



1st International Conference 'Economic Scientific Research - Theoretical, Empirical and Practical Approaches', ESPERA 2013

The central bank policy between the price stability objective and promoting financial stability

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Abstract

The paper aims to emphasize the role of the monetary policy and the central bank's position concerning the financial stability in the new context created by the global financial crisis, and given that it pursues the price stability, as the primary objective. The analysis highlights the need to review the position of the central bank in order to promote a more proactive stance to deal with financial stability, beyond the traditional framework of regulation and supervision, but there is a risk of emerging conflicts derived from the pursuance of the primary objective (the price stability) while maintaining financial stability.

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Selection and peer-review under responsibility of the Organizing Committee of ESPERA 2013

Keywords: financial crisis; central banking; inflation targeting; governance; independence; non-standard monetary instruments, responsibility for financial stability

1. Introduction

Along with the outbreak of the global financial crisis in 2007, the “Great Moderation” period, characterized by a low macroeconomic volatility and a non-inflationary economic growth worldwide, has ended, and has begun a new

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stage of global transformation, for redefining the political and economic relations between countries, but also for restoring the priorities of the general policy to reduce the financial instability. On the one hand, the new macroeconomic framework underlines the importance of the clear and proper regulation, as the main condition for defense against the financial instability, and on the other hand, underlines the strengthened link between the financial stability and the macroeconomic policies, especially the monetary policy, to support it. Thus, it becomes obvious the increase of the Central Bank's responsibility, with the monetary policy as an element of the macroeconomic policies' mechanism.

The complex processes of expansion, liberalization and globalization of financial flows developed in the recent decades increasingly deepened the financial system, producing a widening gap between the financial economy and the real one, while the relationship between the financial and monetary stability (price stability) had complicated. Changes of the financial regimes (liberalization of financial flows) in most countries have made the financial factors, especially those related to the "boom-bust" cycle of credit or asset prices, to be generators of the economic fluctuations. Changes of the monetary regime during the "great moderation" were directed instead towards achieving monetary stability by keeping inflation and returns low, assuming that in this way would avoid the potential unsustainable development of the economy and would ensure stability of the financial system. In fact, the strong development of the financial sector weakened the ability of the inflation to report anomalies in economic activity development, while the furtherance of the monetary stability during the "great moderation" besides the fact that did not supported the financial stability but affected her, actually fostering speculative bubbles, given that, in a confident and optimistic background for businesses (especially for banks) was encouraged greater risk taking. In this context, it is necessary to reconsider the role of the central bank in terms of its primary objective of price stability, in conjunction with the promotion of the financial stability. This problem began to be raised especially after the crisis started in 2008. Although the central banks were those that protected the economies, they failed to support the recommencement of the economic recovery.

In this article we try to identify the new framework in which monetary policy can operate taking into account a reassessment of the role of the central bank given the increasing importance of the general objective of financial system stability, but also suspicions that central banks have allowed the appearance of conditions that led to the crisis. To better illustrate the research, the authors considered both a review of the literature on the relationship between financial and price stability, and a comparative analysis of how the major banks (European Central Bank - ECB the U.S. Federal Reserve - the Fed, and the Bank of England - BoE) relate to the issue of financial stability after the global financial crisis.

2. The changing role of central banks

The oldest central banks appeared at the end of the seventeenth century (Bank of Sweden in 1688, the Bank of England in 1694), followed by the Bank of France which appeared only in 1800 and other central banks that have been established by the end of the nineteenth century (Goodhart et al.1994). We mention, in order of their appearance, the central banks from Finland, the Netherlands, Portugal, Spain, Germany, Japan, and Italy. The number of central banks increased from 18 in 1900 to 161 in 1990 (Pringle et al.1993), most banks being relatively new, established since the mid-twentieth century. According to a study of the (Bank of International Settlements,2009) the last three central banks were established around the year 2000.

Predecessors of current central banks had completely different role than monetary policy, their main skill being to improve the government's ability to borrow money in times of war, many of them being established during some wars or immediately after their end (Clapham, 1944; Timberlake, 1993; Wilson 1957; Hamilton,1945). The central banks' roles reflected the history, and were created to meet the needs of those times. Meanwhile, older functions such as monetary policy are different now, compared to beginning periods. Initially, the main functions of central banks' early forms were the issuing of banknotes and governments' bankers (these regnant banks became the classic choice for governments' banking activity), and later some central banks (e.g. in Austria, France, Portugal and Spain) were established to rebuild the monetary stability and the currencies' credibility, the primary motivation being survival, and not necessarily wider macroeconomic issues. In time these regnant banks became bankers of the banking system and for economic reasons they provided loans for bank customers to cover their lack of liquidity, turning into lenders of last resort, but also in banking system supervisors, different function from the current one

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