



Monetary policy in Sweden

2010

The CPIF as target variable for monetary policy

As of September 2017, the Riksbank uses the CPIF, the consumer price index with a fixed interest rate, as target variable for monetary policy. The target is that the annual change in the CPIF shall be 2 per cent, which is to say the same level previously applied to the consumer price index, CPI.

From September 2017 the Riksbank uses a variation band to illustrate in a simple way that monetary policy's capacity to steer inflation in detail is very limited and that inflation normally varies around the inflation target. The variation band, which stretches between 1 and 3 per cent, captures approximately three quarters of outcomes for CPIF inflation since mid-1995. The variation band does not affect the formulation of monetary policy, but is only to illustrate the fact that inflation normally varies. The Riksbank always aims for 2 per cent inflation, regardless of whether inflation is initially inside or outside the variation band.

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Summary

This document describes the overall principles for how the Riksbank conducts monetary policy – what is sometimes called the monetary policy strategy. The monetary policy strategy has evolved gradually in the years since the inflation target was formulated in 1993. It is the result of practical experiences in Sweden and other countries and to new findings in academic research. As the means of conducting monetary policy develop, the document that describes the monetary policy will be updated from time to time.¹

The contents of the document can be summarised in the following points:

- According to the Sveriges Riksbank Act, the objective for monetary policy is to maintain price stability. The Riksbank has specified this as a target for inflation, according to which the annual change in the consumer price index (CPI) is to be 2 per cent.
- At the same time as monetary policy is aimed at attaining the inflation target, it is also to support the objectives of general economic policy with a view to achieving sustainable growth and high employment. This is achieved through the Riksbank, in addition to stabilising inflation around the inflation target, also striving to stabilise production and employment around long-term sustainable paths. The Riksbank therefore conducts what is generally referred to as flexible inflation targeting. This does not mean that the Riksbank neglects the fact that the inflation target is the overriding objective.
- It takes time before monetary policy has a full impact on inflation and the real economy. Monetary policy is therefore guided by forecasts for economic developments. The Riksbank publishes, among other things, its own assessment of the future path for the repo rate. The interest rate path is a forecast, not a promise
- In connection with every monetary policy decision, the Executive Board makes an assessment of the repo-rate path needed for monetary policy to be well-balanced. A well-balanced monetary policy is normally a question of finding an appropriate balance between stabilising inflation around the inflation target and stabilising the real economy.

¹ The first version of the document *Monetary policy in Sweden* was published in May 2006.

- There is no general answer to the question of how quickly the Riksbank aims to bring the inflation rate back to 2 per cent if it deviates from the target. A rapid return may in some situations have undesirable effects on production and employment, while a slow return may have a negative effect on confidence in the inflation target. The Riksbank's ambition has generally been to adjust the repo rate and the repo rate path so that inflation is expected to be fairly close to the target in two years' time.
- According to the Sveriges Riksbank Act, the Riksbank's tasks also include promoting a safe and efficient payment system. Risks linked to developments in the financial markets are taken into account in the repo rate decisions. With regard to preventing an imbalance in asset prices and indebtedness, the most important factors, however, are effective regulation and supervision. Monetary policy only acts as a complement to these.
- In some situations, as in the financial crisis 2008-2009, the repo rate and the repo rate path may need to be supplemented with other measures to promote financial stability and ensure that monetary policy has the intended impact.
- The Riksbank endeavours to ensure that its communication is open, factual, comprehensible and up-to-date. This makes it easier for economic agents to make good economic decisions. It also makes it easier to evaluate monetary policy.

The Riksbank's tasks and independence

The Riksbank is an authority under the Riksdag, the Swedish parliament, and has responsibility for monetary policy. It is governed by an Executive Board, which consists of six persons. The Executive Board makes decisions on the Riksbank's policy rate, known as the repo rate, and about other matters concerning monetary policy. The members of the Executive Board are appointed by the General Council of the Riksbank.²

As of 1999, the statutory objective of monetary policy has been to maintain price stability.³ According to the Riksbank Act, the Riksbank shall also promote a safe and efficient payment system. In the preparatory works for the Act, it was stated that the Riksbank, without prejudice to the price stability target, should furthermore support the objectives of general economic policy with a view to achieving sustainable growth and high employment.

Decisions on the Riksbank's repo rate are made at the monetary policy meetings. The Executive Board holds six scheduled monetary policy meetings a year, but may also hold more meetings if deemed necessary. The Board members have extensive material, including forecasts and scenarios of future economic developments as a base for their decisions. The decision on the repo rate is made by voting, where each member of the Executive Board has one vote. The Governor of the Riksbank is the Chairman and has the casting vote if two proposals should have an equal number of votes. The majority view of monetary policy and economic prospects is presented in a Monetary Policy Report or a Monetary Policy Update published at the same time as the repo rate decision.⁴ The members of the Executive Board have the possibility to enter a reservation against a repo rate decision and/or a report. The minutes of the monetary policy meeting, which are published around two weeks after the meeting, describe the discussions held.

Each member of the Executive Board has an independent position regarding the monetary policy stance, as the members are covered by a ban on taking instructions. This ban means that a member of the Ex-

² The members of the General Council are appointed by the Riksdag.

³ See the present wording of the Sveriges Riksbank Act. The previous wording contained a more general formulation that the Riksbank was responsible for "foreign exchange and credit policies".

⁴ In connection with three of the six monetary policy meetings, a Monetary Policy Report is published. A Monetary Policy Update, which is less comprehensive than the Report, is published in connection with the other three monetary policy meetings.

ecutive Board may not seek or receive instructions when carrying out his or her monetary policy tasks. This independence is based on the Instrument of Government and the Sveriges Riksbank Act. The Riksdag has delegated the responsibility for formulating monetary policy to an independent Riksbank with the aim of ensuring that the policy will have the long-term perspective necessary to maintain the credibility of the price stability objective. Experiences in Sweden and other countries show that independence creates better conditions for maintaining price stability.

The Riksbank's independence makes considerable demands regarding openness and insight. This is to some extent regulated in the text of the law. For example, the Sveriges Riksbank Act states that the Riksbank must present a written account of monetary policy to the Riksdag Committee on Finance at least twice a year, and that the Chairman and Vice Chairman of the General Council have the right to attend the Executive Board meetings. The Executive Board has chosen at its own initiative a higher degree of openness and insight into monetary policy than is formally required by the law.⁵

⁵ See the section "Openness, clarity and communication".

The inflation target

Over the years, central banks have tested different ways of giving the economy a “nominal anchor”, that is, anchoring the general price level. For instance, they have tried holding the currency at a fixed exchange rate in relation to gold or to a basket of other currencies, or attempted to ensure that the money supply grows at a particular rate. However, neither a fixed exchange rate nor a money supply target has been able to prevent high and fluctuating inflation in all situations. Since the early 1990s, it has therefore become increasingly common to formulate the nominal anchor in terms of an explicit inflation target.

As of 1999 the Sveriges Riksbank Act states that the objective of the Riksbank’s operations is to maintain price stability. When the inflation target was introduced in 1993, the Riksbank specified price stability as being that the annual change in the consumer price index (CPI) should be 2 per cent.⁶ The fact that the Sveriges Riksbank Act does not specify what is meant by price stability was justified when the Act was drawn up by the claim that this would make the law text too inflexible and prevent the Riksbank from having sufficient scope to adjust its target to different circumstances.⁷

The reason the Riksbank has been given the task of keeping inflation low and stable is that it is primarily in this way that monetary policy can contribute to a favourable economic development. When inflation is high it also tends to fluctuate substantially. High and fluctuating inflation has harmful effects. It impairs the economy’s ability to distribute resources efficiently and it becomes more difficult for households and companies to make the right decisions. High and fluctuating inflation also leads to arbitrary and unfair redistribution of income and wealth.

One reason why the Riksbank has not set the inflation target at 0 per cent is that a little inflation can facilitate necessary adjustments in relative prices and wages. For instance, it may be difficult to cut nominal wages in cases where lower real wages would be justified to increase employment. Another reason is that the real interest rate, that is, the nominal interest rate minus expected inflation, may in some cases need

⁶ The original wording of the inflation target from 1993 included what was known as a tolerance interval, but this has been removed, as the interval has no actual significance for monetary policy. See the memorandum “The Riksbank removes the tolerance interval for specifying the monetary policy target”.

⁷ Ds 1997:50, *Riksbankens ställning* (the position of the Riksbank), Swedish Ministry of Finance.

to be negative to stimulate demand in the economy. As there are limits as to how far the nominal interest rate can be cut, a certain level of inflation creates additional scope for action. A general consensus has been established that an appropriate level for inflation is around 2 per cent. Countries with an inflation target have often chosen to formulate targets that entail an inflation rate of around 2 per cent.⁸

Monetary policy is a blunt instrument with regard to steering inflation. For instance, it takes some time before monetary policy has a full impact. There is also uncertainty over how the economy functions and over the size of the effects of changes in the repo rate in different situations. It is therefore impossible to avoid inflation fluctuating and sometimes being higher, sometimes lower than 2 per cent. However, seen over a longer period of time, monetary policy can ensure that inflation is in line with the target.

CPI and other measures of inflation

Inflation can be measured in many different ways. One key question is therefore which price index the target should refer to. The need for a nominal anchor that prevents inflation from drifting off is an argument in favour of specifying an inflation target in terms of a broad price index that represents ordinary purchases and that is well-known to the public. This is the most important argument for the Riksbank specifying its inflation target in terms of the CPI, which Statistics Sweden calculates and reports every month. Moreover, the CPI statistics are of good quality, are not normally revised, and are published soon after the end of the month.

But even if the inflation target is formulated in terms of the CPI, other measures of inflation may be usable for analysing and forecasting the development of inflation.⁹ The CPI is often affected by factors expected to have only a temporary impact on inflation, and which the Riksbank should not therefore react to. To describe the development of inflation and to better explain the structure of monetary policy, the Riksbank may then choose to highlight various measures of what is known as underlying inflation. These measures have been adjusted for price fluctuations that are expected to have temporary effects on the CPI, but not to affect the trend. This can include, for instance, mortgage interest expenditure, which directly affects the CPI when the Riksbank adjusts the repo rate. Over time, cuts and increases in

8 C. Berg, "Experience of inflation targeting in 20 countries", *Sveriges Riksbank Economic Review*, no. 1, 2005.

9 See J. Hansson, J. Johansson and S. Palmqvist, "Why do we need measures of underlying inflation?" *Sveriges Riksbank Economic Review*, no. 2 2008.

the repo rate offset one another, and therefore do not influence the interest expenditure in the CPI in the long term. But during certain periods, when the repo rate is raised or cut substantially, there can be a significant difference between CPI inflation and an inflation measure adjusted for the direct effects of interest rate changes. The oil price is another example of a component that one may sometimes be justified in excluding from CPI inflation.

■ Real economic stability

The working group that produced the new Sveriges Riksbank Act discussed whether the target of price stability should be complemented with targets for, for instance, economic growth and employment.¹⁰ The working group came to the conclusion that the Riksbank, without prejudice to the objective of price stability, should support the objectives of general economic policy with a view to achieving sustainable growth and high employment. This was considered to be a direct consequence of the Riksbank being an authority under the Riksdag and there was thus no need to confirm it by law.

It was also noted in the preparatory work on the Sveriges Riksbank Act that monetary policy cannot be used to influence real economic quantities such as growth and employment other than in the short term. A central bank thus cannot lastingly increase growth and employment by conducting systematically expansionary policy. A systematically expansionary monetary policy would lead to high inflation and probably ultimately entail a poorer development of the real economy. It is therefore neither useful nor appropriate to set lastingly high growth or high employment as targets for monetary policy. Growth and employment are determined in the long term by other factors, such as technological advances, the supply of labour and the functioning of the economy. However, monetary policy can affect the average development of the price level and thus the average inflation rate. Accordingly, the statutory and thereby overriding objective for monetary policy is to maintain price stability.

However, the fact that monetary policy is aimed at attaining the inflation target does not prevent the Riksbank from attaching importance to achieving good growth and high employment. Although monetary policy is unable to raise growth and employment more permanently by holding the repo rate at a low level for a long time, it may affect these quantities in the short term. The best thing monetary policy can do to attain good growth and high employment is therefore, to attempt to stabilise production and employment around long-term sustainable paths besides stabilising inflation around the inflation target. The reason for trying to attain a relatively stable development not merely of inflation but also of the real economy is that it will probably lead to higher welfare for all, compared with what happens when produc-

¹⁰ Ds 1997:50, *Riksbankens ställning* (the position of the Riksbank), Swedish Ministry of Finance.

tion and employment fluctuate substantially over time. The Riksbank therefore conducts what is generally referred to as flexible inflation targeting.

Some form of measure of resource utilisation is often used to summarise developments in the real economy, measuring to what extent labour and capital are used in relation to what is considered sustainable in the long term. The level of resource utilisation in the economy as a whole at a given point of time is not something that can be seen in, for instance, public statistics; it is in many ways a question of judgement.¹¹

¹¹ See M. Jonsson, C. Nilsson and S. Palmqvist, "Should monetary policy stabilise resource utilisation?" Economic Commentary, no. 1, 2008, S. Palmqvist, "Flexible inflation targeting – how should central banks take the real economy into consideration?" *Sveriges Riksbank Economic Review* no. 2, 2007 and the box "Resource utilisation, costs and inflation" in Inflation Report 2006:2.

■ Well-balanced monetary policy

As it takes time before changes in the Riksbank's repo rate have a full impact on inflation and the real economy, monetary policy is guided by forecasts of economic developments. The Riksbank publishes its own assessment of the future path for the repo rate. A published repo rate forecast makes it easier to explain to the general public and the financial markets how the Executive Board of the Riksbank views developments, and its reasoning when making monetary policy decision. It also makes it easier to manage expectations regarding future monetary policy.

In connection with every monetary policy decision, the Executive Board makes an assessment of the repo-rate path needed for monetary policy to be well-balanced. A well-balanced monetary policy is normally a question of finding an appropriate balance between stabilising inflation around the inflation target and stabilising the real economy.

The fact that the Riksbank tries to stabilise both inflation and the real economy does not mean that it disregards the fact that the inflation target takes precedence. As inflation is stabilised around the inflation target, inflation will on average be equal to the target. In this way the Riksbank fulfils the statutory task of maintaining price stability at the same time as it can be said to be supporting the objectives of general economic policy through its endeavours to stabilise the real economy.

The exact horizon within which the Riksbank aims to ensure inflation is on target depends, for instance, on the reasons why inflation is deviating from the target, the size of the deviation, and the effects on the real economy. It can also depend on how much emphasis the Executive Board members place on stabilising inflation on the one hand, and stabilising the real economy on the other hand.

In certain situations there may be reason to allow more time for inflation to return to the target, as a rapid return could have undesirable effects on production and employment. But if the return to the inflation target takes too long, on the other hand, there is a risk that the general public will begin to doubt the Riksbank's intentions and ability to attain the target even in the long term. The general public may then adjust their long-term inflation expectations upwards. The nominal

anchor role of the inflation target in price-setting and wage formation may then be undermined and it may require a longer period of weak demand and high unemployment before confidence in the inflation target is restored. It is important to avoid this happening.

There is no general answer to the question of how quickly the Riksbank aims to bring the inflation rate back to 2 per cent if it deviates from the target. The Riksbank's ambition has generally been to adjust the repo rate and the repo rate path so that inflation is expected to be fairly close to the target in two years' time.

It is important to emphasise that the Riksbank, in presenting its view of a suitable path for the repo rate, is not committing itself to any particular future monetary policy. If, for instance, newly-received economic statistics were to indicate that the forecasts need to be changed, the repo rate path will be adjusted so that the forecasts for inflation and the real economy can once again be considered to be well-balanced. The interest rate path is a forecast, not a promise. The future repo rate path is shown with uncertainty bands around it to make this clear.¹²

¹² For a detailed description of how the uncertainty bands are constructed, see D. Kjellberg and M. Villani, "The Riksbank's communication of macroeconomic uncertainty", *Sveriges Riksbank Economic Review*, no. 1, 2010.

■ Monetary policy, financial stability, credit markets and asset prices

According to the Sveriges Riksbank Act, the Riksbank's tasks also include promoting a safe and efficient payment system. For the payment system to be perceived as safe and efficient, it is necessary that the bank system functions well, as all payments, with the exception of cash, entail transfers between bank accounts. The banks' activities are closely interwoven with the rest of the financial sector. The Riksbank's responsibility for the payment system is therefore often expressed as the task of safeguarding financial stability. An imbalance in, for instance, asset prices and indebtedness could cause problems for the banks and ultimately risk threatening financial stability. However, the Riksbank does not have sole responsibility in this field. The Ministry of Finance, Finansinspektionen (the Swedish financial supervisory authority) and the Swedish National Debt Office all have important functions to fill with regard to maintaining financial stability.

The task of safeguarding financial stability and the price stability objective have clear links to one another. For example, stability in the credit markets and the payment system is a necessary condition for monetary policy to function efficiently.

Monetary policy with an inflation target and some emphasis on stabilising developments in the real economy, contributes to a balanced development on the financial markets. However, experiences show that even with such a policy, asset prices and indebtedness can sometimes develop in a manner that is untenable in the long term. This can entail risks of large price adjustments in the future, which can in turn have unfavourable and serious repercussions on the real economy and inflation. From experience, it appears to be primarily fluctuations in property prices and credit volumes that create problems. This type of risk cannot always be easily quantified or captured in the normal analysis and forecasting work, but may nevertheless need to be taken into account in the monetary policy decisions. A change in the repo rate path may be justified if such risks are assessed as substantial. When it comes to preventing an overly rapid increase in asset prices and indebtedness, the most important factors are effective regulation and supervision. Monetary policy only acts as a complement to these.

If imbalances have already arisen and are quickly corrected, with negative consequences for the economy, the Riksbank may be able to alleviate or prevent a crisis in the payment system by cutting the

repo rate. As such a crisis could have serious repercussions for the real economy and jeopardise the price stability objective, there would not be any conflict in this type of situation between the policy that needs to be conducted to safeguard financial stability and the policy that is desirable to attain price stability.

Normally, however, the Riksbank carries out its task of safeguarding financial stability using other means than the repo rate. For example, the Riksbank regularly analyses the stability of the financial system and publishes its views twice a year in Financial Stability Reports. In this way the Riksbank contributes to the early detection of potential threats to financial stability. If problems nevertheless arise, and they are so serious as to threaten the entire system, the Riksbank may provide emergency liquidity assistance to financial institutions.

The financial crisis 2008-2009 has started up a discussion, both in Sweden and abroad, as to how the work on financial stability can become more effective. Questions discussed include what are the best means for maintaining financial stability, the potential design of future supervision and regulation, and the allocation of roles and responsibilities between different institutions. The crisis has also made it clear that the implementation of monetary policy can be affected by financial unease. The repo rate and the repo rate path may in these situations need to be supplemented with other measures to safeguard financial stability and ensure that monetary policy has the intended impact. This could entail, for instance, the Riksbank offering loans at longer maturities than normal and accepting more types of collateral. Such measures make it easier for the banks to manage their short-term and medium-term funding and thus contribute to lower interest rates for households and companies.

■ Openness, clarity and communication

The Riksbank endeavours to ensure that its communication is open, factual, comprehensible and up-to-date. The fact that the Riksbank is open and clear with regard to monetary policy fulfils several purposes. The information given to households, companies and other participants in the economy is then better and it thus becomes easier for them to make good economic decisions. If the participants in the economy can form realistic expectations of future monetary policy, this may also contribute to market rates being adjusted in line with the Riksbank's assessments. Monetary policy thus has greater effect. Moreover, if it is clear what information and which deliberations have formed the basis for the decisions made by the Riksbank, it will be easier to assess monetary policy. This is important, given the Riksbank's independent position. The internal work at the Riksbank will probably also become more efficient in that there is an even greater incentive to produce well-founded analyses when these are subject to external examination.

The Riksbank's views on monetary policy are communicated through many different channels. Decisions on the repo rate are normally made six times a year. Every monetary policy decision is announced in a press release. On three of these occasions a Monetary Policy Report is also published. This contains analyses of the factors that determine inflation and forecasts for the repo rate, inflation and the development of the real economy over the coming years - in other words, the most important factors on which the monetary policy decisions are based. On the other three occasions a Monetary Policy Update, which is less comprehensive than the Report, is published.

The press releases and the Monetary Policy Reports describe how the majority of the Executive Board has interpreted the information received since the last decision was made. The press release also states how the individual members voted and provides the main motivation for any reservations entered. Press conferences are held the day after each monetary policy meeting. The minutes of the Executive Board's monetary policy meetings are published approximately two weeks after the respective meeting. The minutes are attributed, so it is possible to see who has put forward which arguments.

The Governor of the Riksbank appears before the Riksdag Committee on Finance twice a year for a discussion on monetary policy. In addition, the members of the Executive Board hold speeches in which they talk about monetary policy issues and describe their personal deliberations in connection with the repo rate decisions. They can also comment on new statistics, and relate these to the earlier forecasts. However, the members of the Executive Board do not comment in their speeches on how they intend to vote, or might vote, at the next monetary policy meeting. The overall assessment of the economic developments is made at the monetary policy meetings.

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