SPEECH

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A springboard for the monetary policy meeting in September

It has become something of a tradition for us members of the Executive Board of the Riksbank to hold a speech at the end of August about the current economic situation and developments during the summer. I think that this is a tradition worth upholding. True, not many people here today manage to completely cut themselves off from world events during their holidays. We still manage to maintain a watchful eye on the inflow of news and statistics. However, although I believe that many of us follow the economic news coverage during the summer months, it may be useful to have a round-up of what has happened. It provides an overview and can act as a "springboard" for starting work in the autumn.

A natural starting point for me is the assessment of economic developments described by the Riksbank in the Monetary Policy Report published in early July. I therefore intend to run through this assessment briefly and comment on my own thoughts at the meeting in July. I shall then try to summarise developments since then. Of course, this concerns to a large extent the crisis in the euro area, although some interesting statistics have also been received. I will also mention the on-going discussion on Libor and Stibor as this has been a major news item during the summer.

I have chosen to call this a "springboard" for the monetary policy meeting in September. This is not intended to direct one's thoughts to sporting achievements, which can easily happen, given that the Olympics are still fresh in our minds. What I mean to indicate is that this is a status report on which to base the start-up of a new process, which for the Riksbank is a process that will lead to a new joint economic assessment. I will not be presenting this type of assessment today. This will be released in connection with the next monetary policy meeting on 5 September.

The assessment in the July Monetary Policy Report

Great uncertainty over future developments

Perhaps the most difficult question we had to deal with at the most recent monetary policy meeting was how an unexpectedly strong outcome in Sweden at the beginning of the year should be viewed in relation to increased concerns over poorer developments in the euro area. When we Executive Board members gathered in July, concerns on the financial markets regarding the crisis in the euro area had increased and the prospects for growth in Sweden had thus deteriorated. There was considerable uncertainty over future developments. Work was underway on resolving the problems in the euro area. But it was also clear that much remained to be done before sustainable solutions could be implemented.

Risks in the euro area – focus on Greece and Spain

The concern on the financial markets stemmed of course from the public finance situation and problems in the banking sector in the euro area. Concerns increased during the spring, mainly due to developments in Greece and Spain. The situation following the parliamentary election in Greece in May fuelled speculations of an EMU exit. After a new election in mid-June, the political parties that support the savings programme managed to form a new government. However, it was still uncertain whether the new government would be able to implement adequate measures.

At the same time, Spain continued to have problems with its public finances and yields on their government bonds rose. The problems in the Spanish banking sector also became more acute. In June, the Eurogroup promised to provide loans of up to EUR 100 billion to enable the Spanish banks to increase their capital adequacy, and the Spanish government formally applied for assistance. Increased concern over the situation in Spain also meant that Italy and the country's large sovereign debt attracted greater attention.

At the end of June, just before our monetary policy meeting, the European Council decided on a number of measures to stabilise the situation in the euro area in the short term. The focus was on how the EFSF funding programme and later the ESM can be used. For instance, the possibility was created to use the mechanism to recapitalise a banking system directly, without burdening the country's national debt. In this way, the link between the banks' and the country's credit rating can be broken. When we met to decide on the repo rate on 3 July, it was uncertain what effect the measures would have and whether they were sufficient.

Crisis management but persisting concern

Personally, I found it difficult to evaluate the European Council's agreement and the other decisions taken during the spring to improve the situation in the euro area. As I noted at the monetary policy meeting, it is necessary to assess what is going on from both a short-term and a long-term perspective. In the short term, we need measures that will quickly lift the euro area out of the acute crisis, so that credible solutions can be implemented to deal with the problems in Greece and Spain and to limit the contagion effects. Long-term measures are also needed to make the countries less vulnerable to future crises. Confidence in the euro and in the monetary union also needs to be boosted. This probably requires greater collaboration within the euro area on fiscal policy as well as banking supervision and the management of banks in distress, and such solutions take time.

Although the risk of a much weaker development in the euro area had increased during the spring, we Executive Board members thought it was reasonable to assume that the crisis in southern Europe would be managed so that the acute phase gradually faded and sustainable solutions were eventually implemented. The forecasts presented in the Monetary Policy Report were thus made under this assumption. But we also pointed out that there were major challenges ahead and that further measures would need to be taken by governments and central banks. Correcting large sovereign debts, problems in the banking sector and weak competitiveness all takes time. We therefore also made the assessment that the unease and uncertainty over developments in the euro area would remain and would not begin to fade until 2013.

Strong start to the year, but unease in Europe casts a shadow over the Swedish economy

While the unease in southern Europe was building during the spring, we also noted that the Swedish economy had started the year stronger than expected. Consumption and investment had increased relatively strongly, while unemployment had been lower than expected. But our assessment was nevertheless that the effects of the increased financial unease abroad during the spring would have a dampening effect on the Swedish economy during the coming period.

One of the reasons for this was weaker demand from abroad. Our assessment was that demand on Swedish export markets would only increase by around 1.5 per cent this year, mainly due to weak developments in the euro area. Another reason why we envisaged a slowdown in economic activity in Sweden was that the increased financial unease would reduce sentiment among Swedish households and companies and in this way have a negative effect on consumption and investment. However, at the same time, our assessment was that the slowdown in economic activity would be alleviated by the fact that the Swedish is competitive, has sound public finances and resilient banks.

Our forecast was that GDP growth in Sweden would be weak for some time to come and that unemployment would increase somewhat. As the unease in the euro area subsides next year, economic activity will strengthen, unemployment will decline again and resource utilisation will increase. Inflation will rise at the same time, after being held back by a low cost pressure and a stronger krona since the financial crisis 2008-2009.

Repo rate remains low to stimulate the economy

With regard to monetary policy, our assessment was that it needs to be expansionary to support economic activity and give an inflation rate in line with the target of 2 per cent. We therefore decided to hold the repo rate at 1.5 per cent and assessed that it needs to remain at roughly this low level for just over a year, and should then be raised gradually. The deterioration in international economic prospects meant that we revised down the repo-rate path somewhat, in relation to the assessment made in April.

Personally, I thought that an unchanged repo rate gave a better balanced monetary policy in July than a cut would have done. Monetary policy was already expansionary, and our forecast was that inflation would attain the target of 2 per cent and that the real economy would reach sustainable levels within the forecast period. I also believe that there are risks in having low interest rates over a long period of time – risks that unsustainable behaviours and imbalances will arise in connection with the build-up of debt. Such risks also need to be considered in our assessments, while we try to ensure that we attain the inflation target and stabilise the real economy.

Having said this, we also emphasised in July that there was considerable uncertainty over future developments. As I mentioned before, we assumed in our assessment that the problems in the euro area would be managed in such a way that a deeper crisis could be avoided. If the financial unease were to escalate, the situation for monetary policy would of course be quite different and policy would probably need to be even more expansionary. However, if credible measures were put in place, confidence could also return sooner than expected, which could increase demand in the Swedish economy. This might justify a higher repo-rate path.

Developments during the summer

So, what has happened since the July monetary policy meeting? To begin with, we can note that the storm clouds are still hovering over Europe. A number of important questions are currently being investigated and suggestions or announcements within various areas have been promised by September.

After the European Council's meeting at the end of June, the sentiment on the financial markets was characterised by uncertainty over the details in the measures the Council announced and the yields on Spanish and Italian government bonds remained high. The uncertainty concerned how to implement and design a joint banking supervision in the euro area, something that is a very large step for the member states. Joint banking supervision is, according to the agreement reached at the meeting, a necessary condition for the European Stability Mechanism, ESM, to be able to recapitalise banks directly. The uncertainty was fuelled by the criticism of another agreement reached at the meeting that the European relief funds should be able to buy government bonds to hold back countries' interest costs.

More details on the loan to the Spanish banking sector

More details of the loan of up to EUR 100 billion to the Spanish banking sector were released after the meeting of the Eurogroup finance ministers in July. A Memorandum of Understanding with Spain states, for instance, that the exact size of the loan will be determined after a revision of the Spanish banking sector during the second half of September. However, EUR 30 billion is to be made available this summer as a preliminary bailout for urgent measures.

Once the joint banking supervision facility in the euro area has been established, the idea is that the ESM will take over from the EFSF and the loan can be channelled directly to the Spanish banks. This will break the links between the crisis banks' finances and the Spanish government's finances. The European Commission has signalled that a proposal regarding banking supervision will be announced in early September. One condition for the ESM to be able to take over the loan is, of course, that the mechanism is actually activated. This requires approval from countries that together account for 90 per cent of the capital paid into the mechanism. At present, approval is yet to be given by Germany – which is awaiting a verdict from its constitutional court in mid-September.

The Memorandum of Understanding regarding support to the Spanish banks makes it clear that the Spanish government is expected to carry on with its work on reducing its budget deficit to just below 3 per cent. The time limit they have been given to reach this has been extended by one year to 2014. Spain has given an account of its budget plans and the savings to be implemented to reach the target. During the summer the IMF has also given strong support to Spain's efforts.

Concern over the situation in Spain and Italy

The market's reactions to the agreement on banking support to Spain can be described as cautiously positive. But during the second half of July, concerns increased again when reports were received of the weak finances in Spanish regions. This contributed to new speculations regarding whether the loan to the Spanish banks is sufficient, or whether it will be necessary to implement a full-scale support package for Spain. Yields on Spanish government bonds with both short and long maturities rose to new heights. Italy was also affected by the unease. At the same time, yields on German and French government bonds remained at extremely low levels.

The problematic situation on the bonds markets was discussed by the European Central Bank, ECB, at the beginning of August. After the meeting, ECB Chairman Mario Draghi made it clear that countries needing acute assistance should first turn to the EFSF/ESM and accept support under the terms they stipulate. After interventions might be undertaken by the ECB, within its mandate for price stability, and the ECB will investigate potential measures. It was already clear that potential bond purchases by the ECB would focus on bonds with shorter maturities.

Expectations were fairly high prior to the ECB meeting, and Spanish and Italian bond yields had fallen during the days before the meeting. When the ECB did not announce any immediate measures, yields rose quite strongly at first. They have since fallen somewhat again, primarily yields on government bonds with shorter maturities. After this the meeting, market focus has been transferred to the governments in Spain and Italy, to their attitudes to seeking assistance from the EFSF and to the conditions to which the countries would then be subjected.

Assessment of Greece's savings measures in September

Greece, Ireland and Portugal already have relief programmes set up and at the end of June Cyprus also applied for assistance. Representatives of the IMF, the European Commission and the ECB – the so-called troika – visited Greece during the summer to inspect whether Greece had made sufficient progress in its savings measures to meet the requirements for the next payment in the programme. The goal is a savings package of EUR 11.5 billion, which is to be implemented in 2013 and 2014. The troika has announced that it will conclude its inspection of Greece's progress in September. It appears that Greek funding until the next payment will be secured through new issues of treasury bills.

The importance of reliable reference rates

Crisis management in the euro area has of course been a fairly central issue during the summer. Another news item that has attracted a lot of attention is the revelation of manipulation of the international interbank rate, Libor. Confidence in international banks received a further blow when it was revealed that several banks had been involved in providing incorrect interest rate data as a basis for calculating the daily Libor. As Libor is a reference rate that is used globally for large volumes of contracts, it is quite inacceptable that individual banks should casually report incorrect figures.

The Riksbank has long followed developments concerning the corresponding reference rate in Sweden, known as Stibor. We are currently carrying out our own investigation into how Stibor is determined and we also have an on-going dialogue with the Swedish banks on how they need to strengthen governance and increase transparency with regard to Stibor. I assume that Swedish banks will take heed of what has happened with Libor and help reinforce confidence in Stibor. It is possible that we may need to wait and see what happens with Libor before we can establish a better model for Stibor, but meanwhile Swedish banks should make it clear to the market and the general public how Stibor is set on a daily basis and what controls and checks exist in the current organisational framework. The Riksbank's investigation is not yet complete, but will be presented during the autumn.

Weak developments in Europe and some uncertainty over the strength of the US recovery

If we move on to the economic statistics released during the summer, they have mostly concerned developments during the second quarter, that is, up to the end of June. However, there have also been some indicators for the third quarter. To summarise, one can say that developments abroad have largely been in line with the assessments we made in July. Possibly, the outcome has been slightly weaker than we expected.

The most recent labour market statistics show that unemployment in the euro area remained at an all-time high in June. Spain and Greece were hardest hit, with an unemployment rate exceeding 20 per cent. At the same time, inflation has remained high. A week ago, preliminary GDP figures for the second quarter were published. They showed that GDP in the euro area fell in relation to the first quarter. Statistics for developments in July pointed to a continued weak outcome in the euro area in the coming period. Our forecast in July was that GDP will fall somewhat this year and then rise again in 2013. The statistics released so far support the impression that GDP will decline this year.

In the United Kingdom, preliminary calculations show that GDP fell during the second quarter, compared with the first, which means that GDP has fallen three quarters in a row. At the same time, inflation in June and July was at its lowest level in more than two years.

The new statistics from the United States have probably increased uncertainty over the strength of the recovery in the US economy. Preliminary figures show that GDP increased in the second quarter by 1.5 per cent, calculated as an annual rate, compared with the first quarter of this year. This means that growth slowed down by half a percentage point compared with the first quarter. The slowdown was unexpected, although our forecast in July pointed to modest growth in the US economy in the coming period. Indicators for the third quarter are rather mixed so far. For example, unemployment increased somewhat in July, but at the same time employment increased at a relatively strong rate. Consumption was weak in the second quarter, and sales of motor vehicles fell in July. However, the situation on the housing market appears to be improving. For instance, some indicators point to a continued rise in housing prices.

Unexpectedly strong second quarter in Sweden

While developments abroad have been weak, the Swedish economy has continued to be surprisingly strong during the summer. At the end of July, a first preliminary compilation of National Accounts figures for the second quarter was released. This showed that GDP, when seasonally-adjusted, increased by 1.4 per cent compared with the first quarter, corresponding to 5.7 per cent when calculated as an annual rate. This was a much stronger figure than we and other forecasters were expecting. It was primarily a stronger growth in investments in stock, and to some extent exports, that came as a surprise.

The labour force survey statistics show that the number of persons employed continued to rise in June, both in relation to the corresponding period last year and compared with May this year, seasonally adjusted. Unemployment adjusted for seasonal effects was 7.5 per cent. The inflation rate in June and July remained low, which was expected. In July, CPI inflation increased by 0.7 per cent compared with July last year, and CPIF inflation increased by 0.8 per cent. This was completely in line with our forecasts and with market expectations.

Information on developments in the real economy during the third quarter is so far limited to the business and consumer tendency surveys for July and to the purchasing managers' index for July. The National Institute of Economic Research’s economic tendency survey fell in July and is at a level indicating that growth in the economy is weaker than normal. The confidence indicator for households did rise compared with June, and then to a level just above the historical average. Another bright spot was that the indicator for the manufacturing industry rose. This is in line with the indications from the purchasing managers' index for the manufacturing industry, which also rose in July. However, one must exercise caution in drawing conclusions on the basis of changes in individual months.

Appreciation of the krona during the summer

Another significant factor this summer has been the large appreciation of the krona in relation to the euro. This, together with the fact that the krona has increased in value against other currencies, too, means that it has appreciated in trade-weighted terms this summer. Our forecast in July was that the krona would strengthen, given the relatively good economic developments in Sweden and given our robust public finances. However, the krona has strengthened more during the summer than we were expecting. It remains to be seen how much of the strengthening is perceived to be permanent. This will to a large extent determine the impact on inflation. The unease on the financial markets has entailed large fluctuations in the currency markets and we know that changes can happen suddenly.

Next decision on 5 September

What I have said today is, as I mentioned initially, an attempt to summarise what has happened in the economic sphere during the summer. At the Riksbank we are busy working on new analyses and forecasts on which to base the next repo-rate decision on 5 September. Of course, a lot can happen before that, and we will not be making an overall economic assessment until then. But without getting ahead of ourselves, one can note that so far developments abroad may have been slightly weaker than expected, while developments in Sweden have been unexpectedly strong, at least during the second quarter. The krona has strengthened more during the summer than we were expecting in July. There is still unease over the situation in Europe. What we now have to consider is how these factors should be balanced against one another. Our conclusions on this matter will be presented at the beginning of September.