Mr Bäckström discusses the monetary policy situation in Sweden

Speech by the Governor of the Bank of Sweden, Mr Urban Bäckström, at Stockholm Chamber of Commerce and Veckans Affärer on 2/2/99.

Thank you for the invitation to attend this conference and talk about "The krona and the interest rate". I shall be speaking mainly about the current monetary policy situation and the factors that may be crucial for the policy's future formulation. However, now that the Riksbank is directed by the six members of the new Executive Board, which also makes the monetary policy decisions, the decision-making process has changed. So I shall begin by briefly describing how monetary policy will be decided and presented in this new environment.

The new process for monetary policy decisions

At 1pm on Thursday 11 February, the new Executive Board of the Riksbank will be convening for its first meeting specifically devoted to monetary policy. Compared with the Board's ordinary sessions, the discussion at what are called monetary policy meetings is to cover monetary policy more comprehensively and conclude with a decision on the policy's future stance. The discussion will be minuted and published in this form on 6April, around eight weeks after the event. Moreover, a brief account of the grounds for the decision will be presented in a communiqué on the day after the meeting, in this case at 9.30am on Friday 12 February.

These monetary policy meetings will be held 8–10 times a year and the minutes will be published with a time lag of 6–8 weeks. Monetary policy matters may, of course, appear on the agenda in the intervals between these meetings, particularly as repo rate decisions are normally made once a fortnight and announced for the coming two weeks. In the normal course of events, however, it is envisaged that repo rate decisions will be based on the discussions at monetary policy meetings. So it is only under special circumstances that monetary policy will need to be discussed more comprehensively in between the meetings specifically reserved for this.

For the Riksbank, this is a new procedure. The time when decisions will be announced is also new. In future, monetary policy decisions will be published on Fridays at 9.30am, though there may be exceptions to this rule in certain cases, such as the publication of the Inflation Report. Judging from their newsletters, it seems to me that so far most market players have understood our new arrangements. That is a good thing and also important.

There may be situations in which members of the Executive Board reach divergent conclusions. That will necessitate a more formal voting procedure. The outcome will be recorded in the minutes. No mention of a vote indicates that the Board agreed unanimously; otherwise, members with dissenting opinions will be named.

Disagreement on the Executive Board is clearly not something that is desirable as such. I am, indeed, convinced that each of the six members will aim for as collegiate an attitude as possible. To me, this is already evident from the work to date. But it is also the case that, in making monetary policy, a variety of factors have to be weighted into an overall assessment of inflation's future path. In weighing up the odds, different people may reach different conclusions, which need not be an entirely bad thing. It might even have the advantage of demonstrating that decisions on the monetary policy stance tend to involve assessments that are complex and tricky.

From interviews and comments in the press, it is already evident that members of the Executive Board voice somewhat different shades of opinion in their inflation assessments. This, too, is something that all those who follow monetary policy will have to get used to. It is, moreover, an assurance that our discussions in the Riksbank will be properly informed about aspects of the monetary policy stance. It is also consistent with the transparency that the Riksbank is striving for and which is a basic condition for the new legislation.

The monetary policy situation

Sweden's economy in perspective

In the years since the crisis in the early 1990s, economic development in Sweden has been rather good. Growth has been relatively high, yet inflation has been kept at a low level. Since summer 1993, annual GDP growth has averaged almost 3%. In other words, Sweden is now in the sixth year of favourable economic growth. The 3% average is much the same as during the upswing in the 1980s but clearly above the annual average of 2% achieved in the 20 years from 1970 to 1990. It may be more than we can expect to sustain in the long run.

An important reason why it has still been possible to keep inflation down in recent years has been the existence of unutilised capacity. This in turn has to do with the deep recession from which the recovery started and the comparatively rapid expansion of capacity since then. Medium-term inflation expectations have gradually stabilised around the 2% inflation target.

At times, however, including the recent period, transitory price movements have brought the annual average change in the CPI just outside the lower limit of the target's tolerance interval. There have even been periods when trend inflation has been lower than expected. For the decision-making of monetary policy, as the Riksbank has pointed out earlier, transitory effects on inflation are normally a secondary consideration. We are working to clarify how the target formulation is applied in order to dispel any uncertainty about how we should appraise direct effects on consumer prices that come from movements in, for example, house mortgage interest costs and indirect taxes.

Altered conditions for international developments

Last autumn, in the September Inflation Report, the Riksbank pointed to a growing risk of a weaker international trend on account of the crisis in Asia. However, the outlook was complicated by a marked weakening of the krona, which could have a contrary effect on inflation.

The exchange rate influences inflation via the level of resource utilisation and via the development of import prices; in the past two years the impact has come mainly from the first of these two mechanisms. As the effects on import prices should be regarded as transitory, they are of secondary importance for the monetary stance provided they do not alter expectations of inflation in the medium term. In other words, exchange rate movements are relevant only if they affect inflation's future trend though, for a small, open economy, exchange rate stability is, indeed, desirable.

In September and part of October last year, immediately before and after the publication of the Report, the monetary policy environment was turbulent and difficult to assess. Besides the international unrest, it was uncertain how fiscal policy would be constructed after the general election. All this prompted the Riksbank to keep the repo rate unchanged. The possibility of a repo rate cut would be considered when inflation prospects had become clearer.

During the autumn the financial unrest grew. The suspension of debt payments by the Russian government in mid-August, followed by the problems in the US hedge fund Long-Term Capital Management that came to light at the end of September, contributed to the markedly more nervous mood. Stock markets fell around the world and the financial crisis spread to other emerging markets that had previously not been hit. The lower share prices and the contagious spread of the crisis to other markets were liable to have consequences via decreased demand for exports from the industrialised countries, as well as via more cautious behaviour among their consumers and firms.

The problems in LTCM also aroused fears of a considerably more serious scenario where banks in the industrialised countries became so cautious about granting credit that this would paralyse global economic activity.

As the signs of an international slowdown became increasingly clear and were accentuated by the growing turbulence in financial markets, the Riksbank revised its assessment of the Swedish economy and the path of inflation. This warranted some easing of the monetary stance. In November the repo rate was therefore lowered in two steps, from 4.10 to 3.60%.

In the December Inflation Report it was still considered that in one to two years' time, both the change in the CPI and the underlying rate of inflation would be below the Riksbank's 2% target for price stability. On 16 December the repo rate was therefore lowered another 0.2 percentage points, to 3.40%. After this adjustment, responsibility for the future formulation of monetary policy passed to the Riksbank's new Executive Board, which would be taking over from the turn of the year.

Strong finish to 1998

Most signs suggest that activity in the Swedish economy was fairly strong in the latter part of 1998. GDP figures have still to be published but the available statistics point to a good fourth quarter. The strong trend is mainly due to the expansion of domestic sectors, not least in retailing. The development is not dramatic but Statistics Sweden does report a 12-month increase in retail sales of 3.3% in November. According to the Wholesale & Retail Research Institute, this was followed by a good Christmas season. The contribution to growth from investment also seems to have been favourable. As a result of all this, employment is rising more markedly than in recent years and this in turn led to a drop in unemployment during 1998.

Current inflationary pressure is still low. The rate of CPI inflation remains negative and the December out-turn was lower than expected: the level of consumer prices dropped 0.6% from December 1997, as against the fall of 0.3% that had been foreseen in the Riksbank's latest Inflation Report. However, this is partly a consequence of the Riksbank's repo rate cuts, which have brought house mortgage rates down. So while we lowered the repo rate in the light of favourable inflation prospects, the cuts have had the initial effect of depressing CPI inflation even more. This has been accompanied by a further decline in commodity prices. But underlying domestic inflation (UNDINHX) in December was unchanged from the preceding month at 1.6%, though this was still somewhat below our forecast.

US equity prices a possible risk

The global financial unrest subsided towards the end of 1998. Interest rate differentials between different market segments narrowed again and stock markets stopped falling. This made it less probable that the global economy would remain weak for a number of years.

Recent developments in Brazil have contributed to some recurrence of unrest in international financial markets. Once again there has been an international flight to securer assets but it has been more limited than last autumn. There has, however, been a substantial depreciation of the Brazilian currency.

It is still difficult to tell just how crisis in Brazil may affect the world economy. The future course in Brazil, with the attendant risks of knock-on effects in Latin American and other parts of the globe, will depend on what the national authorities do to construct a sound foundation for the economy. It has been shown, not least by our own economic experience in the early 1990s, that changing from a fixed to a floating exchange rate does not by itself provide a lasting solution to economic problems. What is needed is rather a comprehensive programme for enhancing confidence, with budget policy as not the least important component. A clear target and a consistent approach in monetary policy can also contribute to economic policy's credibility. But it does seem likely that developments to date in Brazil will tend to subdue growth in Latin America and even to some extent in the OECD area as a whole.

Despite the unusually long duration of the US economy's upward phase, the situation there is still buoyant. Growth in the closing months of 1998 was very strong. However, some slowdown is foreseen, partly because of a weak international trend but also due to subdued consumption. The high level of equity prices has been cited as a risk to US economic development. US stock markets have recovered completely from last autumn's fall and new all-time highs have been noted. Equity prices are considered by many observers to be unduly high in relation to the companies' profit expectations and there has been talk of a future correction. Given the importance of the share price rise for the US economy's upward trend, a price fall could by the same token lead to a slowdown.

Prospects for the euro area as well as for the Japanese economy seem to have become somewhat poorer since the December Report, at least for the coming year. In the euro area, it is mainly manufacturing which has weakened, while the consumption trend still looks relatively good. At the same time, household sentiment is closely related to the development of employment, not least in Germany.

Thus, the international outlook can hardly be said to have improved since the publication of the December Report and there still seem to be risks of a development that is weaker.

Industrial activity weaker but domestic demand good so far

Turning to the Swedish economy, the statistics suggest that industrial activity may go on weakening. But households' expectations of their own economy indicate that private consumption may remain relatively strong. Increased employment and a good development of real disposable income, not least as a consequence of low inflation, are grounds for households' optimism.

The duration of this trend is, however, uncertain, as it was last autumn. One question lies in the differences between households and firms in their assessments of the future. Negative news from the corporate sector could make households more pessimistic. Recently, moreover, there have been certain tendencies for households to become somewhat less optimistic about their own economic future.

The picture of total resource utilisation suggests that the Swedish economy still has unutilised resources. This in turn acts as a damper on inflation.

The weaker activity in manufacturing has led to a fall-off in net exports. If earlier cyclical patterns still hold, stockbuilding may be heading for a downturn. Moreover, if manufacturing remains weak, there could be some slackening of investment later this year. The rate of GDP growth this and next year will thus depend on the extent to which domestic demand makes up for the development of foreign trade and industrial activity.

When assessing future inflationary pressure, however, a point to bear in mind is that the past year's comparatively sharp fall in market interest rates is exerting a stimulatory effect on the Swedish economy. Since January last year the 10-year bond rate has moved down almost 2% and the short-term interest rate has fallen more than 1%. As only part of the effects of this have probably been transmitted to date by various mechanisms, allowance should still be made for some effects in the future.

The Executive Board's monetary policy discussion on 11 February will thus focus to a large extent on assessing global economic prospects and their consequences for Sweden's economy. Other questions will be the durability of the positive trend for domestic sectors and how the relationship between demand and supply will affect the development of prices.

Monetary policy’s focus on price stability is important in the context of economic stability. While the possibility of fine-tuning an economy should not be exaggerated, a policy for price stability should normally lead to a real economic development that is also balanced.

The Riksbank’s representatives continuously talk about the prospects for inflation; however, the question we are trying to analyse could equally well be put like this: how should the Riksbank handle the repo rate so that the Swedish economy’s favourable path in recent years is maintained?

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