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Journal of International Money and Finance ■■ (2015) ■■–■■

Contents lists available at ScienceDirect

Journal of International Money and Finance

journal homepage: www.elsevier.com/locate/jimf

On the separation of monetary and prudential policy: How much of the precrisis consensus remains?

Stephen G. Cecchetti [a,b,c,*]

[a] Brandeis International Business School, Waltham, MA
[b] National Bureau of Economic Research, Cambridge, MA
[c] Centre for Economic Policy Research, London, UK

ARTICLE INFO

Article history:
Available online

JEL Classifications:
E52
G01
G28

Keywords:
Monetary policy
Prudential policy
Financial stability policy
Capital requirements
Stress tests

ABSTRACT

Prior to the crisis, monetary policymakers and prudential authorities had clearly defined tools and goals with little or no conflict. The crisis revealed a variety of overlaps, where one set of policies seems to influence those in another. Does this mean that two policy realms can no longer remain separate? I address the question by first asking whether monetary policy creates significant financial stability risks. My answer is generally no. Given that, central bankers should refrain from reacting to financial stability risks in most circumstances. Instead, the job of safeguarding the financial system should be left, as it was prior to the crisis, to prudential policymakers. But how can prudential policy best maintain financial stability? I argue that given our current state of knowledge, stress tests are the best tool to ensure crisis will be rare and not terribly severe. So, my answer to the question in the title is that the precrisis consensus remains largely intact.
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1. Introduction

Prior to the financial crisis of 2007–09, it was nearly axiomatic that prudential, fiscal and monetary policies could be separated. Objectives and instruments could be cleanly mapped to different policymakers, with minimal overlap.

Prudential policy would use capital and liquidity regulation to reduce the likelihood that individual institutions would fail. In doing so, authorities seek to limit contagion from such failures; to ensure

* Corresponding author. Tel.: +1 781 736 4856.
E-mail address: cecchetti@brandeis.edu

http://dx.doi.org/10.1016/j.jimonfin.2015.12.011
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Please cite this article in press as: Stephen G. Cecchetti, On the separation of monetary and prudential policy: How much of the precrisis consensus remains?, Journal of International Money and Finance (2015), doi: 10.1016/j.jimonfin.2015.12.011

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continued market functioning, and to counter the moral hazard arising from retail deposit insurance and implicit government guarantees. Furthermore, because the policy's ultimate purpose was to address an externality, prudential policy was thought to be more or less unchanging through time.

Fiscal policy, by setting taxes and expenditures, would focus on promoting growth and employment. It would address social preferences about the way that income is distributed across households and among its ultimate uses. And, through straightforward countercyclical taxes and spending, fiscal policy could automatically stabilize the economy. Importantly, with its focus on long-term objectives, fiscal policy would be slow moving.

By contrast, monetary policy would use interest rates or the exchange rate as the short-term, flexible tool for maintaining price stability and stabilizing aggregate demand. And, as the lender of last resort, central banks would maintain short-run liquidity to the banking system in times of stress. Both of these were to be achieved by the combination of the central bank's judicious use of its balance sheet and a set of announcements.

The differences in time horizon – prudential policy, timeless; fiscal policy, long-term; and monetary policy, short-term – reduced the need for any one authority to worry about the objectives of the other two. The division of tools – capital and liquidity requirements, tax and expenditure policy, and various interest rates – meant that decisions could be taken independently. And, importantly, we had empirical models that let us predict the response of goals to changes in instruments.

The events of the past decade have thrown the deficiencies of this precrisis consensus into bold relief. We are now acutely aware of a whole raft of overlaps and conflicts between objectives and instruments. Among other things, we now see that monetary policy influences prudential policy through its impact on bank, household and firm balance sheets, as well as by changing incentives for risk taking. Prudential policy influences financial conditions by influencing the cost of lending; it influences the monetary policy transmission mechanism by changing how intermediaries react to changes in interest rates; and it influences fiscal policy through its treatment of sovereign debt. Monetary policy influences fiscal policy through the central bank's balance sheet and its impact on the quantity and maturity structure of privately-held sovereign debt. And, monetary policy has an impact on the usefulness of fiscal policy as a stabilization tool when interest rates are at the zero lower bound.

So, after receding for several decades, the issue of interconnections and trade-offs between the various policymaking realms has returned in full force. But how important are these policy interactions?

There are two clear sides to the debate. The first is exemplified by the statement of Jaime Caruana, General Manager of the BIS. In 2011 he said:[1]

"[F]inancial stability is too large a task for prudential or macroprudential frameworks alone. Monetary policy strategies also need to be modified, so that central banks can lean against the build-up of financial imbalances even if near-term inflation remains low and stable" Caruana (2011).

The alternative is summarized in a recent statement by John C. Williams, President of the Federal Reserve Bank of San Francisco:[2]

"My main conclusions are: (1) monetary policy is poorly suited for dealing with financial stability concerns, even as a last resort; (2) a macroprudential, financial system-wide perspective is needed – but in the United States, explicitly macroprudential tools are hard to find; and (3) given (1) and (2), we need to rely primarily on microprudential regulations and supervision to achieve macroprudential goals" Williams (2015).

Which is it? Must financial stability become part of the core of our monetary policy framework as Caruana claims? Or, can we retain the separation between monetary policy and prudential policy, as Williams concludes?

In the remainder of this essay, I will bring evidence to bear on these questions. Starting in Section 2, I present a framework to organize the discussion. In Section 3, I examine whether monetary policy creates financial stability risks, and whether it should react to financial stability risks. Next, in Section 4, I turn my attention to prudential policy and focus on how I believe it can best be used to maintain

[1] Also see Borio (2014).

[2] Interestingly, while the Williams view echoes that in Yellen (2014), it is counter that of Fischer (2014).

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