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■ The Riksbank's monetary policy strategy

Deputy Governor Lars Nyberg held a speech at a meeting arranged by Nordea on Friday. The theme of his speech was the Riksbank's monetary policy strategy.

"For some time now, there has been discussion of the monetary policy objective. Some have argued that we should have more than one objective; while others considered that we already try to attain too many objectives and that this has created a lack of clarity. During the spring we have described in various speeches the Riksbank's view of which principles act as a guideline for conducting monetary policy, and today we have published a special document on monetary policy strategy. I shall therefore begin with a few words about the Riksbank's objective and strategies, using this document as a foundation, and then I shall give my views on the monetary policy situation," began Mr Nyberg.

"The document makes it clear that the Riksbank has *one* statutory objective for monetary policy; to maintain price stability. We have defined this as an annual change in the consumer price index (CPI) of 2 per cent with a tolerance interval of ± 1 percentage point. Monetary policy is often guided by other measures of inflation, in particular UND1X, which is CPI inflation excluding household mortgage interest expenditure and indirect taxes and subsidies. Monetary policy is normally aimed at attaining the inflation target within a period of two years. The reasons for this time horizon are that monetary policy has an impact with some delay, and a desire to dampen fluctuations in the real economy. By not aiming to bring inflation back on target as quickly as possible the Riksbank has some scope to also take into account developments in the real economy, such as growth and employment. At the same time, the two-year horizon and the tolerance interval set a limit as to how large a deviation from target can be permitted. This flexibility can only be taken advantage of as long as there is confidence in our inflation targeting policy. Otherwise, we would be forced to change the interest rate more often and in larger stages and we would not have the same possibilities to take into account the development of the real economy," emphasised Mr Nyberg.

"However, situations may arise where we will need even greater flexibility than allowed by the two-year perspective. If, for example, the economy were to suffer an unexpectedly large supply shock, it might be necessary to allow longer time

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than two years for inflation to return to target. There is otherwise a risk that the strains on the real economy will be too severe. To enable this flexible application of the inflation target and not be perceived as arbitrary, it is important that we openly and clearly describe why inflation is expected to deviate from target in the normal time horizon. We do this in Inflation Reports, press releases, minutes from monetary policy meetings and speeches held by members of the Executive Board," said Mr Nyberg.

"Since the third Inflation Report last year, the Riksbank has changed over to basing its forecasts on the assumption that the repo rate will develop in line with market expectations, as reflected in implied forward rates. Previously, we based our forecasts on the assumption that the repo rate would remain unchanged during the forecast period. One advantage of basing the forecasts on more realistic assumptions of the development of the repo rate is that it is easier to make consistent forecasts of, for instance, exchange rates and long-term interest rates, which are to a large degree dependent on expectations regarding the development of short-term interest rates. Another benefit is that it makes it easier to assess the Riksbank's forecasts and to compare them with those of other forecasters. The new interest rate assumption means that the old policy rule for monetary policy, which said that if the inflation forecast deviated from target one year ahead, the interest rate would normally be adjusted, is no longer applicable. The inflation forecast is now based on the repo rate developing in line with market expectations. If inflation according to this interest rate path is assumed to be close to target two years ahead, market expectations of future monetary policy can usually be regarded as reasonable. However, to settle this more conclusively, we must take into account the entire development paths for inflation and the real economy. The monetary policy decisions and how we regard market expectations are based on a total assessment of these courses of events," said Mr Nyberg.

"As yet, the Riksbank has not gone one stage further and reported its own forecast for interest rates. However, this is one possibility the Executive Board may have reason to discuss," continued Mr Nyberg.

"Since the beginning of the year, the Riksbank has conducted slightly less expansionary monetary policy to the extent that the repo rate has been raised by a total of 0.5 percentage points. The main motive for the increases is that we see ahead of us a continued economic upswing and rising capacity utilisation, which means that the interest rate needs to be increased gradually to ensure inflation remains on target two years ahead. In addition, there is reason to take into account the fact that household indebtedness and house prices have continued to increase at a rate that is scarcely sustainable in the long term. If this development continues, there is a risk it will lead to a situation further ahead where there is a sudden downward adjustment in house prices which would have major repercussions for domestic demand and inflation," continued Mr Nyberg.

"A gradual increase in the repo rate increases the possibility of having a smoother slowdown in the rate of price increase on property and thereby reduces the risk of major fluctuations in the real economy. This does not mean that the Riksbank has any special target for how much house prices and lending may increase. On the other hand, there is reason to take these aspects into account in monetary policy decisions, to the extent that they include a risk of severe fluctuations in the real economy and inflation. As far as financial stability is concerned, there are no indications that house prices or household debt constitute a threat to the banking system at present," observed Mr Nyberg.

"Let me conclude with a brief comment on the decision at the most recent monetary policy meeting to hold the repo rate unchanged. The international picture looks slightly stronger. It is particularly interesting to note that economic indicators are now also showing a clear strengthening in the euro zone. The new information received since February largely confirms the favourable economic picture outlined for Sweden in the Inflation Report. With regard to inflation, the assessment in the Inflation Report was that inflation would rise and approach 2 per cent a couple of years ahead, on the assumption that gradual increases were made in the repo rate during the forecast period. This picture remains largely unchanged, although inflation is slightly higher than expected in the short term. Let me also say a few words with regard to the unease in the financial markets over the last few days. We have had a long period of very low volatility in most of the financial markets and it is not surprising if this volatility increases slightly. It does not necessarily mean that we are on the verge of a lasting decline in the stock market. The P/E ratios are not abnormally high, for instance," said Mr Nyberg.

"At the most recent monetary policy meeting we chose to hold the repo rate unchanged. However, this was not a self-evident decision. Monetary policy is still very expansionary, which is expressed, for instance, in the continued rapid credit expansion and the rapid rise in house prices, which also appears to have spread to the commercial property market. In my opinion, the economic indicators and inflation prospects imply it will soon be time to take the next step towards less expansionary monetary policy. This is also in line with market expectations," concluded Mr Nyberg.