Svante Öberg: The economic situation

Speech by Mr Svante Öberg, First Deputy Governor of the Sveriges Riksbank, to the Västerbotten Chamber of Commerce, Umeå, 25 August 2011.

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My message today can be summarised in four points:

- Developments have been dramatic over the summer.
- However, statistics for the Swedish economy received during the summer have been in line with the forecasts made in July.
- The turbulence on the financial markets has nevertheless increased uncertainty over future developments.
- We will discuss how this may affect monetary policy in September.

It is now the fourth year in a row that I have held a speech on the current economic situation in the month of August. Normally, I give an account of the most recent forecasts from the latest monetary policy decision in late June/early July and of the statistics received since then. This year it seems justified to give just a brief account of the forecasts made before the summer holidays and of the new statistics and to instead discuss events during the summer and what future consequences they might have. I shall therefore begin with a brief background, and then move on to discuss in more detail the turbulent developments in the financial markets during the summer, concluding with a few words about the problems I believe we will face at the next monetary policy meeting.

July monetary policy report

Continued recovery in the world economy as a whole…

We pointed out in the July Monetary Policy Report that growth in the world as a whole was good. The forecast was that GDP growth in the coming years would be just over 4 per cent a year, which is higher than the historical average. The emerging economies, including the BRIC countries (Brazil, Russia, India and China), acted as motor (see Figure 1). We also noted that inflation was relatively high in many countries, but that energy and commodity prices in the world market, which rose substantially last year and had pushed up inflation, had levelled off or fallen slightly this year (see Figure 2).

…but the recovery in the United States and euro area is sluggish

However, the international outlook was divided. The recovery in the United States and the euro area was expected to be slow (see Figure 3).

GDP growth in the United States was expected to be just over 2 per cent this year and to only gradually return to more normal levels of around 3 per cent. Unemployment had fallen only marginally from the peak levels noted in the most acute phase of the financial crisis. The impact of energy and commodity prices on inflation had been surprisingly large in the United States, which had led to inflation being relatively high (see Figure 4). We also noted that the United States needed to reduce the large deficits in its federal budget, which would entail fiscal policy tightening over the coming years.

GDP growth in the euro area was expected to be around 2 per cent a year during the forecast period. But there were substantial differences between countries. Germany, which is the largest economy in the euro area, showed relatively rapid growth, driven by exports and the upswing in world trade. At the same time, developments in southern Europe were hampered by the sovereign debt problems. We also noted that inflation was still high in the euro area and above the ECB's inflation target, partly because energy and food prices had risen (see Figure 4).

Strong but declining growth and rising inflation in Sweden

GDP growth in Sweden was expected to be high this year, around 4.5 per cent, but then to slow down to more normal rates of increase of around 2.5 per cent a year in the coming years (see Figure 5).

All components of demand contributed to the positive development. Household consumption was expected to increase by between 2 and 2.5 per cent a year over the coming years. Exports benefitted from the upswing in world trade, but we assessed that export growth would slow down in the coming period and approach more normal levels. A strong economic situation, combined with historically-low investment levels, meant that investments in Sweden were expected to increase substantially over the coming years.

Unemployment had fallen since 2009 and we expected it to continue to fall over the coming years as economic activity recovers (see Figure 6).

CPI inflation was over 3 per cent prior to the summer. However, CPIF inflation, which excludes the effects of interest rate adjustments on housing costs, was just below 2 per cent and even lower if energy prices are excluded. Our assessment was that underlying inflationary pressures would gradually rise as economic activity strengthens (see Figure 7).

Interest rate increases necessary to attain the inflation target

Against this background, we raised the repo rate in July from 1.75 to 2 per cent. We also considered that the repo rate increases would need to continue in the coming period. This was to stabilise inflation around the target of 2 per cent and resource utilisation around a normal level. The forecast for the repo rate, the repo rate path, which includes two further interest rate increases in autumn 2011, was therefore held unchanged. As usual, we pointed out that there was considerable uncertainty in the assessment of the future repo rate and that we would need to reconsider the monetary policy stance if conditions were to change significantly (see Figure 8).

At the monetary policy meeting in July I said that I personally believed that the repo rate would be raised at all three meetings this autumn, especially if the sovereign debt problems looked to be resolved without any major negative effects on the financial markets.[1] But so far the management of the sovereign debt problems has not been particularly successful. I will come back to this.

New statistics

The statistics received during the summer on the Swedish economy are largely in line with the assessments we made in July. However, the international outlook appears weaker, particularly in the United States. The statistics refer mainly to the second quarter and the summer months of this year, and do not actually say very much about the forecasts for the second half of the year and the coming years.

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1 See the minutes of monetary policy meeting no. 3 2011, Sveriges Riksbank.

Weaker international developments…

Since July, we have received preliminary national accounts figures for the second quarter of this year for the United States and the euro area.

GDP growth in the United States was 0.3 per cent in the second quarter of this year, measured as a seasonally-adjusted quarterly change. This was slightly lower (0.1 of a percentage point) than we were expecting in July. However, the national accounts for the United States also contained a review of earlier figures, which shows that the decline in 2009 was greater and the GDP level this year lower than was previously assessed (see Figure 9). The labour market improved in July, but not at a rate that points to a good recovery. CPI inflation in the United States remained high in June and July, 3.6 per cent, which was unchanged from May. Underlying inflation, excluding energy and food, was lower, but rose in both months to a level of 1.8 per cent in July.

GDP growth in the euro area was 0.2 per cent in the second quarter of 2011, measured as a seasonally-adjusted quarterly change, which was also slightly lower (0.1 percentage point) than we were expecting in July. Inflation in the euro area fell from 2.7 per cent in June to 2.5 per cent in July, when measured as the HICP. Underlying HICP inflation excluding energy and unprocessed foods also fell in July, to 1.5 per cent.

At the monetary policy meeting in July I said that developments in the United States were troublesome. Both monetary policy and fiscal policy must be tightened there in the longer run, which will subdue growth. A strong, self-supporting recovery is therefore needed, a recovery that does not depend on short-term cyclical policy stimulation, to ensure a tangible improvement in the labour market. We cannot see this type of strong growth yet. It is also a common pattern that a financial crisis is followed by several years of weak growth.[2] I also noted at the July meeting that there was a tendency in the United States and Europe towards stagflation, with low growth and high inflation at the same time. Developments over the summer reinforce this image, but this does not mean that things will necessarily continue in the same way.

…but developments in Sweden largely in line with the forecasts

In Sweden we have received the first preliminary national accounts figures for the second quarter of this year, and new statistics for the labour market and inflation, for instance.

GDP growth was slightly higher in the second quarter than we were counting on in July. Seasonally-adjusted quarterly growth came out at 1.0 per cent, against an expected 0.6 per cent. Although both domestic demand and exports were marginally weaker than the Riksbank had forecast, imports, which are a deduction item when calculating GDP, were even weaker. This means that GDP growth was slightly higher than expected.

I expressed some concern at the monetary policy meeting in July that the second quarter would be weaker than our forecast in the Monetary Policy Report. This was not the case, which in itself is a good thing. But at the same time, more forward-looking indicators such as the purchasing managers' index and the National Institute of Economic Research's economic tendency surveys point to economic activity slowing down. This is something that we have already counted on. However, the purchasing managers' index has fallen more than expected, which indicates that the slowdown may be greater than estimated (see Figure 10).

The labour force survey statistics show that the labour market continued to improve in June. Employment rose by just over 2 per cent, compared with the same month last year, and unemployment fell, when seasonally-adjusted, to 7.5 per cent. This was a marginally smaller

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[2] See Carmen M. Reinhart and Kenneth S. Rogoff, "This time is different: eight centuries of financial folly", SNS, 2010.

improvement than we were counting on in July (unemployment 0.1 of a percentage point higher).

CPI inflation was 3.3 per cent in July. CPIF inflation (1.6 per cent) and CPIF inflation excluding energy (1.1 per cent) were much lower. All of these outcomes were marginally (0.1 of a percentage point) lower than expected.

I said at the monetary policy meeting in July that there was still a risk that inflation would increase more than we were expecting, particularly in 2012 and 2013. This was partly because inflation had recently been held back extra hard by the strengthening of the krona. I also pointed to the risk of rising energy and commodity prices in the world market, higher wage increases than expected due to pressure in the labour market, and higher inflation and wage expectations due to the high CPI inflation.

But so far, inflation has been marginally lower than expected and energy and commodity prices have fallen. The outlook for 2012 and 2013 depends, for instance, on developments in international economic activity and on the result of the coming wage bargaining rounds in the labour market.

The financial markets during the summer

Developments in the financial markets have been dramatic over the summer. Share prices, government bond yields and exchange rates have fluctuated substantially. This turbulence is one factor that could have significance for future forecasts.

This is essentially due to renewed concern over sovereign debt problems in the euro area and the United States. Focus has primarily been on four issues: public finances in Greece, the risk of problems spreading to Spain and Italy, potential problems in the European banks and the management of the debt ceiling and public finances in the United States.

New support package for Greece

At the beginning of the summer there was particular concern over developments in Greece. After a series of meetings of various policy-making bodies within the EU as well as a vote of confidence and a decision on budget-strengthening measures, structural reforms and the sale of state-owned companies in the Greek parliament it was decided in mid-July that Greece would receive a further support package from the euro area and the IMF. This led to a slight fall in the yield on Greek government bonds from their extremely high levels (see Figure 11).

Spain and Italy in the danger zone

At the beginning of August concern increased that the problems would spread to other countries than Greece, Portugal and Ireland, who were already receiving support. Market participants focussed on the sovereign debt situation in Spain and Italy, which caused government bond yields to rise in these countries. Both countries have problems with their public finances, but in different ways. Italy has a very large national debt, but not such a large deficit in public finances, while Spain has a smaller national debt but larger public finances deficit. Both countries have suffered declining competitiveness over the past ten years. Recently, the lack of confidence has also begun to affect France.

The banks managed the stress tests

There is also concern that the sovereign debt problems will spread to the banking sector. On 15 July the European Banking Authority, EBA, reported the results of the stress tests of 91 European banks, which together account for 65 per cent of the EU’s banking sector. This showed that all the banks but 8 had sufficient resilience to manage a deterioration in the scenario for the period 2011–2012, but that a further 16 banks almost did not pass the tests. However, all four major Swedish banks passed the stress tests with flying colours.

The results were received with some scepticism, as they were not considered to be sufficiently credible, but the markets nevertheless calmed down. European bank shares have since fallen, however, as a result of concern that sovereign debt problems may spread.

US sovereign debt problems cause concern

The sovereign debt problems in the United States have also caused concern on the financial markets. This rose gradually in July as the prolonged three-way negotiations between the parties in Congress and the President were underway. At the beginning of August, a decision was reached at the last minute to raise the debt ceiling and to implement greater cutbacks. However, these decisions did not succeed in calming the market. Standard & Poor's lowered the credit rating for the United States on 5 August from the highest level of AAA to the second highest level AA+ with a negative outlook. The other two dominant credit rating agencies, Moody's and Fitch, retained their AAA ratings. The poor statistics received during the summer regarding the US economy have further increased the financial market turbulence.

Sovereign debt problems create uncertainty

In my opinion, the public finance problems in the United States have remained fairly unchanged since July. The deficit in US public finances is calculated by the IMF to correspond to around 10 per cent of GDP this year. It should not be so difficult to decide on a long-term programme that will bring down the deficit to a manageable level within a few years in the way Sweden did in the mid-1990s. However, the decision-making system in the United States is constructed in a way that makes it difficult to take the necessary type of decision. Moreover, my impression is that the problems with the public finance deficit are underestimated in the United States to the extent that they believe growth will resolve much of the problems. On the other hand, they have now decided on certain budget-strengthening measures and the United States usually succeeds in managing difficult problems in the end.

The sovereign debt problems in the euro area are actually smaller than the US problems. The deficit in public finances in the euro area is calculated by the IMF to correspond to around 4 per cent of GDP this year. All in all, there is thus less need of budget strengthening measures in the euro area than in the United States and the tightening effects need not be so great. But the deficit is unevenly distributed and some countries have very large deficits and/or national debts. The problem is that even in Europe it appears to be difficult to reach decisions on credible long-term programmes for consolidating public finances. Instead, many countries have been forced by the markets to decide on further budget strengthening during the summer to increase confidence.

However, even if the sovereign debt problems in the United States and the euro area are essentially the same, the market turbulence may lead to the situation deteriorating. This could lead to rising government bond yields and increased uncertainty regarding the future, and thereby to lower GDP growth. It could make it harder to rectify the deficits in public finances in the countries concerned. At the same time, the market turbulence would probably decline if one succeeded in presenting credible programmes for managing public finances. However, it is uncertain whether the decisions made during the summer will suffice to calm the markets.

ECB buys government securities

A further problem is that self-generating processes can arise on the financial markets. If the price of a particular type of asset, such as a certain country's government bonds, falls, this can lead to this type of asset being sold, as those holding these assets may want to avoid continued losses. This pushes the price down even further. It may be difficult to break such a process.

To avoid this situation arising, the ECB began to buy Spanish and Italian government securities on the secondary market in August, which has pushed down interest rates for these countries. In addition, the European Council has agreed to increase the flexibility of the European Financial Stability Facility (EFSF). This facility will be able to grant loans to governments and – in exceptional cases – to buy government bonds on the secondary market. Formal approval by the respective countries is required for these changes to be able to come into force, and this process should move quickly. In July the euro countries signed an agreement to establish a permanent rescue funding programme, the European Stability Mechanism (ESM), which will replace the EFSF in the middle of 2013.

Sweden has strong public finances

In this context it is worth pointing out that public finances in Sweden are relatively strong. This is partly the result of the problems we faced and succeeded in managing in the mid-1990s. Regulations regarding expenditure ceilings, surplus targets and balance requirements for the municipalities have contributed to the good situation we have now. Our strong public finances also mean that there is no need for the fiscal policy tightening in Sweden that several other countries will have to implement.

Important questions at the September meeting

The turbulence on the financial markets has increased uncertainty regarding international economic developments in the coming period, and ultimately regarding developments in Sweden. I shall conclude with a few words on the problems I consider we will thus need to discuss at the next monetary policy meeting in early September.

Sweden affected through foreign trade…

International economic developments affect developments in Sweden in two main ways: through foreign trade and through the financial markets. Exports are dependent on developments in world trade. During the summer we have seen lower growth than expected, particularly in the United States. Lower international growth usually also leads to lower growth in Swedish exports. An important task here will thus be to assess GDP growth in various parts of the world and what significance it has for the Swedish export market. One of the most difficult questions in this context is to assess how increased uncertainty abroad will affect international developments.

Inflation in Sweden is also affected by trade with other countries, for instance, when the prices of goods imported into Sweden are adjusted in the world market. As I have already pointed out, energy and commodity prices have fallen since last spring, which we will also have to take into account in our inflation forecasts.

…and via the financial markets

The Swedish economy is also affected through the financial markets. Interest rates abroad have fluctuated substantially and this also affects Swedish interest rates. This is clear from the strong covariation between government bond yields in the United States, Germany and Sweden. Developments during the summer have entailed falling interest rates in Sweden, which is in itself positive for growth (see Figure 12).

At the same time, share prices have fallen and the stock market is very volatile. Since the Monetary Policy Report was published on 5 July, the Stockholm Stock Exchange has fallen by around 20 per cent until the beginning of this week (see Figure 13). This could mean that households increase their precautionary saving and that companies postpone investments. We must also take a stance on how this may affect our forecasts. But then one must also take into account the fact that we have already counted on a significant slowdown in GDP growth, from around 4.4 per cent in 2011 to around 2.2 per cent in 2012, which is a much lower growth rate than the 3.8 per cent the government was anticipating for 2012 in its Spring Budget Bill.

Economic developments in Sweden can also be affected by developments in the Swedish krona. History shows that the Swedish krona usually weakens in times of turbulence, which was clearly demonstrated during the financial crisis. One effect of the severe krona weakening in 2008–2009 was that the price of imported goods rose. In this way, inflation in Sweden was stabilised; otherwise there was a risk that it would have been too low. Even during the most acute phase of the crisis, CPIF inflation remained close to the target of 2 per cent. The krona has also weakened during the financial turbulence this summer, but so far the depreciation has been modest (see Figure 14). We will also take into account the consequences of this in our inflation forecasts.

At the same time, the recent financial market turbulence, with falling share prices and interest rates, may suddenly be reversed. My experience is that one should be cautious in interpreting fresh events when one is shaping economic policy. Our repo rate decisions are aimed at the future. Although uncertainty has increased, and economic activity abroad so far has been slightly weaker, the Swedish economy has developed largely in line with the outline we sketched in July. Moreover, the repo rate is still low.

Swedish banks are stable

The Riksbank has two main tasks. The first is to conduct monetary policy with the objective that inflation shall be low and stable. The second is to safeguard financial stability. The Riksbank therefore closely monitors developments in the financial markets. During the summer we have extended out monitoring as a result of the international turbulence.

Swedish banks are still financially strong. They currently have good access to funding on all of the markets they normally use. The Riksbank’s stress tests also show that they have a good capacity to manage increased loan losses. But as the Swedish banks obtain funding largely through market borrowing in foreign currency, they are of course vulnerable to problems abroad. We currently have daily contacts with the banks and we have access to data on their funding. So far, there is nothing to indicate that it will be necessary for us to lend money to the banks.

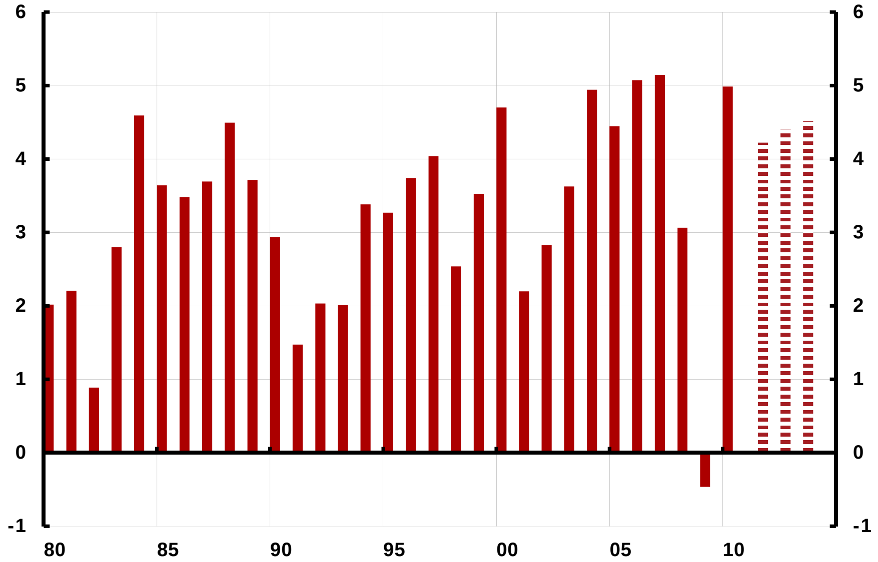
Next decision is on 6 September

We are currently working hard on new analyses and forecasts for the monetary policy meeting on 6 September. I have today attempted to outline events during the summer and the issues I consider we will discuss at our next monetary policy meeting. My colleagues and I will return to how this will ultimately affect monetary policy in the coming period in a couple of weeks’ time when our decision has been made. Moreover, we are constantly monitoring developments in the financial markets.

Figures

1. World GDP growth

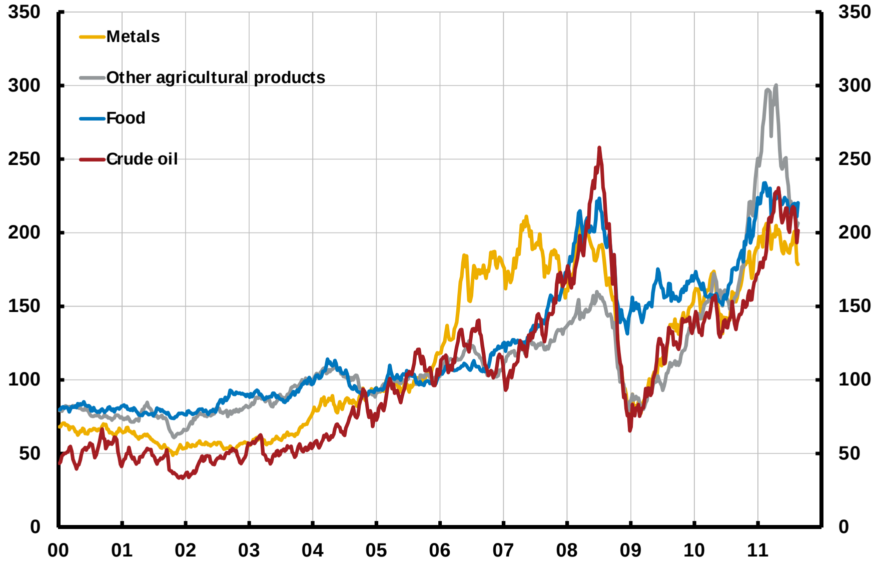
Annual percentage change, calendar-adjusted data



Sources: The IMF and the Riksbank

2. Commodity prices

Index 2005 = 100, USD

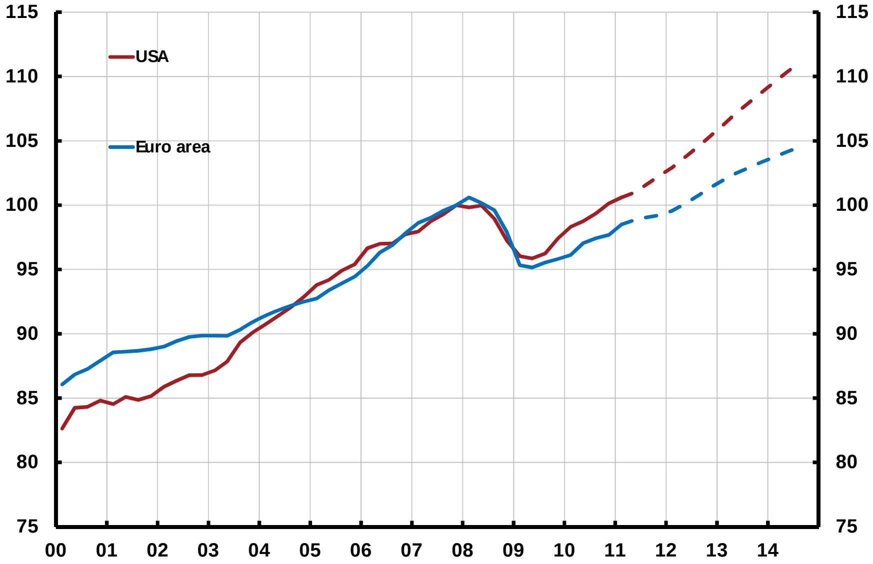


Note. Data are updated with new outcomes after the publication of the July Monetary Policy Report.

Sources: The Economist and Intercontinental Exchange.

3. GDP in the USA and in the euro area

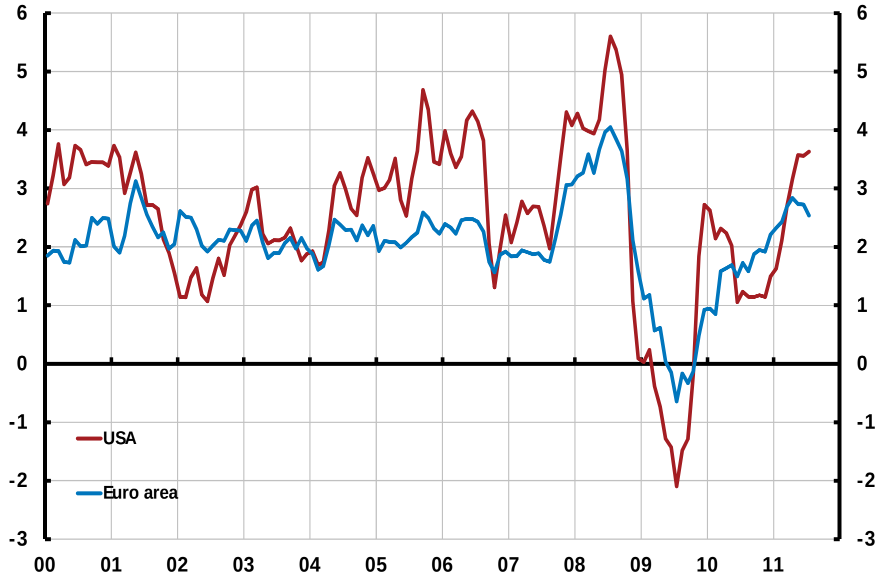
Index 2007 Q4 = 100



Sources: Bureau of Economic Analysis, Eurostat, Statistics Sweden and the Riksbank

4. Inflation

Annual percentage change

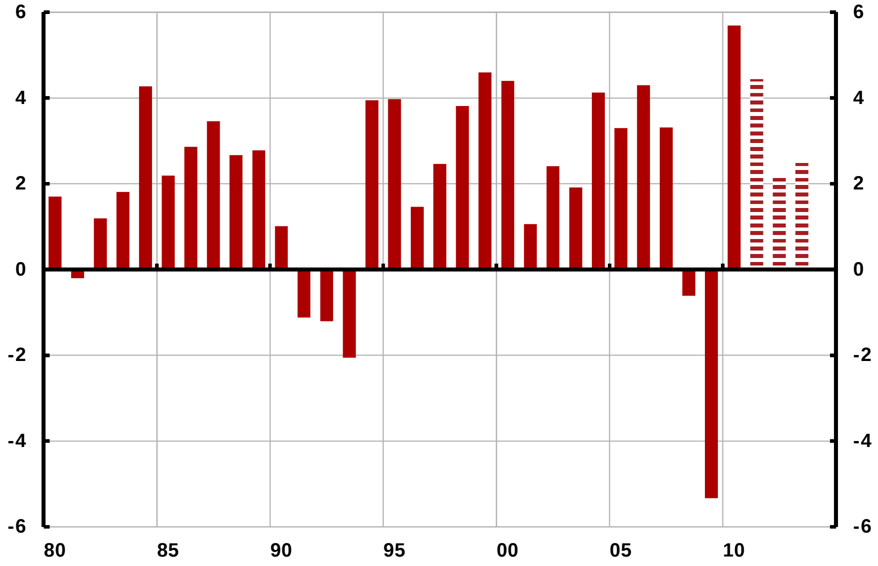


Note. Data are updated with new outcomes after publication of the July Monetary Policy Report.

Sources: National sources

5. GDP growth in Sweden

Annual percentage change



Sources: Statistics Sweden and the Riksbank

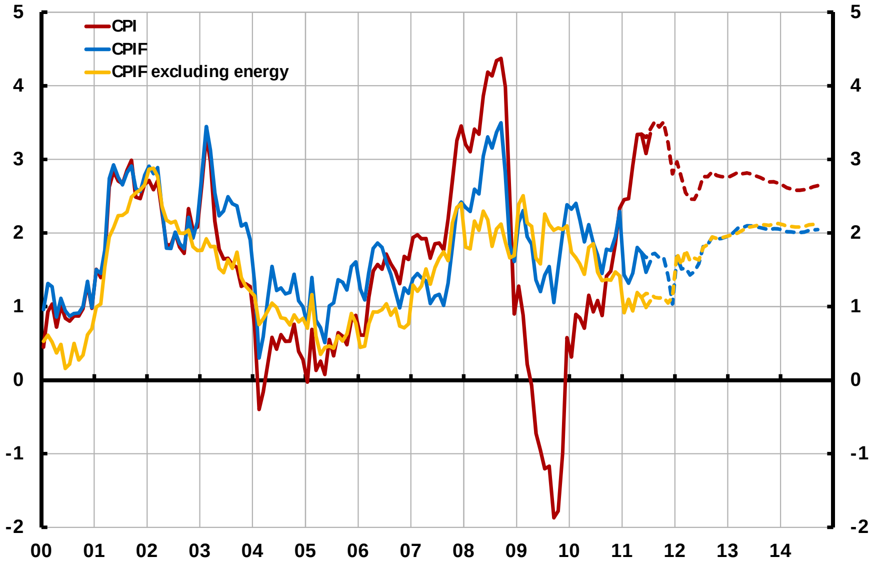
6. Unemployment

Percentage of the labour force

Sources: Statistics Sweden and the Riksbank

7. Inflation

Annual percentage change

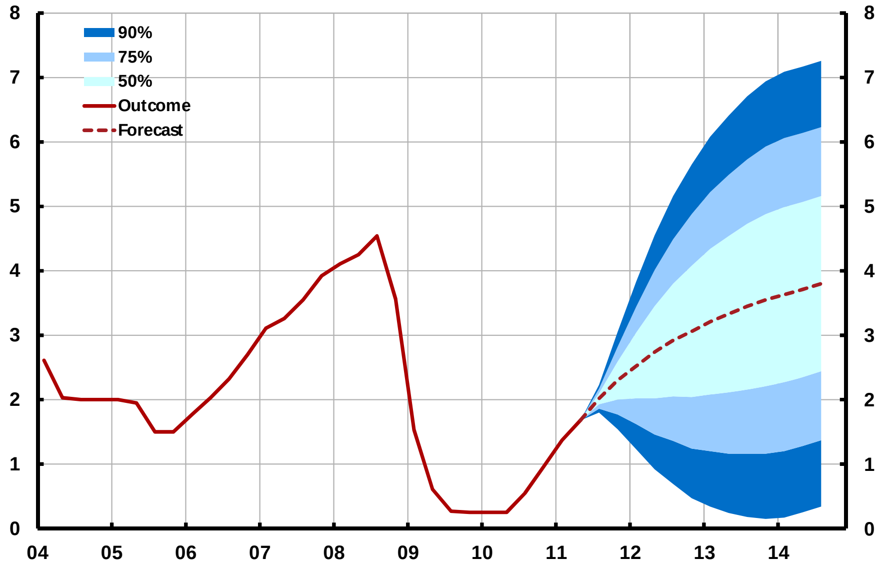


Note. The CPIF is the CPI with a fixed mortgage rate. The data are updated with new outcomes after the publication of the July Monetary Policy Report.

Sources: Statistics Sweden and the Riksbank

8. Repo rate with uncertainty bands

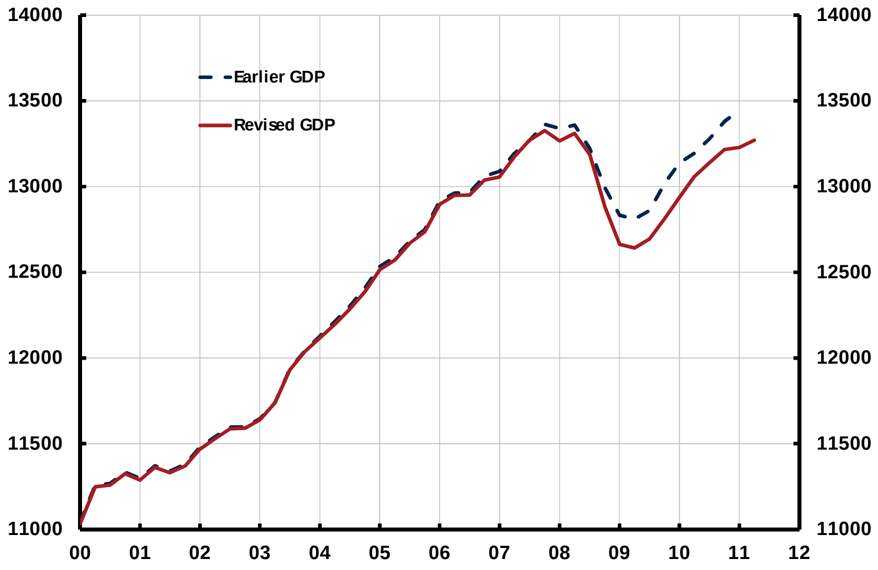
Per cent, quarterly average



Source: The Riksbank

9. GDP in the USA

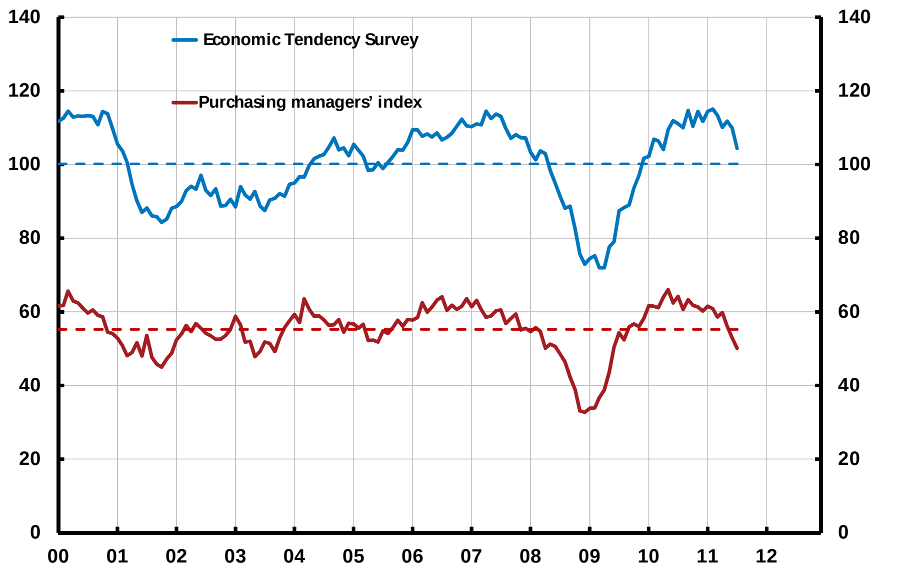
USD billion, fixed prices



Source: Bureau of Economic Analysis

10. Forward-looking indicators

Economic tendency indicator: index, average = 100, standard deviation = 10
Purchasing managers' index: seasonally-adjusted index

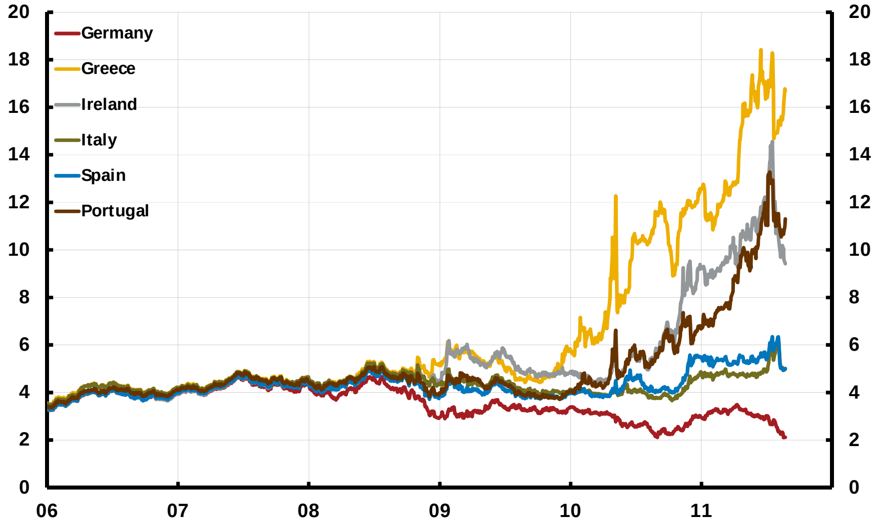


Note. The broken line represents the average 2000–2011.

Sources: National Institute of Economic Research and Swedbank

11. Government bond yields

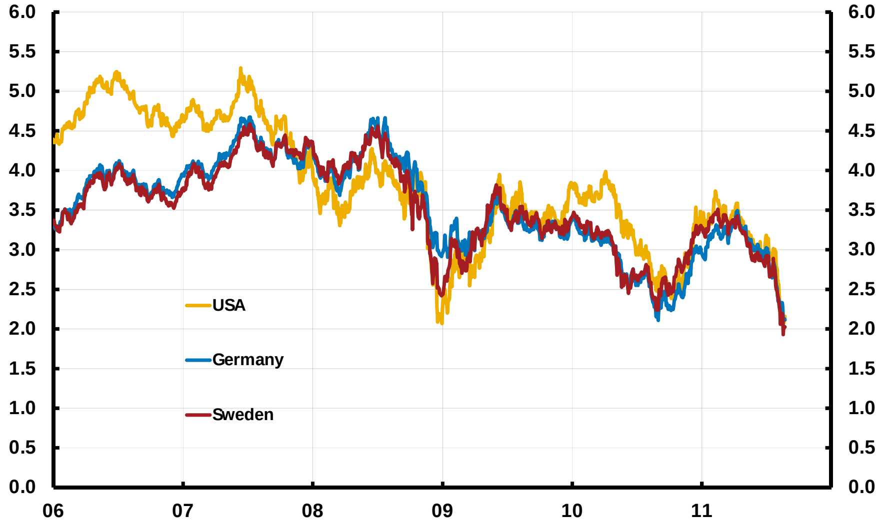
10 year maturity, per cent



Source: Reuters

12. Government bond yields

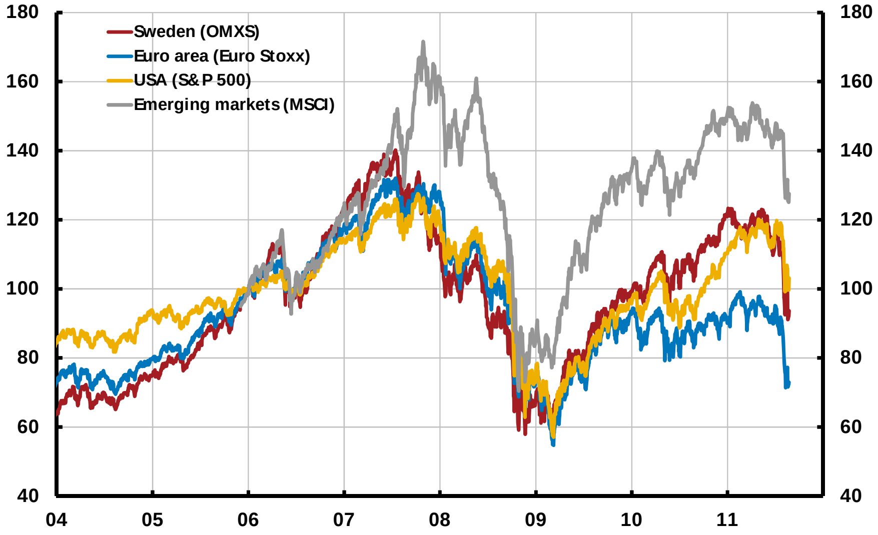
10 year maturity, per cent



Source: Reuters

13. Stock market developments

Index, 1 January 2006 =100



Source: Reuters

14. Krona exchange rate, TCW index

Index, 18 November 1992 = 100

Note. The outcomes are daily rates and the forecasts refer to quarterly averages. Data are updated with new outcomes after the publication of the July Monetary Policy Report.

Source: The Riksbank