Cecilia Skingsley: Reasonable expectations of monetary policy

Speech by Ms Cecilia Skingsley, Deputy Governor of the Sveriges Riksbank, at Danske Bank, Stockholm, 19 September 2013.

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This is not the first time I will present my view of monetary policy in Sweden. I have done so in many different contexts during my 20 years as a professional economist, for instance as a columnist for “Dagens Industri” or, most recently, as Chief Economist at Swedbank. Now, however, I am here as one of the new members of the Executive Board of the Riksbank. It is of course quite a different thing to be one of the six people responsible for the monetary policy decisions than to be an external analyst. It is of course also the case that the experience I have gained marks my monetary policy stance and colours my view of what it is reasonable to expect of monetary policy in practice. Today I intend to talk about my thinking at the two latest monetary policy meetings and about my thinking on monetary policy in principle.

Monetary policy through my eyes

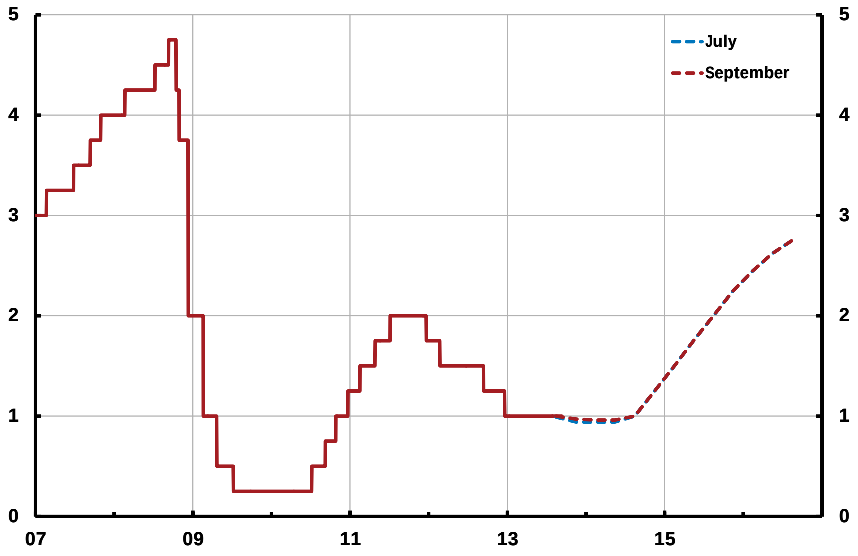
It is now two weeks or so since I took part in my second monetary policy meeting as a member of the Executive Board. The situation prior to the meetings in both July and September was marked by a low rate of inflation, for example CPIF inflation has been below two per cent since 2011, and a level of resource utilisation in the economy that was deemed to be lower than normal.

The forecasts in July and September were that inflation was expected to rise towards two per cent in 2015 and that resource utilisation was expected to increase as growth picked up. The assessment was that the expansionary monetary policy would contribute to this. I personally voted to keep the repo rate at the historically-low level of one per cent at both the July and September meetings.

Figure 1

Repo rate remains low

Repo rate, per cent



Note. Outcome data are daily rates and forecasts are quarterly averages.

Source: The Riksbank

What were the trade-offs behind my decisions? On the one hand an even lower repo-rate path could, according to the Riksbank's calculations, lead to inflation reaching the target somewhat sooner and to resource utilisation improving somewhat faster, while on the other hand there were other circumstances to take into account that made the decisions more complicated. For example, there is always uncertainty about exactly how monetary policy will affect the economy during the forecast period. When analysing the state of the economy I have focused on understanding how much can be attributed to cyclical fluctuations and how much to structural factors. In practice it is of course difficult to precisely distinguish between structural and cyclical factors, but it is nevertheless important to analyse this as monetary policy can only affect the latter. I have also asked myself what the relatively strong development of the Swedish household sector in relation to the weaker situation in the industrial sector means for monetary policy. All in all, I thought it was reasonable to leave the repo rate unchanged, for two main reasons. First, I think it would be wrong to lower the repo rate further in a situation in which the economy is improving. Second, I believe that a lower repo rate today could increase the risks associated with household indebtedness in the longer term.

I will now explain my thinking about monetary policy today in more detail and describe how I see the current situation in the Swedish economy, what I believe monetary policy can achieve and how I see the situation in the period ahead.

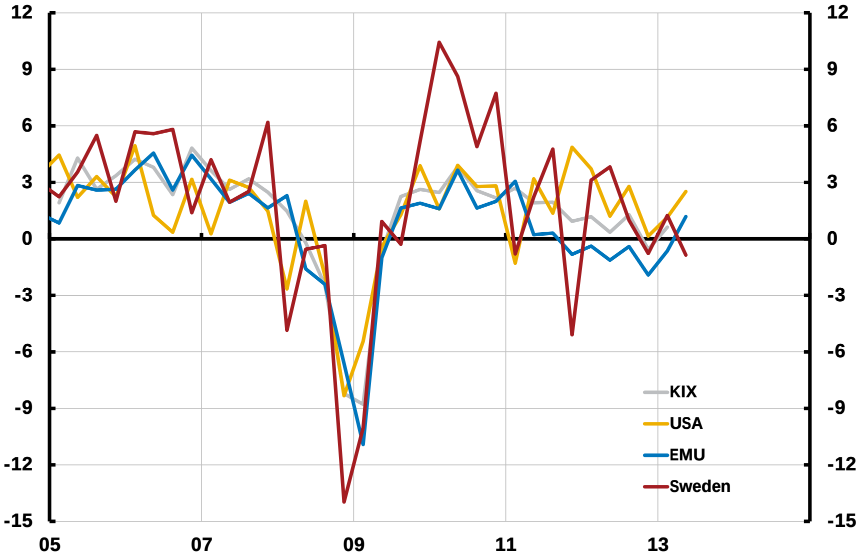
Divided demand – the explanation is to be found abroad

I would like to begin by looking back in order to describe my view of the situation today. Approximately five years have passed since the financial crisis began in earnest and these have been turbulent years for the global economy. Sweden is highly affected by what happens abroad but we have coped much better than many other countries, partly because we have not been hit by problems resulting from an excessive level of debt in either the public or the private sectors.

Figure 2

Weak developments abroad have affected Sweden

GDP, quarterly changes in per cent, annual rate, seasonally-adjusted data



Note. KIX is an aggregate of countries that are important for Sweden's international transactions.

Sources: Bureau of Economic Analysis, Eurostat, national sources, and Statistics Sweden

After the sharp downturn in 2008–2009, Swedish GDP growth initially recovered quite quickly. Unfortunately, the improvement in the rate of growth stopped short when the financial crisis developed into a debt crisis in Europe, and this has restricted Swedish exports. This has happened directly, as the euro area is Sweden's largest export market, and indirectly, as the euro area affects industrial activity in other parts of Europe and Asia that in turn are important growth markets for the Swedish manufacturing industry.

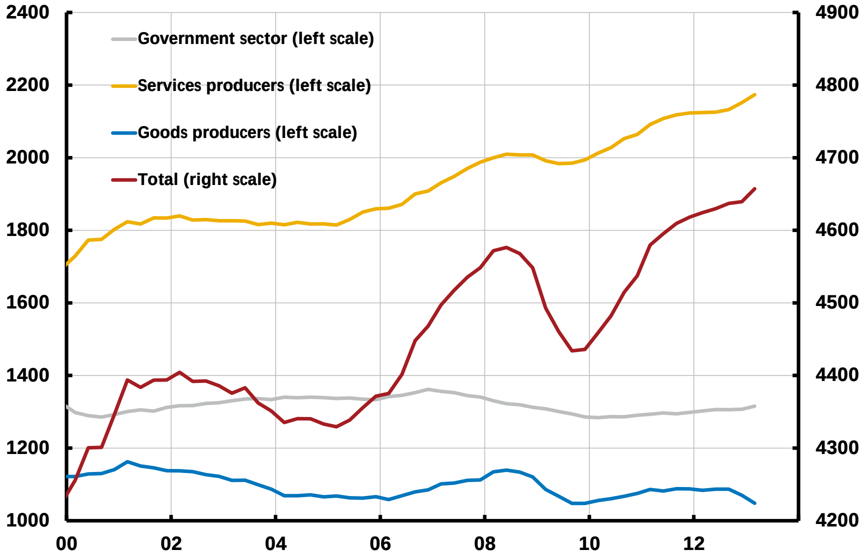
However, while indicators have long shown that the manufacturing industry is in a weaker than normal state, the financial situation of the households has been relatively strong. Moreover, if the weak development of exports and investment during, above all, 2012 had not been counteracted by household consumption, then the latest slowdown in the Swedish economy would have been more pronounced. Households have become more optimistic over the last 12 months and this is reflected in higher housing prices, increased lending and increased consumption. They have been helped by the increase in their disposable incomes over a period of several years. Low interest rates have of course contributed to this development in the household sector.

Turning to the labour market, employment has increased but unemployment is nevertheless higher than it was a year ago as the labour force has increased relatively quickly. This is partly due to an increase in those of working age in the population, but also to the government's labour-market reforms, which are both factors of a structural nature. At the moment unemployment is approximately 8 per cent and with the Riksbank's current forecast we are approaching the interval of 5 to 7.5 per cent within which the Riksbank believes the long-run sustainable rate of unemployment lies.[1] If we look at the situation in different sectors we can see that employment has increased in the service sector while the weak demand for Swedish industrial products is in part responsible for the weak development of employment in the manufacturing industry.

Figure 3

Weak developments abroad have affected the labour market

Employment by sector, thousands, seasonally-adjusted data



Source: Statistics Sweden

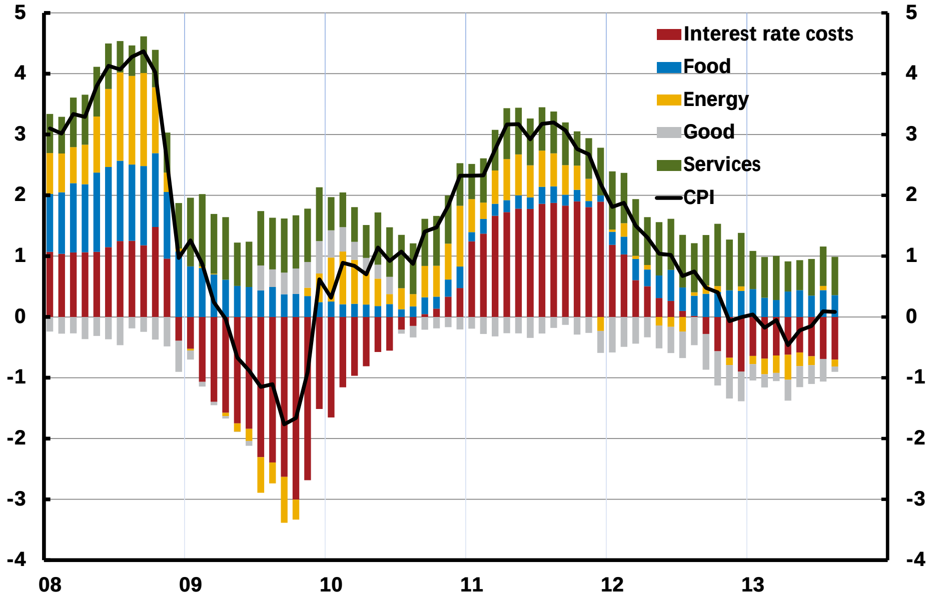
[1] The Riksbank (2012)

The relatively low level of economic activity abroad has also affected inflation in Sweden more directly. One reason for the low rate of inflation recently is namely that the prices of goods have increased slowly. The strengthening of the krona in recent years has led to a further reduction in import prices. On the other hand, service prices in Sweden have helped to keep up the rate of inflation.

Figure 4

What lies behind the low inflation?

Annual percentage change



Source: Statistics Sweden

All in all, given the relatively weak development abroad, it is thus not difficult to understand the division in demand that has marked the Swedish economy in recent years.

What can monetary policy do today?

Swedish monetary policy cannot do anything about the causes of the weak demand from abroad, but it can mitigate the effects on the Swedish economy. How low the repo rate needs to be, and how quickly inflation should rise towards the target are ultimately questions of judgement. I believe that it is appropriate that the Riksbank has let the repo rate remain at one per cent since the end of last year in order to boost the Swedish economy and to get inflation to rise to 2 per cent. According to the forecast, the repo rate will remain at this level until the end of 2014. In the forecast, the real interest rate will remain negative until the beginning of 2015, which shows that monetary policy is expansionary.

Monetary policy can mitigate the effects of weak development abroad

An even lower repo rate could help inflation to return to the target somewhat more quickly, as illustrated in a monetary policy scenario in the Monetary Policy Report published in July. According to the Riksbank's model calculations, a further repo-rate cut would lead to a further increase in consumption and increased investment. A lower repo rate would also weaken the exchange rate, which could benefit exports while at the same time making imports more expensive. All in all, this would lead to higher GDP growth and a higher level of resource utilisation, which would lead to a higher rate of price increases. According to the calculations in the Monetary Policy Report, a 0.25 percentage point lower repo rate for one year would lead CPIF inflation to approach 2 per cent during the first half of 2015, which is approximately six months earlier than in the Riksbank's main scenario.[2] Thereafter, in this example, CPIF would be marginally above 2 per cent.

Looking at these calculations it appears that a lower repo-rate path would be the better strategy for stabilising CPIF inflation and resource utilisation. However, this interpretation does not take into account the fact that there is uncertainty about the effects of monetary policy on the economy. The quantitative effects in the scenario are estimated using the Riksbank's macro model for the Swedish economy, but such estimates entail a degree of uncertainty and other empirical approaches could lead to different results. A common result in the research literature is that if we take into account the fact that there is uncertainty about the impact of monetary policy then we should act more gradually over time. However, it may then take longer for inflation to approach the target and for resource utilisation to normalise than if we do not take such uncertainty into account.[3] This line of reasoning may therefore mean that a higher repo-rate path is better balanced than the example's lower path, despite the fact that it will take longer for inflation to reach the target. Put another way, if we are not absolutely certain about the outcome of monetary policy it is better to proceed gradually.

Moreover, the repo rate is already low at present at the same time as we are seeing more and more signs that economic activity is picking up and at the same time as there are risks associated with household indebtedness. I would like to begin by discussing why household indebtedness has affected my stance on monetary policy.

Risks and rewards must be weighed against each other

Asset managers think in terms of risks and rewards. A strategy is evaluated using a financial risk calculation that is based on how much an asset portfolio can increase in value in relation to the risk that it will fall in value. This approach can also be applied to the world of central banking, although instead of being about an asset portfolio it is then about monitoring risks relating to the development of the economy and to the central bank's target variables, for example inflation.[4] As in the case of an asset manager, the time horizon on which the strategy is based is important. Translated to the current situation in the Swedish economy, this risk-reward approach could be expressed by saying that better target attainment in the short term must be weighed against increased risks in the longer term.

In other words, using a more expansionary policy to boost a part of the economy that is already relatively strong, that is the households, to counteract weak demand in the export sector – which in the main is due to factors beyond the reach of Swedish monetary policy – risks leading to imbalances in the long term in my opinion. Of course it is true that a more expansionary monetary policy could weaken the exchange rate, which would benefit the export sector, but in the monetary policy trade-off I cannot ignore the risks associated with the high level of household debt.

At the same time, there is also a risk that monetary policy itself can contribute to the build-up of imbalances in the economy, not only by affecting various players through the well-known transmission channels, that is the interest rate channel, the exchange rate channel and the

[2] If the repo rate is set 0.25 percentage points lower for four quarters, CPIF inflation in the example would reach 1.9 per cent in the first quarter of 2015 and 2.0 per cent in the second quarter of 2015. This can be compared to the main scenario from July in which CPIF inflation reaches 1.9 per cent in the second quarter of 2015, 1.95 per cent in the third quarter of 2015 and 1.96 per cent in the fourth quarter of 2015, but does not reach 2.0 per cent until 2016.

[3] See, for example, Williams (2013). However, the insight that uncertainty about economic relations often justifies a more cautious policy goes back to Brainard (1967).

[4] See, for example, Kilian and Manganelli (2003) who analyse the behaviour of central banks on the basis of risk-management principles.

credit channel, but also through the risk-taking channel. The risk-taking channel, which was analysed in an article in the Riksbank's own journal, "Sveriges Riksbank Economic Review", last year, is really a collective term for several different mechanisms which mean that monetary policy, by setting low policy rates, can encourage various players in the economy to take greater risks.[5] The argument is that banks and other financial institutions take greater risks when the policy rate is low by increasing their level of debt or changing the maturity of their funding. This may be justified from the individual player's point of view, but poses a risk to the economy as a whole. In the light of my experience of the financial market before and after the financial crisis, this theory seems intuitively correct. There is also empirical evidence to support the hypothesis that low interest rates lead to increased risk taking. It is not certain, however, that the change in the players' risk taking is solely due to monetary policy, it may also stem from a generally low level of interest rates that has structural causes. This is a subject that I am sure we will continue to discuss, not least in terms of what it is reasonable to expect monetary policy can achieve.

Monetary policy must take financial stability into account

The risk-taking channel has been described as a possible link between monetary policy and the work to safeguard financial stability. My starting point is that it is reasonable for monetary policy to take into account factors that relate to financial stability. This is partly because financial stability is a necessary condition for an effective monetary policy, but also because financial instability risks leading to major fluctuations in both the real economy and inflation. We should also take financial stability into account because part of the Riksbank's assignment is to promote a safe and efficient payment system.

Furthermore, in order to adapt monetary policy to the risk of future crises in the wake of financial imbalances we do not need to know that a crisis will actually occur, or exactly when, but we do need to know through what mechanisms or under what circumstances the probability of a crisis increases. Nor is it a case of a crisis being the most likely outcome but rather that the risk that something major can happen should make us focus our attention in that direction.[6] If we learned anything from the financial crisis it was that there is every reason to take even less likely outcomes into account. The financial crisis has also reminded us that cleaning up after a crisis can entail huge costs and take a long time. Five years after the financial crisis began, for example, unemployment is still high in many of the countries that were hit hardest.[7]

With regard to household indebtedness it is obviously the case that monetary policy cannot do much about a high level of debt that in turn is due to high housing prices if these have structural causes, such as insufficient new construction, tax regulations, building regulations and so on. However, the repo rate nevertheless has an impact on the situation of households that purchase housing. Experience from other countries shows that a high level of debt can pose risks to the economy, and the level of household debt in Sweden is now high in both historical and international terms.

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5 Apel and Claussen (2012)

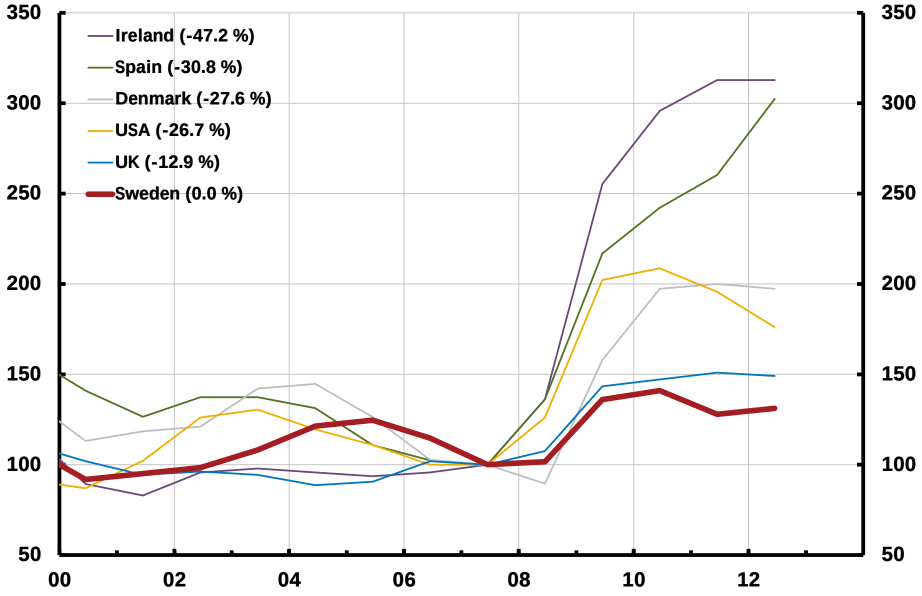
6 This has also been pointed out by Michael Woodford, one of the Riksbank's scientific advisers, in Woodford (2012).

7 For discussions of how the crisis has affected views on monetary policy and the work of the central banks, see for instance Blanchard, Dell'Ariccia and Mauro (2013).

Figure 5

High unemployment following a crisis on the housing market

Unemployed as a percentage of labour force, Index 2007= 100



Note. Figure in brackets refer to the decline in real house prices from the peak to the trough.

Source: OECD

An article in the Monetary Policy Report published in July analyses the potential consequences of this.[8] One risk in this connection is that the major Swedish banks largely fund their operations on the international capital markets and the level of confidence in the banks is decisive for their ability to get funding. A future economic downturn with a fall in housing prices in Sweden could therefore in the worst case be aggravated if international investors chose to reduce their exposure to the Swedish banking sector. The IMF recently repeated its warning about the high level of household debt in Sweden and the relatively large and concentrated banking sector and called for the quick implementation of the macroprudential policy instruments.[9]

Clearer boundaries affect the risk analysis

However, clearer boundaries have been set for the work on preventing future crises since I became a member of the Executive Board. The government has proposed that Finansinspektionen should be responsible for macroprudential policy in Sweden and that a stability council should be formed in which Finansinspektionen, the National Debt Office, the government and the Riksbank should openly present their assessments and recommendations concerning financial stability. It is good that there is now a plan for clarifying the framework for financial stability.

Macroprudential policy should also be able to use special instruments to manage developments in that part of the economy where there is a risk of imbalances. More specific instruments, such as amortisation requirements and higher risk weights for mortgages, are also probably more precise in their effects than the repo rate when the aim is to prevent and

8 The Riksbank (2013)

9 See IMF (2013)

manage the risks associated with household indebtedness. A mortgage cap is already in place. But we still do not know exactly what form future instruments will take and when it will be possible to begin using them. Once they are in place, however, I hope that there will be less need to take household indebtedness into account in the decisions on the repo rate.

The current discussion on the division of responsibility for macroprudential policy also calls to mind the relationship between monetary policy and fiscal policy. Through the medium of monetary policy, the Riksbank can influence the development of the real economy and thereby the loan losses of the financial institutions, the profitability of the companies and assets prices on the financial markets. All this in turn affects financial stability. And a macroprudential policy that aims to promote financial stability and comprises risk weights, capital requirements and amortisation requirements will affect interest-rate margins and interest-rate differentials which in turn will have an impact on the transmission mechanism of monetary policy. When the new framework for macroprudential policy is eventually in place and in use, the Riksbank will need to consider how it believes macroprudential policy measures will affect the development of the economy and financial stability in its forecasting work. The Riksbank should be able to take into account the effects of the macroprudential policy instruments in roughly the same way as it now takes into account how the government's future budget plans will affect the economy.

Gradual improvement in economic activity, but uncertainty remains

I began this speech by looking back at the economic situation over the last few years. I would now like to spend the rest of my time looking forward. My second argument for leaving the repo rate unchanged at 1 per cent in July and September was namely that the economy seems to be taking a turn for the better. A gradual improvement in economic activity was indeed in line with the Riksbank's earlier forecast, but ahead of the September meeting we had received additional statistics and other information that supported this assessment. For example, confidence indicators for Sweden and abroad had improved. Share indexes on the financial markets had risen thanks to positive signals about the recovery of the global economy. The outlook for a continued recovery in the United States was good and there were signs that an improvement had begun in the euro area.

Economic activity improving

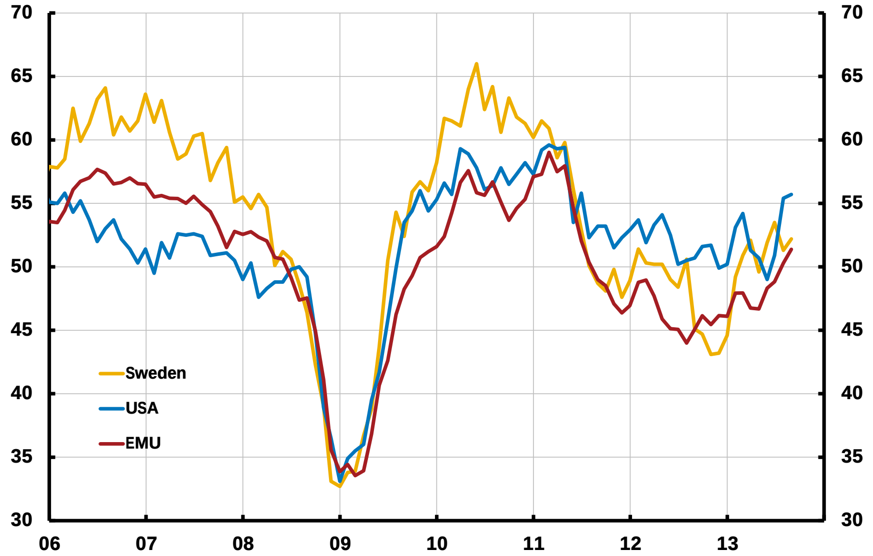
When it comes to the prospects for higher demand from the euro countries following the debt crisis and all the structural problems, I have become gradually less pessimistic over the last 12 months. This is for example because several highly-indebted countries have made progress in reducing their budget deficits. The Swedish crisis of the 1990s made a great impression on me as an economist and my experience from that period tells me that when households and companies see that the worst problems are over and that the situation is being managed then there is potential for increased confidence about the future, which we have also seen in recent months. This is despite the fact that unemployment is still high and that the recovery of economic activity in these countries is starting from a low level. Of course a lot remains to be done and here the responsibility primarily lies with the politicians in the respective countries.

The euro area's common monetary policy is an important tool for easing the readjustment, but it cannot correct all the causes of the crisis. This requires decisions at the national level in order to come to terms with weak public finances and to change economic and political structures so that competitiveness is improved. It has long been the Riksbank's assessment that the crisis can be resolved in an orderly way and that economic growth will gradually improve. This assessment still applies, and it is gratifying that recent events have confirmed an improvement, although forecasts of the future of course remain uncertain.

Figure 6

Positive signs

Purchasing Managers' Index PMI, manufacturing industry, seasonally-adjusted data



Source: Markit Economics

Uncertainty remains

However, apart from uncertainty regarding developments in the euro area there are, to paraphrase Donald Rumsfeld, the former Secretary of Defence of the United States, also other "known unknowns" that may affect the short-term prospects. One example of this is if there is a tangible change in market expectations regarding monetary policy in the United States. Ahead of yesterday's meeting of the US central bank, the Federal Reserve, long-term interest rates had risen in the United States and Europe, partly due to expectations that the Federal Reserve would reduce its asset purchases and partly due to the more positive signals about the performance of the economy. Share prices have risen in parallel with the rise in interest rates. However, a side effect of the better growth prospects and the expectations of a less expansionary monetary policy in the United States has been that several emerging economies have been hit by capital outflows.

In the slightly longer term, questions also remain about the outlook for global trade at large, a factor that has a substantial impact on an export-dependent country such as Sweden. According to some analysts, the development of global trade is now weaker than implied by historical links with global growth.[10] If this is the case, is it because companies have less access to trade credits in the wake of the financial crisis or because there has been a structural shift in the growth curve for global trade? It is perhaps not reasonable to expect the high rates of growth that we saw in the early 2000s – and which were boosted by globalisation in the wake of technological development, lower transports costs, increased specialisation, China joining the WTO and so on – to continue. It is also important to monitor how Swedish exports develop in relation to global trade. These are complex questions that it is probably too soon to answer. However, there is every reason to return to these questions too, particularly with regard to the potential consequences for Sweden. All in all, the Riksbank's assessment from the September Monetary Policy Update is nevertheless that

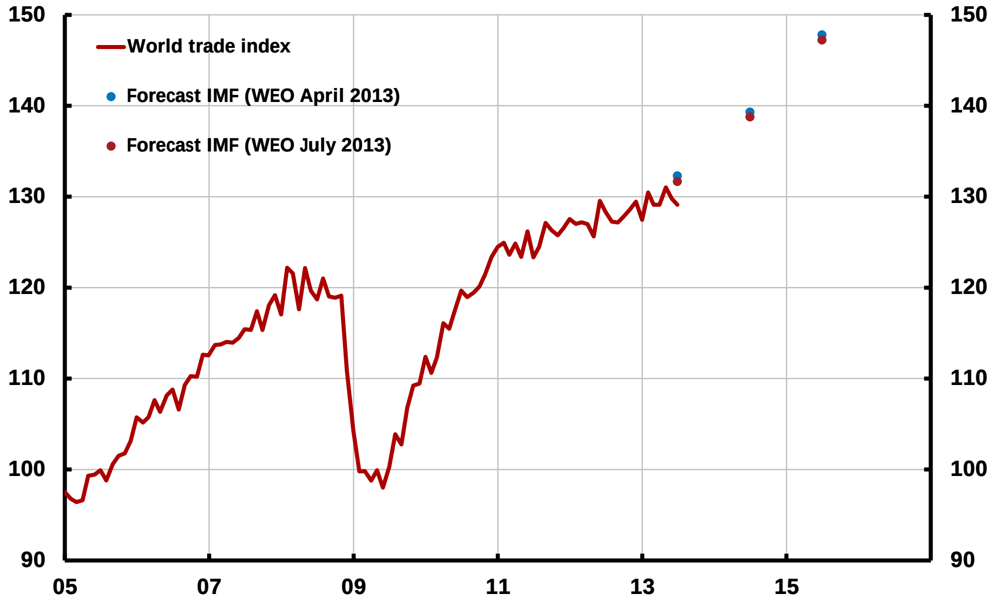
[10] See, for example, the World Trade Organization (2013)

economic activity abroad will, if only gradually, make a positive contribution to Swedish growth.

Figure 7

What can we expect of world trade?

Word trade index, volume, Index 2005 = 100, seasonally-adjusted data



Sources: CPB Netherlands Bureau of Economic Policy Analysis

Manufacturing industry catching up

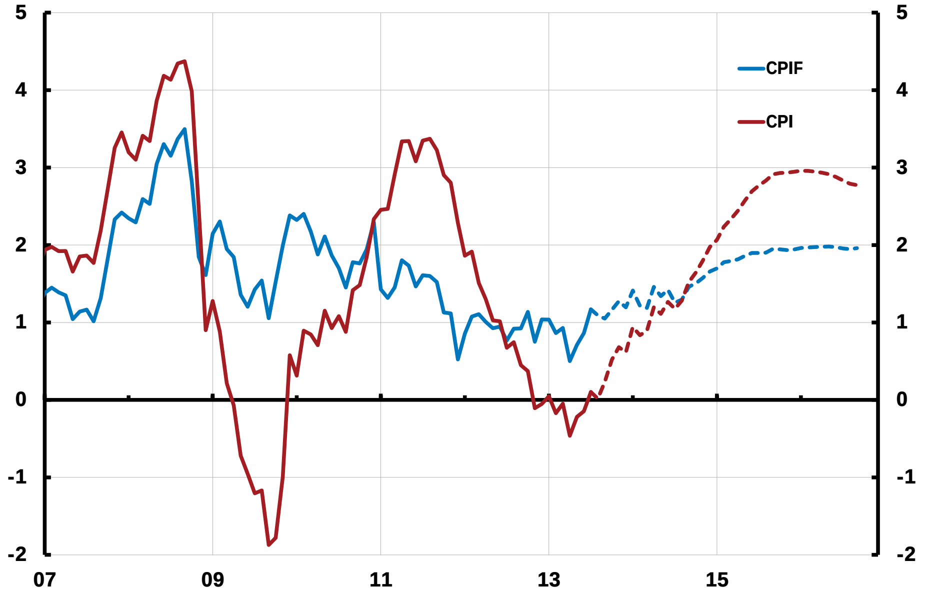
It is probable that we will be able to continue to describe the Swedish economy as divided for a while longer, even though confidence indicators suggest that the situation in the manufacturing industry is returning to normal. However, given the prospects for higher global demand we should also expect Swedish exports to increase in the years ahead. In combination with a more expansionary fiscal policy in Sweden and a low repo rate, GDP growth can thus be expected to pick up and the current low rate of CPIF inflation can be expected to gradually increase.

Some new statistics have been published since the monetary policy meeting in September that shed light on the current situation in the Swedish economy. CPIF inflation was 1.2 per cent in August, which was somewhat higher than expected. A revised version of the National Accounts has also been published which shows that GDP fell slightly more in the second quarter than indicated by the figures published earlier. The growth figures have also been revised down somewhat for 2011 and up somewhat for 2012. In addition, new labour market statistics show that seasonally-adjusted unemployment amounted to 8 per cent in August. The next Monetary Policy Report will not be published for a while yet, but at the Riksbank we are already working with new analyses and forecasts. Ahead of the monetary policy meeting on 23 October I will weigh these factors against each other, but also take account of any additional information that becomes available before then in order to arrive at a new assessment.

Figure 8

Low but gradually increasing inflation

CPI and CPIF, annual percentage change



Note. The CPIF is the CPI with a fixed mortgage rate

Sources: Statistics Sweden and the Riksbank

Good development in the short term, sustainable in the long term

I hope that in my speech today I have been able to convey my thinking on monetary policy at the two latest monetary policy meetings and how I view the current situation.

The repo rate is low at present. The Riksbank's forecasts show that inflation will reach 2 per cent within the forecast period at the same time as resource utilisation will improve. Although the global economy is weak at the moment, the preconditions for a recovery are in place. Sweden is in a better position than many other countries, but there is work to be done to put an effective structure for macroprudential policy in place. Once this structure is in place, we will be more able to manage the risks associated with the high level of household debt. Monetary policy could of course be somewhat more expansionary in the short term but we must remember that monetary policy is not perfectly precise and we must have realistic expectations of what it can achieve in relation to the risks that exist. As I see it we are already at full stretch as far as household indebtedness is concerned. A continued low repo rate offers the possibility of good economic development in the short term and sustainable development in the long term.

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