MONETARY POLICY AND FOREIGN BORROWING AT THE BEGINNING OF THE EIGHTIES

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Monetary Policy and Foreign Borrowing at the Beginning of the Eighties

For some considerable time stabilisation policy in Sweden has been concerned with the consequences of our budget deficit. However, these consequences depend entirely on the combination of wage policy and exchange-rate policy that has concurrently been pursued in Sweden. In this article we shall, therefore, concentrate on the financial and monetary policy aspects of the stabilisation policy so that we do not have to consider all aspects simultaneously. It will be assumed, therefore, that Sweden maintains its relationship with the present basket of currencies and that wage policy is compatible with this exchange-rate policy.

What Has Been the Result?

When the first signs of the massive budget deficits began to be discerned a few years ago, considerable uncertainty existed as to how disastrous they could be for Sweden's economy and in what way they could be dangerous. It was maintained, on the one hand, that, since the economy was in a state of recession, with widespread unemployment, the budget deficit would lead to increases in production and income. Increased incomes would give rise to increased tax revenue and the budget deficit would thereby automatically be balanced and the problem solved. On the other hand, the view was put forward that the budget deficit would lead to an "inflationary bonfire" of devastating proportions.

It turned out that neither view proved to be correct. In spite of a powerful expansion of incomes from 1978 to 1979 no Keynesian budgetbalancing effect occurred; instead, there was an increase in the budget deficit. Nor was it possible to record the sharply growing inflation predicted by the monetarists.

Faced with this generally widespread uncertainty concerning the effects of the budget deficit, it became necessary to illustrate in some suitable manner the nature of the problem and indicate its magnitude. One way to do this was in the form of a credit market estimate of the type published in this review a year ago. The substance of the argument was:

1) that the Swedish budget nowadays contains a large number of financial transactions which do not directly give rise to increases in demand. On the other hand, they can exert disturbing effects on credit market flows.

2) A credit market estimate was presented in order to illustrate the nature and magnitude of the problem.

3) If the budget deficit were to result in "excessive" liquidity in the country, the consequences would not be an immediate, sharp increase in the rate of inflation. In a small country with a fixed rate of exchange the main result would, instead, be a decline in the foreign exchange reserves, which would also automatically reduce the "excessive" liquidity.

The credit market estimate in my earlier article [1] was not intended as a *forecast* of developments, but as an *arithmetical example* in order to illustrate the nature and magnitude of the problem. For instance, it was assumed that the current account balance would remain in equilibrium (which it had been in 1978), whereupon the result would be that it would lead to unreasonable consequences for the demands on the commercial banks' purchases of Government securities. In actual fact, I pointed out at the end of the article that, since the commercial banks could scarcely be compelled to purchase what would be necessary for the desired development in the money stock, the resu't, as far as Sweden was concerned, would quite simple be increased borrowing from the Riksbank (Central Bank of Sweden) and a growing outflow of foreign exchange from the end of 1979.

Since, judging from all appearances, it appears as if the budget deficits will not only remain at the same level for a considerable period to come, but will even grow still further, there are grounds for examining the outcome of 1979 more closely. An

1) See Myhrman 1979.

analysis of this kind can then be used to form the basis for a discussion of what we can expect in the years ahead. The discrepancies between my estimate and the outturn depend mainly on three factors. First, the National Swedish Debt Office managed to place much larger sums with the general public than has been the case in earlier years. Secondly, by means of liquidity-restricting accounts with the Riksbank and increases in the commercial banks' cash ratios, liquid funds have been absorbed from businesses and banks. Thirdly, an outflow of foreign exchange of around SEK 10 billion has eased the pressure on the Swedish credit market.

The conclusion of what has happened in 1979 is that the Riksbank and the National Swedish Debt Office have performed an extremely good job in relation to the burden of the budget deficits, but they were, nevertheless, compelled to rely on the assistance of an adequate outflow of foreign exchange. The question is what is going to happen in the future.

What Can We Expect at the Beginning of the 1980's?

The budget forecasts do not indicate any improvements, if anything, further increases in the deficits. What development is possible or probable?

	(SEK billion)	
	1979	1980
Budget deficit	44	51
Less:		
Investment		
Capital market	9	10
General public	10[1]	6—8
Banks	5	13—20
Abroad	9	10—15
Change in foreign exchange reserves	— 3	0
Borrowing by the Commercial banks from the Riksbank	+ 6	0
Statistical discrepancy	— 2	
Residue = Increase in the monetary bases	+ 12	+ 12——2

(1) This figure includes SEK 3 billion from the liquidity equalization account.

Sources: Government Finance Plan and weekly reports of the Riksbank.

Let us start from the outcome of 1979.

According to this estimate the monetary base increased by approximately SEK 12 billion in 1979. In my estimate last year I pointed out that the monetary base ought not to be allowed to rise by more than approximately SEK 4 billion if the money stock was to rise by no more than 15 %, assuming a constant money multiplier.

The rise in the money stock in 1979 from year-end to year-end was 12 % with an annual average of 14 %. Taking into account the fact that, of the SEK 12 billion, SEK 6 billion result from the raising of the cash ratios and are, therefore, locked up in the Riksbank, the monetary base has not increased so much either. We can thus state that, in spite of all the talk about the control of bank lending, liquidity ratios and other selective measures, there would appear to be an active emphasis on general measures, which, in combination with the outflow of foreign exchange, has led to a fairly restrictive money market. Presumably, something of an international record in view of the size of the budget deficit.

The question now is whether one can continue further along these lines or whether too many coincidences have occurred. There is always a risk that one is content to rest upon one's laurels. I shall take the liberty here of playing the part of the slave riding in the chariot of the victorious Roman general and reminding him in the midst of his glory that he was a mortal man (memento te mortalem esse).

For 1980 the budget deficit is expected to be SEK 51 billion. The Government Finance Plan has risked making a forecast of investments during 1980 cautiously expressed in intervals and the figures have been inserted above in the Table. It will be seen that the opportunities for getting the

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general public and the capital market institutions to subscribe for Government securities are not expected to increase. In actual fact, this opportunity was utilised to breaking point in 1979. If it is not desired to take any risks of excessive investment with the Riksbank, the only remaining options are the commercial banks and foreign investors. As far as foreign investors are concerned, a figure of at least SEK 15 billion will be necessary if the foreign exchange reserves are to be kept unchanged, may be considerably more. In such case, this would mean that the commercial banks must be willing to purchase around SEK 13—14 billion if the monetary base is not to rise by more than with 5—6 billion or what is compatible with an increase of 10—12 % in the money stock, which is the maximum that we should permit (see below).

An increase of this magnitude means that the commercial banks' holdings of Government securities will rise by upwards of 45 %. This also means that, if commercial bank deposits rise by 12 % or by approximately SEK 16 billion, then SEK 15 billion, or approximately 94 %, will be invested in Government securities. The ratio of Government securities will rise from 24.3 % to 37 % (Government securities as a percentage of deposits from the public).

It should be noted that a holding of Government securities of this magnitude (which the authorities are now obviously expecting) is, historically speaking, something unique for Sweden in peacetime. At the end of World War II the ratio of Government securities was 32 % (31st December, 1944). A "normal" value for this ratio, or a value which the commercial banks would choose if they were completely uncommitted in their choice, would probably lie in the interval 5—15 %. This overloading of Government securities, which is forced upon the commercial banks means that they are obliged to reduce, to a corresponding degree, the activity which they originally found to conduct, namely, making available private credit facilities to approved customers. *It appears to be a great waste of economic resources for specialists in the field of credit appraisal and credit allocation to have to devote themselves to the administration of Government securities.*

In order to determine how reasonable the estimate is or how it reacts to different assumptions, a number of scenarios have been outlined. In the first place, it has been assumed that it would be possible to get larger sums taken up by the capital market or the general public. This would then reduce, in a corresponding manner, the need for borrowing from the commercial banks or from abroad. However, increased investment by these groups of purchasers is scarcely possible without a further improvement in the rate of yield; perhaps even tax benefits may have to be resorted to. Every attempt of this kind to obtain an improved yield on Government securities will mean for example, that shares and other forms of investment will find it increasingly difficult to compete for the savings available and be crowded out of the credit market to an increasing scale.

Another alternative is that which was tried to a certain extent in 1979, namely borrowing from the Riksbank and then locking in the liquidity increase in the commercial banks by raising the cash ratios. If this alternative were adopted, the cash ratios would once again have to be raised by approximately 5 %. These examples show that the effects in these two cases fairly closely resemble borrowing from the commercial banks. Even if the mechanisms are different, the results in all three cases are a crowding out of private credit. *In essence, the choice lies between this crowding out and increased borrowing abroad. The more that escapes via the balance of payments, the less will be the crowding out.*

According to this line of reasoning and, on the basis of the budget deficits for the last few years, the opportunities for providing the credits that are to form the basis of an upturn in business sector investments do not appear to be very bright. These investments are absolutely necessary for the in-

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dustrial expansion that must take place if we are to be able to reverse the trend of a steadily weaker current account balance. The vicious circle in which we find ourselves must be broken. Basically, it is a question of the expansion of the public sector. The budget deficits, in conjunction with a high level of employment, imply, in actual fact, that the Government is either unwilling or dare not meet the cost of public expenditure out of taxes, which crowd-out private consumption.[2] Instead, the Government chooses to force its way into the credit market and obtain credit financing of public expenditure. In this way the Government crowds out private investments and private consumption, but, in a more indirect and less obvicus way than if tax increases were to be adopted. The only cure is a reduction in the budget deficits.

What is the position in the "basket-currency" countries?

Even with the extremely unpleasant estimate for the commercial banks, which has been presented here, there will be an increase of at least about 12--15 % in the money stock. How serious is then such a development? Sweden maintains a fixed rate of exchange against a basket of currencies of 15 countries. This means that we have chosen to try to maintain the same rate of inflation as a weighted average of these countries. If we are unable to do so over the longer term, the rate of exchange cannot be defended. One way of determining whether it can be done or not is to compare whether the expected rate of inflation in Sweden corresponds to the expected rate of inflation in that of our "basket friends". An indication of what the rate of inflation can be expected to be in the basket-currency countries can be obtained by making use of a forecast carried out by the Kiel Institute in March 1980. If the inflation forecasts for each of the 15 countries are aggregated with the weights of the basket of currencies, the foreign rate of inflation is obtained which we, in Sweden, must adapt ourselves to if the exchange rate is to be kept unchanged. For 1980 this is 10 %.

Development of GNP (volume, annual percentage development) and development in consumer prices (annual percentage change) in Sweden and abroad.

	GNP		CPI	
	Sweden	Abroad	Sweden	Abroad
1977	−2.1	3.0	11.4	8.7
1978	2.8	3.0	10.0	6.7
1979	4.5	3.0	7.3	8.2
1980*	2.0	0.3	13.0	10.0
1981*	1.0	0.5	10.0	7.8

Note. GNP and consumer price development abroad have been estimated as a weighted average of data for 13 countries. As weights, the Riksbank's basket of currencies has been used (excluding Finland and Spain). The appraisals for 1979 and 1980 are by the Kiel Institute.

*The figures for 1980 and 1981 = forecast.

Sources: Economic outlook, OECD, Kiel Institute of World Economics, Riksbank.

When the "international" rate of inflation is mentioned in public discussions, the OECD's rate of inflation is often given as a benchmark. However, a line of reasoning of this kind provides an example of a fallacy which, unfortunately, has been widespread since the breakdown of the Bretton Woods system in 1973. The reason why it is wrong is because, when a country has a flexible rate of exchange vis-à-vis us, its rate of inflation has little effect on our rate of inflation. For instance, when the United Kingdom had a rate of inflation of 20 %, Switzerland could have nil per cent because the pound sterling was devalued by 20 % vis-à-vis the Swiss franc. *As a first approximation, the rule is that the international rate of inflation which we risk importing is the rate of inflation in those countries with which we maintain a fixed rate of exchange.*

2) See Dahmén (1979) for an analysis of these and closely-related problems.

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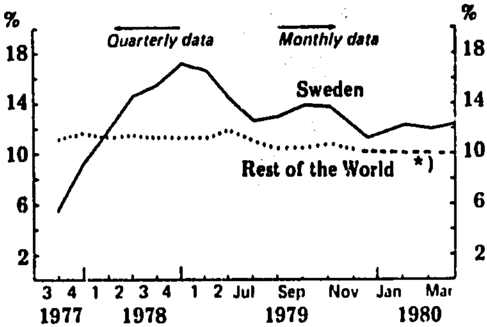
Figure 1. Development in the Swedish money stock in comparison with the rest of the world.
(Annual percentage change)



Note. M2 is defined as M1 plus quasi-money according to Main Economic Indicators. Development in the rest of the world constitutes a weighted average of development in those countries making up the so-called basket of currencies (excl. Finland, Holland, Belgium and Italy).

* The period November 1979 to March 1980 is forecast.

Sources: Main Economic Indicators, Riksbank, OECD.

In other words, it looks as if the Swedish rate of inflation will be much higher than that in the basket-currency countries. We shall, therefore, receive no assistance from these countries as regards extra scope for a certain over-expansion in Sweden.

However, there are other opportunities for obtaining a basis for appraising the scope for the expansion of the Swedish credit market. We know, namely, that another consequence of fixed exchange rates is that the money stock in Sweden in the short run will grow at approximately the same rate as the average of the countries with which we maintain a fixed rate of exchange. We then ignore the difference in the increase of production and the circulation. If we now add together the rate of increase in the money stock of these countries, we shall see the result in Fig. 1.

As will be seen, the Swedish money stock has been increasing faster than that of the rest of the world since the beginning of 1978. While we started with a lower rate after the devaluation in 1977, we have clearly exceeded their ceiling by several percentage points for more than two years. An analysis of this kind has, of course, any number of weaknesses. For one thing, a discussion must be pursued that is often slightly too partial. Money stock, foreign exchange reserves, inflation and production developments are all intricately interwoven. For another thing, it is risky to make forecasts of public authorities' and private individuals' actions. The goal is, however, not to provide exact numerical forecasts of each of the separate items, but to carry on a discussion that can form the basis of an assessment of the general trend over the next few years.

The conclusion to be drawn from the line of reasoning pursued so far is that the rate of inflation and increase in GNP in Sweden are well supported by the increase in the money stock, which, on account of the budget deficits, cannot be much lower. In comparison with developments in the basket-currency countries, developments in Sweden are far too expansive and their monetary policy tends, if anything, towards further restraint. It would appear to be difficult to reduce the Swedish money stock to less than 15 % at the same time as the trend of the money stock abroad is towards 10 % or lower. All this indicates clearly a weaker foreign position in the Swedish balance of payments.

Currency Crisis or Increased Borrowing?

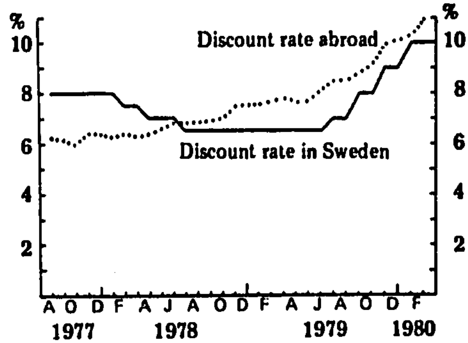
During the second half of 1979 the Swedish discount rate was raised at an unusually rapid rate and, in conjunction with the increase in January, 1980, the Governor of the Riksbank announced that there was no imminent danger and that the step had been taken mainly for precautionary measures for the future. In the short run everything would be all right, according to the Riksbank. This poses two questions of considerable principle importance. In the first place, our statistics of our foreign business are lagging behind to such an extent that, in the short run, we never really know whether the currency flow is of a short-term nature or whether it corresponds to change in the balance on current account. This makes it of greater importance to know how high the Swedish discount rate really should be in order to be able to counteract short-term capital outflows. The Riksbank is obviously of the view that the discount rate was more or less correct even before the January increase. But, how is a comparison really to be made? It has been said, at some time or other, that the discount rate should lie midway between that of the USA and that of West Germany. Instead, let us apply the same method as before and add together the basket-currency countries.

According to Fig. 2 it looks as if Sweden achieved parity with the discount rate in our exchange rate area only after the January increase. According to this method of calculation we have been falling behind ever since the middle of 1978. This method, too, is open to objections. For instance, it can be claimed that, owing to the strong position of the Eurodollarmarket as an alternative money market for the business sector, and, owing to the importance of New York and London as international financial centres, their discount rates ought to play a much more important role.

This would, in such case, indicate that the Swedish discount rate ought to be raised still further. Even from a more long-term view-point, where the rate of inflation has an important role to play, the fact that the Swedish level of interest rates must be in parity with that of the basket-currency countries must be taken into account.

Even if the Swedish discount rate were to be adjusted to the "correct" level to enable the short-term currency flows to be controlled, the more long-term trends mentioned earlier point toward a growing outflow of currency. Under the Bretton Woods System (1945—1973) it was not considered

Figure 2. The Swedish official discount rate in comparison with that abroad (August 1977 — March 1980)



Note: The discount rate abroad has been calculated as a weighted average of 15 countries' official discount rates: current basket currency weights have been used.

Sources: General Monthly Statistics, The Swedish Central Bureau of Statistics, Main Economic Indicators, OECD, Svenska Dagbladet (national daily newspaper).

the proper thing to do for countries to borrow money abroad in order to strengthen their foreign currency reserves. After the breakdown of the Bretton Woods System, and even more noticeably after the oil crisis, it has become increasingly common for various countries to raise loans abroad; one of them being Sweden, as is well-known. From a principle or theoretical viewpoint, this implies that a restriction on economic policy has been removed or more correctly has been modified and become more long-term.

Under the Bretton Woods System it was necessary to ensure that the stabilisation policy pursued did not become so expansive that an excessive decline began to take place in the foreign exchange reserves. Should that be the case, policy had to be rapidly reversed in a contractive direction. Today, the position is quite different. Nowadays, a country can go on year after year having a deficit in its foreign transactions, which is covered

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by means of new foreign loans.[3] Denmark has proceeded a long way along this path. Even Sweden has chosen to take the same path. In the absence of foreign loans in 1979, Sweden would certainly have had a foreign currency crisis. Now, there is nothing wrong, in principle, in borrowing abroad, but the question is how to choose a reasonable level of these loans.

Reasonable Level of Foreign Borrowing?

A couple a years ago a discussion flared up here in Sweden as to how large our foreign borrowing was and how high it should be. The discussion soon came to an end when the current balance of payments improved after the devaluations in 1977 without any definite conclusions having been reached. Let us resume the discussion and begin with one or two principle aspects.

Like private individuals and firms, the State can borrow to meet expenses which exceed revenues.

If borrowing takes place on a domestic basis, no increased net debt results for the country because taxpayers borrow from themselves. If, on the other hand, the State borrows abroad, the taxpayers' net debt is increased. When borrowing is undertaken because expenditure exceeds income, there is one of two reasons for doing so. In the first place, and this applies in particular to firms, borrowing is undertaken for the purpose of an investment which it is hoped will prove profitable, i.e. it will provide a return that will cover the interests and repayments on the loan as well as something extra. Even private individuals may sometimes undertake borrowing for investment purposes, but mostly for the other reasons, namely, to redistribute their consumption expenditure over time.

If the State borrows abroad, it is also mainly for one of these reasons. However, it may also be because of a desire to replenish the foreign exchange reserves or offset a private outflow of currency. We shall revert to this aspect of the problem later on. If the Swedish Government borrows abroad in order to achieve a few, very productive investments which otherwise would not be made, there is probably no one who would not encourage this type of borrowing. In this context it is usual to point to historical developments in Sweden and quote, as an example, our large foreign borrowing at the turn of the century. What is often forgotten is that Sweden was very lucky on that occasion because the loans were raised during a period of stable prices. This meant that the loans could be offered at a nominal price and at a relatively low rate of interest. The large inflation, in conjunction with World War I, subsequently drastically reduced the real value of these loans, which resulted in the repayments and interest being easy to meet since our export prices and incomes increased in step with the inflation. Even if we, in Sweden, now had productive investments which could justify borrowing abroad, our sacrifices in real terms would be considerably greater since the fixing of interest rates today includes compensation for expected inflation.

However, borrowing by the State during the 1970's has, above all, been of the other type, namely to redistribute consumption over time. When the oil crisis occurred, the Swedish State had not undertaken any foreign borrowing. The abrupt redistribution of income in favour of the oilproducing countries meant that they received a surplus of purchasing power which they were unable to absorb in the short run, i.e. they were unable to increase their demand for consumer and investment goods in step with the increase in income. As a result, they had a surplus in their balance of payments and an increase in wealth.

The other side of this equation was that the oil-importing countries recorded a deficit in their balance of payments. The rise in oil prices may be regarded as a rise in taxes for the oil-consuming

3) A country can thus have equilibrium on the credit market although the foreign currency reserves decline as long as sufficient borrowing is undertaken. In theoretical literature this case is usually called "quasi-equilibrium". See Myhrman (1978).

countries. For these countries it was, therefore, only natural, not to have to bear the adjustment to a lower level of income and consumption all at once, but spread it out over time by means of foreign borrowing.

As far as Sweden was concerned, the first step after the oil crisis was to compel private firms to obtain funds on the international loan market. However, after the non-Socialist coalition government came to power in 1976, the State, too, began to borrow abroad and this has since continued. And in 1979 the State borrowed more than 9 billion abroad. The total state loan amount at the end of 1979 was 20 billion. With this trend for the next few years, which has just been outlined, this borrowing must continue and foreign indebtedness will, therefore, increase still further. Should this prospect then give rise to a feeling of fear mingled with horror, or merely lead to a controlled calm?

The answer to this question is that it depends on how much we contemplate paying back. If Sweden had not reached its borrowing ceiling earlier, we should not need to repay all our loans in the future, but only that part lying above the ideal degree of indebtedness. In this case there is every reason to remain calm. The question is, however, if there is any ground why this optimal degree of indebtedness should not be nil. For a private individual a permanent degree of indebtedness may be optimal owing to inflation and the construction of the taxation system.

For a country the problem is different. The desire to borrow or the demand for savings depends on the profitability of the available investment projects. The supply of loans or savings depends on the public's general habits of thrift. The difference at a certain rate of interest indicates whether there is a surplus or lack of savings. In the long term the rate of interest behaves so that the demand for and the supply of savings are in balance. In a country with plenty of profitable investment opportunities in relation to the thrift habits, the rate of interest at which demand and supply balance will be relatively high and a scarcity of capital is said to exist. Where there is a state of completely free trade, capital will move to the country with a scarcity of capital. The rate of interest will thereby fall in that country and rise in the lender country and a tendency towards equalisation of interest rate levels will occur. As circumstances are today, it is, above all, in the Third World countries that a capital scarcity exists and the flow of loans runs mainly from the developed countries to the developing countries.

For a rich industrialised country there appears to be no acceptable reason for borrowing real resources from other countries on a permanent basis.

If, therefore, there are no grounds for permanent Swedish borrowing from abroad, there are several grounds for temporary indebtedness. Assume that the Swedish economy were to get into a serious state of imbalance with a growing current account deficit as a consequence as, for example, in 1976—1977. In such a case it may be rational to borrow abroad to cover the deficits. The advantage of such a policy is that the domestic adjustment, which must occur before the current balance is corrected, can be spread over a longer period and that it need not, therefore, be so abrupt and costly.

Another example are the large oil-price rises of 1973 and 1979. Since, in the short run, the oil-producing countries do not have time to absorb the large increases in income by means of sufficiently large increases in consumption and investment, they will have a joint current account surplus vis-à-vis other countries. During the first transition period, it is, therefore, advisable for all parties concerned with increased lending from the oil-producers to the oil-consumers.

The discussion pursued so far has arrived at the conclusion that there may be strong grounds for foreign borrowing in the event of disturbances to Sweden's economy. Since borrowing of this kind is of a temporary nature, interest and repayments will be paid on these loans in the future. This means that some time in the future the domestic consumption of resources must be restricted in order that the current balance will produce adaquate surplus. In view of today's situation in Sweden and the prospects for the next few years as they have been described in this article, the following conclusion may be drawn: If something is not done to reduce the Government budget deficit, it will be impossible to avoid a current account deficit and increased foreign borrowing. This will not, however, solve the problem; it will merely postpone the demand for an adjustment of the domestic consumption of resources until later in the future. The question is then just how far are we entitled to put it off without taking into account those who will be responsible in the future for the adjustment and repayments.

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