

Can monetary policy still deliver? A natural experiment

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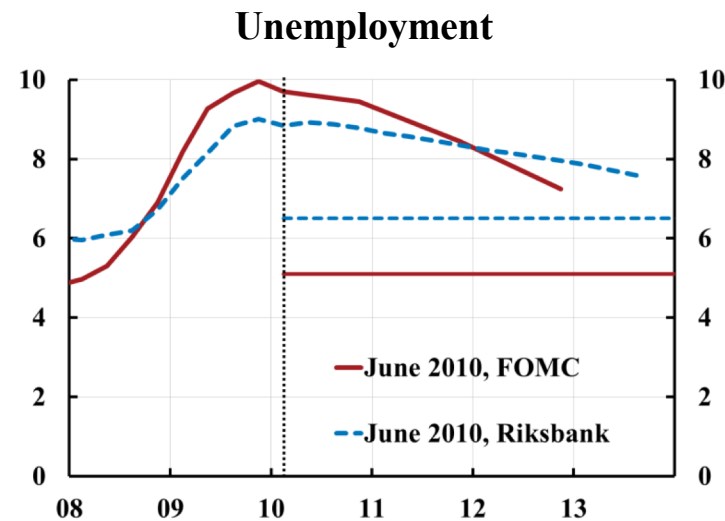
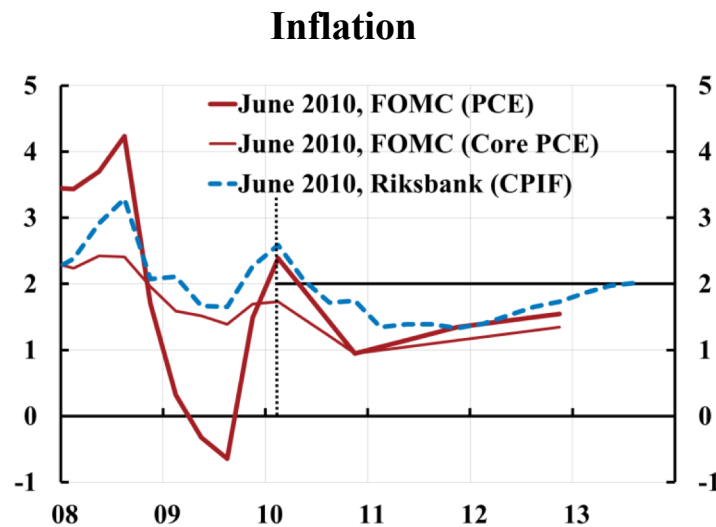
Oxford, September 27-28, 2018

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) raise the policy rate by 175 bp?
- What about the neo-Fisherian view?
Does inflation really increase?

175 bp for no good reason?

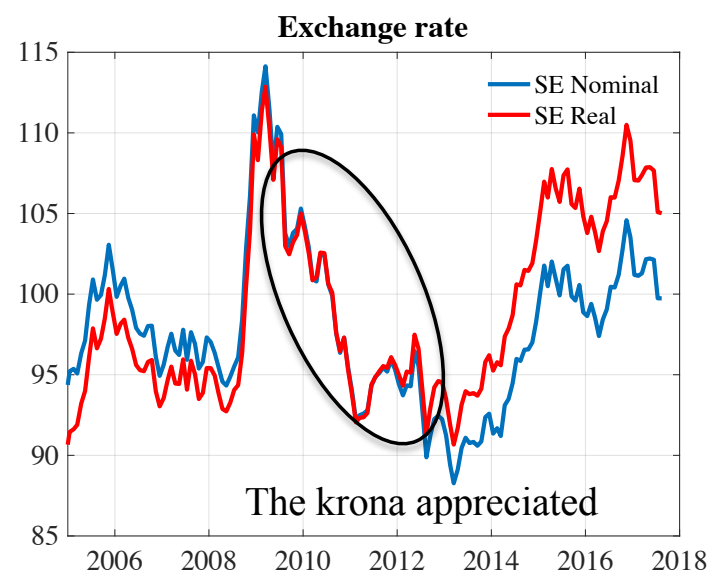
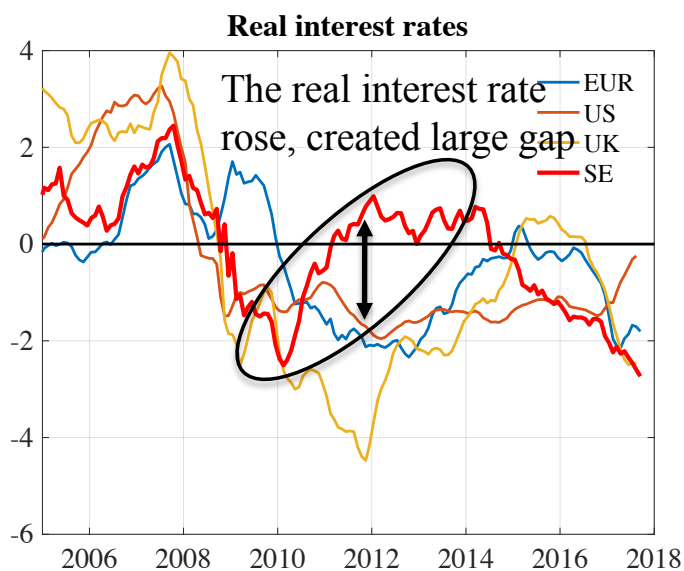
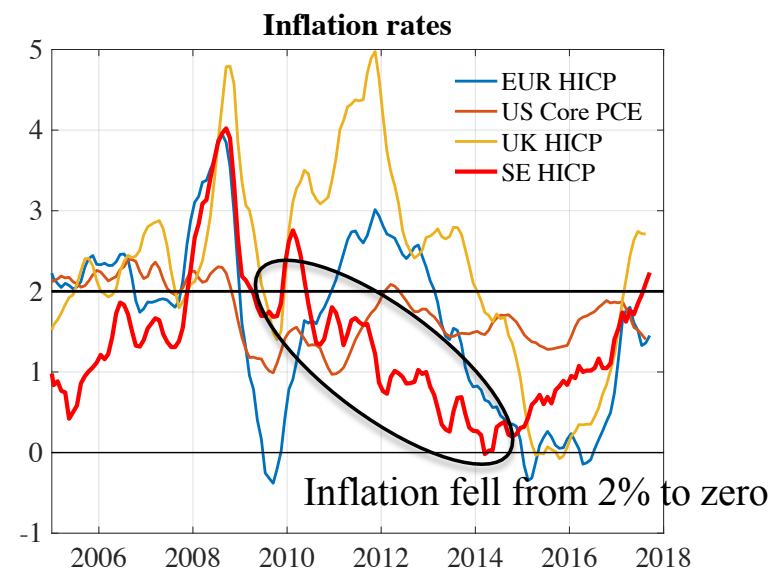
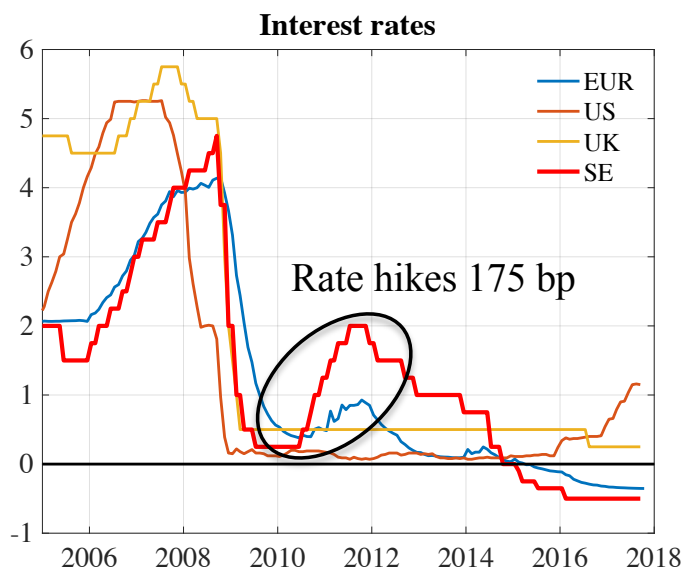
Fed and Riksbank forecasts in June 2010



- 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 cannot be right (Karolina Ekholm and I dissented against the hikes)

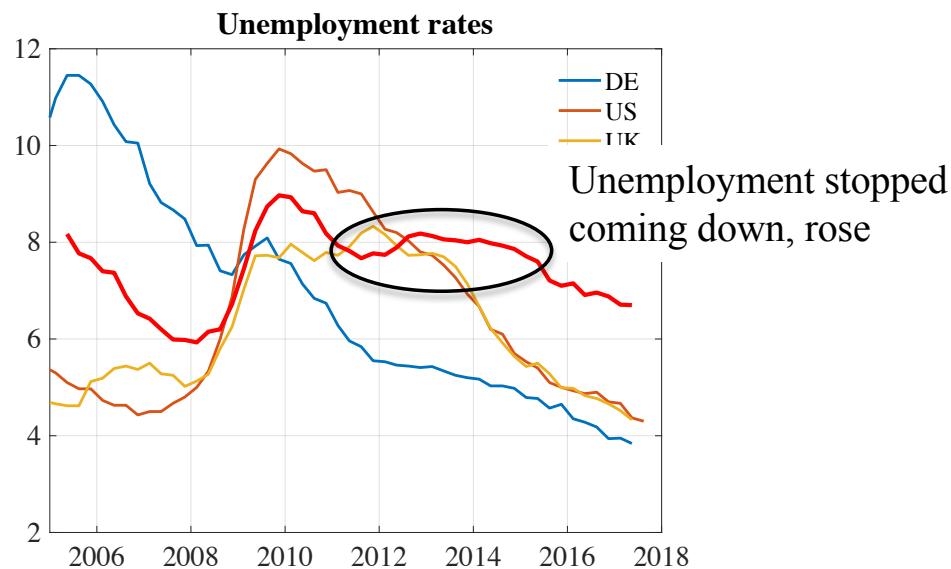
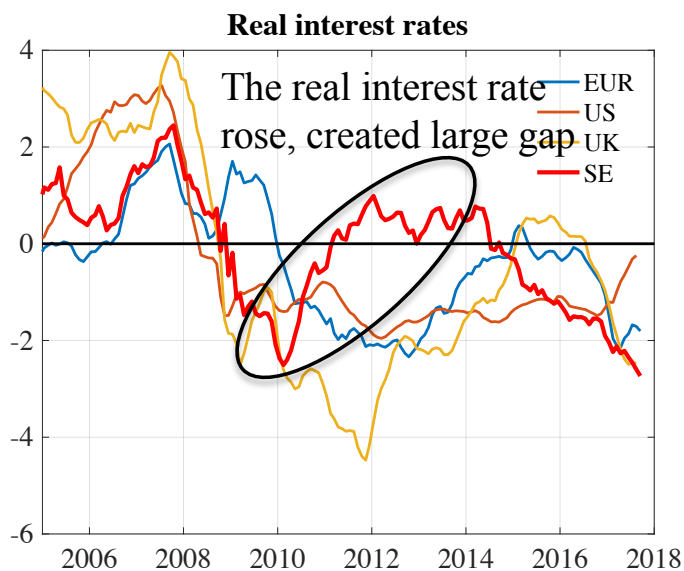
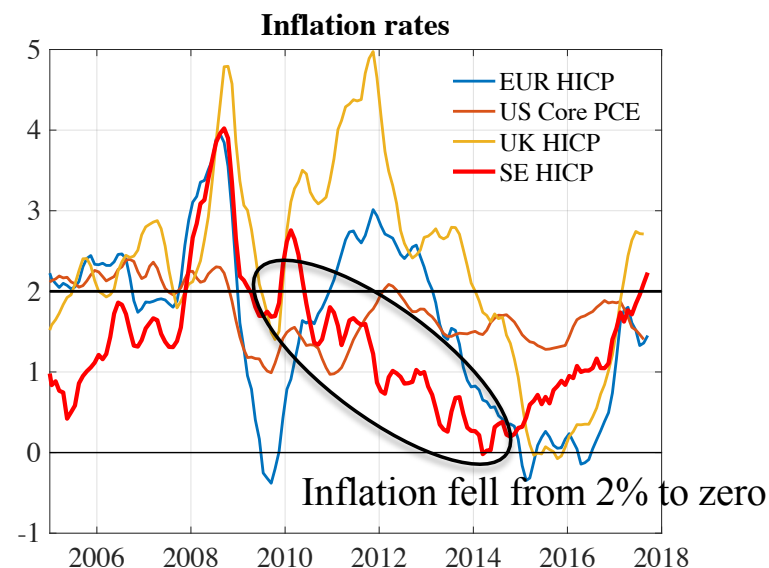
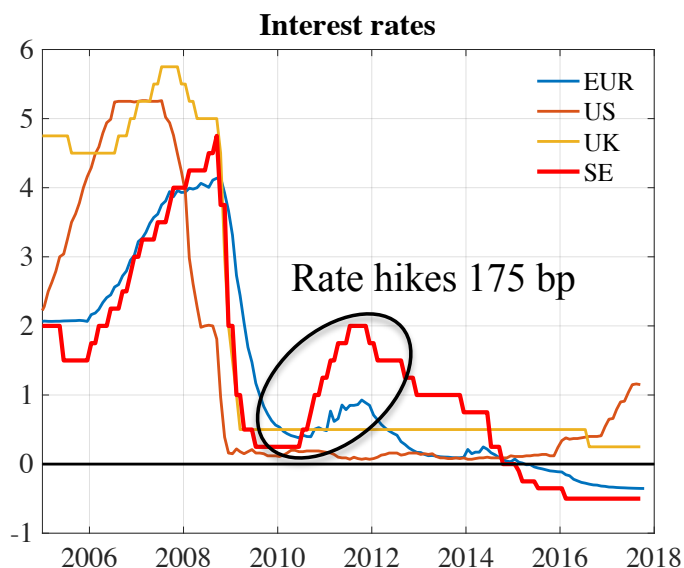
Source: Svensson, Lars E.O. (2011), "Practical Monetary Policy: Examples from Sweden and the United," *Brookings Papers on Economic Activity*, Fall 2011, 289-332.

The Swedish experience: Rate hikes 2010-2011



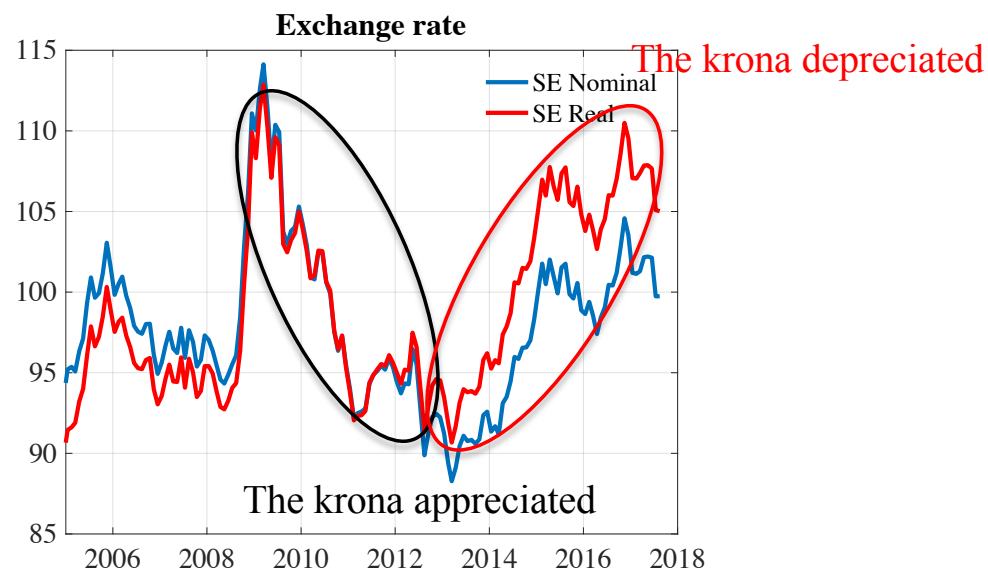
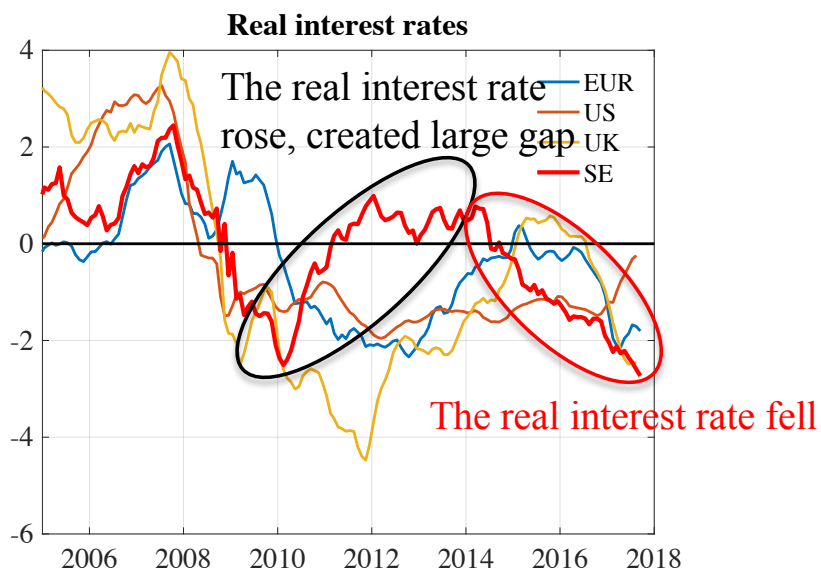
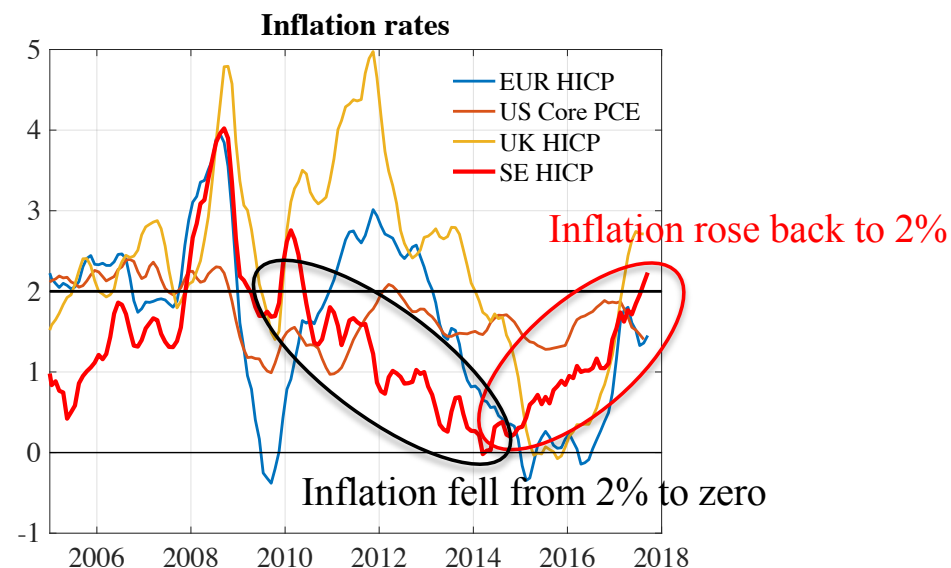
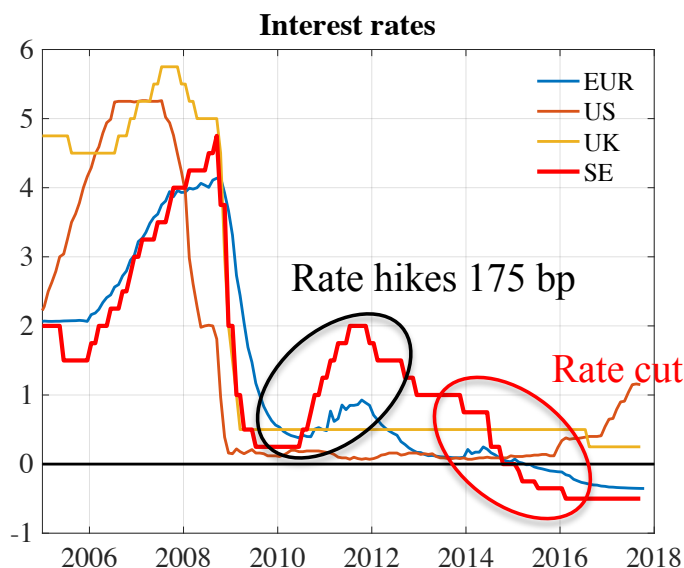
“The Future of Monetary Policy and Macprudential Policy,” paper prepared for the “The Future of Central Banking: An ECB Colloquium Held in Honour of Vitor Constancio,” Frankfurt, May 16-17, 2018. www.larseosvensson.se

The Swedish experience: Rate hikes 2010-2011



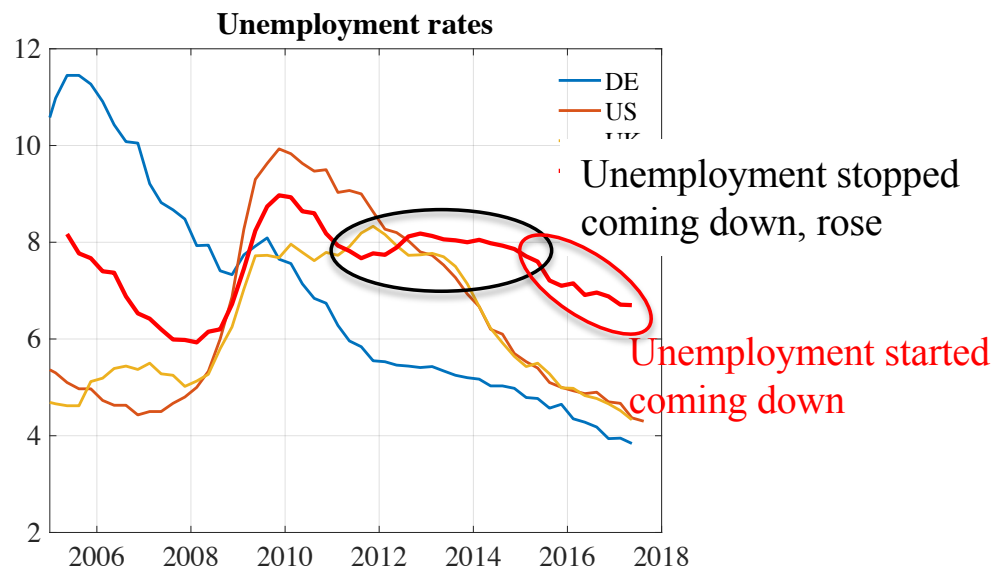
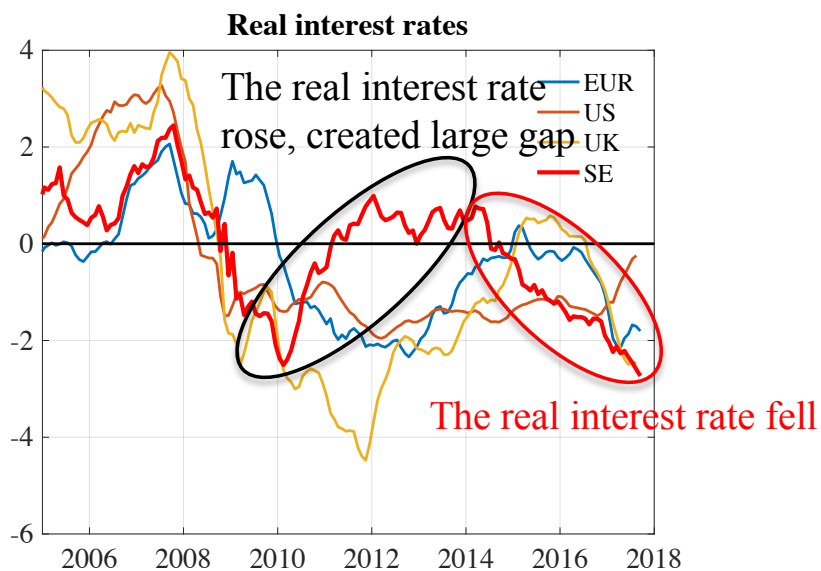
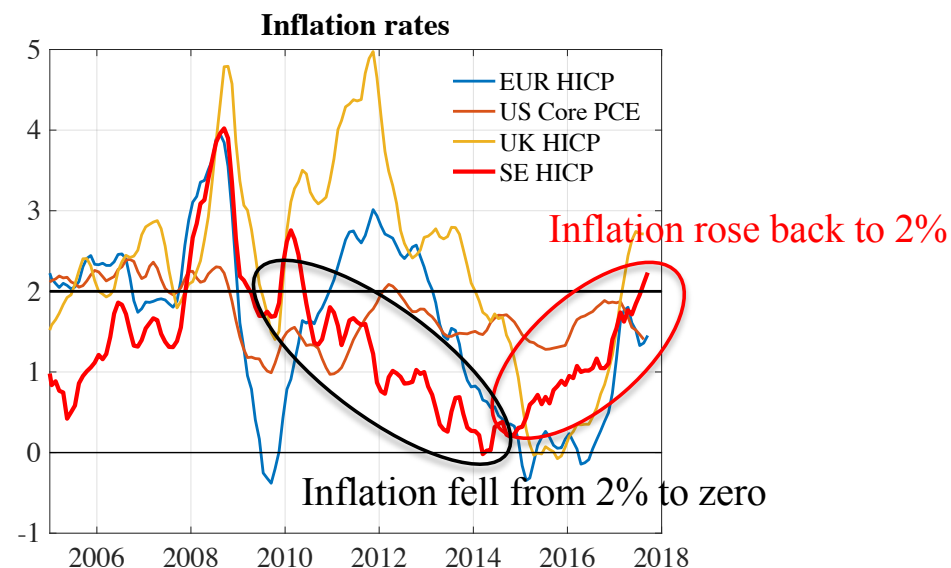
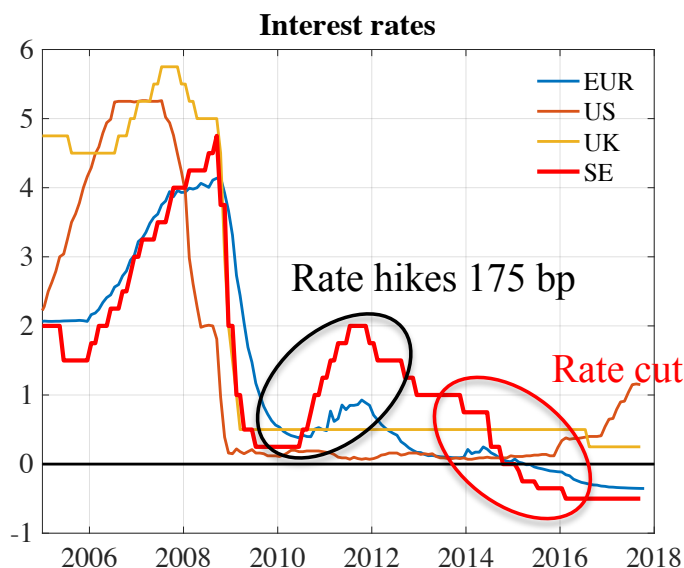
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The Swedish experience: **Turnaround** (after I had left)



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The Swedish experience: **Turnaround**



Can monetary policy still deliver?

A natural experiment 1

- Monetary policy works like clockwork in Sweden
- Neo-Fisherian view rejected
- What contributes to powerful monetary policy in Sweden?
 1. Strong **exchange-rate** channel
 2. Strong **household cash-flow** channel

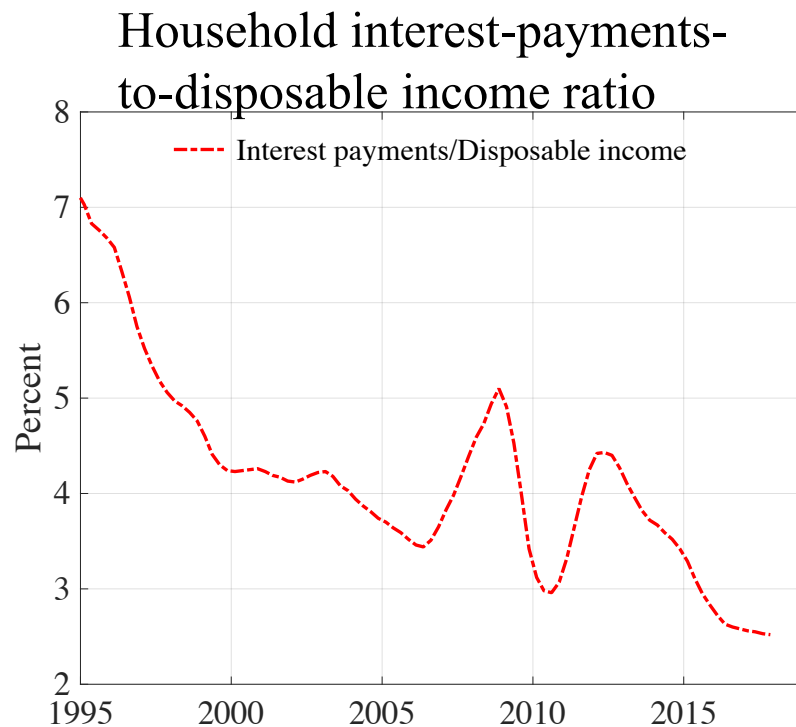
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A natural experiment 2

- Small very open economy
 - Strong **exchange-rate channel**
 - Affects export and import-competing industry
 - Affects prices of imported final goods and intermediate inputs

Can monetary policy still deliver?

A natural experiment 3



- High household debt, variable mortgage rates
 - Strong **household cash-flow channel**
 - Lower policy rate and mortgage rates reduce interest payments and improve indebted households' cash-flows
 - Insurance against recessions (with **flexible** exchange rates, not with **fixed** exchange rate)

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A natural experiment 4

- Reconsider risks with variable mortgage rates:
Depend on monetary-policy/exchange-rate regime
 - Variable mortgage rates **uncorrelated** with income:
Increased risk compared with fixed mortgage rates
 - Previously: High mortgage rates **negatively correlated** with income (with **fixed** exchange rates, **high** interest rates in recessions: **1990s** crisis):
Increased risk compared with fixed mortgage rates
 - Now: Variable mortgage rates **positively correlated** with income (with **flexible** exchange rates and flexible **inflation targeting**, **low** interest rates in recessions: **2008-2009** crisis):
Reduced risk compared with fixed mortgage rates