Where is the Economy Heading?

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Thanks first for the invitation! I must start by saying that I had never heard of NOPA before being asked to speak here.

When I googled I found out that NOPA could mean the *National Oilseed Producers Association,* but I take it that this is not where I am. I don´t know anything about oilseed production, but unfortunately not much more about printing either, except from my own experience from having written books and reports in economics.

And I take it that is why I have been invited. The title of my speech is *Where Is the Economy Heading?* I chose the title myself, but given all the uncertainty about the current situation, it is an almost impossible question to answer. It might have been better to use a more humble title.

Outline of speech

Anyway, this is what I shall speak about.

- I shall begin by describing the current inflation.
- Then I shall turn to the causes of price increases.
- I'll stress the difficulties of handling a situation with simultaneous *stag*nation and in*flation*, what we call *stagflation*.
- I'll describe what central banks try to achieve by raising interest rates.
- I shall discuss how this is likely to affect economic activity.
- I'll ask the question if central banks are doing the right thing.
- Finally, I'll turn to government fiscal policy. Are governments doing the right thing?

We all know what characterises the current situation. That is *high inflation* after a decade with very low inflation.

Inflation in the Nordics

Inflation has developed similarly in the Nordic countries and reached levels around 10 per cent in Denmark and Sweden and somewhat less in Norway and Finland if we use the EU harmonised consumer price index which excludes interest costs and costs of home ownership.

Inflation: HCPI index

This slide includes the Baltic states as well. It shows average yearly inflation with forecasts for this year and next. The inflation problem is much worse in the Baltic states than in the Nordic ones with inflation rates close to 20 percent last year and double-digit inflation predicted also for this year.

Causes of high inflation

The causes of these developments are well-known. A strong recovery after the covid crisis in 2020 in connection with various supply problems (freight bottlenecks, lockdowns in China, shortages of microchips and so on) and then rapidly rising energy costs, mainly in connection with the war in Ukraine and reduced gas supply from Russia, but also because of factors such as stoppages of nuclear power plants in France, too little water in Norwegian magazines, and summer heat last year in Europe.

Then we also have rising food prices because of the war in Ukraine.

Causes of inflation: Denmark and Sweden

One can try to sort out how much of inflation is due to *increasing demand* and how much to *falling supply*. The OECD has made an attempt at this for some countries, including Denmark and Sweden. It gives a clear picture: most of the inflation is due to *supply shocks*.

Polar cases of inflation

If inflation is caused by high aggregate demand, it is rather obvious that economic policy should cool the economy by reducing demand through higher interest rates and more contractionary fiscal policy, that is cuts in government expenditure or rises in taxes. Lower demand will then reduce both inflation and employment, but the employment reduction will not be a problem if the labour market is strong to begin with with high employment and many vacancies.

But a situation like the current one when inflation comes mainly from the supply side is very difficult to handle because one gets inflation and unemployment at the same time when rising input prices make production less profitable.

Energy expenditures

If one looks back at history, one does find that periods with similar supply shocks as now, with soaring energy costs, are associated with recessions. This is clear from the picture which looks at the whole OECD area, that is more or less all advanced economies.

The couloured staples show expenditures on various forms of energy in per cent of GDP. The grey shadings indicate years or recession, years with at least two consecutive quarters of falling GDP. There are four such episodes: 1974, 1981-82, 2008 and 2020.

2020 is the pandemic. But the three other recessions were associated with rising energy costs: 1974 the oil crisis after the arab states’ oil embargo on the Western world; 1981-82 the oil price increases after the start of the Iraq-Iran war in 1979, and 2008 with general energy price rises after a boom period in the world economy.

And in 2022 we see again a huge increase in energy costs which likely will trigger a recession this year.

Polar cases of inflation

Supply shocks, leading to *stagflation*, create a dilemma for economic policy with conflicts of goals. If policy makers try to reduce inflation by lowering aggregate demand, output is reduced even more than what is caused by the supply shock itself.

If policy makers try instead to stabilise output through expansionary policy they instead exacerbate inflation. So policy makers must make a choice: should they try to stabilise inflation or should they try to stabilise output and employment? It is impossible to stabilise both.

The choice made almost everywhere is to focus on inflation. That is why central banks are now raising interest rates. The latest example was the European Central Bank, the ECB, which raised its deposit rate by 0,5 percentage points to 3 per cent last week, which affects interest rates in all countries with the euro.

ECB and Danmarks Nationalbank policy interest rates

The Danish krona has a fixed exchange rate to the euro, so the policy interest rate of the Danish central bank, *Danmarks Nationalbank*, usually follows the ECB's policy interest rate. Last week the Danish policy rate also increased by 0,5 percentage points, to 2,75 per cent.

Norges Bank policy interest rate

The Swedish and Norwegian central banks have also been raising their policy rates, to 3 per cent in Sweden and 2,75 in Norway: in fact *Norges Bank* was earlier than other central banks to do this: it started already in 2021, whereas others waited till 2022.

GDP growth

The outlook for output this year is bleak. GDP will probably fall in Sweden, Finland and Latvia, with the largest fall in Sweden.

The OECD forecasts positive growth for the other countries in the table, but the figures are quite low, with Norway and Estonia coming out somewhat better than the others.

Weak development of private consumption

A main reason for the weak output developments this year is a weak development of private consumption. It is predicted to fall in all the Nordic and Baltic countries except in Norway and Lithuania. The largest falls, between 1 and 2 per cent, are in Sweden and Denmark.

One explanation of the weak development of private consumption is inflation itself, which is eroding the purchasing power of wages.

Year-to-year real wage change 2022, Q3

This is happening everywhere, but real wage falls have been quite large in the Nordic and Baltic countries. We are talking about real wage cuts last year of 4-8 per cent except in Norway. Real wages will continue to fall this year, too.

Weak development of private consumption

The other main reason for weak private consumption is the interest rate hikes. Traditionally, economists have argued that what matters for saving and consumption (and investment) is not nominal interest rates, but *real interest rates*, that is the difference between the nominal interest rate and inflation. And realised real interest rates are now lower than ever, as realised inflation is much higher than nominal interest rates: they have increased much less than inflation.

But here economists´ thinking has been changing. Today we put much more stress on the *liquidity constraints* of households (and firms, too). The main channel of influence of interest rate changes on aggregate demand is probably that higher nominal interest rates increase the interest payments of households on their debt and this way reduce the *cash flow* that can be used to purchase various goods and services.

Ratio of household debt to net disposable income

Here, the Nordic countries are very sensitive as household debt is very high relative to the disposable income of households. You find the Nordic countries to the right in the diagram with household debt ratios of 150–250 per cent. Debt ratios are much lower in the Baltic countries.

Share of variable-rate mortgages in new mortgage issuance

There is also a fast pass-through of higher interest rates to households in especially Finland, Norway and Sweden as variable-rate mortgages are very common here. They are less common in Denmark.

House prices

Rising interest rates also have large effects on house prices. There have been significant falls in Sweden and Denmark and smaller ones in Norway and Finland. But more is likely to come. This will also contribute to lower private consumption as it reduces household wealth.

Changes in house prices from the peak in 2022

This picture shows the percentage fall of house prices from the peak in 2022 in some countries. Sweden stands out with a fall of almost 14 per cent.

Interest rate increases in the current tightening cycle

Central banks are now raising interest rates at record speed. The solid lines show how central bank policy interest rates have risen from the point of time last year when they started to be raised last year in the US, the euro area and Australia.

The broken lines show the average speed of interest rate rises in earlier processes of monetary policy tightening. Tightening is much faster now. After 8 months of rises, interest rates have been raised by about 2 percentage points more than in earlier tightening periods.

The picture does not include Norway and Sweden, but Norges Bank and the Riksbank have followed similar trajectories.

Are central banks doing the right thing?

The crucial question is if central banks are doing the right thing? Should they really be raising interest rates in this aggressive way even though this reduces the purchasing power of incomes strongly and may cause a recession?

There exist basically *two views*. The *first view* is that the current inflation is *temporary* and will more or less disappear by itself.

If this view is correct, there is no need for central banks to reduce aggregate demand. It has not caused inflation so it is the wrong lever to use. It will just inflict unnecessary damage to the economy.

Some also argue that the interest rate rises might trigger a financial crisis because some financial institutions will not be able to pay higher interest on their debts, like the Silicon Valley Bank in the US.

Energy and food prices

Those with this view emphasise that prices of energy, food, cereals and fertilisers are now coming down. They have fallen a lot from the peaks last year. The argument is that this will gradually feed through into lower inflation.

Are central banks doing the right thing?

If this view is correct, we would get a development similar to the Korea inflation in 1951–52. When the Korea war started in 1950 there emerged serious supply shortages for many raw materials. This triggered high inflation worldwide. But this was only temporary. It blew over with some – but not much

– tightening of monetary policy and inflation returned to earlier low levels in the rest of the 1950s and 1960s.

The *second view* is that, although inflation started mainly because of temporary supply shocks, it will become entrenched unless action is taken to reduce aggregate demand. So this has to be done even if it causes pain.

Those with this view instead look to the 1970s when the world, and the Nordics, entered a period with very high inflation. It was to a great extent triggered by the large oil price increases in 1974. But it became self-perpetuating because *expectations of inflation* were affected.

When higher inflation became anticipated, firms began to increase their prices faster because they expected their competitors and suppliers to do the same. Employees demanded higher wage increases because they expected higher consumer prices. Firms gave in to these demands as they expected to be able to pay for them by raising their own prices faster.

The result was a *price-wage-spiral,* where prices and wages chased each other. It was not stopped until harsh monetary policies were adopted in the 1980s which led to very large unemployment rises.

Which of these two views is the right one: that inflation will fall by itself or that it requires policies causing the economy to contract? This is indeed a very hard question to answer since there is so much uncertainty.

The dangerous thing is if inflation expectations were to start rising and this would lead to large wage increases. So far we are not seeing this.

Inflation expectations

In Sweden, to take an example, long-run inflation expectations have been stable. Expected inflation 1 year ahead is, much above the Riksbank's inflation target of 2 per cent. But 2 years ahead it is 3,1 per cent and 5 years ahead it is close to the target of 2 per cent.

No signs of high wage increases so far in the Nordics

There are no signs yet that wages will start increasing much faster in the Nordic countries. Wage demands are rather moderate compared to inflation.

Most forecasts for wage increases lie around 4 per cent this year in Denmark, Finland and Sweden; they are somewhat higher for Norway with 5 per cent.

I am less familiar with the Baltic economies. But there wage increases in last year were much higher than in the Nordic countries and forecasts for this year are also considerably higher. This will make it harder than in the Nordic countries to get inflation down again.

My take on monetary policy

What is my take on monetary policy? Since there is so much uncertainty I believe it is wise to base policy decisions on a risk minimisation strategy.

Unemployment

I don’t see the risks of monetary policy becoming unnecessarily contractive as so large. It doesn’t look like very severe contractions in the labour market. The OECD forecasts for Denmark, Finland, Sweden and Lithuania are that unemployment will rise this year by around 1 percentage point or less. Much smaller rises are predicted in the other countries.

My take

We seem to be far from the labour market deteriorations that we experienced in the 1990s, during the global financial crisis 2008–10 and in the pandemic of 2020.

And I would not be too worried about the risk of a financial crisis either. The financial system in Europe is better regulated today than before the global financial crisis with more capital buffers in banks and better prepared solutions to handle banks that become insolvent.

There are likely to be failures of financial institutions as some have taken too large risks during the years with low interest rates – like Silicon Valley Bank in the US and Credit Suisse in Switzerland.

But I would be surprised if that would lead to massive repercussions like during the global financial crisis when many institutions had invested in opaque mortgage-based securities where risks were very hard to assess. I say this with the caveat that it is in the nature of financial crises that they cannot be predicted: if they could, they would never arise.

But, of course, if turbulence continues in financial markets, banks will become more cautious in their lending, which tends to dampen aggregate demand in itself. Then central banks do not have to raise interest rates by as much as they planned to fight inflation. We shall know a bit more about this tonight after Fed, the US central bank, has announced its new interest rate decision. It could very well be a 0,25 percentage point rise or no rise at all instead of the 0,5 percentage points that seem to have been planned two weeks ago.

If the Fed holds back, the ECB, the Riksbank, Norges Bank and other central banks may hold back as well. This might in fact be quite wise. Since it takes time for higher interest rates to affect inflation, it is reasonable to pause and await the effects of earlier rises. This might be more difficult for the ECB than for the Riksbank for example, as there are more signs of higher wage increases in the euro area.

My take is that the risk of pursuing monetary policies that turn out to be too harsh are much smaller than the risk of pursuing policies that turn out to be too mild. That is because the cost of ending up with an inflation process where prices and wages start to chase each other is so large. We have learnt from the past that if we let this happen it will in the end require a dramatic contraction of the economy to stop inflation.

So my view is that it is better to now take the risk that monetary policy becomes overly restrictive than to risk that we do too little in the short run.

Then I also weigh in that inflation so far has proved more persistent than we thought. Most economist would have expected it to begin coming down earlier. The longer it persists at high levels, the greater is the risk that wages will begin to increase too fast.

Fiscal policy

I have so far talked mostly about interest rate policy to fight inflation. This is because central banks have the main responsibility for price stability. But *fiscal policy*, that is decisions about taxes and government expenditure, also matter because they, too, influence aggregate demand.

The effects of fiscal policy differ depending on whether a country is a member of the euro area or has its own monetary policy (like Norway and Sweden).

The ECB's interest rate is not much influenced by what a single euro country does. So an expansionary fiscal policy in Finland or the Baltic economies will just work in the opposite direction to a contractionary monetary policy. Such fiscal policy, by keeping up aggregate demand, will make it more difficult to get inflation down.

For Norway and Sweden, an expansionary fiscal policy is likely to work differently. It still tends to offset the reductions in aggregate demand that the central bank tries to achieve. But for us, the consequence is likely to be that the central bank raises interest rates even more if its attempts to reduce inflation is counteracted by the government's fiscal policy.

The central bank can always achieve the reduction in aggregate demand that it wants in Norway and Sweden. But it may have to raise interest rates more than otherwise would be the case. This will hurt

highly indebted households and firms more, reduce house prices more and increase the risk of financial instability.

The high energy costs have put pressure on governments to reduce the burden on both households and firms through various forms of support: both subsidies of various types and energy tax cuts.

Budgetary costs of energy support 2022

This picture shows the amount of budgetary support for high energy prices in per cent of GDP in various EU countries in 2022. It is given by the dots. It has amounted to as much as 2–3 per cent in some countries.

The staples show the increases in energy costs for the poorest households: the blue parts for the 20 per cent of households with the lowest incomes. When the red parts are added one gets the energy cost increases for the 40 per cent of households with the lowest incomes.

Most countries have paid out much more in energy support than was needed to compensate only the most vulnerable households. There are two exceptions: Denmark and Finland, which both have been quite restrictive.

But Latvia, Lithuania and Estonia all follow the general picture of much larger compensation than would have been needed to protect only the most vulnerable households.

The main risk is that compensating also higher-income households for energy price rises could make fiscal policy generally too expansionary and this way counteract the attempts by monetary policy to reduce aggregate demand and inflation.

Energy support in Norway and Sweden

The diagram does not include Norway and Sweden. But as far as I understand, Norwegian energy support has been – and is – extremely generous. It has also been constructed in such a way that it has directly held down electricity prices – and this way inflation as we measure it: by compensating households for 90 per cent of prices exceeding 70 öre per kilowatthour (up to a limit).

The Swedish support for high electricity prices is instead paid out *retroactively*. Then it does not affect measured inflation. The retroactive construction is better from an efficiency point of view than the Norwegian one: by linking the support to past electricity consumption instead of the current one, it does not in the same way weaken the incentives to save on electricity.

In Sweden it is still not clear exactly what support for 2022 firms will be getting. My guess is that the energy support for last year – paid out this year – will amount to a bit below 1 per cent of GDP. Unfortunately, the government has been quite slow in organising the actual payments.

How does the overall fiscal policy look for the various countries? Economists usually measure the stance of fiscal policy by what we call the *structural fiscal balance*, that is the balance (the difference between revenues and expenditures) that would obtain if resource utilisation were normal, so that the economy is neither in a recession nor in a boom.

Structural fiscal balance

This is what is shown in my picture. There are minuses for Finland, Estonia, Latvia and Lithuania. It means that these countries would have fiscal deficits (expenditures exceeding revenues) if resource utilisation would be normal. Then fiscal policy is stimulative, raising aggregate demand. So, in these countries fiscal policy is in fact counteracting monetary policy which tries to reduce aggregate demand in order to bring inflation down.

There are many reasons for this stance of fiscal policy. One is the support for rising energy costs. But there are others as well such as social benefits indexed to prices and increasing defence expenditure. And in Finland, which I know the best among these countries, there are also costs for increased investment in infrastructure, for a reform of health and social services and in general for an ageing population.

Denmark and Sweden have structural fiscal surpluses, that is contractionary fiscal policies, working in the same direction as monetary policy or at least not contradicting it.

One might jump at the figures for Norway – an expected fiscal surplus 2023 of 16,3 per cent of GDP. But this does not say anything about fiscal policy’s impact on the economy. The figures reflect taxes on the petroleum companies that are channelled into Norway´s oil fund.

What matters for aggregate demand in Norway is what is taken out from the oil fund and used for government spending in Mainland Norway. At present one takes out less than what one intends to do on average. This means that fiscal policy can be seen as weakly contractionary and thus working in the same direction as monetary policy in dampening aggregate demand.

Summing-up

To sum up, let me repeat that our economies now experience *stagflation*, simultaneous stagnation and inflation. There is no *quick fix* for such a situation. It will take time to get out of it.

It is possible that inflation will abate more or less by itself because it has been triggered by supply shocks that are hopefully temporary. But there is also a risk that inflation becomes persistent.

To minimise that risk, it may be wise to adopt a *precautionary approach* and accept a period of hardship with contractionary monetary policy, even if we cannot be certain that it is necessary. The reason is that it will be extremely costly if we err on the side of too lax policies, because then we could be forced to fight inflation in the future with even tougher policies.

We should be cautious with fiscal policy so that it does not counteract the efforts of monetary policy to dampen inflation. Overall fiscal policy should not be stimulative. Instead, it should focus on support for the most vulnerable households.

What about firms? Should we support them as we did during the pandemic. This is a tricky question. We probably have to accept that energy prices will be higher in the future than in the past. Then firms have to adapt which will mean some restructuring of the economy, where very energy-consuming activities, perhaps also printing, will have to contract.

For firms, there is a case for support only to the extent that we believe high energy costs are temporary and we do not want to destroy organisational capital that will be profitable in the future again.

All this is easy to say. It is much harder to implement in practice, since it is so hard to know which changes are temporary and which are permanent.

How far should inflation be lowered?

Another difficult question is how policy should act if and when inflation is coming down. Suppose that it comes down to say 3 per cent but then gets stuck there. Should we then take the cost of pushing it all the way down to the earlier inflation targets of 2 per cent if that would require a long period of elevated unemployment?

This is also a tricky question. There is not really anything sacrosanct about 2 per cent inflation. There was no deep research behind this number when it was chosen. In fact, there are many analyses suggesting that the optimal inflation rate is higher, perhaps around 3 per cent.

The main reason is that with a low inflation target, there is a risk that we, as in the years before the pandemic, end up in situations where monetary policy cannot stimulate the economy enough in bad times because it is difficult to lower interest rates much below zero.

That risk is smaller with a somewhat higher inflation target, because then interest rates would be higher under normal conditions with more space to fall in bad times.

But there are also risks with raising the inflation target in response to a situation where we find it hard to get inflation down to the earlier 2 per cent. When inflation rises the next time, there might be expectations that if we have once raised the inflation target, we might do so again. That might make it difficult to stay at a new higher inflation target.

I shall not try to answer the question of the appropriate inflation target. I just want to raise it.

To finish: we are in a difficult situation but also one in which it is quite interesting to be an economist. The charm with my profession is that every time one believes that the economic problems have been solved – most recently those from the pandemic – new and unexpected problems pop up. This is interesting for economists but unfortunately quite challenging for the rest of society.