

# Speech

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## The Riksbank, growth and inflation

Företagarnas Riksorganisation, Trosa

Firstly, I would like to thank you for the invitation to come here. It is important to meet with representatives of industry and be able to talk about the role of the Riksbank and its significance for growth.

### **The role of the Riksbank**

The objective for monetary policy is clearly stated in the Sveriges Riksbank Act - to maintain price stability. The Riksbank has further defined this in its inflation target, i.e. that CPI inflation shall amount to 2 per cent, with a tolerated deviation interval of plus/minus one percentage point. This means that when we are determining the direction for monetary policy, we must take into account changes in a number of areas that affect price trends directly or indirectly. I intend to comment on one of these in particular, namely the potential growth of the Swedish economy in a long-term perspective.

The Sveriges Riksbank Act also establishes that the Riksbank shall be independent, this means that we six members of the Executive Board, who make decisions regarding the instrumental rate, may not request or receive instructions from the government or parliament. The idea is that we are thereby always free to safeguard the value of money and are not tempted, for instance, to contribute to an increase in growth and employment through lower interest rates during an election year.

At the beginning of the new monetary policy regime, when the fixed exchange rate was abandoned in 1992, there was a certain amount of criticism of the inflation

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target; many people feared that the unconditional attachment to an inflation norm would have a negative effect on growth and employment. A monetary policy aimed at price stability could lead to a prolonged period of low growth and, in extreme cases, to declining production.

It may appear as though this objective forced the Riksbank to give a lower priority to the development of the real economy, i.e. production and employment. We have only one objective for monetary policy, unlike, for instance, the US central bank that also has the task of taking into consideration the effects of interest rate decisions on growth and employment. However, in actual fact, the difference is probably not so great - indirectly the assessments of the future path of the real economy also play an important role in our decisions. Moreover, we also have the task "without neglecting the price stability objective, of supporting the objectives for general economic policy with the aim of attaining sustainable growth and a high level of employment." This is expressed in the proposal for the Sveriges Riksbank Act from 1999.

However, even more importantly, there is no opposition between good growth and price stability, quite the reverse. If we look at developments during the 1990s, growth since 1992 has shown an average rate of 3 per cent a year, despite the fact that inflation was under the target level for several years. At the same time, unemployment has fallen from 9 per cent to approximately 4 per cent. This can be compared with the 1970s and 1980s, when inflation was at around 8 per cent and growth an average of 2 per cent.

Price stability and the importance of achieving it are also well established among the general public in Sweden. This is important, as understanding and acceptance of monetary policy is important for inflation expectations and thereby for behaviour on the labour and goods markets. It is you - particularly those of you with your own businesses - who set the prices and who must be able to trust that it will turn out as we say; that inflation will not rise above or fall below the target of 2 per cent for a longer period. This is also the reason why we members of the Executive Board often travel around holding speeches. Communication with the Swedish public and the operators on the various markets is important for monetary policy.

As monetary policy operates impact with a certain time lag, the instrumental rate is adjusted so that the total assessment of future inflation, taking into account the risk scenarios, 1 to 2 years ahead is in line with the target. Interest rate decisions are based on forecasts of future prices. There will be deviations from these forecasts, even if they are well founded, partly because the economy is hit by unforeseen shocks from time to time. If fruit-growers' crops are attacked by insects, the price of apples will rise, if the dams are not filled with water, electricity prices may rise, and if cows in Europe suffer various diseases, the price of meat and certain other foodstuffs rises. If the Riksbank tried to make corrections for this type of temporary price disturbance, it would probably lead to large swings in monetary policy and unnecessary fluctuations in demand.

It would therefore be wrong to give the impression that inflation will always lie at 2 per cent. On the other hand, it is important that the Riksbank constantly adapts the instrumental rate to ensure that the inflation forecast 1-2 years ahead is in line

with the inflation target. This means that households and firms can rely on temporary deviations above or below this level being just temporary.

One factor that could seriously undermine the credibility of the inflation target is if a higher rate of price increase led to large-scale demands for wage compensation. If wages and prices begin to chase one another upwards, as happened in the 1980s, everyone will lose out in the end.

### **The importance of monetary policy for growth and vice versa**

The importance of monetary policy for growth is primarily connected to the need for stability in trade and industry and the labour market. When you businessmen and women have to make a decision on investment, you can now usually avoid having to worry that sudden fluctuations in the inflation rate will overturn your calculations. In most cases, temporary, minor deviations from the target should not change the final results of the calculations. The stability in planning that this creates should lead to more and better quality investments, which in turn should stimulate growth.

This is reflected, for instance, in the fact that total factor productivity in the Swedish economy increased strongly once macroeconomic stability was established in the 1990s. Other countries around the world have had the same experience. Macroeconomic stability promotes growth and productivity.

What may be given less attention in the public debate is the importance of growth for our capacity to meet the inflation target - despite the fact that this really is a key issue. It is the demand in the economy in relation to production capacity that is the decisive factor as to whether inflationary bottlenecks arise or not. Or, if we instead under-utilise production potential and therefore need to try to increase capacity utilisation. What determines whether there is a risk of overheating is the Swedish economy's capacity utilisation in relation to its potential.

I believe that one can say there is a type of inbuilt speed limit for the economy. It is difficult, as a rule, to know where this goes; moreover it changes over time. External events, the dynamics in industry and in particular economic policy can change the potential growth rate of the economy. In other words, it is possible to both raise and lower the speed limit, depending on what is happening in the economy. However, at a given point in time there is a limit that cannot be exceeded or gone below without damaging consequences. If growth exceeds the limit for a longer period, overheating and inflationary pressure will arise. If growth is too low, the opposite will apply, resulting in higher unemployment and poorer welfare than necessary.

Let us compare the Swedish economy with driving a car. The Riksbank's job is made easier if the car and the road allow some speed, without accidents occurring. The work done in other political areas to promote growth in trade and industry is therefore very important in enabling the Riksbank to maintain a low interest rate. The Riksbank cannot affect potential growth; our role is to create good conditions for other private and public operators. It is their work on structural reforms, better infrastructure, education, research, entrepreneurship, innovations, etc. that

improves the economy's long-term capacity to create growth and thereby welfare in the long term.

The decisive factor for monetary policy is the speed limit over a longer period of time. If we have low capacity utilisation from the start, we can temporarily have higher growth, i.e. accelerate until we have achieved the economy's cruising speed. One complication is the lack of clear signs stating the speed limit - in other words; there is always uncertainty over where the capacity ceiling lies - or how high the Swedish economy's potential growth rate is. At the Riksbank we have previously estimated this to be approximately 2-2.5 per cent. Today, when we conclude that the inflation tendencies in the Swedish economy appear to have been higher than we had previously realised, one of the possible explanations is that we may have over-estimated the Swedish economy's production capacity. The Inflation Report to be published in March, which will form the basis for our decision on the interest rate at our next monetary policy meeting, will provide an overall assessment of resource utilisation and inflation.

### **Economic progress in the 1990s**

In the seam between the 1980s and 1990s, we had a clear overheating of the Swedish economy, despite the fact that growth had been a modest 2 per cent a year during the 1980s. Over the past five years, the economy has grown by 3 per cent a year without the corresponding worries. Something has evidently changed for the better.

My opinion is that the reason is positive changes particularly in four areas important for growth: the macroeconomy, increased competition, trade and developments in technology. I shall briefly discuss these and then, in conclusion, say a few words about the challenges I see for the Swedish economy at present.

Economic policy has changed in different stages during the 1990s. Monetary policy has been aimed at maintaining price stability, which has given us lower interest rates and an increased stability and predictability, which is beneficial for the willingness to invest. Fiscal policy has also contributed through a consolidation of central government finances and the new budget system, which also gives us increased predictability.

Sweden's membership of the EU's common market and deregulation also mean that several markets that were previously monopolies and screened off from competition, have now been opened up to competition. These include financial services, transport, telecommunications and energy. The pressure on companies to use their resources efficiently has thereby increased.

The stiffer competitive pressure is both a result of increased internationalisation and of deregulation of various sub-sectors. The new competition act introduced in 1993 should also have contributed. However, despite the fact that it is several years since the new competition legislation was introduced, the development towards increased competition appears to be moving very slowly. One indication of this is that price levels in Sweden are higher than in many other countries, without this being completely explained by differences in VAT and wage levels. This applies, for instance, to foodstuffs and to the construction materials sector, areas characterised

by a high company concentration, significant entry barriers for new companies and weak competition from imports. Some of the limitation in import competition is due to norms, standards and regulations that are specific to Sweden. The Swedish market is too small for companies from other countries to find it profitable to manufacture products especially for us.

There may therefore be reason to consider how competition legislation may have greater effects in practice. Increased competition benefits the economy in two ways: by initially contributing indirectly to lower inflation and by stimulating efficiency and new ways of thinking.

I believe that one of the problems with the competition legislation may be that the incentives to follow the law are too weak. It is always individuals (company managers, owners) who prepare and make decisions on limiting competition against the provisions of the law, but there is little personal responsibility in the current legislation. Merely sentencing the companies to fines risks creating a situation where it is ultimately the consumers that have to pay a second time; first the cartels' higher prices and then the cost of the cartels' fines. In the USA, it is the responsible decision-makers that are penalised when breaches of the law come to light.

The Swedish Competition Authority expresses the opinion in its response to the report by the committee on combating cartels (SOU 2001:74) that the possibility of personal penal responsibility should be considered in Sweden. It makes comparisons with other economic crimes that lead to prison sentences.

Increased mobility for ideas, goods, services, work and capital during the 1990s, partly through our membership of the EU, has probably also had a positive effect on growth. Internationalisation and increased competition are particularly valuable for growth in a small country like Sweden, as they involve resources that would otherwise be used inefficiently instead being moved towards more efficient use in other sectors or companies.

Some years ago, there was a widespread hope in Sweden and in other countries that the "new economy" following the breakthrough of information technology would lead to a sustainable higher growth rate. It is possible that this still remains, in the USA there are calculations indicating that growth has been one percentage point higher because of IT than it would otherwise have been during the 1990s.<sup>1</sup> The setbacks experienced by telecommunications and IT recently should probably be seen mainly as an unavoidable sobering process for a sector that was too heavily inflated by expectations. The fact that the bubble burst does not change the situation that IT developments have in many ways lastingly changed the conditions for growth, particularly through more efficient flows of information, decentralised production in networks, etc.

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<sup>1</sup> According to Stephen Oliner and Daniel Sichel at the Federal Reserve in Washington, the productivity trend has increased by one percentage point during the second half of the 1990s. Half of this increase is a result of investments in IT.

In Sweden we have seen how total factor productivity, the part of productivity considered to reflect progress in technology and organisation, has risen more strongly than before, and much more strongly than in many other countries, during the 1990s. The high productivity figures in Sweden were partly connected to the rise in the telecommunications products industry, but a rise in total factor productivity has also been seen in other parts of Swedish trade and industry, mainly in the engineering and pharmaceuticals industries.

Despite the fact that the importance of IT is now being played down, the extensive use of computers, networks and the Internet in Sweden will make a positive contribution to productivity. Efficiency gains should arise, for instance, when tax authorities, social insurance systems, municipal services, etc. move over to Internet-based self-service. The connection between IT use and internationalisation of trade and industry appears particularly strong, with increasingly advanced networks of specialised sub-contractors. It appears that the countries which had good productivity growth during 1995-2000, such as the USA, Finland, Australia and Sweden, all had trade and industry that opened up to international exchange more quickly than other OECD countries, parallel with an increase in IT use.

### **Challenges**

The question is whether these improved conditions are enough to provide Sweden with stable, good growth over the next five to ten years. Can we trust that the problems of the 1970s, 1980s and 1990s are definitely over? Or are there other institutional or structural changes which the economy need to undergo? Some of the growth during the 1990s was probably a temporary effect of the economy making a recovery after having been so hard pressed at the beginning of the 1990s. This effect should have faded now, and it is therefore up to the labour force, technology and renewal to do the job of raising potential growth in the long term.

There are two main methods of increasing growth: firstly, that more people work or more people work more, secondly that productivity is improved. When, for instance, new technology or new organisations are introduced, production can be rationalised and productivity increases. If the content of production changes through a renewal in the direction of products and services that demand a higher value on the global market, the value of production rises. When this occurs without a corresponding increase in the number of hours worked, it leads to higher productivity.

During the 1970s and 1980s and a little way into the 1990s, Sweden lost considerable ground in terms of real growth compared with other countries in the OECD region. According to an SNS paper produced last year, if Sweden had a growth rate of one whole percentage point over the average among the richest countries, it would take 17 years for us to regain our place among the ten richest countries in the world.<sup>2</sup>

If growth is going to increase through more people working, part of the large percentage of the adult population that is absent from working life for various

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<sup>2</sup> Economics council report 2001: kluster.se. Sweden in the new geographical economy 2001.

reasons would have to work. Today approximately 800,000 full-time workers disappear from working life as a result of ill health<sup>3</sup>. At the end of 2001, it was estimated that the number of persons who had been on sick leave for longer than one year amounted to 120,000, which is almost three times the figure for 1997. The number of those on sick leave shorter than one year is also continuing to rise.<sup>4</sup> The problems are accentuated by the fact that the pensioner support ratio, which expresses the number of professionally active in relation to those retired due to ill-health or old age, is moving up from 2.1 in 2000 to 1.4 in 2030, according to Statistics Sweden's population forecasts.<sup>5</sup>

This means that if potential growth is to be sustained through more people working, more need to participate in working life in the higher age groups. Another method of raising potential growth would be to invest so heavily that the productivity of the labour force increased sufficiently to allow one worker to support one pensioner in the future.

### **Capacity for renewal**

To summarise, much has changed recently in the Swedish economy. The external framework is currently characterised by a substantial fiscal policy and monetary policy stability, which facilitates planning and decision-making for both households and companies. These fundamental conditions, together with a marked increase in openness to the world around us, give reason to believe in a continued favourable development in productivity.

At the same time, one should remember that many markets in Sweden still show clear signs of poor competition. This involves considerable costs. I believe that the Swedish economy has considerable unutilised potential for stronger development if we concentrate on this, i.e. how we shall increase the "speed limit" in the economy.

It is not enough to have good macroeconomic conditions; a policy for growth is concerned more with microeconomics than macroeconomics. It is a question of creating good incentives for individuals and people to behave in a rational social manner in their roles as economic agents. What is profitable and attractive behaviour for the individual should also be profitable for the whole.

This takes me into the field of politics, which is not part of the Riksbank's responsibilities. However, this is a field where I have been very involved in my previous career roles. I would therefore like to very briefly round off by saying something about what I personally believe could increase the long-term growth potential in Sweden.

I believe that the stimulance for increased growth capacity in the Swedish economy can be found in three main areas, which concern, firstly, efforts to

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<sup>3</sup> 800 000 full-time posts is calculated on approximately 400 000 early retirements plus total sick leave, including the qualification days and absence during the sick-pay period which when translated becomes approximately 400 000 full-time posts (Source: SOU 2002:5, An action plan for increased ill-health at work.)

<sup>4</sup> Source: SOU 2002:5, An action plan for increased ill health at work.

<sup>5</sup> Source: The National Social Insurance Board analyses 2002:3 "Older people's exit from the labour force - now and in the future."

promote entrepreneurship, i.e. more people choosing to start up companies and companies growing. The entrepreneurs' share of the work force in Sweden is low. Compared with other OECD countries, Sweden was ranked no. 19 in 2000.<sup>6</sup>

Secondly, we should invest more in knowledge and education, at all levels and for everyone. Research belongs here too, as does the link between research and new products - innovations. Education promotes both economic growth and individual welfare.

The third area can be called the renewal of working life. A good, rich society must make use of the productive force that all people have. To make this possible probably requires new thinking in many areas.

So, how about access to capital, this is surely decisive for growth? Certainly, but capital seeks to go where it will obtain the best return. Attractiveness, an ability to attract and retain investments, is created by entrepreneurs, research & development and competence. In an increasingly globalised market, regions and places compete with one another for investments. The most important factor in attracting investments is tied to people's capacity. The key to growth is human capacity and will.

This reasoning can be applied to small places such as Trosa municipality, but also to regions and countries such as Europe or Sweden. The EU competes with the USA; recently the USA has often been superior with regard to productivity, growth and inflow of capital. An important question for Europe is whether the common market, single currency and co-operation can achieve the same degree of dynamism as in the USA. And how to pursue a European welfare policy without losing competitiveness. Excessively deep social chasms, extensive crime and social maladjustment could become an internal threat to growth.

Even with good microeconomic conditions and a well-tended macropolicy, we will not be able to avoid fluctuations in economic activity; this is built into the way the economy functions. However, we can subdue the fluctuations through stability and predictability and above all, we can have a different development in welfare than we have had since the 1970s.

Thank you for listening!

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<sup>6</sup> OECD, DSTI/IND(2002)11: "Benchmarking: Fostering firm creation and entrepreneurship".