ARTICLE – The economic-policy framework facilitates a return to the target

Inflation has been unexpectedly high for longer than expected. It is now at levels reminiscent of those during the 1970s and 1980s. The start of the internationally high inflation then, with soaring energy prices resulting from unease and production disruptions in the Middle East, was not unlike the situation today. However, compared with that period, the conditions for returning inflation to low levels are much better today. The Riksbank now has an inflation target and can act to dampen inflation, and the long-term inflation expectations are more firmly anchored. Moreover, central banks have in general reacted earlier and in a more coordinated manner than in the 1970s, when the inflation impulse from high oil prices was allowed to spread throughout economies and affect long-term inflation expectations.

Inflation higher and more protracted than expected

Inflation has recently become much higher and been high during a longer period of time than many, including the Riksbank, had expected. This is largely due to international factors that have been difficult to predict, such as the pandemic and the Russian invasion of Ukraine.

The pandemic has caused sharp fluctuations in economic activity across the world. Demand fell dramatically in spring 2020, but the recovery was also very rapid. In the United States and Europe, major fiscal and monetary policy measures were implemented to support households and companies, which contributed to the rapid upturn in both demand and inflation.

During 2021, the oil price rose gradually as a result of increased demand and production limitations. At the same time, deliveries of natural gas from Russia were unusually small, which had a substantial effect on electricity prices in Sweden and the rest of Europe. The war in Ukraine further worsened the problems. Energy prices have contributed to higher inflation, partly via a direct effect, as prices of fuel and electricity are included in the usual measures of inflation. But there are also delayed, or indirect, effects of the price increases, which are more difficult to measure. An example is when higher fuel costs lead to more expensive transport and thus to higher prices for the products being transported. Companies have also been affected by bottlenecks in transport, higher commodity prices and a shortage of various input goods.

The fact that inflation has increased is thus largely due to supply factors, but the price increases on energy and commodities have also spread to other prices in the economy. The expansionary fiscal and monetary policy conducted in many countries in connection with the pandemic has stimulated demand and contributed to the recovery after the pandemic being unexpectedly strong. In this environment, companies have had the opportunity to a large extent to pass on the large cost increases caused by supply disruptions.[27] As the forces that have pushed inflation upwards have been unexpectedly strong and lasting, the forecasting errors have been substantial.[28]

Inflation is at present at levels reminiscent of those in the 1970s and 1980s, when the average rate of inflation was 8.3 per cent. The purpose of this article is to illustrate how the conditions for once again bringing down inflation to a level in line with the target differ from those during this period.

Similarities to rise in inflation in the 1970s

The start of the internationally high inflation in the 1970s and 1980s was not totally dissimilar to the situation today. One important circumstance was that energy prices increased substantially in the 1970s as a result of geopolitical unease and production disruptions in the Middle East, in around the same way as energy and commodity prices have now been pushed up in the wake of the pandemic and the war in Ukraine.

An important explanation for the lastingly high inflation during that period was the expectations that economic agents had of inflation. If households and companies expect inflation to be high going forward, this will affect price setting and wage formation in the economy. The inflation that is then realised confirms expectations and in its turn affects the updated expectations of future inflation. The high inflation will thus become a self-generating process.

One reason why the high inflation was built into expectations among households and companies was that it was not sufficiently counteracted by the overall economic policy, which became systematically too expansionary.

At that time, Sweden had a fixed exchange rate. The idea was that this would have a disciplining effect on price setting and wage formation, but the domestic inflation trend nevertheless became too strong. If Swedish prices and wages rose faster than those abroad, economic agents expected that the resulting cost crises and unemployment would be solved by writing down the value of the krona, that is, through deval-

[27] There was a discussion in the June Monetary Policy Report as to whether inflation had been pushed up as a result of companies having increased their prices over and above the cost increases. Economic activity will weaken going forward, so in the cases where companies have historically increased their margins it will be more difficult going forward. The Government has recently given the National Institute of Economic Research the task of analysing whether prices have changed more than can be motivated by companies' recently increased costs. The National Institute of Economic Research shall report the task by 5 December 2022.

[28] For a more detailed analysis of the factors that have affected inflation over the past year and the Riksbank's forecasting errors, see J. Johansson, M. Löf, P. Stockhammar and I. Strid (2022), ”Vad förklarar Riksbankens prognosfel för inflationen?” (in Swedish only) *Staff memo*, June, Sveriges Riksbank.

uation. The recurring devaluations then fulfilled the high inflation expectations. Moreover, wage formation did not function well, because of a lack of coordination between the social partners.

As the aim was to hold a fixed exchange rate, there was no real possibility to dampen the inflation trend through interest rate increases. Nor was fiscal policy sufficiently tight. This economic environment was a breeding ground for lastingly high inflation. While the inflation trend in, for instance, the United States was broken in connection with a change in monetary policy at the beginning of the 1980s, it was not broken in Sweden until the crisis in the early 1990s, and the changes in economic policy that this brought about.

Better institutional settings now

The framework introduced after the 1990s crisis has proved to work well with regard to managing crises, such as the global financial crisis just over ten years ago. When it comes to correcting high inflation, however, they are now really being put to the test for the first time. However, the conditions today are different from those in the 1970s and 1980s. Unlike then, we now have a floating exchange rate and an inflation target that the Riksdag has given the Riksbank the task of attaining. This is very important for expectations. It was difficult to predict and to counteract that global inflation would rise so quickly and so much. However, the expectations of inflation a few years ahead appear relatively well in line with the target. Although they do appear to be currently somewhat over 2 per cent, in the light of the very high actual inflation they must be regarded as well anchored. While there was no really credible anchor for inflation during the high inflation of the 1970s and 1980s, we do have one today.

The fiscal policy framework that was launched after the 1990s crisis has meant that Swedish public finances are now in good condition. This has increased the market's confidence in Sweden's ability to keep its accounts in order and fiscal policy is no longer feared, as was the case during the 1970s and 1980s, to be a contributing factor to sustained high inflation.

Wage formation also functions much better now than was previously the case, much as a result of the Industrial Agreement and the inflation target. It functions as a built-in brake in the system and reduces the risk of price-wage spirals, which is important both to stabilise fluctuations in economic activity and to keep inflation expectations close to the target.

To summarise, the conditions are good for avoiding prolonged high inflation and bringing inflation back to the target relatively soon. It is a major advantage that the frameworks are now well-designed, but it also requires that economic policy decision-makers and other agents act within them. The Riksbank’s task, like that of other central banks, is to bring inflation back to the target and to prevent the high inflation being incorporated into the expectations of economic agents. The interest rate increases required will be noticeable for households and companies. But if monetary policy acts in a way that prevents inflation from becoming entrenched in the expectations, as was the case in the 1970s and 1980s, the Swedish economy will benefit in the long term.

The cost of safeguarding the inflation target will also be lower when economic agents interact in a good way. In a situation with declining economic activity, but at the same time too high inflation, fiscal policy measures facilitate for especially hard-hit groups. Although this can mean that the policy rate needs to be raised more to be able to attain the inflation target, this type of policy mix may nevertheless be justified from a socio-economic perspective. The important thing is that fiscal policy does not entail broad demand stimulus, which would clearly make it more difficult to attain the inflation target, would risk contributing to long-term inflation expectations being adjusted upwards and thus mean that the policy rate needed to be raised substantially. Wage formation can facilitate by maintaining a continued long-term perspective based on the high inflation being temporary and on inflation soon returning to the target.

Important to attain the inflation target

Today's high inflation has created challenges for the Riksbank and other central banks that they have not previously faced. At the same time, there are good conditions for managing these challenges. Central banks have since long had the task of keeping inflation low and stable and the long-term inflation expectations are better anchored now than during earlier periods of high inflation. Combined with factors that have temporarily pushed up inflation declining in significance, this indicates that inflation will relatively soon begin to fall towards the target (see the article "What indicates that inflation will fall back next year?").

The long period with low and stable inflation has been beneficial for the Swedish economy. It is therefore important to safeguard confidence in the inflation target by not letting the high inflation affect economic agents' long-term inflation expectations. If inflation does not develop as the Riksbank is now forecasting, but shows signs of remaining high, monetary policy will be further adjusted.