Monetary policy, financial stability, and “leaning against the wind”

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Outline

- Flexible inflation targeting
- Financial stability
- Leaning against the wind
- Swedish monetary policy in the last few years
- Household debt in Sweden
- The Riksbank’s framework for monetary policy and household debt
- Lowflation/deflation and debt
- Conclusion about leaning against the wind

Flexible inflation targeting

- Strict inflation targeting
  - Only objective: Stabilizing inflation around inflation target
- Flexible inflation targeting
  - Stabilize inflation around inflation target and resource utilization around long-run sustainable rate (unemployment around long-run sustainable rate)

Financial stability

- Definition: The financial system can achieve its 3 main functions (transform saving into financing, allow risk management, submit payments) with sufficient resilience against disturbances that threaten the main functions
- Resilience requires sufficient capital, buffers, liquidity, net stable funding…
- Monetary policy cannot achieve financial stability
- Financial stability requires micro- and macroprudential policy
Leaning against the wind

- Tighter monetary policy than justified by stabilizing inflation and unemployment
- Dampen asset-price and credit booms, moderate threats to financial stability
- Presumes (Smets 2013):
  1. Macroprudential instruments or policies are ineffective
  2. A higher policy rate has a significant negative impact on threats to financial stability
- My view:
  1. Varies from country to country
  2. Has little theoretical and empirical support, although the latter may vary depending on the structure of the financial sector (competitive/oligopolistic, shadow banking…)

Sweden: Monetary policy outcome in recent years

- Inflation is far below the target
- Unemployment is far above a long-run sustainable rate
- Inflation below expectations has increased household real debt

Target achievement:
Average inflation significantly below target

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

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


Inflation in Sweden, euro area, UK, and US

Policy rates in Sweden, UK, and US; Eonina rate in euro area

Real policy rate in Sweden, UK, and US, real Eonia rate in euro area
Why?
- Household debt is high relative to disposable income

Why?
- Household debt is high relative to disposable income
- But debt is normal relative to assets

Household debt-to-income ratio
(% of disposable income)

Household debt and assets (excluding collective pensions), % of disposable income
What is the problem?

- Household debt is high relative to disposable income
- But debt is normal relative to assets
- Housing prices are in line with fundamentals (disposable income, mortgage rates, tax changes, urbanization, construction…)
- High debt mainly with borrowers with the best capacity to manage them (high income, high education, safe jobs, large assets) (Hedborg Government Commission of Inquiry)
- Household repayment capacity is good (FSA)
- Household resilience to disturbances in the form of mortgage rate increases, housing price falls, and income falls due to unemployment is good (FSA)
- Is there really a problem?
- What is the Riksbank’s case for leaning against the wind?

Riksbank’s case for leaning against the wind

- Higher debt could imply higher probability of a future crisis, or a deeper crisis if it occurs
- Hence, a tradeoff between tighter policy now and worse expected outcome in the future
- A higher policy rate now leads to worse outcome now but better expected outcome in the future (insurance premium)
- Is that true?
- The answer can be found in the Riksbank’s own boxes in MPR 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

- Benefit 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: The effect of 1 pp higher policy rate
  - 1 pp higher policy rate leads to 0.25 % lower real debt in 5 years
  - Lowers probability of crises by 0.25*0.4/5 = 0.02 pp
  - Riksbank crisis scenario (MPR July 2013, box): 5 pp higher unemployment in crisis
  - Benefit: Expected lower future unemployment: 0.0002*5 = 0.001 pp
  - Compare to cost: 0.5 pp higher unemployment rate

Source: MPR July 2013, chapt. 2; Svensson, posts on Ekonomistas and larseosvensson.se, March 31, 2014.
**Benefit 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:

  ![Graph showing the effect of 1 pp higher policy rate on debt ratio and unemployment.]

  - 1 pp higher policy rate leads to 0.44 pp lower debt ratio in 5 yrs
  - Smaller increase in unemployment in crisis: 0.44*0.02 = 0.009 pp
  - With probability of crisis as high as 10 %, divide by 10: 0.0009 pp (Shularick & Taylor: 4 %)
  - Compare with 0.5 pp increase in unemployment

Source: Svensson, posts on Ekonomistas and larseosvensson.se, March 31, 2014.

**Inflation below target causes real effects**

- Inflation expectations anchored at target
- Lower average inflation than expected causes real effects
- Higher unemployment
- Higher *real* debt for households …
- … and higher LTV ratios, lower net wealth and net wealth to assets …
- … and higher debt ratio

**Summarize cost and benefit of 1 pp higher policy rate**

<table>
<thead>
<tr>
<th>Cost: Higher unemployment during the next few years, percentage points</th>
<th>0.5</th>
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<tbody>
<tr>
<td>Benefit: Lower expected future unemployment, percentage point</td>
<td></td>
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<tr>
<td>1. Because of lower probability of a crisis</td>
<td>0.001</td>
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<tr>
<td>2. Because of a smaller increase in unemployment in a crisis</td>
<td>0.0009</td>
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<tr>
<td>Total benefit, percentage points</td>
<td>0.0019</td>
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<tr>
<td>Total benefit as a share of cost, percent</td>
<td>0.38</td>
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</tbody>
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**Lowflation/deflation and debt:**
**Increased real debt**

- Chair Yellen: “[W]ith longer-term inflation expectations anchored near 2 percent in recent years, persistent inflation well below this expected value increases the real burden of debt for households and firms, which may put a drag on economic activity.”
- Governor Ingves, in reply to a question if low inflation increases indebtedness: ”Interest rates are low and then it is easy to borrow… But in this context, the inflation rate is not a particularly significant issue.”
Leaning against the wind and household debt

- "Leaning against the wind" is counter-productive in Sweden
- Inflation on target, stable growth, and lowest long-run sustainable unemployment is monetary policy’s best contribution to the debt issue (at least in Sweden)
- Financial stability and any problems with debt are better handled with other means: macro- and microprudential tools (LTV cap, higher capital, risk weights…), taxes, deduction rules…

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