

The Swedish economy's future path

Speech by Mr Urban Bäckström, Governor of the Sveriges Riksbank and Chairman of the Board of Directors and President of the Bank for International Settlements, to the Association of Swedish Chambers of Commerce & Industry, Stockholm, on 8 November 2000.

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First of all, a word of thanks for the invitation to discuss the economic situation in Sweden with you. As I see it, there are a number of dimensions to our economy's favourable development at present. Today I will be considering some of them, as well as the challenges facing the Riksbank.

Globalisation has created a new economic environment

Conditions in general for the Swedish economy, and for the environment in which Swedish companies operate, have changed in major respects. I am referring, of course, to the globalisation that has swept over the world in recent decades, leading to more international trade, increased competitive pressure and growing cross-border capital flows. Today people can travel and work all over the world. With the removal of barriers, countries have become increasingly interdependent.

These developments have benefited the international economy and raised living standards for many people throughout the world. In the course of two decades, the global level of per capita purchasing power has more than doubled. The improvement has occurred in developing countries as well as in the industrialised world. It is generally true to say that never before have things become so much better so quickly for so many people as they have during the past twenty years of globalisation. Take Asia, for instance, where six persons out of ten were living in absolute poverty in 1975, while today the proportion has fallen to two out of ten. This positive picture is reinforced by statistics on other parts of the world. Studies show that in twenty years, countries with a liberal trade policy have become six times more prosperous than countries where policy has been more protective. This illustrates the potential conferred by economic integration. We must, however, bear in mind that all the problems are far from being solved. Still, globalisation has contributed to growing prosperity throughout the world.

The economic processes created by globalisation have been accentuated by many of the impressive innovations we have seen, in computer technology and telecommunications, for example. The new technologies in turn are providing additional facilities for further internationalisation. Measures for making economies function more efficiently are being taken in many quarters to benefit from the opportunities that internationalisation offers.

The ongoing integration can be described as the second wave of globalisation in economic history. Before the crises in the 1930s and particularly before World War One, there was a period characterised by openness, increased cross-border trade and growing international capital flows. Major technical advances in the 19th century were introduced successively as the production of goods and services gradually become more modern. These developments peaked in the 1920, a period of high economic growth in many countries. Stock-market investors as well as consumers looked forward to rising future income. These expectations were broken, however, when the gains from the new technology, instead of leading to rapidly rising corporate profits, accrued mainly to the national economy in the form of a lower price rise and substantial real wage increases.

With the global depression in the 1930s, the move towards further integration was checked. A number of decisions to raise tariffs and prohibit international capital movements exacerbated the economic situation. This made the negative consequences for the global economy even more serious and the international economy landed in a deep depression. Developments in this period demonstrated that protectionism and closed doors are not conducive to higher living standards. After World War Two, some minor steps were therefore taken once more towards increased international cooperation. The deregulation of trade began in earnest in the 1950s and financial deregulation started in the 1970s.

Important breakthroughs in technology followed in their wake. All this heralds another favourable period of rising living standards in the countries that manage to reap the benefits. Turning now to Sweden, there are a number of parallels with developments here in the 19th century.

From a poor agrarian society to a wealthy industrial nation

In the early 19th century Sweden was still a poor country. Strategic social institutions were in a shaky state. The form of government was unstable, the payment system was rather chaotic and there was a general shortage of credit facilities. People who wanted to try something new found themselves restricted. Many saw no alternative to emigrating and trying their luck in America. It seems that more than a million people left Sweden for the new country in the west before the process of industrialisation began in earnest here.

Less than a hundred years later, at the end of the 19th century, the Swedish economy had undergone a dramatic transformation. Inflation was low and the payment system functioned properly. The country vibrated with energy in every sphere. An impressive number of new products were developed on the basis of Swedish inventions and many of them became world leaders. Swedish financial experts were involved early on in exploiting the innovations. More and more people found work, living standards rose and Sweden achieved one of the highest growth rates in the world.

When it comes to the causes of Sweden's rapid economic transformation, there are some differences of opinion. The industrialisation taking place elsewhere was probably a major factor. Another was the possibility of importing capital for large investments. Domestic reforms in key areas may also have helped create the conditions for growth.

Price stability was presumably of some significance. Low, stable inflation reduces uncertainty about the future for those who have to plan for the long term. Confidence in the commitment to price stability was gradually built up after parliament in 1830 decided to base the currency on the value of silver. Another important factor was probably the development of the credit system in the 19th century. Banks were established and financial know-how grew after interest controls had been abolished. This made it possible to finance industrial investment and exploit all the new inventions. An increasingly stable form of government no doubt also contributed to the transformation. The constitution was reformed by degrees and served to guarantee stability. Business enterprise benefited from the abolition of trade guilds, the freedom to trade and the introduction of joint stock companies. Another import measure was, of course, the introduction of compulsory education, which led in time to increased human capital.

This is not intended to be a complete account of all the factors behind Sweden's transformation from a poor country into a rapidly growing industrial nation. My point is that, if a number of institutional changes had not been made, the outcome would have been less favourable. These changes provided a stable framework for the process of industrialisation and ensured that our country could benefit from the ongoing globalisation.

Realignment of Sweden's economic policy

It may be asked whether the good growth at present can also be attributed to a realignment of Swedish economic policy. There are no doubt those who consider the political decision-makers could have gone further in this direction, just as there are others who think they have gone too far. I shall not enter that discussion but simply note that a number of important decisions have been made in the past ten to fifteen years.

They include the deregulation of credit and foreign exchange markets, the reform of the tax system, changes to components of the transfers system and the enhancement of competition. All this has helped the Swedish economy to function better. Moreover, price stability is now monetary policy's statutory objective and the Riksbank, now also formally independent, has been made accountable for this. Other steps, in the form of a far-reaching consolidation of the government budget, provide a stable and credible framework for this objective. As a further move in the new direction of economic

policy, Sweden joined the European Union in 1995. This opened up sectors that previously had been protected from international competition. Competition grew in many fields and prices for some goods and services began to be adjusted downwards towards European levels.

The economic policy realignment, which began some time in the 1980s, has coincided with larger changes in the global economic environment. The Swedish economy has therefore been in a position to benefit from the developments elsewhere and so far this has led to a favourable economic path.

The realignment of economic policy and the ongoing globalisation were accompanied in the 1990s by a rapid development of the new information technology, globally as well as in Sweden. The innovations have been adopted successively in various segments of our economy. The thresholds for establishing and operating companies have been lowered. Existing production processes can be made more efficient. The internet has made information more accessible and many firms can cut transaction costs. There is less need to hold large stocks that tie up capital.

The same applies to consumers, who can quickly search the internet for cheap goods and services. So far, however, prices on the internet differ relatively little from shop prices. But this will presumably change as the internet continues to be developed and usage rises.

Sweden, spearheaded by the telecom company Ericsson, is one of the countries where the IT sector is relatively large. This sector is also contributing a growing share of our annual output. But we are also one of the countries with a relatively high level of spending on the introduction of new information technology in various parts of the economy.

The introduction and development of information technology in Sweden has been facilitated by an efficient capital market, particularly as regards the supply of venture capital.

So, as I have tried to show, the favourable economic development at present has many aspects. But it should not be forgotten that the fundamental economic laws still apply, just as they did in the late 19th and early 20th centuries. That makes it important to prevent a build-up of imbalances that can create tensions and jeopardise a continuation of good economic growth and low unemployment. This brings me to the subject of stabilisation policy.

Strong economic activity

We can look back on several years of strong economic growth. This has occurred in an environment where price and wage increases have remained comparatively low even though the economic upswing is now in its seventh year, with annual GDP growth averaging around 3%. In recent years, annual demand growth has been in the region of 3 to 4%. A common, though not entirely certain, estimate is that in the long run the Swedish economy can sustain an annual growth rate of 2 to 2.5%.

So the economy has been expanding faster than the supply side can cope with in the longer run. This is liable to result in problems with bottlenecks. That in turn can generate growing tensions and accelerating rates of price and wage increases. In the worst case, the result could be a recession, with falling output and rising unemployment. It goes without saying that that must not happen. The Riksbank is required by the Riksdag (Sweden's parliament) to "*maintain price stability*", which involves ensuring that the rate of price increases is kept stable around the 2% target. If we can manage this and take timely measures that prevent imbalances from arising, economic growth will normally follow the long-term trend.

As the economy has been expanding above its sustainable rate, the spotlight falls on the amount of unutilised resources. When resource utilisation is liable to generate upward pressure on prices, the economy must wind down from the strong upward trend to a stable rate that is more sustainable.

A rapidly expanding economy is liable to encounter bottleneck problems because new production facilities are not always available just when demand is rising. Experience from the 1990s suggests, however, that firms are more flexible than they used to be. This applies both to the utilisation of the existing capital stock and to investment in machinery and plant and the introduction of new

technology when demand does pick up. The amount of unutilised capital resources may therefore not be the important factor at present.

Instead, an analysis of the amount of unutilised resources in the Swedish economy should probably focus on the labour market. Another reason for this is that in a macro analysis of price trends, wages are the largest component of costs, being equivalent to over two-thirds of GDP.

In an economy that is moving closer to full resource utilisation, one can accordingly expect certain phenomena to occur with a greater intensity and frequency. This refers, for instance, to companies reporting difficulties in recruiting competent labour. It can also take the form of a greater propensity to resort to disputes, both regular strikes and unlawful action. Firms are also forced to compromise when recruiting and employ less qualified personnel in order to cope with demand for goods and services.

The matching of job seekers with job vacancies has functioned better than expected and to date this year the wage statistics show increases that, if anything, are slightly lower than expected. During the past year, however, there have been certain signs of incipient tensions between demand and supply. Firms are already having difficulties in recruiting some categories of labour. Shortages have not yet reached alarmingly high levels in general but each measurement is higher than the previous one. Moreover, the situation is more strained in some parts of the country than in others.

It also seems to be considered that those in work have increased their negotiating strength. How else is one to explain that, according to the negotiating parties, wage demands in the coming round are higher than on the previous occasion? That at least is the picture which has emerged in recent weeks.

Could this be a sign that the Swedish economy is approaching the point at which the increase in wage costs begins to accelerate, albeit from moderate levels? If that is the case, it can be concluded that, if the present rate were to continue, the Swedish economy is moving towards a situation where resource utilisation will be unduly strained.

A gradual adjustment of demand to the long-term growth trend can result from a spontaneous slowdown in the economy, for instance because external demand slackens. It could also come from more subdued household demand for durable goods after the extensive purchases in recent years. Another possibility is a damper on demand from a diminishing effect of the positive supply shocks that have depressed prices and thereby benefited real wages.

To some extent there have been a number of signs of more subdued growth in the rest of the world, above all in the United States. Moreover, new statistics suggest that Swedish households are not quite as optimistic as before. Somewhat weaker car sales may be an indication of more subdued demand for durables. Asset prices also seem to be in a calmer phase. All of this may point to some slowdown in the development of demand. But is it enough? It is still a matter of forward indicators and we have not yet seen any clear outcome in the statistics. Neither does there seem to be any notable fall-off in labour demand. The number of new job vacancies continues to be comparatively high, at least to date.

In the absence of a sufficient slowdown in demand, an adjustment to the long-term growth path will need to be achieved with interest rate increases by the Riksbank. It seems to me that it is deliberations of this type that the Riksbank will face at the coming monetary policy meetings. Consideration will also have to be paid, of course, to the inflation risks associated with the high price of oil and the high dollar rate. These were some of the risks we highlighted in the October Inflation Report.

This type of discussion about the direction of stabilisation policy basically deals with how, after some favourable years in the late 1990s, we should act so that growth and employment in the Swedish economy can be sustainably high and stable. The Riksbank's assignment from the Riksdag requires that we do what we can to ensure this.