Kristina Persson: Economic conditions and welfare in Sweden and the Nordic countries

Speech by Ms Kristina Persson, Deputy Governor of Sveriges Riksbank, at Union conference of the Nordic Teachers' Council, Marienlust, 23 October 2003.

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Thank you for your invitation to participate in this conference.

I would like to begin by clarifying the Riksbank's role after the referendum in which the Swedish people said a clear "no" to introducing the euro in Sweden. Then, I would like to take the opportunity to account for our current view of the economic outlook and inflation prospects. I shall do this in the light of the year's third Inflation Report, which was published last week. This formed the basis for the Executive Board's decision to leave the repo rate unchanged. Subsequently, I shall discuss some longer-term factors that are of great importance for welfare in the Nordic countries.

Different economic-policy situations in the Nordic countries

The result of the referendum means that the Riksbank will continue to conduct monetary policy as before. The repo rate is set according to the outlook for economic activity and inflation in Sweden. The Riksbank has defined the objective of monetary policy, to maintain price stability, as keeping the rate of change of consumer prices at 2 per cent, with a tolerance for deviations of +/- 1 percentage point. The Riksbank's experiences of inflation targeting have been positive, and there is therefore no reason to change our monetary policy strategy as a result of the referendum outcome.

Ahead of the referendum, I believed that the advantages of a single currency in Europe outweighed the loss of a monetary policy adapted to a specific level of Swedish economic activity. The debate ahead of the referendum sometimes gave the impression that the monetary policy regimes in Sweden and the euro area are different. In actual fact our monetary policies are similar, as we both have an inflation target, a floating exchange rate and an independent central bank. One difference is that monetary policy in Sweden is based on Swedish conditions, while that in the euro area is based on average developments in prices and economic activity in the area as a whole.

The Nordic countries have different economic-policy situations. Sweden, Finland and Denmark are members of the EU. But Norway and Iceland, who have chosen to remain outside the EU, also enjoy the four freedoms, i.e. free movement for capital, goods, services and labour, through the EEA Treaty. Finland has taken a step further in the EU cooperation by participating fully in EMU since 1999. Consequently, Finland no longer has its own currency and does not conduct a national monetary policy. Denmark has not introduced the euro but participates in the exchange rate mechanism, ERM II. This means that the Danish krone has a fixed exchange rate with the euro and that interest rates in practice track those of the euro area. In Norway monetary policy is now similar to that in Sweden, with an explicit domestic inflation target.

In spite of the differences between the Nordic countries, our central banks cooperate closely with each other. The central bank governors meet regularly for discussions, and once a year there is a big meeting between the central banks' Executive Boards and a number of experts, depending on the themes that are up for discussion. Together with Estonia, Latvia and Lithuania the Nordic countries are jointly represented in the International Monetary Fund (IMF) and the World Bank. This has partly resulted in close cooperation between the countries' respective central banks on all issues related to the IMF. Furthermore, a memorandum of understanding was recently signed by the Nordic central banks regarding the management of financial crises. There is also a continuous exchange of expertise between the Nordic central banks.

The Riksbank expects moderate inflation

The Riksbank's monetary policy remit is to adjust interest rates with a view to influencing price developments so that inflation is 2 per cent one to two years ahead. As a basis for our decisions, we carry out regular forecasts of inflation and economic activity in Sweden. Thus, at our monetary policy meetings, we in the Executive Board must decide whether inflation is forecast to be above target, which usually implies raising the repo rate, or whether it will be below target, thereby resulting in a repo rate cut.

Last week the Riksbank presented a new assessment of economic and inflation prospects in this year's third Inflation Report, which led to our decision to leave the repo rate unchanged.

Assessment of economic activity and inflation

It is our assessment that there has been an improvement in the economic outlook for Sweden and the world economy since June. But the picture is neither clear-cut nor problem-free. Economic conditions in Europe have continued to be gloomy, with several countries experiencing a decline in GDP during the second quarter, in particular large countries such as Germany and France. Elsewhere, mainly in the US, expansionary economic policy appears to have had some impact. This has been reflected in high consumption and signs of a recovery in business investment. The positive signals have been mirrored in rising equity prices and long yields in the financial markets. Moreover, in the US labour market there are indications of a possible turnaround, which is a precondition for a sustainable upswing in economic activity. Asia has also been witnessing relatively favourable economic conditions, particularly in China, where economic growth has been approximately 8 per cent per year. In Sweden, GDP growth was somewhat more robust during the first half of this year than we previously thought, and the outlook for the economy appears now to be slightly brighter. Adding to this is the repo rate cuts totalling 0.75 percentage points during the summer. However, in the labour market, conditions remain weak.

Inflation has fallen back since June but not as much as we had expected. This is because energy prices have not dropped as forecast. This decline will now come somewhat later. Excluding energy prices, inflation two years ahead is expected to be on target.

Risk factors for Swedish inflation

What then are the risks and threats that we see regarding a continued improve-ment in economic activity? In the Riksbank's Inflation Reports, we always assess the risk of inflation being higher or lower than in the main scenario that we present, which in turn is closely related to our forecast of future economic activity.

There is a risk that international economic activity will be slacker than in our main scenario. In the US, the large deficits in the public finances and current account may prompt a rise in long-term interest rates, which in turn would hamper consumption and investment. The large current account deficit implies that there has been a substantial flow of capital to the US from abroad. Good productivity growth and high GDP growth have so far contributed to considerable confidence in the US economy. This has enabled the US to attract international investors. But should investors believe that they risk earning less or risk losing money by investing in US assets, their interest will wane. This could give rise to both a weaker dollar and a rise in bond yields. While a weaker dollar would facilitate the necessary adjustment to a smaller current account deficit in the US, it would also be likely to delay economic recovery in Europe. A dramatic depreciation of the dollar cannot be ruled out either.

In Europe, the strained budget situations in mainly Germany and France also constitute a source of uncertainty. Savings in the public finances and a weak labour market risk subduing consumption and thereby delaying a revival. The combination of imbalances in the US and the sluggish growth in the euro area risk derailing an economic upswing, and could perhaps even result in a decline.

According to the Riksbank's assessment, the risks to Swedish inflation prospects posed by weaker international economic activity are balanced by the risk of higher inflation in Sweden. New collective-wage agreements will be negotiated at the beginning of next year for employees in the private and central government sectors. Wages are the single most important factor for inflation and are therefore always associated with inflation risks. But unlike the last big wage bargaining round, which was initiated during the final stages of an economic boom, these negotiations will be conducted when demand in the labour market is weak.

Nevertheless, there are tensions in the labour market that could result in wage rises that increase cost and inflationary pressures. Furthermore, energy prices have not fallen as much as we expected during the summer, which means that the risks of contagion effects have increased somewhat.

Growth and welfare in the long run

A monetary policy that leads to price stability creates favourable conditions for economic activities, consumption, trade and investment. But monetary policy in itself cannot generate growth. Other economic policy decisions can, however, especially those that affect people's willingness to work and invest in new businesses.

Between 1975 and 1995 Sweden lost its previously so prominent position in the world. These years were also characterised by substantial wage increases and high inflation. Average inflation during this period was 8 per cent per year. We also lagged behind our Nordic neighbours. Had we experienced the same growth as Norway, Denmark and Finland during these years, the standard of living in Sweden today would be about 20 per cent higher. Partly as a result of the economic policies of the 1970s and 1980s, Sweden found itself in serious economic crisis at the beginning of the 1990s. This led to large deficits in both the central government budget and the current account, as well as to unemployment that quadrupled in the space of a few years. It was the largely the lessons drawn from this crisis that formed the basis for the changes in economy policy at the beginning of the 1990s.

It was then that price stability was introduced as the objective of monetary policy. As regards fiscal policy, an expenditure ceiling and surplus target for central government expenditure were introduced, while cutbacks were also implemented. Moreover, entry into the EU and reforms in the tax and social security systems helped create better conditions for economic growth.

Today, Sweden's central government finances are healthy, there is a surplus in the current account, inflation expectations are anchored around the Riksbank's target of 2 per cent and unemployment has fallen to a level that is far below the European average.

Potential growth

The decisive factor for economic growth and thereby the resources available for wage increases, earnings or an expansion of the public sector is the economy's long-term production capacity. Another term for this is potential growth, which determines the rate at which the economy can grow without giving rise to inflationary pressures. So it is demand in the economy in relation to production capacity that to a large extent determines the future path for inflation. Potential growth is therefore of vital importance for monetary policy.

In turn, the long-term production capacity is determined by how much we work (the labour supply) and how productive we are (productivity). The labour supply depends partly on the number of people that work and the number of hours each person works. Important factors here include the age structure in the economy and the number of people on sick leave. Productivity is partly dependent on investment and technological progress - for example that machinery becomes more modern or that it is employed more efficiently. Educational levels also affect productivity. Knowledge can be put into practice in production and increase opportunities to assimilate new ideas and innovations.

The labour supply

Because labour force participation varies so much in different age groups, the future age structure is highly significant for the labour supply and thereby also for growth. The Nordic countries have generally high activity rates, around 87 per cent in the age group 25-54, compared with the other European countries. In the oldest age group, participation has decreased over the last 10 years. One reason for this is that the retirement age has fallen. In Sweden today, the actual age of retirement is 62 years. The only group in which there has been a rise in the labour supply in recent years is elderly women, since those that live to a higher age today are better educated than their predecessors.

The proportion of elderly in the population is growing larger throughout Europe, and the Nordic countries are no exception. At present, 16 per cent of the European population are 65 years or older. This percentage is forecast to increase to 18 percent by 2010. If we look instead at the number of people over 80 years in Europe, this will double over the next 15 years.

According to Statistics Sweden, the proportion of people in Sweden that are 65 years or older will rise from 17 per cent today to 23 per cent in 2050. Meanwhile, the economically active proportion of the population, those between 20 and 64 years, will decline from 59 per cent in 2002 to 54 per cent in 2050. So, from having experienced a rise of almost one million people between 1950 and 2000, this group will increase by half as much, or by half a million people, over the next 50 years.

This trend means, according to Statistics Sweden's forecasts, that the economically active population in Sweden will have to support an increasingly large percentage of the young and old. Today, each person of working age supports 0.7 people that do not work. By 2050, it is forecast that each worker will have to support 0.84 people. If we only look at the elderly, there are 0.29 people that are 65 years or older for every worker. By 2050 this ratio is forecast to have risen to 0.42. These developments will entail ever increasing demands on higher labour force participation among the elderly. According to a study by Statistics Sweden, the percentage of Sweden's retirement pensioners that have to work to support themselves is forecast to rise by 50 per cent by 2035.

One part solution to the problem comes from the immigrant population. It is people with a foreign background that are forecast to account for the net contribution to the economically active population. By 2015 it is forecast that approximately every fifth person in Sweden between 20 and 64 years will have been born outside Sweden or have foreign-born parents. Meanwhile, the number of Swedes with Swedish-born parents will be fewer in 2015 than in 2000.

People with a foreign background in Sweden have found it difficult to get a foot-hold in the labour market. Employment among people with a foreign background is around 30 per cent lower on average than among native Swedes. Were the employment rate for this group to be as high as the average for Sweden's population, employment would rise by 96,000 people.

Finally, the decisive factor for the labour supply is how many hours we work. The number of hours worked has fallen recently for several reasons: overtime has declined, part-time work has increased and absence to care for own children has also risen. But the single biggest reason and consequently the most serious problem in Sweden is sick leave. Both the number and length of absences due to sickness have risen sharply in recent years, thus entailing a reduction in working hours per employee. Three years ago the number of hours worked increased by 2.7 per cent. Last year the number decreased by 1.2 per cent.

Larger proportion of elderly entails increased demands

The age composition will place great demands on welfare services, increasing further the need for labour. In Sweden the number of people that are judged to require extensive care, i.e. those that are 85 years or older, will double up to 2035.[1] This is expected to result in greater pressure on the public finances since the costs for care rise steeply in line with increasing age. All in all, public expenditure on pensions, nursing and geriatric care is forecast to rise from about 18 per cent to around 23 per cent of GDP around 2030.

Furthermore, a smaller labour supply and thereby lower production implies lower central-government receipts from employer contributions and income tax, for instance. A relevant example from Sweden is the costs of sick leave. If the Government's target of halving the number of sick days up to 2008 were to be attained, estimates from the National Institute for Economic Research show that the number of hours worked could be 0.4 percentage points higher per year up to 2008. If productivity were to remain unchanged, this could result in higher GDP growth of just over 0.4 percentage points per year over the period 2003-2008, thus enabling an improvement in the public finances of SEK 45 billion during the period. These resources could be used to enhance care and education - or to reduce the central government debt and thereby create greater scope for borrowing in the future when we are more likely to need it.

When our requirements grow in relation to our resources, it naturally brings questions about the organisation and financing of welfare to the fore. The Nordic countries have a long tradition of dealing with welfare issues and a comparatively large public sector that provides, for instance, healthcare and nursing, education and geriatric care. Important issues on the political agenda in the future will be how the Nordic welfare model should be renewed to make it both economically and socially sustainable. Will we once again be able to serve as a model for other countries during the change that the whole of Europe now faces?

Regardless of the chosen model, our demographic situation will require measures that result in a higher average number of hours worked, a larger number of workers e.g. pensioners, and an increase in immigration. This assumes that we want to keep or enhance our welfare system.

[1] Swedish Association of Local Authorities, "Aktuellt om äldreomsorgen" (Current trends in geriatric care), October 2003.

Productivity growth can help

When the long-term growth rate receives little or no contribution from the labour supply, dependency on labour productivity increases. Compared with other countries, Sweden has thus far performed well in terms of productivity growth. During the 1990s productivity has risen by 2 per cent per year or slightly more. This is a clear improvement on the 1980s when productivity growth was around 1 per cent per year, and even more so compared with the 1970s when the trend was actually negative. So it is productivity rather than the labour supply that has fuelled growth in recent years. This also applies to the other Nordic countries, al-though the labour supply has made a bigger contribution than in Sweden.

The particularly steep rise in labour productivity during the 1990s was due to several factors. One important factor was that many low-productivity firms went bankrupt in connection with the sharp economic slowdown at the beginning of the 1990s, while other firms implemented cutbacks of low-skilled labour that had less qualified tasks. When the economy began to grow again there was plenty of unemployed labour, and it was possible to attain high growth without inflation gathering pace. Another cause was the IT boom towards the end of the 1990s, which also contributed to productivity growth. In the years ahead, we can also expect to have good productivity growth in Sweden.

Increases in productivity growth can be a solution for large parts of the corporate sector, but this is less often the case for parts of the public sector. Quality care and education often require a strong presence of human labour. Nevertheless, there is probably much to be gained by organising and financing the public sector in new ways. The contribution made by trade union organisations in this regard could prove to be a decisive success factor. Here, the Nordic countries have an advantage over others through a high degree of organisation and an established cooperation between employers and employees.

The education sector also faces considerable challenges. When the current generation of teachers in Sweden retire, a substantial increase in new teachers will be needed. According to the National Labour Market Board, the number of new recruitments required to replace retired teachers is forecast to come to around 100,000 up to and including 2015. This is 40 per cent of the number currently employed. Recruitment difficulties are forecast to begin within certain teacher categories as early as 2006. This means that measures must be taken immediately to ensure a satisfactory supply of staff in the future.

Investing in education is different to investing in care. Education is unique in the sense that it can be an investment to both increase productivity and to increase fairness. A society that for various reasons is forced to accept increasing income gaps can to some extent make up for this by providing education on terms that enable real freedom of choice and opportunities for everyone.

Monetary policy and wage formation

The labour supply is a problem in both the short and long term. If it is not dealt with through measures that increase the labour supply - e.g. by reducing sick leave, raising working hours per employee or through an influx of foreign labour - potential growth in the Swedish economy may decline. The Riksbank may then be forced to curb demand in the economy through interest rate rises at a lower level of growth than during the last ten years.

In coming years, when actual growth is expected to approach and gradually reach its potential level, the labour market's ability to ensure satisfactory wage formation will be put to the test. While we don't believe that resource utilisation will exert any pressure on prices and wages so soon, increasing demands for restraint will be placed on labour market organisations as economic activity gains impetus.

Concluding remarks

The main problem that I have discussed has been the implications of an ageing population for the Nordic countries and the resultant imbalance between the supporters and the supported. The problem is aggravated further by the fact that it will become difficult to maintain high taxes as a result of globalisation. So the great challenge facing the Nordic welfare states in the future is a combination of two processes that are both important and difficult to influence.

The demographic changes will entail a loss in tax receipts due to fewer people in work while expenditure on pensions and healthcare will rise. At the same time, globalisation and openness has made it easier to transfer money abroad or to live and work in other countries. Our tax bases have in other words become more mobile, which reduces the scope for high-tax policies.

In Sweden we have taken certain preparatory measures, including a reformed pension system to enable the public finances to bear the costs of an increasing number of retirers. In this respect, Sweden has been a leading country from a European perspective. We have also consolidated our public finances thanks to our surplus target. This has laid firmer foundations to meet future demands. The question is whether it is enough. Sweden's weak point is the number of hours worked. In relation to the total demands on resources, there are already far too few that can or want to work full-time.

The demographic situation will therefore place great demands on innovation. It is likely that employers will be forced to make better use of their labour, recruit from abroad and support people to be mobile so that they can find the right tasks in life. Employees will have to realise that if too many choose not to work, the welfare system will collapse. People that no longer feel satisfied with their work must think of alternative ways of supporting themselves. The welfare model must be designed to encourage people to work.

Great demands will be placed on society to think in a longer-term strategic manner so that changes can be implemented in time. Competition in Europe for the young, and especially the well-educated, will be fierce. More people will have to want to stay in or move to our countries. Immigrants must be integrated quickly and successfully. Next year ten accession countries will join the EU and become a part of the free market. The enlargement of the EU and the establishment of a common labour market around the Baltic could perhaps increase the potential for an influx of foreign labour to the Nordic countries. But poorer countries further away are likely to offer greater potential - and pose a bigger challenge.

So it is not the Nordic central banks that possess the instruments for or solutions to these problems. But if other policy areas are effective, it will help us to fulfil our objectives, i.e. to ensure price stability and thereby also favourable economic growth.

It will require great leadership, a lot of cooperation and a high degree of openness in many areas in society. In particular, I believe that you, as teachers and participants in teachers' trade unions, have a vital role to play in this exciting process.

Thank you.