Speech

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The Inflation Target, the State of the Economy and the "New Economy"

The Swedish Economic Association

I would like to begin by thanking you for inviting me to come and speak at this meeting of the Swedish Economic Association. I am looking forward to this evening's discussion. Sweden is now in its seventh year with an inflation target since it was announced at the beginning of 1993. A number of other OECD countries have also been pursuing inflation target policies for several years, so by now there is a rich fund of experience to draw on.

This evening I intend to take up some of the challenges for monetary policy under an inflation target regime, bearing in mind in particular the position of Sweden. How active should an independent central bank be in stabilising economic conditions? What form of interplay between monetary and fiscal policy leads to favourable economic development when monetary policy is directed towards an inflation target? Naturally this is a big question, so I intend here to confine myself to a few key points. In conclusion, I thought I would make a few remarks on the "new economy".

Stable conditions rather than stabilisation policy

Stable conditions in the form of less variability in the real economy mean enhanced welfare for society as a whole.

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One essential question is whether, in general terms, short-term stabilisation policies should be pursued in an attempt to bring about high real growth in the long term. It is worth emphasising here that monetary and fiscal policy differ in how promptly they react to changes in economic circumstances.

In principle, the Riksbank can adjust its instrumental rate at any time whatever so as to stimulate or curtail demand. At the same time, however, the impact of such measures can be expected to peak only after 1 to 2 years. This means that monetary policy should be framed primarily with a view to its long-term effects.

Fiscal policy, in contrast, can have a major direct impact on the economy but its most important components resist rapid change. There are administrative costs associated, e.g., with changing tax rates, and changes in regulations take time to implement. This means that fiscal policy is difficult to adapt quickly to meet changed economic prospects.

This leads to the conclusion that even if monetary policy can react immediately to changes in the economic situation, neither monetary nor fiscal policy should aim to influence economic conditions in the short term, i.e., to function as instruments of “fine tuning” stabilisation policy. Instead, both monetary and fiscal policy should be designed so as to create stable long-term conditions.

The contribution made by monetary policy to welfare is precisely to create as stable conditions as possible in the economy by means of the inflation target policy. As this task is formulated in the Riksbank Act, the objective of the Riksbank’s operations shall be to pursue price stability and to promote a secure and efficient system of payments.

The role of fiscal policy should include shaping the tax system so as to create the best conditions for the highest possible potential output. Changes in the Government’s financial savings and the requirement that there should be a surplus in the public finances over the course of a business cycle both work to create greater confidence in economic policy. The orientation of the budget policy, like that of monetary policy, is of great significance for the way the economy develops. If the fundamental rules of the game are stable, the actors in an economy will dare to make long-term decisions.

Of course, it would also be desirable for monetary policy and fiscal policy to work together in such a way as to moderate major variations in employment and growth, i.e. so as to reduce cyclical fluctuations around potential growth.

Since this may be difficult to achieve in practice, one question that arises is what is the optimal mode of interaction for fiscal policy and monetary policy within the framework of the inflation target regime.

What happens in an inflation target economy if fiscal policy completely disregards the state of the economy?

What happens, e.g., when the economy is in a boom if fiscal policy is conducted along excessively expansive lines? In the *absence of a credible nominal anchor* in the economy, e.g. in the form of an inflation target, demand increases further. This in turn leads to a tendency on the part of firms to raise their prices, particularly in a situation where production is constrained by bottlenecks. In addition, employees will demand higher wages, and the combined effect will be to create a spiral with rising inflationary pressure, such as we experienced, for example, in the 1980s.

Adjustments towards a higher price level can occur over an extended period but will gradually set in motion processes that put a brake on growth. This is a manifestation of the established theory that it is not possible to raise the long-run productive capacity of the economy with short-term stimulation policies.

What happens in this scenario if the central bank has an inflation target? When inflationary pressure in the economy increases, the central bank will tighten monetary policy so as to prevent the inflation target from being exceeded.

Such a course of events would result in an unfavourable policy mix. The stimulation provided by fiscal policy would be counteracted by the monetary policy, which would mean that even the positive short-term effects of the stimulation would decrease or even become negative. Moreover, if the stimulation provided by fiscal policy is very powerful, this could lead to expectations of an increased risk that the inflation target cannot be upheld, which would then lead to rising inflation expectations and higher risk premiums on Swedish interest-bearing papers. Households and companies may feel growing uncertainty both about developments in public revenues and expenditure, and about the formulation of monetary policy. This can be costly for the economy if it leads to a failure to carry out investments and to unnecessarily cautious decisions about the allocation of resources. To sum up, then, it becomes more costly to pursue an excessively expansive fiscal policy when monetary policy is guided by an explicit inflation target.

A good policy mix makes for better conditions

A better policy mix arises if the orientation of fiscal policy does not make for higher inflation risk premiums. It can avoid this if the orientation of fiscal policy appears to be sustainable in the long run. The surplus-target in the public finances is a good example of this.

One means by which the confidence felt by the general public in economic policy can be monitored consists of inflation expectations, which should not diverge substantially from the Riksbank’s inflation target. When expectations of inflation diverge from this target in the longer term – whether upwards or downwards – it implies that monetary policy should be adjusted so as to steer expectations back towards the target.

In this connection it is important to observe that a central bank whose inflation target commands high credibility often has more scope for acting than one that has little credibility. Assume, for example, that an economy where the credibility of the inflation target is high experiences a positive disturbance to the business cycle, leading to higher demand. Since the inflation risk premiums are low, employees will not need to demand extra high nominal wages to insure themselves against unexpectedly high inflation. This is because it can be anticipated that the central bank will tighten monetary policy. This in turn will mean that less stringent measures will probably be required than would be needed by a central bank that had not yet established its credibility.

Turning more specifically to the situation in Sweden, it can be said that the macroeconomic conditions today are favourable: inflation is low, budget deficits have been transformed into surpluses and the prospects for growth are good. However, economic policy is a continuous learning process and the successes of recent years should not be taken as evidence that the structural problems have been solved. On the labour market, for example, structural rigidities remain; also, the tax-pressure is still high, which inevitably distorts incentives to work and save. As far as monetary policy is concerned, the credibility of the inflation target regime has as yet hardly been tested in a period of economic upturn.

What does this mean for how much and how often monetary policy should react to changes in the economic outlook? This, of course, is a question that the Executive Board of the Riksbank addresses on an ongoing basis, communicating its views in inflation reports, the minutes of its meetings and speeches. In general terms, it can be said that the need for action should be based on the outlook for domestic demand, the stringency of fiscal policy and international trends. In addition, inflation expectations play a key role as an overall indicator of inflationary pressures. In a situation where inflation risk premiums are low, an independent central bank with a price stability target can also contribute to stabilising the economy around its potential growth.

How far does this responsibility extend? According to the way the Riksbank has explained the target, annual inflation measured by the CPI is normally to be restricted to 2 per cent with a tolerance interval of ±1 percentage point. In the event of a deviation from this target, inflation is normally to be brought back on target within 1-2 years. In the event of a major deviation, caused for example by a major external disturbance, there may, however, be reason to extend the horizon of the target so as to limit fluctuations in production and employment. In other words, in these circumstances it may be too difficult or too costly for monetary policy to quickly bring inflation back on target.

The "new economy"

Let me now take up another question that is the subject of much discussion both in the media and in academic circles: the existence of a "new economy". When people talk about this, their eyes are turned primarily towards the American economy. The concept seems to be capable of covering many phenomena. In this context I define the "new economy" as an increase in the potential growth of the economy.

In the last few years, the growth of the American economy has surpassed most forecasts. Not only has the rate of growth been high in historic terms during the present upswing – around 3.5 per cent per year on average since the end of 1991 – it has besides been very stable and unusually long lasting. At the same time, unemployment has fallen to near 4 per cent; levels this low have not been witnessed since the 1960s. However, in distinction to previous booms, there has been no increase in the rate of inflation and the underlying rate of inflation has been more than halved since 1991, from over 4 to 2 per cent. Public finances have improved considerably, from a deficit of 5 per cent of GNP in 1991 to an expected surplus of around 1 per cent this year.

Looking at productivity per hour worked in American business, which is perhaps the best measure of how good a country's growth potential is in the longer term, this has risen sharply, by over 2.5 per cent on average since 1997; this figure can be compared with an average growth of productivity of around 1.5 per cent over the period 1974-96. A substantial part of the improved productivity of labour can be explained by very high investments – so-called "capital deepening" – not least in computer equipment. In spite of the fact that unemployment has continued to fall throughout the period, the growth of productivity has been impressively high. This is remarkable considering the fact that the new jobs have principally been created in the service sector, where productivity generally increases at a lesser rate than in manufacturing.

Three principal groups of reasons for the positive trend in America can be distinguished:

One important reason behind the upswing appears to be *good economic policies.* Since the beginning of the 1990s, fiscal policy has been directed towards achieving a balanced budget, and for a year or so now the budget has been balanced. In order to achieve this, taxes have been raised, expenditure diminished and budgetary procedures made more stringent. Monetary policy has been directed towards keeping inflation low and stable and has succeeded in warding off both destabilising inflationary and deflationary pressures at an early stage. The policy mix of monetary and fiscal policy therefore appears to have been favourable.

A number of *structural factors* seem to have been important. Deregulations in many sectors and increased globalisation have intensified already tough competition and increased the pressure on the partners on the labour market, leading to greater flexibility in the labour market and enhancing labour mobility. The increased and more effective use of new technology (IT) has raised productivity, and the use of JIT (Just-In-Time Inventory Management) has meant that the match between supply and demand in the economy has improved. The increased openness in the economy that has resulted from among other things the NAFTA and GATT agreements, has meant that foreign trade has functioned as a "shock absorber" for fluctuations in domestic demand.

Finally, *fortunate circumstances* seem to have played a part. With the end of the Cold War at the beginning of the 1990s, resources were freed up, principally in the military sector, which could be put to more productive use in the private sector. Further, both the Mexican crisis and the Asian crisis have been shocks that have checked certain tendencies towards overheating and thus also inflation, yet without leading the economy into recession. During the crises, a "flight to quality" appears to have led to falling long interest rates, which has benefited stock exchange prices and strengthened the dollar. Foreign investors have been willing to finance the deficit in America's current account, which at present comes to about 4 per cent of GNP.

To sum up, it seems likely that a certain rise in the growth potential has taken place in the USA during the 1990s and that inflationary tendencies have declined. Just how much nevertheless remains an open question. The OECD, for example, has raised its estimate of the potential growth rate to just over 3 per cent. However, in the past three years growth has amounted to more than 4 per cent on average, which means that the OECD regards some of the factors discussed above as temporary in nature and expects growth to slacken as these factors die away.

In the course of the very powerful upturn in the American economy, significant imbalances have built up at the same time. Among other things, the deficit in the current account has never been as great as it is now, and recently consumption has been increasing more rapidly than household incomes, which means that the savings ratio has been at a record low. Sooner or later these imbalances will need to be corrected. However, a discussion of how this might come about lies beyond the bounds of what I intended to talk about this evening.

Are there traces of a "new economy" in Sweden?

- Since Sweden switched from a fixed exchange rate to an inflation target, monetary policy has been designed so as to reach this target and thereby create credibility. Monetary policy has succeeded in stabilising prices and at the present time long-term inflation expectations approach the Riksbank's target of 2 per cent. The changes in fiscal policy, which have entailed among other things a reform of budgetary procedures and the imposition of a ceiling on public expenditure, have had positive effects. This is manifested, for example, in the budget surpluses now being produced. Overall, we have made good progress towards achieving macroeconomic stability and therefore appear to fulfil the requirements for "good economic policy", even if we have fulfilled these for a considerably shorter time than the USA.

- If, on the other hand, we look at structural factors, our problems were perhaps also worse from the start. The Swedish economy is less open to competition than the American. For example, even adjusted for differences in value added taxes, the level of prices in Sweden is on average 15-20 per cent higher than in the USA. Many deregulations that were carried out long ago in the USA, such as the deregulation of the transport sector, for example, have been carried through more recently in Sweden and there are many indications that we have not yet seen their full impact. However, competition in many markets is expected to increase in Sweden in the future, in part as a result of increased globalisation and European integration. One area in which very little has been done is the labour market, which is very rigid and regulated compared with the American.

- Where the introduction of new technology is concerned, Sweden has gone further in this than many other OECD countries. For example, we have the highest number of Internet users per capita in the whole world.

- Like the American economy, the Swedish economy is very open to the world around it and Sweden has a long tradition of free trade. To some extent this counteracts the tendencies towards limited competition on the Swedish market.

- But on the other hand, as yet we have seen no clear indications in the statistics of the impact of the new economy. For example, Sweden shows no signs of the strong growth of investment that has been seen in the USA in the last four to six years. Further, there are no indications that the productivity of labour has increased very much, which appears to have been an important element of the strong growth in America.

In the opinion of the Executive Board of the Riksbank, as stated in the Inflation Report (1999:3), the trade-off between inflation and growth has improved to some extent, even if there is considerable uncertainty about how much. In conclusion, the Swedish economy appears to have undergone *only some of* the structural changes that the American economy has implemented. It remains to be seen whether the "new economy" can have any further impact in Sweden.