Speech

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The Swedish economy – cyclical upswing or a more fundamental improvement?

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The current economic situation in Sweden differs appreciably from the early 1990s, when our country was on the brink of a serious financial crisis, with a currency and banking crisis, sizeable public sector deficits and rapidly rising unemployment. Today the picture is considerably brighter.

The question I want to consider here with you is whether the impressive performance in recent years amounts to a conventional cyclical upswing or has to do with a more fundamental improvement in the workings of the Swedish economy.

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In the three years from 1991 to 1993, the Swedish GDP fell by a total of 5 per cent, employment dropped more than 10 per cent, unemployment shot up from 3 to 8 per cent, the public sector financial deficit grew to 12 per cent of GDP and government debt accumulated rapidly. Meanwhile, the stock of non-performing loans in the banking sector peaked at 10 per cent of GDP or 8 per cent of the total loan portfolio. The fixed exchange rate was questioned, there were sizeable interventions and for some days in the autumn of 1992 Sweden's central bank raised its instrumental rate to 500 per cent.

Various explanations have been put forward for the depth of Sweden's economic crisis. They range from the loss of demand in connection with the adjustment to

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the bursting of the bubble from the late 1980s, to more underlying structural factors. To some extent the explanations overlap and each of them certainly played a part in the dramatic course of events in the early 1990s.

In order to understand what happened I believe that we have to go back to the beginning of the 1970s and the collapse of the Bretton Woods system. For it was then that the stability oriented regime — a regime that had worked well in the post-war era — broke down in our country. In the absence of a global currency system, it proved difficult to establish a regime in Sweden that would be equally stable. During the 1970s and '80s Sweden had to manage without a distinct anchor for either monetary and exchange rate policy, wage formation or economic policy in general.

We moved through a series of devaluation cycles, fiscal discipline was undermined, structural problems accumulated and wage formation ceased to function properly. When the financial sector was deregulated in the mid '80s, the problems with stabilisation became even more difficult to manage. Meanwhile, the structural weaknesses were being concealed by an overheated economy. Activity looked strong but the potential growth rate in the Swedish economy had weakened some time before.

As the '80s drew to a close, however, there was a growing awareness that something would have to be done. The structural problems, high inflation and speculative behaviour all warranted a realignment of economic policy. In time, the necessity of a change was supported more and more widely. The tax system was reformed and so were certain segments of the transfers system. Sweden also applied for membership of the European Union. Our currency was pegged to the ecu and during the wave of international exchange rate speculation in the autumn of 1992 the krona was defended to the bitter end in order to demonstrate the determination to re-establish a credible low inflation regime.

The economic policy realignment coincided, however, with the setback that followed the bursting of the bubble from the late '80s and the Swedish economy descended into a profound crisis. Whether this dramatic downturn could have been managed somewhat differently is a question that will no doubt be analysed in the future. Some things could certainly have been done differently in the late '80s, as well as in the throes of the crisis.

However, I believe that the main lesson to draw is that the *roots* of the deep crisis ran quite a long way back. A realignment of economic policy was essential. The fact that there had been no credible stability oriented policy regime in Sweden for almost twenty years had had far-reaching repercussions that ultimately affected our material prosperity. It was high time to establish a new anchor for monetary and exchange rate policy, wage formation and economic policy in general. Structural reforms were also needed to correct earlier structural mistakes and restore our economic vitality. Whether the measures that have been taken up to the present are sufficient is a debatable issue; but the point I want to make is that a change of direction and some political action had already been initiated in the 1980s. The work has continued since then and been undertaken by governments of diverse political hues and personalities. In other words, something happened to Swedish economic policy in a wide sense in the late 1980s.

When the immediate crisis had been managed in the early 1990s it was clear that the weak government finances would have to be tackled. Moreover, the independent status of our central bank has been formally confirmed, accompanied by a clear mandate. The floating exchange rate regime and the explicit target for price stability have worked well. Several segments of the Swedish economy have been deregulated, though less has been done in this way in the labour market than in markets for goods and services. But the labour market organisations have been working on their own account to improve the system for wage formation.

As a result of all this, the Swedish economy is doing better than we have seen for a long time. The economic upswing has now continued for more than six years, during which annual GDP growth has averaged around 3 per cent. And notwithstanding the strong growth of demand, inflation has been lower than one would expect from earlier relationships. Everything suggests, moreover, that the economy will continue to impress. Last year, GDP growth was 3.8 per cent and the increase in employment was the highest in the past twenty-five years. Another indication of the good circle in which the Swedish economy is developing at present is that forward-looking GDP assessments have also been revised upwards, whereas forecasts of inflation have not been adjusted upwards to the same degree. Financial market pricing is also a tribute to the present credibility of Swedish economic policy. Who would have believed a decade ago that the Swedish economy would achieve such a favourable path?

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The successful combination of relatively high GDP growth and low inflation can in principle be attributed to a number of factors. One may be the plentiful supply of unutilised resources after the crisis in the early 1990s. A change in pricing behaviour may have contributed once the rate of inflation had been brought down to a low and stable level. Increased competition in connection with, for example, deregulations, globalisation and IT commerce may also have played a part. But it may also have to do as well with an upward shift in trend productivity, so that more goods and services can be produced without an increase in prices, in other words, a higher rate of potential growth.

It can be argued that all these factors have in fact contributed to the favourable development. When the upswing started there were plenty of unutilised resources. It is highly likely that pricing behaviour in a low inflation regime differs from that when inflation is high. Another circumstance worth mentioning is that both external and domestic competitive pressure have increased and led in many cases to downward price adjustments or just a slow increase. The most recent figures for inflation are one of several illustrations of this phenomenon. While this is strictly speaking a matter of a series of one-off effects, the increased competition can continue to leave its mark on the general price level for some time to come.

Another point worth noting is the prominent part that investment has played in the Swedish economy over the past six years. Increased investment tends to generate higher productivity growth. That in turn raises expectations of future corporate profits, which often leads to higher share prices. Higher corporate valuations stimulate additional investment by the firms in question and also give enterprises better access to risk capital for further expansion. Meanwhile, share-owning households perceive an increase in the net value of their assets. Increased wealth and optimistic expectations lead in turn to a stronger growth of consumption.

In this way, a growth process that is driven by investment can create a good circle. The supply side of the economy generates increased demand and a favourable composition of demand tends to strengthen the supply side still more.

In the twenty years from 1974 to 1993, the annual growth of labour productivity averaged only 1.4 per cent. The rate since 1994, however, has averaged 1.9 per cent and this cannot be attributed solely to cyclical factors. Thus it may indicate an increase in potential growth. While it is not yet on a par with the United States, where productivity growth has been accelerating in recent years, it does constitute an improvement.

Neither would it be surprising if future productivity growth turns out to be somewhat higher than observers have counted on to date, though this is not a matter of any dramatic change. Certain indicators in the early part of this year, although still somewhat uncertain, may point to some upward adjustment. It would be interesting if this is confirmed because it would mean that productivity growth is tending to move up even in such a late phase of the business cycle. At the corresponding stage of the previous upswing in the 1980s, productivity growth had already slowed down and price and wage increases were beginning to accelerate.

From this it can be concluded, at least for the time being, that the economic upswing in Sweden has not been just a cyclical improvement. It is also a result of factors that are more structural.

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The transformation of economic development and its new patterns naturally face forecasters and macro economists, including the Riksbank, with major challenges. From this I conclude that when making assessments of the future, we must be highly alert to new economic information and be prepared to reassess earlier models, relationships and forecasts as and when the need arises.

The continuation of a strong demand trend can be expected to render resource utilisation in general and in the labour market in particular increasingly strained. On the other hand, inflation is still low and the prospects to date in this respect appear to be balanced. So there are not all that many signs at present of resource utilisation becoming excessively strained. Accordingly, it seems that there is ground to believe that the Swedish economy is functioning better than before.