Swedish monetary policy experience

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The views expressed in this presentation are those of the author and do not necessarily represent those of the IMF or IMF policy.

Outline

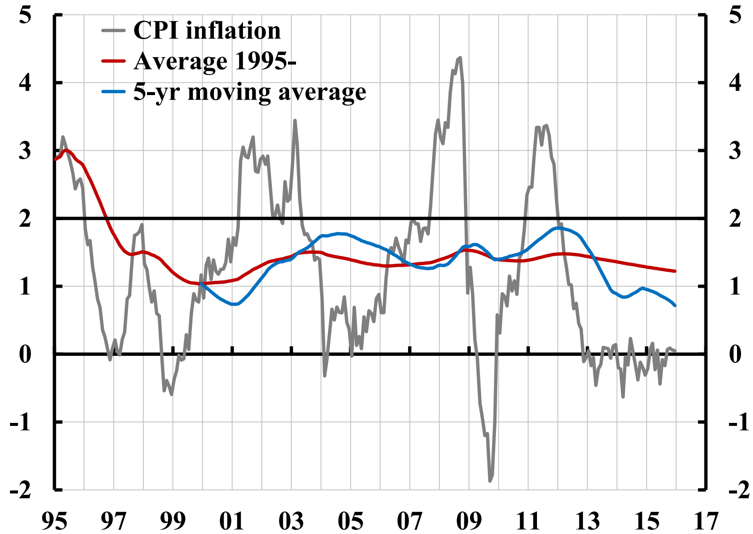
- Monetary policy objectives in Sweden
- Inflation and unemployment since 1995
- The policy tightening 2010-2011
- Cost-benefit analysis of “leaning against the wind”

Monetary policy objectives in Sweden

- CPI inflation target of 2%
- Riksbank's *Monetary Policy Report*: "[I]n addition to stabilising inflation around the inflation target, [the Riksbank is] endeavouring to stabilise production and employment around paths that are sustainable in the long term"
- My interpretation: Stabilize inflation around the inflation target and unemployment (resource utilization) around its long-run sustainable rate

Inflation and unemployment since 1995

Average CPI inflation substantially below inflation target



Average inflation expectations close to target, 1995-2011; Average inflation substantially below target

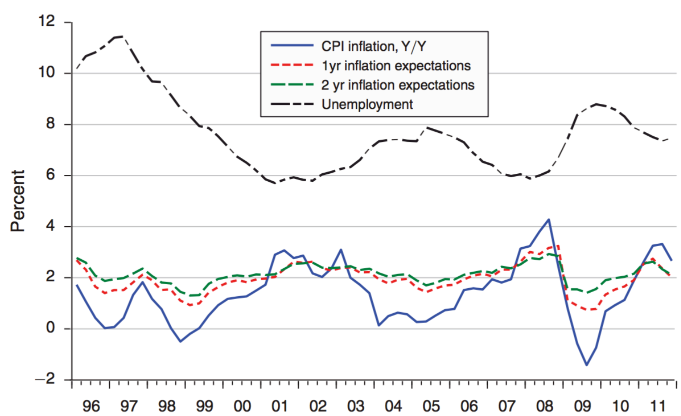


Figure 1. Annual CPI Inflation, CPI Inflation Expectations One and Two Years Ahead (Prospera, All Interviewees), and Unemployment (15–74 Age Group)

- Wage setting assumes inflation equal to 2% in Sweden, no TBU!
- Average inflation < 2%, higher real wages, higher unemployment

Svensson (2015), "The Possible Unemployment Cost of Average Inflation below a Credible Target," *American Economic Journal: Macroeconomics* 7(1), 258-296.

On average, 0.8 pp higher unemployment rate than if average inflation had been on target

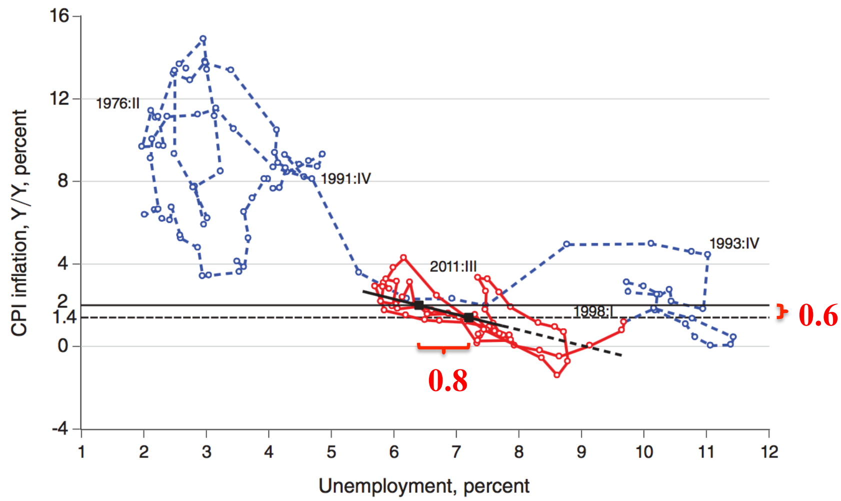


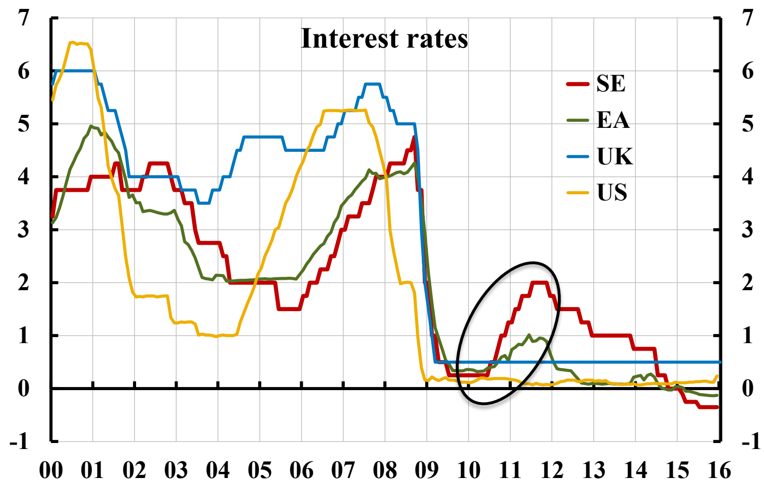
FIGURE 10. UNEMPLOYMENT AND ANNUAL CPI INFLATION, 1976:I–2012:IV, AND THE BENCHMARK LONG-RUN PHILLIPS CURVE, 1997–2011

Svensson (2015), "The Possible Unemployment Cost of Average Inflation below a Credible Target," *American Economic Journal: Macroeconomics* 7(1), 258-296.

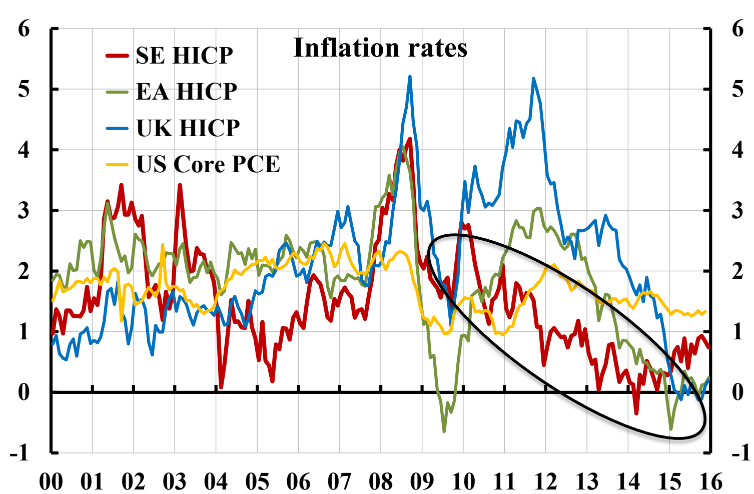
The policy tightening in 2010-2011

- After the fact:
  Obviously a serious mistake, a premature lift-off
- Justified given the information at the time?

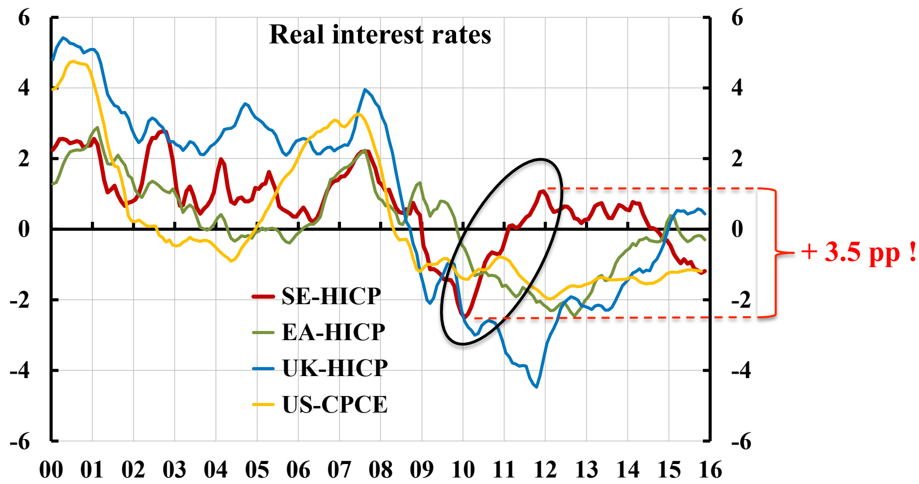
Policy rates in Sweden, Eurozone, UK, and US



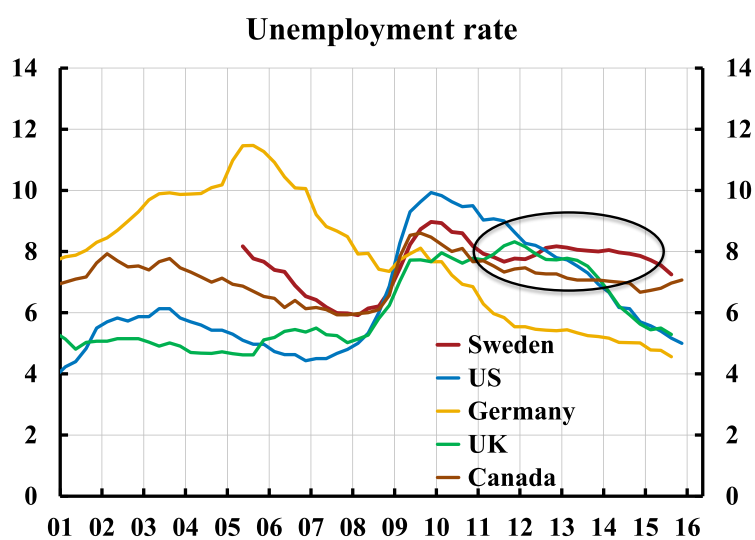
Inflation rates in Sweden, Eurozone, UK, and US



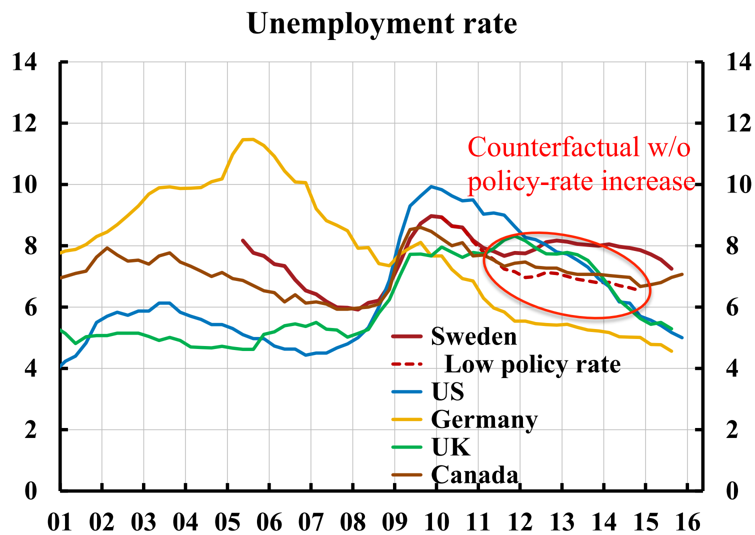
Real policy rates in Sweden, Eurozone, UK, and US



Unemployment in Sweden, Canada, Germany, UK, and US



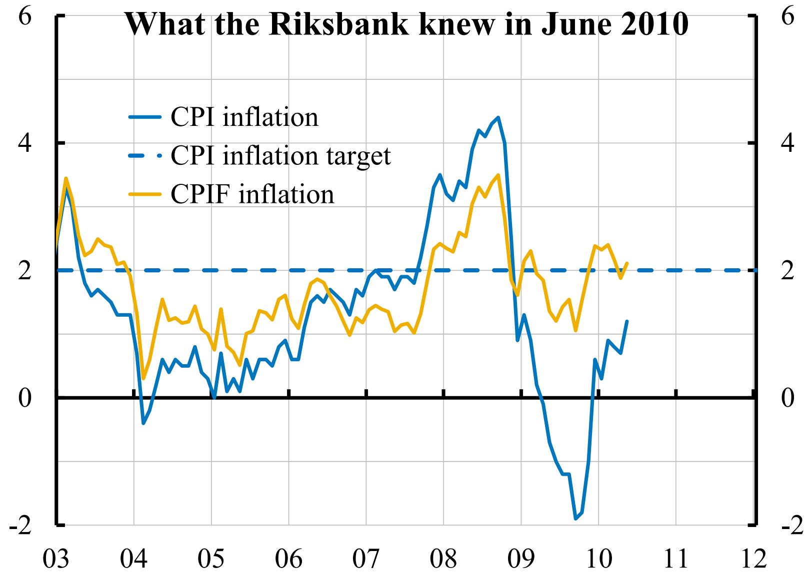
Unemployment in Sweden (incl. w/o policy-rate increase), Canada, Germany, UK, and US



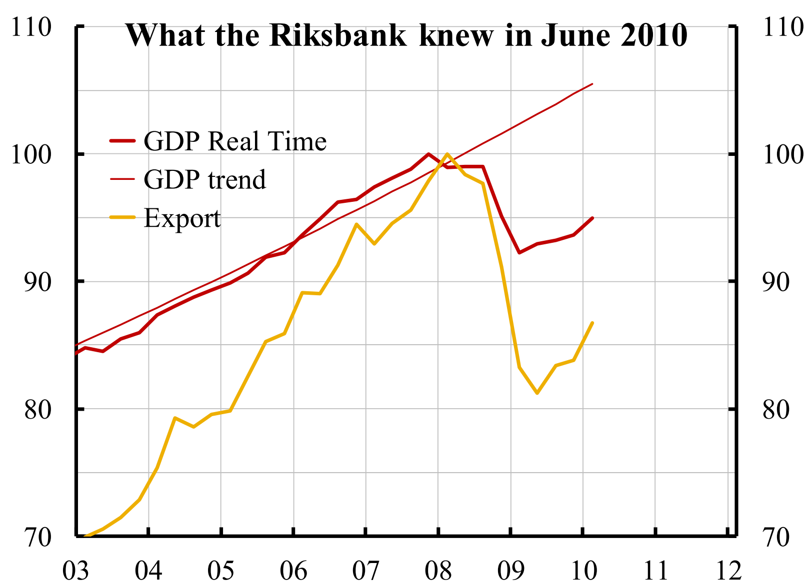
Was the tightening justified given the info at the time?

- What did the Riksbank know?

CPI inflation below target

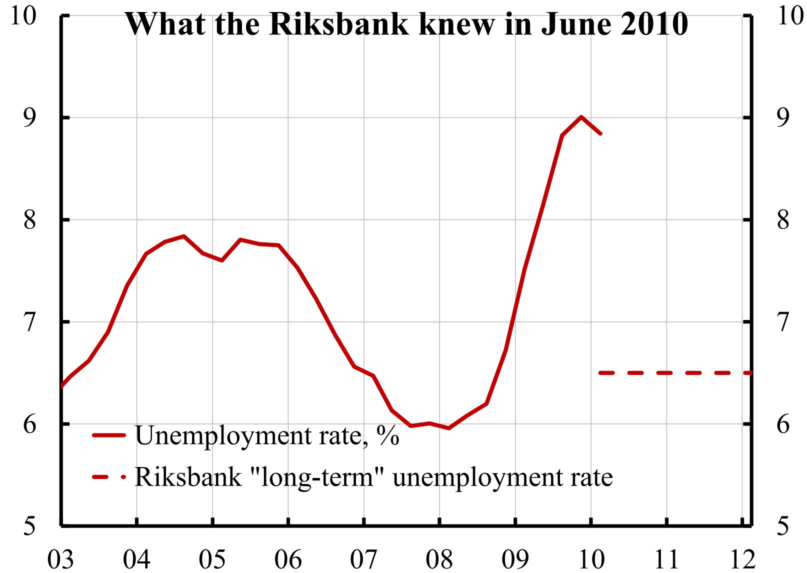


GDP 5% below peak, 10% below trend; export 13% below peak



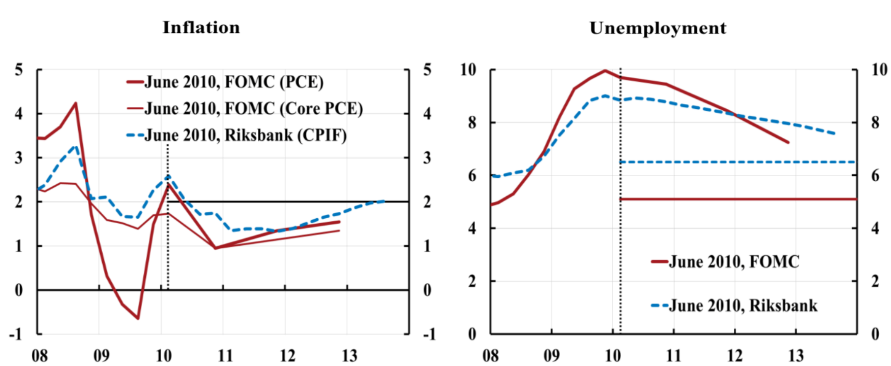
Svensson (2016), "Two serious mistakes in the Goodfriend and King review of Riksbank monetary policy," Blog post, January 22, www.larseosvensson.se.

Unemployment close to 9%, at peak; far above Riksbank's "long-term" unemployment rate



Svensson (2016), "Two serious mistakes in the Goodfriend and King review of Riksbank monetary policy," Blog post, January 22, www.larseosvensson.se.

Fed and Riksbank June 2010 forecasts of inflation and unemployment very similar; policies very different



- Should Fed have followed the Riksbank example?

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

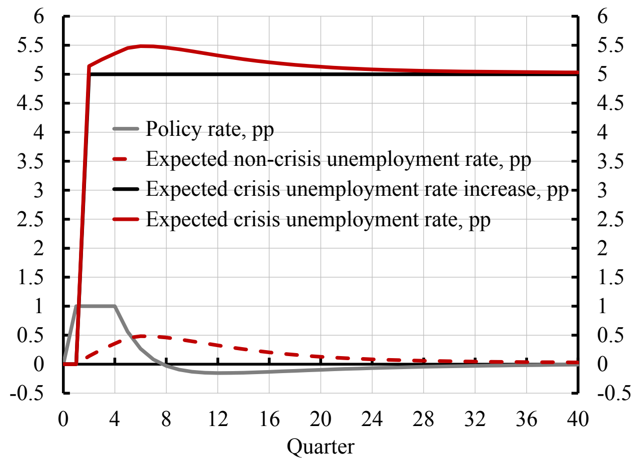
The policy tightening in 2010-2011

- After the fact:
  Obviously a serious mistake, a premature lift-off
- Justified given the information at the time?
- Given the information at the time:
  Clearly a serious mistake, a premature lift-off

Cost-benefit analysis of "leaning against the wind" (LAW)

- LAW: Tighter policy than justified by normal inflation targeting; instead undershooting the inflation target
- Costs: Higher unemployment, lower inflation
- Possible benefits: Lower probability or severity of a financial crisis
- Forgotten additional cost: Higher cost of a crisis if economy initially weaker because of LAW
- Separate questions: What if macroprudential policy is less effective? Is then LAW more or less justified?

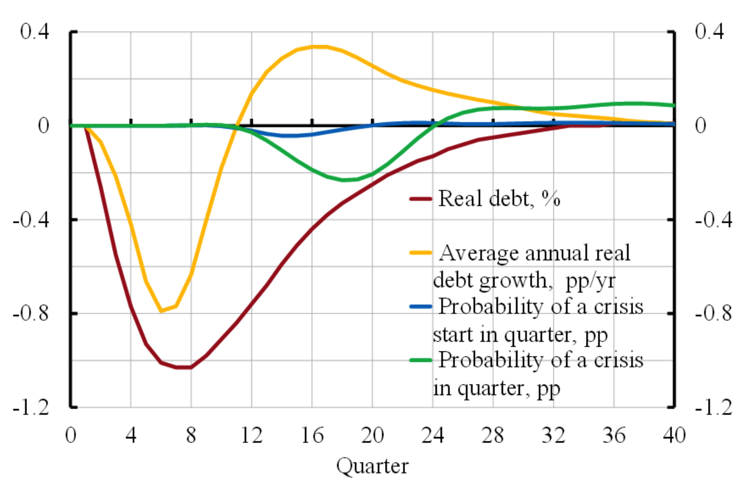
Unemployment (gap) in non-crisis and in crisis for 1 pp higher policy rate for 4 quarters (Riksbank estimates)



- Crisis:
  Unemployment: 5 to 5.5 pp
  Loss (squared): 25 to 30.25
  Loss increase: 5.25
- Non crisis:
  Unemployment: 0 to 0.5 pp
  Loss (squared): 0 to 0.25
  Loss increase: 0.25
- Additional cost:
  Crisis loss increase, is 11 times non-crisis loss increase

Svensson (2016), "Cost-Benefit Analysis of Leaning Against the Wind : Are Costs Larger Also with Less Effective Macroprudential Policy?" IMF Working Paper WP/16/3.

Benefit: Lower probability? Household debt, debt growth, probability of crisis start, and probability of crisis from 1 pp higher policy rate (Riksbank, Schularick and Taylor 2012)



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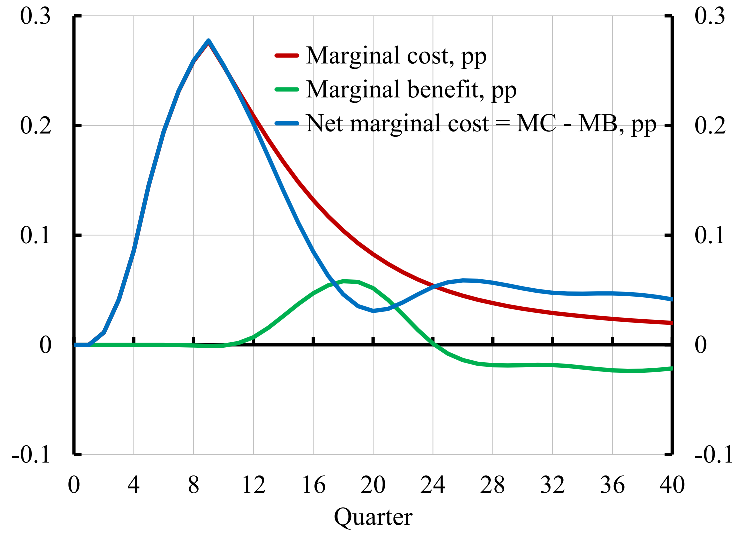
Marginal cost, marginal benefit, and net marginal cost of policy-rate increase



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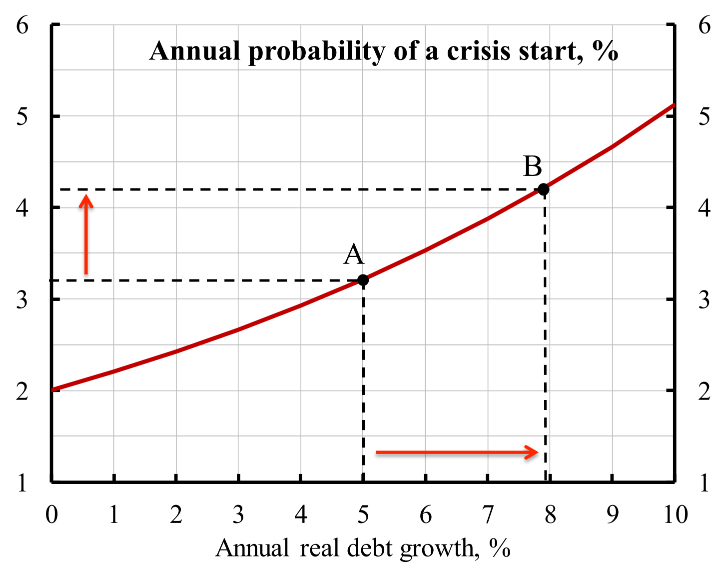
Less effective macroprudential policy, higher debt growth, higher probability of a crisis



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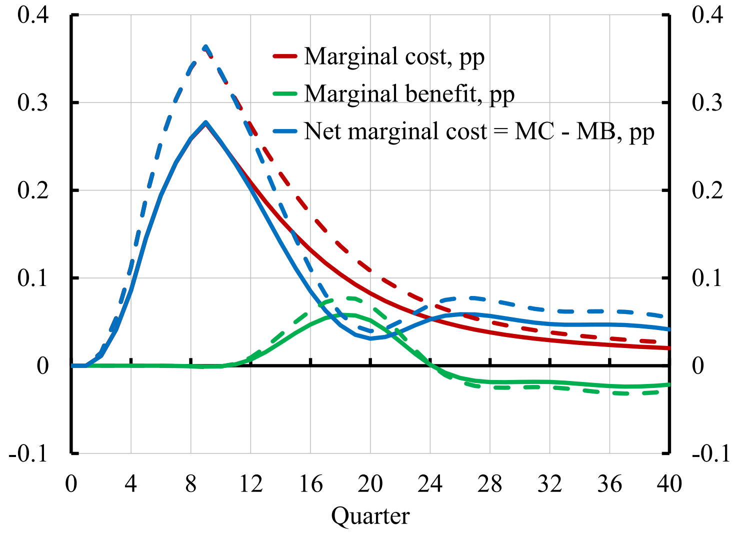
Less effective macroprudential policy increases marginal cost more than benefit



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Cost-benefit analysis of "leaning against the wind" (LAW)

- LAW: Tighter policy than justified by normal inflation targeting
- Costs: Higher unemployment, lower inflation
- Possible benefits: Lower probability or severity of a financial crisis
- Forgotten cost: Higher cost of a crisis if economy initially weaker because of LAW
- What if macroprudential policy is less effective?

Cost-benefit analysis of “leaning against the wind” (LAW)

- Given existing empirical estimates, the cost is larger than the benefit by a substantial margin
- Empirically, the possible effect of the policy rate on the probability or severity of a crisis is too small
- The main component of the cost is the additional cost (the higher cost of a crisis because the the economy is weaker due to LAW)
- Ineffective macroprudential policy may increase the probability
- A higher probability of a crisis gives more weight to the additional cost
- Ineffective macroprudential policy therefore increases the cost of LAW more than the benefit, makes the cost exceed the benefit by an even larger margin

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