

The 2008 Lindahl Lectures: Monetary Policy in Theory and Practice

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Uppsala University
October 28-30, 2008



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2008 Lindahl Lectures: Outline

- **Lecture 1, October 28:**
Transparency under flexible inflation targeting:
Experiences and challenges (the present)
- Lecture 2, October 29:
What have economists learned about monetary policy
over the past 50 years? (the past)
- Lecture 3, October 30:
Optimal monetary policy in an operational medium-
sized DSGE model (the future)



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Transparency under Flexible Inflation Targeting: Experiences and Challenges

Lars E.O. Svensson
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Outline today

- Flexible inflation targeting
- The role of transparency
- Publishing an instrument-rate path
- Committee decisions on instrument-rate paths
- Management of instrument-rate expectations
- Publishing attributed minutes
- Desirable future developments
- Flexible inflation targeting in a financial crisis



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Lindahl on rational monetary policy

- “The most important task for monetary economics at present is to practically apply the theoretical results and to clarify the meaning of *the principles of a rational monetary policy*.

When accounting for these principles one should first define the aim, which the monetary policy should seek to realize, and then examine the conditions and the means for the achievement of this aim.”

[*The Aims of Monetary Policy*, 1924, p. 3]



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Lindahl on transparency

- “As a general rule, it can be stated that the greater the publicity, the greater the effectiveness of monetary policy actions. Publicity thus becomes a means of *psychological influence* on the public in a price-stabilizing direction. We shall seek to clarify this with respect to what the publicity mainly should comprise, to wit, in part the general program for monetary policy and in part the motivation of the actions, which are taken in each specific case.”

[*The Means of Monetary Policy*, 1929, p. 27]



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Flexible inflation targeting

- Stabilize both inflation around target and resource utilization
- “Forecast targeting:” Choose an instrument-rate path such that the forecast of inflation and resource utilization “looks good”
- “Looks good:” Inflation goes to target and resource utilization goes to normal at an appropriate pace
- Publish and explain instrument-rate path and forecast of inflation and real economy
- “Management of expectations”



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Lindahl on managing expectations

- “The issue is the degree of *publicity*, which the [central] bank applies in its policy. We have previously explained that the individuals’ expectations about the future are an important determining element for the price level. By applying a larger or lesser degree of publicity the bank influences the individuals’ expectations and by that means indirectly the price level and the effectiveness of the measures, which the bank takes for its stabilization.”

[*The Means of Monetary Policy*, 1929, p. 27]



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The role of transparency in flexible inflation targeting

- More effective “management of expectations”
- Improve public-sector information, reduce uncertainty
- More effective external scrutiny and evaluation: Improve central-bank incentives
- Strengthen democratic accountability
- Riksbank
 - High transparency ranking in academic literature
 - Explicit communication policy (appendix)



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Publishing instrument-rate paths

- RBNZ 97, Norges Bank 05, Riksbank 07, Sedlabanki Islands 07, CNB 08
- Why so few?
- Commitment? Not a problem in NZ, Norway, Sweden: “It is a forecast, not a promise”
- Decrease welfare if more bad public information (Morris-Shin 02, Svensson 06)
- But CB info about own intentions should be better



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Committee decision on instrument-rate path impossible?

- Goodhart 07 (single number OK, path not)
- Svensson 07 aggregation mechanism: Median path
- Not yet needed at Riksbank
- Interaction between staff and Executive Board during decision-making process results in main scenario, possibly alternative scenarios
- At final policy meeting discussion and vote on current rate and main scenario
- Dissenters explain dissent in minutes published after two weeks



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Committee decisions on instrument-rate paths impossible?

- Good side effects: Policy discussion forward-looking, on repo-rate path more than current rate
- Works fine for individualistic committee of 6
- Should work for committee of 9, 12, 19, ...
- Perhaps more complex if not in-house full-time committee
- No regrets



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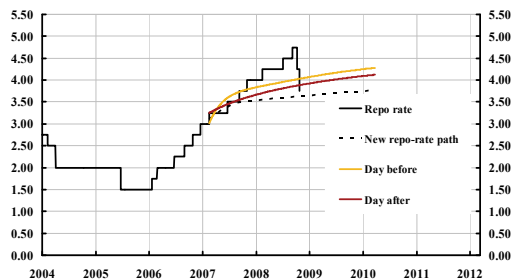
Management of interest-rate expectations

- Riksbank publishes and explains forecast of inflation, real-economy, and repo-rate
- What is the Riksbank's record in managing interest-rate expectations?
- Compare repo-rate path to market expectations (adjusted implied forward rates) before and after announcement

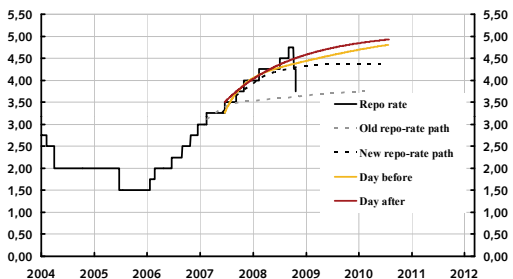


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Repo-rate path and market forward rates February 15, 2007



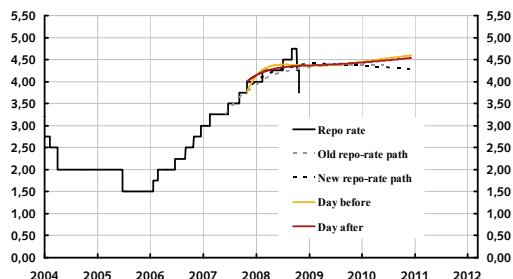
Repo-rate path and market forward rates June 20, 2007



Note:

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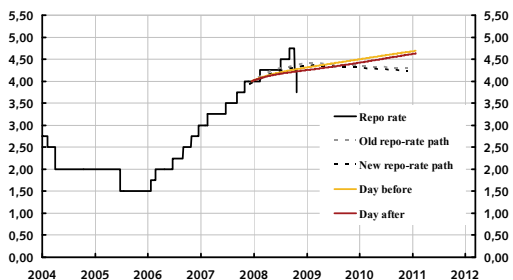
Repo-rate path and market forward rates October 30, 2007



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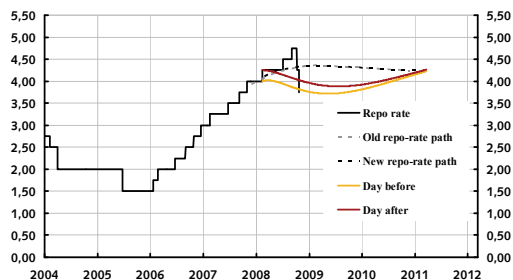
Repo-rate path and market forward rates December 19, 2007



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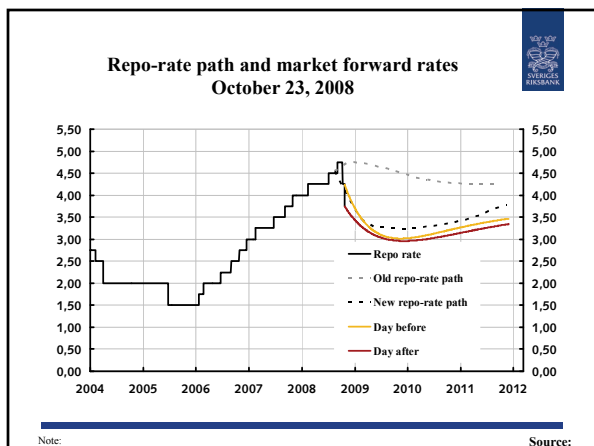
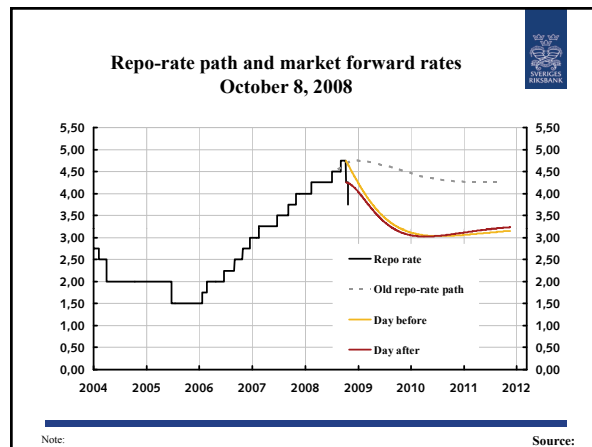
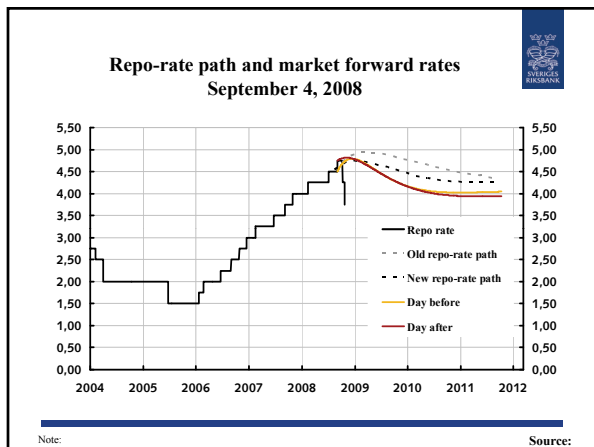
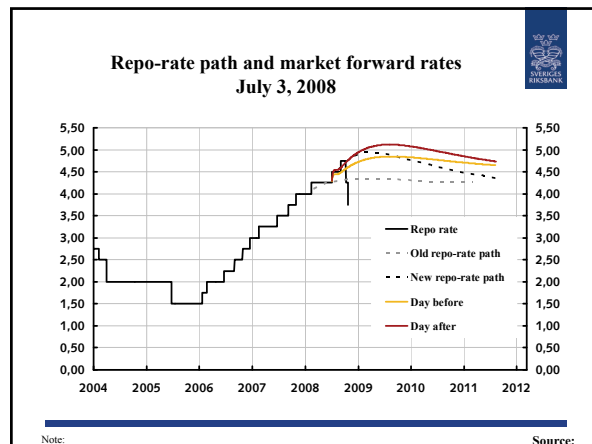
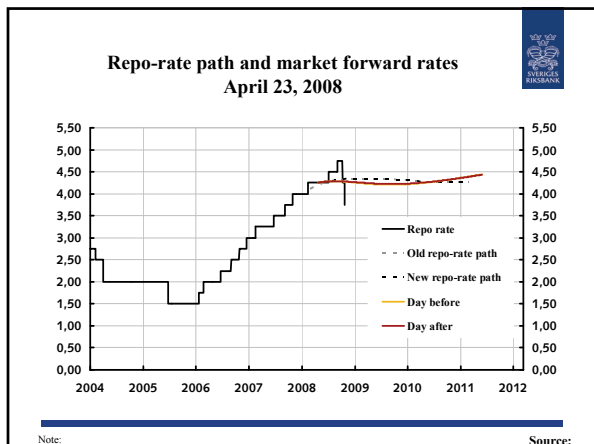
Source:

Repo-rate path and market forward rates February 13, 2008



Note:

Source:



Management of interest-rate expectations

- Pretty good, but not a complete success
- Riksbank taken more seriously over time
- “Forecast, not a promise”
- About 8 out of 10 paths reasonably well predicted by market
- Shift of market expectations towards repo rate expect June 2007 and July 2008

Note: Source: 24

Management of interest-rate expectations



- Adjust policy so as to reduce any surprise?
- No, always do the right thing
- Geerats 08: “For instance, by delaying policy decisions to avoid market surprises it becomes harder for the public to understand the central bank’s monetary policy reaction. As a result, a focus on short-term predictability could actually undermine monetary policy transparency, harm credibility and reduce predictability in the medium and long run.”

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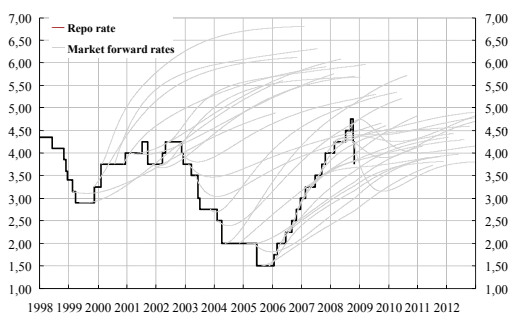
Management of interest-rate expectations



- Reduce surprise: Leak before policy meeting?
- No, would move decision earlier
- Cause surprise at leak instead of at policy announcement
- Evaluate predictability at announcement misleading
- But slight modification of Riksbank communication policy: Comment on new data and issues, but not anticipate decision

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Market forward rates: Not so good forecasts



7,00
6,50
6,00
5,50
5,00
4,50
4,00
3,50
3,00
2,50
2,00
1,50
1,00

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Explaining monetary policy



- Monetary Policy Report/Update morning after policy meeting (6 per year)
- Attributed minutes 2 weeks after policy meeting

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Lindahl on explaining monetary policy?



- “Apart from ... [the] program declaration, the central bank could psychologically influence the public by having the monetary policy actions in each given case be followed by a distinct *motivation*. This motivation could include an account of the monetary policy situation and a clarification of how it should be influenced in a certain direction and that the action taken served this purpose. These statements of principle, which would give the public an insight into the causal connection, would undoubtedly increase the effectiveness of monetary policy actions.”
[*The Means of Monetary Policy*, 1929, p. 28-29]

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Publishing attributed minutes



- Decided in May 2007, before I joined
- Nervous: Less free discussion?
- Unique for Riksbank
- More individual preparation, no free riding/social loafing (Blinder 08)
- Strengthen individual accountability

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Publishing attributed minutes

- Less group-think?
- Less free discussion, less genuine interchange of views?
- Some staff members say discussion has improved
- More free discussion over time
- Final policy meeting culmination of long decision-making process with lots of free discussion: More of summary and final vote
- Attributes are edited (good; transcripts would be bad)

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Desirable future developments

- Better explanation of flexible inflation targeting (Giavazzi-Mishkin, Committee on Finance)
- De-emphasize two-year horizon (Riksbank history)
- Better measures of resource utilization, output gap, potential output
- More emphasis on real repo-rate path
- Better measures of neutral real interest rate
- Better measures of monetary stance
- Optimal policy projections

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Financial crisis

- Since mid September: Financial crisis in Sweden
- From abroad (US, Europe, Iceland)
- Money market (interbank): Problem for longer maturities
- Increased risk premia, interest-rate spreads, insufficient liquidity
- Financing more expensive and difficult for banks, firms, households: Credit crunch
- Fall in asset prices (stocks, property)

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Financial crisis: Specific policy measures

- National Debt Office: Supply liquid Treasury Bills against collateral (illiquid mortgage bonds)
- Riksbank: Relax collateral requirements, lend SEK and USD 1, 3, 6 months (against collateral), issue Riksbank Certificates, lend to Kaupthing Bank Sweden and Carnegie Investment Bank
- Government: Increase deposit guarantee, stabilization plan (guarantees, capital injections, public administration of failed banks)

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Financial crisis: Flexible inflation targeting

- Sand in transmission mechanism
- Contractionary effect on real activity
- Lower forecast of inflation and resource utilization
- Specific policy measures: Improve liquidity, maintain financial stability, restore transmission mechanism
- Monetary policy: More expansionary, lower repo-rate path
- Principles for flexible inflation targeting still valid; practice more difficult, repo-rate path less effective?

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