Speech

Deputy Governor Lars Heikensten

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Monetary Policy

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Let me begin by expressing my thanks for the opportunity to come here and speak about monetary policy. The autumn conferences are a fine tradition and at the Sveriges Riksbank we appreciate having the chance to take part in a discussion of monetary policy offered by this forum.

Today I intend to discuss four aspects of monetary policy. By way of introduction I plan to speak about the general framework that guides the Riksbank when working with an inflation target. Then I plan to follow last year's outline and make some comments on monetary policy developments since we met here a year ago. The third issue that I would like to discuss is the outlook for inflation, which has as its starting point the most recent *Inflation Report*. Finally I intend to touch upon two factors that are important in assessing inflation - fiscal policy and wage formation.

1. The General Framework for the Inflation Target Policy

To understand how the Riksbank works, one needs to have a clear grasp of the basic conceptual framework that guides monetary policy. Such a framework is necessarily schematic and simplified, but it is a conceptual basis all the same.

Telephone
+ 46 8 787 00 00

Telefax
+ 46 8 21 05 31

E-mail
registratorn@riksbank.se

The objective of monetary policy is to safeguard the value of money. The formulation of this objective is based on the understanding that it is by ensuring low and stable inflation that monetary policy can best contribute to creating favourable long-term conditions for growth, employment and prosperity. In Sweden, as in a number of other countries, the conduct of monetary policy is now directly guided by an inflation objective. In other words there is no intermediate objective between the instrumental rate and the final goal of low inflation.

Inflation Forecasts Are Crucial

The lag between a monetary policy measure and its effect on demand and inflationary pressures means that forecasts of inflation are an important instrument in policy implementation. Of course estimates of inflation, like most other economic forecasts, suffer from uncertainty. Therefore the Riksbank does not work with individual point estimates of future inflation. In practice the forecast is a probability distribution with a number of more or less probable outcomes.

With the aid of economic modelling, as well as forecasts of the business cycle of a more traditional type, scenarios are produced for the economy as a whole and especially for inflation. Normally a main scenario is identified. With the help of an analysis of particularly uncertain “key factors“ in the estimates, alternative inflation scenarios are analysed, discussed and assigned probabilities. These are scenarios that are considered less probable than the main scenario, but here the factors that call for special vigilance are highlighted.

Demand and Inflation Expectations

In estimating inflation, the Riksbank employs a broad spectrum of indicators. These can be divided naturally into two groups - those that give a picture of the development of demand and supply conditions in the economy and those that help gauge expectations about the future rate of inflation.

Inflation expectations are important as measures of confidence in the ability of the Riksbank to achieve the inflation target. They play a crucial role in assessments of inflation, inter alia, because expectations of future inflation affect price and wage formation.

With respect to *demand and supply conditions* in the economy, the starting point in the discussion is that in the long run demand can grow more quickly than productive capacity - the potential level of production. A level of demand that means that resources in the economy are being utilised at a rate than cannot be sustained in the long term eventually results in bottlenecks and other shortages, which in turn lead to price increases. It is easy to illustrate this line of thought by seeing how capacity utilisation in the economy as a whole measured against the so called output gap has developed in relation to inflation. The correlation is obvious. *(Chart 1.)*

Therefore to achieve the inflation target it is important that monetary policy be adjusted so that demand in the economy grows neither too quickly nor too slowly, but at a pace that the economy can manage with the help of, inter alia, new investment, improved efficiency and a good supply of labour. If future demand is estimated to be too high, monetary policy needs to be tightened and vice versa. In this way monetary policy that is focused on an inflation target can contribute to stabilising the economy.

Adjustment to the Inflation Target

The principles for the design of monetary policy can be formulated using a simple rule of thumb. If the inflation forecast (or rather the probability distribution for different possible outcomes) - assuming that the instrumental rate is unchanged - indicates that inflation will be in line with the target over one to two years, monetary policy is correctly balanced. If the estimates show that inflation risks exceeding (falling below) the inflation target, then monetary policy is too expansive (tight), and the instrumental rate should be raised (lowered).

An important question in such situations is over what time horizon these estimates should be made and, given that, how fast and strong the adjustment should be. There is much to be said for making the change gradually and for having a sufficiently long time horizon over which monetary policy aims at achieving the inflation target. That is one of the reasons why we usually speak of viewing the inflation target over a somewhat longer - an annual - perspective.

In the first place *uncertainty about the effects* of monetary policy changes on inflation and demand, both with respect to magnitude and time lag, is unavoidable. Under such conditions it seems intuitively reasonable to proceed prudently and, with the help of all new incoming information, carefully evaluate the monetary policy being pursued.

In the second place a major change in monetary policy runs the risk of *creating unnecessary instability* in real variables such as production and employment. Careful and gradual interest rate changes, which instead are allowed to work for a somewhat longer time, are therefore preferred. A longer horizon over which the inflation target can be achieved and a gradual adjustment of monetary policy makes it possible to achieve the inflation target and at the same time stabilise the real variables to some extent.

This also has a bearing on today's situation; it is important that monetary policy is changed in time. Countering rising inflationary pressure in good time does not require the measures to be so forceful. The risk of inflationary tensions occurring during an upturn in the business cycle will be less. The same is true for the risk that inflation expectations will rise. With that the swings in interest rates can be smaller and the influence on the real economy more subdued. The American monetary policy can serve as an illustrative example of how a central bank with small changes in interest rates - up as well as down - appears to have succeeded in holding inflation low during this past year at the same time that the economy showed stable and solid growth.

However two reservations are in order:

- One should not overestimate *fine-tuning* by monetary policy as a means of dampening cyclical swings in the economy. Experience shows this to be difficult - among other things, because the necessary *proficiency is lacking* and developments are more or less regularly disrupted by factors that one cannot predict.
- In practice the *credibility* enjoyed by the policy being pursued must be taken into consideration. If uncertainty prevails about the possibilities for economic policy to meet the inflation target in the long term, a strategy that aims at gradually reducing inflation to the target can, for example, lead to problems by further reinforcing uncertainty. It is worth emphasising that in this connection it is not only monetary policy that is of consequence. Historical experience - not least in Sweden - shows that fiscal policy must also be formulated in a manner that over the long term is in line with price stability for the inflation policy to enjoy complete confidence.

2. Developments During the Past Year

From Imbalance to Credibility

When we met here about one year ago, the Riksbank had been successively lowering the interest rate since the beginning of 1996. The reductions in the interest rates went on until December, when the repo rate had fallen to just over 4 per cent. The interest rate had been lowered by a total of nearly 5 percentage points.

The Minister of Finance usually prides himself on being the world champion in budget consolidation. While I am not taking a position on this assertion, it is clear that confidence in economic policy - as expressed, inter alia, in exchange rate and interest rate developments in the market - increased markedly during 1995. This, in turn, made it possible for the Riksbank to lower the interest rate radically. However Sweden is not unique. A similar development, with rapid reductions in interest rates in the wake of a consolidation of government finances, has also happened in Canada, for example.

The setting for the initiation of interest rate reductions by the Riksbank at the beginning of 1996 was a pronounced improvement in the inflation picture during the summer and autumn of 1995. This positive development was to a large extent associated with a strengthening of the krona, which had been significantly undervalued for several years. The stronger krona made possible a better balance in the monetary stimulus from the interest rate and the exchange rate. Thanks to the lower interest rate level, domestic demand received a much-needed boost at the beginning of 1996.

Inflation expectations by both households and business had gradually crept downward, which showed that to an ever greater extent participants in the economy were beginning to expect that the low rate of inflation would become permanent. In many respects the interest rate reductions in 1996 represented an adjustment in the interest rate level from an economy with substantial imbalances and credibility problems to an economy with better balance and growing confidence in economic policy's price stability objective.

Monetary Policy Stimulus

In the *Inflation Report* from December last year it was said that there were clear signs of a recovery in the domestic economy. At the same time the Riksbank thought that the risk of overheating was small since the recovery started out from a low level. The overall assessment was that some further room could be found for relaxing monetary policy. That the market shared this assessment was evident from the implied forward rates at the time. *(Chart 2.)*

The estimates of inflation were based, inter alia, on the assumption that the krona would strengthen somewhat. This strengthening did not occur. Instead the krona weakened by 6 per cent from November 1996 up to June 1997. Given this situation the Riksbank choose not to lower interest rates further. The weakening appeared to be of a lasting nature and affected demand to such an extent that no additional lowering of interest rates was judged to be necessary. In the *Inflation Report* this past March the Riksbank noted that monetary policy was well balanced and that the large reductions in the repo rate needed to be evaluated. The same assessment was made in June.

This year the business cycle on the whole appears to have evolved according to the Riksbank's assessment. In hindsight it appears as if the recovery got started a little later than expected. On the other hand the recovery appears - in any case during the second quarter - to have accelerated so much that the average figure for the year should be in line with the forecast.

For the first time since the Riksbank began to work with an inflation target, Sweden's economy is now in a broad recovery. One important explanation for this is the important support that the economy has received in the past year from monetary policy. Expectations in the market now are such that the discussion among participants in the economy is no longer about *if* but *when* an increase in interest rates will take place.

3. The Economic Situation

A Broad Recovery

In the *Inflation Report* in September, the Riksbank drew a relatively bright picture of economic developments in Sweden, even if it was not a picture without reservations. The recovery appears to be continuing. Since the business cycle bottomed out in the summer of 1993, Sweden's economy has grown by more than

2.5 per cent on average, which is more than in the 1980s. This year the recovery during the first half of the year also shows a more balanced development, with domestic demand to an increasing extent contributing to the growth. *(Chart 3.)*

Industry's cyclical position is now getting even stronger and various indicators from surveys show that new orders from both export and domestic markets continue to increase. *(Chart 4.)* Several factors indicate that profitability is good in large parts of the business sector. The exchange rate of the krona has favoured exporters' profitability while productivity is growing strongly. *(Chart 5.)* Productivity in industry increased by more than 7 per cent during the first half of this year compared with the same period last year. In the economy as a whole, including the public sector, productivity increased by nearly 4 per cent.

Against this background of rapid growth in industry, it is not surprising that capacity utilisation is rising. The number of companies that reported that the supply of the factors of production is restricting output rose between the first and the second quarters and statistics on the scarcity of certain skilled workers are approaching the levels that prevailed during the temporary peak in 1995.

Private consumption now also appears to be increasing at a faster rate. By way of example turnover in the retail trade rose by approximately 4 per cent during the first half of 1997 compared with the same period last year. *(Chart 6.)*

The increase in private consumption is taking place despite the fact that household incomes were restrained by tax increases and reductions in public expenditures that were decided on in recent years. The austerity of fiscal policy has contributed to the decline in the real disposable incomes of households during 1995 and 1996, though the number of hours worked has increased and average hourly wages have grown considerably more than consumer prices. *(Chart 7.)* Budget consolidation will continue during the next few years, though at a slower rate. Real disposable incomes will probably increase weakly during 1997. A more pronounced increase is expected in 1998 and 1999.

Households' expectations of both their own and the country's economy improved considerably in September after a minor setback in August. This is also reflected in the marked rise in house prices and the even more marked increase in stock prices. The survey of household purchasing plans (HIP) for September shows that households are more optimistic about labour market prospects. For the first time since 1995 the number of households that believe unemployment will decline was clearly greater than the number that believe unemployment will increase. There are also signs that the demand situation in the labour market is improving. The number of available jobs reported increased between June and August by 15 per cent on an annual basis and some improvement in employment can be discerned.

To sum up, most indications are that demand will develop strongly over the next few years. Exports should continue to grow at a relatively fast rate. At the same time the Riksbank estimates that the growth in private consumption will increase and public consumption at least will not decline. In the main scenario of the *Inflation Report,* the increase in GDP is about 2 per cent this year and about 3 per cent in 1998. During 1999 growth is estimated to rise somewhat further.

The Output Gap Is Closing

Accordingly the Riksbank reckons that the business cycle will strengthen during the next few years. In the *Inflation Report* we made it clear that the risk of growth being weaker than in the main scenario has diminished since the spring. Later information also points to this.

The difficulty in estimating inflation at present lies primarily in uncertainty about the economy's supply side. It is therefore especially important to follow different indicators of economic conditions that give a picture of how the strengthened demand affects developments in the labour market and in various markets for goods. How are different measures developing - for example, capacity utilisation - and what picture does one get by following price developments in the economy?

Inflation measured as the change in the consumer price index has risen swiftly during 1997. The rate over twelve months was near 0 per cent for two months in the spring and since then has moved up at a fairly rapid pace to 1.9 per cent for the month of September. The principal features of this development are not surprising. One reason for the rising CPI is higher indirect taxes on such items as tobacco and an increase in several different administratively set prices. Another reason is that the effect on the CPI of the fall in interest rates in 1996 and 1997 is declining. In total, this means that the CPI is approaching the various measures of underlying inflation that the Riksbank employs. (*Chart 8.)* However the CPI for September was slightly higher than the Riksbank and several other observers had expected. Even if one should not make too much of one individual figure, developments in both the CPI and some of the measures of underlying inflation stress that increased vigilance is essential.

The growth that the Riksbank expects in the main scenario of the *Inflation Report* is higher than the growth we estimated that the economy could accommodate in the long run without shortages emerging and inflation accelerating (the growth potential). This means that the excess capacity that exists today will gradually disappear. How large then is the excess capacity? The Riksbank estimates the so called output gap using several different methods. *(Chart 9.)* When we weigh together the result of the various estimates - and take into account all the other information on capacity utilisation - we have estimated that there is an excess capacity in the economy as a whole that amounts to about 2 per cent of GDP. With the growth rates that we reckon on - and with a potential growth of slightly more than 2 per cent during the next few years - the output gap will consequently be closed sometime during 1999.

In the *Inflation Report* other information is also taken into account that gives a picture of when inflation can be expected to begin to accelerate. Estimates of structural unemployment - and thereby indirectly of the unemployment that can be associated with inflation that is stable and low - indicate that there are also inflationary risks in the somewhat shorter run.

The *pace* at which capacity utilisation is rising can also influence the rate of inflation. If available resources decline at a rapid rate, the result can be increased inflationary impulses even if excess capacity can still be seen in the economy as a whole.

4. Fiscal Policy

Two Kinds of Effects

In every assessment of the inflation outlook, the direction of fiscal policy is essential. Fiscal policy affects the conditions for monetary policy in two ways:

- First, the degree of contraction or expansion in fiscal policy affects the *demand in the economy*. This is the traditional impact of fiscal policy on the business cycle.

- Second, *the confidence in the long-term sustainability* of fiscal policy is important for the monetary policy climate. If the government budget deficit seems to grow in an uncontrolled way, uncertainty may emerge as to whether the problems can be solved at all. The risk that the policy of low inflation would be abandoned and the Government would choose to inflate the debt away can, in this situation, be perceived as tangible, irrespective of what official messages are given.

The ongoing budget consolidation is dampening demand in the economy. Tax increases and reduced transfers have diminished household incomes by 3 to 4 per cent annually. The strain on household incomes was probably most severe in 1996 but this year and the next, fiscal policy is also restrictive measured in this way. To this should be added the savings pressure on the public sector that has resulted from the budget consolidation. Against this background, there is no doubt that fiscal policy has contributed to the reduction of inflationary pressures in recent years and thus also made possible an easing of monetary policy.

For a long time, however, the big budget deficits - in spite of several extensive savings programmes being presented - led to a fundamental long-term concern about the ability of Sweden's political system to come to grips with the problems of the government finances. This concern was a central factor behind the repeated currency and interest rate unrest during the period 1990 to 1995. The situation has changed in this respect. The budget consolidation is an important explanation for the strengthening of the krona since the crisis years and the substantial reduction of long-term interest rates. In this way fiscal policy made possible a more expansionary monetary policy.

The effects of the budget consolidation in terms of improved optimism and lower interest rates have contributed to rising stock market prices and to the recovery in the housing market. This has increased household asset values and room for consumption. In that sense, the restrictive fiscal policy has contributed to stimulating the economy. This is not unique. Academic studies have shown that measures to consolidate government finances can have an expansionary effect, especially in situations where there is a concern about the long-term sustainability of government finances. When the krona strengthened at the same time, dampening growth somewhat in the sectors subject to foreign competition, Sweden achieved a more balanced growth of the economy.

Reducing the Government Debt

How shall the approved fiscal policy be evaluated in this light? It is clear that fiscal policy in the next few years will be less restrictive. However during 1998 and 1999 it appears still to mean that the national government will take away from households a part of the increase in their incomes. From an international perspective as well, policies are restrictive. In no other country is the so called structural deficit (as it is estimated by the OECD) expected to improve so rapidly between 1997 and 1998.

The concern that one may have is more long term. Sweden's government finances are sensitive to the business cycle. A number of different studies have shown this. It can be argued that this sensitivity may have lessened, but no one knows for sure to what extent this has happened. More extensive work needs to be done in this respect. Cyclical sensitivity is linked not only with the size of public expenditure and taxes, but also with the design of different systems. To add to the debate there is a neglected factor; the policy that in fact has been conducted during the most recent business cycles. The experience here has not been altogether positive. Fiscal policy has not been formulated in such a way that the accumulated effect has stabilised the economy.

It is against this background that the Riksbank has argued that the goals of fiscal policy during the next few years should be to reduce the central government debt. From the standpoint of monetary policy, these goals should be helpful since they would lessen the risk of a situation arising sometime in the future in which the long-term sustainability of the government finances would be called into question.

A policy that reduces the cyclical sensitivity and contributes to shrinking the central government debt also creates better conditions for the stable development of production and employment by reducing the risk of restrictive measures during the next recession. It is somewhat of a paradox - and one that is difficult to understand when one considers what happened at the beginning of the 1990s - that there are those in the debate who today in the middle of an upturn in the business cycle want to weaken government finances because of the unemployment. Now, if ever, is the time to be fiscally prudent.

5. Wage Formation

Conditions for Better Results

One factor that is critical in assessing inflation in the present situation is future wage developments. Preliminary information on wage developments so far this year indicates that the rate of wage increases has moderated. It now is a little less than 4 per cent for the economy as a whole. That may indicate that wage formation is adjusting to an economy with low inflation.

Wage negotiations in 1998 will be an important test of whether there is reason for such optimism. Large parts of the agreements now in force will be renegotiated then. At the time of the most recent major round of negotiations in 1995 the agreements resulted in excessive wage increases. This increase was in spite of the fact that about 12 per cent of the labour force at the time were registered as unemployed or were in labour market programmes.

This time the conditions for wage agreements that are consistent with a balanced economic development appear to be more favourable in certain respects; we have price trends that have come down to levels near the inflation target at the same time that profit levels in the export industry are lower. In contrast the cyclical upturn is broader than in 1994-1995.

Inflation expectations of the social partners indicate that they foresee a rate of inflation that continues to be in line with the inflation target. *(Chart 10.)* This is important. The discussion about the wage negotiations also shows that there is a growing insight that a rate of inflation of about 2 per cent will represent the starting point for the nominal wage demands. Several important players in the labour market have commented that they have the inflation target as the starting point for their negotiating strategies. In such a way we in Sweden are beginning once more to come closer to the type of world that we found ourselves in during the first decades of the post-war period, with firmly established playing rules for the social partners. At that time there was a regime with fixed exchange rates (the so called Bretton Woods system). Now we have a flexible exchange rate with an inflation target.

Productivity of Various Kinds

The real problem today with wage increases that cause inflationary pressures is the effects on employment, not on inflation. If the rate of wage increases is forced up so high that the inflation target is threatened, it is the Riksbank's obligation to act and raise the instrumental rate. By that means inflation will, at least in about a year, come into line with the target.

There are important connections between wage formation and the growth of productivity. It is improvements in productivity that create room for increases in real wages. But in fact the opposite can also apply; wage increases can push up productivity growth. It is therefore important to make a distinction between different kinds of productivity growth.

Normally high productivity is assumed to be a result of investment; new, more efficient work methods and technical developments. By way of example a better technique increases the value of the work effort. Productivity improvements of this kind *make room for increases in real wages*. Developments during the past century have shown that a dramatic increase in productivity has been able to go hand in hand with both a growth in real wages and a rapid increase in employment. *(Chart 11.)*

In addition there are productivity improvements that are a result of *a strengthening of the business cycle*. When demand - and thereby production - increase, productivity gains at the beginning of an upturn in the business cycle can often occur without any need to add new resources.

However a high measure of productivity can also be *caused by high increases in real wages*, which are pushed through by wage earners. In this case the wage increases create pressure on the company to lower the cost of wages in production by rationalisations. In the statistics this is also recorded as increased labour productivity.

In practice it is not easy to distinguish between different sorts of productivity. The high growth in productivity in recent years has very likely been a mix of all three. It is important to emphasise that it is not the historical productivity growth that can lay the basis for wage increases but estimates of how the productivity of the kind discussed first - the more fundamental kind - will develop. To count also on productivity growth of the latter type risks forcing the elimination of jobs.

6. Conclusion

In conclusion let me come back to the monetary policy framework and monetary policy in the years ahead. The task of monetary policy is to safeguard the value of money. The policy must be changed when the inflation forecasts are not in line with the target. Monetary policy is conducted in an environment in which uncertainty prevails - uncertainty about the way in which the economy functions, uncertainty in the interpretation of new information and uncertainty on the effects of changes in the instrumental rate. To avoid sharp changes in production and employment and create stability, monetary policy should be adjusted gradually and with good advance planning.

For the first time since the fixed exchange rate was abandoned and the Riksbank formulated the present inflation target, the Swedish economy is in a broad recovery with both strong domestic demand and strong export growth. In the *Inflation Report* in September the Riksbank made it clear that the risk of growth being weaker has diminished since the June report. Later information also supports this picture.

Uncertainty in the estimates now dwells primarily on the supply side of the economy. Until now Sweden has not experienced a broad upturn in the business cycle since the low inflation regime was established at the beginning of the 1990s.

Most indications are that the level of activity and resource utilisation has risen further during the autumn. However, according to the Riksbank´s assessment, there is still available capacity to meet an upswing. Therefore our assessment is that monetary policy at present is well balanced.

As activity in the economy strengthens and the monetary policy perspective is moved forward in time, monetary policy has to be gradually adjusted so that instead of giving a certain expansive effect, it has a more neutral effect on the economy. The timing and the speed of this adjustment must constantly be weighed against new information.