

MONETARY POLICY AND BANKING STABILITY

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Medium and Long-Run Trends in Interest Rates – Causes and Implications for Monetary Policy

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What are the effects of monetary policy rates for banking stability? For example, when inflation started rising in 2022, central banks raised monetary policy rates substantially, with a more than 400 basis points increase in the United States and in the euro area. As of April 2026, monetary rates in the United States are still high and significantly higher than before 2022. This monetary policy action of raising interest rates implies crucial trade-offs, not only between monetary tightening and the risk of an economic recession, which has been extensively analyzed in policy circles and in academic studies,¹ but also between tighter monetary policy conditions and the risk of financial instability, in particular, the risk of a banking crisis.²

These financial stability concerns due to tighter monetary policy—higher policy rates and potentially quantitative tightening (QT)—may be particularly pertinent after a long period of expansive monetary policy, including too-low-for-too-long monetary rates.

These interactions between monetary policy dynamics and concerns on financial stability have been discussed in recent policy and media debates,³ and are illustrated by the failures of Silicon Valley Bank and Credit Suisse, and broader banking distress in March 2023.⁴ Moreover, during this recent period, there have also been problems in some nonbanks (e.g., hedge funds and pension funds in the United Kingdom in September 2022), problems in commercial real estate (and funds associated with this type of investment), the failure of some

1. See, for example, Blinder (2023).

2. See Jiménez and others (2026), International Monetary Fund (2023), and Schnabel (2023).

3. See, for example, Rajan (2023).

4. Legras (2023); Wall Street Journal, 20 March 2023.

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stablecoins such as Terraluna, and very recent defaults in the private credit market. In addition, there have been tensions in sovereign debt; as an example, a new facility was created in the euro area (the so-called transmission protection instrument) when the European Central Bank (ECB) started raising interest rates in 2022.

Furthermore, the normalization of monetary policy has also been difficult in QT. For example, QT has been recently stopped in the United States, and neither the ECB nor the Fed had conducted any active QT, but just passive QT, allowing assets to mature and not renewing them. Moreover, many commentators believe that monetary policy is dominated by either financial stability concerns or/and that there is a fiscal dominance—i.e., that the extremely high levels of private and public debt determine the actions of monetary policy.⁵

In this essay, I review the effects of monetary policy on financial stability. It is not obvious whether and why monetary policy actions, which are high frequency in nature, may affect financial instability. Banking crises are instead phenomena that tend to occur at a low frequency. Moreover, it is unclear whether lower or higher monetary policy rates are negative for financial stability. On the one hand, there is evidence that lower monetary rates increase lending and asset prices, as well as bank risk taking.⁶ These factors have shown to be strongly associated with future financial crises.⁷ On the other hand, other studies have revealed that monetary rate hikes (as opposed to cuts) may increase crisis risk.⁸

As I discuss in this article, for banking crisis risk, however, the whole path of past and current monetary rates matters, not simply whether monetary policy rates were recently cut or raised. For example, recent theoretical work suggests that periods of expansive monetary policy may create financial vulnerabilities (e.g., elevated credit and asset prices), and subsequent tightening may crystallize these financial vulnerabilities into a crisis.⁹

Crucially, recent evidence shows that the whole path of monetary policy rates affects financial stability, a U-shaped path. In Jiménez and

5. See Schnabel (2020).

6. See, for example, Borio and Lowe (2002), Bernanke and Kuttner (2005), Adrian and Shin (2010), Maddaloni and Peydró (2011), Jiménez and others (2014), Becker and Ivashina (2015), Hanson and Stein (2015), and Di Maggio and Kacperczyk (2017).

7. See, for example, Greenwood and others (2022).

8. See Schularick and others (2021) and Gali (2014).

9. See Diamond and Rajan (2012), Acharya and Rajan (2022), Boissay and others (2026), and Goldberg and López-Salido (2023).

others (2026), we show that a U-shaped monetary rate path increases banking crisis risk via credit and asset price cycles. This analysis is based on an analysis of 17 (relatively) high-income countries over the last 150 years. Monetary rate hikes (raw or instrumented using the international finance trilemma) materially increase banking crisis risk, but only if monetary rates were previously cut for an extended period. These patterns are unique to banking crises (different from noncrisis recessions, even the deep ones), and are stronger for a deeper U (over the systematic monetary policy component). That is, the shaped monetary rate path is crucial for banking crises but not for nonfinancial recessions, even the strongest ones; therefore, the mechanisms at play may be financial ones.

Regarding the mechanisms, monetary rate cuts for a prolonged period increase the likelihood of vulnerable “red zones” of high credit and asset price growth, consistent with credit supply including bank risk-taking—expansions. Subsequent monetary rate hikes strongly reduce credit and asset prices and increase banks’ loan losses and banking crisis risk. Moreover, for this channel of monetary policy dynamics affecting the likelihood of banking crises, the evidence on higher crisis risk stems mainly from credit risk rather than the realization of interest rate risk or liquidity problems related to bank runs. Importantly, only those red zones with U-shaped monetary rates strongly increase banking crisis risk; i.e., monetary policy is at the center of banking crises, not just credit booms and asset price bubble without monetary policy components.

We also find consistent results in administrative, loan-level data from Spain’s post-1995 real-estate boom and subsequent banking crisis. It is important to highlight that anecdotal evidence from emerging markets may give a similar narrative. For example, the Latin America crisis in the 1980s that started in Mexico in 1982 came after a strong U-shaped monetary policy rate in the United States, with important associated capital flows for emerging markets.

Once I have shown that there is a clear connection between monetary policy dynamics and financial stability, an important question then is whether central banks should lean against the wind and raise monetary policy rates during the credit and asset price boom. I discuss the issue in this paper, arguing that monetary policy should take into consideration financial stability implications beyond a simple Tinbergen rule. It is important to highlight that financial crises are very costly, that there is regulatory arbitrage of micro and macro prudential policies that reduce their effectiveness, and that an

important part of the financial system is nowadays nonbank credit (financial) intermediaries, which are less subject to macroprudential policies. Furthermore, even if price stability is important for financial stability, there may be instances in which there are conflicts between the two, as I examine in this paper. In addition, I also discuss that monetary policy actions may also be dominated by financial stability concerns or by fiscal dominance.¹⁰

The plan for the rest of the sections is the following. In Section 1, I review in detail the evidence on the impact of monetary policy and banking crises, as well as the different mechanisms. In addition, I discuss the impact of monetary policy actions in crisis times. In section 2, I discuss some normative implications for policy, including whether monetary policy should take into account financial stability issues and lean against the wind, or whether financial stability considerations should only be dealt with through macroprudential policies. Moreover, I discuss some issues that are more relevant to emerging economies, for example, the US monetary policy and the global financial cycle, the role of prudential capital controls and the future of dollarization and stablecoins. In Section 3, I provide some concluding remarks.

1. MONETARY POLICY AND BANKING CRISES

In this section, I base my analysis on Jiménez and others (2023), in which we study the link between monetary policy rate dynamics and financial stability. In particular, we analyze the impact of the path of monetary rates on the likelihood of subsequent banking crises and the associated mechanisms. Experience of past crises suggests that the full dynamics of monetary rates may indeed matter. For example, important crisis events such as the 1930s US Great Depression, the 2007 US Subprime Crisis, the 1990s Japanese crisis, the post-2008 Spanish banking and real-estate crisis, the 1990s Swedish banking crisis, and the 1890 UK Baring crisis all show that monetary rates display one salient feature: the U-shaped pre-crisis path, consisting of sharp monetary rate cuts approximately eight to three years before the crisis, followed by rate increases in the years running up to the crisis onset.

Analyzing many crises and monetary cycles across countries and time periods, we show that the U-shaped monetary rate path is a key

10. See footnote 5.

driver of banking crisis risk in modern history. Most historical crises are preceded by U-shaped monetary rates. Moreover, raising monetary policy rates (raw or instrumented using the international finance trilemma) materially increases banking crisis risk, but only if policy rates were previously cut for a long period, and especially if these cuts and raises go above and beyond the systematic reaction of monetary policy to business-cycle dynamics. Importantly, these patterns are unique to banking crises as opposed to noncrisis recessions.

As to the mechanisms, a long period of monetary rate cuts (U's first half) raises the likelihood of "red zones" of high credit and asset price growth,¹¹ with evidence consistent with higher credit supply and bank risk-taking (including some mispricing). Moreover, raising monetary rates—in the red zone—greatly increase crisis risk. Consistently, U's second half strongly decreases credit and asset prices, and leads to strong materialization of credit risk and bank stock price crash risk. Importantly, a monetary rate U shape without red zones, or red zones without the U shape, do not strongly raise crisis risk. Finally, Spain's case study using post-1995 administrative data confirms—and allows stronger identification of—credit supply, bank risk-taking, and credit risk as key mechanisms.

More concretely, to study the link between monetary policy dynamics and financial stability, we exploit long-run data for 17 countries going back to 1870 obtained from Jordà and others (2013) and detailed administrative data covering the post-1995 period in Spain obtained from the supervisory credit register, matched to firm and bank administrative datasets. We use the long-run data to study i) the link between the path of monetary rates and crisis risk across many monetary cycles and crises, and ii) the mechanisms linking monetary rate dynamics, financial cycles, and crises. We use the administrative data for a detailed case study of the Spanish crisis of the early 2000s—a real-estate banking crisis, representative of many crisis episodes after World War II. This allows us to validate the main patterns found in the long-run data and explore the loan-level heterogeneities in the build-up and crystallization of risks linked to monetary policy.

We start by documenting the path of monetary rates before historical banking crisis episodes. The patterns documented for the above six crises (US Great Depression, etc.) extend to the average crisis in the overall sample, with (short-term nominal) monetary rates decreasing from about eight to three years before a crisis and

11. See Greenwood and others (2022).

increasing in the three years prior to the crisis. These patterns hold for different crisis definitions—baseline Jordà and others (2013) and robustness Baron and others (2021)—and become stronger for deep (lowest-GDP-growth) crises and after World War II.

Splitting eight-year monetary rate paths into four shapes—the U shape (cuts over five years followed by raises over three years), double cut, double raise, and raises followed by cuts—, we find that most historical crises, and all deep crises after World War II, were preceded by a U shape in monetary rates. These patterns are different for noncrisis recessions (even the deepest, worst ones), with only recent monetary rate increases being crucial (i.e., for non-financial crises, what matters is the recent increase in monetary policy rates, not the U shape). We also study whether higher monetary rates after previous cuts raise subsequent crisis risk.

First, we document three-year crisis frequencies for different monetary rate paths over the preceding eight years. The crisis frequency following U-shaped monetary rate paths is 18 percent, roughly double the unconditional crisis frequency, and substantially higher than for the other monetary paths. As before, these differences become more pronounced for deep crises and after World War II. Consistently, using a regression analysis, we find that the U-shaped monetary rate path materially increases (banking) crisis risk, whereas other monetary rate paths do not.

To mitigate potential endogeneity concerns in such regressions, we use an instrument exploiting the famous trilemma of international finance.¹² The instrumental variables (IV) approach is based on the variation in base-country monetary policy rate changes and their transmission through variations in both exchange rate pegs and openness of capital accounts, following Jordà and others (2020). The IV approach results confirm that higher monetary rates increase crisis risk if monetary policy rates were previously cut over a long period. In particular, a 1 percentage point raise over three years, following monetary rate cuts over the preceding five years, increases the three-year crisis probability by 12 percentage points, more than doubling the unconditional crisis risk.

We further show that these effects are stronger for a deeper U shape (i.e., above the systematic component). To do this, we separate monetary policy rate changes into a proxy for the systematic component predicted by main business-cycle variables (GDP growth,

12. See Mundell (1963).

inflation, and other macro variables, including lags) and residual changes above and beyond this component. We find that residual cuts and raises (i.e., monetary rates above the systematic component) substantially increase crisis risk in the data. Systematic cuts followed by systematic raises are also weakly associated with crises, but the magnitudes are smaller and less robust. Furthermore, we show that the U-shaped monetary rate path is not key for noncrisis recessions, not even the deepest ones or those after World War II. For noncrisis recessions, only recent monetary rate increases are key, irrespective of previous monetary rate cuts.

In the second part of the paper, we analyze the mechanisms behind our main result; in particular, we ask why the U-shaped monetary rate path increases banking crisis risk. Narrative accounts of previous financial crises have argued that monetary policy plays a key role.¹³ Recent theoretical work points to subtle links between extended periods of monetary loosening that foster financial vulnerabilities and subsequent monetary rate hikes that, when these financial vulnerabilities are elevated, can trigger a financial crisis.¹⁴ To test these hypotheses in the data, we study the link between the path of monetary rates and a combined measure of financial vulnerabilities from Greenwood and others (2022), namely “the red zone”, defined as the zone of simultaneous high credit and high asset price growth. We show that high credit and asset price growth (red zone) is the overall main mechanism for our results.

We first show that monetary rate cuts over a long period (raw, instrumented, or above and beyond a proxy for the systematic component) strongly raise the likelihood of financial red zones. This credit expansion is consistent with a credit supply mechanism.

The boom in credit volume is accompanied by low credit spreads, and credit booms associated with ex-ante low (vs high) credit spreads are followed by ex-post worse bank outcomes—lower bank stock prices, lower bank profits, and higher loan losses—not only consistent with credit supply but also with high bank risk-taking and credit mispricing.

Moreover, during the strong boom that defines the red zone, bank equity prices and book capital increase in real terms and relative to nonfinancial firms’ equity, thus facilitating the credit supply boom. Furthermore, proxies for bank equity sentiment also increase (also relative to firms’ equity). Consistently, red zones are associated with

13. See, for example, Taylor (2013).

14. See Boissay and others (2026).

predictably lower future bank stock returns, suggesting excessively high bank stock prices during the boom.

We then show that raising monetary policy rates, once in the red zone, strongly increase the risk of a future banking crisis. Moreover, the combination of the two forces—monetary rate paths and red zones—is key. Red zones are only materially associated with future banking crises if monetary rates were cut for long before entering the red zone and, once in the red zone, crisis risk increases substantially only if monetary rates are raised. To summarize these patterns, we show that, if the economy experiences both a U-shaped monetary rate path and a red zone, the three-year crisis probability is close to 40 percent. Experiencing only the red zone or only the U shape leads to crisis frequencies of around 10 percent, close to the unconditional mean. Again, these differences become starker for deep crises, deeper U shapes (relative to the systematic component of monetary policy), and after World War II.

To understand why the combination of U-shaped monetary rates and red zones increases banking crisis risk, in addition to the above results on credit supply and bank risk-taking, we study links between monetary rate hikes, credit and asset price vulnerabilities, and bank performance. We first show that, while raising monetary rates generally reduces credit and asset prices, it leads to a much stronger reversal if credit and asset prices are already elevated. That is, monetary rate hikes trigger a much larger decline in, for example, house prices when house prices previously expanded rapidly (above the red zone threshold).

Second, we show that raising monetary rates after previous cuts leads to substantial stress in the banking sector, which comes in the form of higher bank loan losses, lower bank profits, lower bank stock returns, and a higher risk of a bank equity price crash. Our results are consistent with a credit risk mechanism but offer little support for an interest rate risk mechanism (based on different measures of bank profits and stock returns). This suggests that monetary rate hikes trigger a reversal in financial vulnerabilities that had built up over the long period of monetary rate cuts (including an expansion of credit supply, bank risk-taking, and asset prices), with a crucial role for realized credit risks in the banking sector.

To further validate these findings we use in a more granular dataset and to study loan, borrower, and bank heterogeneity, including a stronger identification of credit supply and bank risk-taking, we conduct a detailed case study of the 2008 crisis in Spain. This crisis is

representative of many historical crises, especially after World War II, as it was preceded by a large bank credit boom related to real estate.

We use loan-level data on the universe of bank loans and defaults granted by Spanish banks between 1995 and 2008.III via the supervisory credit register, matched to firm and bank administrative datasets. Spain also offers monetary policy conditions which, before the banking crisis, were relatively exogenous to macroeconomic developments in Spain. This was so because Spain had been part of a monetary union since 1989 (the European Monetary Mechanism and then the euro), with monetary policy set at euro-area level and—before the crisis—focusing on core euro-area countries such as Germany, whose macroeconomic dynamics differed markedly from those of Spain.¹⁵

Using these data, we first show that long periods of monetary rate cuts are associated with higher bank credit growth, especially for loans granted by ex-ante riskier banks—those with high ex-ante nonperformance loan (NPL) ratios—to ex-ante riskier firms (those in the construction and real-estate sector). As we control for borrowers' unobservables (e.g., time-varying firm-level credit demand) through firm-time and firm-bank fixed effects, results suggest a credit supply (including bank risk-taking) mechanism.

Furthermore, and consistent again with credit supply, we find that firms ex-ante associated with riskier banks not only obtain higher credit volumes but also lower cost of credit, following cuts in monetary policy rates for lengthy periods. Finally, turning to the crystallization of credit vulnerabilities, we show that raising monetary policy rates are associated with a substantially higher likelihood of ex-post bank loan defaults, especially after previous monetary cuts. Effects are, again, larger for loans made by ex-ante weaker banks to ex-ante riskier firms.

Other related research. There is a contemporaneous paper by Grimm and others (2026), which is closely related to my paper above (Jiménez and others, 2026). In this paragraph, I discuss the differences of our paper with respect to this paper, which finds that, when the real monetary rate is below an estimated natural rate over an extended period, crisis risk increases, and credit and asset prices are key channels. Our main differences are the following.

First, we show that not only loose monetary policy but also the subsequent monetary tightening is key for the crisis to take place.

15. See, for example, Maddaloni and Peydró (2011).

Note also that these U-shaped rate dynamics are crucial for banking crises but *not* for noncrisis (even deep) recessions, which suggests that financial mechanisms are crucial.

Second, we show that, even though red zones unconditionally imply a higher banking crisis risk, a closer look reveals that—to materially matter—red zones need to be accompanied by a monetary rate U shape, and the combination of the two forces is crucial. This result is important not only for the monetary policy literature but also for the literature on the determinants of financial crises.

Third, our paper provides a detailed understanding of the mechanisms behind banking crises and U-shaped monetary rates: the long monetary rate cuts induce financial red zones associated with elevated credit supply, bank risk-taking, and mispricing, while subsequent monetary rate hikes trigger banking crises through a strong reversal in credit and asset prices, materialized credit risks, and bank equity crashes. Crucially, both papers are highly complementary, showing that monetary policy dynamics are key for financial stability.

I would also point out that the paper that I have discussed in this section is different from my papers on the so-called risk-taking channel of monetary policy.¹⁶ These papers show in loan-level analysis that monetary rate cuts increase the risk-taking in credit, a key source of financial instability pointed out in the literature. On the other hand, Schularick and others (2021) show that it is monetary rate hikes, not cuts, that increase crisis risk. We instead show that it is the path of monetary rates (the U shape) that matters for banking crises—on their own, neither monetary rate cuts nor hikes are sufficient.

We also provide evidence for the mechanisms behind our main result. The full path of monetary rates is key to the dynamics of credit and asset price cycles. Notably, we find strong credit supply booms (including bank risk-taking) due to too low for too long monetary rates. Then, after monetary rate hikes, there is a strong reversal of credit and asset prices, the materialization of credit risk (i.e., loan losses), and the risk of a bank stock price crash.

In this paper I have discussed the effects of monetary policy before crisis times, or recessions, but monetary policy is also important for financial stability during crisis times. In this case, monetary policy can support credit supply and hence the overall economy. In Jiménez and others (2012), we analyze the impact of monetary policy on the supply of bank credit. Monetary policy affects both supply of and

16. See Maddaloni and Peydró (2011), Jiménez and others (2014).

demand for loans, thus making identification a steep challenge. We therefore analyze a supervisory dataset with loan applications from Spain. Accounting for time-varying firm heterogeneity in loan demand, we find that tighter monetary and worse economic conditions substantially reduce loan granting, especially from banks with lower capital or liquidity ratios. Finally, firms cannot offset the resultant credit restriction by applying to other banks.

2. POLICY IMPLICATIONS

Taken together, the findings in Jiménez and others (2026) point towards a very nuanced view on the use of monetary policy to reduce financial vulnerabilities. Several prior studies have suggested that, in order to deflate booms in credit and asset prices, policymakers could lean against the wind by raising monetary policy rates.¹⁷ Based on our results, however, once in a red zone that followed cuts in monetary policy rates, such a policy action is much more likely to trigger the banking crisis by crystallizing the financial vulnerabilities that built up during the period of monetary loosening.

Even though the previous empirical analysis provides only reduced-form evidence within a positive analysis, without any analysis of the optimal conduct of monetary policy (nor any normative or welfare analysis), the results presented in the previous section point towards several policy options.

First, if policymakers need to raise monetary policy rates to maintain price stability or rein in a nascent financial boom, doing this preemptively—i.e., before the economy enters the financial red zone—substantially attenuates the risks to financial stability.

Second, if policymakers have to raise monetary policy rates while in the red zone, especially if they have cut monetary rates over a long period previously, moderating the monetary raises and keeping their magnitude in line with the systematic policy reaction to GDP and inflation will, again, attenuate crisis risk.

Third, if policymakers need to tighten policy when the economy is already in the red zone, they can rely on other tools, for example, stronger banking supervision or macroprudential policy.

These recommendations are in line with insights from recent theoretical work. In the model of Boissay and others (2026), optimal

17. See Adrian and Liang (2018), Gourio and others (2018), and Greenwood and others (2022).

monetary policy in the presence of endogenous financial crises involves a preemptive response to impending financial booms and a moderation of monetary rate hikes when financial vulnerabilities are elevated. Goldberg and López-Salido (2023) show that, when in a financial boom, the optimal policy response moderates the pace of rate hikes, for example, by committing to hiking rates in the future instead of immediately, and uses macroprudential tools (one way is to tighten supervision) to rein in financial sector excesses.

Once we have shown that there is a clear connection between monetary policy dynamics and financial stability, an important question then is whether central banks should lean against the wind and raise monetary policy rates during an incipient credit and asset price boom. One could argue, following Greenspan's doctrine, that it is much easier to clean the mess after a financial bubble rather than knowing *ex-ante* that we are experiencing a bubble and acting accordingly with monetary policy—in which case monetary policy should not lean against the wind.

However: (i) Financial crises are very costly in terms of output, employment, innovation, political stability, etc. (ii) Financial crises have clear predictors, or even determinants, such as credit booms, especially when these credit booms are in low productivity sectors, including real estate, or in household loans for consumption or to buy real estate, or credit boom to firms in nontradables sectors, as well as complementary determinants of financial crises, such as asset price booms, and foreign debt inflows.¹⁸

On the other hand, leaning against the wind is difficult when the financial crisis may happen only years ahead and is highly uncertain, while the costs of rising monetary rates are borne immediately by the economy. Therefore, it is difficult (for the central bank) to take away the punch bowl while the party is still on and the banks are still dancing, following the metaphors of William McChesney Martin (then Chairman of the Federal Reserve) and Chuck Prince.

Moreover, if monetary policy does affect financial stability while acting in an optimal way for price stability (including business-cycle stabilization), macroprudential policies could adjust and improve some unintended consequences of monetary policy on financial instability. In other words, with two different objectives (price and financial stability), central banks and public policymakers in general could use two different instruments (monetary and prudential policies) following

18. See, for example, Jordà and others (2013, 2015), and Mian and others (2017).

a Tinbergen rule, with monetary policy pursuing price stability and macroprudential policy pursuing financial stability.

There is, however, regulatory arbitrage of (micro- and macro-) prudential policies that reduces their effectiveness; in addition, an important part of the financial system nowadays consists of nonbank credit (financial) intermediaries, which are less subject to macroprudential policies. Moreover, following Stein (2012), then governor at the Federal Reserve Board, monetary policy “gets all the cracks in”, that is, it affects all intermediaries that are (short-term) leveraged, even the unregulated or the less regulated ones.

Furthermore, one could argue that price stability is the best way for monetary policy to improve financial stability. For example, deflation may give rise to Fisherian debt problems (i.e., higher real value of debt, and hence higher debt problems); by contrast, excessive inflation may be seen as a run on the currency, with less trust in the local money and government debt, including the public guarantees for the banking sector, which are fundamental for its financial stability. That is, either very low or very high inflation are bad for financial stability, and hence a monetary policy that pursues price stability is already very important for financial stability.

However, positive supply shocks, for example those stemming from increased globalization (e.g., China in 2001 or immigration), can reduce prices, and central banks may react to this lower inflation with a long-lasting expansionary monetary policy. This, in turn, may create financial imbalances, such as credit and asset price booms. Furthermore, if monetary policy affects the likelihood of a financial crisis, then monetary policy via financial instability may increase the risk of deflation over the medium term, and hence monetary policy should directly care about financial crises insofar as they affect price and business cycle stability.

There are also instances in which a country has limits to affect monetary policy. First, the US monetary policy affects the global financial cycle,¹⁹ especially in emerging markets.²⁰ Second, some countries may have fixed exchange rates against some other currencies, such as the US dollar or the euro, and following the international trilemma, if there are no frictions in international capital flows, local monetary policy is not independent. This was the case, for example, in Spain and Ireland in the 2000–2007 strong boom period. In this case,

19. See Rey (2013).

20. See Morais and others (2019).

macroprudential policies may be the only solution, and within these policies, there may be useful prudential capital controls, especially in emerging economies.²¹

In Fabiani and others (2026), we show that capital controls, by slowing-down firm debt growth in the boom, improve firm performance during crises. More concretely, we exploit a tax on foreign currency (FX) debt inflows in Colombia before the Global Financial Crisis (GFC) and multiple firm-level and loan-level administrative datasets. We find that capital controls reduce FX-debt inflows. Firms with weaker local banking relationships cannot fully substitute FX-debt with domestic debt, thereby reducing firm-level total debt and imports during the boom. However, by pre-emptively reducing firm-level debt, capital controls boost exports and employment during the subsequent GFC, especially for financially constrained firms. Moreover, capital controls do not significantly alter credit allocation between productive and unproductive firms.

Moreover, in Fabiani and others (2022), we study how capital controls and domestic macroprudential policy tame credit supply booms, either directly or by enhancing the local bank lending channel of monetary policy. We exploit credit registry data and the introduction of capital controls on FX-debt inflows and the increase of reserve requirements on domestic bank deposits in Colombia during a boom. We find that capital controls strengthen the bank lending channel. Increasing the local monetary policy rate widens the interest rate differential with the United States; hence, relatively more FX-indebted banks carry-trade cheap FX funds with expensive Colombian peso lending, especially toward riskier firms. Capital controls in a way tax FX debt and break this carry-trade. Differently, raising reserve requirements on domestic bank deposits directly reduces credit supply, particularly for riskier firms, rather than enhancing the bank lending channel. Importantly, banks differentially finance credit with more domestic vis-à-vis more foreign financing; hence, capital controls and domestic macroprudential policy complementarily mitigate the credit boom and related bank risk-taking.

It is also important to discuss the impact of monetary policy, and in general, central banks' liquidity policies, in crisis times. As Lucas and Stockey (2011) argue, lender-of-last-resort (LoLR) policies are crucial for liquidity-based banking crises, so that the policymaker minimizes bank failures due to bank illiquidity rather than bank insolvency.

21. See Fabiani and others (2022, 2026).

However, monetary policy actions beyond liquidity provision via short-term rates and quantitative easing (QE) can also improve credit supply and debt overhang problems,²² thereby supporting consumption, investment, employment, as well as innovation. In consequence, monetary policy can help financial stability in crisis times by improving the real economy via bank credit over the short run and even the medium run. However, there may be some unintended consequences on credit misallocation (zombie lending) by excessively delaying necessary creative destruction during crisis times. Moreover, too much help from central banks and governments may provide the seeds for the next crisis if monetary policy stays too low for too long, consistent with a moral hazard channel.

Monetary policy actions may also be dominated by financial stability concerns and/or there may be a fiscal dominance. For example, as said above, there may be expansive monetary policy for a long period due to positive supply shocks and monetary policy following a narrow Taylor rule setting, or monetary policy may react to a financial crisis by being expansive over a long period, including forward guidance promises and quantitative easing policies. After such a long period of expansive monetary policy, private and public debt may be too high, and in this case, it may be more difficult to then tighten monetary policy, either with higher monetary rates,²³ or QT (such as in 2019 or 2025).²⁴ More broadly, it has been very difficult to exit the abundant liquidity policies post 2008, also shown by the recent Fed policy of reintroducing asset purchases in December 2025 after tensions in the repo market.

In Acharya and others (2022), the authors analyze monetary policy dynamics in terms of the balance sheet of the Fed rather than in terms of monetary policy rates. When the Fed expanded its balance sheet via QE, commercial banks typically financed reserve holdings with uninsured demandable deposits. They also issued credit lines to corporations. In the aggregate, these bank-issued claims on liquidity did not shrink commensurately when the Fed halted QE and turned to QT. Consequently, banks that increased liquidity risk exposure—especially small and regional banks—became vulnerable to liquidity shocks, necessitating further liquidity provision by the Fed.

22. See Bernanke (1993, 2025), and Jiménez and others (2012).

23. See, for example, the failure of Silicon Valley Bank in 2023, and the discussion in Jiménez and others (2026).

24. See, for example, Acharya and others (2022).

The evidence suggests that the expansion and shrinkage of central bank balance sheets have led to liquidity dependence of banks on central banks.

In Darst and others (2025), we show that the effectiveness of unconventional monetary policy is limited by how banks adjust credit supply and manage liquidity risk in response to fragile nonbank funding. For identification, we use granular US administrative data on deposit accounts and loan-level commitments, matched with bank-firm supervisory balance sheets. Quantitative easing increases bank fragility by triggering a large inflow of uninsured deposits from nonbank financial institutions. In response, banks that are more exposed to this fragility actively manage their liquidity risk by offering better rates to insured deposits while cutting uninsured rates. Doing so, they shift away from uninsured to insured deposits. Importantly, on the asset side, these banks also reduce the supply of contingent credit lines to corporate clients. Firms that are reliant on more exposed banks experience an aggregate reduction in the amount of liquidity insurance they enjoy against future shocks. Our analysis reveals that the fragility of deposit funding can disrupt the complementarity between deposit-taking and the provision of credit lines.

Not only do actual monetary policy actions matter or are important, but also the perceptions from economic agents of central bank's future actions. An important policy after 2008 has been forward guidance, but in general, there is an impression in the market that there is a central bank's put to minimize losses in bad states of nature. These perceptions can create excessive risk-taking as potential losses are minimized. Moreover, governments and central banks try to minimize most of the losses after banking distress episodes, as was clear with the failure of Silicon Valley Bank and other mid-sized US banks in 2023. For instance, some massive deposits from, for example, the stablecoin company Circle or Peter Thiel were guaranteed, despite the huge size of their deposits, hence there is little incentive for bank disciplining from even very large depositors. On the other hand, there was a bail-in of CoCos in the failure of Credit Suisse, but other policymakers said immediately afterward that they were not going to pursue similar policy actions. Moreover, there are calls to reduce not only the complexity of current banking regulations but also potentially the level of regulation. Hence, it is not clear that regulation is the only defense to financial instability, and hence there is a more active role for monetary policy in taking into consideration financial stability.

3. CONCLUDING REMARKS

In this paper, I have discussed whether and how monetary policy affects financial stability, in particular of the banking sector. In particular, I review in detail the evidence on the impact of monetary policy and banking crises, as well as the different associated mechanisms such as, during the boom—such as credit and asset price booms, bank risk-taking, and credit supply versus demand—and, during the bust—such as credit and interest rate risk, bank runs, as well as the collapse in credit and asset prices. Moreover, I discuss whether monetary policy should take into account financial stability issues as well as whether monetary policy should lean against the wind, or whether financial stability considerations should be dealt with only through macroprudential policies. I also discuss some issues which are more relevant to emerging economies, for example, the US monetary policy and the global financial cycle, the role of prudential capital controls.

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