
Price stability and financial stability in the context of EUROSYSTEM's monetary policy

Anca Bandoi¹, Dorel Berceanu², Dana Danciulescu³

Abstract:

In this article we propose to review some aspects of the relationship between price stability and financial stability in the current economic context. It is acknowledged that monetary policy of the EUROSYSTEM still have as the main objective the price stability, this being one of the most important ways of supporting sustainable economic growth. Although there are many theoretical approaches of the price stability concept all converging towards the idea of measuring and control of permanent inflation. Financial stability can be seen in the broad sense as the situation in which the financial system may ensure the efficient allocation of savings to investment opportunities and may face the shock without major disruptions. Viewed from this perspective the increased complementarity between price stability and financial stability is associated with economic globalization and, in particular, eliminating impediments to the free movement of capital flows. On the other hand the financial stability may be defined as a situation characterized by the absence of banking crises and by the existence of a certain level of price stability of the assets, including interest rates.

Keywords: price stability, monetary policy, capital movement, exchange rate

JEL Classification Codes: E 31, E 42, F 33, F 32, O 11

¹ Assoc. Prof. PhD, Faculty of Economics and Business Administration, University of Craiova, ROMANIA, E-mail anca.bandoi01@yahoo.com

² Assoc. Prof. PhD, Faculty of Economics and Business Administration, University of Craiova, ROMANIA, E-mail dorelberceanu@yahoo.com

³ Assoc. Prof. PhD, Faculty of Economics and Business Administration, University of Craiova, ROMANIA, E-mail danadanciulescu@yahoo.com

1. Introduction

All monetary authorities are facing with problems regarding immediate control and forecast issues of some interventions effects through monetary objectives and tools.

These problems become more complicated if we take into consideration savings through globalization phenomenon and intersection between monetary and financial market. It is unanimous accepted that economical stabilization mechanisms becomes impossible without using a proper mix of macroeconomic policies where monetary policy has a recognized place.

Specific objectives of monetary policy are different from one country to another, and in recent years all states, regardless their degree of development, faced numerous difficulties and economic uncertainties due to several new phenomena, such as:

- deteriorating financial position of domestic enterprises and the existence of a external debt crisis;

- the existence of some unfinished contradictions between economical stimulation and inflation;

- Interdependencies of monetary and financial markets, having as background a instability of funds flows, especially capital movement;

- financial innovations that have created a series of new financial products, which involves great difficulties in defining the monetary aggregates and in establishing their influence on monetary policy

Concernings regarding the achievement of economic goals in the final lines as close to ideal values have determined in the last decades shaping of three standard strategies of monetary policy that have enjoyed success in terms of providing an effective nominal anchor such as targeting monetary aggregates , targeting exchange rate and inflation.

From all of these only targeting the exchange rate and inflation are currently used by the new EU members from Central and Est Europe.

Targeting monetary aggregates has lost the support in these countries; the situation met in the past and in most developed countries, because of the disintegration between inflation and monetary aggregates;

This trend is related in particular to accelerated remonetization, which occurred after inflation came down to moderate levels, the banking sector was privatized and capital flows liberalized.

However, the ECB still take into account, explicitly, the rithm of money in the process of establishing its monetary policy by promoting a heterodoxe strategy with two pillars:

- 1) The assesment of price determinants on short and medium term, emphasizing the activity of the real economy and financial conditions in the economy (economic analysis);

2) Recovering the long-term link between money and prices (monetary analysis). In this context, it should be noted that targeting inflation does not prevent the central bank to pay attention to monetary aggregates to the extent that they contain relevant information for the forecast of inflation.

Economies of a lower scale tend to prefer the anchors of exchange rate, more exactly arrangements like "monetary council" in Bulgaria, Estonia and Lithuania or "hard peg" in Latvia .

Other countries choose arrangements for more flexible exchange rate with free regimes in Poland and controlled regimes in Czech Republic and Romania until a fluctuation band of exchange rate type ERM II in Hungary, associated with the adoption of targeting inflation strategy.

2. About Inflation and Price Stability

In 1998, the Government Council announced this definition of price stability, as following: "price stability is an annual variation of the Harmonized Index of Consumer Prices (HICP) more than 2% and maintaining this price stability on the medium term". Later, in 2003, the same Council has made further clarifications on this definition by specifying that prices should vary by more than 2% annually but changes must be very close to that amount;

Inflation targeting aims the ensuring of Inflation targeting that will contribute to the achievement of a sustainable economical growth, macroeconomic stability and finally to ensure a high level of social welfare.

Following this judgement we find an excuse to the fact that "the main objective of the European System of Central Banks is to maintain price stability" as recorded in Establishing Treaty of the European Community.

Theoretically, there are several ideas about what means price stability. Realizing this concept is based on the following assumptions:

a. Price stability refers to the aggregate price level measured by indices (CPIs in the case of Romania, HICP in case of EU)

b. Price stability is achieved when the money keeps their value over time or their speed erosion of purchasing power is very slow;

c. The monetary stability concept overlaps the price stability concept.

In the opinion of many central banks, the "price" component is considered as some aggregate measure of the prices of currently produced goods and services. However, this could be either the CPI or HCPI⁴, with or without some sectoral

⁴ Long before Romania's accession to the European Union, the National Institute of Statistics to rally in the calculation of the European harmonized index of consumer prices (HICP) and began to publish and transmit to Eurostat in 1997 as data on the evolution of prices Consumer determined according to the concept of national (CPI), as well as comply

exemptions to purge the series of undesired volatility. Over the longer term, these series tend to move quite closely together so that the distinctions between them are less important. However, over shorter time periods, like the one- or two-year horizons conventionally targeted by central bankers, definitional differences can be significant. In other words, defining “stable” means that the conventional approach would be to define it as some low level of inflation, say between one half of one per cent (to account for upward measurement bias) and 2 to 3 per cent per annum. Implicit in this definition is also the view that any measure of deflation (where prices actually fall in aggregate) is not consistent with price stability.

The benefits of achieving any public policy objective are not absolute, but have to be assessed against the costs of doing so. Today, the costs of achieving low inflation would be assessed as significantly lower than they were thought to be in the 1960s and 1970s. At that time, many believed there was a long-run trade-off between inflation and unemployment, implying that low inflation meant permanently higher unemployment. Even as that belief began to fade, reflecting the insights of Friedman (1968) and Phelps (1968) into how shifting expectations would render vertical the long-run Phillips curve, there was still resistance to trying to reduce inflation through market processes. In part, this was because of the perception that even the short-run costs could be substantial. One strand of thought was that the short-run trade-off was very flat, implying that a large unemployment “gap” would be required to move inflation materially. A related strand of thought was that inflationary expectations were very “sticky” and thus disinflation would not receive much support from a ratcheting down of the Phillips curve in inflation-unemployment space. This kind of thinking led to a preference for wage price controls and other non-market processes, along with a belief that “gradualism” in reducing inflation would do so at the lowest cost over time. What is interesting, now that inflation has been reduced to low levels, is that similar views currently prevail about both sticky expectations and shallow trade-offs.

While the assessed costs of achieving price stability tended to fall over time, the assessed benefits rose in tandem with central bankers’ actual experience of living with high inflation. It was not a pleasant experience. Perhaps the first observation was the disquietening tendency for unleashed inflation to move ever higher when not firmly resisted by macroeconomic policies. In many countries, particularly when exacerbated by the negative supply side shocks of the 1970s, the battle for factor

Romania, like all EU countries, calculated two indices of consumer prices, taking into account the fact that each of them to serve distinct purposes:

a. CPI is used to set up monetary policies on national level (this is why Central Bank aims inflation), social policies (minimum salary, indexation, social assistance, pensions, etc.) and economical, budgetary and taxation policies;

b. HICP serves exclusively for international comparison of the rate of inflation between Member States and for setting monetary policy at the EU level.

shares led to a spiralling of wage and price pressures that moved steadily upwards. This eventually led to the conclusion that just stabilising inflation, once it had reached a level high enough to significantly affect economic decision-making, was simply not a viable option.

Price stability plays a dual role in modern central banking. It is both an *end* and a *means* of monetary policy. Fundamentally, price stability preserves the integrity and purchasing power of the nation's money. When prices are stable, people can hold money for transactions and other purposes without having to worry that inflation will eat away at the real value of their money balances. Equally important, stable prices allow people to rely on the dollar as a measure of value when making long-term contracts, engaging in long-term planning, or borrowing or lending for long periods. As economist Martin Feldstein has frequently pointed out, price stability also permits tax laws, accounting rules, and the like to be expressed in dollar terms without being subject to distortions arising from fluctuations in the value of money.³ Economists like to argue that money belongs in the same class as the wheel and the inclined plane among ancient inventions of great social utility. Price stability allows that invention to work with minimal friction. In principle, the problem of inflation could be reduced by the practice of indexing euro payments such as interest and wages to the price level, but people seem to find indexing costly and avoid it when they can.

Although price stability is an end of monetary policy, it is also a means by which policy can achieve its other objectives. In the jargon, price stability is both a goal and an intermediate target of policy. As I will discuss, when prices are stable, both economic growth and stability are likely to be enhanced, and long-term interest rates are likely to be moderate. Thus, even a policymaker who places relatively less weight on price stability as a goal in its own right should be careful to maintain price stability as a means of advancing other critical objectives.

There is a relationship between price stability and the other two goals of monetary policy. First, price stability promotes efficiency and long-term growth by providing a monetary and financial environment in which economic decisions can be made and markets can operate without concern about unpredictable fluctuations in the purchasing power of money. As I have already noted, the dollar provides a reasonably secure gauge of real economic values only when inflation is low and stable. High and variable inflation degrades the quality of the signals coming from the price system, as producers and consumers find it difficult to distinguish price changes arising from changes in product supplies and demands from changes arising from general inflation. Because prices constitute a market economy's fundamental means of conveying information, the increased noise associated with high inflation erodes the effectiveness of the market system. High inflation also complicates long-term economic planning, creating incentives for households and firms to shorten their horizons and to spend resources in managing inflation risk rather than focusing on the most productive activities.

Research is not definitive about the extent to which price stability enhances economic growth. We do not have controlled experiments in macroeconomics, and inflation and growth are both endogenous variables that respond jointly to many factors. Nevertheless, I am confident that the effects is positive and see the international experience as at least consistent with the view that, in combination with other sound policies, the maintenance of price stability has quite significant benefits for efficiency and growth. That view appears to be widely shared among policymakers, as governments around the world have made extensive efforts to bring inflation down over the past two decades or so, with substantial success. More recently, the evidence has mounted not only that low and stable inflation is beneficial for growth and employment in the long-term but also that it contributes importantly to greater stability of output and employment in the short to medium term.

3. Financial Stability

Unlike price stability, there is no universally valid definition of financial stability. According to Jaime Caruana (2005), “although we benefit from a well structured framework for discussing and applying monetary policy, our judgment concerning financial stability is less advanced”. The approach of financial stability can be broadly made, if we refer to the situation in which the financial system can ensure the efficient allocation of savings towards investment opportunities and can face shocks without major perturbations or, in restricted sense, specific to the banking system, if we refer to the situation characterized by the absence of banking collapse and by the existence of a certain stability level of the assets’ prices, including the interest rates. Central banks are demonstrated to hold an important role in ensuring financial stability, although there have not been established patterns which would define the realization of this process, and in its analysis, economics uses intuition.

Both approaches involve an active role of monetary politics, but the relative importance associated to it is different. The first of the above-mentioned definitions, which presents the general functioning of the financial system, suggests that the prudential surveillance occupies the main role in the promotion of financial stability; the monetary policy is important from the perspective of the efficient allocation of resources in the way they contribute to the price stability. BCE and Eurosystem systematically monitorize the cyclical and structural evolutions of the banking sector of euro/EU area, as well as of other financial sectors. The purpose of this activity is to evaluate the possible vulnerabilities of the financial sector and its resistance to possible shocks.

The evaluation is made in collaboration with the surveillance agencies and national central banks in the EU, which have representatives in the banking surveillance Committee of SEBC. Inside of the BCE, the monitoring of financial

stability needs the significant implication of more departments (Financial stability - as a coordinating department, Economy, Operations, Foreign and European Relations and Systems of payment). The result of this action is annually published, for example, in the reports named *EU banking sector stability*, *Structural analysis of the EU banking sector* and in the annual reports of BCE.

On the other hand, if we define financial stability as being “the smooth” trajectory of interests’ rates, according to the second definition, monetary policy has a more important role, and the manoeuvre space concerning its instrument use (the monetary policy interest rate) may be the object of a limitation – thus, we could assist a conflict between price and financial stability.

Practically, the level of the increase of monetary mass, that of interest rate and the exchange currency may independently evolve, but are difficult to administrate at the same time. They are permanently involved in economy mechanisms, and the effects may be transitory or definitive, these effects depending on the intervention degree and its efficacy, as well as by the influence of the anticipation of different participants in economy.

The conflict between the growth of monetary mass and the level of the interest rate is a classic conflict also demonstrated in the modal IS-LM, so that the effects of the interest rate variation on monetary mass in manifested according to the period of time taken into consideration, and that is:

- *on short-term*, the fluctuation of the interest rates allows arbitrary actions between certificates and currency, since a growth of interest accelerates the growth of monetary mass, and a decrease slows it down. In short, the growth of interests stimulates the speculative demand of currency, while the decrease of interests diminishes this demand. This effect does not last forever and when interests stabilize themselves at a certain level, the anticipations which lay at the basis of speculative demand of currency stabilize in their turn and the arbitrary actions stop. The transitory effect of the variation of the interest rate disappears under these conditions.

- *On medium term*, an increase of the interest slows the increase of the monetary mass and the other way round. Thus, the level of the interest rate affects the demand of currency for transactions, but the effect is permanent.

In a functional economy, the reverse sense of variations of the monetary mass and of the interest rates doesn’t reflect a conflict of objectives. But, the transitory effect of the interest variations can hide its permanent effects. In case of incoherence in the behaviour of the monetary authorities, intern disagreements by which it is settled on the one hand the increase of the monetary mass, and on the other hand a certain level of the interest rate. In this case, the conflict cannot end unless one of the two objectives or both of them are modified directly or hidden at the same time.

Using the interest rate as an intermediary objective of monetary policy may be a risky solution for an unstable economy. That is because, if the interest rate

grows, then the investments will be reduced, and the economic growth disappears; but if the interest rate decreases a lot, then the inflation is high again. As a consequence, even for Romania, the duplicitary attitude towards this objective becomes evident, because:

- on the one hand, the monetary authority in the market economy has reduced possibilities in influencing the level of the interest rates, the influences of the central banks on this indicator is limited only to the short term operations on the inter-banking market.

- on the other hand, *the practice of the developed countries shows that it is easier to control the interest rate than the cash stock*, so only the objective of the monetary aggregates, but the interest rate may be indeed controllable only in the states with a well developed financial market through the operations on the open market.

The conventional point of view of the relationship between price and financial stability considers inflation as being the main source of financial instability. Previous experience seems to confirm this opinion, because most severe financial instability periods and crises at the level of the banking sector have happened at the same time with the periods of high rate inflation or even rapid inflation, either with intervals marked by recession as a result of adopting some inadequate measures for the tempering of the inflationist phenomenon by authorities.

Recent economic literature highlights the fact that, in nowadays economy, the reaching of a low and stable inflation has led to the creation of a new economic climate, which needs the serious reconsideration of the relationship between price and financial stability (Borio and Lowe, 2002). Nevertheless it has been proved that a low level of inflation does not represent a sufficient condition for ensuring long-term financial stability. According to Andrew Crockett (2002), the successful war against inflation has not brought as big "peace dividends" as economists hoped for. As such, a new battle field was adopted, the one famous for the combat of financial stability. In this sense, some Asian countries experience from 1997-1998 is highly obvious concerning the complexity of this relationship: in the periods anterior to the start of a financial crisis, it has been noticed the accumulation of some significant disequilibrium at the level of those states economies, despite the existence of a relatively high degree of price stability.

Recently, the high number of cases for payment incapacity noticed on the market sector of real estates credits in the USA has made turbulences comprise the credit market both in the USA and in Europe. In the newly created context, it is highly important to evaluate the measure in which the central bank has the capacity to ensure price and financial stability at the same time through using the available instruments, as well as the way in which the two stability categories may be reconciled under the hypothesis in which their realization needs the adopting of conflictual measures. There may appear a series of situations in which the need to

maintain financial stability may be more important than the objective to maintain price stability. The sudden evolutions of the interest rates for the recovery of price stability on short term will prove inefficient on long term if these contribute to the accumulation of some disequilibrium in other economic sectors. I must state again the fact that there are no universal rules in such situations- it is always necessary to take into consideration the features of each case.

4. How Capital Inputs Influence Price Stability and Financial Stability

The capital inputs are mainly determined by the liberalization of the capital account and by the high interest differential. The greatest advantages are given by the banking sector. The presence of foreign operators on the banking market determines a more stable financial environment and the improvement of the capacity to manage risks. At the same time, the rapid expansion of the credit may exceed the capacity of the banks to evaluate risks, thus leading to the increase of informational asymmetry which may result in a greater non-reimbursement rate.

At the macroeconomic level, the rapid expansion of the credit stimulates the aggregated request, thus generating inflationist pressures and contributing to the accentuation of the external disequilibria. If the inflationist pressures have been generally successfully counteracted by the monetary policy in all the regional countries, on the other hand, the external disequilibria have significantly increased in the Baltic States, Bulgaria and Romania, countries which have registered the most rapid increase in credit in the last five years. In spite of all these, the central banks have difficulties in trying to restrict the credit expansion, both because of the fact that the moderation of the increase of the credit in national currency throughout a restrictive monetary policy may lead to its replacement with the foreign currency loans, and because of the fact that the administrative measures meant to limit the exposure capacity of the banks may determine the externalization of their exposure towards the “mother” banks.

The large current account deficits are dangerous because they are associated with a greater risk of producing an abrupt adjustment of the exchange rate and the high volatility of the exchange rate has major implications in the monetary and macroeconomic stability, in general. The evaluation of the sustainability of current account deficits of the countries from Central and Eastern Europe is difficult, while the presence of the external disequilibria is absolutely natural in the case of countries which find themselves amidst the process of real convergence. Despite all, there is the possibility for the excessive external deficits registered by some countries to continue generating risks over the macroeconomic stability.

Regarding the risks over the financial stability, the specialized literature confirms the fact that the accelerated expansion of the credit is one of the warnings regarding the appearance of financial turbulences but without leading to the materialization of these crises. The standard warning thresholds of the specialists, as

well as the annual increase rhythm of the financial brokering with more than 5 percentage points from the GDP over a period of 5 years (Demirgüç-Kunt and Detragiache, 1997), beyond which the probability of generating a crisis increases significantly, have been exceeded by the evolutions registered in Bulgaria, Croatia, the Baltic States and Slovenia.

At first sight, the banking prudence indicators from the countries in Central and Eastern Europe, such as the capital adequacy rates and the non-performing credits weight of the total loans have maintained at comfortable levels and, regarding the second situation they even improved in the last years. However one must bear in mind the high volume of new credits which may artificially decrease the non-performing credits weight and thus mask the quality problems of the credit portfolio.

Table 1. Prudent indicators

	non-performing credits/total of credits		the capital adequacy rate		ROE		ROA	
	2002	2006	2002	2006	2002	2006	2002	2006
Bulgaria	2,6	2,2	25,2	14,5	14,9	24,4	2,1	2,2
Croația	10,2	5,2	17,4	13,6	13,7	13,0	1,6	1,5
Republica Cehă	8,1	4,1	14,2	11,4	27,4	19,4	1,2	1,2
Ungaria	2,9	2,5	13,0	11,3	19,8	29,0	1,4	1,9
Polonia	21,1	9,4	13,8	14,0	5,5	22,2	0,5	2,1
România	1,1	2,8	25,0	18,1	18,3	10,2	2,6	1,3
Slovacia	7,9	3,7	21,3	13,0	11,5	16,6	1,2	1,3
Slovenia	3,9	2,5	11,9	11,1	12,6	15,1	1,1	1,3

Source: IMF Global Financial Stability Report, October 2007

The structure of the credit's dynamics presents supplemental risks over the financial stability, except for those which derive from the actual expansion of loans. Thus, the increase rhythm of the consumption credit has exceeded the rhythm for investment credits in most countries in the region. This means that risks are mostly associated with the people's households, which lack the necessary experience for managing the risks which derive from the high degree of indebtedness. Moreover, the foreign currency loan weight is maintained high in some countries in the region under the condition of the real and nominal appreciation tendencies and of the availability of the foreign currency funds due to the inflows of capital. These evolutions might increase the vulnerability associated to the non-correlation from the perspective of the denomination currency of the incomes and payment liabilities, especially in the context of abrupt correction risk of the external disequilibria.

The decisions which must be taken in the context of the overheating danger following the capital inflows are difficult. These decisions must be based on the economic objectives of the respective country and it is imperative to take into consideration the exchange rate regime, the institutional constraints as well as the determinants and structure of the capital inputs. Often the decisions are based on incomplete information, especially in the early stages of a capital inflow episode, when it is difficult to evaluate the nature of these inputs, the extent to which they are temporary or permanent.

The capital inputs generate a possible vicious circle of monetary policy as it

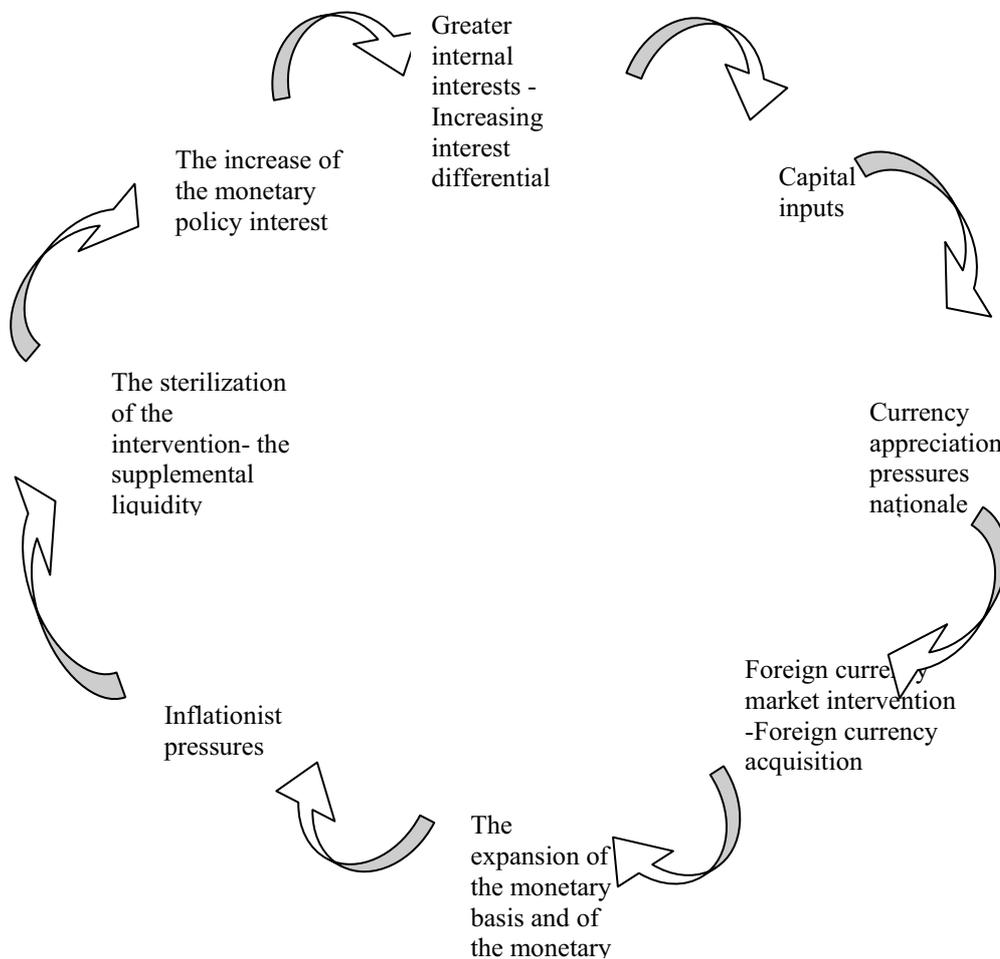


Figure 1. The vicious circle of the monetary policy

may be noticed in Figure 1.

The attempts of the monetary policy to diminish the pressures regarding the sudden appreciation of the currency may result in failure because of the impossible trinity which a monetary independent policy, the free circulation of capitals and a fix rate form.

The floating rates which respond to the idea of free movement have generated a series of serious phenomena in a globalize economy:

- a powerful short-term volatility of the exchange rate which is not connected to the real economic movement;
- important deviations of the real exchange rate in relation to the parity of the purchasing power;
- destabilizing speculations (speculative bubbles);
- lack of financial discipline both internally and internationally.

The exchange rate of the national currency has an important symbolic role because it appears as *an expression of the economic power of the nation and as a support of the national dignity and pride*. However, the re-appreciation of the national currency may have a negative impact over exports, discouraging them while its depreciation may constitute a propelling factor of exports. The re-appreciation reduces the competitiveness of its own products in export and represents a handicap for national companies, while the depreciation represents “an export bonus”.

The exchange rate plays an essential role in defining the economic and financial strategy of a government, which has important consequences:

- Its maintenance at a too low level encourages the inflationist pressures and allows enterprises to survive without too many efforts, thus promoting a relaxed short-term policy having to pay the price of affecting the industrial capacity of the state on a long term and of relatively reducing the living standards of the members of the society.

- Sustaining the exchange rate at a too high level equals with imposing some deflationist measures over the economic agents, which leads to the disappearance of a certain number of enterprises which are incapable to adapt and, implicitly generates the deceleration of the increase. On the other hand, maintaining an overvaluated rate under the condition of an obvious disequilibrium of the payment balance means using appreciable currency reserves.

The attitude towards the level of the currency rate is however characterized by pragmatism, as many states overcome doctrines. Therefore, the German experience has demonstrated that a relative monetary overvaluation has decelerated the inflation and has forced enterprises to constantly invest in order to be competitive. On the other hand, the British experience of the powerful currency policy has determined a stagflation state which has lead to the degradation of the financial situation of the enterprises, the erosion of the industrial capacities concomitantly with the imports expansion.

Resuming the vicious circle of monetary policy this may be integrated in a general diagram (figure no.2) which represents the way in which the vulnerabilities and macroeconomic disequilibria generated by the massive capital inputs may trigger a crisis with negative effects both over the price stability and over the financial stability.

As previously mentioned, one of the characteristics of the economies from Central and Eastern Europe represent the predominant role of the channel of the exchange rate in the transmission of the monetary policy, as a consequence of the

high degree of commercial opening and still insufficiently developed financial systems of this country. The capital inflows increase the efficiency of this transmission channel of the monetary policy, insuring a low inflation rate in an extremely short period of time, both directly, through the lowering of import prices and indirectly, through the effects over the net exports and implicitly over the aggregated request. However, though it is beneficial on a short-term, the excessive use of this transmission mechanism risks becoming a two-edged weapon because it can deepen the external disequilibria and may increase the vulnerability towards the reversibility of the capital flows which may be sometimes produced through the simple change of the investors' feeling.

Thus, there may be situations in which the decrease of the interest rates may prevent the sudden appreciation of the exchange rate, but such a monetary policy action would be incomparable with reaching the inflation target.

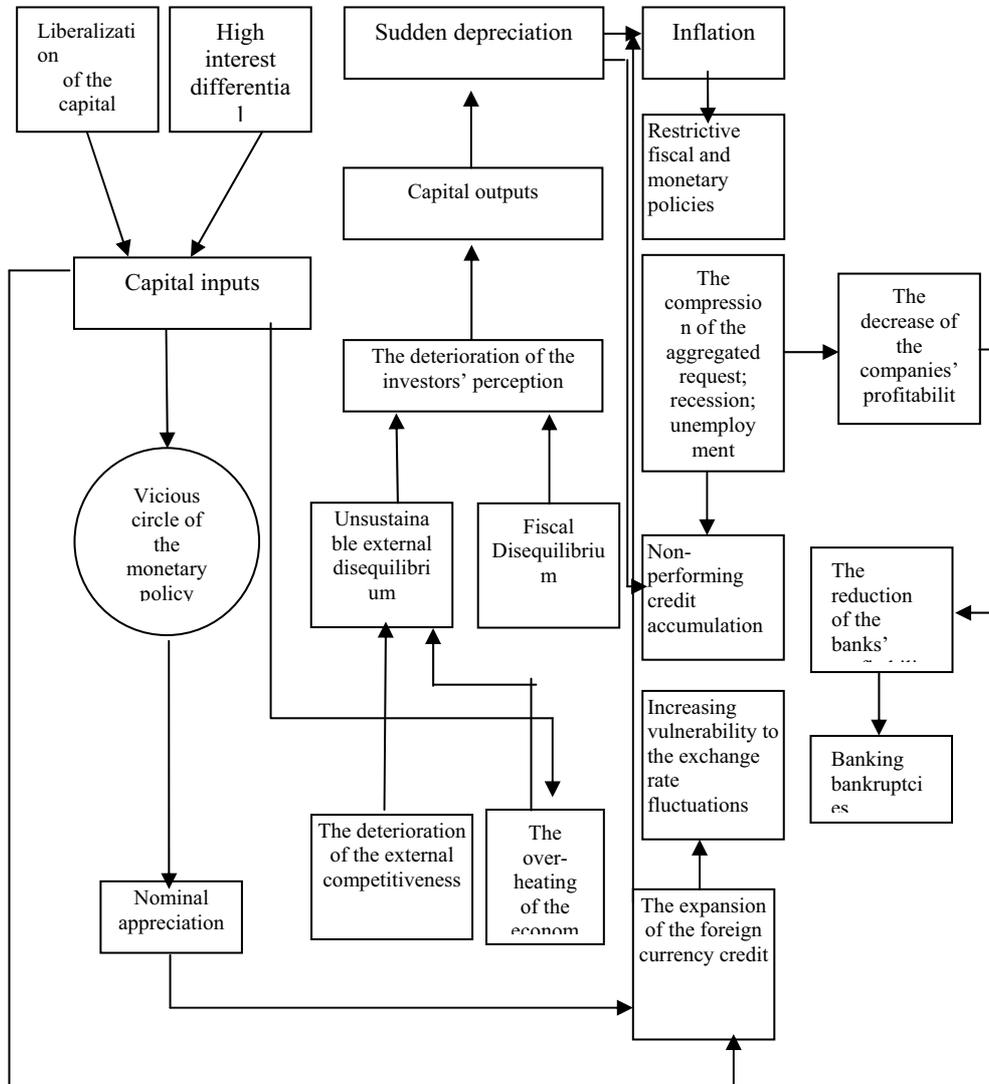


Figure 2. Vulnerabilities for price stability and financial stability Induced by the capital inputs

In the terms of some powerful capital inputs, the currency will continue to appreciate itself, and the external competitiveness of the economy will erode itself. The imports will increase in a more supported rhythm than the exports, thus contributing to the expansion of the aggregated demand. The current account deficit would be able to reach unsupportable levels as a reflection of the increase of the aggregated demand. In case these evolutions will be counteracted in due time by implementing some measures of enforcement of the fiscal and incomes policies, the

investors' mood can modify, which will determine foreign capital withdrawal. It was observed that the amplitude of these capital outputs can exceed the authorities' capacity to protect the national currency value and can amount to an abrupt correction in the sense of the depreciation, a foreign currency crisis respectively.

It is obvious the way in which the sudden depreciation influences the price stability / the effect is both a direct one, through the import prices, and also an indirect one, through the alimentation of the inflationist expectancies. Just as obvious is also the reaction of the monetary policy, whose main objective is represented by the price stability. A more restrictive conduit of the monetary policy will lead to the compression of the aggregated demand, pushing the economy towards the recession and generating unemployment.

The financial stability can also be affected by the foreign currency crisis, and the restrictive policies meant to restore the price stability might have a contrary effect. In case the public opinion perceives the appreciation of the national currency as a long term phenomenon, the preference for the loans in foreign currency becomes unavoidable, conditions in which the monetary policy will no longer be as efficient as it was. Still, as we have previously pointed out, an abrupt correction in the sense of the depreciation might lead to a deterioration of the balance situation of the households and companies, whose net wealth will decrease.

The health of the financial sector will also suffer from the constraints from the real sector. A great deal of the bank credits will become non-performing within the non-achievement of the mature payments by the economical agents. The problems related to the maturity non-correlations in the balance sheets of the banks would add to the significant, already existing, balance sheet non-correlations from the perspective of the currency of denomination of the incomes and payment obligations, risking transforming in a generalized financial crisis

5. The Relation between Price Stability and Financial Stability: The Romanian Situation

Romania's economy shows "clear signs" of overheating and estimated GDP growth for 2008 and 2009 is "somewhat optimistic"

In the Notice of the EU Council regarding the updated convergence programme of Romania for the period 2007-2010 is stated that "Romania has registered a strong economical growth, meaning 6.5% in average annually between 2003 and 2006.

However, its very performing economy gives very clear signs of overheating, presenting a high external deficit and still growing (estimated at nearly 13% of GDP in 2007) and a reduction in financing from FDI (foreign direct investment), despite the high investments other than those relating to privatizations, but still attenuated due to higher proportions of capital's contributions on medium

and long term, according to information available at present for 2007 ", it says in the opinion of the Council.

The deficit of employment, still high, strong wages growth and fast development of credits are other signs of overheating. EU document also shows that the magnitude and quick worsening of the external imbalance are alarming, as it proves a trend of depreciation of the leu since the middle of 2007, in the context of a general reassessment of the risks on international financial markets.

Also, the programme forecasts regarding inflation seems also to be very pessimistic. "Strong inflationary pressure due to wage growth (including the salaries of public functions), quickly growth of international prices of foodstuffs and consumer goods, as well as the lower exchange rate (after a long period of appreciation) suggest a more pronounced slowdown of the disinflation process. Thus, it is estimated that the inflation differential (HICP) against EU-27 will stabilize or will not be reduced only slightly during the analyzed period.

Generally, there is the possibility that the combination of policies set in the program will not determine the progress towards nominal convergence, it says in the evaluation of the EU Council.

It is unacceptable to ensure price stability, the most important objective of central banks, sacrificing financial stability or allowing an excessive external imbalance. "Between a quick disinflation, but unsupported, and a stable macroeconomic and financial consistency, it is wise to choose the second variant. In this way we will get for sure to the price stability "said Isarescu (2008) the Governor of National Bank of Romania. Central Bank estimated recently, an inflation of eight per cent to end of the first quarter of 2008, respectively 3.8 percent for the full year 2008. Isarescu has given assurance that, after the first quarter of the year, will go on a downward trend as regards inflation, which will continue in the second half of the year.

"We do not forecast a major increase of the oil's price on international markets, but no major decline," said Isarescu (2008), who mentioned among the causes of high inflation, registered starting at the end of the third quarter of last year, the continued effect of weak agricultural production in 2007, and the fact that we had a more pronounced depreciation of the national currency, a higher level of international oil prices and persistent excess demand.

"Current account deficit remains an important issue. In view of the central bank, correcting the external deficit has become unavoidable. And an increase of 1 per cent of the current account deficit is costly, because one of the criteria of that corrections is a plus of inflation", has warned Isarescu (2008).

Annual inflation rate was at 6.57 percent at the end of last year, compared to 4.87 per cent in December 2006.

6. Conclusion

In this paper we will try to show that the theoretical argumentation according that the two types of stability sustain and mutually potentiates on long-term, is fought against by the reality of the fact that starting with the inflation stabilization at low levels, it is creating a new economic environment in which monetary policy has a greater role, and using its tool (interest rate of monetary policy) may be subject to limitation - so we could see a conflict between price stability and financial stability.

We also will bring up the need for the exchange rate appreciation of national currency because the massive capital inputs worsening macroeconomic imbalances and vulnerabilities in host economies, with potential to generate crises with adverse effects on both, price stability and financial stability.

Price stability contributes to:

2) Price stability take into account limitation of price increasing or decreasing on the Single Market;

3) Price stability allows to the companies and consumers to substantiate much better their consumption or investment decisions;

4) Marketing resources will be allocated more efficiently (lower risks, higher productivity);

5) Thus, price stability increases the productive capacity of the European economy;

6) Price stability makes the risk premium included in the interest rate to be very low, which significantly decreases the cost of financing;

7) The absence of a higher inflation rate makes investment in real assets (stocks of goods) to be much lower, investments in real assets are not the best investment decision;

8) Price stability decrease the twisted effect on taxes and social contributions;

9) Price stability decrease demand for cash on the market;

10) Price stability decreases the differential redistribution of income and wealth in the economy.

Price stability has a dual role in monetary policy. Stable prices are desirable in them and thus are an important target of monetary policy. But stable prices are also a prerequisite to the achievement of the Federal Reserve's other mandated objectives, high employment and moderate long-term interest rates. In particular, low and stable inflation and inflation expectations enhance both economic growth and economic stability.

The complementarity of price stability with the other goals of monetary policy is now the consensus view among economists and central bankers. That consensus has not been achieved easily, however, but is the product of many years of policy experience, policy leadership, and sustained economic analysis.

7. References

1. Archer, D. (2005): Central-Bank Communications and the Publication of Interest Rate Projections, paper presented at Sveriges Riksbank conference Inflation Targeting: Implementation, Communication, and Effectiveness (Stockholm, June).
2. Blinder, A., Morgan, J. (2005): Are Two Heads Better than One? Monetary Policy by Committee, *Journal of Money, Credit, and Banking* 37(5, October):789-812.
3. Borio, C. and Lowe, P. (2002): Asset prices, financial and monetary stability: exploring the nexus, BIS, Studies book no.127
4. Caruana, J. (2005): Basel II – back to the future, speech presented at The 7th HKMA Distinguished Lecture, Hong Kong, (4, February)
5. Crockett, A. (2003): Central banking under test?, speech presented at the conference Monetary Stability, Financial Stability and the Business Cycle, The Bank for International Settlement, Basel, (28-29, March)
6. Friedman, M. (1968): The Role of Monetary Policy, *American Economic Review* 58(1, March): 1-17.
7. Isarescu, M. (2008): Issues of monetary policy in a country emerging. Romania, speech presented at Royal Academy of Economics and Finance, (21 February).
8. Isarescu, M. (2008): Slaughter financial stability, an unacceptable price for Romania, *Romania Libera*, www.romanalibera.ro/a118661 (25, February).
9. Phelps, E (1968): Money, wage dynamics and unemployment equilibrium, *Journal of Political Economy*, 76 (4), Part 2, pp 678-711.
10. Popa A. and Bandoi A. (2008), *Theory and Monetary Policy* (Universitaria, Craiova)
11. Selgin, G (1997): Less than zero. The case for a falling price in a growing economy, IEA Hobart Papers 132, Institute of Economic Affairs, London.
12. *** Notice of the EU Council regarding the updated convergence programme of Romania for the period 2007-2010.