

Reservation against the Account of monetary policy in 2012

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I enter a reservation against the Account of monetary policy in 2012, because I consider the account to be incomplete and in several respects misleading and thus it does not offer an adequate basis for an assessment of the Riksbank's monetary policy. Target attainment is currently poor, since inflation is way below the inflation target and unemployment is way above a reasonable long-run sustainable rate. An important issue is whether target attainment could have been better with a more expansionary monetary policy, but a thorough analysis of this issue is missing in the account. That monetary policy has not been more expansionary is, as far as can be judged, because it has to a great extent been conducted for the purpose of limiting household debt. However, extensive research and several inquiries show quite unequivocally that the policy rate has little effect on the household debt ratio. The fact that this is the case is not indicated in the account. A more expansionary monetary policy with an unchanged low policy rate since 2010 would according to a preliminary calculation have held CPIF inflation close to the target, led to much lower unemployment and led to an insignificantly higher debt ratio in the short term, while not affecting the debt ratio in the long term.

Analysis of alternative monetary policy is treated unfairly and wrongly dismissed

Inflation in Sweden is now way below the target and unemployment is way above a reasonable long-run sustainable rate. Inflation in Sweden is the lowest in the Nordic region and among comparable EU countries, while unemployment is the highest in the Nordic region and among comparable EU countries, with the exception of France. Altogether, target attainment is thus poor.

A natural question in the light of the poor target attainment is whether monetary policy could have been conducted differently so target attainment had been better. Such a question can be analysed by studying how different monetary policy alternatives were expected to affect inflation and resource utilisation at the time the decisions were made. There is indeed such an analysis in the Account – the figures with alternative policy-rate paths and corresponding forecasts for the target variables of monetary policy that at the Riksbank are called four-panel figures – but the analysis is treated unfairly and is wrongly dismissed.

The Riksdag Committee on Finance commented on such analysis in its report on 7 June 2012 regarding the monetary policy conducted in 2009-2011, more precisely in its comments on the article “A method for assessing different monetary policy alternatives” in the Riksbank's Material for assessing monetary policy 2011. The Committee on Finance pointed out that this analysis facilitates and illuminates decision-making and makes it easier to understand the policy-rate decisions and clarify the basis on which the decisions were made. I have shown such figures at almost every monetary policy meeting with effect from December 2009. Figure 1 below is an example from February 2012 (Figure 4 in the minutes of the meeting in February 2012).

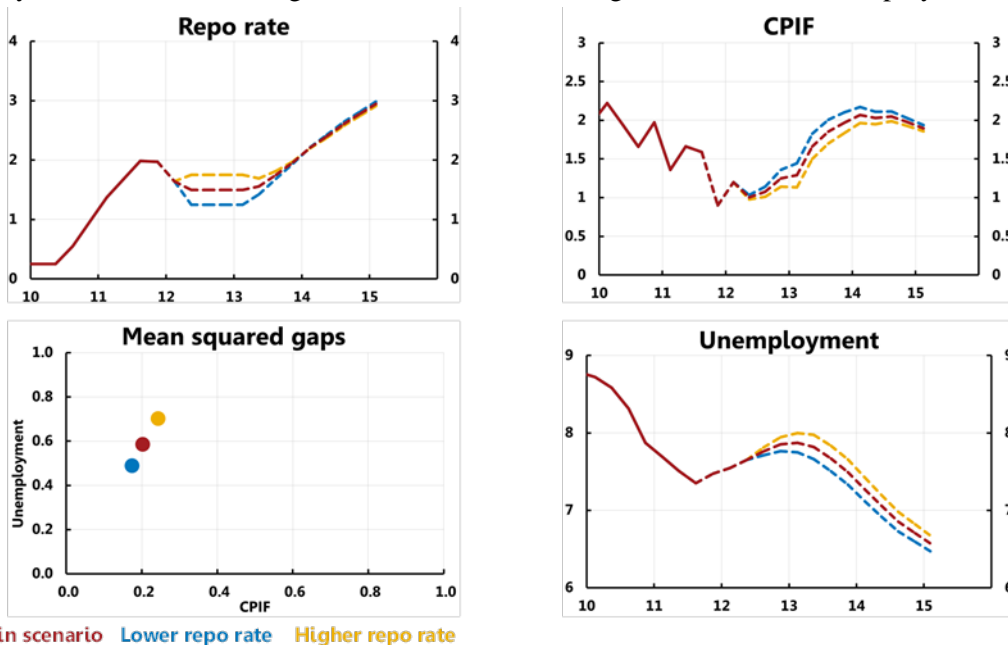
In the Account the figures are presented in a way that makes it difficult to assess monetary policy. For one thing, the discussion shifts between CPI and CPIF inflation, and for another thing it shifts from one measure of resource utilisation to another. However, there are strong reasons for consistently focussing on CPIF inflation and unemployment. If one does, the analysis consistently supports Karolina Ekholm's and

my standpoints in favour of more expansionary monetary policy, also if all assumptions behind the main scenarios are accepted.¹

Why focus on CPIIF inflation? Well, there is a generally-accepted principle that over the coming few years it is CPIIF inflation that is relevant. The reason for this is that in the short term, CPI inflation is affected directly by the Riksbank's own policy-rate adjustments and monetary policy should not react to these temporary effects. If there is reason to believe that average CPIIF and CPI inflation would differ in the longer run, due to a trend in the housing cost component of the CPI, this could be managed by monetary policy aiming for an average CPIIF inflation rate that deviates from the target, so that average CPI inflation is in line with the target.

Figure 1. Monetary policy alternatives, February 2012

Policy rates abroad according to the main scenario. Long-run sustainable unemployment rate 6.5 per cent.



Sources: Statistics Sweden and the Riksbank.

Why focus on unemployment instead of other measures of resource utilisation? Well, the government bill that proposed the Sveriges Riksbank Act (Swedish government 1997, p. 1) states that the Riksbank, without prejudice to the price stability target, should support the goals of general economic policy with the aim to achieve sustainable growth and high employment. “High employment” of course means “the highest possible sustainable employment”. Stabilising employment around a long-run sustainable path is in practice the same thing as stabilising unemployment around an estimated long-run sustainable rate.² The government bill thus provides support for focussing on employment and thus on unemployment.

¹ The minutes and the reservations entered against the decisions show that several of the assumptions behind the main scenarios can be called into question, for instance, the forecasts for policy rates abroad, euro-area growth and general inflationary pressure, as well as the estimate of the long-run sustainable unemployment rate. Then the arguments in favour of a more expansionary monetary policy are reinforced.

² To be quite accurate, the unemployment gap should be corrected with the labour-force gap, unless this is so small as to be negligible. The labour-force gap refers to the difference between the actual and potential labour force.

In economic policy it is now well-known that targets must be measured quantitatively to obtain sufficient weight and to be fulfilled in practice. “What is measured gets done,” as they say. This is why there is an inflation target in monetary policy and why in fiscal policy one endeavours to attain measurable targets, such as a target for the budget surplus. It is thus important to have a measurable, quantitative target attainment not just for inflation but also for unemployment. One should thus focus on unemployment in relation to an estimated long-run sustainable rate of unemployment. Moreover, compared with other indicators of resource utilisation, one can claim that unemployment has greater welfare relevance, is better known and understood and is measured often and has less measurement errors than, for instance, GDP and the GDP gap.

From this follows a natural principle for conducting monetary policy, namely to choose the policy-rate path that during the forecast period best stabilises CPIF inflation around the target of 2 per cent and unemployment around an estimated long-run sustainable rate. Monetary policy should then be assessed on the basis of to what extent it follows this principle. The four-panel figures enable this type of assessment.

Since the fall of 2012 it has been rather clear that monetary policy to a considerable extent has been conducted with the purpose of limiting household debt, which has been a reason why it has not been more expansionary in spite of low inflation and high unemployment. A counter-argument to the four-panel figures is that they do not give consideration to effects on the household debt ratio (the ratio of household debt to disposable income). It says in the Account (page 34) “There is currently no simple way of taking considerations [regarding debt] of this nature into account within the framework of the method [using four-panel figures].” This statement is misleading, since it is quite possible to add to the figures debt-ratio forecasts for alternative policy-rate paths.

Problems with focussing monetary policy on an attempt to affect household debt, including the effect of the policy rate on the debt ratio, are not discussed

There are several problems with focusing monetary policy on an attempt to influence household debt, but there is no real discussion of them in the Account. First, one can question whether it is appropriate to introduce what is in practice a new target for monetary policy without first investigating whether this is compatible with the Sveriges Riksbank Act and its preliminary works. There is no discussion of this in the Account. Second, one should clarify whether monetary policy can actually affect the attainment of such a new target. Extensive research and several inquiries, including the Riksbank's own inquiry into the risks in the Swedish housing market, have reached the same conclusion.³ This conclusion is that monetary policy normally has very little effect on the household debt ratio within a few years' time and, with low and stable inflation, no effect in the long run.⁴ A typical result (mentioned in the minutes from the monetary policy meeting in December 2012, p. 5) is that a policy rate that is raised by 1 percentage point in one step, held at this higher level for a year and then gradually returned to its original level leads to a household debt ratio that is approximately 1 percentage point lower a couple of years ahead than would otherwise have been the case. That is, a debt ratio of 175 per cent of disposable income would fall by less

³ See, for example, Englund (2011), Walentin and Sellin (2010), Iacoviello and Neri (2010), Assenmacher-Wesche and Gerlach (2010), Claussen, Jonsson and Lagerwall (2011), Bean, Paustian, Penalver and Taylor (2010) and Kuttner (2012).

⁴ The addition “with low and stable inflation” is justified by the fact that the value of the tax deductions for interest rates and thus the real mortgage rate after tax depend on inflation, and the real mortgage rate after tax in turn affects housing prices and debt. With low and stable inflation, monetary policy has no long-run effect on the real mortgage rate after tax and thereby no effect on housing prices and debt.

than 2 percentage points to just over 173 per cent. This would not tangibly influence the potential risks linked to household debt. In the long run, the policy rate has no effect on the debt ratio and thus in all likelihood no effect on potential risks linked to household debt. There is no description or discussion of this in the Account. This is an important shortcoming and makes it more difficult to assess monetary policy.

There are references in the Account to debt playing a role in a long-run perspective (page 34): "[S]everal members of the Executive Board argued that the risks associated with household indebtedness needed to be considered in the assessment of how expansionary monetary policy should be in 2012. In their assessment, this should bring about better target fulfilment seen over a longer perspective." As mentioned, however, the policy rate has as far as can be judged no effect on the debt ratio in the long run. Housing prices and mortgages in relation to disposable income are determined by factors, primarily the real mortgage rate after tax, which monetary policy is unable to affect in the long run, with a low and stable inflation rate.

The different alternative policy-rate paths compared in the four-panel figures thus, as far as can be judged, have a negligible effect on the debt ratio and potential risks connected with this. It is thus difficult to see any problem in disregarding these effects when using the four-panel figures for monetary policy decisions and for assessing monetary policy.

An alternative monetary policy from June 2010 with an unchanged low policy rate would have held CPIF inflation close to the target, led to much lower unemployment and led to an insignificantly higher debt ratio in the short term, while not affecting the debt ratio in the long term.

A different way of approaching the question of how appropriate monetary policy has been in the light of the actual outcome for the economy is to analyse what kind of monetary policy would have been required to achieve a good target attainment. Such a so-called counterfactual analysis is quite possible to do although the results have to be interpreted with some caution.

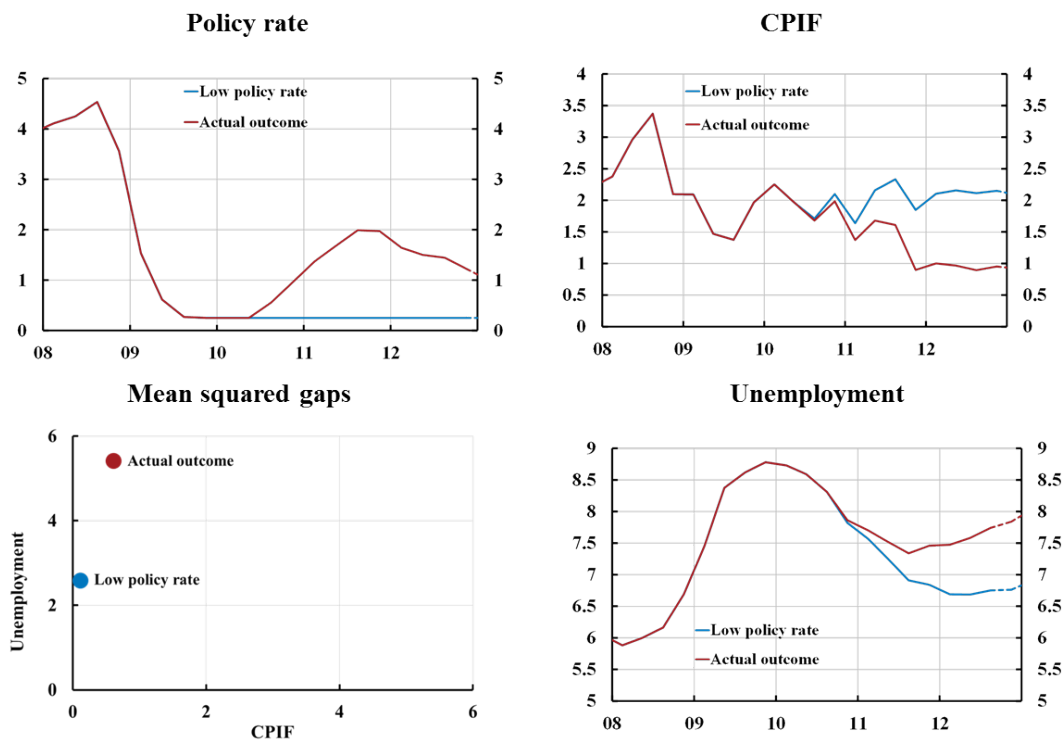
From and including the monetary policy meeting in June 2010, the majority on the Executive Board steadily raised the policy rate at every monetary policy meeting, from 0.25 per cent in June 2010 to 2 per cent in July 2011, an increase of 1.75 percentage points. Svensson (2011) shows that these increases began despite the CPIF forecast in June 2010 being below the target and the unemployment forecast being well above a reasonable long-run sustainable rate (Figures 1 and 2 in the minutes of the monetary policy meeting held in February 2013, Figures 1 and 2 in Svensson 2011). Since December 2011, the majority on the Executive Board has lowered the policy rate to 1 per cent in December 2012, a cut of 1 percentage point. On average, the policy rate has been approximately 1.5 percentage points higher than if it had remained at 0.25 per cent until now.

One might ask what would have happened if the policy rate had remained at 0.25 per cent until now. This can be examined using the standard method to calculate the effects of alternative policy-rate paths in the four-panel figures.⁵ I report the results of one such preliminary calculation of mine in the minutes of the

⁵ The method calculates with the Riksbank's macroeconomic model Ramses the impact on inflation and unemployment of the anticipated or unanticipated shocks to the central bank's reaction function that result in a given alternative policy-rate path. It builds on Leeper and Zha (2003) and Laséen and Svensson (2011) and is discussed in general terms in Svensson (2010). For Figure 2 unanticipated shocks are used. See Laséen and Svensson (2011, appendix 4) for details when unanticipated shocks are used.

meeting in February 2013, although without the figure that it instead shown here, Figure 2. Such an analysis implies that CPIF inflation would have remained fairly stable at around 2 per cent instead of falling to 1 per cent and below. Target attainment for CPIF inflation would then have been as perfect as possible. Unemployment would have fallen and would now be about 1.2 percentage points lower, at a rate between 6.5 and 7 per cent. Around 60,000 fewer people would be unemployed.⁶ Target attainment for unemployment would have been much better than at present, irrespective of whether one compares with a long-run sustainable rate of unemployment of 5.5 or 6.25 per cent. These calculations are of course uncertain, but they provide a clear indication of the magnitudes we are talking about and how much better the situation would have been if the Riksbank had not begun to increase the policy rate in the summer of 2010.

Figure 2. Policy rate, CPIF inflation and unemployment; actual outcome and low policy-rate path from 2010



Note: Mean squared gaps calculated for 5.5 per cent long-run sustainable unemployment rate

Source: Statistics Sweden and own calculations

The conclusion of this analysis is that the actual monetary policy conducted has led to much lower inflation and much higher unemployment than a policy that would have held the policy rate unchanged at 0.25 per cent. If one wants to trade off that cost against possible benefits in terms of a lower household debt ratio, once can start from the above discussion of the effects of the policy rate on the debt ratio. A policy rate that is raised by 1.5 percentage points in one step, held at this higher level for a year and then gradually returned to its original level leads to a household debt ratio that is approximately 1.5 percentage points lower a couple of years ahead than would otherwise be the case. That is, a debt ratio of 175 per cent

⁶ This figure is hence compatible with a different less detailed calculation in Svensson (2013) that came to a figure of 65,000 fewer unemployed.

of disposable income would fall by less than 3 percentage points to just over 172 per cent. This is a very small reduction in the debt ratio and would not tangibly reduce any potential risks connected to household debt. And in the long run, this little effect on the debt ratio would disappear. The important thing here is not the exact figures, but the magnitude, that the effects on the debt ratio are very small and almost insignificant, while the effects on inflation and unemployment are significant. This would have been an important piece of information in a report that is supposed to be a basis for an assessment of the monetary policy conducted.

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