

## The financial market environment: the new role of the central bank

### L'environnement du marché financier : le nouveau rôle de la banque centrale

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#### **Abstract:**

The consensus of the pre-crisis 2008 on the central bank's role is shredded because of the results of its strategies and levels of intervention, which inadvertently, created the conditions leading up to the current credit crisis. Unfortunately, when we turn to the economic orthodoxy for an opinion on what went wrong and how we can fix it we find there is not even an established framework by which we can discuss the issue.

This work paper aims to show how the central bank role (which is the epicenter of the financial system) has radically changed in order to respond to the current financial crisis constraints, focusing on the central banking before this crisis, secondly the new role of the central bank as a monitor of financial stability (not only a monetary one) with an action combined with its government to implement a growth and development strategy.

**Keywords:** new role of central bank, leaning strategy, cleaning strategy, macro-prudential regulation and supervision, financial stability.

#### **Resumé:**

Le consensus de l'avant crise de 2008 sur le rôle de la banque centrale est déchiqueté en raison des résultats de ses stratégies et ses niveaux d'intervention, qui, par inadvertance, ont créé les conditions qui ont mené à la crise actuelle du crédit. Malheureusement, quand nous nous tournons vers l'orthodoxie économique pour une opinion sur ce qui s'est passé et comment nous pouvons le corriger. Nous constatons qu'il n'est même pas un cadre établi par lequel nous pouvons discuter de la question.

Ce document de travail vise à montrer le changement radicale du rôle de la banque centrale (qui est l'épicentre du système financier) pour répondre aux contraintes actuelles de la crise financière, en se concentrant sur le rôle de la banque centrale avant cette crise, d'autre part, son nouveau rôle en tant que moniteur de stabilité financière (et non seulement de la politique monétaire) et ce en action combinée avec son gouvernement pour mettre en œuvre une stratégie de croissance et de développement.

**Mots-clés :** nouveau rôle de la banque central, Stratégie du Lean, Stratégie du nettoyage, la supervision et la réglementation macro-prudentiel, Stabilité financière.

## **Introduction:**

Until the beginning of the second half of the twenty-first century's first decade, scientists and central banks had arrived to a consensus about most elements of monetary policy strategy and prudential supervision of the financial System. Then, starting in August 2007, the world was shocked by the description “once-in-a-century credit tsunami.” by Alan Greenspan, former Chairman of the Federal Reserve. The credit tsunami not only had strongly shaken the world economy, resulting in the most severe worldwide economic contraction since the Great Depression, but has also put in doubt the basic policy strategies used to manage the economy. However, with the collapse of Lehman Brothers bank in September 2008, the world of central banking changed forever. The worldwide financial crisis revealed that some of the basic assumptions related to the central bank consensus were no longer tenable, requiring a major rethinking on what the role of the central bank should be. As a necessity, a reformulation of the regulation and supervision of the financial system (macro-prudential regulation and supervision) clearly appear the risk of the entire financial system through a systems approach, rather than simply the level of risk at the financial micro-level (financial institutions), which represents a powerful political tool to support a stable economic growth.

### **1- The Friedman school and central banks :**

The Efficient Market Hypothesis of Milton Friedman leads to only one conclusion is that central banks distorted financial markets and should be abolished. If markets are self-optimising, then free market forces should be allowed to set interest rates. Banks should be permitted to lend and borrow on whatever terms they deem appropriate, guided only by the market forces of the supply and demand for capital.

In an interview shortly before his death, Friedman was asked: ‘...would it be preferable to abolish the Fed entirely and just have government stick to a monetary growth rule?’. Friedman replied: ‘Yes, it’s preferable, and there’s no chance at all of it happening. (Reason magazine, 2006). Apparently, Friedman’s position on central banking looks radical.

Today’s economic orthodoxy parrots Friedman’s reverence of free markets, but does not apply his intellectual rigor in extrapolating what efficient markets imply about the role of central banking.

#### **1.1- The conditions of the Efficient Market:**

The most important condition for markets to operate efficiently is that they be left alone, free to operate without interference or manipulation. If market prices are pushed around and manipulated by external forces, for example by government interference, then the markets cannot be expected to behave as efficient markets should (Paul Woolley, 2010). In addition, we can summarize these conditions as follows:

1. Asset price bubbles do not exist; the prices of all assets are always correct;
2. Markets, when left alone, will converge to a steady equilibrium state;
3. That equilibrium state will be the optimum state;
4. Individual asset price movements are unpredictable;
5. However, the distributions of asset price movements are predictable.

## **1.2- criticisms to efficient markets friedman's view:**

Many others think that financial markets as friedman's view cannot work well in the real world except by chance because:

1. There are many equilibrium;

2. Only one of them is Pareto efficient;

3. For all other equilibrium, the whims of market participants cause the welfare of the young to vary substantially in a way that they would prefer to avoid, if given the choice. ( Farmer, Venditti, 2012 ).

## **2- The Keynes/Minsky school Hypothesis of Financial Instability:**

Hyman P. Minsky developed an original business cycle theory based on a Financial conception of economic fluctuations, and more specifically, on the 'Financial Instability Hypothesis' (FIH) (Minsky, 1986). This theory is mainly based on the succession of two phases during the business cycle: first, a process of transition toward greater financial fragility of the economy which builds up in the expansionary phase; second, the transition from a financially fragile situation to a situation of recession and then of large amplitude economic crisis.

Minsky's commentators usually point out two central features characterizing his business cycle theory. First, his approach is considered as a continuation of the theory of economic fluctuations developed by Keynes in the General Theory (Keynes, 1973). Minsky indeed developed an approach where one could recognize the main themes developed by the Keynesian fundamentalists: the role of uncertainty and the behaviors it generates, the dynamic instability of market economies, the role of money and liquidity preference. The second often pointed out feature is the endogenous nature of his approach of fluctuations. For most commentators, the FIH is based on the behaviors of private economic agents which endogenously create processes of Financial and economic instability.

### **2.1- Central banks role according to Minsky's view:**

In Minsky's approach, stabilizing economic activity, that is, setting new initial conditions in order to contain the amplitude of time series, is essentially the concern of the government, and of the central bank.

Minsky views budget deficits and interventions by the central bank as lender-of-last-resort as extremely effective instruments for stabilizing economic fluctuations. Even if full employment is not achieved, these instruments help to limit the drop in income and in liquidity during economic recessions and during the onset of a financial crisis.

The main purpose of this type of intervention is to offset debt-deflation phenomena or the different forms of financial instability that market economies experience. For Minsky these phenomena also emphasize the need for an extended interpretation of the role of lender of last resort. This is why he distinguishes three aspects of this type of intervention (Minsky, 1986). First, when funds are lacking in the money market (a situation generally synonymous with substantial falls in the value of the claims agents exchange for liquidity), the central bank must intervene by increasing the amount of money in circulation. Second, during the financial restructuring period that follows a crisis, the central bank must take care to favor recourse to long-term rather than short-term borrowing by acting accordingly on interest rates. Finally,

the central bank is responsible for guiding the development of the financial system, both through regulations and banking system surveillance, in order to restrain speculative banking (excessive reliance on liability management in particular).

The inclusion of the role of institutional mechanisms implies that Minsky's theory does not simply describe the cycle as an endogenous mechanical phenomenon, as a succession of phases of the following sort: increase of financial fragility → financial crisis → gradual return to more safe and sound finance.

A central bank takes interest in financial markets, in major part, because markets serve as allocators of capital. Capital is allocated productively in rational markets since prices which equal intrinsic values send correct signals as to where capital should be allocated. But capital is misallocated in bubbles, when prices deviate from intrinsic values. Free markets are best if they result in rational markets, but central bank intervention, such as popping bubbles, might be called for in markets which are not rational (Shefrin, Statman, 2011).

### **3- The monetary policy before the 2008 financial crisis:**

The crisis poses serious challenges to the conventional, pre-crisis views and approaches of central banks and other financial supervisors.

#### **3.1- Central bank role Before the Crisis:**

The science of monetary policy had several implications for the strategy of monetary policy, some of which were generally agreed to by almost all central bankers and others which were accepted by most central bankers, but for which there was not complete consensus.

##### **3.1.1- Flexible Inflation as a goal:**

The monetary policy strategy that follows from the eight principles of the new neoclassical synthesis is referred to in the academic literature as "flexible inflation targeting" (Svensson, 1997). It involves a strong, credible commitment by the central bank to stabilize

inflation in the long-run, often at an explicit numerical level, but also allows for the central bank to pursue policies to stabilize output around its natural rate level in the short run.

Many central banks that have an independent monetary policy follow the general principles of flexible inflation targeting, they do have very different approaches to the communication strategy surrounding it. Some central banks have announced an explicit numerical inflation objective and treat it as a target and these are classified as full-fledged inflation targeters, while others are reluctant to be so explicit.

such as practical case, the Federal Reserve has arrived to a consensus decision to stabilize inflation, but was not being disposed to announce an explicit inflation objective. Instead, the Federal Reserve reports on the individual FOMC members' projection of inflation in the long-term under adequate monetary policy. In effect, the Fed provides the long-term inflation objective for each FOMC member, but has not requested that the members agree on a common objective for inflation. The Federal Reserve has therefore not yet espoused an inflation objective agreement, but it does not make belong to the inflation targeting camp. However, the FOMC members long-term inflation projections all are defined in a strict range between 1 ½ and 2%, and so they are not far from committing to a specific inflation objective and not very large modifications in their communication strategy would move them to the inflation targeting camp (Mishkin, 2008).

the European Central Bank was being disposed to announce an explicit numerical inflation objective, but are unfavorable to treat it as a target because they believe that this would not give them sufficient flexibility. They are reluctant to be classified as inflation targeters because they believe that the use of the word “target” might lead the public to expect them to hit the inflation targets too precisely or over too specific a horizon.

Central banks adhere to the eight principles of the new neoclassical synthesis and were ready to carry the same independent monetary policy to stabilize inflation in the long term, despite their different communicative strategic approaches. The role of reducing inflation and the output gap inter-temporally led to qualify a central bank of flexible inflation targeter, which is the qualification of the majority of central banks (Svensson, 2002).

### **3.1.2- Risk Management and Certainty Equivalence:**

Temporal non-response-to-shock strategy of certainty equivalent of the optimal policy under the assumptions of the linear quadratic framework will disorient the optimal monetary policy from the role of risk management. Furthermore, when financial market participants and wage and price setters are relatively forward-looking, the optimal policy under commitment is characterized by considerable inertia, which is commonly referred to as gradualism. (Woodford, 2003).

A reasonable approximation of how the optimal monetary policy operates in relatively normal circumstances can be provided by a linear-quadratic framework, but the presence of a small risk brings up the lack of policy in this context. This is why central banks have conducted uncomfortably this policy under a certainty equivalence strategy. Linearity can not express all economic phenomena because of their dynamic behavior (Kim, Morley, and Piger, 2005). Secondly, the incidence minimizing of worst-probabilities can not be guaranteed by using a quadratic objective function

### **3.1.3- Financial Stability Policy and Monetary Policy: the Dichotomy**

A serious negative impact on the economy resulted from a high financial disruptions were expected by central banks, even before the crisis. This is why many central banks had published monetary policy and Financial Stability Reports simultaneously to think about an eventual financial system threats. Nonetheless, the general equilibrium modeling frameworks at central banks did not incorporate financial frictions as a major source of business cycle fluctuations. This naturally led to a dichotomy between monetary policy and financial stability policy in which these two types of policies are conducted separately. Monetary policy instruments would focus on minimizing inflation and output gaps. It would then be up to prudential regulation and supervision to prevent excessive risk taking that could promote financial instability (Joon-Ho H. and all, 2011).

### **3.1.4- (Central banks - Asset Price Bubbles) debate: Leaning or Cleaning:**

An active debate in central banks before the crisis focused on how central banks should respond to potential asset price bubbles. Because asset prices are a central element in the transmission mechanisms of monetary policy, the theory of optimal monetary policy requires that monetary policy responds to asset prices in order to obtain good outcomes in terms of inflation and output. Hence, the issue of how monetary policy might respond to asset-price movements is whether it should respond at all but whether it should respond over and above the response called for in terms of objectives to stabilize inflation and employment. Another way of stating the issue is whether monetary policy should try to pop, or slow the growth of possibly developing asset-price bubbles to minimize damage to the economy when these

bubbles burst? Alternatively, should the monetary authorities not respond directly to possible asset price bubbles, but instead should respond to asset price declines only after a bubble bursts to stabilize both output and inflation? These two positions have been characterized as *leaning* against asset price bubbles versus *cleaning* up after the bubble bursts and so the debate over what to do about asset price bubbles has been characterized as the “lean” versus “clean” debate (FREDERIC S . M, 2010).

Inappropriate investments can be resulted from asset prices' departure from fundamentals, and that can causes negative effects on the economy. In addition, big economic activity declines have followed bubbles bursting during economic history (Dupor, 2005).

before the crisis, economists and central banks thought that the use of a lean strategy led to slowing, stopping the bubble's growth or to have a less severe bursting of the bubble by raising interest rates, which would generate good outcomes and smallest economy damage. (Borio ,2002), and (White ,2004).

(Greenspan, 2002) was convinced that monetary policy should clean up after bubbles burst. There are several elements of this argument.

First, bubbles are difficult to detect, because the central bank does not have an informational advantage over private markets, to act before the formation of a bubble.

Second, Market participants expect high rates of return from buying assets, so the bubble can not be restrained by raising interest rates. bubbles are started from normal conditions to arrive to abnormal conditions, therefore ,this monetary policy tool can not work effectively.

Third, Monetary policy actions are a very blunt instrument, therefore it can't make differences between asset infected by bubble and the other one.

The bottom line from this analysis was that the cost of leaning strategy is very higher than the cleaning one. This monetary policy focuses on stabilizing inflation and employment and neglects the asset price bubbles.

Before the crisis, the cleaning strategy has a big influence on the central banking world; however, the prominent opposition is that of the Bank of England. It argued for raising interest rates more than could be justified in terms of the Bank of England's objectives for inflation over its normal policy horizon (Bank of England, 2004). it is convinced that the risks that high house-price appreciation and the rapid accumulation of household debt would be reduced by elevating interest rates which would lead to an abrupt adjustment process, with serious negative consequences for the economy. It extends the horizon over which inflation is brought back to target, in order to prevent a buildup of financial imbalances (King, 2004).

### **3.2- The role of central banks after the crisis:**

The current financial crisis has revealed three primordial lessons which are essential for the central banks' future role in crisis prevention and resolution.

First, the financial instability accelerates the contagion risks, especially in financially integrated market (the euro area).

Second, the cleaning monetary policy has a high cost compared to the leaning one, because of the arbitrary materialization of financial instabilities which lead to intense recessionary that carry risks for medium-term price stability.

And third, the previous policy measures taken by both of national authorities and central banks were not enough to deal with the accumulation of risks and imbalances that didn't let possibility to keep the financial stability. As well as, the stable macroeconomic environment with stable prices is not a sufficient to let it.

Consequently, the post-crisis period requires a new role of central banks as stability guardians and crisis managers.

### **3.2.1- The future role of central banks: financial stability and supervision:**

The importance of financial stability for central banks has been acknowledged in the European Treaty. The ESCB (*The European System of Central Banks*) shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system.( Article 127/5, European Treaty).

The ECB has already taken over some tasks in European macro-prudential supervision which was established with the European Systemic Risk Board (ESRB) in January 2011. The ECB is an integral part of the ESRB, providing analytical, statistical and administrative support. This is a clear recognition of the important role that central banks have gained over time in monitoring financial stability and the acquired stock of financial market expertise. In principle, the active use of macro-prudential policy could provide a new array of previous policy instruments which can lean against financial imbalances and asset bubbles.

The recent events in the crisis have revealed vulnerabilities in the monetary union, reflecting an incomplete financial architecture. Two prominent examples are the sudden and large reversals of financing flows and the degree by which banks and their own sovereign have become intertwined. Effectively, these developments endanger the financial stability in the euro area as a whole. Neither the financial resources of some member states nor the institutional framework proved adequate to solve the problems on the level of the member states. Therefore we are invited to rethink elements of the financial architecture at the European level, including the tasks of the central bank.

A future European financial architecture will include a fully-fledged financial market union which rests on three pillars.

-First, a banking supervisory authority with sufficient instruments and competencies to implement on a level playing field the regulatory framework. This authority should in particular have the competence to order the closure and the resolution of non-viable institutions. The resolution of non-viable banks should no longer be a rare exception. For that, the best example is the 464 banks that were closed in USA since 2008.

-Second, a resolution authority and a coherent regulatory framework for the resolution of systemically important banks. The costs of a resolution shall ultimately be borne by a fund. This fund needs to be financed by the financial sector itself to unwind systemically relevant financial institutions without relying on public finances and ultimately taxpayers' money.

-Third, deposit insurance should be organized or at least further harmonized.

The banking supervision can only work efficiently if it has access to the relevant information, for example on the deposits. It can only act effectively if it has the adequate instruments in its toolbox, such as the closure of a non-viable bank.

However, there is several conditions should be fulfilled:

-Firstly, any new task in banking supervision may not prejudice price stability as our primary objective. Monetary policy and banking supervision have to be kept separate. This calls for separate decision making bodies within the institution. 14 out of 17 national central banks in the euro area engage in banking supervisory today already without any negative impact on their monetary policy mandate.

-Secondly, the Central Banks' independence may not be impaired by the new task. Monetary policy by definition is independent. Banking supervision by its very nature is not. It must be subject to parliamentary and judicial control. We're open to this request to show accountability to the parliament and the council of ministers.

-Thirdly, the Central Banks must be equipped with all instruments it needs to perform banking supervision effectively and efficiently. The Central Banks will only engage in banking supervision if it gets a comprehensive tool box.

The implementation of a banking supervision is closely linked to the possibility of direct banking recapitalization via a technological database system (like the ESM: European Stability Mechanism) in the future and should not least therefore be advanced without undue delay. However, the task is complex and banking supervision in itself is too important to present solutions under time pressure that will not work in practice. We should therefore take the time it takes to get it right.

### **3.2.2- Real economy, financial stability and monetary policy:**

Having reviewed the additional tasks that central banks are asked to take over, a question regards the implications for the practice of monetary policy. The crisis has clearly demonstrated how essential financial stability is for the effective conduct of monetary policy. Financial market developments have always been an integral part of monetary policy considerations and have influenced the design of non-standard measures. However, monetary analysis and financial market analysis should play an even greater role for the conduct of monetary policy – particularly with regard to financial imbalances and financial fragilities. There are three main areas to incorporate the lessons from the crisis.

First, the world is faced with the fact that the smooth functioning of the financial sector is key for macroeconomic outcomes and monetary policy transmission. We saw that adverse financial conditions can have strong and impairing effects on the effectiveness of monetary policy. Academia and central banks have already taken up this research agenda and macroeconomic models and monetary policy assessments are refined in that regard. For instance, the work by Cúrdia and Woodford (2010) has provided an important advancement by introducing central bank balance sheet considerations into the New-Keynesian framework. Corsetti *et al.* (2012) complemented this with interlinkages between the sovereign and the real economy. Moreover, many new modeling approaches now account for liquidity and credit constraints in macroeconomic models. Still, the links and the channels between the financial sector, the real economy and their ultimate impact on output and inflation still leaves many questions open addressed for central bankers and academics.

Second, the two-pillar monetary policy strategy foresees that we take into account monetary and credit developments – particularly to ensure a medium- to long-run orientation. Over time monetary analysis at the Central Banks has been continuously refined and deepened. In the crisis it was crucial to better gauge short-term risks from financial flows and imbalances. And also in the future, its scope and methodology needs to be kept continuously



updated. In particular, the analysis should encompass not only a detailed understanding of banks' behavior, but also developments in the shadow banking sector as provider of private sector liquidity. In order to conduct these types of analyses detailed data on financial intermediaries and their transactions is crucial.

And third, a flexible framework to implement monetary policy has allowed us to react swiftly to the instabilities during the crisis. In fact, most of non-standard measures have focused on providing adequate liquidity to financial institutions and did not require changes to operational framework. The adjustments were merely on the parameters of the existing framework.

Yet, the provision of liquidity by central banks needs to be linked to a clear assessment of solvency of the counterparties. Only by being able to distinguish solvent from insolvent financial institutions can central banks continue to fulfill their mandate of being lenders of last resort to the financial system. Detailed information on the health of financial institutions and the capacity of the central bank to resolve insolvent banks would ensure that liquidity provision is kept to the circle of solvent banks.

### **3.2.3- Financial instability:**

The present crisis is a new reminder of the inadequacy of the theoretical framework of the gap between conventional theory – based on the hypothesis of efficiency, rationality, neutrality and self-regulating market mechanisms – and actual experience.

The most developed countries of the world are shocked because at the epicenter of the crisis are the most sophisticated and “deep” financial systems of them. Thus, financial dysfunction can no longer be attributed to underdeveloped financial institutions or governance shortcomings, which were commonly considered to be the cause of the repeated financial crises in developing and transition economies in the 1980s and 1990s. There is now increasing recognition of the need to reintroduce the notion of financial instability in the theoretical framework (Borio, 2013; Blanchard, 2013). The causes of the repeated financial crises lie in the very nature of finance, because they have followed fairly similar patterns, regardless of where and when they have occurred. The intrinsically stable supposed markets are not destabilized by the External shocks and occasional mismanagement which may accentuate financial vulnerability or trigger a financial crash (Reinhart and Rogoff, 2009). The goods markets, where suppliers and purchasers are clearly distinct and where some material factors (e.g. productivity, costs and stocks) set limits to price movements. In financial markets, such limits are much scarcer or simply do not exist. It's not the case for the financial markets that do not function like the goods markets, which produced this recurrent financial instability (Aglietta and Brand, 2013). Unlike in other markets, most agents can be buyers as well as sellers in financial markets. This may lead to “manias”, when most investors anticipate price increases and buyers outnumber sellers, followed by “panics”, when prices are expected to fall and buyers disappear from the market. On financial markets, unlike other markets, rising prices encourage – rather than discourage – demand for financial assets, and the opposite is true when demand is falling, thus leading to overshooting. Investors can maximize their gains by incurring debt: when the expected gains are higher than the cost of the debt, higher leveraging increases the ratio of profits to capital. If borrowers are able to provide collateral in the form of financial assets that are rising in price, lenders will be willing to meet their demand for credit. And as that credit is partly used for buying more financial assets, their prices will continue to increase, thereby feeding back the whole process and inflating a speculative bubble. In other words, there is a close correlation between credit supply and demand: they both grow in parallel during expansionary phases and validate the

increase in asset prices, with no endogenous adjustment forces in the financial markets to stop the process (Aglietta and Brand, 2013).

The perception that financial markets are inherently unstable and potentially irrational challenges the orthodox view that they are essentially not only stable and efficient themselves, but also help to stabilize the economy as a whole. In that view, access to credit is supposed to smooth expenditure, as non-financial agents can borrow during bad times and repay their debts during good times. Financial markets are therefore seen as playing a countercyclical role.

#### **3.2.4- Credit for Money:**

The higher fixed capital formation can not be only linked to savings, which can lead to the idea of the importance of the provision of credit compared to the money one. (Stiglitz, 2013). Credit expansion creates deposits, and consequently money, and not the other way around.

This contrasts with the monetarist tradition that assumes that “high-powered money” issued by central banks determines the amount of credit and other monetary aggregates – an assumption that has been invalidated by recent experience, which shows how massive money creation by a central bank can have little, if any, impact in terms of increasing credit to the private sector. More importantly, by focusing excessively on the quantity of money, economists and monetary authorities have given less importance to how it should be utilized. Money is not neutral, in particular because it is not distributed evenly among all economic actors when it is created. Oversimplified monetarist views of monetary creation miss this essential point, and yet the view of Cantillon and Wicksell and others is the opposite.

#### **3.2.5- Central banks remit broadening:**

The broadening of central banks remits as well as the diversification of the types and the number of the instruments which they should be used, including for macro-prudential regulation and for keeping track of what is being financed in the economy, and policy coordination between central banks and other economic authorities help to achieve the goal of financial stability. All this requires a reassessment of the idea that central banks must maintain their independence (Blanchard, 2013). The rationale for their independence was to keep them free from political pressures as they implemented their (supposedly) technical responsibility of controlling inflation. Even in cases where their mandate was limited to one single goal (monetary stability) with one single instrument (policy interest rates), their “technical” nature was debatable. With the progressive broadening of their mandate and their use of more instruments (already under way), they have assumed wider responsibilities in a comprehensive approach to macroeconomic and financial policy.

The current financial crisis revealed the need to have another look at the role of central banks, as well as the concept of their “independence” to guarantee the sole task of ensuring stability of prices of goods and services. This need has never been more evident than during this crisis. The crisis obliged central banks to take more and more unconventional measures, which highlighted the gap between the theoretical basis for the concept of central bank independence and the need, derived from experience, to involve the monetary authorities in efforts to stabilize financial markets in the interests of the economy as a whole. The **traditional** view holds that the private financial sector is efficient, even to the extent of being able to ease the impact of shocks on the real economy. The assumptions that financial institutions always have correct information about current and future economic developments,

and that the government mismanagement leads to financial crises, were the reason-base to exclude the possibility of mismanagement by financial institutions and markets. The Central bank independence from government did not prevent the financial crisis, as it is confirmed by the present crisis which has turned that hypothesis upside down, as it was caused by the private sector. as a consequence, the central banks must combine their action with their governments, in order to response to the crisis, and giving help to financial institutions considered “too big to fail” in order to arrive to financial rescue of them.

A further step forward would be to accept that central banks must play an active role in the implementation of a growth and development strategy. Monetary stability, in the sense of price stability, is insufficient to secure stable financial conditions for the real economy. Moreover, financial stability depends on the performance of the real sector of the economy, because, in severe crisis situations, banks have tended to accumulate non-performing loans and eventually fail. Thus, supporting economic growth should not be considered merely a supplementary responsibility of central banks; it constitutes the very basis of financial and monetary stability.

### **Conclusion:**

The current financial crisis requires some fundamental reviewing about the detailed elements of monetary policy strategy. It is now recognized that the financial sector plays a very prominent role in the macro economy and makes it highly nonlinear at times. This requires that we abandon the linear-quadratic framework for defining how to conduct monetary policy when there is a financial disruption. There is now a very important case for a risk management framework that factors in tail risks that can produce very adverse outcomes for the economy. There are policy options that can complement traditional tools of bank regulation and the tools of monetary policy in reining in the excesses in the financial system. Macro-prudential policies aim to constrain excessive growth in lending during booms, and thereby attain both a more viable long-term growth in lending. So, monetary policy is to lean against credit bubbles (but not asset-price bubbles per se), rather than just cleaning up after the bubble has burst. Using monetary policy to contribute in realizing the financial stability goals and research on the best credit conditions monitoring so that its decisions to use monetary policy to restrict excessive risk are based on the correct information will be the priority for research in the future. The financial crisis has made it clear that the interactions between the financial sector and the aggregate economy imply that monetary policy and financial stability policy are strongly interfered. To facilitate that and in addition to the new macro-prudential regulation and supervision (as it is suggested by the bank of England), the central bank should orient commercial banks to finance sectors of the real economy, in action combined with its government to implement a growth and development strategy.

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