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Financial Stability and Macroeconomic Policy

Remarks by

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at

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I have been asked to talk about monetary policy and financial stability in today's economic environment.[1] The recent stress in the U.S. banking system has brought these two topics, their interlinkages, and the tools we use to achieve our goals to the forefront of central bank policy and public discourse. In short, although financial stability and monetary policy tools are used independently, they are nevertheless interconnected via their respective effects on the macroeconomy. So let me take a few minutes to discuss this topic in more detail.

Financial stability is essential for monetary policy in the United States to achieve its congressionally mandated goals of maximum employment and price stability. Importantly, stable financial markets and institutions allow changes in the stance of policy to transmit in a smooth and expected way to the financial conditions that households and businesses face in making spending and production decisions. Instability in the financial system, on the other hand, hinders economic activities of households and businesses, which impedes the attainment of our dual mandate. This is in large part why the Federal Reserve monitors financial stability risks—to help ensure that banks, nonbank financial institutions, and financial markets can continue channeling credit to households and businesses.

But this is a two-way street. Financial stability depends on a healthy economy, and all else equal is strengthened by monetary policy actions taken to promote our macroeconomic goals. The U.S. financial system is generally resilient enough to handle large shocks. However, in March, we saw an instance where this wasn't true. A rapid, sizable increase in interest rates resulting from persistently elevated inflation contributed

[1] The views expressed here are my own and are not necessarily those of my colleagues on the Federal Open Market Committee.

to stresses in the banking system that we needed to address using our financial stability tools.

Despite the interconnections between maximum employment, price stability, and financial stability, the tools we use to promote financial stability are separate and distinct from the tools we use to carry out monetary policy. And, I will argue, that separation is appropriate, as each set of tools is fit to its respective purpose.

The set of tools the Federal Reserve uses to address financial stability issues is targeted and surgical. These include bank supervisory and regulatory tools that are used on an ongoing basis to promote the safety and soundness of individual financial firms and build a resilient financial system. There are also tools that provide liquidity to banks and other financial intermediaries in emergencies, such as the discount window or lending facilities created to extend credit more broadly.

So far, these financial stability tools have had a good track record of effectively promoting financial stability in the United States. Numerous lending facilities set up in the spring of 2020 helped limit strains that the pandemic put on the financial system. More recently, when the failure of Silicon Valley Bank led to the loss of deposits at other banks, the discount window and a new facility to help ensure banks have the ability to meet the needs of all their depositors have been effective at containing stresses in the banking system. Importantly, these actions to address financial stability enabled us to continue to pursue our monetary policy objectives during these times.

Compared with financial stability tools that address liquidity or other strains in targeted individual institutions or segments of the financial system, monetary policy affects everyone and every part of the economy and would be a blunt and less effective

tool to address financial stability problems. That said, in carrying out monetary policy, we do consider how credit conditions and other factors related to financial stability are affecting the economy. As I argued in a speech last month, the recent strains in the banking sector may lead to a tightening of price and nonprice conditions for lending.[2] If that is the case, then it might reduce the need for at least some further tightening of monetary policy to lower inflation. The Fed could tighten policy too much if it ignored such a development.

To make this argument more concrete, consider the onset of the pandemic in March 2020. The Federal Open Market Committee held two unscheduled meetings where, recognizing that the coronavirus would weigh on economic activity and pose risks to the economic outlook, it lowered the policy target range down to zero. At the same time, the unprecedented uncertainty about how the macroeconomy would be affected by the pandemic destabilized financial markets, which led the Federal Reserve to put in place several lending facilities to support the system. We took each of these actions independently; we did not lower the policy rate for the sole purpose of achieving financial stability. Although both types of tools were used simultaneously, they were used to solve different problems.

Financial stresses in the banking sector are a factor that my colleagues and I are closely watching as we determine the appropriate stance of monetary policy going forward. While lending conditions imposed by banks have tightened since March, the changes so far are in line with what banks have been doing since the Fed began raising

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[2] See Christopher J. Waller (2023), "Hike, Skip, or Pause?" speech delivered at the 2023 Santa Barbara County Economic Summit, University of California, Santa Barbara Economic Forecast Project, Santa Barbara, Calif. (via webcast), May 24, https://www.federalreserve.gov/newsevents/speech/waller20230524a.htm.

interest rates more than a year ago. That is, it is still not clear that recent strains in the banking sector materially intensified the tightening of lending conditions.

Let me end by noting that some have argued that the Fed's tightening of monetary policy was significantly responsible for the failures and stress in the banking system. They argue we should have taken this into account when setting policy. Let me state unequivocally: The Fed's job is to use monetary policy to achieve its dual mandate, and right now that means raising rates to fight inflation. It is the job of bank leaders to deal with interest rate risk, and nearly all bank leaders have done exactly that. I do not support altering the stance of monetary policy over worries of ineffectual management at a few banks. We will continue to pursue our monetary policy goals, which ultimately support a healthy financial system. At the same time, we will continue to use our financial stability tools to prevent the buildup of risks in the financial system and, when needed, to address strains that may emerge.