SPEECH

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■ Monetary policy in an uncertain economic policy landscape

Continued low repo rate so growth and inflation can rise

At the beginning of September, we members of the Executive Board of the Riksbank decided to allow the repo rate to remain at 0.25 per cent so that the currently low inflation will rise towards our target of 2 per cent. The low inflation we have today reflects the weak developments in economic activity both in Sweden and abroad. In this weak economic situation, companies have found it difficult to pass on their increased costs to higher consumer prices. However, as economic activity strengthens and demand rises, companies will have greater opportunity to raise their prices, which will contribute to higher inflation.

We are expecting this to happen as economic activity abroad strengthens in the coming years. However, the world is somewhat out of step. While the signals from the United States are strong, developments in the euro area are surrounded by storm clouds, which can be seen in confidence indicators such as the purchasing managers' index for the manufacturing industry.

The subdued confidence in the euro area is probably because uncertainty over what direction events will take is unusually great. This is partly because of the conflict in Ukraine and the remaining questions regarding European banks' balance sheets. The public finance situation is not entirely clear in all of the countries either. But once this uncertainty has calmed, developments in the euro area may also pick up, as we are expecting that monetary policy will remain very expansionary, fiscal policy will ease and credit granting will function better.

The currently weak development in the euro area is of course also leaving its mark on the Swedish economy. The development of exports is weak, which is in turn holding back investment. Exports will not pick up again until economic activity abroad strengthens and it may take a year or so before export growth returns to a normal rate. But then investment is also likely to pick up as interest rates are low and the funding opportunities are good.

Demand from our most important trading partners is currently fairly weak, therefore, and this has contributed to dampening growth in Sweden. On the other hand, demand from Swedish households has developed positively. In recent years, household incomes have increased at a good pace and consumption and housing investment have shown strong development. Since our previous forecast at the beginning of September, new revised GDP statistics for the second quarter showed a somewhat higher GDP and a somewhat stronger development in consumption and investment than we had reason to expect, given the preliminary statistics.

Employment has also risen somewhat since the start of the year, and if economic activity strengthens as we are expecting, the demand for labour will rise. Then unemployment will fall and the employment rate, that is, employed as a percentage of the population, will attain roughly the same level as before the financial crisis. When the labour market situation improves, we will also see gradually higher wage increases.

Even if the situation is currently uncertain, we thus see signs that economic activity will gradually strengthen, both in Sweden and abroad, and thus companies will have greater scope to raise their prices.

However, we believe that one condition for growth, employment and inflation to rise in accordance with the forecasts is that we continue to hold the repo rate at a very low level. This forecast for the repo rate – what we call the repo-rate path – is, however, a highly uncertain forecast, at least with regard to the end of the forecast period. This relates to something as self-evident as the fact that we live in a world full of uncertainty, not least with regard to the preconditions for monetary policy – for example, developments abroad, inflationary pressures, the level of unutilised resources in the economy and coming measures in the field of economic policy.

Here there are many factors contributing to making our forecasts uncertain and our repo-rate decisions difficult, and I shall touch on some of these problems.

Unclear international developments - unclear conditions for monetary policy

There is greater geopolitical uncertainty in our immediate area than there has been for a long time. The ongoing conflict in Ukraine could escalate, trigger more far-reaching sanctions, put further downward pressure on demand in parts of Europe and push energy prices up or down. We are monitoring developments closely, taking note of other analysts' assessments and working with different scenarios, but it is of course difficult to assess the probability of an escalating conflict and to quantify what potential effects it might have.

Another uncertainty factor concerns the situation in the euro-area banking sector. The European Central Bank's review of banks' assets (Asset Quality Review) and accompanying stress tests, which will be published soon, can strengthen confidence in the banks and thereby hopefully give new vitality to the banking sector, which has so far hampered a much-needed recovery through restrained credit granting and high interest rates on bank loans. But the problems in the Portuguese, Bulgarian and Austrian banks that have surfaced over the summer imply that some problems remain and there is a risk that the review will either point to extensive problems or be perceived as insufficient.

Another extremely important condition for monetary policy in Sweden is the shape that monetary policy abroad will take and what effects it will have on growth, inflation and exchange rates. In many parts of the world, and not least in the euro area, low inflation over a long period of time has come as a surprise to central banks and others. The European Central Bank (ECB) has expressed concern over falling inflation expectations and recently cut its policy rate to 0.05 per cent, at the same time as declaring that this is the lowest possible policy rate for them.

Moreover, they have announced several measures aimed at stimulating lending to households and companies. But it is still uncertain exactly what the measures will be and how extensive they will be. Moreover, there is little or no previous experience of these interest rate levels and measures in the euro area. It is therefore difficult to assess what effects the ECB's measures will have on GDP and inflation in the euro area and thus, ultimately, what they will mean for inflationary pressures here in Sweden.

One complicating factor is that the central banks in the United Kingdom and the United States appear to be taking a different direction with their monetary policy than the ECB. Their monetary policies are diverging. One reason why we are interested in expectations of policy rates and supplementary measures in other countries is that they influence interest in assets denominated in Swedish krona and therefore ultimately the development of the krona exchange rate.

Interpreting exchange rate fluctuations is often very difficult, but the changes in the expectations of the European and US central banks probably contribute to explaining the recent weakening of the krona in relation to the dollar and the strengthening against the euro. It is difficult to foresee the net result for inflation in Sweden, as that is dependent on both how much the various exchange rates alter and what effects this in turn has on import prices, competitiveness and purchasing power.

Factors at home also lead to uncertain conditions for monetary policy

International events thus account for many of the sources of uncertainty monetary policy needs to deal with. However, there are also developments at home contributing to the uncertainty over the conditions for monetary policy.

One question that we have long been seeking an answer to is why inflation has been lower than we and many other analysts have forecast. The answer is, of course, an important piece of the jigsaw puzzle when putting together the picture of future inflationary pressures. At the Riksbank we have therefore put a lot of energy into analysing the available statistics, and also into interviewing companies about the development of their costs and pricing. The other day we published an Economic Commentary on the subject of company pricing.[1] The responses from 895 companies in the retail trade, construction and various service industries imply that companies have experienced difficulties in passing on their increased costs to consumers. A natural explanation is that demand has been weak and uncertain. Our ordinary Business Survey, which was published last week, confirmed the picture that many companies currently perceive the situation as relatively uncertain and that they are so far cautious in

[1] "Results from a survey on company pricing", Economic Commentary No. 4, 2014.

implementing price rises.[2] Although there are some signs that price increases have been held back by an increase in competition, it is nevertheless reasonable to expect faster price increases and higher inflation when economic activity strengthens again and demand increases.

In addition to inflationary pressures, developments in housing prices and household debt – and not least the counter-measures needed and their consequences – comprise an important, but difficult to assess, domestic condition for monetary policy.

One should bear in mind the fact that experiences from other countries point to a high and growing indebtedness sooner or later having serious socio-economic consequences, but there is no clear limit as to when the situation becomes unsustainable. If one looks at the information available on indebtedness among the households taking on new mortgages, which thus in many respects comprise the purchaser side of the housing market today, I think there is reason for concern. On average, these households take mortgages equivalent to more than 350 per cent of their disposable incomes. The interest rates they pay on these mortgages are very low in an historical and an international perspective. This is partly due to the fact that a very high percentage of new Swedish mortgages are taken at variable interest rates. Many of the mortgages are also interest-only loans. This means that there is a risk that housing prices and indebtedness will now be driven up to unsustainable levels.

For those of us making the monetary-policy decisions, the key issue is what measures will be taken to slow down the build-up of debt and, not least, what effects these might have on household consumption and ultimately on inflationary pressures in the Swedish economy while our monetary policy is taking effect. This is an important source of the uncertainty we have to deal with.

Unfortunately, there is so far little experience to learn from with regard to the effects of so-called macroprudential policy measures. This makes it difficult for those making decisions and for those of us assessing what the decisions will be and what effects they may have.

One trade-off concerns "dosage". What one wants to achieve is that the growth in debt and housing prices slows down, but at the same time one wants to avoid a heavy fall in housing prices. This is a delicate task.

Another question concerns the fact that macroprudential policy involves getting banks and borrowers to behave in ways that they would not otherwise, for instance, amortising their loans quicker than they do now. Before one has managed to gain experience of the effects of a particular package of measures within the framework of the Swedish financial system, it is difficult to assess to what extent it affects monetary policy.

Managing uncertainty in monetary-policy decision-making

My impression is that we are now in a situation where the conditions for monetary policy are perhaps even more uncertain than usual. However, monetary policy decisions must nevertheless be made, and I therefore want to

[2] The Riksbank's Business Survey, September 2014

discuss my views on how this uncertainty should be managed and how it has affected by own stance recently.

An obvious measure that I have already mentioned is to try to acquire more knowledge of the sources of uncertainty and in this way reduce the uncertainty we are facing. We of course follow international developments closely and rely on both our own and other analysts' assessments of what they may entail. With regard to inflationary pressures in Sweden, as I mentioned earlier, we have put a good deal of energy into analysing the available statistics and into gathering new information from companies regarding their pricing behaviour. On the question of household indebtedness, we are currently calculating what effects an amortisation requirement would have. At the same time, we are developing our analysis of how monetary policy and indebtedness will affect the risks in the Swedish economy in the coming period.

I think that when making the actual decision, one must be sensitive to the difficulty of quantifying everything that needs to be taken into account. Models cannot capture everything. One often sees forecasts as mean forecasts. This means in principle that the risk that the economy will develop less well is as great as the chance that it will develop better. A mean forecast for GDP growth abroad, for instance, balances everything that could give rise to lower growth against everything that could give rise to higher growth. Another way of expressing the same thing is that the forecast is a form of middle way of all the different roads the economy could take in the coming period.

This way of working with forecasts means that one acts as though one has succeeded in quantifying the possibilities and effects of all of the different potential courses of events. A year or so ago there were frequent discussions of the risk of a split or disintegration of the euro system – what was the probability that this would happen and what effects would it have for Sweden? Today there may be reason to ask these questions with regard to an escalation of the Ukraine conflict or to a substantial fall in housing prices in Sweden.

If one considers these difficulties in quantifying various possible sequences of events and probabilities that they will occur, it may not be as simple a matter to make decisions on monetary policy and make forecasts for future interest rates as it is sometimes made out to be. It is not necessarily a case of assuming that one has succeeded in capturing all possible sequences of events in a balanced manner and then choosing the repo-rate path that provides the smallest deviations from the inflation target and a long-term sustainable development of employment during the forecast period.

As my colleague Stephen Poloz at the Bank of Canada recently pointed out, the shaping of monetary policy is more a question of risk management than a precise feat of engineering.[3]

If one takes the uncertainty seriously, and I think we have to do that, my assessment is that one should put particular emphasis on the really serious negative scenarios that we have the capacity to influence with monetary policy. One such risk that we have tried to take into account is that in a situation where macroprudential policy measures cannot manage all of the risks linked to household indebtedness, a low repo rate over a long period of time could aggravate and increase the probability of a domestic crisis caused by

[3] Poloz, Stephen S., "Monetary Policy as Risk Management", speech on 12 December 2013. Several central bank governors have expressed this opinion, including Alan Greenspan in the speech "Monetary Policy under Uncertainty" on 29 August 2003.

household indebtedness. Another risk that requires particular consideration is that a low inflation rate over a long period of time could make inflation expectations lose their connection to the inflation target.

When I entered a reservation against the monetary policy decision in July this year, all of us Executive Board members agreed that the repo rate needed to be cut for inflation to rise. The difference concerned how much it should be cut. My stance was based on the assessment that we could have given a slightly smaller impulse to further indebtedness and at the same time contributed to bringing inflation and inflation expectations back on target by limiting the cut to 0.25 percentage points and at the same time signalling a willingness to wait before increasing the rate again until 2016, even if this looked as though it might mean that inflation would overshoot the target.

Economic activity in Sweden is now beginning to improve, supported by very low interest rates charged to households and companies and by stronger developments abroad. However, our forecasts are, as I have argued, quite uncertain, especially a couple of years ahead. Anyone wanting to know more definitely what will happen needs a crystal ball that can describe all the situations that will arise here in Sweden and abroad over the coming years. However, there is no such crystal ball, so as always when making decisions in an uncertain situation we will have to deal with what happens as it comes.