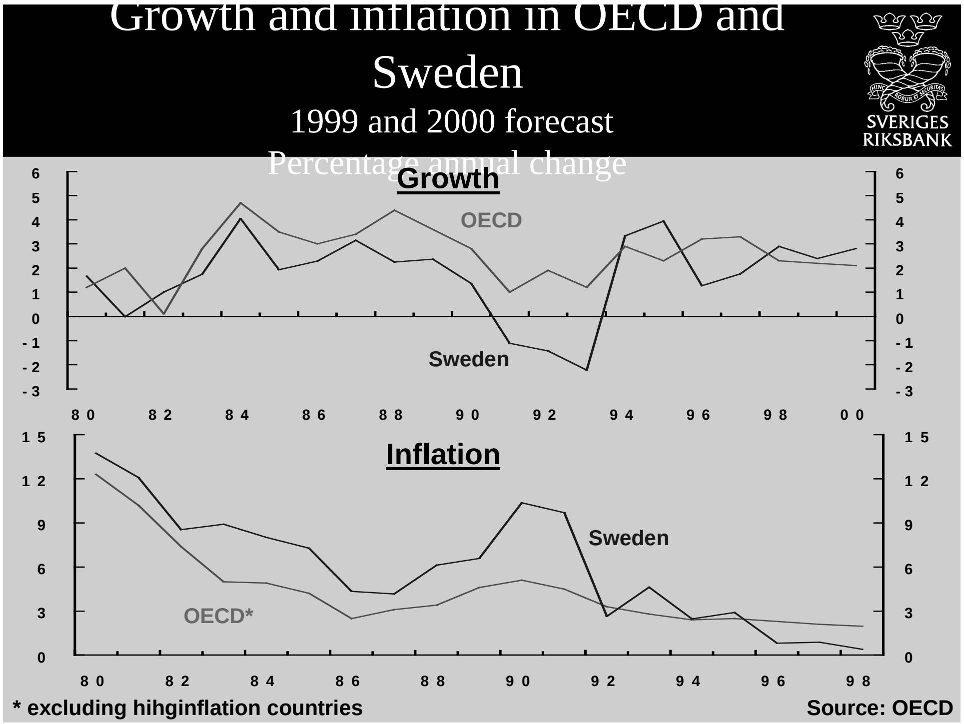
Mr Heikensten talks about the interaction between monetary and fiscal policy and labour market developments

Speech by Lars Heikensten, First Deputy Governor of the Sveriges Riksbank, the Swedish central bank, to the Landskrona Municipality in Landskrona, Sweden on 16 June 1999.

For more than six years now, monetary policy in Sweden has been conducted with an inflation target. Sweden was one of the first countries, together with Canada, New Zealand and the United Kingdom, for example, to adopt an inflation targeting strategy. Other countries have recently displayed an interest in targeting inflation directly as the guideline for monetary policy. Examples are countries with strong economic growth in Asia, South America and Eastern Europe.

In many respects, Sweden's period with an inflation target has been one of good economic results. Inflation and interest rates have come down to levels that are historically low and growth since the crisis in the early 1990s has been relatively high and stable. Part of the explanation is, of course, that the recession left us with plenty of unutilised resources. But new production capacity has also been created at a rapid rate. Moreover, inflation expectations have been lowered, which gives a new and better environment for price and wage formation. International inflation has also been low. The picture of unemployment is more disappointing, though here too the recent trend points in the right direction.



Monetary policy, however, is just one of the factors that are important for economic development. Two crucial matters for economic development in general and thereby for the conditions underlying monetary policy are the situation in the labour market and fiscal policy. In recent years it is not least the construction of fiscal policy that has contributed to the good economic performance.

The interaction of fiscal and monetary policy has been debated a good deal of late. Income tax cuts have been discussed, for instance. Now that Sweden's economy seems to be moving into a stronger phase, in large measure as a result of higher domestic activity, it is of the utmost importance that we do not land in a situation with wage drift and overheating as a consequence of an unduly expansionary fiscal stance. Against this background, I shall be talking today about the conditions for monetary policy and its interaction with fiscal policy and labour market developments.

Interaction with fiscal policy

Fiscal policy affects the chances of success in monetary policy in various ways: via its impact on general confidence in monetary policy, via short-run effects on demand and by modifying the long-term conditions for economic growth and low inflation.

Let me begin with *credibility*. If the direction of fiscal policy is perceived as being unsustainable in the longer run, economic policy's overall focus on low inflation and stable growth is liable to be questioned. Few industrialised countries have experienced this as recently and tangibly as Sweden. The massive budget deficits in the early 1990s, with rapidly accumulating government debt, made Sweden's economic future uncertain and pushed interest rates up. With the consolidation of government finances, however, and the long-term ambitions for fiscal policy that the Government, supported by the Riksdag (Sweden's Parliament), has presented, confidence has improved.

The new budget process — with a moving budget ceiling and a budget surplus of 2 per cent of GDP as a medium-term target — means that the Government and the Riksdag have set up a clear set of rules to show that Sweden has no intention of relapsing into earlier habits. There is nothing fortuitous about these rules. But the purpose of the budget ceiling and the budget target as confidence-enhancing instruments does presuppose that they are observed consistently and continuously over the business cycle.

Changes in fiscal policy also affect monetary policy through their direct impact on *demand*. The debate in recent weeks has focused not least on these effects. An adjustment of income tax or of transfers to households alters disposable income and thereby private consumption. Similarly, a change in corporate tax or transfers to firms affects company profits and thereby investment and other economic decisions. Activity in the economy may also be affected if the government decides to spend more on public sector consumption or investment.

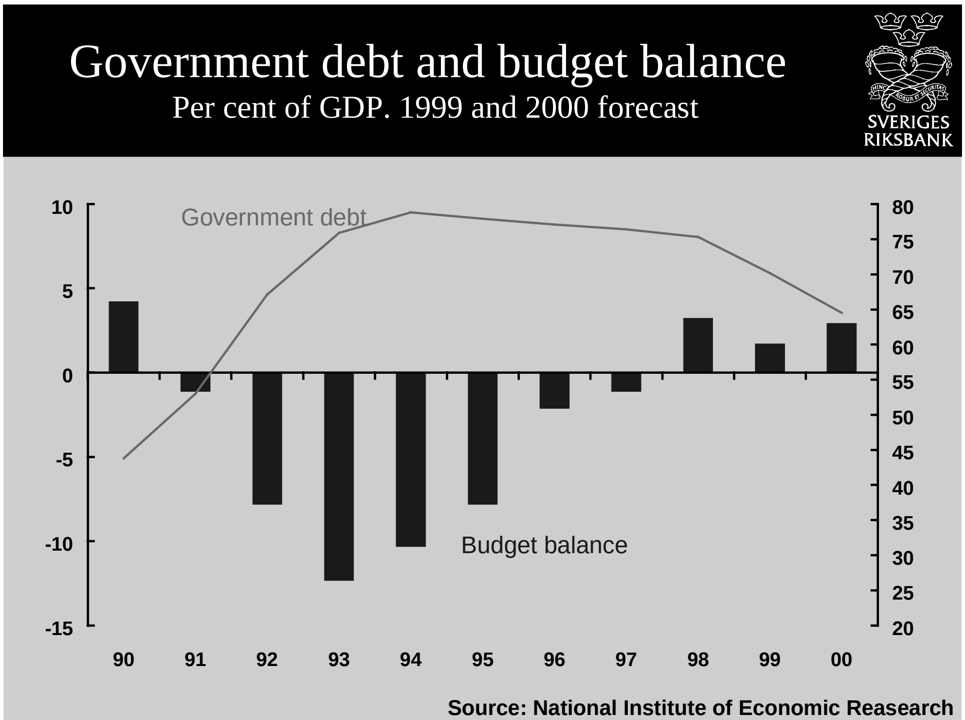
This makes fiscal policy a factor of importance when assessing economic activity and future inflationary pressure. At the same time, the changes that are generated do not lend themselves to mechanical calculations. Part of the reason is that the path of inflation is determined by other factors besides fiscal policy.

A third important aspect of fiscal policy's interaction with inflation has to do with fiscal effects on potential output. Lower tax on productive capital or companies may lead to more companies being established and thereby raise potential output. Similarly, lower tax on labour or increased educational inputs may generate an increased supply of labour and also influence wage formation. These are examples of the numerous ways in which changes in tax and expenditure systems are likely to modify economic opportunities and promote conditions for good growth without the attendant capacity shortages that generate price pressure.

Current fiscal policy

The trade-off between monetary and fiscal policy — the policy mix, as we economists like to say — has improved considerably in the present decade.

The rapid accumulation of government debt has ceased and the stock is now being reduced. While the consolidation of government finances has made the fiscal stance restrictive, it has been possible to lower interest rates and this in turn has stimulated investment, economic activity and employment lately. This is accordingly a considerable improvement compared with the early 1990s, for example, when factors such as very weak government finances led the Riksbank to keep interest rates up at a time when government debt was rising markedly.



In the June Inflation Report we noted that as a result of measures proposed in the Budget Bill, during 1999 and possibly also in 2000 fiscal policy would probably be more restrictive than the Riksbank had assumed earlier but would still become successively more expansionary. The restrictive economic effect of fiscal policy was accordingly judged to be less marked than in the period 1994 – 97.

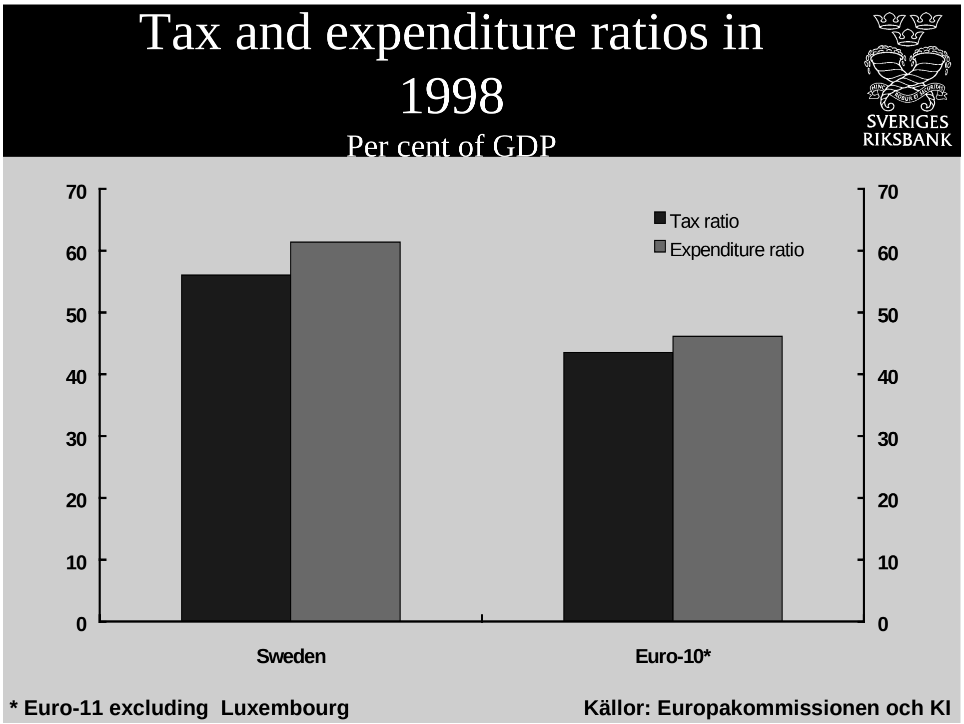
Our scenario assumed, however, that there would be no further tax cuts next year. We foresee a government financial surplus somewhat above 2 per cent of GDP but have thus assumed that it will be used to repay government debt. In 2001, on the other hand, we assume that any surplus in excess of 2 per cent of GDP will be transferred to households.

The Swedish debate about tax cuts and increased spending has become more intense as the government budget moved out of the red and is expected to show continued and growing surpluses in the years ahead. That is hardly surprising. We had exactly the same debate in the 1980s as soon as the budget deficits had been eliminated. Some comments are therefore called for.

One comment concerns the formulation of the budget target. A medium-term average implies that in good years the surplus should be *above* 2 per cent and by most standards the coming years must be regarded as good. While the economy does admittedly still appear to have some unutilised resources, they will gradually be utilised. Maintaining a surplus above 2 per cent when activity is high means that a smaller surplus can be tolerated when activity is lower. In this way, room is created for the budget to act as an automatic stabiliser. If, instead, the surplus is held mechanically at exactly 2 per cent from year to year, fiscal policy will tend to accentuate cyclical fluctuations and exert a destabilising effect.

Another comment concerns the demand effects of an easier fiscal stance in the present situation. The tax changes being discussed seem largely to be unfinanced income tax reductions for low and medium income groups. Judging from what has been indicated to date, a corresponding adjustment of public spending is not envisaged. In that case, the tax cuts would enlarge household income and raise the level of economic activity via increased consumption. That *could* result in increased inflationary pressure that monetary policy *might* need to counter.

That said, I want to underscore that tax cuts may well be motivated. There are many indications that the Swedish economy would work better if taxes were lower. Moreover, with the growing international exchange in almost every economic domain, maintaining taxes in Sweden at a higher level than in the rest of the world will become increasingly difficult. But there is reason to deliberate the type of tax cuts that would benefit the Swedish economy most in connection with good growth. Tax reductions with positive supply-side effects — instead of the cuts being discussed, which mainly stimulate demand — would increase the possibilities of combining the good growth with persistently low inflation.



Interaction with labour market trends

Let me now leave monetary policy's interaction with fiscal policy and consider its relationship with the situation in the labour market. What forms does this interaction take?

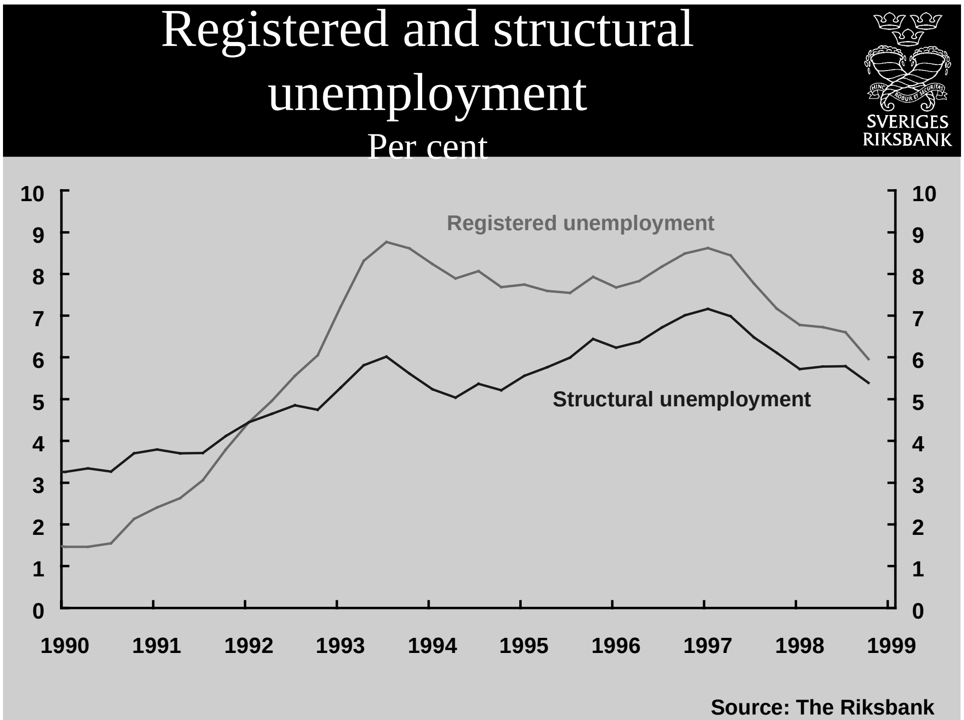
Monetary policy's chief contribution to employment lies in the creation of economic stability and clear rules for wage formation. A monetary policy that is predictable and operates with a clear inflation target provides good guidance for wage negotiations. The lack of a properly functioning stabilisation policy was presumably one reason why wage formation did not work in the 1970s and 1980s. The rules of the game were unclear to the labour market organisations. That is hardly the case today, as the Trade Union Confederation, for example, has acknowledged. Their wage negotiations in 1997 started, in fact, from the 2 per cent inflation target.

In the assessment of future inflationary pressure, monetary policy in turn must take the labour market situation into account. Wages are of major economic importance: in that the wage bill accounts for almost 70 per cent of value added, the development of wages has a large impact on costs and thus on price formation. Moreover, wage settlements are liable to influence inflation expectations.

Wage tendencies are therefore one of the principal variables in any assessment of inflation. However, the difficulties in forecasting wage trends are considerable. The Riksbank does, of course, follow data on wages and unit labour costs; other important indicators include labour shortages in particular industries, wage drift, registered and total unemployment in relation to job vacancies.

A central concept in this context is equilibrium unemployment, often referred to by the English acronym NAIRU—the level of unemployment that can be combined with stable inflation. Attempts to push unemployment down below the NAIRU with monetary stimuli are liable to have the sole effect of boosting inflation. In other words, the NAIRU is not responsive to an expansionary stabilisation policy. It depends instead on the workings of the labour market, together with demographic changes and technology. Thus, lastingly higher employment cannot be generated by continuously implementing an expansionary monetary policy. This is a basic tenet of economics, yet to judge from the public debate it still seems to be misunderstood.

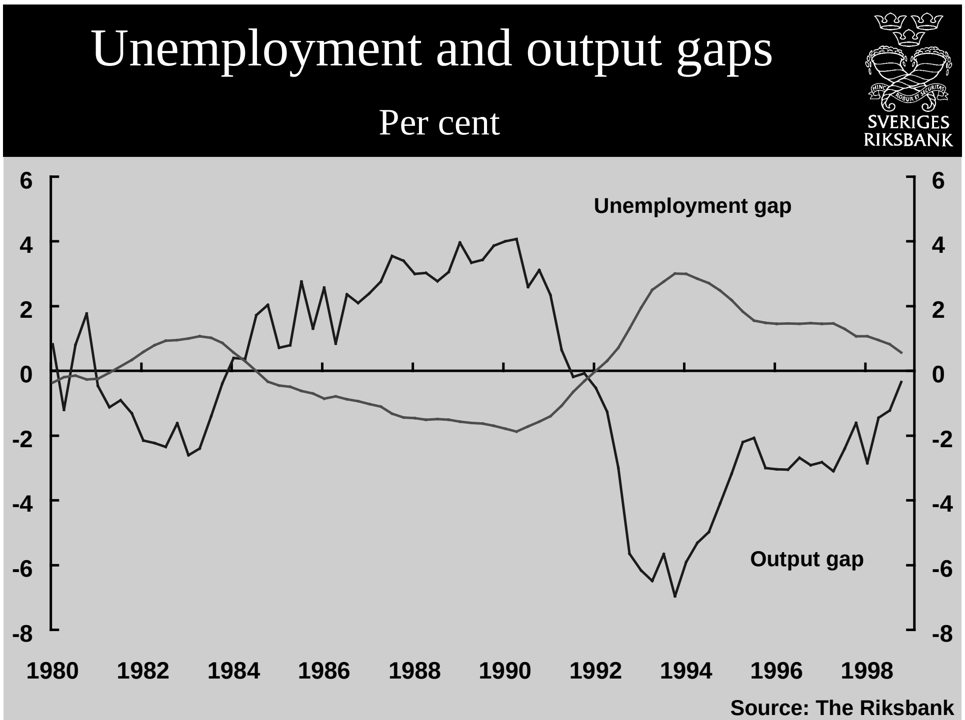
Various attempts have been made to estimate the NAIRU for Sweden. If this could be done with some certainty, it would obviously be of interest. Insights into when a reduction of unemployment risks boosting inflation would be a useful guide for monetary policy. The matter is unfortunately not that simple, mainly because equilibrium unemployment is something that cannot be observed directly.



Assessing the level of the NAIRU for Sweden is presumably particularly difficult at present. We still do not know all that much about the long-term consequences of all that has happened in the past decade. After fluctuating around a low level for decades, possibly with a slight upward trend, with the crisis in the early 1990s, unemployment shot up in just a few years. Moreover, policy has been realigned and focused successfully on low inflation. This is likely to influence wage formation and hence the NAIRU.

It is notable that problems have also been encountered recently in estimating the level of the NAIRU for the United States. Yet the adjustment to low inflation occurred there back around the turn of the 1970s. For some time now, US unemployment has been below the rate that an earlier rule of thumb identified as the equilibrium level but inflation has not accelerated. Some explain this mainly in terms of favourable transitory effects, while others attribute it to more far-reaching changes of a structural nature. In any event, the US example shows that drawing conclusions about the NAIRU can be difficult even in economies where unemployment has remained close to a level that is comparatively constant.

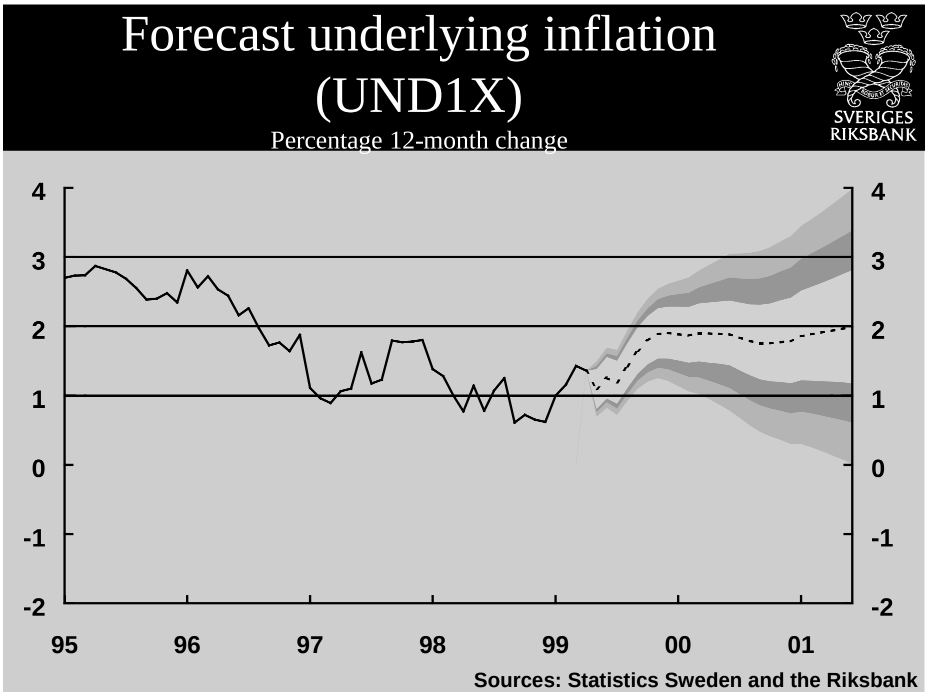
In the Riksbank's work, estimates of the NAIRU are accompanied by, for example, calculations of the output gap, which aim to provide a picture of total capacity utilisation. The output gap is the difference between current production and the economy's long-term production capacity or potential GDP. Like the NAIRU, the latter equilibrium level is not directly observable and therefore has to be estimated with statistical methods. The equilibrium level of output and the NAIRU evidently have points in common. The situation in the labour market must be a central aspect of any assessment of total capacity utilisation.



While good forecasts of inflation can be made without knowing the exact levels of potential GDP and the NAIRU, for those of us who conduct monetary policy it is naturally a problem that it is difficult to tell just how much employment can rise without entailing a risk of a renewed acceleration of wages and inflation. But that is no reason for believing that the functioning of the labour market and wage formation will not be of central importance for future inflation. This brings me to the current situation in the labour market.

The current situation in the labour market

The Riksbank's view of the Swedish economy in the coming years is comparatively optimistic. With the low interest rates and some recovery in international economic activity, GDP growth is judged to be 2.5 per cent this year and 3 per cent in both 2000 and 2001. As I mentioned earlier, this will presumably involve the gradual utilisation of the resources that are unutilised at present.



Increased employment is also foreseen and in the June Inflation Report we counted on a reduction of unemployment to below 5 per cent in two years time. Against this background, in the period 1999–2001 the average annual rate of wage increases is judged to be 3.5–4 per cent. That seems to be consistent with a forecast annual rate of productivity growth of 1.5–2 percent and the same order of inflation expectations among the labour market organisations.

I should perhaps underscore that this is a forecast, not a desired rate of wage increases. A lower nominal wage rise would create better conditions for a quicker increase in employment.

How wages actually develop and the consequences of this for inflation and monetary policy will depend in large measure on how the labour market turns out to function in the coming upward phase. The Riksbank will be keeping a watchful eye on the available indicators. The estimates of the NAIRU and the output gap suggest that inflationary pressure is rising and that in our forecast period the economy will approach or even reach full capacity utilisation. But, as I emphasised earlier, it is not only these indicators that we will be considering. All incoming statistics that contribute to the picture of future inflationary pressure will be followed closely.

It should also be underscored that the outcome is not inevitable. An influence can be exerted with economic policy. I spoke earlier of how budget measures in the form of taxes as well as expenditures can modify the workings of the labour market and the economy in general. As regards the labour market and wage formation, there are many other things to do, for instance in labour market policy, the rules and implementation of unemployment support, the rules that influence wage formation and so on.

Concluding remarks

In many respects, economic policy has produced good results in recent years. This applies not least to the interaction of fiscal and monetary policy. Government debt has been reduced, interest rates have fallen and economic growth has been good, and all this has been combined with low inflation. Employment has been a problem; there are now clear signs of an improvement here, too.

One important explanation for the successful combination of high growth and low inflation in recent years is that the crisis in the early 1990s brought capacity utilisation down to a low level. If economic activity strengthens as expected, the situation may gradually change. Capacity utilisation is rising. This presents policy with new challenges, with an increased risk of higher inflation.

It is desirable that the interaction of fiscal and monetary policy continues to function well. There are strong reasons for adhering to the rules that have been established. An increase of 1 percentage point in the level of interest rates weakens the budget balance by about SEK 10 billion. A continued amortisation of the sizeable government debt will create much-needed room to manoeuvre in economic policy. There will be more scope for stimulating increased demand in future slowdowns.

At the same time, tax cuts would clearly benefit the Swedish economy in the somewhat longer run. But the cuts must then be concentrated to just those taxes that play a major part in the workings of the economy, where changes can help to raise potential output. Together with other measures that improve wage formation and the functioning of the labour market, such tax adjustments could lead to the creation of new jobs without an acceleration of inflation. The more steps that can be taken in this direction, the better will be the conditions for a continuation of a good economic development in Sweden.