An account of fiscal and monetary policy in the 1990s

Annex 5

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The 1990s was an economic period affected by major fluctuations in the Swedish economy. This annex is a fiscal and monetary policy balance sheet for the 1990s. The intention of the annex is to analyse and discuss the role and conduct of economic policy. The annex has been produced under the supervision of chief economic advisor, Jens Henriksson, Ministry of Finance. Lars Hörngren, chief economist at the National Debt Office, and Hans Lindberg, head of forecasting at the National Institute of Economic Research have made major contributions to the material for this annex.

1. Introduction

The Swedish economy underwent major fluctuations during the 1990s. At the beginning of the decade, there was still an upswing. Open unemployment was approximately 1.5 per cent and GDP growth was around 2.5 per cent in 1989. The central government budget was in surplus. However, there were clear indications of imbalances. The rate of inflation was approximately 7 per cent and nominal wages were increasing by almost 10 per cent. The deficit on the current account balance was equivalent to around 2 per cent of GDP. High price and wage increases in combination with a fixed exchange rate had deteriorated the cost situation in relation to the surrounding world. Accelerated to some extent by a rapid expansion of credit, prices for and new construction of commercial premises had risen rapidly.

The turn in the course of development of the economy was likewise both swifter and stronger than anticipated. At the end of 1993, open unemployment was almost 9 per cent and the economy receded by a rate of almost 2 per cent per year, the third year in a row with negative growth. The central government borrowing requirement corresponded to around 17 per cent of GDP and central government debt grew rapidly. This development forced Sweden to abandon the fixed exchange rate. Instead, the krona had a floating exchange rate for the first time since the 1930s. A bank and fiscal crisis had forced the government to make major commitments to secure confidence in the bank sector and to prevent a systemic crisis. The imbalances were again large and there was widespread uncertainty about the possibilities for starting off an economic recovery and preventing a durable increase in unemployment.

Once again, developments were surprising. By the end of the decade, Sweden had undergone six years with positive growth; on average over 3 per cent per annum. Unemployment was down below 4.5 per cent. Inflation was low, both in absolute terms and in relation to the average for the past decades and it was generally expected to remain at a low level. Public finances reported considerable surpluses and central government debt in relation to GDP had fallen for a number of years in succession. The surplus on the current account balance was stable at over 2 per cent of GDP. Imbalances in the economy had been substantially eliminated and the prospects for the coming years were regarded as favourable.

Such a turbulent period raises many questions. This annex is intended, against the background of a mainly chronological account of the course of events, to analyse the conduct of economic policy and its role in the process. It focuses primarily on fiscal and monetary policy.

2. The initial situation – the aftermath of the 1980s

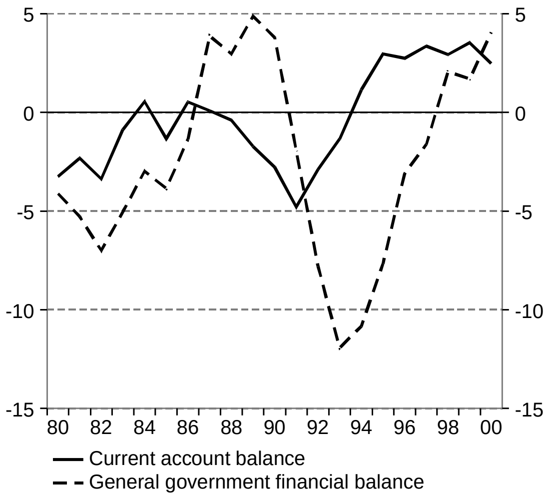
This annex deals with the 1990s although it is necessary to look further back to understand the initial situation.

2.1 The strategy underlying the devaluation in 1982

The 16 per cent devaluation in 1982 can be taken as the starting point. In contrast to the devaluations during the 1970s and in September 1981, the intention was not only to correct the domestic cost situation after a period of higher inflation than in the surrounding world. The primary intention was instead to rectify structural imbalances in the economy.

Diagram 1 The current account balance and general government financial balance

Per cent of GDP



Source: Statistics Sweden

In the background, there was the assessment that too small a part of the economy was exposed to competition. This imbalance was reflected in more or less permanent deficits in public finances and in the current account balance. A discussion had started about the risk for central government being caught in a debt trap, i.e. a situation where interest on debt grew in an uncontrolled way. The Government that took office intended to stop the undermining of central government finances by a tighter fiscal policy.

This restraint would lead to a fall in employment in the protected sector. By starting the change of course with a large devaluation, the Government wanted at the same time to stimulate the sector that was exposed to competition. The combination of the two measures was intended to lay the basis for a favourable development with stable growth and high employment. Devaluation and the planned tightening of fiscal policy were thus integrated parts of the incoming Government's strategy for economic policy. A tightening without a devaluation would have led to an extended period with low employment before the price and cost situation had adapted. A large devaluation without a tighter fiscal policy would have increased demand from the sector exposed to competition in a situation of full employment. This would have led to overheating and inflation, i.e. a repetition of the course of events that characterised the 1970s. The awareness of this need to maintain a balance is shown in the following quotation from "A crisis plan for Sweden" presented by the Government on 11 October 1982:

> A number of devaluations have taken place in recent years. These have not led to the intended effects in the form of improved competitiveness and increased production. The reason for this is that the devaluations were not accompanied by a deliberate anti-inflation policy and that they mainly only corrected earlier differences in the rate of inflation between Sweden and most important competitor countries. After the devaluation has taken effect, inflation must be pushed down and stabilised at a low level. Both the development of demand and costs in the Swedish economy must be adjusted to this. The Government will conduct fiscal policy and tax policy and apply other means of economic policy with this end in view.

In the incoming government's plans, it was emphasised that the 1982 devaluation was intended to be the last and that Sweden would subsequently adopt a "hard currency" policy. If the cost situation became too high again, adaptation would take place through a period of lower profits for the business sector and lower employment. The idea was that the link to a fixed exchange rate would affect the behaviour in the commodity and labour markets so that price and pay increases would be held down even at a high level of employment.

The aim was to break the pattern that characterised the 1970s when exchange rate adjustments were made with a view to adapting the cost situation retrospectively to high price and cost increases without sufficient measures to break the price and cost increases. Instead, the fixed exchange rate policy was made the norm for stabilisation policy. The norm was intended to keep the inflation rate on a level with developments in the surrounding world defined as the average of the currencies that were included in the trade-weighted basket of currencies to which the exchange rate of the krona was linked.

There was thus a consistent plan underlying the devaluation. At the same time, the strategy was risky. The economy was exposed to high inflationary pressure and an expansive impulse in a situation where the inflation rate was approximately 7.5 per cent and unemployment around 3 per cent. The plan was based on it being possible to prevent demands for compensation for the price increases caused by devaluation. Moreover, it required that fiscal policy measures were carried out to control expectations and the actual development in paths that were compatible with low inflation. The decision to devalue could be made directly after the Government took office.

2.2 Follow-up of the devaluation

The 1982 devaluation entailed an increase in both exports and profits in the sector exposed to competition. As from 1984, net exports were the driving force in growth. Private consumption was largely unchanged during the period while there was a weak increase in public consumption.

Diagram 2 GDP growth

Percentage change

Source: Statistics Sweden and OECD

From 1985, the picture changed markedly. During the period 1985–1988, consumption was the driving factor in growth while net exports fell sharply. There was a marked increase in private consumption. Public consumption also continued to increase. In addition, transfers to households increased markedly during the second half of the 1980s despite the strong upswing. Accordingly, no marked tightening of fiscal policy took place during this period either.

External factors also played a role. According to the normal pattern, an international cyclical downturn should have taken place around 1985–86 which would have dampened demand for exports and restrained growth in the Swedish economy. Partly due to the substantial drop in oil prices in 1986, the international upswing persisted until the end of the 1980s (see Diagram 2). Lower oil prices also had direct expansive effects on the Swedish economy as it increased scope for private consumption through increased real income.

Diagram 3. Relative unit labour costs

Index 1980=100

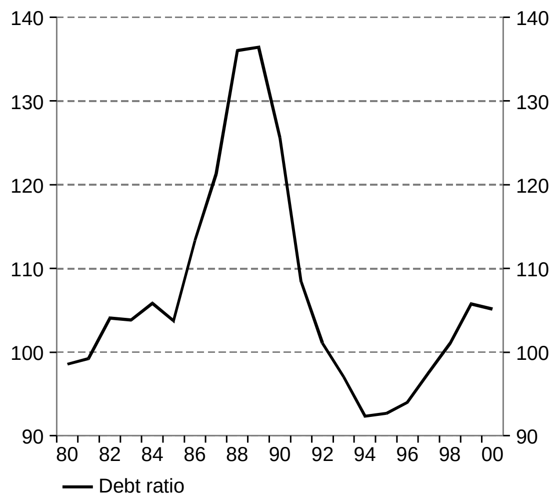
Note: OECD-14
Source: National Institute of Economic Research

The final result was that the rate of price and pay increases rose, in particular from 1987 when unemployment fell below 2 per cent. At the same time, the increase in productivity was low, which meant that unit labour costs increased (see Diagram 3). The economy was characterised by overheating which affected both the commodity and the labour market and many asset markets. Not least prices increased in the property market.

A driving force underlying private consumption was the rapid expansion of credit in the wake of abolition of the quantitative regulations of the credit market. The last domestic credit regulations were removed in 1985 in a situation where the majority of analysts considered that the system had not succeeded in limiting the expansion of credit. It rapidly became evident that this assessment was incorrect since the household debt ratio increased greatly after the deregulation (see Diagram 4). During the period 1985 to 1990, the volume of credit increased by an average of 16 per cent each year.

Diagram 4. The household debt ratio

Percentage of disposable income



Note. The debt ratio is the household's total debt in relation to disposable income.
Source: Statistics Sweden

With a fixed exchange rate, the main task of monetary policy is to keep interest at such a level that the capital flows are kept in balance at the given exchange rate level. This means that as long as there are no expectations about adjustments of the fixed exchange rate that the domestic interest rate must be adapted to the level in the countries where there is a fixed exchange rate. The other side of this is that responsibility for affecting the cyclical development, counteracting inflationary impulses etc. in a fixed exchange rate primarily rests on fiscal policy.

The mobility of capital increased gradually during the 1980s. Combined with the undermining of and the formal termination of the domestic credit market regulations, this meant that the Riksbank had limited scope for increasing domestic interest rates with a view to dampening the demand for credit. However, measures were taken to attempt to keep interest rates up.

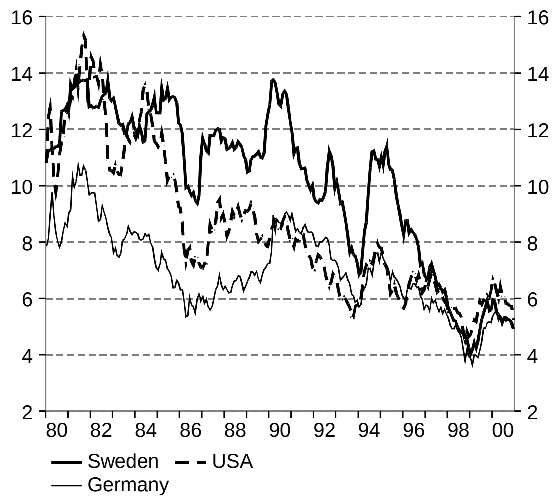
In the first place, the Riksbank attempted to create depreciation expectations by keeping the value of the krona at the bottom of the exchange rate band.

Secondly, the prohibition for foreigners to hold krona bonds was maintained until July 1989 as a means to keep up interest rates in relation to the surrounding world.

Domestic interest rates were also affected by the rule that central government should not have any net borrowing in foreign currency, the "foreign exchange loan norm". The idea underlying the foreign exchange loan norm was that the state would be dependent on financing costs in the domestic market, i.e. that major financial deficits would push up interest rates. This was intended to contribute to a more stringent fiscal policy. The consequence was that Sweden's foreign debt, which increased as a consequence of the deficit in the current account balance was financed to an increasing extent by the private sector. In the same way as the prohibition for foreigners to buy krona bonds, the foreign exchange loan norm led to the outstanding stock of krona assets being concentrated to a small number of investors. This can thereby be thought to have contributed to higher risk premiums on the krona and higher domestic interest rates (see Diagram 5).

Diagram 5. Five-year interest rates

Per cent



Source: The Riksbank

Thirdly, the Riksbank continuously purchased foreign currency and sold the corresponding quantity of krona (with the exception of a shorter crisis of confidence in the krona's fixed exchange rate in the 1985 when support buying of the krona took place). From a level corresponding

sponding to 4 per cent of GDP in 1982, the exchange rate reserve grew to the equivalent of 10 per cent of GDP in 1990. This meant that the Riksbank tried to meet the demand for kronor which existed at the current interest rate level.

These measures could not change the situation that the Swedish interest rate position was lower than would have been motivated taking into consideration the high inflation rate. On the part of the Riksbank, as well as in the Government's budget statements, it was repeated that monetary policy was "tight". Monetary policy was also in principle as tight as possible given the fixed exchange rate and the limited freedom of action that exchange control regulations permitted, although it still meant low interest rates and rapid expansion of credit.

The course of events illustrates certain basic characteristics of a regime with a fixed exchange rate. If the economy moves into a period of overheating and the inflation rate is higher than in the surrounding world, real domestic interest rates will fall. As long as there is full employment in the economy, no expectations of devaluation will arise since it is not meaningful to devalue in a situation without free resources. Long interest rates also tend to be relatively low. Unless the rest of economic policy succeeds in keeping domestic demand and price movements in balance, a fixed exchange rate can in this way contribute to strengthening cyclical fluctuations.

Concretely, this means for instance that the real interest rate before tax on a typical housing loan at the start of 1989 was around 5 per cent, i.e. the difference between a nominal rate of 12 per cent and an inflation rate of almost 7 per cent. In principle, it is the future expected inflation rate which is important in this context although there are reasons to assume that the majority of players during this period did not expect any marked reduction in the rate of inflation in Sweden.

Tax policy

The tax system was another factor that contributed to stimulating the demand for credit. Nominal interest expenditure in 1989 produced tax relief of approximately 50 per cent. In the above example, this meant that the real rate of interest after tax was –1 per cent. The high nominal interest rate in turn conditioned by high inflation contributed to increasing the importance of the right to make tax deductions. These circumstances led to a fast increase in demand for credit and private consumption. The mirror image was the negative financial balance of the household sector.

A new tax system was in the process of coming into effect. This included symmetrical taxation of income from capital at a 30 per cent tax rate. In this way, the value of tax deductions for interest would be lessened, which, all other things being equal, would increase households' real interest expenses after tax.

The rapid expansion in credit was partly due to the credit regulations being terminated before the tax reform. However, it is doubtful whether it would have been possible to maintain the regulatory framework for credit policy until the early 1990s. The abolition of credit and foreign exchange regulation was regarded as an adaptation of the formal regulatory framework to changes that had already taken place, among other things due to the internationalisation of the economy. No discussion therefore took place on the possibility of carrying out deregulation gradually or trying to counteract its expansive effects on the provision of credit and the general demand position by other measures.

Diagram 6. Unemployment

Percentage of the labour force

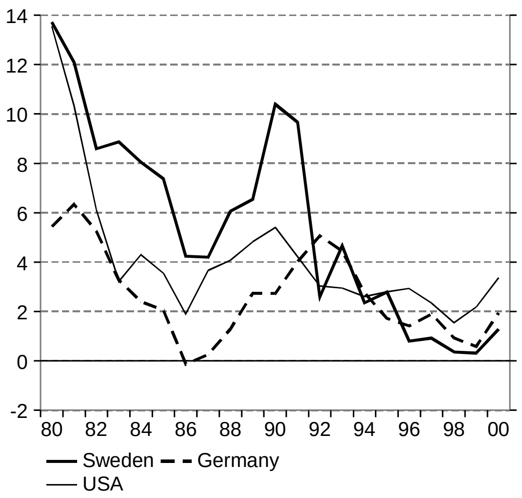
Source: Statistics Sweden and the National Labour Market Board

Fiscal policy

The removal of credit and foreign exchange regulations placed the responsibility for controlling the development of demand – and indirectly price and cost increases – on fiscal policy.

Diagram 7 Consumer prices

Annual percentage change



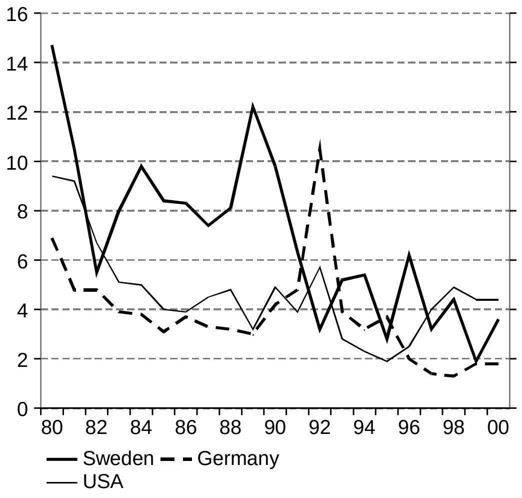
Source: Statistics Sweden

Public finances were in surplus during the latter part of the decade and central government debt in relation to GDP decreased. This was an effect of increasing tax revenue and of certain expenditures falling in an upturn. Viewed in relation to overheating, where open unemployment was less than 2 per cent (see Diagram 6), and private consumption was extremely high, public finances during this period should have shown considerably greater surpluses. However, it is difficult to assess the size of the tightening that was required, in the light of the swift improvement in public finances.

At the same time, responsibility for price and wage formation primarily rests on the social partners. It had been made clear at the time of the devaluation in 1982 that the exchange rate would be maintained. Consequently, price and pay increases that were far higher than the surrounding world would lead to an undermining of competitiveness and reduced employment (see Diagram 3, 7 and 8). The social partners should thus have changed their behaviour without necessitating direct economic policy interventions. The fact that the social partners did not adapt their wage formation is probably related to the declarations on low inflation policy and an unalterable fixed exchange rate not being perceived as credible.

Diagram 8. Nominal wages

Annual percentage change



Source: OECD

Note: Including collective charges etc. per employee in the business sector.

The fixed exchange rate was established as a stabilisation policy norm in 1982 and it was repeated in later declarations. However, this decision was not followed up in the way that was anticipated when drawing up the strategy, namely that it was the task of fiscal policy to ensure that inflationary impulses were restrained and inflation expectations kept down. This applied regardless of whether the impulses derived from the labour market, the credit market, or oil prices. The result was that the overall economic policy in the years after devaluation was not sufficiently stringent.

3. From overheating to depression – the period from 1990 to 1992

3.1 The governmental crisis and currency turbulence

The budget statement describes the state of the Swedish economy at the end of 1989 as follows (Government Bill 1989/1990:100, Annex 1, p. 14):

The overheating of the Swedish economy has now gone so far that the rate of price and pay increases has been so high for a long time as to motivate a further tightening of economic policy. Before the Government adopts measures to this end, it is prepared, together with the social partners, to consider whether there is any way, through a combination of a tight economic policy and mutual understanding and taking of responsibility, to bring down inflation without high unemployment.

The background was that nominal wages increased by an average of 10 per cent during 1989. The rate of inflation was around 7 per cent at the year-end. In 1990, the first steps of the tax reform were implemented, which inter alia meant reduced income tax financed by increased VAT and increased excise duties. This would increase the consumer price index by around 4 percentage points, i.e. bring up the registered inflation rate to around 11 per cent. Existing wage agreements contained price index clauses in many cases. In a number of areas, pay bargaining took place with high wage demands and threats of industrial action or disputes already in progress.

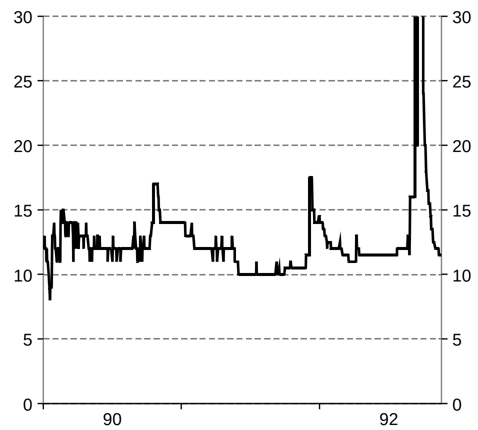
The aim of the Government's discussions with the social partners was, among other things, to investigate the possibilities of rapidly reaching agreements for the whole labour market for 1990 and 1991 which inter alia removed the part of indexation that could be linked to the tax reform. These discussions did not lead to any agreements. Instead the Government proposed statutory interventions in price and wage formation in the "freeze" package. This included a pay freeze, a rental freeze, a freeze on increases in local government tax, restrictions in the right to take industrial action, and increased penalties for illegal strikes. The Government lost the vote in the Riksdag on 15 February 1990, after which the prime minister submitted his resignation. However, the social-democrats were again asked to form a government and a new social democrat minority Government took office at the end of February.

During the spring, the Government introduced proposals on a tightening of fiscal policy. These included some revenue reinforcements and expenditure cuts. Furthermore, the proposals for a sixth holiday week and an extended parental insurance were withdrawn.

The political uncertainty in February 1990 spread to the foreign exchange market. In conjunction with the discussions on the freeze package, a strong outflow of currency took place for the first time since 1985. The Riksbank was obliged to make purchases to support the krona to defend the exchange rate. In order to reverse the flows, the Riksbank increased the instrumental rate by 3 percentage points to 15.25 per cent on 14 February (see Diagram 9). This was sufficient to reverse the flow and the instrumental rate was gradually adjusted downwards.

Diagram 9 The Riksbank's instrumental rate

1 January 1990-18 November 1992, per cent



Source: The Riksbank

Stability around and confidence in the fixed exchange rate had been broken, however. One explanation was the clear indications of an imminent financial downturn. This was due in turn to external and internal factors. On the one hand, the international cycle slackened and Sweden also lost market shares as a result of the weakening of the competitive situation due to high price and wage increases. When growth slackened and unemployment started to increase, the Swedish economy was again in a situation where the krona had previously been devalued. Swedish and international investors then had a reason to try to analyse how Sweden could handle its problem of competitiveness this time and the threat of low employment and profits in the business sector. Calculations indicate that the expected exchange rate in twelve months' time was outside the exchange rate band specified by the Riksbank from the time of currency turbulence in February and onwards.

3.2 Further currency turbulence and the start of a financial crisis

In October 1990, there was renewed turbulence in the foreign exchange market. This time, the currency flow was caused by rumours that the krona was to be linked to the European currency unit ECU (the predecessor of the euro) and would be devalued in conjunction with that. The Riksbank increased the instrumental rate by 5 percentage points and currency flows reversed.

The Riksbank then had a second opportunity to demonstrate its readiness to defend the fixed exchange rate. For a central bank with a credibility problem, currency turbulence can in this way offer an opportunity to strengthen confidence in the fixed exchange rate. By increasing short-term interest rates, the central bank can show its willingness and ability to defend the exchange rate with the aid of interest rate increases. If the central bank succeeds in reversing the currency flows, the market agents can draw the conclusion that the central bank will resist next time. In the best case, it will lead to there being no further speculation against the currency.

However, repeated interest rate shocks are damaging to the economy. Interest rates will in future lie at a high level and the large fluctuations create uncertainty in the economy. Both factors contribute to dampening demand.

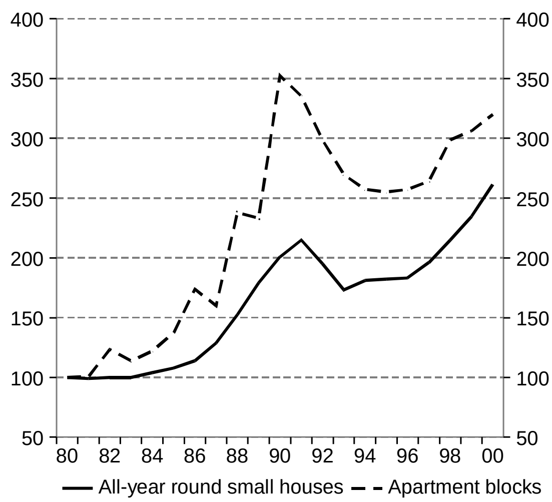
Just as important for the changed picture of expectations in autumn 1990 was therefore the Government´s decision that it intended to start a process that aimed at Swedish EU membership (then still the EC). EU collaboration was characterised at this time by a strong prioritisation of fixed exchange rates within the framework of the exchange rate collaboration, EMS. The political significance of the Swedish commitment to a fixed exchange rate thereby increased. The decision was announced in October together with a proposal for further budget policy measures aiming at maintaining the budget balance during the 1991/92 fiscal year. These measures included expenditure reductions of SEK 15 billion and a reduced level of compensation in the health insurance system.

During autumn 1990, a further source of concern for the state of the economy and the economic stability of the financial system appeared. The imbalances that had been built into the financial system had not previously been noted by the authorities concerned.

In September, it emerged that the finance company Nyckeln had made large losses on loans for property transactions. The banks were refusing further loans to the company and Nyckeln could not either borrow through securities in the certificate market. Lack of confidence spread rapidly to other independent financial companies and the Swedish commercial paper market ceased to function.

Diagram 10 Property prices

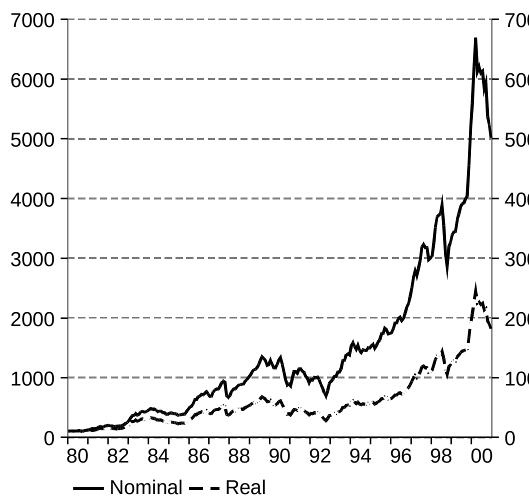
Index 1980=100



Source: National Institute of Economic Research and Statistics Sweden

Diagram 11 Share prices

Index 1980=100



Source: National Institute of Economic Research

In the previously very hot market for commercial properties, rental levels fell which led to a fall in both prices and turnover in the property market. In the same way as lending and property prices were driven upwards in the 1980s in a self-reinforcing spiral, they now both turned downwards (see Diagram 4 and 10). Other financial indicators as well, for instance, the stock market developed negatively (see Diagram 11). The effect was a swift decline in both private consumption and capital expenditure, in particular investment in properties. Employment fell, not least in the construction sector.

Asset prices and saving were also affected by the tax reform that was carried out in stages in 1990–91. A central idea in the reform was to encourage saving and counteract borrowing. Other key principles were uniformity and a striving for low tax rates and broad tax bases. This meant among other things that a separate, uniform taxation was introduced on capital incomes with a tax rate of 30 per cent. In this way, the value of interest deductions was reduced which increased the real cost of borrowing after tax for borrowers, at the same time as yield after tax on savings increased. This contributed to reducing the price of houses and tenant-owned housing. This also contributed indirectly to increased saving. The real debt ratio of households increased which strengthened the motivation to reduce loans i.e. to save by amortisation.[1]

The tax reform took place at the same time as a strong increase in household saving. It is not possible to determine with any exactness to what extent this depended on the reform, an unavoidable normalisation in relation to the situation with strong negative saving during the 1980s and an adaptation to the cyclical downturn, markedly lower inflation and increased insecurity as regards, for instance, security of employment. However, it can be noted that the tax reform to a certain extent contributed to reinforcing the downturn in the economy where the restraining effect on private consumption via reduced asset values dominated over the effect on disposable incomes of the initial underfinancing.[2]

3.3 The 1991 Budget Statement

The Government noted in the budget statement for the 1991/92 fiscal year that the Swedish economy was affected by serious problems. Inflation was pointed out as the central stabilisation policy problem. Low growth, the continuing deficit in the current account balance and the low level of saving were also mentioned as weak aspects. Among the strong aspects, the Government mentioned the financial position of the business sector and the strong public finances.

Under the heading “The direction of economic policy”, the Government stated the following (Government Bill 1990/91:100, Annex 1, p.4):

> It is not possible in the long term to secure employment in an economy where prices are increasing faster than in the surrounding world. To safeguard employment and welfare, economic policy in the next few years must be focused on a durable decrease in inflation. This task must take precedence over other ambitions and demands. This means that very strong restrictions must be placed in future on central government as well as municipal and county council expenditure at the same time as the sector exposed to competition must be strengthened.

The role of exchange rate policy and the division of responsibility between fiscal and monetary policy is described as follows (p.18):

> A fixed exchange rate is one of the cornerstones in the economic policy pursued since 1982. It is to create stability and credibility in economic policy and thus contribute to combating inflation. The overarching task of monetary policy is to maintain the fixed exchange rate. In order to make this possible in the long-term, a tight fiscal policy must be applied.

Furthermore, the Government confirmed that a previously announced commission of enquiry into the position of the Riksbank would be appointed. Its objective was stated to be to design a clear, purposeful framework for future monetary policy.

The task of bringing inflation under control as a means to maintain employment and welfare was thus again confirmed as well as the economic-political division of responsibility to achieve this objective.

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[1] According to the Committee for Evaluation of the Tax Reform, KUSK (SOU 1995:104) approximately half of the real price fall on houses during the period 1991-93 is related to the tax reform..

[2] According to the calculation reported by KUSK, an estimated approximately one percentage point of a total fall in real GDP from 1991-93 of 5 per cent can be derived from the tax reform. A summary of KUSK and the Government’s evaluation of the tax reform, including its effects on cyclical developments, is reported in Government Bill 1997/98:1, Annex 6.

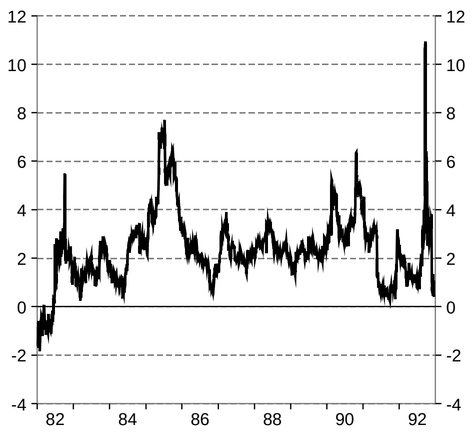
3.4 The link to the ECU and temporary stabilisation

Sweden's new European policy and the clear declarations in the budget statement contributed to stabilising the situation in the interest and foreign exchange markets during the first half of 1991. The approach to the EU also made it possible to review the construction of the fixed exchange regime with the intention of creating a more credible exchange rate.

In a process where it appeared probable that Sweden would join the EU, it was perceived as a question of when, not whether, Sweden would enter the EMS and the krona receive a fixed exchange rate within the exchange rate mechanism (ERM). In EU collaboration, internally fixed exchange rates were an important component, with a view to future monetary union. The most recent adjustment of the target exchange rates had been made in 1987 and since then the EMS had not been subjected to the kinds of speculative attacks, with accompanying interest rate shocks, that affected Sweden. Unlike Sweden's unilaterally declared fixed exchange rate there were mutual undertakings in the ERM, i.e. speculation against a country's currency would be met by support buying by a number of central banks.

Diagram 12 Six-month interest rate differential

Per cent



Source: The Riksbank

Formally, it was possible for a country outside EU to be an associated member of EMS, although in practice this route was closed. The ambitions to create a monetary union meant that the EU Member States were unwilling to complicate the collaboration by including associated countries. In May 1991, the Riksbank announced instead that the krona had been unilaterally linked to the ECU at a rate that exactly corresponded to the value in relation to the basket of currencies, i.e. the link to the ECU was made without adjusting the exchange rate. In reality, however, the decision entailed an appreciation of the currency over the next few years since the US dollar would depreciate in relation to the European currencies. The decision followed Norway's example; the Norwegian krona had been linked to the ECU in the same way in October 1990. Finland also followed Norway's example.

The link to the ECU was perceived as a more binding undertaking. It also meant that an end to concern about a linkage at a lower rate in connection with the coming election in autumn 1991. The difference between short interest rates in kronor and ECU respectively, the new measure of the yield premium required by investors in krona assets as compensation inter alia for the exchange rate uncertainty was reduced by a couple of percentage points (see Diagram 12).

Developments in the surrounding world were more turbulent. In the wake of German reunification, monetary policy in Germany was tightened. The other members of the ERM were obliged to increase their interest rates despite there being clear indications of a downturn in a number of these countries. Uncertainty about the durability of the ERM exchange rates began to spread which obliged a number of countries to increase their interest rates more than Germany. This led to a further dampening of activity which led to tensions in the system gradually increasing.

The problems were even greater in Finland which among other things was affected by a strong decline in trade with the former Soviet Union. Unemployment increased at a rapid rate and a deep economic crisis threatened. In November 1991, the Finnish mark was devalued by 8 per cent in relation to the ECU. Sweden's underlying credibility problem then resurfaced. Outflows of currency increased rapidly and the Riksbank increased the instrumental rate by 6 percentage points in December. Similarly to previous periods of currency turbulence, the currency flows reversed and the Riksbank was able to reduce the interest rate again in stages. The interest rate differential in relation to the surrounding world remained, however, at a higher level than before the exchange rate outflows in December.

The sparking off of the crisis by currency turbulence in a neighbouring country shows how sensitive to disturbances the krona was. Although the economic downturn in Finland was far steeper and there was disagreement there on the fixed exchange policy, it was clear that investors drew parallels with Sweden. There were also more and more indications of the weakness of the Swedish economy. Industrial production fell by almost 7 per cent in 1991. Open unemployment increased sharply, as well as the number of employed in labour market programme measures. Central government finances also weakened sharply. In the Finance Statement for 1992/93, the forecast for the deficit in 1991/92 was revised from SEK 5.5 to SEK 47.7 billion. Public finances were now automatically weakened.

A further parallel with Finland was that credit losses in the finance company sector spread to the banks. In October, it emerged that Första Sparbanken had incurred such large credit losses that the bank's survival was threatened. The Government contributed by various loan guarantees to enable the savings bank business to undertake the necessary reconstruction measures. Nordbanken had also reported major credit losses and the Government made a capital contribution in its capacity of main owner to safeguard the bank's capital coverage. It was clear that the price fall in the real estate market in particular was starting to create problems for the institutions that provided credits with properties as security. High interest rates contributed to a further increase in difficulties for borrowers who had already felt the effects of falling asset values and falling rental levels.

3.5 The 1992 Budget Statement

The newly-appointed non-socialist four-party Government's objectives and plans for economic policy were formulated in the Budget Bill for 1992/93. The emphasis was placed on what was considered to be the economy's structural problems (Government Bill 1991/92:100, Annex 1, p.7):

> Sweden's problems are largely structural. Short-term measures must be in accord with the long-term strategy. It is important to make fast progress with the necessary changes. This applies not least to tax reductions and the consolidation of budget expenditure. It also applies to reforms in the large public expenditure systems.

The budget policy ambitions were quantified in the following way (p. 8 and p. 9 respectively):

> Preliminary assessments indicate a need for tax reductions in the range of SEK 10 billion per year until the mid-1990s (...). The Government's savings target was SEK 10-15 billion for the 1992/93 fiscal year calculated on a full-year basis. In the assessment of the Government, the long-term expenditure strategy during the period of office will require continuous decisions on expenditure reductions of the same size.

The new Government, like its predecessor, placed the fight against inflation at the centre. Moreover, the Government repeated the objective of a fixed exchange rate as a basis for monetary and foreign exchange policy. The division of responsibility in economic policy was clearly expressed (p.10):

> The Swedish credit market is practically wholly integrated with the surrounding world. In the light of this, the Riksbank's monetary policy has become increasingly focused on balancing currency outflows by adaptations to the domestic level of interest rates. Monetary policy can thereby not be used to affect domestic demand. Fiscal and structural policy bears the main responsibility for creating the prerequisites for low inflation and stable growth.

The Government regarded it as sufficient to finance planned tax reductions with approximately equivalent expenditure reductions which can be interpreted as a deficit being perceived as substantially cyclically conditioned, i.e. it would disappear in the event of a return to normal capacity use. (p.16):

> Despite the measures that were undertaken, some weakening of both the central government budget and public finances took place. This is primarily due to economic stagnation, i.e. the after effects of an earlier unsuccessful economic policy weakening central government revenue.

At the beginning of 1992, the direct effects of the tax reform disappeared from the measured CPI inflation. The rate of inflation fell to around

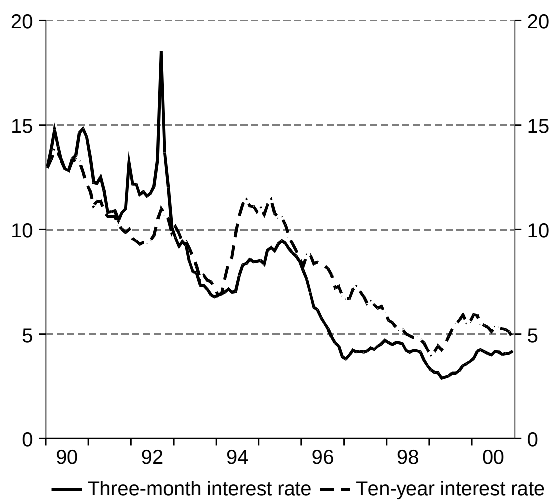
2 per cent, which made it clear that the financial weakening reduced the inflationary pressure in Sweden. The reduction in price and wage increases which – through a reduced demand for commodities and labour – takes effect with a fixed exchange rate after a period with higher inflation than the surrounding world could now be clearly seen. The “Renberg” agreement in the labour market had also contributed to the swift adaptation of wages.

The latest lack of confidence in the krona meant, however, that the Swedish interest rate level was clearly over 10 per cent (see Diagram 13) despite inflation now being adapted to European level. The Swedish economy had ended up in a situation which was a mirror image of the 1980s. Then it was not possible to increase real interest rates since the fixed exchange rate was perceived as credible. Now it could not be reduced despite the economy going steeply downwards, since the credibility of the exchange rate regime was weak.

In the 1992/93 budget statement, there was no awareness of this dilemma. The reduction in inflation was welcomed and the Government interpreted the increase in private saving as an expression for a welcome structural change. To the extent that the rapidly growing deficits in central government finances were an expression for structural imbalances these should, in the assessment of the Government, be corrected by long-term growth promotion policy with reduced taxes as the most important means.

Diagram 13 Swedish interest rates

Per cent



Note: Monthly average
Source: The Riksbank

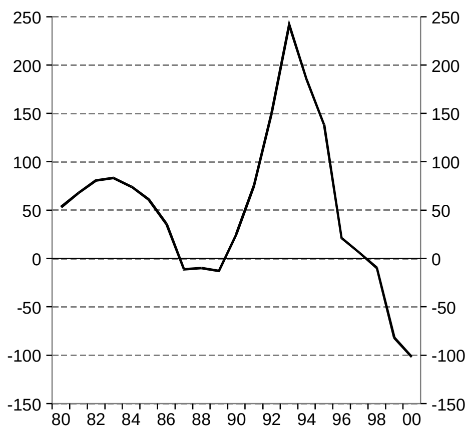
3.6 From insecurity to foreign exchange and fiscal crisis

With the exception of a minor disturbance in April, again sparked off by currency turbulence in Finland, the situation in the foreign exchange market was stable until the decision in June that Denmark had said no to the Maastricht treaty in a referendum. France also announced a referendum on the treaty. At the same time, the differences grew between Germany which needed high interest rates to handle the unification of Germany and the other ERM countries where the economy was developing weakly.

The question arose in the financial markets of the extent to which the ERM countries would be able to handle these tensions with continued inalterably fixed exchange rates. Since the Swedish foreign exchange policy was linked to the approach to the EU, this further increased uncertainty on the extent to which the exchange rate for the krona should be maintained. If exchange rate adjustments were made within the ERM, the opposition to adjusting the exchange rate of the Swedish krona would be lower. The high interest rates in Germany also had direct demand-dampening effects since Swedish interest rates due to the association with the ECU to a great extent followed the German with a considerable addition.

Diagram 14 Central government borrowing requirement

Billion kronor



Source: National Debt Office

At the same time, public finances continued to worsen. The net central government borrowing requirement, an indicator which had attracted increasing attention, was SEK 111 billion at the end of August 1992 measured as a 12-month rate (see Diagram 14). This corresponded to an increase of SEK 65 billion compared with a year earlier. The situation in the bank sector also deteriorated. Credit losses grew dramatically apace with the reduction in property prices. Other borrowers also encountered payment problems due to downturn and the high level of interest rates.

The increasingly poor development of the Swedish economy led to the krona being sensitive to disturbances. At the end of August, the calm was definitively over and an extensive outflow of currency took place. The Riksbank increased the instrumental rate in two steps from 12 to 16 per cent. This sufficed to stop the outflow although unlike earlier interest rate increases, no appreciable return took place.

The same day that the Riksbank increased the interest rate to 16 per cent, the Government announced that it intended to initiate discussions with the opposition with a view to achieving as broad a unity as possible around economic policy. Before discussions had started, the situation in the surrounding world deteriorated, however. The fixed exchange rates in the ERM were affected by acute distrust. The pressure was greatest on the Italian lira and the British pound. The Finnish mark with the same association with the ECU as the krona was affected by a new currency crisis. On 8 September, Finland stopped intervening to defend the rate of the mark in relation to the ECU and the variable mark rate immediately fell by approximately 13 per cent. The Riksbank increased the instrumental rate to 24 per cent. However, the outflows continued. The next day therefore, the Riksbank increased the rate to 75 per cent. Furthermore, the Riksbank announced that the equivalent of SEK 120 billion would be made available to the currency reserve through loans. The intention was to strengthen the bank's resources to make purchases to support the krona. Statements were made by both the Government and the Social Democratic opposition in support of the fixed exchange rate regime. Both parties also announced that discussions on economic policy would now be initiated.

A few days of calm took place and the Riksbank lowered the instrumental rate to 20 per cent. Despite a devaluation of the lira and reduced interest rates in Germany, turbulence within the ERM was not over, however. On 16 September, new attacks occurred primarily against the lira and the pound. The krona again came under pressure. The Riksbank increased the rate to 75 per cent, but when this did not help to stop the currency outflow, the instrumental rate was increased the same afternoon to 500 per cent. The same evening it was announced that the lira and the pound had a floating exchange rate.

The outflow of currency continued the next morning. A decision was made at the Riksbank to increase the instrumental rate to 4,000 per cent if this development continued. Before the decision could be put into practice, the outflow ceased, however. [3]

The same evening a statement was made that announced that discussions on a crisis agreement were in process between the Government and the Social Democrats. The result which was later called Crisis Package 1, was presented on 20 September. The budget was to be reinforced by approximately SEK 20 billion net through a combination of expenditure cuts and revenue increases. The Riksbank reduced the instrumental rate to 50 per cent and a few days later to 40 per cent.

Partially as a result of the extreme interest rate situation, the crisis in the bank system risked becoming acute. The Riksbank gave loans on special terms to banks and mortgage institutions to soften the impact of the high instrumental rates on the financial system although credit losses threatened to rise. In combination with the ongoing economic downturn, this meant that the Swedish banks' financing, in particular in foreign currency was threatened since the banks' lenders began to call into question their payment capacity and solvency. Sweden was threatened by a financial systemic crisis, which it was thought could seriously damage the national economy not least taking into consideration the already critical situation in the economy as a whole. On 24 September, the Government issued – with explicit support from the Social Democratic opposition – a general guarantee therefore for claims on Swedish banks and mortgage institutions.

The situation in the foreign exchange and interest market remained unstable until crisis

[3] The plans to increase the instrumental rate to 4,000 per cent were not generally known until several years after the crisis and therefore did not affect the course of events.

package 2 was presented. This contained measures that meant improved competitiveness for the business sector through shorter holidays and lower employers' social security contributions, financed through inter alia higher VAT, which meant an "internal devaluation". The intention was to improve the prerequisites for – and thus confidence in – a continued fixed exchange rate. Altogether, the measures corresponded to a reduction in business sector costs by approximately 4 per cent.

After the second crisis package, the situation in the foreign exchange market stabilised, partly due to tensions in the ERM being reduced. The Riksbank lowered the interest rate step for step. At the beginning of November, the instrumental rate was down to 11.5 per cent, the same level as during the summer.

In mid-November, market interest rates started to increase again. This was triggered off by one of the National Debt Office's auctions of treasury bills not being fully subscribed. In the background, there were forecasts of a continued deterioration of the economic prospects and thus central government finances. The Riksbank again had to make purchases to support the krona. A new interest rate increase was regarded as excluded as it would further hasten the economic downturn and deepen the financial crisis.

When the outflow had started, it grew rapidly. Plans for a third crisis package were drawn up although discussions did not lead to any agreement. On the morning of 19 November, the Riksbank decided to increase the instrumental rate to 20 per cent without expecting this to have any real effect on the outflow. The same afternoon, the Riksbank announced the decision to allow the krona to float with immediate effect.

3.7 The defence of the krona – an evaluation

With a fixed exchange rate, the task of monetary policy is to set the level of interest rates so that the fixed exchange rate can be maintained. The Riksbank followed this simple rule until November 1992. To this extent the bank fulfilled the task it had been given at the time of the decision that the 1982 devaluation would be the last one. At the same time, the situation was untenable when the decision was finally made to abandon the fixed exchange rate. The downturn in the economy – with fast rising unemployment, negative growth, falling asset prices and rapidly deteriorating central government finances – was so deep that a continued prolonged defence of the krona was economically unsustainable. In that situation, an adjustment of the exchange rate was necessary among other things to avoid an even longer period of economic stagnation.

Given that the assessment that it was not correct to continue defence of the krona in November 1992, the question arises whether the fixed exchange rate could and should have been abandoned earlier. In the debate on the 1990s, different points of view have emerged, for instance that Sweden should have shifted to a floating exchange rate in the mid-1980s to be able to handle the effect of deregulation of the credit market with monetary policy measures. A meaningful evaluation of economic policy must, however, take into consideration the environment in which decisions were made and the alternatives for action that existed then. No one could imagine that Sweden would abandon the regime that characterised exchange rate policy in small countries in Western Europe. At the same time, the lack of a discussion on the consequences of a floating exchange rate raises questions on the breadth of the debate on economic policy.

As the plans for a European monetary union took shape and Sweden decided to move closer to the EU, the reasons for a fixed exchange rate became even stronger, however. A floating exchange thus appeared to be excluded from a political perspective.

There were other aspects of the defence of the krona. Different governments and the Riksdag had placed great emphasis on the fixed exchange rate as the overarching stabilisation policy norm for a number of years. There was a broad support for the fixed rate policy otherwise, including from the social partners. There was no such support in Finland, for instance. There was therefore a substantial amount of confidence in the assumption of a fixed exchange rate.

After the September crisis, a kind of waiting position. The foreign exchange market stabilised and interest rates gradually decreased, although they were still at too high a level to appear as compatible with a recovery of the economy.

Developments in the surrounding world did not give any assistance either since tensions in the ERM remained. Since the interest rate level remained so high there were no conditions for a long-term economic upswing. In this way, it was in practice only a question of when the next currency crisis would occur.

When the exchange rate flows returned in November, new discussions took place on broad crisis agreements. The Riksbank then again viewed its task as creating a respite for negotiations. This time it took place only by support buying, since more interest rate increases for the reasons given above were deemed to be counterproductive. The Riksbank's action was connected this time as well to the prospects of achieving political unity on a crisis package. When it became clear that this was not going to happen, the Riksbank made what was in practice a symbolic rate increase and then it was only a matter of hours before the krona was to have a floating exchange rate.

Whether it was meaningful to continue with support purchases for six days is doubtful. This depends partly on how good the prospects for a new crisis package were, but also on the assessment of whether the package discussed would create credibility for a continued fixed exchange rate. This assumed that measures could be taken which would so quickly and thoroughly change the picture of the Swedish economy that a turn appeared possible.

The interest rate increases in September and the prevailing crisis situation made it possible to produce crisis packages by agreements between the blocs.[4] At the same time, it is difficult to evaluate the importance of the ability to reach agreement in a crisis situation. The stubborn defence of the krona may to some extent have affected the picture of the Swedish political system in the long term and thus expectations of the policy that would be pursued after the fall of the krona.

It is also possible to adopt a more overall critical perspective and argue that the defence of the krona had no chance of success and was not based on reasonable economic policy considerations. According to this view, the threatening depression meant that the exchange rate norm lacked significance for the view of the Swedish economy; concern for expectations on continued high inflation in the long term in Sweden should have been pushed into the background. It should have been possible to realise that the downturn was so deep that it would not be possible to reverse developments with an unchanged nominal exchange rate. The krona should thus have been released earlier. Probably not even major expenditure reductions and tax increases would have been sufficient to create long-term confidence in the fixed rate policy in a turbulent international environment and when the main problem was an overvalued exchange rate.

Table 1 Demand and output 1990–1994

Annual percentage change

	1990	1991	1992	1993	1994
GDP	1,1	-1,1	-1,7	-1,8	4,1
Household consumption expenditure	-0,4	1,0	-1,3	-3,0	1,8
General government consumption expenditure	2,4	3,3	0,1	-0,2	-0,9
Central government	4,6	6,2	2,8	3,0	-0,6
Local government	1,7	2,2	-1,0	-1,6	-1,1
Gross fixed capital formation	0,2	-8,6	-11,6	-15,0	6,1
Stockbuilding1	0,2	-1,0	0,8	-0,4	1,3
Export of goods and services	1,8	-1,9	2,2	8,3	14,1
Import of goods and services	0,7	-4,9	1,5	-2,2	12,0

[1] The rate of change is expressed as a percentage of GDP last year.
Source: Statistics Sweden

3.8 The situation after the fall of the krona

Until the end of 1992, the krona depreciated by about 15 per cent in relation to the ECU. The real effective exchange rate was then at approximately the same level as immediately after the devaluation in 1982. In other respects, the situation was different, however. The economy was in a deep downturn (see Diagram 15 and Table 1) which meant that the risk was little for inflationary effects of the krona's depreciation. On the other hand, there was after the transition to the floating exchange rate no economy policy rule that could serve as an anchor for expectations on economic policy and the economic development.

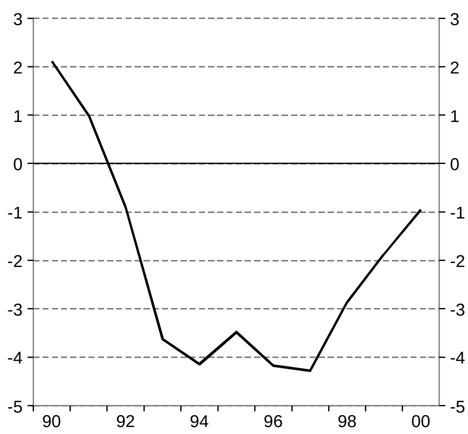
Immediately after the fall of the krona, both the Government and the Riksdag expressed the

[4] Viewed retrospectively unanimity on handling the banking crisis was perhaps the most important aspect of the agreements since it made it possible in an acute situation to give a credible guarantee despite the formal Riksdag decision only being made several months later.

ambition to return to a fixed exchange rate. Exchange rate policy was still linked to an approach to the EU and a future entry into EMS. However, it was evident that a fixed exchange rate assumed a stable economic situation and that the road there could be a long one. The Swedish krona had not had a floating exchange rate since the 1930s. A first task was then to produce a new framework for the economic policy adapted to a system with a floating exchange rate.

Diagram 15 Output gap

Per cent of actual GDP



Source: National Institute of Economic Research

4. Adaptation of economic policy to the new conditions

4.1 A framework for monetary policy with a floating exchange rate

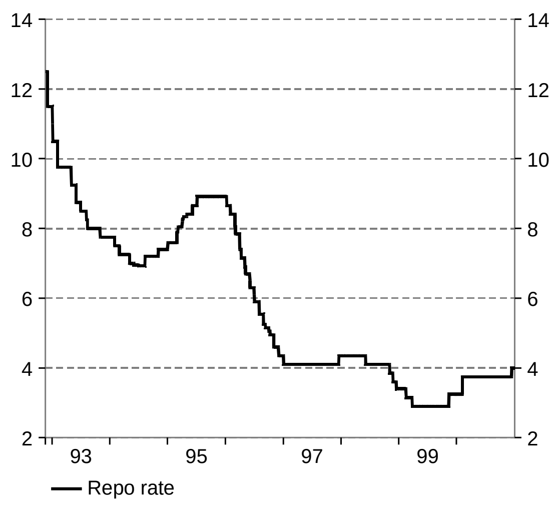
After a swift process of investigation, partly documented in Sveriges Riksbank (1992), the Riksbank set a quantitative inflation target, as had previously been done in Canada and New Zealand. Concretely, the Riksbank's decision in January 1993 meant that the target for inflation (measured with CPI) was set at 2 per cent with a symmetric interval of ± 1 percentage point. Among other things taking into consideration that the depreciation of the krona was expected to have an effect on the price level and that monetary policy affects the actual inflation rate with a considerable time lag, it was stated that the target would apply only from 1995. There were accordingly no formal targets for 1993 and 1994, although the monetary policy control was guided from the very beginning by the two per cent target.

Even if the task of monetary policy under the new regime was clearly expressed, it was difficult to determine how policy should be formed in practice to achieve the long-term target. This was partly due to the Riksbank lacking direct experience of monetary policy with a floating exchange rate although the fundamental uncertainty that existed on the economic prospects and the mode of functioning of the economy after the deep recession and the replacement of the exchange rate regime were just as important. A complicating factor was also the continued reduction of production and employment which led to an increasing deterioration in central government finances. The central government borrowing requirement during 1992 totalled SEK 150 billion, a doubling compared with 1991. Already in February 1993, the annual rate was up at SEK 205 billion.

This uncertainty was reflected in a further fall in the value of the krona and the interest rate differential to the surrounding world was high. This indicated that the new inflation target was not credible. There was concern that the central government crisis would be further deepened and that this would compel a reorientation of monetary policy. It was evident that the economy would benefit from lower interest rates, although the ability of monetary policy to contribute to sustainable low interest rates and a reduction in the long rates as well was unsure and open to question.

Diagram 16 The Riksbank's repo rate

Source: The Riksbank



The Riksbank lowered the instrumental rate to 12.5 per cent directly after abandoning the fixed exchange rate. Reductions subsequently took place in stages. Two steps were taken before the year-end and after a further step in February, the instrumental rate was 9.75 per cent (see Diagram 16). The Riksbank's action was contrasted in the discussion with the line adopted in the United Kingdom where the instrumental rate was reduced by 6 percentage points directly after the transition to a floating exchange rate. In Finland as well interest rates had been reduced faster than in Sweden.

The Riksbank's action was commented on in the following way by the Economy Commission, whose report was published in March 1993 (SOU 1993:16, p. 49):

> We advise the Riksbank to continue to pursue its strategy of successively reducing the short interest rate and check what happens to the exchange rate, the time structure of interest rates (the "yield curve"), wage and price inflation and inflation expectations. In order not to get stuck at today's high money market interest rate and worsen the downturn, we consider that interest rate reductions should continue as long as there are no further dramatic developments with the long rate or the krona exchange rate.

The Commission warned in particular that a strong weakening of the krona could worsen the bifurcation of the economy. The export-oriented sector would be stimulated too strongly while at the same time the domestic sectors would be affected by further restraint through falling real incomes. The Commission also discussed the central government financial imbalances and underlined that lack of confidence with regard to the long-term development of central government debt reduced the freedom of action of both monetary and fiscal policy.

Approximate calculations indicated that long-term budget reinforcements of the order of SEK 100 billion were required. In the event of a large increase in structural unemployment, a further SEK 30 billion of expenditure cuts would be required. Taking into consideration the weak domestic demand, the Commission recommended, however, that the cuts should take effect in stages and first from 1995 onwards. The Commission underlined at the same time the importance of making quick decisions on measures so that the consolidation programme became credible. A central component of the Commission's report was moreover measures to improve the growth potential of the economy.

On the part of the Riksbank, it was underlined that drastic reductions in short-term interest rates risked further weakening the krona and pushing up long rates. This would worsen the prospects for a long-term recovery of the economy. Through the decision on measures with a long-term effect to stabilise public finances, lack of confidence in the economic policy objectives would be reduced. In this way, the exchange rate would be reinforced and instrumental rates could be reduced at a faster rate. The imbalance between the far too weak krona and the too high interest rates could be rectified in this way. The freedom of action in the field of monetary policy required, in the assessment of the Riksbank, confidence in the objective of long-term stable central government finances. [5]

The Riksbank's critics emphasised that the high real interest rates pressed asset prices and led to indebted businesses and households being in an increasingly poor situation, a so-called debt deflation process. The Economic Experts Group of the Industrial Council for Social and Economic Studies drew attention in January 1994 to the possibility of faster short interest rate reductions increasing the prospects for recovery in the private sector. This would in turn strengthen public finances and reduce uncertainty about future economic policy, which would give lower long interest rates. The Economic Experts Group also considered that the weak public finances were a reflection of the increase in private savings, in turn primarily controlled by household debt consolidation. It therefore warned about trying to counteract the weakening of central government finances with budget policy measures.

4.2 Handling the problems of central government finance

The weakening of public finances was clearly conditioned by the deep economic recession with falling employment, which both under-

[5] The Riksbank's view is contained for instance in Sveriges riksbank (1995).

mined the tax bases and increased expenditure. In addition to the normal effects of expenditure on labour market policy programmes and measures, there were inter alia costs for bank support totalling SEK 65 billion from 1991 to 1993. However, it was difficult to determine the extent to which the deficit was structural or cyclical. It was not least unclear how the economy was affected by the crisis, e.g. what would happen to the level of structural unemployment. In many countries where unemployment had increased greatly, it had remained at a high level. There was widespread concern that Sweden would be affected by similar effects. The higher structural unemployment became, the more far reaching were the measures that would be required to balance public finances. Measures that were perceived as insufficient would thus not remove the distrust against central government finances and not give lower real interest rates. On the other hand, there was a risk that rapidly introduced cuts would increase unemployment in the short term which would contribute to higher structural unemployment and thus greater balance problems. The choice of path was complicated.

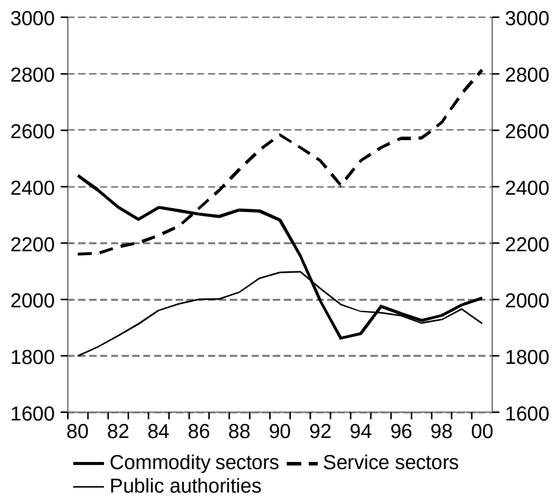
In the Budget Bill in January 1993, the Government stated consolidation of public finances as a main task of economic policy. This was described as a condition to "increase confidence in economic policy and make a sustainably lower interest rate level possible" (Government Bill 1992/93:100, Annex 1, p. 1).

In the Supplementary Budget Bill, the Government stressed – in terms inspired by the Economy Commission's report - again the importance of consolidating public finances and rejecting expansive fiscal policy as a means of reversing the economic downturn (Government Bill 1992/93: 150, Annex 1, p.16):

> Today, a fiscal policy expansion through unfinanced increase in expenditure or unfinanced tax cuts would increase the budget deficit and thus nourish long-term inflation expectations. Confidence in economic policy would be seriously damaged (....). The disadvantages of a general fiscal policy expansion in the form of persistently high budget deficits and, due to the consequently higher interest rate, lower confidence, lower investments therefore clearly outweighs the benefits that could be achieved from a somewhat higher level of activity in the short term.

The sustainability of the Government's plans was questioned. The Government's own calculations showed that the debt would continue to grow year by year and that these calculations had underestimated the deterioration of public finances for a number of years. Likewise, there was uncertainty about the possibilities of carrying out the necessary measures.

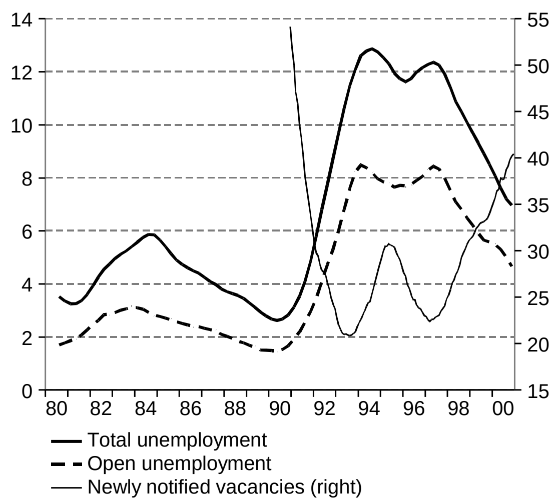
Diagram 17 The number of employed



Sources: National Institute of Economic Research and Statistics Sweden

Diagram 18 Unemployment and vacancies

Per cent of labour force and in thousands.



The real economic situation was still serious. During 1993, GDP decreased by 1.8 per cent. Employment in the private sector decreased rapidly (see Diagram 17), above all in industry and the construction sector, and total unemployment amounted to approximately 10 per cent (see Diagram 18). The weakening of public finances continued as well. The deficit in the financial balance of public finances corresponded to 12 per cent of GDP. The central government borrowing requirement which measures central government need of new credits totalled SEK 242 billion in 1993 which corresponded to almost 17 per cent of GDP.

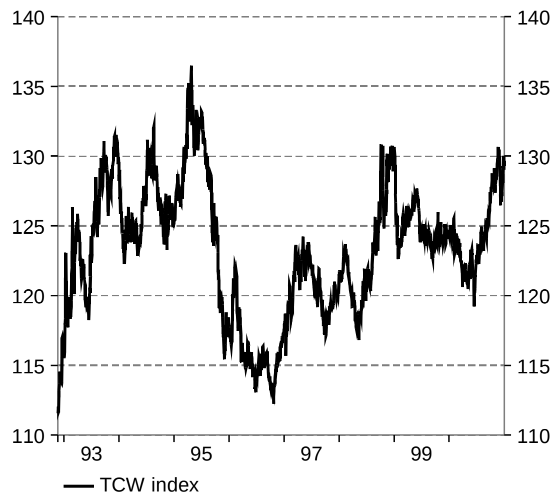
The central government debt at the end of 1993 corresponded to 76 per cent of GDP, an increase by 30 percentage points since the beginning of the decade. The increase in consolidated gross debt was almost as large. Interest on central government debt had grown in a year by almost SEK 20 billion. The Government's explicit ambition to save SEK 10 billion per year in addition to the proposals already made was not in parity with what was required to reverse the trend.

Lack of clarity about the possibilities of achieving long-term sustainable public finances can per se worsen a government financial crisis. At some point, central government finances become so weak that expenditure increases like tax reductions, lead the private sector to more than compensate for these by increasing its saving. This is due to their anticipating higher future taxes and/or poorer public service and undermined transfer systems in future. If the underlying development of Government finances does not appear as sustainable in the long term, normal automatic stabilisers via taxes and transfers can produce destabilising effects. In this situation, expenditure cuts which show in a credible way that public finances are under control, can have expansive effects by reducing the tendency to save in the household sector and giving the business sector more stable conditions for investment decision.

It is impossible with any degree of exactness to assess when an economy is approaching a threshold of this kind. The rapid deterioration of public finances combined with the difficulties of producing concrete consolidation measures meant, however, that the risk for the Swedish economy entering such a vulnerable situation gradually increased.

The financial environment continued to be unstable. The depreciation of the krona compared with the exchange rate in November 1992 increased gradually during 1993. In December, the value of the krona was closer to 130 (see Diagram 19) measured in terms of the TCW index (with the value of 100 immediately before the fall in the krona. The Riksbank none the less continued to cut interest rates by steps of 0.25 percentage points. At the end of 1993, the instrumental rate was down to 7.75 per cent.

Diagram 19 The competition-weighted exchange rate of the krona



Source: The Riksbank

The development of the long interest rates was more favourable. The ten-year rate went steadily down during 1993 from approximately 10 per cent at the end of the krona crisis to 7 per cent at the end of the year (see Diagram 13). The interest rate differential to Germany reduced to approximately 1.5 percentage points. In early 1994, the interest rate decrease continued at the same time as the krona was markedly reinforced. In February 1994, however, a turn took place on the international bond market set off by the US Federal Reserve increasing its instrumental rate. The risks were now priced in a completely different way. Until summer 1994, the ten-year rate increased to almost 12 per cent and the interest rate differential with Germany expanded to over 4 percentage points. At the same time, the krona was weakened and again touched 130 in TCW terms.

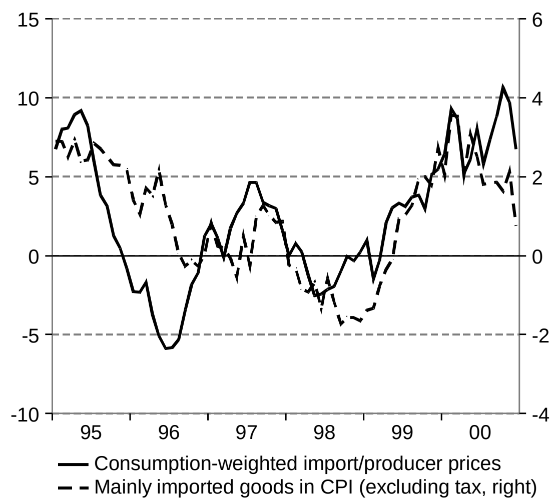
Once again budget policy was in the centre. In the Supplementary Budget Bill (Government Bill 1993/94:150, Annex 1), the Government had reported budget reinforcements with long-term effects of SEK 91 billion. However, this included parts of a several-year consolidation programme where all measures that were still not decided upon or specified in detail. From these estimates, it also emerged that it was required that growth in GDP would total 4 per cent per year from 1996 and onwards to reverse the increase in the public sector debt ratio by 1999. In this situation, the Government would still have a borrowing requirement corresponding to 3.6 per cent of GDP. Although the drop in production and increase in unemployment had flattened out, an assumption of 4 per cent growth appeared optimistic, in particular in a situation where real interest rates had increased sharply. The strong increase in interest rates also increased central government interest expenses and thereby worsened the public deficit.

4.3 The conduct of monetary policy

The Riksbank continued with interest rate reductions, in smaller and smaller steps, until June 1994 (see Diagram 16). Monetary policy faced a dilemma. The development of long rates, both absolutely in relation to the surrounding world and the weak exchange rate indicated that the inflation target was not credible (see Diagram 5 and 19). On the other hand, increased short interest rates could be perceived as a further stone on the burden of interest and debt consolidation that already weighed the economy down. Further dampened demand would reduce employment and thus worsen public finances in addition to the direct effect of higher interest rates on the central government debt.

Diagram 20 Import prices

Annual percentage change



Source: Statistics Sweden

Thus the choice of path in monetary policy was complicated. In a situation where economic policy as a whole did not appear consistent with long-term price stability, an attempt by a central bank to reduce inflation expectations by interest rate increases may be counterproductive. On the other hand, passivity on the part of the central bank could be as damaging, since this can be interpreted as there being no obstacle on the way towards a crisis in central government finances and successively increasing inflation.

In mid-August 1994, the Riksbank made the assessment that credibility was so weak that it had to indicate its concern about developments. The Riksbank therefore decided to increase the instrumental rate by almost 0.3 percentage points. This decision was motivated with reference to tendencies to increasing inflationary pressure and inflation expectations; import prices increased rapidly (see Diagram 20) and, according to the survey measure, industry’s inflation expectations were around 4 per cent in a one-year time horizon. This increase was unexpected and the initial reaction was that long-term rates increased and the krona was weakened. It appeared as if the risks sketched above with the interest rate increase would predominate. After some time, the situation stabilised, however. The Riksbank interpreted the changed situation in the following way, which illustrates the dependency on budget policy (Sveriges riksbank 1995), p.17:

Diagram 21 Gross profit shares in the business sector

Proportion in per cent

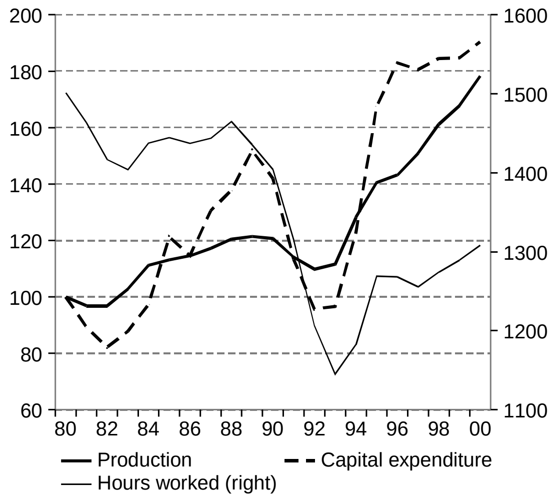
The turbulence subsided (...) quickly since it became apparent from the election campaign that budget consolidation would be a key element in economic policy at the same time as the Riksbank’s increase showed that there was a readiness to counteract inflationary tendencies at an early stage.

It was also part of the picture that the Riksdag after a referendum in autumn 1994 decided that Sweden would join the EU.

The Riksbank made a further two interest rate increases during the autumn. At the year-end, the instrumental rate increased by 7.60 per cent. In September and October, the interest-rate differential with the surrounding world was somewhat reduced although it remained clearly over 3 percentage points. The ten-year interest rate continued to fluctuate around 11 per cent. After some strengthening, the value of the krona again fell in the fourth quarter. At the year-end, the TCW index was once more around 130.

Diagram 22 Industry

Index 1980=100 and million hours respectively



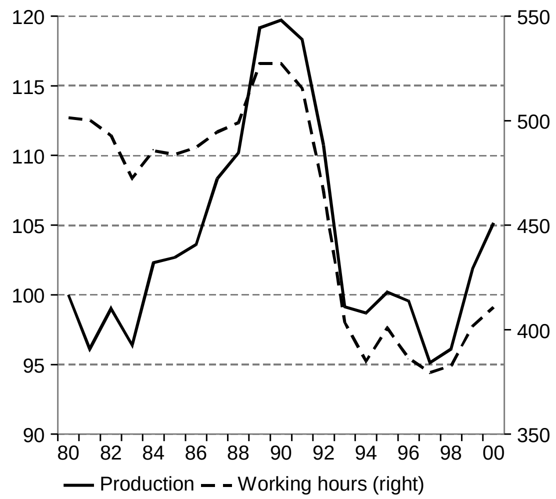
Source: Statistics Sweden

The economy was characterised by tendencies to bifurcation. The sector exposed to competition was greatly stimulated by the weakening of the krona. This was reflected in increasing profits, production, employment, and investments in industry (see Diagram 21 and 22). Neither were businesses in this sector under so much pressure by the high nominal interest rate situation, since they had access to international credit markets, and had scope to increase their prices in kronor. At the end of 1994, export prices increased by over 20 per cent since the fall in value of the krona. This development was in itself beneficial through the sector exposed to competition being again strengthened after the elimination that had taken place during the period of excessively high costs.

The domestically-oriented parts of the economy were affected all the harder. The high interest rate situation affected both businesses' own financing costs and domestic demand. The private financial balance was around 15 per cent of GDP in 1994, an increase from –6 per cent in 1990. Not least private consumption had fallen sharply (see Table 1). Many households and businesses had a weak financial position as a result of the drop in price on properties. Increasing interest rates pressed asset prices further and made the way to consolidated private finances for households even longer. The high interest rate position also depressed prices on commercial premises (see Diagram 10). Many newly-constructed properties had been taken over by the banks. The consolidation of the bank's balance sheets – and thus a return to normal provision of credit – was accordingly also delayed. The excess demand and price fall on properties meant that the downturn in the construction sector was particularly strong (see Diagram 23).

Diagram 23 Construction activities

Index 1980 = 100 and millions of hours respectively



Source: Statistics Sweden

Low employment, high unemployment, and uncertainty in the labour market also contributed to the strong rise in private saving. Price increases in the domestic sector were low. In the wake of the financial crisis, the credit risk supplement for provision of credit to companies and private persons had been increased. The increase in interest rates in the private sector was accordingly greater than could be seen by examining treasury bill rates. A turn in the financial markets with lower interest rates and a stronger exchange rate was also a prerequisite for a durable upswing in employment, since the export industry – even in a phase of growth - demanded relatively little labour.

The directly negative effects of the Riksbank's interest rate increases and exchange rates were certainly temporary. Likewise developments in the financial markets indicated that the Riksbank could not correct the imbalances that arose as a result of the high long-term interest rates and strong weakening of the krona by interest rate increases. The measures taken from 1991 to 1994 had not been satisfactory. In order to break the negative spiral, a reorientation of public finances was required. This assumed a programme for consolidation of public finances which was sufficiently extensive and deliberate to gain confidence within Sweden and internationally.

5. The consolidation of public finances

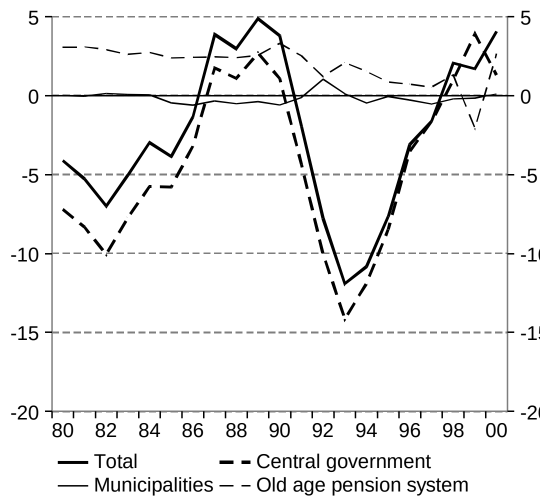
5.1 The start of the work to consolidate public finances

The deficit in public finances totalled 11.9 per cent of GDP in 1993 and would not have been eliminated even in a relatively strong economic upswing (see Diagram 24). At the end of the year, central government debt had increased to SEK 1,132 billion which was equivalent to 76 per cent of GDP (see Diagram 25). Every third krona of expenditure in the central government budget was borrowed and approximately a third of expenditure was for interest payments on central government debt. Public finances were thereby not sustainable in the long term. Turbulence in the financial targets with the weakening of the krona and increasing interest rates in summer 1994 underlined the necessity of restoring confidence in Swedish economic policy and public finances. Otherwise, there was a risk of continued high interest rates delaying the economic recovery.

The consolidation of public finances was given priority when the Social-Democratic Government took office after the election in September 1994. A credible and sufficiently extensive programme to achieve a sustainable development of public finances was regarded as a necessary prerequisite for continued economic recovery with rising employment and falling unemployment. The design of the "Consolidation Programme" was a difficult and sensitive balancing act, however, Too late and weak budget reinforcements would not have appeared credible and would have limited the freedom of action for economic policy. Too fast and extensive budget reinforcements would on the other hand have entailed a too strong tightening, which could have delayed or interrupted the cyclical upswing.

Diagram 24 General government financial balance

Per cent of GDP



Source: Statistics Sweden

The consolidation programme, which was carried out between 1994 and 1998, entailed a permanent reinforcement of public finances of SEK 126 billion. The programme was designed according to three basic principles. It was to take effect swiftly so that the increase in central government debt was checked at an early stage although the effects were to be distributed over a number of years so that the effect on demand would not be too great. It was designed from the point of view of distribution policy so that those with high incomes contributed most. Moreover, priority was given to public activities such as education, health care and social services above transfers to households.

The measures to achieve credible, long-term sustainable public finances also entailed a clearer target formulation for budget policy by introduction of targets for the public financial balance and expenditure ceilings. Work on the budget was also given a firmer regulatory framework through a new budget act and through changes in the budget process in the Government Offices and Riksdag. These institutional changes were as important parts of the consolidation work as the exact design and distribution over time of the measures in the Consolidation Programme.

5.2 The Consolidation Programme and the stabilisation of central government debt

Budget policy was first focused on stabilising central government debt.[6] In the Government's economic policy bill from November 1994, a budget policy target was proposed that meant that central government debt in relation to GDP would be stabilised at the latest by 1998 (Government Bill 1994/95:25). An extensive consolidation programme to consolidate public finances was presented to achieve this target. The Riksdag adopted a decision in principle in 1995 on the whole programme which amounted to a total of SEK 118 billion, corresponding to 7.5 per cent of GDP, in permanent effects on public finances in 1998, including the SEK 18 billion which decisions had already been on in the preceding period of office (Government Bill 1994/95:100 and Government Bill 1994/95:150).

In the Supplementary Budget Bill in April 1995, which was also supported by the Centre Party, the budget policy ambitions were increased. The public finances, measured by general government financial balance, were to be in balance by 1998 and central government debt as a proportion of GDP to be stabilised by 1996 (Government Bill 1994/95: 150 p.25). In the Convergence Programme that was presented in June 1995 and which was based on the Supplementary Bill, it was moreover stated that the deficit in the public sector should not exceed 3 per cent of GDP in 1997, which is one of the criteria for entry into the EU monetary union.

Further details of the consolidation programme were presented in the form of statutory proposals in different economic policy bills. An important component for safeguarding the implementation of the programme and thereby rapidly achieving credibility was the Government's assumption on a six-monthly follow-up of the programme in the economic policy bills and in checking of the convergence programme. In the Spring Fiscal Policy Bill in April 1996 (Government Bill 1995/96:150), it was noted that a further SEK 8 billion of permanent budget reinforcement measures were needed to achieve the Government's budget policy objectives. The consolidation programme thereby totalled SEK 126 billion or around 8 per cent of GDP. The last parts of the programme were detailed in the budget for 1998 (Government Bill 1997/98:150).

Table 2 The Consolidation Programme

Effect 1998, billion kronor

	1998
Expenditure reductions	*71.2*
Transfers to households	34.6
Reduced subsidies	8.1
Reduced central government consumption	6.8
Other	21.7
Of which reduced investments in roads and railways, etc.	2.7
Of which medicines and dental care	2.8
Of which education	4.1
Revenue reinforcements	*69.0*
Individual national insurance contributions	23.7
Uniform capital taxation	7.5
Increased tax for high income earners	4.2
Production taxes	6.1
Other	27.5
Budget weakening	*-14.7*
Reduced value-added tax on food	-7.6
Other budget weakening	-7.1
The consolidation programme	**125.5**

Budget reinforcements in the Consolidation Programme consisted of over 50 per cent of expenditure cuts. The major part entailed reduced transfers to households while other parts of the expenditure cuts related to public consumption and reduced subsidies. The revenue reinforcements included in the programme were mainly successively increased individual contributions to health insurance.

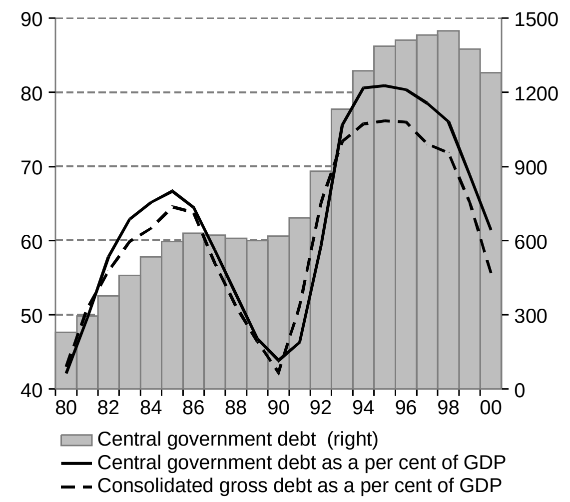
The distribution policy consequences of the consolidation programme were presented in the Budget Bill for 1998 (Government Bill 1997/98: 1 p.30-32 and Annex 7). It was noted "that the fifth of households which have the highest economic standard contribute with over 43 per cent of the total budget reinforcements while the

[6] . For a review of the political considerations in the design of the consolidation programme, see the then Minister of Finance Göran Persson's book "Den som är satt i skuld".

fifth with the lowest economic standard contribute with 11 per cent".

Diagram 25 Public debt

Billion kronor and per cent of GDP respectively



Source: National Institute of Economic Research and Statistics Sweden

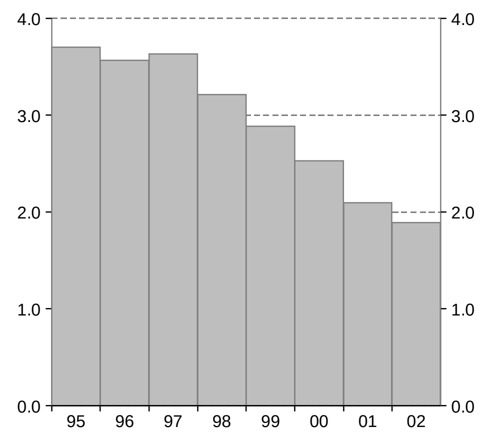
The consolidation programme had a rapid effect on the development of public finances. Of the budget reinforcement measures totalling 8 per cent of GDP, 3.5 per cent came into effect in 1995, 2.0 per cent in 1996 and 1.4 and 1.1 per cent in 1997 and 1998 respectively. However, just as important was the fact that the programme laid the basis for low interest rates and stable economic upswing which in turn supported the improvement in government finances. The objective of stabilising central government debt by 1996 was achieved by a broad margin. Central government debt peaked at 81 per cent of GDP in 1995 and was thereafter successively reduced (see Diagram 25).

5.3 Budget targets, the expenditure ceiling and the reform of the budget process

In the Budget Bill in January 1995 (Government Bill 1994/95:100, Annex 1), the Government stated that budget policy besides implementation of the reductions in expenditure and additional revenue that had been proposed should be focused on a long-term work of change. The Government underlined that the institutional framework was of great importance for the development of central government finances. Among the changes were mentioned measures to achieved an increased long-term approach, more extensive and transparent budget documents and the need for a review of the framework of rules around the budget process. The new guidelines were developed in the Supplementary Bill in April 1995 (Government Bill 1994/95:150, Annex 1) where the Government proposed that a ceiling for central government expenditure should be introduced. The expenditure ceiling was to be viewed as a complement to the objective of stabilising the central government debt that the Government had proposed in the economic policy bill in November 1994. While the objective of stabilising the central government debt ratio and thereafter reducing it was still the overall medium and long-term objective, the expenditure ceiling should be regarded as more operational and thus easier to follow up each year.

Diagram 26 Labour-market related transfers*

Per cent of GDP



Unemployment benefit, AMU (labour market training) grants and social welfare payments
Source: Statistics Sweden

The basic features of a reformed budget process in the Government Offices were presented at an information session in the Riksdag in December 1995 (Minutes 1995/96:33). At this meeting proposals were reported for a design of the expenditure ceiling, a new budget year cycle with a Spring Fiscal Policy Bill in the autumn and measures relating inter alia to a changed structure of appropriations and abolition of estimated appropriations. It also contained a description of how the forecast and follow-up work were to be improved. These changes, aimed at strengthening the institutional framework of the budget process were described as a continuation of the changes that the Riksdag had decided upon. The present budget process was designed on the basis of this work. An important basis was that the central decisions such as setting the expenditure ceiling and allocation of funds to the expenditure areas were to be made early on in the process. To this end, special Government deliberations were arranged before the Spring Fiscal Policy Bill. The continued budget preparation should therefore take place within the set framework. In the new budget process, the follow-up of the economy and performance would also have a key role.

The more detailed design of the expenditure ceiling for central government was presented in the Spring Fiscal Policy Bill in 1996 (Government Bill 1995/96:150). It was proposed that the expenditure ceiling should be nominal and three-year. The expenditure ceilings proposed in the bill consequently covered the years 1997, 1998 and 1999. These decisions were made on a rolling basis and an expenditure ceiling for an additional year was made in each spring fiscal policy bill. The expenditure ceiling includes all expenditure in the central government budget except interest on central government debt. Moreover, expenditure is also included for the social insurance schemes presented outside the central government budget. The set expenditure ceilings for the years 1997-2000 are presented in Table 3 and the outcomes for the expenditure limited by the ceilings. The expenditure ceiling was met each year. The prerequisites to meet the expenditure ceiling were made easier by economic growth being higher and inflation lower than what they were when the ceiling was decided upon. The strong economic growth entailed that employment rose rapidly and that unemployment fell, whereupon the labour market related transfers reduced (see Diagram 26).

Table 3 The central government expenditure ceiling

Billion kronor

	1997	1998	1999	2000
Expenditure ceiling for central government	723.0	720.0	753.0	765.0
Expenditure subject to expenditure ceiling (outturn)	698.9	718.0	751.5	760.1

As a further component in the reform of the budget process, the Government appointed a special investigator with the task of investigating the need for a firmer regulatory framework for the central government budget process. In the report presented by the Budget Act Commission, The Budget Act – the Government's powers in the field of finance power (SOU 1996:14) (in Swedish), it was noted that central parts of the central government budget process were incompletely regulated and that Sweden differed from other countries in not having a budget act. The Commission proposed that a budget act should be introduced which would detail and complement the provisions of the Instrument of Government and the Riksdag Act. The budget act would clarify the Government's powers and obligations in the field of finance. The Government bill on introduction of a state budget act was presented in May 1996 (Government Bill 1995/96:220), the Budget Act (1996:1059) came into effect on 1 January 1997. In connection with the introduction of the Budget Act, estimated appropriations were also abolished.

In conjunction with the budget work for the 1997 budget year, the "expenditure limit" decision model was applied for the first time. The expenditure limit decision model meant that the Riksdag made decisions on the budget in two steps. In the first step, the Riksdag set the overall budget space and distributed this to 27 expenditure areas. The Riksdag also establishes an estimate of revenue in the budget. When the limits for each expenditure area have been set, the expenditure areas are dealt with and the allocation to appropriations in the various Riksdag committees. The limits set for the respective expenditure area in the first step thereby form a binding restriction. After consideration by the committee, the Riksdag makes the final decision on the various appropriations. All appropriations within an expenditure area are distributed in a single decision.

A long-term surplus target was established in the 1997 Spring Fiscal Policy Bill (Government Bill 1996/97:150 p. 81). The Government proposed that the general government financial balance should have a surplus amounting to 2 per cent of GDP on average over a business cycle. The Government had a number of motives for this surplus target:

– Public finances will be exposed to considerable pressure some way into the twenty-first century, among other ways due to the increasing number of elderly people. The surplus target plays an important target for equipping the public sector to meet this development.
– The prospects for pursuing a cyclical policy are improving. With a surplus of 2 per cent of GDP as a starting point, there is a margin

for actively counteracting cyclical slowdowns without the deficit in public finances threatening to become too large.

– A surplus in public finances promotes and makes possible high private investments without Sweden's foreign debt increasing.

The target for the general government financial balance includes the whole public sector as defined in the national accounts, i.e. in addition to central government also the old age pension system and the local government sector. The general government financial balance shows the change in the net wealth of the public sector which depends on real transactions. Financial transactions such as purchase and sale of shares and other financial assets do not affect the financial balance; the same applies to changes in value of assets and liabilities. The new pension scheme means that the financial balance in the old age pension scheme will increase and probably amount to over 2.5 per cent of GDP some way into the twenty-first century (see Diagram 24).

The local government financial balance is governed by the so-called balance requirement for municipalities and county councils which was introduced in 2000 (Government Bill 1996/97:52). The balance requirement means that municipalities and county councils are to draw up their budget so that revenue exceeds expenditure. Any negative outcome is to be compensated for within two years. The financial balance in the local government sector can thereby be expected to be slightly positive.

The consequence of the two per cent target for the total general government financial balance together with the design of the old age system and the local government balance requirement will therefore be that the central government balance requirement can be expected to be negative on average over a cycle. Central government debt will therefore tend to increase in nominal terms. This increase will not be larger, however, than that the debt can be expected to continue to decrease in proportion to GDP.

On the basis of the target of a general government financial balance of 2 per cent of GDP on average over a cycle, detailed targets are set for each year in conjunction with the budget bill. If the target is set at 2 per cent for each year, there is a risk that fiscal policy will intensify cyclical fluctuations. The target is therefore set on the basis of an assessment of the state of the economy among other things. The basis is that 2 per cent surplus shall be achieved when the use of resources in the Swedish economy is at a level that is possible to maintain without inflation accelerating. In a downturn, the surplus should consequently be less than 2 per cent and in an upswing more than 2 per cent.

In the 1997 Spring Fiscal Policy Bill, a gradual adaptation to the long-term surplus target taking into consideration the low use of resources and the risk for an unnecessarily tight fiscal policy could interrupt the economic recovery. The surplus target was therefore set at 0.5 per cent of GDP in 1999, 1.5 per cent of GDP in 2000 and 2.0 per cent in 2001. The target for 2000 was subsequently increased to 2 per cent of GDP (Government Bill 1998/99:100) and the target for 2001 at 2.5 per cent (Government Bill 2000/01:1). Experiences to date of the detailed budget targets have been good. As is shown by Table 4, the surplus target was achieved in every year from 1997 to 2000 by a broad margin.

Table 4 General government financial balance

Per cent of GDP

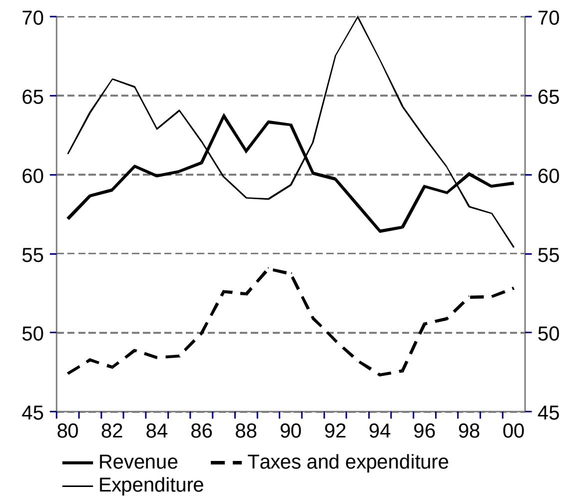
	1997	1998	1999	2000
Target for financial balance in the public sector	-3,0	0,0	0,5	2,5
Outturn [1]	**-1,6**	**2,1**	**1,7**	**4,1**

[1] Nationalräkenskaperna för år 2000 är ännu preliminära

The new budget process is more stringent than before. In the ESO report Central government debt and the budget process (Ds 1992:16) (in Swedish), it was noted that the Swedish budget process in 1991-92 was one of the weakest in Europe. As of the changes that were implemented in the second half of the 1990s, Sweden has had a considerably more stringent budget process, well on a par with comparable European countries. The expenditure ceiling and the Riksdag's expenditure limit decision model in which proposals on expenditure increases must be financed within the expenditure area and within the ceiling respectively, entail overall restrictions in the process of preparing the budget. The central government budget is also clearer and easier to oversee than before, since a number of social insurance and labour market funds have been included in the budget. The expenditure ceiling and the budget targets thereby entail an increased long-term approach and discipline in the budget work.

Diagram 27 Revenue and expenditure in the public sector

Per cent of GDP

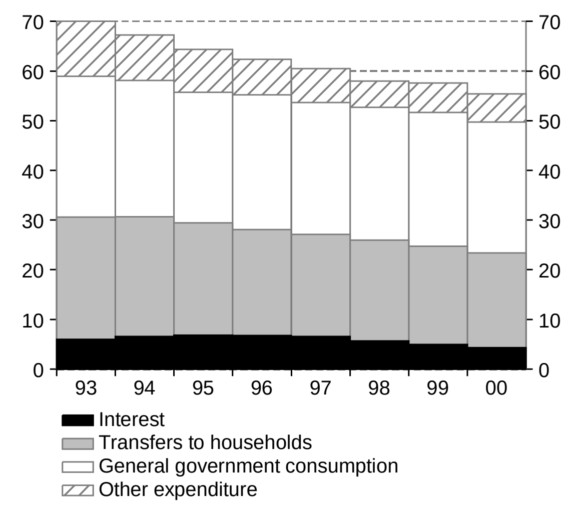


Source: Statistics Sweden

The stringency of the new budget procedure together with the measures that were included in the consolidation programme have together meant that the general government financial balance is again positive (see Diagram 24). Compared with the end of the 1980s, public sector expenditure in relation to GDP has fallen (see Diagram 27), which is mainly a result of reduced transfers to households and a levelling out of central government consumption (see Diagram 28). Tax in relation to GDP was somewhat lower at the end of the 1990s than at the beginning of the decade.

Diagram 28 General government expenditure

Per cent of GDP

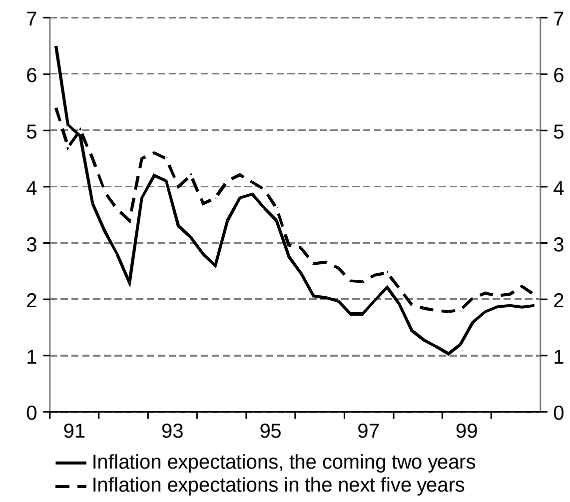


5.4 Monetary policy 1995–1997

The consolidation programme and other measures to consolidate and strengthen confidence in public finances initially had little effect on interest and exchange rates. Confidence in the financial market continued to be low after the experiences from the 1991-94 period. The long interest rates remained at around 11 per cent and the krona weakened further, at most to over 135 in TCW terms. CPI inflation was close to the upper limit of the inflation target. Inflation exceeded 3 per cent for a few months. Inflation expectations according to the surveys remained at around 4 per cent. Wage increases were also high, both in relation to the inflation target and taking into consideration the continued high unemployment. Despite the tight fiscal policy that followed from the consolidation programme, interest rate increases continued, periodically in very small steps, until July 1995 when the instrumental rate reached 8.91 per cent. It had then been increased by 2 percentage points in just under a year.

Diagram 29 Inflation expectations

Per cent



Source: Aragon fondkommission

From mid-1995, the mood changed, however. Market rates fell steadily during the second half of the year both absolutely and in relation to Germany. The krona also strengthened greatly. In November and December, the TCW index was around 118, over 13 per cent stronger than in April. The survey measure of inflation expectations indicated that credibility had been strengthened. At the end of the year, inflation expectations on both short and long term were just under 3 per cent, i.e. the inflation target's upper tolerance limit (see Diagram 29).

The reason for the changed expectations was that the Consolidation Programme and the budget policy targets were more and more known and gained increasing credibility both in Sweden and abroad. The picture of the measures that were initially based on cautious assumptions about future economic growth and employment was extensive and would be adapted to what was required to achieve the objectives gained credence. The institutional reforms of the budget process probably also contributed to changing the assessment of the prerequisites to achieve sound public finances. [7]

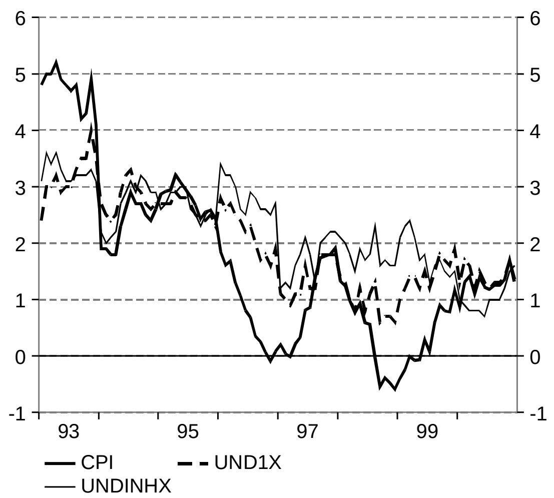
The Riksbank maintained the instrumental rate at 8.91 per cent throughout the latter half of 1995, despite the stringent fiscal policy and the dampening of inflationary pressure that followed on from the appreciation of the krona. However, inflation expectations remained, even though they had fallen, clearly over the Riksbank's target of 2 per cent. In the inflation report in November, the Riksbank underlined the risk that increased private consumption would lead to increased costs for imported goods and higher wages would be passed on and increase consumer prices. However, this assessment proved to be incorrect. Household consumption expenditure increased by 0.6 per cent in 1995 and 1.4 per cent in 1996 and thus more slowly than in 1994. The low CPI inflation depended partly on falling interest expenses for homes although the underlying inflation also developed weakly. Probably a larger proportion of households had a longer period left before they had adjusted their asset position than the Riksbank anticipated, which led to the Riksbank misjudging the future inflation threat in 1995 from increased consumption. It was still the case in November 1995 that the Riksbank made the assessment that inflation (with an unchanged interest rate policy) would be close to the target's upper limit in 1996 and even higher in 1997.

In January 1996, the Riksbank made the first of a long series of instrumental rate adjustments which continued until December. Altogether, the interest rate was reduced by almost 5 percentage points to 4.1 per cent. This was one of the largest interest rate reductions carried out in an industrial country with a floating exchange rate. Initially, the long interest rates rose somewhat but from March until the end of the year the ten-year interest rate fell from 9 to 6.5 per cent. The krona was relatively stable in the interval between 115 and 120 during the major part of the year. Inflation expectations went steadily down.

The inflation rate trend fell from March 1995 (see Diagram 30). At the end of 1996, the rate measured with CPI was almost zero, i.e. under the Riksbank's inflation target and its lower tolerance threshold. GDP growth fell greatly from 3.7 per cent in 1995 to 1.1 per cent in 1996. An important cause was the weak state of the international economy which meant that the contribution of net export to growth fell from 1.4 per cent to 0.3. Despite the weak increase in consumption, household consumption made the greatest contribution to GDP growth. The fact that domestic demand increased so weakly is reasonably related to some extent to the tightening that took place through consolidation of public finances combined with the high short and long interest rates.

Diagram 30 CPI and underlying inflation

Annual percentage change



Source: Statistics Sweden

Retrospectively, it can thus be noted that monetary policy in 1994 and 1995 was tighter than required to attain the inflation target of 2 per cent in 1996 and 1997. The background was that

[7] For a summary of the message, see Minister of Finance Göran Persson's contribution at an international conference in the USA at the end of August 1995, reproduced in the Federal Reserve Bank of Kansa City (1995). See also Göran Persson's book "Den som är satt i skuld är icke fri".

monetary policy had been tightened to overcome a credibility problem.

The Riksbank opted to tone down the effects of the appreciation of the exchange rate and the change in inflation expectations in the second half of 1995. The bank instead emphasised the risk of an upswing in private consumption driving up inflation in a situation where there were few marked indications that consumption was going to increase markedly. It thereby took time before the instrumental rate came down to a level adapted to the tightening of budget policy and the linked reinforcement of credibility.

Diagram 31 The employment ratio among those aged from 20 to 64

Proportion of population

Source: Statistics Sweden and National Institute of Economic Research

6. On the road to full employment with strong growth and low inflation 1998-2000

6.1 Targets for unemployment and employment

In the Government Declaration in March 1996, the target of halving open employment to 4 per cent by 2000 was established. This target was to be followed up every six months according to the successful method already applied for the budget targets. The economic recovery accelerated during 1997 and GDP growth amounted to 2.1 per cent. Employment rose and open unemployment fell to around 7 per cent by the end of the year. In the six-monthly follow-up which was made of the unemployment target in the Budget Bill for 1998 (Government Bill 1997/98:1), it was noted that high economic growth was required and an efficient wage formation to achieve the target of 4 per cent open unemployment by 2000.

In the Budget Bill for 1999 (Government Bill 1998/99:1), a supplementary target for employment was also established. In this way, the level of ambition was increased and the time perspective extended. The employment target meant that the proportion of those aged between 20 and 64 in regular employment would increase from 74 per cent in 1997 to 80 per cent in 2004 (see Diagram 31).

6.2 Independent monetary policy outside EMU

In December 1997, the Riksdag made a decision that Sweden should not participate in monetary union from the start in January 1999 but that the door should be kept open for entry at a later date. In Government Bill (1997/98:25, p. 62), the consequences of this decision were expressed in the following way:

The demands on economic policy are not reduced if Sweden remains outside the monetary union. It is not least important to carry out economic policy focused on stability. Outside the monetary union, Sweden must demonstrate its endeavour to maintain stable prices and establish a long-term surplus in public finances.

Monetary policy thus continued to be conducted on the basis of the Riksbank's inflation target within a system with a floating exchange rate. There was broad political support for monetary policy's focus on stable prices, one expression of which was a five-party agreement on monetary and foreign exchange policy (Government Bill 1997/98:25) which aimed at reinforcing credibility for price stability. The changes in the Riksbank legislation meant that the Riksbank as from 1999 has the statutory target of maintaining price stability. Since the Riksbank is an agency under the Riksdag, the bank has in has in addition an obligation to support general economic policy, inter alia with a view to promoting sustainable growth and high employment to the extent that this does not conflict with the price stability objective. In the new legislation it was clarified that the Riksbank may not accept instructions from outside on the conduct of monetary policy. The obligation of the Riksbank to consult with the Riksdag before taking important monetary policy decision was then changed to a duty to inform.

In the sphere of foreign exchange policy, the new legislation meant that responsibility for overall foreign exchange policy issues, such as entry into ERM2, was transferred from the Riksbank to the Government. The Riksbank shall on the other hand decide whether the central exchange rate and the band width in a fixed exchange rate system and on the practical application of foreign exchange policy in a system with a floating exchange rate.

6.3 Monetary policy in the shadow of the Asian crisis

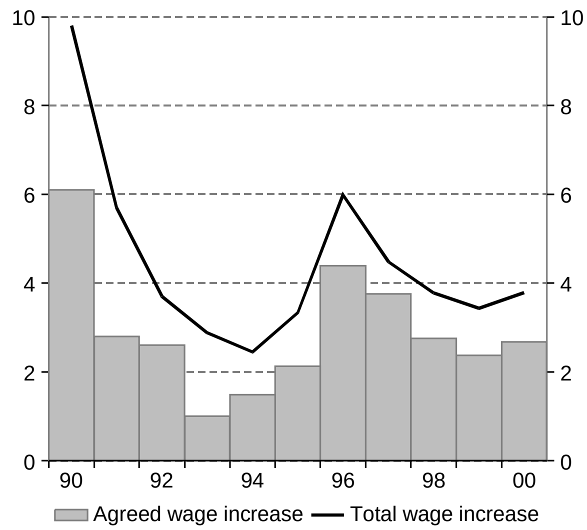
In the inflation report in December 1997, the Riksbank made the assessment that inflation would exceed the target of 2 per cent in a one to two-year horizon. The starting point was among other things that the economy would grow by 3 per cent in 1998-99 and reach its capacity ceiling in 1999. This assessment included concern inter alia that the wage bargaining just started would lead to excessively high wage increases. The Riksbank drew the following conclusion:

In the cyclical phase that the Swedish economy is now in, it is important that monetary policy is not expansive for too long. Monetary policy must be made less expansive in good time before the output gap is closed, bearing in mind the time lag associated with the effects of monetary policy. Such a change of monetary policy will in the next few years dampen the expansion of the economy although the result is better prerequisites for a more long-term increase in production and employment (...). Altogether there are good reasons for making monetary policy less expansive during the winter.

Shortly thereafter the Riksbank also changed the repo rate by 0.25 percentage points to 4.35 per cent. The Riksbank thus decided to take note of the domestic factors in its assessment of inflation and make a preventive increase in the interest rate before expectations of higher inflation became established. For the time being, the Riksbank did not take into account that the Asia crisis that was beginning could lead to a stronger international cyclical downturn.

Diagram 32 Hourly wages

Annual percentage change

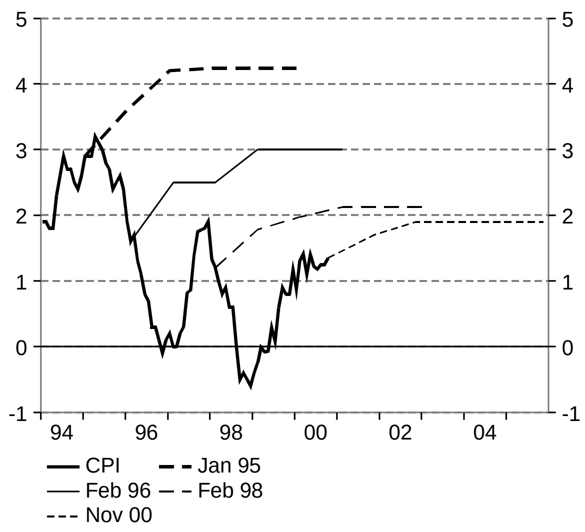


Source: Statistics Sweden
Note. The development of hourly wages according to the national accounts 1990-1992 and Statistics Sweden's cyclical statistics 1993-2000.
Source: Statistics Sweden

The picture of inflation prospect soon rapidly changed, however. The pay agreements were agreed at a considerably lower level than in the preceding round of collective bargaining (see Diagram 32). Altogether, the risk of a domestically generated upswing in inflation was considerably less therefore. Underlying the downward shift was among other things lower inflation and the belief that inflation would also be low in future (see Diagram 33) supported by the increase in interest rates carried out. Favourable changes had also taken place in the pay bargaining system not least in the "collaboration agreements", the agreements between the social partners on how negotiations were to be conducted to promote development of the Swedish economy. Moreover, agreements were reached that were designed in new ways with local distribution of pay increases that prevents wage drift.

Diagram 33 Inflation expectations

Annual percentage change

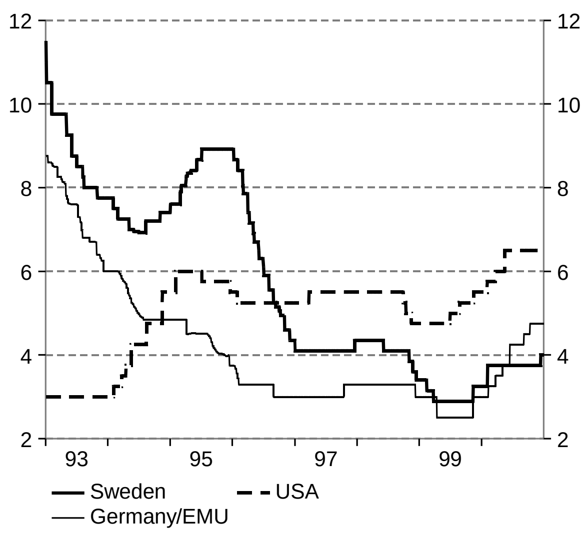


Sources: Prospera Research AB and Statistics Sweden

During the following months, it was also increasingly evident that the financial crisis in the growth markets in Asia that had started in spring 1997 was on its way to deepening and spreading to other countries.

Diagram 34 Instrumental rates

Per cent



Source: Datastream

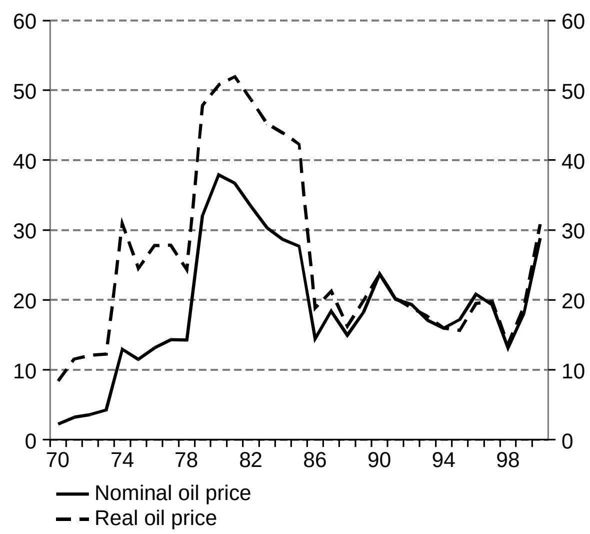
The international economic development had thus fundamentally changed since the increase in interest rates in December 1997. The Riksbank's assessment was now that inflation would be less than the inflation target in a one to two-year term, in particular taking into account the risk for a significant international cyclical downturn. In the light of this, the repo rate was reduced at the beginning of June 1998 by 0.25 percentage points to 4.10 per cent.

The international turbulence in the financial markets increased at the beginning of October 1998. The collapse of the American hedge fund Long Term Capital Management reinforced turbulence in the global financial system.

The international financial crisis meant in turn that global cyclical prospects gradually deteriorated which together with the risks for a deeper and more long-term downturn led to a more expansive monetary policy in the surrounding world, for instance in the United States. In Europe interest rate reductions started rather later but from a considerably lower level. First out was the Riksbank, the future EMU countries followed somewhat later (see Diagram 34). The weaker international demand led to growth in Swedish exports being dampened and the contribution of net export to GDP growth was negative in 1998.

Diagram 35 Oil price

US dollars



Source: National Institute of Economic Research

Table 5 Demand and output 1995-2000

Billion kronor

	1995	1996	1997	1998	1999	2000
GDP	3.7	1.1	2.1	3.6	4.1	3.6
Household consumption expenditure	0.6	1.4	2.0	2.7	3.8	4.1
General government consumption expenditure	-0.6	0.9	-1.2	3.2	1.7	-1.7
Central government	-1.4	2.6	-4.8	-5.3	2.7	-2.9
Local government	-0.1	0.0	0.5	7.1	1.3	-1.2
Gross fixed capital formation	9.4	5.0	-1.1	8.5	8.1	4.5
Stockbuilding [1]	0.4	-1.0	0.3	0.4	-0.5	0.6
Export of goods and services	11.3	3.5	13.7	8.4	5.9	9.8
Import of goods and services	7.2	3.0	12.5	11.2	4.3	9,7

[1] The rate of change is expressed as a percentage of GDP last year.
Source: Statistics Sweden

The concerns about a cyclical downturn were not confirmed, however. The Swedish economy continued to develop strongly as a result of high investments and increasing private consumption (see Table 5). The use of resources continued to be relatively low, which held down domestic inflation. The effects of deregulations in the telecommunications and electricity markets, which led to reduced prices for important groups of commodities operated in the same direction. At the same time, falling oil and raw material prices (see Diagram 35) led to imported inflation developing weakly (see Diagram 20). In the light of this, the Riksbank could continue to reduce the repo rate successively to 2.9 per cent in March 1999. The repo rate was then under the instrumental rate level in the euro area where the new European central bank, the ECB, had recently taken over responsibility for monetary policy.

6.4 The Riksbank's inflation targets

The Riksbank's newly appointed executive board started its work by clarifying that the inflation target would be maintained. "The task of monetary policy continues to be to limit the change in the consumer price index to 2 per cent in a rather longer perspective with a tolerance of ±1 percentage point". (Press release no. 1, 4 January 1999). Taking into consideration the Riksbank's more independent position and to facilitate an evaluation of the bank's action, the bases for the conduct of monetary policy were also clarified. (The Riksbank's inflation targets – clarifications and evaluation Press release 2 February 1999.

Normally, monetary policy is focused on achieving the target defined in terms of CPI in a one to two year time horizon. However, there are two reasons for deviating from this rule. In the first place, CPI in the relevant time perspective can be pushed up and down by factors that are not considered to affect inflation in the long term. Examples of such factors constitute changes in interest expenses, indirect taxes and subsidies. Another reason can be that a swift return to the objective when a large deviation has taken place can sometimes be associated with large real economic costs. If any of the above situations exists, the Riksbank will make clear in advance how great a discrepancy from the inflation target defined in terms of CPI which will be motivated in a one to two-year time horizon.

The establishment of the details of monetary policy was in accord with the practice that had gradually been established since the Riksbank's inflation targets had been announced in January 1993. Likewise they are important, for instance, for the evaluation that the Riksdag makes of the Riksbank's actions. These details entail for instance that it can be clearly seen whether discrepancies from the target are a consequence of decisions made in advance or have other causes, for instance inaccurate forecasts. The Riksbank also continued to publish the bank's inflation assessments in its inflation reports. Moreover, the Riksbank decided with some time lag to publish the minutes of the Executive Board's monetary policy meetings. These measures aimed at further increasing openness and clarity on monetary policy and the monetary policy decision-making process.

The low inflation during the 1990s was not only due to the weak use of resources. Also part of the picture were changes of a more structural nature in Sweden and in the surrounding world. The international competitive pressure increased markedly during the 1990s. One consequence of this was that it has become more difficult for companies to increase their prices. Even if this is in a strict sense probably mainly involves one-off effects on inflation, the increased competition can have an effect on global inflationary pressure for a long time. Increased international trade, stronger competition legislation, EMU and deregulations of various kinds argue in favour of a more long-term effect.

Diagram 36 Pay increases

Annual percentage change

Source: Statistics Sweden

The strong confidence in the Riksbank's inflation targets and increased competition mean that it is more difficult for companies to pass on cost increases in the form of price increases. Companies tend to hold down costs, for instance, by not conceding excessively high wage increases and to some extent by taking further measures to increase productivity. The low and more stable inflation expectations have also dampened employee organisations wage demands in the most recent pay bargaining rounds. Despite the low nominal pay increases, real wages have risen rapidly (see Diagram 36).

6.5 Strong increase in productivity during the 1990s

The development of productivity is of great importance for economic growth and welfare. Increased productivity makes it possible to produce more goods and services with a given input of resources. Usually, labour productivity is used, i.e. production per worked hour as a measure of productivity. Productivity growth was higher during the 1990s than in the 1980s as shown by Table 6 below that shows the development of labour productivity in various parts of the Swedish economy. Industry shows the strongest increase, which is largely explained by development in the telecommunications products sector which includes companies with exceptional increases in productivity.

Table 6 Labour productivity 1981–2000

Annual percentage change

	81–85	86–90	91–95	96–00
GDP (base price)	1.3	1.1	2.2	2.0
Business sector	2.3	1.6	3.1	2.4
Business sector excluding finance and property activities	2.5	2.2	3.4	2.8
Industry	3.2	1.8	5.2	4.2
Of which excluding telecommunications products		1.5	3.8	2.8
Other business sector excluding finance and property activities	2.2	2.4	2.7	2.2

Sources: National Institute of Economic Research and Statistics Sweden

Labour productivity can be divided up into a factor that depends on capital intensity i.e. how much capital in relation to how labour that is used in production, and total factor productivity. Total factor productivity reflects, for instance, technical level, the skills of the labour force and the way in which production is organised. Table 7 shows the development of labour productivity and the contributions from capital intensity and total factor productivity for the business sector excluding finance and property operations.

Table 7 Labour productivity in the business sector excluding finance and property activities.

Annual percentage change

	81–85	86–90	91–95	96–00
Labour productivity	2.5	2.2	3.3	2.8
Capital intensity	0.7	0.6	0.7	0.6
Total factor productivity	1.8	1.6	2.6	2.2

Sources: National Institute of Economic Research and Statistics Sweden

Increased capital intensity produced as great a contribution to the increase of labour productivity in the 1990s as in the 1980s. The total factor productivity increased, however, markedly quicker during the 1990s. The strong increase during the recession in the early 1990s was connected with the extensive elimination of less competitive and low productive companies and extensive rationalisations. During the second half of the 1990s, total factor productivity was positively affected by the cyclical upswing. The use of existing resources was initially low which meant that existing capital and labour could be used increasingly well when demand increased.

These factors cannot, however, fully explain the strong growth in the total factor productivity in the 1990s compared with the 1980s that were weak from the point of view of productivity. To some extent, the increase depends on the strong increase in productivity in the telecommunications products industry. However, productivity development can also to some extent have been promoted by higher educational investments and a more efficient incentive and decision structure following from a better functioning tax system, low, credible inflation and sound public finances. Another possibility is that the introduction of the new information and communication technology can have started to give clear effects on productivity growth in the economy as a whole.

6.6 Fiscal and budgetary policy after the consolidation of public finances

The fiscal policy that was carried out on the basis of the Consolidation Programme with the expenditure ceiling and clear objectives for financial balance and central government debt was successful. Public finances improved greatly from 1994 to 1998. Within the framework of the objective on balance in general government financial balance in 1998, it was noted in the Spring Fiscal Policy Bill (Government Bill 1996/97:150) that there was scope for expanded measures against unemployment. A total input of SEK 16.3 billion in 1998 was allocated to an investment inter alia in work and education in a five-point programme.

An increasingly positive development for public defences following on from strong growth and falling unemployment made further reforms possible in the coming years. In all the various reform programmes were equivalent to SEK 86 billion in 2000 compared with the level in 1996 (see Table 8). In addition to measures to promote employment and training/education, distribution policy considerations were also to be given prominence. Those who had borne the heaviest burdens in consolidation of public finances were to be given priority in compensation for cuts in the Consolidation Programme. Compensation for increases individual national insurance contributions was initiated in 2000. The reforms carried out were also included within the expenditure ceiling and other budget policy goals. The general government financial balance amounted for instance to 4.1 per cent of GDP in 2000 and thereby exceeded the target by 2.1 percentage points of SEK 43 billion.

The main direction of welfare policy is to prioritise activities over grants. Healthcare, school and social services have therefore been given high priority in the work of reform. The funds that were made available to the municipalities will also make up a large proportion of the total reform programme at the beginning of the period. As the economy continues to improve, measures for training and work stimulating measures could be undertaken to a higher degree. The same applied to distribution policy focused reforms. General tax reductions were first undertaken at the end of the period.

Table 8. The 1997-2000 reform programme

Increase in level compared with 1996, billion kronor, gross amount excluding financing

	1997	1998	1999	2000
Health care, schools and social services	4.0	12.0	17.3	21.3
Families and pensioners		3.2	7.0	9.6
Education/training	0.5	3.1	5.7	8.2
Labour market and employment	0.9	2.8	1.9	3.4
Entrepreneurship		4.2	7.8	11.1
Sustainable develoment/environment		1.5	5.3	6.4
Taxes		0.3	7.1	20.9
Other		0.2	3.3	5.1
Total before financing	5.4	27.3	55.4	86.0
Financing	4.5	5.1	13.6	15.0
Net effect	0.9	22.2	41.8	71.0

During the period 1997–2000, a total of SEK 54.6 billion was made available to health care, schools and social services. Central government grants to municipalities and county councils were exempted from the consolidation programme despite practically all other budget items experiencing extensive demands for economies. However, it was not possible to completely protect health care, schools and social services from the effects of the economic downturn since the tax base of local government was weakened. A part of the efforts in the five-point programme in the Spring Fiscal Policy Bill in 1997 therefore aimed at braking the falling employment in municipalities and county councils and thus safeguarding the quality of health care, education and social services. During the next few years, health care, education and social services were provided with additional resources (see Table 9).

Table 9 Increased resources for healthcare, education and social services

Increase in level compared with 1996, SEK billion

	1997	1998	1999	2000
1997 Spring Fiscal Policy Bill	4	8	8	8
1998 Budget Bill			4	8
1998 Spring Fiscal Policy Bill		4	4	4
1999 Budget Bill			1.3	
1999 Spring Fiscal Policy Bill				1.3
Total	4	12	17.3	21.3

Since knowledge is a central factor for growth, development and modernisation were included in the reform policy to promote education. The additional resources were focused to a great extent on adult education in the form of inter alia the special adult education initiative primarily for the unemployed who lacked or had incomplete three-year upper secondary school education. It was considered at the same time as important that those in work increased their skills. Considerable emphasis was therefore placed on reinforcing the skills and level of knowledge of the labour force, which would stimulate growth and employment and counteract unemployment. Altogether, the reforms in the educational sphere totalled SEK 8.2 billion in 2000 compared with the level in 1996.

A number of different measures have been carried out to reverse economic development in an ecologically sustainable direction by for instance, reduced load on the environment, more efficient use of resources, and increased use of renewable resources. This policy was made concrete, for instance, in local investment programmes for ecological sustainability. In all, SEK 13.2 billion was set aside to promote ecologically sustainable development between 1997 and 2000. During the 1990s, the tax system has also been adapted to the environment. The first steps in a green tax shift were taken in conjunction with the tax reform in 1990.The Government resumed this political approach in the budget bill for 2000 with increases in diesel, oil and nuclear power taxes.

In the five-point programme, a series of measures were also initiated to promote small and new enterprises. In all, the reforms to promote entrepreneurship amounted to SEK 11.1 billion billion in 2000 compared with the level in 1996. The measures that were taken in labour market policy in 1997-2000 were primarily focused on specific labour market training, temporary severance compensation and resource employment.

Since families according to the surveys had been hardest hit by the consolidation than other groups, children's allowance and the study grant portion of study allowance were increased from 1998. At the same time, the supplement for large families was reintroduced. Children's allowance and study grants as well as the supplement for large families were subsequently further increased. In order to improve the financial situation of pensioners, pensions were also increased as from 1999. Measures to promote the financial situation of families and pensioners corresponded to a total of SEK 9.6 billion in 2000 compared with the level in 1996.

In conjunction with the Consolidation Programme, the threshold for state tax was not adjusted upwards at the intended rate and individual national insurance contributions were raised for all wage earners. In 2000, the state income tax was reduced in such way as to constitute a compensation for individual national insurance contributions. Wage earners thereby receive an initial refund of the tax increase that the individual national insurance contributions had in fact constituted. Moreover, the threshold for state income tax was increased. Together with other tax relief during the period 1997-2000, these measures meant during the period meant that the tax take-up from households was SEK 21 billion lower in 2000 compared with the level in 1996.

6.7 Unemployment halved by 2000

In October 2000, the objective was achieved of halving open unemployment in Sweden to 4 per cent. A strong contributory cause to achieving the objective was the transition to a stability-focused economic policy and in particular consolidation of the public finances. Initially, extensive active labour market policy measures and programmes were carried out to reduce open unemployment and prevent an extensive exclusion of labour. At the end of the 1990, the special adult education initiative was introduced and various types of educational/training initiatives, for instance at universities and university colleges with a view to increasing the level of skills and thus future employment.

The consolidation of public finances laid the basis for a credible low inflation policy with a monetary policy that could be carried out in an expansive direction without price and wage increases accelerating. At the end of the 1990s, both nominal and real interest rates were low. The Swedish economy was undergoing a strong cyclical upswing with high growth and increasing employment. Between 1996 and 2000, the number of employees increased by 4.9 per cent (see Diagram 37) and towards the end of the period, employment rose faster than in 40 years. During the corresponding time period, the number of persons in labour market policy measures increased by around 90,000. The objective of halved unemployment was therefore achieved through increased employment, The major part of the increase was in the private sector.

Diagram 37 Employed, in the labour force and open unemployed

Hundred thousands and per cent respectively

Source: Statistics Sweden

During the 1990s, labour market policy was forced to concentrate on handling the onrush of a large number of unemployed. In order to prevent people being excluded and permanently forced to leave the labour force, the number of people in labour market policy measures was increases to at most more than 200,000 people or 5.3 per cent of the labour force. Towards the end of the decade when unemployment fell, labour market policy was focused on more growth promoting measures, which among other things aimed at stimulating the supply of labour, The focus in the efforts to achieve full employment were then shifted to educational policy. In 1997, the special adult education initiatives was introduced, a five-year investment in adult education that annually makes it possible for over 100,000 people to improve their education. The target group is primarily adult unemployed who wholly or partly lack three-year upper secondary education. During the 1990s higher education has been expanded greatly. During the period 1997 to 2003, additional resources are being made available to higher education for almost 100,000 new permanent places.

7. Summary and conclusions

Important choices of direction were made in Swedish economic policy in the 1980s and 1990s. It is possible to identify some points at which decisions were taken which were crucial for the continued course of events and where – not just in the strong searchlight of wisdom after the event – there were alternative paths to follow.

A first crucial decision was the devaluation in 1982. It was intended to facilitate adaptation of the structure of the economy – a process that required redistribution of labour and other resources between domestic and export-oriented sectors – without unduly reducing total employment.

Another crucial factor was when the plans for domestic restraint after the devaluation were not carried out to the extent required to maintain balance between supply and demand in the economy. These problems were intensified when the credit market was deregulated. The result was the general overheating and the high price and wage increases, in particular during the latter half of the 1980s. In this way, Sweden experienced a cost crisis i.e. the krona was overvalued in relation to other currencies.

The readiness to defend the fixed exchange rate when the effects of the cost crisis became clear at the beginning of the 1990s was in agreement with the analysis made and the objectives established in 1982. It was also in accord with the commitments made during the intervening period. To this extent this was not a new choice of direction but a consequence of earlier positions.

The cost crisis coincided with an international downturn, high real interest rates in the surrounding world and a domestic finance and debt crisis. The inflation rate fell drastically, both in absolute terms and in relation to earlier expectations, at the same time as the tax reform reduced tax relief for household and company interest expenditure. The result was a dramatic rise in real interest rates after tax, which in turn contributed to a fast increase in financial saving, in particular in the household sector.

The readiness for action for economic downturn proved to be low. Central government finances rapidly deteriorated. This was partly a reflection of the rise in private savings and to this extent a prerequisite to prevent an even more drastic reduction in demand and employment. Apace with the continuing downturn, concern increased, however, that employment and production would not recover. In this case, the deficit would be made permanent which would create concern for long-term stability in public finances.

The non-socialist Government that took office in 1991 was focused on long-term structural issues and undertook wholly inadequate measures to increase employment and strengthen public finances. Not before the exchange rate crisis became acute in September 1992 was the focus shifted to the problems with central government finances and the cost situation.

At the same time, the financial crisis culminated. The determination and unanimity in handling the financial crisis was an important choice of direction. An extended period with an instable banking system would have contributed to further delaying the recovery. This is illustrated by experiences from countries where similar crises have been handled less resolutely.

The fixed exchange rate contributed without doubt to the fall in demand and employment between 1990 and 1992, However, it is difficult to see a time before September 1992 - when the exchange rate crises in a number of countries meant that the norm on a fixed exchange rate in the EU was loosened – at which time Sweden would reasonably have been able to opt for a floating exchange rate.

Action from September until the fall in the krona in November is characterised by a holding action to defend the krona first by means of drastic interest rate increases and then by purchases to support the krona. As international currency turbulence continued, and the domestic imbalances increased, the fixed exchange rate became increasingly unsustainable. In this way the transition to a floating exchange rate was a necessity-. The decision to release the krona was thus in itself not a choice of direction.

Important choices were made, however, in the economic policy after transition to the floating exchange rate. When the inflation target was introduced in 1993, it was a controversial decision. Inflation targets had not been tested in other countries for a longer period as a method for monetary policy with a floating exchange rate. After some years in the shadow of central government problems, policy has, however, proven to function well and become increasingly accepted.

The handling of the instrumental rate has periodically been called into question. Monetary policy was guided for a long time by the endeavour to create credibility for price stability in a situation where the previous stabilisation policy norms, i.e., the fixed exchange rate had been pulled away. The Riksbank made the assessment that the need to create credibility for the new regime did not provide any scope for rapid interest rate decreases. With reference to the United Kingdom, where the instrumental rate was drastically reduced directly on the transition to the floating exchange rate, the Riksbank was criticised, however, for depending the decline by an unduly restrictive monetary policy.

The key issue is the circumstances under which the economic policy has such freedom of action that it is possible to deviate from long-term objectives. A conclusion of what happened in the Swedish economy during the 1990s is that the freedom of action requires that the long-term objectives appear credible To drastically reduce instrumental rates in a situation where the public is convinced that the inflation rate will not be permitted to remain at a high level in the long run is unproblematic since the long-term inflation expectations are not affected. Doing so when uncertainty about inflation is great can however further increase insecurity, which pushes up long nominal and real rates and removes the desired expansive effects. The actual monetary policy will in all essentials comply with the cautious line.

In the same way, expenditure increases and tax reductions in a situation where public finances are perceived as strong and in balance can in the long term contribute to stabilising the economy over the cycle In a situation where deficits are already large and rapidly growing, the same measures can create expectations about future drastic tax increases and expenditure reductions or in the worst case a collapse of government finances. In this case, real interest rates on longer terms will remain high even though monetary policy reduces short interest rates. Together with the general economic uncertainty that then arises, such a development leads to dampened demand and low employment also in the short term.

Both the non-socialist Government and the Social-Democratic Government which took office in 1994 rejected fiscal policy expansion. The assessment was that the initial position did not allow any expansive experiments. Instead, credibility is strengthened and lower interest rates promoted by a deliberate consolidation programme, extending over a number of years.

The assessment that expansive fiscal policy measures after 1994 such as unfinanced expenditure increases or tax reductions would not have been a successful way to stimulate growth also appears correct in retrospect. Uncertainty about the sustainability of public finances was too great to provide scope for such an experiment.

The definitive turn came after the change of government in 1994 when awareness of budget consolidation became clear. As the Consolidation Programme became more credible, inflation expectations were dampened and monetary policy was eventually altered. In this way, a positive spiral started, where recovery of production and employment took place more quickly than anticipated, which also led to a quick recovery of central government finances.

The path chosen proved to be long but feasible. Sweden had found a way out of the crisis. Deciding what the effects would have been of a different monetary and budget policy after the fall of the krona is impossible, The risks of changing policies in an expansive direction were great, however, The weak confidence in economic policy made the necessary freedom of action did not exist. In such a vulnerable situation, drastic measures were required to regain confidence. When such measures were successful, they can retrospectively appear to have been overdimensioned. This applies both to budget policy and monetary policy. The intention was in both cases to remove any shadow of doubt that the targets were seriously intended.

This does not prevent here being reason to have points of view on the implementation of economic policy after the transition to the floating exchange rate. The decision on a credible medium-term consolidation of public finances during 1993 and 1994 had been in accord with the declared strategy could have given scope for an earlier easing of monetary policy. It had prepared the way for a more balanced and faster economic recovery.

Furthermore, monetary policy could have been adapted earlier to the favourable development in 1995 when the extensive consolidation programme had been established and started to gain confidence. The Riksbank adopted a cautious approach and waited to reduce the interest rate with a view to ensuring a continued fall in inflation expectations.

Together the absence of a sufficiently extensive and credible consolidation programme and the late adjustment of monetary policy when the consolidation programme had been adopted contributed to the recovery taking longer time than had been possible.

It is worth trying to summarise where the Swedish economy stands now after the difficult process during the 1990s:

– High growth on a par with other EU Member States.
– Strong public finances, supported by concrete budget policy objectives, a reformed budget process and a new robust pension system.
– Credible low inflation supported by a statutory price stability objectives, delegated to an operationally independent central bank with explicit responsibility for price development in Sweden.
– Low unemployment and increasing employment combined with low nominal real wage increases and rising real wages. The labour market has recovered far more quickly than expected in the light of the course of events in the 1990s.
– The surplus in the current balance as a reflation of a better structural balance in the economy.
– Restored freedom of action in economic policy. Automatic stabilisers in the budget

and the possibility of contra cyclical monetary policy provides better conditions for handling figure shocks.

The objectives that were sated in conjunction with devaluation in 1982 have thus been achieved to a great extent. This is reflected in the overall goals for economic policy being relative unchanged over time. High growth and employment are overarching welfare goals and price stability (low inflation) is a prerequisite for being able to achieve these goals in the long term. What is noticeable is that the degree of compliance with the goals is so high despite the deep decline that the Swedish economy has undergone and the critical situation that existed as late as the mid 1990s. During the past two years, employment has also increased more quickly than in other EU Member States. The substantial increase in employment contributes to employment again being a god bit lower than the EU average.

The favourable position that now exists may not conceal the economy's up- and downturns in the 1980s and 1990s caused considerable costs to society and individuals. A more even course of events would have meant a high average rate of growth and a more favourable development of real wages. The high unemployment has also led to distribution effects which disadvantaged persons with long periods outside the labour market. Although central government debt has fallen in recent years the annual interest rate payments are still considerable and also reduce in future the scope for other public expenditure.

A basic task for the future is to care for the confidence in public finances and price stability target that has been built up in the way Sweden came out of the crisis in the 1990s and to continue to reform the public sector and public tax and expenditure systems to support good growth and high employment. It is by virtue of this credibility and continued reform work that it is possible to counter future economic disturbances with an economic policy focused on stabilising growth and employment.

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Fact panel 2.1 Structural measures in Sweden since the mid-1980s

– Macroeconomic policy

New budget process with expenditure ceiling, expenditure limit decisions, and medium-term forecasts have improved the general government budget balance. Monetary policy has been changed by a new Riksbank Act that reinforces the independence of the Riksbank. A price stability target based on the consumer price index has been introduced.

– Credit and currency regulations

The reforms started in the macroeconomic sphere with credit and foreign exchange regulation during the second half of the 1980s. At the same time, financial services sphere was opened up for foreign establishments. Therefore the bank and securities market have received more competition-promoting environment for a more efficient allocation of capital. Practically all financial legislation has been reformed with a view to increasing competition at the same time as the financial stability has been retained.

– The tax reform

The 1991 tax reform aimed at increasing the incentive to work and saving by reducing marginal taxes and making capital taxation more uniform, as well as special taxing income from employment and services.

– Reform of national insurance schemes

A qualifying day has been introduced, and the employer is responsible for sick pay during the first two weeks, the so-called sick pay period. At the same time, compensation levels have been reduced from 90 to 80 per cent in unemployment benefit, after having been down at 75% in the wake of the crisis. A pension reform has been implemented where future payments are made in relation to contributions paid in which gives an incentive to work.

– New competition legislation

In 1993, new competition act was introduced which partly contains an explicit prohibition on collusion between companies to limit competition, and a prohibition against abuse of a dominant position. The previous law prohibited collaboration between companies only if harmful effects could be proven.

– Increased competition in the public sector

Several important measures have been carried out in recent years to increase efficiency in the public sector, including allowing more competition. Central government grants to municipalities have been reorganised to make resource use more efficient and new act on public procurement has been passed.

– Reduced housing subsidies

Interest rate subsidies have been reduced substantially since 1993 and housing policy has shifted from production support to a focus on the demand side, i.e. providing support to the tenants. The Government support system has been deregulated and simplified.

– Deregulation of product markets

Considerable changes have taken place during the 1990s with regard to transport, communications and energy. State monopolies have been abolished , freedom of establishment has been introduced and reforms and regulatory changes have taken place, On the whole, the changes have led to increased competition and higher efficiency. An important part of the reform work has been to separate transport services from operation of the infrastructure.

In 1996, a reform of the electricity market took place in Sweden. The new regulatory framework in the electricity market has meant that production and sale of electricity has been changed into competitive markets. However, network activity (operation, maintenance and leasing of lines) is still a monopoly and subject to special regulation and control both of the accessibility of the network for participants and price development of network services. Competition in the electricity market has moreover increased by improve opportunities for international trade establishment of new players, abolished metre requirement and increased mobility among certain categories of customers.

A new telecommunications act came into force in 1993 and has since then been changed on a number of occasions. As a consequence of this Sweden has one of Europe's most deregulated telecommunications markets which has made the industry internationally competitive which has in turn favoured customers by lower prices. The sole right of Sweden Post to carry letters was abolished in 1993 and Sweden Post has been made a limited company since then. The deregulation of domestic air traffic was started in 1992. As from 1997 foreign air companies can compete with domestic air. The deregulation of railway transport has led to Sweden having the highest levels of work and total factor productivity in the railway sector according to OECD. The taxi sector was deregulated in 1990.

Increase in efficiency in some sector in Sweden in the 1990s

OECD=100

	Labour productivity	Total factor productivity	Price level
Telecommunications	108	120	59
Electricity distribution	154	131	42
Rail transport	150	366	142
Civil aviation	61	67	161

Source: OECD [1998i].

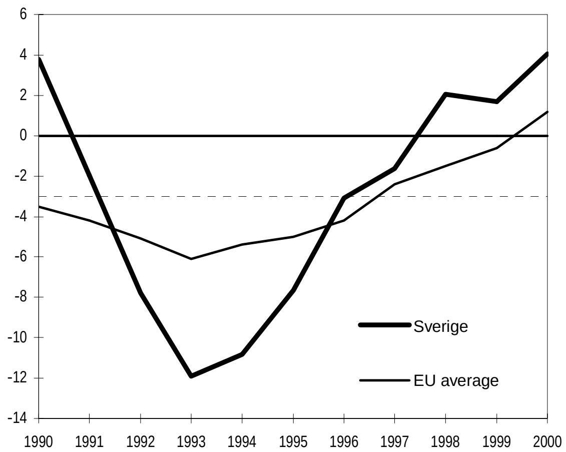
EU membership has meant a more competitive market inter alia in food production. Sweden has internationally little regulation as regards opening hours although the sector is dominated still by three players that account for over 2/3 of daily food trade.

Financial balance

As shown by Diagram 1, the general government financial balance deteriorated considerably more in Sweden than in the EU on average at the beginning of the 1990s. This is partly explained by Sweden together with Finland entering a deep recession, while the EU as a whole had a low but nevertheless growth in the economy from 1991 to 1993. The deficit in the financial balance in 1993 was twice as high in Sweden as in the EU. In Sweden the consolidation programme contributed to a rapid reinforcement of public finances and already in 1996, the deficit was lower than in the EU as a whole. During the second half of the 1990s, the improvement in the financial balance continued both in Sweden and in most other EU Member States. Sweden achieved a surplus in the general government financial balance in 1998 while it took until 2000 for the EU as a whole.

Diagram 1 General government financial balance in Sweden and EU

Per cent of GDP



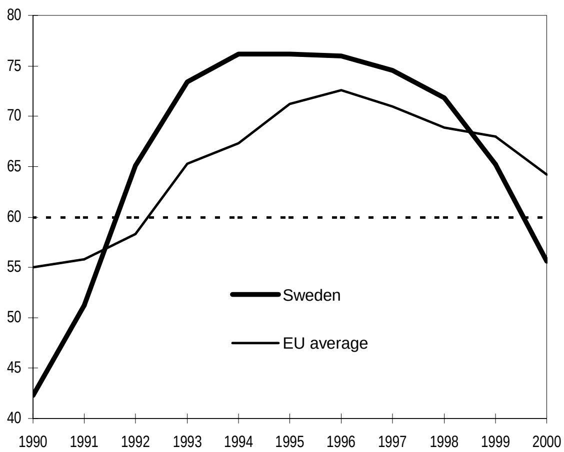
Sources: Eurostat and Statistics Sweden

The general government consolidated gross debt

The general government consolidated gross debt was in 1990 considerably lower in Sweden than in the EU as a whole. The large deficit in financial balance entailed that public deficit increased both in Sweden and the EU until the mid-1990s. The reduced deficit and then the surplus in the financial balance have contribute to the debt in proportion to GDP falling in both Sweden and the EU as a whole. In 2000, the Swedish debt was under the referenced value in the EU of 60 per cent of GDP. For most other EU Member States as well the debt is lower than 60 per cent of GDP. A few countries with a very high level of debt draw up the debt for the EU as a whole.

Diagram 2 General government consolidated gross debt in Sweden

Per cent of GDP



Sources: Eurostat and Statistics Sweden

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