MONETARY AND FISCAL POLICY DURING THE CRISIS AND THEIR EFFECTS ON FINANCIAL STABILITY AND GLOBAL INTEGRATION

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Abstract

The key point that is arising from the last financial crisis is the need to create a framework for macro financial goals and directions in the medium and long term. The main emphasis can be putted on the creation of so-called macro prudential policy, which main goal is to prevent the materialization of systemic risk in the financial system. Although prudent policies should aim to ensure financial stability, the crisis has shown that monetary policy should also take a major role in the reaction observation of the financial developments. It is obvious that current macroeconomic models used in monetary policymaking suffer from poor understanding of macro financial ties and do not include possible financial imbalances, such as risk of falls and systemic liquidity risk. Here monetary policy should reach at a level that would ensure financial stability. The volume and severity of the financial crisis bring a new discussion about the need for new regulatory supervision and monitoring on the financial institutions and financial markets. This new regulatory and supervisory framework for financial markets and institutions is not placed just at EU level, but also on the global level.

This paper is elaborating the regulatory and supervisory framework for financial institutions at EU level. Also, this paper is covering the global environment in which monetary policy persisted, and elaborates the challenges as a result of changes that started with globalization in trade and financial fields.

Key words: role mismatch, financial crisis, macro prudential policies, legislative framework

Introduction- The basic role of monetary and fiscal policy

The analysis of traditional role of monetary and fiscal policy begins with an emphasis on consensus views of economists and politicians that central banks are responsible for ensuring price stability in the medium term. While inflation outlooks remain well secured and fixed, monetary policy can and probably should contribute to stabilization. Monetary policy should work promptly and efficiently which is a task that is given to technocrats who are entitled to act on some degree of discretionary manner, free from political impact, but with a clear legal or legitimate mandate. A general view is that monetary policy should have only limited

distribution effects and acceptable distribution effects of monetary policy are those arising from changes in interest rates, with benefit or negative impact on savers and investors.

In contrast, fiscal policy is leaded by elected politicians and as politics takes strong distribution effects through decisions on taxes and public spending. The role of fiscal policy after the financial crisis is considered to be limited within the borders of automatic stabilizers. The reason for opposing the use of discretionary fiscal policy is a major concern because of tenacious budget deficits, unsustainable debt levels, and worries about the capability of the political system to deal with tax issues and decisions on fiscal spending quickly and effectively to achieve the anticipated stabilization.

Role mismatch

During the last financial and economic crisis, fiscal policy again remained indecisive and powerless in taking clear steps in many countries during the recent financial crisis. Contrary to fiscal policy, monetary policy has lifted more to the center of macroeconomic policy, ranging from limited to almost unlimited decision making and a sort of carefulness. One basic way on which central banks reacted during the crisis was to reduce the interest rates at levels that were extremely low, but many central banks implemented other ways to reduce the effects and respond appropriately to the crisis. First of all, they applied quantitative easing and credit easing, which can be considered as unusual monetary policy measures. Secondly, they reduce the quality requirements in the way that they enlarge the list of financial instruments that they were accepting as guarantee. The last, but maybe the most important was the role of lender of last resort to rescue banks that without the help will collapse. These measures put central banks in a position to give predilection to specific group of borrowers, such as mortgage banks, industrial companies and governments, and specific sectors such as export oriented companies, in contrast to domestic selling oriented companies.

These measures can be justified, as long as we can put these measures of the monetary policy as special monetary measures that should be compatible and common with the measures that implement the fiscal policy, but on the other hand, it is clearly not according to the traditional allocation of the responsibilities and roles that have the monetary and fiscal policy.

Monetary policy and the influence on financial stability

The key point that is arising from the crisis is the need to create a framework for macro financial goals and directions in the medium and long term. The main emphasis can be putted on the creation of so-called macro prudential policy, which main goal is to prevent the materialization of systemic risk in the financial system. This should be perceived by the monetary policy as a positive reaction from the crisis, but it also involves certain tasks.

It will provoke positive reactions from the monetary policy if these macro prudential policies succeed in the process of making the financial crises less sharper and with minimal negative influence for the whole financial and economic system. This will reduce the necessity for monetary policy to react not according to the given goals and be a policy that will clean the mess when the crisis will erupt. The central bank should have the main role in this type of institutions that will set and govern macro-prudential policy, which will serve not as a separate part, but as addition to the monetary policy.

Although prudent policies should aim to ensure financial stability, the crisis has shown that monetary policy should also take a major role in the reaction observation of the financial developments. It is obvious that current macroeconomic models used in monetary policymaking suffer from poor understanding of macro financial ties and do not include possible financial imbalances, such as risk of falls and systemic liquidity risk. Here monetary policy should reach at a level that would ensure financial stability. While ideally prudential policies are explicitly those policies that should ensure financial stability, in less ideal conditions in which we live the financial stability should be supported by monetary policy. Monetary policy should not take additional responsibilities and goals that should be done, but when price stability is taking into consideration, monetary policy should more explicitly take into account the rising financial imbalances and as monetary policy to take additional measures and actions to find a way to address these imbalances. So, the monetary policy should pay more attention when setting policy regarding the evolution of credit and debt, especially when they are going together with the rapid growth in asset prices and current account deficits. These are the most important signals for the increase of the financial imbalance, which could ultimately jeopardize the financial and price stability. The favorable effect of the foregoing is that monetary policy will become more symmetric with respect to the economic cycle, with greater representation at a time of growth and less need for intervention during the crisis and slowing growth.

New regulatory and supervisory framework for financial institutions at EU level

The volume and severity of the financial crisis bring a new discussion about the need for new regulatory supervision and monitoring on the financial institutions and financial markets. This new regulatory and supervisory framework for financial markets and institutions is not placed just at EU level, but also on the global level. The need for new regulatory and supervisory framework for financial markets and institutions have been set by G20 leaders, while the concrete work on the development of policy is being carried out by international standard setters, coordinated primarily by the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS).

The key regulatory initiatives in the EU, which are among the global regulatory and supervisory reform agenda is presented in the next table, clearly presenting the perspectives of financial stability and macro prudential policy.

Table 1: Proposals for the banking sector in EU

Initiative	Description	Current status
Banking union	A single supervisory mechanism with strong ECB powers for the supervision of all banks in the euro area (in cooperation with national supervisory authorities). Further components of the proposal: single rulebook, common deposit protection and single bank resolution	The European Commission's proposal was published in September 2012.

	mechanisms. Main aims: avoid future banking crises, restore confidence in the financial system and protect savers.	
Capital Requirements Directive and Regulation (CRD IV)	The proposal implements Basel III in the EU. Overarching goal is to strengthen the resilience of the EU banking sector, while ensuring that banks continue to finance economic activity and growth. The proposal consists of a Directive, which relates primarily to the national supervisory process, and a Regulation, which sets prudential standards for financial institutions.	The European Commission's proposal was published in July 2011."Trialogue" negotiations between the Commission, the European Parliament and the Council are ongoing.
Deposit guarantee schemes	The legislative proposal deals mainly with the harmonization and simplification of protected deposits, a faster pay-out, and an improved financing of schemes.	The European Commission's proposal was published in July 2010.
Bank resolution	The proposed framework sets out the necessary steps and powers to ensure that bank failures across the EU are managed in a way which avoids financial instability and minimizes costs for taxpayers. The proposed tools are divided into powers relating to "prevention", "early intervention" and "resolution".	The European Commission's proposal was published in June 2012. Revision of the proposal after comments from Member States and other relevant parties.
Mortgage credit directive	The aim of the proposal is to create a responsible, efficient, healthy and competitive pan-European mortgage credit market that works to the benefit of consumers, also promoting customer mobility, cross-border activity of creditors and intermediaries, and creating a level playing field for all actors involved.	The European Commission's proposal was published in March 2011.

Source: Financial Stability Review 2012

One of the basic necessities for actual and legitimate Economic and Monetary Union is the foundation of a banking union. The European Commission published legislative proposal which is connected with the Single Supervisory Mechanism (or SSM), which in fact is a step toward the banking union. The basic point here is that the building of a banking union is a multipart process, but necessary and crucial plan for better and more effective monetary union. Obviously after the crisis, there is a need for banking supervision that will be on national level in every country part of the Union, and also countries that pretend to be part of European and Monetary Union. The problems that occur today in the monetary policy are

easily transmitted to fiscal policy, and vice versa. On the short run, the Single Supervisory Mechanism should stabilize the connections and negative effects between monetary and fiscal policy in the country, but at the long term this Mechanism should have much positive influence on the Monetary Union and the whole global economy. In fact, the idea is that SSM will fulfill the necessity for common supervisory system with common resolution regime.

Concerning the recovery of credit institutions and investment firms, there is a need to avoid "contamination" of other institutions from bank failures, which obviously can be done with efficient management of these failures. There is a need for specific tools that can be implemented from related authorities, which will guarantee the financial stability. Concerning the Deposit Guarantee Scheme (DGS) Directive, the basic point is to maintain financial stability in the way that will build up depositor assurance and protect their wealth. The idea of Capital Requirements Directive and Regulation (CRD IV) is the implementation of Basel Committee' regulatory framework posted at the global level. The purpose of this framework is to increase the confidence of the banking system, sustain the market confidence and assuring the work of international banks. This framework is covering all the banks and investment companies in EU. This framework requires better capital in financial institutions and gives directives concerning the liquidity requirements and leverage. Also, it gives the supervisory authorities additional supervisory power and building the way towards unified bank regulation. Here, one of the most important things is the incorporation of macro prudential policymaking concerning the systematic risk.

Globalization

The global environment in which monetary policy persisted brings more challenges as a result of changes that started with globalization in trade and financial fields. Concerning the trade, in the period before the crisis in many western economies targeting low inflation was easier with cheaper imported products. Analyzing further, things will probably be different as structural upward trend in commodity global prices becomes a dominant factor. So, the tasks that the monetary policy has now are more difficult concerning this upward trend. Speaking from a financial point of view, after the crisis the capital inflows in developing countries will be at higher level. There are many reasons for this. First of all, there are better expected rates of return, better growth prospects and macro fundamentals. These capital inflows will require from the policymakers to set the economic policies in those countries. They can choose between the significant appreciations of the exchange rate, or limit the appreciation by intervention in the currency market. In the second case scenario, there is no availability to sterilize the intervention, which will lead to increased inflation. Raising rates to lower inflation will bring more capital inflows, which will not be positive for the economy in the country.

The emergence of these fluctuations suggests the need for new ways and opportunities for developing countries to cope with the challenges they face in large capital inflows. Macroeconomic adjustment policies to enable sustainable rate of expansion of aggregate demand with lower domestic interest rates may help to limit capital inflows. Macro-prudential measures can be used to lower the risks in terms of financial stability. This situation will allow monetary policy to continue to focus on its key objective of maintaining price stability.

Conclusion

All the actions taken by central banks were forced by the severity of the crisis and they were inevitable. However, there are five major lessons about the conduct of monetary policy that can be learned from the recent crisis. First, there is no doubt that central banks should play a role in the economic downturn of the market level and at the level of individual systemically important banks. In order to act appropriately, they need room to maneuver, which involves significant balance sheet of the central bank with sufficient capital. In normal times, the distribution of profits of the central bank should be limited to achieve this goal. In order to be able to act in a crisis, central banks need to have a balance to be able to restore the previous level after crisis caused by the implementation of unconventional measures. Second, it is important to ensure that responsibility is not only transmitted to the central bank. When acting on behalf of another authority, central banks need to be very careful (even if they get a guarantee on their balance sheet risks). Moreover, when they expanded their activities in time of crisis, it is important that they remain within their mandate. Third, central banks must be protected from finding the position where they are forced to take action because of the inaction of other institutions. Fourth, when making monetary unconventional policies, it is important that central banks carefully assess side effects and will set a clear exit strategy from the outset. Fifth, there is a need for implementation of the proposals included in the regulatory and supervisory framework at EU level. This will alleviate the negative effects of the future financial and economic crises.

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