Press Release

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Financial risks slow down recovery

First Deputy Governor Lars Heikensten today gave a speech under the heading “Some monetary policy issues” at the Center for Business and Policy Studies’ (SNS) annual conference on the economic situation and economic policy. He also took part in a discussion of economic policy with Minister of Finance Bosse Ringholm and others.

Some drama, but the stabilisation policy has stood its ground
“Monetary policy conditions have changed dramatically in recent years. At the beginning of 2000, the stock market was still on a high and economic activity was showing few signs of slowing down. Interest rate hikes were imminent. Later in the year there was a desirable and necessary downward adjustment of share prices, but economic activity nevertheless appeared stable. It was not until summer 2001 that prospects took on a more gloomy perspective and following the terrorist attack on 11 September the outlook darkened even further. Interest rates were lowered in many countries, including Sweden. During the winter and spring this year the storm clouds dissipated somewhat; there were clear signs of an approaching economic recovery, particularly in the USA. However, since then the storm clouds have begun to mass once again and the stock markets have fallen further. The total downturn is now greater than at any point during the 20th century. In addition, there have been numerous corporate scandals and threats of war. At the same time, economic policy problems have become even more evident, principally in Japan, but also in Europe, which means that hopes for a recovery are still mainly directed at the USA”, said Mr Heikensten.

“So far, Sweden has managed the period of unrest relatively well. Are there any lessons to be learnt here? I believe the answer is yes. At the beginning of the 1990s a clear framework for stabilisation policy emerged, with budget targets, expenditure ceilings and inflation targets. This has laid a good foundation for the economy and economic policy”, continued Lars Heikensten.

“The severe - and often strongly criticised - tightening up during the mid-1990s has created some scope for an expansive fiscal policy, which has been utilised in recent years. The household sector’s economy has thus remained good, despite the stock market falls. At the same time, it should be remembered that the problems related

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to conducting fiscal policy with the aim of fine tuning economic activity have not disappeared. The good 'timing' of the stimulation of the economy was at least partly coincidence this time. Nor is it likely that fiscal policy could in the long term protect the Swedish economy from the international downturn in economic activity. Now that employment is not growing at the same rate as before and the costs of parts of the transfer systems are rising rapidly, the policy is really being put to the test," emphasised Mr Heikensten. "Earlier monetary policy has also contributed to increasing our room for manoeuvre. Clearly directing policy towards achieving the target of 2 per cent over an almost 10-year period has created a credibility that contributed to limiting the unease on the financial markets last year, when inflation unexpectedly exceeded the target level. Households and companies also remained calm and assumed that inflation would return to the target level. This meant that the Riksbank only needed to use the repo rate for some minor signalling."

The perspectives on economic activity and inflation have been revised

"The decisive factor for the development of the global economy in coming years appears to be current events in the USA. Stock markets come under focus here. Will they fall further, a prospect that cannot be ruled out when comparing current developments with past history? And even if they do not fall further, will the falls that have already taken place have a greater effect on behaviour in the corporate and household sectors than we have seen so far? Another key issue is the stability of the property markets, which are highly valued in many areas. Added to this are the continuing large current account deficits in the USA and what they may mean for foreign exchange developments in the near future," continued Mr Heikensten.

"Over the past six months the Riksbank has on several occasions gradually made a downward adjustment of its assessment of economic activity. This has been expressed mainly in a postponement of the expected timing for an upturn in the global economy. We have also come to focus more on the financial risks caused by continued falls in share prices. At the same time, monetary policy conditions have improved in the sense that actual inflation has largely followed our forecasts and has now come down in line with our target level," pointed out Mr Heikensten. "This has reduced uncertainty over inflationary pressure in Sweden. It has also meant that inflation expectations have been lowered and are now more in line with our target level. Given this, it is not surprising that we have moved from a situation last spring, where we raised the repo rate and saw further increases ahead of us, to a situation at the beginning of the summer, where we refrained from raising the rate but signalled future increases. In August most analysts seem to have perceived us as fairly neutral."

"As I see it right now, there is reason to further postpone the expected time for the recovery in our forecasts. However, our main scenario is still that economic activity will continue to strengthen somewhat next year. At the same time, the risks of adaptation on the financial markets have increased, which also affects our assessment," said Mr Heikensten.

"The most likely scenario today is that inflation will remain roughly in line with our target level over the coming years, although probably at the lower edge. However, perspectives have changed rapidly and can do so again. Although there are still upside risks connected, for instance, with wage formation, it is primarily developments on the financial markets and what they may mean that could change the total assessment of future inflation. Given this, we at the Riksbank are now considering how we should act at the autumn's monetary policy meetings," concluded Mr Heikensten.