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Interactions between monetary and macroprudential policy
(Article in the September 2015 Economic Review)

Prior to the onset of the financial crisis in 2007, most policymakers traditionally assumed that price stability should be the prime objective of monetary policy, typically combining a medium-term inflation target with capacity utilisation objectives such as the highest attainable employment or output consistent with price stability. Financial stability was considered to be an altogether different policy domain – and assuring it not monetary policy's main purpose. Implicitly, it was generally believed that, if a central bank managed to keep inflation stable and slightly positive – typically at around 2 % –, next to real economic, also financial stability would be assured.

The Great Recession has taught policymakers that price stability in and of itself is no guarantee of financial stability and cannot prevent financial crises. As it turns out, shocks to the financial system can have major repercussions for the real economy – and thus also in terms of risks to price stability. And so strengthened microprudential policies targeting individual institutions have been given their macroprudential counterparts, focusing explicitly on systemic risks to the financial system at large and its interactions with the real economy. It is within this new framework that the ECB has been given macroprudential responsibilities to ensure financial stability as part of the single supervisory mechanism (SSM), while keeping its (macro)prudential objectives separate from its duty to ensure price stability.

This article establishes the implications of an active macroprudential policy for monetary policy, paying particular attention to the ways in which the two policy domains interact. The article starts off by outlining the framework in which macroprudential and monetary policies operate, discussing the objectives of both policy domains, the range of instruments to help achieve these objectives and the main transmission channels. It then goes on to describe the institutional framework for monetary and macroprudential decisions in Belgium.

Major trade-offs sometimes exist between price and financial stability, and these trade-offs between the two key objectives determine the very nature of the interactions between monetary and macroprudential policies. The second part of the article analyses this interface: drawing on a theoretical model supported by real-world evidence, it demonstrates that such trade-offs depend on shocks that might affect the economy. Against this background, the article suggests in which cases it might be desirable for monetary policy to 'lean against the wind', implying that monetary policy might be used to support macroprudential policy to help achieve financial stability when financial imbalances are widespread, or if effective prudential instruments are lacking.

The article also touches upon the challenges currently facing the euro area, where non-conventional monetary policy easing might contain risks for financial stability. Given the downward risks to price stability, expansive monetary policy appears to be justified as the economy shows no signs of widespread, excessive risk behaviour, as monetary policy in fact has positive spillovers on financial stability via macroeconomic stabilisation, and as targeted macroprudential instruments are available to help address risks that might emerge.

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