

Urban Bäckström: The current situation for monetary policy

Speech by Mr Urban Bäckström, Governor of the Sveriges Riksbank and Chairman of the Board of Directors and President of the Bank for International Settlements, before the Standing Committee on Finance, Stockholm, on 10 October 2000.

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It is gratifying to be able to note, as on so many of my previous appearances here, that economic developments in Sweden are impressive. Having achieved a growth rate in the past six years that averages 3%, it seems that our economy is now expanding at an annual rate of around 3 to 4%. Employment has really taken off. To date this year the number of people in work is 70,000 higher than in the same period of 1999. I can also note, once again, that notwithstanding the rapid economic growth, the rate of inflation has remained moderate.

But these favourable developments do not mean that the Riksbank can sit back and relax. The path ahead contains a number of risks to which we must be alert.

What lies behind the favourable economic trend?

A basic factor behind the Swedish economy's favourable path is, in my opinion, the economic policy realignment that has been carried out in the past decade and a half. Credit and currency markets have been deregulated, the tax system has been reformed, components of the transfers system have been modified and competitive pressure has increased. All this has helped improve the workings of our economy. Then there is economic policy's commitment to stability, with price stability as a statutory objective, as well as a successful consolidation of the government finances.

In the inflation forecast we are presenting today, productivity growth is judged to be marginally higher than we foresaw in the June forecast. That in itself is a sign that the economy is functioning better.

The Riksbank's assessment of productivity has been revised gradually over the past few years. Higher productivity means that more can be produced with the same input of resources. So a lasting improvement raises the economy's potential long-term output. The higher productivity growth does not seem to be solely connected with the economy's upward phase. Whereas productivity growth in the period from 1974 to 1993, for example, averaged less than 1.5% a year, the average rate since 1994 has been almost 2%.

At the same time I want to underscore that there are not yet any clear signs of the kind of accelerating productivity growth which has occurred in the United States. One explanation for the discrepancy between our economies may lie in the different ways in which productivity is measured in the United States and in Europe. There are also some indications that productivity growth may accelerate in the future but they are still too uncertain to support any more far-reaching conclusions in the formation of monetary policy.

It is accordingly conceivable that the Swedish economy will move into a process with accelerating productivity growth but let us wait until that happens before incorporating it in our expectations and policy decisions. Our economy is developing favourably enough as it is.

A growth process driven by rising investment and productivity can result in good circles. To some extent, that can be said to have been the case in recent years. It accordingly helps to explain the favourable economic developments in Sweden. Another cause lies in the various deregulations that have been implemented.

Inflation this year improved by deregulation and competition

Thus, it is other positive supply side effects that have helped to achieve the rapid output growth without generating inflationary impulses. The effects have come from the deregulation of electricity and telecom markets, as well as from the EU's agricultural reform. Meanwhile, the temporarily lower rate of inflation has meant that real wage growth has exceeded expectations and thereby acted as a general demand stimulus.

On the whole, however, the effects are of the one-off kind that lower the price level and stimulate demand for just a limited period. But if these effects have a gradual impact on different segments of the economy, their overall impact on inflation may be spread over many years.

Another explanation for the favourable overall price trend is the generally stronger competition. It is now more difficult for firms to raise prices in order to improve profit margins, as usually happens at this stage in a business cycle. To some extent this may also be because firms know that price impulses from that quarter will inevitably cause the Riksbank to raise the instrumental rate. To achieve a reasonable return on capital, firms are obliged instead to make production more efficient. That tends to result in better productivity.

The increased oil prices can be cited correspondingly as an example of a negative supply shock. That is not an entirely adequate description, however, because to a certain extent, rising oil prices have to do with the better global activity, which normally leads to a general increase in commodity prices. The oil price increases tend to push prices up and curb output. But so far, the combined impact of all the supply shocks seems to be positive, that is, lower inflation and high demand growth.

Larger amount of unutilised resources

Yet another explanation for the moderate path of inflation could be that the amount of unutilised resources is larger than we - and many others - counted on earlier. Last autumn, for example, many observers believed, along with the Riksbank, that labour shortages would lead to increased price pressure via higher wages. But our fears have not yet been confirmed. Wage increases have been moderate even though the increase in employment is the highest for 40 years and unemployment has dropped to a level that few believed would be feasible after the profound crisis in the early 1990s. Moreover, the labour shortage figures in the Swedish economy have continued to be moderate.

More people have joined the labour market. Many of those who were full-time students earlier and thus not classified as participating in the labour force have now found work. The number of persons on labour market programmes has also fallen, thereby making a further contribution to the increased labour supply and helping to meet demand.

These are some signs that the extent of the unutilised resources has been somewhat larger than allowed for earlier. We have therefore gradually altered our appraisal of resource utilisation in the Swedish economy in recent years.

There are, accordingly, a number of factors that have contributed to such a good economic development in recent years. A combination of favourable circumstances has so far made it possible to combine high total demand with price stability.

But if the strong demand continues, sooner or later there will be labour shortage situations. Shortages of labour with certain qualifications already exist in some regions. As the labour market becomes increasingly tight and shortages arise more generally, the risk of accelerating wage and price increases will grow. Then, if not before, the repo rate will have to be raised.

The present assessment

Today the Riksbank is presenting a new economic assessment of the coming one to two years. The general features of the picture are the same as in our June report. Although the economy has moved further along the upward phase, we continue to believe in a main scenario that combines a strong

economic trend with no unduly alarming inflationary tendencies. It is important to note, however, that there are also a number of clear risks that we must keep an eye on in the future.

Monetary policy is currently formulated on the basis of an assessment of inflation excluding transitory effects from indirect taxes, subsidies and house mortgage interest expenditure (UND1X). In the main scenario in the Inflation Report, UND1X inflation with an unchanged repo rate of 3.75% is forecast to be 1.5% one year ahead and 1.9% after two years. When various alternative paths are taken into account - above all the risks of a higher oil price, a weaker exchange rate and more rapid wage increases - the rates of inflation are judged to be somewhat higher, namely 1.6% and 2.1%, respectively.

The inflation assessment starts from a continuation of strong international economic activity. Together with rising consumption and a favourable development of investment, this provides conditions for further rapid growth in Sweden, too. GDP growth in the main scenario is forecast to be 4% this year, 3.7% in 2001 and 3% in 2002. Compared with the June Report, only minor revisions have been made to GDP growth in Sweden up to 2002. Neither has the inflation forecast been altered more than marginally. That future inflation is not higher, even though the economic upswing is continuing and the forecast horizon has been shifted ahead, is partly a consequence of the amount of unutilised resources now being considered to be somewhat larger. Wage increases are judged to be somewhat lower, accompanied by marginally higher productivity growth. In the short run, however, inflation is expected to be somewhat higher than forecast in June, mainly because the oil price is higher and the exchange rate somewhat weaker.

While the oil price and exchange rate assessments have been revised in the light of developments in the summer and early autumn, the forecast of inflation one to two years ahead still counts on a successive appreciation of the krona and a gradual fall in the price of oil. However, the uncertainty is considerable. A higher oil price and a weaker exchange rate could lead to inflation rising more rapidly than assumed in the main scenario.

The assumption of a somewhat lower rate of wage increases is supported by, for example, wage outcomes to date this year as well as inflation expectations that are relatively low and stable. Still, there is considered to be some risk, albeit relatively small, of a development of wages that is considerably stronger, for example as a result of negotiators' demands for parity and compensation. Together with confidence in the low-inflation policy, the situation in the labour market and the coming wage negotiations will be of crucial importance for the future formation of monetary policy.

The present decision to leave the repo rate unchanged for yet another while is to be seen in the light of the assessment that for virtually the whole of the time horizon the Riksbank currently appraises, inflation is calculated to be below 2%. When various alternative paths are incorporated in the assessment, however, inflation two years ahead is marginally above the target. The picture of a strong upswing in the Swedish economy still holds, with rising resource utilisation in the labour market, for example. That suggests that the repo rate may need to be raised in the future.