# Monetary Policy and Macroprudential Policy: Different and Separate

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## Questions

- How can different economic policies be distinguished?
- How can monetary and macroprudential policies be distinguished?
- Should monetary policy have a third goal, financial stability?
- Should monetary and macroprudential policies be conducted separately or coordinated?
- Should they be conducted by the same or different authorities?
- What if monetary policy would pose a threat to financial stability?
- Should monetary policy ever “lean against the wind”?

## **Questions and short answers**

- How can different economic policies be distinguished?
- How can monetary and macroprudential policies be distinguished? They are very different
- Should monetary policy have a third goal, financial stability? **No**
- Should monetary and macroprudential policies be conducted separately or coordinated? Normally separately
- Should they be conducted by the same or different authorities? Separate decision-making bodies essential
- What if monetary policy would pose a threat to financial stability? BoE model: Macroprudential authority judges and warns
- Should monetary policy ever “lean against the wind”? Only after thorough cost-benefit analysis

## How can different economic polices be distinguished?

- Goals, instruments, responsible authorities
- Example: Fiscal policy and monetary policy
- Different goals, different instruments, different authorities
- Considerable interaction
  - Fiscal policy affects inflation and real activity
  - Monetary policy affects government revenues and expenditures
- Conducted separately, not coordinated, Nash equilibrium
- Is the relation between monetary and macroprudential policies any different?

# How can monetary and macroprudential policies be distinguished?

## Monetary policy

- Goals
  - Price stability and real stability
  - Stabilize inflation around inflation target and unemployment around its long-run sustainable rate
- Instruments
  - Normal times: Policy rate and communication (forecasts, forward guidance, …)
  - Crisis times: Unconventional measures, balance sheet policies (QE), FX policy (interventions, currency floors) …
- Authority: Central bank

## Macroprudential policy

- Goal
  - **Financial stability**
  - Definition: 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
- Instruments
  - Normal times: Supervision, regulation, communication, stress tests …
- Authority(ies)
  - Varies across countries: FSA(s), CB, Treasury, …

## How can monetary and macroprudential policies be distinguished?

- Clearly quite different and distinct polices
- But how closely related?
- Should they really have different goals?

# Should monetary policy have a third goal, financial stability?

- Answer: No
- 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

# Should monetary policy have a third goal, financial stability?

- 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

## Should monetary policy have a third goal, financial stability?

- But there is interaction between the two policies!
- Macroprudential policy affects financial sector, lending, and housing demand and indirectly, but not systematically, inflation and real activity
- Monetary policy affects interest rates, inflation, activity, profits, debt service, balance sheets, leverage and indirectly, but not systematically, financial stability
- Argument for conducting each under full information about the other, but not for sharing goals or explicit coordination
- As for fiscal and monetary policies

## Should monetary policy and macroprudential policies be conducted separately or coordinated?

- In normal times: Conducted separately, also when conducted by the same authority
  - But each policy should be fully informed about the conduct and impact of the other policy and take that into account
  - Nash equilibrium rather than coordinated equilibrium (joint optimization)
  - MP more efficient in achieving price and real stability
  - MaPP more efficient in achieving financial stability (Bean 2014)
- In crisis times: Full cooperation and coordination of policies by FSA, CB, MoF, bank-resolution authority, …

## Should monetary policy and macroprudential policies be conducted by the same authority or different ones?

- Separate decision-making bodies w/ separate goals and instruments
- Accountability and efficiency justifies all macropru instruments in one authority
- Two clean models: UK and Sweden

# Swedish model

- Gov’t Aug 2013: New strengthened framework for financial stability
- Swedish FSA
  - Main responsibility for financial stability
  - All macro- and microprudential instruments
  - Boundary between macro- and microprudential policy unclear, especially in Sweden (oligopoly of 4 banks dominate financial sector)
  - Efficiency and accountability: Micro- and macropru together, in one authority
  - But legal authority remain to be fixed
- Riksbank
  - No macroprudential instruments
- Financial Stability Council
  - Members: MoF (chair), FSA, NDO (bank resolution authority), RB
  - Forum for discussion and exchange of information, not decisions
  - Published minutes, reports from workgroups
  - FSC will lead crisis management in crisis

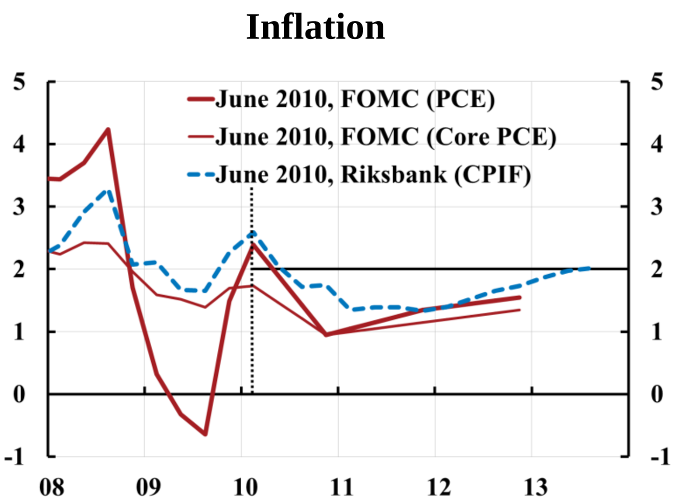
## What if monetary policy would pose a threat to financial stability?

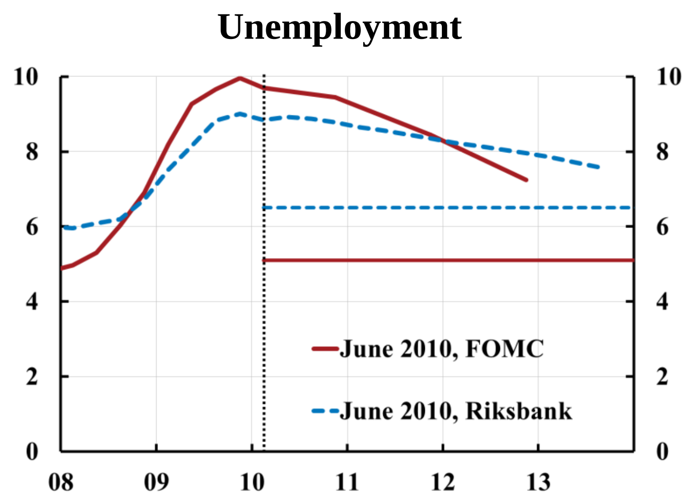
- BoE model, Aug 2013, forward-guidance promise
- 3rd knockout: FPC would judge that MP poses a significant threat to financial stability that it cannot contain with its instruments
- It should be the macroprudential authority, not the monetary policy one, to make judgment and to warn the
- Monetary policy authority may then adjust monetary policy or not
- Effectively "comply or explain"
- Preserves independence of monetary policy

# Should monetary policy ever lean against the wind for financial-stability purposes

- Leaning against the wind for financial stability purposes strongly promoted by BIS
- Skepticism against leaning elsewhere (Bernanke, Evans, Williams), but debate continues
- Sweden a case study: Quite aggressive leaning since summer 2010, because of concerns about household debt
- Not supported by any analysis of policy-rate effect on household debt; estimates at the time indicated high costs and small effects on debt
- Outcome now: Zero or negative inflation, very high unemployment, most likely higher real debt, negative policy rate
- Costs and benefits of Riksbank leaning?

# Fed and Riksbank forecasts June 2010

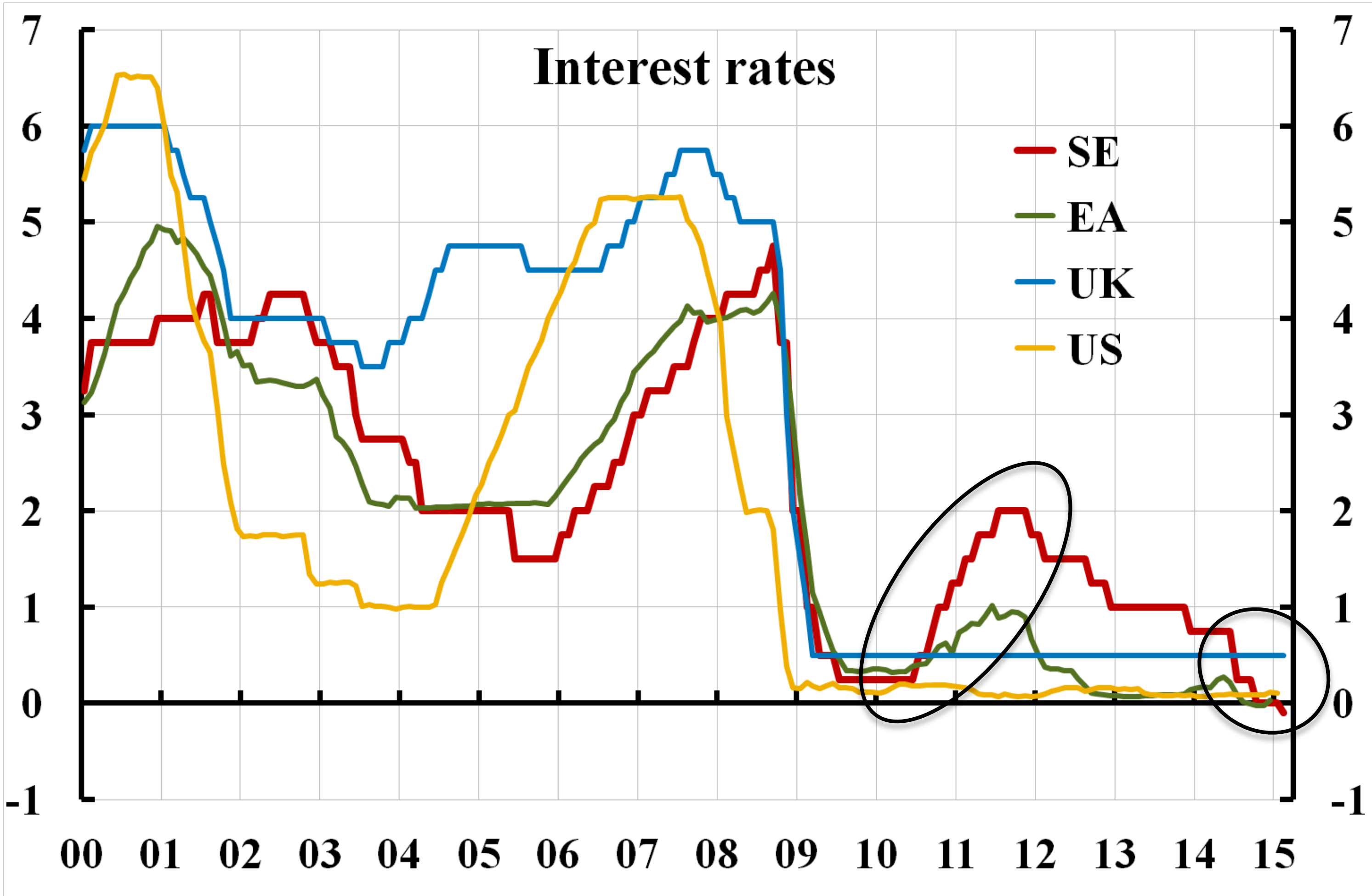


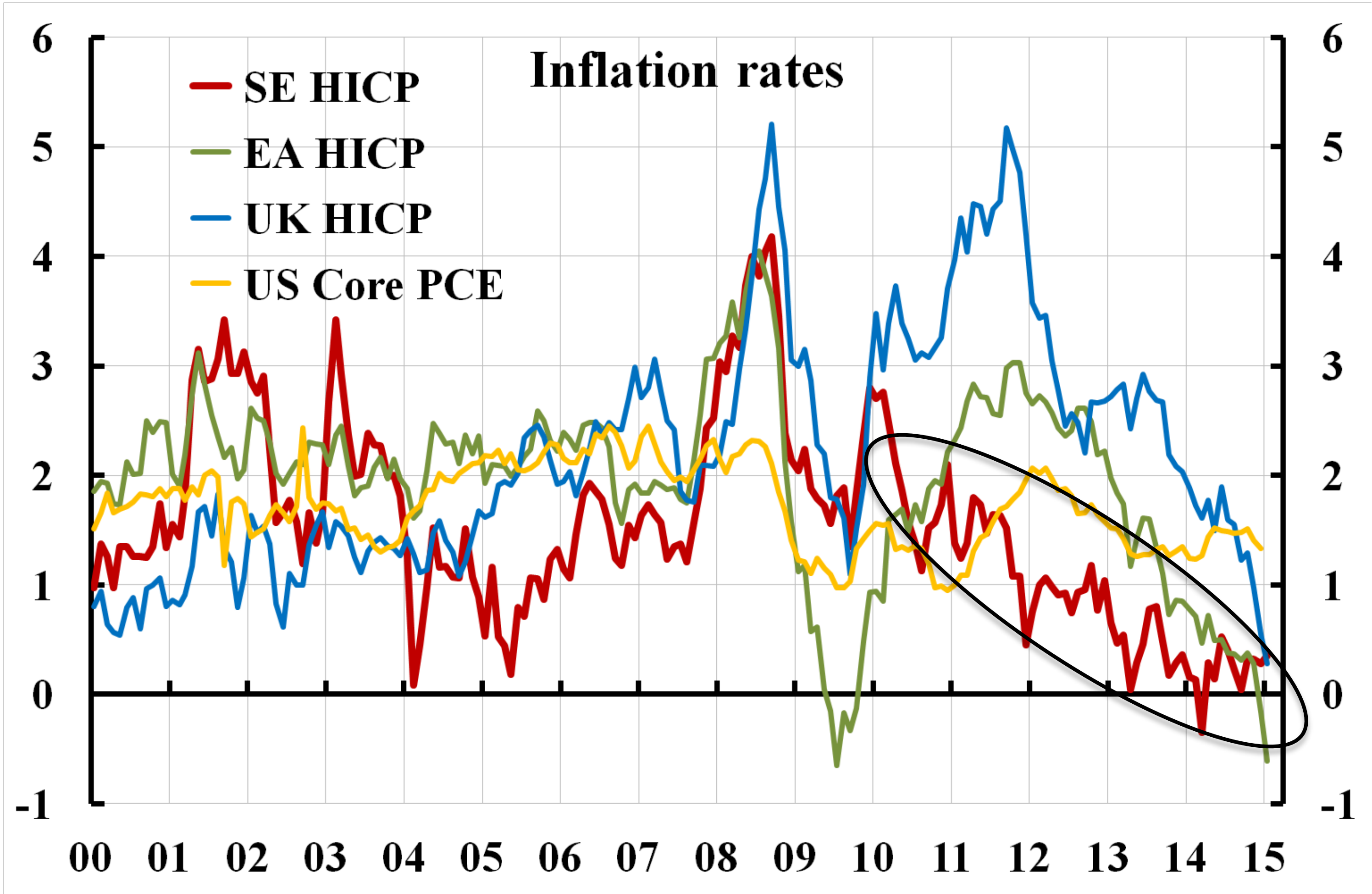

- Riksbank and Fed forecasts quite similar
- Policies very different
  - Fed: Continue to keep policy rate between 0 and 0.25%, forward guidance, prepare QE2
  - Riksbank: Start raising the policy rate from 0.25 to 2% in July 2011
  - Imagine if it had been the other way around?

Source: Svensson, Lars E.O. (2011), "Practical Monetary Policy: Examples from Sweden and the United," *Brookings Papers on Economic Activity*, Fall 2011, 289-332.

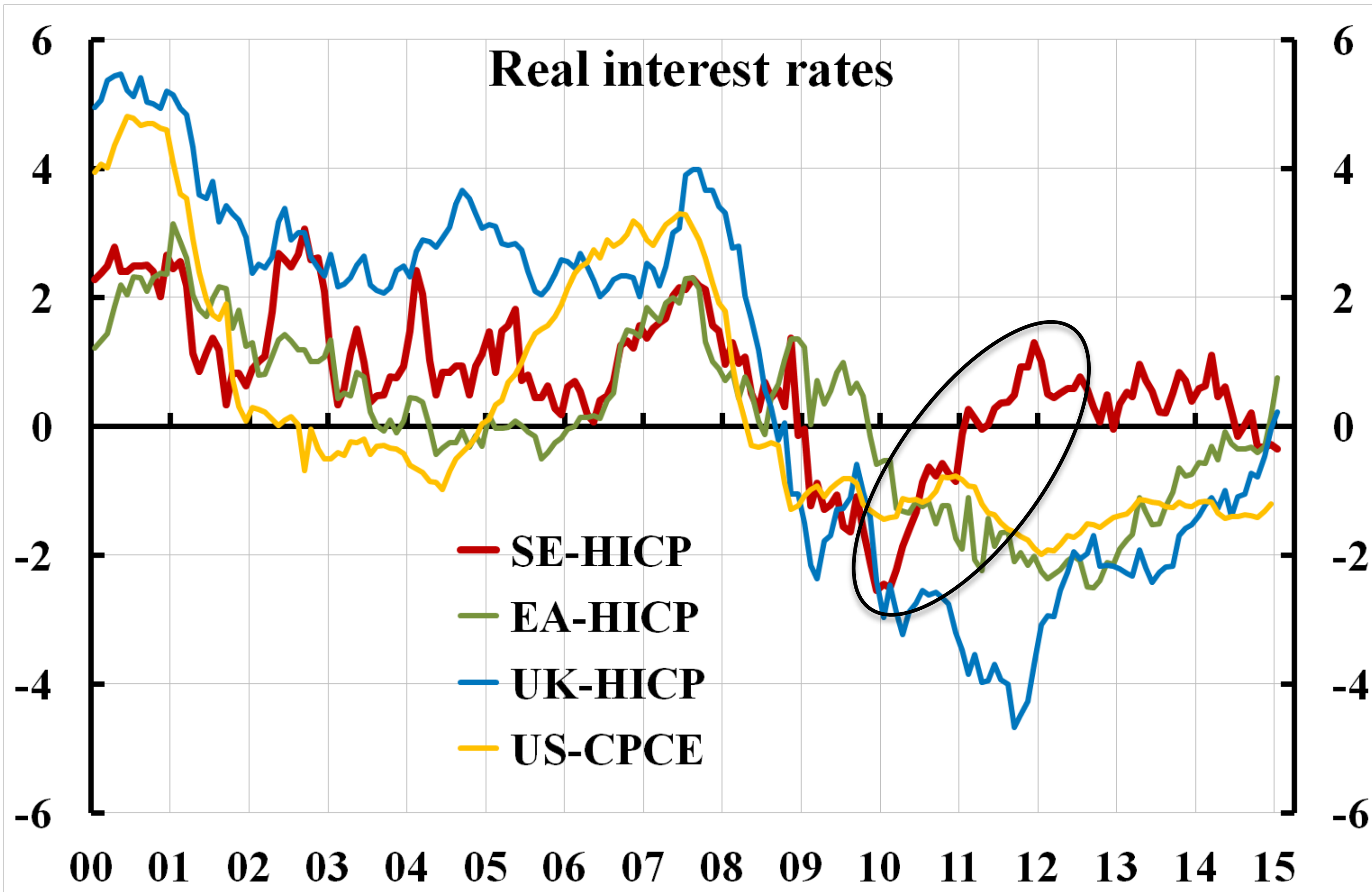
# The leaning: Policy rates in Sweden, UK, and US; Eonia rate in euro area



# The leaning: Inflation in Sweden, euro area, UK, and US



# The leaning: Real policy rate in Sweden, UK, and US, real Eonia rate in euro area



## Cost-benefit analysis of leaning against the wind?

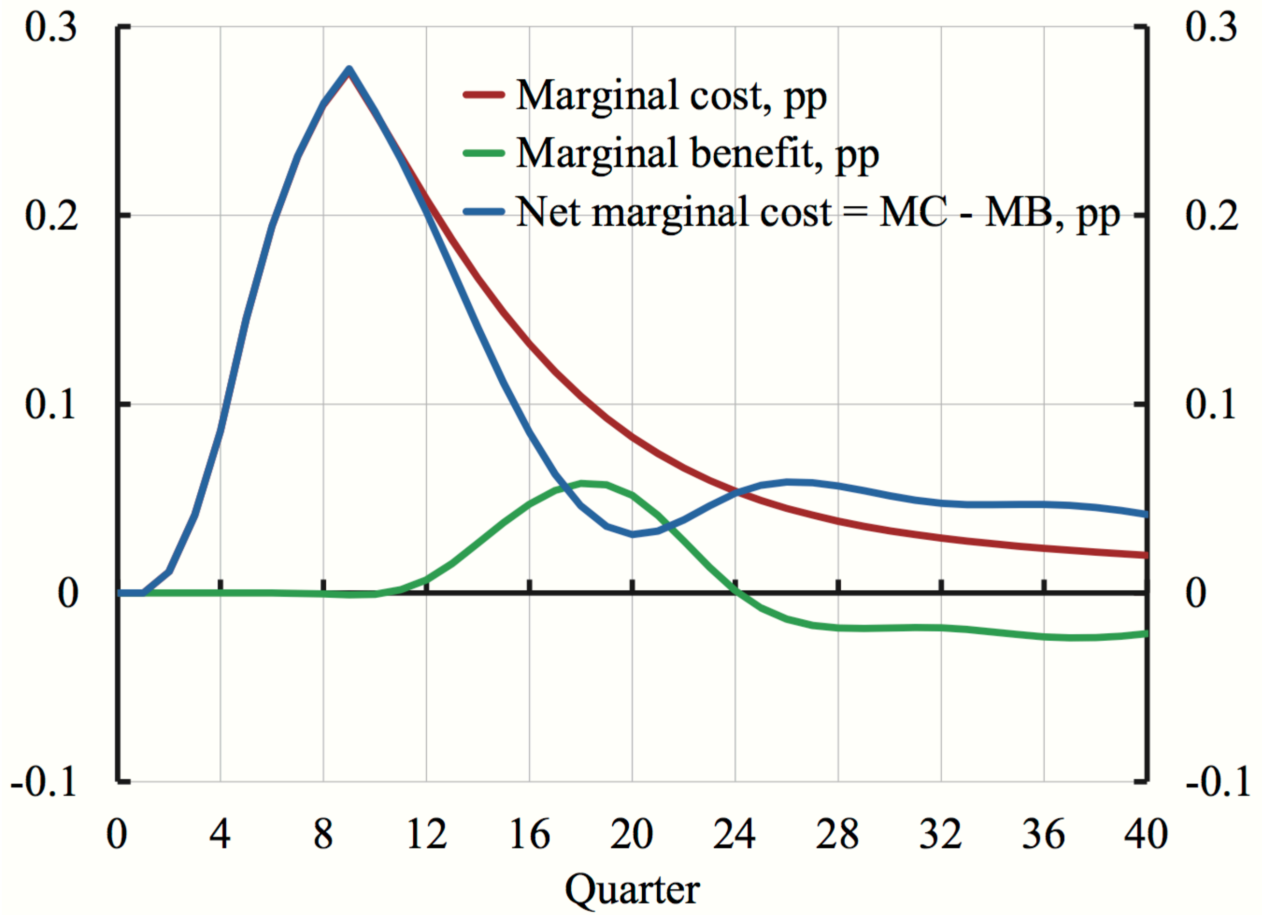
- Costs of higher policy rate: Lower inflation, higher unemployment, both if no crisis *and* if crisis occurs
- Possible benefit: Lower real debt growth and lower crisis probability (Shularick and Taylor 2012)
- Costs in most cases much higher than benefits (Svensson, IMF Staff Paper)
- Somewhat surprisingly, 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

# Example: Marginal cost, marginal benefit, and net marginal cost of increasing the policy rate; Quadratic loss

| **Cost** | No crisis | | | Crisis | | | | **MC** |
|---|---|---|---|---|---|---|---|---|
| | Prob. | Ugap | Loss | Prob. | Ugap | Loss | Loss incr. | |
| Initial situation | 94% | 0 pp | 0 | 6% | 5 pp | 25 | 25 | |
| Rate +1 pp | 94.1% | 0.5 pp | 0.25 | 5.9% | 5.5 pp | 30.25 | 30 | |
| Change | 0.1% | | 0.25 | -0.1 pp | | 5.25 | | |
| Prob. weighted loss increase | | | 0.23 | | | 0.31 | | **0.54** |
| **Benefit** | | | | Crisis prob. decrease | | | Loss incr | **MB** |
| Crisis prob. decr. x Crisis loss incr. | | | | 0.1 pp | | | 30 | **0.03** |
| **Net Cost** | | | | | | | | **NMC** |
| | | | | | | | | **0.51** |

Simplified example from Svensson (2015), "Cost-Benefit Analysis of Leaning Against the Wind: Are Costs *Always* Larger Than Benefits, and Even More So with a Less Effective Macroprudential Policy," working paper.

# Marginal cost, marginal benefit, and net marginal cost of increasing the policy rate; Quadratic loss

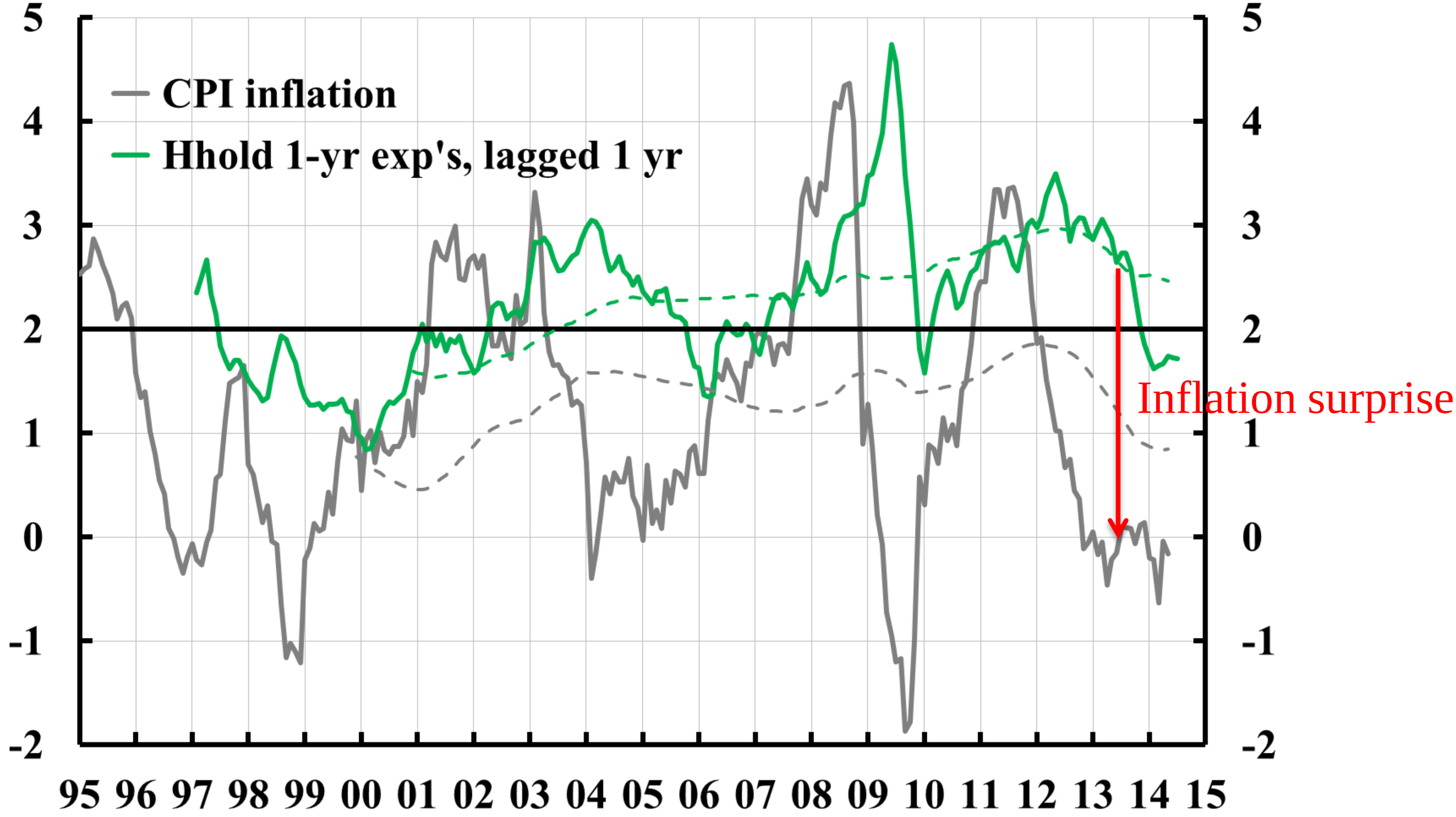



Source: Svensson (2015), "Cost-Benefit Analysis of Leaning Against the Wind: Are Costs *Always* Larger Than Benefits, and Even More So with a Less Effective Macroprudential Policy," working paper.

# Conclusions

- Do not ask too much of monetary policy; it cannot achieve financial stability. It should not have financial stability as a goal
- Monetary and macroprudential policies: Very different policies, with different goals and instriuments
- Considerable interaction, but not systematic
- Efficiency and accountability considerations support that the two policies are normally best conducted separately, with separate decision-making bodies, but with full information about each other (like monetary and fiscal policies)
- UK and Sweden: Two alternative clean models that should work well
- If monetary policy would pose a threat to financial stability? BoE: Macroprudential authority judges and warns, monetary-policy authority decides whether to act (effectively "comply or explain")
- At current state of knowledge, little or no support for leaning against the wind for financial stability purposes. Any such leaning only if justified by a thorough cost-benefit analysis. Burden of proof should be on the advocates of leaning.

# Additional cost: Inflation below household's expectations has increased household real debt burden




Note: Dashed lines are 5-year trailing moving averages