Can monetary policy still deliver?
A natural experiment

Lars E.O. Svensson
Stockholm School of Economics, CEPR, and NBER
Web: larseosvensson.se

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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) 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)

The Swedish experience: Rate hikes 2010-2011

The real interest rate rose, created large gap

Rate hikes 175 bp

Inflation fell from 2% to zero

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 coming down, rose

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

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

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

- **Real interest rates**
  - The real interest rate rose, created large gap
  - The real interest rate fell

- **Exchange rate**
  - The krona depreciated
  - The krona appreciated

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The Swedish experience: **Turnaround**

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

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

**Real interest rates**
- The real interest rate rose, created large gap
- The real interest rate fell

**Unemployment rates**
- Unemployment stopped coming down, rose
- Unemployment started coming down

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
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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