NationalBank OF BELGIUM
Eurosystem

2010-09-16

PRESS RELEASE

Lessons from the crisis: Monetary policy and financial stability

(Article published in the September 2010 Economic Review)

This article examines the link between monetary policy and financial stability in the context of the recent financial and economic crisis. It aims to draw lessons from those recent events and to examine the implications for monetary policy. More specifically, it asks whether, apart from its price stability mandate, monetary policy should play a more significant and pro-active role in safeguarding financial stability. The link between monetary policy and financial stability is currently the top priority of both theoretical research and more practical research conducted by central banks and the academic world, and that is likely to remain so in the coming years. It is therefore obvious that only provisional lessons can be drawn at the moment.

The first section reviews the pre-crisis consensus on monetary policy against the background of the main economic developments of recent decades. These developments had shifted the focus of monetary policy to the link between price stability and economic growth, while the issue of financial stability had taken a back seat. In the prevailing macroeconomic context, known as "the Great Moderation", a clear consensus on monetary policy emerged in terms of objectives, strategies and the institutional framework. According to the dominant view, financial stability must be primarily achieved by an appropriate prudential policy in terms of regulation and supervision.

The monetary policy strategy of the Eurosystem is largely in line with this pre-crisis consensus. Unlike most other central banks, however, the Eurosystem has a unique two-pillar strategy in which the monetary pillar pays explicit attention to financial developments. Although initially aimed at identifying risks to price stability, it gradually focused more on aspects of financial stability. On the basis of its monetary analysis, the ECB Governing Council repeatedly expressed its concern, during the years preceding the recent financial crisis, over the movement in property prices in certain euro area countries.

The second section draws a number of provisional lessons from the crisis. First, the recent crisis has provided evidence that price stability is not sufficient to maintain financial stability and macroeconomic stability in general. Second, not only has the continued firm anchoring of inflation expectations enabled monetary policy-makers to respond appropriately during the crisis, but it is also destined to remain one of the key elements of future monetary policy. Furthermore, recent research has revealed recurrent patterns which may help to identify financial vulnerabilities in the run-up to a serious financial crisis. However, it is still hard to identify financial imbalances *in real time,* and further research in this field is desirable.

The debate on whether, in the future, monetary policy should make a greater contribution to financial stability and perhaps be given a broader mandate is still ongoing. However, some key points are already becoming clear. Financial stability should in the first place benefit from a strengthening of prudential policy, and particularly from the conduct of a macro-prudential policy. Moreover, a successful macro-prudential policy, through e.g. limiting the procyclicality of the financial system, will make it easier for monetary policy to achieve macroeconomic stability and more particularly, to aim at price stability. Furthermore, specific macro-prudential instruments reduce the risk of serious policy dilemmas precisely because the two aspects of policy can move in opposite directions, depending on the circumstances, and therefore address specific challenges in an appropriate way. That could happen, for example, in situations where the financial system is vulnerable, but at macroeconomic level there are nevertheless upside risks to price stability. At that point, macro-prudential policy could be eased while monetary policy is tightened. Conversely, in certain circumstances it may be desirable to ease monetary policy while tightening macro-prudential policy, e.g. in situations where there is no inflationary pressure whereas unsustainable developments are threatening the financial system.

In principle, this does not imply any significant modification of the existing monetary policy frameworks. Nevertheless, it seems right that monetary policy itself should make a bigger contribution to safeguard financial stability than in the past. Above all, it is necessary that monetary policy takes full account of its own

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impact on the risk-taking behaviour of the various economic agents. In addition, greater importance should be attributed to analysis of the formation of financial imbalances. That is not at odds with the priority of the price stability mandate, because the crisis clearly showed that risks to financial stability in the longer term also imply risks to price stability. However, it does assume an extension of the monetary policy horizon. If that horizon is actually extended, that should preferably be made explicit, as it would clarify the monetary policy strategy and increase accountability.

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