MONETARY POLICY PERSPECTIVE

Address by Mr. Urban Bäckström,
Governor of Sveriges Riksbank,
to the Monetary Policy Forum,
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This is the fourth year in succession that the Riksbank and the Centre for Business and Policy Studies have jointly arranged the Monetary Policy Forum. That this event is now becoming a tradition is admirable. An open discussion of monetary policy and its conditions is essential both for the Riksbank and for the general debate on economic policy.

At the time of last year's Forum, which was held on 11 April, the repo rate was 8.34 per cent, the long bond rate was 11.5 per cent and the krona's TCW exchange rate was above 130. The high bond rate and the weak exchange rate left their mark on my address on that occasion. I saw them as expressions of a lack of confidence in Sweden's ability to conduct an economic policy that would promote stability. My conclusion was that the situation could be changed by persisting with an economic policy that focused on price stability and sound government finance.

In the year since then, confidence in economic policy has grown. The convergence programme, with the six-monthly monitoring arrangement, has helped to enhance confidence in budget policy. The Riksbank has demonstrated that the inflation target is a serious objective.

This in turn has meant that, compared with the situation at the time of last year's Forum, the bond rate has moved down about 3 percentage points, to around 8.50 per cent, while the krona has appreciated more than 10 per cent, to between 114 and 116 on the TCW index. Moreover, since January this year it has been possible to lower the repo rate about 2.4 percentage points to 6.50 per cent.

Today I shall be taking up the discussion about the importance of confidence for monetary policy's room to manoeuvre. I have chosen this topic because we can now see the earlier development in perspective. Hopefully, that puts us in a better position to analyse and discuss the various choices that, from time to time, monetary policy has to face.

As far as current monetary policy is concerned, I intend to be rather brief because the Riksbank will be presenting this year's second inflation report the day after tomorrow.

What is meant by "confidence in economic policy"?

First let me rehearse a couple of basic matters that have a bearing on what I have to say. When Riksbank representatives talk about "confidence in economic policy", we are referring to the extent to which economic agents believe that economic policy is both intent on and permanently capable of maintaining a development of prices that is in line with the inflation target. It is accordingly a matter of the agents' inflation expectations - the rate of inflation they foresee in 1, 2, 5 or 10 ten years time - and how these expectations relate to the 2 per cent inflation target.

Inflation is ultimately a monetary phenomenon. Keeping inflation permanently at a certain level - high or low, as the case may be - calls for the participation of the central bank. Inflation is liable to fluctuate upwards and downwards but its level in the longer run is determined by the central bank's monetary policy. The degree of confidence in the low-inflation policy and, thus, the level of inflation expectations are therefore inevitably bound up with perceptions of the central bank's future management of monetary policy.

However, the difficulty of the central bank's task depends on the circumstances. Credibility may suffer if the country's history of inflation is unfavourable. Another factor that weakens confidence in a policy for long-term stability is the existence of a budget deficit. This does not mean that inflation is generated by the deficit as such. The relationship is more indirect and has to do with assessments of how such problems of deficits and debt are likely to be managed. Fears may arise that in one way or another, the central bank will be obliged to accommodate the disturbances that arise when policy is internally inconsistent. The picture of how inflation and budget policy have been tackled in the past is an important consideration when economic agents form their opinions about the future.

A lack of confidence in an economic policy for long-term stability, with the result that expected inflation is higher than the authorities' stated aim, shows up in various ways.

Firstly, inflation expectations tend to be self-fulfilling. If households and firms count on inflation being higher, they will act accordingly. In the labour market, employers and employees may conclude agreements that run counter to the level of inflation the authorities are striving to attain; the employers consider that their higher costs can be covered by raising prices, while the employees want to maintain their purchasing power. The same applies in the market for goods; producers put prices up because they foresee increased turnover in any event, while consumers are prepared to pay because they expect to make up for this with higher wages.

Secondly, inflation expectations are mirrored in price setting in financial markets. While it is true that, with the new type of global financial market that has grown up in the past decade, prices do tend to deviate temporarily from economic fundamentals, in the somewhat longer run they serve as a measure of the existing confidence in the ability to focus economic policy on stability. If savers and investors fear that future inflation will be high, premiums for this will be built into bond prices and exchange rates. This is simply a way of obtaining cover for the perceived uncertainty. The result is high bond rates and a weak currency.

Consequences of a lack of credibility

Let us suppose that the central bank disregards any problems of credibility and conducts policy instead so as to achieve a short-run stimulation of growth.

Such a policy may convey the impression that the central bank's attitude to higher inflation in the medium and longer term has become more tolerant. That in turn suggests that the fears expressed by various agents in surveys or in price setting in the financial market are becoming more warranted. The higher expected inflation may then become self-fulfilling and then actually become even higher. As a result, the bond rate may remain high or go on moving upwards.

When inflation expectations are high, measures for augmenting nominal demand are liable to boost actual inflation rather than generate real growth. In order to elicit any effect at all on growth - in a situation where expectations are being adjusted upwards - new and unanticipated monetary stimuli would be needed continuously. In the worst case that would entail an unlimited increase in the price level. When inflation, sooner or later, has to be brought down to more reasonable levels, the task of breaking the inflation expectations will be even more difficult and this is liable to result in weaker growth.

A lack of credibility accordingly reduces the chances of attaining high, stable growth and employment.

This brings us to the monetary policy paradox: the greater the central bank's credibility and success in keeping inflation under control in the longer run, the larger will be its short-run opportunities of allowing for other aspects of growth. The opposite also tends to apply: the greater the importance the central bank attaches to short-run growth stimulation, relative to price stability, the poorer will be the chances of achieving favourable long-term growth.

Confidence in the ability to maintain price stability is therefore decisive for an economic development that is stable and favourable in both the short and the long run. The primary question, then, is what the central bank can do to generate this confidence.

What should the central bank do to repair credibility?

To counter a lack of credibility, a central bank can operate with a distinct target for its policy and work to achieve it. The target may either be defined by the central bank and then actively supported by the political system, as is the case in Sweden, for instance, or, as in other countries, it may be set by the government or parliament.

Limiting the room to manoeuvre by adopting, say, an inflation target or, for that matter, a fixed exchange rate is not an end in itself. Neither can one say for certain that just an one, two or three per cent inflation, or a particular level for the exchange rate, is optimal for making the economy function as well as possible. In the first place, a distinct target should be seen as a way of stabilising the expectations concerning economic policy. Over time, as economic agents observe that the central bank manages its instrumental rate so as to achieve its objective, credibility is successively enhanced. As I mentioned earlier, in time this also gives monetary policy more room to manoeuvre in the short term. Once credibility has been established, there cease to be fears that a monetary easing when the economy is slowing will be followed by inflation being allowed to rise above the target in a subsequent cyclical phase. Consequently, inflation expectations are not affected, which means that bond rates do not rise and the exchange rate remains more or less stable.

Of course, situations may occur where the internal inconsistencies in economic policy become so great that the burden on monetary policy and its target becomes insupportable. That happened, for instance, in the autumn of 1992, when the marginal rate had to be raised to 500 per cent and even that did not suffice to maintain the fixed exchange rate.

At times during the flexible exchange rate regime there has also been a public debate about whether monetary policy would - as some have said - "crush the economy" and jeopardise both growth and employment. With an inflation target, however, weaker growth entails less risk of demand-side inflation, so that expected inflation tends to move down. If anything, this lessens the need for a tight monetary stance. At the height of last year's discussion, the Riksbank argued that as long as the consolidation of government finance is continued and leads by degrees to increased confidence in economic policy in general, the burden on monetary policy will not be excessive.

Events in the past year

As I mentioned initially, since our meeting at last year's Monetary Policy Forum, the credibility of the inflation target has grown. This is indicated by the lower bond rate and the stronger exchange rate. Various surveys also show an increasingly widespread belief that the Riksbank will fulfil the inflation target in the coming years. Today, economic policy displays a consistency that differs completely from the situation earlier. The expectations for the somewhat longer run have also fallen, though there is room for further improvements. The differential with Germany, for instance, is still around 200 basis points, which is twice as much as in the case of our neighbour, Finland.

When last November's inflation report was presented, many contributors to the monetary policy debate expected that the Riksbank would begin to lower the instrumental rate. At that time the available information suggested that inflation in 1996 and 1997 would be a bit above the 2 per cent target. This was reinforced in that most other, not to say all, economic observers also considered that conditions were not in place for inflation in line with the target. A cut in the instrumental rate at that time might have created the impression that the Riksbank had become more tolerant of inflation and that the target was not meant seriously. During the late autumn it seems that the target's credibility grew. From mid November into January the bond rate moved down more than 80 basis points and the differential with Germany narrowed more than 50 points. The expectations reported in various surveys gave the same impression.

In January this year the Riksbank began to lower the repo rate. This was done in the light of a further improvement in the outlook for inflation. Contributory factors here included a continued fall in inflation expectations, the economic slowdown and a stronger exchange rate. Since then the repo rate has been lowered from 8.91 to 6.5 per cent, or by over 2.4 percentage points. This has brought money rates down by about as much. The level of bond rates, on the other hand, is broadly the same as in January. This, however, should be seen in the light of the concurrent upward bond-rate tendency in the rest of the world; for the first time in a long while, this has not pushed Swedish bond rates up. Instead, the differential with Germany has narrowed about another 40 basis points. Here we have a sign that credibility has developed favourably even in a period when international bond-rate movements have been unfavourable. At the same time, as I mentioned earlier, there is room for further improvements. The bond rate may therefore go on falling. In this context a trend towards balanced government finance continues to be a key factor.

The lowering of the repo rate, which has been relatively rapid, has thus been achieved without jeopardising credibility. On the contrary, there has been a further improvement. It is therefore highly probable that economic growth in Sweden will be favourably affected by the repo rate cuts in a way that would not have occurred if the effect on credibility had been negative.

The reception among market agents has been essentially good. In some market letter, however, there has been speculation to the effect that monetary policy is now governed by cyclical activity and that alone - consequently not by credibility. Somewhat typically, the discussion had often previously centred on the primary consideration being credibility and the exchange rate - but not growth. Both these views are misleading.

May I remind you once again that monetary policy decisions are founded on the outlook for inflation. Generally speaking, future inflation is invariably determined by three factors. Two of these are *demand and supply conditions* and *inflation expectations*; the third, the *exchange rate*, is involved because it affects the first two. A permanently weaker or stronger exchange rate influences demand in the internationally-oriented sector and thereby leads to changes in the output gap. At the same time, the exchange rate tendency serves to indicate movements in inflation expectations or credibility. What matters here is not short-run market fluctuations in the exchange rate but more lasting changes in its level.[1]

The enhanced credibility does, however, imply an improvement in the monetary policy environment. When inflation expectations stabilise around the inflation target, tendencies in the real economy become more important for the course of inflation than is the case when expected inflation is a good bit above the target and the krona is markedly under-valued.

Conclusion

Briefly, then, confidence in economic policy has grown since the Monetary Policy Forum was last held in April 1995. This has been achieved with a combination of increased confidence in the consolidation of government finance and the Riksbank demonstrating that it takes the inflation target seriously. Expressions of the improvement are the fall in money and bond rates as well as the change in the yield curve, which besides acquiring a positive slope, shows a more or less parallel downward shift. The earlier undervaluation of the krona has also been reduced. Various types of survey suggest, moreover, that inflation expectations have moved down.

The earlier lack of confidence in Swedish economic policy in general meant that expected inflation was too high and there was a definite risk of the inflation target being exceeded. That led to high market rates of interest in Sweden, a markedly undervalued currency and also a comparatively high repo rate.

With the changes that have occurred for the better, the conditions for sustained and balanced growth in the Swedish economy have improved. This tends to be overlooked in the public debate. Upturns and downturns in international economic activity are not a new phenomenon. What matters instead is whether the Swedish economy is capable of benefiting in full from international trade and reaping the reward in terms of increased employment and rising real wages. In macroeconomic terms, the past year has unquestionably seen an appreciable improvement. In structural terms, too, many steps in the right direction have been taken since the turn of the 1980s. A discussion is now

[1]For a more technical account of how a central bank that operates with an inflation target can act, in principle as well as in practice, see my address to the Swedish Economics Association on 21 February 1996.

in progress on how to improve the functioning of the labour market. Considering the high level of unemployment and the unduly large wage increases in the latest round of wage agreements, a focus on this matter is reasonable.

Since January the Riksbank has been able to lower the repo rate relatively rapidly without this having negative repercussions on confidence in monetary policy. On the contrary, it looks as though inflation expectations, as reported in surveys, are still being adjusted downwards. The Riksbank's own assessment of the outlook for inflation in the coming years, which includes an appraisal of tendencies in the real economy, likewise indicates that the possibility of fulfilling the inflation target is good. Under these circumstances, therefore, there may continue to be some scope for easing the monetary stance.