Eva Srejber: Competition and growth

Speech by Ms Eva Srejber, Second Deputy Governor of the Sveriges Riksbank, to the Swedish Taxpayers Association, Stockholm, 21 September 2001.

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According to the Sveriges Riksbank Act, the objective of monetary policy is to safeguard the value of money. The Riksbank has specified this in its inflation target, i.e. that CPI inflation should amount to 2 per cent with a deviation interval of plus/minus one percentage point. This means that when we formulate monetary policy, we must take into account changes in a number of areas that affect price trends, either directly or indirectly. I thought that I would comment on one of these areas today, namely competition, and its effects on potential growth. This is an area that we are forced to consider when we analyse the economy, as it is essential to assess potential growth when shaping monetary policy. However, before I begin, I should like to make the point that I will not be discussing the current monetary policy situation.

Growth is a constant central feature of monetary policy discussions, as demand in the economy in relation to production capacity is crucial for determining whether inflationary bottlenecks arise or whether we will underutilise the production potential. It is sometimes claimed that maintaining price stability limits growth. This is incorrect. The limits are determined by the potential growth rate. We must take into account the potential growth rate, even if we do not influence this by means of monetary policy once price stability has been established. Correspondingly, we must take into account changes in conditions for competition, as such changes can influence inflationary trends both directly and indirectly. Any measures taken to strengthen potential growth come under other economic policy than monetary policy. Such measures can include avoiding limits to competition that would lead to a poorer allocation of resources.

The Swedish economy was showing very favourable growth until last winter. Today, now that growth has slowed down, it may be worthwhile to remember that it is from this starting point that growth was subdued. We can put it even further into perspective by comparing with the situation in the beginning of the 1990s. Conditions then were very difficult and characterised by rising unemployment, a high inflation rate and poor public finances. The situation was so strained that the government turned to the academic world for advice and a report from the Economics Commission was delivered in spring 1993.[1]

This report, which is usually referred to as the Lindbeck Commission, contained no less than 113 proposals – many of them were controversial, which stimulated the debate of the day. The Lindbeck Commission took the view that the crisis was based on problems in three fundamental areas; stability, efficiency and growth. The proposals were also grouped into measures to create stability, measures to increase efficiency in resource utilisation and measures to increase growth in the economy.

Price and budget stability has been attained

If one reads this report today, one is struck by how many of these proposals have actually been implemented. When it comes to measures for attaining macroeconomic stability, most of them have been implemented and Sweden has for several years enjoyed low inflation and sound public finances. Progress has also been made in the field of wage formation. With regard to measures to increase efficiency and potential growth, the result of a survey of which proposals have been implemented gains more mixed results. Important changes have been made in some areas; while in others very little has happened.

If we look at developments during the eight years that have passed since 1993, the results are heartening. The average growth rate during this period has amounted to 3.1 per cent. This is very different from the average growth rate of 1.8 per cent that prevailed during the previous ten years. If developments since 1993 had been limited to this 1.8 per cent, we would currently have a GDP level around SEK 174 billion lower than now, i.e. more than eight per cent lower, and the situation would have looked radically different in most areas. Open unemployment would be twice as high if one

[1] "New terms for economics and politics", proposals from the Economics Commission, SOU 1993:16.

utilises the "Okun relation" - at approximately 8 per cent rather than roughly 4 per cent. It is doubtful, however whether the Okun relation is relevant over such a long period of time. The greatest part of the difference would probably have resulted in lower real wages, i.e. our disposable incomes would have been substantially lower. It is possible to make many calculations of this nature, all of which illustrate how differences in the growth rate provide very strong effects over a number of years.

There is therefore good reason to discuss which factors have contributed to this favourable development. It will probably not be possible to agree on a definitive answer, but I believe it is likely that the structural reforms implemented even before 1993 (in particular the tax reform of 1990/91) and the proposals by the Economics Commission that were implemented have all contributed.

A more efficient economy

One interesting condition is that total factor productivity really took off in 1993 and that it thereafter developed more strongly than it had during the previous decades. Total factor productivity concerns the quality of available resources and how efficiently we utilise them, and in this respect developments show a marked improvement. From the mid-1980s up to 1993, there was in general terms no increase at all in factor productivity, which means that the limited increase in productivity that arose was due to investment, i.e. to an increase in capital intensity. From 1993 onwards, the relationship has been reversed. We have had an impressive annual increase in factor productivity of per cent[2], while capital intensity has increased by a modest 0.1%.

The fact that this change began in the same year that the Economics Commission presented its proposals is probably mainly coincidence, but the fact that a macroeconomic stabilisation has a rapid and enduring effect on the development of productivity has been proved by the economist Easterly, amongst others. That is to say, the combination of price and budget stability is an important explanation of developments in total factor productivity. It is probably due to stable prices providing a better information value in relative prices, which improves the allocation of resources. The combination of price stability and budget stability also increases willingness in the household sector and corporate sector to make long-term decisions.

If we consider other factors that stimulate the rise in total factor productivity, there are a number of changes that play a central role. In general, one tends to seek explanations for increasing factor productivity among factors such as technological developments, education, competence and incentives among the labour force, allocation of resources in society, as well as between and within branches and companies. There is therefore a large group of possible factors, but many of these are connected to general incentives behind the transformation and to the capacity to utilise technological progress in the world around us.

The allocation of resources in society includes an area where important changes were implemented mainly before the days of the Lindbeck Commission. I am referring to the deregulation of the financial markets and the development of these in recent years. A number of international studies indicate that a deregulated and well-functioning financial market clearly stimulates the development of factor productivity.

With regard to a more efficient use of the labour force, several changes have been implemented that have probably stimulated development. These include reforms in the pension system, the tax system and the social insurance system. The burden of taxation has been subdued and the economic return on higher education has increased - in particular in technical education. In addition, wage formation has been improved, which should have been facilitated by the monetary policy focus on price stability.

At the same time, the pressure on companies to use resources efficiently has increased during the 1990s. Tougher competitive pressure as a result of both increased internationalisation and deregulation in a number of sectors has increased the need for companies to economise with scant resources. Less wastefulness with resources means that labour force and capital are employed in other areas, where they can better contribute to the national economy. The development of investment is another factor that may have contributed, even if capital intensity has increased at a very slow rate.

One factor that has not contributed to a long-term improvement in resource allocation is the development of the exchange rate. The devaluations in the 1970s and 1980s have been followed by a floating exchange rate, but with an undervalued Swedish krona. The longer the krona remains

[2] These calculations are based on a Cobb-Douglas production function with a constant returns to scale.

undervalued, the greater the risk of bad investments being made in domestic businesses. I do not intend to go into these issues in greater detail here and now, but would nevertheless like to point out that undesirable effects on business can arise through a misaligned currency giving flawed relative prices. Companies may make decisions regarding investment and employment on the basis of these relative prices. The foremost risk here is that too many resources will be drawn to the export sector and to the import competition sector before there is a return to the equilibrium exchange rate and to corresponding relative prices. At that point, the resources overinvested in these sectors will be transferred to other sectors. We know from previous structural changes in, for instance, shipping, steel manufacture and the property sector, that such a development would result in considerable costs to the real economy. One should not underestimate the importance for welfare of a correctly valued Swedish krona.

Openness is important

Factor productivity is also affected by a country's capacity to utilise technological progress in the outside world. This capacity in turn depends on how open the country is to impulses from outside, which is determined by the barriers that exist to ideas, goods, services and production factors moving freely across the borders. A number of studies have shown that countries, which are more open have a greater capacity to imitate technological progress. The capacity to renew regulatory frameworks and institutions to enable the country to embrace change is an important part of this openness.

Obstacles to ideas, goods, services and production factors moving freely across borders have declined during the 1990s, partly thanks to our membership of the EU, and it is reasonable to assume that this has had a positive effect on factor productivity. For a small country like Sweden, internationalisation and increased international competition are expected to lead to particularly favourable productivity effects. Various measures indicate a marked increase in the degree of internationalisation in the Swedish economy. Both the import share and the export share have risen, which means that trade and the degree of specialisation have increased. Moreover, foreign direct investment in Sweden has multiplied and it is mainly direct investment from EU countries that has increased.

Although the increasing international openness has been pronounced in Sweden with, for instance, a rise of 13 percentage points in the export share of GDP during the 1990s, there are several smaller countries that have shown an even more rapid increase in the equivalent figures. This reflects the globalised world in which we live, and does not reduce the significance of openness for the development of factor productivity.

Internationalisation has thus contributed to ensuring that an increasing percentage of trade and industry is exposed to competition. Increased competition means that companies must become more efficient and cost-conscious, which in turn should have a positive effect on productivity. In addition, a new competition act came into force in Sweden in 1993, containing an expressed prohibition of co-operation between companies that limits competition, as well as a ban on the misuse of a dominant position. There has also been deregulation in a number of areas. For instance, government monopolies have been abolished and freedom to establish businesses has been introduced with regard to, for instance, transport, communication and energy.

Changed conditions for competition thus affect productivity growth, but they can also affect price trends in a more direct manner. Despite the fact that we gained much tougher competition legislation in 1993, it appears that developments in this field are moving rather slowly. Swedish prices continue to lie at a higher level than those in other countries in most areas, without this being fully explained by differences in VAT rates and wages. Increased competition could contribute to a convergence of price levels.

High food prices

Swedish food prices were, for instance, more than 18 per cent higher than the average prices in the EU in 1998[3]. The difference has declined somewhat since then, but apparently at a very slow rate. If one regards 1998 prices in current terms with the aid of HICP development since then, one finds that

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3 Eurostat's survey of the price level index for 1998, published in 2000.

we probably still have approximately 17.5 percentage points of the 18 percentage point difference in food prices.

Another field in which competition appears to be weak is the construction sector, and in particular the construction materials sector. This area is characterised by a high company concentration with considerable entry barriers to new companies and weak import competition. With regard to prices for construction materials, one can also see a much more rapid price rise than for other industrial products over a number of years, which may indicate rising profit margins or considerable inefficiency in resource utilisation.

In some further fields, such as telecommunications services and electricity, deregulation had a pronounced dampening effect on price development for some time. This is no longer the case. The most recent statistics available indicate price increases of 7 per cent and 20 per cent respectively for these areas. In addition, Telia has announced a large rise in its subscriber fees with effect from October. I therefore see it as natural that there are investigations underway and planned into competition conditions in these markets.

Vested interests versus consumer interests

Although we have thus achieved improvements in certain areas, it appears to me that the description in the Economics Commission's report of 1993 (page 10) still applies to large parts of the economy.

"It is evident that a number of important markets in the Swedish economy function poorly and that this leads to considerable wastefulness with resources and to large costs for the national economy. The Commission's assessment is that the fundamental reason is the lack of competition in Swedish trade and industry. One indicator of the lack of competition is that prices on a large number of goods are much higher in Sweden than in other countries. Other indicators are the many public regulations of the market, the agreements between companies that limit competition and the monopoly-like market structure in many sectors. The limitations to competition are a clear example of how vested interests dominate over general consumer interests."

More recently, this type of question has arisen with regard, for instance, to the EU Commission's revelations of price collaboration between the airline companies SAS and Maersk. From an economic perspective, these are important questions that motivate a broad discussion. From a monetary policy perspective, an influence on price developments from changed conditions for competition is one of several important areas that we at the Riksbank must consider, as the potential growth rate depends on how effectively resources are allocated.

To summarise, there has been considerable change in the Swedish economy in recent times. The external framework is currently characterised by significant fiscal and monetary stability, which facilitates planning and decision-making by both households and companies. These fundamental conditions, together with a pronounced increase in openness towards the outside world give reason to expect a continued favourable development in productivity.

At the same time, one should remember that several markets in Sweden still show clear signs of poor competition. This involves considerable cost. The various parts of the economy are connected, which often means that a strengthening of the weaker parts is even more important to the economy as a whole than to the effects on a particular branch or sector. It is exactly this – the complementarity of the economy[4] – which makes it particularly important to deal with our weak links and to listen with humility to the proposals of the OECD and IMF, for instance. It is often easier to identify problems if one can see things with a little perspective. I believe that the Swedish economy has considerable unutilised potential for a strong growth if we concentrate on it, if we all work together to make our joint cake grow.

[4] The significance of a complementarity in economic policy has been demonstrated by, for instance, Aziz and Wescott 1997 in "Policy Complementarities and the Washington Consensus".