Lars Nyberg: The repo rate - Spring 2002

Speech by Mr Lars Nyberg, Deputy Governor of Sveriges Riksbank, to the Swedish taxpayers' association in Malmö and Kristianstad, 22 April 2002.

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I should like to begin by thanking you for the invitation to this discussion and the opportunity to develop some ideas on the Swedish economy as it looks in spring 2002. I shall start with the Riksbank's most recent Executive Board meeting on 18 March, where we decided to raise the repo rate by 0.25 percentage points to 4.0 per cent. It may seem as though the interest rate hike did not come at the most appropriate point in time, as economic activity is still weak. Why did we raise the rate so quickly and before most other central banks had done so? Moreover, we, in common with most of the analysts in the market, expect the inflation rate to fall during the spring. Why did we raise the repo rate when inflation is on its way down? These are questions that I shall try to answer today. Some analysts also consider that the Riksbank has made a sudden U-turn in its assessment of inflation and so I thought I would explain a little about how our view has changed and why. However, it was not actually a major change and cannot really be regarded as a total U-turn.

Why was the repo rate raised when inflation is on its way down?

The Riksbank has been given a statutory task of maintaining price stability and promoting a safe and efficient payment system. The Riksbank has specified the monetary policy objective as a rate of increase in consumer prices, measured as CPI inflation, of 2 per cent, with a tolerated deviation interval of plus/minus one percentage point. The most important instrumental rate, the repo rate, is the instrument normally used by the Riksbank to maintain price stability.

Our monetary policy strategy can be described in a simplified manner using the rule of thumb that when an assessment indicates that inflation one to two years ahead will deviate from the target level, the instrumental rate is adjusted. The Riksbank's assessment of future inflation is communicated, for instance, in the Inflation Reports published four times a year.

The Riksbank has chosen to maintain the inflation target in a medium-term perspective. One reason for this is that monetary policy affects inflation with a significant time lag. An attempt to ensure that inflation also develops in line with the target in the short term would probably require much larger changes in the instrumental rate and thereby contribute to excessive fluctuations in demand and employment. The fact that the inflation target is worded in terms of a medium-run perspective also helps tone down the significance of temporary price changes.

The unexpectedly high inflation rate last year can partly be explained by a number of transitory factors. These include the low precipitation that affected hydroelectric power, various diseases that affected livestock and the fact that Sweden and southern Europe suffered poor harvests. We are in agreement with other forecasters and analysts that the inflation rate will fall as the effects of the transitory price rises abate and inflation approaches 2 per cent in early summer. In the longer term perspective, however, the picture looks slightly different and developments indicate an inflation rate above the target of 2 per cent.

The assessment contained in the main scenario of the most recent Inflation Report has CPI inflation at 2.2 per cent one year ahead and 2.4 per cent two years ahead. The corresponding forecast for underlying inflation, UND1X, is an increase of 2.2 per cent at both one and two years ahead. It is the latter measure that is the most central to monetary policy. However, each inflation assessment also takes into account the risk spectrum. The risk spectrum mainly concerns domestic inflationary pressure. If resource utilisation comes under greater strain than the Riksbank has estimated in its main scenario, or if the potential growth rate has been overestimated, there is a risk that inflation will be higher than expected in future. Taking into account the risk spectrum, underlying inflation comes out at 2.3 per cent both one year and two years ahead.

Although the inflation rate is expected to fall over the coming months, the forecasts indicate that it will exceed the inflation target one to two years ahead. As it takes such a long time for an adjustment in the repo rate to have an impact on the economy, it is both natural and reasonable to raise the rate now.

Now the transitory rise in inflation has affected not only Sweden but also a number of other countries. The decision to raise the repo rate meant that Sweden was the first central bank in the OECD region that chose to ease up on the accelerator somewhat and make monetary policy less expansionary. This is partly because resource utilisation appears to have been higher in Sweden than in other countries during the economic downturn and, above all, because it has been expressed in rising costs, primarily payroll expenses. To provide a more nuanced picture of this, I shall go on to discuss what lies behind our inflation forecast and why underlying inflation is high at present. It is important to begin with how we view the global economy and Swedish economy today in order to give a clear picture.

Brighter prospects for the global economy

The terrorist attacks on 11 September increased uncertainty over how the already weak global economy would develop. Investments were postponed in the face of a possibility of escalating anti-terrorist measures of unknown scope and consequences. There was also the risk of a considerable slowdown in consumption. Many central banks around the world cut their instrumental rates to counteract a feared decline in demand. The Riksbank cut its repo rate by 0.5 percentage points, to 3.75 per cent.

Now, just over six months later, we can conclude that the impact of the attacks on the global economy was less than feared, although certain sectors were hard hit. In addition, there are more and more signs of an imminent improvement in activity in both the USA and Europe. The stocks that had been built up during the downturn in activity appear to have been largely phased out and according to a number of indicators, production has begun to increase. A cautious optimism has begun to spread. There is also the additional impetus that comes from the expansionary economic policy in many countries and strengthens confidence in an impending upturn.

However, for the global recovery to really take off and become stronger, it is necessary that it is accompanied by a broad and sustained increase in demand. If production increases because stocks are too small and need to be refilled, there is a risk that the upturn will be short-lived.

We have been receiving both positive and negative signals regarding the situation in the US economy. The positive signals come from an unusually strong growth in productivity during the slowdown in activity, which indicates that the US industry has managed to adapt its production structure in an impressive manner. Private consumption, which is important in all countries, but particularly in the USA, has also remained strong during the whole of 2001 and early 2002.

Negative signals are coming from manufacturing, where companies' profit expectations are subdued in both the USA and Europe. However, the first reports just presented for Q1 look better than the market had expected. Although as private consumption has been relatively strong in the USA, there is no pent-up need to purchase capital goods as is usually the case after an economic downturn. Household consumption may also be negatively affected if households' wealth in property, and not just equity, is undermined. If the US long rates continue to rise as they have done in recent years, this may be one of the consequences.

A large part of Sweden's exports go to the euro area, which means that developments in economic activity here are particularly important. There are fewer signs of a recovery in Europe and the upturn in economic activity may be less strong. However, if one examines the leading indicators, companies appear to have become more optimistic.

All in all, it can be concluded that growth prospects in the world around us have improved. The effects of the expansionary monetary and fiscal policy conducted on both sides of the Atlantic are becoming more tangible. The slowdown in economic activity therefore looks to be relatively limited. At the same time, there are risks. The structural imbalances in the US economy, which were built up during the end of the 1990s as a result of excessive optimism, are threatening to slow down the recovery. However, the picture of the global economy is nevertheless much brighter than it was in the autumn and the signs of a turnaround are becoming more distinct.

Developments in Sweden

The signals of a general recovery in Sweden have also become more tangible. According to Statistics Sweden's sales index, the retail trade's sales volume rose in January, compared with December 2001. During the most recent three-month period (November-January) industrial production and order intake had increased, compared with the immediately preceding three-month period. The manufacturing industry is optimistic with regard to the coming months and the retail trade is expecting sales statistics to remain high, according to the National Institute of Economic Research's economic barometer.

The expansionary fiscal policy contributes to a strong development in households' disposable income and forms a basis for both higher private consumption and increased savings. Exports increased gradually during the period, but relatively cautiously, both because the international upturn in activity is rather tentative to begin with and because the krona is expected to appreciate. According to the Inflation Report, GDP was estimated to increase by 1.6 per cent this year and then accelerate to between 2.5 and 3 per cent in the coming years.

Despite the weaker demand last year, employment continued to develop strongly and unemployment declined slightly. Both the number of hours worked and the number of those employed increased during 2001. Part of the favourable development in employment may, however, stem from the increased absence due to sickness. The picture of employment is nevertheless rather divided. The number of jobs in the manufacturing industry has declined markedly, while jobs in the public sector and the service industries have increased.

Given this, the situation on the labour market is of particular interest. It appears to be relatively constrained, considering that we are at the end of an economic downturn and wage increases have also been slightly higher than expected, particularly in the construction sector and the service industries. As the level of employment has been retained, despite the decline in demand, productivity has shown a weak development, particularly in the services sector. To some extent, the effect of companies' higher costs has not had an impact on prices, but instead led to falling profit shares. However, it now appears that the demand situation has enabled companies to shift a larger part of the cost increases onto consumers.

So, how come wage increases have been higher than expected? One possible explanation may be that the resource utilisation in the economy has been higher in recent years than we had earlier believed. A strained resource utilisation means quite simply that the total demand is high in relation to the production capacity of the economy. This is usually revealed, for instance, in rising wage increases and higher underlying inflation. In the Inflation Report presented on 19 March 2002, we have made a slight upward revision for resource utilisation. This means that we believe that there are now, and will be in future, less available resources that can be used without price and wage increases accelerating.

Inflation above the target level

Looking at inflation, it is primarily the underlying rate that has been surprisingly high. The largest rise has been in prices of services. Here, the relatively high resource utilisation in the services sector has contributed to rising labour costs. In addition, prices of input goods, such as electricity and foodstuffs, have risen.

Given the developments in prices and wages over the past year, the Riksbank has gradually altered its view of the inflation propensity in the Swedish economy in a broader sense. A higher resource utilisation, together with rapid wage increases and a weak exchange rate, have led to slightly higher inflationary pressure than in previous assessments. It is this gradual shift that has sometimes been referred to as a total U-turn.

Recent events

Since the most recent Executive Board meeting, new statistics have been received that largely confirm the picture of the Swedish economy painted by the Riksbank.

In my opinion, there is no reason, all in all, to alter significantly the assessment of economic prospects made in the latest Inflation Report, with regard to either the international picture or the Swedish picture. We wrote in the press release from the Executive Board meeting on 18 March: "If economic activity continues to strengthen as expected - and if there are no grounds for changing the appraisal of the inflation propensity - it is, however, reasonable to assume that the level of interest rates in Sweden will be adjusted successively upwards." We thus see before us a path leading towards a less expansionary monetary policy than we have now. I think this assessment will remain the case.