Mr. Heikensten looks at the prospects for the Swedish economy against the background of the central bank's monetary policy Speech by the Deputy Governor of the Bank of Sweden, Mr. Lars Heikensten, given at the Centre Party's Economic Seminar in Haparanda on 15/6/97.

I should like to begin with a word of thanks for the invitation to talk to you here.

In these introductory remarks I shall be discussing the economic situation. Sweden's economy presents many positive aspects: the outlook for growth is good, the general government deficit is estimated to be eliminated next year and the low inflation policy is becoming more and more established. But there are also persistent economic problems to solve, not least in the labour market.

Before considering the economic situation, however, I thought I would say something about monetary policy, the role of the Riksbank and the changes in the status of the Riksbank that recently gained the support of five of the political parties in Sweden's parliament, including the Centre Party.

1. Monetary policy and the role of the Riksbank

Why low inflation?

In the past decade there has been a growing awareness of low inflation's importance as a central condition for the proper workings of an economy. This has been the case not just in Sweden but virtually throughout the western world. The significance of price stability is clearly demonstrated by Sweden's experience in earlier decades. The economic climate in the 1950s and 1960s, with low inflation, high and stable growth and low unemployment makes a sharp contrast with the 1970s and 1980s, when attempts to keep the price rise on a par with the rest of the world failed and a series of devaluations had negative effects on wage formation, productivity and economic growth.

There is reason to believe that the high and fluctuating inflation in the 1970s and 1980s contributed to the weak state of investment and productivity. The recurrent crises over wage costs generated uncertainty about business profits and thereby about the conditions for investment. And although the devaluations did lead to a temporary improvement of profitability in the sector exposed to foreign competition, they also eased the pressure for structural adjustments.

By concealing important economic signals, high and fluctuating inflation impairs the workings of the economy. Households and firms are less able to make rational consumption and investment decisions and planning for the longer term is more difficult. The risks are greater and the required return, including compensation for the risks, rises. Decision-making therefore becomes more short term and speculative.

A good example is Sweden's real estate boom in the 1980s. The combination of high inflation and the tax system at that time meant that speculative capital was attracted to the property market. Financing more productive investment became comparatively difficult. When inflation fell back in the early 1990s it became apparent that the investments in real estate had been founded on unrealistic expectations that prices would continue to rise. The property market collapsed and credit institutions were hit by massive loan losses. The bank crisis accordingly accentuated the economic downturn in Sweden.

Inflation is also associated with an arbitrary redistribution of income and wealth, often contrary to the ambitions of distribution policy. Referring again to the 1980s, the chief losers from the inflationary economy at that time, with the resultant price fall, were probably not the property speculators but households whose bank savings were eroded by two-digit inflation and whose wages were only subsequently adjusted for inflation.

Price stability is the Riksbank's objective

The reason why monetary policy is assigned the task of safeguarding the value of money is basically simple: by adopting an appropriate monetary stance the central bank can choose, or at least strongly influence, the rate of inflation. In the short run price increases are of course affected by many other factors such as the state of economic activity, the direction of fiscal policy, wage formation, etc. But in the long run inflation is a monetary phenomenon. By controlling the supply of money in a wide sense, in the long term the Riksbank can also govern movements in the value of money and in inflation.

Interest rate management by the Riksbank cannot, on the other hand, generate economic growth and employment in the longer run. The crucial factors for this are quite different, such as capital formation, demographic trends, advances in technology and education, how the economy functions, etc. Some scope for stimulating the economy may exist in the short run but this presupposes an established confidence in economic policy's commitment to price stability. If economic agents have doubts about economic policy, attempts to stimulate demand will be liable to elicit an upward shift in the rate of inflation that is expected by firms, households, trade unions and others. Wages and prices may then start to chase each other as they did in the 1970s and 1980s. The longer market rates of interest, which the Riksbank can influence only marginally, will begin to move up and the ultimate effect on demand may be the opposite of what was intended. The outcome may be a combination of low growth and high inflation.

Much accordingly depends on the confidence that the price stability policy enjoys. In an economy where a low inflation policy is firmly established, it is easier to lower the interest rate without eliciting uncertainty about monetary policy's long-term commitment. There is, quite simply, more room to manœuvre. But this does of course presuppose that the outlook for future inflation condones such a policy.

Independence and accountability

The institutional framework for monetary policy is important for underpinning confidence in long-term economic policy. The agreement announced recently between five political parties concerning measures to strengthen the formal status of the Riksbank is therefore a good thing, even though it amounts in many respects to a codification of current practice. It is a clear demonstration that the political system supports a monetary policy that focuses on price stability consistently and over the long term. Increased confidence in the low inflation policy among economic agents implies greater opportunities of supporting economic activity in practice when the conditions for inflation so permit.

Some voices in the public debate have chosen to see this as a move towards a monetary policy that is less democratic. Such an interpretation is comprehensible but no less misleading for that. It is the Riksdag, Sweden's parliament, that lays down monetary policy's objective and elects the governing board, which then appoints the members of the directorate for a term of six years. The proposed changes mean that the practical execution of the monetary policy objective as established by the Riksdag is entrusted to the Riksbank. We can concentrate on this task and build up the competence that is needed to do the job properly.

At the same time there is less risk of monetary policy being influenced by various short-term considerations. One way of describing the consequences of the reform is to say that the delegation improves the conditions for attaining the objective of low inflation that the Riksdag has ordained. At the same time, an independent status for the Riksbank calls for more in the way of accountability. It will be even more important that monetary policy decisions are anchored - at the political level as well as among a broader public - by means of clear motivation and an open dialogue. Decisions to adjust the interest rate tend to affect both households and firms very directly and specifically. It is therefore vital to gain an understanding for our execution of monetary policy.

In recent years the Riksbank has done a great deal to promote an increased understanding of what we do. This work must continue. One instance of transparency is the clear focus on the 2 per cent inflation target. In that this target and our tolerance interval of 1 percentage point are clearly specified, the Riksbank's operations are open to assessment.

Our policy involves adjusting the instrumental interest rate - the repo rate - to a level that we judge to be in accordance with the inflation target. Experience tells us that a change in the short interest rate has its full impact on inflation after a time lag of one to two years. Consequently, the Riksbank has to operate in a relatively long time perspective - the interest rate has to be set in the light of forecasts of what the rate of inflation will be one to two years ahead. Our assessments of future inflation are presented continuously in speeches and various publications, above all the quarterly inflation reports. What I now have to say about the economic situation in Sweden is largely taken from the latest inflation report, which was published about a fortnight ago.

2. The economic situation

Activity is strengthening

In the period since 1993, when economic activity in Sweden turned upwards after the profound crisis, growth in annual terms has averaged 2.7 per cent, which is higher than we were accustomed to in the inflationary period in the 1970s and 1980s. The growth has also had a favourable composition, coming primarily from exports and investment. This has contributed to a period of expansion without any appreciable capacity shortages. The good export performance has also led to sizable current account surpluses, making it possible to repay foreign debt.

Private consumption has been restrained by the measures taken to consolidate government finance. This consolidation will continue on a substantial scale in the years ahead but its effects have probably peaked. Together with a pent-up consumer demand, this leads us to count on rising private consumption, though the labour market situation is a factor that we believe will tend to make the increase relatively cautious.

GDP growth in 1996 was held back by destocking and a continued fall in public consumption and investment. We envisage that the stock adjustments are now coming to an end. Together with some increase in consumption and a continuation of strong exports, this means that the outlook for growth in the coming years is relatively bright. Our assessment is that growth in 1997 will amount to approximately 2 per cent, followed by 3 per cent in 1998.

Inflation in line with the target

The path of inflation largely depends on growth in relation to the economy's long-term potential output - in other words on how the gap between actual and potential output changes - as well as on the inflation expectations of different economic agents.

The Riksbank considers that 5 per cent growth in the coming years is compatible with low inflation, mainly because in general the economy has plenty of unutilised capacity. In other words the *output gap*, which is affected by, for example, the labour market situation, is not expected to close in the coming years.

Structural changes and increased competition in several fields suggest that the Swedish economy's inflation propensity has fallen. Deregulation has been carried out in transport and communications, for instance, and to some extent in the food sector. EU membership has had positive effects for competition in Sweden, partly via increased competition from imports. The new competition laws have also helped to strengthen competition.

Changes of this type, as everyone knows, are positive in that they pave the way for lower consumer prices. Another consequence that is less evident and therefore worth underscoring is that, in so far as the changes affect the outlook for inflation, they can provide room for a somewhat less tight monetary stance.

The continued fall in *inflation expectations*, to a level that for Sweden is historically low, likewise suggests that inflationary pressure is subdued. Agents in markets for labour, goods and money now count on inflation being in line with the Riksbank's inflation target in both the short and the medium term. Increased confidence in the inflation target can of itself lower the inflation propensity. The rate of wage increases to date this year indicates that the parties in the labour market are beginning to act in line with the lower expectations; the new wage settlements that have been concluded in 1997 show a downward shift in the rate of wage increases compared with 1996, towards levels that are more in line than before with the Riksbank's inflation target.

The Riksbank's overall assessment is that in the coming two years the underlying rate of inflation will be between 1.5 and 2 per cent. Registered inflation, however, will rise by degrees with the disappearance of transitory effects that have pushed the CPI down in recent months. The registered rate will probably remain below the inflation target during 1997 and then move up towards two per cent in 1998. Against this background, in the inflation report the Riksbank considered that the monetary stance is well balanced.

Forecasting inflation a couple of years ahead is, as everyone appreciates, a very difficult matter. So there is good cause to be humble. In the inflation report we have highlighted a number of factors that may cause inflation to follow a different path. A weaker exchange rate than we assume or a stronger increase in consumption could result in higher inflation. The opposite effect could come from, for example, better productivity growth or a different picture of resource utilisation. For the Riksbank it is therefore important continuously to assess new information that may provide guidance about the path of inflation.

3. Two questions

The picture of Sweden's economy I have painted thus far is relatively bright. This is warranted. The economy has gone through a deep recession after the policy realignment in the early 1990s. Difficult adjustments have been made and we are now beginning to see the results. There are many resemblances with Denmark and other countries that have experienced similar processes of adjustment earlier. In every case it has taken time for the situation to become more stable and for households and firms to recover confidence.

However, the bright picture must not blind us to the continued presence of serious challenges for economic policy. For one thing there is the importance of securing sound government finance in the long run. For another there is the situation in the labour market. I choose to raise these two questions because what happens with fiscal policy and in the labour market is of great consequence for the Riksbank's ability to safeguard the value of money. It would therefore be almost a dereliction of duty not to place these matters on the agenda as clearly and distinctly as we are able.

Fiscal policy and monetary policy's manœuvrability

Let me begin with *fiscal policy*. Since the dramatic deterioration of government finance in the early 1990s there has been a remarkable recovery. From a deficit equivalent to over 12 per cent of GDP in 1993 the Government now counts on a deficit of 2 per cent for 1997. This consolidation, besides attracting praise from the European Union and international organisations, has earned the confidence of our creditors; since 1995 the interest rate differential between Swedish and German treasury bonds has narrowed from 3.5 to little more than 1 percentage point.

Even with the SEK 16 billion for expansionary measures in fiscal 1998 that the Government proposed in the Spring Economic Bill, the Swedish budget trend looks favourable in a European context.

Notwithstanding these successes, there is reason to comment briefly on how fiscal policy influences the conditions for monetary policy and thereby the future development of interest rates. This influence acts in two ways.

Firstly, fiscal policy is an important consideration for monetary policy in that it *affects the demand situation* in the economy. An illustration of this is provided, for example, by the recent years' changes in household disposable income. Although household wage income rose strongly from 1994 to 1997, the sector's disposable income hardly changed. Household income has been held back by increased taxes and decreased transfers; but for the negative effects of changes in public systems, the annual level of household income would have been 3 to 4 per cent higher. The burden on household income was probably greatest in 1996 but even in the coming two years the fiscal stance measured in this way will be tight. It is accordingly helping to lower inflationary pressure.

If, in the current situation with good prospects for growth, unexpected budget improvements were to be used to give fiscal policy a more expansionary turn, the result might be an earlier need to tighten monetary policy in order to secure the objective of price stability. It is then by no means certain that the overall effect on demand would be what was intended.

Secondly, the fiscal trend in a longer context of "*sustainability*" is also important for monetary policy. If the government deficit appears to be growing uncontrollably, as was the case for some years in the early 1990s, uncertainty may arise as to whether the problems can be tackled at all. This can have negative consequences for monetary policy; the exchange rate may weaken sharply, for instance, with an increased risk of inflation. The budget consolidation has naturally been important in this respect, too. It is the main single explanation for the krona's appreciation since the crisis years, as well as for the Riksbank being in a position to lower interest rates so markedly.

As a result of the years with massive general government deficits, however, from 1990 to 1996 public sector debt has grown from 44 per cent of GDP to 78 per cent. This restricts the future freedom of action in economic policy and means that there is a risk of fiscal policy in practice having a destabilising effect. This is particularly the case in that, with high revenue and spending ratios, the Swedish budget is sensitive to cyclical factors. Seen from this angle the Government's target of a 2 per cent budget surplus over the economic cycle appears reasonable, though there is no academic foundation for a quantified level of ambition. There may be grounds for strategic tax cuts to improve the long-term growth potential. But in the light of the experience with government finance in recent decades a warning should be issued against tax cuts without parallel cuts in spending.

Weak employment

The *labour market* trends in recent years have been bleak. Although annual economic growth since 1993 has averaged 2.7 per cent, employment has not risen. This indicates that a considerable proportion of unemployment is structural in the sense that the level is liable to remain high even if activity continues to improve.

The difficulty in generating new jobs is not confined to Sweden; it is a problem we have in common with much of Europe. But there are countries in Europe that have succeeded in turning the employment curve upwards since the mid 1980s. I am thinking in particular of the Netherlands, where employment, after a long period of stagnation, has been increased by 20 to 25 per cent since the mid 1980s. In the course of a decade unemployment has been virtually halved, from 12 to just over 6 per cent.

Of course one cannot be certain that other countries' solutions apply to Swedish conditions in every respect. But it is important to note that GDP growth in the Netherlands has been fairly close to the EU average even though employment has developed very differently.

So it is not higher demand in the past decade that lies behind the creation of so many new jobs in the Netherlands. Most of the evidence suggests that traditional demand management is not capable of lowering unemployment appreciably. Instead it is the workings of the labour market and wage formation that are key factors for the possibility of turning the path of unemployment. That is where the efforts must be made.

Such efforts might make it possible to combine low inflation with a better development of employment. They could then contribute to increased confidence in economic policy as a whole. At times there seems to be a tendency for the problem of unemployment to generate some uncertainty about economic policy's long-term commitment. Reforms in the fields of wage formation and the labour market can mitigate the potential conflicts between economic policy's goals. That would improve the conditions for a continued fall in the level of interest rates relative to the rest of the world, even in a situation where Sweden stays outside the euro area for the time being.

4. Summary

Today, future prospects for the Swedish economy are bright in many respects. The consolidation of the government budget, accompanied by growing confidence in and support for the low inflation policy, has paved the way for a marked reduction of interest rates. This favours domestic demand. Together with a continuation of strong exports and favourable productivity, this points to good conditions for growth in the coming years, with persistently low inflation.

At the same time it is a major problem that growth does not seem to be generating new jobs to a sufficient extent. This suggests that to a high degree the unemployment is structural. Measures must therefore be taken to improve the functioning of the labour market. For further favourable economic development it is also essential that the efforts to reduce government debt are continued. The conditions for monetary policy in the years ahead will then be improved and greater freedom of action will be created for economic policy in the longer term.