# SWEDEN'S ECONOMY AND MONETARY POLICY

Address by Mr. Urban Bäckström,
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at Handelsbanken's Seminar
in New York, 19 April 1996

First I want to thank Handelsbanken for this opportunity of discussing developments in the Swedish economy and our current monetary policy here in New York.

## Economic developments in recent years

In the past few years Swedish economic policy has achieved tangible results.

- During 1994 and 1995 favourable economic growth in Sweden has been combined with a rate of inflation that is the lowest for several decades. By enhancing confidence in Swedish economic policy, important steps have been taken towards greater economic stability.

- There is broad political agreement on the consolidation of government finance, manifested in the programme that aims to eliminate the budget deficit not later than 1998. The budget reinforcements which the Government and the Riksdag (Sweden's parliament) have undertaken in recent years are extensive. The six-monthly monitoring arrangement provides a means of ensuring that government finance is developing as planned. There is, moreover, an explicit readiness to introduce additional measures in the event of deviations from the plan and there have also been practical examples of this.

The general government financial balance has been strengthened, as reported by the National Institute of Economic Research, from -12.3 per cent of GDP in

1993 to an estimated -4.9 per cent this year and -3.3 per cent in 1997. This is a very marked improvement. Including the additional reinforcements that were proposed recently, the Government calculates that the deficit will be less than 3 per cent in 1997 and that the target of eliminating it in 1998 will be achieved.

- Broad political support also exists for the objective of price stability. With the enhanced confidence in budget and monetary policy, together with the tighter interest rate policy from the second half of 1994 up to the end of 1995, it has been possible to check the earlier inflationary tendencies and bring inflation expectations down appreciably.

- What used to be an almost chronic deficit on current account has now been turned into a surplus. This is reducing Sweden's external debt, which also contributes to greater financial stability.

- Many structural measures have been implemented since the late 1980s and there are signs that, together with economic policy's promotion of stability, this has reduced the economy's inflation propensity and raised its potential output.

Against this background, the direction of Sweden's economic policy contrasts sharply with the unstable and inflationary path we experienced in the 1970s and 80s and which contributed to the recession in the early '90s, which was the worst for over sixty years.

Since the turn of 1995 the Riksbank has lowered the repo rate relatively rapidly. This has been done in the light of an expected outlook for inflation in line with the target.

- In the past six months activity in the Swedish economy has slackened. The slowdown in Western Europe has entailed weaker export demand and the effects of this fall-off have been accentuated by domestic stock adjustments.

- Inflation expectations have continued to fall back as the policy for stability has earned increased confidence.

- The krona has appreciated and is now almost 10 per cent stronger than its average level in 1994 and 1995. A stronger currency implies lower demand for the tradable sector at the same time as it eases the price pressure from imports.

## The frame for Swedish monetary policy

Following the move to a flexible exchange rate, monetary policy in Sweden is directed at a quantified inflation target. In this it resembles the situation for monetary policy in Australia, Canada, Finland, New Zealand and the United Kingdom, where inflation targets are also used.

In Sweden the target is formulated as being to limit the change in the consumer price index to 2 per cent. This target is to be assessed, not in terms of isolated twelve-month change figures but in an annual perspective. As monetary policy cannot control price developments exactly, the target is accompanied by a tolerance interval of ±1 percentage point. This tolerance interval also serves to absorb temporary deviations from trend inflation. Such deviations may arise, for instance, from political decisions to alter indirect taxes and subsidies, as well as from international price shocks.

Given the time lag that applies to monetary policy, a central bank that targets inflation has to monitor the various factors which determine inflation one to two years ahead. In a simple analysis of inflation's determinants one can start from the familiar Phillips curve, which can be described in somewhat different terms. Their common denominator is that the rate of inflation is determined by two factors: the relationship between supply and demand in the economy and inflation's expected rate. To simplify matters I shall confine my account to the output gap.[1]

The simple model tells us that when the output gap is closed, inflation is constant and equal to the expected rate. This means that, with normal capacity utilisation and given a low level of inflation expectations, actual GDP can follow potential output. In such a situation some form of external shock is needed to shift inflation upwards or downwards. This can mean either that production falls below or rises above the level for normal capacity utilisation or that inflation expectations move up or down. The latter case is ultimately a matter of confidence in economic policy's consistency and its future reactions.

[1]Note, however, that while the output gap is a serviceable starting point for an inflation analysis, there is no simple way of measuring it which tells the whole story. This makes it necessary to go into more detail and study a variety of indicators in order to analyse any tensions between demand and supply. Still, the output gap is a suitable starting point for my present purpose.

The ability of monetary policy to influence inflation has to do with the impact of the instrumental rate on the path of GDP and thereby on the degree of capacity utilisation, together with its effect on inflation expectations. In practice a period of restricted demand has frequently been necessary for the central bank to show that expectations of high inflation are unfounded. Besides monetary policy, expectations are affected by other factors. One of these is the budget. Unsustainably large budget deficits are liable to undermine confidence in long-term price stability.

Simplifying somewhat, one can therefore say that future inflation is conditioned by three factors: demand-supply relationships, inflation expectations and the exchange rate. A weighted combination of these factors results in an overall inflation forecast that serves as a foundation for the construction of monetary policy. If monetary policy is directed at stabilising price movements in this way, it will help to stabilise demand so that this is in line with the economy's available capacity.

In order to clarify our line of reasoning and the construction of our inflation assessments, the Riksbank publishes an inflation report four times a year. A range of indicators is reviewed in these reports, accompanied by a discussion of risks and opportunities in the field of inflation. Our next inflation report will be presented at the beginning of June.

**Current monetary policy**

With the improved outlook for inflation, early this year the Riksbank began to lower the repo rate. The previous situation, with high interest rates and a weak exchange rate, had made it difficult for the economy to enter a path with a balanced and smooth renewal of growth. With the markedly undervalued currency, demand in the internationally oriented parts of the economy had surged very strongly. In just a few years industrial output rose more than twice as much as in the whole of the 1980s and appreciably more than in other West European countries. As inflationary tendencies soon materialised, this led to higher interest rates. As a result, demand in the domestically oriented sectors was subdued.

The present downward tendency in interest rates and the stronger exchange rate represent a process whereby Swedish economic policy is earning increased confidence for a more permanent focus on price stability. This also means that conditions have improved for attaining more sustained and balanced growth without jeopardising price stability.

As previously, monetary policy will continue to be contingent on the most probable outlook for inflation and how this relates to the target**.** Generally speaking, the construction of monetary policy has the following alternatives to choose from:

- In a situation where capacity utilisation is normal and expected to remain in line with potential output, accompanied by low inflation expectations, the probability of fulfilling the inflation target is good. It is then reasonable that the monetary conditions bear the hallmark of neutrality.

- If actual production is tending to exceed the potential level, the risk of higher inflation grows. In that situation, as well as when inflation expectations move up, the monetary conditions should become more contractive.

- If the output gap widens, on the other hand, accompanied by low inflation expectations, there is a case for some monetary stimulus.

The question of whether monetary conditions are contractive, neutral or expansive is not easily answered. Today, however, it seems reasonable to say that the monetary conditions are approximately neutral. The repo rate cuts, although rapid, have accordingly been warranted by the slowdown in economic activity, the fall in expectation expectations and the krona's appreciation. This brings us to the future development of the real economy and the attendant risks of inflationary pressure from demand.

The main scenario for the Swedish economy, in our view, is some renewed increase in activity in the second half of 1996 or, at the latest, early in 1997. Our assessment is that during 1996 the economy as a whole is below normal capacity utilisation. The path in 1997 will be influenced by domestic as well as external factors.

The Japanese economy appears to be climbing out of a long trough and it seems that observers also count on a persistently favourable development in the United States. This should contribute indirectly to a successively stronger trend in Europe. The low rate of inflation in Europe has led to an easing of monetary policies. Together with falling bond rates, this will act as a stimulus in the European economies. Stronger growth in European markets can be expected to benefit Swedish exports.

The contractive effect of the inventory cycle in Sweden should therefore diminish later in 1996. At the same time, the underlying conditions for an expansion of private business in Sweden are favourable, with persistently good profitability and strong investment. Even the conditions for private consumption may generate a cautious recovery.

The demand-side risks of inflation in this main scenario seem to be limited and the conditions in other respects can be regarded as good for inflation in line with the target in the years ahead.

As always in a slackening phase there is still a risk of economic activity being weaker both this year and next. This, in fact, is where the assessments for Swedish monetary policy become more difficult. The risks lie in a more protracted decline of activity in Europe, as well as a weaker labour market in the domestic economy, for instance as a result of the ongoing stock adjustments. This in turn could weaken household confidence in the future. With a slacker economic development it would be reasonable to count on a lower rate of inflation compared with the main scenario.

All in all, this background suggests that there may be some scope for a further easing of interest rate policy. The real economic trends and the related outlook for future inflation will provide guidance in the task of assessing how large this scope may be. This assessment starts from sustained confidence in Sweden's economic policy, measured in terms of inflation expectations and exchange rate movements, viewed over a somewhat longer period.