Speech

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The New Economy and the Long Boom

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It is no exaggeration to say that the prospects for Sweden's economy look much brighter today than when I spoke here in Linköping a year ago. At that time there was discussion of whether private consumption, which was then the main driving force behind demand, would be able to reverse the negative trend in the industrial sector. However, as it turned out, the financial turbulence in the global economy had limited real impact, and the turnaround in Asia came much earlier than expected. The lowering of interest rates by central banks probably contributed to the rapid recovery.

The international economic outlook is therefore much brighter today. There is great optimism in Sweden about the future, both in households and business, and domestic demand is expected to remain strong in the years to come. Employment is also increasing at a satisfactory pace and public finances are being consolidated.

Most observers, including the Riksbank, have substantially revised their forecasts for GDP growth for this year and for following years. As the economy has improved, expectations that inflation will rise have increased slightly, but they are still at a low level. The repo rate is currently 2.9 per cent and monetary policy is expansive, which may cause real GDP to increase faster than the economy can cope with in the long run. If this is allowed to continue for too

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long, different types of bottleneck problems and inflationary tendencies will emerge. Such a development must be prevented.

During earlier booms, in the 1970s and 80s, the brakes were often applied too late, as a result of which the growth in production and employment came to an abrupt halt. This must not be allowed to happen this time. The purpose of monetary policy is to adjust GDP growth to the long-term growth trend, thus promoting continued growth in employment and an unemployment rate that is as low as the structure of the economy will allow.

To sum up, the future for Sweden's economy looks rather bright, and it is the task of monetary policy to try to prolong this period of favourable economic development.

The "new economy" and the "long boom "

A common view, mainly inspired by the debate in the US is that this favourable development not only reflects a cyclical economic recovery, but is largely attributable to "the new economy". Definitions of the "new economy" vary, but most people seem to mean that for various reasons the growth potential of today's economy is higher than before. Among the reasons given for this are increased globalisation and the development and dissemination of information technology.

This is an interesting hypothesis, but it must be pointed out that it is difficult to prove whether, and, if so, how much growth potential has actually changed. This obviously restricts the room for manoeuvre in monetary policy to a certain extent. What we must do here is to strike a balance between not holding the economy back more than necessary while at the same time making sure that the credibility of our inflation target policy, which has taken so much effort to build up, is not lost.

However, there is another aspect of the American debate that has received much less attention than the "new economy", but that I think is at least as important, and that is the role that monetary policy is assumed to have played in the favourable developments of the last twenty years. There is much talk in the US about the "long boom", i.e. the period lasting from the early 80s to the present, which has been characterised by a high rate of growth, with only one rather mild recession in 1990-91.

(Diagram 1. The "long boom" (Growth in the USA, 1970-1998))

There are various theories about the reasons for this positive trend. However, it is often assumed that the monetary policy pursued by the American central bank ("the Fed") has played a decisive part. The Fed's policy during the last twenty years differ from the policy in the preceding period in their more active and determined use of monetary policy to keep inflation low and stable. As a result, it has been possible to avoid both the overheating and the recessions that often occur when an overheated economy suddenly comes to a halt. In other words, the Fed is credited with succeeding in making recessions fewer, smaller and shorter, mainly by ensuring that the economy does not become overheated. It is important to point out that the favourable trend in the US economy during the last twenty years is not, as you might gather from following the Swedish debate, due to the American central bank "leaning back" and basically letting the economy "take care of itself". Quite the contrary, in fact.

If we were to try to draw a lesson from all this that would be relevant to the Swedish context, it would mean that in future the Riksbank should try to avoid the great fluctuations in economic activity that were caused by the devaluation policy of the 70s and 80s. During those years there was a long succession of cost crises and exchange rates were adjusted so many times that in the end devaluations were virtually accepted as a fact of life.

Obviously, it is difficult to decide exactly how much interest rates should be increased in order to ensure that the present surge in the economy does not lead to overheating, particularly since the current monetary policy regime with declared inflation targets has never really been subjected to such a test. We simply do not have any experience to fall back on. However, most people, including the Executive Board of the Riksbank, agree that the current repo rate will have to be raised sooner or later, although opinions differ as to when and how much.

Whatever the Riksbank decides to do, the main lesson of the long boom in the USA remains valid: a long period of sound real economic growth is not necessarily the result of any exceptional external events, such as the emergence of a "new economy". It is just as likely to be the result of a carefully conceived monetary policy which applies an active and sometimes rather forceful policy to make sure that overheating – and subsequent deep recessions – are avoided. Naturally, a more detailed comparison between the USA and Sweden would have take into account other differences too, such as the functioning of the labour market.

The role of asset prices

I should like to devote the rest of my speech to another topical issue in the American debate, and that is the actual and potential role of asset prices in monetary policy. The debate in the USA focuses on the stock market, which many consider to have been overvalued for a long time, even if there has been a slight fall in the Dow Jones Index recently.

The main question at issue seems to be if, and in that case how, a central bank should act when certain asset prices rise very sharply. Alan Greenspan, Chairman of the Fed, has famously said that stock prices seem to the result of “irrational exuberance”.

Although the current discussion of the role of asset prices in monetary policy focuses mainly on the situation in the USA, I think this issue is relevant to the Swedish debate too. For one thing, it is a matter of general interest and of principle, and for another there is no guarantee that, sooner or later, Swedish asset markets will not experience a situation similar to that in the USA today.

(Diagram 2. Development of the US stock market)

How do fluctuations in asset prices affect the economy?

One question of crucial importance in this connection is how fluctuations in asset prices affect the real economy. There are several different factors involved here. One mechanism is the wealth effect, which means that households consume more since rising asset prices make them feel richer, and vice versa. Another factor – which many regard as at least as important – has to do with the interaction between the credit market and companies’ balance sheets. When asset prices rise, the value of the collateral that households and enterprises can provide when they borrow for consumption and investment rises too. Higher assets make it easier for them to borrow, or to borrow at lower cost, as a result of which aggregate demand increases. Large fluctuations in asset prices can have substantial effects on the real economy.

(Diagram 3. US saving ratio and household debt)

Why should a central bank worry about the development of asset prices? One obvious reason is that it is natural for a central bank with a declared inflation target to follow asset price trends since, as I just mentioned, they can affect aggregate demand in the economy. And changes in demand in turn ultimately affect inflation, as we all know.

However, the discussion in recent years has mainly focused on another reason why the central bank might want to keep an eye on asset price trends, and this is that the collapse of inflated asset markets can have a serious impact on the real economy and in some cases eventually threaten the stability of the financial system. Apart from protecting monetary value, which is perhaps their best-known function, it is also the task of central banks to promote financial stability, whether directly or indirectly. This is even suggested by the Swedish legislation, which lays down that the Riksbank shall seek to “promote a secure and effective payment system”.

Dramatic events following the collapse of asset markets are usually assumed to be triggered by the consequences in the credit market and company balance sheets. When asset prices rise more than economic fundamentals justify, a fall in prices is inevitable sooner or later. Such an adjustment can be very costly if financial institutions have widely accepted assets as collateral for loans during the period of rising asset prices. When there is a sudden sharp fall in prices, the value of the collateral diminishes. In such a process falling asset prices can cause losses to banks and other financial intermediaries and, if the worst comes to the worst, a full-scale financial crisis. These problems can, moreover, be exacerbated by exchange rate fluctuations. In the crisis in Southeast Asia, which is the most spectacular example of such a financial crisis in recent memory, the real value of foreign currency loans often rose when domestic currencies depreciated sharply.

This kind of dramatic event only occurs when asset prices rise higher than the levels justified by underlying economic factors. This kind of situation in an asset market is what is known as a bubble.

It might be worthwhile at this point to stop and reflect for a moment on the fundamental relationship between monetary policy and asset markets, on the one hand, and product and commodity markets on the other. The purpose of explicit inflation targeting policy that has been introduced in Sweden and many other countries in the last decade is to address recurrent overheating in product and labour markets. It might be said – even if it is strictly speaking not quite correct – that the aim is to avoid the “bubbles” that tend to appear in these markets from time to time. Generally speaking, inflation targets have hitherto proved their worth in this respect, and inflation targets appear today to constitute a credible basis – a nominal anchor – for price and wage formation. However, no corresponding anchor exists in asset markets. This means that there is nothing to prevent the prices of various assets rising to levels higher than those justified by economic fundamentals owing to psychological factors, or “irrational exuberance” if you like. The fact that low inflation is not sufficient to achieve a moderate price trend in asset markets is illustrated by the development of the American stock market in the last few years. Naturally, this represents something of a dilemma.

What should central banks do?

Does this mean, then, that monetary policy should, to a greater extent than hitherto, be used to take firm action in response to rapid price increases in asset markets? There is no easy answer to this question, but the predominant view nowadays is that the answer is no. Nevertheless, as a decision-maker I must keep my options open on this one. Situations may arise in the future that we cannot predict today in which monetary policy might have a role to play.

Perhaps the main reason why it is normally not advisable to try to influence asset prices is that it is extremely difficult, if not impossible, to be sure when a bubble has formed and when rising prices are due to improvements in underlying economic factors. The appropriate monetary policy must be determined by the fundamental causes of the rise in asset prices. Let us assume, for example, that a rise in share prices reflects better prospects of higher future corporate profits as a result of faster underlying growth in productivity. In that case, the rise in prices is the result of an improvement in fundamental economic factors, which means that it is based on "real", rather than psychological, causes. That being so, monetary tightening would not be a very good move and might in fact be counterproductive, since future inflation would probably actually be *lower* as a result of higher productive capacity in the economy due to the underlying growth in productivity.

Another reason why it is not usually a good idea to use monetary policy to take action against rises in asset prices is that even if you do succeed in identifying a bubble, it is probably very hard to burst it with such precision that you do not damage the financial markets and the rest of the economy in the process.

Therefore, the general view nowadays is that central banks should not try to use interest rate policy to control asset price trends by seeking to burst any bubbles that may form. The normal strategy is rather to seek, firmly and with the help of a great variety of instruments, to restore stability on the few occasions when asset markets collapse.

Inflation targets are an effective instrument

According to many observers, the kind of monetary policy regime with declared inflation targets that is applied in Sweden and other countries is a suitable instrument for dealing with the problems associated with fluctuating asset prices. One reason for this is that setting inflation targets means that monetary policy automatically has a stabilising effect in the event of instability in asset markets. Since asset prices, as I have already mentioned, affect aggregate demand in the economy, interest rates will be raised when asset prices rise and vice versa. Although we know from experience that there are no guarantees, this is likely for various reasons to have a stabilising effect on asset markets. For one thing, macroeconomic stability in itself has a stabilising effect on financial markets. For another, there is less likelihood of over-reaction, since participants in the financial markets will expect central banks to pursue a policy dictated by their inflation targets. Thirdly, lowering interest rates helps to mitigate the imbalances that may occur as a result of rapid falls in asset prices. In addition, a credible inflation target allows monetary policy more room for manoeuvre when it comes to preventing a financial crisis.

However, a monetary policy strategy that waits until the market collapses before responding to changes in asset prices may, at least hypothetically, pose a dilemma. The fact is that we still do not know very much about how the incentives of players in asset markets are affected by such “asymmetrical” action on the part of a central bank, i.e. being largely passive while asset prices are rising and then acting forcefully when they fall. Perhaps the devaluation policy that was pursued in Sweden in the 70s and 80s is a relevant parallel in this context. During that period expectations about the rate of inflation were determined by an economic policy which responded to excessive rises in prices and wages by devaluing the krona. According to one theory, similar mechanisms could emerge in response to an asymmetrical policy vis-à-vis asset prices. If central banks took action to stop asset prices falling below a certain level, the players in financial markets might attach less importance to a rigorous analysis of economic fundamentals. The strategy of waiting for bubbles to burst by themselves might then establish a climate that actually encouraged bubbles. This must of course be regarded as an unproven but interesting theory, and it certainly calls for a great deal more careful thought.

Conclusion

In my speech today I have dealt with some issues that at the moment are being debated particularly in the USA. This is not due to a special interest in developments in the USA but because the conditions under which monetary policy is pursued in the USA and Sweden are quite similar. Many of the problems and issues that are being addressed there are also of interest here, or may be so in the future. Therefore I feel that we have something to learn from them.

As I see it, one important lesson is that monetary policy, at least today, should take a greater interest in the “long boom” than the “new economy”. In other words, I think that it is a wiser basic strategy to concentrate on making sure that the economy does not overheat – which leads to recessions – than to count on large hypothetical improvements in future productivity which, if they do not materialise, will involve loss of credibility and a drastic slowing down of the economy similar to those we have so often witnessed in the last couple of decades.

I have also discussed various aspects of fluctuations in asset prices. One encouraging conclusion that I think we can draw in this connection is that the present monetary policy framework in Sweden, with built-in inflation targets, provides a reasonable basis for tackling any problems that may arise.