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

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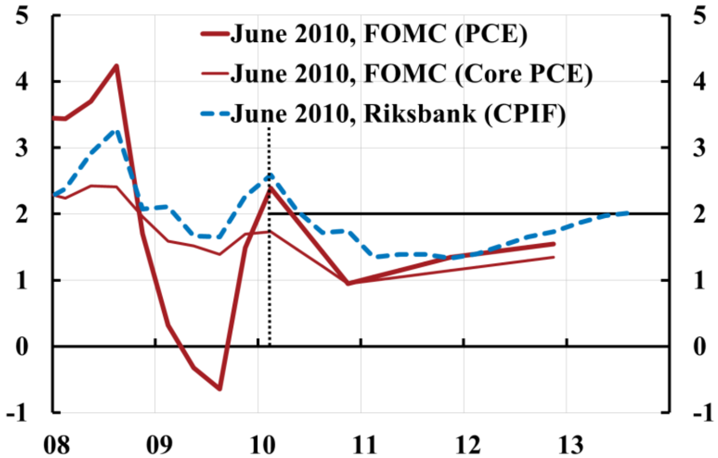
Can monetary policy still deliver?

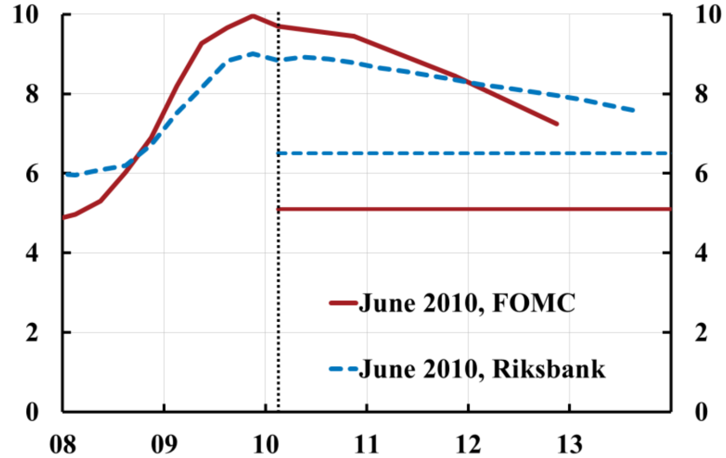
- Can monetary policy still deliver inflation on target and full employment?
- A natural experiment: Riksbank policy-rate hikes 2010-2011, from 0.25% to 2%
- What happens to inflation and unemployment when the central bank (for no good reason) raises the policy rate by 175 bp?
- Also a natural experiment 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

Inflation



Unemployment

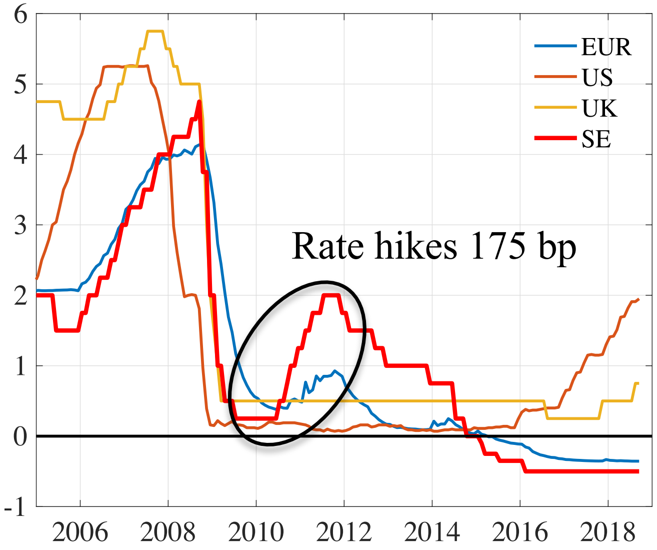


- Riksbank and Fed forecasts quite similar
- Policies very different
  - Fed: Keep policy rate between 0 and 0.25%; use forward guidance; prepare and initiate QE2
  - Riksbank: Raise policy rate from 0.25% to 2%
- Both policies cannot be right
  - Karolina Ekholm and I dissented against the majority's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

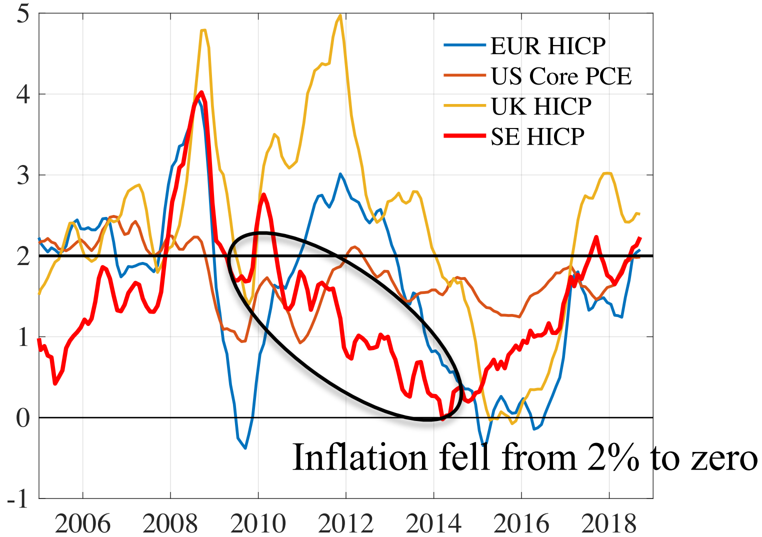
Source: Svensson, Lars E.O. (2011), "Practical Monetary Policy: Examples from Sweden and the United," *Brookings Papers on Economic Activity*, Fall 2011, 289-332.

The Swedish experience: Rate hikes 2010-2011

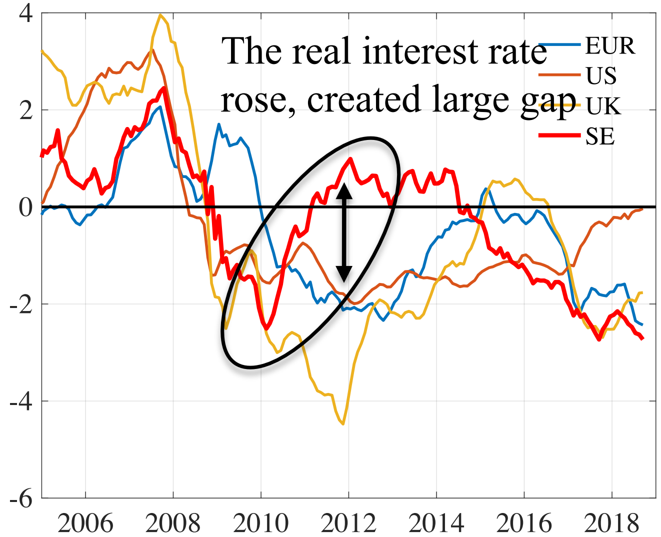
Interest rates



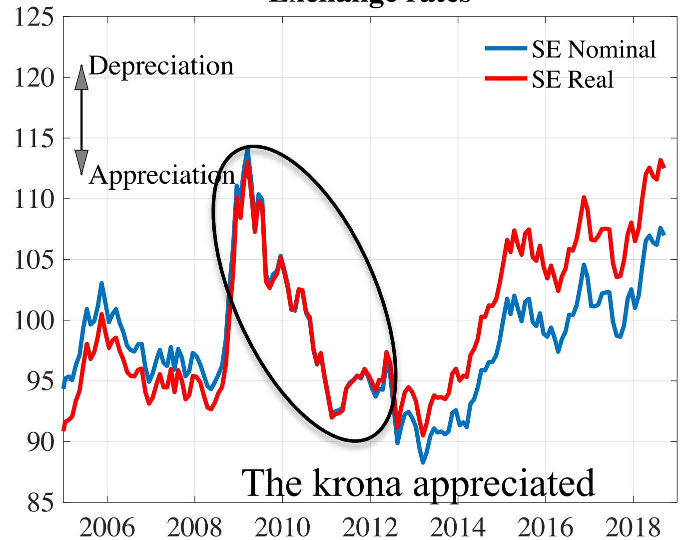
Inflation rates



Real interest rates

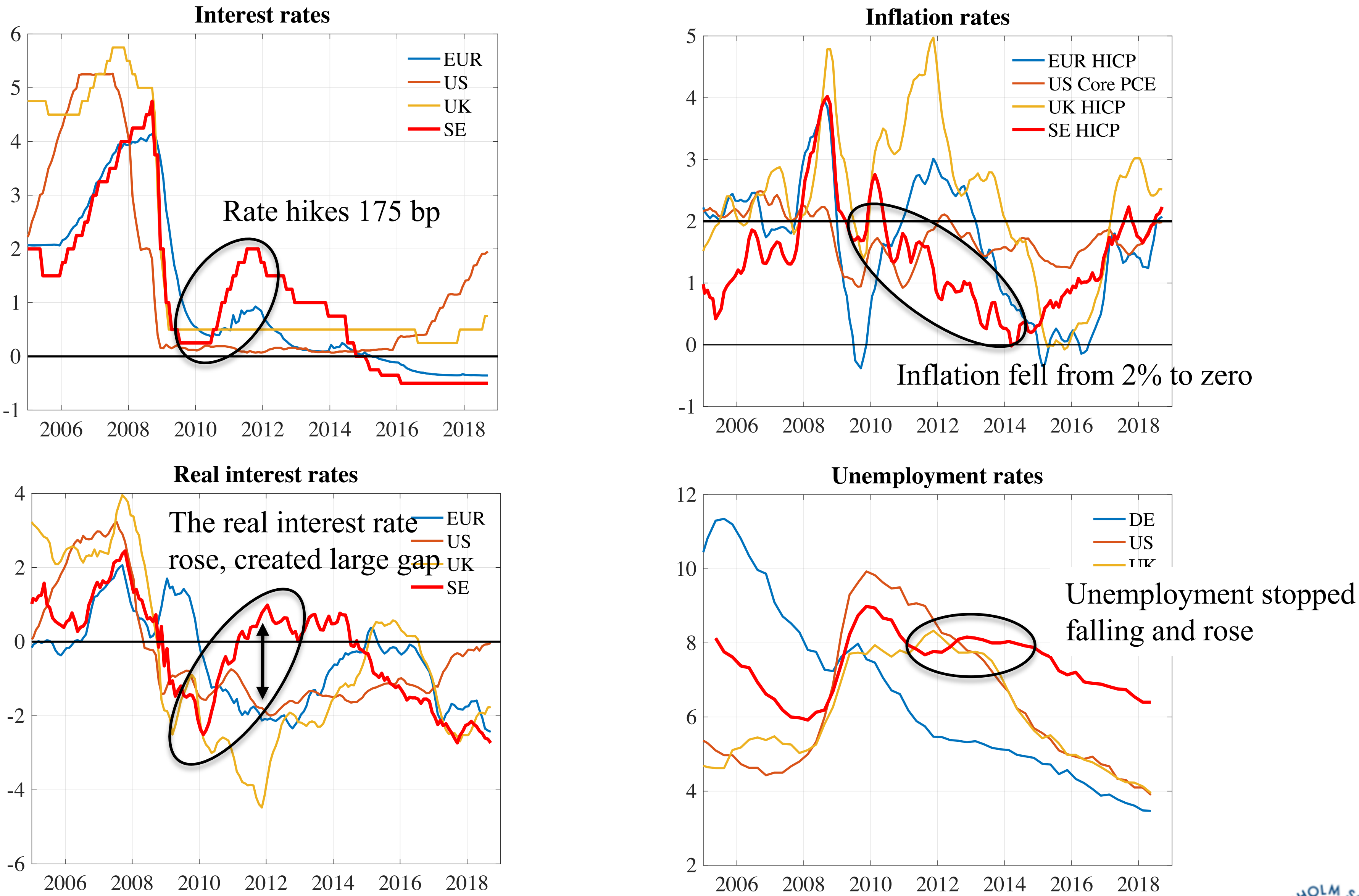


Exchange rates



Source: Svensson (2018), "The Future of Monetary Policy and Macroprudential Policy," paper prepared for the "The Future of Central Banking: An ECB Colloquium Held in Honour of Vitor Constancio," Frankfurt, May 16-17, 2018.

The Swedish experience: Rate hikes 2010-2011



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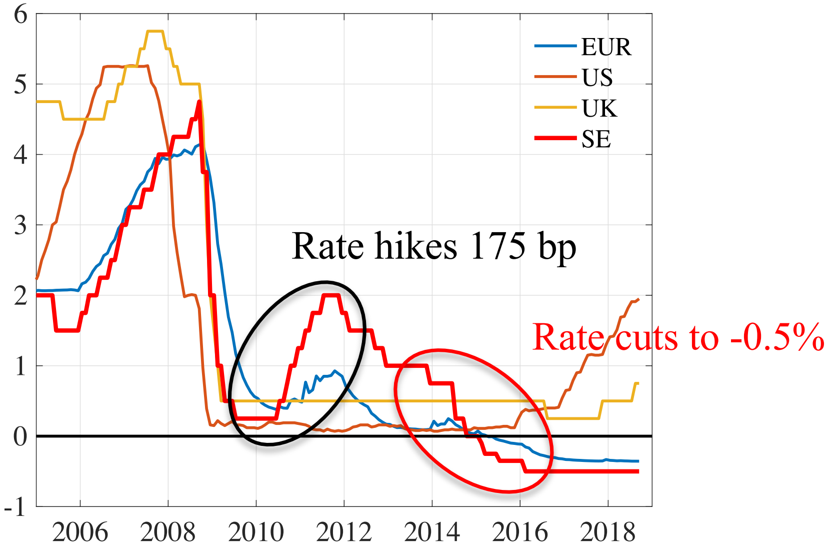
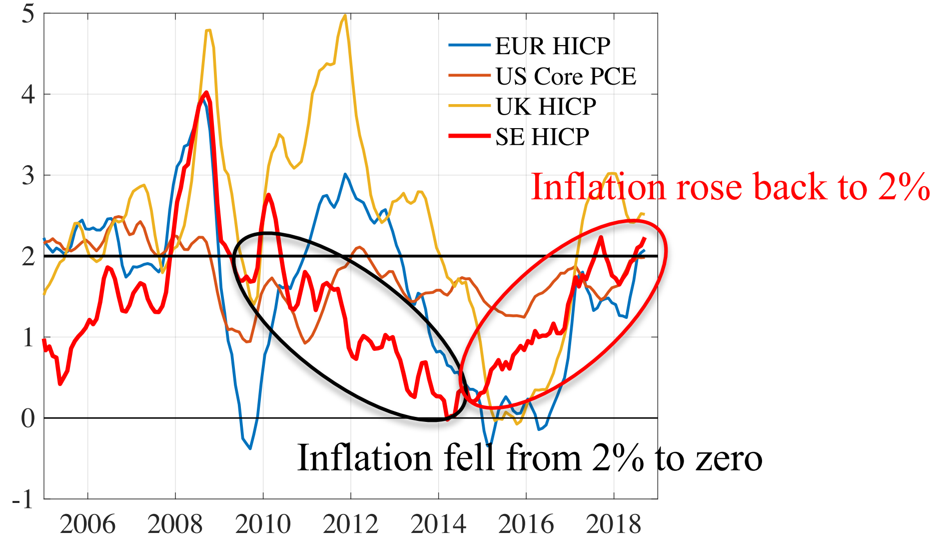
The Swedish experience: Turnaround Spring 2014

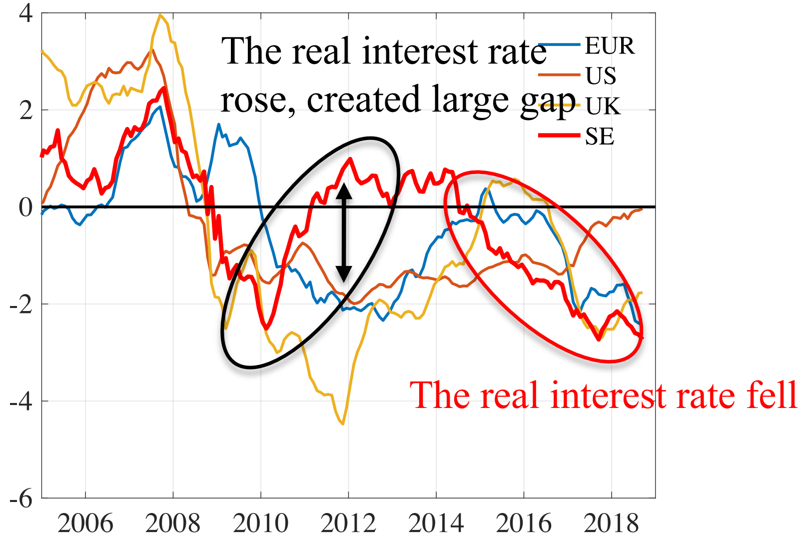
Interest rates



Inflation rates



Real interest rates



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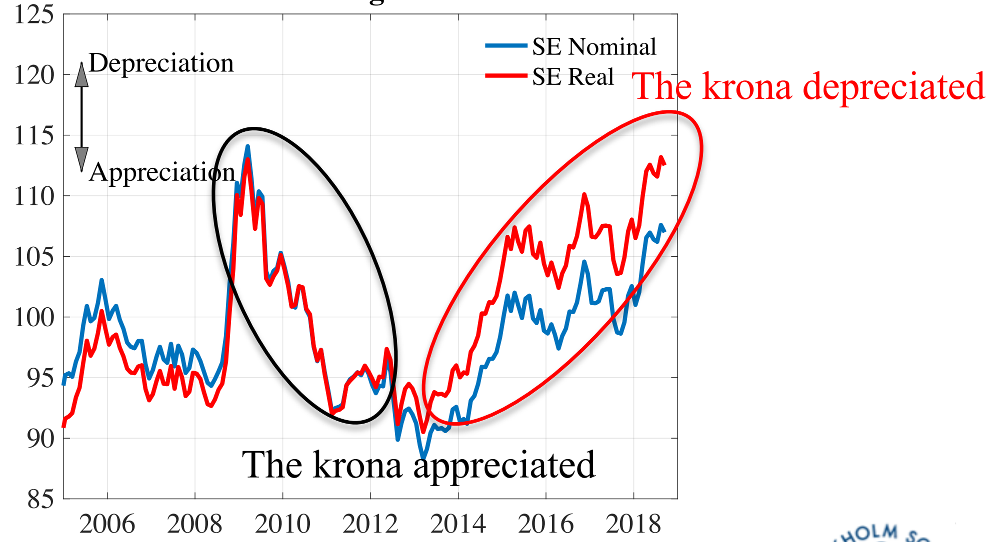

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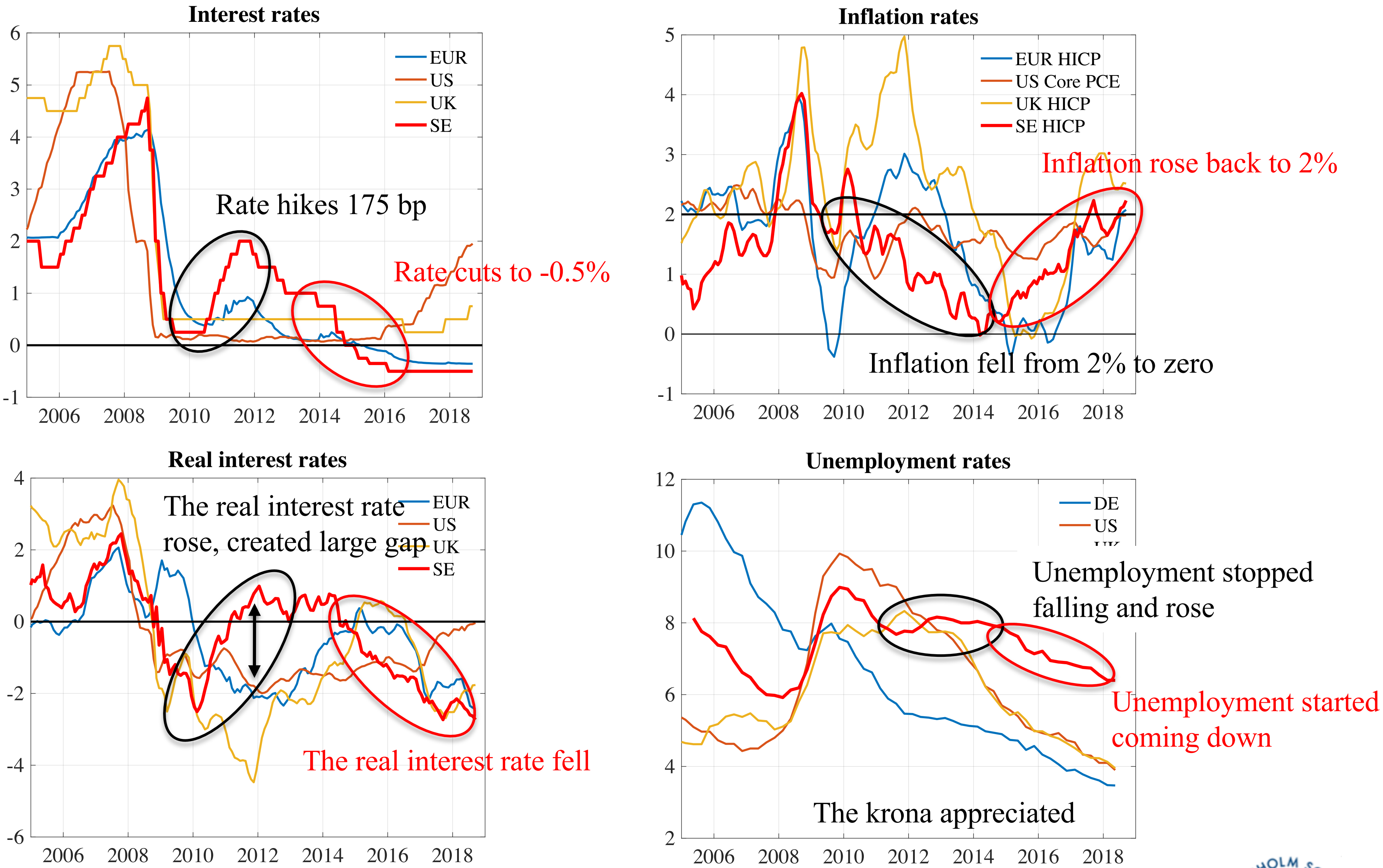

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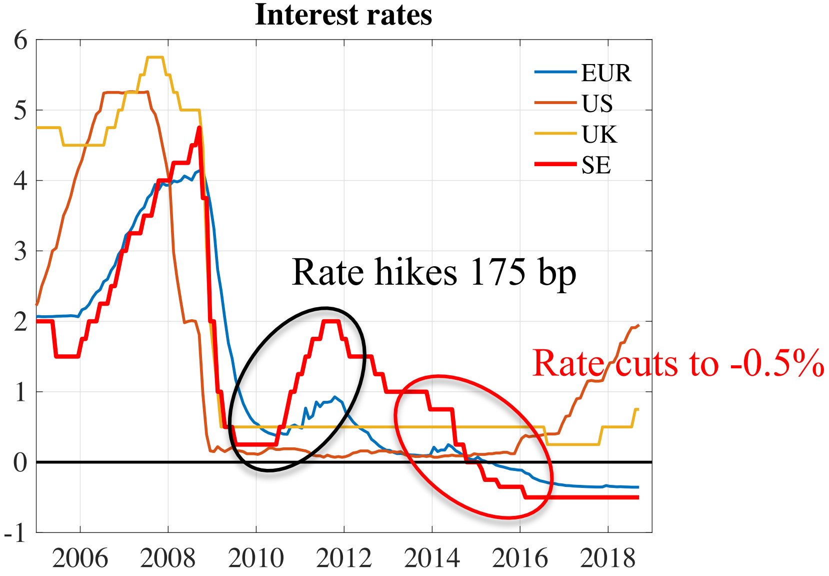
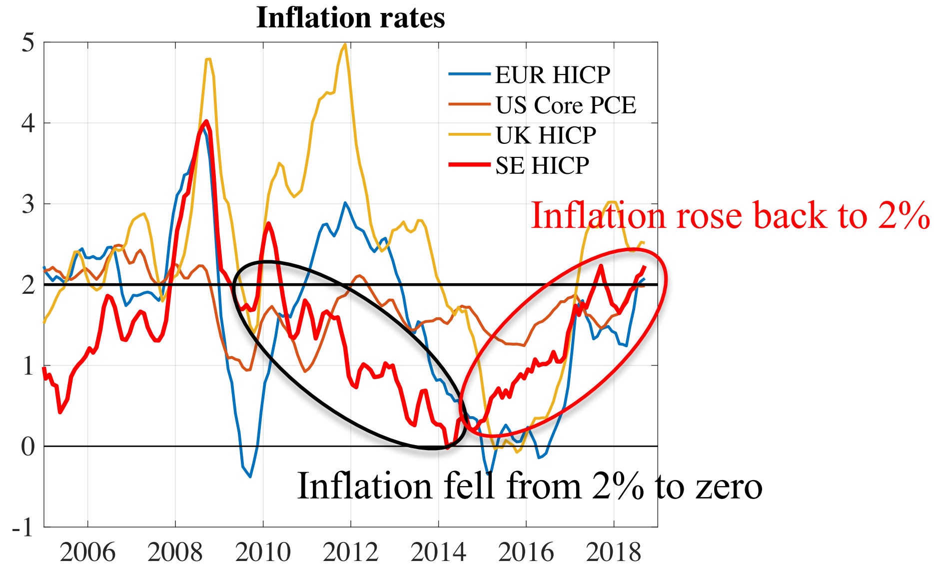
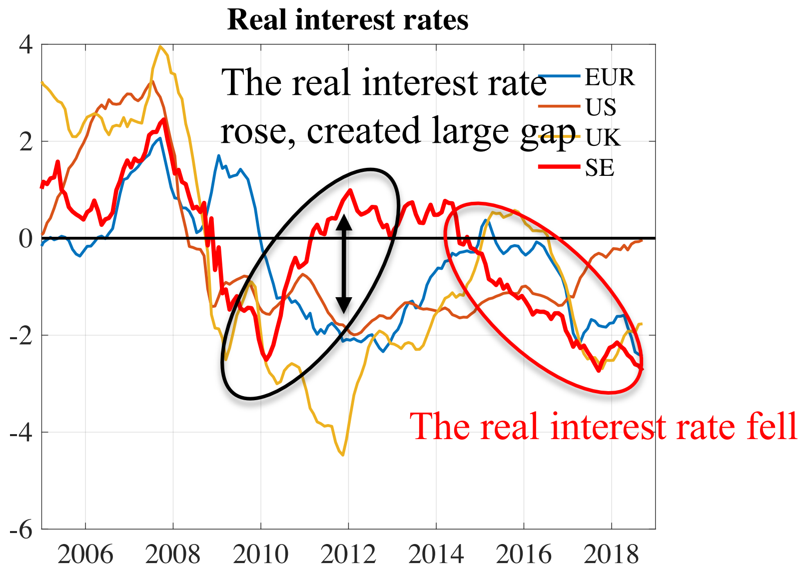
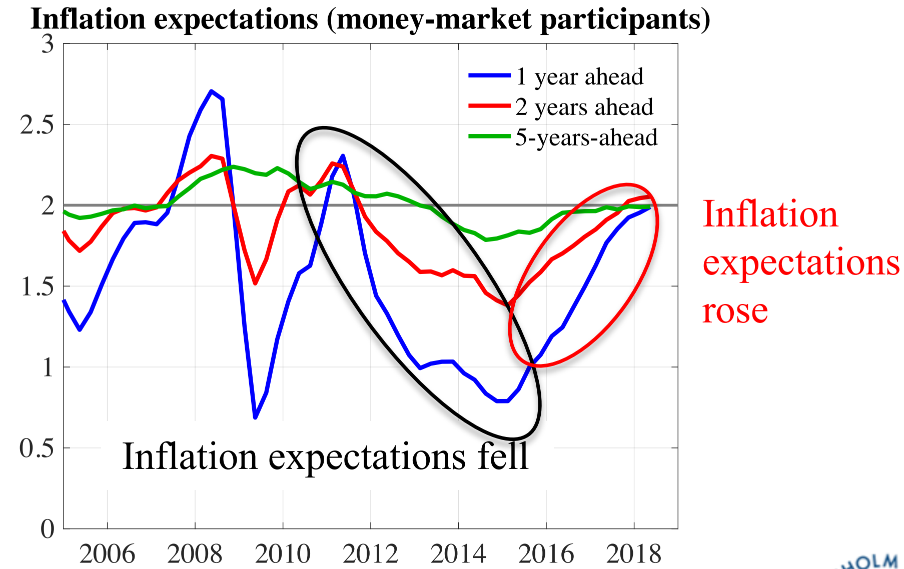
The Swedish experience: Inflation expectations









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The Swedish experience

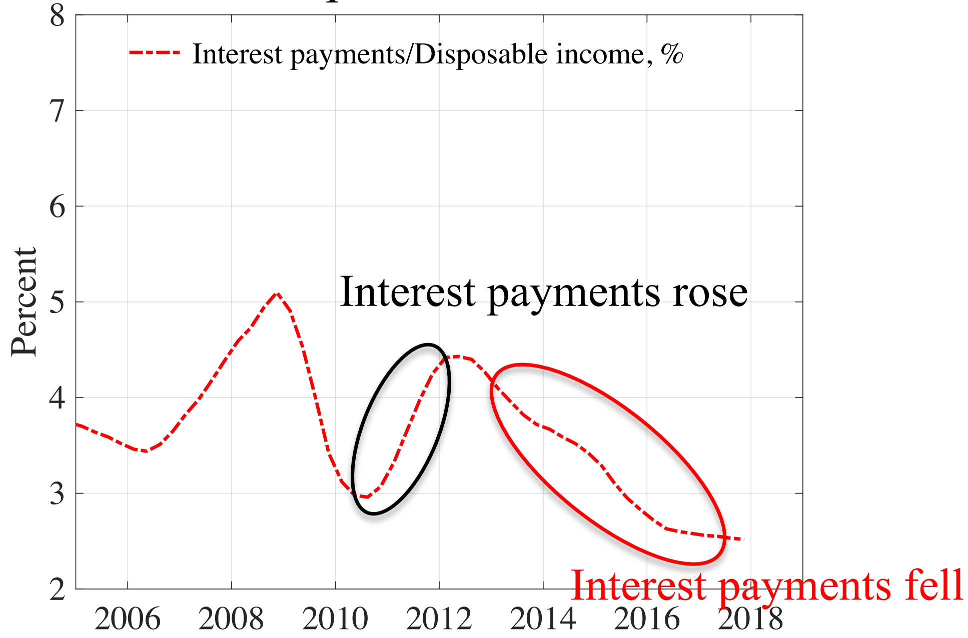
- Monetary policy in Sweden works like clockwork and according to the textbook
- What contributes to powerful monetary policy in Sweden? (Small, very open economy; flexible exchange rates; flexible inflation targeting)
  1. Strong exchange-rate channel
  2. Strong household cash-flow channel

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

Swedish household interest payments to disposable income



- 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