Mr. Bäckström explains why price stability ought to be a central bank's principle monetary policy objective Address by the Governor of the Bank of Sweden, Mr. Urban Bäckström, at Handelsbanken seminar in London on 28/1/97.

For most central banks today the primary monetary policy objective is price stability. The situation is thus very different from that which prevailed in the earlier period of high inflation.

The reorientation of monetary policy stems from people's growing awareness of an inflationary economy's harmful effects. The central banks, which are ultimately accountable to their countries' citizens and the latter's representatives, would otherwise not have been mandated to focus policy on price stability.

In Sweden, for example, 60 per cent of the population see 2 per cent inflation as an appropriate monetary policy objective and only 12 per cent are against this. In my country a low inflation policy therefore has broad political support.

I shall be talking today about why price stability ought to be a central bank's principal monetary policy objective and what this means for economic growth, employment and unemployment. From there I shall consider development in Sweden, the framework of our monetary policy and the current situation.

Why price stability?

Why should price stability be singled out as a central bank's overriding objective? Why not attach equal importance to targets for growth, employment and unemployment, particularly as these factors have high priority for economic policy in general?

The answer to these questions calls for an understanding of what monetary policy can and cannot do. In the long run monetary policy is only capable of influencing inflation; a systematically higher rate of inflation, however, would not lead to higher long-term growth. The level of long-term growth is determined instead by real economic factors such as demographic changes, technology, education and the efficiency of markets. In so far as a long-term relationship between inflation and growth does exist, most of the evidence suggests that, if anything, higher inflation impairs the workings of the economy and thereby weakens output. Today there is widespread - though not yet complete - agreement on this.

What monetary policy can do, on the other hand, is influence the economy's fluctuations around the long-term trend, albeit without any lasting effects on growth. This means that if resource utilisation is low or high, monetary policy can be used to stimulate or dampen activity temporarily, but not to fine-tune the economy. With an inflation target which applies downwards as well as upwards, so that deflation as well as inflation are avoided, monetary policy can then exercise a stabilising influence and help to smooth economic fluctuations around the long-term trend.

Problems arise if resource utilisation becomes so high that inflation starts to accelerate and the central bank has not intervened. People may then begin to count on inflation remaining high in the longer run. A higher level of inflation may then be established, whereas the effects on production and employment will be only temporary. This is a reason why the central bank should act with foresight and be alert to the development of inflation expectations.

The potential for influencing fluctuations in activity around the trend is dependent on people's appraisal of the central bank's determination and ability to maintain price stability. Central bankers talk of the importance of credibility, by which is meant the extent to which people expect inflation to be in line with its targeted rate. The degree of credibility is conditioned by, for example, the historical record of inflation and the existence of government financial deficits. Weak credibility calls for caution in monetary policy, just as higher credibility confers more room in which to manœuvre.

Experience has shown, moreover, that even in the shorter run, the possibility of influencing employment and unemployment via monetary policy is very limited. Limited fluctuations around the growth trend are by no means sufficient condition for a smooth development of employment and low unemployment. Comparisons between countries and regions reveal that a similar growth pattern, even over a considerable period, can involve markedly divergent effects on employment and unemployment. This highlights the function of the labour market. It is there that measures must be taken in order to tackle problems with employment and unemployment.

I want to underscore some conclusions from this discussion. Monetary policy cannot have growth as the primary objective because it is not capable of influencing growth in the longer run. At the same time, monetary policy can be used to smooth fluctuations in activity around the growth trend. But I should emphasise that this presupposes that the central bank is committed to price stability and that its policy is perceived as credible. With low inflation, moreover, the economy will function more efficiently.

It is important, I believe, to realise that price stability's status as the monetary policy objective does not imply a lower priority for growth and employment as economic policy's overall objectives. Rather than being an impediment, low inflation creates good conditions for growth. In order for this to be combined with low unemployment, the labour market must also function properly.

Monetary policy with an explicit inflation target

Since the move to a flexible exchange rate in the autumn of 1992, monetary policy in Sweden has been conducted with an explicit inflation target. The Swedish target for the rate of inflation, which is appraised in an annual perspective and expressed in terms of the consumer price index, is 2 per cent. The target is surrounded by a band of ±1 percentage point, which serves among other things as a buffer for temporary effects on inflation. I should like to mention some factors which illustrate how the Riksbank works on the construction of monetary policy with an inflation target.

As monetary policy is characterised by long and variable lags, the policy needs to be forward-looking and based on an inflation forecast. In order to clarify our deliberations in the assessment of future inflation, the Riksbank presents an inflation report four times a year. A number of indicators are reviewed in these reports, together with an assessment of future tendencies and a discussion of risks and opportunities in the field of inflation.

Simplifying somewhat, an inflation forecast can be said to rest on two factors in particular: one is the relationship between supply and demand and the other is *expected inflation*. The difference between the actual level of demand and the potential level of production that can be combined with an unchanged rate of inflation is commonly referred to as the *output gap*. As this gap is a notional variable, it is difficult to calculate exactly. We therefore use a variety of indicators to check for consistency of the assessments.

The inflation target is symmetrical; that is, preventing inflation from falling below the target is as important for the Riksbank as stopping it from rising above the target. Over time, the economy will then expand at its potential rate. The inflation targeting approach accordingly has a built-in control mechanism. If the monetary stance is unduly tight, bringing economic activity below the potential level, inflation will decrease and sooner or later fall short of the target; and vice versa. This calls for a calibration of the output gap, a new inflation forecast and an adjustment of monetary policy.

Factors that generate changes in *ongoing rate of inflation* must be distinguished from *temporary effects on inflation* due to once-and-for-all shifts in the price level. It is mainly variations in the output gap and in expected inflation which have an impact on the ongoing rate of inflation. Monetary policy accordingly focuses on these factors.

Temporary effects on inflation may come, for example, from changes in indirect taxes and subsidies or from shifts in terms of trade. Monetary policy measures as such may likewise have temporary effects on inflation via changes in house mortgage costs, which are included in the measurement of consumer prices. This was the case in 1996, when the average rate of inflation fell below the lower band limit of 1 per cent mainly as a temporary consequence of the Riksbank’s reduction of its instrumental rate. Clearly, monetary policy should not respond to temporary effects on inflation from upward or downward movements in the instrumental rate; to do so would be to make interest rate policy procyclical and thereby destabilising.

The monetary policy reaction to other temporary effects depends essentially on how these affect inflation expectations. If a temporary increase in the rate of inflation is taken, for example, to indicate a more lasting upward shift, so that people adjust their inflation expectations, monetary policy would have to respond in order to prevent the ongoing rate of inflation from increasing. If expectations are unaffected, on the other hand, temporary effects may be of secondary importance for monetary policy.

Where, then, does the exchange rate come in? Apart from its short-run effects via import prices, the exchange rate features in our inflation assessments in two respects. One is that exchange rate movements affect demand in the internationally oriented sector and thereby in time the development of the output gap and ultimately inflation, too. The other is the information which the exchange rate may provide about the development of inflation expectations. While temporary exchange rate fluctuations hardly affect forecasts of inflation one to two years ahead, more lasting tendencies have an overall impact on demand and thereby on the output gap and consequently on the inflation forecast.

Adjustment after the inflation era

Sweden is one example of the numerous countries that in the 1970s and 1980s systematically aimed for higher growth and employment with the aid of expansionary economic policies, with less regard for the effects on long-term price stability. The outcome was very different from what had been intended. Compared with countries more devoted to stability, for example the Netherlands, Austria and Germany, macroeconomic development in Sweden was poorer in many respects.

Inflation in Sweden moved up substantially from the late 1960s onwards, trend growth weakened and the period ended in the early 1990s with a dramatic fall in production, a sharp increase in unemployment and a serious crisis in the financial system.

The tendencies in the latter part of the 1980s were not sustainable. The levels of growth, employment and prices for real and financial assets could not be maintained. Partly for these reasons, Sweden experienced a profound crisis. Had the adjustment been made earlier and resulted in stability, perhaps the crisis would have been less painful.

In recent years, however, the process of adjustment in Sweden has come a long way. The economy is in the process of adjusting to the conditions that apply in a low inflation regime. This is being accompanied by an appreciable improvement in government finance, not least as a result of the extensive consolidation programme. From a two-digit level just a few years ago, for 1996 it seems that the government deficit has been reduced to between 3 and 3.5 per cent of GDP. Moreover, the improvement is expected to continue.

That the consolidation of government finance proceeds successfully to the goal of balance in 1998 is of the utmost importance in that this lays a foundation for balanced, sustainable growth. With the new, globalised capital market, the need for discipline in economic policy soon makes itself felt, particularly for a country that has had a difficult period of deficits and has therefore become more dependent on domestic and foreign creditors. After all the experiences earlier in the 1990s, this is widely understood in Sweden.

The resolution with which the consolidation is being achieved has been questioned from time to time. However, the six-monthly control stations that are an integral part of the Swedish consolidation programme have made - and continue to make - it possible for observers to monitor the political system's determination in this respect to achieve the goal of balance in 1998.

The current situation

At the beginning of 1996, favourable prospects for inflation prompted a monetary policy realignment. Continuously falling inflation expectations, accompanied by subdued demand, improved the outlook for inflation in 1996 and 1997. At the end of 1996 underlying rate of inflation was about 1.5 per cent. The twelve-month rate of headline inflation, which was actually negative for some months in the latter part of 1996, was affected by temporary factors, above all as a result of the Riksbank's interest rate cuts.

The better prospects for inflation paved the way for a notable reduction of the repo rate during 1996, from 8.91 to 4.10 per cent, the latter being the lowest instrumental rate in Sweden for at least thirty years. Together with the impact of the exchange rate, the overall monetary conditions are accordingly contributing to a continued recovery in the real economy.

A shift in the composition of demand began in the course of 1996. But although the contribution to GDP growth from net exports decreased, the effect of foreign trade remains positive. Private consumption is continuing to rise at a subdued but stable rate and its composition seems to be shifting in favour of durable goods, cars in particular. There are no signs that in the coming two years the economy will exceed the level of potential output at which inflation is liable to pick up. The level of inflation expectations is also compatible with the inflation target.

The exchange rate has been weaker than assumed in the latest inflation report and the current level of the effective exchange rate does not mirror fundamental trends in the economy. This points to some future appreciation. Meanwhile, GDP growth in 1996 seems to have been somewhat lower than the Riksbank counted on, which implies a somewhat larger output gap.

All in all, the picture of future inflation does not appear to have changed from the assessment in the December inflation report. The conclusion in that report - that monetary policy is relatively well balanced - therefore holds good. The Riksbank is continuing to evaluate effects of the interest rate cuts that were implemented during 1996, together with new information about real economic activity, inflation expectations and the exchange rate. This in turn will determine the future course of monetary policy, that is, whether the repo rate should be kept at its present level or whether there is any limited room for manoeuvre.