Interest rates, exchange rate and money supply

BOND RATES STILL LOW

Long bond rates have fallen by degrees in recent years, in Sweden as well as abroad. Important domestic factors behind the lower interest rates in Sweden are the consolidation of government finances and a successive enhancement of confidence in monetary policy's commitment to price stability, which among other things has lowered inflation expectations.

Even with the recent upward tendency, the level of Swedish long bond rates is still historically low.

After the publication of the March Report, Swedish long bond rates went on falling; recently, however, they have turned upwards again, mainly in connection with the global increase, occasioned primarily by signs that the strong trend in the US economy is continuing. But even with the recent upward tendency, the level of the Swedish ten-year rate is still historically low, around 4.5 per cent (Annex: Fig. 10). The corresponding euro rate has risen about as much. The interest rate differential is accordingly unchanged at around 0.4 percentage points (Annex: Fig. 11). A differential of this magnitude is a sign that confidence in the Swedish economy among players in financial markets is still good.

In the United States, bond rates have gone on rising since the March Report, so that during 1999 the differential with euro rates has widened by about 0.5 percentage points. This probably reflects the relatively stronger economic growth in the American economy. Swedish interest rates have largely followed the euro rates, which is to be expected in the light of

MONETARY POLICY'S ECONOMIC IMPACT

The Riksbank's main monetary policy instrument is the repo rate, which is the short-term rate for the private banks' deposits in and borrowing from the Riksbank. Simplifying somewhat, the Riksbank influences other interest rates in Sweden by altering the repo rate. Via these market interest rates an influence is exerted in turn on economic activity, for example business investment and household consumption, and thereby ultimately on price formation. However, the effect of the Riksbank's actions is not the same for every type of interest rate. The rates with the shortest maturities are controlled by the repo rate more or less directly, while those with longer maturities are also influenced by factors that the Riksbank does not control directly, for example the construction of fiscal policy, the development of international interest rates and the credibility of economic policy's overall commitment to price stability. It should also be noted that households and most firms finance their procurements and consumption mainly at interest rates above the quoted market rates. The loans are usually provided by banks and house mortgage institutions at rates that to some extent mirror credit risks and competition between different institutions.

Monetary policy also influences the course of inflation via the exchange rate because exchange rate movements have effects on demand and investment mainly in the internationally oriented sector of the economy. Under normal conditions a repo rate increase, or expectations of this, leads to a stronger exchange rate because the higher interest rates make Swedish assets more attractive than equivalent interest-bearing investments in other currencies; this draws foreign capital to Sweden, with an increased demand for Swedish kronor. All else equal, a relatively permanent weakening or strengthening of the exchange rate will affect demand via shifts in relative prices between Swedish and foreign goods. This in turn affects inflation. Inflation is also influenced directly by exchange rate movements in that these alter import prices.