MONETARY POLICY UNDER THE CONDITIONS OF THE GLOBAL FINANCIAL CRISIS

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Rezumat

Economiile moderne sunt caracterizate de crize financiare endemice, o bună funcționare a sistemelor financiare reclamând asigurarea depozitelor şi autoritatea reglatoare a băncii centrale.

Actuala criză economico-financiară are ca adevărată cauză creşterea prețurilor unor bunuri, precum cele alimentare, conjunctura economică globală, care a precedat actuala criză, caracterizându-se prin şocuri şi tensiuni financiare la nivel global, extinderea riscurilor reale referitoare la dezechilibrele economice şi financiare mondiale, care impun abordarea politică a crizei prin respectarea unor cerințe precum: implementarea, în întreaga lume, de răspunsuri coerente şi eficace ale polilitICilor economice şi monetare; considerarea ,ca prioritate principală, în țările afectate de criză, a restaurării funcționării piețelor; restabilirea rapidă a trendului creşterii economice, sectorul financiar accentuând creditul şi, îndeosebi, temperarea tulburărilor financiare.

Pentru a face față provocărilor viitoare ale crizei globale este necesară constituirea următoarelor linii de apărare: politica monetară; politica fiscală; intervenția directă. Într-o lume globalizată, unde crizele aparent separate pot rapid să disemineze la nivel global, răspunsul trebuie să fie global, coordonat, flexibil şi rapid.

Din perspectivă mondială, provocările crizei financiare globale pentru politica monetară pot fi abordate sub următoarele aspecte: provocări privind elaborarea şi aplicarea politicii monetare; impactul crizei globale asupra economiilor naționale; subminarea măsurilor de

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politică monetară, în lipsa unei coordonări adecvate şi fără proiectarea unei politici prudente.

Abstract

Modern economies are characterized by endemic financial crisis, a good performance of the financial systems requiring the guarantee of the deposits and the regulating authority of the central bank.

The current economic and financial crisis has as real causes the increase in the prices of certain goods, such as food products, the global economic conjuncture, which preceded the crisis, characterized by global financial shocks and tensions.

The propagation of real risks concerning world economic and financial disequilibria requires a political approach of the crisis by observing some requirements such as: implementing, worldwide, coherent and efficient answers of economic and monetary policies; considering as main priority, in the countries affected by the crisis, the restoration of market operation; fast re-establishing the trend of economic growth, the financial sector exacerbating credit; and especially, moderating financial disturbances.

In order to bear up with the future challenges of the global crisis it is necessary to establish the following lines of defense: fiscal policy, monetary policy and direct intervention. In a globalized world, where apparently separate crisis can become global fast, the answer must be global, coordinated, flexible and expeditious.

From world outlook, the challenges of the global financial crisis for the monetary policy can be touched under the following angles: challenges concerning elaborating and implementing monetary policy, the impact of global crisis on national economies, the disruption of monetary policy actions, failing a proper coordination and without the projection of a prudent policy.

Key words: global economic conjuncture, global economic and financial crisis, liquidity, global inflation, world unemployment, volatility, real risk, political approach.

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Crises are endemic to the modern world economies and they must not be blamed absolutely by the monetary policies, a good functioning of the financial systems claiming deposit insurance and central bank's regulating authority.

Initially, the world financial crisis started as a mere *liquidity problem*, but FED, as last resort creditor, introduced a number of new responses of monetary policy, these policies including the significant signal transmitted by the intervention on the interest rate target, monetary swap with the central foreign currency and three new loan mechanisms (due term tender, loans by securities and credit commercialisation at the due date).

Beginning of the crisis

Many developing countries had a dangerous dynamics, while expecting initially a 6.4% growth for 2009, they are now credited to a decrease of activity to 4.5%. The economies with high income, many of them already in recession, are now expecting to reduce their growth for 2009, on the background of a global negative growth of 1%; these scenarios, loaded of incertitude, are rather optimistic.

After 2000, there was a *boost of* goods' *production*, the prices for primary goods increasing again after the 1980-2000 recession, but the prices of some goods, such as foods, which increased suddenly in early 2008, *are the real cause of the economic deterioration*, with a trend towards *stagflation* and slowing down of globalization. In January 2008, the crude oil price exceeded 100 USD per barrel, reaching 147 USD in July, only to decrease gradually afterwards. Food and fuel crises became critical. During the second half of 2008, the prices for most commodities knocked down dramatically the expectations regarding the decrease of the demand in a world in recession.

In February 2008, the *global inflation* reached historical levels, and the internal inflation was at its highest levels of the past 20 years for most countries. The world excess of currency offer, the relaxation of the monetary policy, particularly that of the FED, to smooth the financial crisis, the wave of increase supported by the relaxed policy from Asia, the speculations on goods, the weakness of agriculture, caused an increase of the imports from China and an increased demand for food in the emerging economies.

By mid 2008, as IMF has shown, *inflation* increased mostly in the oil exporting countries, particularly because the increase of foreign currency reserves was not sterilized; there were no monetary policy operations to compensate for such an intervention on the foreign currency with the purpose to maintain the monetary policy target. Inflation also increased in the developing, non- oil exporting countries and in Asia, on the background of increased price of oil and food; the increase of inflation was lower in the developed countries compared to the increase in the developing countries.

The International Labour Organisation forecast that over 20 million jobs will be lost by the end of 2009, most in constructions, financial services and car manufacturing, the *world unemployment* reaching 200 million for the first time.

For a while, the large economies of the beginning of the century thought that a period of decreasing *volatility* started, called some times the *great moderation*, because many economic variables seemed to have reached a relative stability. The incomes from the commodity and securities markets, the volatility of currency value were regarded as indicators supporting the great moderation, which proved to be a guide based on false beliefs.

Characterisation of the crisis

The ***global economic conjuncture,*** which preceded this global economic and financial crisis, was characterised by the following:

- ❖ The advanced and emerging economies moved towards the same direction, meaning that the growth slowed down everywhere; actually there was a discontinuation of the growth; despite the prospects for a poor economic growth, inflation increased faster since 1990, all over the world;
- ❖ In the developed economies, inflation increased by about 4.5% in July, the increase being determined mainly by the increased oil prices; the basic inflation has been controlled and it may remain moderate afterwards;
- ❖ The recurrence of inflation was more stressed in the emerging and developing economies, although the risks might be diminished, inflation exceeding 9% in these countries by mid year, some countries expecting a two-figure inflation.

The ***global shocks*** which affected the world economy during the period before the official acknowledgement of the crisis can be characterised as follows:

- ✓ The general state of business in the world economy reflected the conjunction of three major shocks – increase of merchandise price, shrinking real estate market in the USA and in some advanced countries and the financial crisis – the interaction of these shocks making it much more difficult to take *decisions of economic and monetary policy*;

✓ The price for goods, even under the conditions of conjunctural reductions, are expected to remain high and volatile; however, if the trends of merchandise prices maintain, a new field for the monetary policies might develop, budgetary, anticyclic in this case;

✓ Oil price tempered its increase, but the incertitude remains high, the signals of a poor global growth showing a response of the demand to the high oil prices and to the improved conditions of the offer, which may result in lower prices;

✓ However, the balance of the offer and demand on the market remains tense, the strong increase of the demand stimulated by the accelerating activities in the field of resources and the slow reactions of the offer in the intensive emerging economies, leading to the decline of stocks and available capacities, which might keep the prices high and volatile;

✓ The shrinkage of home building, with the epicentre in the USA, is still high, the prices continuing to drop and the problem of the negative aspect of the actions is still present on the background of a decreased value of the collaterals, but the future might bring a lower rate of price decrease; the decrease of real estate prices and the shrinkage of home building has also been noticed outside the USA (Great Britain, Ireland, Spain etc.).

The current global economic crisis involves *two basic aspects*:

- The macroeconomic implications of this financial storm on the global economy, in junction with the major shocks on the goods markets during the recent period and the shrinking activity on the real estate market;
- The capacity of economic policies to navigate in storm and to follow a course which restores the financial system and supports the economic activity, under the conditions of maintaining inflation within the desired limits.

Financial tensions are generated by the exacerbation of the financial crisis which dominates the short-term global perspective:

o Despite the decided actions of the large central banks, the *interbanking gaps* expanded rapidly, enhancing the incertitude and aversion towards risk; the tensions on the markets for due date funds reflect increasingly not just the liquidity, but also the serious risks of credit and anxiousness regarding the counterparts;

o Although progress has been achieved in balance adjustment, the aspect of the consolidated financial positions turned much more worrisome both in the US and in Europe, the banks increasing substantially the volume of capital, compared to the evaluated losses amounting to more than 1.5 billion USD for the overall financial system;

o The emerging economies also are increasingly affected by the financial crisis, the stock price decreasing rapidly and the securities gap expanding; the countries with large current account deficits are confronted with significant pressure on the credit and stock exchange markets.

Political approach of the crisis

Although the real risks are very large, the *economic balance must be further ensured*, and the current challenges must not bear upon the expectations for balance restoring. At least the *following requirements* must be observed if a global recession is to be avoided:

➢ Worldwide implementation of coherent and efficacious responses of the economic and monetary policies;

➢ Consider restoration of market operation as the main priority in the countries affected by crisis, preventing thus the manifestation of the mistrust spiral among the participants on the financial markets;

➢ Even if the financial disturbances justify the reduction of the prospects for the global growth, the growth should be restored in early 2009, the financial sector stressing the credit and particularly, the tempering of financial disturbances;

Overall, at the global level, measures of economic and monetary policy will have to be promoted which should support *the sustained positive evolution of the global economy*, under the conditions of avoiding the risks of slowing economic activity or of significant inflation deterioration.

Regarding the *global perspective*, four main factors support the view that a serious decrease of the economic activity can be avoided:

▪ First, oil price decreased from the previous high rates, even if conjuncturally, oscillatory increases can still take place;

▪ Second, one may anticipate, reasonably, that the real estate market will reach a base level during 2009, the stabilization of the prices of houses potentially contributing to decrease the losses due to mortgages in the financial sector;

- Third, while the crediting conditions hardened, the economic growth might continue, the future slowing of lending not causing, necessarily, the delayed restoration of the growth;
- Fourth, the vigorous domestic demand and the growth of the emerging economies are expected to support the global growth; this would contribute to the alleviation of the global disequilibrium and would support the activity of the advanced countries, the USA particularly, through their net exports, the real multilateral value of the US dollar potentially closing its fundamental value, more than noticed during the past years.

Within this context, we must show, however, that that the insufficient adjustment of the currencies from some economies to the flexible exchange rates mechanism and to the foreign surpluses didn't support the global adjustment. Some economies which grow faster, China particularly, should appreciate their currencies in order to support the global economic growth and to alleviate the disequilibria. We may anticipate a slower global growth before the gradual restoration of the growth may take place during 2009. However, the challenges to the global economy and to the financial sector will be extraordinary and the global risks will increase.

The *risks and challenges of the monetary policy* will be determined mainly by the potentially negative feedback between the tension on the financial market, which will continue, and the slowing down of the economic activity. Despite the aggressive actions of policy which target the alleviation of the liquidity tensions and the prevention of the systematic accidents, the markets will remain in a severe state of stress. Beyond the systematic accidents, a major worry is the increase of losses and of the difficulties generated by the capital, the rather aggressive temptation to shift the balances out of equilibrium, which may contract the credits severely.

The confluence of shocks made it much more difficult to *take monetary policy decisions*, the sustainable solution of the financial crises requiring creative solutions for the use of the *monetary policy instruments*.

The *key challenges* for the restoration of the financial system to its full functionality consist in ensuring a proper liquidity, eliminating balance deterioration and capital restoration. An element which makes these challenges very difficult is the fact that on many markets the financial sector became quite large, the restoration of the system including its consolidation, too. Not all the institutions can and must be salvaged, the monetary policies being important to sustain the challenges of the world crisis; it is clear, however, that alone, they will not be enough to restore a balanced growth.

The following "*defence lines*" are necessary to cope with the future challenges*:*

- ***Monetary policy.*** The monetary authorities will have to ensure the liquidity for the financial sector and will have to set the interest rates policy. The monetary policy must play a critical role in supporting the economies, but the target of the monetary policy will depend on the cyclic position of each individual country. In the developed countries, the slowing economic activity is expected to help controlling inflation, but in many emerging economies the shift of risks between inflation and growth suggests a wider policy target, particularly for the countries with moderate inflation, the credibility of the policy involving a "wait and see" approach. In other words, the risks of inflation remain serious in some countries in which the growth continues to be vigorous and where, given the lags, the increase of energy and food prices is still actual and may generate side effects; the monetary policy must have a trend towards hardening in these countries.
- ***Fiscal policy***. It will have to use *automatic stabilizers* and support the growth through *fiscal sustainability*. The fiscal policy plays an essential role in the advanced countries, the automatic stabilizers providing the adequate support in many of these countries. In most of he emerging economies the fiscal policy will play an important role in supporting the monetary policy to ensure the decrease of inflation. The fiscal policy is adequate in the advanced economies, but the manoeuvring margin is limited by the necessity to consolidate the fiscal policy on the medium term in many of these economies. However, the support of the financial sector will involve *budgetary costs* which must be done taking into consideration the policy alternatives.

In the emerging economies, where inflation remains a problem, the fiscal policy may play a higher role of support in limiting the demand and in attenuating the inflationist pressure. In particular, a stronger restriction on the increase of the expenditure will be complementary to a more vigorous monetary policy

- ***Direct intervention.*** It was and has to be taken into consideration as long as the systemic risks of the financial system remain high. The key is to maintain a balance between *limiting the* *moral hazard and the financial stability*. It became a rule that the direct fiscal interventions are necessary in any country to accomplish the objectives of transferring the affected assets from the balances of the financial institutions and of recapitalising the financial system. A solution in this direction could be based on long-term swaps of mortgages against state bonds, the advantage of such an approach being that it offers a short-term relaxation for the bank balance. Furthermore, the efforts target the reduction of the systemic risks, including particularly the supply of support to the essential financial institutions, which will claim a realist approach. Under these circumstances, the key is, as stated, the accomplishment of a proper balance between the current financial stability and the limiting of the future moral hazard; this task is not easy, but its short and long-term consequences will be severe if the balance will prejudice too much in either direction.

The realism of the financial globalization involves the necessity that the political interventions, including the long-term aspects of the reforms of regulation and monitoring, are globally coherent and consistent so as to be efficacious. No doubt, the new actions will have to cope successfully with the short-term challenges and, furthermore, the problem will probably consist in the way to prevent the excessive risk assumed in the future, without smothering the potential positive force of the actual financial markets.

The prevention of crises, of their contagion, involves the dissemination of information, at least under three aspects: the credit rating; evaluation of the tradable assets; and transparency on the retail markets for financial assets. At the same time, the political and institutional arrangements must be improved in terms of an efficient insurance of the deposits, the regulative and regulatory coordination, division of responsibilities and the monitoring standards.

At the same time, the crises show that inflation targeting restricts the capacity of the banks to limit the balloons of assets, as well as the adverse consequences of the central bank's attempt to stabilise the assets price, the role of the central bank being that of lender of last resort.

Role of the monetary policy

Generated initially, as mentioned, by the shocks of the food and energy prices, the global financial crisis might significantly *stop the* *struggle against poverty*. In a globalized world, where apparently separate crises may disseminate rapidly at a global level, *the answer must be global, coordinated, flexible and rapid*. The lessons of the past crises stress the importance of *protective investments* in the long-term development, investments in infrastructure in social development, in the quality of the economic growth etc. The *international financial institutions* must contribute to the establishment of *bridges of multi-facet political answers*, to protect the economies which are the poorest and the most vulnerable to the immediate and long-term impact of the crisis, by actions oriented towards supporting the financial and private sectors, supporting the countries to manage the fiscal challenges and to avoid the delay of long-term investments on which restoration and development depend.

From the *world perspective, the challenges of the global financial crisis for the monetary policy* can be approached under the *following aspects:*

1. *Challenges concerning the elaboration and enforcement of the monetary policy*:

- The monetary policy must look beyond the balance of payments and the financing of the immediate liquidity, in order to contribute to relaunching growth and sustainable development;
- Even if it struggles to put out the current fire, the monetary policy must look ahead, the liquidity and credit which are now pumped within the system risking to contribute to a future explosive cycle, particularly if this pumping is not adequately regulated and monitored;
- The monetary policy from the developed countries must avoid the establishment of policies, structures and norms which undermine or exclude the interests of the developing countries.

2. *Impact of the global crisis on the national economies:*

- Reviewed global vision:
  - o The global economic perspective worsened dramatically, the projections of the growth rate, of the inflation rate and of unemployment rate being reconsidered unfavourably, getting sometimes into the area of social danger;
  - o Virtually, the developed or developing countries can be affected by the expanding crisis, although the countries which entered

the crisis with strong fundaments and are least integrated in the global economy, are generally, less affected;

- o The poor countries, Africa included, will be significantly affected by the crisis, even if the transmission channels are different from those operating on the emerging markets

- Response of the monetary policy:
  - o After some hesitation, the reaction of the financial sector policy became increasingly robust, the governments and central banks being gradually involved in debt guaranteeing, involving the promotion of interbanking liquidity and recapitalisation, healthy banks being required for this;
  - o Many governments will have to offer fiscal stimuli and help the commerce, the consistency of their actions and the effectiveness of their interventions being crucial in maintaining the credibility of the public system's ability to fight the crisis and to keep on acting as main lender of last resort;
  - o Although the recession seems to expand, some *elements of relaunching,* of restoring the growth can be distinguished, including the stabilisation and restart of the building sector in the USA and gradually in Europe, the continuous reduction of the debt and consolidation of banks' balance and adjustment of the losses born by the financial institutions involved in mortgaging;
- Vulnerabilities and their impact on the economy:
  - o Some economies, such as the developing economies, have been at shelter at the beginning from the financial turbulence, but this didn't last long because the cycle of activity reducing, which started after 1999, intensified and expanded, the financial conditions became more restrictive, the capital flows of most economies drying out and huge amounts of capital being withdrawn, which made the shares value to plummet and the spread of the bonds to increase;
  - o The interest rates gaps increased suddenly and the shares' price flamed up;
  - o If the rigidity of the credit market will not relax rapidly, then the consequences will be severe, particularly for the developing countries, the financing conditions deteriorating rapidly and the domestic financial sectors, otherwise healthy, may become incapable to lend or to take domestic or foreign loans, so that the productive sectors will be short of capital;

- o Lower capital flows are expected, even if the waves of panic which flooded the credit and shares markets all over the world are somehow under control;
- o The shocks of the food and energy prices already imposed fiscal costs, diminishing the reaction capacity, particularly of the developing countries, to exit the financial crisis, the conjectural decline of these prices not meaning that the problems and pressures have gone;
- o Without a proper coordination and without the design of a prudent policy, the measures taken by the governments may undermine their efforts.

- Challenges and responses of the monetary policy

- o It is essential to have *multilateral cooperation*, the challenges of policies developing at the national level, but the answers depend on the way in which the international community acts in a coordinate manner and supports each country to ease, differently, the policy tasks;
- o A vigorous answer to the crisis is required, which can involve a *new multilateralism*; the new approach must not be a fixed and unitary system, but rather a *network of institutions which maximizes the strength of the interconnected global actors*, including the existing international institutions, reformed according to the network vision, as well as private firms, civil society organisations; the new economic multilateralism must be inclusive (total) and pragmatic, comprehending not just the finances and commerce, but also the development, change of the climate, the environment, the frail states, the energy, etc;
- o The crisis showed the *necessity to reform the Bretton Woods institutions*, adapting them to the new realities, requirements and challenges;
- o *The global financial crisis must be prevented* so as to *avoid a huge human crisis*; as mentioned before, the policy must build bridges between economies, must elaborate multi-facet answers which to protect the poor and vulnerable, to stabilise the financial and private sectors, to manage the fiscal challenges and to develop long-term business security.