Financial Stability and Monetary Policy

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My own views; not necessarily shared by anyone else at the Riksbank.

Outline

- How should systemic risk/financial stability be included in the monetary-policy reaction function?
- Should financial stability be an objective for monetary policy?
- Specify monetary policy and financial-stability/macro-prudential policy
- When using monetary policy for financial-stability purposes, *very* unfavorable tradeoff
- Is amplification of systemic risk a problem? What tools are necessary?
- What should financial-stability policy do, and what should monetary policy do?

[How] should systemic risk be included in the monetary policy reaction function?

- The question needs to be modified
- Monetary policy (MP): Need to specify the mandate, and targets, indicators (information variables), instruments
- **Mandate** of MP (flexible inflation targeting): Price stability and maximum sustainable employment (minimum sustainable unemployment) [Systemic risk/financial instability (FS)??]
- **Targets** of flexible inflation targeting: Inflation and unemployment gap

[How] should systemic risk be included in the monetary policy reaction function?

- **Targets** of flexible inflation targeting: Inflation and unemployment gap.
- **Reaction function** of MP: How MP instruments (policy rate, communication,…) respond to information variables (determinants/indicators of forecasts of inflation and unemployment)
- MP should respond to FS *if* indicators of FS are also information variables for MP; that is, affect forecast of inflation and unemployment (through transmission mechanism, spreads, confidence, …)

Should financial stability be an objective of monetary policy?

- FS should be an objective of **financial-stability/macro-prudential policy** (FSP/MPP), **not** of MP
- **Definition** of FS: The financial system can fulfill its three main functions (payments, saving→financing, risk management) and has sufficient **resilience** to disturbances that threaten these functions
- FSP/MPP and MP distinct and different: Different objectives, different indicators, different suitable instruments, and (in many countries) different responsible authorities
- FS objective of MP only in 2nd/3rd-best situation, when no suitable FSP/MPP instruments are available
- "MP should be the *last* line of defense of FS, not the *first*"

When using MP to affect FS, *very* unfavorable tradeoff

- **Example**, Sweden: Housing prices, household debt and MP (Riksbank "Risks in the Swedish Housing Market" 2011, Assenmacher-Wesche and Gerlach 2010, other research)
- Use MP to prevent **10** percent increase in housing prices
- Requires higher policy rate by 2-3 percentage points (pp)
- Leads to lower GDP by **6** percent
- Leads to higher unemployment by **3** pp (Okun coeffient 2)
- Leads to lower inflation by 1-2 pp
- **Better use other instruments**: Loan-to-value ceilings, property taxes, mortgage rate deductions, risk weights/capital requirements on mortgages for banks, countercyclical buffers…

Is amplification of systemic risk a problem? What tools are necessary?

- The financial system **may** amplify the business cycle by increasing leverage and taking on too much risk in booms and having too small buffers coming into a downturn
- Data? Analysis? Evidence of amplification? Evidence on bank credit channel, financial accelerator, leverage, risk-taking?
- Depends on characteristics of financial system?
  - Commercial vs. investment banking?
  - Oligopoly w/ cozy profits (Canada, Sweden, Australia) vs. cut-throat competition w/ risk-taking competitors?
  - Effective regulation or not, binding capital requirements or not?

What should financial-stability policy do?

- Watch indicators (leverage, …), evaluate **sustainability** and **resilience**
- Credit growth/gaps not sufficient statistics (good or bad credit depends on whether matched by good or bad assets)
- Act if necessary (cyclical capital buffers, other macro-prudential instruments, automatic stabilizers)

What should monetary policy do?

- Contribute to financial stability by stabilizing business cycle and inflation, preventing excessive booms (overheating) and recessions
- Low policy rates are not a problem in themselves
- If low policy rates lead to overheating, there is a problem (namely overheating!)
- As noted above, MP should be last line of defense, if lack of or very imperfect FSP, not the first line of defense
- But remember, *very* unfavorable tradeoff