THE INTEREST RATE
AND THE SWEDISH KRONA

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I should like to begin by expressing my thanks for the invitation to attend this meeting and talk about the Swedish economy.

Today I shall be speaking in the main about three things. First I intend to give a relatively detailed account of the reasons why the Riksbank lowered the repo rate a fortnight ago. That will also give you a picture of how we appraise the future outlook for inflation. Then I want to look somewhat more closely at a couple of features in future economic development that are of significance, among other things, for inflation. Finally I shall briefly consider events in the past week in currency and bond markets and their conceivable implications for monetary policy.

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Inflation in line with the target

The reason why we lowered the repo rate on the 9th of January is basically self-evident: We consider that the probability of inflation in line with the price stability target is good. The target, as you all know, is 2 per cent (with a tolerance interval of ± 1 percentage point). It is the conditions for attaining this target which guide our actions.

In various contexts the Riksbank has pointed out that inflation is determined by the state of demand and supply in the economy and by inflation expectations. In both these respects a central part is played by the krona. It affects demand, for example in the sector exposed to foreign competition, and it serves as an indicator of inflation expectations. That makes it instructive to conduct the discussion in terms of three factors: demand and supply conditions, expectations and the krona.

The importance of these three factors for monetary policy can vary over time. In general, the more that low inflation has been established in a country, the greater is the freedom of action in monetary policy. More specifically, the Bundesbank and, nowadays, the Federal Reserve can, if they wish, pay more consideration to, say, the picture of economic activity than can a central bank in a country where inflation has recently been brought down. They are able to do so because virtually no one suspects that they will relax their hold on price development.

Now for a short look at the arguments behind the repo rate cut, beginning with demand and supply.

Weaker economic activity

International economic activity has weakened during the autumn, particularly in Europe.

Growth in Sweden has also fallen back. From the second to the third quarter of 1995 GDP rose 0.3 per cent, which corresponds to an annual rate of 1.2 per cent, whereas the increase from the third quarter of 1994 amounted to 4.4 per cent.

The sector that has expanded fastest is manufacturing. Here the situation has changed. Industrial production and the inflow of orders both seem to have peaked last June. Since then, industrial production has been unchanged but the order inflow has fallen (Diagram 1). This weaker picture is confirmed by the business tendency survey from the National Institute of Economic Research.

During the autumn it also became gradually clearer that the relationship for 1995 between growth and inflation in the Swedish economy would be better than expected. The forecasts from the autumn of 1994 had generally pointed to growth around 2 per cent accompanied by 3-4 per cent inflation. Although growth now appears to have reached 3.5 to 4 per cent, inflation stopped inside the tolerance interval, that is, below 3 per cent.

Lower expected inflation

Also as regards expected inflation, information from the latter part of the autumn provides grounds for greater optimism.

Allow me to give you a couple of examples:

- Households in December expected that inflation in 1996 would be 2.5 per cent. That was 0.2 percentage points lower than they had foreseen in November.

- Financial market agents, according to the November survey from Aragon, predicted that in the next two years the annual rate of inflation would be 2.8 per cent. That was 0.6 percentage points lower than in the previous survey, in August 1995. It was also 0.2 percentage points below the October figure from Prospera.

- Bond rates show a similar development. From a high of more than 450 basis points, the differential with the German 10-year bond rate had narrowed at the time of the repo rate cut to just over 230 basis points (Diagram 2).

- The exchange rate supports this picture. Since the end of May, the Swedish krona had appreciated by 14 per cent.

It may be worth underscoring, however, that, as measured when the repo rate was lowered, inflation expectations were still not at or below 2 per cent. But we saw reasons for believing in a further change in the picture of expectations in the right direction.

Stronger krona

The krona had thus become markedly stronger (Diagram 3). At the time of the cut in the repo rate its appreciation compared with the level on which our November inflation report had been based amounted to a couple of percentage points. As you know, it continued to strengthen after that but has recently swung back, both as a consequence of factors in the international currency market and due to specifically Swedish circumstances, to which I shall be returning.

The signs of slackening growth in manufacturing last autumn presumably stemmed to a limited extent from the krona's appreciation. But it is probable that such an impact will now materialise by degrees. The risk of inflationary tendencies in manufacturing - and of inflation spreading from there - has thereby decreased. Our assessments of wage drift have also been adjusted downwards and I understand that others have done the same.

The krona's appreciation lies behind a major part of the clear decrease we have seen in producer prices (Diagram 4). Import prices are now rising by about 2 per cent, compared with the earlier high around 10 per cent. This has had and, if the krona is strong, it will continue to have an increasingly large impact on the development of consumer prices.

So much concerning our arguments for lowering the repo rate. Our decision gave rise to a lively debate and I shall refrain from commenting on all its aspects. Let me confine myself to perhaps the most common opinion - that our cut came too late.

In the latter part of last autumn appraisals of the Swedish economy changed abruptly. Forecasts of both growth and inflation were revised downwards. The fact remains, however, that as recently as in November very few observers counted on inflation in Sweden being below 2.5 per cent in either 1996 or 1997 (Table 1). Most forecasters, some of them also lively advocates of an interest rate cut, accordingly did not envisage that the inflation target would be met.

Although the picture of inflation improved during the autumn, our assessment resembled that of other observers. But we neither did, nor do we, think of moving our sights from the target. The lowering of the repo rate accordingly indicates some revision in our assessment of economic activity and inflation.

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When we cut the repo rate we indicated that we saw a possibility of some recovery in growth in the latter part of this year. This is a matter that has attracted some attention since then and of course it is also highly pertinent for developments on the stock exchange. Let me therefore move on to my next point and discuss some features of economic activity and its development that have a bearing on future inflation.

Slowdown in Europe

Gloomy economic predictions are having a field-day at present. Glad tidings from almost everyone early in the autumn have given way to an increasingly black outlook.

I shall begin by commenting on the picture of activity in Europe.

- Last year's downturn might be explained by the *exchange rate turbulence* that prevailed during 1994 in particular but also in the spring of 1995. Among other things it entailed a considerable appreciation of the Deutschemark bloc in relation to the dollar area (America and Asia apart from Japan).

- Another explanation concerns *interest rates*. As we all recall, in the spring of 1994 bond rates in Europe were driven up by rising bond rates in the United States even though the economic recovery in continental Europe was still in its infancy (Diagram 5). Traditional wisdom has it that an appreciable dampening effect from this on activity in Europe would not be unreasonable about a year later, that is, at the present time. Since then and particularly during 1995, however, both money and bond rates have become markedly lower and in time this will affect activity in the opposite direction.

- A recovery in the near future is also favoured by the comparatively good *profit levels* that still prevail in European business. On the whole, moreover, *household balance sheets* are in a good state. Neither of these situations usually heralds an economic downturn. Nor is there any need for monetary tightening because in most places *inflation* remains low.

- Finally there is reason to mention the *stocks cycle*. This contributed to the slowdown in growth last autumn even though final demand in Europe stayed more or less on course (Diagram 6). In time, the destocking should become less marked.

These arguments should not be pushed too far. Of course one cannot rule out a continued slowdown in Europe. That there may be a certain probability of this is evident not least from the better picture of inflation and the interest rate cuts that were implemented towards the end of last year. But such an outcome is not certain.

As regards Japan there is cause for some optimism. The forecasts in this respect are being revised upwards. Those for the United States, on the other hand, seem to be fairly stable (Diagram 7).

Recovery of consumption in Sweden?

The question of consumption in Sweden is somewhat different. Here there has been no marked upswing such as that in international activity in the period 1994-95. Neither are there any clear signs of a recent fall. It is rather a matter of whether the cautious recovery in the past couple of years will be broken.

Consumption is basically fairly stable. In the absence of anything that radically alters households' perceptions of future income, consumption tends to plod along (Diagram 8). Annual fluctuations in income appear to be largely accommodated with savings.

It is probable that the development of *income* this year and in 1997 will be better than last year even though fiscal policy is still making inroads (about 3.5 per cent of household income is being withdrawn this year compared with 5 per cent in 1995). The decent development of income this year and next reflects comparatively rapid wage increases combined with curbed inflation.

So what about *savings*? In recent years that has been the jackpot question in every economic assessment. There are certainly arguments for a level of saving that remains relatively high historically (uncertainty about government finance and social security systems, the new tax system, high unemployment, etc.). But there are also grounds for some reduction of savings in the coming years.

- Household balance sheets are now relatively sound. The debt ratio for the average household has fallen appreciably (Diagram 9). The picture is somewhat worse in terms of, for instance, interest expenditure after tax but even this situation is considerably better than at the beginning of this decade.

- Interest rates have fallen markedly. This is particularly true of bond rates, which are highly important for households (about 2/3rds of loans have fixed interest rates). In the past, economic assessments by households have shown a strong covariation with bond rates. Today, households are also more optimistic than they were towards the end of 1994 and early in 1995, although there has recently been an increased element of pessimism.

Risks also exist. If developments were to be considerably worse in various respects - in Sweden and/or abroad - and this results in lower employment, consumption will be affected too. My conclusion even so is that the jet-black pessimism which has spread recently in this field is a little difficult to understand.

Decreased inflation propensity

Allow me to conclude the discussion of demand and supply conditions with a brief comment on yet another aspect - the notion that the economy has become less inflation-prone.

One indication of this that I mentioned earlier is the picture at the macro level. Even though growth was considerably higher than most forecasters had predicted, inflation was lower.

The standard explanation for this is the weak development of consumption, which prevented retailers from increasing their prices. Against this it can be argued that even last year's growth of consumption exceeded most predictions. So erroneous assumptions about consumption do not explain why inflation forecasts were on the high side.

The latter naturally does not mean that a larger increase in consumption would not have effects on prices. But we do not know the magnitude of the accumulated need - in terms of costs - for price increases. Productivity gains have been extensive, not just in manufacturing but in trade as well

(Diagram 10). The structure of trade is also undergoing considerable changes. If import and producer prices now fall back, perhaps profit margins can be maintained even with limited price increases.

Another aspect of this picture is the changes in the competitive situation in the Swedish economy. The construction sector, one of the major generators of inflation in the 1980s, has undergone radical changes. Import penetration has increased in other parts of the economy. There is also reason to hope for further positive effects, for example from membership of the EU.

Wage formation, however, remains troublesome. Despite the increased unemployment, wage increases were higher than in the rest of the world (Diagram 11). The effects of this on competitiveness and inflation have been limited to date by the growth of productivity but this development cannot go on for ever. In any event, the wage increases have restricted the room for manoeuvre in monetary policy and also lead to a weaker increase in employment.

To sum up, the assessment of demand and supply in the coming years poses a number of questions. As I see it they primarily concern activity in Europe, consumption in Sweden and the inflation propensity in our economy.

If the outcome in all or most of these respects were to point in the direction of lower inflation, then the probability of keeping to the inflation target should be good even if there is decent economic growth. As regards inflation, it is an advantage that the krona has strengthened. It is specifically the internationally-oriented sector which has displayed the clearest inflationary tendencies in recent years. More balanced growth implies less risk of inflation.

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In conclusion permit me to note that confidence in Swedish economic policy was enhanced in the second half of 1995. The risk of relapsing into the former inflation economy is perceived to have decreased. This implies a better possibility of sustained and balanced growth in the Swedish economy.

It does not, however, mean that the risks of a less favourable future development have disappeared. Nurturing confidence in economic policy must continue to have high priority. In the convergence programme, a mechanism is specified for the management of any recurrent problems with government finance. An improvement in wage formation is also important to prevent a reduction of unemployment from being hampered by accelerating wage increases. Lower wage increases would have provided more scope for interest rate policy.

In the past week market rates of interest have risen and the krona has weakened. There may be many different reasons why markets react as they do and this seems to have been the case on the present occasion. Experience shows that the fluctuations in financial markets sometimes may be exaggerated. Certain agents with a short-term horizon are prone to reap profits without delay. The future course of development will show whether the market sentiment has definitely changed or whether the interest rate increase and the krona's fall were temporary phenomena.

Still, last week's events are a reminder that a clear and consistent development towards sound government finance is highly important for confidence in the Swedish economy and thereby in time for growth and employment. The basis for sustained and stable growth and employment is sound government finances and price stability. This has been demonstrated not least by developments in the second half of 1995, when confidence in Sweden's economic policy rose appreciably.

For future monetary policy it is the overall assessment of the outlook for inflation which is decisive. This assessment is conditioned in turn by, for instance, the development of economic activity, inflation expectations and exchange rate movements. It is the course in the somewhat longer run that is important. Isolated figures or short-run movements in financial markets are therefore not decisive. Against this background, we have today eased monetary policy somewhat.