Price stability policy in perspective

Address by Mr. Urban Bäckström, Governor of Sveriges Riksbank, at the annual gathering arranged by Swedish Bond Promotion and Dagens Industri on 26th September 1996

The Riksbank presented an inflation report last Tuesday, which means that our view of Sweden's economy, inflation and interest rate policy in the period ahead are fairly well known. By way of a contrast to the more short-run analysis, today I shall therefore be considering monetary policy and the fight against inflation in a somewhat broader perspective.

Another reason for such an outlook is that it is 65 years to the day since Sweden, as the first country to do so, began to focus monetary policy on price stability. It was late on Saturday the 26th of September 1931 that the Riksbank and the Government announced that Sweden was to leave the gold standard, which was replaced by the objective of price stability. In this way, the ideas which Knut Wicksell, a Swedish economist with an international reputation, had put forward more than three decades earlier - in an address to the Swedish Economics Society on 14th April 1898 - were put into practice. Sweden was thereby the first country to adopt an explicit monetary policy objective expressed in terms of the general development of prices. Wicksell advocated a stable price level; neither inflation nor deflation would be admissible. Today, explicit price targets are commonplace, in use in many countries. So price stability is still a topical subject almost a century after Wicksell's proposal and exactly 65 years after the first introduction of a price stability objective.

During the 1980s and ’90s there has been a global effort in economic policy to bring inflation down to a low level. Many countries have achieved a high degree of price stability. This situation has now given rise to an interesting international discussion among leading academics as to what the next step should be. What is inflation's appropriate level? Is it advisable to aim for price stability in a literal sense, that is, a situation in which the overall price level in the economy neither rises nor falls? That would imply that inflation in one period is corrected with some deflation so that prices do in fact follow a stable path over time. An alternative could be to strive for zero inflation and disregard deviations in earlier periods; the price level would then not be entirely stable. A third approach is to accept inflation at a minimal rate of, say, 1, 2 or 3 per cent.

The optimal rate of inflation

In recent years a great many studies have been presented of ways in which inflation harms production and employment. Their purpose has been to define and quantify these negative consequences. The results so far suggest that inflation in the interval from 1 to 3 per cent seems to be desirable. In this range the damage inflicted by inflation is minimised.

There is no support for the notion that high inflation would lead to a favourable development of production. Neither can one claim, on the basis of current knowledge, that zero inflation would be preferable to a rate that is very low but positive. But the discussion of price stability is continuing because the data for most of the existing studies necessarily stem from recent decades, when inflation was relatively high.

In general, the usual arguments against price stability in the literal sense are of three kinds.

- The first argument is that official consumer price indexes overestimate the development of living costs, partly because full allowance is not made for changes in quality, the introduction of new products and substitution in favour of products that have become relatively cheaper. This margin of error has been estimated to be at most around 2 per cent for the United States and around a half of one per cent for Canada. For Europe, the available study by the Bank of England points to an overestimation of between 0.4 and 0.8 per cent. For Sweden, the extent to which the consumer price index is likely to overestimate changes in living costs has not yet been assessed so exactly.

- The second argument has to do with the downward rigidity of nominal wages. With zero inflation, nominal wages would have to fall in order to achieve real wage reductions in connection with structural adjustments in firms and industries. This does, however, assume that there are no productivity gains in that part of the economy. To prevent the wage rigidity from inhibiting production and employment in such a situation, some inflation would be needed. To this it can be objected that the frame for these studies is the inflation economies of recent decades. Some argue that in a world of low inflation, wage cuts in special cases would not necessarily be impossible. It is also important to look, not just at the hourly wage but at total wage costs, including fringe benefits; even today it is not uncommon for benefits of various types to be reduced if the firm is not doing well.

- The third argument is that a central bank cannot lower its instrumental rate below 0 per cent. With zero inflation, there is no way of achieving a negative real short interest rate with a view to countering a severe recession. This accentuates the risk of deflation and declining production. It follows that inflation should be somewhat above 0 per cent. Objections have been raised against this argument, too, with reference to the case of Japan, where some price fall has been managed with instrumental rates that have been low but positive. The Japanese economy now seems to be recovering from its recession. Moreover, the exchange rate and its development should also be incorporated in the analysis, as should fiscal policy, which means that economic policy has instruments at its disposal in a given situation if interest rate policy were to encounter a constraint.

If current knowledge suggests that it is not appropriate to aim for zero inflation, then where should inflation be? The damage done by inflation is evident from numerous studies. Inflation muffles the economic signals transmitted by relative price movements and elicits general uncertainty about the future. This in turn inhibits economic efficiency and the development of production. Inflation also entails an arbitrary redistribution of incomes and wealth. Many of inflation's costs have been recognised for a long time, particularly the problems associated with high inflation. It has been more difficult to quantify the full costs when inflation is low or moderate. Only in recent years has this terrain been possible to map.

Consequently there are good reasons for trying to achieve and maintain very low inflation. In the light of all the studies in recent years of the harm done by inflation and of what can be considered its "optimal" rate, it seems that Sweden's inflation target of 2 per cent strikes a good balance. For the time being I feel it is not terminologically inappropriate to equate Sweden's 2 per cent target with the concept of price stability.

The Swedish inflation target, which is flanked, moreover, by a tolerance interval, has a particular property that also stems from Knut Wicksell. This is that not undershooting the target is just as important as not exceeding it. From this it follows that in the construction of monetary policy, the development of production is an implicit consideration. This issue is sometimes raised in the Swedish debate, for instance by saying that the Riksbank's policy has focused too one-sidedly on inflation.

The development of production in relation to the available capacity is a factor of importance for inflation. Excessively strong growth is liable to generate rising inflation, bringing this above the inflation target. That calls for a tighter monetary stance. Conversely, weaker growth and a large output gap bring inflation down below the target, which by the same token warrants an expansionary monetary stance. This illustrates how, with an inflation target, monetary policy serves to smooth unduly large fluctuations in economic growth, rendering this more sustainable and more in line with the expansion of production capacity and the level of available resources.

Experience in Sweden

Since 1992 inflation in Sweden has averaged between 2 and 3 per cent, in marked contrast to the average annual rate of about 8 per cent in the 1970s and ’80s. Thus, inflation has been established at levels that are considerably lower than in the two previous decades.

For a long time, however, firms, households and financial agents did not regard the fall in inflation as entirely permanent. It was not until 1996 that expectations of inflation in the somewhat longer run began to move down towards the inflation target. Moreover, it is only when the economy as a whole has made up its mind that the lower inflation is also going to be permanent that there can be reason to expect positive results from the new low-inflation regime.

There are probably two reasons why it took until the beginning of 1996 for inflation expectations to respond in earnest. One is the earlier imbalance in government finance and the other is Sweden's poor history of inflation since the 1970s.

A budget deficit fuels doubts about the central bank's persistence in fighting inflation. Recurrent deficits and the attendant accumulation of government debt generate expectations that sooner or later the central bank will be pressured into conducting a more expansionary monetary policy. One of the phenomena that may accompany budget problems and the associated high inflation expectations is that unduly high wage increases create employment problems even though the economy is expanding. Moreover, the combination of a weak exchange rate and high bond rates tends to dualise the economy, which impairs growth.

In Sweden we have also experienced a clear example of the opposite - how budget consolidation leads to falling inflation expectations, a stronger exchange rate and lower bond rates. This in turn creates better conditions for future growth that is more evenly distributed, and thereby higher, in the various parts of the economy.

A country's history of inflation plays an important part in the credibility of its authorities with respect to inflation. One way of giving a new direction in economic policy greater credibility more quickly is to implement structural changes that promote adjustments. Inflation expectations can then be moulded more by future prospects than by the historical pattern. Considering the comparatively high wage increases during 1996, despite widespread unemployment, it seems that measures for improving wage formation and the workings of the labour market can generate support for the policy of price stability in the somewhat longer term. There is then ultimately a clear link to growth and employment.

Conclusion

My main points today are all essentially positive. They can be summarised as follows:

- There is notable evidence in the numerous studies in recent years that low inflation helps to create conditions for higher production and employment. The numerous studies in recent years indicate that a rate of inflation around

2 per cent represents an appropriate trade-off between the argument that the consumer price index somewhat overestimates the actual development of living costs and the damage that may be inflicted by even a fairly low rate of inflation.

- Developments in recent years mean that Sweden's credibility as a country with low inflation may now really be on the way to being established. This can be underpinned with a persistently firm fiscal policy as well as with the structural labour market measures that may follow the current discussion.

- With permanently low inflation, much of the damage that has been inflicted on the Swedish economy in recent decades can be made good, while production and employment grow more quickly. Today, however, it is difficult to predict how long it will be before these effects can be discerned more clearly.