CHAPTER 2

The Scope of Monetary Policy

In this chapter we describe how the global financial crisis has recast the debate over the scope of central banking functions. We focus on the relationship between the traditional narrow goal of monetary policy—price stability—and the broader goals of macroeconomic and financial stability. We explain why the traditional separation, in which monetary policy targets price stability and regulatory policies target financial stability and the two sets of policies operate independently of each other, is no longer tenable. We then review some practical issues that arise in connection with attempts to coordinate the two sets of policies.

Central Banks and Financial Stability

The global financial crisis shook confidence in microprudential tools of regulation as the primary instrument for ensuring financial stability. Yet many central bankers still subscribe to the traditional dichotomy between monetary policy and financial stability, except that *microprudential* tools have given way to an embrace of *macroprudential* tools of financial regulation (countercyclical capital adequacy requirements, for example). These tools or policies, which mitigate risks to the financial system as a whole rather than solely at the level of the individual institution, are to be developed and implemented by specialists in financial stability, not by central bankers responsible for the conduct of monetary policy.

The case for this separation rests on the belief that interest rates are too blunt an instrument for the effective pursuit of financial stability. The question is commonly framed as whether the central bank should raise interest rates in response to asset bubbles. In the 1990s and early 2000s, central bankers discussed at length whether and how to respond to asset market developments.[5] The conclusion of that debate was that central banks had a mandate to react to bursting bubbles but not to target asset prices. Not everyone, however, shared this conclusion. The 'lean vs. clean' debate remained active in the run-up to the crisis.[6]

[5] The early debate was framed by the stock market boom of the late 1990s. Arguments in favor of "leaning against the wind" when it comes to financial developments have been given by Blanchard (2000), Bordo and Jeanne (2002), Borio and Lowe (2002), Borio and White (2003), Cecchetti, Genberg, Lipsky and Wadhwani (2000), Crockett (2003), Dudley (2006) and Goodhart (2000) among others. The argument against is given in Bean (2003), Bernanke and Gertler (1999, 2001), Bernanke (2002), Greenspan (2002), Kohn (2005), Mishkin (2008) and Stark (2008).

[6] A policy school, primarily associated with economists from the Bank for International Settlements and the Bank of Japan, was critical of narrow inflation targeting and maintained that central banks could not forgo their responsibility for financial stability. Bank of Japan economists regretted having allowed the bubble to become too large in the second half of the 1980s. The European Central Bank never fully endorsed the standard formulation of inflation targeting and argued that the growth of monetary aggregates and credit developments were also important indicators of potential risks to price stability over a longer-term horizon.