

Discussion of
Lars Svensson, “Monetary Policy and
Macroprudential Policy: Different and
Separate”

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Paper's Two Main Points

1. Monetary policy should almost never be used to contain threats to financial stability and so should not have a financial stability goal
2. Monetary policy and macroprudential policies should be conducted by separate entities and not be coordinated

Overview of Paper

- Paper is an important contribution to the debate on what role monetary policy should play in promoting financial stability
- Although I am very sympathetic to his view that there is a danger on having monetary policy focus on financial stability, Svensson two points go too far

Should Monetary Policy Be Used to Contain Threats to Financial Stability?

- Main argument against is that it violates Tinbergen principle which implies that monetary policy should be used to stabilize economy while macroprudential policies should stabilize financial system
 - Macroprudential tools more effective at reducing market failures, the source of financial instability
 - Monetary policy more effective at stabilizing the economy and inflation

Should Monetary Policy Be Used to Contain Threats to Financial Stability?

- But macroprudential policies may not be effective and so monetary policy may be only tool available
 - Why? Because prudential policies affect bottom line of financial firms more directly, so engage in:
 - “loophole mining” to avoid regulations
 - lobbying to weaken regulations

Should Monetary Policy Be Used to Contain Threats to Financial Stability

- Svensson objection: monetary policy is ineffective at leaning against excessive risk taking
- However, evidence relating to risk-taking channel of monetary policy suggest that raising interest rates can help restrain lending growth and excessive risk taking
- If central bank commits to keep on raising rates with increased risk-taking, expectations that rates will rise further as long as it continues means that rates may not have to rise as much
 - Reserve Bank of Australia: 2002-2004

Should Monetary Policy Be Used to Contain Threats to Financial Stability?

- Nonetheless, Svensson is right that there is danger from monetary policy focus on financial stability
- Wrong to focus on asset-price bubbles per se
 - Riksbank example: Focus on housing prices led it to tighten inappropriately

Giavazzi and Mishkin (2006) warned about this and Svensson rightfully dissented against this policy

Should Monetary Policy Be Used to Contain Threats to Financial Stability?

- Focus should not be on asset-price bubbles, but rather on excessive credit
- Tradeoff between containing excessive credit and deviating from output and inflation stabilization requires careful cost-benefit analysis, as Svensson states

Should Monetary Policy Be Used to Contain Threats to Financial Stability?

- Low interest rates do not necessarily imply excessive risk taking
 - Important issue for Fed right now: not at all clear that zero fed funds rate is promoting excessive risk
- Need to monitor credit markets to assess if it is taking place:
 - credit spreads
 - credit growth
 - underwriting standards
- Should be part of any cost-benefit analysis

Should Monetary Policy Be Used to Contain Threats to Financial Stability?

- Rigorous cost-benefit analysis will help to avoid mistakes
 - Svensson is right that this would have helped promote better policy at Riksbank
 - Since 2010 outside commentators and even some FOMC voters have *mistakenly* called for the Fed to raise rates to contain financial imbalances

Should Monetary Policy and Macroprudential Policy Be Separated?

- Svensson has valid argument that having monetary policy and macroprudential policy done by separate entities makes them more accountable

Should Monetary Policy and Macroprudential Policy Be Separated?

- However, political economy argument suggests having central bank do both
 - Political pressures on prudential regulators is more intense than on central banks because regulators actions hurt bottom line directly
 - Independence of central banks may make it easier for them to tighten macropru regulations when needed
 - separate macropru authority may not communicate well with central bank, either because of turf battles or because it is politically influenced, interfering with a good Nash equilibrium

Concluding Remarks

- In terms of where we are now, Svensson and I would agree that tightening monetary policy because of financial stability concerns is not called for
- However, this will not always be the case and so I argue for a more nuanced view
 - There can be situations where monetary policy should take financial stability concerns into account, but do so with cost-benefit analysis
 - For these situations, not completely separating monetary policy and macroprudential may make sense.