FINANCIAL STABILITY ASPECTS IN THE CONDITIONS OF EUROPEAN MONETARY UNION

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Abstract: *Under the current conditions of conducting international economic relations, there is a risk of failing to accomplish the monetary policy objectives due to reasons pertaining to the mechanisms that convey shocks cross-border. The conceptual review of object definition, under such conditions, leads to the necessity of attaching to them these risks of unfulfillment; this requires an additional chapter of macroeconomic policy design, chapter that identifies the possible risks emerging from the integrated cross-border regime of the European economies, as well as the possible solutions to absorb such shocks. This implicitly presumes the quantification of the whole phenomenon or risk emergence and of its possible effects, with the view to determine the effort necessary to be undertaken in order to absorb the associated shock.*
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1. Current conditions of the international economic relations

Considering the situation of Romania, characterized by the fact that most of its international economic relations are within the European Union, we may say that one of the main features of the economic framework is given by one of the outcomes of the process of economic integration, i.e. removal of barriers hindering the economic relations between the member states. This set of facilities directed towards increasing the efficiency of the interstate economic relations has a high risk attached to it, namely, the cross-border propagation of the economic shocks and cross-border conveying of the risks. Consequently, the macroeconomic policies are also confronted with an additional category of macroeconomic risks generated by the possibility of importing adverse economic phenomena whose underlying causes are not related to the internal environment. Thus, an additional and permanent task for the macroeconomic policies is to provide a potential for shock absorption – which acts best if the design of the policies allows for enough mobility by providing additional funding.

The crisis found the Romanian banking system dominated massively by the foreign capital, and the financing from the mother banks for their local branches tends to decrease, which makes it more difficult to access funds from the banks. The foreign direct investments in Romania also display a decreasing trend, in agreement with the regional evolutions. It is therefore absolutely necessary to identify alternative sources of financing.

Another particularly important problem for the national economy is the decreasing demand for credits, because of the shrinking economic activities and lower purchasing power, which diminished the function of financial intermediation.

2. General objectives of the monetary policy

The monetary policy, component of the macroeconomic policies system, derived its objectives from the general objectives of this system, namely, from the strategic objective represented by the macroeconomic sustainability; within this context, the main objectives of the monetary policy are:

- Ensure price stability;
- Ensure national currency stability;
- Ensure financial stability;
- Ensure the monetary conditions for the establishment of an efficient economic flow on the market.

The accomplishment of these objectives is understood as the involvement of the monetary policy within the system of macroeconomic policies.

3. Price stability

Conceptual theoretical aspects

Theoretically speaking, an economic concept is approached via elements such as:

- What real economic aspect is it referring to;
- How does it prove that it is a real phenomenon or process.

Thus, price stability:

- Refers to the aggregate level of the prices measured by indices;
- It is accomplished when
    - The money maintain their value in time, or when
    - The rate of purchasing power erosion is very slow.

Definitions

- ***Reputed specialists -***

Paul Volcker (Federal Reserve President 1979 - 1987) defined price stability as the situation in which the expectations regarding the general long-term increase or decrease of prices don’t have substantial influence on the economic and financial behaviour;

Alan Greenspan (Federal Reserve President 1987 - 2006) defined price stability as the situation in which the change of prices expected by the public is sufficiently low and gradual, so as not to be taken into consideration in company and household decision-making;

Alan Blinder (Federal Reserve President 1994 - 1996) defined price stability as the situation in which the ordinary people cease to speak about inflation and worry about it;

Ottmar Issing (first Chief Economist of the Central European Bank, 1998) defined price stability as a stable level of the aggregate prices, or a low level of inflation;

Lucas Papademos (Governor of the Central Bank of Greece, 1994-2002, Vice-president of the Central European Bank, 2002-2010) defined price stability as that state of the economy in which the general level of prices is stable, strictly speaking, or when the inflation rate is sufficiently low and stable, so as the considerations regarding the nominal dimension of the transactions ceases to be a pertinent factor for the economic decisions.

- ***Institutions -***

The Central European Bank defined price stability as an inflation rate, calculated on the basis of the harmonized index of consumer prices, below (almost) 2 percent.

Monetary stability

The concept of monetary stability overlaps that of price stability.

Financial stability

The literature doesn’t provide a recognized definition of the financial stability because of the novelty of this aspect, which regards matching the needs for macroeconomic administration with the needs of a theoretically studied problem, synthesized in a quantification indicator.

The following points of view can be approached regarding the concept of financial stability:

- In the broad meaning, with accent on the overall functioning of the financial system, the financial stability is defined as the situation in which the financial system is able to draw and place efficiently monetary funds, while withstanding shocks without bringing any damages to the real economy;

It results from here that the prudential monitoring by the central bank is essential for the maintenance of the financial stability.

- In a narrower meaning, with accent on the avoidance of crises, financial stability is the situation in which no bank crises occur and when asset prices and, particularly, the interest rate, are highly stable.

It results from here that the interest rate policy is very important for the financial stability; a conflict may even arise between the price stability objective and the financial stability objective.

4. Relation between price stability and financial stability

According to the theory there are two approaches, although the theory is yet to be recognized because of the novelty of aspects, which require further studies and practice in order to add conceptual elements:

- Conventional approach: the two types of stability mutually support and potentiate each other, on the long-term;
- The novelty aspect, verified as *hypothesis*: as inflation stabilizes at low levels, a new economic environment is established, in which the financial stability is not guaranteed.

According to BNR Governor (M. Isărescu, 2011), the macroprudential policies comprise measures that aim to secure the proper health state of the financial system, or that can avoid losing control on some sector-specific problems.

According to the studies of Borio (2003), a successful macroprudential policy will accomplish its goal, so that the microprudential policy is sub ordinated to the policy that encompasses the entire financial system. José Viñals (2011) considers that irrespective of the macroprudential policies performance, they cannot be regarded as sufficiently good replacement of efficient macroeconomic policies, and he suggests the use of a combination of macroeconomic and prudential policies ta avert shocks within the economy. In the opinion of Clement (2011), the macroprudential policy differentiated from the other economic policies not just through flexibility and minimal costs, but also through the two dimensions it approaches, the *temporal dimension* and the *structural dimension*, so that it marks the major distinction between the macroprudential and microprudential policies in term of objectives, mechanisms and instruments of transmission.

The macroprudential policy targets the viability of the financial-banking system as a whole, as essential relation for the operation of an economy, with the main objective of avoiding macroeconomic costs resulting from the instability of the financial system and of decreasing the systemic risk. The macroprudential policy is considered to be complementary to the microprudential one, while it also has interactions with different types of economic policies, which have a particular impact on the financial stability; thus, it acts towards the build-up of financial imbalances by enhancing protecting barriers, by the joint identification and approach of the exposures, of the risk concentrations, of the relations and interdependencies as risks of contagion.

One may say that the macroprudential policy is directed exclusively towards ensuring the stability of the financial system using a set of specific instruments to limit the risks that exist at the financial level, particularly the systemic risk. The number of countries that implement such measures seems to have increased lately, because their innovating character presumes additional efforts of the monetary authorities in order to ensure an efficient communication and the transparency within the financial system.

Two dimensions of approaching the existing risks were observed:

- The *temporal dimension*, i.e. risk procyclicality;
- The *structural dimension*, i.e. risk distribution within the system.

The differentiation, within the prudential policy, between the microeconomic and macroeconomic approach was also noticed. The first delimitation targets the financial stability at the institutional and individual level, presuming an easier and more flexible application, while the macroprudential approach presumes supporting the entire financial system. The macroprudential policy aims to ensure a higher transparency, it doesn't distort competitiveness and, compared to the microprudential policy, the risk factors are considered to be endogenous.

The main objectives of the macroprudential policy are:

- *Consolidating the resilience of the financial system* to economic shocks and imbalances;
- *Limiting the propagation of the international financial crisis*.

Besides these objectives, there also are actions to *minimise the costs* caused by the financial instability, the *decrease the discrepancies* between the settling date of the assets and of the liabilities, *stimulate* the credit holders to use it efficiently, etc.

A difficulty in approaching the macroprudential policy regards the identification of its *limits*, the division of responsibilities pertaining to the different categories of financial policies, so that while the main concern of the macroprudential policy is the stability of the financial system, the other policies must act in close correlation with the prudential policy.

For the financial system it is very important to have an accurate coordination between the macroprudential policy, the monetary policy and the fiscal-budgetary policy, because problems may arise regarding the operational independence when assigning responsibilities and regarding the institutional orientation.

A strong relation was noticed between the *macroprudential policy* and the *monetary policy*, since they condition each other. Thus, the measures aiming to consolidate the resilience of the financial system can also strengthen the monetary policy, while the macroeconomic stability will decrease the vulnerability of the financial system. The evolutions noticed within a particular policy must take into considerations the changes in the other policy; thus, the principles of the macroprudential policy will influence the conditions for lending credits.

Regarding the instruments of the macroprudential policy and their role in the development of macroprudential instruments, the operation started from the microprudential instruments, which have been adapted to the economic conditions and to the existing prudential standards.

Among the main instruments in use there are risk measuring methodologies, financial reports, regulation capital, financing and liquidity standards, collateral arrangements, limits for risk concentration, compensation designs, restrictions regarding the distribution of the profit, insurance mechanisms, etc.

The literature discussed several instruments which were actually used in practice, i.e. the liquidity rate, the level of indebtedness, proportion of the credit within the GDP, test resistance trials, VaR, etc.

The macroprudential instruments used by the developing economies also include measures to limit the mismatches regarding the currency system, which aim to limit the internal financial consequences of the capital inflows. The large number of ways of action has a positive effect on the economy, but the instruments used by a specific segment can lead to the amplification of the imbalances in that particular sector. Thus, the transmission mechanisms of the macroprudential policy can change at the same time when changes in the financial intermediation occur, the financial innovation and the consolidation of the financial system can lead to unpredictable changes in risk distribution. The macroprudential policy is in its early stage in most countries, being preponderantly noticed in the emerging economies. The macroprudential policy relied on experience, not necessarily on the definition of a set of rules, and its efficacy has been proved by the benefits of its implementation. The use of macroprudential policy lead mainly towards the limitation of credit allowance in particular sectors, using the minimal compulsory reserves to prevent the onset of imbalances. New evolutions have been noticed within the macroprudential instruments; thus, the macroprudential instrument that has the strongest influence on the emerging economies is the systemic overtax of the capital and of the liquidity, included in the last Basel agreement. Thus, Basel III, which is considered to be the answer to the deficiencies caused by the international financial crisis, includes two additional safety systems, as mentioned above. It is believed that if, on the long-term, the new regulations will be enforced and will function properly, the banks will be able to absorb violent shocks, despite the lower profitability of the banking sector. The systemic risk is limited through several structural measures; thus, short selling operations are noticed in Central and Eastern Europe, although other major risks still persist on the financial markets, such as the risk of unpredictable behaviour of the capital flows, of risk concentration in particular financial institutions considered TBTF, the risk of procyclicality, etc.

The macroprudential policy presumes the existence of a capacity to identify the risks in due time, so that actions can be taken to control them. The purpose of the macroprudential policy is to *monitor the aggregated risk, in a robust manner and oriented towards the future*, because the risks display a trend to manifest within periods of normality; thus the instruments used by this policy must provide enough time to dampen the cyclic implications of the monetary vulnerability. However, so far, none of these instruments proved sure enough to predict the possible risks and guide the economic policies.

Three possible patterns of macroprudential policy exist, which differ in their purpose, instruments and cooperation, as follows:

- The *prudential model*
- The *„eclectic" pattern*
- The *„overarching policy"*.

The second pattern uses specific instruments besides prudential instruments, while the third acts indirectly, relying on the cooperation between authorities. The first two models refer, as main objective, to ensuring the stability of the financial system, while the third aims bot the financial and the non-financial sectors. Overall, each pattern has both strengths and weaknesses, but for the establishment of a framework of action, the strengths have to be combined, while the weaknesses have to be limited.

As mentioned before, one of the challenges confronting the macroprudential policy regards the coordination of the economic policies, so that in order to improve the efficiency of the implemented measures, the institutional representation had to be enhanced. Therefore, several financial institutions have been established at the European level, their main goal being the macroprudential surveillance, risk alleviation, ensuring a more efficient management of the credit institutions, etc. Thus, the European Parliament and the Council of the European Union adopted, in November 2010, the reform of the European architecture, in terms of financial surveillance, with three European Supervisory Authorities: the European Banking Authority (EBA); the European Securities and Markets Authority (ESMA); and the European Insurance and Occupational Pensions Authority (EIOPA).

These authorities will strengthen the macroprudential supervision. The European Systemic Risk Board (ESRB) plays a significant role by its activity of collecting and analysing basic and relevant information, identification and classification of systemic risks depending on their priority, issuing of warnings about the identified risks. Compared to the other policies, the macroprudential policy was noticed for the several advantages it has in approaching the systemic risk. First, the macroprudential instruments of action are less disconcerted and are much more flexible, so that part of them can be directed specifically towards particular sectors of intervention, which thus decreases the costs. Another advantage is that these instruments are implemented especially when there is no desire to harden the monetary policy.

The macroprudential approach was noticed within the European context due to the existing constraints, to the absence of a harmonized monetary policy and of a policy of harmonizing the capital standards.

Under exceptional circumstances, such as the crises, the central banks must alleviate the panic from the financial markets, must ensure credit market operationality and prevent the collapse of the financial institutions and of the institutions of systemic importance.

The crisis manifested throughout all the categories existing within the financial system, mainly within the banking system, by narrowing the activity of giving bank credits, by increasing the credit risk, by deteriorating the banking performance indicators, etc.; however, it also acted within the other components of the financial system. Thus, the economic activity of the non-financial companies, of the insurance companies, of the pension funds also deteriorated, while the aversion towards the reference index of the capital market intensified.

The measures initiated by the monetary authorities to support the financial system have been used in a combination of *ad-hoc* measures implemented within the individual financial institutions and *complex schemes* applied on the background of an intensifying financial crisis. The *ad-hoc* measures have been implemented at the kevel of financial institution because they were set up in a rapid and flexible manner, while the complex schemes provided more transparency than the initial ones, didn't distort the competitiveness and could be easier adopted because they were part of a well-defined plan. The governmental authorities acted to guarantee the bank deposits, to support recapitalization, to delimit the bad banks and to nationalize financial institutions of major importance.

From the perspective of the monetary authorities, they can use *conventional measures* and *unconventional measures*. The first ones include measures adopted through monetary policy instruments, i.e. monetary policy interest rate, permanent facilities and compulsory minimal reserves. In a first stage, the central banks have decreased the monetary policy interest rates because the deterioration of the financial market conditions has changed the perspectives regarding the financial stability, and also the purpose of reviving the bank credits.

Given the major deficiencies observed in the transmission channels of the monetary policy and the significant deterioration of the economic environment, the central banks were compelled to use so-called unorthodox measures, which mainly involve interventions on the national markets and interventions on the currency market.

The enforcement of unconventional measures differs in the case of the developed countries from the situation of the emergent economies, due to the differences in the financial stress and in the credibility of the monetary policy. Thus, the developed economies used non-standard measures immediately after the Lehman Brothers crash, relying heavily on measures that support the liquidities. They promoted a decreasing rate of the interest rate near to zero, and also acted to expand the eligible counterparts and the maturity of the refinancing operations. Unlike the developed economies, the emergent economies promoted the use of direct measures, such as supporting the requirement for reserves. The major difference in the implementation of measures was the use of the qualitative and quantitative support of the credit. Thus, the developed economies relied particularly on this type of measures, while the emergent economies used them just slightly. Thus, only Israel implemented for a brief period (6 months) measures for the quantitative support of the credit, and only some central banks have also implemented measures for the qualitative support of the credit.

On the background of the international financial crisis, it appeared absolutely necessary to approach the financial intermediation and supervision both in microprudential and in macroprudential perspective, developing a, yet missing, framework of action that helps forecasting the possible economic imbalances.

The macroprudential policy is regarded as complementary to the microprudential policy, and it interacts with different types of economic policies which have a sizeable impact mon the financial stability, working towards the elimination of financial imbalances by enhancing the protecting barriers, by identifying and joint approach of the exposures, of the risk concentrations, of the relations and interdependencies as risks of contagion.

Thus, what was the purpose of these measures? The authorities acted in a consistent manner just in order to avoid a collapse of the financial system, to ensure its sturdiness, because the financial system plays a primordial role in ensuring the financial stability, being cleaned and consolidated in time. There is a positive direct relation between the macroprudential policy and the financial stability, so that a *solid and credible transparent policy will potentiate the financial stability*, implicitly accomplishing the basic goal of the monetary policy too.

The financial stability is seen in a new approach, because the prevention of the systemic vulnerabilities is not any more done exclusively by temporising the accumulation of risks through the requirement for capital, but also by working on the amplitude of the financial risk cycle. Furthermore, the anti-cyclic role of the macroprudential policy is consolidated (additional capital reserves), including by proactive measures to temper the demand for credits, while the capital reserves accumulated during the periods of expansion are to be used in periods of economic adjustment.

5. European institutional aspects in the field of financial stability ensuring

Because of the importance ascribed to the provision of an economic climate proper for the objectives developing from the economic sustainability goal, the European Union has established several institutional mechanisms that provide financial stability.

Thus, the European Financial Stability Facility (EFSF) has been established by the Euro zone member countries following the decisions that the Ecofin Council took on May 9th, 2010. EFSF mandate is to protect the financial stability within Europe by granting financial assistance for the Euro zone member countries. EFSF can use, under certain conditions, several instruments such as: loans to the countries experiencing financial difficulties, interventions on the primary and secondary credit markets and recapitalization of the financial institutions by loans granted by governments.

The European System of Financial Supervisors (ESFS) has been also established, in association with an intricate network of regulatory and supervisory institutions. Its objectives are to facilitate the cooperation between the national and EU supervisors.

Within the same spirit, three European supervisory agencies have been established on January 1st, 2011: the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA).

Besides the development of the EU regulatory and supervisory institutional structure, just before the onset of the crisis, several mechanisms of cooperation on matters of financial stability have been established in several European countries. The financial stability committees have been established with the purpose to facilitate the cooperation on matters of financial stability between the central banks, the national supervisory agencies and the national governments.

The flows of capital and their consequences on the macroeconomic and financial stability

Current account liberalization is one of the most debated decisions of macroeconomic policy because the different theoretical approaches have different interpretations on the opportunity of taking such a measure.

Necessary elements of the system of macroeconomic policies

The process of real convergence with the European Union of the emergent economies from Central and Eastern Europe is in progress and will continue for many years, given the lags existing in many of these countries.

The real convergence is characterized by the simultaneous manifestation pf the following evolutions:

– Rates of economic growth higher than the average, particularly during the early stages of the catching-up process;
– Sizeable increase of the income per capita;
– Massive inflows of foreign capital;
– Strong tendency for the real appreciation of the national currency.

The accomplishment of the goals of sustained economic growth, on the one hand, and the macroeconomic stability, on the other hand, presume the stimulation of investments and the avoidance of the pro-cyclic character of the macroeconomic policies.

In terms of investments, the authorities should improve their capacity to absorb European funds, while the measures for the betterment of the business environment would allow a higher flow of private investments.

Because the Central and Eastern European economies display overheating trends during their real convergence, the fiscal imbalances must not add to the economic cycle.

The economic policies should capitalise on the periods of sustained growth in order to promote the necessary reforms, thus adding supplementary room for manoeuvre for the monetary policy during the possible subsequent periods of economic decline (Krueger, 2004).this calls the fiscal policy to use the periods of economic boom as a good opportunity for the build-up of fiscal surpluses that can be used as “dampens” in the perspective of the periods of decline, when it will have to control the economic divergences and asymmetric shocks (Trichet, 2001).

The monetary policy might be confronted with a dilemma in the context of the massive inflows of capital, which is very likely, due to a possible change in the world financial polarity. On the one hand, the evolution of the inflation might claim successive increases of the monetary policy interest rate, which encourage saving, thus providing a balance between the level of saving and the extent of investments, balance which is essential if one wants to avoid an excessive current account deficit. On the other hand, the higher interest rates might create a positive interest rate differential, which would draw additional inflows of capital, with the ensuing pressure towards the appreciation of the national currency. The episodes of sudden appreciation might get reversed subsequently, with the consequences of a higher rate of inflation and tensions within the financial sector. The market could solve this dilemma by setting lower risk premiums for the investments in the transition economies. However, since the risk premiums sometimes have non-uniform evolutions and are sensitive to factors that are not under the control of the authorities, the capital inflows may thwart the efforts towards economic stability (Lipschitz et al., 2002).

Another extremely sensitive aspect is the recommended behaviour of the monetary policy when inflation is under control for the forecasted period, but the financial and macroeconomic imbalances deepen. If the economic policy fails to design and implement a swift response, in an early stage, the authorities passively bring their contributions to the deepening of these imbalances which, sooner or later, might either start a crisis, or involve much higher economic costs in the case of a subsequent intervention, when the financial or macroeconomic problems are already acute. Although theoretically, the necessity for intervention cannot be doubted, the decision of the right time for intervention by the central bank, probably with the support of the other authorities, may rise several hard to solve problems, such as:

1. Is it possible to identify clearly the imbalances in an early stage?
2. If the imbalances that appear in an early stage disappear by themselves/spontaneously, and the authorities adopt swift restrictive measures, the combined effect of the two factors might push the economy in a steep recession.
3. How could a restrictive monetary policy be explained in the absence of inflationist pressures? (Crockett, 2003).

6. Final aspects and conclusions

Given the complexity of these aspects, the proper calibration of the monetary policy reaction is much more so difficult. Furthermore, given the limitations imposed by the opening of the capital account, the preservation of the macroeconomic balances cannot be exclusively the task of the monetary policy; the fiscal policy and the income policy should come to aid, by assuming part of the efforts towards stabilization. More precisely, the fiscal policy should hold the main role in correcting the current account imbalances. This means that the countries must thus calibrate their budgets so as to cope with the increasing demand from the private sector and take appropriate measures of protection against a possible crisis, because the size of the fiscal deficit contributes directly to the magnitude of the current account deficit. At the same time, through its component of incentives creation, the fiscal policy might encourage the exports and the productive activities in general. Besides the restrictiveness of the fiscal policy, the government should also implement a prudent policy of incomes by limiting the pay rise in the public sector, action which might also narrow the copying effect which the excessive pay rise in the public sector may have on the wages from the private sector. This would avert the uncorrelated evolution of the wages with the evolution of work productivity.

Looking in perspective, the process of real and nominal convergence of the Romanian economy will be accomplished at a rate which depends largely on the general coherence of the economic policies implemented by the authorities.

The process of adopting the Euro presumes a realist, visionary management, which to take into consideration that the Romanian economy needs a period of adjustment before joining the ERM II. This period must be regarded as an opportunity to finish the structural reforms and to consolidate the macroeconomic stability, rather than a "break" that might relax prematurely the macroeconomic policies. The central bank must ensure, maintaining its inflation targeting strategy, the gradual nearing of the inflation rate to the levels that are compatible with the Maastricht price stability criterion. Once the reduced inflation has been consolidated, favourable conditions will be set up for the sustainable accomplishment of the nominal convergence criteria regarding the long term interest rate and the exchange rate stability. At the same time, the implementation of a prudent fiscal policy will support the sustainability of the public finances. Under these conditions, Romania might join the Euro zone by 2019.

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