SVERIGES RIKSBANK

# SPEECH

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# Monetary policy and the Riksbank's communication

## Introduction

In recent decades there has been a clear trend for central banks to strive for greater openness in their monetary policy. Central banks are now publishing an increasing amount of background material in the form of analyses and forecasts for inflation and other economic developments. The number of countries introducing explicit inflation targets is also growing. Something that is being discussed to an increasing extent, but which not so many central banks have dared to carry out yet, is the publication of the central bank's own forecast for its policy rate[1]. At the beginning of this year the Riksbank decided to take this step. The purpose was to become even more open and clear regarding the way we conduct our monetary policy.

I will begin today by discussing this new system and how it affects our communication. I will also give some reflections on the experiences of the two occasions on which we have published our own interest rate path in connection with the Monetary Policy Reports published in February and June this year. I will then conclude with a few words on the most recent monetary policy meeting in September.

## The Riksbank's communication with an own interest rate path

### *Advantages of an own interest rate path*

What are the advantages of publishing our own forecast for the repo rate? One advantage is that monetary policy can be more easily evaluated. This is particularly important given the Riksbank's independent position and the requirements made of us from a democratic perspective. A second advantage is that it becomes easier to explain monetary policy and it then has the prerequisites

[1] At present the central banks in Iceland, Norway, New Zealand and Sweden publish their own paths for the policy rate.

to become more efficient. This is because monetary policy largely acts through the expectations of future interest rates which it gives rise to, rather than through the current repo rate. Good explanations give an increased understanding and thereby a better opportunity for us to steer expectations. Let me explain this further.

## Easier to evaluate and compare

Firstly to the question of evaluating our forecasts and comparing them with those made by others. Are our forecasts for inflation and the real economy accurate? How do our forecasts differ from those of other analysts? While our forecasts were based on the assumption of an unchanged repo rate (up to the end of June 2005) it was in principle impossible to answer such questions. The purpose of the forecasts then was to analyse how economic developments and inflation would look if we did *not* change the repo rate. It was a simple way of explaining whether or not the repo rate needed to be changed. But at the same time it meant that the forecasts could not be expected to be particularly accurate.

The assumption of an unchanged repo rate was in most cases unrealistic and also made it difficult to produce consistent forecasts. This was one of the reasons why we changed over in autumn 2005 to basing our assessments on the assumption that the repo rate would develop in line with market expectations. But although this was a more realistic assumption, it was still the case that the forecasts did not necessarily reflect the Riksbank's assessment of the most probable economic development. This is because market expectations do not necessarily agree with the interest rate path the Riksbank considers to be most appropriate.

Now that our analyses are based on our own path for the repo rate, they describe the course of events we are actually expecting to see. This has several advantages. For one thing, it is possible to say something about how accurate our forecasts have been and how well the Riksbank has done its job. And for another thing it will also be easier to internally evaluate and improve the models and methods of working used as a basis for our forecasts. Finally, it makes it more worthwhile to compare our picture of the economy with the picture painted by other forecasters.

## Reasoning and considerations made clearer

The second advantage of an own interest rate forecast is that it becomes easier to show why we believe in a particular policy and how we reason when we make our decisions. We will have a better internal base for making decisions. In addition, if we manage to succeed in communicating how we see the driving forces behind economic developments and also the objective and effects of monetary policy, it will also be easier for others to assess how new information will affect the future development of the repo rate.

If it becomes clearer to the general public and financial market agents how we view future interest rate developments, this will give us better tools for influencing expectations of the future repo rate. By affecting expectations of short-term interest rates, we as the central bank can also indirectly affect interest rates with a slightly longer duration, which in turn increases the effect of monetary policy. As I said, monetary policy largely works by influencing expectations of future repo rates.

- When we based our forecasts on market expectations of the repo rate we could only indirectly express our view of the interest rate path by commenting on market pricing. For several reasons this was not very clear. One reason is that there is no clear-cut method for measuring expectations of the repo rate on the basis of market pricing. Different securities differ from one another with regard to duration, credit risk and liquidity, which makes the calculations complicated. Different calculations give different results without any of them being clearly better than the others.

Another reason for the lack of clarity was that market expectations could change quickly. It was therefore sometimes perceived as unclear which expectations we meant when we commented on whether market expectations were reasonable. This gave rise to some criticism for unclear communication in 2005 and 2006. Using our own forecast for the repo rate removes the risk of being misunderstood for this reason.

### *Experiences so far of our own interest rate path*

My impression is that the comments on the new system of publishing our own path for the repo rate have largely been positive, although there has also been some criticism. With regard to our concrete forecasts for the repo rate, the discussion has become livelier and we have heard more criticism. On the two occasions so far when we have presented a new assessment the monetary policy decision to raise the interest rate to 0.25 percentage points has indeed been anticipated and hardly been questioned. But our forecasts regarding future developments have surprised some market agents.

#### The Riksbank's forecast was a surprise in February

The path for the repo rate that we presented in February was lower than the expectations that could be detected in the market pricing at that time. It was also lower than the average of the interest rate forecasts made by other forecasters. However, there were considerable differences between the different market analysts. Some had views relatively close to ours, while others differed substantially.

But our view of inflation prospects and what they entail for the repo rate had not changed to any great extent in February compared with the previous monetary policy meeting in December 2006. We also expressed this attitude in speeches given in the weeks prior to the February meeting. When we presented our own interest rate forecast for the first time in February some analysts showed considerable surprise.

Using our own interest rate forecast enables us to explain more fully how we viewed developments in the Swedish economy during the forecast period, and what demands this made of monetary policy. Our assessment was that cost pressures in the Swedish economy would not be overly high. Productivity has been high in recent years and is one important reason why inflationary pressures have been low. We were assuming that productivity would increase slightly more slowly when employment began to pick up and that wage increases would be slightly higher as it became more difficult for firms to recruit employees with the right competence.

But inflation was still low and although the forecast was based on cost and inflationary pressures rising during the forecast period, our assessment was that this would occur at a moderate pace. We therefore concluded that it would be sufficient to have a fairly limited raise in the repo rate in the future. But to emphasise that forecasts are uncertain, we also published uncertainty bands for the repo rate and for GDP growth and inflation. Or as we usually say, the interest rate path is a forecast, not a promise. The uncertainty was also illustrated with some alternative scenarios, where we among other things examined how the forecast for the repo rate would be affected by a more rapid increase in wages. For the first time, we wrote in detail about these problems of monetary policy considerations in our report and to mark this the Inflation Report changed its name to the Monetary Policy Report.

During the spring new information was received, which to some extent made us revise our assessments. The labour market situation looked to be tighter than expected, partly because the supply of labour was not increasing as much as we had expected. The new wage agreements signed in the labour market were slightly higher than both we and many other analysts had anticipated. At our monetary policy meeting in May, we Executive Board members were unanimous that the repo rate needed to be raised in total more than we had previously thought. But we did not yet have a complete picture of the central wage negotiations and I personally did not consider the change to be so large that there was reason to move more quickly and raise the interest rate already in May. An own repo rate forecasts allows us to discuss in a natural way the timing of future interest rate changes. But in May we did not publish any new interest rate forecast and our communication was limited to a qualitative assessment.

## New surprise in June – but in the opposite direction

Prior to the meeting in June, we received the National Accounts figures for the first quarter. These showed that productivity had developed much more weakly at the beginning of the year than we had anticipated. The labour supply was also still lagging behind the assessment we had made, which indicated that the labour market had tightened. This of course changed our assessment of how quickly cost pressures could rise and we revised up our forecast for the repo rate by an average of around one half a percentage point in relation to the February one.

The differences between our forecast and market expectations were small over the coming year, but our interest rate forecast was still *lower* than market expectations in the longer term. Despite this, implied forward rates *rose* over the entire forecast period by approximately 0.15 percentage points when we published our forecast. Market reactions were thus actually stronger than in February.

## But why were market reactions so strong in June?

Of course, we have no interest in creating major fluctuations in the financial markets through our decisions and our communication. It is therefore important to us to understand why the market reacted the way it did. This is a natural part of the work on making communication as clear as possible.

One reason for the rise in interest rates in June was that international interest rates rose on the day we published our interest rate decision. Swedish interest rates do not only react to the Riksbank's actions; they are also very dependent on interest rate developments abroad. This applies in particular to longer durations. Our estimate is that around one third of the rise in the Swedish two-year interest rate on 20 June is explained by the fact that interest rates in Europe rose. But the shorter the duration, the more importance the expectations of the Swedish repo rate will normally have and the less importance the international interest rate developments will have.

It is difficult to draw any reliable conclusions with regard to why the reactions were so strong in connection with the June meeting. One possible explanation is that some market analysts may have expected the Riksbank to make a more cautious upward revision to our interest rate path than we actually did. This is despite the fact that they themselves were assuming that the interest rate would be raised by roughly the same in the short term and actually by more in the longer term.

One indication that this is a correct interpretation is that some analysts criticised us for having revised the interest rate path more than could normally be expected in such a short time. There were also arguments in some of the market analyses published prior to our meeting in June that we would be forced to revise up our interest rate path in several stages during the autumn.

Another possible explanation is that it was due to misunderstanding. The reactions and comments regarding a couple of our speeches in the early summer indicated that some analysts perceived them in a way that was not intended. The speeches were interpreted as though they pointed forwards although we had provided information on changes in our way of signalling and said that we did not intend to make any forward-looking comments that would provide clues regarding the next interest rate decision.

## Some concluding reflections on communication

The fact that our message had not entirely come across is partly due to some market agents not understanding what we actually *had* communicated. But it is also partly because we have not been sufficiently clear in our communication. I believe this is quite simply a learning process. We at the Riksbank and those we want to communicate with – the general public, journalists and market analysts – must learn to understand one another.

In this respect we will try to improve. One step in this direction is the decision to name the Executive Board members in the minutes of the meetings. In this way it is possible to follow how each member has reasoned. A further step that we recently decided on is to also publish forecasts for the repo rate and a small number of key variables at the monetary policy meetings held between the publication of the Monetary Policy Reports. If, for example, we had published a new interest rate path in May, I believe that the market would have been less surprised in June.

However, I think it is unavoidable that a central bank sometimes surprises analysts when publishing its own forecast for the policy rate. The future is uncertain and different analysts may at times have vastly differing perceptions of economic developments. Publishing a forecast for the repo rate means that the central bank more clearly reports its view of future developments than with earlier more mechanical assumptions of the interest rate. At the same time it means that the central bank to a greater extent risks being exposed to criticism. Even if this is the case, it is my firm opinion that it is better to go the whole way and publish a forecast for the repo rate. The advantages of an own interest rate path clearly outweigh the disadvantages.

We will not normally give any signals regarding the way we will vote on the next interest rate decision other than in connection with the monetary policy meetings. This means it will become more important to try to understand the way we reason and how we estimate the driving forces behind inflation and growth. What we will contribute is forecasts for the most important variables, combined with individual clarifications by the respective members. If one understands our way of thinking, one has in total all the information needed to be able to form a good impression of coming interest rate decisions.

## *The interest rate decision in September*

Let me move on to the stance I took at the most recent monetary policy meeting around a month ago. I, like the rest of the Executive Board, then voted to raise the repo rate by 0.25 percentage points. At the same time, my assessment was that the forecast for the repo rate that we made in June still appeared reasonable. Today I shall return to why I made this assessment.

### Increased uncertainty abroad…

On the whole, my view in September was that international growth was good and had not changed significantly since June. But this does not prevent the view of growth in some individual countries having changed in important respects. In September our assessment was that growth would be lower than we had expected in June, in the United States in particular, but also in Europe. At the same time, developments were slightly stronger in a couple of our neighbouring countries and in several emerging markets.

However, the international risk outlook had changed gradually in connection with the rising unrest in the financial markets. The change in the risk outlook largely originated in the United States. There the problems in the housing market had worsened and according to several statistics house prices in the United States fell on average, measured as an annual change. The question we asked ourselves at the September meeting was to what extent the problems would spread and slow down activity in the rest of the US economy.

The unrest in the international financial markets in the wake of the US subprime crisis has also led to an increase in the price of risk, which means for instance that it has become more expensive to borrow. In this way the effects can be compared to the effects of tighter monetary policy. But apart from the changed pricing, the uncertainty has also led to greater caution in general. This also has a certain dampening effect on economic activity.

In Sweden, the effects of the unrest in the financial markets have been more limited than in, for instance, the United Kingdom, the United States and Germany. Over the past weeks there appears to have been some stabilisation. But the US mortgage market may present further surprises. If, for instance, house prices were to fall more than expected, this could once again increase the unrest in the markets and lead to rising interest rates and falling stock prices, not only in the United States. In a slightly longer perspective, this can also slow down growth in the US economy and even have contagion effects in Europe and the rest of the world.

## …but strong developments here at home

If one looks at developments in the Swedish economy, our assessment in September was that it was actually stronger than in June. Here the labour market and productivity deserve special attention. These are two of the most important factors, which determine how cost pressures and thereby inflation will develop.

It was clear in September that the labour market had tightened further. The increase in the number of persons employed had been around as large as we were expecting in the June Report. However, the number of people in the labour force had not increased at the same rate we expected then. This meant that unemployment was also lower than we had predicted.

Given these signs of a tighter labour market, it was fairly reasonable to believe that wages would increase more rapidly in future than they had done in previous years. But we could note that this was not yet visible in the statistics. The picture painted by the National Mediation Office's statistics shows very moderate increases. But as I pointed out at our September meeting, it is probable that this picture will change when the new central wage agreements signed in the spring begin to make their mark in their respective sectors. And just as for developments in the labour market as a whole, this is something we follow closely.

As I have just noted, it is now clear that an increasing number of people are working. It is normally the case that when many new people obtain work towards the end of an upturn phase of the economic cycle, the work is a little less efficient, that is, productivity growth declines. And this is just what we have seen during the first half of this year. The fact that this would happen is something we have foreseen for a long time, although not that it would happen as soon and as quickly as it actually has.

This has also led to the forecast for productivity for the whole of 2007 being lowered as early as June. But I did not see any reason to change the forecast for productivity for coming years; my assessment was still that productivity would recover. This was because I viewed the slowdown in productivity as temporary. But productivity is a factor that is difficult to assess – there is a risk that the slowdown will be prolonged and lead to stronger cost pressures. This was one of the risk factors we noted in the June Monetary Policy Report.

The assessment in September was that food prices would contribute to higher inflationary pressures than we had previously anticipated. If we look at how inflation has developed in recent months, the forecasts from June have been relatively accurate. In August inflation was actually completely in line with the forecast, although it had been slightly higher earlier in the summer than we had forecast in June.

The assessment we made in September was that economic activity in Sweden actually looked slightly stronger than we had anticipated in June and that cost pressures had risen. We therefore decided to raise the repo rate to 3.75 per cent. This could in itself also motivate a slightly higher interest rate path. But uncertainty had increased as a result of the financial unrest and we expected this to lead to some negative consequences for growth both internationally and in

Sweden. This was why I concluded that it was still reasonable to count on roughly the same interest rate path as in June.

But such considerations and deliberations are the final stage in a long process. For me and my colleagues on the Executive Board, the next opportunity for this will be at the monetary policy meeting at the end of this month.