

Stefan Ingves: The Riksbank and the Swedish economy

Speech by Mr Stefan Ingves, Governor of the Sveriges Riksbank, to the Swedish Association of Local Authorities and Regions, Tylösand, 28 May 2007.

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Introduction

Firstly, thank you for the invitation to come and speak to this assembly. Today I will talk about my views on the role of the Riksbank and about the current monetary policy situation, roughly as expressed in the discussion at the May monetary policy meeting.

International economic activity remains good

Sweden is a very open economy and large parts of the business sector are dependent on being able to sell their products to customers abroad. If the economies in countries around us are doing well, then the Swedish economy also does well. In recent years global growth has been extremely high. We believe that the growth rate will slow down slightly in 2007 and 2008, but will nevertheless remain high.

After many years of high growth the US economy has now entered a slowdown phase. Economic activity has been dampened above all in the housing sector, but also in the manufacturing industry. Productivity growth is lower. The earlier upturn in house prices has slowed down and residential construction has declined. The problems have been aggravated by the fact that it has been easy for people with low incomes to obtain large loans for housing. As yet the problems in the housing market do not appear to have spread to the rest of the economy. The labour market and household consumption are showing stable development and companies are still making good profits. We also know that US households and companies generally have strong balance sheets. But although most indications are that the economic downturn will be mild, there are risks of a more pronounced slowdown.

From a Swedish perspective, the weakening in the United States is counterbalanced by the fact that the economies in the euro area are now developing better than they have done in a long time. The euro area is Sweden's most important export market. We are seeing signs that both households and companies in the euro area have a more positive outlook on the future. Above all, it is the turnaround in Germany – Europe's largest economy – that is important to the euro area. Several years of restructuring in German companies has led to lower costs and higher competitiveness. Unlike many other countries in Europe, Germany has taken a larger percentage of world trade and is now once again the world's largest exporter.

Japan has long been struggling with economic problems. Hopefully the Japanese economy is now heading for better times. The economy is growing at a fairly good rate and investment and exports are increasing. At the same time, higher incomes provide scope for higher consumption. There are many indications that the long period of falling prices and wage cuts will soon be over. The impression is in any case that the Japanese economy is moving in the right direction.

In China the annual growth rate has been over ten per cent for several years. Exports comprise a large part of the gross domestic product. China's share of total global exports has increased from around 1 per cent at the beginning of the 1980s to just over 8 per cent in 2006. The Chinese Government is worried that the high growth will lead to excessively rapid growth in investment and credit and thereby to bad investments. They are therefore trying in various ways to cool down the economy. As yet there are no clear signs that they have succeeded in this.

Possible risks for the world economy

The question is whether there is anything that can threaten a positive development in the world economy over the coming years. The International Monetary Fund (IMF) has tried to identify some possible scenarios that could in the short term lead to lower growth. They envisage above all four such scenarios:

1. Continued high growth leading to a shortage of resources that means that inflation accelerates again.
2. Problems in the US housing market spreading to other sectors of the economy and leading to a sharp fall in economic activity.
3. A large fall in stock market prices on the world's stock exchanges leading to lower investments and lower consumption.
4. A rapid and brutal correction in the US current account deficit that could have large repercussions.

The IMF does not only envisage risks of a poorer development than expected – it may also be worth pointing out that they also see the possibility of an even more positive development. The Riksbank's overall assessment is that international economic activity will enter a calmer phase over the coming two years, but at the same time global economic developments are very good right now.

Sweden: Continued strong economy leads to slightly higher inflation

The situation in the Swedish economy is also good. Last year growth was over 4 per cent. For instance, strong global growth has meant that exports have developed strongly for several years. Domestic consumption is also increasing rapidly now, at the same time as employment is rising. But the slightly weaker international economic activity means that activity in Sweden will also be dampened somewhat in the coming years.

Inflation is the Riksbank's particular responsibility. The Riksbank's objective is to maintain inflation at around 2 per cent a year. We measure inflation as a change in consumer prices. Last year inflation was over 1.4 per cent.

Over the past twelve months the main contribution to the increase in the consumer price index, or CPI, came from increased interest costs. However, higher electricity prices, rents and food prices also contributed to the increase in price levels. Price reductions on post and telecommunications had a dampening effect on inflation, as did falling prices for computers, DVDs and TVs. CPI is affected by technological changes, making it cheaper to make phone calls and to use the Internet. Inflation is also affected by the changes that come under the designation of globalisation, and that lead to increased trade and competition and to, for instance, cheaper imports of TVs.

During the first three months of the year, inflation has not been as low as expected in the forecast made in February. This is mainly because energy prices have been slightly higher than calculated. In February we believed that CPI would be 1.5 per cent in March. Instead it was 1.9 per cent.

Higher costs lead to higher prices

One explanation as to why inflation is expected to rise in future is that growth in productivity – how much is produced per hour worked – is slowing down. At the same time, wages are rising slightly faster than they have done in recent years. All in all, this means that companies' costs are rising more quickly. It is difficult to say when a higher rate of increase in costs will lead to a higher rate of increase in prices. Many Swedish companies are currently making large profits and can probably manage a period with higher costs without raising their prices. There are also other factors holding back inflation. For instance, prices of many imported goods are continuing to fall.

Better understanding productivity

Inflation has been below target since the beginning of 2004, but we can now see that it has begun to increase again. The low inflation can largely be explained by the surprisingly strong productivity. Over the past fifteen years Sweden has had higher productivity growth than many other industrial nations, including the United States. Productivity is important for the development of inflation in the slightly shorter term. If productivity rises quickly, wages can increase without the companies' costs rising. High productivity growth thus leads to low inflationary pressure, all other things being equal.

We still know too little about what lies behind the strong productivity growth. There are many indications that globalisation and increased use of information technology play an important role.

These changes have probably led to many companies meeting tougher competition that has forced them to rationalise. However, IT developments have also given them new tools to make their production more efficient. In other words, there has been an increase in both the driving forces and the opportunities for making production more efficient.

We must become better at understanding the driving forces behind productivity growth. For instance, the Riksbank has begun a project to gain greater insight into the relationship between investments in IT, organisation changes, on-the-job training and productivity. At the beginning of May we organised a seminar where a number of organisations and authorities presented their views on the situation. In December we will also be organising a workshop where external researchers will contribute valuable points of view. As a complement to this, we are creating channels for direct contacts with companies. The purpose is to improve our knowledge of the current status and current events in the economy.

Hopefully this will make us wiser with regard to developments in productivity growth. But at the same time, one must have realistic expectations of what can be achieved from this work. It will probably always be difficult to assess future developments in productivity.

Wage increases slightly higher than expected

The wage bargaining rounds in Sweden have entered the final phase. Large central agreement areas such as manufacturing, trade, construction, the hotel and restaurant and the local government sectors have concluded their agreements. These have been slightly higher than we had expected in February. But just like other observers, we find it difficult to translate all of the ingredients in the agreements into exact forecasts for companies' wage costs. What we do know is that in the long term, productivity growth determines the size of the wage increases that are possible for the economy.

The actual wage increases have several components. These include the agreed levels of wage increases and also wage increases in addition to the central agreement. The strong labour market involves risks of higher wage increases outside of the agreements than was the case in the previous wage bargaining rounds.

One means of managing higher growth without this leading to a wage and inflation spiral is to get more people to participate in the labour force. The Government's Autumn and Spring Budget Bills have contained several measures aimed at increasing the labour supply. If more people take part in the labour force, wages and thereby inflation should be held back. Developments in the wage bargaining rounds so far do not indicate that the potential labour supply is holding back wage demands quite as much as we had earlier estimated.

Abolition of property tax on housing

One of the Government's proposals that has received considerable attention is the proposal to abolish property tax on housing. A working group has been commissioned by the Government to investigate a model that would finance this tax cut in the housing sector. In this model, the tax is replaced by a municipal charge and higher tax on profits made when selling property. In theory, a fully-financed proposal should not involve any effects on general housing price levels. However, in practice there is reason to believe that house prices will increase at a slightly faster rate due to the tax changes. In those parts of the country with high property taxes, and where the difference between the municipal tax and the current property tax is substantial, there could be fairly large price increases. But this would probably be mainly a one-off effect that did not have any more long-term effect on the rate of price increase. Therefore, a fully-financed abolition of the property tax would not necessarily have any major direct impact on CPI inflation. But one cannot rule out the possibility that it would have some effects on, for instance, consumption, and would thereby also contribute to strengthening demand, even if the effects were not substantial.

The Riksbank and monetary policy

The Riksbank's task is to use all this information on what is happening in the Swedish economy and abroad to make a forecast of future inflation. The aim is normally to attain the inflation target within two years. The fact that we have this horizon is because monetary policy has an effect on economic developments after a time lag. We also want to have the opportunity to adjust the interest rate

gradually to take into account developments in what economists call the real economy. This refers to basic economic concepts such as growth and employment.

In the long run, monetary policy cannot affect either growth or employment. These are instead governed by factors such as population growth, technological developments and the way various markets function. But by setting the interest rate at the right level we can ensure that fluctuations due to variations in economic activity are slightly smaller. At the same time, we must not forget that the interest rate is a blunt instrument. It cannot be used to fine tune the economy.

The development of the repo rate

Last year we raised the repo rate by a total of 1.5 percentage points to 3.0 per cent. In February this year the interest rate was raised by a further quarter of a percentage point to 3.25 per cent. At the most recent monetary policy meeting on 3 May we decided to keep the repo rate unchanged. At the same time, our assessment was that the repo rate will need to be raised gradually, which we had also assumed earlier. Now we believe that it will need to be raised more than was anticipated in February. This is necessary so that inflation will develop in line with the target.

The main reason why we need to revise our forecast upwards is the outcome of this year's wage bargaining rounds. The central wage agreements have been slightly higher than we had earlier had reason to believe, given that unemployment is still quite high in Sweden.

Some forecasters have believed in a higher interest rate path than we have predicted. However, this does not appear to be because their forecasts for wages or fiscal policy have differed substantially from those made by the Riksbank. I would also like to point out that so far there are no dramatic differences in our picture of current economic developments today compared with February. We will return to this in the Monetary Policy Report to be presented in June with a more detailed account of how we view the situation.

Own interest rate forecasts

When we expressed our views in February regarding the future development of the interest rate, it was the first time we presented our own assessment of the future repo rate path. By this we mean that we try to calculate what we believe will be a well balanced monetary policy over the coming years. Previously we presented forecasts for the economy on the basis of what the financial market participants believed about the repo rate. Now that we are presenting our own interest rate path it will be clearer both what we believe about the interest rate and what we believe about the economy in general. We consider this to be a major step forward in the Riksbank's way of explaining how monetary policy functions. For most people I believe it is more important to have an idea of the development of the interest rate over time, rather than to know what an individual interest rate decision will entail.

In this context I always try to be as clear as possible. The interest rate path is merely a forecast, not a promise. The economic conditions on which we base our forecasts are constantly changing. Changes are constantly taking place in the economy, which means that we have to reconsider our opinions of future developments. The interest rate path represents nothing more nor less than the best assessment we were able to make at the time it was published. When the world around us changes, we also have to change our forecasts.

Arguments in favour of openness and clarity

It is sometimes described as a problem that considerable openness also means that one displays one's mistakes. If we present an interest rate forecast that extends several years ahead, there is of course a substantial risk that we must change our forecast. I cannot see why this would be a problem. Anyone with insight into forecasting work knows how difficult it is to make assessments of future events. Once upon a time, mystery and prestige were perhaps important assets for a central bank. But the way that monetary policy is currently conducted in Sweden and many other countries means that this no longer applies. The key concepts for a modern central bank are rather clarity and openness. Showing how the forecasts for the repo rate change when new information is received should lead to a better understanding of how monetary policy is conducted.

There are primarily three types of argument in favour of openness and clarity. Firstly we have the democratic argument. The Riksbank's independence means that the general public can require us to be open. There is also an economic argument. If it becomes clearer how we view the interplay between monetary policy and the rest of the economy, it will be easier for monetary policy to have the intended effect. Last, but not least, there is an argument concerning our own methods of working within the Riksbank. By being open and clear towards the outside world, we force ourselves to become better at analysing. When it is easier to evaluate how well monetary policy functions, there is greater pressure on us to do a good job.

Our decision to publish an interest rate forecast has made it possible to compare different forecasters' assessments. It has further stimulated the debate on monetary policy and the economy. And this is excellent. More voices and clear opinions increase the possibilities for making well-founded assessments.

The fears expressed by a number of academics and practitioners that financial market participants will now stop making their own forecasts of the interest rate have not been realised. Even after the interest rate path is published, there will still be a broad spectrum of opinions on how the economy and the interest rate will develop in the future. There is nothing unusual in this. Those who operate in the financial markets know that we live in an uncertain world and for this reason they will continue to make independent assessments of interest rate developments.

Changes in communication

The Riksbank recently decided to take a further step towards greater clarity in its communication.

Firstly, we will in future hold press conferences after each monetary policy meeting, regardless of what decision has been taken. Previously, press conferences have only been held if the repo rate has been changed or when a Monetary Policy Report has been published. However, information on why the repo rate is being kept unchanged is in principle just as important for understanding the monetary policy conducted as is information on why the repo rate is being adjusted.

Secondly, we have decided to make changes with regard to monetary policy signalling. By this I mean how we on the Executive Board of the Riksbank communicate what we intend to do with the interest rate. Now that we publish an entire path for the interest rate, the need to signal between the meetings has declined. Our conclusion is that there will not normally be any reason between the monetary policy meetings to give an indication of how the interest rate will be set. In exceptional cases, such as when an event occurs that radically changes the economic situation, while there is a long time to go until the next meeting, there may be reasons to signal between two monetary policy meetings. Of course the individual Executive Board members should continue to be able to express their own opinions publicly. But this is above all a question of afterwards clarifying and explaining personal deliberations made in connection with the monetary policy meetings. Differences of opinion within the Executive Board will also, as before, be made clear when the minutes of the meetings are published.

This leads me on to the third change we have decided to make. The minutes from the monetary policy meetings will now include the names of the Executive Board members in relation to the discussion and not merely if they enter a reservation against the majority decision. In this way it will be easier and clearer to examine the motives behind the monetary policy decisions and therefore also to form an impression of future decisions.

These and all of the other changes we have made in recent years are intended to create the best possible opportunities to understand, evaluate and debate monetary policy. The debate on monetary policy is important and useful for us. It contributes to developing the way we work. The Riksbank's openness, which we are now increasing further, enables a qualified public debate, which in turn is a part of how we can ensure accountability in a democracy.

Thank you!