Irma Rosenberg: The objective of monetary policy

Speech by Ms Irma Rosenberg, Deputy Governor of the Sveriges Riksbank, at a meeting arranged by Öhman Fondkommission, Stockholm, 14 February 2006.

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A discussion has recently taken place in the media on the objective of monetary policy. Some have argued that we should have more objectives while others considered that we already work with too many objectives and that this has created a lack of clarity. In my opinion this discussion is a bit misleading. We have *one* objective: keeping inflation low and stable. However, in our efforts to achieve this objective, we have, like many other central banks, opted to be flexible to avoid exposing the economy to strain.

Our statutory objective is to maintain price stability. It has been left to the Riksbank to decide on the detailed interpretation of this objective. We have defined it as meaning that inflation should be 2 per cent. However, monetary policy affects the economy with a time lag and is simply not precise enough to maintain inflation at a constant 2 per cent. The inflation target includes a tolerance interval of +/- one percentage point to underline that temporary deviations are permitted, provided that these are not too large. For further clarity, we apply the principle that in the event of any deviation, inflation should normally be brought back to the target within a two-year period. When we set the interest rate, we must accordingly base our decision on an inflation forecast. In most cases, this two-year horizon provides us with the scope to return gradually to the target without having to apply monetary policy with such force as to create unnecessary fluctuations in the real economy. Occasionally in the wake of a major disturbance, there may even be grounds to allow a period of more than two years to return to the target. In such cases, however, we should communicate this clearly. Like most central banks with inflation targets, we apply what is usually referred to as a flexible inflation target policy.

When we decided at the most recent monetary policy meeting to increase the repo rate, we once again had to take into account the continuing rapid increase in house prices and household debt. This was not because we have a target for household debt or house prices. However, it is important for us to monitor the trend in the housing market, bearing in mind both financial stability and price stability. As far as financial stability is concerned, there are no indications that house prices or household debt constitute a threat to the banking system. We produce regular analyses and reports on such matters in our six-monthly stability reports.

As far as the work with price stability is concerned, we must take into account the effect that house prices have on household saving and consumption decisions through their impact on wealth and thus the level of demand in the economy as a whole. For households with debts, the scope for consumption is also affected by interest rate adjustments if the share of income used for interest payment changes. Accordingly, we take this into consideration when we make our inflation assessment. There has been a swift increase in household debt and house prices over a long period. One potential cause of concern, which we cannot disregard, is that if this trend continues at the same rapid rate, a situation could develop where, at a later date, there is a risk of a considerable slowdown in growth and employment as a result of households finding themselves compelled to increase savings owing to a heavy debt burden. The risks involved here are very difficult to quantify in forecasts or pinpoint in time, but could none the less be a threat to macroeconomic stability. Inflation could then also revert to a state that might prove difficult to deal with. However, it should be underlined that the likelihood of such a scenario arising is regarded as slight, in particular when we have identified it in good time. We have taken these factors into consideration even if they have not been crucial for our monetary policy decisions.

The Riksbank does not have a target for the krona exchange rate. However, since the exchange rate is one of many factors affecting growth and inflation, we must naturally take the path of the krona into consideration in the inflation assessment. The exchange rate affects inflation directly and generally relatively quickly through prices of imported goods and services. The exchange rate also affects inflationary pressure indirectly and usually with a long time lag, by its impact on the level of activity. A weaker krona entails, everything else being equal, greater demand for Swedish goods and services, which in turn leads to an increase in resource utilisation. The exchange rate can also affect inflation expectations indirectly.

I would now like to move on to inflation prospects and monetary policy. In the December Inflation Report, we made the assessment that international growth would be good this year and in the next few years but would slow down somewhat. New information prior to our January meeting suggested that development would be stronger than expected. This applied primarily to the euro area and Asia while the latest US statistics indicated that the trend was more or less in line with the assessment made in December. Overall, the international prospects for growth and thus the growth of the Swedish export market seemed slightly stronger in January than in December. In my view, this assessment still holds good.

The assessment in December for the Swedish economy was that growth would increase this year but subsequently slow down slightly in the next few years. In January, according to revised GDP statistics, growth in Sweden was considerably stronger from the final quarter of 2004 onwards than indicated by the information available at the beginning of December. Several indicators of economic activity also suggested a stronger development than expected. New information made available since our January meeting appear to confirm this. According to the National Institute of Economic Research's most recent Business Tendency Survey, the level of economic activity continued to improve in the fourth quarter of 2005 and firms were very optimistic about the future. Household expectations have also become more optimistic about their own finances and the Swedish economy. In the light of these developments, it seems reasonable to adjust the GDP forecasts for 2005 and 2006 upwards slightly compared with our expectations in December.

The situation in the Swedish labour market appeared to be somewhat brighter in January and the number of those employed increased slightly more than expected. However, the trend for the number of hours worked was surprisingly weak and productivity growth in the business sector was therefore stronger than expected. There is no apparent reason to make any substantial change to that assessment either. The labour market is improving although domestic cost pressures are expected to remain subdued. Overall, this means that inflation is expected to approach the target during the forecast period, more or less as we said in December. Given the strong growth in demand, we envisage a relatively moderate increase in inflation.

However, it is important to bear in mind that the inflation assessment in December was based on the assumption that a gradual increase of the repo rate would be initiated at the beginning of 2006. In January, we also decided to raise the key rate. In view of the favourable economic climate, the Executive Board judged that a further increase of the repo rate was justified. In my opinion, the information that has subsequently become available does not warrant any change to this conclusion pending our next meeting.