The role of monetary and financial policies when there are price and financial stability trade-offs

Sole Martinez Peria
International Monetary Fund

Federal Reserve Bank of Cleveland and the Office of Financial Research

2023 Financial Stability Conference

Financial Stability in Times of Macroeconomic Uncertainty

November 16th, 2023

Price and financial stability trade-offs

- Trade-off ➔ CB actions to achieve price stability are not aligned with those to guarantee financial stability ➔ What should CBs do in these situations?
- Not an entirely new topic➔ after GFC ➔ search for yield ➔ rising financial risks
- Opposing views:
  - Jeremy Stein: MP should take into account financial stability ➔ MP "gets in every crack"
  - Others, (e.g. Ben Bernanke and Lars Svensson), advocated for the separation principle:
    - ✓ Monetary policy focuses on price stability; financial policies (e.g., macropru) tackle financial risks
- Debate over separation principle when there are trade-offs has resurfaced recently

Navigating trade-offs under high inflation

- Option 1: Incorporate financial stability considerations in the MP policy reaction function
  - ✓ MP is a blunt tool➔ calibration is difficult
  - ✓ Could weaken CB credibility and risk de-anchoring inflation expectations
- Option 2: Use financial tools to deal with financial instability
  - ✓ Macroprudential policies ➔ circumvention & arbitrage are possible ➔ financial risks may prevail
  - ✓ CB might face limits on ability to use other tools (e.g. liquidity facilities or asset purchases)
- Option 3: Rely on other tools (resolution frameworks and fiscal policy)
  - ✓ Might be needed when solvency issues are significant
  - ✓ But cannot be adopted quickly if not already in place or used if there is no fiscal space
- How to proceed is not a simple question. Will depend on the scenario…

Financial stress	Monetary policy	Financial policy
Moderate **(Risks are building)**	• Monetary policy focuses on price stability • If financial conditions tighten and aggregate demand contracts trade-off less severe	• Use macropru to contain risks and build buffers • Strengthen supervision and use stress tests to identify vulnerabilities
Intensifying **(Stress materializes in specific segments)**	• Trade-off becomes more severe • MP should stay the course to fight inflation • CB communicates any use of liquidity facilities or loosening through asset purchases as temporary • If financial policies fail and risks of full-blown crisis are high, MP might need to deviate from rate path➔ communication key here too	• Use macroprudential buffers • Deploy liquidity facilities to reduce stress and avert runs if justified • Use resolution tools or fiscal backstops to address cases of insolvency
Acute **(Full-blown financial crisis)**	• Financial stability considerations will weigh heavily on MP decisions • If due to financial crisis, aggregate demand contracts, MP loosening will be consistent with price and financial stability ➔ no trade-off	Same as above

Principles for central bank interventions

- Intervention is only warranted if financial stresses pose a very material or systemic risk

- Interventions should be temporary, targeted, and priced to facilitate a return to market-based finance

Thank you!