



# Should monetary policy ever lean against the wind?

## Panel introduction

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1

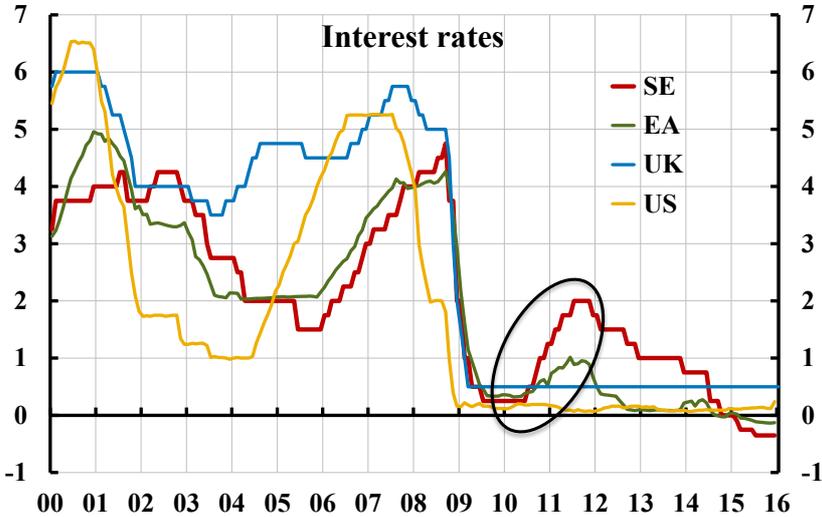
## Outline

- Should monetary policy take into account financial stability risks explicitly?
- Should monetary policy “lean against the wind”?
- Background: The Riksbank’s policy dramatic tightening 2010-2011...
- ... despite an inflation forecast below the inflation target and an unemployment forecast above a long-run sustainable rate
- Cost-benefit analysis of leaning against the wind

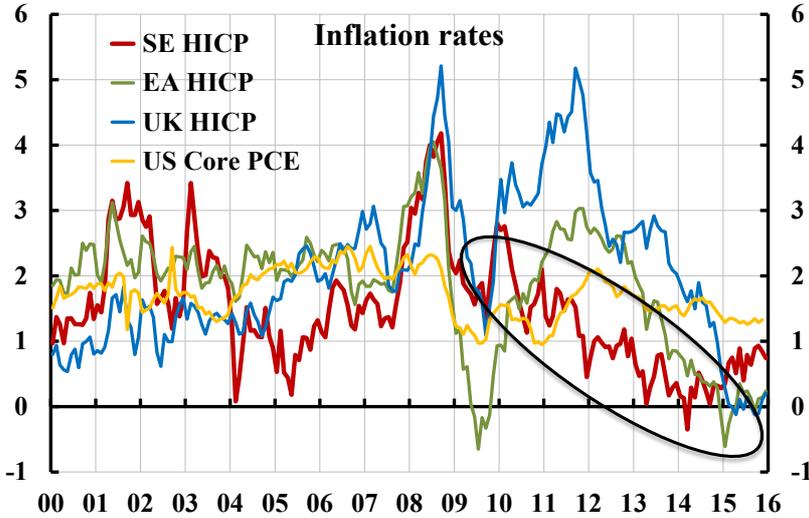


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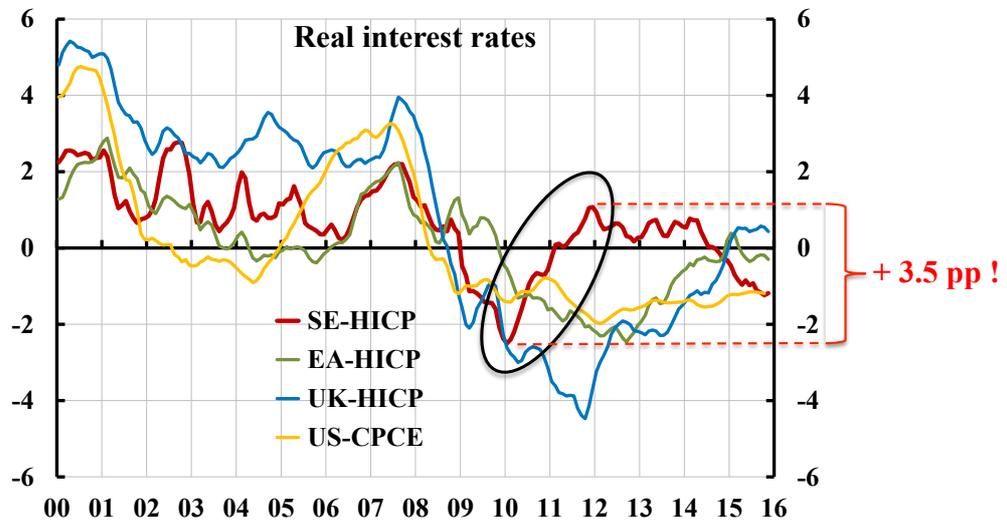
# Background: Large and rapid increase in Riksbank policy rate 2010-2011



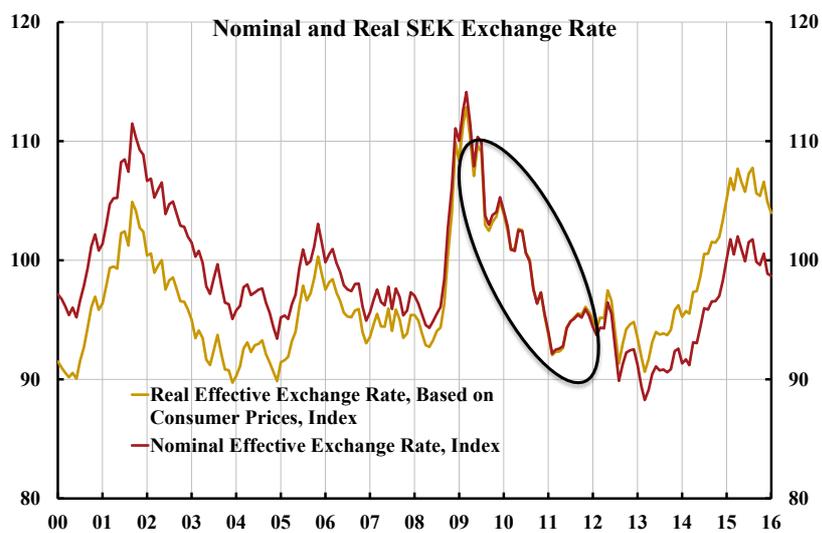
# Swedish inflation fell rapidly



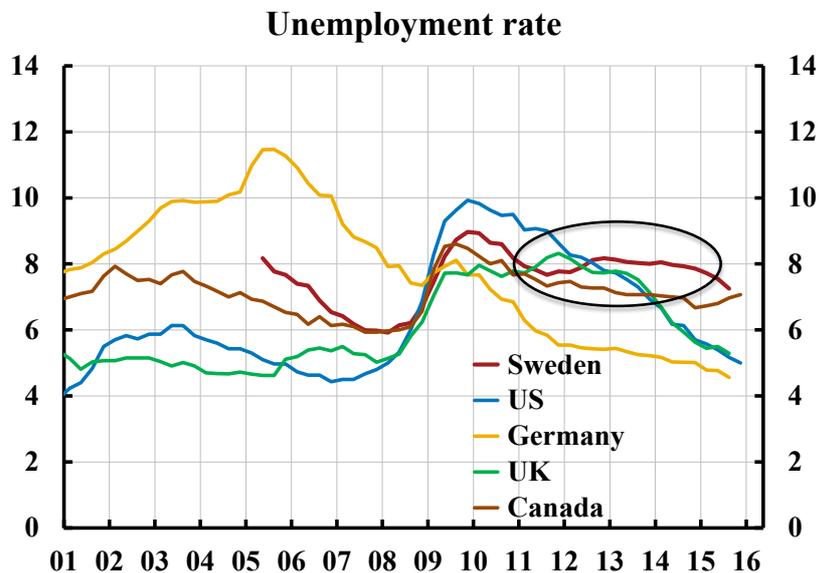
**Riksbank real policy rates increased even more,  
causing large real interest gap to Eurozone, UK, and US**



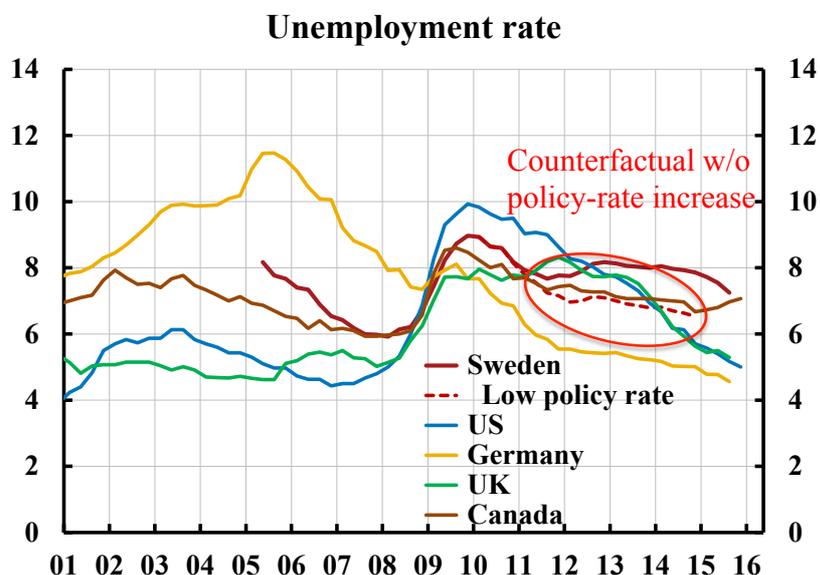
**Swedish Krona appreciated dramatically**



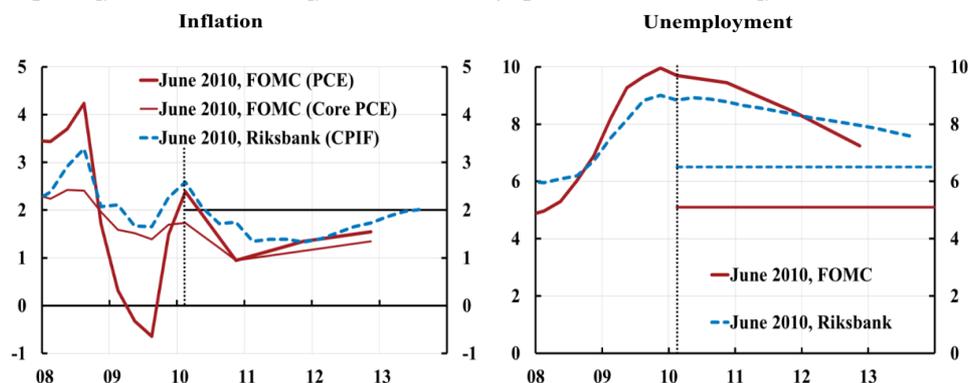
## Swedish unemployment stayed high



## Swedish unemployment rate more than 1 pp higher than counterfactual with no policy-rate increase



## Fed and Riksbank June 2010 forecasts of inflation and unemployment very similar; policies very different



- If inflation forecast below target & unemployment forecast above long-run sustainable rate, then policy *easing* is the right thing
- Bernanke (2010): Given these [June 2010] forecasts and FOMC objectives, “there would appear to be a case for further action” [, prepare QE2]
- Or does anyone wish that the Fed would have followed the Riksbank example?

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



9

## Riksbank tightening 2010-11

- Large costs of Riksbank tightening
- Including making the economy more vulnerable to any negative shock (such as the Eurozone crisis)
- Could there have been any benefits?
- Cost-benefit analysis of leaning against the wind
- Numbers and estimates are needed



10

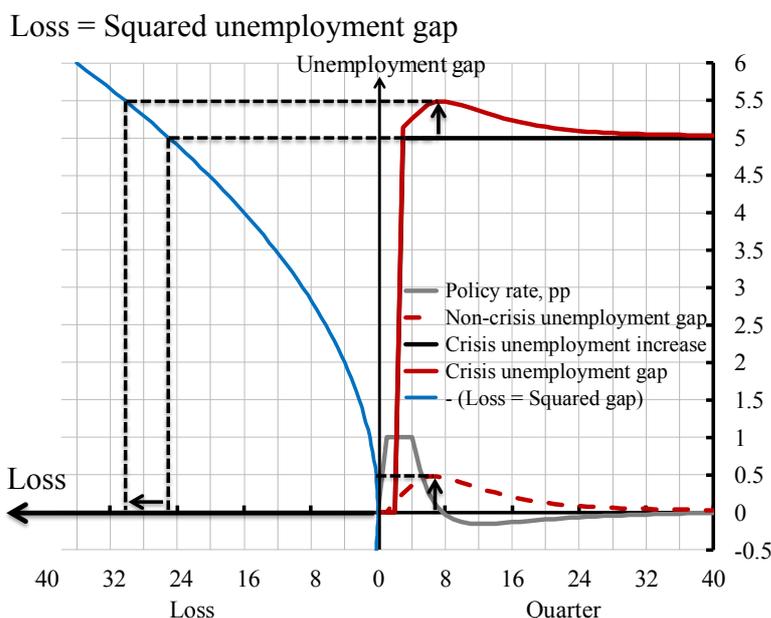
## Cost-benefit analysis of “leaning against the wind” (LAW) for financial-stability purposes

- LAW: Tighter policy than justified by normal flexible inflation targeting
- Instead undershooting the inflation target and/or overshooting the long-run sustainable unemployment rate
- Costs: Higher unemployment, lower inflation
- Possible benefits: Lower probability or severity of a financial crisis
- Forgotten additional cost in previous literature: Higher cost of a crisis if economy initially weaker because of LAW



11

## Unemployment gap in non-crisis and in crisis, for 1 pp higher policy rate for 4 quarters (Riksbank estimates)

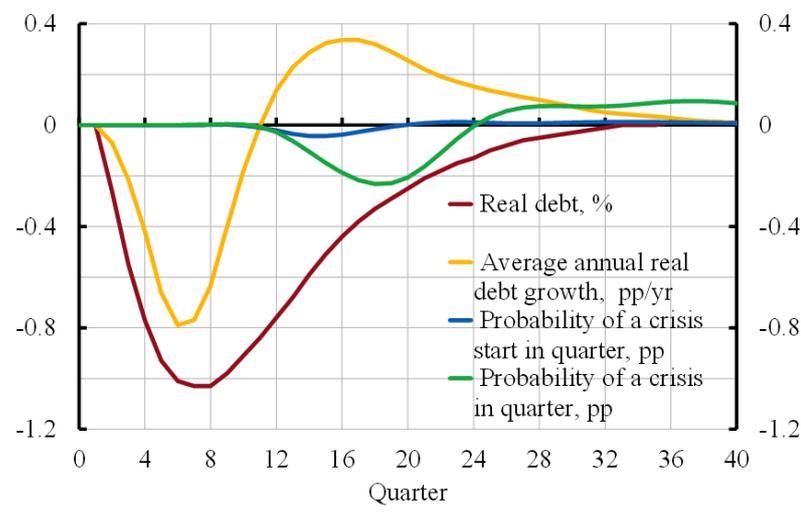


- Noncrisis:  
Unemployment gap:  
From 0 to 0.5 pp  
Loss: From 0 to 0.25  
Loss increase: 0.25
- Crisis:  
Unemployment gap:  
From 5 to 5.5 pp  
Loss: From 25 to 30.25  
Loss increase: 5.25
- Additional cost of LAW:  
Crisis loss increase is 11 times  
non-crisis loss increase



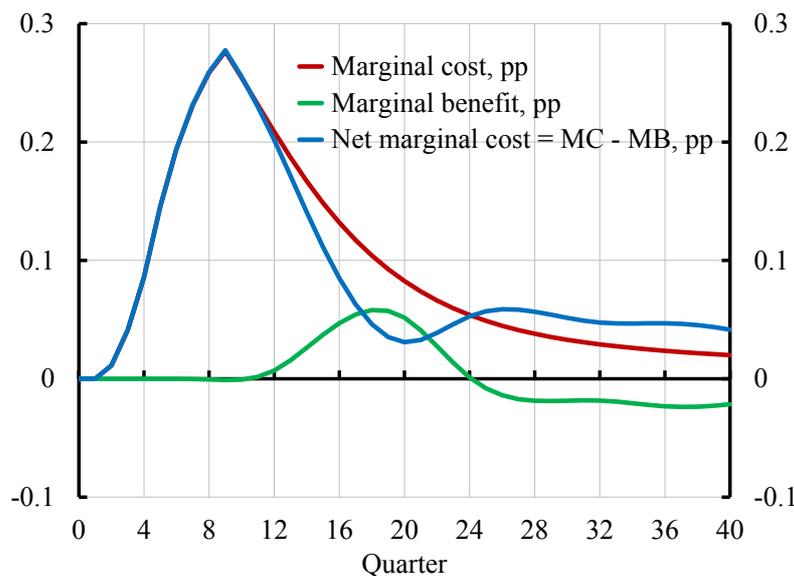
12

**Benefit: Lower probability? Household debt, debt growth, probability of crisis start, and probability of crisis from 1 pp higher policy rate (Riksbank, Schularick and Taylor 2012)**



Svensson (2016), “Cost-Benefit Analysis of Leaning Against the Wind : Are Costs Larger Also with Less Effective Macroprudential Policy?” IMF Working Paper WP/16/3.

**Marginal cost much larger than marginal benefit of policy-rate increase; net marginal cost large**



Svensson (2016), “Cost-Benefit Analysis of Leaning Against the Wind : Are Costs Larger Also with Less Effective Macroprudential Policy?” IMF Working Paper WP/16/3.

## Cost-benefit analysis of “leaning against the wind” (LAW)

- Given existing empirical estimates, the cost is larger than the benefit by a substantial margin
- Empirically, the possible effect of the policy rate on the probability or severity of a crisis is too small
- The main component of the cost is the additional crisis cost (the higher cost of a crisis because the economy is weaker due to LAW)
- Ineffective macroprudential policy may increase the probability or severity of a crisis
- Higher probability of a crisis gives more weight to the additional cost; larger severity increases additional crisis cost
- Ineffective macroprudential policy therefore increases the cost of LAW more than the benefit, makes the cost exceed the benefit by an even larger margin

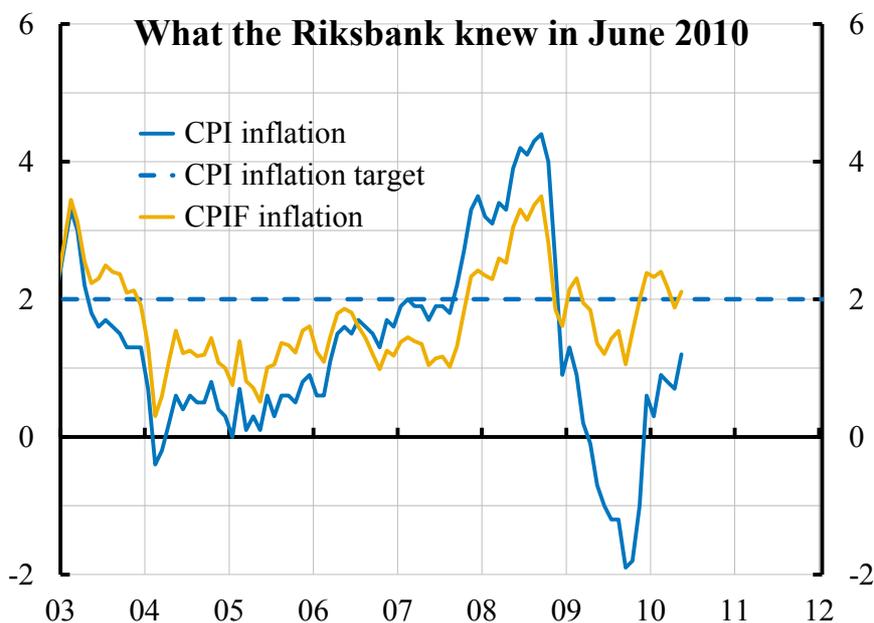


## Extra slides

**Was the tightening justified given the info at the time?**

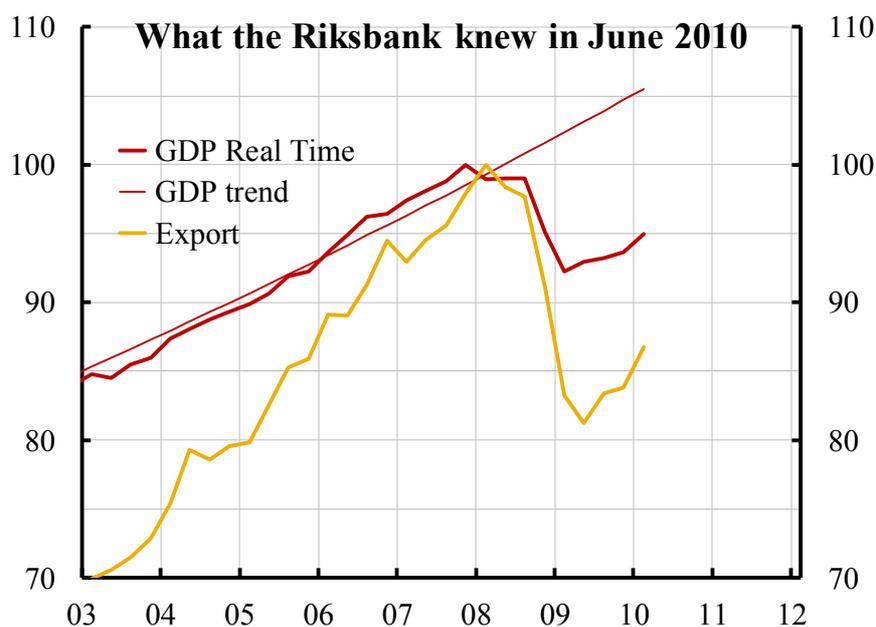
- What did the Riksbank know?

## CPI inflation below target



19

## GDP 5% below peak, 10% below trend; export 13% below peak

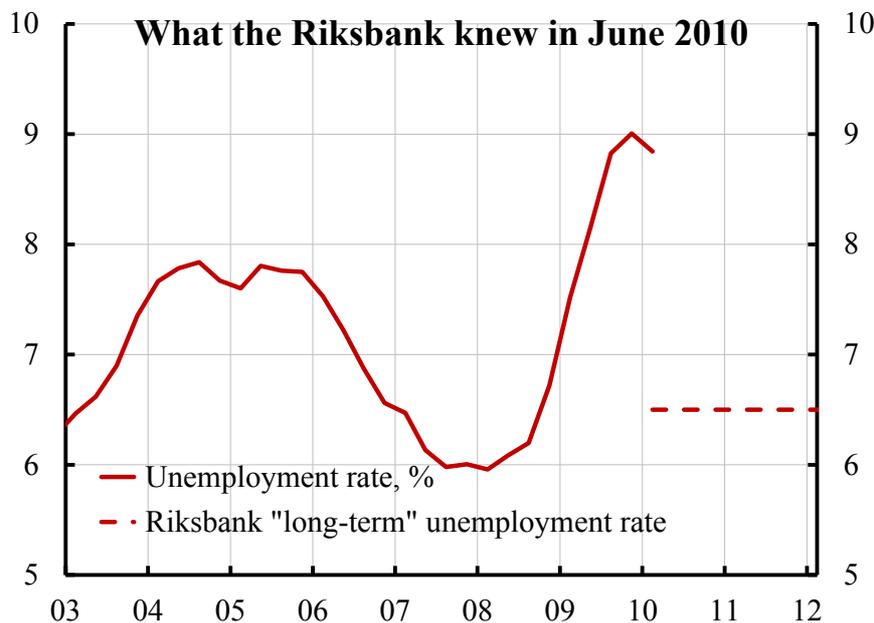


Svensson (2016), "Two serious mistakes in the Goodfriend and King review of Riksbank monetary policy," Blog post, January 22, [www.larseosvensson.se](http://www.larseosvensson.se).



20

## Unemployment close to 9%, at peak; far above Riksbank's "long-term" unemployment rate



Svensson (2016), "Two serious mistakes in the Goodfriend and King review of Riksbank monetary policy," Blog post, January 22, [www.larseosvensson.se](http://www.larseosvensson.se).



21

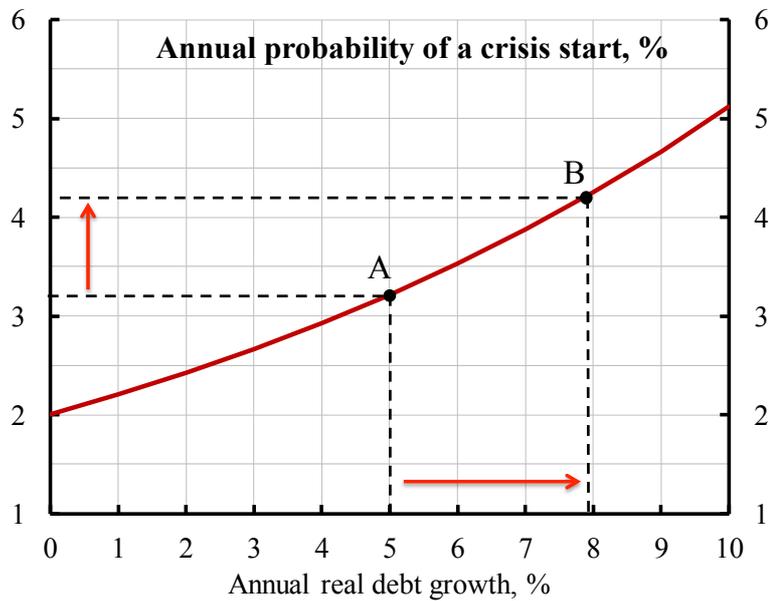
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- LAW: Tighter policy than justified by normal inflation targeting
- Costs: Higher unemployment, lower inflation
- Possible benefits: Lower probability or severity of a financial crisis
- Forgotten cost: Higher cost of a crisis if economy initially weaker because of LAW
- What if macroprudential policy is less effective?



22

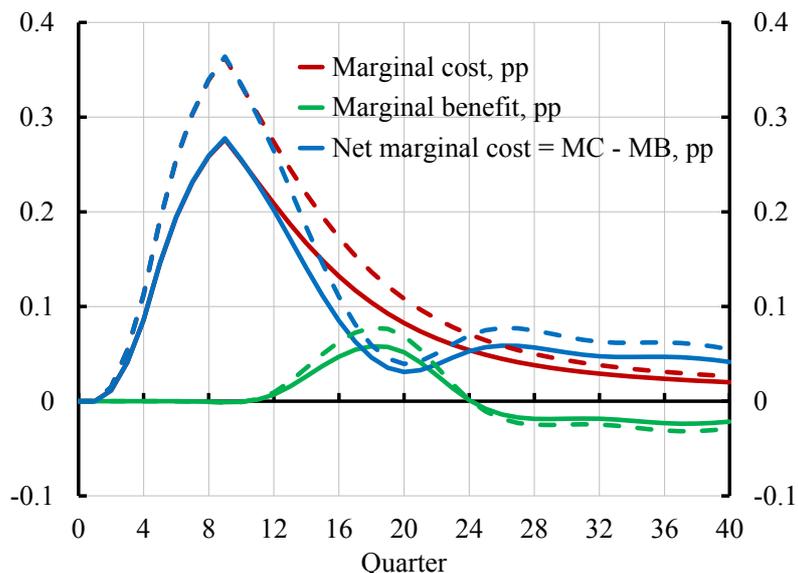
## Less effective macroprudential policy, higher debt growth, higher probability of a crisis



Svensson (2016), "Cost-Benefit Analysis of Leaning Against the Wind : Are Costs Larger Also with Less Effective Macroprudential Policy?" IMF Working Paper WP/16/3.



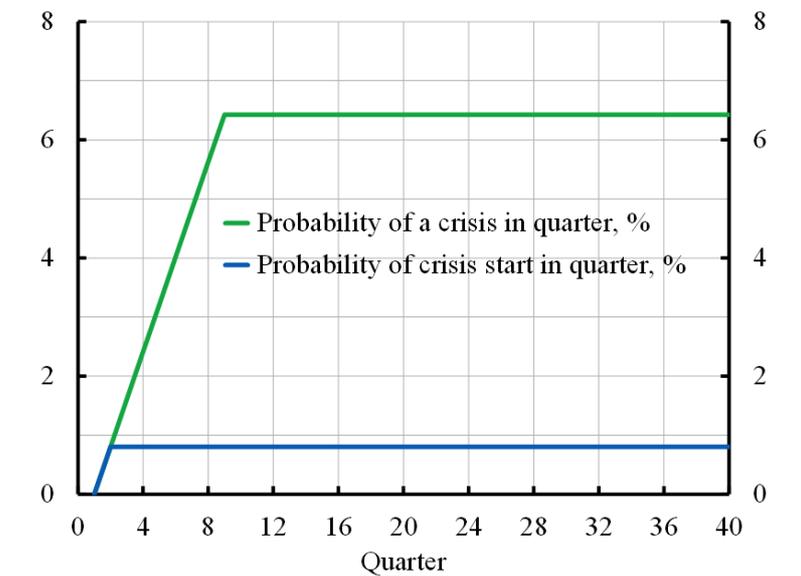
## Less effective macroprudential policy increases marginal cost more than benefit



Svensson (2016), "Cost-Benefit Analysis of Leaning Against the Wind : Are Costs Larger Also with Less Effective Macroprudential Policy?" IMF Working Paper WP/16/3.



# Benchmark probability of crisis start and crisis in given quarter



Svensson (2016), "Cost-Benefit Analysis of Leaning Against the Wind : Are Costs Larger Also with Less Effective Macroprudential Policy?" IMF Working Paper WP/16/3.