Speech

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Sweden's economy

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First a word of thanks for being asked to talk to you about Sweden's economy. I intend to begin by putting our current economic situation in a more long-term context. Having done so I shall say something about how the price stability target functions and conclude by commenting on the present situation.

Sweden's economy in perspective

In the early 1990s Sweden experienced a profound economic crisis - in the course of three years production dropped about 5 per cent and unemployment shot up to almost 9 per cent. Government finance deteriorated, bringing the budget deficit to a high of over 12 per cent of GDP. Serious problems also arose in the banking sector. In a search for the roots of the crisis it is instructive to appraise it in a wider context.

In the 1950s and 60s growth in the Swedish economy had been high and stable. In this period both inflation and unemployment were low and government finance as well as our external position were balanced. In the next two decades, however, the picture changed radically. This had to do with a number of interacting factors.

1. *An unsuccessful exchange rate policy*. The background here is that in the postwar era Sweden had participated in the Bretton Woods system of fixed exchange rates. The krona had been tied to the dollar, which was based in turn on gold. When the Bretton Woods system collapsed in the early 1970s it proved

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difficult to establish a correspondingly stable exchange rate regime. This also meant that neither economic policy in general nor wage formation had any strict "anchor". A series of devaluation cycles was accompanied by increased uncertainty, with consequences for investment, growth and employment, for example.

2. *Wage formation functioned poorly.* An important cause of the recurrent devaluations was problems with wage formation. Lower productivity growth was not accompanied by a corresponding fall in wage increases. Instead, as employees in different parts of the economy competed for the smaller frame for wages, nominal wage increases actually tended to rise. At the same time, increased employers' contributions added to the growth of labour costs.

3. *Weak fiscal policy.* Rising government expenditure, unaccompanied by equivalent budget reinforcements, resulted in deficits and this generated an accumulation of government debt.

4. *Many structural problems.* A rapidly expanding public sector meant, among other things, that taxes and government expenditure had increasingly distortionary effects on the economy. Some sectors, housing and agriculture for example, were massively regulated and in these two there was also a large element of subsidies. Competition was weak in other sectors, too, one example being parts of trade in goods and, at least until the mid 1980s, the financial sector.

5. F*inancial sector deregulation temporarily accentuated the imbalances.* Both corporate and personal liabilities grew dramatically in the second half of the 1980s. Monetary policy, confined by the fixed exchange rate, did not curb this tendency. Fiscal restraint also proved difficult to achieve.

The end result was that economic growth in Sweden weakened relative to other countries. Nevertheless, the economy overheated and this, together with the expansion of the public sector, held unemployment down for some time.

The situation, however, was not sustainable. Sooner or later an inflationary, speculative bubble is bound to burst. Moreover, the scope for additional publicly financed employment was limited. The Swedish economy at the end of the 1980s was also in need of structural adjustments. A policy realignment became unavoidable.

The subsequent recession was deeper than anyone had envisaged, to a large extent because the economic imbalances had been allowed to grow for so long and the adjustments coincided with a weak phase internationally.

A new direction in economic policy

The 1970s and 80s illustrate how a period of inflation renders the economic environment uncertain and unstable. Inflation also tends to generate a speculative climate and short-run economic thinking. Step by step, this impairs the long-term conditions for production.

High and rising inflation implies that households and firms have adapted to continuous price increases and that there are underlying tensions between demand and potential output. Such a situation calls for measures to preempt an economic setback. If economic policy is too late in reacting to the warning signs - as was the case, for instance, in the second half of the 1980s - the tensions will become so great that growth and employment are threatened. This has been our bitter experience after Sweden's longest period of inflation since the beginning of the 19th century.

An economic policy aimed at low, stable inflation is not capable of preventing cyclical fluctuations in activity but it can contribute to a more sustained performance. Experience also points to a higher production trend because a more stable environment facilitates planning by households and firms, besides stimulating productive investment.

It was partly this background that prompted the realignment of Sweden's economic policy at the turn of the 1980s. Since then the focus on price stability has won broad support in the community as well as among the political parties in parliament. A 2 per cent inflation target for monetary policy is approved by 60 per cent of the population and only 12 per cent are against it. The Riksdag (Sweden's parliament) has noted that there is a consensus about the value of price stability and stated that focusing on this tends to promote growth and employment. The Government has explicitly backed the Riksbank's target of 2 per cent inflation.

However, after the severe economic problems in the early 1990s, memories of the years of inflation and the massive budget deficits, it proved difficult to make the new line in economic policy credible in the short run. This has been evident from time to time in interest and exchange rate unrest. Financial market trends in the somewhat longer run can be seen as an indicator of the prevailing degree of confidence in the determination and ability to conduct an economic policy that is consistent and oriented for stability.

Experience from other countries suggests that establishing the credibility of a low inflation regime takes time and hard work. The task of keeping inflation down and government finance in order is a process that never ends if the aim is to maintain low interest rates, a stable exchange rate and, ultimately, favourable growth and good employment.

A resolute policy

When the krona was allowed to float in the autumn of 1992, it weakened appreciably. The depreciation, as one says when the exchange rate is flexible, was a strong stimulus to demand, mainly in the export-oriented sectors of our economy. The result soon materialised in one of the strongest industrial upswings that Sweden has experienced for a long time.

Money and bond rates fell, thereby contributing to increased production even in other segments of the business sector. The recovery here, however, was considerably less marked than in the sectors that had benefited from the weak exchange rate. A dual situation arose in the economy but overall growth still seems to have been stronger than noted by many. Loan losses decreased and the crisis in the banking sector receded.

In the first half of 1994 the credibility of Swedish economic policy then suffered a setback due to growing concern that the earlier pattern would reassert itself. The consolidation of government finance was inadequate and inflationary tendencies began to appear.

Would the economic upswing be allowed to result once again in an inflationary bubble? In other words, would there be a repetition and a continuation of what had been the regular course of events in the 1970s and 80s, with the attendant risk of subsequent setbacks for growth and employment?

During the summer of 1994 more and more people began to count again on rising inflation. During the spring, moreover, the long bond rate had moved up from just under 7 to almost 12 per cent. The krona continued to weaken, confirming the uncertainty about inflation. The pass-through from increased import prices to consumer prices started to rise, accompanied by clearer signs of inflationary pressure in manufacturing. Cost consciousness declined, while the probability of troublesome wage agreements grew, a prospect that materialised in the spring of 1995 when multiannual settlements were concluded at far too high a level. More and more characteristics of the 1970s and 80s could thus be discerned.

In this situation a passive economic policy would have confirmed the fears and implied a continuation of the old ways. Economic policy was accordingly at a crossroads. The choice lay between a passive acceptance of the earlier pattern or an active, consistent adherence to the policy for stability and a break with the past. The Government, the Riksdag and the Riksbank opted for the resolute stance.

The Government and the Riksdag worked on the consolidation of government finance; via a number of "packages" this led to the convergence programme, presented around mid 1995 and aiming to balance general government finance by 1998. The programme is being monitored every six months. Moreover, in the Economic Bill this spring the Government states that the long-term target for budget policy is to be a general government financial surplus of 2 per cent of GDP as a cyclical average. The gradual adjustment to this goal is also specified.

Faced with the situation around the middle of 1994, the Riksbank found that in view of the risks of inflation it was necessary to establish higher instrumental rates in order to demonstrate that the goal of price stability was to be taken seriously. The repo rate was therefore increased in the middle of August 1994.

In these ways it became increasingly probable that the old pattern would *not* be repeated. Inflation remained at a low level and there was a gradual increase in confidence that this would continue to be the case for a long time to come.

Relaxation in interest rate policy

It is the reinforcement of government finance and the break with our history of inflation that lie behind the lower market rates of interest in recent years. The platform for the future is therefore different and better than in similar cyclical phases in the 1970s and 80s.

The motive for the easing of interest rate policy that occurred during 1996 was, to put it simply, the favourable outlook as regards inflation. Continuously falling inflation expectations and a subdued demand situation implied a successive improvement in the outlook for inflation in 1997 and 1998. During 1996 the repo rate was lowered from 8.91 to 4.1 per cent, bringing it down to its lowest level in more than thirty years.

The interest rate stance in recent years is a clear illustration of how monetary policy functions with price stability as the objective in the context of a floating exchange rate. The more unfavourable inflation forecasts that prevailed in the middle of 1994 made it necessary to initiate a period of rising instrumental rates. The sooner monetary policy reacts, the smaller the increase that will be called for. Now that the outlook for inflation has improved, the repo rate has been lowered.

Fulfilling the price stability target provides a foundation for stable, sustained growth and employment. If the low inflation policy is perceived as credible, there is also room for monetary policy to make short-run contributions to supporting the economic recovery.

The price stability target

Last Tuesday the consumer price index for March was published by Statistics Sweden and showed a twelve-month fall of 0.4 per cent. Does this mean that the Riksbank has missed its monetary policy target? Before answering that question, it is important to understand how the target works.

1. The price stability target states that inflation is to be 2 per cent, with a tolerance, downwards as well as upwards, of 1 percentage point.

2. The target is to be assessed in a somewhat long, annual perspective and thus not in terms of isolated monthly figures.

3. It is also important to distinguish between underlying inflation and changes in the CPI. Transitory effects, for example changes in interest rates or in indirect taxes and subsidies, may cause the general price level to jump up and down. In the conduct of monetary policy it is therefore important to keep an eye on underlying inflation; the transitory effects are of secondary significance as long as they do not affect inflation expectations and thereby trend inflation. The tolerance interval exists partly so as to absorb the most common transitory effects.

In formal terms inflation is short of the target even when measured in a slightly longer perspective but reality says otherwise. The reason for the low change in the CPI is not that monetary policy has been too restrictive earlier, with an unduly high repo rate; on the contrary it mainly has to do with last year's sharp repo rate cuts. When home owners renew mortgage loans at lower interest rates we get a transitory downward effect on inflation.

In the most recent months the monthly figures for the CPI do, however, imply that underlying inflation has moved down to around 1 per cent. Were it to go on falling and then remain low in an "annual perspective", one could indeed talk of the level being short of the target in the intended sense. But neither the Riksbank nor any other observer believes this will happen.

The situation at present

So now I would like to look in more detail at the outlook for inflation in the years ahead by commenting on the Riksbank's latest inflation report and what has happened since it was compiled.

The Riksbank publishes an inflation report four times a year in order to explain, as openly and clearly as possible, how we analyse the outlook for future inflation and approach the construction of monetary policy. The analyses in these reports serve as a foundation for monetary policy discussions by the Governing Board; the conclusions from those discussions are regularly included as a chapter in the reports.

In the latest inflation report, published this March, it was considered that GDP growth in 1997 and 1998 would be 2 and 3 per cent, respectively. It was also argued that sizeable capacity restrictions should not arise in the course of the period. Given that households and firms go on counting on inflation remaining low and starting from an unchanged monetary stance, underlying domestic inflation (measured with the CPI excluding transitory effects on inflation) in the coming years was put at between 1.5 and 2 per cent.

As we all know, the estimation of future economic activity and price movements is not exactly simple. In view of the shortcomings in such estimates, it is more a matter of assessing risks and opportunities. Our latest inflation report therefore includes a discussion of two secondary alternatives and situations in which future inflation might be either lower or higher than in the main scenario.

One alternative is that inflation could be lower than in the main scenario, mainly because consumption is weaker. The other envisages the opposite - higher inflation - on account of a weaker exchange rate that stimulates a stronger growth of exports and GDP, leading to increased inflationary pressure.

What are the statistical tendencies that have subsequently appeared to date? In simple terms it can be said that, on one hand, exports seem to be doing somewhat better than expected, though the differences are not all that great. On the other hand, the signals about private consumption point either to agreement with the main scenario or to a somewhat weaker course.

In the past winter there were signs of a slowdown in manufacturing. The December survey from the National Institute of Economic Research showed an unchanged inflow of orders and expectations of subdued production. The order statistics from Statistics Sweden, which fluctuate fairly widely from month to month, gave the impression of relatively weak orders in the fourth quarter of 1996. In December and January, however, the order inflow has picked up and more recent survey data likewise paint a brighter picture of activity in manufacturing. The improvement mainly applies to production for export but even the domestic market is somewhat optimistic about the future. In the light of this, exports and industrial production could develop somewhat better than expected earlier. The changes are not very large but to date various indicators, including the continued undervaluation of the krona, do point in the same direction.

In the case of private consumption, the indicators to date are not uniform. *On one hand*, in the first three months of 1997 the number of new car registrations for private individuals has risen in annual terms by more than 60 per cent, albeit from a low level. Moreover, the survey of household purchasing plans by Statistics Sweden shows that since the autumn personal economic expectations have become more positive. The development of banknotes and coins in circulation is also an indication of rising private consumption. *On the other hand*, retailing figures from Statistics Sweden and the quick index from the Wholesale & Retail Research Institution give a relatively weak first-quarter picture of retail trade. Another indicator of a slower increase in private consumption could be the weak labour market.

The registered development of economic activity provides a foundation for the assessment of future supply and demand conditions that, together with inflation expectations, constitutes the basis for the inflation forecast that in turn guides the construction of monetary policy. The conclusion in the latest inflation report was that monetary policy is well balanced. It must be borne in mind that in the past year there have been major changes, for example in the repo rate, and time is needed to assess both their effects and overall economic development.

Conclusion

Good progress has been made in recent years in the adjustment to a low inflation economy. Step by step, the entire economy is adapting to the conditions that apply in such an environment. Inflation is low and government finance is steadily improving.

Some signs of new thinking among labour market organisations are also discernible. Let us hope that this reaches the point where employment can rise and unemployment fall in the coming years.

Since the summer of 1993 the economy has been expanding at a higher average overall rate than in the period of inflation in the 1970s and 80s. We did experience a temporary slowdown last year but that is not unusual when firms make cyclical stock adjustments. This year and in 1998 most of the signs point to a renewed increase in growth. There is a possibility that growth in the future will display more long-term stability than we have been accustomed to. That, too, is a characteristic of a low inflation economy founded on a disciplined economic policy.