Monetary policy and inflation in times of war

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When major and unusual events such as a war occur, there is no 'manual' for how to act as an economic policy-maker. All wars are different – in terms of their scale and duration, their location and their impact on the world around them. Instead, one must try to find parallels with previous historical episodes and study the research literature on the economic consequences of war to see if it is possible to find common denominators. It is clear, however, that war often leads to higher inflation in one way or another. In this article, we will first briefly review what research literature has to say about the connection between war and inflation. Then we will take a look back at earlier episodes when war was associated with rising inflation in Sweden, and draw some conclusions from this.

1 Introduction

In February 2022, Russia invaded Ukraine. The consequence has above all been great human suffering and the invasion has become a further strain on the world economy. However, this article does not specifically deal with the war in Ukraine, but with war in general and its economic consequences. The focus is on the effects on inflation, as this is particularly important for a central bank.

In general, the empirical macroeconomist's method usually involves quantitative analysis based on time series for macro variables. The tool is typically econometric models with many observations. Fortunately, war does not occur very often, so there are few observations. This has two important consequences for the analysis of the links between war, inflation and monetary policy: Firstly, the time horizon must be long in order to obtain get a number of observations to study. But even with a long time perspective there are few observations. Secondly, the analysis is therefore by necessity qualitative rather than quantitative.

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2 War often leads to inflation

The fact that war and inflation often go hand in hand has been known for a very long time. Back in around 500 BC, Sun Tzu, Chinese general and author of a book on the art of war, observed:

"Where the army is, prices are high; when prices rise the wealth of the people is exhausted."[1]

What this refers to is, of course, that an army of perhaps tens of thousands of soldiers requires a lot of resources just to be able to feed itself and these can be difficult to raise in a geographically restricted area. Thus, demand rises in relation to the available supply of food and other necessities, and this causes prices to rise.[2] If, as has often been the case throughout history, the army supports itself by looting, it may be able to survive for a while, but for the civilian population, prices will rise because of a smaller supply. Of course, an army could not survive indefinitely in one place, because resources sooner or later run out. In his book "Ofredsår" ("Years of Trouble"), historian Peter Englund has likened the Swedish army during the thirty-year war 1618−1648 to a shark that must be constantly on the move to avoid succumbing (Englund, 1993).

Once a war had started, the armies of the time partly lived their own lives, separated from the state, and largely organised their own supplies, especially of course during campaigns abroad. Inflation therefore increased more locally depending on where the armies happened to be, as a result of the demand for food and other necessities exceeding supply.

2.1 Rising demand and printing money

When a country rearms and fights a war, inflation can also rise in the whole economy for the same reason, that is, that demand rises in relation to supply. A sharp increase in public expenditure as a result of rearmament or war effort increases capacity utilisation in the economy and can therefore lead to higher inflation. In connection with the Second World War, the US economy approached full capacity utilisation, which contributed to a rise in inflation. Some economists argue that it was the US rearmament that finally put an end to the 1930s depression.[3]

The way in which a state finances rearmament or war is also of great importance to the way in which inflation develops. The financing can entail the state increasing taxes, reducing other expenditure than military, raising loans or making the central bank print more money. If a war is financed by increasing taxes or reducing other expenditure, the purchasing power of the public will be reduced. This counteracts the inflationary effect of increased public expenditure. However, it can be politically

[1] Goldstein (2003).

[2] "Inflation" usually means a more sustained increase in the price level. If, for example, prices are raised to a new level but then they do not continue to rise, we are talking about 'one-off inflation', a concept which we will return to later in the article.

[3] See, for example, Vernon (1994). However, others, such as DeLong and Summers (1988), instead argue that the recovery was essentially completed even before the war.

difficult to raise taxes sufficiently.[4] The way that is usually politically easiest in the short term is through printing money. But in the longer term it is perhaps the most harmful, as it almost inevitably results in higher inflation.

A fairly large share of the literature on the effects of war on inflation is about the financing of war. A review of the effects on inflation of the United States' wars, from the American Revolution in 1775−1783 to the First Gulf War 1990−1991, shows that minor wars have usually been financed through higher taxes or increased borrowing or a combination of these (Rockoff, 2015). However, in the case of major wars, the point where these two methods of financing have been considered exhausted has often been reached, and the government therefore turned to the money printing press. The result has often been a considerably higher inflation rate.[5] The two world wars are examples of this.

After a war, sovereign debt has often increased considerably. At the same time, it may be difficult to raise tax revenue in the same way as before the war. This may be because the political situation has become more unstable or the economy's production capacity has declined.

In such a situation, there may be a great temptation for a government to try to alleviate the situation by using the money printing press to finance current expenditure and pay off the loans. Difficulties in generating sufficient tax revenue are considered to be an important explanation for the use of the money printing press in countries such as Germany, Austria, Hungary, Poland and Russia after the First World War, thus resulting in high inflation there. Financing through the printing press also led to the largest hyperinflation in modern times, that in Hungary in 1945-1946.[6] According to some estimates, prices at their fastest then doubled in fifteen hours (Hanke and Krus, 2012).

2.2 Inflation often also rises in the rest of the world

The factors we have mentioned so far are those that can contribute to higher inflation in countries that are, or have recently been, directly involved in a war.

But war can also cause higher inflation in the rest of the world. The war itself can generate increased demand on the world market for various products such as oil and certain metals. The warring countries can also be important exporters of some commodity or product which they can no longer produce or export as a result of the war. The latter results in lower supply and higher prices on the world market. Examples include the increases in oil prices that arose in connection with, for

[4] For example, Hamilton (1977) notes the difficulties for the US administration in obtaining taxes to finance the American War of Independence 1775–1783: "Our revolutionary ancestors were willing to fight … for [the] country; but hardly anyone was willing to pay taxes for it." (p. 14). Hall and Sargent (2022) compare US funding for 'three World Wars', where the third world war refers to the war against COVID-19. They find that tax financing was considerably lower during the coronavirus pandemic than during the First and Second World Wars.

[5] The Vietnam War is an exception, to the extent that it can be described as a minor war. Part of the funding then came through printing money.

[6] Bomberger and Makinen (1983). Another possibility is that the government simply refuses to pay its debts, which is of course associated with major problems with regard to future confidence.

example, the Yom Kippur war 1973, when the oil-exporting countries in the Arab world decided to cut their exports, and the war between Iraq and Iran that started in 1980. Following Russia's invasion of Ukraine, rising energy and commodity prices have been an important explanation for inflation rising globally.

War can also force many people to flee, which requires increased public spending in the countries where the refugees are received. This may have some effects on inflation in the recipient countries. The most pronounced example of huge waves of refugees is, of course, in connection with the Second World War. A more recent example is the people who fled from the war in Syria, and we are now seeing a similar development as a result of the war in Ukraine.

A war could also greatly increase geopolitical uncertainty, which may mean that countries not directly involved in the war choose to arm and increase their public spending. However, greater uncertainty about the future may also mean that the private sector chooses to postpone investment and increases its precautionary saving. There are thus counteracting effects on aggregate demand and thereby on inflation.

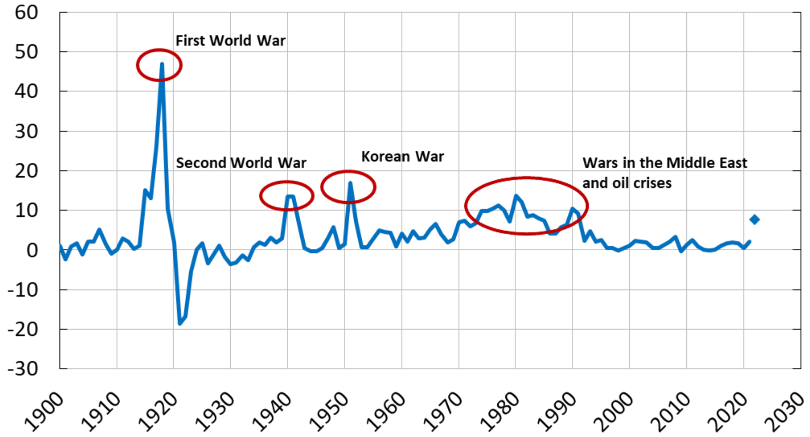
All in all, there are a number of different ways, both on the demand and supply sides, in which war can lead to inflation rising, both in individual countries and in the world economy as a whole.

3 Four periods of high inflation since the year 1900

The fact that war leads to inflation becomes quite clear when studying a longer time series for inflation. Figure 1 shows inflation in Sweden from 1900 onwards.

Figure 1. Swedish inflation 1900-2022

CPI, annual percentage change



Note: The dot for 2022 refers to January-October.

Source: Statistics Sweden.

There are some occasions when it has been higher than 10 per cent, sometimes much higher. All of them occur in connection with war or some other type of conflict. A few periods have short-term peaks, where inflation rapidly falls back again, while inflation in the 1970s and 1980s was fairly high over a longer period of time. Although inflation did not always exceed 10 per cent, we have chosen to regard the latter as a continuous period.

We intend to go through each of these periods – why inflation rose, why it fell back again, and how economic policy-makers thought and acted.

3.1 Highest inflation in connection with the First World War

The inflation during the First World War is by far the highest in the whole period and peaked in 1918 at 47 per cent. This episode is also special because the high inflation was followed by a severe deflation, that is, a fall in the general price level, 1921−1923. Fortunately, we have not experienced any such dramatic fluctuations in inflation since then.

In his book "Money and Power" on the history of the Riksbank, Gunnar Wetterberg notes that at this time the Riksbank's governors were faced with a series of questions that neither they nor most other scholars knew how to deal with. The war and the first post-war years thus became a difficult time for monetary policy (Wetterberg, 2009, p. 256).

The organisation of the monetary system played a major role in the course of inflation. Prior to the war, Sweden had a gold standard, which had been introduced in 1873 in connection with the establishment of the Scandinavian monetary union. The gold standard meant that the krona was linked to gold and that the Riksbank had an obligation to exchange notes for gold at a fixed price. This meant that the krona had a fixed exchange rate against other countries with the same system. The gold standard was abandoned in connection with the outbreak of war in 1914, because in the uncertain times, companies and individuals began to exchange their banknotes for gold on a large scale. The same thing happened in other countries.

In the countries directly involved in the war, the war efforts required rapid and immediate funding. Budget deficits grew and were financed by the government borrowing from the central bank, that is, through printing money. The money supply and price level thus rose sharply around the world. The war and international rearmament caused the demand for Swedish products to rise dramatically, and the increased exports gave a considerable boost to the economy. Swedish inflation toward the end of, and shortly after, the war has been described as a classic price, wage and profit spiral in an environment with growing access to money and bank credits, speculation and a shortage of fuel, commodities and labour.[7]

The Riksbank was thus rather uncertain as to how it should act. At this time, it was mostly academic economists who believed that one could slow down inflation by raising the discount rate, the period's equivalent to today's policy rate, while the Riksbank was more hesitant (Lundberg, 1983, p. 56). The fact that economic policy-

[7] Lundberg (1983). The introduction of the eight-hour day in July 1920 contributed to the shortage of labour.

makers did not share the view that the interest rate can be used to influence inflation was not, of course, a good starting point and in itself a partial explanation for the fact that inflation could rise so sharply.

An interesting, but perhaps not so well-known, event during this period was that Eli Heckscher, professor at the Stockholm School of Economics and internationally renowned national economist, actually caused a bank run at the Riksbank in 1920.[8]

Although the inflation peak had passed, inflation at the beginning of 1920 was still so high that Heckscher thought that the Riksbank should raise the discount rate significantly. When the Riksbank did not want to do this, Heckscher decided to do something about it.

The right to exchange notes for gold had ceased in connection with the outbreak of the war in 1914, but was reintroduced in 1916. However, since an export ban on gold had been introduced in 1914, this did not mean in practice that the gold standard had been re-established. The export ban allowed the gold price to differ between countries and the value of the krona to change against other currencies. This was also the case as the krona depreciated against the dollar.

At the US Federal Reserve, the price of one kilogram of gold in the depreciated Swedish currency was SEK 3,600 at the beginning of 1920. At the Riksbank, the price of one kilogram of gold was instead SEK 2,480. *If* the export ban were to be lifted, then a considerable arbitrage gain could be made.

Heckscher decided to draw the general public's attention to this fact and did so through an article entitled “Den nya prisrevolutionen” (The new price revolution), published in the daily newspaper Stockholms Dagblad on 11 March 1920. The article was more or less an explicit encouragement to readers to withdraw their money from the bank and go to the Riksbank to redeem it for gold:

“Anyone who brings SEK 1,000 in banknotes to the Riksbank has the legal right to receive 50 20 kronor pieces and these currently have a value of SEK 1,450. It is true that the amount cannot be realised immediately, namely not as long as the gold export ban remains, or the gold content of the Swedish currency is not officially reduced. However, 45 per cent profit on the most risk-free among investments is worth quite a long wait.”[9]

The ‘pieces’ that Heckscher referred to were the gold coins denominated in SEK 20, which existed at that time. Indeed, the result was an onslaught of people wanting to redeem their banknotes at the Riksbank, which was therefore forced to raise the discount rate to increase the yield on alternatives to redeeming banknotes and thus defend the gold reserve. In connection with this, the Riksbank requested release from the obligation to redeem banknotes for gold, which was subsequently also granted.

[8] See, for example, Fregert (2013) and Hasselberg (2021).

[9] Heckscher (1920).

3.2 ...but it was also followed by deflation and recession

However, shortly afterwards, the price trend was reversed. There were various reasons, including the weakening of international economic activity. But the most important reason for the severe turnaround in general prices was connected with the view of the monetary system that prevailed at the time.

The political view was that Sweden should return to the gold standard as soon as possible, and to the parity that had applied before the war. To make this possible, the krona needed to be strengthened, which required bringing down prices and wages (Wetterberg, 2009, p. 270). It was therefore recognised that a period of deflation would be required.

Knut Wicksell, perhaps Sweden's most famous economist, was among those who argued that the gold standard should not be reintroduced, but should be abandoned for all time. He argued instead for a free standard, without any metallic base (Wetterberg, 2009, p. 271). On the other hand, he too seems to have supported the idea that the price level needed to be lowered and that this would not cause any major problems, given that the policy was expected (Boianovsky, 1998).

Swedish monetary policy became more restrictive than in other European countries and in the United States. The tightening caused real interest rates to rise sharply and the economy to enter a recession. In 1924, Sweden was the first European country to return to the gold standard at the pre-war parity. However, the cost of deflation in the form of unemployment and stagnation had been extremely high, and this undermined confidence in the gold standard as a monetary system (Jonung, 2000).

3.3 Second World War and Korean War gave short-term inflationary peaks

At the time of the Second World War, economic policy-makers were determined not to repeat the mistakes of the First World War. Extensive regulations such as currency regulation and rent regulation were introduced early on to dampen expectations that inflation would rise sharply.[10] Nevertheless, inflation rose quite a lot during the first years of the war, but in 1942 the government approved a programme drafted by a specially appointed commission. The main objective of the programme was to stabilise prices and the most important means of doing this was a general price and wage freeze. Interestingly, the commission did not include the interest rate in its report when discussing means of influencing economic activity and inflation. The view at this time too was that the interest rate should mainly be regarded as a cost factor, especially from a political point of view.[11]

[10] See, for example, Jonung (2017).

[11] Wetterberg (2009), p. 314. The Social Democratic Government's post-war policies were focused on full employment and keeping interest rates down, known as low interest-rate policy. Instead, fiscal policy would steer economic activity. The Riksbank opposed the low interest-rate policy and Riksbank Governor Ivar Rooth tendered his resignation in 1948.

This policy was much more successful than that conducted in connection with the First World War. There was no post-war recession, and the inflation peak was short-lived and was not followed by any appreciable deflation.[12]

Developments during the Korean War in 1950–1953 followed the same pattern, with a high but short-lived peak in inflation. The upturn was preceded by a devaluation against the dollar in 1949, which Sweden and a number of European countries carried out to meet the competition from American industry. After the outbreak of the war, international inflation rose sharply. The price increases on commodities were particularly high. Profits in the Swedish manufacturing industry rose markedly and resulted in a price and wage build-up process, where wage costs rose by at most about 20 per cent a year.

The Minister of Finance at the time, Per Edvin Sköld, took a number of measures: Excise duty on sales of cars was raised, building regulations were tightened, the forest industry had to deposit some of its large profits in special accounts and an investment tax was introduced (Åsbrink, 2019). The interest rate was also raised by half a percentage point, which, according to a modern yardstick, may seem rather modest given the circumstances. Altogether, this meant that inflation was short-lived on this occasion too, and it is also known in the history books as 'one-off inflation'.

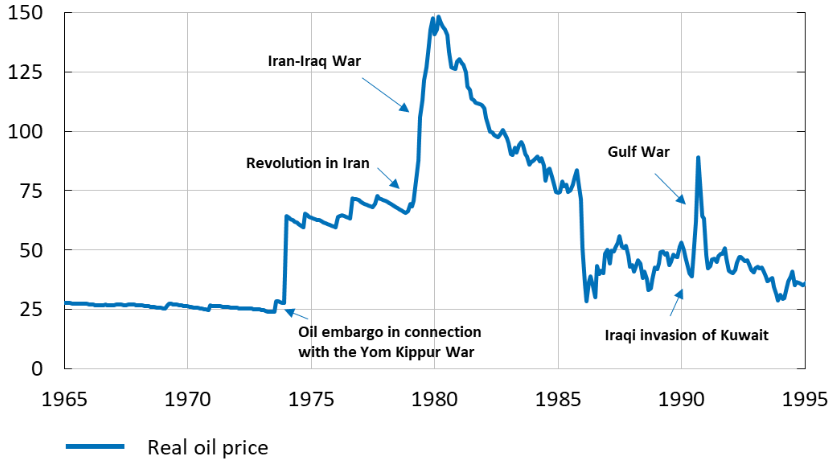
3.4 Expansionary policy during the most recent inflation period

As for the longer period of high inflation from the early 1970s, the link to war is not as obvious as in the previous episodes, but it is there in the form of several wars and conflicts in the Middle East that affected the price of oil (see Figure 2).

[12] According to Statistics Sweden's annual statistics, inflation was –0.4 per cent in 1944 and 1945.

Figure 2. Real oil price

USD/barrel



Note: Real prices have been computed with the CPI October 2022 in United States.

Sources: U.S. Bureau of Labor Statistics (BLS), U.S. Energy Information Administration and the Riksbank.

The two oil crises in 1973–1974 and 1979–1980, often referred to as OPEC I and OPEC II, play quite an important role in this process. OPEC I was preceded by the so-called Yom Kippur War of 1973 between Egypt and Syria on the one hand and Israel on the other. OPEC II is linked to the revolution in Iran in 1979, which led to a significant loss of oil production that was not matched by the other oil-producing countries. When Iraq then invaded Iran in 1980, the situation became even worse. The price of oil also rose, but very briefly, when Iraq attacked Kuwait in 1990.

However, the policy that was conducted during this period also played a significant role. It became, for various reasons, on average too expansionary or, as it is called, too accommodative. In economic textbooks, this period of high and long-term inflation in the world is known as 'The Great Inflation'. This usually refers to the period 1965−1982, where the 'the Volcker disinflation', the tight monetary policy conducted by then head of the Federal Reserve Paul Volcker to curb inflation in the United States, is regarded as the endpoint.[13] For Sweden, it is more appropriate to refer to a period that both starts and ends about ten years later.

The Swedish economy was wrestling with serious economic problems during this period. Perhaps the main concern was the strong domestic inflation trend with price and wage spirals that collided with attempts to maintain a fixed exchange rate, and therefore led to recurring cost crises and devaluations. Another reason, which was partly connected to this, was that fiscal policy was often too expansionary, with rapidly rising public spending and tendencies toward structural deficits as a result. In addition, there was a deregulation of the credit market in the mid-1980s, which would

[13] Drechsler et al. (2020) provides an alternative explanation for 'the Great Inflation' in the United States, which is based on the failure of the monetary policy transmission mechanism. A special law, Regulation Q, imposed a ceiling on the banks' deposit rate. When the Fed raised the interest rate to slow down inflation, this ceiling meant that the interest rate changes made no difference for most people. When Regulation Q was lifted at the end of the 1970s, monetary policy once again had an impact and inflation fell.

lead to far greater problems than were anticipated when the reform was implemented (Economic Commission, 1993).

On the international arena, the German reunification in 1990 created a local German economic boom and inflation that caused the Bundesbank to raise its policy rate. This attracted large amounts of capital to Germany as investors in other countries sought the high return on the German capital market. This in turn increased the tensions within the European exchange rate mechanism, the ERM. Other countries were forced to raise their policy rates to maintain the exchange rate parities, despite the fact that this worsened the already weak economic activity there. In addition, in Sweden, the tax reform of 1990–1991 made borrowing more expensive. From having been negative, the real interest rate rose in a short time to around 5 per cent, in what has been called the 'real interest rate shock'.

In the early 1990s, this contributed to a severe economic downturn in the Swedish economy, which also coincided with a financial crisis largely caused by excessive lending to households and companies. Unemployment rose sharply and public finances deteriorated dramatically. The krona was put under strong pressure by investors who expected Sweden to devalue again soon and, in November 1992, the Riksbank was forced to give up its defence of the fixed exchange rate.

It had become clear that the type of policy Sweden had pursued for a number of decades had reached the end of the road, and needed to be fundamentally reshaped. Instead of defending a fixed exchange rate, the task of monetary policy from now on would be to keep inflation low and stable around 2 per cent. For its part, fiscal policy would focus considerably more than previously on keeping public finances in good condition so as to maintain market confidence. Looking back now, 30 years later, we can see that the restructuring was successful. We have not had any problems with excessive inflation since then, until recently when inflation has once again risen towards the levels from the 1970s and 1980s. The problem has usually been the reverse, that is, that inflation has been lower than the target.

4 Some conclusions from the history of inflation

So what conclusions can be drawn from this review of Swedish inflation history since 1900? One conclusion, which was also in some way the starting point, is that inflation tends to rise in connection with war, and that this also applies in countries like Sweden, which has been fortunate not to be directly involved in any war during this period.

Another conclusion is that the first three inflation peaks in the 1990s were so short-lived that expectations of higher inflation in the longer term were never built into price- and wage formation.

A third conclusion is that the reason why high inflation *was* so short-lived on these occasions was either that politics became too tight and caused a severe recession, as in connection with the First World War, or that inflation could be parried by far-reaching regulation and direct control of price-setting and wage-formation, as in connection with the Second World War and the Korean War. However, such tools have proved to do more harm than good in the long run, and are therefore in principal discarded from the political toolbox.

It is sometimes said that economic policy-makers often base their actions during a crisis on the interpretation of the previous crisis (Jonung, 1999). This means that one sometimes gets things wrong and tends to 'fight the last war'. But if we are at the beginning of something that turns out to be a longer period of lastingly higher global inflationary pressures, it is the last period of high inflation, during the 1970s and 1980s, from which we have the most to learn. That is our fourth conclusion.

5 More difficult for monetary policy to deal with supply shocks

For our continued reasoning, we need to refer to some economic theory. An economy is constantly exposed to what in economist speak are called shocks, which in principle refers to a rapid and unexpected development. Some shocks are positive and imply, for example, that economic activity improves and unemployment decreases. Other shocks are negative and lead to recession and higher unemployment. Shocks can be divided into demand shocks and supply shocks, depending on whether demand or supply is developing unexpectedly.

The economic impact of the war in Ukraine can be described as what textbooks call a negative supply shock. This means that activity in the economy is declining, *at the same time* as prices are rising. In other words, the effect will be stagflationary, that is, we will have a combination of lower growth and upward pressure on inflation.[14] Earlier examples of negative supply shocks are the oil crises in the 1970s. In addition, the war in Ukraine was preceded by another supply shock – the pandemic – when large parts of the world economy closed down and distribution chains were broken. As described earlier, war does not always entail a negative supply shock. In connection with the Korean War, for example, there was talk of the 'Korea boom', because inflation was then largely due to increased *demand* for Swedish goods and it increased economic activity and inflation.

For a monetary policy decision-maker, supply shocks are more difficult to deal with than demand shocks. If inflation rises because demand has risen unexpectedly, the remedy is simple: The central bank raises the policy rate and thus suppresses both inflation and demand, thereby reducing the risk of the economy overheating.

[14] There is broad agreement among economists regarding this conclusion. The IGM Forum at Chicago Booth regularly asks a panel of leading economists in Europe and the United States to what extent they agree or disagree with different statements. The survey published on 8 March included the following statement: 'The fallout from the Russian invasion of Ukraine will be stagflationary in that it will noticeably reduce global growth and raise global inflation over the next year'. A very large majority agreed, while nobody thought that would not be the case. The European panel's responses are presented at https://www.igmchicago.org/surveys/ukraine/ and the American at https://www.igmchicago.org/surveys/ukraine-2/. The results are summarised by Vaitilingam (2022).

But if inflation rises as a result of a negative supply shock, the problem is more complex. If most people assume that the effect on inflation is transitory, the problem does not need to be so great. The central bank can then simply wait until inflation falls back. However, one risk that is always present is that price impulses spread to other prices and start to affect economic agents' expectations. These may then expect inflation to remain high, or even rise further. What we have seen in Sweden and other countries recently is that the inflation impulse that was initially mainly supply-driven has started to spread in the economy and caused the more underlying inflation to rise.

This creates a tricky balancing act for monetary policy: At the same time as one wants to maintain confidence in the inflation target and prevent inflation from becoming entrenched at a high level, one wants to avoid pursuing a policy so tight that the economy enters a deep recession. As we saw, this was what happened after the First World War, although the motive then was to return to the previous *price level* rather than bring down inflation. To be a little drastic, one can say that the task facing the central banks is to avoid 'The Great Inflation 2.0', and to do so at the lowest possible cost in terms of lower production and higher unemployment.

6 The conditions are better than before

The conditions for coping with this balancing act are quite good for Sweden and at least considerably better than they were when inflation began to rise in the mid-1970s. There are several reasons for this.

Firstly, in 1993 we decided to adopt an inflation target in the Swedish economy. During the most recent period of lastingly high inflation in the 1970s and 1980s, the idea was that inflation would be kept down by means of the fixed exchange rate. The fixed exchange rate was expected to have a disciplinary effect on price-setting and wage-formation, as excessive inflation in relation to the rest of the world would lead to difficulties for the export industry and increased unemployment. However, as we noted earlier, this did not work very well. Expressed in economist terms, there was no credible nominal anchor in the economy, that is, a clear, quantified benchmark for price-setting and wage-formation. Today, we have one in the form of the inflation target. During the period of inflation targeting, long-term inflation expectations, in the way we can measure them, have remained fairly stable at around 2 per cent.

This does not, of course, mean that the Riksbank can sit with its arms folded when inflation rises and expect inflation to return to the target 'by itself'. The fact that long-term inflation expectations are firmly anchored to the target is because economic agents *expect* the Riksbank to act when needed. The fact that there is a credible nominal anchor today of course makes things easier, even though the outcome ultimately hinges upon the way monetary policy is conducted.

Secondly, Swedish wage-formation works in a completely different way than in the 1970s and 1980s. One important reform was the so-called Industrial Agreement, under which the manufacturing industry has set the benchmark for wage negotiations and ultimately steered wage cost increases in the entire economy for over twenty years. In this way, international competitiveness is taken into account when Swedish wages are set. The relationship between this benchmark and the inflation target has not always been crystal clear. For instance, employers' representatives have sometimes expressed the view that the inflation target is outdated and should not be used as a base in wage negotiations. However, this was during the extended period when inflation tended to be at the lower end of the target. However, as developments now show, we must assume that inflation will sometimes be above the target as well. Hopefully, this will further underline the importance of the inflation target as a nominal anchor for the Swedish economy, both upwards and downwards, so to speak. Should it now be the case that we are entering a longer period of lastingly higher inflationary pressures – which we do not know yet, of course – then our assessment is that the forms of wage-formation we have today will act as a built-in and useful brake in the system when it comes to counteracting a wage-price spiral.

Thirdly, a stricter and more robust fiscal policy framework was introduced after the 1990 crisis. This has contributed to public finances now being in a much better shape than they were in the 1980s and 1990s. A large and growing sovereign debt may raise inflation expectations, if agents suspect that the government may eventually try to solve the problem of sovereign debt by inflating it away. What this means is that the central government reduces the real value of the debt by letting inflation rise. However, unlike in the 1970s and 1980s, we now have a number of control mechanisms in place, which means that this potential source of excessive inflation has in practice been eliminated.

It is nevertheless important that fiscal and monetary policy interact in a proper way. When monetary policy is tightened to bring inflation down, there may be reason to pursue a targeted fiscal policy that seeks to mitigate the negative consequences for households and companies that are particularly affected by the weaker economic conditions. It is however important to avoid broad fiscal stimulus measures, as they may drive up aggregate demand and make it necessary to raise interest rates even further.

During the past year, inflation has risen to higher levels than ever during the period with an inflation target. In that sense, it is the first time that inflation targeting policy has been put to the test 'on the upside' in earnest. However, it is also true that we now have an economic policy framework in place that provides favourable conditions for dealing with the situation.

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