Villy Bergström: Monetary policy and economic stability

Speech by Mr Villy Bergström, Deputy Governor of Sveriges Riksbank, at a conference organised by the real-estate market magazine “Fastighetsvärlden”, Stockholm 12 May 2004.

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Thank you for the invitation to participate in Fastighetsdagen 2004 here at Grand Hotel. The property sector is an interest rate-sensitive component of the economy, and it is therefore interesting for me in my capacity as a member of the Riksbank’s Executive Board to come here and speak with you and discuss how the Riksbank views the current economic situation.

The current economic situation

In conjunction with the publication of the year’s first Inflation Report on 1 April the Riksbank cut its key interest rate, the repo rate, by a half percentage point. The reason was that the Executive Board judged that inflation would be below the target of 2 per cent inflation over the next two years. In the past year inflation has been low, averaging 1.3 per cent. This is attributable to a large extent to an adjustment of energy prices to more normal levels. But recently the drop in inflation has been sharper than expected and the Riksbank has gradually changed its view of inflationary pressures. Among other things this has been due to unexpectedly low import prices. The labour market has also been weaker than forecast and productivity has increased faster, resulting in lower domestic wage and price pressures.

Inflationary pressures are also expected to be low in the period ahead despite the fact that the international economic upswing appears to have taken firm root in more or less all regions except the euro area. The international upswing is bolstering the Swedish recovery and during the next three years the Riksbank expects growth to average just over 2 ½ per cent a year. The relatively strong rate of growth means that the economy will approach full resource utilisation in spring 2006, according to our forecasts in the Inflation Report.

At the monetary policy meeting on 31 March a majority of the Riksbank’ Executive Board decided to lower the key interest rate by a half percentage point. My assessment of the situation was somewhat different, which led me to enter a reservation. In my opinion there were three principal reasons to limit the rate cut to 0.25 percentage points. Firstly, the general economic upswing in both Sweden and abroad will result in mounting inflationary pressures. Secondly, the expansionary economic policy in several parts of the world gives reason for caution. Asset prices, the willingness to take risks, and commodity prices have risen steeply in the past year. The third reason was that property prices risk rising further and with that households’ indebtedness. In my opinion, encouraging a further increase in indebtedness through a rate cut of 0.5 percentage points could lead to problems once rates rise.

A mild economic downturn

There are many indications now that the Swedish and international economies have embarked on a stable upswing. This means that the recent economic downturn has been mild in an historical perspective. In 2001 the Swedish economy grew by 0.9 per cent, and in 2002 by 2.1 per cent. Last year the recovery was derailed slightly and the economy grew by 1.6 per cent. During these three years production fell in only one quarter. For a downturn the rate of growth from 2001 to 2003 was high. This was also reflected in the labour market, where employment held up throughout the period 2001 to 2003.

Macroeconomic changes

The mild economic slowdown is likely a result of institutional changes that have helped increase the stability of the economy. Unlike the situation at the beginning of the 1990s the government finances are sound and monetary policy is transparent and predictable. This does not only apply to Sweden but also to large parts of the rest of the world. Stability has become a guiding principle in the economic policies of OECD countries, among others, and has entailed an increased focus on healthy government finances and stable prices.[1] The process has been helped by the absence of external cost shocks during the 1990s and beginning of the current decade such as the oil crises during the 1970s and 1980s.

Monetary policy has also benefited from a better government finance situation now compared with 10-20 years ago when there was a trend rise in debt ratios, i.e. government debt as a percentage of GDP, in the majority of OECD countries. Healthier government finances are contributing to stronger macroeconomic performance. Lower borrowing requirements in the public sector contribute firstly to lower real interest rates, which stimulate investment and growth. Secondly, stable government finances boost the credibility of monetary policy. During periods of large deficits and burgeoning government debt there is always a risk from a lender's point of view that the government will attempt to reduce the real burden of the debt by eroding its real value through increased inflation. The high interest rate levels that Sweden experienced in the wake of the crisis years 1991-93, when nominal long-term rates stood at 12 per cent, was a result of high risk premiums on Swedish bonds owing to lenders' concerns after a period in which the government debt had risen dramatically. Thirdly, balanced government finances allow automatic stabilisers to have their full effect. This means that demand can be sustained in the economy thanks to unemployment benefit and other factors when economic activity slows if the government finances are in such shape that there is sufficient economic leeway to finance the automatic stabilisers.

Generally speaking a more stable climate benefits the economy in many ways. Lower inflation brings with it lower volatility in inflation. In this way uncertainty diminishes and therefore also the risk premiums in the fixed income market, thus leading to improved efficiency in the economy. Economists also say that the price mechanism works better when inflation is low. This means that changes in relative prices become more evident the more stable the general price level is.

There has also been a marked stiffening of competition as many markets in a large number of countries have been deregulated or re-regulated with the express purpose of lowering barriers to entry and increasing price competition.

Another contributory factor is the rise in productivity that increasingly appears to be a reverse in the trend. In the US and a number of European countries, including Sweden, labour productivity has increased considerably faster since the middle of the 1990s. In Sweden productivity growth in the business sector averaged 2.7 per cent during the period 1995-2001. It has risen further since then, although cyclical effects have presumably something to do with this. We will have better information regarding the durability of the rise in productivity when the business cycle matures and employment picks up.

It is worth noting that low inflation in the world economy has not come at the cost of higher volatility in the real economy. Instead GDP growth has also stabilised during the 1990s and current decade, as indicated by the recent, mild downturn.

Prices of commercial property are following the economic cycle

Lower inflation and lower volatility in the inflation level has not led, however, to lower volatility in the prices in asset markets. As we all know, developments in the equity market have been unusually dramatic since 1995, with a steep rise up until spring 2000 and then three years of price declines. In the property market price developments have been somewhat more orderly, and less dramatic than they were at the end of the 1980s and beginning of the 1990s.

When the Riksbank discusses developments in the property market, which is mainly done in the Bank's Financial Stability Reports that are published twice a year, we usually divide it into two parts: the commercial property market and the housing market. Commercial property is defined as such property that is leased for commercial purposes, e.g. office premises, shops and industrial premises.

Developments in the prices of commercial property, especially those of office premises, have tracked the economic cycle relatively well in recent years. Developments in the prices of commercial property

[1] See, for instance, OECD working paper No 353: Macroeconomic policy and economic performance, 2003.

are largely determined by rent developments, which in turn depend on the demand situation. The weak economic situation in recent years has contributed to dampening demand for mainly office premises. This is evident partly in the number of vacancies, which continue to rise, with the exception of the Stockholm region. The subdued demand has entailed declining office rents for new leases. This has led to price falls in the office market. Since 2000 real prices have dropped by 35 per cent in Stockholm and by 21 and 11 per cent, respectively, in Gothenburg and Malmö. However, since the beginning of the year, both the rate of increase in the number of vacancies and the decline in office rents has moderated; as a result prices have stopped falling and have stabilised in the metropolitan regions.

Future developments in prices and rents depend on economic developments in general, and developments in office-intensive sectors in particular. The low number of new offices, coupled with expectations of higher employment in the metropolitan regions in 2004, is likely to contribute to a reduction in the number of vacancies in the office market in the long run. Given the Riksbank's assessment that the Swedish economy will recover in 2004 and a positive outlook for the Swedish business sector, with improved earnings and a lower or unchanged risk of bankruptcy, conditions are in place for a stabilisation of prices and rent levels for commercial property during the year.

It is likely, however, that price increases may not materialise until further into the economic upswing. The slowdown in recent years affected to a large extent office-intensive sectors, and many premises are vacant today as a result. Consequently there is a surplus of office space at present. Moreover, firms today appear to be adapting their costs to more strained financial conditions, which has resulted partly in less office space per employee.

A bubble in the housing market?

Developments in the housing market have been markedly different than those in the rest of the property market. Housing prices have risen by almost 60 per cent since 1992. During the same period the general price level has increased by around 20 per cent. The sharp rise in prices has continued despite the economic slowdown in recent years. This is a new experience that distinguishes the situation from previous business cycles.

A significant driving force behind these price developments is the lower interest rate level. Lower interest rates mean that households and firms can finance more expensive properties, all other things being equal. The low-inflation economy that has been established in Sweden since the crisis at the beginning of the 1990s has therefore also brought with it higher debt ratios among households. Debt as a proportion of disposable income has risen on average from 90 per cent in the mid-1990s mitten to around 120 per cent at the end of last year.[2] In spite of this, households' interest ratio, i.e. the proportion of disposable income that is used to make interest payments, has fallen from 7 per cent to below 5 per cent. In comparison, the ratio during the crisis years was up to 11 per cent.

A relevant question for the Riksbank is whether there is a risk that the recent years' increases in the prices of houses and notably tenant-owned apartments have been excessive and that consequently there are risks of a downward price correction. Our assessment so far is that the price increases can be explained by fundamental factors. Low interest rates, increased disposable income and a low supply of new housing coupled with high demand have pushed up prices. The number of new housing starts, which was 70 000 per year around 1990, today stands at 21 000. This is a recovery, however, compared with the mid-1990s when volumes were as low as 11 000. The background to this considerable decline compared with 15 years ago is regulatory changes rather than cyclical factors. Reduced interest subsidies, as well as deregulation and simplification of the government support system aimed at making the system more demand-driven, have resulted in consumers bearing a larger part of the costs of both the capital and production.

So the price developments do not appear to be an expectations-driven "bubble", i.e. a price situation brought about by private persons and households buying housing as investments with the primary aim of making a capital gain. That appears to be the situation in other countries, however, where it has become increasingly common to buy housing with a view to subsequently sub-letting it. Examples of

[2] Financial Stability Report 2003:2, Figure 2:20.

this are the UK and Australia, two countries that have tightened monetary policy during the past half year, referring explicitly to price developments in the property markets.

Monetary policy and asset prices

I would like to round off with some reflections on an interesting discussion that has been going on for some time among researchers. The discussion is about whether central banks should attempt to influence asset prices. The generally low level of interest rates in many countries, and in particular historically low key interest rates, have together with the stock market bubble during the second half of the 1990s helped to raise a discussion about monetary policy and asset prices.[3] At present, low inflationary pressures coupled with low interest rates have resulted in large volumes of liquidity in the world economy. There is quite simply a lot of money in circulation. This money has to be invested somewhere, and the major beneficiaries have been the world's asset markets such as equity and bond markets as well as property markets. In combination with improved corporate earnings and increasing confidence that the economic upswing has taken root, this has led to steep rises in these markets in the past year, notably in equity markets.

The discussion is about whether central banks can and should attempt to stabilise asset prices, which are not included in the CPI. The advantage of such an approach, given that the central banks should succeed, would be stabler real developments thanks to the fact that household consumption and business investment would be stabler if bubbles in the equity and property markets could be avoided. As stability is an important objective for all central banks it is an attractive idea to try to limit the emergence of prices in these markets that deviate substantially from those warranted by fundamental economic factors.

As in so many other situations the problem is that this is easier said than done. Firstly, the central banks have to identify when a bubble arises. In other words they have to be able to distinguish between what is warranted by fundamentals and what represents unreasonable expectations of continued price increases.

Secondly, once a bubble has been identified, the central banks have to be able to "burst" it. Asset markets are indeed sensitive to the interest rate situation, but it is possible that it would take such large rate adjustments from the central banks to neutralise a bubble that the negative effects on the rest of the economy would be far too high. For example the force of the most recent equity market bubble gives the impression that monetary policy would have to have been tightened considerably in order to slow the increase of almost 150 per cent that was seen on the Stockholm exchange between 1998 and March 2000.

Few central banks today say that they counter bubbles actively. But the very fact that there is such a discussion is an interesting and healthy sign.

Thank you.

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[3] For example, there are a number of papers from the Centre for Economic Policy Research in London, (CEPR) that raise the issue. These include Monetary Policy Rules, Asset Prices and Exchange Rates (Discussion Paper 4114, November 2003), Boom-Busts in Asset Prices, Economic Instability and Monetary Policy, Discussion Paper 3398, May 2002, and Financial Asset Prices and Monetary Policy: Theory and Evidence, Discussion Paper 1751, November 1997.