Urban Bäckström: Swedish economy in transition

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, at the Independent Academy of Building & Construction, on 2 October 2000.

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Thank you for inviting me to talk with you this evening about the Swedish economy and monetary policy. The issues I have chosen to consider are why the Swedish economy is performing so well and what can be done to ensure that this continues.

As you know, output and employment are rising rapidly at present. Annual output growth has averaged 3% over the past six years and the current rate seems to be somewhere between 3 and 4%. Unemployment has come down and is still falling to levels that few had believed possible some years ago, particularly in view of the high European rate. At the same time we have seen that even comparatively low nominal wage increases can result in higher real wages. As a matter of fact, the real wage increases have exceeded most people's expectations and been higher than for many years.

Moreover, inflation has remained low in spite of all this. But monetary policy may still have challenges to face as resource utilisation in the Swedish economy becomes increasingly strained. The current situation also contains a number of risks that have to be assessed.

Stable economic policy interacts with structural changes and IT

In order to see why the Swedish economy is doing better than it has been for a very long time, we need to consider how economic policy has been realigned in the past decade and a half.

Credit and currency markets have been deregulated, the tax system has been reformed, components of the system of transfers have been modified and competitive pressure has increased. All this has helped to improve the workings of our economy.

Moreover, price stability is now monetary policy's statutory objective and it has been explicitly assigned to what has become even a formally independent central bank. Low inflation is admittedly not an ultimate objective for economic policy in general. It serves instead as an instrument. All those who experienced the economic situation in Sweden in the 1970s and 1980s know that inflation can never be associated with an economic development that is lastingly favourable. That is why price stability is an integral part of any economic policy's strategy for rising prosperity and high employment.

In order to provide a stable and credible framework for the new direction of economic policy, the government budget was successfully consolidated. Difficult political considerations and decisions were involved in this process and opinions may differ about particular items or aspects of the consolidation policy; but that does not detract from the main impression of a successful outcome in the sense that economic policy's commitment to stability was rendered credible.

A further component of economic policy's new direction was Sweden's membership of the European Union in 1995. Sectors that had previously been protected were now exposed to international competition. Stronger competition in a number of fields meant that prices for some goods and services began to be adjusted downwards towards European levels. This process may continue in the years to come, though we cannot take that for granted. There are a good many goods and services for which prices in Sweden are higher than elsewhere in Europe.

The point I want to make is that in many respects the favourable economic trend in recent years stems from the economic policy realignment that began in the 1980s and has been in progress ever since. This conclusion has two positive implications.

One is that the measures which have been taken have most probably contributed to what is happening now.

The other is that a continued policy orientation on stability and credibility can yield even better results in the future.

In the 1990s the new direction of economic policy was accompanied by rapid, worldwide advances in the new information technology, which is being adopted successively in various sectors in Sweden. This has lowered the thresholds for establishing and running companies. 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 tie up capital by holding large stocks.

The same applies in principle to consumers, who can search the internet quickly for inexpensive goods and services. It is still the case, however, that the price difference between products sold on the internet and in shops is relatively small. But this will probably change as the internet is developed and more people use it.

Sweden, spearheaded by the telecom company Ericsson, is one of the countries where the IT sector is large. This sector is also contributing a growing share to our annual output. Sweden is, moreover, one of the countries that is spending most on the introduction of new information technology in various economic sectors.

The introduction and development of information technology in Sweden is facilitated by a capital market that is efficient, particularly as regards the supply of venture capital. I mention this to underscore the part that the deregulation of capital and currency markets in the 1980s is playing for the path of growth today. Another crucial factor has been the removal of transaction taxes on equity and bonds after an experimental phase in the late 1980s; that, too, is worth recalling as the old idea of a Tobin tax is being revived in some quarters.

Improvements in productivity and flexibility

National accounts data from Statistics Sweden suggest that our economy is now capable of growing faster than in recent decades. It looks as though the higher productivity growth is not only attributable to rising activity. In the period from 1974 to 1993, for example, productivity growth averaged less than 1.5% a year, while since 1994 the average rate has been almost 2%. This is what lies behind the common, though not yet entirely certain, estimate that the potential rate of GDP growth is now between 2 and 2.5%.

At the same time it should be noted that there are still no clear signs of an accelerating rate of productivity growth such as we have seen in the United States. I say this even though I believe that one cause of the difference between the United States and Europe in this respect has to do with how the statistics are obtained. Such a process could conceivably come about in the Swedish economy, too, but I suggest we wait until that happens before incorporating it in our expectations and policy decisions. Our economy is developing favourably enough as it is.

Given certain assumptions, there are, in principle, two ways in which labour productivity can be increased.

Firstly, the growth rate of total factor productivity can rise. Total factor productivity seems to have been on an upward trend since 1993, which implies a successive improvement in production technology. That in turn may mean that information technology, for example, has been gradually increasing its contribution to output.

Secondly, labour productivity can be affected by changes in capital intensity. A rising input of capital equipment per employee, for instance, means that each person can produce more. Historically, increased capital intensity has often been a characteristic of periods when the growth of labour productivity was notably high.

During the present upswing, however, capital intensity has been more or less constant. So, at least to date, this mechanism cannot account for our increased productivity growth. It is not the case that business investment has been sluggish. On the contrary, investment growth, excluding the real estate sector, has been higher than for a long time. But as employment has risen equally strongly, capital intensity has been unchanged so far. But it would not be surprising if investment growth, and thereby growth of the capital stock, were to accelerate as the labour market becomes more and more strained and the utilisation of capital resources becomes high.

A growth process driven by rising investment and productivity can result in good circles. Increased demand generated from the supply side leads to a favourable composition of demand that tends to strengthen the supply side even more. Let me mention some examples.

One effect of higher productivity growth is an upward adjustment of future profit expectations and that often leads to rising share prices. Higher corporate values stimulate the companies in question to invest still more and also make it possible for new establishments to raise venture capital for continued expansion. Meanwhile, shareholding households see an appreciation of their net assets, at least on paper. Increased wealth and optimistic expectations of the future lead to a stronger growth of consumption.

Another consequence of higher productivity growth is that inflation tends to be held back in that unit labour costs are curbed. Labour costs are the dominant item of expenditure in the economy as a whole.

Everything suggests that the higher productivity growth in Sweden has contributed to the favourable economic development since the end of the crisis in the early 1990s. But there are other explanations, too.

Labour market working better than expected

One is the *workings of the labour market*. Many studies have shown that, at least in a formal sense, Sweden's labour market is characterised by more or less the same rigidities as continental Europe. So there was every reason to suspect that after the crisis in the early 1990s, unemployment would also stick at a high level in Sweden. Here are some of the grounds for this:

- Labour demand is liable to be low in a labour market that is heavily regulated. Firms are reluctant to recruit because of uncertainty about being able to cut costs if economic activity were to decline.
- Labour supply may be affected after unemployment has risen as steeply as it did in the early 1990s. People are excluded from the labour market. Long-term unemployment may leave competence out of line with what firms are now looking for. The determination to find a job can be affected both by a long period of unemployment and by the structure of unemployment insurance.

To date, however, the economic upswing in Sweden suggests that the labour market is functioning better than one might expect. That in itself is a sign that the output gap has been larger than estimated earlier, so that our economy has coped for a time with higher GDP demand.

It is conceivable that the crisis in the early 1990s taught firms that they can, in fact, cut costs if they need to. That may mean that their propensity to recruit now that demand for goods and services is rising is stronger than might have been feared. Moreover, various labour market measures, the willingness of the parties to improve the wage bargaining system and, not least, the real wage increases in recent years, may have strengthened the propensity to look for work as well as the possibility of finding it.

Of course, this process cannot continue for ever. Sooner or later, shortage figures will show that there is simply no additional labour available. To date this year the number in employment has risen by 70,000 from the year before, which is over 50,000 persons more than the underlying increase in labour supply. Unemployment is accordingly falling and more and more persons who did not seek work actively before are now available in the labour market. While that is a good thing, the time will come - though when that will be is not certain - when the available supply of labour is smaller than the jobs that are vacant. Then, if not before, wage costs are likely to accelerate and pull the rate of inflation up. That must not happen, of course, and in good time the Riksbank will do what it can to prevent it.

Certain signs of shortages are already evident in some industries and occupational groups in some regions. Moreover, the matching process in the labour market is now working a little less smoothly - filling job vacancies is taking somewhat longer. In general, however, the Swedish economy does not yet appear to have reached a situation where labour shortages are widespread. At the same time, experience from our Nordic neighbours has shown that in an economic upswing such a situation can arise relatively quickly. So this calls for heightened attention from the Riksbank.

Inflation held back this year by deregulations and competition

Besides higher productivity growth and a more efficient labour market, other positive supply shocks have helped to achieve the rapid output growth without generating inflationary impulses. A positive supply shock is one that tends to lower the price level - slowing the rate of inflation more or less temporarily - at the same time as it stimulates demand. A single change's impact on both inflation and GDP growth is normally transitory. All else equal, inflation moves up to the earlier rate and demand growth falls back when the shock has subsided.

Higher productivity growth due to new technology is an example of a positive supply shock. In recent years, however, similar effects have come from the deregulation of electricity and telecom markets, as well as from the EU's agricultural reform. Meanwhile, the temporarily lower rate of inflation has meant that real wage growth has exceeded expectations and thereby acted as a general demand stimulus. Strictly speaking, as I mentioned, the latter effects fade away, even in the case of a series of positive shocks that last for some time.

This is countered by the oil price increases, an example - at least in part - of a negative supply shock. It should be added, however, that a part of the process which the rising oil price represents has to do with the better global activity, which normally leads to a general increase in commodity prices. The higher oil prices accordingly tend to push prices up and curb output. But so far the combined impact of all the supply shocks seems to be positive: temporarily lower inflation and stronger demand growth.

A third factor that has contributed to the favourable price trend is the *general increase in competition*. This has made it difficult for firms to raise their prices in order to improve profit margins as they usually do in this phase of the business cycle. To some extent this may also be because firms know that price impulses from that quarter will inevitably cause the Riksbank to raise the instrumental rate. To achieve a reasonable return on capital, firms are obliged instead to make production more efficient and that tends to result in better productivity.

Many factors have accordingly contributed to our economy's good performance in recent years. A number of favourable circumstances have coincided, making it possible to combine high growth with price stability.

Demand must be adjusted to growth sooner or later

Looking ahead, most things suggest that the rapid growth can continue for a time. But in the end - though it is not clear when - demand for goods, services and labour will have to slacken and move more in line with what the long-term growth trend can sustain. Letting demand be too high for too long raises the prospect of accelerating inflation and ultimately a recession, with falling output and rising unemployment. The Riksbank must therefore do its utmost to avoid marked fluctuations in economic activity and endeavour to create conditions for sustainable growth.

Demand can come into line with long-term growth as a result of a spontaneous economic slowdown, for instance in connection with a slackening of growth in the rest of the world. It can also result from a fall-off in household demand for durables after the high procurements in recent years. A further possibility is that the positive supply shocks fade, which would admittedly involve some increase in inflation but also a downward effect on demand.

But interest rate increases by the Riksbank may also be needed to assist demand’s adjustment to long-term growth. With the past and present upheavals in the Swedish economy, however, it is particularly difficult to be clear about the exact timing. The Riksbank should naturally not raise interest rates too early but not too late either. In my opinion, the time for another increase is coming closer, at least as long as demand growth remains strong. But today I find it hard to envisage a main scenario that unequivocally threatens price stability in the period of one to two years ahead that is our main concern.

The Executive Board’s monetary policy discussions this autumn will clearly deal with conceivable threats to continued price stability. The risk spectrum has consequences for the formulation of monetary policy. It may include the future development of labour shortages and how wage trends are affected in alternative scenarios. Although wage development has been stable to date, we must of course bear in mind that the labour market has not been tested in earnest. New wage negotiations will begin during the autumn. As always, the Riksbank will be following them closely to divine whether the labour market situation in general constitutes a threat to price and wage stability.

Our discussion may also dwell on any risks to inflation in Sweden in connection with the rising dollar. Will the dollar remain high against the euro, as well as against the Swedish krona? Could that then have some impact on the feasibility of continued price stability in Sweden?

Yet another risk is, of course, that the international price of crude oil does not fall back as most observers expect. It is not the oil price as such that is primarily important for the analysis but rather any impact it may have on other prices in the economy, for example wage increases. The discussion in the euro area has, moreover, highlighted the international crude oil price’s interaction with exchange rates.

Risks of these types have to be weighed against the probability of a faster correction of existing imbalances in the world economy, for instance the US current account deficit, the level of stock markets and the dollar’s exchange rate. Assessing the likely course of such adjustments is exceptionally difficult. Instead of attempting to predict such a course, which may be impossible, one needs to be alert to signs that it is appearing.

Concluding remarks

The picture I have painted of the Swedish economy is fairly bright but it is accompanied by a number of clearly identified risks. It looks as though the favourable trend can continue but our economy is now in the cyclical phase that calls for heightened attention. The conceivable risks have to be assessed and weighed up by us on the Executive Board. Regardless of whether we conclude that the repo rate must be increased soon or that it can be left unchanged for somewhat longer, the Riksbank’s commitment to price stability is intended to make a contribution to a path for output and employment in Sweden that remains stable.