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STUDY ON THE CORRELATION BETWEEN PRICE STABILITY AND FINANCIAL STABILITY IN THE EVOLUTION OF THE ECONOMY

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Abstract *With the globalization of financial flows and the increasingly high degree of financial markets integration, financial stability has become a topic of study particularly important for financial institutions and researchers alike. Society's net benefits overwhelmingly depend on the effectiveness of the financial system which becomes a valuable public asset and an essential feature of such a system is stability.*
Price stability and financial stability are crucial for the proper functioning of an economy, price stability is the primary objective of monetary policy and it examines the connections between price stability and financial stability. Price stability is essential for achieving financial stability in a country, while to achieve these two objectives it's also necessary a good collaboration between the political and financial factors. Price stability is both an end in itself as well as a means for monetary policy, as it contributes to achieving a sustainable economic growth and macroeconomic stability.

Key words:

monetary activity, banking system, banking activity, stability, prices

JEL Codes:

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1. INTRODUCTION

With the globalization of the financial flows and the increasingly high degree of integration of the financial markets, *financial stability* has become a topic of study particularly important for financial institutions and researchers alike. The net benefits of society overwhelmingly depend on the effectiveness of the financial system that becomes a precious public good and an indispensable feature of such a system is *stability*. Under these conditions, economists and researchers have tried to define stability through its opposite, i.e. *instability* without reaching a unanimous conclusion on its content. As regarding The Central Bank of Romania, in its first *"Report on financial stability"*, it defines *"financial stability",* broadly speaking as the particularity of the financial system to withstand shocks on a sustainable basis and without major disruption, to efficiently allocate resources across the economy and identify and manage risks.

On the same line of thought, the BNR governor pointed out that *"financial stability is a situation where the financial system is able to attract and place monetary funds effectively and to withstand shocks without prejudice to the real economy"* (Isărescu, M., 2006).

Price stability and financial stability is of great importance for the functioning of a country's economy.

2. THE NEED FOR PRICE STABILITY IN A COUNTRY'S ECONOMY

Price stability is achieved when your money conserves its value over time or the rate of their purchasing power erosion is very slow. The concept of monetary stability overlaps with that of price stability, without any coincidence between the two concepts.

The factors that determine price level are the inflation or the deflation level, which can have negative consequences on the economy. Inflation is characterized by a generalized increase in prices and services over a long period of time, resulting in a decrease in the value of money and their power of purchase, while deflation is the reverse of inflation, in which case there is a general decrease in prices over a long timeframe. (Isărescu M., 2008)

One can talk about price stability only in the absence of the inflation or deflation effect, when prices neither increase nor decrease, they remain stable over time. If for instance, using 100 euro one can buy the same basket of goods as a year or two before, price stability can be considered absolute.

Even if the existence of financial stability means no inflation or deflation register, frequent changes in individual prices are quite normal in market economies, even when prices are stable overall. A change in the conditions of demand and/or supply of goods or services considered to be individual, leads inevitably to price changes. For example, in recent years the prices of mobile phones and computers declined substantially, mainly as a result of rapid technological progress. However, in the same period of time, the prices of oil and other energy products increased, partly due to concerns regarding the future supply of energy and partly as a consequence of higher demand for energy. Overall, inflation was maintained at a low and stable level in most countries. Finally, the stability of the general price level may be accompanied by substantial changes in individual prices as long as the increase and the decrease of prices compensate each other, so that the general price level remains unchanged. In our view, price stability means that we can talk about this state, in those cases where the expected changes in the average prices are sufficiently insignificant and gradual so as not to be taken into account in the decisions of households and economic entities. All these represent arguments to adopt measures leading to the reduction of inflationary pressures. This is why, in recent years, national economies have shifted their macroeconomic policies towards ensuring price stability.

3. SIGNIFICANCE OF FINANCIAL STABILITY

Financial stability is a relatively new concept, which is closely related to globalization. It is not as easy to define as price stability, but although we "benefit" from a well-structured framework for the discussion and implementation of the monetary policy, our thinking with regard to financial stability is less advanced. (Isărescu M., 2008)

Broadly, financial stability can be understood as a situation where the financial system can ensure the efficient allocation of savings to investment opportunities and can withstand shocks without major disruptions. In a narrower acceptance, financial stability can be defined as that condition characterized by the absence of banking crises and a certain level of stability in asset prices, including interest rates.

As demonstrated by the recent global economic crisis, financial stability plays a crucial role in the financial system and the economy as a whole. Given the increasing number of large financial institutions, currently active, global financial stability has become even more important.

The financial system comprises:

- financial markets, including money markets and capital markets. They channel excess funds from lenders, namely businesses or individuals who want to invest their money, to borrowers, who need capital;
- financial intermediaries such as banks and insurance companies. They directly reunite creditors and debtors but debtors can also obtain funds directly from financial markets by issuing securities such as stocks and bonds;
- the financial infrastructure allows the transfer of payments as well as the trading, clearing and settlement of securities.
- Financial stability can be characterized as a situation where the financial system is able to attract and place monetary funds and to withstand shocks without major harm to the real economy.

4. POTENTIAL FOR CONFLICT BETWEEN PRICE STABILITY AND FINANCIAL STABILITY

Institutions that have control over the financial stability are central banks, in our country it is the National Bank of Romania which has the role to maintain monetary and financial stability

Prudential supervision has a leading role in promoting financial stability. Monetary policy is relevant in terms of efficient allocation of resources to the extent that it can contribute to price stability.

Instead, if we define financial stability as being especially the "neat" path of interest rates, as specified by the second definition, monetary policy has a more important role, and the room for manoeuvre in the use of its instrument (interest rate monetary policy) may be subject to limitations - therefore we could see a conflict between price stability and financial stability.

The conventional point of view of the relationship between price stability and financial stability considers inflation as the main source of financial instability. Past experience seems to confirm this view, as most periods of financial instability and severe crisis in the banking sector have coincided either with periods of high rates of inflation or even galloping inflation or intervals marked by recession following the adoption by the authorities of inadequate measures to moderate the inflationary phenomenon.

It is particularly important to assess whether the central bank has the capacity to provide simultaneous price stability and financial stability, by using the tools at its disposal as well as the manner in which the two categories of stability can be reconciled, on the supposition that their realization involves conflictual actions.

A number of situations can arise where the need to maintain financial stability is more important than the objective of maintaining price stability; sudden developments in interest rates intending to restore price stability in the short term will be ineffective in the longer term if they contribute to the accumulation of imbalances in other economic sectors.

Given the strong capital inflows, the currency will continue to appreciate and the economy's external competitiveness will degrade. Imports will grow at a more sustained pace than exports, thus contributing to the expansion of the aggregate demand. In this situation, the current account deficit could reach unsustainable levels as a reflection of aggregate demand growth. If these developments are not resolved in a timely manner it is necessary to implement measures to strengthen fiscal and income policies, because investors can foresee these problems, which will cause the withdrawal of foreign capital. It was determined that the magnitude of these outflows may exceed the capacity of authorities to protect the value of the national currency and may amount to a precipitous correction in the sense of depreciation, namely a currency crisis.

It is obvious how the sudden depreciation affects price stability - the effect is both direct through import prices as well as indirect, by feeding inflationary expectations.

Equally obvious is the reaction of monetary policy, whose main objective is price stability.

5. COMPLEMENTARITY BETWEEN PRICE STABILITY AND FINANCIAL STABILITY

Following the stipulations set out in the European Community Establishment Treaty we notice that maintaining price stability is the primary objective of the European System of Central Banks (ESCB). The complementary relationship that occurs between price stability and financial stability is based on the removal of impediments to the free movement of capital flows and economic globalization. Thus, a fundamental element of macroeconomic stability is represented by financial stability, because capital inflows take advantage of the financial system’s vulnerabilities.

In order to analyse the complementary relationship between price stability and financial stability, we consider important as a starting point the definition of financial stability.

BNR defines financial stability as the characteristic of the financial system to withstand shocks on a sustainable basis and without major disruption, to efficiently allocate resources across the economy and identify and manage risks.

Regarding financial stability, Central Bank governor Mugur Isarescu argued that "financial stability is a situation where the financial system is able to attract and place the funds effectively and to withstand shocks without hurting the real economy" (M. Isarescu , art.cit., 2008).

We believe that financial stability should be addressed broadly or narrowly. Addressed broadly financial stability is the situation where the financial system can ensure efficient allocation of savings to investment opportunities, and can withstand shocks without major disruptions, where prudential supervision plays a key role in promoting financial stability and the efficient allocation of resources from the monetary policy can contribute to reaching price stability.

Narrowly, financial stability can be characterized by the absence of banking crises, as well as a level of stability in interest rates, namely price stability, where monetary policy plays a key role through the use of interest rate in the monetary policy, but whose room for manoeuvre may be limited, this leading to a potential conflict between price stability and financial stability. Schematically, complementarity between financial stability and price stability can be presented as follows:

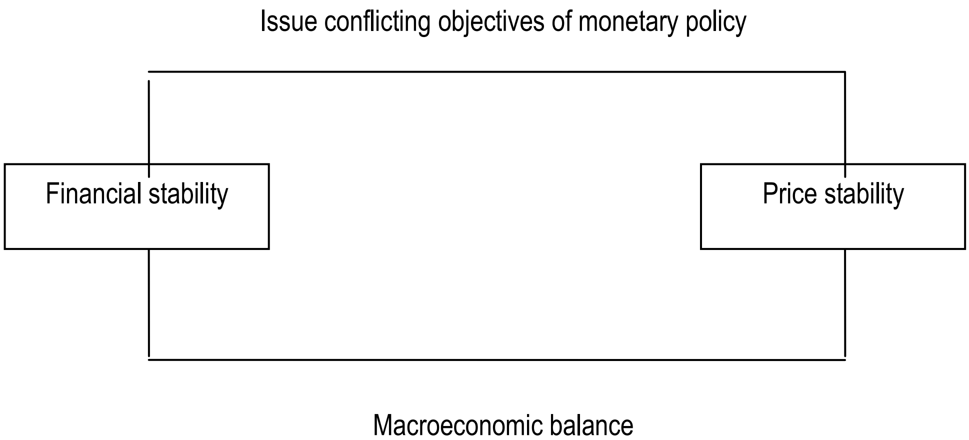

Figure no.1. Complementarity between financial stability and price stability
Source Isărescu, M., *Stabilitatea preţurilor şi stabilitatea financiară (Price stability and financial stability)*, Dissertation on the occasion of being awarded the degree of ”Doctor Honoris Causa” of the Piteşti University, 8 December 2006;

An important role in analysing the relationship between price stability and financial stability is that inflation is the main source of financial instability. In modern economies, achieving a low and stable inflation level creates a new economic climate that requires rigorous reconsideration of the relationship between price stability and financial stability. A low level of inflation is not a sufficient condition for ensuring long-term stability. Price stability leads to improved quality of life as it helps to reduce the level of uncertainty related to the general price development and, as a consequence, transparency of relative prices increases. Price stability allows consumers to identify more easily variations in commodity prices in relation to prices of other goods, provided that such variations are not concealed by fluctuations in the general price level. However, the uncertainty related to inflation could cause companies to adopt erroneous decisions on employment. Also, price stability reduces inflation risk premiums in interest rates.

When creditors are certain about price stability in the future, they will not demand an" inflation risk premium" to compensate for inflation risks arising from holding nominal assets over the long term. Due to reductions in risk premiums and, as a result of the nominal interest rates, price stability contributes to improving the efficiency of capital markets in terms of resource allocation and thus stimulates investment, leading to economic welfare.

Also, if price stability is plausible, it is unlikely that individuals and firms will divert resources from productive activities to ensure themselves against inflation. For example, in the context of high inflation, businesses are encouraged to make reserves of real goods, taking into account that, in such circumstances, they are better storage of value than money or certain financial assets. However, hoarding goods is not an efficient investment decision and therefore prevents economic growth.

Price stability prevents the arbitrary and significant redistribution of income and prosperity, which is common both in the inflationary and deflationary environment. Therefore, an economic environment characterized by stable prices contributes to stability and social cohesion.

All these arguments suggest that a central bank that ensures price stability contributes substantially to the achievement of general economic goals, such as standard of living, the level of economic activity and a higher and more stable occupancy level.

6. ROMANIA'S EXPERIENCE WITH RESPECT TO PRICE STABILITY AND FINANCIAL STABILITY

Regarding the relationship between price stability and financial stability in Romania, BNR governor Mugur Isarescu stated: "I believe that Romania's experience indicates that financial stability is of particular importance for price stability. This experience shows that where there are constraints to choose between an alert disinflation process and maintaining financial stability, the latter must be prioritized to achieve the objective of maintaining price stability in the long term. It is noteworthy that the countries that initiated the process of disinflation should opt for an appropriate pace of deflation so as to avoid conflict with financial stability. I believe that Romania has gained good experience in this regard. Our country has achieved an average deflation of 5.8% per year in 2000-2007, while maintaining financial system stability. In the long term, failure to maintain financial stability can only lead to a regrowth of inflation. This reminds me of standard safety instructions on aircraft that, in the case of cabin pressure, the parent is the one who must put the oxygen mask on his face and only after that he should attach the mask to his child who, in most cases, is the very raison d'être "

(Isărescu M., 2008).

We believe that the complementary relationship between price stability and financial stability will last on the long-term, if the central bank would follow in addition to its long-term fundamental objective- price stability - and financial stability as well as the overall evolution of the macroeconomic indicators, to avoid situation where the disinflation gains at a time can become completely unsustainable.

Measures taken by the central bank to promote price stability and financial stability were:

- transition to positive real interest rates;
- full liberalization of the current account;
- start of the banking system's restructuring program;
- capital account liberalization;
- adoption of the inflation targeting strategy.

Increase in inflationary pressures and deteriorating international financial climate led to strengthened regional monetary policies, putting pressure on companies and households with high rates of indebtedness. Rapid credit growth, especially foreign currencies credits, is a source of concern for both financial stability and price stability:

- generates inflationary pressures;
- contributes to increasing current account deficit;
- proliferates currency risk;
- increases credit risk, especially for households.

Romania registered a strong growth, 6.5% on average annually between 2003 and 2006. However, the economy has given clear signs of overheating, with a high and growing external deficit and a reduction in funding from foreign direct investment, despite the high level of investments other than those related to privatization, but still mitigated due to a higher share of capital gains in the medium and long term, according to the information available for 2007.

Regarding developments of 2008 in terms of financial stability we can say that there were very important changes in Romania, changes resulting from the early signs of the global financial and economic crisis.
At the onset of the crisis, Romanian economy covered a period of several years of high economic growth rates, but followed by accumulation of a significant external deficit and the increase in short-term external debt. The Romanian banking sector represented a dominant part of the financial system.
The financial stability of our country has been tested by a new vulnerability, the external volatility. With a small gap, the deteriorating economic climate also manifested itself on the Romanian economy with negative consequences on the quality of the loan portfolio, which continues to unfold, the credit risk remaining a major vulnerability of the banking system.
The effects of the international financial crisis extended on the Romanian economy. However, in terms of direct impact, the banking system was less affected because it was not exposed to toxic assets, and because of prudential and administrative measures adopted over time by the National Bank of Romania. Financial stability in Romania in 2009-2010 remained robust despite the internal and international economic context in the previous year. Risks in the banking sector were offset by credit institutions through their own efforts undertaken in the context of the work performed by the National Bank regarding prudential regulation, supervision and proper management of risks in the system, efforts materialized in enhancing levels of solvency, provisioning and liquidity.
The main external vulnerabilities of the Romanian economy at the start of the crisis eased considerably. First, the current account deficit continued to remain at a moderate and sustainable level (4.4% of GDP in 2010, rose in 2011 reaching 4.5% of GDP for 2012 to decline to 3.8% of GDP in 2013 and to grow slightly reaching 3.9% of GDP), compared to the level of 11.6% at the end 2008), while exports have performed above the regional average. Short-term external debt (STED) - another important vulnerability of the previous years - has diminished its negative impact on financial stability.
Financing the current account deficit was achieved in proportion of 33.9% by foreign direct investments which were lower by 6.7% compared to 2011 when they registered 1.815 million euros. However, the current account deficit was covered entirely of independent sources which do not generate interest, particularly the portfolio investments which totalled 3.785 mil. euro.
In the medium term, the current account deficit will be maintained at a value between 6.4 to 6.9 bln. euro, with a share in GDP of 4.3% in 2014 and 4.1% in 2016.
In the economic context determined by extended tensions in the international financial markets and the slowdown in national real GDP growth, financial intermediation - measured as a share in the GDP of the financial system's assets - continued to decline in 2012 but the pace of decline was lower than in the previous year. In the structure of the financial system's assets, most part is held by credit institutions, followed by the NBFI and investment funds. In 2012, banking sector assets grew modestly, while the NBFI sector has narrowed.
Over the analysed period, the evolution of the financial system components shows a steady increase in the share of private pension funds and a decrease in the NBFI sector. In the last quarter of 2012 and first half of the current year, the main variations were given by the slight decrease in the position of credit institutions sector and the advance of investment funds.
The direct dependence of the credit institutions sector to the other components of the financial system was maintained at low levels in the period, both in terms of investments and of attracted funding.

7. CONCLUSIONS

Starting from the known efficacy of the monetary policy on the economic activity as well as from the main channels of transmission, it is easy to deduce objectives: controlling the volume of currency in circulation in an economy and an appropriate level of real interest rates.
The effectiveness of monetary policy depends on a number of factors related to the nature of the economic and financial system, the degree of effective control of the monetary authorities, the quality of coordination with other economic policy instruments or the behaviour of private agents and their ability to adapt to the decisions of public authorities.
With globalization of financial flows and the increasingly high degree of integration of financial markets, financial stability has become a topic of study particularly important for financial institutions and researchers alike. Society's net benefits overwhelmingly depend on the effectiveness of the financial system that becomes a precious public good and an indispensable feature of such a system is stability.
As achieving stability is a dynamic process, it in the fact that results that the normality of the financial system is instability, as shown by the phenomena of market volatility and turbulence, imbalances that lead to a wrong assessment of financial assets, artificially inflated asset prices (price bubbles), many financial crises that have confronted the financial markets.
Given the vulnerabilities manifested in the financial markets in recent decades, which through more intense capital flows may spread rapidly contributing to increased fragility of markets, financial stability has become a key goal of public policy. Evaluating the

financial stability level is necessary to prevent, remedy or address situations of imbalance, so that the financial system remains within accepted stability limits. This initiative falls under the responsibility of central banks and / or supervisory institutions and the tools and strategies must have a systemic dimension focusing rather on the whole and not on each individual component.

Central banks should pay attention to developments on financial markets as a stable financial system is an essential precondition for ensuring effective and free of tension transmission of monetary policy, ultimately contributing to the achievement of price stability over the long term. In this respect, the systematic monitoring and assessment of financial stability conditions is a must, in order to identify the main sources of risks and vulnerabilities in the financial systems.

Financial stability is critical to the effectiveness of monetary policy and therefore to ensure price stability. Nowadays, when the Romanian economy has managed to successfully overcome the economic downturn, high inflation and financial instability in the 90s, threats to the financial stability have not disappeared but have changed their nature.

Long-term commitment to price stability is the only way to build a lasting economic growth by achieving increased efficiency associated with low levels of inflation. Safeguarding financial stability and not a rapid disinflation, should take precedence in case of conflict between these objectives, in order to ensure achievement of the objective of price stability in the long term.

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

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