# Monetary Policy under the Border between Price Stability and Financial Stability

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Abstract: *The international financial crisis drew the line for the international and national authorities that conducted and implemented faulty monetary and financial policies, regardless the potential risks that might arise. It was only after the crisis burst when everyone realized the impact the systemic risk can have on the global financial system and, consequently, on every national economy. The conventional point of view is that inflation is the main source of financial instability, but recent evidence points out the fact that reaching the inflation target does not necessarily mean that the financial system is stable. What is the most important is that any source of financial instability should be diminished if not erased, hence preserving financial stability has become an important goal for the authorities, who dispute whether to include it on the objectives list of central banks or authorize another institution to achieve it. Therefore, the main goal of this paper is framing the present monetary policy framework with respect to its objectives and strategies and the necessity to reconsider it in a realistic manner in order to prevent another collapse in case of an economic downturn.*

**Keywords: financial crisis, central banks, financial stability, price stability, inflation targeting**

**JEL Classification: E31, E44, E58, G01**

## 1. Introduction

To begin with, everything in economy is related to the notion of stability/instability since the international financial crisis, that turned upside down every theory and economic model regarded as optimal for macroeconomic stability. Needless to say that in order to become resilient to this kind of shocks, authorities should rethink their policies. Therefore, preserving the financial stability has become a systemic objective, a ‘bet’ as important as the monetary stability, both pillars for a sustainable economic growth. The analysis of financial stability as a goal for the monetary policy stands out as a challenge in the context of the multiple interlinkages among markets and financial institutions and international capital flows.

This paper briefly presents the state of the monetary policy and the general thinking about it, its objectives, strategies, instruments embedded in different theories before the crisis, emphasizing the fundamental objective of price stability and the inflation targeting strategy. The second and most important paragraph represents a comparison between different views on how a sound monetary policy should be conducted. On the one hand, there are economists who claim that central banks should not include financial stability in their monetary policy; on the other hand, a more popular view admits the importance of the macroprudential regulation and central banks’ contribution to a stable financial system. Do price stability and financial stability converge or are they divergent in terms of monetary policy and central banks’ authority?

## 2. Objectives of the monetary policy promoted in the Pre-Crisis years

First of all, the period before the crisis was dominated by excessive confidence in the 'too big to fail' welfare goals of both the population and financial institutions. Moreover, the central banks developed strategies relying on a well defined "science of monetary policy" and monetary policy was perceived as being successful in OECD countries, with not only low inflation, but also low variability of inflation. In addition, these countries faced a substantial decline in macroeconomic volatility, development known as the Great Moderation. (Bernanke 2004). Some theoreticians claim that the Great Moderation did not result primarily from changes in the structure of the economy or improvements in policymaking and it occurred due to smaller and more rare shocks hitting the economy . Whether the great reduction of macroeconomic volatility is a result of efficient policies or it is a matter of good luck, this should be a lesson for policy makers, in order to promote a resilient and sound monetary regime.

The price stability objective was set as the major objective of the central banks as a result of the ideological debates of two schools of economics. Thus, the Monetarist School or Currency School, which had as an influential figure Milton Friedman, claimed that "Inflation is always and everywhere a monetary phenomenon" (Friedman); on the other hand, the Keynesian School or Banking School attributed the main causes of inflation to supply shocks. We could say that there was a general agreement with Friedman's arguments regarding the fact that the expansionary monetary policy will eventually lead to high inflation. Therefore, the policy makers put an emphasis on monetary aggregates targeting, in order to prevent the price raising.

The comparison Henry Wallich (ex-governor of FED) made on this respect meant that the monetary approach lacked some important and relevant aspects: „inflation is a monetary phenomenon, just like shooting at people if ballistic one".

Given the fact that a monetary policy that complies with the traditional objective is credible, there is a high risk for inflationary pressures to accumulate for longer periods of time without being reflected in the prices of goods and services.
Consequently, the financial system deals with a shortcoming of an anti-inflationary policy, which is the gap between the imbalances produce and their perceptible effects, that are more likely to have a negative impact on the system as a whole.
The monetary authorities tackle with the paradox of a credible monetary policy, since having price stability as the fundamental objective can lead to both stability and instability, the latter consisting of uncontrolled financial imbalances.

The Pre-Crisis period identifies itself with' certainties' and favourable macroeconomic trends, which cemented a few monetary policy related concepts (Mishkin,2011): the key for macroeconomic stability is stabilizing the inflation; a low level of inflation is the proof of the financial system's soundness, therefore the self-adjustment mechanism exists within the system; price stability is a warrant for sustainable development; the transmission mechanism of the monetary policy consists of the interest rate channel; monetary policy operating through the control of a short-term interest rate is sufficient to capture the impact of monetary policy on the economy. Although short-term interest rates independent of other financial factors have only a modest influence on economic activity, their transmission affects medium- and long-term interest rates, which do have a substantial role in the economy. It is argued that the future path of a short term interest rate is able to affect the entire range of interest rates and their impact on the economy.

As a long-term objective, price stability is the adequate fundamental objective of the monetary policy. Price stability represents a goal itself and the means for it, as it is a major contribution to a sustainable economic development and to macroeconomic stability.(Bernanke, 2006). Moreover, promoting price stability is not only the most efficient action to take by the policy makers, but a contribution to social welfare. According to the Founding Treaty of the European Community, "the main objective of the Central Banks European System is maintaining price stability".

As I mentioned above, the so called Science of the Monetary Policy guided the central banks' actions with the help of some scientific principles, highlighted by Mishkin in his papers. These principles sum up the ideology and the empirical evidence that led the economic thinking up until 2007, as it follows:" inflation is always and everywhere a monetary phenomenon"; price stability has important benefits; there is no long-run trade-off between unemployment and inflation; expectations play a significant role in the determination of inflation and in the transmission of monetary policy to the macroeconomy; real interest rates need to rise with higher inflation, i.e., the Taylor Principle; monetary policy is subject to the time-inconsistency problem, which means that, in time, policies that were considered to be optimal at one moment in time are no longer perceived to be optimal at some point in the future and are not implemented; central bank independence is crucial for the enhancement of the monetary policy efficiency; "in order to receive good outcomes of the monetary policy a strong nominal anchor is required; financial frictions are an important determinant in business cycles" (Mishkin, 2011).

The inflation targeting strategy of the central banks involves a strong, credible commitment of the central bank to stabilize inflation in the long run, but also allows the central bank to implement and promote policies designed to stabilize output around its natural rate level in the short run.

The type of inflation targeting which is commonly applied is called "flexible" as it does not pursue price stability as a sole target, though in connection with the real economy performance. As such it aims at stabilizing inflation around the inflation target and resource utilization around desirable output-gap. The concept of flexible inflation targeting thus means that a trade-off between inflation stabilization and output stabilization is built into monetary policy making. The policy implementation then aims at a reasonable compromise between the two.

## 3. Reassessing the objectives of the monetary policy after the crisis

Traditionally, central banks focus their policy on obtaining and maintaining price stability, as their status stipulates clear responsibilities regarding the fundamental objective. Considering financial stability as a second priority objective of central banks generates a reassessment of the banking regulation in terms of macroeconomic stability and monetary policy.

Even before the crisis, central bankers were aware that financial disruptions could have a serious negative impact on the economy, so their overall surveillance is necessary when coping with a vulnerable financial system. This is why many central banks not only carried out reports on monetary policy, but also published *Financial Stability Reports* that provide an assessment of the financial conditions and the systemic ones that engage potential threats to the financial system. I have previously mentioned a notable principle for Mishkin's monetary policy theory, which is the one that refers to the financial frictions as a determinant of business cycles. In a Basel world, these frictions are the subject of macroprudential regulation, as a necessary pillar for financial stability and implementing a 'new order' in the financial system is a step forward and against potential distresses. Nonetheless, Basel III represents a toolkit for the banking system in terms of macroprudential regulation, creating a solid framework for the implementation of a successful monetary policy. However, it is still debated whether the financial stability and price stability goals converge into a unitary monetary policy or not. “This naturally led to a dichotomy between monetary policy and financial stability policy in which these two types of policies are conducted separately. Monetary policy instruments would focus on minimizing inflation and output gaps whereas it would then be up to prudential regulation and supervision to prevent excessive risk taking that could promote financial instability.”(Mishkin, 2011)

It is considered that a central bank is responsible for payment systems functioning efficiently. The turbulences that the financial systems have undergone recently usually have changed the perception and extended the field of responsibilities of a central bank, and its independence is considered a main factor in conducting an efficient monetary policy. (Jacobson, 2001).

The financial fragility that describes the financial systems nowadays and the contagion that could affect all the linked financial institutions in case of a disrupture give us a different perspective of what the role of central banks is, the tools and the authority they have to promote and ensure macroeconomic stability. Beyond the traditional core functions of the central banks such as monitoring the banking system, the payment systems and acting as a lender of last resort(microeconomic functions), and price stability(macroeconomic function), there is macroprudential dimension that introduces another macroeconomic function, dubbed as financial stability. Central banks have the responsibility not only to maintain price stability, but the financial system’s stability; the macroprudential regulation outlines the central banks’ responsibilities with regard to the financial stability as it follows: evaluating potential risks that may affect the financial system stability; evaluating the solidity of the financial system and its resilience to shocks. From this point of view, we cannot refer to these main objectives as dichotomic.

“The global financial crisis of 2007-2009 was not only a tsunami that flattened the economy, but in the eyes of some commentators it has flattened the science of monetary policy, requiring a total rethink.”(Mishkin, 2011).

The financial system was the subject of a collapse during the global crisis, comparable to the shock resulting from the calamities of the Great Depression. However, “the economic contraction turned out to be far less severe”.(Mishkin, 2011)
Despite the similarities between the two severe crises, the current financial crisis was managed with an aggressive monetary policy, effectively reassessed in terms of prudential regulation and countercyclical measures in order to diminish the downturn caused by the cyclical behaviour of banks.

On the other hand, central banks were forced resort to unconventional monetary policies (policies that operate on balance sheets), beyond the standard interest rate policy in order to influence longer term interest rates and general financial conditions. Central banks engaged in supporting the banking sector from bankruptcy and managed to ‘bail-out’ systemic financial institutions; the support the central banks gave firstly consisted of massive assets purchases and secondly of capital injection in order to solve the liquidity issues. As a consequence of these balance-sheet operations, there was a high increase in the public debt and sovereign risk as well.

In my opinion, nonconventional monetary policy consists in the actions central banks took in their struggle to counterbalance the impact of the crisis and represent monetary stimuli that are difficult to withdraw from the economy: liquidity provisions; asset purchases; “quantitative easing, in which central banks greatly expanded their balance sheets”(Mishkin, 2011); long-term low rates of banking policy.

‘’The problem during the financial crisis episode with conventional monetary policy is not that it was ineffective, but that the contractionary shock from the financial crisis was so severe that it overwhelmed the ability of conventional monetary policy to counteract it.''(Mishkin, 2010)

The trade-off between the price stability and financial stability is similar to the one between the monetary policy and the regulation and surveillance policy. This conflict is the subject of overheated debates among authors, theorists, authorities and other 'stakeholders' of financial systems and it has as main argument is missing the inflation target as a consequence of the liquidity injections made by central banks in order to bail-out some financial institutions at risk. Another argument is related to the reputation of the central bank, which could be affected by its failure in 'fostering' the banking system and which could compromise the credibility in its authority.

We have seen during the recent financial turmoil that the lendor of last resort(LOLR) function is extremely important in avoiding an eventual collapse and regaining trust in the financial system, and ensuring liquidity is an essential condition for preserving stability.

Whereas the central banks seen as the systemic stabiliser are allocated a new set of macroprudential instruments to operate, such as (possibly time- and state-varying) capital, liquidity and leverage ratios in order to promote and preserve banks' resilience to shocks, the traditional focus of stabilisation has been the central bank's "capacity to lend, and thus to create liquidity, either to an individual bank, as the lender of last resort, or to the market as a whole, via open market operations." (Goodhart, 2010)

Whether the dichotomy between the tradition monetary policy and the financial stability goal means a short-term trade-off in literature (Goodhart 2010), there is another view on this which claims that the mentioned above objectives converge to the financial system's stability.

In an open economic environment in which capital pressure generate adverse economic conditions, the expansionary monetary policy used to balance the contractionary phase of the business cycle and to stimulate the economy may also alter the financial fragility of the system, because the liquidity injections can be used by some banks in a wrong manner, causing distress in the financial system.

Moreover, this dichotomy is revealed if economy goes through a high inflation period and banks are vulnerable. In order to counteract the inflation pressures, central banks normally proceed to raising interest rates. Taking into account the fact that the surveillance responsibilities give central banks information on system's fragility and that high interest rates might amplify this vulnerability, central banks give up raising interest rates and so they miss the inflation target.

A short review of literature outlines multiple arguments for the consistency of a monetary policy including the two interrelated goals, price stability and financial stability. Mishkin asserts that "both a sustained increase of the price level and a reduction under the level of expectations represent potential instability sources."(Mishkin, 2010)

In an economy with moderate or low inflation, banks normally give loans at a fixed interest rate. A disinflation process would lead to higher real interest rates, diminishing cash-flows and increasing financial instability. Nevertheless, when monetary authorities conduct an abrupt disinflation policy, they have to pay attention to the soundness of the financial system and its tolerance to changes.

As far as the financial stability objective is concerned, there is historical evidence that pleads for the importance of macroeconomic stabilization. Therefore, the banking crises were caused by vicious macroeconomic policies, with flawed fundamentals and applied principles.

Nevertheless, a price stability oriented policy reduces risks and has a toolkit for achieving price stability and financial system's stability. However, if we follow the Tinbergen rule, a conflict between the two goals is relevant. Tinbergen's study "On the Theory of Economic Policy assumes that "policy designers have a relatively freehand in selecting tools from a large toolbox of possibilities in order to address their policy goals and attempts to discern the optimal arrangement f policy goals or "targets", and the means or 'instruments' available to resolve them."(Del Rio&Howlett,2013) In his work, Tinbergen analyzed what he termed the 'normal' case in which it was possible to match one goal with one target so that one instrument could fully address its task and accomplish the goal set out for it. In my opinion, Tinbergen rule could apply in some cases, but definitely not in all cases.

The banking system is the transmission mechanism of the monetary policy, thus the links among the central bank, the banking system and their objectives is imminent. Arguments against their separation mainly rely on the necessarily intimate connection between the two facets of monetary policy. "For example, once the zero lower bound to interest rates is reached, then monetary policy, in the guise of inflation targeting, and systemic stability issues become indistinguishable." (Goodhart, 2010) There are several arguments in favour of separating interest rate setting from central banking, such as the conflict of interest that may arise in respect of independence and growing responsibilities. Central banks' failures as interest setters mainly resulted from not taking into consideration the financial conditions and frictions and the monetary policy in the context of a fragile financial system.

The recent international financial crisis demanded some unconventional monetary policy that sacrificed inflation targeting in favour to numerous capital injections, in order to preserve financial stability.

The recent evidence the ongoing financial crisis gives us is a contradiction to the economic theories on which monetary authorities relied on when conducting the monetary policy. On the one hand, there was a general outlook concerning the optimal monetary policy according to which "a policy that stabilizes inflation and output is likely to stabilize asset prices, making asset-price bubbles less likely to appear"(Mishkin, 2011). On the other hand, central banks succeeded in implementing a credible and 'safe' monetary policy from the end of the 80's until the major financial crisis burst in 2007. Moreover, the stabilized inflation and the decreased volatility of business cycle fluctuations, which were the features of the Great Moderation, made policymakers complacent about the risks from financial disruptions and unaware of the fact that everything in the financial world is prone to risk and should be treated accordingly.

The Great Moderation period surely did not protect the economy from financial instability, but kept it from clearly signalizing it. The context of low inflation volatility and not severe fluctuations of the output gave the false impression of stability, even though it did not generate very good economic outcomes. Accordingly, this "benign economic environment may have led market participants into thinking there was less risk in the economic system than was really the case. Credit risk premiums fell to very low levels and underwriting standards for loans dropped considerably". (Gambacorta, 2009).

The aftermath of the financial crisis reveals different views on how central banks should conduct their monetary policy and there is the view sticking to continuity and the adjustment oriented view. The continuity view holds that "flexible inflation targeting does not require any explicit addition of financial imbalances or asset prices to the formal structure of inflation targets".(Svensson, 2010) This statement is clearly asserted by L. Svensson, an expert on flexible inflation targeting, who has the belief that the outbreak of the financial crisis was not entirely connected to monetary policy and it was mainly due to “regulatory and supervisory failures, distorted incentives in financial markets and mishandled macro conditions”.(Svensson, 2010)

Moreover, the outbreak of the crisis made an impact on the advocates of the continuity of the existing monetary policy framework as well. They are striving to prove that the applied regime of flexible inflation targeting has a potential to cope with the risks for financial stability without any substantial change in its operational framework. Personally, I consider that taking for granted the existing monetary policy framework eventually means ignoring its flaws in terms of regulation, risk management, liquidity management and the new requirements of the Basel III Accord.

Overall, central banks succeeded in stabilizing inflation, but a low and stable inflation is not a guarantee for stability.

According to the continuity perspective, “the targets of monetary policy should remain to be confined to price stability and resource utilization (output gap) and should not be extended on financial conditions”.( Hrnčíř, 2012)

The advocates of this view have the following arguments for this approach:

• the two highly debated goals of monetary policy, financial stability and price stability, though interrelated , are different goals. Accordingly, financial stability policy and monetary policy are different, with different objectives, instruments and responsibilities and should not be conducted similarly or simultaneously ;

• flexible inflation targeting is not sufficient for achieving financial stability and there is recent evidence from the latest financial crisis to state that . In accordance with Tinbergen’s principle, who claimed that each goal must have its own instrument, interest rate policy is therefore not enough to achieve financial stability;

• there is a relatively wide range of instruments except the interest rate,(credit-to-GDP ratio, capital standards, loan-to-value ratio) that are likely to be much more effective in avoiding excessive credit growth and asset-price bubbles, and are preferable to the interest rates in order to achieve the financial stability goal;

• the extension of the monetary policy targets to financial stability would cause overburdening the monetary policy and it would question the achievement of the fundamental goal of the monetary policy, price stability. Hence, a trade-off between financial stability and price stability is undesirable from this point of view.

There are two principal arguments why it should be not only useful but also desirable to effectively engage monetary policy in financial stabilization:

• the monetary policy framework undoubtedly affects the financial environment, the degree of leverage of financial institutions and the probability of occurrence of a crisis;

• the regulatory authorities develop a new range of regulation tools or consolidate and put into practice the existent appropriate ones for both the individual financial institutions and the system as a whole. The Basel Accords implemented and the third one is still mplementing new requirements towards a more efficient and less vulnerable financial system. Moreover, the new regulatory framework is supposed to strengthen its macroprudential dimension and to change its character from a procyclical to a more countercyclical one and to become consistent with the financial stability goal.

Nevertheless, an extended engagement of monetary policy in financial stabilization, though its milestone, is, however, exposed to several constraints, which were logically and concisely summarized by the czech banker Miroslav Hrnčíř as it follows:

• there may be conflicts between the goals of price and financial stabilization. These conflicts start where the responsibilities broaden for the regulators. Prior to the global financial crisis it was well known that monetary policy safeguards price stability and promotes it as its fundamental goal whilst the regulatory framework is in charge with preserving financial stability. In the post-crisis world, we highlight the necessity of a reassessment of this order and a consensus between the two goals in order to avoid or minimize the effects of a potential financial disarray.

• "the extended policy framework should still provide a clear anchor for medium term inflation expectations"( Hrnčíř, 2012)

• it is difficult to dispose of "the technical background and the practical experience on how to implement "leaning against the wind""( Hrnčíř, 2012) is lacking to a great extent; it is arguable if the regulators have the ability to extract the relevant information from financial imbalances in a way that allows preemptive policy to be implemented, so as to counteract the cylical damage or the necessary background is lacking to a great extent. (Hrnčíř, 2012)

Personally, I consider that taking for granted the existing monetary policy framework eventually means ignoring its flaws in terms of regulation , risk and liquidity management.

To put it in a nutshell, the conflict between price stability and financial stability lays not only in the activities central banks are engaged to, that have to 'wear two hats' simultaneously, but in choosing the right tools to achieve these interlinked major objectives. The policy objectives, the strategies, the instruments to achieve the objectives and the transmission channels of the monetary policy represent the configuration of the monetary policy, in which all the elements presented are linked to each other.

One of the most important lessons from the crisis is the fact that the inflation targeting goal is necessary but not sufficient for preserving financial stability and there should be taken into consideration both quantitative and qualitative aspects of the targeting. The central banks do not have as main concern inflation targeting at any horizon independent of the intermediate objectives, since they managed it during the crisis, but every strategy is oriented towards financial stability.

Central banks need to reconsider their monetary policy frameworks with a view to ensuring symmetry in the conduct of monetary policy over the financial cycle and to better internalise the externalities associated with global monetary policy spillovers (Borio 2011).

## 4. Conclusions

This paper aimed at identifying clear and valid "pros and cons" referring to the current monetary policy framework and the need to reconsider central banks' objectives. In the first paragraph there were mentioned some scientific principles that guided thinking at almost all the central banks before the crisis outburst and it is clear that the agenda of central banks has suffered and has to suffer serious changes in terms of monetary policy.

The global financial crisis resulted in a trigger for the authorities that are charged with implementing monetary policy, leading to the expansion of policy goals, instruments, strategies, due to the failures of the narrow oriented policy conducted before the crisis. Even though there is a divergence among the views on the role of the monetary policy, we can appreciate that the adjustment view mentioned above is gaining ground ; the monetary policy disposes of a range of instruments that can consolidate the financial system and preserve its soundness and stability. Hence, the established consensus on the goals of monetary policy is likely to go through reassessment and adjustment.

As a conflict is likely to exist between the requirements of price and financial stability, such an extension of monetary policy targets implies that a trade-off between them is faced. Given the fact that there was not adopted a practical model of the monetary policy and no legislation amendment was made, we could assume a temporary “switch” to the financial stability mode once a situation characterized by substantial financial stability risks develops, while the commitment to the medium term inflation target remains untouched.

**Acknowledgement**: *This work was cofinanced from the European Social Fund through Sectoral Operational Programme for Human Resources Development 2007-2013, under the project number POSDRU/159/1.5/S/140863 with the title „ Competitive Researchers in Europe in the Field of Humanities and Socio –Economic Sciences. A Multi-regional Research Network”.*

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