

# The current situation for monetary policy

BY URBAN BÄCKSTRÖM

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*First a word of thanks to the Committee for the invitation to discuss the situation for monetary policy. Today, as required by Chapter 6, Article 4 of the Sveriges Riksbank Act (1988:1385 with amendments), the Riksbank has presented this Committee with the year's second written account of monetary policy. The account is in the form of the third Inflation Report during 1999. In my opening remarks I shall briefly summarise the content of the Report and present the Executive Board's appraisal of the present conditions for monetary policy.*

## Impressive economic performance

New statistics during the summer gave a picture of stronger activity than most observers had counted on as recently as in the spring. GDP growth in the first half-year is calculated to have been 3.4 per cent. At the same time, inflationary pressure is currently low.

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have been as strong as this. Growth is good, inflation low, and both the current account and public finances are showing a surplus. Last but not least, the economy is generating more jobs than what we have been accustomed to previously. Unemployment is therefore decreasing, though it is still above the levels that were customary in earlier decades.

So the situation before us today is completely different from what we experienced last autumn. During the past year, Sweden's economic prospects have changed considerably in the eyes of various observers, and the Riksbank has been no exception in that respect.

## Monetary policy in the past twelve months

Last autumn the financial markets became increasingly turbulent in connection with, for example, problems arising from the hedge fund Long Term Capital Management and the suspension of Russian debt payments. The financial crisis was expected to add to the negative real economic effects of the Asian crisis. International observers, including the IMF and the OECD, therefore revised their global growth and inflation forecasts downwards. The Riksbank did the same. Although growth in Sweden's domestic sectors was relatively good and the exchange rate tendency remained weak, the overall picture did point to slacker growth and lower inflation in the forecast period. In November and December, the Riksbank therefore reduced the repo rate from 4.10 to 3.40 per cent.

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The early months of this year were marked by continued repercussions of the Asian crisis in the world economy, with weaker international demand. In order to prevent this from leading to a dampening of economic development in Sweden and an even lower rate of

inflation, in February and March the Riksbank reduced the repo rate in two more steps to 2.90 per cent.

Since then the situation has stabilised. An easing of monetary policy in many parts of the world as well as in Sweden has been an important factor behind the better tendencies in recent months and the more positive forecasts. Even though the statistics show a stronger economic trend, inflation has been in line with the Riksbank's forecasts. For this reason the repo rate has been kept unchanged since March.

In August the 12-month rate of CPI inflation was 0.6 per cent, and inflation's underlying rate, measured by UND1X, was 1.5 per cent. It is changes in indirect taxes and subsidies, together with house mortgage interest expenditure, that are continuing to result in an underlying rate of inflation that is higher than CPI inflation.

## Economic prospects from 1999 to 2001

We are now moving into a period of strong growth, externally as well as in Sweden.

As regards the international picture, the Riksbank judges that annual growth in the OECD area up to the end of 2001 will amount to not quite 2.5 per cent. It looks as though effects of the Asian crisis are now dying away and that emerging market growth will become stronger in the next two years, above all in the crisis-hit countries in Southeast Asia but to some extent also in Latin America and Eastern

Europe. In Japan, too, the earlier risk of negative growth has turned into cautious optimism about an upturn. Prospects for the euro area have likewise improved, with a recovery in manufacturing and stronger consumer confidence. In the United States there seems to have been a further extension of the upward phase this year, and a slowdown may be softer and more cautious than anticipated earlier.

Even with stronger international growth, external price pressure is likely to be weak. For one thing, after the Asian crisis there is still some unutilised capacity on the whole in the global economy. Other factors are increased price competition and an expected appreciation of the krona.

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Economic prospects in Sweden also look brighter. Besides the positive cyclical signals from abroad and their expected effects on the Swedish economy, there is the stronger growth of domestic demand. Firms as well as households are optimistic about the future. There are a number of reasons for this. Real wages and employment are rising rapidly, and public sector finances are becoming stronger. Fiscal policy in 2000 and 2001 is now assumed to be somewhat more expansionary. All in all, GDP growth is judged to be 3.6 per cent in 1999, 3.8 per cent in 2000 and 3.0 per cent in 2001. These assessments are based on the technical assumption that the repo rate is kept unchanged.

The strong growth trend means that in the coming years the economy's unutilised resources at present will be utilised more quickly than the Riksbank envisaged earlier.

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Inflation is accordingly judged to move up somewhat faster than the Riksbank assumed earlier. In the main scenario the underlying rate of inflation, measured as UND1X, is judged to be 1.8 per cent twelve months ahead and 2.1 per cent after twenty-four months. CPI inflation is judged in turn to be 1.1 per cent after twelve months and 2.0 per cent in twenty-four months' time.

Thus, CPI inflation will be moving closer to underlying inflation. One reason for this is that the downward effect on inflation from house mortgage interest expenditure is diminishing. In other words, just as the previous marked fall in interest rates held back CPI inflation so that it was well below the underlying trend, so house mortgage interest expenditure is now tending to bring them closer together. As I have pointed out before to this Committee, monetary policy ought to disregard these direct effects of interest rates because repo rate adjustments mean that they are accentuated. It is also for this reason that the Riksbank is currently focusing monetary policy on inflation's underlying rate, measured as UND1X.

Transitory factors – changes in indirect taxes, subsidies and house mortgage interest expenditure – are judged to have a downward CPI effect of 0.5 percentage points in one year's time. The contribution from interest expenditure is still negative because the process whereby house mortgage loans at high rates are renewed at the present lower level is still in progress. As the earlier house mortgage loans had a long duration, this process takes time. In two years' time, however, the CPI contribution from transitory factors is judged to be an upward effect of 0.1 percentage point.

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The fact that so far, at least, the strong growth has not generated an acceleration of inflation that is comparable to what happened in earlier upward phases has started a discussion of whether the trade-off between growth and inflation has changed in the 1990s. Judging from historical patterns, inflation ought not to have remained as low as it has. The relationship between growth and inflation is, of course, crucial in the assessment of future price trends and thereby for the formulation of monetary policy.

It is not possible to arrive at definite assessments in this field. The analysis is complicated by, for example, the combination of decreased inflation expectations, uncertainty about the rate of potential growth and the size of the output gap, and how the labour market is functioning. The Riksbank has to be alert to every sign that may support or contradict the hypothesis of a lower trade-off between growth and inflation. We have revised our opinion about this on several occasions in recent years and have done so again in the present Report. In this we are not alone. Various international observers have changed their appraisal of the corresponding trade-off in the OECD area as a whole. In Sweden's case it is judged that the low and stable inflation expectations, increased competition and EU membership are among the factors behind a better trade-off.

In the Inflation Report, the Riksbank's main scenario is accompanied by an analysis of likely risks. Since the June forecast the spectrum of risks has changed somewhat; the chances of inflation being higher than in the main scenario are now judged to be greater than the probability of a lower rate. The increased upside risk has to do with fears that inflation will react more quickly to the rising economic activity and that labour market shortages may be more serious and lead to a stronger development of wages.

The assessment of an increase in upside risks is accompanied by less likelihood of a slowdown in the global economy. But there is still the risk of international activity being dampened appreciably in connection with a major correction of the

high stock market prices and the financial imbalances that have been a feature of the American economy in recent years. Such a scenario would affect price tendencies in Sweden. The risk of financial bubbles, with serious real economic effects if they burst, is something that the Riksbank, along with other central banks, has to heed.

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## Monetary policy

In the late summer, at the monetary policy meeting on 12 August, the Executive Board had already noted that stronger economic growth in Sweden and rising resource utilisation pointed to growing upward pressure on prices. That in turn indicated that monetary policy might have to be given a less expansionary direction in the future. Two members of the Board even advocated a small repo rate increase in August.

The main scenario in the Inflation Report that is published today does not represent a future development of inflation that threatens price stability. But every inflation

forecast contains an element of uncertainty, and the risk spectrum also has to be considered when formulating monetary policy. The present Report concludes that higher inflation compared with the main scenario is more probable than lower inflation. Remember, moreover, that to be most effective, monetary policy has to focus on the situation one to two years ahead.

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This suggests that the Riksbank is moving towards a situation in which the repo rate will be raised. Yesterday, however, the Executive Board decided in favour of an unchanged repo rate. But sooner or later, if developments continue along the lines in the present assessment, a repo rate increase will be called for. If some kind of international shock with a probable downward effect were to occur, or if indications of more subdued economic activity or prices were to be observed, that would naturally be taken into account in our future assessments.

## Why a higher repo rate?

A repo rate of 2.90 per cent is probably too low over a complete business cycle, even in an economy where inflation expectations have settled down around the targeted rate of 2 per cent.

Under such circumstances, the direction of monetary policy can be described as expansionary. This is not countered by a restrictive fiscal policy. In the absence of negative shocks, that normally tends to generate GDP growth above the rate that is sustainable in the longer run. If such a situation is left to continue for too long, various bottleneck problems arise that may push inflation up.

Such a course of events has to be prevented by the Riksbank, which the Riksdag (Sweden's Parliament) has made accountable for maintaining price stability. So in order to counter an acceleration of inflation in an upward cyclical phase, sooner or later the level of the repo rate has to be normalised.

It is generally true to say that a repo rate increase should not be postponed unduly. If a central bank waits too long, the increase has to be larger in order to arrest the overheating and inflationary tendencies. That would run the risk of the next slowdown being deeper and more severe than otherwise.

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A higher repo rate does not necessarily impede the continuation of a favourable economic trend; it may even be required for a good and sustained development of employment and growth, as is illustrated by how the Federal Reserve has acted in the United States. This shows what a forward-looking

monetary policy can do for sustained growth. The formulation of monetary policy in the United States, with timely restrictive measures, has contributed to the American economy now being in its longest post-war period of growth.

During rapid economic expansion, problems with bottlenecks may occur temporarily because new production facilities are not always available just when they are needed to cope with increased demand. Experience in the 1990s suggests, however, that firms have become more flexible, both in the utilisation of existing capital stocks and in the procurement of new technology, machinery and plants when demand rises. This suggests that, if anything, it is not the level of unutilised capital resources that is critical at present. Instead, an analysis of resource utilisation should probably focus on the labour market. Another reason for this is that in a price analysis at macro level, the weightiest item in costs is wages; total wage costs are equivalent to over two-thirds of GDP.

The level of unemployment has been reduced but remains high, particularly compared with the post-war period up to the early 1990s. Seen from that angle, some might say that the Swedish economy has plenty of unutilised resources. Experience from other European countries has taught us, however, that after a



severe shock, as happened in the early 1990s, unemployment tends to stick at a high level, at least for a while.

Estimates of the equilibrium level of unemployment in Sweden suggest that it moved up in the early 1990s and in terms of registered unemployment is somewhere in the interval 4.5 to 7.5 per cent. Considering that the rate of registered unemployment is currently inside this interval, the estimates would suggest that the Swedish economy is now close to full capacity utilisation.

Estimates of equilibrium unemployment are uncertain, however, and it is important that the Riksbank's monetary policy does not unnecessarily hamper decreased unemployment. All the other information about labour market

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tendencies has to be considered as well. A deeper analysis is needed as a foundation for any conclusions that the economy is approaching full capacity utilisation.

When an economy is moving closer to its capacity ceiling, certain statistical phenomena can be expected to occur more clearly and frequently. The same applies to anecdotal information in such a situation. This can take the form of, for example, bottleneck problems in the labour market and signs of difficulties in recruiting skilled labour. Other signs are an increased propensity to resort to labour disputes, either regular strikes or wildcat behaviour. Moreover, firms may have to compromise over job qualifications and take on less skilled personnel in order to cope with demand for their goods and services.

Some such signs have been observed in recent months. Firms are already finding it difficult to recruit computer consultants, for instance, as well as some other categories of personnel. The situation in some parts of Sweden is also more strained than elsewhere. This suggests that firms will find it increasingly hard to keep up with demand for their products. In other words, a situation where demand is rising too rapidly. To date, however, the bottleneck problems are fairly limited.

Thus, there are still no signs of more widespread shortages that might generate unsettling inflationary impulses; but the risk spectrum has shifted. Moreover, the situation can change at short notice, and the Riksbank has to be alert to this. We must be ready to take preventive action.

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In earlier upward phases, in the 1970s and 1980s, a tightening of economic policy often came too late. The normal result was that the growth of production and employment was checked and unemployment rose. That must not happen



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this time. The purpose of normalising the repo rate in time is to bring GDP growth into line with the path for long-term growth, with a continued increase in employment and as low a level of unemployment as the structure of the economy allows.

This is the starting point as we face the future challenges to monetary policy. That is what is meant by price stability. It is also how we, as members of the Executive Board, perceive the task assigned to us by the Riksdag.