

Current challenges for the conduct of monetary policy in the euro area:

Should the ECB do more?

Lars E.O. Svensson

Web: larseosvensson.se

Blog: ekonomistas.se (English on larseosvensson.se)

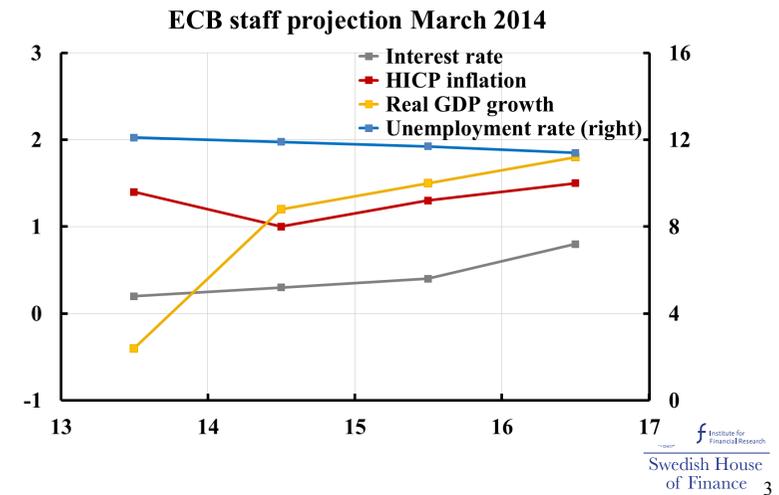
The ECB and its Watchers XV
Frankfurt, March 12, 2014

1

Outline

- Should the ECB do more?
- How has the ECB done?
- Does the ECB have enough policy measures?
- More on forward guidance: Normal procedure?

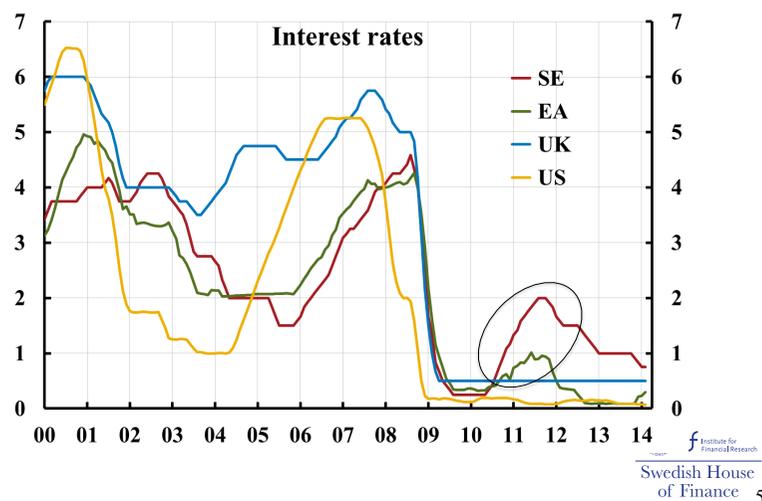
Should the ECB do more? **Yes, if possible**



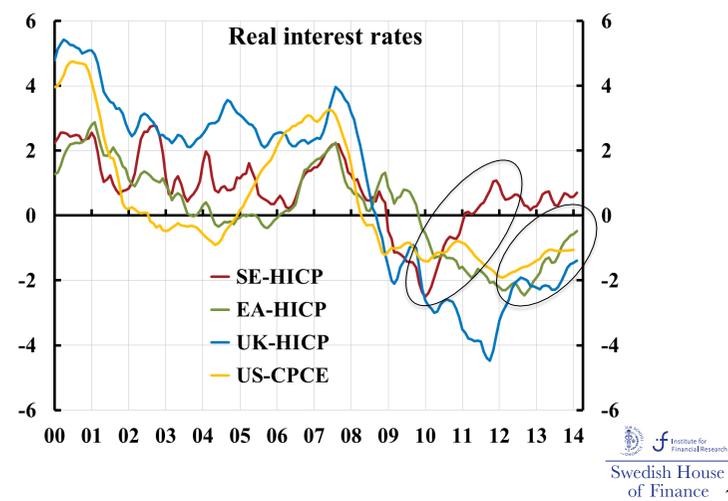
How has the ECB done?

- A partial view: Short real interest rate

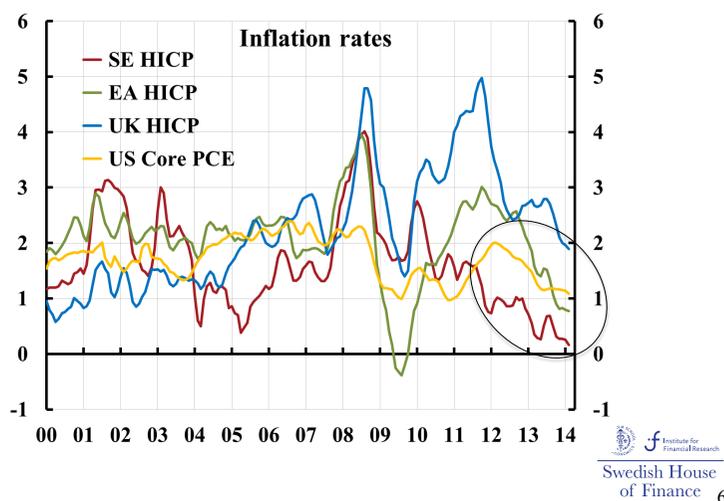
Nominal Eonia rate and policy rates in Sweden, UK, US



Real Eonia rate and policy rates in Sweden, UK, US



Inflation: Euro area, Sweden, UK, US



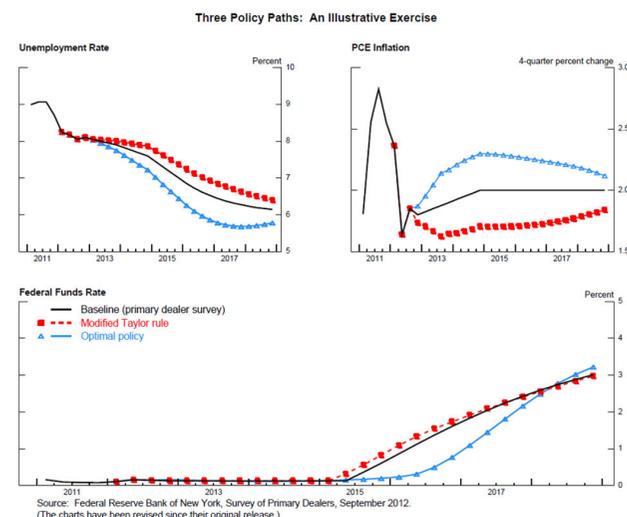
Does the ECB have enough policy measures?

- Difference policy rate (MRR) and Eonia rate: Why not smaller corridor?
 - Riksbank “fine tuning”, corridor ± 10 bp
- Do not exclude zero/negative interest rate (-0.25%)
- Balance-sheet policies, large-scale asset purchases (OMT)
 - Set up so ready to be used, then use
 - Distinguish from liquidity support (LTRO, financial stability)
 - Prohibition of monetary financing? Should be prohibition of *inflationary* financing
 - Risk of losses unavoidable: Central banks have to take risks in crises
 - Monetary-policy actions in crises have unavoidable fiscal and financial-stability side effects
 - Classify actions according to main purpose

Does the ECB have enough policy measures?

- Forward guidance, in the form of a published policy-rate path (forecast, not commitment), should be normal part of policy
 - Other forms of forward guidance when needed (commitment, conditional, threshold, balance-sheet, etc.)
- Policy-rate path part of normal “forecast targeting” – setting the policy-rate path so forecasts of target variables “look good” (fulfill objectives)

Forecast targeting: Yellen (2012)

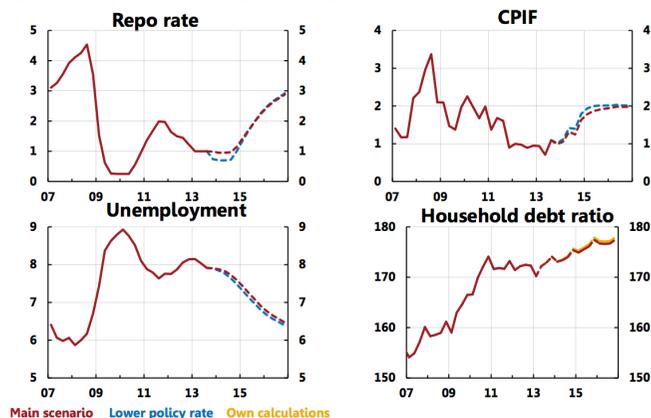


Source: Yellen, Janet L. (2012), “Revolution and Evolution in Central Bank Communications,” speech at the Haas School of Business, University of California, Berkeley, November 13, 2012, www.federalreserve.gov.

Forecast targeting, alternative policy-rate paths

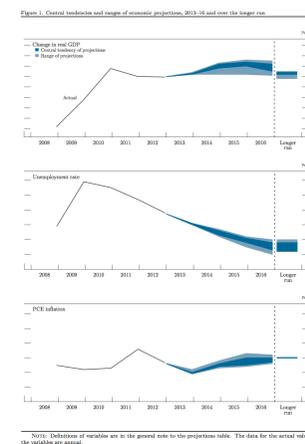
Corresponding forecasts of inflation, unemployment, and debt ratio (Riksbank, Ekholm 2013)

Figure 2. More expansionary monetary policy

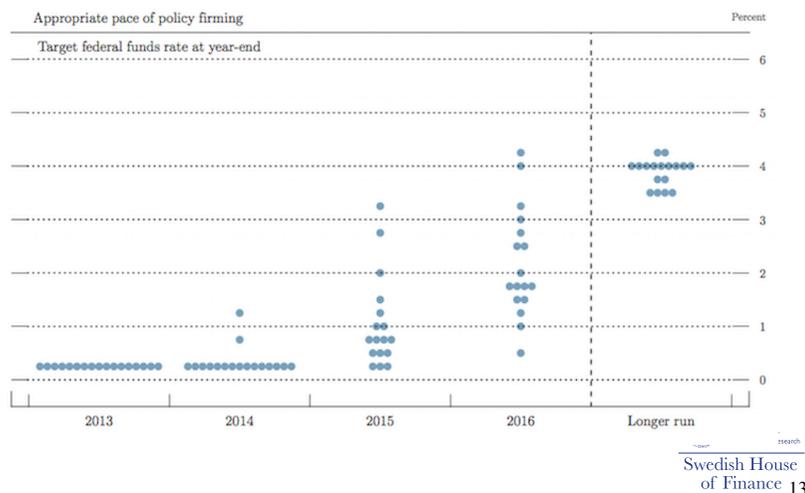


Source: Ekholm, Karolina (2013), “Why Swedish Monetary Policy Needs to Be More Expansionary,” speech on November 15, 2013, www.riksbank.se.

Fed Economic Projections, Dec 2013



Fed Economic Projections, Dec 2013



Swedish experience

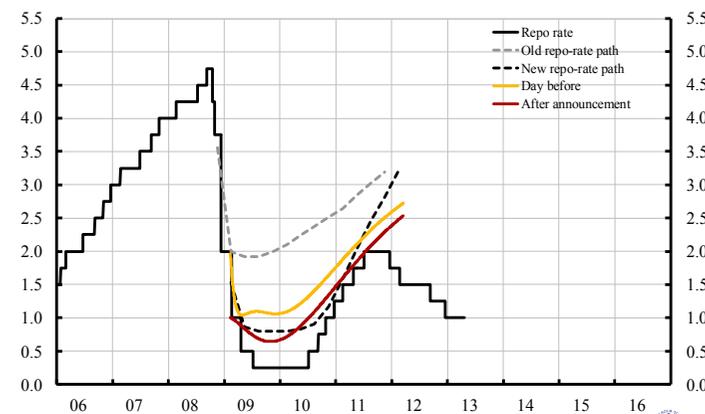
- “Forward guidance in theory and practice: Swedish experience,” Dec 2013, larseosvensson.se

Why normal to published policy-rate path?

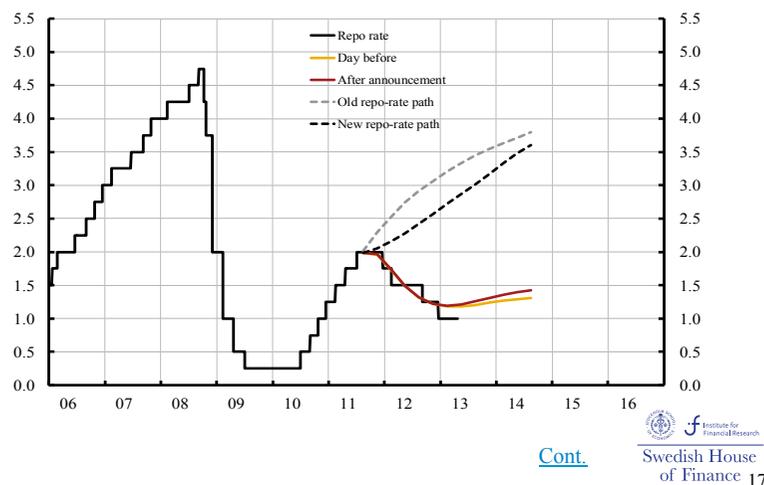
- Transparency:** Coherent forecast of target variables requires forecast of instrument. Then publish this.
- Effectiveness:** Management of expectations (of the future policy rate)
- Informativeness:** Central bank should have more info about its future policy settings. Useful info for private sector
- Justification:** Provides a coherent way of justifying policy choice by comparison with policy alternatives
- Accountability:** Simplify external evaluation of policy by comparison with policy alternatives and assessments of tradeoff between target variables

Riksbank record mixed:

February 2009: **Success!**



Riksbank record mixed:
September 2011: **Failure!**



Extra

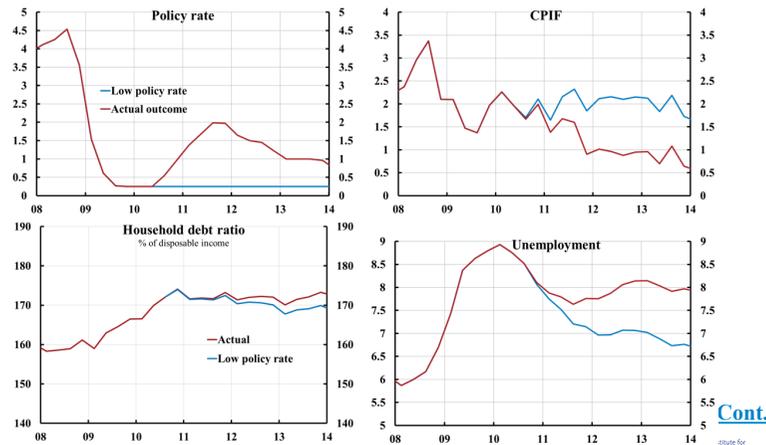
Risks from forward guidance about policy rate?
(Filardo and Hofmann; FT)

- Central-bank reputation?
- Financial stability?
 - Disruptive market reactions
 - Risk of MP becoming too concerned about market reactions, delaying normalization (financial dominance)
 - Excessive risk-taking, build-up of financial vulnerabilities
- Learning process (both market and CB)
- Reputation risk, old argument against inflation targets
- After crisis, probably too little risk-taking. But what is optimal risk-taking?
- Watch indicators of vulnerability, use macroprudential instruments if needed

Monetary policy and threats to financial stability

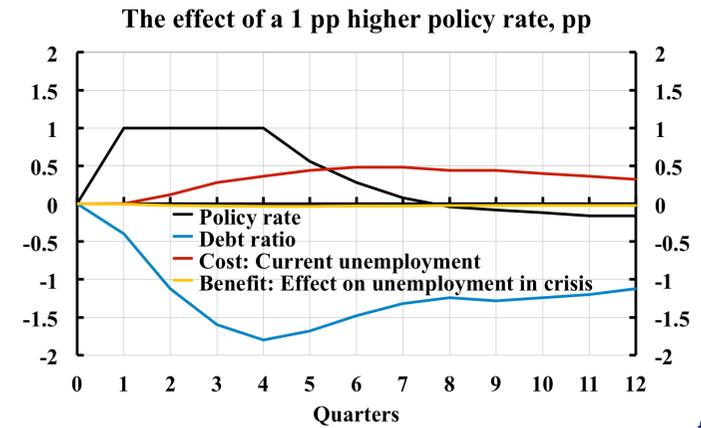
- Monetary policy has normally little effect on financial stability
- Financial stability can normally be handled by other means
- Only if monetary policy is considered to pose a *significant threat* to financial stability, and that threat *cannot be handled* by the standard macro-prudential instruments, should monetary policy be allowed to deviate from the standard monetary-policy objectives.
- Who should decide? The authority/committee responsible for financial stability
- Bank of England provides an example: August 2013 forward guidance, knockout 3: *FPC* decides if risk, not MPC

Tightening in summer 2010 has led to inflation below the target, higher unemployment, and higher (!) debt ratio



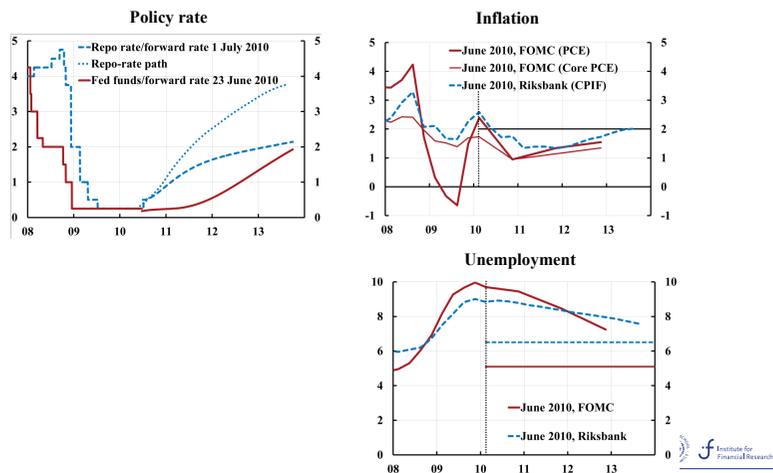
Source: Svensson (2013), "Unemployment and monetary policy – updatating for the year 2013," Swedish House of Finance 21
larseosvensson.se

Riksbank tradeoff reasonable?



Institute for Financial Research
 Swedish House of Finance 23

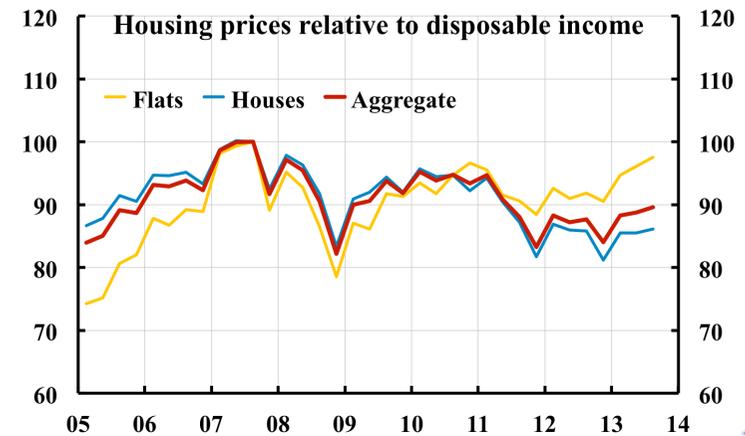
Fed and Riksbank, June/July 2010 Similar forecasts, very different policies



Svensson (2011), "Practical Monetary Policy: Examples from Sweden and the United," *Brookings Papers on Economic Activity*, Fall 2011, 289-332.

Institute for Financial Research
 Swedish House of Finance 22

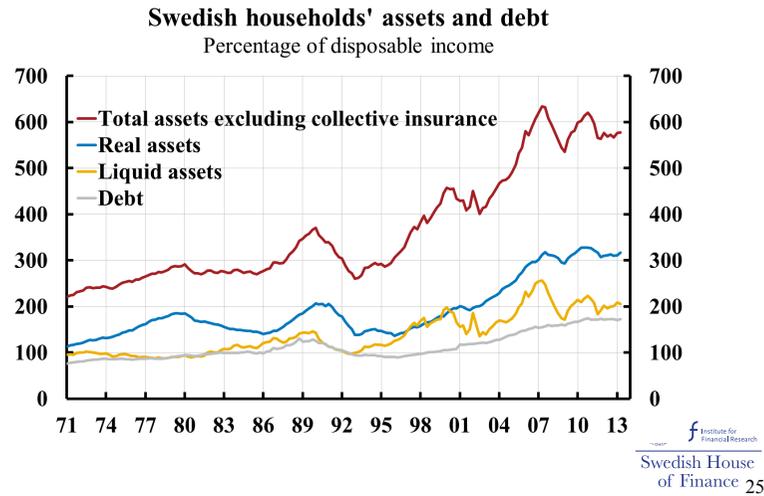
Housing prices relative to disposable income



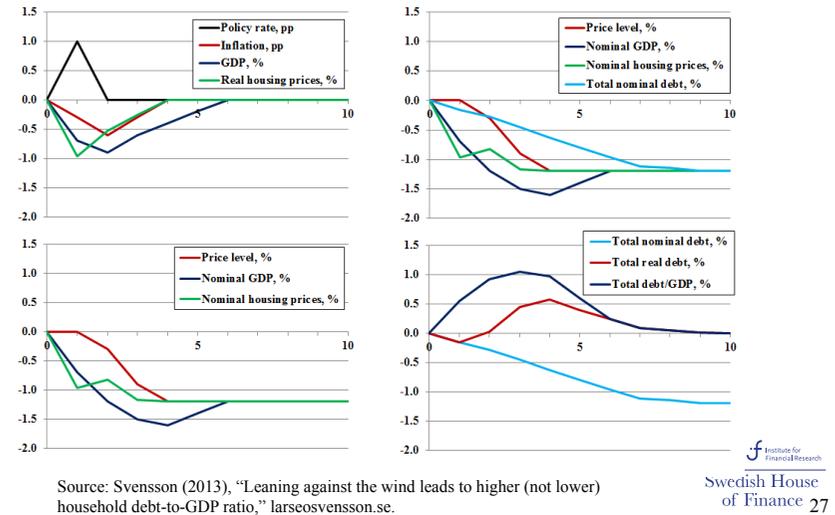
Source: Statistics Sweden, Valuegard

Institute for Financial Research
 Swedish House of Finance 24

Household debt and assets (excluding collective pensions)

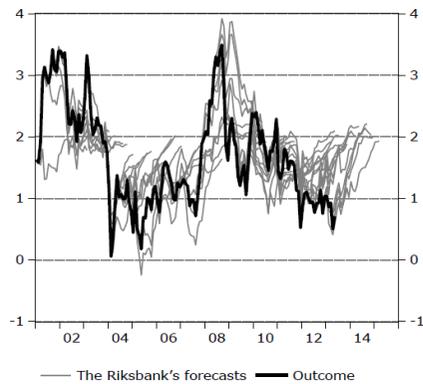


Impulse responses to 1 percentage point higher policy rate during year 1



Riksbank inflation forecasts biased upwards

Riksbank inflation forecasts and actual outcome (CPIF)



Source: National Institute of Economic Research (2013)