SPEECH

DATE: 25 August 2003

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Growth and competition - lessons from the past

Thank you for the invitation to come here and speak on the occasion of Sparbanken Gripen's 150th anniversary. In my speech today, I intend to attempt to draw some conclusions from the experiences of our economic history during this period. One of my conclusions is that Swedish growth has been stimulated during the periods when we have allowed the market economy to operate under clear and fixed game rules, including a stable framework for both fiscal policy and monetary policy. If these conditions have not existed, we have paid a price in the form of weaker economic growth. This speech does not contain any signals regarding current monetary policy.

The past 150 years have been an exciting time, in particular the first part of this period. This was when Sweden changed from being a remote, developing country with a high infant mortality rate, widespread poverty and starvation, into a prominent industrial nation. Around 1850 Sweden entered into a dynamic period of rapid development and change. A wave of liberalisation swept across the country and opened up important markets. GDP growth amounted to more than 2 per cent a year, which was twice as high as the growth rate during the first half of the 19th century. A doubling of the GDP growth rate might not sound particularly exciting, but over time it has very major effects. An increase in the GDP growth rate from one to two per cent entails the standard of living doubling within 35 years instead of 70 years. For Sweden the stronger growth rate during the second half of the 19th century meant that we emerged from the developing country stage.

A number of factors contributed to this development. Free trade was an important element. Our exports abroad were central to this process, which was of course facilitated by the development of the railway system. During the first decades after 1850, there were three main export products contributing to a very rapid export upturn; oats, iron and timber. The importance of exports of oats from the southern part of Sweden is something of a curiosity. Oats were the fuel of that time. All of the horses providing transport in industrial cities like London required oats and much of this came from Götaland.

The construction of the railway, as well as investment in industry, housing construction and agriculture naturally required capital. This was mainly obtained from abroad. Sweden was a typical example of a country with an expansionary economy making use of saving in other parts of Europe. This borrowing from abroad was on a very large scale and, prior to the outbreak of the First World War, Sweden was probably the most indebted nation of the time.

High level of international mobility

If one looks at this period in diagram form, it is quite striking how much growth varied, even if a five-year sliding average is used. The fluctuations in economic activity were considerable and this of course put households in a vulnerable position, as there was broadly speaking no social welfare system at that time. Although living conditions improved rapidly, they were still insufficient for many people. There was extensive emigration. However, a large number of these emigrants returned to Sweden and we had a widespread interchange with other countries. There were very few limitations to international mobility for people, capital, products and ideas.

If we instead look at price developments, we can observe average low rates of price increase around 2 per cent a year during this time, and during the period as whole. However, there are also substantial variations. There were general price falls – deflation – on a number of occasions. Deflation is normally associated with very large shocks such as those during the 1930s depression in the USA and Germany, but at the end of the 19th century, there were also price falls in Sweden during an otherwise favourable economic climate. One important explanation for this is that deflation is not necessarily caused by weak demand in the economy. Rapid productivity growth can also generate a price fall and this was what occurred periodically during the second half of the 19th century. In these situations deflation need not be the bugbear to economic development that it is often made out to be.

On the other hand, if we move forward a few years to the period during and after the First World War, we do see large shocks - falling GDP combined with very high inflation, followed by severe deflation at the beginning of the 1920s. This was when Sweden experienced its most severe economic crisis, rather than during the 1930s as was the case in the USA and Germany, for instance.

If we move forward to the post-war period, this was a unique time of high and constant growth. During the period following the Second World War and up to the 1970s, standards of living rose at a record rate throughout the world. An interesting fact is that although growth in Sweden during this period was higher than it had been at any other time, it was nevertheless rather low in an international comparison. Many European countries, including our Scandinavian neighbours, grew at an even more rapid rate.

However, from the 1970s the problems increased. Growth waned and inflation rose. We managed to temporarily stimulate growth by means of substantial devaluations, but there was no proper follow-up and the economy overheated, only to turn around entirely at the beginning of the 1990s, resulting in extensive problems for the financial sector. Since then we have had a decade or so with better growth and more balanced developments. The average growth rate during these years was just over 3 per cent. This was very different from the average growth we had during the previous ten years. During the transition phase between these periods a number of important changes were implemented regarding the allocation of resources in society. Here I am referring to the deregulation of the financial markets, reforms in the pension, tax and social insurance systems and a reduction in the burden of taxation. In addition, wage formation has been improved, which has probably been facilitated by monetary policy focussing on price stability. It seems to me probable that the return to macroeconomic stability and in particular the structural reforms have actively contributed to the favourable developments of the past decade. On the other hand, I do not believe that the changeover to a floating exchange rate has been crucial in itself. Over the past century Sweden has mostly had a fixed exchange rate and usually shown good growth.

At the same time, the past ten-year period has been a special one in terms of the euphoric expectations of the "new economy" connected to telecommunications and IT. This contributed to soaring stock market prices, followed by a fall of historic proportions. History can demonstrate similar episodes. The railway construction in the 19th century gave rise to similar over-optimism, as did the introduction of electric and internal combustion engines at the beginning of the 20th century. Sometimes, these periods of over-optimism have put considerable strain on the financial system. The strain caused by developments in recent years appears to be comparatively limited.

When inventions with a broad potential for application are introduced, it generally takes a long time before we learn the best way to use them. We tend to be fixed on the current system solutions and find it difficult to see new opportunities. The sobering process that has occurred since the exorbitant expectations at the end of the 1990s with regard to telecommunications and IT therefore does not rule out the possibility that this technology will stimulate future productivity growth. Following the electricity euphoria at the beginning of the 20th century, various applications gradually changed everyday life for industry and households. Sweden was not fully electric until a few decades later. Essentially, therefore, I am optimistic with regard to what future applications in telecommunications and IT can achieve for economic growth.

The financial sector – the lubricant of the economy

The financial sector has played a very central role in the development of the economy over the past 150 years. It still does, although the general public is sometimes critical of the financial sector – often without considering the services the sector has to offer and how daily life would look without this sector. The fundamental functions of the financial sector – financing, risk management and intermediation of payments – are indispensable to society. Financing entails bringing together the different wishes of savers and investors. Savers want their money to be available directly, while investors often require long-term loans. These opposing wishes can be reconciled via banks, and also directly via the financial markets. The latter assumes that there are well-developed secondary markets with a large turnover in, for instance, equity. This enables companies to borrow long-term while savers can quickly sell their shares if they so desire. Risks are managed through the spread in borrowing, but also by transferring them, against payment, to others in the financial market. The spread and redistribution of financial risks enables investments to be made that would not otherwise have been possible. The third and final main task is the intermediation of payments, which enables payment to be smoothly made and received for goods and services sold either in the conventional manner or via, for instance, the Internet.

In countries like Sweden we tend to take it for granted that these functions work. However, if we try to imagine that they did not exist, we will realise how extremely central they are to the functioning of the economy and to our welfare. If we imagine a country where savers and investors did not have access to functioning and reliable banks and financial markets, it is easy to see how this would hamper development. The effect would be a tendency for savings to move abroad, while profitable investment projects did not get off the ground in countries with an undeveloped financial sector. If we look back at the 1950s, we can see that the intermediation of payments functions much more smoothly today. Then, we used to stand in line to receive a pay packet, life assurance employees bicycled round to customers' homes to collect premiums and almost everyone stood in line at the post office to pay their rent, electricity bill, etc.

From freedom to regulation and the return to freedom

The conditions for Sparbanken Gripen and the financial sector have certainly varied over the past 150 years. During the first part of this period, the financial sector was able to operate under considerable freedom. Bank deposits were developed as a basis for the banks' lending. This meant that the banks created money by expanding credit to the extent that they dared to reduce their reserves. The banks also played an important role in the foreign borrowing that occurred, mainly in the form of bond issues in Germany and France. The banking system was particularly expansionary around the year 1900, when many new banks were established. Some of these did not last long. In 1907 the financial sector suffered a widespread crisis and many banks went into liquidation, were refinanced or taken over by other banks. The next financial crisis coincided with the deflation at the beginning of the 1920s. This crisis was particularly severe in rural Sweden, partly because of a severe fall in agricultural product prices. Deflation made the situation difficult for farmers encumbered with debts and thereby for the banks active in rural areas.

As a reaction to the crisis during the 1920s, the difficulties of the 1930s with the Kreuger crash and in particular the outbreak of the Second World War, the central government tightened its grip on the financial sector. Many of the regulations introduced at that time still remained towards the end of the 1980s. During this period of regulation, the financial sector looked very different. It is probable that the regulations then curbed the development of economic activity. The regulations covered, for instance, the central government guaranteeing financing of housing construction and the central government borrowing requirement. Interest rates were kept lower than the equilibrium level with the hope that this would stimulate investment and growth. This of course resulted in a large demand for loans, which was managed by means of rationing. A necessary condition for this regulatory system was that the country was screened off with the aid of currency regulation that prevented savers from taking advantage of higher interest abroad. One might think it self-evident that an individual should be able to decide where in the world he or she invests his or her savings, but for a long time we lacked this freedom. In other words, one of the financial markets' fundamental tasks was eliminated – allocating capital to the most profitable investments. During this long period of regulation we as a country forgot our own experiences from the 19th century on the value of free movement of capital and the importance of the price mechanism in efficient allocation of resources.

Deregulation since then has meant that there are currently greater similarities with the late 19th century/early 20th century than with the intervening period of regulation. I have used the word deregulation here. On a general level this is an appropriate description, but one can also describe developments in terms of changes in regulation. This is because, at the same time as considerable deregulation has occurred, there are other regulations remaining and new ones have been introduced. One important difference, however, is that today's regulations are aimed at allowing the price mechanism to function, i.e. they are market-conforming. These regulations are usually aimed at protecting savers and investors against risks and abuse. In this sense it is a case of re-regulation.

The financial sector thus fulfils a central role as a lubricant for the economy. An efficient financial sector increases a country's potential growth rate. Today approximately 80,000 people are employed in the financial sector, although the number of bank employees in Sweden is in relative terms lower than in any other OECD country. This and other indicators show that we have a relatively efficient financial sector.

Growth based on productivity and labour

I have emphasised, in this roughly sketched outline, the important role of growth in the development of our standard of living. However it also plays a central role in monetary policy discussions, as demand in the economy in relation to production capacity is decisive for whether inflationary bottlenecks will arise or whether we will underutilise the production potential. It is the potential growth rate that sets the limits. We at the Riksbank must take into account this rate and any changes in its development, even though monetary policy does not directly affect potential growth. Similarly, we must take into account changes in competitive conditions, as changes here can have both direct and indirect effects on the development of inflation. Possible measures to strengthen potential growth are an issue for other forms of economic policy, involving, for instance, the stimulation of competition to improve allocation of resources.

The high growth rate over the past decade has been primarily generated by the fact that we have used available resources more efficiently. On the other hand, we have not supplied many more resources either in the form of hours worked or of capital/investment. From the mid-1980s up to 1993 the opposite applied. The limited increase in productivity that arose then was due to investment, i.e. capital intensity increased. Over the past ten years we have had an impressive annual increase in factor productivity, while capital intensity has increased at a slow rate.

It is worrying that the increase in labour supply has been, and still is, so limited. In this aspect we differ from most of the other countries that have been aided by increased labour supply in raising their growth rate. An important explanation for the poorer development in Sweden is the amount of long-term sickness leave and early retirement. Worry over these tendencies increases if one takes into account the fact that future retirements may further limit the labour supply. However, let us leave the discussion of the labour supply and concentrate instead on the productivity aspect.

The combination of price stability and budget stability is an important explanation for the development in productivity[1]. Price and budget stability increase households' and companies' willingness to make long-term decisions. Stable prices also entail better information value in relative prices, which improves the allocation of resources.

If we consider other factors that have stimulated the upturn in productivity in recent years, there are several central changes. One generally seeks explanations in factors such as technological developments, education, competence and incentives among the work force, as well as the allocation of resources in society.

At the same time, the pressure on companies to use resources efficiently has increased during the 1990s. Greater competitive pressure resulting from both increased internationalisation and deregulation in various sectors has increased the need for companies to economise their scant resources. Less extravagant use of resources means that the labour force and capital are employed in other areas where they contribute better to the national economy. Although the changeover can be difficult for those who lose their jobs, a better allocation of resources is a necessary condition for improving welfare.

Openness is important

Productivity is also affected by a country's capacity to utilise technological progress in other countries. This capacity is in turn dependent on how open a

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[1] The importance of price and budget stability for productivity growth has been demonstrated, for instance, by William Easterley in "When is stabilisation expansionary", the World Bank, Dec 1995.

country is to impulses from outside, which is determined by the obstacles to ideas, products, services and production factors moving freely across borders. The capacity to reconsider regulations and institutions so that changes can be adopted is an important part of this openness.

The negative experiences of the closed economies during the interwar period led to trade barriers being successively lowered after the Second World War. A gradual increase in free trade stimulated the global economy and this was particularly important for small countries like Sweden. Freedom for savers to choose the country in which to save was also introduced in many countries. The obstacles to ideas, products, services and production factors moving freely across borders has declined further during the 1990s, partly due to our EU membership and this ought to have had a positive effect on factor productivity.

Internationalisation has thus contributed to an increasingly large part of the corporate sector becoming 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 was introduced in Sweden in 1993, containing an express ban on anti-competitive cooperation between companies and a ban on abuse of a dominant position. There has also been some further deregulation. For instance, state monopolies have been abolished and freedom to establish new companies with regard to, for instance, transport, communications and energy has been introduced.

Changed competitive conditions thus affect productivity growth, but they can also affect price developments more directly. Despite the fact that we gained much stiffer legislation on competition in 1993, developments in this field appear to be moving slowly. Swedish prices remain higher than in other countries in several areas without explanations for this in the form of differences in VAT rates and wage levels. Increased competition can contribute to price levels converging, but this assumes that the relative price changes will be accepted and it can entail, as in the 1990s when electricity and telecommunications were deregulated, such large price reductions in some sectors that our inflation rate will be lower than that of other countries.

Special interests and consumer interests

Limits to competition are a clear example of how special interests dominate over general consumer interests. There are many examples of this in various areas of the Swedish economy, and in particular the construction sector. This means that we allow inefficiency to remain, which reduces growth and the development of most people's standard of living. One interesting and very recent example of how special interests have declined concerns pharmaceutical prices.

A change in this field was introduced in October last year, which in principle means that pharmacies are obliged to exchange a drug in a prescription for a cheaper equivalent (generic) unless the customer is willing to pay the difference.

The effect of this new regulation, combined with patents expiring, has led to significant price competition. Pharmaceuticals companies have gradually lowered their prices through more than 3,500 reductions, which benefits us as individuals when we purchase prescription drugs and as tax-payers as the cost of the county councils' subsidies for prescription drugs declines.

Pharmaceuticals costs are included in CPI as one of many sub-indices and are intended to reflect the average household's costs for prescription drugs. Over the past ten years this index has risen at an average rate of 12 per cent a year. Now this increase has been turned around to a small decrease. The difference between the historical rate of increase and the current price fall corresponds to a saving of approximately SEK 1 billion a year[2] for Swedish households. Correspondingly, the county councils' costs have been reduced by approximately SEK 2 billion.

There are large sums involved here and they deserve some attention. Nevertheless, it is difficult to find articles dealing with these large savings and with the increase in competition. The main aspect appears to have been lost in the media. Instead, one finds articles on the difficulties for our monopoly company Apoteket to adapt, as it exists on a margin of approximately 20 per cent.

It would be beneficial to have more discussion of, and attention paid to, the question of how to stimulate competition. In this particular case a beneficial change appears to have strongly stimulated competition. If we are to achieve increased competition in other areas, too, it is necessary to constantly emphasise consumer interests so that allocation of resources becomes as efficient as possible and protected sectors are not allowed to operate inefficiently to the detriment of potential growth.

What can we learn from 150 years of history?

To summarise, there have been many changes in the Swedish economy in recent times. The external framework is currently characterised by considerable fiscal policy and monetary policy stability, which facilitates planning and decision-making for both households and companies. Both our own history and that of other countries shows clearly that a stable external framework is an important basis for economic growth.

We have also gone back to being open towards the outside world. During the war we were not, for obvious reasons. After that we were open for a long period according to the rhetoric, but less so in practice. Today we have regained a freedom for ideas, products, services and production factors that is reminiscent of the late 19th century and early 20th century. In both of these aspects we appear to have done our homework.

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[2] Statistics Sweden calculates households' consumption of pharmaceuticals to be approximately SEK 10 billion a year.

At the same time, it should be remembered that many markets in Sweden still show clear signs of a lack of competition. This entails a considerable cost and in this field we appear to have more to learn from history. The significance of this is underlined by the fact that the various parts of the economy are interlinked, which often means that a strengthening of the weaker parts is more important for the whole than for the particular industry or sector.

The complementarity of the economy[3] makes it particularly important to remedy our weak links and to listen with humility to the proposals of, for instance, the OECD and IMF. It is often easier to identify the problems if one can look at things with a little perspective. I believe that the Swedish economy has considerable unused potential for stronger growth if we concentrate on this, that is to say, on how to make our joint share of the cake grow.

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