

## **Mr Bäckström gives his perspective on Sweden's economy and looks at factors that contribute to long-term growth**

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, given at the University of Gothenburg on 27 October 1999.

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A current topic, in the United States and elsewhere, is whether structural changes have made it possible to achieve stronger economic growth than before without generating inflationary tendencies. The term – a new economy – has been coined for this phenomenon.

The US economy's new, improved performance is sometimes said to be due in part to the rapid advances in computer technology and telecommunications. Internet is a part of this. Progress in these fields has led to better and more efficient processes for production and distribution. This in turn has paved the way for stronger competition, higher productivity growth and thereby lower inflation. Consumers, moreover, are better informed than they used to be.

Productivity growth in the United States does seem to have risen. The IMF, to mention one observer, considers that the potential growth rate – the annual growth that can be achieved without boosting inflation – has moved up from 2.25% to 2.75%. An even higher potential rate has been estimated by others.

In Sweden, too, most things suggest that labour productivity has risen somewhat faster in the present decade than it did in the 1980s. The shift may be in the order of one-half of a percentage point. This is the change that lies behind the common, but not entirely certain, estimate that nowadays the Swedish economy can maintain an annual growth rate between 2% and 2.5%. But Swedish data do not yet provide any definite evidence of an improvement in productivity, and hence in potential growth, that corresponds to what has happened in America.

It does seem likely, however, that the rapid advances in information technology will also have a major impact on future production and distribution processes in Sweden. Sweden is well to the fore in Internet applications. Still, when and to what extent these factors will affect growth in general is not yet clear.

But even though appreciable general economic consequences cannot be discerned at present, the tendencies are worth considering. Some parallels can perhaps be drawn with the situation over a century ago, when Sweden was being transformed fairly rapidly from a poor European country into a dynamic and strongly expanding industrialised economy. There are also lessons to be learned from developments in recent decades.

### **Monetary policy's task well defined**

The current monetary policy conclusion is unequivocal and there seems to be broad agreement about the task that monetary policy faces. So today I should like to discuss developments in the Swedish economy in a wider perspective that is not an immediate concern for monetary policy but may have to be considered some time after the turn of the millennium.

In order to formulate monetary policy, the Riksbank needs an approximate assessment of how rapidly the economy can expand without causing inflation to take off; in other words, an assessment of the long-term growth trend. This trend is affected by population changes, growth of the capital stock, technical advances and the efficiency with which the economic resources are utilised in production. These are not factors the Riksbank can control directly. So monetary policy has to use the repo rate to keep demand in line with the growth path the factors make feasible. That leads to stable, low inflation. If demand deviates from the growth path, inflation may be higher or lower.

A problem here is that the long-term growth path is not something that can be measured. In day-to-day monetary policy we therefore have to rely on various indicators and adjust the repo rate successively. It is consequently instructive to pause from time to time and study factors that contribute to growth's long-term path. That is what I shall be doing this evening.

### **Internet's 30th anniversary**

While many of us have woken up to the Internet only recently, it is now actually thirty years, almost to the day, since the Internet was born by linking up two computers, one at the University of California and the other at Stanford University. The project, designated Arpa (Advanced Research Projects Agency), was a part of the cold war strategy of creating alternative communications facilities.

That project, however, had little in common with today's world wide web. It had no pictures, links or e-mail. It was also cumbersome. E-mail was in fact introduced three years later but it was not until the turn of the 1980s that we got the world wide web, which is what we now think of when we talk about the Internet. That was what made it possible to click on a word and move quickly from page to page on the net. At much the same time it also became possible to dispense with complicated manuals and commands in favour of simple graphics and clicking with a mouse.

### **Introduction underestimated**

All forecasts to date about the spread of the Internet have been on the low side. In the United States it was 38 years before 50 million households had radio sets, while the intervals for television sets and cable television were 13 and 10 years. The Internet, however, had reached 50 million households after only 5 years and according to some estimates the number of users next year will be up around 160 million. But, as I said, the outcome has been consistently underestimated.

It has been said that whereas conventional telephony in Sweden is growing by 7% a year, traffic on the Internet is currently rising at this rate every week. It is not just that more and more people are subscribing; those who surf on the Internet are doing so more and more. The number of surfers is measured by Sifo Research & Consulting; the figures for September this year show that almost 3.5 million people in Sweden surfed, which is not quite half of the population aged 12 to 79. Of these, as many as 2 million stated that they surfed on a daily basis. Another noteworthy figure is that in the age group 50 to 79 years, almost 20% are active users of the Internet. So the Internet is not something that only young people find attractive.

Furthermore, Sweden is one of the absolute leaders in information technology (IT), both as regards Internet users and in broader terms such as the number of computers and mobile phones. In such surveys, the United States usually comes out top.

The Internet makes it simple to obtain information, communicate with others and trade in goods and services. Price comparisons are already feasible and one can buy some goods and services, not least bank services. In these ways the Internet cuts distances, overcomes borders, contributes to a more competitive environment and enables consumers to be better informed. Everyone can get the information he or she needs, easily and painlessly, often dispensing with intermediaries.

Besides affecting consumer behaviour, the Internet and information technology in general have consequences for production processes. In addition to more informed consumers, we have firms with a better oversight of production, material inputs, distribution processes and sales.

### **Internet compared with railways**

Simplifying somewhat, the advent of the Internet can be compared with the era of railroad construction in Sweden in the second half of the nineteenth century.

In the initial phase there was a boom for those who constructed the railways and manufactured rolling stock. In the closing decade of the century Swedish firms began to produce locomotives; previously

that had been the preserve of British manufacturers. The Swedish firms took over the domestic market and were even able to export their products. Much the same happened with the manufacture of passenger carriages and goods wagons.

Today we can see similar developments in the IT industry. Besides the giant, Ericsson, Sweden has many different IT enterprises. But growth is still being driven not so much by users of the new communication facilities as by the production of new possibilities.

To continue with the comparison, in the next phase people started to travel by rail. A journey from Stockholm to Gothenburg admittedly took 11 hours and 45 minutes in 1865, but that was nothing compared with a horse-drawn carriage. Travelling became quicker and more efficient; people gained new impressions and learned new things. Sweden became smaller.

Today we travel on the Internet by gathering information simply and efficiently from all over the world, largely for the price of a local telephone call. Millions of people in all parts of the world are indeed using this facility and in that sense the world has now become smaller.

The really important phase, however, was when railways began to affect processes for production and distribution. Previously, production in Sweden had been located in the vicinity of iron ore and forests. The units were numerous and not particularly efficient; transportation was slow. In the county of Värmland, for example, there were sixty different sites for the production of iron in 1870. When the railways had been constructed, it was easier to concentrate production to fewer sites; by around 1900 there were only six sites and they were accordingly considerably more efficient. This is just an example to illustrate how the railways played a major part in Sweden's industrial upswing in the late 19th century. Productivity and growth rose.

For the Internet, this phase of the process probably lies ahead. The new technology has not yet seriously altered either production and distribution processes or consumer behaviour. Progress is still a little hesitant as more and more people use the new technique for surfing and learn the new technology. The potential will also be limited as long as the technique is not entirely user-friendly.

### **IT generates pressure for change**

When the new information technology really catches on, it will probably lead to a rapid expansion and transformation of capital stocks. The entire economy will then be involved in intensive investment and high productivity growth. Old technology will be replaced by new and each unit of capital equipment will then require a smaller input of labour. Unprofitable units or firms will be closed down, accompanied by new establishments. Structural changes generate developments that are often referred to at present as a "new economy". The marked improvement in productivity maintains profits and keeps prices down. During the transformation, a good circle is created but it is difficult to tell how long it will last. It can be described, if you like, as a period of extensive rationalisation and heightened efficiency. The growth trend is raised for an indefinite period, enabling the economy to expand more rapidly without inflation taking off.

It should be born in mind that the adaptation to the new information technology does not occur automatically. It is not the case that one day we suddenly find the new technology has begun to be implemented in ways that are leaving their mark on economic developments in general.

The late 19th century provides important lessons about the necessary conditions for this good circle.

At the beginning of the 1800s Sweden was still a poor country with an unstable form of government, a chaotic monetary system and a general shortage of credit facilities. Ninety years later the Swedish economy had undergone a dramatic transformation. Inflation was low, with an orderly monetary system. The nation was bursting with vitality in every field. An impressive range of products, many of them world leaders, were being developed on the basis of Swedish inventions. Swedish financial experts were engaged in the exploitation of the inventions at an early stage. Employment was provided for more and more people, living standards rose and growth was among the highest in the world.

Opinions about the causes of the pronounced change in the Swedish economy are not completely unanimous. The stable prices presumably played a part. When inflation is low or the price level is stable, those who have to plan for the longer run face less uncertainty.

Another significant factor was probably the credit system's development in the 1800s. Banks were established and the abolition of interest controls was followed by more financial expertise. That made it possible to exploit the inventions and finance investments in the emerging industries.

An increasingly stable form of government presumably contributed, too. A series of constitutional reforms provided a guarantee of stability.

Economic activities benefited from the abolition of trade guilds, freedom to trade and the reform of joint-stock companies. The reform of elementary education was, of course, another important step that ultimately promoted human capital.

This catalogue is not intended to be a complete account of all the factors behind Sweden's transformation from a poor country into a rapidly expanding industrial nation. The point I want to make is that a variety of institutional changes seem to have been needed to provide a stable framework for the subsequent process of industrialisation. It is just this stability in the fundamental conditions for economic activities that was no doubt important for the process that resulted in the industrial revolution, which in itself was full of commercial risks and uncertainties.

### **Improvement in opportunities for change but ...**

A similar gloss can be applied to the realignment of economic policy from the second half of the 1980s to the middle of the 1990s. There have been a number of reforms aimed at creating stability and opportunities. The credit and currency markets have been deregulated, components of the social security system have been reformed, a tax reform has been implemented, targets have been established for government finances, price stability is enshrined in law and the Riksbank has been given an independent status.

All this represents good possibilities of the Swedish economy facing a stable future as we step over the threshold to a new millennium. The question is, however, whether the new information technology will be implemented in the far-reaching ways that are necessary in order to reap the really large benefits. Let us look at another period in Sweden's economic history when things did not go quite as well.

After World War II, when activity in the industrialised countries recovered and competition grew, partly because trade barriers were lowered, it became necessary to realign production in Sweden. The need for change resembled what we are beginning to discern on the horizon today.

For much of this post-war period, however, wage costs rose at a rapid rate. Profitability in Swedish business was accordingly under pressure from two fronts: growing competition from the rest of the world and rising wage costs.

Firms countered the pressure on profits by rationalising in an attempt to cut production costs rather than by investing in new products. The diminishing profits simply did not provide the stimulus that was needed for a prompt renewal of the capital stock in response to the pressure for change. A process of change involves shedding, but development is equally important.

Most things still looked good to begin with. The 1960s was a fantastic decade for growth. But the strategy proved to be defensive and stagnation set in during the 1970s. Rationalisation has its limits as a means for growth. Without renewal, growth normally slows sooner or later. Measures are called for in periods of growth but it is easy to be deceived and lean back to enjoy the fruits. The long-term growth trend did indeed begin to turn downwards more markedly than in other countries.

Economic policy responded with a series of devaluations in an attempt to maintain growth in the traditional industries. The latest devaluation was invariably described as the last, but the cycle of rising wage costs and a devaluation was repeated time and again. The endeavour to compensate for the lack

of change in Sweden's corporate sector, which had its roots in the 1960s, simply did not work. If anything, the devaluations meant that the problems persisted and were accentuated.

The lack of investments in new products and the dependence on a gradually outmoded structure of production helped to impose an adjustment of the entire nation's material standard. For many years growth in Sweden was weaker than in the world around us.

This example shows how a "new economy" at that time resulted in problems for the Swedish economy rather than opportunities. The lack of change, because wage formation did not function properly, led to a weaker economy that was more inflation prone. The period clearly illustrates how globalisation, increased competition and new technology can result in lower growth and higher inflation if changes are not made in time. If the economy is under pressure from strong competition as well as poorly functioning wage formation, there is a risk of economic renewal lagging behind.

### **Concluding remarks**

As I have said, the new information technology is making rapid progress. As far as we can see today, it will affect production and distribution processes as well as consumer behaviour. That in turn makes the environment more competitive and calls for changes in Sweden's corporate sector.

Put to good use, this transformation can probably create stronger potential growth, lead to higher productivity growth and lower inflation, and favour employment. The favourable changes that have occurred over a number of years in the Swedish economy since the 1980s suggest that such a development is within our grasp.

But as I just mentioned, if wage formation does not function properly, firms will be under pressure from two fronts. Profitability will be depressed both by increased competition and by rising wage costs. Investment will be held back and the transformation will proceed too slowly or not at all. There will then be no quick renewal of capital stocks. Firms will not make good use of the new information technology.

I have cited wage formation as a conceivable factor that may hamper a transformation, but of course there are other factors as well, for example the tax system, the educational system, etc. It is not a function of the Riksbank to point out specific factors that can affect the pace of structural change. But perhaps we can contribute to a broader discussion of the new economy.

Various factors that hamper or check an adjustment could thus result in the Swedish economy following a lower, not a higher, path for long-term growth, with a stronger, not a weaker, inflation propensity and a continuation of high unemployment instead of a reduction to the low level that most people want. These risks seldom feature in the general discussion about the new economy.

The changes that many people refer to as the new economy unquestionably present a number of challenges to the Swedish economy in the present situation. My comments have indicated, moreover, that the notion of a new economy is not correct; that is not what it is all about. It is rather a matter of a new challenge in the long series of challenges the Swedish economy has had to face ever since the dawn of the industrial era more than a century ago.