Comments on "Monetary policy in Sweden since 1992"

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Inflation targets in Sweden: an outsider's view

The paper by Berg and Gröttheim (1997), which is similar in spirit to Anderson and Berg (1995) and Svensson (1995), concentrates primarily on the Riksbank's targetry framework since the transition to a floating exchange rate regime. Overall, I am sympathetic to the Riksbank strategy and therefore my concerns address somewhat peripheral issues.

1. Setting up the targetry framework

The experiences of countries with inflation targets have shown that transparent communication is important for a successful policy. I will try to argue that the Riksbank's experience in setting up its targetry framework encountered a few hiccups. The first concerns announcing the targetry framework. The Riksbank's initial policy statement on inflation targets made no mention of possible caveats, bandwidth, or intermediate target path before 1995. These features of the targetry framework were explained later. The commitment to the targetry framework was further undermined by the same day's announcement that the Riksbank "set the inflation target to cover the time that the krona continues to float, but wants to a return to a fixed exchange rate when conditions allow".[1] This left the impression that the Riksbank was pursuing multiple goals or at least favoured a policy of the past.

The endorsement of a policy strategy is important for its success. Unlike the New Zealand, Canada and the United Kingdom, the Riksbank's policy of inflation targeting did not receive the immediate endorsement of the Swedish government. This had consequences for the budget

[1] See "Swedish central bank sets target for inflation", *Financial Times Weekend*, 16th/17th January 1993.

and government wage formation, making the job of the Riksbank more difficult.[2]

A further hiccup regards the purpose of the Riksbank's Inflation Report that was not well defined at the outset. The report is designed to comment and reflect on the past, current and future policy stance with respect to the final goal of price stability. The first inflation reports by the Riksbank were prepared and signed by the Economics Department. It was not clear to the outsider whether the Governor was responsible for the document and whether the report served as a basis for the Governing Board's discussion of monetary policy. This confusion has been corrected recently in that the Governor stands behind the report.

The paper does not address these initial problems and their implications. However, it is not surprising that the Riksbank underwent a "learning by doing" process. The in-house philosophy was always one of exchange rate targeting and, as in the cases of Spain and Finland, it is difficult to break immediately free from the fixed-currency shell. Whether these problems heightened the regime shift premia is an open question. Individually the problems may appear to be small; however, collectively they can create hurdles for the Riksbank in getting its message across.

2. The role of inflation forecasts as an intermediate target

Claes and Gröttheim (1997) raise the issue fostered by Svensson (1996) that the central bank's forecast can be viewed as an intermediate target. The primary merits of Svensson's approach are the capability of outsiders to monitor short-run developments, to provide a consistency check for the Bank, and to encourage debate and interaction between the central bank and the public. The paper, like Svensson is not very explicit as to how the forecast is to be constructed and the underlying assumptions needed for their use. Basically, I see two strategies involved:

1 Strategy 1 involves two steps. An inflation projection, stemming from a reduced-form or an indicator model, is made for period $t+k$. If inflation rises above or below the target range, the next step requires a change in the policy instrument. The instrument response may follow

[2] Svensson (1995) mentions that the government budget used a forecast of 3% rather than the Bank's projected rate of 2%. See the *Riksbank Inflation Report*, March 1997, for comments on wage development in recent years.

an instrument rule with the inflation forecast. However, central banks tend to use judgment or simple rules of thumb to set the policy instrument. Under this strategy the central banker's model is not necessarily identifiable to the public.

2 Strategy 2 involves inflation forecasts from a structural model. The inflation expectations process includes the policy instrument, which is also dictated by an instrument rule observable to the public. Again, if the inflation forecast falls outside the target range, the instrument rule requires a change in policy. The next step is to resimulate the model with an adjusted policy instrument. This is done till the structural model's inflation forecast falls within the target range.

Bernanke and Woodford (1997) argue for various reasons that strategy 2 is the desired strategy to follow. The inflation forecasts from a structural model allow for "story telling", which central bankers need in order to sway the public when changing their policy instruments. This mechanistic approach to monetary policy is transparent, allowing outsiders to monitor short-run developments with respect to the long-run target.

Yet caution needs to be cast regarding the validity of inflation forecasts under these two strategies. Strategy 2 is partly an illusion. The economics profession has been unable to come up with simple models that are structurally invariant to regime shifts and are able to produce valid forecasts. This is not to say that strategy 1 offers better results. Cecchetti (1995) has recently shown that a range of simple indicator and reduced-form models are unable to produce satisfactory inflation forecasts. My intention here is to inject a word of caution with respect to inflation forecasts as an intermediate target; a feature lacking in Svensson (1996). Inflation forecasts are important as a consistency check, however their use in setting monetary instruments is a difficult task.

3. Some worries for the future

I would like to briefly comment on the issues raised in Section 3. The authors first call into question whether the CPI is the ideal index in terms of correctly gauging inflationary pressures. While I do not want to express my preference for a specific index, I would like to highlight the problem from a different perspective. New Zealand, Canada, Sweden and

Spain define their inflation targets with respect to the CPI, yet Sweden and Spain are unique among inflation targeters in that they do not allow for caveats and they do not set policy based on an underlying rate of inflation. This may not pose problems for Spain, since it has an intermediate exchange rate target as an anchor and its CPI inflation behaves smoothly. This is not the case for Sweden; the CPI inflation rate is highly variable even under the period of inflation targeting. As in many countries the CPI is heavily influenced by changes in indirect taxes and mortgage interest rates that are outside the control of the Riksbank. These factors along with other supply shocks can create perverse price movements that mask the evolution of the general price level.

Wage developments in Sweden pose a threat to the programme of inflation targets. The fact that wage formation in the government, export and domestic sectors are running high and parallel to each other suggests that the Riksbank has not conveyed its message. Here, one has to wonder if the timeliness of the indirect taxes in 1993, the introduction of an intermediate inflation target path (as in the case of New Zealand or Canada), or a policy of undershooting the target in eliminating any upside risks would have been helpful in mitigating labour's expectations.

The paper offers a good discussion of the regime shift premium and how that premium may affect the interaction between interest rates and inflation expectations. Figure 13 of Berg and Gröttheim shows that survey inflation expectations are highly correlated with the regime shift premium. It experienced a rise in 1994–95 and has fallen considerably during the latter half of 1996. The explanation given by the authors for the evolution of the regime shift premium is Sweden's vulnerability to international financial unrest stemming from its structural imbalances (external debt, wage formation, etc.). Because sufficient inroads have not been taken to correct these imbalances, a rising regime shift premium lurches in the dark – waiting for the next financial shock.

An alternative explanation for the rise in the regime shift premium in 1994–95 concerns the initial problems mentioned above and the general disbelief that the Riksbank would achieve its announced target. The premium in this case reflects the credibility factors, which are directly related to the Bank's performance. As a consequence, future shocks should not result in a sharp rise in the premium if credibility improves. Personally, I believe the premium reflects both features of central bank credibility and external balances, implying that it is difficult to separate the two.

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