Price Stability and Financial Stability: The Responsibility of Central Banks

Lars E.O. Svensson
Sveriges Riksbank

Swedbank, Stockholm, May 27, 2010

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?

Introduction

- 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

Best-practice monetary policy: Flexible inflation targeting

- 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

MP and FSP different and distinct

- Conduct MP taking FSP into account
- Conduct FSP taking MP into account
- As with MP and fiscal policy)
- FS as objective for *MP* makes little sense
- FS as objectiv *CB* makes sense, if appropriate FSP instruments

Central-bank responsibility?

- Monetary policy
  - As usual, taking effects of financial-stability policy into account
- Financial-stability policy
  - Depends on assignment (varies across countery)
  - Macroprudential 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