Monetary policy

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First, my thanks for the invitation to talk to you today about monetary policy.

I shall be concentrating in the main on two topics. One is the past year's monetary policy - what has happened since we last met here and why? The other is the future - what does the Riksbank expect of the coming year and how may this affect monetary policy? But before launching into these matters I shall say a few words about how I perceive the need for transparency and clarity in monetary policy.

An ambition to be transparent and clear should be a fundamentally reasonable premise for any central bank. It is difficult to find any objective grounds for mystification and smokescreens. Transparency is particularly necessary when central banks become more powerful and independent. It is then all the more important that people are able to understand how the central banks work, assess their actions and call them to account.

In Sweden such an attitude is specially important on several counts. Our democratic traditions, along with the general transparency of government, make any other approach difficult to implement. We are also only in the early stages of building up an understanding of and support for the Riksbank's objective and actions, a process in which I perceive our transparency as significant.

Moreover, transparency and clarity are natural components in the smooth functioning of a market-oriented monetary policy. If market agents do not understand the Riksbank's actions or feel deceived by our measures, monetary policy will be less effective.

Furthermore, the need for clarity is particularly great when a new monetary policy regime is being established. The debate on monetary policy is liable to be coloured by the tendency for agents sometimes to take the short-term view. It matters in the market if an interest rate cut is made in one week rather than the next, or if the cut amounts to 10 rather than 20 basis points. But in a wider economic context this matters less. Perhaps clear explanations of the actions can help to shift the debate onto weightier issues of monetary policy; that at least is our hope.

Change in the monetary stance

Having said this, it is time to consider events in the past year. The conditions for monetary policy have undoubtedly changed appreciably. At this time last year the krona had appreciated from a low on the TCW index of 136.50 on 24th April 1995 to about 124 (*Diagram 1*). At the same time, the two-year inflation expectations, as measured by Aragon for example, had come down from levels around 4 per cent in the early months of 1995 to around 3 per cent for most groups. The twelve-month rate of inflation was 2.7 per cent.

This pattern was consolidated in the latter part of 1995. The krona continued to appreciate at first and then fell back again but the new levels were broadly maintained. Meanwhile, inflation expectations moved gradually downwards (*Diagram 2*). We were beginning to approach the point where it should be feasible to give monetary policy a more expansionary direction and lower the repo rate. But as we still did not consider that inflation could fall below 2 per cent, there was no cause to alter the monetary stance.

Monetary policy was debated intensely around Christmas 1995, when a majority of observers considered that we ought to lower the interest rate. Besides coming from a number of our most frequent domestic contributors to the economic policy debate, this view was heard from foreign stockbrokers and others. At that time we compiled the inflation forecasts of various agents in a table that I have presented on other occasions (*Table 1*). It shows that none of the more established observers of the Swedish economy counted on us fulfilling the target in 1996.

At the Riksbank the appraisal was gradually revised towards the end of 1995. The inflation forecast in our main scenario was adjusted downwards. This was accompanied by an increased probability of an alternative where weaker economic activity pointed to lower inflation. The latter was also something we had cause to allow for in our decisions. As a rule, monetary policy decisions are not based on an isolated estimate of future inflation; we work with a number of alternatives and our decisions stem from an assessment of their respective probabilities.

In January this led us to consider that the time had come to start lowering the interest rate. In this context it may be worth recalling that as late as in early February, criticism of Urban Bäckström was voiced at the Swedish Economics Association - by Lars Svensson, our own advisor in academic matters, as well as by Assar Lindbeck and Anders Verin - on the grounds that the Riksbank, instead of sticking to the rules, had cut the interest rate before, in their opinion, the forecast rate of inflation had come down to 2 per cent.

The situation we faced at the beginning of this year might be described as a voyage into uncharted waters. It was therefore important to make our course clear. But we also had cause to refrain from drastic manœuvres that might disturb the picture. We very much wanted bond rates to go on falling, accompanied by some further appreciation of the krona. For this to happen, the market should feel at home in the new waters and share our appraisal of the economy and inflation.

Today it is easy to forget that the situation in January 1996 was anything but stable. One instance of the unrest was the market reactions to the so-called Persson Plan: the krona weakened and bond rates rose. This led many commentators to question whether the Riksbank would be able to continue with interest rate cuts. We chose to do so, above all with reference to the basic outlook for inflation. Compared with the market, moreover, we evidently had more confidence in the budget trend. While it is true that a central bank needs to “listen” to the market, in the first place it is necessary to arrive independently at a clear picture and abide by this.

Picture of inflation better than expected

During the spring and summer the policy was successful in the sense that the repo rate could be lowered almost four percentage points without leading to a weaker krona or higher bond rates. In actual fact the opposite has occurred: the krona is stronger than in January and bond rates are appreciably lower. The favourable development of bond rates is even clearer in terms of the differential with German rates (*Diagram 3*).

This course of events stems from a variety of factors. The international environment has been good. For much of the past year there has been increased confidence in the establishment of EMU and this has benefited interest rate tendencies in Europe's high-yield countries. Another component has been the continuation of expansionary monetary stances in Europe and Japan, along with no increase in the federal funds rate in the United States. But developments in Sweden have been at least as important. The budget trend has been appreciably better than most observers counted on a year ago and the same applies to inflation. In these respects our relative positions in Europe are now considerably better than a year ago. Moreover, policy is conforming to established plans (the convergence plan, etc.).

Our tactics involved beginning with relatively large steps (25 basis points initially) at fairly regular intervals. As new, favourable information on inflationary pressure flowed in, we gradually revised our assessment of how far down the repo rate would be able to move. It is conceivable that the new information would have warranted cuts in larger steps but we chose to refrain; we did not want to risk the market investing in larger cuts than those we felt certain of being able to implement. The sequence of broadly uniform cuts therefore became relatively long. If today's picture had been completely clear to us from the start, a couple of larger reductions during the spring might have seemed natural. At the same time it should be emphasised that neither then nor now are we tied to any particular pattern. The tactics are always subordinate to the objective of fulfilling the inflation target; new information about inflationary pressure in the economy can always justify a reassessment of the current tactics.

On the whole, our actions seem to have been intelligible. During the spring and summer the market's picture of how much the interest rate might be lowered was revised to much the same extent as we adjusted our assessment. A picture of how the potential for cuts has changed can be derived from the path of the repo rate in relation to expectations of future overnight rates. It will be seen, for instance, that at the end of March the market envisaged that the repo rate would be lowered to just over 6 per cent. That was also approximately our position at that time (*Diagram 4*).

Another way of looking at this is to compare the actual path of the repo rate with the overnight rate expected by the market three months earlier (*Diagram 5*). For this time horizon, price setting had arrived at a good approximation of the outcome. If anything, during the past six months the repo rate has been lowered more quickly than these expectations had indicated. It is also noteworthy that the market appears to have been relatively successful in anticipating the timing of the change in the monetary stance.

A different picture emerges when the repo rate is related to how the market predicted the overnight rate a whole year in advance (*Diagram 6*). Here the discrepancies are considerably larger. In other words, the repo rate could be lowered by more than the market had counted on a year earlier. This is presumably explained to a large extent by an inflow of new information. A picture of Sweden as a country seriously committed to low inflation and sound government finance was gradually established during the spring and summer.

All in all, in the past year there has thus been a radical, positive reassessment of the Swedish economy; one might call it a confidence shock. Just like earlier shocks with the opposite effect, this has notably altered the conditions for monetary policy, above all via the krona's marked appreciation. It is partly this which lies behind the reports in recent months of inflation being under the lower tolerance interval. I would guess - and hope - that such dramatic fluctuations in the exchange rate will prove rare in the future.

Weak inflationary pressure

That leaves me prepared to continue with some remarks on our appraisal of conditions for future inflation. Here I shall start very largely from the inflation report we issued about three weeks ago.

Our assessments of future inflation concentrate on two factors in particular: the relationship between demand and supply in the economy (the output gap in a wide sense) and expected inflation. It is just these factors which are highlighted in most of the simple macro models for determining inflation. Mention should also be made of the exchange rate, partly because it has a direct impact on inflation via import prices and demand; it also serves as an indicator of inflation expectations.

Unfortunately the world is not so simple that the output gap and expected inflation can be represented unequivocally by mathematical terms that one just inserts into an equation to see where inflation will be in one or two years' time. On the contrary, our combined knowledge about the relationship between the output gap and inflation expectations on the one hand and actual inflation on the other is inadequate. This has to do not least with the extensive structural changes that have occurred in the Swedish economy in recent years. There is also the new monetary policy regime, with a flexible exchange rate, which makes reliance on historical patterns even more questionable.

As an overall representation of relationships between supply and demand, the output gap is important in our analyses. When demand tends to exceed supply, the output gap is said to be positive. There is then a major risk of accelerating inflation. The opposite applies when supply exceeds demand. Normally, then, there is cause to tighten the monetary stance if the output gap is positive and to give it a more expansionary turn when the gap is negative. This presupposes that inflation expectations do not present a different picture; if they do, the situation may be considerably more complicated.

The Riksbank has been working for a long time on the measurement of the total output gap. The results have varied greatly from method to method. Three different estimates were presented in the latest inflation report. According to them, today the gap is in the range from 0.5 to 2.5 per cent of GDP (*Diagram 7*). This suggests that at present inflationary pressure should be low.

The uncertainty of output gap estimates at national level makes it almost self-evident to work with a broad spectrum of demand and supply indicators. One way of approaching the issue of capacity utilisation is by studying more disaggregated information. The dual situation in the Swedish economy has resulted in a notably divided picture in recent years (*Diagram 8*). This still applies, though it is somewhat less marked. But this information likewise suggests that the output gap in a wide sense has not closed. It follows that inflationary pressure should be weak.

Wage increases disquieting

The question of the size of the output gap in a wide sense and of inflationary pressure becomes appreciably more complex when wage formation is added to the picture. For the past year the figures from Statistics Sweden point to an overall wage rise of about 5 per cent. These figures have been questioned but we still consider that the rate of wage increases in the total economy is hardly less than five per cent, after corrections have been made for structural factors (e.g. the tendency for job losers to have lower pay than new recruits), differences in the duration of wage settlements, etc. In the longer run this rate of wage increases is not acceptable, as discussed for instance by the Edin Group, which included representatives for labour market organisations.

A pessimistic interpretation would be that when new agreements are concluded, the rate of wage increases may continue to be too high. The existing wage increases have been high throughout the economy, not just in sectors where demand and profit levels were notably strong when the settlements were reached in 1995; trade is the best-known example. The wage increases have also come from wage drift, which continued in spite of the economic slowdown. The concept of the output gap shows a close relationship to the notion of equilibrium unemployment (the level of unemployment at which inflation begins to accelerate). If wage increases do not fall back, the implication will be that the equilibrium rate of unemployment is appreciably higher than indicated to date by most academic studies; this would also point to a smaller output gap.

Good arguments exist, however, for a more optimistic view. The wage agreements were concluded at a time when inflation expectations in the labour market were still high, accompanied by rapidly rising industrial capacity utilisation and extreme profit levels. Among labour market organisations the average level of inflation expectations for the coming years was around 3.5 to 4 per cent, as against about 2 per cent this September (*Table 2*). Moreover, although not entirely unambiguous, international experience seems to show that it takes some years for wage formation to adjust to an economy with low inflation.

Under these circumstances we start from the prospect of the rate of wage increases gradually falling back when the current agreements have expired. The process may be protracted and costly in terms of unemployment, but it will happen. Were it to occur more quickly, on the other hand, it would result in a better growth of employment.

In this context I should like to mention an important difference from the late 1980s that also serves as a good illustration of the interaction of monetary and fiscal policies. This year real wages are rising more than expected as a consequence of high nominal wage increases and low inflation. Compared with the 1980s, however, the real wage increases will have less impact on demand. One important reason for this is the tight fiscal policy. (For example, this year's real wage growth of around 4-5 per cent is accompanied by an increase in disposable income of only about 1 per cent.) Thus the tight fiscal stance is not only necessary for long-term considerations, in order to ensure a lower debt ratio; it also does a great deal to ease the inflationary pressure from wages. This increases the Riksbank's room to manœuver. While monetary and fiscal policies are not coordinated directly, the goal of fulfilling the inflation target means that in practice, fiscal policy is taken into account when constructing monetary policy.

Conclusions for monetary policy

When the Riksbank weighed up the various arguments in the inflation report, the conclusion was that the economy had an output gap. Economic growth in the period 1996-97 was estimated to total 3-4 per cent, with the emphasis on the upper half of this interval. The additional information in recent weeks is in good agreement with this picture. It points, if anything, to a marginal upward revision of growth. At the same time, we consider that the potential economic growth rate is slightly above 2 per cent. Under these circumstances we do not foresee any sizeable inflationary pressure in the coming two years even if demand pressure were to be somewhat stronger than in the inflation report's main scenario. Moreover, as inflation expectations have moved down to the level of the Riksbank's target, it was concluded in the report that inflation in the course of 1996 would be around one per cent and in line with the 2 per cent target during 1997 as well as in the first half of 1998.

Inflation may develop more favourably than in the main scenario. The chief arguments for this are the low inflation expectations and the possibility of a decreased inflation propensity. An output gap that is larger than estimated implies lower inflation in and after 1997.

On the other hand, a stronger tendency in private consumption may increase the pass-through from the rising wage costs to consumer prices. In a longer perspective, wage formation that is not adjusted to the new conditions poses a threat to the feasibility of combining price stability with high employment. The next round of wage negotiations will be important for monetary policy's future construction. The current agreements for the financial sector and the pulp and paper industry are already due to expire at the end of this year.

Our assessment from the middle of September, which still stands, was that the available information pointed to some remaining room for cuts in the repo rate. It should not be expected, on the other hand, that in the period ahead monetary policy will follow a particular pattern. The future path will depend on new information and on how this relates to the analysis in the Riksbank's latest inflation report.