



SPEECH

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■ Sweden in Europe

Ladies and gentlemen,

At the Lisbon summit in March 2000 the EU's heads of state and government decided to initiate an ambitious reform agenda that would extend over the entire decade. The goal was for the European economies to become "the most competitive and dynamic knowledge-based economies in the world by 2010". Today, I intend to reflect upon what has happened with economic reforms in the light of the Lisbon agenda, both in Sweden and in the euro area in general.

But first allow me to thank you for your invitation to speak here today. As I'm sure you all know, the Riksbank attaches great importance to participating at various events and speaking on issues of significance for monetary policy and financial stability. This is perhaps most true of issues regarding the current stance of monetary policy, of which we were informed a short time ago in conjunction with the Inflation Report that we published last Thursday and which resulted in the decision to leave the repo rate unchanged at 2.75 per cent. The interest rate decisions in particular usually attract great interest from the public and the media, which the Riksbank of course finds very gratifying. The task of explaining monetary policy and the risks to Swedish inflation prospects one to two years ahead is an important aspect of our operations and in some ways is a precondition for our ability to attain our objective of maintaining price stability in the Swedish economy. Similarly, we publish regular reports that comment on stability issues in the Swedish financial system so as to ensure a safe and efficient payment system.

But sometimes the Riksbank also needs to look beyond the current monetary policy situation or conditions in the country's banks and comment on issues of a longer-term nature. Here, the Bank may give its views on the labour market, on competition in trade and industry or on the long-term conditions for growth in the Swedish economy. In light of this, the issues relating to the Lisbon agenda are something the Riksbank has been following with great interest.

Potential growth plays a key role for monetary policy

Long-term potential growth in particular also plays an important role in the Riksbank's monetary policy assessment. Economic growth essentially depends on two factors – how much we work and how productive we are. Thus, in somewhat simplified terms, we could say that it is efficiency gains and growth in the working population that enables us to increase consumption. This is what we usually refer to as the potential growth rate, that is, the rate at which the economy can generate new economic resources without giving rise to shortages or surpluses.

In the short term, however, an economy can grow at a different rate than its potential. If growth surpasses the potential rate, demand will gradually exceed supply. This creates upward pressure on prices, mainly because wages rise quicker. In order to compensate themselves for these wage increases, firms are forced to raise prices. Consequently inflation rises, which also erodes the value of recent wage increases. In the worst-case scenario, this results in a wage-price spiral, which greatly undermines the conditions for favourable growth in the real economy.

It is then that the Riksbank is forced to intervene and raise interest rates. But another implication is that the higher the underlying potential growth rate, the less probable it is that bottlenecks and price pressures will arise in the economy, and the more probable it is that the Riksbank can refrain from intervening. This is why long-term potential growth is so important for all monetary policy assessments.

The Lisbon agenda entails greater reform pressure

So what does the Lisbon agenda entail? And what kind of reforms need to be implemented to raise long-term potential growth?

According to the agreement of the heads of state and government during the Lisbon summit, the reforms should, for instance, aim to increase employment in the European Union to at least 70 per cent of the economically active population, and should lead to a potential growth rate approaching 3 per cent. These are significant challenges, considering that the current employment rate averages around 64 per cent and the potential growth rate is close to 2 per cent. Furthermore, during the past two years employment growth has stagnated, and several economies are experiencing zero growth or even recession.

For Sweden, the outlook is somewhat better. Growth has been comparatively favourable in recent years, despite the considerable international slowdown. However, employment growth has also been weak here, and recently we have even witnessed a decline in employment. The employment rate in Sweden nevertheless exceeds the established target already, as just over 77 per cent of the economically active population are employed in some way. That is not to say that Sweden can feel comfortable about its present situation. The Swedish figures conceal large, increasing numbers on sick leave, falling mean working time and

■ total unemployment – open and hidden – of well above 6 per cent. So creating opportunities to raise employment is a key question for Sweden as well.

But it is not only in the labour market where the EU Member States need to take action to attain the goal of the Lisbon agenda. When the World Economic Forum last reviewed how the Lisbon strategy has been implemented, it was found that Europe was lagging behind the US in a number of areas. The biggest differences were in areas such as enterprise environment, network industries, innovation, research and development, and financial services. Moreover, in its latest review of the Lisbon strategy, the European Commission underlined research and development as a shortcoming, but also pointed to insufficient confidence in social security systems and a lack of efficient markets in primarily transport, energy and financial services.

Here I would like to focus on three areas that I believe are important for both increasing potential growth and improving the competitiveness and dynamism of the European economies. The first is to consolidate public pension systems so that they can withstand the demands of an ageing population. The second is to overhaul the structure of tax and benefit systems in order to minimise their distortional effects on the labour supply. Last, but not least, we need to reform the functioning of the financial markets so as to increase efficiency and thereby also the willingness to invest.

The economic crisis gave Sweden a better starting position

With regard to Sweden, much has already happened to improve the functioning of the Swedish economy and increase potential growth. This has helped Sweden to come further than many other euro area countries in terms of living up to the Lisbon strategy. However, some of this has been due to economic developments as opposed to a political will to change.

For example, the economic crisis at the beginning of the 1990s resulted in the winding up of low-productivity operations, thus increasing labour productivity. During the same period, Swedish economic policy was changed with a view to laying the foundations for longer-term, sustainable economic growth. A new regulatory framework was adopted for fiscal policy, including an expenditure ceiling and a surplus target, while the focus of monetary policy was aimed at keeping inflation in check. This increased stability and made policy more predictable, thus boosting the willingness to invest. The tax and social security systems were also reformed, not least by reorganising the pension system.

Sweden's entry into the EU's common market together with deregulation in a number of important markets gave rise to increased competition and greater demands on businesses to use their resources more efficiently. It is likely that the faster growth experienced by the private sector compared to the public sector, as well as advances in IT during the latter stages of the 1990s, also contributed to higher potential growth.

Reforms behind favourable growth in the labour market

If we compare the situation in the Swedish labour market to that of the euro area, we can see a number of differences. Sweden was among the first in some areas to initiate reforms that helped improve the functioning of the economy. Deregulation carried out in the 1980s and at the beginning of the 1990s was partly the reason that Sweden performed relatively well after the crisis years.

One such deregulation was an easing in working-hour legislation, which, for example, has made it possible to shop more or less round the clock in Stockholm today. It is only recently that this has started to catch on in the euro area. For instance, as late as last summer it became possible in Germany to shop after 6 p.m. on weekdays and on Saturday afternoons. However, it is still almost impossible to find a shopping centre in Berlin or Frankfurt that is open on Sundays, a day that ought to be very suitable for retail trade since customers are usually not at work then. So a continued modernisation of working-hour laws could contribute to further improving efficiency in the German economy.

Another area is the costs associated with downsizing. European firms are in many cases obliged to pay for laid-off employees a long time after their employment has finished. This may make the labour market less efficient in downturns, as firms often try to retain existing staff instead of implementing costly cutbacks. The situation can become particularly serious if the downturn turns out to be longer or deeper than firms initially fear, since cutbacks during the economic downturn risk aggravating the decline. In this respect, the euro area and Sweden are at a disadvantage compared with the UK and the US, where the labour market responds much quicker to changes in economic conditions.

Labour market legislation can therefore also be significant for the economic cycle. Firms that are forced to retain a larger workforce than they have use for during a downturn will not be as financially well prepared to meet a future upswing. We can see signs today of how this is having an adverse effect on the European economic recovery. Firms in the US and the UK cut the size of their workforces at an early stage and adapted their operations to demand, whereas European firms waited until the last minute to carry out the necessary cutbacks. While profits and the future outlook have now turned around more and more clearly in the US corporate sector, the immediate future continues to appear gloomy for European firms, which have seen their competitiveness deteriorate during the slowdown.

So in this respect labour market legislation can be a hindrance to high long-term growth. Furthermore, it is likely that legislation sometimes contributes to amplifying cyclical fluctuations rather than smoothing them, since productivity and profits in the corporate sector can easily become pro-cyclical. There are indications that this has been the case during the most recent economic slowdown, as productivity has fallen sharply in the euro area at the same time as it, if anything, has tended to rise in the US. This also suggests that the US economy will normally emerge from slowdowns quicker than the euro area.

Sweden among the first to have a sustainable pension system

Another area in which Sweden has led the way is in pension reforms. The ATP reform in 1960 included buffers for the government finances. On the other hand, the reform was partly based on the assumption of continued robust growth and an average life expectancy of around 70 years. As we know, the 1970s and 1980s can be viewed as wasted years in growth terms. Average life expectancy continued to rise sharply over the period, however. When it then became increasingly obvious during the 1990s that the ATP system was also going to be underfinanced, a number of years of political debate passed before a majority of the Swedish parliament could agree on a new pension system that would be sustainable in the long term. With the implementation of the premium-reserve pension reform of 1998, a system was created that indeed is not guaranteed to result in high pensions for pension savers, but that at least will enable the public finances to bear the costs as an increasing number of people retire.

However, Sweden is not the only country to be facing a difficult demographic challenge, quite the reverse. In the euro area, some countries will have a considerably larger frequency of retirement in the coming decades, which means that in 30 years there will be twice the number of pensioners per worker compared with today. Nevertheless, until recently pension reforms in most euro area countries have been conspicuous by their absence. In addition, the majority of these countries have only used a system whereby current pensioners are paid directly by current workers, and no funds have been reserved. The fact that this is unsustainable in the long run has been obvious for a long period. Yet, it has been politically impossible to bring about the kind of reforms that we in Sweden succeeded in introducing through political accord.

The financing of the state pension systems are of vital importance for the taxpayers' confidence in the economy. If we have learned anything from recent economic developments, it is that households and firms have become better and better at putting things in context, and to change their behaviour accordingly. When forward-looking taxpayers have realised the obvious – that the pension systems sooner or later must be overhauled – it has also affected their behaviour. Because in the end, the taxpayers have to foot the bill when the systems are underfinanced - either by way of higher pension charges or lower benefits. Irrespective of which, uncertainty results in households preferring to save a little extra rather than consume. This could also be one explanation to why saving in many central European countries has remained at a comparatively high level.

It is therefore pleasing that steps have now been taken in the three largest euro area economies to reform their pension systems. Even if these reforms are insufficient to secure the government finances in the long term, they are important stepping stones towards healthier economic growth.

Tax and benefit systems a key question for the labour supply

Income tax and benefit systems are also important for long-term potential growth in a country, particularly in countries with a high tax burden. It is indeed not possible to establish with certainty that a high tax burden in itself would constitute a limitation to growth in the long term. Studies by organisations such as the OECD and the IMF point to a clearer connection between long-term growth and the structure of tax and benefit systems than any direct relationship between the tax burden and potential growth.

However, this is an area to which Sweden by virtue of its high taxes must pay continued attention. Economic policy must be focused on finding ways to reduce the distortional effects of the tax system, not least as regards people's willingness to work. High marginal taxes can reduce the motivation to work, thus hampering the economy's potential growth. This applies particularly when the benefit systems are linked to income. At an individual level, this could mean that someone who is offered a job and at the same time must pay higher tax and receive lower benefits may come to the conclusion that it is more rewarding to remain outside the labour market. This dampens the labour supply and thereby also the economy's long-term potential growth. Growth issues and particularly the labour supply now appear to be increasingly in the spotlight, which is positive provided that it also lays the foundation for further reform.

Having said that, it is pleasing to note that several reforms have been introduced recently with a view to decreasing the distortional effects of the tax system, in particular among low-income groups. This applies perhaps primarily to the steps that have been taken to abolish individual social security contributions, thus reducing marginal taxes among low- and medium-income groups and raising thresholds for state income tax. Changes in childcare fees, for instance, have also lessened the distortional effects for people who receive increases in income, which is also positive for the labour supply.

But Sweden is not alone in introducing reforms in this field. As regards low-income groups several European countries are now making a concerted effort to reduce marginal taxes and change benefit systems with a view to increasing the willingness to work. Germany has decided to lower marginal taxes for low-income groups to 15 per cent, and for high-income groups marginal taxes are to be lowered to below 50 per cent. At the same time, more stringent rules are being introduced for unemployment insurance. Similar tax reforms have been implemented or will soon be implemented in France, Spain, the Netherlands and Belgium. The risk is therefore that the gap between Swedish income taxes and those on the Continent will widen over the coming years.

The financial markets an important reform area

An often overlooked area when it comes to structural reforms is the financial markets. An efficient financial system can raise potential growth markedly. This area has also become increasingly important for long-term growth as technologi-

cal advances have made it possible to quickly obtain information about global developments and to rapidly transfer capital between different countries. Countries that are able to attract capital can thereby attain financing at a lower cost, which also boosts investment in these countries. The US is one example of a country that despite weak domestic saving attracts capital from abroad, thus helping to hold up investment. In turn, investment in new technology forms the basis for productivity growth, thereby making it important for potential growth.

The structure of the tax system is also of significance in this area. Swedish taxes on capital are not appreciably higher than the EU average. Their distribution is distorted, however, with high wealth tax and capital gains taxes for individuals, and low taxes for institutional and foreign investors. This distorted distribution of the tax burden may come to play a more important role for Sweden's attractiveness, in terms of how both Swedish and international investors decide to allocate their investments between Sweden and abroad.

As regards the functioning of the financial markets, the unfortunate truth is that this is also a neglected area in many countries on the Continent. In some respects Sweden has progressed further than the euro area countries in terms of improving the efficiency of the financial system. After the period of deregulation in the 1980s the progress of the Swedish financial market has been well in line with what has happened in the Anglo-Saxon economies in the US and UK. As a result, the equity market has become more important as a source of financing and firms have become less dependent on banks. Meanwhile, banks have focused to a greater degree on providing credit and financing opportunities to individuals. Thanks to deregulation, more Swedes have been able to borrow at a reasonable rate of interest, making it possible for a larger number of people to own their own homes and to better distribute their consumption over their lives. In this respect developments in Sweden have largely followed those in the US and the UK.

Of course such deregulation- or rather re-regulation - is not problem-free. The fact that a greater number have the opportunity to borrow also implies increased risks in the financial system. But in the absence of risks, growth opportunities also decrease. The important thing therefore is that the risks can be managed in the event of a crisis, which, for instance, requires strong consumer protection. Here Sweden has also been at the fore by being the first to publish regular stability reports for the financial sector, with a view to avoiding any reoccurrence of a systemic collapse similar to that at the beginning of the 1990s.

There are now signs on the Continent that the pace of financial market reform has increased. This is partly because the EU Member States, as a part of the Lisbon strategy, have agreed to implement the Financial Services Action Plan. Only last week new steps were taken to harmonise securities trading between the EU Member States through the signing of the Investment Services Directive. This affords both private investors and institutions greater opportunities to trade on exchanges other than those in their own country. Although Sweden in this regard would have liked to go a step further towards full deregulation of the financial marketplaces, it must nevertheless be seen as a step towards freer securities trading in the EU.

■ In addition to developments at the EU level, national reforms are also under way in several countries. In Germany the efficiency of the banking system is being improved considerably now that the state guarantees are being abolished. Similar measures should also be taken promptly in the other major euro area countries, so that they can also capitalise on the advantages of a deregulated financial market. But these are tough reforms that require that special interest groups do not exercise their influence. When there are politicians on the boards of some of Europe's banks, there is reason to suspect that decisions are sometimes made on grounds that are not entirely related to business. As long as this uncertainty remains, it will contribute to the euro area's financial markets often being a second-hand choice for international investors.

Furthermore, there is still much to be done in terms of competition. The majority of countries in the euro area are burdened with overcrowded bank markets that have many inefficient local branches. However, the existence of some 2,400 banks in Germany should not be taken as a sign of stiff competition, but rather the opposite. Overcrowding is at least as ominous an indication that the operations are not been run in a business-like manner. It is in no way justifiable to allow bank customers or taxpayers to pay for either exorbitant profits or inefficient operations, which is happening in many countries in the euro area.

There is no doubt that we in Sweden can also do more to promote competition in the financial market, not least when it comes to banking activities aimed at private customers and small firms. The largest market players continue to enjoy a high level of market concentration. However, the establishment of a number of new niche banks in the past few years and the recently raging price war on credit for tenant-owned apartments show that deregulation gradually leads to increased competition and consequently to lower prices for consumers.

Continued reforms necessary

To sum up, we have reason to be proud of the reforms introduced in Sweden over the last decade. They have resulted in Sweden today having a higher growth potential than several of the large economies on mainland Europe. At the same time, we cannot settle for what we have done so far. Sweden must continue to remain a step ahead on the reform agenda that the EU Member States decided upon in Lisbon in 2000 and which aims to make the euro area "the most competitive and dynamic knowledge-based economy in the world by 2010". Reforms are under way in a number of countries in the euro area and will in the long run make the euro area countries more attractive to international investors. The objective must therefore be to constantly try to find new ways of raising growth without jeopardising economic stability. This also entails a continued challenge for the Riksbank to regularly analyse the Swedish economy's growth potential so that monetary policy will also continue to be well balanced in the future.

Thank you!