Speech

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Monetary policy in an uncertain world

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Following several years of very strong GDP growth, we are now seeing a slowing down in the Swedish economy. It is necessary for the growth rate to slow down over the next few years to avoid a long-term threat to price stability. While there was a plentiful supply of free resources, GDP could grow more quickly than the long-term productivity growth and labour force supply allowed. Now, however, the resources are running out and production needs to be adapted to a slower rate that is more sustainable in the long term. When the Riksbank raised its repo rate by 25 points to 4 per cent in December last year, the decision was based on assessments that demand would continue to increase to such an extent that the shortage of resources would lead to the inflation target being exceeded. The interest rate was raised despite the fact that the inflation rate was then only 1.4 per cent. This shows the pedagogical and practical problems the Riksbank faces when making such decisions. Monetary policy decisions are based on assessments of the inflation rate a couple of years ahead and are aimed at achieving the inflation target in this time horizon. This means that we are often forced to raise the rate, despite the fact that the inflation rate is below the target at the point in time when the decision is made. Conversely, interest rate reductions may be motivated even when the inflation rate is above the target level.

As we all know, since the end of last year, the unexpectedly severe slowdown in the US economy has led to a downward revision in the assessment of Swedish production growth over the next two years. However, according to the assessment published by the Riksbank earlier, the most serious consequence of the slowdown will be that almost all of the resources within the Swedish economy will be occupied. If this is realised, one could say that the USA-led economic slowdown is, in a way, a welcome development in Sweden.

The information on the Swedish and international economies that has been received in recent months does not give reason to change the assessment of the economic slowdown in Sweden. However, the signals are rather mixed and there is still considerable uncertainty. The downside risks with regard to international growth still remain. Despite the fact that growth has so far developed largely in line with our earlier assessments, price increases have been slightly greater than we had estimated. The krona has also continued to develop weakly. However, the wage agreements that have been signed so far appear to be in line with the earlier assessments. In the light of these developments, the Executive Board decided at its monetary policy meeting on 26 April to leave the repo rate unchanged at 4 per cent.

I would like to spend the rest of my time here discussing the conditions for economic growth in the near future – both here in Sweden and abroad.

The American economy is a decisive factor

There is still great uncertainty over how quickly confidence in the American economy will return and what spread effects this will involve for the rest of the world.

The slowdown in the American economy was preceded, as we know, by a long and pronounced economic boom. Great optimism over future growth prospects, based mainly on expectations of gains in efficiency from IT, led to a substantial increase in investment, a strong growth in consumption and rising share prices over several years. The growth in investment and rise in share prices were particularly strong in IT-related sectors. The high level of domestic demand could not be met with American goods and services, but spilled over to create a considerable deficit on the current account over several years. At the same time, there was a strong expansion of credit. Both households and companies have greatly increased their level of indebtedness, while rising asset prices have increased household wealth. This development has been reflected in a considerable deficit in savings. The deficit in savings in the private sector amounted to approximately 7 per cent of GDP at the end of last year, with both households and companies contributing to this figure.

Despite the strong demand, inflationary pressure has been only moderate. The dollar exchange rate was strengthened by widespread inflows of capital from foreign investors who bought American shares and a strong growth in productivity has had the effect of subduing prices.

What characterises periods with a build-up of financial imbalances?
The development of the American economy bears some similarity to the development that has usually preceded the financial crises that have affected many countries in recent decades. Characteristic for the development of countries that have suffered financial crises has been than an optimism, which has later proved to be unwarranted, has been reflected in rising asset prices, over-investment, excessively high consumption and a strong expansion in credit. It has rarely or never been possible to determine in advance when a realistic optimism has passed into over-optimism and in its turn pushed up asset prices, investment, consumption and indebtedness. It has rarely been possible to judge, for instance, whether a large build-up in indebtedness has expressed an adaptation to realistically based expectations of future growth prospects or whether the build-up in debt is based on exaggerated expectations.

In addition, the target that has been used to guide monetary policy has rarely been able to signal early enough that imbalances were being built up, regardless of whether monetary policy was aimed at a fixed exchange rate or towards a price stability target. To simplify, one can say that the result of an exaggerated optimism in countries with a fixed exchange rate has been that the build-up of financial imbalances was expressed in rising inflation without any depreciation pressure on the currency. It has not been possible to subdue inflationary pressure through raising interest rates while optimism regarding the country's economy and confidence in the fixed exchange rate regime have remained, as a more stringent monetary policy would have reinforced the nominal exchange rate. At the same time, increases in consumer prices have been kept down by the strong currency, temporary increases in productivity, or by demand being aimed towards, property, shares and land - assets whose prices are not included in the central bank's target function. There has thus been no reason for monetary policy to counteract the emergence of financial imbalances.

When the financial bubble has actually burst, the country has often suffered a deep and long-lasting recession caused by adaptations to the imbalances that have been built up. A high level of indebtedness, falling asset prices and unprofitable investments have subdued demand for a long period of time. Households have chosen to increase their savings to reduce their debts. Companies have been unable or unwilling to invest as a result of earlier investment mistakes and poorer prospects for the future. The banks have suffered severe credit losses, which has further intensified the recession, as their capacity to provide new credit has been limited. The situation becomes particularly serious when losses have led to acute bank crises, which has often been due to the banks being greatly exposed to a particular sector. For instance, it was an overheated property market with banks strongly exposed to this sector that was one of the main reasons behind the bank crises afflicting several countries – including Sweden – at the beginning of the 1990s. Adaptations to large financial imbalances have also put a burden on central government finances and increased uncertainty. This has in itself prolonged and intensified the crisis. Japan is a well-known example of what can follow in the tracks of a serious financial crisis if confidence cannot be recreated in economic policy and future growth potential.

The consequences of financial imbalances have proved particularly serious in countries with a fixed exchange rate, partly because interest rates need to be kept high when confidence in the fixed exchange rate policy declines, and partly because there has often been a large foreign currency debt. When the fixed exchange rate has to be abandoned and the country's own currency is weakened, the burden of debt increases.

Should the central bank then concern itself with asset prices?
Following the dramatic 1990s in the USA (and Sweden), with soaring prices on shares and property, many people began to think that perhaps the central banks should keep an eye on asset prices and react to these, even if there were no sign of rising inflation.

Overrated share prices and/or property prices lead sooner or later to an adjustment in asset prices. If this adjustment is dramatic, the effect could be an economic downturn, with rising unemployment and a slowdown in prices. The extreme valuing of certain shares in the IT and telecom sectors on the American stock exchange, Nasdaq, should perhaps have warranted more stringent monetary policy a few years ago, according to the international debate on monetary policy.

One argument put forward as to why the central banks should not merely look to forecasts regarding consumer prices when making decisions on monetary policy, but should also monitor the development of asset prices, is that ownership of shares is much more widespread now. Thus, changes in asset prices probably have much greater significance for household expenditure now than they did before. Deregulation, liberalisation and globalisation have increased the importance of the capital markets for economic developments and made them more volatile. Assets with market prices now comprise a much greater share of households' balance sheets than before. This is thus claimed to be a good reason for monetary policy to take into account developments in asset prices.

In the worst case, falls on the stock exchange that correct overvaluations can lead to financial instability, if share prices have been driven by pledged shares and if the market participants are in some cases unable to pay back their loans. This can result in panic sales, exaggerated falls in prices and credit institutes facing difficulties as a result of exposure to households and institutions that have become insolvent. This result risks leading to large fluctuations in the real economy.

Critics of the Federal Reserve in the USA claim that when Alan Greenspan coined the phrase "irrational exuberance" in 1996, it was clear that prices on the stock exchange had risen too much and that this development should have been counteracted. Nothing was done and the rise in share prices continued until March 2000. Since then the stock exchanges have fallen, Nasdaq by 70 per cent, and the fall on the stock exchange risks pulling the USA down into a recession that could have been avoided.

However, comes the objection; is it really possible to realise when a stock exchange has risen too much? The answer is that prices on the stock exchange must have some relation to the underlying development of productivity in trade and industry, to company profits and to the market's pricing of risks.

Of course, it is not possible to determine precisely when the stock market has risen too much or when it is undervalued. However, it should not be too difficult to detect obvious deviations. The problem is similar to the central banks' analyses of the output gap, which indicates whether there is an inflationary risk in the economy as a result of an excessively high level of activity or a risk of deflation. The output gap is calculated routinely by central banks around the world, and these calculations estimate the sizes that would be included in a calculation of over-valuation or under-valuation on the share markets. It can hardly be easier to calculate potential growth for the entire economy than the fundamental value of the stock market, according to critics of US monetary policy.

It should be possible, at least in the case of major deviations from fundamental economic conditions, to detect imbalances on the asset markets, exaggerated valuations that could potentially give rise to monetary policy measures being necessary, even if the target for consumer prices is being followed fairly well.

This is how the international discussion runs, caused by stock market developments, primarily those in the USA, with the current fears that the large downturn on the stock exchange will be followed by a deep recession.

For a small, open economy like Sweden's, the possibility of affecting share prices through monetary policy restraint should be limited. The Swedish stock market is strongly correlated with that in the USA, partly because many of the companies listed on the Swedish stock exchange are multinational. In principle, however, there is good reason for taking action if we assess that large financial imbalances are being built up. This is partly because these can cause instability in both the real economy and prices when the bubble bursts and partly because the stability of the banking system could be threatened. Measures to avoid financial imbalances being built up are thus motivated on the basis of both of the Riksbank's objectives; to maintain price stability and to promote a safe and efficient payment system. However, the question is how effective the interest rate is as a weapon - perhaps other means can be utilised. Examples of such measures are monitoring the financial institutions and making capital adequacy requirements of them. The analyses made by the Riksbank in its Financial Stability Report are also aimed at drawing the attention of the banks and other authorities to any problems and they thus play a role in this context.

How great are the problems created by the imbalances in the USA?

Is there a risk that the imbalances in the American economy are so great that the process of adaptation back towards a balance will dramatically intensify and prolong the economic slowdown? It can be noted that none of the ten major economic analysts of the American economy assesses that the USA will suffer a recession during the next few years.

Firstly, it is probable that the growth potential that can be created by developments in technology is far from exhausted. There should thus be good reason for at least some of the optimism that has comprised a basis for earlier developments. When confidence in the American economy returns and investment growth takes off, there is every indication that productivity will continue do develop favourably. However, this does not mean that the long-term growth path indicated earlier by developments in share prices and demand will be realised. Secondly, it seems that the over-investment has mainly taken place in the IT sector, where financing has been largely via the risk capital market. The depreciation period for IT investments is often short, which means that investment mistakes do not affect the willingness to invest in the long term. The bank system does not appear to be particularly strongly exposed to the IT sector and the risk spread among the banks' assets is assessed as good. There would thus appear to be little risk of problems in the banking sector reinforcing the slowdown to any great extent. Finally, there is scope to use fiscal and monetary policy to stimulate the economy, if necessary. The American central bank has utilised part of this scope and lowered interest rates by a total of 2 percentage points since the beginning of the year. The central government finances are in good condition. For several years now the public sector – unlike earlier periods of large American current account deficits – has shown a surplus in savings.

All in all, there are thus many factors indicating that confidence in the American economy can quickly be recovered. If this is true, the economic decline will not last very long. The most likely situation is therefore that although the high level of indebtedness, the large deficit in savings in both the household and corporate sectors, combined with over-investment in certain sectors, will subdue growth for a time, there will be no dramatic or prolonged economic recession.

However, in order to increase saving in the economy and thus correct the constant deficit on the current account, it is necessary that growth is not primarily driven by increases in consumption. Net export and investment should instead be the motors behind growth to a larger extent than before. Bringing about this state of affairs requires a weaker dollar exchange rate. One can therefore look with scepticism on the idea that tax cuts will bring the American economy out of its decline.

How will Sweden be affected?

The American economy affects developments in the rest of the world through many different channels, with exports to the USA as the most direct channel and the one where the effects are easiest measured. However, exports to the USA are only responsible for a couple of per cent of GDP in Sweden and have a similar significance for the euro area. Spread effects via the expectations that largely govern consumption, investments and the stock market are probably much greater, although more difficult to measure. Nevertheless, there are numerous indications that the Swedish economy is more sensitive to developments in the USA than the economies in the euro area. For instance, shareholding is more widespread among Swedish households and many of the major "Swedish" multinationals - in which Swedes have invested a substantial part of their shareholdings - are very dependent, directly or indirectly, on developments in the USA.

Developments in the Swedish economy in recent years have shown many similarities to developments in the USA. Rapidly rising share prices, a strong GDP growth driven by both investment and consumption and an increase in indebtedness is a description that fits both the Swedish and American economies in recent years. However, the increase in economic activity began later in Sweden and has not really had the same speed as that in the USA. Moreover, the rise in Sweden was preceded by a period where adjustments following the crisis at the beginning of the 1990s had forced down investment and consumption considerably and where both the household and corporate sectors had reduced their level of indebtedness. Saving in both of these sectors was therefore at a high level and indebtedness fairly low when growth in the Swedish economy picked up. Now that economic activity is slowing down, the private sector's indebtedness is not particularly high, from a historical perspective. Furthermore, the lower interest rates will mean that interest expenditure comprises a much smaller burden for borrowers now than previously. Although the surplus in saving in the private sector has declined gradually in recent years, it only became a slight deficit towards the end of last year. This applies to both the household sector and the corporate sector. There is thus a substantial difference here from developments in the American economy, where saving in the private sector at the same point in time amounted to almost 7 per cent of GDP. The risk of widespread financial imbalances having built up here in Sweden is therefore slight. Growth in Sweden thus need not be hampered to any large degree by indebtedness in the household and corporate sectors or by investment mistakes in Swedish companies. At the same time, central government finances have been consolidated and the central government's established ceiling for expenditure and its targets for the current account balance have reduced uncertainty over central government finances in the near future. The support for and confidence in the inflation target are yet another fundamental factor helping to create favourable conditions for growth in the Swedish economy.

To summarise, the Swedish economy is in good condition. This speaks in favour of the slowdown in GDP growth being moderate and production now entering a growth path that is at a level more easily sustainable in the long term. The uncertainty stems mainly from the outside world and particularly from the risks arising from financial imbalances in the American economy. However, there are also many indicators there that confidence will return fairly soon and that the economic decline will not be dramatic.