SPEECH

DATE: 6 February 2006
SPEAKER: Governor Stefan Ingves
LOCATION: Umeå, Umeå University

SVERIGES RIKSBANK
SE-103 37 Stockholm
(Brunkebergstorg 11)

Tel +46 8 787 00 00
Fax +46 8 21 05 31
registratorn@riksbank.se
www.riksbank.se

The Riksbank's role in the economy

Let me begin by thanking you for the opportunity to come here and talk to you! Travelling around the country and meeting representatives of different regions, industries and sectors of society is an important part of the openness the Riksbank wishes to maintain. These trips provide us with input for our discussions at the bank, while we build up confidence in our operations. This is my first public appearance as Riksbank Governor, and it feels good to stand here in front of students, teachers, local politicians, regional business representatives and other Umeå residents. I hope we will have a stimulating discussion and I will certainly do my best to answer your questions.

Introduction

After living and working abroad for many years, it is an honour, as well as exciting and a pleasure to be back in Sweden and at the Riksbank. The bank I left some years ago is now different in many ways. The most important change is that the Riksbank has been governed since 1999 by an Executive Board, consisting of a Governor and five deputy governors, which makes all of the strategic decisions, including monetary policy decisions. Previously the interest rate decisions were formally made by the General Council, which now instead appoints the members of the Executive Board. The Riksbank has obtained greater independence in relation to parliament and this is why its management has been given greater breadth – five deputy governors compared with two previously.

The change towards greater independence for the Riksbank coincided with the clarification of the bank's monetary policy task. It is now written in the Sveriges Riksbank Act that the bank shall maintain price stability. This is a development that has also taken place in many other countries. Inflation was for a long time a major problem in many parts of the world, but since the shift in monetary policy towards a greater focus on price stability, inflation has been brought under control. In addition to Sweden, twenty or so other countries currently have inflation targets, although not all of them have chosen exactly the same system for inflation targeting. Sweden was one of the first in this context.

The increased independence has entailed greater demands for the Riksbank to explain its decisions. When I worked at the bank prior to 1999, work had already begun on improving analyses and communication and aiming for increased openness. This is a continuous process. During my years abroad I have seen several examples of the prominent role played by the Riksbank in central bank circles, particularly bearing in mind that we are a small central bank in a small economy. The Riksbank is now regarded as one of the most open central banks in the world.

Today I will talk about how we at the Riksbank work to achieve our price stability target and to ensure we have a safe and efficient payment system. I will for instance claim:

- That monetary policy is not conducted automatically without any consideration for other parts of the economy. Legislation and our methods of working give us the scope to conduct flexible inflation targeting. At the same time, we cannot, of course, accept too much deviation from the target if it is to remain credible.
- That we will continue the work on developing our methods of forecasting. One possible step in this could be to publish our own interest rate forecast instead of assuming that the repo rate will develop in line with market expectations.
- That it is important to follow up the legislatory work in Sweden on how banks in distress should be managed. This is a project that began a long time ago and needs to be completed.
- That my ambition is for the Riksbank to remain at the forefront as regards both of our areas of responsibility. We shall be a small, efficient central bank that is respected both at home and abroad.

Before I return to these issues, I believe that the current monetary policy regime can be best understood in the light of the historical experiences of conducting monetary policy. I will therefore begin with a look back at the experiences from various monetary policy regimes. Finally, I shall briefly discuss the current monetary policy situation.

The value of low, stable inflation

Let me begin by saying a few words about why a low inflation rate is desirable. Most people now agree that a high inflation rate is not good and has a negative effect on the functioning of the economy as a whole.

A high, fluctuating inflation rate entails uncertainty for operators in an economy. This uncertainty obstructs decision-making with regard to prices, wages, consumption, production and investment.

When inflation is high, nominal wage increases tend to be relatively meaningless, in other words, the amount in the wage packet is worth less because general prices are also increasing. If, for example, we look at real wage increases, which take into account inflation, these were almost non-existent in Sweden during the 1970s and 1980s. This is because the nominal wage increases pushed up prices, which resulted in recurring cost crises. This type of development affects companies' competitiveness, production, investment and households' purchasing power.

High inflation also leads to arbitrary distribution of income and wealth. For instance, those who saved their money in bank accounts during the 1970s and

1980s, when inflation was high, saw their wealth decline in value, while those who instead borrowed money and bought, for example, property, made a profit as property prices then increased at roughly the same rate as inflation.

The conclusion is that low, stable inflation is an important condition for an efficient economy.

Experiences of different monetary policy regimes

Countries have long endeavoured in different ways to control inflation, often by trying to fix the nominal exchange rate by one means or another. However, during the post-war period it is only in recent years that we have really understood the long-term costs of high inflation. And it was not until then that there was a serious political ambition to deal with the inflation problem. During the 1960s and 1970s many considered that the cost of bringing down inflation was too high in relation to the advantages it would entail. There was also a belief that by accepting slightly higher inflation it would be possible to achieve a sustainable higher level of employment and lower unemployment. However, in time it became increasingly clear – thanks to both practical experiences and results from academic research – that this reasoning was not viable.

At the same time, it is important to remember that during the first decades after the war we were living in a completely different type of economy compared with now, not merely with regard to the view of inflation. Most western world countries had strongly-regulated financial systems. This was partly a consequence of the war, and partly due to the view that access to credit should be steered towards certain tasks. At the same time, many countries had fixed exchange rates and regulated capital movements, initially within the Bretton Woods agreement – the system that was generally based on fixed exchange rates. The task of safeguarding price stability had to make way for other central bank tasks.

It was partly therefore that almost the entire western world lived with a rising inflation rate during the late 1960s and the 1970s. At the same time, the upswing in inflation did not go hand in hand with higher growth and employment.

When the world economy and world trade grew, the regulations became increasingly ineffective. Interest rate regulation, credit restrictions and exchange rate regulation hindered capital from flowing to where it could give the highest return. In addition, the regulations became more difficult to maintain when an increasing number of companies began to conduct operations in several countries, while new, unregulated companies and operations arose in the financial markets. In Sweden, as in many other countries, credit and exchange rate regulations were gradually abolished during the 1980s. This of course radically altered the conditions for monetary policy.

The fixed exchange rate system was also subjected to considerable strain during the 1970s and 1980s. This had long been perceived as the best means for a small, open economy to promote international trade and at the same time maintain a low inflation rate. The idea was that a fixed exchange rate would lead to an inflation rate in Sweden that was roughly the same as that among our most important trading partners. However, for various reasons, economic policy did not manage to achieve this target. Inflation was much higher in Sweden than in other countries, which resulted in poorer competitiveness. Instead of examining the real problems in the way the economy functioned, Sweden gave in to the temptation to conduct a constantly expansionary policy combined with repeated devaluations of the krona. There were five devaluations between 1976 and 1982. The fixed exchange rate lost credibility and was put under enormous pressure. Following large currency flows and extreme interest rate hikes, the Riksbank was forced to abandon the fixed exchange rate system on 19 November 1992.

Today the capital markets and capital flows are substantially larger than they were at the beginning of the 1990s. The gross turnover in portfolio flows in Sweden is around 25 times greater now than in 1990. The free movement of capital has made it increasingly difficult to maintain a fixed exchange rate. This is evidenced not only by our own financial and exchange rate crisis, but also crises in other parts of the world; the United Kingdom in 1992, the EU's ERM system in 1993, Mexico in 1995, South East Asia in 1997, Russia in 1998, Brazil in 1999, Turkey in 2001 and Argentina in 2002. When it comes to exchange rate systems, the financial integration in the world economy appears to have in principle limited the alternatives to a floating exchange rate or to an irrevocably fixed rate, for instance through a monetary union or currency board. If we look back a few years, both alternatives appear to have worked relatively well.

During more recent decades, global inflation has declined. This is of course due to many factors. One is increased competition resulting from the deregulation of the financial and product markets as well as from the fact that previously closed economies are now integrated into the world economy. In Europe, the preparations for and introduction of the EMU contributed to a greater degree of price stability. In addition, the shift in economic policy in general has made a contribution, not least the introduction of inflation targets.

In Sweden we chose the alternative of a flexible exchange rate combined with an explicit inflation target in 1993. Since then the inflation rate has gradually shifted down and appears to have stabilised at a low level. Inflation has been around 2 per cent a year on average since 1993, which can be compared with an average inflation rate of almost 8 per cent a year during the 1970s and 1980s. Everyone now understands that we are serious in our fight against inflation, which is important for the policy to succeed. There has been less fluctuation in the real economy than during the decades prior to the crisis in the early 1990s, and developments in both real growth and real wages have been significantly better. In addition to the introduction of an inflation target, the consolidation of central government finances and efficient wage formation have been important conditions behind this positive development.

Where has this development taken us?

The Riksbank's tasks are stated explicitly in the Sveriges Riksbank Act. Our objective is to maintain price stability. In addition, we have the task of promoting a safe and efficient payment system. The Riksbank's tasks were established in the new law introduced in 1999. This also created greater independence for the Riksbank. Decisions on the repo rate are made by the Executive Board of the Riksbank and the members of the Board are explicitly forbidden to seek or accept instructions when carrying out monetary policy tasks. Given this, I shall now discuss the Riksbank's tasks and how we work to achieve price stability and financial stability.

Formulation of the inflation target

We have more precisely defined the first of our statutory tasks in the inflation target, which states that the annual rate of change in CPI should be 2 per cent, with a permitted deviation of ± 1 percentage point. The Riksbank chose CPI as the measure of inflation, partly because it is a broad price index that represents typical consumer purchases and it is familiar to the general public. In addition, CPI is used as a basis for price clauses in many types of contract.

An explicit numerical target makes it easier to understand what we do. Choosing an inflation rate of 2 per cent as a target was not self-evident. Real price stability could be perceived as the inflation rate being zero per cent, but neither we nor any other country has chosen such a target. One argument is that it is good to have some margin as there is a risk that CPI overestimates inflation. For instance, it is difficult to exactly measure price increases as a result of better quality, which is thus not inflation. Another argument is that it is often difficult in practice to implement nominal reductions in prices and particularly wages. Some measure of inflation may therefore simplify necessary adjustments in relative wages and prices. At the same time, there have seldom or never been attempts to stabilise inflation at a level much higher than 2 per cent. This may be because this does not sufficiently anchor inflation expectations.

Experiences from Sweden and other countries indicate that low, stable inflation is an important condition for favourable economic growth and that the work on maintaining low, stable inflation is made easier if the central bank can act independently. This is why the Riksbank, like many other central banks, has been given greater independence and an inflation target. If the central bank is not allowed to independently formulate monetary policy there may be political pressure to conduct monetary policy that aims to achieve other objectives.

How does the Riksbank influence inflation?

The tool the Riksbank has at its disposal for steering inflation is the repo rate. This is the interest rate the banks pay to borrow money from us. The objective of changes in the repo rate is to influence demand in the economy and thereby price developments. When the Riksbank alters the repo rate, there is an effect on total demand and ultimately also inflation through various channels within the economy. These channels are the cost of borrowing, incentives to save and wealth, as well as exchange rate fluctuations that affect imported inflation, exports, imports and capital flows. In addition, there is an effect on inflation expectations. It takes some time for an interest rate change to have an effect through these channels. The monetary policy decisions must therefore be based on an assessment of future inflation.

Flexibility thanks to credibility

Conducting monetary policy is not the same as flying a familiar, well-tuned aircraft. The repo rate is unfortunately a blunt instrument with regard to steering inflation, even a couple of years ahead. What monetary policy can do is to ensure an inflation rate that is over a number of years in line with the target and to contribute to reducing fluctuations in the real and financial economy.

When the inflation target was announced in January 1993, the Riksbank formulated a tolerance interval around the target of ± 1 percentage point. The purpose of this was to explain that it is not within the power of monetary policy to exactly meet the target all of the time. In addition, the tolerance interval provides scope for temporary deviations from the target which may be justified by taking growth and employment into consideration. If there is no conflict with the price stability target, the Riksbank should as an authority under the Riksdag (parliament) support the general economic policy objectives of sustainable growth and high employment. At the same time, of course, it is not possible to accept large deviations if the inflation target is to retain credibility. In an attempt to clarify further, monetary policy is guided by a principle that when there is a deviation from the target, the aim is normally to bring inflation back to the target level within two years. This also gives the Riksbank some scope to take into consideration other factors than the path of inflation when setting interest rates, such as growth and employment, while the principle is based on the idea that the deviations will only be temporary.

We thus endeavour in normal situations to meet the inflation target within a two-year perspective. We have chosen this because we would otherwise be forced into substantial interest rate adjustments to keep inflation exactly at target level in the short term, which could subject the economy to considerable strain. In certain cases, however, we may need to have greater flexibility than the two-year perspective allows. If the economy were to suffer a very large supply shock – for instance, in the form of soaring energy prices, or during extreme situations such as wars or natural disasters – the adjustment of inflation could need to be even more prolonged. Otherwise, the strain on the real economy could become unacceptable. This is explained in the Riksbank's clarification of monetary policy, published in 1999. It is important that we communicate clearly when we intend to deviate from the ordinary time horizon.

This type of flexible application of monetary policy assumes that there is considerable confidence in the policy and that it does not decline. If this were to happen, we would be forced to act more forcefully without having the same opportunity to take into account, for instance, growth and employment. It does not appear likely that such a situation would arise in the present climate. Inflation expectations are securely anchored around our target and everyone knows we take our objective of price stability very seriously.

There has recently been a debate on the objective of monetary policy. Some have said that we should have several objectives, while others have considered that we already strive to achieve too many. This indicates that we have not quite succeeded in explaining how we work, despite the fact that we are considered one of the most open central banks in the world. Let me therefore now be extra clear – there is one objective for monetary policy and that is to maintain price stability. However, this objective does not rule out taking into account the real stability of the economy. This possibility is allowed by the legislation on the Riksbank's activities and is something we always bear in mind.

This is something that I and my colleagues will continue to work on explaining over the coming year. At the same time, it should be emphasised that this is a complex task and that it is therefore quite natural that there is a debate on monetary policy. Nor are we Executive Board members always unanimous on which interest rate decision will be the best one in a given situation, despite the fact that we are agreed on the objective of our monetary policy.

Credibility demands openness and clarity

In order to combine confidence in price stability in the longer term with flexible inflation targeting, it is important that we are open and clear when conducting our monetary policy. This is also a necessary condition for the legitimacy of the Riksbank's objective, independence and actions. Important elements of this endeavour include publishing the analyses on which interest rate decisions are based in the form of Inflation Reports. In addition, after every monetary policy meeting a press release is published, which gives an account of the reasons behind the decision made. Moreover, when an Inflation Report is published or the repo rate is adjusted, the Riksbank holds a press conference. The Executive Board's monetary policy discussions are reported in separate minutes of the monetary policy meetings, which are published around two weeks after each meeting. In this way, all those who wish can closely follow our reasoning and a basis for evaluating our assessments and decisions is created.

I can also mention that the Governor of the Riksbank appears before the Riksdag Committee on Finance twice a year for a discussion on monetary policy. In addition, we Executive Board members hold around thirty speeches a year, in which we present our own views of the economic situation.

All this means that there is ample opportunity for the general public to obtain an understanding of how monetary policy decisions are made and it creates conditions for a serious debate. In the long term, this reinforces the Riksbank's credibility and legitimacy.

How do we work with financial stability?

As I said earlier, the Sveriges Riksbank Act states that we shall also promote a safe and efficient payment system. In other words, we are to safeguard financial stability. The Riksbank was the first central bank to publish a report containing a coherent analysis of financial stability in 1997, and we have published these reports twice a year since then. Other countries were more hesitant in speaking openly about the stability of the financial system. Some considered it impossible to be open on such issues if a crisis were to occur, while the Riksbank's attitude was that openness also benefits financial stability. By discussing risks and vulnerabilities at an early stage, crises could be avoided. In addition, we had positive experiences of openness in the price stability field.

It appears as though our method of working with financial stability has set a good example. Today around thirty countries have followed. Recurring financial crises have made it clear that there will always be problems that need to be tackled and that the authorities can therefore benefit from a structured approach to financial stability.

What can the Riksbank do if it considers that financial stability is threatened? There is no direct steering instrument or lever to pull in the same way as for price stability. Moreover, the Riksbank cannot intervene in the banks' operations at a microeconomic level.

The work is instead largely concerned with preventing crises. This is achieved partly by regulations that establish the framework within which financial companies can operate, and partly by regular monitoring of the system. There must also

- be an emergency system so the central government can manage any crises that may nevertheless arise.

With regard to the first part of the stability work, the responsibility for regulations in the financial markets lies mainly with the Ministry of Finance and Finansinspektionen (the Swedish Financial Supervisory Authority). However, the Riksbank can affect financial market legislation by responding to consultation documents, participating in commissions of inquiry and in the international work on developing regulations. On the basis of my own earlier experiences of the management of bank crises in different countries, I consider it particularly important to complete the Swedish legislatory work on how banks in distress should be managed. It is surprising that this issue is still outstanding, despite the fact that it is more than ten years since the bank crisis occurred and despite a draft bill being taken up for consultation five years ago.

We play a central role in the monitoring work and concentrate our task to assessing how the financial system functions and what risks might arise. Our Financial Stability Report is very important here. The aim of this report is to identify potential risks and to influence market operators with good analyses.

The third part of the stability work – crisis management – arises because the central government might need to take action to avoid a crisis that threatened the stability of the system. In order to manage a crisis, the central government must be able to assess what consequences will arise if an institution suffering problems should become bankrupt. If these consequences are judged to be serious, the central government must also be able to take measures to alleviate the effects. In extreme cases the central bank can act as "lender of last resort" (provide emergency liquidity assistance, ELA) if this is necessary to prevent the bank system from collapsing.

A lot has happened with regard to stability work since 1997 and the work changes continuously as the world around us changes. For instance, the increase in the banks' operations abroad means that foreign borrowers also need to be analysed to a greater extent. In addition, the stability work must follow the increasing integration of the financial markets.

Monetary policy and financial stability

As I described earlier, the idea is that changes in the repo rate will affect inflation via total demand, as well as via effects on the exchange rate. Repo rate adjustments are thus primarily governed by the inflation target and not by financial stability considerations.

However, certain aspects that are normally analysed within the framework of our financial stability work also affect demand and thereby inflation. Take, for instance, the present situation of rising house prices and substantial household indebtedness. House prices affect households' decisions on saving and consumption via wealth effects and thereby also demand in the economy. Consumption decisions by households with debts are affected by changes in the percentage of their income that is used to make interest payments. These aspects should therefore be taken into consideration when making monetary policy decisions.

When financial stability risks arise, they may also be connected to real economy risks. However, these risks are difficult to quantify and are therefore not captured by our usual forecasting methods. It is therefore not possible to rule out situations arising when the timing of an interest rate adjustment is affected by whether it may reduce financial stability risks. However, these considerations definitely do not entail any new objectives for the Riksbank. The fact that the experiences of deregulated financial and currency markets are as yet limited to a few business cycles contributed to the difficulty in establishing simple policy rules in this field.

Conclusion and the current situation

Let me now briefly comment on our most recent interest rate decision. It may appear strange that the Riksbank chooses to raise the repo rate in a situation where inflation is very low. To understand this, it is important to remember that monetary policy must be conducted on the basis of expectations of the future, i.e. forecasts. It is therefore not the present inflation rate we intend to influence, but the expected inflation rate a couple of years ahead. Back in December we envisaged an inflation rate in line with the target towards the end of the forecast period, given a gradual rise in the repo rate during 2006. Information we have received since December indicates that developments will be slightly stronger in Sweden and abroad than we had assumed. As is often the case when making decisions, there are also arguments against raising the interest rate; productivity growth and import prices are continuing to dampen inflation, and inflation is expected to remain low for a large part of the forecast period.

One thing that must be remembered when considering our decision to raise the repo rate, is that monetary policy is still expansionary even after this decision, both from a historical perspective and compared with other countries. An interest rate increase of 0.25 percentage points does not mean that monetary policy has been tightened; it is merely the first step towards less expansionary monetary policy. Something which in my opinion is quite natural, given the current economic situation, to ensure continued good growth.

Developments in household indebtedness and house prices are also factors that are important; however they are not in any way decisive for this interest rate decision. From a monetary policy perspective, one can say that we are on somewhat unfamiliar ground with regard to this type of aspect. We cannot say with certainty what will happen to house prices when the interest rate is increased. We probably have a gentle adjustment ahead of us, with a rate of price increase that cautiously slows down. If house prices and indebtedness were to continue to rise very rapidly, there could be a risk of a more dramatic adjustment further ahead, with effects on the real economy and effects on inflation. With this background, too, the timing of the interest rate rise appears reasonable.

The bank raised the repo rate in January. Given the good economic developments, the Executive Board's assessment was then that a continued gradual increase in the repo rate would be reasonable. The information received since then does not alter this picture, in my opinion. Now the work on producing and discussing a new forecast of inflation begins, so that we can make a decision on 22 February regarding the monetary policy stance. I look forward to seeing the forecasts and participating in the ensuing discussions.

Let me conclude by saying that since I last worked at the Riksbank, a lot has happened internationally, in Sweden and at the Riksbank. Over the past year there have, for example, been some changes in the Riksbank's forecast work. For instance, we now base our forecasts on the assumption that the repo rate will develop in line with market expectations. A further development could be to present our own interest rate forecast. This is something I will discuss with my colleagues on the Executive Board. At the same time, we shall develop our work on financial stability. My ambition is that the Riksbank will remain at the forefront of both our areas of responsibility. We will be a small, efficient central bank respected both at home and abroad.