"Monetary Policy and Financial Stability: Challenges in the Wake of the Crisis"

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It is both a pleasure and a privilege to participate in the closing panel of this conference honoring Ben Friedman. Ben taught me monetary policy and central banking, and his teaching had a major influence on my decision to spend most of my career as a central banker. My intellectual debt to Ben, as a scholar and a friend, is so great that I do not think I will ever be able to repay him. So much for intertemporal budget constraints.

Today I would like to address four issues that I believe should be high on the agenda of central bankers, particularly in light of the substantial changes brought on by the great financial crisis that we lived through over the past few years. These issues are (i) the relationship between monetary policy and financial stability; (ii) the legacy of high public debt; (iii) systemic liquidity risk; and (iv) globalization.

1. The Relationship between Monetary Policy and Financial Stability

One of the key lessons from the crisis is that we need to complete the macrofinancial policy framework. Of particular importance is the addition of the so-called macroprudential policies, which seek to prevent the materialization of systemic risk in the financial system. From the viewpoint of monetary policy, this is good news but it also entails challenges.

The good news is that if macroprudential policies succeed in making financial crises less likely and less severe, this will lessen the need for monetary policy to do "unprecedented" things to clean up the mess when crises do erupt. The challenge is that the new institutional arrangements governing macroprudential policy—in which central banks are likely to play an important role in many cases—should not undermine the independence of monetary policy. Furthermore, macroprudential policy needs to be regarded as a complement, not a substitute, for monetary policy.

While it is primarily through prudential policies that we should aim at ensuring financial stability, the crisis has shown that monetary policy also needs to take fuller account of financial developments. First, current macroeconomic models used in monetary policymaking suffer from a rather poor understanding of macrofinancial linkages and do not incorporate financial frictions, such as default and systemic liquidity risk, or the financial intermediation within shadow banks. These are all areas where much work is needed.

Second, while in a first-best world prudential policies should deliver financial stability, in the second-best world in which we live financial stability needs to be supported also by monetary policy. Does this mean that monetary policy should augment the list of its goals to include financial stability? Not in my view. What it means is that in the pursuit of price stability, monetary policy should more explicitly take into account the build-up of financial imbalances and non-mechanistically lean against them. That is, beyond indicators of price and output developments, it should pay more attention when setting policy rates to the evolution of variables like credit and indebtedness, particularly when they are accompanied by rapidly rising asset prices and current account deficits. These are often powerful signals that financial imbalances are building up that could eventually threaten both financial and price stability. A favorable consequence of the above is that monetary policy will become more symmetric over the cycle, with more "leaning" in good times and less need for "cleaning" in bad times. However, one should not underestimate the difficulties of detecting empirically when financial imbalances are building up.

2. The Legacy of High Levels of Public Debt

A key legacy of the present crisis is that countries have been left with huge amounts of public debt, reaching levels in terms of GDP that prevailed after World War II. Ensuring the sustainability of public finances in many advanced economies will thus require considerable efforts for many years. Clearly this is politically very challenging, although necessary to avoid future bouts of instability.

A main danger to guard against is the temptation to exert "subtle" pressure on the central bank to keep interest rates low, so as to have "just a bit more inflation" in order to reduce public debt burdens. This is why the hard-won independence of central banks remains as necessary as ever to avoid new episodes of "fiscal dominance," which would have very adverse macrofinancial consequences.

3. Systemic Liquidity Risk

Systemic liquidity risk results from the interplay between financial markets and institutions. In the run-up to the crisis it was seriously underestimated both by the private sector and the authorities, contributing to the heavy dependence by banks on short-term wholesale funding. Once the crisis erupted and liquidity evaporated, there was little choice but for central banks to supply huge amounts of systemic liquidity.

This is why it is necessary to better take into account systemic liquidity risk. Possible actions in this regard include enhancing the transparency and structural liquidity of systemic markets, like derivatives. This would be much helped by moving from over-the-counter markets to central counterparties and exchanges for the clearing and trading of standardized derivative contracts. A complementary avenue is to use macroprudential tools to enhance the "pricing" of systemic liquidity risk by internalizing the systemic costs associated with overreliance on continued liquidity. For example, the International Monetary Fund has recently proposed a systemic liquidity surcharge to be imposed on financial firms (banks and non-banks) based on their marginal contribution to systemic liquidity risk.

4. Globalization

The environment in which monetary policy operates is also becoming more challenging as a result of the forces unleashed by globalization in both the trade and financial domains.

As regards trade, during the years that preceded the crisis, in many advanced economies the task of monetary policy in keeping inflation low was made easier by the global disinflationary pressures associated with cheaper imports of manufacturing goods. Going forward, things are likely to be different as the structural upward trend in global commodity prices becomes the dominant factor. Thus the task of monetary policy is likely to become more difficult through this channel.

As regards financial flows, capital inflows to emerging markets are likely to be structurally higher following the crisis, given their relatively better growth prospects, expected rates of return, and macro fundamentals. The size and speed of such inflows, however, can pose considerable challenges to recipient countries and lead to well-known policy dilemmas. Specifically, countries faced with large inflows can choose between letting the exchange rate appreciate substantially, which may squeeze the tradables sector, or intervening in foreign exchange markets to limit the appreciation. Yet, in the latter case, under perfect capital mobility the authorities will not be able to sterilize the intervention, leading to higher inflation. In turn, raising policy rates to fight inflation will just bring in more capital inflows and be self-defeating.

The emergence of these policy dilemmas suggests that new policy tools are needed to cope with the challenges facing emerging countries that receive large capital inflows. Adjusting the macroeconomic policy mix so as to deliver a sustainable rate of expansion of aggregate demand with lower domestic interest rates can help limit capital inflows. Macroprudential measures can also be deployed to mitigate the financial stability risks associated with surges in capital flows. All of this is likely to allow monetary policy to continue focusing on its key goal of delivering price stability.

Let me conclude. I have briefly gone through some of the key challenges that monetary policy and central bankers face following the substantial alterations of the economic and financial landscape caused by the crisis. Successfully coping with those challenges is far from easy, but failure is not an option. I am certain that we will continue benefiting from Ben's insightful thoughts in these and many other domains. We do need them.