Irma Rosenberg: Monetary policy and the Swedish economy

Speech by Ms Irma Rosenberg, Deputy Governor of Sveriges Riksbank, to the Swedish Society of Financial Analysts, Stockholm, 5 March 2003.

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Thank you for the invitation to come here and speak at the Swedish Society of Financial Analysts. This is my first public appearance in my new role as Deputy Governor of the Riksbank. It is stimulating to meet people and discuss economic issues. At the same time, I feel a little nervous, as I know I am facing an audience who are used to examining and interpreting statements by the Riksbank. One difference between this post and my previous work is that a member of the Executive Board must to some extent exercise caution when speaking publicly. This is to avoid creating any misunderstandings among participants in the financial market, who try to translate statements by representatives of the central bank into future interest rate policy. This means that some of you may not be acquainted with me, but my aim is to be as honest and clear as I possibly can.

What I intend to start talking about today is the development of the economy in recent years and to follow this with a look ahead at the challenges facing both the Swedish and international economic climates, and finally say something about monetary policy.

Those of you who are familiar with the economic assessments I have made know that I sometimes have not shared the Riksbank's conclusions. But please remember that this should not be interpreted to mean that I have a different opinion of the Riksbank's objectives. I consider it a good thing to conduct an open discussion on the policy pursued. And I hope that you intend to take part in this discussion, as the whole point of an open central bank is to facilitate such discussion and allow it to improve monetary policy.

Riksbank focuses on total inflation picture

I shall begin by describing the way the Riksbank works. The Riksdag has assigned two main objectives to the Riksbank: to maintain price stability and to promote a safe and efficient payment system. Today I shall concentrate on the first of these two objectives.

The Riksbank has defined the target for monetary policy as to limit inflation to 2 per cent, with a tolerated deviation interval of plus/minus one percentage point. This tolerated interval indicates that deviations are likely, but that they will be limited. The objective is worded in terms of the consumer price index (CPI), which is a broad index consisting of the prices in a basket of goods and services consumed by an average Swedish household. As interest costs and indirect taxes included in CPI inflation are not assessed to have a long-term effect on inflation, the Riksbank has chosen to normally focus on UND1X, which is an index that excludes these factors. From time to time there may also be reason to disregard other price changes that are assessed as temporary. Our ambition will then be to make it clear that we have done so.

By raising and lowering the steering interest rate - the repo rate - the Riksbank attempts to influence inflation. As it is so difficult to steer inflation in the short term, the Riksbank makes an assessment of developments for the coming 1-2 years. This is the period of time usually assumed necessary for an interest rate adjustment to work its way through the economy and have a full impact on the rate of price increase, i.e. inflation.

The Riksbank uses a simple rule-of-thumb when shaping its monetary policy. If the total picture of inflation shows that it is expected to be above or below the target level, the steering interest rate is adjusted accordingly.

There are four main factors in the analysis of future inflation that stand out as central to the shaping of monetary policy: the development of total resource utilisation, international price trends, the exchange rate and the general public's inflation expectations.

Inflationary pressure varies according to the demand situation and to changes in **resource utilisation**. The stronger the upturn in demand in relation to potential production, the greater the risk that prices and wages will rise rapidly and vice versa. This is why we who work in central banks around the world must analyse the picture of economic activity as a whole, despite the fact that inflation is our target variable.

International price trends, where, for instance, oil prices are an important factor, affect domestic inflation by way of imports. An assessment of international resource utilisation can provide an indication, for instance, of how international prices may develop.

The development in the **value of the krona** is important in the assessment of inflation. A change in the exchange rate has a direct effect on inflation in that the price of imported goods and services is affected, and also an indirect effect via aggregate demand. If the value of the krona changes in relation to other important trading currencies, this affects the competitiveness of Swedish goods and services and thereby demand and resource utilisation.

Inflation expectations among households and companies can also affect the price-setting and wage formation processes and thereby inflation. One purpose of a clear inflation target and a monetary policy governed by such a target is to firmly establish the inflation target with the general public.

At the same time, one should remember that the Riksbank is forced to take into account many other factors that influence price trends. These are often non-recurring factors, such as supply shocks in various forms, which are often difficult to predict. But above all it can be difficult to use monetary policy to prevent them having an impact on inflation. Monetary policy has an impact with a time lag, and it does not always reach the source of such a price rise. For instance, a central bank cannot prevent oil prices rising in the wake of the concern over a possible war in the Middle East. On the other hand, a central bank could of course try to quickly tighten demand in the country to push down prices in other areas and thus ensure the average rate of price increase remains in line with the target level.

The focus on inflation 1-2 years ahead, entails monetary policy being conducted gradually, little by little, rather than a constant acceleration and braking, which would risk creating unnecessary variations in demand and which could in turn have a negative effect on production and employment. The focus on the coming 1-2 year period thus means that temporary rises or falls in the inflation rate can be tolerated. However, it is important that the Riksbank is clear in its communication of whether it considers the rise to be temporary and when it expects it to subside.

One-off shifts in price levels can have a more lasting effect on future inflation if, for instance, those involved do not believe that the rise is temporary, assessing that it will be lasting and thus wishing to compensate for the upturn. If this occurs, monetary policy must be used to intervene, even if the economic situation in itself does not provide cause for concern with regard to inflation, to prevent inflation taking a hold through expectations. The reason for this is quite simply that it is more costly in terms of reduced production and employment to force down inflation expectations once they have become established at a higher level rather than to prevent them rising.

Parallels between the current situation and 2001 plus 2002

Let us take a look at the current situation and begin with the price rises. Now, as in spring 2001, inflation has risen as a result of temporary factors pulling up the general level of prices. During 2001 mad-cow disease and foot-and-mouth disease pushed up meat prices and poor harvests led to soaring prices on fruit and vegetables. Then as now there was also a water shortage in the hydroelectric power companies' reservoirs, which pushed up electricity prices. At the moment, it is electricity and oil prices that are soaring and have pushed up inflation figures above the target level in January. This becomes particularly clear if one separates energy prices from the inflation figures for January (Diagram 1).

The Riksbank's assessment is that the upturn in inflation is temporary, as it was in 2001, and we can expect to see lower inflation as early as the late spring and summer. However, our assessment is based on the assumption that those setting prices will not try to compensate themselves for the temporary price increase. If this occurs, there is a risk of inducing tendencies towards an inflation spiral, which the Riksbank could not stand by and witness in silence. At the same time, it would be very unfortunate, particularly in the light of the challenges facing the Swedish economy, to be forced to manage contagion effects from the energy price rise with interest rate rises.

If one looks at the economic climate, I consider the similarities between the present situation and this time last year to be more striking than a comparison with 2001. Here I am mainly referring to the fact that economic prospects were at that time very uncertain with regard to how far the adaptation process had come after the over-optimism of the previous years, which had led to abnormally high share prices and overly large investments by companies in the USA. Let me go back in time roughly one year and see what conclusions can be drawn from last year and what implications they might have for future developments.

Developments 2002 to 2003

At the beginning of last year there were signs of a light at the end of the economic outlook tunnel. I wasn't working at the Riksbank then, so don't be surprised if parts of my historical description differ slightly from that of the Riksbank, as expressed in the Inflation Reports.

The signs of a turnaround were most pronounced in the USA, but there were also some signals that Europe was on the threshold of a recovery. The reduction in stocks appeared to be well on its way, which is usually the first requirement for an upturn in production. However, for a production increase brought about by adjustment in stocks to be durable, it must be supported by a lasting increase in demand. Household consumption continued to increase, but there was no upturn in investment. The imbalances in trade and industry in the USA were perhaps more tangible than many had anticipated. Bankruptcies and accounting scandals created further unease on the financial markets, which then fell at a rate reminiscent of the 1930s crisis.

In Europe the signs of economic recovery mainly concerned more optimistic expectations; expectations which were not later realised. The largest euro economy, Germany, in particular proved to be in a poorer condition than anticipated. However, here it was not a question of imbalances like those in the USA, but structural problems, such as a high level of unemployment that had set in and weak public finances, which made it difficult to conduct an economic policy that would support the business climate. Furthermore, the expected supporting forces from the other side of the Atlantic for the export industry were weaker the expected.

In Sweden, the slowdown during 2001 had a limited effect on unemployment. The Riksbank's calculations at the beginning of 2002 indicated that resource utilisation was relatively strained. Economic policy had a stimulating effect on the economy, through lower taxes and higher transfers. Given these conditions, when the signals of a recovery became clearer at the beginning of 2002, the Riksbank elected to raise its steering interest rate on two occasions during the spring, by a total of 0.5 percentage points to 4.25 per cent. These increases should also be regarded in the light of the fact that inflation was still at a high level then and risked having a negative effect on inflation expectations. During the spring the rate of price increase turned back towards the target of 2 per cent as forecast.

As an external analyst my assessment differed slightly from that of the Riksbank. This applied to both the international picture, where it was uncertain whether a turnaround had actually taken place, and resource utilisation in Sweden and the risk of tension that could cause rising inflation. I interpreted the high rate of wage increase that we had then as a delayed effect of an overheated labour market during 2000 and part of 2001. Shortages on the labour market had eased considerably in spring 2002. In the services sector, as in construction, capacity utilisation had fallen significantly, which indicated that wage increases would gradually become more subdued. I therefore perceived the inflation risk as less evident and did not see any immediate need for raising the interest rate.

It is clear that the inflation risk the Riksbank seemed to see declined as unease on the financial markets grew in the wake of bankruptcies and corporate scandals in the USA. Gradually, unease increased because of security policy developments. The financial unease gradually infected the real economy; confidence among companies and consumers began to fall in several countries over the summer and it became increasingly clear that total demand had been negatively affected. This contributed to enabling the Riksbank to lower the repo rate twice during the autumn, measures that were in my assessment quite fitting under the circumstances.

What we can observe today, compared with one year ago, is that the questions baffling forecasters are roughly the same and that they are dominated by the question of how far the adaptation process following from the stock market bubble has come. Today an additional factor making assessments more difficult is the threat of war in the Middle East. We do not know whether there will be a war or how it will all end. The crisis also creates uncertainty that makes it difficult to correctly interpret economic signals. In addition, the more prolonged the crisis is, the greater the risk that the actual uncertainty will have a negative effect on the real economy.

I shall now turn towards the future and discuss developments over the coming 1-2 years.

Right conditions for a recovery in the USA…

One difference now compared with the situation one year ago is that the adaptation of the imbalances in the US economy has probably progressed further. Consolidation of balance sheets has continued, productivity is strong and normal business activity patterns indicate that the conditions should be relatively favourable for an increase in industrial production during the spring. Low stocks levels in relation to sales and an investment ratio that is below the long-term trend would indicate this is the case. An expansionary economic policy provides further support for the optimism. However, the question most people are asking themselves now, as they were in 2002, is whether the adaptation to the imbalances has reached a sufficient stage to enable a broad, lasting increase in demand that can take over as the driving force behind a production increase. It is much too early to be able to give a clear answer here.

If we look at households in the USA, we can see that they have become more passive since the December Inflation Report was published. The explanation could be the security policy unease and the still weak stock markets. Continuing high oil prices will also cut into disposable incomes. However, the expansionary economic policy should partly counteract these effects.

All in all, I believe that the picture of a relatively prolonged recovery in the USA, where growth gradually increases over the year and attains the economy's long-term sustainable level, remains for the most part intact.

… while the conditions for a turnaround in the euro area are poorer.

The total international recovery expected during the coming year does not look to be as strong as the Riksbank anticipated in December. The background to this is that developments in the euro area in general and in Germany in particular look rather gloomier than they did before. The euro area's export industry is hampered by international uncertainty, as well as a stronger euro and a weak labour market is affecting households' consumption and confidence in the future.

This means that the international economic prospects look rather poorer now, which was also the conclusion of the Executive Board at its monetary policy meeting on 6 February. However, this assessment is based on the assumption that the Iraq crisis will develop in a way that will not significantly deteriorate economic prospects.

Flat growth path for the Swedish economy

The financial unease has also affected the Swedish economy. Industrial production has stood still during the autumn and order books have been slow to fill. This is perhaps not so strange in the light of the "wait-and-see" mentality prevailing on important export markets. However, as the international economic climate improves, this and the cyclical pattern for investment are expected to give impetus to industrial production in Sweden.

Over the past six months, Swedish households have become increasingly pessimistic in their view of the future, which is perhaps understandable taking into account the negative news with which they are confronted: rising energy prices, higher taxes and expected cuts. The scope for consumption will be under pressure from these factors in the near future. At the same time, households' savings were at a high level in 2002, which means that there may be some scope to increase consumption despite the restraining effects.

Altogether, I believe there is also reason for a downward revision of the estimate of the Swedish growth rate over the coming years. The expected upturn is assessed to be somewhat superficial. This also assumes that the Iraq conflict does not develop in a way that will seriously deteriorate future prospects.

The shaping of monetary policy

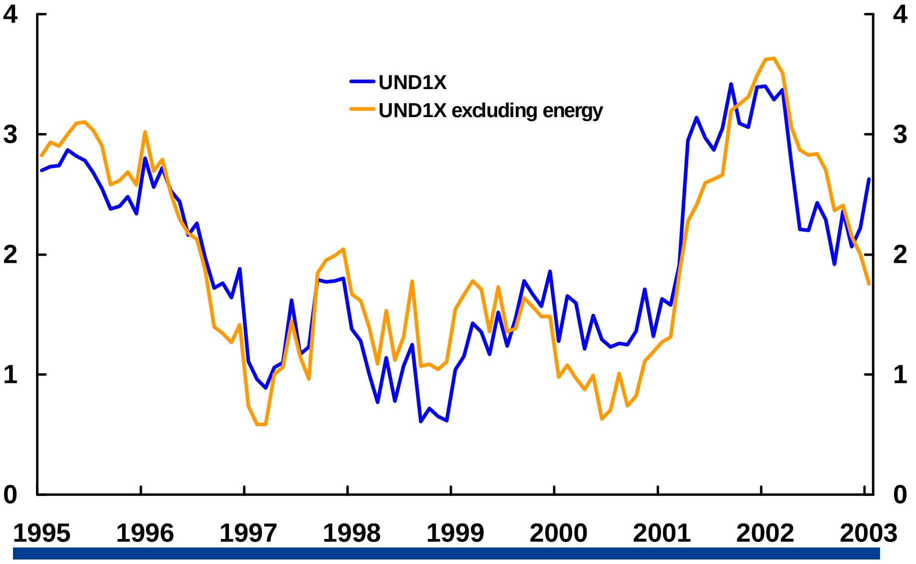
A decisive factor in the shaping of monetary policy in future is the total picture of inflation prospects. A slightly more subdued growth in demand both in Sweden and abroad is expected to lead to capacity utilisation being slightly less strained. At the same time, energy prices have pushed up inflation. However, the Riksbank's assessment is that the upturn in inflation is temporary and that there is reason to expect lower inflation as early as the late spring and summer. Although, as I said earlier, this assumes that those setting prices and wages do not attempt to compensate themselves for the temporary price rise.

All in all, it is a question of balancing the risks of, for instance, a weaker growth in the economy, against the risk that the upturn in inflation will have contagion effects.

This is what the Executive Board must do at its monetary policy meeting on 17 March.

Chart 1

UND1X including and excluding energy



Sources: Statistics Sweden and the Riksbank