

Urban Bäckström: The monetary policy situation in Sweden

Opening remarks by Mr Urban Bäckström, Governor of Sveriges Riksbank, to the Riksdag's Finance Committee, Stockholm, 19 March 2002.

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First I want to express my thanks for this opportunity of discussing the Swedish economy and monetary policy with members of the Finance Committee. The Riksbank is required by law to present your Committee with a written account of monetary policy at least twice a year. The first of this year's accounts was handed over this morning. It contains a description of the Riksbank's view of economic developments and the prospects for inflation. In my opening remarks I shall summarise the report and then discuss the consequences the Riksbank's Executive Board draws as regards monetary policy. Then I look forward to a discussion with members of the Committee and shall do my best to answer your questions.

Brightening outlook for the world economy

The discussion at our previous meeting last autumn was coloured to a high degree by the terrorist attacks in the United States on 11 September and their effects. At that time there was considerable uncertainty about the extent to which economic activity, which was already weak, would be affected. There was a risk of the attacks making households and firms even more uncertain and eroding their confidence in the future, with negative consequences for demand. As inflationary pressure varies with the state of demand and resource utilisation, the events influenced the formulation of monetary policy in many countries, including Sweden.

Six months later, however, we are now seeing more and more signs of an imminent improvement in activity abroad. The attacks' impact on the global economy were fortunately limited, though certain sectors, such as air transport and insurance, have been heavily hit by the attacks and their repercussions. Production last year was constrained by excessively large stocks but it now looks as though stock adjustments have come a long way, which is a good sign for output. A certain amount of optimism is beginning to spread. Order books are becoming more stable and in some cases even improving. Then there is the additional impetus that comes from the expansionary economic policy in many countries.

A proper global recovery that becomes increasingly strong does, however, presuppose a broad and sustained increase in demand. An increase in production that is generated solely by an end to stock reductions is liable to be relatively brief. In this respect there may be some uncertainty. There are still large imbalances in the American economy and stock market values are high, both in a historical comparison and in relation to the current cyclical phase.

Opinions differ somewhat about the imbalances in the United States. Many observers focus on and are worried about structural imbalances in the U.S. economy. The adjustment problems, after undue optimism among households and firms in the late 1990s had given rise to the imbalances, will lead to the recovery being more sluggish than usual. Some even consider there could be a more drastic correction that breaks a global upswing in the coming years. Those who are more optimistic point instead to the U.S. economy's productivity growth; if this remains high, there is less cause to be concerned about the imbalances because a higher potential growth rate permits higher incomes with which to service the debt burden.

The Riksbank's current analysis does not envisage a quick correction of the imbalances. Still, there are grounds for supposing that growth in the American economy in the coming years will not be as high as in the late 1990s. And if the imbalances were to be adjusted more quickly, the Riksbank would, of course, have to take that into account in the formation of monetary policy.

Turning now to Europe, we see fewer signs of a recovery. The prospects for Germany, the largest economy in the euro area, are still uncertain. However, a look at the leading indicators does show that firms have become more positive. Imbalances like those in the United States have not accumulated in the euro area and this may benefit a recovery. Moreover, economic policy is also markedly expansionary in Europe, although the scope for fiscal measures is not as great as on the other side of the Atlantic. In addition, an upswing is likely to be held back by product and labour market rigidities.

So all in all, it is hard to see how the coming economic upswing can be as rapid as earlier recoveries. But the world economic picture is now appreciably brighter than last autumn and the outlines of an upturn are becoming increasingly clear.

Inflation in Sweden is high

If the picture we present in the Inflation Report holds good, the present cyclical dip in the Swedish economy will turn out to have been the mildest for over thirty years. GDP growth was admittedly subdued in 2001 but the figures from Statistics Sweden do not show any negative rates. Neither has the labour market deteriorated as much as usual. Nor have any serious imbalances arisen. So thus far there is reason to be positive about the economic situation; most leading indicators point to an economic recovery, with an upturn in activity during 2002.

There is, however, the problem that inflation has for a time been clearly above the Riksbank's 2 per cent target. To a *certain* extent the comparatively high inflation can be explained by various supply shocks that have raised the prices of electricity, meat, fruit and vegetables, for instance. The background to these shocks includes the previous winter's low precipitation for hydroelectric power, livestock diseases and poor harvests due to last autumn's unusually cold weather in Europe. As I said, shocks of this type can raise the general price level and lead, as in these cases, to a transitory increase in the rate of inflation.

But even if one disregards these price increases, inflation has risen. As we discussed in a number of Inflation Reports last year, this probably has a number of interacting explanations. One is that resource utilisation in the Swedish economy has probably been somewhat higher than envisaged earlier. This in turn no doubt explains why wage increases, particularly in domestic sectors, have been higher than expected. As this has been accompanied by weak productivity growth, mainly it seems for cyclical reasons, it has led to upward pressure on prices. A general contraction of profit shares in the economy as a whole has presumably helped to modify price increases in recent years. But this has also left firms with less room to "absorb" further additions to costs and weak underlying productivity growth.

All this naturally raises questions about potential growth resource utilisation, inflationary pressure, competition in various markets and the workings of the economy.

Resource utilisation higher than expected

Ever since inflation expectations closed onto the target some time after the mid 1990s, a very important consideration for inflation forecasts and thereby for the formation of monetary policy has been resource utilisation. This indicator concerns the relationship between actual demand and what the economy is capable of producing in the longer run without price and wage increases accelerating.

Let me point out first that neither the potential growth rate, resource utilisation nor the inflation propensity in a wide sense is something that can be measured directly. For some years now the Riksbank has been drawing attention to questions of this type, analysing them and presenting detailed accounts in the Inflation Report. Although we have mainly referred to various supply shocks as explanations for inflation's relatively high rate in the past year, we have also drawn attention to other conceivable factors right from the start. In the Inflation Report last May, for example, we wrote:

The risks for inflation connected with domestic demand and the relationship between growth and inflation in Sweden are somewhat more on the upside than foreseen in the March Report. The inflation forecast in the main scenario has admittedly been revised upwards in view of the unexpectedly high domestic inflation but this has been done mainly for the coming year. It is conceivable that the higher registered inflation is partly a sign that resource utilisation is more strained than assumed in the main scenario. (Inflation Report 2001:2, pp. 24–25)

Some upward revision of resource utilisation is incorporated in the Inflation Report the Riksbank is presenting today. That was done partly because the underlying rate of price and wage increases has been moving gradually upwards for a time. This resembles our response, though with the opposite sign, when inflation repeatedly turned out to be a positive surprise in the late 1990s. The present adjustments imply that there are less unutilised resources that can be brought into production without this leading to a rising rate of price and wage increases. That in turn affects the prospects for future

inflation, particularly as economic activity, in Sweden as well as elsewhere, seems to be improving and overall economic policy is expansionary.

This analysis has ramifications in the labour market. The general weakening of demand during 2001 did not show up in employment. Unemployment has been more or less stable. Both the economy as a whole and the labour market show signs of a dichotomy; industrial output and employment have fallen, accompanied by an increase in demand and jobs in the services sector. At the same time it is mainly in services that wages and prices have risen.

Thus, in the light of what has been happening to prices and wages during the past year, the Riksbank has gradually arrived at a somewhat altered view of the Swedish economy's inflation propensity. Higher resource utilisation, together with higher wage increases and a weak exchange rate, has led to somewhat stronger inflationary pressure. This affects the forecast we are presenting today. Meanwhile, we are, of course, continuing the work of developing our analysis and interpreting new data as they become available.

Rising inflation

All in all, in the Inflation Report the Riksbank notes that incoming statistics confirm the impression that activity in Sweden has probably stopped falling. The expansionary fiscal policy is contributing to a strong development of household disposable income in the coming years, providing a basis for higher private consumption as well as increased saving. Exports rise during the forecast period but the increase is relatively modest both on account of the international upswing being tentative initially and because the krona is expected to appreciate. GDP growth is judged to be 1.6 per cent this year and then accelerate to between 2.5 and 3 per cent in the coming years, which as far as can be judged is somewhat more than the Swedish economy can sustain in the longer run without giving rise to inflationary tensions.

With the high resource utilisation, labour costs are judged to rise somewhat more than we foresaw in the December Report. Partly for this reason, domestic inflation in the forecast period is somewhat higher than foreseen earlier. CPI inflation stops at 2.2 per cent one year ahead and 2.4 per cent after two years. The corresponding forecast for inflation's underlying rate, UND1X, is 2.2 per cent both one and two years ahead. Monetary policy focuses in the first place on the latter rate.

In this price forecast, the supply shocks that are now leaving their mark on inflation are judged to drop out of the twelve-month change figures successively during the late spring. Inflation is accordingly expected to approach 2 per cent in the early summer. After that, however, it is foreseen that the more strained resource utilisation connected with stronger economy activity will lead to a renewed increase in inflation.

The risk spectrum mainly concerns domestic inflationary pressure. If resource utilisation is more strained than the Riksbank now assumes or if potential growth has been overestimated, there is a risk of future inflation being higher than in the main scenario. When the risk spectrum is taken into account, underlying inflation, measured by UND1X, amounts to 2.3 per cent both one and two years ahead.

Monetary policy conclusions

I should like to conclude with some words about monetary policy.

In the light of increasingly clear signs of an economic recovery and resource utilisation that is somewhat more strained than expected, the Riksbank has decided to raise the repo rate 0.25 percentage points, to 4.0 per cent. By safeguarding price stability, we aim to create conditions for a stable and sustainable development of production and employment in the Swedish economy.

Last year's higher inflation and our assessment that it was not solely transitory have already left their mark on monetary policy. That was the case not least last summer, when we raised the repo rate because of concern that the weak exchange rate combined with comparatively high resource utilisation might lead to the higher inflation becoming entrenched. In September we, like other central banks, cut the interest rate 0.5 percentage points; later in the autumn, however, we were more cautious about lowering the instrumental rate than, for example, the European Central Bank. Since last May, the risk of higher domestic inflation has been weighted into our decisions. Whereas the

Swedish repo rate at the beginning of last year was lower than its counterparts in the euro area and the United States, it is now higher.

Looking ahead, we have as usual not committed ourselves. What we do or refrain from doing with the repo rate will depend on the new information that becomes available and on how we assess and analyse it. What happened last year is a good illustration of the appropriateness of this approach. Neither positive nor negative surprises can be ruled out. We have to be ready to cope with that.

That said, we have inflation that is relatively high, even though we count on it becoming a good deal lower in the coming six months. Resource utilisation is probably relatively high, too. The path of the interest rate will then depend – as long as inflation expectations remain in place – on how economic activity develops.

If activity continues to strengthen as expected and there is no reason to reappraise the economy's inflation propensity, it is reasonable to assume that the repo rate in Sweden will be adjusted successively upwards. This does not come as a surprise to participants in financial markets. It is a natural consequence of the Riksbank being in earnest about its task of ensuring a rate of price and wage increases that is in line with the inflation target in a situation where economic activity in Sweden is become gradually stronger.

Here I am prompted to refer to what Knut Wicksell, the well-known political economist, pointed out in his day; it is a matter of looking for the “natural” rate of interest at which the economy can expand without prices and wages rising too quickly.