The Relation between Monetary Policy and Financial Policy*

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In the discussion of monetary policy and financial policy, I believe that it is important to conceptually distinguish financial policy from monetary policy. Different economic policies, such as fiscal policy, monetary policy, and labor market policy, can be distinguished according to their objectives, the policy instruments that are suitable for achieving these objectives, and the authority or authorities that control the instruments and are responsible for achieving the objectives. From this point of view, it is clear that monetary policy and financial policy are distinct and different, and understanding this is important.

Monetary policy, in the form of flexible inflation targeting, has the objective of stabilizing both inflation around the inflation target and resource utilization around a sustainable level. Under normal circumstances, the suitable instruments are the policy rate and communication, including the publication of forecasts of inflation, the real economy, and (by some central banks) the policy rate. In times of crisis, as we have seen during the current crisis, other more unconventional instruments can be used, such as fixed-rate lending at longer maturities and adjustment of the size and/or composition of central bank assets (such as quantitative easing or “twist” operations) to affect longer interest rates and expectations of future short rates, and foreign exchange intervention to prevent currency

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appreciation or even to induce currency depreciation. The authority responsible for monetary policy is typically the central bank.

Financial policy has the objective of maintaining and promoting financial stability. Financial stability can be defined as a situation where the financial system can fulfill its main functions (of submitting payments, transforming saving into financing, and providing risk management) with sufficient resilience to disruptions that threaten these functions. Under normal circumstances, the available instruments are supervision, regulation (including capital and liquidity requirements), and financial stability reports with analyses and leading indicators that may provide early warnings of stability threats. In times of crisis, authorities may use instruments such as lending of last resort, variable rate lending at longer maturities (credit policy, credit easing), special resolution regimes for insolvent financial firms, government lending guarantees, government capital injections, and so forth. The responsible authority or authorities vary across countries. In some countries it is the central bank, in other countries there is a separate financial supervisory authority, and sometimes responsibility is shared between different institutions.

The fact that financial policy and monetary policy are distinct and different does not mean that financial policy has no impact on inflation and resource utilization or that monetary policy has no impact on financial stability. Monetary policy affects activity in the real economy, the rate of default among firms, and thereby credit losses on loans to those firms, asset prices, and balance sheets. All else equal, it thereby affects financial stability. Financial policy affects the operation of financial markets and thereby the monetary policy transmission mechanism. Through risk premiums (for credit, liquidity, counterparty, and other risks), it also affects financial conditions, which all else equal have an impact on inflation and resource utilization. This means that monetary policy should be conducted taking financial policy into account, and financial policy should be conducted taking monetary policy into account.

So, financial policy and monetary policy are conceptually distinct, with distinct objectives, distinct suitable instruments, and distinct authorities in control of the instruments and responsible for achieving the objectives. (They are also distinct policies when the same authority, the central bank, is in charge of both policies.) This has to be taken into account when lessons from the crisis are drawn
for the organization of monetary and financial policy and the assigning of instruments and objectives among institutions. For instance, the policy rate is an effective instrument for affecting inflation and resource utilization and hence for achieving the monetary policy objectives. But the policy rate is a blunt and unsuitable instrument for achieving financial stability. It thus makes little sense to assign the objective of financial stability to monetary policy. However, it may make sense to assign the objective of financial stability to the central bank, if the central bank is given control of the supervisory and regulatory instruments that are effective for achieving and maintaining financial stability.

This is similar to the relation between fiscal policy and monetary policy. Fiscal policy has an impact on inflation and the real economy. Monetary policy has an impact on the government’s costs and revenues and thereby on the budget deficit. Still, we have learnt that it is best to let the fiscal policy instruments be directed towards the fiscal policy objectives, taking monetary policy into account, and to let the monetary policy instruments be directed towards the monetary policy objectives, taking fiscal policy into account. More precisely, the equilibrium is a non-cooperative Nash equilibrium rather than a coordinated equilibrium. Similarly, I believe the monetary policy and financial policy should be conducted in line with a non-cooperative Nash equilibrium rather than a coordinated equilibrium. Thus, under normal conditions, financial stability is best handled by financial policy, not by monetary policy. And in a crisis, monetary policy should be used to achieve financial policy objectives only as a last line of defense, that is, only when the financial policy instruments are lacking or insufficient. With steadily improving financial policy frameworks and new financial policy instruments, this last line of defense is less and less likely to be needed.