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Transitional and longer-term challenges for monetary policy

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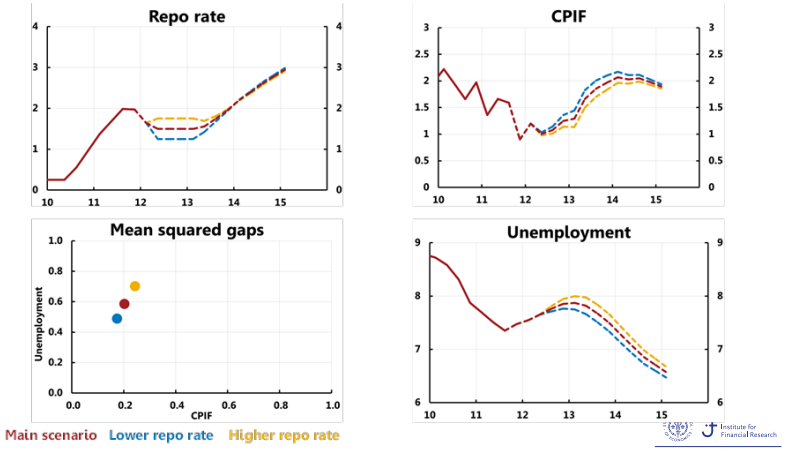
Outline

- Forward guidance – normal and special
- Monetary policy and financial stability
- Riksbank "leaning against the wind"

Forward guidance: normal and special

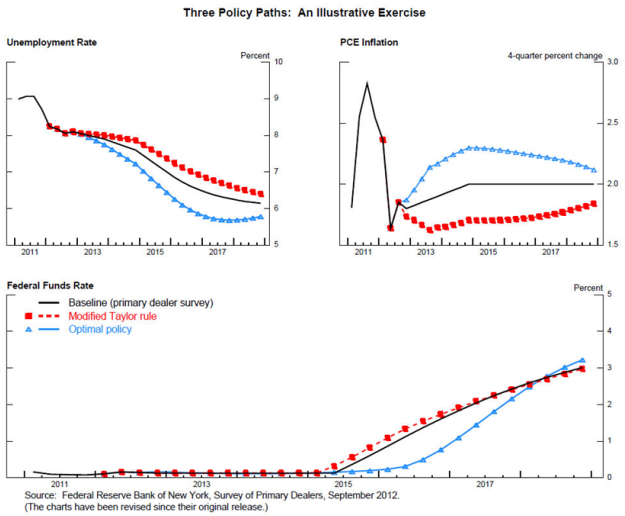
- Forward guidance, in the form of a published policy-rate path (forecast, not commitment), should be normal part of policy and policy communication
- Other forms of forward guidance in special situations when needed (commitment, conditional, threshold, balance-sheet, etc.)
- A policy-rate path is a necessary part of normal "forecast targeting":
  Choose a policy-rate path so that corresponding forecasts of target variables "look good" (that is, fulfill objectives)

Illustrate policy choices: Riksbank Feb 2012 minutes



Sources: Statistics Sweden and the Riksbank

Illustrate policy choices: Yellen (2012)

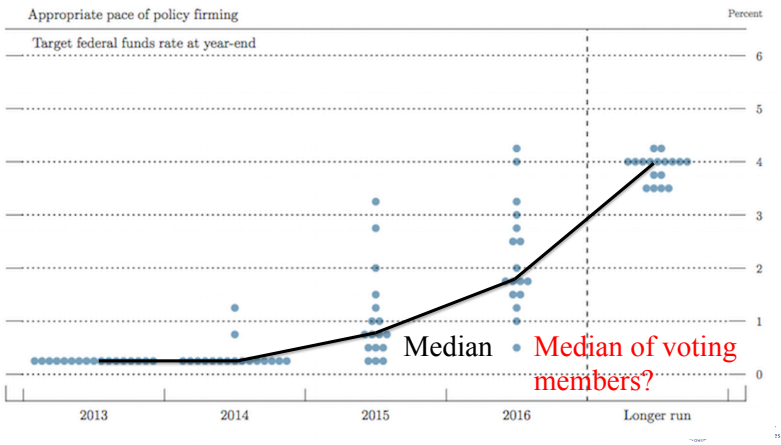


Source: Yellen, Janet L. (2012), "Revolution and Evolution in Central Bank Communications," speech at the Haas School of Business, University of California, Berkeley, November 13, 2012, www.federalreserve.gov.

Why normal to published policy-rate path?

1. **Transparency**: Coherent forecast of target variables requires forecast of instrument. In the name of transparency, the all should be published.
2. **Effectiveness**: Monetary policy is the management of expectations – then publishing your policy-rate path should contribute to that management
3. **Informativeness**: Central bank should have some private info about its future policy settings. Should be useful info for the rest of the economy
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

FOMC Economic Projections



Source: FOMC Economic Projections, December 2013.

FOMC Economic Projections

- How to make the projections of inflation, unemployment and policy rate internally consistent?
- Aggregation problem
- Median? Better: off voting members?
- Errors relative to consistent forecast, small or large?
- Other?

Monetary policy and threats to financial stability

- Financial stability is to a large extent about the financial system having sufficient resilience to disturbances (buffers: capital, liquidity, net stable funding…)
- Monetary policy
  - cannot normally affect such resilience
  - cannot achieve financial stability
  - normally has little effect on financial stability
- Resilience can be achieved and maintained only with micro- and macroprudential policy (regulation and supervision of buffers)
- Financial stability must then normally be achieved by other means than monetary policy

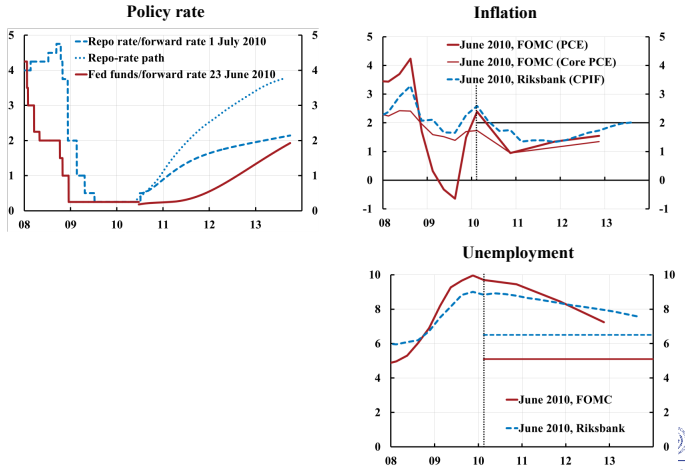
Exceptions, abnormal situations?

- Only if the monetary policy stance is judged to pose a significant threat to financial stability that cannot be contained by micro- or macro-prudential policy, should monetary policy be allowed to deviate from the standard monetary-policy objectives
- Such threats and deviations should be announced and justified
- Who should decide? The authority/committee responsible for financial stability (easier in UK and Sweden than in US)
- UK example: August 2013 forward guidance, knockout 3: FPC decides if threat that cannot be contained, not MPC
- Responsibility and accountability is then clear

Riksbank "leaning against the wind" to try to contain household indebtedness

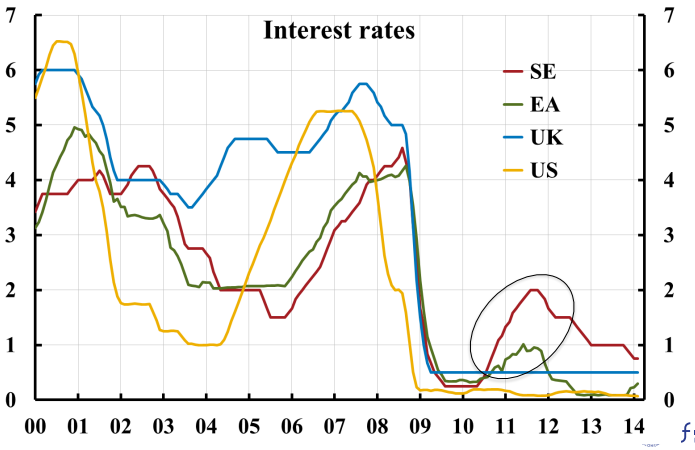
- Roosevelt's "mistake of 1937." Now Riksbank's "mistake of 2010."
- Dramatic preemptive tightening in summer 2010, in spite of low inflation forecast and high unemployment forecast
- Result: Inflation now much below target, unemployment much above reasonable long-run sustainable rate
- Probably very little effect on household debt ratio, perhaps even higher debt ratio
- Price level lower than expected: Real debt higher than expected (4 % in 2 years) (Fisherian debt deflation)
- Benefit: Less deleveraging and lower increase in unemployment in future crisis
- Cost: Higher current unemployment
- Recently some number from the Riksbank: Imply thatthe cost is more than 10 or rather more than 50 times benefit!

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

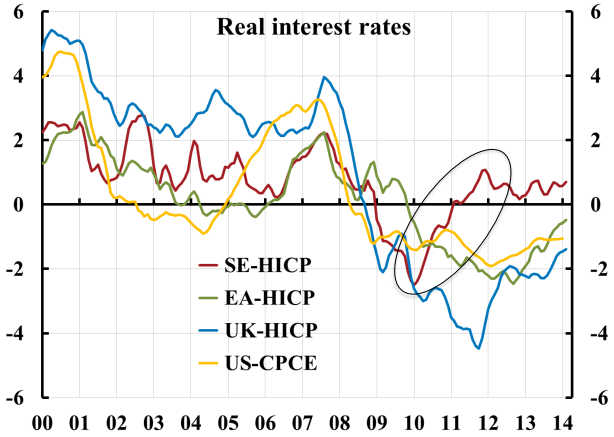


Svensson (2011), "Practical Monetary Policy: Examples from Sweden and the United," *Brookings Papers on Economic Activity*, Fall 2011, 289-332.

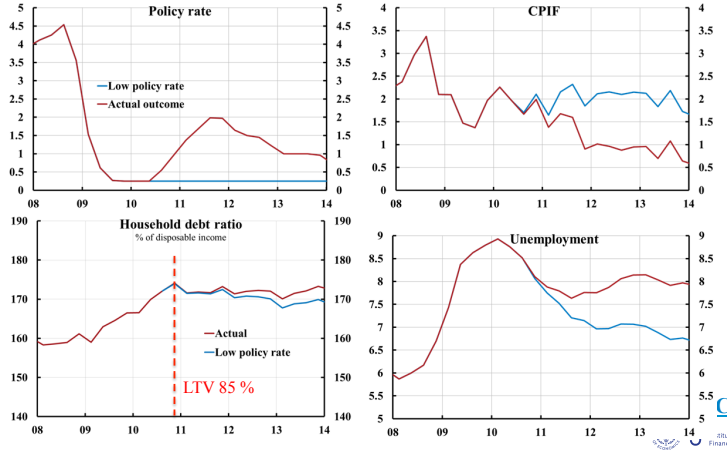
Nominal policy rates in Sweden, UK, US, and Eonia rate in EA



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



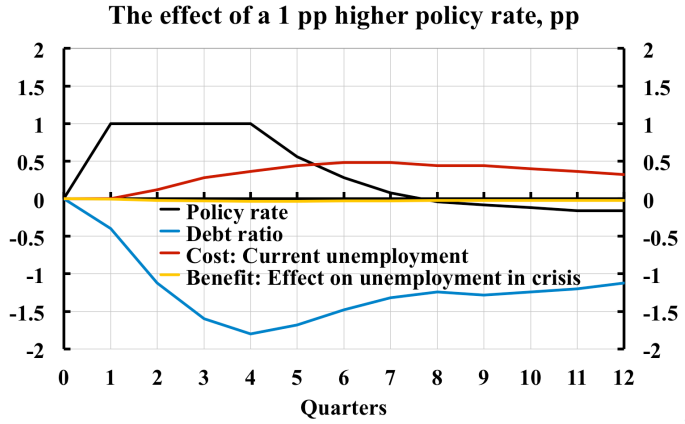
Tightening in summer 2010 has lead to inflation below the target, higher unemployment, and possibly higher (!) debt ratio



Cont.

Source: Svensson (2013), "Unemployment and monetary policy – update for the year 2013," larseosvensson.se.

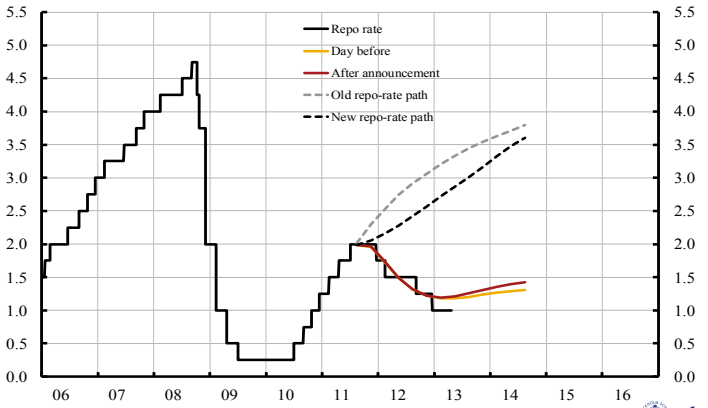
Riksbank own numbers: Unemployment cost of "leaning" at least 10 or 50 times larger than benefits



Source: Svensson (2014), "The end for the Riksbank's 'leaning against the wind'?" Ekonomistas post on February 21, larseosvensson.se..

Extra

Riksbank record mixed:
September 2011: Failure!



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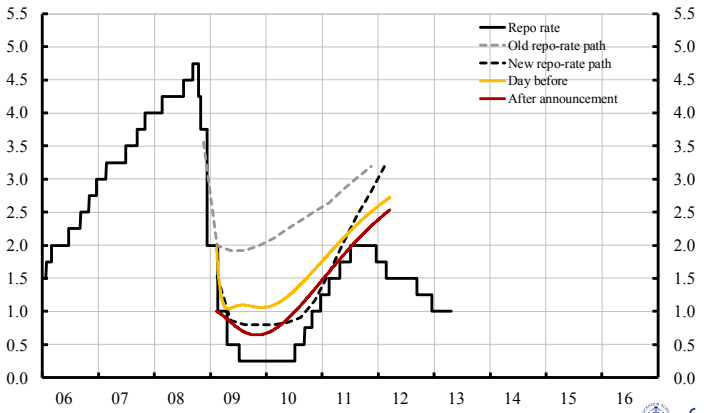
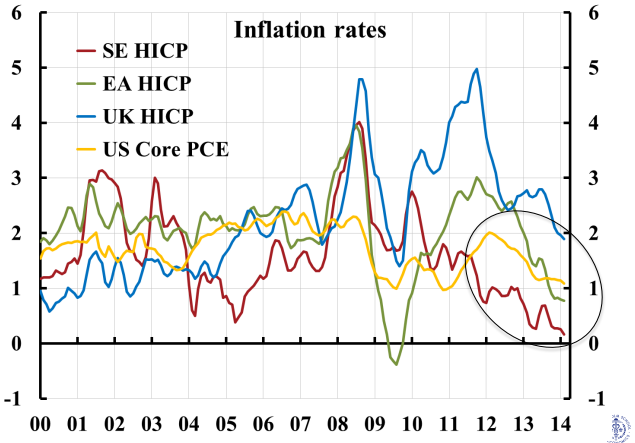
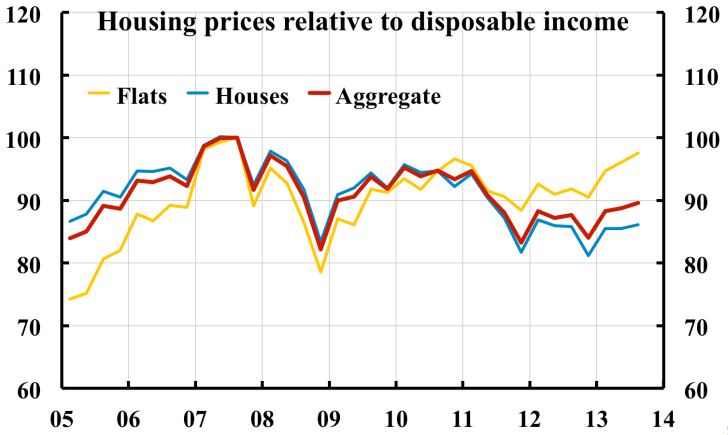
Riksbank record mixed:
February 2009: Success!



Inflation: Euro area, Sweden, UK, US

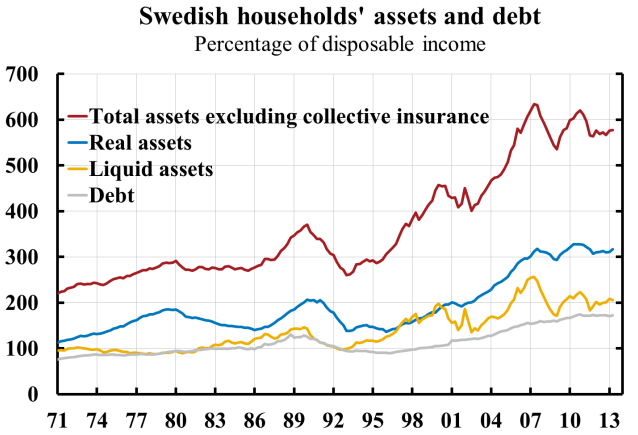


Housing prices relative to disposable income



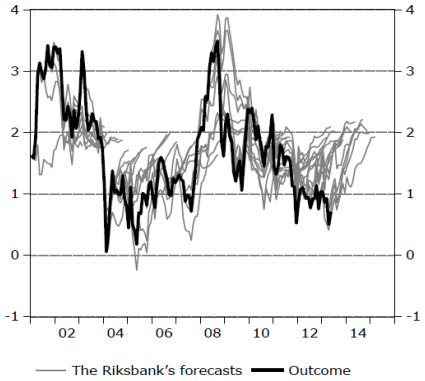
Source: Statistics Sweden, Valuegard

Household debt and assets (excluding collective pensions)



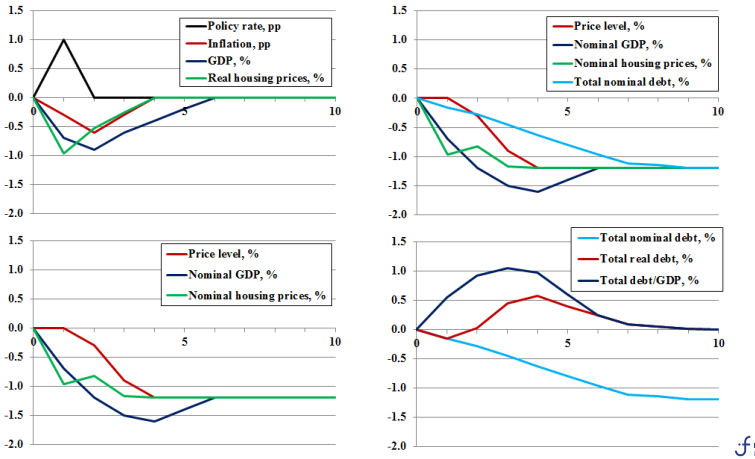
Riksbank inflation forecasts biased upwards

Riksbank inflation forecasts and actual outcome (CPIF)



Source: National Institute of Economic Research (2013)

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.