Mr Bäckström discusses the Swedish economy in the 21st century

Speech given by Mr Urban Bäckström, Governor of the Sveriges Riksbank and Chairman of the Board of Directors and President of the Bank for International Settlements, at the Swedish Shareholders Association, held in Gothenburg on 22 November 1999.

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First a word of thanks for the invitation to Gothenburg to discuss the Swedish economy in the 21st century.

A week or so ago the Riksbank raised the repo rate from 2.90% to 3.25%. The decision was based on the assessment of inflation prospects we had presented in the October Inflation Report and our analysis of economic statistics that had subsequently become available. By raising the instrumental rate now, we aim to contribute to the continuation of a favourable economic trend, with stable prices and sustainable growth. We made the increase somewhat larger than was expected so as to be in a position to leave the repo rate unchanged for the rest of this year, given that the Swedish economy follows the path predicted by the Riksbank.

Under these circumstances there is no point in dwelling on current monetary policy and its conditions. Instead I shall be considering a couple of matters to do with growth conditions for the Swedish economy in the longer run. This has a topical flavour on the threshold of a new millennium, perhaps particularly so at a time when so much discussion refers to the so-called new economy.

Just why should the Riksbank be at all concerned with the debate about the new economy and the conditions for long-term growth? Monetary policy’s concern surely lies in influencing the development of aggregate demand in order to keep inflation in check.

The reason is that fluctuations in the rate of inflation stem mainly from demand’s deviations from the trend rate of growth. The Riksbank therefore has to form an opinion about the economy’s potential growth rate. We also need to know how the growth trend changes over time. A dilemma here, however, is that the growth path cannot be observed directly.

The fundamental factors behind an economy’s trend rate of growth include population changes, the capital stock, technology and the efficiency of resource utilisation.

In the United States, recent innovations in telecommunications and computerisation have contributed to higher gains in productivity. The far-reaching effects that the new information technology is having on production and distribution processes have improved the conditions for growth.

A period of high investment growth is needed if information technology is to generate tangible effects. The new investment transforms the capital stock; new technology replaces outmoded practices and the labour required for each unit of capital equipment decreases. Unprofitable units or firms are closed and new facilities are established. Productivity rises in the economy as a whole.

High productivity growth makes it possible to maintain business profits and keep price increases down. The transformation process generates a positive spiral; the introduction of the new technology results in widespread rationalisation and greater efficiency. The resultant increase in the trend rate of growth for a longer or shorter period means that the economy can expand more rapidly than before without boosting inflation.

This is the process that is often being referred to today as “the new economy”. I do not find the term particularly apt but if it can serve as a simple aid to understanding what the new information technology can bring about, I have no objection to using it here.

A similar economic transformation is not yet discernible in Sweden nor, for that matter, in other countries in Europe. So the growth path has not been adjusted upwards as it has in the United States. The rate of investment both in Europe as a whole and in Sweden has been appreciably lower than in the United States for the past four to six years. It may be asked why the new technology is being introduced so quickly on the other side of the Atlantic and so much more slowly here.

First I should say that this is a very knotty question. Economics has no precise methods that tell us when a technical breakthrough is likely to show up in higher economic growth. Basically, however, the process is bound up with the growth climate in general. There is no exact definition of the growth climate but it does include the degree of macroeconomic stability, how the education system performs, the construction of the tax system, the legal framework and so on. So there are numerous factors to consider.

It is also important to realise that adjustments to the new technology do not occur automatically. The new facilities will not necessarily be utilised in such a way that the effects suddenly show up in general economic development.

A proper transformation presupposes that the right driving forces are in place and that other important requirements have already been met. Otherwise the so-called new economy may mean difficulties rather than opportunities.

A lack of adaptability can result instead in the economy being weaker and more susceptible to inflation. In other words, if the global economy faces Sweden with stronger international competition and demands for change and the necessary renewal of the capital stock and production facilities does not happen, our economy will be liable to lag behind.

I should like to consider two factors that I believe will be significant for Sweden's growth path after the turn of the millennium, namely wage formation and a functional financial system. Of course there are other factors of importance for the future growth path, such as the construction of taxes and how the education system performs. They obviously have to be discussed as well.

I have chosen to consider wage formation because wages make up approximately 70% of total costs in the economy, which makes them a major determinant of the profit level; profits in turn are important for the development of investment. The functioning of the financial system has a bearing on the possibility of financing new investment at a reasonable cost. As I see it, expected corporate profits and access to reasonable investment financing are vital for a process of transformation.

Wage formation

Let us now take a look at a period when wage formation was one factor behind a less successful transformation of the Swedish economy.

When the industrialised economies began to recover after World War Two and international competition increased, partly because trade barriers were dismantled, it became increasingly necessary for Swedish firms to adjust their product range. The requirements resembled those that now seem to lie in the not too distant future.

For much of that period the level of Swedish wage costs rose rapidly. This meant that corporate profitability was under pressure both from the increased international competition and for rising wage costs.

To cope with this pressure, firms tried to cut production costs by means of rationalisation rather than by investing in new products. With diminishing profits, they lacked the new investment stimulus and the rapid renewal of the capital stock that the pressure for change called for. During a period of transformation, rationalisation is not enough; new developments are equally important.

At first, most things still went well. The 1960s was a fantastic decade for growth. In time, however, the strategy proved to be defensive and stagnation set in in the 1970s. There are limits to growth through rationalisation. Without renewal, growth normally slows sooner or later. Compared with other countries, the trend rate of growth in Sweden did indeed turn downwards.

In an attempt to maintain growth in the traditional industries, economic policy responded with a series of devaluations. Each devaluation was invariably said to be the final one but the cycle of rising wage costs and a devaluation was still repeated again and again. The aim of compensating for the lack of change in Sweden’s corporate sector, which stemmed from the 1960s, simply did not work. If anything, the devaluations meant that the problems persisted and were accentuated.

With the lack of investment in new products and the dependence on an increasingly outmoded structure of production, the entire nation’s material standard had to be adjusted. For many years, growth in Sweden was weaker than in the world around us.

This example shows how a “new economy” at that time posed problems for the Swedish economy rather than opportunities. The lack of change, because wage formation did not function properly, resulted in an economy that was weaker and more susceptible to inflation. The period clearly illustrates how globalisation, increased competition and new technology can lead to lower growth and higher inflation if changes are not made sufficiently quickly. If the economy is under pressure from strong competition as well as poorly functioning wage formation, economic renewal may lag behind.

It is therefore gratifying that the labour market organisations seem to be increasingly in favour of the inflation target policy. Many representatives of trade unions and employers express a strong ambition and determination to arrive at wage increases that are commensurate with the macroeconomic situation. This is all to the good.

But the fact remains that even in recent years, the rate of wage increases in Sweden has been higher than in major competitor countries and also above the macroeconomic potential. Real wage increases in excess of productivity growth enlarge the wage share and reduce the gross profit share. That is what is happening now in Sweden. Bit by bit, at least a part of the increased profit margin that resulted from the krona’s fall in the autumn of 1992 is being eroded.

This is a difference from the United States. There the economy has entered what might be described as a good spiral, where higher productivity increases and comparatively moderate wage increases have generated profits that help to drive new investment in advanced technology.

In such a process, unduly high wage increases can bring the changes to a halt, as happened in Sweden in the late-1960s and early-1970s. Present economic assessments do not generally suggest that a break is imminent in the path of Swedish wage formation. So will this have a negative impact on the propensity of firms to invest in the new technology?

The financial system

This brings me to the significance of the financial system and access for corporate financing in the transitional phase. Are there differences between Europe and the United States that may have a bearing on the pace with which new technology is introduced? And what part does EMU play in this context?

One important factor in the process of industrialisation in the late nineteenth century, when Sweden was transformed from poor country into a wealthy nation with almost the world’s highest growth rate, was the contemporary development of the financial system. Banks were established and financial know-how grew when interest controls had been abolished. As a result, inventions could be exploited and investment in the nascent industries could be financed.

A mounting body of research findings published in the 1990s indicates that economic growth in various countries is appreciably affected by how the financial system works: the more highly-developed the financial system, the greater the stimulus to economic growth. An accessible banking system and efficient financial markets contribute to the development of investment and thereby to the economy’s growth trend.

One conceivable reason why the US economy is being transformed more rapidly than is the case with Sweden and, even more so, the European Community, is the efficiency with which the US financial system works. Corporate financing may well be facilitated by the breadth and liquidity of diverse financial markets.

With the rapid development of information technology, moreover, a new type of company has emerged. It differs from the traditional pattern in that its operations involve highly mobile human capital. The financing of these companies accordingly imposes different requirements in markets for risk capital and loans.

The US markets for risk capital appear to be more highly developed and more focused on the financing of high-risk projects than seems to be the case in Europe, where bank loans predominate and a larger proportion of financing goes to reliable, established firms.

With the advent of the euro, the financial system in Europe may become more developed and, like its counterpart across the Atlantic, offer more alternative forms of financing. With a single currency in the euro area, the capital markets will gradually become more liquid and thereby more efficient. There will probably be more corporate financing with bonds and equity, forms of financing that are less common at present in Europe than in the United States. Signs of this are already evident.

There is reason to make a deeper analysis of the financial system’s contribution to the changes that are needed in the Swedish economy. The introduction of a single currency may come to play a more important part in this transformation in that it influences the development of Europe’s financial system. This is an argument in the discussion about EMU that I have not encountered hitherto.

Conclusion

Sweden has already come a long way in utilising information technology. In order to reap the full benefit of this and go on enjoying the combination of high growth and low inflation, it is essential that the right driving forces and conditions are in place. It is important that these matters are discussed, particularly as one cannot expect the economy to transform itself automatically.

We have made good progress in recent years by establishing macroeconomic stability, with sound government finances and stable prices. Efficient wage formation and a financial system that functions properly are other important pieces. The fact that I have concentrated on these two factors this evening should obviously not be taken to imply that they are all that is needed to complete the puzzle.