Lars Heikensten: Monetary policy and the economic situation

Speech by Mr Lars Heikensten, Governor of the Sveriges Riksbank, at Handelsbanken, Karlstad, 26 January 2004.

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It is nice to meet a group of representatives of the business and social community in this way in Värmland. I would therefore like to begin by thanking the organisers of today's lunch meeting.

When I took office as Riksbank Governor last year I decided that I would leave Stockholm shortly before each monetary policy meeting and visit different parts of the country; both to learn more about developments in various parts of Sweden and to explain the Riksbank's work and actions. My visit to Karlstad today is the first of these trips. During the morning, I visited the university and spoke about how the Riksbank works. Later this afternoon I will first be visiting coffee manufacturer Löfbergs Lila and thereafter be discussing labour market conditions at the county administrative board. We at the Riksbank make these visits in order to meet the Swedish people and increase understanding for our policy, something that is particularly important today given our statutory independence.

In Sweden we have an inflation target, which the Riksbank has defined as 2 per cent with a tolerance interval of plus/minus one percentage point. As I see it, our policy of inflation targeting has worked well. We managed to gain respect for our conduct of monetary policy a lot quicker than many other countries. Moreover, in the ten years that have passed since the introduction of the new regime, average inflation has been very close to our target. At the same time, growth has been higher than in previous decades. Prospective inflation has also been remarkably stable for the past 6-7 years despite periods of rather large transitory fluctuations in actual inflation. The stable inflation expectations have been particularly important for wage negotiations, which have been able to proceed against a completely different, more secure background than during the 1970s and 1980s.

When we conduct monetary policy, we do so on the basis of forecasts of inflation for primarily the coming 1-2 years. The reason we work with this time perspective is that the effects of our actions are exerted mainly during this horizon. When our forecasts indicate that inflation in the relevant time horizon will be above target, there is normally reason to raise the repo rate, and vice versa. Particularly when it comes to debate situations such as that we have been involved in recently, it feels secure to gain a foothold in the clear framework that we have developed for our work in the past ten years. Although we do not mechanically set the repo rate in relation to our inflation forecasts, everyone that is interested in our work methods knows that our forecasts play a decisive role for our actions.

Permit me now therefore to move on and say something about my current views on inflation perspectives before I comment on monetary policy.

The international recovery is progressing

It is natural to begin a survey of inflation perspectives by touching upon the international economy. At the end of 2002, the Riksbank and other forecasters expected world economic activity to embark on an upturn. However, during spring 2003, we gradually had to revise down our growth forecasts. While a recovery in the world economy was still expected, it was now judged to occur at a later stage. The weak growth, however, prompted a shift to more expansionary economic policy in many countries. Both the European Central Bank (ECB) and the US Federal Reserve, as well as the Riksbank and other central banks, continued to cut key interest rates to historically very low levels.

However, most factors now indicate that both the Riksbank and other forecasters were somewhat overly pessimistic in connection with the Iraq war, particularly regarding the view of economic developments in the US. During the second half of 2003, we have had reason to again revise up our growth forecasts for the world economy.

What has happened then since December, when the Riksbank published its latest Inflation Report and forecasts? The most apparent and perhaps the single most important change in the world economy has been the sharp depreciation of the dollar, mainly against the euro.

It is likely that the dollar's weakening against both the euro and the yen is an effect of the US current account deficit, coupled with a growing deficit in the US federal budget. Concern over how to resolve these problems has overshadowed factors that have been pointing to a strengthening of the dollar, mainly the relatively favourable US growth and the investment opportunities that this is likely to bring about.

The weaker dollar can be assumed to have implications for the euro area and Japan, where growth has been fuelled in recent years by high net exports. A substantial appreciation in the exchange rate similar to what we have seen now will make it more difficult to increase exports, which means that growth will have to come from domestic demand to an even greater extent than today. At the same time, we must not forget that the depreciation of the dollar has occurred from levels that were generally deemed much too high, and that a change in the dollar exchange rate is likely to be a precondition for resolving the problem of the high US current account deficits in the long term.

There has also been some new data on the real economy. As regards the US, the data suggest that economic growth there last year - once again - may have to be revised up. For example, housing construction reached record highs in October and November. In addition, consumption growth was stronger than expected during the same period. One reason for this was that households chose to save a smaller proportion of their income than expected. A pattern can be discerned here; on several occasions before we have underestimated US consumer demand, in spite of rather optimistic forecasts. Thus, there may be reason to revise down the forecast of households' saving ratio in the coming years, which if so would point to higher consumption growth. The increasingly weak dollar and stronger euro should also boost US exports, particularly in Europe. In the short term, there is really only one serious concern in the US economy: that employment growth continues to be weak. This could create uncertainty among households and contribute to subduing consumption. But it is hard to believe that it would derail the current upswing.

Also with regard to Europe, we began to see signs of somewhat more robust growth and greater optimism at the end of last year. In our assessment in December, we forecast a rise in growth in the years ahead. New data received since December broadly supports this assessment. Business tendency surveys for manufacturing indicate that optimism has continued to increase while industrial production has now begun to rise slowly, although for the euro area as a whole the picture is still not as unambiguous as in the US. The strong performance of the euro could also result in higher imports and lower exports than expected, which of course would have an impact on demand in the economy and growth.

To sum up, as I see it there is no reason to change the main features of the assessment we presented in December regarding international economic activity and price developments. It could perhaps be argued that the upswing in Europe may be somewhat weaker as a result of the stronger euro, whereas the opposite may prove to be the case in the US. Therefore, there is neither any strong reasons to change our view of Swedish export market growth compared with December. In the period ahead, the rate of growth can still be expected to accelerate in the world economy and in Swedish export markets.

Developments in equity markets also indicate expectations of a continued strengthening of economic activity in the period ahead. The rise in equity prices around the world, which began in the spring last year, has continued. At the same time, long-term international interest rates have fallen recently. It is difficult to determine how much of this is due to lower optimism about growth in the coming years or if it perhaps is more indicative of lower expectations of inflation. Looking ahead, there is reason for some concern regarding developments in long-term interest rates, partly against the background of the weak US public finances.

Upswing also evident in Sweden, but the picture is not entirely clear

With that, I am now ready to discuss the Swedish economy. Allow me to begin by noting that the Swedish economic outlook last year changed in approximately the same way as internationally. During the first half of the year, the economic outlook became increasingly pessimistic. In Sweden, it was mainly investment that was weaker than expected. The weak economic activity was also reflected in the Riksbank's forecasts of inflation. This in turn was a contributory factor in the Riksbank's decisions to cut the repo rate on three occasions for a total of one percentage point. During the latter part of the year, however, the outlook became somewhat less pessimistic. In Sweden, the weak investment was countered by favourable growth in consumption, both private and public, and a rise in exports. The assessment at the end of the year was that growth had increased gradually in 2003 and would reach 1.5 per cent. Growth in 2004 and 2005 was forecast to be approximately 2.5% both years, which on the whole is somewhat faster than what the Riksbank considers to be possible in the long term without giving rise to inflation.

New Swedish data support this scenario, but the picture is still not entirely unambiguous. The National Accounts for the third quarter showed higher growth compared with previous quarters. Household consumption also rose, as did exports. At the same time, business tendency data are indicating growing optimism among firms during the latter part of the autumn, while retail sales continue to grow at a historically high level. But growth in industrial production was relatively weak in October and November while there was a reduction in the number of new orders. Moreover, new estimates of the public finances indicate that public consumption this year may be somewhat weaker than assumed in December. This is mainly due to the financial situation of municipalities. The municipal sector as a whole is running a deficit, which must be redressed in the years ahead.

One issue that has been debated recently is the effects on the Swedish economy of the weaker dollar. It is true that the dollar's performance has been weak, but this is not the whole picture. In trade-weighted terms (TCW), the krona has not strengthened recently. This is mainly because the krona - quite contrary to what many had expected - rather has weakened slightly against the euro. So for foreign trade as a whole, the currency developments should not constitute any great problem. Another issue of course is if the weaker dollar, primarily in relation to the euro, could jeopardise the revival in the world economy. Neither does this appear likely as long as the adjustment is fairly orderly. As I mentioned earlier, it is probable that growth in Europe will be slowed down somewhat, but on the other hand it is likely to be more robust in the US. Moreover, the most recent data for the National Accounts and foreign trade indicate that we so far rather have been slightly too pessimistic about Swedish exports.

The most palpable concern is the labour market, where growth has been weaker than expected particularly towards the end of 2003. Employment was indeed somewhat higher in 2003 as a whole than we expected at the beginning of the year. But this was primarily because the unexpectedly robust growth in the public sector countered weak growth in the private sector. We have no reason to expect any such pattern during 2004. The strained financial situation in the public sector points to weak employment growth in the public sector, while the economic upswing is likely to be reflected to a rather small extent in a rise in employment during 2004 in the private sector. Of course there is a risk that the weak labour market growth will affect households' expectations of the future and propensity to consume, which is a risk that we highlighted back in December. The higher the rate of unemployment, the more cautious households are likely to be when it comes to purchasing and consuming. This in turn could entail a risk of lower growth in 2004.

Nor as regards domestic economic activity is there now reason to make any large revisions compared with our assessment in December. A number of factors are indicating possibly weaker growth, but at the same time there are factors that are pointing in the opposite direction. Compared with the picture we had in December, however, developments in the labour market at the end of the year constitute a somewhat greater risk to economic activity at least in the coming year. Our growth forecast entails that resource utilisation is still expected to rise only weakly and thereby remain relatively moderate during 2004 and 2005.

Signs of lower domestic cost pressure

Last year employment growth in the business sector was weaker than expected, while economic growth was approximately in line with expectations. This means that productivity growth exceeded our expectations. The most recent National Accounts figures also indicate stronger productivity growth last year than was assumed in December. It is likely that this has contributed to lower inflationary pressure during 2003. However, of greater interest for monetary policy is what this says about the future; is what we're seeing an indication of permanently higher productivity growth? We don't know this yet of course. There are many problems associated with the data in this area and even if this were not the case, it would be difficult to determine what had caused the developments we have seen recently. But this uncertainty is no reason to completely disregard the new information we have received. Just like the latter part of the 1990s, when productivity was also unexpectedly positive, there is now perhaps cause for a somewhat more optimistic view of supply conditions in the Swedish economy.

One important, perhaps decisive question is what consequences the weak labour demand and the strong productivity growth will have for the outcomes of wage negotiations. It is clear that labour market conditions suggest moderate wage rises. As opposed to the situation in the two most recent wage bargaining rounds, unemployment has risen recently. There is neither any shortage of labour other than within very limited areas. It is also positive that the rate of wage increases last year was decelerating and that this was also the case for expected inflation. With the currently low rate of inflation, even limited nominal wage increases would imply higher real wages. The demands that have been put forward are also lower than what has been the case in recent years. At the same time, there is always the risk of disturbances from the negotiation process itself. Neither is it inconceivable that some of the productivity gains will be taken to justify a higher wage-payment capacity.

In December, the Riksbank revised down its forecast of unit labour costs somewhat. Behind this was both a marginally more positive view of productivity growth and a small decline in the rate of wage increases. The data that has been received since December reinforces this picture. As I see it, there is probably reason now to further revise down the forecast of unit labour costs somewhat and thereby also the forecast for domestic inflationary pressure.

Inflation and monetary policy

That brings me to the inflation assessment. In 2003 average inflation was somewhat above target. However, the situation changed considerably over the year. Inflation rose from just over 2 per cent at the end of 2002 to just below 3.5 per cent in February, after which it fell back again. One reason that inflation rose so sharply at the beginning of the year was that electricity prices increased due to weather-related supply problems in hydroelectric power stations, while oil prices increased at the prospect of war in Iraq. During the spring energy prices then declined, as did inflation.

However, it was not only developments in energy prices that caused inflation to decline during the year. The fall in prices was broader and probably due in part to lower resource utilisation and higher productivity growth. Of even greater importance, however, were falling import prices, which were a result of both weak international economic activity and the appreciation of the krona.

Our forecast at the end of last year was that inflation would continue to fall over the coming months due to a return of energy prices to more normal levels. In the late spring 2004, however, inflation was expected to rise again, partly because the restraining effect of energy prices on inflation would diminish. The rise was also due to expectations of a slight rebound in import prices. However, domestic cost pressure was only expected to contribute marginally to the increase. UND1X inflation excluding energy, which at the time was considered to be the best indication of the more cyclical inflationary pressure, was forecast to be in line with the inflation target both one and two years ahead. Thus, the Executive Board decided to leave the repo rate unchanged.

However, the decision we made in December was not clear-cut. Factors supporting an unchanged repo rate - as I see it - were mainly that new economic data indicated that the upswing was proceeding as expected, not least internationally, and that this in due time was likely to affect both growth and inflation in Sweden. What advocated a rate cut was that our forecasts were below target in the short term. Moreover, a new factor in the balance of risks in December was signs that domestic cost pressure may be lower than expected; these signs included unexpectedly robust productivity growth, the fact that underlying inflation adjusted for energy prices had risen less than expected during the year and the weak growth in the labour market. However, these signs were still fairly new and I personally found reason to await further information to confirm this picture before I was prepared to take action. Thus, at the meeting, I stressed the importance of monitoring that economic activity was strengthening as expected and also monitoring how supply conditions were developing in the period ahead in order to ascertain whether a repo rate cut in February would be warranted.

As I see it now, the data that has been received since December has largely confirmed the picture of international and domestic economic activity that was presented in the Inflation Report. We are some way into a cautious upswing both in the world economy and the Swedish economy. There is possibly a risk that labour market conditions in Sweden could result in a somewhat weaker economic upswing than we expected, mainly in the current year. As regards the view of domestic cost pressure, there are reasons to be somewhat more optimistic. It appears possible that the rate of wage increases could be slightly lower. At the same time, productivity was unexpectedly positive last year. Inflation in November and December has also been slightly lower than we expected in our last forecast. One of the risks of higher inflation that we stressed - that rises in electricity prices would filter through to other areas of the economy - also appear now to be somewhat lower. This is both because electricity prices have fallen sharply and that those rent negotiations that have been concluded have not resulted in such high outcomes as could have been feared. So it is a case of small adjustments to our assessment on a few points that, on the whole, imply somewhat lower inflation. But as the inflation outlook as early as December was judged to be fairly benign, even a small revision as I now see it could be significant for the monetary policy decision we will make at the beginning of February.

By way of conclusion, there is, as always, reason to underline the fact that new data is being received every day and that any decision on interest rates at the next monetary policy meeting can not be made now. This must be taken in the light of all the information that is available at the time. For my part, I will also look forward with great interest to what my colleagues have to say.

Thank you.