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CONSIDERATIONS REGARDING CENTRAL BANK'S DILEMMA: PRICE STABILITY OR FINANCIAL STABILITY?

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Abstract

In this study, we intend to highlight the interaction between the decisions of the central banking concerning the fulfillment of the two main objectives: price stability and financial stability, as well as the effects of such decisions upon the economy.

We suggest that central banks should be more preoccupied in taking into account the evolution of the stock market indicators, the evolution of the exchange rates, as well as the indicators on the residential and commercial real estate market when decide monetary policy's measures, being recommended that the central bank should influence these evolutions through its specific tools, whenever it is adequate. Besides the traditional monetary policy tools, communication with the public and persuasion would be viable instruments under these circumstances.

Also, we consider that all the banking institutions have to do their best in order to maintain their credibility

Key words: central bank; main objectives; price stability; financial stability; monetary policy; credit crunch; real estate market
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1. Introduction

A challenge for the central banking can be represented by the existence of an *inherent conflict for the accomplishment of the role it can have for the implementation of monetary policies as well as for the financial stability insurance.* Thus, the central banks are going through a difficult period when taking the best decisions.

In this study, we intend to highlight the interaction between the decisions of the central banking concerning the fulfillment of the two main objectives: price stability and financial stability, as well as the effects of such decisions upon the economy.

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2. The implications of monetary policy on financial stability

The implementation of central bank's polices represents a compromise between multiple objectives [Beju, 2007, 22].

The interest rate increase, influenced by the central banking in order to implement a more restrictive monetary policy can cause problems for some banking institutions whose viability depends on the level of the market interest rate (especially when these institutions are important from the point of view of their activity).

On the other hand, *the use of some monetary policy tools could solve this conflict*. For instance, by using the open market operations, the central banking could inject the liquidities necessary to some banks that, although having already liability problems, are solvent. The condition is that these banks possess collateral liquid assets and be accepted for transactions by the central bank. The possession of such collateral assets is also a proof that the bank is solvent.

This way, we can notice the fact that it is not sufficient that banks should be cautious about their borrowers' choice, but they should also have promissory notes that can be easily negotiated, that they could give to the public, or as a final solution, to the central bank [Turliuc, 2002, 71].

Still, the open market operations cannot solve simultaneously the conflictual problem that has occurred. The central bank has to know thoroughly the prudential situation of each banking institution in the system in a way that could forecast the effects of the monetary policy actions.

The central bank also plays a decisive role when helping the market in the process of distinguishing between the solvent and the insolvent institutions, because this goal cannot be always attained on the market [Schinasi, 2003, 9].

The financial stability is strictly linked to the price evolution for the market assets. It is well known that during the financial downturns/crises, the price of securities and of real estate assets show significant fluctuations and can be the cause of such crises.

The monetary policy measures aim at inflation control, having as a reference point indicators that reflect the evolution of consumer prices. *The evolutions of the economies from the last years have brought the conclusion that it is found a double-determination relation between the monetary policy measures and the prices of securities on the financial markets and of real estate assets*.

This fact involves that the central bank must control the evolution of the financial and real estate assets' prices on their specific markets, by taking monetary policy measures and measures relating to the financial stability. In this respect, *the change of the stock market indicators and the indicators of real estate assets' prices can constitute prudential indicators at macroeconomic level.*

A relaxation of the monetary policies can determine both the increase of mortgages' amount and of consumer mortgaged credits. Thus, if the demand for real estate assets increases, being supported by relaxed financing, their prices could go up very fast, and if the prudentiality and control conditions are relaxed, the amount of sub prime credits could be higher. In this respect, we witness an increase of bank exposure at real estate prices fluctuations as well as an increase of consumption in economy, which could cause inflation pressings.

Thus, the central bank, in order to control the inflation tensions, will have to react through more restrictive monetary policies that could lead to the market interest rates' increase and further more, to the increase of rates owed by the borrowers to the banks. The debt service's increase for borrowers could lead to their payment default and real estate securities' foreclosure, whose price on the market, in the event of the amplification of the phenomenon, can cause a significant decrease. This phenomenon would endanger the banks' solvency and would involve bankruptcies, thus becoming clear the premises of a financial crisis.

Unlike the other assets, the evolution of real estate prices can have more serious implications on economy and at social level. The increase of real estate assets' prices, both commercial (offices, retail space) and residential, can cause a *state of well-being*, as this increase could be translated into an increase of the patrimony, of possessors' wealth. Thus, these persons can react by *reducing their economies and increasing the consumption expenses*, supported by credits got through mortgages on the real estate assets. Under these circumstances, we assist also to *an increase of the population's life standard*.

If the product market favors the consumption demand, the economic increase is stimulated. Helbing and Terrones [Helbling; Terrones, 2003] noticed *a correlation between the real estate assets' prices increase and the GDP (Gross Domestic Product)*. The magnitude of this impact differs from one country to another or from one sector to another. Thus, the increase of commercial real estate assets' prices has a more powerful impact upon the economic growth, as it influences the decision to invest and improves the corporate financial situation.

A real estate boom can also lead to *the development of subsidiary economic fields*, such as construction and construction materials industry, the real estate companies etc., as well as the workforce occupation from these fields.

The experience of developed countries proves that *a reduced and stable inflation can coexist with the boom of prices on the real estate market* [Zhu, 2003, 15]. The reduced inflation encourages the population's debts, due to the relaxed credit conditions. The increase of the credits' amount and, implicitly, of real estate demand, sustain the prices' increase of this segment. Moreover, a long period of price stability on the real estate market can influence the goods and services market.

Problems may occur when the internal offer cannot be adjusted according to the conditions of increasing consumption demand, therefore creating the *premises for inflation increase*. If the internal offer is completed by the imports' increase, we can observe *a deterioration of the trade balance*, through the appearance and increase of its shortfall, fact that could lead to a possible accentuated depreciation of the national currency with impact on the financial stability and the inflation evolution. Thus, the central banking will have to interfere through appropriate measures in order to support the national currency.

A possible downturn of the real estate market, doubled by personal bankruptcies due to their inability to pay the increased credit rates can cause *profound social problems*, also having major consequences on the economic growth and financial stability. The housing loss is a phenomenon that affects the primary needs of the individual, with negative consequences on his ability to work and to integrate in the society.

The companies can also face the same negative effects, whose total assets will be lower than their liabilities, *leading to difficulties in liquidity acquisition* and sources of financing new projects or the continuation of those already launched.

Hofmann, Davis and Zhu consider that between the evolution of the bank credits and that of prices on the real estate market there is a positive long-term correlation[1]. The price changes on the real estate market have an important impact on the performances of the banking activity. It could be a direct impact, through the growth of non-performing credits oriented to the real estate field, that have a significant weight in the banks' portfolio, especially in the developed countries, the worsening of the financial situation of the borrowers and of banks, the decrease of banking performances and also an indirect impact which refers to the contracting activities from the financial and economic fields.

The risk is higher in case of credits granted to *the commercial real estate* field, where the credit reimbursement is made from the revenues got as a result of their exploitation. If the yields lower on this real estate market the payment default risk is extended.

In turn, *the residential real estate market* is less risky due to the retail customer behavior, who regularly pays his rates from the salaries and the social negative implications in case of housing loss determines him to be more responsible and cautious. A possible increase of credit rates level, in the event of interest rates increase, can determine him firstly to increase his incomes, through a higher amount of work (overtime work, a second job, the employment of several family members etc.) or/and the reduction of his consumption expenses.

Thus, we consider that a special attention should be paid to the evolution of prices on the real estate market, although sometimes the evolutions on this market make it difficult for the authorities to take the best decisions. This tendency has been especially highlighted by the evolution of financial crises from the last decades, notably by the mortgage credit crisis that occurred in USA in 2007, spreading its effects also on the European continent.

3. Conclusions

When *taking the monetary policy decisions we should also take into account the evolution of the stock market indicators, the indicators on the residential and commercial real estate market, as well as the evolution of the exchange rates*, being recommended that *the central bank should influence these evolutions through its specific tools, whenever it is adequate*. Besides the traditional monetary policy tools, *communication with the public and persuasion would be viable instruments under these circumstances*. Thus, the concept of price stability can apply also to the aspects regarding the stability of assets' prices in economy, implying also the insurance of financial stability.

As far as we are concerned, the most important aspect of all the changes from the banking activity is *the trust in the banking system*. A financial system works best when the economy is strong and the population's trust in the financial system depends on how well it works.

The present tendencies in the banking activity will bring about essential changes in the banking system but *the public's trust will remain the basis for success and stability*. All the banking institutions have to do their best in order to maintain their credibility [Căpraru, Boariu, 2001, 24-29].

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Note

1. See Hofmann, Boris - The Determinants of Private Sector Credit in Industrialised Countries: Do Property Prices Matter?, BIS Working Papers, no 108/2001 and Davis, Philip; Zhu, Haibin - Bank lending and commercial property cycles: some cross-country evidence, BIS Working Papers, no 150/2004