Barbro Wickman-Parak: Reflections on recent monetary policy

Speech by Ms Barbro Wickman-Parak, Deputy Governor of the Sveriges Riksbank, at Skandinaviska Enskilda Banken AB (SEB), Stockholm, 14 October 2010.

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The last fixed-interest rate loan granted by the Riksbank to the banks when the financial crisis was in full storm fell due on 6 October. The banks have not needed to use the Riksbank's loan facilities to any great extent since the beginning of this year, and when we held the final auction of variable-rate loans just over a week ago, no bids were received. This means that the banks are now managing their short-term funding entirely in the private loan market. It also means that the banks have once again taken responsibility for the overnight market. There are some smaller outstanding loans that will be repaid during the winter. But on the whole, the Riksbank has now left behind what is called "extraordinary measures" and returned to "business as usual" in our monetary policy. Of course, we cannot rule out the possibility that the repercussions of the financial crisis may affect us in some way in the future. But it certainly seems as though we in Sweden can now turn the page and put the most acute chapter of the crisis behind us.

Sweden has come through the crisis relatively unscathed

So, where do we stand now? Looking back, it appears increasingly clear that the Swedish economy has come through the crisis relatively well. Although the fall in GDP was greater in Sweden than in many other countries, the recovery has gone more quickly and we are now on much more stable ground than most others. There are several reasons for this. But I believe that one important explanation is the insights we gained from the deep recession at the beginning of the 1990s. We then realised the importance of building stable frameworks for both monetary policy and fiscal policy to create proper conditions for long-term stability. When economic agents make decisions they have been able to rely on inflation being reasonably stable and on public finances not being weakened to an extent that requires severe tightening. The latter in particular is now a problem in many countries.

When things get difficult, as in the recent crisis, the fundamental faith in the economic policy framework has meant that we could stimulate the economy strongly without anyone questioning the credibility of the inflation target or the sustainability of Sweden's public finances. Our bank system has also managed better than those in many other countries. To some extent this is probably due to lessons learned from our own earlier bank crisis. For example, the banks have avoided so-called structural products with elements of high-risk US mortgages, which were one of the causes of the crisis in the first place.

The Riksbank's assessment and decision in September

At our most recent monetary policy meeting in September we could note that the situation in the world economy had continued to improve, although the strength of the recovery was still uncertain. The public finance problems in certain eurozone countries were still causing some concern and there was uncertainty over the consequences that stricter fiscal policy might have for growth in these countries. But compared with the situation in the spring and early summer, the unease on the financial markets had toned down, partly as a result of the stress testing of the banks by the EU during the summer. Growth prospects in the eurozone were in principle thought to be the same as at our meeting in June. However, we could note that the risk of slower growth in the United States had increased and we revised down the forecasts for US growth this year and next year. Nevertheless, we envisaged, as before, that the international economic climate would gradually improve.

We could also note at the meeting that the recovery in the Swedish economy had been more rapid than expected, and our assessment was that the Swedish economy would grow more quickly than, for instance, those in the eurozone and the United States. One reason for this, as I have just discussed, is that unlike many other countries, we do not need to tighten policy to correct large budget deficits and debt ratios. World trade had picked up again and this had shown an impact on our exports. Moreover, the strong optimism among both households and companies in Sweden indicated that domestic demand could be maintained over the coming years. Our forecast in September was for GDP growth in Sweden of around 4 per cent this year, to be followed by a slower growth rate. This would put GDP in mid-2011 back at the same level as at the end of 2007, that is, before it began to fall.

In September we could once again note that the recovery in the labour market had been surprisingly strong. The new forecast made entailed employment being at the same level as prior to the crisis as early as next year. Our assessment of unemployment was that it would fall relatively quickly over the coming quarters and then decrease at a slower rate.

Given this, we adjusted up our assessment of resource utilisation in the economy in relation to that made at the monetary policy meeting in June. We foresaw resource utilisation continuing to rise over the coming years. The overall picture was that resource utilisation was still at a low level, but that it would be at an approximately normal level at the end of the forecast period.

We estimated in our forecast in September that underlying inflation measured as the CPIF would continue to fall in 2010, and then increase as rising resource utilisation made an impact on inflation. It would reach 2 per cent at the beginning of 2013. CPI inflation was forecast to increase quickly next year, mainly as a result of mortgage rates rising due to the repo rate increases. CPI inflation was expected to temporarily overshoot the inflation target in 2012 and 2013, but to be around the 2 per cent target in the longer run when the repo rate has reached more normal levels.

The majority of the Executive Board members made the assessment that it was appropriate to continue the process of normalizing monetary policy that had begun in the summer. The repo rate was raised to 0.75 per cent and the repo rate path was held unchanged from June.

This is roughly the picture we painted in the Monetary Policy Update published in September. The statistics received recently have continued to point towards a rapid recovery in Sweden. The GDP outcome for the second quarter has been revised up relatively substantially compared with the preliminary outcome, and expressed as an annual percentage change amounts to 4.6 per cent. The National Institute of Economic Research's economic tendency survey points to the mood among households and companies being much stronger than normal, and the indicator is now only marginally lower than the peak listing from 2000. New international statistics present a mixed picture. How the new information will be taken into account is something we will return to at our next monetary policy meeting.

My deliberations at the September meeting

Let me now discuss in slightly more detail the deliberations that lie behind my personal stance with regard to monetary policy this summer and autumn. Part of the recent debate has concerned whether the repo rate path advocated by the Riksbank is too high. This debate has arisen partly because the market appears to believe that the Riksbank will not raise the repo rate as quickly and as much as we ourselves are forecasting, and partly because the Executive Board members have recently had differing opinions on what level is appropriate for the repo rate now and in the coming period.

I have noted that the fact that I have advocated increasing the repo rate has meant that anyone who now reads some reports in the media about the activities of the Executive Board may gain the impression that I am an inveterate "hawk", perhaps even some form of iron lady who is ready to quash any tendency towards an economic upturn. To modulate this picture, I would like to point out that immediately prior to the crisis, in summer and autumn 2008, I actually entered reservations against what I considered to be the excessively tight policy advocated by the majority of my colleagues. So the idea of putting Executive Board members into compartments, or perhaps rather cages, and expecting us to stay there, is not usually wise, at least not with regard to me. I recall, by the way, that I said roughly the same thing two years ago, when I was regarded as being a dove.

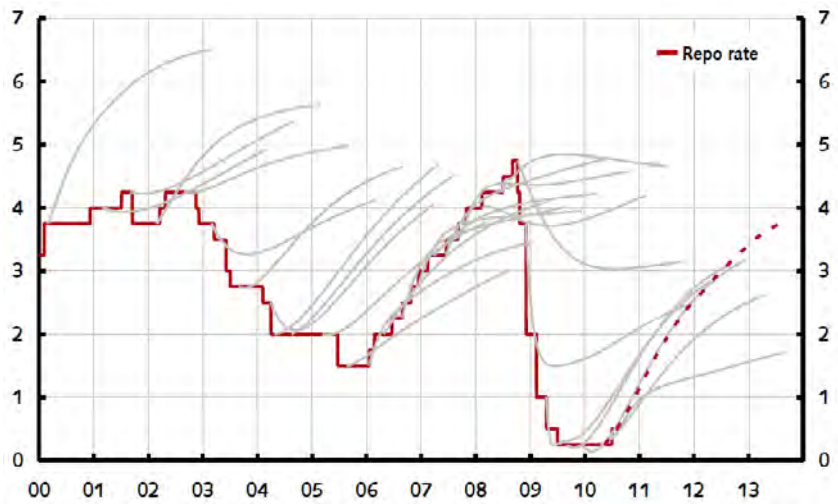
It may also be worth noting that I am not the only one who from time to time prefers a higher or lower repo rate path than the published one. The same applies to market expectations regarding the future repo rate. For instance, during most of 2009 market expectations were largely *above* the Riksbank's repo rate forecast. Since the beginning of 2010 they have instead been *below* our path.

In this context it is important to point out that there is no "true" measure of market expectations of monetary policy. The expectations I am talking about here are the expectations of the repo rate that can be read from forward rates. To produce these expectations, one must among other things adjust for various types of premium in the forward rates, and there is no obvious way of doing this. So one should remember that discrepancies between the Riksbank's repo rate forecast and market expectations as understood from forward rates could be due at least in part to measuring problems.

Regardless of these difficulties, it is also worth emphasising that there are no particularly strong reasons to believe that the market is always "right", in the sense that the repo rate the market is expecting is the one that will be realised. If one looks at historical patterns, the actual repo rate has often shown a rather different development to what market agents were expecting, according to forward rates (see Figure 1). The fact that market expectations are now below the Riksbank's forecast for the repo rate is of course worth analysis and consideration. But one must remember that this is just a snapshot image, and that it is primarily in the longer run – where uncertainty is greatest – that the differences are really tangible. It is also worth mentioning that many forecasters are much closer to the Riksbank's view of the repo rate.

Figure 1

The repo rate and forward rates



Sources: Reuters EcoWin and the Riksbank.

It should be added that the Riksbank is of course also "wrong" sometimes, and that the actual policy turns out to be quite different from what we had forecast. The repo rate path is, after all, a forecast and not a promise, as we often point out. It is not reasonable to believe that we and market agents will always reach the same conclusions, and the differences do not necessarily express any form of confidence crisis. Inflation expectations are well-anchored around our target, which in my opinion is the most important indication that the market has confidence in monetary policy.

So why did I support the repo rate path we published in the September Monetary Policy Update? If inflation undershoots the target at the same time as resource utilization is lower than normal, should it not be possible to keep the repo rate lower and thus have inflation closer to the target during the forecast period and more quickly return resource utilisation to a normal level? As I have described, I think there are fairly convincing reasons for the repo rate path described in the September Monetary Policy Update. The Swedish economy is strong and to attain the target a couple of years ahead we need only to start easing up on the accelerator. Because this is exactly what we are doing. The repo rate is being raised from an extremely low level and the repo rate path implies that we will have a negative real interest rate for a good time to come. This cannot be regarded as a contractionary policy – we are not slamming on the brakes.

I have expressed some concern at recent meetings over what a lower repo rate path might entail. One view that I have put forward on several occasions is that monetary policy must manage risk. In this context it may be important not to treat the forecast period as separate and independent, but to try to take into account how decisions made now might affect developments beyond the forecast horizon. Of course it becomes more difficult to comment with any great certainty on what will happen the further ahead one tries to look. But one can often nevertheless have some suspicion of what might happen, even if it may be difficult to quantify. My impression is that there are risks on the domestic side that are not conspicuous or visible yet but may build up.

Although resource utilisation is low and unemployment is high at present, the labour market is constantly improving and we have had to revise our forecast for employment up several times. The shortage figures are also rising. The levels may not be alarming, but an upward trend is clear. And there is a clear risk that labour shortages may arise further ahead. During the previous economic upturn a labour shortage arose fairly early, despite relatively high unemployment, and it is easy to forget that the major theme before the crisis was the severe problems in obtaining skilled labour. Although structural reforms have been made, it is difficult to say how great an effect they will have, and at what range. If monetary policy is too expansionary for too long, and the wheels are allowed to spin too fast, this could create problems with bottlenecks, if not during the forecast period then immediately thereafter.

Household borrowing is also a risk factor, and perhaps an even larger one, in the slightly longer run. A lower repo rate means there is a risk that the debt ratio will continue to build up from already high levels. This cannot go on for ever, and if there is a sudden turnaround it could have substantial negative effects on the real economy. This applies in particular if a situation were to arise where house prices fall and households' net wealth shrinks. Once households have reached a situation where they consider that they need to consolidate their balance sheets by reducing their debts, it is difficult to break off this process with the aid of monetary policy. This can be clearly seen in the United States right now, for instance.

I do not believe in a wait-and-see strategy that could mean that the repo rate needs to be raised even faster further ahead. A slightly higher interest rate now could make households begin to adjust and contribute to a more subdued development. To me, this is a well-balanced monetary policy.

This is fairly self-evident, but let me nevertheless emphasise: My aim is of course as always to try to attain the Riksbank's objectives – that inflation and inflation expectations should be firmly anchored around the target and that developments in the real economy should be stable. But to achieve this, I would like to take into account risks that I perceive exist and to put them in a slightly longer perspective than the usual forecast horizon – as I currently see good reason to do this.

Reflections on judgements and monetary policy decision-making

This leads me on to a slightly broader question regarding judgements and how they fit into the monetary policy deliberations. Let me therefore conclude with a few words on my views on this and how I approach a repo rate decision.

It is sometimes claimed in the economic debate that we at the Riksbank rely too heavily on economic models and that this can lead us to make the wrong decision regarding the repo rate. My opinion is that economic models are important and absolutely necessary aids. They organise ideas and ensure that we have consistency in our analysis of inflation, production, interest rates, employment and so on. The models also help to identify weaknesses in one's reasoning. The Riksbank has sophisticated models that provide good forecasts in themselves, but that also allow us to "experiment" with different repo rate paths and examine potential scenarios. Without these possibilities the preparation process would not function as smoothly as it does now.

But of course this does not mean that we merely push a button, lean back and buy exactly what the models come up with. This is not how monetary policy decisions are made. And I don't believe anyone would claim this was a good way of making these decisions. However good and sophisticated the models are, they are nevertheless simplifications of reality. They must therefore always be supplemented with judgements. The forecasts in our main scenario are always based on a combination of model analyses and judgements that take into account factors which the models either cannot capture at all or are unable to capture in a way we consider reasonable. These "hands-on" adjustments become particularly important when the historical correlations on which the models are based appear to have changed.

The judgements may be of different types and opinion may be divided as to which factors are most important to take into consideration at any given meeting. My view is that the judgements should as far as possible be reflected in the forecast figures for inflation, the real economy and the repo rate that a monetary policy decision is based on. But I believe that we must learn to live with the fact that it is impossible to quantify all of the factors we monetary policy decision-makers consider should be taken into account in the monetary policy decisions.

As I see it, there is no point in trying to produce, at any cost, a quantified adjustment of the forecast just to make a judgement one considers relevant fit into the monetary policy discussion. There must be scope to put forward arguments that appear reasonable, without necessarily having to translate them into exact probabilities or quantifying their effects on inflation and the real economy. As I see it, there is nothing wrong with having "misgivings" about a particular development and allowing this to affect the decision, without being able to exactly quantify the risks it entails. The kind of arguments that I have put forward at our most recent monetary policy meetings regarding the risks of an even more expansionary policy are of this type. I am quite convinced that most central banks' monetary policy discussions largely consist of this type of more qualitative argument.

By this I do not mean, of course, that "anything goes" in monetary policy. There must be a sufficient amount of structure and consistency checks in the monetary policy decision-making process. And I think there is today. The entire analysis process that precedes the monetary policy decision is carried out in an orderly and structured manner. And I also believe that there is confidence in our way of working. Although there are slight differences between different forecasters' views of future economic developments, as far as I know there is no one who thinks our assessments are completely off the wall.

The fact that we Executive Board members have had some differences of opinion recently has come under focus recently. But one thing that should be remembered is that dissension is hardly strange on a monetary policy committee like our Executive Board. It is intentionally assembled in such a way that it will consist of people with different backgrounds, experiences and knowledge. We are not supposed to be cast in the same mould. The whole point of allowing monetary policy decisions to be made by a group of people and not one individual can be summarised in the expression "many heads are better than one". And this would not apply if we all thought in the same way, if we were all clones. Then one single decision-maker would be sufficient.

It may be worth pointing out that the fact that we have been publishing our own forecast for the repo rate for a few years now has probably meant that it becomes more noticeable when we disagree. The repo rate path makes it necessary to have a deeper and more long-term discussion than if we were just making a decision on whether or not the current repo rate should be changed. My impression is that the repo rate path has increased the quality of the monetary policy discussion both internally and outside of the Riksbank. But it also means that, to put it simply, we have more to disagree on.

The fact that members of a monetary policy committee have different backgrounds, experiences and knowledge means that they approach an interest rate decision from slightly different directions, and they analyse and argue in slightly different ways. These differences do make demands that one must find some form of "common denominator" in the monetary policy discussion so that members do not talk at cross-purposes. In other words, a monetary policy committee must not only agree that it can disagree, it must also agree on which way it is okay to disagree.

But these differences also contribute to the diversity that leads to better decisions. There is no one who holds the key to the truth with a capital T, and when views and assessments are contrasted with one another there is less risk of bad decisions. There is some support for this in academic research, where one result is that a group of persons who process information and reach their decisions in different ways can outperform even very skilful individuals when it comes to solving complex tasks.[1] One could say that diversification trumps specialisation – it is the differences that create added value.

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[1] See, for instance, Alan S. Blinder, "Monetary Policy by Committee. Why and How?" *European Journal of Political Economy* 23 (2007).