

ASPECTS OF THE BANKING SYSTEM IN THE PROCESS OF MONEY CREATION IN THE REPUBLIC OF MOLDOVA

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Abstract

The saying "banks create money" can be often heard nowadays. The issue is particularly relevant at present because the idea that banks can create money from nothing has generated social anger. Without a proper understanding, the misconception that banks create money from nothing will continue to influence business patterns in the financial sector and interventions of the monetary policy. The ability of the banking system to create money is influenced by a number of factors. The banking system of the Republic of Moldova faces numerous problems in the process of money creation, and namely: banks eagerly invest in securities only for a short period of time; a significant share of loans in foreign currency in the total of loans; dollarization of the currency and economies; a large share of cash in the money supply structure; an increased degree of risk associated with loan services of the real sector of the national economy – all these factors determine the amount of money created.

Key words: banking system, money, money stock.

The framework of the monetary policy often related to the money supply began in 1993 with the introduction of the national currency. During the period 1993-2006 we observed the influence on the amount of currency in circulation and the banking system's ability to generate this money in the Republic of Moldova. As the monetary policy is directed towards fund raising, the National Bank is focused on the quantitative factors that exist at the money market and influence mainly the functional capacity of the banks' ability to create money.

In 2006, as they signed the Action Plan the Republic of Moldova – the European Union and there was a need to correlate the national legislation with the legislation of the European Union, the National Bank of Moldova refocused its monetary policy on prices and the ultimate objective was changed from "achieving and maintaining the stability of the national currency" to "ensuring and maintaining the stability of prices". Thus, the monetary policy changed its focus from the money supply to the money demand in the economy.

All these actions have also changed the environment of money creation, i.e. the conditions under which banks used to create currency in the Republic of Moldova. Thus, before 2006 they were under immediate subordination of the National Bank and their ability to create money was directly influenced by the money stock stipulated by the

NB, well, since 2006 they are already under its indirect control and some tools to regulate the banking activity are applied.

The new objective of the monetary policy in the Republic of Moldova was adopted along with the increase of the share of cash in circulation in the structure of the monetary base as well as the excessive inflow of foreign currency and its dollarization. At the same time the control of monetary aggregates under the conditions of long-term inflation becomes rather difficult.

MATERIAL AND METHOD

The objective of the given research is the banking system of the Republic of Moldova in the process of money creation. The research methodology is based on the following methods: logical and dialectical methods, analysis, synthesis, scientific abstraction. We studied the data provided by both the National Bureau of Statistics of the Republic of Moldova and the National Bank of Moldova.

RESULTS AND DISCUSSIONS

The Republic of Moldova has a banking system with a money market which offers a very narrow range of tools. Only government securities are traded there and there is no other circulation of capital in the short term, the incidence of tools

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related to the cost is very low (the basic rate). Therefore, there is a strong correlation between the share of mandatory reserves and the amount of money supply in circulation. Discrepancy between the fundamental objective of the monetary policy and sound sustainability of the banking sector influenced the pace of monetary expansion. Although the volume of money supply used to increase throughout the period (2000-2015), the increase of money supply in the post crisis period has slowed considerably (*figure 1*). The smallest indices of the money stock increase was registered in 2009, when the national economy assimilated the consequences of the global financial crisis

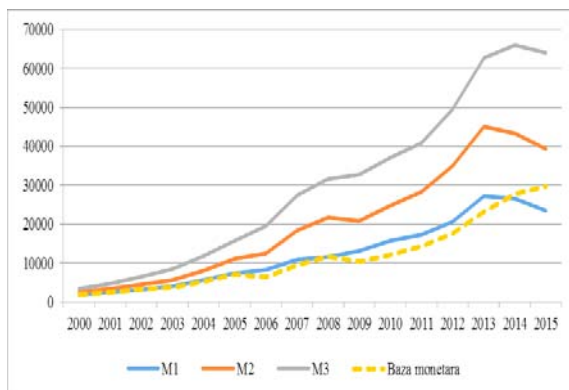


Figure 1 The evolution of the money stock in 2000-2015, mln. MDL

Following the influence of the monetary policy tools on the money supply, we can observe that it is uneven as related to the structure of the quantity of money in circulation, being influenced by certain specific factors.

The amount of money created by the banking system of the Republic of Moldova has been subject to the following tools, applied by the NB with disruption of money supply: basic interest rate and the ratio of minimum mandatory reserves.

Along with the transition to the inflation targeting regime, the basic interest rate became the main tool of the monetary policy, by means of which the central bank influences directly interest rates on interbank deposits, balancing both supply and demand at the money market (*figure 2*).

In 2001-2015 the NBM changed basic rates several times. The highest level of the basic rate was registered in early 2001 (21%), afterwards it was gradually lowered to 3.5% by the second half of 2013 and remained at this level until December 2014, when the NBM increased it again under the influence of inflation expectations.

The next tool applied to regulate the process of money creation is the ratio of minimum cash reserve. It is an active instrument of the NBM monetary policy. In 2000-2015 the mechanism was

changed many times as compared to the European Central Bank, where the minimum cash reserve is no longer an active instrument of the monetary policy. The NBM appeals to the change of the minimum cash reserve to influence both short-term money demand and interest rate, increasing – to constrain money stock in circulation, and decreasing – to ease monetary conditions.

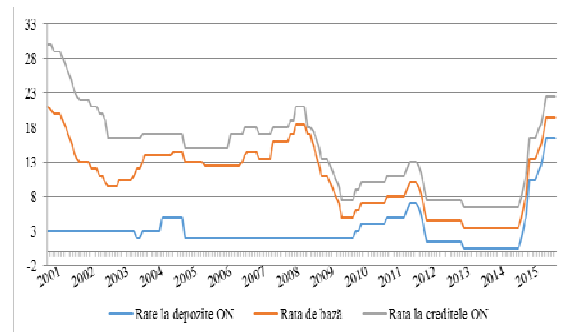


Figure 2 The evolution of interest rates on NBM tools of monetary regulation in 2001-2015, %

The efficiency of the process of money creation for the economy can be transmitted, calculating the effect of money supply propulsion created by the central bank on the economy by banks. The propulsion effect is also useful if we decide to analyze the behavior of banks in various monetary policy impulses (Hayek F. A. 1937).

The propulsion effect can be calculated by relating the credits in the economy to the money supply in the economy, and is an effectiveness indicator of the monetary policy on the banks' ability to create money, stimulating the economy.

The propulsion indicator may provide an insight into the evolution of the amount of money in the economy, financing the economy by banks. The uneven development of these two indices may prove the existence of some endogenous factors which influence the banks' ability to transmit impulses of the monetary policy to the economy. The identification of these factors and their impact on the banks' ability to create money in terms of the economic growth is a key task of this paper taking into account the formulation of some proposals to correlate the activity of monetary authorities and the banking system with the needs of the real economy.

The diverse evolution of the propulsion indicator during different time periods (*figure 3*) demonstrates the change of the banks' behavior of banks in creating and providing funds for the economy, depending on the action of various factors.

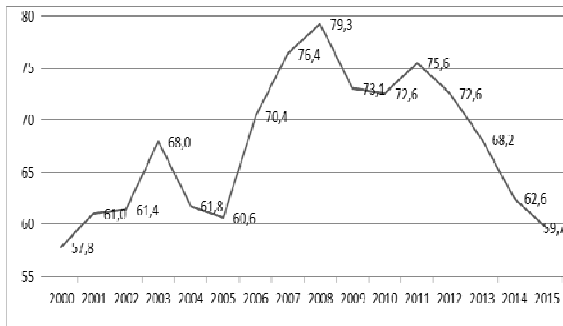


Figure 3 The evolution of the propulsion indicator in the Republic of Moldova in 2000-2015

Having analyzed the figures of the propulsion indicator evolution, we notice that the peak value of the propulsion indicator during the studied years was about 79% (figure 3). This level can be considered very close to the maximum level, based on prudential requirements imposed on banks, related to the maintenance of liquidity. According to principle II of liquidity, imposed on banks by the NBM, they must maintain 20% of its assets liquid, depending on risks. Based on this prudential requirement, we may conclude that the propulsion indicator in the Republic of Moldova may tend to about maximum 80%.

The evolution of the propulsion indicator in the Republic of Moldova (figure 3) it is observed that during the studied period one can identify three specific periods:

- It was noticed that banks' ability to create and propulse money was significantly low in 2000-2006.

- In 2007 - 2008 banks' ability to create and propulse was utmost advantageous, reaching 74.4%.

- Since 2009 banks' ability to create and provide the real sector with money again decreased and reached low levels regardless of the fact that the money stock increased.

If the central bank tries to stimulate banks to create liquidity by means of various mechanisms of the monetary policy in order to finance the real sector, there is a number of factors that could stimulate or hinder this process at the level of the banking sector (Selgin G., 1996). Among the main factors that constrain the process of money creation in the Republic of Moldova with the approval of the central bank we should note the following:

- Constraints from the real sector of economy, i.e. the ability of real econom to absorb a greater amount of money. Regardless of the facilities granted by central banks, the process of liquidity injection into the economy at the level of banks by lending money, being strictly regulated in order to reduce risks, can result in minimal effects.

Especially considering that the real sector is still suffering the consequences of the global financial crisis and economic agencies do not meet all the requirements necessary to be eligible for a bank loan, being insolvent or having an adverse credit history.

- Prudential constraints, originated from the regulatory system of the banking sector. The modern banking system is highly regulated. Although it is very good for stability and economic sustainability, it can block the propulsion effect of liquidity in the economy (White L.H. 1995). Even if banks take some risks and offer loans, counting on their own experience and knowledge to support the economic growth, they could not do because of the existing regulatory system.

- Cost constraints. To protect banks' exposure to risks arising from lending, losses and possible shock absorption, the NBM stipulates the creation of a special risk fund by every bank in the system. This was an additional prudential requirement to manage credit risks. The increase of loans presupposes extra costs that can not be carried by all banks. And again, there is a regulation effect of the banking activity under which any bank is required to establish a reserve fund for losses on balance sheet assets / conditional commitments subject to credit risks (at least 2% for those classified as standard ones) (Rothbard, M.N. 1990). The establishment of additional reserve funds in its turn requires the availability of a certain amount of equity capital for a period, which cannot be afforded by all banks due to insufficient capital.

The identification of the factors that affect the mechanism of money creation in the banking system of the Republic of Moldova allowed us to conclude that macroeconomic indices have a greater impact on the banks' creation capacity than microeconomic indices in our country, and banks' interest in the money creation process has the smallest contribution to this process. To optimize the process of money creation the BNM should correlate both the monetary policy and the policy at the mezzo-economic level that is related to the influence on banks or the policy may be guaranteed by prudential supervision of the banking activity. Therefore, it is important to bring to the foreground the intercorrelation between the monetary policy and the banking supervision as we can improve the process of money propulsion in the economy by motivating the direct supervision of banks that would like to create money and ease restrictions.

CONCLUSIONS

To sum up the information mentioned above, we can conclude with certainty that role of banks in the process of money creation is indispensable, having a major impact on the sustainable economic growth and development. Monetary authorities must take this into account and they fulfill their tasks, promoting the monetary policy and controlling the banking activity, and coordinating these two activities through the impact on the banks' money creation. Only by correlating the promoted monetary policy with prudential constraints imposed on banks and their impact on their ability to create money and propel the economy can be achieved not only by fundamental objectives of the monetary policy, but also by random ones, related to the creation of favorable conditions for the sustainable economic

development. As the real economic growth can be achieved only if economic agents have permanent access to money and banks can fulfill the function of money creation only if it reaches the final consumer.

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