Irma Rosenberg: Monetary policy with our own interest rate path

Speech by Ms Irma Rosenberg, First Deputy Governor of the Sveriges Riksbank, at a lunch meeting arranged by Öhmans, Stockholm, 8 June 2007.

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Introduction

Let me begin by thanking you for the invitation to come here and speak about monetary policy. Today I would like to take the opportunity to talk about some issues that are important to me. I would like to explain why I considered that the repo rate should be kept unchanged at the most recent monetary policy meeting. I shall also comment on some of the views we at the Riksbank have received with regard to our forecast of the interest rate path. But I intend to begin with a few words on the changes in our monetary policy communication which were decided by the Executive Board recently.

Changes in the monetary policy communication

Since the inflation target was introduced, the Riksbank has tried in different ways to become more open and clear with regard to how monetary policy is conducted. We have gradually published more and more of the background information used for our decisions, in particular the forecasts for inflation and economic developments in general. The decision to publish our own forecast for the repo rate, which we took at the beginning of the year, was a natural continuation of this process. In mid-May we decided to implement some further changes to become even clearer in our monetary policy communication.

From now on, we will hold press conferences after each monetary policy meeting, regardless of what decision has been taken. Until now we have only held a press conference if the repo rate has been adjusted or if we have published a Monetary Policy Report. But to understand the monetary policy conducted, it is equally important to explain why the repo rate has been held unchanged as to explain why the repo rate has been changed. By publishing our own interest rate forecasts and by holding press conferences after each monetary policy meeting we will provide more detailed and more regular information on the considerations taken by the Executive Board.

We have also decided to make changes in our way of signalling. By signalling I mean how we communicate our monetary policy intentions. Previously, when we Executive Board members have gone out and talked about the current economic situation between the monetary policy meetings we have sometimes given indications of how we consider the repo rate should be set at the next meeting. This has been on the condition that it is clear that the points of view expressed are the individual member's. The idea was that when the interest rate decision was taken at the monetary policy meeting, enough information on the different Executive Board members' views would already have been given by degrees so that the decision would not surprise market agents. We have now concluded that there is not normally reason to indicate prior to the monetary policy meetings in speeches and press releases how our views of the repo rate path have changed. Our assessment is that it is enough to signal our intentions clearly in connection with the seven monetary policy meetings held every year. In connection with three of these meetings we will publish our own forecast for the future repo rate, and our Monetary Policy Report will show clearly why we have chosen this particular path. On the other four occasions we will make a qualitative assessment of how the most recently published interest rate forecast relates to the new information received. Even if the interest rate path forecast is only a forecast and not a promise, a central bank can hardly be clearer than this with regard to its views on economic developments and the consequences for the interest rate.

There may also in exceptional cases be justification for some signalling between two monetary policy meetings. If, for instance, something occurs to radically alter the economic situation, while there is a long time until the next meeting, it may be necessary to make a comment in order to avoid the risk of unnecessary uncertainty in the financial markets. It should then be clear whether the entire Executive Board supports this view or whether it is the opinion of an individual member.

I and my colleagues on the Executive Board will thus continue to go out and talk about monetary policy and financial stability, but there will be no signals regarding coming interest rate decisions. We will each express our own assessments, but this will be a case of justifying and explaining our own considerations after a meeting and not of signalling a stance to be taken at a coming meeting.

The third change we decided on was to state our names in the minutes of the monetary policy meetings, with effect from the meeting to be held in June, so that it is possible to see who said what. Previously, we have only named members who have entered a reservation against the decision. This change will make differences of opinion between Executive Board members even clearer. It means that it will become easier both to predict how monetary policy will be conducted in future and to assess it. This change is also a step towards increased openness and clarity.

The monetary policy decision on 3 May

This naturally leads me on to the stance I myself took at the most recent monetary policy meeting in early May. My assessment was then that the new information received indicated that the repo rate should be raised more during the forecast period than was implied by the forecast in the February Monetary Policy Report. This is to ensure an inflation rate in line with the target and a balanced development in the real economy. But at the same time I considered that the changes in the economic picture were not so great that the interest rate needed to be raised immediately. Let me explain why.

In February we believed that growth would continue to be good, although it was expected to be slightly lower than last year. We estimated that cost pressures would rise during the forecast period as employment was expected to increase and wages were expected to rise faster. Higher cost pressures could also lead to inflation rising, but we estimated that the favourable supply conditions would contribute to a relatively modest rate of increase. At the same time, we pointed out that the assessment of wage developments was uncertain. For instance, the rapid upturn in employment and the increased labour shortage implied more rapid wage increases, while the increase in labour supply and continued price pressures from abroad indicated slower wage growth. The assessment in the main scenario was that the repo rate should be raised at a fairly slow pace. We also presented a number of alternative scenarios and the consequences they would have for monetary policy. In one such scenario we investigated the consequences of more rapid wage increases than calculated.

At our monetary policy meeting in May we were able to observe that the new information received since the publication of the Monetary Policy Report in February indicated higher inflationary pressures than we had predicted. One reason was that the result of the spring wage bargaining rounds indicated that wages could increase more quickly during the forecast period than we had estimated in the main alternative in the report published in February. The motive for high wage increases not being part of our main scenario was that we considered that the spare capacity in the labour market still appeared substantial, which would slow down the rate of wage increase.

How high wage increases will be in total will depend not only on the collective wage agreements, but also on how much wages rise outside of the agreements. As I mentioned in May, it is reasonable in the currently strong labour market situation to count on wage increases outside of the agreements being higher than they have been in recent years. How high will depend on how well the labour market functions. I pointed to a number of important questions then. Will the labour supply increase to the extent expected? Will the matching of demand for and supply of labour function? How will the stronger labour market situation affect wage negotiations?

At the May meeting we were also able to observe that the statistics received for the first quarter showed a slightly more strained labour market situation than we expected to see in February. Employment had developed roughly in line with our forecast, while the labour supply appeared to have increased slightly less than expected. Unemployment was therefore a little lower than we had predicted in the February report. Shortages in the business sector continued to increase. But my assessment was nevertheless that there was still plenty of spare capacity, if not yet to the same extent as we expected in February. A further reason why we foresaw higher inflationary pressures was that the Government's Spring Budget Bill appeared likely to stimulate demand slightly more, at least next year, than we had previously estimated.

As I said earlier, I drew the conclusion from this that the repo rate needed to be raised more during the forecast period than we believed in the February report. But my assessment was that the economic picture on the whole had not changed so much that the repo rate needed to be raised immediately. Inflation was low, and it appeared, as I saw it, reasonable to assume that it would rise fairly slowly. The reason for this was that there were still several factors holding back prices. I pointed out that the important thing was to balance the pace of the interest rate increases so that inflation does not accelerate more rapidly than expected, but so that growth in production and employment is not slowed down too soon. How these considerations will be transformed into a new interest rate forecast is something we will return to in our next Monetary Policy Report in June.

Views on our interest rate path

In conclusion, I would like to say a few words on the experiences thus far of publishing our own interest rate path. It is still too early to draw any definite conclusions about how this has functioned, but some reflections may be worthwhile.

The debate after our monetary policy meeting in February, when we presented our own interest rate forecast for the first time, was very lively. This was not because we chose to raise the repo rate by 0.25 percentage points – this decision was hardly discussed at all. What attracted attention was the fact that the forecast for the repo rate that we published differed from the average expectations prevailing at the time. This applied both to the expectations that could be interpreted from market pricing and to the average of the interest rate forecasts made by other forecasters. But there were also fairly substantial differences between market analysts. There were those whose views were relatively close to ours and there were those whose views differed substantially from ours. I do not consider it strange that such differences of opinion should arise. They reflect in part differences in the view of economic developments and how inflationary pressures may develop. For instance, in February we considered that the new information received since our previous monetary policy meetings in October and December did not justify the relatively large upward adjustments in the interest rate forecasts made by some other market analysts.

The fact that other agents make their own assessments of how the interest rate will develop is essentially very positive. One of the arguments put forward against a central bank presenting its own forecast for the interest rate path was that the agents in the financial market would then stop making their own analyses of interest rate developments. However, these misgivings have proved unjustified. Opinions on the interest rate and future economic developments still differ, which is a natural consequence of the uncertainty regarding the future development of the economy. In particular those who operate in the financial markets know that we live in an uncertain world and for this reason the assessments of interest rate developments will continue to differ.

Another argument against a central bank presenting its own forecast for the interest rate is that the central bank would lose credibility if the forecast proved to be wrong. It has also been speculated in various market comments that it would entail a loss of prestige for the central bank to revise its forecasts and that the central bank should therefore by wary of doing so. But it is no stranger that we should revise our view of the future development of the repo rate than that we should revise our view of growth, employment or inflation when new information is received that changes the outlook. Nor is it stranger for the central bank to revise its forecasts than for other analysts to do so. What is important is that we can motivate why we are revising our views and that we can do so in an understandable manner.

This is linked to the fact that it is difficult to make forecasts, not merely for interest rates, but also for other macro economic variables. The fact that it is difficult to make forecasts for the interest rate is illustrated clearly in the development of, for instance, forward rates over time. The figure (figure 1) shows implied forward rate curves calculated on the basis of bank papers from the middle of each quarter. Expectations of the development of the repo rate have varied substantially over time when measured in this way. During the years the interest rate has gradually been cut, expectations according to implied forward rates have substantially overestimated the level of the repo rate. After we began to raise the interest rate one and a half years ago, there has rather been a tendency for the repo rate path to be slightly underestimated.

It can thus be noted that market agents have had difficulty in forecasting interest rate developments. The fact that forecasters revise their assessments is not at all strange, as new information is received all the time. This indicates that as the conditions for the real economy change and new information is received the forecasts for the repo rate path need to be adjusted. There is nothing particularly dramatic about this. It applies to all market agents, to the major banks, to the Ministry of Finance and also to us at the Riksbank. The great uncertainty factor means that all forecasters should be humble, but this should not prevent them from making forecasts.

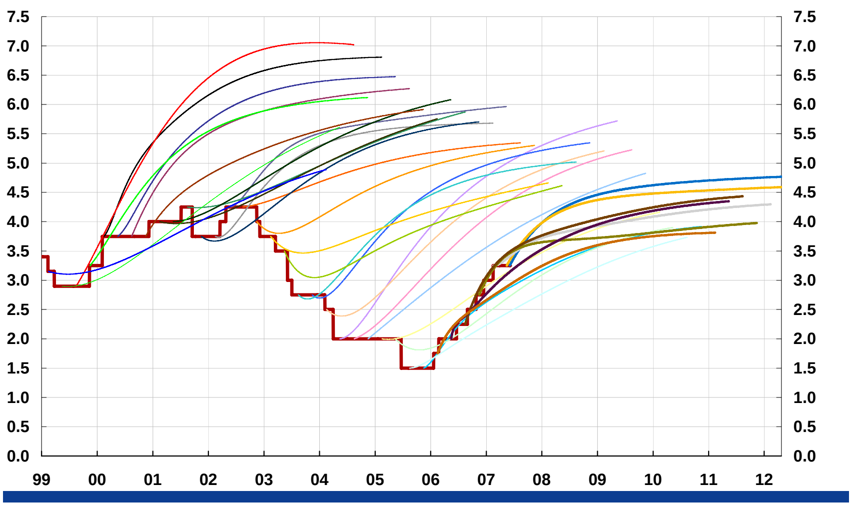
I would therefore like to emphasise once again that the repo rate path we present in the Monetary Policy Report is a forecast and not a promise. The Riksbank cannot undertake, regardless of what happens in the economy, to follow the path published. The interest rate path is quite simply the best assessment we can make at a given point in time, given the information that is then available. New information may change the picture of the economy and then the Executive Board will have to rethink how we set the repo rate.

The reason why we have chosen to publish our interest rate forecast despite the uncertainty over the future is largely because we believe this is the best way of explaining our thoughts on monetary policy. It also makes it easier for us to justify forecasts and interest rate decisions and to outline alternative scenarios for the repo rate. It will also be easier to evaluate monetary policy. The debate has not been slow in coming. Analyses and discussions on monetary policy are now being conducted outside of the Riksbank in a way that would not have been possible if we had not presented our own interest rate path. It is not, as before, primarily the current interest rate decision that is discussed, but more a question of the monetary policy fluctuations throughout the entire forecast period. The fact that the interest rate forecast may later be changed is a different, and quite natural, matter. Withholding information on how we view the future development of the interest rate merely because this view may need to be revised would make us a less open bank.

Figure 1. Is the market always right?

Repo rate expectations according to implied forward rates

Per cent



Source: The Riksbank