Securing Financial Stability: What Role for Monetary Policy?

By Steven J. Davis

The Global Financial Crisis (GFC) of 2007-09 has compelled central bankers to reconsider the role of monetary policy in securing financial stability. In his excellent opening speech at the Asian Monetary Policy Forum (AMPF), Ravi Menon describes three approaches to this issue:

1. Stick to the pre-GFC approach to monetary policy and its focus on price stability. Supplement monetary policy with traditional prudential regulations such as capital requirements for financial institutions.

2. Explicitly incorporate financial stability concerns into the conduct of monetary policy, tightening, for example, in response to an unsustainable credit boom.

3. Retain the focus on price stability in the conduct of monetary policy, but deploy a range of macroprudential tools to secure financial stability.

The first approach still prevails at most central banks, especially in advanced economies, but policymakers now pay more attention to financial stability concerns.

The second approach rests on the insight that monetary policy affects financial stability through the risk-taking channel. “Loose monetary policy can heighten vulnerabilities in the financial system” by lowering risk premiums, thereby promoting risk-taking activities and encouraging banks to expand credit.
Conversely, tight monetary policy raises risk premiums, discouraging risk-taking behavior and restraining credit growth.

An appealing feature of the second approach, as Menon explains, is that monetary policy can “get in all the cracks” of the financial system. Financial institutions cannot easily evade the effects of tight monetary policy the way they often work around restrictive regulations. Also, the second approach requires only modest departures from well-established and well-understood monetary policy practices. Operationally, the approach amounts to augmenting the Taylor Rule so that financial stability concerns influence the central bank’s choice of its policy rate.

Menon also explains why relying on monetary policy to secure financial stability may not be enough. First, the policy rate that promotes financial stability may differ from the rate needed for price and output stability. Second, global financial forces may constrain the conduct of monetary policy, an especially important factor for many emerging market economies. Third, although monetary policy can get in all the cracks, it may not be sufficiently potent to fully address serious threats to financial stability.

These limitations of monetary policy lead central banks to consider, and sometimes use, a range of macroprudential policy tools. I will have more to say on that topic in the next post.

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