Urban Bäckström: Monetary policy in a small open technology-oriented economy outside the major currency blocs

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, at the Conference on New Challenges for Credit Markets and Monetary Policy, hosted by Handelsbanken and held in Stockholm, 18 May 2001.

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Thank you for inviting me to this conference and to discuss the Swedish economy and monetary policy with such a distinguished group of people. Today I intend to begin by looking back at economic developments in recent years in Sweden. 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.

Economic policy realignment in the early 1990s

The direction of Sweden's economic performance during the 1990s contrasts sharply with the unstable, inflationary path we experienced in the 1970s and '80s. That stop-go policy contributed to the recession in the early '90s, which was the worst for over sixty years. The 1970s and '80s illustrate how a long period of high and variable inflation creates an atmosphere of uncertainty and instability. Slowly but surely, long-term conditions for production deteriorate.

It was partly in the light of these experiences that Swedish economic policy was realigned in the early 1990s. Since then, the focus on price stability has gained broad support in our society.

However, because of the severe economic problems in the early 1990s, with inflation expectations based on our historical record and a massive budget deficit, it took quite some time for the new direction of economic policy to acquire credibility. Financial market developments can be regarded as an indicator of the prevailing degree of confidence in the determination and ability to conduct an economic policy that is consistent and oriented towards stability. With the free movement of capital and the globalisation of financial markets, economic policy decision-makers need to be highly disciplined. Experience from other countries, where the policy realignment had already been made in the early 1980s, indicates that the creation of a low inflation regime's credibility takes time. But it also shows that after a while, such a process does ultimately yield a favourable economic development.

The price stability target

In the past decade a growing number of countries have chosen to conduct monetary policy with an explicit target for inflation. One reason behind this choice has no doubt been these countries' poor experience with a fixed, but adjustable, exchange rate regime.

The first country to formally adopt a policy of targeting inflation was New Zealand in 1990. Canada did the same in 1991, followed by the United Kingdom, Sweden and Australia. Other industrial countries have also introduced some variant of inflation targeting since then, most recently two other Nordic countries, namely Norway and Iceland.

It is interesting to note that before the 1990s the predominant view was that a floating exchange rate regime is not suitable for a small open economy. Today, I believe that experience has been exceptionally good among those countries that are explicitly targeting a low rate of inflation. In fact, some emerging market countries are now building the same kind of regime. In recent years countries such as South Africa, Brazil, the Czech Republic, Poland and Thailand have been inspired to introduce a similar strategy. Consequently, explicit inflation targets have been introduced in quite a number of countries.

The challenge during the 1990s for the inflation targeting countries has been to build a rigorous analytical framework around the new regime. Questions such as the choice of rate and index to be targeted, the usefulness of tolerance intervals around the target and the degree of transparency in the monetary process all needed to be answered. It has also been important to formulate a monetary policy reaction function; in particular, to define the balance between inflation variability and output variability. The reason why central banks do not aim for maximum short-term stability in either inflation or output is that attaining only one of the targets would be costly for the economy. On the one hand, the central bank's legitimacy among the general public could suffer if short-term interest rates have to move sharply, causing **output to fluctuate widely** while inflation is held stable and exactly on the target. Maximum stability in output could, on the other hand, result in **sharp fluctuations in the rate of inflation** and erode the credibility of the monetary regime. A point somewhere midway between the two extremes must therefore be found. Consequently we cannot be called "inflation nutters" as Mervyn King, deputy governor of the Bank of England, once said.

Let me also stress the importance of central bank independence. In order to be successful with the implementation of an inflation target approach, the central bank needs to be able to act independently of day-to-day party politics and to set interest rates continuously according to the specified inflation target. Otherwise a credibility problem may arise because it would be hard for policymakers to convince the general public of monetary policy's long-term nature.

Following the changeover to a flexible exchange rate in 1992, monetary policy in Sweden was directed towards an explicit and quantified inflation target. The decision rule by which our monetary policy is usually guided is in fact quite simple. It states that if the forecast rate of inflation 1-2 years ahead is above 2 per cent, then normally the repo rate should be raised and vice versa. The reason why we chose this target horizon is that an adjustment of the monetary stance takes time to exert its full impact on inflation and the macro economy in general. Although we are also able to influence inflation in the shorter run, doing so is normally inappropriate because it is liable to result in large fluctuations in production and employment.

Of course the rule is not applied mechanically. The basic intention is to stabilise inflation around the target and at the same time avoid unduly large fluctuations in production and employment. We tend to disregard economic shocks with effects on inflation that can be assumed to be only transitory. Moreover, there may be grounds for heeding the expected course of events beyond the regular target horizon. There may be a case for adjusting the repo rate immediately if there are already strong reasons for expecting a marked increase or decrease in inflation directly after the two-year horizon. Another point to remember is the Riksbank's mandate to promote a safe and efficient payment system; problems in this context may call for interest rate adjustments even though the inflation target is not threatened. Such adjustments may be needed both to prevent potential risks from building up in the payment system and to moderate effects of problems that have already arisen.

However, departures of this type from the normal decision rule should be made restrictively. Moreover, deviations should be stated clearly, and carefully justified.

Favourable economic development over several years

Under the new regime the Swedish economy has experienced several years of strong growth. Since the upturn began in the summer of 1993, the annual GDP growth rate has averaged around 3 per cent. Not since the period in the late 1960s and early '70s has our economy experienced growth figures like this. The favourable trend has contributed to rapidly rising employment and decreased unemployment. 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 '60s. The markedly favourable trend is not confined to growth, employment and unemployment. Both the current account 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 under 1.5 per cent. This has paved the way for real wage increases on a scale we have not seen since the 1960s.

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 has indeed been very bright. What, then, is the explanation for this advantageous course of events? As always, it has to do with a combination of factors.

The economic crisis in Sweden in the early 1990s clearly meant that resources were available when activity subsequently recovered. That reduced the risk of production quickly 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. During the 1990s we have experienced an upward shift in the rate of productivity growth. However, productivity growth has not accelerated as in the United States. One explanation behind the shift in Sweden's productivity growth probably lies in the realignment of economic policy towards sound government finances and price stability. Today we can say that the credibility of the inflation target is high and it functions as a clear benchmark for price- and wage-setting decisions, thereby promoting a longer planning horizon in the business sector.

Transformations have also been achieved by new companies, not least in the IT sector. Financial markets have been deregulated, the tax system has been reformed, the system of social transfers has been modified and competitive pressure has increased. All this has helped to improve the workings of our economy 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 with tensions between supply and demand and an acceleration of wage and price inflation. Even in the best of worlds, an economy cannot disregard the fundamental laws by which it functions.

What, then, is the level of this potential growth rate? According to a common, though not very precise estimate, the Swedish economy's sustainable annual growth rate has shifted upwards from 1.5-2.0 per cent in the 1980s to somewhere between 2 and 2.5 per cent. In view of the high growth rates in recent years and considering that we had moved towards a situation where resources were becoming increasingly strained, we in the central bank concluded last autumn that it would be healthy for the Swedish economy if activity were to slow down somewhat to a more sustainable rate.

In principle, an economic slowdown to a more sustainable growth rate can happen either as a spontaneous slackening of activity, for instance coming from an international disturbance, or via a monetary policy adjustment, or from a combination of the two.

For a while now there have been clear signs of a slowdown in the U.S. economy. In the 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 growth in the United States may have a regional effect on Southeast Asia. Accordingly, it is now becoming increasingly clear that a global economic slowdown is tending to adjust the expansion of demand in the Swedish economy towards a more sustainable growth path.

However, it remains to determine the extent to which the international slowdown will sufficiently dampen the previous unduly rapid expansion in the Swedish economy. On the other hand, it cannot be ruled out that the downturn in the U.S. economy will be more pronounced than various observers count on at present. In such a scenario the Swedish economy could experience a more pronounced slow-down.

Focus on the U.S. economy…

During the 1990s the United States experienced its longest economic upswing ever without any serious signs of accelerating price inflation. A more productive economy, with strong competition and more efficient product and labour markets, accompanied by advances in computer and telecom technology, are said to have contributed to a higher rate of potential growth. Even so – or perhaps as a consequence of this – the euphoria led to growing imbalances. The rapidly rising stock markets in the late 1990s seem to have stemmed from unduly high expectations of future profits and incomes. Partly in view of the booming stock market, households stepped up their expenditure on consumption in excess of current income. Corporate investment expanded rapidly to meet the growing demand. High share prices stimulated the procurement of venture capital and generated a plentiful supply.

The growth of demand in relation to the expansion of the U.S. economy's supply side was proceeding at a rate that was based on expectations that simply could not be fulfilled. American households pledged future incomes for current consumption to such an extent that their savings no longer sufficed to finance corporate investment. The saving deficit in the private sector grew, as could be seen from the rising deficits on the current account, and large amounts of capital had to be imported. The apparently unending increase in expectations of rising share prices on U.S. stock markets stimulated the capital imports, which continued to such an extent that the dollar rose to high levels against other currencies. Together with large investments in the real capital stock, which led to a capital-deepening process and hence an acceleration of productivity, the dollar's appreciation held back the price impulses that normally accompany growing pressure from wage costs.

It is not yet possible to tell to what extent the U.S. economy will experience a lengthy, more difficult process of adjustment. That is probably the background to how the Federal Reserve has acted in recent years. A series of interest rate hikes during 1999 and 2000 was presumably intended to restrain the euphoria and excessive expansion. When a downturn then became evident, it seemed desirable to try to limit the mood swing by means of the marked interest rate cuts we have seen this year.

It is precisely the Federal Reserve's vigorous action that underlies certain analysts' view that the current economic slowdown will be fairly mild and brief.

…and the tensions between supply and demand in Sweden

Since the previous inflation report, demand in the Swedish economy has slowed down somewhat. This is true in particular for industry. Incoming statistics also indicate a slightly weaker growth in household sector consumption. Employment, on the other hand, remains strong even though more forward indicators of the labour market are signalling slower growth later this year.

If international activity were to move into a recovery, most things suggest that demand in the Swedish economy would start rising more rapidly again from a level of resource utilisation that is already relatively high. The earlier restrictions would then be back on the agenda, with the attendant risk of higher inflation.

During the past week, new statistics on prices have been published and show that the rate of inflation has picked up more than expected. Although higher than expected inflation figures should be taken seriously, it is nevertheless important not to overemphasise them. The recent pick-up in inflation is to a large extent a consequence of a few very special factors that could prove to be temporary. The price increases for petrol, electricity, and meat could be examples of this. At the same time, resource utilisation in the Swedish economy is at a high level and there is thus reason to closely monitor the trend rate of inflation (i.e. excluding the mentioned special factors), which has been slowly moving upwards from last year's very low levels.

If the storm clouds in the international economic skies were to disperse and growth were to improve, there is a risk of tensions arising that could require a tightening of monetary policy.

On the other hand, it cannot be ruled out that the downturn in the U.S. economy will be more pronounced. In such a scenario the Swedish economy could experience a more pronounced slowdown, stemming through various channels from weaker exports, investments and private consumption. In that case the Swedish repo rate is more likely to be lowered somewhat.

My conclusion is that the future path of the U.S. economy is highly important for economic developments in Sweden. The situation is difficult to assess and the appraisals our Executive Board has to make are more difficult than usual. Probably the only way to arrive at a clear assessment of the balance of risks is to wait a while and see in which direction developments appear to be moving.