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SPEECH

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Public finances and monetary policy

Public finances are of central importance to stable economic development

The financial crisis has made it clear just how important it is for a country to have sound public finances and for confidence in fiscal policy to be maintained. The situation in Greece and several other countries arouses unpleasant memories of the crisis in Sweden in the 1990s. Being forced to pay higher and higher interest rates on a rapidly growing central government debt is not an enviable situation to be in, nor is being forced to increase taxes and reduce public expenditure at the same time as unemployment is rising. When such a situation arises it also becomes much more difficult to use monetary policy to inject new life into the economy because the interest rates in the economy begin to be affected more by the credit rating of the central government than by the central bank policy rate.

In this speech I intend to discuss the importance of public finances for stable economic development in the slightly longer term and the implications they have for monetary policy. I will not, on the other hand, comment on the formulation of fiscal policy in the short term. I would like to point out that the assessments and values expressed here are my own and that they are not necessarily shared by my colleagues on the Executive Board of the Riksbank.

Public finances have deteriorated

In 2008 and 2009, public expenditure in most industrial nations increased while revenue declined. Expenditure in the OECD area as a whole increased as a percentage of GDP from 40 per cent in 2007 to 45 per cent in 2009, while revenue as a percentage of GDP fell from 39 per cent in 2007 to 37 per cent in 2009.[1] (Slide: Public finances in the OECD countries).

The situation with regard to general government net lending, that is the relationship between public-sector revenue and expenditure, has therefore deteriorated. The deficit in public finances in the OECD area has increased from 1 per cent of GDP to 8 per cent of GDP. (Slide: General government net lending in the OECD countries).

[1] These figures are taken from the OECD's latest Economic Outlook, November 2009.

This has in turn led to a substantial increase in public-sector indebtedness. The gross debt of the public sector in the OECD area has increased from 73 per cent of GDP in 2007 to 90 per cent of GDP in 2009 and will continue to grow rapidly as long as the large deficit remains. (Slide: Gross public debt in the OECD countries).

The problem is largely the same for all the established industrial countries. However, there are significant variations. For instance, the public-sector deficit has increased more in the USA during the crisis than in the euro area. (Slide: General government net lending in the United States and the euro area).

There are also major differences between the countries in the euro area. In some of the euro countries the deterioration in public finances has been dramatic. I will come back to this later.

There are several reasons for the deterioration in public finances

There are a number of causes behind the substantial deficits in public finances. Firstly, many countries were in a weak initial position even before the crisis began, as their public finances were already in deficit. Many countries failed to save money for a rainy day when times were good. This is illustrated by the fact that in the decade prior to the crisis average general government net lending was -2 per cent of GDP in the OECD area, the USA and the euro area. In the case of the euro area this is remarkable given that the so-called growth and stability pact stipulates that the aim should be to achieve a balance or a surplus in public finances in the medium term. (Slide: Average general government net lending).

Secondly, a downturn automatically leads to a weakening of public finances. Tax revenues fall and cyclical expenditure, for example on labour-market policy, increases. The OECD estimates that this effect has accounted for just under half of the total deterioration in public finances since 2007.

Thirdly, most countries have implemented extensive fiscal policy stimulus measures. The OECD estimates that these measures have accounted for just over half of the reduction in general government net lending in the OECD area. In the United States, where stimulus packages have been introduced on an unprecedented scale, the OECD estimates that these active stimulus measures have accounted for as much as three-quarters of the deterioration in public-sector finances. In the euro area it is instead the automatic effects on tax revenues and cyclical expenditures that have predominated.

Consequences of the deterioration

Extensive historical studies of financial crises show that they are often followed by a severe weakening of public finances and prolonged periods of subdued GDP growth.2 The deterioration in public finances that we have seen during this crisis will keep GDP growth and inflation down in many regions for some time to come, as the weak finances will enforce fiscal policy contraction and/or may lead to higher interest rates.

A tighter fiscal policy is inevitable to make public finances stable in the long term. Restoring the deficit to the level that prevailed prior to the crisis, and one might

[2] See Reinhart and Rogoff (2009).

ask whether this will be sufficient, is not simply a case of replacing the fiscal policy stimulus measures implemented during the crisis with corresponding tightening measures after the crisis. In addition, expenditures have to be replaced as potential GDP and thus potential tax revenue have fallen due to the crisis. The OECD estimates that potential GDP in the OECD area will decline by around 4 per cent as a result of the crisis. All in all, this means that public finances in the OECD area require a structural strengthening of around 5-6 per cent of GDP over the coming years.

At the same time, several factors indicate that interest rates will rise, which will lead to increased interest expenditure and thus put even greater pressure on public finances. Monetary policy is expected to become less expansionary in the years immediately ahead, which means that short-term interest rates will rise. The large general government deficits and thus rising borrowing requirements will probably lead to higher government bond rates. In addition, there is the premium that the market participants require as compensation for the risk that the debt may become unsustainable. Meanwhile, stricter financial regulations will probably also lead to higher interest rates.

In the past, there have been periods when the debts of the public sector as a percentage of GDP have been reduced as a result of high inflation. But as experiences of the harmful effects of inflation have led to more or less explicit inflation targets for central bank activities and as interest rates tend to adapt very quickly to inflation expectations, it is not probable that higher inflation will reduce public-sector debt as a percentage of GDP.

Our own experience from the Swedish budget consolidation process of the 1990s shows that it is important for the credibility of fiscal policy not just to make general statements about what needs to be done to achieve a balance, but also to make concrete decisions on the spending cuts and/or tax increases that are considered necessary. Experience also shows that it is important to base forecasts regarding improvements in public finances on cautious assumptions about economic growth.

It may also be worth recalling that there is a link between fiscal policy tightening measures and interest rates. More stringent and credible tightening measures can lead to lower interest rates as they justify lower risk premiums and lower policy rates.

The problems in Greece and other vulnerable countries

In those countries where public finances are particularly strained, developments may be more dramatic if they prove unable to implement the necessary fiscal tightening measures in an orderly way. In a situation where there is a need to renew loans but no one wants to lend, there are in practice two choices, that is, to either default on debt payments or to stop paying wages to public employees, pensions and so on. Rapidly increasing interest rates and an exploding central government debt that leads to the suspension of payments are unfortunately entirely in line with the experience of previous episodes of financial crisis.[3] This would normally also lead to problems in the bank sector, which ultimately risks leading to a new financial crisis.

[3] See Reinhart and Rogoff (2010).

Greece's problems

Greece is the country that has lately been the main subject of speculation and discussion with regard to the sustainability of its public finances. Decades of substantial public-finance deficits have meant that Greece entered this recession with a gross public debt of over 100 per cent of GDP. The growth of the Greek economy has so far been less affected by the global economic downturn than the OECD average. This is partly explained by Greece's relatively limited exposure to the world market but also by a considerable increase in public expenditure. This increase in expenditure, together with a slight fall in revenues, means that public-sector indebtedness in Greece has increased to 115 per cent of GDP, and according to OECD forecasts from November it is expected to reach 130 per cent of GDP in 2011. (Slide: Gross public debt in Greece)

The development of the central government debt in Greece, together with uncertainty about the country's ability to actually carry out the far-reaching consolidation of its public finances, has caused Greek government bond rates to rocket. The market participants have seen an imminent risk that Greece will not be able to overcome its debt crisis without outside assistance. (Slide: Difference between Greece's and Germany's government bond rates).

A couple of weeks ago, the euro countries reached an agreement, together with the IMF, on the design of a financial support package for Greece in order to safeguard financial stability in the euro area. However, the aid measures promised so far have not succeeded in reassuring the markets.

Several other countries also have serious problems with their public finances

Other countries are also experiencing serious problems. Among the euro countries, apart from Greece, these are mainly Portugal, Italy, Ireland and Spain. Critical conditions for assessing how these countries shall attain a sustainable development of their public finances in the future are the current size of the public sector debt in relation to GDP, the credibility of their future fiscal policy and the conditions for growth in domestic and external demand.

The larger a country’s debt in relation to its GDP, the greater its interest expenditure and the closer it is to an untenable situation. Among the countries I just mentioned, Italy has the largest burden of debt, with a gross public debt similar to that of Greece at just over 100 per cent of GDP. The other countries are not quite so vulnerable, but their debts are rising rapidly. (Slide: Gross public debt in Portugal, Ireland, Italy and Spain).

The credibility of their future fiscal policy is a decisive factor, not least for the rate of interest they are forced to pay on their public debt. Here, earlier patterns of balance or deficit play an important role, as does, of course, the content of their fiscal policy consolidation programme. The deficits are currently large in all of the vulnerable countries, but while Ireland and Spain have been able to show a balance or surplus during the years prior to the crisis, Italy and Portugal have shown a deficit throughout. (Slide: General government net lending in Portugal, Ireland, Italy and Spain).

A common precondition for the ability of these countries to renew their loans at a manageable cost is the credibility of their fiscal policy consolidation plans. The example of Ireland points to a credible consolidation plan with concrete decisions on large cuts in public expenditure being able to reverse an upward trend in interest rates, while the greatest pressure is currently on Portugal, where the ten-year rate rose last week. (Slide: Government bond rates of Portugal, Ireland, Italy and Spain, compared with those of Germany).

The more favourable the conditions for the development of domestic and foreign demand, the greater are the chances that good GDP growth will be able to reduce the problems in public finances. Those countries that have not had large falls in asset prices, including Italy, do not risk suppressed domestic demand in the same way as, for instance, Spain and Ireland, where property prices have fallen substantially.

With regard to demand from abroad, the problems are made more severe by wages and prices having grown faster in these countries than in the euro area as a whole since the euro was introduced. This deterioration in competitiveness can be illustrated by the fact that unit labour costs have increased by between 10 to 20 per cent more than in the euro area as a whole since 2000, and even more in relation to unit labour costs in Germany. The deterioration in competitiveness entails less chance of a boost from exports and thus poorer opportunities for a rapid recovery as international demand increases. (Slide: Unit labour costs compared to the euro area).

The strong growth in domestic demand in recent years and the weaker competitiveness have resulted in a current account deficit and thus rising foreign debts. (Slide: Current account deficits).

In the case of countries with their own currencies one would expect a depreciation of the currency to restore competitiveness. This opportunity is not available to the countries in the euro area. Here, it is instead necessary for wages and prices to fall in relation to other countries. One difficulty in this context is that both public and private debts and the interest payable grow in real terms – that is, a larger part of production goes to meeting the costs of the debts.

Developments in Germany show that such internal cost-cutting in relation to other countries is fully possible. The combination of a muted growth in nominal wages and productivity improvements has led to unit labour costs in Germany falling by 15 per cent since 2000, compared with the euro area as a whole. In the Baltic countries, which have not yet adopted the euro, but have retained fixed exchange rates throughout the crisis, one can even see falling wages.

The situation of the United Kingdom has certain similarities to that of the group of countries I have just described. Following several years of a deficit in the region of 3 per cent of GDP, the crisis entailed a rapid deterioration to a deficit of 13 per cent in 2009. According to the OECD's forecast, gross public debt in the United Kingdom will double between 2007 and 2011. Here, too, we can see an increase in unit labour costs compared to the euro area, but the crucial difference is that the weaker pound has made it possible to strengthen competitiveness. (Slide: General government net lending in the United Kingdom).

Things look better in Sweden

Public finances in Sweden are in a much better state than in many other countries. However, our experience of the severe Swedish crisis in the early 1990s is reminiscent of the situation I have just outlined for some of the euro countries today. At that time, our public finances deteriorated from a surplus of 3 per cent of GDP in 1990 to a deficit of 11 per cent of GDP in 1993. (Slide: General government net lending in Sweden).

This put us in a situation with a gross public debt of 84 per cent of GDP, a central government debt of 76 per cent of GDP and interest expenditure amounting to over 6 per cent of GDP in 1996. (Slide: Sweden's central government debt and gross public debt).

Like the countries in the euro area whose public finances are in a poor state today, Sweden had also experienced problems with the development of costs. However, unlike these countries, it was possible for us to limit the loss of competitiveness by means of a depreciation of the currency, just as in the United Kingdom today. We also had a long-established pattern of substantial surpluses in public finances in normal times, which probably increased the credibility of our consolidation measures and thus limited our costs for financing the central government debt.

At the beginning of the current downturn we had a surplus in public finances of around 4 per cent of GDP in 2007 and it looks as though we will have a deficit of approximately 1-2 per cent of GDP in 2010. This is a weakening of the budget balance of the same magnitude as that expected for the euro area, and unlike most other EU countries, it appears that Sweden will be able to stay above the stability and growth pact's deficit limit of 3 per cent of GDP. The comparison with the euro area and the United Kingdom is striking. (Slide: General government net lending in Sweden, the euro area and the United Kingdom).

The strong public finances to start with have helped Sweden to pursue an expansionary fiscal policy during the crisis without putting the long-term sustainability of public finances at risk, and to keep interest rates down at German levels. (Slide: Government bond rates of different countries).

Important to have a surplus over the economic cycle

One of the reasons why public finances in Sweden are so strong is that after the crisis of the 1990s the government and parliament formulated a surplus target for the public sector. Public finances were to show a surplus of 2 per cent of GDP over an economic cycle. This was in line with the growth and stability pact in the EU, which among other things meant that public finances should be in balance in the medium term, or show a surplus. This target was changed to 1 per cent of GDP when the definition of general government net lending was changed in the National Accounts. During the ten-year period prior to the most recent crisis, the surplus averaged 1.4 per cent of GDP and it was possible to reduce the gross public debt by almost half in this period.

The framework for fiscal policy also includes another essential part, the expenditure ceiling that prescribes an upper limit in Swedish kronor for general government expenditure over the coming three years. This has been a decisive factor in contributing to the fall in public expenditure as a percentage of GDP from 56 per cent in 1998 to 50 per cent in 2007.

It is important to continue using a surplus target for public finances over the next ten years. There are two main reasons for this. Firstly, it will strengthen Sweden's ability to manage crises and recessions. If there is a public-finance surplus when a crisis begins, there is little risk that the deficit will exceed the 3 per cent of GDP limit of the growth and stability pact when the crisis is most severe.

Secondly, averaging a surplus over an economic cycle means that the indebtedness and interest expenditure of the public sector will decrease over time. In a review of the lessons that can be learned from this crisis, Olivier Blanchard, Chief Economist at the IMF, points to the value of "fiscal space" in the form of strong public finances in the initial position and mentions that fiscal policy rules may be helpful in this respect.4

The surplus target is thus a valuable component of the Swedish fiscal policy framework. It anchors expectations regarding public finances in such a way that those who are interested in investing in Swedish government securities can be relatively certain about how public sector finances will develop in the longer term. It reduces uncertainty regarding the preconditions for saving and investment. The more established the surplus target is perceived to be, the higher will be the credibility of Swedish fiscal policy and the lower will be the future interest rates on Sweden's central government debt.

There is a clear parallel here with the Riksbank's inflation target.5 The more certain households and companies are that inflation will be close to the inflation target, the less time and energy they will need to devote to adapting their savings, investments and wages to inflation, and the fairer price setting in the economy will be.

From the Riksbank's perspective, it is also clear that monetary policy will be more efficient the more predictable developments in public finances are, and the greater the confidence in the sustainability of fiscal policy. Predictability is important to us as our forecasts for fiscal policy affect our assessments of resource utilisation and future inflationary pressures. Confidence in the sustainability of fiscal policy is important as otherwise it will be the market participants' demands for risk premiums, which often vary substantially, rather than our repo rate path, which determine interest rates.

For these reasons the Riksbank has, in its response to a consultative document from the government in March this year, expressed its support for making the surplus target obligatory by incorporating it into the Budget Act. We have also declared that we share the assessment that general government net lending over the next 10 years should once again average 1 per cent of GDP.

Consequences for Swedish monetary policy

When determining Swedish monetary policy, there are several reasons why we should pay particular attention to the conduct of fiscal policy in Sweden and abroad over the next few years.

Firstly, the large deficits in public finances around the world will dampen the growth of GDP. Fiscal policy will be tightened sooner or later, which will also dampen GDP in the short term. The fact that nearly all countries will need to

[4] See Blanchard (2010).
[5] See Leeper (2009).

strengthen their public finances at more or less the same time means that we can assume that growth impulses from abroad will be weaker then normal. There is also a risk that the major public deficits will drive up long-term interest rates for government bonds, which will have an additional dampening effect on growth.

Secondly, there is a risk that developments will be more dramatic than we expect. Greece is not the only country with serious problems. Several countries in southern Europe also have major problems with their public finances. The deficits in the United States and the United Kingdom are very substantial, too. What we call sovereign risk has recently become the main risk to the financial system. When risk premiums for countries increase, banks in these countries may also experience financing problems, and these problems can spread to banks in other countries.

Thirdly, monetary policy will be affected by fiscal policy in Sweden. Swedish fiscal policy constitutes one of the external preconditions for monetary policy. However, fiscal policy in Sweden does not need to be tightened to the same extent as fiscal policy in other countries. The Government is assuming in its Spring Fiscal Policy Bill that public finances will weaken further by one percentage point to a deficit of -2 per cent in 2010, while we at the Riksbank believe that the deficit will stop at -1 per cent. After that, we are assuming, as is the government, that there will be a gradual improvement in public finances of around one percentage point a year. If fiscal policy is different from our expectations, this may affect the picture of resource utilisation and inflationary pressures, and this could be a reason to adjust the forecast for the repo rate in the future.

Concluding remarks

Debt crises in several areas in the world around us have illustrated the importance of sustainable public finances. The large deficits in public finances in the wake of the financial crisis tend to lead to higher interest rates and will force tighter fiscal policy to be conducted, which will subdue growth abroad. This is a factor which means that in our most recent Monetary Policy Update we assume that GDP growth in Europe will be relatively weak over the coming years.

There is also a risk of a more dramatic development. Greece has recently been the primary object of speculations regarding the sustainability of public finances. But Greece is not the only potential problem. Other countries also have major problems. In a worst case scenario, this could develop into a debt crisis in several countries, which also affects the bank system.

In Sweden the surplus target has led to greater confidence and predictability with regard to developments in public finances. The strong public finances have also enabled us to use fiscal policy stimulus measures during the recession without jeopardising the long-term stability in public finances. The Riksbank supports the idea of a surplus target being included in the Budget Act and that the target should be set as a surplus of 1 per cent of GDP over the coming ten years.

If fiscal policy is predictable and sustainable, then we at the Riksbank can make better assessments of resource utilisation and inflationary pressures. This helps us to conduct a well-balanced monetary policy.

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