THEORETICAL CONSIDERATIONS OF PRICE STABILITY AS PART OF THE FINANCIAL STABILITY

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Abstract: *Currently there are many authors who consider that the only objective of the central bank should be the price stability and between the respective objective and financial stability there is incompatibility. As far we are concerned, we subscribe the idea that between price stability and financial stability there are complementarities. And a strong argument in the favour of this position is also historical. Actually, many older or newer facts show that banking crises were often caused by the unfavourable macroeconomic situation coupled with the bad macroeconomic policies carried by the authorities. But, a monetary policy that aims the price stability reduces this risk. The truth is that the central banks have a series of tools that allow them to act for achieving both the objective of price stability, and that of the stability of financial sector. Although the financial stability is not, usually, an explicit objective for the modern central bank, the systematic financial instability can cancel their performances in achieving their major final objective: the price stability. Being that, because of the need that it creates to inject additional liquidity into the banking system, a crisis of the banking sector may directly affect the monetary stability. Here the mentioned complementarities arise between price stability and financial stability, although the achievement of the first does not necessarily involve the assurance of the last.*

Key words: *financial stability, price stability, evaluation, monetary policy.*

JEL Classification Codes: E52, E58, E59

1. INTRODUCTION

In the literature there is a unanimous opinion that price stability refers to the aggregate prices evolution, that measured by various indices (CPI in the case of Romania) to be relatively constant or with small changes. Price stability is achieved when the money keeps its value over time and their speed of erosion is insignificant.

Price stability is in practical terms a challenge achieved in many countries, but this does not guarantee the financial stability.

Thus, as a result of economic globalization in the context of open economies, appears a potential conflict between price stability and financial stability.

The European Union requirements towards the financial crisis management assess the existence of a cooperation agreement between all the supervisory national authorities of the financial system, the central bank and ministry of finance.

To implement these requirements, 31 of July 2007 were sign the *Cooperation agreement in the field of financial stability and financial crisis management,* under which was established the National Committee for Financial Stability.

From the perspective of a central bank, the financial stability is defined as a situation where banking crises does not occur and that there is a certain stability of asset prices and interest rates.

But, the massive capital inflows worsen vulnerabilities and macroeconomic imbalances in host economies, having the potential to generate crises with adverse effects both price stability and also financial stability.

Currently, financial stability is essential for the effectiveness of monetary policy and therefore for the assurance of price stability.

2. THE COMPLEMENTARITY BETWEEN FINANCIAL STABILITY AND PRICE STABILITY

Price stability is achieved when the money keeps its value over time and their speed of erosion is insignificant. The concept of monetary stability overlaps over that of price stability.

The former president of the Federal Reserve System of the USA (central bank of USA), Paul Valcker defined price stability through the inflation anticipations: a useful definition of reasonable price stability, seems to be the situation where the anticipations of the general increase (or decrease) of the prices on a considerable period of time do not have a materially influence on the economic and financial behaviour (1983). From this perspective, the price stability involves the development of the decision documents in the economy within the assumption that the nominal and real values of the economic indicators are practically on the same horizon on which those decisions are adopted.

Alan Greenspan the president of the S.R.F. USA till 2006 (Alan Greenspan is an American economist, former president of the Federal Reserve. Greenspan led the American central bank in the period 1987 - 2006 and is considered the architect of the financial crisis during 2007 – 2009, because led legislative changes that strongly reduced the banking regulation, giving a green light to the big financial groups, and maintaining the interests at very low levels to encourage lending to large scale), stated that price stability is the situation where the public expected change in the average level of prices is sufficiently small and gradual that not actually be taken into account in final decisions and of the households not affecting their economic behaviour, and Allen Blinder, asserted that the price stability is the state in which ordinary citizens stop to think about inflation and worry about it.

Ben Bernanke, with the occasion of the hearings in American Senate as the president of the American central bank Federal Reserve FED (2005) showed that the price stability is the headstone of a strong economic growth.

In Europe personalities of the European Central Bank offered similar definitions. Thus Otman Issing argued that price stability refers to a stabile level of aggregate prices or to a low inflation level, and in the vision of Lucas Papademas, the price stability is defined as the state of the economy in which the general price level is stable in the strict sense or the inflation rate is so low and stable, that the considerations relating to the global dimension of the transactions cease to be a relevant factor for the economic decisions.

Although from the above mentioned there are no major discrepancies on the concept definition, of price stability, nowadays there are debates on the optimum modality to measure the level of prices increase (base inflation versus total inflation), to compose the price index (basket composition) and to identify appropriate time horizon.

For example the European Central Bank (ECB) explicitly defines price stability as inflation annual rate calculated on the harmonized index of consumer prices from the euro area under (almost) 2%, to be maintained over the medium term

There are also opponents of this definition (ex. Alan Greenspan) who consider that the prices indexes available now have an insufficient accuracy for this purpose and argues that, consequently, the inflation targets are an unnecessary and false prediction.

Unlike the price stability, for the financial stability there is not internationally a definition general accepted and there are no clear responsibilities in the statutes of the central banks around the world, (Isărescu, 2006).

In a broad sense, the financial stability can be considered the situation in which the financial system is capable to place monetary fund effectively and to resist to shocks without damaging the real economy.

From the perspective of a central bank, financial stability is defined as the situation where banking crises does not occur and that there is a certain stability of prices of all assets and the interest rate.

Generalizing, (Cernea, 2008) the financial stability is that state in which economic mechanism of prices build, of evaluation, and financial risks management, work well enough to contribute to the increase of economic performances.

More precisely „the financial stability" is the state in which is the financial system when is able to perform three essential functions:

- intertemporal intermediation (dynamic), efficient and without shocks of financial resources (transfer of funds from those who have to those who use them).
- evaluation, anticipation and correct management of the risks involved in this process.
- shock absorption that are suffered and/or are generated by the real or/and financial economy.

In terms of the above mentioned, the financial stability is a feature of the financial system that reflects its capacity to determine an efficient allocation – in space and time of the resources and to evaluate, divide and manage the financial risks through own self correctional mechanism.

In the area of the financial stability concept are financial markets, financial institutions and their infrastructure. As a result of the multiple existent links between these elements, any imbalance in the functioning of either of these links relieves the functioning of all the others.

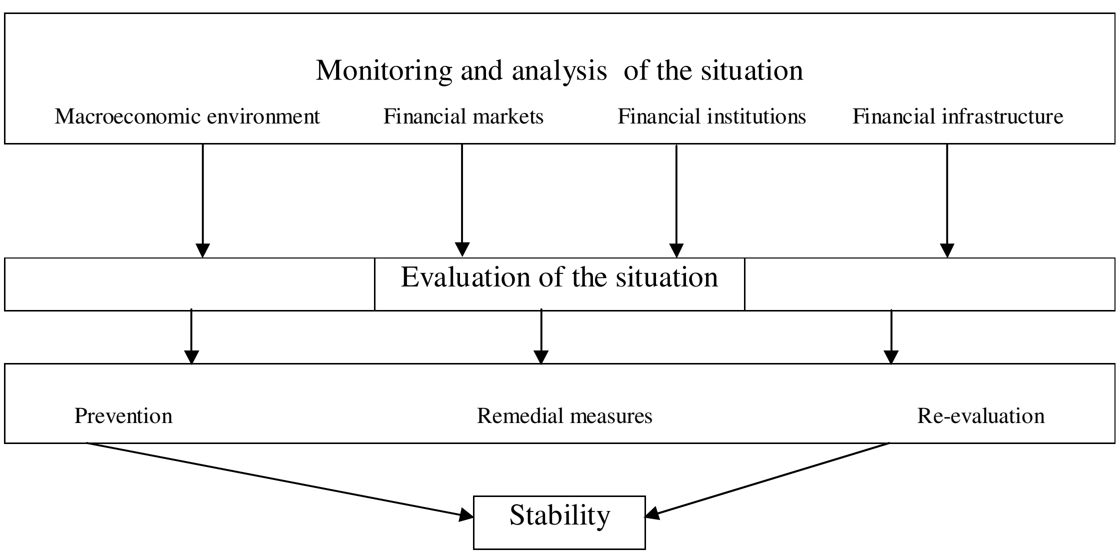

Figure 1. Evaluation of financial stability degree (*Schinasi, 2005, p. 106*)

The vulnerabilities that may arise and could endanger the financial stability are related to the three basic components of the financial system shown above: the market, institutions, and infrastructure (endogenous components) respective the macroeconomic environment (exogenous source of vulnerabilities) in the context in which function this financial system (Dăianu and Isărescu, 2003).

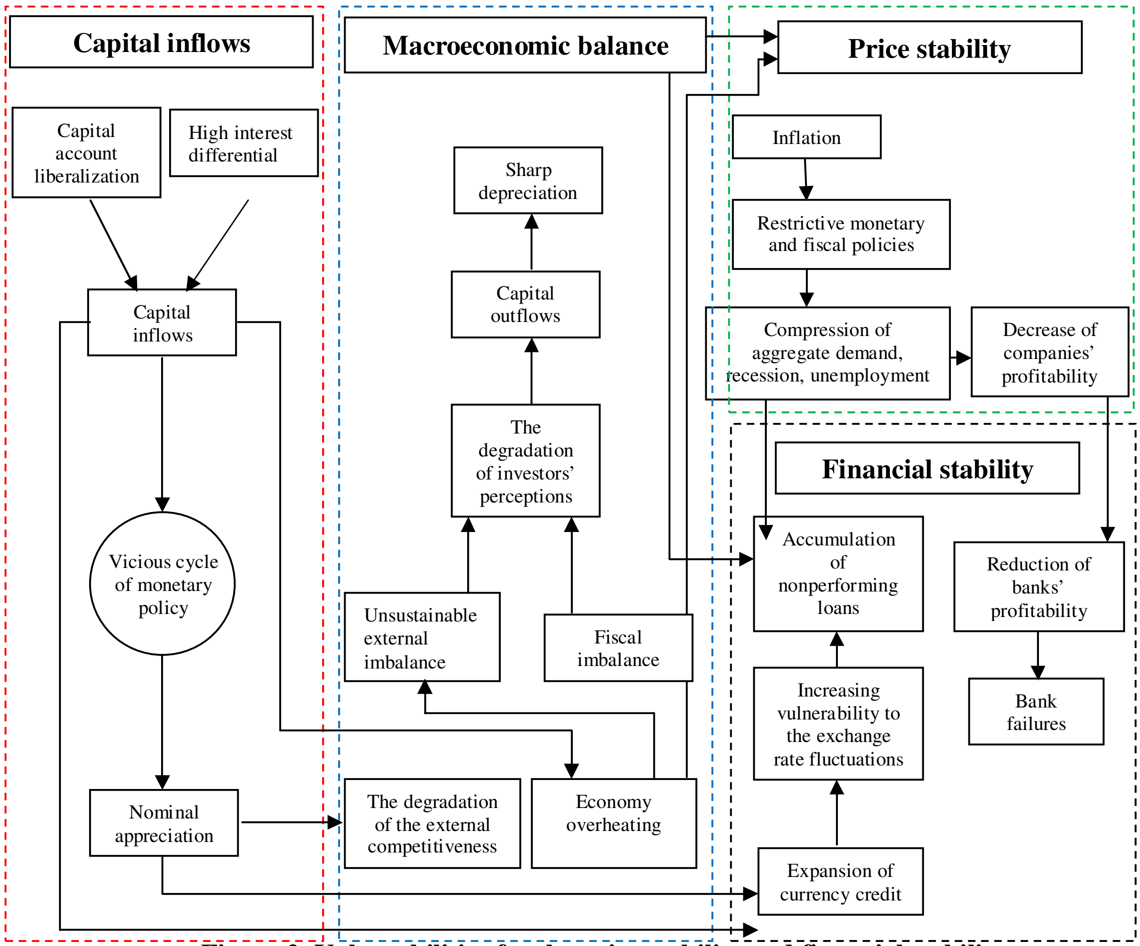

Figure 2. Vulnerabilities for the price stability and financial stability induced by the capital inflows

To the extent that the existing vulnerabilities are eliminated through appropriate mechanisms or measures, the risks is facing the financial system spread and endanger the whole socio-economic system. In other words, from risks they become systemic risks.

The financial stability when is touched by the above presented causes and vulnerabilities can create that systematic risk that has an adverse influence on the entire real economy: population and companies.

But, in the contemporary economy with the inflation stabilization at low levels, the literature emphasizes the creation of a new economic environment, which requires extremely careful reassessment of the report between price stability and financial stability.

The relation price stability - financial stability is based on the widespread belief that both kind of stability are supporting and are mutually reinforcing long term.

Some economists (Burda and Wyplosz, 2002) believe that price stability is a sufficient condition for ensuring financial stability while others just see it as a necessary condition.

Conventional approach is concordantly with the inflation treating as a principal factor of the financial instability.

Historical experience seems to confirm this approach, most acute episodes of financial instability and banking crises taking place in periods of high inflation or hyperinflation, (Dinu and Socol, 2006).

In the opposite direction, a low inflation proved not to be a sufficient guarantee to ensure a lasting financial stability.

In this respect, the experience of Asian countries in the years 1997-1998 is particularly relevant for the complexity of this report. Before the financial crisis there were accumulated substantial imbalances in the respective economies given that prices continue to maintain at a high level of stability.

In this context it is the question if the Central Bank can simultaneously provide the instruments that dispose the price stability and financial stability and how to can be reconciled the two types of stability.

An optimum construction between financial stability and prices stability can be the adequate objective of the Central Bank with the condition that the responsibilities to be properly distributed and the instruments availed to the institution to allow the following in a consistent manner of this objective

3. CONCLUSIONS

Currently, the international economic and financial environment became tenser, being marked by the sovereign debts crisis and by the concerns about the quality of balance sheets and the financing of some institutions and banking systems, especially in the euro area, and representing the source of some growing challenges inclusive for the financial stability in Romania.

The risks of the financial system stability generated by the domestic macroeconomic evolutions continued to ameliorate on the whole, especially in what concern the economic growth, fiscal consolidation and development of the current account deficit.

After two years of decline, economic growth returned in 2011 in the positive territory (+ 2,5 percent), and the prognosis show the continuation of the GDP growth in the period 2012-2013 at a higher rate than the EU average. The most important challenges to the domestic economic and financial evolutions concern: maintaining an appropriate rhythm of the real convergence process, while continuing the reduction process of external and fiscal imbalances and the implementation of the structural reforms, along with the improving of the level of European funds absorption (representing only 9.2 percent of the total at the end of June 2012); strengthening the efforts to resume the economic growth on a sustainable basis, inclusive through measures oriented on achieving the objectives assumed in the Europe 2020 program.

But, despite the positive developments recorded at the macroeconomic level, the banking sector in Romania recorded a deterioration of financial results in 2011, these being placed in the negative territory, as in the previous year.

This trend continued also in the first part of 2012.

Thus, the achievement of the objectives concerning the financial and price stability, in the context of fulfilling the commitments stipulated in the agreements with EU and IMF and other international financial institutions is essential for the assurance of a durable economic growth (Haldane and Vasileios, 2012)

Under these conditions, the financial crisis brought the problem of the conflict between the maintenance of the financial stability and preservation of the price stability. The two objectives that the central banks try to reconcile enter, sometimes, in conflict, because measures that are adopted, for example, to maintain price stability may have negative implications for financial stability. On the other hand, the economic theory shows that price stability is a condition for financial stability (Goodhart, 2010).

Thus, the National Bank of Romania earlier put the question of the conflict between financial stability and the prices stability and this dilemma do not appear only in periods of financial crisis, but also when there is a notable process of disinflation.

Romania is not currently confronting with the conflict between financial stability and price stability, but this problem remains valid on theoretic level.

But, there is a potential conflict between the fact that the instrument of the central bank (the key interest rate) while supporting the disinflation may not favour the financial stability and vice versa.

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