To lean or not to lean: The Swedish experience

Lars E.O. Svensson
Stockholm School of Economics
Web: larseosvensson.se

Dinner speech
SNB Research Conference 2014,
Zurich, September 26-27, 2014

or...

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Outline

- Should standard flexible inflation targeting be combined with some leaning against the wind, in order to promote financial stability?
- Leaning promoted by the BIS
- Skepticism elsewhere, but debate continues
- Sweden a case study: Quite aggressive leaning since summer 2010
- Outcome: Very low inflation, very high unemployment, probably higher real debt
- Was the Riksbank leaning justified?
Case study: Sweden

- Riksbank has been leaning against the wind since summer of 2010, referring to concerns about household debt
- This has led to inflation far below the target and unemployment far above a long-run sustainable rate
- With inflation much below expectations, it arguably also led to higher real debt than expected and planned for

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- But debt ratio has been stable since LTV cap of 85% in Oct 2010

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- And debt is normal relative to assets
- Housing expenditure is not high (15-20% of disposable income)
- Average LTV for new mortgages has stabilized around 70%
- Housing prices have not increased faster than disposable income since 2007
- Housing prices are in line with fundamentals (disposable income, mortgage rates, tax reductions, rapid urbanization, little construction…)

- And, the FSA has:
  - introduced an LTV cap of 85%
  - introduced higher risk weights on mortgages (25%)
  - introduced higher capital requirements (16% CET1)
  - proposed individual amortization plans for borrowers
  - produces an annual mortgage market report, according to which
    - lending standards are high
    - households’ repayment capacity is good
    - households’ resilience to disturbances in the form of mortgage rate increases, housing price falls, and income falls due to unemployment is good

- Macroprudential tools and policy are arguably effective and good in Sweden

Was it a premature exit?
Fed and Riksbank, June/July 2010
Similar inflation and unemployment forecasts, very different policies


The leaning: Policy rates in Sweden, UK, and US; Eonia rate in euro area

The leaning: Real policy rate in Sweden, UK, and US, real Eonia rate in euro area

The leaning: Policy-rate increases from summer of 2010 have led to inflation below target and higher unemployment (and probably a higher debt ratio)

Riksbank’s case for leaning against the wind

- Higher debt could imply (1) a higher probability of a future crisis and/or (2) a deeper crisis if it occurs
- Hence, a tradeoff between (1) tighter policy now with lower debt but worse macro outcome now and (2) worse expected macro outcome in the future
- Worse macro outcome now is an insurance premium worth paying
- Is that true?
- The answer can be found from the numbers in the Riksbank’s own boxes in MPRs of July 2013 and February 2014, plus Schularick and Taylor (2012) and Flodén (2014)

Cost of 1 pp higher policy rate:
0.5 pp higher unemployment rate in next few years

Benefit (1) of 1 pp higher policy rate:
Lower probability of a crisis

- Schularick and Taylor (2012): 5% lower real debt in 5 yrs implies 0.4 pp lower probability of crisis (average probability of crises about 4%)
- Riksbank MPR Feb 2014, box:

Source: Svensson, post on larseosvensson.se, March 31, 2014.

Benefit (2) of 1 pp higher policy rate:
Smaller increase in unemployment if crisis

- Flodén (2014): 1 pp lower debt ratio may imply 0.02 pp smaller increase in unemployment rate in crisis
- Riksbank MPR Feb 2014, box:

Source: Svensson, post on larseosvensson.se, March 31, 2014.
Summarize cost and benefit of 1 pp higher policy rate

Table 1. Cost and benefit in unemployment of 1 percentage point higher policy rate during 4 quarters

<table>
<thead>
<tr>
<th>Cost: Higher unemployment during the next few years, percentage points</th>
<th>0.5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Benefit: Lower expected future unemployment, percentage points</td>
<td></td>
</tr>
<tr>
<td>1. Because of lower probability of a crisis</td>
<td>0.001</td>
</tr>
<tr>
<td>2. Because of a smaller increase in unemployment in a crisis</td>
<td>0.0009</td>
</tr>
<tr>
<td>Total benefit, percentage points</td>
<td>0.0019</td>
</tr>
<tr>
<td>Total benefit as a share of the cost</td>
<td>0.0038</td>
</tr>
</tbody>
</table>

- Riksbank case does not stand up to scrutiny

More costs: Inherent flaw in leaning against the wind:
Inflation below credible target causes negative real effects

- Leaning: Lower inflation than target
- Inflation expectations anchored at target
- Lower average inflation than expected causes real effects
- Higher unemployment
- Higher real debt for households (additional cost of leaning against the wind)
- Fisherian “debt deflation”: Inflation less than expected, rather than deflation per se

CPI inflation and household inflation expectations

Note: Dashed lines are 5-year trailing moving averages

The real value of an SEK 1 million loan taken out in Nov 2011, actual and for 2 percent inflation

5.6% higher real debt since Nov 2011
Sum up:
Leaning against the wind and household debt

- "Leaning against the wind" is counter-productive in Sweden
- Leaning generally involves undershooting (credible) inflation targets
- Leads to lower inflation than expected
- Leads to higher unemployment and higher real debt
- May increase debt ratio by affecting disposable income faster than nominal debt (Svensson 2013)
- Also, may undermine the credibility of the inflation target
- Not the best way to handle any debt problem
- Use macroprudential tools if any problem