The ideological debate on monetary policy – lessons from developments in Sweden

Fores
6 December 2017

SVERIGES RIKSBANK

Per Jansson

Deputy Governor

What this speech is about

- Fundamental international debate on inflation targeting policy (“Borio vs Yellen”, after Gavyn Davies, FT)

- Sweden is ‘ahead of the international cycle’: in both debate and inflation

- Meaning its experiences may be of interest

International ideological debate on inflation targeting

*The critics - the ‘Borio camp‘ **

- The inflation process has changed (globalisation, digitalisation, etc.)
- The Phillips curve is no longer valid
- Monetary policy should focus (more) on financial stability

*The defenders - the ‘Yellen camp’**

- Conducting monetary policy has become more difficult, among other reasons due to lower (global) neutral interest rate
- But the Phillips curve still works
- Inflation target is still meaningful and important

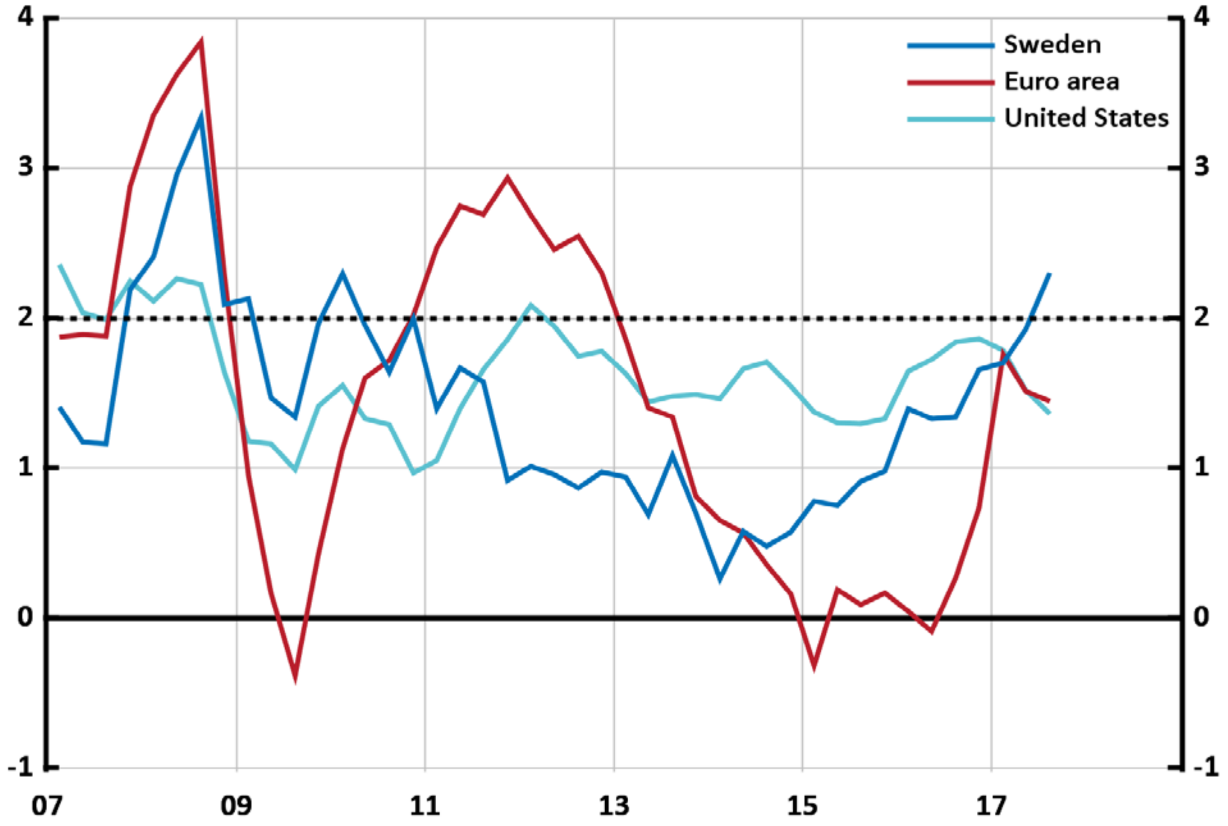
*According to Gavyn Davies’ terminology

Swedish experiences may be of interest

- Swedish debate on inflation targeting started several years ago
- Experience of a policy that (to some extent) has applied ‘leaning against the wind’ (LAW)
- Inflation fell earlier in Sweden than in other countries
- Long period of highly expansionary monetary policy
- Inflation is (at least for the moment) back on target

Swedish inflation 'is ahead of the cycle'

Annual percentage change



Note. Inflation for Sweden is measured as the CPIF, for the US as 'core PCE' and for the euro area as the HICP.

Sources: Bureau of Labor Statistics, U.S. Department of Labor, European Commission (Eurostat) and Statistics Sweden

What input could our experiences provide to the debate?

- *My interpretation* of the lessons

- Discussion divided into two periods
  - The period 2011–2014 – inflation falls far below target
  - The period 2015–2017 – inflation rises towards target again

- Just a field study: but small number of cases in practice may make our experiences interesting

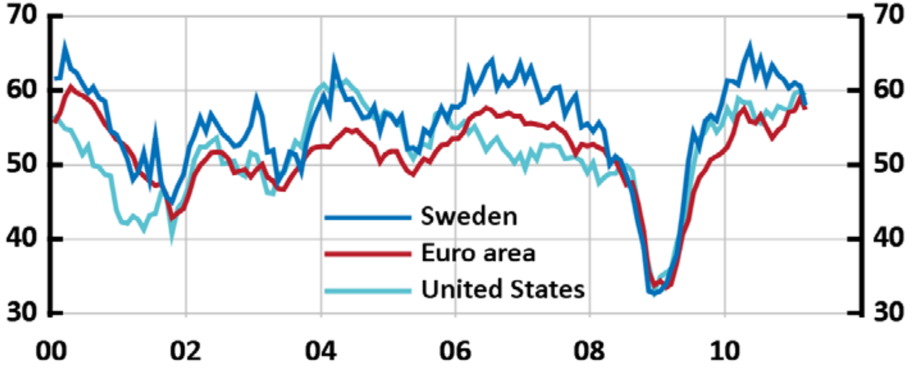
2011–2014 – inflation falls below target

- Rapid recovery after financial crisis 2010–2011
- Rate increased July 2010–July 2011 (from 0.25 to 2%)
- Elements of LAW, but definitely not main theme (Jansson, 2014)

Natural to raise the repo rate 2010–2011

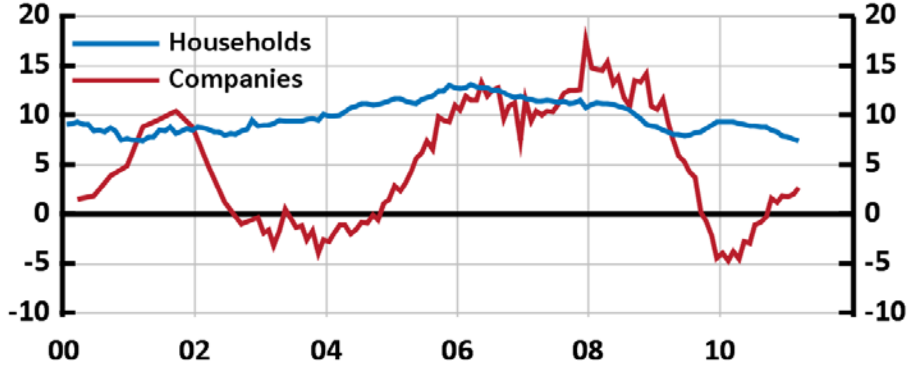
Purchasing managers' index in the manufacturing sector

An index over 50 indicates growth



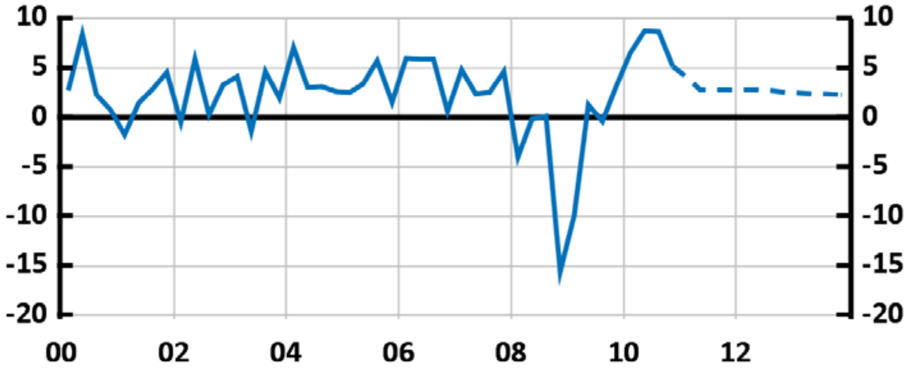
Lending to households and companies

Annual percentage change



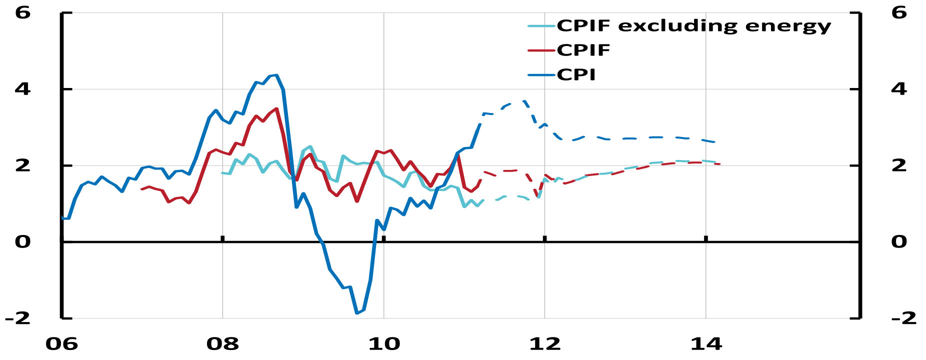
GDP

Quarterly change in per cent calculated as an annual rate, seasonally-adjusted data.



Inflation

Annual percentage change



Note. Forecasts from April 2011.

Sources: Institute for Supply Management (ISM), Swedbank, Statistics Sweden and the Riksbank

2011–2014 – inflation falls below target

- Rapid recovery after financial crisis 2010–2011
- Rate increased July 2010–July 2011 (from 0.25 to 2%)
- Elements of LAW, but definitely not main theme (Jansson, 2014)
- Increased international unease over debt in summer 2011, slowdown in Sweden too
- Inflation fell until 2014
- The Riksbank started to cut the rate in December 2011

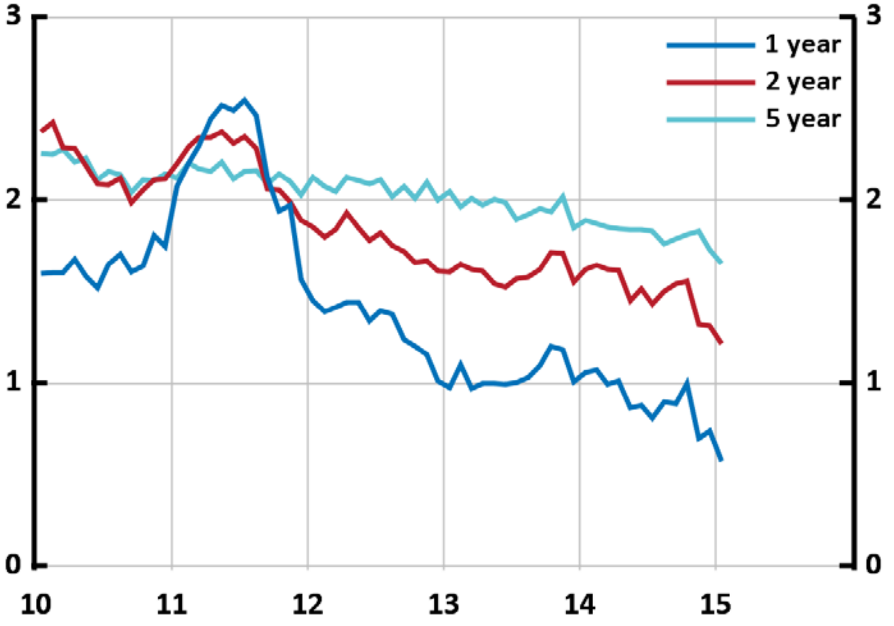
Troubling situation at turn of year 2014-2015

Inflation

Annual percentage change

Inflation expectations

Per cent, mean



Note. Measured as the CPIF (left) and the CPI (right).

Sources: Statistics Sweden and TNS Sifo Prospera

Lessons from the period 2011–2014

- Conclusion (i): It is important not to lose sight of inflation and inflation expectations
- Conclusion (ii): Fairly significant rate rises may be needed to brake the build-up of financial imbalances

Conclusion (i): It is important not to lose sight of inflation and inflation expectations

- What could we have done differently?
  - Difficult to predict a debt crisis and its effects ...
  - But perhaps there was too much talk about financial imbalances
  - The status of the inflation target may have become unclear, which may have contributed to the fall in expectations
  - Exaggerated criticism (the Riksbank is conducting a ‘housing policy’) may also have been significant

- Is losing sight such a problem? Yes!

Conclusion (ii): Fairly significant rate rises may be needed to brake the build-up of financial imbalances

- Previous opinion:
    - Even a little LAW can have a positive effect
    - Signalling value: increased awareness makes it more likely that measures will be adopted
    - Also greater confidence that a little LAW may have some direct effect (expectations)

- Have revised my opinion (quite) a bit:
    - Increased awareness? At any rate, not so much as to lead to sufficient measures
    - For direct effects, more comprehensive LAW is needed But this would have led to weaker growth and *even lower* inflation
    - Also doubtful for more fundamental reasons: I will return to this

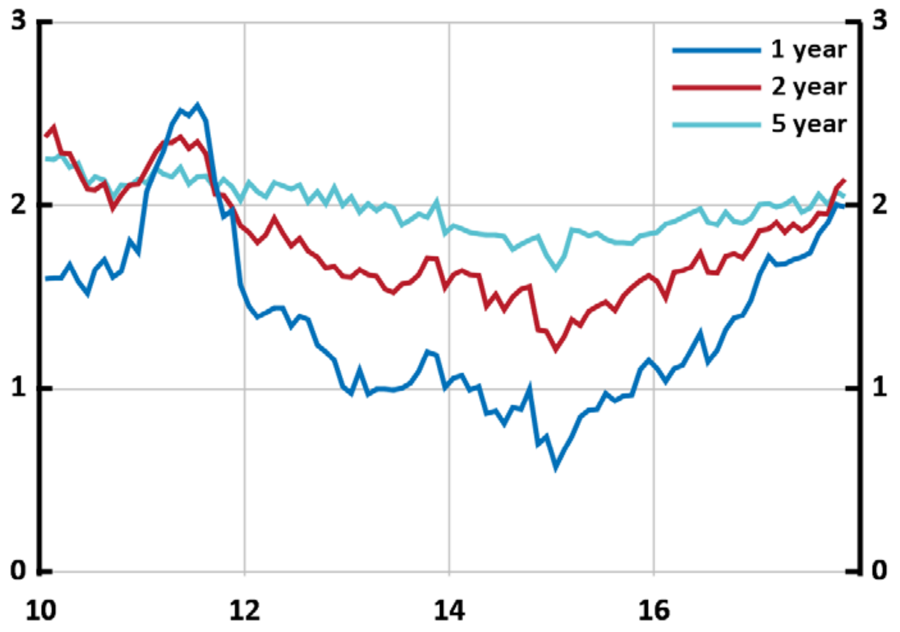
2015–2017 – inflation rises towards target again

Inflation

Annual percentage change

Inflation expectations

Per cent, mean



Note. Measured as the CPIF (left) and the CPI (right).

Sources: Statistics Sweden and TNS Sifo Prospera

Lessons from the period 2015–2017

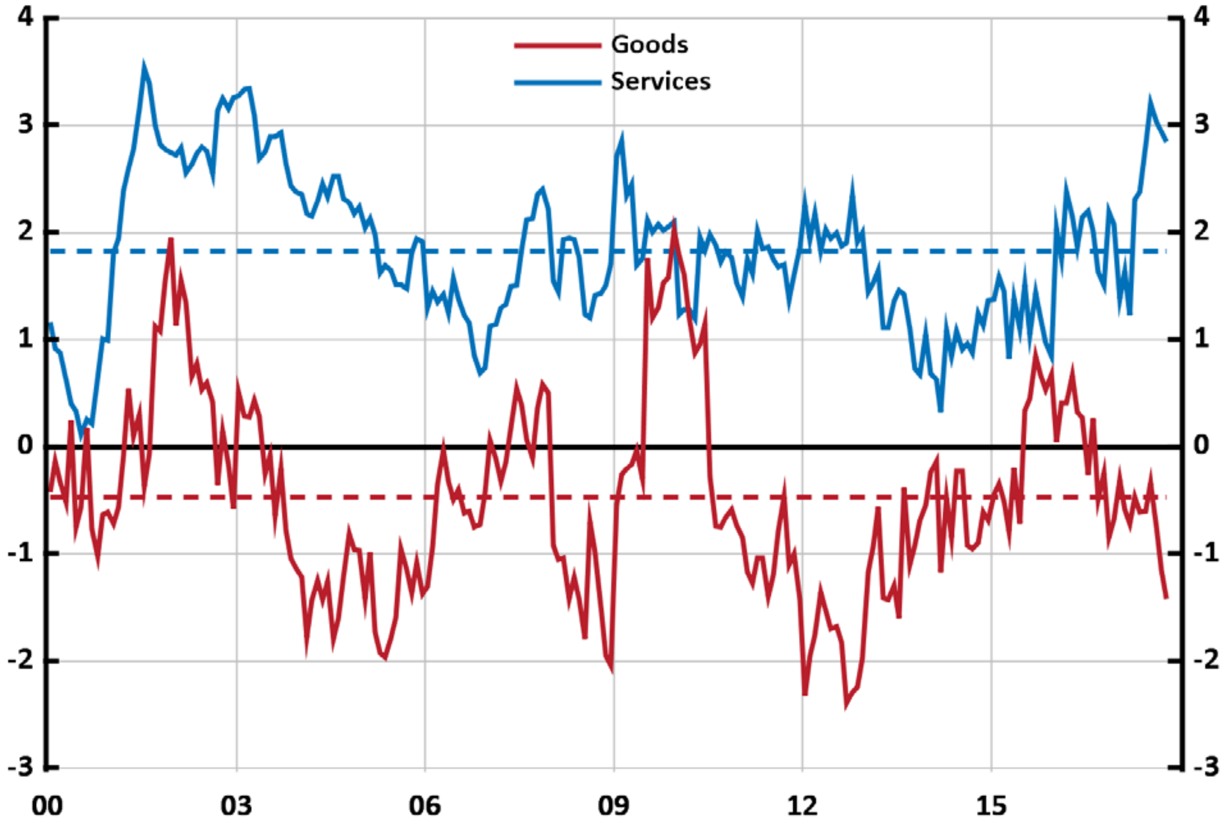
- Conclusion (iii): It may take a long time with a highly expansionary policy to bring inflation up – but it is possible

Sweden's experiences and the international ideological debate

- More in line with the Yellen camp
  - Inflation target and confidence in target good and important for the economy
  - Inflation target possible to reach
    - Reservation 1: Will inflation remain at 2 per cent?
    - Reservation 2: The role of the Phillips curve unclear

The development of service prices indicates that the Phillips curve works

Annual percentage change



Note. The broken lines represent the mean values since 2000.

Source: Statistics Sweden

Sweden’s experiences and the international ideological debate

- More in line with the Yellen camp
  - Inflation target and confidence in target good and important for the economy
  - Inflation target possible to reach
    - Reservation 1: Will inflation remain at 2 per cent?
    - Reservation 2: The role of the Phillips curve unclear
  - A little LAW does not seem to function (neither via direct or indirect effects)
  - Comprehensive LAW has not been tested in Sweden. Would have major negative side effects

- But the Borio camp points out important problems
  - What does a central bank do when it is having difficulty reaching the target despite a highly expansionary policy (Jansson, 2016)?

Do we really need an inflation target?

- Risk that inflation and expectations will fall and become permanent is very low
  - Low inflation → low nominal rates → little scope to cut the rate → difficult to counteract future recessions (thus also proposal to raise, not cut, central banks' inflation targets)
- Inflation target is guideline for price and wage formation (nominal anchor)
  - Easier to take economic decisions
  - Greater fluctuations without anchor
  - Risk of nominal disorder, above all in wage formation

More fundamental problems with policy that focuses on LAW

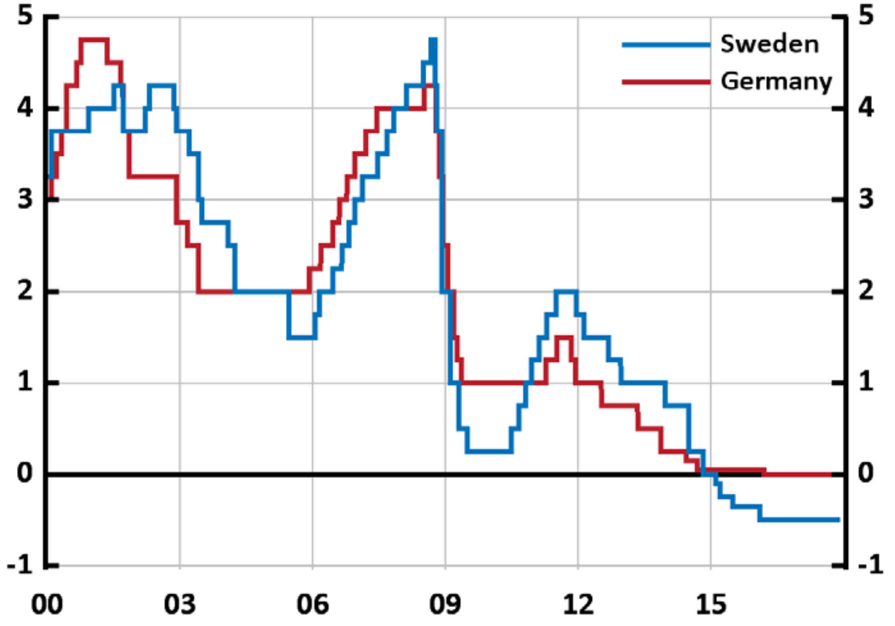
- Reasonable to demand that the financial system can cope with the following, without collapsing:
    - Low neutral interest rate for periods
    - Monetary policy focused on the inflation target

- If it is not sufficiently stable: ensure that it becomes so!
    - Better regulations or perhaps even a ‘business model’ for the financial system
    - Not reasonable for the entire economy to be restrained by an unnecessarily high rate

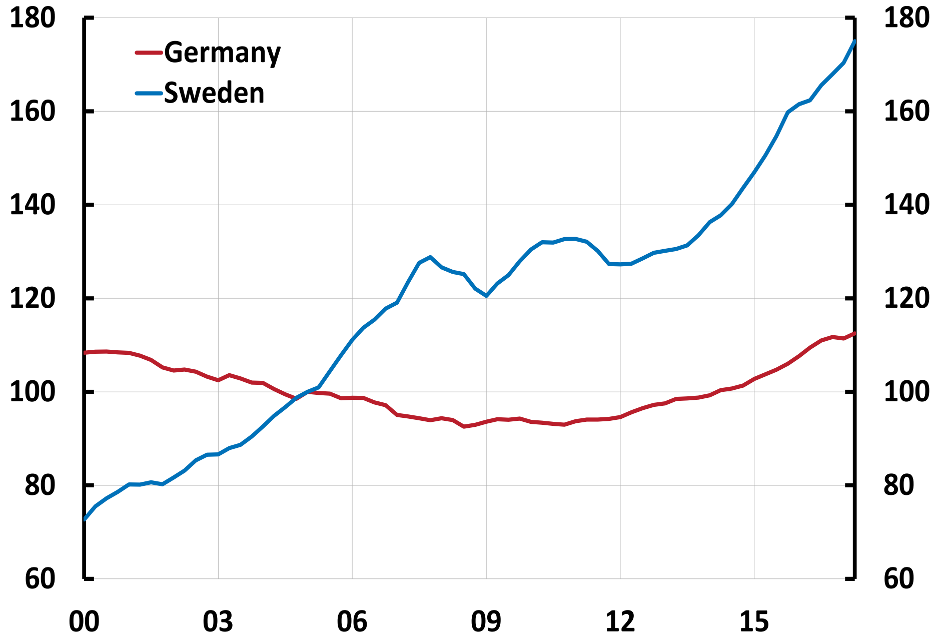
- Shortcomings in other important markets may also be of great significance
    - But neither in this case is it reasonable to solve the problems with a high rate

A monetary policy like that in Sweden does not have to result in runaway housing prices

Policy rates in Sweden and Germany



Housing prices in Sweden and Germany



Note. Per cent and house price index (HPI) respectively, 2005 Q1 = 100.

Sources: ECB, Macrobond and Federal Reserve Bank of Dallas

Summary

- A fundamental international debate on inflation targeting is in progress
- Sweden is ‘ahead of the international cycle’ and our experiences may be of interest
- Sweden’s experiences are so far in line with the ‘Yellen camp’: monetary policy and policy rate are better suited for inflation target than for financial imbalances
- In no way does this eliminate the roles and responsibilities of central banks in financial stability