The Role of Financial Stability with Regard to Monetary Policy

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Opening remarks

Professor Sinn, Dr Beise,

thank you very much for inviting me to speak at this series of seminars in which so many illustrious academics, politicians and central bankers have already participated in the past. I would also like to thank all you ladies and gentlemen for coming today, which is positive proof of the broad interest that monetary policy inspires nowadays.

In my speech today I will focus specifically on the role played by financial stability with regard to monetary policy, a subject that admittedly sounds rather highbrow and hard to grasp. I won't deny that the subject matter is indeed demanding, but I shall do my best today to convey it to you in a digestible form. And there is plenty to digest. If you will allow me to make a gastronomical analogy, following on from Professor Sinn's *canapés*, it is now my turn to serve you a starter consisting of a selection of observations on current monetary policy in the euro area. As a main course, I shall address the crucial question of the extent to which financial stability should influence monetary policy. Let us now turn to the starter.

Monetary policy during the crisis

The financial crisis and the subsequent sovereign debt crisis in the euro area undoubtedly presented monetary policymakers with a raft of major challenges. Exceptional circumstances have now become the norm for monetary policy. About six years ago, it was at one of these Munich Seminars that the then ECB President, Jean-Claude Trichet, explained the Eurosystem's response to the financial crisis. At that time, the first purchase programme for covered bonds had just been agreed and Mr Trichet was keen to emphasise that this step, along with any further unconventional monetary policy measures like full allotment policy for refinancing operations, additional longer-term refinancing operations and loosening of the collateral framework, were aimed at galvanising bank lending by means other than massive interest rate cuts on their own.

A little less than one year later, the Eurosystem was purchasing government bonds, because the ECB Governing Council believed that the sovereign debt crisis, which had originated in Greece, was compromising the effectiveness of its monetary policy. In the years that followed, European monetary policy was instrumental in preventing a further escalation of the crisis in the euro area. Ultimately, the result is that monetary policy has been stretched to the limits of its mandate. In particular, there is a risk that the selective purchasing of government bonds issued by the crisis countries might stray into the realm of fiscal policy.

Unfortunately, the crisis in the euro area has not yet been overcome, as shown by the recent debate surrounding Greece. Nevertheless, progress has been made. In overall terms, the euro-area economy, including the banking sector, has a much better bill of health today than it did three, four or five years ago. The crisis countries have made great strides in terms of implementing adjustments. Measured in terms of the deflators of total sales, price competitiveness up to the end of 2014 improved by 6 percent in Portugal, for example, and by 9 percent and 12 percent respectively in Spain and Ireland. The competitiveness of the Greek economy increased by as much as 14 percent. Although these figures are due to the depreciated euro to a certain extent, positive developments are nonetheless discernible if a comparison is made with other euro-area countries. The current account deficits of these countries were broadly eliminated and in Ireland the deficit was even turned into a large surplus.

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There is no denying that the austerity measures and structural reforms in the crisis countries have entailed great hardship for their peoples and that these countries deserve our respect for making the necessary adjustments. However, it is important to emphasise that there is no alternative to following this path. The financial aid provided by the partner countries facilitate the affected countries' efforts to adjust. But only fundamental reforms will enhance the economic prospects of individuals in these countries on a lasting basis.

Those who now blame the ECB and European policymakers for the sluggish economic performance of the crisis-hit countries are confusing cause and effect. Incidentally, the measures are now starting to have a noticeable effect. The European Commission is expecting positive economic growth and falling levels of unemployment in all crisis countries in 2015. It would therefore be tragic if Greece were now to give up on its adjustment measures and jeopardise what has already been achieved. But it is also clear that the economic adjustment process is more of a marathon than a sprint. The second half of a marathon is, however, harder than the first, and the finishing line is still a considerable way off.

One side-effect of the economic adjustment taking place is lower inflationary pressure. The fact that inflation in the entire euro area recently entered negative territory is, of course, attributable to a completely unrelated development, namely the sharp fall in energy prices, and particularly the price of crude oil. In economic jargon we would say that the low level of inflation is the result of a positive supply-side shock. In general terms, the word 'shock' usually has negative connotations, but in economics it is a neutral word for an unexpected change in (exogenous) factors – and the oil price is undoubtedly a central factor in cyclical and price developments.

By the way, one month before Jean-Claude Trichet's Munich speech, the inflation rate in the euro area also turned negative. The then ECB president also attributed this to a heavy tumble in oil prices and stressed that it was a 'welcome development' that improved the income situation of households. He certainly didn't see it as a cause for concern, especially as long-term inflation expectations at the time were in line with the stability mark of below, but close to 2 percent.

By contrast, some measures of long-term inflation expectations have diminished distinctly in recent months. The longer the period of extremely low inflation rates continues, the greater the risk of second-round effects – in other words, falling wages – which would then exert further deflationary pressure. And the longer monetary policy misses its target, the more likely it will be that its credibility is called into doubt. Against this background, the ECB Governing Council was certainly in a difficult situation when it deliberated in January whether to adopt a broad-based purchase programme for government bonds.

As you know, the ECB Governing Council made a majority decision to purchase government bonds, and Eurosystem central banks started purchases about two weeks ago. Asset-backed securities and covered bonds, which in Germany are better known as *Pfandbriefe*, have been purchased since autumn 2014. The objective of the securities purchases is ultimately to make monetary policy more accommodative and to move inflation back towards the definition of price stability – in other words, to make it rise.

Now that might sound as paradoxical, to some ears, as the idea of the Federal Government calling on the general public to engage in more moonlighting and tax evasion. After all, conventional wisdom has it that monetary policymakers are there to combat inflation, not foster it. And indeed they are. The Eurosystem's primary task is to safeguard price stability. But there are a number of good reasons why a central bank looks to achieve a marginally positive rate of inflation.

One reason is that the measurement of inflation is sometimes impaired by statistical uncertainties. After all, higher prices might also be driven by quality improvements, and these are rather more difficult to capture in price statistics. Another is that a monetary policy stance that targets 'zero inflation' runs the risk of bumping into the zero interest bound more frequently. Monetary policymakers who are already navigating such shallow waters will find it difficult to respond to a negative demand shock with an economy-stimulating cut in policy rates.

Another problem afflicting the European monetary union arises from the differences in economic growth rates across the euro area. Inflation rates in the member states are also mixed. So if we were to target a pan-euro-area inflation rate of zero, in practice there would always be some countries whose rates were in negative territory. A modicum of inflation, on the other hand, lubricates economic adjustment processes – all the

more so since improvements in price competitiveness driven by cuts in real wages are quite a tricky feat to achieve in the absence of inflation. That is why, since 2003, the ECB Governing Council has defined price stability as maintaining an average inflation rate across the euro area of below, but close to, 2 percent over the medium term. And for what it's worth, the Bundesbank also assumed a '2-percent price norm' when it derived its money supply targets.

But I nonetheless took a sceptical line during the debate on government bond purchases as part of a broad-based quantitative easing (QE) programme. I did so because the slack price pressures in the euro area are primarily the outcome of the drop in energy prices. Lower energy prices can only be expected to dampen inflation rates temporarily, and they are also distinctly boosting growth in the euro area because – let's not forget – its member states are net importers of oil on balance. At the end of the day, the drop in oil prices is stimulating consumers' purchasing power and eroding businesses' costs. In effect, it's rather like a small stimulus package.

So it's no surprise that the ECB staff project euro-area growth of 1.5 percent this year, rising to 1.9 percent in 2016. The inflation rate, meanwhile, is forecast to be zero in 2015, rebounding quickly to 1.5 percent a year later. Of course, this projection partly also reflects expectations regarding the impact of the monetary policy measures adopted by the Governing Council. However, my reading of the latest data and the projection is that they are more an endorsement of my restrained monetary policy stance.

Inflation rates may be slightly negative, that's true, but we are not seeing any signs of a deflationary spiral of falling prices and wages. The threat of self-reinforcing deflation is as remote as it ever was. Indeed, the European Commission expects euro-area employee compensation to climb by 1.3 percent on average in 2015. In addition, the available survey data suggest that long-term inflation expectations are still anchored. In fact, they are only marginally lower than they were in the summer of 2009, when Jean-Claude Trichet spoke here and the rate of inflation had previously dipped into negative territory. And in the current setting, slightly stronger drops in market-based expectations don't automatically mean that inflation expectations have contracted. Incidentally, inflation expectations derived from financial market data have shrunk in the United States recently too – and that happened in spite of the Fed's bond purchases.

Inflation rates look set to bounce back in the medium term, and the ECB is not alone in projecting this upturn. That's the reason why, on the whole, I don't think it would have been necessary to further ease monetary policy by rolling out the broad-based government bond purchase programme. All the more so given that the purchase of sovereign bonds in the euro area harbours specific risks, making it a monetary policy instrument unlike any other.

It is true that the recently adopted public bond purchase programme addresses a number of concerns that had arisen in connection with its two predecessors. Risk-sharing among Eurosystem central banks is limited to just a small part of the programme, and caps have been put in place to ensure that sovereigns continue to primarily tap the capital markets for funding. The broad exclusion of risk-sharing – a feature that distinguishes this programme from earlier government bond purchase programmes – at least counteracts the direct threat of sovereign credit risks being mutualised. Or, as Hans-Werner Sinn put it recently: "the Federal Republic's exposure [was] effectively diminished without restricting the ECB's scope for monetary policymaking". By the way, that also reduces the legal risk of a programme of that kind.

However, the danger of the boundaries between monetary and fiscal policy becoming increasingly blurred, with all the ramifications that this would entail, remains. This particular programme is no different from its predecessors in that regard. For when the purchases come to an end, sovereigns will finance a substantial portion of their debt very cheaply *via* the central bank without these financing costs being differentiated in any way according to the risk profile of the sovereign in question. If the member states were to become accustomed to these funding terms, they might become less inclined to embrace further consolidation or reform measures. And if that were to happen, it might impair the ability of monetary policymakers to achieve their goal of price stability in the long run.

This risk ultimately needs to be traded off against the danger of an excessively long period of excessively low inflation rates damaging the credibility of monetary policy. And it is precisely in weighing up these factors that I arrive at a different outcome to most of the other Governing Council members, because I believe that

there are very good reasons for a 'steady as she goes' monetary policy stance if oil prices plummet; just as there were in 2009 and still are to this very day. The US Federal Reserve and Bank of England are a case in point here.

Ladies and gentlemen, the crisis has not only confronted monetary policymakers with difficult trade-off decisions: it has also called into question the traditional monetary policy paradigm – the credo we once thought we all agreed upon. And that brings me to the 'main course' of the menu, if you will – that is, to the connection between monetary policy and financial stability.

Monetary policy and financial stability

Monetary policy paradigm called into question

In the pre-crisis era, central banks in the industrial countries did not pursue a common monetary policy strategy. There was, however, a broad consensus that the primary objective of monetary policy ought to be the goal of price stability. These central banks set about achieving this goal using slightly different indicators to gauge price stability, but the vast majority of them now target rates of somewhere in the region of 2 percent. None of them are looking to hit zero inflation. Central banks in transition, emerging and developing countries, meanwhile, normally target higher rates of price increase.

Independence is another element of the pre-crisis consensus. In the wake of a protracted and pathological learning process, central banks succeeded in gradually shrugging off political paternalism or government control. In this context, West Germany was lucky that, on the one hand, the Allies conferred a large degree of independence on the central banking system – this was based not so much on monetary theory, but rather on political-historical factors – and, on the other hand, that the first *Bank deutscher Länder,* subsequently called the *Bundesbank*, knew how to utilise the independence it had been granted to ensure monetary stability. One key reason why the Bundesbank was able to do this was that it had the backing of the German population, for whom monetary stability had always been a valuable asset. Even an independent central bank struggles without the support of the population. Or, as Otmar Issing put it: "ultimately, every society has the inflation rate that it wants and deserves".

The learning process was pathological insofar as, particularly in the 1970s, countries with government-controlled central banks sometimes had significantly higher inflation rates during periods of poorer economic performance than, say, Germany or Switzerland, whose central banks were both independent. The average inflation rate in Germany and Switzerland in the 1970s was a substantial 5 percent. However, the inflation rates of countries without an independent central bank were significantly higher still during the same period: for example, 13 percent in Britain, 14 percent in Italy and 15 percent in Spain – and it is worth noting that those are averages for the entire decade.

The notion that central banks should be independent and primarily responsible for monetary stability has also been underpinned by major academic studies. In addition, the increasing academic penetration of monetary policy has brought with it the realisation that the effectiveness of monetary policy is positively influenced by the transparency of its decisions. Central banks are therefore considerably more transparent in their communication nowadays than they were two or three decades ago. The press conferences held by central banks following monetary policy meetings to describe their decisions in detail – something which the ECB, for example, has done regularly ever since it was founded – are a recent development. The latest achievement in this context is the publication of 'accounts', or detailed written summaries of the monetary policy meetings of the ECB Governing Council in which the breadth of arguments presented is also reflected.

Another aspect of monetary policy that central banks largely agreed on prior to the crisis was the issue of how to tackle asset price bubbles. As I mentioned earlier, central banks refer to various indicators when setting stability objectives. What these indicators have in common is that they are consumer price indices. The prices of non-financial assets, such as shares, real estate and gold, are not taken into account in these consumer price indices. Nevertheless, the inflation of these asset prices has certainly influenced consumer price inflation. This is clearly demonstrated by real-estate: rising real-estate prices can also have an indirect effect on the consumer price index *via* increasing asset prices. As much as individual non-financial assets may vary, the one thing they have in common is that their markets can become subject to speculative exaggerations, which are commonly referred to as bubbles.

The pre-crisis consensus on monetary policy was also that monetary policy should not even attempt to prick such asset price bubbles to let the air out. For example, Alan Greenspan, the man whose name is most closely associated with this stance, said in 2002: "the notion that a well-timed incremental tightening could have been calibrated to prevent the late 1990s bubble is almost surely an illusion". The argument against the targeted management of asset prices, according to this viewpoint, was that central banks are ultimately no better than financial markets at judging whether rising asset prices are fundamentally justified or should be classified as speculative exaggeration. Instead, monetary policy should limit itself in some measure to picking up the pieces after the financial markets have crashed. That is to say, if an asset price bubble were to burst, monetary policy would respond with massive cuts in interest rates to dampen the impact on the real economy. For instance, when the dot-com bubble burst and pulled the stock markets down with it, the Federal Reserve slashed its key rate from 6½ percent to 1¾ percent in 2001.

Monetary policy in developed nations definitely played a role in the emergence of an era in the 1980s referred to by macroeconomists as the 'Great Moderation': a protracted period with relatively minor cyclical fluctuations and low inflation. For a long time, little attention was given to the fact that, in the end, the Great Moderation brought about a sharp rise in asset prices and debt. In retrospect, it must be concluded that monetary policy was a factor in this because it appeared to operate under the misconception that the Goldilocks scenario of the Great Moderation could be carried forward into the future. In reality, monetary policy obviously set the wrong incentives for the development of asset markets.

The central banks were able to keep consumer price inflation low in the years prior to the crisis with relatively low interest rates. While they were aided by the reputation that they had established for themselves, the economic tailwind resulting from globalisation also helped in this regard.

Speculative exaggerations in real-estate markets

Favourable refinancing conditions, however, had serious side-effects. In combination with lax banking regulation, in some countries they led to overinvestment in housing construction and speculative price bubbles in the real estate market. The old stock market adage, 'Boom nourishes boom', can also be observed in the real estate market. At some point, however, doubt emerges surrounding the sustainability of high prices, and even small events can cause the bubble to burst. It is a little like the fairy tale by Hans Christian Anderson, in which everyone was marvelling at the emperor's new clothes until a small child exclaimed, "but he isn't wearing anything at all!" whereupon the whole crowd exclaimed, "but he isn't wearing anything at all!"

Given the house price bubbles that have burst in the United States, Ireland and Spain, for instance, many are concerned that speculative exaggerations can now also be observed in the German real estate market and that these could, at some point, come to an abrupt end and lead to a rude awakening. But there is currently no sign of a real-estate bubble threatening the stability of the overall financial system. While house prices have risen considerably in Germany in recent years, the price hike is primarily concentrated in towns and cities, especially in large cities such as Munich. Bundesbank calculations suggest that housing in towns and cities is now significantly overvalued. We believe that prices are 10 percent to 20 percent higher than the values that could be fundamentally justified. Overvaluations in the trendy neighbourhoods of large cities are likely to go above and beyond that.

However, real estate prices in fashionable areas are not an indication of what is happening in the rest of the country. For Germany as a whole, there are still no signs of a substantial overvaluation of housing. Furthermore, price dynamics continued to wane substantially last year, while the recent expansion of construction activity is also making itself felt. But there is no dangerous housing bubble in Germany for another reason: the two key ingredients, strong lending growth and rising debt, are missing.

Speculative exaggerations in the property market combined with growing household borrowing mean that there is a risk of over-indebtedness if prices slump. And that risk is all the greater, the lower the amount of equity households possess. In such cases a crisis in the real estate market can soon develop into a banking and financial crisis, as we have seen in the countries I have mentioned. In Germany, however, we are, firstly, not seeing any especially dynamic growth in credit. It is true that the annual growth rate of loans for house purchase has gone up over the past few years. But, standing at 2½ percent at the moment, this

rate is still low – and interest rates for construction are at an all-time low.

Secondly, the majority of banks still tend to be conservative when it comes to lending. Lending standards have not been eased and the shares of own capital are still quite high on average. A special Bundesbank survey conducted in the final quarter of 2013 and the first quarter of 2014 nevertheless shows a relatively large percentage of loans with a high loan-to-value (LTV) ratio in large towns and cities: in other words, real-estate loans where the amount borrowed is greater than the collateral value. There is therefore a certain vulnerability on the part of banks to a price slump in the real estate market.

In short, it can be said that watchfulness is indeed appropriate in the German property market, but that alarmism is unwarranted. At all events, borrowers and lenders would be well advised to adhere to conservative standards. The real estate market provides a striking example of how monetary policy influences movements in asset prices. An econometric analysis by the Bundesbank has shown that housing prices in 2014 were, on average, 3½ percent higher than in a scenario where mortgage rates stayed at their 2009 level. Given the stability risks that can be triggered by corrections in the assets markets, thought should be given as to how such risks, which also emanate from other market segments, should be taken into account in monetary policy terms.

The pivotal question of post-crisis monetary policy

The pivotal question in future monetary policy will be: "what is your stance on monetary stability?" The Bundesbank defines financial stability as the capacity of the financial system to fulfil its key macroeconomic functions, especially in stress situations and periods of upheaval. Financial stability as a concept is thus much more multi-layered than price stability, which can be measured by a single index: namely, the consumer price index. Financial stability benefits from price stability and, at the same time, financial stability makes it easier to safeguard price stability. We are therefore dealing with different objectives, but not with unrelated aims.

But who is to take responsibility for financial stability if monetary policymakers already have the task of ensuring price stability? There are a wide range of proposals on that question, ranging from assigning financial stability its own policy field to enshrining financial stability as an autonomous monetary policy objective – alongside price stability as a kind of dual mandate.

As the crisis has clearly shown, in order to safeguard monetary policy, it is not enough to use prudential supervisory methods to oversee the stability of individual institutions. Anyone who thinks that is the way to safeguard financial stability is failing to see the big picture. As Janet Yellen put it recently, "before the financial crisis" we were "too concerned with the trees in the banking industry and not the forest". Those responsible for financial stability policy must therefore take a larger view: in other words, of the financial system as a whole.

Our experience of the crisis thus led to the establishment of a new policy field, one that did not exist prior to the crisis. A newspaper article said that, since the outbreak of the financial crisis, a terrible new term – 'macroprudential supervision' – has become fashionable among experts. What is behind that 'terrible term', which is not, in my view, a passing fad? The adjective 'prudential' has to do with *prudence* and comes from the Latin word *prudentia* – and refers to regulation and supervision. The first time the term was used with 'macro' as a prefix was in a publication by the Bank for International Settlements (BIS) in 1986, but it is only since the crisis that the term has come into common use. In contrast to microprudential supervision, which looks at particular institutions – the individual trees, as it were – macroprudential supervision focuses on the whole forest: in other words, the functioning of the financial system as a whole. Macroprudential policy thus aims to safeguard the overall stability of the financial system using the instruments of regulation and supervision.

As a response to the financial crisis, it was decided that the banks should hold more and better equity capital in future. The regulatory framework known as 'Basel III' describes how much regulatory capital banks should hold depending on their balance sheet risks. The greater the risk, the higher the minimum regulatory capital – that is the basic rule. At the same time, the possibility of requiring banks to provide for additional capital buffers was introduced if that should be necessary from the perspective of financial stability. With countercyclical capital buffers, the banks can be urged to form additional regulatory capital if macroeconomically excessive growth in credit can contribute to a systemic risk. This means that, in this instance, an

instrument of banking regulation is being used to safeguard the stability of the financial system.

Institutional structures for macroprudential supervision have now been created at both the national and European levels. The European Systemic Risk Board (ESRB) is hosted and supported by the ECB. The key task of the ESRB is the early identification of risks in the European financial system. In 2013, the German Act on Monitoring Financial Stability (Financial Stability Act) entered into force, which transferred the task of macroprudential supervision to the Financial Stability Committee, which comprises representatives of the Bundesbank, the German Federal Ministry of Finance, BaFin and the Federal Agency for Financial Market Stabilisation (FMSA). The Financial Stability Committee can issue warnings and recommendations.

Using Bundesbank analyses, the Financial Stability Committee is concerned with the risks to financial stability emanating from the real-estate market. The Committee is currently investigating what specific instruments should be additionally created and how they should be designed in preparation for any contingency. This relates, for example, to creating the legal basis for limiting the share of borrowed capital in real-estate financing. This means that the toolbox has to be assembled. In view of the risk assessment that I have just given, however, it is not necessary to deploy those instruments at present. As the youngest player in macroprudential supervision, there is now also European banking supervision, which even has the right to tighten adopted national macroprudential measures. Generally, however, responsibility for macroprudential policy remains with the member states.

Even although the development of macroprudential instruments still represents work in progress, the question arises as to whether this means that monetary policymakers can be absolved of responsibility for financial stability. My answer is 'no', since monetary policy measures and macroprudential measures can indeed complement each other, but can also come into conflict with each other.

The Head of Research at the BIS, Professor Hyun Song Shin, describes such a conflict when he says that there is – to put it mildly – a certain tension between an accommodative monetary policy and a restrictive macroprudential policy. According to the professor, a macroprudential policy operates, for example, by attempting to limit lending and the assumption of risks – above all via banks. An accommodative monetary policy, by contrast, has the explicit objective of increasing lending and bolstering risk appetite – and has a broader impact on the financial markets.

In terms of the euro area, one of the key advantages of macroprudential policy is that it can be used to specifically counteract unsound national developments that cannot be addressed by the single monetary policy. Regardless of whether it is intentional or merely a side-effect, monetary policy influences the appetite of financial market participants for risk and, thus, by extension, affects financial stability.

Let us consider an accommodative monetary policy scenario for a moment. If investors have certain nominal expectations about future returns, they are compelled by a low-interest-rate environment to assume greater risks in their 'search for yield'. In addition, a monetary policy that is asymmetrical – in other words, which reacts one way to financial market gains and another way to losses – actually affects the risk propensity of financial market participants.

Indeed, a monetary policy that reacts very quickly to a burst bubble by substantially lowering interest rates in order to limit the macroeconomic consequences, yet is slow to counteract the development of such bubbles because the rise in asset prices has not yet filtered down to higher consumer prices, facilitates moral hazard behaviour in the financial markets. When that is the case, monetary policy resembles an insurance policy that limits the exposure of market participants.

The relationship between monetary policy and macroprudential policy

There are various views on what the proper relationship between monetary policy and macroeconomic policy should be, depending on how significant one considers the risk-taking channel of monetary policy to be.[1] According to a rather idealised perspective, the tasks of the two policy areas should be clearly separated from one another: separate objectives and separate instruments. This perspective ascribes little importance to the risk-taking channel.

Even according to an extended perspective, macroprudential policy should, to a certain extent, be the first

[1] For a more detailed account of the three perspectives, which not only differ with regard to the assessment of the risk-taking channel, see Deutsche Bundesbank (2015), "Die Bedeutung der makroprudenziellen Politik für die Geldpolitik", *Monthly Report,* March.

line of defence against financial stability risks. However, as financial stability risks probably cannot be eliminated through macroprudential instruments alone, monetary policy should, from this perspective, extend its time horizon and take into account the longer-term effects of financial imbalances on price trends in order to ensure price stability in the long term. According to an integrated view, the risk-taking channel is so significant that separating the two policy areas is anathema. According to this perspective, which certainly represents the most radical departure from the pre-crisis consensus, monetary policy should provide a powerful preventative contribution to ensuring financial stability and should dovetail closely with macroprudential policy. Both the extended and integrated perspective therefore regard monetary policy as having a joint responsibility for financial stability, and there are indeed good arguments for this view.

However, a strong role for monetary policy also presents considerable challenges:

1. We still do not fully understand the interactions between monetary policy and macroprudential policy, especially since we simply have too little practical experience of the new macroprudential policy instruments.
2. Monetary policy's main instrument, interest rates, is not particularly suitable for counteracting regional or sectoral imbalances in assets markets. Changes to interest rates influence the entire financial and economic system, acting like a sledgehammer when a scalpel is needed.
3. Joint responsibility for financial stability could harbour risks for the credibility of monetary policy if it leads to conflicting objectives. This makes the communication of monetary policy decisions even more complex, especially as financial stability is not nearly as easy to operationalise as price stability.
4. Extending the mandate of monetary policy jeopardises central bank independence, which is precisely what is supposed to prevent it from losing sight of its price stability objective.

Against this background, conferring ever more responsibility on central banks is not without problems.

Conclusions

Before I come to the end of my speech, I would like to hazard some conclusions on this topic. They are, of course, only preliminary conclusions, as the debate on the appropriate role for monetary policy in ensuring financial stability has not been definitively concluded. Nevertheless, some points are already clear. Financial stability should primarily be secured *via* macroprudential policy. The instruments necessary for this need to be developed as soon as possible and their interactions with monetary policy must be subjected to an in-depth examination.

At the same time, monetary policymakers must take into account the effects of financial imbalances on price stability as part of their mandate. I am therefore probably a proponent of the extended perspective and am well-disposed to the approach taken by the BIS. However, financial stability should not be placed on a par with price stability as an objective of monetary policy.

Monetary policymakers should make monetary policy more symmetrical over the course of the financial cycle by taking the financial cycle into account in their decisions. Financial cycles last longer than economic cycles, on average between eight and 30 years. In other words, if monetary policymakers are aware of the effects of monetary policy on financial stability and the resulting feedback effects on price stability, monetary policy will tend to be tighter in upturn periods than would be required by short-term inflation alone. Claudio Borio, chief economist at the BIS, says that the more you concentrate on the long-term perspective, the more price stability and financial stability complement each other and the less they contradict each other.

With its two-pillar strategy, the Eurosystem has, in effect, an analytical framework that can be used to take financial market developments into account. The data on money and credit developments provide valuable clues about the longer-term price-stability risks that may arise from imbalanced financial market developments. However, more must be done before monetary analysis can be used as a reliable early warning system for identifying the longer-term price risks posed by financial imbalances.

At the start of my speech I used the imagery of a starter and a main course. As we all know, both courses meet in the stomach and must be digested together. The question that must be asked at this juncture is how monetary policymakers should deal with the financial stability risks that stem from the current ultra-

loose monetary policy. In my view, monetary policymakers should not be allowed to simply shrug their shoulders if there are signs of speculative exaggerations in the asset markets. The substantial, and in some cases rapid, rise in prices in European equity and bond markets in previous weeks and months points to a highly increased risk appetite, which we as central banks must watch carefully.

At the same time, the risks to financial stability from the protracted low-interest-rate environment may not be limited to asset markets alone. Because this low-interest-rate environment depresses the earnings situation of banks and insurance companies, it increases the risk of instability the longer it continues. It is therefore all the more important that financial institutions continue to improve their capitalisation and critically scrutinise their business models.