SWEDEN'S ECONOMY AND MONETARY POLICY

Address by Mr. Urban Bäckström, Governor of Sveriges Riksbank, to the Gothenburg Stock Exchange Association on 25 January 1996

Thank you for the invitation to discuss the development of the Swedish economy and the issue of how monetary policy can contribute to a sustainably favourable path.

I shall begin with a historical review so that the Riksbank's measures in recent years can be seen in a wider context. The reasons for easing the monetary stance this January will then be considered before I conclude with some comments on events in financial markets in the past week.

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A look at the historical record illustrates monetary policy's fundamental principles, as well as why confidence is so important.

The Riksbank's basic function is to provide final means of payment, what we commonly refer to as money. Today's notes and coins, however, do not possess the substance that their denominations represent. Instead, there has to be confidence in the value of money. It might be said that the Riksbank provides money and safeguards its value.

In the old days, commerce was often conducted with precious metals. Instead of merely representing value, they possessed it intrinsically. Later on, "tokens of value" were introduced. In 1644 the Swedish mint at Avesta began to issue money in the form of copper plates. This was a cumbersome instrument, weighing up to 20 kilograms, which in those days was roughly the price of a cow.

In 1661 Johan Palmstruch, founder of Stockholm Banco, the first Swedish bank, launched an innovation to simplify money transactions - he introduced notes of credit. These notes did not earn interest and they were issued for fixed sums, backed by money deposited in the bank. Being simple to handle, the notes were at first a success. However, the venture ended with a banking crisis when Palmstruch issued notes too liberally in relation to the underlying value of the bank's deposits. Confidence in the value of the notes quite simply dissolved.

Swedish history provides many examples where the temptation to issue too much money has led to its value being eroded:

- During the reign of John III the value of Sweden's coinage deteriorated rapidly. In order to make the silver go further, it was debased with more and more copper, with the result that in 1590 inflation was running at 800 per cent.

- In 1715 the government of Charles XII issued "necessity money" to finance the costs of war. This pushed inflation up to 50 per cent.

- In the early 19th century there was another bout of inflation when the printing presses were used to finance the war with Russia.

Another theme in Swedish history, however, is the endeavour to find ways whereby the temptation to erode the value of money can be countered. When the Riksbank was established in 1668, which actually makes it the world's oldest central bank, it was constituted as an agency of the Riksdag, Sweden's parliament. This was done in part to prevent the Crown from debasing the currency. Acting on the poor record of Palmstruch's bank, moreover, the Riksdag initially prohibited the Riksbank - known in those days as the Bank of the Estates of the Realm - from issuing notes. It was not until 1701 that the Riksbank was given permission for this.

Precious metals have had an important function for confidence in the value of money. After a period of high inflation, in 1830 Sweden's parliament decided to adopt a silver standard. After that, from 1863 onwards, gold played a prominent part. With relatively short interruptions, mainly in connection with the two world wars, Sweden's currency was tied to gold for more than a century. That was the case even under the Bretton Woods system from 1951 to 1973, when the Swedish krona had a formal link to the US dollar but its value was based on the price of gold.

A long period of price stability commenced in 1830. From then until 1960 the average annual rate of inflation was less than 2 per cent. Except during the two world wars and in the 1970s and '80s, price stability has been the norm for more than a hundred years. So there is reason to talk of a Swedish tradition.

As evidence that the monetary stability did not obstruct economic development it can be noted that from the middle of the 19th century up to the end of 1960s economic growth in Sweden was among the highest in the world. It was rather the case that the low rate of inflation and the associated stability promoted this favourable development.

It was not least in the immediate post-war decades that high growth, low inflation, external balance and confidence in the future generated a period of economic expansion. In this favourable era of good and stable economic development, standards of living rose.

During the 1970s and '80s the Swedish economy then encountered increasingly difficult problems, which ultimately resulted in the profound crisis in the early 1990s. Various types of disturbance, both domestic and external, were countered with expansionary fiscal policies accompanied by devaluations. This favoured production and employment in the short run but led to inflation, speculation, recurrent economic setbacks, further devaluations and more fiscal expansion.

A vicious circle was created as each cycle of inflation and devaluation was followed by another. The government's creditors obtained compensation for the higher rate of inflation and for the declining value of the krona. Market rates of interest were therefore high compared with many other countries. This was accompanied by weak investment and low savings.

The result for this period is depressing: weak growth, rapid inflation, high interest rates and a tendency for unemployment, with each economic downturn since the

1960s, to become higher and higher. The painful development during the crisis in the early 1990s is well known.

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When the krona was allowed to float in the autumn of 1992 it became appreciably weaker. This depreciation (the appropriate term when the exchange rate regime is flexible) gave a strong demand stimulus, in the first place to the export-oriented sectors of our economy. The results were soon apparent in one of the strongest industrial upswings in Sweden for a long time. In just a few years industrial production has risen twice as much as in the whole of the 1980s.

Money and bond rates fell, thereby contributing to a recovery of production in other parts of the business sector. The upswing here, however, was considerably less widespread than in the sectors which benefited from the weak exchange rate. A dual situation developed in the economy, though the overall growth rate has been well in line with earlier recoveries and no doubt stronger than many have observed.

During the first half of 1994 Swedish economic policy lost credibility. There was growing concern about a relapse into the earlier pattern - that once again an economic upswing would be allowed to develop into an inflationary bubble. In other words, would Sweden experience a repetition and a continuation of the habitual course of events in the 1970s and '80s, with the risk of a subsequent setback for growth and employment?

In the summer of 1994 various surveys indicated that more and more agents were again beginning to count on rising inflation. Since the turn of the year the bond rate had moved up from just under 7 per cent to almost 12 per cent. As confirmation of the risk of inflation, the krona had continued to weaken. The pass-through from higher import prices to consumer prices had begun to increase. There were also growing signs of inflationary pressure in manufacturing. Cost-consciousness was waning and a troublesome round of wage negotiations became increasingly likely. More and more features of the pattern from the 1970s and '80s were discernible.

In this situation a passive economic policy would have underpinned the fears and amounted to a continuation of the old ways. Economic policy was accordingly at a crossroads. It was a matter either of repeating the earlier pattern or of continuing to implement a policy for stability with vigour and consistency.

It is important to draw lessons from the earlier devaluations, perhaps above all from the economic development that followed the devaluations in 1981 and 1982. At times the krona's depreciation after 1992 has been at least as marked. In the early 1980s the weak exchange rate likewise provided an impetus for the subsequent expansion, which began in manufacturing and benefited from an international upswing. In these respects the development of activity accordingly resembled that in recent years.

In the 1980s, however, the expansionary development also included sectors - public as well as private - with a more domestic orientation and in time the overall increase became too strong. The growth of total demand therefore exceeded the economy's production potential. Prices and wages started to accelerate and this led to renewed problems with costs and a completion of the devaluation cycle.

The conclusion is obvious. A markedly undervalued currency makes it necessary to keep interest rates comparatively high in order to counter inflationary tendencies. While this stance is clearly undesirable in itself, it was unavoidable when there were expectations that the historical pattern would be repeated.

The Riksdag, the Government and the Riksbank have demonstrated their determination in order to render the policy credible. Low inflation is not just an end in itself - it promotes the economic stability that is needed in order to achieve wider goals such as sustained growth and increased employment.

The key element in such a policy is ***confidence***.

- The Government and the Riksdag focused on the consolidation of public finances. Via a number of "packages" this ultimately led up to the convergence programme that was presented early last summer.

- The Riksbank had to start from the current situation. Given the prevailing risks of inflation, starting in August 1994 the Riksbank found it necessary to establish higher instrumental rates.

The result of this policy was a successively increased probability that the earlier pattern would not be repeated. Inflation has been kept in check and this has generated increased confidence that it will also be low in the future. It is these matters - stronger government finance and the break with historical inflation - that lie behind the fall in market interest rates and the strengthening of the exchange rate that we have observed in the second half of 1995.

For 1995 the annual rate of inflation is 2.9 per cent. The twelve-month figure for December is 2.6 per cent. The outcome accordingly exceeds the target of 2 per cent but it is inside the tolerance interval of ±1 percentage point. Temporary effects boosted the rate of inflation during 1995 and the underlying rate was around 2 per cent. Increased indirect taxes and charges are mainly responsible for the difference. The tolerance interval on either side of the target is partly intended to accommodate such deviations.

The fact that inflation in 1995 stayed inside the tolerance interval - even though growth was strong and at times the krona was markedly undervalued - is an achievement. It suggests that the inflation propensity in the Swedish economy has diminished.

Notwithstanding the economic upswing and the price effects of the krona's depreciation, for the past four years inflation has stopped at an average annual rate around 3 per cent. This is a notable retardation compared with the 1970s and '80s, when annual inflation averaged around 8 per cent. One has to go back to the turn of the 1950s in order to find as long a period when inflation was as low as in recent years. This constitutes important steps on the path towards establishing a low-inflation economy.

Today the starting-point for the future differs from that in corresponding phases of activity in the 1970s and '80s. In those decades, problems with inflation and costs, as well as high interest rates and downward pressure on the krona, were leaving their mark when international activity was weakening some years after a devaluation. Today this situation does not apply.

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I shall now turn to a brief account of reasons for the easing of interest rate policy this January. It is the composite picture of three fields that has been decisive.

Inflation expectations have decreased appreciably during the autumn and winter. This is evident from surveys and it is confirmed by the lower bond rates and the stronger krona.

The ***stronger krona*** will make the business sector more attentive to costs. Prices in early stages of production - as well as wage drift - are likely to be held back. Low wage drift is essential for the maintenance of competitiveness because wage agreements have been concluded at too high a level in relation to the rest of the world.

International ***economic activity*** slackened during 1995, mainly as regards continental Europe. Since Swedish firms are heavily dependent on the state of their respective export markets, a slowdown there affects their sales potential.

The weaker activity in Europe is partly a matter of typical cyclical factors that include a swing in stockbuilding and a delay in the transition from external to domestic demand as the motor behind the recovery. Such factors also led to short pauses in growth at much the same stages of upswings in the mid 1970s and the 1980s.

The effect of these factors, however, has been accentuated by disturbances from the global financial markets, particularly in the spring of 1995. Those disturbances in turn were reflections of specific events early last year, for example the developments in Mexico. They were reinforced, moreover, by uncertainty about the course of fiscal consolidation in a number of countries. The high international interest rates in the first part of 1995, like the exchange rate movements, no doubt tended to subdue international activity.

In the course of 1996, however, a recovery of activity in Europe is indicated by a number of factors. Internationally, business profits are favourable, which makes firms more resilient. Moreover, pressure from prices and wages is low. The initial conditions have not been as good since the 1960s. Falling money and bond rates in many European countries suggest that monetary conditions may facilitate a continued upswing. In order to reduce the risks of future disturbances from interest and currency markets it is important that work in Europe on the consolidation of public finances continues.

For Sweden, a fall-off in international activity implies that demand from the internationally-oriented sector becomes less strong. With a less undervalued krona it is more likely that, when activity abroad picks up again, the development of demand will be more in line with the expansion of production capacity. That would reduce the risk of inflationary tensions and provide an opportunity in turn for a recovery in sectors with more of a domestic orientation.

Interest rate policy in recent years provides a clear illustration of how monetary policy functions with a flexible exchange rate. The more negative inflation forecasts that were prevalent in the middle of 1994 made it necessary to initiate an upward movement in the instrumental rate. Now that the inflation outlook has improved and there is an increased probability of a development in line with the target, the repo rate has been lowered.

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In conclusion, I should like to note that in the second half of 1995 confidence in Sweden's economic policy was enhanced. The risk of relapsing into the earlier inflation economy is perceived to have receded. Falling market rates of interest, not least for long bonds, and a stronger krona are testimony to this. The picture from periodical surveys is the same. The inflationary tendencies in manufacturing are also easing and cost-consciousness is growing. The slackening of activity internationally means, moreover, that capacity utilisation in manufacturing can be adjusted to levels that are more sustainable. There is therefore a greater probability that inflation in the coming years will be in line with the price stability target. This implies better conditions for sustained and balanced growth.

This week began with rising interest rates and a falling krona. Market reactions have many different reasons. Experience shows that the movements are sometimes exaggerated. Some agents with a short horizon have a propensity to reap profits or minimise losses without delay.

Still it can be stated - in case anyone should happen to claim that a clear and consistent development towards sound government finances is of no consequence for growth and employment - that the phenomenon is a clear signal to the opposite effect.

The foundation for sustainably stable growth and employment is laid with sound government finances and price stability. This is evident not least from the development in the second half of 1995. The appreciably increased confidence in Swedish economic policy constituted the beginning of a basis for more balanced and sustainable growth and employment. Sweden's political system is also well aware of the importance of sound government finances. There is broad support for this objective in Sweden's parliament.

Finally a few words about future monetary policy. The development of the repo rate is contingent on the overall assessment of the outlook for inflation, based on developments in the three fields: expected inflation, the development of the exchange rate and the relationship between demand and supply. It is not the short-run market reactions that are decisive for the Riksbank's assessment of inflation expectations.