RISKS AND CONSTRAINTS FOR THE MONETARY STABILITY

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Abstract

Starting from the definition according to which monetary stability requires an appropriate level of liquidity in an economy with dynamic objectives, of growth and job creation, non-inflationary in terms of price stability, based on the analysis of the effects of some relevant economic phenomena and on the economic literature, in this article, the author has highlighted some of the risks to monetary stability. One of the major risks is represented by the loss of its instruments, i.e. the instruments for liquidity management, through monetary and exchange rate policies. Another important risk is represented by the capital fluctuation due to various shocks: exchange rate, political, financial and capital account liberalization. Also, as a result of the analysis of relevant studies and of the effects of the European integration in terms of monetary stability, the author has shown the elements on which depends monetary stability. Among these, there are: the existence of an institutional framework with a clear goal and a proper degree of responsibility, strong operational independence of monetary policy, monetary policy implementation with a view to ensuring an appropriate balance between discipline and discretion, the level of the interest rate of monetary policy, the efficiency of the transmission mechanism of monetary policy, the existence of a viable and stable financial system, the existence of enough instruments at hand for the central bank, the structure and soundness of the financial and banking system.

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1. Introduction

Although the targeting of monetary aggregates has been one of the three standard strategies of monetary policy that have been considered successful over the past decades in terms of providing an efficient nominal anchor, alongside exchange rate targeting and inflation targeting, it has lost support following the disintegration of the previously stable relationship between monetary aggregates and inflation. This development has been mainly related to accelerated remonetisation, which has occurred after inflation had fallen to moderate levels, the banking sector had been privatized and capital flows had been liberalized. It should be mentioned that the inflation targeting strategy, currently adopted in many countries, does not prevent the central banks to pay attention to monetary aggregates to the extent to which they offer useful information for the process of inflation forecasting.

Based on the definitions existing in the literature, we can say that **monetary stability requires an appropriate level of liquidity in an economy with dynamic objectives, of economic growth and job creation, non-inflationary in terms of price stability. Thus, monetary stability is one of the essential prerequisites for economic development**.

Monetary stability ensures the existence of conditions conducive to normal economic development, without shocks, and / or constitutes a potential buffer for possible shocks, by absorbing them, by gradual assimilation and by mitigation.

2. Risks to monetary stability

There are many risks to monetary stability. Considering the definition of monetary stability mentioned above, we shall present the risks that we have identified and that may affect monetary stability.

A risk is represented by the loss of instruments used for achieving monetary stability, i.e. the instruments for managing liquidity, through monetary policy and exchange rate policy (the interest rates on monetary policy, used in open market operations; the interest rates on standing facilities, the interest rates on required reserves, foreign exchange market intervention), for example by joining a monetary union, which implies a common monetary policy.

Joining a monetary zone means giving up the member country's own monetary policy. In a monetary union, there is a central bank that enacts the measures of monetary policy applicable to all member states. These measures should provide a response to the liquidity problems from each of the member countries, both under normal circumstances, and in the case of a shock. This is possible when all the countries from the monetary area are situated at a similar level of the economic development cycle, when they have a similar level of economic development and of the money market, both in terms of monetary policy transmission mechanism and its efficiency, and in terms of regulations, institutions, levels of interest rate on monetary policy, of interest rates on standing facilities and of the ratios of minimum reserve requirements.

Quitting one country's monetary policy before achieving real and nominal economic convergence, i.e. before being eliminated the imbalances that the economy is facing, as well as the different phase of the economic cycle of that country compared to the main economies of the monetary union would have negative consequences both concerning the real economy development and the monetary and financial stability. Thus, if there are regional disparities in terms of economic growth in the monetary area, some countries registering high rates of economic growth, while others recording low or negative rates of economic growth, differences of interests appear among the member countries. Whatever decision the central bank takes, through the measures enacted, it will influence positively the trend of economic growth and the liquidity only in a category of countries, in the other countries, the response of the monetary policy would be inappropriate in terms of the economic problems and of the monetary and financial stability.

Another risk is the emergence of an endogenous or exogenous shock with impact on liquidity in several ways: through the occurrence of investors risk aversion, due to the bankrupcy of banks. If they perceive the situation as extremely risky, the investors withdraw completely their investments from that country, causing instability on the money market.

Such an exogenous shock may be that of the sovereign debt crisis from the euro area which arose from the shock of the bankruptcy of the financial institution Lehman Brothers, in September

2008, and which had originally propagated through the interbanking[1] market channel, following the route towards the financial market and the real economy. This shock has led to increased uncertainty and risk aversion of investors, causing a qualitative distinction made by them. Thus, the investors have treated differently the debts of the euro area countries. So, they have reorientated from the countries with high economic growth (Ireland, Spain, Portugal) towards those with slower economic growth, but who had enjoyed long-term macroeconomic stability and institutional maturity (Germany). Thus, investors have quickly changed preferences for risky assets, the demand for low-risk instruments increasing significantly, although yields on these securities are lower. This generated the change of the liquidity level in the two groups of countries. In addition, investors' behavior with consequences in the direction of lower inflows of foreign direct investments (FDI) in the countries considered risky brought about the adjustment of the current account deficit (given that FDI are an important source for financing the external deficit) (Criste, Milea, Ailincă, 2013).

The financial and economic crisis has as consequences the reduction of international liquidity due to increased risk aversion of investors. On the other hand, financial instability has attached a high-risk of bank collapse, which in certain situations generates inflows of liquidity (see the measures taken by the European Central Bank after September 2008), with effects on monetary stability.

The excessive volatility of the capital markets brings about costly crises in the financial markets. The developments in the late 90s, especially the Asian crisis, have led many economists to believe that the globalization phenomenon, the cause of this volatility, has gone too far. Moreover, they (Stiglitz (1999), Krugman (1998), Rodrick (1998 and 2000)) have advocated for the return to the old order of controlled flows, arguing that the free movement of capitals leads to financial crisis as a result of their excessive volatility.

[1] *The disturbances in the interbanking market represent, generally, a fairly accurate indicator for evaluating the intensity of a financial shock. Also, the initial shock from August 2007, specific and local (the subprime shock), has been strongly reflected in the interbanking market.*

Another exogenous shock, with effects on monetary stability, may be the significant change in the interest rates of deposits or government securities, resulting in massive migration of capitals seeking to exploit profitable conditions.

The exchange rate shock leads, also, to the migration of speculative capitals from the country whose currency depreciates strongly generating significant reduction of liquidity in the money market.

Political instability is a factor causing migration of capitals towards more stable and more secure countries both economically and politically, as a result of increasing risk aversion of investors.

Monetary stability can be also affected by the effects of some shocks on the level of foreign investment. These shocks may be represented by the change of national investment policy (through macroeconomic policy decisions), capital account liberalization (which enhances FDI flows).

The increase of foreign prices may encourage foreign capital inflows and possibly discourage domestic capital outflows, if interest rates remain unchanged, with effects on liquidity.

3. Constraints for monetary stability

During the crisis, it increases the pressure on central banks, in terms of developing monetary policy, due to augmentation of uncertainties.

The limits of monetary policy derive from knowledge, from the prevalent approaches or from the operational framework of monetary policy (Croitoru, 2009).

Ensuring monetary stability depends on the existence of an institutional framework with a clear objective, on the existence of a proper degree of responsibility, on the strong operational independence of monetary policy, on the possibility to take the appropriate decision for the ongoing economic or monetary phenomenon. This refers both to the independence of the monetary authority inside that economy against the government and the other macroeconomic policies, as well as to whether a country is or is not part of a monetary union (which means giving up its own monetary policy), and also to the diversity and adequacy of the available instruments.

Thus, joining a monetary area by a country that does not have a sufficient level of development of the financial and monetary markets in order to control monetary stability, and giving up the tools provided by the monetary and foreign exchange rate policies for liquidity management, creates the premises for monetary instability in the event of a shock with effects in terms of liquidity. Thus, by quitting prematurely the possibility of using the changes in the exchange rate and in the interest rates in the processes of adjusting the differences between that country and the other countries of the monetary union means putting too much emphasis on the labor market and on the goods prices adjustments, as the only markets remaining for adjustments would be the labor and goods markets. The fiscal policy could absorb some of the shocks, although sometimes it must remain procyclical. But these policies influence only a little the liquidity and therefore they can not compensate for the liquidity management tools of the monetary and foreign exchange rate policies.

Obtaining monetary stability depends also on the way monetary policy is conducted, taking into consideration guaranteeing an appropriate balance between discipline and discretion (Croitoru, 2009).

Monetary stability depends on the level of the interest rate on monetary policy, but also on the level of the interest rates on standing facilities and on minimum reserve requirements. Thus, the identification of the equilibrium level of these interest rates is based on an adequate knowledge of the economy's structure. In addition, this level may be different from the level of the natural interest rate for long periods of time.

The period of time for which is established a certain level of the interest rate on monetary policy is also important. The appropriate level of the interest rate is difficult to estimate for a duration of more than 1-2 years (Croitoru, 2009).

Another constraint is represented by the efficiency of the transmission mechanism of monetary policy. Thus, in several models based on the prevailing theory, the liquidity plays no part or it plays only a very small role in the transmission mechanism. The current financial crisis has invalidated the hypothesis according to which the economy balances quickly, not allowing the buildup of financial imbalances that cause distortions in the current real spending and in

the investments. The abundant liquidity in the years before the crisis caused the assets prices and the credit to grow at rates significantly higher than the historical levels, indicating the accumulation of imbalances. But their coexistence with the relatively low inflation led to ignoring the signal (Croitoru, 2009). Therefore, we can conclude that both credit and assets prices can be a valuable signal about the accumulation of financial imbalances and it is advisable that their level and development should be considered in the conduct of monetary policy.

The characteristics of emerging economies, such as the predominance of supply-side shocks, the expansion of monetary substitution phenomenon, the fragility of institutions, the shallow financial markets, the vulnerability to sudden stops of capital inflows and the labor migration contribute to increasing complexity of the decisions of monetary policy. Thus, the shallow financial markets impede the efficient functioning of the interest rate and credit channels, limiting the ability of the central bank to fine tuning the economy. This could lead to a situation of excessive dependence on the exchange rate channel in the process of managing the aggregate demand. Therefore, the existence of a viable and stable financial system is essential in order for the monetary policy to be efficient.

In addition, the immaturity and the existence of a limited number of tools available for the central bank, in the context of nominal and real shocks, limit the effects of monetary policy. These limitations for the effectiveness of monetary policy make more imperative the need to implement a coherent mix of policies in the emerging economies. Without the support of other economic policies, monetary policy might have difficulties in securing, in a sustainable manner, monetary stability and, implicitly, low inflation. In other words, it is possible that price stability might be achieved at the expense of other macroeconomic equilibria (Isărescu, 2008).

The efficiency of monetary policy depends also on the degree of euroisation, dollarization of the economy. The higher is the degree of euroisation, dollarization, the lower are the effects of the monetary policy measures on the interbank market, on the real economy and towards guaranteeing monetary stability.

The structure and the functioning of the financial and banking system determines how monetary policy impulses are taken by the

liquidity and the prices of the financial markets and then passed on to macroeconomic behavior. In addition, the soundness of the financial and banking system is a prerequisite for the existence of monetary stability. Thus, in the case of turbulences in the financial markets, the problems of the financial institutions can generate inflows of liquidity from the central bank into the financial and banking system with effects on monetary stability.

4. Conclusions

Considering on the one hand, the importance of monetary stability for obtaining financial stability and price stability, and for the sustainable and sinuous development of any economy and, on the other hand, the existence of multiple endogenous and exogenous risks and constraints for monetary stability, we consider necessary that the achievement of monetary stability to become a target pursued by the central banks in the framework of the monetary policy strategy. The Central Bank is the institution the most eligible to pursue and achieve monetary stability, because it has the necessary tools and procedures and it has the position in order to influence the monetary market.

The existence of a monetary policy strategy[2] is one way to improve monetary stability. The argument is considering several ideas, as follows:

- the strategy requires an exact structure of the decision-making process,
- the strategy is a tool by which the decisions of monetary policy are explained to the public,
- the strategy concurs to central bank credibility in the financial markets.

Consequently, the emotional behavior is eliminated with positive influence on expectations.

Although monetary stability depends mainly on the characteristics of the national monetary policy, in the recent years,

[2] *The monetary policy strategy represents a coherent and structured description of the way in which the decisions of monetary policy are taken with a view to achieve the objective of the central bank.*

due to the expansion of globalization, monetary stability is increasingly influenced by the situation and the developments in the financial markets of partner countries.

Thus, the financial and economic crisis that started in 2008 has revealed the fact that, given the link, proven by the practice, between the fluctuations of the financial markets and monetary stability, it is necessary that the developments in the financial markets should be watched closely by central banks, because in the case of occurrence of tensions or turbulences, central banks should take the appropriate measures to maintain monetary stability and price stability.

The financial globalization has less potential to cause instability in those countries where financial sectors are more developed, institutions are stronger, macroeconomic policies are healthier and trade systems are more open (Rato, 2007b). Therefore, the fulfillment of these conditions represents a way of achieving monetary stability.

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