



# Time to scrap the inflation target?

Swedbank

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S V E R I G E S   R I K S B A N K



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Deputy Governor

# Two parts

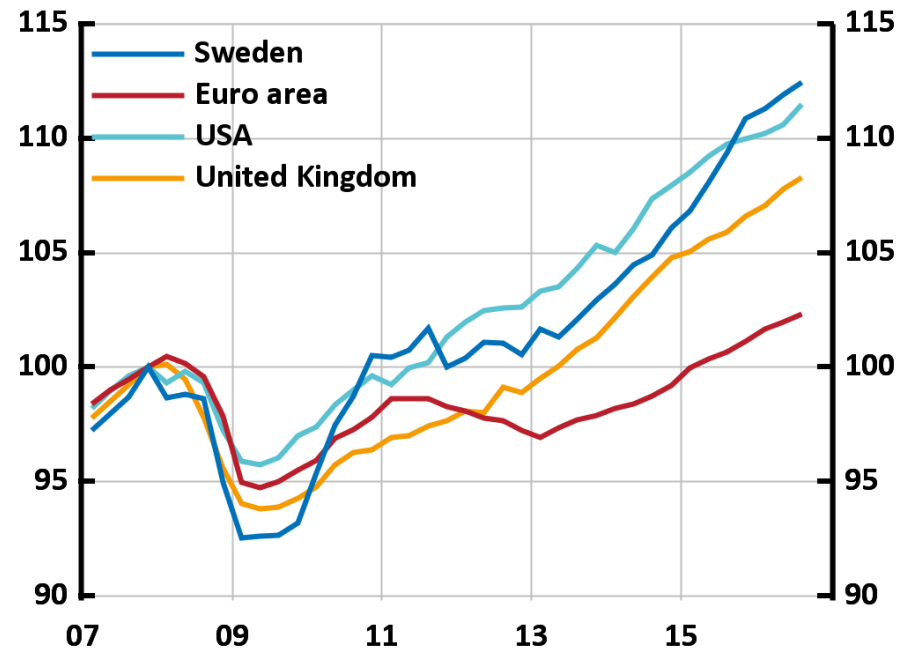
- Part 1: The Swedish monetary policy debate
  - Negative repo rate in particular
- Part 2: Looking ahead – future possibilities for monetary policy
  - Looking at problems with a scenario where monetary policy is not made more expansionary despite taking longer to attain the target.

# Part 1: The monetary policy debate – a new speech for the defence?

- Very unusual monetary policy in recent years
- Important to seriously review and reflect on views and criticism
- Everyone benefits from a debate where efforts are made to understand one another's arguments

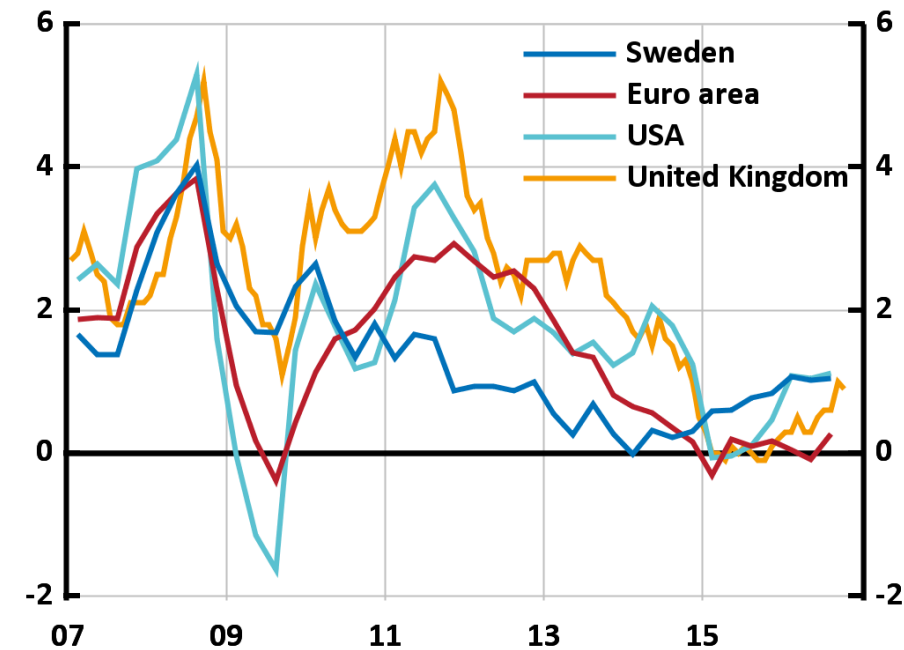
# Good growth but low inflation since the crisis

## GDP development



Note. Index, 2007 Q1 = 100, and annual percentage change. Inflation refers to the CPI for the USA and the HICP for others.

## Inflation

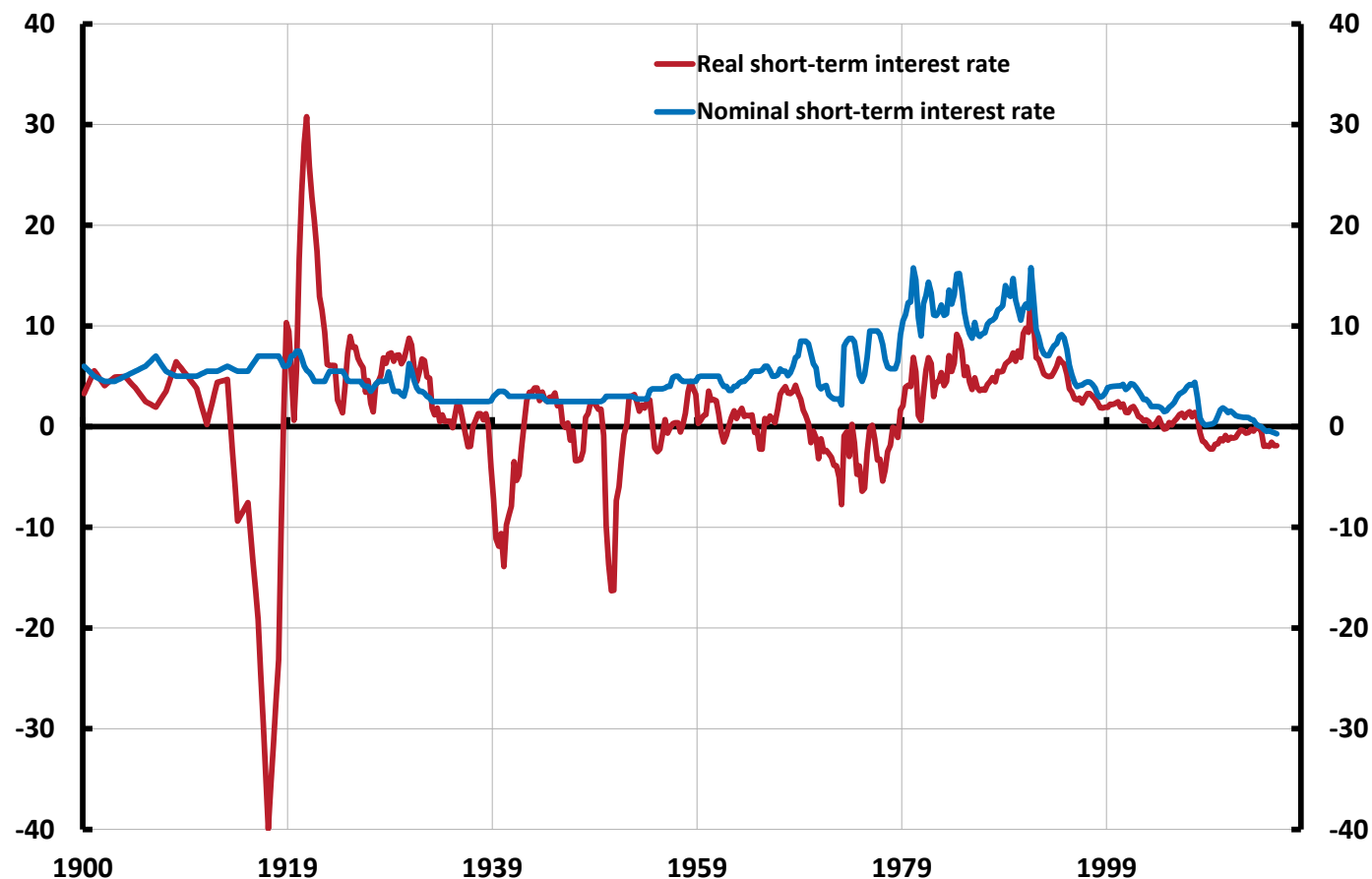


Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, Eurostat, Office for National Statistics and Statistics Sweden

# Different types of criticism

- A negative repo rate is...
  - unnatural and unhealthy in itself
  - wrong in the current economic situation
- Important to point out the logical conclusions of this criticism
  - Usually: The inflation target is not so important
  - Less often: The inflation is (not un)important but could have been defended with a different, less expansionary policy

# Negative nominal interest rates unusual but not negative real interest rates



Note. Per cent. The real interest rate is calculated using series for the nominal interest rate and inflation/inflation expectations. For the nominal interest rates, annual data from historical monetary statistics is used for the period 1900-1918, while the Riksbank's discount rate is used for the period 1919-1983 and after that the rate on a three-month treasury bill is used. For inflation/inflation expectations, annual data from historical monetary statistics is used for the period 1900-1918, the cost-of-living index/CPI from Statistics Sweden is used for 1919-1979 and after that inflation expectations in the household sector for one year ahead, as calculated by the National Institute of Economic Research.

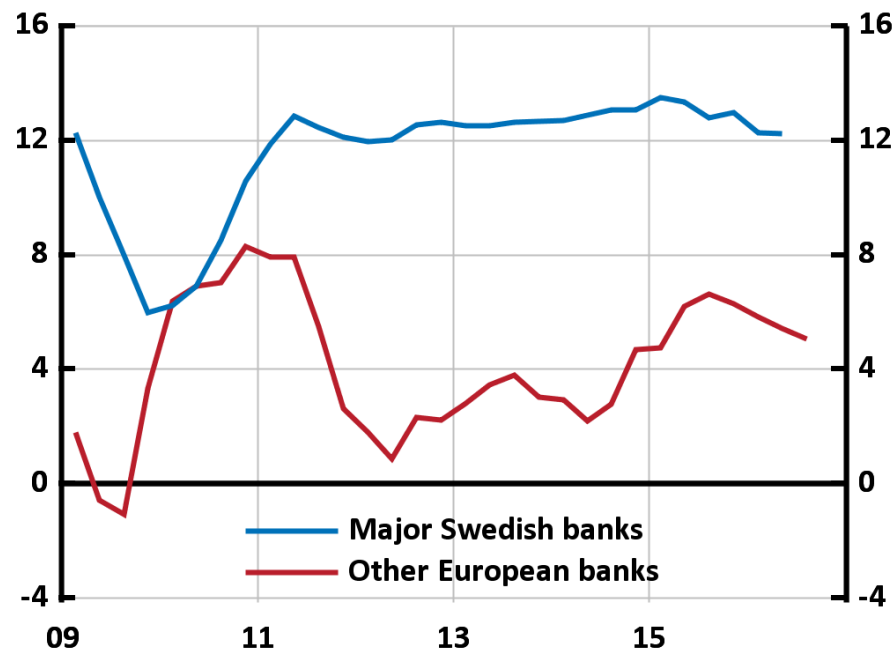
Sources: National Institute of Economic Research, Statistics Sweden and the Riksbank

# Negative repo rate – unhealthy in itself?

- Pay to save and get paid for borrowing?
  - General interest rates are low but not negative
- Harmful to the banks' profitability?

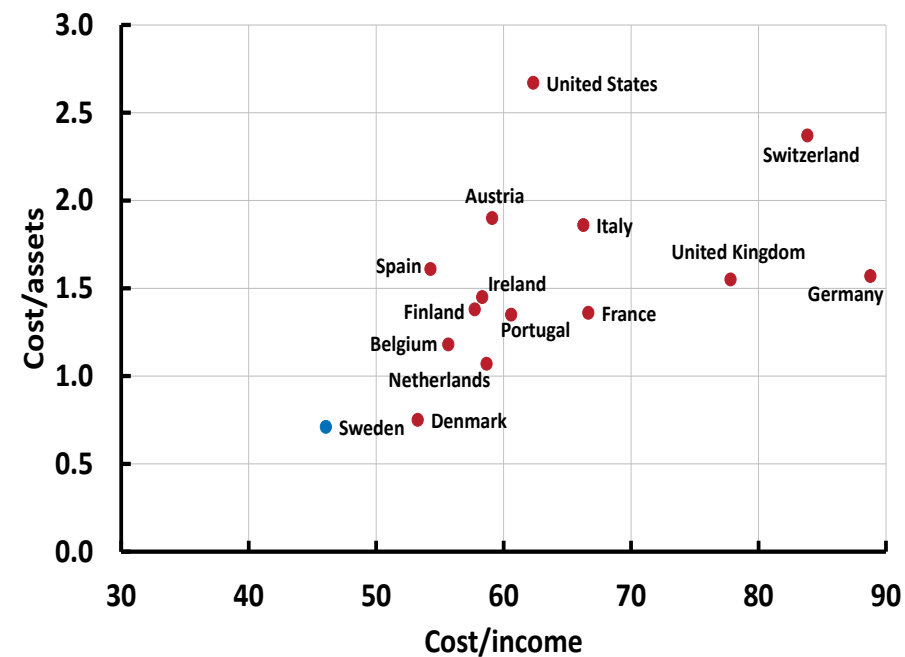
# Good profitability in Swedish banks

## Return on equity



Note. Return on equity measured in rolling four quarters, per cent. Unweighted mean value. The red line refers to a selection of major European banks. Cost in per cent of assets and per cent of income.

## Cost structure in the banks



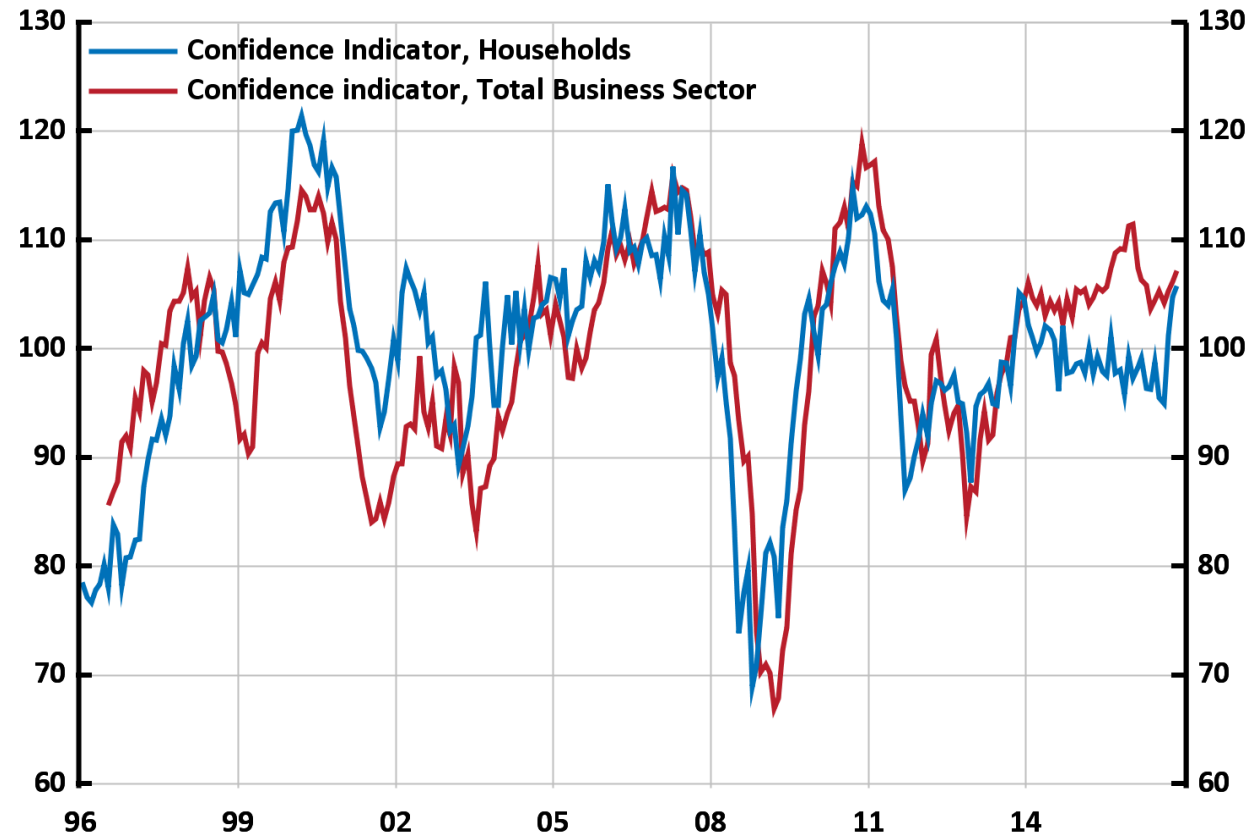
Sources: The banks' interim reports, the IMF and SNL Financial



# Negative repo rate – unhealthy in itself?

- Pay to save and get paid for borrowing?
  - General interest rates are low but not negative
- Harmful to the banks' profitability?
- Crisis signal: increased uncertainty and slower demand?
  - Important to take it seriously

# Positive sentiment in household and corporate sectors



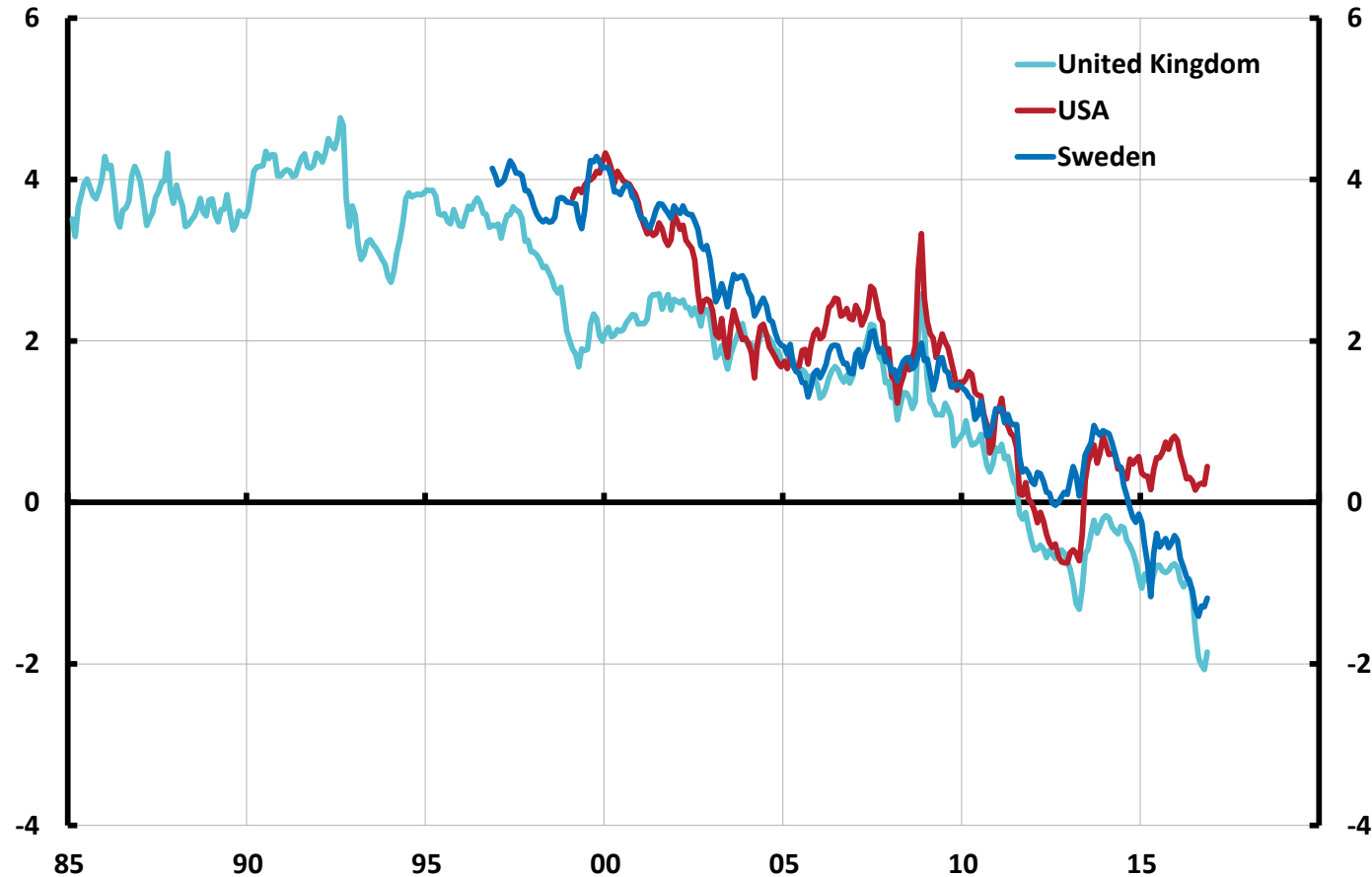
Note. Index, mean= 100, standard deviation = 10.

Source: National Institute of Economic Research

# Negative repo rate – wrong in current situation

- Reflection: Really concerns the fact that the repo rate is much too *low* rather than that it is *negative*
- Important insight: Low global interest rates are not due to monetary policy
  - Increased saving – reduced investment, weaker long-term growth prospects
  - Central to the debate on negative side-effects (e.g. Pension saving)
  - Very low policy rates required for expansionary effect

# Downward trend in global real interest rates



Note. 10-year yield on real government bonds in Sweden, the United Kingdom and the United States, per cent. Swedish real interest rates are zero coupon yields interpolated from bond prices using the Nelson-Siegel method.

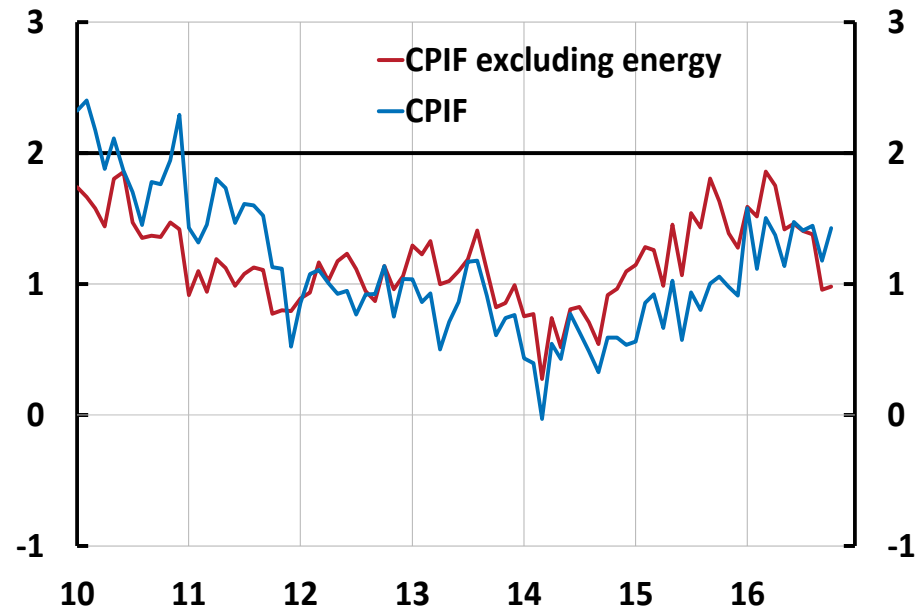
Sources: The Bank of England, the Federal Reserve, Thomson Reuters and the Riksbank

# Negative repo rate – wrong in current situation

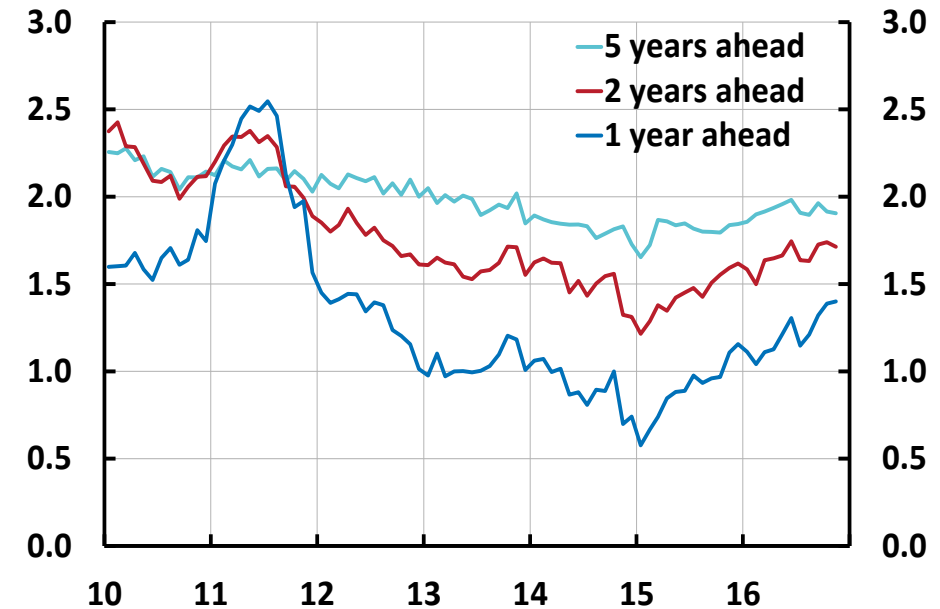
- Reflection: Really concerns the fact that the repo rate is much too *low* rather than that it is *negative*
- Important insight: Low global interest rates are not due to monetary policy
  - Increased saving – reduced investment, weaker long-term growth prospects
  - Central to the debate on negative side-effects (e.g. Pension saving)
  - Very low policy rates required for expansionary effect
- The credibility of the inflation target was at risk
  - Critical situation 2014-2015

# Problematic inflation conditions, especially 2014-15

Low inflation for a long time...



...led to credibility problems

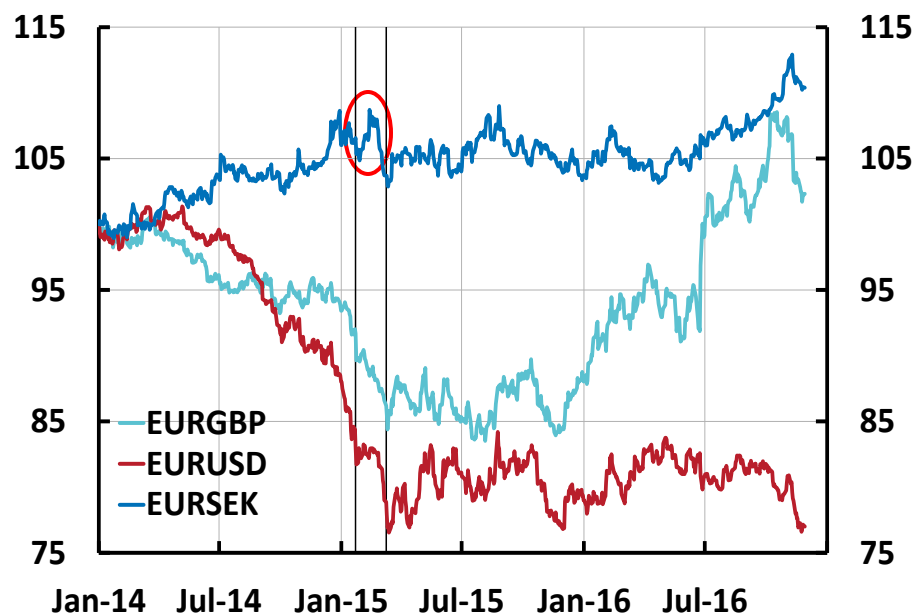


Note. Annual percentage change. The CPIF is the CPI with a fixed mortgage rate. Inflation expectations refer to mean value for money market participants.

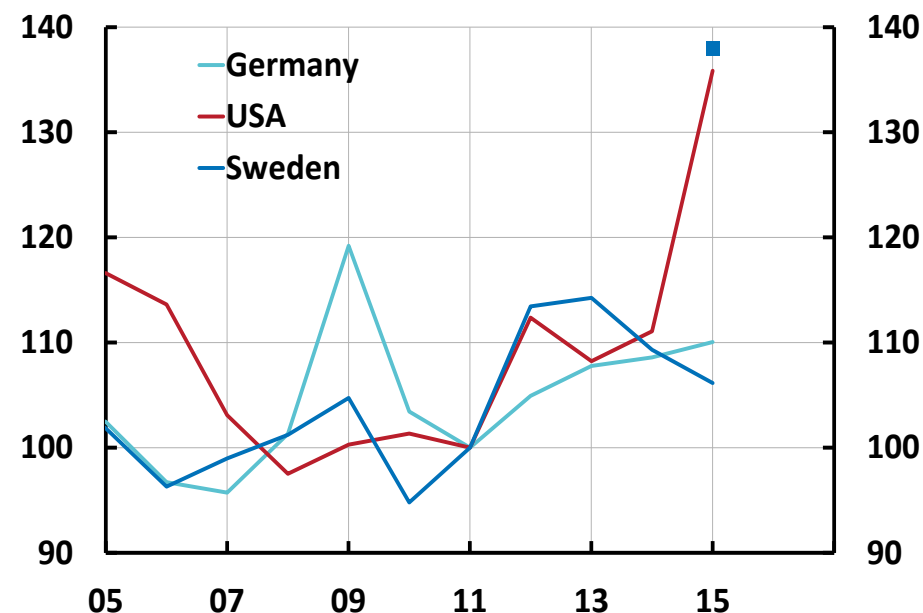
Sources: Statistics Sweden and TNS Sifo Prospera

# Dangerous situation in spring 2015\*

In an unfavourable scenario, the krona could have appreciated like the dollar and sterling...\*



...which would have had serious consequences for the competitiveness of Swedish companies



Note. The ECB communicated its decision to purchase securities on 22 January 2015 and initiated purchases on 9 March 2015. Exchange rates, index, 1 January 2014 = 100. Unit labour costs in manufacturing industry, euro, index, 2011 = 100. The blue square indicates the effect of the krona appreciating by 30 per cent against the euro.

Sources: The ECB, Macrobond and Conference Board

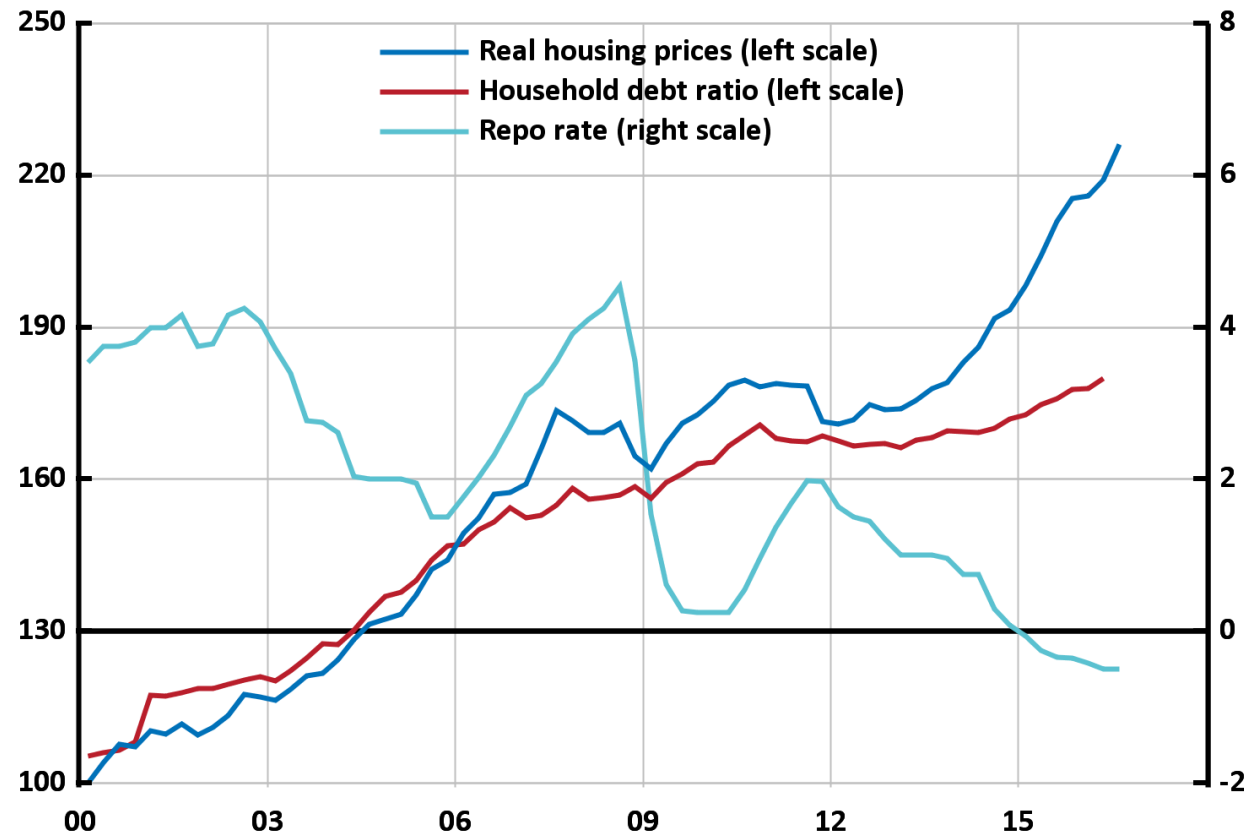
\*The figure has been corrected in this version.

# But household indebtedness and house prices?

- “You did the right thing before!”
  - No severe “leaning”, no credibility problems, specified allocation of roles 2013
- Problems on the housing market much deeper than low interest rates



# Rising trend in debts and housing prices in the event of fairly high and very low repo rate

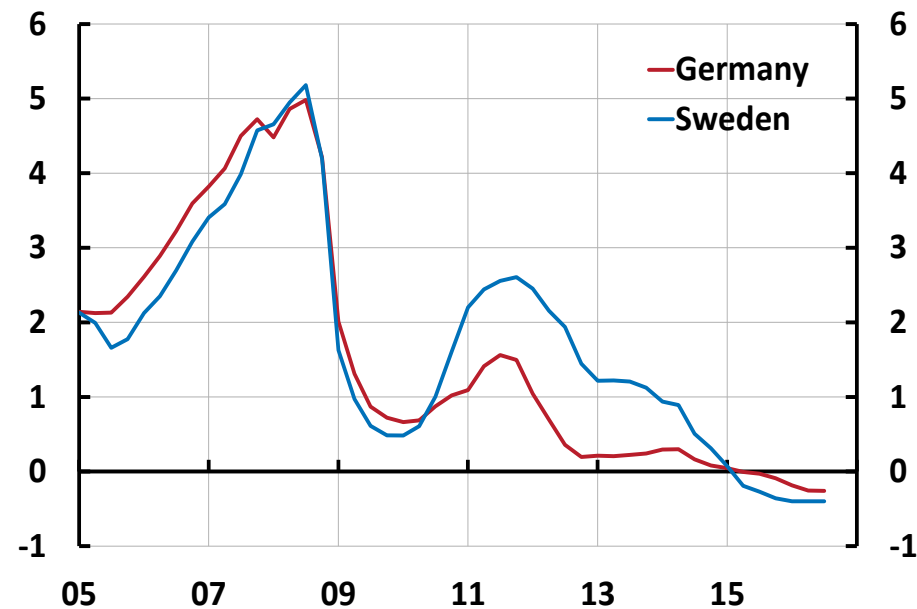


Note. Index, 2000 Q1=100 Real housing prices are calculated from series for nominal housing prices and the CPIF.

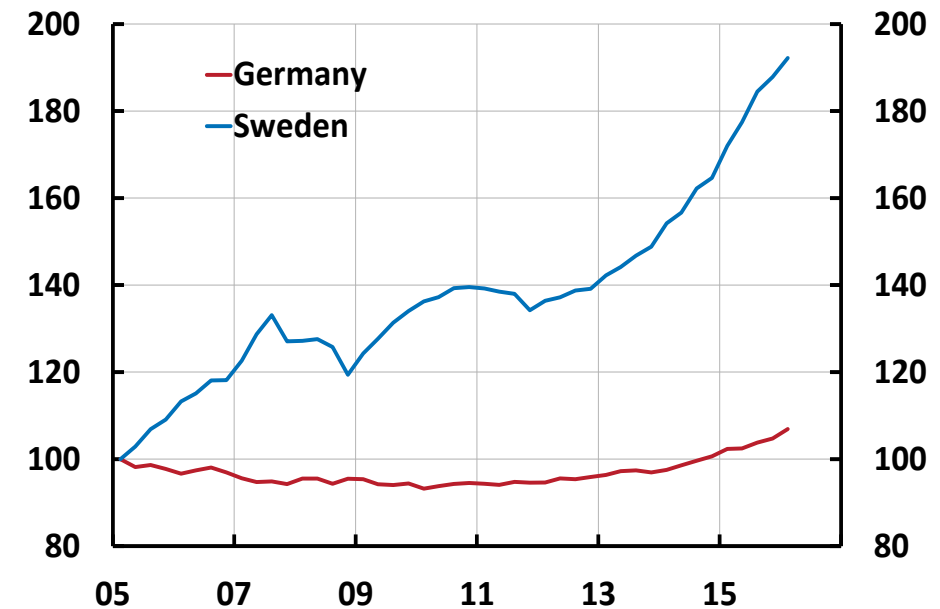
Sources: Statistics Sweden and the Riksbank

# Much slower price increases in Germany despite similar monetary policy

## Short-term interest rates



## Development in housing prices



Note. Per cent for the respective index, 2005 Q1 = 100

Sources: The BIS and the OECD

# But household indebtedness and house prices?

- “You did the right thing before!”
  - No severe “leaning”, no credibility problems, specified allocation of roles 2013
- Problems on the housing market much deeper than low interest rates
- Not reasonable that the Riksbank should sacrifice its main objective, the inflation target
  - The inflation target is central to Sweden's economic policy framework
  - Possible slowdown temporary and does not deal with basic problems – must be resolved with housing policy, fiscal policy, macroprudential policy

# Part 2: Looking ahead – future possibilities for monetary policy

- Negative policy rates
  - Have given expected effects
  - Various fears have not come true (yet)
- But are not a cure-all
  - Sooner or later problems will arise when the policy rate becomes increasingly negative
  - It will hopefully take a long time before the policy rate becomes negative again

# Current situation

- Strategy: Keep inflation up until economic activity takes over as motor
  - Not too rapid strengthening of krona
  - But not permanently fighting against “fundamentals” (however uncertain how large an appreciation the fundamentals indicate)
  - Good conditions for succeeding (strong economic activity)
- There is scope to cut the repo rate further and buy more securities if necessary
- Although the remaining scope cannot be quantified, it is not possible to ignore the fact that it is limited
  - Important to seriously discuss problems linked to alternative scenarios

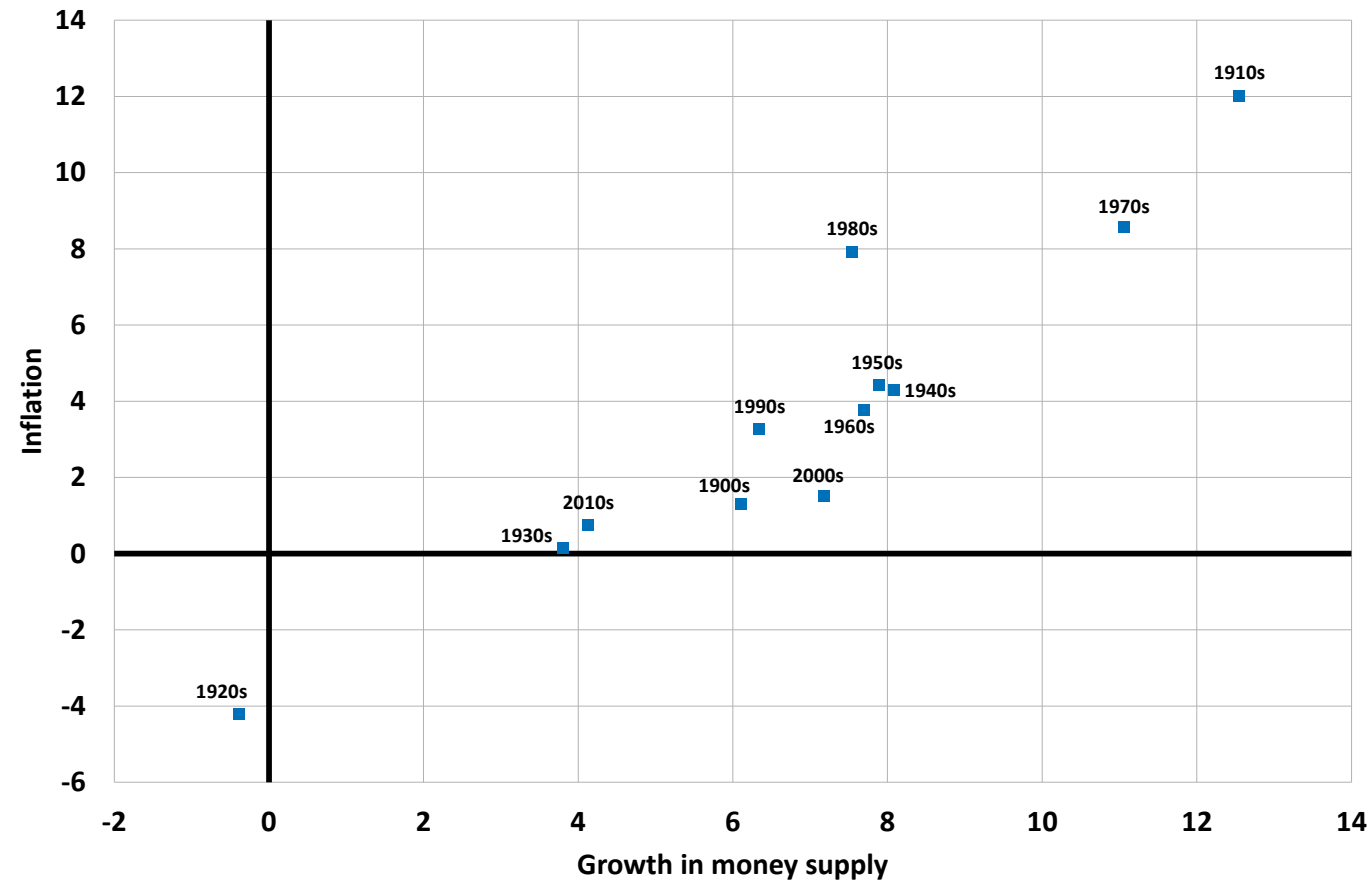
# Scenario where monetary policy is not made more expansionary despite taking longer to attain the target

- Economic activity does not take over the baton
  - Weaker economic activity?
  - Lower inflation propensity?
- Still scope for more expansionary policy
- But a situation may arise where the Riksbank is unable or unwilling to make monetary policy more expansionary despite poorer inflation prospects

# Scenario where monetary policy is not made more expansionary despite taking longer to attain the target (cont.)

- Does not mean the Riksbank is “giving up the target”
  - Advantages with a target of 2 per cent still apply
  - Inflation can be subdued over a long time by structural factors, but not for ever – in the long run it is a monetary phenomenon

# Monetary policy determines long-term inflation – inflation is a “monetary phenomenon”



Note. Annual percentage change. Money supply refers to M3 and inflation refers to CPI. The squares show the averages for different decades.

Sources: Statistics Sweden and the Riksbank



# Scenario where monetary policy is not made more expansionary despite taking longer to attain the target (cont.)

- Does not mean the Riksbank is “giving up the target”
  - Advantages with a target of 2 per cent still apply
  - Inflation can be subdued over a long time by structural factors, but not for ever – in the long run it is a monetary phenomenon
- Does not mean an entirely different policy, e.g. that repo rate is raised
  - Policy still as expansionary as possible to avoid taking longer than necessary to attain the target
- Communication of central importance
  - Much less damage if everyone realises the target has not been abandoned
  - “Rational” long-term inflation expectations should be in line with the target