Yves Mersch: Monetary policy and financial stability under one roof

Keynote speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the 6th Policy Roundtable of the European Central Bank: “The future of global policy coordination”, Frankfurt am Main, 6 September 2013.

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Ladies and Gentlemen,

It is my pleasure to join you at the 6th Policy Roundtable of the ECB, which this year focuses on “The future of global policy coordination”. I will be speaking about the interaction of a particular set of policies, namely monetary, micro-prudential and macro-prudential policy. But rather than discussing the global dimension or replicating the discussion at Jackson Hole, I will restrict myself to the changes taking place under the roof of the ECB: the ECB taking over responsibility for elements of micro and macro-prudential supervision in the euro area.

Having the financial stability function under the roof of the central bank is of course nothing new. It is almost exactly hundred years since that the Federal Reserve Act was signed into law. According to the regulation, Federal Reserve Banks were created “to furnish an elastic currency, to afford means of rediscounting commercial paper” – and notably – “to establish a more effective supervision of banking”.

This combining of monetary and supervisory functions reflects the fact that, for monetary policy authorities, financial stability is obviously key. A stable financial system with sound and solvent banks supports the smooth transmission of monetary policy and ultimately contributes to macroeconomic stability. This is particularly relevant for the euro area, where banks play and crucial role in providing financing to the real economy, most notably to SMEs. Conversely, financial imbalances can be a genuine threat to price stability, in addition to being extremely costly from a macroeconomic perspective.

But in my remarks today I would like to focus on a specific aspect of these interactions – that is, between monetary and *macro*-prudential policy. The key point I would like to make is that this interaction should be stronger than in the micro-prudential area, where the impending regulation imposes a separation between monetary policy and supervision. The reason for this is simple. While micro-prudential policy focuses on the stability of individual institutions, both monetary and macro-prudential policy take a more systemic perspective and aim ultimately at system-wide stability.

Let me explain the interaction between these two policies in more detail.

In many ways – objectives, frequency and instruments –monetary and macro-prudential policy are different. But there are also important ways in which they have a mutual impact.

In terms of objectives, they differ in the way their objectives can be quantified and achieved. Price stability can be quite easily quantified, and actually has been for the ECB as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2% over the medium term. Consequently, the central bank has to achieve its objective symmetrically: to avoid falling short of its price stability objective on either side. Financial stability, by contrast, is about avoiding a tail event with high potential costs. Given the binary nature of such events, this is much more difficult to capture quantitatively in terms of a value or a threshold. As a result, the financial stability objective has a more asymmetric nature.

In terms of frequency, monetary policy tends to follow the business cycle, whereas macro-prudential policy is related to the financial cycle. Certainly, these cycles are not independent from one another. But the BIS has calculated that the financial cycle in advanced economies has an average length of about 16 years, whereas business cycles tend to have a duration of 1 to 8 years.

And in terms of instruments, the main tool of monetary policy is a set of key interest rates (and I will abstract here from the conduct of non-standard monetary policy measures). For macro-prudential policy, there are instruments related to the asset side of bank balance sheets, such as loan-to-value ratio ceilings and debt-to-income ceilings; liquidity-related instruments such as liquidity coverage ratios and the net stable funding ratio; and capital-related instruments such as the leverage ratio and the countercyclical capital buffer.

Yet despite these differences, the two policies undoubtedly have a strong mutual impact. The instruments deployed in one policy domain affect the objective of the other. Or put differently, the two policies work through similar transmission processes, although not necessarily with the same intensity, as they have a bearing on the same economic variables.

For instance, if macro-prudential authorities deploy a stricter loan-to-value ratio, this would curtail bank lending to some extent. This could in turn slow down investment and production, and possibly have some adverse impact on prices and inflation. As an example in the other direction, keeping monetary policy rates too low for too long may encourage excessive risk-taking in some markets. This may spur the creation of asset bubbles and have repercussions on financial stability.

We can see why monetary and macro-prudential policies need to be properly aligned. In striving for price stability, the ECB needs to keep an eye on the possible effects of currently deployed or planned macro-prudential policies. Likewise, from a macro-prudential perspective, the current and expected future course of monetary policy needs to be taken into consideration.

For this reason, we would support different institutional arrangements for macro-prudential decision-making within the SSM than those that are foreseen for micro-prudential. In the latter case we have always argued for a clear separation of functions between the ECB as monetary policy-maker and supervisor. For macro-prudential decision-making, however, we see it as important that the Governing Council is more closely involved.

But beyond these considerations, one may ask, when the SSM is operational, what role should monetary policy play in financial stability *directly*? You will recall the discussion after the Lehman failure about whether central banks should do more to "lean against the wind". With a close-to-optimal macro-prudential framework in place, should monetary policy leave financial stability out of sight?

In my view, the answer should be no. There are two reasons why it is important that the central bank remains alert to financial stability issues, even though its primary objective will remain to secure price stability.

First, the ECB's policy analysis for price developments can contribute to financial stability surveillance.

Here, I have in mind our monetary analysis, which focuses on money and credit developments. Exaggerated dynamics in such aggregates can help identify dangerous trajectories that could threaten financial stability. We will have to reflect, once the SSM is operational, on how best to have the broader financial stability assessment benefiting from tools or insights from the monetary analysis. By doing so, we have to be examine closely – first – how structural changes in securisation markets influences the information stemming from monetary analysis, and –second –that analyses and policy goal are closely related and should not be mixed.

Second, in most of all cases the actions necessary to maintain price stability and those required to maintain financial stability are fully aligned. If, however a conflict arises between these two objectives, it is clear that ECB's mandate leaves no discretion: The primary mandate is to secure price stability.

Generally speaking, financial stability risks should be addressed through macro-prudential policies, especially now that we have the SSM. But there could be a situation where financial imbalances are broad-based across sectors and countries. Macro-prudential policy instruments and the distribution of competences between the national and European level could be ineffective in addressing such area-wide imbalances. If the central bank decides that these imbalances could eventually threaten medium-term price stability, interest rate policies may be relevant.

As Federal Reserve Board member Jeremy Stein recently put it, the advantage of the policy rate tool in such circumstances is that it can “get in all of the cracks and reach into corners of the market that supervision and regulation cannot reach”.

So there are some circumstances where a “leaning against the wind” approach would still be valid and helpful even under a properly working macro-prudential framework. But any such actions by the ECB would be based on our policy framework – that is, to fulfil our primary mandate of price stability over the medium-term.

And let me stress that I am not referring here to the current situation: we do not see risks to financial stability stemming from the current low level of interest rates that would warrant policy action at the European level. Moreover the medium-term outlook for inflation remains subdued.

So, let me conclude by reiterating what I would see as the general principles for guiding the interplay between monetary and macro-prudential policies, when both functions are partly under one roof at the ECB.

First, macro-prudential and monetary policy both have a systemic dimension, and macro-prudential instruments affect monetary policy objectives and vice versa. This suggests that decision-making for monetary and macro-prudential policy should be more closely integrated than for micro-prudential policy.

Second, there should be close interaction on the level of policy analysis to exploit synergies and maximum information regarding risks to price and financial stability.

Third, for monetary policy, even with suitable macro-prudential frameworks in place, there always remain circumstances that could warrant leaning-against-the-wind policies.

I now look forward to our discussion.