Bulletin of the *Transilvania* University of Braşov • Vol. 4 (53) •No. 2 - 2011
Series VII: Social Sciences • Law

FINANCIAL STABILITY AND THE ROLE OF CENTRAL BANKS

Carmen-Adriana GHEORGHE[1]

Abstract: *The role of central banks in promoting monetary stability is well known. Modern central banking laws are usually explicit on making monetary stability the core objective of central banks. Also, other competing objectives are sometimes added to the central bank's mandate, such as growth and full employment.*

Key words: *financial stability, monetary stability, Central banks, the role of central banks.*

1. Introduction

The reason for central bank's involvement in the promotion of financial stability is twofold. First, it is generally agreed that financial stability is a condition of monetary stability. A financial crisis will result in a contraction of the money supply, which affects monetary stability. Conversely, too much liquidity is being created, which generates a risk of inflation, usually followed by a downturn. Second, financial crises affect the real economy. As credit is based on trust, it will dry up if there is a loss confidence in debtor's solvency. No credit means no investment, which leads to unemployment and economic recession. A central bank can not be indifferent to these consequences. Even if it has not explicit mandate concerning the real economy, a major recession will inevitably raise questions about its usefulness to the country.

2. Central banks – a particular social institution

Central banks are an archetype of a particular social institution that is now faced with a variety of pressing challenges. Among the principal issues are: the primacy of price, exchange and financial stability as objectives, the relative scope of monetary, regulatory, advisory and developmental roles of central banks, the transmission to direct monetary policy instruments, the conflict between monetary policy and other roles, the fiscalization of central banks, organizational reform of central banks, the case for divertissement of their quasi-fiscal activities, scope and limitations of central bank independence and of ceilings on credit to government.

The more practical approach is to discuss the objectives and functions of typical central banks, which are best regarded as organizations rather than institutions. D. North differentiates them as: institutions

[1] Department of Law, *Transilvania* University of Braşov.

are "humanly devised constraints like rules, laws, constitutions, informal constraints like norms and conventions, self-imposed codes of conduct, and their enforcement characteristics, which together define the incentive structure of economies and societies". Organizations, on the other hand, comprise "groups of individuals bound together by some common purpose to achieve certain objectives" and include political bodies- political parties, the Senate, the City Council, regulatory bodies, economic bodies- firms, trade unions, family farms, cooperatives, social bodies- clubs, churches and educational bodies- universities, schools, vocational training centres.

Other approach is to regard a central bank as an autonomous public interest bureau with a constitution, operating rules and a managerial bureaucracy. In so far as a central bank acts as a fiscal agent for the government its behaviour is also amenable to agency theory which is concerned broadly with the interaction between principals and agents. On the other hand, a central bank has also approximates interaction to a firm which aims not at profit, but at an operating surplus and adequate reserves while meeting economic policy objectives. In conclusion, a central bank is very much an amalgam of an autonomous knowledge-based public interest bureau and a cost-effective financial entity.

The contemporary debate happily no longer concerns the rationale of central banking except perhaps for the small core of unreconstructed ”free bankers” who would rely on the Invisible Hand even in monetary affairs and even those theoreticians argue that ”economic theory does not yield decisive arguments for and against laissez faire in bank-issues money".

Rather the contemporary focus is on the range and scope of the objectives and functions of central banks. The literature has focused on issues such as: should central banks have a hierarchy of objectives with stability of the domestic currency (price stability) as the overriding aim? Should central banks concentrate on the so-called core functions of monetary policy and lender of last resort or should they also assume other responsibilities such as prudential regulation and supervision, exchange rate policy and developmental activities?

Central banks perform a variety of functions, which vary with the degree of institutional and marked development of an economy. These are not all limited to the achievement and maintenance of price stability but may also include the more wide-ranging prudential, developmental, advisory and representational functions. It is possible to classify the list of more or less conventionally agreed central banking functions as follows.

3. Central banks- functions

Central banks perform a variety of functions, which vary with the degree of institutional and marked development of an economy. These are not all limited to the achievement and maintenance of price stability but may also include the more wide-ranging prudential, developmental, advisory and representational functions. It is possible to classify the list of more or less conventionally agreed central banking functions as follows.

Core functions:

1. Issue and regulation of legal tender currency (coinage is a government responsibility).

2. Banker and fiscal agent for the government (this may still leave the

government the option to use commercial banks as depositories).

3. Banker for commercial banks.
4. Lender of last resort.
5. Management of foreign exchange reserves.
6. Macroeconomic management of the cost availability and supply of money and credit.

As in the case of targets, the core functions of central banks can conflict with the peripheral, for instance, monetary policy considerations may conflict with developmental as well as prudential objectives.

The role a central bank can play in the prevention or resolution of the financial crises depends, to a large extent, on the extent of the rights and powers conferred upon it by legislation.

4. Prevention and resolution

Regardless of the rights and powers conferred by the legislation, a central bank can always conduct research on the country economy‘s financial system and issues reports as long as they do not disclose confidential information on a particular financial intermediary or its clients. More and more central banks publish financial stability reports on a regular basis. In addition, the governor of the central bank may issues public warnings when they conclude that unsound conditions are developing in the financial sector. One of the most useful exercises is to conduct stress tests that will reveal any potential weaknesses. Unless the central bank already has access to that information, as supervisor of banks, legislation requiring the provision of such information to the central bank may have to be enacted. Central bank is also able to detect looming crisis at an early stage because it is aware of banks liquidity problems, and also to require the adoption of corrective prudential measures within the limits of its powers.

The ability to expand or contract the volume of liquidity in the economy and to rise or lower its costs is a powerful tool for the conduct of monetary policy, but the macroeconomic effects of these measures make them ill suited to channel resources to or away from a particular economic sector.

The resolution consists in two types of measures available to a central bank- the temporary injection of liquidity into economy and the provision of financial assistance to solve banks but illiquid.

When the central bank is also the supervisor of banks, the situation of banks that no longer meet the required prudential rules because of a financial crisis may create a temptation for the central bank to refrain from enforcing these rules in order to avoid having to close those banks. This temptation should be resisted. Yielding to it would undermine the central banks credibility and its efforts to restore confidence among financial sector operators and between them and their clients.

4. Conclusion

A central bank’s financial instruments are better suited to deal with the effects of a financial crisis than to prevent its occurrence. This is particularly clear in the context of financial bubbles. There is no symmetry between the role of the central bank during the build-up of a financial bubble and after has burst. During the built up, a central bank can issue warning but cannot restrict credit going to the expanding market. It can only tighten credit in general, which will dampen economic growth in all sectors of the country’s economy. Once the bubble has burst, however, the central bank can provide liquidity to the economy in order to ensure a soft landing and, as lender of last resort, to banks that only suffer temporary liquidity crunches. The importance of financial stability for a country's economy is now generally recognized. A Financial Stability Forum has been created at the initiative of major central banks to coordinate research on financial stability issues.

While there is agreement on the importance of financial stability and the role of central banks, there are differences on what it means in practice.

References

1. Bercea, L.- *Considerations concerning banking contracts in New Civil Code,* in Mondial Financial Crisis, Ed.Wolters Kluver, Bucureşti, 2010
2. Butnariu, D.- *European Directive concerning Payments Services. Some aspects about consumer rights* in Juridical Issues in Banking, Ed. Wolters Kluwer, Bucureşti, 2008
3. Chandavarkar, A.- *Central Banking in Developing Countries.* Macmillan Press LTD, Great Britain, 1996
4. Klein, D.K.R.- *The banking system of the EU member states*. Gresham Books, England, 1995
5. Minea, M.S. - *International Financial Law Elements*, Ed. Accent, Cluj Napoca, 2001
6. Motica, R., Bercea, L.- *General Banking Conditions- contractual document,* in Current issues in banking law, Ed. Wolters Kluwer, Bucureşti, 2008
7. Răţulea, G.- *Democracy and Cultural Rights in European Union,* in European Reserch Studies, vol.XIII,Issue 2, 2010
8. Săulean, L, Smarandache, L., Dodociu, A.- *Banking Law*, Ed. Universul Juridic, Bucureşti, 2011
9. *Current issues in banking law*, Ed. Wolters Kluwer, Bucureşti, 2007
10. Şaguna, D., Raţiu, M.A.- *Banking Law,* Ed. C.H.Beck, Bucureşti, 2007
11. Ştefan, T., Andreşan-Grigoriu, B.- *European Law*, Ed.C.H.Beck, Bucureşti, 2007