MONETARY POLICY: A JOURNEY FROM MICRO TO MACROPRUDENTIAL FRAMEWORK

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This paper aims to address the issue of adjusting monetary policy to the implementation of new macroprudential framework, with reference to the challenges accompanying this hassle. The analysis performed in this paper shows that the financial system is characterized by high sensitivity to the pressures existing in international financial markets, so macroprudential policy and its instruments support investor protection, the limiting of systemic risk and financial stability, being defined through a high flexibility, increased transparency and lower costs of implementation. In this paper it has been observed the link between monetary policy and prudential policy, suggesting the relationship of interdependence and focusing on the challenges faced by this policy. The methodological approach used in order to develop this paper starts with a literature review, which establishes the role and the place of this research. The analysis conducted in this paper is based on various reports, studies and research and emphasizes the vital importance of macroprudential policy design and implementation of macroeconomic and financial imbalances prevention and financial stability.

Keywords*: monetary policy, macroprudential policy, financial crisis, Basel III, systemic risk.*

Introduction

The world today is at a crossroads in international monetary relations and it's necessary to point out the fact that the global financial crisis has exposed a series of shortcomings in national policies and in economic governance at European Union level, as well as in financial supervision and regulation, providing a comprehensive event risk in the financial system, mainly the most devastating one, namely systemic risk.

The paper aims to approach the repercussions of the financial crisis, providing an insight into the banking system from the perspective of the monetary policy and its connection with prudential policies. So far there has been no policy framework in place to prevent such contagion effects, and although the source and the various sequels of the financial crisis may have been almost impossible to predict, better micro and macroprudential supervision may have emphasized, at an earlier stage, certain risks for the European financial sector.

The paper is structured in five sections, namely: *the first one* includes some introductory remarks on the importance of the theme, *the second* section is devoted to literature review, *the third* section focuses the attention on the interdependencies and conflicts between monetary and macroprudential policy and *in the forth* section it's stressed out the notable lessons learned from the recent crisis and the challenges faced by central banks to support financial stability. The paper is summing up with a *summary conclusion*.

Literature review

The recent financial crisis has painfully highlighted the limits of the banking regulation. The history offers various examples of crisis such as The Oil Crisis, The

Great Depression, the Black Monday, but considering the long-term impact we assist to a different type of crisis.

The existing literature is focused on monetary policy and financial stability issues related to the appearance of the financial crises. We mention here a series of papers that argue the importance of financial stability in the financial system, as follows: *Monetary policy and financial stability - some future challenges* [12], *Lessons from the crisis: Monetary policy and financial stability* [3] majority of these studies focuses on the relationship between monetary policy and financial stability in both macroeconomic and microeconomic dimensions [5].

The international financial crisis, through its extremely serious effects, has highlighted the vital need of macroprudential policy, in supporting the entire financial system and reduce risks that exists at this level. The policy responses, resulting from nearly *15 crisis summits* over the past two years have contained but not resolved the crisis, so this is one of the reasons for the need of change in the policies used. With reference to the measures taken to counteract the negative effects of the crisis, we can point out the most important like: Vienna Initiative, Basel 3 and European Committee for Systemic Risk (macroprudential framework).

Beyond traditional microprudential regulation, the crisis has led to a new focus area, namely *macroprudential* policy, which aims to address systemic risk, that is, "the risk of developments that threaten the stability of the financial system as a whole and consequently the broader economy" [9].

According to the Governor of National Bank of Romania, macroprudential policies consists in measures to ensure the health of the financial system, or to prevent the loss of control in the problems referring to a specific part of the financial system [13].

The recent debate on macroprudential policies moves from the idea that a regulatory gap - the fact that no authority was explicitly in charge of controlling systemic risk - has played an important role in the financial crisis. First of all, macroprudential policy is linked to other policies that moderate cyclical fluctuations, the most important one is monetary policy, which affects asset prices and credit. So it's likely to influence the transmission mechanism of monetary policy.

José Viñals believes that regardless of the performance of the macroprudential policies, it can't be considered good enough to substitute the effective macroeconomic policies, meanwhile he is suggesting a combination of macroeconomic policies and also prudential ones to avoid shocks in the economy [20].

In the opinion of Clement, the macroprudential policy distinguishes from other economic policies, not only through flexibility and lower costs, but also through the two dimensions addressed, namely the time dimension and the cross-sectional one, so this marks a major distinction between the macroprudential policy and the microprudential one, in terms of objectives, mechanism and transmission instruments [7]. In the existing literature there are three types of macroprudential policy models, as follows: prudential model, eclectic model and overarching policy model. Associated to these, the regulation scheme has to follow Van del Heuvel model, but there are clear evidence that the agreement does not make progresses in terms of procyclicality, does not reduce the liquidity excess of capital minimum requirements and does not promote a long-term perspective of provisioning. Otherwise, pressures may occur on the normal performance of the monetary policy objectives [19].

Although the term "macroprudential" dates back in the 1970s, this policy is developing, with significant growth potential, especially after the failures caused by the global financial crisis.

Macroprudential rules and monetary policy

According to those mentioned in the literature review, the role of monetary authorities in ensuring financial stability is arising from traditional functions but also from the interrelation between their primary function – to develop and implement monetary policy – and the stability of the financial system.

Monetary policy has a really *noteworthy role in the economy*, as it aims to ensure a balanced economic growth, price stability, full employment labor, balance of payments but also a correlation between the volume of available payment facilities with the needs of the economy through specific monetary instruments.

In tremendous circumstances, such as a crisis, central banks are meant to act in order to eliminate the panic from financial markets, to ensure the functionality of credit markets and to prevent a collapse of systemically important financial institutions [8][18]. In the financial system the crisis manifested itself in all existing categories, mainly in the banking sector by restricting bank lending activity, by increasing the level of credit risk, by damaging banking performance indicators etc., but also in the other components of financial system.

The measures initiated by the monetary authorities to support the financial system were used in combination, noticing *ad-hoc measures* implemented in the individual financial institutions and *complex schemes* applied in case of intensification of economic crisis. In the first instance, central banks have reduced monetary policy interest rates, because the deterioration of the financial market has changed the outlook regarding financial stability but also to revive bank lending activity. Given the major deficiencies observed in the monetary policy transmission channels and significant deterioration of economic environment, central banks had to resort to the measures so called "unorthodox" intervention, consisting primarily of domestic markets and foreign exchange intervention.

Faced with significant tensions in the financial markets with a high potential of spreading on real economy, three leading monetary authorities has gradually *diminished monetary policy rate*, which reached historical values (for ECB), located around the level of 0% (ECB, FED and BOJ) (see figure 1).

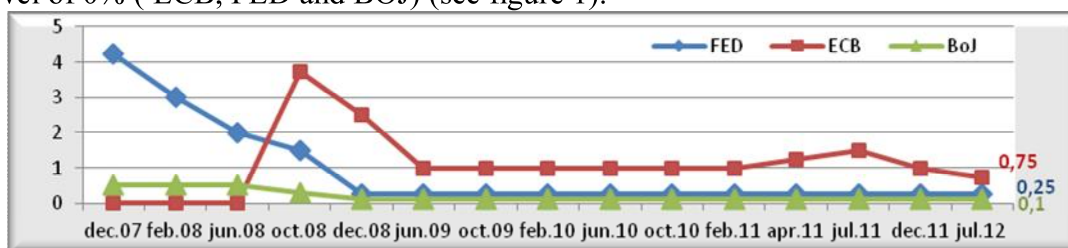

Fig.1. Evolution of interest rates charged by FED, BoJ and ECB, between 2007-2011 (%)

Source: data processed after http://www.global-rates.com/interest-rates/central-banks/

Due to the severe deterioration of financial systems and real economies, central banks were forced to adopt and implement unconventional measures to restore the functionality of monetary policy transmission mechanisms by providing the necessary liquidity to unlock financial markets.

From the triad of central banks mentioned, ECB is the only one that printed a restrictive character to monetary policy by raising interest rates, twice, during 2011 (see figure 1). However, it should be noted that this was possible due to the stabilization of financial and economic climate and to the inflationary phenomenon, the last being represented in figure 2. On the other hand, due to the worsening forecasts of economic and financial conditions in the euro area, which are potential risks to financial stability, ECB lowered two times the monetary policy rate to 0.75%, starting in July 2012.

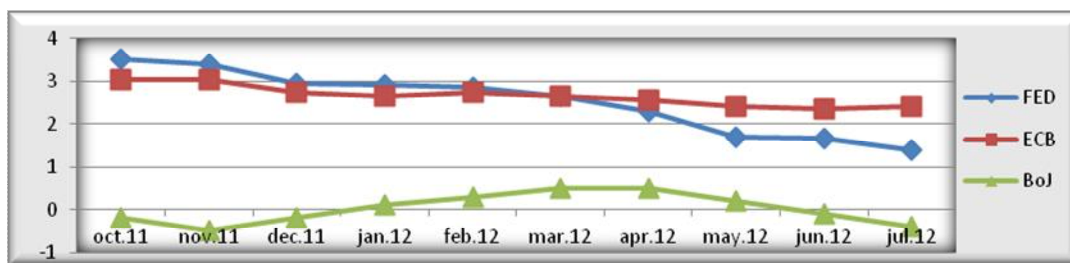

Fig. 2. Evolution of inflation in euro EU, USA and Japan, between 2011-2012 (%)

Source: data processed after http://www.global-rates.com/economic-indicators/inflation/inflation.aspx

According to figure 2, unlike ECB and FED, Japanese central bank is facing deflationary pressures, no less dangerous than inflation to financial stability.

In the case of FED, although is facing with serious inflationary pressures, is necessary to correlate the evolution of monetary policy interest rate with the second component of the fundamental objective, namely ensuring of sustainable economic growth and employment. Moreover, for the first time in the history of the bank, FED said it is possible to maintain the actual level of monetary policy interest rate until the end of the first half of 2013, suggesting a high degree of vulnerability of the economy and also of financial stability.

On the background of the financial crisis it has been outlined the crucial need of approaching intermediation and financial supervision both in term of micro and macro perspective and it has been highlighted the absence of an action framework to help predict potential economic imbalances.

Macroprudential policies have emerged after it has unanimously recognized that the actions covered by it are appropriate for the entire financial system, although initially it was considered that the actions directed to individual institutions were more than enough to prevent systemic risk (fallacy of composition). The macroprudential policy is considered *complementary to the microprudential one*, standing out with its interaction with different types of economic policies that have a profound impact on financial stability, acting to eliminate financial imbalances by increasing protective barriers, by identifying and addressing common exposures, risk concentrations, linkages and interdependencies as contagion risks.

On the other hand, it can be said that macroprudential policy is aimed exclusively in ensuring financial stability using a set of *specific tools* to mitigate existing risks at the financial level, particularly systemic risk. In developing a set o macroprudential tools it started from the microprudential ones, which were adapted to economic conditions and existing prudential standards.

Comparing with the other policies promoted the macroprudential was noted through a series of advantages in approaching systemic risk. First of all, the macroprudential tools are *less blunt* and with *a higher degree of flexibility*, some of the instruments can be specifically targeted to some sectors that need intervention thus reducing costs. It is also worth noticing that macroprudential policy is *interrelated with monetary policy* because of the interdependence level, of the manner it can provide a greater level of stability as monetary policy is strengthened.

Conflicts between macroprudential and monetary policy are likely to be rare, because the financial cycles that matter for prudential policy have a much lower frequency than business cycles so this suggests that monetary policymakers can treat macroprudential policy developments as a relatively slow-moving background and it’s also relevant policy hierarchy. Macroprudential policy should not be used as an excuse to postpone or reduce the inevitable tightening of monetary policy. But despite the

conflicts, there will be a need of mutual consistency and coordination, so the close relationship between these two policies makes that inevitable, outlining the fact that *financial stability is a shared responsibility* that requires clear cooperation arrangements.

Lessons from current global financial crisis regarding the financial system

The current international financial crisis has generated negative effects of high intensity, so monetary authorities have drawn a number of lessons from them, focusing mainly on the financial stability. In this context, we see *three basic lessons*, namely the orientation to macroprudential policy, the maintaining of the primary objective of monetary policy and its credibility and last but not least it is necessary to implement some changes in the liquidity and flexibility of operations of central banks.

One of the most representative lessons of the current turmoil is captured in the work of Mishkin *Is monetary policy effective during the crisis?,* where emphasizes the efficiency even increased of monetary policy decisions during the crisis. Mishkin also stresses out another important lesson in the paper *Monetary Policy strategy: Lessons from the crisis,* where it shows that most of the framework regarding monetary policy used before the crisis is the same, but there are required changes in the strategy used [16][17].

Given the strong propagation of the repercussions of financial crisis from the financial sector to the real one, *it should be paid more attention to understanding the monetary policy transmission channels* between the two spheres, especially in terms of shaping a new channel, namely the one so „risk taking", which by definition constitutes a potential threat to financial stability. Also, due to the major blockage of the transmission mechanism of monetary policy made during the crisis, it is recommended *to better incorporate financial conditions in monetary policy transmission mechanism* to the real economy. It has to be mentioned that the subprime crisis has exposed *the need of a macroprudential orientation of central banks*, which in turn, raises a series of institutional, organizational concerns and also those connected of an appropriate instruments: identification of financial sustainable indicators, outlining the early warning systems to address imbalances, patterns of financial contagion and some models which can capture in a better manner the connections between the real and financial sphere, given the huge size of the statistical information. Another lesson which should be learned from the current financial crisis is that of *temperance*, both in monetary policy makers and for all the participants on the financial markets, which from the desire of higher and quicker gains, took excessive risks, not falling under the circumstances of the "rational agent" pattern.

One of the most recent challenges to monetary authorities is referring to the identification of the unknowns elements which are forming the *exit strategy equation*. Another challenge of a significant importance for monetary authorities, but also for the fiscal ones is the *deepening of sovereign debt crisis*, based on the efforts made by the public authorities to sustain the economy, but also in the period before the crisis when the consumption power was exaggerated. Therefore, there should be a *close cooperation between the fiscal and monetary front*, this aiming in increasing the capacity of financial stability and therefore a better transmission of monetary policy in the financial sector and real economy.

While fiscal and monetary policies should ideally be mutually reinforcing, the euro area sovereign debt crisis has exemplified the opposite, namely that unsustainable public finances and high levels of debt can impede the conduct of stability oriented monetary policy. So, the experience of recent years has highlighted that weak public finances can trigger a vicious circle that puts the financial sector under strain. Another

issue that stands in the attention of monetary policy during the sovereign debt crisis is the increasing level for the risk of damage the central bank credibility in fighting against inflation.

The analysis made outlines the fact that in normal times, without crisis and fluctuations the use of countercyclical requirements has limited the effects on macroeconomic stability and the lack of cooperation between macroprudential authority and the central bank could increase the percentage of volatility. In the case of a crisis, macroprudential policy is effective, and the cooperation between the authorities mentioned will reduce the volatility of output and of credit-to-output ration, despite the higher level of volatility of policy instruments.

So, the level of challenges that central banks are addressing is a high one, with reference to the potential risks to financial stability, the associate costs, the influence factors etc.

Conclusion

The paper accentuates a strong link between monetary policy and financial stability, particularly in distinguished circumstances, such as the current global financial crisis. The most optimistic assessment, see the crisis as an opportunity to bring forward the idea of an *ever closer union* regarding European Union, by pursuing greater economic integration and unite coordination of fiscal policy on the European level. Other observers consider that a break-up of the currency union cannot be ruled out, due to the snag existing in a number of governments regarding their debt service so they point out the fact that this kind of crackup would be destabilizing for the financial system.

The debate on macroprudential issues ignited by the financial crisis is in full swing, so it outlines the fact that financial supervisors and monetary policymakers have overlooked systemic risk, because they were typically focused on a single institution and are accordingly liable to neglect risks outside their purview. So it's necessary to point out the main *purpose* of this kind of policy, namely the limitation of accumulation of financial risks, in order to reduce probability and mitigate the impact of a financial crash.

The study revealed also a number of *lessons* learned from the international financial crisis and some *challenges* that central banks are addressing, suggesting the essential role of central banks to the banking system, thus highlights the need to approach a macroprudential framework in ensuring financial stability, improving central banks flexibility, in terms of their operations and last but not least, maintaining the primary objective of monetary policy, namely price stability.

Concluding, it may be indicated that the short term prospects of the financial system depends on the confidence in economic environment, of the sustainable recovery of economic growth and the developments in international financial markets.

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