A Swedish monetary policy reversal during 2017?

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On December 21, Sweden's Riksbank will announce its last monetary policy decision of 2016, amid a changing global scene. Donald Trump's stimulus plans have underscored the issue of role allocation between fiscal and monetary policy, as international debate on the drawbacks of unconventional monetary policy intensifies. Given the relatively tight resource situation in various countries and a trend towards less transparency, the inflation picture may also change – which is reflected especially in the rising inflation expectations of financial markets. In light of this, last week's Federal Reserve decision to raise the key interest rate and signal a faster pace of rate hikes in 2017, appears logical.

Things have also been happening on the domestic front. The Riksbank has succeeded in weakening the krona to a greater extent than analysts and the central bank itself had anticipated. Resource utilisation in Sweden has climbed higher, generally decreasing room for stimulus measures. Yet low inflation statistics have persuaded the Riksbank to stick to its dovish bias. In SEB's assessment, the bank is under-estimating the 2017 economic growth outlook and thus also labour market tightness. But we are not yet prepared to adjust our inflation forecast upward, among other things due to low pay hikes and the signals we have seen so far in the ongoing national wage round. In such an environment, the Riksbank's attitude towards short-term inflation statistics will determine to what degree it will reverse its monetary policy during the coming year.

Riksbank defensive about methodology

The Riksbank has recently become defensive in several areas, yet we can discern new openings on some important points. The bank's October *Monetary Policy Report* included an in-depth review of the time lag between degree of resource utilisation and inflationary impulses. This varies somewhat depending on how resource utilisation is measured, but it averages around 1½ years. The conclusion that there is a considerable yet stable delay is a good argument for being a little more relaxed about downside inflation disappointments, since resource utilisation in the Swedish economy is on its way upward at a fairly rapid pace.

Another interesting angle is provided by two deputy heads of the Monetary Policy Department, Christina Nyman and Ulf Söderström, in their article "Forecasts and Monetary Policy" in the Riksbank's Economic Commentaries publication series. The authors point out that the bank's inflation forecasts differ from those of other forecasters, since *"they are based on an assessment of which monetary policy is required to bring inflation back towards the target at an appropriate pace. An inflation forecast that does not aim for 2 per cent in a few years' time could then be interpreted to mean that the Riksbank is departing from the mandate given by the Riksdag."* The authors state that the bank could make forecasts that do not reach 2 per cent within this time horizon, but that this "would require special circumstances." Per Jansson, Deputy Governor of the Riksbank, touched on this in a recent speech entitled *"Time to scrap the inflation target?"* He declared that in such a situation, communication is very important and that clarifying that the Riksbank had not yet abandoned the inflation target *"would be a difficult but hopefully not impossible task."*

Upside bias, due to a high pain threshold

The above comments indicate that the Riksbank has a rather high pain threshold for divergences from its 2 per cent target in 2017-2018. One consequence of this, as hinted by Nyman and Söderström, is the creation of a bias towards rapid target fulfilment in the Riksbank's forecasts. In the inflation environment we have been in for a fairly long time, this implies a bias towards higher inflation forecasts. Observers have pointed this out for a long time, but the Riksbank has not previously confirmed it so clearly. It is also reasonable to believe that such an approach will contribute to exaggerated activism in monetary policy actions. Conveying the impression on every decision date that Riksbank policies are completely well-balanced – combined with the above-mentioned bias tendencies – creates unnecessarily great pressure to make revisions. Given the Riksbank's philosophy, revisions in turn require an immediate policy response.

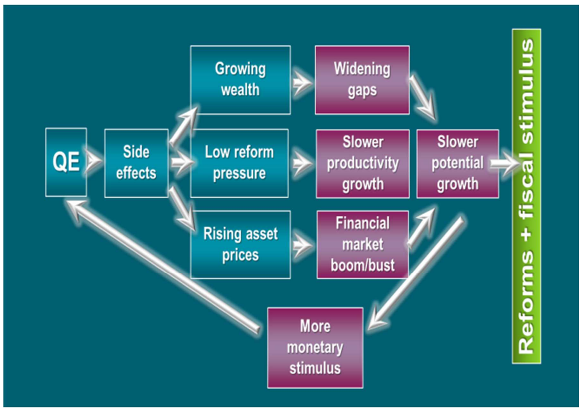
Paving the way for a policy reversal?

One can also interpret the above discussion as meaning that the Riksbank now feels uncomfortable with the situation and is beginning to prepare for a change. Since Per Jansson has, in many respects, been a driving force on the bank's Executive Board in favour of an aggressive monetary stimulus policy, it may be interesting to examine his arguments in particular. Jansson answers the rhetorical question *"Time to scrap the inflation target?"* with a clear No. He describes criticism of the Riksbank as vague and unclear, among other things because it is hard to know if it concerns whether the bank should defend its inflation target at all, or if it concerns whether it can do so with a smaller dose of stimulus. Jansson also turns up the volume of the discussion by arguing that *"essentially the criticism concerns whether or not to have an inflation target."*

On some points, Jansson's opinions are understandable. The argument that a weak krona is making Sweden a poorer country is somewhat lame, since the most important mechanism – rising import prices that undermine purchasing power – is largely absent. The Riksbank is also understandably frustrated because tough criticism before the summer of 2014 to the effect that it was not taking the inflation target seriously has now shifted to its diametrical opposite. Unwillingness to give the Riksbank credit for actually contributing to higher economic growth and inflation in recent years may sometimes go a bit far.

The Swedish FSA's appeal for help

But the question is how far Jansson's arguments actually extend. As the global debate on the drawbacks of unconventional monetary policy (shown in the chart below as widening gaps, low reform pressure and risks of financial market bubbles) becomes more prominent, it would be strange if this debate were not also pursued in the country that is most clearly testing the reasonableness of inflation targeting. The tensions on this issue are illustrated by the minutes of Sweden's latest Financial Stability Council meeting (with the Minister for Financial markets and the heads of the Riksbank, Financial Supervisory Authority and National Debt Office as the main participants). At this meeting, the FSA appealed for help from the Riksbank and the government to decelerate the growth of household debt. For the Riksbank, this is a matter of accepting that its inflation target will take somewhat longer to achieve, since *"Sweden is in an extreme situation, with above-normal resource utilisation at the same time as negative interest rates."* A few years ago, it was the Riksbank that was calling for help in a similar way, so now we are seeing a role reversal.



Target must be moderate and sensible

Although inflation targets are being questioned, at present it is difficult to see any alternatives on the international scene for a small country that does not wish to peg itself to any major currency or participate in a currency cooperation mechanism. This makes the ability of its central bank to balance various factors crucial to a country's economic development. In such a situation, it is not so strange that criticisms shift between fears that the inflation target as such is dysfunctional and objections to the Riksbank's excessively literal interpretation of the target. If one were to identify any systemic error in modern-day Swedish economic policy, one would probably be a fundamentalist application of policy frameworks. This was true, for example, of the Keynesian "fine tuning" policies of the 1970s and the defence of the krona in the early 1990s, which were both pushed further than in any other country. Since it began inflationary targeting, the Riksbank has mainly erred during the initial period (1994-95) and at the outset of the 2008 financial crisis, when it responded to energy price-driven inflationary impulses by hiking key interest rates, even though the economy otherwise signalled entirely different needs.

But the Riksbank is not alone in allowing a few tenths of a point in forecasts to have major consequences. In budget debates, both clashing politicians and the affected government authorities tend to use sharp formulations about minor divergences from the official fiscal target: a surplus 0.33 per cent of GDP over a business cycle. As for national wage rounds, variations of half a percentage point in pay increases are often described as the difference between preserving and losing Sweden's competitiveness. This rhetoric is often justified by citing the importance of learning the lessons of the 1990s fiscal crisis. But to provide a bit of proportionality, it is worth noting that the scale of Sweden's divergences against other countries that built up imbalances in the 1990s were much larger than those of today.

The positive interpretation of this is that the Swedish economy is now so stable that we can afford the minor luxury of polemics about tenths of a percentage point. But it is probably more relevant to state that today's challenges are not mainly a matter of macroeconomic imbalances. At least this is true except for home prices and debt, which of course are not covered by quantitative targets. Today the major challenges are instead the integration of immigrants into Swedish society and the risks posed by breaches in the social contract when the quality of such core public activities as health care, social services, the police and the defence system are undermined. Yet public discourse is strongly slanted towards macroeconomics – not only because the new challenges are politically sensitive but also because both government authorities and interest organisations have built an extensive structure around budget framework issues and are thus inclined to focus mainly on yesterday's problems.

Gridlock due to excessive transparency?

Another related issue concerns the degree of transparency – a focus of this year's Nobel laureates in economic sciences among others. One of them, Bengt Holmström, once commented that the Fed has"made the mistake of being overly transparent, which puts it in a bind...Not all transparency is bad but we must also be able to rely on our representatives to defend our interests." This reflection applies even more to Swedish conditions. First, various quantitative targets in themselves may create gridlock. Second, it is worth wondering whether transparency about forecast details, methods and models are leading public discourse into overly technical discussions that not even the Riksbank's Executive Board or other national decision makers can keep track of.

To summarise, 2017 has the potential to be a year of reassessment for Swedish monetary policy. In addition to the currents we are seeing in the international discourse on the role of fiscal policy and the drawbacks of unconventional monetary policy, the Fed's announcement of a more resolute rate-hiking pace makes the situation of the Riksbank easier. At the domestic Swedish level, we note a greater understanding by the Riksbank about the late-cyclical features of the inflation process. We also note that the bank now appears to be preparing the market to accept the idea that meeting its inflation target may take a bit more time. The fairly rapid rise in Sweden's resource utilisation also allows increased room to lean against the wind, thereby offering the help in combating greater debt that the Swedish FSA is so clearly requesting. Further key interest rate cuts thus seem increasingly unlikely, although our main forecast is that the Riksbank will end its stimulus cycle by announcing purchases of a further SEK 30 billion worth of government bonds. As for future rate hikes, there are stronger arguments for predicting that the Riksbank will act a bit earlier than it is now saying. As a result, we are sticking to our forecast of an initial rate hike in December 2017.

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