MONETARY POLICY AND PARALLEL FINANCIAL MARKETS

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Abstract

Monetary policy is one of the economic policy "tools" through which it acts on the currency demand and supply in the economy. The importance of monetary policy results from its primary objective - price stability, plus limiting inflation and maintaining internal and external value of the currency. Responsibility for achieving these objectives rests with the Central Bank, which has a monopoly in the formulation and the implementation of monetary policy targets. Price stability is the primary objective of monetary policy and also the central objective of economic policy, alongside with: sustainable economic growth, full employment of labor force, balance of external payments equilibrium. To achieve these overall objectives of economic policy, monetary policy acts through currency as an instrument of action and it represents the overall action exercised by the monetary authority to influence economic development and to ensure price stability. In economic processes numerous factors emerge to the sale or purchase of capital available for a shorter or longer period and to achieving their aspirations of maximize capital gains, they are negotiating, they are confronting and agreeing within specific market relationships.

The entirety of relations between various economic issues, enterprises and individuals, between them and the banking intermediaries, as well as the relationship between banks and other credit institutions on the transfer of cash money as specific form of debt and fructification of capital, form capital markets or credit markets.

These markets are carved up according to the nature and purposes of the participants.

Keywords: *structural objectives, operational objectives, monetary variables, bond market, credit market, placing capital, capital circuit.*

1. Introduction

Monetary policies in all countries and in all periods aimed primarily the currency stability, maintaining it at a relatively constant value and purchasing power. Monetary policy can not directly lead to currency stability, no matter how good legislation.

Monetary policy is conducted according to the play of economic forces and the principle of self-regulation.

Effective monetary policies are based on the idea that money embodies cash flows that occur during transactions and domestic and international economic processes. All these flows and exchanges are met in the stability and growth, in balance of payments, in trade balance surplus or deficit of the state. In turn, all these phenomena and economic processes related to the central bank of issue of a country. Any imbalance between transactions, cash flows, either internally or between two or more countries - so internationally, conduce to a currency-based solution, which not only affects the stability and purchasing power of the currency, as well as foreign exchange reserves and the economic power of the one supporting the unfavorable operations.

Monetary policy stands in the global action of the state by specific tools and methodologies on the main economic variables: prices, GDP, employment of labor (unemployment rate), the balance of the balance of payments etc. This action shall be exercised by handling monetary variables, ie certain sizes that are themselves difficult to control, but that monetary policy aims to influence. The target of monetary policy consists of so-called "intermediate targets" such as interest rates, monetary aggregates, the volume of bank credit and the exchange rate.

But in addition to these issues, monetary policy means the multitude of possibilities to act on the currency by currency.

Price stability is the primary objective of monetary policy and also the central objective of economic policy, with sustainable economic growth, full employment of labor and balance of payments equilibrium. To achieve these overall objectives of economic policy, monetary policy acts as an instrument of action by currency and represents all measures exercised by the monetary authority to influence economic development and to ensure price stability.

The government has approved a series of austerity measures due the financial crisis, without aproper analysis of medium and long term effects over economy and population. One of theme asures was the instatement of the minimum income tax that each firm had to pay no matter the profit or loss it had obtained during the financial exercise.[1]

After creating and expanding European Community, later the European Union by the Treaties, EU institutions and Member States were obliged to pursue a policy of deregulation and then abandoning

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[1] Adrian Stefan-Duicu; Viorica Mirela Stefan-Duicu, *Income tax shifts-causes and effects on Romanian enterprises*, Lex ET Scientia International Journal, 2011.

the monopoly structure, which were organized around the major public services. Thus, in the '80s, states have tried a new technique to finance their public infrastructure needs, which they could build without debt.[2]

2. Content

The contemporary era has long given up the concept of monetary neutrality which in the past hid the essence of monetary relations, so that now monetary policy is recognized as an essential component of economic policy. In a market economy, politics is a deliberate intervention of the state in the economy in order to accomplish certain goals of structural or of a certain juncture nature.

In all market economies the state is considered the center of the policy makers and their promoter under the control of parliament who instructs the administration to execute such orders[3].

Because "interim targets" are quite diverse, it is necessary to choose among them some "operational objectives" i.e. monetary variables that authorities can influence in an effective manner with the tools at their disposal. The interbank interest rate or "exogenous monetary base" are targets in a higher extent under the jurisdiction of monetary authorities than, for example, the interest rate on loans Debenture.

Regarding banking system, securitization is a financial transaction recovery of claims by an investment vehicle, which acquires, gathers and uses them to guarantee securities issues. The balance sheet of the banking institutions include in the active side the decrease of bank loans to all its customers, individuals and legal entities and liabilities, and in the passive side are included the deposits and customers current accounts and also, the loans contracted from other banks or financial institutions, plus the bonds issued by the bank, which, in fact means debts, too. In the context of balance sheet of the banking institutions, securitization means a kind of funding by securities issue.[4]

Finally, the monetary authorities have certain tools, i.e. processes that enable them to act on monetary variables. Some of these tools are direct and binding (credit control, foreign exchange control etc.), but in general, it is considered that they must rely on indirect mechanisms, which preserves the action of market laws and allow to subsist a certain adaptive capacity banking system as a whole.

So monetary policy works using tools on operational objectives, which in turn exerts some effects on intermediate targets, which allows achieving endpoints.

The main objectives of monetary policy are:

- Price stability and therefore of the national currency;
- Ensuring an increase in the number of the employees;
- An appropriate rate of foreign exchange;
- A high rate of economic growth.

To achieve these objectives are also necessary some constraints, which are all four:

- Prevent financial panics;
- Avoid excessive volatility in interest rates;
- Prevent certain sectors of the economy to bear the burden of restrictive policy;
- To gain and maintain the confidence of foreign investors. Goals or objectives are:

Price Stability

This target seems evident in any modern economy, but is far from being realized. Inflation is a danger for not properly redistribute income. Specifically, all salaries, contracts, laws, taxes and accounting procedures are adapted to inflation.

Rising inflation has three drawbacks:

- The maximum price and catalog prices are to be modified frequently;
- As long as the prices cannot be changed continuously, they are out of balance short periods of time between two changes;
- Inflation impels to keeping a very low amount of currency, for currency loses its preserved value without the benefit of a higher nominal interest rate than other assets.

Monetary policy takes into account that inflation cannot always be predicted correctly, and economically it neither can be fully indexed. For example nominal income (salary etc.) is more a subject to taxes than income from real interest.

Monetary policy tries to reduce inefficient allocation of investments fund for periods of inflation. It intends to reduce the impact of inflation on the distribution of income and wealth. Non-anticipation of inflation bother creditors and the retired persons and it's in favor of borrowers. The impact of inflation disadvantages employees if wages are following prices.

Inflation causes insecurity and uncertainty. Families cannot plan their future for a longer period for they do not know what real value will have their fixed assets. People are inclined to save but the lack of inflation anticipation punishes them severely.

Inflation increases government revenue over expenditure and monetary policy must determine the extent for that. The balance should not be broken as

[2] Stoica Emilia Cornelia –Financement des projets publiques par la technique PPE.

[3] Basno C., Dardac N., Floricel C-tin – "*Monedă, Credit, Bănci",* Ed. Didactică şi Pedagogică, Bucureşti, 2001 [Basno C., Dardac N., Floricel Constantin - *"Currency, Credit, Banking"*, Didactic and Pedagogic Ed., Bucharest, 2001].

[4] M. Sudacevschi, Ion Niti „ The Innovations on the financial matkets. Useing derivatives for banking market risk coverage"- *Internal Auditing & Risk Management, 2010.*

government is the largest debtor in the economy and therefore it wins from inflation. When inflation increases, the real value of government debt and the interest it has to pay is reduced.

The state has privileges in times of inflation also because the currency and bank reserves that it is holding.

Increasing the Number of Employees

Monetary policy aims as well increasing employment (avoiding unemployment), and determine its most appropriate level.

There are two selection criteria:

- The unemployment rate to be effective in terms of maximizing production;
- A minimum unemployment rate, determined on the basis of monthly tracking of families.

The last is uncertain and less effective, so ultimately lead to accelerating inflation. This is also because unemployment data may not be accurate. For example, are eliminated those who have given up looking for work or those who work part time are not counted partial unemployed.

The number of unemployed depends on the level and duration of compensation payments.

An Appropriate Rate of Exchange

It's taken as read that monetary policy must consider the increase in the exchange rate of the national currency (i.e. exchange rate). This leads to lowering inflation. Exporters win and the direct result is the entry of a larger amount of currency on the national market.

Economic Growth

Monetary policy contributes decisively to a constant rate of growth, which in turn promotes the growth of loans. To promote investment, monetary policy envisages a very real low interest rate. This measure must be accompanied by a restrictive fiscal policy, including maintaining a lower budget deficit.

Constraints:

Preventing financial panic

Financial panic and recession lead to increased unemployment, so no way to increase the number of employees, which was seen to be an objective of monetary policy. Those who bought assets on credit can sell their obligations by paying the creditors. As some of loan applicants fail because they cannot pay off loans, some of their lenders give themselves bankrupt (e.g. banks). Bank failures and their temporary inability to replenish were the main features of financial panics. To prevent financial panics in countries with developed market economy were created reserves (e.g. the USA - the Federal Reserve).

Interest rate stability

Keeping interest rates relatively stable is a monetary policy of balance, but peaks too high for interest rates should be prevented. Financial markets operate more efficiently if interest rates are stable. If increase of interest rates is to high, the value of banks and insurance companies portfolios decreases, which is equivalent to a loss of capital. Financial panics occur also because people have an aversion to risks. Therefore, they prefer to sell their assets at prices below their value. Unstable interest rates lead to fluctuations in exchange rates as well.

Burden on Some Economic Sectors

Tight monetary policy makes some sectors suffer more than others. The most affected sectors are products or services exporting sector and housing construction one.

Restrictive policy goal is to reduce the demand for resources, when this request is excessive and too inflationary.

Maintaining the Confidence of Foreign Investors

Monetary policy should pay more attention to how foreign investors respond to changes in monetary and financial market movements. If a country's assets are declining, foreign investors will withdraw their capital. They sell stocks and obligations held in the country. Therefore, prices of stocks and bonds reduce (increases supply). This cutting down of prices leads to reduced wealth and increased costs of investment and ultimately to economic recession.

The objectives of monetary policy largely overlap with those of fiscal policy to the extent that both are instruments of macroeconomic stabilization. Another possibility which monetary policy has to improve monetary circulation is budget constraint, namely its ability to finance from loans.

Debt, i.e. the budget deficit can be monetized (e.g. the currency issue and stabilizing interest rate).

In general, in a developed market economy monetary policy does not impose laws that increase or reduce aggregate demand.

There are two types of monetary policy instruments: general (indirect) and specific (direct) ones.

The former are used in most contemporary economies and acting on monetary mechanisms without blocking their operation. Thus handling re-discount fee, open market policy and required reserves policy intervention are general tools; they are based, each, on some logic inherent in a particular economic-monetary mechanism: the loan and its historical form - the discount (in re-discount case), financial market (in the case of open market policy), monetary creation (if required reserves policy).

The second category of tools are used only in certain countries and periods and acts directly on the financial position of commercial banks, imposing on them a certain conduct. The selectivity (routing) and rationalization (capping) of loans are coercive procedures that transform ordinary commercial banks in common credit distributor officers to economic sectors and branches designated by the state power, in proportions determined through administrative means.

At present, the general evolution of monetary policy is characterized by a return to indirect instruments, particularly those that rely on capital markets mechanisms and therefore, on the interest rate action.

Re-Discount Tax Policy

The usual discount rate is the interest rate for loans extended by the bank of issue within the re-discount operations.

The specific name comes from the fact that for a long time the main form of credit by the bank of issue was re-discount based on discount operations. Today the bank's lending operations have diversified and have other structures, but the bank of issue continues to fulfill in the economy the role of a source of credit, related to its main function of issue.

Open Market Policy

Open market operations are operations whereby the central bank buys and sells securities in the money market. Unlike re-discount, which relates directly commercial banks with the central bank, at the initiative of the former, open market operations allow the central bank to take the initiative and intervene in the money market, from which it supplies commercial banks with liquidity. The interest rate related to these operations forms on the mentioned money market – which the central bank can influence however -, that by modulating its cash contribution - achieved through purchases of securities they carry out and by modulating the withdrawal of liquidity - made by sales of securities they perform.
Open market policy is historically a natural companion to re-discount policy, both originating in the English economy where they were used complementary in order to ensure the desired direction of trends for liquidity, credit and interest.
This tool is applied by the National Bank of Romania who is all the time in the know of the price and interest rate. Also the N.B. of R. grants credit to banks for the recovery of economy, primarily the investment.

Required reserves policy

Required reserves are the primary currency availability that banks must preserve in their assets proportional to the aggregate deposits or other aggregate established by the monetary authorities. Determining the level of required reserves can be done by applying one or more coefficients differentiated by envisaged calculation basis. Thus, as a general rule, for deposits is used a type of coefficient, another factor for term deposits, etc.

Required reserves policy effectiveness depends on the degree of dependency of the commercial banking system to the central bank.

NBR has the capacity to float reserve requirements within certain limits. Increasing reserve requirements affects the money stock (e.g.: if reserves are in excess it's used the money issue).

If reserves are high, banks do not build up anymore deposits for individuals and body corporate or lower interest rates. In developed countries, the required reserve is not changed for decades.

Monetary Policy and Parallel Credit Markets

Money market or credit market comprises the available short-term capital and foreign exchange market, being also a bound compartment to capital flows to and from the outside. As stated, these markets are individualized by functional institutions and the conduct of transactions in these markets. But it is estimated, with good season that on the one hand the boundaries between these markets cannot be clearly defined and on the other hand, the links between these markets are really tight. Thus, events and trends in a market can influence the events and trends in other markets, the more so as since many participants operates in several markets and thus can transfer if deemed favorable, their participation in other markets. Between the two possible extremes respectively "permanent" hiring of capital by purchasing shares/bonds and loans from day to day, there is a differentiated range of ways of placing it in the capital or credit markets, different but gradually close to each other.

Money market or credit market works with large participation of the population, of companies and especially intermediaries of banks, institutions with broad functionality in this market.

The complexity of relationships within the monetary market leads to its specific segmentation, based upon the natural diversity of certain sides of the process of modernization and activation of available capital. The general credit market functionality is provided by the activity of some component markets, each of them with specific participants and specific operations.

The Relationship between Money Market and Classical Parallel Markets

In the money market we distinguish:

- Money market (the classic one);
- Parallel markets.

Money market, the so-called classic one has in fact several aspects:

- Money market or discount market;
- The actual money market.

The first state - money market or short-term discount market comprises a broad framework of the relationship regarding on the one hand the mobilization of monetary availability from companies, people, institutions of credit and on the other hand granting loans to companies or individuals. Specific credit periods in this market are at sight for maximum one year (US) or 18 to 24 months in the European banking systems. The resources that are mobilized on the market are usually current availability of firms and individuals, respectively balances of the call deposit accounts or current accounts.

Distribution of these resources is carried out by loans to companies in order to meet current needs related in principle to providing in advance the production costs or those related to the movement of goods from the producer to the distribution network. Also, families are beneficiaries to receiving loans mainly for the purchase of housing and consumer goods. Mobilization of availabilities and credit distribution is performed under market conditions, participants to transactions manifesting freely their preferences according to the best interest level that could maximize earnings.

In its second state - the actual money market, there mainly the banks lend to each other the amounts needed to square the interbank operations relations related to the liquidation of balances from mutual operations within 24 hours or more. This particular circuit of available capital has an important role in regulating and establishing record- setting monetary circulation and balanced functioning of the banking system. The smooth operation of the money market is closely related to savings market which can be considered an auxiliary market for the money market. The banks attract their customers based on permanent collaborative relationships and in competitive conditions, mainly resources from the sphere of the savings banks, credit unions, insurance companies, pension funds, investment funds, well-established institutions for mobilizing and specific fruition of an important part of the population savings[5].

Parallel markets were gradually formed in the aftermath of the Second World War, in specific historical and economic development circumstances, which led to structure new credit markets, independent in their operation and with restricted direct communication channels with the other markets belonging to the traditional credit markets. This is the origin of their name as parallel markets. The first existing parallel market in the developed countries is the Euro-currency market, Euro-currency is representing receivables denominated in the currency of a country that is used across national borders by non-residents.

The prefix "euro" initially reveals the location of this market in Europe for dollar-denominated resources (where the name of Euro-dollar comes from) is routinely used today to characterize all such operations carried out in the world, with the object mostly in dollars but pounds and yen as well etc.

The Euro-currency market is a credit market, its main mission is to mobilize and redistribute by credits, with the goal to best taking advantage of the existing availability in this market.

Direct participants in this market are the banks licensed in foreign currency operations, according to the laws of each country. Contracting and negotiations take place between banks independently of their nationality and borders, being agreed different loan terms and amounts and at the interest level appropriate to this market. Obviously, banks issue offers and extend requests in relation to the possibilities and needs of its own clientage. The Euro-currency resources of this market have different origins: exporters, large transnational companies, commercial and issuance banks of various countries, depending on their foreign exchange reserves. In their turn major credit recipients are recruited from importers and the categories listed above.

Euro-currency market plays a major role in the economies of developed countries; provides additional liquidity and related resources to companies' expansion and to the accomplishment of capital exportation. As a parallel market it leads to a significant increase of credit resources, countervailing the national policies and often accounting for inflationary stimuli.

Another parallel market is the market for credit between companies (intercompany market). This market has developed under the challenge of credit restrictions which at the beginning obstructed credit relationships in developed countries and that consisted in the advancement of significant amounts from some firms to others for a short term. This was a form of avoidance of intermediaries, called also disintermediation, which provided participants an extra yield profits at the expense of proper banking intermediaries.[6]

In England, these loans are brokered by specialized brokers between major companies (about 500) and the minimum circulated amounts are about £ 50,000, loans being actually negotiable.

In the US was created an instrument specific to this commercial market – papers, which are negotiable and represent values between 10,000 and $ 5 million USD with terms from 25 to 270 days. These instruments have grown in relevant rhythms, showing increased preference for this option as an expression of deleveraging processes.

In relation to the respective economic characteristics and to national banking systems, appear as parallel markets:

- Financial firms market, in connection with the formation and redistribution of resources for specialized operations as leasing, factoring and others;
- Mortgage market, in connection with the establishment of resources, especially through short-term loans, necessary for the activity of local authorities.

Thus, the nature and specificity of the operations in these markets will be mainly determined by credit institutions which act in those markets.

[5] Moşteanu Tatiana - coordonator, Buget şi trezorerie publică, ediţia a III-a, Editura Tribuna Economică, Bucureşti, 2002 [Moşteanu Tatiana – Content master, Budget and Treasury 3rd Edition, Economic Tribune Publishing House, Bucharest, 2002].

[6] Văcărel Iulian – coordonator, Finanţe publice, Editura Didactică şi Pedagogică, Bucureşti 2003.

It is also useful to remember that markets function scope is elastic, in some cases difficult to mark off, while banking brokers' functionality has boundaries and precise sequence rules paramount to knowing and understanding the mechanism of credit.[7]

Considering of the credit process through point of view of market functionality provides a general guidance allowing positioning and receiving concrete knowledge about banking intermediaries in overall connections of the financial market. Monetary authority supervises the money supply in the economy through monetary policy implementation. The changes occurring in the money supply as a result of applying one of the instruments of monetary policy causes a range of transmission effects that lead ultimately to increase or decrease of the demand in the goods and services market.

Long-term stabilization of prices and therefore inflation is the most important goal of any monetary policy. So the existence of parallel markets financial, i.e. credit and currency market may lead to certain results of the monetary policy that widely differ from those anticipated.

In all developing countries informal credit and foreign exchange markets coexist alongside the official ones. The mobility of capital suggests that assets in the informal credit market and foreign financial assets are imperfect substitutes. Thus a complete description of the financial system in a developing economy requires consideration not only of the interactions between formal and informal financial markets but also more the interactions between informal credit markets and currency markets[8].

3. Conclusions

At any time and in any country, the central bank watches national currency stability. In Romania there was a period especially between the two world wars, when there used to be a strong monetary stability and a very strict monetary policy. First, during this period our currency was backed by gold and was convertible. There is a legal parity of Leu, i.e. the amount of gold it contained. When parity increased or decreased as a result of monetary flows and economic situation, the central bank intervened and balanced the demand and supply of money. At that time, the balance was made especially by importing or producing gold. A convertible currency and monetary stability meant maintaining the balance between points of exit and entry of gold.

When it happened to be an unfavorable balance of payments, the central bank was promptly intervening, providing the money and foreign exchange market with gold or foreign exchange. But its cover stock was in danger, so the central bank had to recover the potential loss. If there were no other options, the central bank was forced to restrict the issuance and circulation of paper money, which were covered in gold, and thus increased (relative) gold and foreign exchange reserves. Withdrawing some of the money (notes) in circulation, the percentage of gold cover up against the money in circulation was maintained. Another solution was the central bank to lend domestically discount only with great caution. This was done simply, i.e. by raising the discount rate at the central bank and by a more rigorous management of bills and other debt and securities. Raising interest (discount rate) delays some initiatives, some transactions and thus reduces credit. With an increasing discount rate, the currency becomes more sought after, so increasing purchasing power. It means that prices begin to fall which encourages exports and limit imports. In this way it can be obtained an improvement in the trade balance and it can balance foreign exchange reserves.

The great importance that monetary policy has in any economy has led incessantly in applying safeguards measures of cash and removing currency imbalance factors.

Monetary policies have often considered a control of flows and domestic and international monetary transactions that each country is involved in. There are also required surveillance measures of the exchange rate and of trade with foreign currency and securities.

Many of the instruments of monetary policy from between the two world wars are even now in use in our country.

Internationally monetary policy is lately characterized by a relaxation on the coercive, interventionist and legislation levels. Protectionist policies no longer represent the number one factor in the stability of national currencies. Much more important are the policies of opening and adjustment, those of determining the purchasing power of currencies based on complex calculations and models with a high degree of accuracy and rigor. There are occurring regional developments of monetary policy and creation of monetary unions. The latest and most spectacular is the creation of the European Monetary Union (or the Euro-zone). Weak currencies increasingly depend on reference currencies and international currencies, implicitly on international monetary and financial organizations.

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[7] Văcărel Iulian – coordonator, Finanţe publice, Editura Didactică şi Pedagogică, Bucureşti 2003.

[8] Moşteanu Tatiana – Content master; Budget and Treasury 3rd Edition, Economic Tribune Publishing House, Bucharest, 2002.

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