Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

# Financial stability and monetary policy:
## A new policy framework for the euro area?

Comments by Stefan Gerlach

- Overview paper on linkages between monetary policy (MP) and macro prudential policy (MPP).
  - MPP is a set of new tools introduced as a consequence of the financial crisis.

- Key question:
  - When and where should MP and MPP be used to prevent financial instability?
  - Depends on the features of the economy.

- The fact that both policies work through the financial system raises questions:
  - What are their strengths and weaknesses?
  - How do we best combine them?
  - How do we assign objectives?
  - What institutional arrangements are desirable?

- Agreed with almost everything.
  1. Euro system issues.
  2. Fiscal policy.
  3. Risk-taking channel.
  4. Inflation bias.

# Issues for the euro system?

- Given the title, I had expected a discussion of euro system specific issues.
  - Are there reasons to believe that the choice between using MP and MPP will be different in the euro area than elsewhere?
  - Greater reliance on MPP?

- Paper makes one important point:
  - Single MP implies that country-specific threats to financial stability must be dealt with by national MPP.

- The ECB's mandate:
  - Paper states that the ECB has a mandate to contribute to financial stability.
  - Correct, but secondary task.
  - MPP national policy.

The primary objective of the European System of Central Banks … shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union (TFEU, Art. 127(1)).

The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system (TFEU, Art. 127(5)).

- The financial system in the euro area is bank-centric:
  - Would seem to raise the scope for MPP.
  - The "seeping in" argument for using MP seems less important than in market-based financial systems.

- Sovereign credit risk source of financial stability concerns in the euro area.
  - Prohibition of monetary financing.
  - Debt reduction essential in the long run; how can this problem be dealt with in the meanwhile?

# Fiscal policy

- Paper does not mention fiscal policy:
  - Fiscal policy is not part of the MPP tool box, but a frequent cause of financial instability.
  - Is too expansionary fiscal policy better counteracted by MP or MPP?

- Asset price booms are popular:
  - Rising property prices make house owners happy.
  - Plentiful tax revenues permit tax cut taxes & spending increases while rapid growth erodes debt/GDP ratio.

- MP ineffective in dealing with house price booms:
  - Expected capital gains can dwarf interest rate costs of borrowing.
  - Property-related lending highly profitable.
  - Output losses of tight MP can be very large.

- MPP potentially more effective in dealing with asset price booms?
  - Can in principle be better focussed.

# Risk-taking channel

- Plenty of evidence that risk-taking by financial institutions influenced by the stance of MP.
  - Should this problem be dealt with with MP or MPP?

- Primary concern lies with less well capitalised banks:
  - More likely to lend to riskier borrowers.
  - More likely expand lending to riskier firms.
  - Less likely to end lending relationships with risky firms.

- Problem tied to banks holding too little capital.
  - Raise capital requirements.
  - Tighten supervision of poorly capitalised banks when rates are low.
  - Hard to understand the suggestion that because of the risk-taking channel, interest rates should not be reduced to low levels.

- Paper suggests that excessive risk-taking was observed in many countries and is endemic.
  - But one sample period that perhaps was unusual?
  - Low long interest rates.
    - Interest rate convergence in euro area.
  - Financial innovation particularly in mortgage finance.
  - Weak regulatory and supervisory regimes.

- Might consequences of risk-taking be less severe in "normal times"?

# Inflation bias

- Sometimes claimed that assigning a financial stability goal to MP leads to an inflation bias.
  - CBs adopt too expansionary policies after a financial crisis to promote rapid recovery.
  - With "long and variable lags", risk that policy is tightened too late.
  - Committing to keep rates low for a long time particularly inadvisable.

- To reduce risk, MP must focus on price stability.

- This argument applies to the <u>aftermath</u> of financial crises and not in normal times.
  - Financial crises are contractionary & deflationary.
  - Clear risk that zero lower bound will constrain MP and led to too tight policy.
  - Not clear that risk to inflation on balance are on the upside.

- Key question:
  - What might assigning a financial stability objective to MP do to inflation in <u>normal</u> times?

- Plausible that policy makers will hesitate to rely on MPP:
  - – If CB does not set MPP there is a need to persuade other policy makers.
  - – Potentially a need to forewarn financial institutions about changes in MPP.
  - – MPP may move activity to unregulated part of the financial system.
  - – Policy makers have little experience with MPP.

- These caveats do not apply to MP:
  - MP is easily changed and "seeps into the cracks."

- Plausible that policy makers may rely on MP rather than MPP to constrain financial system.
  - Could lead to undershooting of inflation objectives.
  - But financial crises are rare and, if policy is successful, don't happen -- hard to judge.

# Conclude

- This is an excellent analytical overview that will be widely read and cited.