MONETARY POLICY AGAINST FINANCIAL STABILITY IN THE REPUBLIC OF MOLDOVA

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Abstract

The financial stability of a country is one of the most current and most discussed issues worldwide. Until the global financial crisis, the financial stability achievement was strongly subordinated to monetary stability, which is considered the priority task of the central bank. But the last evolutions have shown that financial stability involves certain more complicated problems of measurement and definition, more of those that belong to central bank proficiency. The paper's aim is to analyze the ability of NBMs' monetary policy, to maintain the financial stability of RM within the limits of its objectives and duties, in order to highlight the causes of financial instability and in providing solutions overcoming them.

Keywords: Financial stability, monetary policy, price stability, financial crisis.

JEL classification: G01, G28

Introduction

The international financial crisis which began at the end of the first decade of the XXIst century imposed monetary authorities in tandem with academia to review monetary policy instruments and their impact on financial stability and sustainable economic growth. The lately achieved successes in the accomplishment of the primary objective of monetary policy pertaining to the maintenance of price stability have not brought the expected results for the real sector. Regardless of low inflation rates over the medium term, it wasn't recorded an economic recovery as many people expected.

At the moment, a good example in this sense would be the European Central Bank, which implements a series of unconventional measures to combat the risk of installation of low inflation for a long time: from negative interests to the liquidity of banks, in order to encourage lending (ECB, 2014). Thus, through various monetary policy mechanisms it is tried to facilitate the process of money creation by commercial banks in such a way that they in turn expand their business funding in the real sector, in order to achieve real economic growth (Weidmann, 2015).

These decisions have as grounds the economic theory developed by many economists, and are based on the fact that avoiding the development of disinflation processes in economy can be done by increasing the money supply in circulation (Taylor, 1996, Keynes, 2009, Brăilean, 2006; Ignat, 2002).. Thus, the mechanisms of monetary policy seek to stimulate money growth in order to create the required minimal inflation for sustainable economic growth.

The description of the problem

Until the beginning of the financial crisis, the relationship between price stability - financial stability was based on the belief that both types of stability maintain and protect each other mutually on long term. Most of the economists delimited price stability as a necessary and sufficient condition for financial stability.

Inflation is largely perceived as the main factor in generating financial instability. The solution for financial stability seemed simple: a monetary policy oriented towards price stability on relatively short periods (two years) complemented by a component of micro-prudential supervision (focused on the risk of individual institutions, irrespective of the interconnections between these risk contagion and systemic risk).

The financial crisis and its consequences have proved that price stability is not enough to ensure macroeconomic and financial stability, as there is no prudential framework focused on individual entities.

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The crisis has initiated an extensive process which is still ongoing - the reconfiguration of the conceptual framework of central bank action: on one hand, there is now a broad consensus on the need to develop macro prudential or systemic dimension of the business of banking regulation and supervision; on the other hand, it is called into question the viability of a monetary policy to maintaining price stability in the narrow sense, namely the short term.

The fact that price stability is usually the primary objective of central banks from functioning market economies has long become an axiom. But it is equally true that their mandate has always included ensuring financial stability, even if references are made often in relatively general terms. The reasons are multiple:

- on one hand, there is the concept of financial stability complexity and difficulty of formulating such an objective in explicit terms - it is clear that here there cannot be only one indicator, as ii is in the case of price stability;

- on the other hand, the necessary tasks and tools to maintain financial stability do not belong only to the central bank.

In this context, we are going to analyze in this paper the ability of BNM's monetary policy to maintain the financial stability of Moldova within its objectives and tasks.

Method and hypothesis

Given the fact that economic literature has not yet reached a common consensus on the concept of financial stability, we have decided to use as a basis the definition of financial stability brought by authors of the monograph published within National Institute for Economic Research of Moldova, according to which*: "Financial stability: the condition in which the financial system is when it is able to fulfill specific functions simultaneously, such as to allocate resources efficiently and absorb shocks, avoiding that they have a destructive effect on the real economy or other systems"* (Perciun, 2015,16).

Thus, this definition shows that to achieve its objective of financial stability, the monetary policy must contribute to:

• the increase of the real economy;
• efficient allocation of financial resources
• shock absorption and the reduction of their negative impact.

The central bank carries out its functions through monetary policy instruments at its disposal. But monetary instruments depend on the objectives and the monetary policy regime. By 2006 NBM has followed national currency stability, since 2006 – till present - price stability through monetary targeting until 2008, and then was approved the transition to inflation targeting regime.

In order to achieve the inflation target, the Bank has provided a major tool: open market operations and several auxiliary instruments: standing facilities, required reserves and foreign intervention on the exchange market.

The main instruments through which the National Bank exercises its influence on monetary conditions are the basic interest rate (which follows from the monetary policy regime) and the rate of required reserves (known as fast and powerful effect of its implementation).

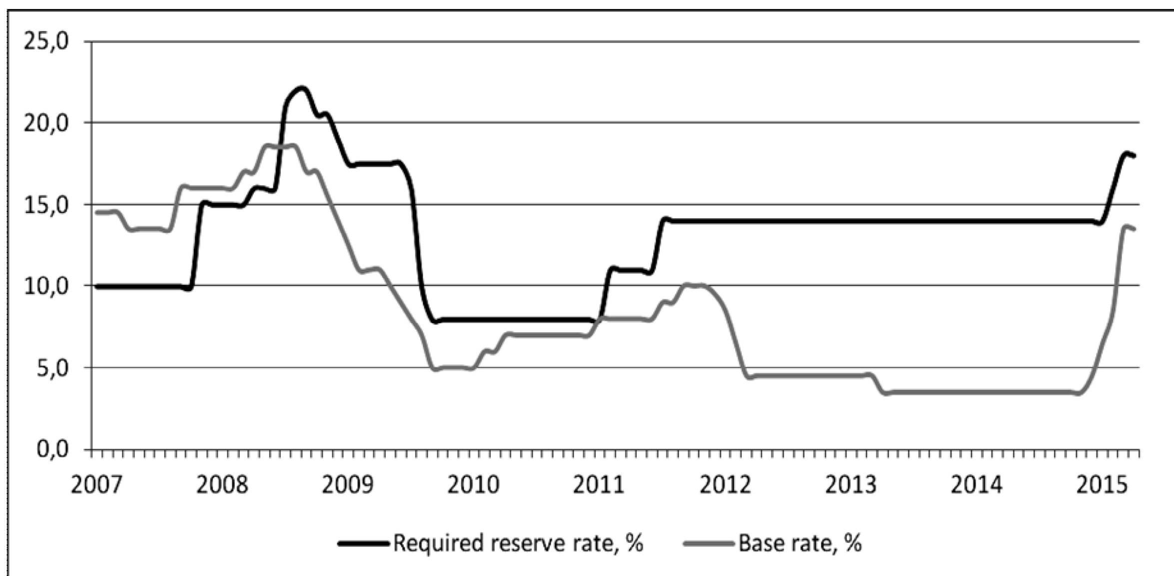

Fig.1. *Evolution of key monetary policy rates in Moldova*
Source: National Bank of Moldova

The evolution of these tools is necessary in order to analyze the central bank's ability to meet the objectives of financial stability previously made. The analysis of the monetary policy instruments shows that in times of increased uncertainty and risks NBM tightened monetary conditions, this is the period of 2008-2009 - when the impact of the international financial crisis began to be felt in the national economy in 2012 and recently at the beginning of 2015 (fig.1).

In the light of these interventions ii is important to check whether the monetary policy promoted by the National Bank carries out its functions through the first concept of financial stability.

Hypothesis testing

1. The first function is - The function of ensuring economic growth.

If you oppose the chart of gross domestic product evolution to development policy rates we can observe that the periods of economic slowdown coincide with the constraint of monetary policy, and is characterized by the increase of the policy rates, while in periods of economic growth the promoted monetary policy is relaxed, creating favourable conditions for economic development.

In this context, we can say that monetary policy through its used instruments fulfils its function of ensuring economic growth. The causes of the economic slowdown coming out of the scope of its duties may be seen in this chart (fig.2):

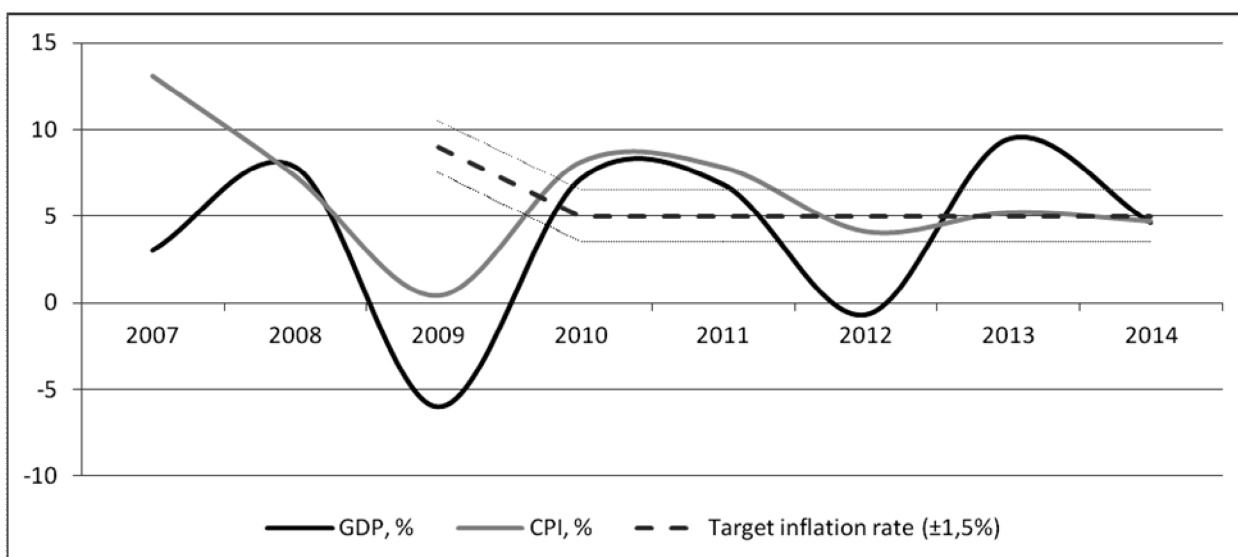

Fig.2. *The main macroeconomic indicators of Moldova.*

Source: National Bank of Moldova

2. The function of efficient allocation of financial resources - is a very important one.

The saturation of the economy with monetary mass volume represents one of the essential functions of the central bank.

Looking at the evolution structure of monetary expansion in the Republic of Moldova (fig.3) we can notice that the percentage of the monetary aggregate M0 - represents that part of the money supply on which the Central Bank can exercise influence (money created and allocated by the Central Bank) retains throughout all the period of time almost the same share in the total money supply. Significant changes are observed more in the behaviour of commercial banks which in times of economic recession, under the influence of risks and uncertainties, constrain their activity of multiplication of money, as well as from the population, who in this period change their preference for keeping savings from national currency into foreign currency, which also can be explained by the increased share of M3 in periods marked by economic recession.

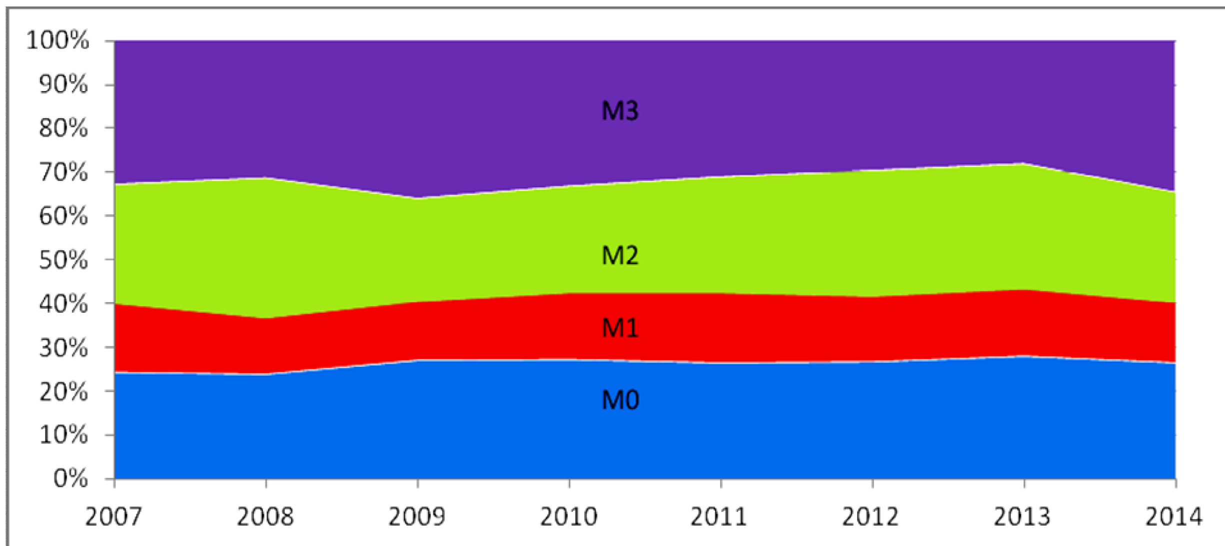

Fig.3. *Broad Money Moldovan in dynamics.*

Source: National Bank of Moldova

This conclusion is confirmed by the graphic evolution of credits in the economy (fig.4). The major interest in this graph is that by 2013 the volume of loans in the economy slightly exceeded monetary system M2 because some of them were funded including on the expense of M3, while in 2013 the balance of credits in economy is lower than the money supply M2. A reduction in lending is due to the slump credibility of borrowers, which required banks to behave more cautiously, maintaining liquidity and not investing in loans.

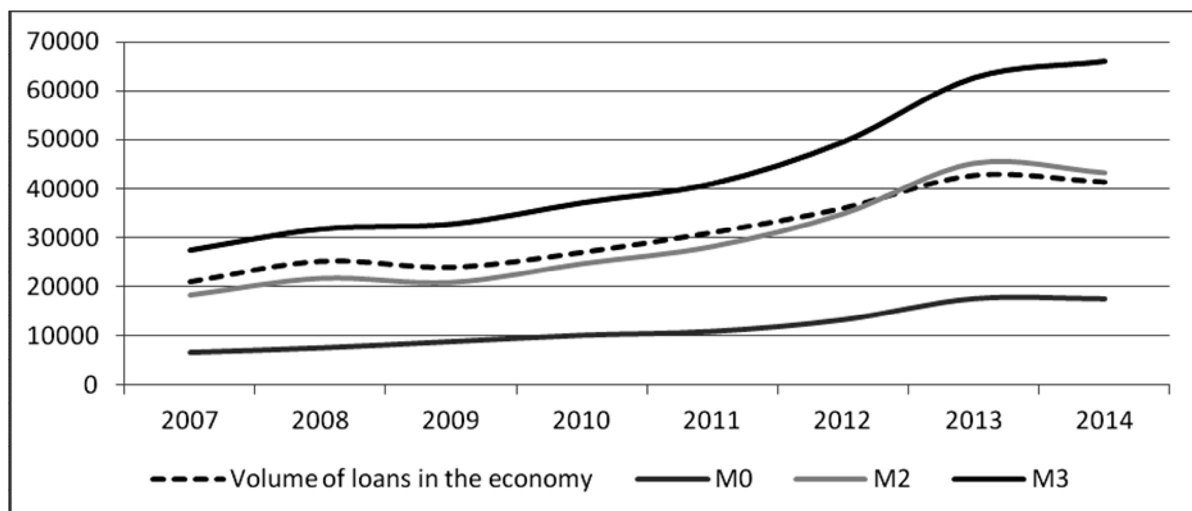

Fig.4. *The evolution of monetary instruments and balance of credits in the Moldovan economy.*

Source: National Bank of Moldova, National Bureau of Statistic of the RM.

The decrease of the ability to absorb the supply of credits in the periods of economic recession is presented in the following chart. This graphic once again proves the responsiveness of the central bank's monetary policy to economic conditions. In the periods of weak demand for currency from the real sector, because of the lack of creditworthy borrowers, the money supply decreases (fig. 5).

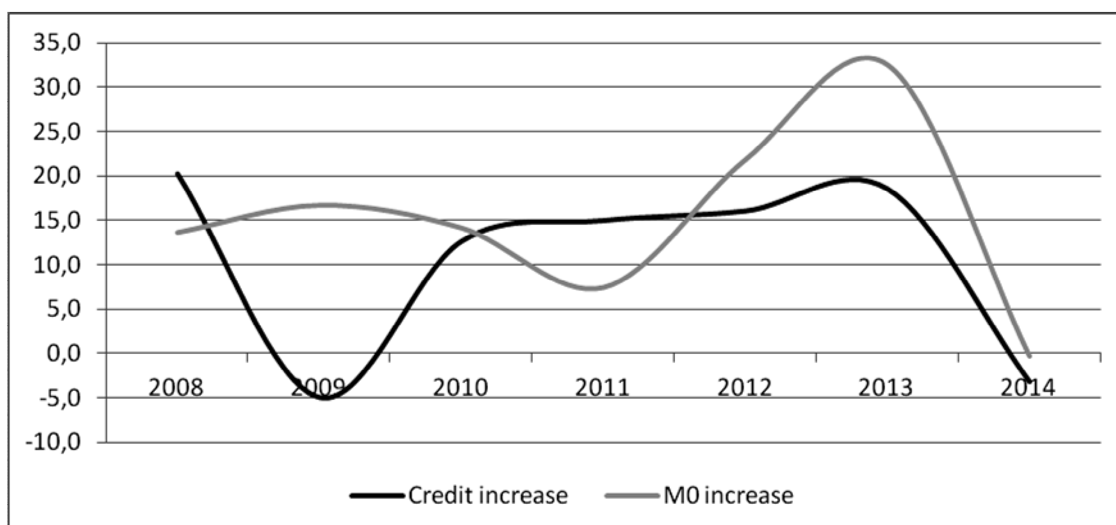

Fig.5. *Dynamics of bank cash in circulation and increasing loans RM, pp.*

Source: National Bank of Moldova, National Bureau of Statistic of the RM.

3. The last but not the least function is Shock-absorbing function and reduction of their negative impact.

Given that Moldova is part of the group of countries with the highest current account deficit, balance of payments that is always negative, invokes the need to protect the exchange rate of the national currency from unpredictable fluctuations, because the debts that should be paid in foreign currency exceed the amounts to be collected, and any devaluation of the national currency will result in a macroeconomic destabilization. It is also known that the prices are not affected by domestic demand of products in the Republic of Moldova, which is very low, but the prices of imported products. Therefore, to maintain the both stability (financial and price) in a country like Moldova, with imported inflation, we must keep the exchange rate stability of the national currency, otherwise any increase in the price of foreign currency will be passed on the CPI.

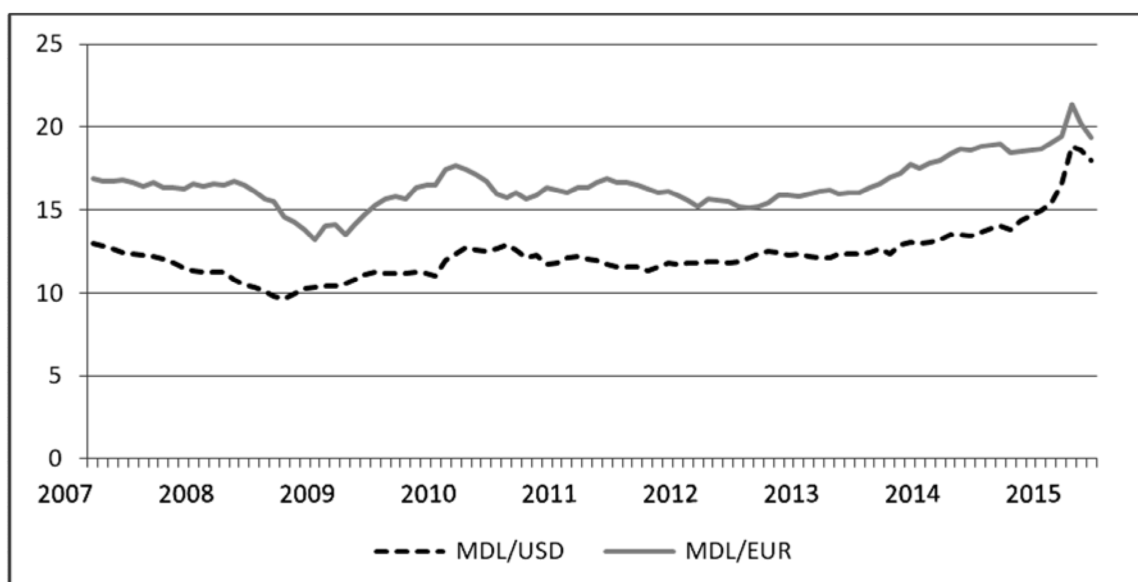

Fig.6. *The evolution of the nominal exchange rate of the national currency against major currencies reference.*

Source: National Bank of Moldova.

From this graphic of evolution of the exchange rate of the national currency can be observed that by tightening the monetary policy of BNM were finally fixed the excessive fluctuations in the

exchange rate (fig. 6). However, taking into account the recent events, we consider that latest monetary policy decisions are greatly delayed, which also brought a great damage to the country's economic stability and welfare.

Premises for intervention existed since the beginning of 2014, which also could protect the economy from the experienced shock rate from the early months of 2015. The reason that there were no pronounced risks to price stability, the great depreciation of MDL against single European currency and the US dollar recorded early in 2014, were not taken into consideration by the monetary authorities.

This situation proves that Moldova changed too early the inflation targeting regime, regardless of the fact that inflation is imported in the country. That is why every time when there is an increase of other currencies and the lowering purchase price of national currency we face the problem of price increase.

Once we import all resources from a strong exchange rate growth (used for international payments) the price increase is immediately carried out on the market - non monetary factor. That is why BNM should aim not only to pursue inflation targeting, but also analize the exchange rate developments until 2006- because only analysing efficiently the exchange rate it becomes possible to carry out its inflation targeting (ex. New Zealand - the first country to introduce inflation targeting as a target of monetary policy and later to review its application by introducing it in the target of the central bank and the evolution of the national currency. This country like Moldova has closed economy which pretty much depends on other imports and in these conditions the exchange rate led to the increase of inflation).

Conclusions

Based on the analysis done in the present article we can conclude that the monetary policy promoted by the NBM over the recorded years fulfilled its functions: the monetary system has sufficient tools to maintain the financial stability of the state, they are applied at their fair value with effect response.

However, in the light of recent events that have disrupted the stability of the country's financial situation we believe that for better absorption of shocks currency it is necessary either to review target monetary policy (adoption of a target mix) or the efficiency of monetary policy decisions by anticipating the risks and adoption of preventive decisions.

Unfortunately the monetary policy remains only a part of the financial policy of the state and it can be noted that the major problems in the financial stability have a different origin than those of monetary factors (at present in Moldova the major problems come from the banking system, due to strong intercorrelations between monetary policy and banking system, while other segments of the financial market remain underdeveloped).

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8.* * *, National Bank of Moldova, http://www.bnm.md/

9.* * *, National Bureau of Statistic of the Republic of Moldova, http://www.statistica.md/.