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Concluding Remarks

Over the past two days a number of highly interesting and sometimes controversial reflections on “Monetary Policy and Financial Stability” have been presented. Let me briefly summarize the main insights, inspirations and conclusions I have drawn from the conference in three areas centering around the relationship between monetary and financial stability, the role of asset prices in monetary policy and the potential effects of Basel II on bank lending behavior.

The topic of the conference indicates a close relationship between monetary stability and financial stability. They are mutually dependent: a stability-oriented monetary policy enhances the stability of the financial system and, at the same time, a stable financial system is a prerequisite for the effective conduct and implementation of monetary policy.

A stability-oriented monetary policy contributes to financial stability: Price stability reduces uncertainty with respect to the real value of future nominal returns. Sound monetary policy provides a stable medium of final settlement in financial transactions and, hence, reduces the risks associated with final settlement. An efficient framework for monetary policy implementation can reduce the volatility of money market rates and,

thus, contribute to deep and liquid money markets and bolster the liquidity provision to the banking sector.

At the same time financial stability contributes to the successful implementation of monetary policy: Stable financial institutions and markets reduce uncertainty with respect to the impact of monetary policy on the real economy, as financial institutions and markets play a major role in various transmission mechanisms, be it the credit, investment or wealth channels. Deep, liquid and integrated money markets as well as efficient, well-functioning and reliable payment systems enhance the effectiveness of monetary policy implementation. In order to ensure the smooth functioning of payment systems, central banks play an important role in one or more of the following areas: operation, regulation and oversight of payment systems. The Eurosystem and the NCBs operate efficient and reliable large-value payment systems with (collateralized) intraday credit provision to reduce banks' exposure to counterparty and liquidity risk. The ECB and the NCBs are also responsible for the oversight of cross-border and national payment systems in the euro area.

From the above considerations I draw the practical conclusion that macroprudential financial analysis is of paramount importance for central banks. It can lay the foundation for preventive measures against potential financial instability and contribute to the effective implementation and conduct of monetary policy.

My second topic, the role of asset prices in monetary policy, has received increasing attention in the popular press throughout Europe recently. Does the interdependence between monetary and financial stability imply that central banks should react to asset

price inflation in a more systematic and determined manner?

I do not think so. Let me briefly share my assessment of the major arguments on both sides of this debate with you, starting with the pros.

The approach of measuring inflation only in terms of current goods and services was questioned theoretically by Alchian and Klein (1973). They argued that current consumer welfare depends not only on current service flows but also on (expected) future service flows. Hence, if constant purchasing power is defined as keeping consumer welfare constant at constant expenditure, it must take into account both current and (expected) future service flows. As a consequence of inadequate measurement which does not explicitly take future service flows into account monetary policy can be either too contractive or too expansionary. This is attributable to the different speeds of adjustment, as current consumer prices react more slowly to monetary policy than the approximation for expected prices of future service flows (i.e. asset prices). Under the current approach to inflation measurement, asset price inflation already influences monetary policy decisions, albeit in an indirect manner. If monetary policy focuses on the stability of consumer prices, asset price inflation factors into the considerations by its impact on aggregate demand via private consumption (wealth effects) and investment demand. But under certain circumstances asset price inflation might not translate into consumer price inflation fast enough to trigger a tightening of monetary policy before a bubble builds up; consumer price inflation remains low while asset prices soar.

Therefore, the Eurosystem explicitly takes monetary conditions into

account in its monetary policy strategy, which rests on the two-pillar approach. Liquidity conditions are regarded as revealing useful information about future consumer price inflation. The Eurosystem therefore does not need to rely on asset prices as proxies for future inflation. In addition, historical evidence indicates that liquidity conditions also reveal useful information concerning potential asset price bubbles, many of which have been fueled by lax liquidity conditions in the past (ECB, 2005, p. 53). The ECB argues that high aggregate credit growth and ample liquidity in comparison to past trends in conjunction with large deviations of asset prices from past trends can provide leading indicators for financial instability caused by sharp corrections in asset prices. Asset price inflation can increase the exposure of the financial system to a variety of downside risks (i.e. market risk, credit risk). Thus the conduct of monetary policy in the euro area already indirectly factors indicators of future consumer price developments – which are also indicative for the future development of asset prices – into policy decisions via the role of the monetary analysis pillar.

The counterarguments focus primarily on the critical assumptions of the underlying theoretical models and the practical problems of implementing their results.

The theoretical arguments rest on the heuristic assumption that markets are complete and that there is a full set of state-contingent prices. This assumption is clearly untenable, as market prices for all future service flows are not available. Alchian and Klein (1973) suggested that asset prices could serve as proxy for these missing prices and that a true “cost of life” index would consist of a weighted

average of current service flow prices (e.g. HCPI) and asset prices.

Fundamental practical problems have caused central banks to refrain from including asset prices in their measures of inflation:

1. Asset price bubbles are notoriously hard to identify;
2. Theory does not provide unambiguous results as to how to determine the appropriate weight of asset prices in price indices – if lifetime utility were taken into



consideration, the weight of asset prices would have to be very high and monetary policy would end up targeting asset prices rather than consumer prices; and

3. Increases in interest rates would probably have to be quite large in order to effectively end asset price inflation; large interest increases could lead to sharp reversals of asset prices, thus, potentially contributing to a financial crisis, which could have severely negative repercussions on financial stability and the real economy.

Despite the theoretical appeal of some of the pro arguments, I have come to the conclusion that monetary policy should not explicitly target asset prices. Weighing the pros and cons, I regard the practical problems as inhibitive. We are concerned about asset price bubbles primarily in cases, in which they are caused by an increase in the expected nominal price of future service flows. Only in these cases they

are indicative of expected future inflation rather than changes in underlying preferences and, hence, according to Alchian and Klein, should also be taken into account in appropriate measures of current inflation. I fully agree. But I regard the Eurosystem's credible commitment to a long-term strategy of price stability and its two-pillar approach as the most effective contribution to contain expected future inflation and, thus, asset price bubbles fueled by inflation expectations.

Let me now turn to my third topic, namely the effects of Basel II on bank lending behavior.

Past experience demonstrates that bank lending behavior has traditionally been positively correlated with the cycle. However, given that the new capital adequacy framework is more risk sensitive, increased risk during economic downturns will obviously be measured more accurately and increase the capital costs of lending. Thus, concerns have been expressed as to whether banks may be encouraged to reduce their lending supply in an economic downturn when borrowers appear more risky.

Unexpected loan losses that have a negative impact on capital adequacy ratios represent the core concerns related to procyclicality. Therefore, the best measures against procyclicality are those that reduce unexpected loan losses. Basel II addresses this issue explicitly, as improved risk management and adequate financial supervision should reduce unexpected loan losses. These measures should decrease both the trend of loan losses and their volatility. As a result, negative shocks to regulatory capital and ensuing credit crunches become less likely and less pronounced. Furthermore, Basel II encourages banks to take account of uncertainty over the full

cycle in their rating processes. Thus, a smoother adjustment to new macroeconomic data can be expected. Currently banks tend to hold more capital than required. These capital buffers will further insulate regulatory capital requirements from negative shocks and reduce the probability that regulatory capital will be binding even in downturns.

How will Basel II affect the credit conditions for SMEs? In the course of the negotiations on Basel II a number of alleviations for SMEs were introduced into the framework, in particular the categorization of business loans of up to EUR 1 million as retail loans. The evidence of the Quantitative Impact Study 3 (QIS 3) suggests that capital requirements for loans to SMEs of up to EUR 1 million are even expected to decrease relative to current levels. Basel II does not contain explicit provisions concerning the pricing or the conditions of loans to SMEs. The latter are derived from the assessment of their perceived risk characteristics based on the banks' risk management framework. This framework will be improved in the course of the implementation of Basel II. It will take into consideration business and financial data of SMEs, so that the latter can improve their credit conditions through professional balance sheet management and transparency. Increases in the efficiency of credit allocation reduce the level and the cyclical variation of loan losses and reduce the likelihood that sound SMEs become credit constrained due to the misallocation of credit, sharp increases in provisioning requirements and ensuing reductions in the supply of credit by banks.

Let me close the conference with words of gratitude. I want to thank all the distinguished contributors, who

deepened our understanding of the interdependence between monetary and financial stability by sharing their insights and assessments with us in their function as speakers, discussants and panelists. Furthermore, I wish to express my appreciation for the efforts of my colleagues at the OeNB who helped to prepare and organize this conference. Finally, it is my pleasure to invite you to a farewell lunch which will conclude the conference. 🍷

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