Speech

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The Swedish economy

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First of all I should like to thank Svenska Handelsbanken for the invitation to meet with you today here in New York. I arrived late yesterday from the 1998 Annual Meeting of the International Monetary Fund in Washington D.C. The discussions in Washington over the weekend focused on the current problems in the world economy. At the centre was of course the crises in emerging markets that began in Thailand last year, which spread to other economies in East Asia and Russia and which most recently have been pressuring economies in Latin America. Lately, we have also seen some contagion effects spreading to the industrial countries. Stockmarkets have been falling and there have also been some problems in connection with the Long-Term Capital hedge fund.

However, today I will talk about the Swedish economy. I shall be using a fairly broad brush to paint you a picture of how our economy has developed in recent years and I will conclude by saying a few words about the present situation in my country.

Positive trend in recent years

The Swedish economy is now entering its sixth consecutive year of favourable growth. The average annual GDP growth rate since the summer of 1993 is almost 3 per cent. This is an improvement compared to the average that has characterised our economy in the past twenty-five years. It has been accompanied by external surpluses that are larger than for many years, making it possible to repay foreign debt. Government finances, moreover, now show a surplus instead of the earlier

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deficits, which means that government debt is already being reduced in relation to GDP.

The latest figures show that prices in Sweden's economy are virtually stationary. The falling trend in market interest rates in recent years has been a major factor here in that it has reduced house mortgage interest expenditure and thereby *temporarily* exerted a downward effect on inflation. The underlying price trend is not, in fact, as low as the CPI figures might suggest but that does not alter the conclusion that in the years ahead, inflation will continue to be low.

If Sweden sticks to disciplined fiscal and monetary policies, together with other ways of enhancing economic policy's credibility, we have a real opportunity of reinstating the tradition of price stability that existed in Sweden prior to the 1970s and '80s. Let me give you a short historical background to our current economic policy strategy.

Tradition of price stability

In the period from 1830 to the late 1960s, the annual rate of inflation in Sweden averaged around 2 per cent. So if one disregards the 1970s and '80s, low inflation has been the norm for almost a century and a half. There are indeed grounds for saying that price stability is a long Swedish tradition.

The tradition of price stability did not obstruct the economy's development. This is shown by the fact that from the mid 19th century up to the late 1960s growth in Sweden was among the highest in the world. It is rather the case that the favourable outcome was promoted by low inflation and the stability this represents.

The decades immediately after World War Two were particularly notable for high growth, low inflation, external balance and an optimistic mood that resulted in the Swedish economy's successive expansion. That was a prosperous period with a good, stable economic trend, a rising standard of living and high employment.

After the collapse of the Bretton Woods system in the early 1970s it proved difficult to establish an equally robust fixed exchange rate regime. A firm anchor no longer existed for economic policy in general and wage formation in particular. Sweden experienced a series of devaluation cycles, with an expansionary fiscal policy, inefficient wage formation and growing structural problems. With the deregulation of the financial sector the problems became all too evident.

During the 1970s and '80s economic growth in Sweden became weaker than in other countries. But the economy still became overheated and this, together with an expansion of public sector activities, meant that unemployment was restrained *for the time being*.

The situation was of course unsustainable. An inflationary, speculative bubble cannot grow indefinitely; sooner or later it is bound to burst. There was also a limit to the public resources for financing employment.

New direction in economic policy

In the late 1980s there was a growing awareness that something would have to be done. The structural problems, high inflation and relatively low growth called for an economic policy realignment.

This realignment involved a variety of measures. The tax system was reformed and so were certain components of transfers. Sweden, moreover, applied for membership of the European Union. Sweden's currency was linked to the ecu and in the autumn of 1992, during the wave of currency speculation, the exchange rate was defended. Short term interest rates were raised to high levels. The idea was to demonstrate the determination to re-establish low inflation.

However, Sweden's economic policy realignment coincided with a profound economic crisis. Output fell around 5 per cent over a three-year period, open unemployment shot up to over 9 per cent and total unemployment to around 13 per cent, figures that had been completely unknown in modern Sweden. The government finances deteriorated sharply and budget deficit reached a high of more than 12 per cent of GDP, which was almost without precedent in the industrialised countries. In the middle of this crisis, moreover, virtually the whole of the banking system was threatening to collapse. In the light of the crisis in the East Asian economies, all this sounds very familiar.

Researchers will no doubt be studying whether this dramatic setback in the Swedish economy could have been managed differently. Some things could definitely have been arranged in another way both in the late 1980s and once the crisis was over us in the early '90s.

But the vital conclusion is, I believe, that the roots of the profound crisis stretched a long way into the past. An economic policy realignment was essential; a credible stability oriented policy had been lacking ever since the collapse of the Bretton Woods system in the early 1970s. It was high time to put this right.

Making the new regime credible

After the long period of high inflation, together with extensive economic problems and massive government deficits, the task of inspiring confidence in economic policy's new direction proved difficult at first. Economic agents listened to the new approach with doubts and hesitation.

As we know from other countries, however, creating confidence in a new regime with low inflation is a rather long process that takes time. Moreover, if the work of keeping inflation low and government finances in order is to be combined with low interest rates and stable growth, it is a task that never ends.

In recent years the low-inflation regime has gained increased credibility. Besides a disciplined monetary policy for price stability, a major contribution to this has come from the consolidation of government finances. In just a few years a budget deficit at 12 per cent of GDP has been turned into today's surplus.

In order to underscore its ambitions for public finances, the Government has a long-term objective: as the average level over a business cycle, government finances are to generate a surplus at 2 per cent of GDP. A surplus will make it possible to reduce public debt so that future challenges which the Swedish economy may encounter can be accepted without leading to problems for government finances.

Considering the public debt that has accumulated in the 1990s and the fact that government finances in Sweden are relatively sensitive to cyclical factors, I find this objective reasonable.

Besides the increased awareness of the importance of stable finances, the conditions for achieving Sweden's budget target have been improved by institutional changes in the budget process. Sweden now has a budget process that is inherently more disciplined and can thereby contribute to maintaining sound finances.

Further steps are being taken to consolidate economic policy's focus on stability. The independence which the Riksbank already has in practice is to have a formal legal status as of next year. The monetary policy objective of price stability will be enshrined in law and the Riksbank will be accountable for fulfilling it.

This new Riksbank legislation has already been approved once by the Riksdag (Sweden's parliament) and the final decision is due this autumn. The reform is backed by five political parties, whose combined representation in the newly elected Riksdag is over 80 per cent.

According to the timetable for the new legislation, the Riksdag's final decision will be made sometime in the middle of November. It will be followed by the appointment of the Riksbank's new Governing Board, which will consist of eleven Delegates. One of its major tasks will be to appoint the Riksbank's new Executive Board. This Board will consist of six full-time members who will direct the Riksbank and decide monetary policy as of January 1999.

The present situation

Sweden's monetary policy is conducted in a flexible exchange rate regime and has an explicit inflation target. We sometimes use the following simple rule of thumb to describe what governs our actions: if the overall assessment of inflation indicates that in one to two years time the rate of inflation will deviate from the 2 per cent target, then the repo rate should be adjusted accordingly. Our approach is symmetrical, which means that it is equally important to avoid undershooting the target, as it is to avoid overshooting it.

The Riksbank's appraisal of inflation up to the autumn of 2000 and the monetary policy conclusions that can be drawn from this are presented in the Inflation Report we published last week. In order to visualise the consequences for the future path of monetary policy, the report is based on the working assumption of an unchanged repo rate. As the Swedish krona is judged to be undervalued at present, we also assume that the exchange rate follows a path that represents a gradual appreciation.

The technical assumption of an unchanged repo rate and the presumed path for the exchange rate are then incorporated in the main scenario for inflation. As inflation's future course is not a straightforward matter, we also include assessments of uncertainties. The overall picture of inflation prospects amounts in practice to an estimate of probabilities.

The assessments in the *main scenario* imply favourable economic fundamentals: a growth rate between 2.5 and 3 per cent between 1998 and 2000, low inflation and a rising government surplus. Domestic demand in the main scenario is expected to generate a relatively limited increase in inflation's underlying rate, from 1.1 per cent at present to 1.6 per cent at the end of next year and 2 per cent in the autumn of 2000.

The 12-month change in CPI inflation is expected to be somewhat below the inflation target in one to two years time but the figure at the end of the period is judged to be approximately 2 per cent. All this means that at the end of the period under review, inflation is relatively well in line with the Riksbank's target.

It should be underscored, however, that the assessment of inflation prospects is more difficult than usual on account of the financial turbulence. This naturally reflects the international unrest but the political situation after the general election in Sweden has also left its mark on price setting, above all in the currency market.

Inflation prospects and the future path of monetary policy accordingly depend on two—contrary—factors: on the one hand, the international economic trend could be weaker than we have counted on and thereby lead to lower inflation; on the other, a sustained weak exchange rate that has no counterpart in a weaker real economy could generate increased inflationary pressure.

Our monetary policy conclusion is that we will go on analysing the course of events and appraise monetary policy continuously in the light of new information. Hopefully, the analysis in the Inflation Report should give an indication of our line of reasoning about the inflation outlook in Sweden and the future path of monetary policy that is as clear as possible in the global economy's present state of uncertainty.

The unsettled situation in international financial markets has meant that investors are shifting to currencies which are historically secure. As a result, other currencies, particularly those of smaller economies, have weakened. This tendency has been evident for the Swedish krona in recent weeks and very clear in the last few days. The recent path of the Swedish krona is not consistent with the development of our economy's fundamentals. Under these circumstances the Riksbank has chosen to use currency interventions to underscore that the movements in the krona's exchange rate have been unduly abrupt and exaggerated.