

ARTICLE – Is activity in the Swedish economy too high?

The Riksbank's expansionary monetary policy has contributed to high growth and rising inflation. It is sometimes stated in the debate that activity in the economy is now on such a high level that the expansionary economic policy risks leading to overheating. The Riksbank's assessment is that resource utilisation is higher than normal, but there are nevertheless few signs of wages and prices rising too quickly. Neither do factors such as continued high savings and good competitiveness indicate major imbalances in the economy in general. This does not mean, however, that the risks of high activity in the Swedish economy can be ignored. There is, for example, a risk of housing construction declining rapidly from its current high level, which could contribute to or exacerbate a future recession. The Riksbank has also been emphasising the risks linked to household indebtedness for a long time. There is still reason to closely analyse the housing and the mortgage markets.

High resource utilisation raises questions

The Riksbank has the task of trying to keep inflation close to the target of 2 per cent while simultaneously striving to stabilise output and employment around long-term sustainable levels. Against the backdrop of factors such as weak developments abroad, this has required a very expansionary monetary policy to stimulate demand and push up inflation and in so doing safeguard credibility for the inflation target.

Inflation is now close to target and the Riksbank assesses resource utilisation to be higher than normal (see Figure 4:12 and 4:14). Continued high activity in the economy is needed for inflation to stabilise around 2 per cent. At the same time, the strong development means that it is natural for various risks associated with high resource utilisation to be highlighted in the debate.

One way of analysing the risks of high resource utilisation is to divide them into two categories: High inflation and misallocations or imbalances in output and demand. Both contribute to greater economic fluctuations, increased uncertainty and poorer conditions for households and companies to, for example, plan their saving and investment.

While there are a number of different measures of prices and cost pressures, it is much harder to identify imbalances in output and demand. It is difficult to measure resource utilisation with any great precision and it is even more difficult to say which level constitutes a problem. Even if there are signs of increased matching problems, such as labour shortages and recruitment times, it is complicated to determine the extent to which the high employment rate is sustainable in the long term or reflects an imbalance. Unemployment in certain groups on the labour market remains high and it is a positive development that more people now have access to the labour market without it leading to rapidly rising wages and prices.

In order to analyse misallocations and imbalances in output and demand, one needs to look at the development behind the Riksbank's normal measures of resource

utilisation. A low and falling level of saving, poorer competitiveness or rapidly growing output within a specific sector can be a sign of imbalances that risk deepening a future recession. In the current economic situation, there is, for example, reason to analyse more closely possible risks associated with the rapid growth in housing investment.

In addition, there are still the financial risks linked to high household indebtedness. Even if this development is not primarily due to high resource utilisation, it leads to greater vulnerability that may exacerbate the problems related to any imbalances in housing construction.

Risk of high inflation deemed low

Too high inflation is harmful to the economy, partly because inflation is usually volatile when it is high. Uncertainty increases and it becomes more difficult for economic agents to plan. This is why the Riksbank has the task of stabilising inflation close to 2 per cent.

The correlation between resource utilisation and inflation is an important component in the Riksbank's assessment of how inflation will develop. The starting point is the so-called Phillips curve, which, in simple terms, implies that wages and prices tend to increase rapidly when resource utilisation is high.⁷

Inflation in Sweden has in recent years risen from low levels and is currently close to target. However, the Riksbank considers that inflationary pressure is still low and that continued high economic activity is therefore needed for inflation to remain around the target. This is in part due to the fact that international inflation is low and that agreed wages for the next three years are moderate (see Chapter 4). The low risk of wages and prices rising too quickly is also supported by inflation and wage expectations.

Level of saving does not indicate emerging imbalances

Another risk associated with resource utilisation is that it may exacerbate a future recession. This is in contrast with the Riksbank's aim of stabilising output and employment around

⁷ See, for instance, "The correlation between resource utilisation and inflation" in the Monetary Policy Report, October 2016.

long-term sustainable levels. Alongside the direct effects such as higher unemployment in times of recession, greater fluctuations also lead to increased uncertainty, which normally slows down economic development.

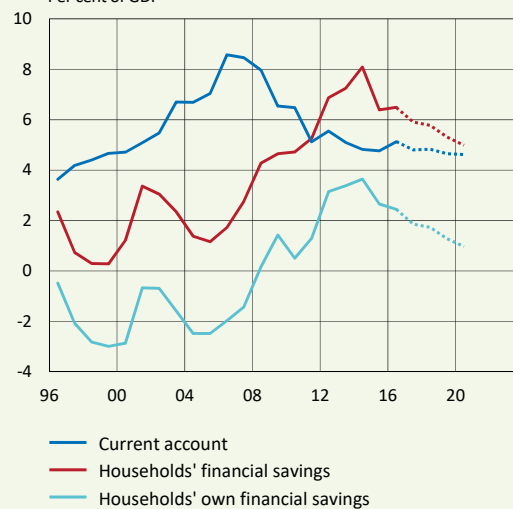
The correlation between high resource utilisation and greater fluctuations in economic activity can in part be related to saving and investment decisions. The Riksbank's assessment is that monetary policy needs to remain expansionary to support demand and stabilise inflation. At the same time, more consumption and investment today mean both less need and less scope in the future. Excessive demand can therefore contribute to deepening a future recession. This can happen, for example, if agents' expectations are significantly influenced by the current situation in the economy. In an economic boom, it can contribute to consumption, saving and investment decisions being based on excessively optimistic expectations of future incomes and vice versa in a recession. A low level of saving also reduces resilience when economic activity deteriorates and can hence increase the risk of a deep recession.

Swedish households have increased their saving significantly over the last ten years (see Figure 1:14). If collective insurance saving is excluded from household financial saving, a figure for own financial saving is obtained. This component reflects households' active saving decisions and the saving that households can adjust if the economy weakens and income growth slows. It is households own financial saving that has driven the upturn in the saving ratio. Even if households now reduce their saving, it will still be high in an historical perspective in the years ahead.

On a national level, a saving deficit implies a dependent on external funding. Under certain circumstances, for example during periods of financial stress, access to external funding can decrease and countries with a current account deficit can then be forced into significant adjustments in consumption and investment. Sweden has had a high current account surplus since the mid-1990s. It has decreased slightly in recent years but is expected to be close to 5 per cent of GDP in the years ahead (see Figure 1:14). There is therefore a significant saving surplus in the Swedish economy. Rising investment is in other words funded to a high degree by higher domestic saving.

As the current account is largely a mirror image of the relationship between exports and imports, the stable surplus is also an indication that the high level of activity in the Swedish economy is not associated with imbalances in the form of weakened competitiveness. This view is also supported by other competition indicators. The relationship between unit labour costs in Sweden and our trading partners has, for example, been stable in recent years and exports have developed approximately in line with import demand on Swedish export markets.

Figure 1:14. Current account and households' financial savings
Per cent of GDP



Sources: Statistics Sweden and the Riksbank

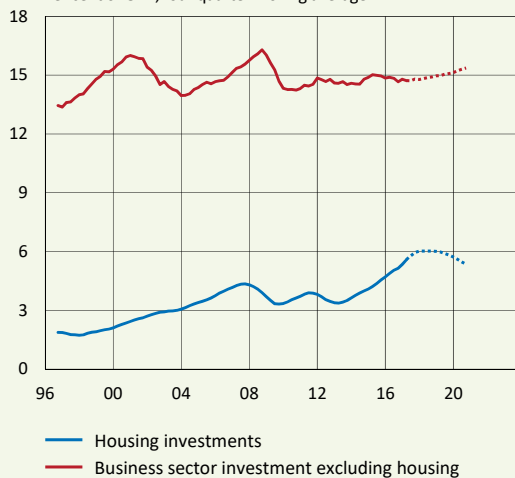
Historically high levels of housing construction

The part of the economy that has increased particularly rapidly in recent years is housing investment (see Figure 1:15). This development is relevant from at least two perspectives. Firstly, there is a risk of a direct effect, in which a slowdown in housing construction contributes to exacerbating a future recession. In addition, there is a connection between housing construction, housing prices and risks associated with household indebtedness.

Put simply, the direct effect can be related to the fact that housing that is constructed today does not need to be constructed tomorrow. The Riksbank's assessment is that there is a structural deficit after many years of low construction but the transition can take place at different rates. Housing investment's share of GDP has increased rapidly in recent years and the current level is almost twice as high as the average in 1993–2013. Rising housing investment has thereby had a significant direct effect on GDP development. Housing investment still makes up only a limited part of the economy, but according to historical patterns, the fluctuations are significantly greater than in GDP. Today's high level of construction therefore poses an increased risk of greater fluctuations in economic activity.

The level of housing construction is also linked to housing prices. The rapid increase in housing prices indicates that there has been a large deficit in housing on the market. The Swedish National Board of Housing, Building and Planning also considers that there is still a demographic need to satisfy after many years of excessively low housing construction. Neither is housing investment as a share of GDP in Sweden particularly high in an international perspective. The Riksbank's forecast shows a gradual reduction in housing construction with limited growth effects and a gradual slowdown in the housing price growth rate.

Figure 1:15. Business sector investments
Per cent of GDP, four quarter moving average



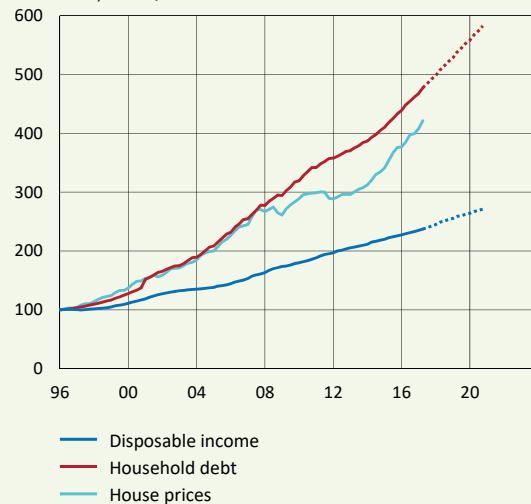
Sources: The National Institute of Economic Research, Statistics Sweden and the Riksbank

Developments on the housing market need to be tracked in the period ahead, not least because there is a link to housing prices and the risks associated with household indebtedness. In addition to the demographic need, the demand for housing is also influenced by factors such as incomes, housing costs and housing prices, both actual and expected. Tax reductions, generous loan conditions and low interest rates have, for example, contributed to higher demand and rising housing prices. The incentive to build housing is in turn influenced by price developments. In Sweden, this is reflected in a high covariation between housing prices and construction volumes. There is a risk of both demand and supply being based on overly optimistic expectations of incomes and prices, which can contribute to too many homes or homes that are too expensive being built in relation to households' long-term income growth. The economic consequences of such a development will be falling housing investment as well as falling housing prices.

Risks and consequences associated with overproduction and a fall in housing prices are also closely linked to credit growth and indebtedness. For example, a high loan-to-value ratio implies greater vulnerability in the event of a fall in housing prices as it increases the risk of the value of the home being less than the loan. A high loan-to-value ratio and

high indebtedness also undermine households' scope for consumption and reduce their resilience in the event of an economic downturn, thereby heightening the risk of major economic fluctuations. Experience indicates that recessions preceded by rapidly increasing credit growth and house prices tend to be both deeper and longer than other economic downturns.⁸

Figure 1:16. Disposable income, house prices and household debt
Index, 1996 Q1 = 100



Note. Disposable income refers to four quarter moving average.

Sources: Statistics Sweden and the Riksbank

However, the development of loan-to-value ratios and household debt is not primarily a result of the business cycle. Both house prices and debt have grown more rapidly than household income for a long period irrespective of the economic situation (see Figure 1:16). It is also relevant to distinguish between increased indebtedness as a result of a growing housing stock and more people owning their own home and an increase driven by rising house prices and rising loan-to-value ratios.

⁸ See, for example, Jordá, O. Schularick, M. and Taylor, A. "The Great Mortgaging: Housing Finance, Crises, and Business Cycles", NBER Working Paper No. 20501, September 2014 and Drehmann, M. Borio, C. and Tsatsaronis, K. "Characterising the

financial cycle: don't lose sight of the medium term!", BIS Working Papers No 380, June 2012.