

# Contemplations of an interest-rate dove and inflation hawk

Danske Bank  
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Deputy Governor



# Two-part speech

- How I view current monetary policy
  - My arguments at the latest monetary policy meetings
  - In-depth reasoning on the role of the inflation target and how we communicate around it
  - Some aspects of the lower bound and long time to reach the target
- My view on the advantages of the inflation target and a floating exchange rate
  - Good to remind people of positive aspects, bias towards disadvantages in the debate
  - Discuss significance of the inflation target in two areas in particular:  
wage formation and the exchange rate

# Communication is of great importance

- Lesson I discussed in Jansson (2017): “Important not to lose sight of inflation and inflation expectations”
- 2011-2014: Much focus on financial imbalances, too little on the inflation target?
  - Feasible interpretation: We had “taken our eye off the ball”

# 2011-2014: Considerable focus on household debt

Household indebtedness is growing

Household debt under the microscope\*

## Measures to mitigate the risks from high and increasing household debt

Recent development of housing prices and debt constitute another source of uncertainty

Still no slowdown in household debt

Risks associated with household indebtedness must be managed

Housing prices and indebtedness still rising

House prices and debts increasing

■ The effects of monetary policy on household debt

The effect of the repo rate on household indebtedness is an important part the assessment

Household debts rise further

This development is now being reinforced, and household debt as a percentage of their income is expected to increase more than was previously forecast. This increases the risks that the economy will develop in a way that is not sustainable in the long run.

Jansson: How do we stop the trend in household debt? Work on several fronts



Note. Annual percentage change.

Source: Statistics Sweden

# Lessons of interest even now

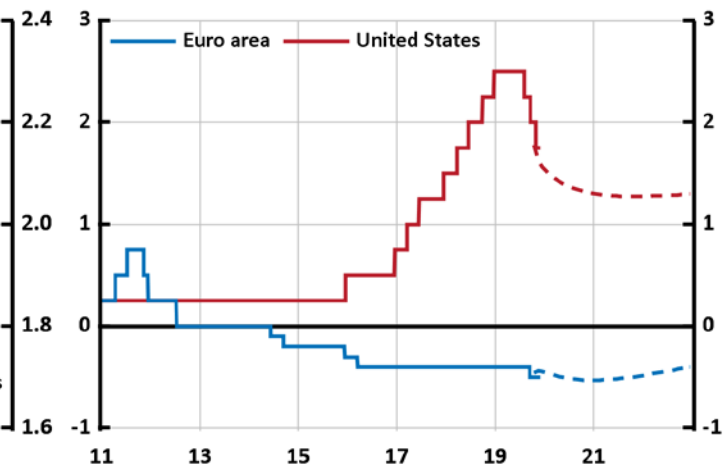
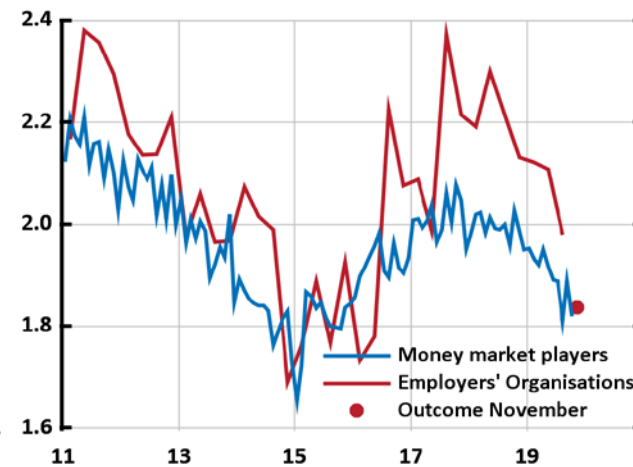
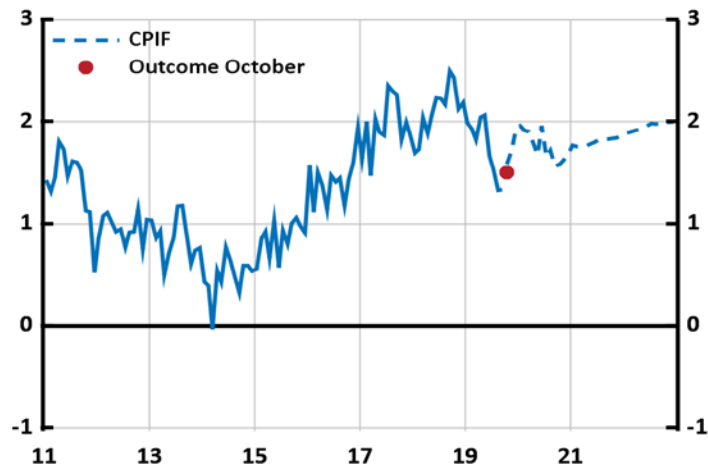
- At the meeting in October: Reasonable that the repo rate gradually rises (and turns positive in the longer term), but sceptical to an increase already in December
  - Inflation still below target in the near term, stable on target not until end of 2022
  - Not possible to identify any serious upside risks
  - Downward trend in inflation expectations (even longer-term)
  - Fed and ECB more expansionary policy – what does this mean?
- Interpretation among analysts
  - “Zero rate an end in itself”, “The Riksbank has realised the problems of negative rates” (Bloomberg, Financial Times)
  - “Higher threshold for negative rates going forward”
- Risk of interpretation (again) that we have taken our eye off the ball
  - “Tenths” not important in themselves but the signals can be, especially if confidence in target is at stake

# Sceptical at October meeting about increase already in December

Inflation still below target near term, on target not until end of 2022

Downward trend in long-term inflation expectations

More expansionary policy from Fed and ECB



Note. Left: Annual percentage change, dashed line represents the Riksbank's forecast in October. Middle: Annual percentage change. Right: Per cent, dashed line represents forward rates 21 October 2019. Forward rates describe expected overnight rate.

Sources: Kantar Sifo Prospera, National central banks, Statistics Sweden and the Riksbank

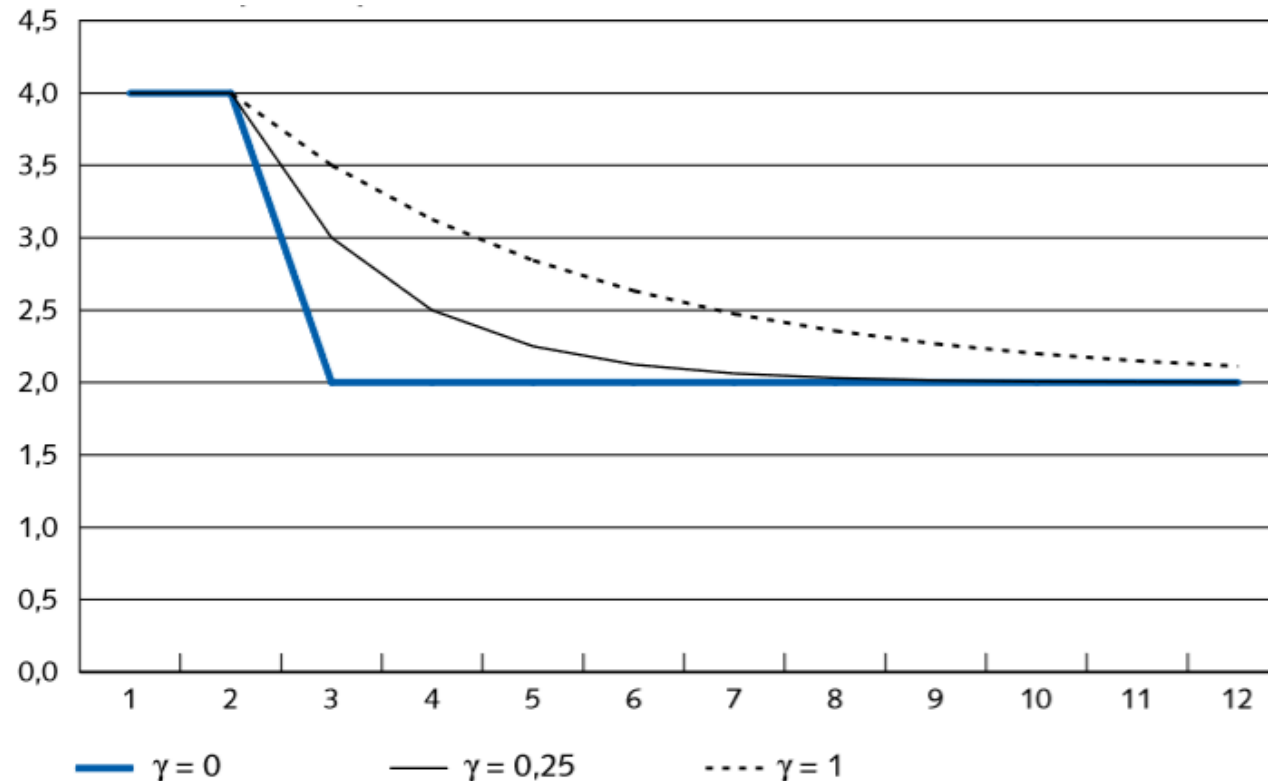
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# Very important to be clear about the guiding role of the inflation target in monetary policy

$$L_t = (\pi_t - \pi^*)^2 + \gamma(y_t - y_t^*)^2$$



Note. Apel, Heikensten and Jansson (2007) "The role of academics in monetary policy: a study of Swedish inflation targeting", Economic Review 1/2007.

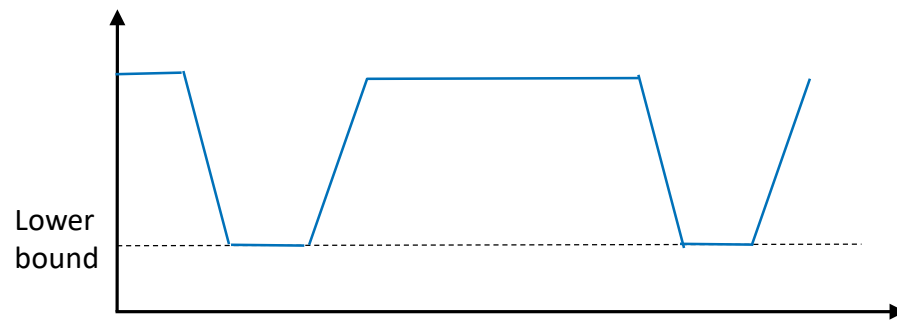
Source: The Riksbank

# Ultimately a question of maintaining confidence in the target

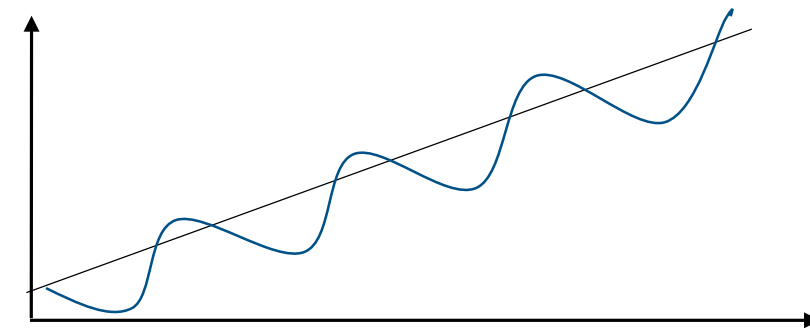
- Inflation target not “holy” just for the sake of it – high inflation problematic (we learned from the 1970s and 1980s), but also too *low* inflation (have we learnt that?)
- Reasons why very low average inflation creates problems
  - More difficult for wage formation to allocate resources (as nominal wage reductions improbable) – some inflation acts as “grease”
  - Some distance to effective lower bound for policy rate – difficult to combat recessions, *more* of negative rates

# Lower average inflation and policy rate make it more difficult to combat recessions

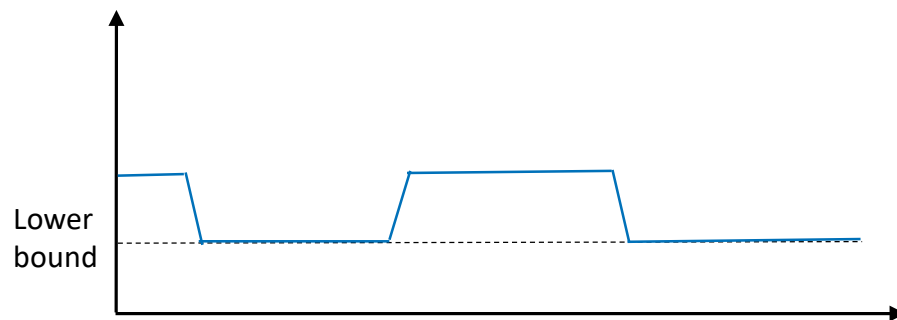
- Policy rate with 2-percent inflation



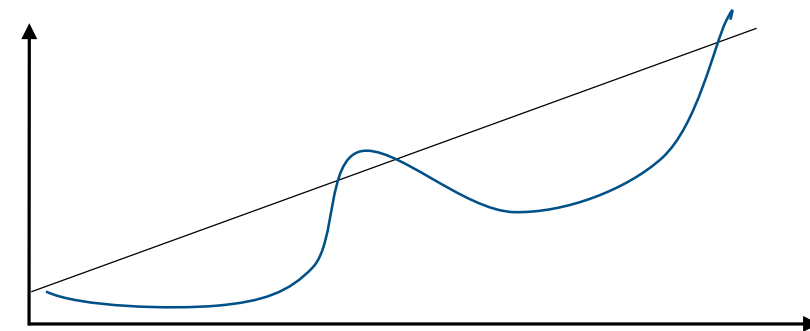
- Economic activity with 2-percent inflation



- Policy rate with lower inflation



- Economic activity with lower inflation



Note. Schematic illustration.

Source: The Riksbank

# Where is the lower bound for the repo rate?

- Jansson (2018): Problem with legitimacy when bank-savers have to “pay to save”
- Repo rate  $-0.5$  per cent for a long time without this happening
- Some room below zero that should be utilised, to avoid economic costs

# IF it were to take longer to reach the target...

- A case where it is especially important (even more important than in the previous case) to communicate appropriately
- Very low global real interest rates
  - Scope for managing economic slowdowns has decreased as we hit the policy rate lower bound more rapidly
  - *May* mean that we at some stage end up in a situation where we choose not to make policy more expansionary
- Does not mean we give up the inflation target
  - Still conducting as expansionary a policy as we consider possible
  - We *can* do more but consider letting it take a little longer to be a better option
  - If it works: Long-term expectations still 2 per cent, anchor has not slipped
- Difficult but hopefully not impossible to clarify in our communication

# The principal monetary policy debate

- The inflation target is *Sweden's* not *the Riksbank's*
  - Decided by the General Council of the Riksbank (then a politically appointed decision-making body) in 1993
  - The Riksdag has always supported it and still does
- Inflation target has had significant advantages, but these seem to have begun to fall into oblivion
  - More focus on disadvantages recently

# The principal monetary policy debate

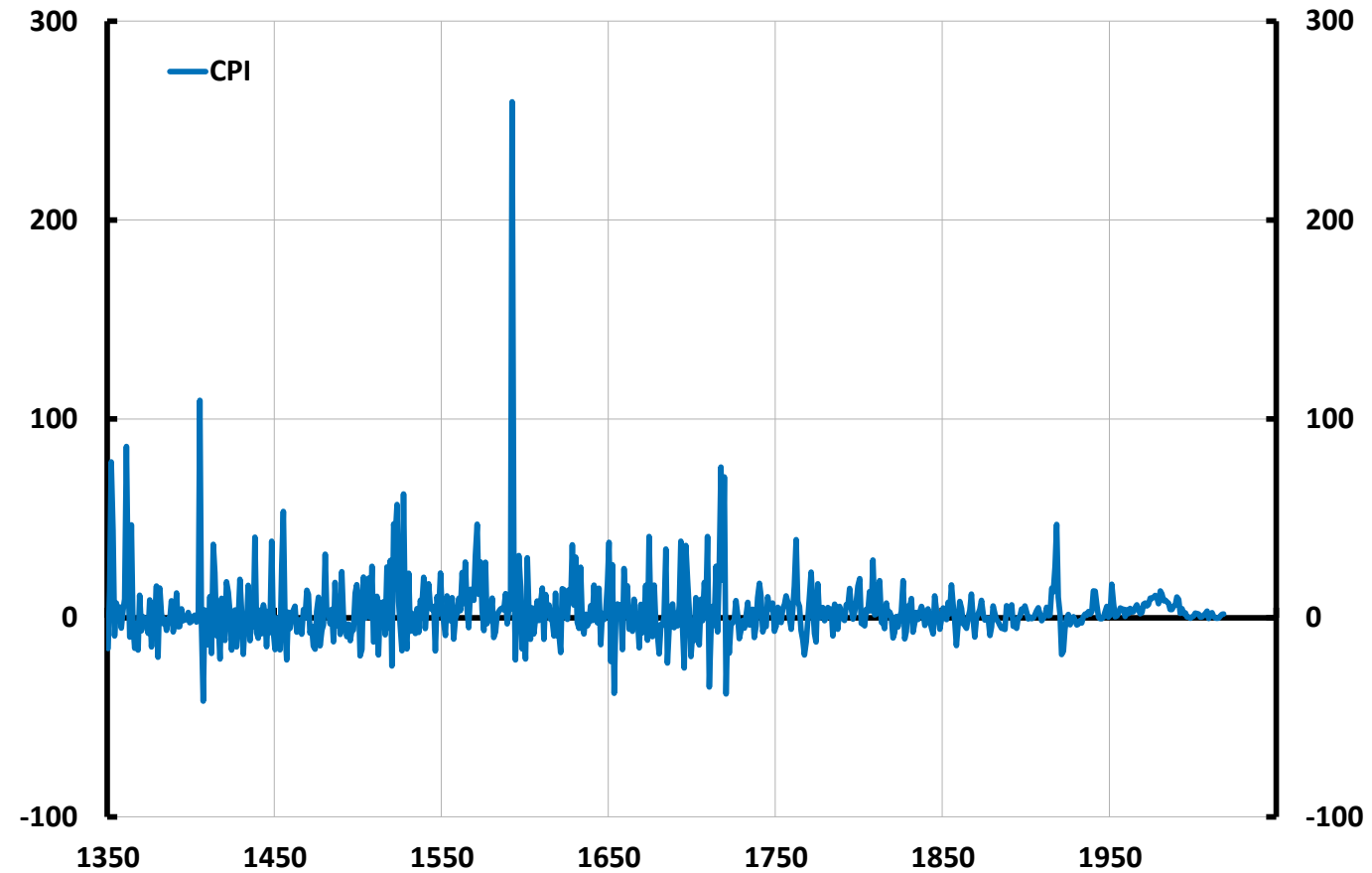
- Often unclear whether the criticism is of the conducted policy or the target
- Many think the policy has been too expansionary but say they support the target
  - In recent years, we have only just reached the target, never had excessively high inflation
  - A *very* different policy had therefore hardly been possible
  - Therefore, criticism seems implicitly to apply to the target nevertheless
- Criticism of the target concerns, among other things
  - Wage formation
  - Exchange rate

# Wage formation

- In some quarters
  - “Inflation target has become obsolete”
  - “Useful in bringing down inflation, but no longer necessary”
  - “Industrial Agreement sufficient”
- Historically questionable and myopic
  - Inflation target stabilises wage formation when inflation is both unexpectedly high and unexpectedly low
    - Beneficial to have anchor at 2 per cent if inflation is, for example, 4 per cent a few years ahead
  - What would replace the inflation target as anchor for prices and wages in the whole economy?
    - Well-established ways: inflation target or fixed exchange rate
    - Industrial Agreement – intensive debate, avoid being empty-handed!
- Important to analyse and discuss interplay between monetary policy framework and conditions for wage formation



# Inflation over the last 669 years



Note. Annual percentage change, annual average.

Source: Statistics Sweden

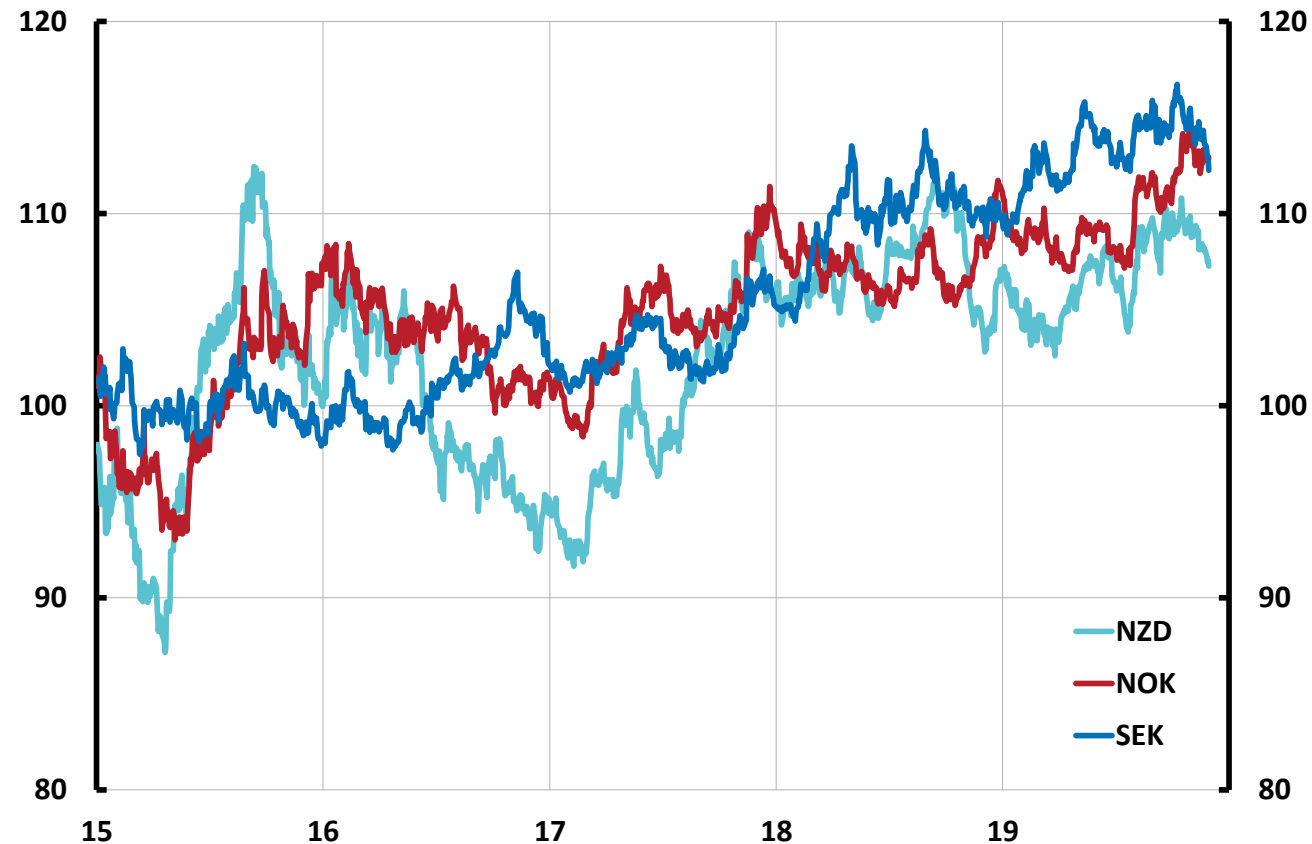
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# Perspectives on krona development

- Inflation target/floating exchange rate and fixed exchange rate respectively – different strategies to give the economy a nominal “anchor”
  - Experience of fixed exchange rate not good in Sweden
- Broad support for inflation target (and floating exchange rate) means:
  - Expectation that the Riksbank tries to maintain confidence in the target
  - Krona affected by monetary policy – via usual exchange-rate channel
- Monetary policy has contributed to a weak krona for a few years but this is far from the whole picture
  - Similar trends on other small, open economies despite higher policy rate – gives perspective to “krona collapse”

# Development of the Swedish krona, Norwegian krone and New Zealand dollar against the euro



Note. Exchange rate against the euro. Index, 2015 = 100. The most recent outcome refers to 29 November 2019.

Source: ECB

# My most important messages

- Important to always be very clear about the guiding role of the inflation target
  - Risk of average inflation getting stuck at too low a level
  - More difficult to use monetary policy, negative rates more often
- Discussed and responded
  - “Inflation target has become obsolete in wage formation”
  - “Costs of having a floating exchange rate have become too great”
- “[D]emocracy is the worst form of government except for all those other forms that have been tried from time to time.”
  - Apt also for inflation targeting, so far at least