

Kerstin af Jochnick: Current monetary policy and the economic situation

Speech by Ms Kerstin af Jochnick, First Deputy Governor of the Sveriges Riksbank, at the Centre for Business and Policy Studies, Stockholm, 21 August 2015.

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Accompanying figures can be found at the end of the speech.

Economic developments in Sweden look positive and the Riksbank's expansionary monetary policy is continuing to support the upturn in inflation. I am pleased to note this as I hold an August speech for the fourth year in a row based on the monetary policy decision in July and discuss what has happened during the summer. Although I expect most people here follow events on stock exchanges and other markets around the world even during the summer, I hope that a summary of the most important events may be useful prior to assessing the prospects for the autumn.

One can say that Greece has not entirely unexpectedly been in focus during the summer, too. The forecasts in our July Monetary Policy Report were based on the sequence of events not preventing a recovery in the euro area. While some work remains to be done before the new 3-year loan programme is formally in place, my assessment is nevertheless that developments so far are in line with the assumptions we made in July.

Developments in global economic activity since July also support our assessment that we would see a gradual strengthening of growth and that the weak global growth during the first quarter of the year was temporary.

The Swedish statistics received also support our view that economic activity in Sweden is gradually improving and that inflation is continuing to rise. Unemployment was lower than expected in June, while GDP growth was higher than expected in the second quarter. Although inflation was somewhat lower than we expected in June, it was higher than expected in July.

The low interest rates entail risks that could cause problems in the Swedish economy further ahead. A high level of indebtedness among households and rapidly rising housing prices could make the Swedish economy vulnerable if there were to be a slowdown in economic activity for some reason. The Government should therefore quickly ensure that Sweden has a framework for macroprudential policy and that Finansinspektionen (the Swedish Financial Supervisory Authority) has a clear mandate to conduct this policy.

The assessment and the decision in July

The global recovery is continuing after a temporary fall at the beginning of the year, but some concerns remain

I would like to begin by looking back at our assessments prior to the decision in July. The year began with unusually weak figures for both global production and world trade. This was partly because growth slowed down substantially in the United States, the United Kingdom, China and several commodity-exporting countries. However, we assessed that this was largely due to temporary factors and that growth would in future be good, see Figure 1.

There are several factors that point to a favourable development in the global economy going forward. One factor is the oil price, which has fallen substantially over the past year. This can be expected to have a positive effect on growth in the countries that do not produce oil. For instance, it provides scope for increased consumption in these countries, which could favour global growth.

Another factor is that the relatively large fiscal policy restraint in the large developed economies in recent years appears to be over. During 2015 and 2016, the restraints will be

relatively small. Fiscal policy will not therefore have the same restrictive effect on GDP growth in the years ahead as before.

A further factor that affects developments in the global economy is the expansionary monetary policy around the world. The policy gives continued support to credit granting and helps to push up inflation expectations, which benefits both consumption and investment. This is particularly true of the euro area, where inflation expectations have now started to rise and lending has begun to show a more positive trend. Many countries also have an unmet need to invest, following the financial crisis, and this can be met as the credit supply improves.

The assessment was thus that there are several factors pointing towards a favourable development in the global economy going forward, but there still remain some causes for concern. The funding crisis in Greece has still not been resolved, and the situation in Russia and Ukraine is also creating continued uncertainty.

Rising global inflation in the years ahead

Internationally, inflation has fallen in recent years and is under the inflation target in many countries, see Figure 2. The falling oil price over the past year has contributed to this downward trend. However, the effects of the falling oil price on inflation are expected to gradually decline. Unemployment is also falling in many parts of the world and this trend is expected to continue in the years ahead. This contributes to a higher rate of wage increase and rising demand for goods and services. International inflation can therefore be expected to rise in the coming years.

Recovery in the rest of the world contributing to a broad upturn in Sweden

Sweden is a small, open economy and therefore dependent on what happens in the rest of the world. The weak international demand following the financial crisis has thus led to weak development for Swedish exports. But a continued recovery abroad will benefit Swedish exports and growth going forward.

Domestic demand is expected to continue growing relatively fast, partly due to relatively strong private consumption. The rising wealth level in the household sector and the low interest rates create scope for relatively high growth in consumption. The global recovery also increases the need for investment in the business sector and contributes to stronger growth in investment. The demand for housing remains strong, which helps maintain the level of housing investment. All in all, the increasingly strong demand, both domestic and international, means that GDP growth will be higher than the historical average over the coming years, see Figure 3.

Good prospects for inflation in Sweden to continue to rise

Inflation in Sweden is still low, just like in many other countries, see Figure 4. However, CPIF inflation excluding energy has been rising for some time and several different indicators point to it continuing to rise.

The ever-stronger global economy leads to both higher international prices and higher demand for Swedish goods and services. Domestic demand also becomes higher and contributes to rising price pressures. The weakening of the Swedish krona over the past year has meant that imports of goods and services has become more expensive, which tends to increase consumer prices. The weaker exchange rate has not yet had a full impact on prices yet, either. Import prices are expected to rise further for a time before the contribution to higher inflation from the exchange rate wanes.

A more expansionary monetary policy supports the upturn in inflation

The Riksbank has implemented strong measures to reduce interest rates in general in the Swedish economy and thereby make monetary policy more expansionary. The repo rate has been cut to negative levels. We have also made extensive purchases of Swedish government bonds. Although it is difficult to distinguish the effects of different measures on the economy, our assessment is that the impact of monetary policy is essentially functioning as expected. The interest rates charged to households and companies on loans with short maturities have fallen more or less in line with the repo rate. Data from the financial markets also imply that the asset purchases have had the intended effect. Our intention with this expansionary monetary policy has been to increase the rate of inflation so it approaches the target of 2 per cent. As I mentioned earlier, underlying inflation has also shown an upward trend for some time now, at the same time as economic activity has strengthened and the situation on the labour market has gradually improved.

But although developments are mainly heading in the right direction, there is still considerable uncertainty. Economic activity became stronger in the euro area, but several countries were still being held back by high indebtedness and as yet unresolved structural problems. The course of events in Greece also entails a tangible risk. If the situation deteriorates, unease may spread to other countries in the monetary union. Uncertainty over how the krona will develop is another risk. The relatively strong fluctuations on the foreign exchange market are making it difficult to assess how the exchange rate will continue to develop. A too strong exchange rate would risk halting the upturn in inflation that has begun.

Given this, we assessed in July that monetary policy needed to be even more expansionary to ensure that inflation continues to rise towards the target of 2 per cent. We therefore decided to cut the repo rate by 0.1 percentage points to -0.35 per cent, see Figure 5. We also resolved to extend the purchases of government bonds by a further SEK 45 billion until the end of the year, see Figure 6. The purchases decided upon in April are expected to be concluded in September, at which point the new purchases will be initiated. At the end of the year, the Riksbank is expected to have purchased nominal government bonds for a total of SEK 135 billion. This corresponds to around 20 per cent of the outstanding stock of nominal government bonds and around 4 per cent of GDP.¹ If the ECB continues to buy government bonds at the same rate as so far, their purchases at the end of the year will correspond to around 7 per cent of the stock and, there too, to 4 per cent of GDP.

The Riksbank has been portrayed as particularly "strict" in relation to other central banks, as we charge a negative interest rate to the banks when they deposit money with us. I would like to emphasise that the Riksbank is not endeavouring to be kind or strict. The rate-setting with regard to the banks' deposits with the Riksbank is part of the monetary policy transmission mechanism and a means of further cutting interest rates in the Swedish economy so that inflation will continue to rise towards the target. In this way, we contribute to price-setting and wage-formation in society functioning better, which gives the right conditions for a good development of the economy.

It may be worth pointing out that the Riksbank is not in any way unique in this context. Our central bank colleagues in, for instance, Switzerland and Denmark have similar systems, although some details differ. For instance, the Swiss central bank has chosen to limit how much of the bank's deposits should be subject to a negative interest rate and part of the deposits in the Danish central bank is also interest-free. However, the effective interest rate the banks in these countries pay is nevertheless in line with what the Swedish banks pay.

¹ The reason why this is 4 per cent of GDP is that the nominal amount of SEK 135 billion had a market value corresponding to SEK 160 billion.

I can also note that the four major Swedish banks made profits of almost SEK 44 billion during the first half of the year. In the same period, they have had to pay around SEK 90 million on their deposits with the Riksbank, as a result of the negative interest rates.

Developments during the summer

Focus on Greece

As you know, at the beginning of July the Greek people voted no to the proposed measures presented by the country's creditors in a general referendum. However, shortly thereafter the Greek parliament nevertheless decided to make extensive reforms and savings. They have thus been able to reach an agreement of principle regarding a third loan programme and negotiations are currently under way regarding the details of this programme.

However, it will be some time before we can fully understand what effects the summer's discussion on the future of Greece will have on the monetary union and the development of the euro area. On the one hand, it was a relief that the euro area succeeded in reaching a new agreement with Greece. On the other hand, confidence in the euro area and in Greece may have been damaged further, which creates uncertainty and may further delay the growth that the area so needs.

There is still the question of whether Greece will succeed in recovering without needing to write off some of its debts. Here, for instance, the IMF has been very clear that such write-downs are necessary to create reasonable conditions for a recovery.

So far, the crisis has not led to any major turbulence on the financial markets, or to any other significantly negative effects in other countries. This means that developments as a whole can be said to be in line with our assessments.

With regard to the euro area as a whole, optimism among households and companies has been somewhat subdued in recent months, probably as a result of the crisis in Greece. However, the most recent survey in July indicates that optimism among companies is rising again, which may be due to the third loan programme for Greece appearing to be within reach. GDP growth in the euro area in the second quarter, compared with the same quarter last year, was 1.2 per cent according to our forecast.

US developments still looking good

We see continued signs of good economic growth in the United States. GDP rose by just over two per cent in the second quarter, compared with the same quarter last year, see Figure 7, entirely in line with our forecast. Household consumption remains strong. Exports also rose significantly in the second quarter despite the dollar appreciating for a period of time. The housing market is continuing to recover and this creates an increasing number of jobs. Unemployment fell to its lowest level since 2008.

The US Federal Reserve signalled at the end of July that it still has plans to raise its policy rate this year. The labour market is expected to be able to develop better than was previously believed and only a "few" further improvements are needed before monetary policy may need to be tightened.

However, although most signs are pointing in the right direction in the US economy, the recent statistics on wage developments have been at relatively low rates of increase. Over the past twelve months, wages have not increased by more than around 2 per cent. Inflation is also still at a low level, which reflects earlier downswings in energy prices and falling prices on non-energy-related imports.

Relatively calm on the financial markets

Despite the fears one might have had prior to the summer with regard to developments on the financial markets, there have not on the whole been any major fluctuations in interest rates and exchange rates. The krona weakened roughly as expected in connection with the repo-rate decision in early July. Since then it has weakened further, and then strengthened, but it is still in line with our forecast, see Figure 8. However, one should not draw any major conclusions regarding the krona, given the weak trade in the summer months.

Nor have there been any major fluctuations on the stock markets in Sweden, the euro area (with the exception of Greece) and the United States. The stock market values are approximately as they were in the beginning of July, see Figure 9. Stock market developments in China, on the other hand, have been more dramatic with heavy stock market falls since the middle of July. The downturn should nevertheless be regarded in the light of equity prices rising by around 100 per cent during the first half of this year. Despite the heavy fall, equity prices are still much higher than at the beginning of the year. The fall in equity prices is not expected to have any major effects on growth in China.

The Chinese central bank's decision to devalue its currency came as a surprise to the market. The motive given for the devaluation was that the yuan had strengthened substantially in recent years. However, another motive may be that the Chinese regime wants to create the conditions for the yuan to eventually become a reserve currency. This is bearing in mind that the guidelines for the daily pricing of the currency were also moved toward a more market-based way of valuing the yuan in connection with the devaluation. However, there is also a possibility that the devaluation is a sign that the Chinese economy is weaker than we previously thought.

The fall in the oil price may contribute to lower inflation abroad

The oil price has fallen by around 10 dollars a barrel since the beginning of July, see Figure 10. It has thus become lower than we had forecast. Forward pricing also indicates a lower oil price in the coming years than we had expected. International inflation may thus be slightly lower than our earlier assessment. But the lower oil price can also be positive for growth and demand in the oil-importing countries, which could counteract the direct downward effect on inflation.

Swedish economy is continuing to perform strongly

According to the preliminary version of the National Accounts, GDP grew by 3.0 per cent during the second quarter compared with the same quarter last year, see Figure 7, which was more than both the market and we had expected. Despite GDP growth being a little stronger than expected, both consumption and investment were slightly weaker, which was counteracted by unexpectedly weak imports. The number of hours worked developed roughly as expected, which means that labour productivity was stronger than we assumed in the July Monetary Policy Report.

During the summer (June and July) unemployment has become lower than we predicted, at the same time as the labour force and employment showed weaker development than expected. However, the labour market surveys statistics are particularly uncertain during the summer months, which makes it difficult to draw any definite conclusions. Further outcomes are needed to be able to determine whether the earlier positive development in employment and the labour force has really been subdued.

Our forward-looking indicators regarding demand for labour on the whole point to the labour market continuing to improve in the coming period. The number of redundancies is still low and newly-registered vacancies at the Swedish employment service are at a high level. Employment plans in the National Institute of Economic Research's Business Tendency Survey rose somewhat in July, after having fallen earlier in the year, and indicate rising employment in the business sector.

The National Institute of Economic Research's Economic Tendency Surveys, which summarise companies' and households' views of the Swedish economy, rose in July, see Figure 11. This is the third month in a row that the indicator exceeds the historical average and thus points to a somewhat stronger growth than normal in the Swedish economy. Households' confidence in the economy as a whole slowed down further in July, although the view of their own economy is still more positive than normal.

Inflation expectations according to money market participants in Prospera's survey 1, 2, and 5 years ahead have remained broadly unchanged during the summer. Long-run inflation expectations 5 years ahead remain at around 1.8 per cent.

CPIF inflation was measured at 0.6 per cent in June and at 0.9 per cent in July, see Figure 12. The outcome in June was lower than our forecast. It is difficult to point to any individual component that contributed to the forecasting error – goods prices services prices and food prices all increased somewhat slower than expected. The outcome in July, on the other hand, was higher than our forecast. It was in particular the volatile air travel and package holidays that were higher than anticipated, although food and clothing prices were higher than expected. All in all, the outcomes over the summer have been in line with our forecasts.

Low interest rates entail risks

Increasing debt levels and rising housing prices

The low interest rates contribute to household debt as a percentage of disposable income continuing to increase and to housing prices continuing to rise. This creates risks that can threaten future economic developments. If there were to be an economic slowdown for any reason, this could be significantly strengthened when indebted households are forced to cut back on consumption and other expenditure, particularly if housing prices were also to fall in connection with this. It is therefore important that household debts do not continue to increase. Their debts have increased more than their disposable incomes since the middle of the 1990s and the debt ratio is now at just over 170 per cent, which is a record-high level, see Figure 13.

As can be seen in Figure 14, housing prices, and especially prices of tenant-owned apartments, have risen sharply in the past ten years. Prices of tenant-owned apartments have more than doubled since 2005. We can also see that prices of tenant-owned apartments have increased substantially in relation to the consumer price index in the past ten years, but even in relation to disposable income the increase is significant.

This development indicates that there are structural problems in the Swedish housing market. The fact that the rental market functions poorly is a problem. Another problem is that too little housing is being built. Figure 15 shows that the population has increased much more than the number of completed homes over the past ten years, which is an indication that housing construction has been too low. Despite housing investment now increasing, it is important that structural problems on the housing market are discussed so that we can obtain greater efficiency on this market in the longer run. Several inquiries have put forward proposals regarding what needs to be done, most recently this was done in an annex to the Long Term Survey of the Swedish Economy. Not having an efficient housing market is not merely a problem for indebtedness, it can also comprise a threat to a healthy development of society and it can create conflicts between the generations.

The Riksbank has long pointed out the risks linked to the high level of household indebtedness and has previously also weighed in them in the repo-rate decisions to some extent, by setting the rate somewhat higher than would otherwise have been the case. However, the effect these considerations have actually had on monetary policy – the amount by which the repo rate has actually been set higher – has been exaggerated substantially. There are quite simply limits as to how far the policy rate can be used for this purpose. And

let me emphasise that the main focus for monetary policy has always been to bring inflation back on target and to attain a good development in the real economy.

Credibility for the inflation target a binding restriction

One condition for a central bank to be able to use the policy rate to counteract financial imbalances is that confidence in the inflation target is solidly established and that inflation expectations are firmly anchored around the target. This is a very important condition and I would claim that it is a binding restriction, that is, if it is not met, the central bank will have no scope to take other considerations.

When the Riksbank gave consideration in its monetary policy decisions to the risks linked to indebtedness and housing prices rising too fast a few years ago there were no reasons to question confidence in the inflation target. It was firmly established and long-term inflation expectations were just over 2 per cent.

However, what has happened since then is that the Riksbank and other analysts have on several occasions been surprised by inflation being lower than expected and have therefore been forced to gradually revise down their inflation forecasts. As the period with an inflation rate undershooting the target has become longer, economic agents have adjusted their inflation expectations downwards. During 2013 and 2014, for instance, the five-year inflation expectations in Prospera's survey showed more or less a falling trend to just under 2 per cent. The further long-term expectations deviate from the target, and the larger the deviation, the greater is the risk that the inflation target will begin to lose its role as benchmark for price-setting and wage formation. In this way, expectations can have an impact on actual inflation, which risks reducing expectations further, and so on, in a self-reinforcing negative process. It can be very difficult to get out of this situation.

This is how the rapid cuts in the repo rate since the middle of 2014, and the purchases of government bonds that have recently been a complementary part of monetary policy, should be regarded. The Riksbank is the authority that has the explicit responsibility for attaining the inflation target. Although we must also act to ensure the financial system is stable and functions efficiently, through the wording in the Sveriges Riksbank Act on "promoting a safe and efficient payments system", the latter is a task that we share with the Government, Finansinspektionen and the Swedish National Debt Office. And the first line of defence with regard to counteracting the emergence of financial imbalances is macroprudential policy, including the tools for which Finansinspektionen has been given chief responsibility.

Finansinspektionen's mandate and tools for macroprudential policy need clarification in law

It is therefore very unfortunate that there appear to be doubts with regard to the legal possibility for Finansinspektionen to use some of the tools – as in the case of the amortisation requirement.² The decision to give Finansinspektionen the responsibility for macroprudential policy was preceded by a fairly intensive debate, where other possible solutions were also discussed. One can therefore assume that the decision finally reached actually reflects the solution desired from a political point of view. It is then of course essential that one also ensures that Finansinspektionen is equipped with the most efficient tools possible to be able to manage its task in a good way. And if one later discovers that there are doubts regarding some parts of the mandate, it is of course important that these are remedied without delay.

² Finansinspektionen was intending to introduce an amortisation requirement from 1 August 2015. However, the administrative court of appeal in Jönköping, among other instances, questioned the legal authority of Finansinspektionen to decide amortisation requirements. Finansinspektionen decided not to go further with the amortisation requirement as the legal position was uncertain and at the same time observed that its mandate needed clarification; see press release from Finansinspektionen on 23 April 2015.

To avoid a future economic downturn from being deeper than normal as a result of the high indebtedness, it is therefore essential that the Government quickly ensures that Sweden has an efficient framework for macroprudential policy and that Finansinspektionen has a clear mandate. It is almost seven years since the financial crisis broke out. One of the major lessons learnt from the crisis is the importance of an efficient macroprudential policy that enables early identification of financial imbalances and rapid implementation of necessary measures. There is broad agreement on which imbalances have built up in the Swedish economy, but there also appears to be what is known as an inaction bias, which means that no authority has taken adequate measures. What is needed here is a system where macroprudential policy fulfils an important role and can, in an interplay with fiscal and monetary policy, counteract the emergence of financial imbalances.

The Riksbank's assessment is that an amortisation requirement corresponding to at least Finansinspektionen's proposal needs to be introduced as soon as possible. However, further measures in addition to this are needed to reduce households' willingness to take on debt. Feasible measures include a reduction in the tax deduction allowed on interest payments, the introduction of a debt-to-value limit and stricter requirements for the banks' credit assessments of individual households. More structural measures are also needed to increase the supply of housing and lead to a more efficiently-functioning housing market as I have already mentioned. But such reforms can only be introduced gradually and it will therefore take time before they can have any significant effect on household indebtedness.

Next monetary policy decision presented on 3 September

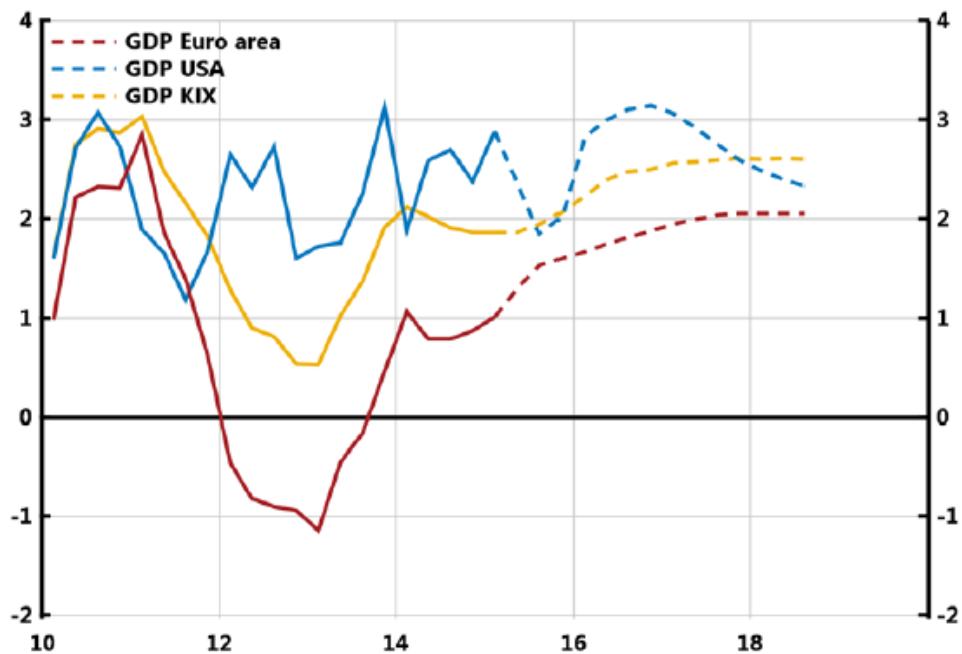
To summarise, I consider it is of the utmost importance that the mandate for macroprudential policy is clarified and that the application of the different tools does not come to a standstill. There is currently widespread awareness that a long-term sustainable solution requires a holistic approach that involves several policy areas. Nevertheless, there is a risk that more comprehensive measures and reforms are perceived as so unwieldy and difficult to manage that politicians would rather wait and hope for the best. One possible way forward to ensure something happens and to increase our knowledge in this field would therefore be a strategy that combines different possible measures on a smaller scale.³ Even a journey of a thousand miles begins with just one step, and it is important to take this step.

With regard to the statistics received over the summer, both in Sweden and abroad, they agree fairly well with the assessments we made in July. Economic developments in Sweden still look good and the expansionary monetary policy is supporting the upward trend in inflation. And if it were necessary, there is a high level of preparedness to make monetary policy even more expansionary. We are now working on producing an overall assessment of the situation in the Swedish economy, and in connection with the publication of the monetary policy decision on 3 September, we will present new forecasts.

³ See Per-Anders Bergendahl, Monika Hjeds Löfmark and Hans Lind (2015), "Bostadsmarknaden och den ekonomiska utvecklingen" (The housing market and economic development), SOU 2015:48, Appendix 3 to Långtidsutredningen (Long-Term Survey of the Swedish Economy), which proposes this strategy with regard to reforming the housing market.

Figure 1. GDP growth abroad improving gradually

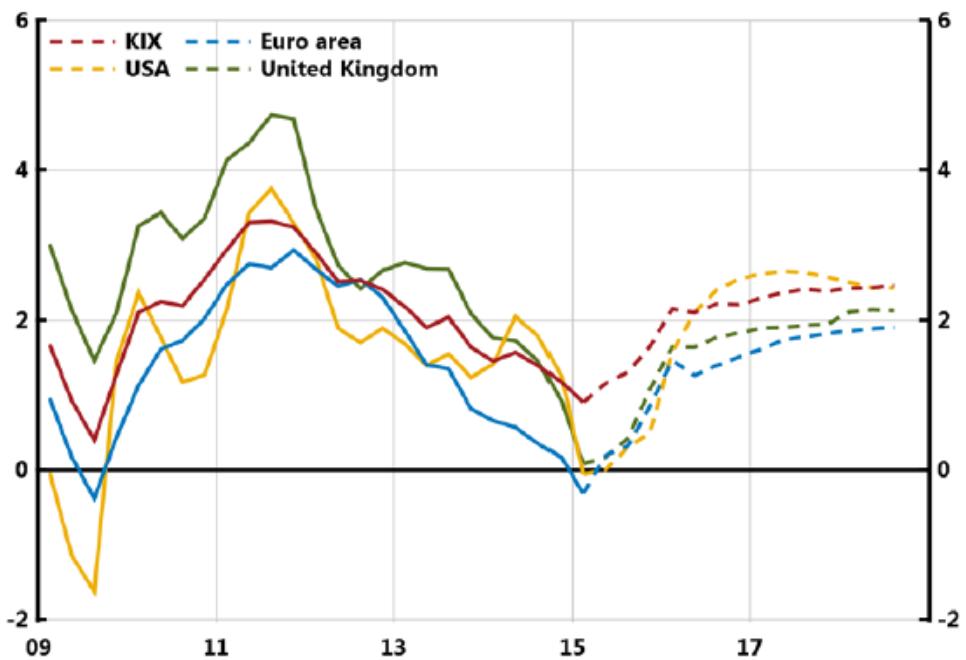
Annual percentage change



Note. The KIX is an aggregate of the countries that are important to Sweden's international transactions.
Sources: Bureau of Economic Analysis, Eurostat, national sources and the Riksbank

Figure 2. Rising global inflation

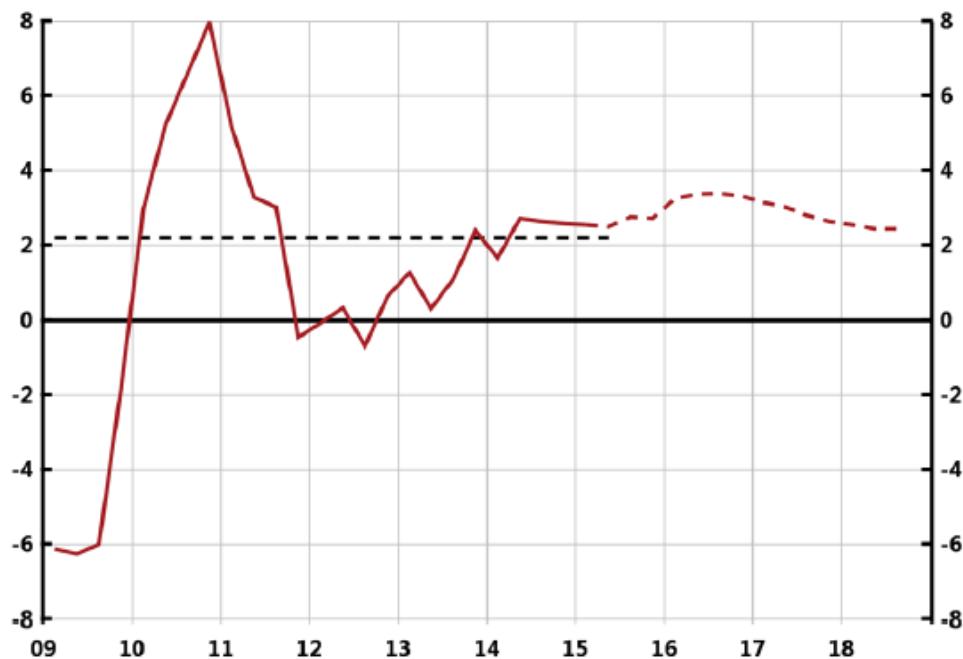
Annual percentage change



Note. The KIX is an aggregate of the countries that are important to Sweden's international transactions.
When calculating KIX-weighted inflation, the HICP is used for the euro area and the CPI for other countries. For the euro area, inflation is measured as the HICP and for the USA and UK as the CPI.
Sources: Bureau of Labor Statistics, Eurostat, national sources, Office for National Statistics and the Riksbank

Figure 3. GDP growth is expected to be higher than the historical average in the coming years

Annual percentage change

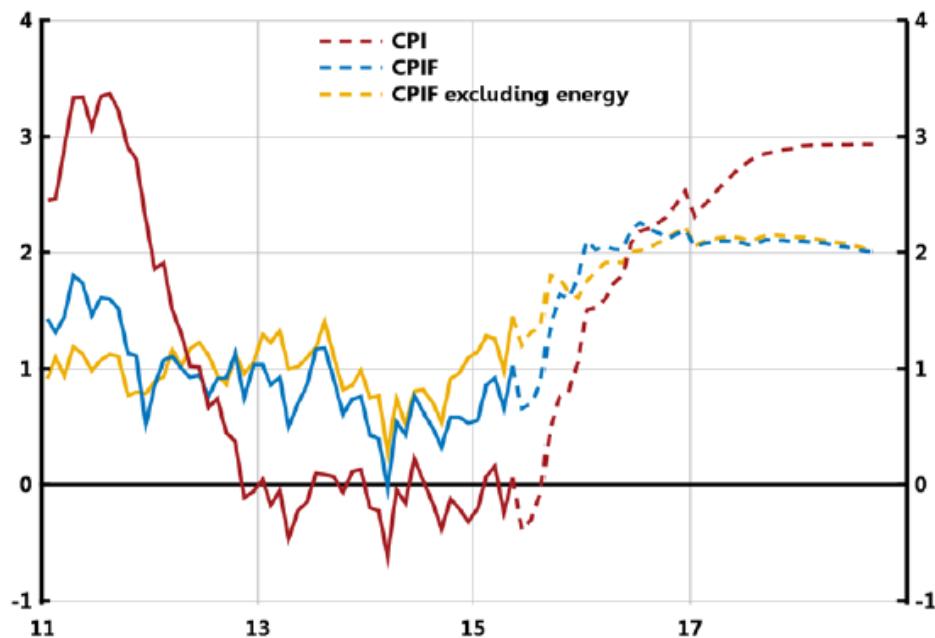


Note. Broken lines refer to average since the year 2000.

Sources: Statistics Sweden and the Riksbank

Figure 4. Inflation rising towards the target

Annual percentage change

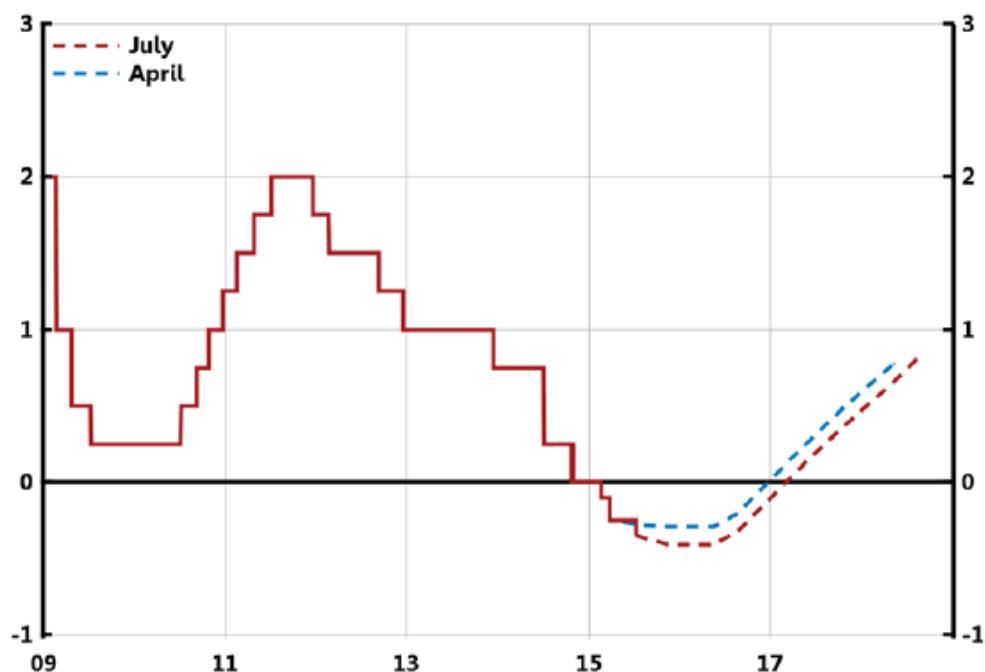


Note. The CPIF is the CPI with a fixed mortgage rate

Sources: Statistics Sweden and the Riksbank

Figure 5. Repo rate cut in July

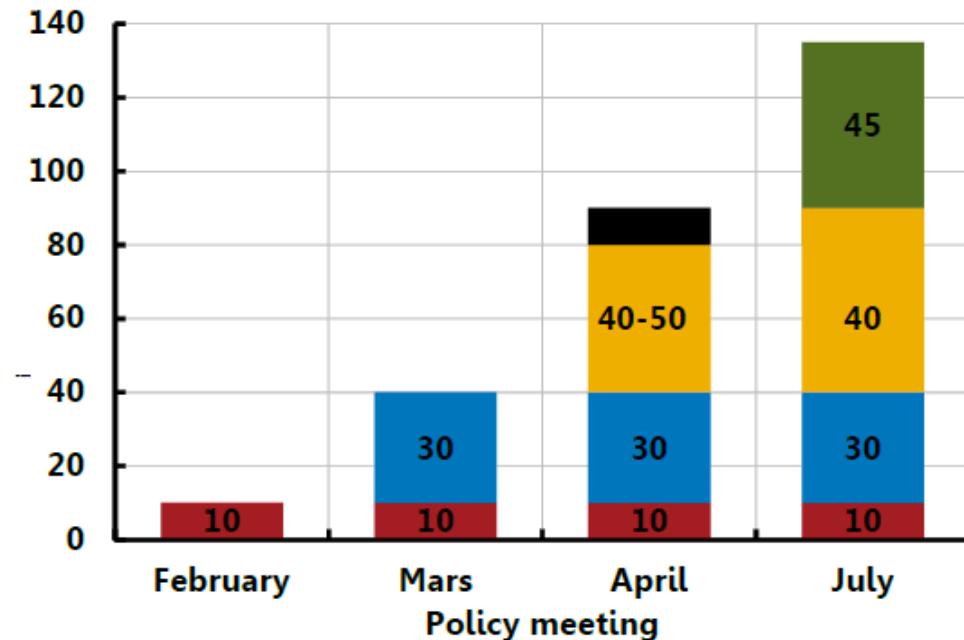
Per cent



Source: The Riksbank

Figure 6. Purchases of government bonds extended by SEK 45 billion up to the end of the year

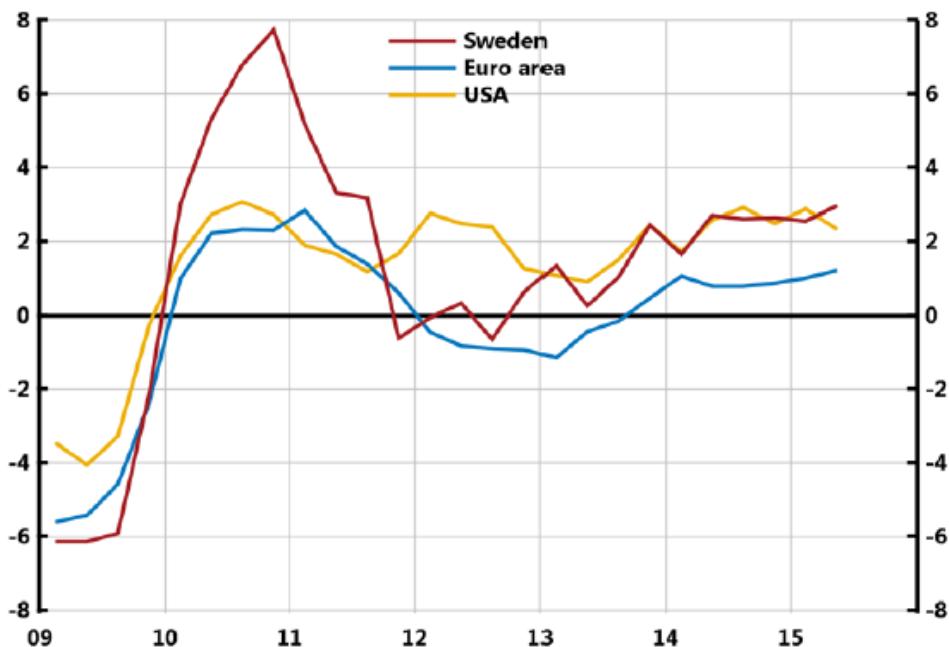
SEK billion



Source: The Riksbank

Figure 7. GDP growth in the second quarter was higher than our forecast in Sweden and in line with our forecast in the euro area and the USA

Annual percentage change, calendar-adjusted data



Sources: The Bureau of Economic Analysis, Eurostat and Statistics Sweden

Figure 8. The krona weakened in connection with the repo-rate decision and is in line with our forecast

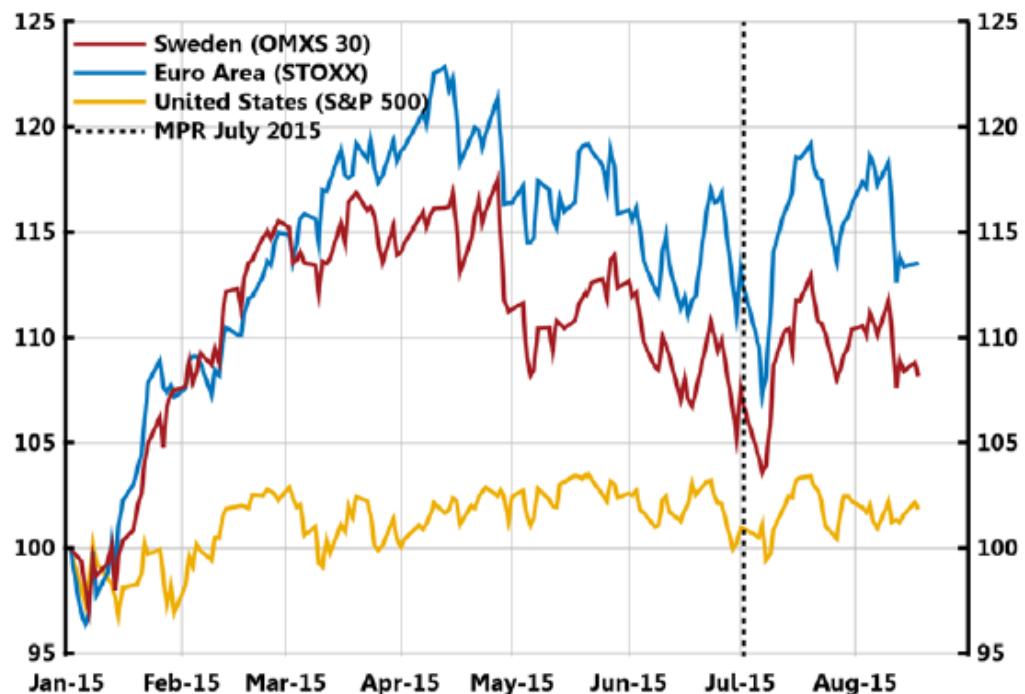
Index, 18 November 1992 = 100



Source: The Riksbank

Figure 9. Stock market values in Sweden, the euro area, the USA approximately as they were in the beginning of July

Index, 02/01/2015 = 100



Source: The Riksbank

Figure 10. Falling oil price since the beginning of July

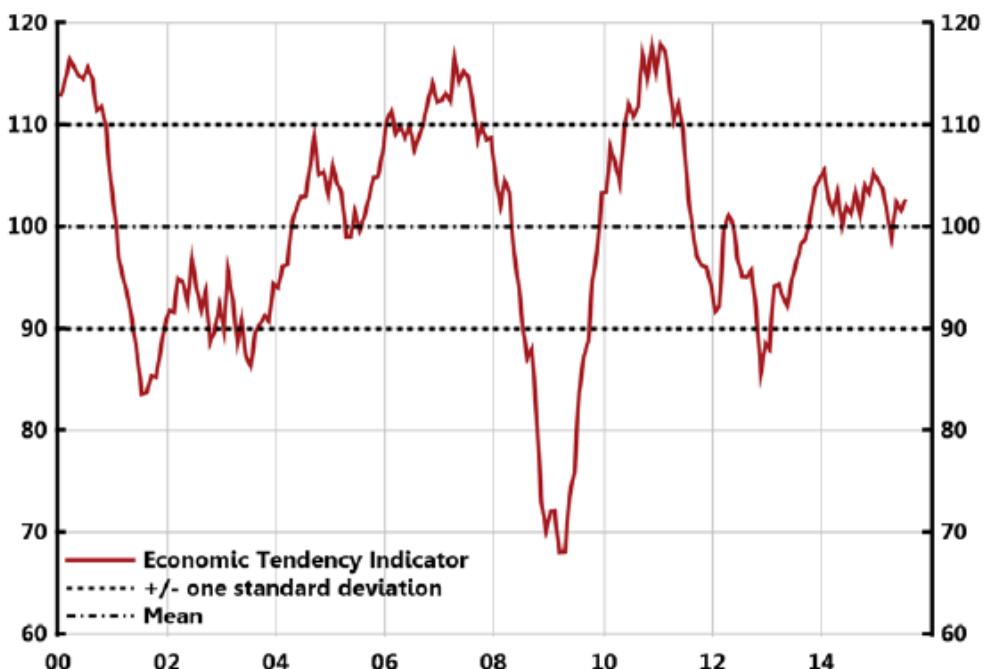
USD per barrel



Source: Macrobond

Figure 11. Business Tendency Survey indicator rose in July

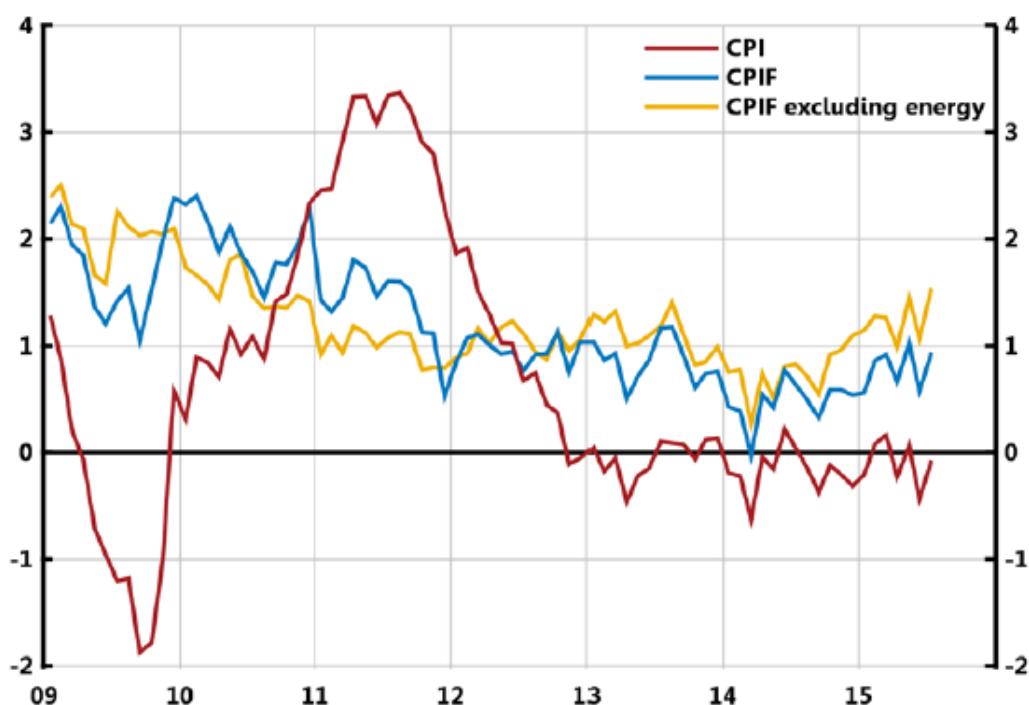
Index, average = 100, standard deviation = 10



Source: National Institute of Economic Research

Figure 12. Inflation on the way up

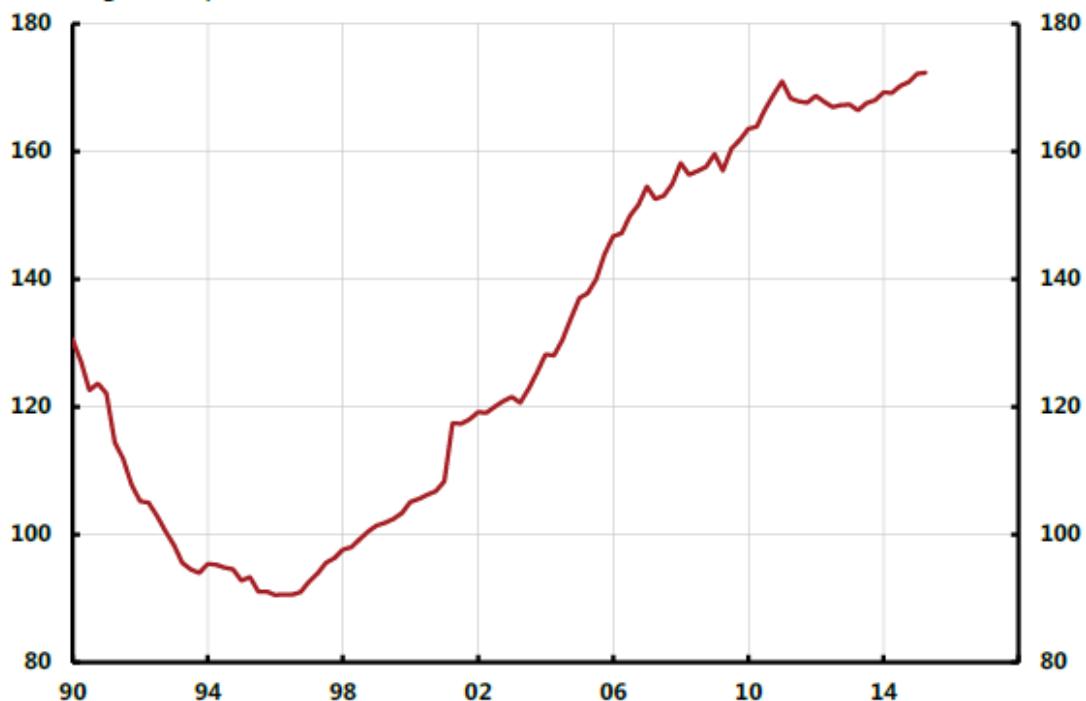
Annual percentage change



Source: Statistics Sweden

Figure 13. Household debts at a record-high level

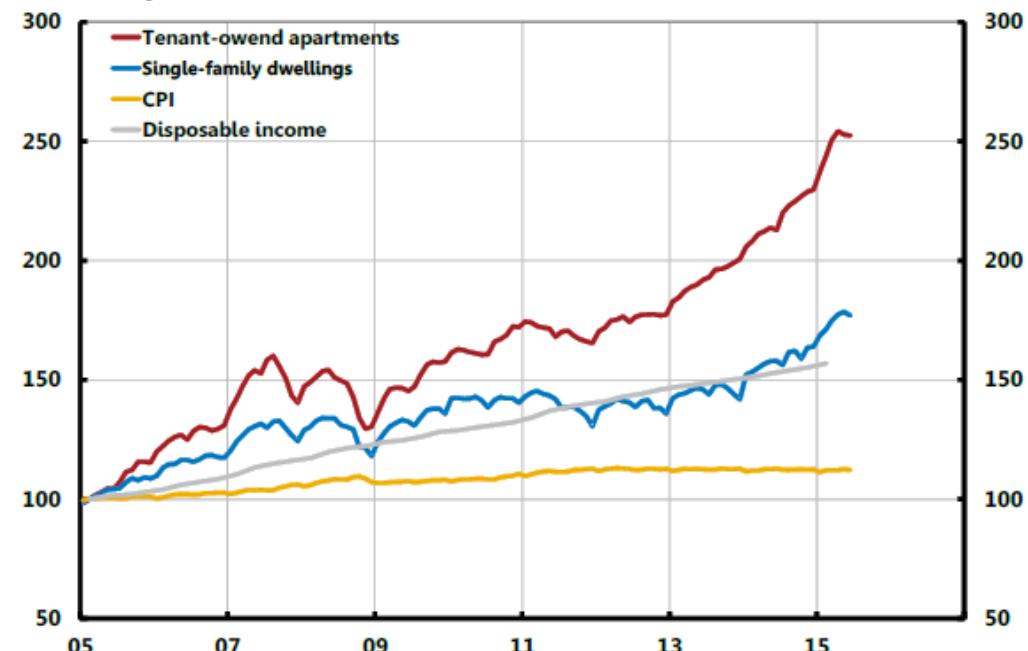
Percentage of disposable income



Note. Households' total debts as a share of their disposable incomes, totalled over the past 4 quarters.
Source: Statistics Sweden

Figure 14. Housing prices have increased substantially in recent years

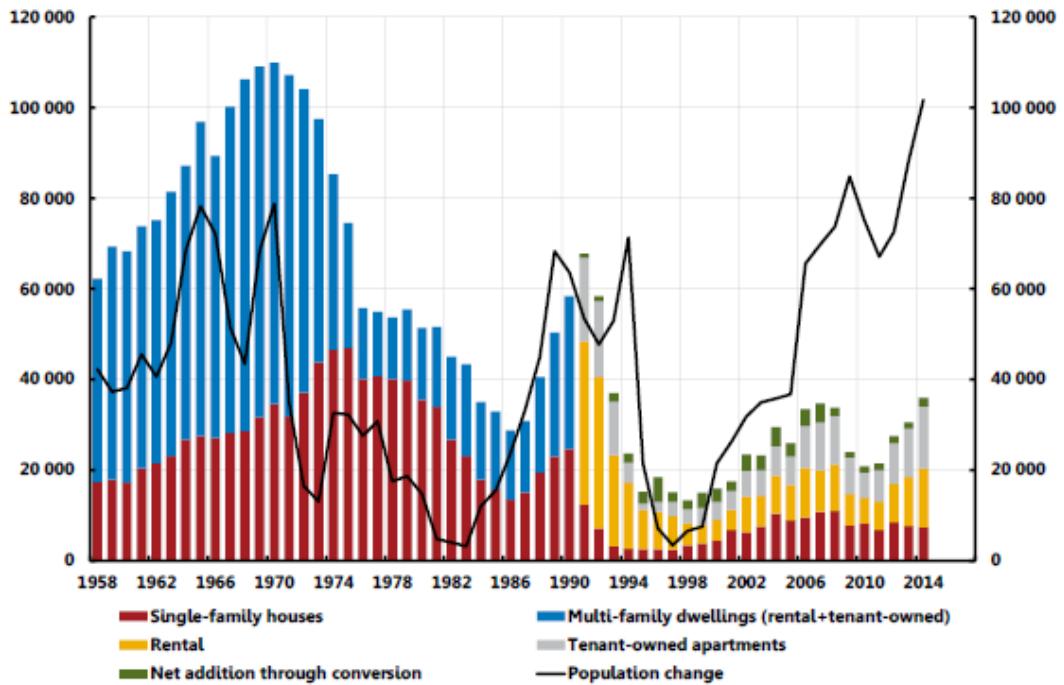
Index 2005 Q 1 = 100



Note. Tenant-owned apartments, single-family dwellings and the CPI refer to monthly data. Disposable income refers to quarterly data, four-quarter moving average.
Sources: Statistics Sweden and Valueguard

Figure 15. Population increase has been much greater than the number of completed homes in past ten years

Number of completed homes and number of persons



Sources: Statistics Sweden and the Riksbank