Optimal Design for Monetary Policy in the Post-Crisis Period

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Optimal design for monetary policy in the post-crisis period

1. Do forecast targeting (Bernanke’s blog, Svensson 2011 Handbook chapter)
2. Do not lean against the wind unless supported by thorough cost-benefit analysis (IMF Staff paper 2015, Svensson WP 2015)
3. Conduct monetary policy (MP) and financial-stability policy (FSP) separately, like monetary and fiscal policies (Kohn and Svensson 2015 papers for recent Boston Fed conference)
1. Do forecast targeting

- Choose policy rate and policy-rate path so that (mean) forecasts for the target variables (inflation and unemployment) best achieve the goals of MP (price stability and maximum sustainable employment)
- The goals should be symmetric, not ceilings or floors (quadratic loss function)
- The policy rate is an instrument, not a target variable
- If inflation forecast below (above) inflation target and/or unemployment forecast above (below) long-run sustainable rate, lower (raise) policy rate and policy-rate path
- “Filter information through forecasts,” that is, respond to all information that shifts the forecasts of the target variables
- “Forecast-targeting rule,” very different from Taylor rule

2. Do not lean against the wind unless supported by thorough cost-benefit analysis

- Leaning against the wind for financial stability purposes strongly promoted by BIS
- Skepticism against leaning elsewhere (Bernanke, Evans, Williams, IMF…), but debate continues
- Costs of higher policy rate: Lower inflation, higher unemployment, both if no crisis and if crisis occurs
- Possible benefit: Lower real debt growth and lower crisis probability (Schularick and Taylor 2012)
- Costs in most (or all) cases much higher than benefits (Svensson 2015, IMF 2015)
- Somewhat surprisingly, less effective macroprudential policy with larger probability and severity of crisis may increase costs of leaning more than benefits
- Any leaning against the wind should be supported by thorough cost-benefit analysis
Simple example: Quadratic loss (squared unemployment gap); Cost, benefit, and net cost of policy-rate increase

- Cost exceeds benefit by substantial margin
- Higher initial crisis probability and/or higher crisis unemployment gap (because of less effective macroprudential policy) increase cost more than benefit; makes case against leaning against the wind even stronger


Marginal cost, marginal benefit, and net marginal cost of increasing the policy rate 1 pp qtr 1-4; Quadratic loss

3. Conduct monetary policy (MP) and financial-stability policy (FSP) separately

- MP and FSP very different
  - Different goals: Price stability and full employment vs. “financial stability”
    “Financial stability”: Financial system fulfilling 3 main functions (submitting payments, transforming saving into financing, allowing risk management/sharing) w/ sufficient resilience to disturbances that threaten those functions
  - Different instruments: Policy rate and communication vs. regulation, supervision, stress tests, communication…
  - Different responsible authorities: Central bank vs. central bank, FSA, Treasury, other authorities (varies across economies)

- MP should not have a financial stability as a goal
  - Economic policies should only have goals that they can achieve
  - Monetary policy can stabilize inflation around an inflation target and resource utilization around its estimated long-run rate (thus suitable goals)
  - Monetary policy cannot achieve financial stability
  - There is no way monetary policy can achieve sufficient resilience of the financial system
  - Leaning against the wind? Existing empirical and theoretical evidence says costs higher than benefits
  - Effect of policy rate on probability and/or severity of crisis too small
3. Conduct monetary policy (MP) and financial-stability policy (FSP) separately

- **Jeremy Stein (2013):**
  
  “[W]hile monetary policy may not be quite the right tool for the job, it has one important advantage relative to supervision and regulation – namely that [the interest rate] gets in all of the cracks.”

- But empirical evidence indicates that a modest policy-rate increase will barely cover the bottom of those tracks

- To fill the cracks, the policy rate would have to be increased so much that it would kill the economy

- **Strong case for separate decision-making bodies w/ separate goals and instruments but full info about conduct of each other’s policy**

- MP much more effective in achieving MP goals; FSP much more effective in achieving financial stability

- Accountability and efficiency justifies all FSP instruments in one authority

- Two clean but different models: UK and Sweden

  - UK: Same institution, different committees (Kohn 2015)

  - Sweden: Riksbank monetary policy, no FSP instruments; FSA has FSP, all FSP instruments; Financial Stability Council (MoF, FSA, NDO) (Svensson 2015 Boston)
Optimal design for monetary policy in the post-crisis period: Conclusion

1. Do forecast targeting
2. Do not lean against the wind for financial stability purposes unless supported by thorough cost-benefit analysis
3. Conduct monetary policy and financial-stability policy separately, with separate decision-making bodies, also when conducted by same institution