The Riksbank's Business Survey

STRONG DOMESTIC DEMAND BUT DIFFICULT TO RAISE PRICES

FEBRUARY 2016

■ The Riksbank's Business Survey in February 2016[1]

Swedish companies are now more optimistic about the economic situation than they were in the autumn. But despite an ever-stronger economic situation, many companies are finding it difficult to further increase their prices. This is revealed by the Riksbank's February 2016 Business Survey.

Above all, it is demand in Sweden that is driving development and increasing sales in the retail and construction sectors, and part of the service sector. But despite a strong economy, retail companies in particular expect prices to continue to develop slowly in the period ahead. This is mainly due to import costs no longer rising while competition has also become tougher. An example of the latter is the fact that it has become more common for companies to offer their customers discounts.

Parts of the export industry are still being affected by uncertainty surrounding global demand. The energy and commodity sectors are particularly weak. However, the rest of the export industry is benefitting from a slow but stable increase in demand in Europe.

The February survey features a more detailed study of the significance of the interest rate for companies' investment decisions. It shows that internal interest rates used in investment calculations are relatively unaffected by the general interest rate level. Accordingly, the direct connection between the interest rate level and its effect on investment decisions is weak for the majority of companies. At the same time, companies indicate that a lower level of interest rates is positive for general demand and benefits sales.

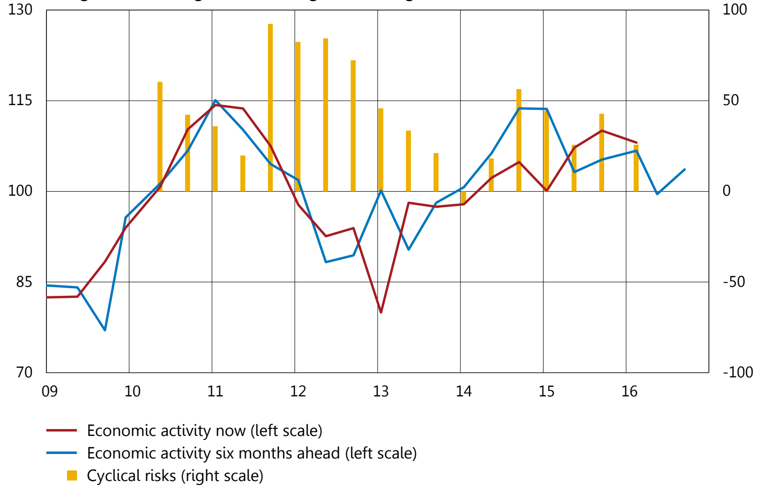
"PLENTY OF DRIVE IN SWEDISH CONSUMPTION"

The economic situation is considered still to be strong and more companies expect the economy to strengthen in the period ahead, see Figure 1. This positive development is being primarily driven by companies that have Sweden as their domestic market. Consumer-

[1] Three times a year, the Riksbank interviews the largest companies in the construction, retail, manufacturing, and service sectors. Representatives of 43 companies with a total of approximately 260,000 employees in Sweden were interviewed this time.

related retail and service companies, mainly in the travel, non-durable goods and retail sectors, are increasingly optimistic. Demand from households is seen as strong and companies expect the growth in sales to continue.

Figure 1. Risks, the economic situation and expected economic situation
Weighted index figures and weighted net figures



Note. Index figures show a standardised value (mean value = 100 and standard deviation = 10) of the total percentage of responses about whether the economic situation will be better or worse in six months' time and the total percentage of responses about the current economic situation, on the left-hand scale. The columns show the net figures for those companies that say that the risks are greater (smaller) than normal at present, on the right-hand scale.

"JUST NOW THE FUTURE LOOKS VERY BRIGHT"

Overall, the risks of an economic slowdown have decreased lately due to strong development in the majority of sectors in Sweden.

The sector that is the most satisfied with the economic situation is the construction industry. This is mainly due to a rising demand for housing, although the rest of the construction sector is also faring reasonably well. Demand was earlier centred on Sweden's metropolitan regions, but construction has also increased outside these areas, something that smaller construction companies in particular are reporting. According to one business leader from the construction sector, "the market is at its strongest since I began in the industry in the early 1990s".

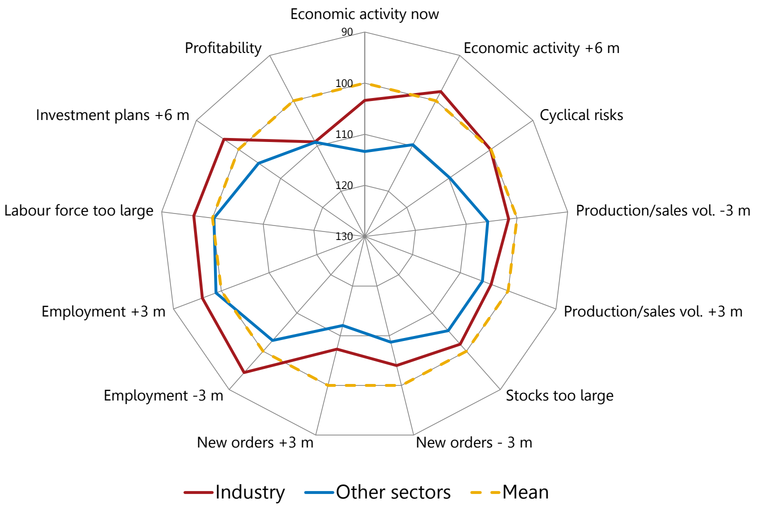
At the same time, the increasing demand for housing has presented a challenge for construction companies. The shortage of labour in the construction sector is obvious for certain types of specialist jobs, such as site managers, production managers and project managers. In the first instance, the industry is trying to compensate for the shortage by using sub-contractors but companies are also looking to recruit increasingly often from abroad. As in earlier surveys, construction companies say that the shortage of labour is a constraint that is forcing them to prioritise between projects. All construction companies also say that wage drift is increasing for specialist jobs as a consequence of the competition for labour.

Other signs that the property market is currently very strong come from property companies, which own and manage properties. They are encountering the same bottlenecks as construction companies as regards the development of new property projects and report that both prices and rents are rising.

"IT'S A FRAGILE SITUATION – IF SOMETHING HAPPENS, IT MAY HAVE A MAJOR IMPACT"

The situation is not as good for manufacturing companies as it is for other sectors, see Figure 2. On the whole, export-based manufacturing companies are more pessimistic about developments than companies on the domestic market. The energy and commodity sectors are particularly weak, and manufacturing companies who sell to these have had weak orders for some time. An opposite tendency is noted in other sectors, including the automotive industry and pharmaceuticals, which are seeing a healthy demand.

Figure 2. Companies' overall response patterns: manufacturing in relation to other sectors
Weighted index figures



Note. The responses to the questions are plotted along a "spoke" in the figure where an index figure closer to the centre is better. The historical average is calculated for the periods when the questions were put and for all sectors. The term -3 m / +3 m refers to the most recent three months and the coming three months respectively. +6 m refers to the coming six months.

As previously, there is strong pressure within the manufacturing industry to reduce costs and increase efficiency. No new major rationalisation programmes have begun, however, and it seems to be more a question of continuing programmes that are already under way in order to increase productivity and review staffing.

"THE ECONOMY IN EUROPE CONTINUES TO DRAG ITSELF UPWARDS"

Demand for Swedish manufacturing companies' products is slowly strengthening in Europe, with Scandinavia, Italy and Spain as good examples. Global economic developments are otherwise seen as fitful and uncertain. South America is continuing to go backwards, mainly because economic developments in Brazil have been negative for some time, and a turnaround does not seem close at hand.

The North American market continues to disappoint several Swedish manufacturing companies. The ever-stronger dollar is perceived as having an effect on the US industrial sector that has slowed in recent months. In addition, the low oil price has contributed to a fall in the demand for products to the energy sector.

In China, several manufacturing companies talk of falling sales. One explanation given is the substantial increase in the supply of industrial goods from China's own manufacturing sector. One business leader says that "the Chinese have built beyond their means" and even if manufacturing companies overall do not see any decline in demand on the Chinese market, there is palpable unease about future developments.

MANUFACTURING SECTOR INVESTING TO CUT COSTS

Capacity utilisation is on the up but for the majority of companies in the manufacturing sector, it is still easy to increase production rapidly from current levels. For this reason, companies are neither prioritising nor implementing any large-scale investment in increasing their output at the moment. Investment is instead focused on reducing costs. Expressions such as the following are significant: "everything is geared to reducing unit costs" and "it's not that we need more capacity, on the contrary we have too much".

Investment within sectors other than the manufacturing industry is not as unilaterally focused on increasing productivity. In the retail sector, for example, companies are investing for growth in new shops and more eCommerce, while construction companies are continuing to improve their production capacity.

■ Article: Companies' investment decisions and the discount rate

"LOW INTEREST RATES NOT THE DECISIVE FACTOR FOR INVESTMENT DECISIONS"

In the February 2016 survey, detailed questions about companies' investment and investment decisions have been asked. In this part, the interviews have mostly concerned the decision process and the connection between the internal interest rate, cost of capital and investment decisions.[2]

Various methods can be used to evaluate investment opportunities. It is common to calculate the payback period, i.e. the time taken to recoup the capital outlay. Another option is to calculate different variants of the Net Present Value (NPV) model.[3] The NPV of an investment is calculated by discounting future revenue generated by the investment using an internal interest rate, also called a discount rate, minus the initial investment outlay. The discount rate is in turn set in relation to the cost of capital. It is also common to include a risk premium in the discount rate as a measure of uncertainty. According to the NPV model, the general level of interest rates should accordingly have an impact on the discount rate and thereby affect the willingness to invest.

The results show that the first step in the decision process is for the company executive to adopt the overarching investment strategy based on the company's market strategy and financial position. Companies also take the following into consideration: what share of the profit is to go to the owners or be reinvested in the company; what the relationship between borrowed capital and equity looks like; and whether new, large-scale initiatives must be implemented to maintain long-term competitiveness. For these decisions, the discount rate is of only minor significance.

Investment implemented in response to new regulatory requirements is mandatory for companies while maintenance investment is largely guided by need. The payback period method is often used for maintenance investment to help prioritise the order in which investments

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[2] In a survey, the Reserve Bank of Australia has shown that low interest rates do not directly stimulate investment. The companies in the Australian study normally use hurdle rates that are higher than the weighted average cost of capital and seldom change them. *"Firms' Investment Decisions and Interest Rates"*, Kevin Lane and Tom Rosewall, Reserve Bank of Australia, Bulletin June Quarter 2015, http://www.rba.gov.au/publications/bulletin/2015/jun/pdf/bu-0615-1.pdf

[3] The Net Present Value, where C_0 is the initial investment outlay, CF is the future revenue generated by the investment and i is the discount rate. $Nettonuvärde = \sum_{t=0}^{N} \frac{CF_t}{(1+i)^t} - C_0$

are to be implemented. Even in these cases, the connection to the discount rate is weak since the investment is often mandatory for one reason or another.

However, for other investments, for example investment in a new machine to increase productivity, different variants of the NPV model are used where the discount rate is included as a variable. It is apparent from the interviews that manufacturing companies don't like to change the discount rate as their investment horizons are normally very long. It also emerges that manufacturing companies have kept the discount rate more or less constant for many years despite the fall in the general level of interest rates. Companies adjust the risk premium to a corresponding degree when capital expenditure decreases so that the discount rate remains unchanged. One business leader from the manufacturing industry expresses it thus: "You cannot be opportunistic when the interest rate is cut". Another reason why manufacturing companies have not changed the discount rate is because the current level of interest rates is not seen as a normal situation. All in all, the link between cost of capital and the discount rate is weak.

Neither does the low interest rate seem to have increased their propensity to borrow in order to invest. On the other hand, changes in the interest rate level have a much greater impact on companies that traditionally fund investments with loans, e.g. property companies, than on manufacturing companies.

In general, the calculation methods used when making investments constitute just some of the data used to underpin investment decisions. In many cases, the methods are mainly used to prioritise between different investment opportunities, the most important aspect being that the investment is in line with the company's strategic focus.

However, companies point out that changes in the interest rate level have an indirect effect on investment decisions in that they impact demand. It is pointed out, for example, that demand has risen in connection with customers having more scope for consumption when interest rates go down. Companies have then invested in order to meet the increased demand.

All in all, the results of the survey suggest that manufacturing companies' discount rates have been relatively unaffected by recent changes in the general level of interest rates. Individual investment decisions don't therefore seem to have been affected by the ever lower general level of interest rates, but may have been affected indirectly by higher demand.

“NEGATIVE INTEREST RATES MORE OF A CONCERN”

More companies than previously say that banks are charging for deposits at the same time as having set a floor for the lending rate. This can be problematic for companies who have large amounts of cash and in certain cases leads to an increase in capital management costs.

The property sector has benefited from the low interest rate level, but several companies also say that the negative interest rate is building up risks. The level of interest rates is causing several players to look to the property market to buy property, which is forcing up property prices. There is hence a concern among property companies for what will happen on the commercial property market once interest rates start to rise.

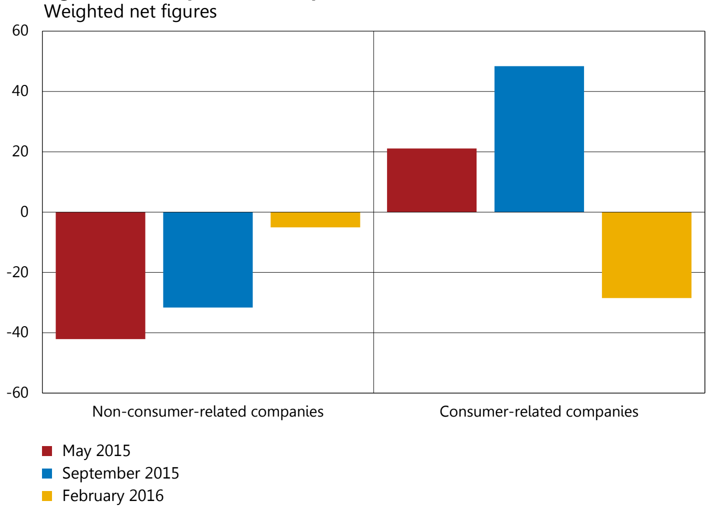
Overall, companies still feel that they have good access to external funding. But some companies with a lower credit rating say that it has recently become more difficult to secure the loan terms they want.

COSTS NO LONGER RISING IN THE RETAIL SECTOR

Over the last 12 months, costs have developed quite differently in different parts of the economy. In the manufacturing industry, unit costs, measured as costs per unit produced, have gone down as a result of falling commodity prices and in certain cases increased production volumes. Even though commodity prices are not falling at the same rate as before, tough global competition is prompting companies to constantly rationalise their operations and reduce costs.

In 2015, retail companies have seen their import costs rise as a result of the earlier appreciation of the dollar. Companies now say that this trend has been broken and that costs are no longer increasing, see Figure 3. Companies have previously said that they have not been able to fully compensate for the increased import costs. They are therefore working to reduce the costs that can be influenced. Several mention their constant endeavours to optimise the use of personnel and to rationalise their operations at every opportunity. The abolition of tax rebates for young people has increased costs for companies that employ a large number of young people, but this does not seem to have been of any crucial significance for their recruitment plans.

Figure 3. Development of companies' unit costs
Weighted net figures



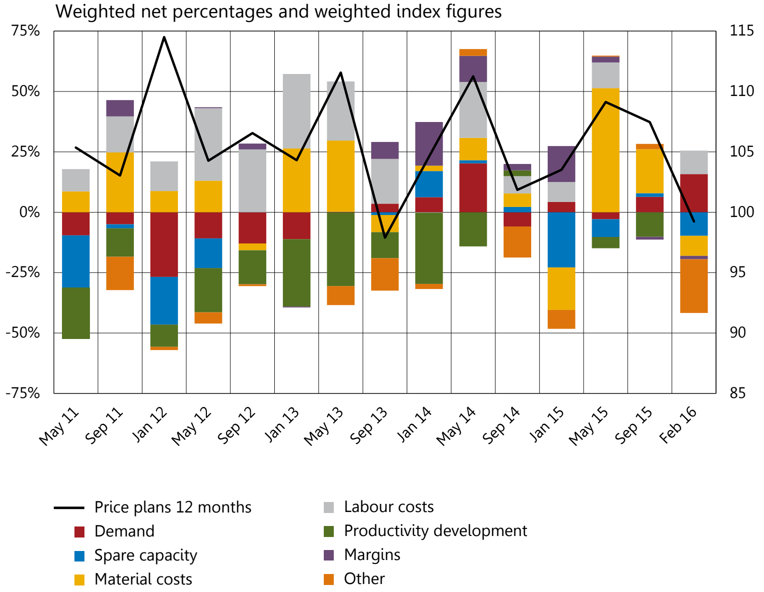
Note. The weighted net figures show the total percentage of responses to the question of whether unit costs have increased (decreased) over the past three months.

"NO UPWARD PRICE PRESSURE AT ALL"

In February, consumer-related companies say that the pressure to increase sales prices to counteract the weak krona has decreased as the krona has been relatively stable against both the dollar and the euro. Retail companies normally safeguard some of their purchases with forward contracts, which means that exchange rate changes affect sales prices with a time delay. Further adjustments as a result of the exchange rate appear not to be relevant at present. The foreign exchange effect seems therefore likely to level out in 2016. Consumer-related companies believe that it will be difficult to increase prices over the coming year. They say that consumer demand is rising but that ever-tougher competition is holding back planned price rises, see Figure 4.

Figure 4. Driving forces behind pricing in the 12 months ahead, consumer-related companies

Weighted net percentages and weighted index figures



Note. The bars (left-hand scale) show the net balance between responses that the factor concerned will have an upward or downward effect on prices in the year ahead. A bar above (below) zero means that the factor will contribute to rising (falling) prices in the period ahead. The index figures (right scale) show the percentage of responses as to whether prices will be increased or decreased over the next 12 months. In February 2016, the bar other consists mainly of competition.

"THERE IS MUCH MORE FIGHTING OVER CUSTOMERS"

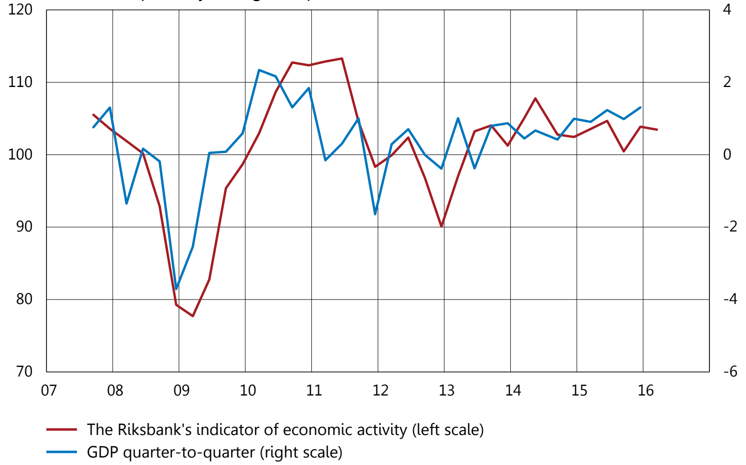
Competition and greater price transparency through eCommerce is not a new phenomenon, but companies say that competition has increased in recent months. There is also a trend towards offering more and more discounts of various types. One business leader from the retail sector says that "the industry is more and more price-sensitive and the customer has become more discount-focused". Even if eCommerce is currently responsible for only a relatively limited proportion of companies' turnover, it is continuing to grow and companies see it as strategically important to enter the online market or increase their Internet operations. eCommerce is seen as an important complement and a service to customers, who now make many of their purchasing decisions online. An increasing number of companies say that it is not possible to stand on the sidelines of eCommerce, which they see as being here to stay. Companies that already have substantial eCommerce operations are looking into how they can automate purchase orders, invoices and customer contacts online to further improve productivity.

Digitalisation makes it easier for customers to compare prices, which pushes down sales prices in the retail sector. As eCommerce develops, shop prices are expected to decrease as it is difficult for companies to have different prices in their shops and online.

THE INDICATOR OF ECONOMIC ACTIVITY SHOWS GOOD GROWTH

All in all, companies in February 2016 are more optimistic about the economic situation than during the autumn of 2015. The aggregate indicator points to good growth in the first quarter of 2016, see Figure 5.

Figure 5. The Riksbank's indicator of economic activity and changes in GDP
Index and quarterly changes in per cent



Note. The Riksbank's indicator of economic activity is calculated as a weighted average of the responses to various questions in the survey. The responses are then weighed together on the basis of their ability to predict seasonally-adjusted GDP changes from quarter to quarter. The indicator is calculated up to two months before the outcome for GDP is published and provides an early indication of developments in economic activity. The indicator has been standardised so that the mean value = 100 and the standard deviation = 10. This means that a value above (below) 100 should be interpreted as a somewhat stronger (weaker) business cycle than the average. Figures for quarterly GDP growth are seasonally adjusted.

ABOUT THE RIKSBANK'S BUSINESS SURVEY

The Riksbank's Business Survey aims to reflect developments in prices and economic activity in the manufacturing, construction and retail sectors and in parts of the service sector. As only a few players account for a very large part of the Swedish business sector, relatively few interviews can provide information about a large part of the sector. Many of the interviewed companies also provide information about other parts of the business sector through their contacts with, for example, small and medium-sized enterprises.

The survey is conducted by personnel from the Riksbank who visit the companies for approximately one hour. The interviews are, as a rule, conducted with members of the company's management. The discussions give the companies an opportunity to develop their answers and the interviewer the chance to ask more detailed follow-up questions. From time to time, specific questions are asked about current issues in monetary policy.

The survey entails interviewing approximately 40 companies in May, September and January. Over 300 companies have taken part in the survey since it was started in 2007.

The figures in the report present the companies' responses weighted in terms of the respective companies' number of employees in Sweden. The indices in the figures capture upturns and downturns in the pattern of responses well. These responses are then combined with the companies' reflections during the interviews. The February 2016 report presents the results of interviews with 43 companies, which were mainly held between 11 and 29 February.

A more detailed description of the survey can be found on the Riksbank's website: Hokkanen, Melin and Nilson (2012), "The Riksbank's Business Survey – a quick indicator of economic activity", Sveriges Riksbank Economic Review 2012:3.

http://www.riksbank.se/Documents/Rapporter/POV/2012/rap_pov_artikel_3_121017_eng.pdf

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