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**Article**

# Monetary Policy and Financial Stability

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*Stephan Kohns*

# Monetary Policy and Financial Stability[1]

## INTRODUCTION

Among many other issues, the global financial crisis brought to the fore the question of how monetary policy and financial stability interact – in both a positive and a normative way.

Understanding this relationship and its implications for monetary policy is an ongoing process, with many research questions and their policy implications still remaining open. To arrive at a first conclusion, it helps to recall the pre-crisis consensus and how the financial crisis challenged this consensus, before elaborating on what elements a reassessment of the role of financial stability for monetary policy could comprise.[2]

## THE PRE-CRISIS CONSENSUS

The experience of the global financial crisis has brought the "monetary consensus" formed in the years prior to the crisis under scrutiny.

While the details of monetary policy differed notably across central banks, the primary objective under the pre-crisis consensus was price stability. Steering short-term interest rates was considered an adequate means of achieving this objective.

With the exception of Japan, the interest rate lower bound was deemed a theoretical curiosity of little practical relevance. Model-based forecasts of output and inflation played a prominent role in the monetary policy decision-making process. As capital markets were mostly assumed to be efficient under the consensus view, however, financial market imperfections and their potential macroeconomic effects were regularly left out of the forecasters' equations.

Although temporary disruptions such as asset price bubbles were considered possible, using interest rates to prick bubbles at an early stage – i.e. "leaning against the wind" – was thought to be too blunt an instrument to contain such disruptions, not to mention the difficulties of correctly predicting the onset of an asset price bubble in real time.

An inflation-targeting monetary policy was, therefore, supposed to follow two guiding principles regarding financial market developments: respond to asset price movements only if they affected the rather short-run inflation forecast, and intervene only once a financial crisis had occurred, minimising – or "mopping up" – the damage through vigorous interest rate cuts, and eventually through liquidity injections.

In addition, microprudential regulation and supervision – with their focus on individual financial institutions – were regarded as adequate means of preventing financial crises and ensuring financial stability, and it was feared that mingling monetary policy with financial stability objectives would dilute the target of price stability.

## HOW THE FINANCIAL CRISIS HAS CHALLENGED THE CONSENSUS

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With hindsight, the pre-crisis consensus led to excessive risk-taking in the financial system. The crucial triggering factor was not so much low interest rates *per se*, but expectations that the central bank would behave in a very specific way. The fact that monetary policymakers more or less explicitly promised to provide support in the event of a financial crisis encouraged the development of collective moral hazard. The role of monetary policy in encouraging, or at least facilitating such excessive risk-taking, was probably underestimated.

Furthermore, it became obvious that microprudential policy alone is not sufficient to guarantee the stability of the financial system as a whole, as it does not grasp potential systemic implications of developments at the level of the single institution. Additionally, the crisis has highlighted how financial instability undermines the central bank's capacity to safeguard price stability.

Hence, the stability of the financial system as a whole became a policy objective in its own right with its own instruments. Macroprudential policies – designed to target specific sectors of the financial system, rather than just focusing on individual financial institutions – are key to achieving this goal. The necessary instruments have been or are in the process of being made available.

## HOW TO RECONCILE MONETARY POLICY AND FINANCIAL STABILITY

As regards the role financial stability considerations should play in the conduct of monetary policy, the interaction with macroprudential policy has several dimensions. In the long run, the two policy areas ultimately complement each other. In the short run, however, conflicts between monetary and macroprudential policy can arise, especially if the business and the financial cycles exhibit different frequencies.

For example, an expansionary monetary policy to stimulate inflation transmits, among other channels, through stimulating banks' lending activity. This conflicts with macroprudential policy if the financial cycle demands that lending activity be reined in. Such interactions imply that monetary policymakers – more so than before the crisis – have to make up their minds about the relationship between monetary policy and financial stability.

On the one hand, it seems clear that monetary policymakers have to take into account financial market

[1] Disclaimer: The views expressed do not necessarily reflect the opinions of the Deutsche Bundesbank.

[2] For a more comprehensive presentation of the arguments, including references, see Deutsche Bundesbank (2015).

developments, given the awareness of the existence of the risk-taking channel and the limited experience and knowledge available to date concerning the effectiveness of the new macroprudential instruments.

On the other hand, the interest rate instrument is blunt, and there could be risks to the credibility of monetary policymakers and the effectiveness of their policies in terms of ensuring price stability once they also take financial stability into consideration.

Depending on how much weight is assigned to these aspects, it is possible to arrive at quite different policy conclusions.

At one end of the spectrum lies what might be called the *idealised perspective*. From this point of view, monetary policymakers – while being fully aware of the impact that developments in the financial sphere have on the transmission mechanism and taking into account the possible effects of macroprudential policy – should remain focused on price stability. Macroprudential policymakers, on the other hand, should stay focused on financial stability and use their own toolkit to achieve that goal.

The idealised perspective is founded on the assumption that each policy area – especially the newly created area of macroprudential policy – is more or less fully capable of precisely and effectively reducing the key problems in its own sphere.

Furthermore, from this perspective, monetary policy contributes relatively little to the development of financial imbalances, which means that the risk-taking channel is viewed as being of secondary importance. Similarly, the policy rate is regarded as an ineffective tool for containing or avoiding risks to financial stability.

The key difference between the idealised perspective and the pre-crisis consensus lies essentially in establishing an effective and credible macroprudential policy. Monetary policy can then, as before, focus exclusively on the objective of price stability.

At the other end of the spectrum lies what might be called the *integrated perspective*. According to this view, the objectives of price stability and financial stability, and the instruments and transmission mechanisms of monetary policy and macroprudential policy, are so closely interwoven that both macroprudential and monetary policy instruments should be used to ensure financial and price stability at the same time. The risk-taking channel plays a notable role in the build-up of financial stability risks. Moreover, the intensive preventive contribution of monetary policy to ensuring financial stability is deemed necessary in order to protect credibility regarding the price stability objective. Such a perspective represents a radical departure from the pre-crisis consensus.

Within this spectrum, an intermediate position – which might be termed an *extended perspective* – may prove superior. The cornerstone of this view is that monetary policy fundamentally remains geared to price stability. The objective of financial stability is achieved primarily by macroprudential policy. However, it seems questionable whether an excessively pronounced financial cycle, and thus risks to financial stability, can be eliminated with macroprudential tools alone. Monetary policy, therefore, should not focus too narrowly on achieving a relatively short-term inflation target, but also take a longer-term perspective. In this way, monetary policy helps counteract the occurrence of undesirable developments in financial markets, which could spill over to the real economy and thus jeopardise price stability over the medium to long term.

The extended perspective suggests a "symmetrical" monetary policy stance over the financial cycle: a monetary policy stance that is not only eased aggressively during a marked downturn, but tends to be stricter in upswings, implying a less persistent expansionary policy stance following a period of economic downturn.

Although aggressive monetary policy action is specifically called for during business cycle downturns, the meat of crisis resolution lies in "repairing" the balance sheets in the private sector, which means, above all, eliminating the debt overhang. Monetary policy is only of limited help and less suited to this task; conducting a prolonged expansionary monetary policy could bring the risk-taking channel to bear and may therefore be counterproductive.

If a crisis occurs, despite a more symmetrical monetary policy stance and other preventive measures, micro- and macroprudential, structural and fiscal policies would play an important role in its resolution – and in creating the conditions that decrease the probability and scope of future financial crises.

All in all, an approach based on the extended perspective could have the potential to unify the objective of price stability in the medium term and the contribution made by monetary policy to financial stability and, hence, price stability in the longer term.

## REFERENCES

Deutsche Bundesbank (2015), "The Importance of Macroprudential Policy for Monetary Policy", *Deutsche Bundesbank Monthly Report*, March Issue, 39–71.