The interaction of monetary and macroprudential policy

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Outline

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The need for macroprudential policy

- Financial stability policy has been mainly focused on microprudential supervision so far.
- Monetary policy has concentrated on price stability until now.
- The recent crisis revealed the shortcomings of these approaches:
  - Microprudential regulation is no guarantee that growing system-wide risk can be contained.
  - The interest rate may not be the ideal instrument for responding to system-wide financial risk.
- Against this backdrop, there is a strong need for a system-wide (macroprudential) element in financial stability policy.

Macroprudential policy: definition and objectives

- Macroprudential policy is preventative and thus distinct from financial crisis management.
- Main objectives:
  - Strengthening the resilience of the financial system
  - Preventing the build-up of excesses or imbalances on asset and credit markets, i.e. actively leaning against the financial cycle

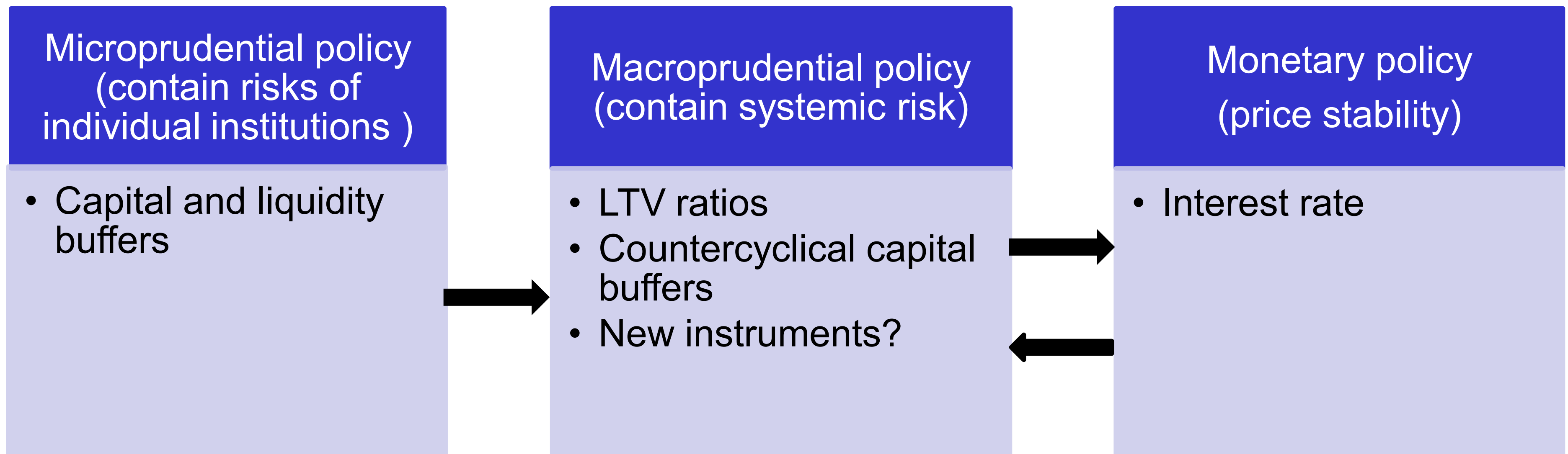
Macroprudential policy: instruments

- Characteristics of instruments are strongly dependent on the goals they address.
  - Adaption of microprudential instruments to strengthen the resilience of the financial system.
  - Caps on LTV ratios or countercyclical capital buffers are examples of tools designed to lean against the credit cycle.
- Macroprudential policy and monetary policy tools are closely related.
  - Asset price and credit cycles are influenced by monetary policy stance.
  - Macroprudential instruments aimed at credit markets will influence monetary policy decisions.

The role of central banks in macroprudential policy

- Central banks are naturally involved in financial stability issues.
  - Monetary policy needs a stable financial system for transmission of policy shocks.
  - Successful monetary policy helps to stabilise the financial system.
  - Extraordinary monetary policy measures are already one important element of crisis management.
- Monetary policy could assist in actively leaning against the financial cycle.

New financial stability framework



Prerequisites for implementation of macroprudential policy

- Sound understanding of the interplay between the three elements of the new financial stability framework.
- Monitoring system-wide risks requires good indicators.
- Knowledge of the transmission mechanism of macroprudential policy.

Monetary and macroprudential policy: potential conflicts of interest

- To counter imbalances on credit markets, monetary and macroprudential policy reinforce each other in the long run.
- However, there may be situations where conflicts of interest arise, especially when the interest rate is the only means to lean against the financial cycle.
- Under such circumstances, additional instruments to prevent imbalances on asset and credit markets would be an advantage.

Governance issues

- Central banks are key players in the financial stability framework.
- This requires collaboration with other policy institutions.
- Many facets of macroprudential policy are more sensitive to political interventions than monetary policy.
- Hence, if central banks are explicitly made responsible and accountable for macroprudential goals, their independence could be at risk.

Suggestions for future development

- Price stability should remain the main goal of central banks.
- A macroprudential policy concept should be developed carefully and avoid overly ambitious goals such as fine-tuning of asset prices or credit growth.
- A realistic first step may be the introduction of few macroprudential instruments to counter pronounced imbalances on credit or asset markets.
- Experiences with the operation of these instruments over a longer period of time could be the basis for next steps (e.g., defining a more precise mandate).

Conclusions

- The urgent need for a macroprudential element in financial stability policy is one major lesson from the current crisis.
- The implementation of macroprudential policy requires answers to questions concerning governance and operationalization.
- While the theoretical and empirical foundations of monetary policy are well established, experiences with macroprudential policy are rare.
- Therefore, we should avoid setting overly ambitious macroprudential policy goals at the current stage.
- Given the interactions between monetary and macroprudential policy, appropriate macroprudential instruments may help monetary policy to focus on price stability.