

ECONOMIC POLICY AND INFLATION

During the past year there has been a considerable expansionary adjustment of both fiscal and monetary policies in a number of countries. This text aims to describe how expansionary Swedish economic policy is and relate this to the situation in the United States and the euro area.

MONETARY AND FISCAL CONDITIONS

The Riksbank and other central banks influence inflation indirectly through the instrumental rate's effects on market interest rates, credit flows, the exchange rate and other asset prices and these effects act in turn on inflation expectations, resource utilisation and ultimately the rate of price increases. One approach to measuring country differences in monetary policy uses a monetary conditions index (MCI). In its traditional form, an MCI's components are just a short-term interest rate and the exchange rate, so a number of important factors in the transmission mechanism are disregarded. Another problem lies in country differences in the transmission mechanism. The exchange rate's impact may vary with, for example, an economy's degree of openness, just as the relative importance of the real interest rate can depend on, among other things, country differences in the duration of household and corporate borrowing. It follows that an interest rate adjustment's impact on demand and the price level in Sweden is not necessarily the same as in the euro area and the United States.²

An MCI is normally based on estimations of how the short real interest rate and the real effective exchange rate affect resource utilisation and inflation. The uncertainty in such estimations is considerable, neither are the relationships necessarily stable over time.³ Partly for these reasons, most central banks do not now publish a monetary index.⁴

A rough comparison of some major indicators of the fiscal and monetary conditions in the United States, the euro area and Sweden is presented in Table B2.

- 2 Dornbusch, R., Favero, C.A. & Giavazzi, F. (1998), The immediate challenges for the ECB, *NBER Working Paper 6369*. Gerlach, S. & Smets, F. (1995), The monetary transmission mechanism: evidence from the G-7 countries, *CEPR Discussion Paper 1219*.
- 3 Eika, K.H., Ericsson, N.R. & Nymoen, R. (1996), Hazards in implementing a monetary conditions index, *Oxford Bulletin of Economics and Statistics*, 58, 765–790.
- 4 King, M. (1997), Monetary policy and the exchange rate, *Bank of England Quarterly Bulletin* May, 225–227. Stevens, G.R. (1998), Pitfalls in the use of monetary conditions indexes, *Reserve Bank of Australia Bulletin* August, 34–43.

Table B2. Monetary and fiscal conditions.

Per cent and percentage change

	United States				euro area				Sweden			
	1995-00	2000	2001	latest	1995-00	2000	2001	latest	1995-00	2000	2001	latest
Treasury bonds												
3-month less CPI	2.8	2.6	0.7	0.1	2.6	2.1	1.7	1.2	3.9	2.7	1.5	1.0
2-year less underlying inflation	3.3	3.8	1.4	0.1	2.9	3.6	1.8	0.6	4.0	3.5	1.6	0.9
5-year less long-term inflation	3.4	3.6	2.1	1.4	3.7	3.4	2.7	2.2	4.2	3.2	2.7	2.4
10-year less long-term inflation	3.6	3.5	2.6	2.0	4.3	3.6	3.2	3.0	4.7	3.3	3.1	2.9
Housing bonds (5-7 yrs.) less long-term inflation	4.1	4.7	3.1	2.6	3.36	4.21	3.74	3.58	3.6	4.0	3.3	3.4
Corporate bonds (5-7 yrs.) less PPI	5.0	3.4	2.6	5.4	3.90	0.01	1.48	3.70	5.0	2.2	3.2	4.2
M1 y/y	-0.6	0.2	2.1	5.6	7.9	7.8	3.2	5.3	4.7	6.5	5.6	7.2
M3 y/y	8.0	9.3	11.4	13.0	5.0	4.8	5.1	7.4	4.9	6.2	1.7	4.9
Exchange rate y/y	2.4	4.2	7.0	2.5	-3.0	-9.4	0.1	5.4	0.4	0.2	-8.7	-8.9
Stock market y/y	20.1	10.5	-18.2	-23.5	23.8	32.3	-20.3	-35.6	27.2	48.7	-30.5	-33.3

Note. *Latest*: October outcome data. *Euro area bonds*: French, German, Italian and Spanish T-bonds weighted for GDP. *Underlying inflation* in the United States and the euro area: CPI excluding food and energy. *Long-term inflation* assumed to be 2.5 per cent for the United States, 1.75 per cent for the euro area and 2 per cent for Sweden. *Housing bonds*: United States, Lehman Brothers' index; euro area, a German *pfandbriefe*; Sweden, Handelsbanken's housing bond index (5-7 years). *Corporate bonds*: United States and euro area, Lehman Brothers' corporate bond index; Sweden, Handelsbanken's index. *Exchange rates*: Bank of England's effective exchange rate index. *Monetary aggregate*: Sweden, M0 instead of M1. *Stock market*: Wilshire 5000, DAX and OMX.

These variables say something about the extent to which the monetary and fiscal conditions are expansionary.

It will be seen from the table that real T-bond rates are lower in the United States than in Sweden and the euro area. In a historical perspective it is reasonable to maintain that the impact on demand from real interest rates, short-term rates in particular, has been expansionary in all three regions.

The development of monetary aggregates could indicate that monetary policy is more expansionary in the United States than in Sweden and the euro area. The exchange rate can be said to be restrictive in the United States, while in the euro area the weak exchange rate probably acts as something of a stimulus; however, the recent appreciation of the euro implies that this effect is diminishing. In Sweden, the weak exchange rate constitutes a clear difference in the monetary and fiscal conditions there compared with the United States and the euro area. In relation to the calculated real equilibrium rate, the krona is appreciably weaker than the dollar in particular.

The stock-market trend in Sweden has been weaker in the past year than in the United States and the euro area. This effect is offset to some extent by share prices having risen faster in a longer perspective in Sweden and the euro area compared with the United States.⁵

5 The lack of comparable statistics for real-estate prices makes it difficult to interpret differences in the development of wealth.

FISCAL POLICY

Discretionary (active) changes in fiscal policy can affect the price level both *directly* and *indirectly*. A change in direct taxes (taxes on income, for instance), public consumption or public investment influences inflation indirectly via effects on demand, while the price level is affected directly by changes in taxes on goods and services as well as by price controls, for example. Public investment in infrastructure, education, research and development, as well as certain tax reforms, normally tends to enhance potential output, at least over the long term.

Besides analysing fiscal policy's direct and indirect impact on the price level and inflation, it is important to assess the public finances' cyclical sensitivity. The combination of a progressive tax system and income-related transfers strengthens the automatic stabilisation of economic activity even in the absence of an active stabilisation policy.

It is important to distinguish between *fiscal stance*, which denotes the direction of discretionary fiscal policy, and *fiscal impulse*, which stands for fiscal policy's impact on the economy. The direction of fiscal policy is usually measured in terms of the structural budget balance (the cyclically adjusted balance). A structural balance that is deteriorating over time indicates that policy is becoming more expansionary.⁶

Table B3. Structural budget balance in Sweden, the United States and the euro area.

Per cent of GDP	2001	2002	2003	Change 2001–03
Sweden	4.4	2.8	1.9	-2.5
United States	0.7	-0.5	-0.2	-0.9
Euro area	-0.9	-0.6	-0.5	+0.4

Note. The OECD's calculation for Sweden in 2003 has been adjusted for an additional step in the income tax reform.

Sources: OECD and the Riksbank.

It will be seen from Table B3 that the direction of fiscal policy in Sweden is considerably more expansionary than in the United States and an average for the euro area. Among other things, this relative difference should be seen in the light of Sweden's public sector financial surplus in recent years. The public finances in a number of large EU countries, including France and Germany, have been weaker, which limits the scope for easing fiscal policy.

⁶ Note that there are a number of alternative methods for calculating the structural budget balance and they yield appreciably different results. However, this is less of a problem when analysing *changes* in the balance.

Changes in the structural balance indicate the direction and magnitude of the fiscal impulse but say less about its likely effect on inflation. The deterioration of the structural balance indicates a recent expansionary shift in the fiscal impulse. Even so, the public sector financial balance shows a surplus.

Economic effects of fiscal policy are also influenced by other factors. The same weakening of the structural balance in two countries can lead to effects of different magnitudes on account of, for example, differences in the composition of fiscal policy, households' expectations and the size of the automatic stabilisers.

Large components of the fiscal easing in Sweden in the forecast period are aimed at household income (Table B4). The extent to which they affect private consumption depends in part on which categories of household are recipients. If the tax cuts are aimed at low-income households, who are often assumed to consume a larger proportion of their income, the effect on total demand and the price level will be greater than if they are aimed at high-income households, who are assumed to save more. The income tax cuts in Sweden mainly constitute compensation for employee-paid contributions to the national pension system, which means they are aimed at all individuals who pay the pension charge.⁷

Table B4. Sweden's public sector financial balance.

Change as a percentage of GDP

	2000	2001	2002	2003
Financial balance	2.5	-0.2	-2.4	-0.1
of which from:				
Discretionary policy	-1.4	-1.7	-1.7	-1.2
of which:				
Direct effect on household disposable income	-0.7	-1.2	-1.4	-0.9
Automatic stabilisers	0.9	-0.7	-0.3	0.2

Note. Periodisation effects of taxes, etc., are disregarded. The size of the automatic stabilisers has been calculated by multiplying the budget elasticity (assumed to be 0.75) by the change in the output gap. As the source for this table is not the same as for Table B3, differences in underlying assumptions may have led to some discrepancies in the results.

Sources: Ministry of Finance and the Riksbank.

In the United States, a factor that points to the tax relief having more limited effects on private consumption is saving's very low initial level, which is hardly sustainable in the longer run. This makes it reasonable to foresee a rising saving ratio in the coming years and to some extent that would counter the impact

⁷ As the marginal consumption propensity (the change in consumption that results from additional income) is smaller in the short than the long term, effects of the tax cuts can also be expected to vary in size over time. Moreover, the marginal consumption propensity should be somewhat smaller when a permanent increment to income comes unexpectedly than when it has been foreseen.

of fiscal policy. A rising saving ratio is also expected in Sweden but as the saving imbalances in the United States are relatively larger, their tendency to counter fiscal policy's impact is likely to be greater.

The effect on private consumption also depends on whether households expect the tax cuts to be permanent or not. Although the level of the structural balance should be interpreted very cautiously, it does indicate that the tax cuts in the United States and Sweden are sustainable in the longer run, so their upward impact on private consumption can be expected to be more permanent.

A difficulty when gauging the demand impact of fiscal policy concerns the extent to which households have already adjusted consumption to the expected future tax take. In both the United States and Sweden, the public sector financial balance has improved in recent years, which may have been an important inducement to reduce private saving. To the extent that households have already adjusted consumption, the impact of the current tax cuts will be reduced. In the United States it has been announced that further tax relief will be forthcoming in the coming decade, which may accentuate the short-term impact.

In the ongoing economic slowdown, the automatic stabilisers may also tend to maintain consumer demand. The effect of these stabilisers is reflected in budget elasticity (the increase/decrease in the budget balance, as a percentage of GDP, that accompanies a 1 per cent increase/decrease in GDP, given an unchanged fiscal policy).⁸ The higher the budget elasticity, the greater in principle is the effect of the automatic stabilisers. For Sweden, budget elasticity is usually estimated to be 0.75. The magnitude of the automatic stabilisers is shown in Table B4. In 2001 and 2002, automatic stabilisers and discretionary fiscal policy are expected to pull in the same direction; in 2003, when a renewed increase in resource utilisation is foreseen, the automatic stabilisers will have a somewhat restrictive effect.

The OECD's estimated figure for budget elasticity in the United States is 0.25. Compared with the United States, the tendency for the automatic stabilisers to smooth cyclical fluctuations in the economy can therefore be expected to be considerably stronger in Sweden.

8 Budget elasticities should be interpreted very cautiously, partly on account of the considerable uncertainty in the empirical estimations but also because no allowance is made for the cause of the change in GDP. In that tax on exports is low in Sweden, an export-led economic slowdown should not affect the public finances as much as a slowdown led by falling domestic demand. A method for calculating the structural budget balance that to some extent takes this problem into account was presented recently by the European Central Bank (ECB Working Paper 77, *Cyclically adjusted budget balances: an alternative approach*).

SUMMARY

Comparisons of economic policy's impact in different countries are fraught with difficulties. It should therefore be underscored that the present conclusions are to be interpreted cautiously.

The impact of the monetary and fiscal conditions on demand and the price level appears to be somewhat more expansionary in Sweden than in the United States and the euro area. Real interest rates are admittedly lower in the United States but Sweden's exchange rate is appreciably weaker. The more marked share price fall in Sweden in the past year is not considered to make up for the whole of this difference.

Fiscal policy in Sweden is judged to be more expansionary than in the United States and the euro area. Large components of the fiscal easing in Sweden and the United States in the forecast period affect household disposable income. The saving imbalances in Sweden are not as considerable as in the United States, the tax cuts are aimed at low and medium incomes and the credibility of the government finances' long-term sustainability is firm, so there are grounds for expecting that the shift in fiscal policy will contribute in the coming years to a comparatively favourable development of demand in Sweden.