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Economic Insights

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Weak krona has little effect on GDP, due to high resource use

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In recent months the weak Swedish krona has generated a broad discussion about the consequences of monetary policy, especially after the National Debt Office expanded its krona positions on grounds that that the krona is now unreasonably weak. Although a bit of exaggeration is sometimes discernible in the debate, for example regarding the symbolic role of the krona exchange rate in measuring Sweden's prosperity, the Riksbank's ongoing experiment obviously needs to be analysed from various perspectives. This *EI* (based on a theme article in the latest *Nordic Outlook*) mainly discusses the consequences of a weak krona in a situation of already high resource utilisation. An exchange rate depreciation of around 5 per cent this past year would normally stimulate GDP by 0.5-0.6 per cent over two years. But given high resource utilisation among exporters, uncertain capital spending conditions and structural pressures on retailers, the balance between positive and negative effects is changing dramatically. We thus estimate that the net stimulus effect on GDP is close to zero. Today's SEK depreciation is therefore occurring under unfavourable circumstances and risks creating new imbalances ahead.

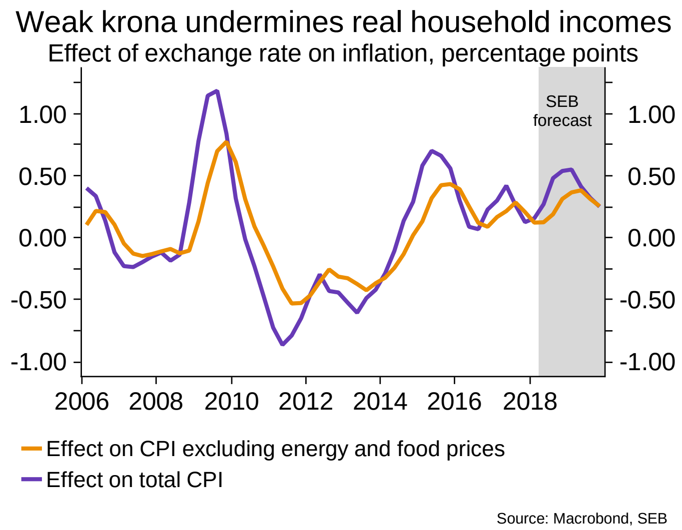
Exchange rate movements have long played a major role in the Swedish economy. After the Bretton Woods system collapsed in the early 1970s, Sweden struggled to find a role in the international currency system. Wage and price formation fell out of step with other countries, leading to recurrent devaluation cycles that shaped the behaviour of economic players. Over the past 25 years of floating exchange rates, movements have also been relatively large – often driven by relative differences in economic conditions between Sweden and other countries, mainly in Western Europe. Like many small currencies, the SEK has tended to depreciate during bouts of global economic weakness, most clearly illustrated by its collapse during the Lehman Brothers crisis. SEK movements have thus helped soften economic downturns by widening exporters' profit margins and enabling them to boost market share by holding down prices in foreign currencies. Businesses that compete with foreign companies in the Swedish market also gain an advantage, which benefits domestic production. But a weaker exchange rate also carries a price, for example when real household incomes are squeezed by higher import prices. At present, this effect has been softened because many companies find it difficult to raise consumer prices, but then their profit margins are squeezed instead. This, in turn, adversely affects their capital spending and hiring plans.

Positive and negative effects of various channels

The krona depreciation of the past year differs from earlier major declines, since it is taking place in an international economic boom and amid a heated Swedish labour market. This greatly changes the balance between positive and negative consequences. To get some idea of how the recent 5 per cent SEK depreciation (in trade-weighted KIX index terms) normally affects GDP and employment, we estimated the impact of the krona exchange rate on exports, household consumption and capital spending, based on data between 1993 and 2017. Below we discuss to what extent today's special conditions change the outcome.

Exports: Exports are determined by estimating international market growth, exchange rates and relative labour costs. Market growth is the dominant factor, but exchange rates are also significant and show that a 5 per cent weaker SEK boosts exports by about 3.5 per cent over three years; the biggest effect comes in the second year.

Household consumption: Consumption is determined by unemployment as well as disposable household incomes and assets. An SEK depreciation of 5 per cent boosts inflation (and lowers real household incomes) by more than 0.5 per cent. According to our estimate, this lowers household consumption by 0.3 per cent.



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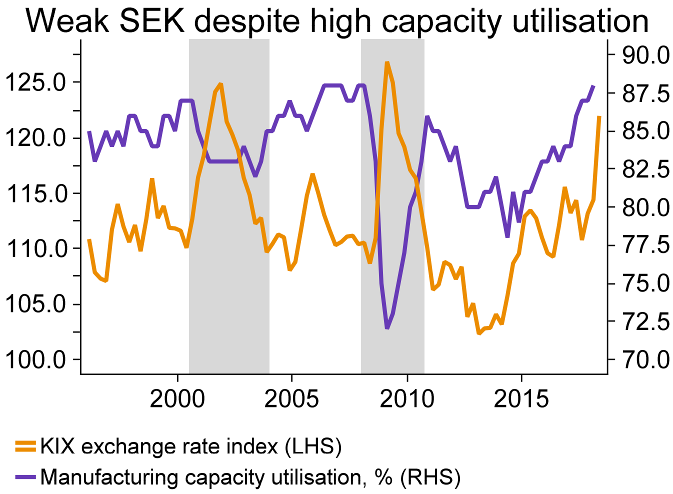
Capital spending: Capital investments are mainly determined by the trend of demand, and rising exports have a dominant positive effect. Weaker consumption and higher prices for investment goods have the opposite effect. The net positive effect is estimated at 2 per cent.

Our overall assessment is that under normal circumstances, a 5 per cent weaker exchange rate boosts Swedish GDP by about 0.5-0.6 per cent in a 2-3 year perspective. We have also taken into account 1) that various demand components have a given import content, 2) that Swedish producers also gain ground against foreign competitors in the domestic market and 3) that the initial export impulse has a positive secondary impact on domestic demand.

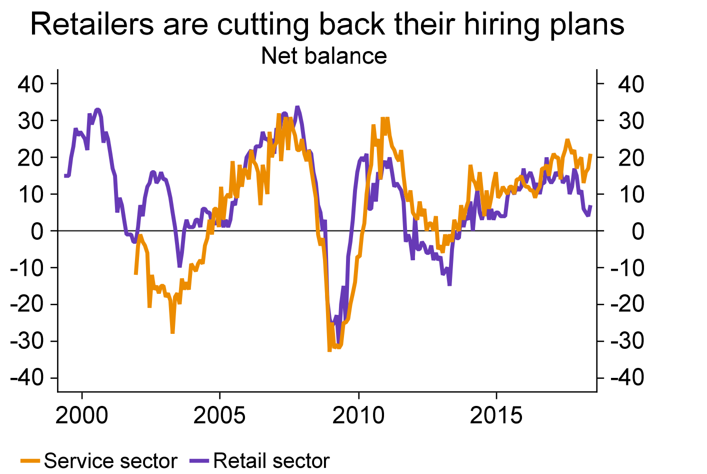
Weaker GDP effect due to new conditions

These results are based on data from 1993 onward, i.e. the period of floating exchange rates following the collapse of the krona in November 1992. The effects were probably somewhat larger during the period before this, when various kinds of temporary currency pegs were interrupted by 4-5 major devaluations. This applies especially to the capital spending side, with companies at the time feeling they had more stable planning conditions in terms of competitiveness. However, there are various reasons to believe that at present, the effects are significantly weaker than during our estimate period. In particular, the potential for higher export volume is hampered by capacity utilisation in the manufacturing sector that is already close to historical highs at the outset. A clear upturn in capital spending cannot be ruled out in such a situation, but so far the relatively cautious investment behaviour of manufacturers suggests that they do not regard today's weak SEK level as sustainable, which thus also hampers the stimulus effect via this channel.



Source: NIER, The Riksbank

There are also many indications that the negative impact on domestic demand is larger than our estimates show. Today the retail sector is undergoing a tough restructuring process, driven among other things by increased e-commerce that is leading to stagnating brick-and-mortar store sales. For example the Swedish Trade Federation's report "The Great Transformation of the Retail Industry" sketches a scenario of retail staff reductions in the 30-50,000 range by 2025. In such a situation, it is especially distressing not to be able to pass on rising exchange rate-driven purchase prices to consumers. One warning signal is that retailers have cut their hiring plans for the next six months. Consumer confidence has also fallen this spring, which may likely be connected to depressed real incomes due to the weak krona. A fragile housing market and rising energy prices, which boost purchase prices and undermine real incomes as much as the exchange rate, are of course other factors. Our overall conclusion is that **due to a number of factors, the GDP effects of today's weak krona are much less than before and probably close to zero**. As for employment, the net effect is probably negative, considering that the "losing" sectors are much more job-intensive than the export sector.



Source: NIER

Insidious interplay between wage formation and SEK

Timing and durability aspects are also important when discussing the consequences of krona depreciation. Even if the Riksbank rejects arguments that it should gather more ammunition ahead of the next recession, there are other aspects to consider, especially the interplay between exchange rates and wage formation. During the past two national wage rounds, the unions' modest pay demands were due to unexpectedly low inflation over a long period, which had led to solid real wage increases. But historically, labour unions have been vigilant in ensuring that rising import prices do not undermine the purchasing power of their members. From that perspective, union support for today's exceptional monetary policy has been a bit divergent. By the next wage round in 2019-2020, it is possible that the climate will have changed and that unions will feel pressure from their members to demand compensation for import price-driven inflation. The manufacturing sector's leading role in wage formation may also be challenged to a greater degree, since the consequences of relatively low collective pay agreements have proved beneficial to exporters at the expense of domestically oriented sectors. The Riksbank may view higher wage demands as proof that its inflation target has regained credibility as an anchor of wage formation. But there is an obvious risk that we will see an overshooting in wage and salary increases at the wrong time, and that this will intensify the kind of late-cyclical inflation surge that has often occurred in Sweden and that created major problems for the Riksbank in 2001 and 2008.

There are several other obvious hangover risks now that monetary policymakers are loosening conditions further. The effects of long-lasting extremely low interest rates may contribute to increasing gaps and social tensions, due to soaring asset prices. The correlation between household optimism and home prices has been weakening for some time – another example of how economic players feel uncertain about the sustainability of the ongoing monetary policy experiment. As a consequence, the effectiveness of this policy weakens in the short term as well.

To summarise, the tendency of the krona to depreciate during periods of international instability has clearly helped to stabilise the Swedish economy during the floating exchange rate era. The preceding period of devaluations proved to be a dead end – weakening reform pressure and thus productivity growth in the economy – but this does not prevent us from learning some lessons from that period's thinking when it comes to the impact of exchange rate movements. **It is unfortunate that** the ongoing monetary policy experiment has now led to a historically weak krona in a situation where **the economy has poor potential to reap the fruits of further improvements in competitiveness**.