

A NEW PARADIGM OF MODERN CENTRAL BANKING

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Abstract

The changes in the modern monetary policy, which took place at the beginning of the twenty-first century, in response to the global financial crisis led to the transformation of the place and the role of central banks. The strategic aim of the central monetary institutions has become preventing financial instability. So far, central banks have defined financial stability as a public good, which took care independently of other monetary purposes (Pyka, 2010). Unconventional monetary policy resulted in changes the global central banking. The aim of the study is to identify a new paradigm of the role and place of the central bank in the financial system and its new responsibilities, aimed at countering financial instability.

Keywords: Modern Monetary Policy, Central Bank, Financial Stability, Banking Sector Instability, Macro-Prudential Policy

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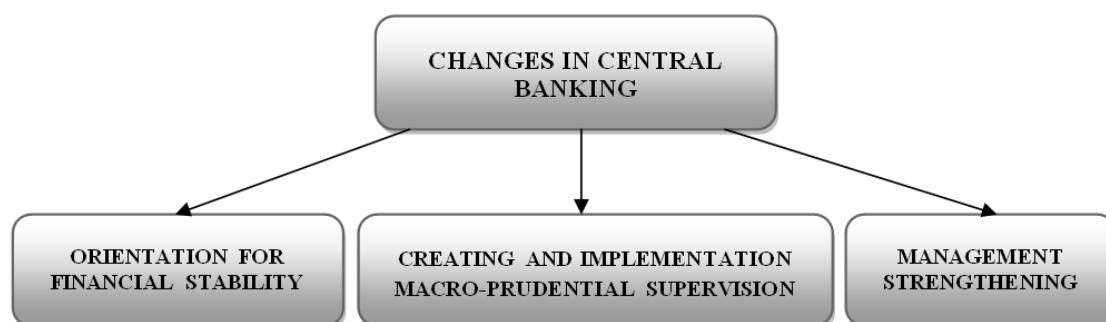
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1. Transformation of modern central banking

The breakdown in the financial system implies the evolution of the functions and responsibilities of central banks regardless of the level of economic development the global economy (Goodhart, 1988; Bordo, 2007a; Bordo, 2007b). After a series of banking crises in the nineteenth century, it was decided that the main aim of central banking is to ensure the correct functioning of financial markets, particular during the instability (Bagehot, 1973). After the Great Depression in the 30s twentieth century indicated that the central banks had been responsible for the economic recession, so the monetary policy was provided to the government. The independence of central banks and

implementation of monetary policy by them were restored in 1950 (Bordo, 2007a; Bordo, 2007b). After a period of hyperinflation in the 70s (*Great Inflation*) in industrialized countries, the primary goal of monetary policy has become the price stability and the independence of the central bank as the only institution which may achieve these objectives. The global financial crisis is the biggest economic downturn since the Great Depression. Central banks and national governments have played a key role in reducing the effects of global instability and prevention of financial and economic collapse. At the same time, the crisis has caused important implications for central banking. These changes can be seen in three main areas (Figure 1).

Figure 1. Changes in central banking after the global financial crisis



Source: Own work

Firstly, financial stability will play a more significant role in a monetary policy strategy, not only during instability, but also in the stable period. Central banks are in fact the first institution in the chain which identifies signals of system's collapse. Central banks are focused on the prevention of instability, because it threatens the monetary transmission mechanism and causes significant economic costs. However, modern central banks began to implement new functions. They do not limited only to the classic triad of functions: the function of the bank of banks, state bank and the issuing bank. Their strategic goal, except issuing of money and determining the state of base rates, has become achieving objectives beyond the traditional monetary policy strategy. The stability of the financial system was recognized as the main aim of central banking. Moreover, central banks are also obliged to publish periodic *Financial Stability Reports* - about current conditions of the financial system.

Function of central bank as a *Lender of Last Resort* (LoLR) has also gained new meaning. Originally it was intended to counteract the negative effects of instability and decline in economic activity by increasing the capacity of banks' credit activity. During the global collapse central banks are in fact obliged to immediately supply the liquidity to commercial banks, without any restrictions on the volume of provided capital. Furthermore, this capital was mainly medium or long-term (as opposed to the traditional short-term financing by central banks), and its cost was minimal. The lender of last resort plays a significant role in sustaining the existence of endangered institutions and controlling the situation on the interbank market. Central banks have also started to play a new role – *The Buyer of Last Resort* (BoLR). This was due to the special asset purchase programs, implemented under the policy of *Quantitative Easing*. Central banks have become the final purchasers of the toxic assets which worsened the structure of banks' balance sheets. At the same time, these purchases resulted in increasing banks' liquidity and allowing them more efficient capital investments. On the other hand, bad and overdue loans have caused for central banks freezing their capital, which will be returned in next years or will be completely impossible to get back. These actions weaken the national banking systems and decrease the possibility of further intervention by monetary institutions.

After the crisis was also stated the new regulations - the institutional framework of central banking. New functions in the context of macro-prudential supervision have been assigned to central banks. The regulations aimed mainly at identifying threats to the stability of the financial system. The European Union has established the *European Systemic Risk Board* (ESRB) as a new macro-prudential authority, which takes care of

counteracting next breakdowns through early identification of systemic risk and identifying effective measures to minimize it. This authority cooperates with the European Central Bank. Despite both institutions are independent, their goals are clearly defined: ECB - price stability, the ESRB - reducing systemic risk. If central banks will play a greater role in financial stability policies they also need the right tools and skills for their successful use. At this level are not yet defined the specific macro-prudential instruments of individual national central banks. However, these must include instruments which ensure that the financial system will be more resistant in terms of structural and countercyclical deteriorations. Some of them should be like automatic stabilizers - immediately react to irregularities, and others, just to be used occasional, in temporary situations. Institutional changes may also strengthened the role of the central bank as the regulator and supervisor of the financial market. Since the beginning of the new century the institutional supervision was replaced by integrated supervision with the dominance of a single supervisor, separated out from the central bank. The crisis has revealed that integrated supervision is ineffective because a single institution, independent from the central bank, is not able to prevent instability. Especially that information about the functioning of the financial markets firstly reaches to the central bank. So that, it turned out that removing central banks from supervisory authority was improper solution. In current terms, there are tendency to return to the institutional or twin peaks supervision, which cooperates with the central banks, and where the greater specialization of the institutions may counteract destabilization in the future. Thus, the central banks' role as a part of safety net has become increasingly important. Greater cooperation between monetary institutions, national governments, deposit insurance institutions and supervisors ensures consistent market conditions monitoring and control of the main indicators that inform about the level of market risk. The roles of all safety net institutions are redefined and focus mainly on preventing instability and first achieving the strategic goal.

The third area of transformation in the modern central banking includes changes in the management system. Extended powers in managing financial stability include significant changes in the structure and functioning of the central bank. This requires greater interaction monetary institutions with national governments, while ensuring the autonomy of the central bank to achieve price stability. On the one hand, banks will continue the monetary policy, and on the other hand - more attention will be focused on cooperation with government institutions for the stability of the whole system. So that, the challenge is to develop appropriate management mechanisms at central banks and clearly define their strategies in achieving all the objectives.

The crisis also revealed weaknesses of paradigm of the monetary policy strategy, which dominated before the collapse. First, the definition or interpretation of the objective of price stability - by defining an acceptable level of inflation, so far was based solely on short-term horizon. Second, central banks did not take into account the permanent changes which have been taking place in the financial environment, and which threatened price stability. These weaknesses were not allowed to meet the challenges resulting from changes in the cycle of financial markets, which was a very serious threat to the economic stability and to maintain the general level of prices. Monetary policy based on short-term forecasts of inflation and ignoring threats from the financial markets have led to too expansionary policy. It has been observed since the second half of the 90s until the first signals of global instability in August 2007. In the advanced economies, monetary policy must be aimed at maintaining price stability in the medium term, as well as has to take into account monetary trends and long-term threats arising from the instability of financial markets.

2. Modern instruments of central banks

The main aim of the central banks are implementation of monetary policy and achieving goals included in the strategy. Depending on economic conditions, these objectives may focus on defining the terms of trade - as it was in period of dominance of gold, or in accordance with the modern trend - price stability (Goodhart, 1988). Along with changes in strategy, instruments have also been transformed. Economic changes in last decade imply the need to identify new tools that enable counteracting the negative effects of instability. In response to growing inflationary pressures as a result of the global economic slowdown, the basic interest rates of central banks have been reduced to historically low levels. The European Central Bank lowered the refinancing rate to 1% - to a level that has not been observed in the modern history of central banking in any of the Eurozone countries.

In July 2012, by the lack of meaningful economic recovery and the next round of economic stimulus programs implemented by the world's major central banks, ECB has decided to further lower its main interest - to the level of 0.75%. Bank of England and the People's Bank of China have also decided to further loosening the monetary policy. Moreover, ECB lowered the level of deposit rate to zero percent, which is the rate of interest on deposits of commercial banks at the central bank. Such decisions had not even been taken by the U.S. Federal Reserve, which politics was more aggressive in minimizing the effects of the crisis and the economic slowdown. Decision of the central bank of the euro area was aimed at encouraging banks to increase credit activity using funds previously held in accounts in ECB.

The global financial crisis also caused the qualitative changes in the instrumentation so far used by central banks. Many institutions have introduced unconventional tools to support the functioning of financial markets, improve liquidity in the banking sector and increasing economic activity. Extraordinary monetary policy instruments includes:

- unlimited capital support for banks, with maturities of up to one year;
- supply of liquidity in foreign currencies;
- expand the list of assets eligible as collateral;
- outright purchases of mortgage bonds in open market operations;
- interventions in the bond market in the asset purchase program.

Central banks, after the implementation of the unconventional instruments, face the problem of when and how often they should limit these operations and return to the traditional tools. Too long intervention of central banks to stimulate economic growth may in fact cause the negative effects for the market. Therefore, it is important appropriate implementation the *exit strategies*. On the other hand, too rapid changes in banks' positions may create new market stress, with the negative consequences for the ongoing economic recovery and medium-term outlook for level of prices. In Japan in the 90s twentieth century, the combination of zero interest rates and the asset purchase program in *Quantitative Easing* policy, which solved the liquidity problems of financial institutions, led to negative effects on the bank's function as a financial intermediary in the money market and the corporate bond market (Baba, Nishioka, Oda, Ueda, Ugai, 2005).

3. Interaction between monetary and fiscal policies

The changes that have occurred in central banking as a result of the global financial crisis are also seen in two other areas. Firstly, there have been changes in the relationship between monetary policy and fiscal policy. Moreover, changes in the balance sheet of the central banks were considered as one of the monetary policy instruments.

In view of the banking sector instability in the first decade of the twenty-first century and the recession many economies in the world there has been a significant increase in government spending. A part of these increases were due to implemented tools, defined by economists as the automatic stabilizers. It caused a sharp increase in budget deficits, resulting from the use of fiscal instruments, implemented to improve economic indicators. This led to the significant implications also for monetary policy. In general, government spending is financed by current taxes, while deficits - with future taxes or through printing money. In this sense, monetary and fiscal policy are interrelated through dependencies in

financing the state budget. Printing money is the easiest way to solve budget problems. However, in the last 60 years all over the world was recognized the independence of central banks, which means that the monetary authorities have the ability to make autonomous decisions about monetary policy and they are free from interference and pressure from government institutions. Regulations protecting central banks created protection against pressure from the government which seeks to maintain fiscal discipline. So it is reasonable to maintain appropriate boundaries between institutions responsible for the fiscal policy and issuing money.

Over the past 25 years, most of the world's central banks have adopted inflation targeting as the primary objective of central banking. Moreover, the size and the structure of the balance sheets of central banks was limited. These institutions might have only had certain types of assets, which was associated with a reduced ability to conduct credit activity and allocation of their assets. Along with implementation of extraordinary monetary policy instruments, which were aimed at increasing the liquidity of the banking sector and improving the quality of assets of banking institutions, there has been a rapid increase in the size of central banks balance sheet and the structure of their assets. There were created new assets, which were a result of the purchase programs. Central banks purchased credit receivables, classified as past due or uncollectible, from the commercial banks which had a negative impact to the quality of banks' balance sheets. Finally, the banking sector instability as well as persistent fiscal imbalances have led to the collapse of institutional structures and created barriers between monetary and fiscal policy. On the one hand governments tend central banks to cross the limits of their monetary activities, and on the other hand - central banks enter into new areas, previously seen as inappropriate from the point of view of central bank independence. However, disappearance the boundaries might result in the significant risk. It is a reason why previously rules were established which separate their mutual activity. Their failure may create significant costs for the global economy in the future.

Another important issue is transformation of the size and structure of the central banks' balance sheets. Asset structure, limited so far, has been extended of the new items. The U.S. Federal Reserve System in the balance sheet before the period of instability, had mostly short-term Treasury securities. By the asset purchase programs, long-term government securities and *Mortgage-Backed Securities* (MBS) have become an important position in the balance sheets. The increase in the size of totals assets and liabilities reached so high level that despite the exit strategy, it will be difficult to return central banks to the pre-crisis situation. Thus, regulations are needed to help banks and financial system to gradually restrict unconventional tools' activity. Lack

of adequate regulations may cause further unlimited expansion of banks' balance sheets and finally decrease their role in financial system and effectiveness of their interventions.

Conclusions

Modern monetary policy should focus on maintaining price stability in the medium term and guarantee the independence of the central bank to ensure achieving these goals. These rules define a framework for monetary policy almost all developed economies. Their validity has been verified and confirmed by the experience of the recent crisis. However, situation in the financial markets in last decade has revealed shortcomings in the framework of the current monetary order. Nearsightedness of central banks led to excessive loosening of monetary policy (too expansionary monetary policy) in many developed economies, which is considered as one of the main causes of the global financial crisis. In the implementation of the exit strategies and the withdrawal of extraordinary instruments, should be taken into account the new determinants of central banking. Excessively expansionary policies may create the risk of new imbalances and severe financial disruptions. Appropriate relationship between fiscal and monetary policy ensures the independence of central bank, but also its trustworthiness. Monetary authorities should also not finance the budget deficit from their own capitals.

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