Svante Öberg: The current economic situation

Speech by Mr Svante Öberg, First Deputy Governor of the Sveriges Riksbank, at Kulturens hus, Luleå, 18 August 2009.

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It gives me particular pleasure to come to Luleå to talk about the economic situation. This is because my father, Folke Öberg, was born and raised in Luleå and he began working at the Riksbank here in 1930. This is also where he met my mother, Margareta. In the 1930s they moved to Stockholm, where my father began working at the Riksbank's head office, where he was employed until his retirement in 1972. The local offices that the Riksbank previously had in each county, including here in Luleå, have long been closed down and activities are now concentrated in Stockholm.

What I intend to say here today can be summarised in three points:

- The deep recession has hit bottom, but the recovery will be weak.
- New information received over the summer tends to indicate a slightly stronger GDP growth than we have forecast, but the labour market is continuing to weaken and inflation is low.
- Monetary policy is aimed at dampening the economic downturn. The repo rate was cut to an all-time low of 0.25 per cent in July and is expected to remain at this low level for the coming year.

In my speech today I will present the Riksbank's assessment of economic developments both in Sweden and abroad. This is the assessment that was described in the Monetary Policy Report published on 2 July this year. I will also comment on the new information received over the summer. Finally, I shall report how the majority of Executive Board members and I personally viewed monetary policy in July. But I shall began by describing developments in the financial markets, which are both the reason for the economic downturn being so severe and a necessary condition for growth to pick up again.

Financial markets

Improved situation in the financial markets

The situation in the financial markets has improved over the past six months both in Sweden and abroad. Risk premiums in the interbank market, for instance the TED and basis spreads, have fallen and are now close to the levels prevailing prior to the outbreak of the crisis two years ago (see Figure 1). This is a sign that the interbank market is functioning better. Other positive signs that the situation in the financial sector has stabilised are that Swedish companies can once again take loans in the international capital market, that equity prices have risen and that the krona has strengthened.

However, the problems in the financial sector are not over yet. Several other types of risk premium are still at higher levels than prior to the crisis, for instance, credit spreads for companies and Credit Default Swaps. Moreover, the banks' loan losses will probably increase (see Figure 2).[1]

[1] See the Financial Stability Report 2009:1, Sveriges Riksbank.

The financial crisis has so far been less serious in Sweden than in many other countries. The Swedish banks are well capitalised. But they are also to a large degree dependent on the securities markets for their funding and they have expanded substantially in the Baltic countries. The greatest risk for Sweden therefore lies with the banks' credit exposure to the Baltic countries.

International developments

Slow global recovery

Over the past year, the global economy has been hit by the most rapid economic downturn since the Second World War. Economic developments abroad are very weak this year and much weaker than we had previously anticipated. Since September last year, the Riksbank has gradually revised down its forecasts for global GDP growth in 2009 from approximately 4 per cent to around -1 per cent (see Figure 3). The forecasts in the most recent Monetary Policy Report are no exception, but for the first time they only involve a minor downward adjustment.

There are numerous indications that the severe economic downturn has now touched bottom. During the spring there were increasing signs pointing to a slowdown in the heavy fall in world GDP. At the same time the financial markets have begun to function more efficiently, which is an important condition for ensuring that the economic recovery will begin. World trade has also begun to show signs of stabilisation during the spring, after the earlier heavy fall in exports. But our assessment is that the recovery will be a slow one (see Figure 4).

The view that a recovery in the world economy has begun is also confirmed by the IMF's most recent forecasts for global developments. However, the IMF report also depicts the recovery as being sluggish.[2]

Inflation abroad has continued to fall and has been negative in recent months, but underlying inflation has been more stable. I shall return to this point.

Nevertheless, commodity prices have begun to rise. The oil price fell substantially last year, but has now risen again to around USD 75 per barrel, and according to forward rates it is expected to rise slightly during the forecast period (see Figure 5). The price rise may be a consequence of the expectation that demand will increase, but oil stocks are large and the OPEC countries have good capacity to increase their production, which should have a restraining effect on the oil price. Other commodity prices – metals, foods and other agricultural products – have also risen in recent months (see Figure 6).

USA

The United States is currently suffering its most prolonged recession since the 1940s. It started back in December 2007. According to our most recent forecast, the US economy will shrink by an average of around 3 per cent in 2009. Growth is expected to be positive again with effect from next year. Since the monetary policy meeting in July the national accounts figures for the second quarter of this year have been published. They showed that GDP fell by only 0.3 per cent between the first and second quarters of this year, which was slightly better than we anticipated. Employment continued to fall in July, but less than expected, and unemployment fell by a tenth of a percentage point, which was better than market expectations.

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[2] IMF, World Economic Outlook Update, July 8 2009.

CPI inflation in the United States fell to -2.1 per cent in July, but when food and energy prices are excluded it fell to 1.5 per cent (see Figure 7). The underlying inflation rate measured in this way has been relatively stable in recent years and has only declined slightly over the past year.

An important condition for a turnaround and stabilisation in the US economy is that house prices touch bottom and begin to rise again. Developments in real house prices in the United States since 1950 comprise a good example of a price bubble (see Figure 8). The question now is how far house prices will fall before the turnaround comes. The Federal Reserve notes in its most recent monetary policy report that developments in the housing market remain weak, although there are some signs of an improvement.[3]

Euro area

GDP growth in the euro area remains weak. According to the forecast in the Monetary Policy Report, GDP in the euro area will fall by an average of almost 5 per cent in 2009. Next year we are expecting largely zero growth and after that a fairly weak increase. Domestic demand in particular is expected to be weak for a long time to come in the euro area. The weak domestic demand means that the euro area is dependent on a boost from abroad – in particular the United States and other important trading partners – to be able to make a recovery.

Since the Monetary Policy Report was published statistics received from Eurostat have reinforced the picture of production in the euro area beginning to stabilise at a lower level following the heavy fall at the beginning of the year. GDP fell by only 0.1 per cent between the first and second quarters of the year, which was much better than we had estimated. In addition, it can be noted that the purchasing managers' index for the euro area rose in July for the fifth month in a row (see Figure 9). Both the manufacturing and service sectors show an improvement in July. However, the index is still below 50, which is the level indicating growth. Employment is continuing to be weak and unemployment rose to 9.4 per cent in June.

Inflation measured in terms of the EU harmonised index, the HICP, was -0.7 per cent in July. The HICP is not affected by interest rate cuts in the same way as the Swedish CPI, but it is affected by energy prices. HICP inflation excluding energy, which is a measure of the underlying inflation rate, was 1.0 per cent in July. In the euro area, too, the underlying inflation rate measured in this way has been relatively stable in recent years and declined considerably less than HICP inflation over the past year (see Figure 10).

Rest of the world

We are forecasting better growth for emerging markets and developing countries outside of the OECD than for the OECD countries. This view is supported by the IMF's most recent update to its World Economic Outlook. The IMF writes that the global economy is beginning to pull out of the recession, but that the stabilisation is uneven between different regions and that the recovery will be sluggish. The IMF, for example, is forecasting strong growth in China and India both this year and next year (see Figure 11). However, the economies in Russia and Brazil are expected to shrink this year and then grow again next year.[4]

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[3] Monetary Policy Report to the Congress, July 21, 2009, Board of Governors of the Federal Reserve System.

[4] See the World Economic Outlook update, 8 July, 2009, IMF, http://www.imf.org/external/pubs/ft/weo/2009/update/02/pdf/0709.pdf.

The OECD's leading economic indicators for June paint a slightly brighter picture and indicate that economic developments have shown a turnaround during the first half of this year in all of the "BRIC" countries: Brazil, Russia, India and China.[5]

The current economic situation in Sweden

In my review of the economic situation in Sweden I will focus on five areas: GDP, the labour market, inflation, the current account and public finances. My experience is that these variables usually provide a good picture of a country's economic situation.

Signs of a turnaround, but the recovery will be weak

The Swedish economy has also been hard hit by the international economic downturn. We forecast in the Monetary Policy Report that GDP in Sweden will fall by more than 5 per cent this year (see Figure 12). However, during the spring there were several signs that the deep recession may have bottomed out. The financial markets have begun to function better, which creates opportunities for an economic recovery. World trade, which is very important for the Swedish economy, has also shown signs of stabilising during the spring.

At the same time, we believe that the recovery will be weak. This is usually the case following serious financial crises. Our forecast is that GDP will not reach the same levels as prior to the start of the economic downturn in the second quarter of 2008 until 2012.

Since the most recent monetary policy meeting there have been further signs to support the view that the worst is now over. The preliminary national accounts published on 31 July indicate that GDP remained unchanged between the first and second quarters of this year after four quarters of falling GDP (calendar-adjusted). This is a slightly better outcome than in our July forecast, where we assumed that GDP would fall by 0.3 per cent in the second quarter and that the fall would not come to a halt until the third quarter. However, there was unusually great uncertainty regarding the preliminary national accounts figures on this occasion.

In recent months various confidence indicators have also shown an improvement. The National Institute of Economic Research's Economic Tendency Survey, which summarises companies' and households' views of the economic situation, increased by almost seven units in July, to 87.1. However, the level is still below 100 and indicates that the mood among companies and households is still much weaker than normal (see Figure 13).[6] The purchasing managers' index for July was also more positive than market expectations had implied. It rose by almost four units to 54.3 and was thus above 50 for the second month in a row (see Figure 14). The purchasing managers' index is usually a slightly quicker indicator of developments than the economic tendency survey and an index above 50 indicates growth.[7]

Labour market continues to weaken

Our assessment in the most recent Monetary Policy Report was that the labour market would continue to be weak. A deterioration in the labour market usually lags behind in an economic downturn, which was also the case this time. We are expecting employment to fall by around 300,000 persons from the peak in 2008 to a trough in 2011 and that unemployment will continue to rise to around 11 per cent (see Figures 15 and 16)

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[5] See the OECD's Composite Leading Indicators, 7 August, 2009, http://www.oecd.org/dataoecd/45/9/43453886.pdf.

[6] Economic Tendency Survey, July 2009, National Institute of Economic Research, 30 July 2009.

[7] Institute for Supply Management (SILF) and Swedbank, 3 August 2009.

After the recent monetary policy meeting new information was received from the Labour Force Surveys, which was roughly in line with our assessment. Employment fell by 1.7 per cent in June compared with the same month in the previous year and unemployment increased to 9.8 per cent. This was respectively two-tenths and one-tenth of a percentage point better than we had forecast.[8]

Underlying inflation is in line with the inflation target of 2 per cent

Inflation has fallen rapidly in recent months and is expected to become negative for a large part of the year. However, CPI inflation is strongly affected by interest rate changes and by changes in energy prices. It is therefore better to study the underlying inflation rate. Underlying inflation measured as the CPIF, where mortgage rates are held constant, is expected to be close to 2 per cent throughout the forecast period (see Figure 17).

New inflation figures published after the most recent monetary policy meeting have also been roughly in line with our assessments. CPI inflation was -0.9 per cent in July, which was three tenths of a percentage point lower than our forecast, but underlying inflation measured as the CPIF amounted to 1.8 per cent, which was entirely in line with our forecast.[9]

Inflation measured in terms of the EU harmonised index, the HICP, was also 1.8 per cent in July and when measured as the HICP excluding energy it was 2.8 per cent. Inflation was thus much higher in Sweden than in the EU. One reason for this is probably that the krona has weakened since last autumn. We are assuming that the weakening is mainly due to the financial crisis and that the krona will strengthen again. Since the July monetary policy meeting, however, the krona has strengthened more than we had anticipated (see Figure 18). Another reason is probably that unit labour costs have risen rapidly for three years in a row, mainly as a result of falling productivity, but also because of higher wage increases than before (see Figure 19).

According to Prospera's most recent survey in June, inflation expectations five years ahead were 2.2 per cent and were well-anchored around the inflation target. However, inflation expectations two years ahead are slightly below the inflation target (see Figure 20).

The current account and public finances are strengths

Sweden's current account and public finances can be said to be its strengths. These look relatively good in comparison with other countries. Sweden had built up large surpluses in both its public finances and on its current account prior to the start of the crisis (see Figure 21) and the public sector's indebtedness is low. This has provided a greater degree of freedom with regard to managing the crisis.

Public finances will deteriorate substantially this year and next year as a result of expansionary fiscal policy combined with a decline in public income and an increase in expenditure related to unemployment, etc. as a result of the economic downturn. Our assessment is that the public sector financial balance will fall from +4 per cent of GDP in the peak year 2007 to a trough of -4 per cent of GDP in 2010. But this is a much better situation than in many other countries, such as the United Kingdom, where public finances have also deteriorated substantially, but where they had a deficit to start with. The ambition in Sweden for public finances to show a surplus when regarded over an economic cycle has made it possible to dampen the economic downturn with an active fiscal policy without this leading to an unmanageably large deficit.

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[8] Labour Force Survey (AKU) June 2008, Statistics Sweden, 3 August 2009.

[9] Consumer Price Index (CPI) July 2009, Statistics Sweden, 11 August 2009.

The current account is also showing large surpluses. Our forecast is that the surplus this year will correspond to around 7 per cent of GDP this year, despite exports being expected to fall by around 16 per cent. One reason for the large surplus in the current account is that exports have developed strongly since the early 1990s. At that time exports corresponded to around 30 per cent of GDP, but now the figure is around 50 per cent of GDP. This means at the same time that exports are very important to the Swedish economy and that the weak economic growth abroad therefore hits Sweden particularly hard.

New information during the summer points to a slight improvement

To summarise, the new information received during the summer tends to point to a slightly stronger economic activity than we had forecast at the beginning of July. GDP was three tenths of a percentage point better and employment fell two tenths of a percentage point less than we had forecast. A number of indicators have also exceeded market expectations. All in all, this supports the view we had that the deep economic recession has bottomed out. However, most indications are still that the recovery will be weak. Inflation fell slightly more than we had anticipated in July, but underlying inflation was in line with our forecasts.

However, we will not make an overall assessment of economic developments until it is time for our next monetary policy decision on 2 September. It is likely that more information will have come in by then and we will have to update our forecasts.

Monetary policy

Monetary policy is expansionary

Since the financial crisis worsened last autumn, monetary policy has been aimed at moderating the depth of the economic recession following in the wake of the crisis. The repo rate was cut from 4.75 per cent in September 2008 to an all-time low of 0.25 per cent in July 2009. The Riksbank has also supplied the banks with liquidity to counteract the negative effects of the financial crisis. In this section I shall discuss in slightly greater detail our reasoning at the most recent monetary policy meeting, and the risks I see of developments being better or worse than we forecast.

In July we cut the repo rate from 0.50 to 0.25 per cent. The economic recession appeared likely to be deeper than the Riksbank had earlier forecast and we were expecting GDP growth to be slow over the coming years. Resource utilisation would therefore remain low throughout the entire forecast period. At the same time, the forecasts for underlying inflation were close to the inflation target of 2 per cent. We therefore considered that the repo rate probably needed to remain at this low level until autumn 2010 (see Figure 22).

We also decided to grant loans to the banks of SEK 100 billion, with a twelve-month maturity and at a fixed interest rate. We have been lending money to the banks since the crisis worsened in September 2008 to ensure they can manage their liquidity. For instance, we have granted loans with a one-year maturity at a variable interest rate. The purpose of granting loans with a one-year maturity at a low and fixed interest rate was to bring down the rates in the interbank market and thus contribute to lower interest rates on loans to companies and households. It was a means of increasing the scope for monetary policy to have the intended effect.

Reasons for optimism

Although the situation is still serious and requires extraordinary measures, there is beginning to be some cause for optimism. It is now the first time since September last year that our forecasts and those of other analysts no longer need to be substantially revised down between the forecasting rounds. After having revised down the forecasts heavily in four reports in a row since September, we made only a small downward revision in July and the most recent information points more to a slightly stronger picture of the real economy than the one we painted then. The IMF has even made an upward revision to the forecasts for the world economy in its July report.

My assessment in July was that the risk outlook for economic developments in Sweden is now balanced for the first time since spring 2008. There is an equally great risk that developments will be better than forecast as that developments will be worse than forecast. Previously I have mainly seen risks of poorer developments than in our main scenario.

Downside risks primarily include two factors that could indicate a poorer development in the real economy. One is that the economic recovery abroad could take time, which would have negative effects on Swedish exports. The other is that the situation in the Baltic countries could deteriorate and cause larger loan losses for the Swedish banks than we have anticipated. This could indirectly dampen the recovery in the Swedish economy.

Upside risks include the expansionary fiscal and monetary policy measures taken in most countries and which may lead to the international recovery taking place sooner than anticipated. This could also hasten the Swedish recovery by means of an increase in exports. The new information received during the summer also indicates a slightly stronger development in economic activity than we had assumed.

One could interpret the recent signs of increased optimism to mean that the need to increase the repo rate will approach sooner. However, one should take into account the fact that resource utilisation is very low and will remain so during the forecast period (see Figure 23) and that our monetary policy task primarily concerns ensuring that inflation remains close to the target. At present it is difficult to see any indications that inflationary pressures are increasing. Rather the reverse; the weak labour market and the unusually low resource utilisation point to low wage increases. This, combined with the fact that productivity usually improves when economic activity turns around, implies that unit labour costs will be weak in the coming period. We are also assuming that the krona will strengthen, which will hold back import prices. It is also difficult to believe that demand would become so strong that it pushes up inflation.

It is considerations like this that are behind the assessment that I made in July; that the repo rate will probably need to remain at a low level for a long time to come. Resource utilisation will remain low during the foreseeable future and it is difficult to envisage any inflationary pressures. At the same time, borrowers should be aware that the current situation is an extreme one and that at some point in the future we will need to raise the interest rate back to a more normal level.

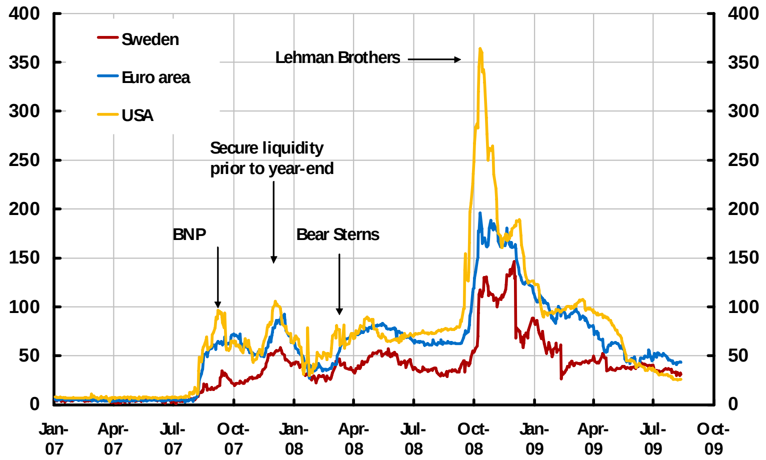
Concluding remarks

I have now described the Riksbank’s view and my personal view of developments in Sweden and abroad. Despite GDP falling heavily this year, employment falling and unemployment rising, there are now signs that an improvement is on the way. The situation in the financial markets has improved and the new information received during the summer confirms the view that the deep recession has bottomed out. But the improvement is from unusually low levels and the recovery will probably be weak. Inflation will be negative this year, but underlying inflation will be close to the inflation target of 2 per cent. Monetary policy is aimed at dampening the economic downturn. The repo rate was cut to an all-time low of 0.25 per cent in July and is expected to remain at this low level for the coming year.

Thank you for your attention!

1. Financial markets functioning better

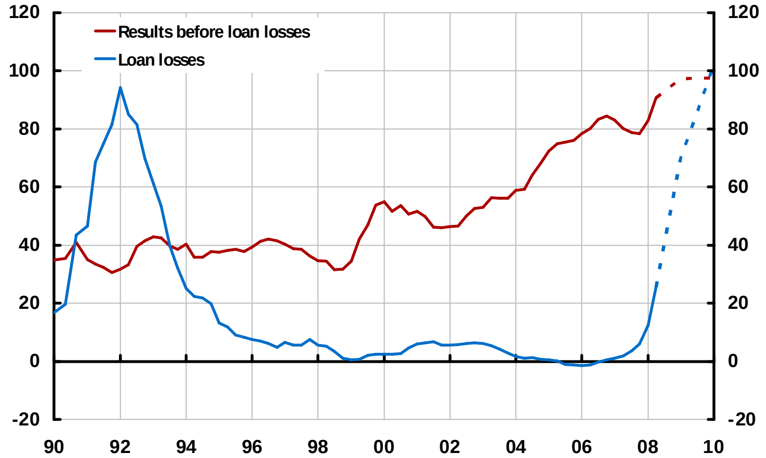
Difference between 3-month interbank rate and expected policy rate, basis points (Basis spread)



Sources: Reuters EcoWin and the Riksbank

2. Loan losses increasing

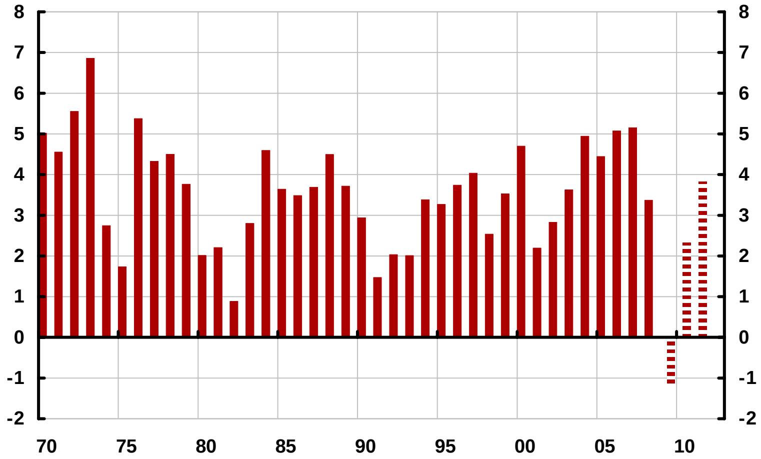
SEK billion net, totalled over four quarters, fixed prices, 31 March 2009



Source: Finansial Stability Report 2009:1, the Riksbank

3. World GDP growth

Annual percentage change

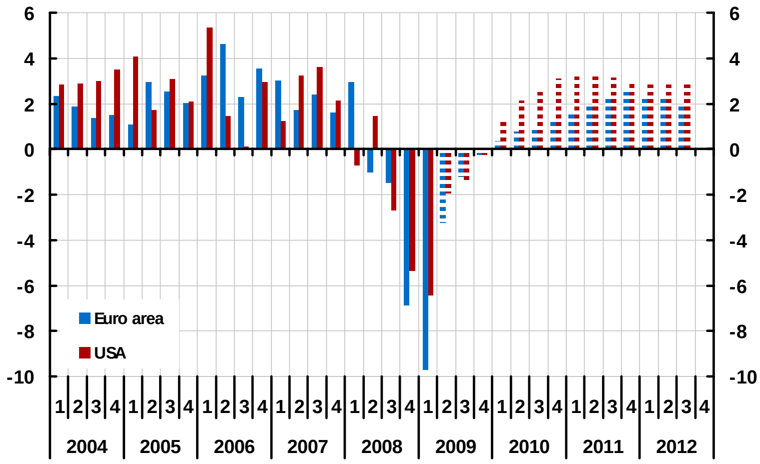


Note. The broken column represents the Riksbank's forecast.

Sources: The IMF and the Riksbank

4. Slow recovery

Quarterly changes in per cent calculated as annual rate, seasonally-adjusted data

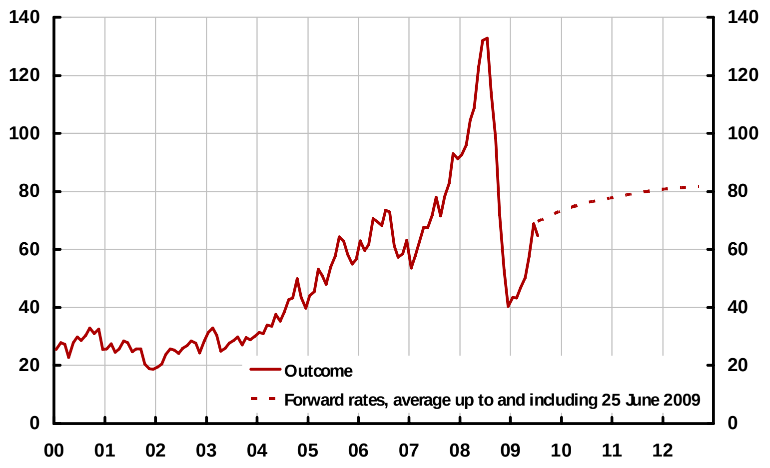


Note. Broken columns represent the Riksbank's forecasts in July 2009.

Sources: Bureau of Economic Analysis, Eurostat and the Riksbank

5. The oil price, Brent crude

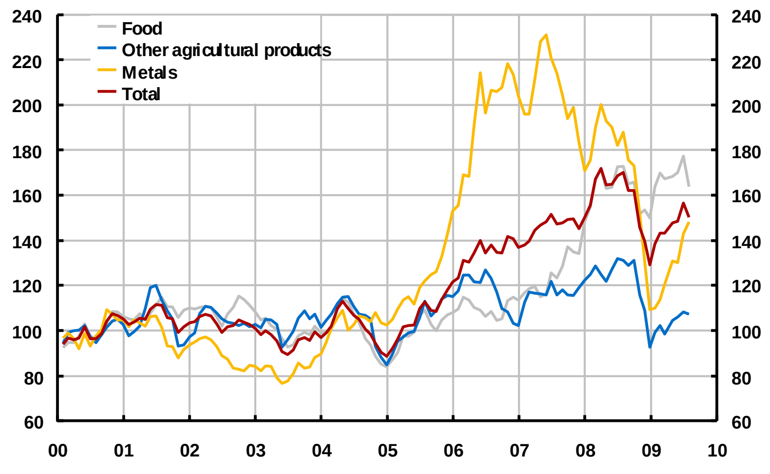
USD per barrel



Note. Broken lines represent the Riksbank's forecasts. Sources: Intercontinental Exchange and the Riksbank

6. Commodity prices

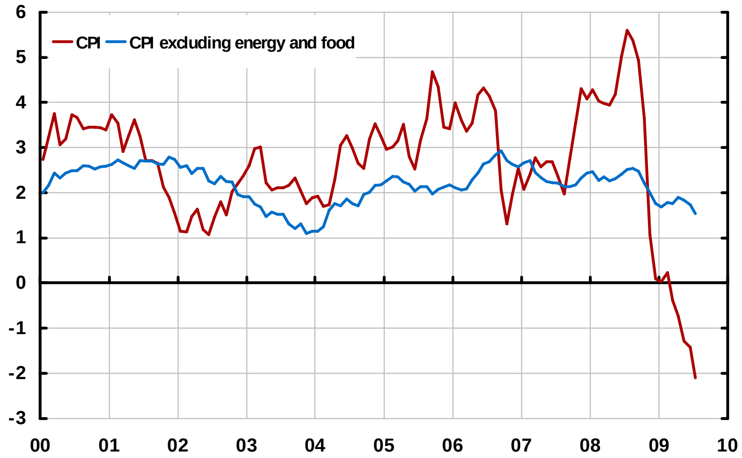
USD, Index 2000 = 100



Source: The Economist

7. Consumer prices USA

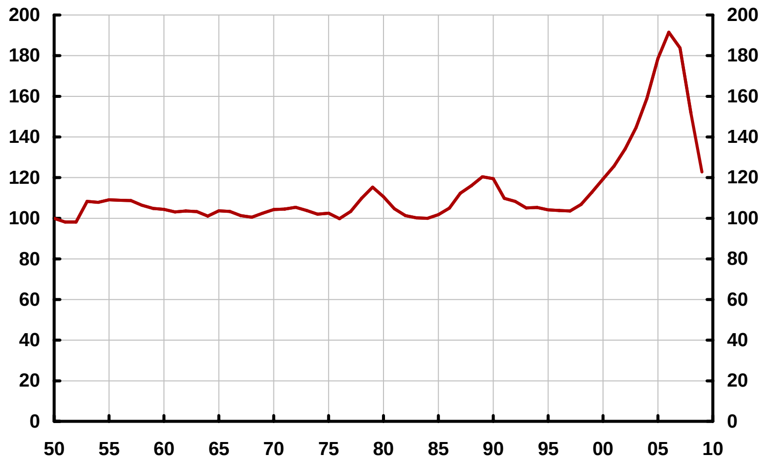
Annual percentage change



Source: Bureau of Labor Statistics and the OECD

8. Real house prices, USA

Index 1950 = 100

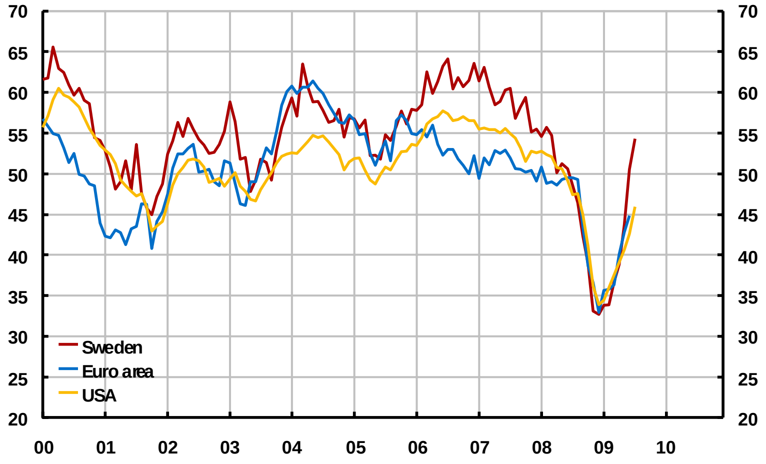


Note. Outcome up to end of Q1 2009.

Source: Robert J Schiller, Princeton University

9. Signs of a turnaround

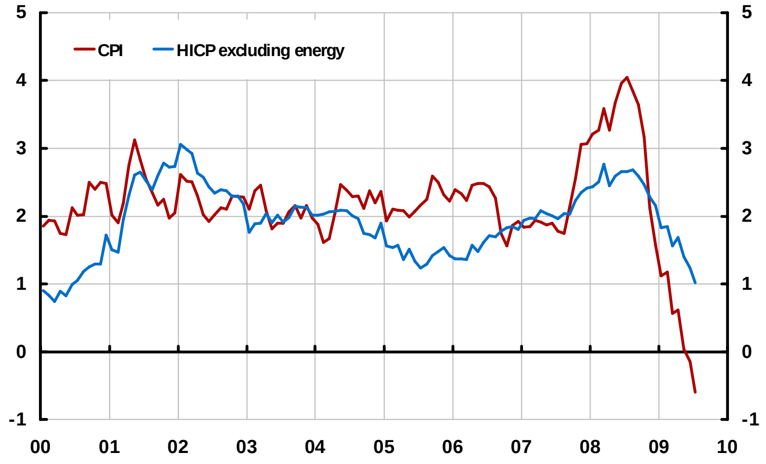
Purchasing managers' index, index above 50 indicates growth



Sources: Institute for Supply Management, NTC Research Ltd and the NIER

10. Consumer prices euro area

Annual percentage change



Sources: Eurostat and the OECD

11. GDP abroad

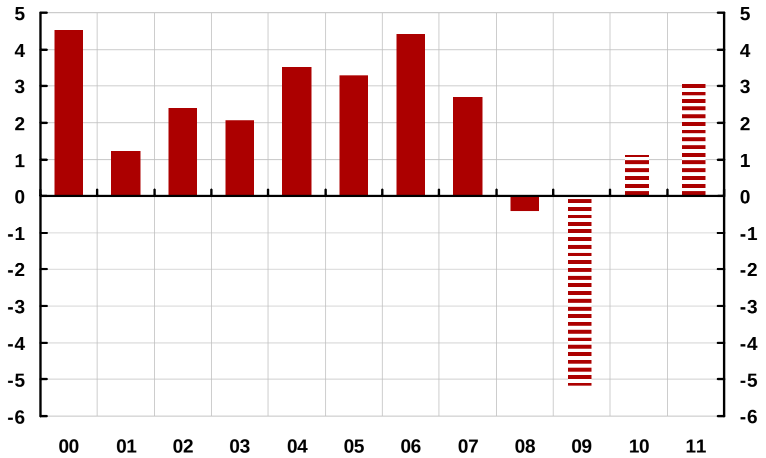
Annual percentage change

	2008	2009	2010
Brazil	5,1	-1,3	2,5
Russia	5,6	-6,5	1,5
India	7,3	5,4	6,5
China	9	7,5	8,5

Source: IMF July 2009

12. GDP in Sweden

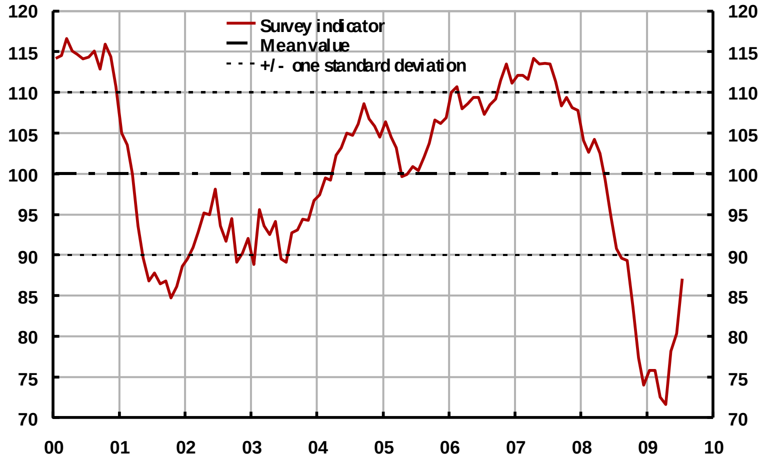
Annual percentage change



Note. Broken columns represent the Riksbank's forecasts. **Sources: Statistics Sweden and the Riksbank**

13. Survey indicator

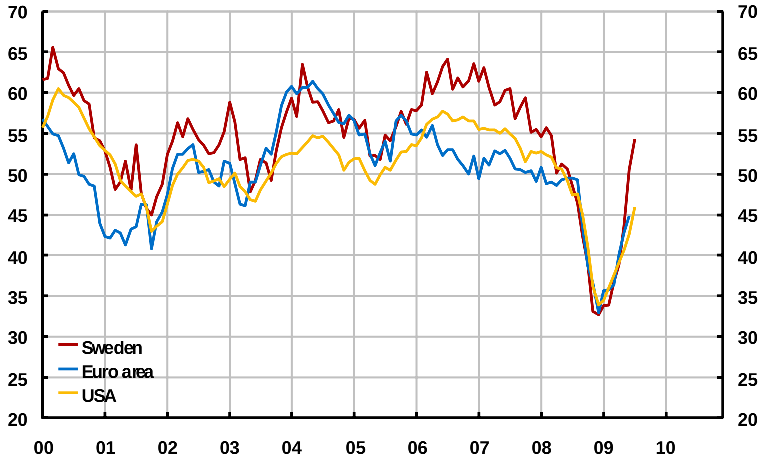
Index



Source: National Institute of Economic Research (NIER)

14. Signs of a turnaround

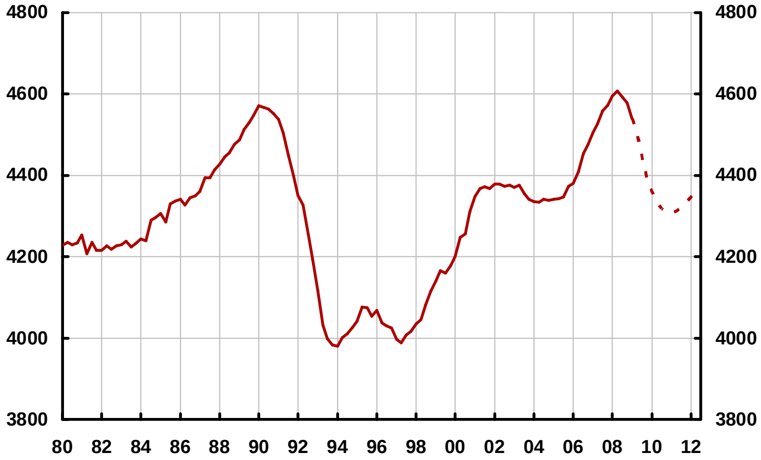
Purchasing managers' index, index above 50 indicates growth



Sources: Institute for Supply Management, NTC Research Ltd and the NIER

15. Employment

Thousands, EU definition, 15-74 years of age, seasonally-adjusted data



Note: The dotted line indicates the Riksbank's forecast. Data prior to 2001 has been chained by the Riksbank

Sources: Statistics Sweden and the Riksbank

16. Unemployment

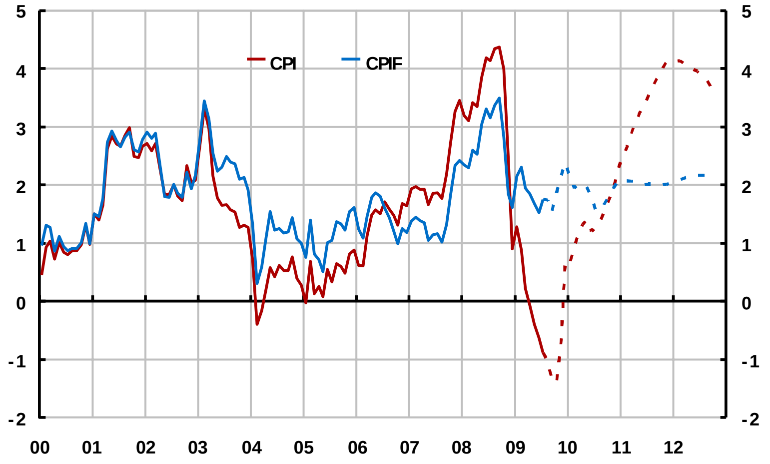
Percentage of workforce, EU definition, 15-74 years of age, seasonally-adjusted data

Note: The dotted line indicates the Riksbank's forecast. Data prior to 2001 has been chained by the Riksbank

Sources: Statistics Sweden and the Riksbank

17. Inflation close to target

Annual percentage change

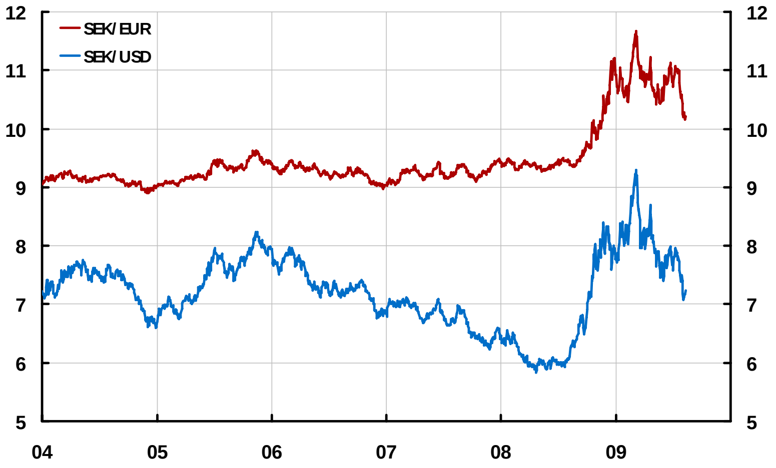


Note. Broken lines represent the Riksbank's forecasts

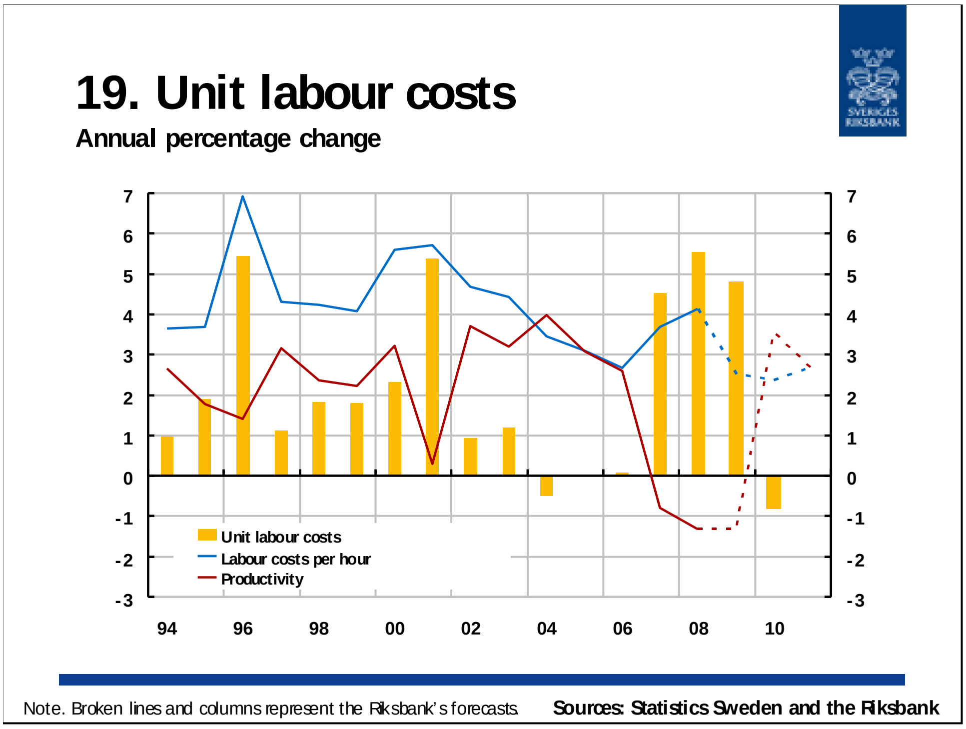
Sources: Statistics Sweden and the Riksbank

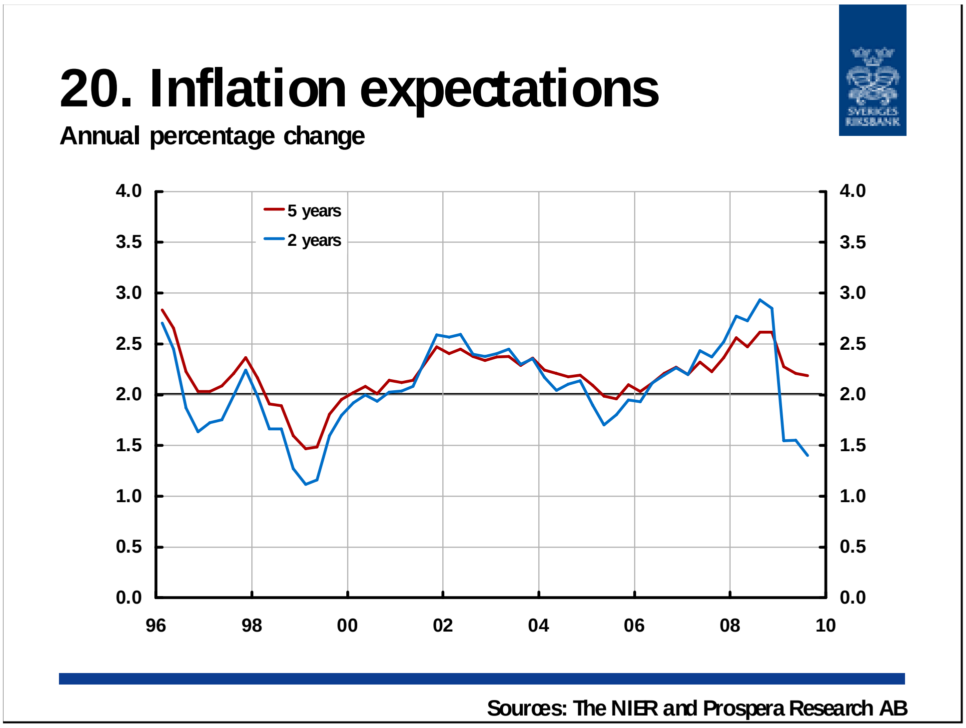
18. Exchange rates

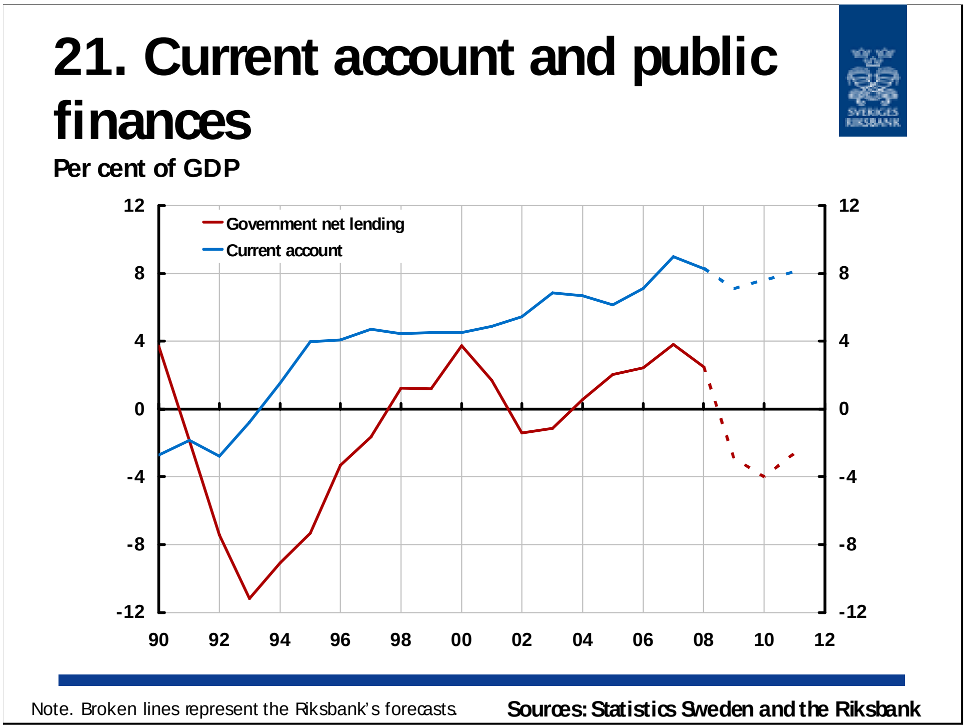
SEK per EUR and per USD respectively

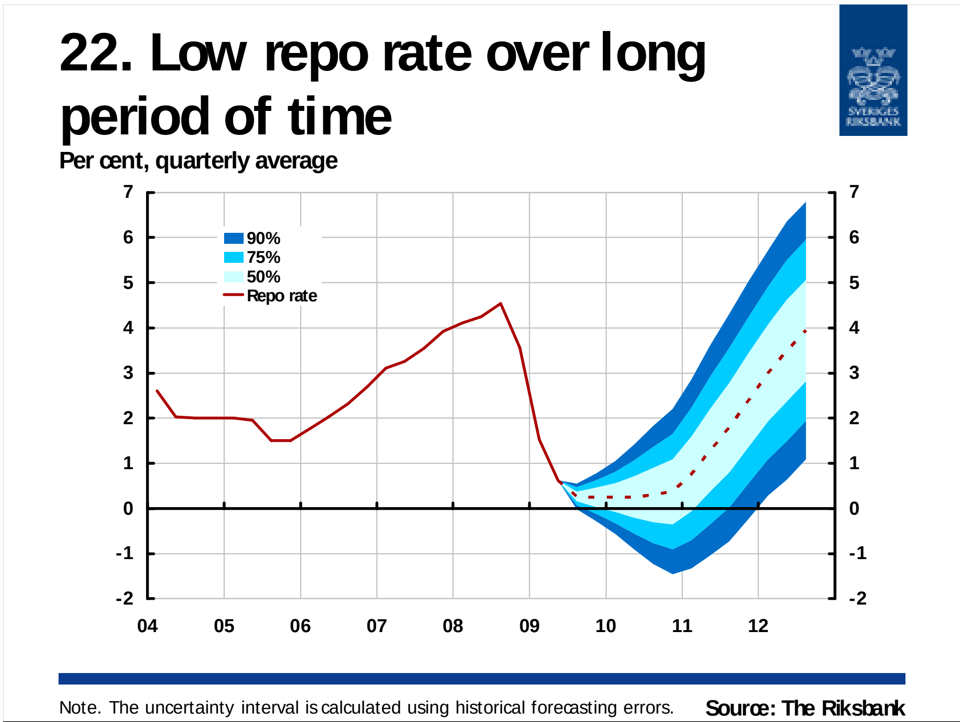


Source: Reuters EcoWin


19. Unit labour costs
Annual percentage change
7
6
5
4
3
2
1
0
-1
-2
-3
94
96
98
00
02
04
06
08
10
Unit labour costs
Labour costs per hour
Productivity
Note. Broken lines and columns represent the Riksbank's forecasts
Sources: Statistics Sweden and the Riksbank

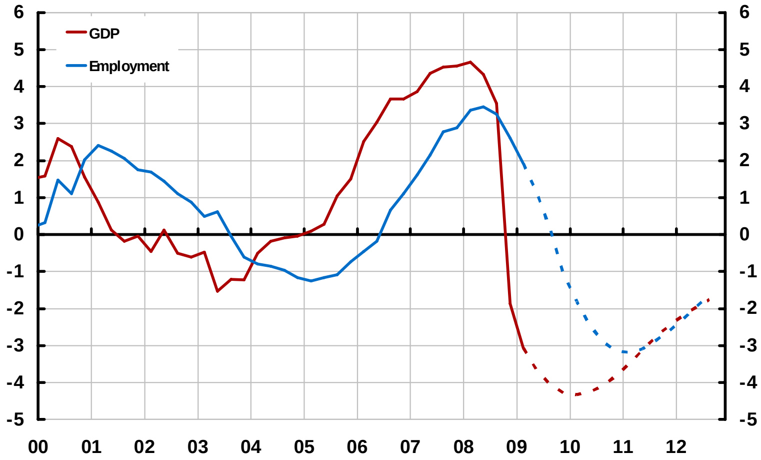

20. Inflation expectations
Annual percentage change
4.0
3.5
3.0
2.5
2.0
1.5
1.0
0.5
0.0
96
98
00
02
04
06
08
10
5 years
2 years
Sources: The NIER and Prospera Research AB


21. Current account and public finances
Per cent of GDP
Government net lending
Current account
12
8
4
0
-4
-8
-12
90
92
94
96
98
00
02
04
06
08
10
12
Note. Broken lines represent the Riksbank's forecasts.
Sources: Statistics Sweden and the Riksbank


22. Low repo rate over long period of time
Per cent, quarterly average
90%
75%
50%
Repo rate
7
6
5
4
3
2
1
0
-1
-2
04
05
06
07
08
09
10
11
12
Note. The uncertainty interval is calculated using historical forecasting errors.
Source: The Riksbank

23. Utilisation of resources

Percentage deviation from the HP trend



Note: The dotted line refers to the Riksbank's forecast.

Sources: Statistics Sweden and the Riksbank