Irma Rosenberg: The current situation and monetary policy

Speech by Ms Irma Rosenberg, First Deputy Governor of the Sveriges Riksbank, at the Stockholm Chamber of Commerce, Stockholm, 30 May 2008.

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The Riksbank is currently facing a rather difficult task. This, by the way, does not apply just to us but to the other central banks as well. The Riksbank's task is to keep inflation low and stable and to help make sure that production and employment levels do not fluctuate too much. However, inflation is now high at the same time as economic activity is slowing down. Raising the policy rate in order to curb inflation would lead to a further decrease in economic activity. This is a dilemma that we and other central banks face.

When the Executive Board met on 22 April to decide on monetary policy, we took into account, as usual, all the factors that may affect the development of the Swedish economy. Our decision then was to hold the repo rate unchanged. Today, I intend to tell you a little about our thinking at the time and to discuss the problems we now face in the current situation. In particular I will, in a little more detail, address the dramatic development in food and energy prices in recent years and how these affect inflation in Sweden. I will conclude by discussing the new information we have received since our latest meeting.

However, let me say straight away that although energy and food price trends will affect the general price level during a transitional period, it is monetary policy that determines the level of inflation in the long term. The Riksbank does not need to, and shall not, accept a higher rate of inflation in the long term just because the prices of certain goods rise. However, the time required to get inflation back on target may vary depending on how severe and prolonged the shocks are and how much consideration the central bank wants to give to the real economy. I will return to my views on this issue in a moment.

Weaker economic activity versus rising inflation

Let me begin by summing up the situation at the time of our latest policy rate decision in April. The turmoil on the financial markets had continued since our previous meeting in February and the interbank rates had risen again. The high interest rates on interbank loans revealed that many banks were still experiencing liquidity problems. There was considerable uncertainty over how long it would take for conditions to return to normal. This also increased uncertainty over how great the impact of this financial turmoil would be on the real economy internationally and in Sweden.

Economic activity in the United States had been weaker than expected and our forecast for US growth was revised sharply downwards in April. In the euro area too, economic activity appeared to be slightly weaker. We assumed therefore that growth in the world economy would be somewhat weaker in 2008 and 2009.

In Sweden on the other hand, economic activity was somewhat stronger than expected. Nevertheless, it was assumed that the weaker prospects for economic activity internationally would lead to a slowing down of growth in Sweden as well later this year and early next year. Signs of this slowdown were already beginning to appear, for example in the data in the National Institute of Economic Research's Economic Tendency Survey and in the statistics on retail sales and new job vacancies.

Our assessment, however, was that the slowdown in Sweden would be relatively moderate. GDP growth remained good, and the potential for future growth was still relatively favourable. The level of saving among households and in the public sector was high. Property prices were fairly stable and the direct effects of the financial turmoil were expected to be relatively slight.

At the same time, inflation was high both in Sweden and abroad. This related above all to higher energy and food prices on the world market. Inflation expectations in Sweden also remained high, and were also way above the inflation target even in the longer term. We thus had to take various counteracting factors into account. On the one hand, growth in the Swedish economy was still good and both inflation and inflation expectations were high. On the other hand, the turmoil on the financial markets and weaker growth in the world economy were expected to curb growth and inflation in Sweden. This led to our decision to hold the repo rate unchanged at 4.25 per cent, a decision I voted in favour of. We also held to our forecast that the repo rate would remain at this level over the coming year in order to bring inflation back to the target over a period of a couple of years and to enable production and employment to develop in a balanced way.

We also emphasised that there was still considerable uncertainty over future developments. Personally, I saw an evident risk that the slowdown in the United States could become more prolonged than was assumed in the forecast. I also saw a risk that the rapid price increases in the world energy and food markets could subdue demand and thereby growth in the rest of the world, which could also further hold back Swedish growth and inflation. There were also clear signs that the Swedish labour market was about to cool down and my view was that the weak productivity growth indicated that companies' demand for labour could decline. This indicated that there was no great risk that the rate of wage increase would accelerate more than anticipated. This was the combined reason why I did not wish to rule out the possibility of a cut in the policy rate later in the forecast period.

For my part I considered it important to ensure, when making the interest rate decision that the strong price impulses from the world market do not push up inflation expectations lastingly and through second round effects lead to higher permanent inflation. However, there is considerable uncertainty as to how commodity prices in the world market will develop and what consequences this will have for inflation and monetary policy. Let me explain this reasoning.

Relative prices are only important to monetary policy if they influence inflation…

Since last autumn Swedish food prices and oil product prices in the CPI have increased rapidly. In April this year food prices had risen by around 6 per cent compared with the same month last year. They thus contributed around 1 percentage point in April to the CPI inflation, which amounted in total to 3.4 per cent. Oil product prices contributed a further 0.3 percentage points.

The upswing in Swedish food prices mainly reflects the rapid price increases in the world food commodities market over the past year. Despite the turbulence in the financial markets and weaker growth in the world, food prices in the world market have increased by 60 per cent (expressed in USD) since the end of 2006.[1] Prices of many goods have reached record high levels, including prices of soya beans, maize and wheat. The oil price has also constantly reached new record levels in recent years.

In the world market we have nevertheless been able to see a slightly calmer development in the price of some food commodities. The price of wheat has fallen. According to the Chicago stock exchange, the forward price in dollars fell by 30 per cent between mid-March and the end of April. But the price is still slightly above the average for last year. One factor contributing to the decline in the price of wheat is that the Ukraine has eased its restrictions on wheat exports. The price of rice has also fallen very recently, while maize prices have

[1] According to The Economist's commodity price index for food.

continued to rise.[2] In total, food prices have fallen slightly in recent months, but are expected to remain at high levels in the future.[3]

What significance does the fact that world market prices are rising rapidly have for monetary policy? One must realise that these are examples of changes in relative prices. That is, the prices of commodities such as food and energy are rising in relation to the prices of, for instance, manufactured goods. For monetary policy it is important to note that the changes in relative prices are not in themselves inflation. Inflation refers to a rise in the general price level, or the average of all prices.

Central banks cannot and should not counteract changes in relative prices. But what central banks can influence with monetary policy is the way inflation develops in the long term. Some changes in relative prices can occur when inflation is low if the price increases on the goods that have become relatively more expensive is compensated by a weaker growth in prices of other goods. The same relative price change can be achieved when inflation is high, if the prices of all goods rise, but at different paces.

If food commodities and oil prices soar, this means that companies' costs will rise and inflation will be pushed up. It is not possible to immediately counteract such strong inflationary impulses with monetary policy, as monetary policy works with a time lag. But what a central bank with an inflation target then faces is the task of ensuring that the rising food and energy prices do not result in permanently higher inflation expectations and second round effects in the form of demands for higher wages and prices of other goods. Regardless of what happens to the relative prices, our task is – and this is important – to ensure that inflation is on average 2 per cent a couple of years ahead.

…and we are only concerned with the lasting effects

How should monetary policy respond to the rapid increases in food prices? This depends on whether the effects on inflation are assessed as temporary or lasting. Monetary policy cannot respond to temporary upswings in inflation that can be expected to subside quickly, as monetary policy acts with a time lag. Raising the interest rate to counteract temporary inflationary impulses could cause unnecessary costs. And here I mean costs in the form of production and employment falling too much. However, monetary policy should react to price impulses that would otherwise risk having lasting effects on inflation.

As I have mentioned earlier, monetary policy both in Sweden and abroad is facing a severe challenge. On the one hand, the fact that oil and food prices have recently shown a rapid upturn, both in the world market and in Sweden, means that inflationary pressures have increased substantially. This implies that the interest rate should be raised.

On the other hand, our most recent growth forecasts indicate that international growth will be weaker, or at least in the United States and the euro area. There is a risk that this will also subdue growth in the rest of the world.

In addition, the upswing in oil and food prices risks further dampening world growth. Domestic demand is a strong driving force for growth in many developing countries and it may be weakened by the large rises in food prices. But US growth is also highly dependent on domestic consumption, which can be negatively affected by the high oil price. All of these factors would instead indicate that the interest rate should be cut.

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2 International perspective, no. 15 2008, LRF, the Federation of Swedish Farmers.

3 According to the Food Outlook from the Food and Agricultural Organization of the United Nations (FAO), 22 May 2008.

When we decide on the future direction of monetary policy, it is important to know whether the rising oil and food prices will have lasting or temporary effects on inflation.[4] It is difficult to know this in advance. We must follow developments closely. But we can receive some guidance by looking at the factors that lie behind the price increases.

Increased demand, supply effects and portfolio investment behind rising commodity prices

One reason for the high commodity prices is the increased demand in the world market from emerging economies. Higher incomes per capita in China, India and other rapidly growing economies have led to increased demand for food and also to changes in the patterns of food consumption. Demand for meat has increased in particular, which has in turn pushed up the demand for and prices of feed grain. This also spreads to other food crops. It is reasonable to believe that the demand for food in the world will remain high.

Another important driving force behind the world demand for commodities is the investment in ethanol and biodiesel in recent years. The increased use of some food commodities in the production of biofuels limits the supply of food and increases the price of food crops. When the oil price reaches record high levels it creates a further incentive to increase the production of biofuels at the cost of food. The IMF observes in its most recent report that biofuels account for only 1.5 per cent of the supply of liquid energy. But the use of these fuels led to demand for crops used in their production doubling between 2006 and 2007.[5]

In the slightly longer term the high food prices lead to the supply of food increasing and this dampens prices. But there are also factors that could hold back supply and mean that it does not increase as much as would be necessary to meet the increased world demand. Some supply shocks are of a temporary nature, such as the drought in Australia last year and poor harvests in some regions. One cannot rule out the possibility that climate effects have played a role, and in this case such shocks may be a recurring problem.[6]

Another factor that has had a restraining effect on supply and has thereby contributed to boosting the increase in world food prices is the export restrictions introduced by some countries that are major producers of food, in an attempt to protect their domestic consumption from the price increases. The effect on the price of wheat when export restrictions were reduced in the Ukraine is, as I mentioned earlier, a good example of how this can have tangible effect on prices.

Another factor that has certainly been significant is the depreciation of the dollar. Commodities are priced in dollars, and this may mean that commodities exporters will try to gain compensation through higher prices if the dollar falls.

In recent years, portfolio investment in commodities has become an increasingly common means of diversifying and spreading risks. The fact that interest has increased is due to the return on other investments deteriorating and this has probably contributed to reinforcing the upswing in commodity prices. If the expectations of the relative return on this type of investment were to decline, it could instead have a subduing effect on prices.

How does one weigh together all of the factors I have mentioned? There is of course considerable uncertainty. The assessment we made at our last monetary policy meeting was that the world market prices would not continue to rise at the same rapid rate. This meant that the high inflationary impulses from the price rise on food commodities were assessed as

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4 See Irma Rosenberg, "Rising commodity prices", speech held on 9 May 2008.

5 IMF (2008) World Economic Outlook.

6 See the UN's climate panel 2007: Impacts, Adaptation and Vulnerability.

partly temporary. This is something that is so far supported by the tendencies towards a slowdown in food commodities prices in the world market which we have been able to see recently.

Information received since the last meeting

I now intend to move on to say a few words about the information received since the most recent interest rate decision.

There are now signs that may indicate that the turbulence in the financial markets has declined somewhat. The Federal Reserve's actions to save the US investment bank Bear Stearns appear to have contributed to restoring confidence among investors. Some signs of this are that both access to capital and investors' willingness to take risk have increased. The CDS premiums, which reflect the market's valuation of credit risk, have fallen since the end of March. The so-called TED spread (the difference between the three-month interbank rate and the corresponding treasury bill rate) has fallen in the United States and is currently at around the same level as in the euro area. However, the Swedish TED spreads have not fallen back recently, and they are slightly higher than, for instance, the corresponding spreads in the euro area. This is partly linked to the short-term Swedish government rates not having risen as much as the US rates, for example, which is probably due to a reduced supply of treasury bills. In other words, this spread cannot be regarded as a sign that the market has changed its view of the risks in the Swedish bank sector. As always, the Riksbank is closely following this development and has not seen any reasons to take extraordinary measures. The Swedish banks have no problems with funding.

However, there is still considerable uncertainty in the financial market, and there is a risk of setbacks. Although the interbank rates, that is, the rates banks pay when borrowing from one another, have fallen they are still much higher than the average rate in recent years. The TED spread in the United States and the euro area is for example three times higher than the average. The housing market in the United States has not yet bottomed out. If new large loan losses arise in the financial system again this may shake market confidence once again.

Over the past few days a large amount of new information has been received regarding the situation in the US economy. Inflation in the United States remains high. This is largely due to the increasingly high food prices, as well as high energy prices. However, the rate of wage increase has slackened. Inflation in the euro area is also affected by the higher energy and food prices. However, growth appears to have been stronger than we had expected for the United States in the most recent quarter, as well as in the euro area, particularly Germany. At the same time, there are indicators for both the United States and the euro area pointing to a slowdown in the second quarter.

International developments affect us all, both you as entrepreneurs and Sweden as a whole. We have assumed that foreign trade will slow down in the future, as world growth is expected to continue slackening. Orders from the export market have so far declined in 2008. New statistics on foreign trade indicate that a slowdown can be expected during the second quarter, roughly in line with the assessment made in the April Monetary Policy Update. But it is difficult to compare foreign trade in recent months with the corresponding period last year, as we have had a leap year this year and the Easter holiday came unusually early. This has an effect on the number of business and working days.

Employment has continued to increase relatively strongly in recent months and unemployment is still falling slightly. But there are also indications that the labour market will weaken in the future. The number of redundancy notices in April was double that in the same month last year. At the same time, it is still difficult to find the right competence to fill job vacancies in some industries. The demand for labour has declined in recent months, for instance, the number of newly-reported vacancies has declined. This picture is confirmed by the National Institute of Economic Research's most recent Economic Tendency Survey, which indicates a declining need for new recruitment in the business sector. The survey also shows that companies' views of the Swedish economy have deteriorated. All in all, the confidence indicator for the business sector has moved from being stronger than normal to slightly weaker between April and May.

The Consumer Tendency Survey also indicates that consumers have become increasingly pessimistic. Their view of the Swedish economy has continued to deteriorate and they have also become gloomier with regard to their own economy. At the same time, households' inflation expectations one year ahead have risen significantly. However, it can also be noted that households perceive the current inflation rate to be much higher than it actually is. Prior to our next monetary policy meeting we will receive measures of inflation expectations among other groups which must also be analysed (Prospera).

The new National Accounts for the first quarter that were published earlier today show that growth in the first quarter was weaker than we had expected. They also show that labour productivity increased slightly in the first quarter of this year, after having fallen for most of 2007. We will be closely analysing what the new GDP statistics otherwise entail for our assessments prior to our next meeting in July.

Preliminary statistics indicate a lower rate of wage increase than we had estimated – both for blue-collar and white-collar workers – during the first months of this year. One possible reason for this is the composition effects in the wage statistics. If, for example, new groups are being employed at low entry wages to a greater extent than before, then the average rate of wage increase will be lower. But so far there have not been any signs that the rate of wage increase has accelerated. Of course, this is something we are monitoring closely.

Inflation is still high, just as I said before. In April it was 3.4 per cent according to the CPI. This was entirely in line with our assessment at the most recent monetary policy meeting. Since April the oil price has risen substantially. Spot and forward prices of oil are now around 30 per cent higher than they were in April. It is probable that the higher oil prices may affect inflation via higher petrol prices.

In July we will once again weigh up these counteracting forces

This was some of the new information received in recent weeks. Further information will be presented over the coming weeks, and we will give consideration to this information as well at our next monetary policy meeting.

At the most recent meeting in April the Executive Board's view of the interest rate path was the same as in February. My view then was that there was a greater risk of international price impulses forcing up inflation through higher inflation expectations. This was a reason why I voted to hold the repo rate unchanged. At the same time, I also considered that the financial unease and the slowdown in international growth could mean a risk of weaker growth and inflation in the long term.

The counteracting forces we had to consider in April are still in place. There are discussions of what will happen to monetary policy when the oil price has risen roughly in line with the alternative scenario outlined in our February report. This could indicate a higher interest rate path. But it is not that simple. The analysis made in that scenario only takes into account an alternative outcome for the oil price. The analysis made in a monetary policy decision takes into account everything that has happened in the economy. How all these aspects should be weighed together is something I and my colleagues on the Executive Board will have to consider when we meet for a new monetary policy meeting in the first week of July.