THE ROLE OF FINANCIAL STABILITY IN THE STATE REGULATION OF MONETARY PROCESSES

Bayarsaikhan Zolzaya
Postgraduate student, the department of Financial Markets And Banks,
Financial University under the Government of the Russian Federation

Peter Kovacs
Professor, University of Szeged, Hungary, *kovacs.peter@eco.u-szeged.hu*

Purevsuren Munkhtuya
PhD, Head of the department of "Economic statistics and mathematical modeling"
Mongolian University of Life Sciences

Abstract

This paper focuses on the role of financial stability in the state regulation of monetary processes in a modern economy. There were shown the role of financial stability by cross-country, to show the dependence of the role and the economic development of countries. It is also an attempt to develop a function of monetary policy targets taking into account the financial stability. The results allow us to suggest a new monetary policy function, which takes into account not only GDP, inflation, and exchange rate, but also financial stability, one of the most considering issues in nowadays economy.

INTRODUCTION

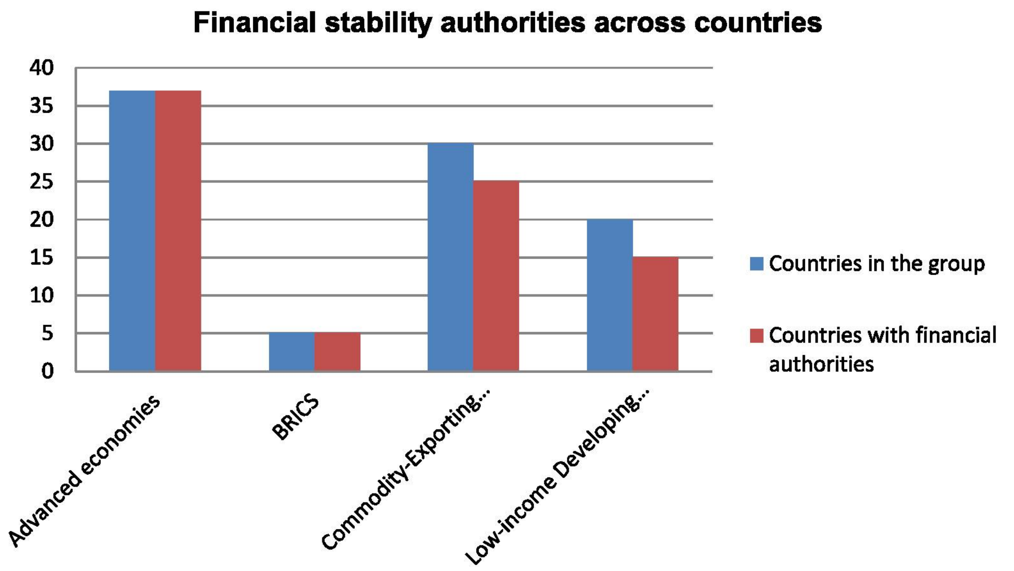
At the present stage of development of social and economic relations, economists, both practitioners and theoreticians, in monetary regulation take into account not only money, credit, and exchange rate issues, but also financial stability. Despite the fact that financial stability was considered in regulation of monetary processes by theoreticians in the last century, only the last financial and economic crisis and the subsequent recession drew the attention of most economists to this issue.

Nowadays economists pay special attention to such economic schools as the new synthesis, new monetarism, post-Keynesianism and the Austrian economic school, among the existing. It should be noted that if post-Keynesianism and the Austrian economic school have been formed for a long time, the new synthesis, that dominated the monetary theory from the 90's of the XX century, after the crisis of 2007 is updated, including questions of financial stability in its theory, and a new monetarism is only having been formed on the basis of monetarist doctrines. A distinctive characteristic of all these schools is that they consider in their theories finance, financial stability.

Before the Bank of England published the Financial Stability Review in 1996, the term "financial stability" was not widely used. However, despite the fact that today this term is not only widely used, but also used to reflect one of the main goals of the monetary policy of some countries, there is still no generally accepted definition of this concept. Nevertheless, in our opinion the most accurate and complete interpretation of this concept was proposed by G.J. Schinasi: "Financial stability is a situation in which the financial system is able to perform its three key functions simultaneously. First, the financial system efficiently and uninterruptedly distributes resources from savers to investors and the distribution of economic resources in general. Second, the possible financial risks are estimated fairly accurately and continue to be relatively well regulated. Third, the financial system is in such a state that it can calmly, if not smoothly, absorb financial and real economic surprises and shocks " [1].

Analysis of the literature shows that the financial system is understood as the complex of three elements. First of all, these are financial institutions, which are banks, insurance companies, institutional investors, etc., which direct funds from those who want to invest to those who want to borrow. Also, as the elements of this system are considered money, stock and other markets, where the interests of creditors and borrowers intersect. In addition, the financial system includes the financial infrastructure of the market, i.e. payment systems, security systems of settlements, etc., through which money and financial assets pass between sellers and buyers. The development of the economy in modern conditions requires stable uninterrupted operation of all three elements of the financial system that have a positive impact on economic activity.

In recent years, "the achievement and maintenance of financial stability" include many monetary authorities of the world in their monetary policy goals. This change in views on monetary policy was conditioned by the experience of the global financial and economic crisis. According to our research, the monetary authorities of all the central banks of the advanced economies, as well as the BRICS countries, 83.3% of export-oriented countries and 75% of low-income countries have financial stability regulators (according to the classification of the countries of the International Monetary Fund). This suggests that with the economic development of the country more actively take financial stability as one of the main issues in the regulation of monetary processes.



However, this does not mean that the monetary authorities did not know about the key role in the economy played by financial stability. According to the former chairman of the US Federal Reserve, B.Sh. Bernanke, the whole point is that before the crisis there was not enough "macroprudential or system-wide view" [2].

Professor of Columbia University Mishkin believes that the financial sector and macroeconomics, as well as monetary policy and financial stability are closely interrelated, while notes that using tools of monetary policy is difficult to achieve such a goal as financial stability [3].

C Benoit, a member of the ECB's executive board, ranks the goals of monetary policy as follows: the main goal of monetary policy is to ensure the stability of the price level in the medium term, and short-term goals are to maintain stability of economic growth and the financial sphere [4].

Thus, the economist shows his approach to modern monetary policy - the stability of the price level is most important, and the remaining tasks are of secondary importance. Meanwhile, as practice shows, a low and stable level of prices does not provide a guarantee of financial stability, and consequently, an efficient functioning of the economy. Therefore, in modern conditions, scientists and economists are actively discussing how to ensure financial stability and price level stability at the same time.

It should be noted that there are also other views, according to which monetary and financial policies need to be considered separately. Supporters of this approach argue their position by the fact that monetary and financial policies have different goals and different tools to achieve them. One of the economists who adhere to this approach is L. Svensson. According to the scientist, the main goal of the monetary policy should be flexible inflation targeting, in which all information about financial conditions related to forecasting inflation must be taken into account [5].

There are also views on the relationship between monetary policy and the financial system, according to which the degree of their relationship depends on the level of development of the latter. Supporters of this approach argue that the developed financial system, the more it is able to absorb financial stress, because and households and firms in today's conditions can replace banks with financial markets, thus benefiting from the so-called paired engines of the financial system. As a result of his analysis, R.J. Rajan and L. Zingales [6].

METHODOLOGY

However economists agree on importance of the financial stability, there is still no consensus on whether to include financial stability in monetary policy or it should be considered in parallel with it, and Analysis of the possibility of determining the reaction of real short-term interest rates, taking into account the factor of financial stability and/or instability gives the following results. The original model is as follows:

if so, by what means and methods. In our opinion, the solution of this question may be the expansion of the Ball's rule [7].

$$i_t = \alpha(\pi_t - \pi^*) + \beta(y_t - y^*) + \gamma q_t + \delta q_{t-1} \quad (3)$$

где $\alpha, \beta, \gamma, \delta$ – the significance of the indicator

i_t – nominal short term policy rate at the time t
π_t – inflation rate at the time t
π^* - targeted inflation rate at the time t
y_t – real growth of GDP
y^* - nominal growth rate of GDP
q_t – real effective exchange rate at the time t
q_{t-1} – real effective exchange rate in the previous period

To derive a model of monetary policy, where the financial state will be taken into account, it is necessary to introduce a variable of financial stability. As such variable, we take the financial instability index (FSM), which we obtained by finding the overall measure of financial instability based on the methodology of the Central Bank of Mongolia. According to this methodology, the closer the indicator to 1, the greater the financial instability. Therefore, if to insert this indicator into the equation for the reaction of real short-term interest rates in an open economy, then the greater the instability of the financial market, the greater the interest rate will be. Thus such a monetary policy will increase economic growth by reducing inflation.

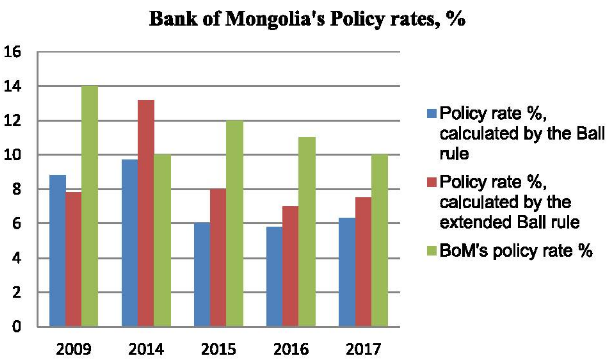
As a result of the expansion of the Ball equation (initially the Taylor equation), we obtain the equation for the reaction of real short-term interest rates under current conditions (5):

$$i_t = \alpha(\pi_t - \pi^*) + \beta(y_t - y^*) + \gamma q_t + \delta q_{t-1}) + \tau(1 - FSM) \quad (5)$$

где τ – the significance of the financial stability indicator

RESULTS

The application of this rule on the example of Mongolia's monetary policy shows that the key policy rate of the central bank of Mongolia is overstated, which may be the reason for the delay in economic growth. The analysis shows that inclusion of the financial stability indicator raises the interest rate, however, the real established rate is overestimated even in this case. Such a policy of expensive money with low inflation rates of 1-2% may become a deterrent to economic growth. Exceptions are 2009 and 2014, when there was a high difference in nominal and real GDP growth, and high inflation at 9%.



Authors' calculations on the basis of the BoM's data [8]

It should be noted that there is a trend towards a lowering of the interest rate of the central bank, which is a positive factor in the state regulation of monetary processes. Nevertheless, it is still very much overestimated, as indicated by the analysis.

CONCLUSION

The function we obtained reflects the reaction of real short-term interest rates as response to changes in inflation, GDP, exchange rate and financial stability or instability indicators. However, it should be noted, as the Taylor's rule does not reflect unconventional methods of monetary policy, they are also not taken into account in the extended equation. In addition, since the monetary authorities do not have instruments to directly affect financial stability or instability, and the interest rate is not the mean to do it, it becomes necessary to carry out a comprehensive analysis and regulation of the financial system as a whole, i.e. macroprudential regulation.

REFERENECES

[1] G. J. Schinasi, Safeguarding financial stability: theory and practice, Washington D.C.: International Monetary Fund, 2005, p. 82.

[2] B. B.S., "federalreserve.gov," 22 August 2008. [Online]. Available: Bernanke B.S. Reducing Systemic Risk / Speech at thehttp://www.federalreserve.gov/newsevents/speech/bernanke20080822a.htm. [Accessed 18 April 2018].

[3] F. S. Mishkin, "Monetary policy strategy: lessons from the crisis," *NBER working paper,* p. 62, February 2011.

[4] B. C., "ecb.europa.eu," 17 May 2013. [Online]. Available: http://www.ecb.europa.eu/press/key/date2013/html/sp130517.en.html. [Accessed 18 April 2018].

[5] S. L., "Monetary policy after the financial crisis," in *International Journal of Central Banking*, Tokyo, 2010.

[6] Z. L. Rajan R.G., "The great reversals: the politics of financial development in the twentieth century," *Journal of Financial Economics,* vol. Vol. 69, pp. 5-50, 2003.

[7] B. L., "Policy rules for open economies," *NBER working paper No. 6760,* p. 30, October 1998.

[8] "mongolbank.mn," [Online]. Available: https://www.mongolbank.mn/eng/default.aspx.

[9] S. T. Jakubik P., "Measuring Financial (In)Stability in Emerging Europe: A New Index-Based Approach," *Financial Stability Report (Journal of Austrian Central Bank),* vol. Vol. 25, pp. 102-118 June 2013.