Kerstin af Jochnick: Monetary policy and the current economic situation

Speech by Ms Kerstin af Jochnick, First Deputy Governor of the Sveriges Riksbank, to the County Administrative Board, Kalmar, 22 August 2013.

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It has become something of a tradition for a member of the Executive Board of the Riksbank to hold a speech on the current economic situation at the end of August. I think this is a good idea; starting off the new term by summarising what has happened during the summer. I appreciate being given the opportunity to come here to Kalmar to talk about the economic situation. Kalmar is part of a region where economic developments are greatly affected by cyclical fluctuations. Kalmar and Kronoberg, together with Blekinge, are the counties that have experienced the largest fluctuations in growth since the early 1980s. One reason for this, of course, is that a large share of the companies in the region comprises subcontractors to the cyclically-sensitive manufacturing industry.

Today I intend to start off with the economic assessment we made in July and in particular to describe my view of developments at that time and of the monetary policy we have decided on. The main message in July was that the Swedish economy is heading for a recovery. But we decided to hold the repo rate at a low, unchanged level to help the economy along. Personally, I think the decision was a reasonable balance as it means that inflation will attain the target in around two years' time, while we take into consideration the risks linked to the high level of household debt.

One important issue that I would like to discuss in greater depth today is how monetary policy takes into account household debt and what important role the emerging macroprudential policy can play. Macroprudential policy is more suitable than monetary policy for managing financial imbalances, such as a high build-up of debt in the household sector, and it is therefore essential that it is implemented as soon as possible.

Well-balanced monetary policy in July

At the most recent monetary policy meeting in July we noted that growth would be weaker than normal this year, both in Sweden and abroad. However, developments in the Swedish economy were divided. At the same time as the household sector looked strong and consumption was growing, companies were being affected by the weak demand abroad, which was leading to lower export and investment. Moreover, the inflation rate was still low. But our assessment at the meeting was that there were signs that the recovery in Sweden and abroad was gradually strengthening.

Uneven but gradually strengthening recovery abroad

Economic prospects have for some time now looked different in different parts of the world, but on the whole our assessment in July was that economic activity would gradually improve in the coming period. However, I personally thought there were a number of factors in the global economy that made the forecast unusually uncertain. Prior to the meeting in July, there had been considerable fluctuations in the financial markets, which were largely due to the uncertainty over when the Federal Reserve will begin phasing out its quantitative easing. There was also uncertainty over what effects the problems in the Chinese banking sector would have on the Chinese economy and also, as has been the case for a long time now, over developments in the euro area.

Economic developments in the euro area are still marked by the need for the private and public sectors to reduce their debt, which is a process that will of course take a long time. However, compared with one year ago, developments had been in the right direction in most of the problem countries and a number of measures had been taken that led to interest rates falling to lower levels. Our assessment in July was based on the assumption that the reform process would continue and the forecast was that GDP growth in the euro area would remain weak but gradually increase. However, the slow recovery means that GDP will not reach the same level as prior to the decline in 2009 until 2015. This shows what enormous costs the global financial crisis has entailed, not only in the form of capital injections to international banks and governments, but also in the form of loss of growth and welfare.

In the United States, conditions for a continued recovery were good, although growth was expected to be slow this year. There were several signs that households would soon have reduced their debts to more sustainable levels, at the same time as the housing market continued to improve, with rising housing prices and increased turnover. We therefore assessed that GDP in the United States will grow by just over 3 per cent on average in 2014 and 2015.

The economic prospects for other regions looked rather mixed. In China, the high growth had slowed down at the beginning of 2013, while Japan had showed some positive signals after the new stimulus package. The United Kingdom and Denmark showed weak growth, partly due to problems in the housing market, while Norway was assessed to have somewhat higher resource utilisation than normal. All in all, the economies in the countries important to the Swedish economy were expected to be weaker than normal this year, and then to gradually improve.

Gradually brighter growth prospects in Sweden

In July we pointed out that the weak developments in the euro area in particular affect the Swedish economy, partly through low demand for Swedish exports and investment. We therefore assessed that GDP growth in Sweden would also be lower than normal this year, but would gradually strengthen in the coming period. However, developments in the Swedish economy were divided. At the same time as companies in the manufacturing industry in particular showed a low level of confidence and investment declined, households' finances were relatively strong. Optimism in the household sector had begun to rise, which was reflected in higher house prices, as well as increased lending and consumption. However, we began to see some signs of a turnaround in activity in the manufacturing sector, too.

Our assessment in July was that the demand for Swedish exports would rise as international demand increased, while the upturn in domestic demand was expected to broaden. Household consumption and housing investment were expected to increase at a faster pace as household confidence strengthened further and the labour market improved. At the same time, companies are expected to increase their investment as demand rises. We therefore made the assessment that GDP growth in Sweden will rise gradually in the coming years and reach just over 3.5 per cent in 2015.

The labour market saw an increase in both the number of people in the labour force and the number of persons employed. Our assessment was that unemployment will remain unchanged in the coming year and then begin to fall when the higher GDP growth causes employment to increase faster than the labour force.

Low but gradually rising inflation

Inflation in Sweden has been low for a long period of time and we devoted extra space to this fact in the July report.[1] It is not so strange that inflation has been low, given the Swedish economy's dependence on global economic activity. One of the main reasons is that prices of Swedish import goods have been low. This is largely due to global economic activity being weak and having affected global export prices, but the stronger Swedish krona has also

[1] A more detailed analysis of the development of inflation is included in the article "The development of costs and inflation" in the Riksbank's Monetary Policy Report published in July 2013.

contributed. Another reason is that companies have not raised their prices to the same extent as their costs have increased. The low price mark-ups are partly due to demand being lower than normal and to the considerable uncertainty over international developments.

In July we assessed that inflationary pressures would gradually increase over the coming years, as Sweden and other countries recover. This means that CPIF inflation is expected to reach 2 per cent in 2015. CPI inflation is expected to be higher than the target of 2 per cent at the end of the forecast period, which is due to mortgage rates rising when the repo rate starts to increase as the economy improves. Let me describe in more detail the factors expected to contribute to the upturn in inflation.

When global economic activity improves, global export prices are expected to rise. Initially, the krona is expected to strengthen somewhat in trade-weighted terms, which will dampen the impact on Swedish import prices in the near term. However, from the beginning of next year, we assess that the krona will no longer contribute to holding down import prices and they will then rise faster. As economic activity in Sweden strengthens, the rate of wage increase will also rise. At the same time, we have assessed that labour productivity is increasing, which means that unit labour costs will continue to grow by around 2 per cent a year in the coming years. The fact that import prices rise faster, at the same time as unit labour costs continue to increase at a normal rate, will lead to companies' total marginal costs gradually beginning to grow at a more normal pace.

We also predicted in July that the demand situation would improve during the forecast period, partly thanks to higher demand from abroad and a continued expansionary monetary policy in Sweden. We are expecting that it will become easier for companies to raise their prices when demand increases. Companies' profit shares will also increase towards more normal levels then. All in all, these factors – increasing unit labour costs, rising import prices and higher price mark-ups – lead to the assumption that inflation will rise in the coming period.

Continued low repo rate stimulates the Swedish economy

We Executive Board members assessed that the repo rate needs to remain low to support economic activity and to ensure inflation rises towards the target. We therefore decided at the meeting in July to hold the repo rate unchanged at 1 per cent, and the repo-rate path shows a slow increase beginning during the second half of 2014.

Monetary policy is thus very expansionary. However, the decision to hold the repo rate unchanged also gives consideration to the risks linked to Swedish households' high debts. Personally, I consider the repo-rate decision to comprise a reasonable balance. The forecast showed that CPIF inflation will attain the target in around two years' time. An even lower repo rate could have led to inflation attaining the target slightly earlier, but the decision is about stepping on the gas just enough. A lower repo rate would probably also lead to the risks linked to household debt increasing further, particularly bearing in mind that the situation for households was relatively favourable to start with. There could be a particularly difficult situation if households expect the low interest rate to persist. This could lead to both house prices and debts increasing further, which can have very negative consequences in the form of sharply rising unemployment and difficulties in attaining the inflation target further ahead.

There are numerous discussions in Sweden and abroad with regard to how much consideration monetary policy should give to various types of financial imbalance, such as high household debt. After the most recent financial crisis, which demonstrated how costly a crisis can be as a result of a large build-up of debt, the pendulum has swung towards the belief that monetary policy should to a greater extent lean against the wind, and take such imbalances into consideration. Personally, I think that as long as there are no other tools in place that can counteract the build-up of financial imbalances, monetary policy must take into account the risks the imbalances entail. Let me explain my view of these questions before I move on to summarise the information received during the summer.

Monetary policy and financial imbalances

International experience shows that a high level of indebtedness in all its forms can pose major risks to the economy. It makes the economy more vulnerable to various types of shock, such as a fall in house prices, and it can also increase the risk of shocks actually occurring. The flexible inflation targeting conducted by the Riksbank is compatible with giving consideration to this type of financial imbalance in our monetary policy decisions. Such imbalances ultimately risk jeopardising both the stability of the real economy and the inflation target. In a really bad scenario the imbalances could also entail risks for financial stability. As the Riksbank's two main tasks are to attain price stability and financial stability, we must take these risks into account.

Monetary policy needs a more long-term focus

As I see it, we need to make it clear in the monetary policy analysis how monetary policy affects the risk of a financial crisis arising and how such a crisis scenario would look. As financial imbalances usually build up over a long period of time, this means that, in practice, we need to look beyond the three-year perspective that normally forms the base for our forecasts. Monetary policy is already forward-looking, but with a more long-term focus we could also include target attainment in the longer run.

So, to what extent can monetary policy affect the probability of a crisis occurring? Well, it is mainly the effect of the repo rate on debt that is important in this context, as the probability of a financial crisis increases when indebtedness is high or when debt increase at a faster rate than normal.[2] As the interest rate entails the cost of taking on debt, monetary policy has an effect on indebtedness. In the short-term perspective it seems as though the relationship between the repo rate and household debt is not very strong. However, if households expect the prevailing low interest rates to persist, and therefore increase their debts to unsustainable levels, the effects can be substantial.

In the July report we describe a potential scenario in Sweden if house prices were to fall at the same time as indebtedness is high.[3] Experiences from other countries show that this would probably mean that households increase their savings and reduce their consumption, which would subdue demand in the economy and push up unemployment. The effects on GDP and unemployment may therefore be both substantial and long lasting. Relevant examples here are Spain and Denmark. Experiences also show that the higher households' debts are, the greater the negative consequences will be of a fall in housing prices.[4] At the same time, there would probably be long-lasting difficulties in attaining the inflation target, as the uncertainty over future inflation increases significantly.

Conducting a flexible inflation-targeting policy in this context involves taking into account the risk of a crisis occurring by balancing the effects within the normal forecast period against the long-term risks I described. There is of course considerable scope here for different assessments, for instance, to what extent monetary policy affects the probability of a crisis, as well as how a crisis scenario would play out. These are difficult monetary policy deliberations without easy answers. As Sweden is a small country with its own currency and strongly dependent on other countries, it is particularly important that we do not create

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[2] See, for instance, M. Schularick and A.M. Taylor (2012), "Credit Booms Gone Bust: Monetary Policy, Leverage Cycles, and Financial Crises, 1870–2008", American Economic Review 102, pp. 1029–61.

[3] A more detailed analysis is provided in the article "Financial imbalances in the monetary policy assessment" in the Riksbank's Monetary Policy Report published in July 2013.

[4] See, for instance, IMF "World Economic Outlook", April 2012, A. R. Mian, K. Rao and A. Sufi (2011), "Household Balance Sheets, Consumption, and the Economic Slump", Chicago Booth Working paper, November 2011 and K. Dynan, (2012) "Is a Household Debt Overhang Holding Back Consumption?" Brookings Papers on Economic Activity, spring edition.

imbalances that can affect confidence in the country, the currency and the banking system. I consider the assessment we made in July to entail on the whole a good balance between these difficult questions.

Macroprudential policy needs to be implemented without delay...

At the same time, I consider it important to emphasise that the repo rate is a blunt instrument. Other policy areas have more effective tools for influencing household debt. One such policy area is macroprudential policy, which entails limiting the risks in the financial system as a whole. If there were more effective tools available for managing and preventing financial imbalances, monetary policy would not need to take such risks into account to the same extent.

At present, several countries and international organisations are working on producing and implementing a new framework for financial stability, where macroprudential policy will be in focus and the central bank will be given an important role. However, the design is slightly different in different countries. For instance, in the United Kingdom the central bank has been given the entire responsibility for macroprudential policy, while in Germany the responsibility has been given to a council, on which the central bank has a central position.

It is important that a small country like Sweden does not deviate from the international pattern, but also that it makes efficient use of the existing resources and competence. Both the Riksbank and Finansinspektionen (the Swedish Financial Supervisory Authority) have important competence with regard to conducting effective macroprudential policy. The Riksbank has considerable knowledge and experience of analysing the risks that might threaten the stability of the financial system, as well as of macroeconomic analysis and forecasting. It is therefore easier for us to understand the linkages between the financial and the real economies, which is essential for a successful macroprudential policy. Moreover, there are clear points in common between macroprudential policy and monetary policy, as they affect the conditions for one another. At the same time, Finansinspektionen currently conducts supervision with a focus on individual institutions and thus has important competence and experience for ensuring that macroprudential policy is effective.

As I see it, there are two main principles that should be used when drawing up macroprudential policy. Firstly, there should be a clear mandate covering accountability and the requirement for insight. Secondly, it is important that the authority that is given responsibility for macroprudential policy is also equipped with the right tools, that is, given the possibility to intervene at an early stage when risks that could lead to negative effects on the Swedish economy have been identified. Sweden’s place in the global financial system and our domestic conditions mean that we cannot delay any longer in designing a framework for financial stability and macroprudential policy; we need to get this in place as soon as possible.

...and we need an even better analytical base

However, to be able to make the best possible analyses and thus design effective tools to counteract the risks of high indebtedness, we also need to have better statistics on household borrowing. This has also been pointed out by both the IMF and the European Commission in their assessments of the Swedish economy.[5]

As a preliminary step towards improving the analytical base we at the Riksbank have asked the Swedish banks to provide us with data on households’ loans. The data collected by the Riksbank will be used to analyse how vulnerable the Swedish households are and how potential risks are distributed among the population. Finansinspektionen already makes good

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5 “Sweden – 2013 Article IV Consultation: Concluding Statement of the Mission”, IMF, 31 May, 2013. “Council Recommendation (COM(2013) 377 final)”, European Commission, 29 May, 2013.

analyses and have on several occasions gathered random samples among newly-granted loans. The Riksbank and Finansinspektionen cooperate in the analysis of the mortgage survey, but these random samples entail a small selection and only capture the new loans granted by the banks. There is thus a need to go one step further to see how the debts are distributed and thus how large the risks in the entire banking system are, not merely those in the newly-granted loans.

Another factor that affects household debt is residential construction. Not enough housing is being built in metropolitan regions to keep up with the growth in population. This naturally affects both housing prices and household debt and is a long-term problem that should be managed but that neither monetary policy nor macroprudential policy can affect.

Developments during the summer

While waiting for macroprudential policy to be established, we are continuing to work on our monetary policy analysis in the way I have described and at the beginning of September it will be time for a new repo-rate decision. Since we made our assessment in July new information has been published that we will analyse and make an overall assessment of at our meeting in September, but I shall now summarise what has happened so far.

Clearer guidance about future monetary policy

During the summer the financial markets have largely focused on expectations of future monetary policy, in particular how the Federal Reserve is expected to act in the coming period. At the same time, both the European Central Bank and the Bank of England have stated clearer forward guidance in order to increase transparency and reduce uncertainty. One reason for the need to increase transparency is that these central banks have come down to very low policy rates. This means there is a greater need for central banks to clearly communicate their views on future monetary policy. The Riksbank has long emphasised the importance of a central bank being transparent and giving clear guidance, which is why we started publishing a repo-rate path and forecasts for inflation and unemployment, for instance, in connection with our monetary policy decisions back in 2007.

The uncertainty on the global financial markets has declined during the summer and the increased volatility which we noticed prior to the meeting in July in the stock markets as well as the bond and foreign exchange markets has also decreased somewhat. Government bond yields in the United States and Europe have continued to increase while stock markets around the world have risen, even if the latter fell somewhat during the last week. The Swedish financial markets have followed the international developments and market rates and the stock market have risen in Sweden during the summer. The Swedish krona has fluctuated considerably but all in all the change is small compared to the level at the beginning of July. The Swedish krona has strengthened somewhat in trade-weighted terms, which is mainly due to a strengthening against the US dollar.

Some improvement in the euro area

Developments in the euro area have been relatively calm over the summer, despite some political uncertainty in Portugal, Spain and Italy. Moreover, there have been assessments of Ireland and Greece, for instance, that indicate the on-going reform work is progressing well. The reform work in both countries has been approved, which has paved the way for continuing aid payments. But the problems remain, and during the summer both Italy and France had their credit ratings downgraded because of poor growth prospects.

Perhaps the most important thing is that new statistics show that the euro area GDP has begun to grow again. After being negative for six quarters in a row, GDP growth was 1.1 per cent in the second quarter of this year, according to preliminary figures and calculated as an annual rate. In Germany, which is very important to Swedish exports, GDP growth was clearly above the average for the euro area as a whole. At the same time, indicators for the start of the third quarter point to a continued improvement. The aggregate purchasing managers' index rose in July to just over 50, for the first time since the start of 2012, and consumer confidence also began to rise. New labour market statistics also show that unemployment in the region has stabilised, albeit at a very high level. All in all, the new information confirms the picture that the recovery in the euro area has begun.

Mixed signals from the rest of the world...

New US statistics indicate continued strength in the US economy. Preliminary figures show that GDP increased in the second quarter by 1.7 per cent, calculated as an annual rate, compared with the first quarter of this year, which is in line with the assessment we made in July. At the same time as the new outcomes were published, the statistics authority released revised GDP figures for previous periods. These show that GDP growth has been slightly higher since 2007, and that the fall in GDP during the financial crisis was thus not as large as indicated by earlier statistics. In the United Kingdom, GDP was slightly better than expected during the second quarter. The indicators for July also point to a gradual recovery in the British economy.

However, in Japan, which showed positive signals at the start of the year, newly-received statistics over the summer have not been as clear. GDP growth slowed down during the second quarter and the recovery in both the household and corporate sectors appears to have been dampened slightly further at the start of the third quarter. At the same time, data shows that emerging markets are slowing down somewhat. In China, preliminary figures for the second quarter show that GDP increased by 7.5 per cent as an annual percentage change, which was a slowdown compared with the previous quarter. Indicators for the other BRIC countries, that is, Brazil, Russia and India, show some slowdown. All in all, the new information shows some signs of strength in the recovery in advanced economies, but a rather more subdued development in emerging markets.

...but also in Sweden

It was clear that international developments play an important role for the Swedish economy when the preliminary GDP figures for the second quarter were published. GDP fell by 0.2 per cent when calculated as an annual rate compared with the first quarter of this year. The negative growth was largely due to a fall in exports, but household consumption also fell somewhat. The outcome was slightly weaker than we and several other analysts had expected. But as the figures are preliminary, we probably should not draw any major conclusions from them. At the same time, new monthly statistics for the retail trade showed that sales were strong at the end of the second quarter.

Indicators for the start of third quarter have given mixed signals. So far, the information is limited to the business tendency survey for July and the purchasing managers' index for the same month. The economic tendency survey, which includes both households and companies, rose slightly in July and the upturn was on a broad front. Confidence in the household sector is now at its historical average. The purchasing managers' index for the manufacturing industry was over 50 in July, for the third month in a row, which indicates growth in the manufacturing industry, but the most recent outcome showed a fall compared with the previous month. At the same time, however, the purchasing managers' index for the service industries rose.

According to new labour market data for June, the earlier positive trend continued for both the number of people in the labour force and the number of employed. Unemployment rose marginally in June, but monthly data is usually volatile and if one looks at the second quarter as a whole, unemployment fell somewhat more when compared with the first quarter than we had assessed in July. During the summer, inflation outcomes were published for June and July. CPI rose by 0.1 per cent in July, compared with the same month last year, at the same time as the underlying CPIF inflation rate was 1.2 per cent. This was somewhat higher than expected, mainly owing to an unexpectedly sharp rise in energy prices.

During the summer, new financial market statistics were also published for the month of June. The annual growth rate for lending to households was 4.7 per cent in June, that is, the same as in May. This means that the rate of increase in lending has remained more or less unchanged since last summer.

Next monetary policy decision on 4 September

A number of mixed signals have been received during the summer. While the volatility on the financial markets has declined, there is still some uncertainty over the strength of the recovery in the real economy. There have been signs of a gradual improvement, for instance, in the euro area and the United States, but on the other hand the GDP outcome in Sweden, for instance, signalled that the recovery is fragile. At our monetary policy meeting on 4 September we will have to balance these factors against one another, and also take in the information received in the meantime.

Until macroprudential policy has been established, we will continue to conduct a flexible monetary policy that enables us to take into account a number of different factors, such as household debt. At the Riksbank we are busy working on new analyses and forecasts on which to base the next repo-rate decision. We will return with a new overall assessment in connection with the monetary policy meeting in September.