

## Villy Bergström: The Riksbank's role in the economy

Speech by Mr Villy Bergström, Deputy Governor of the Sveriges Riksbank, to the Swedish Shareholders Association, Jönköping, 28 February 2001.

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Some time ago, the British journal *The Economist* wrote that the world's central banks were now at the height of their power. It is easy to get that impression when you see the enormous amount of interest devoted to the central banks in the daily press, the broadcasting media and economic journals. This applies to the Riksbank in Sweden, to the European Central Bank – the ECB – and, especially to the U.S. central bank, the Federal Reserve with Alan Greenspan in the foreground.

During the autumn electoral campaign in the United States, a number of newspapers put forward the view that it would not make any difference whether Al Gore or George Bush was elected as President - it was in any case Greenspan who was in control. When Greenspan surprisingly cut the American instrumental rate by 0.5% in January between two ordinary monetary policy meetings of the Federal Reserve's decision-making body, the decision was applauded with headlines such as "Greenspan saves the world again". This type of statement is simply ridiculous. The importance of monetary policy cannot be compared with the Government's general policies or with the office of President. However, things have gone so far that the central bank is regarded as a second government in many countries. These comparisons are, of course, unreasonable.

Central banks have one or sometimes two well-defined tasks, namely to maintain stable prices and often also to safeguard the stability of the financial system. For that purpose, the central banks have primarily one instrument, the instrumental rate, sometimes supplemented by other means of exercising control. The objectives for central bank activities are thus simple and clear, their arsenal of tools is limited. This cannot in any way be compared with the complex tasks of governments, their decision-making situations with conflicting goals and a continually changing agenda. In Sweden, a small part of the public policy has been removed from the Government and the Riksdag to the Riksbank by the Riksdag's own decision, namely responsibility for stable prices and financial stability. Everything else remains on the Government and Riksdag.

The tasks and policies of the central banks are thus not in any way comparable with government policy as regards importance and degree of complexity.

However – having said this – I should like to strongly emphasise the importance of there being a high level of confidence in the Riksbank. It can perhaps be said that the most important variable we have to comply with is the public's inflation expectations. After all, it is these expectations that reflect confidence. If disturbances affect the economy through, for instance, an oil price shock, so that inflation exceeds the Riksbank's target of 2 per cent, a return to the target can take place more quickly if public expectations remain at the 2 per cent target. Despite oil prices more than tripling from the beginning of 1999 to the end of last year, inflation expectations stayed at the Riksbank's target. If expectations also increase, monetary policy must be made considerably more stringent to expel inflationary expectations from the economy. From this point of view, it is important that monetary policy is reviewed and that a discussion takes place on the Riksbank's actions, although the importance of the bank should not be exaggerated.

Having said that to provide a perspective on the tasks we have at the Riksbank, I should like to move on to discuss the economic situation in Sweden.

### Favourable growth

During the past three years, GDP has increased in Sweden by an average a bit more than 3.5 per cent. The rate of growth is increasingly higher than what is possible in the long term. The Swedish economy has expanded approximately a half per cent more quickly per year than the euro area in the past four years, although over one per cent more slowly than in the United States during the same period.

Strong foreign trade has made a positive contribution to growth in Sweden for large parts of the 1990s and since 1994, the current account has been in surplus. The weak exchange rate for the krona throughout almost the whole of this period with a floating exchange rate, combined with the vigorous growth in the telecommunications sector have been the driving forces underlying the increase in exports.

However, it is first when private consumption has accelerated in recent years that GDP growth has increased so strongly that unemployment has also fallen. Many factors have led to households starting to consume: Cuts in public finances no longer burden household budgets – instead lower taxes have increased disposable income. Unemployment has fallen at the same time as real wages have risen markedly. Finally, household net wealth has increased due to increasing property and share prices up to summer last year. However, household's expectations about the future seem to play a crucial role for household's propensity to consume.

In the last few years, investments in the business sector have increased quite strongly in volume while it is only just recently that investments in housing construction have started to increase.

The strong growth we have seen in recent years is higher than that sustainable in the long term. The Riksbank makes the assessment that annual increases in production of 2- 2.5 per cent are possible in the long term. The amount that GDP can increase is determined by the increase in productivity and by how much employment can increase. The larger increase in production in recent years is primarily due to there being a lot of unused resources in the economy after the problem years in the early 90s, when there was a substantial drop in production. While the productivity of the business sector has increased, it has primarily been increased employment that has created scope for growth. If we compare with the high-inflation period – the 20 years from the mid-1970s, we can, however, see that we have had a faster increase in productivity in the past five years. We should not therefore rule out the possibility that we are on threshold of a faster growth in productivity when IT investments spread on a broad basis to the "old economy" in the same way as has happened in the United States.

The strong increase in productivity in recent years has taken place without inflation accelerating. This has surprised many people – for even though the previously high unemployment, indicated that there were a lot of unused resources in the economy, there were many who doubted whether it would be possible for so many to return to the labour market so quickly. Month after month, we have seen increases in employment of 80-90 000 persons on an annual basis, 70 per cent of which have taken place by an increased supply of labour. Flexibility in the labour market has thus exceeded expectations. Open unemployment is now down to around 4 per cent, which, while it is higher than that considered normal in the 1980s, is lower than what many people in the early 1990s feared would be normal.

### **Stable inflation expectations**

The stabilisation of inflation expectations at a low level shows that the Riksbank's inflation target has attained high credibility. A number of factors have contributed to confirming confidence in the price stability objective. High real wage increases despite moderate nominal pay increases are one factor that has undoubtedly increased the support of wage earners for the price stability objective. The fact that the price stability objective has been confirmed by law has also probably contributed to confirming confidence in the inflation target.

However, the Riksbank has a pedagogical and practical problem. Monetary policy decisions are based on assessments of inflation a couple of years ahead and are focused on achieving the inflation target during that period. This means that we can often be compelled to increase the interest rate despite the actual rate of inflation at the time being under the target. In December last year, for instance, the Riksbank increased interest by 25 points despite inflation then being at 1.4 per cent. Decisions are then made on the basis of forecasts over a two-year horizon.

The most important reason for not waiting until inflation actually exceeds the target is that inflation expectations would then risk accelerating since it takes up to two years before monetary policy has its full effect. And then we may – to rein in inflationary expectations again – be compelled to tighten up the economy more than we would have to have done if we had reacted earlier.

The Riksbank's way of conducting monetary policy obviously plays an important role with regard to maintaining confidence in price stability. However, we should not forget that fiscal policy also has to be conducted in a way compatible with the price stability target. The budget consolidation, the

Government's expenditure ceiling and balance targets have strongly contributed to achieving credibility in the price stability objective. It was first when the budget consolidation in the mid-1990s had come quite a long way and optimism on the Swedish economy began to return that inflation expectations showed that the price stability objective had attained credibility. The Riksbank did not then need to counteract high inflation expectations by monetary policy.

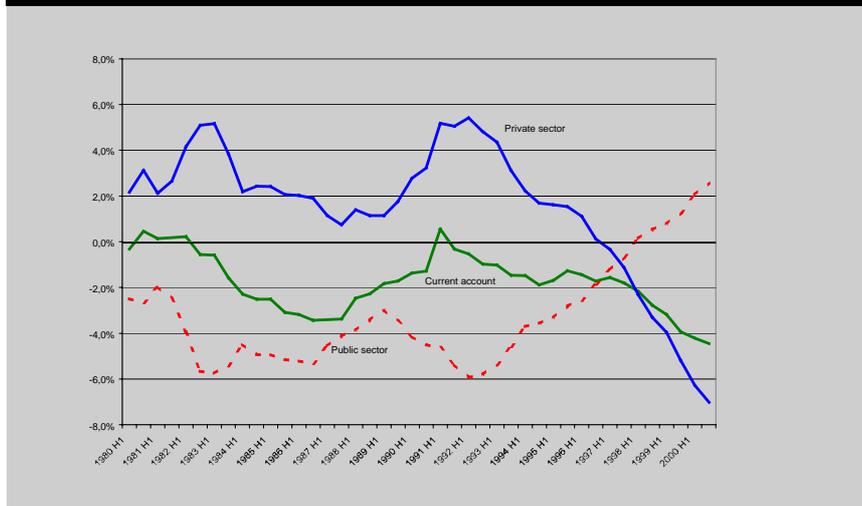
### **The United States important for future growth**

Inflation has not just been kept down by the fact that there have been a lot of unused resources until now and that inflation expectations have stabilised at a low level – we have also been aided the pressure on prices from deregulations and increased competition. However, it is no longer probable that this process will pull down inflation to the same extent in future.

Some dampening of the rate of growth in coming years is therefore probably necessary if we are to avoid tendencies to overheating. This dampening can be achieved either by a more stringent monetary policy or by the economy dampening by itself. It now looks as if a slackening of the cycle is on its way led by developments in the United States. However, the strength and duration of this downturn is uncertain and depends among other things on future cyclical development in the United States and the effect that this has in Europe and Sweden.

After many years of exceptional growth, a rapid cooling off is now taking place in the American economy. The indicators that have been received in recent months have mainly led to successively downward adjustments of future GDP growth in the United States by most forecasters. What argues in favour of a brief downturn is the fact that the effects of the IT development in spreading to the rest of the economy can hardly be regarded as exhausted. Investments in the American economy have been of a record size and a lot of these investments have been related in fact to IT investments. Depreciation periods are also short there, which in itself reduces the risk for locking-in effects in large mistaken investments. However, it can also be noted that both households and companies have a high level of debt. They have invested and consumed more than they have produced during the period in question and the current account has therefore been in substantial deficit for a number of years. (See Diagram 1). The savings deficit indicates high indebtedness in both households and businesses. If optimism about the future were to be replaced by considerable uncertainty, the high indebtedness would per se reinforce the cyclical downturn and make it more prolonged. Uncertainty about the future can lead to businesses and households restraining demand in order to consolidate.

## Financial savings in different sectors in US, per cent of GDP



The earlier optimism about the American economy also made it attractive to invest in American assets. This resulted in the dollar appreciating greatly despite the large deficit in the current account - the strong demand for investments in American companies and shares resulted in the effects from the current account deficit being counteracted. When optimism has reduced in the past six months, interest in American investments has also been reduced and the dollar has weakened.

Although there is fundamentally a lot to indicate that the American economy will continue to be able to grow for a period to come at a historically high rate, there is also an evident risk that there will first be a fairly strong downturn. There is also a risk that uncertainty about the future will drastically reduce households' consumption and increase their low saving, that investments will drop and that the dollar will clearly weaken because other countries are no longer willing to finance the gigantic current account deficits.

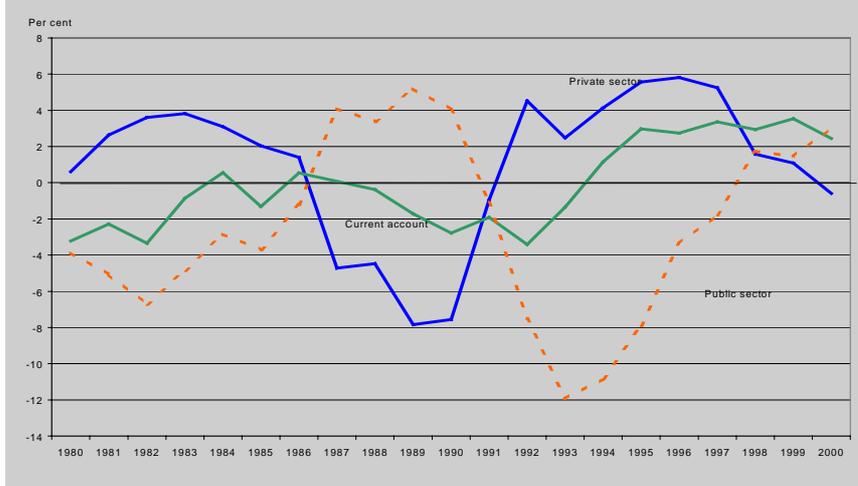
The dollar could then drop considerably in value and there would be a risk of considerably poorer growth. The current account deficit is large – almost 5 % of GDP – and particularly large in relation to the United State's limited foreign trade. In my opinion, American analysts who in general have a very optimistic view of a very short downturn underrate these risks.

What effect will the American economy have on the Swedish economy? The question is also what effect developments in the American economy will have. If you look just at the effects on trade flows, the effect on Europe and Sweden is not so strong. Exports to the United States only account for a bit more than 2 per cent of our GDP and the American market has about the same importance for the euro area. In addition, we are affected by demand for Swedish goods from other countries reducing when their export to the United States drops. Moreover, some international companies with activities in the United States can affect household wealth in Europe as well through share prices –this applies not least to Sweden. Our "Swedish" companies are very international (Ericsson, Electrolux, Stora-Enso, Volvo, Atlas Copco, Skanska) at the same time as a large part of Swedish households' shareholding is invested there.

### What conclusions should we draw then for the Swedish economy?

I would like to begin by reminding that the Swedish economy is better equipped than for a very long time as regards the underlying climate for growth. We have sound and stable public finances. We have paid off our foreign debt after a number of years with a current account surplus. Inflation expectations are stable and unemployment has been considerably reduced (see Diagram 2). Deregulations have also led to increased competition in many areas. The labour market also seems to operate more flexibly than before.

## Financial savings in different sectors in Sweden, per cent of GDP



And it is considered that there is considerable potential for growth with regard to making use of IT development. This is perhaps more true for Sweden than for the US economy. In the IT sphere, Sweden is a long way forward although to date development has not affected productivity in the whole of the business sector to the same extent as in the United States. Neither have we seen such a strong growth in investment as in the United States. It will be a while before the new technology is implemented and used to the full although it will be first then that major benefits for the whole economy can be expected.

Many have pointed out that development in the Swedish economy in recent years has resembled that in the United States although with a time lag. A difference in the assessment of the impact a cyclical downturn can have is that Swedish households and companies overall are not indebted to the same extent as their American counterparts have been in recent years. This is reflected among other things in our having had a balance of trade surplus ever since the mid-1990s. The current account in the United States has on the contrary been negative throughout the 1990s and it has been the private sector's savings deficit that has increased and now totals over 6 per cent of GDP. Swedish households and businesses have instead had a savings surplus for large parts of the 1990s and it is first recently that a deficit has been noted.

There are also many other factors that are positive for the Swedish economy in the short term: tax reductions keep household disposable income up and the real hourly wage increases are high. Another factor that counteracts a cyclical downturn is that housing investment is on the increase and will not be affected in the short term by a dampening of the cycle. It also seems as if the expansion of broadband is taking place in an appropriate cyclical situation if the plans are fulfilled. These investments are also spread throughout the country.

However, there is also a risk that uncertainty about the future of the Swedish economy will result in households reducing consumption. At present, household's financial savings are insignificant. In this respect, the situation is similar to the United States although the problems there are more serious.

Uncertainty about the development of the krona remains great, however. There is general agreement that the krona is fundamentally undervalued – this has contributed to creating the surplus in the current account that has reduced our foreign debt in recent years. When the foreign debt starts to reach levels that are more sustainable in the long run, the krona should be strengthened. There is thus no reason to depart from the Riksbank's assessment that the krona will appreciate in the long term. However, asset prices and exchange rates are sensitive to changes in expectations. And just now it seems that the krona is being weakened by the focus on the foreign exchange market on the expected capital outflows, which will be the result of pension funds being invested abroad. Reduced interest in purchasing Swedish shares is considered by others to be the explanation why the krona is so weak

just now. During the years with a floating exchange rate, we have noted short-term fluctuations in the exchange rate do not seem to have any great effect on domestic prices. There is only an effect on prices if businesses believe that changes in the real exchange rate will be of some duration. Competition on markets is also determined moreover by the ability to adjust prices.

If export companies decide to reduce their prices in foreign currency, they can win market shares. This in itself counteracts the negative effects of the weaker international economic situation. At the same time, there is a risk that import prices will rise if importers take compensation for the weaker krona exchange rate. On a market with dampened growth where there is stiff competition, the risk may be less. In this case, the effect of a weaker krona would mainly lead to an increased demand for exports.

It is still too early to say anything about the conclusions for monetary policy that can be drawn from this reasoning about future cyclical developments. The Riksbank's overall assessment will be included in the next inflation report on 27 March. There will then be a clearer basis for assessing whether resource use is expected to be under such strain that a more stringent policy is required or whether the cyclical outlook has weakened so much that stimulation is called for. One thing is clear, however. Downward adjustments of growth assessments mean that the large number of interest rate increases that most analysts expected during the spring will hardly be necessary to keep inflation on target!