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SPEECH

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SPEAKER: Governor Stefan Ingves

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Introduction on monetary policy

I was here as recently as two days ago to discuss the development of housing prices and household indebtedness. Today, I am here to discuss monetary policy.[1] After several years of crisis management, it feels positive to return to discussing more "usual" monetary policy issues. When I was here a year ago, I showed a picture of a skater on the ice. Having been out on thin ice, I considered we had returned to thicker ice. Today, I would instead say that we're back on dry land. To use a different metaphor, Sweden, with its small, open economy, could be described as being a small boat on a wide ocean. The financial crisis required "Sailboat Sweden" to navigate some dramatically stormy waters. After such a traumatic experience, it is natural to try to lift your gaze and ask certain all-embracing questions:

- Where have we come from?
- Where are we now?
- Where are we going?

Personally, I would be just a little worried if I found myself aboard a boat without knowing where I boarded it, its current position or final destination. Let me therefore attempt to give you my answers to these questions as they concern Sweden's economy.

[1] I refer to my speech of 1 March, "The housing market, the banks and household debts" as regards details of the housing market and indebtedness among households. The speech is available at the Riksbank's website, www.riksbank.se. However, at the end of today's speech, I will touch on household debts and housing prices when I discuss our forecast for the repo rate.

Where have we come from?

The years before the financial crisis – the calm before the storm

From about the middle of the 1990s until the outbreak of the financial crisis, economic development both in Sweden and abroad was characterised by positive growth and low inflation. Fluctuations in production and inflation decreased, at the same time as productivity growth in Sweden and elsewhere increased. There are many ways of illustrating this development, but one way would be to examine government bond rates in Sweden, the euro area and the United States (see Slide 1). Certain clear patterns can be detected. These include decreased interest rate levels and a reduction of fluctuation in these over time. In addition, from the mid-1990s, interest rates in various countries developed in a strikingly similar manner. This strong development can be further illustrated by growth in the world economy, which fluctuated between 2 and 5 per cent and averaged almost 4 per cent (see Slide 2). All in all, developments from the mid-1990s until the start of the financial crisis can be compared to a voyage through relatively calm waters, to return to our nautical analogy. But then the storm broke.

Sweden's economy during the financial crisis – what happened?

Happily, we can now start talking about the financial crisis as something we have left behind us. It is also much easier now to see the implications of the crisis for Sweden than it was while the crisis was in progress. One way of emphasising the drama of the financial crisis is to look at GDP in the world as a whole, which decreased for the first time since the 1940s (see Slide 2). With an economy in free fall in many parts of the world, policy rates dropped with full force (see Slide 3). At the same time, very extensive fiscal easing was implemented in many countries. Furthermore, both governments and central banks launched various support measures to avoid a collapse of the financial system.

Today, we know that, in the end, the financial crisis mainly manifested itself in Sweden in the form of decreased demand from abroad. World trade declined sharply, as did Sweden's exports (see Slide 4). The uncertain situation meant that the currencies of many smaller economies were weakened in relation to the US dollar and euro. To a great extent, this also applied to the Swedish krona, which reached its lowest point ever (see Slide 5). Despite the weakened krona, the decrease in exports was extremely severe. It is natural to ask why. One explanation is that a large part of the decline in world trade affected investment goods and durable consumer goods such as cars. The purchase of these goods could easily be postponed when the crisis broke out. Such product groups represent an important part of Sweden's exports. In could thus be said that Sweden was impacted particularly severely due to the composition of its exports. As I mentioned in my introduction, Sweden is a small, open economy that is highly dependent on exports. During 2009, GDP fell by over 5 per cent, the sharpest decline since the Second World War.

Even if the krona was heavily weakened, this was not enough to prevent a major fall in exports. On the other hand, there are many indications that the weakening of the krona contributed strongly towards preventing inflation from becoming excessively low. Unlike abroad, where inflation became negative, inflation in Sweden remained around the target even during the most acute phase of the crisis (see Slide 6). Note that inflation in Sweden here disregards changes in mortgage interest expenditure – it is measured using the CPIF. This approach corresponds better with the way that inflation is measured abroad.[2]

Developments in Sweden during the financial crisis differ in several regards from the crisis we experienced during the 1990s, when major problems were present in the Swedish economy before the crisis erupted. Inflation was very high and the credit market had recently been deregulated. This led to overheating tendencies and the fixed exchange rate eventually needed to be abandoned. In somewhat simplified terms, I usually describe the crisis of the 1990s like this: "things were quite OK abroad, but Sweden was not OK".

This time, the crisis had its origins in problems on the US housing market, which then had unanticipated consequences. With the bankruptcy of Lehman Brothers in September 2008, these events turned into a global financial crisis. And in several other countries, such as Spain and Ireland, problems arose on the housing market. At the same time, the public finances of several countries were not in sufficiently good shape to handle a crisis like this. This was not true of the Swedish economy. Thanks to regulations on surplus targets and expenditure ceilings, Sweden's public finances were in good shape before the crisis broke out. Unlike during the crisis of the 1990s, the situation could now be described as follows: "things were not OK abroad, but Sweden was OK".

There are also other differences if the current situation is compared with the crisis of the 1990s. Back then, there were no elements of lending to the banks by the Riksbank. On the other hand, loan losses among the Swedish banks were enormous, as I clearly remember from my position as head of the Swedish Bank Support Authority at the time. Now, the situation has rather been the opposite: comprehensive lending from the Riksbank, but very limited loan losses on the home market for the banks. How can this be explained? Well – as a reflection of the nature of the crisis. Back then, in the early 1990s, the banks had suffered loan losses in the commercial property sector, which impacted on profitability in the banking sector and led to a degree of restructuring aimed at maintaining capital adequacy; it was a solvency crisis, rather than a liquidity crisis. This time, in conjunction with the financial crisis, an acute shortage of liquidity instead arose in the banks when the functioning of the capital markets became impaired. A further sign that the financial crisis is behind us is that the Riksbank has now wound up all of the extraordinary measures adopted during the crisis.

It was not entirely easy to understand the development of the financial crisis while it was unfolding. Today, however, the view is much clearer. This brings us to the question of where we are today.

[2] For example, in the euro area, the price index HICP measures inflation without the effects of changes in mortgage interest expenditure.

Where are we now?

Strong recovery after the crisis

The Swedish economy has recovered very strongly from the financial crisis. The growth of GDP in Sweden is very high from both a historical and an international perspective. According to new figures, GDP growth amounted to 5.5 per cent in 2010 (see Slide 2).[3] This is the strongest growth seen since 1970. There have thus been very wide fluctuations in the economy in recent years. After developments in 2009, which entailed the sharpest fall in GDP since the Second World War, we have instead experienced, in 2010, the greatest increase of GDP in 40 years. Sweden is now among those economies with the highest GDP growth rates in the world. At the same time, the indicators are very strong, suggesting continued high levels of growth throughout early 2011.

Exports, which decreased so drastically during the crisis, are showing very high growth figures (see Slide 4). One natural explanation is that world trade is now growing and Sweden has a high percentage of exports. This is the case even though the recovery in the United States and euro area is proceeding relatively sluggishly.

From what I have just said, it is easy to conclude that the "emerging economies" have a high demand for Swedish exports and have heavily increased their proportion of these. This explanation is only partially correct. If we look at which countries Swedish exports go to, the United States and Europe remain completely dominant (see Slide 7).[4] However, over a longer period, the United States has decreased its share in favour of the BRIC countries (Brazil, Russia, India and China). There are many indications that the significance of the emerging economies for Swedish exports will continue to increase in the period ahead. This is an example of an important gradual change that has taken place independently of the financial crisis and which will affect developments in the future. It could perhaps be said that the crisis has contributed towards shedding light upon the increased significance of the emerging economies, as these are now driving the recovery of the global economy.

Interestingly enough, the composition of products in Sweden's exports, which was a disadvantage for Sweden when the crisis erupted, has now been turned into an advantage. There is a natural explanation for this: just as purchases of goods of this type (large amounts of which are exported by Sweden) were easy to postpone, so are they also easy to resume. However, over the last year or so, the krona has appreciated considerably, reducing the impetus previously provided by the weakened exchange rate (see Slide 5).

At the same time, exports are far from being the only part of the Swedish economy that has grown. Domestic demand in the form of consumption and investments has developed very strongly. So why is the growth of domestic demand also so high in Sweden, compared, for example, with the United States and the euro area? There are several explanations for this.

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[3] This was entirely in line with the Riksbank's forecast from February, which also predicted GDP growth of 5.5 per cent for 2010.
[4] The slide shows percentages of goods exports, which constitute about two-thirds of Sweden's total exports.

- To start with, Sweden's public finances are in good shape in an international comparison, which means that there will be no need for fiscal policy tightening in the period ahead. In addition, household saving in Sweden was high before the crisis broke out. Saving increased further in conjunction with the crisis, presumably due to the general uncertainty prevailing. Moreover, household confidence has recovered strongly, as various types of survey have shown. Together with relatively sizable incomes, this has made it possible for consumption to recover. A further favourable factor is that, in the end, the Swedish financial system was never fully drawn into the financial crisis.

Towards a normalisation of GDP and inflation – even for the repo rate

Let me refer back to Slide 3, which shows the policy rates of Sweden, the euro area and the United States. The policy rates of both the United States and the euro area remain on extremely low levels. This emphasises that the situation in these countries is far from being "business as usual". Part of this can be explained by the development of public finances. In the euro area, unease remains high over how countries such as Greece, Portugal and Ireland will cope with their long-term commitments. One of the forms taken by this unease is that of rising government bond rates in these countries, which is further increasing the burden of debt (see Slide 8). The high levels of public debt are partially a consequence of the fiscal policy stimulation packages introduced during the crisis. In many cases, the situation has been exacerbated by the excessively weak development of public finances in the years leading up to the crisis.

Several countries are now facing a difficult balancing act. On one hand, significant fiscal policy tightening will be necessary for a long time to come in order to reduce public debt to a more reasonable level. On the other hand, this tightening must not be so comprehensive as to threaten the economic recovery. Hopefully the planned European Financial Stability Facility will have a beneficial effect, but the public finance problems will characterise developments for a long time to come, one way or another.

The United States also has a large and growing central government debt, and it will require comprehensive fiscal policy tightening to gain control over this development. One advantage is that US government bond rates are still low (see Slide 1). Moreover, asset purchases by the US central bank have contributed towards keeping interest rates down. These expansive financial conditions, together with high profits within the corporate sector, suggest that the recovery will pick up further speed, despite the need for fiscal policy tightening.

On the other hand, problems remain on the housing market, which are dampening household demand and restraining the recovery. Many households have seen the value of their homes decrease sharply, with homes now being worth less than mortgages in many cases. In such a situation, many households are choosing to strengthen their balance sheets by restraining consumption in favour of saving. Furthermore, house sales entail a serious risk of incurring losses. In turn, this may mean that the unemployed are less willing to move to regions in which there exist job opportunities. The labour market may thus have become less flexible, and long-term unemployment in the United States may have risen as a consequence of the crisis.

Happily, in Sweden, the level of GDP seems to have returned to about the same level as prevailed before the crisis erupted. Our overall assessment is that resource utilisation is on the way to becoming normalised. However, I would like to point out that it is very difficult to measure resource utilisation, as this cannot be directly observed. Different measures also provide somewhat different pictures. While a number of measures indicate that resource utilisation has already returned to normal, other measures continue to point to a certain degree of spare capacity. There are many indications that unemployment has the potential to decrease a bit more before any "bottleneck problems" arise in the labour market (see Slide 9).

CPIF inflation has shown significantly more stable development than CPI, which includes the effects on mortgage interest expenditure of the drastic interest rate cuts implemented during the crisis, as well as the recent interest rate increases. Inflationary pressures are starting to increase in tandem with the economic recovery. This means that the repo rate has also been increased from the very low level of 0.25 per cent that prevailed one year ago to 1.5 per cent today. This allows us to safeguard the balance of Sweden's economy and simultaneously attain the inflation target of 2 per cent.

Where are we going?

Having come this far, it may be appropriate to stop and spend a moment reflecting over the financial crisis and long-term economic development. As I mentioned in my introduction, the period from the mid-1990s until the financial crisis was characterised by good growth, low inflation and decreasing variation in output and prices. In addition, the financial crisis was preceded by a period of about 60 years of unbroken growth in the world economy. So we could ask ourselves: are crises of the type we have just experienced "improbable events" that take place perhaps once in fifty years and something we just have to accept? My answer is both yes and no. We have learned that financial crises are extremely costly. Governments and central banks are now busy discussing different measures both to reduce the likelihood of crises arising and to mitigate the consequences of any such crises. This work is very important, but unfortunately will not mean that, as of now, there will never be any more crises.

So what should we do to ensure that it takes as long as possible until the next crisis breaks out? To start with, it is important to develop the financial regulatory framework both in Sweden and abroad, so as to boost the resilience of the financial system. Work on this is currently in full swing, but it will take several years before we will be able to gain a clearer view of how such a new regulatory framework may look. However, regardless of how it may look, it will affect the conditions for monetary policy, one way or another. It is thus important for central banks to continually monitor and analyse changes in the financial regulatory system. The financial crisis has also emphasised the need to better incorporate the financial markets' significance into the macroeconomic assessment that guides monetary policy.

Future developments – the stable development of Sweden's economy requires the repo rate to be raised

The recovery of Sweden's economy after the financial crisis has now made a lot of progress. Output has largely returned to the pre-crisis level, and unemployment is in retreat. Our assessment of developments is that the high growth rate in the economy will gradually decrease in the period ahead and will approach normal levels. Underlying inflation is increasing and will be close to target by the end of the forecast period (see Slide 10). It could be said that the Swedish economy, including monetary policy, is in a process of normalisation. This also means that issues that were being analysed before the crisis erupted, such as commodity prices and the development of the krona, are again on the agenda, now that the need for acute crisis management has decreased. One example of this is formed by the alternative scenarios in the last monetary policy report, which dealt with both the stronger krona and commodity prices, which are now rising rapidly on the world market (see Slide 11). I will return to these scenarios later.

Another sign of normalisation can be seen in the occasional differences between the Riksbank's repo rate forecast and different measures of market expectations of the repo rate. During the financial crisis, there was unusually great uncertainty regarding where the economy was going and how various monetary policy measures would affect developments. Consequently, it was not surprising that different analysts arrived at different conclusions regarding the future development of the repo rate. During 2009, most measures of market expectations indicated that participants expected earlier repo rate increases than were indicated by the Riksbank's repo rate path. The situation in 2010 was the opposite: that is, the market expected slower increases of the repo rate than were suggested by the repo rate path. The direction of Sweden's economy is now clearer and this may explain why different measures of market expectations have moved closer to the Riksbank's forecast (see Slide 12).

All in all, the monetary policy stance suggests a gradual increase of the repo rate towards more normal levels (see Slide 12). This is a precondition for the balanced development of the Swedish economy. As I mentioned two days ago, housing prices and debts among households have increased heavily for a longer time. The rate of increase of household debts has far exceeded the rate of increase of incomes. If this development continues, imbalances may arise in the Swedish economy over the long term. Consequently, in this regards, the normalisation of the repo rate level may also contribute to promoting a stable economic development in the future.

Even if the development of Sweden's economy is favourable, it is naturally not risk-free. What risks can we see at present?

Firstly, the krona may appreciate more than we had expected. The assessment we have made is that the krona, to a significant extent, already reflects the high growth rate of GDP and the strong state of public finances, for example. However, I would like to point out that forecasts of exchange rates are always associated with significant uncertainty. It cannot be ruled out that the favourable development of the Swedish economy has led many investors to reappraise their view of investing money in Sweden. So could an excessively strong exchange rate form a problem? Yes, it may form a "problem" in so far as demand for Swedish exports will decrease and inflation may not increase in line with expectations, as imported goods become cheaper. Should this be the case, it may not be necessary to increase the repo rate as rapidly. An alternative scenario in February's Monetary Policy Report examines this possibility. But let me clearly emphasise that the Riksbank has no target for the level of the exchange rate. Monetary policy is governed by the inflation target, even if the exchange rate is an important determining factor for inflation.

Secondly, as I mentioned, commodity prices have increased very steeply over the last year (see Slide 11). To a certain extent, although far from completely, this price rise has been counteracted by the appreciation of the krona. If commodity prices increase as a result of rising demand, this price increase will probably be more permanent than one resulting from supply shocks – that is factors obstructing output.[5] It seems likely that the strong economic development of the emerging economies – with increased demand for intermediate goods as a result – can largely explain the increase of commodity prices over the last year. The very recent unease in North Africa has contributed to rising oil prices and has more of the character of a supply shock. All in all, the increase of commodity prices may have greater contagion effects on prices in the rest of the economy than we have estimated.

Thirdly: even if unemployment has decreased over the last year, it is still relatively high. Despite this, a certain degree of labour shortages can already be discerned in several sectors. Shortages have even risen rapidly in the manufacturing sector, where employment fell the most during the crisis. Only one-fifth of the jobs lost in the manufacturing industry have again been filled. This may have effects on wage formation and inflation. In our forecast, wages will increase by 3–3.5 per cent over the coming three years. Labour shortages in combination with a strong economic climate may lead to a situation in which wages increase at a faster rate. In that case, inflation will be higher and it may be necessary to raise the repo rate more rapidly.

Having discussed these risks, it may be worthwhile to point out that they are only risks. Our main scenario for future developments suggests the stable recovery of the Swedish economy and gradual increases of the repo rate.

Conclusion

Let me now summarise the basis for the future direction of monetary policy. Following the financial crisis, Sweden's economy has shown a strong recovery. Growth is currently high, but is expected to decline successively. The labour market is on the road to recovery, and unemployment is falling. Prices are increasing on the world's commodity markets, contributing to rising inflation. Resource utilisation is on the way up, also contributing to the increase of inflationary pressures in Sweden in the period ahead.

All in all, it can be said that the financial crisis is now behind us and that the situation is in the process of normalisation. This also requires a normalisation of monetary policy in the form of rising repo rates in the years ahead.

In this context, allow me to clarify an important issue linked with the forecast for Sweden's economy. As I have mentioned, our assessment is that growth in

[5] Examples of such factors include natural disasters or political unease in countries of production.

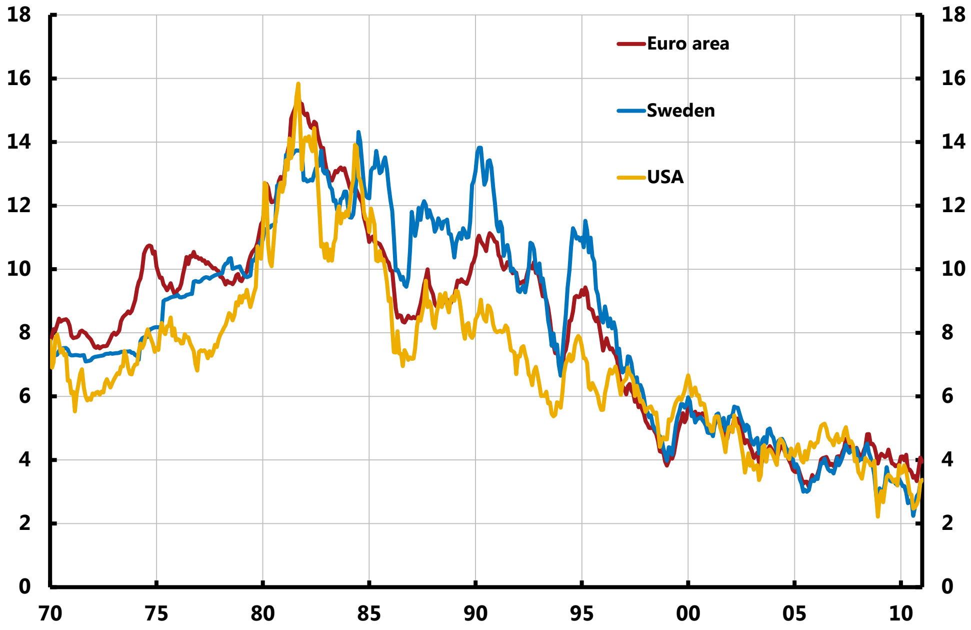
- the Swedish economy – following its very bumpy journey during the financial crisis – will gradually decrease (see Slide 2). Whether the forecast for Sweden's GDP growth "levels off" at 2, 2.5 or 3 per cent will be determined by the workings of the economy, by the development of output and more. Monetary policy cannot influence long-term growth rates or the long-term level of unemployment.

The inflation target and monetary policy are thus, in themselves, no guarantee of high growth, but they create the right conditions for consumption and investment decisions and reduce uncertainty over future price changes. And this is a strong foundation.

Figures

Slide 1. 10-year government bond rates in Sweden, the euro area and the United States

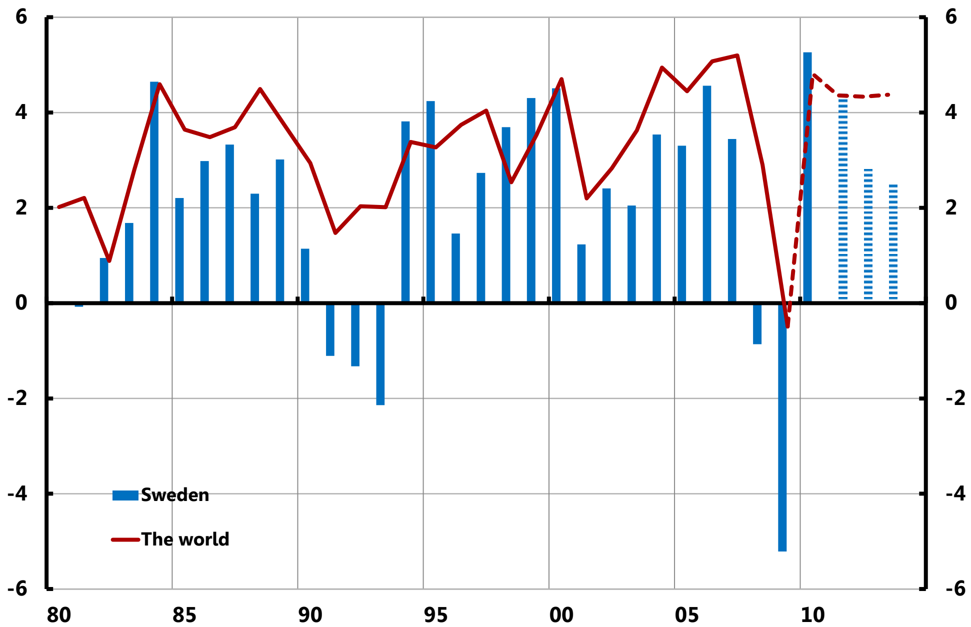
Per cent



Sources: The ECB and Reuters Ecowin

Slide 2. Growth in the world and Sweden

Annual percentage change, calendar-adjusted data

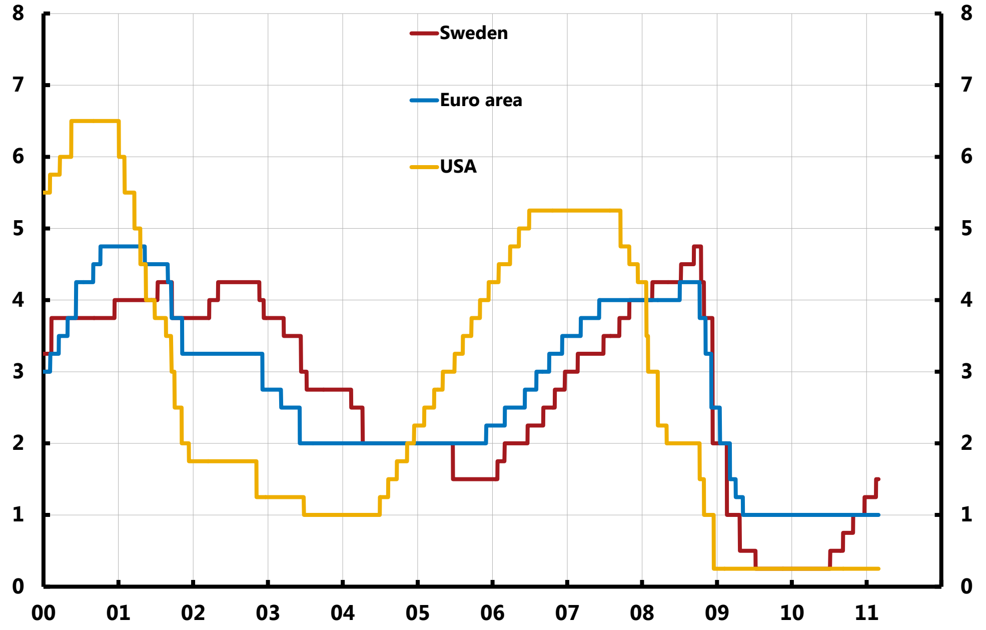


Note. The broken line and striped bars represent the Riksbank's forecast.

Sources: The IMF, Statistics Sweden and the Riksbank.

Slide 3. Policy rates in Sweden, the euro area and the United States.

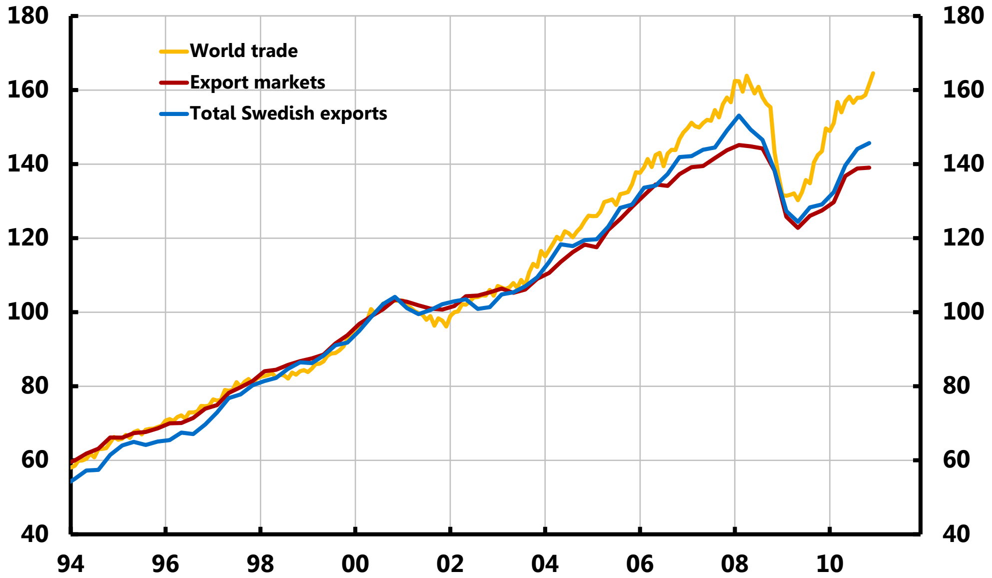
Per cent



Sources: ECB, Federal Reserve and the Riksbank.

Slide 4. Volume of world trade, export markets and Swedish exports

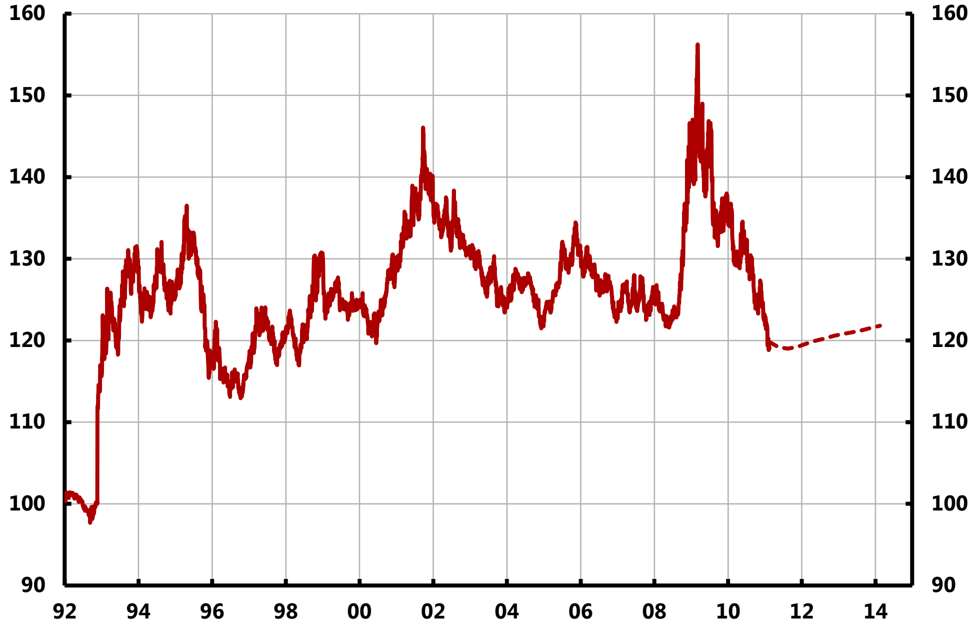
Index 2000 = 100, seasonally adjusted data



Sources: Netherlands Bureau of Economic Analysis, Statistics Sweden and the Riksbank.

Slide 5. TCW exchange rate

Index, 18 November 1992 = 100

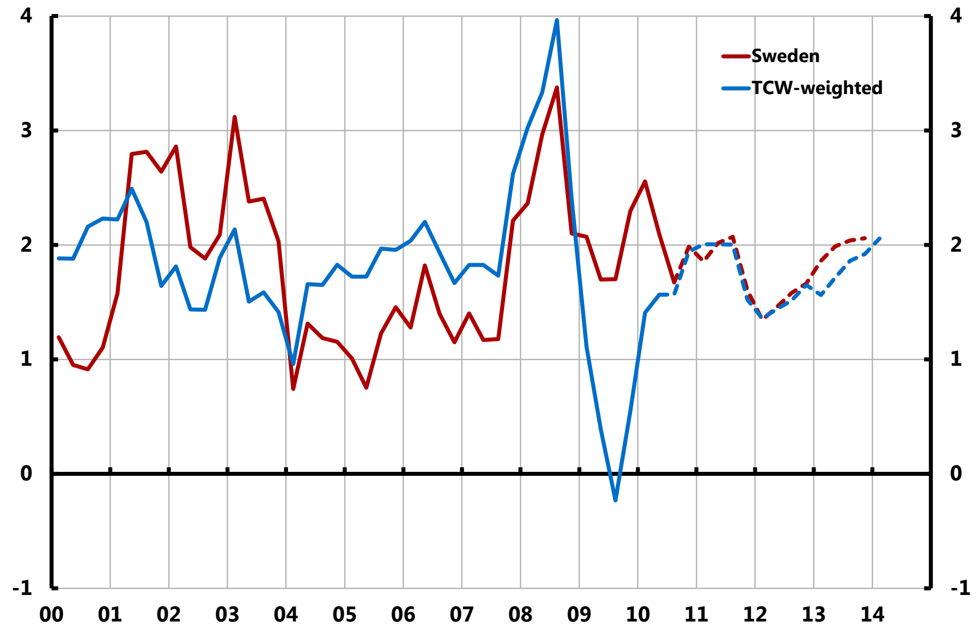


Note. Outcomes represent daily rates and forecasts refer to quarterly averages. The broken line represents the Riksbank's forecast.

Source: The Riksbank

Slide 6. Consumer prices in Sweden and abroad

Annual percentage change, seasonally adjusted data

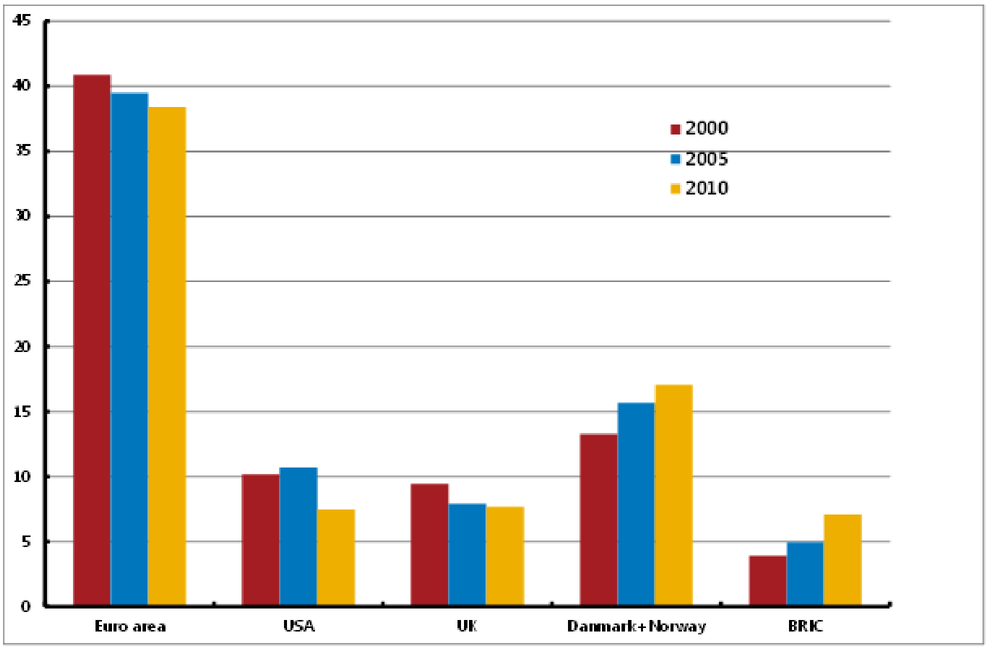


Note. Swedish data refers to CPIF inflation. TCW-weighted international data refers to CPI or HICP. The broken lines represent the Riksbank's forecast.

Sources: National sources and the Riksbank

Slide 7. Percentage of Sweden's total exports of goods to various countries and regions

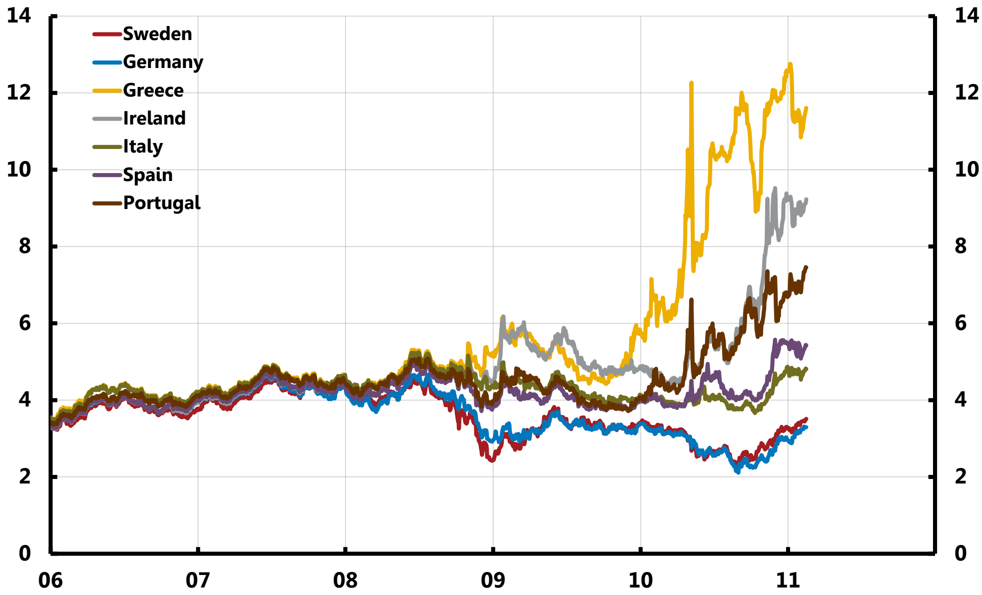
Per cent



Note. These figures do not total 100 per cent, as not all countries have been included.
Source: Statistics Sweden

Slide 8. Government bond rates in Sweden and various euro area countries

10-year maturity, per cent



Source: Reuters Ecowin.

Slide 9. Unemployment in Sweden

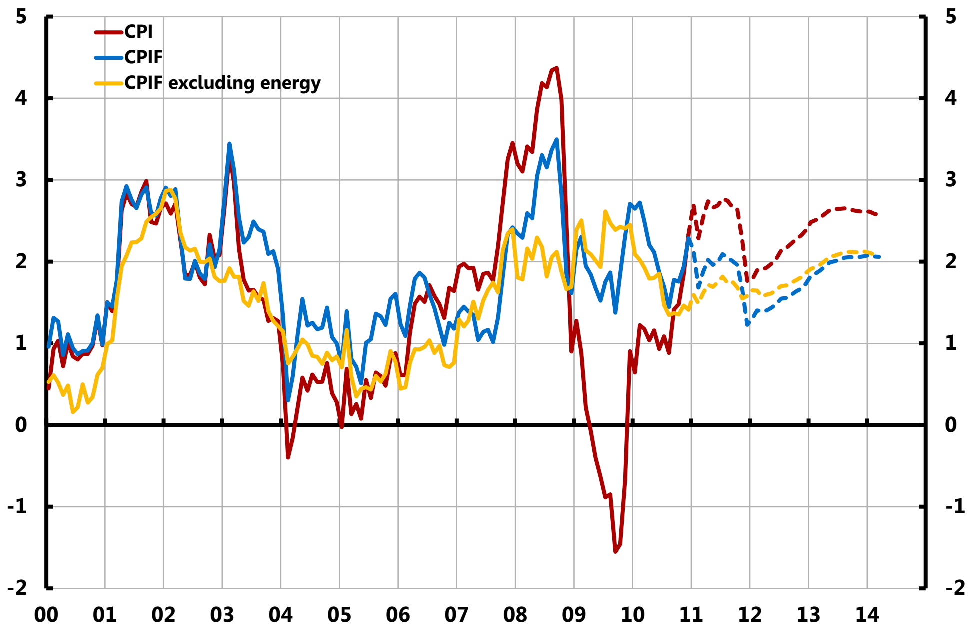
Percentage of the labour force, seasonally-adjusted data

Note. Pre-1993 data has been spliced by the Riksbank. The broken line represents the Riksbank's forecast, 15–74 years.

Sources: Statistics Sweden and the Riksbank

Slide 10. CPI, CPIF and CPIF excluding energy

Annual percentage change

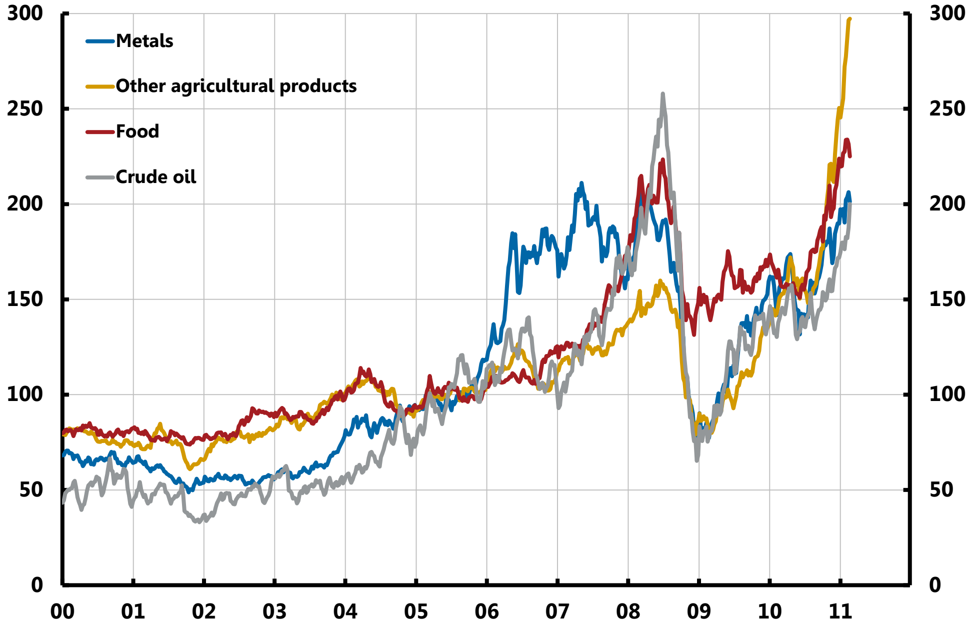


Note. The CPIF is the CPI with a fixed mortgage rate. The broken lines represent the Riksbank's forecast.

Sources: Statistics Sweden and the Riksbank

Slide 11. Commodity prices

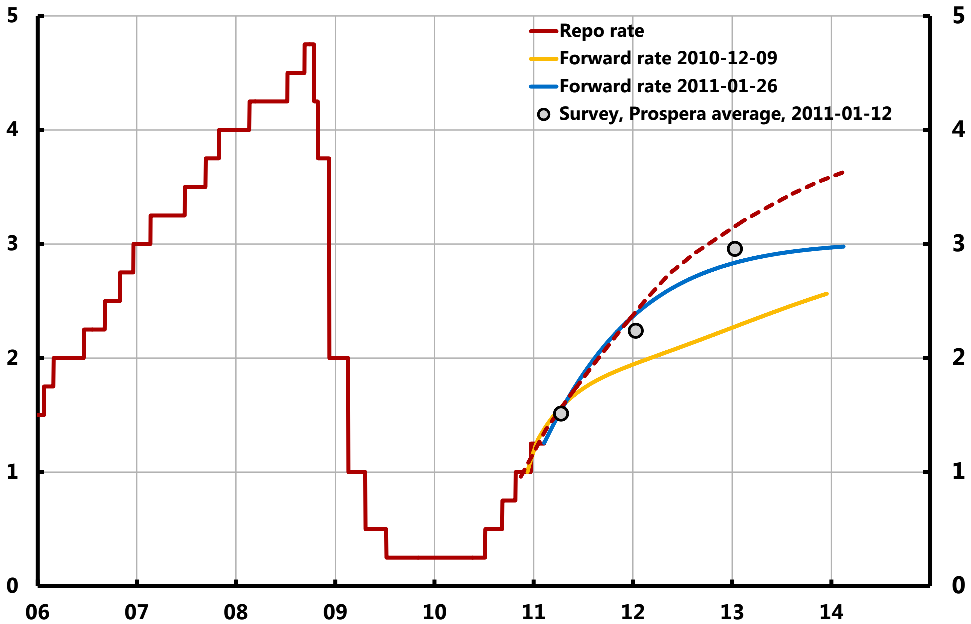
Index 2005 =100, USD



Source: The Economist and Intercontinental Exchange.

Slide 12. The Riksbank's repo-rate forecast and monetary policy expectations in Sweden

Per cent



Note. Forward rates have been adjusted for risk premiums and describe the expected overnight rate. The broken line represents the Riksbank's forecast.

Sources: Reuters EcoWin, TNS SIFO Prospera and the Riksbank