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Are Price Stability and Financial Stability Complementary or Contradictory Mandates? Four Issues

Welcome to our first panel of this conference. The topic of this panel is: "Safeguarding Price Stability and Financial Stability: Complementary or Contradictory Mandates?"

To a central bank practitioner, this issue may seem theoretical at first sight: in practice, he would argue, virtually any central bank in the world nowadays will in the event of a severe financial crisis do anything possible to restore functioning financial markets and to resolve the crisis.

However, this is not precisely the issue of this session. The question which we will discuss rather is: What potential conflicts might arise for a monetary policy maker in pursuing both goals? Against this background, should the central bank be mandated to safeguard financial stability, alongside price stability? If so, what kind of instruments would the central bank need to be able to fulfil these two mandates in parallel at the same time? Should it in the first place be the central bank which is in charge of both tasks, or should separate institutions with separate tools be responsible?

Let me, by way of introduction, briefly address four issues, which will then certainly be broadened and developed in more depth by our panellists.

1 How Should Central Banks Deal with Financial (In)stability ex ante? Changing Mainstream Views

The first point touches upon the rapidly changing mainstream view on how central banks and/or monetary policy should deal with financial (in)stability.

The traditional view of the past couple of decades was:

1. The central bank should be in charge of (consumer) price stability.
2. By doing so, it makes its best possible contribution also for financial stability.
3. With one instrument the central bank cannot pursue several targets at the same time.

4. In any case, influencing asset prices ex ante would be very difficult, and potentially very costly.
5. So, the answer seemed to be benign neglect ex ante, and mopping up the mess ex post.

In this set up, only minor goal conflicts are felt in normal times. In a way, the issue is avoided. This may also be described as the approach followed during the *Great Moderation* in the two decades up to 2007.

This view was challenged by some, most notably BIS economists several years ago. They argued:

1. Central banks' success in ensuring low consumer price inflation may in itself create a paradox of stability: the underpricing of risk leads to asset price and financial bubbles.
2. A successful inflation targeting-type of monetary policy may itself be-

come a source of financial bubbles and macroeconomic instability.
3. Therefore, central banks should also take asset prices into account – in other words, inflation is to be defined more broadly than just consumer price inflation.

This view implies that there may be major tensions between the two objectives. In practice, asset prices never gained substantial weight either in ex ante monetary policy strategies or in practical policy action, and there are only quite few central banks around the world that have openly mentioned asset price developments as one factor (among many others) informing their interest rate policy.

The latest developments in mainstream thinking may be summarised as stating:

1. (Macro)financial stability is so important that it needs to be pursued explicitly as a policy goal in itself.
2. But two objectives – price stability and financial stability – need two instruments to be pursued successfully at the same time.
3. For (consumer) price stability, monetary policy, in other words the level of interest rates, is the appropriate tool, for macro financial stability, a new set of instruments summarised under the term *macro prudential policies* needs to be installed.

So, the potential tensions between monetary and financial stability are explicitly acknowledged, and a solution to this problem is offered – at least in theory. It will be interesting to discuss at this conference and to see over the next couple of months and years, what macro prudential surveillance will turn out to be, what concrete instruments it will encompass, and what it will be able to achieve – in practice.

2 Goals and Strategies: Important Differences between Monetary and Financial Stability

Secondly, I would like to point to interesting differences between monetary policy and financial stability in terms of goal definition and formulation of an explicit strategy.

Concerning the goal, most central banks nowadays have a fairly clear quantitative definition of their price stability objective. By contrast, I have so far not seen a clear quantitative definition of financial stability, and due to its broad nature, this also seems quite inconceivable. This raises important issues for decision-making in collegial decision-making bodies and for accountability.

There are also important differences in the area of strategy. Most central banks have defined – for internal and for communication purposes – clear strategies on how to achieve the price stability goal. By contrast, I am not aware of any explicit *financial stability policy strategies* so far. Given the complexity of the issue and the lack of precision of the goal, formulating such strategies will likely be very difficult. I am not sure whether it will – or should be – attempted at all.

It also seems to me that the role of credibility in influencing behaviour is much more emphasised and observed in monetary policy than in financial stability matters. What credibility is for inflation expectations, one might argue, should be incentives and the avoidance of moral hazard for financial market regulation and supervision.

3 What Are Monetary Policy Instruments? What Are Financial Stability Instruments?

A third point that seems important to me is the increasingly blurred nature of what we have traditionally viewed as monetary policy instruments, and the potential challenges arising from this.

Over the past two years, what would normally and traditionally have been considered as typical monetary policy instruments – to some extent at least – turned into instruments to safeguard financial stability. To name just a few examples: collateral policy, the maturity and tender procedure of repos, the use of foreign exchange swaps, and recourse to outright purchases. Are these unconventional *monetary policy instruments*, or are these *macro prudential stabilisation instruments?*

Some central banks have taken great pains in keeping a clear distinction. For instance, the ECB in the early phases of the crisis emphasised the so-called *separation principle* between measures affecting the monetary stance and those (just) affecting liquidity in the interbank money market. More recently, the ECB Governing Council explicitly emphasised that the Securities Purchase Program (SMP) does not aim to alter the monetary stance (and is fully sterilised), and instead explicitly aims to restore orderly market conditions. So if the instrument does not aim to influence the monetary stance, this would suggest that we are dealing with a financial stability instrument. At the same time, dysfunctional financial markets affect the monetary policy transmission mechanism. This was also emphasised by the Eurosystem. Arguing in this way implies that any measures restoring orderly financial market conditions are an integral part of monetary policy.

I am sure, this issue is going to stay with us for some time.

4 Credibility Spillovers

Let me, to conclude my introduction, mention a fourth aspect where I see potentially important linkages between the two mandates, which may pose problems. I am talking about credibility spillovers.

Let us, purely hypothetically, assume, that a central bank which is also, officially and by formal mandate, in charge of financial stability, was not able to ensure financial stability, e.g. because of spillovers from other countries outside the influence of the central bank, or because of other reasons outside its sphere of influence. Obviously, such failure might have severe negative implications for its public acceptance, its credibility also in the area of price stability, and for long-run political support for its independence, which would in turn negatively affect its monetary policy mandate of maintaining price stability.

Or, to take another scenario, let us assume that, to safeguard financial stability, the central bank takes measures which are – rightly or wrongly – regarded by the public and by financial markets as signalling a softening up of its commitment to price stability. Then this might also affect inflation expectations and thus potentially inflation itself. Or it might affect the required path of official interest rates to achieve a given level of inflation, with, in the

short run, potential negative effects on output.

I am sure there are many more possible examples for potential synergies but also tensions between the two mandates of price and financial stability, and the instruments used to achieve them. To shed further light on these issues, we have two eminent speakers on our panel.

Petra M. Geraats from the University of Cambridge tellingly called her paper *Price and Financial Stability: Dual or Duelling Mandates?* As you will see, Petra's paper brings academic structure into the topic, by discussing potential tradeoffs, or policy conflicts, under different shocks, and by discussing to what extent the seemingly straightforward distinction between the two mandates and the instruments to be used in their pursuit is in reality quite blurred. The many links and synergies in turn lead her to the conclusion that both objectives should be pursued by the same institution, the central bank.

Our second speaker, Martin Čihák from the International Monetary Fund, discusses the topic of *Safeguarding Price Stabililty and Financial Stability: Complementary or Contradictory Mandates for a Central Bank?* from a practitioner's point of view. He will argue that, yes, there might be goal conflicts for central banks formally mandated to pursue price and financial stability, but they have these conflicts already now, due to their functions of lender of last resort and crisis managers. Against this background he suggests to introduce financial stability as an explicit, subordinated secondary objective in central bank mandates, while he concedes that financial stability will have to be defined quite broadly, and will be hard, if not impossible, to quantify. He also shows empirically that independent central banks are likely to perform better in safeguarding financial stability than less dependent institutions.