Mr Bäckström elucidates the economic situation in Sweden and describes the consequences it may have for future monetary policy

Speech given by Mr Urban Bäckström, Governor of the Sveriges Riksbank at Föreningssparbanken, Ulricehamn on 1 September 1999.

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First a word of thanks for the invitation to visit Ulricehamn and talk about something that is close to the heart of a Riksbank governor, namely Sweden's economic situation. I shall be describing the situation as I see it and saying something about the consequences it may have for future monetary policy.

Unexpectedly strong trend

The new statistics in recent months show that economic activity is stronger than most forecasters had foreseen as recently as in the spring. The growth of both domestic and external demand has been higher than expected. Relative to the first half of 1998, the GDP growth rate for the first six months of this year is an estimated 3.7%.

Most observers are in the process of revising their forecasts upwards, if they have not already done so. In the Inflation Report last June the Riksbank judged that growth this year would reach 2.5%, followed by 3% next year as well as in 2001. When the Executive Board discussed monetary policy on 12 August, however, our assessment was that this year's growth rate would be 3.5%. We also saw grounds for an upward revision of growth in the next two years, though the prospects for that period are more uncertain.

It is not just total output that has exceeded expectations. The same applies to employment. In the first half of 1999 there were approximately 100,000 new jobs compared with the same period last year. Much of the increase occurred in the private sector. This has been accompanied by decreased unemployment, if one disregards the temporary seasonal upturn during the summer. However, the reduction of unemployment is less marked than the increase in employment because many people are returning to the labour market now that jobs are becoming available.

Meanwhile, price increases have been moderate. The underlying rate of inflation (UNDIX, which measures inflation excluding interest expenditure, indirect taxes and subsidies) fluctuated during the spring between 12-month figures of 1.0 and 1.5%. Other indexes also point to low inflation, despite an increase in some commodity prices, oil in particular.

Altogether, then, the Swedish economy is developing very well. We are now entering the seventh year of favourable economic growth – an average annual rate of about 3% – since the upturn in the summer of 1993. Today, moreover, there is no immediate threat to price stability.

Market interest rates rising

The better economic situation and expectations that inflationary pressure will be somewhat higher than before have caused a worldwide increase in market rates of interest. Sweden is no exception. During the summer the five-year T-bond rate, for example, has moved up just over 1.0 percentage point.

Along with this increase, the spread between T-bond and other interest rates has widened. In other words, the rates for long borrowing by housing institutes and firms have risen relatively more than the rate the Treasury has to pay for government borrowing with the same maturity. Since June, the rate for a five-year housing bond has moved up around 1.3 percentage points.

Similar shifts have been noted in the international financial markets. Spreads of this kind often tend to widen when the future path of interest rates becomes more uncertain. Besides the uncertainty about interest rate tendencies in the cyclical upswing, a contribution to the wider spreads is said to have come from the turn of the millennium: concern about limited liquidity at the turn of the year is considered to induce some investors and borrowers to try to carry out transactions earlier.

In this context I should like to take the opportunity to underscore that the Riksbank, with its responsibility for monetary policy and financial stability, has the instruments that are needed to manage any liquidity problems that may arise. Together with the extensive preparatory work that has been done in the financial sector, this means that the turn of the millennium should not be seen as a serious problem.

The revised expectations of future inflationary pressure have entailed an adjustment of expectations about monetary policy. Price setting in the financial markets includes built-in expectations that in the coming years many central banks, including the Riksbank, will be raising their instrumental rates.

A point worth noting is that, if they continue, today's higher market interest rates will have a direct impact on inflation from household interest expenditure, just as the recent years' steeply falling interest rates had a sharp downward effect on inflation. In that case, the higher interest expenditure would pull CPI inflation upwards fairly rapidly towards the targeted rate and above inflation's underlying rate (UNDIX). Monetary policy would then face the same situation, albeit in reverse, as on so many occasions in the recent past. An attempt to counter the tendency by tightening the monetary stance would accentuate the direct impact and add to the increase in CPI inflation. That is why it is inflation excluding transitory factors that is the focal point for monetary policy.

Central issues for monetary policy in an upward phase

About a fortnight ago the Executive Board of the Riksbank confirmed that the stronger growth can lead to increased price pressure. Monetary policy may accordingly need to be conducted in a less expansionary direction in the future.

But the Board also emphasised that the Swedish economy is not yet in such a situation. The trade-off between inflation and growth is uncertain and earlier relationships therefore have to be tested in the light of new information.

I consider that this conclusion still holds.

When the Riksbank begins to talk of a less expansionary monetary stance, I can imagine it raises a number of questions. I should like to take this opportunity of discussing some of them.

One such question could be: Why must the Riksbank spoil the party? The Swedish economy has finally begun a period of good growth, rising employment and decreased unemployment, while inflation is low. So why do central bank representatives have to talk about the need to raise the interest rate in such a situation? May it not lead to a renewed increase in unemployment?

Another question is how strongly the Swedish economy can expand without risks for inflation. Can it be the case that even the Swedish economy is displaying new tendencies, as certain observers argue has happened in the United States, that is, that growth can be higher without inflation taking off? If so, why is the Riksbank talking of a need to raise interest rates?

Let me begin with the first question.

Why spoil the party?

History teaches that when the growth of demand outpaces the economy's long-term output trend, this leads in time to risks of capacity shortages and bottlenecks that result in turn in rising prices and wages. At the same time, as it takes one to two years for an adjustment of the instrumental rate to affect the economy, the central bank's monetary policy decisions have to be based on assessments of the future. Faced with the risk of a situation of this type occurring, it is therefore better to try to slow things down with a small interest rate increase at an early stage. Demand growth can then be brought into line with the growth of production capacity and result in a more stable path. By acting in good time in a manner that is predictable, it is hopefully possible to avoid interest rate adjustments that are more drastic. Meanwhile, economic agents can continue to count on stable, low inflation.

An example of the good results that can be achieved with a forward-looking monetary policy is the US economy. With a judicious and timely tightening of the monetary stance, the Federal Reserve has contributed to a long period of sustainable growth. Since the gradual increase from 3% between 1993 and 1994, the fed funds rate has fluctuated between around 4.5 and 6%. This has accompanied a notably good economic development, with the longest postwar period of unbroken growth. The latent inflationary pressure has been held in check without arresting growth. Similar reasoning lay behind last week's interest rate increase. The positive trend has been aided by the consolidation of federal finances.

On the other hand, if inflation has already risen to a high level that is expected to last, the central bank may have to resort instead to larger interest rate increases to signal its determination to fulfil the inflation target. That weakens economic activity and risks a renewed increase in unemployment.

Thus far the argument – and the question of which alternative is most advantageous – seems fairly simple. But that is where the difficulties begin. How is the central bank to arrive at an interest rate increase that is appropriate in its timing as well as its size? A large, abrupt increase might lead to demand being curbed too early and too much, along with the risk of inflation falling below the price stability target of 2%[1]. That is naturally not desirable. Which brings me to the second question: What rate of GDP growth can the Swedish economy sustain without inflation taking off?

How strongly can the Swedish economy grow?

In situations involving rapid changes, there is a tendency to affix labels such as the new economy. The logical implication is the existence of an old economy that works less well. I find this misleading. There have been periods in Sweden's economic history when the economy performed exceedingly well; one example is the 1950s and 1960s. There have also been periods that were less successful, for instance the 1970s and 1980s.

The concept of a new economy might be apposite if the comparison is confined to the present and the preceding decade. There are signs that the Swedish economy is functioning better in the 1990s than it did in the 1980s. But what does this concept actually stand for?

One of the many interpretations of the new economy is that long-term growth's trajectory has shifted upwards on account of a better productivity trend. For a given input of the production factors labour and capital, the economy is able to sustain higher overall growth. It follows that if the supply side of the economy works better, then its demand side can expand more rapidly without leading to bottlenecks and inflation.

One of the driving forces behind the new and better functioning of the US economy is sometimes said to be the rapid advances in data and telecommunications. By improving production and distribution processes, the innovations are seen as a basis for stronger productivity growth.

Some consider that, for the United States, the potential growth rate has been raised from 2 to 3%. It also looks as though the potential growth rate for Sweden has become somewhat higher – still compared with the 1980s – but it does not seem to have reached an annual rate of as much as 3%.

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[1] I refer here, not to the consumer price index but to an index of underlying or core inflation, e.g. UNDIX, which Statistics Sweden publishes regularly on behalf of the Riksbank. That index excludes house mortgage interest expenditure and indirect taxes. If the Riksbank were to raise the interest rate prematurely, the resultant increase in house mortgage expenditure could cause the CPI to overshoot the target, while UNDIX is on the low side. This is the reverse of the situation in recent years when the interest rate was lowered.

A common, but not entirely certain estimate is that today the Swedish economy can sustain an annual growth rate of between 2 and 2.5%. Growth above this level leads to decreased unemployment and vice versa. But it is not just the strength of demand growth that determines the level of unemployment. Other factors, such as economic structures, are also involved and at some level of unemployment the only result of additional growth stimuli is bottlenecks and shortages. Wage costs will then rise in a way that conflicts with low and stable inflation.

The GDP growth rate of 3.7% for the first half of this year accordingly exceeds any reasonable assessment of the Swedish economy's long-term potential. For a time, however, such a high growth rate can be feasible if firms are able to recruit the necessary labour, for instance because the economy is recovering from a situation with high unemployment. That has been the case in Sweden's labour market and pressure from wages and prices has thereby been able to remain low. Neither are any dramatic changes foreseen in respect of wages in the near future. But how long can this situation last in the present economic upswing? How far can unemployment be reduced without firms encountering recruitment problems more generally?

Even with the high unemployment at present, it is, for example, already difficult to recruit computer consultants and some other occupational categories. The situation in certain segments of the Stockholm labour market is also tighter than in other parts of Sweden. But so far, the bottleneck problems seem to be fairly restricted. As yet there are no indications of more widespread shortages. It is a positive sign that the matching of job seekers and job vacancies is still running comparatively smoothly, as it is that although the shortages of skilled workers in manufacturing have grown, the level remains relatively low. To date this year, moreover, the wage drift statistics show increases that are lower than expected.

Good credibility promotes price stability

Experience from the 1990s and earlier periods demonstrates that the relationships which are discernible in economic models have to be constantly questioned and reviewed. Above all, they can never be adopted uncritically when forecasting the future. So much happens in different economies, not least as regards economic policies, that earlier truths have to be reassessed continuously.

Inflation has been subdued in recent years for a number of reasons. Imported inflation has been low because of subdued commodity prices in connection with the Asian crisis. Productivity growth in Sweden has been better than before. Another major factor is the increased confidence in monetary policy and economic policy in general. All the survey data, as well as the underlying trend in market prices, show that no one expects inflation in the somewhat longer run to be anything but 2%.

The inflation target accordingly seems to constitute a clear anchor for price formation. In the 1970s and 1980s, inflation prospects did not depend on the level of domestic economic activity alone. Relatively abrupt shifts in more long-term inflation expectations also played a part. Today, there are no abrupt shifts of that kind. Economic players simply count, with good reason, on the Riksbank acting if signs of rising inflation were to appear. In such a world, overall price formation centres above all on the level of economic activity. The improved credibility is thus a further factor that may have contributed to a level of inflation that is lower despite relatively strong growth.

At the same time, the Riksbank has the major responsibility of keeping a close eye on the more long-term inflation expectations in order to maintain the credibility that has been built up in recent years.

Demand assessments difficult

A question that naturally has to be included in the assessments is whether the stronger growth of demand we have experienced, not least this year, will last. An important matter to bear in mind in this context is that as long as the monetary stance is expansionary, demand growth will normally be above its sustainable level. But some restrictive effect has, of course, already started to come from the higher bond rates in recent months.

However, both the Swedish and the international economy can be exposed to unforeseen shocks. We need to remember that no one foresaw either the extent or the course of the crisis in Asia. Neither was attention drawn at an early stage to the risks behind last autumn’s international financial unrest. Our knowledge about phenomena of this type is still limited. It may be asked whether we shall ever be capable of making definite predictions in this field. The models being tested at present are simply too rough and ready. They tend to sound the alarm about events that never occur and miss those that actually happen.

Although the picture looks bright, we know there are countries in the global economy that are vulnerable, with a situation that may deteriorate. Share prices, moreover, have climbed very high, not least in the United States. There are also imbalances in the US economy that may affect the future course of events.

There is also the possibility, however, of demand growth in Sweden becoming even stronger. We do not know how other components of economic policy will be constructed in detail. I am thinking in particular of the current discussion about the direction of tax policy. The Riksbank is in no way opposed to tax cuts. On the contrary, strategic tax reductions could make the Swedish economy function better and thereby lead to higher growth. But we have a duty to issue a warning about a tax policy that would give additional force to a growth of consumption that is already rapid and thereby lead to economic overheating in Sweden. At the same time, I believe that decision-makers are aware of these risks.

Taken together, all these factors make it difficult to assess the future development of demand. So there is reason to monitor developments closely.

Conclusion

At present I do not for my part see any direct, immediate threat to price stability in the Swedish economy. But I do believe that a continuation of strong demand growth, with all else equal, requires the members of the Riksbank’s Executive Board to consider how we can best ensure that economic growth in Sweden remains stable. How soon and with what safety margin shall demand be brought back to the rate that is sustainable in the long run? Do we need to take out the insurance provided by an early, small adjustment of the interest rate? Or can we wait? That is something about which opinions can differ slightly.

In my opinion, there is no reason as yet to reduce the expansionary effect on the Swedish economy that monetary policy is currently exerting. A monetary policy adjustment will indeed be called for at some time in the economic upswing but I still see its timing as an open question. My colleagues and I on the Executive Board, as well as all those who analyse us, must follow the incoming statistics closely. New knowledge and new insights must be continuously woven into the analysis.

Maintaining price stability, as the law prescribes, accordingly means that the Riksbank delivers its contribution to making growth in the Swedish economy sustainable.