Mr. Bäckström's opening remarks at the Conference on Monetary Policy Rules Opening remarks by the Governor of the Bank of Sweden, Mr. Urban Bäckström, at the Conference on Monetary Policy Rules, in Stockholm, on 12-13/6/98.

It gives me great pleasure to open this conference, which is a joint arrangement by Sveriges Riksbank and the Institute for International Economic Studies. First of all I want to extend a warm welcome both to the authors of the seven interesting papers and to all the discussants who will be participating in our proceedings. All those who are attending the conference are likewise heartily welcome and we hope they will take an active part in the series of discussions. For us at the Riksbank, as well as for me personally, the opportunity of welcoming such a large assembly of leading international experts and central bank representatives is a notable landmark in the practical task of restoring price stability in Sweden.

Monetary policy has attracted a great deal of research in recent years. Much of this research work has concerned major practical issues that are highly relevant for those of us who are engaged in monetary policy's daily round. I should like to take this opportunity of thanking all of you here who have made contributions in this field. My thoughts go, not least, to Torsten Persson and Lars Svensson, who also as advisors have provided valuable assistance to us practitioners to the Riksbank.

One thing is clear: the sounder the theoretical foundation for monetary policy, the easier is the life of a central bank governor.

Sweden on the way to establishing price stability

There has been something paradoxical about Swedish economic policy.

After the period of generally high inflation that started with OPEC 1, Sweden was one of the last of the industrialised countries to re-focus economic policy on price stability. The notion that a trade-off exists between inflation and unemployment lived on in Sweden for longer than in other countries. It took rather a long time for the drawbacks of a level of inflation that was relatively high, for an industrialised country, to be widely recognised.

At the same time, Sweden has a long tradition in the field of central banking. The Riksbank, founded in 1668, is the world's oldest, still-functioning central bank. This gives us three hundred and thirty years experience. It was in Sweden, too, that the first banknotes—in Europe at least—were introduced in the seventeenth century. A monetary policy focus on price stability, which is one of the themes for our forthcoming discussions, has always been an important item on the central bank policy agenda. A well-known Swedish economist, Knut Wiksell, was a clear exponent of the idea in the late nineteenth century. As it happens, he addressed an audience on the subject here in Stockholm a hundred years ago almost to the day, namely on 14 April 1898. In one of his books he wrote:

"If prices rise, the rate of interest is to be raised; and if prices fall, the rate of interest is to be lowered; and the rate of interest is henceforth to be maintained at its new level until a further movement of prices calls for a further change in one direction or the other."

Just over three decades after his address in Stockholm, Sweden had to leave the gold standard in September 1931. The objective of monetary policy was declared to be to use "every available means to maintain the Swedish krona's domestic purchasing power". In this way

the Riksbank was the first central bank to declare openly that its monetary policy norm was price stabilisation.

Notwithstanding this long tradition, after inflation's rising trend in the post-war era, Swedish economic policy's reorientation toward price stability did not begin until the late 1980s and early 1990s. That was a decade or so after such realignment had been initiated in other countries. By then, Sweden had experienced twenty years of inflation that averaged 8 per cent a year. That was the longest inflationary period since the early nineteenth century. In contrast, in the one hundred and forty years from 1830 to 1970, inflation in Sweden had averaged an annual rate of 2 per cent. So one can say that in the present decade we have been re-establishing our roots.

Sweden's policy realignment in the early 1990s was, however, more painful than anyone could have foreseen. One conceivable explanation is that, having waited longer than other countries, the road back to price stability was more difficult for us. There were also a number of exceptional events along the way. What was perhaps the worst bank crisis of the century erupted in the wake of the 1980s' bubble economy. Exchange rate turmoil was such that, during some dramatic days, the instrumental rate was hiked to 500 per cent. In the early 1990s the budget deficit grew to be the largest in the industrialised world. There are many similarities, as well as some differences, between the financial crisis in Sweden and those in Mexico and Southeast Asia.

In recent years the situation in Sweden has become more stable and, with a resolute economic policy, developments have taken a positive turn. The bank crisis has been resolved, the economy is in an expansionary phase and inflation expectations are low. Step by step, the credibility of the new regime is being established. Experience in other countries clearly shows that the consolidation of a changeover to a low-inflation regime takes many years.

Inflation target's historical roots and advantages

The idea of focusing monetary policy on price stability goes back, as I mentioned earlier, at least to Wiksell's arguments a century ago. It seems to me that Wiksell's emphasis on deflation being as important to avoid as inflation has much to do with the acceptance of this policy today.

In Sweden and many other countries, the old idea, in the 1950s and 1960s, that a trade-off exists between inflation and unemployment resulted in an increasingly high level of trend inflation. When the drawbacks of active economic policies of this type became apparent, people in general and their representatives also feared the other extreme - a monetary policy that consistently aimed at keeping inflation as low as possible. Some countries, of which Sweden is one, are basically averse to deflation. So a regime whereby monetary policy has a systematic, long-term commitment to keeping inflation at a predetermined level of 2 per cent, neither more nor less, represents what many people perceive as a balanced approach to avoiding deflation as well as inflation. This has made it easier to establish the legitimacy of the regime in the public mind.

Some relevant issues for a practitioner

Let me now turn to some matters which a practitioner finds important and which will also be touched upon during the coming two days.

One issue concerns the indicator of inflation that is appropriate to use as an explicit target. The practical considerations in this respect are complex and are currently being debated in Sweden. The consumer price index has the advantage of being familiar to a wide public. Besides measuring trend inflation, however, it also gives information about price fluctuations that stem from transitory supply-side shocks, for example changes in indirect taxes and interest costs. With the CPI as the target variable, the central bank encounters problems in the public discussion because shocks of various kinds are liable to result in temporary deviations from the target. If some indicator of underlying inflation is targeted instead, however, it is likely to be relatively unfamiliar to people in general. Neither is it entirely clear how the optimal indicator of underlying inflation should be constructed.

Whichever alternative one chooses, it is essential in my opinion that the central bank be prepared to contribute to as open a discussion as possible, so that its ambition of achieving and maintaining price stability is not lost sight of and the public's ability to hold the central bank responsible for the conduct of monetary policy is not weakened.

Another issue is the choice of a targeting horizon for the monetary policy. This relates to the trade-off between output volatility and inflation volatility. As it stands this sentence is correct but very difficult to understand.

A short horizon for inflation targeting, say keeping inflation at the target level from quarter to quarter, yields a very stable inflation rate. In order to maintain this target, however, the central bank must make drastic adjustments to the instrumental rate and this causes a high degree of variability in real economic activity. A long target horizon may well imply greater variability in the inflation rate but would allow for more gradual interest rate adjustments and smaller real economic fluctuations. In our approach the normal target horizon is set at between one and two years.

A third issue is the degree of transparency. It is widely agreed that transparency is not merely compatible with an inflation target regime but actually essential if the regime is to function properly. For one thing, the central bank must be accountable for its conduct of monetary policy. This is a question of monetary policy's basic legitimacy, which is important not least when the central bank operates independently. For another, the actual implementation of monetary policy needs to be as predictable as possible.

Would maximum transparency be preferable? Is there really any point at which a line should be drawn or would it be more reasonable to try to identify a certain minimum level of transparency? Should the minutes of monetary policy meetings and the voting be published? Would it even be right to allow the central bank's monetary policy meetings to be shown on television?

For my part, it seems reasonable to publish relatively detailed minutes of monetary policy meetings without revealing exactly who said what at which stage in the discussion. It is, after all, important that discussion during the meetings is open and unprejudiced, so that the participants can listen to their colleagues' arguments, change their minds in the course of a meeting and accept joint responsibility for the decisions that are made. At the same time, it is important that each individual is responsible for arguing for his or her position. I can also see a case for reporting how votes are actually cast. This is, in fact, already the practice of the US Federal Reserve and the Bank of England.

Monetary policy and asset prices

Finally some words about a matter that is not directly on the agenda for our discussions. I am referring to how monetary policy should respond to asset prices. The reason for bringing it up today is threefold. First, it is a matter that is widely discussed today in many international forums as well as in many central banks. Second, as a practitioner I would like to encourage our leading international experts present here today to study it further in the years to come in order to develop more knowledge in this area. It could be the topic for a future conference. My third reason is more personal. Before I came to Sveriges Riksbank I was state secretary at the Ministry of Finance and involved in the management of Sweden's financial crises. The obvious question for me is why did it happen and how can we prevent it from ever happening again.

I have already touched on the question of monetary policy's target variable, which, as we all know, is a very complicated matter. An additional dimension is whether asset prices more formally should be included in the target variable for monetary policy?

The question about monetary policy and asset prices is by no means new. At the beginning of this century economists like Irving Fisher were already emphasising the importance of following not just consumer prices but also asset prices. Some decades later, the tradition from Fisher was taken up by Alchian & Klein in what has became a well-known paper from 1973. CPI can be seen as a measure of "current service flow prices". Asset prices in turn measure "future service flow prices". A weighted index consisting of CPI as well as asset prices could serve as an inter-temporal indicator of living costs. The underlying idea was that such an index could contribute to a monetary policy aimed at price stability. The authors argued that if the central bank concentrates solely on the development of consumer prices, monetary policy may be either too contractive or too expansionary, the reason being that consumer prices usually react more slowly than asset prices to a contractive or expansionary impulse from monetary policy. There is then a risk of monetary policy having a destabilising tendency.

Alchian & Klein found, however, that the construction of such an index was rather difficult in practice; but they did underscore the importance of monetary policy's taking the development of asset prices into account. Recently, Charles Goodhart drew attention to what is now the twenty-five year old paper by Alchian & Klein; he, too, sees difficulties involved in a weighted index of consumer and asset prices. The conclusion is probably that asset prices should not formally be included in the target variable for monetary policy.

Asset prices are, however, taken into account in a regime that explicitly targets inflation in terms of the consumer price index or a variant of this. This occurs via household wealth effects and corporate capital costs, which influence total demand, alter the output gap and thereby modify inflation prospects. If asset prices rise so strongly that, via increased demand, inflation tends to rise above the targeted rate, the central bank will normally respond by tightening the monetary stance. Conversely, the monetary stance will be eased if asset prices fall so much that inflation is liable to be below the target. Thus far the analysis is fairly straightforward. Even if asset prices do not feature explicitly in the target variable, they will be taken into account in a monetary policy model that targets the consumer price index.

Sweden had a combination of high inflation and rising asset prices in the 1980s. It might then be argued that policy failed to concentrate on price stability in terms of the consumer

price index. It should be noted that with the fixed exchange rate regime at that time, the overheating in the economy was primarily a matter for fiscal policy. Price bubbles developed in asset markets, followed later by price falls for shares and real estate, for example. This in turn led to the severe bank crisis. But can the Swedish bank crisis be explained simply in terms of an insufficient focus on price stability?

The example of Japan in the 1980s suggests that consumer price stability may not be a sufficient condition for precluding bubbles in asset prices and financial instability. With trend inflation averaging two per cent a year, the situation in Japan in the 1980s was very close to what we now commonly mean by price stability. Yet the Japanese economy still moved towards a period of grave financial instability.

Thus, the question practitioners have to consider is how to deal with a situation where asset price effects are taken into account with reference to consumer price inflation but where there may still be a risk of asset price bubbles that may lead to financial instability, a destabilisation of the real economy and a severe downward effect on consumer price inflation later on.

One could argue that the effects of a large rise in asset prices on aggregate demand may be smaller than the effects of a large fall if such a fall increases general uncertainty and leads to more cautious spending behaviour. If the collapse of a bubble in asset prices has a much stronger effect than the preceding boom, it may be optimal to increase interest rates to raise the probability of bursting a bubble even though such a policy action may temporarily lead to lower consumer price inflation in the short term than otherwise would have been desired. The reason for this conclusion is that that bursting the bubble sooner rather than later reduces the probability of a still larger bubble later on with an even greater downward effect on consumer price inflation.

Hasn't experience taught us that a growing risk of instability may be indicated by a steep increase in asset prices at a time when the credit supply have been expanding at an unsustainable rate for some time? If such a situation happens to coincide with low prospects for consumer price inflation, might there then be grounds for the central bank to depart from its inflation target for the time being in order to curb the increase in asset prices?

That special circumstances might prompt a temporary departure from a central bank's inflation target is not a novel suggestion. It has been discussed, for example, in the context of natural disasters, large supply shocks and so on. And what is a full-blown bank crisis if not a serious economic disaster?

At the same time, curbing rapidly rising asset prices when prices of goods and services still show little sign of turning upwards is not exactly an easy task for the central bank. One of the difficulties lies in justifying this to the general public. Another is whether an asset price bubble is actually developing; does the central bank really have better information than the market participants? A third problem is that an interest rate hike might exacerbate the subsequent course of events when asset prices are corrected. Fourthly, the central bank's ambition to steer asset prices directly could perhaps pave the way to a much larger bubble in the future. In other words, can safeguards against financial bubbles and an absence of subsequent economic consequences lead to a moral-hazard type of phenomenon among the market participants?

Circumstances must evidently be very special to warrant central bank action to counter asset price bubbles if there is no concurrent upward pressure on consumer price inflation.

It is also reasonable that the central bank presents a clear case for such a course of action and does so before such a special situation arises.

The Riksbank has started a biannual series of reports on the financial system's stability. The idea is to draw lessons from our recent experience of a bank crisis and be in a position - should the need arise in some distant future - to discuss any policy measures that might be called for in the event of a risk of financial instability. This could also be done in our Inflation Reports.

The situation today in Sweden is very different from the 1980s. Asset prices have been rising steeply since 1994 but indebtedness did not turn upward until quite recently. This suggests that the risk that the banking sector will experience significant problems in the event of a fall in asset prices is relatively small today. However, we must continue to monitor risks in this field in the years to come.

Conclusion

Now when we are assembled here for an important conference, with interesting contributions from a number of the world's leading experts in the field, we would do well to be temperate in our appraisal of what we believe we know today. To this end I shall quote Lawrence Summers. In connection with the Federal Reserve Bank of Kansas City's symposium on "Achieving Price Stability", Summers considered the major changes that have occurred in macroeconomic thinking in the past two decades and then rounded off by saying:

"It would be a misreading of history to think that we have now identified final truth or that some of the views expressed here will not look archaic twenty years from now."

That is a stimulating and challenging statement. Think how dull life would seem if we ever arrived at the final truth. As luck would have it, the increasingly complex reality in which we live is an endless source of challenges for researchers as well as central bank colleagues throughout the world.

References

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