Speech

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Sweden's economy

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Thank you for inviting me to discuss the Swedish economy and monetary policy. This morning the Riksbank published an inflation report with an analysis of economic tendencies in Sweden and the future path of inflation. The Riksbank's appraisal of future monetary policy is therefore public knowledge, so this evening I shall paint a somewhat broader picture.

Favourable tendencies

The Swedish economy displays many favourable features. We are gradually extricating ourselves from several decades of recurrent economic problems that culminated in a profound crisis in the early 1990s.

GDP growth since the summer of 1993 has averaged about 2.8 per cent in annual terms, which is considerably more than the average rate to which we became accustomed in the previous quarter-century. The surplus on our transactions with the rest of the world is also larger than it has been for many years. The level of investment is high and the central government deficit has been successively reduced. Inflation has not been so low for several decades.

Since last autumn there have been a number of months in which the level of consumer prices was lower than a year earlier. Strictly speaking, however, this does not mean that Sweden is experiencing deflation. One important cause of the fall in the CPI is that the repo rate cuts by the Riksbank have led to lower house mortgage rates and this in turn has had a transitory downward effect on inflation.

Provided Sweden continues to implement disciplined budget and monetary policies and generally enhances confidence in economic policy, there are good indications that, after the slowdown in 1996, growth will become successively

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stronger again without generating higher inflation. In our modern history this is, in many respects, a novel situation. The comparison here is with the 1970s and '80s. At the same time, the low inflation at present harks back to an earlier, time-honoured Swedish tradition.

In the first seven decades of this century annual GDP growth averaged around 3.5 per cent. In that period Sweden was one of the industrialised countries that expanded most rapidly. In those decades, the annual rate of inflation averaged around 2.5 per cent.

In the course of those seventy years there were also some problems in connection with two world wars and the international depression in the early 1930s. But the economy recovered relatively quickly and continued to grow at a good rate under conditions of price stability.

Our economic history demonstrates that inflation, instead of being an obstacle, is rather a precondition for a favourable economic development.

Why did things change after the 1960s?

The early 1970s mark a notable change in the Swedish economy, which encountered problems that ultimately culminated in the profound crisis in the early 1990s. Shocks of various types, internal as well as external, were countered with expansionary fiscal measures as well as devaluations. This favoured production and employment in the short run but led to inflation, speculation, recurrent economic setbacks, repeated devaluations and renewed short-term expansion.

The outcome of this vicious circle makes depressing reading. The series of inflation and devaluation cycles resulted in the longest period of inflation since the early 19th century. In the period from 1970 to the early 1990s annual inflation averaged 8 per cent. The government's creditors required compensation for the higher inflation and the decreased value of the krona. Market rates of interest were therefore higher than in many other countries. This was accompanied by low investment and saving. Growth became weak and the economy moved in fits and starts.

Why was this so? Something clearly happened in Sweden in the late 1960s. While the course of events in the next twenty years was admittedly conditioned by numerous factors, it is important to note that monetary policy was imbued by a new line of thought, namely that both fiscal and monetary policy, including exchange rate policy, should be used more actively to counter shocks. This approach was based on a widespread notion that inflation had to be accepted in the interest of low unemployment and economic growth.

A similar change, based on the same premise, occurred in other countries. But unlike them, Sweden continued to adhere to the idea that inflation and unemployment are interrelated.

A more active policy along these lines was rendered feasible, moreover, in that economic policy was released from a major restriction when the Bretton Woods system collapsed in the early 1970s. Under that system the value of the krona had been tied to the US. dollar, which in turn was tied to gold. This international exchange rate arrangement, which had been in force since 1945, imposed strict discipline in economic policy and thereby contributed to a stable development accompanied by low inflation.

The end of the Bretton Woods system seemed to do away with the need for economic policy discipline. It was believed that Sweden could conduct policy independently. Instead of being perceived as harmful, inflation was regarded as more of a correct economic policy's side-effect that had to be accepted.

Unfortunately, the theory failed to deliver. It disregarded the importance of expectations. An expansionary economic policy's presumed effect on production and employment presupposes that wage increases are not adapted to the higher inflation, which in practice they were.

A simple example will illustrate this. Suppose that inflation is 2 per cent initially and economic policy is given an expansionary turn without considering the underlying production potential. If wage agreements run for a considerable period, an upward shift in inflation to, say, 5 per cent could in the best case contribute to a short-run increase in employment because firms' real wage costs are reduced (prices rise faster than wages). In time, however, 5 per cent inflation will be perceived as normal and wage demands will be pitched accordingly. The higher nominal wage increases then push real wage costs up again and unemployment will tend to return to its initial level while inflation remains at 5 per cent.

The level of unemployment to which an economy returns when inflation expectations have adjusted is usually called equilibrium unemployment. It is immune to demand stimuli from monetary and exchange rate policy, for instance, and is determined primarily by structural factors. Consequently there is no long-term trade-off between inflation and unemployment. A generally expansionary policy is not capable of reducing unemployment so that this stays below its equilibrium level. Inflation, on the other hand, can run at various levels.

If the rate of inflation moves up, however, problems may arise because the economy then functions less efficiently and output is impaired. Put differently, under certain circumstances fiscal and monetary policies are capable of influencing fluctuations around the growth trend, though one should not expect to be able to fine-tune demand. But if demand is over-stimulated, inflation will rise and be liable to damage the economy. Together with consequences of structural problems, that is probably what happened in the 1970s and '80s.

This is also relevant to the present situation. The Swedish economy presents some favourable features, as I mentioned earlier. But the outlook is less bright in one respect - the high level of unemployment. Even if wage formation does adapt sooner or later to the currently low inflation, it is disquieting that this is taking so long. Despite fairly favourable activity in the past three years, to date the recovery in employment has been very slow. Most of the evidence suggests that unemployment's equilibrium level has risen, which means that if nothing is done, unemployment is liable to remain high even though activity improves. This in turn is a sign of a poorly functioning labour market, which basically has to do with wage setting in that price formation is the central market mechanism. If equilibrium unemployment has risen, measures should be directed at bringing it down. That, however, is a matter outside the domain of monetary and demand policies. What monetary policy can do is try to keep inflation low and stable as an indirect contribution to stable growth and increased employment.

Low inflation - a long Swedish tradition

I mentioned earlier that Sweden has a long tradition of low inflation. Low inflation has accompanied good economic growth even since the industrial era began in the mid 19th century. Efforts to counter the risk of inflation by various means and instil confidence in the value of money are a constant theme in Swedish history. Inflation ultimately amounts to the value of money being eroded by an excessive supply of money and other means of payment.

The notes and coins issued by the Riksbank are not intrinsically worth the sums they represent. The metal in a five-kronor coin is not worth 5 kronor as scrap, neither is the paper in a fifty-kronor note worth 50 kronor. The production of a thousand-kronor note costs very little. So in principle we could issue any amount of money. This sometimes affects how people regard the Riksbank. There are frequent calls for a lower repo rate, whatever its current level. Yet the repo rate is simply what we charge for lending notes and coins to the general public. A low repo rate means that more money comes into circulation and this may impair its value by leading to inflation.

There are many historical cases where the temptation to issue too much money and erode its value proved too great. In the 18th and early 19th centuries Sweden waged war, which costs money. The Riksbank was obliged to contribute to the financing of this expenditure and the result was *very* high inflation.

In order to stabilise the value of money, in 1830 the Riksdag (Sweden's parliament) introduced a silver standard, whereby the issuing of banknotes and coins was related to holdings of silver. This meant that the government could no longer print "cheap money". Monetary policy was anchored to a constraint, an operational rule. This generated public confidence in the monetary system and monetary policy, thereby laying a foundation for a long period of low inflation in Sweden, accompanied by conditions for growth and employment.

In 1873 Sweden changed to a gold standard and introduced denominations in kronor and öre. Banknotes carried a declaration to the effect that "Sveriges Riksbank redeems, on demand, this note with gold coin." That further enhanced confidence in the monetary system, the value of money and economic policy.

For a century after that - apart from the period around the two world wars and the depression in the 1930s - the value of the krona was tied, directly or indirectly, to gold and this generated stability in the value of money as well as in the economy in general.

This demonstrates the importance of an operational rule in monetary policy. Today this rule is to keep inflation at 2 per cent, with a tolerance interval of ###1 percentage point. We must be as meticulous in fulfilling this task as earlier generations were about keeping the value of the krona on a par with silver and gold.

A silver or gold standard or an inflation target makes the Riksbank's commitment and responsibility clear. It also makes it particularly clear if the Riksbank has departed from its commitment. Such a rule can promote confidence that inflation will be low, not just this and next year but for a long time to come. In our world, this confidence is the foundation for a stable currency and lastingly low market rates of interest.

Financial unrest represents uncertainty

A bad history of inflation and weak government finance are two factors that may impair confidence in economic policy and the value of money. The periods of turbulence in interest and exchange rates earlier in the 1990s stemmed from doubts, among savers and investors, about Sweden's determination and ability to break inflation's historical pattern in the 1970s and '80s and come to terms with the problems in government finance. This, briefly, is a matter of uncertainty - government's creditors required compensation for perceived risks. The financial unrest has sometimes been triggered by tendencies to financial fluctuations in other countries but it has often had to do with uncertainty in the domestic arena.

Several pieces of the puzzle dropped into place towards the end of 1995 and in the course of 1996. Higher inflation in connection with the economic recovery had been prevented and vigorous efforts over a number of years to consolidate government finance yielded results. Inflation expectations declined, bond rates fell and the krona appreciated. The growing confidence in economic policy was an important reason why the Riksbank was in a position to lower the repo rate last year from almost 9 per cent to 4.10 per cent.

Events in the past year witness to the importance of implementing a sustained and consistent economic policy for price stability and sound government finance. The Government's convergence programme, with six-monthly monitoring, enables economic agents to follow the determination of the political system to complete the consolidation of the budget and fulfil the goal of balance by 1998. Government representatives have even expressed an ambition to achieve surpluses after that. We must bear in mind that building up confidence is a laborious process that never ends.

There are additional ways of promoting confidence in the future value of money and thereby trying to lessen the risk of abrupt shifts in bond rates and the exchange rate. What I have in mind is not so much an undertaking along the lines of the Riksbank's earlier promise to "redeem, on demand, this note with gold coin", as institutional changes of the type that are now being discussed. The idea of the Riksdag giving the Riksbank's objective the force of law and introducing a direct ban on monetary policy instructions except in a statutory form is not an end in itself. These are further ways of generating confidence but their underlying principle is the same as for the 19th century measures to tie the krona to the value of silver or gold.

A serious problem in the discussion about a clear delegation of monetary policy to the Riksbank is the recent proposal from the Exchange Rate Competence Inquiry, whereby exchange rate policy decisions would be transferred from the Riksbank. The investigator seems to have overlooked the fact that monetary policy and exchange rate policy are two sides of the same coin. The problem with the proposal is that it would be more difficult to make permanent price stability credible. The proposal accordingly counters other legislative proposals concerning the Riksbank that are being discussed. It is therefore important that the investigator's proposal be rejected. The purpose of new legislation for the Riksbank is, after all, to strengthen confidence in economic policy and thereby contribute to greater stability both in the economy and in financial markets.

It is also in the light of creating confidence that one should see the plans for establishing the European Monetary Union. This union provides a framework for monetary policy that enhances the long-term credibility of disciplined economic policy and a stability-oriented policy.

Conclusion

My remarks this evening can be summarised in three points:

There are many positive features in Sweden's economy. Slowly but surely we are moving away from the recent decades' recurrent economic problems, which culminated in a deep crisis in the early 1990s.

Unemployment, however, remains high. There are many indications that equilibrium unemployment has moved up. This cannot be influenced by either fiscal policy or monetary and exchange rate policy.

Experience has taught us that financial unrest has often had to do with uncertainty. Developments in 1996 demonstrate that a disciplined monetary policy and consistent budget consolidation yield good results. Building confidence is a laborious process that never ends. At the same time, institutional changes can make additional contributions to financial stability. But it is important not to regress, as proposed by the Exchange Rate Competence Inquiry. That would be seen through and lessen results that may be generated by other measures that clearly delegate monetary policy to the Riksbank. The EMU should also be appraised in the light of measures for improving financial stability.