Lars E O Svensson: Why a low repo rate for an extended period?

Speech by Mr Lars E O Svensson, Deputy Governor of Sveriges Riksbank, at Handelsbanken, Stockholm, 4 May 2010.

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The opinions expressed here are my own and are not necessarily shared by other members of the Riksbank's Executive Board or staff. I would like to thank Claes Berg, Per Jansson, Stefan Laséen, Christina Nyman, David Vestin and Staffan Viotti for discussions and comments. Björn Andersson, Joanna Gerwin, Tora Hammar, Lina Majtorp and Magnus Åhl have contributed to this speech.

In this speech I would like to present my view of how monetary policy can best focus on stabilising both inflation and resource utilisation. I advocate an "extended" repo-rate path where "extended" refers to the period with a low repo rate of 0.25 per cent being extended until the end of the fourth quarter 2010. Here I will explain why.

As I am sure many of you know, over the past year I have advocated a more expansionary monetary policy than that chosen by the majority of the members of the Executive Board. I entered reservations and advocated a lower repo rate and repo-rate path at all of the monetary policy meetings from and including the meeting in April 2009 to and including the meeting held in February 2010. Such a repo-rate leads to a better utilisation of resources and a better attainment of the inflation target without threatening financial stability.

However, at the latest monetary policy meeting in April 2010 I chose not to advocate a lower repo-rate path but instead an "extended" repo-rate path. In this extended path, the period in which the repo-rate is 0.25 per cent is extended to the end of the fourth quarter of 2010 instead of to the end of the second quarter as the majority decided.

I thus supported the decision to leave the repo rate unchanged at 0.25 per cent, but entered a reservation in favour of the extended repo-rate path. My reason for this was that such a repo-rate path has the same effects as the lower repo-rate path; that is a higher level of resource utilisation and a level of CPIF inflation closer to the target.[1]

An expansionary monetary policy can thus be achieved either with a lower repo-rate path in which the repo rate is reduced now or with an extended repo-rate path in which the repo rate is maintained at a low level for a longer period of time. Some of my colleagues have had certain doubts about a repo-rate level below 0.25 per cent. As you know, I do not share these doubts. In this context, the extended repo-rate path has the advantage that these doubts are no longer relevant. It also has the advantage that it reduces the monetary policy decision to the question of when the repo-rate should be increased.

Today, I intend to discuss my view of monetary policy and explain in more detail why I entered a reservation at the latest monetary policy meeting. Much of the reasoning is the same as when I advocated a lower repo-rate path.[2] The new points that I want to make here today relate to the reasons why I entered a reservation in favour of the extended repo-rate path rather than a lower repo-rate path with a reduced repo rate. Let me begin by presenting my general view of monetary policy.

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[1] One may ask why the focus should be on the CPIF and not the CPI. In a situation in which significant repo-rate changes have very large direct effects on the CPI, I consider it to be more appropriate to focus on stabilising the CPIF around the inflation target, instead of the CPI.

[2] See also the speech "Why a lower repo rate?" that I made at Umeå University on 24 February this year for a detailed account of that reasoning.

Flexible inflation targeting stabilises both inflation and resource utilisation

When discussing what repo-rate path one should choose it is natural to take the Riksbank's monetary policy objectives as a starting point. The Sveriges Riksbank Act and its preparatory work stipulate that monetary policy focuses on stabilising inflation around the inflation target and resource utilisation around a normal level. This is what is referred to as flexible inflation targeting.

That the Riksbank should aim to stabilise *inflation* follows from the Act's price-stability objective, which the Riksbank has chosen to specify as an inflation target of 2 per cent. That the Riksbank should stabilise *resource utilisation* follows from the fact that the preparatory work for the Act states that the Riksbank "without prejudice to the price-stability target, should support the goals of general economic policy with a view to maintaining a sustainable level of growth and a high rate of employment".[3]

So what can the Riksbank do in order to achieve sustainable growth and high employment without prejudicing the price stability objective? Well, the best thing the Riksbank can do is to attempt to stabilise resource utilisation around a normal level. But why around a *normal* level? Surely, a higher level of output and employment than normal would be better? Yes, but it is beyond the power of monetary policy to increase the average level of output and employment and thus increase average resource utilisation. To increase the average level of resource utilisation one would have to use areas of policy other than monetary policy, for example a structural policy designed to improve competitiveness and the workings of the labour market.

Unfortunately – as 40 years of experience have shown and 30 years of research have explained – attempts to use monetary policy to keep resource utilisation above the normal level only result in average inflation being higher than the target without raising the average level of resource utilisation. This would entail prejudicing, or setting aside, the price-stability target. Without prejudicing the price-stability target, monetary policy cannot aim at a higher level of resource utilisation than the normal level.

It is thus a misconception, and unfortunately a common one, that the stipulation to not prejudice the price-stability target means that monetary policy should only aim to stabilise inflation around the inflation target irrespective of what happens to resource utilisation, what is usually referred to as *strict* inflation targeting. The stipulation means instead that monetary policy should also stabilise resource utilisation, but around a *normal* level, not a higher level. As far as I can judge there is now general agreement about this interpretation of the provisions of the Sveriges Riksbank Act and its preparatory work.

So, at every monetary policy meeting we, that is the members of the Executive Board, have to decide what repo-rate path will best stabilise inflation and resource utilisation. The Riksbank usually expresses this by saying that monetary policy should be *well balanced*.

If there is a conflict between stabilising inflation on the one hand and stabilising resource utilisation on the other, then a well-balanced monetary policy entails a reasonable compromise between the two. Such a conflict is in fact regarded as the normal situation, but a conflict does not always exist. In my view, there is no such conflict at present. I have therefore maintained that the lower repo-rate paths that I advocated between April 2009 and February 2010 would have stabilised both inflation and resource utilisation better than those adopted by the majority of the Executive Board.

[3] Bill 1997/98:40.

The repo rate and the repo-rate path are means, not ends

Are there other aspects of the repo-rate path to consider apart from the fact it should stabilise inflation and resource utilisation? It is important to realise that the repo rate and the repo-rate path are means and not ends in monetary policy. “A normal repo rate” is not a target for monetary policy. There is no support in the provisions or the preparatory work of the Sveriges Riksbank Act for using a too high or a too low repo rate as a reason to stabilise inflation and resource utilisation less effectively and in this sense set aside the objectives regarding price stability or the stability of resource utilisation.

Consequently, I cannot see any situation when monetary policy should set aside price stability and the stability of resource utilisation so as to “normalise” the repo rate and the repo-rate path in order, for example, to get away from a “crisis rate”, or to attempt to influence credit volumes or house prices, or because the economy has bottomed out and economic activity has begun to pick up. The focus of monetary policy should always be on achieving the best stabilisation of both inflation and resource utilisation. Credit volumes, house prices and the level of economic activity should only affect monetary policy to the extent that they affect the forecasts for inflation and resource utilisation. Credit volumes and house prices are not targets for monetary policy.

One can claim, however, that the repo-rate path chosen should not threaten financial stability. This may mean that one avoids repo-rate paths with very high repo rates in a situation in which financial stability is fragile and there is a lack of instruments to deal with this. It is also possible that in certain situations this can justify the avoidance of very low repo rates. But, as long as financial stability is not threatened I see no reason to rule out any repo-rate path at a monetary policy decision.

The extended repo-rate path has the same effects as the lower repo-rate path

This leads me to the latest monetary policy decision. One of the reasons why different people may prefer different repo-rate paths is of course that they have different views about underlying – of monetary policy independent – economic developments in Sweden and abroad. One may for example have different views about international growth, wage bargaining outcomes and productivity growth.

Here I would like to make it clear that I share the view of underlying economic developments in Sweden and abroad presented in the latest Monetary Policy Update. I advocate a different repo-rate path not because my assessment of underlying economic developments is different but because I believe that, given these developments, a different repo-rate path will better stabilise inflation and resource utilisation.

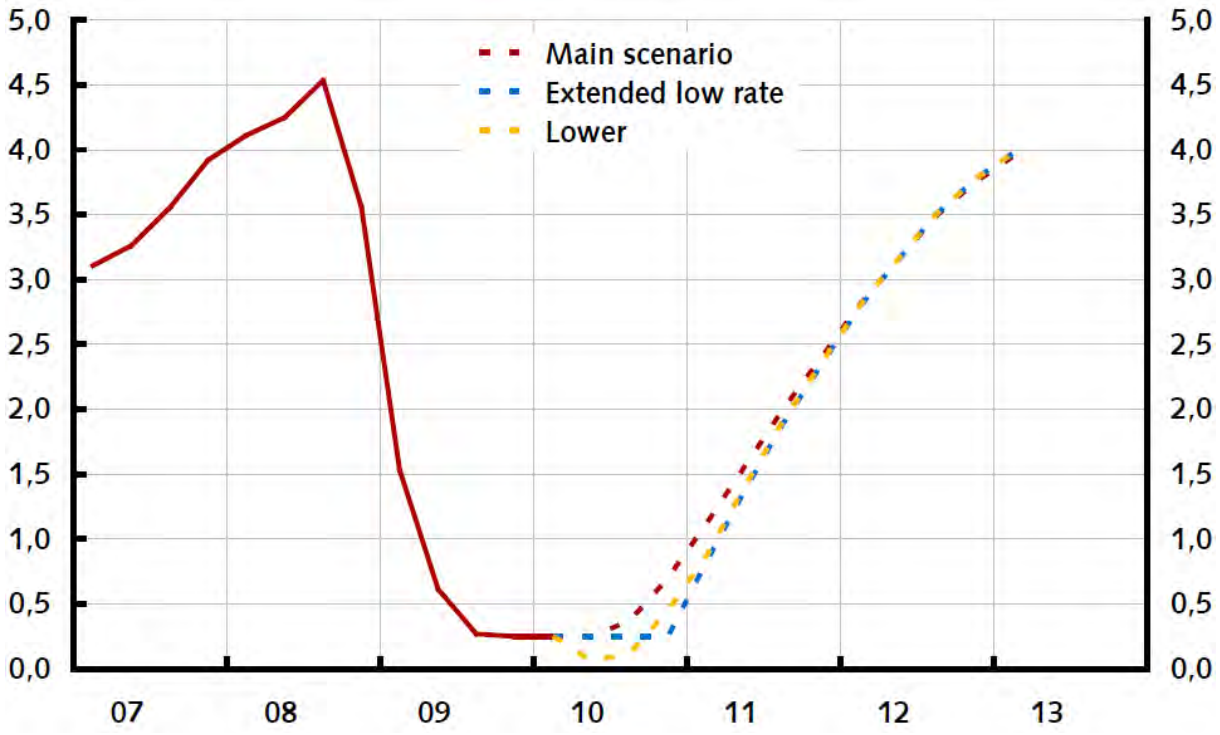
Figure 1: Three repo-rate paths

Figure 1 shows three repo-rate paths. The curve marked “Main scenario” is the repo-rate path of the main scenario of the Monetary Policy Update in which the repo rate is left at 0.25 per cent until the end of the second quarter of 2010 and then increased. The curve marked “Lower” is the lower repo-rate path in which there is a reduction in April after which the repo rate is 0.25 percentage points below the path in the main scenario for three quarters and then gradually returns to the main scenario’s repo-rate path. The curve market “Extended low repo rate” is the extended repo-rate path in which the period with a low repo-rate of 0.25 per cent is extended to the end of the fourth quarter 2010 before the path gradually returns to the main scenario’s repo-rate path.

Figure 1.

The main scenario's repo-rate path, a lower repo-rate path and an "extended" repo-rate path with a low repo rate for an extended period.

Per cent, quarterly averages



Source: The Riksbank

I have previously advocated a lower repo-rate path because this provides better outcomes for both resource utilisation and CPIF inflation. The Monetary Policy Department at the Riksbank performed an interesting analysis ahead of the monetary policy decision. This shows that the effects of the lower and the extended repo-rate paths on resource utilisation and inflation are very similar. Both alternatives lead to largely the same higher level of CPIF inflation, the same higher level of output and the same higher number of hours worked compared to the main scenario.

So, which of the two alternatives is to be preferred? The lower repo-rate path entails a lower repo rate now, while the extended repo-rate path entails a forecast of an unchanged repo rate further ahead. The lower repo-rate path can be seen as a stronger signal. A cut now may be seen as more credible than a forecast of a postponed increase further ahead. From this point of view, the low repo-rate path may be preferable.

As I have argued in previous minutes, and in my speech on 24 February, there is no reason to believe that the lower repo-rate path would have a negative impact on financial stability. My colleagues have, however, previously expressed doubts about a lower repo-rate path. As you know, I do not share these doubts. It is also the case that neither the Monetary Policy Department nor the Financial Stability Department at the Riksbank have in their analyses found any signs that a lower repo-rate path would threaten financial stability. However, in this context the extended repo-rate path has the advantage that these doubts are no longer relevant. This may therefore make the extended repo-rate path more acceptable to my colleagues. Furthermore, there is a very convincing argument for the extended repo-rate path in that it provides better outcomes for both resource utilisation and CPIF inflation, which can give it just as much credibility as the lower repo-rate path.

The extended repo-rate path also has the advantage that the monetary policy alternatives can be reduced to the question of when we should begin to increase the repo rate: in July or September or, as I advocate, in December. The monetary policy choice thus boils down to deciding which point in time for the first increase gives the best outcomes for inflation and resource utilisation. That is, which point in time gives a forecast for CPIF inflation that is as close to the target as possible and a level of resource utilisation that is as close to normal as possible. Could the monetary policy decision between alternatives be any simpler, more distinct and more transparent?

Given this background I thus decided to advocate the extend repo-rate path rather than the lower repo-rate path as an alternative to the path in the main scenario.

The extended repo-rate path stabilises inflation and resource utilisation better than the repo-rate path of the main scenario

In my view, various monetary policy alternatives must be discussed and assessed before any monetary policy decision can be clearly justified. The best way to justify why a certain repo-rate path has been chosen is to compare the consequences of this path for inflation and the real economy with those of the alternatives.

What does this mean in concrete terms? Well, it means that one must be able to show that the repo-rate path one prefers gives rise to the forecast for inflation and resource utilisation that best stabilises inflation around the target and resource utilisation around a normal level. It is as simple as that.

Figure 2: Forecasts

Figure 2 shows the forecasts for CPIF inflation (panel a), the output gap (panel b) and the hours-worked gap (panel c) for the main scenario and for the extended repo-rate path.

The curves marked “Expected” show the forecast under the following assumptions: The extended-repo-rate path is announced in April. It is perceived as credible in the sense that the market from and including April expects an unchanged repo-rate path until the end of the fourth quarter of 2010.

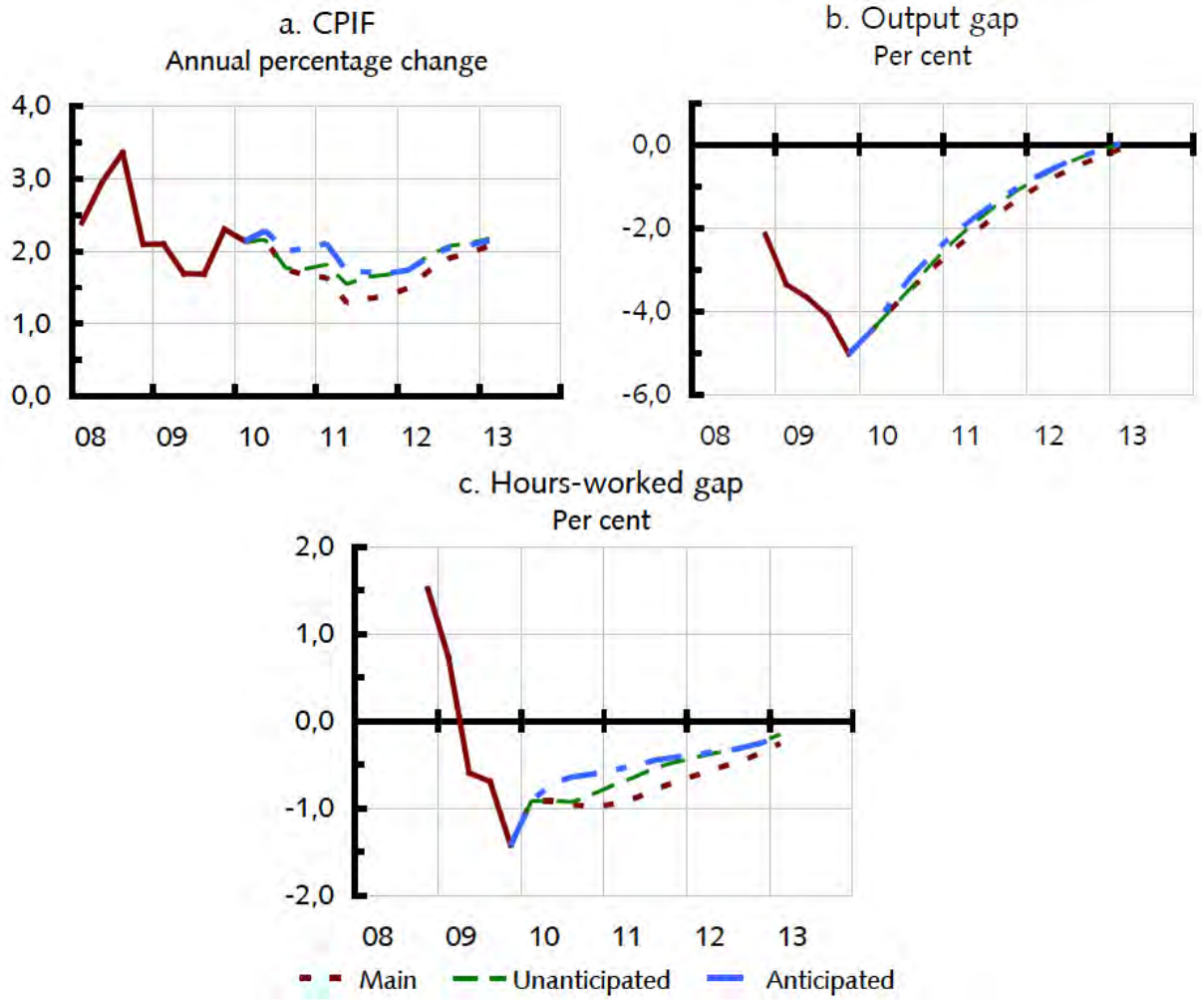
The curves marked “Unexpected” show the forecast under the following assumptions: The extended repo-rate path is not incorporated in market expectations and the market instead continues to believe in the main scenario’s repo-rate path. The market is taken by surprise in the third and fourth quarters of 2010 when the repo rate is left unchanged.

We can see that the effects of an expected extended repo-rate path are greater than those of an unexpected extended repo-rate path. It is therefore of course desirable that the extended repo-rate path is perceived as credible. As I mentioned earlier, it is possible that the extended repo-rate path with an unchanged repo rate further ahead would be perceived as less credible than a lower repo-rate path with a reduced repo rate now. In this case the effects are shown by the curves marked “Unexpected”. However, as the extended repo-rate path can be justified by the fact that it provides better outcomes for inflation and resource utilisation than the main scenario it may perhaps be perceived as being more credible, in which case the effects are shown by the curves marked “Expected”.[4]

[4] The effects of deviations from the repo-rate path of the main scenario on inflation, output and hours worked are calculated using the Riksbank's model Ramses with the methods described in Laséen and Svensson (2009) for expected deviations and Leeper and Zha (2003) for unexpected deviations. They are discussed in more detail in Svensson (2010c). The lower repo-rate path gives as an expected deviation (unexpected deviation in parenthesis) a largest increase in CPIF inflation of 0.42 (0.22) percentage points, in output of 0.33 (0.21) per cent and in hours worked of 0.35 (0.22) per cent. The extended repo-rate path gives as an expected deviation (unexpected in parenthesis) a largest increase in CPIF inflation of 0.48 (0.25) percentage

Figure 2.

Forecasts for the CPIF, the output gap and the hours-worked gap in the main scenario and in the extended repo-rate path, for expected and unexpected deviations.



Source: The Riksbank

We can also see that the extended repo-rate path provides a higher level of CPIF inflation closer to the target and a higher level of resource utilisation closer to normal for both the output gap and the hours-worked gap. This applies irrespective of the assumption of whether the extended repo-rate path is credible or not but to a greater degree if it is credible.

Figure 3: Different forecasts of resource utilisation

Resource utilization is usually measured as so-called output gaps or hours-worked gaps. These gaps are calculated as the differences between actual and “potential” levels. These measures of resource utilisation are uncertain. However, according to all available measurements, there is no doubt that resource utilisation is and will remain very low during the forecast period. Other forecasters’ output gap forecasts are shown in Figure 3. Several of the forecasts from other forecasters indicate an even lower level of resource utilisation than the measure published by the Riksbank.

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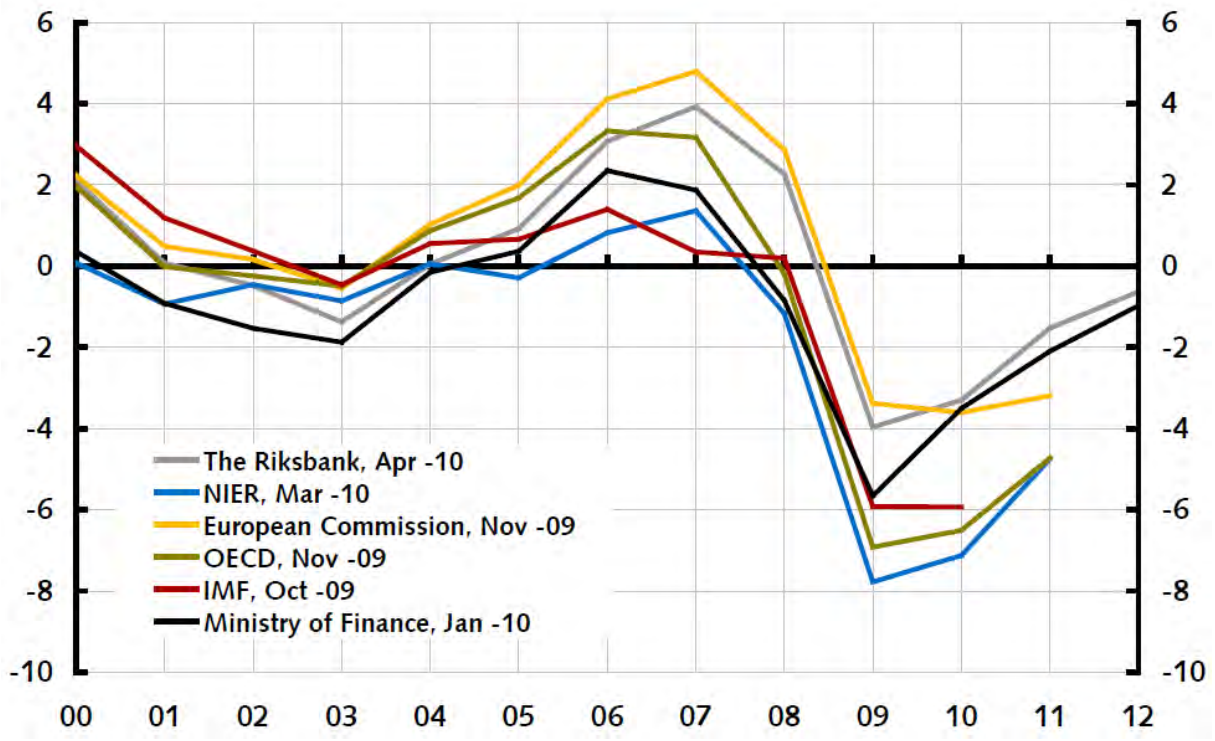
points, in output of 0.38 (0.22) per cent and in hours worked of 0.40 (0.24) per cent. The increase then abates over time.

Figure 3.

Different forecasts of resource utilisation



Sources: The Riksbank, National Institute of Economic Research, European Commission, OECD, IMF, and the Ministry of Finance.

Figure 4: Mean squared gaps

The fact that the extended repo-rate path leads to a better stabilisation of both inflation and resource utilisation is confirmed by the mean squared gaps in Figure 4. The mean squared gap for inflation is the mean squared deviation between the inflation forecast and the inflation target during the forecast period. A lower mean squared gap for inflation entails a better stabilisation of inflation around the target and thus a better attainment of the inflation target.

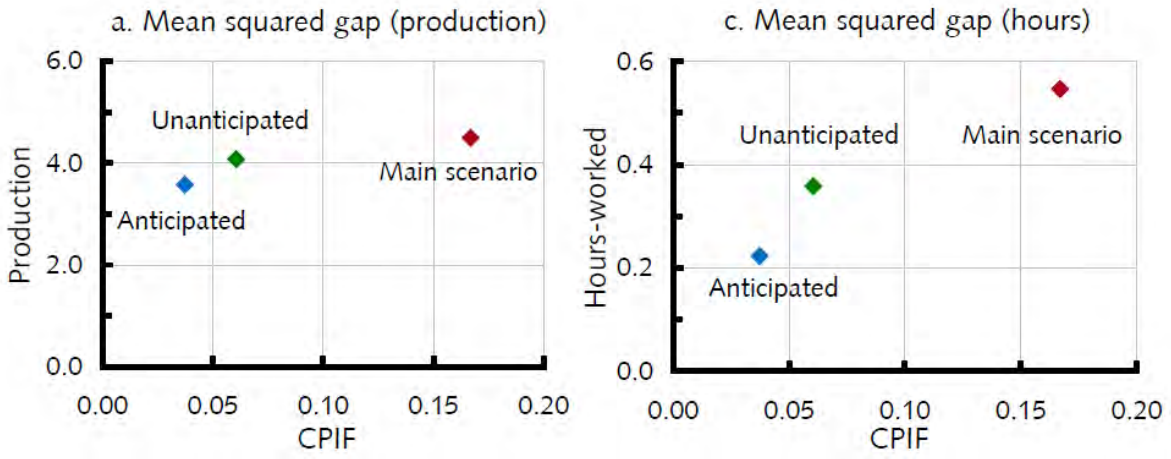
The mean squared gap for output and for hours worked is the mean squared gap for resource utilisation measured in two ways, that is using the output gap and the hours-worked gap during the forecast period. A lower mean squared gap for output or hours worked entails a better stabilisation of resource utilisation around a normal level measured as the output gap or the hours-worked gap. The closer to origo the mean squared gap for inflation and resource utilisation is, the better the stabilisation of inflation and resource utilisation.

This case is special as there is no conflict between stabilising inflation and resource utilisation; the extended repo-rate path stabilises both better than the main scenario. This is of course already obvious in Figure 2, so the mean squared gap does not add much new information here.

However, the normal situation is considered to be that there is a conflict between stabilising inflation and resource utilisation. In such a situation, the mean squared gap in Figure 3 would lie in a north-west to south-west direction and determining monetary policy would entail weighing up whether to stabilise one more or less than the other.

Figure 4.

The mean squared gap for CPIF inflation and output and hours worked respectively.



Source: The Riksbank

Figure 5: The decision-making situation for Norges Bank in 2005

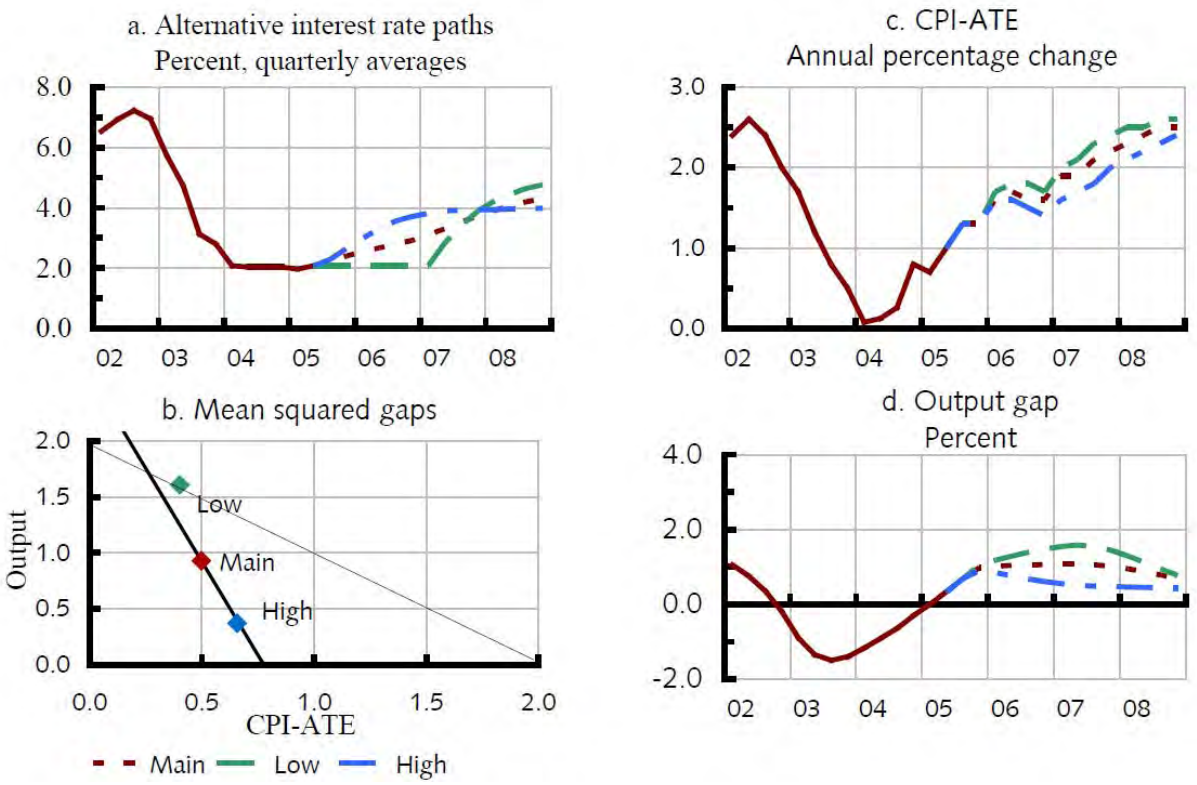
Figure 5 shows the policy decision facing Norges Bank in March 2005, which is an example of a case where there was a conflict between stabilising inflation and stabilising resource utilisation.[5] The problem at that time was that the inflation forecast was under the inflation target of 2.5 per cent, so that the gap between the forecast and the target was negative, while the forecast for the output gap was positive. In such a situation, a lower repo-rate path stabilises inflation around the target better but the output gap less well, and vice versa for a higher repo-rate path. The mean squared gap then lies in a north-west to south-west direction. This case is discussed in more detail in my Umeå speech and in my chapter "Inflation targeting" to be published in a new North-Holland *Handbook of Monetary Economics*.[6]

[5] Norges Bank (2005).

[6] Svensson (2010b).

Figure 5.

Monetary policy alternatives for Norges Bank, March 2005



Source: Norges Bank

Are there any arguments against an extended repo-rate path?

In the minutes of the monetary policy meeting in April, several of my colleagues put forward the development of credit and house prices as reasons for not pursuing a more expansionary monetary policy. My view is that if this development represents a threat to financial stability then the situation should be handled using instruments that impose restrictions regarding leverage, amortisation and so on. The repo rate is a blunt and inappropriate instrument.[7] However, the analyses performed by the Riksbank and Finansinspektionen indicate that this development does not pose any threat to financial stability at present.[8]

Credit volumes and house prices are not targets for monetary policy. From the monetary policy point of view they are indicators and should only affect monetary policy to the extent that they affect the forecasts for inflation and resource utilisation.

There are no signs, and as far as I know no analyses, that show credit volumes and house prices are now affecting the forecasts for future inflation and resource utilisation one way or another. Indicators should only affect monetary policy if they contain information that is relevant to future inflation and resource utilisation.

Two speeches by Donald L. Kohn of the Federal Reserve specify three conditions that should be fulfilled before central banks implement “extraordinary measures” to handle

[7] Svensson (2010a, b).

[8] Finansinspektionen (2010).

possible asset price bubbles, such as the unsustainable development of housing prices:[9] "First, policymakers must be able to identify bubbles in a timely fashion with reasonable confidence. Second, there must be a high probability that a somewhat tighter monetary policy will help to check at least some of the speculative activity. And third, the expected improvement in future economic performance that would result from the curtailment of the bubble must be sufficiently great." It is obvious that these conditions do not prevail at present.[10]

The division of the Swedish economy

The crisis has led to a division of the Swedish economy in which the export industry is struggling while the service sector is doing well. It is, however, beyond the power of monetary policy to influence development in an individual sector. Monetary policy can only focus on stabilising average resource utilisation and average inflation. This division is therefore not itself normally an argument for either a more expansionary or a more contractionary monetary policy.

However, in the current situation, with a very low level of resource utilisation and a very weak export industry, one can claim that irrespective of how sensitive to interest rates the export industry is it should benefit from a weak krona and suffer from a strong krona. As a more expansionary monetary policy would entail a weaker krona one can claim that the division is in this situation an argument for pursuing a more expansionary monetary policy. This argument is strengthened by the fact that there do not appear to be any signs of overheating in the service sector in the form of a shortage of labour and excessive wage increases.

Conclusion: An extended repo rate path better stabilises inflation and resource utilisation

It is possible to reduce the monetary policy decision to the following questions: When should we begin to increase the repo rate from its current level of 0.25 per cent – in July, September or December of 2010? Which of these alternatives stabilises inflation and resource utilisation best?

An extended repo-rate path with a repo rate of 0.25 per cent to December 2010 stabilises both inflation and resource utilisation better than the repo-rate path in the main scenario. It poses no problems to financial stability. There is therefore a very strong argument for an extended repo-rate path. In my view there are no strong counterarguments. In fact, I cannot really see any valid counterarguments at all.

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[9] Kohn (2006, 2008).

[10] Questions regarding the significance of asset prices for monetary policy and of the monetary policy conclusions to be drawn from the financial crisis are discussed further in Svensson (2010a, b). See also Kohn (2009).

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