SPEECH

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SPEAKER: Deputy Governor Karolina Ekholm
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SVERIGES RIKSBANK
SE-103 37 Stockholm
(Brunkebergstorg 11)

Tel +46 8 787 00 00
Fax +46 8 21 05 31
registratorn@riksbank.se
www.riksbank.se

Weak international public finances and Swedish monetary policy

Thank you for inviting me to the Swedish Association of Local Authorities and Regions today to speak about weak international public finances and their significance for Swedish monetary policy. I will also discuss the line I took at the latest monetary policy meeting in October.

As representatives of local authorities and regions you are certainly familiar with the challenge of struggling with budget restrictions to keep operations in balance. Budgeting is currently of great global interest since several countries, mainly in Europe, will need to make considerable savings to reduce the deficits in their public finances. This will affect growth in these countries and thereby also the conditions for monetary policy. Sweden stands out as one of the best in the class as regards public finances, in part due to the regulatory framework for fiscal policy established in the wake of the crisis in the early 1990s. But as a small open economy we are always affected by what is happening in the world and so it is important for us at the Riksbank to follow fiscal policy in other countries as well.

Large public sector debts have been built up over a long period

Public sector debt is currently high, particularly in the advanced economies. On average the gross debt in the major advanced economies – the United States, Japan, Germany, France, Italy, the United Kingdom and Canada – was close to 100 per cent of GDP last year, and it is expected to rise more in the coming period. In the rapidly growing emerging economies – including China and India – the debt levels are much lower.

(Figure 1: Public sector gross debt in advanced and emerging economies)

There are several reasons for the current high level of debt. Of course, one important factor is that the deep and prolonged global recession, whose after-effects we are still experiencing, has led to major budget deficits in many countries. But this in itself need not have led to high levels of debt if it had not been for the poor initial position even before the financial crisis. It has been politically difficult to restrict public expenditure, even when growth was good and there was need for restraint rather than stimulation. The result has been that debt as a percentage of GDP has risen in most advanced economies in the last 30 years or more.

This development has been particularly notable in the eurozone, where the Stability and Growth Pact stipulates that public finances should be close to balance or in surplus in the medium term and that gross debt should be a maximum of 60 per cent of GDP. Instead, in the ten-year period preceding the crisis the average general government net lending in the euro area was negative, while gross debt according to the criteria of the Stability Pact was on average almost 70 per cent of GDP. The deterioration in public finances has been reinforced by the tendency of eurozone countries to conduct a pro-cyclical fiscal policy, which has fuelled rather than dampened the cyclical fluctuations, partly by stimulating the economy in good times.

(Figure 2: Fiscal policy and the economic cycle in the euro area)

The financial crisis exploded in 2008 and 2009. A severe drop in GDP automatically contributed in most countries to a weakening of public finances, partly because expenditure on labour market and social security transfers was higher and tax revenues from earned income and corporate profits were lower. The IMF, the International Monetary Fund, estimates that these "automatic stabilisers", along with falling asset prices and other growth-related factors, have accounted for almost three quarters of the total increase in debt in the major advanced economies between 2008 and 2010.[1]

(Figure 3: Increase in debt in the G7 countries, 2008-2010)

Most countries also actively increased public expenditure in order to counteract the negative effects of the financial crisis on output and employment. Spain was one of the European countries that implemented the most vigorous fiscal stimulus, including extending the social safety net, increasing public investment and reducing some taxes. The United States also implemented extensive measures in the form of tax breaks and public infrastructure projects. The Swedish measures included infrastructure projects and increased central government grants to the municipalities.

In addition, several countries also infused capital into the financial system. But these extraordinary measures only account for a small part of the total debt increase.

Austerity expected…

When output and employment increase as the global economy recovers, public deficits will decrease. But more than that is needed if the advanced economies are to be able to stabilise or succeed in reducing public sector debt from the current average of almost 90 per cent of GDP. The IMF estimates that these countries on average will have to save almost 1 per cent of GDP per year between 2010 and 2020 in order to reduce the average level of debt to a maximum of 60 per cent in 2030.[2] This means that considerable budget consolidation is needed, even though it is not extreme compared with the measures taken in other countries at other points in time. Sweden, Finland and even Ireland achieved consider-

[1] For a summary of debt developments, see C. Cottarelli and A. Schaechter, "Long-term Trends in Public Finances in the G-7 Economies", IMF Staff Position Note, September 2010

[2] See IMF, "Fiscal Exit: From Strategy to Implementation", Fiscal Monitor, November 2010

ably greater budget improvements in the 1990s. As did Denmark in the early 1980s.

(Figure 4: Austerity according to the IMF)

As the most acute phase of the financial crisis abated, focus has shifted fairly quickly from the need for fiscal stimulus to the design of credible strategies to reduce deficits. In many European countries there are plans to achieve this through higher taxes and lower public spending. In the United States it rather seems to be a matter of not letting public expenditure increase further. Several European governments recently presented their budget proposals for next year. All in all, it seems that the eurozone countries are planning to improve their budget balances by an average of about 1 per cent of GDP and the United Kingdom by slightly more than that. Many countries are at the same time facing the challenge of coping with rising costs for an ageing population. Managing these commitments will require a combination of savings and structural reforms. Partly because of this several European countries, such as France, are now trying to reform their pension systems by raising the retirement age.

Sweden has a better starting position than many other countries. Our gross debt is already now well under 60 per cent of GDP and the Riksbank's latest forecast is based on public finances showing a surplus already this year. This gives us better prospects than many other countries in the near future. But as a small open economy we will be affected by other countries' fiscal restraint. For the Riksbank the significance is primarily how this may affect Swedish inflation and resource utilisation.

…which could suppress growth

As regards the effect of fiscal policy on the level of activity in the economy, there is an ongoing debate between two main schools of thought. According to traditional economic theory, a tighter fiscal policy suppresses demand because households and firms have less money to spend when taxes are raised or transfers reduced. A tighter fiscal policy can then be expected to lead to lower GDP growth.

But there are also those who maintain that higher confidence in future fiscal policy may offset the negative effects of a reduction in disposable income today. Under the theory of Ricardian equivalence it is assumed that people understand that a public sector deficit must sooner or later be funded by higher taxes or lower public expenditure. Thus, households are expected to react to increased budget deficits by increasing their own savings. Since this means that consumption will not increase as much, an expansionary fiscal policy will have less effect than intended.

In the same way, a tighter fiscal policy can lead to households daring to consume more than they would otherwise have done. A tighter fiscal policy in a highly indebted country could also be expected to contribute to increased confidence in the country as a borrower on the capital market, which in that case may contribute to lower market rates, which in turn stimulate the economy. Some studies even find that the effect on demand of a tighter fiscal policy can be positive.[3]

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[3] See for example A. Alesina and S. Ardagna, "Tales of Fiscal Adjustments", Economic Policy 27, 1998, 487-545

However, in a relatively recent analysis of previous periods of fiscal restraint the IMF draws the conclusion that fiscal policy tightening suppresses growth. According to that study, a tightening of fiscal policy by 1 per cent of GDP tends to reduce GDP by 0.5 per cent in a two-year perspective, while unemployment will rise by 0.3 percentage points.[4]

The IMF study also shows that fiscal policy tightening has often been associated with lower interest rates. The central banks have reduced their policy rates, and the long market rates have fallen. Overall, this has tended to dampen the negative effect of the tightening measures on domestic demand. Fiscal policy tightening has also tended to coincide with a weaker exchange rate. This has helped to boost the countries' net exports, and thereby dampened the negative effect of the tightening on GDP growth.

But now when several countries are planning to tighten fiscal policy at the same time, the prospect of them all being able to increase their net exports is less likely. At the same time, policy rates in many countries are already close to zero. This is an indication that the negative effects on growth will be greater.

The Riksbank's latest Monetary Policy Report notes that the economic recovery is continuing, both in Sweden and abroad. In Sweden, activity is increasing fast, but in the United States and above all in Europe, growth is expected to be relatively slow. Consequently, even if there is uncertainty as to the effects of tighter fiscal policy, the Riksbank's assessment is that it will dampen growth in the eurozone as well as in the United Kingdom and the United States. All in all, the global economy is expected to grow by over 4 per cent a year during the forecast period up to and including 2013. Growth in the eurozone, however, is only expected to be about 2 per cent and in the USA about 3 per cent a year.

Figure: 5 Recovery in Sweden, the euro area and the US

The justification for pursuing a less expansionary fiscal policy that risks dampening growth in an already weak economic situation could of course be questioned – even if the long-term effects of gradually decreasing debt will probably be positive. But for some countries there is quite simply no choice. If fiscal policy is not amended there is a risk that debt will rise so steeply that it will make it problematic for the countries to finance themselves, which also threatens to affect other countries through increased financial turbulence. Greece, Ireland, Portugal and Spain are examples of countries forced to plan for tighter fiscal policy, despite the fact that their growth prospects are weak.

Sweden can be affected via several channels

A less expansionary and in some cases tighter fiscal policy in parts of the world may affect Swedish inflation and Swedish resource utilisation via several channels. Sweden can be affected via foreign trade if fiscal policy tightening suppresses demand on Swedish export markets. About 70 per cent of Swedish exports go to Europe, and more than half of these go to countries in the euro area. Of the remaining close to 30 per cent, more than a tenth goes to Asia, slightly less than a tenth to the US and the remainder to the rest of the world.

[4] For a more thorough description, see IMF World Economic Outlook, October 2010.

(Figure 6: Swedish exports to different parts of the world)

Sweden can also be affected via changes in the exchange rate, depending on the monetary policy conducted in the rest of the world. If tighter fiscal policy abroad dampens growth prospects there, foreign central banks can be expected to respond with a relatively more expansionary monetary policy, which keeps interest rates down. If the Swedish interest rates were then markedly higher it could lead to a substantial strengthening of the krona. As long as the return on holding assets in kronor is expected to be higher than that on holding them in other currencies, there is in fact reason for investors to increase their krona assets. In that process a strengthening of the krona can be expected.[5] A stronger krona would in turn lead to lower inflationary pressure, partly directly through cheaper imported goods, partly indirectly through dampened resource utilisation as demand for relatively more expensive domestically produced goods and services falls.

In addition, there is a financial channel through which we can be affected, for example, by changes in asset prices abroad spilling over to Sweden and in turn affecting demand and inflation. When Greece earlier this year had difficulties in borrowing in the international bond market due to its public finance problems it was via the financial markets that the unease spread. Rising Greek government interest rates and falling Greek government bond prices contributed to rising interest rates on other more risky assets and to lower share prices.[6] The Greek crisis also helped to increase focus on large budget deficits and government debt even in other countries, such as Spain and Portugal. Recently, market concerns surrounding Ireland have increased again. As regards the budget situation of the eurozone countries, it is worth noting in this context that the EU is now working on reforming the stability pact and creating independent supervisory bodies so as to be able to discover and deal with macroeconomic imbalances at an earlier stage.

(Figure 7: Spreading effects)

Risk of too rapid strengthening of the krona

As I mentioned earlier, the international interest rate level can impact Sweden through the exchange rate. One effect of lower expected interest rates abroad may be that the Swedish krona strengthens. As I was saying earlier, a stronger krona means lower inflationary pressure. This may in turn justify a more expansionary monetary policy in Sweden, too.

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[5] One starting point for assessing the relationship between interest rates and exchange rates is to assume that exchange rates adapt so that the expected return on assets in different currencies remains the same. Uncovered interest rate parity means that the expected return is the same when the difference between the domestic rate and the rate abroad corresponds to the expected change in the exchange rate (in per cent). If interest rates are equal, the expected return on assets in domestic and foreign currency is the same when the exchange rate is expected to remain constant. An increase in the domestic interest rate from such a situation would lead to a strengthening of the exchange rate until it reaches a level where one can expect a depreciation corresponding to the interest rate differential that has arisen in relation to other countries. The correlation between exchange rates and interest rate differentials resulting from this condition does not, however, have particularly strong empirical support, which means that it is not very easy to forecast how the exchange rate is really affected by changes in interest rate differentials.

[6] Increased uncertainty often tends to contribute to a weaker krona, as demand less volatile currencies increase among international investors,. This can help explain the large depreciation of the krona during autumn 2008 and spring 2009. It also underlines the difficulty in making exchange rate forecasts.

At the moment, monetary policy expectations in the countries around us seem to be low. Surveys and market prices indicate that expectations are for a first interest rate increase in the eurozone to take place in around one year's time. In the United Kingdom and the United States, too, market pricing and surveys imply that policy rates are expected to remain low for a long time. However, current expectations should be included in the current krona rate.

Figure 8: Monetary policy expectations

But the main scenario in the Riksbank's most recent Monetary Policy Report is based on policy rates abroad gradually beginning to rise, and that this will soon be reflected in the long-term interest rates, too. My own assessment at the latest monetary policy meeting was instead that policy rates abroad will remain low for a longer period than is assumed in the main scenario. One reason for this is that communication from the central banks in the United States, the eurozone and the United Kingdom indicates that they, given their own forecasts, envisage a need to hold policy rates low for a long time.

Moreover, I see a risk that the desire to avoid stronger exchange rates will lead to generally lower interest rates abroad. When it is not possible to use fiscal policy to stimulate domestic demand, it is tempting to put one's hope in exports. Additionally, some countries need to increase saving not only in the public sector, but also in the private sector. This means that demand must come from abroad in the form of increased exports to avoid growth being suppressed. The countries will then of course be unwilling to allow exchange rates to move in a direction that will lead to poorer competitiveness for themselves. The desire to keep monetary policy expansionary is thus partly due to difficulties in using fiscal policy to stimulate domestic demand, and partly due to the limited scope for increased consumption in some countries.

I therefore believe that a reasonable assessment of the international policy rates in the longer run, in 2012 and 2013, is that they will be lower than is assumed in the main scenario of the Monetary Policy Report. In my opinion, the repo rate path in the main scenario entails the interest rate differential in relation to other countries increasing too much and too quickly. It also entails an increase in the interest rate differential that I do not believe to be in line with market expectations and thus incorporated in the current krona exchange rate, which could lead to a much stronger currency than is envisaged in the forecast. As a stronger krona can be assumed to suppress inflation and resource utilisation, I voted at the most recent monetary policy meeting to hold the repo rate unchanged and to have a repo rate path where the repo rate is raised more slowly.

(Figure 9: Alternative repo rate paths, CPIF, CPI and unemployment in different alternatives)

However, I would like to emphasise that my stance with regard to monetary policy was not to avoid a strengthening of the krona as such. Given the current strong performance of the Swedish economy and the very large current account surplus we have had for a long time, it is reasonable to have a stronger real exchange rate. Also, Sweden, with its healthy public finances and high level of household saving, does not face the same challenges in terms of growth prospects as the countries needing to consolidate their balance sheets.

Overall assessment

All in all, we can note that the economic and financial crisis has contributed to poorer public finances in the advanced economies in particular. Budget deficits and debt ratios that were, in many cases, already high before the crisis have risen further and risk worsening as the countries' populations age. In some countries in Europe the deterioration in public finances has led to increased financial unease and problems in borrowing on the international bond market. These countries, as well as others, are now facing severe cutbacks. This will entail a balancing act between on the one hand initiating the right measures to hold down the level of debt and to create confidence to avoid higher interest rates on the public debt, and on the other hand avoiding suppressing demand too far. However, the overall effects of a possible tightening of fiscal policy depend on several factors, including developments in financial conditions.

To consolidate public finances will also take time, and until this is achieved there is a risk that markets will judge the measures to be insufficient, which could lead to renewed financial turbulence. But there are also bright spots, for instance, there are plans for new and reforming supervisory bodies in Europe.

Public finances in Sweden are in better shape than those in most other European countries. At the same time, we are affected by what happens in the world around us, and things look slightly different there. Tighter fiscal policy abroad will mean – all else being equal – that there is a greater need to use monetary policy as stabilisation policy instrument. If the interest rates in other countries remain very low while those in Sweden are raised, one can expect the krona to strengthen. This will reduce the inflationary pressure in Sweden as import prices rise and resource utilisation will be dampened. This is the most important reason why I wanted to hold the repo rate unchanged this time and to then raise it more slowly than the majority of the Executive Board members wished at the most recent monetary policy meeting. My stance was not about avoiding an appreciation of the krona in itself. What I feel is that we must try to avoid this appreciation happening so quickly that inflation ends up far below the target.

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