Blog

On financial stability, monetary policy, and macroprudential policy

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Should monetary policy concern itself with financial stability? If yes, how should it do so?

Should monetary policy concern itself with financial stability? If yes, how should it do so? These are some of the questions tackled in the recently concluded monetary policy strategy review by the European Central Bank (ECB).[1] This is an important topic, central to many of the challenges that the Eurosystem has faced since the previous review in 2003. In what follows, I cover some of the major findings on monetary policy and financial stability.

Macroprudential policy is the first line of defense against financial risks. Macroprudential policy makes use of tools specifically designed to address market inefficiencies and distortions that give rise to financial imbalances. Further, given asynchronous developments in financial conditions across countries, macroprudential policy at the national level is essential to tackling threats to financial stability.

Monetary and macroprudential policy, and their corresponding primary objectives of price and financial stability respectively, are intertwined. Financial stability is a precondition to price stability. A resilient financial sector helps preserve the effective transmission of monetary policy to the economy. In turn, by stabilizing prices and by serving as a lender of last resort in extreme circumstances, a monetary authority helps contain risks in the financial sector.

By the same token, the pursuit of one objective by its respective authority entails *side-effects* on the other. For example, macroprudential limits on leverage and bank capital may affect the transmission of monetary policy to the economy via bank lending. On the other hand, low interest rates can lead to an increase in risk-taking and may also affect profitability in the financial sector.

Monetary policy and macroprudential policies should in general work towards their respective primary objectives but be mindful of what the other is doing. This is the logical and practical conclusion that arises from these considerations. It is also consistent with the *Tinbergen Principle* which calls for a specific tool to address each objective. It acknowledges that monetary policy responses to risks to financial stability (e.g. *leaning against the wind*) may in some cases entail considerable costs also to its primary objective of price stability.[2] Therefore, each authority should ideally remain within their respective competencies and take advantage of synergies whenever feasible.

Concretely, what this means for the ECB monetary policy strategy is an enhancement of financial stability considerations in the revamped analysis framework. This involves a broadening of the tools and inputs used in the formulation of monetary policy to help monitor build-ups in financial vulnerabilities, assess how macroprudential measures address these vulnerabilities, and evaluate how these interact with the monetary policy stance and the monetary policy instruments that could be deployed. Further, the new strategy calls for a sustained research effort to continuously improve upon these tools and inputs.

It is important to emphasize that this does not mean that financial stability is a new and distinct goal to be pursued with monetary policy. The main aim of these enhancements is to help make more informed decisions regarding price stability while minimizing side effects on financial stability and contributing to the smooth operation of macroprudential and other policies. Further, financial stability considerations have always been, to some extent, part of the deliberations for monetary policy. The new analysis framework builds on improvements to these considerations which have gradually accumulated over time.

A review of the EU-wide macroprudential framework remains an important complementary task. While significant leaps have been made in the European macroprudential framework since the Global Financial Crisis, there are nevertheless reasons to believe that the current macroprudential framework may not be fully complete at this time.[3] In this regard, the European Commission's upcoming review of the macroprudential framework in the European Union is eagerly anticipated.

Keywords

financial stability, macroprudential policy, monetary policy