THE SWEDISH ECONOMY

Address by Mr. Lars Heikensten,
Deputy Governor, Sveriges Riksbank,
at SE-Banken in New York,
7th November 1996

1. Introduction

First I should like to express my thanks for the invitation to talk to you about Sweden's economy. My talk is arranged as follows:

- I shall begin by discussing the crisis which the Swedish economy went through in the early 1990s. In my view, the crisis was triggered by a realignment of economic policy. This realignment was necessary in order to achieve greater stability, with better conditions for long-term growth. It also represented an adjustment to the policy which had been conducted in much of Europe in the 1980s.

- Then I shall review what has happened in the Swedish economy in recent years. Growth has picked up, led by strong trends for exports and investment. This has been accompanied by budgetary reinforcements and low inflation. These developments have helped to enhance confidence in the Swedish economy and made it possible to cut interest rates substantially in the course of this year.

- Finally I intend to say something about the outlook for inflation and future monetary policy. In doing so I shall start from the inflation report that the Riksbank published earlier this fall.

2. The crisis in the 1990s and its background

The Swedish economy went through a profound crisis in the early 1990s. In the three years from 1991 to 1993, output fell about 5 per cent. This recession was the longest and deepest in Sweden since the early 1930s and one of the worst in post-war Western Europe.

A look at earlier decades will help to clarify the recession's causes. In the 1950s and '60s, growth in the Swedish economy had been high and stable. At that time inflation and unemployment were both low; government finance was in balance and so were external payments. In the next two decades, however, the picture was very different. Opinions vary about the reasons for this but they clearly included both political and economic factors. Without claiming to present a full account or to know all the answers, I should like to mention some of the main causes.

1. *Exchange rate policy* failed. When the Bretton Woods system of fixed exchange rates collapsed, it proved difficult to establish an alternative fixed arrangement that gave the same stability. This meant that no firm "anchor" existed for either economic policy or wage formation. A series of devaluation cycles led to widespread uncertainty, with repercussions on such factors as investment and productivity.

2. An important cause of the recurrent devaluations lay in problems with *wage formation*. Productivity growth slowed without a corresponding retardation in the rate of wage increases. This was accompanied by further additions to labour costs in the form of increased social charges.

3. *Fiscal policy* was weak, for both economic and political reasons. When economic activity slowed, it proved impossible to reinforce the budget to match rising expenditure and diminishing revenue. Government debt rose higher and higher.

4. *Structural problems* were also at work in the economy:

a) With a rapidly expanding public sector, the distortionary economic effects of taxes and public spending grew.

b) Certain sectors, such as agriculture and housing, were heavily regulated. In both these cases there was also a large element of subsidies.

c) Competition was also inadequate in other parts of the economy, for instance in parts of trade in goods and, at least until the mid '80s, in the financial sector.

5. The imbalances were accentuated when the *financial sector* was deregulated in the mid '80s. Households and firms both accumulated debts on a dramatic scale. Being confined by the fixed exchange rate, monetary policy was not used to curb this tendency.

All this meant that Sweden's standing in the international prosperity league slipped. Thanks to the expansion of public activities, however, unemployment was held back. But by the end of the 1980s, the scope for continuing the fiscal financing of employment was very limited. At the same time, inflation had accelerated. The need for a policy realignment was evident. The devaluation policy had come to a dead-end.

3. The policy realignment 1990-91

Early in 1990 the Government of the day signalled a change of course in economic policy. Priority would now be accorded to price stability. The aim was to establish more stable conditions for production and low inflation. Work on improving the Swedish economy's structure had started earlier and was now stepped up.

An awareness that policy should take this course had gradually emerged in Swedish society and the changes were also broadly supported by Swedish economists. Moreover, developments in Europe had contributed to the new picture. Inflation there had been pressed down in the course of the 1980s and after a difficult period in the '70s, some countries had succeeded in generating a stable economic development. In this situation, when Sweden applied for membership of the European Union, it was even more natural to opt for a more long-term, "European" economic policy. As confirmation of the endeavour to achieve price stability, in June 1991 the Swedish krona was tied to a basket of European currencies.

In the following years, however, economic development in Sweden was dramatic. Industrial production faltered first, due to a combination of weaker export demand and an excessively high level of costs. Investment followed the downward path and the slowdown then spread to private consumption. This situation was accentuated both by a far-reaching tax reform, which included decreased tax deductions for interest expenditure, and by a rising real interest rate. The household saving ratio moved up from -5 per cent in 1989 to about +8 per cent in 1992.

The high real rate of interest had to do with inflation's retardation from 10.4 per cent in 1990 to 2.6 per cent in 1992. Partly as a result of the problems with government finance, there was no equivalent adjustment in nominal interest rates. The problem was exacerbated by the upward movement in European interest rates in the wake of German reunion. Matters became even worse when the winds of European currency unrest turned into a gale and a financial crisis erupted.

The need for measures to counter the weakening of government finance became increasingly acute. Cuts were implemented, for instance in local government financing and in housing subsidies. Household income was also affected, via decreased transfers and higher taxes.

Having begun as a problem of industrial costs, of the kind that Sweden had already experienced several times, the crisis accordingly became more and more widespread and ultimately affected the entire economy. Every source of growth - in manufacturing, in industries geared to private consumption, in the housing sector and in public activities - was closed. As a result, open unemployment increased from 1.5 per cent in 1989 to 8.2 per cent in 1993. Meanwhile, government finance deteriorated sharply, from a surplus in 1989 to a budget deficit in 1993 that was equivalent to -12.3 per cent of GDP.

It is quite clear that at the beginning of this decade the Swedish economy was in great need of structural changes. Neither could the inflationary bubble that had developed in the late 1980s continue indefinitely. So a policy realignment was inevitable. To a considerable extent, however, the recession was more marked than anyone foresaw because the economic imbalances had been allowed to accumulate over such a long period and the changes happened to coincide with a weak situation internationally.

4. Stabilisation

On 19 November 1992 the Riksbank was obliged to abandon its defence of the krona and for the first time since 1933 Sweden adopted a flexible exchange rate. This was done, however, only after a long autumn during which the Riksbank had raised the instrumental rate, on one occasion to as much as 500 per cent.

The krona depreciated sharply and reached a low in April 1995 that was about 25 per cent below its level when the fixed rate was abandoned. This was accompanied both by a slower increase in wage costs compared with other countries and by good productivity growth. As a result, from 1992 to 1995 relative unit labour costs improved almost 40 per cent.

This represented a strong stimulus to exports, which shot up almost 40 per cent from 1992 to 1995, while industrial output rose 27 per cent. The growth of industrial investment was also dramatic, amounting in 1994 and 1995 to as much as 29 and 44 per cent, respectively.

In the domestic market, however, growth remained subdued. The development of household income was weak, partly due to the high unemployment and sizeable fiscal withdrawals to reinforce the government budget, particularly from 1995 onwards. Households were notably concerned about their own as well as the national economy. Another factor was the high real interest rate, which also tended to accentuate the fall in residential construction.

But on the whole, growth has been good. Since the upturn in mid 1993 the rate in annual terms has been about 3 per cent. There has, indeed, been a manifestly dual situation but that has not been entirely negative. A necessary structural adjustment has been initiated. From 1991 to 1995 the GDP share for manufacturing, for instance, rose from 18 to 21 per cent and in recent years the public sector's share has diminished. Moreover, the current account has begun to show sizeable surpluses.

Since the summer of 1995, confidence in the Swedish economy and in Swedish policy seems to have improved. The krona has become appreciably stronger and both long and short rates of interest have fallen. There are plausible explanations for this:

- The development of *public finance* in 1994, 1995 and the current year has been better than many observers expected. This has to do both with the generally strong economic development and with the extensive budget reinforcements. Relative to GDP, the government deficit peaked in 1993 at 12.3 per cent; the level for 1995 was 8.1 per cent and for 1996, 1997 and 1998 the most recent official forecast points to levels of 4.0, 2.6 and 0.0 per cent. The central government debt-to-GDP ratio had already been stabilised in 1994 and since then it has begun to fall.

The Government and the Riksdag, Sweden's parliament, are firmly committed to the goal of balanced public finance in 1998. The situation is being followed continuously in accordance with the principles incorporated in Sweden's convergence programme. On each occasion to date in the six-monthly monitoring process the Government has tightened its policy to the requisite extent.

- The *picture of inflation* has also improved in the past six months. Current inflation, as measured by the CPI, was 0.2 per cent this September and various measurements show that inflation's underlying rate has crept down towards 1 per cent. This has been accompanied by a marked drop in expected inflation, as measured in surveys or from price setting in financial markets. Most agents now consider that in the coming two years the rate of inflation will be well inside the tolerance interval of ±1 percentage point that surrounds the Riksbank's inflation target of 2 per cent.

The improved picture of inflation mainly reflects an enhancement of confidence in economic policy, manifested for instance in a stronger exchange rate and falling interest rates. There are signs, moreover, that the Swedish economy now has a lower inflation propensity. The trade-off between economic growth and inflation appears to have decreased. Such a tendency is also suggested by the structural adjustments and the increased competition in some markets for goods and services in the wake of deregulation and EU membership. The lower inflation expectations have probably contributed, too. A direct test of the economy's inflation propensity will, however, have to await the next economic upturn.

5. Monetary policy in the past year

Since the summer of 1995, conditions for monetary policy have changed substantially. In terms of the TCW exchange rate index used by the Riksbank, the appreciation of the krona from the low in April 1995 amounts to about 18 per cent. At the same time, the expected rate of inflation two years ahead has come down from levels around 4 per cent in early 1995 to around 2 per cent at present.

At the Riksbank the appraisal was gradually revised towards the end of 1995. The inflation forecast in our main scenario was adjusted downwards. This was accompanied by an increased probability of an alternative where weaker economic activity pointed to lower inflation. The latter was also something we had cause to incorporate in our decisions. As a rule, monetary policy decisions are not based on an isolated estimate of future inflation; we work with a number of alternatives and our decisions stem from an assessment of their respective probabilities.

In January we considered that the time had come to start lowering the interest rate. After two years of major instability it was important to make our course clear. But we also had cause to refrain from drastic manœuvres that might disturb the picture. We very much wanted bond rates to go on falling, accompanied by some further appreciation of the krona. For this to happen, the market should feel at home in the new waters and share our appraisal of the economy and inflation.

Today it is easy to forget that to many observers, the situation in January 1996 seemed anything but stable. One instance of the unrest was the market reactions to the so-called Persson Plan: the krona weakened and bond rates rose. This led many commentators to question whether the Riksbank would be able to continue with interest rate cuts. We chose to do so, above all with reference to the basic outlook for inflation. Compared with the market, moreover, we evidently had more confidence in the budget trend. While it is true that a central bank needs to “listen“ to the market, in the first place it is necessary to arrive independently at a clear picture and abide by this.

During the spring and summer the policy has been successful in the sense that the repo rate could be lowered more than four percentage points without leading to a weaker krona or higher bond rates. In actual fact the opposite has occurred: the krona is stronger than in January and bond rates are appreciably lower. The favourable development of bond rates is even clearer in terms of the differential with German rates. This should mean that inflation expectations have been lowered.

Our chosen tactics involved beginning with relatively large steps (25 basis points initially) at fairly regular intervals. As new, favourable information on inflationary pressure flowed in, we gradually revised our assessment of how far down the repo rate would be able to move. Looking back, it is conceivable that the new information would have warranted cuts in larger steps but we chose to refrain; we did not want to risk the market investing in larger cuts than those we felt certain of being able to implement. It was also important to maintain confidence in the commitment to price stability. The series of broadly uniform cuts therefore became relatively long.

On the whole, our actions seem to have been intelligible. During the spring and summer the market's picture of how much the interest rate might be lowered was revised to much the same extent as we adjusted our assessment. A picture of how the potential for cuts has changed can be derived from the path of the repo rate in relation to expectations of future overnight rates. This shows, for instance, that at the end of March the market envisaged that the repo rate would be lowered to just over 6 per cent, which was also approximately our position at that time.

Another way of looking at this is to compare the actual path of the repo rate with the overnight rate expected by the market three months earlier. For this time horizon, price setting has arrived at a good approximation of the outcome. If anything, during the past six months the repo rate has been lowered more quickly than these expectations had indicated. A different picture emerges when the repo rate is related to how the market predicted the overnight rate a whole year in advance. Here the discrepancies are considerably larger. This is presumably explained to a large extent by an inflow of new information. A picture of Sweden as a country seriously committed to low inflation and sound government finance was gradually established during the spring and summer.

All in all, in the past year there has thus been a radical, positive reassessment of the Swedish economy. Just like earlier reassessments in the opposite direction, this has notably altered the conditions for monetary policy, above all via the krona's marked appreciation. I would guess - and hope - that such dramatic fluctuations in the exchange rate will prove rare in the future.

6. Inflation in the coming years

That leaves me prepared to continue with some remarks on our appraisal of conditions for future inflation. I shall start very largely from the inflation report we issued at the end of September.

Our assessments of future inflation concentrate on two factors in particular: the relationship between demand and supply in the economy (the output gap in a wide sense) and expected inflation. It is just these factors which are highlighted in most of the simple macro models for determining inflation. Mention should also be made of the exchange rate, partly because it has a direct impact on inflation via import prices and demand; it also serves as an indicator of inflation expectations.

Unfortunately the world is not so simple that the output gap and expected inflation can be expressed in straight mathematical terms that one just "plugs into" an equation to see where inflation will be in one or two years' time. On the contrary, our combined knowledge about the relationship between the output gap and inflation expectations on the one hand and actual inflation on the other is inadequate. This has to do not least with the extensive structural changes that have occurred in the Swedish economy in recent years.

The Riksbank has been working for a long time on the measurement of the total output gap. The results have varied greatly from method to method. Three different estimates were presented in our latest inflation report. According to them, today the gap is in the range from 0.5 to 2.5 per cent of GDP. But as the estimates are uncertain, I need hardly say that we work with a broad spectrum of supply and demand indicators. The picture can be filled in with, for example, assessments of capacity utilisation in different parts of the economy. However, this does not alter the impression that at present the output gap in the Swedish economy is negative.

The issue of inflationary pressure becomes more complicated when the picture is extended to include wage formation. Our assessment is that during the past year the wage level in the Swedish economy has risen more than 5 per cent. In the longer run this rate of wage increases is not acceptable.

A new round of wage settlements is due to begin around the turn of this year. A pessimistic interpretation is that the rate of wage increases may continue to be too high. The increases in recent years have been high throughout the economy, not just in sectors where demand and profit levels were notably strong when the settlements were reached in 1995; trade is the best-known example. The wage increases have also come from wage drift, which continued in spite of an economic slowdown. If wage increases are not curbed, the implication will be that the equilibrium rate of unemployment is appreciably higher than indicated to date by most academic studies; this would also point to a smaller output gap.

There are arguments, however, for a somewhat more optimistic view. The earlier wage agreements were concluded at a time when inflation expectations in the labour market were still high, accompanied by rapidly rising industrial capacity utilisation and employment, and extreme profit levels. Among labour market organisations, the average level of inflation expectations for the coming years was around 3.5 to 4 per cent, as against about 2 per cent this September. Moreover, although not entirely unambiguous, international experience seems to show that it takes some years for wage formation to adjust to an economy with low inflation.

Under these circumstances we start from the prospect of the rate of wage increases gradually falling back when the current agreements have expired. The process may be protracted and costly in terms of unemployment, but it will happen. Were it to occur more quickly, on the other hand, it would result in a better growth of employment.

In this context I should like to mention an important difference from the late 1980s that also serves as a good illustration of the interaction of monetary and fiscal policies. This year, real wages are rising more than expected as a consequence of high nominal wage increases and low inflation. Compared with the 1980s, however, the real wage increases will have less impact on demand. One important reason for this is the tight fiscal policy. (For example, this year's real wage growth of around 4-5 per cent is accompanied by an increase in disposable income of only about 1 per cent.) Thus the tight fiscal stance is not only necessary for long-term considerations, in order to ensure a lower debt ratio; it also does a great deal to ease the inflationary pressure from wages. While monetary and fiscal policies are not coordinated directly, the goal of fulfilling the inflation target means that in practice, fiscal policy is taken into account in the construction of monetary policy.

7. Conclusions for monetary policy

When the Riksbank weighed up the various arguments in the inflation report, the conclusion was that the economy had a negative output gap. Economic growth in the period 1996-97 was estimated to total 3-4 per cent, with the emphasis on the upper half of this interval. At the same time, we consider that in annual terms, the potential economic growth rate is slightly above 2 per cent. Under these circumstances we did not foresee any sizeable inflationary pressure in the coming two years even if demand pressure were to be somewhat stronger than in the inflation report's main scenario. Moreover, as inflation expectations have moved down to the level of the Riksbank's target, it was concluded in the report that inflation in the course of 1996 would be around one per cent and then in line with the 2 per cent target both during 1997 and in the first half of 1998.

During the summer and fall there have been appreciable signs of improved activity in both manufacturing and trade. The conditions for good economic growth in Sweden in the next two years therefore appear to be favourable. Even so, it seems that inflationary pressure will be moderate, mainly because the output gap will not close. At the same time, inflation expectations remain low. All this means that the prospects of inflation being in line with the inflation target still remain good.

The Riksbank has highlighted wage increases as the primary risk factor for inflation, particularly in conjunction with a strong increase in consumption. Today there are no grounds for changing earlier assessments that the rate of wage increases will gradually fall back to more reasonable levels. Neither is there any cause to alter the forecast that consumption will rise at a stable but undramatic rate. Moreover, it is considered that even a more substantial increase in consumption need not lead of itself to rapid price increases. Experience from other countries shows that the pass-through is dependent on a variety of factors, such as the future development of wages and productivity, the level of unutilised resources, etc.

Against the above indications that there may be certain risks of inflation there is, in the first place, the signs that in a broad sense the Swedish economy's inflation propensity appears to have diminished. Since the publication of the inflation report in September, additional information has been received that points in this direction. It concerns, for instance, data on price increases and on economic growth in recent years.

At present the rate of inflation is low mainly as a consequence of transitory factors such as, for instance, the Riksbank's interest rate cuts and the krona's appreciation. However, the retardation of inflation does not stem solely from transitory factors. A certain, albeit limited, component appears to be of a more permanent nature. Additional observations are needed before definite conclusions can be drawn about this.

In the light of the available information, the Riksbank considers that there is still some limited room for lowering the repo rate. But the picture is not unambiguous. This means that additional time is needed to follow and analyse incoming information. The conclusion to be drawn from the assessments that are made may also turn out to be an unchanged repo rate.