MONETARY POLICY AND FINANCIAL-STABILITY ARE DIFFERENT AND NORMALLY BEST CONDUCTED INDEPENDENTLY

Discussion of Brunnermeier and Sannikov, “Monetary Analysis: Price and Financial Stability”

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ABSTRACT

The I Theory of Money argues that price stability and financial stability, and hence monetary policy and financial-stability policy, are inseparable. But monetary policy and financial-stability policy are different and distinct, in the sense that they have different objectives, different suitable instruments, also when the same authority is in charge of both. Similar to what the case is for fiscal policy and monetary policy, in normal times monetary and financial-stability policy are most likely best conducted independently, but with each taking the conduct of the other policy into account. Sweden provides a bad example of aggressive leaning against the wind, with high costs in terms of too low inflation, too high unemployment, and a higher real debt burden for households.

1 THE I THEORY OF MONEY

According to Brunnermeier and Sannikov (2014), in their I Theory of Money, price stability and financial stability are inseparable. Consequently, monetary policy and financial-stability policy would be inseparable. This is very different from a more conventional view, according to which monetary policy and financial-stability policy (micro- and macroprudential policy) are separate policies, with different objectives, different suitable instruments and, depending on the economy in question, sometimes different authorities in control of the instruments and accountable for achieving the objectives.

Furthermore, as far as I can see, the I Theory of Money is not yet fully developed to deal with the standard issues in monetary policy, for instance, how monetary policy affects inflation and unemployment. In particular, the version of the I Theory that I have seen has flexible prices and wages, whereas in the conventional view of monetary policy, stickiness of prices and wages is essential for a realistic and relevant view of the transmission mechanism.

2 HOW TO DISTINGUISH MONETARY POLICY AND FINANCIAL-STABILITY POLICY?

When we discuss different economic policies, we distinguish policies according to their objectives, instruments, and authorities controlling the instruments and being responsible for achieving the objectives. For instance, fiscal policy and monetary policy have distinct and different objectives, instruments and responsible authorities. Still there is considerable interaction, in that the objectives of fiscal policy are affected by monetary policy and vice versa. Therefore, good fiscal policy has to take the effect of monetary policy on the fiscal-policy objectives into account, and vice versa. But they are clearly separate policies. Similarly,
financial-stability policy and monetary policy are separate policies, although with some interaction, sometimes considerable.

Regarding monetary policy, for flexible inflation targeting, the objective is price stability and real stability. More concretely, the objective is to stabilize inflation around an inflation target and resource utilization around a long-run sustainable rate. The instruments are, in normal times, the policy rate and communication. The latter includes publishing forecasts of the target variables, such as inflation and unemployment, and possible forward guidance, such as publishing a policy-rate path, a forecast for the policy rate. In crisis times, the set of instruments include balance-sheet policies, such as asset purchase (quantitative easing), fixed-rate lending at longer maturities, and foreign-exchange interventions. The authority controlling the instruments and responsible for achieving the objectives is the central bank.

Regarding financial-stability policy, the objective is financial stability. The definition of financial stability is not as clear and obvious as the definition of price stability. A definition that I prefer is that the financial system can fulfil its three main functions (transforming saving into financing, providing risk management, and transmitting payments) with sufficient resilience to disturbances that threaten these functions. The crucial part of the definition is arguably sufficient resilience. In the future, there will be unavoidable disturbances and shocks to the financial system, very likely from unexpected directions and of unexpected kinds. The crucial thing is then that there is sufficient resilience to disturbances.

The instruments of financial-stability policy are, in normal times, supervision, regulation and communication, including capital- and liquidity requirements, loan-to-value (LTV) caps, financial-stability reports, and so on. In crisis times, further instruments include lending of last resort, variable-rate lending at longer maturities (credit easing), guarantees, bank resolution, capital injections, asset purchases, and so on.

The authority or authorities controlling the instruments vary across countries and may include the financial supervisory authority, the central bank, the ministry of finance, the national debt office, a separate bank-resolution authority, and so on.

3 MONETARY POLICY AND FINANCIAL POLICY ARE DIFFERENT AND DISTINCT

Clearly, from the above perspective, monetary policy and financial policy are different and distinct policies. This is also the case when the same institution, the central bank, is in charge of both policies.

Importantly, price stability does not imply financial stability. Monetary policy can achieve price stability, but it cannot achieve financial stability. There is no way monetary policy can achieve sufficient resilience of the financial system; there is obviously no way monetary policy can ensure that there is sufficient capital and sufficient buffers in the financial system.

Furthermore, financial-stability policy cannot achieve price stability. Financial-stability policy can achieve financial stability, but it cannot stabilize inflation around the inflation target and unemployment around a long-run sustainable rate.

Thus, both policies are needed to achieve both monetary-policy objectives and financial-stability objectives.
Still, there is interaction between the two policies. Financial-stability policy affects financial markets, spreads between different interest rates, and lending by banks. This way it indirectly affects inflation and resource utilization. Monetary policy affects resource utilization, credit losses, and assets prices. This way it indirectly affects balance sheets and leverage. Thus, there is interaction between the two policies, as there is interaction between fiscal policy and monetary policy.

My view is that, in normal times, it is best to conduct monetary policy and financial-stability policy independently, with each policy taking the conduct of the other policy into account in order to best achieve its objectives. This is similar to how monetary policy and fiscal policy are conducted. In game-theory terms, it corresponds to a Nash equilibrium rather than a coordinated equilibrium. Bean (2014) provides a thorough discussion of why and how monetary policy and financial-stability policy by focusing on each own objective can achieve a good outcome.

4 WHAT IF MONETARY POLICY WOULD POSE A THREAT TO FINANCIAL STABILITY?

There could arise situations when monetary policy might pose a threat to financial stability even when it fulfils the monetary-policy objectives. Normally, the financial-stability authority should be able to contain such threats with its available instruments. But how to handle a situation when the threat cannot easily be contained?

The August 2013 forward guidance by Bank of England’s Monetary Policy Committee (MPC) provides an example for handling such a situation (Bank of England 2013). The MPC agreed in August its intention not to raise the policy rate until the unemployment rate had fallen to a threshold of 7%, subject to three "knockouts" not being breached. The third knockout was that the Financial Policy Committee (FPC) judges that the stance of monetary policy poses a significant threat to financial stability that cannot be contained by the substantial range of mitigating policy actions available to the FPC, the Financial Conduct Authority and the Prudential Regulation Authority in a way consistent with their objectives.

Thus, according to this example, the financial-stability authority should warn the monetary-policy authority if monetary policy poses a threat to financial stability that the financial-stability authority cannot contain with its available policy instruments. Then the monetary-policy authority may choose to adjust monetary policy, tightening, that is, leaning against the wind, or loosening, depending on the situation. This clarifies the responsibility of each authority and makes it possible to hold them accountable.

So, is there any role for monetary policy in maintaining financial stability? If financial policy is ineffective or inappropriate, monetary policy may have to be adjusted (to be tighter or looser, depending on the situation). This means using monetary policy, as a last line of defence, when the first line of defence, financial-stability policy, is failing. But normally, that defence is unlikely to be needed.

5 SWEDEN, A BAD EXAMPLE OF LEANING AGAINST THE WIND AS A FIRST LINE OF DEFENCE

Sweden provides a bad example of aggressive leaning against the wind as a first line of defence against perceived risks from household debt.
The background is that Swedish households' debt has risen, and the debt-to-disposable-income ratio, the debt ratio, is high. But assets have risen at least as much as the debt, so debt to assets is not high. Asset prices, including housing prices, are in line with fundamentals. Debt service to disposable income is low.

One may discuss what risks the current situation poses, but, in any case, Finansinspektionen (the Swedish financial supervisory authority), has taken several actions. It issues a regular mortgage market report (Finansinspektionen 2014), where it uses individual data on new borrowers to monitor that lending standards are high and that borrowers’ debt-service capacity is good. In particular, it uses the individual data to conduct stress tests. It has concluded that borrowers' resilience to disturbances, in the form of mortgage rate increases, housing-price falls, and income losses due to unemployment, is sufficient. Furthermore, Finansinspektionen introduced an LTV cap of 85 per cent on mortgages in October 2010. Since then the household debt ratio has stabilized. The average LTV ratio for new mortgages has also stabilized, around 70 per cent, so the average equity is as high as 30 per cent. Finansinspektionen has also increased the risk-weights on mortgages to 25 per cent, increased capital requirements to 16.4 per cent CET1 on systemically important banks, and recommended that lenders suggest individually adapted amortization plans to borrowers. Clearly, Finansinspektionen has done a lot. It judges that current actions are sufficient to contain any risks, but it is monitoring the situation closely and prepared to take further action if justified.

The Riksbank started to tighten monetary policy in the summer of 2010. The policy rate was raised steadily from 0.25 per cent in July 2010 to 2 per cent in July 2011. The Riksbank did this in spite of the actions of Finansinspektionen, and in spite of an inflation forecast in July 2010 that was below target and an unemployment forecast that was much above the Riksbank's estimated long-run sustainable rate (Svensson 2011).

As a result of this tightening, CPI inflation has been zero or even negative the last 2½ years, much below the 2 per cent target for CPI inflation. The unemployment rate has remained high at around 8 per cent, and long-term unemployment has increased. Furthermore, households' debt burden has become higher, since the real value of nominal debt has become 5 per cent larger in the last 2½ years than if inflation had been on target.

Recently, the Riksbank has published its own calculations of the impact of a higher policy rate on household debt. According to these calculations, a higher policy rate has a very small and uncertain impact on household real debt and the debt ratio, and the effect on any risks with household debt are even smaller (Sveriges Riksbank 2013, 2014). As discussed in Svensson (2014), the Riksbank's estimates imply that the benefit of a higher policy rate, expressed in terms of a lower expected future unemployment rate, due to lower probability and less depth of a future crisis, is only about 0.4 per cent of the cost in terms of higher unemployment the next few years. Furthermore, the Riksbank's calculations and discussion disregard that a lower price level than expected has actually increased households' debt burden.

Figure 1 illustrates the dramatic tightening i 2010 by the Riksbank. It shows real policy rates for Sweden, the UK, and the US, and the real eonia rate for the euro area. We see that the central banks lowered their real rates in 2008 and 2009 to negative numbers, the ECB a little slower than the others. But from the beginning of 2010 to the end of 2011, the real policy rate in Sweden increased from minus 2.5 per cent to plus 1 per cent at the end of 2011, an increase of a full 2.5 percentage points. This increase was due to both the Riksbank's increase in the policy rate and the fall of inflation.
In figure 2, the red lines show the actual outcome for the policy rate, CPIF inflation (CPI inflation excluding the effect on housing costs of changes in the mortgage rate), the unemployment rate, and the household debt-to-income ratio. The introduction of the 85 per cent LTV cap is marked as a vertical dashed line in the panel for the household debt ratio.

The blue line in figure 2 shows a counterfactual outcome under the assumption of a policy rate held at 0.25 per cent since July 2010. The counterfactual outcome for CPIF inflation and unemployment is calculated using the Riksbank’s main model, the DSGE model Ramses. In the counterfactual outcome, CPIF inflation would have remained close to 2 per cent and the unemployment rate during 2013 would have been about 1.2 percentage points lower. The cost of the Riksbank’s actual policy in terms of higher unemployment and lower inflation is substantial.

The outcome for the household debt ratio is calculated using the model of Svensson (2013a), where mortgage debt is sticky and adjusts slowly. Then a lower policy rate increases nominal disposable income faster than it increases nominal debt, in which case the debt ratio falls rather than increases. The difference between the debt ratios at the end of 2013, about 174 per cent for the actual outcome and about 170 for the counterfactual, is, however, too small to have any effect on any risks associated with household debt.

Figure 3 shows CPI inflation (the grey line) and household 1-year-ahead inflation expectations lagged (the green line). Thus, the gap between the grey and green lines shows how much realized CPI inflation has deviated from household expectations. In the last few years, actual inflation and the actual price level has fallen substantially below the previously expected inflation and price level. This means that household real debt has become substantially larger than expected.

In figure 4, the blue line shows the real value of a loan of SEK 1 million taken out in November 2011, if inflation had been 2 per cent (left axis). Then the real value of the loan would have fallen by 2 per cent per year and been around SEK 950,000 in May 2014, 2½ years later. The red line shows the actual real value of the loan. Since inflation has been about zero, the actual price level was in May 2014 about the same as in November 2014. The real value of the loan in May 2014 was hence still about SEK 1 million. The black line shows the difference between the red and the blue line, that is, the increase in the real value of the loan compared to if inflation had been 2 per cent (right axis). In May 2014, the real value of the loan was SEK 50,000 higher than if inflation had been at 2 per cent. A 5 per cent increase in the real value of the loan in 2½ years is a substantial increase in the real debt burden of households.

6 CONCLUSION

In the I Theory of Money, Brunnermeier and Sannikov (2014) argue that price stability and financial stability, and hence monetary policy and financial-stability policy, are inseparable. But monetary policy and financial-stability policy are different and distinct, in the sense that they have different objectives and different suitable instruments, also when the same authority is in charge of both. Monetary policy cannot achieve financial stability, and financial-stability policy cannot achieve price stability. Monetary policy is needed to achieve price stability, and financial-stability policy is needed to achieve and maintain financial stability. Similar to what is the case for fiscal policy and monetary policy, in normal times monetary and financial-stability policy are most likely best conducted independently, but with each taking the conduct of the other policy into account. If the monetary-policy stance would in some situation pose a threat to financial stability that the financial-policy authority cannot contain with its available instruments,
the financial-stability authority may warn the monetary-policy authority about this, in which case the latter authority may choose to adjust monetary policy.

Sweden provides a bad example of aggressive leaning against the wind, in an attempt to restrict household indebtedness, in spite of low inflation forecasts, high unemployment forecasts, and strong actions by the financial-policy authority to contain any risks associated with household debt. The Riksbank’s policy has indeed been quite costly. It has led to inflation substantially below target and unemployment substantially above a long-run sustainable rate. Furthermore, since it has led to a price level substantially below what was expected, it has lead to a substantially higher real debt burden than if inflation had been kept on target. Thus, if anything, it has increased any risks with household debt.

REFERENCES


Figures for Svensson discussion of Brunnermeier and Sannikov

Figure 1. Real policy rates for Sweden, the UK and the US; real eonia rate for the euro area.

Source: Datastream.

Notes: Real interest rates are constructed as nominal rates minus HICP inflation for the euro area, Sweden, and the UK, and as the nominal rate minus core PCE inflation for the US.

Figure 2. Actual and counterfactual outcome in Sweden for the policy rate, CPIF inflation, the unemployment rate, and household debt-to-disposable-income ratio.

Figure 3. CPI inflation and household 1-year-ahead inflation expectations lagged one year.

Notes: The dashed line are 5-year trailing moving averages.

Figure 4. The real value of a loan of SEK 1 million taken out in November 2011, actual and if inflation had been 2 percent.

Source: Statistics Sweden.