



Monetary Policy and Financial-Stability Policy

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Introduction

- Distinction between monetary policy (MP) and financial-stability policy (FSP)
- Financial stability (FS) as additional objective for *monetary policy* makes little sense (makes sense as objective for *central bank*)
- FS may imply restriction on MP (rare event)
- Mean squared gaps in MP: Another step towards increased transparency
- Flexible inflation targeting is fine: before, during and after the crisis

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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

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Monetary policy

- **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

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Financial-stability policy

- **Objective:** Financial stability (financial system fulfils main functions w/o any disturbances with significant social costs)
- **Instruments**
 - Normal: Supervision, regulation (policy rate blunt and unsuitable)
 - Crisis: Lending of last resort, variable-rate lending, liquidity policy (credit easing), guarantees, bank resolution, capital injection, ...
- **Authority(ies)**
 - FSA, CB, treasury, ... (varies across countries)
 - Sweden: FSA (regulation, supervision), Debt Office (bank resolution, guarantees), RB (lending of last resort)

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MP and FSP different and distinct

- **Interaction**
 - FSP affects inflation and resource utilization via financial markets and transmission mechanism (spreads, lending)
 - MP affects activity, asset prices, balance sheets
 - Cf. interaction MP and fiscal policy
- Responsible authority(ies) for FSP open question (CB for macroprudential regulation?)
- Distinction and difference to be taken into account
- FS as objective for *MP* makes little sense (objective for *CB* makes sense)

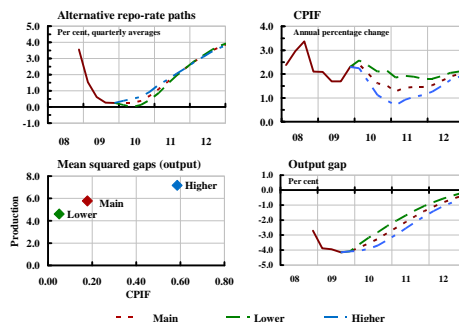
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Monetary Policy

- Choose policy-rate path so as to best stabilize forecast of inflation and resource utilization (or reasonable compromise)
- Incorporate effect of financial conditions in forecast of inflation and resource utilization
- If policy-rate path would threaten financial stability, compromise (rare event)
 - Restriction could imply lower or higher policy rate

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Monetary policy alternatives, Riksbank, February 2010



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Mean squared gaps: Another step towards increased transparency

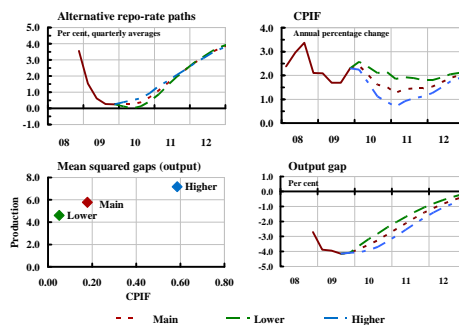
- Measure stability of inflation around target and resource utilization around normal level

$$\frac{1}{T+1} \sum_{\tau=0}^T (\pi_{t+\tau,t} - \pi^*)^2, \quad \frac{1}{T+1} \sum_{\tau=0}^T (y_{t+\tau,t} - \bar{y}_{t+\tau,t})^2$$
- Intertemporal forecast loss function ($\delta = 1$)

$$L_t = \sum_{\tau=0}^{\infty} \delta^{\tau} (\pi_{t+\tau,t} - \pi^*)^2 + \lambda \sum_{\tau=0}^{\infty} \delta^{\tau} (y_{t+\tau,t} - \bar{y}_{t+\tau,t})^2$$
- Verify whether policy is
 - Efficient
 - Reasonable compromise
 - Consistent over time

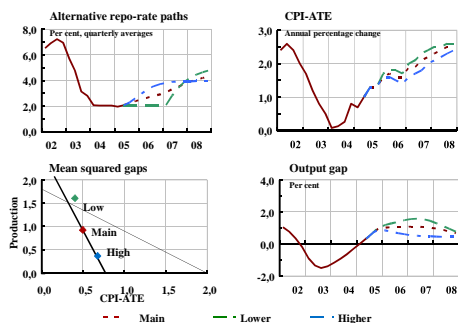
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Normally tradeoff Norges Bank, March 2005



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Crisis not caused by easy MP

(speeches Amsterdam, Mumbai)

- Main causes (Bean 09): macro conditions, distorted incentives, lax regulation and supervision, housing policy, information problems (BIS 09)
- Easy MP not leading indicator of crises (IMF WEO 09)
- US MP 2001– appropriate ex ante (deflation risk)
- Higher policy rates little or no effect on FS and house prices (Bernanke, Kohn)

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Lessons for monetary policy



- Price stability not enough to achieve financial stability
- Interest rates not enough to achieve financial stability
- No reason to permanently raise inflation target (Blanchard et al.): If ZLB binding, temporary overshoot inflation target, price-level target
- Financial conditions and asset prices remain indicators, not targets: Incorporate effects in forecasts of inflation and resource utilization

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Summary



- Distinguish between monetary policy and financial-stability policy
- Financial stability as additional objective for *monetary policy* makes little sense (makes sense as objective for *central bank*)
- Financial stability may imply restriction on MP (rare event)
- Mean squared gaps in MP: Another step towards increased transparency
- Flexible inflation targeting fine before, during, and after the crisis

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