Speech

Governor Urban Bäckström

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The Swedish economy

Skånska Sparbanksföreningen

First I would like to express my thanks for the invitation to come to Skåne and talk about the national economy. In order to put developments in Sweden in recent years in perspective I shall be painting the scene with a broader brush. Having done so, I will conclude with some comments on current monetary policy.

Favourable trend in recent years

There is much that is positive about Sweden's economy. In my opinion there is a definite possibility than in future we will be able to avoid the economic problems which recurred time and again in the past decades and culminated in the early 1990s in a profound crisis.

Since the summer of 1993 GDP growth in annual terms has averaged about 2.8 per cent, which is considerably higher than the average rate to which we became accustomed in the past quarter-century. The surplus on external transactions is also the largest for many years and enables us to pay off foreign debt. The level of investment has been favourable and the government deficit has been successively reduced.

It is several decades since inflation was as low as at present. An important explanation for this is that repo rate cuts by the Riksbank have reduced house mortgage rates and this in turn has had a transitory downward effect on inflation.

Although the underlying development of prices is not as low as the CPI figures suggest, inflation does seem to be under control. Provided Sweden continues to implement disciplined fiscal and monetary policies and generally enhances

Telephone
+46 8 787 00 00

Telefax
+46 8 21 05 31

E-mail
registratorn@riksbank.se

confidence in economic policy, most of the evidence points to successively stronger growth without an acceleration of inflation. We are now in a good position to resume the tradition of price stability that Sweden practised before the 1970s and '80s.

Tradition of stability

A long history of price stability in Sweden began in 1830 when parliament decided, after a period of high inflation, to base the currency on a silver standard. In 1863 the base was changed to a gold standard and apart from short breaks, primarily in connection with the two world wars, this remained in force for more than a century. The krona continued to be tied to gold under the Bretton Woods system up to the early 1970s; the formal link was to the value of the US dollar but this in turn was based on the price of gold.

In the period from 1830 to 1960 the annual rate of inflation averaged less than 2 per cent. If one excepts the two world wars and the 1970s and '80s, price stability has been the rule in Sweden for over a century. There are real grounds for calling this a Swedish tradition.

The stable value of money was not an obstacle to economic development; from the middle of the 19th century up to the end of the 1960s the growth rate in Sweden was one of the highest in the world. It is rather the case that the low rate of inflation and the stability this represented actually contributed to the favourable trend.

High growth, low inflation, external balance and confidence in the future were characteristic, not least, of the decades after World War II, when the Swedish economy expanded continuously. That was a favourable period of good, stable economic development and a rising standard of living.

The crisis in the 1990s and its roots

When the Bretton-Woods system collapsed in the early 1970s it proved difficult to establish a fixed exchange rate regime with the same stability. Economic policy and wage formation no longer had a definite "anchor". Sweden experienced a series of devaluation cycles, fiscal policy was expansionary, wage formation did not function properly and structural imbalances accumulated. Deregulation of the financial sector made the problems conspicuous.

Growth in Sweden in the 1970s and '80s weakened in relation to other countries. Even so, the economy tended to overheat and this, together with the build-up of public activities, kept unemployment *temporarily* in check.

The situation was not sustainable. An inflationary, speculative bubble cannot grow indefinitely; sooner or later it is bound to burst. Moreover, the scope for a further expansion of publicly-financed employment was limited. In the late 1980s the Swedish economy was in need of structural adjustments.

The situation resulted in a profound crisis in the early 1990s. Output fell for three years by a total of around 5 per cent and registered unemployment shot up to almost 9 per cent. Government finance also deteriorated, bringing the budget deficit up to a high of over 12 per cent of GDP. This was accompanied by serious problems in the bank sector.

The recession proved to be much deeper than anyone had envisaged, largely because the economic imbalances had been allowed to accumulate for so long and the adjustments coincided with weak international activity.

New direction in economic policy

The 1970s and '80s illustrate how a period of inflation leads to economic uncertainty and instability. Inflation also tends to generate a speculative mood and short-term economic thinking. In this way the long-term conditions for production are gradually impaired.

High and rising inflation stems from households and firms being accustomed to continuously rising prices and from underlying tensions between demand and the economy's potential output. In order to avoid economic setbacks, such tendencies have to be countered. If economic policy fails to react to warning signals in time - as was the case in the second half of the 1980s - the tensions will rise and threaten growth and employment. That has been our bitter experience after Sweden's longest period of inflation since the 1830s.

An economic policy for low, stable inflation is not capable of preventing cyclical fluctuations in activity but it can contribute to a more sustained performance. Experience also suggests that the growth trend may be higher in that a more stable environment facilitates planning by households and firms and stimulates 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 both in the community and among the political parties in parliament. A 2 per cent inflation target for monetary policy has the approval of 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 both in interest and exchange rate unrest and in unduly large wage increases. 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 and a stable exchange rate, which in the long run are necessary for growth and employment.

A resolute policy yields results

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 since the early 1960s.

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 there was 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. Government finance was consolidated and monetary policy was given a restrictive turn.

In these ways it became increasingly probable that the old pattern would *not* be repeated. The low level of inflation was maintained, accompanied by a gradual increase in confidence that this would continue to be the case for a long time to come.

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.

Interest rate policy in recent years provides 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 were current in the middle of 1994 made it necessary to embark on a period of rising instrumental rates. The sooner monetary policy reacts, the smaller will be the requisite increase. With the improved outlook for inflation, the repo rate has now been lowered.

The motive for the easing of interest rate policy during 1996 was, quite 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.

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 Sweden's economic recovery.

Conclusion

My message today has been mainly positive. The Swedish economy displays many favourable tendencies. Step by step we are restoring the low inflation regime that had been a characteristic feature of our country for so long, providing a stable foundation for growth and employment.

But we are not there yet. Swedish *bond* rates, for instance, are still higher than in countries on the European continent and our currency has weakened in recent months. The need for a high degree of discipline in economic policy is unchanged.

One aspect of developments in recent years is less favourable, namely the persistently high level of unemployment. Despite the fairly good activity, the recovery in employment to date has been very gradual. Most of the evidence suggests that unemployment has become structural, which means that, unless measures are taken, it is liable to remain high even if activity continues to improve. This in turn is a sign that the labour market is functioning poorly, partly on account of wage formation since this is the central market mechanism. If a large proportion of unemployment has structural causes, measures should concentrate on reducing this component. That, however, is not a matter for demand policy, that is, fiscal and monetary policy. What monetary policy can do is try to keep inflation low and stable as an indirect contribution to stable growth.

It seems that Sweden's economy is entering a period of increased growth. Everything suggests that the economy has unutilised resources, so in the near future there should not be any crucial capacity restrictions. And if households and firms continue to count on low inflation when making economic decisions, there is a good prospect of price increases remaining low in 1997 and 1998, which is the period we can assess at present.

The repo rate was lowered most recently last December. Since then we have frequently declared that the monetary stance is well balanced. My message today is the same. On the whole, economic tendencies confirm the picture in the Riksbank's latest inflation report. So at present we see no need to alter the repo rate.