Lars Heikensten: Behind the granite walls up at Brunkebergstorg - monetary policy in practice

Speech by Mr Lars Heikensten, First Deputy Governor of the Sveriges Riksbank, to the Riksdag's Social Democrats, Stockholm, 21 March 2001.

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The theme for today's seminar is monetary policy in practice. I find it extra stimulating because it is a subject I don't often get a chance of talking about. While thinking about how to arrange what I want to say, I felt that, besides talking concretely about how we at the Riksbank go about assessing inflation, it would be a good idea to spend some time on some matters of principle. In that way I hope to lay a good foundation for the ensuing discussion.

First I shall say a little about monetary policy's purpose and our target. Then I shall describe how we make our assessment and how the Executive Board works. Before winding up, I shall also consider some issues connected with communication and transparency.

'Hate inflation'

As we all know, monetary policy's purpose is to safeguard low inflation. That has been the case in any event since the beginning of the 1990s. It became explicit, of course, when the Riksbank adopted an inflation target in February 1993. Since 1999, moreover, the Riksbank Act states that the objective of the Riksbank's operations shall be to "maintain price stability".

So why is this our objective? Basically, there is now a broad consensus that low inflation is good for economic development and accordingly contributes to gains in prosperity. While it is true that in certain situations the economy can be stimulated by means of low interest rates, this works only if there are unutilised resources. Taken too far, it is liable to result in bottlenecks that push prices and wages up. There is then a risk of households and firms gradually starting to act in the belief that inflation will continue to be high — inflation expectations become firmly fixed on this.

In other words, in the long run monetary policy is not capable of influencing growth. What does underlie a country's economic development and thereby its prosperity are such factors as the labour force, a willingness to invest and technical progress. The best the Riksbank can do is promote an economic development that is more stable, with smaller fluctuations around the long-term trend. It therefore seems to me that the economic debate is somewhat lopsided. The long-term issues you work on in the Riksdag (Sweden's parliament) ought to attract more attention. The Riksbank's doings get more than their fair share.

Convincing people in Sweden about the value of low inflation really should not be difficult. After all, what did we get out of letting inflation take off in the 1970s and '80s? Recurrent devaluation cycles and a level of prosperity today that is considerably below that in many other countries. The economic imbalances became so large that when the bubble finally burst as we moved into the 1990s, the consequences were considerable.

I should perhaps stress that I am not just talking about the economy in some abstract academic sense. These developments were very tangible to the man in the street. Take the example of someone who placed, say, 10,000 kronor in bonds in 1970 and looked forward to reaping interest at the current rate of 8 per cent; by 1990, after twenty years, the real value had actually shrunk more than 750 kronor, leaving only 9,250 kronor. For someone who bought a property in Stockholm at the same time, things turned very differently; by 1990 the real value had grown to almost 17,800 kronor. The same amount invested in the Stockholm stock exchange had doubled in real terms to over 20,000 kronor.

Such differences were not solely due to inflation, of course, but it did play a large part. Arbitrary redistribution in this fashion causes problems for those who are hit by them as well as for the social climate. It was not by chance that Gösta Rhen, perhaps the Trade Union Confederation's foremost economist, in the 1960s coined the slogan: Hate Inflation.

A distinct target: 2 per cent

Some months after the krona's fall in 1992 the Riksbank introduced an inflation target of 2 per cent. A tolerance interval of 1 percentage point on either side of the target was included mainly to make it clear that deviations would probably occur but also that they should be limited. The target was tied to the consumer price index, the measure of inflation that was most familiar and reliable, besides being published regularly.

There is a great deal to say about this — the choice of the target's level and the choice of index — in the light of our experience and the academic literature that accumulated in the 1990s. I shall have to be brief, however, because otherwise there will be no time for the more practical issues about our procedures, which is today's theme.

So here are three short comments:

- The *appropriate level of inflation* is one debatable point. There are arguments for a somewhat higher level as well as a somewhat lower. With our present knowledge, this is ultimately a matter of judgement and so far there has been nothing to persuade me that there are any grounds at present for changing our target. As I see it, the most important thing is to set up a distinct target so that a given rate of inflation is anchored among all economic agents, be they households or firms, employers or employees. In this we have been very successful.
- The choice of an *index* is a complicated matter. Unfortunately there is no measure of inflation that in every situation can show whether monetary policy is properly balanced or which measures are called for. I have already mentioned the CPI's advantages. The main drawback is that from time to time this index is markedly affected by price movements that the Riksbank neither can nor wants to counter. Not wanting to counter them mainly has to do with the time lag before monetary measures bite; another reason is that we would be chasing our own tail if, for example, we were to raise the interest rate to counter an increase in interest expenditure that stems from our own earlier interest rate hikes. We have therefore clarified how policy is formed in relation to price movements that are transitory. In practice, monetary policy in recent years has been based on forecasts of inflation excluding indirect taxes, subsidies and interest expenditure, that is, on the index known as UND1X.
- The third issue is the *exchange rate's* role in monetary policy. There is less talk about this today but in the early years with the inflation target the public debate was all the more lively. The discussion subsided when the Riksbank, early in 1996, made it clear that policy is guided by the long-term outlook for inflation and continued to lower the repo rate even though the krona had weakened. For monetary policy the central consideration is thus the exchange rate's impact on inflation. Perhaps I should add that we do have a rough idea of the level of the exchange rate that seems reasonable in the longer run. We have not intervened since the occasion during the financial turbulence in 1998 when the krona weakened in a way that both then and in retrospect seemed unreasonable.

Assessments of the coming 1–2 years are crucial

It takes time for monetary measures to affect inflation. Some effects of an interest rate adjustment may indeed occur very quickly. The stock market, for instance, is influenced as soon as an adjustment is announced and this can have immediate consequences for household consumption, for example, and thereby a quick impact on certain prices. Monetary policy can also elicit exchange rate movements and quickly affect prices for exports and imports. Normally, however, there is a time lag between monetary measures and their effects. For example, an interest rate hike leaves households with less money for other expenditure and also reduces the return on investments. By gradually influencing consumption and investment, this leads in time to changes in total demand. With weaker demand, firms then have more difficulty in raising prices and that leads to lower inflation.

Interest rate adjustments accordingly affect inflation through a variety of channels that economists refer to as the transmission mechanism. We know more about some channels than we do about others. It is not clear just how long it takes for the effects to materialise. Calculations by the Riksbank and other central banks suggest that a reasonable time perspective when formulating monetary policy is the coming twelve to twenty-four months. Our simple rule of action is accordingly that if inflation one to two years ahead looks like being above the target, then normally the repo rate should be raised and vice versa. But we also attach some importance to our policy's effects before as well as after this time horizon.

In view of the uncertainty in this respect, some differences of opinion — in our Executive Board as well as in the public debate — as to what policy's time perspective should be are only natural. If it is feared that inflation will, for instance, shoot up beyond the target horizon, then there may be grounds for acting particularly early. In my opinion, however, the clear target horizon has stood us in good stead in recent years. It has made policy easier to understand and foresee. It has also been beneficial internally by forcing us to be specific and have good arguments for departing from the rule of action.

There have, moreover, been a number of occasions when our ideas about prospects in the longer run were faulted by new developments. One example is when rising activity and inflation in 1997–98 were broken by the Asian crisis and the associated fall in international prices. Today, when rising domestic resource utilisation is beginning to slacken in response to developments in the United States and falling stock markets, the element of uncertainty in our work is highlighted again. All this cautions against attaching undue importance to assessments of the longer run.

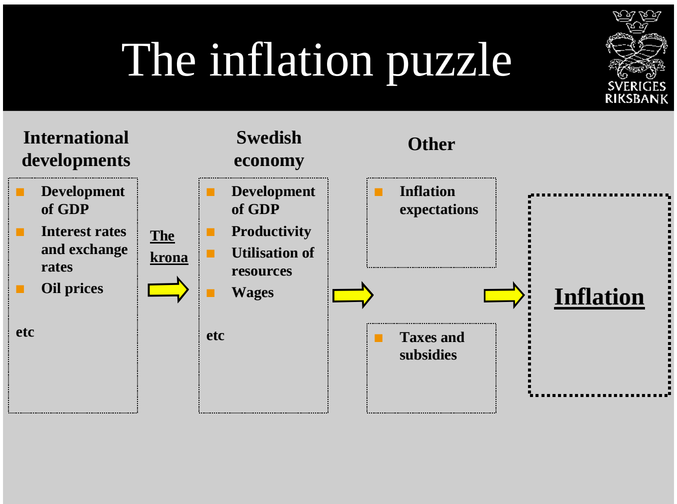
Another matter that has been discussed a great deal in recent years is how monetary policy ought to handle price movements in assets such as real estate and shares. This is not much of a problem in the normal course of events. Rising house prices, for example, are usually connected with a general economic upswing that may generate increased inflationary pressure and thereby prompt an upward revision of forecast inflation and perhaps a repo rate increase. But what if that does not happen inside our normal time horizon? I personally believe there may still be grounds for adjusting the repo rate if one either foresees a future 'bubble' that may show up in inflation in the longer run or is concerned about the consequences for the economy and the financial system when the 'bubble' finally bursts. In the light of our experiences when the 'financial bubble' burst in the early 1990s, I believe that support for such a line of action could be justified, which of course would require clear motives and arguments.

Not an exact science

Our preparations for monetary policy decisions consist to a large extent in constructing forecasts. And as Alf Henriksson, if my memory does not fail me, said on some occasion, making forecasts is difficult, particularly about the future. It calls at least for knowledge of what has happened and is now happening in the economy, as well as of various economic relationships that can be used to interpret the available information.

One approach involves assessing the factors that affect prices and trying to identify simple relationships between them and inflation. Such calculations are a part of the material that is presented to the Executive Board as a basis for decisions. If they add up to a uniform picture, the calculations presumably say something about the direction in which inflation is moving.

Our main assessment, however, uses methods that are more complex. Like other economic observers, we endeavour to construct a picture of economic developments in the coming years that is coherent and consistent. We do this with the aid of what economists call a model: a computer spread-sheet for processing economic data. This largely guides the presentation of our assessments in the Inflation Report (*Chart 1.The Inflation Puzzle*). Starting from appraisals of global economic



developments, various international prices, for oil for example, the exchange rate, interest rates and what is happening in the domestic economy, we estimate a picture of economic activity and resource utilisation in Sweden. Normally it is resource utilisation that is crucial for inflation. To this we add an assessment of inflation expectations as well as estimates of factors with effects that may be more or less transitory, such as changes in interest rates and taxes. The combined result is a forecast of inflation.

The large model is made up of a number of relationships, The equations for calculating exports are one example. Swedish exports are estimated as a function of, for example, global economic developments and the path of the krona's exchange rate or some other measure of relative prices. But as some important relationships are not particularly stable, we have to make judgements on the basis of other experiences. Sometimes, moreover, there are grounds for supplementing a model-based calculation with more specific information. There may be indications that investment activity, for example, will be higher than historical relationships indicate.

The information we use comes from many different sources. The bulk of it consists of official statistics from Statistics Sweden, the National Institute of Economic Research and so on or their counterparts in other countries. We also take a close look at the assessments of other forecasters in Sweden as well as elsewhere. In addition, we try to collected as much information as possible on our trips in Sweden and abroad. I set great store by a continuous dialogue with a number of colleagues about what is happening in their parts of the world and their thoughts about monetary policy.

Monetary policy is obviously not a matter of applying an exact science. As our Governor and I have both talked about earlier in this building, domestic inflationary pressure has been unexpectedly low in recent years, for example. The historical relationships suggested that domestic inflation would be higher. Part of the explanation seems to lie in deregulations and increased international competition making prices increases in the traditional manner more difficult. There are also signs that the low and stable inflation expectations I mentioned earlier have aided us. We now believe, moreover, that resource utilisation has not been quite as high as our earlier calculations suggested. All in all, the economy seems to have been functioning more efficiently than we and most other observers expected earlier.

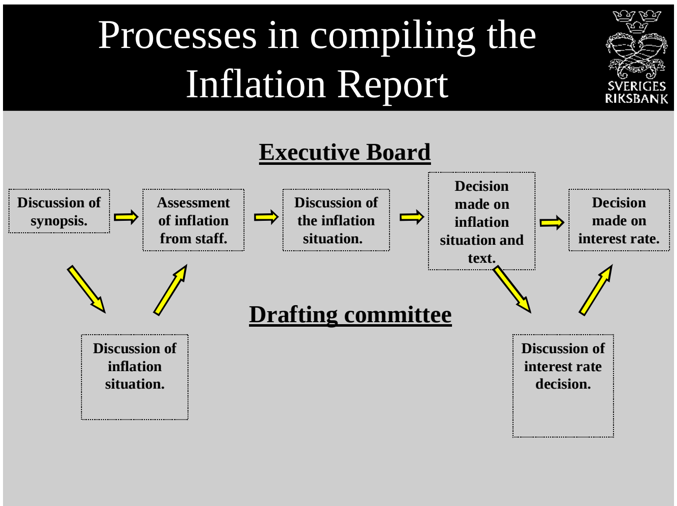
Examples of other forecasting problems are not hard to find. A highly topical issue is, for instance, how developments in stock-markets, which are now of major importance for households, are likely to affect private consumption. Then, of course, forecasts can be wrong simply because something unexpected happens. The Gulf war and the Asian crisis are two examples but even smaller shocks can upset earlier predictions.

The uncertainty that is inherent in decision-making is handled by not concentrating exclusively on one forecast for the economy and inflation. We also look at a spectrum of risks in the form of alternative scenarios. Last December, for instance, it was conceivable that economic activity would be weaker on account of a slowdown in the United States, with repercussions on the Swedish economy and inflation. At the same time, factors that might lead to higher inflation were the wage negotiations going wrong, the oil price rising and the exchange rate remaining weak. Since then the picture has shifted; weaker activity and a lower oil price have reduced the risks of inflation, though there are still certain upside risks from domestic inflation, future wage agreements and the weak exchange rate. We try to gauge the probability of each scenario and multiply this probability by the effects on inflation. In this way we arrive at a distribution of the probabilities in our assessment of inflation. The result serves as a foundation for monetary policy.

A broad, comprehensive internal discussion

Monetary policy is discussed by the Executive Board eight to ten times a year. On four of these occasions the Board also adopts an Inflation Report. The meetings are scheduled about six months in advance both for the sake of our internal work and to inform those who follow this, for instance in the financial markets. Additional meetings can, of course, be arranged if necessary and we have said that they will be announced as soon as we have fixed a date. But we have now used this procedure for more than two years and that has not yet happened.

The publication of the Riksbank's quarterly Inflation Report is preceded by at least three discussions in the Executive Board: one or two to consider which general questions to include in the Report and our picture of future inflation, a meeting to finalise the text and a final meeting about a week later to set the repo rate. At the intervening Board meetings we simply compare new information with the picture in the most recent Inflation Report and decide the repo rate.



Material for each Board meeting is prepared by the Monetary Policy Department, where some forty economists are involved in various ways. Starting from this material, the Board members endeavour to arrive at a joint view of economic developments and inflation. By and large, we follow the structure of Chapter 2 in the Report and start with international prospects. Our opinions naturally differ on some things, large as well as small, as can be seen, for example, from the published minutes of the meetings. But an effort has always been made to arrive at a joint view and in this we have generally succeeded.

I want to underscore that this is a balancing act. It is important that different perspectives are compared and as many difficult questions as possible are discussed. But it is also desirable that we ultimately arrive at something of a consensus. In the longer run it would hardly be good for the Riksbank to publish six different inflation reports, which in a way would be the logical outcome of carrying the Board members' individual responsibility to an extreme. This raises the issue of what the Inflation Report stands for. The Board's decision that it represents a majority view enables us to compile a clear and consistent presentation. The Bank of England has a different procedure that aims to present different views in a single report.

The material produced in the Monetary Policy Department is distributed simultaneously to all the Board members to make their conditions as similar as possible. As the member responsible for monetary policy preparations, I am in a position to influence discussions and decisions, apart from those at Board meetings, mainly as chairman of the internal monetary policy group that is made up of leading members of the Bank's competent departments. Matters on the monetary policy agenda are discussed by this group on a continuous basis. In the light of that discussion, at Board meetings I also present proposals about the direction of policy. However, all the members of the group attend Board meetings and are able to present their own views.

The arrangements we have chosen for internal discussions and preparations build on experiences at other central banks. A proposal for the approach we have used since autumn 1999 was drafted by some of us after talks with colleagues at the Bank of England, the Bundesbank and the Federal Reserve. There are some important differences, however. The officials who prepare the Board's material are in a stronger position compared with other central banks. We ask them to produce a comprehensive assessment of inflation independently, whereas in the Bank of England, for instance, the counterpart to our Executive Board is involved in this work. And at neither the Bank of England nor the ECB are staff present at policy meetings. In other central banks, moreover, before the preparatory material is presented to the counterpart to our Executive Board, it has to be approved by the competent board member. So in all these respects our internal process is very open. We opted for this in order to make discussions as fruitful and lively as possible, as well as to motivate and engage our staff.

That does not alter the fact that the final decision is up to the Executive Board. In the past two years or so we have not refrained for altering either the main scenarios or the risk spectrums that the staff has produced. Neither have we always shared the policy group's majority view of the appropriate interest rate. But the Board has had well thought-out and consistent assessments on which to base its decisions.

Communication and transparency

The issue of central banks' communication and transparency is sometimes discussed as though it were unconnected with the actual formation of policy — as though it were just a matter of selling a given message. I see this differently. The extent to which a central bank is understood and the credibility of its policy do, of course, depend on its track record in goal fulfilment and how long it has been operating. But the clarity of its policy framework also plays a part, as do the procedures for arriving at decisions.

That the Riksbank managed to establish reasonable respect for its task and confidence in its policy so quickly was no doubt largely a consequence of the Swedish economy's good performance in recent years. But it presumably helped that the Riksbank has endeavoured to open up discussions, present the grounds for its policy and do so in accordance with clear principles.

In my opinion, the most important link in our communication is monetary policy's analytical framework. This includes the distinct 2 per cent target and the specification of the deviations from this that may be acceptable in connection with transitory effects. It also includes the rule of action and the fact that to a large extent we have adhered to it. Finally, it has to do with the forecasts and assessments on which the policy is based being published and used to argue for the policy.

The changeover to the new Executive Board with six members gave transparency a new dimension. Previously, external communication had been in the hands of the governor and the deputy governor responsible for preparing monetary policy. It involved mutual consultations and aimed to voice a single opinion. With the new Board, each of the six members is individually accountable for the monetary policy decisions. So ought not each one be allowed to make their voice heard? How could their individual contributions be properly assessed without knowing their positions on monetary policy issues? But how were all the speeches and other statements to be coordinated efficiently in practice to ensure that they conveyed a single, clear picture?

With the procedure we have chosen, you know that each of us normally speaks independently of the others. The minutes of the monetary policy meetings are published after a time and record our discussions in outline, besides containing information about how each of us voted. We have deliberately refrained from labelling what we say at the meetings with our names. We believe that would not work very well; the discussion would presumably be more premeditated than one would wish. But even with the system we have chosen, there is presumably a risk of jeopardising the spontaneous exchange and testing of ideas.

Our joint communication about monetary policy issues takes the form of the Inflation Report and the press notices and communiqués that are issued after the meetings. We also have an arrangement whereby one of us is entitled to speak for a majority of the Executive Board. An announcement to that effect is made and to date it has happened only when the Governor meets the Riksdag's Standing Committee on Finance. At the press conferences on monetary policy, moreover, the Governor and myself, as the member responsible for the preparation of material, speak on behalf of the Board.

Our procedure clearly entails risks. The media may focus most of the time on differences between our views, which could harm the Riksbank's image and possibly also create internal problems. While that has generally not been the case, our system is vulnerable. It would not be difficult for a Board member to act in such a way that 'conflicts at the Riksbank' hit the headlines. We have tried to avoid this, for instance by not arguing with each other in public. We have also refrained from evaluating colleagues' arguments and proposals.

Before choosing an approach to communication and transparency, we again tried to learn from other central banks. The main issue in the public debate seems to have been the minutes of our meetings. I believe the publication of minutes has advantages. The minutes provide a clear opening for the evaluation of what individual Board members contribute to the monetary policy discussion, besides facilitating the democratic control of and insight into our work. In my opinion, the arrangements we have chosen can promote a better understanding in society in general of the Riksbank's policy and our deliberations. That is important not least in a small country where the discussion of stabilisation policy is not all that broad.

Some conclusions

Work on monetary policy has been arranged in ways that differ from country to country. This has to do with historical differences that stem from the society in which the policy is constructed. Scandinavian and Anglo-Saxon countries require a greater degree of openness, for example, than countries in Central Europe. The duration and acceptance of low-inflation policies also play a part. A reluctance to change a winning concept was no doubt an important reason why the Bundesbank continued to adhere to money supply targets in its communication for so long even though academic studies showed that in practice its policy was being guided by inflation forecasts.

The internal construction of monetary policy is also related to the central bank's legal framework. With a clear mandate from an elected assembly, there is a sense in which the task becomes more technical. That is the British model. It can make it possible to work in a different way and choose other forms for decision-making.

Yet I still feel one should not be too agnostic. Our experiences seem to speak in favour of a number of things that ought to be of fairly universal importance.

- A clear intellectual framework is an advantage because it makes policy easier to explain, understand and evaluate. That in turn reduces the risks of being misunderstood by media and the general public and of disturbing the markets unnecessarily. The clearer the policy, the better it can function as a short-cut to credibility.
- Our clear intellectual framework does, of course, tie us down to some extent but it has also obliged us to make a deeper analysis. The fact that this 'straightjacket' has worked to date does not, however, mean that we follow our rule unconditionally. But a departure from simple rules does exact a price in terms of less clarity.
- The internal decision-making processes are important because, for instance, they can ensure a good foundation for the decisions and contribute to a better internal discussion. Typical features of the Riksbank in an international perspective are the short distance between staff and decision-makers and a continuous and extensive two-way communication between the two. We also have an extensive interchange with the academic world.
- Transparency has presumably helped to gain acceptance for the low inflation policy more quickly in many circles than would have been feasible otherwise. It has also paved the way for a broader internal discussion as well as a dialogue between the Riksbank and external observers in markets, academy and elsewhere. This in turn has made us sharpen the analysis and contributed to a monetary policy discussion in society in general that is more realistic.