THE ROLE OF CENTRAL BANKS IN CRISIS PREVENTION AND TREATMENT

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Abstract. *The economic crisis has highlighted the importance of central banks' actions both in terms of prevention and therapy application in the context of the economic and financial imbalances. The lack of adequate control prior to the year 2008 has determined the financial-banking operators to turn to a lot of improper practices. That is why many of the measures taken by the European Central Bank and the Federal Reserve have not manifested their effects immediately. The article highlights the decisions taken by these two institutions during the crisis and their impact on the key economic indicators.*

Keywords: *economic crisis, central banks, quantitative easing.*

JEL Classification: *G28, E58.*

1. Introduction

Central banks are the financial institutions that serve to limit, keep under control, eliminate and prevent financial instability. By achieving this complex goal, central banks influence decisively the functioning of the economy.

Along with the rise of monetarism central banks have strengthened their role in the economy. According to the monetarist perception the state's role in the economy could be limited by increasing the money supply at a fixed rate each year. This was in their opinion the best way of keeping prices stable and a low level of inflation.

The failure of monetarism has oriented the authorities to the promotion of a different type of monetary policy based on inflation targeting. This change in the role of some central banks took place in the early 1990s and it remained in force until present day.

However, the development of the banking system requires the extension of the central banks activity beyond the regulation of other banks

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and the control of money supply. A central bank must ensure that the money supply on the key markets is not threatened by a wave of massive withdrawals. The intervention of the lender of last resort has the ability to save certain structures of the economic activity, this role of central banks is even more important when the financial system is in distress (Minsky, 2011).

The article is structured in two parts. The first part looks at the role of the central bank in ensuring financial stability. The analysis focuses on the measures adopted by the European Central Bank (ECB) and the US Federal Reserve (FED) during the 2008 crisis. The second part of the paper includes a comparative analysis of the main macroeconomic indicators of the two economies (Euro area and United States) in order to highlight the effectiveness of the monetary policy measures.

2. The role of central banks in crisis management

Until the early 1990's the function of monetary policy makers has dominated the general perception regarding the central banks activity. With the development of the banking system, central banks activity has diversified and the regulatory and supervisory framework has changed significantly.

The economic crisis has highlighted the important role that the authorities responsible for the maintenance of the financial stability have in crisis prevention. Nowadays the analysis of system's capacity to withstand shocks, the insurance of financial system stability and the analysis of the vulnerabilities through stress tests have gain a lot of importance. These objectives can only be achieved if central banks assume a more important role in macro-prudential policy making and implementing.

Central banks expertise in analyzing financial systems from a global perspective is essential to ensure stability and risk management. The recent financial crisis has demonstrated that the complex and opaque financial system can generate systemic risk which in turn can affect the behavior of monetary policy. Hence, since monetary policy transmission mechanisms have been affected, central banks had to take unconventional measures. Therefore, the new economic context gives central banks an important role to play as coordinator/ facilitator/ initiator of the new regulatory and supervision framework (Praet, 2011).

European Union

The current banking system, characterized by extensive communication between banks, including mutual borrowing operations, has allowed in 2008 the transfer of the problems from the US banking system to the European one.

With the intensification of the crisis and the loss of confidence, ECB has adopted a number of standard and non-standard monetary policy measures in order to stimulate lending and to achieve its primary objective, namely, price stability.

The standard monetary policy measures involved primarily key interest rate reduction. Normally, central banks coordinate monetary policy by controlling nominal interest rates whose effects are transferred in the economy through various channels. Since the changes in the nominal interest rates do not affect immediately the inflation, central banks can control in the short or medium run real interest rates. The changes in real interest rates will influence the economic decisions through changes in the price of assets. Thus, a change in short-term real interest rates will affect the production levels and the employment in the economy.

The problem with standard measures of monetary policy is that the nominal interest rates cannot be reduced below zero. Therefore, the effectiveness of these measures is quite limited and during a long term crisis, such as that of 2008, appears the need to adopt additional measures.

The so called non-standard measures adopted by the ECB have included providing unlimited liquidity to banks at a fixed interest rate and the opportunity to borrow cash to a wider range of maturities, up to 12 months; all this, in exchange for a wide range of collateral. The new measures adopted by the ECB through which unlimited funds were granted to the banks at a fixed rate represented a change in the conventional policy of the ECB, that of granting limited funds at an interest rate determined by the auction process. The implementation of these measures was achieved through the normal lending procedures. These procedures consisted in refinancing operations, which involves direct lending to banks at two maturities, two weeks for the main refinancing operations and three months for the long-term refinancing operations. The difference between the classical and the new procedures implemented during the crisis lies in the fact that in the classical procedures ECB predetermine the amount of funds available at rates determined by the bidding process, while in the procedures implemented during the crisis the ECB has provided funds for all loan requests at its primary policy rate (Fawely and Neely, 2013).

The approach chosen by the ECB that of complementing the standard policy measures differs from that of other central banks how have decided to change the standard measures of action and to focus on quantitative easing measures (Stark, 2011).

BCE measures were accompanied by harsh austerity measures adopted by the European governments which have generated a new problem, that of sovereign debt. After seven years of austerity and anemic economic growth, the ECB decided to adopt a program of quantitative easing in 2014. The quantitative easing program which started in March 2015 is expected to be carried out until at least September 2016. The value of the program is 1.1 trillion euros (ECB, 2015).

The decision to implement this program is based primarily on the evolution of the inflation rate which has reached historic levels, and which can have serious implications for the price stabilization processes. The asset purchases aim to support investment and consumption, leading on a long run to a return of inflation rates towards 2%.

ECB's actions during the crisis were based on several key principles that will be the foundation of the new operational framework of the ECB. These principles are: operational efficiency, strong orientation towards the market, simplicity and transparency and equal treatment of counterparties. At the same time post-crisis operational framework needs to be designed in a way that ensures stability and safety of the banking sector even if the achievement of these objectives requires setting up a sound regulatory and supervisory framework (Stark, 2011).

United States of America

Unlike the ECB who adopted the quantitative easing program long after the crisis, the Fed announced in November 2008 plans for quantitative easing, after already decreased in October, the level of interest rates to 1%. The program announced for December 2008-June 2010 involved the purchase of mortgage-backed securities, U.S. treasury notes and bank debt.

The purpose of these acquisitions was to release the bank's balance sheets of the subprime mortgage-backed securities, to reduce borrowing costs and to boost lending for house purchases which in turn should support housing markets and should improve the financial markets conditions, in general. In June 2010, the expected time for completion of the program, the economy was growing again; therefore Fed stopped the purchasing program.

Without the financial support coming from the FED the economic difficulties hindered further economic growth. Two months after the

program completion the economy began to show again signs of destabilization, these signs were visible especially in the very low level of inflation.

The economic developments forced the authorities to adopt a new program of quantitative easing in November 2010 announcing the purchase of treasury securities worth 600 billion dollars. This new program aims, like the one recently adopted by the ECB, to increase the level of inflation (Fed, 2010).

After approximately four years since the beginning of the crisis, economic activity continued to expand at a moderate pace, the unemployment rate was still recording high levels and the inflation remained low even if the prices of some commodities have risen. Therefore, the Federal Open Market Committee announced in September 2012 a new program of quantitative easing to support the markets.

The quantitative easing programs implemented by the United States proved to be quite effective in the end, managing to revive the US economy faster than the one in euro area. Thus, in December 2013 it was decided to reduce the volume of purchases because the three relevant indicators reached an acceptable level. The unemployment rate was 7%, the growth rate of GDP was 3.2% and the inflation although at a low level did not present prospects of deterioration. In October 2014 it was decided to end the quantitative easing program which begun in 2008.

3. The comparative evolution of the main economic indicators

In a crisis, the reduction of interest rates is one of the primary measures taken by the authorities. The motivations for such an approach is to increase the money supply in the market to support the economy while the prices of the commodities decline, thereby controlling the inflation. Both the US and European authorities have lowered interest rates to historic levels during the 2008 crisis. In the US, the Fed funds rate was cut since December 2008 to the range of 0-0.25%, a level maintained until present day. The ECB was somewhat reluctant to lower interest rates. Successive reductions were recorded in the euro area, but the decision to lower the interest rate at a comparable level to the one in the US was taken only in the middle of 2014, when it was announced the cut of interest rate to 0.15%, and then again in September to 0.05% (Figure 1).

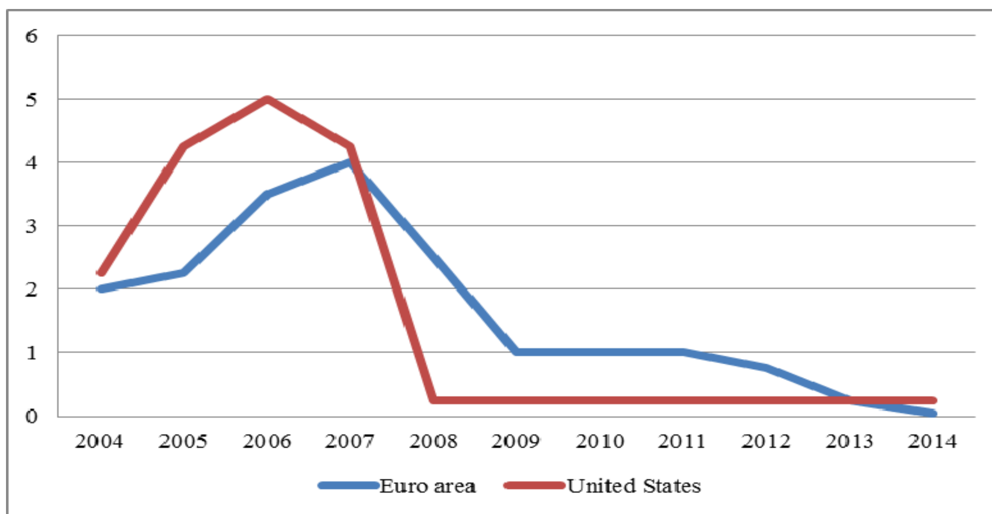

Figure 1. The evolution of interest rates (%).

Source: IMF, World Economic Outlook 2014

Although interest rates have been reduced to historic levels thus reducing the cost of loans and possession of money, prices have declined to such a magnitude that changes in interest rates could not compensate the loss, causing the decline of inflation. This shows the pre-crisis speculative practices that have led to the unfounded increase of prices. The return of prices to their real value caused the collapse of inflation recording in some cases negative values (-0.32%) in the United States in 2009 (Figure 2).

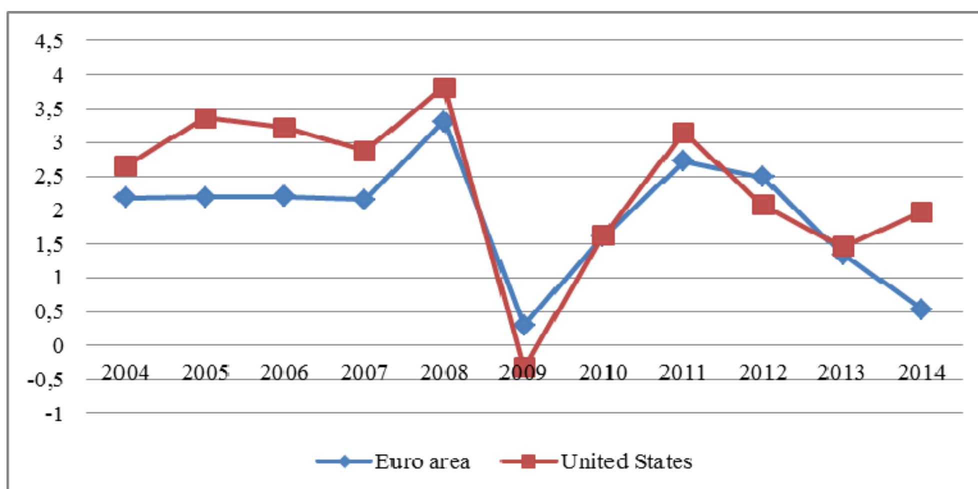

Figure 2. The evolution of the inflation rates (%).

Source: IMF, World Economic Outlook 2014.

Regarding the effects of the implemented policies on the unemployment, it appears that the United States quantitative easing programs implemented by the Fed were able to stop the ascending trend of this indicator. Since 2011 the unemployment followed a downward trend being situated well below the rate registered in the euro area (Figure 3). From this point of view the policy applied by the ECB did not prove its efficiency as quickly. Significant increases were recorded up until 2013 inclusively.

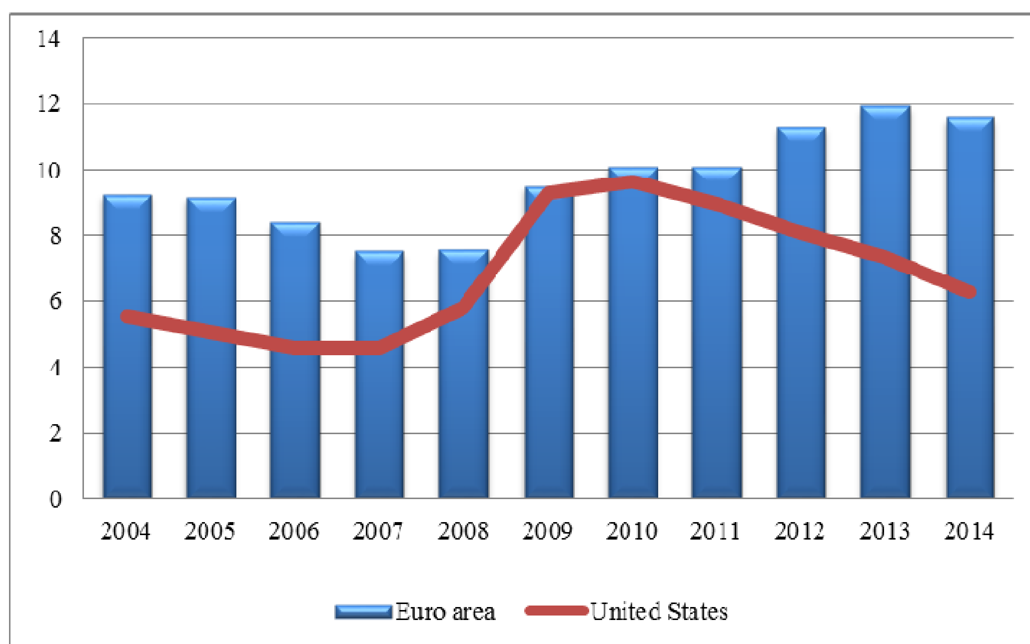

Figure 3. The evolution of the unemployment rate (%).

Source: IMF, World Economic Outlook 2014

The programs implemented in order to support the economy including massive injection of liquidity has led to the increased of debt. In the United States the four programs of quantitative easing have increased the debt by approximately 30 percentage points between 2008 to 2014 (Figure 4). The euro zone debt followed the same trend but the increase was only by 20 percentage points in the same period. These differences can be explained to some extent by the fact that the ECB has avoided actual quantitative easing programs in the period under review. However, given the new measures applied by the European Central Bank a deepening in the debt is not excluded in the coming years.

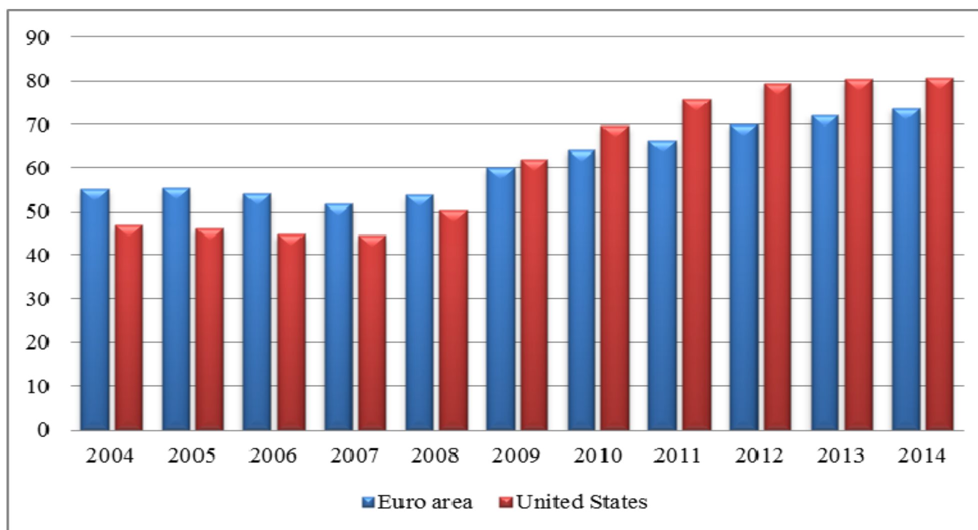

Figure 4. General government net debt (as % of GDP).

Source: IMF, World Economic Outlook 2014

The economic crisis has led to a significant contraction in the economic activity in both regions. The euro area economy registered a negative growth rate even after five years since the economic crisis (Figure 5). Instead, in the United States, the quantitative easing program has proven effective, managing to restore economic growth since 2010.

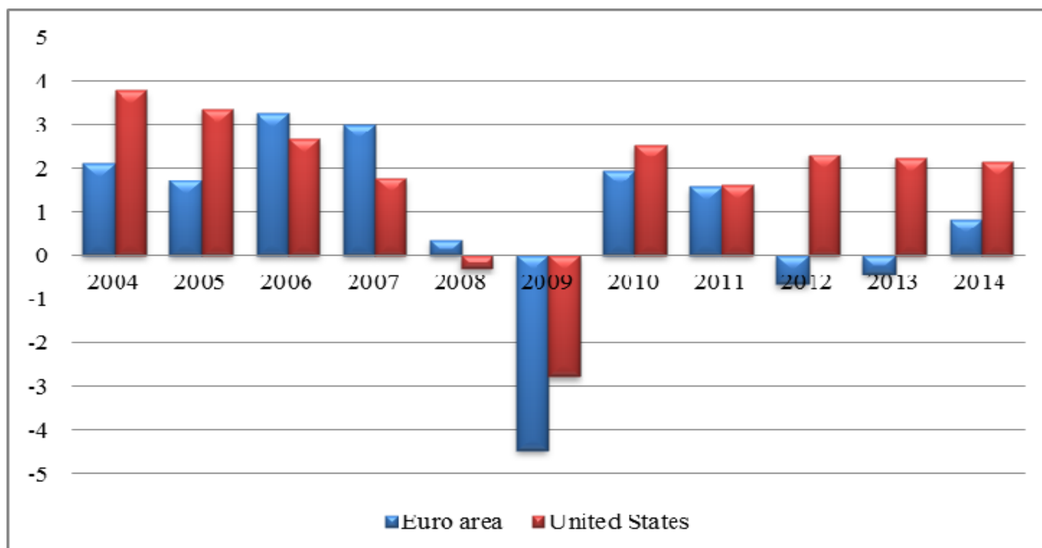

Figure 5. The evolution of GDP growth rate (%).

Source: IMF, World Economic Outlook 2014

4. Conclusions

The analysis of the two models reveals that they led to significantly different results. The immediate reaction of the Fed has proved effective in stabilizing the markets and boosting the economy. Although quantitative easing programs have led to the increase of debt they reached their goals. In Europe however, the measures implemented by the ECB failed to support the economy in the same way, thereby it registered significant fluctuations.

Although the above analysis shows that the model applied by the Fed was more effective than the one of the ECB, applying a similar model in Europe does not guarantee it will be as effective as in the United States. The specifics of the euro area economy require a high degree of caution in monetary policy decisions.

The new economic governance framework puts particular emphasis on ensuring closer regulation and supervision of the banking sector especially in Europe. The achievement of this is the responsibility of the central banks, consolidating therefore their role in the prevention and treatment of economic crisis.

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