Conflict Between Monetary and Financial Stability Policies

<u>**GROUP C**</u>

Summary

- It is observed that central banks have assumed or continue to take responsibility for monetary and financial stability policies.
- This is in spite of the conflicts that arise in the implementation of monetary and financial stability policies.
- Is it possible for a central bank to combine monetary and financial stability polies?
- In answering the question, we consider selected situations in which monetary and financial stability policies conflict.
- In each case, we examine whether the challenge can be overcome.
- We conclude that central bank can and should combine these policies.

Signature Policy Objectives

- Signature objective of monetary policy is price stability. Some countries use monetary policy for output stabilization too.
  - Target for consumer price index inflation
- Signature objective of financial stability is a sustained stable and liquid market based financial market.
  - Micro- and macro-prudential policy targets including liquidity ratio, cash ratio , and exposure position limits
  - Deposit protection insurance fund

Policies are, by Design, Consistent

- Ideally, a **stable financial system provides a conduit through which monetary policy is transmitted** to attain desired price (/output) stability outcomes.

- Also, price stability checks excessive expectations for higher future inflation and this supports financial stability.

  - Stable real interest rates; and
  - Stable domestic currency exchange rates.

- In any case, monetary and financial stability policies are, by design, consistent to each other. The policies, among other economic **policies are formulating using a consistent macroeconomic framework**.

- **Problem is that both policies are hinged on liquidity management**.
  - Require more than one policy instrument

Policy Conflict in Implementation

- There are situations when implementation of monetary policy can prejudice attainment and sustenance of financial stability e.g. monetary tightening and the balance sheet channel of monetary policy transmission mechanism.

- Situations do also arise when deployment of financial stability instruments e.g. tightening of prudential requirements hinders successful monetary policy implementation e.g. Tightening prudential requirements which entail bank recapitalization amid need for stimulating growth.

- The severity of the tension between the two sets of policies largely depend on the prevailing phase of the business cycle and how well integrated the financial sector is.

Business Cycle and Policy Dilemma

- During the upswing phase, the policies are mutually realizable. Beyond full employment level, need for price stabilization kicks in with implications for financial stability. Cautious monetary policy response by the Fed Reserve.
- Monetary tightening impairs firms and households (with floating interest rate mortgages) balance sheets. Consequently, banks balance sheets will be impaired too. See balance sheet credit channel of monetary policy transmission mechanism.
  - Situation would be complicated further should banks opt to, as they likely will, hoard liquidity akin to the Keynesian liquidity trap phenomenon.
  - In this situation, any policy initiative aimed to injecting liquidity to the real sector through the banking system will fail as banks soak up the liquidity to boost their respective capital ratio requirements; policy transmission will be truncated.
- Hence, the unusual policy monetary policy measures such as quantitative easing used by the Fed Reserve Bank System.

Segmented Banking System

- A segmented banking system is susceptible to skewed liquidity distribution.
  - While banking system may have adequate liquidity, large banks tend to hold surpluses which they may choose not to lend to smaller banks (Ltd credit lines)
  - Central bank cannot help injecting liquidity as lender of last resort while at the same time mopping up excess liquidity.
  - Costly monetary policy operations and could perpetuate segmentation. Use Horizontal Repurchase Agreements to foster trade regardless of bank size.

Unpredictable Government Cash Flows

- There are also seasonality effects regarding monthly government tax receipts through banks and government payments of, say, civil service salaries.
  - Momentarily, between tax receipts and government spending using the tax revenues, the liquidity in form of tax receipts is frozen in government accounts.
  - Liquidity tightening ensue and central bank is compelled, depending on the severity of the credit crunch, to inject liquidity with potential of causing price instability with a lag.
  - Monetary and fiscal policy coordination improves liquidity forecasting and calibration of monetary policy instruments including the open market operations (OMO).

Shallow Money Markets and IPOs

- Significant amounts of initial public offering (IPOs) have also presented situation which can be unsettling to financial sector stability and monetary policies.
  - IPO lead bank(s) that execute the transaction would accumulate liquidity at the expense of the other banks during the period leading to allotment of shares and eventual payment to listed company concerned.
  - During this time, barring adequate policy safeguards, the lead bank(s) can ratchet up the price of liquidity in the interbank market with significant adverse implications for the other banks and execution of the government domestic debt program for the fiscal year under consideration.
  - Kenyan cases: SAFARICOM IPO, privatization of Kenya TELCOM and Direct foreign investment in Equity Bank. Mitigation measures included elaborate collaboration process between the central bank of Kenya, the Kenya Bankers Association, Nairobi Stock Exchange and concerned corporate institutions. Ceiling was set on interbank interest rate, and the central bank would participate on both sides f the interbank money market when necessary.

Forex-Buyer of Last Resort

- In the event of **central bank monetization of external government budget support**, there is eventual liquidity injection.

- **Banks would also liquidate foreign exchange reserves** into domestic currency which could change liquidity conditions in the domestic foreign exchange market significantly (for shallow markets).

- Mindful of its role in fostering financial sector stability, the central bank cannot help participating in the domestic interbank foreign exchange market (as buyer of last resort) to check excessive volatility in the exchange rate while also providing the necessary liquidity.

- In both cases, the liquidity ejection may compromise efforts directed at attaining and sustaining price and output stability. Hence the need for cautious sterilized intervention and intensified OMOs. Rest, a vicious circle of short term capital flows sets in.

National Payments and Settlement System

- Perhaps the central bank fulcrum in leveraging synergies between monetary and financial stability objectives is an efficient national payments and settlement system.

- While many modern central banks have embraced real time gross payments and settlement systems, which informs the design of modern approaches to liquidity management, e.g. overnight cash rate (OCR) of the Reserve Bank of New Zealand, the efficiency gains deriving from this system should be weighed against the potential risks it presents to financial stability.

  - There should be intra-day standing liquidity facilities to ensure that the system clears at the end of each market day while ensuring compliance to eligible securities to check undue monetary expansion

  - Business continuity plans and recovery processes should also be put in place

Question Answered ...1/2

- Yes, monetary and financial stability policy management can be, and in fact should be, a responsibility of the central bank.

  - *Should be* to optimize necessary policy coordination/ harmonization at formulation and implementation levels

  - *Can be* subject to **effective economic forecasting and policy analysis** and **effective communication of policy actions/inactions** to foster correct processing of policy signals and check destabilizing expectations

Question Answered ...2/2

- It is necessary therefore to continuously educate members of the public, legislators, and business editor at media houses about the salient aspects of the economic policy formulation and implementation process, objectives and instruments.
  - for a critical mass of policy enlightened residents and non-residents for correct interpretation of policy decisions and anchor expectations to monetary authority policy objective targets.
  - -this will promote fundamentals based expectations at the expense of chartists' approach to expectation formation

Summary and Conclusion

- In summary, macroeconomic and financial policies are designed to be consistent for efficient and effective realization of economic policy objectives including real (price and output/employment) and financial sector stability.

- However, depending on the prevailing phase of the business cycle and state of development of the financial markets, situations arise when deployment of monetary policy instruments aimed at securing price/output stability unintendedly threaten financial instability.

- Conversely, situations do also arise when seeking financial stability through micro- and macro-prudential policies threaten price and output instability.

- Because of the potential policy implementation conflicts between the pursuit for price/output and financial stability, which entails adequate coordination harmonization of the two sets of policies at the design and implementation levels, it will be appropriate that monetary and financial policies be brought under the purview of the central bank for efficient and effective management.

- If however, adequate consultations can be ensured between central bank and another independent institution charged with the responsibility for attaining and sustaining financial stability, then it will not matter much whose responsibility it is in the design and implementation of monetary and micro- and macro-prudential policies.