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■ Some questions regarding current monetary policy

Deputy Governor Irma Rosenberg gave the introductory speech at the Swedish Sawmill Managers Association's annual general meeting in Stockholm on Thursday. The theme of her speech was current monetary policy.

"Following our most recent decisions in January and February to raise the repo rate by a total of 0.5 percentage points, the debate on monetary policy has continued. This is quite natural, as we have raised the repo rate for the first time in several years. Today I intend to take up three questions that seem to recur in the discussion of current monetary policy. I hope that this will contribute to greater understanding of how we conduct monetary policy," began Ms Rosenberg.

"The first question concerns whether the Riksbank is overly concerned, or only concerned, with inflation. How do we take into account general economic developments and, for instance, developments in the labour market when we decide to adjust the repo rate? According to law, the Riksbank has *one* objective and this is to maintain inflation at a low, stable level – 'to maintain price stability' is the wording in the Act. We try to achieve this by ensuring that the increase in the consumer price index is 2 per cent a year. As long as confidence in the inflation target is not threatened, the Riksbank also has the possibility to take into account developments in the real economy, such as production and employment. On the whole, this strategy is common to many other central banks," observed Ms Rosenberg.

"Giving consideration to the real economy can mean that inflation is allowed to deviate from target during a period of time. Of course, these deviations may not be too large and the Riksbank has therefore made it clear that an interval of ± 1 percentage point around the inflation target of 2 per cent can normally be tolerated. Nor can we allow the deviation from target to be prolonged. For this reason the Riksbank follows the principle of normally bringing inflation back in line with the target within two years' time following a deviation. This means that we have the possibility to bring inflation back to the target level gradually," continued Ms Rosenberg.

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"A general example of how this flexibility could be used is if the economy were to suffer a shock that led to inflation moving in one direction, and production and employment moving in the opposite direction. This could be a shock to commodity prices or food prices or some other disruption in the supply side of the economy. In this type of situation, adjusting the interest rate so much that inflation would immediately be brought in line with the target could have an overly drastic effect on the real economy. Our method of working, with the principle that inflation should normally be in line with the target two years ahead, gives us scope to take into account the real economy and to adjust the interest rate gradually. The Riksbank has also pointed out that in exceptional cases, in the event of major disruptions, it may be necessary to allow longer than two years for inflation to return to target level in order to avoid unnecessarily severe fluctuations in the economy. All in all, this method of working entails better conditions for ensuring a stable development in production and employment and for avoiding large fluctuations," explained Ms Rosenberg.

"The second question I would like to take up is the one that most often recurs in the discussion of current monetary policy. Why is the Riksbank raising the interest rate now when inflation is low and the labour market has not yet picked up in earnest? It is important to bear in mind that our decisions must be based on forecasts of future developments. It takes some time for the economy to adapt completely to a change in the repo rate and, as I mentioned earlier, our principle is normally to bring inflation back on target within two years. When we make a decision on the repo rate, our intention is first and foremost to influence inflation a couple of years ahead. If we merely acted on the basis of an assessment of the immediate future of the inflation rate, interest rate policy would be too abrupt and would have a negative effect on the real economy," continued Ms Rosenberg.

The Riksbank's view of future economic developments was presented in the Inflation Report published at the same time as the interest rate decision in February. The data received since then largely support the assessment in the Report. The Riksbank observes in the Inflation Report that the Swedish economy is in the midst of an economic upswing. Growth is currently high and we envisage that it will continue to be good. We foresee continued stable growth in international demand for Swedish goods and services. Household consumption is expected to increase at a rapid rate and corporate investment is also expected to continue rising. The labour market situation will improve gradually as demand for labour increases. Capacity utilisation and cost pressures will rise in time. We therefore also expect inflation to rise, which indicates that monetary policy needs to be less expansionary," continued Ms Rosenberg.

"I believe that almost all forecasters are painting a similar picture of economic prospects, although of course some details differ. Most forecasts indicate that the economic upswing will continue, inflationary pressure will increase and the repo rate will need to be raised from its current very low level. What can be discussed is at what rate this should occur," observed Ms Rosenberg.

"Our forecasts in the Inflation Report were based on the assumption that the interest rate would be raised by a further 0.25 percentage points during the first quarter and would then continue to be raised gradually over the coming years. Given this interest rate path, the forecast was for inflation to be close to target two years from now, but it was also clear that inflation would be below the target level for the greater part of the forecast period. While we Executive Board members felt that this indicated the possibility of conducting slightly more expansionary monetary policy than that on which the forecast in the Inflation Report was based, we at the same time agreed that there were factors which meant that raising the rate in February was nevertheless the best alternative. Let me explain why," continued Ms Rosenberg.

"Over the past few years, inflation has been held down by weak growth in import prices and strong domestic productivity growth. Production has been able to grow rapidly without an increase in inflationary pressures. Inflation has thus been held down by favourable factors on the supply side of the economy, and these have had a more prolonged effect than either the Riksbank or other forecasters had expected. I mentioned earlier that changes of this nature can lead to difficult considerations regarding how quickly inflation should be returned to the target, for instance, it can be difficult to know how durable such factors are. In recent years, the Riksbank has cut the repo rate to a record-low level in order to bring inflation in line with the target. This has stimulated the economy and contributed to rapid growth. However, there are risks in continuing to conduct a very expansionary monetary policy in a situation where the economy is already growing strongly," observed Ms Rosenberg.

"For instance, the very low interest rates have contributed to house prices and lending to households – which have been increasing rapidly for several years – continuing to rise at a rate that is not sustainable in the long term. If this development continues, we Executive Board members believe there is a risk that a situation could build up where a sudden slowdown in house prices later on would cause households to perceive their debt burden as overly high and to rapidly increase their saving. This could lead to a severe decline in demand in the economy and also to inflation becoming too low. This risk confirmed our assessment that there was reason to make monetary policy less expansionary in January and February," said Ms Rosenberg.

"This brings us to the third question: does this mean that monetary policy now has a target for house prices? I have worded the question rather strongly here, but what I want to say is that there has sometimes been a mistaken assumption that concern over house prices and households' growing indebtedness have been the main motive behind our interest rate increases. This is not the case at all, I can assure you. The main motive is, as I mentioned earlier, that we see ahead of us a development where the economic upswing continues and inflation begins to rise. It is first and foremost inflation prospects a couple of years ahead that are the reason why we do not wish to continue stimulating the economy as much as we have done recently. That is why we have raised the repo rate," Ms Rosenberg pointed out.

"As always, there are also various risks that we take into account when making our monetary policy decisions. In our deliberations on monetary policy we have seen the risks linked to house price developments and household indebtedness as an argument against postponing a repo rate increase by a few months. This does not mean that we have any special target for how much house prices and lending should increase. Nor does it mean that monetary policy is governed by concern that household borrowing could negatively affect the stability of the financial system. Of course, developments in the housing market are also important in this perspective, but the Riksbank sees no sign of house prices and indebtedness comprising a threat to the banking system. It is rather the risks linked to the future stability of the real economy that we have highlighted," continued Ms Rosenberg.

"The Riksbank has now raised the repo rate to 2 per cent. With inflation expectations at between 1.5 and 2 per cent, this means that the real interest rate is close to zero. Monetary policy is therefore still very expansionary, something I believe is often forgotten in the debate on our latest interest rate decision," concluded Ms Rosenberg.