Reflections

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Changes in the monetary policy framework?

Håkan Frisén
Head of Economic Forecasting
+46 70 763 80 67
hakan.frisen@seb.se

Last year the Federal Reserve changed its monetary policy principles. The Fed is now prepared to accept inflation a bit above its 2 per cent target in order to compensate for its previous bias against undershooting the target. This also means that the central bank is really prepared to test how hot the US labour market can become before harmful overheating problems emerge. Reviews of monetary policy frameworks are currently underway in various other countries, and the question is what inspiration the Fed can provide. The EU Treaty imposes some restrictions on the ability of the European Central Bank (ECB) to follow in the footsteps of the Fed, but the ECB can at least make its inflation target more symmetrical. Sweden's Riksbank also has limited room for manoeuvre, but it must still try to find its own ways to prevent inflation expectations from distancing themselves too far from the 2 per cent inflation target. Deputy Governor Per Jansson has raised the idea of eventually making the inflation target higher. He has also signalled that the Riksbank may need help from both fiscal policy makers and a re-imagined wage formation system in order to handle the challenges. This may be the beginning of an intensified debate on how Sweden should deal with the problems that arise when its existing stabilisation policy framework is being questioned in various ways.

Debate on monetary policy frameworks and their applications has gained new momentum, due to the changes that the US Federal Reserve implemented during 2020. The Fed's expanded ability to test how hot the labour market can become before harmful overheating symptoms emerge will change the playing field substantially. The Fed is also taking steps towards price level targeting, in the sense that its previous bias towards undershooting the inflation target will now be offset by increased tolerance for overshooting the target. There is an asymmetry in this arrangement. The Fed wants to avoid committing itself to forcing inflation below 2 per cent if it were to face the opposite of today's challenge after a period of above-target inflation. This attitude clearly reflects which way the winds are now generally blowing; by various means, the Fed wants to avoid being caught in the trap that arises when a low neutral real interest rate eats up the manoeuvring room of interest rate policy on the downside. In practice, this shift represents a kind of forward guidance in a dovish direction. It has already had some effect in the form of rising inflation expectations, although announcements in the United States and elsewhere about fiscal stimulus measures have also played a part. Evaluations of such frameworks are now also taking place in Europe. The overriding role of the inflation target is enshrined in the Treaty on European Union, which entails some restrictions. But the European Central Bank (ECB) is likely to make its inflation target symmetrical. Leaving behind its previous bias – a certain preference for undershooting the target – is an easy way to try to boost inflation expectations.

Bad timing for the Riksbank Commission of Inquiry. The economic crisis caused by the pandemic, combined with the Fed's changes, almost seem to have created a certain amount of confusion in the Swedish monetary policy debate. The report of the parliamentary Commission of Inquiry on the Riksbank, which was published early in 2020, will now start to be processed in the political system. But this will take a long time, and some of its proposals even require amending the constitution. There were probably expectations of more concrete proposals on how monetary policy could meet new challenges. But this is largely already in the hands of the Riksbank. The EU Treaty's restrictions also apply to Sweden, even though we are outside of the euro area. This applies, for example, to the possibility of formally elevating employment to a target of equal importance alongside inflation. The focus of the commission report is instead on more clearly delimitating areas of responsibility between the Riksbank – on the one hand – and Parliament, the government and other public agencies such as the Swedish Financial Supervisory Authority (FSA) and the National Debt Office (NDO) on the other. This may concern frameworks for the management of foreign exchange reserves, the Riksbank's balance sheet, equity capital, asset purchases and so on. As the Riksbank gains access to more and more tools that have a profound impact on the entire market economy, this becomes increasingly important. We may sometimes get the impression that the Riksbank "takes on" a bit too much. This may be due to the fact that it has a strong organisation with great authority and confidence in its capabilities. These issues are thus important, even if they perhaps do not attract as much attention among economists as the more mundane application of monetary policy.

Riksbank out of step with other countries. Looking at Swedish public debate, we can certain say that criticism of the Riksbank in recent years has aimed at bringing about changes that would go in the opposite direction from what the Fed is now doing. Critics have argued in various ways that the Riksbank should not devote all of its ammunition to pushing up inflation:

"Leaning against the wind". An even more expansionary monetary policy has the disadvantage of driving up asset prices and household debt. By "leaning against the wind" and taking this into account, the Riksbank can mitigate future problems.

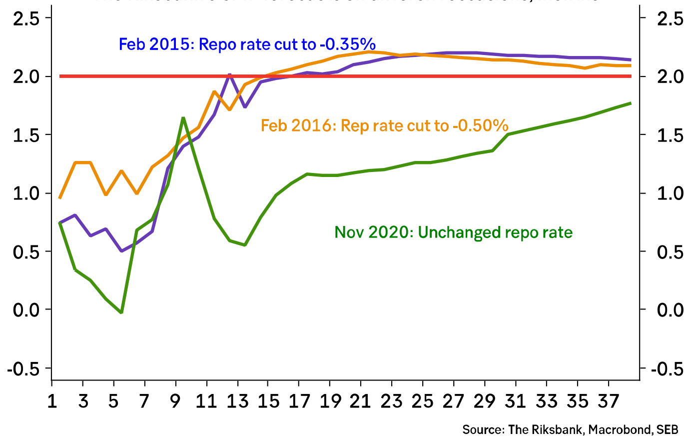
"Mission impossible". The Riksbank should realise that it is waging a hopeless battle against strong international disinflationary forces and should therefore increasingly accept deviations from its 2 per cent inflation target. A lowering of the inflation target is sometimes regarded as one way of adapting to these new conditions.

"That maddening CPI metric". The Consumer Price Index (CPI) has various shortcomings. Some people argue that it is too narrow and should also take asset prices into account. A more common argument is that Swedish CPI is measured in an overly sophisticated way. For example, Statistics Sweden makes more extensive quality adjustments for price increases than its peers in other countries. Increases in official CPI thus tend to be lower than price increases for a more "down to earth" consumption basket, with the Big Mac Index as the most extreme approach.

Harder to use the Fed as a model. The above factors have thus been put forward as reasons why the Riksbank's struggle to bring inflation up to target has actually been unnecessarily aggressive and sometimes also harmful. Our own assessment is that problems with measurement methods are often exaggerated, and we also see clear disadvantages in lowering the target as an adjustment to a recalcitrant world. On the other hand, we have some sympathy for the idea that in certain situations it is reasonable to "lean against the wind" and take into account such risks as runaway household debt and asset prices. We have also identified other factors that make the application of monetary policy more difficult. One important factor is time lags in the inflation process, with inflationary impulses often arriving late in the economic cycle. The Riksbank's focus on actual inflation in such an environment has led to a clear pro-cyclical pattern, with its key interest rate increases in 2001 and especially in 2008 as clear examples. There are also examples of key rate cuts amid heated economic conditions. For this reason, we have viewed the Fed's pragmatic way of also taking into account the general economic situation – especially in the labour market – as a way of making monetary policy work, even in an environment where an inarticulate Phillips curve provides ambiguous associations between economic conditions and price and wage formation.

Increased tolerance for deviations from the inflation target

The Riksbank's CPIF forecasts on different occasions, months



Source: The Riksbank, Macrobond, SEB

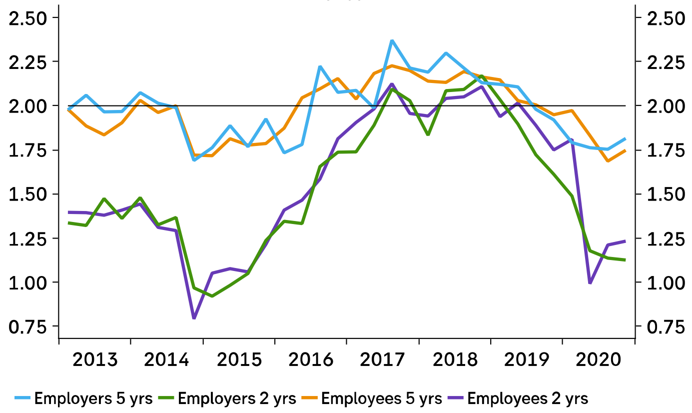
Special disadvantages of negative key interest rates. There has been an especially great need for increased flexibility in a situation where negative interest rates and a highly volatile krona have created uncertainty for economic actors. Our interpretation is that the Riksbank has now also begun to view this situation as a problem. Over the past six months, the Riksbank has published inflation forecasts in which it "admits" the difficulties of reaching the inflation target within its forecast horizon. In spite of this, the bank has settled for expanded asset purchases and has refrained from bringing its key interest rate back into negative territory. Of course, there is a risk that this will lead inflation expectations to fall uncomfortably low unless the Riksbank signals what it wants to do about this.

No plans to lower the inflation target. Among those on the Riksbank's Executive Board, Deputy Governor Per Jansson is perhaps the member who has discussed these issues most concretely, for example in a recent speech entitled "Some thoughts on the need for changes to inflation targeting" (December 16, 2020). Although the Board may include some differing points of view, it is interesting to examine Jansson's ideas about how the current situation – where inflation looks set to remain low for the foreseeable future – can be managed given the conditions prevailing in Sweden. Jansson firmly rejects the idea of lowering the inflation target and adopting a generally relaxed attitude to inflation that remains clearly and persistently below target. His main argument is that this would only aggravate the situation by leading to unnecessarily high real interest rates and further declines in inflation expectations. In the long run, such action would further reduce the manoeuvring room for monetary policy in an environment of depressed neutral real interest rates. Jansson's thoughts on these matters are probably close to the mainstream in the international debate, both among academics and policy makers, and it seems highly unlikely that Sweden would move in that direction.

Is it possible to raise the inflation target? Jansson goes one step further and adopts a rather sceptical attitude towards the Fed's attempt to raise inflation expectations with its long-term guidance. He concludes that at least it is not suitable to Swedish conditions. Instead, Jansson raises the bigger question of the potential for raising the inflation target to 3 per cent in the long run, in order to increase room for manoeuvre and create a greater distance from the zero interest rate bound. Although this feels remote at present, conditions may change once the economic situation normalises. In addition, Jansson believes that global disinflationary forces may weaken in the long term. Making an early announcement of plans for a higher inflation target when the opportunity presents itself might raise inflation expectations in the near future.

Falling inflation expectations

Per cent



Source: TNS Prospera, Macrobond, SEB

Help from fiscal policy and wage formation. Yet the big picture today is attempts to broaden responsibility for the dilemma we are facing in fiscal policy, macroprudential supervision and wage formation. During the COVID-19 crisis, fiscal policy makers have shouldered a larger share of responsibility, cheered on by both international organisations and central banks. Jansson goes one step further and raises the question of whether it is possible to formalise fiscal relief measures so that they arrive faster and are not delayed by political battles. The issues he discusses at greatest length concern the interaction between the Riksbank and wage formation. "Maintaining confidence in the inflation target, so that it can continue to function as a benchmark for price-setting and wage formation…is the whole point of inflation targeting," according to Jansson. He then addresses the debate on the role of the "industrial sector's benchmark" in Swedish wage formation, noting that this system worked smoothly for a long time, but that it may now create socio-economic imbalances. This is mainly because of the tendency to reach collective agreements that are a bit too low to be compatible with the inflation target. In addition, the current system makes it hard to change relative wages in ways that might make the labour market work better, which is also a problem. (See also "Theme: 2020 Wage Round", *Nordic Outlook*, November 2020)

A focus on both inflation targets and other countries. The leading role of the industrial sector in Swedish wage formation has recently been questioned with varying intensity. The main criticism is that the system is actually rigged for a fixed exchange rate system. In such a system, industrial firms that are exposed to foreign competition will be the first to suffer if high wage and salary increases undermine their competitiveness. In a world of floating exchange rates and inflation targets, domestically oriented sectors are affected at least as severely if the Riksbank is forced to hike its key interest rate in response to collective pay agreements that threaten to drive up inflation. This is nothing new, of course. Ever since today's wage formation framework took shape in the mid-1990s, employer and employee organisations have tried to balance both perspectives and take into account restrictions imposed both by the inflation target and pay increases in other countries. There is a consensus between the two sides that they cannot rely on exchange rate movements to offset large deviations from wage and salary increases in other countries – especially Germany – within a reasonable time. This is one good reason for preserving the system of letting the industrial sector go first and establish a "benchmark" for the rest of the Swedish labour market. The word "benchmark" is also carefully chosen; it does not need to be a norm that everyone must follow, if there are good reasons to diverge from it. In practice, however, the standards for valid reasons to diverge from it have become stricter and stricter.

Stronger reasons to enter a minefield. As long as pay increases tended to be slightly higher than was consistent with the inflation target, the Riksbank quite often took the initiative to offer clear advice. But after the opposite problem emerged around 2012, it has probably been regarded as more sensitive to complain about excessively low pay agreements in a world of generally low wage hikes. The reason why a member of the Riksbank's Executive Board is now choosing to get involved in this very sensitive discussion is probably that the balance has been disrupted a bit. Over the past decade, both the Riksbank and the ECB have found it difficult to reach their inflation targets, due to strong disinflationary forces. Not surprisingly, these forces have been even stronger in the euro area, which among other things has suffered an existential crisis. A certain underlying decline in the nominal exchange rate of the krona is a natural consequence, both theoretically and anecdotally. This is also reflected in SEB's estimates of the krona's equilibrium exchange rate, which has moved upward and is now believed to be about SEK 9.70 per EUR.

Reversing the target for pay hikes? Such estimates are, of course, uncertain and must be handled with care. Employer and employee organisations are probably wise to remain cautious about relying on exchange rate movements to offset large divergences from other countries. Yet there are signs that the pendulum is swinging in the other direction. Sometimes it is considered a problem that Sweden has succeeded a little better than the euro area in meeting its inflation target; it would thus be desirable for Sweden to have a lower rate of price and pay increases in the future than, for example, the euro area. In principle, such reasoning means accepting a reverse version of the historical "sin" than the Fed now wants to atone for. Instead of compensating for earlier undershooting of the target by allowing higher inflation, Sweden would try to push down the rate of pay and price increases in order to compensate for the previous trend. Such an approach represents a major deviation from floating exchange rate principles and would introduce strong deflationary forces into the economy. It is therefore reasonable for the Riksbank to object to this. Not only are some representatives of the employer side pursuing similar arguments, but there is also a broader reluctance in Swedish society to accept certain consequences of the current monetary policy framework, which may be a problem as long as public resistance to joining the euro area is so compact.

The Riksbank needs to show its own cards. It is thus reasonable to try to broaden the discussion about how changes in other countries are best handled under prevailing Swedish conditions. For the Riksbank to point out that fiscal policy and wage formation can contribute to easing current tensions is natural. But to be realistic, it is unlikely that much will change over the next few years. Three-year wage and salary agreements were recently put in place. Given the prevailing labour market situation, the Riksbank can hardly complain about their levels. In any case, the two sides have no reason now to begin discussions about systemic changes. Meanwhile, the EU Treaty blocks some opportunities for coordination between fiscal and monetary policy. It is also difficult to foresee that an increase in the inflation target, for example to 3 per cent, will seriously be put on the agenda in the international debate during the foreseeable future. Sweden can hardly pursue this path alone. There will also be calls for the Riksbank to display its own creativity when it comes to finding solutions that will allow it manoeuvring room and will prevent inflation expectations from moving in a direction that indicates serious credibility problems. Unfortunately, on a number of occasions in recent decades the Riksbank has been unclear about its intentions, and its lack of flexibility has led to sudden policy shifts and sometimes harsh applications of the existing framework. It is obvious that at present, the Riksbank wants to avoid lowering its key interest rate to negative levels. But since its motives are quite unclear, there is a risk that the Riksbank will deliver cuts at a time when actual inflation is again falling. In that case, it would occur at a stage when the economy has reached firmer ground and would thus give monetary policy a pro-cyclical direction again, as we have previously seen on multiple occasions.