

Inflation assessment

This chapter presents the assessment of price tendencies up to mid 2000. International factors are considered first, followed by a survey of demand relative to supply in the Swedish economy. Transitory effects that will be acting on consumer prices in the coming twenty-four months are then discussed, followed by inflation expectations. Finally, a comprehensive forecast of inflation is presented, together with an assessment of its uncertainties.

The present forecast, like those in earlier inflation reports, starts from an *unchanged repo rate*. This is a technical assumption and its primary purpose is educational—to clarify whether a repo rate adjustment is called for and, if so, in which direction. Thus, an inflation assessment which results in the conclusion that, at the time horizon of twelve to twenty-four months which is the Riksbank's primary concern,

inflation will be above (below) the target rate, normally implies that there is reason to raise (lower) the repo rate. Note, however, that the Riksbank flanks its main inflation forecast with a number of risk scenarios for inflation prospects. This assessment of uncertainties is incorporated in the final foundation for monetary policy decisions.

DETERMINANTS OF INFLATION

Monetary policy targets an inflation rate of 2 per cent. The time lag before monetary measures affect economic activity and inflation makes it necessary to base policy on an inflation forecast. With a time horizon of twelve to twenty-four months, the development of inflation is essentially determined by the following factors:

1 International activity and inflation

In that Sweden's economy is highly dependent on foreign trade, external economic developments are an important consideration in the assessment of inflation.

Economic activity in the rest of the world affects demand for Swedish exports and is therefore an important

component in the assessment of total demand. *External inflation* affects the price of imported goods in foreign currency, while *exchange rate movements* condition the extent to which changes in world market prices are mirrored in *import prices* in Swedish kronor. An appreciation of the krona reduces the impact on domestic inflation from a given external price rise. The effect on domestic inflation is also conditioned by the development of profit margins on imports. Moreover, changes in world market prices that are not countered by exchange rate movements affect the competitive position for Swedish exports and this can have repercussions on the rate of wage increases and other production costs in Sweden.

2 Demand relative to supply

Demand that exceeds long-term production capacity normally generates inflationary pressure. Monetary policy therefore has to be gauged so that demand is kept as close as possible to the development of production capacity. A variety of indicators can be used to obtain an overall picture of the inflationary pressure that is emanating from demand in relation to supply. One of these indicators is the National Institute's business tendency data on industrial *capacity utilisation*. Another is the *labour market situation*, where, for example, comparatively high wage increases despite high unemployment may indicate a limited possibility of enlarging total demand without incurring wage inflation. A third type of indicator is the *output gap*—an econometric estimate of the difference between GDP's registered and potential long-term levels.

The higher the level of demand relative to capacity, the greater the probability of capacity shortages arising in parts of the economy. The occurrence of bottlenecks can therefore be a sign that production is approaching its potential long-term level. A shortage of a particular category of labour may be such a sign. A complication here, however, is that high demand and high wage increases for a certain category of labour can also result from better productivity and profitability compared with other activities. In that case, such wage increases are not a direct inflationary threat, though they do call for efficient wage formation and labour market flexibility. Assessments must also allow for the fact that, in time, high investment, an increased labour supply or improved technology lead to an increased production capacity.

Changes in demand do not, however, exert an influence on all prices through market mechanisms. Some prices are set by administrative decisions, based above all on the cost side or with a sizeable element of subsidy. Examples of administered prices in Sweden are rents and fees for medical care and certain municipal services. One of the consequences for monetary policy is that for certain prices, the impact of interest rate

adjustments is subject to particularly long lags. Monetary policy can influence these prices only through effects on the general development of costs, e.g. wages.⁸

3 Other cost shocks and transitory effects

Inflationary impulses can also be generated by cost increases that are specific instead of stemming from a general increase in world market prices or strong domestic demand. A price rise for primary products as a consequence of supply-side shocks is one example. Similar inflationary impulses can come from fiscal policy in the form of changes in *indirect taxes and subsidies*. Such inflationary impulses are normally transitory in the sense that they entail an immediate change in the general price level without necessarily affecting inflation's long-term trend. However, they may have a lasting impact on the inflation process if they affect inflation expectations. In order to gauge trend inflation (inflation excluding transitory impulses), the Riksbank uses various indicators of underlying inflation and inflation expectations, for example.

4 Inflation expectations

High demand prompts producers to raise prices and employees to bargain for higher wages. But inflationary price and wage increases can also stem from high inflation expectations as such, because economic agents strive to maintain or increase their real income level. In this way, inflation expectations are liable to be self-fulfilling.

The factors outlined above are those which, according to accepted economy theory as well as practical experience, affect inflation. An analysis of these factors is accordingly an important component of the foundation for monetary policy decisions.

⁸ For an account of administered prices in the CPI, see *Inflation Report 1997:3*, p. 8.