My view of monetary policy

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Introductory statement at the meeting of the Nationalekonomiska föreningen (the Swedish Economic Association) on May 11, 2012, at the Stockholm School of Economics, on "What is the view of the Executive Board on Its Monetary Policy?"

My view is that monetary policy should focus on stabilizing CPIF inflation around the inflation target and unemployment around a long-run sustainable rate. In the Sveriges Riksbank Act it says that the objective of the Riksbank shall be to maintain price stability. In the Government Bill proposing the Riksbank Act it says the Riksbank shall also, without prejudice to the price-stability objective, support the objectives of the general economic policy with the aim of achieving sustainable growth and high employment.

High employment is of course the same as the *highest sustainable* employment. In the beginning of each Monetary Policy Report the Riksbank states in line with this that it, in addition to stabilizing inflation around the inflation target also strives to stabilize output and employment around long-term sustainable paths. This is in practice the same as stabilizing unemployment around an estimated long-run sustainable rate.

Therefore I want to focus on unemployment and not on a number of other, rather unreliable measures of resource utilization. Compared with other measures of resource utilization the unemployment rate is more related to household welfare, is better understood and known by the general public, is measured more often and with less measurement errors, and is seldom revised. It is the rate of unemployment, not for instance output growth, that should be in focus.

With my view, at each monetary-policy meeting it is then a matter of choosing a policy-rate path such that the corresponding forecast for inflation and unemployment best stabilizes inflation around the target and unemployment around a long-run sustainable rate. It should not be the case that a lower or higher policy-rate path implies better goal attainment for both inflation and unemployment. Such things are apparent in the so-called four-panel figures that I use to bring to the meetings and are published in the minutes. In these figures you can clearly compare different policy-rate paths and corresponding forecasts for inflation and unemployment. These figures are in my mind very useful for selecting the appropriate policy-rate path, for justifying the selected path, and for evaluating monetary policy.

I have dissented in favor of a lower policy rate and policy-rate path since April 2009, because the forecast for inflation has been below the target and the forecast for unemployment has been above any reasonable long-run sustainable rate. The case for a lower policy rate and policy-rate path is even stronger taking into account what Karolina Ekholm has said about the forecasts for foreign policy rates. I agree completely with her that they have been too high.

I am also of the opinion that one should not neglect the price-stability target and stabilization of unemployment around a sustainable rate in order to conduct some kind of leaning-against-the-wind policy. Leaning against the wind implies tight monetary policy in the belief that one then improves financial stability, for instance by limiting mortgage growth. I cannot see that there is any theoretical or empirical support for the presumption that a higher policy rate should under current conditions have any significant effect on financial stability in Sweden.

Instead there are now much better policy instruments within macroprudential policy, such as minimum capital requirements and maximum mortgage loan-to-value ratios, and new instruments under way, such as the minimum so-called Liquidity Coverage Ratio and Net Stable Funding Ratio in Basel III. These instruments have better and more directed effect on financial stability and mortgage growth. With the Riksbank's Financial Stability Reports and Finansinspektionen's (the Swedish Financial Supervisory Authority's) report on the Swedish mortgage market there is also very good information about potential risks. My view is thus that one shall do as now in Great Britain and conduct monetary policy and financial-stability policy separately, with separate objectives and separate instruments.

If you mix monetary policy and financial-stability policy it also becomes more or less impossible to evaluate monetary policy, since tight monetary policy can then be justified as an attempt to improve financial stability.

Inflation expectations have become anchored to the inflation target during the last 15 years even though average inflation has fallen below the inflation target. As I have discussed in the minutes, and shown in a paper on my Stockholm University website, this implies that the long-run Phillips curve is no longer vertical.[1] This in turn implies that average inflation below the target leads to a real cost in terms of higher average unemployment. Then it becomes important not to have a bias towards too tight monetary policy.

Instead it becomes a matter of making sure that the inflation target is symmetrical and that average inflation over a longer period, as in Canada, Great Britain, and the Eurozone, falls close to the target. For instance, you must not be afraid of overshooting the inflation target if this is necessary to reduce unemployment quicker towards a long-run sustainable rate. Unfortunately, in Sweden average inflation has fallen substantially below the target during the last 15 years, which has caused a considerable real cost in the form of higher average unemployment during the same period.

[1] Svensson, Lars E.O., "The Possible Unemployment Cost of Average Inflation below a Credible Target," working paper, May 2012, www.larseosvensson.net.