SPEECH

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International dependence and monetary policy*

Sweden is a small, open economy with extensive foreign trade and a financial market that is well integrated with international markets. This makes the Swedish economy highly dependent on international economic developments. So, what does the fact that we appear to be facing a slowdown in economic activity abroad mean to the Swedish economy? The recovery of the US economy is sluggish and the problems relating to weak public finances in the euro area have increased uncertainty about developments in Europe. How does this affect Swedish monetary policy? Today, I intend to present my views on these issues on the basis of the stance I took at the latest monetary policy meeting in September.

My views can be summed up in the following four points:

- As a result of the weak public finances in the United States and several countries in Europe many other countries are expected to launch extensive austerity programmes and this can be expected to slow down growth in the period ahead. Growth will also slow down due to the recent financial turmoil.
- A lower rate of growth in Europe and the United States will slow down growth in Sweden too, as these regions constitute such important export markets for Swedish companies. This is one reason why monetary policy in Sweden was made more expansionary September.
- We can expect monetary policy to remain expansionary in the United States, the euro area and the United Kingdom as it may be necessary to compensate for the fact that several countries will need to implement fiscal policy tightening in a relatively weak economic climate.
- In my view, expectations that monetary policy will continue to be expansionary in the United States, the euro area and the United Kingdom have also had an expansionary effect on Swedish monetary policy. When the repo-rate was set in September, I supported the decision to leave the repo rate unchanged and advocated a larger downward adjustment of the repo-rate path than the majority. One of the important factors behind this stance was my view that Swedish interest rates can-

* The views expressed in this speech are my own and are not necessarily shared by the other members of the Executive Board of the Riksbank I would like to thank Magnus Wiberg for all his help with writing this speech.

not deviate too much from foreign rates without affecting the exchange rate, and the exchange rate is of great importance to inflation.

Slowdown in economic activity abroad

During the summer the financial markets have been characterised by considerable turbulence as a result of the sovereign debt problems in the euro area and the United States. In the euro area, it is above all the state of central government finances in Greece that has been in focus in the media, but other euro countries such as Portugal, Ireland Italy and Spain have also suffered debt problems.

The situation in the euro area has made the situation in parts of the European banking sector increasingly strained. For example, a number of banks, above all those that are highly exposed to the countries with weak public finances, have suffered a shortage of liquidity and are finding it difficult to borrow money. There is concern that a collapse of these banks would lead to contagion effects in the international banking system. Uncertainty about the situation in parts of the banking system has led credit rating agencies to reduce the credit rating of a number of banks.

GDP growth in the United States was weak already during the first six months of 2011. The increases in corporate investment and in employment have been low – far too low to reduce unemployment by more than a percentage point or so. Household consumption has also been weak. This is because a high level of debt in combination with falling asset prices has reduced the net wealth of the households and they are now trying to counter this by reducing their debts. The continued weak development of the US housing market is also a factor that is holding back an improvement in the net wealth of the households.

As in parts of Europe, the United States is experiencing a major budget deficit and a growing national debt. In May this year, the US national debt reached the so-called debt ceiling, which limits how much the United States is allowed to borrow. This meant there was a risk that government grants and everything from salaries for government employees to interest payments on the national debt could not be paid. As the United States is the largest borrower in the world this led to a lot of unease on the financial markets. Reaching agreement on how to deal with this was made more difficult due to the political divisions between the Republicans and the Democrats. An agreement to raise the debt ceiling and reduce the federal deficit was actually reached at the end of June, but the strongly politicised process prior to the agreement and the fact that it was reached so late has created doubt about the United States' ability to handle its national debt.

The increasing concern about economic problems around the world is dampening the prospects for global growth. At the same time, the pressure that that is being put on the euro countries with weak public finances means that more countries in the euro area can be expected to tighten fiscal policy even further than was previously assumed. This applies not only to relatively small economies like Greece, Portugal and Ireland but also to larger economies such as Spain and Italy, and perhaps France too. We can expect the tightening measures to have a restraining effect on growth over the next few years.[1] In a

[1] According to the theory of expansionary fiscal contractions, an extensive budget consolidation programme can have a positive effect on growth. This can happen if the households expect a permanently lower level of

situation where it seems that growth is anyway slowing down this is of course unfortunate. Nevertheless, tightening measures are necessary to reduce concern and increase confidence on the financial markets.

However, not everything is gloomy in the global economy. It is expected that growth in Asia and Latin America will remain high, even though it may be dampened by the slowdown in the United States and Europe. It is difficult to assess exactly how much the emerging economies in Asia and Latin America will be affected by the slowdown in the western world. This depends in part on to what extent they manage to reduce their dependence on exports to maintain a high rate of growth. A major challenge for many of these countries is to move from primarily export-driven growth to growth driven more by domestic consumption.

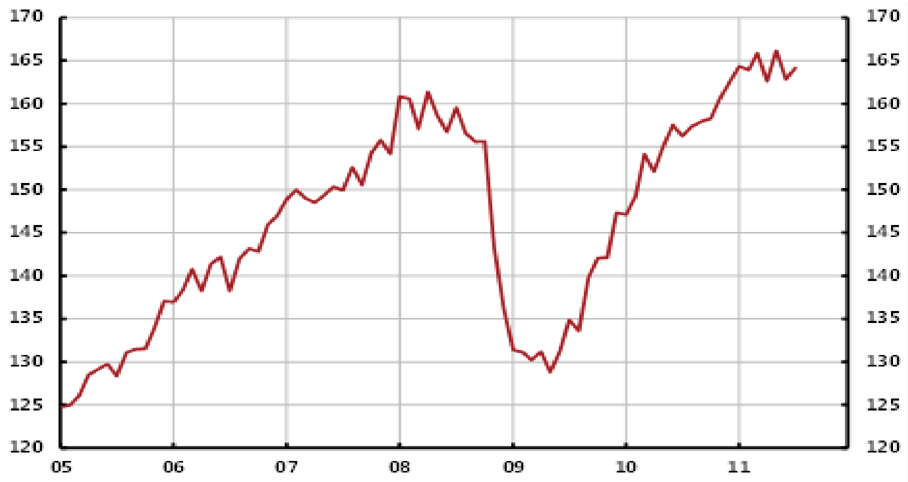
How does this affect the Swedish economy?

How do these economic developments affect resource utilisation and inflation in a small open economy like Sweden? Their impact will be through two main channels: through trade links with the rest of the world, that is via imports and exports of goods and services, and through the globally-integrated financial markets. Let me begin by discussing the role of the trade channel.

Trade links

When a slowdown hits major economies like the United States and Europe it leads to a reduction in world trade as a whole.

Figure 1. Development of world trade
Index, 2000=100



Note. The index series is calculated on the basis of global import and export volumes.

Source: CBP Netherlands Bureau for Economic Policy Analysis

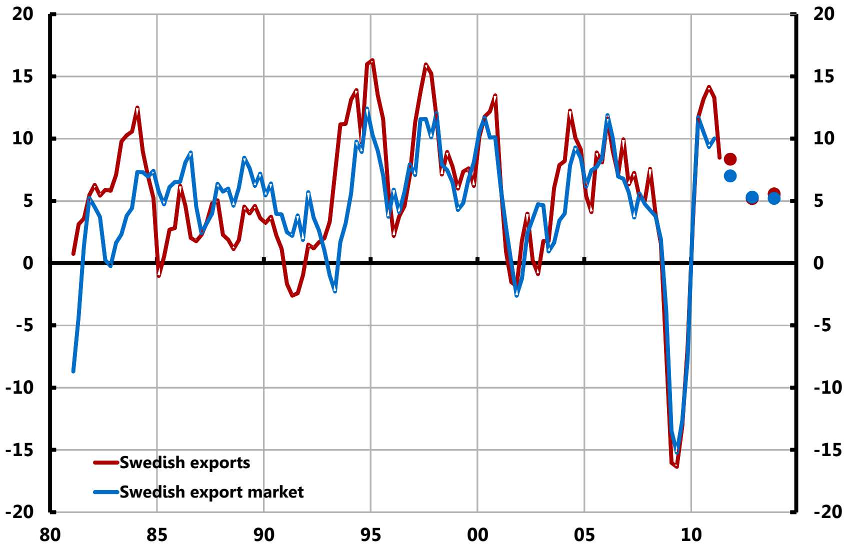
public expenditure in the future and thus also a lower level of taxation. In such a situation, budget consolidation would lead to an increase in private consumption and production. How applicable this hypothesis is to the current situation in the United States and Europe is being widely discussed by economists at the moment. My assessment is that it is more likely that the expected cutbacks will have a negative impact on growth.

Figure 1 shows that world trade has developed relatively weakly in 2011, which has had a negative effect on Swedish exports.

A fall in demand on large markets has both direct and indirect effects on Swedish exports. Let's look, for example, at the trade links between Sweden and the United States. A slowdown in the US economy spreads directly to Sweden in the form of reduced demand for Swedish exports. There is also an indirect effect in the sense that a slowdown in the United States leads to a reduced demand for goods and services from, for example, Asia. Countries in Asia in turn import intermediate goods from, for example, Sweden. Sweden is thus exposed not only to the direct effect but also to indirect so-called third country effects because the downturn in the United States affects Asia and other parts of the world.

When we at the Riksbank produces forecasts for Swedish exports we take into account both direct and indirect effects. The forecasts are based on growth on the Swedish export market and take into account the growth in imports in the recipient countries as well as how much Sweden exports to the respective countries. The latest forecast for Swedish exports and the growth of the Swedish export market is shown in Figure 2.

Figure 2. Swedish exports and the Swedish export market
Annual percentage change



Note. The dots represent the Riksbank's forecast for the whole year.

Sources: Statistics Sweden and the Riksbank

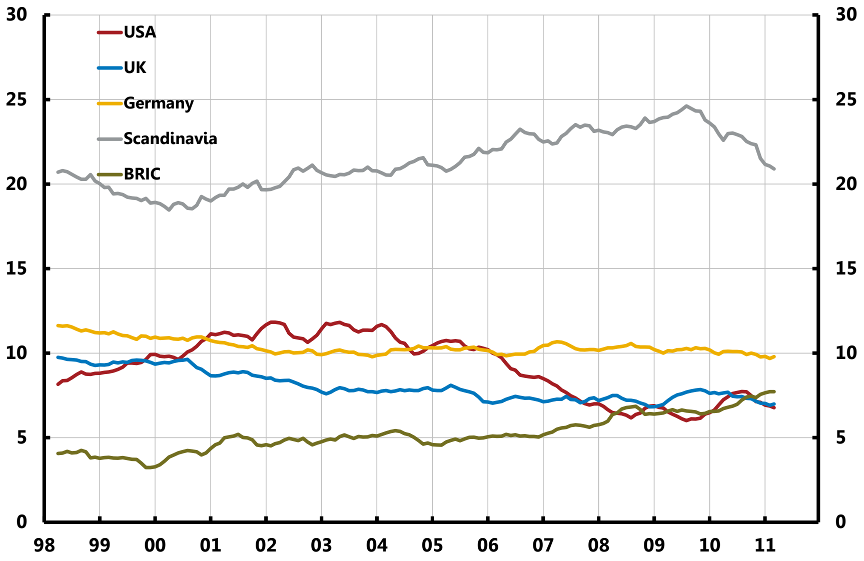
Swedish exports grew rapidly in 2010 and during the early part of this year, but already in the July Monetary Policy Report it was stated that growth was expected to enter a calmer phase. Since then, demand abroad has weakened which, in combination with the recent international financial turbulence, led us in September to believe that exports would grow even more slowly than previously calculated. This is because Swedish exports consist to a large extent of investment goods and in times of unrest companies in Sweden as well as abroad often choose to postpone their investments, which has a negative impact on Swedish exports.

The composition of Swedish exports is changing

The forecast for the growth of the export market is calculated on the basis of current trading patterns (see Figure 2). At present, the predominant component of Swedish exports relates to trade with Germany and our Scandinavian neighbours. Together these countries account for approximately one third of Swedish exports (see Figure 3).

Figure 3. Swedish exports per recipient country

Percentage of total Swedish exports



Source: Statistics Sweden

The United Kingdom and the United States are also important export markets for Sweden. They each account for 7 to 8 per cent of Swedish exports. However, their importance has declined over time. Statistics from Statistics Sweden for the first half of 2011 show that Swedish exports to China, India and Russia are together now as large as exports to the United States. If Brazil is included in this group of countries then exports to the so-called BRIC countries exceed exports to the United States and also those to the United Kingdom. The rate of increase in trade with the BRIC countries has been high recently. While exports to the BRIC countries have increased by 150 per cent since 2002, exports to the United States have fallen by 17 per cent in the same period.[2]

This change in the relative significance of different export markets at the macro level is confirmed by micro data. In the company interviews conducted by the Riksbank, the Swedish export companies report that sales are falling in parts of Europe compared with China and Brazil.[3]

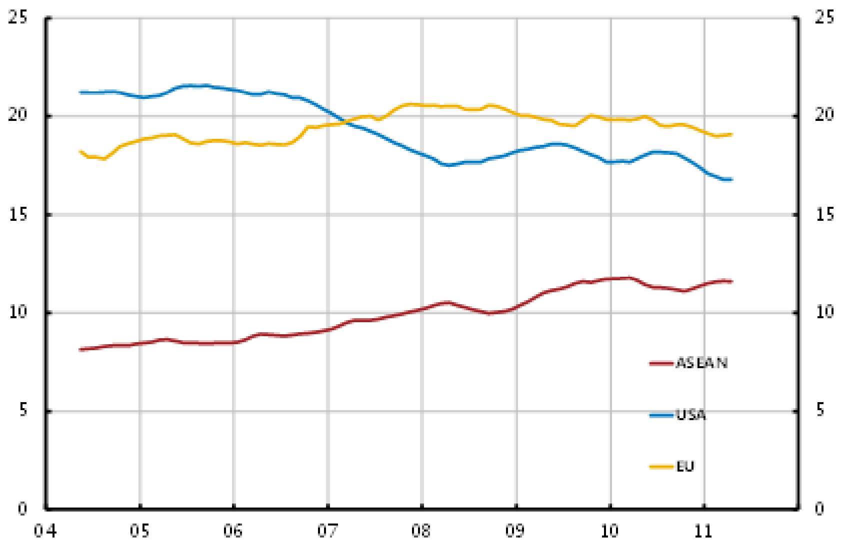
Increased intra-regional trade in Asia

The increased importance of the BRIC countries to Swedish exports is a natural consequence of the fact that these countries now constitute a larger part of the global economy. The extent to which the slowdown in Europe and the United

[2] This applies to the value of exports in nominal terms.
[3] The Riksbank's company interviews, September 2011

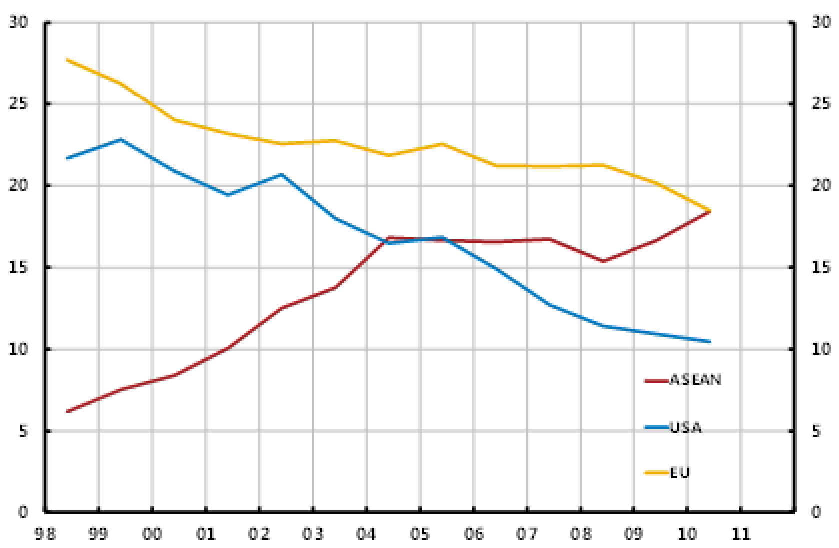
States spreads to the emerging economies in the United States and Europe will be a major factor in determining the course of development in the period ahead. One factor that indicates growth could continue to be high in these countries is that intra-regional trade has increased in Asia and the continent is therefore less exposed to negative direct and indirect trade effects from countries outside Asia. This is illustrated in Figures 4 and 5, which show how exports from China and India have developed per trading partner.

Figure 4. Chinese exports
Percentage of total Chinese exports, ASEAN includes India



Source: National Bureau of Statistics of China

Figure 5. Indian exports
Percentage of total Indian exports, ASEAN includes China



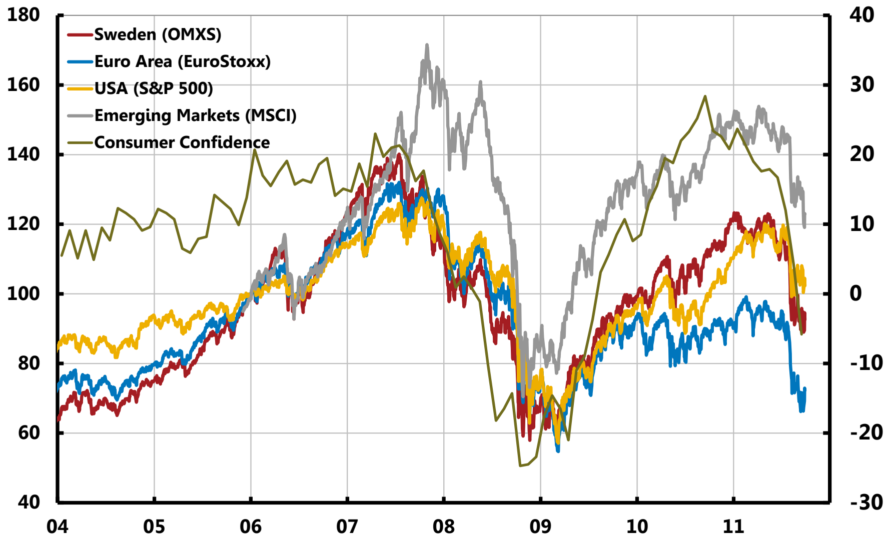
Source: Ministry of Commerce and Industry, India

As the figures show, an increasing proportion of China's and India's exports are going to countries in the rest of Asia and exports to the United States have declined in importance. China and India are thus somewhat less sensitive than previously to weaker demand in the European Union and the United States. However, it is clear that the European Union is still the most important export market for these countries, which means that weak economic development in Europe will have significant consequences for growth prospects in China and India too. So, even if increased trade with the more rapidly growing markets in the BRIC countries may boost Sweden's export industry somewhat, we can also expect negative third-country effects from a slowdown in the United States and the euro area.

Financial channels

However, it is not only through trade that Sweden is affected by weaker economic development abroad. We are also affected through the financial markets. These markets have become increasingly interlinked, which is illustrated not least by the recent turbulence on the stock market.

Figure 6. Share indexes and Swedish consumer confidence in the economy
The stock market index January 2006=100



Note. The left axis is the stock market index and the right axis the value of the households' confidence indicator.

Sources: Reuters Ecowin and the National Institute of Economic Research

As Figure 6 shows, share prices on the various stock markets are highly correlated. Share prices have fallen on the stock markets of the world recently. However, the fall has been particularly substantial on Stockholmsbörsen, which has fallen by 21 per cent since the turn of the year, while the Dow jones index and S&P 500 index have fallen by 1 and 4 per cent respectively. The Swedish households' holdings in shares in companies listed on Swedish market places have increased by over 475 per cent since the early 1990s.[4] This means that the fall in share prices entails a reduction in wealth, which has a certain restraining effect on Swedish household consumption. This in turn has an impact on growth and employment as household consumption, adjusted for its import content, constitutes around 35 per cent of GDP in Sweden. For Swedish companies, falling share prices in Sweden and abroad thus have negative effects on

[4] This relates to an increase from over SEK 100 billion to over SEK 577 billion (Statistics Sweden, 2011).

both domestic and foreign sales. Falling share prices also make it more difficult to fund investments by issuing new shares, which reduces capacity utilisation.

Households' and companies' expectations of the future

It is assumed that movements on the stock markets reflect the market participants' expectations regarding profits in the future. The development of the stock exchange is therefore related to the prevailing economic climate and to the households' and companies' expectations regarding the development of the economy. Research indicates that a fall on the stock market affects household confidence relatively quickly, that is already after two to four weeks.[5] The indicator of Swedish consumer confidence in the economy published by the National Institute for Economic Research tends to fall when the Stockholm stock exchange falls (see Figure 6). There may therefore be good reasons for believing that the recent falls on the stock markets of the world are one of the reasons why the Swedish households have become more cautious and are expected to increasing their saving. Financial turbulence has also led the companies to lower their expectations regarding the period ahead and to begin to postpone investments. All in all this has a dampening effect on economic activity in Sweden.

High sovereign debts abroad affect Sweden

As we have noted, the level of debt is high in the euro area and the United States. Following many years of budget deficit, what were in many cases already weak public finances were further undermined in connection with the financial crisis of 2008-2009. In 2009, the average budget deficit in the euro area amounted to 6.4 per cent of GDP. This figure fell to 6 per cent in 2010 and is expected to be 4.4 per cent in 2011. The average sovereign debt in the euro area increased from 79.7 per cent of GDP in 2009 to 85.8 per cent in 2010, and is expected to increase to 88.6 per cent in 2011.

Table 1. Budget deficit and sovereign debt in the euro area
(Percentage of GDP)

	Budget deficit	Sovereign debt
2009	6.4	79.7
2010	6	85.8
2011	4.4	88.6

Source: IMF Fiscal Monitor

The budget deficit in the United States is expected to reach 10.8 per cent of GDP this year, while the United States' gross debt currently exceeds 100 per cent of GDP. In the summer, this situation, in combination with what appeared to be a political inability to deal with the problem of public finances, led the credit rating agency Standard & Poor's to reduce the credit rating of the United States for the first time in 70 years.

[5] See for example Jansen and Nahuis, 2003; Kremer and Westerman, 2004; and Beckmann, Belke and Kuhl, 2011.

The main reason for the increase in the level of debt is that GDP growth decreased and unemployment increased in connection with the crisis in 2008-2009. Public finances are automatically weakened when GDP growth is low in developed countries as tax revenues then decrease and expenditure for transfers increases. Some countries, such as the United States and Ireland, also implemented extensive and costly government measures to support the financial sector.

If countries with large deficits fail to manage their sovereign debt problems in a credible way there is a risk that they will find it difficult to borrow on the capital markets. They may then be forced to make faster and more extensive cuts than is economically desirable in the short term**.** However, the consolidation of public finances is necessary and may lay the foundations for better economic development in the longer term.

Normally, fiscal policy tightening leads to a slowdown in economic activity. In some cases tightening measures may actually stimulate activity if they lead the households to become more optimistic about the development of their net incomes.[6] However, this does not seem to be the case normally. According to an IMF study, fiscal policy tightening (in the form of a combination of reduced public expenditure and higher taxes) equivalent to 1 per cent of GDP leads GDP to fall by 0.5 per cent two years ahead, and unemployment to increase by 0.3 percentage points.[7] The budget consolidation programme carried out in Sweden in the 1990s could be regarded as an example of stimulating fiscal policy tightening as the Swedish economy recovered relatively quickly following the crisis of the 1990s. However, Michael Bergman of Copenhagen University has shown that budget consolidation in Sweden between 1994 and 1997 actually had a negative impact on GDP and consumption and also led to an increase in unemployment.[8] Given this it is reasonable to expect that cuts in the euro area and the United States will lead to reduced demand on export markets that are important to Sweden, and to lower resource utilisation.

Risk of an impact on the exchange rate

The fact that countries with weak public finances may be forced to implement fiscal tightening in what appears to be a weak economic climate has consequences for monetary policy. We can expect more central banks abroad to conduct an expansionary monetary policy in order to counteract the dampening effect of fiscal tightening on demand. However, as policy rates in many countries are already close to zero there is limited scope for further policy-rate cuts. Many central banks are instead expected to leave their policy rates unchanged for some time to come. Low policy rates can also be combined with unconventional measures designed to push down long-term interest rates.[9]

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[6] According to the theory of Ricardian equivalence, or the theory of the stimulating effects of fiscal policy tightening, it is assumed that people understand that a budget deficit must sooner or later be funded by higher taxes or lower public expenditure. They are thus expected to react to increased budget deficits by increasing their own savings. This means that consumption will not increase as much and that an expansionary fiscal policy will have little or no effect (see for example Barro and Redlick, 2011).
[7] IMF, World Economic Outlook, October 2010.
[8] Bergman, 2010.
[9] Central banks can conduct quantitative easing, which entails buying assets with the aim of reducing long interest rates. They can also carry out a twist, as recently announced by the Federal Reserve, which entails selling securities with short maturities and buying securities with long securities in order to push down longer interest rates.

■ If the market expects the policy rate in Sweden to be significantly higher than policy rates abroad, this can lead to an increase in the demand for assets in kronor as a higher Swedish rate, all else being equal, increases the return on investments in Swedish currency. This normally contributes to a strengthening of the krona exchange rate in the short term. A stronger krona slows down any increase in import prices. For the Riksbank, which conducts an inflation targeting policy, this could be positive if inflation was high in the initial position. However, as underlying inflation is currently low, I have argued that a strengthening of the krona would, if anything, have a negative effect. Moreover, a stronger krona has a negative effect on net exports as it means that goods and services produced in Sweden become relatively more expensive. This in turn has a negative effect on GDP growth and resource utilisation.

As I see it there are two reasons why recent developments abroad contributed to the decision to leave the repo rate unchanged and to revise the repo-rate path downwards at the latest monetary policy meeting. The first is that weaker growth abroad has a negative impact on growth in Sweden too and this needs to be countered by providing a stronger monetary policy stimulus. The second is that expectations that monetary policy will remain expansionary in large economies like the Unites States and the euro area, for a longer period than was previously assumed, also have an effect on Swedish monetary policy. Swedish interest rates cannot deviate too much from foreign interest rates without this having an effect on the exchange rate. The exchange rate is of great importance to both inflation and resource utilisation and thus influences what constitutes a well-balanced monetary policy.

What then will be the overall effect for Sweden?

We were able to note in September that the demand for Swedish exports was growing more slowly than previously expected due to the weaker development of the export markets of importance to Sweden. This weaker development is partly due to the fact that market turbulence resulting from the uncertainty about weak public finances in Europe and the United States is forcing some countries to launch extensive austerity programmes.

Falls on stock markets in Sweden and around the world have also reduced the financial wealth of the households. When wealth declines in Sweden and abroad, households reduce their consumption in order to compensate for the reduction in wealth, which also contributes to a fall in demand. In addition, the financial turbulence during the summer also increased pessimism among the households and companies. This pessimism has in itself had a dampening effect on consumption and investment.

The necessary consolidation of public finances in parts of the euro area and in the United States also means that we can expect monetary policy to continue to be expansionary in these parts of the world. In my view, this in itself has an effect on Swedish monetary policy. I believe that Swedish interest rates cannot deviate too much from foreign interest rates without the exchange rate being affected, and the exchange rate is of major importance in determining the ultimate level of inflation. A central bank that conducts inflation targeting is therefore, in my view, dependent on the monetary policy that is pursued internationally. This applies particularly to a small, open economy like the Swedish economy.

However, as always in situations where there is great uncertainty it is difficult to make forecasts about the future at the moment. Today I have presented how I reasoned ahead of the repo-rate decision that we made in September. Since then there has been a lot of manoeuvring around the management of the European sovereign debt crisis. However, I still have to decide how this will affect my stance at our next monetary policy meeting, which will be held at the end of this month.

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