

Speech

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The economic situation in a monetary policy perspective

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First of all, I would like to thank you for the invitation to participate in your congress and for the opportunity to expound the Riksbank's views of the Swedish economy at the present time.

By way of introduction, I intend to discuss the role of monetary policy on a more general level and then to present the Riksbank's view of the economic situation and inflation prospects on the basis of the most recent Executive Board meeting, where we decided to leave the repo rate unchanged. I shall also describe the risk scenario and how we see developments beyond the forecast horizon. In conclusion, I shall briefly touch on an issue that I have personally been interested in for some time, namely the economic aspects of a potential Swedish membership of the Eurosystem.

The role of the Riksbank

Let me first clarify the Riksbank's tasks and explain how monetary policy decisions are taken, i.e. how monetary policy strategy is formulated.

The Riksbank has had a statutory duty to maintain price stability since 1 January 1999. We have chosen to put this in operational terms by means of setting an inflation target. This is defined by stipulating that the annual inflation rate, measured in terms of the consumer price index (CPI), should be two per cent with a tolerated deviation of plus/minus one percentage point. Monetary policy should

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thus be conducted to keep the purchasing power of the krona stable with regard to the basket of goods bought by an average Swedish household.

This means that when central wage agreements are signed, the average wage-earner should be able to be fairly sure of what a nominal wage increase will entail in terms of purchasing power. A predictable rate of inflation can also serve as a rudder when domestically-oriented companies set their prices. Low and stable inflation expectations reduce uncertainty concerning the real effects of borrowing and saving in krona for households and companies with their costs and income in Sweden. This means that the resources within the economy can be allocated in a better way than if the consumer prices vary. A monetary policy that is credibly aimed towards an inflation target can thereby create good conditions for growth.

Moreover, a monetary policy that is conducted with the aid of a symmetrical inflation target often has a counter-cyclical function. This means that it has a stimulating effect on the economy during a downturn in economic activity, as the inflation rate is normally low then, and vice versa. That, in a few words, is the philosophy behind the Riksbank's inflation target.

The Sveriges Riksbank Act also establishes that the Riksbank shall be autonomous, which means that we six members of the Executive Board, who make the decisions on the steering interest rates, may not seek or receive instructions from the government or parliament. The idea is that we are thus free to maintain price stability and will not be tempted to concentrate on short-term considerations when making our decisions.

It may appear that this target forces the Riksbank to give lower priority to the development of the real economy. We only have a target for monetary policy. However, the preparatory work on the Riksbank Act stated that we shall "without setting aside the price stability target, support the objectives of the general economic policy with the aim of achieving sustainable growth and a high level of employment". In any event, the assessments of the future path of the real economy play an important role in our decisions, as developments in economic activity are an important component in determining inflation.

However, what is even more important is that there is no contradiction between good growth and price stability in the long term, quite the contrary. If we look at developments during the 1990s, growth after 1992 was on average 3.0 per cent a year, despite the fact that inflation had been below the target level for several years. Unemployment had at the same time declined from 9 per cent to around 4 per cent. This can be compared with the 1970s and 1980s, when inflation was approximately 8 per cent and growth was on average 2 per cent. Contributing to this positive development was the fact that there was good access to free resources in the economy after the crisis years at the beginning of the 1990s.

An important part of the Riksbank's monetary policy strategy is clarity and openness with regard to the bases for monetary policy decisions. The purpose of this is to create support for the price stability target and understanding of what governs the interest rate decisions among the general public. This is also the reason why we Executive Board members often travel round making speeches. Openness and clarity on our part can contribute to stabilising inflation expectations in society and reduce the risk of unnecessary tension on the financial markets.

As monetary policy has an effect with some time lag, interest rate decisions are based on forecasts of price developments one to two years ahead. If the forecasts show a rate higher than the inflation target, the interest rate is raised, and vice versa. In other words, the instrumental rate is adjusted so that the total assessment of inflation 1-2 years ahead, taking into account the risk scenario, is in line with the target. The assessments are described in the Riksbank's Inflation Reports, which are issued 4 times a year.

As the economy is from time to time subject to unforeseen shocks, there will be deviations from the forecasts, even if the forecasts are well-founded. If, for instance, fruit-growers' harvests are affected by insects, the price of fruit will rise, if the water reservoirs are not filled, electricity prices could rise and if cattle in Europe suffer various diseases, the price of meat and some other foodstuffs will rise. If the Riksbank tried to make adjustments for this type of temporary price disturbance, it would probably lead to large swings in monetary policy and unnecessary fluctuations in demand and production.

It would therefore be wrong to give the impression that inflation will always be above two per cent. On the other hand, it is important that the Riksbank adapts the instrumental rate so that the inflation forecast one to two years ahead is in line with the target. This means that companies and households can rely on temporary deviations upwards or downwards being only temporary.

In retrospect and looking outwards

The attacks on the World Trade Center and the Pentagon on 11 September last year increased the uncertainty as to how the already weak global economic activity would develop. Even before then, signals of a more evident slowdown in industry and a poor development on the stock markets had caused the Riksbank to make a downward revision of its growth forecasts.

The risk was that the terrorist attacks would undermine confidence in future prospects among households and companies, which usually has a negative effect on demand. As inflationary pressure can vary according to demand and changes in the level of resource utilisation, the events caused the Riksbank and other central banks to decide to lower their instrumental rates shortly after the attacks.

Now that almost exactly nine months have passed, we can conclude that the impact on the global economy was less than feared, although some sectors, such as the airline industry, were hard hit.

Furthermore, we are seeing increasing signs that economic activity is improving both in the USA and Europe. One factor that often contributes to turnarounds in economic activity is companies' stockbuilding. When stocks are well-filled and sales decline, companies cut back on production so that it becomes even lower than demand. This destocking then pushes economic activity down to begin with. When the cutback in stocks gradually reaches an end, companies can increase production again without waiting for demand to increase. This gives increased strength to the upturn in activity. It is probable that this is the case right now; according to several indicators production has begun to increase and a certain amount of optimism is

beginning to spread. The total economic policy is expansionary in many countries, which provides additional fuel to the sequence of events.

The economic situation in the USA and Europe

This means that demand on Sweden's most important export markets is increasing. The turnaround has been particularly noticeable in the USA. There, both residential construction and household demand have been upheld during the economic slowdown by stimulation policy. In addition, strong productivity within US industry has contributed to improved profit margins.

However, the upturn in the USA is expected to be fairly modest, which is mainly because households are expected to increase their low level of savings. (*Diagram 1 – savings in the USA*). There is a large savings imbalance in the US economy. Sooner or later an adjustment is expected. The weakening of the dollar that we have seen recently may be an indication that the adjustment process has begun. The deficit on the current account amounted to 3.9 per cent last year. On top of this, households' wealth in the form of shares is expected to continue to develop weakly and the rapid price increases on property are expected to subside. The US labour market does not appear likely to improve before the end of the year, which will give a subdued development in real wages. (*Diagram 2 – unemployment in the USA, the euro area, Germany and France*).

At the same time, there is a risk that imbalances in savings in the USA will be adjusted more rapidly and more forcefully with the result that the US economy may lose speed. If the American household sector were to increase its savings and thereby reduce the debt burden more rapidly than is currently predicted, it could lead to a poorer development in consumption than expected and a stagnating economy. The factors that could trigger such a sequence of events include, for instance, US share prices continuing to fall or a decline in house prices. On the other hand, developments in the USA could be stronger and the positive spread effects to the surrounding world greater than we have estimated.

A large part of Sweden's exports is to the euro area and economic activity in these countries is therefore particularly important to us. The improved growth prospects in the USA will contribute to the recovery in Europe. However, a continued weak development on the European labour market and an unexpectedly high inflation rate will probably subdue the recovery somewhat. Germany, which is an important market for Swedish products, is still showing a very weak development.

According to some leading indicators, European companies have become more optimistic recently. However, profit margins have been pushed down by the fact that productivity has fallen and when productivity falls, labour unit costs rise, which in turn reduces the scope for investment. This could be an explanation for the recent high inflation rate in the euro area. When the level of economic activity rises and productivity increases, the inflation rate is expected to subside. In addition, the high inflation rate can be partly explained by "secondary" effects from earlier price increases on food and energy, and possibly by rounding-off effects on the introduction of euro banknotes. (*Diagram 3 – inflation in the euro area*)

Growth prospects are good for several important Swedish export markets in the rest of Europe. The level of activity in the Finnish economy is still poor, but will benefit, like the Swedish economy, from the global improvement in economic activity. In Denmark and Norway, private consumption will be stimulated by tax reductions. There are also signs of a turnaround in industrial activity in the UK, while private consumption continues to develop favourably.

However, there are also risks for developments in Europe: in the euro area the main cause of uncertainty is wage developments. High wage increases for metalworkers in Germany may spread to other sectors and then to other countries in the euro area. There is thus some possibility that the rate of wage increase and inflation in the euro area will be higher than in the main scenario depicted by the Riksbank.

The economic situation in Sweden

The Inflation Report that was published at the same time as our interest rate decision paints a mainly bright picture of the Swedish economy in the near future. The assessment is that the downturn in economic activity will be shallow and relatively short-lived. The recovery in global market growth, which for Swedish goods amounts to 2-3 per cent this year, will lead to an increase in Swedish exports. Over the next few years, this increase is expected to become 7-8 per cent a year.

At the same time, households' disposable incomes are improving, which contributes to increased consumption. This year they are expected to increase by almost 5 per cent, almost 80 per cent of which will come from increased transfers and reduced taxes and charges. An increase in income of this size has only occurred on a few occasions over the past decades. During 2003 and 2004 the increase is expected to be almost 3 per cent a year. It is primarily the strong development in disposable income that is expected to contribute to an increase in consumption over the coming years. Consumption of durable goods, such as fridges and TVs is expected to increase in particular. An expected recovery on the stock market (albeit modest) and a slight rise in property prices are other factors that will contribute to an increase in consumption in Sweden. Public consumption in Sweden is also expected to grow, by approximately 1 per cent a year.

As a whole, industrial activity in Sweden is showing several signs of improvement, although the upturn is still proceeding at a fairly slow pace. The recovery is fragmented. Base industries such as forestry and steel are in a period of recovery and the motor vehicle industry is also showing some improvement. The telecommunications product industry, on the other hand, has experienced a continued deterioration in demand. In mid-April Ericsson presented an interim report that painted a very gloomy picture of prospects for the near future and the company warned of redundancies. This development is a source of some concern and uncertainty. At the same time, the significance of one particular sector should not be over-emphasised; employment at Ericsson corresponded to approximately one per cent of the total number of employees in Sweden.

In recent times, the Swedish economy has been characterised by a clear division into two parts. Employment in manufacturing declined during the greater part of 2001 and this development has continued during spring 2002. On the other hand,

employment in the private services sector increased last year, although this rise has been subdued slightly during the spring. A generally weak demand in industry, combined with problems of a more structural nature in the information and telecom sector has led to considerable cutbacks in employment and vacant production capacity within these parts of the economy. At the same time, the expansionary economic policy has been a contributing factor in sustaining the demand for consumer goods and services.

This is the explanation for employment remaining at a high total level and even strengthening somewhat during 2001, despite the decline in economic activity. Developments during spring 2002 indicate a slight weakening on the labour market and although growth in the Swedish economy is expected to recover this year, the positive effect on unemployment will probably be delayed until next year. The number of job vacancies has increased during the first four months of the year, while the number of notices of redundancy has declined. However, unlike last year, many of the vacancies are temporary summer jobs. In addition, the number of persons being notified of redundancy could rise in the near future as a result of Ericsson's cutbacks.

A problem for the Swedish economy is that there will be a large increase in the percentage of very young and very old members of the population during 2003 and 2004, which limits the supply of labour. The labour supply is also affected by how the regulations on unemployment benefit, sickness insurance, etc. are formulated. The large number of employed persons who are absent from work as a result of sickness or other reasons also comprises a significant uncertainty factor. It is difficult to estimate to what extent these people could come back to work and boost production capacity. (*Diagram 4 – number of employed persons, excl. sick and other absentees*).

The public sector is expected to provide a positive contribution to growth in employment during the entire forecast period. While employment in industry is not expected to increase until the latter part of the forecast period.

During 2001 wages increased by 4.3 per cent, according to preliminary data. It is partly due to this high rate of wage increase that inflation has been above the Riksbank's target level during 2001-2002. The wages statistics that have been received so far this year indicate a continued high rate of wage increase, or approximately 4 per cent. The design of the central wage agreements and a slightly weaker labour market situation are some important factors in subduing the rate of wage increase. The weak growth in productivity during 2001 and falling profits can also have a subduing effect on wage developments. During 2003 and 2004 the labour market situation is expected to gradually improve, which could contribute to a larger wage drift. A large part (70 per cent) of wages is determined at a local level. At the same time, inflation is expected to be slightly lower, which should have a subduing effect on the wage agreements signed. On average, wages are expected to increase by 4.1 and 4.3 per cent respectively during 2003 and 2004.

Pricing and wage formation are influenced by inflation expectations among the different parties concerned, and therefore comprise an important part of the monetary policy analysis. Since March, households' inflation expectations have remained around 2.5 per cent for one year ahead and the National Institute of

Economic Research's latest economic barometer shows that companies' inflation expectations have remained more or less unchanged. (*Diagram 5 – Actual inflation (CPI) as well as households' and companies' inflation expectations*).

In April, inflation measured in terms of CPI amounted to 2.5 per cent. The effects of the disturbances in supply that temporarily contributed to higher prices on energy and certain foodstuffs last year have abated, which has contributed to a decline in the inflation rate. In the short term, inflation is expected to continue to decline as these temporary effects disappear from the inflation measure. (*Diagram 6 – Inflation. Outcome and main scenario*). The forecast for underlying inflation, measured as UND1X, is 1.9 per cent one year ahead and 2.0 per cent two years ahead.

However, the uncertainty in the inflation forecast has increased recently for several reasons. Between 2000 and 2001 GDP growth was subdued from 3.5 to 1.2 per cent, at the same time as inflation rose from 1.4 to 2.7 per cent on an annual average. One possible explanation for this unexpected development is that the production capacity of the economy increased at a slower rate last year. The production gap, which comprises the difference between actual and potential production, plays an important role in the Riksbank's assessment of inflation. The basic idea is that if the total demand in the economy exceeds the production capacity, it creates price pressure in the economy that can lead to inflation. Potential growth is thus the production level compatible with price stability.

Production capacity depends on factors such as labour supply, production technology, capital stock, as well as institutions and regulatory frameworks that affect the way the economy functions. These factors also affect the development of demand in the economy. The fact that a gap can arise between the actual and potential production could be due to prices and production factors being slow moving and to the fact that it takes time before production and demand have adapted to a change. As the economy is affected by different types of disturbances, the potential production capacity and the level of production vary over time. Disturbances can be temporary, such as a winter with little rain reducing the water level in reservoirs at the power stations, or more lasting – for instance, a new production technique can affect capital stock and industrial structure. Many of the disturbances that occur affect both the supply and the demand in the economy. According to some calculations, which were presented in the Inflation Report, production capacity during the slowdown could have declined from approximately 3 per cent at the beginning of 2000 to 1 per cent at the end of 2001. At the same time, it is important to emphasise that production capacity cannot be measured in a reliable and simple manner, which means that this type of calculation is characterised by uncertainty.

GDP growth in Sweden is estimated to amount to 1.5 per cent this year, 2.7 per cent in 2003 and 2.6 per cent in 2004. An important issue is whether production capacity will increase when the economy picks up. After all, it is the long-term production capacity that determines whether growth is compatible with low inflation and can thereby provide a sustainable positive development in income and welfare in the economy.

The most important factors with regard to developments in the near future are the labour supply and productivity. The labour force has increased considerably in recent years, mainly thanks to increased employment in trade and industry. At the same time, a reduction in the average working hours has had a counteractive effect. The decline in the average working hours over the past year is partly due to the economic downturn, as overtime has fallen. However, there also appear to be structural factors, such as a rising level of absence due to sickness and central agreements on shorter working hours, behind the decline. This indicates that the reduction in the labour supply could be at least partly of a more lasting nature.

The decline in productivity during 2001 was limited in comparison with the declines in 1977, 1980 and 1990. Greater openness towards the world around us, a higher level of education during the 1990s and certain improvements in competitive pressure indicate that productivity will continue to be higher than in the 1970s and 1980s. However, this also presupposes that productivity in the information and telecommunications sector will return to a good level.

There are also other risks: Inflation rose more than expected last spring, which was only partly due to price increases of a more temporary nature. The rest was primarily due to wage developments in the services industries. When employment begins to rise once again, while the labour market is strained, there is a risk that the new central wage agreements signed over the coming years will be affected by the fact that others have previously received high wage increases.

To summarise: Low inflation and consolidated central government finances have meant that there was room for manoeuvre to meet the economic downturn. Last year Sweden had one of the largest surpluses in public savings in the EU, which enabled an expansionary fiscal policy.

The slowdown in 2001 also differs from the problem periods during the 1970s and 1980s in that the manufacturing industry's competitive situation was very strong from the start. The weakening of the krona began as soon as one year before industrial activity slowed down and contributed to a strong development in net exports during 2001. Nor was it lack of competitiveness or a decline in productivity that lay behind the depreciation of the krona – it was financial flows resulting from the decline on the stock market and portfolio investments connected with the AP pension funds being given the opportunity to invest some assets abroad.

A recovery in the Swedish economy has now begun and the Swedish economy has a good foundation to stand on, with a surplus in both the central government finances and in Sweden's trade abroad. Inflation is on the way down. At the same time, wage formation and pricing behaviour in general will comprise an uncertainty factor when economic activity gradually picks up speed. It may therefore be necessary to implement further interest rate hikes in future. However, the next monetary policy stage depends, as always, on what happens with regard to economic activity, inflation and in the world around us.

Developments beyond the forecast horizon

The uncertainty in the forecasts increases the further ahead they look, but despite this it can be interesting to look beyond the two-year forecast horizon in the main scenario.

Economic developments during the past decade have been characterised by considerable free resources following the crisis at the end of the 1990s. That is not the case today, and will be even less the case in two years' time, if the economic upturn continues as expected. This changes the focus of economic policy. A decisive factor for economic growth will be the development of production capacity, as I have mentioned earlier. It is production capacity that governs the development in demand that is compatible with price stability. Here there are some worrying tendencies, which I have touched upon earlier. The labour supply in Sweden risks developing less favourably beyond the forecast horizon as a result of demographical changes. Shorter working hours would have the same effect. On the other hand, measures may be taken to increase the supply of labour and thereby affect developments in the opposite direction. This effect could be obtained by, for instance, lower absence due to sickness. It is clear that the way the labour market functions will play a decisive role for economic growth both in the coming two years and beyond the forecast horizon.

An important issue for Sweden in the near future is whether we shall take part in the third stage of EMU. This will be decided by the government and parliament, following a referendum on this question. The timetable for a decision will be determined by a political process. Statements by, for instance, Prime Minister Göran Persson indicate that a referendum will be held as early as next year. If the result were a "yes", parliament would decide to send in an application to the European Commission and the ECB to examine whether we meet the convergence criteria. In connection with making a decision on application, Sweden would probably also have to take a position on participation in ERM2. The government has said earlier that if Sweden is to take part in stage three of EMU, it would be logical to first tie the krona to this exchange rate mechanism. The economic criteria are the inflation rate, long-term interest rates, exchange rate stability and the budget balance and debt in the public sector. Following this scrutiny, the European Parliament and Council of Europe would give their opinion on the Commission's proposal and after this the ECOFIN Council would take a decision on whether Sweden could participate.

If Sweden were accepted as a member of the Eurosystem, there would be negotiations on when membership could occur and at what exchange rate the krona would be fixed against the euro. Parliament decided as early as 1997 that Sweden should keep the door open for future membership by creating the highest possible level of readiness for action, by means of technical and practical preparations. The Riksbank has therefore been working on internal EMU preparations for several years now.

What would the economic consequences of membership of the Eurosystem be for Sweden?

Swedish participation in stage three of EMU is essentially a political issue on which the Executive Board of the Riksbank has not taken a stand. On the other hand, earlier General Councils of the Riksbank have declared themselves in favour of EMU membership on two occasions, in 1994 and 1997.

So, what economic consequences would membership of the Eurosystem have for Sweden? One advantage, in my opinion, is the strength and stability entailed in belonging to a large currency area rather than a small one. Fluctuations in the value of the currency ought to decline, which would reduce uncertainty. The most evident economic effect of EMU membership would be the transaction gains as a result of the currency borders disappearing. These are the costs and the inconvenience of exchanging currency when one visits or trades with different countries in the euro area. Another concrete advantage is that the administration costs companies have been forced to bear to safeguard against undesirable fluctuations in exchange rates would disappear.

It is probably of greater significance for the economy that a single currency would promote competition to the advantage of consumers, who would meet lower prices and thereby have more money left in their purses. When all parties use the same currency unit, it is possible to make price comparisons between countries. Competition also facilitates the work on holding back inflation.

The EMU has particular importance for the scope of the trade. Many economists have tried to estimate this gain by looking at the way fixed and floating exchanges respectively affect trade, and they have found very little difference. However, a single currency is not the same as a fixed exchange rate. There are considerable practical and psychological differences. Professor Andrew K. Rose at Berkeley in the USA, together with some other economists, has instead compared trade within monetary unions with trade between countries outside of the monetary union, and made adjustments for facts such as monetary unions often sharing the same language, culture and other regulatory frameworks.

When Professor Rose presented such a study for Sweden some time ago, he claimed that EMU could increase trade and integration by as much as 30-50 per cent over the course of a few decades. This could lead to an increase in Swedish welfare of over ten per cent in the long term. Rose himself admits that the figures are uncertain and other economists believe in much lower figures for trade gains.

So what about the disadvantages? Giving up one's own currency entails also giving up some of the right to self-determination in economic policy. The instrumental rate would no longer be set in Stockholm, but in Frankfurt and would reflect the economic situation in a large monetary area.

The criticism of a Swedish membership of the Eurosystem has often concerned the possibility of being able to conduct an independent stabilisation policy under these circumstances. This is based on a supposition that the Swedish economy could for some reason become out of synch with the economic developments in the euro area, what is termed an asymmetric shock. An independent monetary policy and currency, in addition to fiscal policy, gives us the opportunity to stabilise our economy ourselves – a form of shock-absorber that will be lost if we have a joint monetary policy steered by inflation and economic prospects throughout the entire euro area.

This was the primary reason why the Calmfors Commission, which examined the consequences for Sweden of participation in the third stage of EMU, concluded that Sweden should wait before joining the Eurosystem until the Swedish labour

market and wage formation showed sufficient flexibility to be able to manage a serious shock.¹

It is often forgotten that one of the points of the EU is that the union shall function as an insurance; that the countries are strong standing together than they are standing alone. In practice, it is also the case that when the Swedish economy has come out of synch with the euro area, this has not been due to shocks over which we had no control, but to mistakes made in our own economic policy. There are also many indications that the covariance between Sweden and the euro area will increase further if we join the Eurosystem, as trade and integration with the euro countries would be strengthened.

Increased trade and greater openness to the outside world have positive effects on the development of growth and incomes. In my opinion, the European integration of which EMU forms a part should not stop at the borders of the EU, but be the first step towards greater global openness.

Conclusion

I have today accounted for the current monetary policy situation in Sweden and the assessments that formed the basis for our decision last week to leave the repo rate unchanged. A low inflation rate (2%), which is the target for monetary policy, does not in itself create good growth and welfare; it should rather be seen as a fundamental condition to ensure that other parties – trade and industry, organisations, government and parliament – are successful in working to improve Sweden's economy by various different means. In other words, it is an extensive and complicated interplay that will determine how well a country's economic potential is realised. The Riksbank does its best to ensure that monetary policy provides a contribution here.

Thank you for listening!

¹ EMU commission of enquiry report SOU 1996:158.