# MONETARY POLICY

---

**Address by Mr. Lars Heikensten,**

**Deputy Governor, Sveriges Riksbank**

**at Bond Promotion Day in Stockholm**

**19 March 1996**

Thank you for inviting me to talk about the Riksbank's appraisal of the conditions for monetary policy.

Today I shall be concentrating on three topics. First some brief remarks about the Riksbank's inflation target, with reference to issues that have featured recently in market letters and the media. Then some comments on how this winter's repo rate cuts have affected markets. Finally, in the light of the inflation report we presented a few weeks ago, I shall say something about future monetary policy.

*The price stability target*

It is up to the Riksbank to safeguard the value of money. We therefore have a target for inflation: the increase in the consumer price index is to be limited to 2 per cent. This target is bounded by a tolerance interval of ±1 percentage point. The purpose of this interval is to accommodate unexpected shocks in supply, such as an oil price hike, changes in taxes and subsidies or, for that matter, any statistical errors. The point is that inflation cannot be controlled so exactly that we can be sure of landing at 2 per cent.

As it takes a considerable time for monetary policy to affect the economy, we cannot set our sights on inflation in the coming weeks or months. Instead we have to concentrate on inflation one or even more years ahead. Our principal tool is therefore inflation forecasts. When the forecast for the next year or so indicates that inflation is moving down below the inflation target, then there may be room to lower interest rates. Similarly, interest rates may have to raised if it looks as though inflation will exceed the targeted interval.

Unfortunately we do not know enough about the economy to be able to estimate future inflation with the aid of a simple model. Instead we work with a large number of indicators. These are of two kinds - indicators to do with aspects of demand and supply and indicators of expected inflation - because it is the interaction of these two phenomena that determines future inflation.

From time to time in discussions, addresses and so on there may be reason to highlight some of these indicators more than others. Something may have happened, for instance, to economic activity abroad, to the picture of expected inflation or to the inflation propensity in Sweden. But of course that does not mean that other indicators with a bearing on inflation have ceased to matter. When forecasting inflation in Sweden, for example, the value of the krona in the somewhat longer term will always be an important consideration.

I should like to mention another aspect of the inflation target. In recent months some observers have claimed that the Riksbank, unlike previously, now takes the level of activity into account. The argument seems to be that while the fight against inflation has not been abandoned, we have at least toned it down. That is not the case.

There is nothing new in the attention the Riksbank pays to economic activity. It is essential to the idea of an inflation target. Tendencies to an economic slowdown imply that inflationary pressure is subsiding, which may mean that there is room for an easier monetary stance. Lower interest rates stimulate demand, which counters the slowdown. The opposite applies when activity turns upwards; the higher interest rates that are needed to subdue inflationary pressure also curb demand. In other words, given low inflation expectations, monetary policy acts on inflation primarily via demand. The focus on the inflation target means that, among other things, the picture of activity is considered automatically. But we have no other objective than the 2 per cent inflation target.

The focus on an inflation target also means that consideration is paid to another opinion we sometimes hear - that fiscal and monetary policies should be coordinated more closely. Our assessments of future inflation incorporate the direction of fiscal policy in the years ahead. Larger budget reinforcements point in various ways - in the first place via decreased domestic demand - to a better outlook as regards inflation. That renders an easier, or a less restrictive, monetary stance more feasible. Similarly, a weaker fiscal policy implies a need for a tighter monetary policy. In principle, a clear allocation of responsibilities and targets - rules, you might say - lessens the need for continuous coordination. This principle is applicable to the interaction of monetary and fiscal policies.

*Monetary policy this winter*

When our inflation report was published some weeks ago we noted that in recent months the picture of inflation had improved. A particularly important feature of this development was the krona's growing strength last autumn. It is only now that part of the effect is materialising. Meanwhile, real economic activity has weakened and expected inflation, for instance as measured in surveys, has gradually fallen back.

The latest statistics on inflation have confirmed this picture. The consumer price rise is now in the tolerance interval's lower half. Taken together, this information has prompted us to lower the repo rate a number of times in 1996.

Besides the need for a continuous appraisal of monetary policy's effects on the real economy, there is reason to analyse its impact on financial markets. This is because interest and exchange rates are important components of the transmission mechanism and also tell us something about the policy's credibility.

Identifying the part which Swedish monetary policy has played in interest and exchange rate movements in recent months is not an easy task. The cuts in the repo rate have coincided with numerous other events.

In recent years the krona's course has been relatively parallel to the bond rate differential between Sweden and Germany. For much of the period of the repo rate cuts, the krona has been somewhat weaker than last autumn. The same applies to the bond rate differential. This seems troublesome and might indicate a growing concern about future inflation since we began to lower interest rates.

This impression, however, is not conveyed by Diagram 1, which shows that on the whole, the tendencies to depreciation and the upward bond rate movements have not covaried with the Riksbank's repo rate cuts; rather the reverse. The initial effect of most of the cuts was a stronger krona and a lower bond rate.

A more likely interpretation is that Sweden has been affected by a change of mood in the international bond market, a change that has spread to the foreign exchange market. Just as in 1994 and 1995, the impact in Sweden has been more pronounced than in, for instance, the EU's "core countries". In this, however, we are by no means alone. Other countries with previously high interest rats have also been affected. But the upward interest rate shifts have come at somewhat different times: in Sweden mainly when the so-called Persson Plan was presented in January; in Italy and Spain mainly in connection with more recent political crises.

Compared with the situation in 1994 and 1995, however, the increase in the bond rate differential and the weakening of the krona are less pronounced. This points to a better situation for the Swedish economy, though the conclusion is not self-evident since the pattern is similar for other high-interest countries. However this may be, the level of the bond rate differential is evidence that we have some way to go before the financial markets are entirely confident about Sweden's economic policy.

To sum up: we keep a close watch on the market effects of our policy. As previously, we would prefer a stronger exchange rate. And lower bond rates would, of course, benefit the Swedish economy in various ways. In this context the policy we have implemented in recent months does appear to have contributed if anything to a desirable tendency.

*Future inflation*

I want to end with some brief comments on our appraisal of inflation in the years ahead and our related conclusions for monetary policy. My starting point here is the latest inflation report. In the opening section there we singled out three factors as being particularly strategic for inflation in the years ahead. These factors are real economic activity, the inflation propensity and the value of the krona.

1. First the *real economy* and the level of activity. In this respect we considered that in the coming years overall economic growth is likely to be below the potential rate

- In the export sector the earlier signs of incipient bottlenecks are now receding on account of slower growth internationally and a stronger exchange rate. Investment has been high and although the increase is probably slackening in 1996, it is likely to result in a continued expansion of production capacity.

- The domestic sector is more difficult to assess and the discussion in the inflation report is therefore relatively detailed. In our opinion, consumption is most likely to show some recovery, albeit subdued. In this part of the economy, however, capacity utilisation is low initially.

Thus in the coming years there do not seem to be any sizeable risks of inflation from the demand side of the economy.

2. The *inflation propensity* in the Swedish economy is also considered briefly in the inflation report. There are indications that this propensity has decreased. If so, this is hardly surprising in that many other industrialised countries show a similar tendency in the 1990s.

Major changes have occurred in the Swedish economy in recent years. There are reasons for supposing that improvements in the workings of the economy - increased competition, for example - should have reduced the inflation propensity. Developments in the housing sector are a case in point. But in at least one other field, wage formation, we know that the problems are by no means solved.

Compared with forecasts presented in Sweden about a year ago, economic growth has proved to be higher and this has been accompanied by lower inflation. Like the falling inflation expectations, this points to a decreased inflation propensity.

3. The *value of the krona* has strengthened appreciably since last summer. This is important and it has been a major factor behind inflation's downward path in the past six months.

For monetary policy, as pointed out in various contexts, it is not the short-run fluctuations in the exchange rate which are decisive. But the Riksbank's policy would certainly be affected if the krona were to become more permanently stronger or weaker. That is so because, in the absence of countermeasures, effects would show up in the level of economic activity and thereby in prices.

In a long-term appraisal the krona must be said to be undervalued. In our opinion this provides conditions for an appreciation. Whether or not an appreciation occurs will depend both on the development of confidence in economic policy and, as I mentioned earlier, on the international environment.

In this context it must be underscored that there is still a great need for discipline in economic policy.

There must be no doubt that the Riksbank is safeguarding the value of money. Neither is there room for any ambiguity about government finance on the part of the Government or the Riksdag. The convergence programme which the Government presented last year stipulates that budget policy is to be monitored every six months. It is crucially important that this programme is fulfilled.

In the inflation report we concluded that the conditions for inflation in line with our target in the coming years are good. Against this background we considered that there could be some scope for a further easing of monetary policy. There is no reason to revise that conclusion. Thus, the Riksbank has today lowered the repo rate with 25 basis points.