Stefan Ingves: Introduction on monetary policy

Speech by Mr Stefan Ingves, Governor of the Sveriges Riksbank and Chairman of the Basel Committee on Banking Supervision, to the Riksdag Committee on Finance, Stockholm, 10 November 2011.

*   *   *

Clouds have gathered recently in the form of the financial unease and the debt crisis in Europe. As Sweden is a small, open economy we are affected in many ways by developments abroad. Nevertheless, we must of course do what we can to ensure stable economic development in Sweden. In the face of turbulence abroad we must make sure that we maintain order in the Swedish economy. The economic-policy framework in Sweden has worked well. We have learned from the mistakes we made in the past and are now in a much more favourable position than many other countries. This is something that we must build on, and monetary policy is trying to play its part in this.

Today I will begin with an international tour before returning to Sweden. When the tour is complete, I hope that I will have shed some light on the following questions:

- What is happening abroad and how is it affecting us?
- How can we ourselves facilitate developments in Sweden – particularly with the help of monetary policy?

What is happening abroad?

Drama on the financial markets of the world

There have been dramatic developments on the financial markets since the summer. Stock markets have plummeted (see Figure 1). The unease on the financial markets has also contributed to falling long-term interest rates in Sweden, the euro area and the United States (see Figure 2). How does this fit together? Well, in turbulent times investors flee high-risk investments such as shares and turn instead to safe assets like government bonds from countries with a low credit risk. As a result, the price of bonds increases and interest rates fall.

Basically, the financial unease is due to the problems with public finances, above all in southern Europe, and in these countries government bond rates have instead increased substantially (see Figure 3). This is because investors, as in the case of shares, believe that it is increasingly risky to invest in these assets, so prices fall and interest rates increase. There has also been a significant fall in commodity prices recently, which is partly because the emerging economies have also been affected by the international turbulence (see Figure 4). Strong demand from the emerging economies has been an important driving force behind the upturn in commodity prices in recent years.

In parallel with the unease on the financial markets, there has also been a considerable decline in confidence in the world economy (see Figure 5). So what is it that is causing so much unease? Let’s begin by looking more closely at the situation in Europe.

Europe – from financial crisis to debt crisis

In connection with the financial crisis of 2008–2009, problems relating to major budget deficits and sovereign debts became apparent in several countries: primarily in Greece, but also in Ireland, Spain and Portugal (see Figure 6).

One could say that the position of several countries was already too weak when the crisis began, but also that their situations differed somewhat in nature. Greece had long been struggling with a budget deficit and a high sovereign debt (see Figure 6). In the case of Ireland the sovereign debt was not so large when the crisis began, but the combination of a burst property bubble and a large banking sector meant that the costs of supporting the financial sector became enormous (see Figure 6)

Since the end of last year, a number of support measures have been implemented by the ECB, the EU and the IMF. These measures have been vital to the effort to manage the acute problems. On the other hand, it is absolutely clear that neither the European Financial Stability Facility (EFSF) nor the other support programmes can do anything about the long-term problems.

In the longer term, structural measures are instead required to strengthen competitiveness in the countries with debt problems. Costs have increased far too much in several of these countries (see Figure 7). As these countries have adopted the euro, weakening the currency is not a possible escape route for them, providing that they wish to remain within the monetary union. The best way for these countries to increase their competitiveness is instead to employ what is usually called internal devaluation. This means that wages and prices must increase at a slower rate than abroad for a while. Another important measure in this context is to implement reforms that increase long-term growth and productivity.

There are also various political problems that have to be resolved. Difficult dilemmas arise when economic cuts lead to discontent on the part of the public, whose support is needed. In this context the politicians also have to meet a number of pedagogical challenges. They have to be able to explain the choices the country is facing and the consequences of various courses of action. There is a great difference between what you want to achieve and what you can achieve. For example, the desired standard of living is a value judgement, while the possible standard of living is a result of how well the economy works in terms of the potential for long-term growth, how sound public finances are and so on. Another problem is that interest rates rocket when there is a lack of faith in the ability of the political sphere to take action, which further aggravates the problems.

So, how can one overcome these difficulties? The key is that measures designed to put public finances on an even keel and improve competiveness are made credible and therefore implementable. In some cases, such as Greece, stronger institutions are also needed to ensure that tax revenues are safeguarded in the future. The main responsibility for this of course lies with the politicians in the respective countries.

In parallel with this long-term work, the support measures designed to resolve the acute difficulties need to continue. Hopefully this will help us to reduce the widespread financial unease. All in all, however, it will still take time to resolve the debt crisis in Europe.

Slow growth in the euro area, but no recession

Real fiscal-policy improvements are thus required in several of the euro countries in the period ahead in order to stabilise sovereign debts. We therefore expect growth to be weak in the euro countries over the next few years, although the picture varies from country to country. Germany is a locomotive for growth in the euro area.

It is important to remember that the euro area is still managing to get along, even though growth in the area as a whole is not so strong (see Figure 8).

The United States – weak recovery with bright spots

The situation in the United States is, like that in Ireland, the result of an overheated housing market and dramatic falls in housing prices in combination with structural problems. The US economy was in many senses the epicentre of the financial crisis. There are a number of problems that need to be dealt with.

First, many households in the United States have fallen into difficulties because their debts exceed the value of their homes. The households have therefore needed to increase their saving, which they have done. As a result, private consumption has grown slowly for some time but does have the potential to recover in the period ahead.

Second, public finances are weak in the United States too (see Figure 9). The situation became more dramatic in the summer when the country's credit rating was reduced. The political deadlock in the US Congress was one of the main reasons for this. A major advantage in the United States is that, so far, government bond rates have remained very low (see Figure 2). However, it is important that these problems are resolved so that this positive trend can continue and so that interest rates do not begin rising as they have done in several countries in southern Europe.

There are, however, a number of bright spots with regard to the US economy. One is that the companies are making good profits. We have to go all the way back to the early 1950s to find as high a level of profits in relation to GDP as there is now. When confidence returns there is therefore every chance that investment and employment will recover. The current very high level of unemployment may then fall in the period ahead.

All in all, our assessment is that growth in the United States will nevertheless be slow in the near future, but that it will be stronger than in the euro area (see Figure 8). In this context too, it is important to point out that this is a case of weak growth that will subsequently recover when confidence returns.

Global growth holding up

One consequence of the financial unease and the decline in confidence is that global growth will fall this year. Nevertheless, we expect it to be around 4 per cent over the next few years (see Figure 8). The reason for this is that global growth will be maintained by a number of economies other than the United States and those in the euro area, mainly the so-called BRIC countries (Brazil, Russia, India and China). These countries have acted as growth engines for the global economy in recent years and we expect this to largely continue to be the case.

Following this tour around the world it is time to return to Sweden and to look at how we are affected by all the things I have mentioned so far.

How is Sweden affected?

We can say that Sweden is mainly affected by events abroad through three channels: through ***exports***, through the ***financial markets*** *and* ***through the international dependence of Swedish banks***.

Subdued demand for exports

As I mentioned in my introduction, Sweden is a small, open economy with a high degree of foreign trade. Our exports are affected by the level of demand abroad. We expect the BRIC countries to grow at a much faster rate than the United States and the euro area in the period ahead. One way for Swedish companies to adapt to this is to try to export to the rapidly-growing countries to a greater extent. We can see that this is something that is already happening when we look at how high a percentage of our exports go to different parts of the world (see Figure 10).

However, this is a process that will take time; the BRIC countries still account for only a small proportion of Swedish exports. If the trend we have seen over the last 10 years continues for another 10 years, then the BRIC countries will have increased their share of Swedish exports to 15 per cent of the total, but they will still not have reached even half of the share of the euro countries. Europe and the United States will thus continue to be very important export markets for Sweden for a long time to come. The conclusion is that weaker growth in Europe and the United States will have a negative impact on exports, even though new markets are gaining ground. Growth in Swedish exports will therefore be subdued going forward (see Figure 11).

Stock market falls creating uncertainty

There are now strong international links between the financial markets. Share prices have fallen dramatically in Sweden as in a number of other countries (see Figure 1). This in turn has had a highly-negative impact on the confidence of Swedish households and companies (see Figure 12). We could say that a "wait-and-see" attitude is guiding the households and companies at the moment. The households are saving more and investment is weak because people are simply waiting to see what happens in the present uncertain climate.

The banks may find it more difficult to get funding

The Swedish banks form another channel through which the increasing unease abroad may have an impact in Sweden. In this connection it is worth pointing out that the Swedish banks have little direct exposure to the countries in southern Europe that are experiencing public-finance problems and that they are well capitalised compared to banks in other countries. So, what are the risks?

Traditionally, the Swedish banks' lending has been largely funded by deposits from Swedish bank customers. However, in recent years an increasing share of the funding has instead taken the form of market funding, often in foreign currencies (see Figure 13). A greater degree of stress in the financial system may reduce the effectiveness of these markets. This may in turn affect both access to and the price of the Swedish banks' market funding, even if the cause of the stress lies outside Sweden. The Riksbank is monitoring developments closely, but our assessment is that at the moment there are no funding problems for the Swedish banks on the international capital markets.

To sum up we can say that the turbulence around the world will have a dampening effect on Swedish growth in the period immediately ahead. The clearest signs of this so far are the weak stock market in Sweden and the dramatic decline in the confidence of the households and companies, which is reducing demand.

How can we ourselves facilitate developments in Sweden?

We have laid stable foundations – which we must build on

Although we are dependent on what happens abroad, we must do what we can to keep the economy on an even keel in Sweden. We can compare the situation to our own personal finances. Various external circumstances that we have no control over can undermine our financial situation. However, if we have had a firm grip on our personal finances before this happens, we will be better prepared and have a better chance of managing the situation.

But how can we relate this to the Swedish economy as a whole? If we return to Figure 7 we can see that labour costs over the last 10 years or so have increased more slowly in Sweden than in the euro area. We can also go back to Figure 9. Here we can see that while sovereign debts have increased considerably in the United States and the euro area in recent years, Sweden's sovereign debt has decreased more or less continuously over the last 15 years.

This indicates that the economic-policy framework in Sweden has worked well. The framework reflects the lessons we have learned from our own problems in the past, not least during the 1970 and 1980s, and we should build on this. The framework largely addresses three areas: fiscal policy, wage formation and monetary policy.

The first area, fiscal policy, had to be changed following the crisis of the 1990s as the problems with Sweden's public finances became acute. At the same time as austerity packages were implemented, great importance was attached to not ending up in the same situation again. The introduction of surplus targets, expenditure ceilings and the stipulation that municipalities should have balanced budgets also contributed to increased stability in public finances. A number of important reforms were also implemented that significantly improved the budget process. Figure 14 clearly shows the positive effects of all this on the budget.

The second area is wage formation, which has also improved considerably since the mid-1990s. The Industrial Agreement and the setting up of the National Mediation Office are two important factors behind this improvement. Nominal wage increases have been significantly lower over the last 15 years than in the 1980s. The development of real wages shows how much of the wage increases are left when a deduction is made for inflation. Real wages have increased by an average of 2.5 per cent since 1995, while they did not increase at all during the 1980s (see Figure 15). In real terms, wages have thus developed much better over the last 15 years than during the 1980s.

The third area relates to inflation and monetary policy. Monetary policy was also changed in the light of lessons learned in the past, in this case during the periods of high inflation in the 1970s and 1980s. An explicit inflation target and an independent Riksbank have had a positive impact. Inflation has been low and stable since the mid-1990s and has largely been in line with the target (see Figure 16). The success of the inflation-targeting policy is also linked to the fact that fiscal policy and wage formation have been much more effective since the mid-1990s.

We have thus learned from the past, and as a result Sweden's economy is well equipped to meet the future. It is important that we make the most of this strong initial position in the period ahead, and monetary policy must of course play its part in this.

So, what course can we expect development to take in Sweden in the future, and how can monetary policy help to smooth the way?

Growth in Sweden will gradually recover…

In the wake of the financial crisis there were dramatic fluctuations in production in 2009 and 2010, with a fall in GDP of over 5 per cent followed by an increase of over 5 per cent (see Figure 17). The National Accounts indicate that growth continued to be strong in the first half of this year, but not as strong as in 2010. As I have mentioned already, "soft data" in the form of confidence levels and so on looks much weaker as a result of the global unease. Our assessment is therefore that there will be a substantial slowdown in growth next year (see Figure 17).

Thereafter we expect growth to increase towards 2.5 per cent, which historically speaking is a rather normal level (see Figure 17). An important driving force for an increase in growth in the period ahead is that the households have a high level of saving to start with (see Figure 18). Saving is expected to remain high in the immediate future due to the unease around the world, but as unease subsides it is likely that the households will reduce their saving. Consumption may then increase at a relatively good rate.

The labour market has improved and unemployment has fallen rather rapidly since the end of 2009. Our assessment is that this improvement will now slow down. Unemployment will continue to fall, but at a slower rate. Our assessment is that unemployment will reach approximately 6.5 per cent at the end of the forecast period (see Figure 19). A lasting reduction in the level of unemployment also demands that wage formation is effective so that costs in the business sector do not increase too rapidly.

…and inflation can approach the target

A new round of collective bargaining has now begun and the wage demands presented so far are higher than those presented in 2010. The Riksbank's assessment is that wages will rise by almost 3.5 per cent per year in the years ahead. This is compatible with the inflation target. The assumption behind our forecast is that wage formation will work as well as it has over the last 15 years. Responsibility for this lies with the social partners.

The krona is an important factor for inflation in Sweden as it determines how prices abroad are "translated" into import prices in Sweden. Historically the krona has weakened in periods of financial unease as investors often move their money from small currencies like the krona to the dollar and the euro. However, the krona has weakened only moderately this time, despite the financial unease (see Figure 20). We expect the krona to gradually strengthen as the financial unease subsides. The combination of falling commodity prices internationally and a stronger krona means that inflationary pressures from abroad will be rather low in the period ahead.

CPI inflation still reflects the effects of the previous repo-rate increases on housing costs. Various measures of underlying inflation show that inflationary pressures are moderate (see Figure 21). As economic activity recovers, underlying inflation will gradually rise towards 2 per cent in the years ahead.

Continued low repo rate will facilitate stable development

Our forecast for the repo rate is that it will remain unchanged until sometime next year and that monetary policy will continue to be expansionary — the repo rate is low in an historical perspective (see Figure 22). This will contribute to a gradual normalisation of inflation. Apart from stabilising inflation, monetary policy also aims to stabilise the real economy. Stabilising the real economy means, in more concrete terms, stabilising resource utilisation, that is the deviation of production and employment from long-term levels. Resource utilisation can be measured in many ways, but our overall assessment is that it is somewhat below normal at present. An ongoing expansionary monetary policy may also help to normalise resource utilisation during the forecast period. As resource utilisation and inflationary pressures increase, the need for an expansionary monetary policy will decline. There will be a need to gradually raise the repo rate to bring inflation close to the target and to stabilise resource utilisation.

As the situation is highly uncertain, however, things may develop in a different direction than we expect. We see two main risks at present.

First, our forecast presupposes that it will be possible to manage ***the debt crisis in Europe*** so that the acute problems can be resolved. There is a risk that the problems will continue and that the debt crisis in Europe will get worse, which may lead to weaker economic activity in Sweden and abroad. If this proves to be the case, monetary policy in Sweden will have to be more expansionary to mitigate the effects of the more severe crisis. Conversely, it is possible that political agreements will be reached fairly soon and that the financial unease will subside more quickly than we expected. This could lead to stronger economic activity in Sweden and abroad than expected, and it will then not be necessary for the repo rate to be so low.

Secondly, the outcomes for inflation abroad have been surprisingly high recently, despite falling commodity prices and weaker economic activity. There is therefore a risk that the situation abroad will be characterised by economic stagnation and high inflation, so-called ***stagflation***. Central banks abroad may then be faced with a very difficult balancing act. The risk of further weakening economic activity will reduce the scope for raising policy rates to combat inflation, which may result in inflation continuing to be high. All in all, there is therefore a risk that inflation abroad may not fall to the extent we expect. This will lead to higher inflation in Sweden too through higher import prices. A higher repo rate with then be needed in order to keep inflation close to the target.

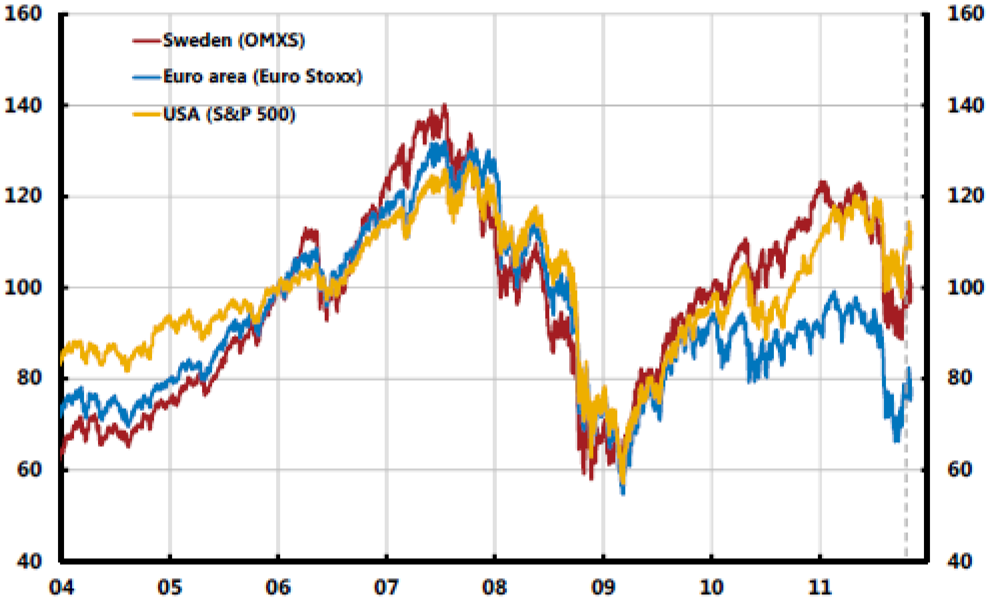
Conclusion

Today I have spoken about the situation in Sweden and abroad: partly about our dependence on events abroad and partly about what we ourselves can do to smooth the course of development in the Swedish economy. I have previously described the crisis in the early 1990s like this: “Things were quite OK abroad, but Sweden was not OK”. At the time of the crisis in 2008 the situation was the opposite: “Things were not OK abroad, but Sweden was OK”.

Recent developments abroad have been marked by great uncertainty. Sweden is highly affected by this uncertainty. With the help of monetary policy we can do all that we can to promote a stable development of the Swedish economy: that is ensure that inflation stays close to the target and that the development of the real economy is as stable as possible. When we look back at how things went in a few years’ time we should be able to continue to say that, despite the uncertainty abroad, “Sweden was OK!”

Figure 1. Stock market movements

Index, 3 January 2006 = 100

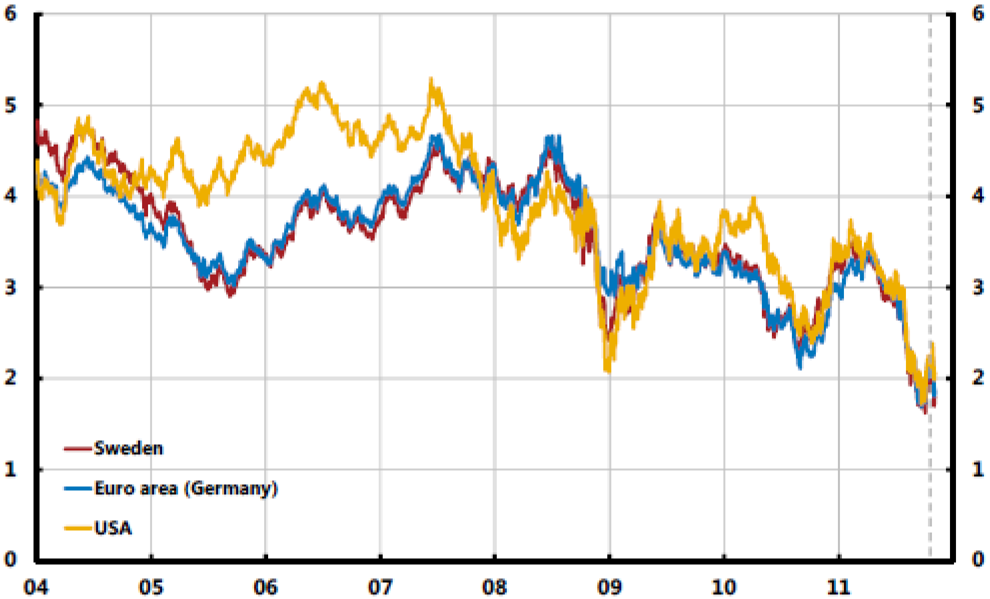


Note. Data have been updated with new outcomes after the October Monetary Policy Report (to the right of the dashed line).

Source: Reuters EcoWin

Figure 2. Government bond rates in Sweden, the euro area and the United States

10-year maturity, per cent

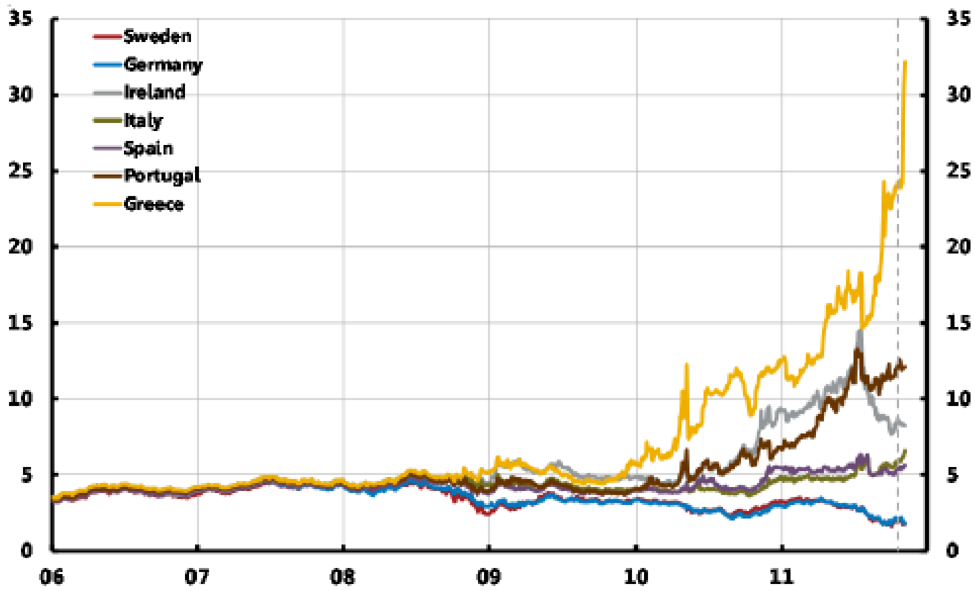


Note. Data have been updated with new outcomes after the October Monetary Policy Report (to the right of the dashed line).

Source: Reuters EcoWin

Figure 3. Government bond rates in Sweden and various euro-area countries

10-year maturity, per cent

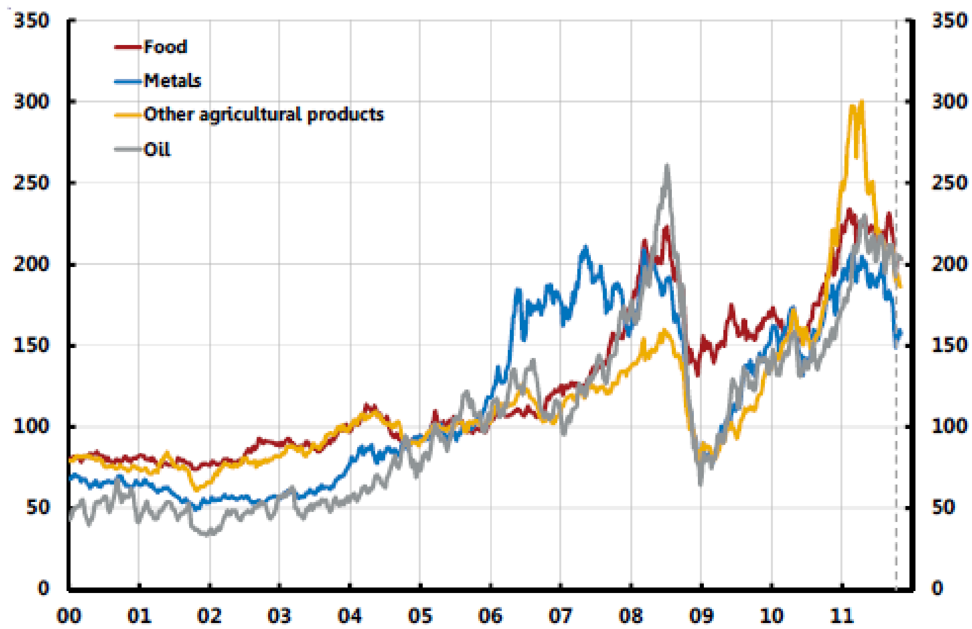


Note. Data have been updated with new outcomes after the October Monetary Policy Report (to the right of the dashed line).

Source: Reuters EcoWin

Figure 4. Commodity prices

Index 2005 =100, USD

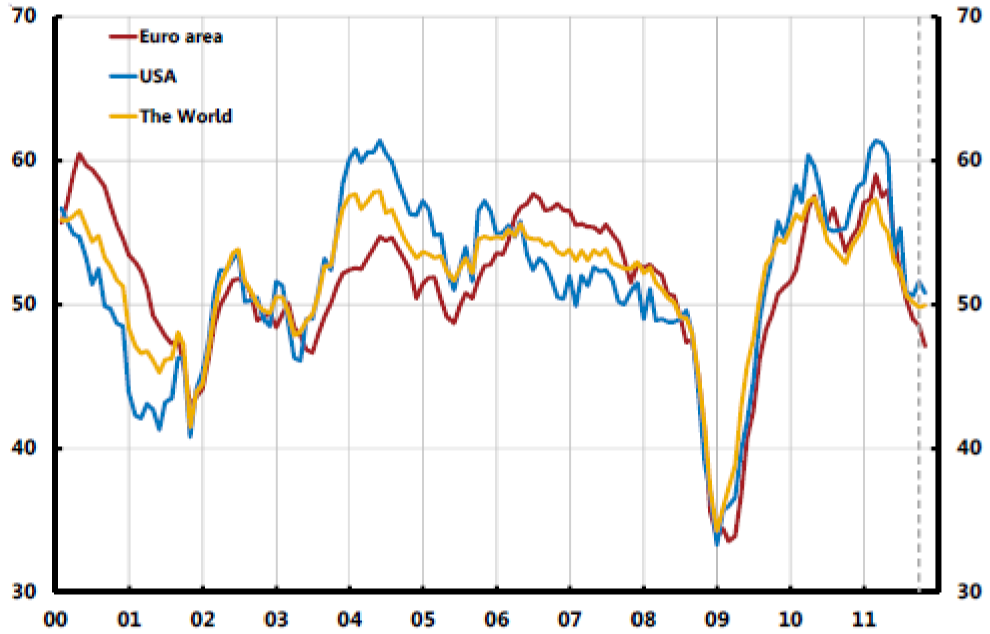


Note. Data have been updated with new outcomes after the October Monetary Policy Report (to the right of the dashed line).

Source: The Economist and Intercontinental Exchange

Figure 5. Purchasing managers' index

Index, seasonally-adjusted data

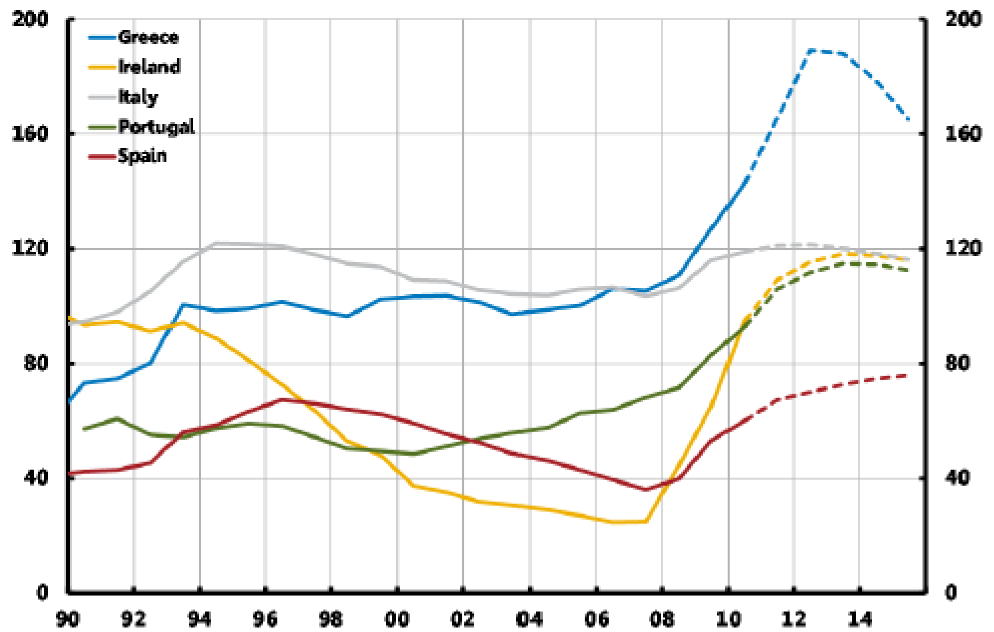


Note. Manufacturing industry. Data have been updated with new outcomes after the October Monetary Policy Report (to the right of the dashed line).

Source: Markit Economics

Figure 6. Sovereign debts in various countries

Percentage of GDP

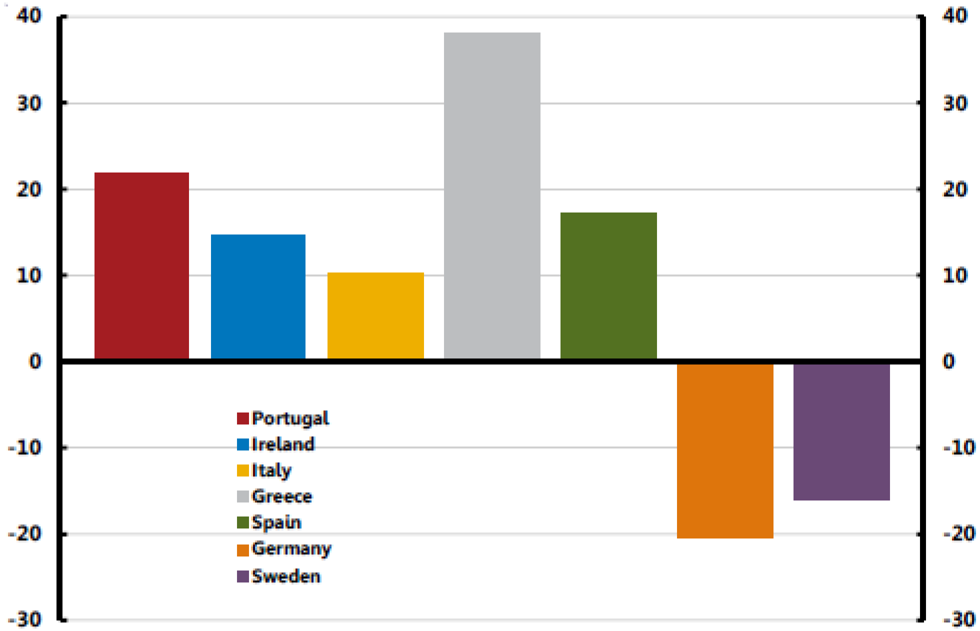


Note. Public gross debt.

Source: IMF World Economic Outlook, September 2011

Figure 7. Unit labour costs in relation to the euro average

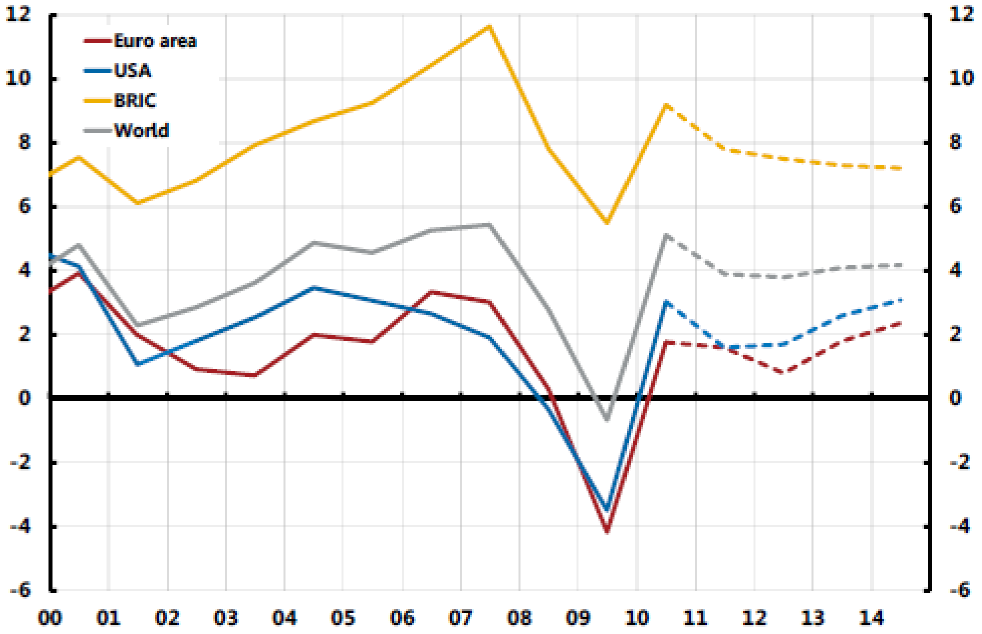
Percentage change since 1997



Note. In the case of Sweden unit labour costs are converted to euro.
Sources: OECD and the Riksbank.

Figure 8. GDP growth in various parts of the world

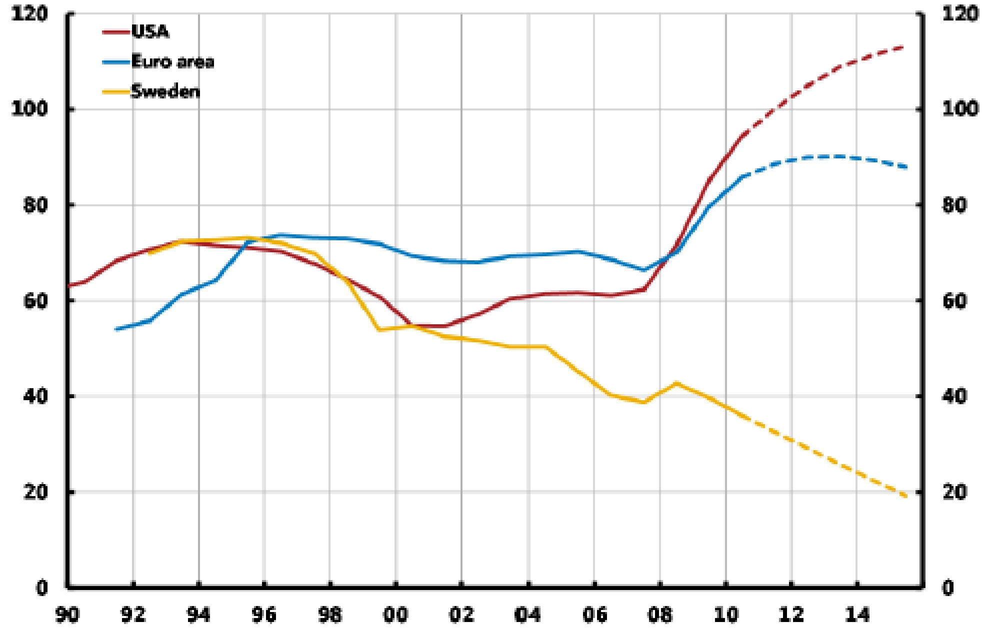
Annual percentage change



Sources: Bureau of Economic Analysis, Eurostat, the IMF and the Riksbank.

Figure 9. Sovereign debts in Sweden, the euro area and the United States

Percentage of GDP

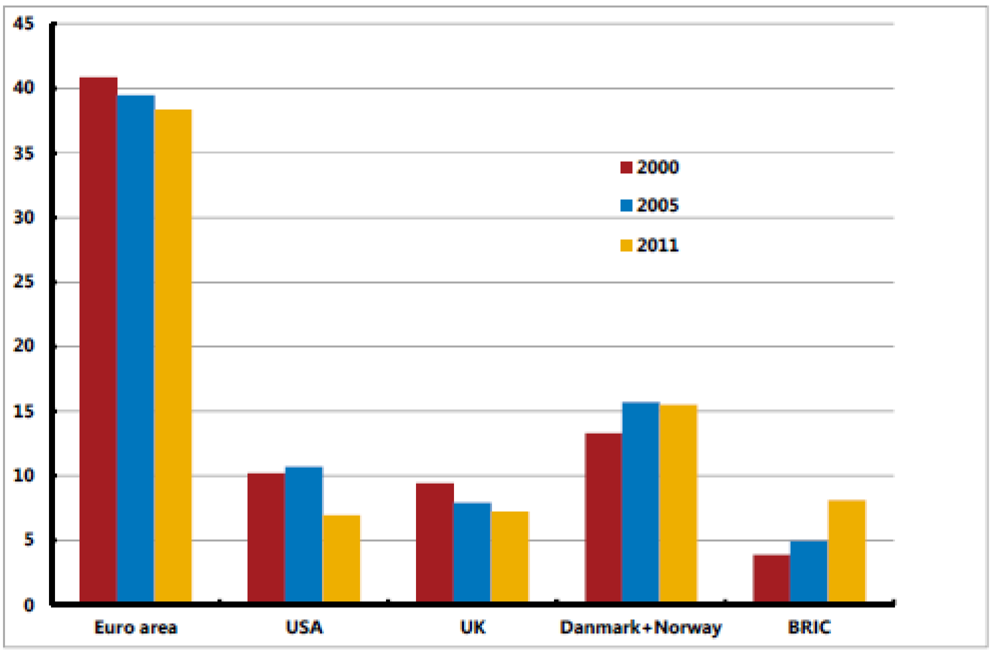


Note. Public gross debt

Source: IMF World Economic Outlook, September 2011

Figure 10. Percentage of Sweden's total exports of goods to various countries and regions

Per cent

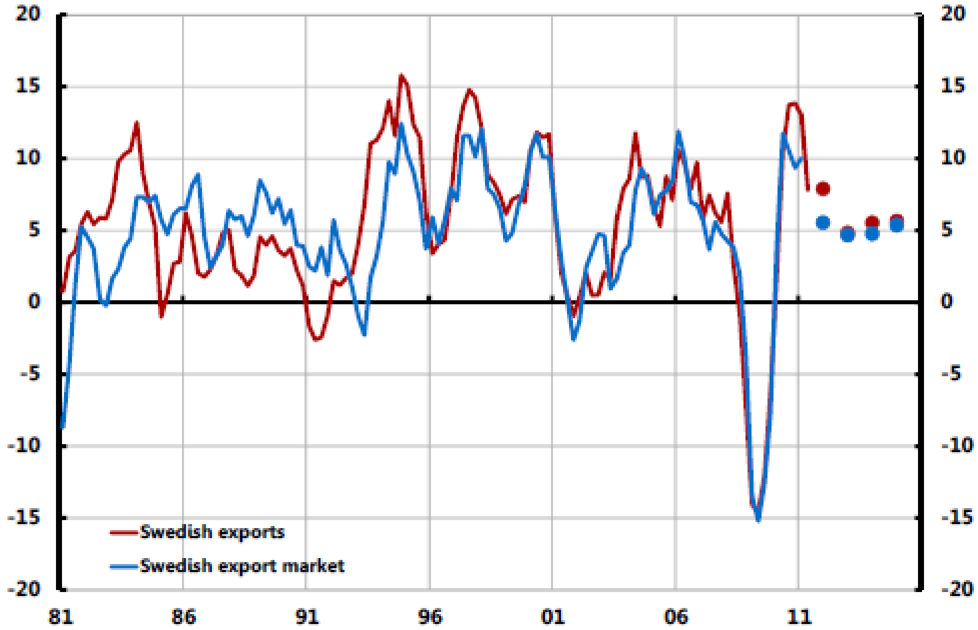


Note. The figures for 2011 are averages up to the end of July. These figures do not total 100 per cent, as not all countries have been included.

Source: Statistics Sweden

Figure 11. Exports and the Swedish export market

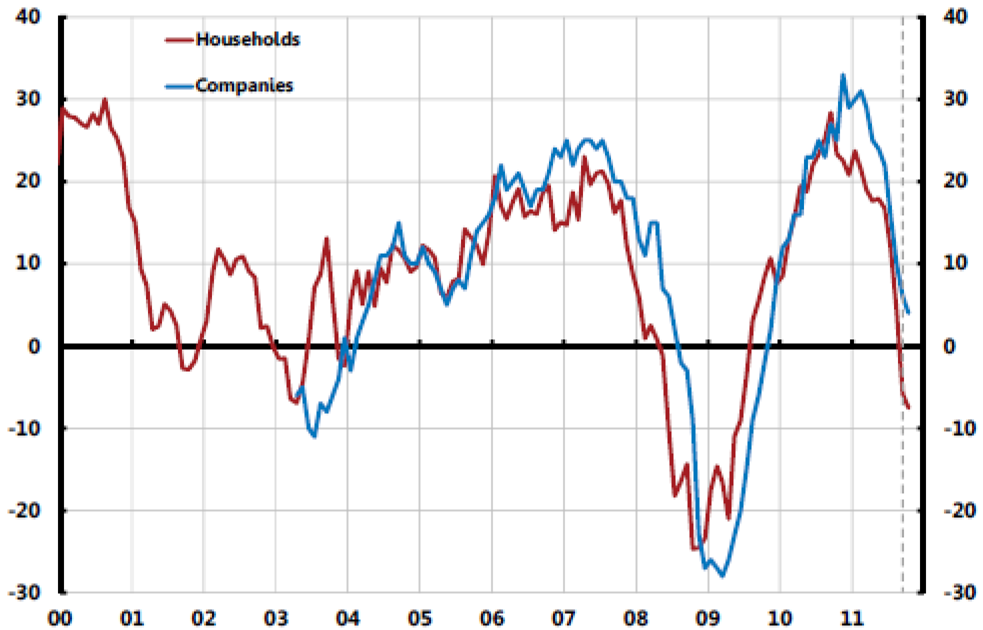
Annual percentage change



Sources: Statistics Sweden and the Riksbank

Figure 12. Confidence indicators for households and companies in Sweden

Net figures

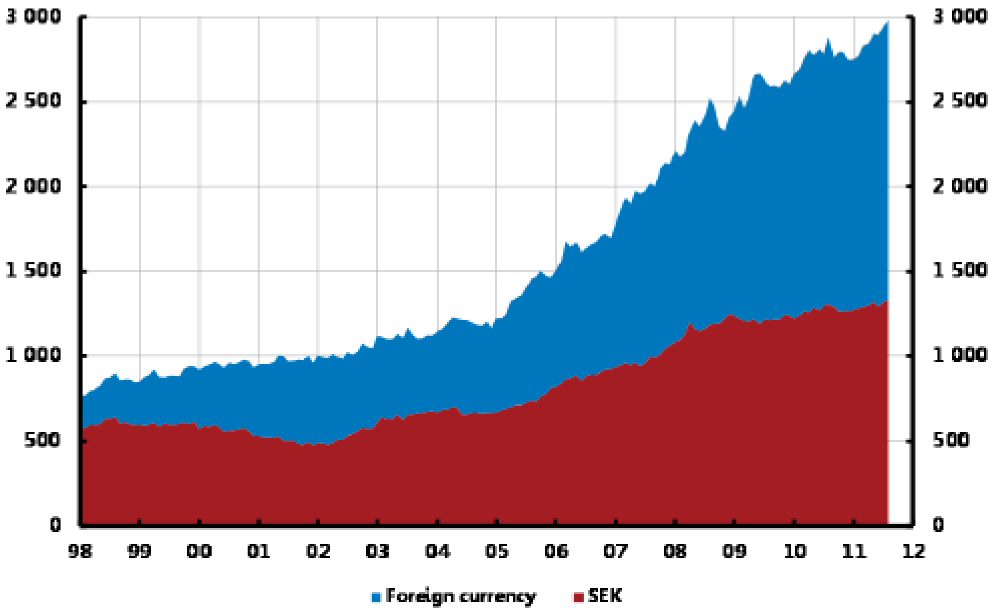


Note. Data have been updated with new outcomes after the October Monetary Policy Report (to the right of the dashed line).

Source: National Institute of Economic Research

Figure 13. The major Swedish banks' market funding via Swedish parent companies and subsidiaries

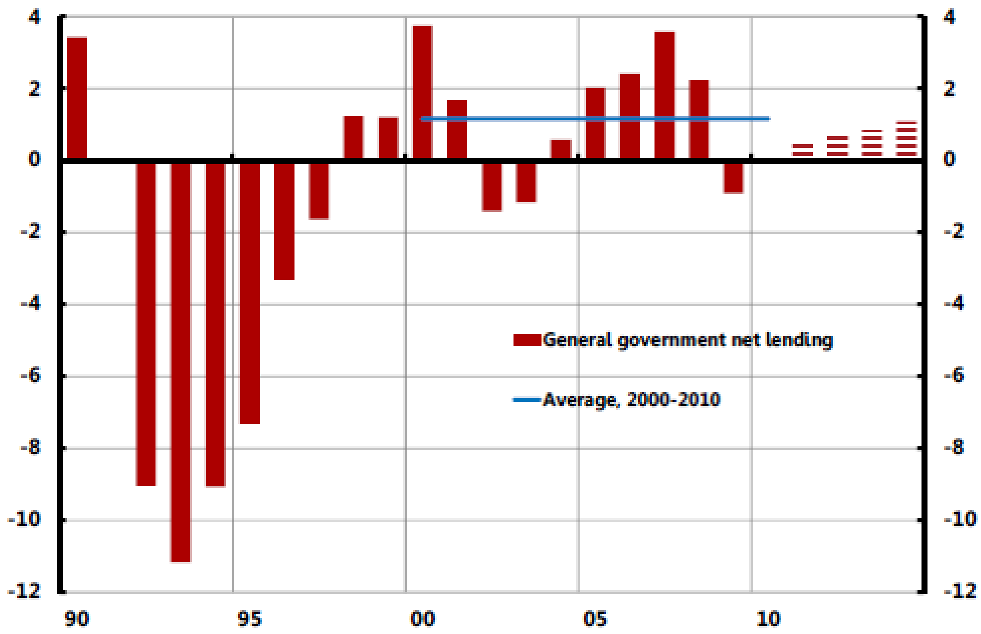
SEK billion



Sources: Statistics Sweden and the Riksbank

Figure 14. General government net lending in Sweden

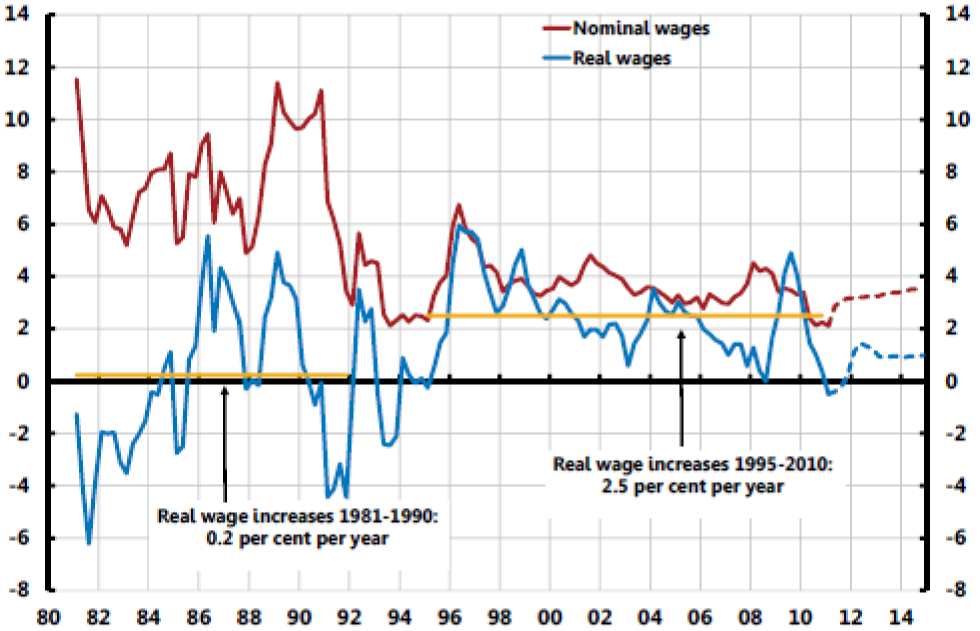
Percentage of GDP



Sources: Statistics Sweden and the Riksbank

Figure 15. Nominal and real wages in Sweden

Annual percentage change

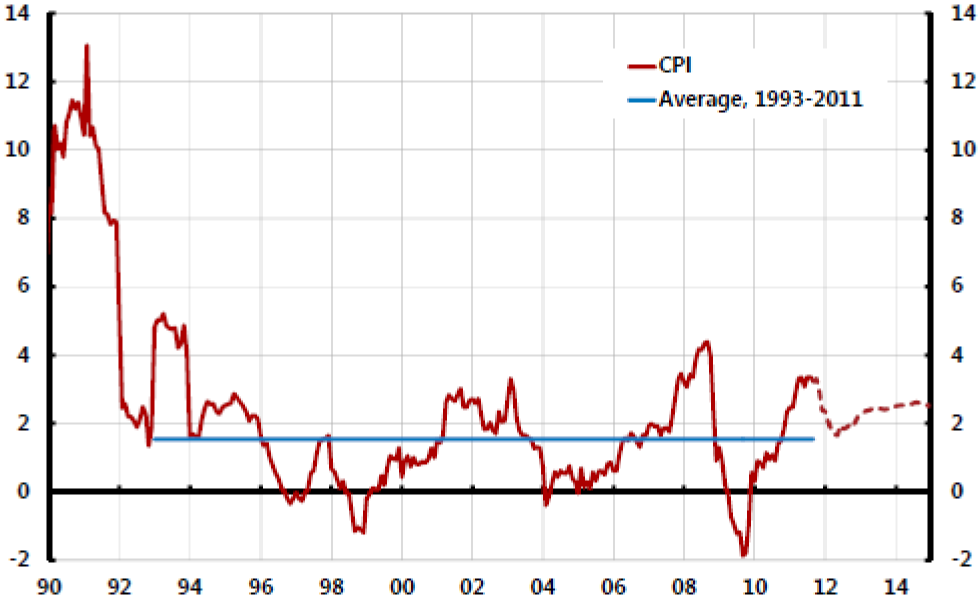


Note. Refers to wages according to the short-term wage statistics since 1993 and the wage structure statistics prior to 1993. Real wages are calculated as the difference between the annual percentage change in nominal wages and the annual percentage change in the CPI.

Sources: National Mediation Office, Statistics Sweden and the Riksbank

Figure 16. Inflation in Sweden

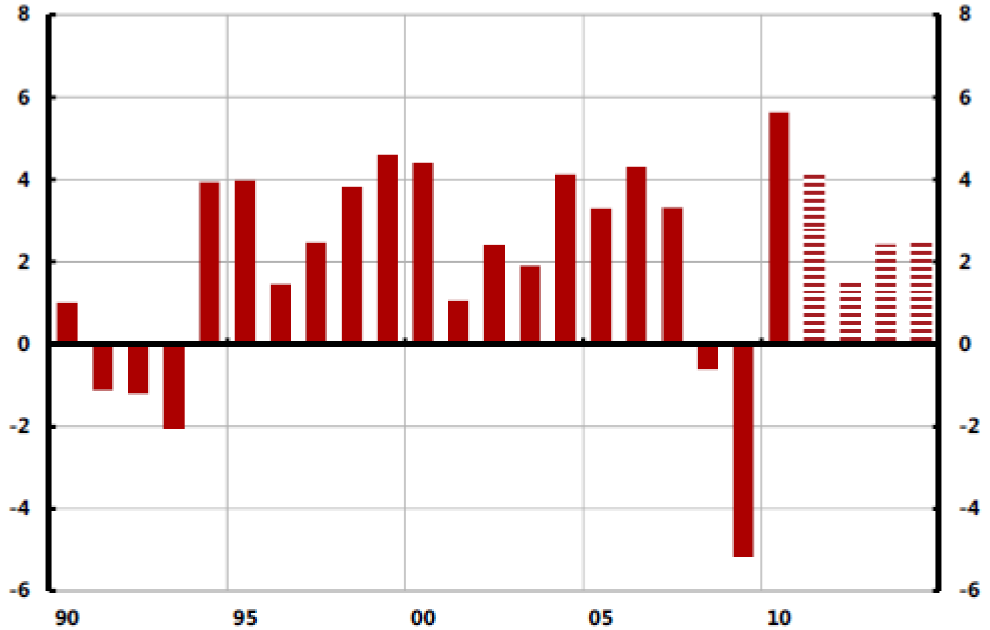
Annual percentage change



Sources: Statistics Sweden and the Riksbank

Figure 17. GDP

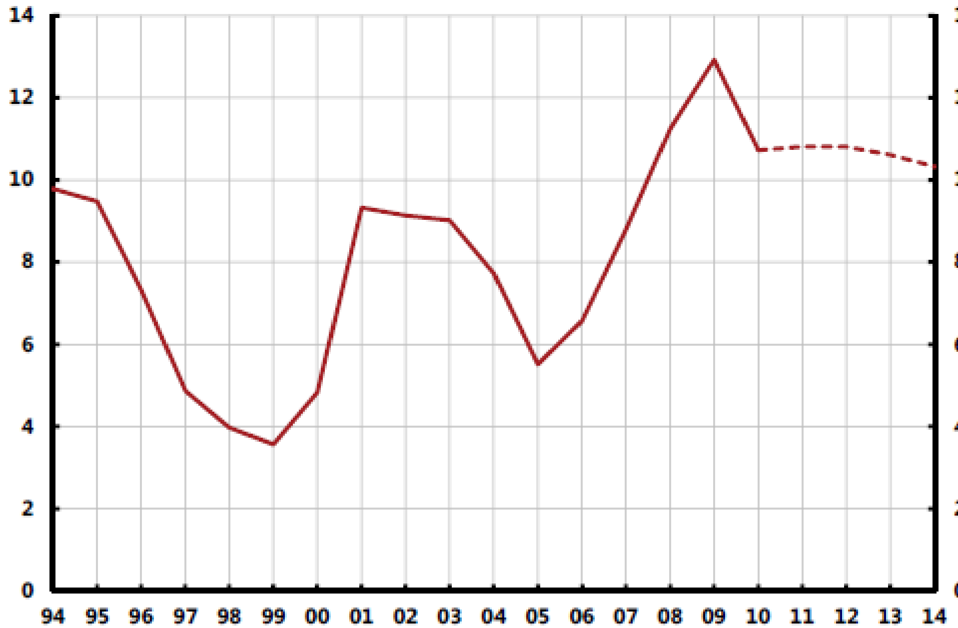
Annual percentage change



Sources: Statistics Sweden and the Riksbank

Figure 18. Household saving

Percentage of disposable income



Sources: Statistics Sweden and the Riksbank

Figure 19. Unemployment

Percentage of the labour force, seasonally-adjusted data

Note. Pre-1987 data has been spliced by the Riksbank. The forecast relates to the 15-74 age group.
Sources: Statistics Sweden and the Riksbank

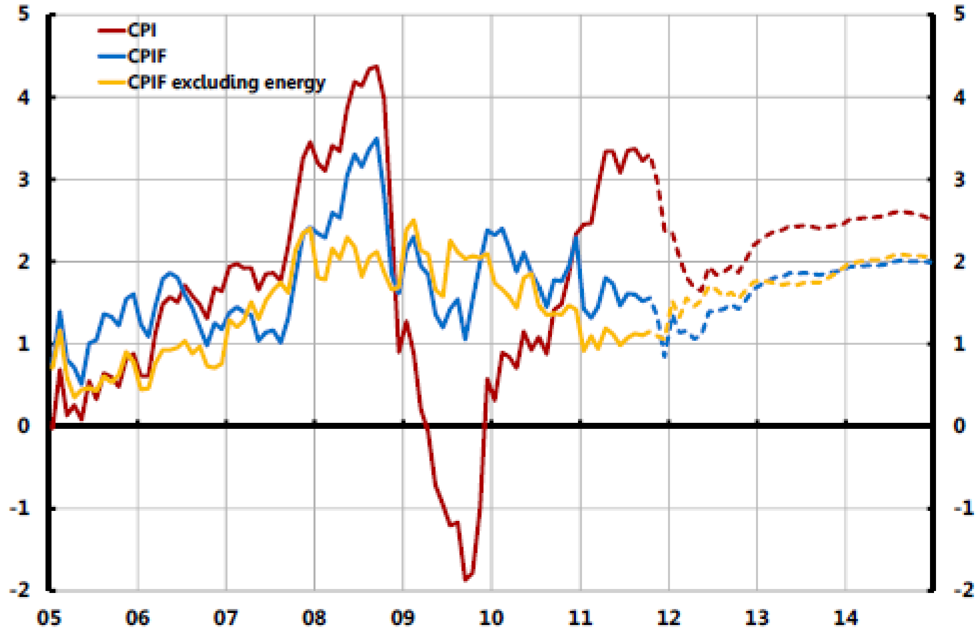
Figure 20. TCW exchange rate

Index, 18 November 1992 = 100

Note. Outcomes represent daily rates and forecasts refer to quarterly averages.
Source: The Riksbank

Figure 21. CPI, CPIF and CPIF excluding energy

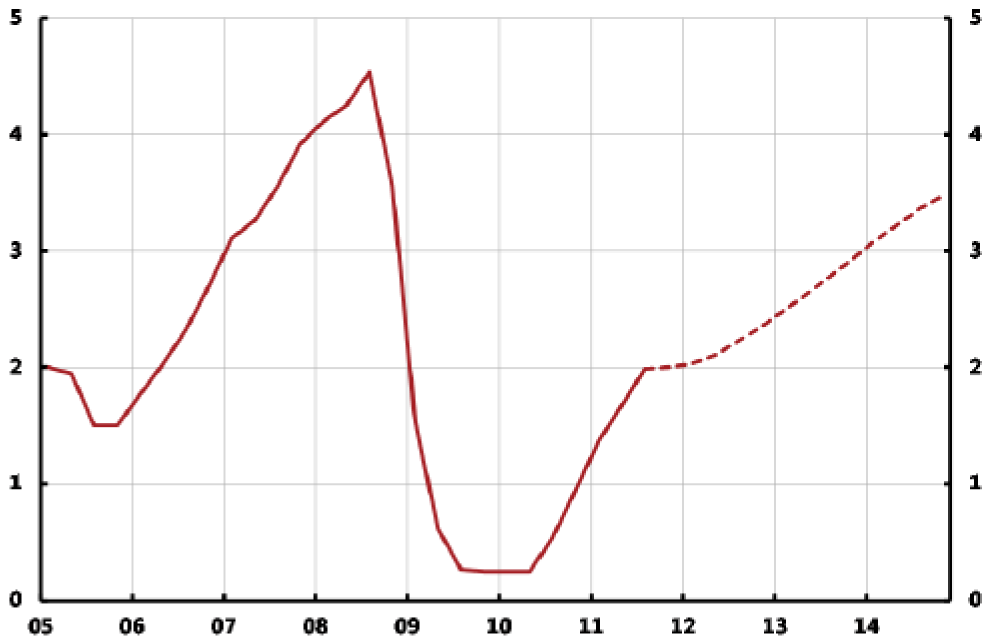
Annual percentage change



Note. The CPIF is the CPI with a fixed mortgage rate.
Sources: Statistics Sweden and the Riksbank

Figure 22. The repo rate

Per cent, quarterly averages



Source: The Riksbank