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?
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

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

Inflation rose back to 2%
The real interest rate fell
The krona depreciated

The Swedish experience: **Turnaround Spring 2014**

- **Interest rates**
  - Rate hikes 175 bp
  - Rate cuts to -0.5%

- **Inflation rates**
  - Inflation fell from 2% to zero
  - Inflation rose back to 2%

- **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

Unemployment stopped falling and rose
Unemployment started coming down

The Swedish experience: Inflation expectations

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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 **variable** mortgage rates, not **fixed** mortgage rates)
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