Speech

First Deputy Governor Lars Heikensten

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Inflation and the interest rate

Forum '99, Swedish Federation of Rental Property Owners

I should like to begin with a word of thanks for the invitation to talk here today about economic developments, inflation and the interest rate.

Before taking a look at the current economic situation and saying something about our deliberations in the Riksbank, however, I feel there may be grounds for adopting a somewhat broader perspective and even for striking a slightly optimistic note. Sweden certainly has economic problems; further measures are needed, not least, to improve the conditions for growth. But at times it may also be fitting to recall the things that have turned out well.

Swedish economic policy was realigned in the early 1990s with the aim of establishing a regime of low inflation. Previously, Sweden had had a long tradition in this respect but in the 1970s and 80s the accepted truths were discarded, including the idea that low inflation provides a good foundation for growth and employment. Following the collapse of the Bretton Woods system, stabilisation policy no longer offered any hard and fast rules. Sweden's external debt—both government debt and the total stock—was allowed to grow at a dramatic rate, accompanied by spiralling prices and wages.

Today, Sweden is in the sixth successive year of good economic growth. Growth since 1993 has averaged almost 3 per cent a year. The deep recession and good investment activity since then have meant that in this period there has been a supply of unutilised resources. As a result, inflation has remained low even though growth can have been somewhat above the level that can be regarded as sustainable. Moreover, Sweden has begun to repay external debt and government finances have recovered after the crisis in the wake of the 1980s bubble. In recent

Telephone +46 8 787 00 00
Telefax +46 8 21 05 31
E-mail registratorn@riksbank.se

years household earned income has been able to grow strongly in real terms, partly thanks to the low inflation.

Altered monetary policy process

The laws that regulate the Riksbank were amended with effect from the beginning of this year. Monetary policy's objective is now explicitly stated to be to maintain price stability. The Riksbank has a new Executive Board, consisting of six full-time members, that independently decides monetary policy issues.

The new Executive Board entails some changes in the work on monetary policy. The centre of attention is the Board's specific monetary policy meetings, which it is envisaged will be held 8 to 10 times a year. Decisions about the repo rate, for example, will normally be taken at those meetings. A brief account of the Board's decisions is to be presented in a communiqué the day after the meeting; a more detailed picture of the discussions will be available in the minutes of the meetings, which will be published with a time lag of 6–8 weeks. As before, the Riksbank will be publishing an inflation report four times a year, with a more comprehensive survey of inflationary pressure in the Swedish economy in the coming twenty-four months.

The Executive Board held its first monetary policy meeting last Thursday and discussed inflation prospects. The Board then decided to lower the repo rate 0.25 percentage points and also lowered the corridor in which the repo rate lies by 0.5 percentage points. The Board's decisions and the arguments behind them were published in a communiqué on Friday.

Another feature of the new Riksbank organisation is that each member of the Executive Board has an individual mandate and one vote. All the members are in a position to make speeches and give interviews on monetary policy in which they express their own view of the situation. It follows that the members can hold different opinions and may also express themselves somewhat differently about joint positions.

Today I shall base my remarks on the picture that was used for last week's Executive Board discussion and summarised in the communiqué. When I elaborate on the communiqué it is my personal opinion I am expressing, though that does not mean that other Board members were not of broadly the same mind.

Poorer international prospects

In the course of last year, international economic prospects became a good deal worse. At the beginning of 1998 it was assumed that a weaker international trend could be offset by other factors, of which one was the good domestic demand. At an early stage, actually when the Riksbank raised the interest rate in the late autumn of 1997, it was pointed out, however, that the international trend could be weaker than assumed in our main scenario and that the crisis could lead to a slowdown in Sweden as well.

The signals of an international slowdown that would also affect growth in Sweden became increasingly clear. The Riksbank therefore successively revised its forecasts in a downward direction and eased the monetary stance in June. This follows from our policy framework, which calls for a lower repo rate when inflation in the forecast period is expected to be below the target and vice versa. The repo rate was cut in two more steps in November, from 4.10 to 3.60 per cent, followed by a further reduction to 3.40 per cent in December when the forecast was revised downwards again.

Even after the series of downward revisions during the autumn, the December assessment still carried a downside risk of the international slowdown being even more pronounced and prolonged than expected.

The uncertainty about international economic prospects has been accentuated somewhat by the economic problems in Brazil and the real's depreciation since the turn of last year. The world economy may be affected contagiously, either via real mechanisms or via increased financial market turbulence. Under normal circumstances, the real economic effects in the industrialised world from decreased trade with Brazil should be relatively limited. There is a risk, however, of the crisis also becoming more profound among Brazil's neighbours, leading in time to somewhat larger repercussions in the industrialised countries as well. The effects via financial markets could be greater in the short run but developments to date in this respect have been better than many feared.

The picture of other parts of the world economy at the end of 1998 is somewhat varied. Growth in the U.S: economy is still good, whereas the slowdown in the euro area has become slightly more marked than many observers counted on and we have yet to see an economic recovery in Japan.

The sustained strength of the U.S: economy is mainly due to the unbroken growth of private consumption—the slowdown that was foreseen in our December Inflation Report has still to materialise. The stock exchange has recovered from last autumn's fall and even reached new all-time highs. Together with a positive development of employment, this has helped improve the confidence of American consumers.

In time, however, a slowdown in the U.S. economy still seems probable; but the course to date does suggest that it will not occur as soon as the Riksbank expected earlier, in which case the trend in 1999 may be stronger. A more dramatic downturn could occur if the U.S. stock markets were to fall markedly. Even without this, economic activity could slacken in connection with decreased investment on account of falling demand and lower profits, as well as with a lower consumption propensity among households whose debt burden is already very high.

In the euro area the available statistics indicate that the slackening of activity in the late autumn and winter was more marked than expected, mainly on account of weaker exports. Manufacturers and households differ in their assessments of the future; the former count on a turn for the worst, whereas consumer confidence has continued to improve. The direction in which confidence moves for these two groups will be crucial for prospects in the euro area. The optimistic trend among households has so far helped to mitigate the consequences of decreased external demand. The question is wether this will continue to be the case if industrial activity does not take a turn for the better.

The Japanese economy has not shown any clear signs of recovering, though in some respects it does seem to have stabilised. The future path here is still highly uncertain.

All in all, the statistics point to an international trend in the next two years that is weaker that in the Riksbank's main scenario last autumn, though the differences should not be exaggerated. Together with lower commodity prices, the weaker international activity should result in lower external price pressure.

The outlook in 2000 and beyond is, however, very difficult to foresee. One uncertainty is the endurance of U.S. economic growth. Will it be possible to maintain the high growth and low inflation despite the high level of share prices and the low saving ratio? Another question concerns Europe; will any slowdown in the United States be offset by a stable recovery in Europe, underpinned by private consumption? Finally, can the Japanese economy finally shake off the profound crisis? A clearly positive outcome in any of these respects would provide conditions for a trend that is stronger than the main scenario's.

Sweden's currency and interest rate

The lower inflationary pressure that was indicated by international developments last autumn was accompanied by a weakening of the Swedish krona that could result in higher inflation. A more permanently weak krona can lead to higher inflation as a result of higher resource utilisation as well as higher import prices.

In the December forecast the Riksbank envisaged that the krona would appreciate in the coming two years. Since then, however, the krona has strengthened more markedly that we expected: to date in 1999 the exchange rate has appreciated almost 5 per cent in terms of the TCW index and a little more than 6 per cent against the euro.

A considerable part of the krona's appreciation and stabilisation should be seen as a return to a more normal situation after the financial markets' very turbulent and volatile autumn. At the height of the unrest, investors sold certain currencies in favour of the safety of larger currencies. Currencies from countries which, like Sweden, have a high foreign debt were most exposed. The currencies of Australia and Canada, which like Sweden target inflation with a flexible exchange rate, depreciated markedly last autumn; in the calmer situation since the turn of the year, these currencies have also strengthened and become more stable.

Another factor in the krona's case is that higher expectations of Sweden joining the euro area have helped push our currency closer to the value implied by economic fundamentals. In the run up to Stage Three there was also some apprehension about how the krona might be affected; after the event, this unrest tended to subside.

The Riksbank's forecast has thus proved to be on the cautious side to date. Nonetheless, I do not consider that developments warrant a revision of our long-term assessment last December, namely a gradual appreciation in terms of the TCW index to about 118 by the end of 2000.

Since the publication of the December Inflation Report, interest rates in Sweden have fallen, by almost 0.15 percentage points in the case of the 3-month rate and 0.4 percentage points for 10-year bonds.

In that inflation expectations have not moved down as much as the nominal interest rates, the real level of interest rates has also fallen and is now historically low. The pronounced downward movement may turn out to have included some overshoot in the market, to be followed by an upward adjustment of market rates. Signs of this have been discernible in recent weeks. Even so, the real level of interest rates is expected to remain low and should act as a stimulus to the Swedish economy, above all in the somewhat longer run.

The domestic economy

In our December Inflation Report, the GDP growth rate was assumed to be between 2.5 and 3 per cent in 1998, between 2 and 2.5 per cent in 1999 and around 2.5 per cent in 2000. The available statistics suggest that our forecast for 1998 is probably correct. For 1999 and 2000, however, we consider that the December forecasts are somewhat too optimistic.

One of the items we believe may be weaker is foreign trade. With the poorer outlook for the international economy net exports could be lower in the years ahead. Industrial activity may then also continue to slacken. The expectations of Swedish firms are low, above all in manufacturing, and this could have a downward effect on investment.

On the other hand, the statistics show that private consumption is still strong, with a 1998 third-quarter increase that exceeded expectations. House prices and the number of new cars registered are continuing to rise and retail turnover is also moving upwards. Other signs are increased lending to households and the growth of the money supply. Households are optimistic about their own economic situation, one reason being the growth of real disposable wage income; a marked increase in 1999 is implied by the low level of inflation and the tax cuts. Another contributory factor is probably the fall in interest expenditure. The mood among households will be crucial for private consumption's future path.

As I see it, however, there are certain grounds for fearing that even consumption will be somewhat weaker than we counted on in December, when our forecast included comparatively strong consumption activity in the coming years. While households are optimistic about their own economic situation, the view of Sweden's economy and employment's future development is more dismal. Poorer international economic prospects and the more pessimistic expectations of firms are liable to dampen the optimism of households and thereby private consumption.

The statistics on industrial capacity utilisation continue to present a varied picture. At total level, however, we consider that in the coming two years the Swedish economy will still have some surplus capacity and this is judged to be somewhat larger than we envisaged in December. The crucial question here is the future development of households' expectations. Continued optimism could result in sustained domestic demand that tends to offset the more subdued international trend and the weaker investment activity.

Construction and property market

For this Forum it may also be appropriate to say something about the situation in the construction sector. Construction activity shows a cyclical pattern, with strongly rising costs in upward phases. An upswing here may therefore entail risks of inflation.

In a historical perspective, the level of construction activity in Sweden in recent years has been very low. As a result, smaller firms have had to close and construction labour has moved abroad or gone to other domestic sectors. There are now many indications that construction activity is picking up again, though the rate of the recovery is difficult to assess. But housing demand has grown and there is a large need for new housing as well as for renovation. The Riksbank does not produce independent estimates; the available figures suggest, however, that in the coming decade between 20,000 and 45,000 new dwelling units need to be built each year and between 30,000 and 40,000 units a year need to be renovated. Activity may then grow rapidly in certain regions.

Now that construction is recovering, the increased concentration among construction companies and producers of construction materials, as well as the shortages in certain categories of skilled labour, are liable to push costs and wages up. Certain problems with bottlenecks are already discernible; in the business tendency surveys from the National Institute of Economic Research, labour shortages are reported by 7 per cent of construction firms as against 2 per cent in March 1998. These shortages are accompanied by a high overall level of unemployment among construction workers; part of the explanation is that unemployment is high in certain regions and those who are unemployed there are reluctant to move a long way to regions where labour demand is stronger.

Bottleneck problems in the construction industry are being studied on the behalf of the Government by industry representatives. This Construction Sector Group has found that approximately one-third of the unemployed construction workers lack occupational experience and around 6 per cent also lack formal training. In that the average age of construction workers is rising and young people do not find construction work attractive, the bottleneck problems may become even greater in the future. In order to prevent this from leading to sizeable problems, proposals have been out forward for increased mobility, improved competence and marketing of construction courses, for example.

Construction costs are measured by the factor price index (FPI); the largest item is wage costs. The price of completed dwellings, on the other hand, is measured by the building price index (BPI), which also includes the construction companies' productivity and profit margins. These indexes do show relatively large price increases but there are no actual signs of any direct risks of an inflationary development in Sweden in the coming years, given that the bottleneck problems do not increase further.

The rising costs associated with earlier upswings in activity have been connected with the contemporary subsidy systems as well as the high degree of concentration in the construction market. The revised system for financing residential construction has appreciably reduced one of these problems; construction companies as well as consumers are exposed more directly to production costs. But the problem of concentration in the construction market still remains and may be a future cause for concern.

Future monetary policy

In the main scenario in the December Inflation Report, the 12-month change in the CPI was judged to be 1.2 per cent in December 1999 and 1.4 per cent in December 2000. Inflation's underlying rate in those months was expected to be 1.7 and 1.8 per cent, respectively. The Riksbank also noted that as the slowdown in international activity could prove to be more marked and more prolonged, the downside risk in the assessment was greater than the upside risk. In recent months the international picture has tended to shift in that direction.

Immediate inflationary pressure in Sweden has been lower than the Riksbank counted on in December. The outturn for inflation in December 1998 was 0.3 percentage points below the figure in the Report's main scenario; around 0.1 percentage point of the difference can be attributed to lower interest expenditure and approximately 0.1 percentage point to lower world market prices for oil. Moreover, underlying inflation has been somewhat weaker than expected.

As I mentioned earlier, the Executive Board considered that the prospects for international economic activity and inflation are somewhat more subdued than they were in December and this will probably lead to economic activity and inflation in Sweden being slightly weaker in the next two years than the Riksbank counted on earlier.

CPI inflation is accordingly judged to be below the 2 per cent target in one to two years time. To some extent this is a consequence of transitory factors that are judged to have no permanent effect on either inflation or the inflation process and should therefore not influence the formulation of monetary policy. These transitory factors—altered indirect taxes and subsidies as well as lower interest expenditure—are judged to lower the CPI by between 0.5 and 1 percentage point in the coming two years. But even excluding the transitory factors, it is considered that inflation will be below the target in 1999 and 2000.

In the light of its assessment, last Thursday the Executive Board decided the ease the monetary stance. The future formulation of policy is something that will also be discussed in the Inflation Report, which will be published on March 25th.