Monetary policy and financial stability

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Drawing on “The role of financial stability considerations in monetary policy and the interaction with macroprudential policy in the euro area”. ECB Occasional Paper - No. 272
Outline

1. What is the **economic case** for monetary policy to address financial stability in spite of the existence of macro-prudential policy?

2. What are the practical **implications for the ECB**?
1. What is the economic case for monetary policy to address financial stability in spite of the existence of macro-prudential policy?
The financial cycle and macro-prudential policy

• Macro-prudential policy as the **first line of defence**
  • especially beneficial in a monetary union

• Apply the **Tinbergen principle**?

• Only if **no spillovers** between monetary and macro-pru.
Interaction between monetary and macro-pru policies: spillovers are pervasive

• The two policies operate through common transmission mechanisms and can therefore affect each other’s objectives:

• In many cases there is complementarity between price stability and financial stability
  • price stability contains the propagation of shocks through the financial system; complementarity is most apparent during financial crises
  • financial stability supports a smooth transmission of monetary policy in the financial sector

• But possible trade-offs/side-effects at shorter horizons
Low rates and financial stability: profitability

Evolution of the distribution of NFC deposit rates, across banks (percentages p.a.)

- **Adverse direct impact** of low rates on the profitability of banks reflecting imperfect pass-through of dep. rates below the ZLB.
- Adverse spillovers on lending margins **exacerbated** by protracted low rates.
- Monetary **policy or structural** factors?
- Mon. policy-induced stimulus reduces credit risk and **indirectly sustains profitability**.

Source: ECB (individual balance sheet item and MFI interest rate statistics) and ECB calculations. Notes: time series of box plots representing the distribution of deposit rates across banks in euro area countries. For each period, the box plots represent the 5th, 25th, 50th, 75th and 95th percentile of the distribution. Quarterly frequency; based on the distribution in the last month of each quarter considered.
Low rates and financial stability: risk-taking

- Evidence of increased risk-taking
- Partly intended as a component of monetary policy **transmission mechanism**
- Risk-taking by **banks partly mitigated** by the **prudential framework**
- More worrisome for **some non-banks** (credit and liquidity)

**Euro area NFC bond holdings of euro area sectors**

(€ billions)

<table>
<thead>
<tr>
<th>Year</th>
<th>Banks</th>
<th>ICPFs</th>
<th>IFs</th>
</tr>
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<tbody>
<tr>
<td>2014-Q4</td>
<td>120</td>
<td>180</td>
<td>80</td>
</tr>
<tr>
<td>2016-Q4</td>
<td>150</td>
<td>150</td>
<td>100</td>
</tr>
<tr>
<td>2018-Q4</td>
<td>200</td>
<td>120</td>
<td>180</td>
</tr>
<tr>
<td>2020-Q4</td>
<td>250</td>
<td>180</td>
<td>200</td>
</tr>
</tbody>
</table>

Sources: ECB Securities Holdings Statistics, ECB securities issues statistics and ECB calculations
Notes: ICPFs refer to insurance corporations and pension funds; IF to investment funds. Latest observation: 2020 Q4.
The financial cycle, macro-pru, and monetary policy

- The presence of spillovers creates a **conceptual case for monetary policy to take financial stability into account** (see also Martin, Mendicino and Van der Ghote, ECB DP, 2021)

- A **symmetric approach** over the financial cycle: “leaning-against-the-wind” and “cleaning”

- **Cleaning receives broader support:**
  - targeted CB interventions repair impairments in MTM and stop runs, or asset fire sales

- **Leaning is contentious:**
  - “Gets in all the cracks” vs. “Blunt tool”;
  - rare and in some instances problematic track record
Overview

1. What is the economic case for monetary policy to address financial stability in spite of the existence of macro-prudential policy?

2. What are the practical implications for the ECB?
Adjusting the horizon as a way to address financial stability?

• Standard approach is to bring inflation back on target within a medium-term horizon reflecting usual transmission lags and depending on the origin of the inflation deviation.

• If financial stability risks are building up, adjust medium-term horizon to prevent a possible crisis (and large deflationary pressure) at a longer horizon.
  • Need to extend the horizon in a phase of economic recovery

• Possible, but extension of the horizon may need to be very long:
  • Implementation challenges, if it goes beyond a plausible horizon for monetary policy
  • Anchoring of inflation expectations critical for net benefits, but not to be taken for granted if expectations are at least partly backward-looking
An enhanced role for financial stability analysis

- Greater **systematic focus** on:
  - the build-up of longer-term financial vulnerabilities;
  - potential side-effects of monetary policy and interactions with macro-prudential policies.

- For example, **regular presentations** at selected monetary policy meetings

- Sustained research effort to **develop relevant quantitative tools**.
Conclusions

- There is a conceptual case for monetary policy to take financial stability into account.

- Adjusting the medium term is generally an imperfect way to address the build up of financial stability risks.

- A pragmatic step forward is to enhance the role of financial stability analysis in the material prepared to inform monetary policy decisions.

- Despite the progress made since the 2003 review, a sustained research effort to develop more suitable quantitative tools and models is required.