# PRICE STABILITY VERSUS FINANCIAL STABILITY IN EUROPEAN CENTRAL BANKS

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***Abstract.*** *In light of recent economic events occurring on a global scale, central banks around the world are beginning to ask themselves whether it would be advisable to review their fundamental objectives assumed. Increasingly more opinions support this view. This paper proposes a brief analyze on the role that a central bank should have in an economy in order to bring the most useful contribution it can to society.*

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## 1. Introduction

Central banking is and has always been a tricky business. One of the primary functions of a central bank is to issue the legal currency. Money and their role and importance to an economy have been a long concerned for economists even from the beginnings of this science. Understanding this is a key element in establishing the most useful way that a central bank can act in the benefit of all the participants of any society.

In the years followed by the oil crisis the monetarism imposed as the mainstream view of how a central bank should be and act. Its main and only objective was to keep prices stability by any means necessary. This is the reason why in most advanced or emerging countries central banks are fully independent institutions from the central administration. Their sole objective is to maintain price stability while the other objectives that a government has set are left in the responsibility of other institutions. This view remained a landmark in the last 40 years. However, what has changed during these years is the way that central banks are doing this. Different strategies have been created overtime, the current most popular being the direct inflation targeting. As for the financial stability issue, the resolution

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promoted by monetarists consisted mostly of deregulation and letting the market do its magic.

This article is divided in five parts. After a short introduction the second part proposes a brief presentation of this article relevant history of money and central banking. These have been two of the most delicate issues addressed by the science of economics from its beginnings. Also the second part includes a short presentation of the main instruments that a central bank has at its disposal in achieving its objectives. Tinbergen principle tells us that we can achieve a certain number of targets only by having an equal or greater number of instruments at our disposal. The third part is about constrains faced by the Eastern European central banks in achieving their objectives of prices and financial stability in the context of the world financial crisis. The forth part tries to imagine how a new and better economic model can be created. The last part is dedicated to conclusions.

## 2. Money and central banking

Since the earliest beginning of economics scholars have tried to explain the notion of money. Money is basically merchandise as any other merchandise with a few particularities mainly that they can be used by anyone, they are not deteriorating with time and they are easy to keep. In its well-known book, entitled “The Wealth of Nations”, Adam Smith establishes the difference between value of use and value of exchange for money with its famous diamond–water paradox. Another classical economist that considered and analyzed in depth money was Carl Menger, who in its book entitled “Principles of Economics” dedicates a full chapter to the occurrence of money in the world, their role and main characteristics. Money was created to facilitate trade with different kinds of merchandises. At first money were consisting from merchandising with characteristics similar to those above, especially in the form of coins of precious metals. In time banks and governments started to issue currency in the form of banknotes. These are called fiat money because they do not have an intrinsic value but instead they are based on lows and other legal acts that attributes them real value.

Actually one of the first financial crises appeared when the ruler of a realm decided to decrease the quantity of precious metal in their coins. Any government has three main ways to finance its spending. To increase the level of taxation (which is the most honest and long-time sustainable way), to borrow money from the internal sector or external sector or to issue new

currency. The last way is considered the worst way possible because it reduces the purchasing power of everybody without exception and because these effects are not felt immediately by individuals. Moreover inflation tends to sustain itself by creating and maintaining a vicious circle from which it's very difficult and costly to exit. As prices increase, individuals will ask for more and more rises which governments can't finance in any other way but trough additional currency issuance.

This is why monetarists brought the idea of complete separation of the authorities that have the responsibility of currency issuance, namely the central banks from the other government authorities. This basically marks the separation between the fiscal and monetary policies. But everybody knows and agrees that there must be synchronization between these two types of economic policies in order to be efficient and not to cancel each other. According to the monetarist school of economics the monetary policy needs to be neutral in the form of constantly increase the monetary base by a specific amount (usually 2-3 percent per year). This on one hand will ensure prices stability and on the other hand will avoid the situation in which an employer will go bankrupt because of not being able to pay its employees as its products would decrease in nominal value. In the monetarist view the sole purpose of a central bank must be maintaining the prices stability.

There have been different strategies applied by central banks in achieving this objective. One of the first was by trying to control the monetary aggregates. As these also depends by the behaviour of commercial banks and ultimately by the behaviour of each individual (through the money multiplier). In time, this strategy proved difficult to follow. Another strategy was favoured called direct inflation target. The main instrument for this is the monetary policy rate.

Another very important responsibility of most central banks is ensuring the financial stability in the economy. This is done by authorization, regulation and prudential supervisions of the other financial institutions.

Jan Tinbergen's principle emphasize that one can achieve a certain number of targets only by having at its dispose an equal or greater number of instruments. If you have the same instrument and you want to achieve two different targets you might be in trouble. Of course there are many instruments for achieving financial stability, none of which are remotely related with monetary policy rate. There are mostly administrative and include maintaining an adequate solvency ratio, forcing banks to make some reserves in the form of provisions to anticipate defaults and

impairment of their assets and so on. The instruments here are many but what is important is that the monetary policy rate affects directly the sustainability of banks by influencing the liquidity available at a particular moment in time. It's like trying to shoot two rabbits with the same bullet. The most common reaction of central banks throughout the world to the financial crisis was an immediate decrease to almost zero of the monetary policy rate. Overnight financial stability became the predominate objective.

The financial crisis was not caused by the misuse of monetary policy rate. Instead it was caused by a different ideas promoted by monetarists, specifically those ideas that supported deregulation of financial institutions. Nevertheless, central banks were left to choose between a possible slow death of their economies or a sure and immediate one. The right choice was evident. However this calls for a change in the mainstream economic model that is analyzed in the fourth chapter.

## 3. Constrains of the central banks from Eastern Europe

Almost no public authority in the world can be proud of their performance in anticipating the financial crisis and reacting efficient to it.

In most countries the main role in the financial crisis management fell on the local central bank and largely on its decisions will depend on the crisis impact on the real sector. As shown above, what the central banks done immediately when confronted with the crisis was to make sure enough liquidity in the money market for their commercial banks.

The Eastern European countries have their economies characterized by a close proximity to the Euro Area. They still have a monetary policy of their own, but everything is depending on the stability of their big neighbour. Before the year 2008 massive foreign direct investments have found their way into Eastern Europe. This area was considered highly recommended for such investments because of their good perspectives determinate by their recent joining of the European Union and their still cheap labour force compared with what you'll find in the west. Inward investments flows were recorded in all institutional sectors of the economy and banks didn't make an exception.

So the 2008 financial crisis caught most countries of Eastern Europe with their financial systems owned by foreign companies. This was a potential big vulnerability as most foreign investors tend to pack up and leave when things go wrong. To avoid this, the Vienna gentleman's agreements was sign with most important of the financial groups investors

in which they decided not to withdraw their investments from Eastern Europe.

Another important vulnerability of the financial system was caused by the fact that most households of this part of Europe borrowed money from banks in foreign currencies, especially euro. This was due to the fact that their local currency known an appreciation before the crisis or, at least, a very stable period as foreign currency continued to enter in the eastern European countries after the liberalization of the financial account and the joining the European Union. The interests rates were more attractive for loans in foreign currencies also due to the fact that banks were avoiding having currency mismatches in their balance sheets and to the fact that local monetary policy rate was significantly higher than that of the euro area. The main cause of this was that most of Eastern European countries were still recovering from a high inflation period.

Most of the central banks failed to address these issues before the crisis or managed to do little about avoiding them. Some economists warned about the potential consequences of liberalizing the balance of payments financial account before the economy is ready but they had pour success. The European dream was too beautiful to think about any problems. However, some central banks did manage to anticipate these vulnerabilities and to cushion their negative effects. This happened mainly by establishing higher minimum reserves requirements for foreign currency liabilities than domestic currency. When the crisis started lowering these was like an oxygen pocket for local banks. These would have a negative impact in the eyes of foreign investors if it would have led to a significant decrease in international reserves so most central banks and governments from this part of Europe borrowed money from international institutions in order to avoid this effects.

It is obvious that any small country will have some economic problems when the world is facing a global financial crisis. However it is very important how the relevant institutions prepare the economy for the incoming crisis, being consistent with their mission to provide long-term economic stability.

## 4. Revising the central bank role for the new economic model

By far, the hardest question of all is in what way the current economic model should be improved? The science of economics must answer this question in order to rehabilitate its image.

It's clear that more attention should be dedicated on financial stability and on adequate banking regulation. The ideas about the benefits of deregulation should be left aside and it already was by most economists in the world. At this moment important changes are being implemented in the area of corporate governance of the financial system for example. Another important aspect of financial regulation is that although this was a crisis of the financial system, the banks were not the only financial institutions to have failed. More cooperation between central banks and the other financial regulation authorities in the area of insurance, pension funds and other types of financial intermediary is definitely needed. But will this be enough?

The Tinbergen problem still lays ahead unresolved. You have two different objectives, price stability and financial stability and you have a powerful policy instrument that affects them both. Of course you can split the responsibilities by creating a monetary authority and a regulation and supervision authority. Some countries already had this long before the crisis emerged and it doesn't seem to have helped them too much. It would be an additional effort to try to synchronize the monetary policy interest rate with the rest of the financial stability measures similar with what happens between fiscal and monetary policies.

The ideal thing would be to find those instruments of ensuring and maintaining financial stability that can be used efficiently independent of the monetary interest rate. However, when things go wrong in the financial area, not ensuring additional liquidity in the market will always be the wrong choice for a central bank and will lead to disaster.

## 5. Conclusions

The need for change is obvious and the problems are also clearly defined. It's time for economics to rehabilitate in the eyes of individuals. Any truly new economic model must bring significant changes to the current monetary policy theories accepted and promoted by the mainstream view. With all its downsides, this crisis can be seen as an opportunity to make some of the old things better.

Throughout their history, the central banks have known important changes both in their primary objectives and in their available instruments. These changes usually happened when something went terribly wrong rather than just as an improvement of the old ways. The current financial crisis might be one of these moments.

Deregulation of the financial sector, although it sounded great on paper prove to be one of the biggest mistakes of economics as a science. This is common sense. What is more complicated and still open for debate is whether central banks must add to their primary objectives the financial stability issue. In a way this can be seen as a obvious acknowledgement of the current reality. On a short term, prices stability, the fundamental objective of most central banks, had to be sacrificed for maintaining the financial stability of banking system. However, the issue is still open for debate, the Tinbergen problem is not solved and it seems that once again economics as a science is a step or two behind the reality.

It's worth to mention that it's very difficult to create a theoretical model for monetary policy implementation that works in every country. As shown in this article the Eastern European countries for example have their own particularities and any monetary policy must be adapted to the field reality. Perhaps this can be a base for reconstruction.

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