Per Jansson: Perspectives on the Riksbank's monetary policy

Speech by Mr Per Jansson, Deputy Governor of the Sveriges Riksbank, at the Centre for Business and Policy Studies, Stockholm, 7 June 2013.

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Nowadays one can hardly open a newspaper without seeing headlines about the Riksbank. Many have opinions about the monetary policy we have conducted in recent years, and the one we are conducting now.

The opinions differ in nature. The Riksbank has conducted the monetary policy we consider best balanced to attain the inflation target and create conditions for long-run sustainable growth. However, some analysts have not shared the Riksbank's view of economic prospects and have therefore reached slightly different conclusions as to how monetary policy should have been designed. Of course, this type of difference of opinion is not particularly remarkable in a field such as monetary policy, where decisions necessarily have to be based on assessments.

But there are also other objections that are more a matter of principle and aimed at the very way the Riksbank conducts its policy. Although it is not always stated explicitly, the message is that the Riksbank is conducting a policy other than the one it is intended to conduct – that, to put it drastically, the Riksbank has misunderstood its task and is "playing by its own rules".

It has been claimed, for instance, that the Riksbank has a tendency to be over-zealous in combating inflation and to care too little about unemployment. Seen over a longer period of time, inflation would thus on average have been too low and unemployment unnecessarily high – this has also led to a discussion about the target for monetary policy.

Others argue that the Riksbank takes into consideration in its repo-rate decision factors that should not be considered. This criticism has been mainly aimed at the Riksbank's concerns over household debt that have contributed to monetary policy being somewhat less expansionary in recent years than would otherwise have been the case. It has sometimes even been claimed that the Riksbank has on its own initiative introduced new targets for monetary policy that lie outside its statutory mandate.

Here I would like to be clear about my personal opinion: I think that the Riksbank has succeeded well in its task of attaining low and stable inflation. I thus do not share the view that we have been over-zealous in combating inflation. I also think that a policy that gives consideration to the risks in the credit and housing markets is entirely compatible with our mandate of creating conditions for stable economic growth and that this has nothing to do with introducing new targets for monetary policy. As it would be unfortunate if the impression that the Riksbank is exceeding its mandate takes root, I intend to use much of the time at my disposal today to explain why I consider this not to be correct. Furthermore, the Riksbank's aim to take risks into consideration to attain a long-run stable development of the economy is well in line with the international discussions now taking place regarding the choice of direction faced by central banks in the wake of the financial crisis. I would therefore also like to broaden the perspective and put the debate here in Sweden in a larger context.

We need a nuanced discussion of the development of inflation

Let me begin with the criticism that the Riksbank has been over-zealous in combating inflation. The actual starting point for this criticism is that CPI (consumer price index) inflation has undershot the inflation target of 2 per cent on average since the target was introduced. This has received considerable media attention and been debated in blogs – which is of course not a problem in itself. It is important and absolutely necessary that the target attainment of monetary policy is analysed and discussed to enable the Riksdag and ultimately the Swedish people, to ensure themselves that the Riksbank is doing the job it has

been assigned to do. But for exactly this reason it is unfortunate that the reporting of the average inflation rate has often been rather superficial and in certain cases, intentionally or unintentionally, not entirely correct. In some extreme cases it has even been claimed that the inflation target has in practice ceased to apply. Headlines and comments of this type hardly contribute to a serious debate on monetary policy.

Let us begin by looking at the data and seeing how inflation has developed since the target was introduced. As you probably know, the target was announced in January 1993, but began to apply officially to the annual increase in the CPI with effect from 1995.[1] To obtain an inflation series that better corresponds to the one the Riksbank had access to when making its repo-rate decisions, one has to take into account the fact that the calculation method for the CPI was changed in 2005. Inflation has varied substantially during the period, both overshooting and undershooting the target, but it has been 1.4 per cent on average during the period January 1995 to December 2012, that is six tenths of a percentage point lower than the inflation target of 2 per cent.

Some critics seem to assume that this is all the information one needs to assess monetary policy. They argue that each tenth of a per cent below the target has entailed major costs to the real economy, and this is enough to draw the conclusion that monetary policy has not been able to deliver what it should.

Do not forget how things were in the 1970s and 1980s!

My view is that one must look at the development of inflation in the right perspective and remember how things were before the target was introduced. Let us compare inflation and economic developments in general during the twenty years the inflation target has been in place with the twenty years prior to its introduction. During the 1970s and 1980s, average inflation was almost in double figures and varied substantially from year to year (see Figure 1). Sweden was a country without a nominal anchor. There was no credible level for inflation that price setting and wage formation could use as benchmark and the economy was stuck in a devaluation cycle. This was a fundamental problem that the Swedish economy was suffering when it entered the 1990s crisis.

We came out of the crisis with a whole new monetary policy regime – inflation targeting. This policy was relatively untested internationally and it was far from clear that it would work. Such doubts may seem surprising today, bearing in mind how natural an inflation target is now and how inflation expectations are stably anchored around the target. And this, in turn, reflects the most important contribution from inflation targeting – in my opinion its main merit – that it has functioned as a nominal anchor for the economy for two decades (see Figure 2).

The reform of the monetary policy framework was not the only important change in the Swedish economy following the crisis at the beginning of the 1990s. However, the inflation target is definitely one of the most important explanations for inflation being on average around 7 percentage points lower during the two decades following the crisis, compared with the two decades prior to the crisis. In addition, inflation has been much more stable. At the same time, growth has not been lower than before; rather it has been quite a bit higher (see Figure 3). From this perspective, I think that one must say that inflation targeting has been a great success.

CPIF inflation of 1.8 per cent on average is a good result

An assessment of monetary policy cannot merely be based on an analysis using hindsight and comparing inflation outcomes with the target. There are a number of reasons why

[1] From 1993 to 1995, monetary policy was aimed at preventing the temporary inflationary impulse that arose in connection with the krona being allowed to float becoming entrenched and leading to an increase in the underlying rate of inflation.

inflation may deviate from the target, despite monetary policy being conducted accurately. It is therefore necessary to modulate the analysis and see which factors explain why CPI inflation has on average undershot the target.

The prices in the Swedish CPI include a component that reflects households' mortgage interest expenditure. When mortgage rates rise, this component contributes to pushing up CPI inflation and, vice versa, when mortgage rates fall, it pushes down inflation. Normally, the variable mortgage rates follow the development of the repo rate fairly closely. This means that when the Riksbank cuts the repo rate to increase activity in the economy and gradually bring up inflation, the initial result is that CPI inflation *falls*, that is to say, the direct impact on inflation is "in the wrong direction". This is why the Riksbank often allows monetary policy to be guided by the CPIF inflation measure – a measure of underlying inflation that is not directly affected by changes in mortgage rates and therefore is not impacted by this effect (see Figure 4).

The fact that the CPI is impacted by changes in the interest rate in this way is of course something the Riksbank was aware of when the inflation target was introduced. The choice was still made to define the target in terms of the CPI, as the CPI is a broad price index that represents normal purchases and is familiar to the general public. But as the Riksbank has pointed out, measures of underlying inflation are also used to obtain indications of the more lasting inflationary pressures. CPI inflation is constantly affected by temporary factors, which there is no reason to counteract with monetary policy – for instance, the direct effect on interest expenditure of the Riksbank's own monetary policy. Underlying measures, such as the CPIF, have thus often been used to guide monetary policy.[2]

Twenty years is a long time, and one might expect that the effects of fluctuations in interest rates on the interest-expenditure component in the CPI would offset one another. The average inflation rate according to both the CPI and the CPIF would therefore be roughly the same. However, this is not the case. The average rate of inflation measured in terms of the CPIF during the period 1995-2012 is 1.8 per cent. In other words, most of the deviation in CPI inflation from the inflation target is explained by interest rates falling more than they have risen during the period. When this effect is discounted, there remains a deviation of two tenths of a percentage point from the inflation target. Although this deviation should not be ignored, it can hardly be called a major failure. From a broader historical perspective and with a realistic attitude to the precision of monetary policy, I think that one can stick out one's neck and say that an average CPIF inflation rate of 1.8 per cent is a pass rate, perhaps even a pass with distinction.

Calculations of costs in terms of number of unemployed must be taken with a rather large pinch of salt

This leads me in to the discussion on the costs to the real economy of inflation on average undershooting the target. One calculation has been presented by my former Executive Board colleague, Lars E.O. Svensson, who arrived at an average cost corresponding to 38,000 persons unnecessarily unemployed.[3] Another figure regarding the costs of the monetary policy conducted that has attracted some attention is that 60,000 fewer people would have

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[2] Support for this use of underlying inflation measures, combined with an inflation target defined in terms of the CPI, was expressed in the assessment of the Riksbank's monetary policy 2005-2010 carried out by professors Goodhart and Rochet in 2011.

[3] Svensson (2013a,b). Mr Svensson examines the period 1997-2011 and calculates that if inflation during this period had on average been 2 per cent instead of 1.4 per cent, unemployment would have been 0.8 percentage points lower. If the labour force is held constant, this corresponds to around 38,000 fewer unemployed.

been unemployed if the repo rate had been kept at the rate of 0.25 per cent, to which it was cut during the financial crisis, until today.[4] I will return to this particular calculation later on.

As I mentioned in my introduction, it is important to assess monetary policy and to analyse potential consequences of deviations from the inflation target. But one must also be aware of the impact of such analyses and that there is a clear risk that apparently exact figures will be regarded as concrete truths in the debate. All calculations of this nature are based on strong assumptions and are very uncertain, something that is easily forgotten or just ignored.

Take the calculations that I mentioned earlier. Without going into detail, one can note that they only focus on what CPI inflation has been on average – the costs in terms of unnecessary unemployment have arisen *solely* because the average *CPI inflation rate* has been below 2 per cent. Supposedly, the idea is that this could have been avoided if the Riksbank had cut the repo rate more and brought inflation up to 2 per cent.

But is this all there is to it? Remember, the important thing here is that CPI inflation is 2 per cent. So the Riksbank should actually have raised rather than cut the repo rate. The direct effect would then have been that *CPI inflation* would have been *higher* through the effects on the interest-expenditure component of the CPI. Of course, this would also have had a dampening effect on activity in the economy and on the inflation rate that is not affected directly by changes in mortgage rates, namely CPIF inflation. But this could have been compensated with more and larger interest rate increases and CPI inflation could thus have been kept at 2 per cent. CPIF inflation would then fall increasingly, but this would not matter as the calculation assumes that it is *solely* the average *CPI inflation rate* that creates the unnecessary unemployment.

Before anyone thinks that I have gone over to the dark side, let me say that this would of course have been an absurd and destructive monetary policy. But it illustrates the difficulty of interpreting the results of calculations that solely focus on the average of CPI inflation.

Söderström and Vredin (2013) discuss this, among other things, in an analysis of inflation, unemployment and monetary policy. One conclusion of their analysis is that the link between CPI inflation and unemployment has many causes and that it in itself therefore does not give much guidance as to how well monetary policy has been conducted. They also make an alternative calculation of the effects of monetary policy on unemployment, based on the deviation in CPIF inflation from 2 per cent and reach a figure of around 12,000 unemployed on average. But the main message in their analysis is that calculations of this type must necessarily be based on a number of more or less realistic assumptions of how the economy functions. It is therefore important to take the figures produced with a fairly large pinch of salt.[5]

Recent criticism

As I noted in my introduction, in addition to the criticism of the historical attainment of the inflation target, there has also been criticism of the policy conducted in recent years. This claims that the Riksbank has considered factors in its repo-rate decisions that should not have been considered. The main focus of this criticism has been that the Riksbank has concerned itself with household debt and developments on the housing market and thus not conducted a sufficiently expansionary monetary policy. Sometimes it has even been claimed that the Riksbank has introduced a new target that contravenes its mandate and that the Riksbank has begun to conduct "housing policy".

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[4] Svensson (2013c).

[5] Assar Lindbeck, although having preferred a lower interest rate than the one the Riksbank decided on, also argues that this type of calculation should not be taken “too seriously”, as it is based on assumptions that are “too uncertain” (Dagens Industri, 2013a).

This is of course an attempt to take the argument to its extreme. Monetary policy has constantly been aimed at bringing inflation back on target and creating conditions for long-run stable growth in the Swedish economy. The reason why the Riksbank has conducted the policy it has conducted is that it has tried to reduce the risk of excessive debt and overly inflated housing prices. Swedish household debt has shown a sharp upward trend over the past 15 years or so and is now very high, both from an historical and an international perspective (see Figure 5). If housing prices were for some reason to fall heavily in a situation with high debt levels, households would find that their earlier calculations no longer held and that their balance sheets did not look the way they expected. This could in turn start a process whereby households try to get rid of some of their debt. This would mean that their income would for some time to come be used for amortisation rather than consumption and investment – we would experience a fall in demand in the economy.[6] One important reason for the recovery from the crisis being so slow in a number of countries is probably that households have a large ”debt overhang” they are trying to get rid of.[7]

If one were to have this type of development, it would most probably mean that unemployment rose sharply and it would probably also be difficult to attain the inflation target for quite a long time to come. In the countries where housing prices have fallen in connection with the crisis, unemployment has increased quite substantially (see Figure 6). Excessive debt thus constitutes a threat to macroeconomic stability and price stability, and counteracting risks in this area is therefore entirely in line with the Riksbank's mandate and objectives.[8]

The idea behind the Riksbank's policy

The idea behind the Riksbank's policy can be illustrated with the aid of two stylised scenarios (see Figure 7). Either one conducts a more expansionary monetary policy, as represented by the blue line, which endeavours to bring inflation up to the target within a relatively short time and to quickly reduce unemployment. However, this policy means that lending to households will increase and prices in the housing market will rise, ultimately to untenable levels. When housing prices fall at a later stage, inflation will therefore undershoot the target substantially and unemployment will be far above its long-run equilibrium level. All in all, target attainment will therefore not be very good.

The second alternative, as represented by the red line, entails a less expansionary policy that lets it take a little longer to return to the inflation target and reduces unemployment more slowly – and in the short-term perspective therefore leads to poorer target attainment. However, this policy also means that one avoids debt becoming excessively high and housing prices accelerating out of control. One thus also avoids the turbulence that arises from a subsequent fall in housing prices and target attainment is better in a longer-term perspective. This policy is usually described as monetary policy "leaning against the wind".

It should be emphasised that this is of course an exaggerated and highly stylised example aimed at proving a point of principle. In reality, the deliberations we have to make are much more complex.[9] Monetary policy is not a question of choosing between two alternatives that

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[6] Large debt levels can entail problems even if housing prices do not fall, as households become more sensitive to interest rate changes. See, for instance, the analysis on the discretionary income calculations in Financial Stability Report 2013:1, Sveriges Riksbank.

[7] See, for example, Mian and Sufi (2011). Jordà, Schularick and Taylor (2011) show in a study of crises in 14 countries during the period 1870-2008 that if the upswing phase is marked by a strong credit boom, the crisis tends to be deeper and the recovery slower.

[8] Note that such a scenario would not necessarily lead to financial stability problems. See, for example, the stress tests published in the Riksbank's Financial Stability Reports.

[9] Of course, the repo rate is not the only tool for managing this type of circumstance, which is discussed below.

will occur with certainty if one conducts a specific policy; it entails weighing the risks and probabilities of various scenarios against one another. In this case, the risk of a really poor development further ahead must be balanced against short-term costs. One is forced, so to speak, to pay an "insurance premium" in that a slightly less expansionary monetary policy in the short term leads to slightly lower inflation and slightly higher unemployment. A particularly difficult situation arises if a weak development of the real economy means that the short-term costs of conducting a less expansionary policy appear to be large at the same time as the risks linked to credit granting and the housing market increase.

To summarise: in principle, there is no doubt that the Riksbank according to its mandate *may* take into consideration risks linked to a rapid increase in household debt. Such risks can constitute a threat to both the stability of the macro economy and inflation. To me, saying that the Riksbank has no mandate to take these risks into account therefore appears rather odd. As the Governor of the Bank of England, Mervyn King, has put it: “Monetary policy cannot just ‘mop up’ after a crisis. Risks must be dealt with beforehand. I do not see this as inconsistent with inflation targeting because it is the stability of inflation over long periods, not year to year changes, which is crucial to economic success.”[10] Similar thoughts are expressed in the IMF's Article IV consultation for Sweden: ”[I]f mortgage credit growth increases unsustainably, the Riksbank might have to raise the interest rate path relative to that warranted by short-run macroeconomic considerations alone.”[11]

Is it meaningful to consider risks linked to household debt in monetary policy?

If one is thinking about giving consideration to risks linked to household debt when formulating monetary policy, it is reasonable to first take a stance on a number of specific questions.[12] Does the repo rate have an effect on the variables one wishes to influence, housing prices and lending? How large are the risks linked to household debt? And finally, are there other tools at hand that are better-suited to managing these risks?

The answers to these questions are important for determining whether it is justified taking the risks linked to household debt into account in monetary policy. It is also precisely these questions that have been discussed in the general debate on the role of monetary policy in this context. I therefore intend to discuss these questions one by one and in relative detail.

Can the repo rate affect housing prices and lending?

It is probably true that the effect of a typical change in the policy rate on housing prices and lending to households is on average not very large. In addition, the policy rate is a blunt instrument when it comes to influencing housing prices and lending, as it is an interest rate that applies to the whole economy. This is why more specific tools, what are known as macroprudential tools, are generally perceived as more appropriate than the policy rate for counteracting this type of specific imbalances.

But the effect of the policy rate most likely varies quite substantially depending on the circumstances prevailing at a specific time. In some situations it may be enough to make fairly limited increases to subdue an overly rapid upswing in the housing market, for instance, if the central bank combines these increases with communication emphasising that current developments are perceived as cause for concern.[13] Small interest rate increases then function more as a concrete "reminder" that the central bank is concerned over

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[10] King (2012), p. 12.

[11] IMF (2013), p. 3.

[12] See, for example Svensson (2012).

[13] Note that it may sometimes instead be a case of refraining from cutting the rate where this might otherwise have been justified.

developments, but it is rather the communication in itself that has the dampening effect. In this case, the impact on the rest of the economy need not be so great either. The fact that communication on monetary policy can play an important role in this context is emphasised by, for instance, Mark Carney, Governor of the Bank of Canada and soon to be Governor of the Bank of England: "[P]rivate agents may choose to accumulate less debt if they understand that a broad-based build-up of debt is likely to cause the central bank to raise interest rates."[14]

Monetary policy is expansionary

It should be fairly clear that it is precisely this type of "signalling strategy" that the Riksbank has used. Monetary policy since the crisis has not entailed using sky-high interest rates to stop an upswing in lending and housing prices, at any cost. What we have tried to do is to find a suitable balance to be able to support the recovery, without "pressing too hard on the accelerator", thereby contributing at least at the margin to a calmer development in house prices and lending to households. It can hardly be claimed that the policy conducted by the Riksbank during the recovery from the crisis has been tight or that the current policy rate level does not contribute to boosting economic activity.

I also think that in this context it is useful to look at the international debate. Although the general view is that macroprudential instruments are normally preferable for counteracting this type of imbalance, there is also a lively debate on what role the policy rate should play.[15] In this debate, it is not assumed that the policy rate is entirely ineffective and insignificant, and "the jury is still out".

A dubious counterfactual experiment

I would like to give an example from the Swedish debate, where I believe one has taken the potential of monetary policy to influence expectations too lightly. As I mentioned earlier, it has been claimed that up to 60,000 more people would have had jobs if the Riksbank had conducted a different monetary policy after the crisis and kept the repo rate at the level of 0.25 per cent to which it was cut in July 2009.[16]

When the Riksbank began to raise the repo rate in the middle of 2010, the situation was such that the Swedish economy had recovered surprisingly quickly from the crisis. Growth was record high, about 6 per cent in annualised terms in the first quarter, and basically all leading indicators of economic activity were pointing upwards. Household lending, which had increased at double figures in terms of annual changes prior to the crisis, had begun to slow down, but the increase in credit was still 9 per cent, far above the increase in disposable income. At the same time, inflation measured in terms of the CPIF was close to 2 per cent.

I find it difficult to see that it would have been realistic to declare in this situation that the repo rate would not be raised, but would remain at 0.25 per cent for the foreseeable future. The expectations this would have created among households and on the credit and housing markets would most likely have been very difficult to manage. Such a policy might be appropriate to try to "kick-start" an economy that has suffered a severe crisis, where housing prices have already fallen and households are trying to reduce their debt. But for countries that are not in this situation, and where debt and housing prices remain high and are increasing, it does not appear to be a realistic policy.

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[14] Carney (2013), p. 18.

[15] See, for example, Blanchard, Dell'Ariccia and Mauro (2013), Carney (2013) and Stein (2013). Woodford (2012) says that this is an area where we need more in-depth knowledge, but on the basis of what we know now, there is no reason to write off the policy rate.

[16] Svensson (2013c). One can also have other, more technical, views regarding this calculation, see the Minutes of the monetary policy meeting in April 2013.

How large are the risks linked to household debt?

Let me now move on to the next question, which concerns the actual size of the risks linked to household debt in Sweden.

It is true that there are estimates suggesting that the housing market in Sweden is not over-valued. Some of these estimates have been made by the Riksbank itself. This could mean that the high level of debt among Swedish households is not such a large problem, either. But there are also estimates that suggest an overvaluation.[17] And when there is so much at stake, there are good reasons, as I see it, to be particularly cautious.

After all, it was not the case that the corresponding estimates prior to the crisis showed any impending problems in the countries that have now been hit so hard. As Stefan Gerlach, Deputy Governor of the Central Bank of Ireland, noted recently, it is always easy to gain support for the opinion that housing prices are currently correctly valued – even if this soon proves to be incorrect.[18] In Ireland, the opinion immediately prior to the crisis was that housing prices were not abnormally high and that the banks were stable and well-consolidated. I am convinced that this was how most countries, which have suffered problems, viewed their situation.[19]

Nor does the size of household wealth appear to have had any decisive significance for the impact of the crisis. The countries that have been hit hardest include ones with both stronger and weaker wealth positions than Sweden (see Figure 8). The reason why a strong wealth position does not necessarily provide a good protection is probably that a large part of the wealth mass is not very liquid and thus its use as a buffer in times of crisis is limited. This applies in particular if the crisis leads to a fall in housing prices. A high level of wealth is thus no guarantee for avoiding problems; the best strategy is of course to try to prevent a crisis from arising at all.

It may of course be the case that we in Sweden really are different. But I am sceptical to this. I think it is very risky to rely on this being the case. Now that we have seen that the costs in many countries have been so high, I at least draw the conclusion that there is reason to try to reduce the risk that we may also find ourselves in this situation, even if it is not the most likely development. As I mentioned earlier, monetary policy is to a large extent about managing risk. I have not so far felt that the short-term gains of a slightly more expansionary policy are sufficient to compensate for the threat of losses further ahead in a really bad scenario.[20] But, once again, it is a question of balance and things may change over time. The policy we have conducted has actually been expansionary and mainly concerned sending signals that developments give cause for concern. At some point the "insurance premium" becomes too large, but I do not think this can be said to have happened yet.

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[17] For a comprehensive survey of the valuation of the Swedish housing market, see Sørensen (2013), in which the following conclusion is drawn (p. 71-72): "[A] cautious reading of the evidence gives reason to expect downward pressure on Swedish real house prices in the years to come. And if the Swedish economy were to be hit by a large negative shock, the downward adjustment of house prices could become more rapid than the analysis … would suggest."

[18] See Dagens Industri (2013b).

[19] Bernanke (2010) describes the difficulties experienced by the Federal Reserve in determining whether or not the housing market in the United States was over-valued.

[20] Similar ideas can be found in, for instance, Blanchard, Dell'Ariccia and Mauro (2013), p. 7: "[G]iven what we have learned about the costs of inaction, higher type I errors (assuming that it is a bubble and acting accordingly, when in fact the increase reflects fundamentals) in exchange for lower type II errors (assuming the increase reflects fundamentals, when in fact it is a bubble) may well be justified."

Are better instruments than the policy rate already available?

The third question concerns the access to other tools than the repo rate for managing risk. Those who are critical of using the repo rate claim that there are already other and better-suited instruments available.

I consider this criticism to be a little strange and to make too many assumptions in advance. It seems to assume that there is already a framework for macroprudential policy in place in Sweden, which clearly states what instruments are to be used and by whom. Let us assume, for instance, that the Riksbank had held the policy rate at 0.25 per cent up until now, as was the case in the counterfactual experiment I mentioned earlier, and that this had meant that lending to households and housing prices had begun to rise sharply again. Would it really have been obvious how this should have been managed and by whom? Bearing in mind how the risks in this field have been allowed to increase in Sweden over the past 15 years, I doubt that this would have been the case.

In other words, I believe we are still a long way from a satisfactory situation. I am quite convinced that for this to work the allocation of responsibility must first be clearly specified and there must be clear guidelines for what should be done. However, a potential framework for macroprudential policy is only under investigation. The Financial Crisis Committee has presented a partial report that was recently circulated for consultation. But it is not likely that a complete solution will be in place in the very near future.

Different views on macroprudential tasks

Judging by the consultation responses to the Financial Crisis Committee's partial report, opinions are relatively divided as to what role macroprudential policy should play with regard to the development the Riksbank has tried to manage in recent years. There is a possibility that excessive debt could result in a conspicuously weak macroeconomic development without any threat to the stability of the banking system. Some of those consulted consider that macroprudential policy does not have a role to play in reducing these types of risk, given that they do not present a clear threat to the stability of the banking system.[21] With this type of solution monetary policy would not obtain the support from macroprudential policy needed to be relieved of "leaning against the wind". Indeed, my impression is that macroprudential policy is often assumed to focus on the stability of the banking system. This means that risks in the credit and housing markets that do not clearly threaten the banking system, but could nevertheless lead to major macroeconomic problems, would risk being overlooked.

There is a lot that remains to be investigated and decided on before a practical framework for macroprudential policy is in place. My impression is that, compared with many other countries, we have if anything fallen a little behind. This is unfortunate, as the situation in Sweden, as I noted earlier, is actually slightly more sensitive than that in many other countries, where housing prices have already fallen and households have begun to amortise their debts to a more significant extent.

Well in line with the international discussion

One thing I think it is important to emphasise – and which is not always clear in the Swedish debate – is that the Riksbank's aim to give consideration to the risks arising from household debt and the housing market is well in line with the international view that has emerged in the wake of the financial crisis. The Riksbank's way of reasoning, and the policy we have conducted, are thus not unusual or strange, but are characteristic for the present time.

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[21] The Swedish National Debt Office (2013) writes, for instance, in its consultation response that with the solution they advocate, "it would not be possible to justify any macroprudential policy measures if the conclusion was that the risks inherent in current household debt were primarily a demand-related problem (rather than a problem for the banking system)." (p. 2).

There is even reason to claim that the Riksbank was one of the first central banks to highlight this type of risk. Household debt and housing prices were a fairly hot topic on the Riksbank's monetary policy agenda a relatively long time before the global financial crisis broke out.[22] Moreover, Sweden is usually regarded as one of the few countries that has in practice applied a policy that, to some extent at least, "leans against the wind".[23]

The dominant view prior to the crisis was that central banks should not actively try to counteract the build-up of financial imbalances, but should act forcefully once a crisis had occurred. Instead of "leaning against the wind", they should in other words make do with "mopping up afterwards" – they should "clean but not lean". Trying to take preventive measures was perceived as too difficult and too costly, while it was assumed that it would not be very problematic to quickly clean up after a crisis.

After the crisis - greater emphasis on preventive measures

There is no doubt that the view has changed considerably since the financial crisis.[24] In many countries, the combination of high household debt and a fall on the housing market marked the start of a period of weak demand, high unemployment and very weak public finances – problems that several countries are still struggling with.

Cleaning up afterwards proved to be much more difficult than anyone had thought. One lesson from the crisis is thus that one must take much more preventive action and try to counteract a development with rapidly-increasing debt and housing prices. How this can best be achieved is a subject for much discussion around the world at present.

It is important to realise that the starting point for this discussion is somewhat different in different countries. In countries that have already been hit hard by the crisis the unthinkable has already happened, so to speak. There it is necessary to consider how to prevent this from happening again, but as housing prices have already fallen and households have already begun to reduce their debt, the situation does not appear acute. In other words, they have a little time to find a way of preventing the next crisis.

The situation in Sweden is different. Here we have not had any tangible fall in housing prices, at the same time as household debt is at a high level, both from an international and an historical perspective. What we must consider is how we should try to reduce the risk of finding ourselves in the same situation as many others. In this sense, the situation here is slightly more urgent and sensitive. Norway and Canada, for instance, are in a similar situation.

Macroprudential policy – but the policy rate also has a role

The main line in the international discussion is that financial imbalances should primarily be prevented through measures within the new policy area known as macroprudential policy. But as I said before, this does not mean that the policy rate has been removed from the agenda.

One obvious reason for this is that macroprudential policy is not yet in place in many countries and where there is a macroprudential policy, it has often not yet been put into practice – it is quite simply too new and untested.[25] The policy rate is thus as yet one of few instruments available for practical use.

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[22] See, for example, Nyberg (2005), Ingves (2007) and Heikensten (2008).

[23] See, for example, Mishkin (2007) and Cagliarini, Kent and Stevens (2010).

[24] See, for example, the Committee on International Economic Policy and Reform (2011) and Mishkin (2011).

[25] Woodford (2012), who develops a theoretical model for how financial stability considerations can be incorporated into inflation targeting, notes for instance: ”[I]t cannot be claimed that such tools already exist and

But there is also an international discussion on whether the policy rate will have a role to play even when macroprudential policy is in place.[26] One reason is that it may very well prove difficult to design a system for macroprudential policy that functions sufficiently well and which inventive market participants are unable to circumvent. The policy rate is a blunt instrument, as it has a broad impact on the economy. But at the same time, this may be a strength compared with macroprudential tools, simply because it is difficult to "circumvent" a policy rate increase. Jeremy Stein at the Federal Reserve's Board of Governors has expressed it as the advantage of monetary policy being that it "gets in all of the cracks".[27] It is also worth pointing out that in countries such as Norway and Canada they are fairly explicit in saying that the policy rate has a role to play in this context – and this is despite the fact that they have come further in the macroprudential field than we have.[28]

It remains to be seen where we eventually will end up when it comes to this issue. My own opinion is that we will probably not be able to have a completely strict division of labour between monetary policy and macroprudential policy and that the policy rate cannot be ruled out as a tool for counteracting financial imbalances. There will probably always be situations where macroprudential policy needs the support of a monetary policy that at least to some extent “leans against the wind”. But we still do not have any certain answers and I believe it is wise to keep all doors open.

A formative stage

Let me round off. There is no doubt that we are internationally in what one might call a formative stage with regard to macroeconomic policy in general and monetary policy in particular. It is no coincidence that we are meeting here today under the theme "Choices for monetary policy" or that the IMF and other organisations arrange conferences on how our ideas on macroeconomic policy should change and that sessions on monetary policy have titles such as "Many targets, many instruments – where do we stand?"[29]

Nor is there any major doubt about the direction to be taken. The financial crisis made it clear that much more effort must be put into trying to prevent financial imbalances and manage risk in the credit and housing markets. That central banks will play an important role in this work is also fairly obvious. It is already clear that monetary policy will not be conducted in exactly the same way as prior to the crisis – when the policy rate was in principle set with consideration to the short-term business cycle, and when financial stability was more or less taken for granted. One clear lesson is that financial imbalances must be taken seriously and that central bankers' analyses and model work need to evolve to take this into account. I also believe that the analysis of risks will become more central and that "robust” monetary policy will be discussed more than before while ”optimal” monetary policy will be discussed less.[30] It

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have proven their effectiveness, so that there is no ground at present to dismiss the relevance of financial stability considerations for monetary policy deliberations.” (p. 22).

[26] See, for example, Blanchard, Dell’Ariccia and Mauro (2013), Carney (2013) and Stein (2013).

[27] Stein (2013), p. 17. The Riksbank has also raised this argument in various contexts, see for instance, Nyberg (2011).

[28] See, for example, the Bank of Canada (2012). Norges Bank writes in an article on the countercyclical capital buffer: ”The countercyclical buffer will strengthen the resilience of the banking sector during an upturn. It may also, to some extent, counteract the build-up of financial imbalances, but the effect is uncertain. Thus, Norges Bank cannot disregard taking financial imbalances into consideration when setting the key policy rate.” See Norges Bank (2013) p.23.

[29] See, for example, the IMF conference ”Rethinking Macro Policy II: First Steps and Early Lessons”, Washington DC, 16-17 April 2013, http://www.imf.org/external/np/seminars/eng/2013/macro2/.

[30] See also Jansson (2012).

is also likely that central banks' operational frameworks for monetary policy will be both slightly more flexible and slightly more complex than they were before.

At the same time, it is important not to "throw the baby out with the bathwater". Above all, we must not jeopardise the anchoring of long-run inflation expectations – now that we have attained a credible nominal anchor. To a large degree, it is thus a question of making adjustments to the existing framework rather than starting all over again.

But as yet we do not know exactly where this process will take us, and how central bank operations will look in detail, say, twenty years from now. What we can say with certainty is that the discussion on monetary policy and central bank activities will be intensive over the coming years, both internally in individual countries and internationally. It is important that this discussion is unbiased and modulated and conducted in a good and positive spirit. This will help ensure that it results in wise and sustainable solutions.

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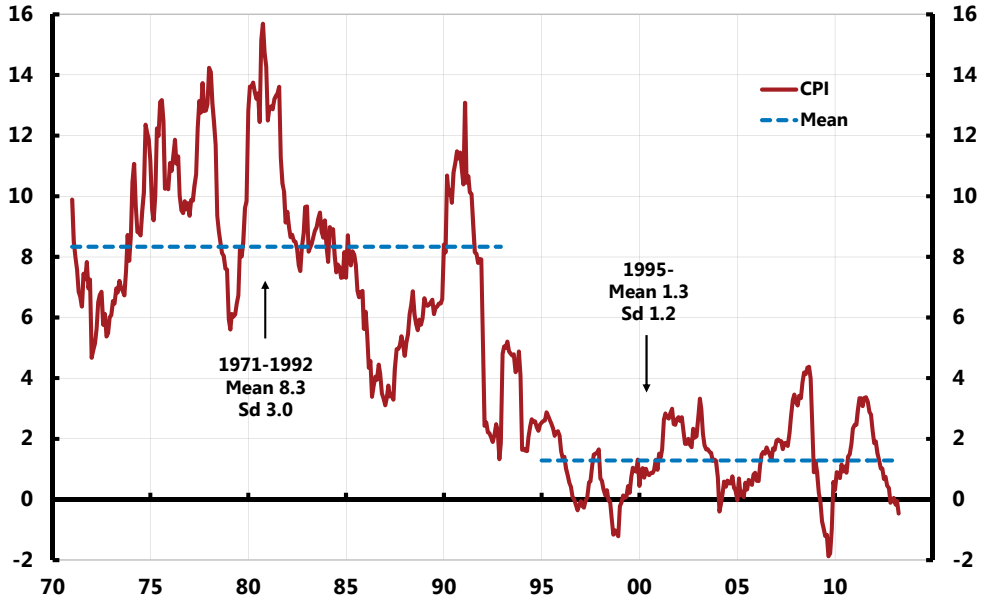
Figure 1. CPI

Annual percentage change

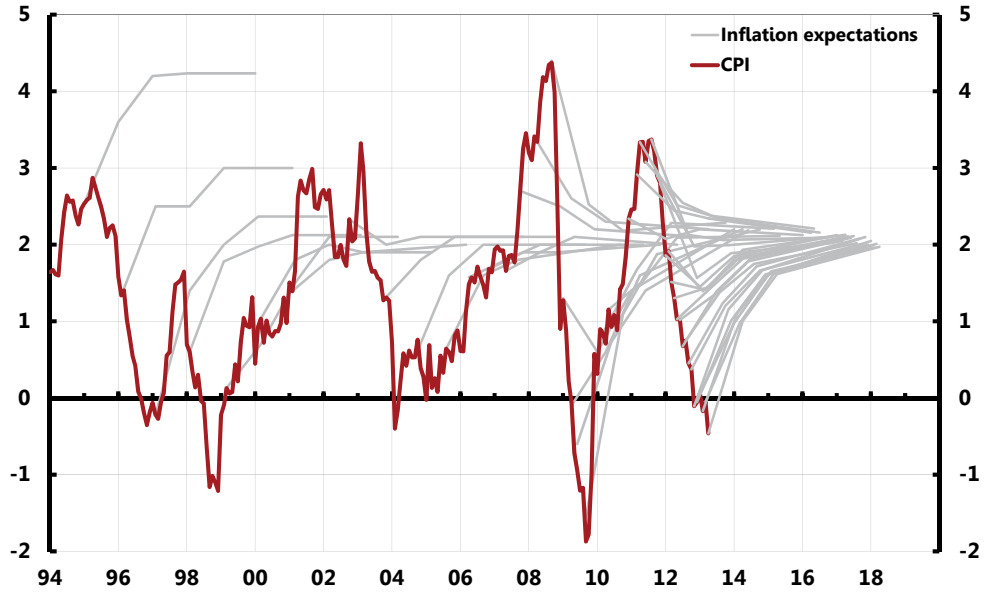


Note: CPI inflation does not refer to real-time data, but is calculated using the current method. The average for the period from 1995 is therefore one tenth of a percentage point lower than with real-time data.

Sources: Statistics Sweden and the Riksbank

Figure 2. Actual and expected inflation

Per cent

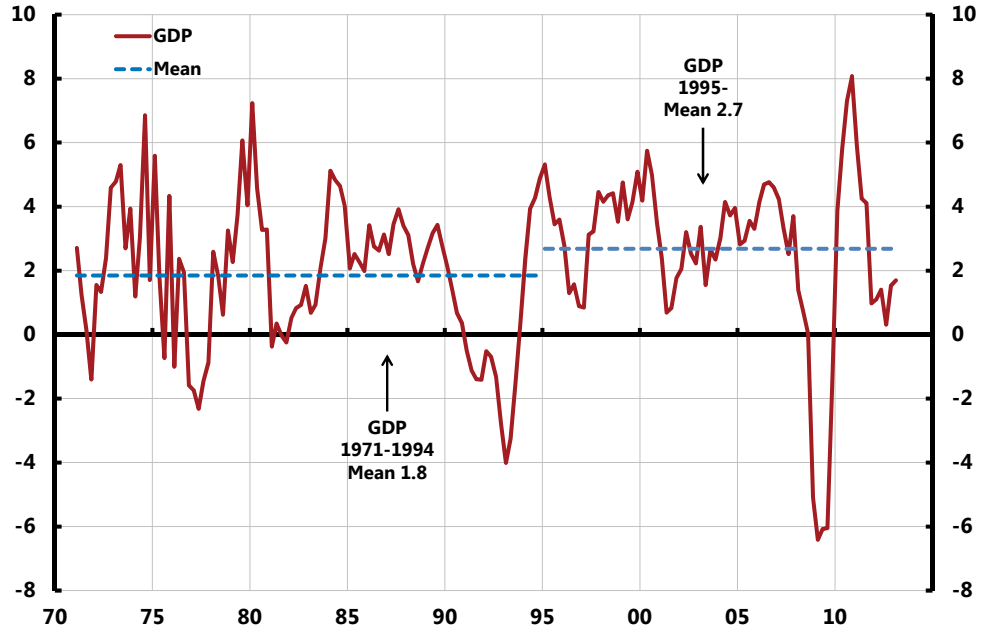


Note: Inflation refers to CPI. The inflation expectations are taken from Prospera's survey of market participants

Sources: Statistics Sweden and TNS SIFO Prospera

Figure 3. GDP growth

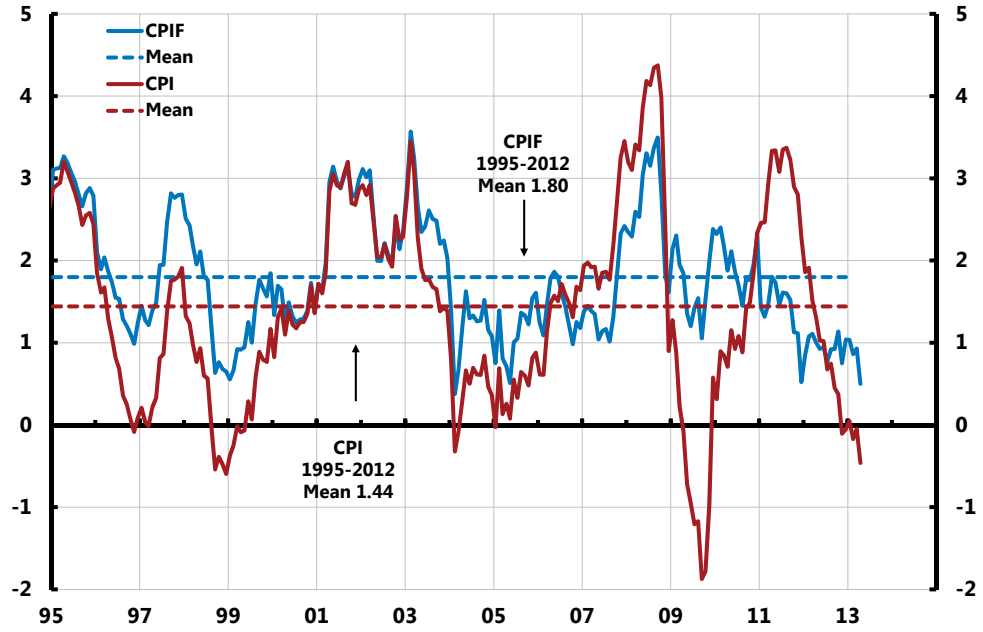
Annual percentage change, seasonally-adjusted data



Source: Statistics Sweden

Figure 4. CPI and CPIF

Annual percentage change

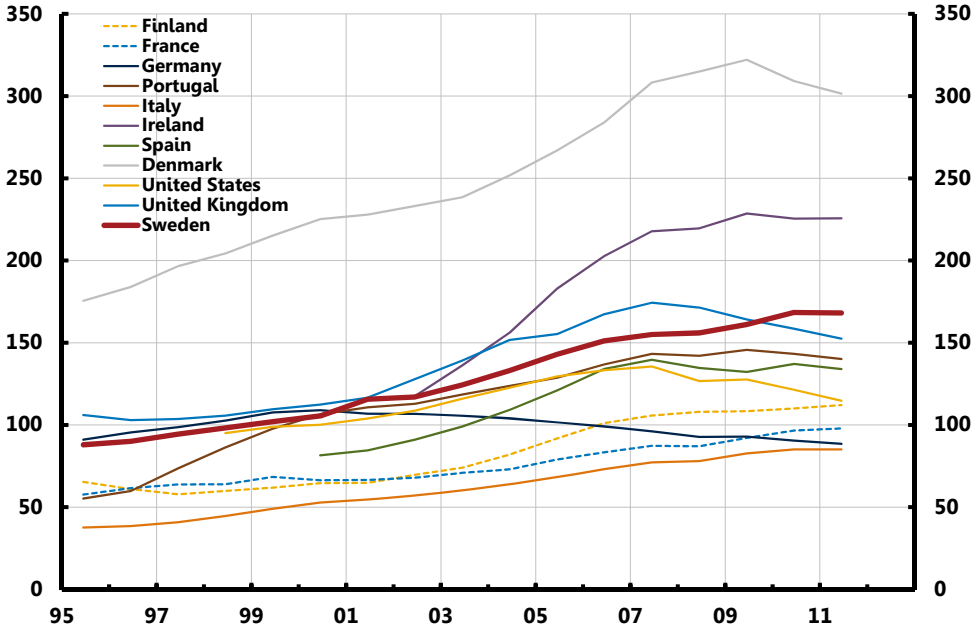


Note: Monthly real-time data, January 1995 – April 2013.

Sources: Statistics Sweden and the Riksbank

Figure 5. Household debt ratio

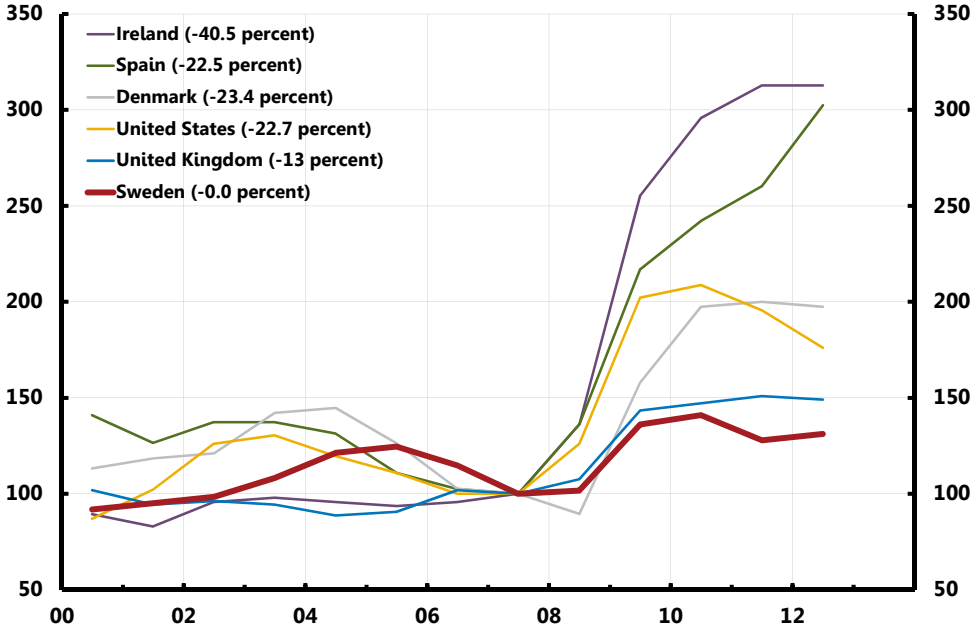
Debt as a percentage of disposable income



Source: OECD

Figure 6. Unemployment

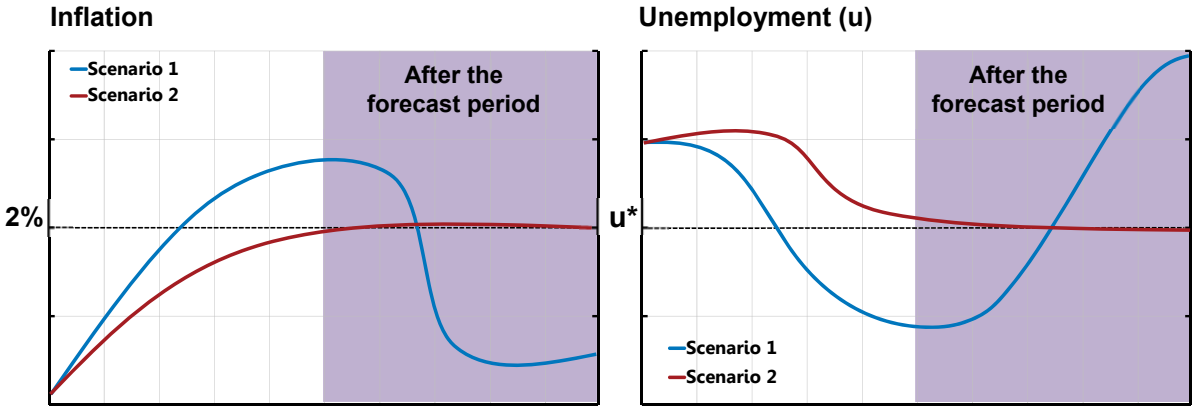
Unemployed as a percentage of the labour force, index, 2007 = 100



Note. The figures in brackets refer to the fall in real house prices from the peak to the trough.

Source: OECD

Figure 7. No new target for monetary policy

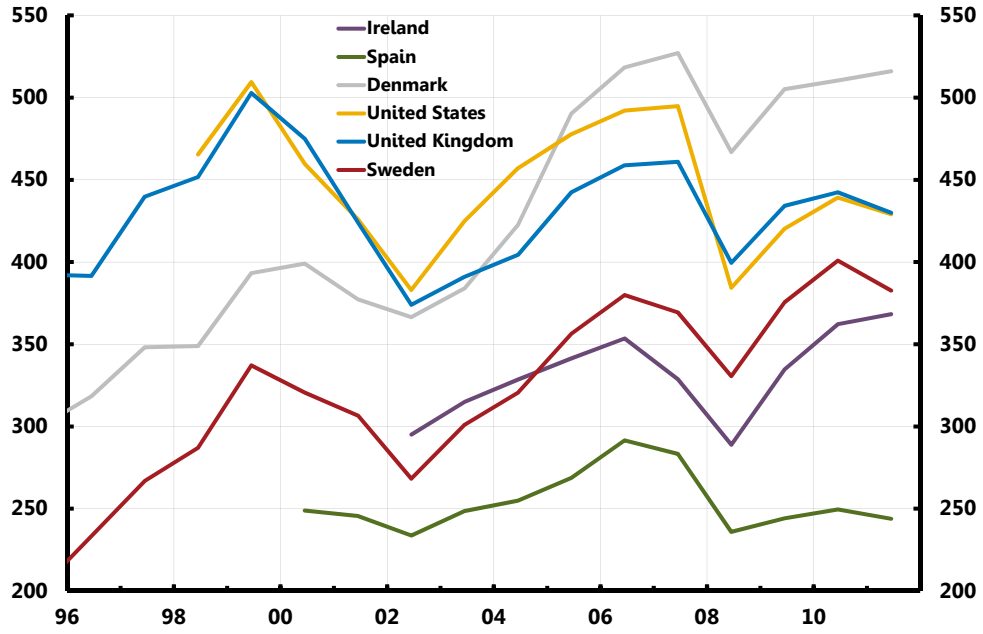


Slow adjustment to the inflation target and long-run stable development

Rapid adjustment to the inflation target but build-up of imbalances that are corrected

Figure 8. Households' total financial assets

Percentage of disposable income



Source: OECD