Monetary policy tradeoffs in CESEE:

Panel introduction

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Outline

- What can monetary policy achieve?
  - Do not ask too much from monetary policy
- What is the relation between monetary policy and financial stability?
  - Monetary policy and financial-stability policy are very different
  - In normal times: Best conducted separately, also when conducted by the same institution
  - But each policy should be fully informed about and take into account the conduct of the other policy
  - In crisis times: Full cooperation between the relevant authorities
  - Monetary policy should be the very last line of defense of financial stability, not to be used in normal times

What can – and cannot - monetary policy achieve?

- MP can stabilize inflation around a given inflation target
- MP can stabilize overall resource utilization around a long-run sustainable rate
  - But the latter is determined by nonmonetary, structural factors
- MP cannot affect the long-run sustainable rate of resource utilization
  - This requires structural policies
- MP cannot solve structural problems
  - This requires structural policies

What can – and cannot - monetary policy achieve?

- MP cannot achieve financial stability
  - This requires financial-stability policy (macroprudential policy)
- Leaning against the wind cannot solve debt problems
  - See Riksbank bad example (FT Big Read Nov 20)
  - In Swedish case, benefits of leaning may be only about 0.4% of costs (should have been more than 100% of costs to justify policy)
- Inherent flaw in leaning
  - Running inflation below a credible inflation target increases households' and other agents' real debt burden
  - It also increases unemployment

What can – and cannot - monetary policy achieve?

- Do not ask too much of monetary policy

What is the relation between monetary policy and financial stability?

- Distinguish economic policies according to
  (1) objectives,
  (2) suitable instruments, and
  (3) responsible authorities
- MP and financial-stability policy (FSP) are clearly separate policies, with different objectives and different suitable instruments, regardless of whether they have the same or different responsible authorities

Monetary policy

- Objective
  - Flexible inflation targeting: Price stability and real stability
- Instruments
  - Normal times: Policy rate, communication
  - Crisis times: Also unconventional measures, balance sheet policies, FX policy, …
- Responsible authority
  - Central bank

Financial-stability policy

- Objective
  - Financial stability: Financial system fulfilling 3 main functions w/ sufficient resilience to disturbances that threaten those functions
- Instruments
  - Normal times: Regulation, supervision, macroprudential policy, buffers, capital requirements, LTV caps, LCRs, NSFRs, taxes, deposit insurance, …
  - Crisis times: Lending of last resort, liquidity support, capital injections, guarantees, banking resolution, …
- Authority(ies)
  - Varies across countries
  - FSA, CB, banking-resolution authority, MoF, …

What is the relation between monetary policy and financial-stability policy?

- Very different policies
- In normal times: Conduct independently, also when conducted by the same authority
  - Each policy should be fully informed about and take into account the conduct of the other's policy
  - Similar to MP and fiscal policy (Nash equilibrium rather than coordinated equilibrium (joint optimization)
- In crisis times: Full cooperation and joint policies by FSA, CB, MoF, banking-resolution authority, …

Monetary policies best contribution to financial stability?

- Inflation on target and resource utilization at long-run sustainable rate
- Suppose 2% inflation and 3% real growth, nominal growth 5% of asset prices and disposable income, doubling every 14 years
- For any given nominal debt, LTV and DTI ratios halved in 14 years. Pretty good for repair of balance sheets.
- Monetary policy should only be the very last line of defense of financial stability, normally not to be used