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, Stockholm, 27 November 2001.

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First a word of thanks for the invitation to this evening's meeting. I intend to talk about the Swedish economy and monetary policy.

The past year has been marked by a successive weakening of economic activity in Sweden as well as abroad. Forecasters all over the world have made sizeable downward revisions to the prospects for growth both this year and next.

Consider the picture of the economic future that Consensus Economics compiles once a month from the predictions of 200 professional observers. At the beginning of this year the combined assessment was that in 2001 and 2002, GDP growth in the United States and Sweden would amount to between 2.6 and 3.5 per cent. It was foreseen that the slowdown would be comparatively moderate and be followed by a quick recovery. Today, growth in the United States is judged to be just a modest 1 per cent or so this year and even weaker in 2002. In Sweden, GDP is now expected to rise 1.4 this year and 1.7 per cent next year.

In other words, it now looks as though the slowdown will be both deeper and more protracted than many observers counted on less than a year ago. We are experiencing a simultaneous slowdown in all the leading economies. After the terrorist attacks on 11 September, moreover, there is an even greater risk of the cyclical decline being more pronounced and persistent.

The almost simultaneous and marked change that occurred in the global economic climate in the latter part of last year was triggered to an important extent by rising energy prices, higher interest rates, falling stock markets and the abrupt swing in corporate investment. Weaker demand led in turn to stock adjustments and thereby to further downward effects on orders and production.

At the same time, falling asset prices, not least in stock markets, tended to subdue private consumption. On top of this, the terrorist attacks entailed a loss of production in the short run and postponed a cyclical upturn.

In many respects, economic activity is following the normal cyclical pattern and is therefore not all that surprising. After a long period of expansion, sooner or later activity turns downwards while the economy gathers strength for a renewed upward surge. While there is nothing exact about the succession of cyclical phases, one can say that activity has always fluctuated more or less regularly.

What was unexpected, however, is the rate at which activity has slackened. The downturn seems to have been accentuated by a reaction to the excessive optimism which the technological breakthrough had generated, giving rise to the notion of a new economy. We can all recall the virtually unbounded enthusiasm over the benefits that would flow from the new computer and telecom technologies.

Expectations of a rapid future increase in profits and incomes inspired firms as well as households in many parts of the world, perhaps above all in the United States. Investment and consumption both rose and so did stock markets and production plans. This led in time to growing imbalances in the American economy, for instance between saving and investment as well as between current and more fundamental stock-market valuations. Investment was probably stepped up rather too quickly. Although optimism in other parts of the world did not become as excessive as in the United States, there were no doubt a good many investment, consumption and share-purchasing decisions that perhaps would not have been made if a more long-term view of economic development and more realistic expectations had prevailed.

Important to learn from history

History has taught us that euphoric phases of economic activity tend to end in a sudden change of mood. Economists of the Austrian persuasion see investment as the key to the economic cycle. In connection with a technological breakthrough, firms are liable to exaggerate the innovation's impact on productivity. They may overestimate the conceivable improvement in productivity, for example, as well as the duration of the upswing. As a result, growth cycles generated by new technology not infrequently culminate with undue optimism and misplaced investment. When profit expectations ultimately fall back to more realistic levels, share prices drop. Corporate investment slackens as the economy's aggregate capital stock is adjusted to match a more reasonable long-term return. This is accompanied by decreased household consumption, not least of capital goods, to match a more realistic assessment of the long-term development of income.

The Austrian School also provides us with a fundamental insight into economic policy's limitations. If a technological breakthrough leads to a period when the growth of investment and consumption exceeds what is sustainable in the longer run, there is bound to be a fall-off. After a supply shock of this type, measures of economic policy are simply not capable of preventing an adjustment to a more realistic appraisal of the future. The necessity of the adjustment means that the measures only postpone it and presumably tend to make it all the more painful when it does occur.

History teaches us that after a period of what I would call "growing pains", the optimism about what the new technology can achieve will be restored, albeit in a more orderly, realistic guise. In my opinion, neither the rapid fall-off in global activity nor the terrorist attacks on 11 September have upset the grounds for being optimistic about the new technology's potential.

Problems for many companies

After the investment boom and the marked slowdown we are now experiencing, there is a risk of a good many companies having balance-sheet problems. One sign of this is the historically high September figure for the 12-month increase in the number of bankruptcies world-wide among companies with a credit rating from Moody's. According to Moody's assessments, we can expect an increasing number of bankruptcies up to the end of March.

This has been accompanied by appreciably higher borrowing rates for companies with a low rating, as well as a down-grading of more and more companies. The group of firms with the highest credit rating has shrunk to a proportion that is small and even lower than at the time of the latest major slowdown in the early 1990s, for example. In view of the increased financing costs for firms with a low credit rating, there is a risk of more bankruptcies in the future, with contagious effects among other firms and sectors. For firms with a higher credit rating, on the other hand, the generally lower level of interest rates implies if anything that financing costs have been reduced. So the risk of increased problems with credit should not be exaggerated, though it does look as though to some extent at least, the present fall in activity stems from the supply side. Above all, it appears to concern an overly rapid and abnormally high investment in the IT and telecom sectors.

Inflation prospects difficult to assess

One consequence of the Riksbank basing its analysis on conditions in Sweden — and not being guided by the actions of other central banks — is that in the past the repo rate has been held at a considerably lower level than in the United States. There have also been periods when our instrumental rate has been below that of the European Central Bank. The central factor when the Riksbank sets its instrumental rate is the prospects for inflation one to two years ahead. A prospect of inflation above the 2 per cent target normally leads to a repo rate increase, while if inflation is expected to be lower than the target level, the repo rate should normally be lowered, and if the rate of price increases is forecast to lie around the target level of 2 per cent, the rate should be left unchanged.

The economic outlook in the rest of the world ought to imply a weak tendency in Sweden as well, with an attendant easing of inflationary pressure and consequently a further reduction of the repo rate. However, the decision-making situation is not that simple. Three things in particular make the picture more complicated:

- *Firstly*, inflation is currently above the Riksbank's 2 per cent target. The greater part of the increase is admittedly attributable to a number of clearly defined transitory factors that are calculated to drop out next spring. Food prices, for example, moved up in connection with mad-cow and foot-and-mouth disease. Moreover, electricity and telecom prices rose for reasons that did not seem to have to do with demand. But does this analysis hold or did the increase in inflation stem — wholly or in part — from an excessively overheated economic upswing? There are also survey data that point to rising inflation expectations. But the picture is not clear-cut.

- *Secondly*, the picture may be upset by the weak exchange rate. In relation to comparable long-term equilibrium exchange rates, the Swedish krona is currently very weak even though there has been some appreciation from the low earlier this autumn. With the important proviso that all else is equal between the economies, by itself the weak krona could warrant considerable differences in monetary policy between the Riksbank and other central banks.
- *Thirdly*, the Swedish economy is being stimulated by fiscal policy. A look at how household disposable income, after taxes and transfers, is developing this year and next illustrates this. Even with some increase in unemployment next year in connection with the economic slowdown, everything points to a sizeable increase in connection with increased public spending and tax cuts.

So on the one hand we have a continuation of weak activity next year, on the other excessively high current inflation, a weak exchange rate that leads in time to a stimulation of exports, and an expansionary fiscal policy that feeds consumer demand. In addition, the current repo rate of 3.75 per cent is comparatively low, not least when one considers that inflation is around 3 per cent.

The next question is how much importance should be accorded to each of the various factors and which side of the balance carries most weight.

As regards the excessively high inflation at present, we have tried to analyse whether there are grounds for supposing that it stems from the Swedish economy having been more “overheated” during the recent upswing than we counted on earlier. The preliminary conclusion I believe can be drawn is that the explanation does not lie there. Most things suggest that inflation ought to fall back next spring as the transitory factors that pushed prices up drop out of the change figures.

An alternative approach to whether the high inflation is temporary or more permanent involves looking at the development of by far the most important component of costs, namely wages. In that wage agreements have been completed, it is possible to arrive at a comparatively firm picture of how wages are developing, at least during this year and next. With reasonable assumptions about productivity, most things suggest that unit labour costs should be in line with the inflation target. This presupposes that the registered increase in inflation expectations, above all among labour market organisations, does not show up in wage increases; if that were to happen it would be very unfortunate and face monetary policy with new challenges. It is therefore important to take very seriously the discussion going on within the trade union movement regarding larger than expected price increases.

The weak exchange rate, with the potential economic stimulus it represents via exports, is more complicated. In the past, a marked improvement in costs for Swedish exports relative to the main competitor countries has tended to lead to an increased export market share. At the same time, there is no denying that the international economic slowdown is particularly evident in markets of importance for Sweden’s economy. As long as those markets remain weak, a larger market share for Swedish firms will not yield a notable increase in volume.

Another matter here is that in the IT and telecom sectors, on which the Swedish economy became increasingly dependent in the 1990s, the problems are not dependent on the krona’s exchange rate; here it is more global factors that are decisive.

However, it can also be noted that the order inflow to manufacturing is now falling less markedly than earlier this year. There are certain signs of a levelling out, usually an early indication of a possible upturn in the coming quarters. Analysts’ expectations of this year’s profits for listed companies have clearly worsened during the autumn but this has been accompanied by a substantial upward revision of next year’s profits.

So the overall appraisal of the krona’s exchange rate and its stimulatory effect is not entirely self-evident.

Finally there is the question of economic policy’s aggregate impact on demand. What I have in mind is next year’s prospect of a relatively large increase in fiscal policy’s contribution to household disposable income, accompanied by low interest rates. An expansionary economic policy normally tends to stimulate cyclical activity, which implies that 2002 should be a fairly good year for domestic demand. However, there are at least two factors that could limit or counter this effect.

One factor has to do with the lower share prices and the tendencies for house prices to stop rising and in certain cases to fall. In recent years, purchases of cars and other consumer durables have been stimulated by the appreciation of assets that feature in household wealth. Conversely, falling asset prices during the past year have tended to subdue these purchases. The stimulus from economic policy may accordingly be dampened or delayed as long as asset prices continue to fall. Of course, the situation will be reversed if share prices and property prices instead stabilise, or even begin to rise once again.

Another factor is connected with the risks in the labour market. The redundancy statistics suggest that employment will level out or even fall next year, which may involve an attendant increase in unemployment. Households are already expressing such fears in Statistics Sweden's surveys. Besides the direct downward effect on household disposable income, a weaker labour market may make people in Sweden more cautious when making purchasing decisions.

Conclusions for monetary policy

All in all, growth prospects for the short term are somewhat more unfavourable than when we published our most recent inflation forecast. However, the major economic policy realignment in a number of important countries looks like paving the way for a recovery after a time. But this does presuppose that households and firms really do start to consume and invest. Major risks here are saving imbalances and over-investment.

In Sweden, too, there has been an expansionary realignment of economic policy that is helping to strengthen household income. Provided there is an international recovery, the weak krona should have a stimulatory effect on exports. As regards inflation, the rate since April this year has been above the Riksbank's target. The increase is mainly due to transitory factors and I envisage that it will, as before, dwindle during the spring. This presupposes, however, that the price rise does not spread to other items or lead to wage increases. Another argument for a future easing of inflationary pressure is the existence of unutilised resources as a result of the slowdown. However, in my opinion, the Riksbank must watch developments closely to ensure that the recent rise in the inflation rate actually falls and does not stick. Most indicators appear to imply that inflation will be close to the target level of 2 per cent, or at least within a small margin on one side or the other.

This evening I have tried to present a general account of my preliminary view of some aspects of assessments of the future path of inflation. I look forward to the continued discussion of these matters with my Riksbank colleagues. Our decision about interest rate policy is due at the meeting next Tuesday, 4 December. The result of our discussions will be published the following day, 5 December, as will the fourth Inflation Report of 2001.