Martin Flodén: Sweden needs its inflation target

Speech by Mr Martin Flodén, Deputy Governor of the Sveriges Riksbank, at Fores, Stockholm, 13 October 2015.

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I would like to thank Mikael Apel for contributions to the text.

"The Riksbank should reconsider its policy. Digitisation and globalisation have made it more or less impossible to reach the inflation target of 2 per cent. The Riksbank's rigid fixation with the target is in fact making the problems of rising debt and housing prices worse. The Riksbank should lower the inflation target or at least accept that inflation will continue to remain below the target for a long time to come. Then the repo rate could be raised and the rise in debt and housing prices would slow down."

These are the main features of the criticism directed at the monetary policy, which has been expressed by an increasing number of commentators over the past few months. It is undoubtedly good that monetary policy is publically debated, as this forces all parties to sharpen their arguments and think a little more deeply, which in turn increases everyone's knowledge and insight. I would like to make my contribution to this discussion here. It may not come as a complete surprise that I believe the ongoing debate is often oversimplified, and that there are a number of points that are unclear in the arguments presented.

As a starting point I think it is worth taking a step back and reminding ourselves why the Riksbank and many other central banks in general have developed inflation targets.[1]

The advantages of an inflation target

Money as we know it in modern times has no natural, intrinsic value. Historically, coins were minted using valuable metals and central banks promised to redeem banknotes in exchange for a certain quantity of such metals. However, since the early 1970s every trace of this kind of link to valuable metals has disappeared. The reason why banknotes and coins nevertheless have a stable value is based on expectations and confidence – expectations that the money will continue to be valuable in the future and confidence that the central bank will pursue a monetary policy consistent with price stability.

There are several ways to build expectations of price stability. It has often been attempted to develop some form of nominal anchor for the economy. The anchor could, for example, be a fixed exchange rate, a target for the development of money supply or an inflation target.

When it is credible, an inflation target acts as a benchmark and guides expectations in the economy. When economic agents have a common picture of how prices will develop in the future, it becomes easier to plan for the long term. The inflation target therefore lays the foundations for efficient price and wage formation. In Sweden the inflation target has contributed to stability in wage formation since the end of the 1990s, which could be compared with the 1970s and 80s when inflation was high and volatile and wage formation created major imbalances.

The monetary policy anchor thus helps coordinate expectations in the economy, and this is particularly the case when the target is well-defined, clearly communicated and generally accessible. For this reason, most central banks with inflation targets have formulated the target in terms of a broad and well-known price index, and as a specific level of inflation. A tolerance band is also often specified to show that the central bank neither can nor wants to

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[1] I also discuss this in Flodén (2015).

meet the inflation target perfectly all the time. However, even when there is a tolerance band, the objective is for inflation to end up at the target level, or in other words in the middle of the tolerance band.

If the target succeeds in coordinating inflation expectations, it can also become self-reinforcing. If expectations are in line with the inflation target, and if price and wage formation adapt to these expectations, actual prices will become consistent with the inflation target. When confidence in the inflation target is strong, it consequently becomes easier to meet the target. The flipside of this reasoning, however, is that the central bank has to fight even harder to succeed if expectations begin to deviate from the inflation target.

A weakness in the current criticism is that it takes the advantages I have just outlined too lightly, or in other words underestimates the benefit of maintaining confidence in an already formulated inflation target. I also think that the criticism *overestimates* the possibility of managing the debt and housing problem by using the repo rate. I will explain what I mean in more detail shortly.

The criticism: Lower the target or accept long term low inflation

It is easier to discuss the criticism if we divide it up based on the conclusions drawn from it. Different commentators have put forward roughly the same arguments in favour of the Riksbank reconsidering its policy, but they have drawn slightly different conclusions about what the consequences should be for the inflation target. Some have claimed that the inflation target is outdated or that it should be lowered.[2] Others have not gone as far, but instead said that the Riksbank should keep the 2 per cent target but accept that inflation will continue to remain below the target for a long time to come.[3, 4]

My perception is that the criticism has gradually aligned itself with the latter view, but I still want to say something about the argument that the inflation target should be lowered, as that discussion is important in principle. What I perceive to be the most common argument for lowering the target is that trends such as globalisation and digitisation are assumed to have such a highly dampening effect on inflation that it is impossible, or at least extremely difficult, to achieve the 2 per cent target.

Do digitisation and globalisation lead to permanently lower inflation?

There are several, and I think convincing, reasons why it is a bad idea to lower the inflation target. One is that it is far from obvious why digitisation and globalisation would give rise to *permanently* lower inflation. The arguments presented are often relatively vague, and say that stiff competition and squeezed margins have changed the economic playing field for companies in various ways. However, because the margins cannot keep falling indefinitely, this kind of price pressure can only lead to a *temporary* effect on inflation. And regardless of

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2 See for example Mitelman (2013), Fölster (2015), Hökmark (2015), Andersson (2015), Schück (2015), Expressen (2015), Sydsvenskan (2015), Cervenka (2015), and Krister Andersson in Dagens Industri (2015).

3 See for example Winsth and Isaksson (2015), Engzell-Larsson (2015), Lars Jonung and Robert Bergqvist in Dagens Nyheter (2015), Mitelman (2015), and Jakobsson (2015).

4 Some even think that the inflation target is in conflict with the Sveriges Riksbank Act and the task delegated to the Riksbank by the Riksdag (Swedish parliament) (Mitelman, 2015b). This is obviously not correct. According to the Sveriges Riksbank Act, the Riksbank shall ”maintain price stability”, but the preliminary works to the Act state that the Riksbank should formulate a more precise inflation target, and also that ”price stability” should not be interpreted to mean that the target for the rate of inflation is zero (Government Bill 1997/98:40, pp. 52–53). Furthermore, the Riksdag has repeatedly endorsed the inflation target as it is currently formulated, and emphasised that it is important for the Riksbank to pursue a monetary policy which ensures that inflation rises towards the target (most recently in the Riksdag Committee on Finance's report 2014/15:FiU24).

the nature of this kind of price pressure, in the long term inflation is determined by monetary policy and its effects on inflation expectations.[5]

It is worth noting that it is mainly in Sweden that we have seen this debate take place. In the US and UK for example, inflation has been considerably higher than in Sweden over the past few years. Inflation has seen a falling trend in those countries too, but it has only been recently that inflation has fallen more sharply, in connection with the major falls in energy prices and the appreciation of the countries' exchange rates. In both countries the central banks as well as other analysts are also expecting inflation to rise soon to two per cent, despite the fact that digitisation and globalisation will likely affect them, too (see Figure 1).[6] It is therefore difficult to understand why the effects should be so much bigger and more permanent in Sweden that the inflation target should be lowered here but not in any other countries, or why the rest of the world has not identified the problems.[7]

It is possible that digitisation and globalisation have played some role in how inflation has developed in recent years, but the Riksbank's assessment is that the low inflation seen in Sweden since 2010 is mainly explained by a strong exchange rate, a weak global economy, falling energy prices, and that companies have generally not been inclined to raise their prices. That prices have not been raised could be due, for example, to the fact that uncertainty has increased following the crises and that inflation expectations have fallen as inflation has remained low for so long.

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5 Another way of expressing this is that inflation is fundamentally a monetary phenomenon.

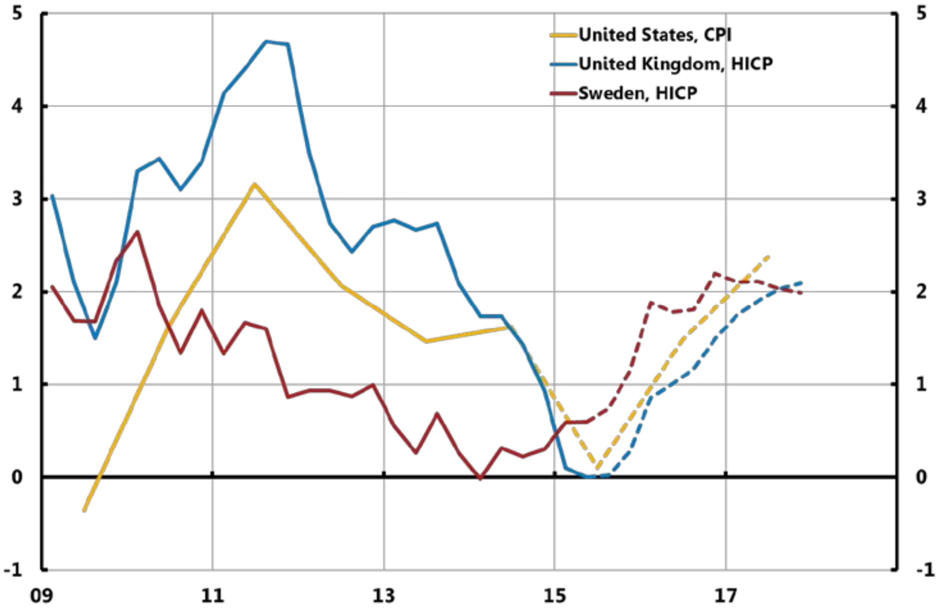
6 There is a lively debate about the low interest rate policy also in the US, but it has a slightly different focus than the Swedish debate. Those who criticise the Fed for pursuing an overly expansionary monetary policy are usually convinced that inflation will soon return to the target even if the central bank tightens monetary policy (see for example George, 2015, and Lacker, 2015).

7 According to Hammond (2012), 27 countries were fully fledged inflation targeters a few years ago. Not one of these countries has a target lower than 2 per cent, but Israel has a target range which goes as low as 1 per cent. If we also include the euro area, Japan, Switzerland and the US among the inflation targeters, we can add that the ECB's target is for inflation to be close to but lower than 2 per cent, and that the target in Switzerland is for inflation to be between 0 and 2 per cent.

Figure 1

Inflation has been higher in the UK and the USA, and the fall is expected to be temporary

Annual percentage change



Note: HICP is an EU-harmonised index for consumer prices. Quarterly data for Sweden and the UK, annual data for the US.

Sources: Bank of England, Bureau of Labor Statistics, Eurostat, IMF, SCB and the Riksbank.

Risky to have a target that is too low

Another objection to lowering the target is that it would risk reducing confidence in the inflation targeting regime. As I have noted, it is important for monetary policy to stand by a target once it has been formulated. If a target is changed because it seems too difficult to achieve, then there is always a risk that economic agents will expect the same thing to happen in similar situations in the future – both when inflation is higher and when it is lower than the target in place. Confidence in the inflation target is then weakened and it will not be able to fulfil its role as a benchmark for expectations in the economy as well as it could.

But there is one more reason why the inflation target should not be lowered – and this is in my opinion, probably the most important. It is that there needs to be enough scope to lower the policy rate if inflation falls substantially or the economy weakens. When the inflation target is, say, 1 or 0 per cent, then inflation will vary around that level. The nominal interest rate will of course also be lower for a lower target on average. And the lower the interest rate is in normal conditions, the less scope there is to lower it before it hits its lower bound and can no longer be used to stimulate the economy.

With an inflation target of 2 per cent and a real interest rate which on average is expected to be around 2 per cent, the policy rate will be around 4 per cent in normal conditions.[8] Before the financial crisis, this was usually considered to be a sufficient distance to ensure that the

[8] The Riksbank's assessment is that in the long term the repo rate will be in the range 3.5 to 4.5 per cent on average. However, international real interest rates are currently very low, and various factors indicate that they will remain unusually low, at least in the medium term (see Armelius et al, 2014).

interest rate would not be restricted by its lower bound too often. During the financial crisis, however, several central banks lowered their policy rate over a short period to nearly zero, which they judged at that point to be the policy rate's lower bound. And now, seven years later, the policy rates are still at the same low levels in many countries. Based on these experiences, many analysts think that it would be desirable to have an inflation target *higher* than 2 per cent.[9] This question is perhaps mainly discussed within the research community, though it has also been highlighted by the IMF and some central banks, among others. In the review of the monetary policy framework which the Bank of Canada conducts every five years, for example, an increase in the target is one of the areas to be examined.[10] Unlike the debate in Sweden, the international discussion therefore focuses on the central banks' inflation targets needing to be raised rather than lowered.

Some inflation is desirable for another reason, namely that wage formation can deteriorate when average inflation is too low. The reason is that in practice it has proved difficult to lower nominal wages. If inflation is low and nominal wages cannot be lowered, it becomes difficult to adjust real wages between individuals at a company and between different sectors. This can ultimately bring about both higher unemployment and poorer productivity growth in the economy. These problems can be mitigated if there is a certain underlying inflation in the economy.

Important to maintain confidence in the inflation target

Let me then move on to discussing the more nuanced argument that the inflation target should not be lowered but that the Riksbank – and all other economic agents – should accept that inflation will continue to fall below the target for a long time to come. This is assumed, in the same way as when the target is lowered, to create scope to raise the repo rate in order to counteract continued increases in household debt and housing prices. One proposal put forward to facilitate this is to reintroduce the tolerance band around the inflation target which was in place until mid-2010.

First, however, I would like to briefly describe why the Riksbank is pursuing the policy it is pursuing today. The low repo rate is essentially due to the fact that inflation has been surprisingly low and has not risen as the Riksbank and other commentators expected. During the first half of 2013 for example, the average of Swedish forecasters expected inflation, excluding interest-rate effects, to be a little less than 1.5 per cent in 2014. The outcome was almost one percentage point lower.

The period where inflation has been below the target has gradually become longer and longer. Even the more stable underlying inflation measure, where both interest-rate effects and volatile energy prices are excluded, has been below 2 per cent since January 2010 (see Figure 2). According to the Riksbank's forecast, it is expected to reach this level again in autumn 2016, provided that monetary policy is very expansionary. This means nearly seven years below the target, at least five of which have been clearly below it.

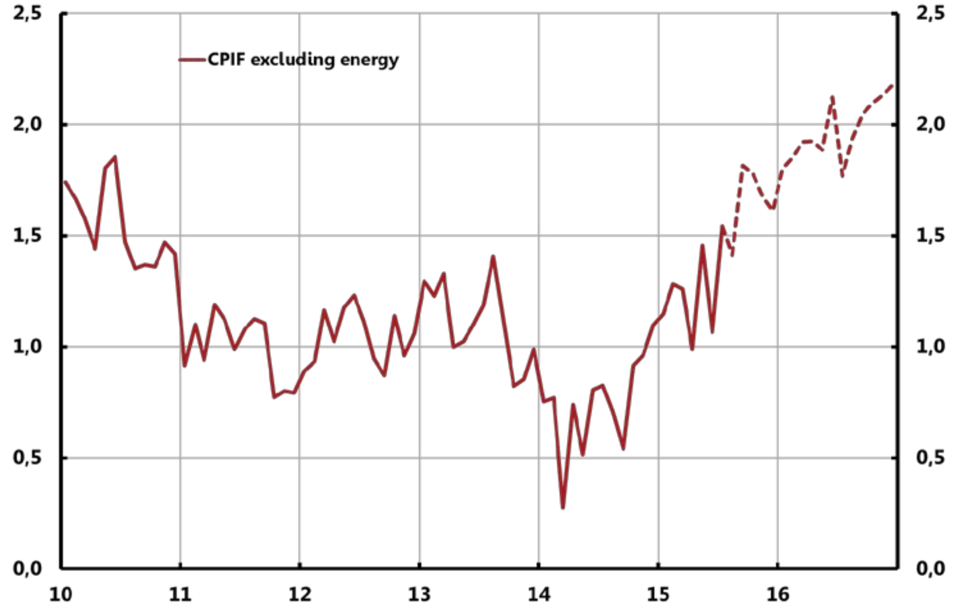
9 Se for example Williams (2009), Blanchard et al. (2010), Calmfors (2013), Ball (2014), Krugman (2014), and Rosengren (2015).

10 See Côté (2014) and Kryvtsov and Mendes (2015).

Figure 2

Inflation has been low for a long time

Annual percentage change



Note: CPIF is CPI with fixed mortgage rate.

Sources: SCB and the Riksbank.

Once inflation had undershot the target for a while, inflation expectations began to fall. Economic agents did not expect inflation to meet the target even five years ahead. In other words, a risk began to build up that the role of the inflation target as a benchmark for price-setting and wage formation would begin to weaken – that the nominal anchor that has been an important part of the favourable developments in Sweden since the 1990s crisis would no longer hold. As the basis of an inflation-targeting policy is that the long-run inflation expectations are anchored around the target, this development has gradually made it more important to bring up inflation. The Riksbank has therefore needed to focus more and more on its main task, to maintain confidence in the inflation target, while the scope for taking other issues into consideration has become more and more limited.

It is these considerations which form the basis for the policy being pursued by the Riksbank today. It is not a question of a rigid fixation with achieving exactly 2 per cent all the time. On the contrary, the Riksbank normally demonstrates a considerable degree of flexibility when it comes to how fast the target should be met. There is a limit to this patience, however.

Difficult to maintain confidence simply through communication

I believe the critics take the importance of maintaining confidence in the inflation target far too lightly. This argument is often not considered at all, with everything focusing instead on the Riksbank needing to stop the increase in household debt and housing prices by raising the interest rate. If confidence in the inflation target is even mentioned at all, the idea seems to be that it is something that should be maintained by the Riksbank *communicating* that even though it intends to continue to allow inflation to undershoot the target for some time to come, it will eventually bring inflation back up to the target at some point in the future.

It would likely be difficult to maintain confidence in the inflation target by using such a strategy. Inflation has already undershot the target for several years and would in that case continue to undershoot the target for some years to come. The fact that inflation has been low for a long time is probably a major reason why long term inflation expectations have fallen. Conversely, the trend we have witnessed over the past year of a slowing fall in inflation expectations has coincided with monetary policy becoming very clearly expansionary and underlying inflation beginning to rise. Against this background it would likely be difficult for the Riksbank to maintain confidence in the target solely by communicating that the inflation target is still valid, without in any way reinforcing that claim with policy measures.

A higher repo rate would weaken economic development

The idea behind the Riksbank needing to have more patience and accepting that inflation will continue to remain below the target for an even longer period seems to be that the policy rate could then be raised to slow the rise in debt and housing prices. But the Swedish repo rate does not exist in a vacuum. Interest rates are also low internationally. Higher interest rates in Sweden in relation to those abroad would strengthen the krona and lead to a weaker real economic development. This would dampen inflation. If inflation not only remains below the target but actually falls further, confidence in the inflation target risks being weakened even further. A monetary policy that is not sufficiently expansionary can contribute to inflation expectations becoming permanently low, which in turn makes the target even harder to achieve. This means that instead of the positive self-reinforcing effect through the expectations I spoke about earlier, we end up with a *negative* self-reinforcing effect which means we then need to fight much harder to meet the inflation target. This would mean that it would be even longer before the repo rate could rise to a more normal level.

There is also reason to ask how much higher the critics think the repo rate should be. Should it be at 0, 1 or perhaps 2 per cent? The impression one gets is that the repo rate is assumed to be the main tool for relieving the problem of rising debt and housing prices. However, for this to be possible a repo rate considerably higher than the one we have today would likely be required. And the more the Swedish interest rate exceeds international rates, the more inflation and growth will be dampened, in part via the usual interest rate channel and in part via a stronger krona in the way I have just described. This in turn means a greater risk that inflation will remain below the target and that inflation expectations will become stuck at a level that is too low. A discussion of these kinds of central considerations is typically missing from the criticism put forward.

In the international discussion, the central banks' policy rates are currently seen as quite blunt tools when it comes to curbing the rise in household debt and housing prices. The reason for this is that the interest rate cannot be targeted at the problem area in question, but has a much broader impact on the economy, such as companies' investments and, via exchange rate effects, their export opportunities.[11] It does not come as much of a surprise therefore that no central bank has so far used the interest rate weapon to any great extent for this purpose. There is currently a relatively high level of agreement that macroprudential policy and well-designed financial regulation should be the first line of defence in preventing financial imbalances from accumulating.[12]

The tolerance band was not a target range

As I mentioned, one proposal has been that the tolerance band for the inflation target should be reintroduced, as it is assumed this would make it easier for the Riksbank to raise the repo

[11] The broad impact of the interest rate is occasionally highlighted as an advantage, however. Unlike macroprudential policy measures which can sometimes be circumvented, "the interest rate gets into all the cracks" (Stein, 2013).

[12] See IMF (2015).

rate. It could be helpful to remind ourselves here why there was previously a band surrounding the inflation target. The main purpose was to explain that the Riksbank is not able to control inflation precisely in the short term, but that it aims to limit deviations from the target.

The band was abolished in 2010 because the Riksbank then assessed that it no longer had a role to fill. In the memorandum published in connection with the decision, it was noted: "There is considerable understanding for the fact that inflation commonly deviates from the target and that the deviations are sometimes larger than 1 percentage point. Inflation can thus be outside of the tolerance band without threatening the credibility of the inflation target. Such deviations have proved to be a natural part of monetary policy."[13]

The view was therefore that even the relatively broad band of 1 to 3 per cent gave the appearance of excessive precision. However, as economic agents did not find it noteworthy that inflation was outside this band at times, the Riksbank felt it was not a problem. The tolerance band was thus a pedagogical tool intended to illustrate the uncertainty surrounding the inflation development. It was never intended to be a target range, i.e. that the target was actually 2 percentage points wide, and that inflation of marginally over 1 or just under 3 was as consistent with the target as inflation of 2 per cent.[14] This appears to be many people's interpretation today, however. The idea then appears to be that a broader target range would mean the Riksbank did not feel as forced to bring inflation up to 2 per cent, which in turn would mean that monetary policy would not need to be as expansionary and that rising debt could be dampened.

As I have just described, however, the policy the Riksbank is pursuing today is due to the fact that the period in which inflation has remained below target has gradually become longer, and long term inflation expectations have fallen. The Riksbank wants to avoid that expectations become permanently stuck at a level that is too low. A relevant question is therefore whether a tolerance band would influence *expectations* in the economy in a desirable way. If the Riksbank reintroduced the band tomorrow, would long-term inflation expectations suddenly increase and adjust to 2 per cent? It is hard to see why that would be the case. If the repo rate were to be raised as a result of the band being reintroduced, as the idea appears to be, then the result could instead very well be that both inflation and inflation expectations would fall further.

After five years without a tolerance band, new arguments could arise in favour of having a tolerance band as a part of the normal monetary policy communication, or older arguments could once again become relevant. In that case it could be worth discussing a comeback for the tolerance band, but reintroducing the band would neither contribute to higher inflation expectations nor consequently to a rise in interest rates.

Monetary policy cannot solve the problem of rising debt and housing prices

What can be said then about the growth of household debt and housing prices? After all, one issue central to the criticism is that the low interest rate contributes to further increases in debt and housing prices.

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13 The Riksbank (2010).

14 For example, Heikensten and Vredin (1998, pp. 585-586) noted that "A tolerance band could be a reflection of the fact that the central bank does not consider it important to aim for an inflation target in the middle of the band. Instead it may, as long as inflation is contained within this band, want to focus on achieving other targets, such as production or employment for example. This is portrayed at times [...] as "opportunistic" monetary policy. We do not feel, however, that this was the reason certain countries chose to put a tolerance band around their inflation target".

It has been obvious to those who have followed the monetary policy debate that the Riksbank shares many people's concerns about this development. This is clear from reports, minutes, speeches and a number of debate articles. The Riksbank has therefore pointed out the necessity of measures in other policy areas for several years. It is a question of dampening these debt and price increases using macroprudential or fiscal policy measures, but also fundamental reforms on the housing market to generate a sustainable and improved balance between supply and demand.

But if the Riksbank is so concerned, shouldn't it then reconsider its policy and raise the interest rate? I hope that it has become clear during my discussion here that I think there are solid and convincing reasons to pursue the policy the Riksbank is currently pursuing, but I would like to repeat them briefly in any case.

The inflation target has been a nominal anchor in the Swedish economy and a major reason behind the favourable economic development over the past two decades. For some time now, following the long period of inflation falling below the target, there have been signs that confidence in the inflation target has begun to falter. The Riksbank's main task is to maintain confidence in the target – a task it does not share with any other authority. The repo rate is a blunt tool when trying to curb increases in household debt and housing prices as it influences so much else in the economy. A considerably higher rate would likely be needed in order to have a substantial effect, but then inflation and growth would be dampened, quite extensively in the worst case scenario. Neither low inflation nor weaker growth would contribute to a sustainable rise in the interest rate level. On the contrary, it is by ensuring that inflation and inflation expectations increase that the Riksbank is able to contribute to an increase in the interest rate level to more normal levels.

Monetary policy is having an effect but hitting strong headwinds

Allow me to conclude by saying a few words about the effects monetary policy has had, and how I see inflation developing in the future. Many point out that inflation is still low despite the very expansionary monetary policy, and at times it seems that some take this as proof that the monetary policy is now ineffectual. I think that this is a far too simple interpretation, however. In reality we are seeing numerous signs that monetary policy is having the intended effect.

One important observation is that the cuts to the repo rate to negative levels have had a broad impact on other market rates, including lending rates to households and companies. Households and companies have thereby had more disposable income to spend on consumption and investment.

Another observation is that the negative interest rate does not appear to have led to any clear disruptions on the markets.[15] A negative interest rate is primarily a phenomenon on certain financial markets, the participants of which are specialists who see that things are mostly working the same as when the rate is positive. Households can read about negative rates in the newspaper but have, as before, zero interest on their bank accounts and positive interest on their mortgages. There has hence been no reason for them to react any differently in the wake of recent interest rate cuts. For example, the demand for cash has not increased.

Another indication that monetary policy is having the intended effect is that inflation in Sweden now appears to be on the rise. Underlying inflation, where interest rate effects and volatile energy prices are excluded, has shown a clear upward trend over the past year, from

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[15] One exception is the FRN market, which is a market for bonds with variable coupons (see The Riksbank, 2015, pp. 16-17). The problems on that market are not however assessed to have an impact on macroeconomic developments or the functioning of the financial markets more generally.

0.5 to 1.4 per cent. This is despite the fact that the inflation rise in Sweden continues to be held back by uncertainty and weak global economic activity. The Riksbank expects this trend to continue and underlying inflation to be near the target in about a year.

An important assumption in our forecast is that the economic situation will strengthen in the euro area over the coming year. Forecasts are always uncertain, however. For example, concern has recently grown over how a slowdown in and rebalancing of the Chinese economy will influence the global economy. If developments internationally are weaker than in our forecast, an even more expansionary monetary policy will be required to ensure that inflation rises. The repo rate could then be cut, and the bond purchases extended. But there is of course a floor for the repo rate and a ceiling for the purchase of bonds – our aim after all is to get inflation up in an orderly manner. If the inflation outlook deteriorates more substantially, we could therefore end up in a situation where monetary policy can no longer do anything meaningful to raise inflation. In such a situation we would be forced to accept that it would take longer to bring inflation up.

I would like to emphasise that I see a major difference between that kind of development and the increased patience with low inflation that the critics call for and that I have discussed in this speech today. My view is that the Riksbank should use its monetary policy tools to the full in order to attain the inflation target as well as possible. This does not mean that we are pursuing an inflexible monetary policy which aims to keep inflation at exactly 2 per cent all of the time, but when inflation has been clearly below target for many years we must focus on raising inflation and ensuring that inflation expectations are anchored around 2 per cent.

Finally, I would like to reiterate that our main scenario is that the monetary policy we are currently pursuing is sufficient to keep inflation rising and make it reach 2 per cent relatively soon. Attempting to achieve this is important to ensure the inflation target continues to function as a benchmark for expectations in the economy, as it has done for twenty years now.

However, this does not mean that the inflation targeting framework will be exactly the same as it is today forever. We are learning from previous experiences, and the global economy is constantly changing. We therefore welcome a discussion of ideas about the content and direction of the monetary policy. Naturally, we at the Riksbank listen to the arguments and analyses presented to us, and we try to contribute to this discussion with our own analysis.[16] I hope that my speech today has conveyed that I am not convinced by the arguments recently put forward which say that the Riksbank should abandon or lower the inflation target, or show even greater patience with low inflation.

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[16] The Riksdag is also contributing to this process by carrying out both its own and external assessments of the monetary policy. An external assessment is currently being conducted under the management of Marvin Goodfriend and Mervyn King (The Riksdag, 2014). Their conclusions will be presented at the beginning of next year.

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