Speech

Governor Urban Bäckström

THURSDAY, 15TH MAY 1997

The current situation for monetary policy

Opening remarks to the Standing Committee on Finance

May I express my thanks for being invited to the Committee's discussion of tendencies in the Swedish economy and the current situation for monetary policy. My opening remarks today mainly concern the following five topics ***(Fig. 1)***:

New patterns in the Swedish economy that may herald a functional improvement, with a permanently higher output potential and a lower inflation propensity.

The continued economic improvement during 1996; stock adjustments did curb total production for a time but final demand remained buoyant. Most indicators now point to a renewed acceleration of growth.

The sluggish recovery in employment despite the fact that total production has recouped the decline in the early 1990s and is now above the preceding high in 1990. This indicates that a good proportion of unemployment is not cyclical but structural.

The persistently higher bond rates compared with countries on the European continent and the weakening of the krona in recent months. This is a sign that a continued improvement is needed in the credibility of Sweden's general economic policy.

Telephone +46 8 787 00 00 | Telefax +46 8 21 05 31 | E-mail registratorn@riksbank.se

The Riksbank's perception that at present there is no need to change the repo rate. Last year's repo rate cuts, together with the development of the exchange rate, are supporting the economic recovery. The information that is currently available suggests that inflation is under control.

Better activity and low inflation

The total growth rate since the upturn in the summer of 1993 has been higher than we were accustomed to in the period of inflation in the 1970s and '80s. The expansion of industrial production has been the strongest since the 1960s. This has been accompanied by the lowest rate of inflation for decades.

The low inflation as such has probably helped the economy to function more efficiently. Growth and demand are perceived to be more lasting; together with clearer price signals, this makes it easier for households and firms to plan and make decisions. The tax reform, deregulations in various fields and adjustments to social security systems have also contributed to the functional improvement. Competitive pressure has grown as a result of EU membership and the globalisation of trade. The result is discernible in a higher rate of capital formation and structural adjustments. The product mix in foreign trade has acquired a larger element of advanced technology and inroads are being made in markets that are expanding rapidly.

In 1996 total final demand rose 2.2 per cent. The rate accelerated in the second half-year, to 3.6 per cent from the corresponding period a year earlier. The contributions from domestic demand and foreign trade were equally large, which means that the dual situation in recent years receded during 1996.

Total production, however, did not rise as strongly as total final demand because firms chose to trim stocks. GDP, which represents total output, grew only 1.1 per cent in 1996. The degree of resource utilisation therefore fell. Together with a downward movement in inflation expectations, this markedly improved the outlook for inflation in 1997 and 1998, which was the background to the Riksbank's reduction of the repo rate by almost 5 percentage points.

At the Committee's hearings last May and November I discussed the ongoing adjustment of stocks. Stock trimming in the current cyclical phase is not uncommon; it occurred at much the same juncture in the 1970s and '80s. It has to do with the tendency to produce in excess of demand when activity is rising so as to avoid being unable to deliver if demand grows rapidly. In time, firms find they have accumulated surplus stocks and initiate an adjustment. This has the reverse effect - production rises more slowly than final demand.

Under certain circumstances stock adjustments may trigger a more marked economic slowdown. This may happen, for instance, if the adjustments are sizeable and their effects either spread to private consumption or have a negative impact on the labour market and household confidence. The Riksbank was therefore alert to the risk of private consumption being weaker last spring and summer, which would have pointed to a further curb on inflation. In practice, however, private consumption went on rising in the summer and its growth became somewhat stronger in the autumn.

As the stock adjustments in the Swedish economy come to an end, demand will generate a renewed increase in production. Most signs suggest that growth is now well on the way to picking up.

The rate of inflation was subdued in the course of 1996 ***(Diagram 1)***. The initial position for the current upward phase in the Swedish economy is therefore more favourable than for many years. It should be noted, however, that the retardation of consumer price increases was appreciably accentuated by the Riksbank's repo rate cuts in that these contributed to the reduction of house mortgage interest costs. Clearly, monetary policy ought not to react when inflation moves temporarily downwards or upwards because the Riksbank adjusts its interest rates in either direction. That would be like a cat chasing its tail.

Under normal circumstances the tolerance interval around the price stability target should suffice to absorb transitory effects. Last year, however, the fall in interest rates was sizeable because many factors came into line. That interest rate fall is also largely responsible for the weak price trend to date in 1997. The technical changes announced by Statistics Sweden at the beginning of May do imply that the estimated reduction of house mortgage costs was exaggerated earlier but the revisions do not affect the Riksbank's analysis of underlying inflation.

Unemployment still high

Although the Swedish economy seems to be working better in many respects, this does not appear to be true of the labour market. Despite the generally favourable economic trend, the level of unemployment is still high and employment is virtually unchanged. A picture of what one can call the employment gap is presented in ***Diagram 2***. It will be seen that total production has recouped the fall in the early 1990s and is now above the preceding high in 1990. Yet the number of persons in employment is still very low - the lowest since 1974.

This suggests that a good deal of the unemployment is structural in the sense that unless the structure of the economy is adjusted, the level is liable to remain high even if activity improves. The estimation of structural unemployment is not a simple matter. In the latest report on Sweden the OECD, an independent observer, found that the level of structural unemployment is between 6 and 7 per cent of the labour force. Other economists have reached similar conclusions or possibly a somewhat lower level. Most of the evidence implies that structural unemployment has risen, though one cannot be certain of its exact level.

Unemployment that is structural cannot be reduced by traditional demand management, either with monetary or fiscal policy. In time an expansionary economic policy - aimed at generating demand in excess of the economy's sustainable output - would actually be liable to exacerbate the labour market situation. Inflation would accelerate and the economy would function less efficiently, leading to setbacks.

High unemployment is not confined to Sweden; it is leaving its mark on virtually the whole of the EU area. Moreover, the level of European unemployment has been high since most of the 1980s. In the United States, on the other hand, unemployment has fluctuated around 6 per cent for the past quarter-century without any upward trend.

The direct explanation for the difference between the EU area and the United States is the appreciably faster growth of employment over there. In the past quarter-century and more, employment in the United States has risen over 60 per cent as against under 15 per cent in the EU area.

Europe, however, does have some positive examples. One of the few countries here that has managed to turn the employment curve upwards from the mid 1980s is the Netherlands. After a long period of stagnation, employment in the Netherlands has risen since the mid 1980s by 25 per cent, while unemployment has been virtually halved, from 12 to just over 6 per cent.

It is important to note that, notwithstanding the marked differences in employment, GDP growth has not differed substantially between the United States, the EU area and the Netherlands ***(Diagram 3)***. So it is not higher demand generated by a more expansionary monetary and fiscal policy that can account for the creation of so many new jobs in the United States or, in the past decade, in the Netherlands.

The labour market, like the whole economy, is changing rapidly. The rate of technical innovation is high and manual work is being replaced by machines. The number of employees in manufacturing is falling or, at best, standing still in the industrialised world. A similar tendency has appeared recently in newly industrialised countries where progress has been good. There is also the growing competition from countries where wage levels are considerably lower. These developments make it highly important that the labour market and wage formation function properly.

A good development of real wages may be desirable in the long term but the fact remains that a low average increase in real wages appears to slow the tendency for existing jobs to disappear as well as stimulate the creation of new jobs.

While the average real wage in the United States has risen since 1970 by a total of 15 per cent, the increase in the EU area is as much as 60 per cent ***(Diagrams 4 and 5)***. The change in employment, as I just mentioned, has been the opposite: a 60 per cent increase in the United States as against 15 per cent in Europe. The slowing of real wage increases also seems to have been important, along with other changes, for the supply of new jobs in the Netherlands. In the United States a wider wage spread has contributed to a rapid increase in private services.

A particular problem in the European labour market is that increased unemployment does not seem to instil wage restraint. A conceivable explanation is that in practice, those who are out of work have a very limited say in wage negotiations. Instead of being restrained, with lower labour costs and the possibility of hiring additional labour, wage increases remain high and so does unemployment. There have been statements by representatives of labour market organisations which indicate that in Sweden, too, real wage increases are given priority over increased employment.

A weak employment trend and persistent unemployment are signs that the labour market is not working properly. This problem in turn stems above all from wage setting - because the central market mechanism is the formation of prices. Regardless of the causes of the high unemployment, the functioning of the labour market is a key factor for the possibility of turning this trend.

Room for enhancing confidence

Interest rate tendencies in recent years are presented in ***Diagram 6***. During 1996 the long bond rate fell 1.75 percentage points, which meant that the differential with German rates narrowed from 250 to 90 basis points. Money market rates fell even more, from almost 9 per cent to less than 4 per cent. This mainly reflected the Riksbank's reduction of the repo rate, which was lowered during 1996 to 4.1 per cent, the lowest instrumental rate since the early 1960s. In 1996 as a whole the exchange rate was virtually unchanged.

All this amounts to an appreciable easing of the monetary stance. The feasibility of such an interest rate reduction obviously presupposes that many pieces fell into place.

To date in 1997 the repo rate has not been changed but the krona has weakened by between 4 and 5 per cent ***(Diagram 7)***. This represents a further stimulation of economic activity. Considering the time lag before monetary policy exerts its full effect, it is probable that a good deal of the impact of the interest and exchange rate movements has still to materialise.

The weakening of the krona and the higher bond rate compared with Germany and other continental countries ***(Diagram 8)*** tell us something about the degree of confidence in economic policy in general. Viewed in a longer perspective, relationships in financial markets can serve as a measure of this confidence. There are signs that Swedish decision-makers must continue to convince various players in Sweden and abroad of the long-term determination and ability to conduct an economic policy aimed at stability.

Although government finance is developing in the right direction and may, if things go well, even generate some surplus in a few years time, fiscal policy must also be conducted in relation to the development of demand. An improvement in government finance that stems from favourable economic activity does not represent a potential for expansionary fiscal measures.

Considering the low inflation in recent years and the generally favourable inflation assessments that are being made for 1997 and 1998, it is understandable if my comments on this topic are perceived as premature. But economic policy in the next few years contains the seed for the economic harvest that will be reaped after the turn of the century. Experience has shown that a stable economic development with low inflation gives a better yield than stimulatory measures of economic policy in the wrong cyclical phase.

The future monetary stance

In the Riksbank's latest inflation report, published in March, it was estimated that GDP growth in 1997 and 1998 would be 2 and 3 per cent, respectively. It was considered, moreover, that no appreciable capacity restrictions should arise in these years. With an unchanged monetary stance and given that households and firms continue to count on inflation remaining low, underlying domestic inflation (the CPI change excluding transitory effects on inflation) one to two years ahead was judged to be between 1.5 and 2 per cent.

Economic developments to date seem to broadly confirm the picture that was presented in the latest inflation report. Various forward indicators suggest that the Swedish economy is again entering a period of increased growth. At the same time, most things point to price increases remaining low this year and next, which is the period we can assess at present.

The repo rate was lowered most recently last December. Since then we have frequently declared that the monetary stance is well balanced. This still applies. At present the Riksbank sees no need to alter the repo rate.