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Sound government finances and low inflation - the road to success!

Riksbank Governor Stefan Ingves today gave a speech at the Swedish Embassy in Helsinki on the theme of Finnish and Swedish economic policy. Mr Ingves did not discuss current monetary policy in his speech.

"At the beginning of the 1990s, both Sweden and Finland suffered a deep economic crisis. However, this difficult situation served as the starting point for the successful stabilisation policy regime changeovers that contributed to low inflation and sound public finances. These are important factors behind the favourable economic developments in Sweden and Finland in recent years," began Mr Ingves.

"The Finnish and Swedish economies have many common denominators, also with regard to the economic policy conducted prior to the crisis period. During the post-war period up to the 1980s monetary policy was conducted under the protection of regulated financial markets and with various forms of fixed exchange rate targets. However, the total economic policy was not compatible with the exchange rate commitments. This led to the stabilisation policy in both countries being characterised by devaluation cycles to manage the high inflation rate and recurring cost crises," said Mr Ingves.

"When the financial markets were then gradually deregulated during the 1980s, the conditions for both economic policy and the private sector were radically altered. The high inflation rate and the design of the tax regulations contributed during the latter part of the 1980s to very low real interest rates after tax, which in connection with the deregulation resulted in a large credit boom. The prevailing economic boom was reinforced by the rapid growth in lending that contributed to a rapid increase in asset prices, investment and consumption. Monetary policy was tied to defending the exchange rate and when fiscal policy was not sufficiently tightened, the economy overheated. High inflation and high costs pressures undermined competitiveness and the credibility of the fixed exchange rates," continued Mr Ingves.

"Economic activity turned at the beginning of the 1990s. When monetary policy in Germany was tightened following the reunification of former East and West

Germany, high real interest rates spread within Europe via the fixed Exchange Rate Mechanism, ERM. The situation intensified and speculation against several currencies, including the Finnish mark and the Swedish krona, contributed to Finland and Sweden letting their currencies float in the autumn of 1992, after a protracted defence. The rising real interest rates, which were partly due to the defence of the exchange rate, aggravated the domestic situation. GDP fell while unemployment and the budget deficit increased rapidly. Asset prices fell and both countries suffered bank crises," said Mr Ingves.

"The economic crisis contributed to the realisation in earnest that reforms were much needed. An economic policy that could break the trend of the 1970s and 1980s and would be compatible with the free movement of capital across national borders was required. Both in Finland and in Sweden, broad support had developed for a policy with price stability and sound public finances as a basis for more long-term stable economic development. Given this, the change in stabilisation policy regime could be implemented. Public finances were consolidated and clear regulations were established for fiscal policy, in Sweden these included the introduction of an expenditure ceiling and a surplus target. The central banks were given the explicit task of maintaining low and stable inflation, and were also given greater independence to give their policy more credibility," continued Mr Ingves.

"With regard to exchange rate policy, however, we chose different paths. While Sweden decided to allow the krona to continue to float, the Finnish mark joined ERM. Finland entered monetary union in 1999. This meant that we had different conditions under which to conduct our stabilisation policy. The Riksbank adjusts its policy rate on the basis of forecasts regarding Swedish inflation and economic developments as a whole. The European Central Bank, ECB, formulates its monetary policy on the basis of developments in the euro area as a whole and thus does not give special consideration to developments in individual member states. In the event of country-specific economic shocks, fiscal policy is therefore forced to shoulder a greater stabilisation policy burden in Finland than in Sweden," observed Mr Ingves.

"Despite the different exchange rate policy paths, economic developments have not in practice differed very much between our two countries. Our starting points at the beginning of the 1990s were fairly similar and we were forced to take roughly the same type of measures after the crisis. Finland and Sweden are two small, open economies and in the current globalised economy with free movement of capital, it is necessary to have a national stabilisation policy and sound public finances, regardless of whether or not the economy is part of a monetary union. I believe that one important lesson is that one needs a fully-functioning economic policy framework around the set targets in order for the policy to succeed," continued Mr Ingves.

"In my opinion, the stabilisation policy regimes Finland and Sweden have had since the mid-1990s have on the whole functioned well and been decisive in these countries' successes. Today we have much more stable economic conditions, with sound public finances, low inflation and a number of years of good growth and rapid productivity developments behind us. However, unemployment remains relatively high both in Finland and Sweden, although we are far from the record levels seen in the early 1990s. The long-term solution to this problem nevertheless lies largely outside of the control of central banks and stabilisation policy," concluded Mr Ingves.