Urban Bäckström: Sweden's economy is slowing down

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, to the Social Democrats, Härnösand, 20 August 2001.

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Thank you for the invitation to discuss economic developments in Sweden here in Härnösand.

First let me say that conducting monetary policy in the past year has not been exactly easy. The repo rate was raised 0.25 percentage points last December, from 3.75 to 4.0 per cent, and this has been followed by an equally large increase to the present rate of 4.25 per cent. In June, moreover, the Riksbank intervened in the currency market in an endeavour to strengthen the Swedish krona and thereby avert a threat to the 2 per cent inflation target.

This evening I shall be attempting to present the Riksbank's actions as I see them in a wider perspective and convey my view of the challenges we will be facing.

Before doing so, however, I want to underscore that a decision by the Riksbank to raise or lower the repo rate does not always appear completely self-evident. In order to avoid an unduly erratic monetary stance, these decisions have to be based on assessments of developments in the period one to two years ahead. The current consensus is that this is approximately the time it takes for an interest rate adjustment to exert its full effect and influence the economy in the desired direction. One alternative might be to act in relation to a shorter time horizon, which would oblige us to adjust the interest rate more markedly as well as more frequently. Both I and many others believe that would be bad for output and employment.

As we all know, assessing the future is difficult and the predictions can almost always be questioned and debated. Interest rate decisions by the Riksbank's Executive Board are preceded by extensive discussions and our opinions sometimes differ. Disagreements are obviously not intrinsically desirable but when a group of people have to decide about complex matters, they are liable to reach different conclusions at times. That happens in business and it also applies to economic policy. The difference is that the Riksbank is an open institution, which means that our task-masters - ultimately the Swedish nation - can, from the minutes of our meetings, see the basis for a decision, the preceding discussion and the positions Board members have taken. I see that as basically an advantage for people's confidence in Sweden's monetary policy. Having said that, I also want to underscore the broad agreement among members of the Executive Board as to the fundamental framework for our efforts. It is important to bear that in mind.

After these preliminary remarks, I shall now turn to developments in the Swedish economy in recent years.

Sweden's rapid economic expansion has slowed

Economic growth in Sweden has been strong for a number of years. And although demand has risen rapidly, inflation has been low. This is partly explained by cyclical factors. By this I mean the plentiful supply of unutilised resources - not least all those who had lost their jobs during the economic crisis that ravaged Sweden in the early 1990s. That lessened the risk of the upswing in production soon leading to the economy reaching its potential output. But as far as we can judge at present, the more favourable trend also has to do with an economy that is functioning more efficiently.

Sooner or later, however, demand growth that is unduly strong and persistent will generate economic imbalances, whereupon price and wage increases usually tend to accelerate. In time, such a development is liable to turn into a recession, with falling output and rising unemployment. Rapidly rising inflation is often - though not always - an indication that the economy has been expanding too rapidly and that economic policy has not been sufficiently tight. Economic overheating and rising inflation were in fact a recurrent problem in the 1970s and '80s. Restricting economic activity when times are good has often proved difficult. But sooner or later it has had to be done in ways that were then more dramatic. Production and employment have then fallen and unemployment has risen.

Towards the end of last year we judged that it was time for economic activity in Sweden to start slowing down to the growth rate that is commensurate with a stable long-term trend. Continued growth at a rate around 3 to 4 per cent was not reasonable. Observers usually consider that the Swedish economy is capable of long-term growth at an annual rate of about 2 to 2.5 per cent. A similar situation had been faced for a time by other central banks around the world. In the United States, for example, the Federal Reserve had raised its instrumental rate successively during 1999 and 2000 to 6.5 per cent. In Europe, the ECB tightened its rate last year to 4.75 per cent, while the Bank of England's rate was raised to 6.0 per cent. The same type of reaction was also evident in other countries.

I recall that in the course of last year many observers counted on relatively large interest rate hikes in Sweden, too. They thought they saw clear signs that the Swedish economy was on the way to becoming overheated and argued fairly strongly that the Riksbank should therefore act quickly to increase its instrumental rate in keeping with other central banks around the world.

But the Riksbank arrived at a different assessment and chose instead to proceed more cautiously with interest rate increases. In our opinion, the relatively favourable inflation prospects last year simply did not warrant a tighter monetary stance. We kept to the level of 3.75 per cent for practically the whole of 2000.

In December, however, we did raise the repo rate 0.25 per cent points, from 3.75 to 4.0 per cent. In other words, a small increase from a level that was a good bit lower than in other comparable countries. That applies not least in relation to the United States, which I take as an example because the central bank there has cut its instrumental rate markedly this spring, a development that of course has to be seen in the light of the relatively large increases earlier. It was only in the late spring that the rate in the United States came down to the level in Sweden. And it is little more than a month ago that the Federal Reserve cut its rate so that this became somewhat lower than the Swedish rate. The Swedish repo rate had in fact been lower than the American rate for almost five years, since September 1996. That is something that is sometimes ignored in the public debate.

So the Swedish economy was moving towards a situation where there was a risk of total output ultimately rising too rapidly. There was nothing dramatic about this. Considering the strength of economic activity, it was to be expected. An adjustment of demand to the long-term growth path can occur either as a spontaneous economic slowdown - for instance because Sweden is affected by a weakening of international activity - or as a consequence of a monetary policy adjustment; it can also result from a combination of the two.

We can note that economic activity in the rest of the world, not least in the United States, weakened appreciably in the first half of this year. The Swedish economy has been affected by this, as is evident from Statistics Sweden's latest quarterly GDP data. The most recent figures for the national accounts are admittedly preliminary but the tendency behind them is clear: GDP growth fell back from an annual rate of 3-4 per cent in recent years to just under 2 per cent in the first half of this year.

Thus, the world economic slowdown has helped to bring about a downward adjustment of demand growth in Sweden towards the long-term path without the Riksbank needing to lift the repo rate up to between 6 and 7 per cent, as the central banks in a number of other countries have been obliged to do.

How does the krona come into it?

But it is not only the interest rate that influences the development of demand and ultimately the rate of inflation. The exchange rate also plays an important part. Among other things, a weak exchange rate tends to stimulate exports and other segments of Swedish production that are exposed to international competition. That could limit the impact of an international economic slowdown. Conversely, an appreciation of the krona can act as a brake and modify the pull from an economic improvement in the rest of the world. Another effect of a weak exchange rate concerns the prices of imported goods and services, with the risk of a pass-through to consumer prices.

In the 1970s and '80s, currency devaluation was frequently used as an instrument for stimulating the economy. The development of demand was boosted via production for export at the same time as imported goods became more expensive. In time, however, inflation began to move up. Now that Sweden has a flexible exchange rate regime, things work somewhat differently. If the krona weakens and firms and households perceive this as a transient movement, the effect on inflation will not be as strong as before, when a currency write-down was seen as a more permanent measure. This has contributed, for example, to an import price pass-through to consumer prices in the 1990s that was smaller than earlier. But the magnitude of the effects on demand and inflation with a flexible exchange rate regime will obviously depend on how much the value of the krona changes. Even with such a regime, a large shift - upwards or downwards - in the value of the krona will have some effect on demand and prices.

Since last summer the Swedish krona has weakened by between 10 and 15 per cent relative to a weighted currency basket. All else equal and given that such a depreciation were to be permanent, the stimulus to the Swedish economy would be fully equal to the effect on the United States economy of the Federal Reserve's interest rate cuts this spring. Against that background it is accordingly difficult to claim that aggregate monetary conditions in Sweden have become tighter, even though the Riksbank raised the repo rate last December and, most recently, at the beginning of July.

I should point out here that it is not the krona's current value that features in the Riksbank's overall inflation forecast and monetary policy. What we use instead, as described in our Inflation Report, is an assessment of the krona's future path. The krona's future path is invariably a major factor behind the Riksbank's inflation forecast. And it is the inflation forecast that forms the foundation for monetary policy. Thus, the development of the exchange rate, demand, inflation expectations and so on all affect the interest rate decision indirectly via the inflation forecast.

It is never a simple matter to determine the path for the exchange rate in the coming one to two years that ought to be used in the assessment of inflation. But as long as all reasonable assessments point to the Swedish economy being in good shape, in the long term that should also motivate an exchange rate that is considerably stronger than we have seen in the past year. In other words, there have been grounds for counting in the Inflation Report on a somewhat stronger krona even in the period one to two years ahead that guides monetary policy. But when the krona began falling almost 5 per cent in the course of only a fortnight early this summer, it ultimately became difficult to count on the exchange rate becoming as strong as the forecast envisaged in the coming two years. The weaker the initial position, the larger the requisite appreciation. To quote the press release from 15 June, the Executive Board considered that "The krona's depreciation since the latest Inflation Report is the most important single factor that may lead to the inflation target being threatened 1-2 years from now". The Riksbank had then initiated currency market interventions with a view to strengthening the krona.

When the Executive Board met on 5 July the krona was still weak. In the light of the current forecasts of resource utilisation, the exchange rate and demand, a majority of the Board members concluded that the repo rate should be raised 0.25 percentage points, to 4.25 per cent, in order to avoid the risk of inflation exceeding the target 1-2 years ahead. The picture also included considerable price increases during the spring which, although mainly transient, were liable to influence inflation expectations.

The decision was not an easy one for the Executive Board. As the minutes show, it was preceded by an intensive discussion. Three members had a different view. In their opinion, the risk of rising inflation on account of a weak exchange rate was balanced by the risk of economic activity becoming more subdued. The other members, of whom I was one, concluded, however, that when everything was taken into account, the spectrum of inflation risks had shifted slightly upwards. The increase was a precautionary measure. It was also considered important to send a clear signal that the inflation target is taken very seriously.

It was underscored that the decision did not imply anything about the repo rate's future path. That would be considered as usual at the Riksbank's regular monetary policy meetings in the light of the overall picture of inflation prospects.

In view of some comments which suggest that the Riksbank's action has been wrongly interpreted, I want to emphasise in particular that the interest rate increase in July did not have the aim of strengthening the krona. As I have indicated, an appreciation would be a good thing in itself but the interest rate increase was actually motivated by a need to counter the risks of inflation that were considered to stem from a weaker currency. Let there be no misunderstandings about that.

During the summer the krona has become somewhat stronger, which is welcome. A major factor here has been the weakening of the dollar. A continued appreciation of our currency would also be welcome. In relation to the Swedish economy's sound fundamentals, the krona is still weak.

Looking ahead

Before I take a look at future tendencies, it may be in place to emphasise that the Swedish economy is fundamentally sound, with a good potential for growth and employment, accompanied by surpluses on the current account as well as the public finances. The recent temporary increase in inflation at a time of slowing activity is a problem that Sweden has in common with other countries around the world.

Global economic growth has slowed, as I mentioned, during the spring. The fall-off has been deeper and more protracted than many observers counted on at the beginning of the year. Information received during the summer confirms the impression of a somewhat more drawn-out course, with an upturn that looks like being delayed, in many respects because the key player in the global economy - the United States - is still limping. The imminent recovery presaged by signals early this summer, above all from the financial markets, now seems somewhat more doubtful. The outlook for the Japanese economy is still highly uncertain. And in Europe the growth forecasts for the leading economies have had to be revised downwards.

It is perhaps not surprising that after a series of years of strong growth it is taking time to overcome the tensions that arose in the wake of the economic euphoria in the United States. Neither is it odd that with an increasingly integrated global economy, the American slowdown is affecting many other countries, too.

After massive investments over a period of years, American companies are now having to cut back plans for expansion. With the abrupt weakening of demand, stocks have become somewhat too large. Share prices, above all in the IT and telecom sector, have fallen sharply during the past year, in keeping with declining profit expectations. American households have had strong expectations about future income and wealth, as indicated by high consumption and rising debt in recent years; these expectations have now been scaled down and consumption has been affected.

The U.S. Federal Reserve cut its instrumental rate six times during the spring, bringing it down to 3.75 per cent. But even with this monetary stimulus, the slowdown still seems to be holding its grip on the American economy. As we know, however, it takes time for interest rate cuts to exert their full effect on economic activity.

In order to form a picture of what lies ahead, one can start from three alternative explanatory models.

The first concerns the notion of the new economy and stresses the U.S. economy's higher growth potential, with a rising underlying rate of productivity growth and increased corporate profits that in turn underpin a higher future return on assets, including listed shares. A more rapid expansion of production capacity and better facilities for managing fluctuations in stocks pave the way for higher demand and smaller cyclical fluctuations in the future. This is the view that favours a rapid recovery or a V-shaped decline and upswing.

The second model is more traditional, with links to the Keynesian school. In the post-war era a long period of high demand has regularly given way to an economic slowdown. Historically speaking, the latest upswing has lasted unusually long, so perhaps it is not so odd that we are now experiencing a decline. But sooner or later activity will pick up, though this will take time. On the other hand, the ongoing downward phase will not be all that dramatic.

The third model has its roots in the Austrian school and harks back to experience from the 1920s and '30s as well as from before the Great War. Proponents of this view are wont to point out that a period of growth not infrequently ends in exaggerated optimism and over-investment. When profit expectations ultimately become more normal, share prices fall and investment undergoes a troublesome adjustment. Sometimes the adjustment problems give rise to some form of financial crisis that accentuates the downward trend. The economic difficulties in Japan in the 1990s are sometimes cited as an example of this model. Another instance is the crisis in the 1930s. Other examples in various countries are to be found in the period before 1913. This explanatory model suggests that the recovery will take time and it is conceivable that the global economic slowdown will continue for some time to come.

Turning now to the economic situation in Sweden, we can say that activity has slackened as a consequence of the slowdown elsewhere. Swedish firms that are dependent on exports have been hit in particular, along with their suppliers. At the same time it should be noted that Swedish households, who account for around 50 per cent of demand, have lowered their consumption. Like their counterparts in the United States, people in Sweden have reduced their expectations about future income and wealth. Infrequent purchases, such as cars and household appliances, have fallen in particular. Sweden has been hit by the global slowdown in technological sectors such as IT and telecom; firms are being compelled to undertake structural adjustments and close down some production capacity. But although Sweden is affected more than other countries, on account of the dominance of IT and telecom firms, compared with earlier downturns the situation still looks relatively favourable, at least so far.

The important thing now is to look to the future. It is not the most recent economic figures that determine the course of events and it is not entirely clear what conclusions should be drawn with regard to developments in one to two years' time. One thing that is clear, however, is that resource utilisation this year will be slightly lower than economic analysts have been counting on. If it turns out to be true that GDP growth only reaches a figure of just under 2 per cent this year, this will nevertheless be a fairly creditable result for the Swedish economy. This is more or less the growth rate that characterised the Swedish economy during the period 1975 to 1990. What we are looking at now is a single year following a period of very rapid expansion and during which the Swedish economy has been exposed to a sudden global slowdown that has largely been concentrated on a sector of great importance for Sweden, namely the IT sector. All in all, it would seem reasonable to assume that the conditions for the near future look relatively good for a cautious economic recovery, combined with an inflation rate in line with the Riksbank's target. However, it is important to follow developments closely in order to detect whether the course of events will strengthen or weaken.