Barbro Wickman-Parak: Economic analysis requires a cool head – my view of developments in Sweden and abroad

Speech by Ms Barbro Wickman-Parak, Deputy Governor of the Sveriges Riksbank, at a meeting, Luleå, 15 May 2012.

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I would like to thank Magnus Wiberg at the Monetary Policy Department of the Riksbank for help with writing this speech.

When we at the Riksbank decided on the repo rate almost exactly one month ago, I was one of the majority who wanted to hold the repo rate unchanged at 1.5 per cent and to keep the repo-rate path set at the February meeting. With regard to developments abroad, I pointed out that there was every reason to express caution with regard to international economic activity in the coming period. I also pointed out that we should continue to expect fairly sudden and dramatic changes on the financial markets. At the time of the April meeting we had seen the financial unease accelerate after a period of stabilisation at the beginning of the year. The focus was on concerns regarding Spain. Now the outcome of the elections in Greece has sent even larger shockwaves through the global financial markets, and this leads to other debt-ridden countries, such as Spain, being hit by greater unease.

Let me say right now that neither I nor anyone else can know with any degree of certainty what this will entail. We have assumed in our forecasts that the euro crisis will be resolved in an orderly manner so we can avoid the abrupt downturn that came in the wake of the Lehman Brothers crash in autumn 2008. Personally, I am not prepared to entirely abandon this assumption. Monetary policy must be based on forecasts, and basing these on disaster scenarios is not reasonable. We must continue in the same way as before, making forecasts that are based on incoming statistics and giving consideration to the risks of a poorer development in the euro area. Our forecasts for the Swedish economy and monetary policy need to be gradually adjusted to this. If there is a sharp downturn in the economy we are prepared to act quickly and forcefully. We demonstrated this during the crisis period 2008–2009.

There is currently considerable focus on the euro crisis, but there is reason to point out that there are other risks, albeit less dramatic, to take into account. I will come back to these.

There are also possibilities that growth in the world around us will be better in the slightly longer run than we are now envisaging. We are currently experience a confidence crisis with political overtones. This also means that if the political measures gradually gain credibility, confidence may return quickly and the economy may recover more strongly than we are predicting. This has happened before.

With regard to Sweden, in April we could see some positive signs in economic developments after the unexpectedly severe fall in GDP in the last quarter of 2011. The statistics we had for the beginning of the year pointed towards the fall being temporary. We did not make any major changes to the forecast for growth we had made in February. Nor was there any reason to change the forecast for inflation. So far, we have not seen any new statistics that should cause us to change the economic outlook we presented in April, in my opinion.

I am one of those people who closely scrutinise the statistics to form an opinion of the economic situation and driving forces behind developments. My long experience in this field has taught me that it is important not to have blind faith in the accuracy of the measures we use to assess the economic situation. It is important not to read too much into individual figures, but to gradually adjust our forecasts as new statistics justify this. This approach to making forecasts reduces the risk of going in the wrong direction. The experiences of recent years provide a good illustration. But of course one should also be prepared to make larger

adjustments if the circumstances so require. Our actions in autumn 2008 provide a good example of this. I have on many occasions expressed my view that monetary policy should normally be conducted on the basis of gradual adjustment. This is based on my reasoning as described above.

In other words, I believe it is always a good idea to "keep a cool head" in the context of forecasting, even when the storm winds are blowing.

Meagre growth in the euro area, but better elsewhere

Developments in the euro area are subject to the problems with sovereign debt and growth is currently weak. In our most recent Monetary Policy Update we assume there will be a small decline in euro area GDP growth this year and a weak increase next year. It is these meagre prospects and concern that developments could be even worse that affect a lot of the economic reporting at present. However, we assume in our forecasts that it will be possible to resolve the problems with public finances and banking systems in an orderly manner, without an aggravated crisis causing an even sharper fall like the one we saw after the Lehman Brothers crash in autumn 2008. Even if the situation does not deteriorate so much, the necessary deleveraging in the euro area may take longer than we are assuming. I shall return later to the risk of a more prolonged debt reduction that would involve postponing the weak recovery we are expecting to see in the euro area.

Since the monetary policy meeting there has been considerable focus on Spain. Standard & Poor's have downgraded the credit rating for Spain and GDP has fallen for the second quarter in a row. The main concern is the problems in the banking system, and the need for capital injections from the public sector has been highlighted. This type of support measure is complicated by the need to address the budget deficit. The outcome of the election in Greece and the uncertainty over whether a government can be formed, and if it would then be able to present the savings needed for the next payment of the support loan from the EU and the IMF, have also sent shockwaves through the financial markets. This means that the unease on the financial markets has increased once again.

With regard to the statistics reflecting real economic developments in the euro area, the confidence indicator showed weaker confidence for the euro area as a whole. The purchasing managers' index for Germany has also weakened, but at the same time other German statistics have been stronger than expected. This applies, for instance, to the IFO indicator, as well as to production in industry.

It is natural for us to focus on the parts of the world that are facing major problems regarding growth. But it is also important to remember that the situation is not as gloomy in all of the euro area countries, as illustrated by Germany. It is also important to note that the US economy has continued to strengthen, albeit at a slow rate. The situation on the labour market is improving slowly but surely and this has contributed to increased confidence among US households. Although the most recent labour market statistics for April point to weaker growth in jobs, at the same time the statistics on job growth were revised upwards for the previous months.

In Japan, fiscal policy investments in rebuilding after the tsunami last year will contribute to growth in Japan being slightly higher than we thought in February. In China, the economy is expected to grow by more than 8 per cent in 2012.

The overall picture we saw ahead of us in April looked fairly good. Personally, I emphasised the improved prospects for the United States as a possible reason for feeling slightly greater confidence in our international forecast. Global GDP is expected to grow at a rate that roughly corresponds to the historical average. The statistics received since the repo-rate decision in April have so far not had any dramatic effect on this picture. But the risk of a poorer development remains and at present there is greater nervousness on the financial markets than there was in April.

International risks

Even if the euro crisis does not trigger a total collapse in the international economy, there are a number of risks in the world economy that could lead to poorer economic prospects than we predict in our April Update. The first risk is that the deleveraging in the euro area will take longer than expected, and affect the Swedish export industry through lower demand. The second risk is that the United States will not rise to its fiscal policy challenges, which could hamper the continued strengthening of the global economy. Let me discuss these risks in more detail.

A third risk that is often discussed concerns the slowdown on the Chinese property market. I shall not go into this in any great depth here; I shall merely note that if property prices were to fall uncontrollably, China has the scope to implement fiscal and monetary policy stimulation, in that they have a low national debt of around 25 per cent of GDP and a high policy rate of almost 7 per cent.[1] The debate on the Chinese economy is otherwise often fairly categorical. It concerns either overheating or an imminent crash. If we look back at earlier developments, we can see that they have successfully managed to avoid both of these extremes. My assessment is that there is good scope for them to do so this time, too.

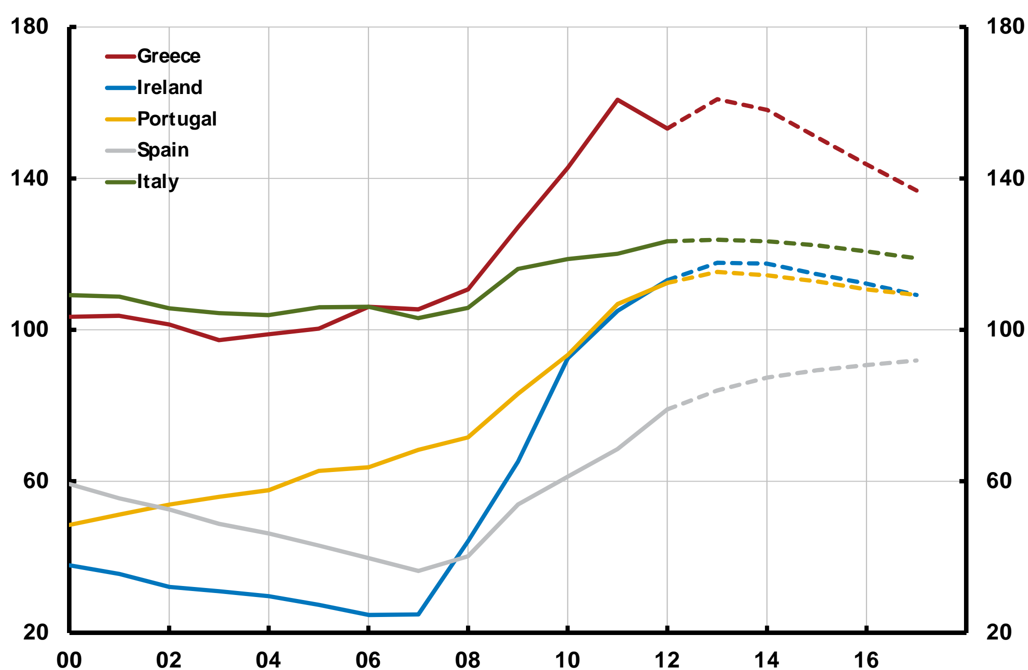
The euro area – prolonged deleveraging

In the euro area, it is mainly the Greek debt that has received attention. But, as well all know, other euro area countries have also suffered debt problems; for instance, Ireland, Portugal and Spain. Italy also has a high national debt, but this is a problem it has had for a long time. The following figure shows how public debt as a percentage of GDP has developed in these countries and the IMF's forecast until the end of 2017.

Figure 1

Development of public debt ratio

Percentage of GDP



Note. Public debt is shown as a percentage of GDP on the vertical axis.

Source: IMF Fiscal Monitor.

[1] IMF Fiscal Monitor (April 2012), "Balancing Fiscal Policy Risks".

Given the high level of debt, the need for deleveraging in the euro area has recently become a question that is much discussed in various contexts.

Deleveraging – course of events and earlier experiences

Experiences of the Swedish and Finnish banking crisis in the 1990s show that the process of deleveraging can take more than a decade. It can generally be divided into two phases.[2] During the first phase, the consolidation phase, households and companies reduce their debts. This means that households reduce their consumption and companies reduce their investment, which entails a weak or negative GDP growth. As a result, public debt increases, as the expenditure for social welfare increases and tax revenue declines. In Sweden, for instance, public debt increased from 46 per cent of GDP to 83 per cent during the period 1990–1994,[3] that is, the period when households, banks and companies reduced their debts. During the second phase, the recovery phase, GDP growth increases and public debt then also decreases, as higher growth leads to lower public expenditure on social welfare and to higher tax revenue. In Sweden, for example, the higher growth after 1996 contributed to reducing the public debt ratio by as much as 28 percentage points during the period 1996–2008.[4]

However, there are major differences in the conditions for the Swedish deleveraging and the consolidation of public finances in the euro area that has now begun. Swedish public debt amounted to only 46 per cent of GDP during the initial phase of the debt consolidation. The average for Greece, Ireland, Italy, Portugal and Spain, on the other hand, is still a good 112 per cent.[5] The Swedish recovery phase was also driven to a large extent by strong growth in exports, which was in turn partly due to the krona being allowed to float and quickly depreciating in this period. As a large percentage of trade in the euro area is internal, and they have a single currency and therefore cannot depreciate in relation to another currency in the euro area, there is a risk that the recovery in the debt-ridden euro countries will be more prolonged. The recovery in Sweden was also facilitated by international growth that was stronger than it is now.

I would like to point out that our cautious forecasts for growth in the euro area are because we are assuming there will be tangible effects from the tightening that is necessary to bring down the public debt ratio. However, there is a risk that the deleveraging will take longer than we have assumed. A prolonged debt consolidation with savings imposed simultaneously in several euro area countries would have a negative effect on the surrounding world through lower trade and demand. This would have effects on the Swedish export industry, which is dependent on trade with the euro area.

Good competitiveness – lower public debt

At the same time, deleveraging at present involves a difficult balancing act, as extensive savings measures risk strangling consumption and leading to a downward trend, with a fall in growth. It is a major challenge to find an appropriate balance between reducing expenditure and raising taxes to alleviate the effects on growth. Structural reforms of the product and labour markets are also necessary to improve competitiveness and ultimately growth potential. This is easier said than done, however, as such measures may be painful in the short term and politically difficult to implement. But countries that can create the right conditions for better competitiveness can hopefully also reduce the pressure on public

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[2] "Debt and deleveraging: Uneven progress on the path to growth", McKinsey Global Institute (January 2012).

[3] IMF Fiscal Monitor, Debt Database Fall 2011.

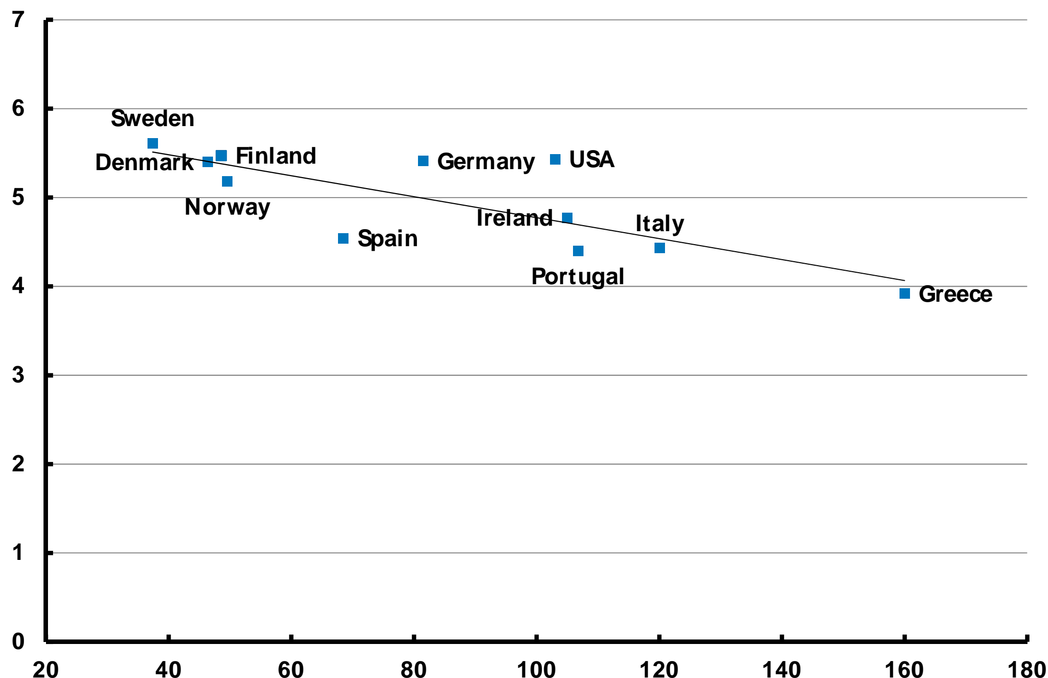
[4] "Debt and deleveraging: Uneven progress on the path to growth", McKinsey Global Institute (January 2012).

[5] IMF Fiscal Monitor (April 2012), "Balancing Fiscal Policy Risks".

finances. If one studies Figure 2, there appears to be a connection between good competitiveness and a lower public debt ratio.

Figure 2

Relationship between competitiveness and public debt ratio



Note. The public debt ratio is shown as a percentage of GDP on the horizontal axis.

Sources: World Economic Forum 2011 and IMF Fiscal Monitor April 2012.

The vertical axis measures the respective country's competitiveness as defined by the World Economic Forum 2011,[6] while the horizontal axis measures the current level of public debt as a share of GDP. A higher value on the vertical axis means that a country has a better competitiveness. There may, of course, be many factors that affect the public debt ratio, but according to the figure it would appear that countries with good competitiveness also tend to have a lower public debt ratio.

At the same time as it will take a while for the euro area countries to bring down their debt levels, it is important to point out that these countries are not alone in facing budget consolidation. The United States is also facing the challenge of improving its public finances.

USA – fiscal policy challenges

The US public debt amounted to 103 per cent of GDP in 2011, and is expected to rise to 107 per cent in 2012 and 110 per cent in 2013. As a comparison, the average public debt for the 14 largest euro area countries amounted to 80 per cent in 2011, while the forecast for 2012 and 2013 is 82 and 84 per cent respectively.[7] The well-known economists Reinhart and

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[6] The World Economic Forum weighs together a number of indicators of a country's competitiveness, for instance, the quality of the infrastructure, the level of education, financial development, etc. See http://gcr.weforum.org/gcr2011/ for a more detailed definition.

[7] IMF Fiscal Monitor (April 2012), "Balancing Fiscal Policy Risks".

Rogoff conclude in an extensive study that a public debt exceeding 90 per cent of GDP entails risks to long-term growth and stability.[8] When public debt reaches these levels, economic growth is rarely sufficient to reduce the debt, in their opinion.

The US economy is thus facing substantial fiscal policy challenges. At the same time, there is great uncertainty surrounding fiscal policy as there is a political deadlock between the Democrats and the Republicans in Congress that may remain after the presidential election in 2012. The uncertainty has caused analysts to talk about the US economy facing a fiscal cliff next year. The concern applies on the one had to whether earlier income tax cuts and reductions in payroll taxes will be extended beyond the end of the year, and on the other hand is linked to the automatic expenditure cuts that will come into force at the turn of the year unless Congress can agree on long-term sustainable budget consolidation. All in all, these automatic tax increases and cuts in public expenditure entail a tightening during 2013 of 3–4 per cent of GDP. A further element of uncertainty is the result of the presidential election in November. If the results of the election are inconclusive and no party gains a clear majority, there is a major risk that the political deadlock will persist.

The lack of credible budget solutions at present, and the low confidence in the political system's ability to deal with the fiscal policy challenge, could led to companies and households beginning to act with greater caution. This would subdue growth in the world economy. We have given consideration to these risks in our forecast, but it is of course possible that the situation will be more problematic than we have assumed.

Realistic to believe in an orderly resolution of the euro crisis?

The risks I spoke of earlier are ones that monetary policy normally faces and has to relate to. Forecasts change over time and monetary policy has to be adjusted accordingly. We would have a completely different situation, however, if the euro crisis were to worsen dramatically, and there was substantial turmoil on the financial markets and economic activity suddenly dived. In these situations monetary policy needs to adjust to a crisis situation, and we are prepared for this.

As a central bank, we need to be prepared to deal with many unexpected events. And we must make an assessment in our forecasts of the probability of these events occurring. A central assumption in our forecasts is that the financial market turbulence will gradually decline and that confidence will gradually improve in the corporate and household sectors. This does not mean that we believe that the road ahead will be straight and narrow. We have to assume that confidence in the countries' ability to resolve their problems will vary over time, and during the process different countries will come under focus.

When we summarise the measures taken since the worst phase of the crisis last autumn, the European Central Bank's two three-year loans to European banks were one measure that provided immediate relief. An acute liquidity crisis was avoided and the loans have also prevented a tighter credit crunch than would otherwise have been the case. However, they do not solve the long-term problems faced by many euro area countries, which was not really their aim, either. The loans have given many countries the breathing space to implement reforms, however, and it is important that they make use of this.

At the same time the EU countries have agreed on a number of measures for stricter budget discipline. For example, reforms have been decided on that will strengthen the current fiscal policy regulations. These are measures that do not have an immediate effect, but which nevertheless manifest a political will that should create long-term confidence in a crisis that has largely political overtones.

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[8] Reinhart, Carmen M. and Kenneth S. Rogoff, "This Time Is Different: Eight Centuries of Financial Folly", New Jersey: Princeton University Press (2009).

When we held our monetary policy meeting in April, Greece had been granted a second support package by the EU and the IMF, and had reached an agreement with private lenders on a debt write-down in return for promises of fiscal policy tightening. The euro area countries had also agreed to increase the capacity of their rescue funds, which was a step in the right direction.[9] After that, an agreement was reached at the IMS spring meeting to reinforce the IMF's resources with USD 430 billion for lending to crisis-torn countries. Building up these financial "firewalls" is an important step in creating confidence in the financial system.

There is often impatience with regard to the sluggishness of the political processes dealing with type of problems we are now seeing in the euro area. But the different steps that have been gradually taken on a political level should, as I see it, be able to alleviate a confidence crisis that is largely political. This would point to an orderly resolution of the euro crisis. It then remains to be seen whether the crisis flaring up around Greece now can have more far-reaching consequences. In a worried, nervous climate even a problem that only affects one small country can have contagion effects.

Could things go better than we are forecasting?

I have earlier listed various downside risks. Are there any conditions under which growth might be better than we are forecasting? My assessment is that this is the case, although things look uncertain right now and we cannot expect any rapid improvements. I think it is worth pointing out that we only expect a cautious recovery in growth in the euro area from the end of 2012 and onwards. What we are now seeing is a confidence crisis of gigantic proportions, but it also means that if political measures can build up confidence step by step, the economy in the euro area can recover with greater force than we are predicting. As I mentioned earlier, there are countries in the euro area with good fundamental conditions for a stronger recovery.

In the United States there are good conditions for a better outcome. In this situation growth can be somewhat stronger than the fairly modest growth we are predicting. Particularly if housing construction picks up again, after several years of adjustment. The driving force behind growth can be very strong, as earlier economic upswings have shown.

The situation in Sweden – some positive signs

What is the situation in Sweden? The weak growth abroad at the end of last year led to an unexpectedly severe slowdown in Swedish exports. This means that the fall in GDP growth in the fourth quarter of last year was larger than we had predicted. The weak year-end has an impact on GDP growth for 2012, which was revised down in April in relation to the forecast made in February.

At first glance, the GDP figure may appear ominous. But unlike exports, domestic demand during the fourth quarter was in line with the Riksbank's forecast. Developments in the retail trade sector and indicators of confidence in the corporate and household sectors pointed to demand beginning to increase again. In addition, exports of goods increased strongly in January and recovered a large part of the fall that took place in the fourth quarter of 2011.

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[9] The support facilities currently available consist of three parts. The largest, the EFSF (European Financial Stability Facility), was established in spring 2010 and has been built using guarantees from the euro area countries themselves. The second part is the EFSM (European Financial Stability Mechanism) which is based on a guarantee from the EU. The third part, which was also announced in spring 2010, was that the IMF could provide loans of up to EUR 250 billion.

When I weighed together the figures received since the monetary policy meeting in February, my assessment was that Sweden's economic prospects had brightened. This may appear strange if one looks at the growth forecast in the Monetary Policy Update and sees that the growth forecast for 2013 and 2014 is slightly weaker than in February. But this is because at the end of February Statistics Sweden revised up the number of hours worked, which leads to a lower productivity trend and a lower growth trend for GDP. This means that the outlook for economic activity and resource utilisation remained largely the same as in February.

The same applied to inflation prospects. The actual CPIF inflation rate, that is, the CPI with a fixed mortgage rate, has undershot the inflation target, but one should also look at the reasons for this. The strong appreciation of the krona that followed in the wake of the Lehman crash is one important reason. Low unit labour costs are another reason, but here there is now a turnaround, with labour costs being expected to rise faster during the forecast period than in the past two years. If one looks at the CPI, the most recent figures are moreover in line with the inflation target. In this context, I think that a little too much focus may be given to current inflation in the monetary policy debate, particularly given that it takes time for monetary policy to have an impact on inflation.

My overall assessment in April was therefore that the repo-rate path from February was still appropriate. This entails a very expansionary monetary policy with a negative real repo rate for most of the forecast period.

As I have mentioned, we saw indications at our meeting in April that the fall in growth at the end of last year was temporary, and we revised up our assessment of growth in the first quarter of this year. Since the monetary policy meeting we have received quite a lot of new information. For example we now know that Swedish exports of goods increased slightly during the first quarter after the steep fall in the fourth quarter of last year. According to Statistics Sweden's figures, employment was higher and unemployment lower than in our most recent forecast. The National Institute of Economic Research's Economic Tendency Survey also showed a large increase during the first quarter and the retail trade index, which rose strongly in February, continued to rise in March. All in all, new information received since the most recent monetary policy meeting shows no tendency to revise the forecast for Swedish growth during the first quarter. Still, I will wait to make an overall assessment of the new statistics until our next monetary policy meeting in July.

Monetary policy in uncertain times

I have described my views of the situation in Sweden and abroad. I have also pointed to a number of risks that could lead to a different development than the one we forecast in the Monetary Policy Update. We try to determine the probability of the risks on the basis of incoming statistics. This gives us a picture of what can be regarded as a main scenario and what can be regarded as an alternative scenario. How should a monetary policymaker weigh up new and often contradictory information about the economy that indicates different paths of development? I shall conclude with a few reflections on this.

As an economic forecaster, one is confronted by a constant flow of new statistics that often point in different directions. Let me illustrate this by describing the circumstances of our most recent monetary policy decision in April. Statistics Sweden had scarcely published a GDP figure for the fourth quarter that was weaker than expected, when the National Institute of Economic Research published a very strong Economic Tendency Survey for March. Nor is it unusual for statistics to be revised in a way that changes history and throws new light on the initial situation in the economy. As I mentioned earlier, Statistics Sweden revised up the figures for the number of hours worked in connection with the publication of the GDP statistics for the fourth quarter of 2011. This revision entails lower productivity growth for 2010 and 2011 than was reported earlier, and thus a new outlook on the future productivity growth trend, which has significance for monetary policy.

New and contradictory statistics and revisions of this type create uncertainty regarding the current economic climate. Personally, I am one of those people who closely scrutinise the statistics to form an opinion of the economic situation and the driving forces behind developments. But my long experience in this field has taught me that it is important not to have blind faith in the accuracy of the measures we use to assess the economic situation. As economic statistics are very uncertain, it is important not to read too much into individual figures and to keep a cool head when sentiment fluctuates after an unexpectedly high or low figure. This slightly conservative approach to forecasting has been, and is, my guiding star as an economic forecaster. Gradual adjustments to the forecast reduce the risk of taking a wrong turn and being forced to repeatedly revise the forecasts. As monetary policy is governed by forecasts, this can lead to fluctuations in the interest-rate policy. This in turn creates uncertainty for participants in the economy when they make their own decisions. I consider that the forecasts we have made in recent years are a good illustration of the gradual changes in the forecasts that I have mentioned. But of course one should always be prepared to make larger adjustments if the circumstances so require. Autumn 2008 is a good example of this.

I have on many occasions, at monetary policy meetings and in speeches, put forward the view that policy rate adjustments should normally be made gradually as a result of the uncertainty connected to forecasts and economic statistics. The well-known economists Orphanides and Williams say in an essay that this uncertainty indicates that one should not allow monetary policy to be influenced by contradictory information and statistics that are constantly revised.[10] Instead, one should normally allow monetary policy to change gradually. This limits the impact of contradictory information and statistics that are often revised.

Former Federal Reserve Chairman, Alan Greenspan, said “Uncertainty is not just an important feature of the monetary landscape; it is the defining characteristic of that landscape.” I can only agree with him.

[10] Orphanides, Athanasios and John C. Williams, “Robust Monetary Policy Rules with Unknown Natural Rates”, *Brooking Papers on Economic Activity* (2002), pp. 63–118.