

Speech

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The Economic Situation HSB Finance Day HSB Bank

The prospects for the Swedish economy look better than for a very long time. We might have to go back several decades to find a period with such favourable conditions as those we are now experiencing. It is estimated that the Swedish economy will grow by as much as 3.6 per cent this year, and the Riksbank forecasts that growth will be slightly higher next year. Despite the marked fall in production at the beginning of the 90s, around 13 per cent more is being produced now than at the end of the 1980s when overheating was worst. Part of the income from production has been used to pay off our foreign debt, which grew during the 1980s in a way that was unsustainable in the long-term. This has been reflected in Sweden's financial balance with other countries, i.e. the current account balance, which has been in surplus for a number of years and is expected to total SEK 40 billion this year. After a number of years of large deficits, central government finances are now in surplus for the second year running. From having had the second worst central government budget balance in the whole EU at the beginning of the 1990s, Sweden's public finances are now among the strongest in the union. Inflation is under two per cent and inflation expectations close to target.

What is unique in the present economic situation is that almost all economic indicators point in the right direction; we have high growth on a broad front at the same time as inflation expectations are stably low and central government finances in order. An important factor underlying this favourable situation is that economic policy in recent years has been carried out in a consistent and competent way.

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Monetary policy with the focus on price stability has played an important role although the favourable development would not have come about without a responsible fiscal policy. While households and wage earners have borne a large share of the burden by income-reducing cuts in central government finances, this seems to have taken place on the basis of a general insight that sacrifices were necessary for the time being.

However, unemployment is still high and the frequency of employment low compared with previous successful epochs in Sweden, although there are statistical indications that the situation is improving. Unemployment is falling and approximately 100,000 more are in work than last year. The employment ratio has risen from 72 to 74 per cent of the working-age population.

The great challenge for economic policy and for the social partners on the labour market is to continue to act responsibly so that the period of good growth that our country is experiencing is not interrupted prematurely. In this way, the period of growth can probably be extended for several years and the employment ratio can also increase markedly then.

Difficult balance to strike for monetary policy

The Riksbank must strike a balance in monetary policy so that growth is not dampened unnecessarily but neither becomes so strong that inflation accelerates. The difficulties lie in foreseeing the growth of demand and its relation to inflation over a period of a couple of years to come. A change in interest rates actually has an effect with a considerable time lag, its full impact only being felt after a couple of years. If changes in interest rates come too late, the consequences will be unnecessarily large fluctuations in growth. However, experience shows that if inflation is allowed to rise, there is a great risk that the higher inflation will persist and that inflation expectations will be driven up. The consequence of the Riksbank's "wait-and-see" standpoint would therefore be to imperil the credibility that has been laboriously achieved – or even lose it. Considerably greater restraint would then be required than if inflation had been stopped in time. In order to avoid this, the Riksbank may need to increase interest rates before registered inflation shows signs of increasing, which will confront us with an educational problem. If the Riksbank wishes to safeguard growth, employment, and a high use of resources in other respects, monetary policy must be adapted in time.

Low inflation expectations

However, as has been said, it is also important not to increase interest rates too early and thus dampen growth unnecessarily. A difficult question that the Riksbank must take a position on in its assessment of inflationary pressure is whether the relationship between growth and inflation has changed and, in this case, which factors have contributed to this. A concept that has been frequently discussed during the past year is the "new economy". Discussion has above all centred on the American economy, which now seems to be at the end of a long period of high growth. It seems as if the USA has skipped an entire business cycle. This was in fact also the case in the 1980s. There was an upswing in 1982

and no downturn occurred before 1990-91. However, it is now speculated whether the new technology, IT investments and computerisation have changed transaction costs, management functions and production processes so that the growth in productivity has been durably increased and that growth has therefore been able to increase more quickly without leading to increased inflationary pressure.

The hypothesis about the new economy has also been put forward with regard to the Swedish economy. However, it will be first in ten years' time when researchers have long and many series of data to analyse that we make any more certain pronouncement about the actual situation.

However, we can talk in terms of a radical change in the Swedish economy in one important respect with regard to the relationship between growth and inflation. Inflation expectations in Sweden seem to have stabilised around two per cent, which indicates that the target for price stability has attained high credibility. During the 1970s and 1980s, inflation amounted to 8 per cent on average. This means that wage-earners, landlords, central and local government and entrepreneurs now calculate with quite different nominal price increases than previously in their budgets and their pricing decisions. However, this is not an expression of a new economy but rather indicates a return to the conditions that existed in the first two decades after the Second World War.

Developments during the Korean War clearly show the importance of low inflation expectations for the development of the economy. The well-based expectations made it possible to restore the economy to a rate of inflation of three per cent a year after inflation had risen to 20 per cent. The return to low inflation could take place without any dramatic restraint and without mass unemployment.

Comparisons between this year's wage development and wage development during the previous high inflation period are a strong illustration that high nominal wage increases do not have a positive correlation with real wage increases. While real wage increases this year are expected to total around three per cent, wage earners have periodically experienced reductions in real wages in the period 1975 to 1995 and on average only slightly over a half per cent increase. This despite the fact that the nominal wage increases remained at 3 per cent this year while being as much as 8 per cent during the comparison period. Neither should we forget the deterioration in living standards that Swedish wage earners and the Swedish people experienced compared with other European countries during these years.

Sustainable improvements in productivity due to a "new economy"?

Developments in IT and biotechnology have taken place very quickly in Sweden. Telecommunications and pharmaceuticals are hi-tech products, which are growing quickly in Swedish exports. Exports of telecommunications products have more than doubled since 1995 and pharmaceuticals have risen by 80 per cent. The economy is undergoing a restructuring towards these areas which releases us to some extent from the cyclical dependence on pulp, paper, steel and engineering products which are our traditional export goods.

However, most important perhaps are not developments in these industries per se. Although they are growing rapidly, they are still of rather small size. The computing consultancy industry has doubled during the 1990s but still only accounts for 80,000 employees, or around 2 per cent of employment. The sector "radio, TV and telecommunications products" is approximately the same size. Industry as a whole has recovered from under 18 per cent of GDP in 1993 to 22 per cent in 1998.

No, the really important effects of the new technology will probably take place outside the hi-tech and knowledge-intensive industries. Personal computers, mobile telephones, the Internet, and other IT can increase productivity within broad segments of the Swedish economy. This can affect trade, office work, distribution and storage, manufacturing production, etc. However, it is important to realise that the introduction of new technology only takes place during a limited period and that it is probably only during these years that a higher growth in productivity is achieved. When the changes to the new are carried out, it is probable that productivity will develop more slowly again. This can be compared with the introduction of electricity and the spread of electrical motors in industry, or the spread of the internal combustion motor.

I would thus like to warn against viewing the future through rose-tinted spectacles. It is true that productivity growth has been higher after 1994 than in the preceding twenty-year period. An increase from 1.4 to 1.9 per cent has been registered. However, the first period included three long downturns and the second a broad upswing. We cannot therefore know whether it is only cyclical differences that underlie the figures or whether technological changes have also contributed to sustainable stronger productivity growth.

To sum up, I would like to point out that we now have a better relationship between growth and inflation due to inflationary expectations being pushed down. It is possible that technical developments have also produced productivity improvements that mean that growth for a period can increase more quickly than previously without inflationary pressure being created. One factor that I have not touched on to date is the effects of increased competition through internationalisation and domestic deregulation. This process too can have contributed to a better relationship between inflation and growth although it is difficult to prove that this is the case. However, I am to say the least doubtful about a new economy in the sense of new technology leading to a sustainable increase in productivity.

Wage formation – a challenge

The strong upswing the Swedish economy is now undergoing is borne up both by domestic and international demand. Private consumption is expanding rapidly, at the same time as export is recovering and the public sector is beginning to demand labour again. In the present situation, it is considered that there are unused resources in the economy, but when growth increases the use of resources and inflationary pressure will naturally also increase. As has been said, the Riksbank must assess how strong growth in demand can be permitted without inflationary pressure compelling interest rate rises. A current theme is the discussion on changes in the relationship between growth and inflation, which I have taken up in general terms. Another very important part in the inflation process is wage formation and I find here that it is justified to give

prominence to the risk that evident imbalances between different categories of wage earners can lead to the positive development we are now seeing being prematurely interrupted.

The collective agreements that have recently been concluded do not give any particularly great cause for concern. Wage increases have been around three per cent per year. I have no doubt about the parties' insight into the importance of the inflation target for wage formation in general. However, most agreements expire next year.

It has proven during the autumn that the majority of the teacher training places in the sciences and mathematics are vacant. This is not so strange since a person who can successfully study mathematics and physics at university, can also become a graduate engineer or industrialist scientist. Initial salaries between a graduate engineer and a science teacher differ by SEK 3-4000. Salaries for a competent engineer have no ceiling while for a teacher the top salary is not much above SEK 20,000. Teachers have not been slow to make use of the scarcity of certain categories of teachers to demand 15 per cent more than all other groups over a five-year period, despite there not being a shortage of all categories of teachers. This has naturally led to protest from the Swedish Trade Union Confederation.

If this type of imbalances cannot be dealt with by the union organisations and employers without a general scramble for pay increases, the Riksbank will be confronted by the unpleasant task of constraining the economy in order to prevent excessively high wage increases having an impact on inflation. The low inflation policy may therefore be said to be confronted by a test: The labour market is improving with falling unemployment and increasing capacity use otherwise. At the same time, there are imbalances in the sense that relative wages do not attract applicants for employment to the areas in the labour market where there are shortages. The challenge is to find a solution within the framework of the scope for pay increases created by the growth in productivity and inflationary expectations on a level with the target.

Make use of available opportunities

Sweden's opportunities for regaining some lost ground in the prosperity league are good. Our country has a population, which has taken to new technology in the field of IT more quickly than in many other countries; computer use is widespread at workplaces and also homes. According to a SIFO survey, 3.5 million Swedes surf the Internet – almost half of the population aged between 12 and 79. No fewer than 2 million Swedes surf every day. Even more remarkable is the fact that almost 20 per cent of the age groups between 50 and 80 are active on the Internet. Together with some other countries, Sweden takes the absolutely leading position with regard to the use of IT, computers and mobile telephones.

Young new entrepreneurs are starting successful businesses within the new areas alongside giants such as Ericsson. Pharmaceutical research and biotechnology are other areas where Sweden is well to the fore. Sweden is investing more in research in proportion to GDP than any other country in the world.

As the conditions are now very good with regard to the immediate economic trends that I mentioned to begin with, and as the structural changes in the

Swedish business sector towards new advanced fields of production are moving quickly, it would be a national misfortune if wage formation were to get out of hand due to the parties not being able to deal with imbalances in relative wages.

Consequences for monetary policy?

What conclusions can be drawn regarding monetary policy? My intention with today's speech is not to make new statements about current monetary policy. The intention is instead to create understanding for the balances that have to be struck and the risks that must be avoided in order for monetary policy to make a contribution to the positive development of the Swedish economy.

The role of the interest rate for demand of goods and services and inflation can be described as follows in a highly simplified way. A real rate of interest, which neither stimulates nor dampens demand, may be said to be neutral. Demand then increases at the rate of capacity growth and inflation is stable. When capacity in the economy is not fully made use of and unemployment is high, the interest rate may – on condition that inflation expectations are in line with the target – need to be below its neutral position in order to stimulate demand so that it increases more quickly than capacity utilisation. In this way, unemployment can be taken up in production, capacity utilisation increase and inflation be adjusted upwards to the target. In the same way, the interest rate needs to be above its neutral position, when capacity utilisation is full and demand is tending to grow more quickly than the utilisation of capacity. The economy then needs to be cooled down to prevent inflation exceeding the target. It is the task of monetary policy to control short interest rates so that demand pressure is adjusted to capacity growth to achieve the inflation target. The growth in capacity in the long-term is determined by other factors, however, than monetary policy.

The level of the neutral interest rate varies over time. According to some theories on optimality, a very rough rule of thumb is that the neutral real interest rate in the long term and when the economy is in balance is near the long-term growth of GDP. In Germany, real short term interest rates have since 1980s been around 3.3 per cent while the corresponding rates in the USA are around 3.5 per cent. While it is not possible to specify a neutral level for Swedish interest rates, there is no doubt that monetary policy even after last week's increase will continue to have an expansive effect on demand.

In practice, monetary policy decisions are based on an overall assessment of a number of inflation indicators. The interest rate reductions during the past year from 4.35 per cent in June 1998 to 2.9 per cent in March this year took place with a view to stimulating demand, increase employment and increase capacity utilisation in order in this way to bring inflation up to the goal of two per cent. The Riksbank's most recent inflation report makes the assessment that there are unused resources in the present situation but that the available resources will gradually be taken into use during the forecast period. The statistics published thereafter give a somewhat fragmented picture but, taken as a whole, do not occasion any change in the view of growth prospects in the economy.

The assessment of the Riksbank is now that inflation in one to two years will be marginally higher than in the most recent inflation reports. In the light of this, the Riksbank made the assessment at its meeting on 11 November to conduct

monetary policy in a less expansive direction. The repo rate was therefore increased by 0.35 percentage points to 3.25 per cent.

As has been said, the difficult balance to be struck in the present situation is to adjust the instrumental rate at a rate that does not interrupt the upswing in capacity utilisation but does it with sufficient foresight to avoid a drastic rise. We do not want to experience "stop-go" policies again. Let us not forget the late 1980s and early 1990s. That period represents a tragic failure for economic policy, a failure that cost Sweden destruction of both physical and human capital.

Earlier in my speech, I pointed to the imbalances in wage formation that could lead to inflation accelerating if they are handled incorrectly. This would make monetary policy tightening necessary that would risk interrupting growth and structural transformation, because the inflation target is mandatory and will not be given up. The Riksbank has both the instrument and the political mandate to achieve the target of two per cent's inflation. The issue then is not whether the inflation target will be met but the consequences that achieving the inflation target will have for the rate of growth and employment in the medium-term. The Riksbank is responsible for achieving the inflation target, but responsibility for the positive development that we can now see in front of us being sustained over a longer period, is shared by everyone in Sweden.