through the implementation of monetary and credit policy within the framework of a uniform financial policy implementation carried out by the state. This is quite a difficult task, because the number of instruments used by the central bank is limited. If the central banks can use a set of specific instruments and "monetary rules" in order to promote their monetary and credit policy (M. Friedman, J. Taylor, L. Ball, A. Orphanides, the central banks of Canada, Norway, etc.), then in order to ensure the financial stability such rules are absent [2, p.784]. There is a need to use the same instruments to solve two or more tasks sometimes. However, this approach violates a so-called J. Tinbergen's rule, which stipulates that the number of targets must never exceed the reserve of available instruments. Consequently, in order to achieve multiple objectives there is a need in a greater number of instruments [1].

Given the current trends in development of the monetary policy, one of the techniques used by central banks to address these challenges should be a macro-prudential analysis. Its essence consists in the ongoing monitoring and complex analysis of relationships inside of the financial system, the interaction of the financial system with the real sector, the budgetary sector, as well of trends in global financial and commodity markets development in order to identify and prevent any systemic risks. As part of the macro-prudential analysis implementation, the financial stability is achieved by identification and reduction of systemic risks, by identification and prevention of imbalances in credit market, as well as by limitation of liquidity and market risks.

The crisis also demonstrated the imperfection of methods used by the central banks to manage the liquidity of the banking system. Many central banks have had to expand the list of securities (in particular - to include corporate bonds), which are used as collateral for refinancing loans. Besides this, up to now it was thought that refinancing loans should preferably be short-term ones. However, due to the fact that during the crisis, many commercial banks did not manage to reimburse their loans to the central banks, as well as due to the fact that, in some cases, politicians required to offer lending of individual sectors of the national economy, the practice has forced the central banks to offer refinancing for longer periods using the so-called stabilization loans. And, according to the ECB declarations, even the ECB will probably continue to implement programs aimed to ensure the stability of the banking system on the basis of long-term refinancing operations with the maturity of up to 6 or even 12 months.

It should be mentioned that one of the main instruments of liquidity management remains the mechanism of required reserves, which in recent years in our literature has been criticized groundlessly. The availability of required reserves and the presence of flexible mechanisms of their use is a key factor for monetary aggregates formation, which contributes to the prevention of liquidity shocks.

The crisis has shown that the practice of banking regulation used within the last period of time and based on micro-prudential approach and on consideration of the need to reduce individual risks (even with the application of the Basel II standards) was unable to prevent the occurrence of systemic risks. This suggests that the "spread of risks" theory that prevailed in the 1990-2000's was not confirmed in practice. The use of hedging instruments for individual risks does not allow hedging the aggregated risk of the financial system; sometimes it even supports the aggregated risk concentration stimulating therefore the appearance of global imbalances. As it was mentioned by Mr. A. Simanovsky, in correspondence with the concept of micro-prudential regulation the attention of supervisory bodies was directed at the individual risks prevention of certain financial institutions. However, contrary to theoretical expectations, the attempt to reduce individual risks has led to their accumulation, which stimulated the appearance of systemic risks [4, p.7-15].

Conclusions

The solution of tasks for ensuring the price and financial stability, which, as noted by some scientists, sometimes enters in conflict with each other, lies on a different plane, at least for countries with emerging markets. The main directions for development and implementation of the new monetary mechanism, which should provide an effective solution for problems with price and financial stability, should be the following:

1. The development and implementation of a clear long-term economic policy focused on the innovative development of the national economy;

2. The recognition of the need to develop and implement a unified state financial policy, part of which should be the monetary policy of the central bank. At the same time, not reducing the role and level of the central bank’s independence in the whole process of its monetary policy formulation and implementation, the functions for a common financial policy development should be assigned to a specific government body, such as the Ministry of Economy or the Ministry of Finance;

3. The development of the coordination principles and mechanisms of the monetary, fiscal and debt policies should be established with a clear alignment of individual responsibilities for each public authority, as well as with precise terms and conditions of the measures that are going to be carried out;

4. The expansion of the range for the monetary and credit policy instruments, the development and implementation of the new monetary regime that takes account of the main development directions of both the monetary and credit policy of the central bank and the fiscal policy of the state;

5. The improvement of the institutional framework and the financial sector regulation instruments based on coordination of activities and strengthening the political, operational and financial independence of regulators and authorities responsible for the government financial policy formation.

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