Speech

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Current monetary policy

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I would like to thank the Swedish Association of Financial Analysts for inviting me here today. I plan to begin by discussing the role of monetary policy on a slightly more general level. I will also touch on a number of economic policy issues that have interested me for some time. I will then devote the latter part of my talk to the considerations behind the Riksbank's latest repo rate decision.

The minutes of our latest monetary policy meeting were published an hour ago. The Executive Board's decision on this occasion was, as you may already have suspected, unanimous. In this sense it was a fairly straightforward decision. However, uncertainty about where the economy is heading was greater than for some time, and so I will be paying particular attention to the risk picture and presenting my view of the current monetary policy situation.

Inflation target makes saving and investment decisions safer…

Since 1 January 1999 the Riksbank has had a statutory duty to maintain price stability. However, the preparatory work for the wording of the act provides little guidance as to how this task shall be interpreted in detail, which means that it is left to the Riksbank itself to define what price stability means and how it shall be achieved.

The Riksbank has chosen to operationalise this duty in the form of an inflation target - more precisely a target for growth in the consumer price index of 2 per cent with a tolerance interval of plus/minus 1 percentage point. Thus, the Riksbank is to pursue a monetary policy that keeps the krona's purchasing power in a stable relationship to the basket of goods purchased by the average Swedish household.

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The idea is that, when a wage agreement is finalised, the average worker can be relatively certain about how a particular nominal increase in his wages will affect his purchasing power during the period in question. A predictable rate of inflation can also serve as a steering oar when domestically-oriented businesses set their prices. Low and stable inflation expectations reduce uncertainty about the real effects of borrowing and saving in kronor for households and businesses with their costs and income in Sweden. This means that resources in the economy can be distributed better than when consumer prices fluctuate. A monetary policy credibly geared towards an inflation target can therefore be assumed to help pave the way for growth. In addition, monetary policy that is conducted with the aid of a symmetrical inflation target often functions counter-cyclically. It has a stimulatory effect on the economy during a downturn, as inflation is normally low then, and vice versa. This, in a nutshell, is the philosophy behind the Riksbank's inflation target.

… but the krona is generating uncertainty

One complication for monetary policy in recent times has been the krona's failure to reflect the economic fundamentals. It has therefore been difficult to predict the exchange rate. Naturally, this creates problems when we make decisions regarding interest rates, as the decisions must be based on assumptions regarding the development in the exchange rate one to two years ahead. On top of this, an undervalued and fluctuating krona over a long period of time can create costs for society and hamper growth.

As we all know, the nominal value of the krona has fared less well recently than the Riksbank had been anticipating, and significantly less well than most economists consider to be fundamentally justified in the longer term. For businesses with production in Sweden but sales in foreign currency, the depreciation of the krona has been a favourable albeit uncertain factor. High profits in these businesses may also have led to higher pay rises than warranted by productivity growth in the sector. The uncertainty has made investment decisions more difficult for export businesses. Some may have invested in projects where profitability calculations were based on expectations of a continued weak krona, while the uncertainty may have caused others to refrain from making investments that were well founded.

However, for businesses with a high proportion of imports but sales in Sweden, the krona's performance has been unfavourable. Competitive pressure and low inflation expectations, especially at consumer level, have made it difficult for these businesses to match high import costs with higher prices and so profit margins have narrowed.

These examples illustrate the problems that can be caused by an unstable and disproportionately weak krona. They show how a prolonged departure from the fundamentally justified value of the krona can lead to distortion in the allocation of resources. Ina market economy it is, of course, the pricing system to which the exchange rate belongs that should signal where capital and labour can best be put to use. A weak krona in the long term can provide an output and export structure based on low costs and will ultimately result in a welfare deficit relative to other countries.

In the early 1990s, when the credibility of the inflation target was still limited and there was also considerable uncertainty about the outlook for government finances, many economists assumed that the krona would rally once the problems with government finances were resolved and inflation expectations had returned to a low and stable level with only moderate fluctuations around this new level. According to the theory of purchasing power parity, if inflation is the same in two countries with roughly the same industrial structure, the nominal exchange rate between their currencies should be stable.

The economic structures of the industrialised nations are fairly similar, and their technology is the same. This was why many believed that the foreign exchange markets would settle once inflation had stabilised at low levels. Since the central banks have succeeded in achieving price stability both in Sweden and in the euro zone in recent years, this means that the krona should have been relatively stable against the euro.

Although many subscribed to this view, the krona has yet to stabilise. It is also difficult to find explanations for the krona's continued weakness in disparities in productivity, activity or household preferences. Furthermore, Sweden has been running a surplus on the current account for a number of years. It is against this background that the Riksbank believes that the krona should strengthen in the longer term.

I think that we can be fairly certain that the adaptation of the financial markets since deregulation and the ensuing rapid process of growing integration and globalisation have affected pricing in the currency markets in the short term in a way that cannot be explained by current economic theory. The models that explain exchange rate movements are generally based on the real economy and tailored to economies with nationally based businesses. As a result they do not seem to take full account of the effects of portfolio decisions made in integrated financial markets. However, this does not prevent the fact that it should still be the economic fundamentals that govern exchange rates in the longer term.

Substantial flows of capital due to transfers in international investors' financial portfolios over a fairly long period are believed to be capable of overshadowing the movement in the currency markets stemming from imports and exports of goods and services. For example, the US dollar has been appreciating over many years despite a growing trade deficit. At the same time the Swedish krona has depreciated despite current account surpluses and low inflation. A minor currency will find it especially difficult to compete with the major currencies and the traditionally "safe" currencies like the Swiss franc during turbulent periods. Other countries, such as Canada, New Zealand and Australia have experienced the same thing.

However, we should not seek a solution to the problem of an unstable exchange rate - in a return to the systems of old. Well-developed and deregulated international financial markets are making it possible to obtain capital for investments that boost world output and thus increase welfare. The reintroduction of regulation is not a solution to the problem. Introducing a fixed exchange rate regime and unilateral attempts to defend this in a deregulated economy could also lead to a high cost to society, such as unemployment.

In my opinion, participation in EMU would therefore be a better solution. Although the need for a stable exchange rate is not the main reason why I advocate EMU membership, the development of the krona in recent years has only reinforced my convictions. As a high proportion of our trade is with the euro zone, it is important that prices are stable against the goods traded in the euro market.

Inflation target policy and economic activity

For as long as Sweden remains outside EMU, a monetary policy geared towards a price stability target will make the best possible contribution to our welfare. Low inflation provides the stable platform necessary to enable the rest of the economy to function well. The inflation target also normally means that monetary policy can help to stimulate the economy in a downturn and slow things down in an upswing. Although interest rate adjustments cannot impact on growth in the long term, monetary policy has real effects in the short term.

The most important determinants for inflation are believed to be resource utilisation, import prices and inflation expectations. When resources are fully utilised and inflation expectations are in line with target, inflation can also be expected to come in on target. This means that decisions on changes in interest rates should not interfere with what is desirable in terms of growth or activity.

Unfortunately, things are not so straightforward in reality - for example, temporary price changes from imported goods can push inflation above the target even if there is spare capacity in the economy. To avoid unnecessary fluctuations in growth, the Riksbank has chosen to aim to meet the inflation target on a one- to two-year view under normal circumstances. However, the inflation target means that a sharp economic slowdown will not in itself provide sufficient grounds to stimulate the economy: first we have to confirm that inflation is likely to fall below the 2 per cent target.

There is a slight difference here from, for example, the US Federal Reserve. The Federal Reserve does not have as clear a monetary policy target as the Riksbank, and so decisions on interest rates are not based quite so unambiguously on an openly reported set of considerations. For example, the Federal Reserve has justified its many interest rate cuts since the beginning of this year by referring to the scope and need to stimulate the US economy. Since growth began to slow at the start of the year, the Federal Reserve's signals seem to have suggested that inflation is being viewed as more of a restriction than a target. In actual fact, the difference is probably not so great in practice; the Swedish Riksbank also takes into account economic developments, as these are an important component in determining inflation. The main difference may perhaps lie in the motivation behind the monetary policy measures.

For a small country like Sweden with a rather problematic inflation history, there has hardly been any alternative. It has been possible to build up and secure the credibility of price stability only by adopting a clear and consistently implemented inflation target combined with openness about the considerations underlying decisions.

The current situation

The economic climate began to deteriorate at the beginning of this year after several years of very strong growth. The slowdown started in the USA, which had been the driving force behind the world economy throughout its lengthy upswing. Optimistic expectations based on information technology fuelling long-term output growth had driven up share prices, investment and consumption. Interest in putting money into US equities and other investments had also caused the dollar to appreciate rapidly. During the spring the consensus interpretation of the economic indicators was that the US economy would soon turn around and that share prices, which had fallen very sharply, would recover. Many believed that growth would soon be returning more to its previous high levels.

However, during the course of the summer it became increasingly clear that the slowdown was a reality and had rapidly spread to the rest of the world. The slowdown was unexpectedly well synchronised, with the downturn in Europe seeming to have taken place at roughly the same time as that in the USA. Uncertainty about the depth and duration of the slowdown began to grow.

Back in Sweden the monetary policy situation was complicated by the sharp fall in the krona at the beginning of June at the same time as the CPI was rising faster than the Riksbank had anticipated. The uncertainty about the situation was reflected in the monetary policy decision of 5 July. The majority then believed that there was an overwhelming risk of the weak krona combining with the higher inflation figures to raise inflation expectations and cause the inflation target to be exceeded. My opinion, shared by two other members, was that there was a significant risk that the international demand picture would weaken and so counter the inflation threat. As the outlook was so uncertain, we thought it best to leave interest rates alone for the time being.

The late summer brought a steady stream of statistics that warranted the downward revision of growth forecasts for both Sweden and elsewhere. Several indicators suggested slacker demand in the USA even before the terrorist attacks on 11 September. The uncertainty generated by these attacks and the security policy situation that ensued naturally brought a further increase in the risk of more subdued demand in the world around us. Household confidence was believed to be the key to how demand would fare, and there was a great deal to suggest that the uncertainty would lead to an increase in saving and thereby a reduction in demand. It was against this background that the Riksbank decided on 17 September to cut the repo rate by 50 points.

The main scenario in the Riksbank's October Inflation Report predicts that Swedish GDP growth will rally from next year, climbing from 1.3 per cent this year to 2.2 per cent in 2002 and 2.8 per cent in 2003. This view is based on the assumption that expansive monetary and fiscal policies in the rest of the world will stimulate demand and that the US economy will recover. At the same time, a weaker krona than previously anticipated by the Riksbank is expected to give Swedish exports a boost. In addition, the easing of fiscal policy is expected to increase Swedish households' disposable income substantially and lead to both consumption growth of a couple of per cent and a rising savings ratio over the next two years. The main scenario assumes that resources in the Swedish economy will not be fully utilised in the immediate future, but that growth should have increased sufficiently for a return to full capacity utilisation towards the end of the forecast period, in other words in 2003.

Despite the low resource utilisation, inflation is expected to remain above the target at the beginning of the forecast period before gradually dropping to close to 2 per cent on a two-year view. In the immediate future inflation will be affected by price increases on goods and services that are not expected to have a lasting impact on inflation. The low resource utilisation in Sweden and elsewhere is also subduing inflationary pressure. It was against this background that the Executive Board decided on 15 October to leave the repo rate unchanged.

The risk picture

However, the main scenario does assume that the international situation in the wake of the terrorist attacks will not deteriorate. The likelihood of this is debatable; it is now harder to predict how growth and inflation will fare over the next two years than it has been for a long time. The fan charts illustrating the degree of spread in the risk assessment are therefore broader than ever. Of course, the downside risk relates first and foremost to the demand situation: the terrorist attacks came during a highly sensitive period - after all, it was US consumers that everyone had expected to kick-start the process of getting global demand growth back on track.

Even before the terrorist attacks on 11 September there was uncertainty about the depth and duration of the economic slowdown. One source of uncertainty was whether the "new economy" could generate a sustainable increase in growth. The previously widespread optimism regarding future growth had greatly stimulated investment and consumption and so pushed up debt levels, especially in the USA. This heightened the risk of pessimism in the household sector now leading to an increase in household savings, a decrease in company profits and an increase in unemployment. The terrorist attacks and the security policy situation that ensued further exacerbated this uncertainty. Integrated commodity and financial markets have meant that economic fluctuations in recent years have been synchronised and that weak demand in the USA has spread rapidly to the rest of the world.

The expansive fiscal and monetary policies now being pursued are expected to be an important driving force behind demand over the next year. The stimulatory fiscal policy effect alone in the USA is equivalent to 2 per cent of GDP, which can be viewed as a very strong Keynesian stimulatory policy. Many countries in Europe, including Sweden, are also cutting taxes. Real interest rates throughout the world are very low, from an historical perspective, which also has a stimulatory effect. The European Commission is discussing the possibility of introducing a co-ordinated stimulatory policy in the form of increased investment, partly funded by the European Investment Bank. All of this should have a strongly stimulative effect on household consumption and lead to a rise at some point during the second half of the year. However, the possibility cannot be ruled out that households' uncertainty may grow further, for instance, as the result of new acts of terrorism, and counteract the effects of this stimulatory policy.

In the Riksbank's risk assessment the potential anti-inflationary effects of weaker international growth are offset partly by the possibility of a weaker krona generating more inflation than anticipated and partly by the possibility of inflationary pressure in the Swedish economy not being curbed sufficiently by the low resource utilisation.

A weak exchange rate would impact on inflation via higher import prices and the stimulation of demand for exports. However, the plight of the krona has had only a moderate impact on consumer prices to date. Stiffer competition may have made it hard to pass the higher cost of imported goods on to consumers. However, slacker demand may make it harder for businesses to squeeze their margins further.

To sum up, right now I can see no immediate threat to price stability but a great deal of uncertainty about the future. An overly rapid slowdown in the world economy is currently believed to be a greater threat to stability than overly stimulatory monetary and fiscal policies. However, in Sweden we must be aware of the risk of a weaker krona and higher domestic inflationary pressure than assumed in the main scenario. This means that the risk picture for inflation is nevertheless balanced.

I can assure you that the Riksbank is monitoring developments very closely. Each new statistical data received constitutes a piece of the puzzle being compiled to ensure that we have the most correct picture possible when assessing inflation. We will do what we can to ensure that inflation does not fall below or rise above the 2 per cent target. The next monetary policy decision is planned for publication on 5 December.