

ARTICLE – The significance of international developments for monetary policy

The economic upswing in the global economy is continuing and includes an increasing number of countries. In the past six months, outcomes and indicators have provided grounds for increased optimism and it is possible that the strength of the economic upturn is being underestimated. At the same time, however, there are risks of setbacks linked to developments in economic policy abroad. This article describes how two alternative scenarios for international developments can affect economic developments in Sweden. The fact that inflation has been low for a long time means that a weaker economic development in Sweden than in the main scenario could have a greater impact than normal on confidence in the inflation target. Lower inflation than in the main scenario is hence a more troublesome scenario than one in which inflation temporarily overshoots the inflation target. If the economy were to develop more weakly than expected, the Riksbank can take a number of different measures to make monetary policy more expansionary. If the development were instead to be stronger than in the main scenario, the low inflation of recent years is an argument in favour of a more cautious adjustment of monetary policy than normal.

Economic recovery fraught with political risks

The global economy is in a recovery phase. In 2016, global GDP grew by 3.1 per cent and growth this year is expected to be 3.4 per cent. After several years of surprisingly low growth, recent outcomes have been more in line with expectations. Furthermore, forward-looking indicators, such as the global purchasing managers' index and consumer confidence, have strengthened since 2016. Predicting turning-points in the economy is difficult and it is possible that the strength of the economic upturn is being underestimated.

At the same time, the political situation in many parts of the world makes economic and political development difficult to predict. Support for anti-EU political parties in Europe is, for example, greater than it has been for some considerable time and the agendas of these parties, should they be realised, have the potential to radically change economic policy. Examples include Front National in France and the so-called Five Star Movement in Italy. There is also uncertainty in the United States regarding the shaping of economic policy, and of financial and trade policy in particular.

There are therefore both upside and downside risks to international development. Here they are illustrated by means of two alternative scenarios that relate to Europe but could more generally be used to illustrate risks in other parts of the world economy, too. The main purpose is to discuss how monetary policy could be shaped, given the current strong economic situation and that inflation has at the same time been low for a long time.

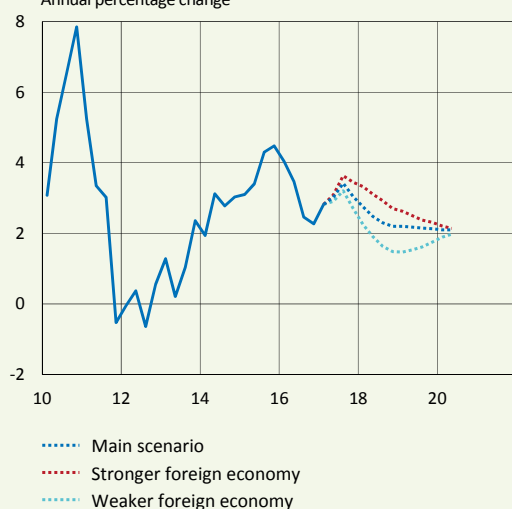
Stronger European economy

Indicators point to rising GDP growth in several European countries and there may be a pent-up need for investment after several years of weak investment growth. At the same time, confidence among households and companies is strengthening. In the first scenario, it is assumed that these trends will continue to strengthen quite quickly and contribute to higher investment growth, and hence a faster economic upturn, in Europe compared with the assessment in the main scenario. GDP growth abroad (KIX-weighted) is assumed to be an average of 0.2 percentage points higher per year than in the main scenario in 2017–2019, and the difference is mainly due to higher growth in the euro area.

Better prospects in Europe affect the Swedish economy in several different ways. A major part of Swedish exports go to European countries and these are in turn made up of investment goods to a large extent. The fact that confidence is strengthening further also means that households save less and instead consume more. All in all, this means that demand in Sweden increases more rapidly and GDP growth is higher than in the main scenario (Figure 1:15). Accordingly, demand for labour also rises more rapidly, leading ultimately to a higher wage rate and higher costs for companies. Higher demand and higher costs means both greater opportunities and greater need for companies to raise their prices. CPI inflation is therefore be higher than expected (Figure 1:16). The krona is slightly stronger than in the main scenario but the effects of this on the real economy and inflation are minor.

The scenario illustrates the effects on growth and inflation when monetary policy is not changed in comparison with the main scenario. However, under normal circumstances the development in this scenario would mean that monetary policy was made clearly less expansionary, particularly given the strong economic activity to begin with. But inflation has been below target for a long time and monetary policy has been made increasingly expansionary. In the current situation, there is an evident risk that confidence inflation target is being affected more than normal by negative inflation surprises.¹¹ This risk is an argument in favour of a more cautious adjustment of monetary policy than normal in the scenario. Such a monetary policy mitigates the risk of the upturn in inflation being interrupted and of once again weakening confidence in the inflation target. Therefore, inflation is allowed to be slightly higher than the inflation target for a time.

Figure 1:15. GDP growth
Annual percentage change



Sources: Statistics Sweden and The Riksbank

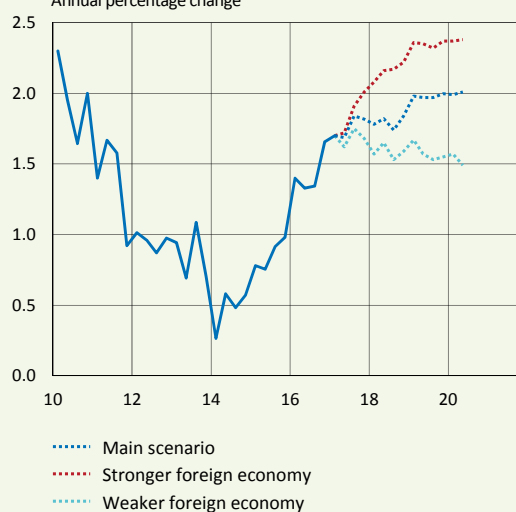
Concern over setbacks gives weaker developments

In the second scenario, it is assumed that political developments in Europe in 2017 will impair the prospects for EMU and EU cooperation. This concern manifests itself partly in the form of the yields on a number of countries' government bonds rising markedly relative to German yields. Several of these countries have a high sovereign debt in relation to GDP and the fact that their yields are rising reflects an increased credit risk, that is a greater probability for the value of the sovereign debt being written down. The yield gap for these countries in relation to Germany is assumed to increase by a maximum of three percentage points in 2017 and then fall back to more normal levels at the end of the

forecast period. This development means that the problems of poor profitability and weak balance sheets in the European banking sector are further reinforced. Confidence among households and companies is negatively affected and the recovery in the European economy is interrupted. GDP growth abroad (KIX-weighted) will be an average of 0.6 percentage points lower than in the main scenario in 2017–2019.

Concern linked to political developments in Europe affects the Swedish economy through several different channels. Weaker real economic development in Europe implies a lower demand for Swedish export than in the main scenario while household and company confidence is negatively affected. Precautionary saving among households rises and companies' willingness to invest declines. GDP growth in Sweden is affected to approximately the same extent as internationally and is lower than in the main scenario (see Figure 1:15). This is also true for CPI inflation (see Figure 1:16). The krona is slightly weaker than in the main scenario but the effects of this are minor.

Figure 1:16. CPI
Annual percentage change



Sources: Statistics Sweden and The Riksbank

The scenario calculates the effects on growth and inflation when monetary policy is the same as in the main scenario. This is done to clarify the effects that would be caused by the weaker international developments. However, the relatively large negative effects on CPI inflation mean that this assumption for monetary policy is not realistic, but that there is a need in the scenario to make monetary policy more expansionary. This could, for example, be achieved by cutting the repo rate, prolonging the period with a negative repo rate, or by additional government bond purchases, or by a combination of these measures. As Swedish public finances

¹¹ The IMF's World Economic Outlook, October 2016 presents empirical findings indicating that the sensitivity of inflation expectations to surprises in inflation outcomes is greater in countries where policy rates are very low. This suggests that

the sensitivity of inflation expectations is affected by how large the scope for monetary policy to respond is perceived to be.

are in good condition, there would also be scope for fiscal policy stimulation.

Monetary policy takes the risks of low inflation into account

In summary, the discussion based on both the scenarios illustrates that monetary policy, in the current situation, might not necessarily react as forcefully if inflation were to be surprisingly high or low respectively. Inflation has been lower than 2 per cent for a long time, which means that the risk of weakening confidence in the inflation target would be greater than normal if economic development were once again to be weaker than expected. In a scenario where economic development is stronger than expected, this may justify a more cautious adjustment of monetary policy than normal. In a scenario where development is instead weaker than in the main scenario, monetary policy would need to be made more expansionary, which in that case could be achieved in a number of different ways.