

Urban Bäckström: The Swedish economy

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, to the Swedish Shareholders' Association, Gotland section, in Visby on 29 January 2001.

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Thank you for inviting me to Gotland to talk about the Swedish economy. Being in Visby is always a pleasure, besides reviving many memories — as some of you may know, I spent some time here in the Sixties.

Today I intend to begin by looking back at economic developments in recent years. That should help to put the current discussion about the Swedish economy in perspective. After that I shall be saying something about the economy's recent cyclical path and how I assess the future in the light of the information that is presently available.

We have now experienced a series of years in which the economy has been expanding strongly. Since the upturn began in the summer of 1993, the annual GDP growth rate has averaged about 3 per cent. Not since the period in the late Sixties and early Seventies have we had growth figures like this. The favourable trend has contributed to rapidly rising employment and decreased unemployment. Open unemployment has dropped in only four years from 9 per cent to less than 4 per cent. In recent years, moreover, an average of almost 100,000 new jobs have been created annually. A look at the statistics shows that this expansion of employment is the strongest Sweden has experienced since the labour force surveys were first published in the early Sixties.

The markedly favourable trend is not confined to growth, employment and unemployment. Both our foreign transactions and the public finances are generating surpluses.

Another aspect of the good situation is that inflation has remained moderate. In recent years the rate of inflation, as measured by the consumer price index, has been just under 2 per cent. This has paved the way for real wage increases on a scale we have not seen since the Sixties.

In the light of all these factors — rapid economic growth, rising employment, falling unemployment, internal and external surpluses, low inflation and favourable real wage increases — the picture of the Swedish economy is very bright. What, then, is the explanation for this advantageous course of events? In my opinion, it has to do with a combination of factors.

The economic crisis that ravaged Sweden in the early Nineties clearly meant that plenty of resources were available when activity subsequently recovered. That reduced the risk of production soon reaching its ceiling.

At the same time, the Swedish economy has been performing more efficiently, particularly compared with the previous quarter-century, when even relatively low growth rates tended to generate inflation. One explanation lies in the realignment of economic policy that began in the late Eighties to promote stability and predictability. Today we can say that confidence in the Riksbank's 2 per cent target for annual inflation is strong; it functions as a clear benchmark for price- and wage-setting decisions.

The transformations that have been achieved with new establishments — not least in the IT sector — and increased competition, as well as the deregulation of important markets, should also be included in a complete account of factors that have contributed to the good performance in recent years. They have pushed prices down and thereby kept inflation in check, making a strong expansion of demand feasible.

Sooner or later, however, an excessively rapid increase in demand that is allowed to continue will result in an unbalanced economy. This is simply because rising resource utilisation increases the risk of tensions between supply and demand. Even in the best of worlds, an economy cannot disregard the fundamental laws by which it functions. In many respects, the most recent crisis in the early Nineties was occasioned by the economy being left for so long to expand at a rate that could not be sustained. This ended in a crash. So in order to avoid a situation with mounting imbalances, in time economic growth in Sweden will have to start slowing down to a rate that is sustainable in the longer run.

What, then, is the level of this potential growth rate? According to a common, though not entirely certain estimate, the Swedish economy's sustainable annual growth rate lies between 2 and 2.5 per

cent. In view of the high growth rates in recent years and considering that we have moved towards a situation where resources are becoming increasingly strained, it might be concluded that it would be healthy for the Swedish economy if activity were to slow a little in the future.

Many observers counted on interest rate hikes

I recall that during the past year a good many observers counted on fairly large interest rate increases. They thought they saw clear signs of the Swedish economy being on the way to overheating and considered we ought to act promptly to prevent this from happening. Along with the frequent warnings, moreover, a number of other central banks increased their instrumental rates. The U.S. Federal Reserve, for instance, raised its rate in the course of last year to 6.5 per cent. In Europe the ECB tightened its monetary stance and increased the refinancing rate to 4.75 per cent, while the Bank of England adjusted the interest rate upwards during 2000 to 6.0 per cent.

The Riksbank, however, took a more cautious course. For although our assessment of economic activity was relatively similar to that of other forecasters, we differed all the more about the path of inflation. In a sense, the inflation forecasts can be said to register the temperature of activity and indicate how quickly the economy is capable of expanding. We saw clearer and clearer signals that the relationship between growth and inflation had become more favourable. It looked as though the economy could cope with somewhat higher growth for a period without becoming overheated and generating higher inflation. We took it in stages, with a relatively mild monetary stance, as the forecast horizon shifted into the future. Today we can note that at 4 per cent, the repo rate in Sweden is lower than in most other industrialised countries.

Closer focus on resource utilisation

During the autumn we focused increasingly on resource utilisation. The economy was moving towards a situation in which the growth of total production was ultimately liable to be excessively high. There was nothing dramatic about this; in view of the strong activity, it was only to be expected. What was perhaps surprising was that shortages had not become more acute, particularly in the labour market.

In an upward cyclical phase, the development of a situation where the tensions in markets for goods, services and labour threaten to gain the upper hand and threaten price stability is a gradual process. That makes it difficult to tell exactly when the imbalances will constitute a genuine problem for inflation prospects.

What we and other observers have to do is endeavour to draw conclusions from a continuous inflow of economic information, where each item is carefully scrutinised. This is not a simple matter and there is a risk that interpretations will sometimes be wrong. Moreover, there is a time lag before measures of monetary policy elicit effects — our premise is that the full effect of an interest rate adjustment takes one to two years to materialise. We therefore have to balance the risks of acting too soon against those of acting too late. If the Riksbank acts prematurely, unemployment is liable to fluctuate more widely than otherwise. Acting too late, on the other hand, may lead to higher inflation expectations as well as rising prices and wages. In that case, the economy may ultimately land in a recession, perhaps with higher unemployment.

Fortunately, it is not a question of either/or. A monetary policy adjustment can be decided gradually, with stepwise adjustments to the repo rate. Consequently it is always possible to compare forecasts with outcomes, assess the policy stance continuously and make any adjustments that are called for.

If monetary policy is successful, a foundation is laid, not only for low, stable inflation in line with the target and the Riksbank's statutory objective, but also for stable output growth in the longer run and a stable development of employment. That is something I find important to underscore.

Various forms of demand adjustment

In the coming years there will accordingly have to be some adjustment of demand to the Swedish economy's long-term growth trend. In principle, this can happen either as a spontaneous slackening of activity, for instance because Sweden is affected by an international economic slowdown, or via a monetary adjustment. In practice it can result from a combination of the two.

There are increasingly clear signs of a slowdown in the U.S. economy. In Europe's euro area, too, activity has been somewhat weaker than expected. In Japan it looks as though a recovery will be further delayed on account of the problems that have already beset the country for a long time. Moreover, the weaker trend in the United States may have a regional effect on Southeast Asia.

The global economic slowdown, together with the Riksbank's repo rate increase of 0.25 percentage points last December, are tending to adjust the expansion of demand towards the long-term growth path. As far as Sweden is concerned, the slowdown we have observed to date can to some extent be regarded as welcome.

Alternative scenarios in the inflation assessment

Now for some comments on the alternative scenarios that can be discerned in the future and which add up to our risk spectrum. As you no doubt know, the Riksbank's quarterly Inflation Report contains a thorough account of our appraisal of economic developments in the coming twenty-four months.

In the Report we presented early last December we counted on growth rates for the Swedish economy of 3.4 per cent this year and 2.9 per cent in 2002. The main scenario accordingly incorporated the assessment that demand growth will slacken somewhat in the forecast period. The underlying assumptions included somewhat lower international growth, a weaker development of consumption and an appreciating exchange rate.

The rate of underlying or core inflation, measured as UND1X, was judged in the main scenario to be 1.8 per cent one year ahead and 1.9 per cent after two years. The corresponding assessment of consumer price inflation, measured by the CPI, gave rates of 1.8 and 2.1 per cent, respectively.

In addition, we presented alternative scenarios that highlighted four different factors that were liable to upset the main scenario. All in all, however, the risk of inflation being higher than in the main scenario was judged to be greater than the risk of lower inflation.

Of the four risk factors, three accordingly pointed to rising inflation:

- For one thing, there was judged to be a risk of the *oil price* remaining at a high level.
- For another, there could be a risk of the *Swedish krona* not appreciating as foreseen in the future.
- Thirdly, a risk was perceived of the *wage trend* being stronger than in the main scenario.
- Fourthly, we considered there was a downside risk of *international growth* being weaker than in the main scenario

A weighted combination of these four factors indicated an overall upside risk for inflation both one and two years ahead. It was against that background that the repo rate was raised 0.25 percentage points in December, to 4 per cent.

So how does that assessment stand today? As far as the exchange rate is concerned, the level relative to Sweden's main trade partners is still weak. On the other hand, the international price of crude oil has become somewhat lower. It is still too early for a more definite assessment of wage agreements, not least because settlements have still to be concluded for a relatively large proportion of the labour market. Thus far, however, it can be noted that there now seems to be less risk of sizeable upward deviations from the Riksbank's earlier wage assessment. When concluding agreements, the negotiating parties appear to start from the inflation target, which is positive.

Generally speaking, it can be said in conclusion that the slowdown which so far seems to be going on in the Swedish economy is in a way to be welcomed. A limited retardation helps us to adjust the development of demand to the long-term path of growth, and thus reduces the need for further interest rate hikes. It remains to determine the extent to which the international slowdown will suffice to dampen the Swedish economy's somewhat too rapid earlier expansion. But neither can one rule out the possibility that the downturn in the U.S. economy will be more pronounced than various observers count on at present. It is therefore important to keep a close eye on and interpret incoming statistics on activity, in Sweden as well as the rest of the world, with the aim of arriving at a picture of future inflation prospects that is clearer than we can form at present. For the same reason, it is also important to monitor the outcome of the current wage negotiations and other influential factors.