THE CAPITAL FLOWS IMPACT ON THE STABILITY OF THE FINANCIAL SYSTEMS

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Capital account liberalization represents a frequent decision taken by the emergent countries in their integration process to the global economy. For the European Union members states, this is a necessary measure. If the capital flows assures the necessary reserves for the development of economical and financial sectors of these states, it could occur negative effects, also (to see the financial crises of the '90). For this reason, it requires some conditions, so that the potential negative impact of these capital flows on financial stability to be lower. On one hand, the paper presents how take place the transmission of the financial vulnerabilities through the intermedium of the Central and Eastern Europe’s capital flows, and on the other hand, presents what is the report between financial stability and prices stability, in the context of capital flows liberalization.

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In the context of financial globalization, the permanent preoccupation of all central banks is represented by the assurance of financial stability. There are several definitions, but there is not yet a common point of view regarding the content of the concept “financial stability”. The Bank of England used this term for the first time in 1994, to appoint those objectives which didn’t represent prices stability or the functioning of financial system efficiency.

Romania’s National Bank considers that the notion of “financial stability doesn’t benefit, for the moment, neither by an acknowledged definition, nor by a model or a standard analytic framework of evaluation. The financial stability can be observed in case no systematic crisis is manifested. At the same time, one can appreciate whether a financial system is stable when this is able to assign efficient economic resources (spatial and temporal), to evaluate and manage adequately the financial risks and to autocorrect when it is affected by exogenous impacts. That is, the financial system is stable when it becomes able to exercise the intermediation function, facilitating thus the performances of an economy and to absorb the impacts by correcting the imbalances appearing as a result of some adverse evolutions”. (www.bnr.ro).

The capital flows liberalization contributed to the increase of financial instability in the world, on the background of the financial markets development with asymmetric information, leading to the “herd behaviour”, to speculations and multiple balances.

If the external savings (the entrances of foreign capitals) don’t eliminate completely the internal savings, the process is favourable for the country receiving the capital: new work places are created; the local work force productivity grows by the capital usage and by the learning of some superior techniques of production and management; the state collects more taxes (or incomes from privatization) and is able to offer more public goods (infrastructure, health and education services); on the whole, the increase is sustained and poverty is controlled. Moreover, the opening of capital account would impose more discipline on the internal capital market through
the appearance of some reference levels for different prices and through the increase of competition in the bank area.

Beside the bestowed advantages, the capital entrances may represent a serious threat for the macroeconomic stability and the external competitiveness, generating an overheating of the economy in case its volume exceeds its capacity to absorb them.

The main channels leading to the overheating of the emergent economies are: the *credit channel* and the *exchange channel*.

The *credit channel* must benefit of a major importance, in the conditions in which the banks occupy a dominant position in the financial system and the accessible capital volume, after the elimination of restrictions concerning the capital account, is much higher. According to Backé, Ţegert şi Zumer (2006), the banks own 85% of all the financial actives, while the capital markets have a more reduced importance.

The quick increase of the credit represents a risk on the financial stability because: it stimulates the generating set of demand, if it grows much more than the production; leading thus to inflationist pressures; encourage the import, contributing to the increase of deficit of the current account; it proliferates the exchange risk and it increases the credit risk.

The consequences of a boom credit are often associated to the macroeconomic and financial crises, as a result of the macroeconomic imbalances and the worsening of financial situation in the bank area. G. Kaminsky, S. Lizondo și C. Reinhart (2007) shows that over 80% of the published papers have the conclusion that credit growth is an important factor that contributes to the banking/monetary crisis. M. Goldstein (2001) and an important study of IMF reveals the vulnerabilities of the credit boom for the countries with an emergent or in transition economy, too. These papers reveals the fact that, a strong credit increase determine almost automatically a fast growth of investments, a decrease of valutary reserves, a real appreciation of the money and finally, a decrease of production. So, the credit boom almost always determine banking and/or monetary crisis.

The macroeconomic disequilibrium can decrease the economic activity: the payment capacity of the debtor decrease, the volume of the bad debts increase, there is a bigger vulnerability of the credit channel and exchange channel. When the financial instability appears into a vulnerable system, the macroeconomical disequilibrium can be bigger, because the credit institutions and the other financial institutions decrease the lending activity and appears the situation when an economic agent cannot finance anymore their activity.

The increase volume of the credits determine the over-demand of the credit risk management system, so, the quality of the credit portfolio decrease.

Another risk factor is caused by the practices of currency credit lending, so that there is a decrease of currency risk, liquidity risk, insolvability risk, because these credits are mainly financed through other types of resources (not only through the deposits attracted from the clients), especially through the external credit lines. In this situation, the unexpected decrease of the exchange rate aggravate more the vulnerability of the banking system.

That’s why the authorities must maintain a viable balance between the assurance of macroeconomic and financial stability and the expansion of the credit that contributes to the economic increase and the efficiency of resources allocation.

The decisions to be taken, must base on the economic objectives of the respective country and to take into account the regime of the exchange value, the institutional constraints, as well as the determinatives and the structure of the capital entrances. On many occasions, the decisions base on incomplete information, especially in the incipient stage of capital inflows when it is still difficult to evaluate the nature of these entrances and whether these are temporary or permanent.

The identification of some viable solutions which can temper the quick credit increase is difficult. The increase of the interest rate in order to limit the inflationist pressures: (i) could encourage even more the credit in foreign currency (inclusively, due to the possible effect of appreciation of
Another solution could arise from the credit institutions, that is the rhythm of the credit increase must be in accordance with the capacity of managing this phenomenon (inclusively, according to the results of stress-testing) and the present and future level of the capital and of the commissions.

The exchange channel occupies an important role in the transmission of monetary policy. The capital inflows increase the efficiency of this channel, assuring a low rate of inflation in an extremely short period of time, both directly, through the lower of import prices, and indirectly, through the effects on the net exports, and implicitly, on the generating set of demand. However, though it is favourable on short term, the excessive usage of this mechanism of transmission risks to become a double-edged weapon, because it may aggravate the external imbalances and may increase the vulnerability to the capital flows reversibility which may take place sometimes through the simple changing of the investors feelings. Thus, there may exist situations in which the lower of interest rates may face the sudden appreciation of the exchangerate, but such a monetary policy act would be incompatible with the inflation target (Isărescu 2008).

In the conditions of some massive entrances of capital, the currency will continue to appreciate and the external competition of the economy will erode. The imports will increase in a quicker rhythm than the exports, contributing thus to the expansion of the generating set of demand. The current account deficit may reach unsustainable levels, as a reflection of the generating set of demand. In case these evolutions are not counteracted in time through the implementementation of some reinforcing measures of fiscal policies and incomes, the investors feelings may modify which will determine the retreat of foreign capital. There has been observed that the scale of the capital exits may exceed the authorities capacity to protect the value of national currency and may be equivalent to a sudden correction in the sense of depreciation, respectively exchange crisis.

In the context of a dis-inflationist process and of an economic increase, there cannot exists at the same time free capital movements, a fixed rate of exchange and an independent monetary policy. This is what in literature is called the triangle of incompatibilities.

If the reduction of the inflation is desired and a fixed rate of exchange is adopted, the monetary policy is efficient only if the capital movements are limited. Otherwise, the entrances and exits of capital undermine the effort of liquidities control and impede the usage of rate of exchange as an instrument of monetary policy. (Cerna et al., 2008).

If a fixed rate of exchange is adopted and the capital movements are liberalized, then one must give up to the monetary policy autonomy (as it happens, for example, in the case of a small country that ties its national currency to the currency of another country).

If it is chosen a fluctuating rate of exchange, then the monetary policy autonomy and a high level of capital movement liberalization can be maintained.

Different schemes of these three caracteristics dominated the monetary arrangements of different areas in a certain period of time. In the monetary system based on the gold standard, in the 19th century, most of the countries have chosen the benefits of capital free movement and the stability of fixed relation between the currency and gold. In the Bretton Woods system, created at the end of the Second World War, several countries gave up to the capital mobility, in order to obtain both a regime of fixed rate of exchange and an independent monetary policy. In the present, at least in the case of the majority of industrial regions, has been chosen a regime which gives up to the fixed rate of exchange in favour of the two other caracteristics.

In the ex-communist countries, it is specific the “Tošovský dilemma”. The continuous appreciation in real terms of the national currencies of the countries in transition from Central and Eastern Europe may attract – if the internal interest rates are maintained at a relatively low level – excessive capital entrances which follows the valuation of interest rate differential. On the other hand, the authorities must promote the sufficiently high interest rates, in order to assure a
balance between the internal savings and the investments. In these conditions, the dilemma of the monetary policy consists of the fact that a too high or a too low level of interest rate determine the inflation increase and the increase of the deficit of the current account.

"The vicious circle" of the monetary policy may be represented in the following way:

**Figure no. 1: "The vicious circle" of the monetary policy**

![Diagram of the vicious circle of the monetary policy]

In the context of economic globalization, the opening of contemporary economies generates a potential conflict between the prices stability and the financial stability. The masive entrances of capital aggravate the vulnerabilities and the existent macroeconomic imbalances in the host economies, existing the risk to generate both inflation and financial instability.

The intrance of capital flows can generate vulnerabilities for the price stability and the financial stability, as in this figure:

*Source: Cerna coord., 2008;*
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It is evident the way in which the sudden depreciation influences the prices stability – the effect is both direct, through the import prices, and indirect, through the inflationist expectations. It is similarly evident the reaction of monetary policy, the major objective of which represents the prices stability. A more restrictive behavior of monetary policy will lead to a compression of the generating set of demand, generating economic recession and unemployment.
The financial stability may also be affected by exchange crisis, and the restrictive policies meant to rebuild the prices stability could have a contrary effect. In case the public opinion perceives the appreciation of the national currency as a phenomenon of long term, the preference for borrow in foreign currency becomes unavoidable and the monetary policy would not be anymore so efficient. However, a sudden correction in the sense of depreciation could lead to a deterioration of the balance situation in the households and in the companies, whose fortune will diminish.

The financial area will also be affected because of the constraints in the real area. A great part of the bank loan would become nonperforming in the context of non-execution of due payments by the economic agencies. The problems regarding the maturity noncorrelation in the bank balances would be added to the major balance noncorrelations, already existing, from the perspective of the designation of the incomes and the due payments, risking to transform all generalized financial crisis.

Despite the vulnerability caused by the capital flows liberalization, we hope that the advantages conferred by them will have priority and the final effect will be a favorable one.

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