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Saving and inflation

Introduction

I would like to begin by thanking you for the invitation to come here and speak at the annual conference of the Vision Center for Futures Creation, Sparbanksstiftelsen Upland and FöreningsSparbanken.

In my speech today I shall discuss Sweden's stabilisation policy framework, its development, mainly over the past 30 years, but also the potential challenges posed to our current framework by an ageing population. In particular I shall speak at length about the role played by saving in this connection. Many of us have learned that it is always better to save than to spend. It's not quite that simple of course, but we can nevertheless conclude that we lived beyond our means during the 1970s and 1980s. Anyone who remembers the crisis years during the 1990s is well aware that we have paid a high price for this. New challenges await stabilisation policy, for instance in connection with our ageing population and a rising dependency burden in society. One important question is whether we are saving enough today to reduce the burden on future generations? Will the public sector be able to bear the dependency burden in the future? And does current private saving, both in terms of quantity and quality, take account of the future demands that will result from an increase in the proportion of senior citizens?

The deregulation of the financial markets, the changes in the tax system, together with the shift in stabilisation policy regime have radically altered and improved our ability to both save and allocate resources in an economically more efficient way. However, the imbalances that arose during the 1970s and 1980s led to substantial economic costs as a result of the adjustments that followed the necessary structural changes. It is only in recent years that the economy has been less marked by adjustment processes after these considerable structural shifts.

But the new stance of stabilisation policy has not yet been exposed to any real pressure. The adjustment towards low inflation during the 1990s occurred during a period of comparatively low resource utilisation and would of course have been much more difficult if resource utilisation instead had been high. One big challenge for the political system and for our low-inflation policy will be to successfully adapt to an increasingly ageing population in Sweden, a problem shared by many other countries in the rest of Europe, as well as Japan, for example. This demographic situation, whereby an increasingly smaller proportion of the population is of working age, makes it imperative for us to increase productivity sufficiently so as to avoid lower potential growth in the long term. An important task for the political system will be to take measures that lessen the pressures from our demographic situation in the time ahead. Without sufficient efforts, there may be a risk that the advances we have made with regard to maintaining price stability will be lost, thus resulting in unnecessarily high costs of adjusting to our demographic changes.

History is discouraging

History shows that the political system has previously tended to approach situations with less scope for consumption in a way that has given rise to higher inflation. The consequences of the inflationary stabilisation policies of the 1970s and 1980s have been discouraging and are still relatively fresh in our memories. Politicians have indeed often learned from previous mistakes, and periods of high inflation have been followed by periods in which economic policy has prioritised and attained price stability. However, the different systems that have been created to maintain such a trend have generally proved unsustainable after being exposed to particularly heavy demands. The economic policy framework or system could be likened to a corset. It holds up fine as long as you stay in trim, exercise regularly and watch what you eat. If you suspect that the corset could be stretched a little and give in to the temptation to skip your run, deciding instead to sit on the sofa and enjoy a bit too much good food over a longer period, well, then the corset will split.

The gold standard, which was abandoned temporarily during the First World War, was reintroduced in May 1925 after a period of high inflation in many countries. The system collapsed, however, at the beginning of the 1930s in conjunction with the Depression. One important factor was that the currencies during the reintroduction were fixed to gold at the exchange rates that applied before the War, in spite of considerable relative differences in inflation during the period of floating exchange rates. The undervaluation and overvaluation of the different currencies contributed to overheating in some countries and unemployment in others, and attempts to deal with the situation through fiscal and monetary measures failed. Another example is the Bretton Woods system, which had an anchor in the form of gold via the US dollar's fixed rate with gold, and was launched after the Second World War while the problems of the 1920s and 1930s were still relatively fresh in memory. This "corset" also split, partly as a result of US efforts to finance its budget deficit via the printing press. But the experiences of earlier years have tended to be forgotten, and when the economy has been exposed to new pressures the political system has opted for solutions that have given inflation the task of bringing about necessary reallocation and adjustments.

For individual citizens, it is very important to safeguard the value of money. High and variable price growth creates uncertainty about the future – both for households and firms. Unexpectedly high inflation erodes the purchasing power of savings. The economy as a whole functions less efficiently as price signals become less effective, leading in turn to poorer resource allocation. The fact that rulers before the establishment of democracy chose to finance wars via the printing press is not all that strange. The population indeed became poorer, but the king's reign continued. But even democratically elected governments have, also in times of peace, for long periods conducted a policy that resulted in high, fluctuating inflation. One such example is the Swedish "bridging policy" of the 1970s and 1980s. The reason of course is that it has been far too tempting to secure political gains by putting the economy into overdrive with a view to achieving short-term employment gains, and by introducing reforms with attendant increases in expenditure that the budget has not been able to finance. For Sweden, the mistakes of the 1970s and 1980s prompted a shift in stabilisation policy. We gradually achieved price stability and healthy government finances, and now have an expenditure ceiling and public-finance target for fiscal policy as well as credibility for the Riksbank's inflation target.

The demographic situation may prove a challenge for the political system.

As I mentioned earlier, one big challenge facing the political system stems from the labour supply and population structure over the coming decades. Two trends can roughly be discerned regarding the Swedish population. First, the number of children per family is decreasing. Second, we are living longer. Compared with approximately 100 years ago, the average life expectancy in Sweden today is around 20 years higher for men and almost 25 years higher for women. Developments have been rapid in the past 50 years, too. Between the years 1951-1960, the average life expectancy was about 70.9 for men and 74.1 for women compared with 77.7 years for men and 82.1 years for women in 2002. During the 1990s alone, the average life expectancy increased by over 1 year for women and by more than two years for men. Statistics Sweden's forecast of population growth up to 2050 shows an upward shift in the age structure with almost one in four citizens being 65 years or older by the middle of the century.

Sweden's current reallocation system was created during a period when a relatively large percentage of the population participated in the labour force and employment was high. In Sweden, a substantial proportion of pension outlays over the coming decades will continue to be financed through the public budgets. In order to withstand the strain of these higher outlays, the Government and Riksdag will have to ensure that the public sector curbs other expenditure and that there is growth in the tax bases. The target of a 2 per cent surplus in the public sector financial balance on average over a business cycle will alleviate public indebtedness as a percentage of GDP as well as the interest burden. The surplus is invested in the AP funds which increases the scope for future pension outlays as a percentage of GDP. If the tax bases are to grow, the labour supply and GDP growth will need to be sustained.

So if the Government is to be able to fulfil its pension obligations in the future, it is necessary that both the budgetary target is maintained and that growth continues, even if the burden could be eased by reforms such as a higher retirement age. But what can we conclude then about the need for private saving in coming years? Increased saving is likely to lead to lower real rates of interest and thereby higher investment. But in highly developed, international markets, saving will be channelled to investments that offer the highest real return regardless of their location. For an individual country, this could mean that expenditure on consumption and investment is lower than the income generated from output during a given period, and that the country runs a current account surplus. If the age composition of the world's countries is very different, it is probable that some of the saving in a country with an ageing population would be channelled to investments in countries with the opposite population trend, as the propensity to save is likely to be lower in a country where the average age of the population is falling.

This is perhaps an indication that Sweden and countries with a similar population structure may need a current account surplus during the years in which the propensity to save is rising, and that saving will be channelled to economies with an increasingly younger population. If so, current account surpluses, or our saving in other countries, entail that we could make use in the future of some of the production of other countries – probably emerging markets and the US - through a current account deficit.

Since the mid 1990s, we have had an annual current account surplus of around 4 per cent of GDP. Household and Government gross saving has partly been channelled into real investment in Sweden, but to a much higher degree into financial saving abroad. The question is what extent an unfavourable investment climate in Sweden has contributed to hampering investment in our country. A different but related question of course is whether households have based their consumption and saving decisions on reasonable assumptions about the future. Confidence in the Government's ability to meet its pension undertakings and commitments to care services, for example, plays an important role in this regard.

Reforms have led to more efficient resource allocation and created favourable conditions for growth

Although many questions remain regarding saving, it is clear that deregulation and the shift in stabilisation policy have contributed to more efficient saving decisions. The choice between consumption, saving and investment is influenced by a number of factors. History shows that market-economy solutions, where tax systems and other regulations do not guide resource allocation, create better conditions for growth and welfare. It is also generally true that predictability is good for investment. Price stability is of course an important factor here. Moreover, highly developed capital markets enable savers and investors to quickly come into contact at a low cost. Risks are also assessed and diversified there so that investors do not need to assume higher risk than necessary. The greater the risk of not getting back invested funds in addition to the real return required in order to postpone consumption, the larger the compensation investors demand to lend their money. This also applies to investors who have to tie up their money for a long period without being able to use it. Lower inflation expectations thereby reduce lenders' demands for compensation.

Until the mid 1980s, practically none of these growth conditions existed in Sweden. Before then both deposit and lending rates were set by the Government, and there were also limits to how much and for what purposes banks were allowed to grant credit. Moreover, foreign exchange controls restricted opportunities to save in and borrow from foreign banks or foreign securities markets. The respite for firms was that they could reinvest their profits. Nor were foreign investors free to purchase Swedish securities. Meanwhile, the tax system made it more favourable to borrow than save. During parts of the 1980s, the system of tax relief on interest meant that people in actual fact were being paid to borrow while it was costing them to save. And last but not least – high, fluctuating inflation made it risky to save as it was impossible to be sure about how the purchasing power of the saved funds would change. This restrained saving and also the willingness to invest.

During the 1980s and at the beginning of the 1990s, changes were implemented that radically improved conditions in the capital market. First, the credit market was deregulated; then the foreign exchange controls were dismantled and the tax system was changed. And last but not least came a shift in stabilisation policy that put the focus on clear frameworks and price stability.

As we know, the financial sector, the general public and public authorities were all unprepared for the effects of the changes that took place in the 1980s, even if lessons had been learned as regards the chronological order of the changes in other countries. Monetary policy was committed to defending the fixed exchange rate. Despite this, fiscal policy, which at the time had full responsibility for stabilisation policy, was not adequately tuned to dampen the overheated economy that resulted from credit deregulation. At the end of the 1980s and the beginning of the 1990s, unemployment was very low while inflation during the 1990s reached more than 10 per cent. Adding to the problems was the financial institutions' pursuit of market shares and the fact that prudential supervision was not sufficiently well developed.

The adjustment costs were high as we know, due to the build-up of very large imbalances over such a long period of time. We remember vividly both the banking crisis and the currency crisis at the beginning of the 1990s, as well as the slowdown that followed. Total unemployment was between 9-12 per cent in 1993, depending on which measurement is used.

In the aftermath of the crises, the negative experiences of the high-inflation economy resulted in a new framework for fiscal policy and a monetary policy targeted at maintaining price stability. Meanwhile, the banking crisis entailed that regulations, prudential supervision and crisis management have been enhanced so as to lessen the risk of new crises.

Since these substantial and economically costly adjustments, it now seems that a low-inflation economy has been established in earnest. Independence for the Riksbank and a statutory price-stability objective, as well as a public-finance target and expenditure ceiling for fiscal policy has contributed to this. Furthermore, the framework for both fiscal policy and monetary policy should guarantee more stable developments in the future. EU membership has also been important in this context. Thus, the likelihood that households will make economically efficient saving decisions should be much higher today than before. So deregulated, efficient capital markets ought to have contributed to a more efficient channelling of resources from an economic perspective.

Saving has been strongly influenced by structural changes

The structural changes in the Swedish economy over the past 20 years have been reflected very clearly in the financial saving of different sectors. As I today want to highlight the role of saving in the economy, I would like to look back on how saving has developed over the past 20-30 years.

In the long term, it is reasonable to assume that a country must adjust its expenditure to the income it receives for its production. As I mentioned, the age composition of the population may justify a surplus or deficit in the current account during a transition period, which sometimes also may be rather lengthy. The desire to maintain relatively even consumption over life means that people need to save during their working lives with a view to using their savings after retirement. One alternative to this is to undertake through paying taxes to support the elderly during the period in which we work in exchange for being supported ourselves when we retire. This would allow private saving to be lower. Problems arise with this system, however, if the age composition of the population varies considerably over time. This applies to Sweden, as we have an ageing population. During periods with a large proportion of senior citizens, the burden on the working population would become very heavy. In order to avoid this, each generation should save towards its own period of old age and ensure that saving is capitalised in an efficient way. This can be carried out either through private or state pension schemes.

However, the focus of stabilisation policy on short-term employment during the 1970s and 1980s was one of the factors that resulted in negative saving in the Swedish economy. During these years we consumed far too much in relation to our production capacity, which led to high inflation, repeated current account deficits and mounting foreign debt. This occurred in spite of the fact that our population structure required us to save in order to avoid a strenuous burden on future generations.

During the period of overheating at the end of the 1980s, financial saving in the private sector was sharply negative, both for firms and households. This indeed was compensated somewhat by a rise in public-sector saving due to the overheated economy, but not enough to avoid substantial current account deficits. The negative trend in financial saving was due in part to an increase in real investment, but during the second half of the 1980s investment was largely confined to commercial property, a sector characterised by overproduction during that period. Such investment did little to improve our chances of servicing our foreign debt or to create future consumption opportunities. Bad investment had also been made on a large scale at earlier stages due to market regulation, recurring devaluations and the structure of the tax system causing resources to be channelled in an economically inefficient way. In all, it can be said that we neither saved enough nor invested to ensure that our production capacity was improved as much as possible.

During the crisis years at the beginning of the 1990s, both households and firms increased their saving markedly. This was partly a result of the need for consolidation after the borrowing spiral, but also because of increased uncertainty about the future. At the same time, real post-tax rates of interest were very high, largely owing to the time it took to sweep away the traces of our poorly implemented stabilisation policy and to establish credibility for our low-inflation policy. In addition, high inflation expectations made it difficult to quickly cut interest rates despite the fact that low capacity utilisation was bringing down actual inflation. The high real rates of interest stimulated saving as well of course. A combination of very weak economic growth and a high interest burden for the Government brought about a dramatic deterioration in the Government finances during these years. The current account continued therefore to show a deficit during the first years of the 1990s in spite of a sharp upturn in private-sector saving.

The turning point came in the mid 1990s. International economic activity strengthened and the Government finances improved. This was partly due to the economic turnaround but also to the savings measures taken by the Government. The consolidation programme that was presented in 1994 and then implemented from1995 to 1998 strengthened the public sector financial balance by approximately SEK 125 billion. Subsequently, the budgetary process was also tightened and two overall targets were adopted for fiscal policy – a ceiling on Government expenditure and a surplus target for the public sector financial balance of 2 per cent on average over a business cycle. Together with the monetary policy stance, this helped lower inflation expectations and interest rates.

So private-sector saving was very high after the crisis years, and once the Government finances were consolidated the current account also started to show a surplus. Since the mid 1990s, there has been a stable surplus in the current account of around 4 per cent every year. It is true that the private sector has decreased its saving considerably, but it is still appreciably higher than at the end of the 1980s – a marginal deficit was reported only one year, 2001. The smaller surplus in the private-sector financial balance can partly be attributed to a rise in the investment ratio, although this has been very gentle. Households have had a positive financial balance throughout the period. At the same time as private-sector saving has fallen, that of the public sector has increased.

So, in all, saving in the Swedish economy has been positive in recent years. This means that we have foregone public and private consumption so as to generate income through net exports to pay the debt from our previous over-consumption. In other words, Sweden has reduced its foreign debt substantially since the beginning of the 1990s, and our net external position has improved. Statistics of Sweden's total net external position at the end of 2002 showed a net debt of SEK 553 billion, corresponding to 24 per cent of GDP, which can be compared with a net debt of 43.7 per cent in 1993. These developments have allowed the interest burden to be alleviated. This in turn means that a larger proportion of what we produce can be used for consumption in the future. But taking our age structure into account, the success we have had in halving our previous consumption debt is unlikely to be enough. We probably needed – and need – to store up more wealth when we had the chance.

Future challenges

As I mentioned earlier, history shows that there is a risk that stabilisation policy frameworks designed to promote price stability and stable demand will give way if the political system is faced with situations where opportunities for consumption are diminishing, and it thereby becomes tempting again to conduct an overly short-term policy since the right choices, when the situation is acute, are so difficult. Thankfully, the system does indeed appear robust at present, but it has not been put to any real test since the crisis in the 1990s. The fact that the age structure of the population is just as problematic in large parts of the EU means that the same risk exists for common international frameworks, including the Stability and Growth Pact. The EU's Economic Policy Committee published recently a study of how the demographic situation will affect the public finances of the EU countries. The study also included estimates of how the change in the population structure – including its impact on the labour market and capital intensity - will affect the EU's potential growth in the future. According to the estimates, the demographic effect will entail a decline in potential growth compared with the average in the 1990s to an average of 1.3 per cent during the period 2000-2050. All other things being equal, this implies that the scope for consumption would be reduced by almost one-third unless other actions are undertaken or enough saving abroad is available.

The desired consumption level could be attained through sales of investments in other countries. If we hold net wealth abroad, it means that we have a claim on future production there. When pensioners no longer contribute to production and this then proves insufficient to cover the desired level of consumption, the shortfall can, in somewhat simplified terms, be replaced by imports that are financed through sales of the equities and bonds we own abroad. When we start to use our savings abroad it will of course result in a current account deficit. This is hardly worth worrying about in itself since it will have been preceded in Sweden by several years of surplus.

If our saving in investments abroad does not suffice to maintain the desired level of consumption for Sweden with an ageing population, what alternatives are there for maintaining this consumption? On the one hand we have to ensure that we increase employment in the labour force and, on the other, raise productivity.

According to LU 1999/2000 (the Long-term survey), a public sector financial surplus averaging 2 per cent of GDP up to 2015 as well as annual average growth of 1.9 per cent during 1998-2015 will enable the Government to meet its commitments. Even if this in the light of different assessments of potential growth in the Swedish economy does not presently appear to be unrealistic, we can say that if it is to materialise, productivity in the private sector must continue to improve and compensate for the low contribution from the labour supply that will result from the unfavourable demographic shift. Against the background of the above, however, it is desirable that current policy be clearly targeted at creating the best possible conditions for growth.

Even if saving and productivity should prove high enough, we still face considerable adjustments in the production of goods and services as well as in the labour market. Demand will increase for care services. In such a case the labour market needs to be flexible enough to enable the movement of labour to these services without also giving rise to inflation.