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SPEECH

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The economic situation

GDP growth will slow down this year and next year. Employment will stagnate and unemployment will begin to rise. Inflation is high but will fall towards the target of 2 per cent over the coming years. This is the picture of the expected development of the Swedish economy reported in the most recent Monetary Policy Report published at the beginning of July.

In my presentation today I shall describe my view of economic developments abroad and in Sweden, explain how we Executive Board members viewed monetary policy in connection with the most recent monetary policy decision at the beginning of July and describe what has happened in the economy over the summer. In the first three sections I will mainly describe the forecasts from the Monetary Policy Report published in early July, but I will also mention some data that have been published since then. In the fourth and final section of my speech I will take up the most important information on developments in the Swedish economy that has been received since early July.

1. International developments

No end to the financial crisis yet

The problems in the international financial markets continued during the first half of this year. Although substantial losses have been taken up in the financial institutions' balance sheets, and they have been allocated new capital to a large degree, we have not yet seen the end of the financial crisis. Different measures of risk premiums are still at a high level compared with the period prior to last summer.

One can illustrate the problems in different ways, for instance by means of the so-called basis spreads, which demonstrate the difference between interest rates between the banks and the expected policy rate set by the central bank. This measure reflects pricing of the risk faced by the banks when lending to other banks. The basis spreads increased significantly in August last year. Sweden has also been affected by the global financial crisis, but to a lesser extent than many other countries. The basis spreads have, for instance, increased more in the United States and the euro area than in Sweden. But it is at the same time important to remember that the crisis has increased the Swedish banks' vulnerability to shocks.

Although the basis spreads have declined somewhat in the euro area and in Sweden since last spring, they have not returned to the earlier levels yet and one cannot exclude the possibility of new problems arising that will push risk premiums even higher.

Weaker growth in the USA

Economic developments in the United States continued to deteriorate during the first half of the year. This was largely connected to problems in the financial markets. In the most recent Monetary Policy Report published at the beginning of July we were expecting GDP growth in the United States to slow down to around 1.5 per cent a year in 2008 and 2009.

I agreed on the whole with the picture of international developments presented in the Monetary Policy Report, but my assessment was that developments in the United States could be even weaker than we were assuming. There is a risk that we will have to lower the forecasts even more in coming reports, particularly the forecasts for 2009. GDP growth in the second quarter of 2008 was actually slightly stronger than we had expected. GDP increased by 0.5 per cent compared with the first quarter.

Growth in the United States is now largely being upheld by exports alone, which are increasing at a good rate as a result of world growth and the dollar depreciation (compared with the level 2-3 years ago). Domestic demand will on the whole not show any increase in 2008 and 2009. I do not believe that the recovery in domestic demand will get started before the financial system has stabilised and before the fall in US house prices has come to a halt. House prices have continued to fall during the summer.

Growth in Europe will also slow down

Europe fared better than the United States at the beginning of the year. This is partly because the financial crisis originated in the United States and the financial market turbulence has not been as severe as there. Another explanation is that the financial balance is better in Europe; public sector finances have improved in recent years and the current account is close to zero. We assumed in the Monetary Policy report that GDP growth in the euro area would slow down to 1.7 per cent in 2008 and 1.2 per cent in 2009, to reach almost 2 per cent in 2010.

At the beginning of July we had seen little sign of the slower growth in the statistics on production and in the National Accounts. On the contrary, there had been several positive surprises. However, there were tangible signs of a future slowdown in other types of data, such as corporate and household confidence indicators. The quick figures for the second quarter now indicate that GDP in the euro area declined by 0.2 per cent compared with the first quarter, which was weaker than we had expected.

Global growth still strong

GDP growth in the world as a whole has been very strong over the last four years, around 5 per cent a year. Not since the early 1970s, prior to the first oil crisis in 1973, have we seen such strong growth in the world for such a long period of time. One important explanation for the rapid growth is that previously planned and closed economies have been transformed into market economies and opened up to the outside world. The forecasts in the Monetary Policy Report entail world GDP growth slowing down to around 4 per cent a year in 2008-2009 and later rising again to around 4.5 per cent in 2010.

Growth in the world was thus expected to remain relatively strong, despite the fact that we see ahead of us a couple of years of slower growth in the United States and the euro area. This is because of the strong growth in emerging and developing economies. For instance, the OECD calculates in its most recent forecast on an average annual GDP growth rate in the so-called BRIC countries of 4-5 per cent for Brazil, 7 per cent for Russia, 8 per cent for India and 10 per cent for China during the years 2008 and 2009. The emerging economies together account for around half of the world GDP and for three quarters of the growth in the world in 2008 and 2009.

Rising and falling commodity prices in the world market

The strong world growth has been the most important reason behind the sharp rise in commodity prices. Commodity prices have risen for six years, and these increases have accelerated over the last two years. Rapid growth has led to an increase in the demand for energy. It is almost impossible to make good forecasts for the oil price. The Riksbank's forecasts are therefore based on the prices of forward contracts for oil, that is, the price of delivering oil in the future. This means that at the monetary policy meeting in July we were assuming a price for crude oil of USD 130-140 per barrel during the forecast period. Since April the oil price has fluctuated substantially. First it rose to USD 147 a barrel and since then it has fallen. At the beginning of this week the oil price was USD 113 a barrel.

Food prices have also risen substantially in the world market, particularly over the past year. Rising incomes, urbanisation and changes in diet lead to an increase in the demand for food. As oil becomes more expensive it becomes profitable to use maize and other grains to produce biodiesel and biofuels. Furthermore, the production costs for foods are rising. Other factors such as supply shocks and speculation in future price changes also affect developments. Our assumption in June was that food prices would not continue to increase, but would stabilise at a high level. Since the beginning of July food prices have fallen.

High international inflation and rising inflation expectations

The upswing in commodity prices in recent years has in turn led to an increase in inflation around the world. In the United States it has risen to 5.6 per cent and in the euro area it rose to 4.0 per cent in July 2008. It has risen much more in several emerging economies. For the world as a whole, the IMF calculated that inflation will rise from around 4 per cent in 2007 to almost 5 per cent in 2008. Inflation expectations have also risen in several countries.

- The most probable development is that inflation will slow down next year. When adjusted for energy and food prices, inflation has been relatively stable. Normally, inflation slows down when growth slows down, even if this is with some time lag, and our forecast in the Monetary Policy Report is for growth in the world to be lower this year and next year. At the beginning of the summer we were also able to note that, unlike the situation in the spring, monetary policy expectations had swung towards higher interest rates in several countries. A tight monetary policy contributes to dampening inflation.

But there is a risk that the inflation process will be more prolonged. It was estimated that growth in the world will continue to be relatively strong, despite a slowdown in the United States and the euro area. In a slightly longer perspective, when the slowdown in the United States and the euro area becomes an upswing once again, there is also a risk that the problem of rising commodity prices will return. Several emerging countries will experience rapid growth for some time to come.

2. Developments in Sweden

Weaker growth and labour market in Sweden

Growth will also slow down in Sweden. In the Monetary Policy Report we assumed that GDP growth in Sweden will be 2.1 per cent this year and 1.2 per cent next year.

Several factors indicate a slowdown in growth. For instance, Swedish exports will be negatively affected by the weaker international growth, particularly in the United States. Moreover Swedish households' consumption will slow down for several reasons. Real disposable incomes will show weaker development and real wealth will be dampened. Households' expectations are very pessimistic.

At the same time, there are factors that may to some extent hold back a slowdown. The financial balance in Sweden is good; the current account shows very large surpluses and public sector finances are robust. The latter make it reasonable to assume further fiscal policy stimulation over the coming years. In addition, the Swedish financial sector has fared relatively well in the international financial turbulence, which reduces the risk of a serious credit crunch.

But growth will nevertheless slow down. This means that the labour market will deteriorate towards the end of the year. We assumed in the Monetary Policy Report that the rapid increase in employment would come to a halt this year and that employment would fall slightly over the coming two years. We also assumed that the decline in unemployment would cease and that unemployment will increase slightly in the coming two years.

Inflation is high but expected to fall towards the target of 2 per cent

Inflation was 4.4 per cent in July. This is the highest figure measured since the mid-1990s. Inflation is now far above the inflation target of 2 per cent.

The upswing in inflation over the past year can largely be explained by rises in energy and food prices, but higher wage increases and weaker productivity growth also contribute to higher inflationary pressures. Higher interest rates also contribute in the short term to the high inflation through rising housing costs. The forecast in the Monetary Policy Report was for inflation to remain high over the coming year and then to fall towards 2 per cent at the end of the forecast period.

Continued high inflation expectations

For a long time inflation expectations have been firmly anchored around the inflation target of 2 per cent. There have thus been no special reasons for us at the Riksbank to highlight them in our reports and speeches. However, since the beginning of 2006 inflation expectations have gradually risen.

According to the Prospera survey in June, inflation expectations for one year ahead were 3.2 per cent and expectations for five years ahead were 2.6 per cent. The expectations for one year ahead are largely in line with our own forecast, but the fact that expectations for five years ahead are way above the inflation target is more worrying.

The rising inflation in Sweden and abroad would not be a problem if it was just a question of a temporary rise and if inflation expectations remained at a low and stable level. But if secondary effects arise, or if inflation expectations rise, monetary policy may need to be tightened. It is important for monetary policy that what started as increases in oil and food prices in the world market does not spread to other areas and that inflation expectations in the slightly longer term do not become entrenched at a higher level, but fall back towards the inflation target once again.

We know that inflation expectations can be largely explained by the actual rise in inflation. However, we do not know very much about how monetary policy affects inflation expectations over and above the effect via inflation, and how inflation expectations in their turn affect long-term inflation.

There is an interesting approach in the academic research which involves the general public looking at outcomes and gradually learning how the economy functions and how the central bank reacts. If households are to believe that the central bank focuses on low and stable inflation they must be able to observe such behaviour. But such a process may take time, which we in Sweden could conclude in the mid-1990s when our own inflation target was established. This is an area we need to study more.

Wage costs rising more than before

In the Monetary Policy Report we assumed that hourly wages would increase by an average of around 4 per cent a year during the three-year agreement period. This is around 1 percentage point a year more than during the previous three-year period. In addition, we calculated on unit labour costs increasing by an average of almost 3 per cent a year in 2007-2010, to be compared with largely 0 per cent a year in 2002-2006.

The high inflation rate could affect wages through demand for compensation for the price increases. However, this does not seem very likely at present. The slowdown in growth and the expected weakening of the labour market are factors that weigh against such a scenario. In addition, we now have three-year agreements in most areas of the labour market which regulate the agreed wage increases. Nor are there, as there were in the 1970s and 1980s and are in some other countries, price guarantees in the agreements that provide automatic compensation for price rises. These were abolished in connection with the so-called Rehnberg agreement at the beginning of the 1990s.

It is, on the other hand, important that inflation and inflation expectations fall to around 2 per cent ahead of the next round of collective bargaining in 2010. With the current inflation forecasts, average inflation over the three preceding years will then have been over 3 per cent, which may be a problem. However, this would nevertheless mean that real wages prior to tax increase by around 1 per cent a year during the current three-year agreement period. After tax the increase is larger, perhaps 2-3 per cent a year.

3. Monetary policy

To summarise, at the monetary policy meeting in July we had a situation with rising inflation and inflation expectations together with growth coming to a standstill in Sweden and abroad. Such a situation brings central banks face to face with difficult decisions. Either they tighten monetary policy despite a slowdown in economic activity, or they accept a higher inflation rate. This was the choice we faced in July.

Given the course of events outlined in the Monetary Policy Report, the Executive Board decided to raise the repo rate from 4.25 per cent to 4.50 per cent, and we assessed that a well-balanced monetary policy entailed raising the interest rate a couple more times over the year.

Events since the previous meeting in April provided justification, in my opinion, for raising the interest rate and the interest rate path. The primary reasons were that inflation had increased and by more than we had previously expected, that inflation expectations had increased and were above the inflation target and that expectations of interest rates abroad had changed from falling to rising policy rates. We had revised our inflation forecast upwards for both this year and next year, despite the higher interest rates.

However, this did not mean that I disregarded growth and employment. The Riksbank's task is to ensure that inflation is low and stable. If we moreover can support growth and employment without neglecting the price stability target, we will do so. In practice this often means that we allow the time for bringing inflation up or down to the target to vary depending on the prospects for economic activity.

According to our monetary policy strategy, our policy is normally aimed at attaining the inflation target within two years. The calculation we made in July indicated that it would probably have required a slightly higher interest rate path than that described in the Report to bring inflation down to 2 per cent in two years. This would have brought down growth even lower next year. Given that inflation was deviating so far from target and taking into account the uncertainty in the financial markets, it would have been better, in my opinion, to aim at bringing down inflation to around 2 per cent in three years.

I do not believe that the decision in July can be regarded as any severe tightening of monetary policy. The interest rate is still relatively low. The nominal interest rate prior to the decision at the beginning of July was at a long-term average of 4.25 per cent. But the real interest rate was still lower than an historical average. In July the real interest rate was around 1.5 per cent, but it will rise during the forecast period to just over 2.5 per cent at most. The interest rate path we described in July entailed a change from a relatively neutral to a slightly contractionary monetary policy.

We were unanimous on the one decision to raise the interest rate by 0.25 per cent, but not on the other decision regarding the interest rate path. The majority of the Executive Board members considered it reasonable to have an interest rate path that involved a substantial probability of a further two increases during the year, while the minority considered it reasonable to have an interest rate path that involved some probability of one further increase. The minority's assessment was that the slowdown of the economy that is now taking place would dampen inflationary pressures to a greater extent than assumed in the main scenario. There would therefore be less need to continue increasing the interest rate.

4. Developments during the summer

I have earlier discussed what happened during the summer in the world around us. The trend of falling growth and rising inflation has broadly continued. One important change is that the oil price and other commodity prices have begun to fall, which may further slow down price increases. The dollar has risen in value against the euro and the krona, which also means that the krona has weakened against a weighted average of other currencies. The financial market turmoil has also continued.

I intend to conclude by summarising the important new information on developments in the Swedish economy since the monetary policy meeting at the beginning of July. Statistics during the summer confirm the picture that growth in the Swedish economy is slowing down and that inflation remains high.

Seasonally-adjusted, the GDP figures for the second quarter remained largely unchanged compared with the first quarter. This was a weaker outcome than we expected in the July Monetary Policy Report. There is a clear trend towards falling GDP growth from around 1 per cent a quarter two years ago to close to zero over the past six months. At the same time we know that GDP growth figures for the first and second quarters are usually revised upwards in later National Accounts publications, so we will not know the final outcome until a couple of years from now. In addition, one should bear in mind that monetary policy looks ahead. We cannot affect what has happened during the second quarter of this year. It is only to the extent that the new information affects our forecasts for the coming years that it is important to monetary policy.

The National Accounts also indicate that productivity continued to decline in the first two quarters. We had assumed that productivity would increase. Hourly wages increased by 4 per cent from January to May this year, compared with the same period last year, according to preliminary wage statistics from Statistics Sweden and the National Mediation Office. Normally the figures are revised upwards in statistics published somewhat later, but the statistics nevertheless indicate that there have not yet been any unexpected rises in the rate of wage increase. If anything, it looks to be slightly lower than anticipated. However, so far this year wage costs per produced unit nevertheless appear to have increased by more than we had expected as a result of the weaker productivity.

Employment continued to increase during the second quarter of this year, but unemployment remained largely unchanged compared with one year ago. The outcomes were close to the forecasts. The number of hours worked per week continued to increase during the first half of the year, which contributed to a decline in productivity.

The Economic Tendency Survey in July was also weak. It fell and now indicates that the Swedish economy is much weaker than normal. It is mainly households that are contributing to the low level. This is the most pessimistic that households have been about the Swedish economy for 15 years. The confidence indicator for the Swedish business sector fell, but it is nevertheless at a level corresponding to the average since 1996.

The Economic Tendency Survey also shows that sales prices in the wholesale and retail trade continued to rise to a large extent and that continued increases are predicted for the third quarter. Households' and companies' inflation expectations continued to rise. They even rose more than is indicated by statistical correlations between inflation and inflation expectations. However, inflation expectations as measured in the bond market, what is known as breakeven inflation, have declined.

Inflation rose from 4.0 per cent in May to 4.3 per cent in June and 4.4 per cent in July. This is around a tenth more than we estimated in our Monetary Policy Report. Compared with the forecast in the Report, it is primarily electricity prices that have been higher than calculated. Food prices increased by 8 per cent, which is more than in almost all of the countries in the euro area and could indicate that what started out as price increases in the world market have begun to spread to other goods. On the other hand, oil and other commodity prices have fallen, which may dampen inflation in the future. However, the krona has weakened, which makes imports more expensive.

To sum up: the picture presented in July largely remains unchanged - with lower growth and high inflation. But GDP growth has so far this year been weaker than anticipated. Inflation is at its highest level since the mid-1990s. However, oil and other commodity prices have fallen. At the same time, productivity has been lower and resulted in increased wage costs.

At the Riksbank we are now working hard on producing new forecasts for the coming years. At the beginning of September my colleagues and I will take a new monetary policy decision. We will then once more take a stance on economic developments and on how the interest rate should be set to attain our inflation rate of 2 per cent.