SPEECH

DATE: 6 Dec 2017
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VENUE: Fores, Stockholm

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The ideological debate on monetary policy – lessons from developments in Sweden*

These are unusually exciting times to be working at a central bank. Challenges have always been present, of course, but I think that it could be claimed that seldom have they been of such a fundamental nature as they are today. One example is the debate on limiting central banks' independence that has arisen recently. This has come about after several countries have found themselves unable to conduct monetary policy using policy rate adjustments alone. Instead, they have had to complement this with tools that some observers feel have blurred the boundary between monetary policy and other economic policies. Another example is that technological progress within the area of payments has led to the rapid decline of cash usage in a number of countries, not least Sweden. Whether and how this trend will affect the conditions for conducting monetary policy and whether it provides reason for the central banks to issue electronic money as a complement to physical cash will be the focus of intense discussions in the period ahead.

These are important and fundamental issues. Today, however, I would like to focus on another discussion, one that I feel is at least as vital and, at the moment, perhaps even more relevant. This concerns whether the conditions for monetary policy have changed so much in recent years that central banks will be forced to abandon, or at any rate considerably modify, the inflation-targeting policy that has been the dominant monetary policy regime of recent decades.

* I would like to thank Mikael Apel for help with the text of this speech, Emelie Theobald for help with the slides and Claes Berg, Charlotta Edler, Rebecka Hallerby, Stefan Ingves, Cecilia Skingsley, Marianne Sterner, Ulf Söderström and Anders Vredin for useful suggestions.

International debate on whether inflation targeting has become outdated

On one side of the discussion are economists and observers who argue that the inflation process now is so different from before that it is very difficult, perhaps even impossible, for central banks to conduct traditional inflation targeting, at any rate with the targets of around 2 per cent prevailing today. More specifically, they argue that inflation faces such strong 'headwinds' in the form, for example, of globalisation and digitalisation that it is doubtful whether central banks can steer inflation in any meaningful way. Instead, it is argued, monetary policy should be focused on dampening financial cycles and maintaining financial stability.[1]

On the other side are most central banks, who argue that rumours of inflation targeting's imminent demise are significantly exaggerated. They admit that it has now become more difficult and more complicated to conduct monetary policy, when global real interest rates have fallen for a long time and are currently very low. This means that central banks' policy rates are likely to reach their lower bounds more often and that monetary policy will occasionally have to be conducted using other means than policy rate cuts. They also agree that digitalisation and globalisation are making it more difficult to reach inflation targets. But, it is argued, even if these complications must be managed, there is nothing to indicate that the inflation process should have changed so much and so fundamentally that inflation targets have become unobtainable and that inflation targeting as such would have to be fundamentally reassessed.

Financial Times columnist Gavyn Davies has described this debate as an implicit ideological struggle between Claudio Borio, chief economist at the Bank for International Settlements (BIS), perhaps the leading advocate of the new ideas, and the departing Chair of the Board of Governors of the US Federal Reserve System, Janet Yellen, advocate of the traditional view.[2]

There are good reasons for looking more closely into this debate. One is that it will probably be an important part of international monetary policy discussions in the years ahead. Another is that the debate is not merely about practical monetary policy but in fact also about fundamental issues within economic science.

The debate in Sweden is ahead of the international debate

There is reason to believe that the experiences we have had in Sweden in recent years mean that we can make useful contributions to the international debate. For quite some time, we have had a discussion on the process of inflation and the conditions for inflation targeting, while this is a relatively new phenomenon in

[1] There is also a parallel debate on whether the inflation target should be replaced, for example, with a price-level target or a target for nominal GDP. However, I will not address this debate in this speech.
[2] See Davies (2017). For the sake of simplicity, I will adopt Davies' terminology hereafter and refer to the two opinions as the 'Borio camp' and the 'Yellen camp'. Of course, this does not mean that all arguments can be linked to specific statements by Janet Yellen or Claudio Borio. For typical references, see Borio (2017), Borio et al. (2017) and Yellen (2017a, b).

most other countries. Almost exactly one year ago, I held a speech where I noted that the long period of below-target inflation had led to a debate in Sweden which had few equivalents abroad. Analysts and observers argued that this development, with inflation persistently below forecast and quite far below the inflation target, indicated that the target was so hard to reach that the Riksbank should abandon the attempt and instead conduct a less expansionary policy aimed at dampening rising household debt and housing prices.[3]

While participating in international meetings recently, I have been struck by how much the discussion reminds me of the one we had in Sweden a couple of years ago. Countries that had not fallen below their inflation targets for very long at that point have now increasingly started to ask themselves whether they have not underestimated the difficulties of getting inflation to rise. One example is the United States, where, even though the Federal Reserve's main argument is that inflation will reach the target of 2 per cent in due course, Janet Yellen has also noted that “many uncertainties attend this assessment, and downward pressures on inflation could prove to be unexpectedly persistent”.[4] Her colleague on the Board of Governors, Lael Brainard, has similarly expressed unease that “the recent low readings for inflation may be driven by depressed underlying inflation, which would imply a more persistent shortfall in inflation from our objective”.[5] The European Central Bank (ECB) is grappling with similar problems. The President of the ECB, Mario Draghi, recently stated that, even if inflation is expected to rise gradually in the period ahead, “progress towards a durable and self-sustaining convergence of inflation towards our objective is not yet sufficiently convincing”.[6]

Of course, it remains to be seen how justified this unease is. But what can be said so far is that we in Sweden have already been in the situation that other countries may be about to enter and have had, for some time, the debate that may be on the horizon there. In this respect, we are, in a sense, ‘ahead of the cycle’, both as regards the development of inflation and the monetary policy debate. It could therefore be worthwhile to summarise our experiences so far. Maybe there will be a few lessons that other countries and central banks may find useful and that have implications for the international debate.

So let me start there. When I discuss the lessons that I think we have learned, I would like to divide the period after the global financial crisis into two different sub-periods and discuss them separately: the period of falling inflation 2011–2014 and the period of rising inflation 2015–2017. I would like to emphasise that, as usual, I am expressing my personal opinion. It is possible that my colleagues on the Executive Board have come to the same conclusions as I do here, but it is also conceivable that they have made a different interpretation.

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[3] See Jansson (2016), where I discuss the criticism of the inflation target in more detail. It should be emphasised that this was *one* type of criticism that was expressed. In the speech, I also address other types of criticism, with less far-reaching implications.
[4] Yellen (2017b).
[5] Brainard (2017).
[6] Draghi (2017).

The period 2011–2014 – inflation falls far below target

In conjunction with the global financial crisis, Sweden's GDP fell heavily, but the recovery was also surprisingly rapid. In 2010, Sweden's GDP increased by about 6 per cent, approximately as much as it had fallen in the year before. The increase was mainly due to the recovery in world trade and strengthening in global activity, which benefited Swedish exports and investment. Exports were also helped along by the weak krona. In July 2010, the Riksbank started to raise its repo rate from the level of 0.25 per cent to which it had been cut in conjunction with the crisis. CPIF inflation in 2010 amounted to 2 per cent.[7] The Swedish economy developed strongly and resource utilisation increased rapidly. Until the summer of 2011, the recovery seemed to be continuing at a fairly good pace. By this point, the Riksbank had raised the repo rate in stages to 2 per cent.

However, during the summer and autumn of 2011, unease increased over developments in public sector debt in the United States and several euro area countries. Growth prospects abroad deteriorated. This also spilled over onto the Swedish economy. Sweden's GDP slowed down sharply in 2011, fell slightly in 2012 and only showed modest growth in 2013. Inflation started to fall in 2011 and basically fell until 2014, when CPIF inflation amounted to about 0.5 per cent and CPI inflation to just below zero. This fall started earlier than in most other countries (see Figure 1). To counteract this development, the Riksbank started to cut the repo rate at the end of 2011.

One circumstance that has a certain significance for my discussion going forward is that the Riksbank was already concerned about the rise in household debt and housing prices by this point. With the aim of contributing, to some extent, to dampening the build-up of debt and price increases, the repo rate was set slightly higher than otherwise would have been the case.[8] This is usually described as monetary policy 'leaning against the wind', where the wind represents some kind of financial imbalance that is deemed to be building up.

However, what is important to understand is that, at this time, monetary policy was nevertheless largely governed by traditional monetary policy motives, that is, the expected development of economic activity and inflation over the coming years (see Figure 2). Risks linked to developments in household debt and housing prices were included in the assessment but did not play a leading role. I discussed this in detail in a speech a few years ago and, consequently, I shall not say much about it now.[9] But let me just emphasise that neither did other economic analysts consider that the monetary policy conducted was mainly a matter of the Riksbank

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[7] The CPIF is the CPI with a fixed interest rate. CPIF inflation became the Riksbank's formal target variable in September 2017 instead of CPI inflation, but, in practice, also acted as target variable before then.
[8] See, for example, Ingves (2012).
[9] See Jansson (2014), where I also note that it cannot be specified exactly how much this affected the repo rate. This is partly because the Riksbank's monetary policy decisions are taken by a committee with six members, and partly because it can also be difficult for an individual member to specify how much of a rate rise is aimed at dampening the accumulation of debt, as opposed to dampening economic activity. The only conclusion that can be drawn is that 'leaning against the wind' was not extensive, but neither was it negligible.

leaning against the wind, even if there were, of course, different opinions on exactly how high the policy rate should be.[10]

This was an educational period in many ways. Looking back on it with a few years' perspective, there are two main conclusions, or lessons, that I would like to emphasise:

(i) It is important not to lose sight of inflation and inflation expectations.
(ii) Fairly significant interest rate rises may be needed to brake the build-up of financial imbalances.

I shall discuss these conclusions separately and explain what I mean in a little more detail.

Conclusion (i): It is important not to lose sight of inflation and inflation expectations

My conclusion that it is important not to lose sight of inflation and inflation expectations may seem obvious and trivial to many people, but it is nevertheless worth some reflection. Moreover, the international debate that has arisen recently suggests that it may not be so obvious after all.

One apparent reason for keeping sight of inflation is that it has turned out to be surprisingly difficult to bring it back on target once it has fallen, particularly if inflation expectations have fallen too. I have to admit that I, for one, underestimated these problems. One possible explanation is that I, probably along with many others, had been lulled into a belief that the positive developments in the years prior to the financial crisis confirmed that we had succeeded in tackling the more significant problems and that the inflation target was completely credible and more or less a natural element of the Swedish economy.

Of course, that it is important not to lose sight of inflation is easy to say, but it is harder to live up to. Obviously, it was not the Riksbank's intention for inflation to become as low as it did and for such a long time.[11] We made the best forecasts we could and implemented the policies we deemed to be the most appropriate. In retrospect, of course, had we known that inflation would become as low as it did, we would have cut the rate sooner and faster.

[10] This view is also supported by Goodfriend and King (2016). Somewhat surprisingly, the interpretation that unease over household debt was the main or even only reason for the increase of the repo rate 2010–2011 is still being put forward occasionally. One clear example that the economic slowdown in 2011 instead surprised most analysts is provided by the forecast made by the National Institute of Economic Research in June 2011. In this forecast, it was assumed that the repo rate would be 3 per cent by the end of 2012 and just over 4 per cent at the end of 2014 (in reality, the repo rate was 0 per cent at the end of 2014). This policy was considered compatible with a balanced resource utilisation in 2014 and a CPIF inflation rate close to 2 per cent in 2013–2015. This forecast, which was representative of Swedish forecasters, thus assumed that continued rate hikes would be justified for normal economic reasons.

[11] For an analysis of the factors that contributed towards this low inflation, see Andersson, Corbo and Löf (2015).

But it is not particularly meaningful to evaluate events with the benefit of hindsight. For it to be meaningful, it has to be possible to identify things that could be done differently in a similar situation in the future. For example, there is no real point in observing that we would have acted differently if we had managed to predict the debt crisis in Europe and its effects. It is highly likely that, in the future, this type of event will be more or less just as difficult to predict.

However, one experience that I believe we should take with us concerns our monetary policy communication. Much of our communication at this time was about pointing out risks connected to the development of debts and housing prices, in particular during the period in which we had again started to cut the repo rate. Even if we still expected to reach the inflation target, it could well be that we talked too little about the target and too much about financial imbalances. This may have created uncertainty among economic agents regarding the status of the inflation target, which may, in turn, have contributed towards inflation expectations falling. This is something worth bearing in mind going forward. The problem was possibly also exacerbated by the Riksbank's critics often exaggerating the significance to monetary policy of the development of debt and housing prices.

A deeper question concerning keeping inflation in sight is whether confidence in the inflation target is really so important. Would it not be possible to conduct monetary policy without there being confidence in the inflation target – or, for that matter, without there being any inflation target at all? Why is it not possible for monetary policy merely to stabilise the real economy or lean against the wind? Such a monetary policy arrangement would be well in line with the new thinking in the international debate that I presented in my introduction, in particular if this were to be taken to its logical conclusion.[12] I intend to return to this debate soon, so let me put this issue to one side for a moment.

Conclusion (ii): Fairly significant interest rate rises may be needed to brake the build-up of financial imbalances

One issue in which I have gradually revised my opinion in recent years is that of how much a central bank should and must lean against the wind to deal with the build-up of a financial imbalance. Previously, I had a rather strong belief that leaning against the wind relatively moderately could have a good effect, primarily by sending a clear signal that the central bank is concerned over developments and perceives them to be risky. Today, I am more doubtful about this. It certainly seems reasonable that the effectiveness of such a strategy will vary over time and from economy to economy, depending on the exact circumstances, for example regarding market sentiment and debt levels, but overall I am significantly more sceptical than before. I still believe that a certain degree of leaning against the wind, combined with clear communication of the risks, could increase awareness

[12] For one example, see Scholes and Alankar (2017).

of the problems among the general public, market participants and economic policy decision-makers. But it is, of course, necessary that this raised awareness results in concrete measures or changed behaviour that counteracts the financial imbalance. It is doubtful, as far as Sweden is concerned, whether it can be said that this has been the case, at any rate not to such an extent or at such an early stage as could have been hoped for.

The fairly modest leaning against the wind that we practised was thus insufficient to halt the build-up of debts and housing prices. Nevertheless, I myself was not prepared to keep the rate any higher than we did in an attempt to achieve this. This was also apparently true of the Executive Board as a whole. If we had set the repo rate significantly higher, the increase in indebtedness would perhaps have stopped more permanently, but, at the same time, there is a severe risk that the development of the economy would also have been significantly worsened. Perhaps even more importantly, the development of inflation would have been even weaker than it actually was and it would have been even more difficult to bring it up and maintain confidence in the inflation target.

One further conclusion, or lesson, is that a policy that leans against the wind requires that there is confidence in the inflation target. When we felt that this confidence was in the process of becoming undermined in 2014 and early 2015, we made the assessment that there was no other option than to increase the pace of repo rate cuts to clarify that the focus was entirely on inflation. Accordingly there was no longer any scope to use the repo rate to attempt to influence debts and housing prices. In this respect too, the Riksbank has been a forerunner in the world of central banking, albeit unintentionally. As far as I know, no other central bank applying a policy that uses its interest rate to counteract the build-up of financial imbalances, such as Norges Bank, has had to make such a clear and important choice.

Having said this, I now also see more fundamental problems with a monetary policy that leans against the wind, even when there is confidence in the inflation target. I will return to this at the end of this speech.

Consequently, my interpretation of Sweden’s experiences so far is that a policy that leans against the wind has its limitations. For example, it seems, at least under certain circumstances, that the policy rate would have to be set quite a lot higher to effectively dampen the increase of debt. But such a policy could slow down the economy as a whole quite seriously and risk leading to inflation falling significantly below target for a long period. It is effects of this type that are referred to in the international debate when arguing that the policy rate is far too blunt an instrument to counter financial imbalances. Sweden's experiences also suggest that the policy rate cannot always be expected to be available for this purpose. Even when a central bank is leaning quite moderately against the wind, such a policy could be in conflict with the task of maintaining confidence in the inflation target.

Here too, of course, the question arises of whether it is really so important to maintain confidence in the inflation target. Would it not be possible for monetary policy instead to just lean against the wind and let inflation develop as it will? Once again, I will return to this shortly.

Before continuing, I would like to add that there is a growing amount of research that explicitly attempts to calculate the costs and benefits of using the policy rate to attempt to counteract financial imbalances. The debate is ongoing and the jury is still out.[13] Of course, in this context, the view I present here should only be seen as a country-specific case study. But considering that practical experience of this type of policy is very limited, reflections from someone who has been involved in taking decisions in a country that is 'ahead in the cycle' may perhaps be of some value.

The period 2015–2017 – inflation rises towards target again

In 2014, monetary policy came to focus on rapidly returning inflation to target and anchoring inflation expectations. The repo rate was cut by 0.5 percentage points to 0.25 per cent in July and further to zero per cent in October. At the beginning of 2015, inflation was still very low and inflation expectations were developing in a worrying manner (see Figure 3). The repo rate was cut further in 2015 and early 2016 to -0.5 per cent. In addition, the Riksbank started purchasing government bonds on a large scale.

The expansionary policy gradually started to have effect. Growth rose and employment increased. Inflation started to show a more-or-less rising trend in 2015 and again reached the inflation target in 2017. Inflation expectations also turned upwards and long-term expectations are now again anchored around the target (Figure 4).

The conclusion from the period 2015–2017 that I would particularly like to emphasise is the following:

(iii) It may take a long time with a highly expansionary policy to bring inflation up – but it is possible.

It could be claimed that neither is this conclusion particularly remarkable. It is the conclusion that comes to mind first, having observed monetary policy and the development of inflation in Sweden in recent years. But, in light of the current international debate, it is nevertheless important and worth bringing up.

[13] For example, the International Monetary Fund (2015) and Svensson (2017) argue that the costs are greater than the benefits, while Filardo and Rungcharoenkitkul (2016) and Gourio, Kashyap and Sim (2016), for example, draw the opposite conclusion.

Conclusion (iii): It may take a long time with a highly expansionary policy to bring inflation up – but it is possible

As I have already mentioned, the first part of this lesson provides an important reason for not losing sight of inflation and inflation expectations. If this is allowed to happen, the way back may be difficult and arduous. In Sweden's case, CPIF inflation was systematically below target for about six years, 2011–2016, occasionally by a considerable margin. To halt and then reverse the fall in inflation, we cut the repo rate to levels it had never previously approached and, in addition, the Riksbank purchased large amounts of government securities. Significant communication interventions were also required, for example when it came to describing which development of the krona the Riksbank deemed to be compatible with rising inflation. Unlike what had possibly been the case earlier, there can, from a communication point of view, hardly have been any doubt of the Riksbank's determination to reach the target.

This policy has thus contributed towards inflation rising and currently being in line with the target. The situation is reminiscent of that in the mid-1990s, when the Riksbank, despite widespread scepticism, managed to establish confidence in the inflation target, even though the aim that time was to bring *down* inflation. There are, of course, no guarantees that inflation will stay at around 2 per cent going forward. Nevertheless, things look good so far, even though a lot of support from monetary policy will still be necessary and further monetary policy easing cannot be ruled out.

Links to the international debate

How, then, can Sweden's experiences be linked to the international debate – the implicit ideological debate between the Yellen camp and the Borio camp? To more easily understand this, it is useful to start by reviewing the debate in a little more detail. There are, above all, two differences, which are closely related, between the two camps: the view of the so-called Phillips curve and the view of the possibilities central banks have to steer inflation.

The Phillips curve exists in different variations but, in one way or another, all of these deal with the relationship between resource utilisation and the development of prices or wages. The starting point is that, by adjusting its policy rate, the central bank can influence resource utilisation in the economy. When resource utilisation increases, prices and wages rise faster, and vice versa, via the Phillips curve.

The Yellen camp's view is that the Phillips curve looks largely as it normally does or, at any rate, has changed so little that it still works as an effective channel through which central banks can influence inflation. According to the Borio camp, the Phillips curve has instead almost broken down or, at any rate, changed so much that it no longer forms a central part of the inflation process. More specifically, high resource utilisation no longer results in higher inflation, according to this view.

Instead, it is claimed, inflation is highly influenced by structural factors. Factors often emphasised as exerting downward pressure on inflation are globalisation and, looking forward, more and more digitalisation.[14] These are arguments that those who have followed the debate in Sweden in recent years will recognise. According to this view, the central banks will find it difficult to steer inflation for a long time to come. As I mentioned in my introduction, taken to its conclusion, this means that it is pointless to set up targets for inflation, as this is mainly determined by factors outside monetary policy. As I also noted earlier, the Yellen camp does not share this view but believes that inflation targets are meaningful, important and possible to attain.

Implications of the Swedish experiences

What view, then, should we take of the international debate in light of our experiences here in Sweden? As I see it, our experiences overall are more in line with the Yellen camp's view. One example is that it seems to be possible to reach the target with a sufficiently powerful expansionary policy. One reservation here, of course, is that we still cannot be certain that inflation will really remain around the target, even if this is what the Riksbank expects.

Another reservation is that neither is it obvious what part the Phillips curve has played in the rise of inflation in Sweden so far. Increased resource utilisation has certainly gone hand in hand with rising inflation, but we have also seen that wage increases have so far been surprisingly modest given the economic situation. In that sense, it is too early to say whether Sweden's experiences suggest that the Phillips curve is continuing to work like usual. But our experiences nevertheless suggest that central banks' inflation targets are fully possible to reach. And the recent, relatively rapid increases in service prices are, after all, a sign that some form of Phillips curve is active (see Figure 5).

There has been quite a lively international debate on the Phillips curve recently – about its slope and even about its existence.[15] Personally, I take a fairly agnostic view of it. I see it as a mostly qualitative relationship between resource utilisation and inflation that does not say much more than that high resource utilisation sooner or later tends to lead to prices and wages rising more rapidly and that low resource utilisation leads to them rising more slowly. The effect on inflation of a given level of resource utilisation can certainly vary over time, which is to say that the slope of the Phillips curve is not necessarily always the same. The time dynamics may also vary, that is the time lag of the impact of resource utilisation on inflation is not always the same. In addition, inflation is, of course, affected all the time by a series of other factors – various shocks, in the vocabulary of economics.

[14] See Borio (2017).
[15] See, for example, Blanchard (2016) and The Economist (2017).

These can be highly temporary, but also relatively persistent. However, I find it very hard to swallow, not to say completely unlikely, that, other things being equal, there should be no relationship between resource utilisation and inflation.

My conclusion that it is important not to lose sight of inflation and inflation expectations is also quite well in line with the Yellen camp's view, in the sense that the inflation target and confidence in the target are seen as vital. It is worth noting that there is a debate, not least in the United States, which has come the furthest with its policy rate rises, about how rapidly monetary policy should be made less expansionary.[16] The concern is precisely that excessively rapid changes will make inflation and inflation expectations fall below target again – something that there thus is reason to avoid.

The conclusion that it could take quite significant interest rate rises to halt the accumulation of financial imbalances is also more in line with the Yellen camp's view. It points to the limitations of the policy that the Borio camp argues should be given a greater influence, or possibly even be the main aim of monetary policy.

Inflation targets are necessary

However, as I have discussed, in this respect it is necessary to go a little deeper into the analysis. More specifically, the issue of whether it is really necessary to have a target for inflation at all needs to be addressed. Would it not be possible for monetary policy instead to focus on attempting to counteract the accumulation of financial imbalances and allow inflation to develop as it will?

As I see it, this would not be an appropriate set-up. In my view, it is extremely important that there is an inflation target in which there is confidence, and that that target is set at a sufficient distance from zero. It is quite common that debaters who advocate a new type of monetary policy omit to discuss the problems that could arise if the central banks were to abandon their inflation targets. This is also the case in the Swedish debate.

If the central banks were to abandon their inflation targets in the current situation, inflation would almost certainly fall and there would be a large risk that inflation and inflation expectations would become permanently stuck on a very low level. This would make it more difficult for monetary policy to counteract recessions in the future. If average inflation is low, the nominal average interest rate will also be low. And the lower the interest rate is in normal conditions, the less scope there is to lower it before it reaches its lower bound.

A more general problem is that the inflation target acts as a benchmark for price and wage formation – it forms what is usually called a nominal anchor in the economy. When economic agents have a collective picture of how prices will develop in the future, it becomes easier to plan for the long term. The absence of a nominal anchor could also lead to not just inflation varying more, but also output and

[16] See, for example, Duy (2017) and Summers (2017).

employment. Assume that a negative shock impacts demand in the economy, causing inflation to fall. If there is uncertainty about the inflation target, inflation expectations may also fall in the slightly longer term. This will cause a rise in the real interest rate, i.e. the interest rate corrected for inflation expectations, if the nominal interest rate remains unchanged. The higher real interest rate amplifies the effect of the original negative shock on demand and weakens the economy even more, as it is the real interest rate that affects companies' and households' investment and consumption decisions. In a corresponding way, a positive shock to demand can make inflation and inflation expectations rise. It lowers the real interest rate and contributes towards further increasing demand. When confidence in the inflation target is weak and inflation expectations are not well anchored, the result thus becomes larger fluctuations in the economy. We went through such a development in Sweden in the 1970s and 1980s, when the fixed exchange rate did not act as a sufficiently strong nominal anchor, which in turn resulted in recurrent cost crises and devaluations.

The reason that debaters do not address the problems of abandoning the inflation target could, of course, be that they consider that the process of inflation has changed so much that central banks simply no longer *can* reach their inflation targets. This seems after all to be quite a common view in the debate. This would imply that it is not meaningful to set up targets for inflation, as it is determined by factors outside monetary policy. However, this is an assumption that, were it correct, would actually turn much of what is considered accepted within economic science on its head. Economic paradigms do change every now and again, of course. But, at a minimum, one may argue that quite a heavy burden of proof lies on those claiming it is no longer possible to choose an inflation target. Among other things, they would have to disprove Milton Friedman's thesis that inflation is basically a monetary phenomenon.[17]

Having said this, in practice, it is probably more of a gradual scale than a binary zero-one solution. Structural factors can push inflation down in a way that can be difficult to counteract for a relatively long time, even if not permanently. It is therefore quite an important discussion that the Borio camp has initiated.[18] How should a central bank act in a situation in which, despite conducting the most expansionary policy it deems possible, it does not expect to be able to reach the target in a foreseeable time frame? As I see it, the reasonable decision in such a situation is to hold fast to the inflation target and continue with the expansionary policy.[19] If the central bank instead were to change its policy in a less expansionary direction, the inflation target would become even more distant and even more

[17] Friedman (1963). It should be mentioned that, according to the so-called 'fiscal theory of the price level', fiscal policy has crucial influence over inflation, see for example Christiano and Fitzgerald (2000). To achieve low and stable inflation, a well-balanced monetary policy is therefore insufficient. It also requires fiscal policy to be conducted in a way that is compatible with the inflation target. However, this theory is controversial and does not actually question the value of central banks having inflation targets.
[18] It should be emphasised that the BIS, where Borio is chief economist, has often been early to bring up issues of fundamental importance for central banks. For example, the BIS was one of the first to emphasise that low and stable inflation does not necessarily imply macroeconomic stability and a reduced risk for financial crises, see for example Borio and Lowe (2002) and White (2006). However, contributions were not only made by the BIS in this context. Rajan (2005) is another example.
[19] I discussed this case in a speech last year, see Jansson (2016).

difficult to attain. Sooner or later, confidence in the inflation target would be lost, bringing us back to the problems I just outlined.

More fundamental problems with a monetary policy that focuses on financial stability

There are also other reasons why a monetary policy that focuses heavily on attempting to counteract the accumulation of financial imbalances may be problematic. I have just addressed one of these, namely that fairly large rate rises may be required to slow down, for example, a rapid increase of debt. Even if the effect of this on inflation is not considered so important, it is more difficult to disregard that the effect on output and employment could be significant.

The issue can also be considered from a more general perspective. Thinking about it, it would be quite strange if the main way of preventing financial crises was to hold monetary policy tighter than could be justified by basic economic prospects. As I see it, financial cycles, at least those which are big enough to create significant disorder, are often the result of the regulations governing the financial system not being sufficiently stringent or even, perhaps, of fundamental shortcomings in the entire 'business model' of the financial sector. The failure of important markets to function sufficiently well may also be of great significance. One example that I have raised before, but which is worth raising again, is the comparison of how policy rates and housing markets have developed in Sweden and Germany (see Figure 6). Despite a similar monetary policy, the development of housing prices in Germany has differed entirely from that in Sweden. Of course, a well-functioning financial sector and well-functioning markets would not generate completely stable credit paths, for example. But it is highly likely that the large and dangerous fluctuations would be heavily restrained.

It seems reasonable that the financial system should be sufficiently stable and robust to be able to handle both an occasionally very low neutral interest rate – as is the case today – and that monetary policy is conducted in a manner that fulfils normal monetary policy targets – such as an inflation target – without collapsing.[20] If it is deemed that the financial system is insufficiently stable to cope with this, the most reasonable and long-term sustainable solution must be to ensure that it becomes so rather than dodging the problem and instead demanding that the central bank slows down the entire economy by setting an unnecessarily high interest rate.[21]

[20] The term neutral interest rate normally refers to the real interest rate, which has neither an expansionary nor a contractionary effect on the economy. Central banks cannot influence the neutral interest rate but they must consider it when they adjust their policy rates. For an analysis of the level of the repo rate in the long term, see the article "The long-term repo rate" in the Monetary Policy Report, February 2017.
[21] See, for example, Wolf (2017) for a similar argument.

Concluding comments

Let me sum up and round off. Monetary policy around the world is, in many ways, at a crossroads. The flexible inflation targeting that has been the dominant monetary policy model of recent decades is facing major challenges. In my address today, I have focused on one of these: the international debate that has arisen recently, in which a number of economists and observers have argued that the process of inflation is now so different from before that it is very difficult, perhaps even impossible, for the central banks to conduct traditional inflation-targeting policies. Instead, it is argued, monetary policy should be aimed at attempting to counteract financial imbalances to a greater degree, possibly even exclusively.

In relation to this debate, Sweden finds itself in a rather unique position. We have discussed these issues for longer than most other countries, we have experience of a policy that was aimed, to a certain extent, at counteracting financial imbalances, inflation fell earlier in Sweden than in many other areas, and we have also – after a long period of highly expansionary monetary policy – managed to bring it back on target. In other words, we have a number of experiences to share.

Here, I have given an account of what I consider have been the most important experiences: that it is important not to lose sight of inflation and inflation expectations, that it may take significant interest rate rises to halt the accumulation of financial imbalances and that it may take a long period of highly expansionary policies to bring inflation up – but that it is possible to bring it up.

In conclusion, to avoid misunderstandings, I would like to emphasise that my comments today do not, in any way, mean that I consider that central banks should not have any role or responsibility for financial stability. That issue deals with much more than whether or not it is appropriate to address financial imbalances with monetary policy and the policy rate. And, in Sweden, the Riksbank has indeed important functions in this context, both in preventing financial crises and tackling them should they occur. In addition, the ongoing parliamentary inquiry into the Riksbank will examine this matter and others in more detail, and I look forward to its conclusions with interest. My discussion today has centred on my view that monetary policy and the policy rate are better suited to focus on an inflation target – and that good conditions exist for them to continue to do so. Of course, monetary policy systems and frameworks do not last forever. But, so far, I consider that there are good reasons to keep the one we have.

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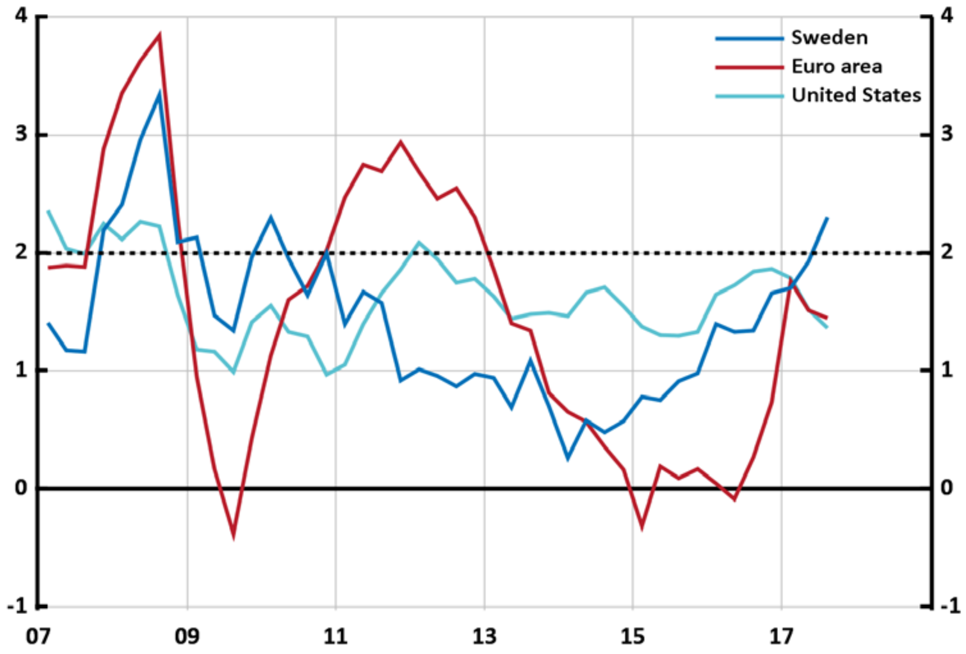
Figure 1. Swedish inflation ’ahead of the international cycle’

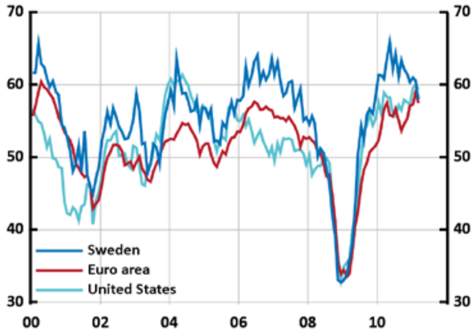
Annual percentage change



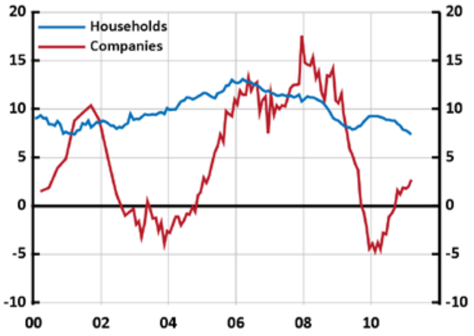
Note. Inflation for Sweden is measured as the CPIF, for the US as ‘core PCE’ and for the euro area as the HICP.
Sources: Bureau of Labor Statistics, U.S. Department of Labor, European Commission (Eurostat) and Statistics Sweden

Figure 2. Natural to raise the repo rate 2010–2011

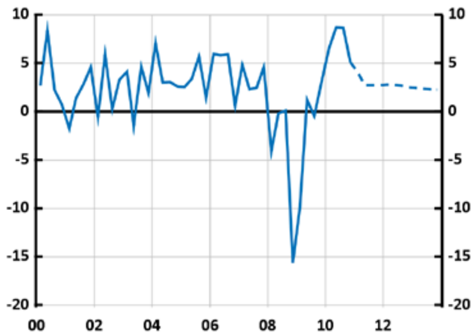
Purchasing Managers' Index in the manufacturing sector
An index over 50 indicates growth



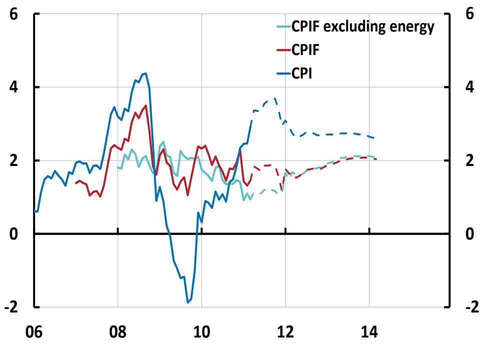
Lending to households and companies
Annual percentage change



GDP
Quarterly change in per cent calculated as an annual rate, Seasonally-adjusted data.

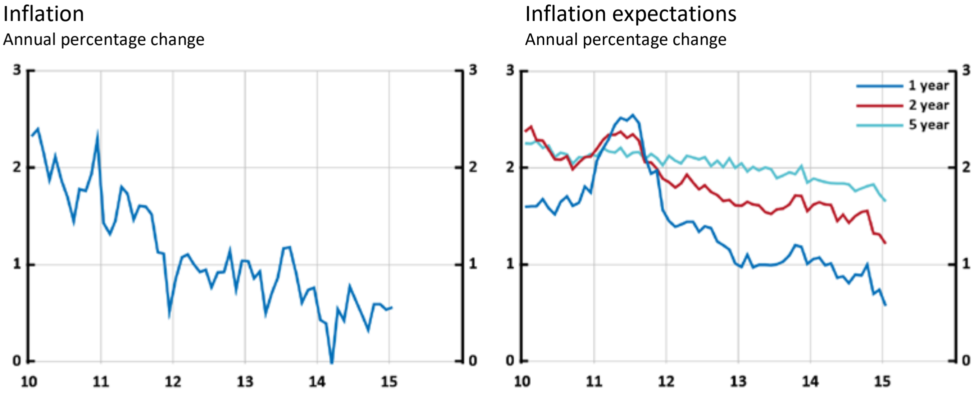


Inflation
Annual percentage change



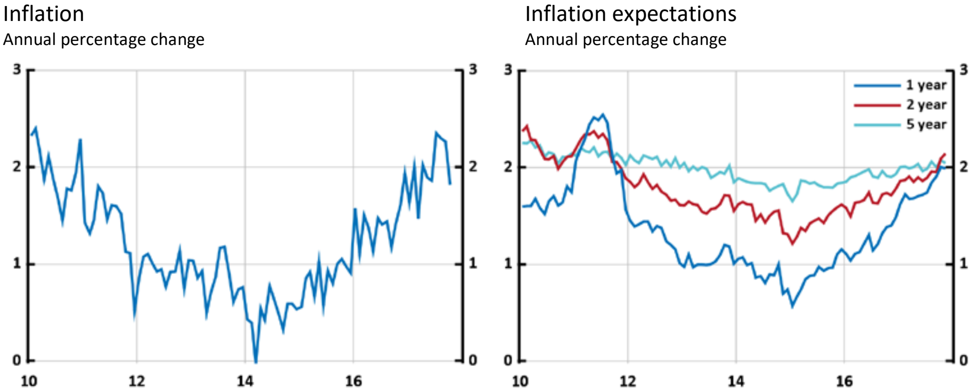
Note. Forecasts from April 2011.
Sources: Institute for Supply Management (ISM), Swedbank, Statistics Sweden and Sveriges Riksbank

Figure 3. Troubling situation at turn of year 2014-2015



Note. Measured using the CPIF (left) and the CPI (right).
Sources: Statistics Sweden and TNS Sifo Prospera

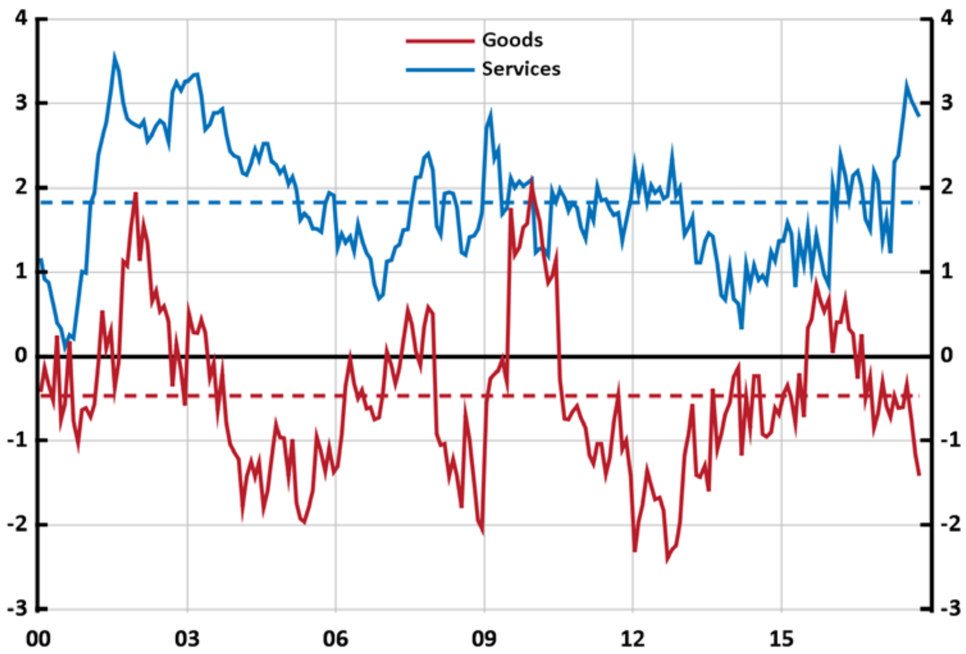
Figure 4. 2015–2017 – inflation rises towards target again



Note. Measured using the CPIF (left) and the CPI (right).
Sources: Statistics Sweden and TNS Sifo Prospera

Figure 5. The development of services prices indicates that the Phillips curve works

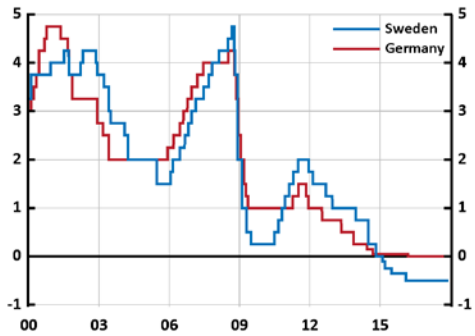
Annual percentage change



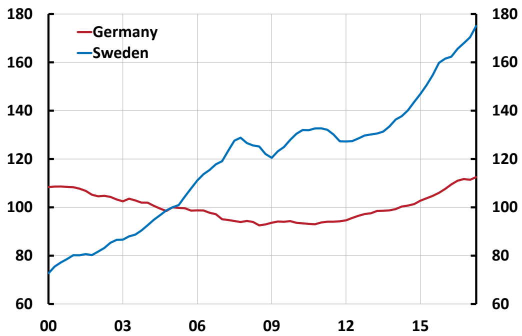
Note. Broken lines represent mean values since 2000.
Source: Statistics Sweden

Figure 6. A monetary policy like that in Sweden does not have to result in runaway housing prices

Policy rate in Sweden and Germany



Housing prices in Sweden and Germany



Note. Per cent and house price index (HPI) respectively, 2005 Q1 = 100.
Sources: ECB, Macrobond and Federal Reserve Bank of Dallas