

Theory meets practice: What have I learnt doing inflation targeting?

Lars E.O. Svensson
Sveriges Riksbank

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Flexible inflation targeting

- Stabilize both inflation around target and resource utilization around normal
- "Forecast targeting": Choose policy-rate path so forecast for inflation and real economy "looks good"
- "Looks good": Inflation goes to target and resource utilization goes to normal at appropriate pace
- Riksbank: "Well balanced" policy
- Set policy rate and publish and justify forecast of policy rate, inflation, and real economy



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Flexible inflation targeting

- More formally: Choose policy-rate path so as to minimize quadratic forecast loss function

$$\sum_{\tau=0}^{\infty} (\pi_{t+\tau,t} - \pi^*)^2 + \lambda \sum_{\tau=0}^{\infty} (y_{t+\tau,t} - \bar{y}_{t+\tau,t})^2$$

$\pi_{t+\tau,t} - \pi^*$ mean inflation gap forecast

$y_{t+\tau,t} - \bar{y}_{t+\tau,t}$ mean output gap forecast

λ constant relative weight on output-gap stabilization



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Transmission mechanism, not obvious?

- Monetary policy affects inflation and real economy through effects on private-sector expectations about inflation, future interest rates, and the real economy
- Expectations about future interest rates (whole repo-rate path) matters, not current repo rate
- Real interest rates matter, not nominal ones
- Expected repo-rate path matters, not published
- Not obvious to everyone



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Characteristics of optimal policy, not obvious

- Linear models, quadratic loss: Inflation approaches target and resource utilization approaches normal gradually (exponentially, asymptotically)
- Equilibrium solution

$$\pi_t - \pi^* = \sum_j A_j \mu_j^t; \quad 1 > |\mu_1| \geq |\mu_2| \geq \dots$$

$$y_t - \bar{y}_t = \sum_j B_j \mu_j^t$$
- Fixed horizon ("normally reach inflation target within two years") not appropriate
- Gap to target at any horizon depends on initial gap



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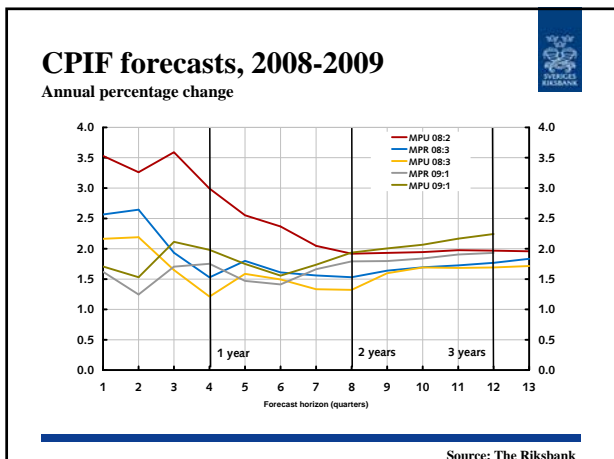
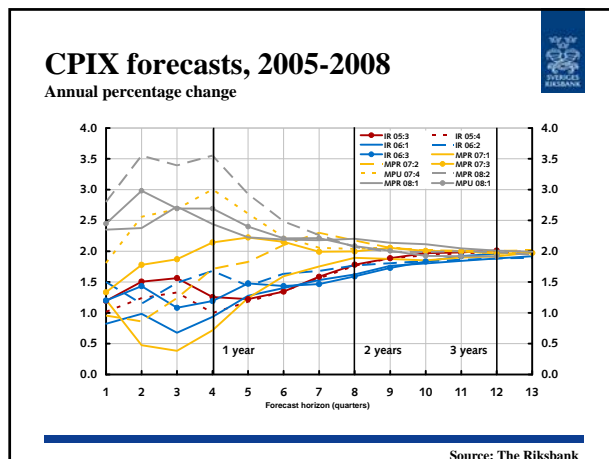
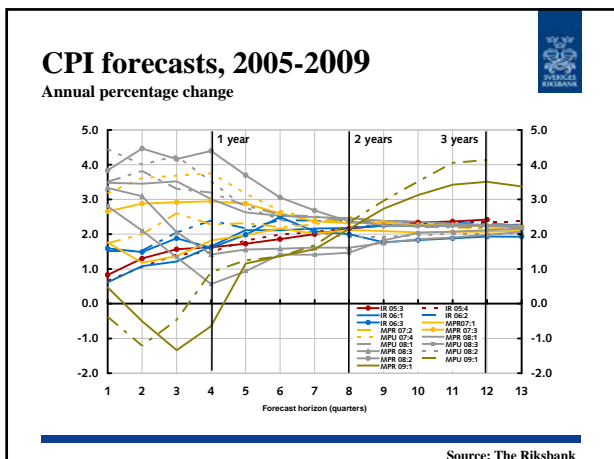
Characteristics of optimal policy, not obvious

- "Half-time" more appropriate (Schmidt-Hebbel)

$$|\mu_1|^H = \frac{1}{2}, \quad H = -\frac{\ln 2}{\ln |\mu_1|}$$
- Riksbank practice: Inflation target not reached within two years



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- ### Characteristics of optimal policy, not obvious
- Riksbank phrases now mixed: “within two years”, “in a couple of years”, “in a few years”
 - Other IT central banks: “Medium term”
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- ### Loss function, not obvious
- Ongoing discussion about loss function or not
 - Examples of arguments:
 - “Monetary-policy objectives too complex for loss function”
 - “Aggregate measure of resource utilization not meaningful, several measures needed”
 - “ λ should depend on the circumstances”
 - Norges Bank seems to be ahead
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- ### Measurement of resource utilization, complicated
- Stabilizing resource utilization requires measures of resource utilization
 - Which measure? Output gap, which potential output?
 - “Aggregate measure of resource utilization not meaningful, several measures needed”
 - Conceptual and estimation problems, not solved, not yet agreement
 - Progress slower than I would like
 - Norges Bank seems to be ahead
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Transparency, not controversial

- Improve public-sector information, reduce uncertainty
- More effective external scrutiny and evaluation: Improve central-bank incentives
- Strengthen democratic accountability
- Riksbank
 - High transparency ranking in academic literature
 - Explicit communication policy

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Publishing policy-rate paths

- RBNZ 97, Norges Bank 05, Riksbank 07, Sedlabanki Islands 07, CNB 08
- Why so few?

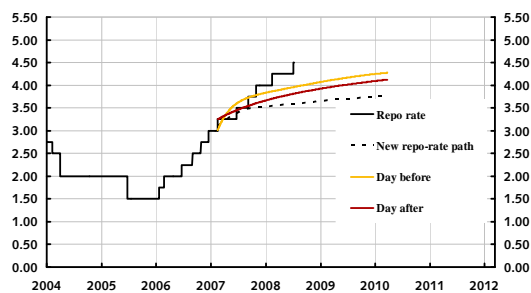
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Management of policy-rate expectations

- Riksbank publishes and explains forecast of repo rate, inflation and real economy
- What is the Riksbank's record in managing interest-rate expectations?
- Compare repo-rate path to market expectations (adjusted implied forward rates) before and after announcement

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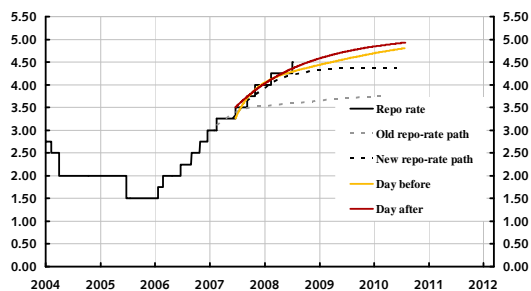
Repo-rate path and market forward rates February 2007



Note:

Source:

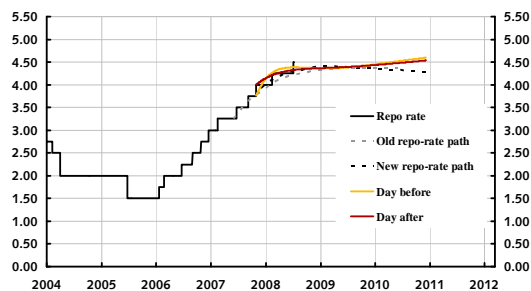
Repo-rate path and market forward rates June 2007



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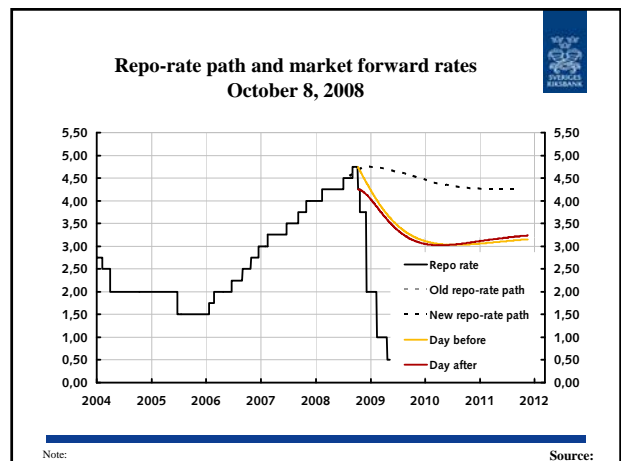
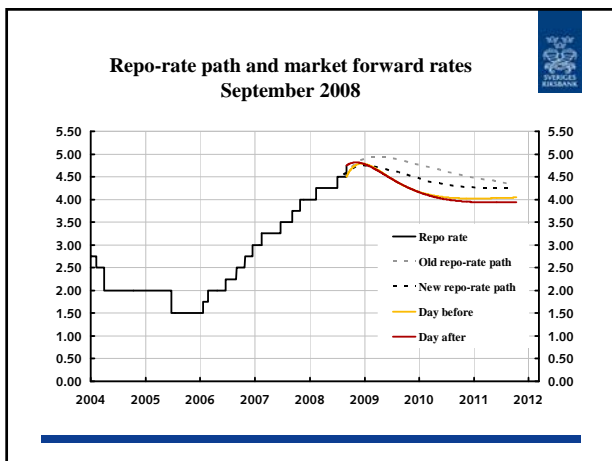
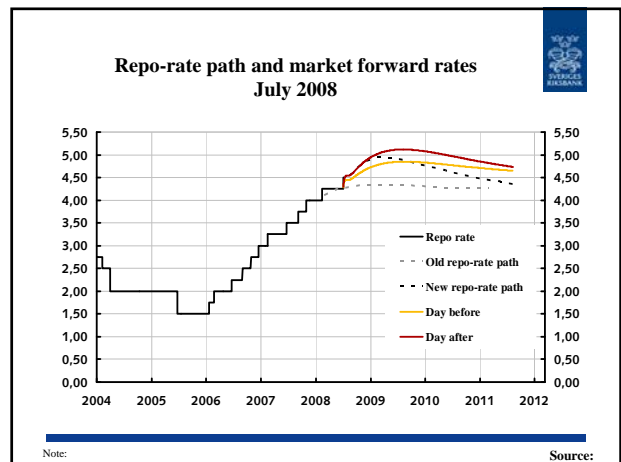
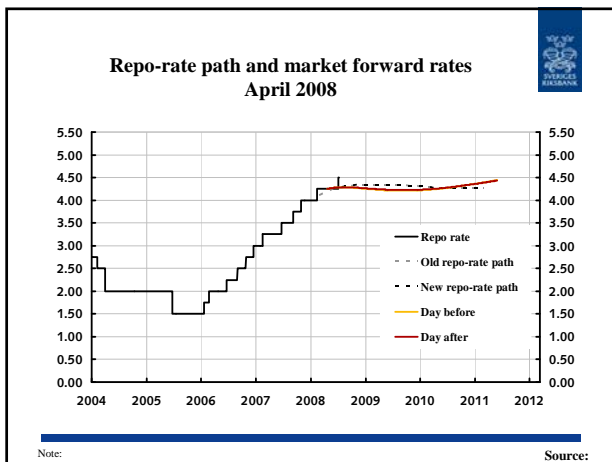
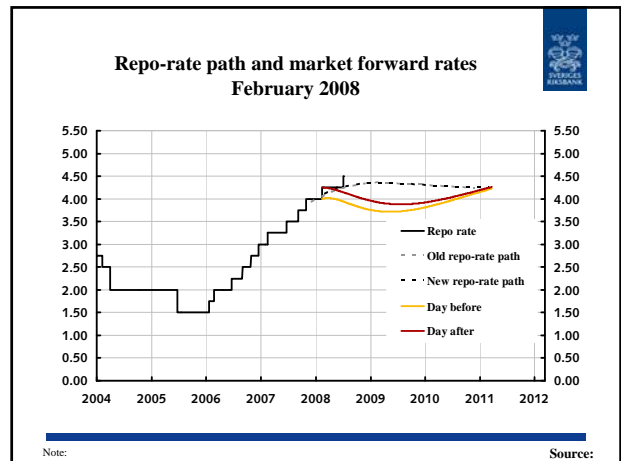
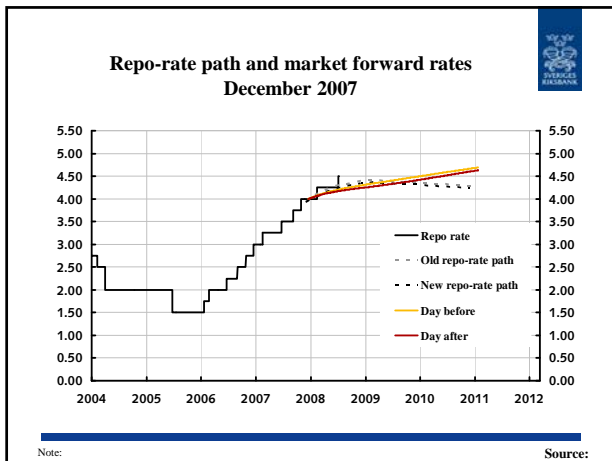
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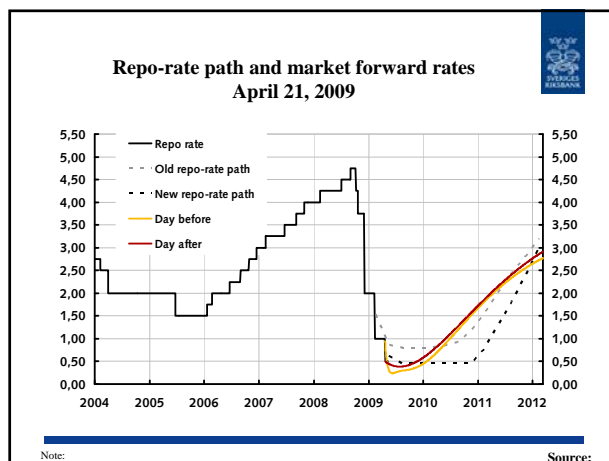
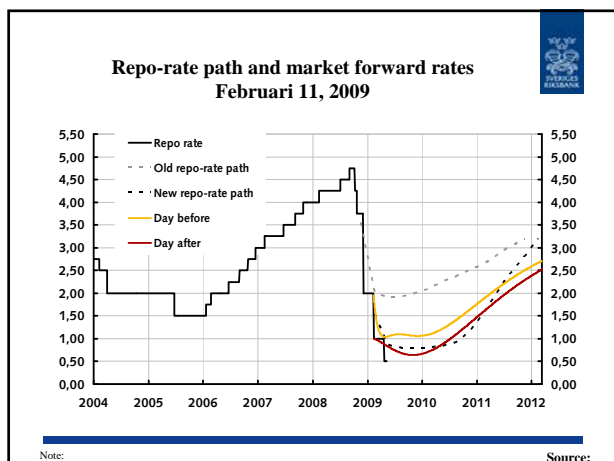
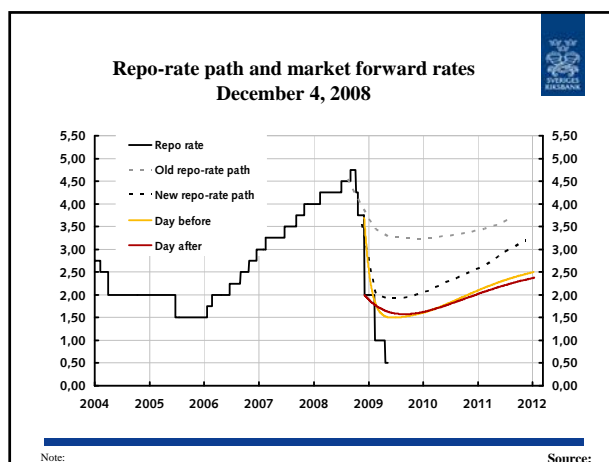
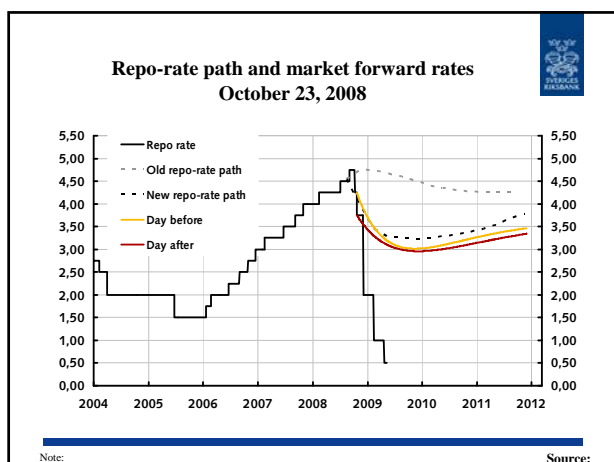
Repo-rate path and market forward rates October 2007



Note:

Source:





Management of policy-rate expectations

- Pretty good, but not a complete success
- Repo-rate path taken more seriously over time
- “Forecast, not a promise”
- Good credibility in February 2009, but low in April 2009
- Then “effective/actual” monetary policy much tighter than “published/intended”

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Management of policy-rate expectations

If longer period of low policy rate credible:

1. Higher inflation and inflation expectations
 2. Lower real interest rate
 3. Higher resource utilization/lower unemployment
 4. Weaker currency
- More expansionary monetary-policy package

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Why current lack of credibility?

- Why repo-rate expectations $> 0.50\%$?
- Inconsistent communication
 - “0.50% may be minimum”
 - “Repo rate may be increased earlier”
 - Implies mean repo-rate $> 0.50\%$
- Credible mean requires consistent probability distribution (Executive Board’s own)
- Problem of too tight monetary policy not obvious to everyone

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What can be done to improve credibility?

To keep policy-rate expectations down:

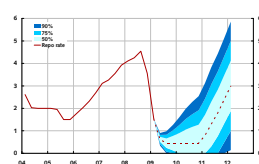
- Lending at policy rate at longer maturities (more direct than buying government bonds)
- Acknowledge that the effective lower bound is soft, not hard, and may be negative
- If cashless economy: Nothing special with zero
- Cash: Effective yield negative!

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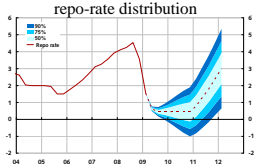
What can be done to improve credibility?

- Publish uncertainty intervals consistent with mean policy-rate path

Published repo-rate distribution



One example of consistent repo-rate distribution



- Better with ambiguity about ZLB?

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The exchange rate, controversial

- One of the risks at ZLB: Too strong currency
- Normally, strong or weak currency countered by higher or lower policy-rate path
- At ZLB, not lower policy-rate path
- Previously, too weak currency often the problem; now, too strong currency the problem
- Requires rethinking about the exchange rate
- Not easily accepted by everyone

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The exchange rate, controversial

- If too strong currency, use FX interventions (Switzerland)
- Not beggar-thy-neighbor: Instead inherent part of expansionary monetary policy
- Not accepted by everyone

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Conclusions: What have I learned?

- Conventional wisdom in academics, teaching, and research not necessarily conventional wisdom among policymakers and staff
- “Knowledge gap” relative to frontier of teaching/research/publishing
- “Intellectual inertia/conservatism”
- Considerable diversity of views, less common ground
- Diversity good, if knowledge-based
- Needed: More discussion and education about both principles and practice of monetary policy

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**Conclusions:
What have I learned?**

- Recently dramatic changes in environment: Financial crisis, deteriorating real economy, ZLB. Requires substantial rethinking
- Six policy meetings per year very appropriate, but two months little time for substantial rethinking

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**Conclusions:
What have I learned?**

- Problem: Staff overworked, too few
- More resources/staff needed for time for discussion, education, research, thinking
- Research not only in designated research department but also in policy departments
- Staff should regularly teach policymakers
- Education of policymakers: First at appointment and then reoccurring

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