Monetary policy under the influence of financial globalization

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Abstract: *The political, economical and social transformations that human society has known throughout its existence had as a basis the settlement of a wide range of relationships and interconnections among the different communities, populations, cultures and state formations, synthesizing gradually but surely the currently phenomenon that they called globalization. As part of globalization, financial globalization is highlighted by two main elements: the free movement of capital flows and the foreign participation in the share capital within the financial system at national level. Throughout its entire evolutionary process, financial globalization has brought some significant challenges for monetary policy that requires an investigation of the multiple macroeconomic issues involved and that are crucial in ensuring and maintaining price stability. Global financial and economic crisis in the years 2007-2010 was impact of a "tsunami" - as expressed Frederic Mishkin, a phenomenon that has not only damaged and endangered the economic environment globally, but also brought a series of challenges science rethink its monetary policy purposes.*

Keywords*:* monetary policy, financial globalization, agents of financial globalization, financial crises, floating exchange rate regimes, foreign capital flows

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1. Financial globalization and its determinants

The political, economical and social transformations that human society has known throughout its existence had as a basis the settlement of a wide range of relationships and interconnections among the different communities, populations, cultures and state formations, exacerbated since the age of the great explorations and voyages of discovery by creating the communication routes to areas of exploitation of natural resources or the areas of trade, by spreading various languages, customs and religious trends across the globe, synthesizing gradually but surely the currently phenomenon that they called globalization.

Joseph Stiglitz, Nobel laureate for Economics, defines globalization as follows: "it is better integration of the countries and peoples of the world [...] brought by the massive drop in transport and communication costs and by the lowering artificial barriers on cross-border flows of goods, services, capital, knowledge and people"[1] .

An attempt to define globalization in a quasi-general way has been made by Nayef R.F. Al-Rodhan and Gérard Stoudmann in their article "Definitions of Globalization: A Comprehensive Overview and A Proposed Definition", namely "Globalization is the process that includes causes, paths and consequences of integration of transnational and transcultural human activities [...]"[2].

[1] Stiglitz J. E. (2002) Globalization and Its Discontents, New York: W.W. Norton, Print, p.10

[2] Nayef R.F. Al-Rodhan and Stoudmann G. (2006) Definitions of Globalization: A Comprehensive Overview and A Proposed Definition, Geneva: Geneva Centre for Security Policy, p.5

As part of globalization, financial globalization is highlighted by two main elements [3]: the free movement of capital flows and the foreign participation in the share capital within the financial system at national level. These two elements of financial globalization can be measured by the following indicators:

- for capital mobility they are taken into account the holdings of cross-border financial assets and liabilities and the volume of in and out cross-border flows of the domestic financial system;
- for foreign participation in the share capital shall be deemed foreign participation in the domestic banking assets and liabilities and the easy access of foreign financial institutions in the domestic market.

A careful management of both components of financial globalization brings significant benefits to the economy[4], such as:

- access to international capital markets financing;
- free access of foreign financial institutions to national financial markets, which leads to competition, innovation and new technologies implementation, along with the application of best practices;
- ensuring a greater transfer of technology in order to share more broader risks in relation to earnings and a more efficient allocation of global capital.

[3] Menon R. (2012) "Financial globalization: why, how and when?", in The future of financial globalization, BIS Papers 69, 11th BIS Annual Conference, Basel: BIS, p.16

[4] Schmukler S. (2003) Financial Globalization: Opportunities and Challenges for Developing Countries, Financial Sector Issues and Analysis Workshop, Washington: World Bank, p.34

On the other hand, there are a number of costs associated with the process of financial globalization[5], one of which can be identified:

- financial crises and contagion phenomena such as sudden changes in foreign capital flows, higher exposure of national financial markets to external shocks, contagion to the real economy or the financial account;
- declining trends in local financial markets correlated to the international ones:
- appealing to international financial markets at the expense of enforcement by national funding.

The key factors that led to the aforementioned changes on capital flows and global financial market structure are highlighted below:

- the liberalization of the national financial market and an increased competition among the financial institutions;
- the IT and telecommunications technological progress;
- the timeliness and standardization of information flow;
- the integration of national economies at different levels (commercial, institutions, ownership structure, capital flows and knowledge);
- the developed countries transition to floating exchange rate regimes, the emergence of the single European currency zone and other supranational integration initiatives;
- the setting of principles for effective banking supervision developed by the Basel Committee on Banking Supervision (BCBS);
- the adoption and the implementation of international accounting standards (IAS) or International Financial Reporting Standards (IFRS) in over 100 countries;
- the implementation of the agreements regarding transactions in the financial market - ISDA (International Swaps and Derivatives Association) and ISMA (International Securities Market Association);
- the development of statistical methodology unit by specialized global institutions International Monetary Fund (IMF), the Bank for International Settlements (BIS) and the World Bank to ensure compliance of the data collected with the guidelines statistics and international comparability of them;
- the adoption of good practice principles developed by international professional associations.

In the paper "Financial Globalization: Opportunities and Challenges for Developing Countries"[6] the authors present four main types of agents of financial globalization, namely governments, borrowers, investors and financial institutions of whose interests and actions strongly influence the development of international financial markets.

Governments are strong elements of financial globalization by liberalizing restrictions regarding the domestic financial sector and the capital account of the balance of payments.

Borrowers and investors, that are mainly households and businesses, affect consumption and investment through their operations in financial markets regarding saving, borrowing or investing.

Financial institutions act as agents for internationalization of financial services,

[5] Schmukler S. (2003) Financial Globalization: Opportunities and Challenges for Developing Countries, Financial Sector Issues and Analysis Workshop, Washington: World Bank, p.42

[6] Schmukler S.L. & Zoido-Lobaton P. (2001) Financial Globalization: Opportunities and Challenges for Developing Countries, Globalization Policy

including global international institutions that can be specialized as UN agencies (the IMF and World Bank Group) or regional financial institutions (BIS, the European Bank for Reconstruction and Development and so on).

2. The impact of globalization on inflation

Since the mid-80s, the world economy has undergone such profound transformations, that sources and effects of these changes are not perhaps fully understood yet. This process of continuous integration in trade, production and financial markets in different countries and economic regions, defined as globalization, directly affect the conduct of monetary policy in a variety of directions[7]:

- induces structural changes which increases the uncertainty of the economic environment in which monetary policy operates - uncertainty in the interpretation and explanation of data and indicators and the use of monetary policy transmission mechanisms;
- intensifies international competition that leads to a change of conditions and constraints in which monetary policy acts;
- influences the external environment due to the influence of national economies on the global business cycle and prices of goods and services in global markets;
- influences the internal environment of national economies by changing the mechanisms of domestic prices and wages;
- steps up international labor migration changing conditions in the local labor market, especially concerning wages;
- influences financial markets leading to an increased uncertainty regarding the central bank's decisions on macroeconomic variables.

The economic literature shows that, the last twenty-five years have been characterized by low inflation, which resulted some specialists refer to this phenomenon as the "Great Moderation" . This refers to a reduction in the volatility of business cycle fluctuations since the mid-eighties of the twentieth century, attributed to the deregulation at the institutional and structural level in developed countries. Among important economic variables which were highlighted, in particular a decrease in volatility has included: GDP, industrial production, unemployment and monthly salary. Totally unexpected, a series of global imbalances have begun to emerge in the last decade of the twentieth century, among them the increasing current account deficits of developed countries or "booms" of prices in various economic sectors - IT, real estate, which led to the end of the period called "Great Moderation"[8] in the mid-2000s.

In this context, there could be made some considerations regarding the factors that had a major impact on the evolution of inflation during this period and are related to globalization:

- the improved management of monetary policy, as a major factor in the decrease in the level and the persistence of inflation;
- the relocation of production to countries with cheap labor, which made the supply of products to grow faster than demand, having a moderating effect on the general price level;
- the major changes in the relative

[7] Manolescu Gh. (2009) Politica monetară în perspective globalizării, București: Universitară, p.289-290

[8] Moutot Ph., Vitale G. (2009) Monetary policy strategy in a global environment, Occasional paper series no.106/2009, Frankfurt am Main: European Central Bank, p.6

prices of goods and factors of production, so that relative prices of raw materials rose sharply, while the emergence of workforce from countries with cheap labor has pushed down the relative prices of manufactured products;

- the international competition, which inhibit inflation temporarily via four channels[9] : domestic firms reduce their profit margins; companies are encouraged to invest more in research and development to increase productivity, so that increased international specialization enables the capitalization of comparative advantages; the fall of product margins and, on the other hand, the strong expansion of cheap labor, which decreased the relative price of labor; the decline of the relative prices of manufactured goods that can produce as a side effect, a change in the geographical structure of imports;
- the structural changes in the industrialized economies, such as the decline of the share of industry in GDP over the last thirty years, in favor of the tertiary sector, the transfer of manufacturing production to the low-cost countries and the increased efficiency of the industry in using raw materials;
- the classic Phillips curve was flattening, which seems to be a global phenomenon that can be explained both by better conduct of monetary policy as well as structural changes in the industry.

3. The impact of financial globalization on monetary policy

Throughout its entire evolutionary process, financial globalization has brought some significant challenges for monetary policy that requires an investigation of the multiple macroeconomic issues involved and that are crucial in ensuring and maintaining price stability.

Scientific literature identifies as relevant characteristics of globalized financial markets the following factors:

a) the decline of investments in national markets made by local investors. The fast growth of cross-border investment flows stimulated by the liberalization of national financial markets, associated with reduced communication costs and accelerated by financial innovation has led to a drop of investments on the domestic markets made by local investors.

b) the strong growth in the volume of financial transactions by size of business transactions in developed economies as a result of interdependencies between the financial markets and innovation; this had serious consequences on the role of global financial markets in the transmission of economic shocks, both domestically and internationally;

c) the rapid spread of monetary policy regimes such as exchange rate targeting and inflation targeting, within central bank practices. In the 90s, it was considered to be an affordable way for emerging countries to achieve monetary stability with low costs by targeting rates against the dollar or the euro, but later it became clear that capital inflows attracted and then invested in real estate or in areas with low productivity, can lead to the appearance of financial risks in case of appreciation of those currencies. Inflation targeting has been adopted successfully by a number of central banks both in developed and developing countries, but it was focused on the pursuit of price stability over short horizons for two or three years.

[9] Ibidem, p.11

The widespread use of inflation targeting regime implied the emergence of a debate in the early 2000s called "lean against the wind" in search for a response on the tremendous increase of asset prices exacerbated in financial markets. The concept considers using monetary policy to counter the expansion phase of the business cycle by tightening them to restrict lending and mitigate the extent of a subsequent recession. The opposite view of the concept "lean against the wind" believes that asset prices should not have a special role in the conduct of monetary policy, vision called "doctrine Greenspan" by taking the name of the former Chairman of the Board of Governors of the Federal Reserve System of the United States. He said about modern and technologically advanced financial markets that it is best to be allowed to drive alone because monetary policy should not attempt to take action against bubbles in asset prices, but rather should clean only after they exploded [10]

Because asset prices are a central issue to monetary policy transmission mechanisms, the theory of optimum currency policy requires monetary policy to respond to an exacerbated increase of asset prices, in order to achieve good results in terms of inflation and output. In this connection, there was a debate over the question: Should monetary authorities respond directly to the creation of possible bubbles in asset prices or should instead respond only after the burst of the prices balloon in an attempt to stabilize the production and inflation? These two positions were characterized the debate as "lean versus clean"[11].

As shown by some authors[12], in an less open economic environment, the implementation of the inflation targeting in the presence of an expansionary balloon could lead to encourage misconduct of persistent price assets, which explains - say the authors – the development of these types of balloons in an environment of low inflation: the central bank pursues inflation targeting, but not enough monitors monetary and credit developments.

d) the financial innovation and the risk transfer. The integration of global financial markets has been accompanied by an increased use of financial instruments designed - according to some theorists - to support growth and the efficient allocation of capital. In this sense, the new technologies of computing and information processing have favored the emergence of new financial instruments (many of them totally unique and therefore called as "esoteric"), tools designed explicitly to "pack" and "re-pack" debts and the risks associated with conventional financial products. This phenomenon - originally intended to improve the distribution of risk depositors - was stimulated by banks in search of higher returns, which led to an exponential growth of credit derivatives, such as swaps credit risk (CDS) and bonds to guarantee debt (CDO).

Taking into account other effects

[10] Greenspan A. (2002) "Opening Remarks", Economic Symposium Rethinking Stabilization Policy: 1-10, Kansas City: Federal Reserve Bank

[11] Mishkin Fr. (2010) Monetary Policy Strategy: Lessons from the Crisis, Graduate School of Business, Columbia University and National Bureau of Economic Research, p.18-19

[12] Christiano L., Ilut C., Motto R., Rostagno M. (2008) Monetary policy and stock market boom-bust cycles, ECB Working Papers No. 955, October, Frankfurt am Main: ECB

produced by financial globalization, it can be said that these, to a certain extent, caused the interest rates to be less sensitive to changes in monetary policy interest rate. A possible explanation is that inflation expectations are more firmly anchored so that fluctuations in short-term interest rate adjustments do not trigger long-term interest. The progressive evolution of globalization has been a discouraging factor with regard to developments in government bond yields in the US, due to the fact that excess liquidity obtained from the economies of emerging countries and oil-producing countries is used partly to finance US economy located in a large savings deficit by buying US government bonds. Since 2000, foreign demand for these securities has increased, especially from Asian central banks, having significant influence on lowering long-term interest rates in the US.

4. The impact of international financial crisis on monetary policy

Financial and monetary systems were created and developed in order to improve the efficiency of the real economy and to allocate better the resources, thus triggering a financial crisis marks a disruption of the normal functions of these systems and harms the economy.

After the bankruptcy of Lehman Brothers, almost all systemically important financial institutions that were in difficulty have been saved ("too big to fall"), by providing liquidity by central banks. Many of these central banks have resorted to unconventional measures, in addition to providing liquidity in the banking system.

Throughout the crisis, the three important central banks in the world - the Federal Reserve System, the European Central Bank (ECB) and the Bank of England (BoE) - have reacted in a similar way, showing themselves once again their role as "a lender of last resort". All three banks have extended collectively the short-term loans worth hundreds of billions of dollars to both commercial and investment banks. In addition to these measures, in 2008 all three banks made a coordinated and simultaneous reduction in policy interest rates, which represented a significant signal for the markets. Central banks have worked together, too, to promote new and innovative monetary instruments to respond in this way the impact that has had the global financial crisis. Among others, Bank of England and European Central Bank were coordinated with the Federal Reserve System to create TAF (Term Auction Facility) - a product designed to provide long-term funding to banking institutions on an open market. Similarly, the Fed was coordinated with the ECB and other central banks (but not with BoE), in a cross-currency swap mechanism, in order to confer availability to loans in dollars worldwide.

According to Frederic S. Mishkin[13], unconventional monetary policies during the crisis experienced four forms: 1) the provision of liquidity by central banks that expanded lending for banks and other financial institutions; 2) the purchases of government bonds and private securities that lower the lending costs for households and businesses; 3) the quantitative easing applied by the central banks increased their balance sheets and 4) the management expectations that central

[13] Mishkin Fr. (2010) Monetary Policy Strategy: Lessons from the Crisis, Graduate School of Business, Columbia University and National Bureau of Economic Research, p.10

banks have pledged to maintain their monetary policy rates at very low levels for a long period of time.

Decisions and actions taken by the three major central banks - Fed, ECB and BoE - were unprecedented, characterized by exceptionally fast responses and proactive, which has prevented a collapse of the financial systems nationally and globally.

Despite overcoming major difficulties induced by the global crisis of 2007-2010, many decision makers have acted undecided in the field of macroeconomic policies under uncertainties such as:

- Uncertainty about the magnitude of the crisis that may have lasting effects over the growth rate of the potential output, and this has consequences for the possible emergence of deflationary pressures and monetary policy decisions;
- Uncertainty about the impact that an output gap could have on fiscal deficits mainly structural rather than cyclical, with implications on strengthening fiscal policies;
- Uncertainty about the effectiveness of the transmission mechanism of monetary policy in terms of decreasing the level of financial intermediation, which complicates decisions regarding the moving on with conventional and unconventional measures and how to phase them.

The global financial and economic crisis in the years 2007-2010 has a "tsunami" impact - as expressed Frederic Mishkin, a phenomenon that has not only damaged and endangered the economic environment globally, but also brought a series of challenges to rethink the science of monetary policy in decisions and actions. The author of the aforementioned features five lessons[14] believes that the crisis has provided us some teaching which should change the way monetary policy science is thought and monetary policy strategy is applied:

1. Developments in the financial sector have a much greater impact on economic activity;
2. Macroeconomics is largely nonlinear;
3. The level zero of the interest rates is a problematic one;
4. The costs of cleaning after financial crisis are very high;
5. Price stability and the output does not ensure financial stability.

[14] Ibidem, p. 22

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