

Urban Bäckström: The Swedish economy

Speech by Mr Urban Bäckström, Governor of Sveriges Riksbank and Chairman of the Board of Directors and President of the Bank for International Settlements, to the Swedish Shareholders Association, in Stockholm on 28 November 2000.

* * *

First a word of thanks for the invitation to talk to you this evening. My topic is the Swedish economy and monetary policy. Provided nothing unexpected occurs, in my opinion it will soon be time to raise the repo rate. It is, however, difficult to tell just when this will happen. The Board is made up of six members, each with their own opinion of what is the most appropriate monetary stance and a say in the final decision. But this evening I would like to elaborate on why I personally believe it will soon be time to raise the repo rate.

In order to put the present monetary policy situation in perspective, we need to look back some years into the past. During 1996, when confidence had been established in economic policy's overall commitment to price stability and the consolidation of the public finances had begun, the Riksbank was in a position to initiate a comparatively marked reduction of the repo rate. This had been preceded by a period with a tight monetary stance, when the repo rate had reached a high of almost 9%.

When the 2% inflation target was introduced, few observers believed at first that trend inflation would ultimately land up around 2%. We would do well to remember, however, that people's perceptions of the future are often shaped not so much by words as by actions. So, after a series of purposeful decisions by the Government, the Riksdag (Sweden's parliament) and the Riksbank, economic policy's general commitment to macroeconomic stability began to inspire confidence.

Economic policy's credibility gave the Riksbank greater freedom to act

The growing confidence accordingly meant in turn that, without jeopardising the objective of price stability, the Riksbank was able to lower the repo rate relatively markedly, from almost 9% to just over 4%. Interest rates for longer maturities also fell. This led, as we have all seen in recent years, not just to higher GDP growth but also to a more uniform development of demand in different sectors.

When the cyclical upswing began towards the end of 1993, most of the growth came from the export sector. However, lower levels of interest rates benefited Swedish households and firms by easing the heavily restrictive effect of the high level previously. This contributed to an increase in domestic demand as well and broadened the economic upswing. That can be said to have instigated the considerable reduction of unemployment we have seen in recent years.

Neither the Asian crisis in 1997 nor the turbulence in international financial markets in the autumn of 1998 had much of an impact, thanks not least to a monetary policy realignment in many countries. The Swedish repo rate was also cut, to a low of 2.90%. So despite these crises elsewhere, growth in Sweden remained stable at an average annual rate of 3 to 4%. When the unrest had subsided, the repo rate was raised to the current level of 3.75%.

The Riksbank has heralded a repo rate increase for some time

During the past year, Riksbank representatives have frequently said that sooner or later, a continuation of strong economic activity will make a further repo rate increase necessary. This is because an annual GDP growth rate of 3 to 4% is more than the economy can achieve without generating imbalances. Higher economic growth is, however, feasible for a time if there are unutilised resources in the economy. But when tensions arise between total demand and supply, various bottleneck problems are liable to result in price and wage increases that ultimately threaten price stability.

Perhaps the best illustration of this is to be found in the labour market. The increase in employment in recent years has exceeded what demographic factors are contributing to labour force growth by around 40,000 to 70,000 persons a year. Employment growth is in fact the strongest for several decades. Considering how high unemployment has been, this is welcome. But sooner or later, such a development means that firms will have difficulties in recruiting labour. Then, if not before, wage costs are liable to accelerate and push prices up. The issue of when this will happen does not have to do with either the actual level of unemployment or the number who were employed when activity last peaked in the late 1980s. It depends instead on how serious any bottleneck problems are becoming and how strong those with jobs consider their bargaining position to be in wage negotiations. Briefly, then, important factors in the assessment of the risks of inflationary tendencies are how well the labour market is functioning and how quickly resource utilisation is rising.

Monetary policy contributes to stability

In an upward cyclical phase, the move towards a situation where the tensions in markets for goods, services and labour threaten to gain the upper hand and jeopardise price stability is a gradual process. That makes it difficult to tell exactly when the imbalances constitute a genuine problem. Observers and those who decide economic policy have to assemble the pieces of this puzzle. In an economy that is approaching a strained situation in resource utilisation, signs that imbalances are beginning to build up will appear with increasing intensity and frequency. As more and more pieces of the puzzle fall into place, they ultimately provide a basis for action. The whole of this process is complicated by the time lag before monetary measures elicit effects. Our premise is that the full effect of an interest rate adjustment materialises after one to two years. So measures taken today would not have their full effect until some time during 2002.

Monetary policy therefore involves balancing the risks of acting too soon against those of acting too late. Acting prematurely is liable to lead to unemployment being higher than it need be. If the Riksbank acts too late, on the other hand, price and wage increases may already have got under way. In that case, the economy may ultimately land in a recession, perhaps with even higher unemployment.

Fortunately, it is not a question of either/or. A monetary policy adjustment can be decided gradually, with stepwise changes in the repo rate. Consequently it is always possible to compare forecasts with outcomes, assess the policy stance continuously and make the adjustments that are considered to be necessary.

If monetary policy is successful, a foundation is laid, not only for low, stable inflation in line with the target and the Riksbank's statutory objective, but also for a stable long-term growth of output and employment. Seen from this angle, low inflation, besides being our objective, is accordingly a means of trying to achieve a stable economic development in general. That is something which should be underscored.

Inflation prospects

In an analysis of the situation in the run up to the next Inflation Report, due to be published on 7 December, the following can be noted:

- The price trend to date is approximately in line with the forecast that was presented in the October Report.
- As expected, there have been signals that international economic activity is tending to become somewhat slacker. The pattern is clearest in the United States but even some slowing of growth in Europe seems likely in the coming years.
- In Sweden, too, there are indications that activity has become somewhat calmer. Both households and firms have become somewhat less optimistic about the future. Car purchases have fallen. Corporate order books are not being replenished quite as rapidly as before. In general, this is in line with what we foresaw in the October Report. But domestic economic

activity still seems to be rising rapidly, even when allowance is made for the signs of a slowdown. That needs to be underscored.

- Share prices, as we all know, have been volatile in the past six months but the fall to date is not a major cause for concern. Private consumption is being sustained in the first place by a strong development of income that stems from higher employment, a good increase in real wages and a fiscal stance that is less restrictive than before. It should be borne in mind that even including the fall that has occurred, aggregate stock-market wealth has grown very markedly in recent years.
- The present round of wage negotiations contains some elements of concern. In a sense, with a wage share that amounts to approximately two-thirds of the economy, that is inevitable when many settlements are being concluded simultaneously. For the path of the Swedish economy in the coming years, no other single factor is therefore anything like as important as the total wage trend. The picture of the negotiations that are now beginning is mixed and tensions do exist. Since the previous survey in September, all the interviewed groups' expectations of the annual wage rise have been revised upwards for all time horizons. Wage expectations are highest among the employee organisations. Moreover, the wage demands that have been presented are higher than before the previous round of negotiations. It is evidently becoming more difficult to find people with the appropriate competence for the jobs that are advertised. This presumably makes the risk of future wage drift greater than in previous years. All this could be a sign that we are approaching a situation where, bit by bit, aggregate wage costs in the Swedish economy start to accelerate, albeit from moderate levels.
- When it comes to judging inflationary pressure in the coming years, a central concept is total resource utilisation. The available amount of unutilised resources is crucial for the domestic generation of inflationary pressure, at least as long as inflation expectations are parked around our 2% target. In the coming years it is highly probable that, for the first time in a long while, our estimates of total resource utilisation - the output gap - will show that the gap has closed and the economy has reached or even moved above the capacity ceiling. This accordingly holds even if activity does move into a more subdued phase.
- The overall picture of inflation is also complicated by the krona having been weak recently instead of appreciating as we assumed in October. Moreover, the price of oil remains high. This may mean that the earlier tendency for import prices to counter what has otherwise been gradually growing domestic inflationary pressure may not apply to the same extent. In this respect, then, the outlook is more in line with the risk spectrum we outlined in the October Report than with our main scenario there.

The composite assessment of the various risks associated with wage formation, the exchange rate, the price of oil and the possibility of weaker activity is naturally a matter of judgement. In my opinion, however, inflation prospects in general are now somewhat more troublesome than before. There has clearly been a gradual increase in resource utilisation. The overall assessment of activity in the coming years implies that growth will continue to be above the level of 2.0 to 2.5% that the Riksbank considers to be sustainable in the longer run. That applies even if there is a slight slowdown in international activity. There are also the high price of oil, the weakening of the exchange rate and signs of some disturbing tendencies in wage formation.

To some extent, therefore, the situation for monetary policy has changed. That is also why I began by saying that the time will soon come to raise the repo rate. Not because I have dramatically revised my assessment of inflation prospects but rather because resource utilisation is still rising and a shift can be discerned in the risk spectrum. We will have to bear these things in mind so that the development of production and employment can remain stable.