# Speech

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# On Clarity and Flexibility

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Let me begin by saying that I welcome this opportunity for a fundamental discussion on the way monetary policy is formulated.

The background to today's discussion consists of a number of contributions to the debate in which it has been asserted in somewhat differing ways that the way we have chosen to formulate monetary policy is not sufficiently flexible. Our critics are of the opinion that by tying ourselves down to an inflation target of 2 per cent we risk allowing unacceptably high domestic inflation. And that we risk strengthening "bubbles" in asset prices. It has also sometimes been intimated, in so many words, that the way we have chosen to formulate policy is one explanation for the very weak exchange rate. Furthermore, in this debate, it has also been suggested that we should adopt less specific inflation targets, similar to those of the European Central Bank (ECB) and its American counterpart – The Federal Reserve.

The debate has arisen primarily in three different contexts. How deregulation should be handled, to what extent asset prices should be taken into account, and the role the krona has to play in this analysis.

The mainstay of my argument is that there are no simple solutions to any of these problems. What is needed is an empirical assessment from case to case. I think that monetary policy does have the flexibility needed to deal with the problems with which we are faced. At the same time, clarity in the formulation of objectives brings advantages.

The basis of the way in which the Riksbank evaluates the future path of inflation and makes decisions on the repo rate is the guiding rule, which we have followed for a number of years. According to this simple rule, policy is based on an inflation forecast with a horizon of several years. If, in one or two years' time, inflation

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exceeds the target, we have said that there is normally a case for raising interest rates and vice versa. But there can be reasons for deviating from this rule. Some of these reasons are given in the clarification issued by the Executive Board of the Riksbank when it took office. Other reasons have been presented in various speeches.[1]

Perhaps I should also say right at the beginning that what I am going to say today is nothing new. I have presented the same message in varying forms in a number of speeches for several years.[2] It is, however, important to emphasise that in practice there are seldom any straight answers when decisions have to be taken on the repo rate. It is often possible to come to different conclusions based on convincing arguments, even when one has the ambition of keeping to a simple and clear rule. Diligent observers reading the minutes of the Executive Board meetings have also been able to see that assessments have varied somewhat between the different members of the Executive Board.

**1. Deregulation**

The first question concerns how monetary policy should deal with the effects on inflation caused by deregulation and by other changes in price developments, which can be considered to be of a temporary nature. The background to this debate was that during the latter part of the 1990s and also during last year, Sweden had a very low inflation rate. This was partly the result of deregulation and increased international competition. Added to this was the fact that import prices fell strongly in the wake of the Asian crisis. The question is, therefore, whether deregulation hid excess inflation in other areas, and whether monetary policy was too passive.

This is not a simple question to answer, either in practice or in theory. The effects of deregulation and other structural changes on inflation are difficult to assess in retrospect. Nevertheless the Riksbank must make assessments, which are presented in its Inflation Reports. In Sweden we have had several deregulations, including those in the taxi industry, domestic air travel and dental care, which have not caused any substantial drop in prices. Other deregulations, including those in the electricity and telephone markets, have had larger moderating effects on prices than expected.

The difficulties do not only involve evaluating the effects on inflation of each single deregulation or every new step in internationalisation. They also concern the more principal question of to what extent this type of effect on inflation should be accepted. Where should one draw the line between a relative price change, which leads to such inflationary effects that a monetary policy reaction is motivated, and a change which does not require any such reaction? Presumably, today's increased competition is only part of the whole picture of developments, in the same way that tax increases were during the 1970s and 1980s. At that time, not taking into

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[1] Minutes of the Executive Board meeting on 4 February 1999. The clarification is also presented in Heikensten, L. (1999), The Riksbank's inflation target — clarifications and evaluation, *Quarterly Review* 1, Sveriges Riksbank.

[2] Heikensten, L. *Six monetary policy issues*. Speech at Umeå School of Business and Economics, 7 November 2000.

account the fact that tax increases were part of the inflation process was a considerable policy mistake. In the same way one can ask whether the effects of deregulation and other effects of international competition should really be taken into account today.

There are fundamental arguments against the idea of discounting considerable aggregates of goods that have been hit by price falls. What central banks should be trying to do is to stabilise general price levels and not to counteract changes in relative prices. This is to do with the fact that it is general price levels that can be influenced by monetary policy, and not the prices of items such as meat or nails. This is also to do with the fact that the positive effects of stable monetary value manifest themselves precisely because the players in the economy can rely on purchasing power which is not undermined.

At the same time the Riksbank has, in various contexts, maintained that there can be reasons for ignoring effects on inflation which are thought to be temporary. The reason for this is that it is not often possible to influence inflation quickly enough to counteract transitional price impulses without this leading to larger real disruptions. We have said, however, that we shall give as clear an account as possible of what the temporary effects are and how we deal with them.

When examining the formulation of monetary policy in situations involving considerable price-moderating effects, it can also be a good idea to give some reflection to the time perspective of monetary policy. One possibility is that the visible effects ebb away quickly, even though they occur beyond the normal policy horizon. In that case, presumably, one should be careful not to stimulate the economy too much. The opposite would apply if inflation were forced up strongly by some effect which could be expected to dissipate beyond the 2-year horizon.

This is obviously a difficult question of judgement. Should a forecast change in prices be considered to be temporary or not? Is there a future risk of inflation rising or falling rapidly?

**2. Asset prices**

The next question concerns the importance of asset prices as regards the formation of monetary policy. Asset prices are not included in the inflation index, which we normally try to stabilise.

It is not controversial to say that supply price trends should influence monetary policy to the extent that they are part of the inflationary process. Asset prices can be a leading indicator of price developments in other areas. They can reflect confidence in the future, both by households and by companies and thus affect inflation by influencing demand. Household consumption is also dependent on wealth, which means that property and share prices are important when predicting inflation. Share prices can also be a leading indicator for industrial production and investment. Developments in the stock market influence the will to invest.

With the guidelines followed by the Riksbank, the question arises as to the significance of asset prices on inflation, primarily in the time perspective on which we focus, i.e. one to two years ahead. But it can also happen that asset prices are judged not to have such a significant impact in this time perspective, but to have an impact if one looks further ahead. For example, should inflation in two or three years' time be thought to be higher than desirable if it results from various factors driving up asset prices at the current time? If so, presumably this should be supported by other central inflation indicators, such as the overall utilisation of resources in the economy. If one is sufficiently convinced about this, there is, as I see it, an argument for taking action. But precisely as with the previous case involving deregulations, it is necessary to make a good case for deviating from the normal rule. It is also necessary to make clear what one stands to gain by acting now.

This leads me to the question of what approach central banks should take to developments in asset prices which are not thought to immediately endanger price stability, but which risk leading to financial imbalances or real imbalances. There is no consensus on this in the academic literature. The prospect of intervening immediately poses the next question: how can we know if an asset is over-valued or not? If one does decide to act, a third question is raised: how can one burst the "bubble" in an organised way? Listing these problems is usually sufficient to make many of my colleagues in the central bank world come to the conclusion that monetary policy should not be used to try to stabilise asset prices.

My own opinion on this question is, however, somewhat different. In any case, it is reasonable to put the argument in a larger perspective. Apart from price stability, the Riksbank has the objective of promoting an efficient and stable payment system. Also, as long as our primary objectives are not threatened, we should do what we can to support other objectives of economic policy. These include favourable economic growth, high employment, etc. It means that we should conduct monetary policy in such a way that we do not cause unnecessary fluctuations in production and employment.

In practice this again comes down to difficult empirical questions which need to be weighed up carefully. If we see that financial imbalances are building up, and come to the conclusion that these either threaten the security of the payment system or risk leading to an abrupt real adjustment in the future, with negative consequences for economic growth or employment, we then have, in principle, a motive for taking action with the interest rate. Whether the knowledge that we can act diminishes the risk of "bubbles", is a different question, but it is a link in the chain of argument which strengthens the case for monetary-political activism.

Another thing is that this is naturally not a simple decision to take in any given situation. There are also possibilities of working with other instruments, for example, capital requirements on financial institutions, supervision, etc. Our Financial Stability Reports are intended to play a role in this context. They should bring problems of this sort into the open, partly with the intention of attempting to contribute to improvements on a voluntary basis. In these context there are reasons to remind that it is normally the case that financial crises are caused by increases in house and property prices rather than increases in share prices.

The actions of the Riksbank should also be put into proportion. The fact that prices on the Swedish stock exchange have both risen and fallen more strongly than many other stock markets has little to do with Swedish monetary policy. Of course, the Riksbank could have raised interest rates during 1998 and 1999 in order to dampen the effects of share price increases. But I have difficulty in believing that increases within reasonable limits would have had any notable effect on the share prices of IT companies and telecom companies. The Riksbank is certainly an important institution. But sometimes there can be reasons to emphasise the limits of our effectiveness.

To sum up, the conclusion is the same as in the previous section. Under certain conditions it is quite possible to deviate from the normal guidelines. For example, as regards taking care of price developments in the long-term, or financial stability, or real stability. But the arguments should be good ones.

**3. The exchange rate**

Now, some words about the importance of the exchange rate as regards our view of monetary policy. In this area, opinions have changed a lot within the Riksbank after the first years with an inflation target.

According to the textbooks, exchange rates are governed, to a large extent, by differences in present and future monetary policies between different countries. In principle, by raising and lowering the repo rate you can control the exchange rate. This affects import prices directly and indirectly, with a certain lag. The same applies to demand and to general price trends.

The conclusion has, however, been drawn many times during the last decade that the world is not as simple as this. One recent example is from 1998 to 1999. It is hard to believe that the weakening of the krona during the autumn of 1998, were effected in a larger extent of the interest-rate cuts which were made at that time. The krona strengthened considerably during the following winter, when exchange rate differences, compared with the outside world, remained unchanged. The fact that the krona has weakened during the past year can, of course, be to some extent due to monetary policy. But stock market trends, fluctuations in expectations of growth and the outflow of portfolios have also played their part. A reasonable conclusion is that short-term interest rates can have an effect on the exchange rate, but that their importance varies quite a lot over time, and is dependent on many other factors. These factors are not always as easy to identify, even after the event.

One comforting factor in this connection is that the link between exchange rates and price trends seems to have weakened during the 1990s. At any rate, this is the picture given by analyses in Sweden, the United Kingdom and Australia, for example. Despite periods of severe weakening of the krona, price trends have been restrained. However, no one knows whether this will continue in the future in exactly the same way.

Against this background, the Riksbank is primarily interested in the exchange rate in the same time perspective as applies to inflation. That is, one to two years ahead. We do not normally react to exchange rate movements in a shorter perspective. We all know that this has not given us a particularly stable krona, but as far as we can see, the krona has not fluctuated noticeably more than other currencies during the last five or six years. Nor has it been easy to make good forecasts regarding the exchange rate. But it is difficult to see any really good alternative to this way of doing things. Experience of trying actively to guide the exchange rate towards some given level has not been particularly promising.

In this context it is worth pointing out that the central bank which in many respects works most closely to the way we do – The Bank of England – continually struggles with the opposite problem. That is, an exchange rate which is too strong. This is one indication that it is not primarily the way monetary policy is formulated which is the problem.

During the first years of floating exchange rates, the Riksbank used something called the Monetary Conditions Index (MCI). This was an attempt to show the combined effects of short-term interest rates and the krona on inflation. The underlying thought was that if the krona strengthened, interest rates could be lower and vice versa. This was something that the Index could only illustrate roughly. The risk with such an index is that it can be interpreted too mechanically, as shown by experience from New Zealand and elsewhere. When the exchange rate weakens it tends to be used as an argument for raising the interest rate. In this context, MCI is a very good example of the risks of over-simplification in monetary policy.

That which is of greatest importance as regards the exchange rate is precisely the same as with deregulations and asset prices – to evaluate each situation in the context of our objectives and our guiding principles. The important question is always why a certain movement in the exchange rate has occurred. If we know – and that is not always the case – we can perhaps say something about how long the movement might last. This can in turn guide us in how we use interest rates.

There are central banks which now and again have to devote most of their communication to discussing the latest movements on the foreign exchange market. This is not something we should try to emulate. It is not the situation in which the Riksbank finds itself nowadays. But this has not always been the case. It has taken us several years to become convinced that we should see the exchange rate primarily as one of several inflation indicators. I think we have every reason to keep to this approach.

**Closing comments**

Finally, let me give some general reflections on clarity and flexibility.

It is sometimes asserted, with quite varying overtones, that the Riksbank is much too restricted by principles. We should act more pragmatically. This is maintained by those who think we should have a higher interest rate and who point to the ECB variant of pragmatism, as well as by those who think the interest rate should be lower and who see the Fed's pragmatism as their ideal.

This is a debate which in essence is based on misunderstandings. The constraints within which the Riksbank works, allow a monetary policy which is both flexible and pragmatic. We can certainly extend our target horizon, monitor risks of problems in the financial sector or act early in order to avoid major subsidence in the economy further ahead. But this places requirements on us to motivate our actions clearly and substantially.

It is, therefore, in this context – by setting very high standards as regards clarity and openness – that we beg to differ.

In essence, I think that demands made on us that we should be more pragmatic in some general way – and not keep to our way of reasoning with a target, with guidelines, etc. – are meaningless. Less clear principles for policy in combination with reduced transparency regarding, for example, the reasons for making decisions, will hardly lead to a policy which will be more successful in the future. Many years' experience in the vicinity of economic policymakers suggests to me that the opposite is more probable. Among the most important things one can do in this type of work is to try to build up clear processes which contribute to decision data, based on good economic analyses, being produced in a systematic way. And that this decision data is subjected to as wide an examination as possible.

I am convinced that our ambition to be as clear and open as possible has served us well. Starting with a numerical, symmetric objective and a guiding rule, in the way that we have done, we have been forced to think through every question with which we have been confronted in a more precise manner. This has resulted in our gradually increasing our understanding in a way which I think would hardly have been possible otherwise. Certainly it is not yet over, and in this context, future developments will place new demands on us and impose further intensification and exactitudes.

There is also a connection between transparency in relation to the outside world on the one hand, and internal work on the other. In getting rid of secrecy we were able to introduce a more realistic debate on monetary policy. This has allowed sharper and more specific criticism from outside, something on which we thrive.

In addition, I think that decision making should be made in a way which contributes to insight and which gives good possibilities for evaluation and requires responsibility. I think that this is something the Swedish people should expect from an institution which has been given such a strong and independent position as the Riksbank now enjoys.