SPEECH

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Monetary policy will bring inflation back to target

Until recently the Riksbank and many other central banks were struggling with stubbornly low inflation. But the picture has now changed completely. Open a newspaper and chances are high that you will find several articles discussing the consequences of rapidly increasing prices.

Inflation will be much higher this year than in our recent forecast

Let me begin by quickly summarizing this turnaround.

When the Riksbank's Executive Board met for the monetary policy meeting on June 30 last year, our last inflation figures were 2.1 and 1.2 percent for headline and core inflation respectively, and we predicted that inflation would average 1.7 percent in 2022. [1]

After this meeting, energy prices started to increase rapidly. At our last monetary policy meeting, in early February, we noted that headline inflation had increased to 4.1 percent in December. This surge in inflation was generated mostly by energy prices as core inflation remained modest at 1.7 percent.

Our February forecast however anticipated a clear increase in core inflation as a result of the high energy prices in combination with a weak exchange rate, continued disruptions in international value chains, high costs for shipping and commodities, and increasing consumer prices abroad. But our forecast turned out to be far too modest. Core inflation stood at 3.4 percent in February in contrast to 2.3 percent in our forecast.

[1] I refer to CPIF inflation as "headline" and CPIF inflation excluding energy prices as "core".

And these prices were mostly unaffected by Russia's invasion of Ukraine. The war will contribute substantially to further upward pressure on inflation, in particular through energy, commodity and food prices.

It is already clear that both core and headline inflation will be much higher this year than we expected at our latest policy meeting. Our plan for monetary policy will consequently have to be adjusted.

Monetary policy can bring medium-term inflation back to target

It is however not clear that inflation will remain high in the medium term. The Riksbank's latest inflation forecast, from early February, is outdated. But some other major forecasters have updated their inflation forecasts after the most recent inflation outcome, and they all predict a substantial fall in inflation next year.[2]

I agree that inflation is likely to fall next year, but the Riksbank cannot take this for granted. What happens to inflation in the medium term is conditional on our monetary policy!

Inflation will not return to the target if high inflation becomes entrenched and results in high inflation expectations and excessive wage increases. Monetary policy must therefore respond to the high inflation so that we maintain credibility for the inflation target and avoid a price-wage spiral.

We must raise the policy rate much earlier than previously planned

Our next scheduled monetary policy meeting is on April 27 and we will analyze the new economic situation and the implications for monetary policy in the coming weeks. As I have pointed out, it is clear that our assessment of inflation developments, inflation risks and implications for monetary policy will differ substantially from our assessments in February. But before concluding what this mean more precisely, there are a number of questions that we have to address.

One question is what monetary policy can achieve in this situation. I am thinking here in terms of three channels: the exchange rate; expectations and confidence in the inflation target; and economic activity.

The inflation we have experienced so far has been generated from the supply side, and mostly from prices that are set internationally. The Riksbank's monetary policy obviously cannot affect international commodity or shipping prices and it is unavoidable that near-term inflation will remain high.

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[2] Headline inflation will average 2.2 percent next year according to Handelsbanken (March 17), 2.8 percent according to the National Institute for Economic Research (March 30), and 1.8 percent according to the Ministry of Finance (April 1). Forecasts for core inflation are around 0.5 percentage points higher.

To some extent, though, our monetary policy affects these prices in SEK through the exchange rate. The krona has been unusually weak in recent years. A higher policy rate would likely support an appreciation of the krona and thereby mitigate the high prices of commodities and other imported goods.

More importantly, the Riksbank can manage how these high prices spill over to inflation expectations and wage-setting. In an ideal scenario, the Riksbank can engineer a soft landing where we sustain credibility for the inflation target without substantially slowing down economic activity. This would require resolute signaling ("walk") paired with active steps ("talk"). There is a kind of paradox here; the more we do, the less we have to do. In other words: to maintain credibility for the inflation target, we will have to raise the policy rate. But there is hope that gradual modest rate increases will suffice if the initial rate increases are well-timed. The ambition is thus that price- and wage setting remain broadly in line with the inflation target without economic activity having to slow down substantially.

If, on the other hand, this soft landing fails and we see a price-wage spiral developing, we will have to raise the policy rate more aggressively. The explicit intention would then be to dampen economic activity so that lower demand cools down the price and wage increases.

Economic activity is already dampened by other forces

This brings us to other questions that we now have to address to calibrate the strength and timing of our monetary response. How much will economic activity be dampened by monetary policy that raises mortgage rates for highly indebted households? By rapidly increasing energy and food prices when wage increases are modest? By the Russia-Ukraine war that results in new disruptions to global value chains?

According to the Taylor principle, the central bank must raise its nominal policy rate more than one-to-one with increases in inflation (or inflation expectations). If it doesn't, the real interest rate falls and monetary policy become more expansionary in response to higher inflation.

The Taylor principle is widely accepted as a foundation for monetary-policy strategies, but I see two reasons for the Riksbank to now deviate from this principle. First, the analysis behind the principle ignores important cash-flow effects. An increase in the nominal policy rate will reduce disposable household income quickly as mortgage payments increase.[3] Second, inflation has so far been asymmetric; prices have increased much more than wages, resulting in a rapid fall in real disposable household income.[4]

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[3] This applies in particular to the Swedish economy where households have high mortgage debt and where mortgage rates vary closely with the policy rate.
[4] If the policy rate is increased by one percentage point, average mortgage rates paid on the outstanding stock of mortgages quickly increase by almost one percentage point (around half of household mortgages have the rate fixed for three months or shorter and the average duration is 1.5 years). The net-of-tax effect is an increase by

Because wage increases are still modest, it is likely that these cash-flow effects will contribute to lower economic activity even if monetary policy does not follow the Taylor principle. The Taylor principle would be much more important if a price-wage spiral were developing.

To understand how strongly monetary policy should respond it is not enough to consider how economic activity develops but also how the supply side in the economy is affected by disruptions to global supply chains and higher production costs. We must understand how activity relates to potential activity and how this in turn feeds into inflation dynamics.[5]

The fiscal response affects monetary policy

Russia's invasion of Ukraine has also initiated developments that can raise economic activity. Spending on military defense is increasing, European economies will likely invest to reduce their reliance on Russian energy, and costs to accommodate refugees are rising. We have also seen fiscal initiatives to mitigate the implications of higher energy and food prices for household budgets.

There were few problematic tradeoffs between inflation and economic activity or between monetary and fiscal policy when inflation was below target and the policy rate was constrained by its effective lower bound. Such tradeoffs are however the historical norm and are now reappearing. It is nonetheless conceivable that targeted fiscal initiatives will facilitate the transition back to inflation close to 2 percent by reducing compensation claims in wage negotiations.

Inflation is now high but monetary policy will respond and bring inflation back to target

Inflation – both core and headline – will be much higher in the coming year than we predicted in February. We cannot do much about near-term inflation, but our monetary policy can ensure that inflation does not remain persistently high. To understand the appropriate strength and timing of our response, we need to consider how robust inflation expectations and wage formation currently are and how economic activity will be affected by recent developments.

In the coming weeks I will analyze and discuss with my colleagues the precise implications of all this for our monetary policy. There will also be new information

0.7 percentage points. Since household debt is around 200 percent of disposable income, the average household's reduction in disposable income (net of mortgage payments) is then 1.4 percent. Energy accounted for 6 percent of household consumption expenses based on 2020 prices, corresponding to roughly 5 percent of disposable income. If energy prices are 40 percent higher in 2022 than in 2020 – which currently does not seem unlikely – average household expenses will rise by 2 percent of disposable income (assuming unchanged consumption patterns). In other words, the cash-flow effect of the higher energy prices corresponds to the cash-flow effect of almost six policy-rate hikes by 0.25 percentage points.

[5] In recent years, there has also been much discussion about the Phillips curve, i.e. how economic activity relative to potential activity feeds into inflation. There are some indications that this relation has weakened.

and data releases to process in the three weeks to our next policy meeting. I want to emphasize that we therefore have not yet concluded what the monetary policy decision will be. It is, however, already evident that we must reassess and substantially adjust our plan for monetary policy. To ensure that inflation returns to the target in the medium term and that confidence in the inflation target remains solid, we must raise the policy rate much earlier than previously planned.