Press Release

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The krona's equilibrium real exchange rate

Assertions that the krona is "overvalued" or "undervalued" are commonplace; to be meaningful, they must relate to a conception of the krona's real value in the longer run. Calculations based on various approaches indicate that the krona is undervalued. These excerpts are from an article, "The krona's equilibrium real exchange rate," by Annika Alexius and Hans Lindberg in the Riksbank's Quarterly Review, no. 1, 1996.

Compared with the level before the fixed exchange rate regime was abandoned in November 1992, the depreciation of the krona in the fourth quarter of 1995 amounted to 19 per cent. The real exchange rate, which measures prices and costs in one country relative to the level in competitor countries expressed in a common currency, has also depreciated. There are various ways of calculating the real exchange rate. Measured in terms of relative unit labour costs, the depreciation in the fourth quarter of 1995 amounts to 30 per cent and in terms of relative consumer prices to around 17 per cent.

A large part of the depreciation can no doubt be attributed to the problems of credibility that have beset Swedish economic policy in recent years. Since the summer of 1995, however, both the real economy and government finance have improved. This has enhanced confidence in the Swedish economy and the krona has strengthened. But there still seems to be uncertainty about the currency's long-term value. To some extent, this uncertainty stems from the difficulties in determining an equilibrium real exchange rate for the krona, that is, a level of the exchange rate that is associated with both internal and external balance. Internal balance implies full employment and price stability, while external balance requires that external debt is not growing unsustainably.

The equilibrium level of the real exchange rate can be calculated in various ways. The simplest theory, purchasing power parity, assumes that country differences in price movements are offset in the somewhat longer run by movements in the nominal exchange rates. From this it follows that the equilibrium real exchange rates are constant over time. For the krona, purchasing power parity gives an equilibrium real exchange rate, using TCWs, of 103 (index: 18 November 1992 = 100).

There are, however, a number of indications that Sweden's equilibrium real exchange rate has weakened since the 1960s. This warrants a search for factors that may have contributed to this tendency, so that they can be allowed for in the calculation of the equilibrium rate. Probable factors in this respect are poorer terms of trade, weak GDP and productivity growth, and the accumulation of external debt. When allowance is made for the historical development of these factors, the equilibrium exchange rate is judged to be in the interval 109 - 118, with the emphasis on the lower half.

At the same time, such an assessment disregards certain factors that affect the economy in the longer run. Sweden's external debt is historically high at present and will presumably be reduced, which in time would strengthen the real exchange rate. Moreover, conditions for the Swedish economy's development and growth may well have improved. Under these circumstances the development of the real exchange rate could be more favourable than in recent decades. All in all, the krona is therefore judged to be undervalued.

Other articles in the latest issue of the Review are "The management of the bank crisis - in retrospect" by Stefan Ingves and Göran Lind, "Sharp swings in international capital flows" by Fredrika Röckert and Karin Stillerud, "Swedish derivatives market dominated by a few agents" by Antti Koivisto and Marianne Wolfbrandt, and "Payment system risks particularly associated with foreign exchange trading" by Hans Bäckström.

Copies of the Swedish edition of the Quarterly Review are obtainable at the Riksbank's staff entrance on Malmskillnadsgatan. They can also be ordered from the Riksbank's Information Centre, Fax. no. +46 8-787 05 26, Phone no. +46 8-787 01 00. The English edition will be available in the near future.

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