weak substitute for good macroeconomic and prudential policies.

Conclusion

This chapter has made the case for augmenting the traditional narrow price stability focus of monetary policy with the additional goal of financial stability. The conventional separation in which monetary policy targets price stability and microprudential policies target financial stability, and the two sets of policies operate independently of each other, is no longer tenable.

This has a number of implications.

- Policy makers need a new set of policies that are macroprudential in nature, targeting the build up of risks to financial stability. These policies range from countercyclical capital ratios to capital controls.
- The neat Tinbergen separation of two tools for two objectives is no longer feasible. Interest rates affect financial stability and, hence, real activity. Equally, macroprudential tools impact credit growth and external imbalances, which have consequences for macroeconomic and price stability. Central bankers therefore will have to consider tradeoffs as they optimize among their policy tools to achieve their multiple objectives.

We believe that explicit recognition of such tradeoffs will, in some cases, move theory closer to practice. In other cases it will make adopting inflation targeting more attractive insofar as the framework now recognizes issues that some policy makers hitherto thought were missing. And in the case of the few who still adhere to narrow inflation targeting, it might prompt a welcome reconsideration.