Monetary Policy and Financial-Stability Policy

Lars E.O. Svensson
Sveriges Riksbank

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Introduction
- Distinction between monetary policy (MP) and financial-stability policy (FSP)
- Financial stability (FS) as additional objective for monetary policy makes little sense (makes sense as objective for central bank)
- FS may imply restriction on MP (rare event)
- Mean squared gaps in MP: Another step towards increased transparency
- Flexible inflation targeting is fine: before, during and after the crisis

Relation monetary policy and financial-stability policy?
- Policies (monetary, fiscal, financial-stability, labor market, structural, industrial, …)
- Distinguish according to
  - Objectives
  - Instruments
  - Authority(ies) controlling instruments and responsible for achieving objectives
- Monetary policy and financial-stability policy distinct and different

Monetary policy
- Objective
  - Flexible inflation targeting: Stabilize inflation around inflation target and resource utilization around normal level
- Instruments
  - Normal: Policy rate, policy-rate path, communication
  - Crisis: Fixed-rate lending at longer maturities, asset purchases (quantitative easing), …
- Authority
  - Central bank

Financial-stability policy
- Objective: Financial stability (financial system fulfills main functions w/o any disturbances with significant social costs)
- Instruments
  - Normal: Supervision, regulation (policy rate blunt and unsuitable)
  - Crisis: Lending of last resort, variable-rate lending, liquidity policy (credit easing), guarantees, bank resolution, capital injection, …
- Authority(ies)
  - FSA, CB, treasury, … (varies across countries)
  - Sweden: FSA (regulation, supervision), Debt Office (bank resolution, guarantees), RB (lending of last resort)

MP and FSP different and distinct
- Interaction
  - FSP affects inflation and resource utilization via financial markets and transmission mechanism (spreads, lending)
  - MP affects activity, asset prices, balance sheets
  - Cf. interaction MP and fiscal policy
- Responsible authority(ies) for FSP open question (CB for macroprudential regulation?)
- Distinction and difference to be taken into account
- FS as objective for MP makes little sense (objective for CB makes sense)
Monetary Policy

- Choose policy-rate path so as to best stabilize forecast of inflation and resource utilization (or reasonable compromise)
- Incorporate effect of financial conditions in forecast of inflation and resource utilization
- If policy-rate path would threaten financial stability, compromise (rare event)
  - Restriction could imply lower or higher policy rate

Mean squared gaps: Another step towards increased transparency

- Measure stability of inflation around target and resource utilization around normal level
  \[
  \frac{1}{T+1} \sum_{t=1}^{T} (\pi_{t+1} - \pi^*)^2, \quad \frac{1}{T+1} \sum_{t=1}^{T} (y_{t+1} - \bar{y})^2
  \]
- Intertemporal forecast loss function (\( \delta = 1 \))
  \[
  L = \sum_{\tau=0}^{\infty} \delta^\tau \left[ (\pi_{t+\tau} - \pi^*)^2 + \delta \sum_{\tau=0}^{\infty} \delta^\tau (y_{t+\tau} - \bar{y})^2 \right]
  \]
- Verify whether policy is
  - Efficient
  - Reasonable compromise
  - Consistent over time

Crisis not caused by easy MP

(Norges Bank, March 2005)

- Main causes (Bean 09): macro conditions, distorted incentives, lax regulation and supervision, housing policy, information problems (BIS 09)
- Easy MP not leading indicator of crises (IMF WEO 09)
- US MP 2001—appropriate ex ante (deflation risk)
- Higher policy rates little or no effect on FS and house prices (Bernanke, Kohn)
### Lessons for monetary policy
- Price stability not enough to achieve financial stability
- Interest rates not enough to achieve financial stability
- No reason to permanently raise inflation target (Blanchard et al.): If ZLB binding, temporary overshoot inflation target, price-level target
- Financial conditions and asset prices remain indicators, not targets: Incorporate effects in forecasts of inflation and resource utilization

### Summary
- Distinguish between monetary policy and financial-stability policy
- Financial stability as additional objective for *monetary policy* makes little sense (makes sense as objective for *central bank*)
- Financial stability may imply restriction on MP (rare event)
- Mean squared gaps in MP: Another step towards increased transparency
- Flexible inflation targeting fine before, during, and after the crisis