Per Jansson: Some aspects of the economic situation

Speech by Mr Per Jansson, Deputy Governor of the Sveriges Riksbank, at Nordea, Stockholm, 13 March 2012.

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Today, I will talk about the assessment of the economic situation in Sweden and abroad that I and the majority of the members of the Executive Board made at the monetary policy meeting in February. At the same time, I would like to go into a little more detail about three aspects that were particularly important to my stance regarding the repo-rate decision. Two of these relate to the management of the European debt crisis and one to the risks posed to the Swedish economy by a low repo rate over an extended period of time.

Those of you who have read the press release or the minutes from the monetary policy meeting in February know that I voted with the majority for a further repo-rate cut to the current level of 1.50 per cent. Our decision to cut the repo rate was mainly due to the weakening of the prospects for growth in Sweden, which in turn is a result of the impact of weaker economic development abroad.

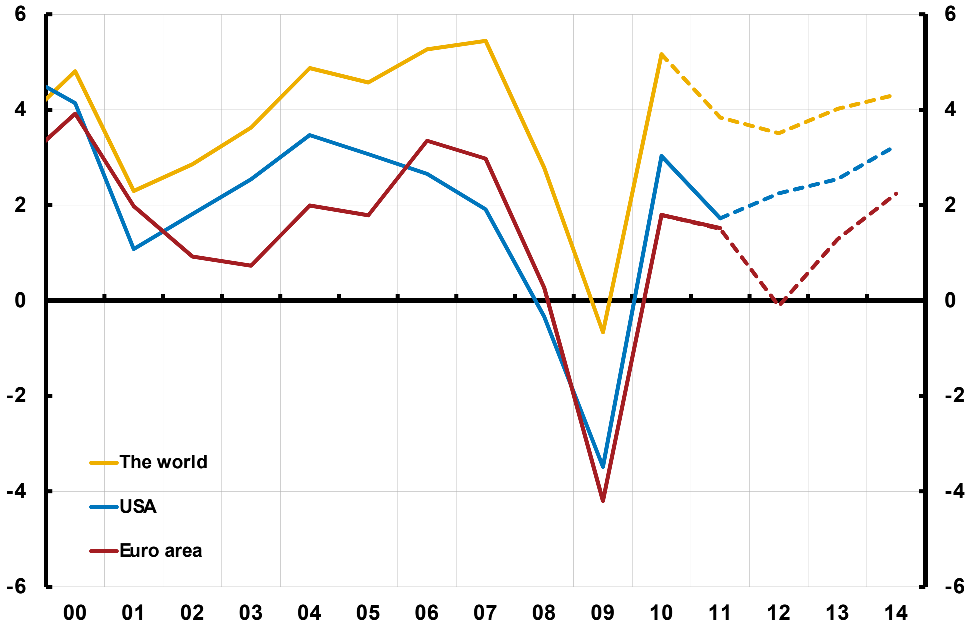
International outlook marked by the euro area's debt crisis

The fact that economic activity abroad has weakened recently primarily relates to developments in the euro area. The euro countries are marked by the debt crisis and growth prospects have deteriorated somewhat compared to the end of last year due to new consolidation measures and a tighter credit situation. There are, however, a number of bright spots in the US economy, where the labour market is improving and the housing market is showing early signs of a positive turnaround. With regard to the global economy as a whole, the Riksbank's forecast is that growth will continue to increase at a relatively good rate in the years ahead, after having declined somewhat in 2012. This is shown in Figure 1.

Figure 1.

GDP in various regions and countries

Quarterly changes in per cent calculated as an annual rate, seasonally adjusted data



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

For some time now, an important assumption in the Riksbank's international forecast has been that the euro countries, by implementing various measures, will succeed in reducing the most acute anxiety about the debt problems in the euro area during the course of 2012. It is expected that this will lead to an increase in the confidence of European companies and households and thus to growth being able to recover towards the end of the year. I think this is a reasonable assumption. Recent figures regarding, for example, the purchasing managers' index for the manufacturing industry and household confidence, indicate that pessimism has declined somewhat since the end of last year. Nevertheless, the economic outlook for the euro area is still of course uncertain.

Consolidation measures required

Some of the uncertainty stems from the fact that we have still not seen the final effects of the fiscal policy tightening that is now being implemented by the governments of the euro countries. Some voices in the current debate claim that this tightening could have such negative consequences for growth that the countries concerned should wait to implement it. This brings me to the first aspect I would like to discuss. The fact is that I am more worried about the reverse; that is that the countries are not dealing with their problems quickly enough.

At present, most of the countries in the euro area have deficits in their public finances and these deficits are expected to fall slowly over the next few years. Moreover, according the IMF's latest assessment from January this year, the deficits are expected to fall even more slowly than was predicted as recently as September last year.[1] According to the IMF, the advanced economies reduced their cyclically-adjusted deficits by an average of less than

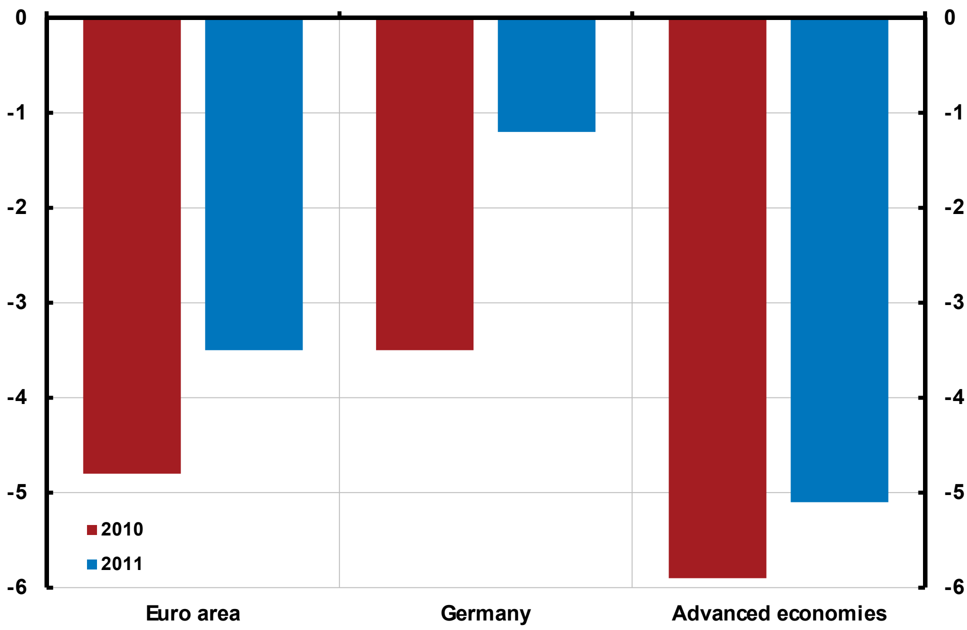
[1] Fiscal Monitor Update, January 2012. IMF

one percentage point between 2010 and 2011, as shown in Figure 2.[2] These deficits are expected to fall by as much or, if you prefer, by as little, in 2012. If we look at the euro area separately, the reduction between 2010 and 2011 was slightly larger, that is 1.3 percentage points. However, it should be noted that a large part of this reduction was due to improved public finances in Germany and not in the countries where such an improvement is needed most. Despite a continued improvement during 2012, the assessment is that public finances in the euro area will, on average, still be in deficit. Consequently, the average level of public debt is expected to increase from almost 90 per cent of GDP in 2011 to 92.5 per cent in 2013 according to the IMF. In order to reduce the level of debt instead, several European countries would need to transform the relatively substantial deficits of today into surpluses over a period of several years.

Figure 2.

Cyclically-adjusted net lending

Percentage of potential GDP



Source: The IMF

The links that exist between the levels of debt, interest rates and growth also suggest that a high level of public debt entails risks. For example, a high level of debt tends to lead to higher long-term interest rates, as shown in Figure 3.[3] A high level of debt may also lead to lower growth due to increased vulnerability to future crises, or because taxes may have to be increased to finance the debt.[4] The higher the level of debt, the more the country must set aside to make the interest payments on its debts. These are a couple of the reasons why

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[2] The term cyclically-adjusted deficits here refers to public net lending adjusted for cyclical effects. The group advanced economies includes the United States, the euro area, Japan, the United Kingdom, Canada, South Korea, Australia, Taiwan, Sweden, Switzerland, Hong Kong, Singapore, the Czech Republic, Norway, Israel, Denmark, New Zealand and Iceland.

[3] See also Baldacci, Emanuele and Kumar, Manmohan S. (2010), Fiscal Deficits, Public Debt and Sovereign Bond Yields. Working Paper no. 10/184. IMF.

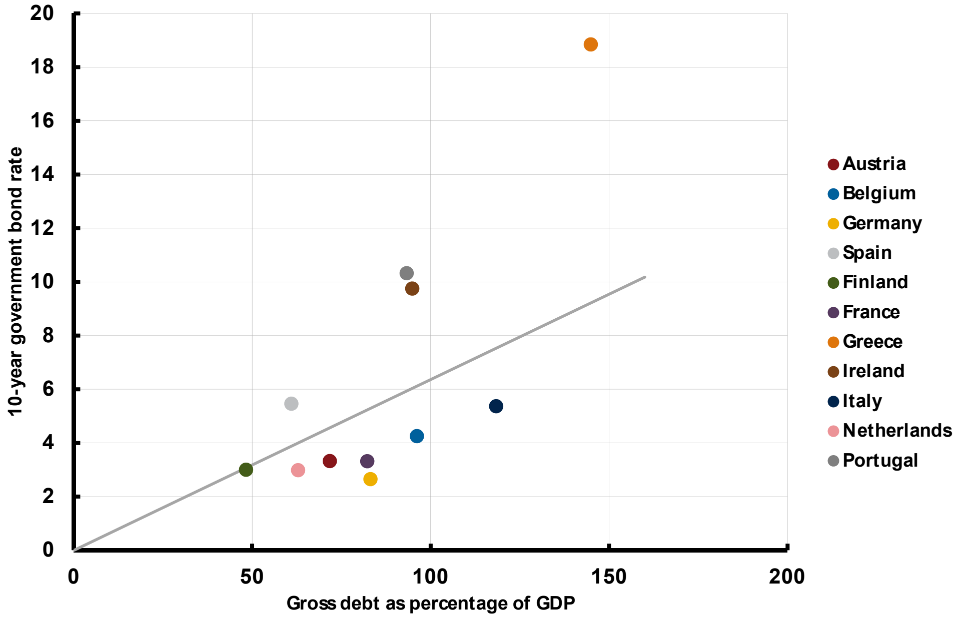
[4] For more details see Fiscal Monitor Update, November 2010. IMF or Kumar, Manmohan S. and Woo, Jaejoon (2010), Public Debt and Growth. Working Paper no. 10/174. IMF.

most studies show that fiscal-policy tightening, or consolidation measures, have positive effects, at least in the longer term.

Figure 3.

It pays to consolidate

10-year government bond rates and gross debt as a percentage of GDP 2011, per cent



Sources: Eurostat, Reuters Ecowin

The current account shows how important it is to consolidate

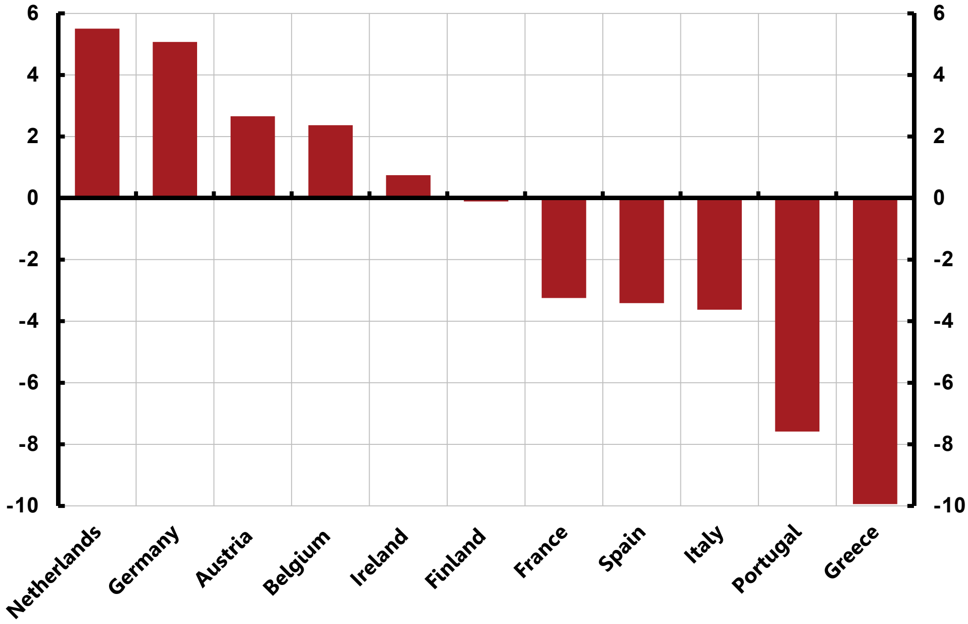
Of course, identifying an appropriate rate for budget consolidation measures is no easy task in a situation in which deficits are large and growth is weak. One way of addressing the question of when it is appropriate to consolidate is to look at the economy as a whole, not just at the public sector. In this context, the current account is an important measure for illustrating the state of the economy in relation to the rest of the world. A substantial current-account deficit indicates that domestic expenditure is high in relation to domestic production. A current-account deficit may be due to factors that are not necessarily negative. However, it can also be due to domestic imbalances, for example to economic policy being too expansionary. Another reason may be that competitiveness is weak, which dampens exports. In such cases, it pays for the country to try to reduce its current-account deficit by restraining domestic expenditure or increasing production.

Many of the euro countries that are having problems have had both current-account deficits and deficits in their public finances. Probably the most effective way of reducing the deficit in such cases is to improve competitiveness and reduce domestic expenditure at the same time. Postponing consolidation in such a situation would only entail domestic demand continuing to be higher than it should be. Figure 4 shows the current-account balance in a number of euro countries last year.

Figure 4.

Current-account balances

Per cent of GDP, 2011



Source: European Commission

Like the Riksbank, most forecasters expect a tighter fiscal policy to dampen growth in Europe in the period immediately ahead. It is difficult to assess the precise effects as these will depend on how and when the measures are implemented. But the measures will of course have an impact, particularly when several countries reduce their public spending and/or raise their taxes at the same time. This will happen, furthermore, in a situation in which there is little scope for monetary policy to further stimulate demand. But what's the alternative? As the risks associated with a high level of debt are so high, it should be in the countries' interests to shoulder a greater responsibility for improving their own situation. This brings me to the second aspect I would like to discuss today, that is how the problems of highly-indebted countries are handled.

Sustainable solutions require responsibility

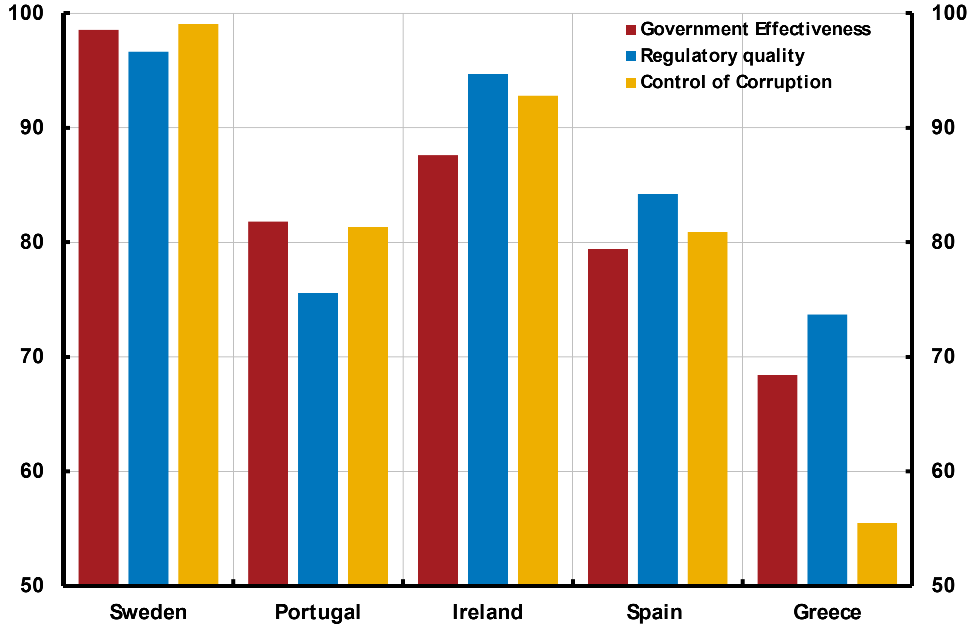
It is now obvious that some European countries need support from the IMF and the EU and it is good that this possibility exists. However, focusing too much on various support measures undermines the incentives for the countries themselves to find sustainable solutions to their problems. I suspect that at least one reason for the comparatively weak results achieved so far with regard to budget consolidation and reforms at the national level is that altogether too much energy has been expended on support facilities and too little on what is needed to improve the preconditions for an economically strong Europe.

However, I am not a fanatic who claims that budget consolidation is the one and only solution. The least painful way to strengthen a country's public finances is to work with structural reforms that benefit the country's economic growth. This may relate to reforms of the labour market and the pension system, reforms of the fiscal-policy framework and, in some cases, fundamental institutional reforms. Many of the countries that now have problems due to their weak public finances have weak economic-policy institutions and are ranked at a relatively low level in various measures of institutional strength, for example the degree of efficiency or corruption in the public sector. Figure 5 shows examples of this.[5] Weak institutions in themselves undermine the potential for growth.[6] By implementing structural reforms, the countries can improve their public finances and increase their potential for growth in the period ahead. However, despite the fact that there have been and still are processes in the EU that aim to improve the workings of the economies and improve competitiveness, for example the Lisbon Strategy or Europe 2020, it has proved to be easier said than done to implement these reforms. A robust plan should therefore be based on both structural reforms and consolidation.

Figure 5.

Structural reforms are important

World Bank's governance indicators



Note. The bars show indicators of institutional quality in which 100 is the best possible value and 0 the worst.

Source: World Bank Worldwide Governance Indicators

Some progress made

In the same way as the weak performance of the European economy today is undermining the economic outlook for Sweden, better growth potential in Europe would benefit the Swedish economy going forward. Eight of Sweden's 10 most important export markets are in Europe and five of them are euro countries.[7] It is of course therefore gratifying that work is underway at the EU level to restore confidence in economic policy. In early March, 25 countries signed the so-called fiscal compact, which entails stricter monitoring of the

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5 See the World Bank's Worldwide Governance Indicators, Transparency International's Corruption Perception Index and the European Commission's measure of the shadow economy as a percentage of GDP.

6 See Kaufmann, Daniel, Kraay, Art and Zoido-Lobatón, Pablo (1999) Governance Matters. Policy Research Working Paper no. 2196. World Bank.

7 Sweden's ten most important export markets in 2011 in order of rank: Germany, Norway, UK, USA, Denmark, Finland, Netherlands, France, Belgium and China.

Member Countries' budget work and a greater possibility to impose sanctions on those countries that have excessive debts or deficits. These are measures that can help to increase the credibility of the countries' budget discipline and reduce the risk of future debt crises. Progress has also been made in putting together a second support package for Greece. At the same time, the decisions by the ECB in December and in February to offer the banks in the euro area three-year loans against collateral have helped to stabilise the situation on the financial markets.

So, although the situation in Europe is still problematic, we can see that progress is being made at approximately the rate the Riksbank has estimated. In such a scenario we can expect to see a recovery in the euro area, although a weak one, over the next few years.

Poorer performance abroad leading to slowdown in Sweden

The weak performance in Europe at the moment is affecting the Swedish economy in several ways. First, the demand for Swedish exports is falling. This was also the main reason why growth slowed down in the economy at the end of last year. Second, household and corporate confidence in the economy is falling and this in turn is leading to a slowdown in consumption and investment. The financial situation in Sweden is also affected by developments abroad. The fall in share prices in 2011 reduced the financial wealth of the households, which contributed to an increase in saving. It is unlikely that there will be any significant decline in saving in the period immediately ahead as the low level of growth is expected to reduce employment and increase unemployment.

Before I move on to my personal reflections on the situation in the Swedish economy, I would like to say that I make the same assessment of the economic outlook in Sweden as that made by the majority of the members of the Executive Board at the latest monetary policy meeting. This assessment is that there will be relative low inflationary pressures and slow growth in the period ahead.

It was expected that the Swedish economy would slow down at the end of last year, but the slowdown was more severe than we believed it would be. In the December forecast the Riksbank predicted that growth would decline and that there was some probability of a further repo-rate cut in February. In February, our assessment was that the slowdown in growth in late 2011 had been even more severe. This was because the indicators for exports, among other things, suggested this. I therefore voted with the majority to cut the repo rate by a further 0.25 percentage points.

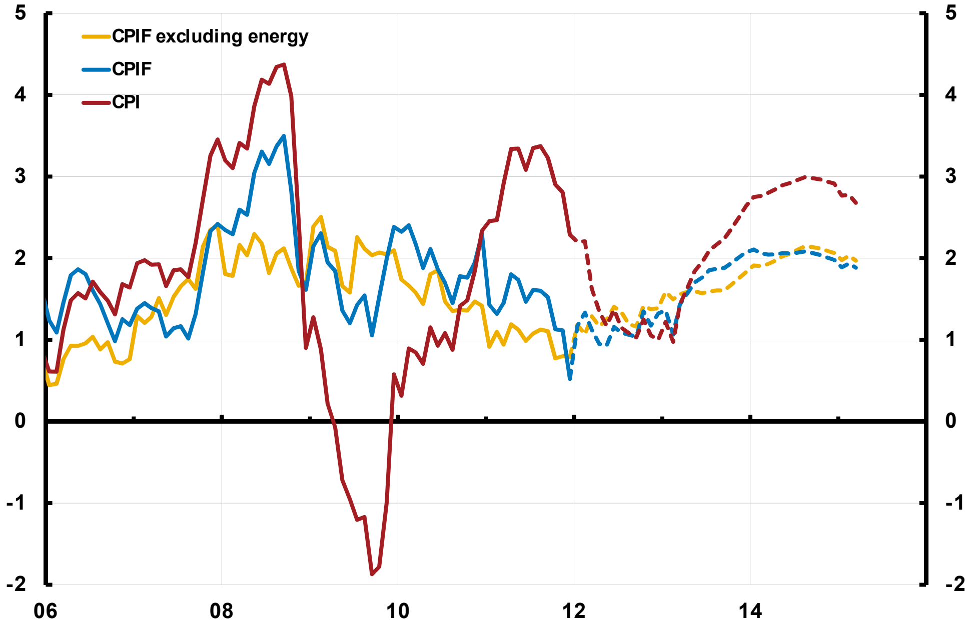
Since then, we have learned that the outcome for GDP growth in the last quarter of 2011 was even worse than we expected at the time of the monetary policy meeting in February. This is largely because exports were even weaker than expected. However, we have also received outcomes for foreign trade in January which indicate that exports strengthened again after the turn of the year. We will receive further clues as to the current state of the economy before the next monetary policy meeting in April and will then review how this new information affects monetary policy.

As I said earlier, in the slightly longer term the Riksbank's latest forecast is that there will be a gradual recovery in the euro area and the global economy following a weaker 2012. This will of course affect Sweden too. It is expected that resource utilisation will increase, the rate of wage increases will accelerate and underlying inflation will gradually rise as growth improves. The latter is illustrated in Figure 6.

Figure 6.

Gradually rising inflationary pressures

The 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

Low real repo rate for some time to come

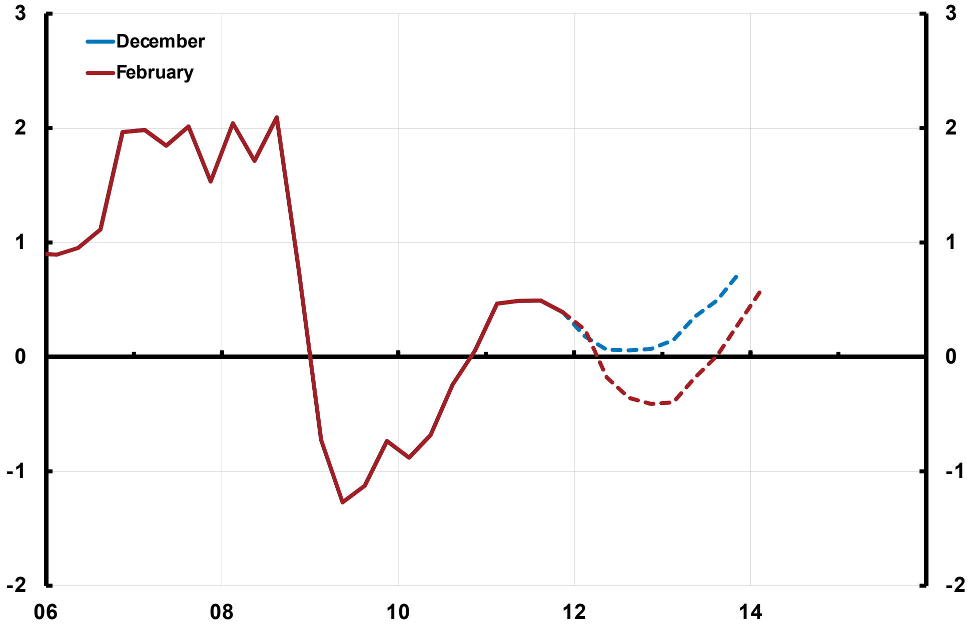
We will need to gradually tighten monetary policy when inflationary pressures and resource utilisation increase. The Riksbank's repo-rate path from February therefore indicates repo-rate increases during the course of 2013 and 2014. Nevertheless, this forecast still means that monetary policy will remain highly expansionary in the years ahead. Figure 7 shows that the real repo rate is expected to be negative in 2012–2013; that is for a substantial part of the forecast period. If this proves to be the case, won't there then be a risk of monetary policy being too expansionary? Won't we perhaps risk overheating, a too high rate of inflation or an unsustainable development of household debt?

This is of course not impossible, but at present I do not think that it is very likely. To explain how I have reached this conclusion I would now like to briefly summarise how I view some of the risks associated with a very low real interest rate.

Figure 7.

Low real repo rate for some time to come

Real repo rate, per cent, quarterly mean values



Note. The real repo rate is calculated as a mean value of the Riksbank's repo rate forecast for the year ahead minus the inflation forecast (CPIF) for the corresponding period.

Source: The Riksbank

Overheating – not a risk at present

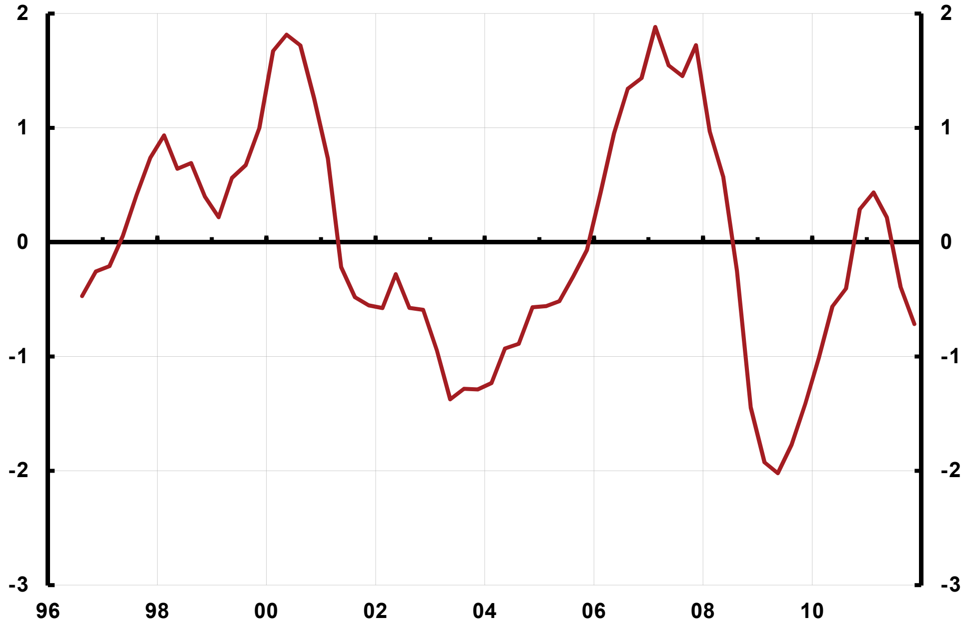
The first risk thus relates to resource utilisation in the economy and the risk of overheating. As I have already said, weak economic development abroad is having a significant impact on the Swedish economy. On the other hand, Sweden is in a much better initial position than many other countries. Sweden's public finances are in good shape and, unlike some other countries; Sweden did not suffer a significant downturn on the housing market in connection with the financial crisis of 2008–2009. It is rather the case that the Swedish economy grew so quickly during the major part of last year that there was a risk of overheating and rising inflationary pressures. The companies reported rising labour shortages, and other measures of resource utilisation in the economy also increased. There were periods during the year when several indicators were higher than normal.

However, there has been a turnaround in these indicators over the last few months. Company surveys show that labour shortages are no longer as acute in most sectors. Capacity utilisation in the manufacturing industry has declined and is somewhat lower than the historical average. Other indicators, such as unemployment and the employment rate, also point to more spare capacity than normal in the economy. My assessment was therefore in line with the overall analysis in the February Monetary Policy Report, that is that resource utilisation in the Swedish economy had declined and was below a normal level at the end of last year. This is shown in Figure 8. I therefore think that there is very little risk of overheating at the moment.

Figure 8.

Resource utilisation lower than normal

The Riksbank's RU indicator, standard deviation



Note. The Riksbank's indicator for resource utilisation summarises information from surveys and labour market data. It is normalised so that the mean value is zero and the standard deviation is one.

Source: The Riksbank

Fewer risks of high inflation

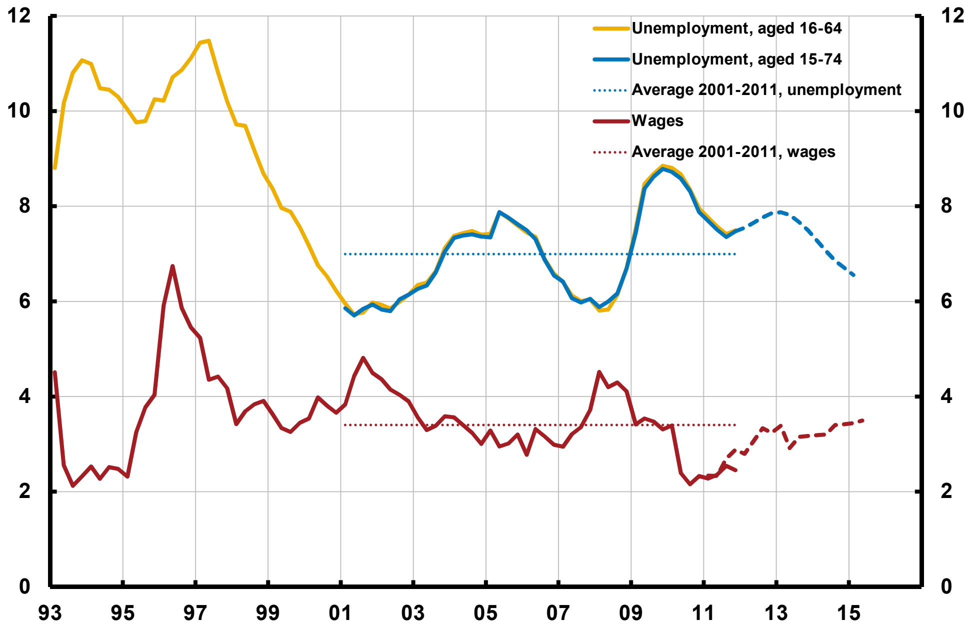
The second risk relates to the rate of inflation. CPI inflation was high last year, which could have led to a substantial increase in inflation expectations and to excessive wage increases in the autumn round of collective bargaining. But this has not turned out to be the case, so far anyway.

Long-term inflation expectations have declined and are now close to the inflation target of two per cent two and five years ahead. In addition, wage agreements have now been signed for large parts of the manufacturing industry. Providing that the new wage agreements for other sectors are in line with the norm set by the manufacturing industry, it appears that total wage increases this year will be around 3.5 per cent. This is actually a rather large wage increase given the fact that unemployment is relatively high, but not so large that it is likely to lead to any serious inflation risks. However, collective bargaining is still underway and it remains to be seen exactly how the results of this process will affect monetary policy.

Figure 9.

Rate of wage increases in line with the inflation target

Annual percentage change and percentage of labour force



Note. Preliminary outcomes in the short-term wage statistics in 2011. The broken lines are the Riksbank's forecast in February 2012.

Sources: National Mediation Office and the Riksbank

Another relevant factor is that the rate of inflation measured in terms of the CPI has declined since the autumn. In August last year, CPI inflation was as high as 3.4 per cent. It has fallen significantly since then and in January the rate of inflation was just below 2 per cent. I expect, in line with the assessment in February, that CPI inflation will fall further in the period ahead when the interest expenditure of the households increases more slowly. Underlying inflationary pressures are also low in the wake of a strong krona and lower resource utilisation.

Low interest rates and household indebtedness

I would like to conclude by saying something about my view of household indebtedness. However, before I discuss the last of the three risks that I associate with a low real repo rate I would like to clarify a matter of principle.

I am one of those who believe that a long period with low interest rates can lead to various imbalances. Such imbalances can arise, for example, if credit growth is too rapid, if asset prices increase too much or if the price of financial risk is set too low.[8] Unbalanced development is characterised by the fact that, for one reason or another, an excessive level of indebtedness arises in the economy. If the economy has fallen into a recession following such a period, the recovery may be very slow as households and companies will spend a larger part of their incomes on amortization payments rather than on consumption and investment. The financial crisis of 2008–2009 is the latest example that clearly demonstrates

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8 For a similar discussion see, for example http://www.norges-bank.no/en/about/published/speeches/2012/annual-address/ or 80th Annual Report, June 2010. BIS.

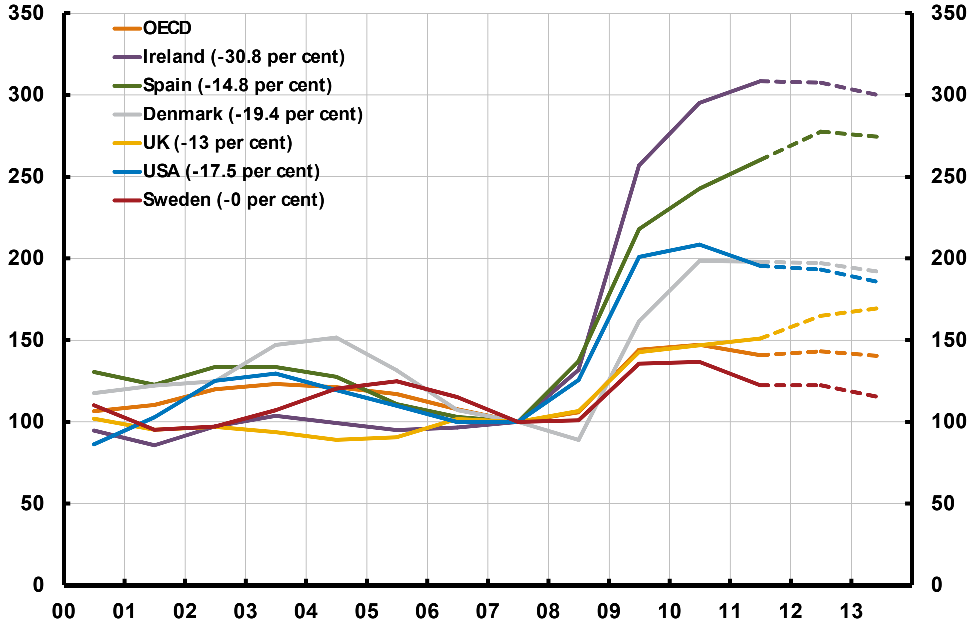
how important it is to avoid such a situation. The US economy fell into recession in early 2008 as a result of problems on the housing market and an excessive expansion of credit in the household sector. Four years later, employment in the United States has still not recovered more than approximately one third of the fall that occurred during the crisis. To refer back to what I said earlier, one could say that Europe's debt crisis is a variation on the theme of excessive indebtedness, although primarily for the public sector in this case.

Figure 10 shows how much unemployment has increased in several other countries that have suffered a downturn on the housing market. I have included Sweden and the OECD as a whole for the purposes of comparison.

Figure 10.

Large increase in unemployment in countries affected by a downturn on the housing market

Unemployment, index 2007=100



Note. The figures in brackets present the fall in real housing prices from the peak to the trough. The broken lines represent OECD forecasts.

Source: The OECD

The high costs associated with reducing indebtedness in the economy means that situations can sometimes arise in which there may be a desire to take factors such as the level of indebtedness into account in monetary policy, as well as inflation and the real economy. How often this actually happens depends on how effective the oversight and supervision of risks in the financial system as a whole are. If this so-called macroprudential supervision is less effective, it is probable that monetary policy must take such factors into account to a greater extent than otherwise.[9]

After having clarified this matter of principle, I will now discuss the development of household indebtedness in Sweden. In 2011, the Riksbank pointed out that a gradually rising repo rate,

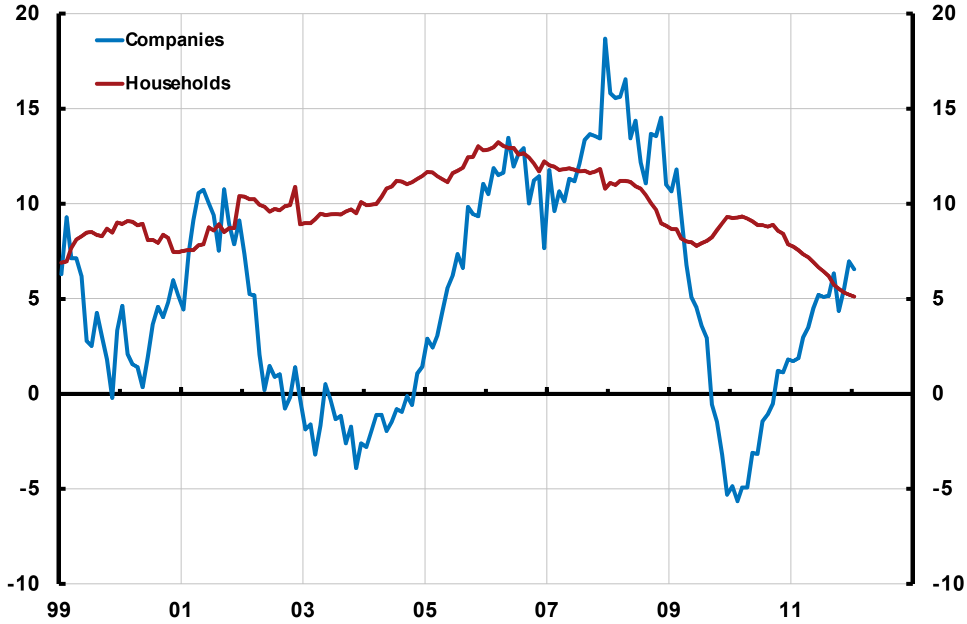
[9] Michael Woodford presents a theoretical analysis of how such factors can be incorporated into a model for inflation targeting in Woodford, Michael (2012) "Inflation Targeting and Financial Stability", Sveriges Riksbank Economic Review, 2012:1. Sveriges riksbank.

apart from stabilising inflation and resource utilisation, may also have the positive side effect of helping to slowdown household borrowing. Credit growth in the household sector, which is closely linked to the development of the housing market, has gradually declined since 2010. Household indebtedness is still high, but it levelled off last year. This suggests that the risks in this area are limited, at least at the moment. However, I believe that it will be important to monitor developments in the period ahead to check that new risks do not arise.

Figure 11.

Decline in lending to households

Credit growth, annual percentage change



Source: Statistics Sweden

Conclusions

Today, I have discussed three aspects that were particularly important to my assessments and my stance when the repo-rate decision was made in February. Two of these relate to the debt crisis in the euro area. My view is that it is taking too long to improve public finances and that the risks associated with a high level of indebtedness mean that the debt-ridden countries themselves must assume a greater responsibility for resolving their problems. The third aspect relates to the risks that can arise when the real interest rate is low for an extended period of time. This can, for example, lead to overheating tendencies or a too rapid increase in indebtedness. My conclusion is that, in the current situation at least, these risks are limited. This was one of the important reasons why I was able to vote for a repo-rate cut at the latest monetary policy meeting.

A lively public debate is currently underway on a couple of the issues I have addressed here. This applies, for example, to the need for consolidation and which strategy is best for finding solutions to the debt crisis in the euro area as quickly as possible. The question of what role the central banks should play in counteracting an excessive expansion of credit and indebtedness is also often debated, and the members of the Executive Board of the Riksbank also have different opinions about this. I don’t find this strange at all, on the contrary it is entirely natural. Hopefully, this debate will contribute to constructive solutions going forward.

Thank you.