

Lars Heikensten: Introduction on monetary policy

Speech by Mr Lars Heikensten, Governor of the Sveriges Riksbank, to the Riksdag Committee on Finance, Stockholm, 18 March 2003.

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Let me begin by thanking you for the opportunity to come here to the Committee on Finance and discuss monetary policy. This is the first time I have come here as Governor of the Riksbank. I have looked forward to today's meeting with you, our owners, and I shall do all I can to provide you with the information you need.

These open hearings began originally at the initiative of the Riksbank. They were an expression of our endeavour to bring about an open discussion on monetary policy in society, an endeavour that has since taken on many other aspects, lengthy Inflation Reports, a clear rule-of-thumb that can be evaluated, published minutes from monetary policy discussions, and so on. Now these meetings are a part of our legislation.

The fact that the Committee closely follows our activities has become even more important since the Riksbank was given an independent status. These meetings illustrate the link between us and the democratically-elected body in Sweden. They make it clear that we are not working in some sort of democratic vacuum, which is sometimes claimed in the debate.

The situation in the global economy and the Swedish economy is currently marked by insecurity caused by the Iraq issue. What the central banks of the world can do in this situation is to continue to pursue their policy consistently to avoid contributing to greater uncertainty and increasing pessimism. If participants in the financial markets of a few years ago could be said to show a strong willingness to take risks and perhaps a sometimes exaggerated optimism, there are today tendencies in the opposite direction, particularly if one looks at the headlines in the media or listens to market participants. The central banks can balance this by maintaining credibility in price stability and by safeguarding the functioning of the payment system.

The Riksbank strives to conduct a clear, credible monetary policy that is generally accepted by both the Swedish people and participants in the financial markets. We have therefore specified an explicit target for the annual inflation rate and explained that we normally try to keep to a simple rule-of-thumb; if the forecasts of inflation one to two years ahead exceed the inflation target we raise the interest rate and vice versa if the forecasts show inflation below target level. This clear intellectual framework makes it easier to influence expectations in society of monetary policy and to evaluate the policy afterwards. Both we ourselves and external analysts can take a stand on whether the policy appears sensible, whether the forecasts we make are reasonable, and whether we follow the principles we have declared that we follow.

Today I intend to begin by describing the current monetary policy situation and then looking back at developments in recent years. The latter discussion shows, not surprisingly, that it is not always so easy in practice to determine what is appropriate monetary policy, despite a clear target with apparently simple principles behind it.

Current monetary policy

Higher energy prices behind rising inflation

Inflation is at present above the target level. Over the past twelve months UND1X inflation has risen by 3.3 per cent. Does this mean that monetary policy has been too expansionary, or that the interest rate should be raised now? No, it does not. At least we do not believe so. The fact that inflation has risen recently is due to large price rises on a few components of UND1X, primarily electricity and oil. Excluding energy prices, UND1X inflation has risen by 1.9 per cent over the past year, i.e. very close to the inflation target.

It is well known and accepted that monetary policy does not have any great immediate effect on inflation, which is one reason why the interest rate is set in relation to changes in the forecast inflation rate rather than the actual rate. Attempts to constantly keep inflation close to the target level could

lead to large fluctuations in interest rates, with negative consequences for the economy as a whole. This applies in particular when the economy suffers supply shocks, which at the same time lead to higher prices and lower production. Increases in electricity and oil prices are examples of this type of supply shock. It is therefore important to separate the effects of the energy price rises from the effects of other driving forces behind inflation. This is also completely in line with the clarification of the inflation target published by the Riksbank in 1999.

The Riksbank's assessment is that energy prices one to two years ahead will fall back to roughly the same levels as forecast before the increases. However, these forecasts include a slight trend increase in electricity prices.

Uncertainty in connection with the Iraq conflict

Assessing more exactly how much is a temporary rise in inflation and how much depends on more lasting tendencies is a delicate task. The assessment of economic activity, both here in Sweden and abroad, plays an important role here. The uncertainty currently prevailing in the global economy makes it more difficult than usual to interpret various economic indicators and to predict future developments. When weak figures are received from various sources, it is difficult to know whether they are the result of a slowdown in the economic recovery due to fundamental reasons, such as households wanting to increase their saving to compensate for the large stock market falls, or whether they are the result of an inability to act while waiting for the solution of the Iraq crisis.

The assessments of the economic situation and even more the oil prices are largely due to the assumptions made with regard to developments in the geopolitical situation. Let me emphasise, before I go into this, what is actually obvious; a war entails much more than just economic consequences of the type the Riksbank has reason to observe in its Inflation Report - first and foremost considerable human suffering. Let me also say that in this field - i.e. geopolitics - we are of course amateurs, although we have tried to use our international contacts when putting together our forecast.

The Riksbank's main scenario assumes a solution will be reached in the Iraq conflict that does not give any reason to significantly reconsider the picture we have of a gradual recovery in economic activity. The surveys we have made indicate that the macroeconomic consequences of a brief war will not be so different from a less dramatic development. In this sense one can say that our main scenario is consistent with both a peaceful solution and a brief war. The Inflation Report describes in greater detail how we assess the effects of a worse development, which is, of course, a possibility.

A weaker recovery

An increasing number of indicators over the past few months have given the impression that the international economic recovery will be more protracted than anticipated. The main difference from the assessment we made in the December report, is the deterioration in prospects for the euro area. All in all, our assessment is that international growth will be slightly lower this year than we believed when making our forecasts in December. The fact that we have revised down the international growth forecast also means that we expect a slightly less strained resource utilisation in the global economy.

The slightly slower recovery for the global economy will also have repercussions for developments in Sweden. Growth this year is now expected to be lower than last year and almost one half of a percentage point lower than we had reason to assume in December - 1.7 per cent instead of 2.1 per cent. Consequently, we are also anticipating there will be slightly more unutilised resources in the Swedish economy in the coming years than we had previously assumed. Our forecast of resource utilisation in Sweden has also been affected by the revisions Statistics Sweden recently made to the National Accounts. These indicate that productivity growth in the economy was higher than estimated during the greater part of the 1990s. This in turn indicates that the economy's long-term potential growth rate may be slightly higher.

To summarise, I can conclude that the pictures of economic activity in Sweden and in the rest of the world are similar to the extent that there appear to be some unutilised resources and that growth will not exceed its long-term potential over the coming years. Developments are currently being restrained by the unease over Iraq. There is also still great uncertainty regarding the size of the adaptations that remain after the earlier rises in share prices and other asset prices. Some figures indicate that most of the adjustments have now been made, but the picture is not unambiguous. Nevertheless, a recovery is under way, after what must be regarded in many areas, and particularly in Sweden, as a fairly mild

slowdown. Our forecasts indicate an average GDP growth over the coming years in line with the economy's long-term sustainable rate and resource utilisation is expected to remain largely unchanged over this period. This means that economic activity and the labour market are not expected to put any great pressure on prices and wages at present or in the coming years.

There is, of course, a risk that developments will follow completely different paths than those we anticipate in our main scenario. This could in turn entail both upside and downside risks for inflation. The downside risk that concerns us most is connected to international developments. There are problems in the euro area in particular that could lead to a weaker development. The upside risks are mainly linked to domestic price-setting and wage formation. The rise in energy prices pushes up costs in other parts of the economy and can spread. It could also affect expectations and wage demands. We are facing collective wage bargaining rounds in the autumn, which will play a decisive role for the future of the economy. All in all, we have come to the assessment that the risk spectrum is neutral; we see equally large risks for a lower inflation path than in our main scenario as for a higher path.

Repo rate lowered 0.25 percentage points

The Riksbank's total assessment is that inflation measured at the rate that has guided policy in recent times, UND1X, will be slightly lower than the target level one to two years ahead. However, the picture is more complicated than this. Despite the fact that this indicates the repo rate should be lowered, the decision has not been a simple one. This is because one important reason for inflation being lower than the target level one to two years ahead is that electricity and oil prices are expected to fall back from their current high levels and it is not certain this fall in prices will affect policy. When adjusted for energy prices, inflation is expected to be in line with the target two years ahead.

The forecasts of inflation presented in the Inflation Report provide scope for lowering the repo rate by 0.25 percentage points. This was also the decision taken by the Executive Board of the Riksbank yesterday. An important circumstance that affected the decision is that the unease and uncertainty in the global economy risk leading in the short term to a much worse development in economic activity than described in the main scenario. It is difficult at present to determine the future direction for monetary policy, which will depend partly on the development of the Iraq crisis and the effects of its possible outcome on inflation prospects.

Before I go on to discuss history, let me emphasise one more thing. The repo rate decision we consider most appropriate depends on the overall direction expected for economic policy. Recently, there have been claims that this is an appropriate time to counteract the weakening of the economy with a more expansionary fiscal policy. Some debaters even claim that it would be desirable in the present situation to give up the principles that have guided budgetary policy in recent years, with an expenditure ceiling and surplus target. I don't agree with that at all. If there is short-term room for manoeuvre and it is possible to obtain higher growth and employment without threatening the inflation target, this should be safeguarded by lowering the repo rate. To relinquish the fiscal policy regulations when they may be really put to the test would send a very negative signal to all those who analyse the Swedish economy. This could in turn risk having directly counter-productive effects on the interest rate and thereby on economic developments.

Monetary policy 2000-2002

Let me return to a retrospective look at the development of the inflation rate and the monetary policy conducted. The Riksbank has published an appendix in the Inflation Report that is intended to facilitate the evaluation of monetary policy during the period 2000-2002.

The focus of my discussion will be on the latter part of this period. This is because developments in 2000-2001 were illustrated very clearly in last year's assessment.

Price rise and monetary policy 2001

The fact that inflation was over the target level during the second half of 2001 and first half of 2002 was largely due to supply shocks similar to those we are experiencing now. Food prices rose considerably as a result of mad cow disease, foot-and-mouth disease and higher prices for fruit and vegetables resulting from poor harvests. There was also a rise in electricity prices. The Riksbank's

assessment was then, as it is now, that these price rises were essentially temporary and inflation would soon fall again.

This proved to be the case and in this sense the upturn in inflation 2001 did not comprise a serious monetary policy problem. However, the inflation rate rose even after adjustments were made for food and energy prices; there appears to have been a rising trend in various measures of underlying inflation from early 1999 to early 2002. It has since been shown that the Riksbank and other forecasters overestimated GDP growth and underestimated inflation when we made our forecasts for 2002 during 2000 and 2001. Perhaps we were a little too optimistic with regard to the economy's capacity to grow without inflation accelerating. However, this should be seen in the light of the earlier forecasts having been wrong in the other direction; when the Swedish and international economies grew at a very rapid rate, while inflation was low.

The surprising upturn in prices during 2001 came to affect policy. Although the Riksbank made the assessment - as early as May 2001 - that the upturn was essentially temporary, there remained concern that it might to a greater degree than anticipated reflect a high level of resource utilisation. When there were signs that inflation expectations were about to rise during 2001, at the same time as the krona weakened, we made the assessment that it was necessary to intervene and raised the repo rate by a quarter of a percentage point. This took place in early July 2001. A couple of months later, after the terrorist attacks in the USA on 11 September, the Riksbank chose to lower its steering interest rate by 0.5 percentage points in the light of the poorer economic prospects. However, no further reductions were made. The reason was that a tentative upturn in economic activity was expected in the future and resource utilisation was assessed as relatively high, despite the slowdown. Compared with other countries, fiscal policy was tangibly expansionary, while a weak exchange rate gave impetus to the Swedish economy.

Developments in 2002

During spring 2002 the repo rate was raised by 0.25 percentage points on two occasions. The background was that resource utilisation was still assessed as relatively high and economic activity was expected to strengthen significantly in the light of the policy pursued, with ensuing higher inflation. In addition, inflation was still high and there was uncertainty over this, partly connected with resource utilisation.

However, the recovery began to slow down, partly in the wake of continued stock market falls. At the same time, the earlier assessment that the upturn in inflation during 2001 had been temporary was confirmed, as inflation was now in line with the target again, which reduced uncertainty over possible contagion effects. Given this development, the repo rate was lowered twice during the autumn, by 0.25 percentage points.

There are important similarities and important differences between the situation now and then. Inflation has risen sharply now, as it did then, as a result of some easily discernible supply shocks, with what are probably fairly transitory effects. The geopolitical unrest has had negative effects on the global economy, ever since 11 September 2001. However, there are also important differences. The krona weakened at the beginning of 2001, which together with a tendency towards higher inflation expectations brought about an interest rate hike. Over the past year the krona has remained relatively stable against the euro and strengthened against the dollar. Expectations of economic activity were also different in 2001. That year, up to the early autumn, they were aimed at relatively high growth and a rise in resource utilisation, although growth expectations were slightly lower than a year earlier. Today, expectations are of a largely unchanged level of resource utilisation. Thus, price pressure is not as high, either, as long as no secondary effects arise from the energy price rises.

Forecasts guide policy

Let me conclude by underlining two important aspects when assessing monetary policy. Firstly, the Riksbank, like many other countries with inflation targeting, has chosen to look ahead when making monetary policy decisions. This is clearly seen when the actual policy is compared in the evaluation appendix with simple, rule-based decisions on the basis of observed GDP growth or actual inflation. The import of this is, of course, that forecasts of inflation and GDP growth become more decisive for monetary policy than the actually observed growth rates in price levels and GDP. A disadvantage of this policy is that forecasting mistakes have effects on policy. But one advantage, which we consider

to outweigh this, is that monetary policy becomes less disjointed, more predictable and on the whole more stabilising for economic developments. Of course, the Riksbank could have raised its rate more when inflation rose because of higher food and energy prices during 2001. But would this have rapidly subdued inflation and led to a more beneficial development in the economy? I don't think so.

Secondly, it is difficult both to make and to assess forecasts, as our picture of history and the current situation constantly changes as a result of revisions to the statistics. The latest revisions have entailed an upward adjustment of GDP and productivity in Sweden during the years 1993-2002. In 2000 and 2001 the Riksbank made the assessment that there were unutilised resources in the economy and that inflationary pressure was thus modest. When the actual inflation rate rose, we felt obliged to review this picture, and some adjustment was probably justified. However, the most recent figures nevertheless indicate that the original assessment was largely correct. It is important not to get carried away by the most recent statistics and rapidly draw up new trends to follow.

Future assessment of the Riksbank

Let me finish by emphasising something I accentuated in the beginning. We aim to provide you on the Committee of Finance with the best possible information for your assessments and discussions. If you have any wishes or views with regard to how the material and the information you have received today could be further developed, we would of course be happy to hear them. We shall do all we can to satisfy your wishes.

Thank you.