CURRENT ISSUES IN MONETARY POLICY

Address by Mr. Urban Bäckström,
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In my talk today I shall be dealing briefly with three matters: how the inflation target functions, the outlook for inflation and the role of wage formation.

How the inflation target functions

A central bank produces and distributes money and safeguards its value. If the Riksbank issues too much money, which is what happens when it sets the repo rate below the level associated with macroeconomic balance, there will be a threat of inflation. Conversely, if the Riksbank issues too little money, by setting the repo rate too high, the result may be deflation. Inflation and deflation are equally undesirable and give rise to economic instability.

The objective behind monetary policy therefore involves issuing money in appropriate amounts, that is, setting the repo rate at a level where both inflation and deflation are avoided, thereby leading to price stability. Appropriate is used here in the sense of the characteristically Swedish word *lagom* - just right. The Riksbank's target of 2 per cent inflation, with a tolerance of 1 percentage point up and down, is fairly close to what is commonly referred to as price stability.

For the past four years annual inflation in Sweden has averaged between 2 and 3 per cent. This has increased the chances of getting the economy to function better and more stably as we distance ourselves from the inflationary and speculative instability of the 1970s and ’80s, when the annual price rise averaged 8 per cent.

Not until last spring, however, did households, firms, savers and investors start to believe in earnest that future inflation would also remain at a level around 2 per cent. This means that inflation is disappearing more and more from our thoughts and actions, as is evident, not least, from the downward movement in interest rates. Permanently low inflation is also the best guarantee of low interest rates.

The Riksbank sets the repo rate in the context of an analysis of inflation one to two years ahead and of how this assessment relates to the target. As a rule it takes that long for a change in the repo rate to impinge in full on inflation.

If the economy is expanding too rapidly and people begin to expect rising inflation, the probability of increased inflation grows and with it the likelihood of a higher repo rate. Conversely, if economic activity is slowing and more and more people begin to base plans and decisions on a conviction that inflation will remain low, there will be an increased probability of falling inflation and thereby of a lower repo rate.

Once a low inflation regime has been established and people count on a long-term rate of around 2 per cent, the factor that determines inflation is the relationship between demand and production capacity. This means that when monetary policy is guided by an inflation target, it ultimately tends to smooth economic fluctuations. This applies when growth is becoming so strong that the economy overheats, as well as when a slowdown is liable to turn into a recession. Growth can then be more sustained and keep pace with the expansion of production capacity, which is determined in turn by such factors as demographic changes, the level of education, technological advances and the extent to which markets function properly. Monetary policy is not capable of affecting long-term growth but by basing it on an inflation target, one can influence the fluctuations around this trend.

The outlook for inflation

In order to provide as transparent and clear a picture as possible of how the Riksbank analyses the outlook for future inflation and approaches the construction of monetary policy, we issue a report four times a year. The analysis in these inflation reports serves as a basis for the Governing Board's discussion of monetary policy. The conclusions from that discussion are incorporated as a chapter in the reports. The latest inflation report was presented some weeks ago and since the analysis and conclusions are still essentially valid, I shall take it as a starting point.

As I mentioned earlier, in an assessment of future inflation the basic components are relationships between supply and demand in various markets and expectations of future inflation.[1] I have already touched on the downward adjustment of inflation expectations towards the inflation target, so I will now concentrate on aspects of the real economy.

The slowdown at the end of 1995 seems to have been brief. The tendency to date in 1996 is upward. This is evident from the preliminary GDP statistics as well as from data that point to a rising inflow of industrial orders and production. The business tendency surveys from the National Institute of Economic Research give the same impression. Moreover, the conditions for an economic upswing in Europe this autumn appear to be favourable, which implies good opportunities for maintaining the growth of Swedish exports, particularly as Swedish firms have lowered their relative prices in order to offset the krona's appreciation. However, as firms may choose to trim stocks, it is not clear how soon the improvement in demand will show up in production.

Domestic demand has also grown during 1996. Investment has risen, above all in mining and manufacturing, and most signs point to a continuation of the favourable trend. Meanwhile, notwithstanding the fears of a fall in 1996, private consumption has been growing at a modest but stable rate. The basic conditions for a future increase in private consumption are also now in place.

At total level, it seems most probable that growth in 1996 and 1997 combined will be between 3 and 4 per cent, with the emphasis on the upper end. It is mainly exports and investment that are expected to contribute to a higher growth rate. Private consumption will presumably

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[1] Another important element in this context is the development of interest and exchange rates; besides influencing demand, they tell us something about confidence in economic policy's determination and ability to achieve and maintain inflation in line with the target.

become an increasingly important component of growth in the next two years.

Economic growth in the coming years is likely to be below the potential rate, which means that the output gap - the difference between demand and potential production - will not close and tensions that might jeopardise the inflation target will not be generated.

This assessment also appears to be consistent with the picture conveyed by financial variables such as the money supply and the volume of lending. They suggest that inflationary pressure from the demand side is weak.

The notably low rate of inflation in the past six months has stemmed in large measure from more or less transitory factors such as the krona's appreciation and falling house mortgage rates. As these transitory effects diminish, during the autumn registered inflation will probably rise. However, a faster increase in consumer prices because temporary effects are fading is not tantamount to an acceleration of underlying inflation.

Under these circumstances the Riksbank considers that there is a good prospect of inflation being in line with the inflation target in the coming years. The available information accordingly suggests that some room may remain for cuts in the repo rate. It should not be expected, on the other hand, that in the period ahead the Riksbank will follow a particular pattern. The future path will depend on new information and on how this relates to the analysis in the Riksbank's latest inflation report.

Wage formation's role

Any assessment of future inflation has to consider risks and probabilities. One such risk, discussed in the inflation report, is wage formation. In the first half of 1996 the wage rise from the same period a year earlier, corrected for some temporary and statistical factors, seems to have exceeded 5 per cent. This is an upswing from the rate of just over 3.5 per cent for the second half of 1995.

In relation to the inflation target of 2 per cent, a wage rise of rather more than 5 per cent implies a real wage increase of 3 per cent, which is more than twice the trend rate for productivity. Real wage increases that exceed the productivity trend are ultimately incompatible with the inflation target because they are liable to generate upward pressure on prices.

In the perspective for the discussion in the inflation report, the risks of inflation being higher as a consequence of the pressure from wage costs would seem to be limited. In time, however, such a development, accompanied by persistently low inflation, would lead to a weaker outcome for employment - a tendency that is already discernible. The possibility of bringing unemployment down is therefore impaired if wage increases are unduly high. This raises the question of how the wage increases should be interpreted.

The pessimistic alternative is that the rate of wage increases in 1996 and 1997 will continue in subsequent years. This would imply that equilibrium unemployment (the level of unemployment at which price and wage increases begin to accelerate) is higher than the level of 5 to 7 per cent which most empirical studies have found and that the output gap has closed.[2] That would mean that the economy has no unutilised capacity, from which it follows that unemployment cannot be very much lower than at present unless extensive changes are made in the structure of the labour market so that its function is appreciably improved.

The main hypothesis on which the Riksbank builds is somewhat more optimistic, though it does not exclude the need to improve the workings of the labour market. The outcome for wages may have been conditioned by the settlements having been concluded before the credibility of the low inflation policy had been established; the 1995 wage negotiations were marked by the contemporary inflation expectations, which were close on 4 per cent. With a productivity trend between 1 and 1.5 per cent, for employers as well as employees a wage rise in the region of 5 per cent was accordingly perceived as feasible. Moreover, at that time in the spring of 1995 export demand was rising strongly and the level of profits in the sector exposed to foreign competition was very favourable.

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[2]The inflation target provides room for the economy to expand as long as this does not generate tensions which push prices and wages up. In the analysis of future inflation, empirical estimates of the output gap and equilibrium unemployment are to be seen simply as concepts; verifying the consistency of such estimates involves work at a more disaggregated level.

If this hypothesis is reasonable, we can expect the rate of wage increases to fall back by degrees as the present agreements are replaced. However, the next round of wage negotiations will be less concentrated in time. The current settlements for the paper industry and the financial sector, for instance, expire already before the end of 1996. There is therefore reason to follow the course of these negotiations and their outcomes closely.

The possibility of progress towards wage increases in accordance with the inflation target being more protracted and also costly in terms of unemployment cannot be ruled out; but it will happen. Were it to occur more quickly, on the other hand, the result would also be positive for employment.