

Comment Rethinking the central bank's mandate

- *The Riksbank would benefit from a more flexible approach to inflation targeting*

The many firsts of the Riksbank

The Riksbank is not alone with its policy dilemmas ...

Sweden's Riksbank can be credited with many 'firsts': it is the oldest central bank in the world; it was the first central bank formally to target the stabilisation of the domestic price level;¹ the first to cut its main policy rate below zero,² and it is now at the forefront of the global debate about the need to reassess central bank strategies post the 2008 financial crisis.³

Meanwhile, the Riksbank is facing an increasingly difficult predicament. The economy is growing above potential; the labour market is tight; inflation expectations are trending upwards (Figure 1); residential property prices have been rising by 15% per year; and the average debt-to-income ratio has risen to over 400%. Yet headline CPI inflation is still stubbornly below the 2% target (Figure 2) – and this despite a repo rate now at -0.5% and the bank committed to buying government bonds equivalent to 37% of the outstanding stock by the end of the year.

Conceptual concerns

... but no central bank wants to make the first move

The Riksbank's experience has raised questions about the appropriate mandate for central banks. After all, below-target inflation is an issue not unique to Sweden, especially given recent energy price falls. Much the same goes for asset price inflation, debt, and risk taking.

The question therefore is whether central banks are unduly narrowly focussed on CPI inflation, and whether a broader and more flexible mandate, or indeed higher inflation targets, would be more appropriate. One potential problem, however, as the Riksbank's Deputy Governor Cecilia Skingsley succinctly put it, is that "central banks are not helping each other" and that "the Swedish repo rate is not set in a vacuum".⁴ Essentially, no central bank wants to be the first to change tack and risk unfavourable consequences for their exchange rate.

Technical tweaks

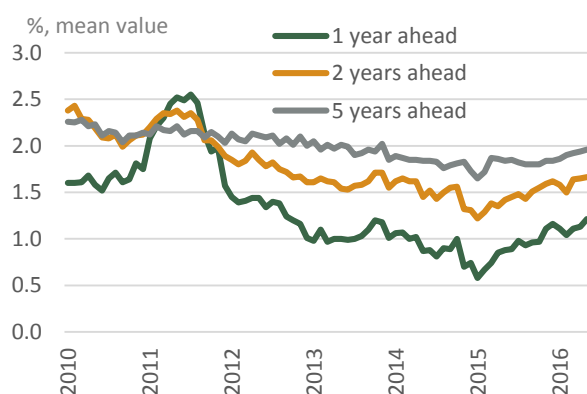
A change of target variable would provide some relief

In Sweden, however, a few practical modifications could give the central bank some additional degrees of freedom.⁵ The targeted headline inflation rate, for example, reflects changes in mortgage rates via the owner-occupied housing expenses component of the CPI. Hence, when the Riksbank cuts the repo rate to stimulate demand and push inflation higher, mortgage rates decline and so also does the CPI (at least in the short term). This effect is counter-intuitive and complicates the communication of policy. Measures of inflation that do not include the direct effects of changes in interest rates, such as CPIF or HICP, would provide a better indicator of price pressures.

Watch for:

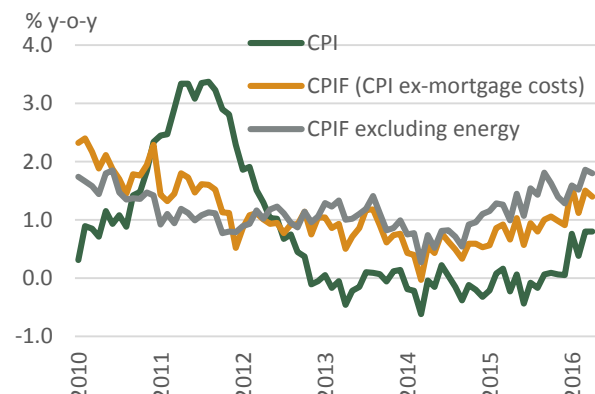
- The Riksbank changing the target variable to CPIF or HICP inflation;
- Introduction of a +/-1% band around the 2% target; and
- Introduction of more flexibility around the monetary policy time horizon. ■

Figure 1: Inflation expectations



Source: TNS Sifo Prospera

Figure 2: CPI and CPIF inflation



Source: The Riksbank



#Comment: The Riksbank would benefit from a more flexible approach to inflation targeting.

¹ Berg, C., and Jonung, L., 1998. Pioneering price level targeting: the Swedish experience 1931 – 1937. *SSE/EFI Working paper*, No. 290.

² The Swiss government ran a de facto negative interest rate regime in the 1970s to counter currency appreciation due to investors fleeing inflation in other parts of the world. For more see:

Investopedia, 2016. *Negative Interest Rate Policy (NIRP) Definition*. [online] Available at: <http://www.investopedia.com/terms/n/negative-interest-rate-policy-nirp.asp#ixzz49a1PxRem> [Accessed 19 May 2016].

³ The Riksbank holds a conference titled “Rethinking the central bank’s mandate” in Stockholm 3-4 June 2016, with the “aim to provide an overview of current issues and topics from leading international experts to provide new insights and inspiration for continued discussion on central banks’ activities and mandates”

Riksbank, 2016. *Notices*. [online] Available at: <http://www.riksbank.se/en/Press-and-published/Notices/2016/Rethinking-the-Central-Banks-Mandate--conference-on-3-4-June/> [Accessed 19 May 2016].

⁴ Speech by Deputy Governor Cecilia Skingsley “A new playing field for monetary policy: what can a small, open economy expect?”, 19th May 2016

Riksbank, 2016. *Speeches*. [online] Available at: <http://www.riksbank.se/en/Press-and-published/Speeches/2016/Skingsley-A-new-playing-field-for-monetary-policy-What-can-a-small-open-economy-expect/> [Accessed 24 May 2016].

⁵ Goodfriend and King (2016) evaluate the monetary policy of the Riksbank’s policymaking and propose a list of practical recommendations in their “Review of the Riksbank’s Monetary Policy 2010-2015”

Riksbank, 2016. *Review of the Riksbank’s Monetary Policy 2010-2015*. [online] Available at: http://www.riksbank.se/Documents/Rapporter/%C3%96vrigt/utvardering_penningpolitik_2010_2015_eng.pdf [Accessed 19 May 2016].