

# **Current challenges for the conduct of monetary policy in the euro areas:**

## **Should the ECB do more?**

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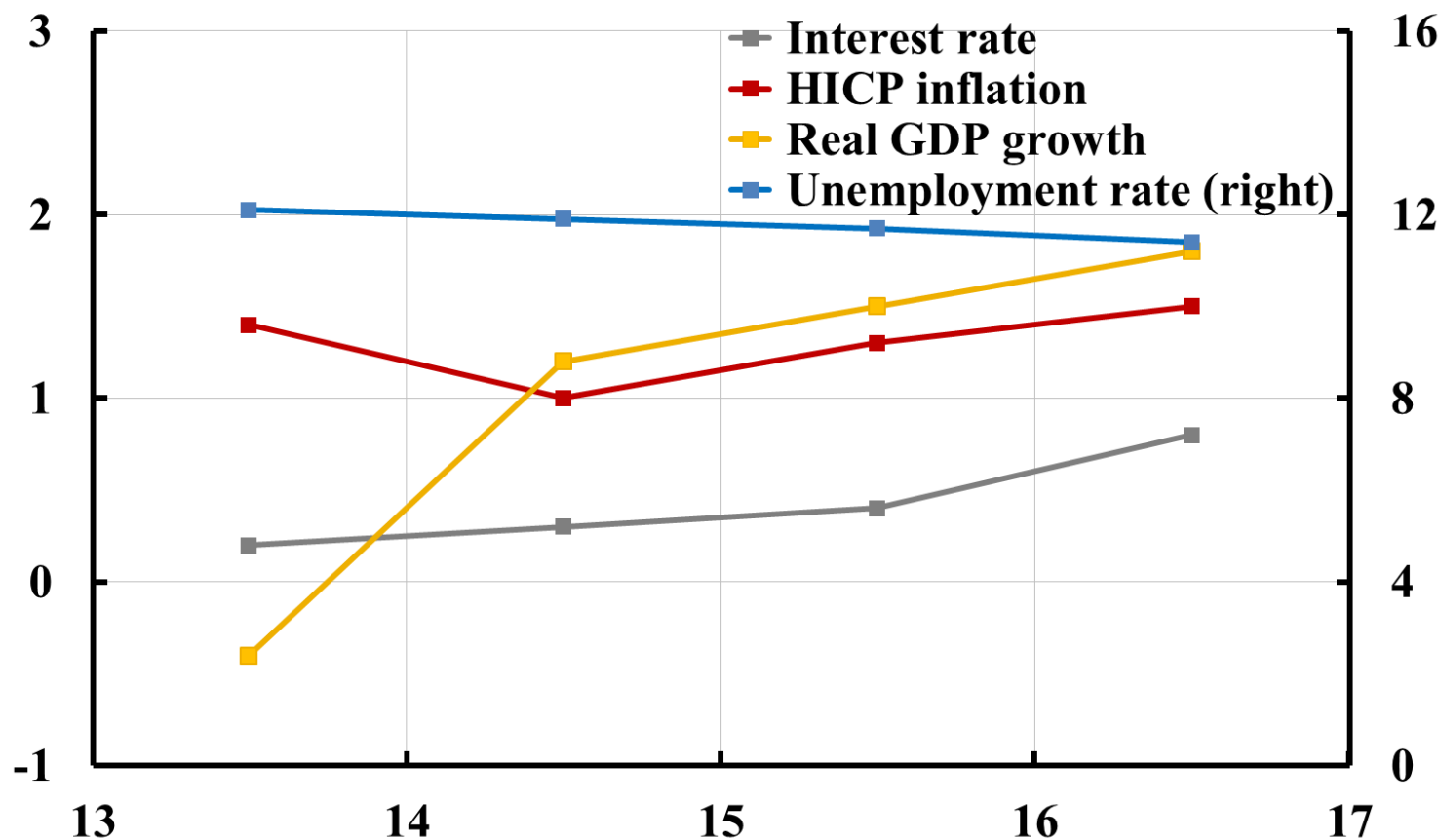
The ECB and its Watchers XV  
Frankfurt, March 12, 2014

# Outline

- Should the ECB do more?
- How has the ECB done?
- Does the ECB have enough policy measures?
- More on forward guidance: Normal procedure?

Should the ECB do more? **Yes, if possible**

ECB staff projection March 2014

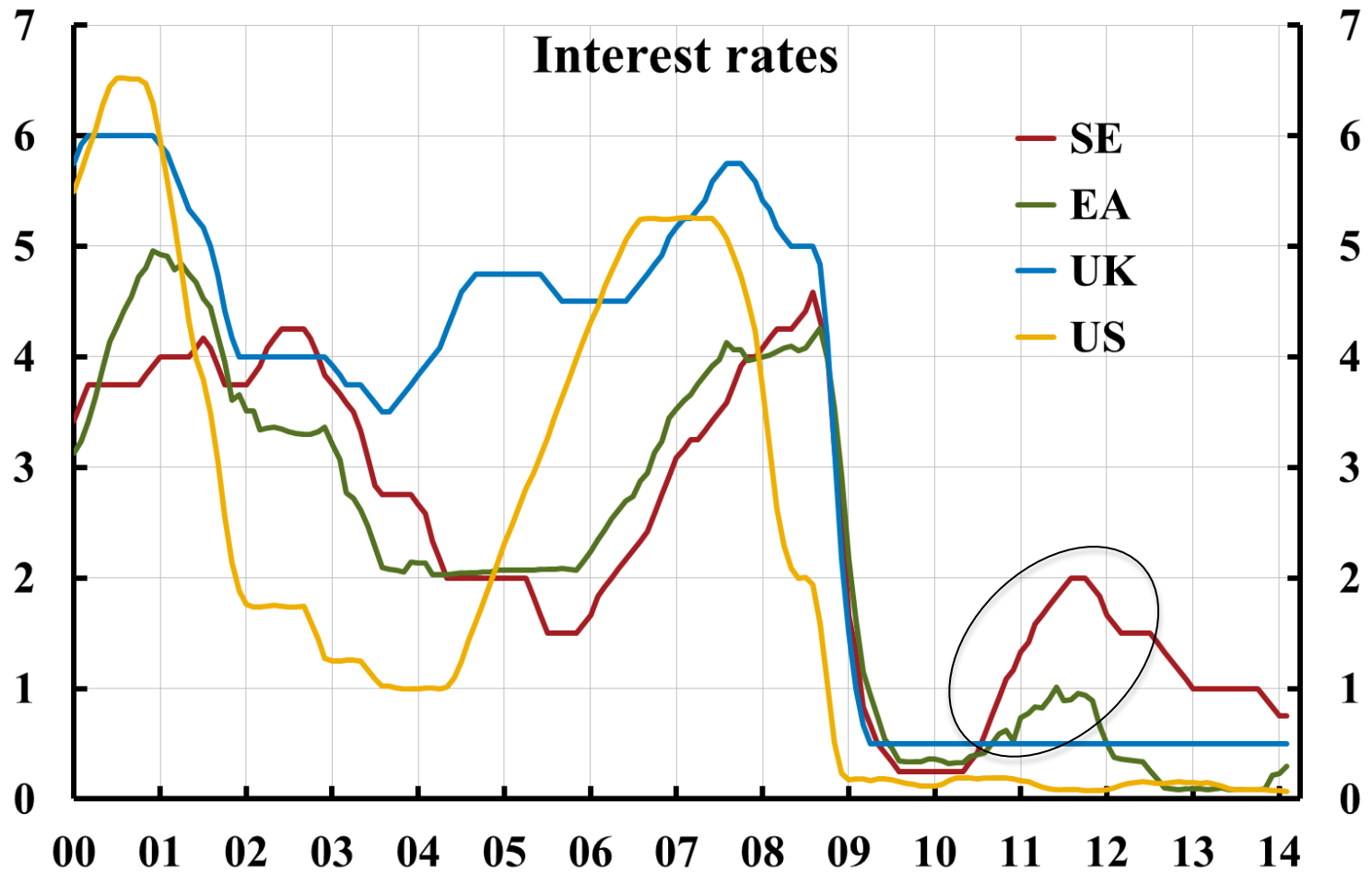


# How has the ECB done?

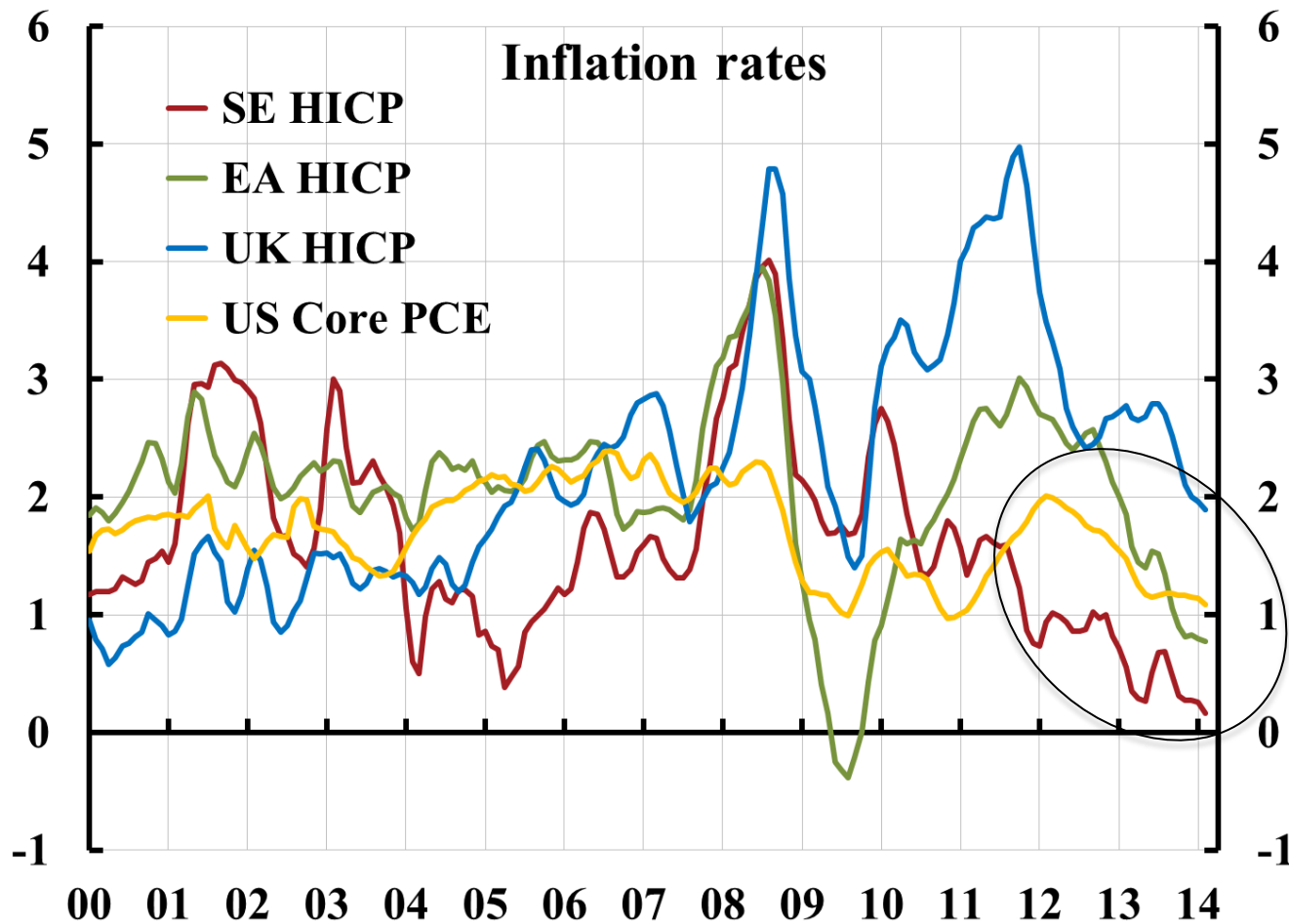
- A partial view: Short real interest rate



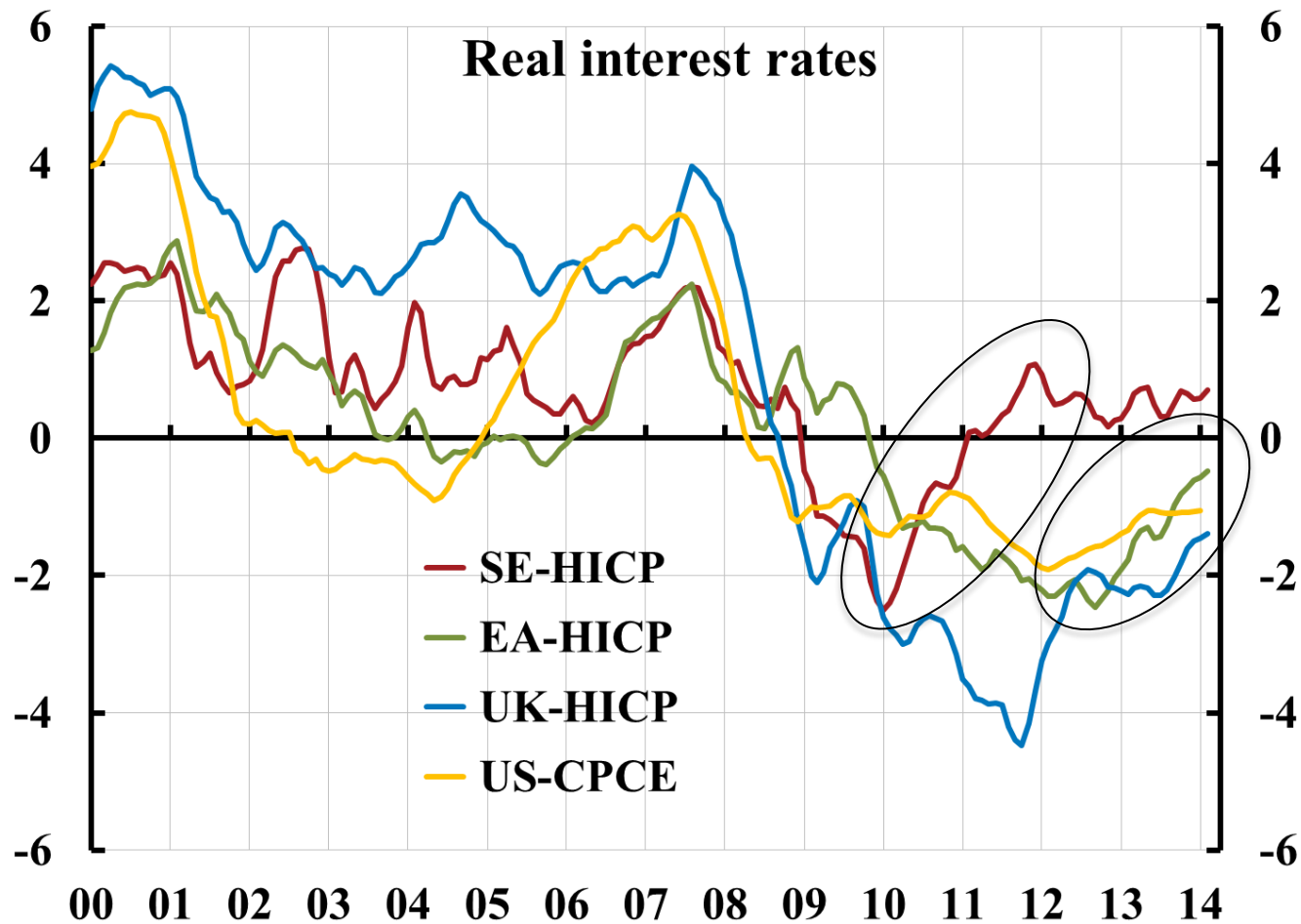
# Nominal Eonia rate and policy rates in Sweden, UK, US



# Inflation: Euro area, Sweden, UK, US



# Real Eonia rate and policy rates in Sweden, UK, US



# Does the ECB have enough policy measures?

- Difference policy rate (MRR) and Eonia rate: Why not smaller corridor?
  - Riksbank “fine tuning”, corridor  $\pm 10$  bp
- Do not exclude zero/negative interest rate ( $-0.25\%$ )
- Balance-sheet policies, large-scale asset purchases (OMT)
  - Set up so ready to be used, then use
  - Distinguish from liquidity support (LTRO, financial stability)
  - Prohibition of monetary financing?  
Should be prohibition of *inflationary* financing
  - Risk of losses unavoidable: Central banks have to take risks in crises
  - Monetary-policy actions in crises have unavoidable fiscal and financial-stability side effects
    - Classify actions according to main purpose



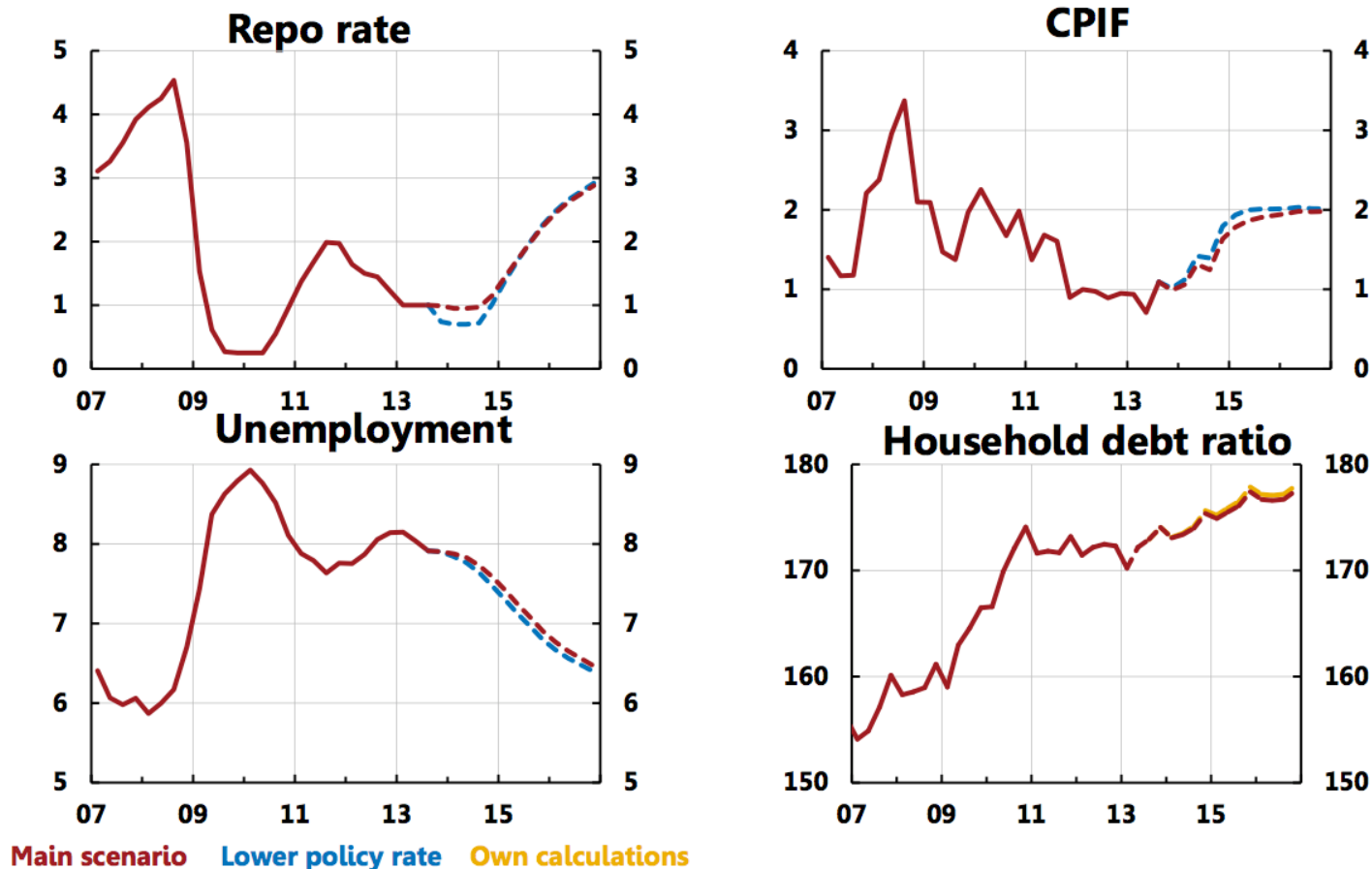
# Does the ECB have enough policy measures?

- Forward guidance, in the form of a published policy-rate path (forecast, not commitment), should be normal part of policy
  - Other forms of forward guidance when needed (commitment, conditional, threshold, balance-sheet, etc.)
- Policy-rate path part of normal “forecast targeting” – setting the policy-rate path so forecasts of target variables “look good” (fulfill objectives)

# Forecast targeting, alternative policy-rate paths

Corresponding forecasts of inflation, unemployment, and debt ratio (Riksbank, Ekholm 2013)

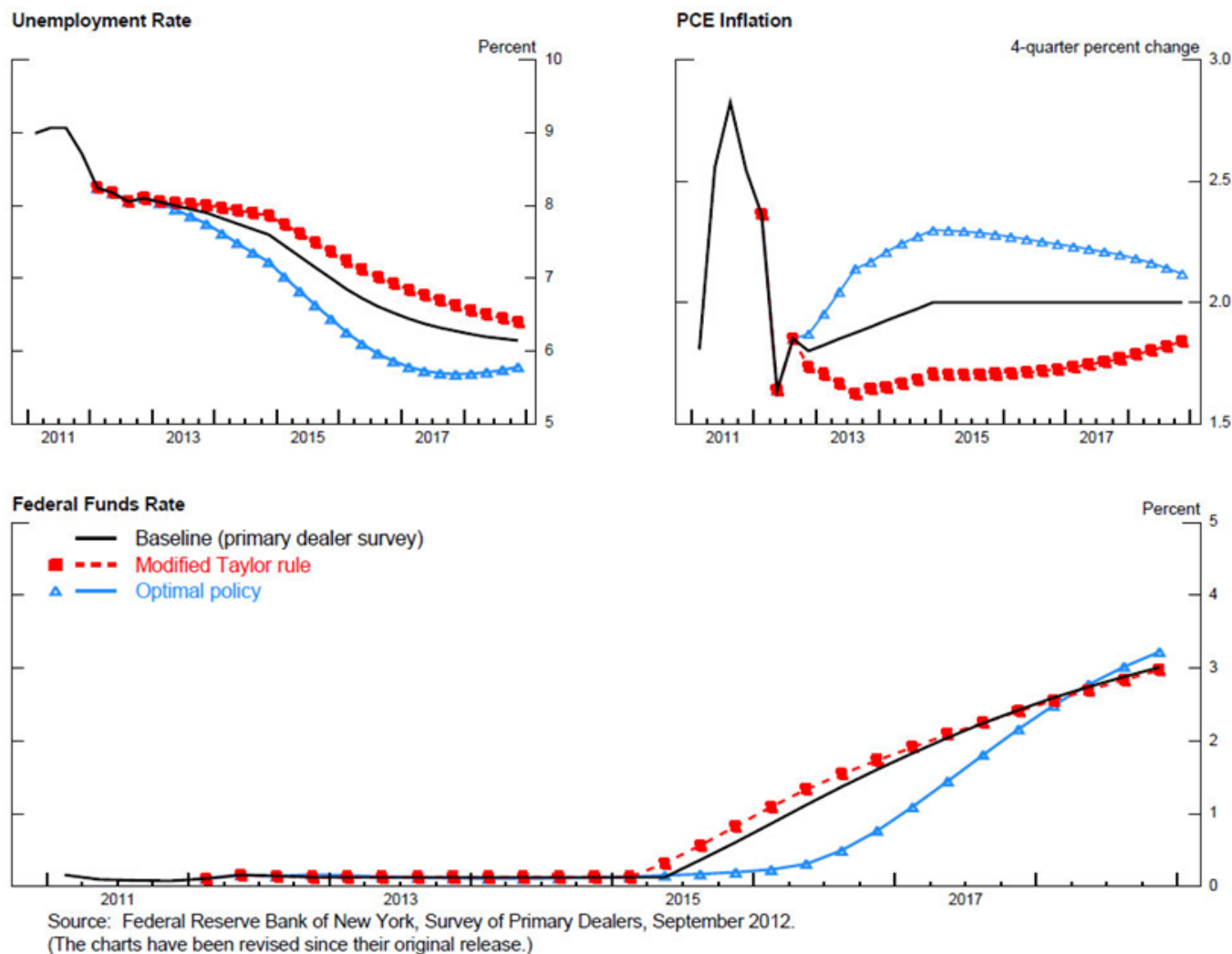
**Figure 2. More expansionary monetary policy**



Source: Ekholm, Karolina (2013), "Why Swedish Monetary Policy Needs to Be More Expansionary," speech on November 15, 2013, [www.riksbank.se](http://www.riksbank.se).

# Forecast targeting: Yellen (2012)

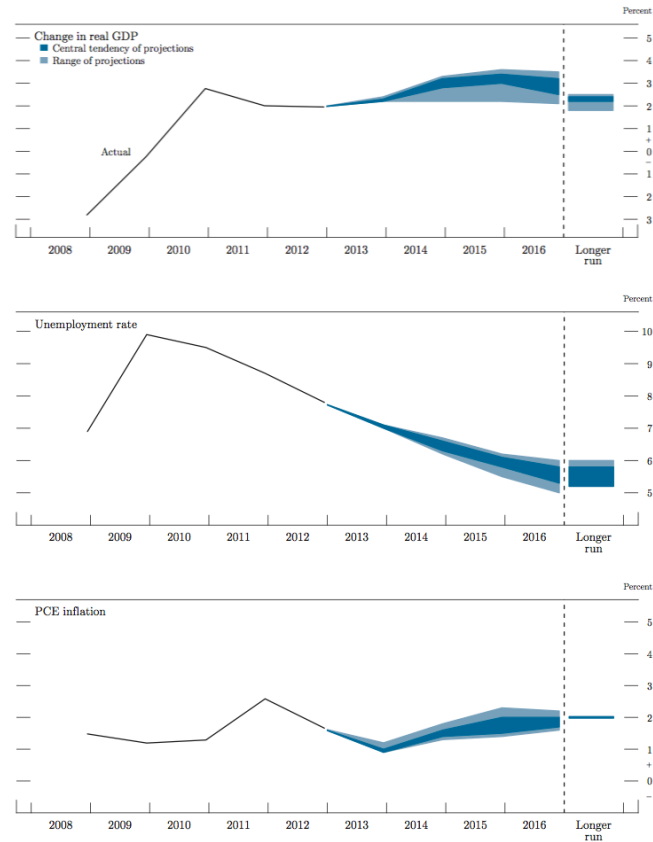
Three Policy Paths: An Illustrative Exercise



Source: Yellen, Janet L. (2012), “Revolution and Evolution in Central Bank Communications,” speech at the Haas School of Business, University of California, Berkeley, November 13, 2012, [www.federalreserve.gov](http://www.federalreserve.gov).

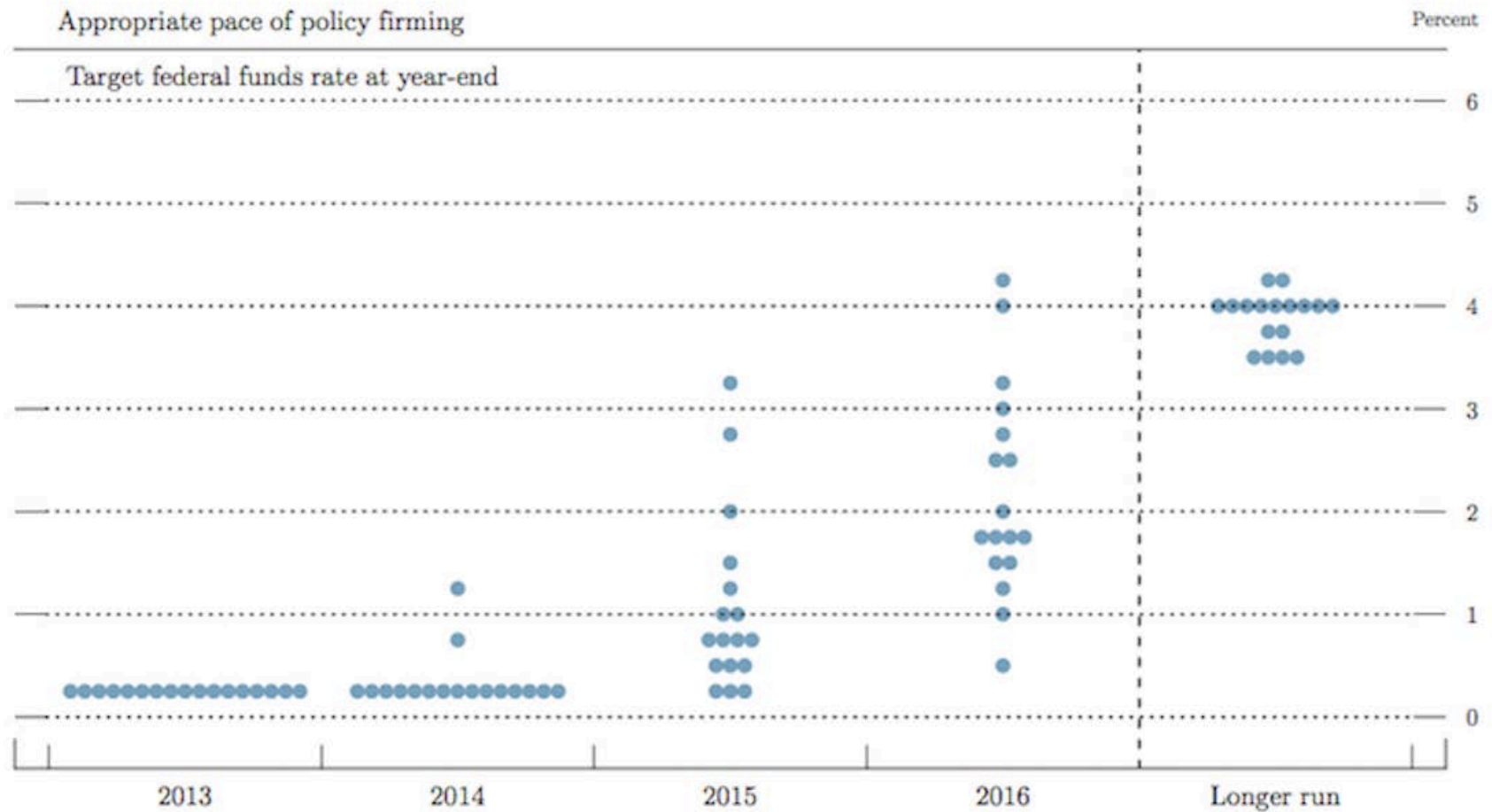
# Fed Economic Projections, Dec 2013

Figure 1. Central tendencies and ranges of economic projections, 2013-16 and over the longer run



NOTE: Definitions of variables are in the general note to the projections table. The data for the actual values of the variables are annual.

# Fed Economic Projections, Dec 2013



## Why normal to published policy-rate path?

1. **Transparency:** Coherent forecast of target variables requires forecast of instrument. Then publish this.
2. **Effectiveness:** Management of expectations (of the future policy rate)
3. **Informativeness:** Central bank should have more info about its future policy settings. Useful info for private sector
4. **Justification:** Provides a coherent way of justifying policy choice by comparison with policy alternatives
5. **Accountability:** Simplify external evaluation of policy by comparison with policy alternatives and assessments of tradeoff between target variables



# Swedish experience

- “Forward guidance in theory and practice: Swedish experience,” Dec 2013, [larseosvensson.se](http://larseosvensson.se)



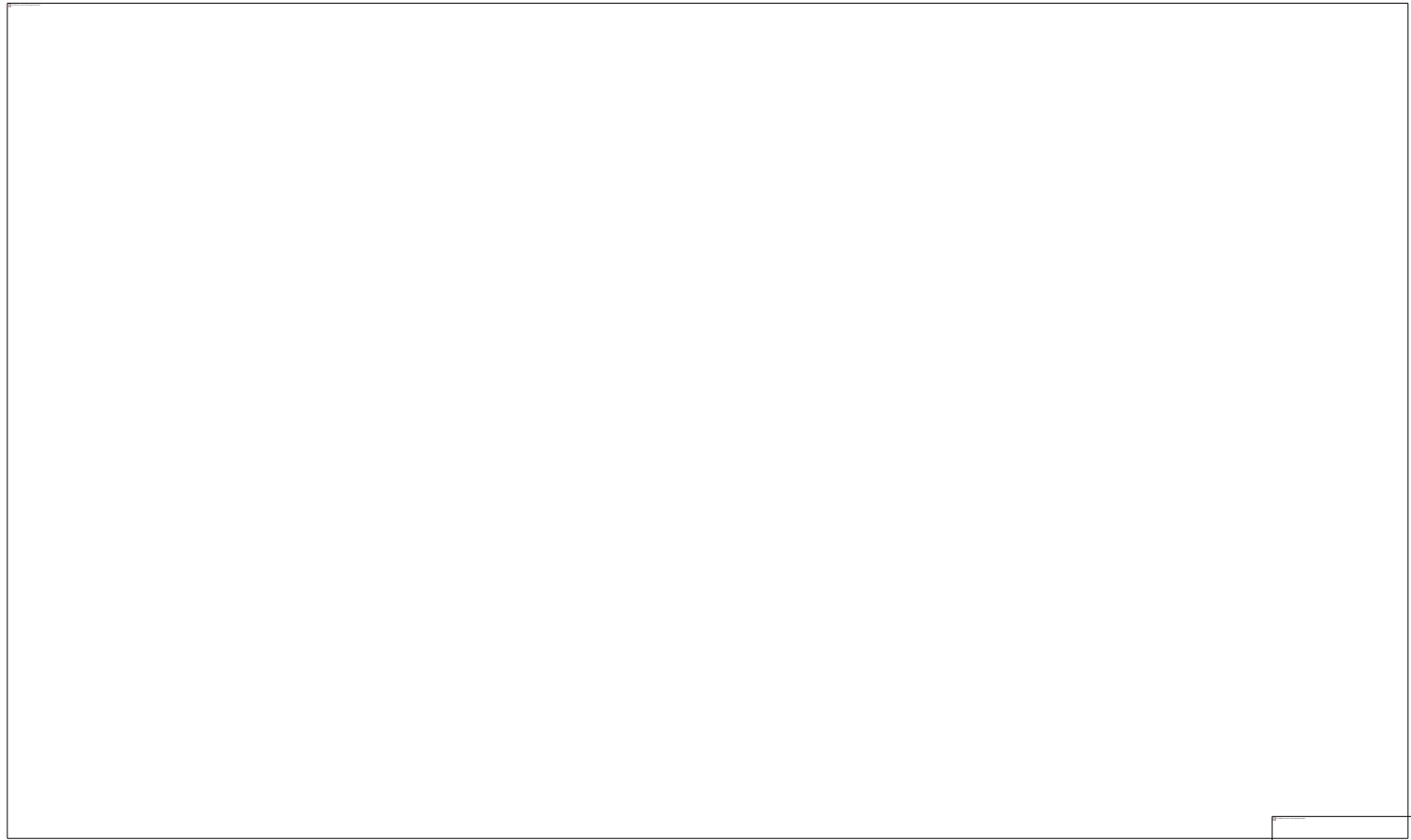
**Riksbank record mixed:**  
February 2009: **Success!**





# **Riksbank record mixed:**

## September 2011: **Failure!**



[Cont.](#)

# Risks from forward guidance about policy rate? (Filardo-Hofmann, Financial Times)

- Central-bank reputation?
- Financial stability?
  - Disruptive market reactions
  - Risk of MP becoming too concerned about market reactions, delaying normalization (financial dominance)
  - Excessive risk-taking, build-up of financial vulnerabilities
- Learning process (both market and CB)
- Reputation risk, old argument against inflation targets
- After crisis, probably too little risk-taking. But what is optimal risk-taking?
- Watch indicators of vulnerability, use macroprudential instruments if needed

# Extra



# Monetary policy and threats to financial stability

- Monetary policy has normally little effect on financial stability
- Financial stability can normally be handled by other means
- Only if monetary policy is considered to pose a *significant threat* to financial stability, and that threat *cannot be handled* by the standard macro-prudential instruments, should monetary policy be allowed to deviate from the standard monetary-policy objectives.
- Who should decide? The authority responsible for financial stability
- Bank of England provides an example: August 2013 forward guidance, knockout 3: *FPC* decides if risk, not MPC

**Tightening in summer 2010 has lead to inflation below the target, higher unemployment, and higher (!) debt ratio**



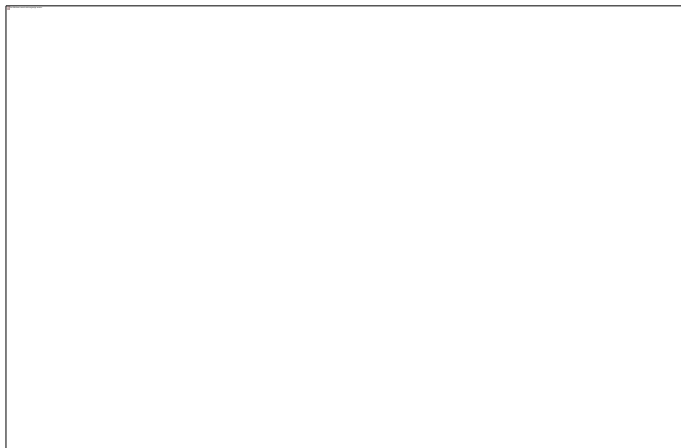
[Cont.](#)

Source: Svensson (2013), “Unemployment and monetary policy – uppdatering for the year 2013,”  
larseosvensson.se.

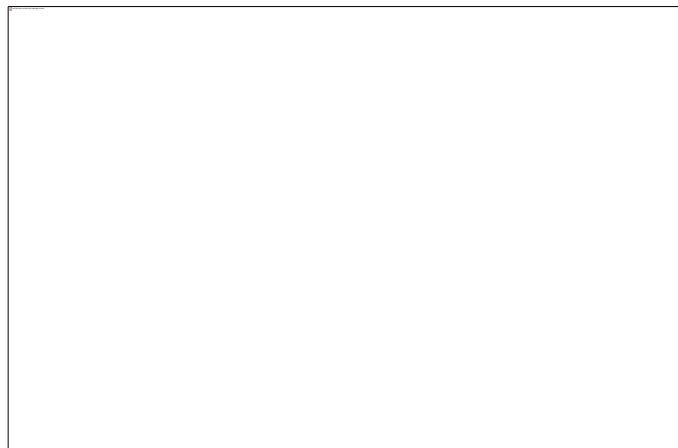
# Fed and Riksbank, June/July 2010

## Similar forecasts, very different policies

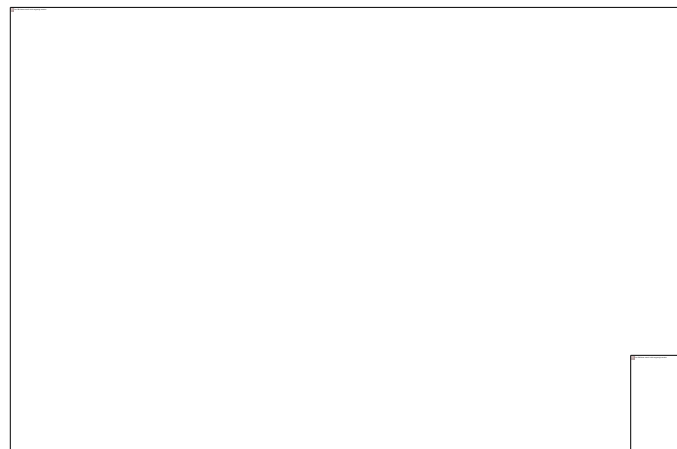
Policy rate



Inflation



Unemployment



Svensson (2011), “Practical Monetary Policy: Examples from Sweden and the United,” *Brookings Papers on Economic Activity*, Fall 2011, 289-332.

# Riksbank tradeoff reasonable?

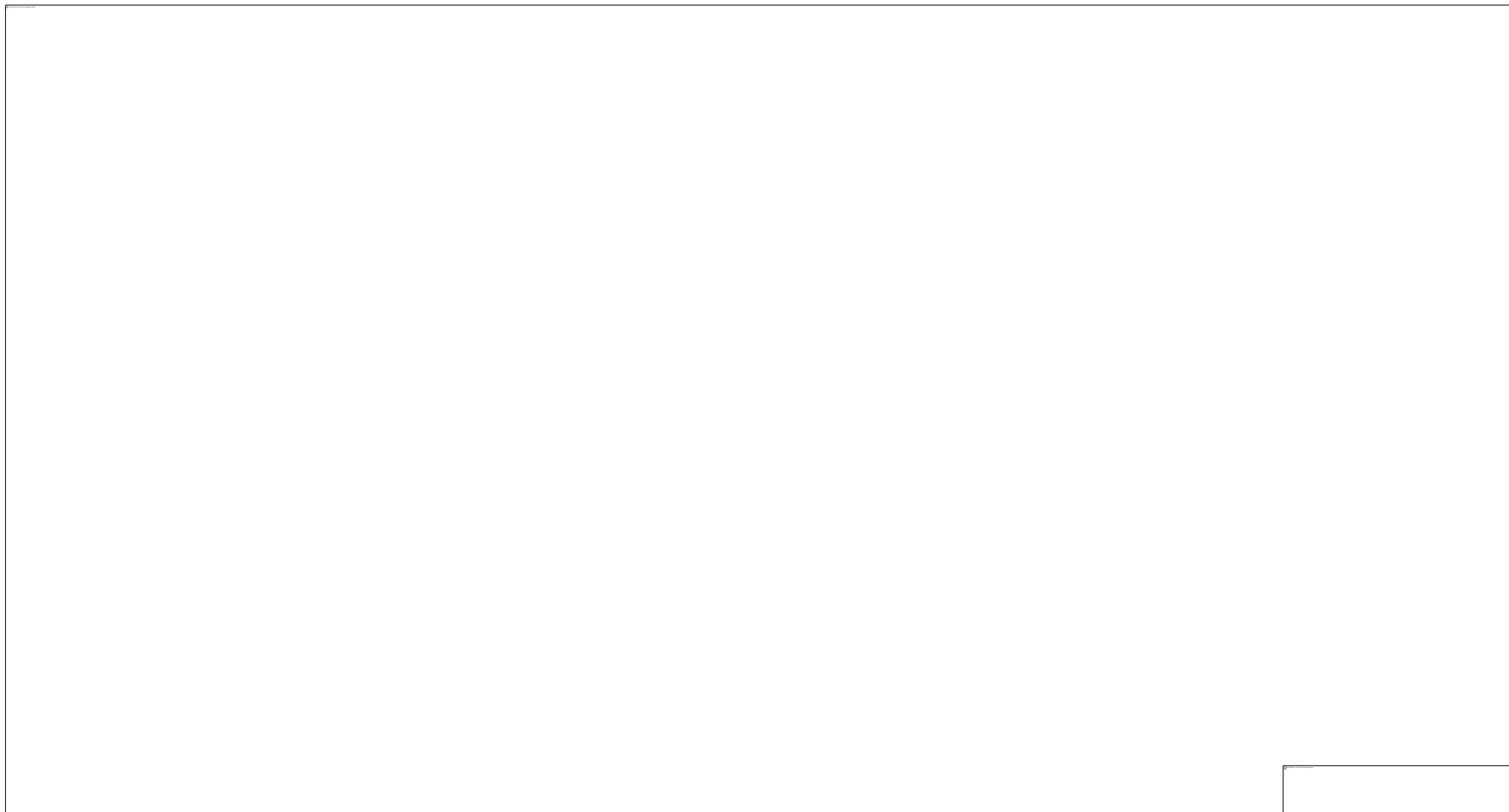
# Housing prices relative to disposable income



Source: Statistics Sweden, Valuegard



# Household debt and assets (excluding collective pensions)




# Riksbank inflation forecasts biased upwards

Riksbank inflation forecasts and actual outcome (CPIF)



Source: National Institute of Economic Research (2013)

# Impulse responses to 1 percentage point higher policy rate during year 1

