Monitoring centrálních bank - červen 2013

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In this issue

The Hungarian and Polish central banks made further interest rate cuts in the past quarter, as did the ECB, which is even considering introducing a negative deposit rate. The other central banks we monitor left their rates unchanged. Rates are also expected to stay the same in the coming quarter in almost all the central banks under review, the only exceptions being Hungary and Poland, where further cuts are expected. The Reserve Bank of New Zealand intervened against the excessively strong New Zealand dollar, and the Bank of Israel also launched purchases of foreign currencies on the market. In Spotlight *we look at how some inflation-targeting central banks are adopting a more flexible approach to their price stability mandates taking into account the implications for growth and financial stability. Our* Selected Speech *presents the thoughts of Mervyn King, the outgoing governor of the Bank of England, on changes in the conduct of monetary policy in the UK in recent years.*

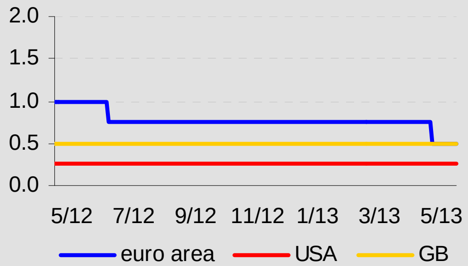
1. LATEST MONETARY POLICY DEVELOPMENTS AT SELECTED CENTRAL BANKS

Key central banks of the Euro-Atlantic area

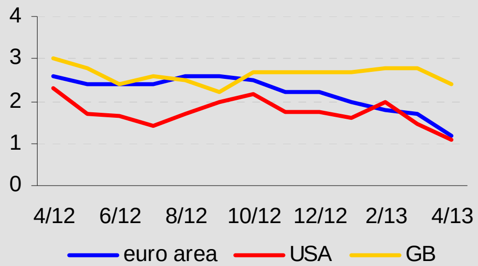
	Euro area (ECB)	USA (Fed)	United Kingdom (BoE)
Inflation target	< 2%[1]	< 2%[2]	2%
MP meetings (rate changes)	4 Apr (0.00) 2 May (-0.25) 6 Jun (0.00)	19–20 Mar (0.00) 30 Apr–1 May (0.00)	3–4 Apr (0.00) 8–9 May (0.00) 5–6 Jun (0.00)
Current basic rate	0.50%	0–0.25%	0.50%
Latest inflation	1.4% (May 2013)[3]	1.1% (Apr 2013)	2.4% (Apr 2013)
Expected MP meetings	4 Jul 1 Aug 5 Sep	18–19 Jun 30–31 Jul	3–4 Jul 31 Jul–1 Aug 4–5 Sep
Other expected events	5 Sep: publication of forecast	17 Jul: publication of Beige Book	7 Aug: publication of Inflation Report
Expected rate movements[4]	→	→	→

[1] ECB definition of price stability; [2] January 2012 definition of inflation target; [3] flash estimate; [4] direction of expected change in rates in coming quarter taken from Consensus Forecast survey.

Key interest rates



Inflation



The **ECB** lowered its key monetary-policy interest rate by 0.25 pp to 0.50% in line with the expectations of some experts. At the same time, the ECB lowered the marginal lending rate by 0.5 pp to 1%. Mario Draghi also suggested at a press conference that the deposit rate might be reduced below zero in the future. Interest rates were not changed at the June meeting. Real GDP contracted by 0.2% in 2013 Q1 and has thus declined for six consecutive quarters. A gradual recovery is expected in the second half of the year, supported by strengthening external demand and accommodative domestic monetary policy. The ECB's current forecast expects GDP to decline by 0.6% in 2013 and to increase by 1.1% in 2014. Inflation is forecasted at 1.4% in 2013 and 1.3% in 2014. GDP growth and inflation have been revised marginally downwards compared to the previous forecast.

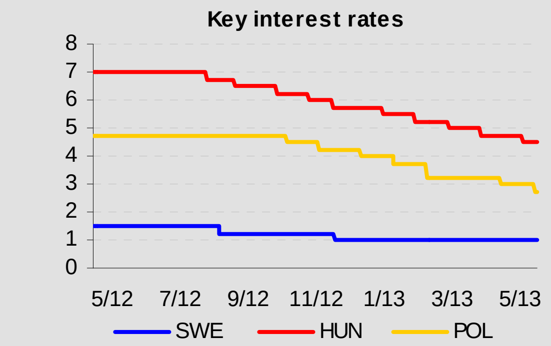
The **Fed** left its key interest rate unchanged and confirmed its commitment to keep rates at the current level at least as long as the unemployment rate remains above 6.5%, inflation between one and two years ahead is projected to be no more than 0.5 pp above the longer-run goal, and longer-term inflation expectations continue to be well anchored. The FOMC is continuing to purchase mortgage-backed securities (MBS) at a pace of USD 40 billion per month and long-term government bonds at a pace of USD 45 billion per month. The unemployment rate edged down to 7.5% in April. Households are gradually increasing their spending and the housing sector is showing further signs of recovery.

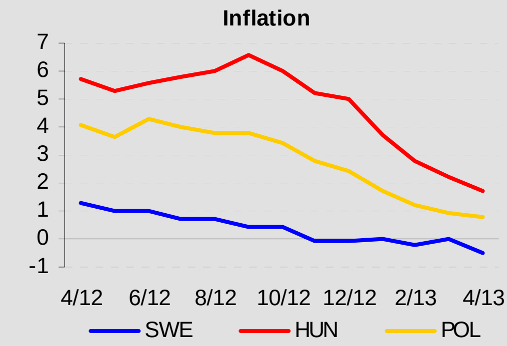
BoE left its key interest rate unchanged at 0.50% in the previous period and almost reached the planned Asset Purchase Programme size of GBP 375 billion, i.e. roughly 25% of GDP. GDP growth stood at 0.3% in Q1 and the BoE expects it to pick up during the year. The inflation rate will remain above the target in the coming months, mainly because of changes to administered prices.

Selected central banks of inflation-targeting EU countries

	Sweden (Riksbank)	Hungary (MNB)	Poland (NBP)
Inflation target	2%	3%	2.5%
MP meetings (rate changes)	16 Apr (0.00)	26 Mar (-0.25) 23 Apr (-0.25) 28 May (-0.25)	9–10 Apr (0.00) 7–8 May (-0.25) 4–5 Jun (-0.25)
Current basic rate	1.00%	4.50%	3.00%
Latest inflation	-0.5% (Apr 2013)	1.7% (Apr 2013)	0.8% (Apr 2013)
Expected MP meetings	2 Jul 4 Sep	25 June 23 Jul 27 Aug	2-3 Jul 20 Aug 3–4 Sep
Other expected events	3 Jul: publication of Monetary Policy Report	25 Jun: publication of Quarterly Report on Inflation	first half of July: publication of Inflation Report
Expected rate movements[1]	→	↓	↓

[1] Direction of expected change in rates in coming quarter taken from Consensus Forecast survey.





The **Riksbank** left its key interest rate unchanged at 1% and expects to maintain low rates for a longer period of time, specifically until the second half of 2014. After a weak outcome at the end of 2012, the Swedish economy is showing a gradual recovery. The Riksbank expects faster growth in household consumption and investment in the coming period. An improvement in the labour market, including a decline in unemployment, is expected next year when GDP growth picks up.

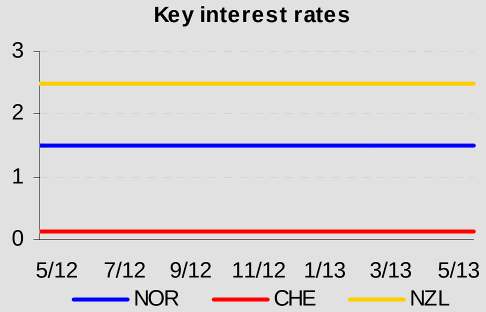
The **MNB** lowered its monetary policy rate by 0.25 pp three times in the last quarter, i.e. by a total of 0.75 pp to the current level of 4.50%, thus extending the series of key interest rate cuts (see the chart). Inflation slowed sharply to 1.7% in April. The Hungarian economy is showing an overall slowdown in economic activity and still subdued domestic demand. According to the MNB forecast, however, the economy should recover from recession in the first half of 2013.

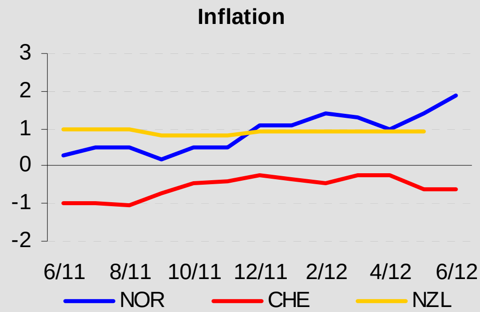
In response to the risk of undershooting its inflation target in the medium term, the **NBP** twice cut its monetary policy rate by 0.25 pp in the last quarter, by a total of 0.50 pp to 2.75%. Preliminary data on GDP in 2013 Q1 point to a stronger-than-expected weakening in GDP growth. Net exports have become the most significant negative contributor to GDP growth. According to forward-looking indicators, weak economic growth is expected in Q2, too. The weak economic activity is being accompanied by declining employment in the corporate sector and rising unemployment. The situation in the labour market supports low wage growth. The inflation rate dropped to 0.8% in April, markedly below the NBP inflation target. Inflation expectations have also declined.

Other selected inflation-targeting countries

	Norway (NB)	Switzerland (SNB)	New Zealand (RBNZ)
Inflation target	2.5%	< 2%	2%
MP meetings (rate changes)	14 Mar (0.00) 8 May (0.00)	14 Mar (0.00)	14 Mar (0.00) 24 Apr (0.00)
Current basic rate	1.50%	0–0.25% [1]	2.50%
Latest inflation	1.9% (Apr 2013)	-0.6% (Apr 2013)	0.9% (2013 Q1)
Expected MP meetings	20 Jun	20 Jun	13 Jun 25 Jul
Other expected events	20 Jun: publication of Monetary Policy Report	27 Jun: publication of Monetary Policy Report	13 Jun: publication of Monetary Policy Statement
Expected rate movements[2]	→	→	→

[1] Chart displays centre of band; [2] direction of expected change in rates in coming quarter taken from Consensus Forecast survey or, in the case of New Zealand, from RBNZ survey.





Norges Bank (NB) left its key interest rate unchanged at 1.50%. Monetary policy remains loose because domestic inflation is low and because external interest rates are very low. At the same time, capacity utilisation in the Norwegian economy is currently above a normal level, and house prices and private sector debt have been rising faster than incomes for a long period. The Norwegian economy is growing at a solid pace and unemployment is low. According to the forecast, inflation should be between 1% and 1.5%. The central bank expects a gradual increase in interest rates next year.

The **SNB** is still maintaining rates in the lower part of the 0–0.25% target range and its commitment to enforce a minimum exchange rate of CHF 1.20/EUR is also unchanged. Inflation was lower than expected in 2012 Q4 due to the continued decline in import inflation. The previous appreciation of the Swiss franc is having a stronger effect on the price level than the SNB expected. According to the SNB forecast, the inflation rate will be 0.2% in 2013 and 0.2% in 2014. The SNB identifies no threat of inflation in the Swiss economy in the foreseeable future. GDP growth of 1.0–1.5% is expected in 2013.

The **RBNZ** left its key interest rate at 2.50%. The inflation rate remains below the lower boundary of the central bank's target range and will remain below the target in the remainder of 2013. The undershooting is due mainly to subdued growth in import prices caused by the appreciating New Zealand dollar, against which the RBNZ intervened in May. Economic activity is rising on the domestic demand side, but the labour market remains weak. Housing investment and business and consumer confidence are being boosted by reconstruction in Canterbury following the earthquake. The RBNZ projects the economy to grow by 2–3% over the forecast period and inflation to gradually return to the 2% target.

2. NEWS

UK Chancellor backs flexibility in monetary policy remit

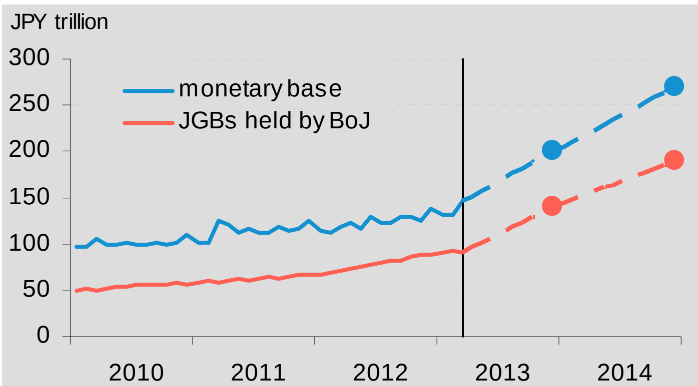
Although the Bank of England (BoE) is responsible for monetary policy, the definition of price stability is set by the Treasury. This it does every 12 months in the remit for the Monetary Policy Committee, which also contains comments on other aspects of monetary policy. This year's remit re-confirms the flexible inflation targeting regime with an inflation target of 2%. Chancellor of the Exchequer George Osborne notes in the remit that this reflects the primacy of price stability, although the actual inflation rate will on occasion depart from its target as a result of shocks. Attempts to keep inflation at the target in these circumstances may cause undesirable volatility in output due to the short-term trade-offs involved. The BoE is now required to communicate these trade-offs. The Chancellor expressed his support for more monetary policy flexibility and his agreement with the current actions of the BoE, which is keeping monetary policy loose despite higher expected inflation. However, Osborne emphasised that inflation expectations need to remain anchored and the BoE has to be transparent. If the BoE judges it necessary to deploy new unconventional policy instruments, it should coordinate them with the government.

British Funding for Lending Scheme extended

The BoE and the Treasury extended the Funding for Lending Scheme, introduced in August 2012, until January 2015. The scheme aims to increase the incentives for banks to lend to small and medium-sized enterprises.

BoJ introduces quantitative and qualitative monetary easing

Under its new governor Haruhiko Kuroda, the Bank of Japan announced a new quantitative and qualitative monetary easing programme. The operating target is changed from the overnight rate to the monetary base (currency in circulation plus bank reserves). The BoJ also specified a time frame of about two years for achieving its price stability target of 2%. Over that period, the BoJ plans to double the monetary base from JPY 138 trillion at end-2012 to JPY 270 trillion at end-2014, mainly by increasing its holdings of Japanese government bonds (at an annual pace of JPY 50 trillion) and, to a lesser extent, other securities. Simultaneously, the average remaining maturity of its JGB purchases will more than double from just under three years to about seven years. The BoJ will purchase bonds with maturities including 20 and 30 years (qualitative easing). The BoJ also terminated its asset purchase programme and suspended the "banknote principle", under which the outstanding amount of government bonds held by the BoJ should be kept below the outstanding balance of banknotes issued (around JPY 90 trillion).



Governor Kuroda stressed that the BoJ should do whatever is necessary to overcome deflation, which has been causing a deterioration in Japan's economy for nearly 15 years. He believes that the BoJ needs to make firm decisions at once, rather than to adopt gradualism. Another key task for the BoJ is to change inflation expectations – most Japanese economic agents expect prices to either decline or be unlikely to rise. Kuroda explained that the BoJ's sole aim is to conduct monetary policy, not engage in monetary financing. He also denied that it is aiming to weaken the yen. Monetary easing is part of Japan's three-pronged strategy, the other two “arrows” being flexible fiscal policy and a growth strategy that promotes private investment.

MNB sees major changes under new governor…

Governor György Matolcsy, appointed in March by Prime Minister Viktor Orbán to head Magyar Nemzeti Bank in March, began his term with tough measures. The personnel changes started with dismissals of experts (those who left the MNB included head of financial analysis Aron Gereben, chief economist Agnes Csermely and head of research Peter Benczur). Matolcsy also altered the powers of two deputy governors, Ferenc Karvalits and Júlia Király, who had been appointed under a previous government. Conversely, the new governor strengthened the role of deputy governor Adam Balog, newly appointed by Orbán together with Gyula Pleschinger. Furthermore, Matolcsy called off news conferences after monetary policy meetings. Deputy Governor Júlia Király responded to the situation by resigning.

…and launches Funding for Growth Scheme

The MNB plans to improve the financing conditions for small and medium-sized enterprises by offering interest-free loans totalling HUF 425 billion (around 1.5% of GDP) to commercial banks. The interest rate on corporate loans will be no more than 2.5%. Moreover, the MNB considers the high ratio of foreign currency loans, especially those denominated in Swiss franc, to be major problem of the SME sector. For the currency conversion of the loans into forints the MNB will provide foreign exchange to credit institutions from its foreign exchange reserves at market price on condition that they use it to repay their short-term external liabilities. A maximum amount of HUF 325 billion has been assigned for this facility. The MNB suspended its two-year liquidity-providing loan tender at the same time.

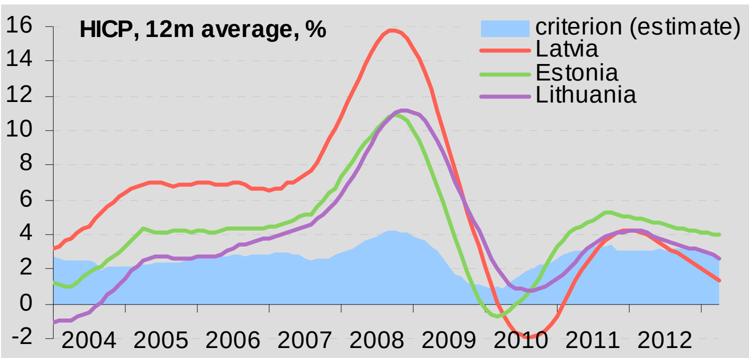
Norway plans to introduce countercyclical capital buffer

Norway is planning to follow Switzerland in imposing a capital buffer. The Norwegian authorities are worried about rising house prices and excessive lending growth. The buffer will be set by the Ministry of Finance, although Norges Bank will issue concrete advice on the buffer level four times a year, together with an assessment of its impacts on monetary policy. Although the decision has not entered into force yet, its effects are already evident in the banking sector. Norges Bank also takes account of financial stability issues in its monetary policy decision-making and is not lowering its rates any further even though a decision based solely on hitting the inflation target would imply easier monetary policy.

ECB and European Commission publish convergence reports for Latvia

Following a request submitted by Latvia, the European Central Bank and European Commission have prepared convergence reports assessing Latvia’s eligibility to join the euro area from the economic perspective and from the perspective of the compatibility of national legislation.

The assessment of the two reports is as follows. The Latvian lats has long been pegged to the euro with a narrow fluctuation band of ±1%, so Latvia fulfils the criterion for participation in ERM II. The fixed exchange rate limits the ability of monetary policy to influence inflation. Over the last twelve months the average rate of HICP inflation has been 1.3%, i.e. well below the reference value of 2.7%.



In the past ten years, however, the annual averages have ranged between -1.2% and 15.3%. The lower inflation over the past year has been due mainly to lower increases in administered prices and a lower VAT rate. The catching-up process is likely to drive up the inflation differential between Latvia and the euro area over the medium term, given that GDP per capita and price levels are still lower in Latvia than in the euro area. It cannot be ruled out that significant demand pressures, similar to those in 2008, may emerge again.

Although Latvia is subject to the Excessive Deficit Procedure at the moment, the country fulfils both numerical fiscal criteria, with a government budget deficit of 1.2% of GDP and a government debt-to GDP ratio of 40.7% in 2012. It also fulfils the long-term interest rate criterion. The convergence reports state that Latvian law complies with European legislation.

Latvia is seeking to join the euro area after Estonia, which did so in January 2011. Lithuania, which requested the preparation of convergence reports in 2006 and which slightly exceeded the reference value for the price stability criterion at that time, has not introduced the single currency so far. The final decision on whether the euro area will gain a new member next year will be made by Ecofin.

Bank of Israel launches purchases in foreign exchange market

The Bank of Israel announced its intention to purchase foreign exchange in order to offset the effect of natural gas production on the exchange rate. Natural gas production in Israel is causing an improvement in the current account, which is leading to appreciation pressures on the shekel. The amounts purchased will be added to the BoI's foreign exchange reserves, but will be managed separately, with a longer-term investment horizon. The programme will be revisited when a wealth fund begins operation, which is expected to be during 2018.

Australia plans to invest part of its reserves in Chinese renminbi

Philip Lowe, deputy governor of the Reserve Bank of Australia, said that the institution intends to hold around 5% of Australia's foreign currency assets in Chinese government bonds. The decision reflects large and still growing importance of Australian-Chinese trade and financial ties. China is Australia's largest export destination, and it is also the largest supplier of imports into Australia. The news follows the announcement of direct trading between the currencies of these two economies. The Australian dollar is only the third currency for which onshore direct trading with the renminbi is possible, the others being the US dollar and the Japanese yen. The two central banks signed a swap agreement in March 2012.

Stephen S. Poloz becomes governor of Bank of Canada from June

Stephen S. Poloz, an experienced economist and manager from Ontario, has begun a seven-year term as head of the Bank of Canada. Poloz previously occupied a range of positions in the central bank and then joined Export Development Canada, where he was later appointed president. Poloz succeeds Mark Carney, who has accepted the position of governor of the Bank of England, a post previously held by Mervyn King for ten years.

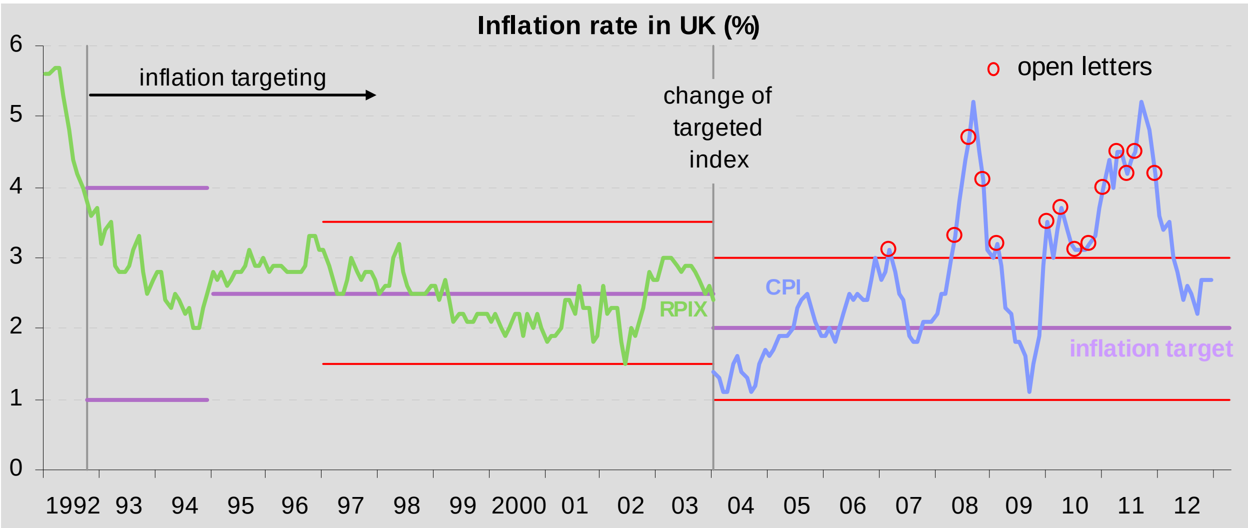
New deputy governors appointed to monetary board in Sweden

Deputy governors Lars Svensson and Barbro Wickman-Parak have left the Executive Board of the Riksbank, as their terms of office expired in May. They had both given notice that they would not be available for re-election to the Board. Professor of economics Martin Flodén and Cecilia Skingsley, previously chief economist at Swedbank, have been appointed as new members of the Board.

3. SPOTLIGHT: FLEXIBILITY OF INFLATION TARGETING

Monetary policy has been going through an exceptional period since the outbreak of the financial and economic crisis. Following an unusually fast and strong rate reduction, many central banks have started to provide extraordinary amounts of liquidity and use a wide range of unconventional instruments. In addition, fundamental changes have recently been apparent in the strategic monetary policy framework. Whereas central bankers in Japan and the United States have set a new numerical target for inflation, the central banks traditionally targeting inflation have put an increasing emphasis on the flexibility of this regime – many are willing more than ever before to accept deviations of inflation from the target. This willingness to tolerate temporarily higher inflation may reflect the very fragile recovery in economic activity and concerns that monetary policy tightening may suppress the recovery. Some central banks, instead of strictly maintaining price stability, are taking into account risks to financial stability. This may result in them undershooting their inflation targets. The monetary policy of some central banks is thus partially taking on the tasks of fiscal and macroprudential policies.

When, in 1997, the UK introduced a requirement for the central bank governor to send an open letter to the Chancellor of the Exchequer – if inflation deviated by more than 1 pp from the target – and to give the reasons for the deviation, it was expected that this would happen only in very exceptional cases. Inflation stayed very close to the target after inflation targeting was introduced in 1992 and fluctuated within the range until 2007. Over the past six years, however, Mervyn King has had to explain upward deviations on 14 occasions. According to his explanations, the increased inflation has been due mainly to higher global oil and food prices, a depreciating pound and rising VAT.



In some cases there are reasonable grounds for tolerating temporary deviations of inflation from the target, particularly if they are caused by supply shocks. The central bank has no influence on such shocks, and any attempts to offset them might lead to undesirable volatility in GDP and employment. For this reason, preference is given to "flexible" inflation targeting. Some central banks have therefore defined escape clauses, i.e. exemptions from fulfilling inflation targets. The Bank of England's increased discretion is due to the fact that it does not have a fixed monetary policy horizon, makes decisions based on the forecast for the whole of the following three years, and can therefore be satisfied with a slower return of inflation to the target.

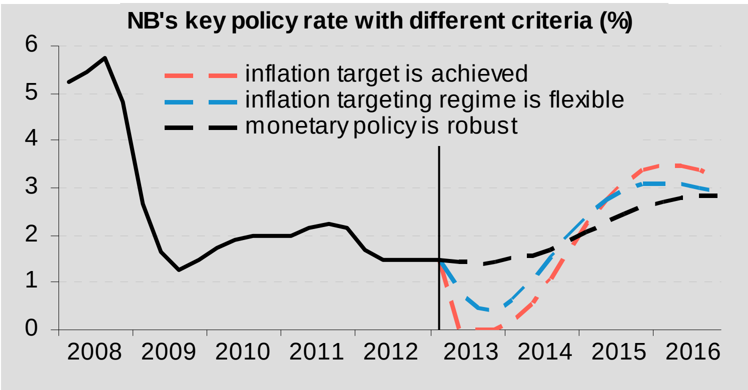
Although inflation in the British economy is being pushed up mainly by supply shocks, the deviation can no longer be considered short term. There is thus a growing risk that inflation expectations will increase and affect wage demands and subsequently domestic producer prices. A modest rise in inflation expectations has already been recorded.

As the Bank of England admits in its February Inflation Report, its monetary policy will remain looser than needed to meet the inflation target. Despite higher expected inflation over the next two years, the MPC members decided unanimously not to tighten monetary policy so as not to derail the already very fragile economic recovery. They believe that efforts to tame inflation at any cost might lead to an even deeper recession and an even larger rise in unemployment. MPC member [Spencer Dale](#) even discusses in detail whether the current trade-off between growth and inflation is unusually favourable. If that were the case, the BoE could inject additional monetary stimulus, thereby supporting growth, with relatively little consequence for inflation. In the current situation, according to Dale, a growing economy could absorb spare resources, without putting much upward pressure on wages and prices. As the recession is due to weak demand, a pick-up in demand could prompt an increase in the effective supply capacity of companies.

The Treasury, which decides on monetary policy objectives, agrees with the BoE. According to this year's remit, price stability is the primary objective of monetary policy. However, the remit regards it as important to minimise serious undesirable impacts of monetary policy on output volatility, so efforts should be made to assess the two variables in a balanced manner. As from March 2013, the remit requires the central bank to explain its decisions and assess the impacts on inflation and output variability.

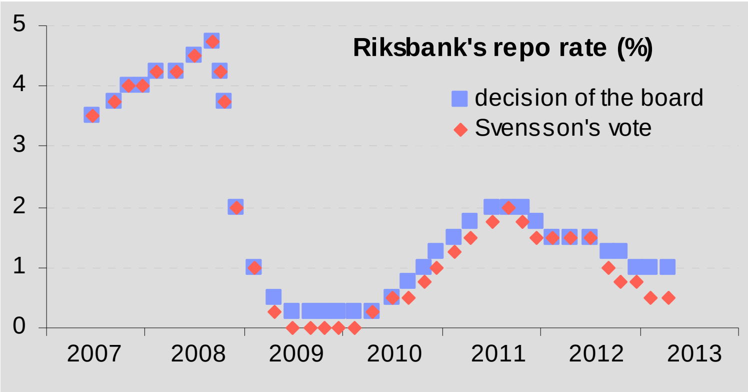
While the Bank of England's monetary policy is easier (after taking into account its effects on economic growth) than needed to achieve moderate price growth, the Scandinavian inflation targeters prefer higher rates than those implied by the inflation outlook, owing to the risks to financial stability they see in their economies.

Norway fears excessive growth in lending and house prices. Even though it is planning to fight the adverse trend by regulating banks, specifically by introducing a countercyclical capital buffer, these risks are also taken into account in monetary policy. If Norges Bank decided solely on the basis of achieving the inflation target, its interest rate would probably be zero until the end of this year. Inflation in Norway is low (owing to the strong Norwegian krone, very low growth in prices at home and abroad, and restrained wage growth) and the outlook for the future is not indicating any rapid rise either. However, capacity utilisation in the Norwegian economy is higher than normal and the central bank expects economic growth to pick up. So, if Norges bank was additionally seeking to stabilise output and employment, it would lower its rate only to around 0.5%; such a decision would thus reflect the flexibility of inflation targeting and an effort to avoid an overheating of the economy. According to the Norwegian central bank, however, monetary policy should mitigate the risk of rising financial imbalances. Sustained low rates could, according to Norges Bank, lead to excessive risk-taking by banks and households, hence such a monetary policy should be avoided. This is why its rate currently stands at 1.5%.



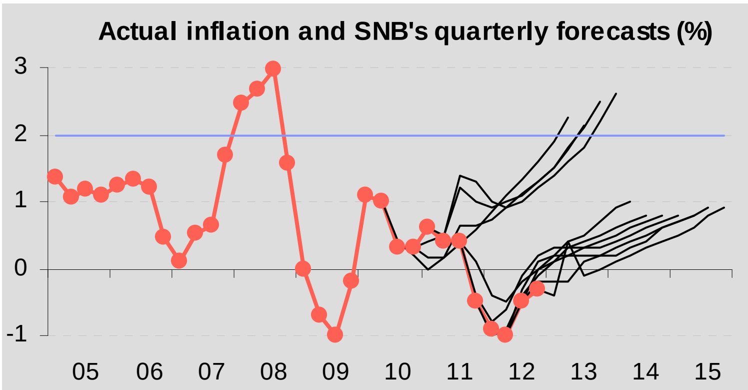
Similar considerations have also recently been affecting the decisions of the Swedish Riksbank. Inflation is now around zero and will probably approach the 2% target later than originally expected. The Riksbank expects the already high household indebtedness to rise and fears that lower rates would increase the risk of imbalances. However, not all the members of the

Riksbank's Executive Board agree with this. Lars Svensson and Karolina Ekholm have long been voting for easier monetary policy. Lars Svensson believes that monetary policy has only a very limited short-term effect on household debt and is therefore an inappropriate instrument for influencing it.



However, the long-term average rate of inflation in Sweden is one of the lowest among the EU countries and is well below the inflation target. Svensson even believes that owing to excessively tight monetary policy, unemployment has since 1997 been higher than necessary, 0.8 pp too high, which is equivalent to about 38,000 unemployed people. He also claims that if current inflation was 1 pp higher, unemployment would be 1.3 pp lower, i.e. there would be 65,000 fewer people unemployed. According to Svensson's calculations, this would increase the household debt ratio from 170% of disposable income to 174%. At the same time, he does not believe this would have increased potential risks to an extent that is worth more than 65,000 jobs. Given the very high unemployment, Svensson would even welcome a temporary overshooting of the inflation target.

Switzerland is another country showing a marked long-term deviation from its target. It is facing unexpectedly persistent negative inflation for the twentieth consecutive month. Despite this, the central bank does not conduct further monetary policy easing. Its interest rates are at zero and its priority since 2011 has been to combat the strong franc by means of foreign exchange interventions and by its commitment to keep the exchange rate above a set minimum of 1.20 CHF/EUR. A favourable phenomenon in the Swiss economy is that the long-lasting negative inflation is not being accompanied by a pronounced downturn in economic activity. However, the very low rates are supporting the already strong growth in lending and property prices, because of which Switzerland has introduced a countercyclical capital buffer. The SNB is meanwhile putting particular emphasis on its flexibility. This may be why it does not officially refer to its monetary policy regime as inflation targeting, even though it exhibits most of its main features.



It is clear from the above examples and from the behaviour and comments of other central banks that the strategic parameters of monetary policy have been gradually changing in recent years. Whereas the central banks of Japan and the USA have introduced a numerical inflation target, inflation targeters are increasingly emphasising flexibility. The risk of this approach is that tolerating longer-term deviations of inflation from the target in the pursuit of other benefits could impair the anchoring of inflation expectations and endanger the credibility of the central bank. While there are other tools and policies for other objectives, price stability is a task for monetary policy alone and should therefore remain the monetary policy priority.

4. SELECTED SPEECH: MONETARY POLICY: MANY TARGETS, MANY INSTRUMENTS. WHERE DO WE STAND?

The Governor of the Bank of England, Mervyn King, who will be succeeded by Mark Carney at the end of June, delivered a speech at a conference of the International Monetary Fund on 16 April 2013 addressing developments in monetary policy in recent years. The speech focused on changes in the definitions of monetary policy targets and on the growing range of monetary policy instruments. King therefore indirectly explains the new remit of the BoE's Monetary Policy Committee. The remit now allows for deviations from strict inflation targeting when these deviations are motivated by financial stability concerns.

Mervyn King notes that while in past decades the sole objective of monetary policy was to achieve price stability, the experience of the last few years has raised questions about the trade-off between price stability and output stability. The banking and economic crisis has also highlighted the question of whether monetary policy should pay attention to ensuring the long term soundness of the financial system while stabilising output and inflation in the medium term. King gives three examples of how monetary policy affects financial stability. First, high economic growth supported by loose monetary policy creates optimistic expectations about future growth, leading to more risky investment. Second, periods of stability are typically accompanied by credit booms, which increase the vulnerability of financial system. Third, low interest rates caused by easy monetary policy encourage more risky behaviour of investors, who search for higher yields in risky investments.

Financial crises are typically costly because their effects are too rapid for economic policy to offset fully and in time. King illustrates the task of monetary policy to simultaneously maintain financial stability, price stability and output stability using the Minsky-Taylor frontier, which defines the maximum effectiveness of monetary policy as the set of feasible combinations of the smallest inflation and output gap variances. The optimal combination of these variances then can be selected from the frontier set according to policymakers' preferences. King plots theoretically feasible combinations of inflation and output variances for last two decades and concludes that it would have been possible to achieve significantly less variation in the output gap with only slightly more variation in inflation in this period. He gives the example of monetary policy rates in the period before the crisis. If rates had been higher, the impact of the subsequent bust could have been much smaller, at the cost of only slightly lower inflation and slightly weaker output during the years before the crisis. Although King is talking primarily about the monetary policy of the Bank of England, his discussion is relevant to the pre-crisis policies of the majority of central banks in developed countries.

King admits that financial stability is currently being maintained primarily using newly defined tools of macroprudential policy. However, even leaving macroprudential measures aside, the above argument suggests it could be possible to achieve smaller swings in output and unemployment using standard monetary policy instruments only. Macroprudential tools thus shift the Minsky-Taylor frontier towards greater financial, price and real economic stability.

Mervyn King concludes by noting that the objectives of monetary policy in the UK are set by elected politicians. However, it is vital to maintain the independence of a central bank, as independence allows the central bank to credibly fulfil its objective – in this case maintaining price stability. The above-mentioned change in the remit of the Monetary Policy Committee is fully consistent with this argument and with the shift towards more flexible inflation targeting observed worldwide.

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