Monetary policy in Sweden

This box provides a description of the goal and strategy of the Riksbank's monetary policy. The most important aim of this description is to explain how the Riksbank, when setting its interest rate, has scope to take into consideration developments in both inflation and in the real economy. A desirable monetary policy is characterised by inflation under normal circumstances being close to the inflation target in a two-year time perspective while at the same time the paths for inflation and the real economy do not exhibit excessively large fluctuations. The box is an extract from the document "Monetary policy in Sweden" which was published on 19 May 2006.[1]

- **The statutory objective of monetary policy is to maintain price stability.**
  This was established in the changes to the Sveriges Riksbank Act, which came into force in 1999. In the preparatory works for the Act, it was stated that the Riksbank, without prejudice to the price stability target, should furthermore support the goals of general economic policy with a view to maintaining a sustainable level of growth and a high rate of employment. These legislative changes also increased the independence of the Riksbank.

- **The Riksbank has specified an explicit inflation target according to which the annual change in the consumer price index (CPI) is to be 2 per cent with a tolerance interval of plus/minus 1 percentage point.**
  A relatively high level of consensus has been established internationally that an appropriate level of inflation is around 2 per cent. Countries with inflation targets have therefore often adopted targets that entail that inflation should be around 2 per cent. To emphasise that it is not within the power of monetary policy to continuously achieve the target exactly, the Riksbank has specified a tolerance interval around the target of plus/minus 1 percentage point. At the same time, this tolerance interval serves to underline that excessively large deviations are unacceptable if the target is to remain credible.

- **Monetary policy is also guided by various measures of "underlying inflation". There is no single measure of inflation that at each point in time indicates the proper stance of monetary policy.**
  A common denominator for these measures of underlying inflation is that they have been adjusted for price components that tend to fluctuate sharply but which are not judged to affect the trend rate of inflation. One such measure, UND1X, has been given a special status. In this measure the direct effects of changes in indirect taxes and subsidies as well as mortgage interest expenditure have been excluded. This measure is used because changes in indirect taxes and subsidies (due to fiscal policy) and in mortgage interest expenditure (due to monetary policy) often have effects on the CPI which should not give rise to any monetary policy response.

- **Monetary policy acts with a lag and is normally focused on achieving the inflation target within a two-year period. The two-year time horizon also provides scope for taking fluctuations in the real economy into consideration.**
  Permitting temporary deviations from the inflation target can be justified on the grounds of consideration to developments in the real economy (growth, unemployment, employment, etc.). By not aiming to restore inflation to target as quickly as possible, scope is created to conduct monetary policy in such a way as to dampen real economic fluctuations. At the same time, it is important that this flexibility does not diminish the long-term credibility of the inflation target. The two-year horizon can be interpreted as a restriction as to how much consideration can normally be given to real economic developments. In certain circumstances, deviations from the inflation target can be so large that it is reasonable to allow inflation to return to target beyond the normal two-year horizon. The Riksbank will

1 For the complete document, see http://www.riksbank.com/pagefolders/26054/Monetary_policy_in_Sweden.pdf.

make it clear in connection with the monetary policy decisions when it considers that a situation of this kind has arisen.

- **The Riksbank routinely takes into consideration changes in asset prices and other financial variables (exchange rates, house prices, share prices, household and corporate indebtedness, etc.) in monetary policy decisions.**
  This should not be interpreted as introducing targets for different asset prices or other financial quantities. However, situations may arise where the consequences for the real economy and inflation of the development of different financial variables threaten to become very unfavourable and serious without it being possible for that reason to quantify or capture this type of risk in the normal analytical and forecasting work. It may be necessary to take these risks into account in monetary policy decisions in a different way than in the normal approach, where the forecasts for inflation and the real economy for the next two years serve as the foundation. In practice, taking risks of this kind into consideration can mean that interest rate changes are made somewhat earlier or later, in relation to what would have been the most suitable according to the forecasts for inflation and the real economy. However, the aim is as always to maintain price stability and dampen fluctuations in the real economy.

- **The Riksbank's forecasts are constructed assuming the repo rate (the Riksbank's policy rate) develops in accordance with market expectations.**
  If inflation according to this interest rate assumption is expected to be close to target two years ahead, the market's expectations about future monetary policy can normally be regarded as reasonable. However, to determine this more definitely, consideration must be given to the whole future paths for inflation and the real economy. If, for instance, inflation increases very rapidly during all of the forecast period, and real growth is high, it is possible that the assumed interest rate path will not be considered reasonable, even though inflation is close to 2 per cent after two years. In this case, the assumed interest rate path probably means that monetary policy is too expansionary. This, in turn, can lead to unacceptably large fluctuations in real activity. A desirable monetary policy is characterised by inflation normally being close to the inflation target in a two-year time perspective while at the same time the paths for inflation and the real economy do not exhibit excessively large fluctuations.

- **Openness and clarity in monetary policy are prerequisites for the successful combination of credibility for the inflation target and a flexible application of the target in the short term.**
  The fact that the Riksbank has the task of specifying independently the price stability target and the considerations to be given in relation to other goals for economic policy in the short term also makes great demands on how these decisions are to be explained to the general public and to the Riksdag. The Riksbank's strategy for carrying out these tasks successfully is to be as clear and open as possible concerning the information and the considerations on which monetary policy decisions are based. The fact that the Riksbank has chosen to specify an exact target for inflation (with a certain tolerance interval) and the principle that inflation should normally be brought back to target within two years can both be justified by the aim of creating clarity and credibility for the inflation target. Explanations of and supporting data for monetary policy decisions are regularly commented on and published in Inflation Reports, minutes from monetary policy meetings, press releases, press conferences and in speeches given by members of the Executive Board. Further, the Governor of the Riksbank appears before the Riksdag Committee on Finance twice a year for a discussion on monetary policy. All this aims to facilitate reasonable expectations on future monetary policy being formed and external assessments of the Riksbank's previous monetary policy analyses and decisions.