Speech

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Sweden and the world economy

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Exactly two weeks ago I landed courtesy of SAS at Newark airport, after circling around Manhattan. As always, I was fascinated by the skyline dominated by the twin towers of the World Trade Center. Less than 24 hours later, those towers were gone and thousands of people had lost their lives in an act of terrorism that shook the entire world. It is tragic, terrifying and in many respects still incomprehensible. You all work in the financial sector and I am sure many of you have business contacts or friends who have been affected, directly or indirectly. I myself will never forget the pictures of human despair reflected in the US media during the week I had to wait for a flight back to Sweden.

Naturally, the events in New York and Washington will have both political and economic consequences. At the moment, everything appears to be very uncertain, for understandable reasons. However, it is necessary to take developments in the US economy as a starting point for any assessment of how the Swedish economy will develop over the next few years. This applied before the attack against the USA and it applies even more now. I would therefore like to share with you - after a brief description of what preceded the economic slowdown we have now entered – my view of what are the core issues for assessing growth and inflation prospects for the near future, both in the USA and in Sweden.

The driving forces behind the economic upturn in the USA

The very optimistic expectations regarding long-term growth comprised an important driving force behind the sustained rise in the US economy. It was the

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rapid developments in information technology and the telecom sector in particular that were assumed to have such spread effects to the rest of the economy that production was expected to continue increasing at a more rapid rate than before, even in the long term. Investments therefore rose strongly, particularly in the IT sector. There were also many people who claimed that future fluctuations in the business sector would be less pronounced than before. Efficient stock management and trimmed production processes were assumed to be factors that would reduce the risk of major fluctuations in growth. The USA had taken the step into a "new economy". And developments on the stock market reflected the belief that ”this time it’s really different”.

At the same time, the fact that demand could increase so strongly and over such a long period of time without inflation accelerating in the USA was regarded by many as the revenue from breaking earlier economic ties. Low inflation expectations and a high level of confidence in the central bank's capacity and willingness to maintain price stability also created favourable conditions for future growth. Confidence in the US economy was further strengthened by the positive development in public finances.

The optimistic expectations for the future - which were expressed in rising share prices and growing wealth - also increased households' willingness to consume durable goods. Together with the strong rise in investment, this led to a large expansion of credit. Many IT companies were able to find cheap financing on the risk capital market, but despite this indebtedness increased markedly among both households and companies. This development was reflected in the rapidly increasing deficit on the current account, which was entirely due to a reduction in saving in the private sector. The financing of the current account deficit was mainly achieved through a greatly increased capital inflow from foreign investors' purchases of US shares. Demand for US capital was so extensive that the dollar continued to rise in value, despite the growing deficit on the current account.

In winter last year, however, the trend on the stock exchange was broken and the air slowly went out of the IT bubble. When raised interest rates and high oil prices reduced household purchasing power and demand during the autumn, company profits also began to decline. Falling profits and a high burden of debt contributed to subduing investment and the downturn in the US economy became fact.

With hindsight, one can wonder how so many people could be so sure that we had left the whole story behind us and entered a new world. However, we will probably make the same mistake again. Let me just remind you of the first "IT bubble" at the beginning of the last century, which concerned wireless telegraphy. 150 companies were introduced onto the New York stock exchange in 1901 and early 1902. In 1907, only one of these still showed a profit and paid dividends, and even that company had halved its market value since its introduction.

Similar development in Sweden

The development I have outlined applies first and foremost to the USA until the end of last year, but many parts of the description also fit the Swedish economy. Here, our GDP growth had exceeded 3.5 per cent for three years at the start of the year. The IT and telecom sectors' large share of Swedish business contributed to a more rapid economic growth in Sweden than in many other European countries. Many people claimed that Sweden also had one foot in the "new economy".

However, the economic upturn here in Sweden started later than that in the USA, and from a situation with a higher level of financial saving in the private sector. The imbalances in saving and foreign trade that distinguished - and still distinguish - the USA thus had no counterpart in Sweden.

Despite the strong growth, however, inflationary pressure was unusually weak, even in Sweden. The usual explanatory variables - resource utilisation, import prices and inflation expectations - were not always enough to explain or forecast the low inflation rate that was established periodically – which was also something that affected many forecasters and analysts around the world during this period. When the economic upturn began, there were still plenty of free resources, which had a dampening effect on inflation. At the same time, inflation expectations had stabilised around our inflation target of 2 per cent and wage agreements were moderate. However, apart from this we had to seek explanations for the low inflationary pressure in increased competition on internationalised and deregulated markets supported by developments in information technology. We appeared able to live with a lower growth rate than before, without this endangering price stability.

The low inflationary pressure meant that the Riksbank could be content with cautiously slowing down the economy during 2000, despite the high growth rate. The steering interest rate was raised only twice from the end of 1999 up to November last year. Before that the rate had been reduced from almost 9 per cent in autumn 1996 to as low as 2.90 in March 1999. The Swedish repo rate was low in comparison with the corresponding steering interest rates in, for instance, the USA and the euro area. At the end of last year, however, resource utilisation in the Swedish economy was beginning to be strained and inflation was estimated to rise to the extent that it would exceed the target level two years' ahead. The Riksbank therefore raised the repo rate by a quarter of a percentage point to 4.25 per cent. The assessment of the risk spectrum indicated at the same time that a weaker economy in the USA could dampen growth in Sweden. As we now know, this is what happened.

Developments during the spring

During the first half of the year, the economic climate continued to weaken both in Sweden and other countries, but the signals regarding the strength of the downturn were mixed. The weakening in the economic climate was concentrated to the manufacturing industry, while household confidence remained strong, despite an undermining of household wealth in the form of falling share prices. Property prices were not affected in the same way as share prices, which probably contributed to keeping household's confidence in the future strong. This applied both to the Swedish economy and the US economy. In the USA the Federal Reserve lowered interest rates gradually by 2.75 percentage points during the first half of the year, while tax reductions provided stimulation for households.

For the Riksbank the picture was complicated by the fact that import prices rose unexpectedly rapidly in May. Later, the statistics showed that consumer prices had also risen more rapidly than expected. The increase (measured at an annual rate) in May was 3.1 per cent. At the same time as the economic climate gradually weakened, there were indications that inflation was beginning to rise. The price increases could to some extent be attributed to non-recurring factors - such as higher food prices caused by BSE ("mad cow disease") and crop failure -but some of the price increase was more difficult to explain. When the exchange rate also weakened substantially in June, there was justified unease that this could have an impact in the form of rising inflation expectations.

Given these developments, a majority of the Executive Board of the Riksbank decided on 5 July to raise the repo rate by 0.25 percentage points to 4.25 per cent. There was still considerable uncertainty as to how rapidly the US economy could recover. Nor was there any other economy elsewhere in the world that could take over the USA's role as growth engine. Quite the reverse, the economies in the euro area and Japan were weakening. The Asian economies that had been strongly IT-dependent in their exports were also unable to act as pacemaker.

When the Executive Board had to make a decision regarding the repo rate this time, the situation was unusually complicated and uncertain. This was also reflected in the fact that we Board members differed in our judgements but hardly at all in our fundamental analysis. My assessment was that there was a greater risk that the international slowdown would be deeper and more prolonged than the majority of the Board believed. The signals regarding developments in the US economy were mixed and the assessment hung in the balance between a rapid recovery and a more long-drawn out sequence of events. In my opinion, there was every reason to wait for clearer indications before changing the interest rate. Others were more concerned that the weaker exchange rate would have an impact on inflation.

The role of the krona for an inflation target policy

As the krona has long come under focus, I would like to briefly remind you of the role the exchange rate plays in monetary policy. We have an inflation target, and the development of the krona has an effect on inflation, partly through import prices, partly through influencing demand for Swedish goods and services. For instance, if the krona has a low value, demand and resource utilisation in the export industry increase.

When we want to influence inflation, we do so primarily via the repo rate. Occasionally, but in my view very rarely, we can also try to influence the exchange rate and thereby the inflation rate, through currency interventions. It is important to remember that we can never have a target for the value of the krona while monetary policy is directed at an inflation target.

The monetary policy decisions are based on forward-looking assessments of the inflation rate. This means that the Riksbank must make assessments of how the krona will develop in relation to other currencies during the forecast period, and assess what effect the development of the krona will have on demand for Swedish goods, as well as the impact the krona will have on consumer prices. None of these assessments is simple.

Allow me first to point out the mechanisms that are important with regard to a direct impact on inflation via import prices. If the krona weakens and prices on the goods we import are determined in the exporter's home country currency, the weaker krona will have a direct impact on import prices. For the weaker krona to have a full impact on prices of imported goods in the consumer channel, all domestic intermediaries must pass the price increases on to the end consumer.

During the years with a floating exchange rate we have been able to note that the weakening of the krona has not had the impact on consumer prices that we had expected. One explanation could be that internationalisation and increased competition have first and foremost meant that the exporting companies endeavour to adapt their prices to developments on the markets where they sell, in order to retain their market share. It is reasonable to imagine that large corporations with sales and production spread around the world can act in this way without facing large fluctuations in profits. A German exporter selling goods both in the USA and in Sweden could, for instance, have kept its profits up fairly well by determining its prices in dollars in the USA and in Swedish kronor in Sweden. At the same time, increased competition should in general mean that wholesalers and retailers in the domestic market have greater difficulty in passing import price increases on to the consumer channel. The general demand situation in the world also has great significance for the capacity to raise prices in all channels - low utilisation of resources subdues price pressure and high resource utilisation increases price pressure. However, our knowledge of pricing behaviour among both exporters to Sweden and domestic operators is limited. This means that assessments of the effects on inflation of a particular development in the krona are uncertain.

An even more difficult task is to make assessments regarding the krona exchange rate during the forecast period. In the medium to long term, we do not obtain much guidance from the theoretical models for determining the exchange rate. Almost all models are based on the real exchange rate creating balance in a country's foreign trade. A particular basket of goods shall, for instance, cost approximately the same here as in Germany. If it is -as is the case today - cheaper in Sweden, we will increase our exports and have a surplus on the current account - which we have. A prolonged surplus on the current account will sooner or later strengthen the nominal exchange rate so that a balance is achieved. However, this can evidently take longer than expected.

Although the long-term value of the krona is determined by flows of goods and other items in the current account, its price is governed in the short term by supply and demand on the foreign exchange market, and here other factors can prevail. Developments on the financial markets have led to rapid and substantial portfolio transfers when, for instance, Swedish investors have bought shares abroad or foreign investors have sold Swedish shares. Changed expectations of earnings on various shares and changes in the willingness to take risks appear to have increasingly governed the developments on the foreign exchange markets in a way that is not captured by traditional exchange rate models. Portfolio transfers as a result of deregulation or changes in investment regulations may also have had significance.

In the long term, however, it is difficult to believe that anything other than the development of the fundamental economy shall determine how the exchange rate develops. Regardless of which model we apply to explain the krona rate, it will show that the krona is undervalued and has been so for a long time.

Despite the difficulties connected with forecasting exchange rates, we have to make assumptions regarding the development of the krona in our assessments of inflation. We have chosen to use fundamental analysis as a basis but to also weigh in as far as possible the effects of other factors. This means that our assessments assume that the krona will appreciate in the long term, which it has so far stubbornly refused to do. Nevertheless, the consequences of these "misforecasts" have not been so great. During the period we have had a floating exchange rate, fluctuations in the krona rate have not had as large an impact on inflation as before, which we have taken into account when making inflation assessment. This means that monetary policy has not been affected to any great extent by the fact that the krona has not developed as expected.

What does the future hold in store?

The prospects for the US economy played a decisive role in the assessment of Swedish growth and inflation even before the terrorist attack a couple of weeks ago. One important factor was whether there was actually grounds for the optimistic expectations of future growth that characterised the economy and that had previously pushed up investment and share prices. Was the economic downturn in the shape of a V, i.e. would it soon be over? There can scarcely be any doubt that developments in information technology had created and are still creating growth potential that is far from exhausted. Or would it take longer time to grow into the overinvestment that occurred when the "new economy" appeared to be a fact, i.e. would the economic downturn take on the shape of a U? Or would the USA simply experience a recession in the backwater of the burst IT bubble?

At the Riksbank we were discussing a "banana-shaped" development from an early state, which could best be interpreted as a very long drawn out U. And even in the USA, the assessments had already changed from V to U even before the catastrophe and there was talk here and there of the possibility of a recession. The positive figures expected with regard to consumption and investment had largely failed to materialise, despite interest rate reductions and tax relief, while unemployment had increased and consumers found it more difficult to pay their debts. Nor had the stock exchange shown the upturn expected by many.

Of course, the tragic events in the USA will have a severe dampening effect on the business cycle, at least in the short term. A number of central banks, headed by the Federal Reserve, have therefore lowered their steering interest rates. The Executive Board of the Riksbank also decided last week to lower the repo rate by 0.5 percentage points from 4.25 per cent to 3.75 per cent. Subdued inflationary pressure as a result of lower resource utilisation both in Sweden and abroad was judged to overshadow any price increases caused by the continuing weak krona.

We stated in the press release that "the uncertainty occasioned by last week's act of terrorism creates the risk of a further dampening of global demand. It is difficult in the present situation to assess the collective consequences for the international economy and thus inflation prospects in Sweden over the next few years. There is a risk that confidence in the future will decline in both the corporate sector and the household sector, which could result in a deeper and more prolonged economic slowdown. This would indicate that inflation two years' ahead, with an unchanged repo rate, would be lower than the Riksbank's target. The shape taken by future developments will depend partly on the economic policy measures taken now."

Despite this gloomy statement, there is no cause for despair. The US economy is basically strong with a high potential growth. Some increase in household saving is needed to reduce the burden of debt and the deficit on the current account. And of course the dollar appears to be rather overvalued. The Swedish economy is also in good condition, with low unemployment, a surplus on the current account, a declining central government debt and low inflation. The conditions for coping with an economic downturn are good, even if the downturn proves more prolonged than we believed in the spring.

Thank you for listening.