

Monetary Policy after the Financial Crisis

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Outline

- The causes of the financial crisis and the role of monetary policy
- Lessons for monetary policy
- The relation between monetary policy (MP) and financial-stability policy (FSP)

The financial crisis was not caused by monetary policy

Main causes of the crisis:

- *Macro conditions*: Global imbalances, global saving glut and investment shortage, low world interest rates, underestimation of risks, very low risk premia
- *Distorted incentives to excessive leverage and lack of due diligence*: lax regulation and supervision, securitization, myopic and asymmetric remuneration contracts
- *Information problems*: Hidden risk in complex securities, underestimation of correlated systemic risks
- These causes had little or nothing to do with monetary policy!

The financial crisis was not caused by monetary policy

- Loose Fed policy after 2001 justified by fear of Japanese-style deflation and liquidity trap
- Modest effects of policy rates on house prices and credit growth; substantially higher interest rates needed to stop house prices: recession, deflation and eventually liquidity trap?
- No impact on problems of distorted incentives, reg and sup, information

Lessons for monetary policy?

- Price stability not enough to achieve financial stability
- Interest rate not enough to achieve financial stability:
Separate financial-stability policy needed
- Let financial conditions and asset prices remain indicators, not targets, of monetary policy:
Incorporate effects in forecasts of inflation and resource utilization at any horizon

Lessons for monetary policy?

- Flexible inflation targeting, "forecast targeting":
Set policy rate path so forecast of inflation and RU best stabilizes inflation and RU, using all relevant info, including financial conditions
- In 2nd best situation w/ imperfect financial-stability policy, *if* policy-rate path affects financial stability, take into account (probably very rare event)
- Normally policy-rate negligible impact on financial stability and strong impact on inflation and RU (unfavorable tradeoff!)

Relation monetary policy and financial-stability policy?



- Distinguish economic policies according to
 - Objectives
 - Instruments
 - Authority(ies) controlling instruments and responsible for achieving objectives
- Fiscal policy and monetary policy distinct and different, but interaction
- Financial-stability policy and monetary policy distinct and different, but interaction

Monetary policy (MP)

- Objective
 - Flexible inflation targeting:
Stabilise inflation around inflation target *and* resource utilisation 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

Financial-stability policy (FSP)

- Objective
 - Financial stability (financial system fulfills main functions w/o disturbances with significant social costs)
- 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,...
- Authority(ies): FSA, CB, MoF, ...(varies across countries). Good case for CB for macroprudential supervision and regulation

MP and FSP different and distinct

- Interaction
 - FSP affects inflation and resource utilisation via financial markets and transmission mechanisms (spreads, lending)
 - MP affects resource utilisation, asset prices, balance sheets, leverage, credit losses
- Distinction and difference to be taken into account

Conclusions

- Flexible inflation targeting remains best-practice MP (but take financial conditions into account!)
- *If* policy-rate path affects FS, take into account
- MP cannot ensure FS; a separate FSP is required
- FS as additional objective for *monetary policy* makes no sense
- FS as additional objective for *central bank* makes sense, *if* additional instruments
- Conduct MP taking effects of FSP into account
- Conduct FSP taking effects of MP into account