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Öberg: Current monetary policy

Deputy Governor Svante Öberg gave a speech in Stockholm today at a meeting organised by Barclays Capital.

"Let me begin by thanking you for the invitation to come here and speak about current monetary policy. Speaking on this topic today suits me very well, as I had a slightly different view of monetary policy than my colleagues on the Executive Board of the Riksbank at the most recent monetary policy meeting on 29 March. This is shown in the separate minutes of the meeting, which were published on Monday," began Mr Öberg.

"My assessment is that the policy rate should have been raised by 0.25 percentage points and that the forecast for the interest rate path should have been revised upwards. I therefore entered a reservation against the decision to keep the repo rate unchanged," continued Mr Öberg.

"There are three reasons why I entered a reservation. The first is that economic developments are very strong, both in Sweden and abroad. The second is that developments are stronger than we had predicted at our monetary policy meeting in February. The third is that the wage bargaining rounds appear to be resulting in higher wage increases than we had anticipated. I shall further explain these three reasons," continued Mr Öberg.

"The first reason is thus that economic developments are very strong. I am thinking here of developments in a longer-term perspective. The International Monetary Fund (IMF) estimates in its most recent report that the GDP growth for the world economy will be around 5 per cent a year during the five years 2004-2008. It is not common to see such strong growth several years in a row. The strong international development also has a broad geographical spread. Growth in the OECD area is around 3 per cent a year, while the rest of the world, which accounts for around half of the world's GDP, is growing at a rate of around 7 per cent a year," said Mr Öberg.

"Growth in Sweden is also unusually strong with a GDP growth of 4.4 per cent in 2006 and around 4 per cent in 2007, alongside rapidly increasing employment. In this strong economic situation, both fiscal and monetary policies are expansionary. Households' real disposable incomes are expected to increase substantially this year, interest rates are still low and credit expansion is strong," observed Mr Öberg.

"One general experience of the past 10-15 years is that the developments in the real economy do not have the same impact on inflation as before. The short-term so-called Phillips curve has become flatter. This is connected to the fact that monetary policy has gained greater credibility. Inflation expectations are close to the target of 2 per cent, which in turn affects price setting and wage formation. The fluctuations in inflation around the target level are also much less than before. However, this does not rule out the possibility that the strong developments in the real economy could nevertheless finally result in increased inflation that would need to be counteracted by raising the interest rate. The most likely scenario in this case is that the inflation process will accelerate through wage costs beginning to rise at a faster rate," continued Mr Öberg.

"The second reason behind my reservation is that economic developments are stronger than we had predicted at our monetary policy meeting in February. "The National Accounts for the fourth quarter of 2006 were slightly stronger than expected. At the same time, earlier quarters were revised down, so that the annual average for 2006 was still in line with the forecast," noted Mr Öberg.

"However, if one looks at how we have revised our forecasts over a slightly longer period, the direction has been consistently upwards. Since the beginning of last year we have gradually revised our forecasts for GDP growth in 2006 upwards, from 3.5 to 4.4 per cent and our forecasts for 2007 upwards from 2.8 to 3.5 per cent. The most recent information indicates that we need to revise our forecasts even further upwards. The National Institute of Economic Research's most recent forecast for GDP growth in 2007 is 3.9 per cent and the Government is estimating in its Spring Budget Bill that GDP growth will be 3.7 per cent in 2007," continued Mr Öberg.

"The National Institute of Economic Research's Business Tendency Survey for February and March showed continued strong growth. Industrial activity has continued to improve and construction activity is record high. The retail trade is continuing to increase its sales and demand in the private service industries is rising. The National Institute of Economic Research's new Economic Tendency Indicator is at a high level. All in all, this means that the economy is developing much more strongly than usual," continued Mr Öberg.

"The labour market has also developed more strongly than we had assessed in February. The labour force surveys in January and February showed a faster increase in employment and a greater decline in unemployment than expected. Employment is now rising by around 100,000 persons on an annual rate. During the three-month period from December to February, unemployment fell to 4.9 per cent and was thus 0.9 percentage points lower than during the same period last year. The number of latent job seekers has also begun to decline now. In addition, other labour market indicators are pointing towards a strong development," claimed Mr Öberg.

"Despite the strong growth in the real economy, inflation is still low. The consumer price index rose by 1.9 per cent in March this year, compared with the same month last year, which is slightly more than we expected in February. Underlying inflation is lower. The UND1X inflation rate excluding energy was only 1.1 per cent in March, marginally higher than in our forecast. However, the important thing is how the increasingly strong economic activity will affect wage developments and inflation in the slightly longer term," said Mr Öberg.

"The third reason for my reservation is that it seems as though the wage bargaining rounds will, in my opinion, result in higher wage increases than we had anticipated. A decisive factor for future inflation and monetary policy is how the strong real developments will affect wage formation and in particular how this can be managed in the spring wage bargaining rounds. From this point of view, the wage bargaining rounds have not begun particularly well. They appear to be resulting in higher rates of wage increase than we had expected. The first three-year agreement in industry is said to involve 10.2 per cent in wage increases and the agreement in the trade sector to involve 12.6 per cent in wage increases over three years," said Mr Öberg.

"In February we were estimating that hourly wages would increase by 3.9 per cent next year when the whole-year effect of the agreements signed this year had an impact. The National Institute of Economic Research's report, which was published recently, instead calculates an hourly wage increase of 4.4 per cent and has then not taken into account the agreement in the trade area. The Government is also calculating on higher wage increases than we anticipated in February," observed Mr Öberg.

"My earlier assessment was that the wage bargaining rounds would most likely result in agreements within a reasonable time, at levels compatible with the inflation target and without major conflicts. At the same time, I considered that the risks were on the upside, that the wage bargaining rounds could, despite the good experiences of recent years, become much more difficult and that market forces could also push up the rate of wage increase to higher levels," said Mr Öberg.

"This risk scenario now appears likely to happen. Coordinated three-year agreements with a moderate level of wage increase could have been compatible with low and stable inflation. What now looks to be the case is instead weaker coordinated three-year agreements with higher wage increases than we had previously anticipated. In addition, a continued strengthening of the labour market risks resulting in increased wage drift," pointed out Mr Öberg.

"At the same time, it is not possible to rule out the possibility that there have been structural changes in the economy which contribute to inflationary pressures remaining low. Productivity and import prices could continue to hold down inflation even in the longer term. One important question for future developments is therefore to what extent the strong productivity growth is cyclical and to what extent it is structural. This is a question that cannot be answered until several years have passed," said Mr Öberg.

"The uncertainty over future economic developments means that we must test our way forward in monetary policy. My assessment is that the upside risks are currently stronger than the downside risks. In a situation like the one we have now, where strong forces are driving economic developments, we should raise the policy rate to a more neutral level. This is important, particularly for anchoring inflation expectations," concluded Mr Öberg.