Current challenges for the conduct of monetary policy in the euro area:

Should the ECB do more?

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Outline

- Should the ECB do more?
- How has the ECB done?
- Does the ECB have enough policy measures?
- More on forward guidance: Normal procedure?

How has the ECB done?

- A partial view: Short real interest rate
Nominal Eonia rate and policy rates in Sweden, UK, US

Real Eonia rate and policy rates in Sweden, UK, US

Inflation: Euro area, Sweden, UK, US

Does the ECB have enough policy measures?

- Difference policy rate (MRR) and Eonia rate: Why not smaller corridor?
  - Riksbank “fine tuning”, corridor ± 10 bp
- Do not exclude zero/negative interest rate (− 0.25 %)
- Balance-sheet policies, large-scale asset purchases (OMT)
  - Set up so ready to be used, then use
  - Distinguish from liquidity support (LTRO, financial stability)
  - Prohibition of monetary financing?
    - Should be prohibition of inflationary financing
  - Risk of losses unavoidable: Central banks have to take risks in crises
  - Monetary/policy actions in crises have unavoidable fiscal and financial-stability side effects
    - Classify actions according to main purpose
Does the ECB have enough policy measures?

- Forward guidance, in the form of a published policy-rate path (forecast, not commitment), should be normal part of policy
  - Other forms of forward guidance when needed (commitment, conditional, threshold, balance-sheet, etc.)
- Policy-rate path part of normal “forecast targeting” – setting the policy-rate path so forecasts of target variables “look good” (fulfill objectives)

Forecast targeting, alternative policy-rate paths
Corresponding forecasts of inflation, unemployment, and debt ratio (Riksbank, Ekholm 2013)

Fed Economic Projections, Dec 2013
Fed Economic Projections, Dec 2013

Why normal to published policy-rate path?

1. **Transparency**: Coherent forecast of target variables requires forecast of instrument. Then publish this.
2. **Effectiveness**: Management of expectations (of the future policy rate)
3. **Informativeness**: Central bank should have more info about its future policy settings. Useful info for private sector
4. **Justification**: Provides a coherent way of justifying policy choice by comparison with policy alternatives
5. **Accountability**: Simplify external evaluation of policy by comparison with policy alternatives and assessments of tradeoff between target variables

Swedish experience

- “Forward guidance in theory and practice: Swedish experience,” Dec 2013, larseosvensson.se

Riksbank record mixed:

February 2009: Success!
Risks from forward guidance about policy rate? (Filardo and Hofmann; FT)

- Central-bank reputation?
- Financial stability?
  - Disruptive market reactions
  - Risk of MP becoming too concerned about market reactions, delaying normalization (financial dominance)
  - Excessive risk-taking, build-up of financial vulnerabilities
- Learning process (both market and CB)
- Reputation risk, old argument against inflation targets
- After crisis, probably too little risk-taking. But what is optimal risk-taking?
- Watch indicators of vulnerability, use macroprudential instruments if needed

Monetary policy and threats to financial stability

- Monetary policy has normally little effect on financial stability
- Financial stability can normally be handled by other means
- Only if monetary policy is considered to pose a significant threat to financial stability, and that threat cannot be handled by the standard macro-prudential instruments, should monetary policy be allowed to deviate from the standard monetary-policy objectives.
- Who should decide? The authority/committee responsible for financial stability
- Bank of England provides an example: August 2013 forward guidance, knockout 3: FPC decides if risk, not MPC
Tightening in summer 2010 has lead to inflation below the target, higher unemployment, and higher (!) debt ratio


Fed and Riksbank, June/July 2010
Similar forecasts, very different policies


Riksbank tradeoff reasonable?

Source: Statistics Sweden, Valuegard

Housing prices relative to disposable income

Source: Swedish House of Finance
Household debt and assets (excluding collective pensions)

Riksbank inflation forecasts biased upwards

Riksbank inflation forecasts and actual outcome (CPIF)

Impulse responses to 1 percentage point higher policy rate during year 1


Source: Svensson (2013), “Leaning against the wind leads to higher (not lower) household debt-to-GDP ratio,” larseosvensson.se.