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Financial Stability and Monetary Policy: How Closely Interlinked?

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Abstract

The recent financial crisis has again raised the question to what extent price-stability-oriented monetary policy frameworks should take into account financial stability objectives. In this paper I argue that the answer will depend on three questions: (i) how effective is macroprudential policy in maintaining financial stability? (ii) what is the effect of monetary policy on risk taking and financial stability? and (iii) what is the risk of financial dominance, i.e., the risk that financial stability considerations undermine the credibility of the central bank's price stability mandate? I review the theory and evidence and conclude that while the new macroprudential policy framework should be the main tool for maintaining financial stability, monetary policy authorities should also keep an eye on financial stability. This will allow the central bank to lean against the wind if necessary, while maintaining its primary focus on price stability over the medium term.

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