Lars Heikensten: What is happening in the United States and how will it affect us?

Speech by Mr Lars Heikensten, First Deputy Governor of the Sveriges Riksbank, to the Swedish Shareholders' Association, Malmö, 9 March 2001.

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First I want to express my thanks for the invitation to speak to you here. It is always a pleasure to visit Malmö at this time of the year; the signs that spring is approaching are more numerous and clearer down here.

The current focus for forecasters — around the world, I would say — is the U.S. economy. As usual when activity is turning, opinions among economists differ greatly. This reminds me of the remark someone made to the effect that if you placed all the economists in the world in a long line, they still would not reach a joint conclusion. That I think catches the mood at present among economists, though assessments do seem to be following a pattern. American economists generally appear to be considerably more optimistic than economists with an outside view of the United States.

The United States has unquestionably been acting as an economic engine for global growth for almost a decade. It is equally clear that to a large extent it is the U.S. economy's future path that will steer international economic activity and thereby the conjunctural situation in Sweden.

Against this background I shall be considering a number of questions to do with the American economy and outlining some conceivable outcomes. In that respect, however, I must at once admit to having no clear answer to the question of how the situation will develop. In conclusion I shall be touching on the consequences for economic developments and inflation in Sweden. In that context it is not just international economic activity that is important but also such factors as wages, productivity and the exchange rate. That will bring me to the challenges which monetary policy now faces.

The longest upswing ever

First let me take you back a number of years. A look at the exceptional performance in the past nine years can, I believe, help us to understand the problems which now have to be handled in the United States. Today we know that the upswing which began in the early 1990s and became successively stronger is the longest period of continuous expansion the U.S. economy has ever experienced.

At first this came to be known as the Goldilocks economy: not too hot and not too cold, as the fabled girl commented on the three bears' porridge. This referred to the phenomenon of high growth without any signs of overheating. Later there was talk of a 'new economy' where investment in new technology and growing use of the internet were the primary factors behind a more efficient performance with rising productivity. Firms that utilised the new technology functioned better and competition increased, partly because the internet made price comparisons easier, stocks could be slimmed and distribution became more efficient.

In my view, however, the technical innovations are not the only explanation. The deregulations that began in the 1980s, as well as the consolidation of the federal budget during the 1990s, should also be mentioned as major factors. The deregulations have helped to strengthen America's corporate sector and the improvement in the federal finances led to increased confidence among households and firms as well as somewhat lower long bond rates.

Low interest rates and higher productivity growth then paved the way for the massive wave of investment. The U.S. economy's growth rate shot up and unemployment dropped to levels that hardly anyone believed could be combined with low, stable inflation. As outcomes proved earlier forecasts wrong, assessments of how strong demand's long-term growth could be without generating rising inflation were adjusted gradually upwards.

Turning then to share prices in the United States, in the first place the Nasdaq exchange with its predominance of high-tech companies, we can see that expectations of corporate profits rose rapidly to levels that had not been seen since the 1930s. The trend peaked last year with share prices at record levels and a GDP growth rate above five per cent, in some quarters even higher.

The reverse side of the medal lies in the imbalances that have built up during this period. The United States has been living on borrowed money; even though the federal budget was first consolidated and then generated a growing surplus, investment exceeded aggregate saving. Investment was still able to reach record levels because the additional capital could be borrowed from investors abroad who willingly placed their money in U.S. securities in the expectation that the good times would continue. That explains why the U.S. current account has been able to run up a gigantic deficit, currently equivalent to almost 5 per cent of GDP, at the same time as the dollar has appreciated strongly.

Even with rapidly rising productivity, the rate of economic growth became incompatible with long-term stability. In order to dampen activity, the Federal Reserve started to apply the brakes in summer 1999, raising the instrumental rate in a series of steps, totalling 1.75 percentage points, to 6.5 per cent.

The setbacks were not long in coming. Last year the value of the Nasdaq exchange was virtually halved. Profit warnings have been pouring in, firms are shedding labour, banks have tightened their lending, consumer confidence is weakening and unemployment is tending to rise. Manufacturing output has virtually stopped growing. In the course of a month the Federal Reserve has lowered the interest rate 1 percentage point to 5.5 per cent and market agents are counting on further cuts this spring.

We now have to consider what is actually happening. Is this just a temporary correction after a period of undue optimism that has led, for example, to surplus investment and will now be followed by a fairly mild and gradual slowdown? Or has the major long-term and painful correction of the imbalances in the U.S. economy now begun in earnest? After some months of unpredictable data, even the most experienced and qualified observers find it difficult to say anything definite.

So let me outline three conceivable paths — one optimistic, another less so, a third pessimistic — and then discuss them.

Three scenarios

The optimistic scenario — the V

The alternative most observers, particularly in the United States, believe in just now is that the fall in the United States is an unpleasant but innocuous ‘air pocket’ in the flight path of the American economy’s soft-landing to lower growth rates. The air pocket is attributed to a temporary output surplus, so that unduly large stocks and rather too much IT investment have to be adjusted downwards during one or, at most, two quarters. The profile of this development is commonly described as a capital V; consumption and investment slacken initially and then pick up again, bringing growth back up to its presumed potential rate of around 3 to 4 per cent.

Underlying this version is the recent years’ exceptional technology-driven improvement in productivity, which helps to inject new life into the optimistic mood. The concern generated by the correction is brushed away by the active monetary policy and the promise of massive tax cuts in the coming years. The optimists set great store by IT’s impact on growth and productivity, as well as by a quick improvement in expected profits.

The less optimistic scenario — the U

Some observers see a risk of the upturn occurring more slowly than the V scenario assumes. They see a path that instead resembles a capital U, with a downturn that is more protracted. Investment has been a strong factor behind the upward phase in recent years and proponents of the U scenario consider the economy has been hit by excessive investment, so that an unduly large capital stock must now be adjusted. This adjustment is accentuating the economic slowdown, making this more difficult to counter than seemed likely earlier. It will take time — perhaps a long time — for the interest rate cuts to have an effect on demand from households and firms.

Moreover, the conditions for a quick recovery have been worsened by the imbalances that have accumulated in the economy. This scenario envisages that the U.S. labour market is still so overheated that if IT prices fall while commodity prices rise, at the same time as a weaker dollar adds to the cost of imports, then inflation will move up even though growth is weak. The Federal Reserve might have more difficulty in handling this scenario because if inflation is threatening to rise, the interest rate would be less available for turning activity upwards. There is also the possibility of the promised tax cuts taking time to materialise, which would be liable to postpone a recovery.

Instead of the slowdown turning upwards after one or, at most, two quarters in the V scenario, this would take another two quarters or a total of about a year.

The pessimistic scenario — the L

Then there are one or perhaps several pessimistic scenarios in which the imbalances in the U.S. economy undergo a painful correction that paralyses the economy or delays the recovery for a very long time. This path can be described as a capital L; the economy loses speed and then fails to get going again, proceeding instead at a snail's pace. One assumption behind scenarios of this kind is that measures of economic policy are not capable of reversing the trend.

In the L scenario, the higher productivity growth is checked, corporate investment is cut back and consumer confidence is muted by falling share prices, thereby accentuating the downward path. In a negative spiral, share prices, investment and consumption all decline at the same time as worried investors abroad become averse to placing their funds in the U.S. economy.

The problems are accentuated by the saving imbalances. When money ceases to flow into the United States, the dollar falls. The relatively limited size of foreign trade means that a correction of the massive current-account deficit takes time. The United States has to invest less and save more.

Moreover, the debt position of households and firms now seems to be more tangible and perhaps more troublesome. The debt levels were possibly motivated earlier, when productivity, expected profits and wealth were continuously improving, but now that wealth stocks have collapsed, this is more difficult.

There is a risk that instead of investing, firms use every cent they can find to strengthen solvency. A similar risk is that heavily mortgaged households will not be prepared to take advantage of lower interest rates.

It is also conceivable that if activity slackens more than expected, the federal finances will not develop as favourably as many people believe at present. That could deliver another blow to confidence in the future.

Which of these scenarios seems most probable is debatable. But they are not mutually exclusive. The outcome may well consist of features from more than one of them. What looks at first like a V, for example, can change into an L. But some variant of the U scenario does seem most likely today. That would call for a clear downward revision of international economic activity in relation to the assessment in our main scenario in December.

Conclusions for the Swedish economy

In this situation it is a great help that after a number of years of good growth and low inflation, the Swedish economy now stands on firm ground and that the public finances are in a much better state than at the time of the previous economic downturn. A series of years of effectively combating inflation and a restrictive budget policy have created a good initial position that makes an economic slowdown easier to handle.

Activity in the Swedish economy slowed in the closing months of last year. The tendency was most evident in export sectors but it looks as though consumption also became more subdued. This is to some extent desirable. Earlier last year, growth in Sweden was so high that a continuation would presumably have pushed inflation up and thereby threatened economic stability.

The signals received during January and February also point to domestic activity being somewhat weaker than calculated earlier. The change is not dramatic, however. The growth rate seems to falling back towards the level — between 2 and 2.5 per cent — that the Riksbank identified earlier as being what the economy can achieve in the longer run without generating higher inflation.

Turning to price tendencies, some increase has been noted in the rate of underlying domestic inflation (UNDINHX). This indicator excludes changes in interest expenditure, taxes and subsidies, and prices of imported goods. The increase is not alarming and it should be borne in mind that in recent years underlying domestic inflation has been exceptionally low. The downward price effects from deregulations, for example, have been greater than we expected initially — and presumably than we can count on in the future.

So how will domestic inflationary pressure develop in the future? Will it continue to creep up? Wage agreements that have been concluded to date are admittedly in line with what we allowed for but in an international perspective they are on the high side. There are also risks of higher wage outcomes in some of the areas where settlements are still pending and, in that case, of this spreading throughout the labour market in the coming years. That could add to domestic price pressure. This might be particularly troublesome if it were to be accompanied by falling productivity, which has been the historical pattern in an economic slowdown. There are grounds, however, for being cautious about historical comparisons. Some slackening of productivity seems likely but not to the same extent as previously because firms now seem to adjust their labour force more quickly.

These, briefly, are the tensions in the situation in which monetary policy is being formulated at present. On the one hand a clear slackening of international activity that may become more marked; on the other, wage negotiations that can still cause problems, rising domestic inflationary pressure and an exchange rate that may lead to inflationary impulses. It is still too early to judge the strength of these factors and reach conclusions about which of them will predominate.

Against this background it is important during the spring to maintain a high state of readiness for a repo rate adjustment if new information indicates that this is called for.