Opening remarks

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The current situation for monetary policy

Standing Committee on Finance

First a word of thanks to the Committee for the invitation to have a stimulating discussion about the current situation for monetary policy. An open discussion of these matters is important for people's perception of the Riksbank's legitimacy. I cannot think of a more suitable forum than you as representatives of our principal, the Riksdag.

Risk of a slowdown after a series of years with strong economic growth
We can look back on a series of years with strong economic growth in Sweden, accompanied by low inflation. As far as can be judged at present, one explanation for this combination is that the Swedish economy is functioning more efficiently. To some extent, however, it has also been a cyclical phenomenon. After the economic crisis that ravaged Sweden in the early 1990s, there were plenty of unutilised resources to draw on and therefore less risk of rising production hitting the ceiling at an early stage.

Sooner or later, however, demand growth that is excessively rapid and persistent will generate imbalances in the economy and that normally pushes the rate of price and wage increases up. Such a course of events is liable to result in a recession, with falling output and rising unemployment.

A monetary policy that is guided by an inflation target is basically concerned with adapting the development of demand to the economy's long-term growth. That is not easy, I can assure you, and our chances should not be exaggerated. Towards the end of last year, however, activity in the Swedish economy did begin to slow to a growth rate that can result in a stable long term development. The last time we

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met, early in October, we discussed the situation in these terms and I concluded that if the strong economic upswing were to continue, it would be necessary to raise the repo rate.

Other central banks around the world had been facing a similar situation for some time. The U.S. Federal Reserve, for example, had raised its instrumental rate successively during 1999 and 2000 to 6.5 per cent. Last year the European Central Bank raised its rate to 4.75 per cent and the Bank of England's rate was increased to 6.0 per cent.

I recall that last year many observers counted on relatively large interest rate hikes in Sweden as well. They thought they saw signs that the Swedish economy was on the way to becoming overheated and argued rather vigorously that the Riksbank therefore ought to act quickly — starting in the autumn of 1999 and continuing with further steps up to last summer — in order to avert the threat they saw looming on the horizon.

The Riksbank, however, saw things differently and chose a more cautious approach to the question of interest rate increases. In our opinion, the relatively favourable inflation prospects and the approaching global economic slowdown simply did not warrant a tighter monetary stance last year.

But in December we did take what I would describe as the precautionary measure of raising the repo rate 0.25 percentage points, from 3.75 to 4.0 per cent. Let me try to explain the economic situation in terms of a motoring simile I often use. At that time the Swedish economy was approaching a crossroads, with the risks that entails for someone who is driving a car. It is then only natural to take one's foot off the accelerator. Now that we have negotiated the crossroads, the question is rather how steep will be the hill we may have to climb on the road ahead. Are we cruising at the right speed or does the engine need less or perhaps still more petrol to keep us going at a stable rate?

What this amounts to is that in the work on the present Inflation Report the Riksbank has had to judge whether global economic activity is slowing down to such an extent that demand growth in Sweden is undergoing a self-adjustment, as it were, down towards the long-term trend. As I mentioned earlier, such an adjustment is essential for maintaining a stable economic course with low inflation. If world economic activity had remained strong, it would have been reasonable to count on the Riksbank continuing to raise the repo rate.

A look at the threats we perceived in December as being liable to push inflation up above our forecast, shows that they have become less troublesome. At the same time, the clouds that were gathering over the U.S. economy have thickened and darkened. To date this year the Federal Reserve has cut its interest rate a total of 1.5 percentage points. The first cut, announced in January in between the regular monetary policy meetings, surprised the market by its magnitude as well as its timing. Another cut came at the end of January and a third last week, on 20 March. There has been a spate of negative news about the global economy in general and certain companies in particular and international stock markets have remained turbulent.

U.S. economy difficult to assess

The focus at present is on the U.S. economy. Its future path is highly important for economic developments in Sweden. In order to arrive at a clear picture of the situation, we need to judge the effects of alternative outcomes.

During the 1990s the United States experienced its longest economic upswing ever without any serious signs of accelerating price and wage increases. A more efficient economy, with strong competition and functional product and labour markets, accompanied by advances in computer and telecom technology, are said to have contributed to a higher rate of potential growth. Even so — or perhaps as a consequence of this — the euphoria led to growing imbalances. The rapidly rising stock markets in the late 1990s seem to have stemmed from unduly high expectations of future profits and incomes. Partly in view of equity capital's appreciation, households stepped up their expenditure on consumption in excess of current income. Corporate investment expanded rapidly to meet the growing demand. High share prices stimulated the procurement of venture capital and generated a plentiful supply.

The growth of demand and the expansion of the U.S. economy's supply side were proceeding at a rate that was based on expectations that simply could not be fulfilled. American households pledged future incomes for current consumption to such an extent that their savings no longer sufficed to finance corporate investment. The saving deficit grew, as could be seen from the rising deficits on the current account, and large amounts of capital had to be imported. The apparently unending increase in expectations of rising share prices on U.S. stock markets stimulated the capital imports, which continued to such an extent that the dollar rose to high levels against other currencies.

Together with massive investments in real capital, which involved considerable rationalisation, the dollar's appreciation held back the price impulses that normally accompany growing pressure from wage costs.

The question is whether the upward phase in the U.S. economy in the 1990s represents a cyclical pattern that differs from earlier post-war cycles. In the past, rising demand led in time to growing tensions as the supply side became increasingly strained and this resulted in higher inflationary pressure. Rising inflation normally functioned as a warning to decision-makers that a tighter economic policy was called for.

The latest upward phase seems, however, to have been more the harvest of a dynamic interaction of demand and supply. Technological advances have contributed to higher productivity. Aided by the new technology, gradually rising consumer and corporate demand seem to have generated an increasingly rapid expansion of supply and thereby a further stimulation of demand in a sort of expansive circle. The traditional alarm bell — inflation — has not sounded because the domestic cost pressure has been countered by the productivity gains and the appreciating exchange rate. But there have been other alarm bells in the form of asset prices, saving and imbalances.

There are a number of historical examples where expectations of rising profits and incomes have contributed to increased demand and an expansion of supply, laying a foundation for an expansive spiral. The clearest instances seem to have occurred before world war one or in the interval between this and world war two. The euphoria over an innovative and favourable beginning has usually led, in the more mature phase of the upswing, to fundamental imbalances in the real economy that have sometimes taken a long time and considerable efforts to rectify.

It is not yet possible to tell to what extent the U.S. economy will experience a lengthy, more difficult process of adjustment. That is probably the background to how the Federal Reserve has acted in recent years. A series of interest rate hikes during 1999 and 2000 were presumably intended to restrain the euphoria and excessive expansion. When a downturn then became evident, it seemed desirable to try to limit the mood swing by means of the marked interest rate cuts we have seen this year.

It is precisely the Federal Reserve's vigorous action that underlies certain analysts' view that the current economic slowdown will be fairly mild and brief. If international activity were to move into a recovery, most things suggest that demand in the Swedish economy would start rising rapidly again. The earlier capacity restrictions would then return to the agenda, with the attendant risk of an accelerating rate of inflation.

So the situation is difficult to assess and I grant that the judgements our Executive Board has had to make in connection with the present Inflation Report have been more difficult than usual. While the difficulty in predicting the future is admittedly a truism, the present international economic situation is perhaps the trickiest for a decade.

Growth with a balanced picture of inflation

The main scenario we have adopted in the Inflation Report envisages weaker real economic activity in the rest of the world, with the slowdown in the United States in the foreground. GDP growth in Sweden slackens from the annual rates of 3 to 4 per cent in recent years to around 2.5 per cent in the coming years. The GDP figure for Q4 last year suggests that a fall-off has already begun. Some observers talk of a soft landing. Most things point to a downward adjustment of demand to the long-term trend rather than a regular downturn with the risk of a recession.

In this situation it is a help that, after a number of years with good growth and price stability, the Swedish economy is soundly balanced and that the public finances are also in a comparatively good state. Combating inflation effectively and consolidating the government budget have increased the freedom of action in economic policy and made an economic slowdown relatively less difficult to handle.

The adjustment we now foresee will occur through a variety of channels. Slacker international activity implies a slowing of exports. The decreased order inflow and less pronounced capacity restrictions tend in turn to dampen investment. With falling share prices and less optimism among households, the growth of private consumption becomes more subdued. Moreover, stock adjustments this year imply a temporary lowering of demand. In the labour market, the number of new job vacancies is already levelling off, which shows that the growth of employment will be slower in the coming years.

This picture of the real economy in the main scenario gives a relatively stable development of inflation around the 2 per cent target in the years ahead, both in terms of the consumer price index and of indexes of underlying inflation.

The risks surrounding the main scenario are chiefly concentrated to two alternative scenarios that point in different directions.

One alternative scenario has to do, of course, with the risk of a deeper global economic slowdown with further stock-market falls. The Swedish economy would be affected via lower export market growth and more subdued demand from households and firms. That would keep inflationary pressure in Sweden down compared with the main scenario. However, the downside risk for inflation in Sweden would be somewhat limited in that the exchange rate would remain weak as a consequence of the lower international activity and concern about its effects on the Swedish economy.

The other alternative scenario concerns a risk of higher domestic inflation. The current round of wage negotiations is still in progress and several of the signals in this respect are not encouraging. If the remaining settlements were to be above the levels that have been agreed to date, inflationary pressure may grow, both as a direct result of the high outcomes and indirectly through a greater risk of compensatory wage drift. It is also conceivable that productivity growth will be lower than assumed in the main scenario, leading to rising pressure from costs. A further risk is that the krona's depreciation may persist even if activity becomes stronger. That could generate inflationary impulses.

All in all, however, the Executive Board of the Riksbank considers that the spectrum of risks is asymmetric, so that inflation somewhat below the main forecast is more probable than a higher rate. With the risks taken into account, inflation in the coming years is forecast to be around two tenths of a percentage point below the targeted level of 2 per cent. At the same time, the margins are so small that we have decided not to adjust the repo rate at this time. In this context it is worth recalling that in the initial position the repo rate is already lower than the instrumental rates in many other industrialised countries, at the same time as the krona is very weak. That makes it advisable to wait somewhat longer to see in which direction developments appear to be moving.

Next monetary policy meeting on 26 April

In conclusion it can be noted that the picture of both real economic tendencies and price movements that is described in the main scenario seems to be relatively favourable. After a rapid expansion for a number of years, an adjustment is now foreseen that involves a levelling off with low and stable inflation.

But while it may seem that we consider everything is fine in the Swedish economy, it must be said that prospects for the U.S. economy are difficult to assess. Real economic changes may occur, with repercussions on the Swedish economy as well as on international capital and currency markets that cannot be predicted at all accurately at present. This is also something that has to be followed and analysed closely, which the Riksbank intends to do this spring.

We are ready to act if action is called for and when the picture becomes clearer. We will be returning to these matters with an analysis of the situation and a discussion of monetary policy a month from now, on 26 April.