Analysis

How can we simultaneously maintain both price and financial stability in the euro area?

Monetary policy | 10 September 2015 | Hanna Freystätter

AUTHOR



Hanna Freystätter
Senior Adviser

The operating environment for monetary policy has changed: the euro area macroprudential system – or macroprudential framework –for dampening country and sector-specific overheating is now stronger than before the financial crisis. The new system is, however, not yet complete, which increases the need to contribute to the maintenance of financial stability also via monetary policy measures. Even if the macroprudential system were stronger than it currently is, it is very difficult to fully prevent the possibly unfavourable side-effects of an exceptionally accommodative monetary policy. In the current situation, however, the strengthening of economic growth via monetary policy measures does also support financial stability.



In the current situation, an accommodative monetary policy maintains both price and financial stability

The aim of the euro area's exceptionally accommodative monetary policy is to keep inflation expectations anchored and ensure that the period of low inflation does not continue for too long. A protracted period of low policy rates and the ongoing expanded purchase programme will serve to depress long-term interest rates, ease financial conditions for non-financial corporations and households and boost asset prices in the euro area. Expectations that monetary policy will remain more accommodative than in other key economic regions weaken the euro exchange rate against other currencies. Overall, the accommodative monetary policy boosts demand and pushes up inflation in the euro area.

In the euro area, monetary policy is transmitted particularly via bank lending. The completion of the comprehensive assessment of banks' balance sheets and the launch of single banking supervision in autumn 2014 are improving the functioning of the bank lending channel. These measures are accompanied by the ongoing gradual tightening of banks' fixed capital requirements to safeguard financial stability. The combined effect of the various components of the new regulatory framework is difficult to assess, and in the transitional period the effects may be different from the longer term. In the transitional period, these tighter requirements may e.g.

dampen the monetary policy stimulus effect, but in future the banking sector will be more resilient to adverse shocks in the economy. A sound banking sector will also be able to increase lending as growth in the euro area picks up.

One of the concerns that has been raised is that under the new regulatory regime banks may avoid high-risk corporate lending because this would require them to have a higher level of additional capital than previously.[1] At the same time, the smaller risk weights of lending for house purchase may attract banks to increase mortgage lending. Most badly hit would be SMEs and new companies, as they are dependent on banks, whereas larger companies are increasingly acquiring finance on the capital markets. In the worst case, in the new regulatory environment monetary stimulus could, via the banks, be channelled too strongly onto the housing markets instead of into corporate sector fixed investment.

A sustainable normalisation of inflation requires that monetary policy impacts extend to the broader real economy. It would therefore be hoped that accommodative monetary policy would ease non-financial corporations' funding conditions and stimulate fixed investment in the euro area. The Eurosystem's monetary policy measures aimed at improving lending are designed to encourage banks to increase lending particularly to non-financial corporations. In the euro area, the problem has been that the exceptionally low policy interest rate has not been fully transmitted into bank lending rates in all euro area countries, and bank lending has been subdued, particularly lending to non-financial corporations. For example, in the targeted longer-term refinancing operations (TLTRO) begun in September 2014, banks are required to increase lending to the euro area non-financial private sector in order to be entitled to low-cost and long-term central bank refinancing (that will mature at the end of 2018).

There is, however, a risk that the significant increase in liquidity brought by the expanded asset purchase programme, combined with tighter regulation, may result in a situation in which the monetary policy stimulus is channelled excessively onto the housing markets or into the shadow banking sector. An overheating of the housing market would be particularly dangerous, as the bursting of a leveraged housing bubble usually results in a deep and protracted recession. Even though the creation of a stock market bubble is similarly not welcome, the impact on the real economy and price stability have usually been smaller than the consequences of the bursting of a housing market bubble. If the monetary policy stimulus focuses strongly on the shadow banking sector and is transmitted via this sector, this contains risks, as the resulting threats to financial stability are not necessarily fully understood yet, let alone managed.

A rise in asset prices is, however, a key channel through which the effects of an accommodative monetary policy are transmitted, as it supports the balance sheets of the household and corporate sectors. A rise in asset prices and growth in lending are not automatically an indication of an

emerging bubble. The improvement of the euro area economy via accommodative monetary policy measures is also beneficial for financial stability,[2] as it boosts employment and facilitates the servicing of debt and the reduction of the considerable leverage ratios, both of which will also have a positive effect on the banking sector.

A strong macroprudential system minimises unfavourable side effects of accommodative monetary policy

Compared with before the financial crisis, the euro area is considerably better equipped, with the help of macroprudential policy, to manage risks to the financial system. The countercyclical (dynamic) macroprudential policy framework being launched extensively in the euro area in 2014–2016 is targeted at curbing excessive credit and leverage growth in a cyclical upswing, thus dampening the procyclicality[3] of the financial system, i.e. tendencies that amplify business cycles. Countercyclical macroprudential policy can be used to support the favourable allocation of accommodative monetary policy measures in the euro area in a way that prevents excess and ensures the effects reach evenly all sectors of the economy.[4]

In the new macroprudential system[5] of the euro area, the risks to financial stability arising from the exceptionally accommodative monetary policy are tackled on two levels: primarily with measures taken by national macroprudential authorities (first line of defence) and secondarily, if necessary, with more stringent requirements imposed by the ECB (second line of defence). Even if lessons have been learned from the crisis, the euro area macroprudential system is not yet fully operational, and several deficiencies have already been pointed out.

Key in the new system is that national macroprudential authorities, e.g. in Finland the Financial Supervisory Authority, bear primary responsibility for the macroprudential policy of their country.[6] The majority of the macroprudential policy toolkit is defined by EU legislation as common to all Member States. Member States may also issue national regulations on additional tools. As yet, however, not all Member States have yet used this opportunity very extensively.

The work of national macroprudential authorities in different countries is thus restricted by the toolkits included in their national legislation. If, for example, a national macroprudential authority notices that an exceptionally accommodative monetary policy is strongly reflected on the housing market, it cannot act effectively if the macroprudential tools that are best suited to preventing the overheating of the housing market have not been provided for in national legislation. Legislators thus play a key role in the construction of an efficient national macroprudential system.

When, in November 2014, the ECB assumed responsibility for the supervision of the largest banks it also assumed macroprudential policy powers. In the new institutional structure of the euro area, macroprudential policy powers are divided between national authorities and the ECB.[7] The ECB can impose more stringent requirements on the macroprudential tools under its power than national supervisors. At the ECB, significant responsibility for euro area macroprudential policy lies with the Governing Council, which is ultimately responsible for ensuring that macroprudential policy is tight enough.

The role of the ECB in the macroprudential policy of the euro area is still taking shape. Members of the ECB's Executive Board have in their speeches discussed their new role by e.g. underlining the protection of financial stability as part of their role, as well as the significant role of the ECB's Governing Council in macroprudential policy decision-making.[8] The macroprudential powers of the ECB are, however, limited. They extend only to certain macroprudential tools available to national authorities, the powers are asymmetric (no power to impose less stringent requirements) and responsibility is shared with the national authority.[9]

For macroprudential policy to have an effect, the tools available should be effective enough.[10] From the perspective of the ECB, the achievement of this goal is restricted by the fact that the additional tools adopted by national authorities are not within the reach of the ECB. For example, the loan-to-value ratio is not part of the tools regulated by the ECB, and each national authority can decide on the use of this instrument.

The ECB does, however, have at its disposal the macroprudential tools included in the EU's Capital Requirements Directive and Regulation (CRD IV/CRR). In practice, these include two countercyclical macroprudential tools: a countercyclical capital buffer imposed on banks and higher capital requirements (higher risk-weights) vis-à-vis real estate exposures. The ECB does not necessarily have the possibility to impose effectively more stringent macroprudential measures on each problem at hand. On the other hand, if the national macroprudential policy is effective and appropriate, the fact that the set of tools available to the ECB is limited does not necessarily create problems.

The asymmetry of powers can also be considered a limitation. The ECB's powers to impose only more stringent measures has, however, been carefully considered. The purpose is to prevent passiveness in situations in which national authorities should implement macroprudential measures that are unpopular with the general public. In contrast, it may be easier for the national authorities to take less stringent macroprudential decisions without the help of the ECB.

The shared responsibility of the ECB and national authorities may also, in a worst case, lead to a

situation in which neither party acts according to their responsibilities. The ECB's (and particularly the Governing Council's) powers can be justified by the fact that the ECB has the best overall picture of the euro area and an ability to understand the interdependencies of the various policy areas.

Doubts[11] about the effectiveness of the available common countercyclical macroprudential tools (e.g. the countercyclical capital buffer) apply to both the ECB and the national macroprudential supervisors. Criticism can also be presented on the limited scope of the macroprudential tools: the instruments currently available in the euro area apply almost entirely to banks and their financial intermediation activities, i.e. they do not cover non-bank financial intermediation or e.g. stock market bubbles.

One perspective, however, is that a macroprudential policy that addresses bank credit can be effective in the euro area because the bulk of financial intermediation takes place via banks and the current macroprudential tools focus on this type of financial intermediation.[12] The euro area is also a special case because there is still some fragmentation on the financial markets. Country-specific macroprudential measures directed at the banking sector are thus more effective than they would be if the importance of the capital markets was high and the degree of financial fragmentation was low.

It is, however, worth considering whether individual banks are already currently able to carry the responsibility for their own macroprudential stability and whether the ECB is able to carry its responsibilities as the last line of defence for euro area financial stability. For example, housing market overheating can be a difficult situation if national authorities are restricted by the lack of adequate macroprudential tools in national legislation and/or measures by the ECB's Governing Council are restricted by the fact that it cannot use in its decision-making the macroprudential tools designed particularly for dampening the overheating of the housing markets. A rapid broadening of the available macroprudential toolkit is to be hoped for.[13] We also have to prepare for the active use of countercyclical macroprudential tools, as policy interest rates are likely to remain at a low level for a protracted period and the expanded purchase programme will be continued until inflation is on a sustainable path towards price stability.

Should monetary policy contribute to maintaining financial stability in the euro area?

The primary objective of the ECB is to maintain price stability. When the objective of price

stability is not endangered, monetary policy can also be used to support other economic objectives of the EU, such as balanced economic growth. Financial stability contributes to the achievement of price stability and thus the fulfilment of the ECB's mandate. Financial stability is necessary for the operation of the financial system and the efficient transmission of monetary policy, which in turn enable the central bank to maintain price stability. An environment of financial stability reduces the probability of reaching the zero-bound interest rate and having to resort to non-standard monetary policy measures.

The euro area's single monetary policy is currently conducted in an operating environment where the effectiveness of the macroprudential system of the euro area is uncertain. Due to this uncertainty, it is unclear whether current monetary policy is conducted in an environment of a weak or strong macroprudential system. To put it simply, we can estimate that if the current macroprudential system of the euro area is strong, the unfavourable side effects of an exceptionally accommodative monetary policy will remain minor. If, on the other hand, the current system is still too weak, monetary policy can be used for actively and fully leaning against the wind,[14] financial stability issues can be left unattended in monetary policy decisions, or the measures can be something in between the two aforementioned.

The new institutional architecture of macroprudential policy in the euro area means that the current situation would not be a standard case of leaning against the wind. Primary responsibility for financial stability lies within national macroprudential policies, which are expected to dampen financial cycles and reduce the need to lean against the wind with the help of monetary policy.

The possible complementary role of monetary policy in the maintenance of financial stability has, however, been reintroduced in recent years.[15] It has been proposed that monetary policy should contribute to the maintenance of financial stability if the macroprudential system is not very strong.[16] In addition, even if macroprudential policy targeted at lending were successful, tighter regulation may push financial stability risks to the shadow banking sector. As long as the euro area lacks macroprudential tools that cover the shadow banking sector, monetary policy may have to take responsibility because its effects extend to the shadow banking sector, too, via general financing conditions.

In a weak macroprudential system, monetary policy decision-making would therefore give a larger-than-zero weight to the maintenance of financial stability (third line of defence). If monetary policy contributes to the maintenance of financial stability, it may have to be tightened so that inflation and output remain for a longer period lower than their target and potential to prevent the creation of a financial bubble. Such a situation does, however, pose the risk that the central bank's credibility as the guardian of price stability could suffer.[17] In such a situation,

measures should be taken to strengthen the credibility of the primary objective. One proposal is that the central bank should commit to a price-level target.[18] In this case, the protracted low level of inflation is compensated at some point so that the price level remains on its target path.

In an environment of a strong macroprudential system, monetary policy decision-making would be easier, as it could focus fully on its primary objective, the maintenance of price stability. However, in the case of a strong macroprudential system, the use of countercyclical macroprudential tools would (via lending and asset prices) also have an impact on the economic cycle, and hence on inflation. In the euro area, this would mean changes to the operating environment of monetary policy that are not yet fully understood. If, for example, a strong monetary policy and strong macroprudential policy work in the same direction, the tightening impact on financing conditions and the dampening impact on credit growth of countercyclical macroprudential policy should be included in the total impact assessment so that the monetary policy stance is not scaled in an inappropriate manner. In such a situation, the macroprudential policy stance in the various euro area countries should be an important component of the assessment of economic developments in the euro area.

In the short term, the other policy areas, e.g. monetary policy, have to take the euro area's current macroprudential system as a given. Over a slightly longer period, the current system could be changed if it turns out that it is not yet effective enough or its coverage is inadequate (e.g. does not reach the shadow banking sector). Various parties have, however, warned about having too high expectations for macroprudential policy: it may not be possible to build even in the longer term a macroprudential system that is so strong that the countercyclical macroprudential policy would be effective enough in the euro area to compensate for the unfavourable effects of a monetary policy that is exceptionally accommodative from time to time. It has also been proposed that macroprudential policy and monetary policy should be thought of as complements.[19] Macroprudential policy cannot be expected to be fully effective if the objective is to offset a monetary policy stance.[20]

Monetary policy must take into consideration that the effectiveness of the euro area's current macroprudential system can be either under or overestimated. If the effectiveness is overestimated, the unwanted side effects of monetary policy may be assigned for management by macroprudential policy, even although it is at least thus far not equipped to do this. If, however the effectiveness is underestimated, the monetary policy stance may be formulated in an inappropriate manner. The euro area may also find itself in a situation in which the macroprudential system is strong in some countries and weak in others. The ECB Governing Council's strong commitment to the objective of price stability is nevertheless essential, and the improvement of the euro area economy will also support financial stability.

Sources:

Barut, M.-L. – Rouillé, N. – Sanchez, S. (2015) The Impact of the New Regulatory Paradigm on the Role of Banks in Financing the Economy. Financing the Economy: New Avenues for Growth. Financial Stability Review, No 19. April 2015. Banque de France.

Bernanke, B. (2011) The Effects of the Great Recession on Central Bank Doctrine and Practice. Speech at the conference 'Long Term Effects of the Great Recession'. Federal Reserve Bank of Boston 18–19 October 2011.

Bruno, V. – Shim, I. – Shin, H. S. (2015) Comparative Assessment of Macroprudential Policies. BIS working papers, No 502.

Cecchetti, S. G. (2015) Monetary Policy within the New European Financial Regulatory Architecture. Presentation at the conference 'ECB and its Watchers XIV', 11 March 2015.

Constâncio, V. (2015) Strengthening Macroprudential Policy in Europe. Speech at the conference 'The macroprudential toolkit in Europe and credit flow restrictions'. Vilnius 3 July 2015. See https://www.ecb.europa.eu/press/key/date/2015/html/sp150703.en.html.

Draghi, M. (2014) Stronger together in Europe: the contribution of banking supervision. Speech in Frankfurt 20 November 2014. See https://www.ecb.europa.eu/press/key/date/2014/html/sp141120.en.html.

ECB (2015) Financial Stability Review. See https://www.ecb.europa.eu/pub/fsr/html/index.en.html.

Fontaine Vive, P. de (2015) Key Initiatives to Unlock Bank Lending to the European Corporate Sector. Financing the Economy: New Avenues for Growth. Financial Stability Review, No 19. April 2015. Banque de France.

Freystätter, H. – Putkuri, H. – Vauhkonen, J. (2013) 'Financial cycles, monetary policy and macroprudential policy in the euro area'. Bank of Finland Bulletin 4/2013.

Grande, M. (2014) Integrating Macro- and Microprudential Supervision at the ECB. Presentation at the conference 'Global Banking Standards and Regulatory and Supervisory Priorities in the Americas'. Lima 4–5 November 2014.

Hannoun, H. (2015) Ultra-low or Negative Interest Rates: What They Mean for Financial Stability and Growth. BIS, Eurofi High-Level Seminar. Riga 22 April 2015.

IMF (2013) The Interaction of monetary and macroprudential policies.

IMF (2014) Monetary Policy in the New Normal. IMF Staff Discussion Note SDN/14/3.

King, M. (2012) Twenty Years of Inflation Targeting. Stamp Memorial Lecture at London School of Economics. London 9 October 2012.

Lauterschläger, S. (2014) The interplay between macro-prudential, micro-prudential and monetary policies at the ECB. Presentation at the conference 'Macroprudential Policy: Implementation and Interaction with other Policies'. Stockholm 13 November 2014.

Panetta, F. (2014) 'On the special role of macroprudential policy in the euro area'. In: Putting Macroprudential Policy to Work. Eds. Aerdt Houben – Rob Nijskens – Mark Teunissen. De Nederlandsche Bank. Occasional Studies, Vol. 12/-7.

Schoenmaker, D. (ed.) (2014) Macroprudentialism. A VoxEU. org eBook, CEPR Press. London.

Smets, F. (2014) Financial Stability and Monetary Policy: How closely Interlinked? International Journal of Central Banking. June. Vol. 10. No. 2.

Woodford, M. (2012) Inflation Targeting and Financial Stability. NBER Working Papers 17967.

Notes

1. See e.g. Fontaine Vive (2015) and Barut et al. (2015). ↑
2. See e.g. ECB (2015). ↑
3. See e.g. Freystätter et al. (2013). ↑
4. Macroprudential policy in the euro area has also been strengthened by introducing macroprudential tools that are not primarily intended for countercyclical use but strengthen the resilience of the financial system. ↑
5. The term 'macroprudential system' refers to a wider concept than the available macroprudential tools (e.g. the countercyclical capital buffer or loan cap), because it also includes issues relating to e.g. competence and decision-making. ↑
6. In Finland, macroprudential supervision is based on cooperation between several authorities. The national macroprudential authority is the Financial Supervisory Authority (FIN-FSA), and the FIN-FSA Board takes the decisions on the use of macroprudential tools. The decisions are based on a macroprudential analysis, made in close cooperation by the Bank of Finland, the Financial Supervisory Authority and the Ministry of Finance. ↑
7. Currently, the banking union consists of only euro area countries, and therefore both the single monetary policy of the Eurosystem and the ECB's macroprudential powers apply to euro area countries. ↑
8. See e.g. Draghi (2014) and Lauterschläger (2014). ↑

9. Grande (2014). ↑
10. See e.g. Schoenmaker (ed.) (2014). ↑
11. See e.g. Cecchetti (2015). ↑
12. Panetta (2014). ↑
13. See e.g. Constâncio (2015). ↑
14. See e.g. IMF (2014). Leaning against the wind refers to a monetary policy stance that is tighter than necessary in terms of only the price stability target but seeks to dampen the rise in asset prices and prevent an increase in financial imbalances. ↑
15. See e.g. Bernanke (2011) and King (2012). ↑
16. Smets (2014). ↑
17. Woodford (2012). ↑
18. E.g. Hannoun (2015) and Bruno et al. (2015). ↑
19. See also IMF (2013). ↑

Keywords

euro area, macroprudential policy, monetary policy