

## **Urban Bäckström: The business cycle and interest rate policy**

Speech by 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, at the Euroforum's Conference, Örebro, 10 October 2001.

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First a word of thanks for the invitation to discuss matters to do with the business cycle and interest rate policy here with you in Örebro. We are living at present in turbulent times. Political events on the world stage have considerable economic and other repercussions in Sweden. Today I shall be saying something about my view of the business cycle's current phase and also try in some measure to look into the future.

### **Weaker activity in the rest of the world**

Global economic growth slackened appreciably in the first half of this year. The downward phase has lasted longer and become deeper than many observers had counted on at the beginning of the year. For the first time in over a decade we are experiencing a synchronous slowdown in all the leading economies. The terrorist attacks on 11 September have accentuated the risk of the downward phase being more pronounced and protracted. At the same time it should be underscored that the attacks can hardly be expected to disrupt the conditions for growth in the longer run, either in the industrialised countries or in what are commonly referred to as the emerging markets.

It was mainly rising energy prices, higher interest rates, falling stock markets and a sudden downturn in corporate investment that resulted in the almost simultaneous and abrupt slowing of global economic activity in the latter part of last year. Weaker demand led in turn to stock adjustments and thereby to a further downward effect on orders and production. At the same time, the falling share prices muted private consumption. On top of this, the terrorist attacks will entail a short-term loss of production and probably also postpone an upturn.

The cyclical downturn is following the normal pattern in many respects and is therefore not particularly surprising. Its course has been accelerated, however, by the collapse of the excessive optimism which had accompanied the technological breakthroughs that gave rise to the notion of a new economy. For a time there was no end to the hyperbole about the blessings that the new facilities for information and telecommunication had in store. Expectations of rapidly rising profits and incomes pervaded households and businesses in many parts of the world, perhaps above all in the United States. Investment and consumption rose. So did share prices. Production plans were revised upwards. In time, imbalances arose in the American economy between investment and saving, as well as between current and more fundamental stock market valuations. Although optimism everywhere else did not become as excessive as in the United States, decisions were no doubt made about consumption, investment and shareholdings that possibly would not have occurred if more lasting economic considerations and more realistic expectations had prevailed.

### **Importance of learning from history**

History teaches us that in business, euphoric phases tend to be followed by a clear change of mood. The fact is that a similar wave of over-optimism attended the era of railway-building in the nineteenth century. The invention of the electric motor and the combustion engine likewise generated a high degree of over-confidence in the early twentieth century. In Sweden it was the possibilities of using the new technology to reap large profits from such natural resources as hydroelectric power, timber and ore that were exaggerated. In the late 1990s the jubilation was about the huge profits that were going to be reaped instead from computer and telecom technology. Once again, the expectations of rising profits and incomes overshot the mark.

We should bear in mind, however, that the major innovations did play a tremendous part in the emergence of industrialised society and the welfare state. Railways have been of lasting importance, not least in Sweden. Without those investments in the early twentieth century, the mining and forest

industries could hardly have done what they did to launch Norrland and other parts of our country on the world market. Sweden is one of the world's best examples of the forces for growth that are generated by innovations, experimentation and creative processes. Companies like Ericsson, AGA, SKF, Atlas Copco and Electrolux are just a number of the instances of inventions that have contributed to our country's long-term growth.

The old Austrian school of economics, with its roots in the period before World War I, had an analytical focus on growth and the business cycle that is relevant for an understanding of the present situation.

One insight is the crucial part innovations play for the path of long-term growth. This has been elucidated not least by Joseph Schumpeter and Erik Dahmén. However, the significance of innovations and technology for growth is not a straightforward matter. They often raise productivity and generate windfall profits. The new products that result from innovations give some firms a monopoly, while other firms that are relying on older technology are pushed to the wall. In such a process there is, of course, a large risk of making the wrong decisions.

The Austrian school also regarded investment as the linchpin of the business cycle. In the event of a technological breakthrough, firms are liable to overestimate the size and duration of the resultant improvement in productivity. That is why an upward phase not infrequently culminates with excessive optimism and faulty investment. When profit expectations then fall back to more realistic levels, share prices fall and corporate investment takes time out until capital stocks have adjusted to a more reasonable view of long-term yields. At the same time, households adjust their consumption, not least of capital goods, to a more realistic assessment of income's long-term trend. Seen in the context of innovations, there is no ready-made pattern for either the occurrence of a cyclical downturn or how quickly it can be reversed.

A third basic insight from the Austrian school concerns economic policy's limitations. If a leap forward in technology leads to a period of unsustainable growth of investment and consumption, there is bound to be a recoil. As argued in the 1970s not least by Fredrich Hayek, perhaps the foremost of the Austrians and a Nobel prize-winner, the necessary adjustment after a supply shock cannot be avoided by trying to bridge the trough with measures of economic policy. As an adjustment to more realistic expectations must come, a bridging policy will simply postpone it and presumably make it more difficult when it eventually happens.

But history also teaches us that after a period of what I would call growing pains, optimism about the new technology's potential will be restored in a more orderly and realistic form. Neither the sudden downturn in the global economy nor the terrorist attacks on 11 September should have changed the grounds for a positive appraisal of the new technology in the somewhat longer run.

### **Signs in the summer of stabilisation in the United States**

During the summer there were signs that economic activity in the rest of the world was becoming more stable. Tendencies in some of the U.S. economy's leading indicators could be interpreted as heralding a slower phase in the decline of manufacturing. Firms also seemed to have made some progress with stock adjustments. The message from financial markets, on the other hand, was that economic activity would continue to be weak for a time: share prices fell another 20 to 30 per cent during the summer, mostly in August and September, and long bond rates went on declining.

The human suffering caused by the terrorist attacks on 11 September is really tragic. They are on a different plane from the indirect effects but the latter still have to be considered. As regards the economic aspects, it can be noted that certain activities closed down in connection with the attacks and production was curtailed in others. This direct loss of output occurred primarily in the financial sector, aviation and recreation. To this must be added the effects on economic developments in the coming quarters. The crucial factors here are how consumers and firms around the world perceive the risk of more extensive conflicts and the scale and duration of the response to the attacks that has now begun.

Today, therefore, it is extremely difficult to gauge at all precisely what the aggregate quantitative effects of the terrorist attacks are likely to be. Global economic activity will presumably still be determined by the requisite adjustment after the over-optimism in recent years. At the same time, economic policy in the United States has become increasingly expansionary. Sizeable interest rate cuts have been accompanied by large fiscal stimuli. But it does look as though this year's GDP growth will have to be revised downwards. The outlook for 2002 is more uncertain but a downward revision is

most probable. An illustration of the current uncertainty is the unusually wide spread between assessments of the American economy in recent years. Some forecasts envisage a very rapid recovery, with GDP growth already up at between 3 and 4 per cent next year in the United States; others foresee falling GDP.

### **The picture in Sweden**

The Swedish economy is characterised by a relatively sharp slowdown and an appreciable depreciation of the krona in the past year. Another feature is that inflation is currently above 3 per cent and thus outside the upper tolerance limit for the Riksbank's 2 per cent target.

The high inflation at present is mainly, though not exclusively, a consequence of price increases that can be regarded as fairly transitory. The causes include foot-and-mouth disease, higher electricity prices and certain changes in the method for measuring electricity prices. Supply shocks of this kind normally do not have lasting effects on the rate of inflation. There is therefore reason to believe that when the increased price levels drop out of the twelve-month change figures between now and next spring, the figures will fall back from the relatively high rates at present. This presupposes that inflation expectations are not affected and that other factors, for example cyclical activity and the exchange rate, do not pull in the other direction.

The picture of inflation does, however, include other features that probably have to do with the high resource utilisation during the latest upward phase. During the past year underlying inflation has gradually moved up. But meanwhile, economic activity — here as well as in the rest of the world — has been slowing markedly. If one is to believe Statistics Sweden's latest figures for the national accounts, GDP growth this year will hardly exceed 1.5 per cent. This will probably tend to dampen any price pressure — as long as nothing unforeseen has happened to our economy's long-term growth potential.

Before the terrorist attacks there were some signs that manufacturing activity was stabilising, not least because the weak exchange rate has lowered relative costs. During the late summer it looked in general as though the inflow of manufacturing orders was falling less steeply than before. In the past, this has usually been the first sign of a stabilisation. However, the picture varies between industries. Orders have already turned upwards in some and in others the decline has slowed, while for telecom products, for example, orders are still falling sharply. That the krona's relatively large depreciation has not yet led to an upturn for total exports is largely explained by the export product mix and market conditions in certain key industries, for example the decline in tele- and data-communication.

With a flexible exchange rate regime, there is nothing new about some depreciation in connection with a cyclical downturn. Numerous examples can be cited from all over the world. Basically, in a small, open economy the exchange rate often functions as a sort of shock-absorber. The problem today is that the krona's depreciation has occurred from a level that was already weak. This amounts to a further appreciable lowering of Swedish manufacturing's relative costs and thus an increased profit share. Our experience from the 1970s and 1980s has shown that a weak exchange rate can generate inflationary tendencies.

Let us not forget what happened in recent years. When the krona weakened in connection with the crises in Mexico, Asia and Russia, Swedish exports recovered quickly and strongly. During the autumn of 1998 exports dropped, order inflows were weak and forecasts were quickly revised downwards; but just a few quarters later production for export was booming again. So it is reasonable to expect that sooner or later, although just when is not clear, Swedish exports will pick up this time as well. But the terrorist attacks have probably postponed the recovery and perhaps even accentuated the slowdown in the short run. It is important to keep an eye on the exchange rate as well as economic activity.

On the domestic scene there are some bright spots. Household disposable income, for instance, looks like rising strongly next year. Contributory factors are a falling rate of inflation, fiscal stimuli and, not least, a labour market with no dramatic changes, at least at present. Moreover, real interest rates are low. All this probably reduces the risk of private consumption continuing to weaken. At the same time there are many indications that the reduction of equity wealth in recent years has had an appreciable negative effect on purchases of consumer durables. So there are good reasons for supposing that it will be some time before households are again prepared to invest in new cars and other capital goods. Consumption may therefore remain weak for somewhat longer. In other words, there is a risk that,

despite the weak exchange rate and low real interest rates, the Swedish economy will recover more slowly than expected earlier.

To sum up, a number of factors point to a gradual economic recovery in Sweden in the course of next year. This picture could still be changed by many things. One factor is the terrorist attacks and their aftermath. Another is, of course, the extent of the economic adjustment that occurs in the United States as a consequence of the imbalances that have accumulated in recent years.

### **Monetary policy**

Swedish monetary policy in the past year has had to consider an economic slowdown on the one hand and a depreciating currency on the other. GDP slowed from rates of 3 to 4 per cent in recent years to between 1 and 1.5 per cent in the first half of this year. At the same time, since last year the krona has weakened around 15 per cent.

These two forces have pulled the Riksbank's inflation forecasts in slightly different directions at different times in the past year. Roughly speaking, with a given potential growth rate, inflation tends to be subdued when economic activity slackens, while a weak exchange rate pulls in the opposite direction and may lead to higher price increases: directly through rising import prices and indirectly by stimulating activity via export production. In addition, sudden exchange rate movements can affect inflation expectations.

Here I should like to be precise and a little formal and say that it is neither the *current* economic situation nor the *current* exchange rate that constitutes the starting point for the Riksbank's comprehensive inflation forecast and monetary policy. What we use instead is an assessment of the *future* economic situation and an opinion about the exchange rate's *future* path. But if economic activity slackens suddenly and unexpectedly, it does tell us something about the strength of the cyclical path and the probable future course. The same applies to the exchange rate. A sudden depreciation normally tells us something about the probable future path; it probably reduces the chances that at the end of a given forecast period the krona will have reached the higher rate that an earlier assessment indicated; for one thing, that would require a very much faster appreciation than envisaged earlier.

The appraisal of a given appreciation or depreciation depends on what caused it, partly because this may have consequences for its duration and its impact on inflation. A weaker exchange rate accompanied by an economic slowdown need not appreciably change the picture of inflation. A depreciation that is a step in an adjustment to a higher expected rate of inflation is a different matter. An upward shift in inflation expectations in a wide sense affects the picture of inflation directly. Various persistent portfolio adjustments can also give rise to a revision of inflation prospects if the exchange rate is affected more permanently. A further interpretation of a depreciation arises when it occurs in conjunction with generally increased uncertainty in the global financial markets; such a situation usually involves an extensive flight to large currencies and to currencies with a historical record of stability. This source of exchange rate movements is usually temporary.

The krona's weakening early this summer, after the Riksbank had presented the year's second Inflation Report, was probably due to a combination of slowing export activity, portfolio adjustments and some upward revision of inflation expectations. Current inflation had been notably high in the late spring. If higher inflation expectations are left to root themselves and are also manifested in a weakening exchange rate, this is a sign that public confidence in monetary policy's systematic commitment to inflation in line with the 2 per cent target is being eroded. I therefore consider it was right to take the precautionary measure of raising the interest rate in the summer. It is better that people get to know that at times we raise the repo rate and at times we lower it than that we tamper with the inflation target.

### **Conclusion**

The terrorist attacks on 11 September have presumably had consequences for assessments of Swedish and international economic activity. Although the effects are difficult to gauge exactly, it seems clear that cyclical developments will be altered. An upturn will be postponed and the slowdown will be accentuated in the short run. In the aftermath of the attacks there has been some uncertainty in the financial markets as well as extensive portfolio adjustments. The pattern from similar periods in the past is clear: some currencies weaken while others, large currencies in particular, appreciate, share

prices fall, long bond rates are unchanged or rise, short-term interest rates fall and the price of gold moves up. In order to mitigate the negative effects on the global economy and the financial markets, the major central banks lowered their instrumental rates and the Riksbank, as you know, did the same. In addition, the central banks have, for example, taken steps to contribute liquidity to the financial system.

The Riksbank will be presenting a new Inflation Report next week. As usual it will contain a main scenario and a spectrum of upside and downside risks. Considering the circumstances I have outlined earlier, the main scenario is inherently uncertain. The risk spectrum will therefore be particularly important to monitor in future as new information is obtained and events unfold. Which direction will cyclical activity take? How will the exchange rate develop? What are the underlying factors here? And how will inflation expectations move? These are critical questions for the Riksbank's future action this autumn and winter. Unfortunately there are no clear answers.