A natural experiment of premature monetary policy normalization and of the neo-Fisherian view

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Can monetary policy still deliver?

- Can monetary policy still deliver inflation on target and full employment?
- A natural experiment: Riksbank policy-rate hikes 2010-2011, from 0.25% to 2%
- What happens to inflation and unemployment when the central bank (for no good reason) raises the policy rate by 175 bp?
- Also a natural experiment of premature policy normalization
- And a natural experiment of the neo-Fisherian view: Does inflation really increase after a policy-rate increase?
175 bp for no good reason?
Fed and Riksbank forecasts in June 2010

- Riksbank and Fed forecasts quite similar
- Policies very different
  - Fed: Keep policy rate between 0 and 0.25%; use forward guidance; prepare and initiate QE2
  - Riksbank: Raise policy rate from 0.25% to 2%
- Both policies cannot be right
  - Karolina Ekholm and I dissented against the majority’s hikes

The Swedish experience: Rate hikes 2010-2011

Interest rates

Rate hikes 175 bp

Inflation rates

Inflation fell from 2% to zero

Real interest rates

The real interest rate rose, created large gap

Exchange rates

The krona appreciated

The Swedish experience: Rate hikes 2010-2011

Rate hikes 175 bp

Inflation fell from 2% to zero

The real interest rate rose, created large gap

Unemployment stopped falling and rose

The Swedish experience: Turnaround Spring 2014

Rate hikes 175 bp
Rate cuts to -0.5%
Inflation fell from 2% to zero
Inflation rose back to 2%
The real interest rate rose, created large gap
The real interest rate fell
The krona appreciated
The krona depreciated

The Swedish experience: Turnaround Spring 2014

Interest rates

Rate hikes 175 bp
Rate cuts to -0.5%

Real interest rates

The real interest rate rose, created large gap
The real interest rate fell

Unemployment rates

Unemployment stopped falling and rose
Unemployment started coming down

Inflation rates

Inflation rose back to 2%
Inflation fell from 2% to zero

Real interest rates

The krona appreciated

The Swedish experience: Inflation expectations

Inflation fell from 2% to zero
Rate hikes 175 bp

Inflation rose back to 2%
Rate cuts to -0.5%

The real interest rate rose, created large gap

Inflation expectations rose
Inflation expectations fell

The Swedish experience

- Monetary policy in Sweden works like clockwork and according to the textbook
- What contributes to powerful monetary policy in Sweden? (Small, very open economy; flexible exchange rates; flexible inflation targeting)
  1. Strong exchange-rate channel
  2. Strong household cash-flow channel
The Swedish experience: The exchange-rate channel

- Small very open economy
  - Strong exchange-rate channel
    - Affects activity of export and import-competing goods industry
    - Affects prices of imported final goods, intermediate inputs and raw materials
The Swedish experience: The household cash-flow channel

- High household debt, variable mortgage rates
  - Strong household cash-flow channel (also the DK, NO, UK, …)
  - Lower policy rate and mortgage rates reduce interest payments and improve indebted households’ cash-flows
  - High household debt and variable mortgage rates provide insurance against recessions: An automatic stabilizer (with flexible exchange rates, not with fixed exchange rate)
Conclusions

- Premature normalization of the policy rate not good
- “Policy normalization” should involve the normalization of the target variables (inflation, employment, output), not of the policy rate
  - Normalizing the target variables may require a non-normal and low policy rate, due to a low neutral policy rate
- The Swedish experience provides no support for the neo-Fisherian view
- With high household debt and variable mortgage rates, the household cash-flow channel of monetary policy is strong, makes monetary policy more effective, and provides some insurance against recessions