Stefan Ingves: The economic situation in Sweden

Speech by Mr Stefan Ingves, Governor of the Sveriges Riksbank, at a meeting arranged by Handelsbanken, Malmö, 12 October 2006.

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Introduction

Thank you for the invitation to come here and speak in Malmö! It gives me great pleasure to visit different parts of the country and explain what we do at the Riksbank. Today I intend to begin with a few words on the current situation in the Swedish economy and on inflation prospects. The Riksbank will provide a more in-depth analysis when the next Inflation Report is published, two weeks from now. I also intend to describe in more general terms how we conduct our monetary policy, that is, the Riksbank's monetary policy strategy. In connection with this I shall take the opportunity to discuss the role of asset prices in the analyses. It has sometimes been claimed in the general debate that the Riksbank puts too much focus on asset prices and too little on inflationary pressures from the labour market, and I would like to refute this claim. I shall then briefly discuss financial stability, an area in which I have been active for many years, both at the Riksbank and during my time at the IMF in Washington. My hope is that you will today gain an idea of now we think and work to attain our statutory objective, maintaining price stability in Sweden. Let me begin with my views on the current economic situation.

The current situation in the Swedish economy

In the June Inflation Report we envisaged continuing good international economic activity. We assessed that growth would remain high in Asia, which has developed strongly in recent years. The strong growth in China is one explanation for the upswing in Asia. The expansion in China has contributed, for instance, to the recovery we now see in Japan. At the same time, the US economy has remained an important driving force behind the world economy as a result of its size. In the euro area, however, developments have been weaker, but we saw clear signs of an improvement in the forecast we published in June.

At the same time as growth in demand in the world economy has been strong, price pressures have been held back. Although oil and other commodities have become significantly more expensive for consumers, the general price increases have been relatively small on the whole. One explanation for this is probably the stiffer international competition. Another is that monetary policy in many countries is now aimed at low inflation. The strong global economic activity has been beneficial for developments in Sweden. The Swedish economy has shown high growth rates in recent years. Despite this, inflation has also been low here in Sweden. This is mainly because import prices excluding oil have not risen and strong productivity growth has held down cost pressures.

New data received since June shows that the international economic prospects still appear favourable. However, the signals from the US economy are slightly mixed. In particular, the cooling in the housing market points towards weaker growth than expected next year. The picture of the euro area and other parts of the world is that developments have rather been slightly stronger than we assessed in June.

Back in June, we envisaged fairly high growth in Sweden over the coming years. The statistics received since then confirm that the economy is growing at a good rate. Household consumption and housing investment have grown more rapidly than expected. However, both the number of persons employed and the number of hours worked have been lower than expected. This reflects the fact that productivity growth has been surprisingly high again. Companies have thus been able to increase production without needing to take on so many new employees. Most indications are nevertheless that the labour market will continue to improve. Generally high lending and the fact that household indebtedness and house prices are continuing to rise rapidly support the picture of strong demand.

Rapid increases in energy prices have contributed to inflation being higher than the Riksbank's forecast over the summer. However, the oil price has fallen during the autumn, although it is as usual difficult to know whether this trend will continue. The oil price, like other energy prices, has a tendency to fluctuate considerably. There has been a recent downward adjustment in expectations of future energy prices.

The strong productivity growth will contribute to unit labour costs being low this year. When employment increases it is reasonable to assume that cost pressures will also rise. Our assessment is that energy prices will not push up inflation in future, but that rising unit labour costs will contribute increasingly to inflation.

Our assessment throughout the year has been that the outlook for inflation and the economy indicates that it is reasonable to assume the repo rate will need to be gradually increased. This will ensure that inflation is close to the target and that developments in the real economy are balanced. Given this, we chose to raise the repo rate by 0.25 percentage points at our monetary policy meeting in August. We have thus raised the repo rate four times so far this year and my assessment is that it is reasonable to assume that further increases will be necessary. However, it is a couple of weeks until my Executive Board colleagues and I meet to discuss the monetary policy stance. In connection with this meeting we will publish a new Inflation Report containing new forecasts for inflation and growth over the coming years.

Let me now move on to the more general discussion on how we conduct our monetary policy. In May we published a new document on our monetary policy strategy entitled "Monetary policy in Sweden", which described the Riksbank's objective and strategy. So what does this document contain, and why did we decide to publish it? I intend to discuss these questions now.

The inflation target and consideration of the real economy

Since the inflation target was formulated in 1993, the reasoning regarding the monetary policy strategy has gradually developed. It has been affected by both practical experiences in Sweden and other countries and new research results from the academic community. The primary reason for our new monetary policy strategy document is to increase understanding of the inflation target and of how we decide the monetary policy stance required to attain this target, while giving consideration to developments in the economy as a whole.

How have we then chosen to conduct monetary policy to meet our commitments in the best possible way? The Riksbank has the statutory objective of maintaining a low and stable inflation rate, or of maintaining price stability as it is expressed in the Sveriges Riksbank Act. We have specified this task as ensuring that CPI inflation is around 2 per cent a year, with a tolerated deviation interval of +/1 one percentage point. As long as confidence in the inflation target is not threatened, the Riksbank also has the possibility to take into account developments in the real economy, such as production and employment.

Although the latter has not been written into the Act, it was stated in the preliminary work to the new Sveriges Riksbank Act that came into force in 1999 that it was natural that the Riksbank should support the economic policy objectives of sustainable growth and high employment without neglecting the long-term price stability objective. This was considered a natural consequence of the Riksbank being an authority under the Riksdag (the Swedish parliament). It was therefore considered unnecessary to specify any further objective than price stability in the law text. It would moreover be difficult to combine such objectives with the EU regulations and also inappropriate given that monetary policy cannot govern long-term developments in production and employment.

Monetary policy affects the economy with a certain time lag. This means that the Riksbank cannot control inflation in the very short term and that monetary policy decisions must be based on forecasts of future inflation. Monetary policy is normally aimed at achieving the inflation target within two years to avoid the deviations from target from being too large and too protracted. The two-year horizon can be regarded as a restriction the Riksbank has taken upon itself to give credibility to the inflation target. At the same time, it provides an opportunity to show consideration for the real economy. If, for instance, there is a shock that leads to inflation being pushed upwards despite weak demand, a very rapid return to the inflation target could lead to a more severe slowdown in the already weak demand, than would be the case if the recovery was allowed to occur at a slower pace. If inflation is instead held back despite good growth in demand, attempts to quickly return it to target through very expansionary monetary policy could lead to the economy overheating. Over time a policy that quickly subdues inflationary impulses would probably result in more stable inflation, but there would be a risk of substantial fluctuations in the real economy.

We have chosen a two-year horizon for monetary policy because this is considered to give sufficient scope in most cases to ensure a good and stable development of the real economy. However, the rate at which it is desirable to bring inflation back on target in an individual case depends on what shocks the economy has suffered and how substantial they are. Sometimes the deviations from target can be so large that there is reason to allow inflation to return to target beyond the normal two-year horizon. In these cases, we shall explain this in connection with our decisions. Back when the new Sveriges Riksbank Act came into force in 1999 and a new Executive Board entered office, the Riksbank published a clarification of monetary policy, where it was pointed out that the horizon might need to be longer when the economy was subjected to large shocks[1]. The new element is that we are clearer on the point that the choice of time horizon concerns a desire to alleviate the consequences for the real economy.

Another new element since last year is that we make forecasts under the assumption that the repo rate will develop in line with market expectations, as these are reflected in implied forward rates. Previously, forecasts were instead based on the assumption that the repo rate would remain unchanged during the forecast period. What consequences does this change have? Monetary policy could previously be described with a simple policy rule. If the forecast for inflation was below two per cent, the repo rate would normally be cut, and it was above two per cent the interest rate would be raised. If the forecast was very close to two per cent the repo rate would remain unchanged. Of course, this rule could not capture all of the nuances in the monetary policy discussion, but it provided a rough explanation of the monetary policy decisions.

Now we no longer use this simple policy rule. According to our new way of thinking, if the inflation forecast is close to two per cent, the repo rate should normally develop in line with market expectations. This could mean that the repo rate should be raised or lowered in a number of stages over the coming two-year period.

The new way of thinking thus means that, unlike before, the monetary policy discussion is now based on an interest rate path that stretches across the entire forecast period. This method of working enables clearer communication regarding future policy. Although it cannot, of course, be regarded as a commitment from the Riksbank that the repo rate actually will follow a particular path. Each time we make a decision, we take a stance on the repo rate path, on the basis of the information available at the time. Our considerations can and should be altered if the economy develops in a different direction than we had expected.

Essentially, this is the same monetary policy strategy as before. The goal for monetary policy still concerns inflation and the ambition remains the same; that is, a desire to ensure that inflation is low and stable a few years ahead, while giving some consideration to the stability of the real economy. This is characteristic of what is known as flexible inflation targeting, which as far as I know, is conducted by all central banks that have inflation targets.

In this context I would like to take up a current issue that has recently featured in the monetary policy debate. It has been claimed that the Riksbank places too much focus on asset prices and too little focus on inflationary pressures from the labour market.

My response is that the basis for the monetary policy decisions includes analyses of demand and production, as well as the labour market and inflation. It is necessary to analyse asset prices and credit volumes as these affect and are affected by economic activity and inflation. Wage formation also plays a central role in the development of inflation. Over the past ten to fifteen years, fiscal and monetary policy has provided the foundation for good economic growth and wage formation has adjusted to this and functioned well. The social partners have actively contributed to this development and the results of the reforms have been good: Growth has been high and real wages have risen, despite the moderate increases in nominal wages.

It is of course extremely important that this positive development can continue over the coming years. Almost the entire economy is covered by a central wage agreement period that comes to an end in mid-2007. The wage bargaining rounds in 2007 will be very widespread. The economic conditions prior to the coming bargaining rounds are good and there is reason to believe that wage formation will be able to function efficiently. However, we will of course follow the bargaining rounds very closely, as we always do. I would like to emphasise that the social partners can sign agreements based on the Riksbank's inflation target standing firm. Judging from the surveys we make of inflation expectations, monetary policy in this respect has a very high level of credibility.

[1] See Heikensten, L, "The Riksbank's inflation target – clarifications and evaluation", Sveriges Riksbank Quarterly Review 1, 1999.

It is fairly clear that the labour market is facing many challenges and changes. This has been seen in particular from the fact that developments in the labour market have long been weak, despite several years of good growth and historically low interest rates. The poor growth in employment thus does not appear to be primarily the result of weak demand. The explanation must instead be sought among more long-term structural factors. This is reflected in particular in the fact that employment has not recovered since the heavy fall in connection with the crisis at the beginning of the 1990s, despite historically high economic growth.

Another sign that the unemployment problems have a structural nature is that there are large differences between regions and between professions. Although monetary policy is common for the Swedish economy as a whole, unemployment figures are twice as high in certain regions of the country as in others, and certain professional groups have twice as many people collecting unemployment benefit as others, and these differences appear to persist over a long period of time. This indicates that the problems are partly related to a low level of mobility in the labour market. The long-term solution to problems of this nature lies outside of the field of monetary policy.

Let me now explain in a little more detail why it is so important for us to also follow asset prices, such as house price developments and household indebtedness. It is important both in view of the Riksbank's task to promote financial stability and of the monetary policy objective to maintain price stability.

Aspects of household indebtedness and house price developments

In addition to maintaining price stability, the Riksbank is responsible for promoting a safe and efficient payment system. This requires, for instance, a safe and efficient banking system. The banks' activities are closely interwoven with the rest of the financial sector. The responsibility of the central bank for the payment system is therefore often expressed as a task to maintain financial stability.

The repo rate is not an efficient instrument for counteracting problems in the payment system. If such problems threaten to arise, it is entirely different types of measures that need to be taken. The monetary policy stance takes into consideration the outlook for inflation and the real economy, but does not consider financial stability.

So if the repo rate is not a good tool for financial stability, how can we protect ourselves against financial crises? In my experience, much can be achieved if the authorities and the financial participants together draw up effective preventive measures and plans for good crisis management. One clear and positive conclusion from the crises in the past twenty years is that good crisis management can save large amounts of money and reduce disruptions to society. On the other hand, it has been demonstrated that bad crisis management aggravates crises, partly by spreading uncertainty among the general public and the financial market agents. This may sound abstract, but in practice entails creating good laws, regulations and supervision.

Sometimes, acute banking problems may nevertheless arise and may mean it is necessary to close down a bank. When a bank needs to be closed, a difficult balance arises, between the owners' interests and the savers' interest, which are both safeguarded in law. One very current example of this dilemma in Sweden is the case of Custodia. Both the county administrative court and Finansinspektionen (the Swedish financial supervisory authority) have made their assessments on the basis of what they should take into account, that is to say the company and owners' interests and the customers' interests respectively. However, I feel that this episode indicates that it is very unsatisfactory that we in Sweden do not have a clear legal framework that can manage this type of situation and I assume that these difficulties will quickly be repaired.

Let me emphasise at the same time that we do not envisage any problems regarding financial stability right now. The fact that we have highlighted developments in house prices and household indebtedness has nothing to do with financial stability. It is because we are concerned about future inflation and growth. Developments in asset prices can in certain situations be a sign of risks to inflation and the real economy that need to be taken into account.

One problem is that it may be difficult in the forecasting and analysis work to know how to interpret major fluctuations in house prices and prices of other assets. One reason for this is that the models used to make forecasts do not have sufficiently sophisticated descriptions of the financial sector and its interplay with the real economy. The problems are particularly great when house prices and credit growth have over a long period developed in a manner that is not sustainable in the long term. Given the analysis and forecasting tools we use today, it is difficult to say whether a sudden correction in house prices will occur, or whether we can count on a calmer and more prolonged adjustment.

At the same time, the Riksbank must take into account the risks when conducting its monetary policy. If house prices and household indebtedness increase rapidly over a long period of time, there is a risk of imbalances building up. These imbalances may force an adjustment further ahead and in the worst case may have severe consequences for the real economy and inflation. If house prices rebound, this could lead to subdued demand further ahead through both a decline in household consumption and reduced investment in construction. This type of development could in the longer term lead to both inflation being below target and to weaker growth in the economy.

It is difficult to manage this type of risk. One possibility is to make changes in the interest rate slightly sooner or later than would otherwise be justified on the sole basis of the forecasts for inflation and the real economy. It is hoped that such a policy will contribute to a smoother adjustment process and help to avoid a more abrupt correction. A two-year horizon is a good decision rule, but it cannot always work in all situations.

There are now signs of some slowdown in the housing market. For the first time in two years the median price for houses has fallen, according to Swedbank's Boindex. Moreover, the rate of increase in household borrowing from mortgage institutions is now slightly lower than it was in the spring. Of course, it is impossible to draw any far-reaching conclusions solely on the basis of these observations. However, we will make a thorough assessment of the situation later in the autumn when we publish our twice-yearly Financial Stability Report.

Summary and conclusion

Let me briefly summarise my message today.

- We have raised the repo rate four times this year and my assessment is that it is reasonable to assume that further increases will be necessary. This will ensure that inflation is close to the target and that developments in the real economy are balanced.
- Our focus is on the inflation target and the central aim is, as before, to anchor inflation expectations in the economy around this target. When we formulate our monetary policy we also give consideration to the way the rest of the economy is developing. You can read more about this in our recently published strategy document "Monetary policy in Sweden", which can be ordered from our Communications Secretariat. It can also be downloaded from our website and is available in both Swedish and English.
- The social partners can sign new agreements based on the assumption that the Riksbank's inflation target stands firm. Judging from the surveys we make of inflation expectations, monetary policy in this respect has a very high level of credibility.
- The Riksbank also has the task of safeguarding financial stability. We see no problems with regard to financial stability at present. The fact that we emphasise developments in house prices and indebtedness does not concern financial stability. It is because we are concerned over how future inflation and growth might be affected by a possible sudden correction in house prices.

Finally, I would like to stress that the monetary policy framework has functioned well. This is indicated in particular by the fact that inflation expectations are firmly anchored around two per cent. There are no signs in the financial markets that monetary policy is regarded as unclear. However, this does not mean we can rest on our laurels. We have one of the most open and transparent central banks in the world and we wish this to continue. The Riksbank's forecasts assume, as I mentioned earlier, that the repo rate will develop in line with market expectations. I have raised the question of possibly going one stage further and instead reporting the Riksbank's own forecast of interest rate developments, as they do in, for instance, Norway and New Zealand. Personally, I see it as quite natural that we should make forecasts of repo rate developments in the same way that we forecast a number of other variables. This type of methodology would require changes in the way the forecasts are produced as well as the Executive Board's internal work. We are discussing this at present. The Riksbank is constantly working on improving our analysis methods and our methods of communicating our decisions. It will therefore be particularly exciting and interesting to see the assessment of monetary policy, which two external experts have made and which will be ready soon. It will no doubt contribute to a serious discussion of monetary policy and how the framework for the policy can be further developed in a small open economy like Sweden. I look forward to these discussions.

Thank you!