# Ms Hessius speaks about the monetary policy and growth conditions for Sweden's economy

Speech given by Ms Kerstin Hessius, Deputy Governor of the Sveriges Riksbank at the Chairmens' Conference of the Västmanland's Local Authorities Association on 27 August 1999.

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## The whole speech

The bright picture of the Swedish economy that has been coming to the fore in recent years now seems to be becoming increasingly distinct. Growth is stable and employment is rising, accompanied by price increases that are moderate. It is important now that this bright picture can become permanent and that the work of creating good conditions for long-term economic development continues. Today I shall be considering the economic situation in Sweden and the rest of the world, with some discussion of the conditions for consolidating the favourable trend.

## Functions of the Riksbank

Ever since Sweden abandoned the fixed exchange rate regime in November 1992, monetary policy has been conducted with its sights on inflation. Sweden was one of the first countries to adopt an inflation targeting strategy. In many respects, the period with the inflation target has been characterised by good results in the Swedish economy. Interest rates and inflation have fallen to levels that are historically low and, after the crisis in the early 1990s, growth has been comparatively high and stable. The general public's expectations of inflation two years ahead are below 2%, which suggests that the inflation targeting policy has achieved credibility – a matter that is crucial for monetary policy's ability to produce good results.

The foundation for monetary policy credibility has been strengthened in that the new legislation in force from the beginning of this year has created a more independent central bank. Maintaining price stability is now the Riksbank's statutory function.

The Riksbank has defined its target as being to keep annual inflation, expressed as the change in the consumer price index (CPI), at 2%. The ambition to keep inflation low stems from the insights about inflation's harmful effects on the economy – that higher growth and employment cannot be generated in the longer run by means of higher inflation. It is other matters, such as how the economy functions, achievements in technology and the educational system, that determine those factors. The best way for monetary policy to contribute to high growth and employment is therefore to improve the long-term growth potential via low inflation.

To achieve its objective, the Riksbank uses its instrumental rate, the repo rate. If the Riksbank's monetary stance is unduly expansionary, that is, if the repo rate is too low to ensure macroeconomic balance, in time the economy will be liable to overheat. Demand then grows more rapidly than production capacity and this generates inflationary pressures. If, instead, the Riksbank's monetary stance is unduly restrictive, that is, if the repo rate is set too high, the result may be declining demand, a weaker price trend and unsatisfactory growth.

The full effect of an interest rate adjustment takes between twelve and twenty-four months to materialise. This means that the interest rate has to be set on the basis of the Riksbank's assessment of the macroeconomic trend and inflation prospects in that period. However, the inflation assessments are subject to uncertainty and this risk spectrum has to be considered too. Since December 1997 the Riksbank's inflation forecast includes what is known as an uncertainty interval. This interval represents the Riksbank's assessment of the uncertainties in the forecast.

Targeting CPI inflation, however, has certain drawbacks. At the beginning of this year the Executive Board of the Riksbank therefore clarified the inflation target in some respects, stating that, under certain specific circumstances, the Riksbank may have grounds for interpreting the CPI target more flexibly. Price formation in the past three years, for example, has been affected by some clearly identifiable price movements that monetary policy neither can nor shall aim to counter in full. This applies mainly to decreased indirect taxes and the direct effects that the Riksbank's own interest rate adjustments exert on interest expenditure and thereby on CPI inflation.

## The economic situation in Sweden

### *Labour market*

As I mentioned earlier, monetary policy's primary contribution to the development of employment lies in creating conditions for a stable economic trend. A predictable monetary policy, focused on a clearly defined inflation target, provides good guidance for wage negotiations. One of the main reasons why wage formation did not function satisfactorily during most of the 1980s was probably that stabilisation policy did not work. Inflation exceeded the official target on several occasions in that period and the labour market organisations had difficulty in discerning the rules of the game. One example of this is the government ambition of bringing inflation down in the mid-1980s: a crisis package was presented in 1983, aimed at inflation rates of 4% in 1994 and 3% in 1995; when inflation exceeded these targets, the employee organisations considered that a 5% ceiling on wage increases was no longer acceptable.

Today's confidence in the Riksbank's current inflation target facilitates wage negotiations. The 1997 wage round, for instance, took the 2% inflation target as a starting point.

The development of wages is always a central factor in inflation assessments, but the difficulties involved in forecasting wages are considerable. The indicators used by the Riksbank include data on wages and unit labour costs, shortage figures (bottlenecks) at industry level, wage drift and unemployment relative to unfilled job vacancies. Another factor of importance for monetary policy is the equilibrium level of unemployment, that is, the level of unemployment that is compatible with stable inflation. Attempts to push unemployment down below the equilibrium level with the aid of monetary stimuli are liable to just boost inflation. Maintaining an expansionary monetary stance cannot therefore generate permanently higher employment.

During the past year the situation in the Swedish labour market has improved appreciably. Since the beginning of 1999 the number in employment has risen by almost 100,000. A continued improvement can be expected, but more employers are reporting difficulties in recruiting qualified labour even though unemployment in Sweden is still historically high. There is still a need for measures of a structural nature to improve the workings of the labour market and thereby the long-term conditions for economic growth.

### *Consumption*

The demand side of the Swedish economy, above all private sector demand, has picked up properly in recent years. In 1997 private consumption rose 1.6% from the previous year, followed by 2.4% in 1998 and a preliminary rate of 3.4% between the first halves of 1998 and 1999. Major factors behind the growth of private consumption are the better labour market situation, rising disposable income and increments to household wealth.

The consumption trend is particularly dependent on future household income. Expectations of an improvement will lead to increased spending on consumption at the expense of current saving.

At present, households' optimism about their own economy seems to have stabilised at a level that is historically high. The Riksbank envisages that household expenditure on consumption will be stimulated in the future by, for example, rising real wages, low interest costs and tax relief. Moreover, international economic prospects have stabilised and employment in Sweden has risen. These developments suggest that the consumption trend will remain favourable.

### *Public sector*

The financial position of the public sector has been strengthened appreciably in recent years, partly as a result of decreased unemployment, but also because interest expenditure on government debt has been reduced as a consequence of lower interest rates and debt repayment. This has been accompanied by comparatively high tax payments from households as well as the corporate sector. For 1998 the financial surplus – measured as public sector revenue less expenditure – was almost SEK 40 billion, which is equivalent to over 2% of GDP.

In recent years the central government budget process has been changed with a view to tightening the control of government spending. The new budget process includes a spending ceiling that sets the maximum level for central government expenditures. In addition to the new budget process, the goal has been established of achieving a general government financial surplus equivalent to 2% of GDP over the business cycle. Thus, the goal is formulated in terms of the average over the business cycle, not as an annual target.

These rules do not owe their existence to happenstance. Both the expenditure ceiling and the goal of a government financial surplus over the business cycle serve to promote greater confidence in economic policy. The direction of budget policy, like the monetary stance, is highly important for economic developments. The observance of these rules is important. Stable fundamental rules encourage economic agents to make long-term decisions.

## The international situation

Favourable conditions in the rest of the world are of course of major importance for economic growth in Sweden.

In the euro area there are now also increasing signs that activity is picking up. Incoming statistics on confidence indicators, for instance from Italy, France and Germany, show that households as well as firms foresee a brighter future than before.

Moreover, the Japanese economy seems to be recovering from its poor performance in recent years. Still, the latest statistics suggest that the trend for manufacturing output remains weak, making it advisable to wait for further statistics before taking a Japanese upswing as given.

The US economy remains strong. GDP growth in the first quarter this year was over 4% and over 2% in the second quarter. Household expenditure on consumption has gone on rising more rapidly than current income, so saving has fallen and is now at a record low. This has been accompanied by a weak price trend for a majority of goods. Nevertheless, the US Federal Reserve now considers that inflationary pressure is building up. At the two most recent meetings the Federal Reserve has raised interest rates in order to forestall an unduly rapid increase in consumer prices.

## New economic relationships?

The prolonged strength displayed by the US economy has been unexpected. In the past five years US economic growth has averaged an annual rate of over 3%. At the same time, the average rate of CPI inflation has been little more than 2%.

Some observers consider that this performance represents a new economic era in which high economic growth and falling unemployment can be achieved without generating increased inflationary pressure. According to this view, potential output has risen in recent years, accompanied by a fall in equilibrium unemployment. Explanations for this could be, for example, improved productivity as a result of new technology and increased international competition. An alternative explanation is that transitory factors, such as the loss of global demand in connection with the crisis in Southeast Asia, have caused prices to fall or remain unchanged.

In Sweden, too, economic growth since the mid-1990s has been comparatively good without inflationary pressure giving cause for concern. The monetary stance has been adjusted accordingly and the repo rate is currently 2.9%. It is too early, however, to say whether or not this is a sign of some far-reaching change in the Swedish economy. The Riksbank will have to take a close look at the incoming statistics and endeavour to arrive at a conclusion.

**Conclusion**

There are many signs that the Swedish economy is growing more rapidly. It is only now that we are beginning to see growth rates above 3%. For the Riksbank – as well as for the economy in general – it is important that this trend does not again land us in a situation where inflation is high and variable. Provided the cards are played correctly, growth can be sustained and lead to a permanent increase in employment.

This calls for an adjustment of demand to the economy's productive capacity. It is important that structural measures which primarily improve the workings of the economy are implemented in good time. The good consumption trend can then be met by rising output and high growth can be maintained without this necessarily leading to unduly high inflation.

As I have already made clear on several occasions, I consider that tax cuts, in tune with the established guidelines for budget policy, are motivated. The tax-to-GDP ratio has risen in recent years as a consequence of the growth of private consumption and rising wage bills; today the ratio is above 50%. The Swedish economy would probably function better with lower taxes.

The reforms that are needed in the tax system – as well as those I consider should occur in the labour market – can be arranged, however, in such a way that they promote the aims of stabilisation policy. Tax cuts in Sweden are probably needed that confer long-term benefits on both the supply and the demand side of the economy; a long-term tax reform with those ambitions would be desirable. In the present situation, however, with growth seemingly reaching around 3.5% this year and 3% in 2000, tax cuts and labour market reforms that primarily favour the supply side would increase the opportunities for good growth without contributing to increased inflationary pressure. That would lessen the risk of overheating and facilitate the interaction of fiscal and monetary policies.

There is the problem, however, that evidence of good results – be they in the national economy or in one's own enterprise – tend to weaken demands for changes which are needed for more sustainable achievements. I would also say that the less one does in the good years, the tougher the going is likely to be when times are worse. Not infrequently, necessary measures are not taken until a crisis is actually looming. Today we are reaping the harvest from many important structural changes that were implemented during the crisis in the first half of the 1990s. It is up to every decision-maker to consider which measures we can now take in order to create robust long-term conditions for the economy.