Monetary policy in less favourable times – what are the options?

Insurance Sweden
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S V E R I G E S R I K S B A N K

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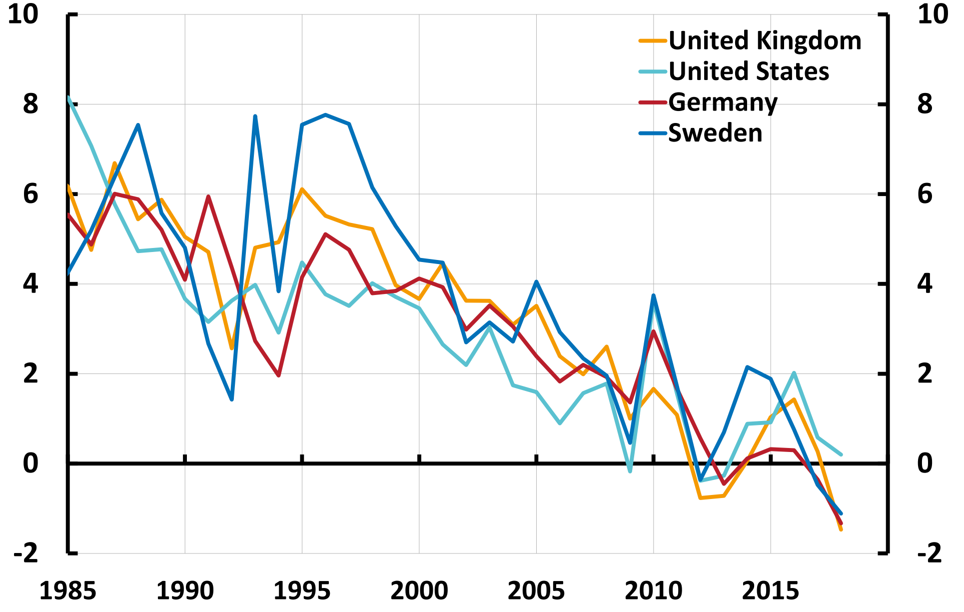
More difficult to make monetary policy sufficiently expansionary

- How expansionary monetary policy will be is determined by the relationship *neutral interest rate–policy rate*
- Low global neutral interest rate – more difficult to make monetary policy sufficiently expansionary
- It is the *real* interest rate that is important. Real interest rate falls if
    - Nominal interest rate falls
    - Inflation/inflation expectations increase

Downward trend in global real interest rates



Note. Per cent, annual data. Government bond yields with 10 year maturity, deflated by CPI.
Sources: Macrobond, OECD, Statistics Sweden and the Riksbank

How can the Riksbank deal with the next economic downturn?

- The repo rate will be somewhat higher
- Cut repo rate below –0.5 per cent
- Affect expectations of the future repo rate
- Purchases of financial assets

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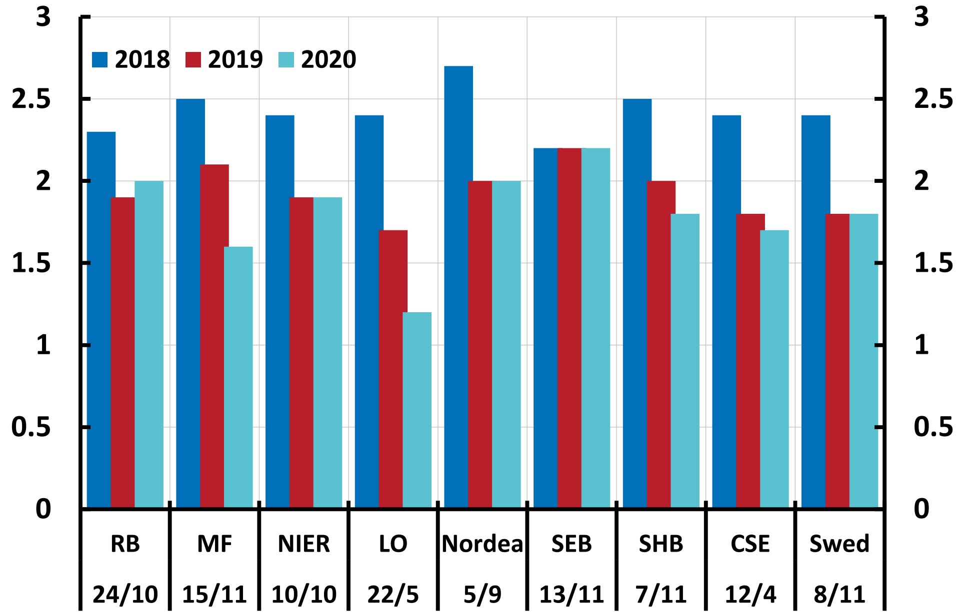
Repo rate somewhat higher

- Most analysts: No economic downturn before 2021, but of course no guarantees
- Forecasts for the repo rate at the end of 2020: 0.5–0.75 per cent
- If –0.5 per cent is the lower bound: it allows a cut of 1.0–1.25 percentage points if there is a downturn in 2021
- Risk that a larger cut will be needed

GDP forecasts 2018–2020 by different analysts



Note. Annual percentage change, annual data. RB refers to *the Riksbank*, MF to *the Ministry of Finance*, NIER to *the National Institute of Economic Research*, LO to *the Swedish trade union confederation* SHB to *Handelsbanken*, CSE to *the Confederation of Swedish enterprise* and Swed to *Swedbank*. The date refers to the day the forecast was published.

Sources: Respective analysts

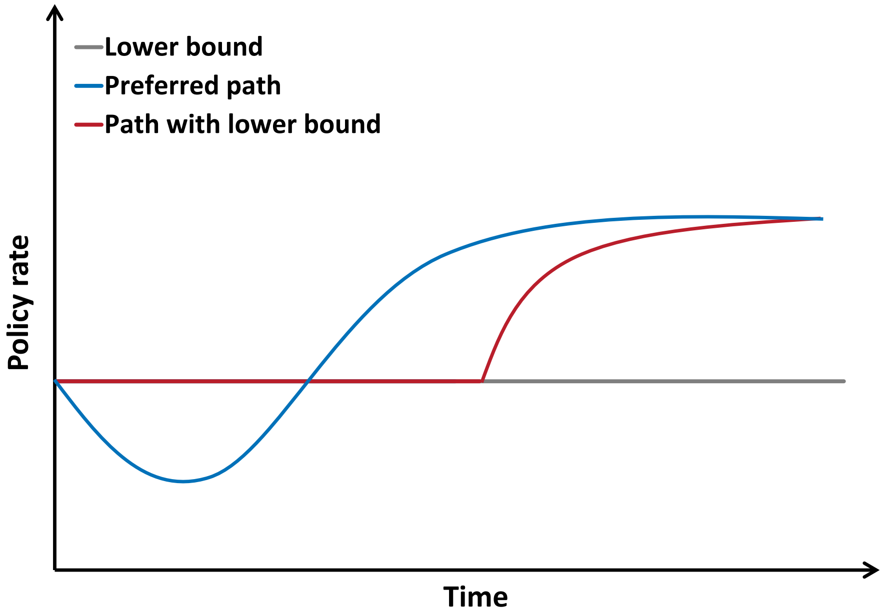
Cut repo rate below –0.5 per cent

- Social and economic conventions: More difficult to gain acceptance for negative *nominal* interest rate, than negative *real* interest rate
- Possibility to cut further, but probably not much
- The limit does not come from the general public begin to save money in cash
- Rather: Difficult to cut so that individuals are forced to “pay to save”

If the repo rate is at the lower bound – affect expectations

- If one cannot cut the interest rate more – keep it instead at the lower bound *for longer* (Janet Yellen)
- In the long run, gives the same *average* policy rate and, if it is credible, also lower long-term rates
- The repo-rate forecast is probably not enough, something more of a promise is needed

Desired policy rate path and path with lower bound



Note. Constructed example.
Source: The Riksbank

Purchases of financial assets

- **Government bonds**
  - The Riksbank already owns around 40 per cent

- **Commercial papers** (e.g. mortgage and corporate bonds)
  - Used in e.g. Euro area, USA, UK
  - Intervention in higher-risk instead of risk-free interest rates
  - Gives a “positive funding effect”, so often used when problems on particular (systemically important) markets

Stabilisation policy when the neutral interest rate is low

- The Riksbank is *not without* means to counteract an economic downturn

- But it is more difficult than it was 15–20 years ago, when neutral interest rate was higher

- Larger role for (discretionary) fiscal policy?
    - Good public finances provide opportunities – but using them can entail problems

Should central banks' frameworks be modified in the long run?

Target for nominal GDP growth (*Summers*)

Temporary price level target (*Bernanke*)

Higher inflation target (*Blanchard*)

My message in two sentences

- It is important to begin discussing how an economic downturn shall be counteracted when the monetary policy scope is not unlimited

- If the monetary policy framework is to be changed *in the long run*, a higher inflation target is the change I consider to be the best alternative