

## **Lars Heikensten: Introduction to monetary policy**

Speech by Mr Lars Heikensten, Governor of the Sveriges Riksbank, at the Riksdag Committee on Finance, Stockholm, 16 October 2003.

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Let me begin by thanking you for the opportunity to come here and talk to the members of the Riksdag Committee on Finance about monetary policy. I believe that the Committee's public hearing of the Riksbank governor provides a good basis for a constructive discussion of monetary policy in Sweden and comprises an important part of the openness the Riksbank wishes to safeguard.

These open hearings began originally at the initiative of the Riksbank. They were an expression of our endeavour to bring about an open discussion on monetary policy, an endeavour that has since taken on many other aspects; lengthy Inflation Reports, published minutes from monetary policy meetings, press conferences where we account for our interest rate decisions and explain our deliberations, and so on. Now these hearings are a part of our legislation.

The fact that the Committee closely follows our activities has become even more important since the Riksbank was given an independent status. These hearings illustrate the clear link between us and the democratically-elected body in Sweden.

Today I shall take up three themes. I shall begin with a few words about the Riksbank's situation following the referendum. Then I shall comment as usual on the assessment of inflation and the interest rate decision we have published. Finally, I shall discuss the Swedish economy's long-term growth prospects.

### **The Riksbank after the referendum**

The result of the referendum was, as we all know, a "no" vote. What this means for the Riksbank is that we will continue to focus our operations on our statutory objectives; to maintain price stability and to promote a safe and efficient payment system. Quite simply, it will be "business as usual" for monetary policy. This means that under normal circumstances we will continue to follow our simple monetary policy rule: if future inflation is forecast to be higher than the inflation target of 2 per cent, we will raise the interest rate, and vice versa if inflation is forecast to be lower than 2 per cent. This clear intellectual framework makes it easier to influence expectations of monetary policy in society and to evaluate the policy afterwards. Both we ourselves and external analysts can take a stand on whether the policy appears sensible in relation to the target, whether the forecasts we make are reasonable, and whether we follow the principles we claim to follow for attaining the inflation target.

Even if the monetary policy framework remains intact, this is no reason to become too comfortable. During the spring we began work on a review of the process used to produce the information on which our interest rate decisions are based. This includes considering how one of our most important documents - the Inflation Report - can be improved. It also involves improving our ability to predict price trends.

Work on the Riksbank's other main objective - financial stability - has been characterised to a great extent by the experiences of the financial crisis that shook Sweden in the early 1990s. The Riksbank has been something of a pioneer, being the first central bank in the world to publish reports on financial stability. There is also reason to make a fresh effort in this field. We are in the process of appointing a group of experts, which includes a couple of international experts, who will evaluate our work and present suggestions for improvements.

The evaluations we make will be followed up with open seminars, where we can discuss the future direction of our operations with economists from the academic world as well as actors in the financial sector.

The Riksbank is currently one of the world's most open central banks, but we can certainly become better. Our work will in future be aimed at ensuring that the Riksbank reaches a broader general public than is currently the case. Our ambition is to create even broader support for our operations and thereby greater understanding of what we do and why we do it. Personally, I intend to travel around

the country before the autumn and spring monetary policy meetings to talk and listen to representatives of local industries and regions.

### **The inflation perspective**

It was observed in the June Inflation Report that for some time there had been gradual downward revisions to the forecasts for the world economy. The Riksbank's forecast, like that of other analysts, was that the international recovery would be slower and more prolonged. There were several reasons for this, including geopolitical unease and increased caution among households and firms in the wake of the stock market fall. The conditions for a clear recovery in the euro area were perceived as poorer than we had earlier believed, which made a recovery in other countries, including Sweden, more difficult. The more negative economic outlook, with inflation prospects below the target of 2 per cent, meant that we decided to cut the repo rate during the summer by a total of 0.75 percentage points. The rate is currently at 2.75 per cent.

### **Minor changes in outlook for economic activity**

So far, international developments have been largely in line with our assessments from the summer. The expansionary policy now appears to be taking effect in certain areas, particularly the United States, where signs of a recovery are becoming more apparent and the risks of a setback appear more slight. The Asian economies are also developing relatively strongly. On the other hand, the prospects for the euro area still appear to be gloomy. In time, the expected upturn in the United States is expected to support a gradual upturn in Europe. All in all, the Riksbank's assessment is that GDP growth in the OECD area will be 1.9 per cent this year, 2.8 per cent in 2004 and 2.6 per cent in 2005.

Neither has the Riksbank's outlook for the Swedish economy changed very much over the summer. However, new statistics indicate slightly stronger growth during the first half of this year compared with June. This means that the outlook for the Swedish economy now appears somewhat brighter than at that time. The repo rate cuts totalling 0.75 percentage points have also contributed to this. However, compared with August when we had our last Executive Board monetary policy meeting, we have not changed our assessment markedly.

The Riksbank's assessment is now that continued stable growth in incomes, wealth and employment will contribute to smooth and relatively robust growth in household consumption. During 2004 and 2005 an increase in investment is also expected, although there are no signs of a turnaround yet. Some upturn in exports is now expected to occur in much the same way as usually happens during economic upturns. However, as a similar upturn is expected in imports, the net export contribution to GDP growth will be limited. Public consumption is expected to grow by approximately 1 per cent per year over the coming years.

The improved economic activity will lead to slightly higher resource utilisation than forecast in the June Inflation Report, which in turn means that wages in the private sector are expected to rise at a marginally higher rate during 2004 and 2005. As a result, domestic cost pressure will also be slightly higher during these years. On average, total wage costs are expected to rise by just under 4 per cent per year during 2004-2005.

### **Inflation in line with target**

Inflation has fallen back slightly in recent months, although less than expected. This is because energy prices have not fallen as forecast. However, when adjusted for energy prices, inflation has been lower than expected. This may be due to the fact that productivity has grown unusually strongly so far this year, while preliminary wage bargaining outcomes indicate slightly lower wage increases than expected.

Over the coming months, energy prices are expected to remain at a relatively high level. Electricity prices are not anticipated to return to more normal levels until spring 2004. This means that they cannot be expected to subdue inflation over the coming year as much as was estimated during the summer. Instead, some of the restraining effect will be postponed. However, at the same time the forecast for underlying inflationary pressure is being revised upwards for 2004 and 2005, as a result of

the slightly higher resource utilisation. As before, the future path of inflation will be greatly affected by fluctuations in energy prices.

The krona exchange rate has been slightly weaker on average over the summer than the Riksbank had forecast in June. However, following the referendum the krona rate has strengthened relatively rapidly and is now in line with the earlier forecast. This recent development is probably due to the market's long-term assessment of the strength of the Swedish economy relative to the euro area, but also to the general weakening of the dollar. The forecast for the coming two years remains largely unchanged since the June Inflation Report.

All in all, the Riksbank's inflation forecasts have been adjusted only marginally since August. Excluding the effects of energy prices, inflation a couple of years ahead is in line with our target. Including energy prices, UND1X inflation is forecast to be 1.7 per cent while CPI inflation is expected to stand at 2.1 per cent at the end of the forecast period.

### **Some risk factors**

Of course there are factors that could upset the main scenario I have presented for economic activity and inflation.

As before, there is a risk that demand in both the United States and Europe could show weaker growth than expected. The deficits in the US public finances and the current account could push up interest rates, curbing consumption and investment. However, there is also a possibility that US GDP growth may surprise on the strong side if households choose not to increase their saving. There are as yet no clear signs of a recovery in Europe. The strained public finances are a source of uncertainty that could affect households and firms. In light of these factors, it is important to monitor new economic data in the coming months to see if it confirms the picture of a more clear-cut recovery.

Another risk stems from a continued weakening of the dollar, although this may be motivated to the extent that it contributes to easing the adjustment to smaller deficits in the United States' budget and current account. The problem is that there is a risk of negative effects on exports, production and employment in the euro area and also Sweden. Adjustment problems and the effects on activity in the world economy could prove problematic if the dollar continues to depreciate at a rapid rate.

However, there are also factors indicating that inflation could be higher than in the main scenario. The impending wage bargaining rounds comprise one risk. The Riksbank's current assessment is based on the assumption that a weaker labour market will hold back the rate of wage increases. However, there are examples of wage bargaining rounds where wage formation has got out of control despite a low demand situation, for instance, in 1995. The conflict concerning the Municipal Workers' Union is evidence of tensions in the labour market, which could have the effect of pushing up wage costs.

No single factor is as central to inflation trends - and thereby to monetary policy - as wages. The Riksbank will therefore follow the development of the wage negotiations closely during the autumn.

Another risk stems from energy price trends and in particular developments in electricity prices. The monetary policy stance so far has been based on the energy price rise being of a transient nature. We have refrained from changing the repo rate when energy prices have risen, although they have meant that inflation, and the forecast of inflation two years ahead, have periodically deviated from the 2 per cent target. If energy prices remain at a high level over a longer period or continue to increase, the inflation rate could be higher than we have assumed. The conclusions for monetary policy would be different if this development begins to leave a mark on inflation expectations.

All in all, the risks of lower inflation stemming from weaker economic activity are judged to be approximately balanced by the risks of higher inflation stemming from wage and energy price developments. The balance of risks therefore does not change the forecast I have reported earlier. It indicates that the underlying, cyclically-related inflation rate will be in line with the inflation target at the end of the forecast period. The Executive Board of the Riksbank therefore found it natural to leave the repo rate unchanged.

The future stance of monetary policy will depend as usual on the new information received and on how this affects the overall assessment of inflation prospects in the coming years.

## Long-term growth prospects

Allow me at this point to shift focus and speak about long-term growth prospects. These are of course a decisive factor for welfare and deserve therefore to be given considerable attention in the economic policy debate. But they also have a huge impact on the Riksbank's operations, which I shall return to. This gives me reason to underscore the worrying signs that I perceive, especially at an opportunity like this, when I before you in the Riksdag Committee on Finance speak about how I see monetary policy and the Swedish economy in the future. This does not mean, however, that I am going to embark on a discussion of different concrete solutions to the problems. I don't believe that this is a natural task for us at the Riksbank.

Over the last ten years, the task of monetary policy has been to safeguard price stability, that is to say, a low and stable inflation rate. This has worked fairly well; inflation has been largely in line with our target. In turn, this has contributed to relatively good economic growth, in clear contrast to the 1970s and 1980s. However, this is not enough. No matter how well stabilisation policy functions, it does not provide higher long-term economic growth.

In reality, growth potential and thereby our welfare is determined by how much we work and how productive we are. Nothing can change this. The amount that we work depends on many different factors, for instance, how many people are of working age, how many of these are employed, absenteeism, etc. Labour productivity, measured as GDP per hour worked, depends partly on the level of education and on technological progress or the prevailing conditions for businesses and investment. To this can be added productivity changes resulting from the labour force moving over from less productive to more productive sectors.

The number of hours worked rose during the years following the crisis at the beginning of the 1990s. But developments were strongly affected by the upturn in the economy, which enabled unemployed persons to gradually return to the labour market and obtain work. The positive growth in employment was supported by an increase in the number of persons of working age at the same time as sick leave was at a relatively low level. In recent years, this trend has been broken, partly due to an increase in sick leave.

The picture of productivity in recent years has been somewhat brighter. For the economy as a whole it has stood at 2 per cent per year, or just above this figure. This is a marked improvement on the 1980s, when the increase remained at around 1 per cent per year, and even more so compared with the 1970s, when the productivity trend was negative. Factors such as the change in fiscal and monetary policy regimes and stiffer competition have probably played a role in this development.

Despite the fact that the strong growth in productivity during the 1990s partly reflects both rapid growth in the private sector relative to the public sector and the large expansion in the ICT sector, there is reason for relative optimism regarding the future. Our economy has become more open, with greater competition and price pressure in many sectors.

The problem is primarily the labour supply. Here, developments seem to have turned in a negative direction. One reason for this, I believe, is that economic policy has not in practice been aimed at putting people in work. One example is that the compensation levels in several transfer payment systems were increased during the late 1990s. Now other changes are being discussed which would directly and tangibly have the same effect, for instance, a reduction in working hours.

Another problem in this context is that the Swedish labour market has not been able to make adequate use of the many people in Sweden who were born abroad. The employment frequency among these people has been much lower than the employment frequency among people born in Sweden. This applies in particular to those who have arrived here quite recently. They include many university-educated or otherwise highly-qualified people who are completely without work or have jobs below their level of competence.

In addition, the problem is exacerbated by the fact that the population's age structure in the near future will become less advantageous from a labour force perspective, with increasing numbers of exits from the labour force. An ever declining group of workers will have to support an ever increasing number of people, unless measures are taken.

It is easy to see the significance for economic growth of measures to increase the labour supply. For example, the number of hours worked could increase by an average of 0.4 percentage points more per year if it were possible to halve the number of people on sick leave by 2008. This means that the number of hours worked could increase by an average of 0.8 per cent annually instead of 0.4 per cent

during the period up to 2008. If it was also possible to break the negative trend for persons born abroad and bring them into the labour market to a greater extent than now, this would also increase the number of hours worked. In 2002, 75 per cent of the working-age population was employed on average, while the figure for those born abroad was 60 per cent. If it were possible to increase the employment rate for this group to the national average, the number of hours worked would increase by approximately 0.1 percentage points more up to 2008. Ensuring that persons with a non-Swedish background can enter the labour market is a central issue, partly because the net addition to the working-age population will come from this group over the coming decade.

If no measures are taken to increase the labour supply, the Swedish economy's long-term growth prospects are likely to be subdued for a fairly long period. The Riksbank usually states that the potential growth rate lies in the interval 2-2.5 per cent. If nothing is done, it is likely that potential growth will decline. In concrete terms, this means that the Swedish economy could reach its capacity ceiling at an earlier stage. The implication of this is that the Riksbank could then be forced to raise interest rates and tighten monetary policy at a lower rate of growth compared with the last ten years.

The problems of a weaker labour supply are particularly serious in Sweden, even if an ageing population is something shared by many other countries. This is because an unusually large part of the expenditure ensuing from an ageing population in terms of medical treatment, care of the elderly and pensions comes from the public sector budgets. In turn, this means that an unfavourable population development will in our case have direct and tangible effects on the public finances. The only realistic means of counteracting these effects is for more people to work and pay taxes and for fewer to utilise the transfer payment system.

Finally, we should have learnt from the crisis more than ten years ago that it is important to prevent problems. To deal with difficulties and challenges in good time - before they grow out of control. Failing to take action does not make the problems disappear. On the contrary, they risk becoming much worse in a few years time, when the population development has taken a significantly negative turn. Then it might be necessary to make larger and more painful changes under less orderly conditions.

Thank you!