Where is the economy heading?

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NOPA Annual Meeting

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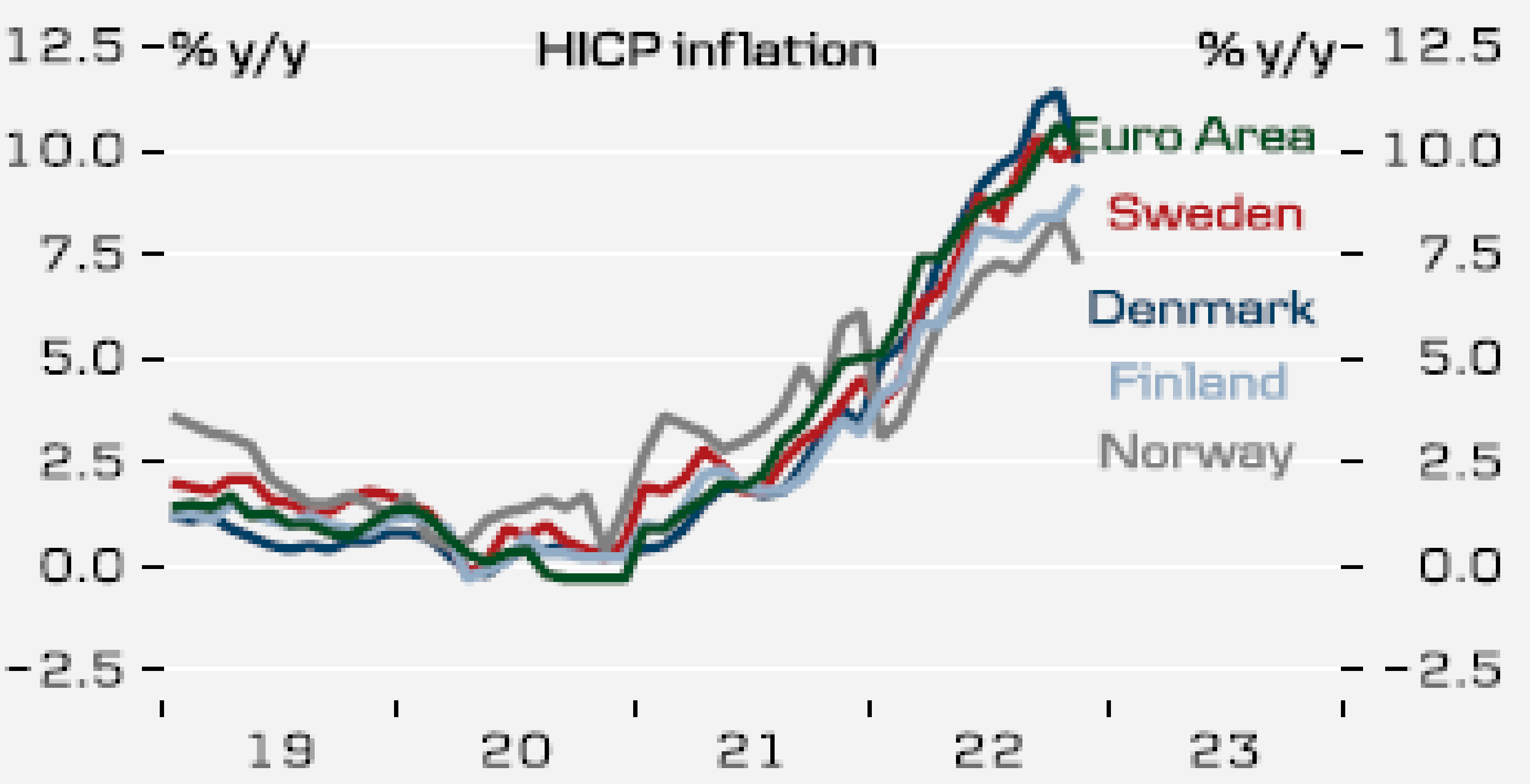
Outline of speech

- Current high inflation
- Causes of the high inflation
- Simultaneous *stag*nation and in*flation*: *stagflation*
- Central banks and interest rate rises
- What is happening to economic activity?
- Are central banks doing the right things?
- Are governments doing the right things?

Inflation surge also in the Nordics



Source: Eurostat, Macrobond Financial

Inflation: HCPI index

	2020	2021	2022	2023	2024
Denmark	0,4	1,9	7,8	5,5	2,8 -
Finland	0,4	2,1	7,0	5,3	3,1
Norway	1.3	3,5	5,7	4,5	3,2
Sweden	0,5	2,4	7,7	5,1	2,2
Estonia	-0,6	4,5	20,2	10,8	2,8
Latvia	0,1	3,2	17,0	10,7	5,0
Lithuania	1,1	4,6	18,8	11,9	4,0

Causes of high inflation

- Strong recovery after the covid crisis in 2020
- Various supply problems

  - freight bottlenecks

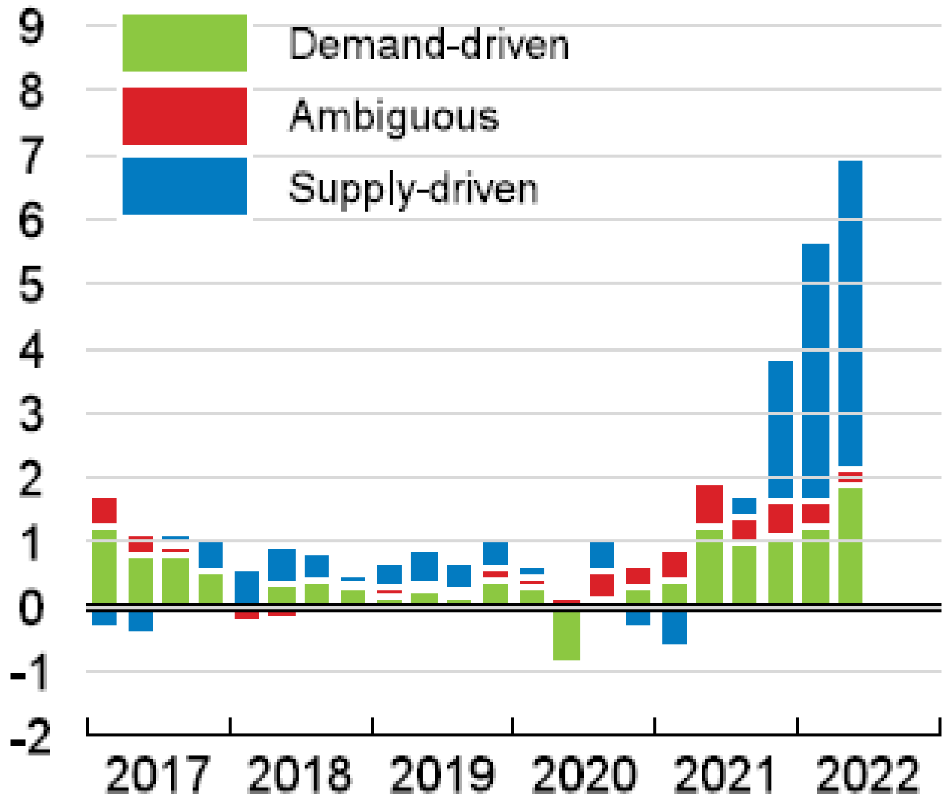
  - continued lockdowns in China

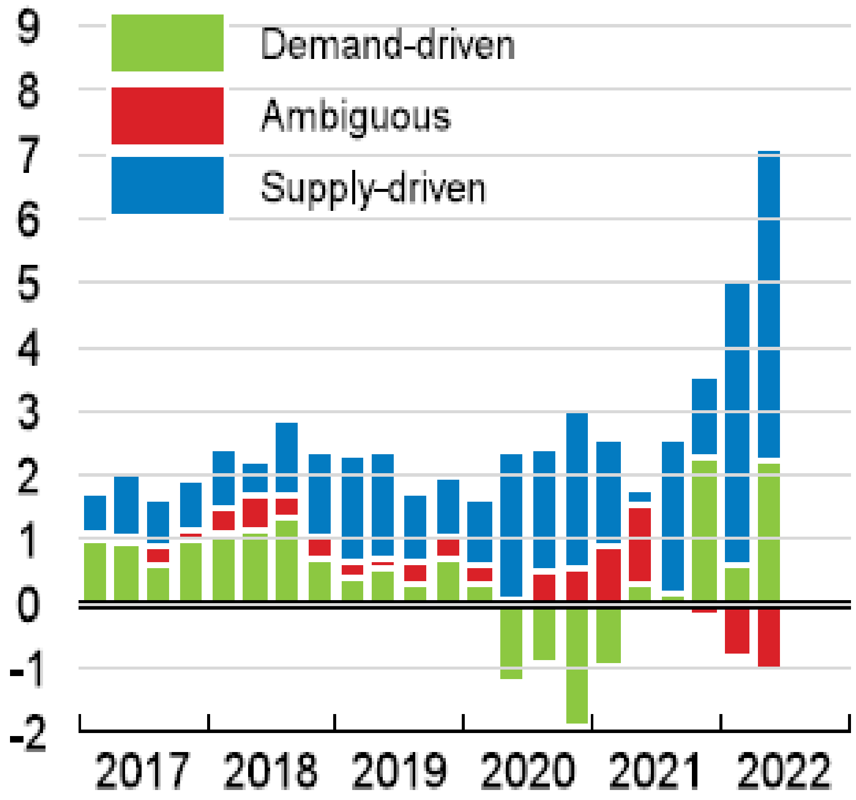
  - shortages of microchips
- Ukraine war

  - higher gas and energy prices

  - higher food prices

Causes of inflation: Denmark (left) and Sweden (right)





Polar cases of inflation

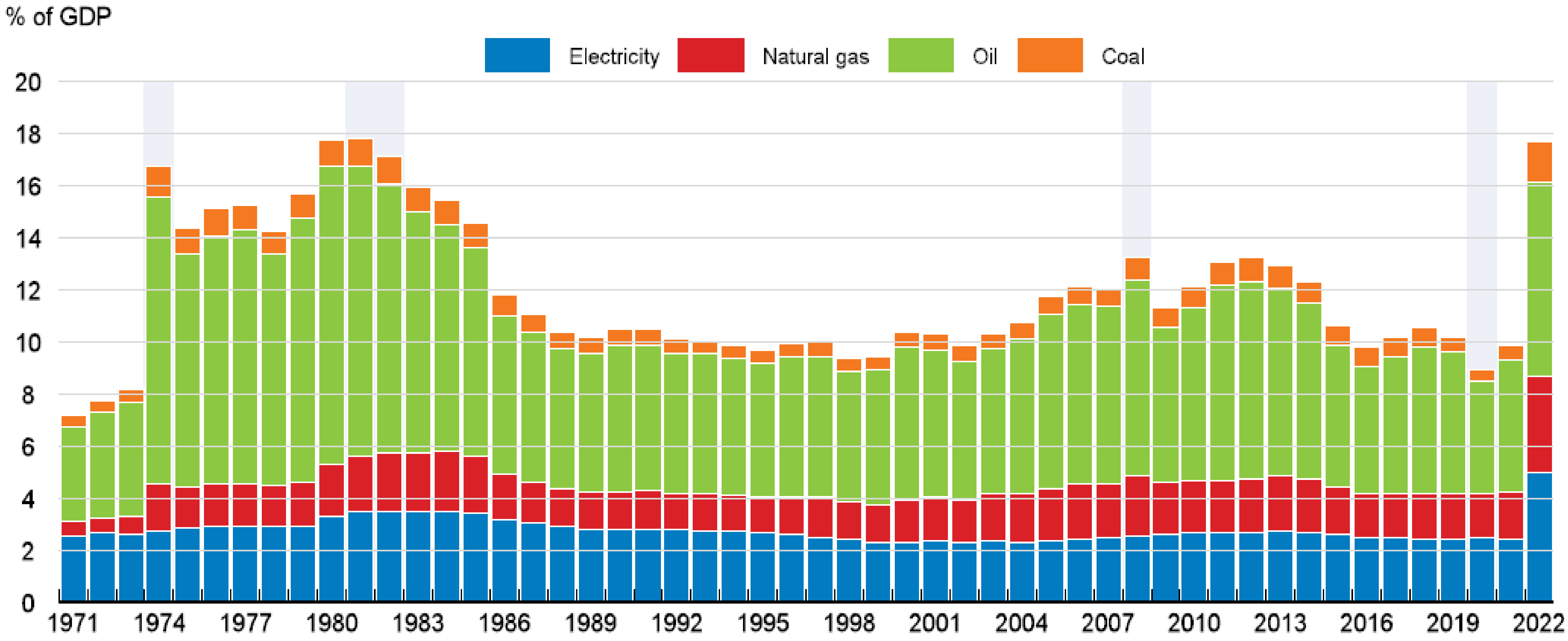
Positive demand shock

- Inflation and high output/employment
- Contractionary policy reduces both inflation and output/employment
- Output/employment falls are not a problem
- No conflict of goals

Negative supply shock

- Inflation and low output/employment (stagflation)
- Contractionary policy lowers inflation but increases unemployment
- Expansionary policy lowers unemployment but raises inflation
- Conflict of goals

Energy end-use expenditures in OECD and recessions



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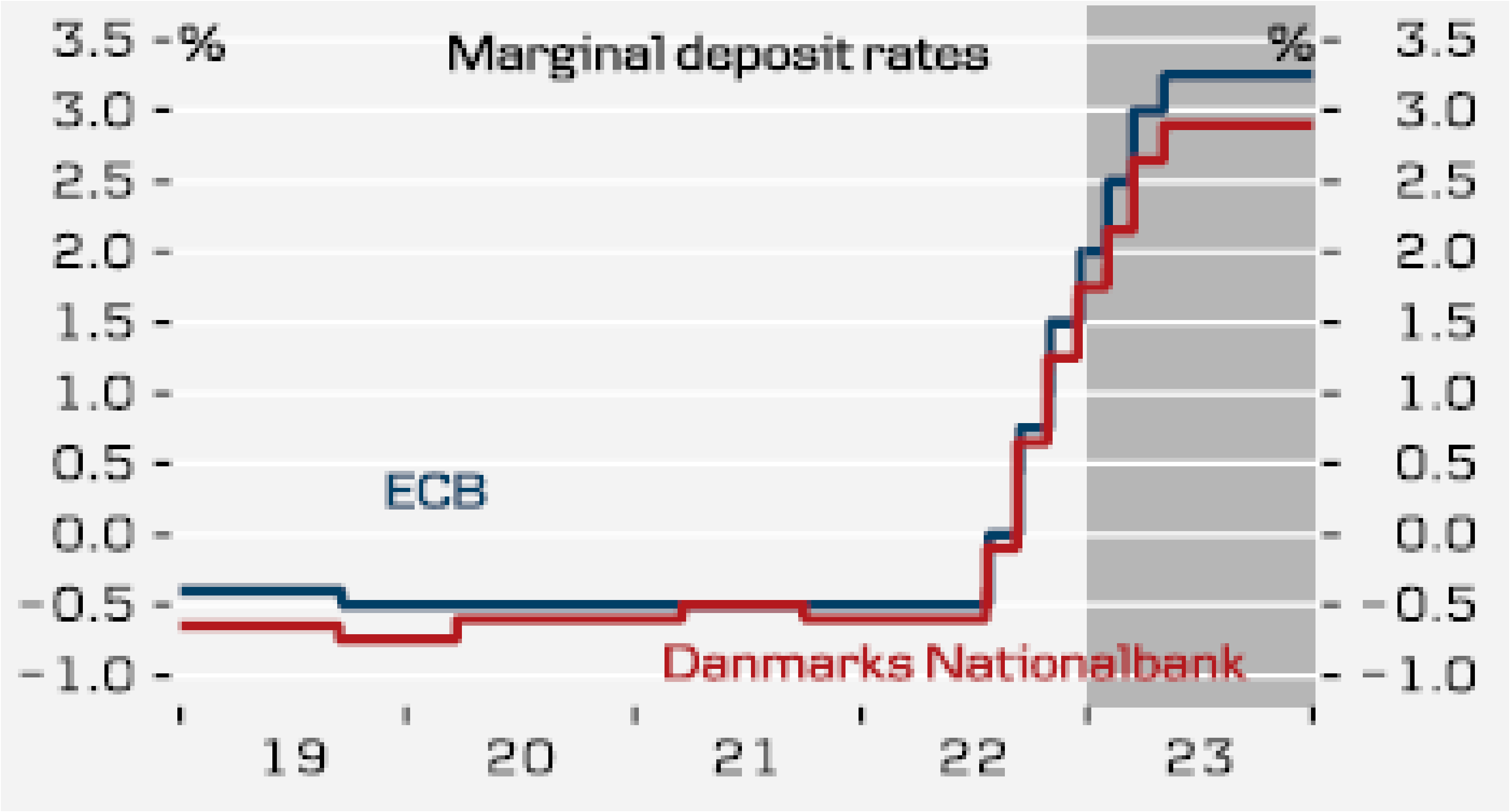
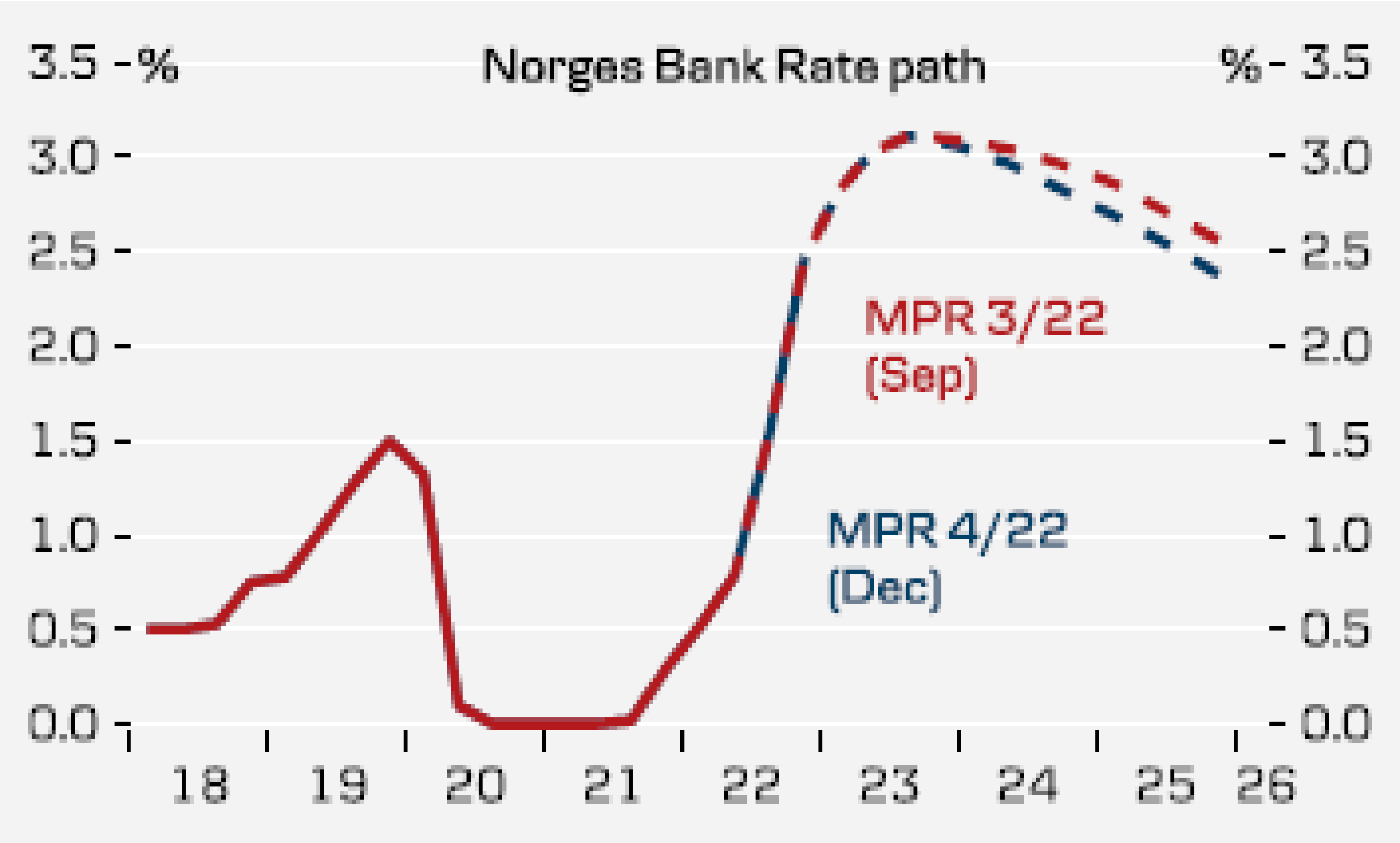
ECB and Danmarks Nationalbank policy interest rates



Norges bank policy interest rate



GDP growth

	2020	2021	2022	2023	2024
Denmark	-2,0	4,9	3,1	0,1	1,1
Finland	-2,2	3,0	2,2	-0,3	1,1
Norway	-2,3	4,1	2,9	0,7	1,3
Sweden	-2,3	4,8	2,9	-0,6	1,9
Estonia	-0,4	8,1	0,8	0,5	3,2
Latvia	-2,2	4,1	2,3	-0,2	2,3
Lithuania	0,0	6,0	2,5	0,5	3,2

Weak development of private consumption in 2023

- Falls in private consumption in all the Nordic and Baltic countries except in Norway and Lithuania
- Largest falls in Denmark and Sweden

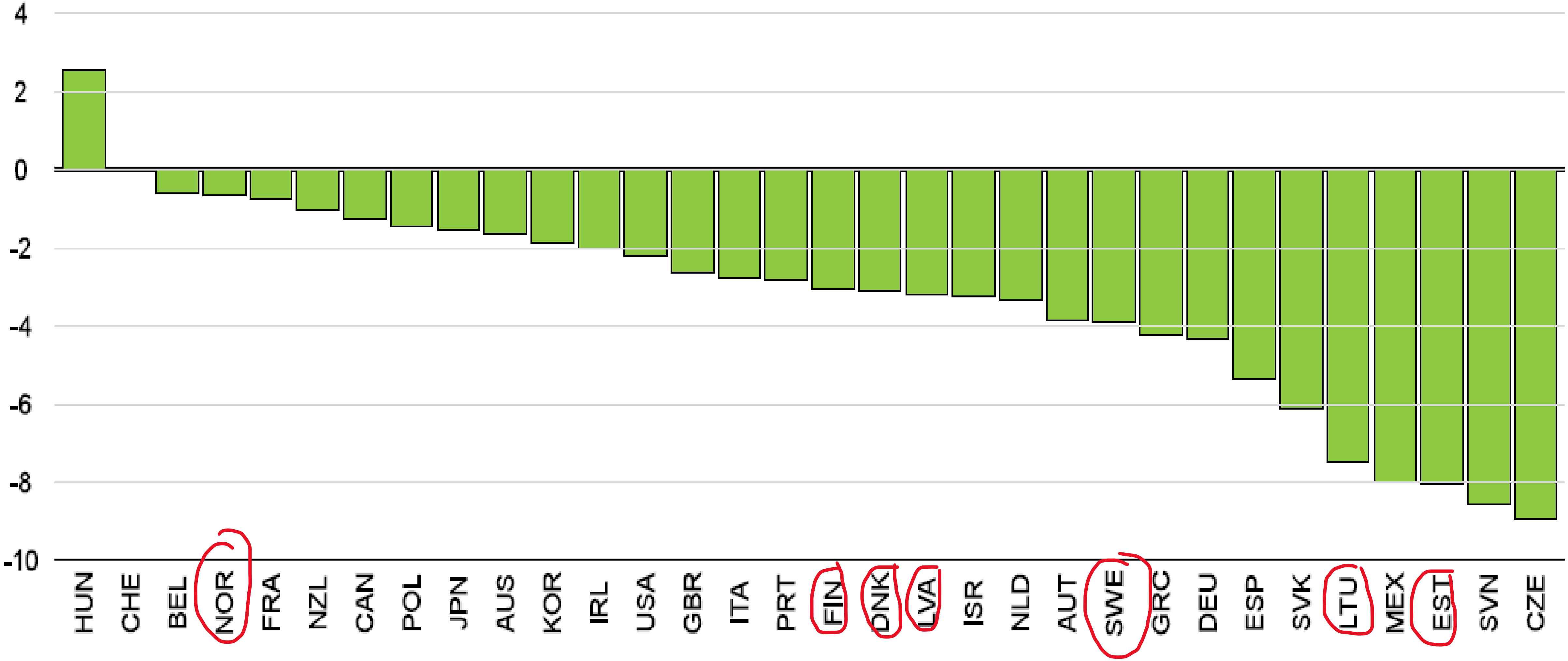
  - between 1 and 2 per cent
- Inflation is eroding the purchasing power of wages
- Interest rate rises are reducing the *cash flow* of households (and firms)

  - high debt ratios for households in the Nordics

  - high share of variable-rate mortgages in Finland, Norway and Sweden

  - but falling savings rates counteract falls in consumption
- Lower house prices reduce households' wealth

Year-to-year real wage change 2022, Q3



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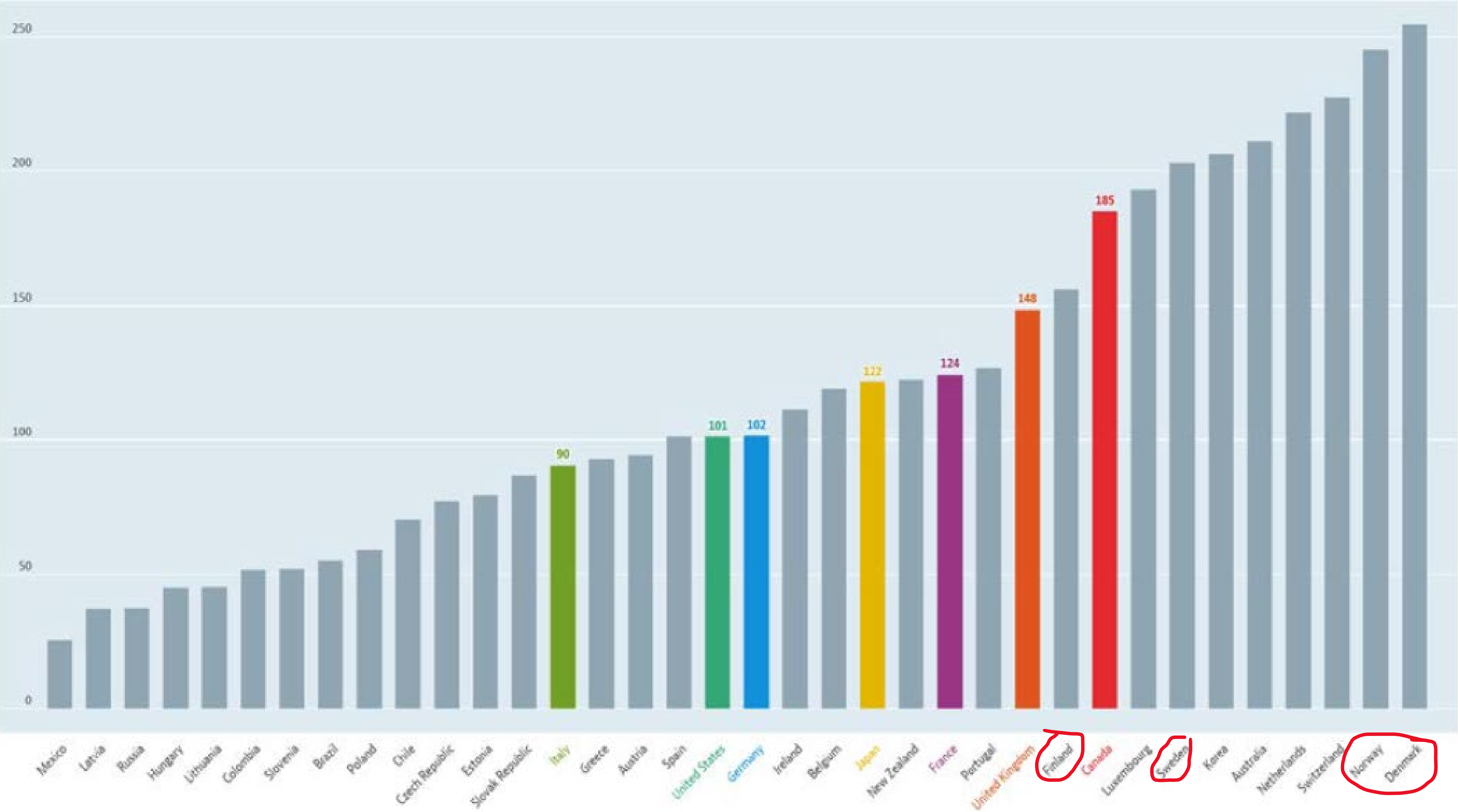
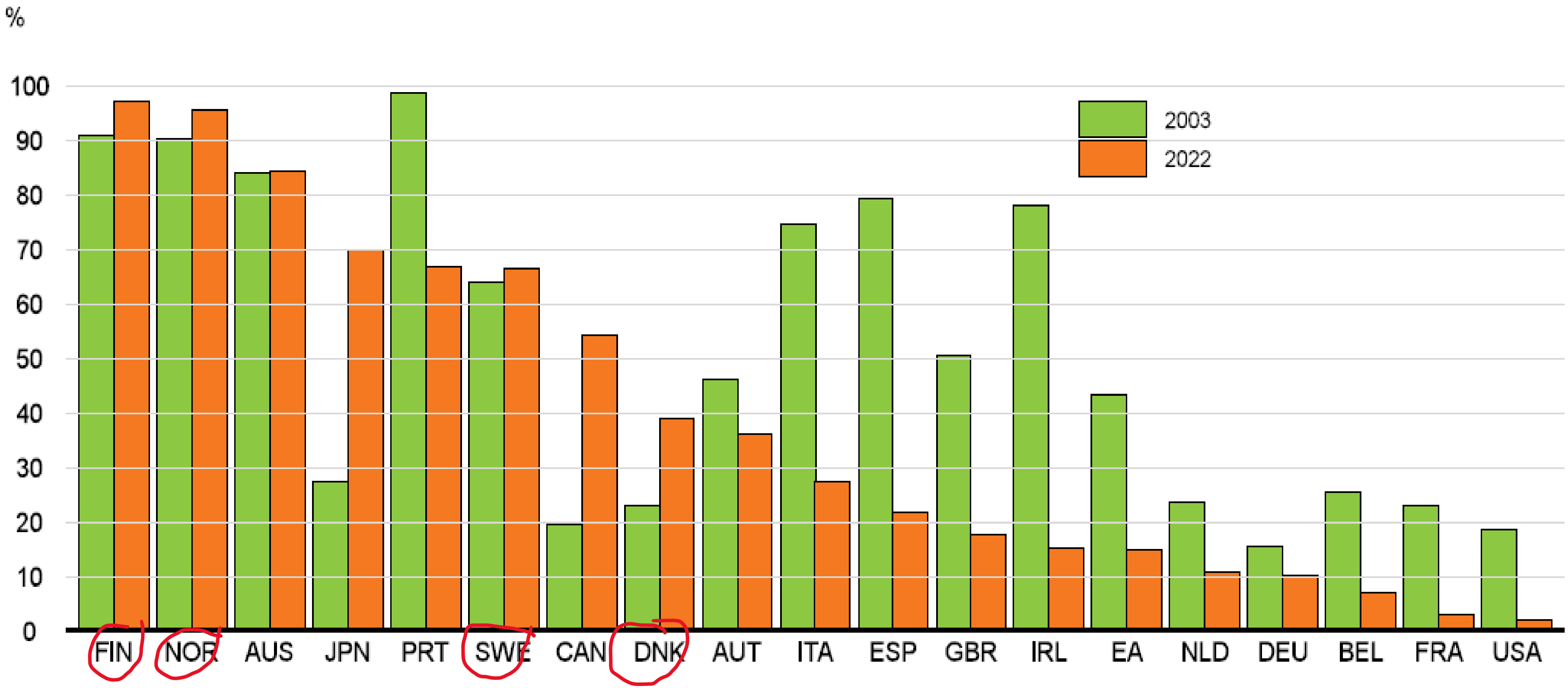
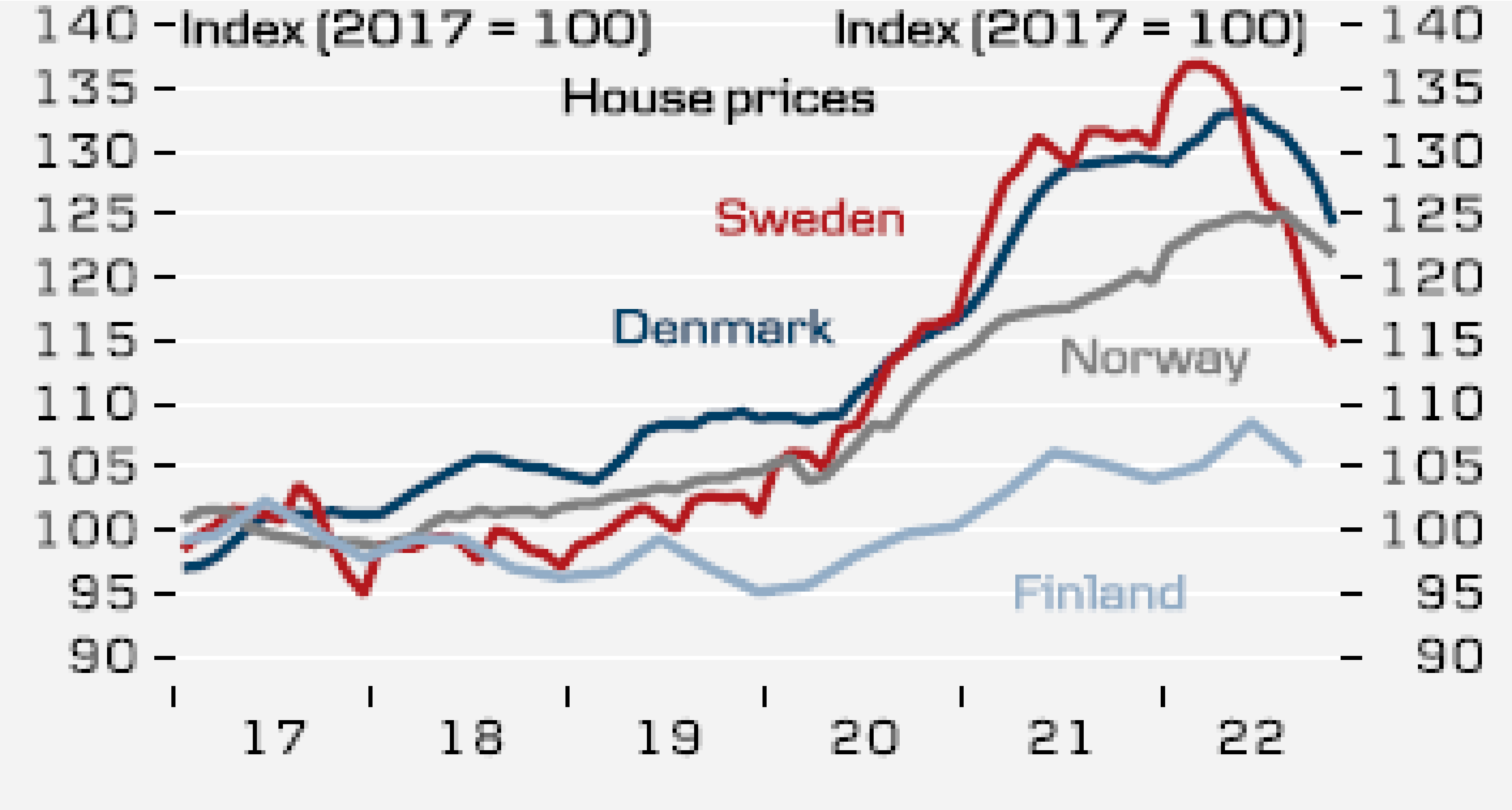
Ratio of household debt to net disposable income



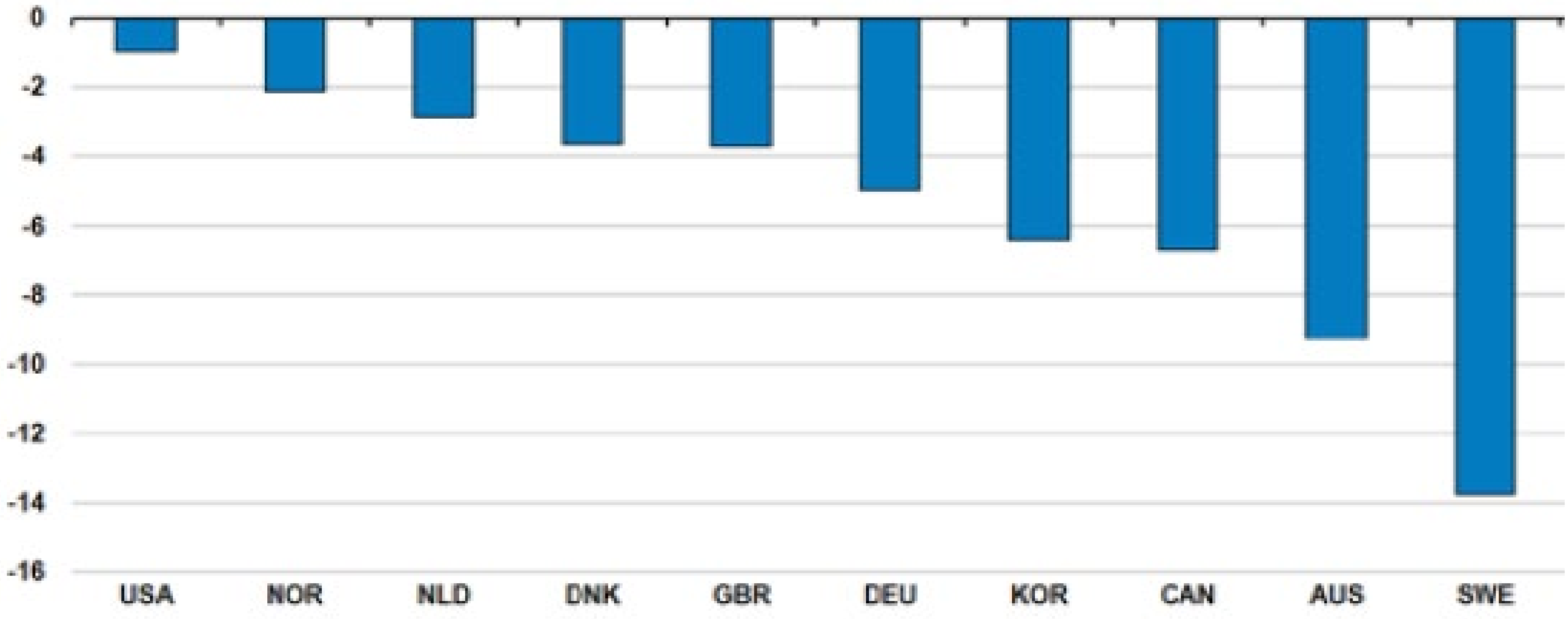
Share of variable-rate mortgages in new mortgage issuance



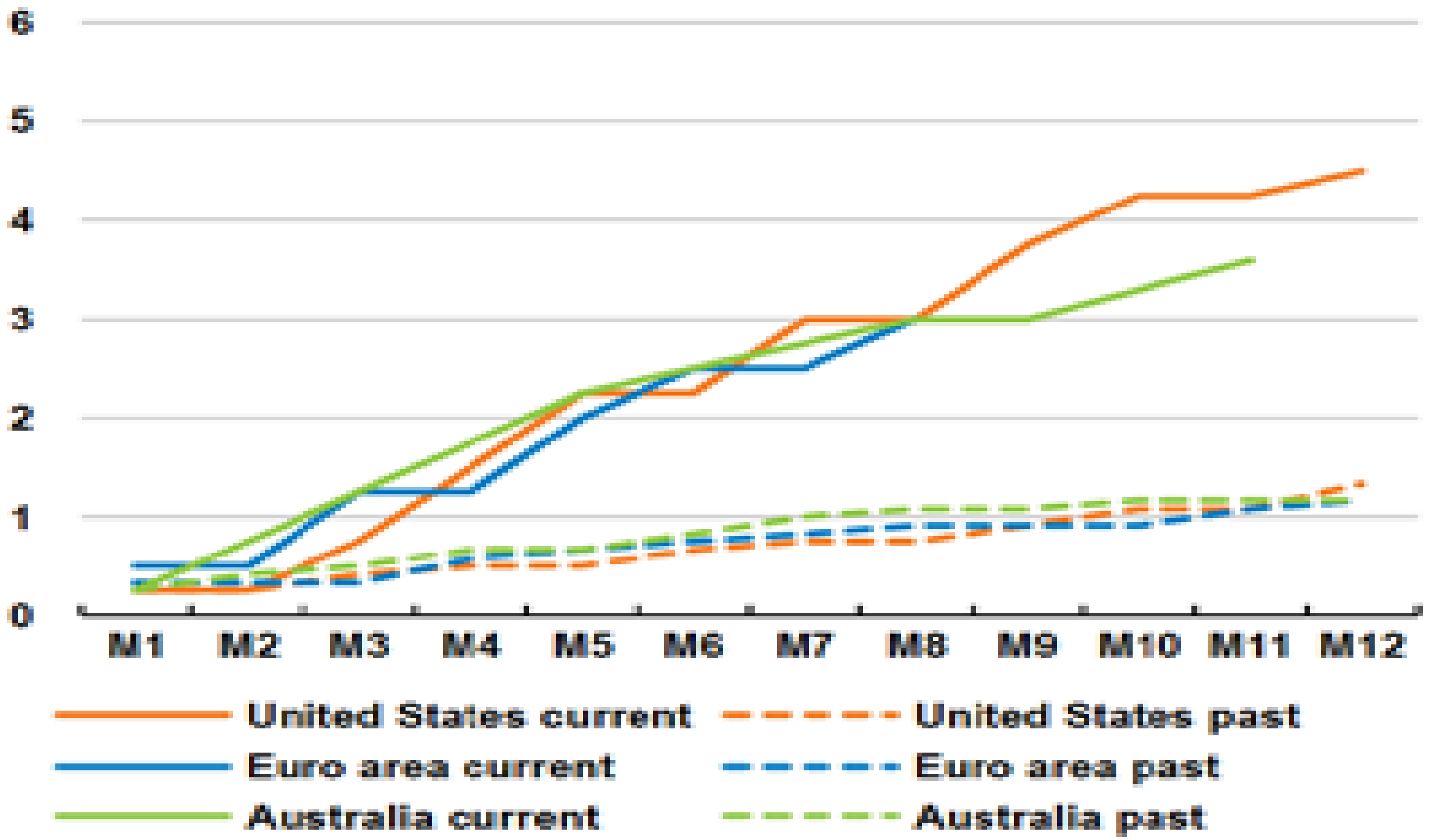
House prices



Change in house prices between peak 2022 and February 2023



Interest rate increases in current tightening cycle and past tightening cycles (average)



Are central banks doing the right thing?

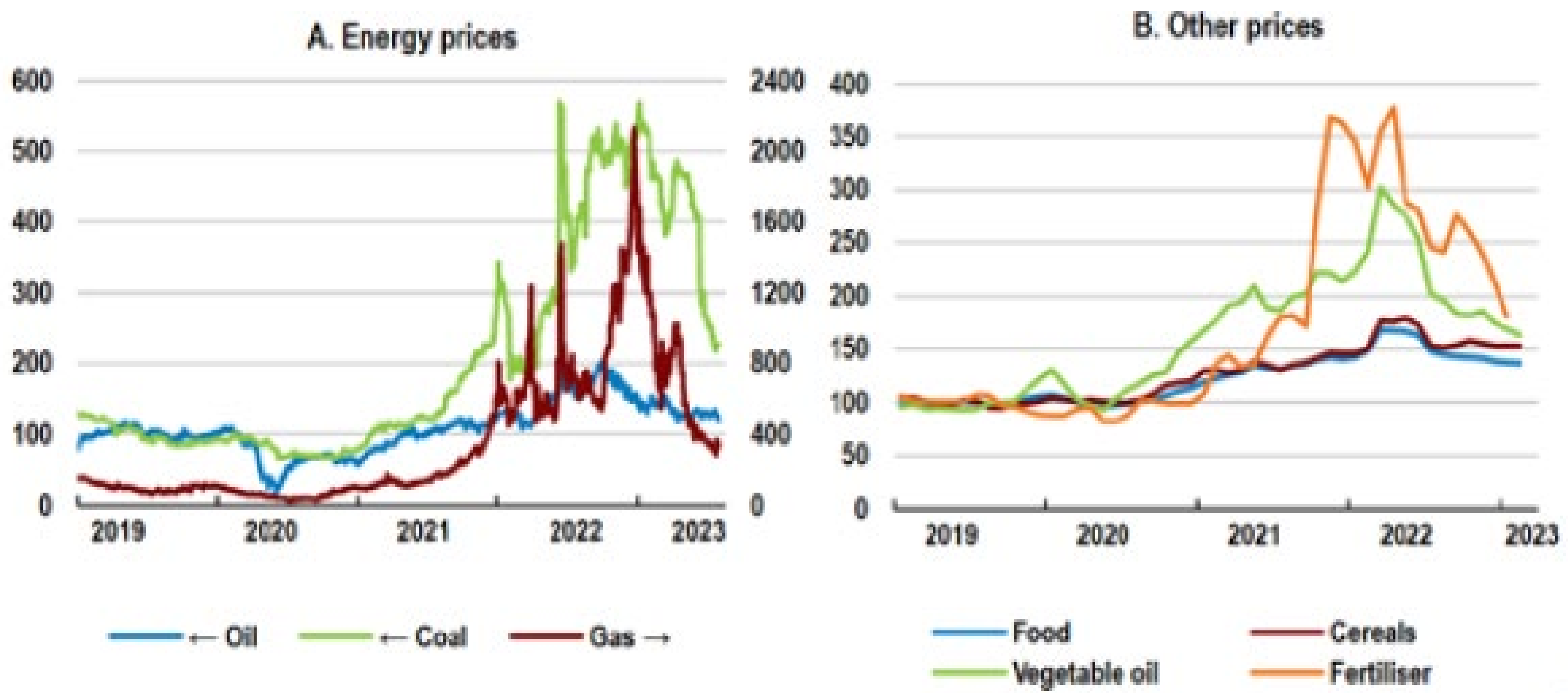
No

- Inflation is temporary
- Supply instead of demand shocks
- Unnecessary to reduce demand
- Risk of financial crisis
- Parallell to Korea inflation 1951–52

Yes

- Inflation could become entrenched
- Inflation expectations could rise
- Risk of price-wage spiral
- Parallell to the 1970s
- Larger contraction in the future if inflation is not stopped now

Energy and food prices, index



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Inflation expections at different horizons in Sweden

1 year	5,7
2 years	3,1
3 years	2,2

No signs of high wage increases in the Nordics so far

- Moderate wage demands
- Forecasts for 2023

  - 4 per cent wage increases in Denmark, Finland and Sweden

  -5 per cent wage increase in Norway
- Much higher wage increases in the Baltic economiies

My take on monetary policy

- Wise to adopt risk minimisation strategy
- Forecasts of small increases in unemployment
- There will be bank failures but major financial repercussions are unlikely
- Too harsh monetary policy is a smaller risk than too lenient policy

  - very high cost if inflation becomes entrenched and has to be stopped through more severe contraction later
- High inflation has proved to be more persistent than expected

Unemployment

	2020	2021	2022	2023	2024
Denmark	5,8	5,2	4,5	5,7 (+1,2)	5,6 (-0,1)
Finland	7,8	7,6	7,0	7,9 (+0,9)	7,8 (-0,1)
Norway	4,7	4,4	3,3	3,6 (+0,3)	3,7 (+0,1)
Sweden	8,5	8,8	7,5	8,3 (+0,8)	8.5 (+0,2)
Estonia	6,8	6,2	5,0	5,3 (+0,3)	6,0 (+0,7
Latvia	8,1	7,5	6,7	7,0 (+0,3)	6,8 (-0,2)
Lithuania	8,5	7,1	5,8	6.5 (+0,7)	6,7 (+0,2)

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Fiscal policy

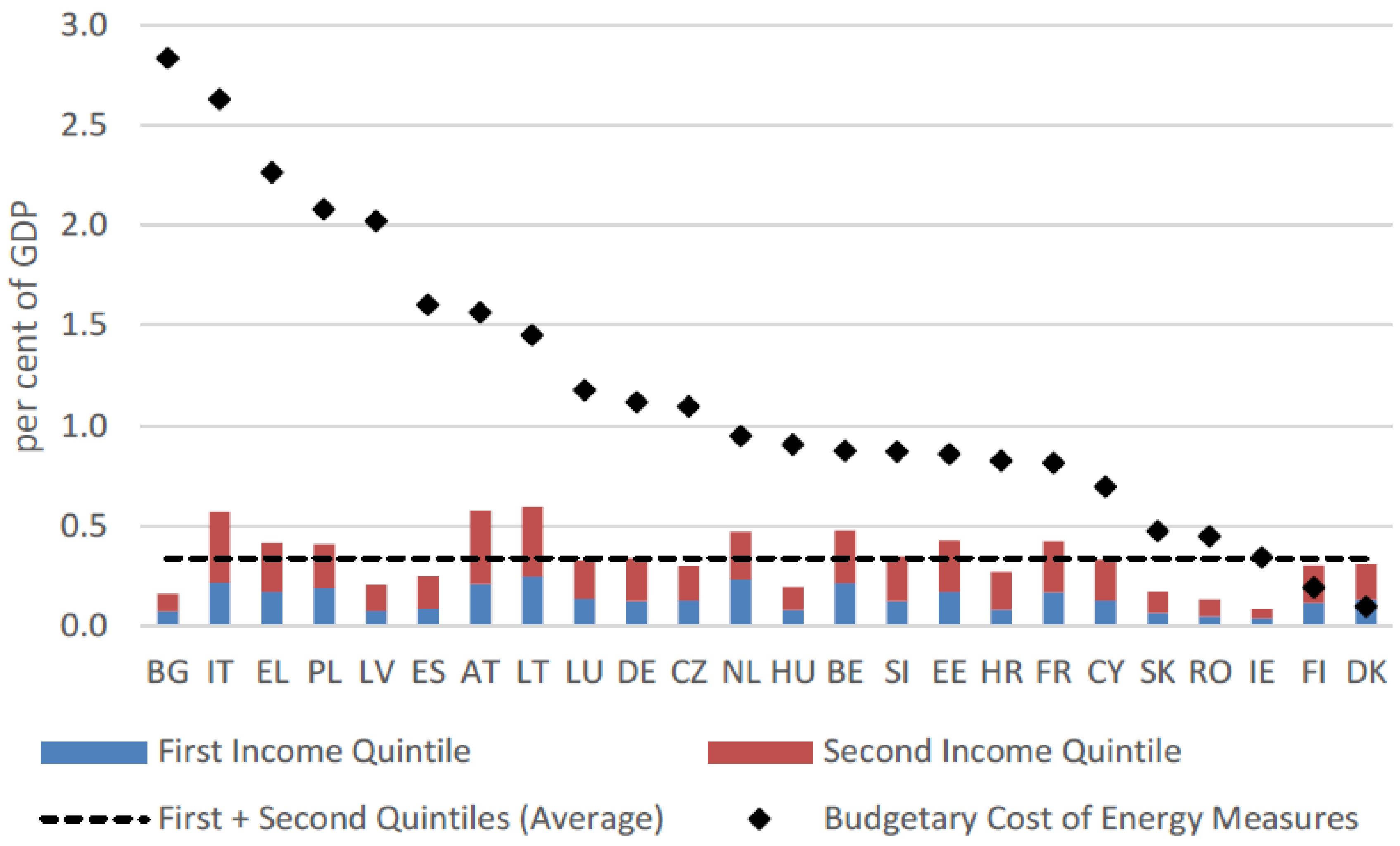
- Monetary policy has the main responsibility for price stability
- But fiscal policy also matters because it, too, affects aggregate demand
- Eurozone countries: More expansionary fiscal policy will keep up aggregate demand and make it harder to reduce inflation
- Norway and Sweden: More expansionary fiscal policy will cause the central bank to adopt higher interest rates

  - larger problems for highly indebted households and firms

  - larger house price falls

  - greater risks for financial instability

Budgetary costs of energy support 2022



Energy support in Norway and Sweden

- Generous support in Norway
  - reductions in electricity prices
- Also support in Sweden
  - the support is retroactive
  - better from a social efficiency point of view
  - delayed payments

Structural fiscal balance, per cent of GDP

	2021	2022	2023
Denmark	4,2	1,6	1,7
Finland	-2,1	-1,1	-1,5
Norway (actual)	9.9	16,2	16,3
Sweden	0,3	-0,1	1,0
Estonia	-4,1	-1,8	-2,5
Latvia	-6,8	-6,9	-2,5
Lituania	-1,4	-1,8	-3,5

Summing-up

- Difficult stagflationary situation without any quick fix
- Possible that inflation will fall by itself
- But also risk that inflation becomes persistent
- Wise to adopt a precautionary approach
  - less dangerous to err on the side of too harsh policy than the side of too lax policy
- Avoid generally expansionary fiscal policy
  - but support vulnerable households
- Support firms only to the extent that high energy costs are temporary
- Do not stop structural change in response to permanetly higher energy costs

How far should inflation be lowered?

- What do we do if it proves hard to get all the way back to inflation of 2 per cent?
- The optimal inflation rate is probably higher than 2 per cent
- Too low an inflation target means a risk that monetary policy in bad times in the future is restricted because interest rates cannot be lowered much below zero
- A higher inflation target reduces that risk as interest rates would then normally be higher
- But raising the inflation target could destabilise inflation expectations

Thank you!