Sweden at the Crossroads
A Macroeconomic Analysis

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BACKGROUND

In the early 1990s Sweden experienced its worst recession since the 1930’s. High inflation for both wages and prices, and the bursting of a real estate and bank share bubble, put pressure on the government to devalue the Krona and highlighted the damaging effects of high public sector employment, welfare benefits, tax rates, and fiscal sensitivity to the business cycle.

In 1992, Sweden abandoned its peg to the ECU. The Krona was devalued and allowed to float on the world monetary exchange market (Technically Sweden specifies fifteen percent bands, an effective float.). Then, in 1993 the Riksbank decided to establish specific inflation targets to control the inflationary effects the depreciating currency was expected to produce. In addition, the government undertook a program of fiscal consolidation designed to reduce the deficit to less than three percent of GDP by 1997, and eliminate it entirely by 1998.

Although these policy measures have been largely successful in restoring the strength of the Swedish economy, they have challenged Sweden’s longstanding economic paradigm of being a social welfare state.

(Graphical trends presented in the Appendix)

Since 1994, Sweden’s gross domestic product (GDP) has shown positive, though not steady, growth. After growing at a rate of 3.3% and 3.9% in 1994 and 1995 respectively, the GDP growth rate dropped to 0.9% in 1996, but then rose back to 2.0% in 1998.

Over this same time period, government expenditures were cut by over ten percent, going from 70% of GDP in 1994 to 62.4% in 1998. The largest reduction came in transfers to households, which declined from 32.8% of GDP in 1994 to 28.6% in 1998. Government consumption and investment expenditure was also cut from 30.2% of GDP in 1994 to 28.0% in 1998.

Output continued to grow despite reduced government spending because private domestic consumption and exports increased. Even with the government cuts in transfers to households, domestic consumers bought more goods—the percentage of GDP increases ranged from 0.8% to 2.6% for the period 1994-1998. Real and net exports increased as a result of a depreciated Kronor, which made Swedish goods more attractive both on the world market and domestically. Exports rose from 385.9 billion Kronor in 1994 to 675.9 in 1998, and the trade balance increased from 53.3 billion Kronor in 1994 to 130.9 in 1998.

The increase in private domestic consumption over the period (855 Skr billion to 908.2 Skr billion), combined with reduced transfers to households, resulted in a household saving rate that declined from 8.0% in 1994 to 1.2% in 1998. Increasing net exports resulted in a current account surplus that rose from 1.6 to 4.6 billion US dollars. At the same time, direct investment in Sweden rose by 13 billion US dollars, driving up the capital account up by 1.8 billion US dollars.

Unemployment fell during this time by 1.5%, though the 6.5% unemployment rate in 1998 was still considered high by historical standards. Along with unemployment, the inflation rate (measured by the GDP deflator) fell from 2.6% to 0.8%, and interest rates (measured by the three-month interbank rate) fell from 7.6% to 4.4%.
PROSPECTIVE PROBLEMS

Potential problems within the Swedish economy can be classified as either domestic issues or global competitiveness issues.

Domestic Problems

Unemployment:

The Swedish welfare economy is based on the assumption of full employment because prior to the 1993 crisis, unemployment levels were a low 1-2%. This framed public expectations for a low permanent (steady-state) level of unemployment. Thus, the current 5% level of unemployment is cause for alarm amongst the Swedish labor force.

Sweden has recently put into force a new 35-hour scheme to help lower the level of unemployment. The Swedish government believes that the result of this policy change lies somewhere on the spectrum between the following extreme cases:

1. **The burden in this case is borne by those who were employed prior to reform:**
   This assumes a constant hourly wage where wage income falls in proportion to a reduction in the number of hours worked per week and a plentiful supply of labor at that nominal (or real) wage. Firms will be able to hire more workers without increasing their wage costs. This extreme case generates the largest positive effect on unemployment.

2. **The burden in this case is borne by the employers:**
   Alternatively, if employees work shorter hours for the same wage income as before, firm’s labor costs rise in proportion to the reduction in working time. If firms are obliged to cut production, in this case due to the rising labor costs, the effect on unemployment may even be negative.

Regardless of which outcome prevails, this new scheme ipso facto serves to artificially lower the labor supply. The 35-hour work week is really an accounting issue where the total number of labor hours “consumed” per week stays unchanged, but the total number of workers employed rises. In other words, the same labor hours are divided amongst a greater number of laborers. One of the major costs of this scheme is that employers are forced to pay the high level of government taxes which finance social welfare programs for each new worker hired. The private sector is thus faced with the burden of paying for Sweden’s costly welfare programs.

These high costs serve as a strong disincentive for all firms operating in Sweden and create incentives for production facilities to migrate to offshore locations where labor costs are lower. Furthermore, it is important to note that this new hour scheme does not really alter employment levels as defined by a change in the total number of hours worked. The 35-hour work week is essentially a temporary solution to the unemployment problem where the government is applying a symptomatic remedy instead of a systematic solution. The Phillips Curve specifies an explicit trade-off between low inflation and high unemployment. The recent independence of Riksbank, coupled with the bank’s judicious monetary policy has contributed to a lower rate of expected inflation. Lower expectations of inflation leads to a lower sacrifice ratio.
Low Savings

A low rate of savings is a high priority problem facing the Swedish economy. According to data collected from the Riksbank, although the rate of savings is on the rise, overall it is still negative. Low savings implies that private consumption is high. In fact, private consumption has been at its highest levels since 1994. With consumers using more of their income to spend today, rather than save for the future, the marginal propensity to consume (the amount consumed from each additional dollar of income) has risen.

The Solow Growth Model demonstrates the potential impact of the savings rate on economic growth (see diagram). When the level of savings declines, output falls and the economy is left with a lower level of future capital stock. According to the Solow Growth model, a high rate of savings yields faster growth until the new steady state is reached. Thus, we can presume that the opposite effects occur in the Swedish economy.

Using data from the International Monetary Fund (IMF) on future expectations for inflation, we can infer that the current low rate of savings is not sustainable in the long run. With expectations for higher rates of inflation, we can deduce that more people would spend their money today to maximize their buying power. In the long run, however, if nominal and real interest rates rise with prices, then more people will begin to save.

The rate of savings and investment also impacts the trade balance. In the equation \( S - I = NX \), the difference between savings and investment determines the trade balance, NX. Currently, a low level of savings coupled by an even lower level of investment and a depreciated currency result in a positive trade balance.

Lastly, low savings also affects money growth in the economy through the influence of the money multiplier. The equation for the money multiplier, \( M/B = 1 + cr/rr + cr \), (where \( cr \) is the amount of currency people hold and \( rr \) is the amount of currency banks hold) shows that when we hold \( rr \) constant and \( cr \) falls, the money multiplier never increases. Therefore, the higher the currency–deposit ratio, the more Kronor the public holds as currency, the less Kronor banks are able hold as reserves, and there is less money banks can create. Thus, an increase in the currency-deposit ratio lowers the money multiplier and the money supply.

Global Competitiveness

Historically, Sweden’s robust economy has been able to support its welfare state largely because of its success in producing high-value export goods (Sweden’s export economy has on average constituted approximately 40% of GDP). Globalization has led to pressures on the Swedish government to reduce burdensome welfare costs to firms, which would otherwise face high relative labor costs.

The Swedish labor market is highly unionized; nearly 80% of all Swedish workers belong to unions, the highest rate of any OECD country. Swedish trade unions have traditionally been strong and extremely centralized. The largest trade union, The Landsorganisation (which has strong ties with the leading political party), has members that represent over half of Sweden’s entire labor force. This strength has allowed the unions to force the real wage far above competitive levels.
POLICY RECOMMENDATIONS

Savings:
According to the Solow Growth Model, Sweden’s low private savings rates are unsustainable in the long term because a low savings rate results in a low rate of capital growth for nations below steady-state capital levels. Recent government efforts to eliminate budget deficits can be thought of as offsetting lower rates of private savings. There are three policies that may raise the rate of savings:

1. **Increase Public Savings:** Currently, the Swedish government seeks to maintain a policy that balances the government budget. To make up for the falling level of private savings, however, it might be desirable to pursue a policy that results in a government surplus, thus increasing the level of public savings.

2. **Increase Interest Rates:** We recommend that Sweden pursue a strategy that creates incentives for higher private savings rates. This includes policies such as increasing the repo rate (the long-term benchmark interest rate).

3. **Decrease Level of Social Support:** Swedes who rely predominantly on the Swedish social welfare net to provide for them in the future have little incentive to save in the present. By decreasing the level of social welfare that Sweden provides, the government will be implicitly increasing the incentive for private savings levels to rise.

Global Competitiveness and Unemployment
There are several policies that the Swedish government can simultaneously adopt to increase Sweden’s competitiveness in the global arena. The fundamental goal is to take steps that effectively lower business costs for corporations that operate in Sweden.

While Sweden’s corporate tax rates are among the lowest in the EU, much of those savings are eroded by the high mandatory social welfare benefits for labor. One way to attack the problem is to further reduce the amount of social welfare that the state provides, hence lowering the amount of social welfare tax that companies are bound to provide. This can be seen as a move toward harmonization with the rest of the European countries that do not provide the same level of social welfare as Sweden, and hence make them much more competitive.

Additionally, in order to lower the operating costs of companies that locate in Sweden, the government should consider lowering corporate taxes and easing tax requirements placed upon international distributions from businesses within Sweden.

A more politically controversial but potentially powerful solution is to change the way wages are set. The Swedish system has traditionally worked to maintain both low levels of unemployment and high real wage levels. In the past, this was sustainable, but competition within the global market compels the Swedish government to make a choice between lower unemployment and lower real wages or higher unemployment and higher real wages. If Sweden continues to pursue both goals, it may face a situation of capital flight. This will result in both lower real wages and higher unemployment as firms close or leave Sweden.

We feel that it is in Sweden’s best interest to pursue a policy of lower real wages. This would involve, however, weakening the unions that typically force the real wage higher than competitive markets would dictate, and also serve to ensure that the labor market and the economy are inflexible in times of economic downturn. By returning the Swedish labor market to a more decentralized wage bargaining structure, not only will real wages move closer to free-market equilibrium, but unemployment levels will also drop. Assuming an adequate labor
supply, lower real wages will increase the level of demand for laborers and hence employment levels as well.

LIMITATIONS

Increasing Interest Rates

The causal link between raising the interest rate and increased savings is tenuous. There is little empirical proof that the government can do anything to influence domestic savings rates. Furthermore, if interest rates are raised in a reckless manner, the Swedish central bank will lose the hard-earned credibility that came with their prudent management of monetary policy in recent years.

Lowering Social Welfare Provision

While lightening the burden that social welfare places on the Swedish economy would improve competitiveness and increase savings levels, it is politically hazardous. Most Swedes perceive welfare as a progressive social attribute. As a result, the polity will challenge any “regression” toward the level of social welfare provided by other European countries.

Lowering Corporate Taxes

The policy that seeks a budget surplus through a combination of higher taxes and/or low government spending makes it difficult to allow for lower corporate taxes. Sweden must recognize its limited ability to achieve all its goals.

Decentralizing the Labor Market

There are two political issues that stand in the way of labor market decentralization. First, the Landsorganisation has strong ties to government and wields sufficient political power to prevent any major government intervention in the realm of wage negotiation.

The other obstacle is convincing the domestic workforce that they should be paid less (in terms of real wages) and consequently, suffer a lower standard of living. This, too, will be a politically difficult task and requires a government with a real desire to improve Sweden’s economic performance and long-term well-being, perhaps at the expense of their short-term political careers. Implementing this policy may have the most positive real effect on Sweden’s long-term economic future, while a lack of implementation may spell Sweden’s economic doom.

TO EURO OR NOT TO EURO?

Sweden will hold a referendum in the year 2000 to decide whether or not to partake of European Monetary Union (EMU). To date, Sweden has proceeded with the maintenance of low levels of inflation and reduced deficit levels in accordance to EMU requirements for membership. Keeping within the requirements of harmonization further constrains Sweden’s choice of monetary and fiscal policy options.

MACROECONOMIC DATA SOURCES!

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