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Radoje Žugić *
Nikola Fabris **

* *Ministry of Finance of Montenegro and Faculty of Economy in Podgorica*

E-mail: radoje.zugic@mif.gov.me

** *Central Bank of Montenegro and Faculty of Economy in Belgrade*

E-mail: nikola.fabris@cbcg.me

Framework for Preserving Financial Stability in Montenegro

Abstract: The global financial crisis has challenged the traditional monetary policy framework of one instrument (short-term interest rates) – one objective (price stability). More and more central banks nowadays consider financial stability as a monetary policy objective, whereas the Central Bank of Montenegro is the only one that has identified financial stability as its primary objective.

As this is a relatively new objective, all central banks endeavouring to attain this objective have been facing numerous difficulties. Therefore, the article analyzes some of these difficulties such as defining financial (in)stability, the selection of indicators, macroeconomic environment for preserving financial stability, and the like.

The main objective of the paper is to analyse the framework for preserving financial stability in Montenegro and the challenges that the Central Bank of Montenegro has been facing in accomplishing this objective.

Keywords: Financial stability, Preserving, Montenegro, Central Bank of Montenegro.

Jel code: E52 and E58.

1. Introduction

The global financial crisis has opened a new chapter in considering the central banks' objectives. To wit, it has raised the issue of central banks` role in crisis prevention, management and resolution. The recent crisis has shown that inflation (unless it turns into hyperinflation) is less of a threat to the functioning of an economy and a financial system than financial instability. Real economy and financial system may function with minor or major difficulties in inflation conditions, while financial instability completely "paralyzes" real and financial flows. Moreover, resolving a financial instability is more time and money consuming than disinflation itself.

Some central banks still refrain from recognizing financial stability as their objective because central bank cannot cover all financial stability aspects. To wit, even those central banks with the widest supervisory powers do not supervise the capital market, hedge funds, and only few of them supervise insurance companies and pension funds. However, the crisis aftermath brought about rising expectations that central banks should be responsible for early warnings of crises, diminishing weaknesses and vulnerabilities in the financial system, and continuously take actions on preserving financial stability.

The Central Bank of Montenegro (CBCG) is currently the only central bank that has identified the financial stability as its primary objective. This objective is defined in the Constitution of Montenegro and the Central Bank of Montenegro Law.

Many other central banks have defined financial stability as an objective, but only as a secondary one. The importance of this objective in central banking will surely grow in the future.

The objective of this paper is to present how the financial stability framework functions in Montenegro. The paper consists of four sections. The first section defines financial stability, the next one describes general principles for preserving financial stability, while the framework for preserving financial stability in Montenegro is described in the third section. The last section discusses outstanding issues and considers further options for improving the framework for preserving financial stability.

2. Definition of Financial Stability

Financial stability does not have generally accepted definition and, unlike inflation, it cannot be numerically expressed[1]. Financial stability usually implies the absence of banking crises or large financial market fluctuations. The Bundesbank

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[1] As Crockett (1997) stated, monetary stability refers to price stability, while financial stability refers to the stability of key financial institutions and markets.

(2003) defined financial stability as a steady state in which the financial system efficiently performs its key economic functions and is able to do so even in the event of shocks, stress situations and periods of profound structural change. According to Gjederm (2005) financial stability is achieved if households and enterprises may obtain optimal consumption and investment over time in the conditions of a well-functioning financial system that can intermediate between savers and borrowers and redistribute risk in a satisfactory manner, with an efficient allocation of real economic resources over time. Wieser (2005) defines *financial stability* as a financial system capable of absorbing severe shocks without triggering a financial crisis, i.e. financial stress that has cross-sectoral spillovers with negative macroeconomic effects. Schinassy (2006.) believes that a stable financial system allows the efficient allocation of economic resources, determine the cost and manage financial risks and is able to perform these functions and when faced with external shocks and imbalances. The European Central Bank indicates that Financial stability poses a "condition in which the financial system—comprising of financial intermediaries, markets and market infrastructures—is capable of withstanding shocks and the unravelling of financial imbalances, thereby mitigating the likelihood of disruptions in the financial intermediation process which are severe enough to significantly impair the allocation of savings to profitable investment opportunities".

On the other hand, there are authors who claim that financial stability cannot be defined, but only financial instability. Thus, Mishkin (1999) points out that financial instability occurs when shocks to the financial system interfere with information flows so that the financial system can no longer do its job of channelling funds to those with productive investment opportunities. Ferguson (2003) defines financial instability as a situation characterized by these three basic criteria:

- some important set of financial asset prices seem to have diverged sharply from fundamentals,
- market functioning and credit availability have been significantly distorted, and
- aggregate spending deviates significantly from the economy's ability to produce.

Alawode and Sadek (2008) differentiate:

- **Financial fragility**, where vulnerabilities are evident, but the financial system is somehow managing to carry out its functions;
- **Financial instability**, where vulnerabilities are beginning to impede the delivery of financial services, and

- **Financial crisis**, the most serious form of instability, where the normal functions of the system cease.

In most countries, the issue of financial stability is not exclusively within the central bank's authority but individual responsibilities are delegated to the central bank, the ministry of finance and supervisory agencies. Since a central bank cannot be the institution solely responsible for financial stability, the question is why financial stability is discussed as the central bank objective. The answer lies in the fact that there are many pieces of evidence supporting the hypothesis that a predictor of future systemic financial crises is the rate of expansion of broad money and bank lending (Goodhart, 2005). Moreover, there is a rather widespread opinion that financial stability and price stability are always coupled (Cukierman, 1996, Schwartz, 1995, Issing 2005). Simultaneously, monetary cycles may intensify real cycles. The best example is the Asian crisis in the 1990s when the financial sector weaknesses instigated the economic activity drop and intensified the effects of shocks to the real sector. On the other hand, through its crisis instruments, monetary policy may affect the liquidity improvement (extending loans to banks, reductions of mandatory reserves, lowering the reference interest rate and the like) and increase public confidence, which may significantly contribute to restoring financial stability.

A financial system includes a set of interconnected components: infrastructure (legal system, payment systems, accounting system, and the like), institutions (banks, insurance companies, institutional investors and the like) and the market. Poor functioning of a single component may aggravate financial stability. However, bankruptcy or liquidation of individual financial institutions is not necessarily a sign of jeopardized financial stability but on the contrary, a result of market competition that is strengthening financial stability.

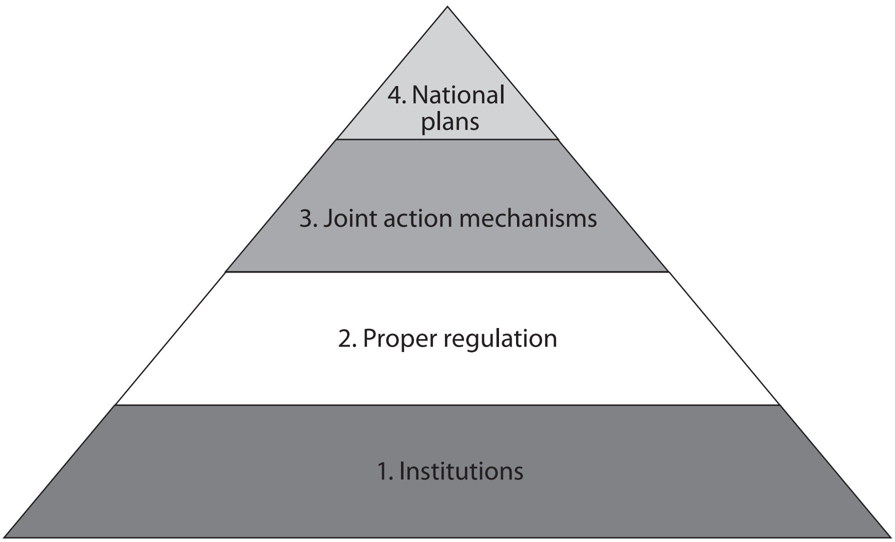
The BIS identified the "paradox of instability" which is the situation when the financial system can appear strongest precisely when it is most fragile. (Borio and Drehmann, 2009). This is exactly what happened during the global financial crisis, when all international institutions (including the IMF) assessed the financial system as stable and the driver of growth, while a bulk of financial institutions collapsed like a house of cards.

3. General Principles for Preserving Financial Stability

To achieve financial stability, it is necessary to identify potential risks before they appear and lead to a crisis or problems in the financial market functioning. This includes pursuing preventive and well-timed policies. Surely, the objective cannot be the prevention of all potential problems in the financial market since all risks and uncertainties cannot be managed, and there is no single market that has not undergone fluctuations or turbulences. Therefore, the objective should be to strive towards minimising the largest risks and ensuring the system vitality during crisis situations. Financial crises have shown that such a framework cannot rely on regulation and market discipline alone (Hannoun, 2010), that is, the framework for preserving financial stability is necessary.

The system of preserving financial stability can be depicted through the pyramid below. The backbone and the foundation of the financial stability pyramid are institutions, which have to be strong, credible and independent. To be able to function, institutions need regulation based on international standards as the prevention from risky behaviour of some financial institutions and, simultaneously, as a framework for adequate supervisory action in preventing any undesired conduct. Since financial stability is a "common good" and the joint responsibility of many institutions, the mechanisms should exist for joint and coordinated actions of all institutions responsible for supervision and regulation of individual financial system segments. National plans should exist at the top of the pyramid, prepared in advance as contingency plans.

Figure 1 – Financial stability pyramid



Source: Fabris, N. (2010) "Current issues of Montenegro's economy", CBCG

In its working paper, the BIS (2011) made the following conclusions on the role of central banks in preserving financial stability:

- Central banks must be involved in the formulation and execution of financial stability policy if such policy is to be effective;
- Charging the central bank with responsibility for financial stability is not sufficient – appropriate tools, authorities and safeguards are also needed;
- Ex ante clarity about the roles and responsibilities of all authorities involved in financial stability policy (central banks, supervisors, deposit insurers, treasuries and competition authorities) is of paramount importance;
- There is no simple structure to ensure that the actions needed to achieve all relevant policy objectives will easily be recognised and adopted.

Stress testing, which analyses the possibilities of individual financial institutions or the entire system to absorb different types of shocks, is widespread. Many central banks and some international institutions like the IMF, the World Bank, the BIS, and others produce "Financial Stability Report", which is based on stress testing. Financial stability analysis covers all sources of risks and potential shocks. It requires systemic monitoring of individual parts of the financial system and real economy. To that end, the IMF issues "Core and Encouraged Set of Financial Soundness Indicators" that is to ease the financial stability assessment.

Table 1 - Sources of Risk to Financial Stability

Endogenous shocks	Exogenous shocks
Institutions-based	Macroeconomic disturbances
Financial risks	Economic-environment risk
Operational risk	Policy imbalances
Information technology weaknesses	
Reputation risk	
Business strategy risk	
Capital adequacy risk	
Market-based	
Counterparty risk	
Asset price misalignment	
Run on markets	
Credit	
Liquidity	
Infrastructure-based	Event risk
Clearance, payment and settlement system risk	Natural disaster
Infrastructure fragilities	Political events
Regulatory	Large business failures
Legal	
Supervisory	

Source: Schinassy, J., 2006., "Safeguarding Financial Stability".

However, a new standard set by the global economic crisis in Europe is the production of contingency plans. To wit, all EU Member States prepare sectoral contingency plans, which are used for preparing the national contingency plans. The aim is to prepare countries for future challenges and likely financial crises although they cannot be forecasted with certainty at the moment. Contingency plans elaborate different types of potential crises, including banking crises, the stock market collapse, foreign exchange crises, payment system disruptions, and the like. The key challenge for these plans is the identification of systemic risks and/or the identification of policies for their removal. Table 2 gives an overview of policies for preserving financial stability.

Table 2 - Policy areas and contributions to global financial stability

Policy area	Primary objective	Financial stability objective
Prudential	Limit distress of individual financial institutions	Address systemic risk
Monetary	Stabilise prices	Lean against boom-bust cycles in credit and asset prices
Exchange rate	Stabilise exchange rate	Reduce capital flow volatility
Fiscal	Manage demand countercyclically	Maintain fiscal buffers that allow a response to financial system stress

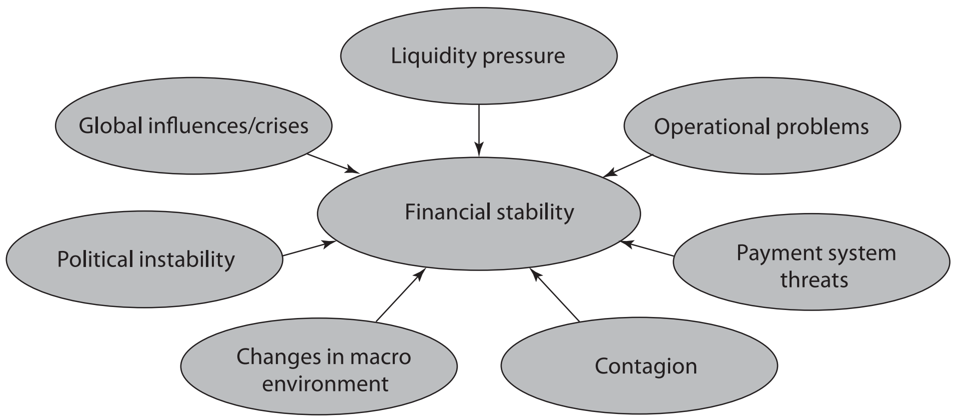
Source: Hannoun, H. (2010), Towards a Global Financial Stability Framework, 45th SEACEN Governors' Conference, Siem Reap Province.

4. Framework for Preserving Financial Stability in Montenegro

The key institution of the financial stability framework in Montenegro is Central Bank of Montenegro. A financial crisis is defined as: "a condition when, as a result of individual factors or a combination of factors, there is a danger that the financial system or some of its components (money and financial markets, financial institutions, and financial infrastructures) are unable to fulfil their functions, which makes them a potential threat to financial stability and generates significant economic cost. A financial crisis occurs when problems in one or more banks become so serious that they exert a significant impact on the real economy and other banks."

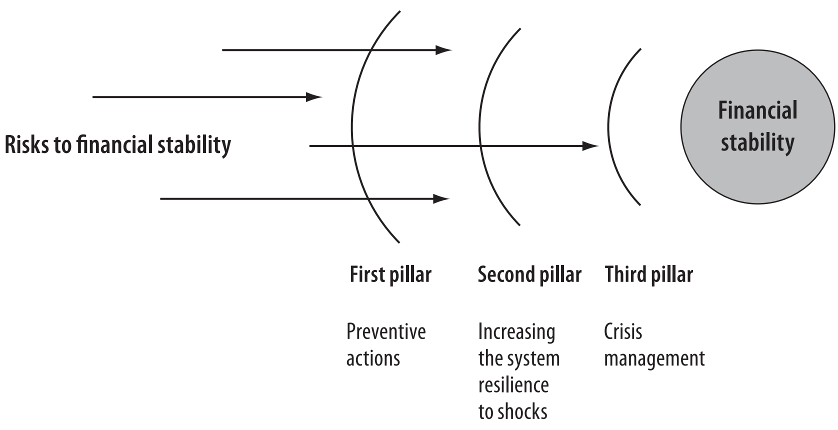
The factors of particular concern are shown in Figure 2.

Figure 2 – Financial stability factors



Maintaining financial stability in Montenegro can be described via three lines of defence. The first line is prevention, the second one is increasing the system's resilience to shocks, and the third line is crisis management. All three dimensions are equally important.

Figure 3 – Three-dimensional approach to preserving financial stability



The CBCG passed the contingency plan, which serves as the backbone for the crisis management. The plan defines:

- the concept of financial stability and financial crisis,
- crisis events involving the Central Bank,

- crisis management principles,
- preventive actions,
- prevention and mitigation of crisis effects,
- management strategy for a bank in crisis, with a special focus on the role of the state and the Deposit Protection Fund in its implementation,
- crisis scenarios,
- communication during a crisis,
- crisis simulation exercises,
- responsibility of various Central Bank organisational units for crisis prevention and management,
- crisis PR, and the like.

With a view to analysing the resilience of individual banks and the system as a whole to risks the banks are exposed to in their operations, including credit risk, liquidity risk and market risks, the CBCG Supervision Department conducts periodical, at least quarterly, stress testing of banks. In addition, crisis simulations are conducted periodically to test the CBCG's ability to respond to crisis challenges, as well as the efficiency of available instruments.

The first step the CBCG undertakes in a crisis is the taking of corrective measures that range from moral suasion (appealing to the sense of responsibility of bank management and board of directors towards the public), informal and formal enforcement measures (including fines and orders to relieve of duty executive officers and persons with special powers and responsibilities), appointing an interim administrator, to revoking the licence and appointing a bankruptcy/liquidation administrator.

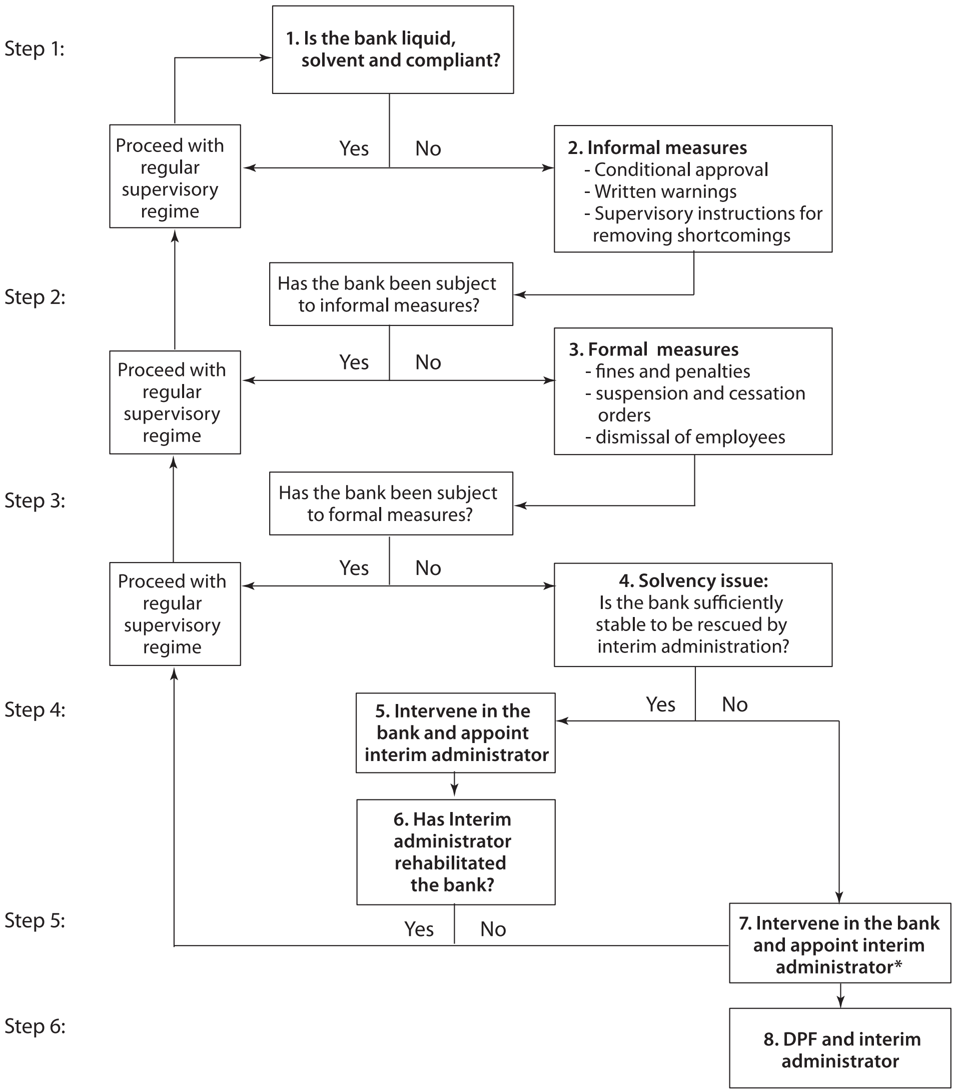
The objective is to ensure bank resolution as soon as possible in order to:

- limit the state's and/or taxpayers' losses,
- enable quick access to guaranteed depositors' funds,
- maintain financial stability and public confidence in the banking sector.

Maintaining confidence into the banking sector is of vital importance to avoid massive bank run and maintain the financial sector stability. Fast payout to depositors and limiting negative economic effects of bank bankruptcy or liquidation on the remaining portion of the banking sector may boost public confidence. Quick bank resolution implies lower costs and the loss of assets and franchise values is minimised. Allowing problem banks to continue operations causes market disruptions and increases moral hazard and costs of problem bank resolution. In order to prevent or at least mitigate crisis in some banks, the CBCG may provide liquidity support to solvent banks to ensure regular settling of their operations or, in exceptional circumstances, when it assesses that providing financial assistance is necessary to prevent aggravation of the banking sector's stability and soundness.

Figure 4 shows the abovementioned activity streamlining.

Figure 4 – Flow chart of problem bank resolution



* Trustee in bankruptcy or liquidation

Monetary policy and its instruments could contribute to the alleviation of the economic crisis effects, yet only if coupled with fiscal policy instruments. Thus, fiscal sustainability is recognized as an important factor of financial stability. Taking into account these facts and the uncertain environment and unpredictable economic trends, Montenegro has been pursuing extremely prudent and responsible fiscal policy. To that end, the main objective is the balancing of the public finance, that is, the improving of fiscal indicators that have deteriorated over the past years due to the crisis impact.

Therefore, Montenegro's fiscal policy aims to:

- continue with the consolidation of public spending and gradually reduce the share of public expenditure in GDP,
- improve fiscal control and strengthen internal and external audit of all budget spending units,
- combat grey economy in order to increase the budget revenues,
- improve taxpayers` culture,
- strengthen fiscal discipline and reduce tax evasion, and
- pursue adequate borrowing policy, both domestic and foreign, in order to avoid the public debt crisis and deepening of structural disproportions.

In Montenegro was established Financial Stability Council (FSC). The Council is chaired by the Governor of the CBCG, and the members are also the Minister of Finance, the President of the Securities and Exchange Commission and the President of the Council of the Insurance Supervision Agency. The FSC is the point of discussion about all potential risks to the financial stability and coordinates activities for preserving financial stability. Pursuant to the FSC Law, the primary tasks of the FSC are:

1. determining, collection and analyses information of importance for financial stability and a potential financial crisis management;
2. promoting and ensuring coordination and exchange of information among competent authorities;
3. assessing and identifying vulnerabilities affecting the financial system;
4. identifying and prioritising risks important for the financial system stability;
5. passing the National contingency plan for financial crisis management (hereinafter: the National contingency plan) and organising financial crisis stress testing and financial crisis simulation exercises;
6. monitoring the financial system development and its impact on the pertinent regulatory policy;

7. monitoring best practices with a view to adopting regulatory standards in the financial system areas;

The FSC passed the National Contingency Plan and the proposal of the Lex Specialis to be sent for adoption to the Parliament in case of a crisis, which would increase the rights of institutions included in the financial crisis resolution. Moreover, the Law allows the use of additional instruments other than those prescribed under the existing legislation.

5. Challenges to Financial Stability Maintenance in Montenegro

The first big challenge refers to the fact that although it is responsible for maintaining financial stability, the CBCG has neither any responsibility nor the possibility to affect other financial system elements except the banking sector and micro-financial institutions. This problem is partially overcome by the FSC being chaired by the CBCG Governor. Taking into account the structure of the financial system in Montenegro, an extenuating circumstance is that it is less likely that a crisis could emerge in any financial system segment other than the banking sector. This hypothesis is maybe best confirmed by the Montenegrin stock exchange crunch in spring 2007 that had almost no consequences to the remainder of the financial system or the real sector.

Another key problem refers to the absence of sufficiently long time series to be used for decision making on financial stability preservation. Namely, during the period when Montenegro was not an independent country, most of statistical indicators were compiled only at the federal level. Although Montenegro has been compiling its own statistics for more than a decade, many data are problematic for two reasons. The first one is insufficiently reliable data particularly at the beginning both due to the lack of experience in statistics and poor quality data sources. The other problem refers to the presence of different shocks over the past several years – high FDI inflow, credit boom, the crisis – so the observed years cannot be taken as representative. The FSC has developed the early warning system, but it needs further improvement and time to obtain representative time series.

Additional problem refers to the absence of many monetary policy instruments, the situation that is imposed by the euroisation regime nature itself. The CBCG does not have the reference interest rate, it does not issue currency, it does not perform open market operations (although these would be theoretically possible), and it has very limited funds at disposal for executing the lender of last resort function. The problem was partially mitigated by foreseeing that, in case of aggravated financial stability, the Ministry of Finance may provide funds for exercising the lender of last resort function. Moreover, the potential passing of the Lex specialis would enable the use of some unconventional instruments.

The problem with staffing should not be neglected nor the lack of experience in financial stability preservation. Still, since the paradigm of financial stability as a central bank objective is relatively new, the problem is not only confined to the CBCG but it is also shared by many other central banks. The problem may be resolved by intensive education of the CBCG employees through financial stability training programmes and the IMF and the World Bank technical assistance. A significant progress has been made in this area lately.

Referring to eventual factors that may lead to aggravating financial stability, these should primarily be sought in the banking sector as a relatively high share of non-performing loans. They amounted to 17.5 percent at end-2013 and they were relatively high although not deviating significantly from the region average, yet being significantly lower than their peak of 25 percent in August 2012. In order to mitigate the problem, in cooperation with the World Bank and the Ministry of Finance, the CBCG developed the model of voluntary financial restructuring of non-performing loans known as the "Podgorica Approach". The model is expected to become operational in the second quarter of 2014.

6. Conclusion

When referring to central bank objectives, financial stability represents a new paradigm. The CBCG is so far the only central bank that has set financial stability as its primary objective, while many central banks have set it as their secondary objective. The importance of this objective will grow in the future.

The CBCG has developed mechanisms to monitor and preserve financial stability. The key challenges that the CBCG is facing in the implementation of the framework for preserving financial stability include: limited instruments, the absence of reliable time series, and some experience in the implementation of this framework. The key threat to financial stability is a relatively high level of non-performing loans. To that end, in cooperation with the World Bank and the Ministry of Finance, the CBCG has developed the model of voluntary financial restructuring of non-performing loans known as the "Podgorica Approach". The implementation of this model is expected to start in the second quarter of 2014.

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