A VIEW OF MACROECONOMIC STABILITY

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Abstract: *The present paper summarizes the history of macroeconomics, the way macroeconomics has developed over time, the influences and trends which appeared during these years. In order to understand what is needed from macroeconomic stability, we need to follow the evolution of the concept, of the limits reached by a certain model and of the approaches which define the macroeconomic models. The complexity of the problems arisen during economical recession has led to a continuous enhancement of the macroeconomic models, meanwhile looking for a model which would respond as much as possible to the identified problems. Also, I have approached macroeconomic stability starting with concepts, with the way it is conceived to work, with the policies which come to support macroeconomics and, implicitly, macroeconomic stability. I have approached the role of macroeconomic stability in resolving financial crises and also the way macroeconomic policies should work or be used both during economical growth and during recession periods. On a short-term, the settling role of fiscal policy is based on the efficiency of automatic stabilizers and on the ability of the governments to create a fiscal stimulus in due time. The governments can deliberately modify public expenses and public fiscal instruments in order to compensate the fluctuations of the business cycle, but, ultimately, the structure of the fiscal system has to be designed for maximizing economical efficiency and market flexibility, thus increasing the endurance of the economy when facing shocks.. During the past two decades and until the initiation of the 2008 crisis, the specialty literature regarding monetary and macro-prudential policies has recorded a diversity of opinions, but is still far from a consensus regarding its objectives. Generally speaking, macro-prudential policy is seen to focus on financial stability, but there is no clear definition of financial stability.*

Keywords: macroeconomic stability, macroprudential instruments

JEL classification: E51,E61;E62;E63

1. Introduction
The recent financial crisis has highlighted the lack of regulatory frames that allow first a predictable economic crises and also managing the cluster of financial imbalances. This lack of regulation has proven to have important macroeconomic consequences, affecting the entire global economy (Catte et al., 2010).
Trusting the self-adjusting ability of the financial system has led to underestimating stock build-ups and, accordingly, the increase of debts (which were the result of expansion of assets and given loans - specially in the field of real-estate) (Galati, 2012).
Regarding macroeconomic policy, the recent financial crisis has highlighted the need to go beyond an approach based on a micro-approach of financial regulations and surveillance (Clement, 2010).
This is exactly the approach we have chosen in the present paper, starting with the history of macroeconomics and then debating the macroeconomic stability.

2. Macroeconomics - Origins and History

Macroeconomics is a branch of Economics which deals with the performance, structure, behavior and decision-making of an Economy as a whole (Blaug, 1986).

The word 'macroeconomics' comes from Greek, being made up of 'makro'- which means 'large' and οίκος [oikos], 'home' and νομος [nomos], 'leading' and studies indicators like gross domestic product, inflation and unemployment rates and the interrelations among these factors and different sectors of the Economy.

In the begining of the macroeconomics study there were two distinct approaches:

- The theory of economical cycles - presented by William Stanley Jevons, Clément Juglar and Wesley Clair Mitchell and
- Monetary Theory - taken from the works of David Hume, Knut Wicksel, David Ricardo, Henry Thornton, Irving Fisher, corroborated with the theory of circular flows of François Quesnay and Karl Marx (Dimand, 2008; Durlauf et al., 2008).

The real establishment of the word 'macroeconomics' came together with the approach suggested by John Maynard Keynes in his book, "The General Theory of Employment, Interestand Money" (1936), (Snowdon et al., 2005) and then, specialists in Economics like Paul Samuelson, Franco Modigliani, James Tobin (who embraced the Keynesian trend) have developed the model initially suggested by Kenyes and presented new approaches.

During 1970 - 1980 the monetary trend developed, its fundamental exponent being Milton Friedman, by which another approach of macroeconomic terms took place, mainly demonstrating a direct connection between high unemployment rate and the increasing of inflation (Blanchard, 2011).

Another approach came from the Neo-Classics, especially through the approach of the theory suggested by Robert Lucas, namely that of rational expectations, which basically is based on the assumptions that people make decisions in the future based on their experience from the past, on the information had and on a rational vision, taking this trend towards the idea that present economical expectations are equivalent with the future in facto status of the economy (Snowdon et al., 1994).

Starting from the paper of Lucas, (Lucas, 1976), Edward C Prescott and Finn E. Kydland, the exponents of Neo-Classicism, have created a new macroeconomic model, RBC (Real Business Cycle), by which this theory promotes the idea that the cycling fluctuation of business is actually the efficient response of the changes which appear in the real economic world (*Blanchard, 2011*).

Towards the end of the 90s, a new approach, Dynamic stochastic general equilibrium (DSGE), tries to explain the connection between different economic phenomenon (economic growth, production cycles) and the effects of monetary and fiscal policies (Huw, 2001; *Blanchard, 2011).*

The theoretical approaches were diverse.

A first approach consists of macro patterns, and, Dynamic stochastic general equilibrium patterns in particular. A main advantage of this approach is that it relies on the analysis of the financial stability and uses patterns in which time (as a scale) plays an important role. Moreover, these models are particularly suited for simulations, that makes them attractive to study the impact of new fiscal policy instruments.

In the same time, a significant disadvantage of Dynamic stochastic general equilibrium patterns is that they are patterns on infinite time horizons, therefore are not well suited to specific situations, well determined. As a result, Dynamic stochastic general equilibrium patterns present trouble modeling financial intermediation (Bean, 2009).

Another research line is based on the idea according to policy decisions must take into account the appropriate role of various interest rates – (the loan interest rate, the reference interest rate (Goodfriend and McCallum, 2007).

3. Macroeconomic stability

The concept of macroeconomic stability has suffered important changes during the economic course of the previous decades. During the years after the war, period dominated by the keynesian concept, macroeconomic stability actually meant a combination of external and internal balance, which would mean a full labor occupancy and a stable economic growth, accompanied by a decreased inflation. During time, fiscal balance and the establishment of prices became the center of attention, replacing the keynestian focus on real economic activity (Ocampo, 2005).

This change of policy has led to minimizing and, in accordance with some more radical opinions (Stiglitz, 2003), even to a complete suppression of the anti-cyclic role of macroeconomic policy.

There is now undeniable proof regarding the fact that pro-cyclic financial markets and pro-cyclic macroeconomic policies did not encourage growth; these actually increased the volatility of developing countries (Prasad et al., 2003).

This fact has generated a renewed interest in the possible role of anti-cyclic macroeconomic policies in decreasing the intensity of production cycles in developing countries.

The recent financial crisis has highlighted the negative effects over life standards, which can be a result of macroeconomic instability. Major changes in the economic activity, high inflation, less developed markets, level of debt and volatility of exchange rates contribute to unemployment and an increase of poverty.

The large objective of macroeconomic policy is to contribute to the economic and social well-being in an equitable and durable manner. Since unemployment and the lack of reforms needed for economic growth are the main causes of poverty, maintaining a full employment of labor in economy, as constant as possible, is an essential task.

Macroeconomic stability presents the way in which a national economy minimizes its vulnerability to external shocks and, in the mean time, the way in which it creates its premises for a sustainable growth.

Macroeconomic stability acts as a safety margin (buffer) against currency and interest rate fluctuations in the market. Exposure to currency fluctuations, excessive indebtedness and inflation that cannot be controlled may generate economic crisis and even cause the collapse of the gross domestic income (product).

According to the Maastricht Treaty, macroeconomic stability is measured through five variables (Hubbard and Kane,2013):

- Low and stable inflation – which indicates well-conditioned market demands.
  In case of high or unstable inflation it can lead to alterations of the values of long-term contracts. Also, high inflation creates some uncertainty in the market, thus, leading to increasing the risk premiums (Wessels, 1993);
- Low long-term interest rates – which leads to a perception of stability of inflation in the future;
- Low debt related to the gross domestic income (product) – which indicates that the Government will have to shape the revenue going to be collected (from charging) in a manner not having to borrow from pledgees and thus having to pay a surcharge;
- Low deficit - which would allow the countries to assure a sustainable growth on a medium term.
- Monetary stability, which would allow both importers and exporters to create a long term strategy for development, without being highly influenced by the fluctuation of the foreign exchange.

Macroeconomic policies can be based on monetary policies and on fiscal policies. The Economists prefer to rather use monetary policies than fiscal policies due to two main reasons.

- The first might be that the monetary policies are implemented by central banks and not political institutions (eg. Public Authorities) which control fiscal policy, therefore, central banks should not take such decisions based on political grounds.
- Secondly, monetary policies can have immediate effect, while in the case of fiscal policies, results can be seen later.(Mayer and Thomas, 2002), (Snowdon et al., 2005).

The different approach come from trends expressed by two distinct groups.

- The first group defines financial stability based on the solidity of the financial system when facing external shock (Padoa, 2003; Allen and Wood, 2006).
- The second group describes financial stability in terms of resistance to shocks in the financial system (Schinasi, 2004) or vulnerability to financial stress in response to midsize shocks (Bario and Drehman, 2009).

Brunnermeier and Sannikov ((2009) has argued that the key goal of macroeconomic stability is for this to work as a counterbalance during periods when macroeconomic indicators start to show downward values in economic growth periods, whereas in times of crisis to act as a lever to increase the value of these macroeconomic indicators.

In approaching economic policies there were opinions regarding the intensity they should interfere with in the economy.

There are several arguments that support the idea of not engaging these economic policies in such an extend they interfere directly with the financial stability issues.

The first argument is that of the principle of Tinbergen (Tinbergen, 1981) according to which for every objective of monetary policy you want to achieve it should exist one independent policy instrument. (For Eg.: if you have two objective of the macroeconomic policy – price stability and a low unemployment rate - you need two independent policy instruments: price stability as a monetary policy and fiscal policy for low unemployment rate).

An example of compromise between monetary policy and macro-prudential policy can be found in the works of Agenor, Alper and Pereira (2009), in a pattern in which „the bank stock's" impact on lending rates presents two forms: a cost effect (associated with the fact that issuance of equity for regulatory purposes is expensive) and a stimulating effect (due to the fact that an increase in capital improves the expectance of refunding loans). If the central bank increases the monetary policy interest rate and, also, increases the minimum capital adquacy rate (to promote financial stability), the netto effect on the loan rate can act as a lever.

Another argument is that monetary policy that manages to keep low and stable prices, can induce cycles of booms in assets prices. For example, low interest rates could encourage taking a higher risk regarding lending which could lead to higher assets prices.

The third argument is that, the monetary policy interest rate alone cannot account for financial stability concerns. Form this point of view there is evidence suggesting a higher association between loan growth, depending on the cost of borrowing and, therefore, the monetary policy rate and real estate assets price inflation (Claessens et al.,2011).

4. The effectiveness of macro-prudential Instruments

The recent financial crisis has enabled us to reveal the vulnerability ot the existing monitoring patterns focused on individual reliability of the institutions, these being unable to identify systemic risks which may spread to the global economy.

Therefore, the institutions responsible with monitoring the financial branch have developed a regulatory and institutional frame for implementing the best macro-prudential policies and instruments to mitigate systemic risks that may affect financial stability.

These reforms are found in the Basel III regulatory frame, which defines the conditions relating to the implementation of a number of available instruments to deliver macro-prudential policies.

Therefore, many macro-prudential authorities have selected a number of instruments to be developed and implemented nationwide. These instruments were analyzed individually by each authority, taking into account the specific risks and characteristics of national economies (without neglecting the risks that may arise through extended consequences between countries).
The implementation of macro-prudential instruments involves:

- identifying a number of appropriate indicators to signal periods of crisis or financial crisis and
- adjusting instruments, taking into account their expected impact on the financial system and economic activity.

A number of criteria are relevant for this selection. First, an appropriate balance between covering risks that can be reduced by instruments and the efforts made so these instruments become operational, must be provided.
Developing criteria to find instruments with major impact, collecting, scanning and adjusting relevant data requires a thorough analysis.
In addition, it is also important to make sure that the selected instruments are the most appropriate to reduce the identified risks. This selection is normally based on effectiveness, efficiency and transparency criteria which tries to assess:

- to the extent the instrument is required to fulfill the goal;
- if cost or potential adverse effects arising from their activation are commesurate with the goals pursued;
- if the instrument is clearly measurably in terms of its application and the goals it pursues, to ensure that the policy is credible and responsible.

Therefore, the selection of instruments nationwide will probably be reviewed and updated in the following years. In this context, the selection of instruments should not be seen as restrictive (meaning it does not block the activation of other instruments that have not been selected), but as an indication of the instruments considered by the authorities as a priority and for which conditions will be developed to become operational nationwide.
Since macro-prudential policy instruments have been introduced recently in approaches and patterns developed by economists, they may not have a proper assessment for three main reasons.
The first would be exactly, the time – it is too early to assess empirically the efficiency of some instruments that have been introduced only in recent years. The data series are relatively new and therefore cannot assist in achieving the goals of macroeconomic policy Lo (2009), Sibert (2010) and Brunnermeier et al., (2011).
The second would be that empirical work is much harder in the absence of established patterns of interaction between the financial system and macroeconomics.
Third, the measures are often combined with other policies and it is quite difficult to realize the impact of each one per total. Therefore, there is a need to measure the effectiveness of macro-prudential instruments.
In the literature, there are five main approaches to determine the basic methodology of macroeconomic policies.

- The first is based on the study of events covering different sections of the countries, and has been carried out, usually, at central banks (CGFS, 2010b), the IMF (Hilbers et al., 2005; Crowe et al., 2011a, b; Terrier et al., 2011), BIS (Montoro and Moreno, 2011)
- A second approach is based on the assessments of authorities and foreign observers regarding the effectiveness of macro-prudential instruments (Borio et al., 2001). In fact, Borio and Shim (2007) argue that in order to draw clear conclusions about the effectiveness of some macro-prudential instruments, they should rely on a systematic analysis of the various situations encountered.
- A third approach consists of country studies using reduced regression analysis (IMF, 2011 b,c). Compared to event studies, this line of research allows more

formal tests of the impact of macro-prudential instruments. However, one of the limitations is that patterns likeso do not capture enough the interaction between macroeconomic, financial and political variables. In addition, since in most cases, macro-prudential instruments have been recently introduced, there is not sufficient data available to perform regression analysis (Galati, 2012).

- A fourth approach uses macroeconomic patterns – usually Dynamic Stochastic general equilibrium (Antipa et al., 2010) or structural patterns (Catte et al., 2010) – to perform simulations of macro-prudential policies.
- A fifth approach is testing the impact of macro-prudential instruments on micro data of the commercial banks, and particularly the data regarding risk exposures of individual banks and the interbanking connections (Gauthier et al., 2010).

All these approaches should be considered a fusion, each generating answers to certain issues and questions, in the same time, for things left unanswered through that certain approach. The more we diversify the certain approaches the more may result in a solution covering answers to many questions.

5. Conclusions

The hereby study analyzed the evolution of the concept of macroeconomics, starting with defining this term up to nowadays approaches. Macroeconomic stability, macro-prudential policies and the effectiveness of macro-prudential instruments were also referred to in the study, starting with the concept following motivation for their admission, their role and the way they responded to different aspects, through time.The recent financial crisis showed us that regardless of what was accomplished until then in the field of macroeconomic stability, of macro-prudential policies, these facts were not enough for foreseeing and preventing what has happened. Therefore, the reassessment of macroeconomic policies had to be rethought in order to find measures which can be taken during economic growth, precisely to be able to limit the effects of possible future crises and to be able to have reserves (from periods of economic growth) which can be used if needed.

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