EUROPEAN CENTRAL BANK
EUROSYSTEM

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Monetary and Macroprudential Policy Interactions

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Macroprudential policy

Aims to:

- ensure high-level resilience for the financial system
- contain excessive pro-cyclicality of the financial system

Scope:

- should be broad
- regulation should be functional and global
- at the same time it should not hamper access to finance, but merely address market imperfections, including system-wide externalities

➔ ambitious, difficult to define, variety of tools and authorities

Monetary policy

Aims to:

maintain price stability. Policy is considered as successful when inflation expectations are solidly anchored to the policy aim through business cycles (internalisation of the central bank reaction function)

Tools:

- Essentially short-term interest rates and signals to influence market expectations concerning future short-term rates
- Also impact on term premium via credibility effects, or more directly via asset purchases (duration extraction)

Transmission:

- Intertemporal substitution
- Risk channel: static, dynamic

Monetary policy and financial stability

Monetary policy enhances financial stability by:

- smoothing business cycles and keeping inflation expectations anchored
- providing liquidity to solvent institutions in stressful situations

On the other hand:

- Monetary policy operates amid uncertainty (degree of slack, relationship between slack and inflation, the nature of shocks, the transmissions of instruments, etc.): miscalibration is a possibility
- However, financial stability risks mostly arise when the chosen policy interacts with distorted incentives in the financial sector (principal-agent problems and system-wide externalities) that lead to excessive leverage and maturity transformation, and funding fragilities

➔ **It is essential to have a sound and comprehensive macroprudential framework complementing the monetary policy framework**

➔ **Monetary policy should also look for signs of financial excesses**

Monetary policy reaction to the global financial crisis

Context:

- strong deflationary forces/balance-sheet recession
- stretched public finances
- zero lower bound
- structural strengthening of banking regulation
- strong global financial interlinkages

Policy reaction needed to be bold and persistent

- to restore the bank lending channel and thereby stabilise the economy and keep inflation expectations anchored
- no trade-off between monetary policy and financial stability
- detailed knowledge of the structure and behaviour of the financial sector was key in the design of monetary policy instruments

Monetary policy: where do we stand?

- Monetary policy has been effective in stabilising the euro area economy and creating conditions for a sustained adjustment of inflation towards below, but close to, 2% over the medium term. This has been achieved in a context of fundamental changes in banking regulation and supervision
- Patient, prudent and persistent monetary policy is still needed
- At the same time and in particular at this stage of the monetary policy cycle the risk channel of our policy has to be closely monitored
- Macroprudential instruments have been rightly activated in a number of instances. Full implementation of the regulatory reforms remains essential