Zdeněk Tůma: The interrelationship between monetary policy, price stability and financial stability

Speech by Mr Zdeněk Tůma, Governor of the Czech National Bank, at the European banking and financial forum 2005, Prague, 22 March 2005.

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Mr. President, Excellencies, Governors, distinguished guests,

It is an honour to be opening the central bankers' forum. As the main part of the conference program concerns the financial sector challenges and opportunities in the "New Europe", the central bankers' panel has to necessarily reflect the close, particularly topical, issue of the financial stability and its relationship to a reasonable monetary policy conduct.

While my colleagues will discuss mainly the particular issues of financial stability, I, having the privilege to be the chairman of the panel, would like to frame the discussion using a more general and historical context. Bearing this perspective in mind, I would like to point to the interrelation between the ultimate goal of monetary policy, the price stability, and the financial stability.

First of all, let me start with the definition of financial stability, simply assuming that price stability does not need any further explanation. To be as brief as possible, financial stability can be defined as the soundness of the financial system, that is, its resilience against various shocks. What I understand as a sound financial system can be thought of as a system that, firstly, enables individuals to do all the payments they want at the very moment they like, and, secondly, enables individuals to smooth their consumption across time by saving and borrowing.

In this respect, the financial stability issue, which arose during the nineties, is not a completely new one. Indeed, it has been of a significant importance since banking emerged. The long years of commodity money system (so called "golden standard") could be characterised as years when money supply, i.e. the supply of gold, was so exogenous that it was even out of the central bank's control. Consequently, monetary policy was relatively easy to do, just establishing the parity between the central bank banknotes and the gold, but the role of the central bank as a lender of last resort was relatively constrained. Under those circumstances, the financial stability was naturally of a high importance, because for any commercial bank the attempt to "run" the bank could be deadly. Moreover, this could cause stampede runs on others banks and bring the whole system to an end, as the central bank's ability to provide the additional currency would be constrained by its gold reserves. To protect themselves, the commercial banks and the central bank established clearing houses to provide, in case of the run on any particular participating bank, the currency to each other. That was in fact a financial stability remedy, of course, being a product of its time.

After the Second World War the abandonment of the "golden standard" changed things completely. The introduction of the fiat money changed the monetary policy framework dramatically, forcing the financial stability issues to take back seats in the central banks considerations. There were two main reasons for financial stability being less of a worry. First, by using the fiat money the role of the lender of the last resort was not limited anymore. The central bank could lend to commercial banks as much as they wanted to borrow, just printing new money. There was no need to hold a parity to anything. Second, many central banks faced serious troubles in order to meet their ultimate target, the price stability, within the new fiat money environment. Therefore the policy focus shifted and huge effort was concentrated on finding a new appropriate policy framework.

The situation was even more complicated due to the fact that both aforementioned points were closely interdependent. To illustrate this point, let's assume that there was an inflationary pressure which caused redistribution disturbances to the financial system as it led to the redistribution of wealth from lenders to borrowers. The central bank either had not established the appropriate framework for dealing inflation yet, or even worse, inflation had not been viewed as an undesirable phenomenon. On the other hand, the central bank was ready to fulfil its role as a lender of last resort. But saving the commercial banks from imminent bankruptcy further increased inflationary pressures. At the end this caused kind of inflationary trap. It was not surprising that during those times the financial stability was not of a main concern for the central bank.

As the central banks learnt during the second half of eighties to deal more properly with inflationary disturbances, the price stability was broadly achieved again. Consequently, the interest in financial

stability issue has been increasing during the nineties. In my opinion, there are two main reasons for it. First of all, central banks have learnt one important rule: that their role of the lender of last resort is something the central bank should be ready to fulfil, but in fact it is optimal, never to do it in practice. Second of all, the financial system is in the end completely incomparable to the pre-World-War-II system. Nowadays, we live in a global world and, although we are more capable of minimising the impact of inflationary disturbances, there are other types of shocks arising.

To sum up, the main message we can learn from the history is that price stability as the ultimate goal of monetary policy is not in contradiction with the effort to achieve the financial stability. Indeed, on one hand, price stability is a necessary condition to achieve financial stability, as the inflationary disturbances have the potential to cause serious damages to the financial system; on the other hand, a sound financial system enables the monetary policy to smooth its actions in order to achieve price stability.

Ladies and gentlemen, thank you for your attention.