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# The Monetary Policy in a Changing World

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**Abstract**: In a context where "the economies' evolution is driven by the crisis", the monetary policies are facing, in the post-crisis period, challenges that bring to the forefront of debates the rethinking of objectives, strategies and even implementation tools. This paper presents in a comparative analysis, the relevance of price stability in terms of theoretical fundaments and effectiveness of the concept for the pre and post – crisis periods, in the Eurozone, the US and Japan in an attempt to identify the explicative resorts of the central bank's monetary behavior. At this time when the central banks are obliged to unconventional measures to save the global economy from the danger of deflation, the topic is important and timely addressed. The paper uses statistical data of official documents taken from the International Monetary Fund, European Union and central bank websites.

**Keywords:** price stability; central bank; the global financial crisis; unconventional measures

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## 1. Introduction

Although in the conception close to the current one, the first central bank was founded in 1694 (Bank of England), the monetary policy occurred during the Great Depression of the years 1929 to 1933, as a government response that aimed at steming the Federal Reserve System US financial panic and bank insolvency and they have over time gained new values. Until the Great Depression, the central banks had to intervene as creditor of last resort to commercial banks and insuring financing of state government spending.

Following the line of Keynesian thought, the expansionary monetary policies implemented after the crash of 1929, designed to stimulate the economic growth by influencing the aggregate demand and which treated inflation as insignificant factor in the development of economy showed prominently its limits.

In the early 70s, the monetary practice, under the sphere of influence of Keynesian theory and theoretical construction of 1958, the Phillips curve, which established an inflation-unemployment compromise, confronted increasingly high levels of inflation, the monetary policy being mainly oriented towards ensuring full employment. It is the time for the emergence of new alternative

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theories, of which it quickly imposed monetarism, as “major pole of opposition to Keynesianism both politically and theoretically” (Beaud & Dostaler, 2000). The basic concepts of monetarism, monetary stability and reliability can be found in the famous “rule of the k percent” of Milton Friedman. Accelerating inflation and rising unemployment in most developed countries, under the impact of the collapse of the Bretton Woods arrangements and oil shocks of the 70s, will require a reassessment of the conventional thinking in monetary policy. The importance of anchoring inflation expectations in the context has represented the catalyst of the institution-building process, aiming at granting a new status to the central bank: independent institutions, with firm mandates for tracking price stability (Isărescu, 2013), which becomes the primary objective of central banks assumed at institutional level, in an intellectual, political and social consensus of the 90s. As a rather pragmatic reply to reality than putting into practice a new academic school of thought (Gill Hammond, 2012), it will be adopted, on a larger scale, a new strategy - targeting inflation, as a solution designed to create the best framework for ensuring price stability. The central banks will say, during the “Great moderation” as “saviors of the global financial system”, winners of the “bet with the inflation.”

Triggered in an economic context characterized by low levels of inflation, the global financial crisis that began in 2007 as a true “tsunami” has shown that insuring the price stability is necessary, but not sufficient to ensure the financial stability and it was brought into the attention of decision makers (i) the relationship between financial stability and price stability in the context macro-stabilization policies, including the opportunity of assuming a single fundamental objective for monetary policy, (ii) the foremost position of the objective of low inflation or (iii) the most appropriate measure to be expressed in the inflation target. They were brought back to the forefront of debates the attributions of central banks, the opportunity of maintaining the objective of insuring price stability, as the primary objective of central banks and even the institutional existence of the central bank.

## 2. Literature Review

The primary objective of central banks assumed at the institutional level, the *price stability* ensured by setting a numerical target for inflation, foreseen for a medium time horizon, transmitting clear messages on the task of monetary policy and criteria for assessing the performance of the central bank and it reflects the ability of the central bank ability “to achieve a stable currency based on trust in the interaction between the economic agents, the confidence in property rights, trust in society and, more generally, the confidence in the future.” (Issing, 2002)

According to Lucas Papademos (2006) the price stability is that state of the economy in which the general level of aggregates price is stable and the inflation rate is low and stable, so that the considerations on nominal dimension of transactions cease to be a relevant factor for economic decisions.

Emphasizing the dual role of price stability, Ben Bernanke (2006) reveals the qualities of “objective and means for monetary policy”: (i) as an objective, the price stability preserves the integrity of the purchasing power of the currency, while affirming as a means by which the policy can achieve other goals; (ii) as a means for monetary policy, the price stability provides a stable monetary and financial framework for the decision on micro and macroeconomic levels, formulated on medium or long time horizons. The effects of these decisions are found in improving the economic growth, increase of employment on long-term and they have a significant impact on the stability of production and occupancy on short and medium term. In a context where the previsions for the medium and long term

are well anchored, the low and stable inflation determine the moderation of interest installments on long-term.

In a three-dimensional approach, Otmar Issing (2000) defines price stability as: (i) steady - state deflation experienced by the USA in the last thirty years of the 19th century, during which productivity earnings were found in lower prices and not in the most wages and subsequently laid down by Milton Friedman; (ii) a constant price level or zero inflation (iii) low inflation, accepted definition on reasons regarding both the seigniorage as a source of government revenue, implying the possibility as method of inflation calculation as being inadequate.

In the plan of practical approach, ensuring the price stability, it allows the monetary policy the reduction of uncertainty in the economy, contributing to an efficient allocation of resources (Isărescu, 2013) by:

- facilitating the formulation of long-term business plans / investments;
- improving the functioning of markets, increasing the signaling role of price changes;
- discouraging the speculative activities;
- elimination of undesirable redistribution effects (unanticipated inflation);
- facilitating the formation of resources for investments (savings) and their involvement in productive activities.

Understanding the dynamics of inflationary phenomenon, its causes and its effects on the economy, nationally and globally, and their relevance of the composition of indicators, where it is expressed, represent widely debated topics in the economic literature and practice, identifying the measures that confer quantifiable dimension of the inflationary phenomenon, representing a major concern.

## 3. Monetary Policy for Crisis or the Crisis of Monetary Policy?

### 3.1. The Consensus of the Pre-Crisis Period

Many national central banks and the European Central bank define inflation essentially as "a general increase - or generalized - of prices of goods and services for a long time, which leads to lowering the value of money and, therefore, their purchasing power" (ECB, 2011), thus replying to the controversy on the meaning of inflation – the prices increase or increasing the quantity of money in circulation.

The specialized literature (Petursson, 2004; Isărescu, 2013) summarizes, based on international experience, "as what the monetary policy is able to achieve": the central bank can ensure price stability, resulting in long-term the inflation rate level in the economy without affecting the level and growth rate of GDP. Pursuing price stability, the monetary policy contributes to a sustainable economic growth, as on long periods of time, the relatively high economic growth is incompatible with a persistent high inflation. Although it has assumed the price stability as the primary objective, the central banks pursue the impact of monetary policy decisions on aggregate demand in the short and medium term, on the exchange rate and it pays attention to the developments in financial markets. Long-term objective of price stability can be achieved in the context of an effective and free of tension transmission of monetary policy in a stable financial system. (Isărescu, 2008)

In an attempt to restrain the inflationary phenomenon, more and more central banks choose, after 1990, the "road" open by the New Zealand, as a strategy of monetary policy, the direct targeting of inflation, "that frame that attaches the highest importance of a low and fixed inflation or price stability" (Napoleon Pop, 2008). Becoming a "global framework" (Sterne, 2001) the inflation

targeting was adopted explicitly or implicitly by the central banks belonging to developed or emerging economies, including Canada (1991), UK (1992), Australia (1993), Sweden (1993), Finland (1993), Spain (1995), Israel (1997), which became, after the financial crises in Asia and Latin America, an attractive alternative for countries with emerging markets: Poland (1998), Brazil (1999), Czech Republic (1997), Hungary (2001), Romania (2005), Turkey (2006), Serbia (2009).

Many central banks, though they do not explicitly target the inflation, they apply elements of this strategy in formulating the monetary policy decisions. The European Central Bank, for example, defines the price stability to be maintained over the medium term, as the annual growth of less than 2% of the harmonized index of consumer prices for the Eurozone and it aims at maintaining the inflation rates at a lower level, but close to 2% on the medium term (the Governing Council, 1998).

Until the global financial crisis, the Federal Reserves of the US were intended as "maximum employment, stable prices, and moderate long-term interest rates." Price stability is defined as "a longer-run goal of 2% inflation", while the Bank of Japan lead the monetary policy based on the principle that the policy aims at achieving the price stability to contribute to the healthy development of national economy. Inflation remains, until 2007, on a path around the proposed target of FED in the Eurozone and ECB in the US, while Japan is experiencing deflation (Figure 1) amid the negative interaction between asset prices, the increase of the financial system malfunction and the deterioration of the real economy.

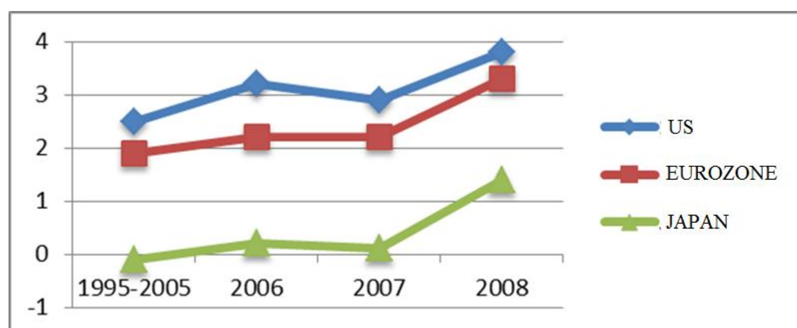


**Figure 1. Evolution of Inflation 1995-2008**

*Source: IMF World Economic Outlook, October 2014*

Hazard or best practice in monetary policy during the last two decades of the pre-crisis period, known as the "Great Moderation" was characterized by substantial reductions in inflation, and also on production volatility in almost all developed countries under the impact of structural economic, institutional, technological changes, of perfecting the macroeconomic policies and especially the monetary ones. The "Irrational exuberance" of this period facilitated the emergence of the global crisis, but as evidence of a compelling reality: the monetary theory and the practice of central banks have lagged behind with the development of financial systems in developed market economies and, therefore, many banks plants were unprepared to deal with the financial crisis that erupted in August 2007. (Cerna, 2014)

### 3.2. Price Stability and the Global Financial Crisis

Occurred amid unprecedented expansion of bank credit and the increase appetite for risk in all financial markets, inducing the adverse selection and moral hazard and creating the impression that only "the sky was the limit," the global financial crisis caused the most severe contraction of economic

activity at global level since the Great Depression of the years 1929-1933 and it doubted even the central bank's ability to fulfill its mission amid the inflation rates close to zero in 1990 (US and Eurozone) or 1.3 in Japan (Figure 2)

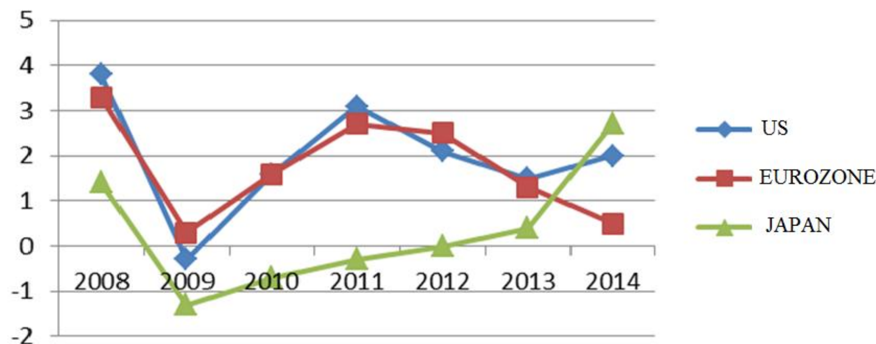


**Figure 2. Inflation 2008 - 2014**

Facing the shock represented by strong inflationary pressures, each central bank acted, in the post-crisis period, depending on the circumstances and the degree of economic development through measures meant to combat the deep and prolonged recession and financial instability from the Great Depression of the 1930s and to ensure the macroeconomic and financial stability.

The global economic crisis has damaged the transmission channels of monetary policy decisions in the economy and it has forced the central banks to act in the new framework emerged in the developed economies, where (Cerna, 2014):

- the balance sheet of commercial banks has been severely affected by their asset accumulation of a large volume of doubtful debts, generating a massive effort to cut debts (deleveraging), which led banks to restrict the credit supply at a time when the central banks also tried to tighten the monetary policy;
- The interest rate practiced on the interbank markets – as the interest on the private titles market - began to include a risk premium increasingly higher, which countered the effects of lower interest directory rates by the central banks;
- Rapid deterioration of the economic situation required a reduction of interest directories, so that in many countries, the monetary policy rate has reached zero or very close to this level (below which it may not decrease).

In many recent theoretical and empirical works caused especially by the debates on the economic policy pursued in the “lost decade” of Japan, it shows that the central banks may apply a wide range of “unconventional” measures of monetary policy (Cerna, 2014). In practice “the central banks in the United States, United Kingdom, Japan, and euro area adopted a series of unconventional monetary policies with two broad goals (IMF, 2013): to restore the functioning of financial markets and intermediation and to provide further monetary policy accommodation at the zero lower bound, (Bernanke & Reinhart, 2004):

• “The commitment on monetary policy orientation - policy duration commitment”, which is to ensure the investors’ confidence that short-term rates interest will be maintained in the future at a lower level than expected by the market in the absence of the commitment;

• “Quantitative easing” aimed at increasing the availability of banks' current accounts at the central bank beyond the level necessary to bring the overnight rate to zero;

• "Qualitative easing" (or credit easing), involving usually an expansion of central bank balance sheet, as in the case of quantitative easing, focusing on the structure of assets and not on the monetary base level, aiming at changing the structure of the portfolio of assets held by the private sector and, consequently, changes at the level of relative prices, with consequences on economic activity.

Accordingly, the central banks were forced to abandon the traditional instruments for reducing the real interest in the medium and long term, becoming largely ineffective. The strong return of credit risk and liquidity on financial markets it has put an end to an "age of innocence" in monetary policy (Liikanen, 2012).

## 4. Challenges of the Global Crisis and even ... Solutions

The crisis has "opened an opportunity" (Issing, 2011) for monetary policy makers and academic research: identifying the explanatory springs of the causes of the crisis, to embed the information in future decisions designed to improve the performance of monetary policies and to avoid repeating the past mistakes.

The importance of low and reduced inflation, as main objective and in many cases the only one, the monetary policy is a concept that the global financial crisis has brought to the forefront of debates: it has shown that maintaining a stable inflation does not necessarily provide a zero level of the GPD deviation compared to the potential. Price stability becomes from the "strong spot" of the pre-crisis to the "weak spot" of the post-crisis period (Table 1).

**Table 1. Price stability**

| **Price stability** | |
|---|---|
| **pre-crisis period** | **post-crisis period** |
| - main long-term objective of monetary policy, assuming the price stability as the primary long-term objective of monetary policy represent a key element for the whole conceptual framework for policymakers (Bernanke, Laubach, Mishkin & Posen, 2001) | - price stability does not guarantee also the financial stability (Svensson and macroeconomic, 2011); it is necessary redrawing borders or rethinking connections |
| - maintaining a low and stable inflation is important, perhaps necessary, for achieving other macroeconomic objectives (Bernanke, Laubach, Mishkin & Posen, 2001) | - it is preferably targeting a price level or inflation targeting adapted in the light of the recent financial crisis and recession (Svensson, 2011) |
| - an explicit mandate for pursuing monetary policy stability and a high degree of operational autonomy (Roger, 2009) | - the ultimate goal should be the output gap and the stable inflation |
| - insuring price stability is a prerequisite (almost) enough to promote financial stability, being invalidated by the recent global crisis | |

The identification of that indicator, while maintaining the set direction, could lead to a greater stability in the economic activity, named by Mankiw and Reis price stability index (2002) representing a debated topic among academics and policy makers in monetary matters.

In the conceptual plan, the crisis requires rethinking flexibility and limits of this flexibility: the liquidity trap into which many central banks fell, it has destroyed the illusion according to which there are no longer shocks that push inflation to zero. A low inflation risk presents the danger of the entry into a negative territory, causing zeroing the monetary policy interest rates, forcing the recourse to quantitative easing measures. (Isărescu, 2012) In order to avoid inflation on negative territory, Blanchard et al. (2010), for example, propose amendments to the inflation target from 2% to 4%, the proposal was not supported by Mishkin (2011) invoking the experience of the 1960s, as a result of accepting the level 4-5%, the inflation has continued to rise over the limit. However, a decision that would meet the consensus is still waiting.

In the field of monetary practice, the ECB has been very active since the beginning of the crisis and its actions helped the financial sector to avoid a complete meltdown and adopted measures that were mainly directed at ensuring the provision of liquidity and repairing the bank-lending channel. The Fed and the Bank of England quickly pursued unconventional monetary policies by implementing quantitative easing programmes that appeared to have a positive impact on financial variables and also on the real economy. (Claeys, 2014) The specialized literature and the international practice shows the effectiveness of the "unconventional" monetary policy measures, but only under certain circumstances, shown in Table 2. (Cerna, 2014)

**Table 2. Constraints on non-standard measures**

| | **Communication on future interests** | **Targets on *quantitative easing via Credit easing*** | | ***Credit easing in long term*** | |
|---|---|---|---|---|---|
| | | Public | Private | Public | Private |
| It involves achieving zero level of directories interest | No | Yes | Yes | Yes | Yes |
| Operational if the financial system is affected by extreme claims | Yes | No | No | Yes | Yes |
| Credit risk in the central bank's active | No | No | Yes | No | Yes |
| The risk for central bank independence | No | Yes | No | Yes | No |

(*) No – in the first moment, Yes - from a certain level

*Source: (Cerna, 2014)*

According to official data published by the European Central Bank, for example, (Economic Bulletin no. 2/2015), the Governing Council has decided in January 2015 extending the assets purchasing program so that it includes, from March, titles in euro with low risk (investment grade) issued by governments and government agencies in euro area and EU institutions. The cumulative monthly purchases of securities issued by the public and private sector will rise to 60 billion Euros. It is intended to carry them to the end of September 2016 and, in any case, until the Governing Council shall determine a sustained adjustment of inflation trajectory, which should be consistent with the objective of maintaining the inflation rates below the level, but close to 2% on medium term.

For central banks that have adopted direct targeting of inflation as a monetary policy strategy, the global financial crisis has put into question all the concepts under which they operated, having even its "obituary" by Jeffrey Frankel in the summer of 2012, when announced "with regret, the death of inflation targeting", at only a few months after the FED and the Bank of Japan announced the establishment of medium-term inflation targets, with the stated aim of enhancing the transparency and effectiveness of monetary policy. (Trandafir, 2013)

The intellectual, political and social consensus of the pre-crisis period, crystallized around the belief that inflation is the main source of financial instability and that the ensurance of price stability is a prerequisite (almost) enough to promote financial stability, is invalidated by the recent global crisis. From this perspective, ensuring financial stability returns as an unsolved problem by the central banks. Reconciliation functions of price and financial stability in one institution, supported as possibility by Mugur Isarescu (2012), is considered inappropriate by Lars EO Svensson (2011) as he finds them as being conceptually distinct, each with separate objectives, instruments and control authorities. (Trandafir, 2013) We cannot omit the decision of European authorities which have reached a consensus: the Union Bank, considered an appropriate response in terms of the "impossible trinity", which points out that the financial stability and financial integration are not compatible with the supervision maintenance at national level. (Isărescu, 2012) If the implementation of a unique manual of rules in over 8000 banks, as they are now in Europe, will be able to reach its goal, in the absence of a fiscal union, remains an open subject.

Given the fact that "companies were managed in the past without central banks" Marvyn King (1999), attempts, since the pre-crisis to decipher, based on the realities of the new millennium, the future concept of central bank, imagining "the central bank with no money", as a result of innovations in the technology domain brought by the "new economy" of the 90s: eligible assets could become any financial asset for which there is the possibility of compensating the prices on the market in real time, the system could determine the price of financial assets, in terms of a unit of account, equivalent, probably, with a commodity standard, by confronting the supply with the demand of financial assets and it may perform the deductions. The concern of the central bank to limit the excessive monetary creation would be transferred to the requirement of ensuring the integrity of computer systems. In 2010, Huerta de Soto considers necessary to reform the banking system with the stated goal of "submitting it to its traditional principles of civil and commercial law, according to which every person and company must meet certain requirements (100% reserves), in addition to strict compliance with the terms established in each contract." In this context, the Austrian school followers propose, in in the banking domain, the following three steps (Cerna, 2010):

- Restoring obligatory reserves 100% for banks that receive deposits from the public and all similar institutions;
- Demolition of central banks as financier of last resort (a function which is no longer necessary in terms of applying the previous measures) and as central agency of financial planning;
- Privatization of fiat money issued by the state as monopoly and its replacement by a monetary system that cannot be handled by humans; for now, it can be the classical golden standard system.

## 5. Conclusion

As a conclusion, we can say that the recent crisis has submitted to the "resistance test" not only the applied strategies, but also the operational framework of central banks, global cooperation and it restored the financial stability in the center of the central bank, changing the very way of thinking of theorists and practitioners on the formulation of monetary policy decisions.

Although the progress registered in the realm of ideas and practice of the economic science, the reality too often does not listen to theory, and the theory claims without grounds from practice (Dinu, 2012) and, regardless of the degree of mastery of the art of distinguishing between cause and effect, it is still affected by the unexpected events, which become points of inflection for economic theory and practice, imposing paradigm shifts of the conventional framework of thinking. As long as it is still

valid the consensus of the pre-crisis period and how much it should be rethought the monetarist principles, if the central bank has the right to broaden the objectives to include, along with price stability also the financial stability are challenges in a world of searches, evaluation, rethinking, where the authorities at the highest level of national and global monetary decision still seek answers. In this world of turmoil, we can say that, unfortunately, crises cannot be anticipated ... so far.

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