Price Stability and Financial Stability: The Responsibility of Central Banks

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Introduction

Questions after the financial crisis:
- Did monetary policy contribute to the crisis?
- Are any changes of best-practice monetary policy justified?
- What is the relation between monetary policy and financial-stability policy?
- What is the responsibility of central banks regarding financial-stability policy?

Best-practice monetary policy: Flexible inflation targeting

Outline of speech:
- Best-practice monetary policy before the crisis
- The causes of the crisis and the role of monetary policy
- Lessons for monetary policy
- The relation between monetary policy (MP) and financial-stability policy (FSP)
- Central-bank responsibility for FSP

Stabilize both inflation around the inflation target and resource utilization (RU) around a normal level

“Forecast targeting”: Choose policy-rate path so that forecast of inflation and RU stabilizes inflation and RU

CB uses and responds to all information that affects forecast of inflation and RU
Best-practice monetary policy: Flexible inflation targeting

- CB responds to financial conditions only to the extent they affect forecast of inflation and RU
- Financial conditions are only indicators, not targets
- Financial stability may impose restrictions on monetary policy (rare event):
  - Exclude policy-rate paths that threaten financial stability
  - Not too high or too low (!) policy rate

The financial crisis was not caused by monetary policy

- Main causes of the crisis (Bean 09):
  - *Macro conditions:* Global imbalances, low world real interest rates (neutral rates), Great Moderation, underestimation of risk, very low risk premia
  - *Distorted incentives:* Lax regulation and supervision, missing bank resolution, US housing policy, securitization, regulation arbitrage, increased leverage
  - *Information problems:* Hidden risk in complex securities, underestimation of correlated systemic risks
- These causes had little or nothing to do with monetary policy!

Was US monetary policy too easy during 2001-2004?

- Ex ante: Genuine threat of deflation and liquidity trap, expansionary policy justified
- Given FOMC forecasts, policy rates not exceptional (Bernanke)
- Neutral real interest rates low because of global imbalances (global saving glut, investment shortage)
- Ex post: Inflation not too high (unanticipated oil-price shocks)

Would tighter US monetary policy have prevented the crisis?

- Interest rates explain small portion of US house-price increases (multiplier ≈ 1.5)
- Initial payments on new exotic mortgage types not very sensitive to short interest rates (Bernanke)
- Collateral damage: To affect boom and credit growth, substantially higher interest rates needed: recession, deflation, and eventually liquidity trap? (Assenmacher-Wesche & Gerlach GDP/house prices 1/3)
- No impact on regulatory problems, distorted incentives, information problems
Would tighter US monetary policy have prevented the crisis

- IMF WEO (Oct 09): Many countries and crises
  - MP stance generally not leading indicator of future financial crises
  - Current crisis: Statistically insignificant and economically weak association between loose monetary policy and house prices (5% of variation explained)
- Beyond actual monetary policy: “Greenspan put”? Floor for asset prices, reduce risk?
  - Communication rather than policy, less emphasis better?

Lessons for monetary policy

- Price stability not enough to achieve financial stability
- Interest rates not enough to achieve financial stability: Separate financial-stability policy needed
- Financial conditions and asset prices remain indicators, not targets: Incorporate effects in forecasts of inflation and RU
- Lean against the wind if forecast of inflation and RU looks better (Kohn’s 3 conditions: Identify bubble, impact on bubble, better inflation and RU outcome)

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 (MP)

- 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 (FSP)

- **Objective**: Financial stability (financial system fulfils main functions w/o disturbances with significant social costs)

- **Instruments**
  - Normal: Supervision, regulation, FS reports (policy rate blunt, ineffective)
  - Crisis: Lending of last resort, variable-rate lending longer maturities, liquidity policy (credit easing), guarantees, bank resolution, capital injection, asset purchases, …

- **Authority(ies)**: FSA, CB, MoF, … (varies across countries)
  - Sweden: FSA (regulation, supervision), Debt Office (bank resolution, guarantees), RB (FS report, lending of last resort), MoF

MP and FSP different and distinct

- **Interaction**
  - FSP affects inflation and RU via financial markets and transmission mechanism (spreads, lending)
  - MP affects RU, asset prices, balance sheets, leverage, credit losses
  - Cf. interaction MP and fiscal policy

- **Distinction and difference to be taken into account**

Central-bank responsibility?

- **Monetary policy**
  - As usual, taking effects of financial-stability policy into account

- **Financial-stability policy**
  - Depends on assignment (varies across country)
  - Macropudential regulation? Perhaps more?
  - Taking effects of monetary policy into account

- **Transparent and effective assignment of objectives and instrument across different authorities**
Independence?
- MP: Conflict of interest (short-term gov’t interest)
- MP by independent CB best
- FSP: Much less conflict of interest
- FSP by cooperating authorities best (at least for Sweden)

Conclusions
- Flexible inflation targeting remains best-practice MP before during and after the crisis
- If done rightly, using all information in financial factors about future inflation and resource utilization
- For MP, financial conditions still indicators, not targets
- MP includes responding appropriately to financial conditions in order to best stabilize inflation and resource utilization over time

Conclusions
- Distinguish between monetary policy and financial-stability policy
- Financial stability as additional objective for monetary policy makes little sense
- Financial stability as additional objective for central bank makes sense, if appropriate additional instruments
- Conduct monetary policy taking effects of financial-stability into account
- Conduct financial-stability policy taking effects of monetary policy into account