Speech

Governor Urban Bäckström

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The current situation for monetary policy

Standing Committee on Finance

On New Year's Day the Riksbank acquired an independent status even in a formal sense. By the same token, Chapter 6, Article 4 of the amended Riksbank Act (1998:1385) stipulates that the Riksbank is to hand over a written report on monetary policy to the Riksdag's Standing Committee on Finance at least twice a year. Today, such an account has been presented to the Standing Committee and I shall now briefly summarise its contents and our appraisal of the conditions for monetary policy.

I shall begin with a short account of economic developments in Sweden and of matters to do with inflation in recent years. Then I shall describe how the Riksbank conducts monetary policy in the context of the new legislation. A review of the past year will follow, with an appraisal of the path of consumer prices and the accompanying monetary policy. Finally I shall be looking ahead at how the Riksbank views the prospects for inflation and the situation for monetary policy.

Sweden's economy in the 1990s

After the profound crisis in Sweden in the early 1990s, a favourable development of exports and investment has laid a foundation for a stable economic recovery. The contribution to growth from private consumption has also risen by degrees. Since January 1993, when the inflation target was announced, annual GDP growth in Sweden has averaged almost 3 per cent.

Inflation expectations have decreased and general economic policy's credibility has been enhanced, partly by the consolidation of government finances and the stabilisation of the bank sector. Long-term inflation expectations have moved down

Telephone
+46 8 787 00 00

Telefax
+46 8 21 05 31

E-mail
registratorn@riksbank.se

to the targeted level of 2 per cent. The prevailing macroeconomic regime is accordingly perceived to be basically credible, which in turn is a precondition for sustaining a favourable economic trend.

In the period with the inflation target, inflation has remained low. The CPI has risen since 1993 at an average annual rate of 2 per cent and the average since 1995, when the target began to apply, is 1.2 per cent. Excluding interest expenditure and the direct impact of altered indirect taxes, core inflation (UND1X) has averaged 1.8 per cent a year since 1995.

A major factor behind the low inflation is the unutilised capacity that existed, and still exists, in the Swedish economy after the recession in the early 1990s. But that is not the only explanation. The low inflation also has to do with changes of a more structural nature, in Sweden as well as elsewhere. Pressure from international competition has increased appreciably in the 1990s. This has made it more difficult for firms to raise prices. Although, strictly speaking, the effects on inflation are presumably mostly of the one-off type, the stronger international competition can continue to act on global inflationary pressure for a long time. Growing international trade, various deregulations and the European economic and monetary union are all on the side of more prolonged effects. At the same time, the heightened credibility of monetary policy, together with the lower inflation expectations that this has engendered, is showing up in price and wage formation.

Clarification of the inflation target and the conduct of monetary policy

The amended Riksbank Act states that the objective of monetary policy shall be to maintain price stability. The Executive Board of the Riksbank has specified this: monetary policy is to be targeted on keeping the change in the consumer price index at 2 per cent in a somewhat longer, annual perspective. A deviation of ±1 percentage point can be tolerated. Thus, even in the transition from the earlier to the amended Riksbank legislation, monetary policy is characterised by continuity.

Monetary policy's main impact on inflation is judged to occur with a time lag of twelve to twenty-four months. The Riksbank therefore has to base its policy on a forecast of inflation with this time horizon. In the account that the Standing Committee received from the Riksbank today, such a forecast is presented as the foundation for monetary policy. Under normal circumstances, monetary policy is formed in the light of a simple rule of thumb:

If the Riksbank's inflation forecast shows that inflation twelve to twenty-four months ahead deviates from the targeted rate, then the repo rate should be adjusted.

The ambition is to adjust the repo rate so that inflation's forecast rate twelve to twenty-four months ahead is in line with the target. But the rule is not applied mechanically. Inflation forecasts are surrounded by considerable uncertainty. In practice, policy therefore has to consider other conceivable paths for the economy and inflation in addition to the main scenario.

Under certain special circumstances, moreover, there may be reasons for allowing a more flexible interpretation of the rule. The Executive Board has decided that there can be two grounds for deviating from the established inflation target. This is, in principle, a codification of recent years' monetary policy practice.

1. *One ground is if consumer prices twelve to twenty-four months ahead are affected by factors that are judged to have no permanent impact on inflation. Such factors may be*

changes in house mortgage interest expenditure or in indirect taxes and subsidies, which alter the path of inflation in the short run but do not have a more lasting impact.

2. *Another ground from departing from the rule can be that a prompt return to the target would generate large real economic costs. In certain cases there may therefore be reason to disregard the time horizon and aim at returning inflation to the target more gradually.*

If one of these situations were to occur, the magnitude of the divergence from the inflation target twelve to twenty-four months ahead that may be motivated shall be stated clearly by the Riksbank *in advance.*

Inflation during 1998 and monetary policy appraisal

Against this background I should now like to discuss how inflation developed last year and comment in that context on the degree to which the Riksbank fulfilled its inflation target. I should add that the appraisal will no doubt be developed in the future in the light of the new Executive Board's clarification.

For 1998 the average of the CPI's 12-month change figures is 0.4 per cent. In other words, CPI inflation was below the 2 per cent target as well as the lower tolerance interval.

The path of inflation last year, as well as in 1996 and 1997, included considerable effects both from the Riksbank's sizeable interest rate reductions in recent years and from the Riksdag's changes to indirect taxes and subsidies. When such transitory effects are excluded, the average rate of inflation in 1998, measured as UND1X, works out at approximately 1 per cent. It is effects of this type that the Riksbank ought to disregard because we are not in a position to continuously eliminate the disturbances they inflict on the rate of inflation. A procedure whereby a change in transitory factors is countered with an interest rate adjustment, followed by a readjustment when the effect of those factors has passed, would inject unnecessary instability into the real economy. An illustrative example is last year's change in the tobacco tax, which had a marked but only transitory impact on inflation.

Another major reason for the low inflation outturn is the weaker international price pressure, occasioned for example by the Asian crisis and its contagious effects. In December 1998, just the price reductions for petroleum-related products and coffee lowered the 12-month CPI change figure almost half of a percentage point. This was more of a direct forecasting error. Along with most other observers, the Riksbank did not envisage that the international crisis would be so extensive or that commodity prices would fall as much as proved to be the case.

While the rate of inflation has been low, it cannot be said that the Swedish economy is experiencing deflation. This is evident from the fact that underlying domestic inflation, measured as UNDINHX, which excludes goods that are mainly imported in addition to changes in interest expenditure, indirect taxes and subsidies, rose by almost 2 per cent in 1998.

During my previous appearance here I underscored the difficulty of making policy transparent when transitory factors—elicited to some extent by the Riksbank's own actions—result in inflation below the targeted rate. That is why the Executive Board recently adopted a clarification of the inflation target and emphasised the importance of the Riksbank giving advance notification of occasions when deviations from the target may be warranted. That should facilitate appraisals. As I pointed out, the basic reason for disregarding transitory effects of this type is concern for real economic stability.

Inflation prospects

Low international price pressure

Since the December Inflation Report, the CPI and underlying inflation have both developed broadly as expected. In February 1999 the 12-month rate of CPI inflation was –0.2 per cent and core inflation, measured as UND1X, was 1.2 per cent.

One reason for the weak tendency is the low international prices. There are also many signs that international price pressure will continue to be low. Weaker international demand, increased competition and surplus capacity in many sectors are likely to mean that inflation in the OECD area will remain low in the years ahead.

The Japanese economy is still in a recession and shows no clear signs of a recovery. Despite a series of stimulatory fiscal programmes, together with vigorous efforts to overcome the bank crisis, consumer and business confidence has not yet improved.

Development in the euro area, which is of major importance for Swedish exports, has also been more subdued this winter than we envisaged in the December report. But a consumption-led upswing still seems probable in the euro area as a whole, though it may be somewhat less lively than the Riksbank counted on earlier. The US economy is showing continued strength; a slowdown there is probable in time.

In the Riksbank's main scenario, GDP growth in the OECD area in 1999 is judged to be just above 1.5 per cent. Partly in the light of the easing of monetary policy in various countries, some recovery is foreseen in 2000, when growth is judged to reach almost 2 per cent. Compared with the Riksbank's assessment in December, the international economic prospects are thus marginally more subdued.

Gradual economic recovery in Sweden

The international outlook, with weaker growth in Sweden's neighbourhood, is expected to result in growth in Sweden being somewhat lower than in 1998. The slowdown in Europe affects Swedish manufacturing to a greater extent than the upward revision in the United States. But the prospects for growth in the coming years are still relatively good. Domestic demand is judged to rise successively in the forecast period, partly on account of the low real interest rate. This picture is supported by various financial indicators, such as lending to households and growth of the money supply. It counters the somewhat weaker prospects for export growth and the poorer outlook for manufacturing, particularly in 1999. In addition, fiscal policy's restrictive effect on demand is assumed to be smaller than during the budget consolidation in recent years.

Together with a gradual recovery of international economic activity, this means that GDP growth is expected to be above 2 per cent in 1999 and approximately 2.5 per cent in 2000. The somewhat weaker cyclical outlook implies that employment may grow somewhat less than was assumed in the December Report. Unemployment is judged to decline from 6.5 per cent this year to 6.2 per cent in 2000.

Financial market pricing and survey data show that households, firms and market players still count on very low inflation in the coming year. Further ahead, inflation is expected to be in line with the Riksbank's target.

Notwithstanding relatively good growth, in the coming two years the economy will probably have unutilised capacity. This points to low underlying inflationary pressure in the forecast period. The Riksbank judges that CPI inflation will be 1.1 per cent in twelve months time and 1.4 per cent after twenty-four months.

The weak consumer price trend is partly explained by transitory factors that are considered to have no lasting impact on inflation and therefore do not influence the formation of monetary policy. Transitory effects—from declining house mortgage interest expenditure and changes in indirect taxes and subsidies—are judged to hold back the CPI increase in the coming twelve months by 0.5 percentage points and by 0.2 percentage points after twenty-four months, that is, in March 2000 and March 2001, respectively. Core inflation, measured by UND1X, is accordingly judged to be 1.7 per cent in March 2000 and 1.8 per cent in March 2001.

Against the background of the Executive Board's formulation of the inflation target, I want to emphasise the Riksbank's assessment that transitory price movements will accordingly also occur in 1999 and 2000 as a result of the interest rate reductions and the approved changes in indirect taxes and subsidies. The combined effect of these factors is expected to lower the average annual rate of CPI inflation in these years by 0.9 and 0.6 percentage points, respectively. Thus, there is reason to count on deviations from the inflation target because of these factors also during 1999 and 2000.

Risks of lower inflation predominate

The inflation forecast is subject, as always, to uncertainty. The somewhat divergent pattern makes the international economic future difficult to foresee. The situation is about as hard to assess as it was last December.

The financial market unrest has admittedly subsided but the uncertainty about international economic prospects is considerable and has increased, if anything, during the recent month with the strong US statistics. This in turn has led to a global increase in long bond rates and also affected cyclically sensitive equity prices.

A weaker international trend could be triggered by an abrupt downturn in the United States. Stock markets in the United States are at a high level, household saving is low and the investments may seem high compared with corporate profit expectations. If a slowdown in the United States were to coincide with a weakening of domestic markets in Europe and a continued lack of growth in Japan, the consequences for the global economy could be serious.

A stronger trend could materialise, on the other hand, if, for example, activity in Europe, thanks to high consumer confidence and a pull from US demand, were to pick up more rapidly than in the Riksbank's main scenario at the same time as the recovery in Asia comes sooner than expected.

All in all, however, there is judged to be a greater risk of international activity being weaker. That is also why the Riksbank considers that the risk of inflation being lower than in the main scenario is greater than the risk of a higher rate.

Monetary policy conclusions

The conclusion from the Riksbank's inflation forecast is that, even when transitory effects from changes in indirect taxes, subsidies and interest rates are disregarded, the rate of inflation twelve to twenty-four months ahead will be below the Riksbank's target. Moreover, as I just said, the risk of lower inflation compared with the main scenario is greater than the upside risk. At yesterday's meeting the Executive Board therefore decided to reduce the repo rate 0.25 percentage points, from 3.15 to 2.90 per cent, with effect from 31 March.