The Role of Central Banks, Instruments and Mechanisms Used to Ensure Financial Stability

Isaac BORȘ

isacbors@yahoo.com

The Bucharest Academy Of Economic Studies

The serious problems which the global economy has been subjected to lately, have indicated there is a need of reconsidering the importance of the financial stability also making the central banks place this aspect as the main objective of their activity along with the costs stability. The objective of the present paper aims at identifying the best steps and the best strategies in order to build up the proper framework and to find the most adequate tools to provide the financial stability. This new economic context along with its objectives claim for the economic reforms to be targeted towards a macroprudential policy that would enable a positive reaction to the given circumstances at the same time with the necessity of the right planning of the appropriate framework that would empower the coordination of all economic and financial policies that need to act together and, in the new framework, the role that the central banks will play is an essential one, considering the competences, information but also their institutional independance.

Keywords: financial stability, macroprudential policy, central bank, financial crisis.

JEL Codes: G01, G28, E30, E58, E60.

1. Introduction

The financial stability concept, nowadays a widely spread term in the reference materials also in the economical practice, has been traced a long time back in the history. The problems regarding the financial stability have become big concerns of the society even since the XIXth century.

Back in the history, there was not an unanimously agreed definition for the term, they used to define the term starting from the opposite meaning, financial instability, or, they also used another approach, through the terms of the systemic risk and their main reasons.

The financial stability was defined, for example, as the capacity of the financial system to resist to external shocks (Padoa – Schiopa 2003). There is another approach that names the term from the point of view of the financial turbulences generated by the endogenous factors. In this case, the term of financial stability means the capacity of the system to resist to the internal shocks of the system (Schinasi 2004).

Considering the resistance to shocks, a financial system can be declared constant, a financial system that has the capacity of maintaining the following functions to an appropriate level:

- Financial intermediation;
- Making payments without any syncopes in the economy;
- Appropriate management of the financial risks;

In the same time, taking into account the definition of the term „systemic risk“: „the risk of interrupting the financial services caused by major problems occurred in the whole or in one part of the financial system, situation that has the potential to cause serious negative consequences to the real economy“ (Danila 2011), it is pointed out the real dimension of the problems generated by the financial instability, respectively, the impact on the real economy.

Under these circumstances, the financial stability can be defined as „the situation in which the financial system is capable of raising and placing moneyed funds effectively also to be able to come through shocks without prejudicing the real economic system“ (Isarescu 2009)

The role the financial stability plays is essential for both, the financial system and the economy, on the large scale. It was the economic conditions affected by the financial turbulences and/or by the economic crisis that emphasized the importance the role plays for the financial stability. Globalization and economic development are supposed to lead to the growing number of financial institutions as well as their activity area, a larger number of entities that operate nationally and internationally, on one or more continents. These phenomena contributed to the awareness of the importance the financial stability plays globally.
Depending on how the concept is defined, “they have a definite influence on identifying the contribution the monetary authority can have in promoting and maintaining the financial stability” (Isarescu 2009), in other words, once the „action way“ of the financial stability is established, they can also figure out which institution is responsible to achieve this objective.

The financial stability is not an objective itself, the final goal is redressing the normal correlation between the real economy and the financial economy. Reconsidering the financial stability and its including as fundamental goal along the costs stability among the goals of the central banks, they need to focus on supporting and ensuring the adequate framework, in order to have a sustainable economic growth.

To maintain a long term relationship between the two objectives, financial stability and costs stability, is a mutual encouragement (Moinescu 2011), but, there are conjunctural contexts when the two objectives become contradictious (Cerna 2011) and then, it is necessary to identify the right instruments that can help reaching the objectives simultaneously.

This desideratum leads to consider the objective necessity of taking up macroprudential policies. They could consider the connexions between the financial system and the real economy in an effective manner (Danila 2011), this way they can procure the diminishing / eliminating of the macroeconomic costs generated by the financial instability.

2. The Financial Instability – causes and effects

2.1. The Economic Stability - a permanent concern of the economic thinking

The issue of the economic stability on long term represents an old problem the economic thinking has been concerned about, all the great economists and / or thinking schools have considered it for a long time.

There was the need of explaining the sinuous evolution of the economic activity and of the economic phenomena that were happening at one point in the past when the economists identified many issues starting from their own vision on the organization and performance, as well as of the laws that rule the economic activity.

The classical liberal doctrine, based on the markets efficiency and freedom of action postulate, claim that the economy has the capacity of readjusting. Adam Smith postulates the principle of the „invisible hand“ in his work „The Wealth of Nations“, demonstrating that the market will handle the society the best, on the condition it is permitted to work at leisure. The natural cost is the main cost around which all the products costs gravitate continuously, the „invisible hand“ controls, with the competition’s help, the real costs and allocates the resources in an optimal manner. This is the way in which the particular interests of the society fit in with their general interests, thus, putting into practice the ”laissez-faire“ dogma. Smith is against the idea of the state interfering in the mechanism of the market.

Jean Baptiste Say, following the previous idea, states that the real balance can not be perturbed because, any demand for products is determined by the corresponding supply of the same products („Say’s law“). Even if, on some specific markets, disequilibriums may occur, the real global balance of the economic system can be characterized as a steady balance/equilibrium and of full employment of labour.

The Great Depression of 1929 -1933 has been a turning point in the economic thinking, when, under the impact of unprecedented economic phenomena, classical liberal doctrine was required to recognize it’s limits and in the economic thinking, are emerging new views, capable to answer to challenges.

Under the pressure of the classical theory’s limitations in explaining the economic phenomena which started to show on the one hand, and on the other hand under the pressure of the alternative proposed by the centralized economy (Soviet Union), John Maynard Keynes proposes a new vision on the organising and functioning of the economic sistem.

Unlike the classics which considered that the market economy is essentially stable, Keynes assumes that the economy is inherently unstable and that, being good in principle, due to fundamental behavioral laws allowed to act for themselves, there is a bad influence on the economic equilibrium, all of these generating crises, unemployment and other negative aspects. Keynes didn’t proposed the abolishment of the market economy, he only said that the time of “laissez-faire“ has come to an end, and the contemporaneous market economy needed a new framework to ensure the identification and correction of the market imperfections. For him the instability, the cyclical fluctuations, the crises, the unemployment were obvious characteristics of the analyzed economic system, generated by the mismatch between demand and supply.
The classical theory being microeconomic by excellence, he considered the macroeconomic results as being a summation of the micro ones, fact which excluded the highlighting of the specific differences and the contradictions between the micro and macro levels of the economy. Keynes was concerned about the functioning of market mechanisms of unstable economies, notices specific differences and contradictions between micro and macro levels, he focuses on the study of macroeconomics and macroeconomic theories and lays the foundation for a new vision, which highlights the need for state intervention in the economy.

Starting with the 70s the reaction to Keynesian doctrine that has dominated the economic theory and practice for a long period of time, gain increasing visibility and materializes in what is called monetarism, a school of thought that went along with the Keynesian one. Ideas contrary with the Keynesian ones which had its roots in the principles of the classicism and manifested even before the 1930s, having their supporters firmly believe in the non-acceptance of the state intervention in the economy.

In this regard we can notice the representatives of the Austrian school mainly Ludwig von Misses and Friedrich von Hayek who initiated and perfected the business cycle theory (de Soto 2010). According to this theory the economic cycles are determined by the credit expansion, expansion which can be generated by the banking activity that takes place within a banking system with factionary reserves. This expansion leads to price increases, generated by the increased amount of currency, and finally to lower profitability. When, at existing prices, the producers can’t sell their goods and make profit the crisis is triggered, i.e. economic system becomes unstable, and a new monetary expansion can only postpone the outcome. The monetarism in the classical sense will be best represented in the USA, where the principles of this thinking will be successfully employed in the economy for a long period of time. The most important representative of this thinking, Milton Friedman best summarizes the principles of this doctrine:

- The inflation is a 100% monetary phenomenon;
- The currency neutrality;
- The monetary policy is structured and not contextual and hence the authorities’ behavior must have a stable and strict action in establishing the framework for the economic agents;
- The inefficiency of the interventionist monetary policies, putting into question the validity of the Philips curve;
- The inefficiency of the budgetary actions, especially the fiscal ones, in the absence of the monetary actions;

2.2. The causes and the effects of the financial instability

The brief presentation of the historical evolution of the economic thinking on the causes of financial instability and the approaches proposed for the elimination or the diminishing of the negative factors that contribute to the generation of the economic cycles, includes the references to my research study, namely, the financial stability, as long as the financial system is an essential part of the economic system, for the proper performance of it as well as in generating imbalance in the system, potentiating each other, this way.

As far as the effects of the financial instability is concerned, we need to point out first of all the fact that it affects the financial system itself and implicitly has an impact on everything concerning the financial system, starting with bank stockholders continuing with the deponents, the clients and not the least even the employees of the credit institutions and the control authority (Dardac 2011).

Dardac (2011) has demonstrated that the effects of the financial instability can be divided into four categories:

- the increase of the budgetary expenses;
- the decrease of the economic growth rate or the reduction of the gross domestic product;
- the decrease of the population personal assets;
- the damage of the efficiency of the monetary policy;

3. The macroprudential policy in supporting the financial stability - concept, tools, objectives.

3.1. The objectives of the macroprudential policy

The term of macroprudentiality was first used in the debates held within the Cooke Committee during the 70s (Clement 2010) and in some documents developed by the Bank of England. Until 2007, the year when the financial crisis started, this term hasn’t been used very often, and as such, hasn’t been rigorously defined compared with the starting period of its usage (Danila 2011).
The definition of the concept is closely related to macroprudential policy objectives even if there is no consensus in the literature on the definition, we can say that the main objective of macroprudential policy is the insurance of the financial stability. The macroprudential policy is required to ensure the achievement and maintenance of a stable financial system.

The macroprudentiality expresses the concern for the financial stability of the system as a whole and its relationship with the macroeconomy, unlike the microprudential policies which are interested in micro policies which are concerned about the situation of system’s components, namely, the health of each financial institutions considered individually.

The outlining of the differences between the macro- and the micro prudentiality (Galati 2011) may lead to a clearer defining of the two concepts.

The macroprudential term vs the microprudential term

<table>
<thead>
<tr>
<th>Tabel 1</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Proximate objective</strong></td>
</tr>
<tr>
<td>The problems limitations at the level of the whole financial system</td>
</tr>
<tr>
<td><strong>The final objective</strong></td>
</tr>
<tr>
<td><strong>The description of the risk involved</strong></td>
</tr>
<tr>
<td><strong>The correlation and the common exposures across institutions</strong></td>
</tr>
<tr>
<td><strong>The calibration of the prudential controls</strong></td>
</tr>
</tbody>
</table>

*Source: Gabriele Galati & Richhild Moessner (2011)*

As it can be seen, the final goal of the microprudential policies is to limitate the risk to the individual level of every component itself, respectively, to guarantee protection to the investors and depositors of every credit institution, and, as far as the macroprudential policy is concerned, the final objective is to limitate/ avoid the macroeconomic costs resulting of the financial instability of the financial system as a whole.

The risk is considered for the microprudential approach- exogenetic (external factors of the system) and for the macroprudential approach is considered –endogenous as the result of the group behaviour of the system components and, consequently, it is a systemic type of risk.

The two approaches show a significant importance to the correlation and the common account among the credit institutions that may determine further on the way in which the control calibration and the prudential checkings are achieved, respectively, *top down* for the macro policies and *bottom up* for the micro prudential policies.

The historical experience shows that there is an internal tendency towards a procyclical evolution of the activity of the financial policy caused by various reasons (Isarescu 2011) and this situation imposes approaching an countercyclical policy. The financial instability is mainly caused by the gradual growth of the risks in the financial system because of the decreasing financial situation of the economic agents, hidden by the increase of the assets value as a result of the credit expension (Cerna 2011). The solution to stop this kind of evolution has to adopt an countercyclical policy of moderating the credit expansion.

Liberalization and financial innovation, besides the fact they amplified the risk of contagion they do not allow any other administrative measures, that are specific to the microprudential policies and through which, when trying to protect every credit institution of the investors and their depositors, they may exagerate because of the overregulation. This situation may have damaging effects on the system as a whole.

The macroprudential policy as a top-down approach, is supposed to determine an aggregate level of the minimum capital that is to be distributed to the financial institutions according to its contribution to the systemic risk.
An effective macroprudential policy may lead to reaching the final objective of the microprudential policy, respectively, the investors and depositors’ protection (Borio 2003) without any possible side slidings that can be generated by an excessive protection.

According to the progress report drawn up by the FSB, IMF and BIS to the G20 (Progress Report to G20, 27 October 2011), the macroprudential policy is defined in relation to three elements:
- The Objective – the limitation of the systemic risk defined as the risk of interrupting the providing of financial services having serious consequences on the global economy;
- Coverage area – the whole financial system;
- The Instruments – the prudential instruments oriented to control the sources of the systemic risk

The macroprudential policy is strongly connected with other public policies because, on one hand, there are many other public policies that have an impact on the systemic risk and, on the other hand, the macroprudential interventions generate macroeconomic effects. Thus, the fiscal policy and the amount of the public debt represent a vulnerability source of the financial field and, for example, the increasing request for capital during a credit boom may affect the aggregate demand.

3.2. The implementation framework of the macroprudential policy

Considering the mutual connections and influences among the various public policies, there is the need for the decision makers to have the dialogues in the best possible institutional framework. They need to synchronize the objectives of every policy and the specific instruments in order to reach the objectives.

According to the report, the implementation framework of the macroprudential policy has to develop on three directions:
- The identification and monitoring of the systemic risk;
- The planning and calibration of the macroprudential indicators;
- Make some institutional „agreements” that may achieve the activity coordination;

The identification and monitoring of the systemic risk

To identify and monitorize the systemic risk is obviously the first and the most important action of this activity. The importance derives of the fact it is necessary for the decision makers to be aware in advance of the information regarding the dimension of the systemic risk. This means that both the growth imbalance throughout time as well as the risks concentration in some areas of the system have to be pointed out.

Studying the national experiences of the past times, a series of indicators and evaluation models of the systemic risk have been identified:
- Aggregate indicators of imbalance in the system- they are indicators that make use of the macroeconomic data (eg the level of the credit, liquidity). For example, the difference between the loan weight in IGP (the intermediary level) and the long term tendency that can be ussed in dimensioning the anticyclical buffer capital necessary to the credit institutions;
- Indicators of the financial mark ets – they are indicators belonging to the category that watch the quantification of the appetite for risk and liquidity of the markets;
- Indicators of the risk concentration in the system- they are indicators destined to monitor and quantify the sending way of the financial shocks considering the transmission channels (contagion), the interdependences among the financial institutions, markets, countries and the common exposures as well as many other factors that may amplify the shocks.Very important steps have been made in bulding the new framework of watching the risks by defining and identifying the financial institutions of global systemic importance (G-SIFIs);
- Macro stress testing;
- Integrated monitoring systems;

The instruments of the macroprudential policy

In the monetary policy there is a definite agreement regarding the instruments used as well as their role in reaching its objective, respectively, the price stability. There are situations at the global level when a second objective occurs (eg USA the maximum employment). Nevertheless, in these cases, the instruments are clearly defined. Not the same thing happens in the case of the macroprudential policy where, because of the objectives diversity, there is a wider range of instruments more or less systemized.
The financial crisis in 2007 outlined the necessity of a set of adequate instruments meant to ensure the optimal results in applying the macroprudential policies, thus, overcoming the disorganized efforts made by the central banks immediately after the crisis spread, they were some non standard instruments. (Danila 2011)

There were Galati & Moessner who have made a classification of the instruments which help in distinguishing between the macroprudential and macroeconomic instruments even if the objective of every category aims at the same thing: the financial stability.

There are other macroeconomic instruments that aim at supporting the financial stability:

- Instruments associated with the monetary policy: eg policy rate, interest on reserves;
- Instruments associated with the fiscal policy: eg the taxes level; measures to reduce the debt levels;
- Instruments associated with the policy of capital control; eg compulsions imposed by the currency of actives denomination;

The G20 report proposes three categories of macroprudential instruments, grouped according to the main objective, thus:

- Tools that aim at vulnerabilities that can lead to the increase of the financial instability like the rapid credit expansion and the asset price booms; In this category the \( \text{loan-to-value} \) (LTV) instrument is included – calculated as ratio between the volume of the given credit and the volume of the needed credit and which, has to be improper ratio. This instrument has as objective the credits beneficiaries to be cointerested in the effective usage of this, this instrument being at the border between the microprudential and macroprudential approach (Isarescu 2011).
- Another instrument \( \text{debt service-to-income} \) (DTI ratio), is supposed to establish a maximum admitted ratio between debt and the client income in order to lower the credit increase by avoiding the excessive debt.
- Tools that address to the vulnerabilities connected to the imbalance created by leverage and maturity;
  - In this category the liquidity ratio is included, which is determined as a ratio between the effective liquidity and necessary liquidity and which needs to be proper ratio.
- Tools destined to diminish the vulnerabilities of the financial system connected to contagion;
  - This category includes, for example, the specific requirements SIFIs, destined to increase their capacity of absorbing the damage in the banking system.

The answer of the international community to the financial crisis is: the building of an effective working environment and of a wider range of instruments, destined to help the decision makers in their endeavour to stop the causes that generate the risks in the financial system and the effects diminishing manifested to some risks.

There are two directions pointed at by the above mentioned instruments: the temporal dimension of the systemic risk (\( \text{time-dimension} \)) and the structural dimension of the systemic risk (\( \text{cross-sectional dimension} \)).

Regarding the temporal dimension of the risk, Basel III suggests three elements that aims at the procyclicity phenomenon: the introduction of a minimum level of the rate of capital (\( \text{leverage ratio} \)), the introduction of the buffer capital to preserve the capital (capital conservation buffer) and of the countercyclical capital buffer.

The level of the capital buffer is established at 2.5% of the common equity and it is projected to work through gathering capital during times of economic boom when the systemic risk is growing, having to absorb the shocks during the times of economic decrease, when the risks materialize themselves.

As per the structural dimension of the risk, they focus on the improvement and monitoring of the loss absorption capacity of the institutions of a systemic importance (G-SIFIs). In order to reach this objective, there have been projected some lines of the organizing framework, that mainly suppose the establishing of some requests of larger amounts of capital because of the impact they may have in case a failure could happen, the establishing of a methodology of identification of a G-SIFIs, the establishing of some measures to increase the intensity and efficiency of the controlling activity.

\textit{The Institutional Reorganization to Provide the Macroeconomic Policy Coordination}

It is necessary for the institutions to organize special arrangements in order to be able to apply the macroprudential policies. These arrangements represent an important aspect in building up the
most suitable organization framework, that is because the macroeconomic, macroprudential and the microprudential policies should act concertedly.

The reorganization or the necessary institutional arrangements point at some aspects like: the mandate of the authorities involved, rights and instruments, transparency and responsibility in taking decisions, coordination with other national organizations.

The adequate coordination of the macroprudential policies is essential in order to reach the established objectives. This represents a direct consequence of a variety of policies, objectives and instruments that can report conflict states at some times.

In many countries abroad that report a relatively large number of authorities who have responsibilities concerning the financial stability, the macroprudential policy is coordinated by a committee/ system in which the respective authorities are represented. In the USA, the organization is called the Stability Oversight Council (FSOC), for the UK – it is the Financial Policy Committee (FPC), for Mexico it is Financial System Stability Council (FSSC) and for our country it is the National Committee for the Financial Stability.

The central banks play a highly important role within these organizations as their activity and attributions are strongly connected with the activity developed by other authorities in the field of the macroeconomic, macroprudential and microprudential policies. Moreover, they are constantly updated with the necessary information and competencies (Isarescu 2011).

The revision of the mandate granted to the central banks needs to be considered from this perspective as well. In this way the responsibilities regarding the financial stability become formalized. According to the G20 report, the fairness of the decision can lead to the avoidance of the situations in which, because of some different perspectives of the authorities involved, the decisions can not be made in the due time. This kind of mandate may improve the implementation capacity of the macroprudential policies, attesting the power of decision but also the responsability of the central banks.

The issue of the role the central banks should have is not a definite one, there are still debates on the matter. Globally speaking, there are various institutional organizations that assign the central banks responsibilities regarding the macroprudential and the microprudential policies (see the case of Malaysia), assignment of a high importance (by voting) within the committees as in the case of the ESRB or, in the USA, the limitation of power of the central bank within the committees (one vote of 10 for the Federal Reserve in the FSOC), but also it is assigned a higher authority in regulating the banking and non banking institutions of systemic importance.

The macroprudential policies have an important role in ensuring the financial stability but they are not a panacea. These policies can not be substituted to some safe microprudential and macroeconomic policies (Vinals 2011) that represent a precondition in applying an effective macroprudential policy. The effective microprudential and macroeconomic policies diminish the necessity of using the macroprudential policies (Isarescu 2011) whose objectives and instruments are not very well defined or whose transmission channels are not fully known.

4. The Role played by the central bank in ensuring the financial stability

The fundamental role of the central banks has been throughout history to provide the monetary and financial stability, role that results of the special quality of the central banks to be the lender of last resort.

The importance of this role is sustained by the fact that the trigger of a banking or financial crises is caused by the lack of trust that generalizing itself, has consequences in affecting the liquidity in the system.

Initially they were founded as institutions intended to support financially the military conflicts, see the cases of the Banks of England, Bank of France and not only (Paun 2010). Gradually, as a result of the absence of the military conflicts, the role played by the central banks has been changed. Generally, the central banks used to have three main objectives , with differences from one historical times to the other, or from one country to the other (Goodhart 2010):

- To ensure the prices stability;
- To ensure the financial stability;
- To support the countries financially throughout the recession time;

Goodhart identifies three main historical periods according to the importance paid to some of the above mentioned objectives also according to the action manner of the central banks:

- 1840 – 1914 – The Victorian Age
- 1930 – 1960 – The times of the governmental control
• 1980 – 2007 – The time of the markets boom

As it can be seen the end or the beginning of a new period of time has been marked out by important events, usually, by serious economic-financial crisis (the first World War 1914, the big Recession of the 1930’s, the Financial Crisis of the 1970’s, etc) that brought major changes in approaching the matter, leading to the defining of new paradigm specific to the respective periods of time.

The period of 1840-1914 named the Victorian Age was characterized by the central banks orientation towards the maintaining of the stability, especially in situation of banking panic. The main concern of the economists of those times was how they could “reconcile the adherence to the golden standard with the maintenance of the financial stability” (Goodhart 2010).

H Thornton and W. Bagehot underlined the theoretical position of the central bank as a lender of last resort. According to this idea, when a bank of the system has a problem with the liquidity, without having solvability problems, it will be ready to accept higher interests for the sources attracted.

Because of the information asymmetry on the banks solvability (Cerna 2008), the high level of the interests accepted by a bank, can lead to suspicions about solvability problems and, in the end, suspicions about the imminence of its bankruptcy. In this context, the banks in the system, will create a blockage of the interbank markets that will not allow it to protect itself, being in the position of asking for the central bank intervention.

The rules they needed to apply in the case of the intervention, established by the theorist of the doctrine, which are still actual, represented by a series of conditions necessary to be fulfilled, are:

• The beneficiary banks need to be solvable;
• The costs of an operation of this kind has to include a gratification penalty which shouldn’t transform the operation in a refinancing classical one;
• The existance of some acceptable and sufficient guarantees;
• The lender of last resort activity has to be a transparent one and it has to be made public in advance;

The government supervision period between the years 1929 – 1960 is influenced by two major events that changed the objectives and the approach manner of the central banks. The two great events, the economic crisis of the years 1930-1933 and the abandonment of the gold standard, put the central banks under the political pressure in order to support the economic development by promoting low interest rates. One of the lessons given by the financial crisis was that for the financial stability the competition in the financial system is dangerous (Goodhart 2010), because of the fact by diminishing the profit margin and the decrease of the capital funds, the stability is threatened.

The consequence of this kind of approach was that they lead a control policy of the competition, limiting the possibilities of development of the system and its efficiency.

The system was definitely more secure, not a banking crisis was recorded during that period of time 1945 -1971 (Table 2), the disadvantage was the efficiency decreased.

The Frequency of the Crisis

<table>
<thead>
<tr>
<th>Period</th>
<th>Banking crisis</th>
<th>Currency crisis</th>
<th>Double crisis</th>
<th>Any kind of crises</th>
</tr>
</thead>
<tbody>
<tr>
<td>1880 – 1913</td>
<td>2.30</td>
<td>1.23</td>
<td>1.38</td>
<td>4.90</td>
</tr>
<tr>
<td>1919 - 1939</td>
<td>4.84</td>
<td>4.30</td>
<td>4.03</td>
<td>13.17</td>
</tr>
<tr>
<td>1945 - 1971</td>
<td>0.00</td>
<td>6.85</td>
<td>0.19</td>
<td>7.04</td>
</tr>
<tr>
<td>1973 - 1997</td>
<td>2.29</td>
<td>7.48</td>
<td>2.38</td>
<td>12.15</td>
</tr>
</tbody>
</table>

Source: Eichengreen and Bordo (2003)

The absence of the problems on the financial stability made the central banks to lose interest about this matter and, in the end, the expertise in the area was lost as well (Isarescu 2011).

The period of the 1970-2007 – the markets boom - is the period of time that was marked up by the dissolution of the System from the Bretton-Woods (1972-1973) and of the deregulation. Under the pressure of the markets and of the innovations, without the constrains imposed by the combination of the deposits and liquid assets, an unpreceanted development of the banks balance happens during this period of time. The commercial banks offered as many credits as they could on all the markets, the introduced new products to avoid any kinds of constrains, covering themselves with the necessary liquidity on the interbanking market.
When the central banks are made to provide enough liquidity to maintain the interests rates on the interbanking market in concordance with the interest of monetary policy, the liquidity could not be considered a limitation factor of the credit extension.

The solution to limit the balance came from the direction of the capital that, due to its size, offers more security to its depositors and lender, but, under the pressure made by the stock holders to rise the ROE, the bankers were encouraged to assume higher risks (Bebchuk and Spamann 2010). The banks tendency, under the pressure of the stock holders, to decrease the capitalization in order to increase its rentability, has been stopped because of the impact of the crises in the countries of the Latin America had on it (1982). It highlighted the fragility of the american banks that were the lenders of these countries.

The solution suggested was to establish a minimum level of capital, accepted and regulated within Basel Committee on Banking Supervision, known later on as the Basel Agreement 1 (1988).

Once the capital requirements (8%) was established and reached for a bank to be considered solvable, this had only to provide itself with the necessary liquidity from the banking market in order to continue the loaning process.

Although this level of solvency was arbitrarily chosen (Goodhard 2010), a theoretical base was not set, even more, there were not many empirical analysis made. It was enough for the banking system to be constant until the year of 2007.

It is the year 2007 that marks up the beginning of a new cycle, that, obviously, involves the discussions about the role a central bank has to play. The consequences of the financial crisis of the years 2008 and 2009 associated with the economic recession, will affect the economy, society, policies and the economic thinking on a long term.

The role the central banks will play depends on the way in which the objectives set by the monetary policies will accommodate with the promotion of the financial stability. Claudio Borio (2011) shows that the central banks will never have peace after the global financial crisis. This crisis has troubled the comfortable world of the banks because there is nothig as it used to be before, many of the approaches of the central banks after the year 2007 are unconventional (Danila 2011).

When establishing the new role of the central bank, they need to consider three characteristics (Borio 2011). First of all, it is about the reprojection of the working environment so that they should consider the interdependence between the monetary policy and the financial stability. Although the central banks did not ignore the objective of maintaining the financial stability within their range of activities in the time prior the crisis period, this situation was seen as a little brother of the monetary policy (Bernanke 2011). Now, it is the moment of reestablishing the balance in assigning the right importance, and the financial stability is a responsibility as important for a central bank as the price stability.

Secondly, they need to reconsider the traditional policies of keeping on’s house in order (Padoa-Schiopa 2008), namely, the adequate activities for the individual institutions are adequate for preventing the systemic risk. Thus, the individual safe of the institutions and the activities developed to achieve this result, does not guarantee the financial stability of the whole system. It is necessary to make a transfer from the micro perspective to the macroprudential one in the regulatory activity and financial supervision. Thirdly, the independance of the central banks from the point of view of their protection and its consolidation has to be discussed. To implement some macroprudential policies, as I have shown so far, depends on the decision authority and of the responsibility of the central banks, which can be improved by ensuring the institutional autonomy. The analysis of the role a central bank has to play, in the new economic global context, is made by Borio taking as reference the crisis and putting the ideas face to face, the accepted approaches ante-crisis and post crisis.

It was until the crisis of 2007 when it was considered that the price stability was sufficient to ensure the macroeconomic stability. The absence of the imbalance of their own economy developing under the form of inflation secured a comfortable situation (Danila 2011). It was considered that if the central bank was pegging the inflation on the market on a short term, the economy will take care of itself (Borio 2011). However, at present, the generally accepted opinion is that, even if the price stability ensured macroeconomic stability on a long term, this was not sufficient to ensure the financial stability as well (Bernanke 2011).

„The house in order” dogma, translated from the level of a single economy to the global level meant to say that if every central bank was ensuring stability at the country level then, the global stability would be ensured automatically. The statement proved not to be valid any more as the globalization of the financial markets reached such a level that the central banks did not have the capacity to ensure liquidity on their own market. This thing led to the approach shift of the important
develop the activity at the national or global level, in the private or public area. The deposits and users of resources, in their capacity of providers of important services to economic growth, the banks being called to provide the necessary financial intermediation between systems with the impact caused by events of the range of the mentioned financial crisis.

The role of ensuring the financial stability, by virtue of its ability to generate liquidity and of its quality as lender of last resort, leaving the monetary policy to be the government responsibility. When establishing the interest rate (monetary policy), what is important is its level not to imbalance the market and not who establishes this or how it establishes this (Danila 2011). On the other hand, the solution above does not resist to a deeper analysis, because the high inflation during the years 1960 - 1980, when the decisions regarding the monetary policy were adopted by governments in many countries (Isarescu 2011), shows the risk that must be assumed by a solution of this kind.

The integration of the monetary policies with those of financial stability represent an objective of the following age focusing on the complementarity of the two functions (Bernanke 2011). The advantages of this kind of approach show that, there are not risks of loosing credibility, there also important benefits for a central bank which, in its quality as a lender of last resort, it can make use of the information held as supervisor in order to react promptly and effectively.

The year 2007, because of the grand events and their consequences, marks up the beginning of a new „epoch”, the fourth in Goodhart’s opinion (2010), that will influence the economic thinking as well as the practices of the central banks. Starting from the necessity of coordinating the macroeconomic, microprudential and macroprudential policies that need to act concertedly, the central banks have to play a prominent role, that is to coordinate the implementation of these policies. This role can be played on the condition the operational independance of the banks is kept and consolidated. The operational independance represent the promotion guarantor of some professional policies in the areas of their assigned competence, without any political interference that would ensure a safe and durable economic growth. The integration of the monetary policy and of the financial stability will reestablish the importance of responsibility of the central banks to ensure the financial stability along with the price stability, placed on a second place in the last period of time. Alongside the monetary policy (the price stability), the central bank has to achieve its main role for which it has been created, that of ensuring the financial stability and of playing an important role in the macroprudential policy, considering the fact that the policy of financial stability includes the micro and macroprudential set of instruments to monitor and analyze the systemic risk that may affect stability. Responsibilities delegation to some other institutions, analyzed by Goodhart (2010) and who suggests that the monetary policy to be part of the government responsability, represent a suboptimal solution because of the conflict of interests that may occur (Isarescu 2011).

5. Transformation of the international regulatory and supervisory framework - a prerequisite for financial stability - Basel III

The financial crisis of the year 2007 asked for an adequate reaction from the regulators part at an international level. Their reaction did not waste time in appearing. The reform proposed by the Basel Committee (Basel III: A global regulatory framework for more resilient banks and banking systems, December 2010), points at the consolidation of the capacity of the banking system to cope with the impact caused by events of the range of the mentioned financial crisis.

The most important condition is to have a strong banking system in order to ensure a durable economic growth, the banks being called to provide the necessary financial intermediation between the depositors and the users of resources, in their capacity of providers of important services to develop the activity at the national or global level, in the private or public area.
Even though many of the regulation introduced have a microprudential character, of consolidating the credit institutions as individual entities, the reform of the international regulatory framework has a macroprudential approach that points at the risks the whole system may encounter.

The solutions proposed by Basel III to consolidate the capacity of reaction to impacts of the financial system are:

- Improve the quality and transparency of the capital base;
- Improve the risk coverage;
- The introduction of a minimum level of the rate of the capital requirement – leverage ratio;
- The introduction of a minimum global standard of liquidity;
- The introduction of some macroprudential standards of capital;

**Improvement of the quality of the capital base** – sets as objective the consolidation of the loss absorption in the context of the continuous activity (Tier 1) also under conditions of activity suspension (Tier 2).

The essential changes aim at:

- to improve the quality of the individual capital by introducing some more strict eligibility criteria for some components of the capital of level 1;
- to increase the minimum request of common capital and of requests of individual funds of level 1 that suppose a quantitative and qualitative change;
- to decrease the capital of level 2(Tier 2) and to eliminate the Tier 3 capital instruments;

A comparative situation of the way in which the level and the components of the individual funds have evolved is shown in Table 3.

### The evolution of the composition of the capital

<table>
<thead>
<tr>
<th>Indicators</th>
<th>Basel I</th>
<th>Basel II</th>
<th>Basel III</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital</td>
<td>Tier 1 + Tier 2 + Tier 3</td>
<td>Tier 1 + Tier 2 + Tier 3</td>
<td>Tier 1 + Tier 2</td>
</tr>
<tr>
<td>Level 1 (Tier 1)</td>
<td>Tier 1 – Common equity and hybrid instruments of capital</td>
<td>Tier 1 – Common equity and hybrid instruments of capital</td>
<td>Tier 1 – Common equity and hybrid instruments of high quality capital</td>
</tr>
<tr>
<td>Level 2 (Tier 2)</td>
<td>Tier2 – max. 100% of Tier 1 Tier 2 – Base Additional – max. 50% of Tier 1</td>
<td>Tier2 – max 100% of Tier 1 Tier 2 – Base Additional – max. 50% of Tier 1</td>
<td>Tier2 – max. 33% of Tier 1</td>
</tr>
<tr>
<td>Level 3 (Tier 3)</td>
<td>Tier 3 – maximum 150% of Tier 1</td>
<td>Tier 3 – maximum 150% of Tier 1</td>
<td>X</td>
</tr>
</tbody>
</table>

*Source: Georgescu 2011*

Apart from the structure changes introduced by Basel III to the capital, there also quantitative changes to increase the request of capital, thus:

<table>
<thead>
<tr>
<th>Indicators</th>
<th>Common Equity Tier 1</th>
<th>Tier 1 Capital</th>
<th>Total (Tier 1 +Tier2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum request</td>
<td>4,5%</td>
<td>6%</td>
<td>8%</td>
</tr>
</tbody>
</table>

*Reference: Basel III: A global regulatory framework for more resilient banks and banking systems – Annex1*

Increasing the risk coverage of the capital framework achieved by the raise capital requirements for:

- risks from complex securitisation exposures;
- risks from operations of the trading book;
- counterparty credit exposures;
The introduction of a minimum level of the risk-based capital requirement – leverage ratio

The objective of this instrument is to control/limitate the expansion in an unsustainable manner of the banks balance, this being one of the most evident causes of the crisis. The instrument is considered to be a simple, transparent one, to measure the determined risk as a ratio between the capital of level 1 and the assets on and off-balance sheet. The minimum agreed level is of 3%, a quite conservative level according to the banking groups activating on the capital market (Georgescu 2011).

The introduction of a global liquidity standard

The proper capitalization of the banks is considered a necessary condition but not sufficient for a safe and stable financial system. The problems of the liquidity management have been outlined during the crisis time as major factors that generate risks to the financial stability. The new global liquidity standard sets two separate but complementary objectives on the liquidity matter: one is on short term - Liquidity Coverage Ratio (LCR) and another is on long term - Net Stable Funding Ratio (NSFR). The coverage of short term liquidity needs (LCR) reflects the banks potential to stand to some punctual situations, when these face the liquidity outflows under stress conditions, within 30 days. The long term structural liquidity rate (NSFR), reflects the banks capacity to ensure a safe financing under the conditions of longer time of crisis (12 months).

The introduction of some prudential capital standards

The instruments used are: the capital conservation buffer and the countercyclical capital buffer

- The capital conservation aims at creating a buffer fund of capital when the economic activity is growing, so that, when the bank reports losses during crisis times, these could be absorbed without having impacts on the capital base.

  The minimum requirement of capital for this part is of 2.5% more than the minimum level of the total requirement of capital of 8% and, in its componentry, there are elements of common equity (common shares, reserves, retained earnings). When the bank capitalization is affected, the bank reporting loss that may diminish the capital conservation buffer, threatening the capital base decrease under the minimum level, then, the bank has to take action in order to readjusting the funds to the required level. This situation can be achieved by the reduction of the dividend payments, payments of bonuses etc. There is the alternative of drawing up capital on the market to reestablish the required level, but, the achievement of one or other option has to be done under the control authority.

- The countercyclical capital buffer is an element strongly connected to the evolution of every single economy. The level of this buffer varies between 0-2.5% and it is added to the capital conservation buffer.

  The objective of the instrument is an countercyclical one and it follows to counteract the excessive growth of the credit, this growth can also mean risks accumulation in the system so that, this buffer may be used to cover the future potential losses.

  The main characteristic of this component is that the level of this kind of buffer capital is established by every single central bank (within 0-25%), taking into consideration the evolution of the macroeconomic parameters, the level increase has to be announced with 12 months in advance. The level of the buffer capital can be established for all the banks that operate in the area, or specific levels can be established for every bank alone, according to the global exposure the banks had. The banks that operate at a global level are assigned the task to agree on the level of the countercyclical capital calculated for the entire bank with the requests coming from different jurisdictions where they activate. The new regulatory framework Basel III, aims at transforming the global financial system in order to consolidate it to be able to provide it with the financial stability. The latest regulations aim at consolidating the credit institutions at the individual level, having a microprudential character, but, on the other hand, many of the changes switches the center of gravity on a macroprudential approach. Starting from the procyclicality of the financial system (Cechetti 2009), emphasized by the fact that the growth in the real economy means growing trust of those who ask for credits in their capacity of the debts reimbursement as well as an raise of the assets, the result is a self sustaining of the growing lending, the conclusion is the necessity an anticyclical approach of counterworking the phenomenon.

  Along with this necessity, the new regulations that point at the capital and its essence, may represent an effective stabilization instrument, simple and transparent which the financial stability of the entire system can rely on.
6. Conclusions

Since 2007, some sectors of the financial system have been affected by financial turbulences that, even though they did not foresee the volume of the phenomenon, it became shortly a global economic and financial crisis. Because of its dramatic effect, the rapidity it spread globally as well as the economic effects, namely, some factories bankruptcy, the unemployment growing rate, financial losses reported by the investors, the governments intervention with large amounts of money in order to avoid the collapse of the financial system, this crisis time represents the beginning of a new age for the economic thinking and practice.

The starting point on this road is to reestablish the reliability on the financial markets by reconsidering the financial stability as principal objective of the economic policies, that aims at building a solid, stable, responsible and transparent financial system.

The globalization phenomenon raises new issues and implicitly requires new approaches in solving them, as it is the contagion phenomenon or the speed of the shocks emissions which had such an impact that in a very short time strong well known financial institutions to collapse, without showing any weaknesses signs in advance.

The new economic context and its objectives ask for the reforms orientation towards a macroprudential approach that could have the capacity to react properly to the given conditions, simultaneously with the consolidation of the macroprudential policy. However, in the same time, considering that, no matter how good the macroprudential policies would be, they can not replace the macroeconomic policies, it is necessary to project the proper framework that will permit coordination for all these policies that need to act concertedly, under the conditions in which they can be the appanage of some distinct authorities: the central bank, financial supervisors, the government.

In this new outlined framework, the central banks need to play an important role considering, on one hand, the importance they play as a lender of last resort in ensuring the financial stability and, on the other hand, the fact they have all the necessary abilities and information and, not the least, the institutional independance in applying the policies. This independance has to be maintained and consolidated as well.

The resetting, in an explicit way, of the financial stability along with the price stability, as an important objective of the central banks, is supposed to represent finding the necessary solutions to integrate the monetary policies with the policies of ensuring the financial stability which are essentially complementary.

To provide the necessary conditions for a sustainable economic growth, they need to start from the idea that the financial stability represents an important objective and the central banks responsibility in ensuring the financial stability is at least as important as the responsability to promote a proper monetary policy in order to achieve the macroeconomic objectives.

Bibliography
Bichi Cristian, Reflecții privind noul cadru european de gestiune a crizelor financiare, Conferința „BNR – Zilele portilor deschise pentru studenții economiști” – Școala de vară BNR, Constanța, septembrie 2011
Borio Claudio, towards a macroprudential framework for financial supervision and regulation?, BIS Working papers, No. 128, februarie 2003;
Borio Claudio, Monetary and Financial Stability: So close and Yet So Far, National Institute Economic Review, no. 192(1), 2005;
Borio Claudio, Central banking post crisis: What compass for uncharted waters?, BIS Working papers No 353, September 2011;
Bernanke, B. S., The Effects of the Great Recession on Central Bank Doctrine and Practice, Remarks at the 56th Economic Conference, Federal Reserve Bank of Boston, 18 October 2011;
Caruana Jaime, Central Banking between past and future: which way forward after the crisis?, Speech at the South African Reserve Bank 90th Anniversary Seminar, 1 July 2011;
Cecchetti Stephen, On the similarities of capital adequacy and monetary policy, Thirteenth Annual Conference of the Central Bank of Chile,19 November 2009;
Cerna Silviu, Politica monetara, Timișoara, iulie 2011;(in curs de publicare)
Cerna Silviu, Probleme actuale în analiza stabilității financiare, Conferința Internațională “Economie și cunoaștere”, Iași, octombrie 2011;