Stefan Ingves: Comments on “An evaluation of Swedish monetary policy 1995-2005”

Speech by Mr Stefan Ingves, Governor of the Sveriges Riksbank, at the Riksdag Committee on Finance, Stockholm, 30 November 2006.

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Thank you for the invitation to come here! I would like to begin by thanking the authors, Professor Giavazzi and Professor Mishkin, for an interesting and comprehensive report. As we at the Riksbank have said earlier, we consider it a very good initiative by the Committee on Finance to commission two highly qualified external experts to make an evaluation of the monetary policy conducted over the past decade.

As the Riksbank has an independent position, it is important that monetary policy should be regularly examined and evaluated. The Committee on Finance makes its own evaluation of monetary policy every year, but I nevertheless think it is a good idea to occasionally supplement these evaluations with reports made by external experts. It is a particular advantage that two foreign academics have carried out the examination. This gives an outside perspective on Swedish developments, which can be very valuable.

As you can see, the report is fairly comprehensive and it is therefore impossible for me to mention all of the aspects that are covered. Let me just say as an overall comment that I feel the report has been very pleasant reading. Although the authors express criticism on some points, it is clear that their overall impression of Swedish monetary policy is very positive. For instance, it is very pleasing that the evaluation gives such high marks to the efforts we have made to improve the analytical base for our forecasts and for monetary policy. Our ambition has been to use the latest and best scientific methods in our analyses and we have therefore continuously updated our working methods. It is therefore particularly satisfactory that the authors observe in their conclusion that "the Riksbank compares favourably with the best central banks in the world".

However, we must not rest on our laurels. Conducting monetary policy is associated with great uncertainty, not least because developments in the economy often follow different paths than anticipated. We must therefore always take heed of constructive criticism, continue to hone our analyses and test new approaches with an open mind. However, after this evaluation I feel fortified in my opinion that we are on the right track.

Recommendations in the evaluation

As I do not have much time at my disposal, I shall concentrate my comments on the recommendations in the report as to how monetary policy and its framework could be improved. Three of the recommendations are aimed at the Riksdag and the Government and concern the forms for the monetary policy debate and the appointment of the members of the Executive Board. As these recommendations are not directed at the Riksbank, I will refrain from commenting on them.

With regard to the recommendations aimed at the Riksbank, I shall first comment on some suggestions on which I agree with the authors. This applies, I can say now, to most of their suggestions. I will then also take up a couple of points on which I do not entirely agree with the conclusions drawn by the authors.

One of the recommendations given is that the Riksbank should make it clear in its Inflation Report that the flexibility of our inflation-targeting policy means that we attempt to subdue fluctuations in both inflation and the real economy. This is a point I agree with, but in my opinion we have actually already done so. With effect from the second Inflation Report this year, we have a special box explaining how the Riksbank has scope when setting interest rates to give consideration to developments in both inflation and the real economy. The box is an extract from a document entitled “Monetary policy in Sweden”, which we published in May this year. The fact that inflation targeting gives consideration to the stability of both inflation and the real economy is moreover something we have long emphasised in speeches and other forms of communication. However, it is probably fair to say that we have gradually become clearer on this point, as we have learnt more about how inflation-targeting policy should be conducted.

Another recommendation in the evaluation is that the Riksbank should base its forecasts on its own assessment of which repo rate path is appropriate; that is, that we should take a step further compared to our current method. At present, we base our forecasts on the development of the repo rate expected by the financial markets. Professors Giavazzi and Mishkin give several reasons why they advocate that the Riksbank should present its own interest rate forecasts. Perhaps the most important reason is that this would show most clearly what the Riksbank's own expectations of future monetary policy are. This would make it easier for companies and households to plan for the future. This point of view is easy to agree with, and I have expressed similar thoughts myself in various speeches. We are currently considering and working on how this might be achieved.

Compensating for earlier deviations from target

As I mentioned to begin with, there are a couple of points where I do not agree entirely with the authors' conclusions. One such point is how the Riksbank should act if inflation has been below, or above, target for a long period of time. Professors Giavazzi and Mishkin suggest that if inflation has been below target for a long period of time, monetary policy should partly compensate for this by being extra expansionary in the future.

As I understand it, the background to this is the developments in recent years, when inflation has been below the target. Here it is worth pointing out that when inflation has been below target level for a long period of time, there have been good explanations for this. The most recent episode has mainly been due to the fact that productivity growth has been surprisingly high. As was observed in the evaluation, this was something that most forecasters missed.

The authors put forward two arguments in favour of monetary policy compensating for persistent deviations from the inflation target. The first is based on the assumption that deviations from target may be a sign that the analysis and forecasting models used by the Riksbank tend to over-estimate inflation. Of course, we are constantly working on ways of improving our assessments and trying to learn from forecasting errors we have made. If our analysis and forecasting models do not function satisfactorily, we must attempt to correct the deficiencies. In my opinion, this would be a more natural measure than compensating for forecasting errors by means of an extra expansionary policy.

The second argument is based on the idea that it might be beneficial to express the target in terms of a path for price levels instead of in the form of a target for the inflation rate. The difference from an inflation target, which may be considered rather subtle, is that if the inflation target is not met, it is regarded as a "bygone" under the current strategy. This is to say, if inflation is for instance below the target for a long period of time, one does not need to compensate for this by then allowing inflation to be above the target for a period of time. Instead, one looks ahead and aims to bring inflation back in line with the target of 2 per cent.

If one instead has a target path for the price level, if prices are below the path this must be counteracted by more rapid inflation during a period of time to enable a return to the path prices were following before the deviation. If the intention is that prices should increase by 2 per cent, but over a period of time they have increased by less than this, the rate of price increase must be higher than 2 per cent for a period in order to return to the original price level path.

The advantages and disadvantages of a price level target have been debated considerably in research and are also discussed in the evaluation. One example of an advantage of having a price level target is that it provides more guidance than an inflation target with regard to the price level far into the future. As I understand it, the authors do not appear to be advocating a pure price level target, rather some form of hybrid. In concrete terms, this means, if I interpret rightly, that the Riksbank should retain its inflation target but still to some extent compensate for the deviations from target that have arisen by deliberately allowing inflation to go above the target for a time.

Here I can imagine a number of practical objections. I believe, for instance, that it would not be an easy task to convey the message to the general public that as inflation had been, say, below target for a period of time, the Riksbank would endeavour to bring inflation up to, say, around 3 per cent for a period of perhaps a year. In my opinion, this could lead to considerable confusion with regard to the status of the 2 per cent target. There is a risk that it could be perceived as the Riksbank beginning to work with inflation targets that vary over time, which could also be said to be the case. I believe that in this type of world it would be more difficult to anchor expectations of future inflation.

The authors claim that this method of conducting monetary policy would only entail a minor change in the current policy. I do not really agree with this. I consider that it would be a fairly major change in a system that, all in all, has been proved to work well. It would in any case be a much greater change than the ones we have made so far, such as abandoning the assumption of an unchanged repo rate and our earlier simple policy rule. Bearing in mind that the Riksbank, as is also noted in the report, has not found it entirely easy to communicate these relatively limited changes in its monetary policy system, it is somewhat surprising that the authors consider this change as minor. However, I am not saying that changes in the monetary policy strategy, for instance in the way suggested by Giavazzi and Mishkin, will never be considered. But we do need further analysis and debate before this can be considered in Sweden.

Monetary policy and house prices

Another point where I have some doubts is whether house prices should be taken into account in monetary policy. The specific recommendation given in the evaluation is that the Riksbank should clarify that house prices, like other asset prices, are not independent targets for monetary policy.

In my opinion, this is a message that we have tried hard to convey recently, which has also been noted in the evaluation. I and other members of the Executive Board have explained, for instance, in several speeches that if prices in the housing market have had an effect on our interest rate decisions, this has not been a reflection of the inflation target being downgraded in any way or that we now have a special target for house prices. The reason is that we believe this the best way to safeguard what we have been set to safeguard – stability in the real economy and inflation.

It is claimed in the evaluation that the Riksbank was initially unclear with regard to the reasons for allowing house prices to affect interest rate decisions and that this meant some people had interpreted it to mean that we had introduced a further target in addition to our inflation target. I believe there is some truth in this criticism. We could probably have been clearer at an earlier stage than we were regarding the reasons for taking house prices into account in our interest rate decisions. Then we would perhaps also have been able to avoid some of the misunderstandings that have evidently arisen.

Now I believe that the criticism made in the evaluation concerns not only to what extent we have been unclear about whether we regard house prices as an independent target – which we accordingly do not. It also appears to stem from the authors having a somewhat different view than the Riksbank regarding how house prices should be considered in monetary policy. The authors argue that monetary policy should react to a rapid price increase in the housing market only if such a price increase is expected to lead via normal channels to problems such as overheating and excessively high inflation.

This method of reasoning is not without problems. A rapid increase in house prices and lending to households may entail risks in the long term, which are difficult to quantify and capture in conventional forecasts for the economy a couple of years ahead. If prices and the increase in borrowing were to some extent based on unrealistic expectations of how house prices and interest rates will develop in future, there is a risk of a fairly substantial correction in expectations and prices further ahead. The consequence of such a correction might be that the economy developed weakly over a long period of time. It would also have effects on inflation.

It may be necessary to take these risks into account in monetary policy decisions in a different way than in the normal approach, where the forecasts for inflation and the real economy for the next two years serve as the foundation. This can be done, for instance, by beginning a phase of interest rate increases slightly earlier than would otherwise have been the case. Of course, the hope is that this will contribute to a smoother adjustment process for house prices and thereby to a more stable development of inflation and the real economy.

Let me say, to round off my contribution on this subject, that there are some questions here that are still debated among central banks and within the academic world. As yet, there is no consensus as to how monetary policy should be used to manage risks related to rapidly rising house and asset prices. I would also like to emphasise that, all in all, I do not see any major differences between the Riksbank's view and the authors' view. The approach we have chosen has in practice only meant a marginally different timing of our interest rate decisions. Given this, the fairly strong focus in the evaluation on the Riksbank's way of managing house prices appears slightly exaggerated, but I agree with the criticism that we should have communicated our actions more clearly.

Conclusion

Let me conclude my comments on the report. It is an important document that the authors have produced. I have put some time into arguing against a couple of the proposals, but I once again would like to emphasise that I agree with the authors on most of what they have written. We will of course closely examine the criticism that has been raised. However, I hope that the fact that the report is critical on a few points will not overshadow the overall message – namely that Swedish monetary policy has worked well.

Thank you!