

Speech

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Construction and monetary policy

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I should like to begin by expressing my gratitude for the invitation to come here today and discuss such an important subject as construction and monetary policy. By its nature, construction often serves as a concertina in the business cycle. Demand seems to be insatiable in upturns, customers want fast delivery despite building of necessity requiring time, bottlenecks arise in production, it is difficult to find labour and prices rise. In downturns, it is just the opposite. Demand for new buildings rapidly falls when vacant premises come on to the market and the shortage of labour is replaced by unemployment. Construction is undoubtedly an activity that has a lot to win from calm, stable economic growth.

Monetary policy for stable, long-term growth

The Riksdag's (Swedish Parliament) instruction to the Riksbank is to maintain price stability. However, it is difficult to maintain price stability if the economy moves between periods of strong overheating with shortages of goods and labour, when inflationary pressure is high, and periods of weak demand, high unemployment and low inflationary pressure. It is therefore important to conduct monetary policy in such a way that the development of production and employment is disrupted as little as possible.

However, a feature of monetary policy is that it does not affect the economy immediately. When the Riksbank changes the repo rate, this has an effect on production and employment with a considerable time lag. This is easily understandable for those involved in construction work, where planning times are

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long for natural reasons. Effects on inflation cannot be expected before one or two years have passed. In order to be able to participate in stabilising economic activity, the Riksbank must therefore act in very good time; if it waits until overheating is a fact, it is already too late.

Now as we are aware, it is difficult to know exactly what the situation will be like in two years' time. All decisions have to be based on forecasts of the economic development and forecasts can be wrong. Moreover, a continual stream of new data means that forecasts are changed. Gradual adjustments of the repo rate due to new information becoming available are therefore a natural part of a monetary policy based on a stable development of production and employment.

During the 1970s and 1980s, Sweden experienced a number of cyclical courses of events where developments were anything but calm and stable. After the crisis at the beginning of the 1990s, and the transition from a fixed exchange rate to an inflation target, it has been possible to combine a growth of around three per cent per year and increasing employment with low inflation. During this time, the interest rate has been adjusted both upwards and downwards.

When the Riksbank increases the interest rate in steps as has happened in recent months, it is thus not at all with the intention of interrupting a positive economic development. The intention is to help make it possible to extend the period of good growth without ending up in an overheated situation, which might require far stronger measures to come to grips with. This should be of great interest not least for construction.

The development of construction

After the crisis in the property market at the beginning of the 1990s, there was a very great decline in building. Vacant premises were available at most places in the country and property prices were practically halved. It was considerably cheaper in most places to buy existing properties than to build new.

During last year, a clear change took place, however. The prices of apartment blocks in big city areas rose by over 20 per cent in the first six months of the year. Home prices are now at a higher level than before the fall at the beginning of the 1990s. Prices of small houses in Stockholm have risen by 33 per cent during the past two years and by 15 per cent from November 1999 to January this year alone. However, it should be underlined that these price increases primarily apply to the big city regions. The price trend in the rest of the country is dampened. This is an important difference from the 1980s when we saw large price increases throughout the country.

The ratio between the cost of an existing house and what it costs to build a new house is usually a useful indicator of what may happen with construction. If the ratio is equal to one, the cost of building a new house is the same as purchasing an existing one. The higher the ratio, the more profitable it will be to build a new house. According to new statistics, the ratio in all big city areas is now above one, and in the hottest municipalities in the Stockholm area such as Lidingö, Danderyd and Sundbyberg almost two. Malmö and Gothenburg show values of around 1.2. In all these areas, we can expect a strong demand for new building then. In places

such as Gullspång, Hagfors and Kramfors, the ratio remains at around 0.3. There an existing house only costs 30 per cent of the cost of building a new one.

One of the reasons for the recent rise in property prices is undoubtedly the historically low nominal interest rates. Interest costs have not been perceived as such a deterrent as in previous cyclical upturns for building clients or for households that are to find room in the monthly budget. Over 70 per cent of new lending from mortgage institutions takes place today moreover at variable interest rates, which can perhaps be interpreted as borrowers having increased confidence that the Riksbank's inflation target will be met. Another reason for the rising prices is undoubtedly that demand in the big city areas has increased very quickly and that it is difficult in a short time to adapt building to a desired level. The lack of construction workers in the big cities points in that direction.

From the point of view of the industry, it is positive that demand and prices are rising, even though development could be smoother both in time and space. From the point of view of the Riksbank, there is an element of concern. Will the shortage of building workers in the big cities drive forward large wage increases and will these spread to other sectors of the economy? And will the rapid increase in demand lead to shortage situations in other parts of the construction industry? These are questions which there is reason to monitor closely during the coming year.

Still an expansive monetary policy

On 3 February, the Riksbank decided to increase the repo rate from 3.25 to 3.75 per cent, i.e. by a half percentage point. This decision was presented and motivated in the usual way in a press release on 4 February. The minutes, which will be published on 22 February, will show the line of reasoning at the Executive Board meeting and I will not anticipate what is said there. Let me instead take up some factors that are important for future development.

To begin with, it should be borne in mind that the Riksbank by its last interest rate decision hardly put its foot on the brake but rather eased the pressure on the accelerator a little. Monetary policy is still in all essentials expansive. Even at a level of 3.75 per cent, the real rate of interest is so low that it is reasonable to say that it contributes to an expansion of economic activity. If we look at the repo rate reduced by household inflationary expectations, this will lie under two per cent, which is historically low. The real interest rate measured in this way has moreover been falling for a longer period up until the most recent interest rate decision.

In both Germany and the USA, short real interest rates have on average been around 3.5 per cent since the beginning of the 1980s.. With inflation expectations at two per cent, this would mean nominal interest rates of approximately 5.5 per cent. The US instrumental rate has also fluctuated between 4.5 and 6 per cent since 1994. During this period, the USA has had the longest upturn since the Second World War without inflation accelerating. However, comparisons with other countries should be made with some caution. The pressure of demand in relation to production capacity has been high in the American economy, while in Sweden we have had considerable free capacity during the 1990s.

There is also reason to draw to attention that the repo rate has in fact been reduced from 4.40 per cent to at the lowest 2.90 per cent during the past two years, i.e. by one and half percentage points. These reductions have taken place against the background of the crises in Asia and Russia but also against the background of concern that the European cyclical development was weak. As late as April last year, there was talk of the risk of deflation in the world economy. If the positive U.S. growth trend had been interrupted in this situation, it could – as the assessment was made then – lead to an altogether too weak development of international demand.

This did not take place. The U.S. economy continued to grow and developments in Europe were considerably better than most people expected. Therefore the Riksbank noted in the most recent inflation report that the international development continued to be strong and was moreover synchronised in the sense that most important countries in the world economy are experiencing increasing growth.

One factor that will be in the centre of interest during the coming months is, of course, the development of the labour market. This applies not least to the construction sector. In spring, agreements for 280 000 wage-earners in health care and education are to be renegotiated. Bargaining is to take place in an economy undergoing strong growth where bottlenecks are starting to appear in certain areas and the negotiating strength of those who want better pay is increasing. At the same time, the pay bargaining is taking place in an environment where understanding of the inflation target has increased and where inflation expectations are low. During the past four years, real wages have risen by almost four per cent per year despite small nominal pay increases. If this experience is sufficient for agreements to be reached at a level that is compatible with price stability remains to be seen.

Rising asset prices

The development of the Swedish economy at the end of last year was marked inter alia by rapidly increasing asset prices. I have already mentioned property prices but even more marked is, of course, the development of the stock market. During the second half of 1999, the share index rose by over 40 per cent and from the end of the year until mid-February this year, prices have increased by around 15 per cent. The Stockholm Stock Exchange is now the highest valued in Europe with a P/e ratio of around 40. In all substantial, the development is governed by internet and communications companies. Eriksson has a P/e ratio of 80. The development of the Swedish (and the Finnish) Stock Exchange has closely followed the American IT dominated NASDAQ stock exchange. Stock exchanges in the rest of Europe have experienced a considerably calmer development.

It is not just prices that have risen but also trading volumes. Banks and stockbrokers made record profits during the final quarter of last year. It is also interesting that private persons substantially increased their share of turnover. Households sold Swedish listed shares for SEK 2 billion during the second quarter last year and purchased for almost SEK 13 billion during the third. The figure for

the fourth quarter has still not been published but it is expected to be considerably higher. The average number of deals per day on the O-list, where most IT companies are listed, rose from around 6 000 during the first quarter of 1999 to 24 000 in December. In January this year more than 29 000 deals took place per day.

There is naturally every reason to think about the consequences that this development can have in the somewhat longer term. From experience, a growth in wealth usually contributes to increasing consumption, but we have never previously been able to study the effects of such a large increase in a short time. To what extent will households be able to realise share profits and use them for consumption? It will thus be of great interest to monitor the development of consumption during the coming months. However, it does not seem unreasonable to assume that a part of the increased demand for housing properties which we have seen in the big city areas – and the consequent price rises – could be derived from the rise in share prices.

It does not seem that the rise in the financial asset values has been used to pay off loans. On the contrary, lending by the banks to households increased by over 9 per cent during 1999 and the increase was especially high during the final quarter. Moreover, liquidity in the form of banknotes and coins increased by as much as 12 per cent from December 1998 to December 1999. Both these circumstances can provide a basis for increasing private consumption and thus increase the high pressure of demand in the economy.

There is naturally also a risk factor in the rapid rise in share prices. An increasing number of analysts point out that prices of many of the IT companies are very difficult to justify for those who calculate the expected development of profits in the company. It is easy to understand such a point of view. “Hopes and confidence in the future are pleasant, but moderation and balance can also be needed” as a leader article pointed out recently. There is moreover reason to ask whether the increased quantity of private investors who have entered the market fully understand the risks that exist. It is worth noting that a large number of owners during the past period have taken the opportunity of taking home some of their profits.

A correction of the prices on the Stockholm Stock Exchange in so-called “orderly forms” would hardly have any serious effects on the development of the economy. Neither would the functioning of the financial system be affected. We are a long way from the situation that existed when property prices fell at the beginning of the 1990s. A large part of the price gains are probably still unrealised and loans have only been raised on the shareholdings to a limited extent. Banks and stockbrokers have as far as can be judged been careful in their lending with shares as collateral. It is possible that shares have been purchased to an increasing extent in recent months with collateral in properties, but this is hardly a problem for the banks as long as property prices do not fall drastically.

Growth and inflation

One question that has come strongly into focus during the past year is the link between growth and inflation. A common view is that the Swedish economy can sustain long-term growth of between 2 and 2.5 per cent without this leading to overheating and thus tendencies to increasing inflation, that the Riksbank must parry with increases in the repo rate. In the USA, the corresponding figure has been estimated at between 3 and 3.5 per cent. How is it possible that the U.S. economy can grow more quickly than the Swedish without this pushing up inflation? And cannot this “new economy” also come to Sweden?

There is still no clear answer to these questions. What can be noted is that productivity development in the USA has been high during a large part of the 1990s. This has in turn contributed to demand being able to grow and be met without bottlenecks in production and labour shortages leading to rising prices. However, behind the increase in productivity is a large increase in investment, above all in hi-tech areas. The U.S. companies have almost doubled their investments during the 1990s. Capital per employee in industry has also increased substantially.

In Sweden, we have, despite the IT boom, still not seen much of this development. While productivity has increased more quickly during the 1990s than during the 1980s according to available statistics, investments are still a good bit under the U.S. level. After the deep crisis in Sweden at the beginning of the 1990s, it was a long way to full capacity use, however, which should not be forgotten when making comparisons.

Perhaps we will follow the American development in the cyclical upswing that we now see before us. This would not be unnatural as the technology is also available to Swedish companies and Sweden has undoubtedly a high level of IT maturity. The high activity and many newly established businesses in the hi-tech area may be indications that something is taking place. However, it takes time to increase the capital stock in industry and in this way give rise to increasing productivity and not much yet is visible for the economy as a whole. It is possible that the aggregated investment figures conceal part of the truth.

Now we are not alone in eagerly peering after signs of a “new economy”. We are in the company of most European countries and they have not come further. It is possible that we have less flexibility than in the USA, above all in the labour market, and thus have greater difficulty in drawing the benefits from the new technology. It can in this case delay but hardly in the long run prevent, an increase in the level of investments and productivity.

Conclusion

It seems like construction is on its way out from a long period of low activity into a considerably better cyclical situation for building. This is naturally a positive development for the construction industry. However, there is a danger in the imbalances that seem to be arising between the big city regions and the rest of the country. Another danger is in the bottlenecks that easily arise when demand

increases rapidly without there being time to create resources at a corresponding rate. This partly reflects construction's eternal dilemma as building is to adapt the stock of properties to what society requires. It easily becomes the case that the stock is too large and then no construction is required or the stock is too little and demand will then exceed the available resources. Words such as sufficient and balance are often more difficult to apply to construction than to other activities in the economy. However, the special prerequisites of construction make a stable economic development especially valuable.

In its endeavour to maintain stable prices, the Riksbank is also working for stable economic growth where periods of strong acceleration or strong braking can be avoided. If the business cycle continues to develop as anticipated, this probably means increasing interest rates for some time to come. At the same time, we realised after the increase at the beginning of February that we had done what was necessary then to secure inflation in line with the objective in a two-year horizon. We now have to evaluate the new information that becomes available. The next time the Executive Board has to take a position on the repo rate will be in connection with the publication of the inflation report on 23 March.