More on the relation between monetary policy and financial-stability policy

Lars E O Svensson
Sveriges Riksbank

www.larseosvensson.net

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Central-banking challenges for the Riksbank – monetary policy, financial-stability policy, and asset management

Lars E O Svensson
Sveriges Riksbank

www.larseosvensson.net

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Outline: Three challenges

- Three core central-banking functions: monetary policy, financial-stability policy, and asset management
- Three challenges:
- Make sure that MP becomes transparent, consistent and clearly focused on stabilizing inflation and resource utilization (unemployment)
- Avoid conceptual and practical confusion between MP and financial-stability policy (macroprudential policy)
- Manage assets efficiently and eliminate unnecessary risks: Eliminate large currency risk

Conclusions on challenges: Monetary policy

- Do not treat the policy rate as an additional target variable. Do not "normalize" policy rate.
- Do not treat housing prices and household debt as additional target variables
- Focus on stabilizing inflation around target and unemployment around long-run sustainable rate, nothing else
- Else poorer outcome for inflation and unemployment, less transparency, more difficult to hold Riksbank accountable

Conclusions on challenges: Financial-stability policy

- Do not confuse monetary policy and financial-stability policy
- They are distinct and separate policies (objectives, instruments, responsible authorities)
- Conduct MP taking the conduct of FSP into account, and vice versa
- Nash equilibrium rather than coordinated equilibrium
- Like MP and fiscal policy
- Else risk for worse outcome for both, and more difficult to hold policymakers accountable

Conclusions on challenges: Asset management

- Manage assets efficiently, good risk-adjusted rate of return
- Avoid unnecessary risks
- Eliminate large unnecessary currency risk
- Opportunity cost of not eliminating the currency risk is large (SEK 2.8 bn per year, or
  extra capital requirement of SEK 43 bn)

Financial-stability policy: Do not confuse MP and FSP

- Distinguish economic policies according to
  - Objectives
  - Instruments
  - Authorities controlling instruments and responsible for achieving objectives

Monetary policy

- Objective
  - Flexible inflation targeting:
    Stabilize inflation around inflation target *and* resource utilization around sustainable 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 maintains main functions with resilience to disturbances)
- Instruments:
  - Normal: Supervision, regulation, FS reports
  - Crisis: Lending of last resort, variable-rate lending longer maturities (credit easing), guarantees, bank resolution, capital injections, asset purchases,…
- Authorityies:
  - FSA, CB, SNDO, MoF, …(varies across countries)

MP and FSP distinct and different

- Interaction
  - FSP affects inflation and resource utilization via financial markets and transmission mechanisms (spreads, lending)
  - MP affects resource utilization, credit losses, asset prices, balance sheets, leverage

MP and FSP distinct and different

- Policy rate blunt and ineffective instrument for financial stability – other instruments better
- Conduct MP and FSP independently, taking the conduct of the other into account (even if by CB)
- Similar to MP and fiscal policy
- Nash equilibrium rather than coordinate equilibrium

Woodford, Riksbank Economic Review

- Assume “leverage” is increasing in output gap
- Assume probability of financial crisis is increasing in leverage
- Then “leaning against the wind”, that is, tighter monetary policy, reduces the probability of a financial crisis

Svensson comment, Riksbank Economic Review

- There are existing instruments, such as bank capital requirements and mortgage loan-to-value ceilings with more direct effect on "leverage" than the policy rate and with less collateral damage
- Then set capital requirement and LTV so as to keep probability of financial crisis sufficiently low
- Then set policy rate so as to stabilize inflation and output gap
- That is, conduct financial-stability policy and monetary policy separately, Nash equilibrium