THE CENTRAL BANK AND THE FINANCIAL STABILITY

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Abstract:
In the last period, the financial stability has developed as an important issue in the context of present international financial crisis. This study aims to be a debate regarding the circumstances and the opportunity for central banks to act as lender of last resort. In this context, we propose a series of solutions that would ensure the optimum exercise of this function held by the central bank. Also, we talk about the incompatibilities between the objectives of price stability and those of financial stability.

Key words: *financial stability, financial crises, central bank, lender of last resort*

JEL classification: *E52, E58, E61, F02, G01*

Introduction

The present international financial crisis has reaffirmed the importance of state interventionism and the role of central banks in supporting the banking systems. The role of the central bank in its contribution to ensuring *financial stability* in a certain economy comes out from the specific manifestations and functions of the central bank as a lender of last resort, surveyor, reimburser of funds and account conciliator, as well as currency center. These functions have been gradually adopted by the central banks as they have been confronted with different challenges during the development stage of banking and financial systems.

This study aims to be a debate regarding the circumstances and the opportunity for central banks to act as lender of last resort. In this context, we propose a series of solutions that would ensure the optimum exercise of this function held by the central bank.

Conceptual approaches on the notion of financial stability

Volcker invoked the fact that, along with the functions specific to the central bank of monetary nature, this institution undertakes a series of "surveillance" functions such as: important participant in the national system of payments; last source of liquidities for the economy; regulator of the key sectors in financial markets, on national and international level [Volcker, p. 547-557].

The definition of financial stability in a certain economical environment can be approached in several ways. The literature and the practice in the field feature a vision of financial stability in a broader and stricter meaning, both involving the central bank [Isărescu].

The definition for the *broader meaning* of the notion of financial stability refers to the situation in which the financial system is able to attract and place monetary funds in an efficient way and to withstand the shocks without bringing prejudice to the real economy. Under these conditions, the central bank might be involved in the surveillance of the banking and financial system.

The definition for the *stricter meaning* emphasizes the avoidance of financial crises and it refers to the situation in which there are no banking crises, and the price of financial assets, especially, and the interest rate are highly stable. Thus, the central bank will be mainly concerned with the efficiency of the interest rate policy, as there could emerge a conflict between the objective of price stability and that of financial stability.

Crockett makes a *distinction between financial stability concerning financial institutions and banks and the financial stability of the markets* [Crockett p. 9]. In this context, the shares of the central bank might differ as related to maintaining the financial stability.

Actually, the financial stability of financial institutions represents the situation when the most important financial institutions in the system are stable and credible enough so as to undertake the operations under contract. The financial instability of the institutions refers to the case when the fall of one of these institutions consequently leads to the bankruptcy of others and various economical losses.

Financial stability related to markets refers to the situation in which the transactions on the financial markets are made at prices which are naturally established depending on the demand and offer. Financial instability on the market manifests itself in great variations of financial assets prices. The results can be noticed especially on the exchange market, on the shares and bonds market, as well as in the real estate field.

In the same line of thoughts, Issing considers that there is a distinction between defining financial stability as a systematic approach towards the perspective which relates to the volatility of financial variables that are directly noticeable [Issing, p. 16]. In order to support the first approach, Issing invokes the definition given by Mishkin, according to which financial stability is capable, without interruption, to ensure the efficient allotment of savings to the investment opportunities [Mishkin, 1991, p. 30]. Thus, the first approach considers the financial system's ability to adapt to different shocks. Issing considers that the bankruptcy of a financial institution is not necessarily proof of financial instability.

The second approach invokes the situation when there is a banking crisis and it supposes a stability of the financial assets price. This definition is given by Goodfriend and Cukierman.

Knight defines the stable financial system as one in which the economic agents undertake different operations with the financial assets without exposing themselves to any risks or unstable situations which might undermine their financial values [Knight, p. 314].

In most cases, the notion and the definition of financial stability can be found in the *reports regarding the financial stability* published by central banks. The wider the definition in the reports on financial stability, the bigger the interest in the aspects related to the stability of the financial system as a whole, whereas the reports are more consistent in information and analysis [Cihak, p. 8].

Starting from the previous arguments, we could understand *financial stability as the state of the economy in which the activity of financial institutions and the financial market as a whole function normally and the causes of instability, coming from both micro- and macroeconomical level, could be foreseen and fought against by the monitorisation and interference of an authority which in many cases could be the central bank, on condition that it obeys the market forces (mechanisms).*

Causes of financial instability

The causes which could endanger the financial stability are diverse. Mishkin considers that *at the basis of financial instability lays asymmetric information between the market participants and moral hazard problems (*the participants' tendency to undertake a great risk when they cannot fully support the costs of their activity). He identifies four kinds of main shocks which could lead to financial instability [Mishkin, 1997, p. 9]:

- *increases in interest rate* – they lead to the phenomenon of adverse selection, more precisely, an increase in interest rate at a certain level will lead to signing contracts only for risky investments, but with a high potential profit, as the clients who have a lower risk activity will not be willing to make loans with high interest rates. In the end, banks will restrain their activity once the portfolios of high risk loans increase. Thus, there emerges a contraction of the loan market which could lead to instability;
- *increase in uncertainty,* which might be caused by the bankruptcy of an important financial institution, political instability, or the crash of the stock market. These phenomena could lead to adverse selection, which, in its turn, influences the banks to restrain their lending activity;
- *effects of financial assets prices on the balance* – these effects could be due to stock exchange crash or decrease in bonds, and the subsequent decrease in company market value, by increase in interest rates, especially for retail loans. This phenomenon affects all budgets, deflation or inflation could lead to changes in liabilities values and company debts, or exchange rate decline or rise;
- *problems of the banks in the system* - might cause a decline in financial intermediation, with effects on investment and the economic activity as a whole. These problems arise as a consequence of balance depreciation in the banks. To these causes we should add the monitoring authority's inability to operate efficiently.

Blejer *finds a relationship between financial instability and the insolvability risk,* considering that the sources of instability can be found by investigating the sources of a bank's insolvency [Blejer, p. 105-122]. The same idea is shared by Burdon and Lombra in their definition of the financial crisis as a *critical distress of the financial market, characterized by a sudden crash of assets prices and the insolvability of the financial and non-financial companies* [Burdon and Lombra, p. 249], whereas Gupta describes the banking crisis as a *situation in which the financial liabilities of certain financial institutions are over the value of the assets on the market, whose effect might be the non-reimbursement of deposits and the insolvency of financial institutions.*

According to Allen and Gale, the seriousness of the financial instability varies depending on the *level of interconnection between banks* [Allen and Gale, p. 1-33]. Three ways of interconnection are considered: complete, when each bank is in a symmetrical degree of dependence on the other banks in the system; partial, when the banks are interrelated only with those banks involved in adjacent activities; and incomplete, when banks function independently, with no relation to the other banks in the system. The degree of gravity and the impact of the shocks on the banking system is smaller in the last situation, and it increases and reaches the maximum level in the case of complete connections.

After analyzing the financial crises from Eastern Asia, Ecuador, Mexico, Russia, Turkey and Venezuela Das, Quintyn and Chenard reached the conclusion that their common premises had been weak regulation and monitoring [Quintyn and Chenard, p. 44].

Financial stability versus prices stability

We should notice the *distinction between the notion of financial stability and that of prices stability.* The two types of stability support and amplify each other on long term. A stable inflation could lead to the financial stability of the economy, but the supporters of "*the new environment*" hypothesis agree that once the reduced inflation is stable, a new economical environment emerges in which financial stability is not guaranteed [see Borio and Lowe; Borio, English and Filardo].

The decrease in inflation (especially in the context of deflation) leads to a reduction of interest rates. The consequences of this fact are a series of economical behavior acts: withdrawal of foreign capital; reorientation of banking deposit resources to the capital market, especially through high risk instruments; easy access to loans which might induce a raise in the consumption or in the price of certain assets (especially real estate ones). Once recoveries of the inflation and increases in interest rate are possible, this fact could cause the non-payment of installments, bankruptcy and decreases in the prices of some assets (see the real estate crisis in USA).

On the other hand, if we consider Schwarz's approach to financial crises, we could keep in mind the fact the financial stability determines monetary and price stability. Schwartz considers that under the conditions of financial crisis, there is a tendency to drop the offer of liquidities on the market [Schwartz, p. 11-31]. This decrease is amplified by the mechanism of monetary multiplication, which is reduced in intensity. Thus, monetary aggregates are diminished, with a deflationist effect and price stability is endangered. In this context, the interference of the central bank is a must, in order to ensure the necessary amount of monetary units to reestablish the equilibrium. But, an injection of liquidities in the economy could further cause the amplification of the inflationary phenomenon.

In conclusion, we could make a note of the fact that *there could be incompatibilities between the objectives of price stability and those of financial stability.*

Issues regarding the function of lender of last resort

Central banks have acquired in time the quality of lender of last resort, as a consequence of certain serious financial crises. What is more, some central banks were founded as a result of these distressing phenomena (The Bank of Canada, Fed).

The change of short-term deposits into another form of long-term capital loan is a representative feature of the banking activity nowadays, based on the system of *bank reserves in installments.* These banking system operational principles could be the cause of certain liquidity problems, at individual level, as well as for the banking system as a whole, in case the liquidity crisis is generalized.

In this context, to ensure the liquidity of last resort for the banks that face liquidity problems represents *a preoccupation on the macroeconomical level, as part of public policies*. The central bank is charged with undertaking these operations, as a consequence of its position of monopoly in supplying the monetary units in economy. Any possible crisis or non-interference in case of crisis could generate bigger costs for the authorities in their attempt to reestablish equilibrium. The monetary market rejects the idea of offering any liquidities to the banks which face problems, in the private system. This is why the central bank remains the last and single lender.

We should draw a *distinction between making available the normal extra-liquidity units by the banks in the system, through operations such as open-market or rediscount, and providing assistance in emergency cases.* In the former situation, the operations are undertaken on the basis of collateral assets, which prove the state of solvancy of the banks involved, and the rules are known in advance. In the latter situation, providing liquidities depends upon the decision of the central bank, except under extraordinary circumstances, and it supposes undertaking a risk in the case the bank faced with problems is not solvent and it does not have collateral assets.

Thus, another challenge for ensuring financial stability is *fulfilling the function of lender of last resort as a central bank*, under the current circumstances. The existence of a lender of last resort in the economy could determine the banks to expose themselves to risks more, since they are aware that the central bank will interfere in order to reach a stable situation. The same thing could be seen in the case of insurance and deposit packages.

Demirguc-Kunt and Detragiache, after conducting an empirical study on 61 countries with emergent or developing economies between 1980 and 1997, noticed that in case the banking system is not rigorously monitored and regulated, the banking crises increase in number and intensity when the schemes are more generous.

A possible solution to discourage this behavior of the banks could be if the central bank offered *liquidities for the installments which would be higher than the ones on the market* at that particular moment. Yet this could have negative effects on the banking system, as it could aggravate the crisis due to the limited access to refinancing or due to the fact that it would seriously diminish the profit rate and the possibility to rehabilitate of the bank.

Also, in the case several banks make use of the most expensive resources of the central bank, this would actually be a sign of imminent crisis in the economy and deposits owners might rush to withdraw the funds.

Another option to diminish the disadvantages related to the banks' exposure in the situation when there is a lender of last resort would be to ask *banks facing problems to offer supplementary information related to the financial situation of the central bank and to present feasible structuring and rehabilitation plans.* At the same time, these institutions will be under the *special surveillance* of the central bank, which will monitor their activity closely and drastically limit their involvement in high risk activities.

The obligation to include liquid assets in the bank portfolios could be another solution to avoid the tendency of high risks banks in the situation when there is a lender of last resort. The central bank can settle a *minimum level of liquid deposits,* which could be used as collateral assets on the monetary market.

The issues become more complicated when *monitorisation and bank regulations are delegated to an independent institution.* Thus, the central bank must *work closely* with that institution of surveillance under the conditions of offering last resort loans.

In the case of financial crises propagated at international level, central banks should *collaborate to fight against these crises*, especially in undertaking the function of lender of last resort. *The decisions regarding the control over the interest rate in refunding and the dimension of the sums injected in the economy by manifesting the function of lender of last resort are decisive in this matter.*

Thus, in order to soften the effects of the crises and to limit the effect of spreading it worldwide, *the decisions made by the central banks, especially the ones that issue currencies at international level, should be united and correlated, depending on the specific function of each economy affected by the crisis.* This fact imposes the establishment of certain *decision groups at regional and world level, by forming international committees.* They can function as prevention bodies as well, to prevent the crises, by imposing international agreements such as the ones from Basel.

This approach is feasible, especially for the European System of Central Banks, where *the necessity to collaborate and coordinate is indispensable.* The function of lender of last resort is undertaken at the *level of the national central bank*, subordinated to the necessities of the national economy that is affected, but only after the decisions of the Governor's Council have been made.

Problems appear especially due to the *cross borders activity of some financial institutions or banks*, which would suppose a surveillance of their activity in the country of origin, as well as in the other countries where they operate. This supposes that the monitoring institutions and the central banks in the member states work closely.

Thus, a new challenge appears, due to the *architecture of the different countries, as regards monitorisation and bank regulation activities,* on consolidated or sectorial level, referring to the central bank or an independent institution. This fact leads to *asymmetrical supply of the information* on the financial situation of the institutions that face difficulties when making decisions as a lender of last resort.

Schinasi and Teixeira discuss the following variant solutions to these dysfunctionalities: *the model of the Northern countries* in the collaboration between their own central banks[1], which, in case of crisis of a bank that operates in all these countries, become organized in working groups so as to improve the situation or apply *the model of consolidated surveillance*, that increases the responsibilities of some central banks in comparison to others, in their monitorisation of some banking groups [Schinasi and Teixeira, p. 16]. These two models suppose the existence of some previous agreements to share the risks. However, there may be another option, more precisely to *agree to exchange information and coordinate the measures taken, on the basis of certain cooperation structures.*

Thus, from what we have presented so far, it comes out that *there is an organic relationship between the function of lender of last resort and that of monitoring and banking regulations,* on condition that there efficient methods to be adopted by the central banks should be ensured, and they would have an impact on the economical environment. Regardless of the surveillance and regulation model to be adopted, the two functions of the central bank should be combined.

Conclusions

In the context of the present international financial crisis, the agreement in the decisions of the central banks that supply international currencies in their activities to foresee and fight against the crisis is a favorable act. This is why we consider it would be appropriate to expand the model of the Northern countries on the international level.

Also, in case all the conditions are fulfilled for the efficiency of the measures adopted by the central banks with an impact on the economic environment, we consider it a must to reach an agreement in sharing the actions regarding banking surveillance with those of lending of last resort. The efficient and close banking surveillance is the main condition for the central bank to successfully undertake the role of lender of last resort.

In our opinion, the most important issue among all changes in the banking activity is *trust in the banking system.* The smooth operation of any financial system depends on the strength of the economy, and the trust shown by the population in the financial system depends on how well it functions.

The current tendencies in the banking activity will bring essential changes in the banking system, but *the trust of the public will rely on its success and stability.* All the financial institutions should make continuous efforts to maintain their credibility.

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