Swedish monetary policy experience

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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

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

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


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

Unemployment close to 9%, at peak; far above Riksbank’s “long-term” unemployment rate

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

- Should Fed have followed the Riksbank example?
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


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


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

Less effective macroprudential policy increases marginal cost more than benefit

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 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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