

## **Central banking in theory and practise *Nikola Fabris* (Central bank of Montenegro, Podgorica 2006)**

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The book of dr Nikola Fabris “Central banking in theory and practise“, in a very reasonable and comprehensive way, presents a broad range of theoretical and empirical findings from the field of monetary policy and central banking. From the historical point of view, monetary policy experienced many challenges with the change of prevailing global macroeconomic imbalances and the dominant macroeconomic schools. Undoubtedly, central bank has the objective to attain and maintain price stability, with the possibility to support other objectives that are not confronted with the primary goal. The book ‘Central banking in theory and practise’ consists of four chapters: first chapter, the concept of central banking; second chapter, the central bank functions; the third chapter, monetary policy; and the fourth chapter, central bank functioning in practise. The book includes various boxes, tables, graphs, annexes, schemes that help to explain the analysed field, including many examples from practise and reminders about crucial knowledge from macroeconomics i.e. monetary economics.

In the first chapter ‘The concept of central banking’, the author introduces key concepts of central banking and overall monetary policy. It deals with historical aspects of central banking and the fact that central banks have had different levels of (in)dependence, discretion, property structure, objectives and instruments. The author underscores that monetary policy and central bank are constantly confronted with evolutionary environment, so the influence, (in)dependence, objectives and instruments have been changing having in mind evolving environment and prevalent economic ideology. The boxes of the I chapter give a useful review of macroeconomic schools related with monetary policy and the influence of monetary policy on a different economic goals.

Central banks’ objectives are not unified, and the author presents the objectives, in the text and boxes, of a number of key central-monetary institutions (FED, ECB, Bank of England, Bank of Switzerland and Japan). Although there are debates about prioritizing particular objectives, the dominant view is that price stability is a primary goal for the most central monetary institutions. This thesis is empirically supported with research of the long run trade-off between

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inflation and economic growth/unemployment, with the conclusion that price stability is in the function of a higher economic growth. It is very useful to remind the readers about the Phillips curve and the relation between two crucial macroeconomic goals (inflation and unemployment/economic growth). Although sometimes central bank's objective can be financial stability, it is concluded that this objective couldn't be the primary goal. Primary goal must be clear, understandable for the public and under direct influence of the monetary authorities.

In the first chapter, the author considers legal and property status, and organizational structure of central banks corroborating these aspects with different empirical data in tables, boxes and graphs. Central banks are mainly public institutions (although there are examples of the corporation type), managed by the Council for monetary policy (or Monetary council). However, there are certain differences in the structure of the Monetary Council, basic functions and the governor's position, the Council is the highest level in the organizational structure to conduct the monetary policy. Besides the Monetary council, there is also a Supervisory council (under different names) with various functions and jurisdictions, depending on the actual environment.

The author also explains the importance of risk management in central banks, identifying different types of risk, presenting risk mapping (risk positioning depending on the influence and certainty) and different strategies of responses on the positions risks (avoiding, reducing, distribution and risk acceptance). Having in mind that central bank is confronted with market and credit risks, just like other market participants, the author emphasizes its operational risk, i.e. its qualitative and quantitative sides.

The question of (in)dependence of central bank is certainly a very delicate question in public debates and empirical research. The author considers independence in details, first as a concept, then from the historical point of view, emphasizing practical question of the central bank independence and the different measuring methods.

The second chapter deals with key central bank functions: issuing function, lender of last resort, management of foreign-exchange reserve, regulatory function, supervision, payment system, research, collecting and processing of statistical data, services to the government, etc.

The third chapter explores monetary policy i.e. instruments of monetary policy, characteristics of contemporary monetary policy and monetary policy regimes. A monetary authority has to answer three main question: what is the objective of the monetary policy, which monetary policy regime will be used and which instruments will be applied to achieve the primary objective. A specific question or dilemma related to the conduct of monetary policy is the choice between rules or discretion. The author highlights the mentioned debate from the aspect of certain macroeconomic schools and the international monetary system

(gold standard and Bretton Woods,) presenting positive and negative sides of both cases.

Before introducing monetary policy instruments, limited attention is devoted to the transmission mechanism of monetary policy. The transmission mechanism is a way of transmitting monetary policy influence, through specific channels, to key macroeconomic variables, mainly the production level (income, employment, economic growth) and the price level. The author focuses the interest rate channel and tries to explain its complexity and influence on the variables, with the ultimate influence on the inflation rate.

Although the transmission mechanism channels are presented briefly, because of the limited space and the author's aim to adjust the book content to a broader public's knowledge (without emphasizing scientific terminology and economic models), the conclusion is made that the transmission mechanism is very complex and quite unpredictable with a significant time lag.

The monetary policy instruments are explained through the concept, purpose, significance and influence of open market operations, mandatory reserves, central bank lending to commercial banks and direct instruments of monetary policy. The author argues that significant public attention is directed to the choice of monetary policy regime. Hence, important attention is dedicated to monetary policy regimes, i.e. exchange rate targeting, monetary aggregate targeting, inflation targeting and nominal income targeting. Intermediate targets represent the connection between the objective and the instruments of monetary policy, because it is impossible to control the objective directly. The exchange rate, monetary aggregate, inflation rate or, as a more theoretical option, nominal income can serve as a nominal anchor, or as an intermediate target.

If monetary authority targets the exchange rate, benefits are achieved through the import of credibility from the country of reserve currency and the inflationary expectations reduction. However, with exchange rate targeting, monetary policy loses its discretionary power because it is obliged to maintain the peg. Empirical research confirmed a higher vulnerability to speculative influence, peg unsustainability, external disequilibrium, as well as asymmetric effects of the monetary policy of reserve-currency country. The exchange rate targeting can nevertheless incorporate more or less flexibility, as the author mentions, emphasizing the difference between hard pegs (dollarization/euroization, currency board, monetary union), intermediate regimes (crawling pegs, basket pegs and bands) and flexible regimes (managed and clean floating).

Monetary targeting, dominant since the 1970s (after the collapse of Bretton Woods system), assumes the adjustment of money supply to growth trends of GDP. A positive side is central bank's direct control of monetary aggregates and the possibility of countercyclical influence. But, a negative aspect is that money demand (often very unstable) comes in between price stability and money supply. The application of money aggregate targeting is less interesting

in comparison to a currently very popular monetary policy regime (from the aspect of developed, as well as developing countries) – inflation targeting.

Inflation targeting assumes short run inflation forecasts on a model base and the reaction of monetary authorities (the movement of the interest rate) depends upon a possible deviation from the target forecast. The monetary regime of inflation targeting presents a combination of discretion and rules, while the monetary policy is mostly released from the obligation of preserving the specific exchange rate peg. The application of such a monetary regime implies the fulfilment of institutional, operational and technical presumptions, which are mentioned in the book. The authors also elaborates on positive and negative aspects of this popular monetary regime.

Nominal income targeting assumes the adjustment of monetary policy (monetary aggregate) to the deviation of nominal GDP growth from the target level, thus working counter cyclically. This Keynesian-oriented monetary regime focuses real variables, like production, employment, investments. However, nominal income targeting is a theoretical option, so in a practical sense it does not have important significance. The author mentions key disadvantages i.e. causes of a practical inadequacy of such monetary regime.

Exchange rate regime, particularly elaborated by the author, is the dollarization (euroization). The author underscores differences between the official, partially official and unofficial dollarization. Monetary policy regime of exchange rate targeting assumes inter alia a rigid exchange rate regime in the form of complete or official dollarization (euroization), although the fact is that the unofficial dollarization (euroization) is widespread in many developing countries. The reason beyond unofficial dollarization (euroization) is a decline of confidence in national currency and a lower credibility of monetary authorities in these countries. The author stresses the hysteresis effect under the conditions of unofficial dollarization (euroization) – even after the macroeconomic stability is achieved, the reserve currency is used as a store of value, for accounting purposes, and as a payment medium. The advantages and disadvantages of the dollarization (euroization) regime are presented in details.

The fourth chapter gives the empirical profile of central banking. Functioning of six central banks (FED, ECB, Bundesbank, Bank of England, Central bank of Montenegro and Central bank of Bosnia and Herzegovina) are discussed. Those central banks are analysed because of their importance, but also due to the implemented monetary regime. The author's intention was to explore different regimes, starting with the system of central banks (FED) with the highest level of discretion, then Bundesbank that successfully practised the monetary targeting regime, the ECB that combines inflation and monetary targeting, the Bank of England that has decided to stay with the inflation targeting regime (after numerous changes of monetary regimes), and, finally, central banks of BiH and Montenegro, with the exchange rate targeting in the rigid form (currency

board vs. euroization). Besides the monetary regimes analyses, the foundation, functions, organizational structures and instruments of monetary policy are analysed for each of the selected central banks.

Most books on monetary economics or international monetary economics require significant econometric and scientific background. The author aimed to prove that a book in this research field can be written in clear and understandable way. The author's aim has been achieved. Another contribution of the book 'Central banking in theory and practise' is the fact that it presents, although in a very concise way, facts and conclusions from the theoretical-empirical aspects of monetary economics. The elaboration of the mentioned topics is additionally enriched with practical examples, reminders about key macroeconomic conclusions and schools, illustrations and schemes, as well as empirical data.