Peter Praet: The interaction between monetary policy and macroprudential policy

Speech by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the Money, Macro and Finance Research Group Conference on the Resilience of the Global Financial Architecture, London, 27 September 2018.

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I would like to thank John Hutchinson for his support in the preparation of this speech.

Introduction

A decade on from the start of the global financial crisis, which led to the biggest drop in economic activity in euro area economies since the second world war, the euro area is currently experiencing a broad-based expansion. Looking ahead, significant monetary policy stimulus is still needed to support the gradual build-up of price pressures for the sustainable return of inflation to levels below, but close to, 2%. At this stage of the recovery, the main risk to price stability would be a significant slowdown in growth that could originate from rising protectionism, vulnerabilities in emerging markets and a global repricing of risk.

The crisis has brought about a major overhaul of the regulatory, supervisory and macroprudential frameworks in Europe. While this is expected to reduce the likelihood of systemic financial vulnerabilities taking root and morphing into a crisis, we should acknowledge that we are still in a transition phase. Some major elements of the new frameworks still have to be implemented or finalised, and legacies from the previous crisis are still present. Furthermore, some areas of the financial system are still not yet adequately covered by regulation, for example leverage in the non-bank financial sector.

In my remarks today, I would like to elaborate on the interaction between monetary policy and macroprudential policy. I will first review the conceptual framework for monetary policy and financial stability and then look at how, at this stage of the cycle, macroprudential policy and monetary policy can best complement each other in the pursuit of their respective objectives.

Monetary policy and financial stability

Price stability and financial stability are tightly interconnected and mutually reinforcing; in the longer-term, each is a necessary – but not sufficient – condition for the other. Price stability contributes to the efficient allocation of resources in the real economy, thereby supporting long-term growth. A stronger and more stable macroeconomic environment contributes to healthy household and business balance sheets, thereby fostering financial stability.

However, history abounds with cases where financial vulnerabilities were built up in good times, while market participants overly discounted the likelihood of adverse shocks. Financial instability is basically the result of market failures, which should be addressed by regulation (covering the time and cross-section dimensions of financial stability). Deficient regulation can lead to excessive leverage and maturity transformation, which may in turn result in funding fragilities and systemic vulnerability. Weak design of crisis management frameworks may also lead to ex ante excessive risk-taking in the private sector (e.g., “too-big-to-fail” behaviours) and, in cross-border crises, to a lack of trust and free-riding behaviours by crisis management authorities, amplifying the initial shock.

Since the 1970s, the frequency of financial instability episodes has increased globally. This prolonged trend appears to coincide with the gradual undoing of the post-war financial and regulatory structures. The shift towards less stringent financial regulation, combined with

breakthroughs in financial innovation, has profoundly altered the incentive structures underpinning the financial industry. This is likely to have been a primary cause of the episodes of financial instability that punctuated the global economic history of the 1980s, 1990s and 2000s and reached a climax with the global financial crisis.[1]

To prevent the emergence of such bad outcomes, a sound, system-wide approach to financial regulation is of the essence. But what is the role of monetary policy? Can monetary policy be conducted in a way that reduces the likelihood of financial instability? The long-running debate on these issues within academic and policy-making circles can be broadly broken down into three different viewpoints.[2]

The first is the "pre-crisis consensus" view, which argues that monetary policy should maintain a relatively narrow mandate of price stability, leaving financial stability to prudential authorities. Under this view, the monetary authority should only take financial stability concerns into account in so far as they affect the outlook for price stability and economic activity. The second view is to "lean–against–the–wind", i.e. that as price stability may not be sufficient for financial stability, central banks should lean against the emergence of financial imbalances by tightening the monetary policy stance over and above the level necessary to bring inflation back to target over a policy horizon that is generally understood to be around two years. The third view is that "financial stability is price stability". Proponents of this view advocate a more radical change in the objective of monetary policy, arguing that financial stability and price stability are so intertwined that one cannot distinguish between the two.[3] Under this view, both standard and non-standard monetary policies are in the first place attempts at stabilizing the financial system, addressing malfunctioning financial markets and smoothing the monetary transmission process.

While all these viewpoints recognise the important interplay between financial stability and monetary policy in pursuit of price stability, their relevance ultimately depends on (i) the weight to be attached to the "risk-taking" channel of monetary policy, (ii) the strength of the macroprudential framework and (iii) the policy strategy of the monetary authority, especially as regards its policy horizon.

The risk-taking channel

Monetary policy contributes to financial stability by smoothing business cycles and anchoring inflation expectations. Monetary policy works through its effects on intertemporal substitution and risk appetite. By lowering risk-free rates, monetary policy increases the attractiveness of investments projects which would not have been profitable under tighter financing conditions. When the central bank wants to exert downward pressure more directly on long-term interest rates, it can absorb duration risk from the market by purchasing securities of relatively longer maturity. This frees up more risk-bearing capacity for investors, which they can redeploy towards bearing different types of risk, including equity and credit risk.

In the aftermath of the financial crisis, restoring risk appetite has been a key condition for stimulating economic activity. And as inflation convergence proceeds only slowly, continued monetary stimulus is still needed today. This begs the question whether the persistent monetary accommodation that is needed for inflation convergence could bring about excessive risk-taking and contribute to financial stability risks down the road.

Risks to financial stability can build up when low interest rates interact with distorted incentives in the financial sector, which arise from information frictions in credit markets and externalities that have not been properly addressed by regulation and supervision. Key financial vulnerabilities include excessive dependence on unstable short-term funding, too much leverage, inadequate capital provision for risk exposure and a weak underwriting of loans.

Macroprudential policy

The regulatory and supervisory overhaul that took place in the aftermath of the crisis aims to ensure high-level resilience in the financial system, contain the inherent pro-cyclicality within the financial system and take into account systemic negative externalities and system-wide feedback loops. By design, this should limit excessive risk-taking in the financial sector resulting from periods of accommodative monetary policies.

The creation of a macroprudential framework with its own objectives, authorities and tools provides an important complement to monetary policy. In the long term, the complementarity naturally arises because the respective objectives are intertwined and one cannot be achieved without the other. At the same time, they complement each other equally well in the short term. When asset prices, leverage, financial exuberance and strength of the economy and inflationary pressures move in the same direction, monetary policy and macroprudential policy typically pull in the same direction too. On the other hand, when financial imbalances increase amid an environment characterised by relatively muted inflation, the twin goals of price stability and financial stability can be best achieved by resorting to two separate instruments, in line with the Tinbergen principle.[4]

While more restrictive monetary policy may be able to lean against the build-up of financial imbalances, targeted macroprudential measures are typically a more efficient way of addressing their causes. This is especially relevant in the euro area, given its multi-country composition. Macroprudential measures can be targeted to specific member countries to address the build-up of local imbalances, which cannot be addressed in an efficient manner by the single monetary policy.

The presence of macroprudential policy should, however, not lead monetary policy to neglect financial stability issues. When the build-up of financial imbalances affects a large part of the economy, only monetary policy rates have the ability to reach into all “corners of the economy” (to borrow from Jeremy Stein’s remark).[5] And when the build-up of financial imbalances pervades the economy, monetary policy should stand ready to adopt a leaning-against-the-wind posture.

The monetary policy horizon

In pursuing its price stability mandate, monetary policy can inadvertently exacerbate financial stability risks. As monetary policy operates under uncertainty, there have been episodes of monetary policy mis-calibration throughout economic history, but the consequences for financial stability very much depend on the prevailing financial regulatory regimes.

Monetary policy mis-calibration may lead to the build-up of financial imbalances in particular when the central bank is faced with a sequence of positive cost-push shocks that curb domestic price pressures for a prolonged period of time. Think, for instance, of the gradual penetration of new technologies in recent decades – primarily the internet and related digital technologies – which boosted on-the-job productivity, or the emergence of new and cheaper sources of global production, which resulted from the ascent of China as a global manufacturing hub and suppressed import costs for advanced economies.

These factors may bring about low inflation conditions which, if not analysed holistically – i.e. taking into account the economic strength and the financial exuberance which typically accompany such conditions – may encourage a looser monetary policy than would be appropriate. Loose monetary policy, in turn, may reinforce the economic momentum that is already under way, further feed optimism and thus favour the build-up of financial imbalances. Empirical evidence indeed suggests that stock market booms usually coincide with atypically low inflation. The run-up to the dotcom bubble in the late 1990s provides one particularly vivid example of this pattern.[6]

There are two responses to these sorts of monetary policy pitfalls. First, an appropriate calibration of the monetary policy horizon. Modulating the horizon over which the central bank aims to achieve its price stability objective depending on the shocks hitting the economy is a principle of prudent monetary policy. A demand shock calls for a shorter policy horizon; a cost-push shock calls for a longer one. Importantly, this principle holds only if inflation expectations remain firmly anchored. Second, the central bank can minimise the risk of mis-calibrating monetary policy if it broadens the scope of its analysis to an encompassing set of observables, including monetary and financial variables. This also allows policymakers to monitor signs of the emergence of financial imbalances and to calibrate a "leaning against the wind" approach to monetary policy.

The effects of the ECB's monetary policy on the economy and the financial system

The monetary policy response to the crisis has been central in restoring the bank lending channel and ensuring very accommodative financing conditions, which has paved the way for the euro area's recovery and continued expansion. While the pace of economic expansion has recently moderated following the strong growth performance in 2017, the economy's underlying strength is expected to persist and crystallise at a pace of growth above potential in the coming years.

Measures of underlying inflation remain generally muted, but have been increasing from earlier lows. The incoming data continue to support our confidence that the sustained convergence of inflation to our aim will proceed and will be maintained even after a gradual winding-down of our net asset purchases.

Overall, prudence, patience and persistence remain the guiding principles for our monetary policy. Significant monetary policy stimulus is still needed to support the further build-up of domestic price pressures and headline inflation developments over the medium term. The protracted period of low interest rates that contribute to the ongoing economic expansion necessary for the continued sustained convergence of inflation has so far not given rise to discernible financial stability risks in the economy as a whole[7]. In the present environment and at the current stage of the monetary policy cycle, however, it is important to be mindful that keeping rates low for long periods can raise challenges for financial stability further down the road. In this context, activating macroprudential instruments where needed is essential to ensure resilience, contain procyclical behaviours and prevent the emergence of financial imbalances.

Macroprudential measures are the appropriate response in situations where signs of financial imbalances are not pervasive. They can be targeted to specific member countries or sectors to address the build-up of local imbalances, which cannot be addressed in an efficient way by the single monetary policy. Macroprudential measures have already been proposed or implemented in some euro area countries. Authorities have taken decisions to calibrate the systemic risk and countercyclical capital buffers, as well as sectoral capital requirements for real estate and housing, and to introduce caps on loan-to-value ratios to counteract emerging risks.

Conclusion

Our monetary policy measures have proven effective in sustaining a resilient recovery and addressing the risks to price stability. This in turn provides a strong contribution to financial sector resilience. Looking ahead, significant monetary policy stimulus is still needed to support the gradual build-up of price pressures for inflation to return to levels below, but close to, 2% in a durable fashion.

At this stage of the cycle, careful monitoring of the risk-taking channel of monetary policy is important. While there is no evidence of excessive misalignment across asset classes in the euro area right now, there are signs that valuations are stretched in specific market segments.

Macroprudential instruments are best placed to counteract the emergence of specific financial imbalances in an efficient and targeted manner. Macroprudential policy and monetary policy thus complement one another in pursuit of their respective objectives.

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1 For a comprehensive overview, see Carmen M. Reinhart and Kenneth S. Rogoff (2013), "Banking crises: An equal opportunity menace", Journal of Banking and Finance Vol. 37.

2 For a detailed discussion, see Frank Smets (2014), "Financial Stability and Monetary Policy: How Closely Linked", International Journal of Central Banking Vol. 10 No. 2.

3 See Markus Brunnermeier and Yuliy Sannikov (2014), "A Macroeconomic Model with a Financial Sector", American Economic Review Vol. 104, No. 2, February.

4 For a quantitative evaluation of the relevance of the Tinbergen's principle in this setting, see Julio A. Carrillo, Enrique G.Mendoza, Victoria Nuguer, Jessica Roldán-Peña, (2018), "Tight money – tight credit: coordination failure in the conductof monetary and financial policies", ECB Working Paper No 2129. They show that a regime with separate financial and monetaryinstruments yields significant welfare gains.

5 See Jeremy Stein, "Overheating in Credit Markets: Origins, Measurement and Policy Responses", speech at the Federal Reserve Bank of St. Louis Missouri, 7 February 2013. He actually concluded that while policy rates have the ability to reach into all corners of the economy, it would be better to use targeted supervisory and regulatory measures to address localised imbalances as they have less potential to damage the economy.

6 L. Christiano, C. Ilut, R. Motto and M. Rostagno, "Monetary Policy and Stock Market Booms", paper prepared for Macroeconomic Challenges: the Decade Ahead, A Symposium Sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming August 26–28, 2010.

7 See Financial Stability Review, European Central Bank, May 2018.