WOULD IT HAVE BEEN BETTER IF CENTRAL BANKS HAD REMAINED ONLY ISSUING AND DISCOUNT BANKS?

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Abstract: : Central banks have started their activities by currency issue and discount operations and have become liquidity providers for the financial and banking system and indirectly for the state.The massive governamental deficits have increased the dependence of central banks on the states and led to currency issues with no real coverage which have worsened the crisis. However it has been proved that the intervention of central banks as issuing banks is a necessity for achieving financial solvency and economic stability and to stop monetary abuses. We believe that it was better that over time central banks did not limit their activity to currency issue but have developed their operations substantially due to the needs imposed by the economic development. By using their own revenues and expenditures, central banks have intervened where it was needed and have tried to offer solutions to ensure the stability of the economic systems. Concerning their monetary policy, it has been proved that a prudent monetary policy is more appropiate than an active policy. The fact that central banks have not always got the expected results is a consequence of the attempt to find optimal solutions by making more accurate predictions of future economic developments. But these have become increasingly volatile and uncertain due to lack of an objective value.

Key words : central banks, credibility, monetary policy, financial solvency, economic stability, inflation expectations .

1.THE BEGINNINGS OF CENTRAL BANKING

Blamed for triggering the financial crisis or, on the contrary, praised for their efforts to counter the vicissitudes of these difficult times, central banks have remained an important arbiter of the monetary policy.

Over time, the activity of central banks has raised many controversies, these being seen either as a factor for cleaning the monetary activity, either as a multiplier of worthless currency.

Issuing banks have appeared in close connection with the wars and the need of the states to cover the implied expenditures. The emergence of issuing banks was closely linked to the increasing role of banknotes in monetary circulation.The establishment of issuing banks represented the first step for the autonomy and the development of the

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monetary activity. Having an apparently private feature, central banks have been placed by the state on the monopoly position over money supply.

The development of these banks was driven by the efforts of the states in order to regulate the issuing systems, often simultaneously with the monopol on the issuing activity. Napoleon said: "The bank does not belong only to shareholders but it also belongs to the state because the state gives the bank the privilege of issuing". Holding the privilege of issuing, central banks have become the possessors of the gold and foreign reserves of their countries, and they have gradually increased the sphere of their monetary operations

So, from discount and issuing operations, central banks have diversified their intervention methods by adopting different strategies like targeting the monetary aggregates, targeting the exchange rate, inflation targeting or monetary adjustment through market operations. It is true that these strategies proved to have a temporary effect on the economic growth, on reducing the unemployment rate and their impact has often led to an increased inflation. However, the existence of central banks is a necessity due to their influence on the money supply in circulation.

2. MONETARY POLICY - EXPECTATIONS AND RESULTS

Central banks have become providers of liquidity for the financial system and indirectly for the state. They are currently accused of an excessive interventionism and for the monetary growth.Though, we consider that central banks are not the only responsible for this fact. The state is also responsible of worthless currency issues which have worsened the crises and it is guilty for its massive government deficits which have increased the dependence of central banks on the state.

Central banks were established from the need to cover the inflationary costs of the state but they should not directly finance the budget deficit or cover the costs of an irresponsible government. By the monetary power they were invested by the state, central banks are responsible for the development of the national economy and hence the global economy. It is necessary to accept that monetary policy should be limited to the control of the banking activity and it should not try to solve the problems of the real economy.

Although central bank intervention was not always favourable, it is obvious that reaching the objectives of financial solvency and economic stability is not possible without the functioning of a central bank which would stop the monetary abuses. This is the conclusion reached by the representatives of the Banking School, although they initially sustained that the the best way to limit the creation of financial instruments and to obtain monetary stability was through a free banking system submissive to the civil and commercial law. But for this it was necessary to keep a reserve of 100% from deposits[1].

Regarding the present intervention of central banks, we wonder if they should lead an active monetary policy or do just the opposite and become more cautious. We estimate that caution is the correct answer because an active monetary policy induces additional volatility in the inflation expectations of private agents[2]. Inflationary expectations generate additional costs which require a greater activism for central banks.

Bertocchi and Spagat (1993), Beck and Wieland (2000) sustained that central banks should be active in order to find the best solutions to the future economic problems. On the contrary, bankers as Blinder (1998) and Issing (1998) considered that the banking policy should be cautious due to the uncertainty[3].

Central banks face difficulties in their market interventions if the expectations of private agents regarding the future optimal monetary policy adopted by banks are uncertain. In an economy with flexible prices, asymmetric and incomplete information an

undesirable volatility and inflation persistence occur. Giacomo Carboni and Martin Ellison showed that transparent monetary regimes promoted by banks lead to macroeconomic stability, both in terms of inflation and output.

Through anchoring inflationary expectations central banks aim to make prices and salaries less sensitive to temporal shocks and to achieve greater macroeconomic stability with a moderate intervention in the economy. On the contrary, an insufficent transparency increases this bound and leads to a deterioration of both inflation and output [4]. For example, Erceg and Levin (2003) showed that a lack of transparency about the inflation target leads to an unwanted inflation increase and thus to additional costs[5]. An increased transparency makes the reputation and credibility of central banks to be more sensitive to their action. For this reason, central banks are determined to have a more moderate intervention and to opt for a policy closer to the optimal social policy. A full transparency of central bank intentions is socially very useful but not in its interest[6].

Realizing the influence of an increasing transparency on the credibility, predictability and efficiency of their policies, central banks are moving now towards improving the communication of monetary policy decisions and to a more powerful information collection. Monetary authorities must apply optimal paths of monetary policy so as under increasing pressures to ensure the equilibrum of the private sector. So central banks, in their conduct, must consider how the adopted policy will influence the future behavior of private economic agents.

Kidland and Prescott, Barro and Gordon were in favor of implementing a credible and transparent policy by central banks recalling that industrialized countries have experienced very high inflation rates between 1960 and 1980 and provided important predictions about the measures to reduce inflation in these economies faced with hyperinflation[7]. In their policy, central banks have adopted strategies that due to the lack of the necessary control instruments have not always led to the anticipated results. Therefore it is necessary that central banks have a second best solution and act prudently. Given the fact that they act in a dicretionary enviroment, Kidland and Prescott demonstrated that maximizing the social function is not possible if the policy-makers choose their monetary strategies based only on the current situation. In order to achieve their objectives, central banks have applied rule-based policies or discretionary policies, the first having proved to be less expensive.

History has shown that central banks have tried to respond effectively in various situations threatening price stability, including exceptional circumstances (hyperinflation, deflation, war, terrorist attacks, price shock of import commodities, the collapse of major capital markets). We believe that in all these situations the credibility of central banks played the decisive role.

For example, in the U.S., after having regained the credibility and the desinflation process has been achieved (after 1985), monetary authorities showed a greater care for the output expansion than for a lower inflation.On the contrary, if gainig credibility is still a problem for the authorities (eg. the UK since 1980 and part of the nineties), the management of the economic cycles for the monetary authorities has been dominated by concerns to maintain a low inflation. The request for more precautions to expand the output and the asymmetries can be a source of generating new inflationary trends. Unlike the traditional views of Kidland-Prescott , Barro-Gordon concerning the inflation trends, monetary authorities have come to generate a volatility of inflation not because they targeted an output level too high but because they have been understood by the private sector as reacting less aggressively to the output growth than to its contraction. Therefore

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this request too large for expansion can generate a return in force of inflation expectations[8].

In the article published in 1983, Barro and Gordon showed that rule-based monetary policy leads to lower costs than discretionary policies. The arguments were the advantages that would be brought by an unexpected inflation by increasing the output, by reducing the unemployment below the natural rate and also the advantages of increasing government revenues by reducing the nominal debt.

Central banks have used either rules as predetermined variable functions (explicit rules) or rules as forward-looking variables (default rules). Ball said that rules are effective if they lead to minimizing the weighted sum of inflation and GDP variation around target levels[9]. The monetary authority is the one that determines the target levels and the assigned weights. The most common rule is Taylor's rule. The current crisis raises the question whether it is effective to characterize the monetary policy. According to the rule developed by Taylor, central banks should take into account in setting the interest rates, the inflation and the gap between the achieved GDP and the potential GDP. Taylor said that the U.S. recorded an unsustainable economic boom as a result of the fact that Fed kept the interest rates too low for too long. According to him, if Fed have had complied with his rule the problems generated by the boom could have been avoided.

Some national banks have applied other monetary policy rules, which took the form of reaction functions, for example the Quarterly Projection Model model that was used by the Bank of Canada or the Forecasting and Policy System used by the Reserve Bank of New Zealand. Central banks have used instrumental rules because they were easier to apply in the used economic models, but they could provide only some guidelines for the monetary policy.

Svensson sustained that the role of these rules is to "never commit the banks' this role being assigned by targeting rules[10]. Through targeting rules, central banks take into consideration targeting some variables, the existence of a vector of the target levels and also a loss function which needs to be minimized. According to Svensson the simplest situation is the one in which the central bank has full control of the target variables there being no form of trade-off inter and intra-temporal among variables. These rules were adopted by central banks since the early nineties (New Zealand-1990, -1991 Canada, United Kingdom and Sweden-1992-1993 Finland, Spain and Australia and Romania in 2005 -1994). Mishkin said that such a strategy requires a more transparent monetary policy, the monetary authority's commitment to ensure price stability as its main objective and a greater responsibility to fulfill the main objectives[11].

Another strategy used by central banks is targeting the monetary aggregates, strategy which has been successfully used by Bundesbank since the early seventies and also by Switzerland. But Svensson said that the German bank's policy was actually a disguised inflation targeting policy which also aimed price stability. Monetary targeting also involves publishing targets on the percentage of the increase in money supply. In order to do this, Mishkin considered necessary to have a strong relationship between money supply and the price stability objective and also the fact that the central bank has to control the used monetary aggregates[11].

Benjamin Friedman said that when applying their monetary policy, central banks also aime at other objectives such as the balance of trade, the stability of the financial markets and also attracting foreign capital in the form of direct and portfolio investments[12]. For this, they currently use mostly open-market operations.

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But the current crisis has shown that central banks have an apparent independence in their market interventions. It is obvious that the state's role has greatly increased (contrary to the Friedman's liberal opinions). We see that through capital injections into the banking system and even through the temporary nationalization of banks and representative companies we are trying to overcome the crisis. Douglas J. Elliott appreciate that the nationalization of large banks by the state, brings forward the risk of turning them into "Zombie Banks", as they will find it difficult to regain the ability to financially support themselves and they will avoid to take additional risks creating more difficulties on the credit market. On the other hand, such measures shift off the banking policies from the immoral pursuit of profit taken by banks and their orientation towards a more social policy[13]. We consider that such measures shoul be adopted as measures of last resort and for a short a period of time. Through banking nationalization, we would return to the monopol of the state to currency issue. So for this crisis the states are to be blamed through their central banks and also through the commercial banks which have become more and more state-owned banks. We appreciate that it is necessary to find a clear and reliable mechanism for the control of monetary issue worldwide.

Through currency issue and credit expansion for the commercial banks, central banks have directly influenced the structure of prices and the output in the economy, including the price of capital and historically they have been one of the leading actors of economic life. The fact that central banks considered that through a very active use of monetary policy instruments they will respond better to the economic cycles and the results were undesirable does not make us believe that it would have been better if they had limited their operations to money issue and discount operations. It is true that the need to find the best solutions to the economic problems required a greater activism from central banks, but the inflation expectations of private agents and especially the uncertainity of the economic environment have generated costs which have brought in the attention of the monetary authorities that their interventions must be above all cautious.

3. REGULATION - SUPERVISION- INDEPENDENCE?!

Monetary policy should be strictly limited to the control of the banking activity and should not be used to solve the problems of the real economy. Central banks have often applied very risky policy giving less importance to their regulatory duties as guardians of the financial flows. For example, the case of the U.S., where Fed is to be accused of having taken wrong measures that triggered this crisis.We refer to: carrying out operations that went beyond monetary policy, the disappearance of the strict delimitation between commercial and investment banks and the fact that during the Bush administration there has been adopted a law for reducing the taxes for the rich while Fed increased the money supply.

In order to overcome the current global crisis, we appreciate that the recapitalization of central banks, the isolation of their toxic assets, facilitating the revaluation of their price guaranteeing interbank loans and reducting the reference interest rates of central banks are necessary. But the underdevelopement of the financial institutions and markets and the lack of data influence the effectiveness and the speed of the transmission paths of monetary policy.

It is also necessary that central banks adopt prudent measures and implement reforms to strengthen the financial system and to reduce the vulnerability to the variation of the exchange rate. For example, in order to support the national currency the National Bank of Romania was forced to perform various currency issue operations. Taking into

consideratino the fact that the Government has lately resorted to heavy borrowings both domestic and to the International Monetary Fund or to the European Commission, the National Bank had to increase the amoun of currency in the market as a counterpart of such amounts. Thus, finding ways to sterilize the excess of money caused by wrong governmental measures raises difficulties. It seems that european model in which central banks have defined their monetary policies turns out to be slower in solving the problems of the current crisis than the american model which was based on the collaboration between the Government and the Federal Reserve.

Besides their different organization and structure, central banks have different relations with the legislative and executive power from one country to another.

We have noticed that in countries with independent central banks the inflation rate was lower than in those where governments have exercised an increased influence on the central bank. Therefore we believe that in order to achieve the objectives of financial solvency and economic stability, ensuring the independence of central banks and also a good cooperation with the governments are essential. So, the overcoming of the problems generated by the current crisis requires a decisive intervention of central banks in cooperation with the governments, taking into account also the fact that monetary policy errors can be avoided by a very good knowledge of the economic realities and financial mechanisms.

We believe that the independence of central banks primarily involves responsibility in terms of market intervention and secondly compels to transparency. We have observed that an increased transparency has proved to be also beneficial in terms of social reputation leading to an increase in credibility of central banks and facilitating the fulfillment of the objectives set.

We recall the essential contribution of the transparency of monetary policy in terms of anchoring inflation expectations. So, anchoring inflation expectations to the objectives of central banks has become a priority and now is a prerequisite for the monetary policy contribution to the economic growth in the euro area.

4. CONCLUSIONS

Currently, it appears that central banks have remained without support solutions for the financial markets and powerless handover this responsibility to the governments.

Thus, the states are responsible for this situation because through their central banks they have affected the banking system with uncontrolled monetary issues that led to the distortion of the most important economic resource, the capital.

We have noticed that for a long time the central bank policy has long pursued the compromise (on a short or long term) between inflation and unemployment and then they have focused on the tradeoff between inflation stability and output stability. Thus, by implication, central banks have made a significant contribution to the knowledge of the functioning of the economic and financial mechanisms.

In recent decades, maintaining a low inflation has become the primary objective of central banks in the world. We appreciate that missing the inflation target is not the result of establishing a too ambitious level by central banks but a consequence of various factors such as insufficient data, the shocks and uncertainty that characterize the economy, deficiencies in the functioning of the financial systems and the transmission mechanisms of the monetary policy.

In conclusion, it was good that central banks have not remained only banks of issue but we must recognize that they have a limited capacity to combat the economic

shocks. While the economic environment becames more and more volatile and unpredictabile, in order to achieve objectives suce as price stability, it is necessary to find a new standard for anchoring the monetary policy issue.

We do not think that it would have been better if central banks had remained only issuing and discount banks because they interfered between two great centers of power, the state and the market, with the main goal of ensuring price stability. The main threat to price stability is the globalization itself which has increased market volatility. But who can survive the globalization process? The one who is stronger, the one who is faster. The globalization requires immediate action. Banking globalization is achieved not only geographically, on a planetary scale, but also structural, large international financial groups becoming major international financial groups, financial or mixed conglomerates. Globalization has led to an excess in lending activity, to the "cheap money policy" practiced by central banks; it led to the position of central bank as lender of last resort, which had the effect of moral hazard in financial markets. The development of the activity of large international financial groups led to a situation of captivity of central banks to the financial markets, an excessive use of derivatives, especially in purely speculative, weak financial regulation and supervision by the authorities, wrong and unethical corporate governance banking;

Now it seems that the fight between the two power centers of capitalism, the state and the financial markets, is increasing. The balance between these two centers of power is adjusted in force major economic crisis. In other words, each power center has evolved to produce its own crisis.

The financial crisis and the sovereign debt crises are independent results of parallel developments in the private and public sector. "Through its interventions, the state created the illusion that it protects its citizens economically".Being trapped in the expectations trap, governments have preferred to maximize short-term satisfaction than to promote fiscal sustainability and reached to excessive debt. It seems that the financial markets also have a rising voice, underlined by reducing the rating of many countries. Thus, this crisis worsens as public policies produce no response that would calm the financial markets and end the crisis. Many banks have assets of governments in countries with serious poblems regarding fiscal sustainability.

In July 2007 banks had in their portfolios more titles which combined good assets with bad assets. When banks lost confidence one in other and did not want to lend themselves anymore, the market crashed. Central banks had to intervene to compensate the lack of private money with public money. Currently there is a risk that banks holding troubled assets of governments are to be isolated and the interbank market can become opaque again. Therefore the intervention of the most powerful central banks is needed again. But this is not sufficient. First of all we need a very good collaboration with governments and very good fiscal policies in order to overcome the present situation. But all these efforts will bring no results if public confidence in central banks and governments will not be restaured.

If in the future, the economic environment becomes more stable, central banks should return to their function of providing liquidity and should have an increased concern for the supervisory and regulatory activity.

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