SPEECH

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■ Introduction on monetary policy

What is the objective of the Riksbank's monetary policy? To maintain price stability – an inflation rate around two per cent a year? Yes, this is of course correct. But behind this wording there lies a deeper meaning – the actual core of the task delegated by the Riksdag (the Swedish parliament) and ultimately the Swedish people to the Riksbank. Because what it is essentially all about is to create the best possible conditions for good and sustainable economic development. And monetary policy contributes to this by keeping inflation low and stable. The inflation target is not merely a target, but also a means.

The fact that I as Governor of the Riksbank have the opportunity to discuss monetary policy with you who represent the Riksdag is also important for the prospects of reaching this goal in the best possible way. The Riksbank must have support and legitimacy from the people to be able to succeed in its policy. It must therefore be easy to examine how monetary policy is conducted and how well we live up to our principles. The fact that the Riksbank Governor regularly takes part in these hearings is an important part of this process. Our task also means that we must constantly strive to become better at what we do and develop our working methods. We must adapt to new demands from outside and implement changes where we or others find scope for improvement. Evaluation and constructive debate contribute to making us better at what we do.

My introduction on monetary policy here today will in a way deal with evaluation and development. I shall talk about the contents of our Monetary Policy Report – our view of inflation prospects, the decision at the end of October to raise the repo rate by 0.25 percentage points and what interest rate policy we believe will be required over the coming years. The report is one of the best tools for examining how well we do our job. But I will also talk about some changes we have made to better meet the requirements made of us, not least in our role as independent authority.

Because if I summarise what has happened in monetary policy since I was here in February, it is not merely a question of the forecasts and interest rate decisions we have published. We have also made changes in the way we communicate, to become clearer and more open. There have been fairly lively discussions of this over the past year.

It is good that the Riksbank's strategy is discussed. But I sometimes think that it has been difficult to distinguish whether the criticism concerns our forecasts not being considered good enough or whether it concerns our changes in communication. It is of course important to distinguish between on the one hand our policy and our assessments, and on the other hand the way we communicate them – our communication strategy. I therefore wish to discuss these areas separately today. Moreover, there are other new elements that have been discussed with the Committee on Finance and are linked to the ambition to become clearer and more open. So let me begin there – by briefly discussing the changes we have made recently and why we have made them. After that I will go on to talk about the economic situation and interest rate policy.

Changes for better monetary policy

The driving forces behind greater openness and clarity.

Both the Riksbank and most other central banks have become more open and clear in recent years (slide 1). This is partly because we have seen it as a way to easier attain our target and to make monetary policy more efficient. By being open about the way we think, it is easier for others to predict our monetary policy. It will also be easier for the general public to make sure that the interest rate decisions we make are really aimed at achieving low and stable inflation. This increases the credibility of the inflation target and makes it easier to anchor expectations around two per cent. Developments in Sweden from the mid-1990s onwards are a good example of this (slide 2).

And by being clear about how we view future monetary policy we can also increase the efficiency of monetary policy (slide 1). It is not merely the current interest rate decision and the current level of the interest rate that are important to future inflation and demand in the economy. Households and companies do not base their financial decisions only on the current interest rates. Expectations of how the repo rate will develop over the coming years are at least as important.

But there are also other reasons for the increased openness. As I mentioned earlier, public support and legitimacy are a fundamental requirement for monetary policy to work. We have freedom with responsibility and with this come demands for insight and accountability. Openness is also something that has long imbued Swedish public administration. The principle of free public access which means that public authorities' activities shall as far as possible be carried out openly, was established as early as the late 18th century, a time when few other countries had such ideas. So this is a long tradition we are maintaining.

The fact that we are examined closely is also something that affects the efficiency of our work. The more open we are, the easier it is for a member of the Committee on Finance or any other member of society to evaluate how well monetary policy works. Clarity and increased openness outwards lead to a better discussion of monetary policy. In this way it functions as an extra incentive for us to become even more efficient within the walls of the Riksbank.

Changes in our way of communicating

So what are the changes that these driving forces have resulted in over the past year (slide 3)? There are primarily two changes involved. One is that we have followed the example of the central banks in New Zealand and Norway and now publish our own forecast for the future interest rate. The other is that representatives of the Riksbank no longer signal in advance, through speeches and press releases, how they consider the interest rate should be set at the next meeting.

There has perhaps been less focus on a couple of other changes, but these are also important components in the whole that makes the strategy for our communication. Since the summer we now publish in the minutes the names of Executive Board members as they express their opinions in the discussion at the monetary policy meeting. We now hold press conferences in connection with all of the now 6 monetary policy meetings a year. From this December we will publish an interest rate forecast in connection with each of these meetings. Previously the interest rate path has only been published in connection with the Monetary Policy Reports issued three times a year.

We have already discussed the interest rate path here in the Committee on Finance, but not the question of signalling. It is true that the signalling has been discussed in several speeches by Executive Board members. But as the idea behind these hearings is that I shall give an account of what has happened since the last time I was here, it seems appropriate to take up this issue again.
Earlier the Riksbank applied something that I have on a couple of occasions described as "signalling by degrees". Between the monetary policy meetings the individual Executive Board members sometimes held speeches where we more or less explicitly indicated how we thought the interest rate should be set at the next meeting. The idea was that sufficient information on how the Executive Board reasoned should have come out by degrees to prevent economic agents being taken by surprise when the interest rate decision was made.

But since we began publishing our own interest rate forecast the need for this type of signalling between the monetary policy meetings has declined. Now that we will also be publishing our interest rate forecasts every second month, the need has declined further. The general public and the financial markets will now receive at fairly regular intervals a detailed description of how a majority of the Executive Board members consider that the repo rate should be set in the future. This is one of several reasons why we have stopped signalling in speeches prior to coming interest rate decisions, unless there are special circumstances.

There were also some problems with the earlier signalling which we wanted to avoid. In certain situations it was probably difficult to determine whether the signal in a speech should be interpreted as an individual member's opinion or whether it reflected the views of a majority on the Executive Board. If the individual Board members sent out different signals it could probably also be difficult to distinguish a clear message. In addition, it was unclear when and if the signals should be sent out.

Finally, and at least as important in my opinion, there was also a democratic aspect to this question. This has to do with the fact that we are an independent authority and that the general public should have good insight into the decision-making process. There must be no doubt that the interest rate decisions are actually made at the monetary policy meetings and not at some other, more diffuse, point in time – in some informal way that prevents insight. If the signalling prior to the meetings leads people to believe that the interest rate decisions have been made in advance of the meetings, then doubts may arise.

Why has this led to a debate?

The fact that the debate on our communication has been fairly lively probably has several explanations. To begin with, the pace of our development towards openness and clarity has been fairly high over the past two years. And if one makes a lot of changes in a short time it is not so surprising that discussions arise. Because even if one has prepared the way, changes often mean that all those involved must undergo a period of "learning by doing" before everything falls into place. This applies not least to us, I would like to emphasise.

The changes also mean, in particular our own interest rate forecast, that we are now sticking out our necks and opening up for criticism more than before. When we describe our policy it is no longer in the form of a simple, but perhaps slightly misleading policy rule. This was the way things were before when we used the more easily understood, but less realistic, assumption of an unchanged repo rate. Instead we are painting a more complex picture, the way it actually looks to us who make the decisions. Slightly more complicated on the one hand, but on the other hand more realistic and with significantly better opportunities to evaluate our work!

The fact that we are publishing our own forecast for the policy rate also means that it will be very clear when we reconsider our view of what interest rate policy will be needed in the future. It also becomes evident when our assessment differs from that of the market, and these differences often cause a debate. But the fact that we are criticised for changing our minds, or for our views being different from the market view, is hardly a reason to refrain from reporting as honestly as possible what we believe. The fact that we changed our view or made a different assessment than the market also happened before, when our forecasts were based on the assumption of an unchanged repo rate. The difference was merely that it did not show as much as there was no interest rate forecast to use as comparison.

But it is important to distinguish between what is criticism of the Riksbank's economic assessments and what is criticism of the actual communication strategy. At the time as we published the first interest rate paths and stopped "signalling by degrees", our view of economic developments differed from many market agents' analyses. I believe that this contributed to criticism that actually dealt with differences in economic assessments partly spreading to the changes in our communication. It is too early to assess as yet, but I am convinced that the advantages of our new method of communicating will in the long term outweigh any disadvantages.

I would like to emphasise that an open and constructive debate is something we welcome. We will not refrain from changes that we believe lead to a better monetary policy, just because we risk being criticised in the process. This would be a very bad strategy and does not fit in with our task. We believe that the best way to conduct monetary policy is to explain as openly and honestly as possible both what we are doing and how we are thinking. And this is definitely something the general public can require of us in our role as independent authority.

All of these changes are steps in that direction. Steps we have taken to become clearer and more open – to become more efficient in our way of communicating. I would also like to point out that much of what we have done is in line with questions discussed here in the Committee on Finance. This emphasises the importance of using debate and dialogue to reach new solutions. We essentially all want the same thing – to create in the best way possible the right conditions for good and sustainable economic growth.

Other changes

The Committee on Finance itself has also initiated several changes that contribute to good discussions on monetary policy (slide 4). One change I am thinking of is the fact that the hearing with the Governor of the Riksbank now takes place a couple of weeks after the Monetary Policy Report has been published and that experts can be called in to assist the Committee, if necessary. Of course, it means I have to answer more difficult questions the more time you have had to prepare yourselves. But this is how it should be and something positive for all parties.

I would also like to mention another new element – a change of name which was largely initiated by the Committee on Finance. I am referring to the measure of underlying inflation calculated as CPI adjusted for households' mortgage interest expenditure. It also excludes the direct effects of changes in indirect taxes and subsidies. This measure was previously called UND1X. This name referred to the fact that it was a measure of underlying inflation, but probably appeared a little too cryptic. I remember that I may have let slip that I thought it sounded like the name of a rocket fuel during my first hearing. The new and hopefully slightly less difficult name since a week ago is CPIX, where the X indicates that something has been excluded from the CPI.

This takes me onto today's second theme, namely inflation prospects, our most recent interest rate decision and our view of what monetary policy will be appropriate in the future.

The economic situation and future prospects

It can hardly have escaped the attention of anyone here today that we now base our forecasts on our own assessment of what future movements in the repo rate we believe will provide a well-balanced monetary policy. So before I take up the rest of the economic analysis, I shall first describe the interest rate assumption. Our analysis is based partly on the increase in the repo rate of 0.25 percentage points to 4 per cent which we decided on just over two weeks ago, and partly on the fact that the interest rate will need to be raised slightly further in the future – to around 4.25 per cent during the first half of 2008. So how did we reach this assessment?

A strong Swedish economy with increased cost and inflationary pressures…

If we begin with the situation at home, it is clear that the Swedish economy is continuing to show strong growth (slide 5). We see increased cost and inflationary pressures ahead of us and there are a couple of main factors in this development that I wish to highlight.

Strong growth

Both the statistics in the National Accounts and the survey of Swedish companies carried out by the Riksbank confirm the picture of strong growth in Sweden. Although the rate of increase in GDP has slowed down slightly, it remains fairly high and is expected to be around 3 per cent this year. Our assessment is that we are in a situation where we are currently making more use of economic resources than normal.

If we look ahead, we are expecting GDP to grow slightly more slowly up to 2010 than it has in recent years. This is due to several interacting factors; we believe that productivity and the labour supply will increase more slowly, and that international growth will be lower. In addition, we are expecting the interest rate to rise gradually, the exchange rate to be stronger and investment to increase at a slower rate. These factors subdue growth.

…and tighter labour market

Despite the fact that GDP growth has been strong for several years, it was not until 2005 that employment began to increase (slide 6). And in 2006 both the number of hours worked and the number of persons employed rose quite substantially. This was partly because the number of people in employment measures increased considerably during the fourth quarter of last year. But despite the fact that fewer people are in labour market programmes this year, the number of employed has continued to increase. This indicates considerable strength in the labour market. We also assess that employment will continue to increase during the forecast period, but at a slower rate. The fact that the pace slows down is due to the economic upturn slackening. It is also due to higher wage increases contributing to a lower demand for labour.

The supply of labour has also increased, but not as much as employment. Open unemployment has thus fallen (slide 7). According to our forecast, the labour supply will continue to increase, albeit at a slower rate, during the forecast period. This development is mainly due to the economic cycle, but also to some of the Government's measures. The fact that the rate of increase is slowing down is due to the economic upturn slackening, and also to factors such as the number of persons in the age groups with high participation in the labour force declining. All in all, this will lead to the number of open unemployed persons continuing to fall, but at an ever slower rate. Compared with what we were expecting in June, the conditions in the labour market have become tighter.

This means in turn that it is reasonable to assume that wages will rise more quickly (slide 8). And the agreements signed so far support this picture. The new agreements will make an impact in 2008, and the labour shortages will also become more marked then. We are therefore counting on wages increasing more during next year than in 2007, by around 4.5 per cent. Labour costs per hour are also expected to increase. How this affects companies' costs for the goods they produce will in turn depend on how productivity develops.

Productivity growing more slowly and labour costs increasing

If one looks back at the past decade, productivity in the Swedish economy has improved significantly (slide 9). This meant that production could increase more quickly than costs. It also contributed to employment showing fairly weak development over a long period, despite good growth.

But more recently employment has increased, while productivity growth has been lower. We believe that the slower productivity growth is to some extent temporary. There can be several reasons for this. One reason is probably that new persons are being employed in the companies and that it quite simply takes time before they are fully productive. Another could be that new groups are entering the labour market. For instance, the service sector normally increases fairly late in an economic cycle and then the productivity measured is slightly weaker. Something that further fuelled the slowdown in productivity during the second quarter this year was the low holiday absence in June, which we assess to be a temporary effect. Our forecast is that productivity will once again accelerate, but increase at a slower rate than it has in recent years.

If one looks at the forecasts for the labour market and productivity together, one can also see that companies' costs in production are expected to increase more rapidly than in recent years. Unit labour costs are rising according to our assessment, by 4.8 per cent a year, but the rate of increase will then fall back as productivity begins to increase more rapidly once again.

Expectations confirm the picture of increased cost and inflationary pressures

If I very briefly summarise the domestic situation, the wheels of the Swedish economy are turning at a good pace. We have a high level of utilisation of economic resources and cost pressures are increasing. Something that supports this picture is that both households and companies have adjusted their inflation expectations upwards, according to various surveys. And if one instead measures inflation expectations by looking at the difference between nominal and real bonds, the results point in the same direction.

…is counteracted by slightly weaker international developments

International developments appear to provide some counterbalance to the slightly stronger Swedish economy. Although we are counting on international growth being good, it will probably be lower than we predicted in June. There has been unrest in the financial markets, particularly in recent months, and there have been signs of weaker economic growth in the United States and the euro area, among others (slide 10). But at the same time we are now expecting slightly higher growth in other parts of the world, including Asia and eastern Europe. Our view of growth in the world economy is therefore only marginally changed. Nevertheless, our assessment is that the slowdown in among others the United

States, together with the unrest in the financial markets will slow down economic developments in Sweden somewhat. I would therefore like to take the opportunity to say a few words about this, as it has received so much attention in recent months.

The financial unrest and how it affects the Swedish economy

The weaker growth in the United States and the anxiety that has arisen in the financial markets is largely linked to the problems in the US housing and mortgage markets. This concerns above all the market for sub-prime loans. These are, somewhat simplified, loans to households that do not have sufficient credit rating to be granted a normal mortgage.

During the summer there were signs that all was not well. The number of households experiencing difficulties in paying their mortgages had gradually increased. The unrest intensified when it was revealed that several financial institutions had made substantial losses related to the sub-prime market. The fact that an apparently national problem has global effects to the extent that we have seen is due in this case very much to the fact that the loans have been "repackaged" into fairly technically complicated securities and sold on to investors around the world. And the unrest that has arisen has largely been concerned with the fact that it is difficult to see who is bearing the credit risks, and to what extent.

These events have had several effects. There has been a more general reassessment of risk in the financial markets. The general uncertainty has led to an increase in demand for liquid and safe assets such as government securities. The interest rate on government securities has fallen, while the unwillingness to take on risk has contributed to rising interest rates on loans and investments between banks; interbank rates (slide 11). But all in all, it nevertheless appears as though the financial turbulence has so far not had as large repercussions on the financial markets as, for instance, the Asia crisis in 1997 and the IT crash in 2000.

What effects can we expect on the Swedish economy? Perhaps the most important effect will arise in that growth in the United States will slow down when housing investments there fall and households consume less. The lower demand in the United States to some extent slows down international economic activity and there will be a slightly slower increase in Swedish exports. The financial unrest will probably also contribute to Swedish households maintain a certain level of precautionary saving. The fact that it costs more for banks to finance themselves may also contribute to households and companies sooner or later facing dearer loans.

But there is considerable uncertainty over how extensive the effects of the financial unrest and the US housing market will finally be. We therefore analyse an alternative scenario with weaker international growth in our Monetary Policy Report.

Prospects for inflation and interest rates

We are expecting inflation to rise fairly sharply next year (slide 12). This is partly connected to energy prices rising more rapidly. But inflation is rising even adjusted for energy prices. And the reasons are primarily that utilisation of the economy's resources and cost pressures have increased. Moreover, there are signs that food prices will increase rapidly over the coming year. Inflation measured in terms of CPI will amount to around 3 per cent in 2008, according to our forecast. The measures of underlying inflation, CPIX, which I recently mentioned, will in our opinion rise from the current level to around the target next year. The differences between the measures are largely due to households' mortgage expenditure increasing and to higher indirect costs. When the economic cycle enters a calmer phase, the CPIX will fall back to levels around 2 per cent, while the CPI will remain slightly higher. This is our assessment, given that we raise the repo rate in the way I described earlier.

The interest rate decision and our forecast for the interest rate

To summarise, one can say that two forces are pulling in opposite directions (slide 13). One is the stronger development here at home, and the other is a slightly weaker demand abroad. But even if we expect that slightly poorer international growth will have a dampening effect on the Swedish economy, this is not sufficient to hold back the increased cost pressures. The interest rate therefore needs to be raised, and this was what we did around two weeks ago (slide 14).

With regard to the future repo rate, our forecast remains largely the same as in June, despite the fact that a lot has happened in the world economy since then. So to keep the underlying inflation rate around our target of 2 per cent a couple of years ahead, our assessment is that it is necessary to raise the repo rate slightly further in the future – to around 4.25 per cent during the first half of 2008. This interest rate policy should at the same time contribute to balanced growth in production and employment.

A couple of words about uncertainty – a forecast and not a promise

There is always considerable uncertainty regarding future economic events. This means there is also considerable uncertainty regarding future repo rate movements. The interest rate path we have published is a forecast. It is not a promise!

There are primarily two risk scenarios involved this time. If cost pressures become higher than in the main scenario, the Riksbank may need to raise the repo rate more. This could occur if wages rise more quickly or if productivity increases more slowly than expected. If the financial unrest persists and international economic activity will be weaker than expected, the interest rate may instead need to be lower. The direction for monetary policy in practice will depend on how new information on economic developments abroad and in Sweden will affect the prospects for economic activity and inflation. (Slide 15)

Conclusion

The Swedish economy is doing well. And the essential purpose of our work is to ensure good economic growth that is sustainable in the long term. As things look today, we are assuming that the interest rate path in our forecast will contribute to inflation being in line with our target around two years ahead. We believe that this will at the same time contribute to a balanced development in production and employment. (Slide 16)

And we also believe that the changes we have made in our communication will help enable us to fulfil the requirements made of us in a better way. We have made the changes in our communication to become even clearer and more open. We always have this ambition, and have had it since the inflation target was introduced.

But it is not merely with regard to communication that we are constantly reviewing and trying to develop our methods of working. No, it applies of course to all parts of our activities – everything from our way of making forecasts to how the organisation looks and how we can improve the opportunities to assess how well we are doing. And an important part of this is discussions like the one we are having today.

Thank you!