Opening remarks

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The monetary policy situation

The Riksdag's Finance Committee

The Riksbank has a statutory duty to present the Finance Committee with a written account of monetary policy at least twice a year. The second account in 2001 was presented this morning. In my opening remarks I shall briefly describe the Riksbank's view of monetary policy and economic developments in Sweden. I also look forward to the ensuing discussion with members of the Committee and will do my best to answer your questions.

First let me say that in the period since I last met the Committee a great deal has happened, some of it very dramatic and tragic. What I have in mind above all is the terrorist attacks in New York and Washington on 11 September. But much has happened in the economic sphere as well. The slowdown has become more pronounced at the same time as inflation has been surprisingly high. Meanwhile, the Riksbank has adjusted the interest rate. Major political events are currently unfolding in connection with all that is happening in Afghanistan. On top of this there was last week's air disaster at Milan airport, with many people from Sweden among the victims in the wrecked SAS plane. In the midst of all the human suffering, I and my colleagues at the Riksbank still have the task of presenting our general assessment of the economy and inflation to the Committee, an assessment that has to include consequences of these tragic events. But I want to underscore that in the coming quarters the economic future is unusually uncertain. I shall begin by briefly recapitulating developments in recent months and accounting for the Riksbank's monetary policy measures.

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Developments in recent months

Shortly after the May Report had been published the Swedish krona depreciated markedly from a level that was already low. That meant that an even more marked appreciation would be needed for the exchange rate to reach the levels the Riksbank had counted on. This seemed unlikely. The combined effect of relatively high resource utilisation, unexpectedly rapid price increases and greater uncertainty about the krona's future path was considered to constitute an increased risk of rising inflation expectations. That was the background to the Riksbank's decision in mid June to intervene in the currency market. Although interventions have proved to be a difficult matter in the past, the Riksbank considered they were worth trying. Judging from some comments, one also gets the impression that the operation cost the Riksbank a lot of money. That seems rather unlikely, however, since we purchased kronor in a situation where we judged that the krona was under-valued.

At the monetary policy meeting on 5 July, the risk of the inflation target being exceeded in the Riksbank's normal time horizon of one to two years still existed. The situation was the same as when the interventions began except that the krona's dramatic weakening had been checked. Resource utilisation was judged to be high, notwithstanding the ongoing slowdown, and there were no grounds for being more optimistic about the krona's future path in a longer perspective. Moreover, although the substantial price increases in recent months were considered to be mainly transitory, there was a risk of them influencing inflation expectations. There were signs of slackening growth in the euro area and Japan but it was judged that towards the end of the year, developments in the United States would result in a gradual recovery that would spread to other countries. An overall assessment of these factors led to the Riksbank's decision to raise the repo rate from 4 to 4.25 per cent.

Inflation expectations, which according to some indicators had tended to move up in the spring, returned during the summer to a level in line with the inflation target. The exchange rate stabilised.

At the monetary policy meeting on 23 August the Riksbank's forecast was that the rate of inflation two years ahead would be approximately 2 per cent. Against this background the repo rate was left unchanged. It was considered that demand had continued to weaken, both in Sweden and internationally, which should reduce the risks associated with the weak exchange rate.

In connection with increasing signs in August of a more marked economic slowdown in the rest of the world as well as in Sweden, share prices started falling again. For the krona, which had appreciated in July, this was a negative factor in the same way as it had been during the spring.

Early in the autumn the picture of an international economic slowdown became even more accentuated. A number of indicators pointed to a worsening of demand in the United States even before the terrorist attacks. The uncertainty stemming from the attacks was liable to subdue demand in the rest of the world even more. After the U.S. Federal Reserve and other central banks had cut their instrumental rates on 17 September, on the same day the Riksbank decided to lower the repo rate 0.5 percentage points. An increased risk was perceived of inflation two years ahead being below the target, mainly because business and household confidence in the future might weaken and lead to a slowdown that was deeper and more protracted. The terrorist attacks led to great uncertainty in the financial markets.

From what I have now said it will be clear that in recent months monetary policy has taken its cue from declining economic activity. GDP growth has slackened from a level of 3 to 4 per cent in recent years to a rate of between 1 and 1.5 per cent. Meanwhile, since last year the krona has depreciated by around 15 per cent. Another consideration is that notwithstanding the low growth of demand, inflation has been surprisingly high.

These forces have acted with varying strength on the Riksbank's inflation forecasts in recent months. Roughly speaking, when economic activity is slowing — with a given potential growth rate — after a time inflation falls back. A weak exchange rate pulls in the opposite direction, however, and can lead to higher price increases: directly through rising import prices and indirectly by stimulating production for export. In addition, abrupt exchange rate movements are liable to affect inflation expectations, a problem that is accentuated when inflation is springing unpleasant surprises.

The krona's weakening in the early summer, after the Riksbank had presented this year's second Inflation Report, probably had to do with a combination of slackening export activity and portfolio adjustments. Moreover, inflation outcomes in the late spring had been surprisingly high. If higher inflation expectations are allowed to take root and also show up in time in a currency depreciation, public confidence in monetary policy's systematic commitment to a rate of inflation in line with the 2 per cent target may be shaken. The weakening of the exchange rate in that period was an isolated Swedish phenomenon, which made it particularly serious.

The krona also weakened in the aftermath of the terrorist attacks on 11 September but the circumstances then warranted a different interpretation. General uncertainty in the financial markets was accompanied by extensive portfolio adjustments after the terrorist attacks. The pattern is clear from similar periods in the past, for example the autumn of 1998 when Russia suspended payments on parts of it s government debt and a major American hedge fund collapsed. What happens is that certain currencies weaken, others, particularly large ones, appreciate, share prices fall, bond rates are unchanged or rise, short-term interest rates decline and the price of gold moves up. Exchange rate shifts of this type are normally transient. The krona has in fact strengthened just recently as markets have become more stable.

The IT bubble has burst

At the time of our previous meeting in March, economic activity was slowing generally throughout the world but above all in the United States. This tendency had also reached Sweden.

Important factors behind the almost simultaneous and marked deterioration of the global picture and perhaps particularly in the United States were, for example, energy price increases, rising interest rates, falling stock markets and the sudden downturn in corporate investment. The prospect of lower profits, a clear slump on the world's stock exchanges and more pessimistic expectations have led to a marked worsening of investment activity.

To illustrate how they believe the American economy will develop, observers have resorted to letters of the alphabet. A V implied a quick recovery, where the favourable outlook for profits meant that the accumulated imbalances would not be a major problem. This alternative rested on a persistently strong belief in a high potential growth rate, with investment in new technology continuing to play an important part. This was the path that most observers counted on last spring.

It was, however, questioned by others, particularly outside the United States. In general, they foresaw a more protracted, U-shaped recovery. Time would be needed for the adjustment of the over-investments that excessive optimism had generated. There is a lag before measures of economic policy have tangible effects.

In some quarters, finally, there is an even more pessimistic scenario, an L. This envisages that growth in the U.S. economy comes more or less to a halt as the imbalances undergo a painful correction and measures of economic policy have little effect.

In my discussion with you last spring I believe I likened my version to a banana. This was because the Riksbank believed that in many respects the cyclical path would follow the normal pattern. An expansionary phase is usually followed by a period of slacker activity. The longer the upward trend has lasted, the more likely it is to take a pause. That made it difficult to believe in the V-shaped scenario that the financial markets were mainly counting on at that time.

The path has been accentuated by the recoil from the excessive optimism that had attended the technological breakthrough and given rise to the notion of a new economy. With rising demand, the supply side of the American economy had been expanded on the basis of expectations that simply were not realistic. American households pledged future income for current consumption to such an extent that no savings were left with which to finance corporate investment. The growing savings deficit showed up as a rising deficit on the current account and large amounts of capital had to be imported. The capital inflow was stimulated in turn by apparently boundless expectations that American stock markets would continue to rise and it persisted to such a degree that the dollar appreciated markedly against other currencies.

In some respects, developments in Sweden resembled those in the United States, not least the rapidly rising share prices, the new technology's major significance for investment and highly-strung expectations of future income and profits among households and firms. That is one reason why Sweden and a number of other countries have been heavily hit now that the IT bubble has burst.

But history teaches us that after a period of what I would call growing pains, optimism about the new technology's potential will be restored. Neither the sudden downturn in the global economy nor the terrorist attacks should have changed the new technology's potential in the somewhat longer run.

Inflation too high at present

In Sweden, inflation rose surprisingly in the spring and the higher rate then persisted. The high figures at present are mainly, though not exclusively, a consequence of price increases that can be regarded as fairly transitory. The causes include foot-and-mouth disease, higher energy and telecom prices and certain changes in the method for measuring electricity prices. This has partly been a matter of supply shocks that do not normally have lasting effects on the rate of inflation. There is therefore reason to believe that when the increased price levels drop out of the twelve-month change figures from next spring onwards, inflation will fall back from the relatively high rates at present.

The picture of inflation does, however, include other features that probably have to do with the high resource utilisation during the latest upward phase. The fact that domestic inflation has moved up even though economic activity is slowing could point to some underestimation of resource utilisation or to a relationship between growth and inflation in a wide sense that for other reasons is less favourable than assumed earlier.

Recovery with prospective inflation in line with the target

In the Inflation Report that now lies on the table we have opted for a main scenario where growth in the rest of the world is lower than we foresaw in the previous Report in May.

The situation is particularly complicated in that the usual difficulties in determining exactly when activity is likely to turn upwards are compounded by the occurrence of a structural adjustment of saving and investment, above all in the United States, at the same time as economic policy there is undergoing a marked expansionary realignment. A further major complication is the future security policy situation, which is naturally hard to assess with traditional economic tools. With due respect for all the forecasting difficulties at present, the Riksbank counts on demand in the industrialised countries turning upwards during the second half of next year. GDP growth in the OECD area is calculated to be 1 per cent this year, followed by 1,5 per cent in 2002. Under present circumstances the uncertainty around our main scenario is, of course, considerable.

We count on GDP growth in Sweden in the coming years being lower than we assumed earlier. The combined economic effect of interest rates and the exchange rate is therefor stimulatory. As the Committee is no doubt well aware, in the years ahead both increased transfers and tax cuts will also contribute to a rapid increase in household disposable income. Given a gradual recovery in the rest of the world, this appreciable overall stimulus from economic policy will lead to a gradual upturn in Sweden’s economy. GDP growth is expected to be 1.3 per cent this year, followed in 2002 and 2003 by rates of 2.2 and 2.8 per cent, respectively.

The lower GDP growth — particularly this year — compared with our earlier assessment implies lower resource utilisation. At the same time, the recovery towards the end of the forecast period means that resource utilisation will then be rising again.

Monetary policy is currently formulated on the basis of an assessment of inflation excluding transitory effects from indirect taxes, subsidies and house mortgage interest expenditure (UND1X). In the Inflation Report's main scenario, which assumes an unchanged repo rate, UND1X inflation one and two years ahead is judged to be 1.7 and 2.0 per cent, respectively.

As I just said, the uncertainty about future inflation is greater than at the time of the May Report. Considering the Swedish economy's present cyclical position and the events that have occurred, that is natural. But it does accentuate the importance of the risk spectrum, that is, a combined assessment of various factors that may affect future inflation. Today the Riksbank judges that this spectrum of risks is balanced; the downside risks associated with international developments are balanced by the upside risks from the weak exchange rate and a less favourable relationship between growth and inflation in a wide sense. As developments unfold, that balance can change so that interest rate policy may need to be adjusted in one direction or the other. That would be something the Executive Board would have to discuss as usual at its future monetary policy meetings. I particularly want to underscore that perhaps it is more than usually important to pay close attention to the future course of events.

In the light of the analysis in the Inflation report, at yesterday's meeting the Executive Board decided to leave the repo rate unchanged.