Retiring the Separation Principle

A consequence of this doctrine of "leaning against the wind" is that the neat Tinbergen assignment of different tools to different objectives becomes more difficult to implement in practice. Interest rates affect financial stability and, hence, real activity. Equally, macroprudential tools impact credit growth and external imbalances with consequences for macroeconomic and price stability. When consumer credit is growing rapidly and the household debt ratio is high, for example, restraining credit growth by changing guidance on loan-to-value (LTV) or debt service-to-income (DTI) ratios over the business cycle will have important macro-stabilization effects.

Rather than viewing the allocation problem as having a corner solution where one instrument is devoted entirely to one objective, the macro-stabilization exercise must be viewed as a joint optimization problem where monetary and regulatory policies are used in concert in pursuit of both objectives.

Believers in a strict interpretation of Tinbergen separation will fret that blurring the assignment of instruments to targets will jeopardize the central bank's operational autonomy, the central bank's mandate will become fuzzier, and its actions will become more difficult to justify.

These are valid concerns. Central bankers will experience more political pressure than if monetary policy were primarily targeted at price stability. Here, however, it is important to remember that central bank independence is a means to an end rather than an end in itself. Limiting the scope of monetary policy purely for the sake of defending central bank independence risks undermining the institution's legitimacy by giving the impression that the central bank is out of touch and that it is pursuing a narrow and esoteric activity that does not square with its democratic responsibilities.

Ultimately, political reality will thrust responsibility for financial stability on the central bank. As happened in the UK following the failure of Northern Rock, the central bank will be blamed for financial problems whether or not it was formally responsible for supervision and regulation. As lender of last resort, it will be charged with cleaning up the mess. It follows that it would be better off devoting more of its resources and attention to attempting to prevent the crisis, the elegance and analytical appeal of the Tinbergen principle notwithstanding.

Macroprudential Policy Tools

Macroprudential tools are designed to buttress the stability of the financial system as a whole, which is distinct from ensuring the stability of individual institutions. These tools are intended to help mitigate externalities and spillovers at the level of the system as a whole. For example, interlocking claims and obligations create externalities if the failure of one higly leveraged institution threatens the solvency of other institutions and the stability of the entire financial system. Fire sales of assets may magnify an initial shock and lead to vicious circles of falling assets prices and the need to deleverage and sell off assets. Externalities also arise over the course of the cycle if the structure of capital regulation allows an increase in leverage in financial booms while dampening it in busts.

It is useful to distinguish between different macroprudential tools that address these different aspects of financial risk. In particular, different tools should be used address the time- and cross-sectional dimensions of risk.

The Time Dimension in Macroprudential Supervision

In terms of the time dimension, the macroprudential supervisor should develop a range of tools capable of tempering financial procyclicality. Countercyclical capital buffers, as recommended by the Basel Committee, are a case in point, although they are confined to the banking system. A supplement would be to impose a systemic levy for all levered financial institutions—that is, an additional charge levied on the unstable (non-core) portion of a