

Scenario: Risks inherent in a rapid appreciation of the krona in a low inflation environment

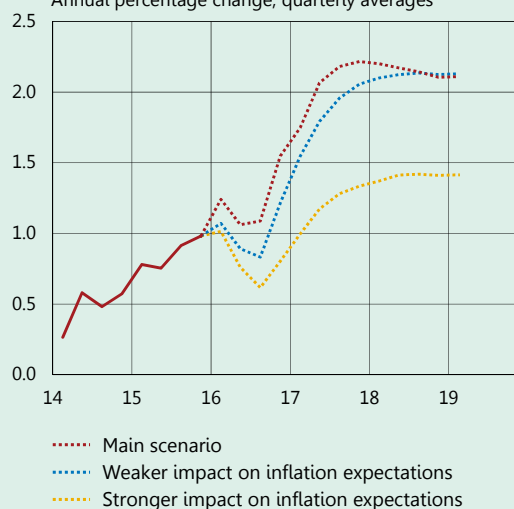
Growth in Sweden's economy is high and the Riksbank expects the krona eventually to appreciate. But a rapid appreciation of the krona in near future could lead to even lower inflation in the period ahead. The fact that inflation has been low for a long time also means that a rapid strengthening of the krona could have a greater impact on inflation than normal, by way of lower inflation expectations. The economy would then risk being in a situation in which confidence in the inflation target more or less evaporates and the low level of inflation becomes entrenched.

The Swedish economy is growing strongly and various measures indicate that resource utilisation is now almost normal. Despite this, inflation is not rising as expected. So far, a large part of the increase in inflation has been due to the earlier depreciation of the krona. In the period ahead, the krona is expected to appreciate. But inflation may remain low for even longer if the exchange rate appreciates quickly. The risk will then arise of a greater than normal impact on inflation and wage expectations if companies and labour market parties start to attach greater importance to the earlier low inflationary outcomes when setting wages and prices.⁷ This will lead to the strengthening exchange rate having a greater effect on inflation than usual. It is therefore important that inflation continues to show an upward trend to safeguard confidence in the inflation target as a nominal anchor in the Swedish economy.

Two scenarios are presented here to illustrate the risks that may arise if monetary policy failed to react to a rapid appreciation of the exchange rate in a prolonged low inflation situation. In the main scenario, the krona is expected to appreciate slowly, from about 110 at present to about 105 at the start of 2019, according to KIX, the competitiveness-weighted index. The scenarios assume that this entire appreciation will instead take place in the first quarter of 2016. This would mean that prices of imported goods and demand for Swedish exports would be significantly lower this year than in the main scenario. As the domestically-generated inflation is still low, this would risk leading to very low CPIF inflation. In the first scenario, the strengthening of the krona is assumed to have a limited impact on inflation expectations, according to normal patterns. The prices of imported goods and the demand for Swedish exports become lower than in the main scenario. Consequently, CPIF inflation also becomes lower in the near future and does not reach 2 per cent until the end of 2017 (see the blue line in Figure 1:15). In the second scenario, we instead assume that the long period of low inflation leads to households and companies starting to believe that inflation will continue to be low in the future. The inflation target becomes less and less effective as a benchmark in the

economy, and inflation remains low over the entire forecast period (see the yellow line in Figure 1:15). This risks leading to a spiral of lower and lower inflation expectations and threatens the confidence in the inflation target.

Figure 1:15. CPIF
Annual percentage change, quarterly averages



Note. The CPIF is the CPI with a fixed mortgage rate.
Sources: Statistics Sweden and the Riksbank

To sum up, the scenario illustrates that a rapid strengthening of the exchange rate implies an increased risk as inflation has been low for a long time. If monetary policy did not react, it would lead to confidence in the inflation target being much lower or, in the worst case, evaporating altogether. In this case, it may be very difficult to bring inflation up again and the period of very low nominal interest rates risks being prolonged considerably. This means that not only will the risks linked to low nominal interest rates in the financial system increase, but it will also limit the scope for monetary policy to act in the event of a significant deterioration in the state of the economy. Weak confidence in the inflation target is a concern as it creates instability and uncertainty in the economy. For example, it will be more difficult for individual companies to judge how their own costs and revenues will develop, which can have a negative impact on investment and recruitment.⁸ There are therefore strong reasons for the Riksbank to defend the credibility of the inflation target.

⁷ See, for example, Ehrmann, Michael (2014), "Targeting inflation from below – how do inflation expectations behave?", Working Paper 2014-52, Bank of Canada. See also the article "Rapid appreciation of the krona" in the April 2015 Monetary Policy Report, Sveriges Riksbank.

⁸ See the article "Why is it important that inflation rises towards the target?" in the July 2015 Monetary Policy Report, Sveriges Riksbank.