Interview: Lars Svensson

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Inflation targetting is in vogue, but does it have all the answers? Lars Svensson discusses the success of this fashionable regime to date and how it might be improved in the future.

Why do you favour inflation targetting? What distinguishes it from other frameworks of monetary-policy making?

The most obvious characteristic of inflation targetting is an explicit numerical inflation target. There is also a logical and efficient decision process, which I have called forecast targetting. The central bank makes forecasts of inflation and other variables, such as the output gap, and then chooses the interest rate so that these forecasts "look good", that is, are consistent with the objective. There is more transparency about monetary policy, which both makes the implementation more effective and the central bank more accountable. Some think that inflation targetting means that inflation equal to target is the only objective, "strict" inflation targetting, and that the objective must be met at a specific, rather short horizon. That is not correct. Inflation targetting is in practice "flexible" inflation targetting; meaning that the central bank is also concerned with the real economy and stability of the output gap, for instance.

It has been suggested that with a broad definition of inflation targetting as looking over the medium term, the policies of the Bundesbank as far back as the mid-1970s would qualify as an inflation targetter. Would you agree with that view?

The Bundesbank's rhetoric was in terms of monetary targetting, but it was really a closet inflation targetter. Whenever there was a conflict between stabilising inflation and stabilising money growth, the Bundesbank always went for the former. It was clear to knowledgeable observers that inflation was the priority. The monetary targetting was mainly rhetoric and obfuscation. One can say that it was inflation targetting without transparency and accountability.

How successful as a monetary policy framework has inflation targetting been?

It has worked very well. In particular, it has worked much better than was anticipated when inflation targetting was first introduced in the early 1990s. Now we know, ten years later, that inflation-targetting central banks all over the world have been quite successful in stabilising both inflation and the real economy. They have also been quite successful in anchoring long-term inflation expectations at the inflation target and thereby achieved credibility for the target. I don't think anyone in the early 1990s anticipated such success.

But has the system been tested in difficult times? How robust is it?

It is sometimes said that inflation targetting has not yet been severely tested by big shocks. But the fact is that there have been some pretty big shocks since the early

1990s. In Sweden there was a deep recession and a big depreciation immediately after the krona was floated, and initially very high inflation expectations and a severe lack of credibility for the target. However, in the end, the difficulties were managed very well by the Riksbank. In New Zealand and Australia you had the Asian crisis, sharp depreciations of the currencies and deteriorations of the terms of trade. This was also handled very well, especially by the Reserve Bank of Australia. Towards the end of the 1990s we have had booms, and more recently the fall of the stock market and the consequences of September 11. So by now we there have been quite a few big shocks and inflation targetting has worked very well during those shocks.

You often cite the Riksbank, the Bank of England and the Reserve Bank of New Zealand as examples of best practice. Are there any improvements that could be carried out in the inflation targetting at these central banks or others?

There have been considerable improvements in inflation targetting since the early 1990s. But there will always be scope for more improvement. As I said, all inflation targetting is flexible in the sense that central banks are concerned with the stability of more than inflation, mainly the output gap or the unemployment gap. Inflation-targetting central banks are becoming more explicit about those objectives, but I think they can go further. There is still some misunderstanding. For instance, some critics of inflation targetting seem erroneously to believe that it involves fine-tuning inflation at a fixed and rather short horizon. Regarding how inflation targetters can be more transparent about additional objectives, I have, for instance, suggested that they should decide on, and eventually go public with, the relative weight they put on output gap stabilisation relative to inflation stabilisation. Furthermore, potential output and output gaps are difficult but important concepts. Potential output cannot be observed directly – it has to be estimated. Central banks could also be more transparent and explicit about their estimates and forecasts of potential output and the output gap.

Do you think that if the central bank released its estimates of the output gap and said how much it "cared" about this relative to the inflation target it would make for better inflation targetting?

Yes, there would be more transparency about what inflation targetting actually is, and it would make the central banks more accountable. It would also increase public understanding of the issues involved and the difficulties these central banks are facing. I have also suggested that inflation targetters should publish the most likely interest rate path, which is their best forecast of their own future policy. This would be a way of providing more information, and also a way of making the implementation of monetary policy more efficient. Monetary policy largely works through expectations of future interest rates, the term structure of interest rates. What better way to affect those expectations than publish your view of the most likely path of future interest rates? So far only the Reserve Bank of New Zealand does this, as far as I know.

Should inflation targetting central banks set their own inflation targets?

Well, that's a very good question. Inflation targetting countries have different set-ups. In some countries the government sets the target. This is good for the political legitimacy of the target. But it has the drawback that the target can become a frequent election issue and frequently be adjusted, as has been the case in New Zealand. This may lead to less stability of, and less credibility for, the target. In other countries the legislative mandate says price stability but leaves the central bank to interpret the mandate and put a number on it. This may lead to some controversy about that interpretation, but it has the advantage that the target may remain more stable over time and therefore be more credible. Arguably, the precise level of the inflation target is a rather technical issue, involving measurement bias, zero-lower-bound issues, and so on, that is more suitable for experts than for governments or legislators. On the other hand, when the government sets the target, the government is also committed to the target, which should increase the probability that fiscal policy is consistent with the target. So there are pros and cons. I don't think it is clear yet that one set-up is necessarily better than the other.

So it's a political decision?

Well, each country should decide what set-up it wants and I don't think we can say necessarily that one is better than the other. From a research point of view it is good if countries try out different things because then after a few years we can evaluate the outcomes and see which is better.

Perhaps we could take the recent change to the Bank of England's target measure as an example. The treasury wants to change the measure and therefore implicitly the target. The Bank appears to be unhappy about this change and is certainly not happy with the timing: Mervyn King made remarks to the effect of "moving the goalposts" and Stephen Nickell said the Bank's job is to explain "what the hell is going on". What are your thoughts on this and what it does to policy credibility?

One should have a very good reason for changing the target because it is an extra complication. It may be difficult to explain to the general public, and may reduce the credibility of the target. The RPIX and the HICP have different properties and measurement bias, so a shift may also require a shift in the level of the target. I have not looked into the issue in any detail, but so far I am not convinced that there is a good reason to change.

Do you feel that an inflation targetting framework is appropriate for all economies at all stages of development?

Inflation targetting requires a certain institutional maturity, independence and competence. Not all countries have that, and inflation targetting may not be feasible in all countries. Nevertheless, it seems to work reasonably well in a number of emerging market countries and transition economies. So while I would not assert that it is suitable for all, it seems to be suitable for many.

It has had a mixed ride in some countries, though.

Well, it was considered very daring of Brazil, for instance, to introduce inflation targetting in the middle of a deep crisis. The central bank did it in a very short time, a few months, under the leadership of Arminio Fraga. But my view is that inflation targetting most likely has been better than any other regime for Brazil.

You outlined a method for Japan to extricate itself from persistent deflation, and indeed claimed that it is "foolproof". Could you describe it?

Japan is in a liquidity trap. Even though the nominal interest rate is zero, expectations of deflation imply that the real interest rate is too high to stimulate the economy out of its recession. The optimal policy in such a situation is to create private sector expectations of a higher future price level, and thus create inflation expectations. If you succeed in that it will reduce the real interest rate and get the economy going. The problem is how to make this higher future price level credible. A very expansionary fiscal policy in Japan has not worked, but has left a very high debt to GDP ratio. Since the spring of 2001, the Bank of Japan has expanded the monetary base more than 50%, which has not worked either.

How do we know that these policy measures have not worked? Because, if the private sector expected a higher future price level in Japan, it would also expect a weaker yen in the future. Expectations of a weaker yen in the future would immediately show up as a weaker yen now. But there hasn't been any substantial weakening of the yen. If anything, it has tended to appreciate recently.

My foolproof way is to set a high price-level target for the future, and to achieve this price-level target by a substantial depreciation today, the depreciation that would come about spontaneously if the private sector already believed in the higher future price level. Given a depreciation today, people would expect a weaker yen in the future, which would induce the desired expectations of a higher future price level. This would reduce the real interest rate today and get the Japanese economy going, and give the Japanese some room to undertake the necessary structural reforms. This is the best method and the one most likely to work. It is just the most effective way to conduct expansionary monetary policy in a liquidity trap.

As you note in your paper, however, the Bank of Japan is responsible for printing money but exchange rate policy is determined by the Ministry of Finance. So it is rather ironic that such depreciation would require cooperation between an independent central bank and a ministry of finance that would look like a loss of independence.

With free capital mobility, monetary policy and exchange-rate policy are two sides of the same coin. Nevertheless, in many countries, it is the ministry of finance that is responsible for exchange rate policy. This is a potentially serious problem for monetary policy independence. It would be better if exchange rate policy everywhere rested with the monetary policy authority. In Japan this division of responsibility should not be allowed to be a problem. The Ministry of Finance and the Bank of Japan should cooperate and jointly conduct expansionary monetary policy. The fact that they haven't done so is the worst monetary policy mistake since the great depression of the 1930s.

How much should Japan devalue and what would be the reaction of other countries?

Maybe a 25-30% depreciation of the currency, if you want a 25-30% higher price level in the future. That is probably what we would be talking about. But all we would really be doing is allowing Japan to have a sufficiently expansionary monetary policy. If the Japanese were not in a liquidity trap they would achieve this just by lowering the interest rate and we would not deny them that. Under my proposal, they would effectively be doing the same thing, but with a different policy measure. And of course the whole world would be better off if Japan were back on its feet and growing. Some of the trading partners have been nervous about losing trade to Japan. The fact is that if Japan were to start growing, its imports of raw materials and a number of other products would increase and the effect on the trade balance might very well be positive for the neighbours after a very short time. Simulations in a number of different macro-models by different authors have supported this.

Would the effect of the depreciation not be hampered by the fact that trade makes up only a small amount of Japan's GDP?

Imports and exports are only about 10% of GDP in Japan. But the purpose of the foolproof way is not to directly stimulate net exports, the purpose is to induce expectations of a higher future price level in Japan, which doesn't necessarily depend on the size of exports and imports.

But given the current institutional arrangements, nationally and internationally, it would require a considerable change of policy.

The Japanese can and should do it on their own. They have already lost more than a decade. They shouldn't have to lose a second decade. They should have done it when I first suggested it at a conference at Bank of Japan in the summer of 2000. The longer they wait, the worse it gets.

Moving to Europe, what will be the consequences of Sweden's recent decision not to join the euro?

I believe the monetary union will suffer a bit, because I think Sweden would have been a good influence. And certainly the ECB would have benefited from the competence and experience of the Riksbank. I guess Denmark and the United Kingdom are less likely to join the euro area now. Sweden will lose quite a bit from being marginalised, becoming an outsider, and losing influence in Europe.

How would you assess the Duisenberg years of monetary-policy making at the ECB? Inflation has averaged just over 2% for the period. Do you feel that commentators are too hard on Duisenberg?

The actual interest rate decisions made by the ECB and the Eurosystem have to be evaluated given the information available at the time of the decisions – *ex ante* rather than *ex post*. *Ex post* it may very well be that policy was too easy in the beginning and therefore had to be too tight later. But it was very difficult to see that *ex ante*. I don't think in the end one can say that interest rate decisions have been systematically wrong. What one can criticise the ECB and the Eurosystem for is an ill-conceived monetary policy strategy, with excessive emphasis on the monetary pillar, and an asymmetric and ambiguous definition of price stability, as well as a lack of transparency. There has been some improvement in the recent clarification of the monetary policy strategy. This was a change in the right direction, but it was not large enough. The best way forward for the ECB and the Eurosystem is simply to adopt all aspects of conventional inflation targetting, following Bank of England and the Riksbank.

What difference will this "clarification" make to the ECB's monetary policy strategy?

I don't think it will make much difference for the interest rate decisions. But it will make things clearer. Less time will have to be devoted to explaining why deviations of money growth from the reference value have been neglected again. The downgrading of the monetary pillar was more or less inevitable. The modification of the definition of price stability from "below 2%" to "below, but close to 2%" seems to be an uneasy compromise between a point target of either 2% or 1.5%.

What role do you think monetary aggregates should play in monetary-policy making?

Monetary aggregates are one set of indicators among many others. The weight you put on them should depend on how much they help you forecast inflation and output. In most cases money does not have much information beyond other indicators about inflation and output over the next few years. Therefore you should place a rather small weight on money.

One argument often made in favour of monetary aggregates is that they provide information about bubbles asset price booms. What is your view on that?

It makes sense to look at households', firms' and banks' balance sheets and watch for imbalances and financial vulnerability, so that action can be taken well in advance of any financial instability. Financial instability, including bubbles and the bursting of bubbles, can have an impact on inflation and the real economy. But monetary aggregates are only a small part of the relevant information about these balance sheets and any financial vulnerability.

Despite the uneasy compromise, as you call it, you would broadly support what the ECB did in its new two pillar strategy?

As I said, I think it was a step in the right direction, but not far enough. The ECB's *Monthly Bulletin* is not of the same quality and not as informative as the reports issued by the Bank of England and the Riksbank. I still think the ECB puts too much emphasis on monetary aggregates in their reporting and rhetoric.

And this rhetoric is crucial to achieving monetary policy goals.

Sure. If the rhetoric is confusing or misleading, it is more difficult for the general public and the financial markets to understand and predict monetary policy. Then the implementation of monetary policy is less effective.

How damaging is recent confusion over the stability and growth pact to the European economy and the euro?

The problems with the stability and growth pact would have been much less if the countries concerned, having agreed to the pact, had undertaken fiscal consolidation in time so as to be able to run a sufficient budget surplus on average over the cycle. This would have left a sufficient margin for expansionary fiscal policy during a downturn without exceeding the maximum deficit under the pact. It is very unfortunate that the big countries now in trouble did not undertake that fiscal consolidation earlier. But the pact itself is far from ideal.

Do you see this situation, where several of the main players in the European project are flouting the rules, as threatening the euro?

It is certainly a problem if some of the larger countries do not take their commitments as seriously as the smaller ones. This causes tension in the euro area, and it gives a bad impression. It certainly did not help the yes-side in the Swedish referendum.

What is the central bankers' role in this situation?

Central banks are responsible for monetary policy. They can point out the consequences of different fiscal policy alternatives and what the impact is for monetary policy. But the responsibility for fiscal policy outcome rests squarely with the government and the parliament in each country.

What is your view of the ECB's new voting rule?

It is very bad. There are three problems with it. First, it violates the principle that the members of the Governing Council should be there in their personal independent and capacity, not as a representative of their country. Second, the Governing Council will be much too large to be an effective decision-making body. Even if everybody cannot vote, everybody will want to speak, and there will not be enough time for any serious discussion. Third, it is very unfair! A miniscule country like Luxembourg gets more influence than a large country like Poland. A simple and much better solution, proposed by several observers, is for monetary policy in the euro area to be run by the Executive Board, and for the Governing Council to meet only every six months or so for an overview and evaluation of the board's decisions. This would be a much better way to do it.

And that sort of arrangement, with a small executive board, is the best institutional arrangement to take monetary policy decisions?

I believe a fairly small board with members who are experts on monetary policy is best for the decisions and for thorough and relevant discussions of the issues. The sixmember board for the Riksbank seems to work quite well. For New Zealand, I proposed a five-member committee. Five would have the advantage that there would be fewer cases of a tie and the need for the governor's decisive vote. For New Zealand, I suggested an internal committee with no external members on the grounds that a small country like New Zealand would have relatively few suitable external members without conflicts of interest.

Do academics make good central bank governors?

A list of excellent governors would include both academics and non-academics. I don't see that formal academic qualifications are required to be a successful governor. Certainly you need a good grasp of monetary economics – if you don't have it when you are appointed, you have to learn it on the job.

Many people have said that inflation has been defeated and concerns about widespread deflation also seem to have gone quiet of late. What is the big challenge for central banks on the horizon?

I would say there are more immediate challenges that should be met first. Japan, the world's second largest economy, is still caught in a liquidity trap. As I have said, this is the worst monetary policy mistake since the great depression. Getting Japan back on its feet is a most immediate monetary policy challenge. Anything else on the horizon pales compared to that.

Do you think that the independence of central banks is here to stay, or is it likely to be a temporary phenomenon?

If central banks do their job well, I don't think their independence will be threatened. If they do their job badly, like the Bank of Japan, one could argue that they don't deserve their independence and that it should be taken away.

Independence has to be continuously earned?

Think of the following trinity for the institutional design of monetary policy: mandate, independence, and accountability. The central bank's objective is to achieve the mandate it receives from the government or the parliament. It receives independence so it can achieve the mandate most effectively, without being subject to short-run political interference. It is held accountable for achieving the mandate. If the central bank does not use its independence well to achieve its mandate, it does not deserve to keep the independence.