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SPEAKER: Deputy Governor Lars E.O. Svensson
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Summary of Lars E.O. Svensson's lecture in Uppsala on September 17

Deputy Governor Lars E.O. Svensson is today giving a lecture at the National Conference of Swedish Economists at Uppsala University. The lecture is titled "Practical Monetary Policy: Why Has the Riksbank's Policy-Rate Path Been So High, and Why Did This Not Prevent the Recovery?" and is based on a paper on monetary policy in Sweden and the United States presented at a conference at Brookings Institution, Washington, DC, on 15 September, 2011.

Two central banks with similar forecasts draw very different conclusions

Mr. Svensson argues that there are no fundamental differences between the Federal Reserve's dual mandate of maximum employment and stable prices and the Riksbank's policy of flexible inflation targeting. Both imply "forecast targeting", that is, the central bank chooses the monetary-policy instruments so as to stabilise both the inflation forecast – the Riksbank around its inflation target and the Federal Reserve around the inflation rate consistent with its mandate – and resource utilisation around a sustainable level.

Lars Svensson examines the policy options for the Federal Reserve and the Riksbank in the summer of 2010 and notes that the two central banks at that time made quite similar forecasts regarding inflation and unemployment. The Riksbank's forecast of inflation was below the inflation target and the Federal Reserve's forecast was below the level considered consistent with its mandate. The forecasts of unemployment were both above the sustainable rates. This situation seemed to call for more expansionary policy, if feasible. However, the Federal Reserve and the Riksbank chose very different policies. The Federal Reserve maintained a minimum policy rate, communicated possible future easing, and later in the fall launched QE2. The Riksbank instead started a period of rapid policy rate increases.

Policy easing was right, and the Riksbank's policy-rate path has been too high because of a too high forecast for foreign interest rates and resource utilisation

Mr. Svensson examines the arguments against the policy easing by the Federal Reserve. These include concerns about inflation and the anchoring of inflation expectations, uncertainty about the effect of the unconventional policy measures, concerns that low policy rates for a long period can have negative consequences for financial stability and the allocation of investment, and uncertainty about the amount of slack in the economy. He finds these arguments unconvincing.

He also examines different arguments for the Riksbank's policy-rate increases and explanations for the, according to Mr. Svensson, too high interest rate path. They include an aim to stabilise growth rather than resource utilisation, a mechanical revision of the policy-rate path from the difference between outcomes and forecasts for inflation and the real economy, the use of the policy rate to limit the increase in household debt and housing prices, and a possible desire to normalise the policy-rate level to prevent unspecified future financial imbalances. He does not find the arguments convincing or supportive to the Riksbank's policy-rate increases.

Thus, Mr. Svensson concludes that the Federal Reserve, in easing policy, did the right thing and that the Riksbank, in raising its policy rates, did the wrong thing. He maintains that the Riksbank's policy-rate path has been too high, and that a too high forecast for foreign policy rates and a too high estimate and forecast of resource utilisation have contributed to this.

The market implemented much easier financial conditions than those consistent with the Riksbank's repo-rate path, which contributed to better-than-expected development

A year later, in the summer of 2011, the Swedish economy had developed better than expected, whereas the US economy had developed worse than expected. Svensson maintains that the good Swedish development to a considerable extent may be explained by the financial market implementing much easier financial conditions than those consistent with the Riksbank's policy-rate path. Development would have been better with even easier policy and financial conditions. The less good US development depends on factors other than monetary policy, and development would have been worse without the Federal Reserve's policy easing.

Only one inflation measure and only one resource-utilisation measure increase the transparency of the policy

Among Mr. Svensson's broader conclusions are that a simple and transparent monetary policy framework has great benefits for policymakers and for external evaluators. The dual mandate of the Federal Reserve and the flexible inflation targeting of the Riksbank are both examples of such a framework. A monetary policy framework is, however, more effective if only one inflation measure and one measure of resource utilisation are used as target variables. With multiple inflation and resource-utilisation measures, policymakers can often find at least some measure that is close to the desired level and thus motivate a particular policy. This makes the framework more opaque and accountability becomes more difficult to enforce.

The gap between unemployment and the sustainable unemployment rate is a more reliable and transparent indicator of resource utilisation

It is also important not to confuse measures of resource utilisation as an indicator of inflationary pressure and as a target variable. Lars Svensson argues that as a target variable, the gap between actual unemployment and the long-run sustainable unemployment rate is more reliable and transparent than the alternatives, for instance, the gap between actual and potential output.

For the monetary frameworks of the Federal Reserve and the Riksbank, the most relevant information is contained in the forecasts of inflation and resource utilisation. In order to enable an effective external evaluation it is essential that those forecasts are published. Monetary policy can be evaluated in real time as soon as the forecasts are available, by judging whether or not the published forecasts are those that best stabilise inflation and resource utilisation.