Erik Thedéen: Monetary policy in recent years and key issues ahead

Speech by Mr Erik Thedéen, Governor of the Sveriges Riksbank, at Danske Bank, Stockholm, 22 November 2024.

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Thank you for the invitation!

Today, I would like to start by looking back at the past few years – years that have been eventful from a monetary policy perspective, to put it mildly. I shall then go on to discuss the Riksbank's latest interest rate decision. Finally, I would like to widen my view and discuss the environment in which monetary policy will operate in the long run.

Several factors behind the rapid rise in inflation

The starting point for the rise in inflation was the pandemic in 2020 and the shock to the economy that the spread of infection and the measures to contain it caused. GDP fell sharply and redundancy notices rose to record levels as companies' supply chains broke down and production and consumption stalled. There were also major fluctuations as some consumption first virtually stopped and then rapidly increased again as the economy started to recover.

For Sweden, this recovery proved to be faster than after other crises. Demand was strong not only in the Swedish economy but also globally. This contributed to a rapid rise in commodity prices in 2021 and a significant increase in freight prices when global trade adjusted after the pandemic. In addition, various supply shocks also contributed to the rapid rise in inflation. In 2021, energy prices, in particular electricity prices, started to increase rapidly. When Russia invaded Ukraine in early 2022, inflation received an extra boost as energy and food prices rose even more. After a time, services prices also increased and, by early 2023, more than 8 out of 10 prices in the CPIF basket were increasing by more than 4 per cent.

Thus there was a broad and sharp rise in prices. That firms started to pass on their increased costs to consumer prices to such a large extent was probably a result of the succession of large cost increases and the large pent-up need to consume among households. Higher prices may also have become more acceptable – both among firms, who saw that other firms were able to raise their prices more, and among households, who realised that firms were in a vulnerable position after the pandemic.

Unexpectedly high resilience despite large impact on interest rate sensitiveparts of the economy

CPIF inflation rose from 4 per cent at the beginning of 2022 to peak at just above 10 per cent in December of that year. In February 2023, it was around 9.5 per cent and, in the same month, inflation excluding energy prices peaked, also at around 9.5 per cent. By that point, the Riksbank had rapidly raised its policy rate from 0 to 3 per cent to halt the unexpectedly sharp rise in inflation, which entailed a large fall in real wages. Together with higher interest rates, the decline in real wages significantly reduced households'

purchasing power. During this period, intensive discussions took place about the extent of the impact this would have on the Swedish economy.

With hindsight, we know that GDP declined slightly in 2023 and that the labour market weakened but the economic downturn was not nearly as deep as many had warned. Interest rate sensitive components, such as household consumption and residential construction, were significantly affected but other investment and exports held up. Employment actually increased until mid-2023. It has fallen since then, although it is still at a historically high level. Indeed, the employment rate is now higher than it was before the pandemic.

Since May, the Riksbank has cut its policy rate by 1.25 percentage points

In 2023, inflation started to decline from its very high levels, partly due to the declining contribution made by energy prices. But inflation remained high throughout the year and the policy rate was raised slightly further. Towards the end of 2023, the Riksbank judged that inflationary pressures had eased more clearly and therefore held off on raising the policy rate further. At that stage, it was still relatively uncertain to which extent firms were passing on their increased costs to consumer prices. Costs had increased partly as a result of higher import prices due to the weak krona and there were signs that the impact of the weak krona on consumer prices had been greater than normal. There was therefore a risk that inflation would fall back at a slower pace if the krona were to weaken more than expected.

For a few meetings in early 2024, we thus kept the policy rate unchanged. But we changed our communication about how it would develop in the future, as inflation evolved in line with our forecasts and we gradually became more confident that inflation would remain low. In February, we said that the policy rate could probably be cut during the first half of the year. And in March, we said that the policy rate would probably be cut in May or June. In May, we cut the policy rate, ahead of the ECB and the central banks of many other countries where inflation had not fallen as rapidly. Apart from a pause in June, the Riksbank has subsequently cut the interest rate at each monetary policy meeting this year, totalling 1.25 percentage points. I have likened this development to the fog having lifted over the course of the year and we have felt increasingly confident that the course we have charted is the right one. The question that then arises is how much we should increase our speed.

It is important in itself that economic activity strengthens but it is also a precondition for inflation to be close to the target in the future

During the year, the Riksbank has noted that inflationary pressures have fallen and that the Swedish economic situation has been weak. However, the conditions have been right for a recovery. Household savings are high and disposable income and wages have increased again in real terms as inflation has fallen. Interest rates have fallen for both households and firms, household expectations about the future have strengthened over the year and business confidence has improved. But despite the favourable conditions, there have been few clear signs that the recovery has started.

It is important in itself that economic activity strengthens but it is also a necessary condition for inflation to stabilise close to the target going forward. At the moment, falling energy prices are pushing inflation below the target. We believe that this is a temporary effect and that inflation will stabilise at around 2 per cent in the future. A precondition for this is that the recovery picks up soon. However, risks have increased that both the Swedish and global economies will recover more slowly than expected. At the last meeting in early November, we judged that the interest rate needed to be cut a little faster than we envisaged in September. Consequently, we cut the policy rate by 0.5 percentage points. This provides further support to the recovery at a point where we recognise that the risk of excessive inflation has diminished.

But it is important to emphasise that there is now also greater uncertainty about the economy going forward. If the outlook for inflation and economic activity remains the same, we can continue to cut the policy rate in December and during the first half of 2025, in line with what we communicated in September. But if the conditions change, this may justify a higher or lower interest rate in the period ahead. This may seem obvious but right now we have reason to place great emphasis on this point. There are question marks over whether and when the turnaround in the Swedish economy will come and how strong the recovery will be once it takes off. In addition, there is considerable uncertainty about global developments, not least the impact of the change of president in the United States on the US economy, the international economy and the geopolitical situation. The Riksbank will monitor developments closely and we are prepared to adjust monetary policy if necessary to ensure inflation around 2 per cent in the long term.

Longer-term developments – productivity a key factor

A question often raised in the debate is where monetary policy and the economy as a whole are heading in the long term. This is partly due to the uncertainty I mentioned earlier but there are also a number of challenges that will characterise the environment in which monetary policy is to operate. There is currently a strong focus on Europe's future competitiveness, including ongoing discussions on the so-called Draghi report and its conclusions on the EU's lack of innovative capacity, low productivity and strategic dependence on the United States and China in several areas.[1]

Productivity determines how efficiently resources in the economy are transformed into goods and services and is one of the most important determinants of material well-being in the long run – the rate of increase in GDP per capita is largely determined by the rate of increase in productivity. Many countries in the EU have high levels of public debt and, with stagnating GDP growth, there is a risk that debt will eventually become unsustainable. In turn, this could mean that the priorities that must then be set will be at the expense of the green transition, for example. To meet the challenges, the report estimates that additional investment equivalent to 5 per cent of GDP is needed each year over a five-year period. It makes no distinction between private and public investment but notes that historically about 80 per cent has been private and 20 per cent public.

The report proposes a large number of concrete measures to boost productivity and competitiveness, including reducing the regulatory burden for small and medium-sized enterprises and the implementation by the EU of the long-discussed Capital Markets

Union. It is also interesting to note that a fact box highlights Sweden as a role model in the financial market area. The box describes how Sweden has created a deep capital market with a high level of participation by private individuals and how this model has resulted in a large number of IPOs and a better market performance than other European countries.

The Draghi report will be a basis for future discussions within the EU and there is a lot to discuss, both in terms of the problems that the report identifies and the concrete measures proposed. For example, as many have pointed out, even greater public debt would be problematic – even if it were to be taken out through a common EU framework – given that several European countries are already struggling with high public debt. Increased government borrowing can be justified if it is properly channelled and actually contributes to higher growth in the long run. However, this is not automatic and the relationship between public debt and public investment has been relatively weak.

Stronger productivity growth in Sweden than in Europe on average

Comparing Sweden with the EU and euro area averages reveals that its public debt is significantly lower. Moreover, over the past 30 years, its productivity has developed more strongly. Starting in the mid-1990s and for about the next ten years, Sweden's productivity improved faster than that of most major European countries. The upturn in productivity growth in Sweden, as in the United States during this period, was largely related to developments in the ICT (information and communication technology) and services sectors. The Draghi report focuses on the differences between technology sectors to explain why the United States has had stronger productivity growth than Europe. However, there have also been differences between European countries.

Swedish productivity growth slowed down in the context of the 2008–2009 global financial crisis. But this was not unique to Sweden. The same slowdown occurred in virtually all advanced economies, suggesting that the explanation may be mainly global in nature. However, as the Swedish productivity commission has pointed out, most evidence suggests that country-specific factors will remain important for future productivity developments. In an interim report last spring, the commission highlighted certain areas and proposed measures such as regulatory reform that could boost productivity in various sectors, including housing and construction. The commission also calls for a comprehensive review of housing policy to improve market conditions for housing construction.

There are several reasons why productivity growth could influence monetary policy. With strong productivity growth, firms' costs for increasing output become lower, given a certain level of labour input. In the shorter term, therefore, there is a link between productivity growth and inflationary pressures in the economy. From a longer-term perspective, productivity is also important for the long-term growth rate of the economy, which, in turn, can influence the normal level of the real interest rate. So there is an interesting link here between the discussion of weak productivity growth and the discussion of the level of interest rates in the long term and whether we are heading back towards an environment with low interest rates. In this context, I would like to take the opportunity to advertise a breakfast seminar at the Riksbank next week, at which my colleague Deputy Governor Anna Seim will discuss the concept of, and the Riksbank's view of, a neutral interest rate.

Challenges for monetary policy in a low interest rate environment

We do not know what interest rate environment the economy will find itself in over the long term. But it is not impossible that, in the future too, we will end up in a situation where the economy needs to be stimulated but the policy rate is close to 0 per cent. One option for the Riksbank would then be to cut the interest rate to a little below zero, although a negative interest rate is associated with uncertainties and risks. Another possible measure would be to purchase securities. The threshold for such purchases, particularly purchases of private securities, will be high.

However, it cannot be ruled out in advance that situations may arise in which securities purchases may be an appropriate monetary policy tool. In order to maintain a good operational capacity to carry out such purchases in acute situations, we have therefore decided to hold a portfolio of government bonds. The entire holding of Swedish bonds built up via the Riksbank's previous purchases of securities will therefore not be wound down; instead we will retain a portfolio of government bonds totalling SEK 20 billion. At the current rate of maturities and sales of government bonds, we will, in principle, reach that level by the end of next year. Holdings of other Swedish bonds continue to decline as they mature and, in a few years, virtually all will be gone.

In a situation where the policy rate is at its lower bound, another option is for fiscal policy to take a more active role in stimulating the economy. Proposals along these lines have been put forward from various participants in the debate in Sweden recently. These have mainly emphasised the contribution made by fiscal policy towards stabilising the economy in recessions. The deliberations and coordination between fiscal policy and monetary policy will become trickier if, for example, inflationary pressures are low in a situation where demand in the economy is still relatively high.

I do not believe that formalising coordination between policy areas is a solution. Firstly, it is difficult to reconcile this with a monetary policy that is required by law to be conducted in an independent manner. Second, I am also sceptical of the view that the overall stabilisation policy should, or even can, be fine-tuned. On the other hand, it would be a good idea to improve the conditions for a good mix of fiscal policy and monetary policy, for example by developing ways for the Ministry of Finance and the Riksbank to exchange information on the economic situation.

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[1] The report, entitled "The future of European competitiveness", was commissioned by the European Commission and published in September this year. The report consists of two parts: Part A. A competitiveness strategy for Europe and Part B. In-depth analysis and recommendations.