

# Speech

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## Competition, trade and inflation

Örebro Association of Building Contractors

What's wrong with prices in Sweden? It may seem odd at first that such a question is put at a time when prices are generally stable. Price increases in Sweden have been moderate even though economic growth has been high for a number of years. In the latest Inflation Report the Riksbank did indeed consider that in the coming years the broad economic upswing would lead to rising inflation but the tendency is not dramatic.

I still believe, however, that prices in Sweden pose a fundamental problem. The problem lies, not in the rate of price increases but in the price level. Here are some examples: Why should Swedish consumers pay almost twice as much as Danes for a bottle of detergent, or almost three times more than the Dutch? And why is it that the price of an air ticket in Sweden is two-thirds higher than in the rest of the European Community for journeys over the same distance?

The price gap between Sweden and the rest of Europe has been documented in a study of price levels in EU countries, published by the Commission.<sup>1</sup> The results show that for the same basket of consumer goods, the price in Sweden is 27 per cent above the EU average, 44 per cent more than in the United Kingdom and as much as 59 per cent higher than in the United States. Sweden is one of the most expensive EU countries, along with Denmark and Germany.

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<sup>1</sup> For example in *European Economy 1999:1*, Supplement A, Economic Trends. The study was done by NERA Consultants on behalf of the Commission in connection with the Cardiff II process.

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### Figure 1. Relative price level

This is something that affects our *prosperity*. For every one per cent by which the price level is lowered, the normal household stands to gain approximately 2000 kronor. So if the high price level in Sweden is a result of circumstances that can ultimately be put to rights, the gains in prosperity could be considerable. And as Swedish prices are particularly high for items such as food and housing, which make up a relatively large share of the basket for low-income households, a correction would be particularly beneficial for those who are worst off.

As a member of the Riksbank's Executive Board, I have an additional reason for raising this issue. As you know, it is up to the Riksbank to safeguard the value of money, defined in practice as meeting the 2 per cent inflation target. Our work to this end accordingly concerns everything that contributes to the *development of prices*. Improved competition can exert downward pressure on prices. The effects are no doubt essentially of the one-off kind but if they occur gradually over a fairly long period, it would then be easier for the Riksbank to hold inflationary pressure down.

In the light of this, today I shall be discussing some factors that impinge on the price level in Sweden. I shall be exemplifying with a sector that is dear to you, where competition does not work all that well. But I will also cite some good examples of deregulation in recent years. Another matter I shall be considering is the importance of free trade. Finally I shall comment somewhat more thoroughly on competition's significance for inflation and thus for monetary policy.

#### **Factors behind the price gap**

One evident explanation for the consumer price discrepancies is value-added tax, which in Sweden is levied at 25 per cent. This is higher than in most of the EU countries, though not in all. Sweden's higher rate has to do with our tax system but fundamentally it is, of course, a consequence of relatively high public spending. This has to be financed in one way or another; a lower VAT rate would make it necessary to raise other taxes and that would presumably show up in the relative price level.

The VAT rate does not account for the whole of the price gap. When VAT has been excluded, the price level in Sweden is still 10–15 per cent above the EU average and 15–20 higher than in the United States.

In addition to VAT, there is Sweden's relatively high labour costs, not least in service occupations like retailing. Moreover, as the wage spread in Sweden is narrower than in many other countries, pay in traditional low-wage groups is usually higher even though in recent decades the wages of these groups have also decreased relative to the rest of Europe). Labour costs are also conditioned to a considerable extent by labour taxes; the level of Swedish payroll taxes, for example, is one of the highest in the EU area. Furthermore, as a sparsely-populated country on the periphery of Europe, Sweden probably incurs higher costs for transportation.

While these factors no doubt explain a good deal of the price discrepancies, there is also the matter of competitive conditions in Sweden.

Segments of the Swedish economy have been exposed for a long time to strong competition. Especially our tradition of free trade has meant that most of the production of goods has had to cope with clear international price pressure. Neither are price differences for these products normally all that large. But there are other markets in Sweden where competition in practice is low. Consumers are in daily contact with some of these markets. The markets are dominated by a few major players whose position enables them to maintain a high price level.

That Sweden in particular lacks competition is partly a matter of geography and cultural factors. As I just mentioned, Sweden is sparsely populated, with a separate language and culture, so there may be natural reasons why just a few firms compete in certain markets. But not infrequently, the lack of competition seems to be associated with regulations and systems that have been set up by government and parliament. There have been instances of statutory monopolies but in many cases administrative rules and laws have sufficed to erect barriers which new players have not been able to surmount. There are some other cases where it can be argued that the authorities have not acted forcefully enough to maintain competition, so that some player or players have managed to abuse a dominant position.

A classic example is the regulations for new retail establishments, which have contributed to a concentration of retail trade that is internationally high. This concentration has presumably contributed in turn to the high prices for food and other everyday goods. At the same time, the situation in retailing illustrates the difficulties for competition policy. After lengthy discussions, the establishment regulations were abolished in the early 1980s but a decade later they reappeared in somewhat new forms.

#### Figure 2. Level of food prices in 1996

A lack of competition might be expected to result in high profit margins. There is statistical support for this in the case of the food industry, where profits are not only higher than in other parts of the corporate sector but also becoming even higher. Moreover, the profit levels seem to be rather insensitive to cyclical changes in activity, which may seem somewhat remarkable. It should be noted that weak competition can also lead to less efficient production. Low competition implies less pressure to rationalise operations, so that sector productivity is poorer than otherwise.

#### **An example: the construction industry**

In this assembly it is natural to take a closer look at the competitive situation and price trends in the construction industry and the housing sector. Housing costs are a large item in household consumption, as much as one-third of the CPI.

Prices for construction and building materials in Sweden are higher than in most other EU countries and the United States. Eurostat data show that in 1996, Swedish construction prices were 27 per cent higher than the EU average. The only country

where residential construction is more costly is Denmark. Apartment doors, for example, cost around 60 per cent more in Sweden than in Finland and Germany.

Figure 3. Building material costs and the CPI

High standards are partly responsible for the comparatively high level of housing prices in Sweden. There can be little doubt, however, that the Swedish system for subsidising residential construction has also been a notable culprit here. The system that applied previously gave producers too little incentive to keep costs down. As a result of considerable changes in the past 5-10 years, construction is now functioning better in this respect. In the light of some problems to do with construction and housing, another policy change is now being discussed in the media. It is exceedingly important that any changes which are made do not weaken competition again and push housing costs up.

The subsidy system has been changed but the problem of concentration remains. According to the Construction Costs Delegation, foreign competition is low. A study from 1996, by the National Board of Trade, the Competition Authority and the National Board for Industrial & Technical Development, shows that the construction market in Sweden is dominated by four companies with a combined market share of over 60 per cent. The building materials industry is also concentrated and its exposure to foreign competition is limited. The study shows, for instance, that a single producer has 95 per cent of the cement market, while two producers has 75 per cent of the market for asphalt. As the transportation of building materials is costly and troublesome, it seems likely that geographical and regional factors contribute to this.

Reports from the Swedish Competition Authority suggest, moreover, that the regulations restrict competition in the single EU market. It may be the case that competition is hampered by the multiplicity of standards and type approvals in different countries and the associated difficulties in getting building materials approved in other member states.

The construction industry has provided numerous examples of poor competition leading to inefficiency and there is reason to believe that this has also affected wage formation. In the 1980s, strong wage-driving impulses from the construction industry spread to other economic sectors. At around 3 per cent a year, the latest wage agreements in construction are above the average negotiated rate for the total economy. Moreover, wage drift in construction has been considerable in the past. The question is whether the lack of competitive pressure in this particular industry means that wage increases in excess of productivity growth continue to be easier to demand there than in, for example, export-oriented engineering, which is so exposed to competition.

**Other examples: electricity and telecommunications**

Thus, Sweden provides examples of markets where competition is incomplete. Today, however, there are also good examples of what can be achieved if bold steps are taken to open markets to competition.

Markets in Sweden that were previously regarded as natural monopolies, with poor competition as a necessary evil, have been deregulated in recent years. The chief examples are telecommunications and energy. Competing players have been given access and succeeded in establishing positions in these markets, aided by amended laws and regulations as well as by new technology.

The *electricity market* in Sweden is a good example both of the need to deregulate consistently and of how competition can be hampered even by simple administrative barriers. Although this market was deregulated in 1996, competition for household customers has been effectively blocked by the need for costly electricity metres. Now that the metre requirement has been abolished this year, considerable downward pressure is already also evident in household tariffs, even though the process is still in its infancy. For a normal-sized house that is heated by electricity, a family can cut the electricity bill by as much as 1500 kronor a year.

The pattern in *telecommunications* has been similar. When the telephone market was opened for competition in stages during the 1990s, the competition pushed prices down for long-distance calls but this was accompanied by an increase in Telia's tariffs for local calls. The new freedom to choose any operator is expected to lead to lower costs for calls in general. Competitors are already offering tariffs for national calls that are up to 50 per cent lower.

In these areas the price level in Sweden is also below that in other industrialised countries. OECD calculations indicate that Sweden is 41 per cent below the OECD area's average price level for telecommunications and 58 per cent below the level for the distribution of energy. Since those calculations were made, prices have continued to fall. The deregulations are contributing to this fundamentally positive picture.

The process of deregulation is not always simple, of course. It has to be done with circumspection and sometimes in stages. Not the least important aspect is giving consumers practical opportunities of comparing prices and products. The deregulation of the taxi trade illustrates some of the difficulties. The changes in air traffic have not had the intended effects. It seems that producers have found new ways of restricting competition.

The effects on inflation from various elements of deregulation are clearly demonstrated by developments in recent years and current tendencies. In the Inflation Report a fortnight or so ago the Riksbank judged that the recent years' deregulations and liberalisation will tend to lower the rate of CPI inflation by 0.2–0.3 percentage points in this and the coming year, followed by somewhat less in 2001. The downward effect on inflation this year is expected to come mainly from the deregulation of the electricity market. Next year it is foreseen that the effect from electricity deregulation will be equalled by effects from the changes in the telecommunications market and the agricultural reforms under Agenda 2000.

Figure 4. Price effects of deregulations

## Free trade

Before discussing the consequences of increased competition for inflation and the work of the Riksbank, I want to say something about the importance of free trade. In a small open economy such as Sweden, free trade is perhaps the primary condition for achieving sound competition, downward pressure on prices and a high level of prosperity. It can be noted that the import share has steadily grown and is currently equivalent to almost 40 per cent of GDP.

The policy of promoting free trade has led to prices in Sweden that are low compared with the EU average for a number of goods, such as clothing, footwear and home electronics. Participation in the EU's single market has accentuated price competition in Sweden. At the same time, Swedish companies operating in other EU countries are encountering stronger competitive pressure. As almost 70 per cent of Sweden's foreign trade is done inside the EU area, the effects of this are of central importance.

The economic and monetary union (EMU) implies additional competition. In that product prices in the monetary union are simple to compare in the single currency, the euro, consumers are in a better position to make their purchases in the countries where prices are lowest. This also influences corporate pricing strategies and draws attention to other costs, taxes for example, that contribute to prices. The combined effect is further downward price pressure. Price reductions of as much as 10–15 per cent have been mentioned, though such studies are bound to be very uncertain.

The scope for strong price competition in the EU area is indicated by the fact that price differences between member states still amount to as much as around 16 per cent. The differences have admittedly decreased in the past decade by about 6 percentage points but they are still 40 per cent larger than the corresponding differences between states and regions in the United States.

Stronger *internal* competition in the single market is not sufficient, however, to reduce the price differences and generally push price levels down in the EU area. External competition is at least as important. A number of studies show that it is precisely competition from countries outside the single market that could contribute to a more uniform and lower price level.

According to an OECD study, the EU area made rapid progress towards free trade from the late 1980s up to 1993, with diminishing barriers to trade and a growing import share in consumption. Since then, however, the tendency has ceased and there has been an increased number of attempts to restrict competition by means of anti-dumping procedures. Having previously been less open than the EU as a whole, the United States is now more open, with a GDP share for imports of 18 per cent as against under 13 per cent for the EU area.

It is particularly discouraging that EU imports of less technically advanced products are lower than in the United States. Discouraging because this is a sign that the existing barriers to trade are acting against countries with less developed industries, including many of Sweden's neighbours in Eastern Europe. It is just those countries we should give a chance as they endeavour to make up for the

decades of lost economic opportunities. Discouraging also because it is just in areas such as these that consumers could obtain notably lower prices if trade were freer.

A new WTO round of free-trade negotiations is due to begin in some months' time, with pressure on the EU and other participants to remove further barriers to trade and open markets for agricultural products, for example. However, a successful outcome is not certain. The possibility of temporary setbacks in negotiations is evident from the notorious 'banana war' and 'hormone beef war' between the EU and the United States, with the latter now imposing penal tariffs on European products.

Another setback for free trade is the EU ban on parallel imports from non-EU countries, in accordance with the Silhouette ruling. Parallel imports enable importers to avoid the price discrimination practised by brand manufacturers as a way of obtaining the maximum price in each country. A study by the Swedish Competition Authority shows that 60 per cent of parallel imports to Sweden do in fact come from non-EU countries and that imports of this type have pushed prices down by 10–30 per cent for such articles as car components, clothing, footwear and pharmaceutical products. Thus, a decision to re-allow parallel imports would be clearly beneficial to consumers. The Competition Authority estimates that for Sweden the CPI effect would amount to as much as 0.4 percentage points, or about 1000 kronor per household.

From what I have said it will be clear that as regards trade policy, the EU has not always put its best foot forward. Since the EU countries implement a single trade policy with the rest of the world, it is important that we in Sweden clearly advocate a policy of promoting free trade as far as possible in the Community.

### **Competition and inflation**

The discussion about competition's importance for inflation has become more intense in recent years. This is due not least to Chairman Greenspan of the US Federal Reserve, in his reasoning about the fact that inflation in the United States has been low for a number of years even though capacity utilisation has been high.

That this matter has also arrived on the Swedish agenda is not surprising. As we have seen, the rate of inflation in Sweden is being affected at present by deregulations at home as well as abroad. The circumstance that the Riksbank targets inflation is another reason for the increased emphasis in the debate on price tendencies.

As I mentioned earlier, world trade has grown as a result of tariff cuts, etc. Moreover, major sectors have been deregulated at the national level. To this should be added the effects of, for example, lower transport costs and the emergence of more countries where efficient production has been achieved together with low costs.

The new information technology adds another dimension to this. Among other things, the Internet makes quick price comparisons possible without having to visit the various shops. Lower prices are therefore already being quoted on the net. One

example is compact discs, which are up to 20 per cent cheaper from Swedish Internet retailers than in ordinary shops. According to the Swedish Wholesale & Retail Research Institute, network shops in the United States are another 10–20 per cent cheaper.

The combined effect of these factors is probably generating increased competitive pressure in large segments of the industrialised economies. Other manifestations of the same process are the rapid changes in the ownership and corporate structures of many sectors.

The question is how inflation will be affected by the increased competition. As an illustrative example we can take the used-car trade, though books or some other type of product would do just as well. The Internet and other factors are said to have induced a number of Swedes to turn to Germany, for example, because used cars are cheaper there. This obviously makes it more difficult to maintain the higher prices for cars of this type in Sweden. So the price level falls. Next, the Swedish car dealers may try to counter the negative impact on profitability by rationalising their operations. So productivity in the car trade rises. If their efforts are sufficiently successful, it may be possible to maintain profit margins. Another possibility is that in the next round of wage negotiations, employers in the car trade do not agree to such high wage increases as would otherwise have been the case or that they pay less for the cars they buy, and so on.

When a market is opened for competition in this way, prices and wages may thus be affected both directly and indirectly. It may also lead to a shift in productivity. The effects, however, are mainly of the one-off type: the price level falls and/or the level of productivity rises. But if a process of this kind, generated by increased competition, gradually pervades different segments of the economy, it can still affect the overall rate of CPI or some other index of inflation over a period of many years.

Perhaps I should add that even effects on the *development* of productivity cannot be ruled out. Stronger competition could conceivably lead to somewhat higher potential growth. There is, however, little empirical evidence that this has happened.

So what does this imply for the Riksbank and monetary policy? One way of putting it would be to say that our endeavours to hold inflation down are being aided at present by new technology, deregulations and decreased trade barriers, for example. These factors are not decisive for inflation in the longer run but neither are they negligible. If one-off effects of this type are a recurrent element in the picture of prices, they ought to be taken into account in our monetary policy, just as the Riksbank, assuming that it had targeted inflation at the time, would have been obliged to allow for the increased taxes in the 1970s and '80s, for instance. If arguments are found for increased competition leading to higher potential growth, this should naturally be taken into account as well. But in this respect there are reasons for being considerably more sceptical.

Finally, I want to emphasise that what I have been saying about the importance of effective competition, primarily for prosperity, should not be taken as a contribution to the current discussion about the repo rate. The Inflation Report earlier this month allowed for the effects of increased competition and so on that



we could identify. So the Riksbank's conclusion in connection with the publication of the Report—that the repo rate will need to be increased if nothing unforeseen happens—holds.