Mr Bäckström asks the question “Is there a new economy?”

Speech given by Mr Urban Bäckström, Governor of Sveriges Riksbank and Chairman of the Board of Directors and President of the Bank for International Settlements, at a conference arranged by the Stockholm Chamber of Commerce and Veckans Affärer, held in Stockholm on 25 January 2000.

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First a word of thanks for the invitation to attend this conference and discuss matters to do with the question “Is there a new economy?”. Besides considering that issue, I shall be looking at other factors that may affect economic developments in Sweden, together with their implications for the future construction of monetary policy.

Monetary policy aims at promoting economic stability

The Riksbank’s primary concern is, as we all know, the future path of inflation. But our deliberations about how to keep inflation at a low and stable level can equally well be described as the Riksbank’s endeavour, with the aid of the repo rate, to ensure that the economic trend in Sweden continues to be favourable. This is because in most situations the task assigned us by the Riksdag (Sweden’s parliament) - “to maintain price stability” - amounts to acting so that the development of production and employment in Sweden is as stable as possible.

There have certainly been times when a tightening of Swedish monetary and fiscal policy has led to an economic downturn and increased unemployment. As a rule, however, this has happened when price and wage increases had already taken off and the economy was therefore well on the way to becoming overheated. This can be likened to a driver who has to slam on the brakes because the car is travelling too fast and heading for the ditch. In such a situation, braking heavily is the only remaining chance of avoiding a serious accident.

The best way of avoiding such a situation is continuously to adjust one’s speed - be it in a car or in economic activity - to the prevailing conditions.

The speed limits on our roads are regulated, of course, by laws enacted by the Riksdag and are also conditioned by the state of the road in question, the weather and other considerations. In the same way, the rate of economic growth is subject to economic laws and the prevailing conditions.

Driving schools teach us to keep an eye on the road well ahead so that we can adjust the car’s speed in good time. In that way, abrupt shifts can hopefully be avoided and, by continuously altering the car’s speed and direction, the journey will be safe and stable.

The same applies in monetary policy. By looking into the future, it is possible to adjust the repo rate so that a continued increase in production and employment is secured even if signs of a future increase in inflation are discerned. The view is not always clear and the forecasts may be slightly off the mark. On other occasions there may be an obstacle in the form of a disruption, such as the Asian crisis the other year. In both cases, monetary policy must be adjusted to the economic laws but also to the conditions that apply for the current phase of the journey.

What I mean is that interest rate hikes and cuts are a natural ingredient of a monetary policy for price stability - a policy that ultimately aims for a stable development of production and employment.

The favourable economic trend in Sweden in recent years is in fact a good illustration of price stability’s affinity with a stable expansion of output and jobs. Since the upturn after the crisis in the early-1990s, the annual GDP growth rate has averaged around 3%, the number in employment has risen by almost 150,000 persons and the rate of inflation has been more or less around the target. This has called for repo rate increases on some occasions and cuts on others.

Rapid GDP growth during 1999

So at what speed is the Swedish economy currently travelling? What are the speed limits? And what repo rate is appropriate for a safe journey?

According to the latest national accounts, published just before Christmas, the GDP growth rate for the first three quarters of 1999 was over 3.5%. It is still difficult to tell just what happened in the fourth quarter but demand growth seems, if anything, to have accelerated. An unusually active Christmas season appears to have resulted in a strong tendency for private consumption, for example. Leading indicators in this respect point to a continuation of the strong development.

Historically, a real GDP growth rate above 3.5% has not been sustainable for very long, at least in recent decades. It is rather the case that, for a safe and stable journey, the normal speed limit for economic growth has been about 2%.

That would mean that, if nothing is done, today's high growth rate will lead, sooner or later, to overheating and a rising rate of inflation. Before drawing this conclusion, however, we need to consider whether the historical record blinds us to what the future has in store.

Is there a new economy?

This brings us to the concept of a "new economy". This concept was first discussed in the United States when the paths of growth and inflation in the 1990s differed from the traditional pattern.

One explanation for this is said to be higher productivity growth, partly thanks to the new information technology. This has improved the workings of the economy's supply side. It follows that even demand can rise more rapidly without leading to bottlenecks in supply that generate higher inflation. Stronger demand stems in turn from expectations that better productivity growth will lead to increased corporate profits, which implies higher share prices, and the resultant increase in wealth results in higher private consumption. Thus, one of the central factors behind the notion of a break with earlier economic patterns is the development of productivity.

In the United States it does look as though productivity growth has improved in recent years. An important reason for this is the investment boom in the 1990s. Corporate investment has almost doubled since 1990 and a very large share has gone into new information technology. In that computer prices have fallen so much, in real terms the level of investment in information technology has risen by a factor of almost twelve. The productivity gains have sustained corporate profits and kept price increases down. The massive investment has resulted in what is known as capital deepening, which amounts to an increased capital input per employee. Many observers therefore consider that the US economy is now capable of expanding at an annual rate of as much as 3% to 3.5% without encountering shortages and an acceleration of inflation. In other words, the speed limit over there has been raised.

A similar change could well occur in other countries that utilise the new information technology's potential benefits. But as far as Sweden is concerned, it cannot yet be said that productivity growth has improved to the same extent. According to the statistics, the productivity trend for Sweden has moved up by around 0.5 percentage points in the 1990s compared with the 1980s. That is the background to the common estimate that over a longer period the Swedish economy can now sustain an average annual growth rate of between 2% and 2.5%.

There are certainly some encouraging signs in Sweden in the form of many new companies and young entrepreneurs in the new information technology. And people in Sweden rank high as Internet users. But this has not shown up in the macroeconomic statistics to such an extent that there would be grounds for supposing that the potential growth rate has moved up towards the US level.

A good indicator of whether conditions are in place for stronger productivity growth in the future is the existence of a sufficiently high rate of economic transformation, for instance in the form of increased investment and a rapidly growing capital stock. There are few signs of this in the Swedish economy, at least if one compares the 1990s with the 1980s.

Neither do other countries in Europe yet show any widespread signs of what is called the new economy. One reason may be that Europe is still in an earlier cyclical phase than the United States, so that investment in new directions has not yet taken off. Given this optimistic interpretation, it should be just a matter of time before the positive effects also materialise in Europe.

A more pessimistic reading could be that many European economies are instead less flexible and more beset by rigidities, not least in the labour market, so that they have more difficulty in implementing and subsequently benefiting from the new technology.

It might be argued that the high stock-market levels in some countries do represent an expectation of higher productivity growth. Stock-market assessments of individual companies are expressed in share quotations; the sum of these assessments and prices gives us an indication of what is expected of the stock market as a whole and this can be presumed to mirror how the total economy is expected to develop. And if current share prices are to be regarded as reasonable, there will clearly have to be an appreciable increase in future profits. This can then be interpreted as expectations of an overall increase in productivity and thus of a higher potential output. An alternative interpretation could be that the stock market is at least partially over-valued. A third possibility is, of course, that the development of share prices is explained by a combination of these two factors.

All in all, it seems that one cannot yet be sure that economic relationships in Sweden have changed to such an extent that a higher speed can be maintained continuously without risking an acceleration of inflation. While there are signs of effects on demand that might be explained in the same way as in the US economy, the supply-side effects via higher productivity growth are not yet as clear or as universal. It is conceivable that such effects on supply will materialise and the Riksbank must be alert to that possibility. But we cannot count on such hopes in advance, particularly as they have not yet left any mark on leading indicators, for instance in the form of rapidly rising investment.

What is the level of unutilised resources?

Another aspect of the speed limit to economic growth, at least in the short run, is the level of unutilised resources.

An important component here is the extent of unutilised labour. Experience shows that the stability of inflation has to do with the level of unemployment. If unemployment falls below a certain level, a stronger stimulation of production and employment (by means of a more expansionary economic policy, for example) simply leads to bottlenecks, shortages and rising inflation. Instead of a permanently higher level of employment, the end result is a return to higher unemployment.

This level of unemployment is not something that monetary policy can alter. It has to do with other factors, such as occupational and geographical mobility, the propensity to take the jobs that are available, and so on. Contributions in this field can be made with other components of economic policy but not, as I said, with monetary policy.

The problem we face is that unemployment’s critical level cannot be identified for certain and we do not know when shortages and rapid wage increases will actually arise. Estimating these matters is difficult and the results cannot be taken for granted. It is therefore hard to tell how much scope there is for a temporary phase of economic growth above the long-term trend.

The ability to look ahead and formulate monetary policy cautiously is particularly important when an economy is moving further and further along an upward phase. Otherwise there is a risk of price and wage increases accelerating so that the brakes have to be applied more abruptly later on, leading to a situation that is worse than would otherwise have been the case. Thus it is in this phase of rising activity that we can be said to influence the depth of the next slowdown. It was the overheating in the late-1960s, the mid-1970s and the end of the 1980s that set the stage for the subsequent deep troughs. And each recession was worse than its predecessor. Looking back, it is easy to see that economic policy ought to have been tightened much earlier than was the case on those occasions. At the same time, it has tended to be difficult, not least in fiscal policy, to take such measures sufficiently early, particularly as that needs to be done before the problems are clear to everyone. That is also why pre-emptive interest rate hikes not infrequently encounter criticism from some quarters. But a central bank has a job to do and must perform its statutory functions.

But neither, of course, should monetary policy unnecessarily obstruct a further reduction of unemployment if that is feasible and firms are actually able to recruit labour without encountering problems. This obviously entails complicated deliberations and assessments.

Unemployment in Sweden is still historically high. That might suggest that the labour market has plenty of unutilised resources at its disposal, in which case the Swedish economy may be able to grow, at least for a time, at a rate that is above its long-term speed limit.

Labour shortages to date have been most marked in the metropolitan regions and other university cities. The recruitment difficulties have mainly concerned technicians, computer specialists and construction workers. Although the proportion of firms reporting difficulties in filling their labour requirements did not rise last year, recruitment problems did grow in certain regions and they spread to additional occupations. Moreover, shortages of teachers and care personnel may arise in the future.

A pattern with a gradual accentuation of labour market shortages can normally be expected as an economy moves closer to its capacity ceiling. There may also be a growing propensity to resort to labour disputes, as well as pressure on firms to compromise on their labour requirements in order to keep up with demand for goods and services. Moreover, the negotiating position of those in employment becomes gradually stronger and this may affect the outcome of wage negotiations. There have already been some wage demands that represent growing tensions.

The Riksbank obviously has to keep a close eye on all this and take any steps that may be necessary in good time. And, as I said, the longer the upward phase lasts, the greater is the probability of coming close to the capacity ceiling, even though this cannot be identified exactly. Another question concerns the speed at which it is healthy for the economy to approach this ceiling.

Today’s repo rate cannot hold over a complete cycle

It follows that, over a complete business cycle, the monetary stance cannot remain as expansionary as it is at present. With a repo rate at the current low level of 3.25%, the economy would expand too rapidly and reach a point where overheating occurs, leading to shortages and rising rates of wage and price inflation. Our Executive Board expressed such ideas unanimously as recently as last month.

The economic advantage of looking ahead and raising the interest rate in good time is evident from what has happened in the US economy since the beginning of 1994. In February that year the Federal Reserve initiated interest rate increases and since then the rate has fluctuated between 4.5% and 6%, which are more normal levels. This succeeded in preventing - let me repeat, in preventing - an increase in inflation without causing the economy to enter a recession. On the contrary, the US economy will soon have achieved the longest upward phase in the post-war era; the earlier record is due to be broken next month. While monetary policy has not, of course, been solely responsible for this, the achievement does demonstrate that a judicious interest rate increase can definitely contribute to a good economic performance, provided the sustainability of growth is taken into account.

Neither should it be forgotten that in the past two years the Riksbank lowered the repo rate from 4.40% to 2.90% in connection with signs that economic activity would be checked by the Asian crisis, the suspension of Russian payments and problems connected with the American hedge fund Long-Term Capital Management. These obstacles are now out of the way.

Conclusion

On Thursday next week the Executive Board of the Riksbank will be having this year’s first monetary policy meeting. In the light of how we jointly consider that the economy will develop in the coming years, the six members of the Board will decide whether the repo rate is to be increased or held unchanged at 3.25% for somewhat longer. Today I have pointed to some of the factors I believe will be discussed at the Board meeting.

It will be a matter, as always, of basing the monetary policy decision on a comprehensive picture of the various indicators of economic activity and inflationary pressure that the Riksbank follows continuously. With the new Executive Board, it is also a matter of combining six individuals' personal perceptions of this picture and of policy's formulation into a joint picture and a joint interest rate decision.

There is no reason for me to anticipate matters. The result of our deliberations and joint assessment will be present on Friday next week.