Monetary policy and the interest rate path

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Flexible inflation targeting

- Stabilise inflation around the inflation target
- Stabilise resource utilisation

2

Strict inflation targeting

- Only stabilise inflation around the inflation target
- Large interest rate adjustments up and down
- Large fluctuations in resource utilisation, output and employment
- Only pedagogical simplification
- All central banks with an inflation target conduct flexible inflation targeting

3

Flexible inflation targeting

- Weight on stabilising resource utilisation may increase over time
- New regime
  - Establish credibility
  - Greater weight on stabilising inflation
- Established regime with credibility
  - Larger weight on stabilising resource utilisation

4

Warning

- Too much weight on stabilising resource utilisation can threaten credibility
- Monetary policy cannot affect average resource utilisation, only stabilise it around the given average level
- Monetary policy target for average resource utilisation: Makes no sense
- Monetary policy target for inflation: Makes a lot of sense

5

Forecasts

- Inflation and resource utilisation react with a significant lag to monetary policy measures
- “Long and variable lags” (Friedman)
- The Riksbank’s interest rate decision is based on forecasts for inflation and resource utilisation 1-3 years ahead

6

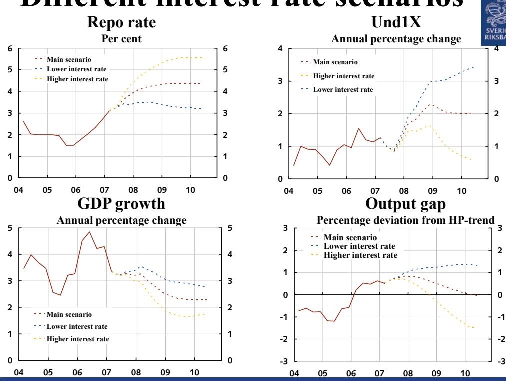
Expectations of the entire repo rate path is what matters

- The repo rate over the next few weeks has little significance for future inflation and resource utilisation
- Expectations of the entire repo rate is what matters, not the repo rate the next few weeks
- “Management of expectations” (Woodford)

Flexible inflation targeting

- Choose the interest rate path so that the resulting forecast for inflation and resource utilisation “looks good”
- “Looking good:” Inflation approximately 2% and resource utilisation normal 2-3 years ahead, or information approaching target and resource utilisation approaching normal level at appropriate pace
- “Well-balanced” monetary policy
- “Forecast targeting”

Different interest rate scenarios



Note. Broken lines refer to the Riksbank’s forecasts Sources: Statistics Sweden and the Riksbank

Natural trinity

- Forecasts for interest rate, inflation and resource utilisation form a natural trinity
- Interest rate forecast (assumption) necessary for forecast of inflation and resource utilisation
- All central banks that stabilise inflation have interest rate forecasts or assumption in their materials preparing the decision (even when these are not published)

Choice and publication of interest rate path

- Monetary policy works through expectations of the interest rate path
- The entire interest rate path matters, not the repo rate over the next few weeks
- Riksbank conclusion:
  - Explicit discussion and selection of main interest rate forecast (otherwise incomplete decision-making process)
  - Publication of interest rate path (otherwise hiding most important information)

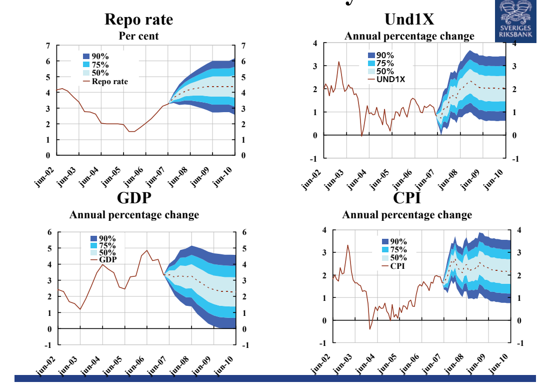
Riksbank not the first (but No. 3)

- Reserve Bank of New Zealand from 1997
- Arguments in favour from several researchers
- Norges Bank from Spring 2005
- Riksbank from February 2007
- Sedlabanki Islands from March 2007
- Czech National Bank from 2008
- Next?

Forecasts are uncertain

- Probability distribution
  - Mean
  - Uncertainty interval
- Dependeds on available information
- Revised when new information is received
- Forecast, not a promise!

Mean value with uncertainty interval



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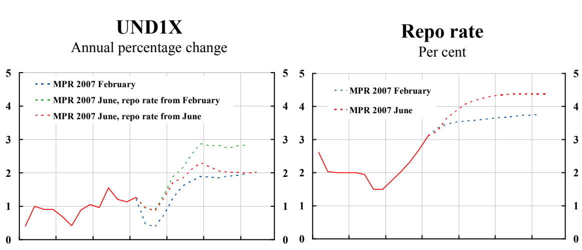
Forecast targeting: Handling new information

- New information relevant only if it changes the forecast for inflation or resource utilisation *forth an unchanged interest rate path*
- "Filter new information through the forecast"
- New info shifts forecasts for inflation and resource utilisation up (down) with unchanged interest rate path
- Shift interest rate path up (down)

Forecast targeting: Handling new information

- Forecast in February: Well-balanced monetary policy given information then
- New info up to June:
  - Higher wage agreements
  - Lower productivity
  - More expansionary fiscal policy
- Shifted forecasts for inflation and resource utilisation up for unchanged interest rate path
- Shift interest rate path up: Interest rate path in June above high-wage scenario in February



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Resource utilisation

- Important variable in flexible inflation targeting
- Can be measured in several ways
- Output gap:
  Actual output less "potential" output
- Theoretical and empirical difficulties in estimating and forecasting: Uncertainty in measures
- Strong reasons for more research

Summary

1. Flexible inflation targeting: Choose an interest rate path so the forecast for inflation and resource utilisation looks good
2. Expectations of the entire interest rate path, not the repo rate over the nest few weeks, is what matters
3. Discussion, selection and publication of the interest rate path is the only right thing to do

- New information relevant only if it affects the forecasts
- Strong reasons for more research on measures of resource utilisation