



# PRESS RELEASE

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## ■ Wickman-Parak: The Riksbank and monetary policy

*Deputy Governor Barbro Wickman-Parak gave a speech at a meeting held today at Swedbank in Stockholm. In her speech Ms Wickman-Parak presented her views on monetary policy and on the decision taken at the monetary policy meeting held on 20 June.*

"The Executive Board raised the repo rate from 3.25 per cent to 3.50 per cent in June and presented a new interest rate forecast. I supported both the proposal to raise the interest rate and the forecast for the repo rate," began Ms Wickman-Parak.

"I saw the decision to raise the interest rate as a natural progression; several years of high growth have pushed up resource utilisation, which is now slightly higher than normal and cost pressures have increased. Over the coming years resources will be under further strain, which will lead to increased cost pressures. To prevent demand from accelerating to such an extent that the economy overheats, triggering a cost/inflation spiral, I considered it reasonable to raise the repo rate roughly in line with the new interest rate forecast. I also said that the repo rate was relatively low prior to the June meeting and that raising it to 3.50 did not change this fact," commented Ms Wickman-Parak.

"A decision to raise the interest rate leads to an immediate delivery. The interest rate path is a different matter. In this case it is a question of a *forecast* for the repo rate. It covers a period of three years and is of course very uncertain. It does not involve any "delivery guarantee" – we may well find reason to raise the rate at a slower or faster pace, and it is important to point this out," emphasised Ms Wickman-Parak.

"With effect from the June meeting, the names of the Executive Board members will be included beside their comments in the minutes of the monetary policy meetings. Those who have read the minutes of the June meeting will recognise the points I am taking up here. I shall sum up the most important reasons for taking the stand I took. I shall also touch on some events that have occurred this summer. The Bank's new policy means that no signals regarding new monetary



policy intentions should be given between the monetary policy meetings. The fact that I am taking up some events that have occurred since the June meeting should not be interpreted to mean that I am acting as messenger for the Executive Board or that I am sending any signals with regard to how I will vote at the monetary policy meeting in September. In conclusion, I will talk about the market reactions to the interest rate decision in June," said Ms Wickman-Parak.

"At the meeting in June I pointed out that the current fiscal policy involves large tax cuts. These have immediate effects on household incomes and stimulate the demand for labour. The tax reductions and other measures are also aimed at increasing the labour supply. It is very uncertain how large the effects will be and when they will have their greatest impact. So far the labour supply has increased, but not at the same rate as demand. The Riksbank's task is not to comment on fiscal policy, but to assess how various measures will affect supply and demand in the economy and therefore also inflation is a central factor of monetary policy," Ms Wickman-Parak pointed out.

"The development of unit labour costs is significant for inflation. These costs are affected by developments in wages and productivity. The wage bargaining rounds have resulted in wages increasing more than expected. In addition, there is wage drift, which was expected in June to amount to approximately one per cent a year over the coming years. At the same time, productivity is expected to show weaker development than in recent years. The size of the wage drift is difficult to determine and productivity growth is a notoriously difficult variable to capture. Productivity growth varies considerably from one quarter to another and we need to learn more about its determinants. All those who make inflation forecasts have good reason to try to improve their understanding of productivity developments. But at the same time this task should be approached with humility and we must assume that we may continue to face surprises in the future," observed Ms Wickman-Parak.

"Productivity is one of the factors that determine how high the growth rate can be without jeopardising the inflation target. Access to labour is another factor. Compared with earlier period of strong economic activity, the labour reserve is now slightly larger. However, the composition of this reserve is also significant. How many of these people have skills that are currently in demand? There is currently uncertainty regarding the answer to this question. The National Institute of Economic Research's surveys indicate that the percentage of companies reporting a labour shortage is increasing, although this percentage is not yet as high as during the previous economic boom," said Ms Wickman-Parak.

"We must closely monitor all signals that may indicate growing problems with bottlenecks. An aggravated labour shortage could force companies to push up remunerations more than was assumed in the Monetary Policy Report. The alternative is to lower their requirements regarding qualifications. This could have an effect on productivity growth, which could then be weaker than was forecast in June. In both cases cost and inflationary pressures would rise," Ms Wickman-Parak pointed out.

"Now a few words on household borrowing and house prices. The Riksbank does not have, and this is worth pointing out over again, any target for house prices or household indebtedness. However, it is clear that house prices and household indebtedness are now growing at a rate that is not sustainable in the long term. There will probably be an orderly return to a more sustainable rate of increase. However, at the meeting in June I pointed out that we cannot rule out the



possibility that the adjustment will be more abrupt, which would then have consequences for both growth and inflation. Raising the interest rate reduces the probability of such a scenario and thereby contributes to a balanced economic development," said Ms Wickman-Parak.

"A lot has happened since the meeting in June. The consequences that new information may have for the repo rate will be discussed at the next monetary policy meeting on 6 September. Without anticipating this discussion, I would like to give some examples here of what I personally consider to be important pieces of the puzzle," said Ms Wickman-Parak.

"The initial version of the National Accounts for the second quarter was published recently. This confirms the Riksbank's forecast that the slowdown in growth in Sweden during the first quarter was of a temporary nature. GDP growth was marginally higher than our forecast from June. On the other hand, employment measured in terms of the number of hours worked was stronger than our forecast and consequently productivity growth was weaker than expected. The figures for the second quarter are based on incomplete data and are thus uncertain, and a revised version for the first quarter has not yet been published. Since the meeting in June the Labour Force Survey figures for the second quarter and the inflation figures for June and July have been published. Employment measured in terms of the number of persons increased approximately as expected; while unemployment was slightly lower than forecast. The outcome for inflation was roughly in line with the forecast we made in June. Domestic economic activity is still developing strongly. With regard to international developments, the new data on the whole confirm the picture of high global growth painted in the June Monetary Policy Report. However, it is clear that the problems in the US subprime market have led to increased uncertainty more generally in the financial markets. We will return to the issue of how these and other factors will affect our overall assessment in connection with the next monetary policy meeting. We will of course follow developments closely. With regard to the Swedish money market, there are at present no liquidity problems. The market is functioning well," continued Ms Wickman-Parak.

"The market reactions to the publication of the Executive Board decision on 20 June were very strong. The krona appreciated and interest rates rose. Market expectations, as reflected in implied forward rates the day before the decision, implied that it would not be a major surprise. The expectations were fairly well in line with the Riksbank's new interest rate path some time into next year and were then slightly higher further ahead," said Ms Wickman-Parak.

"The Riksbank's new path for the repo rate at the end of 2007 was slightly higher than the average forecast according to various market indicators. But in the slightly longer run several analysts were predicting a higher interest rate than the Riksbank. Evidently, some analysts' expectations of the Riksbank's interest rate path differed from their own forecasts for the repo rate. How can this be? One interpretation may be that these analysts believed they had weighed together information on inflationary pressures in the economy in a different way than the Riksbank. The fact that such differences arise from time to time is not remarkable in itself. Different analysts also have different opinions regarding what will happen to the repo rate," Ms Wickman-Parak pointed out.

"The decision to publish the interest rate path has meant a major change in the Riksbank's communication and a step towards greater clarity on the part of the



■ Riksbank regarding its view of the future development of the repo rate. I believe that we are now in an intensive learning process where both the Riksbank and market participants will gradually become better at interpreting one another's reaction patterns. The Riksbank's task must be to constantly endeavour to improve its communication and become more predictable," said Ms Wickman-Parak.

"A natural consequence of presenting our own interest rate path is that the focus is moved from the present monetary policy decision, and even the next couple of decisions, to developments in the longer term. This is essentially positive. Companies' and households' decisions need to be based on an analysis of the development of interest rates. At the same time, it is of course true that the further ahead we look, the more uncertain the assessments become and this leaves greater scope for differences. There are no clear-cut facts. However, the different assessments and considerations can be compared with one another, which may provide a more balanced picture of different possible developments," concluded Ms Wickman-Parak.