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Monetary and financial stability: Here to stay?

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Abstract

We argue that changes in the monetary and financial regimes over the last twenty years or so have been subtly altering the dynamics of the economy and hence the challenges that monetary and prudential authorities face. In particular, the current environment may be more vulnerable to the occasional build up of financial imbalances, i.e. over-extensions in (private sector) balance sheets, which herald economic weakness and unwelcome disinflation down the road, as they unwind. As a result, achieving simultaneous monetary and financial stability in a lasting way may call for refinements to current monetary and prudential policy frameworks. These refinements would entail a firmer long-term focus, greater symmetry in policy responses between upswings and downswings, with greater attention to actions during upswings, and closer coordination between monetary and prudential authorities.

JEL classification: E30; E44; E50; G10; G20; G28

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1. Introduction

Today I would like to share with you some personal reflections on the nexus between monetary and financial stability. Specifically, I will address two questions: What is the relationship between monetary and financial stability? How can we achieve the two *simultaneously* in a *lasting* way?

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My remarks will be based on a line of research carried out with colleagues at the BIS over the last few years. The views expressed, however, should be taken as strictly my own.

This line of work is based on two observations. First, over the last two decades central banks have been extremely successful in conquering inflation, but financial instability has become a major policy concern. Financial crises in both industrial and emerging market countries have resulted in major output losses. Second, throughout modern history the simultaneous achievement of monetary and financial stability has in fact remained rather elusive (Borio and Crockett, 2000; Borio, 2005).

The main conclusion I draw from this work is that we are closer than ever to achieving the goal, but that doing so requires some refinements to current monetary and prudential policy frameworks. These refinements would entail a firmer long-term focus, greater symmetry in policy responses between upswings and downswings, with greater attention to actions during upswings, and closer coordination between monetary and prudential authorities. The main risk is that the problem could fall through the cracks: each type of authority might well agree with the diagnosis, but put the burden of action on the other. The result would be the failure of policymakers to act.

Given the limited time available, I can do no more than sketch the basic argument and some empirical evidence for it. Moreover, while the literature on these issues is quite vast and growing rapidly, I will just refer to BIS work. For a comprehensive set of references, you should refer to those pieces of work.

2. The thesis

The thesis is that changes in financial and monetary regimes worldwide may have been subtly altering the dynamics of the economy and hence the challenges that monetary and prudential authorities face.

On the one hand, financial liberalisation may have made it *more likely* that financial factors in general, and booms and busts in credit and asset prices in particular, act as drivers of economic fluctuations. On the other hand, the establishment of a regime yielding low and stable inflation, underpinned by central bank credibility, may have made it *less likely* that signs of unsustainable economic expansion show up first in rising inflation and *more likely* that they emerge first as excessive increases in credit and asset prices (the "paradox of credibility").

As a result, the current environment may be *more vulnerable* to the occasional build up of financial imbalances, ie over-extensions in (private sector) balance sheets. These imbalances herald economic weakness and unwelcome disinflation down the road, as they unwind. The unwinding may occur because the boom falters under its own weight or because inflation eventually does emerge and the central bank is forced to tighten.

One can refer to the property of the economy that makes the emergence of financial imbalances more likely as increased "procyclicality" (Borio et al., 2001; BIS, 2001) or, more graphically, increased "elasticity" (Borio and White, 2004).

Let me next say a few words about the role of the financial and monetary regimes, respectively.

Financial liberalisation is undoubtedly critical for a better allocation of resources and long-term growth. The serious costs of financial repression around the world have been well documented.