**Problems with rule-based economic policies**

Short-run costs

Short-run price rigidity and production losses

Short-run wage rigidity and unemployment

Hysteresis and long-run unemployment

“In the long run we are all dead”

No fail-safe decision rules

 Demand vs. supply shocks

 Nominal vs. real shocks

 Permanent vs. transitory shocks

 Very big shocks

The problem of transition from accommodation to rule-based policy

**Financial crises and depressions**

Europe (ERM) 1992-93

Mexico 1994-95

South East Asia 1997

Russia 1998

Brazil 1999

Argentina 2001-02

USA (Subprime) 2008

Eurozone 2010

**The boom – bust cycle**

* Fixed exchange rate
* Domestic boom
* Rising interest rates
* Short-term capital inflow
* Turning point
* Short-term capital outflow
* Large deficits
* Depreciation
* Debt crisis
* Financial crisis
* Contractionary policy
* Mass unemployment

**Sweden’s road into the crisis**

Financial deregulation 82-89

Inflationary expectations

Negative real interest rate

Private debt accumulation

Rapidly rising asset prices

Construction boom

Domestic overheating

\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*

Real interest rate shock

**The real interest rate shock**

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Before** | **After** |  |
| **European nominalinterest rate** | **8** | **10** | **German unification** |
| **Depreciation expectations** | **2\_\_\_\_\_** | **4****\_\_\_\_** | **Cost crisis** |
| **Swedish nominal****interest rate** | **10** | **14** |  |
| **Tax deduction** | **-5****\_\_\_\_\_** | **-4****\_\_\_\_** | **Tax reform** |
| **Swedish nominal interest****rate net of tax** | **5** | **10** |  |
| **Inflation** **Expectation** | **-8****\_\_\_\_\_** | **-2****\_\_\_\_\_** | **Policy shift** |
| **Swedish real interest****rate net of tax** | **-3** | **8** |  |

**Consolidated private sector balance sheet**

Actual before shock (SEK bill)

|  |  |
| --- | --- |
| **Financial assets 6500** | **Debt 7000** |
| **Real assets 3500** | **Equity 3000** |
| **Total assets 10000** | **Total 10000** |

Actual after shock

|  |  |
| --- | --- |
| **Financial assets 6500** | **Debt 7000** |
| **Real assets 2500** | **Equity 2000** |
| **Total assets 9000** | **Total 9000** |

Desired after shock

|  |  |
| --- | --- |
| **Financial assets 6500** | **Debt 6000** |
| **Real assets 2500** | **Equity 3000** |
| **Total assets 9000** | **Total 9000** |

**FINANCIAL SAVING**

**(SEK Bill)**

 **(S – I) (T – G) (X – M)**

1990 -96 57 -39

1991 -13 -16 -29

1992 61 -112 -51

1993 148 -177 -29

1994 164 -158 6

1995 168 -133 35

1996 82 -42 40

1997 71 -24 47

1998 45 12 57

∑ 739 -634 105

**The Swedish depression in the 90’s**

A high price for getting rid of accommodation policy expectations

Origin of depression: Private balance sheet adjustment

Budget deficit: A passive reflection of private debt reduction

A portfolio shift: “Sustainability” no issue

Sweden was not “living beyond its means”

No increase in net foreign indebtedness

Public sector a temporary “parking space” for excess private debt

No major problem for the public sector to take on increased debt

The alternatives were much worse