Irma Rosenberg: Current monetary policy – a difficult balancing act

Speech by Ms Irma Rosenberg, First Deputy Governor of the Sveriges Riksbank, at Nordea, Stockholm, 11 March 2008.

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At the monetary policy meeting on 12 February the Riksbank decided to raise the repo rate by 0.25 percentage points to 4.25 per cent. I entered a reservation against the decision and considered that the repo rate should be left unchanged. However, it was far from a clear stance. I would therefore like to take this opportunity to explain my reasoning more clearly and the considerations monetary policy has to take into account.

I will also comment on some of the statistics received since the monetary policy meeting. In this context it feels natural to briefly comment on some of the criticism we have received, namely that the Riksbank has been altogether too silent about how we view economic developments. It is possible that during the autumn, at the beginning of the financial turmoil, we underestimated the need for the Executive Board members to comment on the developments we see around us. It is also possible that we more generally underestimated the need, even in less turbulent times, to discuss our latest assessment and to relate it to the new statistics received since the most recent monetary policy meeting. All this, that is, our published forecasts and new outcomes, is public information and this link can be made by all those who follow our work. However, for the sake of clarity, I also intend to now run through some of the important information that has been received since the monetary policy meeting on 12 February. However, I will not be saying anything about what the new information means to future interest rate developments. This is something that we Executive Board members will have to decide at our next monetary policy meeting.

The material for the February decision

In the Monetary Policy Report published in February an account is given of the way in which the majority of the Executive Board view the prospects for inflation and development of the real economy in Sweden and abroad during the coming years. The monetary policy considerations are also shown and the assessments are based on the forecast for the repo rate described in the report. The main scenario of the report forecasts continued high cost pressures in the Swedish economy and weaker economic growth both abroad and in Sweden, albeit still good. It can be added that the forecast had changed only marginally since the December Monetary Policy Update.

Growth in the United States and the euro area is expected to be considerably lower than last year and also lower than the trend development. Even in the world as a whole growth is expected to slow but remain good since emerging markets such as China and India are expected to continue to grow at a rapid rate. In the main scenario the recovery in the United States and the euro area is expected to begin during the second half of this year and next year growth will largely be back at the trend level. Growth in Sweden is expected to be approximately the same this year as last year, but in reality this is a weakening if one takes into account the larger number of working days this year.

Inflation in Sweden rose rapidly in the autumn and, measured by both the CPI and the CPIX, is expected to exceed the inflation target during a large part of the forecast period.

The uncertainty over future economic developments is still considerable, however, and to highlight this a number of alternative scenarios are described in the Monetary Policy Report. One of these involves greater financial turmoil and that growth abroad will slow down more sharply. In this scenario growth in the US economy will fall more than in the main scenario, at the same time as the borrowing costs for households and companies in the whole world will be higher. This leads to a general dampening of demand and to lower GDP growth and inflation both abroad and in Sweden.

But, as we have written in previous reports, there is also a risk that inflation will be higher than in the main scenario if wage developments are stronger and productivity weaker than expected. In addition, the risk has grown that prices abroad may increase at a faster rate than in the main scenario, which would have an impact on inflation in Sweden also.

My international outlook in February

We must look at the overall picture when we make our monetary policy decisions. The forecast in the report should be seen as an average forecast, which is always surrounded by a substantial uncertainty interval. In this case it was unusually difficult to have an idea of the probabilities for the different outcomes. Even though the present situation has certain similarities with some previous episodes, the differences outweigh the similarities and there is, therefore, little previous experience to learn from.

Prior to the monetary policy meeting in February I felt, and still do feel, more concern over international developments than is reflected in the main scenario of the Monetary Policy Report. My view of international developments did not differ greatly from that of the main scenario in the short-term perspective. However, I was concerned that the financial crisis would be both deeper and more protracted than was forecast.

The financial market turmoil continued up to the monetary policy meeting. The problems in the interbank market appeared to have been alleviated to some extent, although interbank rates were still higher than normal and risk premiums in the credit market continued to be high. The turmoil continued to be great and the financial crisis expressed itself in other ways.

It will probably take a long time to gain a general view of the extent to which international banks and other financial institutions will be forced to write-down losses. One relatively late consequence of the crisis was the problem for the so-called monolines, that is, insurance companies that insure bond loans. Many of them risked being downgraded by the credit rating agencies and this has since been the case for several of them. As I saw it, these problems could lead to a substantial credit crunch.

Developments on the world's stock markets were another clear expression of the financial turmoil. Since the international stock market fall began last summer, and up until the February monetary policy meeting, prices on the largest stock exchanges had fallen by between 15 and 30 per cent. Just since the beginning of the year prices had fallen by 10-15 per cent. It is difficult to predict how the existing turmoil on the financial markets will affect developments around the world and in the Swedish economy. The financial sector in Sweden is outside of the worst crisis area since it has small direct exposures to the most problematic areas of the securities markets, but my assessment was that the Swedish economy would be affected by a continued crisis with abnormally high interest rates and elements of credit rationing.

The problems in the US housing market also continued. According to real estate statistics, house prices had fallen in all regions. As long as the adjustment continues, there is a risk that the problems in the subprime market will be aggravated and the financial turmoil will intensify.

It is difficult to assess how the financial turmoil and the problems in the housing market affect the real economy. Growth in the United States weakened substantially during the final quarter of last year and the fall in housing investments made a significantly negative contribution. Nonetheless, household consumption was maintained relatively well during the fourth quarter. The question is how resistant household consumption, which corresponds to approximately 70 per cent of GDP, will be given the shocks facing the US economy. The fact that house and share prices are falling means that household wealth is declining, which could have a negative impact on demand. The upturn in oil and food prices also means that households' purchasing power is being undermined. These negative effects have been counteracted to some extent by the Federal Reserve's cutting the policy rate and by various fiscal policy measures. The forecast in the main scenario of the Monetary Policy Report entails fairly weak growth in the US economy over the coming quarters. Nevertheless, I considered there to be an evident risk that the problems would be more prolonged than was forecast in the main scenario of the Report.

Growth in the euro area was also more subdued in the fourth quarter last year. The outcome had not been published at the time of the monetary policy meeting, but it was largely as expected. Households in the euro area appear to have been very restrictive with their consumption expenditure. Retail trade turnover fell at the end of last year and it is also possible to discern from survey data that household confidence has declined. As in the United States, more prolonged problems in the financial markets can lead to developments being weaker than in the main scenario.

My view in February of developments in Sweden

Inflation has gradually risen in Sweden in recent years. On average, measured in terms of the CPI, inflation was 2.2 per cent last year, which is close to the inflation target. The upswing in inflation was partly due to resource utilisation in the economy having increased and cost pressures having risen. Hourly wages increased more rapidly than before at the same time as productivity growth slackened considerably. Inflation has been very low for several years, but in 2007 rising cost pressures were a factor that contributed to inflation reaching the target. Underlying inflation, measured in terms of the CPIX, was however 1.2 per cent as an average for 2007.

During the autumn of last year inflation rose very quickly and, measured in terms of the CPI, reached 3.5 per cent in December. Underlying inflation, measured in terms of the CPIX, rose to 2 per cent in December. The rapid upturn in inflation last autumn was largely due to rising energy and food prices, a reflection of the fact that prices rose rapidly on the world market. At the monetary policy meeting I pointed out that it is not possible to immediately counteract such rapid price impulses from abroad with monetary policy. Quite simply, it must be allowed to take some time. In the Monetary Policy Report the rapid price increases are to some extent assessed to be of a temporary nature. If world market prices do not continue to rise at the same rapid pace in future, inflation will fall back again. This is also what is forecast in the main scenario of the Report. However, to some extent, it also concerns the effects on inflation which risk becoming more permanent and which may need to be counteracted with monetary policy.

When inflation rises and is above the target, as CPI inflation now is, it is important that it is not allowed to become entrenched and become permanently high. The risk of this increases if inflation expectations rise, and that is exactly what has occurred. Inflation expectations have risen not just one year ahead, but even two and five years ahead, which is troublesome.

The monetary policy decision

The upturn in inflation and in inflation expectations in the slightly longer term were also factors that indicated the interest rate should be raised at the monetary policy meeting in February. The forecast in the main scenario of the Monetary Policy Report means that growth will slacken but will still remain good during the forecast period. I personally was slightly more concerned about the problems in the financial markets and the risk of weaker developments abroad, which would of course also affect developments in Sweden.

As the minutes of the meeting show I was, on the other hand, not quite as concerned about cost pressures as before. Wages did not appear to be rising as quickly as the Riksbank assumed shortly after the new agreements were met last year. The wage forecasts were also adjusted downwards in the Monetary Policy Report. In addition, my opinion was that the slowdown in productivity growth last year was more comprehensible when the publication of National Account statistics for the third quarter showed that output growth had clearly slowed down as early on as at the beginning of 2007. Growth in the number of hours worked did not slacken as output growth. This is the normal pattern when growth slackens in that the labour market typically lags behind somewhat in the economic cycle. I therefore assessed that weaker productivity growth indicates that companies will be more restrictive in recruiting labour rather than that we will see rapid price increases in the future.

When I weighed together the great uncertainty about developments in the financial markets and the risk for a weaker development abroad with the Swedish economic outlook and the risk of inflation in Sweden remaining high, my conclusion was that the interest rate should be left unchanged. I would like to emphasise that it should not be regarded as though I wished to attach less weight to the inflation target. It was and is more a question of how much time it will take to bring inflation back on target. I also pointed out that the Riksbank has raised the interest rate in a number of stages since January 2006 and that these increases have not yet had a full impact on the economy.

What has happened since the monetary policy meeting?

So far my assessment is that outcome data and indicators in the euro area are largely in line with the assessment in the main scenario of the Monetary Policy Report. My opinion is also that the indications of weak US growth at the beginning of this year and the continued problems on the housing and property markets are in line with the assessment in the main scenario. In the short-term perspective the assessment does not differ from my own. I am however more concerned that it will take longer before the recovery gathers pace.

Swedish GDP growth during the fourth quarter last year was somewhat stronger than expected in the Monetary Policy Report. Employment, measured as the number of hours worked, increased at an unexpectedly high rate and productivity growth last year was weaker than expected in the Report.

The National Institute of Economic Research’s business tendency survey for February shows a clear slowdown in economic activity in the business sector as a whole. The business tendency survey suggests that employment has continued to increase, but at a slower rate. Companies have adjusted their recruitment plans downwards ahead of the coming months. In contrast, the purchasing managers index displays a more positive view in February. The total index rose somewhat and during several months fluctuated around the level of 55, which is close to the average since 2001. However, at the same time, the survey shows that growth in employment has slackened and that companies have become less optimistic about output growth in the future.

In January inflation in Sweden was somewhat lower compared with the forecast in the Monetary Policy Report. However, this was largely connected with the fact that the weights in the CPI basket, as at the end of each year, had changed. The effects of this change were unusually large this time. This could be interpreted as though consumers, to a greater extent than normal, have replaced goods and services that increased rapidly in price in their consumption. The so-called substitution effect was then greater than the Riksbank and most other analysts had assumed.

All in all, activity in the Swedish economy during the final quarter last year appears to have been slightly higher than we expected in February. Productivity on the other hand showed weaker development than in the assessment in the Report. Survey data clearly suggests however that a slowdown is occurring in most parts of the business sector and that the increase in the demand for labour is on the point of slowing.

The turmoil has once again increased in the financial markets around the world. This suggests that these are complicated processes that can be protracted. The so-called TED spreads, which is the spread between interbank rates and T-bill rates, have risen once more, above all in the United States but even in Sweden and the United Kingdom. Credit spreads are still high. In recent days the spreads on the mortgage market in Sweden have increased. This is linked to the unrest on the mortgage markets in a few other European countries. Credit insurance premiums have risen recently both in the United States and Europe. New reports about losses related to the US subprime sector are being received. Share prices in Europe and the United States have fluctuated somewhat, but are at present somewhat lower than at the time of the monetary policy meeting. The krona has strengthened somewhat, especially against the US dollar.

Conclusion

As I mentioned initially, I have in this speech referred to some of the new information received and compared it with the forecasts made in connection with the February Monetary Policy Report. It is important to point out that a lot of important new statistics will be received prior to the next monetary policy meeting in April, and it is not until then that an overall assessment can be made of the monetary policy consequences.

When I look at what has happened since out monetary policy meeting on 12 February I think that events so far support the general outline given in the Monetary Policy Report. Neither does the difference between my own assessment and the main scenario apply to developments in so short a term as a month or two. My slightly more pessimistic view applies to what the consequences might be of the turmoil in the financial markets. It is a question of the risk of a weaker development abroad and the consequences this may have on developments in the real economy and inflation in the Swedish economy. My assessment in February was that, given the considerable prevailing uncertainty, we should wait before raising the repo rate. At the same time, it is important to emphasise that all we Executive Board members, regardless of our stance at the most recent meeting, look seriously upon both the risk of aggravated financial turmoil and weaker development abroad as well as the risk of inflation in Sweden becoming entrenched at a high level. It is not easy to weigh these risks against each other and I therefore believe that it was not so remarkable that we Executive Board members reached slightly different conclusions in our deliberations at the meeting in February.