Some thoughts on the need for changes to inflation targeting

Handelsbanken 16 December 2020

SVERIGES RIKSBANK

Per Jansson

Deputy Governor

Difficulties since the financial crisis

- Low global real interest rates – low “neutral” interest rate
- Difficult to make monetary policy sufficiently expansionary
- Central banks’ policy rates at or close to lower bound
- Inflation below target
- The pandemic has exacerbated the problems, but they were already there

Two main challenges

1 Maintain confidence in the inflation target – continued benchmark for price-setting and wage formation

2 Ensure that monetary policy can fight recessions and sustain employment in difficult times

These are interrelated!

Three themes in my speech

Why it is important to uphold the inflation target

Why it would be even more favourable to increase the target

Why we need to take a holistic approach to the interaction between our economic objectives

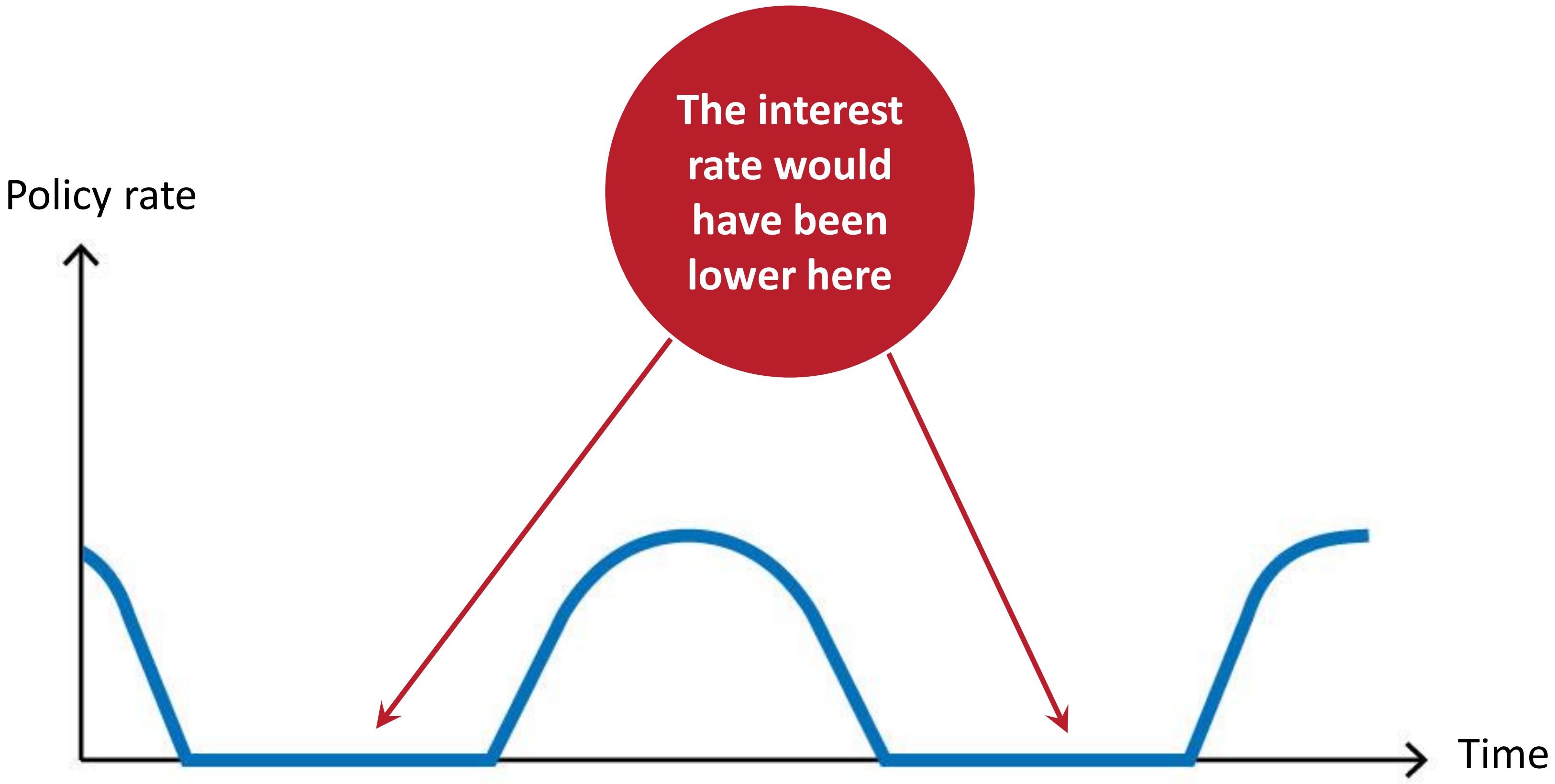
Removing focus from the inflation target is no solution

- *“If you don't take the inflation target so seriously, you can conduct more flexible monetary policy, which is important to dampen rapidly rising asset prices, for instance”*

- Very probable scenario:
  - Persistently lower inflation and falling long-term inflation expectations
  - Lower average nominal interest rate, including policy rate

- The interest rate will become *less* effective – *less* room for manoeuvre

Low average inflation – interest rate often at lower bound



Negative for the Swedish economy

- Swedish price-setting and wage formation without nominal anchor
- And also more difficult to cut rate in poorer times to counteract unemployment
- May also be more difficult to attain other objectives if interest rate does not function well!
- Furthermore: Negative interest rate more common

Central banks reviewing strategies

- ECB and Bank of Canada will complete their reviews in 2021

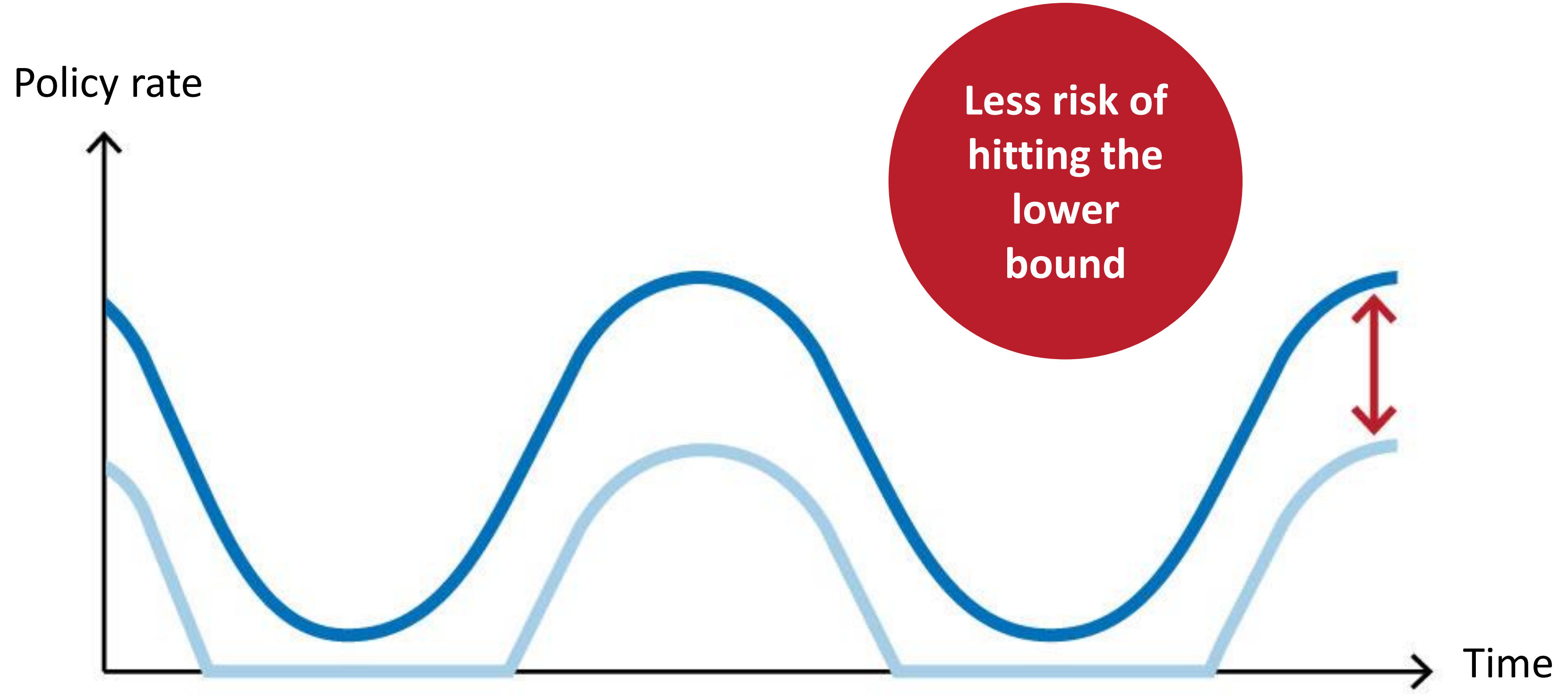
- Federal Reserve made changes in August:
  - “Flexible Average Inflation Targeting”
  - Compensate for earlier (negative) deviations from target – “bygones” not “bygones”
  - “Shortfalls” instead of “deviations” from “maximum employment”

- Aim: Reduce the risk that inflation and expectations will fall

Remaining questions regarding the Fed's changes

- Symmetrical? Perhaps not important right now, and in theory no problem, but unsatisfactory that strategy is not "stance-neutral and cycle-blind" (Angeloni)
- A long time above the target after a long time below – how long, how much?
- Problematic for wage formation with agreements running over several years (as in Sweden)
- Even if it works: target of average of 2 per cent gives limited monetary policy scope

A higher inflation target is a longer-term solution



Is a higher inflation target unrealistic?

- Both the policy rate and asset purchases will function better

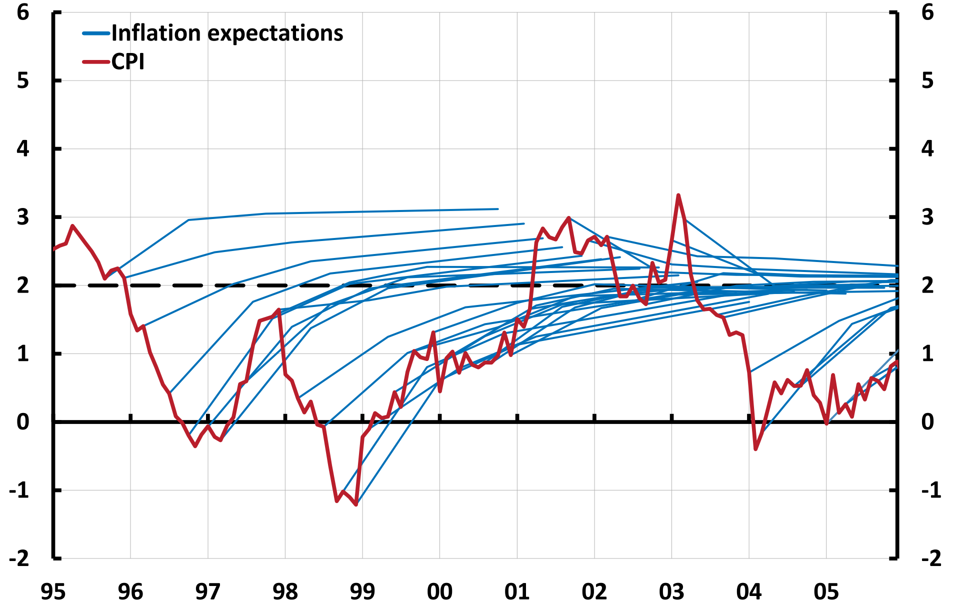
- Central banks' reviews give greater openness to more far-reaching solutions

- Structural forces that have dampened inflation are now going into reverse
  - Global demography, China, etc. (Goodhart and Pradhan, 2020)

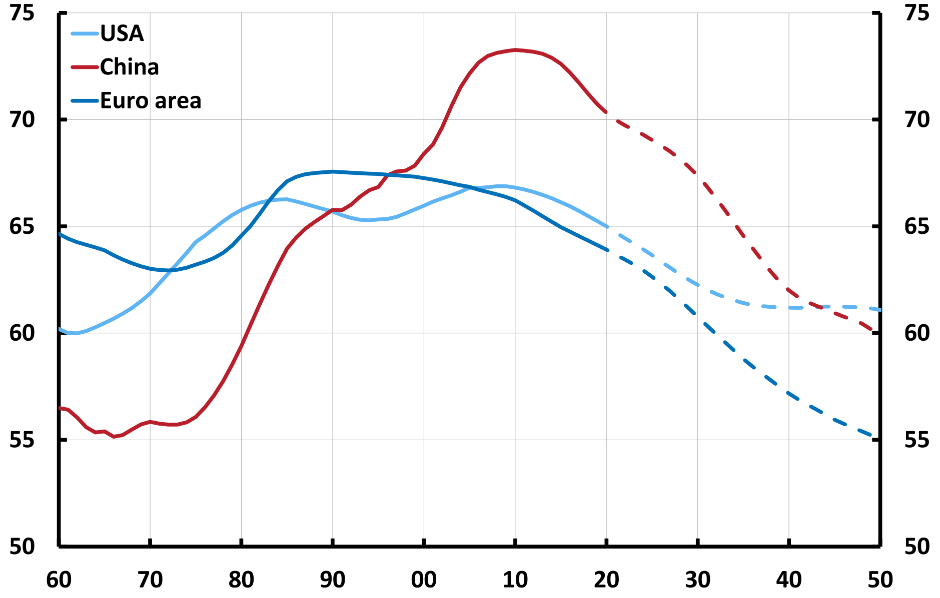
- Should be possible to establish, can be allowed to take some time – in the same way as the current target in the 1990s

Not impossible to establish confidence in a higher target

2-per cent target was anchored gradually



Population of working age is decreasing



The broken line in the left-hand figure shows the 2-per cent inflation target. Inflation expectations refer to money market participants and inflation one, two and five years ahead. The right-hand figure shows the percentage of the population aged 15-64 years, per cent.

Sources: Statistics Sweden, SIFO Prospera and the World Bank

Expectations are key

Structural thinking with the aid of two questions

1

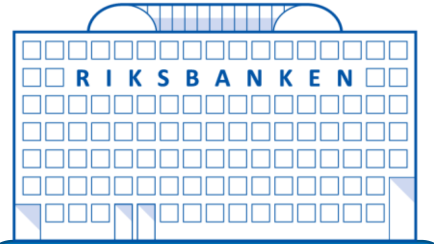
If the Riksbank raises the inflation target, would it affect monetary policy in a more expansionary direction?

2

If the answer to this question is yes, would it in turn affect the expected inflation rate, at least in the slightly longer term?

Answering no to these questions means a very strange Riksbank and very strange economy...

Higher target can give considerable monetary policy stimulus



The Riksbank must make more effort

→ Lower interest rate, low interest rate over a longer period of time

→ Higher expected inflation

↓

Lower actual and expected real interest rate

↓

Higher demand and inflation

Need for holistic approach to the interaction between our economic objectives

- The inflation target
    - Economic objective with political support (Jansson, 2019)

- long-term sustainable public finances
    - Insights after GFC, euro crisis, COVID-19: fiscal policy needs to support monetary policy
    - Balancing act – not jeopardise sustainable public finances
    - Some formalisation of the interaction is desirable

Need for holistic approach (cont.)

- Financial stability
  - Low global real interest rate and expansionary monetary policy and makes demands on macroprudential policy and regulations
  - My view: monetary policy should focus on stabilising inflation and economic activity

- Efficient wage formation
  - Need to give consideration to more than just international competitiveness – balance on the labour market as a whole
  - Bring about a sober and objective discussion on the need for changes in wage formation in the same way as we discuss the need for reform in other areas

My most important messages

- Historically low global real interest rates
  - More difficult to attain inflation target
  - More difficult to counteract falls in employment and production with interest rate cuts
- Less focus on inflation targeting is not the solution
  - Reduces monetary policy room for manoeuvre
- Raising inflation target a more sustainable solution
  - My view: many under-estimate the potential to make a higher target credible
- The interaction between our economic objectives is in need of review
  - Managing trade-offs, see how we can make the whole economy function in the best way