Forthcoming in Oesterreichische Nationalbank, "*The Challenge of Economic Rebalancing in Europe: Perspectives for CESEE Countries*", Edward Elgar, 2015.

X. What can monetary policy achieve, and what is the relation between monetary policy and financial stability?

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In this chapter, I will discuss two questions. First, what can – and cannot – monetary policy achieve? Second, what is the relation between monetary policy and financial stability, and how can, if necessary, monetary policy and financial-stability policy be coordinated?

X.1. What can – and cannot – monetary policy achieve?

Monetary policy can stabilize inflation around a given inflation target and resource utilization around its estimated long-run sustainable rate. Since the inflation rate over the longer run is primarily determined by monetary policy, it is possible to select a fixed target for the inflation rate and for the monetary policy to achieve an average inflation rate over a longer period in line with the target.

In contrast, the long-run sustainable rate of resource utilization (measured by, for instance, potential output or the minimum long-run sustainable unemployment rate) is largely determined not by monetary policy but by non-monetary factors that affect the structure and working of the economy. These factors may change over time and may not be directly observable and measurable. This means that it is not appropriate to set a fixed monetary-policy target for the long-run rate of resource utilization. Instead the long-run rate of resource utilization must be estimated, and such estimates are necessarily uncertain and subject to revision.

Thus, monetary policy cannot improve the long-run sustainable rate of resource utilization; for that, structural policies must be used. Generally, monetary policy cannot solve structural problems.

Monetary policy cannot achieve financial stability

Furthermore, monetary policy cannot achieve financial stability; this requires financial-stability policy (micro- and macroprudential policy). For instance, 'leaning against the wind' cannot solve debt problems.

The Riksbank provides a clear example, having applied an aggressive leaning-against-the-wind policy starting in the summer of 2010 in order to limit household indebtedness. This policy has led to zero or even negative inflation and an unemployment rate much above its long-run sustainable rate. Using the Riksbank's own estimates, the potential benefit of this policy, in the form of a better expected future macroeconomic outcome because of a lower probability of a future financial crisis and a less deep crisis if it would occur, can be shown to be miniscule compared to the cost, in the form of a worse macroeconomic outcome in the near future. Expressed in terms of the unemployment rate, the benefit in terms of a lower expected future unemployment rate turns out to be only about 0.4 per cent of the cost in terms of higher unemployment rate in the next few years. The benefit should obviously have been more than 100 per cent of the cost to justify the policy. (See Svensson 2015 for details.)

Furthermore, the Riksbank experience points to an inherent flaw in a policy of leaning against the wind to limit indebtedness, a policy supported, for instance, in the Annual Report 2014 of the Bank for International Settlements. Leaning against the wind means a policy that is tighter than justified by stabilizing inflation around the inflation target and resource utilization around its long-run sustainable rate. It thus means running inflation on average below the inflation target. But inflation targets have in many economies become credible, in the sense of inflation expectations being anchored to the targets. This means that inflation below the inflation target also means inflation below inflation expectations. This will tend to increase households' and other agents' real debt burden. It will also increase unemployment and reduce employment and incomes, which will in turn reduce the debt-service capacity of indebted agents. The conclusion is that leaning against the wind is generally likely to be counterproductive as a way of managing debt problems.

In particular, in Sweden, since actual inflation has the last three years been running much below the inflation target and households' expectations, the real value a given nominal debt held at the end of 2011 has become about 6 per cent higher at the end of 2014 than what households had expected and planned for (Svensson 2015). This is a substantial increase in households' real debt burden.

X.2. What is the relation between monetary policy and financial stability?

In order to answer this question, we need to distinguish between monetary policy and financial-stability policy.[1]

How to distinguish between different economic policies?

In general, when we discuss different economic policies, we distinguish policies according to their objectives, their instruments, and the authorities that control the instruments and are 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 between the policies, in that the objectives of fiscal policy are affected by monetary policy and vice versa. Therefore, good fiscal policy has to take the effects of monetary policy on the fiscal policy objectives into account, and vice versa. But the policies 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 its long-run sustainable rate. In normal times, the instruments are 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 purchases (quantitative easing), fixed-rate lending at longer maturities, and foreign-exchange interventions and exchange-rate floors. 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 fulfill 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 *sufficient resilience*. In the future there will unavoidably be 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.

In normal times, the instruments of financial-stability policy are supervision, regulation, and communication, including capital and liquidity requirements, loan-to-value caps, banking-resolution requirements, 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.

Monetary policy and financial stability are different and distinct and normally best conducted independently

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, for instance, obviously no way monetary policy can ensure that there are sufficient capital and liquidity 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 its 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 non-cooperative Nash equilibrium rather than a cooperative equilibrium. This is best for two reasons: First, monetary policy is much more effective than financial-stability in stabilizing inflation around the inflation target and resource utilization around its long-run sustainable rate, whereas financial-stability policy is much more effective than monetary policy in achieving financial stability. Second, it clarifies the accountability of the authority responsible for each policy. Bean (2014) provides a thorough discussion of why and how monetary policy and financial-stability policy can achieve a good outcome by each policy focusing on its objective.

In crisis times, full cooperation and coordinated policies by the relevant authorities are warranted. These authorities may include the financial supervisory authority(ies), the central bank, the ministry of finance, the bank-resolution authority, and so on.

X.3. What if monetary policy posed a threat to financial stability?

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

The August 2013 forward guidance by the Bank of England's Monetary Policy Committee (MPC) provides an example of how to handle such a situation (Bank of England 2013). The MPC agreed its intention not to raise the policy rate until the unemployment rate had fallen to a threshold of 7 per cent, subject to three 'knockouts' not being breached. The third knockout is the Financial Policy Committee (FPC) judging 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, either tightening (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 at all 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 defense, when the first line of defense, financial-stability policy, is failing. But only in very rare situations would that defense be needed. And even then such defense would be justified only if the expected benefits exceed the costs.

The best contribution of monetary policy to financial stability

The best contribution to financial stability by monetary policy, except in very special circumstances, is certainly to just fulfill its objectives and stabilize inflation around the inflation target and resource utilization around its long-run sustainable rate. Suppose that the inflation target is 2 per cent and that average inflation equals the inflation target. Furthermore, assume that average resource utilization equals the long-run sustainable rate, and that this is consistent with an average real growth rate of, say, 3 per cent. This would then result in an average growth rate of nominal gross domestic product (GDP) and disposable income of 5 per cent per year. We may then also expect nominal asset prices, including housing prices, to grow on average by 5 per cent per year. This means that the debt-to-income, debt-service-to-income, and loan-to-value ratios for a given nominal debt would on average halve in about 14 years. This is a pretty rapid fall of these ratios and a considerable contribution to any required balance-sheet repair.

X.4. Conclusion

My conclusion is that we should not ask too much from monetary policy. Monetary policy can really at best just stabilize inflation around a given inflation target and resource utilization around its estimated long-run sustainable rate and this way keep average inflation on target and average resource utilization equal to the its long-run sustainable rate. In particular, monetary policy cannot achieve financial stability; a separate financial-stability policy is needed for that. 'Leaning against the wind' is an inherently flawed policy to manage debt problems, since running inflation below credible inflation targets and restricting the growth of nominal incomes will increase the real debt burden and reduce agents' debt-service capacity.

Furthermore, monetary policy and financial-stability policy are distinct and very different policies and normally best conducted independently, but with each policy full informed about and taking into account the conduct of the other. On rare occasions, the monetary policy may pose a threat to financial stability that cannot be contained by the instruments of the financial-stability policy. The authority judging whether such a situation has occurred should be the authority responsible for financial stability. That authority should then warn the monetary policy authority about the threat. This clarifies the responsibility and makes it possible to hold each authority accountable. Monetary policy should only be the very last line of defense of financial stability and therefore only very rarely be used for that purpose. Also in such cases, the use of monetary policy is justified only if the expected benefits exceed the costs.

Normally, the best contribution of monetary policy to financial stability is just to stabilize inflation around the inflation target and resource utilization around its long-run sustainable rate and this way contribute to a healthy and sustainable growth of nominal GDP, disposable incomes, and asset prices.

Note:

1 This section builds on Svensson (2014).

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