Lars Nyberg: Economic slowdown - but how soon and how severe?

Speech by Mr Lars Nyberg, Deputy Governor of the Sveriges Riksbank, to Danske Securities, Stockholm, 2 May 2001.

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I would like to begin by thanking you for the invitation to speak about economic developments in Sweden and the world around us. We economists usually begin and end by covering ourselves and pointing out that the situation is uncertain and that assessments can vary. However, this seems a more relevant approach than normal right now. A lot has happened in recent months and there are some important pieces missing from the economic puzzle.

When in December we raised the repo rate by a quarter of a percentage point, to 4 per cent, we saw signs of an incipient overheating in the Swedish economy. We were approaching the production ceiling in a situation where a number of sensitive wage negotiations were under way and we assessed that the krona could remain weak for some time longer, which would give extra stimulation to export demand. Although we saw signs of a slowdown, particularly in the American economy, the likelihood of this slowdown having a serious effect on the Swedish economy over the next few months seemed limited. The overall assessment was that the Swedish economy needed some easing up on the throttle to move down into a lower gear.

Today, just over four months later, the picture looks rather different in several important aspects. The international economic picture has darkened considerably and in the Inflation Report published at the end of March GDP growth was estimated at 2.4 per cent for both 2001 and 2002. This entails a reduction of a whole percentage point for the current year and half a percentage point for next year, compared with the Report published in December. The growth figures are still good in an historical comparison, but we have undoubtedly begun the slowdown that appeared desirable in December. The question now is whether the downturn will be too rapid and too severe.

A good starting point

When one considers this question, it is useful to observe that the Swedish economy has a pretty good starting point. A lot has happened since the crisis years of the early 1990s. Deregulation of the financial, telecommunications and electricity markets, as well as the ongoing liberalisation in trade has increased competition in the economy and forced companies to become ever more efficient. A purposeful management of the bank crisis and an equally single-minded consolidation of the central government finances have restored the international confidence in Sweden that had become rather tarnished. We have directed our policies towards price stability and thus, hopefully, left behind us a long period of price and wage spirals, followed by devaluation and where growth was lower than in our competitor countries. A credible inflation target is now seen as a necessary condition for macroeconomic stability.

The primary factor behind the falling inflation rate is a growing confidence in inflation targeting, which during the years following 1993 gradually affected inflation expectations. In recent years the repo rate in Sweden has been lower than the corresponding steering interest rates in the USA, the UK and the EMU area. Many doubted whether Sweden as a small country outside of the euro area would ever be able to live with short-term interest rates lower than those set in Frankfurt. However, we have succeeded in doing so for some time. If one looks at the short-term real interest rates now, they are at approximately the same level as in the euro area and Sweden, at around 2 per cent.

The fact that we in Sweden succeeded in achieving a good growth rate during the second half of the 1990s without causing overheating and raised interest rates, was because we started off with a very low level of resource utilisation. Following the crisis at the beginning of the 1990s, unemployment was at a record high level and there was considerable unutilised capacity in industry. It was not until recently, since the end of last year, that we have begun to approach the capacity ceiling.

Furthermore, Sweden has shown a positive development in private saving throughout the entire 1990s, and the household sector's burden of debt is currently much lower than it was after the crisis at the beginning of the last decade. In addition, we have a surplus on the current account, which is tantamount to a surplus in the balance for the economy as a whole. Things look rather different in the USA. There, private sector saving has declined to –7 per cent of GDP, the household sector's burden of debt is at a record high level and the deficit on the current account balance is growing rapidly. Both American consumers and international investors have had strong confidence in the American economy's capacity to generate future income.

USA central point in economic picture

When it comes to the actual economic activity situation, interest is mainly focused on the USA, not least because of the low level of saving and the large build-up of debt described above. If American households were to rapidly increase their saving and reduce their consumption, and if foreign investors were to begin to feel hesitant over financing the current account deficit, there would be considerable consequences for the global economy.

However, the American economic picture is still fragmented. It is true that the household sector's consumption is still at a high level and developments in the construction and residential sector are also satisfactory. Moreover, the large fall in the confidence indicators seems to have slown down, at least for the time being. But at the same time, industrial production is still weak, the inflow of orders is falling and the adjustment of stocks is moving unexpectedly slowly, particularly in the sensitive IT sector. The figures from the labour market also look gloomy and leading indicators are retreating. Although the stock exchange has shown an upturn in recent weeks, it is still very volatile and the household sector's burden of debt is continuing to increase. Leading economists have ceased talking of a V-shape when they describe economic developments. The upturn will come, but it will probably take longer than was estimated a month or so ago.

This is what one should bear in mind when regarding the four American interest rate reductions of a total of 2 percentage points during the spring, two of them outside of the normal Federal Reserve Board meetings. It is hardly likely that the Fed knows something they have not told the market, which is what is sometimes implied by analysts. This is not the way a central bank works. However, the American economy came to a standstill more quickly than expected and the Fed probably fears that the unease on the financial markets will frighten away both investors in real capital and consumers from spending their money. This fear is certainly justified.

Then, of course, one can feel some hesitation over the fact that monetary policy is taking on the role of short-term saviour of the American consumers, who can thus carry on consuming beyond their incomes for some while longer, i.e. with a negative savings ratio. If the substantial optimism regarding the future that is reflected, for instance, in the development in savings proves partially unwarranted, the problems may become even more difficult to handle at a later stage.

Although the focus is on the USA at the moment, concern over developments in Japan has increased recently. Here there appear to be both severe problems in the real economy and in the finance sector, as well as political difficulties in dealing with these problems. In the insurance sector there are a number of major life insurance companies that are insolvent in the technical sense, as they have promised pensioners a return that they are unable to deliver. A large part of the insurance companies' assets are of course traditionally invested in low-yield treasury bonds. The Japanese 10-year bond rate is currently around one and one-third per cent. The Bank of Japan has declared that it intends to continue with its zero interest rate policy for the foreseeable future and the market expects to see prices falling rather than otherwise during the coming year. If interest rates and inflation were to gradually rise, which at the moment does not appear likely, this would of course further erode the value of Japanese pension money, as the bonds stock in the insurance companies would fall in value.

It is not possible for an outsider to take in the size of the holes in the banks' balance sheets as a result of bad credit; it is probably not possible for the Japanese authorities to see this either. However, all of this must eventually rise to the surface, just as it did in Sweden during the finance crisis. It remains to be seen whether the new administration will bring problems in the finance sector closer to a solution.

In Sweden we can of course be pleased that the stock exchange has made a slight recovery during April, although it is too early to conclude that the lowest level has been reached. The stock exchange tends to jump the gun a few times before it really takes off. There is still great uncertainty on the financial markets. At the same time, many of the recent signals regarding economic activity have been distinctly negative. A fall in the inflow of orders and weaker production growth are reported in the telecommunications and motor vehicle industries, for instance. Exports and investment are declining.

Household sector consumption and expectations for the future are also showing a downturn. The number of newly registered vacancies on the labour market is giving negative indications, although employment is still rising.

The inflation figures turned out to be higher than expected, both with regard to the consumer price index and underlying inflation. It is always misleading to draw conclusions from individual observations, as temporary factors can have a major effect. However, price increases may also be due to the fact that the utilisation of resources or propensity for inflation have been slightly higher than we had assessed earlier. There is every reason to increase vigilance in this respect. The rapid price rises in parts of the services sector give particular cause for concern. There is every reason to increase vigilance over the next few months with regard to price signals from the market.

What significance does the krona have?

I thought that in this context I would spend a little more time on the development of the Swedish krona. When the krona is undervalued, as it is today, this tends to stimulate exports, which raises total demand and increases inflationary pressure. At the same time, import prices become higher in Swedish krona. The development of the krona thus affects inflation in various ways and is therefore of interest to the Riksbank and to monetary policy in the same way as other factors that affect inflation. On the other hand, the Riksbank has no target for the krona exchange rate, as was the case prior to 1992, when monetary policy was aimed at a fixed exchange rate rather than price stability.

However, I think, as do many others, that the krona is currently very undervalued. This is because a given basket of goods today costs considerably more if bought in Europe or the USA using exchanged euro or dollars than if bought in Sweden. Sometimes they talk about "hamburger parity" as a simple illustration of this concept, i.e. compare what a certain well-known hamburger costs in different countries. And this brings us to the fact that the krona should be valued approximately ten per cent higher in order to buy the same hamburger here as in the USA. More complicated calculations of the balanced real exchange rate provide similar results, perhaps even slightly more than ten per cent. The Riksbank's forecast of the path of the krona shows a similar development.

Now we in Sweden are not alone in having seen our currency weaken; other industrial nations with a floating exchange rate are seeing the same thing, e.g. Canada, Australia and New Zealand. This is probably due to the unease on the financial markets during the spring, as times of trouble often entail capital moving away from the less liquid currencies and fleeing to those perceived as more stable and liquid, primarily the US dollar.

On top of this comes the development on the Swedish stock exchange, which appears to have played a major role recently. The foreign exchange market and the stock exchanges have been strongly correlated for a period of time, particularly since the stock exchange fell. Since mid-2000, 85 per cent of the variations in the -SEK/EUR exchange rate can be explained by variations in share prices. Foreign investors sold Ericsson shares to a value of SEK 30 billion between September 2000 and February 2001. At the same time, the AP funds' new investment regulations and investments in the premium pension scheme have led to substantial outflows. These flows can undoubtedly have had significance in the short term, although this effect should not be exaggerated.

However, the situation in Sweden is basically stable, as I pointed out earlier. There is no distrust of Sweden pressurising the exchange rate as at the beginning of the 1990s; no fundamental imbalance in our economy to arouse international concern. One measure of this is the spread between the long-term German interest rate and the corresponding Swedish interest rate, which grazed 5 percentage points during the crisis period at the beginning of the 1990s. That was how much more the pension funds in the USA and Japan wanted to receive to invest money in the unstable Sweden rather than the secure Germany. Today the interest rate margin is roughly the same and has been so since early 1999. The long-term confidence in the Swedish economy appears unshaken and the explanation for the weak krona must therefore be sought in the financial markets rather than the real economy.

A floating exchange rate floats!

If the krona is undervalued, shouldn't we at the Riksbank do something about it? We do have a foreign currency reserve that can be used to buy krona if necessary. However, there is good reason to approach this question with great caution. One important reason is, of course, the above, namely that the weakness of the krona is the other side of the dollar's strength and reflects the international financial unease. We can't do very much about this, no more than can the Canadians or Australians who are in the same situation.

Another reason is that we have a price stability target and not an exchange rate target and trying to maintain both with the aid of the repo rate is not an easy task. In many cases the targets are in total conflict with one another. We in Sweden have chosen a floating exchange rate and will therefore have to accept that the exchange rate floats. If the Riksbank were to intervene on the market now and then, we could easily cause speculations as to what exchange rate we might have as a target. The forecasts as to when the Riksbank might intervene and the positions it might take would then become a part of stockbrokers' daily work. This is not a good thing, as it increases unease on the market, rather than reducing it.

Nevertheless, it should be remembered that every central bank may need to intervene under certain circumstances, either by buying or selling currency, e.g. to restore some order to a market that has become unbalanced or to even out sudden large flows. In both cases, one should of course state the purpose of the intervention. There could also be reason at some point to indicate that the market's pricing has moved significantly out of the region considered reasonable. For instance, this was the case, as I understand it, when the ECB intervened last autumn. In these cases the central bank can take action to "nudge" or reinforce a trend in the market without actually establishing any ceiling or floor. In my opinion, however, one should be restrictive in the use of such interventions. If the trend should turn and move in the opposite direction, the intervention might do more harm than good.

Is it good for Sweden if our currency is undervalued over a long period of time? All experience indicates that this is not so. Although an undervalued currency gives the export industry and import-competing industry a competitive advantage, which may sound positive in the short term, it reduces competition pressure and in the longer perspective it delays the structural transformation necessary when the exchange rate eventually returns to a balanced level. At the same time, the import industry has an uphill struggle, which leads to companies being wiped out in this sector that would have not have collapsed with a correctly valued currency.

In addition, major fluctuations in themselves have a subduing effect on developments as the risks increase on all international transactions. This can be counteracted to some extent through hedging, but hedging also has a price that rises as uncertainty increases.

The alternative is, of course, a fixed exchange rate, which in Sweden's case would be synonymous to adopting the euro. In the short term we have managed perfectly well outside of EMU, with lower interest rates and inflation and a higher growth rate than the euro area. However, in a longer term perspective, periods of a wrongly valued krona and major fluctuations in the exchange rate – and we will probably have to live with these – may be a high price to pay. For a small economy with a large foreign trade like Sweden this is a development worth considering.

Some conclusions

Let me finish where I began, namely by concluding that the economic situation still appears uncertain in essential areas. The main clue is that the American economy will show an upturn, but take a more prolonged path than the V shape. However, there are imbalances that could cause a much less favourable development. In addition, the inflation rate has begun to rise more than expected.

There is no sign of improvement in Japan; on the other hand there is a risk of a "cooling down" in the finance sector really taking hold, following an incubation period of ten years. In the longer-term perspective, this may be necessary to put right the underlying problems, but in the short term it may have undesirable effects on the global economy.

In Sweden we can see continuing sings of a slowdown. This slowdown is partly counteracted by a continued weak krona and by the Swedish repo rate being low in relation to the corresponding interest rates in most other industrial nations. At the same time, we can see signs of a high level of resource utilisation and price rises in certain industries. The collective wage negotiations are not yet complete, either. The question of how the threatening international slowdown will affect the Swedish economy in greater detail is still open.

It is in this light that one should regard the Riksbank's decision last Thursday, 26 April, to hold the repo rate unchanged. On 15 May the minutes of the monetary policy meeting will be published, enabling a view of the detailed reasoning behind the decision. It will be time for the next monetary policy meeting on 30 May. A lot can happen before then and perhaps the economic picture will have become a little clearer by then.