Urban Bäckström: Sweden’s economy and monetary policy

Speech by Mr Urban Bäckström, Governor of Sveriges Riksbank, at Skanes Provinsbank, Helsingborg, 7 March 2002.

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First a word of thanks for the invitation to Helsingborg to discuss matters to do with the Swedish economy and the Riksbank’s monetary policy. For me it is particularly interesting to come here since I lived and worked for some years in Helsingborg in the 1980s.

As the published minutes show, at the Riksbank’s latest monetary policy meeting on 7 February the Executive Board concluded that some shift has occurred in the risk spectrum and there is now an overall tendency towards an upside risk for inflation one to two years ahead. The Board also made the overall assessment that the time for an interest rate increase is probably not far off if economic statistics continue to confirm an upturn and if inflation remains high.

In what I have to say here today I shall be starting from this appraisal, which I will place in its context and then to some extent try to look ahead.

Inflation prospects determine the repo rate

When the Riksbank sets the repo rate, the focal point is an analysis of future inflation in Sweden. This analysis is based in turn on three factors in particular: total resource utilisation, the path of the exchange rate and people’s inflation expectations.

Inflationary pressure normally varies with the demand situation and with changes in *resource utilisation*. The stronger the upswing in relation to potential output, the greater will be the risk of a faster increase in prices and wages and vice versa. That is why those of us who work in central banks around the world talk so frequently about the cyclical picture even though our target variable is actually inflation.

The future *value of the krona* plays a part in our assessment of inflation. Exchange rate movements affect inflation directly in that they show up in the price of imported goods and services; they also have indirect effects through aggregate demand. Changes in the value of the krona relative to other currencies of importance for foreign trade have consequences for the competitiveness of Swedish goods and services.

Turning finally to *inflation expectations* among households and firms, there is the effect on the actual formation of prices and wages and thereby on inflation. Altered expectations are liable to influence price formation if the Riksbank does not act through monetary policy.

There are, however, other price impulses that the Riksbank also has to handle. Examples are last winter’s shortage of snow that restricted the supply of hydroelectric power, cattle diseases that pushed up the price of meat, and the unusually cold weather in Europe that raised the price of fruit and vegetables. Price shocks of this type can occasion large shifts in the general price level at the same time as their impact on inflation is probably only transient. Suppose such a price shock occurs in a particular month; it will then leave its mark on the annual inflation rate in the coming year and then drop out of the statistics. As we normally count on a time lag of more than a year before monetary policy has its full effect on inflation, countering such temporary price impulses is both difficult and not particularly meaningful. Monetary policy accordingly focuses instead on the forecast of inflation one to two years ahead.

Occasional shifts in the price level can, however, affect inflation prospects more permanently if they alter the general perception of inflation’s path in the longer run. To put it briefly, if temporarily high inflation induces a general belief that inflation will also be high in the years ahead, then monetary policy must intervene. Even if the economic situation as such does not give grounds for worrying about inflation, in such a case resolute action may be called for so that the higher inflation does not become entrenched via inflation expectations. This is quite simply because, in terms of decreased output and employment, preventing inflation expectations from rising is less costly than pushing them down once they have become established at too high a level.

These, then, are the types of assessment from which we, as members of the Riksbank's Executive Board, form a picture of the prospects for inflation. We look at them from various angles, consider the risks and opportunities. Four times a year the Riksbank presents a more comprehensive account; at present we are working on this year's first Inflation Report. Let me remind you that for those who are interested, these reports are easily downloaded from our website: www.riksbank.se. Perhaps I should add that in addition to the text, the site provides the equally relevant statistics behind the charts.

Two routes for a central bank

Any central bank with an explicit target is faced with a choice that in its most extreme form looks something like this: either aim to keep inflation continuously on target or admit that there will be deviations that may last for quite some time.

If inflation is to be kept close to the target all the time, there will be a constant need for sizeable repo rate adjustments, with the attendant marked fluctuations in market interest rates, output and employment. If temporary deviations from the central bank's target are tolerated, on the other hand, monetary policy can be implemented more smoothly. A gradual adjustment of output and employment ultimately brings inflation back into line with the target.

Both these routes have their drawbacks. Negative effects on employment and output from major changes in the repo rate are liable to erode public confidence in the central bank and the monetary policy regime. At the same time, undue acceptance of large deviations from the inflation target may weaken the target's credibility and lead both to rising inflation expectations and to high costs for ultimately bringing inflation back on target.

As a result, central banks tend to prefer a monetary policy strategy that lies somewhere between these two extremes, avoiding excessively large interest rate adjustments but not hesitating to adjust when this is called for. The Riksbank normally formulates monetary policy with a view to inflation one to two years ahead. This unfortunately means that the repo rate has to be set with the aid of forecasts and forecasts can err. Moreover, there is always the possibility of price shocks that are a-cyclical but still affect the rate of inflation. A forward-looking policy has the advantage, however, of permitting an implementation that is smoother yet firm. The Riksbank reacts to the inflation forecasts in a determined manner but as the forecasts include an assessment of the extent to which inflationary impulses are transient, over-reactions are avoided.

The supply shocks I referred to earlier as having occurred during the past year are examples of price fluctuations that, with the monetary policy strategy the Riksbank has chosen, can occasion deviations from the inflation target. This is not the first time inflation has been affected by occasional factors. In the late 1990s, for example, successive deregulations of electricity and telecom markets resulted in deviations from the target, the difference being that at that time the gap was on the downside. What has happened now is the opposite. With our monetary policy strategy, this is a natural case of striking a reasonable balance between maintaining the fixed value of money and avoiding excessively large fluctuations in economic activity. It cannot be stressed too strongly that although the Riksbank's sights are consistently on the target, inflation will always tend to hover around the bull's-eye. Looking back, however, it will be seen that ever since the target was instituted, inflation has on average been very close to it. The intention is that this will continue to be the case in the future.

More and more signs of a recovery

So it is not the transitory price shocks that give the greatest cause for concern. Things are worse if we cannot rule out the possibility that part of an increase in inflation stems from strong activity earlier. Such effects usually show up after some time and tend to persist. During a strong upward phase, firms can begin to pass through rising business costs to consumers in the form of higher prices. Perhaps it is precisely this we have seen recently, at least to some extent. Support for such a conclusion may lie in that fact that, according to the latest statistics, the average wage level in Sweden is rising somewhat faster than is compatible with a 2 per cent inflation target. This may indicate that resource utilisation is in some sense more strained than we counted on earlier.

If economic activity in Sweden were to rise only moderately, leading in time to a weakening of inflationary pressure, the risk of inflation would diminish. But if activity were rather to show signs of freshening, there is a risk of the existing high inflation continuing and being incorporated in our perceptions of inflation in the longer run, with possible effects on, for example, future wage negotiations. That of course must not happen.

A scrutiny of the current cyclical picture reveals a growing number of signs that activity abroad, above all in the United States, is on the way to improving. This is something that also affects conditions for the Swedish economy. A majority of leading indicators point in that direction. Although the upward phase does contain risks to which I shall be returning, there is still a good deal of evidence that a recovery in the rest of the world as well as in Sweden may be on the way to materialising later this year.

A factor that often contributes to a cyclical swing is movements in stocks. When stocks are plentiful and sales are falling, firms often cut back production so that this falls more than demand. In this way, stock adjustments initially accentuate the cyclical downturn. When the reduction of stocks ultimately comes to an end, firms may step up production again even though demand has not yet started to recover. This drives a cyclical upturn and perhaps it is just such a positive effect that may be on the way. There are signs of this in the United States in particular but also in Sweden.

A continued recovery requires that this is accompanied by a broad and sustained increase in demand; otherwise the upswing is liable to be relatively brief. In this respect there may still be some uncertainty, mainly perhaps as regards the American economy.

The economic imbalances in the United States are still large and stock-market values are high, both historically and in relation to the current cyclical phase. However, high productivity compared with the rest of the world may make these problems less troublesome. Household saving has admittedly become somewhat higher relative to disposable income since the end of last year but the level remains very low compared with earlier years. Unemployment continues to rise. Against this background there are grounds for expecting that growth in the coming years will not be as high as in the late 1990s. But as overall economic policy is expansionary, there should be a successive recovery during the second half-year, though of course there are both upside and downside risks.

Turning now to Europe, there do not seem to be any clear signs of a strong recovery. Leading indicators admittedly point to a more positive business mood but the prospects for Germany – the largest economy in the euro area – are still uncertain and unemployment is rising from a high initial level. The euro area has not accumulated imbalances such as those in the United States and this may help to maintain a recovery once it has begun.

In Sweden, economic policy has charged the economy with a good deal of stimuli that can help to generate a broader increase in demand now that the stocks cycle is beginning to have a favourable effect and the prospects for the international economy are brightening. As a result of lower taxes and increased transfers, for example, most things suggest that household purchasing power is rising comparatively strongly this year. Seen over a complete economic cycle, the Riksbank's instrumental rate is comparatively low. Considering the rate of inflation and the signs that activity is picking up, the real repo rate (the repo rate less the rate of inflation) can be said to be low. Then there is the weak exchange rate, which has subdued effects of the international slowdown and is now helping to stimulate the export-oriented sector. All this amounts to not inconsiderable stimuli to general demand in the Swedish economy, stimuli that look like materialising successively.

How heavily should we tread on the accelerator?

If inflation, even disregarding the temporary effects, is above the target initially, activity is entering an upward phase and economic policy's impact on the economy is expansionary, then monetary policy ought to contribute to a somewhat lighter foot on the accelerator. But if most of the unduly high inflation stems from transient increases in the price level and if an economic upturn is not yet assured, it may then indeed be advisable to somewhat defer an upward adjustment of the instrumental rate.

It is likely to be around these and other aspects that our deliberations at the Riksbank will circle when the Executive Board finally adjusts the coming Inflation Report and next discusses monetary policy on 18 March. That is still almost a fortnight ahead and some more statistics are due to be published. In the meantime, the six of us on the Board will have to form our opinions step by step and decide whether there is to be some increase in the repo rate already in March or whether it is possible to go on waiting. Personally I share the concern about inflation prospects that a number of my colleagues have expressed in speeches recently.