

SOME CONSIDERATIONS ON USING MONETARY POLICY TO PROMOTE FINANCIAL STABILITY

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Abstract: *The current period of crisis on credit markets has highlighted the crucial role of the behaviour of banks in the transmission mechanism of monetary policy. This paper summarises our considerations on how monetary policy, as the main instrument, acts in order to promote financial stability and to stabilize the banking system. Central banks have a variety of tools for implementing monetary policy, but the tool that has received the most attention in literature is the interest rate. We observe that the financial crisis that erupted in the summer of 2007 has refocused attention on other channels of monetary policy, notably the transmission of policy through the supply of credit and overall conditions in the capital markets. Monetary policy has important macroeconomic effects only to the extent that it moves financial market prices that really matter—like long-term interest rates, stock market values, and exchange rates.*

Key words: *monetary policy, channels of monetary policy, effects of monetary policy.*

1. Introduction

The current period of crisis in credit markets has highlighted the crucial role of the behaviour of banks in the transmission mechanism of monetary policy. Communication and transparency of monetary policy – its mandate, strategy and decision making – have become key elements of modern central banking. Communication is an essential tool for managing the expectations of the private sector. In doing so, it makes a significant contribution to enhancing the effectiveness and credibility of the monetary policy. This is of particular importance in periods of heightened uncertainty where it is vital that the general public and participants in

financial markets are given clear information on the central bank's primary mandate of ensuring price stability, the state of the economy and the rationale behind monetary policy decisions. The recent period of financial crisis and the associated economic downturn are a powerful illustration of the importance of appropriate communication. With this in mind, we present in this study some considerations how the monetary policy acts, as the main instrument, in order to promote financial stability and to stabilize the banking system.

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crisis that erupted in the summer of 2007 has refocused attention on other channels of monetary policy, notably the transmission of policy through the supply of credit and overall conditions in the capital markets. This article shows that central bank communication, along with a stable and clear monetary policy strategy, plays a pivotal role in restoring trust and preserving confidence among participants in the financial markets and promote financial stability.

2. Objectives

Our objectives are to define monetary policy, to identify the channels of monetary policy, the behaviour of banks in the transmission mechanism of monetary policy and the effects of monetary policy in the context of global financial crisis to achieve financial stability.

3. What Is Monetary Policy and What Are the Tools and Channels of Monetary Policy?

3.1 Monetary Policy

Monetary policy is the process by which the Government, the Central Bank, or the monetary authority of a country controls (i) the supply of money, (ii) availability of money, and (iii) cost of money or rate of interest to attain a set of objectives oriented towards the growth and stability of the economy. [1] Monetary theory provides insight into how to craft optimal monetary policy.

Today monetary decisions take into account a wider range of factors, such as: short term interest rates; long term interest rates; velocity of money through the economy; exchange rates; credit quality; bonds and equities (corporate ownership and debt); government versus private sector spending/savings; international

capital flows of money on large scales; financial derivatives such as options, swaps, futures, contracts etc. The transmission mechanism of monetary policy starts with the central bank's management of liquidity and steering of short-term interest rates. In practice different countries use the various types of monetary policy.

The distinction between the various types of monetary policy lies, primarily, with the set of instruments and target variables that are used by the monetary authorities to achieve their goals. The different types of policy are also called **monetary regimes**.

3.2 Types of Monetary Policy

3.2.1 Inflation targeting

Inflation targeting is a monetary-policy strategy that is characterized by an announced numerical inflation target, an implementation of monetary policy that gives a major role to an inflation forecast and has been called forecast targeting, and a high degree of transparency and accountability. It was introduced in New Zealand in 1990, has been very successful in terms of stabilizing both inflation and the real economy, and has, as of 2010, been adopted by about 25 industrialized and emerging-market economies.

It is currently used in Australia, Brazil, Canada, Chile, Colombia, the Eurozone, New Zealand, Norway, Iceland, Philippines, Poland, Romania, Sweden, Finland, Australia, South Africa, Turkey, and the United Kingdom.

3.2.2 Price level targeting

Price level targeting is similar to inflation targeting except that CPI growth in one year is offset in subsequent years such that over time the price level on aggregate does not move.

3.2.3 Monetary aggregates

In the 1980s, several countries used an approach based on a constant growth in the

money supply. This approach was refined to include different classes of money and credit (M0, M1, M2 and L). This approach is also sometimes called monetarism. While most monetary policy focuses on a price signal of one form or another, this approach is focused on monetary quantities.

3.2.4 Fixed exchange rate

This policy is based on maintaining a fixed exchange rate with a foreign currency. There are varying degrees of fixed exchange rates, which can be ranked in relation to how rigid the fixed exchange rate is with the anchor nation.

Central banks have a variety of tools for implementing monetary policy. The main tools of monetary policy are:

3.2.5 Monetary base

The total amount of a currency that is either circulated in the hands of the public or in the commercial bank deposits held in the central bank's reserves. This measure of the money supply typically only includes the most liquid currencies. Monetary policy can be implemented by changing the size of the monetary base. This *directly* changes the total amount of money circulating in the economy. A central bank can use *open market operations* to change the monetary base. The central bank would buy/sell bonds in exchange for hard currency. When the central bank disburses/collects this hard currency payment, it alters the amount of currency in the economy, thus altering the monetary base.

3.2.5 Reserve requirements

Requirements regarding the amount of funds that banks must hold in reserve against deposits made by their customers.

Monetary policy can be implemented by changing the proportion of total assets that banks must hold in reserve with the central bank. Banks only maintain a small ratio of their assets as cash available for immediate withdrawal; the rest is invested in illiquid

assets like mortgages and loans. By changing the proportion of total assets to be held as liquid cash, the Central Banks changes the availability of loanable funds. This acts as a change in the money supply. Central banks typically do not change the reserve requirements often because it creates very volatile changes in the money supply due to the lending multiplier.

3.2.6 Discount window lending

Many central banks or finance ministries have the authority to lend funds to financial institutions within their country. By calling in existing loans or extending new loans, the monetary authority can directly change the size of the money supply.

3.2.7 Interest rates

The monetary supply can be achieved *indirectly* by increasing the nominal interest rates. Monetary authorities of different nations have differing levels of control of economy-wide interest rates. This rate has significant effect on other market interest rates, but there is no perfect relationship. In many countries, the monetary authority may be able to mandate specific interest rates on loans, savings accounts or other financial assets. By raising the interest rate(s) under its control, a monetary authority can contract the money supply, because higher interest rates encourage savings and discourage borrowing. Both of these effects reduce the size of the money supply.

3.2.8 Currency board

A *currency board* is a monetary authority which is required to maintain a fixed exchange rate with a foreign currency. This policy objective requires the conventional objectives of a central bank to be subordinated to the exchange rate target. A currency board maintains absolute, unlimited convertibility between its notes and coins and the currency against which they are pegged (*the anchor currency*), at a fixed rate of exchange, with

no restrictions on current-account or capital-account transactions. This limits the possibility for the local monetary authority to inflate or pursue other objectives. The principal rationales behind a currency board are three-fold:

- (i) to import monetary credibility of the anchor nation;
- (ii) to maintain a fixed exchange rate with the anchor nation;
- (iii) to establish credibility with the exchange rate.

Central banks make use of a variety of these tools for implementing the monetary policy, but the tools that have received most attention in the mainstream literature has been the *interest rate* and *inflation targeting*.

In the Eurosystem the primary objective is to maintain price stability, as defined in Article 105 of the Treaty. Without prejudice to the primary objective of price stability, the Eurosystem has to support the general economic policies in the European Community. In order to achieve its objectives, the Eurosystem has at its disposal a set of monetary policy instruments; the Eurosystem conducts open market operations, offers standing facilities and requires credit institutions to hold minimum reserves on accounts with the Eurosystem.

In the case of the United States, the Federal Reserve targets the “federal funds rate,” an overnight inter-bank interest rate among U.S. banks with reserves at the Federal Reserve. [2] However, mainstream models of monetary economics have virtually no direct role for the overnight interest rate to affect the economy.

The conventional view is summarized by Alan Blinder (1998), who states:

Central banks generally control only the overnight interest rate, an interest rate that is relevant to virtually no economically interesting transaction. Monetary policy has important macroeconomic effects only

to the extent that it moves financial market prices that really matter-like long-term interest rates, stock market values, and exchange rates. Today, [2] the mainstream approach in monetary economics has been to emphasize the importance of managing market expectations.

By charting a path for future short rates and communicating this path clearly to the market, the central bank can influence long rates and thereby influence mortgage rates, corporate lending rates, and other prices that affect consumption and investment. This “expectations channel” of monetary policy had become the dominant theme in many central banks, especially among those that practice inflation targeting. [3]

Carl Walsh [4] revisits some fundamental monetary policy issues and concludes that “distortions in financial markets that generate real effects of monetary policy also imply that financial stability may require making trade-offs with the goals of inflation stability and stability of real economic activity”

4. How Can Monetary Policy Achieve Financial Stability?

Monetary policy and financial-stability policy are distinctly different by objectives, instruments and authorities. Financial stability is an additional objective for *monetary policy*.

While most central banks have added a financial stability objective in recent years, the monetary policy and financial stability wings of many of institutions have operated as two solitudes.

The financial crisis that erupted in the summer of 2007 has required of monetary policy to change and to refocuses attention on other channels of monetary policy, notably the transmission of policy through the supply of credit and overall conditions in the capital markets.

There is an emerging consensus, in literature, that the old monetary policies, that of price stability, interest rates, monetary aggregates, and special inflation targeting, does not guarantee financial stability. Price stability and interest rate are not enough to achieve financial stability.

There is also general agreement that the first line of defense should be better regulation, including new macro-prudential tools. To achieve more financial stability a good and stable monetary policy is now seen as lying on three pillars:

- (1) a mandate, with priority to price stability but also with some weight on real stabilization,
- (2) independence, to avoid short-term political interference and to give the central bank the possibility to achieve its mandate, and
- (3) accountability, which improves with transparency, creates incentives for the central bank to achieve its mandate, and provides democratic control of a powerful institution.

The importance of credibility and transparency for the efficient implementation and transmission of monetary policy is also much better understood these days, and a good institutional framework contributes to the credibility of the monetary-policy regime.

The experience of the past two years is quickly changing these attitudes. Central banks admit that they need a deeper understanding of financial system dynamics in order to better understand the relationship between price and financial stability and, ultimately, the contribution of both to the stabilization of economic activity. Central banks have effectively treated the transmission mechanism as uncertain but fixed (or, at best, only mildly variable) when it is, in fact, highly variable and pro-cyclical. [5]

The transmission mechanism of monetary policy is function of, among

other factors, (i) regulation, which changes over time; (ii) financial innovation, which often evolves to circumvent regulation; and (iii) confidence, which is influenced by monetary policy in ways not commonly acknowledged.

Communication and transparency in monetary policy are essential tools for managing the expectations of the private sector and for improving financial stability. The arguments in favor of transparency in monetary policy are strong and well known. Transparency will improve private-sector information, reduce uncertainty about central-bank information and policy intentions, and, therefore, contribute to better decisions by economic agents. Transparency permits a more effective external scrutiny and evaluation of monetary policy and, thereby, improves the incentive of central banks to achieve their targets. [6] It may also improve the implementation of monetary policy by allowing central banks to affect private sector expectations more effectively, especially about future policy rates. Transparency also strengthens the democratic accountability of independent central banks.

5. Conclusion

The lesson for the conduct of monetary policy is that the interaction of leverage constraints of financial intermediaries, short-term interest rates, and financial asset quantities are important to consider in conjunction. Experience has shown that monetary and financial stability are more tightly bound than had been appreciated. Price stability is a necessary, but not sufficient, condition for the stabilization of economic activity, and it must be supplemented by a robust macro-prudential regulatory framework. This, in turn, will have consequences for the implementation of monetary policy. If these macro-

prudential tools prove insufficient to achieve financial stability, monetary policy faces a difficult trade-off between flexibility and credibility. As a consequence, authorities may wish to adjust the monetary policy objective to have the *credible* flexibility required to achieve both targets. In this context communication and transparency in monetary policy are essential tools for managing the expectations of the private sector and for improve financial stability.

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