Mr. Heikensten discusses recent economic and monetary policy developments in Sweden Speech by the Deputy Governor of the Bank of Sweden, Mr. Lars Heikensten, at the Local Authorities Economics Seminar in Malmö on 19/8/98.

Thank you for the invitation to attend this Seminar and talk about the Swedish economy and monetary policy. I shall begin with a brief account of how the Riksbank operates with its inflation target. In that context I shall also be saying something about economic policy's results in recent years. Then I shall consider the Riksbank's appraisal of the Swedish economy, as presented in our latest inflation report last June, together with subsequent economic tendencies. Finally I shall be returning to the somewhat longer perspective of my opening section. This will tie in with the theme of the seminar and highlight some factors that are of crucial importance for our success in creating a potential for future economic expansion.

1. Inflation target policy—how does it work?

The objective of monetary policy is to keep the value of money stable. This has been defined more specifically as keeping the annual rate of inflation (measured as the change in the Consumer Price Index) at 2 per cent. Around this target there is a tolerance interval of ±1 percentage point which serves to accommodate normal deviations that arise, for instance, from transitory impulses. But the possibility of larger deviations than this cannot be ruled out. If they occur, it is important that we explain their causes and state how inflation is to be brought back into line with the target.

To influence consumer prices, the Riksbank uses its instrumental rate—the repo rate. Simplifying somewhat, one can say that, by altering the marginal interest rate for banks, the Riksbank influences other domestic interest rates and thereby the level of economic activity in Sweden and consequently the development of prices. It should be noted, however, that in the short and medium term, pricing is also affected by other factors, such as the construction of fiscal policy and the development of wages. That is why the Riksbank is concerned that, when making decisions, politicians and labour market organisations should also promote low inflation. It is the reason, moreover, for my returning to these matters at the end of this talk. But in the long run the course of inflation is crucially dependent on monetary policy.

Interest rate adjustments have their main effect on prices after an interval of one to two years. Monetary policy decisions therefore have to be based, not on the latest figures for inflation but on the Riksbank's current assessment of *future price movements*. Our quarterly inflation reports accordingly present ongoing inflation forecasts based on analyses of a large array of economic indicators, supported by economic models and knowledge of relationships between different parts of the economy. The inflation assessment is used by the Riksbank in drawing conclusions about the direction of monetary policy. A forecast rate of inflation above the target normally leads to interest rate increases, just as an expected rate below the target prompts the Riksbank to lower the repo rate.

Inflation is assessed on a continuous basis. New information—fresh economic statistics, for instance, or signs of a change in some economic relationships—leads the Riksbank to review its current forecast and make the necessary changes. If a new forecast indicates that future inflation will deviate from the target, then the Riksbank has to adjust the repo rate in accordance with the new assessment.

However, assessments of future inflation—like any other forecast—are bound to include an element of uncertainty. Moreover, observers are liable to differ on which future path is most probable. So it is hardly surprising—rather a healthy sign—that our inflation assessments and monetary policy are sometimes a subject of lively debate. But while inflation assessments may vary, in Swedish society today there is broad support for focusing monetary policy on price stability.

2. Recent years

The Swedish economy, as we all know, went through a profound crisis in the early 1990s. This is not an occasion for discussing the causes of the crisis in depth. It will suffice to note that the origins lay in structural weaknesses in Sweden's economy. But the crisis also had to do with shortcomings in stabilisation policy in the late 1980s and early 1990s.

Since production stopped falling and growth restarted in the course of 1993, economic developments in Sweden have exceeded expectations in several respects. The average annual growth rate of above 2.5 per cent is higher than the average in the boom period in the 1980s.

In a way, perhaps this is hardly surprising. The weak exchange rate gave exports a strong impetus and there was plenty of unutilised capacity. But I do not think many people expected that such high growth could be combined with low inflation. In these years Sweden has rejected the policy from the decades of high inflation and reinstated the time-honoured tradition of annual price increases around 2 per cent. Inflation has also been low in an international comparison. Judging from the expectations of economic agents, a low-inflation regime has now been established.

The composition of growth has also been favourable. After decades of growth that was generated to a high degree by rising consumption—with an accumulation of external debt—it is a healthy sign that expansion been associated with strong export demand and industrial investment. One result of this, the large current-account surpluses since 1994, has made it possible to repay external debt.

A dramatic turnaround has also been achieved in government finances. Massive budget deficits have been succeeded by a surplus. This trend is primarily a consequence of the economic recovery, just as declining activity was the main cause of the earlier fiscal collapse. But without the extensive measures for budget consolidation, neither the economic upturn nor the improvement in government finances would have been feasible.

Tax increases and spending cuts on the scale we have experienced in recent years obviously leave their mark. Household income has been sharply restricted, particularly in 1995–96. So have public activities.

In one respect, moreover, the outlook is still troublesome, namely as regards employment. Despite the economic recovery, a rapid expansion of employment has proved difficult to achieve. It is worth noting, however, that the number of private sector jobs, in services in particular, has in fact been rising continuously since 1995. But this has not made up sufficiently for the contraction of employment during the 1990s in, for example, the public sector and construction.

After this review of developments in recent years, I shall now discuss the Riksbank's appraisal of the coming twenty-four months, which is the period we need to consider when conducting monetary policy.

3. The message in June

In the latest inflation report last June the Riksbank presented an economic forecast for Sweden and its implications for the path of inflation up to the middle of the year 2000. Our assessment was that the trends in recent years, with high growth and low inflation, would continue in the years ahead.

The economic upswing was assumed to continue in the forecast period, with annual growth rates around 2.5 per cent this year and 3 per cent in the next two years. The forecast involved an increasing contribution from rising domestic demand, accompanied by a successive fall-off in export growth. Private consumption was expected to pick up, partly in view of rising household income.

Notwithstanding the prospect of further good economic growth in the coming years, the Riksbank judged that the rate of inflation would remain low and even be less than we had expected earlier. The strong demand was certainly assumed to give some increase in inflationary pressure in the forecast period but not so much as to be a cause for concern. One reason lay in the good productivity growth that was also foreseen, indicating that full capacity utilisation in the economy would not be reached in the coming twenty-four months. Although capacity utilisation was high in certain sectors, the Riksbank envisaged that in the economy as a whole there would be a capacity surplus.

External inflationary pressure was expected to be low in view of subdued international inflation, low raw materials prices and a somewhat stronger exchange rate.

Expectations of future inflation among households, financial agents and manufacturing indicated a belief that future inflation would be low. Thus, confidence in economic policy's focus on price stability seemed to have been firmly established.

The Riksbank noted that the uncertainty in the assessment of future inflation was mainly whether it would be even lower than we foresaw in the main scenario. One of the main factors here was the crisis in Asia and its conceivable effects on international economic developments and prices. There were risks of the crisis' effects being greater than assumed in the main scenario in June, so that weak demand and low inflation in the rest of the world would lead to an even lower price rise in the Swedish economy.

All in all, these considerations meant that in the June report the Riksbank's overall assessment of inflation in the coming years was adjusted downwards. As the rate of inflation twelve to twenty-four months ahead was judged to be below the target, the Riksbank considered that, at least for a time, there was room for a somewhat more expansionary monetary stance. The repo rate was therefore lowered 25 basis points.

4. What has happened since the June report?

Let us now look at what has actually happened since the beginning of the summer.

Low pressure from international prices

During the summer the Asian crisis has got worse and the uncertainty about its future course seems to have grown. More countries in the region are now expected to show a fall in output during the year. One of the main factors behind the deterioration is the weak Japanese economy. The knock-on effects of the Japanese crisis in other parts of the world are highly uncertain, as is the outlook in such countries as Russia and China.

An impact from the Asian crisis is now discernible in economic growth in the United States and the United Kingdom. These economies show signs of a slowdown that can be traced to decreased exports to Asia but there are also indications that their domestic demand is slackening.

In the euro area, however, growth prospects seem to be more favourable. The recovery appears to be firm—to a growing extent as a result of stronger domestic demand—and it looks as though inflation will remain low.

The overall picture of international activity is somewhat weaker than the Riksbank forecast in June. International inflationary pressure is low. The extensive economic problems in Japan and the unrest in global stock exchanges are contributing to this.

Swedish economy strong

Economic growth in Sweden seems to be good, however. As expected, the statistics show an accelerating growth of domestic demand, accompanied by a slowdown in foreign trade.

Private consumption is rising strongly and a continuation of this trend is indicated by a number of factors: households' personal economic expectations are still rising, employment is expanding and disposable income is growing as a result of low inflation and a less restrictive fiscal policy. Uncertainty about share prices could have a contrary effect but the downward movements that have been observed constitute no more than a correction after a relatively strong increase. Since the beginning of 1998 the Stockholm Exchange has risen 20 per cent. The statistics also show strong growth for public consumption as well as gross capital formation.

But foreign trade is weakening; export growth is slowing and imports are rising. There are several signs that exports will go on slackening; the inflow of export orders has deteriorated and confidence has fallen among purchasing managers in manufacturing. However, the weaker exchange rate may have a contrary effect on exports.

The inflation statistics show that inflationary pressure in the Swedish economy is still low. In June and July the price level fell 0.2 per cent. This means that for both months the twelve-month rate of inflation was 0.6 per cent.

All in all, it looks as though the growth of domestic demand in 1998 may exceed the assessment in the June report. On the other hand, foreign trade may be somewhat weaker than we counted on at that time. Thus, the figures on real economic developments that have been published since the latest inflation report do not seem to call for any substantial revision of the forecasts. Neither have the summer figures for inflation or the regular surveys of inflation expectations altered the outlook from the early summer.

Weaker exchange rate

In the June report we counted on some appreciation of the krona in the forecast period. During the summer the krona has weakened and I want to take this opportunity of commenting on the tendency since June. Most of the weakening has occurred in August. In effective terms (TCW) the krona has depreciated somewhat more than 3 per cent since the beginning of June, from 119 to 123. Against the US dollar and the German mark the fall in this period amounts to somewhat more than 5 per cent and 3 per cent, respectively.

Several explanations are given for the weakening of the krona. A downward tendency was already evident in May–June in connection with the repo rate cut. After that the krona seems to have been pulled down by the unrest in Asia, which has hit relatively small industrialised countries that are dependent on foreign trade. Some observers consider that countries with a high export share for raw materials have experienced a currency depreciation in connection with the price fall for raw materials. That explanation is not really all that applicable to Sweden because it is difficult to show that we are still particularly dependent on raw materials exports.

The stock exchange turbulence is also considered to have had a major effect on the krona recently in that nonresidents have disposed of Swedish shares, which involves selling kronor for other currencies. Since the June inflation report there has been no new information that warrants increased concern about economic development in Sweden. So the weaker krona does not appear to reflect a change in confidence in the economic fundamentals. The traditional indicators of credibility, computed from price trends in financial markets, convey the same picture. Both the long bond differential with Germany and the expected future short interest rates point to persistently strong confidence in the low-inflation policy.

In this context I should like briefly to rehearse the role of the exchange rate in monetary policy. The Riksbank does not target the exchange rate; monetary policy focuses instead on a target for inflation. The exchange rate can be seen as one of a number of indicators—albeit one of the most important—that we use to predict inflationary pressure in the Swedish economy. If the krona weakens or strengthens *permanently,* then this—*all else equal*—will affect inflation.

The difficulty accordingly lies in assessing the permanence of exchange rate movements and incorporating the assessment in the overall picture of inflation. The economic fundamentals favour an appreciation of the krona in the coming years. For this reason we believe that the current weakening is temporary and will be followed in time by a renewed appreciation. It should be underscored, however, that if the krona's weakening to date can be regarded as permanent, then there are also reasons for expecting that the weaker exchange rate will lead to inflation at a higher rate than we foresaw in the June report. That would have consequences for monetary policy, always assuming, of course, that other factors have not simultaneously contributed to a better outlook for inflation.

The recent weakening of the krona, together with increased concern about continued turbulence in Asia and global stock exchanges, has shown up in money market pricing. The market's earlier assessment was that room existed for further interest rate cuts. Today the picture is less clear-cut. This I find entirely natural in that the exchange rate is an important factor in our assessment of future inflation.

The overall picture

To sum up, the new statistics since June largely support the opinion about inflation prospects that we presented in the latest report. The figures for real economic activity and inflation suggest, if anything, that the path of inflation will be lower than in our main scenario in the June report. If so, however, it is presumably a question of marginal revisions. The exchange rate, however, instead of moving as we predicted, has weakened. The assessment of this tendency and how it should be weighed up with other factors in an overall assessment of inflation prospects is a matter to which the Riksbank will be returning in the next inflation report on September 28th.

Concluding remarks

Having presented the Riksbank's picture of current economic developments, I should like to return to the somewhat longer time perspective from the beginning of this talk and take up the issue that is the theme for today's speakers. Is there room for expansion in the Swedish economy? In doing so I shall concentrate on two fields that are closely connected with monetary policy: the functioning of the labour market and fiscal policy.

The economic policy that has been implemented in recent years, with its emphasis on price stability and sound government finances, has had favourable results in a number of respects. High growth has been combined with persistently low inflation. Moreover, the composition of growth has been structurally desirable, focusing on exports and industrial expansion. This helps to establish a better foundation for a sustained increase in future consumption. A reduction of external debt has begun.

Prospects for the coming years also look favourable. It seems that output can grow relatively rapidly by Swedish standards, accompanied by relatively low inflation.

There is reason to emphasise, however, that what we see is hardly the final solution to our problems but rather important initial steps towards a more balanced development.

For one thing, the positive trend in the Swedish economy does not yet apply at all substantially to the *labour market.* A downward adjustment in the rate of wage increases towards more reasonable long-term figures has begun but we do not know how permanent it will be. What will happen in the next round of wage negotiations if capacity utilisation at that time is high? Is the functioning of the labour market in other respects sufficiently smooth for the adequate creation and filling of new job vacancies? This is a key question. If we do not succeed in finding good solutions in Sweden when it comes to wage formation and the workings of the labour market, in the longer run it will not be possible to permit such strong economic expansion as we have experienced in recent years.

Another aspect of economic policy that, like the functioning of the labour market, is closely connected with the Riksbank's domain is *fiscal policy*. In recent years monetary policy has been assisted in the first place in that the consolidation of government finances has restored a stable foundation for economic policy; in addition, there has been the more direct restraint—in a cyclical perspective—on demand and price impulses. In recent decades that was by no means invariably the case. On the contrary, there were periods when fiscal policy accentuated the cyclical movements.

I find it important to issue a warning about repeating mistakes of this type. In the middle of an economic upswing we are now hearing calls for expansionary fiscal policies in the form of increased public spending as well as unfinanced tax cuts. There are strong long-term grounds for using the upswing in activity to build up government surpluses as a buffer for harder times. That will increase our future freedom of action in economic policy. It will be easier to cope both with future economic downturns and with structural challenges such as an ageing population. A tighter fiscal policy also eases the burden on monetary policy and increases the probability in the years ahead of being able to continue to have low interest rates and a stable economic development, with good growth of production and employment.