

Speech

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TUESDAY, JUNE 6, 2000

The role of monetary policy for growth

FöreningsSparbanken's Economics Day in Vellinge

I would like to begin by thanking you for the invitation to speak here at FöreningsSparbanken's Economics Day. In my speech today, I shall try to look beyond the day-to-day monetary policy where the focus on interest rate points and minor differences in assessments of the consumer price index at times entails a risk of a lack of perspective. It can therefore sometimes be justified to remind oneself and others of the role that economic policy can and should play. For me as a decision-maker at the Riksbank, this applies in particular of course to the role of monetary policy and the importance of the stability of the payment system. I would also like to recall the successes achieved in the Swedish economy during the past decade, where fiscal and monetary policy have both made important contributions. The challenge now is to reinforce what has been achieved and at the same time be strong enough to carry out the changes that remain. It is also important to continually evaluate and discuss the design of economic policy as new experiences are obtained. This requires openness, which has been a lodestar for the Riksbank in recent years.

To create understanding and support for the goal of price stability, it has been necessary to explain the conceptual framework that guides monetary policy decisions in a simple, pedagogic way. This has perhaps resulted in our creating an exaggerated idea that monetary policy decisions are arrived at with the aid of very simple rules. A simple conceptual framework is a support in a complicated reality. However, factors that cannot be captured in a simple rule for decision-making need to be taken into account. Since the effects of monetary policy extend over a number of years, every decision must rest on assessments of probability and

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individual valuations of the risks that are associated with alternative developments in the macroeconomy in future. In conclusion, I draw attention to some of these risks in the development of the Swedish economy in the present situation.

The three pillars of economic policy

A well-balanced economic policy contributes to creating good prerequisites for stable, high growth, which is generally regarded as an important component of the welfare concept. For this, it is required that all components of economic policy play their roles well. This applies to fiscal, structural and monetary policy. Good conditions for growth are created when uncertainty about future income and expenditure is minimised. If at the same time resources are used where they make the greatest contribution to welfare, there are prerequisites for good development. Economic policy should be designed so as to minimise uncertainty and so that the regulatory framework and tax system do not distort the allocation of resources in the economy.

If *fiscal policy* is carried out so that the central government debt is stabilised at a reasonable long-term level, certainty is established in the design of the transfer systems and coming tax burdens and investment and consumption decisions are facilitated. *Structural policy* also has an important role with regard to creating good conditions for growth. Structural policy is such a broad concept that I can only point to some important components. The tax and transfer systems, for instance, should be designed so that they do not create motives for citizens to act in a way that is harmful to long-term growth and welfare. The task of the educational system is to provide access to relevant, high-quality education and that of labour market policy to ensure that demand and supply of labour power match.

The tasks of the Riksbank

A *monetary policy* aiming at price stability reduces uncertainty about future real incomes. Agreements on future payments and assessments of future income are thereby facilitated. Demands for compensation for risk are reduced which, among other things, stimulates real investments. Price stability also improves the ability of the price system to spread information about how resources are to be distributed to areas where they most benefit citizens. In a market economy, it is the task of the price system to communicate information about household preferences and, for instance, to provide signals as to where productivity is to be best developed.

Besides the task of safeguarding price stability, the Riksbank is also responsible for the country's payment system. It is a prerequisite for the functioning of a modern economy that payments can be carried out in a safe, efficient way. In order for payment systems to function, it is important that financial stability is maintained, which, for instance, means that bank crises shall be avoided. There are close connections between the responsibility of the central bank for price stability and its responsibility for financial stability. In order for the instrumental rate to have the desired effect on interest rate formation, it is, for instance, important that the payment system functions efficiently and securely, since monetary policy

instruments operate via the payment systems. Price stability can further be threatened by financial imbalances and by financial instability. At the same time a monetary policy focused on price stability *per se* probably reduces the risk for financial instability. It is not meaningful to draw a sharp boundary between what is regarded as the central bank's monetary policy tasks and what is included in the responsibility for a secure, efficient payment system. I confine myself here to stressing that price stability and financial stability are both required to create good growth conditions in an economy. And the central bank plays an important role in achieving both these goals.

On 1 January 1999, a new Riksbank Act came into force. It states that the goal for the Riksbank's activity is to maintain stable prices. The Riksbank shall also be responsible for a secure, efficient payment system. In the preparatory legal material on the Act, it is also further stated that the Riksbank, without setting aside the price stability target, shall also support the objectives of general economic policy with a view to achieving sustainable growth and high employment.

The price stability goal has then been confirmed by law. The Riksbank's Executive Board is responsible for making the price stability goal operational and designing the framework for monetary policy. Among other things, this means that the Executive Board decides on how the price stability goal is to be defined and over what period price stability is to be maintained.

The Executive Board of the Riksbank has decided that price stability shall be defined as an annual increase in the consumer price index of 2 per cent with a tolerance interval of plus/minus one percentage points. If the consumer price index is affected by factors that are considered to only have a temporary effect on CPI, the Executive Board has agreed that we shall be able to disregard this. The reason is that monetary policy otherwise risks leading to unnecessary fluctuations in employment and production.

A lot has been achieved although some things remain to be done

Economic policy has been very successful in many areas during recent years. When central government debt increased dramatically during the first half of the 1990s, when, at the same time, unemployment increased to a very high level and large fluctuations in long interest rates and the exchange rate indicated great uncertainty in inflation prospects in the mid-1990s, there were probably not many who could imagine that we would so quickly have such a positive development as we are at present experiencing. Central government finances have improved markedly and we are now one of the best in the EU with regard to the size of central government debt and the central government budget balance.

For some time now, growth has been strong and we expect unemployment to fall towards 4 per cent during the coming year. And despite this, inflation expectations remains at a stable level close to the target. We can therefore note that the Riksbank has been very successful in creating support and credibility around the

price stability target. Without such a responsible fiscal policy, it would not have been possible to reduce inflation expectations in the way that has happened, however. The prohibition against financing the budget deficit at the central bank was a step in that direction. The rule that the Government and Riksdag adopted and which means that fiscal policy is to strive towards a surplus of an average of 2 per cent over a business cycle furthermore supports the price stability target and creates good conditions for growth. The expenditure ceiling for central government finances that sets limits for how much public activity can expand has the same effect.

Many structural reforms that have improved the conditions for growth in the longer term have also been carried out during the past decades. The financial markets are wholly deregulated and the tax system is reformed so that it produces fewer distortions than before. During the 1990s, a process has been initiated which has strengthened competition in many areas. Transport, communication and energy have been deregulated. At the same time, EU membership and continued internationalisation have exposed the business sector to increased competition.

However, there is still a great potential for deregulation. This applies, for instance, to many parts of service production where moreover growth prospects look favourable. A study recently carried out by the Competition Authority confirms that competition has improved during the 1990s, but also points to considerable competition deficiencies in many industries. Besides many industries in the service sector, this also applies, among others, to the construction industry where regulatory frameworks and building norms contribute to excluding competitors from other countries. The study is a follow-up of a study carried out in 1991. Its conclusion was that lack of competition and concomitant high prices was a feature of a number of the industries investigated.

Exaggerated expectations about the growth path can create macroeconomic imbalance

Even though the growth prospects for the Swedish economy now appear very bright, it is too early to write off the risk of old problems in our economy again making their presence felt. There is, for instance, a risk for overheating when households and businesses now seem to make decisions on consumption and investments based on expectations of strong future real income increases as a result of higher productivity growth. This can lead to financial imbalances and exaggerated indebtedness heightened by high share prices and increasing property prices. Earlier periods with strong credit expansion and high demand in Swedish economy have been followed by rising inflation. Low inflation expectations and price-dampening effects from deregulations can now *for a time* hold back the inflationary pressure that builds up when resource use in the economy increases. Low inflation combined with high growth can *per se* strengthen the concept that earlier patterns have been broken away from in the long term and we have entered a period with long-term higher growth. If demand increases so much that resources are put under pressure, however, inflation will sooner or later accelerate. There is a

risk that prices then will increase very quickly and that inflation expectations will also increase. To get inflation in line with the target in that situation, it may be necessary to conduct a stringent monetary policy for a longer period. If expectations of future growth prospects at the same time are interrupted, a need for consolidation can arise in the household and business sector, which will strongly dampen growth. The consequences of altogether too strong growth now could therefore be instability in inflation and production later. If the financial imbalances have become altogether too great, there is a risk that the consequences will not be limited to great variations in growth and inflation but will even lead to lower overall production.

The same course of development as in the U.S.A.?

As we have said, it is incontestable that the Swedish economy has functioned better than before. However, there is a risk that we will overshoot. The exceptionally long upswing in the U.S.A. has contributed to strengthening expectations on faster long-term growth in Sweden as well. There are certain developmental features in the Swedish economy that are reminiscent of the American economy which could indicate that. An important basis for the favourable development in the U.S.A. is probably the approach to budget consolidation and price stability that has guided economic policy there for a long time. And in those areas we have had a similar development in Sweden although the process started later here. At the same time, the strong penetration of information technology in the American economy is considered to be a factor that has contributed to the productivity improvements recorded in the U.S.A. As regards information technology, we are well to the fore, although it is first recently that statistics indicate some increase in productivity growth. Expectations for a continued strong increase in productivity in the U.S.A. have also been a basis for the strong rise on the American stock exchange. The high share prices and the positive expectations have stimulated demand and the debt ratio in the private sector has increased. It is not possible to write off the risk of financial imbalances being built up in the U.S.A., which risks having negative effects on the macroeconomy. However, many analysts consider that the long-term growth rate has in fact increased in the American economy and that the expectations that have served as the basis for investments and increased indebtedness will therefore be realised.

Even if there are some indications that point to the Swedish economy undergoing a similar development to the American, the structural differences cannot be disregarded, which probably create greater inertia in the Swedish economy than in the U.S.A. The labour market is one such area. As I mentioned earlier, considerable barriers to competition also remain in the Swedish economy. Another difference is that the cyclical upswing we are now experiencing is taking place at the same time as growth is increasing in the surrounding world and resource use is increasing. The American upswing could benefit from a surrounding world with a lot of free resources and low price pressure and with few competing investment alternatives for international investors.

Should monetary policy counteract financial imbalances?

How shall monetary policy be designed if there is a risk for exaggerated indebtedness and overheating?

A decision-making rule the Riksbank sometimes uses to motivate its monetary policy decisions can in simple terms be described as follows: when inflation exceeds the target in a one-to-two year horizon, then the interest rate is increased. Interest rate increases reduce the demand for goods and services, which in turn reduces inflationary pressure. In our simple conceptual framework, inflationary pressure is then assumed to vary with the use of resources in the economy. When there is free capacity, inflationary pressure is low in the absence of so-called shocks. When demand is so high that it exceeds the level that is compatible with the long-term production path, inflation tends instead to exceed the target. The line of reasoning is based on inflationary expectations being established close to the target for monetary policy. Price increases when demand is strong may for instance depend on bottlenecks being created in some part of the production chain. As the company in this situation, cannot improve its profits by increasing its volume of sales, profit margins are increased by price increases. Shortage of labour also increases the risk for excessively high wage increases. The result will be higher inflation.

If we strictly apply such a simple rule for decision-making, we shall then disregard the risk of building up of financial imbalances and overheating as long as inflation is not deemed to exceed the target during the forecast period.

In the most recently published inflation assessments, it was assumed that the price stability target was not threatened during the forecast period despite the growth of demand being so strong that use of capacity was under strain at the end of the period. The majority view of the Executive Board was therefore that there was no reason to increase the repo rate. This assessment was based on free resources in the initial situation, good productivity growth, low price increases on certain recently deregulated areas, low import prices and finally low inflation expectations. It is not *per se* strange that GDP can increase as much as 3-4 per cent for a couple of years without inflation sharply accelerating, if the use of resources is low initially.

If the pattern from previous cyclical upswings was to be repeated, price pressure should now increase. However, it has proven difficult to identify any exact and very stable correlation. As I mentioned earlier great changes have taken place in the Swedish economy. While there are still considerable deficiencies in competition in many areas, it is nevertheless not probable that inflation will accelerate strongly in the next few years. An important reason for this is that the price stability target has now obtained such strong support that inflation expectations are not increasing despite a cyclical upswing that is stronger than for a very long time. I have, however, for the reasons I mentioned earlier in my speech, been somewhat more pessimistic than the majority of the Executive Board as regards inflation assessments at the forecast horizon. Fluctuations of consumer prices a few tenths of a per cent up and

down around the target in an economy with a strongly accepted price stability regime are *per se* less important than the mode of functioning of the economy.

I am more concerned about what can happen with inflation and growth after the forecast period if demand increases at the rate we have anticipated. The simple rule that says that monetary policy shall only react if the target for inflation is not met during the forecast period is a good help when conducting monetary policy. However, it is not reasonable to mechanically apply this rule in every situation. The consequences that the economic development can have for macroeconomic stability and inflation beyond the forecast horizon must also be weighed in. The risk for financial imbalances now being built up when indebtedness is increasing and of inflationary pressure accumulating at the same time must in my view therefore be taken into account in the monetary policy decisions. A development that I described earlier can be the consequence if the expansion of demand and credit continue to increase at a high rate. The quantity of money and lending, especially to households, are for instance increasing at present at a rate which is probably not sustainable in the long term.

The advantages of simple rules for decision-making are that they are easy to explain which can be especially important when establishing credibility for a low-inflation regime. With simple rules for action, it becomes clear what has guided monetary policy decisions. However, as I have shown, this does not necessarily result in optimal policy in every situation in the sense that macroeconomic stability and longer-term price stability are achieved. The difficulties in assessing when demand and the increase in lending are too strong are certainly considerable although this applies by and large to all the assessments we have to make.