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The "Swedish Model" and the financial- economic crisis in Sweden in the early 1990s

by

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„ Denn das ist der Weisheit letzter Schluss
Nur der verdient sich Freiheit wie das Leben
Der täglich sie erobern muss“

Goethe,Faust, Zweiter Teil

„ Γιατί αυτός είναι της σοφίας ο λόγος ο στερνός
τη λευτεριά αλλά και την ίδια τη ζωή
εκείνος μονάχα στο τέλος θα αξιωθεί
που κάθε μέρα και για τα δυό μάχεται διαρκώς ”

Γκαίτε, Φάουστ, 2º Μέρος

Στη μνήμη του πατέρα μου,

Χρήστου Παπαδόπουλου (1941-2006)

του οποίου η ζωή και αγώνας μου έδειξαν στην πράξη το πραγματικό νόημα των παραπάνω αθάνατων στίχων του Γκαίτε

To the Memory of my Father,

Christos Papadopoulos (1941-2006)

whose life and struggle taught me in praxis the real meaning of Goethe's immortal verses above

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Introduction.Aims and content of the present work

The “Swedish Model” has always attracted the public interest of both politicians and social scientists- as well as of the less informed wider public opinion. From the time of its emergence in the middle 1930s as the response given by the governing social democracy to the Depression of the 1930s[1], as well as after the three post-war decades, in which it reached its most developed and advanced form, and up until the 1990s, in a time of its shaking to its foundation by an unprecedented financial turmoil with severe repercussion on the real economy, the Swedish Model have been always at the center of interest and of constant scholarly investigation. Although Sweden was always a rather small country and by its size incapable of playing a leading role in the world politics and economics, the set of social and political- institutional arrangements and its underlying political-economy, known as the “Swedish Model”, had aroused a vivid interest already from the first years of its emergence, not only because of its success in addressing the Great Economic Crisis of the 1930s, but also because it seemed to offer a viable and attractive alternative to both the unfettered capitalism of the USA and to the authoritarian State Socialism of the Soviet Union. The Swedish Model, although it never surpassed the regime of capitalist property relations and accumulation as hoped and promised by the theoretician of the Swedish Social Democracy, gave shape to the dream of a democratic socialist order, in which small, step-by-step- and crucial welfare reforms and steady expansion of the social rights, were preparing the ground for the gradual transformation of capitalism while preserving the democratic- parliamentary form of government and averting encroachments upon fundamental human rights. The “Swedish Model”, after having spared Sweden the devastating effects of the mass unemployment and the protracted depression and social dislocation of the World Economic Crisis of the 1930s, seemed able in the three post-War decades to offer an admirable level of social benefits and a wide net of social protection to its population without impairing the rates of capital accumulation and growth. On the contrary, the universal and highly developed Swedish Welfare State (or “Social Citizenship State”, as Gøsta Esping- Andersen, one of the most informed scholars of the Swedish Model, prefers to callit in a book, which continues to be, even today, an

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Theda Skocpol, Margarete Weir, *State Structures and the Possibilities for Keynesian responses to the Great Depression in Sweden, Britain, and the United States* in Theda Skocpok, Ruesmeyer, *Bringing the State Back In*, Cambridge, Cambridge, New York, Cambridge University Press, 1985 indispensable reading [2], was combined with high rates of growth in a dynamic, export-orientated economy capable of continuous structural rationalization and adjustment. Two fundamental pillars of the system, the *active labour market policy* and the *solidaristic wage policy*, permitted the Swedish Model to combine full employment and price stability in the three post- war decades, while constantly improving the living standards and the social protection of the employees on an egalitarian basis. It is true that Sweden was not the only country in securing high growth rates and rising living standards for the broad population : it was a tendency shared by many other Western capitalist countries in the era known as *Golden Age of capitalism* (or *les trente glorieuses* in French). But Sweden was unique in the sense that no other country succeeded in constructing such an encompassing and universal Welfare State, with a such a high degree of social benefits and social spending and the most important, a Welfare State built on a broad class alliance between the wage-earners and the salaried middle-classes. Measured by all standards and indicators the “Swedish Model” was indeed a “success story”- a rather trivial term, so much used and abused in the public discussion that it is unable to give a full account of the originality and of the achievements of the political economy of the Swedish Model.

However, suddenly, the much admired and widely praised “Swedish Model” was confronted with the first crisis symptoms in the mid-1970s: economic slowdown, loss of competitiveness of the Swedish economy, inflationary tendencies and strains bearing evidence to growing social unrest and distributive conflicts. The two oil shocks and the ensuing eruption of stag-flation, took their toil even on the “Swedish Model”- as well as in the advanced Western world: not even the centralized wage-bargaining and the underlying class-compomise, not even the active labour market policy - both of them fundamental pillars of the original Swedish Model - were proved to be able to cope with the underlying causes of the crisis and to redress the sluggish growth rates. Although Sweden by means of an extensive demand-stimulating policy (the *överbyggningspolitiken* as it is termed in Swedish) succeeded in averting a serious explosion of the unemployment , the hegemonic Social democratic party was brought nevertheless in front of serious and ever more complicated difficulties, culminating in 1976 into its fall from state power after 43 years of uninterrupted government tenure. However, the advent to power of a bourgeois coalition government, far from putting into question the social- democratic Swedish Model and bringing about a systemic change, was not going to alter the fundamental premises of the established economic policy. In fact, Center-Right coalition

2 Gosta Esping-Andersen, 1985, *Politics against Markets. The Social democratic Road to Power,* Princeton University Press , Princeton

governments of the period 1976-1982 continued and intensified the policy of subsidizing sectors and enterprises of the Swedish economy under serious difficulties. The results were meager and the rates of growth further continue to deteriorate , while the inflation rate and the budget deficit began to get out of control.

When the social democrats under the leadership of Olof Palme returned to power in 1982, the situation was indeed critical and the social climate radically changed: the macroeconomic indicators of the Swedish economy were in the red, the competitiveness of the Swedish economy dramatically worsened, the Swedish firms had reached a degree of internationalization that made them all the more unwilling to accept the historical compromise with the organized trade – union movement (represented by the LO, the massive Trade Union Confederation of the blue-collar working class) , which only few years ago adopted the famous “Meidner report on wage- earners funds”, incarnating the claim for “economic democracy” and aiming at forcing the big firms to concede part of their profits to collective wage earners funds, which would acquire shares of the firms, thus preparing the ground for a gradual transformation of the property relations of the big firms in favor of the labour movement. The social-democratic party was confronted with serious challenges and had to take crucial decisions, which were going to have strategic consequences on the direction of the Swedish economy- and the future of a Model, which was in a deep need of redirection and reform.

The response given by the social- democrats to those challenges was the so-called “policy of the Third Way” (*den tredje vägens politiken*, as it is called in Swedish). Initially sketched by a collective crisis group headed by Ingvar Carlsson, the successor of Olof Palme, and Kjell- Olof Feldt, the future finance minister in the 1980s, the policy of the Third Way was going to set a new paradigm of social- democratic economic policy in the new, pressing and fundamentally altered conditions of the 1980s. The policy of the Third Way, registered, in the short run, successes and redressed the distressed economy, but in the long run, ran up against serious and unforeseen difficulties and negative side-effects (bubbles in the finance and real estate sectors) , which led to a new emergency situation and successive crisis packages by the social-democratic government before its fall from power in September 1991. The cumulated effects of the Third Way policy, the deregulation of the credit and capital market –a major event that took place in the second half of the 1980s - created a new economic environment and some unfortunate economic measures taken by the bourgeois coalition government under the Conservative leader Carl Bildt triggered a serious monetary crisis and was accompanied by the most severe and protracted crisis of the Swedish economy since the 1930s, a crisis with severe repercussion on the Swedish Model, bringing it during the years 1992-1994 to the brink of the abyss. It was in this period -and while the critical situation of the banking sector became explosive - that the real economy plunged into the worst recession and the unemployment exploded to unprecedented levels. This was a shock for a society which was accustomed to levels of unemployment far below the 5% mark.

The crisis with which Sweden in the period 1992- 1994 was confronted has been a turning point in the history of the “Swedish Model”. Not only because it shook it to its foundations and severely tested its resilience in the midst of a depressive economic environment, but also because it seemed to give right to its (mainly right-wing) critics who pretended that it was untenable as a model of economic development and as a way of social regulation and that the crisis, far from being accidental, had a systemic character and was caused by its excessive generousness, its corporatist institutional character and its ensuing institutional rigidities imposed on the labour market.

For the Swedish public opinion the financial-economic crisis and the ensuing effort to overcome it (especially after the budget consolidation policy of the social-democrats in the period 1994-98) was a painful experience. Even after the crisis of the 1990s had been overcome and the economy had been redressed, the perception was widespread that nothing was the same as it was before. The crisis had lasting effects on the “Swedish Model” and the cuts and the reforms undertaken were perceived to have created a new social and economic reality. “ *And the Swedish Model fell”*, “*The long 1990s. When Sweden changed”*: those are some of the most characteristic titles of books published in Sweden during and after the crisis, while the term “systemskifte” (“change of system”) was amply used to describe the set of irreversible changes which took place in those years. All this testify that for some observers, writers and social scientists the crisis of the 1990s was a turning point, a rupture, the end of an era and the beginning of a new period. For some of them the “Swedish Model” as it was known in its traditional form no longer existed- or it has so dramatically changed that it could hardly be defined as a “model”. In their opinion, Sweden, thus far a model country, had undergone a painful transformation and had become a country like any other. The “Swedish Exception”- to the extent it had existed - had ceased to exist.

Aim and content of the present work is to present and to examine in some details how the Swedish Model in the early 1990s ended up with the most serious financial-economic crisis- a crisis which seemed to spell its final demise. How this crisis was made possible and what was its exact nature? What were the underlying causes and what triggered the crisis? How did the political system of Sweden respond to the crisis- in the short and in the long run? What were the social consequences of the crisis and how did they affect the historically determined traits and features of the original Swedish Model? How did the policy of “ putting the public finances into order” pursued by the social-democrats during the years 1994-1998 affect the “Swedish Model” and to what extent did this policy, undertaken in an era of integrated and deregulated financial markets, give rise to something new- which, to a far or a lesser extent resembles- if it does – the traditional “Swedish Model” ? Those are some of the most crucial questions, which we shall try to respond in this work.

We shall begin the present work by briefly exposing the phases of development, the process of construction and the main characteristics of the “Swedish Model” up until the end of the 1970s and the manifestation of the first “crisis symptoms”. We shall continue by examining the new social-democratic economic policy of the “Third Way”, which was the response given by the new social-democratic government to the crisis of the late 1970s, and the crucial changes brought about by the deregulation of the credit market and the abolition of the exchange controls. Special attention will be granted to the financial bubble and to its burst in 1990 and afterwards. The advent to power of a new center-right coalition government intent on undertaking a system-change away from the social-democratic status-quo, its economy policy and the cataclysmic monetary crisis in September 1992 will be the next step of our exposition. The bank crisis and its repercussion on the real economy will concentrate our attention, since it was through this mechanism that the Swedish Model was thrown to the brink of collapse. The next stage of the work will be to give an account of the gigantic effort undertaken by the new social democratic government to put in order the mismanaged economy, the public finances and bring down the interest rates by a policy of extensive cuts and of freeze on any welfare reform. An effort will be made to consider whether- and to what extent – the new social democratic stabilization policy has ended in the preservation of the “Swedish Model” or to the emergence of a new different one. Some remarks on the changes and consequences of the social and political- institutional changes brought about the new social-democratic government are inevitable in this context. At the end of this work we shall try to respond to the main question: “*Does the Swedish Model still exist? – and if an new order (a new “Model”) has emerged what are its similarities and differences in relation to the old “Swedish Model”* Before examining the crisis which befell the “Swedish Model” it is imperative to have a clear picture of the traditional “Swedish Model” and of the main stages of its creation- something which will be undertaken in the subsequent chapter.

CHAPTER 1

Phases of development and main characteristics of the " Swedish Model" : From the initial *Folkhem* (" *House of the people*") version of Swedish Model in the 1930s to the fully developed "Swedish Model" of the 1970s

A lot has been written and said – often in a polemic or supportive way - about the famous "Swedish Model", its emergence, unfolding and consolidation in successive waves of policy reforms. The literature is really impressive and huge and one can read many useful works and manuals, written by Swedes and non Swedish authors and scholars alike. Before entering into a discussion of the crisis or exhaustion symptoms of the Swedish Model in the 1970s, it is worthwhile selecting from this huge literature and recalling some of the most characteristic features and stages of development of the " Swedish Model". First of all, one should be aware of the fact that by "Swedish Model" is meant the set of institutional arrangements on the field of macro-economic policy, of industrial relations, of labor market policies, of social policy and of policy-making decision at the state- administrative level, which began to be constructed during the 1930s (as an immediate response to the Great Depression of the 1930s) and which was gradually expanded and consolidated until the 1970s. Seen as a whole from its last stage of development this set seems to be impressively coherent, since the model in its above mentioned specific aspects, linked and combined the policies on specific policy fields and levels together in a coherent and rather harmonious whole, securing viability for almost five decades and scoring unprecedented successes on the field of macroeconomic performance and the social security coverage. By the 1970s Sweden was one of the richest and most socially advanced countries of the world- a fact acknowledged even by the liberal *Economist* in its 1994 survey of the Nordic countries – which, at the same time, hardly could conceal its *Schadenfreude* for Sweden's financial crisis at the beginning of the 1990s!

Judging by the existing literature, the Swedish Model was constituted in two main historical periods, its one of which contributing to its renewal and reorientation. A further third advance took place during the 1970s, but it was during this advance- which can be considered as the culmination of the Swedish Model- that the crisis symptoms and the limits of the model became evident and that the economic crisis of the 1970s, in its Swedish version, created objective difficulties rendering necessary a strategic reorientation of the traditional social democratic policy. This schematic presentation of the principal phases of the Swedish Model, with their main developments, may be divided into the following periods:

1) **<u>The first wave of reforms during the 1930s</u>** (**after the crisis agreement between the social-democrats and the Agrarian party and the Saltsjöbaden Deal between the employers and the LO**) . The first wave of reforms which must be seen as the Swedish response to the 1929 crisis[3] and which laid the foundations of the Swedish Model, was initiated by two fundamental agreements, one on the national political level in 1932-33 and the next one on the industrial level, few years later, in 1938. Following their electoral victory in 1932, the Swedish social-democrats struck a crisis agreement *(krisuppgörelse*, as it is widely known in Sweden) with the Agrarian party (*Bönderförbundet*[4]) which guaranteed subsidized prices for the peasants' products and income support in exchange for measures for strengthening the employment (at free market-wages) and welfare reforms, both of them financed by public deficits. The political importance of the "crisis agreements" consisted, as pointed out by Esping-Andersen, in that " *it allowed the social –democrats to stop being o ghetto party of the workers in the large cities and to build a red-green alliance for the implementation of a policy of social reforms."*[5] In fact, it was the first time in the economic history that a form of rudimentary Keynesian policy (a proto-keynesian policy) of deficit spending and public works was implemented, a policy to whose creation the innovative economists of the Stockholm School played a great and decisive role by offering the necessary theoretical justification, in conjunction and close cooperation[6] with some leading figures of the Swedish social democratic

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3 Theda Skocpol, Margarete Weir, *State Structures and the Possibilities for Keynesian responses to the Great Depression in Sweden, Britain, and the United States* in Theda Skocpok, Ruesmeyer, *Bringing the State Back In*, Cambridge, Cambridge, New York, Cambridge University Press, 1985

4 For a insightful analysis of the background of the crisis agreement one can find interesting information in Sven Anders Söderpalm, *Arbetare och bonder. Krisuppgörelse och socialdemokratins väg till makten [Workers and Peasants. The crisis agreement and the social democracy's road to power]* in «Från fattigdom till överflöd. En antologi om Sverige» (1973) [From poverty to affluence. An anthology on Sweden], Stockholm, 1973, Wahlström & Widstrand.

5 Esping-Andersen, *Jämlikhet, effektivitet och makt. Socialdemokratins välfradspolitik.* [Equality, effectiveness and power. The welfare reforms of the social democracy] *in* Klaus Misgeld (ed.) *Socialdemokratins samhälle* 1889-1989, [English edition: *Creating Social democracy* , 1889-1989] , (1989), Stockholm: Tiden

6 It is the great merit of the above mentioned article of Theda Skocpol (1983) l that it sheds light on the particular structure of the Swedish policy-making process, which made possible the participation of the Stockholm

party, with Ernst Wigforss being the most prominent among them.

Four years later an equally important agreement was made- this time on the industrial level- the *Saltsjöbaden* Agreemen between the Confederation of the Swedish Trade Unions (LO) and the Confederation of the Swedish Employers Union, known in Swedish as the " *Saltsjöbadenavtalet*" . With this deal a compromise materialized: the Swedish labour movement accepted the capitalist property of the means of production and recognized the right of the employers to distribute, employ and lay off the work- force, but also the importance of high growth rates, while the employers explicitly recognized the right of the trade unions to make collective bargaining deals and the right of the government power (held by the social democrats) to actively fight against the unemployment and to gradually build an expanding network of social protection. As Walter Korpi observes, the Saltsjöbaden Deal "*was, above all, a way of coping with the social problems on the basis of an agreement , which aimed at making the pie bigger, so that there is more of it to be shared. By controlling the government power the labour movement was able to influence the distribution of the fruits of the economic growth. The business sector, on its turn, has secured favorable conditions for investments and expansion.*"[7]

These agreements, on the political and the industrial level respectively, made possible a series of successive reforms during the 1930s and the 1940s: the creation of the Labour Market Board (the famous and powerful *Arbetsmarknadsstyrelsen*) in 1940 and 1948 , the new "People's Pension" (*folkpension*) in 1935 and 1942, the preventive health care treatment and social care treatment (1937, 1938, 1943), the child benefit (1935, 1937 and 1947) and the House benefit (1941, 1942 and 1948) . Thanks to these reforms a small but important Welfare State was founded giving form to the ideal of "*folkhem*", a particularly social democratic ideal denoting the creation of a " house of the people" guaranteeing to its native inhabitants a sense of security, equality, dignity and civil participation.

1) **The expansion of the welfare reforms and the active labour market policy of the late**

economists to the policy-making process and their implication in the execution of their recommendation through their participation in ad hoc investigatory committees set up by the Riksdag, the Swedish parliament. According to Skocpol, it is this particular structure of the Swedish policy-making process rendering possible the recruitment and participation of external experts and social scientists, which permitted the planning and the implementation of proto-Keynesian policies- in marked opposition to Great Britain, where the bold policy proposals advanced by John Maynard Keynes were prevented from being turned into practical policies by serious institutional obstacles ,inherent in the British policy-making process, to the incorporation of external advisers and unorthodox economists into this very same process.

7 Walter Korpi (1981), *Den demokratiska klasskampen,* Stockholm, 1981. (English edition : *The Democratic Class Struggle*, Verso, 1985)

<u>1950s – and 1960s</u>: By putting aside the 1940s, which was a period of theoretical reorientation - the Social democrats were forced to give up the idea, expressed in their party program *Arbetarrörelsens efterkrigsprogram* (*the post-war program of the labour movement*) , of nationalizing the industry - and of failures in the growth and stabilization policy (which created an inflationary overheating at the end of the 1940s), the 1950s were characterized by the expansion of the welfare state reforms under the inspiring leadership (and propelling force) of Gustav Möller, the chief architect of the social policy of the Social democratic party. After the improvement of the folkpension in 1946 thanks to the obstinate efforts of Gustav Möller, it was the effort of legislating the new general supplementary pension (the so called *allmän tillägspension, ATP*) , which was of particular importance. After a crucial battle and confrontation with the bourgeois parties, the social democratic party managed to pass the ATP in 1959.The importance of the ATP, which was based on the "basic security principle" (*grundtrygghetsprincip*) and is an income related supplementary pension, lies, as brilliantly pointed out by Esping-Andersen, in that:

" It allied the working class and the new expanding middle class around a program of social policy with the values and norms of the middle classes as a rule and with the marginalization of the private security schemes."[8]

By averting the danger of a split between the working class and the new middle classes a broad class coalition was forged which made possible the political domination of the social democrats in the subsequent years of the 1960s.

It is also during this period that the *active labour market policies* (in close connection with the *solidaristic wage policy*) are formulated and implemented. They took their original form in the famous Rehn (-Meidner) Model (named after Gösta Rehn, the LOs chief economist, and his collaborator, Rudolf Meidner), a model conceived as a solution to the dilemma between full employment and inflation. By recommending a solidaristic wage policy ("equal pay for equal work") imposed on all the enterprises independently of their profitability, this set of policies was favoring the closing of the less competitive and dynamic enterprises, thus promoting a structural change of the economy, and the mobility of labour force by means of an active labour market policy aiming at reinserting the laid- off workers of the less competitive firms in the labour market by means of constant requalification and skill-upgrading. The fact that the principle of " equal work for equal pay" was binding also for the workers of the most profitable firms permitted, on the one hand, a wage restraint, thus loosening the inflationary tendencies on the national economy as a whole, and

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8 Gösta Esping - Andersen, *ibid,* pp. 232-234 in the Swedish edition

coordinated, on the other hand, the wage claims of the labour movement, thus promoting an equalizing wage policy propitious to the strengthening of income equality between different groups of the working class. The importance of the Rehn Model lies not only in that it helped overcome the dilemma between full employment and inflation (by securing almost full employment with negligible inflation) but also in that:

" The economic policy was linked to the principles of social policy by means of active efforts to raise the most poor social strata to the status of the middle class [..] The efforts for full employment were based no more only on the aggregate budget and monetary policy, but also was fused with the welfare policy. The purposes of the social policy, like the income equalization, were linked with the labour market policy."[9]

Before turning to the further expansion of the Swedish Model in the subsequent period, we must, at this particular point, recapitulate its most salient features, since by the 1960s it is evident that a "model' had been formed based on a set of concrete -and harmoniously linked to each other - policies :

α) An **active** but **restrained** fiscal policy with strong anti-cyclical stimulating measures, completed by a **well developed supply side policy** based on selective measures (such as education and job training, infrastructure, cheap credit policies, and general support for R&D)

a) A climate of **class collaboration** on the industrial field and of peaceful settlement of the industrial conflicts and **centralized collective bargaining** without state intervention in it or state legislation- and this accompanied by a system **of neo-corporatist tripartite consultation** between employers- employees and state power taking place in a whole range of powerful administrative bodies (with the AMS, *Arbetsmarknadsstyrelsen* , the famous Labour Market Board, being the most prominent among them).

b) **High marginal tax rates** and progressive income taxation financing a policy of constant expansion of a string of social benefits with high replacement rates.

c) Full employment as primary goal of the economic policy by means of an **active labour market** policy based on the principle of **solidaristic wage policy** as the basic instrument for both countering inflation and equalizing the wage inequalities among the wage earners (by imposing wage restraint on the workers of the most profitable enterprises).

d) Promotion of the structural change of the economy by favoring (thanks to the solidaristic wage policy) the most competitive and dynamic firms, which were (or became), in their majority, export-oriented – Strong concentration and centralization of capital in strong companies as a result of

9 Gösta Esping-Andersen, *ibid,* p.236 (Swedish edition)

the continuous process of structural change

e) A **two tier-pension system** consisting of a flat rate **basic pension** (folkpension), which constitutes a right resulting from the social citizenship and **an earnings related supplementary pension** with a relatively high income replacement rate.

We think that the above mentioned traits of the ‘Swedish Model” are fairly accurate and give a clear picture of the “political economy of the Swedish Model” . Let us now see what happens in the next, and third, phase of the evolution of the Swedish Model, since it is in this third wave of reforms that the first symptoms of exhaustion became manifest and since they coincided with the severe economic slowdown triggered by the international economic crises of the mid-1970s and the structural problems of the Swedish industry (certain branches of which facing rising costs and fierce competition by the emerging economies of the South-eastern Asia).

1) **<u>Expansion of the public employment and measures for strengthening the workers' influence</u>**: The most important evolution of the Swedish Model in the 1970s was undoubtedly the unprecedented expansion of the public employment in the sectors of health care, education and social services. The public sector set itself the task to provide high quality services in health care, education and social services, which in other Western countries were provided to a far greater degree by the private service sector. The impressive rate of labour market participation of women since the 1970s ought to be seen in connection with the expansion of the public services, since the vast majority of employment posts in the public social services were occupied by women. It is evident that the functioning of the public sector as provider of social services and as an employer was based on a continuing high taxation- a factor which will have some side-effects, which we are going to discuss later. The question is whether and to what extent a broadening of the tax basis is a sufficient condition for the expanding activity of the public sector as employer and provider of high quality social services. The question is crucial- and a response will be given at the end of this section.

Equally important was the effort of the social democratic government of Olof Palme (who took over the party as successor to Thage Erlander) to pass a set of laws strengthening the influence and the co-decision role of the wage earners in the firms. This initiative, which was going to be called “ *the labour law offensive* “(*arbetsrättliga offensiv* “), was expressed with a battery of succeeding laws: the 1972 Law on Representation on the directory boards (*Lag om styrelserepresentation*), which was proposing to increase the control and information about the firm, the 1974 Law on Security of Job Appointment (*Lag om anställningstrygghet,* LAS), which was limiting the right of the employers to freely appoint and lay off the manpower, the 1974 Law on Representatives, which would strengthen the right of elected representatives to carry out trade union activities, and, finally, the Law on Co-decision (*Medbestämmandelagen*, MBL) which opened the way for negotiations about the conditions of hiring and about the organization of work and the new techniques[10]. All these successive laws were passed through the Swedish parliament before the electoral defeat of the social democratic party in the elections in 1976. A further set of laws strengthening the job security and protecting a range of rights of the workers followed opening the way for changes in the workplaces and leading to the strengthening of the worker rights.

These legislative measures were the result of the pressure exerted by the Swedish trade unions in order to limit - and to encroach on - the managerial prerogatives and the employer supremacy in the firms. They must be equally seen as the answer of the social democratic government to a wave of unofficial strikes in the end of the 1960s and at the beginning of the 1970s, strikes which were e a clear expression of growing unrest against the labour mobility and the often unpleasant measures taken in the framework of the active labour- market policy. The importance of these reforms lay in that their spirit seemed to stand in more or less sharp contrast to the right of the industry owners to " hire, deploy and lay off the workforce at will", a right recognized by the labour movement after the Saltsjöbaden compromise and explicitly enshrined in it. The employers tended to see that "legislative offensive" of the social democratic government, taken in close cooperation with the LO, as a clear break with the spirit of Saltsjöbaden, which precluded government intervention or legislation for matters of the workplace. In fact, the main point of divergence from the "spirit of Saltsjöbaden" consisted in that these laws were an explicit use of the legislation as a means to change the constellation of class forces on the industrial field, whereas the Saltjöbaden Agreement committed the social partners to changes only *by means of negotiations*. The fact that the labour movement (and its political wing, the social democratic party) insisted on changes through legislation was an explicit recognition of the fact that only small changes had been achieved by resorting to negotiations, as prescribed by the Saltsjöbaden Agreement. By taking that into account, one is entitled to support that the "labour law offensive" was both an expansion of the original Swedish Model and a marked divergence from it in one basic respect at least: it was undermining the employers' right to "*appoint, employ, deploy and lay off* " at will the workforce of the enterprise.

Bearing in mind the above mentioned changes marking the further expansion of the Swedish Model, it is high time to turn our attention to the problems, which began to become even more manifest and

10 A concise and very insightful presentation of this battery of labour laws is given by Lars Ekdahl and Lars Olsson in the work *Klass i rörelse. Arbetarrörelsen i svensk samhällsutvecking[The Class in Movement. The labour movement in the social evolution of Sweden]*, Arbetarörelsens Arkiv och bibliothek & Arbeternas kulturhistoriska Sällskap, Stockholm, 2014,

to trigger serious tensions leading to the loss of the government power of the Swedish social democracy in the 1976 elections,- only the first symptom, at the political level, of a dissatisfaction with the Swedish Model. As it is evident, the most important results of the wave of expansion of the Swedish Model during the 1970s, the rapid expansion of the public employment in the social services and the range of successive reforms of the labour laws, were the result of the pressure of the labour movement and of its growing force and politicization in the second half of the 1960s. Perhaps, the single most important factor which accelerated the initiatives of the trade unions (LO) for further reforms was the growing awareness inside the labour movement that *despite the equalizing effects of the constantly expanding "social citizenship state" the unequal distribution of wealth and the concentration of capital had not been halted*: in fact, the solidaristic wage police and the structural change of the Swedish industry, in large part caused by the application of the principle " equal pay for equal work" independently of the profitability of the firm in question, was pushing towards even more unequal concentration of capital, property and fortune in few hands. The public perception that the high growth rates did not suffice to stop the inequality despite the expansion of the social citizenship state, a perception which was confirmed by some expert investigation committees set up by the government, gave rise to further demands for more measures and state intervention in the realm of the industrial relations, even in the form of legislation. To all these were added the unintended side-effects of the, generally successful, active labour market policies. As Esping-Andersen points out with respect to both the structural change and the active labour policy :

" In addition, the negative byproducts of economic rationalization had begun to be felt. One indicator was the AMS's growing burden with respect to absorbing redundant manpower, together with the rising cost of avoiding open unemployment. As mentioned, AMS expenditure had grown to 2 percent of GDP by 1971. The number of workers absorbed in various AMS activities, moreover, had grown to 2 percent of the labour force in 1971. Simultaneously, the rate of worker absenteeism rose, and worker militancy erupted with a series of wildcat strikes in 1969-1970."[11]

It is undoubted that the active labour market policy (*plus* the solidaristic wage policy as its necessary supplement) was, as far as full employment and stabilization were concerned, remarkably successful. However, there were negative side- effects which were beginning to be felt and needed to be seriously addressed: the emphasis given on labour mobility entailed also strains and difficulties for

11 Gösta Esping- Andersen, *ibid*, p.234

the employees, who, as the time passed by, were experiencing them as unnecessary hardships, and the aim of continuous structural change was outweighed by the growing concentration of capital in even fewer hands: a handful of capital owners were reaping the fruits of the growing effectiveness of the Swedish industry in far greater degree than the workers who were urged to adapt to the continuous process of this uninterrupted process by being subjected to the procedures of a too powerful and (even more bureaucratic and authoritarian) AMS.

A further negative factor, which was going to further complicate the situation was the first signs of reduced investment volume- and this despite the fact that an *investment reserve system* had been set up at the end of the 1950s which was seen as a tool at the hands of the government for adjusting to business cycle by providing the necessary capital during slumps or withholding it during periods of economic overheating.[12] The numbers for the first years of the 1970s in comparison with the 1960s are revealing: Gross investment as a percentage of GNP declined from an average of 25 percent in the 1960s to 20 percent in the 1970s. And this falling percentage of investment could not be offset by productivity improvements, thus creating the preconditions for a conflict between wages and profits of inflationary character. And indeed, the inflation rate during the first half of the 1970s was double the rate of the 1960s[13]. In fact the preconditions for a distributional conflict between capital owners and wage earners, triggering wage explosion and price increases, were already in place. The profitability crisis of the Swedish industry, worsened by the new international capitalist division of labour with the emergence of new industrialized countries, was beginning to become acute and the first oil crisis was the external chock that functioned as a catalyst for the eruption of the stagflation crisis.

At the end of the 1970s the first symptoms and manifestations of the crisis of the “Swedish Model” were thus beginning to become increasingly evident and difficult to be managed by resorting to traditional policy instruments. Paradoxically, the bourgeois coalition governments (1976-1982), not only did not tried to put in question the main policy aspects of the “Swedish Model,” but on the contrary they preserved them and responded to the profitability crisis and the dwindling competitiveness of the Swedish economy by a policy of massive subsidizing the branches and enterprises with severe structural problems. Despite successive devaluations of he Swedish krona and the insistence on a demand-stimulating policy, meager results were obtained. When the social

12 Gösta Esping- Andersen, *ibid,* p. 231

13 Esping- Andersen, *ibid,* p. 235

democrats came finally to power in 1982, there was a high degree of awareness among them that the deteriorating economic situation made considerably difficult the pursuit of the traditional social democratic policy of the past.

Although the radicalized trade- union movement imposed upon a reluctant party the task of carrying out the Meidner proposal on economic democracy and wage-earner funds- a proposal which promised wage restraint on the part of the labour movement in exchange for acquisition of influence on the ownership of the big enterprises and which constituted a radical strategic response to the crisis of the traditional “Swedish Model- the party leadership, accustomed to a policy of class compromise and to the spirit of *samförstånd* (a Swedish term denoting the seeking of neutral and consensual solutions to the social problems), was determined to find and carry out a different economic policy. A first sketch of this policy was presented in a brochure under the name *Framtid för Severige (A Future for Sweden*) written and submitted by a collective crisis group headed by the prominent social democrats Ingvar Carlsson and Kjell- Olof Feldt: although it proclaimed its commitment to traditional social democratic goals such as the defense of the full employment and the preservation of the welfare reforms, the references to the urgent need to strengthen immediately the profits of the private firms and to combat inflation permitted anyone to perceive that the social democratic leadership was in search of different, unorthodox solutions to the challenges and the deadlock to which the Swedish economy was caught. Finally, during the 1980s the new economic policy conceived and implemented was different from the neo-conservative deflation policy of Margaret Thatcher’s Britain but has also nothing in common with the radical proposals of the Meidner Report: although the latter became a law, the party leadership succeeded, after subsequent revisions and modifications of the original Report, to water down and de-radicalize it culminating into a law proposal, whose only common point with the initial report presented by Meidner was its name- and nothing more. The social democratic leadership opted, instead, for *den tredje vägens ekonomiska politik*, “ the economic policy of the Third Way”, whose chief architect was Kjell-Olof Feldt, the finance minister in the new social democratic government. It was a third way between the neo-conservative monetarism and the traditional social democratic policy of reflation and demand stimulation. Its primary goal was to reinforce the competitiveness of the private Swedish industry and to increase quickly its liquidity and its main instrument was a significant and immediate devaluation of the Swedish krona. A further priority was the drastic reduction of the budget deficit (12% of the GDP at the time). These two priorities were to be achieved without sacrificing the cherished goal of the full employment and without demolishing the central pillars of the Swedish welfare state. It was a difficult task, but the social democratic leadership was determined to attain it. That in the 1980s further changes were going to take place, which cumulatively would destabilize the "Swedish Model" at the end of the decade, was hardly at the time foreseeable- although the awareness that new adverse conditions were reigning was widespread among the leaders of the social democratic party

CHAPTER 2

The response to the difficulties and challenges to the Swedish Model of the late 1970s: The new social-democratic economic policy of the "Third Way" (*den tredje vägens ekonomiska politiken*) in the 1980s

In this section of the work we shall try to see how the Swedish social democrats, after having returned to power in 1982, responded to the crisis and challenges of the late 1970s by implementing a new economic policy, which, although successfully and viable in the short (and medium) run, led, towards the end of the "turbulent" 1980s, the Swedish economy to serious economic troubles and opened the way for the protracted crisis of the Swedish Model, which culminated in the period 1991-94.

The first sketch of the new economic policy was exposed in the document " *Framtid för Sverige,* already mentioned above. This document was in many ways, a remarkable text: not only because of its unusually extensive size exposing the main aspects and traits of the crisis in the beginning of the 1980s and containing detailed recommendations to the actions which should be immediately taken, but also because it deviates, in some crucial respects, from original and traditional social democratic goals, emphasized and stressed in earlier programmatic texts and documents. The emphasis, of course, is again put on the need to preserve and strengthen the core value of the post-war social democratic policy, the full employment, but as far as the measures for obtaining this aim are concerned, a shift of emphasis had taken place, which was relatively easy to be detected by an attentive reader. The need to strengthen the weakened profitability and liquidity of the Swedish export industry was explicitly emphasized and was presented as a priority of the first order. An expansionary fiscal policy was no longer recommended as an instrument to stimulate the demand and to revive the economy: the *överbryggningspolitiken*, the policy of "bridging the growth gap" and reaching growth by stimulus measures, was no longer perceived as the best instrument to revive the economy. Other goals seem now to be far more pressing such as the profitability crisis, the shrinking competitiveness and the low growth rates of the Swedish economy. Already in the chapter 3 , where the content of the new policy is presented, one can read already in the first paragraph:

" 1)The economic policy must be directed towards bringing down quickly and obviously the costs and price increases in Sweden. The goal must be not only to break with the development of the inflation in the last years, but also to obtain a lower increase in costs and prices than the surrounding world A more favorable cost situation should create conditions for the Swedish industry to win back lost market shares both abroad and- which is at least equally important – on the Swedish market. (…)

As second measure is proposed that :

" An offensive should be launched in order to increase investment.[14]

And the presentation of the main content of the new policy closes with the last point:

" A rise in the industrial production must lead to an *improvement of the profits of the industry* [The emphasis is ours]. At the same time the total savings in the country has to be strengthened by holding back consumption.

And in spite of the fact that the writers of the text point out that the distributional policy must be shaped in such a way that the increase in profits shall not strengthen the concentration of private power and although they explicitly consider the introduction of wage-earner funds as precondition for a policy of economic revival[15], they avoid to analyze more the role of the wage-earner funds as an instrument of change in the property relations of the big firms- as it was mainly proposed by Rudolf Meidner in his famous Report in 1975. In fact, this mention to the wage-earner funds should not be taken too seriously: its is the only one, the basic aim of the writers being clearly how the profitability and the exports of the Swedish firms will be improved as quickly as possible

Ingvar Carlsson, one of the prominent party leaders who took actively part in the writing of the brochure *Framtid för Sverige*, in his very interesting Memoirs in 2003 retrospectively will make the following comment on the content of the new policy presented in the *Framtid för Sverige*:

" In a series of difficult issues we spoke a clear language: the group thought that inside the public sector there was not any room for improvements of the standards or reforms in the following years. Room had, instead, to be created for

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14 Sveriges Socialdemokratiska Arbetarpartiet (Swedish Social democratic Party) , 1981, *Framtid för Sverige. [A Future for Sweden],* Tiden Förlag, Stockholm, p.40

15 *Framtid för Sverige,* 1981, p.41

productive investments in industry, research, development and in measures strengthening the competitiveness of the Swedish industry and trade."

And pointing out the difference with past priorities of the social democracy he concludes:

"For this reason we recommended also an improvement of the profits of the industry, *which was not a usual proposition in a social democratic program* [our emphasis] ." [16]

And it was this deviation from traditionally social democratic goals of earlier periods, which , as Carlsson himself informs, provoked negative reactions inside the party against signaling in a pre-electoral document the intention of undertaking cuts in welfare reforms, which had been carried out in the past. Despite these reactions, the group of the high ranking writers insisted on discussing the text in the leading organs of the party. Carlsson expresses his conviction that the document and the proposed policy gave to the public opinion the impression that the social democratic party was capable of governing by taking all the serious and harsh measures leading Sweden out of the serious economic crisis it was facing.

And undoubtedly the economic situation was very pressing and alarming. The Swedish social democratic party, upon its arrival in power in 1982, was facing serious challenges posed by the failed policy of the previous bourgeois coalition policy, which tried to cope with the serious profitability problems of the Swedish industry by following a policy of strong subsidies in order to keep in life the most endangered industrial enterprises. With the international demand dramatically shrunk by the Second Oil Shock and the hope for economic revival thus indefinitely postponed, this policy led to serious public deficits which at the time of the arrival of the social democrats to power were on the verge of slipping out of control. The policy of subsidizing the most weak sectors of the Swedish industry (mainly, the steel and shipbuilding industry) , a policy inaugurated already in 1974-75 by the social democrats and pursued with astonishing consistency by the bourgeois coalition government, had reached its limits. A new set of policies capable of lifting the Swedish industry out of its chronic problems needed to be found. In general, the bourgeois coalition government not only abstained from any effort to question the policy of welfare expansion, characteristic of the social democratic period, but it stubbornly implemented a policy of subsidizing "lame ducks". In a sense, it tried hard to prove that it was more able than the social democrats to carry out an expansionist policy of demand stimulation. Unfortunately, the much expected global economic upturn did not materialize and the second Oil Shock was going to be a mortal blow to such an expansionist policies.

This very same Swedish industry had undergone during the last two and a half decades a rapid

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16 Ingvar Carlsson, 2003, pp. 175-176

process of an ever increasing internationalization- a process which was speeded up, in part, by the policy of promoting structural change by means of the Rehn-Meidner Model of the active labour market policy (*plus* the solidaristic wage policy). In the words of one very well informed observer:

" Swedish industry became increasingly export oriented and, especially from the 1970s on, increasingly multinational. Capital also became increasingly detached from its Swedish raw materials base. The international character of Swedish business dealings, the unstable exchange rates and the greater role of R&D in total investment made investment more risky. *Therefore, investments came to depend on profit expectations to a much greater degree than assumed by the Rehn-Meidner model.* "[17]

Having considerably profited from the policy of constant structural change in the framework of the Rehn- Meidner Model, the Swedish private industries attained a degree of internationalization, which permitted them to become increasingly independent on- and detached from- their home base, a fact that was beginning to have serious consequences for the capacity of the domestic decision-makers in Sweden to continue with a Model (the Rehn-Meidner) which fell victim to its own successes and seemed to have unleashed forces it was incapable to control. The international business dealings of the Swedish industry, as pointed out by Stephens, taking place in an increasingly unstable international economic environment made investment a far more complicated activity, depending on profit expectation to a much greater degree than assumed by the theoretical cornerstones of the Rehn Model.

This very same international economic environment, inside which the increasingly internationalized activities of the Swedish industry were taking place, had been radically transformed after the shock of the two Oil Crises and the eruption of the stagflation- but, more importantly, by the policy response given to this shocks and crises by the governments of the Western world and the international financial institutions, the *increasing trade openness* and the *deregulation of financial markets*. The new economic environment is characterized by *a far greater financial openness of movement- i.e freedom of capital movement - and, at the same time, by openness of trade exchanges in sharp contrast to previous periods, where only the one of the two was the case*:

"The current era is one of financial *and* [**the italics are Stephens'**] *trade openness* in contrast to the interwar period in which trade was regulated and in contrast to the postwar era in which the financial flows were regulated. Thus neither

17 John Stephens 1997, *The Scandinavian Welfare States: Achievements, Crisis, and Prospects* in: Gosta Esping-Andersen, *Welfare States in Transition. National Adaptations in Global Economies*, 1997

capital controls nor trade regulations can be deployed to defend the external base."[18]

Given that this far more unstable and deregulated international economic environment was leading to a growing liberalization of both the financial and the trade flows and that the internationalization and deregulation of the financial markets was making it more and more difficult for the national governments to diverge from the international interest rates, then one understands that those circumstances were creating difficulties to a social democratic government which, like the Swedish, built the Welfare State on, among other things, a series of supply side policies with instruments, like the control of the interests rates at low levels by channeling credits into the industry and by discouraging financial speculation. The new economic conditions were making the implementation of basic components of the supply side policy of the Swedish Model far more difficult and the internationalized Swedish export industries were gaining in strength in relation to the trade unions and were becoming far more reluctant to accept the historical compromise with the domestic labour movement, something which was becoming manifest with an ever aggressively critical attitude vis-a –vis the Welfare State and a more open advocacy for the deregulation policies, for the privatizations and for the entry of Sweden into the European Community.

When one, thus, tries to assess the crucial choices of the new social democratic government in power after 1982, he should bear in mind, on the one hand, these very important changes and the new structural constraints created by them and making difficult the implementation of a classic social democratic policy. On the other hand, it is important to point out that, however important these structural constraints may have been, their consequences were aggravated by a series of questionable or mistaken or badly timed and coordinated policies whose presentation and critical assessment we are going to undertake now by beginning with the most important one: the devaluation of the Swedish krona by 16% immediately after the return to power of the social democratic party.

A. The Basic Decisions of the Policy of the "Third Way"

I.The decision to devalue the Swedish krona the day after assuming power

One of the first measures which the new SAP government under Olof Palme (and with Kjell-Olof Feldt as new finance minister) takes immediately after arriving in power is the decision to devalue

18 John Stephens, *ibid*, p. 40

the Swedish krona by 16 % in relation to the Deutschmark (this devaluation, it should be noted, came to be added to a series of devaluations of the order of 10% undertaken by the previous center -right coalition government. The decision to undertake a further devaluation, on top of those undertaken by the bourgeois-coalition governments, seems to have been seriously examined even before the advent to power. Some young social-democratic economists, who were implicated in the preparation for the sketching-out of the policy proposals contained and presented in the document *Framtid för Sverige* , had early on, even before the elections, come to the conclusion that the economic situation was so pressing and the need to strengthen the squeezed profitability of the Swedish forms so urgent, that the devaluation was a necessary first step for the implementation of the policy of the “Third Way”. According to the testimony of Ingvar Carlsson:

“ After having read the alarming report of the Business Cycle Institute (Konjunkturinstitutet) I was not surprised , when the economists of the secretariat of the social democratic Riksdag group, Erik Åsbrink and Michael Sohlman, wanted to discuss with me complementary measures to the Crisis Report. They contacted me in the beginning of the election campaign, on August 13. But their propositions surprised me. They thought that the social democratic government immediately after its arrival should carry out a super-devaluation around 20% .”[19]

To the counter-argument advanced by the astonished Carlsson, that “the previous centre-right governments had already devalued the Swedish krona many times without obtaining any durable results, the two economists responded that those devaluation had been unsuccessful because they were too small and **recurring-** and hence unsuccessful. In five years the bourgeois governments undertook four devaluations amounting to a 25%. Those devaluations were rather forced by the falling international confidence in the Swedish currency. The devaluation, which was now proposed, was rather offensive aiming at boosting the Swedish exports. For this reason they proposed a “Bing Bang”- a big devaluation capable of securing credibility and lasting effects. And as a subsequent measure, conceived as a means to secure understanding and support, the government would make it clear that this devaluation would be the last one and any further devaluation as an option from now on would be out of question[20].

Since the question of the devaluation could not be possibly raised during the election campaign, the next step was made in the day after the election of the new social-democratic government. The new Finance Minister Kjell-Olof Feldt invited a small group of prominent members of the government

19 Ingvar Carlsson, 2003, Ingvar Carlsson, 2003, *Så tänkte jag. Politik och dramatik[So I thought. Politics and the dramtic art.]* , Hjalmarson och Högberg, Stockholm, p.179-180

20 Ingvar Carlsson, 2003, *ibid,* p.180

and a group of economists- among them the above mentioned Erik Åsbrinkk and Michael Sohlman – to a meeting in order to discuss the emergency economic measures which the new government had decided to take in order to cope with the drastically deteriorating economic situation. The meeting was taking place while big capital outflows were taking place on the assumption that the new government was intending to devalue as a way-out from the deadlock. This fact, according to Carlsson, was exerting further pressure on the social democratic government to finally undertake a devaluation, which was envisaged already before the elections- and which was lying even in Feldt's back of the head. The only issue which was remaining to be settled was the exact degree of the devaluation. After some contacts and hesitations Feldt proposed a less aggressive devaluation amounting to 16%- which gained the support of the participants. [21]

On this devaluation a Swedish journalist and author of a particularly interesting, detailed and fascinating chronicle on the turbulent period 1982-1992 comments:

"The great devaluation constituted the cornerstone of the economic-political strategy of the new government." [..] The devaluation was not so much the result of deep reflection (…) It was the last chance of escaping that the country ends up with a downward spiral, into which many European countries had found themselves, with counter-inflationist policy-cuts- reduced demand and mass unemployment." [22]

Even today the choice to devaluate is a matter of hot dispute and of divergent opinions - even among the social democrats themselves. For some economists, the strong devaluation in 1982, constituted the beginning to the expansive economic development of the 1980s [23]. it has been criticized, as the leading Swedish economic historian Lennart Schön points out in a very authoritative book on Sweden's economic history, for having impeded the transformation of the economy by protecting against foreign competition and by increasing the profitability within already existing enterprises, thus preventing in this way or making it more difficult the necessary structural adaptation of the economy[24]. Schön himself gives a much more qualified opinion on the effects of devaluation (of the

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21 Ingvar Carlsson, 2003, *ibid*, p.183-184.

22 Björn Elmbrant (1993, 2005) , *Så föll den svenska modellen [And so fell the Swedish Model]*, Stockholm, Bokförlaget Atlas, p.83

23 Lars Jonung, 1991. *Devalvering 1982 – rivstart eller sbedtändning [Devaluation 1982- flying start or flaring up?]*

24 Lennart Schön, 2000, *En modern svensk ekonomisk historia. Tiiväxt och omvandling under två sekel [A Modern Economic history of Sweden. Growth and transformation during two centuries],* SNS Förlag, Stockholm, p.496.

devaluation as a policy tool in general and of the 1982 Swedish one in particular). Based on a structural interpretation of the process of economic change, he assess its results by making a distinction between short- term and long term results in relation to what he calls transformation course (or cycle) of the economy (*omvandlingsförlopp*) He maintains that the long- term effects of a devaluation can not be assessed on the basis of the imbalances, which tend to emerge during the process of the structural transformation itself. The long-term result consists in the new structure, to which the transformation leads, and which appears in a more rationalized form in the next investment cycle- in the case of Sweden form the mid-1990s on. [25] The gist of Schön's argument is that the devaluation can, under certain circumstance, favor the structural adjustment of the economy and result in a new international specialization thus strengthening the competitive and development power of the economy.

What is certain is that the devaluation of 1982 initiated an export- led upturn of the economy, which resulted in a trade surplus corresponding to 4% of the GDP in 1984. The Swedish export surpluses achieved were, as Schön points out, unusually high by historical standards. The devaluation imposed severe constraints on the activity of the state and generated a downward trend in the share of wages in the national income. Both factors contributed to the achievement of the trade surpluses. Thus, the usual picture of the 1980s as the wasted decade for Sweden needs, concludes Schön, a radical correction [26]

It is certain that the motive of the social democratic government was the desire to strengthen the depressed level of profits of industry by boosting the competitiveness of the export-industries. But here lay the root of a possible problem to which at that time not particular attention had been paid or that was greatly underestimated: with their liquidity increased as a result of the devaluation and given the ever increasing degree of internationalization for many Swedish companies

"it was far more attractive to resort to speculative activities, to fly to Europe and to buy up competitors than to invest in Sweden."[27]

This important change, which was considerably accelerated especially after the first serious relaxation of the exchange controls in 1986 (see below on the abolition of the exchange controls) in

25 Lennart Schön, 2000, *ibid*, p. 498

26 Lennart Schön, 2000, *ibid,* p. 501.

27 Björn Elmbrant, *ibid* , p86

comparison to the past was making it clear from the very beginning that the results of the devaluation were going to be exhausted much more quickly than assumed- or were going to have unforeseen side-effects. The boost of the profitability and the increase in their liquidity, combined with the increasingly internationalized character of the Swedish export-firms, pushed the companies to speculative activities (real estate investments, buy-ups, financial speculation) and was leading to uncontrollable domestic movements of capital and capital flight abroad (especially after the abolition of credit controls in November 1985 and the first serious relaxation of the exchange controls in 1986). It is worth mentioning that during the past devaluations Kjell-Olof Feldt had pointed out this unwanted side-effects as a spokesman of the social democratic opposition. Now that the new government added a further 16% to the previous devaluations

" he did it in full conscience of the fact that there was a lot of liquidity inside the Swedish industry and that there was a strong speculative bias in the economy, and that it was difficult to escape attention that those speculative traits would be reinforced."[28]

And generally assessing the stabilization policy of Feldt Elmbrant remarks:

"Feldt was apparently not aware of the full extent of the fact that with the devaluation he threw more oil in the fire of inflation and that the speculative forces of the economy were being further accelerated ,- the very same forces which he did not like but which was encouraging with his own policy and was incapable of controlling. It was thus very easy for him to identify the trade unions as the sole responsible for the ills, although his own field of responsibility, the stabilization policy, was from the start elementary and very poorly planned." [29]

After the devaluation the main goal of the economic policy of the new government was the drastic reduction of the budget deficit. The policy of budget consolidation, conducted by Feldt with obstinacy and steadfastness, was very successful. Helped, in a very lucky way[30], from the recovery of the international demand, the economy began to recover and the deficits fell- due to the huge effort of the new government to reduce the budget deficit within a year by 4,7% with the uses of measures such as the drastic cuts in public expenditures, abandonment of public investment plans, transfer of

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28 Björn Elmbrant, *ibid*, p.85

29 Björnh Elmbrant, *ibid,* p.89

30 Björn Elmbrant observes very characteristically: " *The upward international economic trend began with the recovery of the American economy in October, 1982, that is, exactly when the new government of Palme returned to power. That means luck*!" (Elmbrant, 1993 (2005), p. 87)

costs from the central government to the municipalities, and the abolition of wage indexation[31]. Some very positive results were achieved between 1982 and 1986: the growth rates of the Swedish economy were two and a half points higher than those between 1976-1982. The industrial production increased by 15% since 1982 (whereas during the years of the bourgeois coalition government it fell by 9 per cent) , investment increased by 14%. The economy displayed such signs of revival that even the British "Economist" will comment about the policy of the Third Way that " *it works like a dream"*[32]. Only some time before the 1988 General Election the social democratic government described in the Governmental Statement on the Budget the state of the economy between 1982 and 1987 by giving the following numbers:

- The GDP increased by 13%
- Industrial investments went up by almost 60%
- Employment increased by 160 000 persons
- The budget deficit was reduced from 13 per cent to 1 per cent of the GDP
- The rate of inflation was halved[33]

What is important to underline is that this "new paradigm of economic – fiscal policy that the social democrats were implementing- the cornerstone of which was the drastic reduction of the budget deficit (which, according to Elmbrant, was the main purpose of the new government) – must be understood as " the policy of Third Way" (*den tredje vägens politiken*), in the sense that it was different – or tried to be different - from the other two until then common policies : the traditional Keynesian "reflationary policy" and the hard monetarism – neo-liberalism, which at the same time was being practiced in Great Britain and in the USA. This new social democratic policy, which is supported also by the President of the LO Stig Malm, albeit even more reluctantly and with ever greater embarrassment (since the members of the LO saw with increasing unrest the Swedish industry swimming in the liquidity granted to it by the devaluation, while they were constantly exhorted to display "wage moderation"), although it deviated markedly from the expansive policies of the 1970s, was different in two crucial from the policy at that time practiced in Europe: a) the full

31 Björn Elmbrant, 1993 (2005), p.90-91.

32 The figures and the positive judgment made by the British *Economist* are cited by Ingvar Carlsson, (2003), *ibid,* p.229-230.

33 Budget Statement 1987/88: 100, Appendix 1,3 Cited by Carlsson (2003), p.236

employment continued to be top priority and b) despite the cuts, no serious retrenchment of the Welfare State had taken place. These perceptible differences permit the social democrats to delimit their policy from that of the neoliberal New Right and to win the 1985 elections. On the other side, the rather idyllic picture of the Swedish economy was going to be spoilt by a new crucial development which was going to have serious and far-reaching consequences on the stability of the changed political economy of the "Swedish Model" and affect the long-term results of the policy of the Third Way: the deregulation of the credit market in November 1986, perhaps the most important policy change in the economic policy of the post-war period.

II.The deregulation of the credit market in 1985

1985 is a crucial year for the Swedish model: it was the years of the reelection of the SAP in power, but also the year in which a decision with serious consequences was taken: the deregulation-liberalization of the credit market. On November 21, 1985 the regulations of the credit market – **liquidity requirements, ceilings on the commercial bank lending, interest rate regulations**- was abolished**.** This event "*was going to be called later by the banking circles "November Revolution" and it had the effect of totally wiping out the existing tight regulatory framework for the provision of credit*." [34]. It was a crucial event, whose consequences on the economic policy of Sweden in the subsequent years were going to be of considerable importance. All the observers are today unanimous in their judgment that the deregulation of the credit market was a watershed event, although at the time of its announcement only few were able to grasp that this measure was going to radically change the conditions for the implementation of the economic policy. Lars Jonung, a liberal (and moderate monetarist) professor of economics at the University of Lund, makes the following remark on the importance of the deregulation of the credit market:

" The road to the present day was influenced by the decision in November 1985 to abolish the internal regulations of the credit market. This decision, the so-called November Revolution, laid the ground for the radical change in the Swedish economic policy in the port-war period. Since then, the gates of finance were opened and they stay open up until now."[35]

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34 Elmbrant, *ibid,* p.126

35 Lars Jonung, 2015, *Trettio år på vägen till ett stabilare Sverige. Var står vi nu? [Thirty years on the way to a more stable Sweden. Where are we now?],* in: Birgitta Swedeborg (red), 2015,*Svensk ekonomisk politik- då, nu och i framtiden. Festskrift tillägnad Hans Tson Söderström [Swedish Economic Policy- then, now and in the future. Essays to the honor of Hans Tson Söderström]*, p.41

Apart from a small number of economists, high ranking civil servants of the Swedish Riksbank and some economic journalists the importance of the decision, taken formally by the political representatives on the board of the Riksbank (the so-called *Riksbanksfullmäktige*) , was grasped by very few people in Sweden. And even among those implicated in taking the formal decision (i.e the political representatives sitting on the board of the Riksbank) only few were fully conscious of the far- reaching consequences of this decision.

The regulation of the credit market, a product of the end of the Second World War and of the regulated war economy of the period, was an essential component of the post-war social-democratic policy. Although the bulk of the war-time direct controls was abolished in the 1950s, a system of credit controls- cash and liquidity ratios, loan ceilings, control of bond issues- remained in force with some changes after 1955[36]. Initially conceived as an instrument of planning, the regulation of the credit market was seen- after the abandonment of the idea of an extensive planning by the governing social-democratic party in the beginning of the 1950s - as a necessary instrument to control and influence the investments and to reach the goal of full employment by channeling credits to sectors deemed to be of primary priority for the attainment of such a goal (e.g. the house construction). As the Professor of Political Science at the Uppsala University, Torsten Svensson, writer of a very insightful and well-documented report on the process of the deregulation (ordered by the Ministry of Finance and submitted in 1996, a decade after the crucial decision), observes, " *with the combination of a conditional law on the regulation of the interest rates and the threat to intervene with its help the Riksbank was able in 1952 to set rules by negotiations with the commercial banks which were guaranteeing a political control of the credit market* . As the time went by, the arsenal of the regulations was refined and enriched. Apart from the low interest rate they were introduced instruments such as regulation of the interest rates, control of the emissions, liquidity requirements, placement obligation and ceilings on loans . [37]. Every month the Riksbank met regularly with commercial and saving banks and had the capacity to oblige the banks to hold on the agreements by making use of the legislation and of sanctions in the form of "punishing rates", thus acquiring huge power over the credit market. [38]

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Assar Lindbeck, 1975, *Swedish Economic Policy,* The Mackmillan Press, London, pp.75, pp.108-113.

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Torsten Svensson, 1996, *Novemberrevolutionen. Om rationalitet och makt I beslutet att avreglera kredotmarkanden 1985.[The November Revolution. On the rationality and power in the decision to deregulate the credit market in 1985].* Rapport till ESO, Finansdepartementet, Stockholm, p.29

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What was going to undermine gradually the above described regulation system was the new deteriorating economic conditions at the end of the 1970s and the beginning of the 1980s- especially after the second Oil Shock, which doomed the demand-stimulation policy to failure. Despite the effort to overcome the recession and the stagflation caused in the mid-1970s by making use of a vast program of demand stimulus by increasing public expenditure and by subsidizing branches and firms in distress, the economic slowdown and the declining exports of the Swedish firms could not be reversed and as a consequence the public deficit in Sweden continued to grow steadily. Already by 1978 the Swedish state began to take loans on the international financial markets. The end of the era of the center-right coalition governments found the credit sector tightly regulated. As Torsten Svensson, observes:

" The paradox was that during the center-right governments the legislation on credit was going to be enacted , regulations were introduced and sharpened."

In 1982 and 1983 – with the social democrats back in the power – in order to finance the deficits, the government began to create new market instruments – Treasury bills and different types of bonds- which in turn stimulated the growth of a securities market[39]. The problem was that the effort to finance the bloated budget deficit by these new more sophisticated financial instruments began to collide more and more with the tightly regulated credit market. The situation was further complicated by the fact that a "grey market" had been developed to which credits beyond the control of the Riks bank had been channeled and were circulating beyond the existing regulatory framework.

However, the deregulation of the credit market was not a sudden and abrupt event, but the *culmination of a process*, in which the first decisive step was the abolition of the liquidity requirements for the commercial banks in 1983 and the final step, announced on November 21 1985, was the abolition of all ceilings on loans from banks and finance institutions. But even this decisive step, which meant the abolition of a regulatory instrument in use since 1953, was not undertaken easily and immediately. If there is something which makes the whole event- the decision to deregulate - remarkable is the way in which such a serious decision was taken: *in spite of* the decisions of the Social democratic party congress, which had voted for a more restrictive legislation on the credit policy and *through* a series of reports by technocrats, civil servants in the Riksbank and economists, who in spite of their expertise, greatly underestimated the dangers and were emphasizing the need to implement this measure downplaying the risks for interest rates increases and for

Torsten Svensson, 1996, *ibid,* p.29

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Torsten Sevensson, 1996, *ibid*, p. 164-165 "destabilizing currency outflows". As far as the social democratic party is concerned, even its programmatic declaration on the economic policy of the "Third Way" which the party was aiming to implement , the document *Framtid för* Sverige, did not contain the slightest reference to intentions of relaxing the controls on the credit market- let alone abolish them. In fact, the document contained a formulation which could be interpreted as pointing out the necessity of keeping the controls on the credit market, while at the same time the necessity was underlined to reduce the grey market by finding new forms to restrict the excess liquidity of the firms, to take loans directly from the public instead from the banks, to reduce the loans destined to consumption, to favour the savings of the households, and, to *sharpen the exchange controls as a support to the credit policy*[40] .

When finally the decision to deregulate completely was taken, even the highest ranking party and state officials were not able to grasp the implications and the consequences of a such a crucial change in the monetary policy. Even, the Party chairman and Prime Minister Olof Palme, when he was informed - albeit when the decision of the Riksbank to deregulate was about to be taken- he is quoted to have said, according to the testimony of Kjell-Olof Feldt : "*Do as you wish. I simply do not understand anything."*[41] Everything shows that the party leadership did not have the intention of implementing the abolition of the credit controls, that for some of the party leadership the whole issue was too complicated to have a clear picture of its importance and that there had never been a wide and detailed discussion in the decision- making instances of the party structure in respect to this question.

How was then this crucial decision taken? And more important: who took this decision, who was best situated to influence the whole decision process and how the party and government officials were convinced to give their formal consent to it- given their inability to grasp the far-reaching consequences of such a decision? According to Jan Elmbrant this decision could not have been taken without the presence of persons into key-places as advisors and close collaborators of Kjell-Olof Feldt in the Ministry of Finance, who were recruited at the beginning of the 1980s in order to found the *Economic Association (Ekonomiska föreningen)* and to draft the new program of economic policy of the SAP on the eve of the expected return to power in the elections of 1982. It is well-known that the social democratic party, from the beginning of the 1930s, had established a permanent

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Socialdemokratiska Arbetarpartiet Sveriges, 1981, *Framtid för Sverige. Förslag till handlingslinjer för att föra Sverige ut ur krisen [* Social democratic party of Sweden.*Future for Sweden, Proposistion to lines of action in order to get Sweden out of the crisis* p. 55

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Kjell- Olof Feldt, 1991, *Alla dessa dagar,* [*All those days]* , p. 260. Quoted by Svensson, 1996, *ibid* . p.112

channel of communication with economists professing original and innovative theories. Elmbrant points out - and then rather rhetorically asks):

“ The social democrats have a strong and historically determined passion for the economists as problem-solvers. Did they not have in the 1930s the useful help of Gunnar Myrdal and of the other members of the Stockholm School and was it not the same with the group of economists, with whom Thage Erlander was discussing in the 1950s, the chief economists of the LO, Gösta Rehn and Rudolf Meidner?”[42]

The crucial difference, of course, between the economists of the 1930s with the economists of the *finansdepartementet* in the 1980s was that in the first case the economists of the School of Stockholm had been the intellectual architects of the proto-keynesian policy, which began to be implemented by the social democrats after the Crisis Agreement with the Agrarian party and they can be, consequently, considered as the founders of the Swedish Model, while the second, obviously strongly influenced by the more and more liberal *Zeitgeist* of the 1980s and the loss of predominance of the Keynesian economists inside the circles of the academic economic theory, can be considered as those who, in the new changed realities, were advocating a new economic policy departing from the original “Swedish Model”, by writing memoranda and reports of technocratic nature preaching the necessity of the deregulation and preparing the ground for it. Chief among them were Erik Åsbrink, under –secretary at the Mininstry of finance and after the 1985 Chairman of the political representatives on the board of the Riksbank (*Riksbanksfullmäktige*), future finance minister in the social democratic government of Göran Persson in the 1990s and co-author (with Lars Heikensten) of the report recommending the abolition of the regulatory limitations on the credit market. According to Elmbrant, it seems fairly accurate to say that the decision was taken in the background by a bunch of few initiated who acted in a quasi conspiratorial way. Elmbrant cites the famous economist Andres Åslund confessing that “*I remember a flock of people in the Ministry and in the Royal Central Bank at the time the deregulation took place. A silent fascination was dominating that such kind of deregulations were possible. The main point of discussion was how a deregulation could be passed through the political system (…) The strategy adopted was technocratic and conspiratorial.*”[43]

That in the 1980s a neo-liberal *Zeitgeist* was reigning and that in the academic circles of the economists a decisive shift away from the Keynesian theoretical ideas towards the monetarist and/ or neo-classical theories took place is undoubted. Outside the social democratic government and parallel

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42 Elmbrant 2005, *ibid,* p 72

43 Elmbrant (2005), *ibid*, p.127. The above statement of Åslund, cited by Elmbrant was published in the Swedish newspaper *Svenska Dagbladet,* 21.10.1992

to the new age social democratic economists headed by Erik Åsbrink, other much more liberal-minded economists with links to circles of the Swedish industry were active, emphasizing the necessity for a major economic policy change: the group of economist at the Council of the Business Cycles of the Swedish Industry (the so- called SNS Konjunkturråd) around Hans Tson Söderström and Lars Jonung were the most known ones. It was this group of economists who in 1985 wrote the 1985 SNS Report under the title *Vägen till ett stabilare Sverige" [The Road towards a more stable Sweden*] containing strategic recommendations for extensive changes amounting to a clear break with the interventionist Keynesian policy underpinning the traditional Swedish Model. However, nothing indicates that these last economists were able to exert such a considerable influence on the final decision on the credit deregulation (and on the decision- making process preceding it) so as to be considered as the intellectual fathers of this impressive change.

In order to grasp who was the decisive factor in the gradual but inexorable process leading to the decision to lift the last remaining credit regulations, one needs to bear in mind who was responsible for the monetary policy and who had the formal *and the real* decision making power in order to push through such an importance decision. According to Ingvar Carlsson, at the time Nr.2 in the Swedish government, there was *a clear division of responsibility between the government and the Riksbank. The government was shaping the budget and the fiscal policy, while the Riksbank was taking the decision on the field of monetary policy. That means that the Riksbank was having the responsibility for the level of interest rates as well as the supply of money and credits.* [44]

The remark of Carlsson is undoubtedly accurate: the decisive actor was the Riksbank, which was governed formally by a board of political representatives (*Riksbanksfullmäktige*) from the Swedish political parties represented in the Swedish parliament. The chairman of the Riksbank was appointed by the Swedish government and his mandate lasted as long as the mandate of the parliament lasted. The representatives on the board of the Riksbank were formally responsible for the final decision of the Riksbank and the influence of the government on the decision of the Riksbank was exercised also through a further channel: the close contact between the Chairman of the Riksbank and the Minister of Finance. However, the influence of the political representatives on the decisions of the Riksbank needs to be qualified, as far as the credit policy is concerned: the credit policy is a complicated issue and the majority of the political representatives, though formally responsible on the issue, had not had, according to Svensson, the necessary knowledge and expertise to grasp the nature and the

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44 Ingvar Carlsson, 2003, *Så tänkte jag. Politik och dramatik[So I thought. Politics and the dramtic art.]* , Hjalmarson och Högberg, Stockholm, p.213

possible consequences of the decision to deregulate. In Svenson's opinion

"The political representatives of the board (*Riksbanksfullmäktige*) have the political responsibility for the monetary and credit policy. It is the political representatives who formally have the power and take the important decisions. In reality, however, it seems that the appointed experts – leading civil servants of the Riksbank were those who pursued the policy and were taking the essential decisions."[45]

That the higher civil servants of the Riksbank were those most able to take the essential decision in the process towards the complete abolitions of the credit controls should be attributed to the fact that as experts they have a far better knowledge of the complicated issues of the credit policy- a knowledge which the political representatives sitting on the Board of the Riksbank partially or totally were lacking. And that those experts and high civil servants were best placed to decisively influence the process was, according to Svensson, clear from the role they played in the first crucial step of this process: the abolition of the liquidity requirements. They had, furthermore, the day-to-day contact with the market and they were in charge of the government machinery, which was formulating the problems and issues, as well as the agenda of the day to be discussed by the political representatives at their ordinary meetings. The experts of the Riksban, in fact, were shaping the image of the reality upon which the political representatives were going to take the final decisions on issues of monetary and credit policy[46].

If the Riksbank, with its Chairman, Bengt Dennis, and its experts and higher civil servants, were according the evidence at hand, those who were at the forefront of the deregulation process, what was the role of the Minister of Finance and some of his most close collaborators? In his memoirs written after his resignation, Feldt avoid to analyze sufficiently and in detail the process of the deregulation of the credit market. He insists that Riksbanks chairman Bengt Dennis was the one who was responsible for having played the crucial role in convincing the political representatives to take the final formal decision. He mentions that *Dennis gave the assertion to him and to the government that the abolition of the ceilings on lending will not be accompanied by an uncontrollable credit expansion*[47] –something which Dennis, on his side, categorically refuses. In an interview to Torsten Svensson, Dennis pretends that no one could possibly know in advance the exact consequences of a deregulation and a possible uncontrollable credit expansion:

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45 Torsten Svensson, 1996, *ibid,* p. 55.

46 Torsten Svensson, 1996, *ibid,* pp.55-57

47 Feldt, 1991, *ibid,* 316

“ We had to be ready that a credit expansion might take place. In such a case there is only one instrument, the fiscal policy. And I felt particularly strongly that there was in the Ministry of Finance a compact support behind the idea that the fiscal policy should become more tight.”[48]

Dennis not only denies that the consequences of the abolition of the credits controls were impossible to be predicted by the Riksbank, but, as its perfectly clear from the above-mentioned citation, he places the responsibility for the effective management of the deregulation at the Ministry of Finance, which should, in a case of a deregulation, change its fiscal policy in a far more restrictive direction. A further tightening of the fiscal policy was the only instrument to meet the danger of a destabilizing credit expansion. However, it is very doubtful if – and to what extent- a further tightening of the already tight fiscal policy practiced by Feldt, was politically and practically possible: already in 1985 the working class employees were clearly dissatisfied with the fact that the industrial circles were “swimming” in an ocean of liquidity, while they were being exhorted to display wage moderation and the blue collar trade- unions of the LO were gradually losing their grip on their members and were unable to convince them about the merits of continued wage moderation.

The fact that Feldt claims that Denis reassured him that the no uncontrollable bank lending was going to happen and that Dennis not only denies this but also says that deregulation should have been responded to with a tightening of the fiscal policy by the Ministry of Finance is a typical example of a “blame game” and is bitterly commented even by Carlsson himself who remarks that “*it is impressive that the two main actors in the credit deregulation were not able to settle this issue before the decision and that they continue to disagree on this so decisive issue.*[49] Of course, one thing is who was responsible for – and legitimized to- taking the decision to deregulate and another thing who was capable of coping with the unpredictable consequences after the deregulation had taken place and its effects had begun to assert themselves. As to the first point, the things seem to be clear enough: the Riksbank and its Chairman were in charge of the monetary policy. Its leading senior civil-servants, most of them experts with professional knowledge on credit and monetary issues and with-day-to – day contact with the banks, were preparing the agenda of the day on which the political representatives sitting on the Board of the Riksbank would take the final decision. Exactly this expert knowledge conferred upon them a “superiority” in relation to the political representatives, many of them being simply passers-by on the board of the Riksbank and had not the time to acquire sufficient

48 Interview with Bengt Dennis, in: Svensson, 1996, p.99. The above remarks from Dennis are directly cited by Carlsson in his Memoirs, 2003, p.215

49 Ingvar Carlsson, 2003, *ibid,* p.215-216.

knowledge on such a complicated issue as the credit and monetary policy. The very thorough, detailed, careful and insightful investigatory report of Torsten Svensson, which examined the deregulation from the viewpoint of the political science and investigated it as a process of power and decision-making, had made it amply clear that the initiative and the final push for the deregulation came inside from the Rikbank and that its Chairman and his civil servants had played a crucial role in this process.

Does this mean that the Central Bank, by virtue of its being in charge of the monetary and credit policy and of the fact that its experts had a superior knowledge on such issues, was the single most important actor and the Ministry of Finance under Kjell-Olof Feldt should be seen as marginal players? Such a conclusion would be erroneous and misleading. In fact, Feldt not only was able to have first-class knowledge about the intentions and the policy of the Riksbank, but also was capable of influencing the whole process, since his "long arm" was present in the board of the political directors: At the time of the decision's being taken, on the board of the political representatives an important change had taken place: the old minister of finance during the 1960s and the 1970s, the legendary Gunnar Sträng, was replaced as Chairman of the Political Represntatives, for reasons of age, by Erik Åsbrink, under-secretary in the Ministry of Finance and close collaborator of Feldt. This change was deemed to be important, not only because Sträng is reported to be very hesitant – if not rejecting- towards the thoughts about an abolition of the credit controls, but also because Åsbrinks appointment as Chariman was strenghtening the presence of the Ministry of Finance inside the Riksbank by creating a kind of personal link between Riksbank and Ministry of Finance. Representative of the "Old Guard" of the social democratic leaders, grown-up politically and acting as a Finance Minister in an era where the regulation of the credit market, was an essential pillar of the traditional "Swedish Model", Gunnar Sträng could not be considered a partisan of total deregulation. In fact, he is far more probable that he would prevent or, at least, delay the whole process. Not accidentally, Svensson remarks that " *As long as Gunnar Strang was sitting on the Board of the Political Representatives, he could prevent the carrying out of the reform. Or at least, the perception of the environment of his attitude towards the reform played the role that the decision was not put on the table. This came about with Erik Åsbrink assuming the Chairmanship.*"[50] Åsbrink was a person with a key-role in the reorientation of the social democratic policy in the 1980s: he was participating in all the committees outlining the social democratic economic policy and he was present in the preparation of the famous tax-reform of the century in the critical years 1989-1991. He played such a

50 Torsten Svensson, 1996, *ibid,* 110.

crucial role in the Ministry of Finance as to be considered to be a prominent member of the so-called Right-wing of the Chancellery" (*Kanslihushöger*), a political-journalistic term denoting the new generation of social democratic economists bent on giving the economic policy a decidedly and clearly pronounced market-friendly twist. That he assumed the chairmanship of the Political Representatives of the Riksbank is generally seen as an event which sped up the process of the abolition of the remaining credit controls. Theoretically, Åsbrink could initiate a process of broader discussion inside the Ministry of Finance aiming at informing about the serious risks being present in the process of deregulation. Practically, no investigation, discussion and thorough examination of the whole issue took place in the Ministry of Finance- something which Erik Åsbrink openly admits, by pointing out that the whole issue was thought to be strictly secret. The justification for this was that the credit issues are technically complicated questions, the level of expertise and knowledge was low among the members of the social democratic Riksdag group and that a wide debate around them, even inside the Ministry of Finance, would permit special interests to enter the scene and slow down the process. [51] Since not only Erik Åsbrink, under his capacity of Chairman of the Political Representatives, practically acted as the "long arm" (the expression belongs to Carlsson[52]) of the Riksbank in the Ministry of Finance by trying to pass its decision to deregulate as long as rapidly through the Ministry as possible , but also he carefully and consciously carried out the tactics of the most high secrecy around the whole issue adopted by the Riksbank, the whole issue of the abolition of the remaining credit controls became an issue beyond public discussion, scrutiny and critical examination of its possible consequences, an issue debated only by a few initiated and by a trusted inner circle of experts and senior civil servants inside the Riksbank, who possessed the expertise knowledge and were thought to be qualified for assessing and for pushing for the deregulation. The question had not been presented and discussed in the executive committee, the social democratic party leading committee (*partystyrelse*) or to the social democratic Riksdag group before the decision was taken, points out Carlsson[53]. The presentation to the government took place on November 21, the same day the Political representatives in the Riksbank took the decision.

Since the high secrecy and the avoidance of the intrusion of special interests into the whole decision-

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51 Torsten Svensson, 1996, *ibid,* Interview with Erik Åsbrink, p.113

52 Ingvar Carlsson, 2003, *ibid*, p.214

53 Ingvar Carlsson, 2003, *ibid,* p.216

making process was chosen by the Riksbank as the most possible and effective strategy, the question which arises is whether this decision was taken without special interests intervening in favor of the final direction. The question becomes all the more pressing, since the “Swedish Model” is generally considered to be a *cas d’ecole* of a corporatistic model of decision-making meaning that in it the various interest groups were given institutionally and formally the possibility to participate in shaping the public policies. An even more distinguishing trait of the “Swedish Model” is the close connection between the social democratic party and the Confederation of the blue-collar Trade -Unions, the Landsorganisation (LO) i Sverige. In fact, central aspects of the “Swedish Model” in the post-war period were constructed with the initiative of the leading economists of the *utredningsavdelningen* , the investigation department of the LO, playing a decisive in the formulation of strategic proposals. The Rehn-Meidner Model combining full employment by means of active labour market policy and price stability by means of wage restraint and solidaristic wage policy was the most known example. It is worth mentioning that this close connection was not friction-free and exempt of tensions: even the Rehn-Meidner Model was accepted after initial strong resistance by the then finance minister Per-Evin Skjöld, who went as far as to ridicule the whole concept underpinning the theoretical construction of the Model and trying to convince the social democratic Prime Minister Thage Erlander to reject it completely. In any case, the link between the political and the trade-union wing of the labour movement was vital- and the LO had always an open channel permitting it to present to the party leadership its proposals on matters of tactical and strategic importance. However, on the issue of the credit controls and their abolition, nothings shows that the leadership of the LO or its prestigious economists – at the time the leading economist was Per-Olof Edin – were consulted or that an organized contact with the LO had been established in order to inform it or to hear its views on an issue – the credit policy – which was an essential pillar of the post-war economic policy. According to Svensson, no one in the Riksbanks Political representatives remembers any organized contact with the LO, when asked by Svensson both the LOs Chairman, Stig Malm, and LOs second Chairman, Rune Molin, refused that any discussion of the whole issue within the small discussion group with the party leadership took place. The conclusion drawn is clear: the trade- union movement had by no means been part of a possible corporatist discussion of the credit controls. In fact, the years 1985 is considered to be a critical year for the co-operation between the LO with the social democratic party, according to the testimony of PO Edin[54]: after this year the party leadership practically ceases to discuss in advance policy issues with the trade- union wing: the latter will be put

54 Torsten Svensson, 1996, *ibid,* p. 114-115.

in front of successive *faits accomplis* and the de facto incapacity to influence upon the course of the government policy will bring LO's Chairman, Stig Malm under considerable embarrassment and will be forced to express his disaffection in unorthodox ways.

If the LO was in fact totally absent from the whole project of the decision process leading to the deregulation, the Association of the Swedish Banks (*Bankföreningen*) was from the very beginning an integral part of the whole process and actively pushed for the abolition of the remaining credit controls by taking advantage of some indisputable objective advantages: the banking sector had almost day-to -day contact with the Riksbank about the credit policy and the implementation of the existing tight credit controls – and of course, their expertise knowledge on the issues of the credit policy. Even more important: the banks' monthly reports on their lending activity constituted the indispensable basis upon which the Riksbank was able to shape a clear picture of the lending activities inside and outside the banks- especially when a " grey market" began to develop. And the banks could not fail to become aware of the fact that the Riksbank was beginning to seriously consider the abolition of the credit controls: for the banks the final decision was hardly a surprise or an unexpected event, as Svensson points out.[55]. Having in time perceived that "a wind of deregulation was blowing" the banks were beginning to occupy a more favorable position even in relation to the Riksbank: Dennis tried to strike the deal with the banks, that in case of a deregulation the banks will behave responsibly and they will act with restraint and with mutual willingness of co-operation instead of reckless lending activity. However, when the last remaining credit controls were removed, the deal with the Riksbank had no real influence on the lending behavior of the banks: the banks breached it knowing very well that the only means of disciplining them, the credit controls and the ensuing sanctions, were completely removed and they had nothing to fear from the Riksbank. In the new deregulated credit environment, the individual bank was running the risk of being the loser in the fierce competition for parts of the credit market. When everyone was tempted to abandon the co-operative and restrained attitude, a situation with a high credit explosion emerged , where even the normal assessment of the credits is thrown away[56]. The banks opted for the deregulation, acted in favor of it, transmitted to the Riksbanks monthly reports confirming the ineffectiveness and the futility of the existing credit controls and when they perceived that the Riksbank was moving towards the desired goal of the deregulation, they took part wholeheartedly in the frenzy of reckless lending in

55 Torsten Svensson, 1996, *ibid, p120*

56 Torsten Svensson, 1996, *ibid,* p.126

spite of the "gentlemen's agreement" with the Riksbank to show restraint and co-operative attitude. The "corporatist arrangement" with the Riksbank was immediately abandoned in favor for a ferocious struggle to conquer credit market share.

But beyond the question who took the decision and who was best positioned to influence the process leading to it, a further- and perhaps much more important question arises: What were the arguments in favour of the deregulation and what kind of factors made it possible? Three arguments were particularly used in order to prepare the ground for the total deregulation of the credit market: 1) that the need for regulation of lending became smaller because of the emergence of the new credit market, 2) that the existing regulations had become ineffective and 3) that the regulations had created distortions on the credit market. Let us have a closer look at these basic arguments.

The growing budget deficit and the need of the state to take loans in order to finance its expenditures was the new and most pressing phenomenon in the changed economic realities of the 1980s. And as one senior civil servant of the Riksbank, Thomas Franzen points out, "the more the state borrowed , the more difficult it became to control the credit volumes in an administrative way. In order for the state to be able to place its state papers, a state-paper market had to be developed , which could not be controlled, as the banks , by use of quantitative rules. To the extent that such a market was being developed, the effects of the rules diminished. The ceiling on lending began to be questioned. [57].

The lack in effectiveness of the regulations was due to the fact that a) a grey market had been developed, where one could take credits outside the regular market. When the supply of credit by the banks was reduced, the big firms and other more or less serious actors offered credit (at high interest rates. Channels had been opened, which made it easier to reach the loan-takers in other ways. And b) to the fact that the banks themselves had learnt to handle the system of controls, by removing parts out of their credit portfolios temporarily before the Riksbank could "read" it. They had learnt to circumvent the regulations and to keep a far higher degree of lending than that contained in the official statistics.

And, finally, the emergence of a grey market had led to unequal conditions for the agents of the credit market- something which gave rise to distortional effects on the credit market. A reality had arisen where the big companies and individuals with contacts and inside information were far more able to take credits than others. [58]

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57 Torsten Svensson, 1996, *ibid*, p. 81-82

58 Torsten Svensson, 1996, *ibid,* pp. 81-83.

It is not easy to assess the validity of the argument. As far as the grey market is concerned, it is very difficult to know objectively its exact size and operational field and to support that it had reached such an extension so as to render the regulatory framework totally useless and ineffective. The same holds for the practices of the banks and their capacity to circumvent the checking system of the Riksbank by temporarily lifting out parts of loans offered. On the other hand, it seems hardly easy to deny the fact that the credits controls were exposed to severe pressures which reduced their effectiveness. The ever increasing budget deficit and the necessity to finance the public expenditure was undoubtedly the most pressing and destabilizing factor to the established system of credit controls. That this increasing deficit was the natural result of the deteriorated economic situation of the late 1970s and of the failure of the practiced demand- management policy to redress the growth rates is of course common knowledge. The things looked like the following, according to the concluding remarks of Svensson: In Sweden in 1982 and 1983, in order to finance the deficits, the government began to create new market instruments – Treasury Bills and different types of bonds – which in turn stimulated the growth of a securities market. It gave the Riksbank new opportunities for open market operations, but at the same time triggered growing problems in keeping the traditional financial sector regulated.[59] The essence of the policy of the Third Way was its effort to reduce the public deficit by avoiding severe cuts in the welfare provisions. The effort to finance the deficits and the continued high public expenditures led the state to seek financing in the above mentioned state paper market, whose development was running counter to the tight credit regulation system. It is in this sense that Svensson, in his concluding recapitulation of the results of his report, feels able to state with caution that "*with slight exaggeration one can argue that the Social Democratic policy of the full employment and of high public expenditure caused the erosion of the traditional Social Democratic control over private capital.*" In the pressing and radically altered conditions of the 1980s the effort to preserve one pillar of the social democratic policy – full employment and high public expenditure – was obtained, according to this interpretation, at the cost of abandoning an other essential pillar of the social democratic policy- the control over the credit market, which permitted the social democratic governments to pursue their own supply-side policy by channeling credits into socially determined priority sectors. The abandonment of this second pillar had symbolic and real importance, which even Kjell-Olof Feldt in his memoirs points out: in his –already mentioned - presentation of the proposition to abolish the credit controls to Olof Palme, Feldt insisted that " *the proposition was practically meaning that the social democracy after decades of fierce*

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Torsten Svensson, 1996, *ibid,* pp.164-165 *resistance was abandoning one of its most symbolic fortresses to the control of the market forces. That could be interpreted as a big concession to the neo-liberal ideology.'*[60]

Finally the decision to deregulate the credit market was announced with a communiqué the journalists found confusing and with the President of the Riksbank of Sweden, Bengt Dennis, justifying the decision with the argument that by taking this measure credits which were in the "grey market" would be moved now to the official banking system, while he refused to admit that this could lead to an exponential increase of the whole volume of the loans. [61]In general, the media presentation of the decision was moderate and in no case did it became clear that the decision was tantamount to a " systemic change in monetary policy". It was going to become very soon clear that it was a change of systemic nature, which was leading to an explosive increase of the volume of the loans, was creating ideal conditions for an uncontrolled explosion of the lending and for a consumer and speculative boom, thus favoring the creation of a credit bubble. In a report of the state committee on the bank law the following conclusion was drawn about the immediate consequences of the deregulation of the credit market:

"After the final act in the deregulation in 1985 the lending of the banks increased dramatically. The total bank lending almost trebled after the abolition of the ceilings on lending between 1985-1990. Expressed as a part of the Gross Domestic Product the bank lending increased from only 50 % to almost 80 % of the GDP. By a more close examination of the accessible statistical material it becomes evident that the increase in lending rose immediately after the abolition of the lending ceiling in November 1985 and that it receded a little during 1987. During 1988 increased again and in an almost explosion- like way." [62]

Commenting on the immediate and medium-terms consequences of the deregulation of the credit market Elmbrant observes:

" A huge credit bubble was created. Lending in Sweden increased in three years from 352 billion to 622 billion. We had an increase in consumption which was triggered by the uncontrolled lending, in which wage-earners , companies, real estate firms, credit institutes and banks, like a ran- away train, were heading for the abyss."[63]

Could the exponential growth of the deregulation of the credit markets have been avoided? Before

60 Kjell-Olof Feldt, 1991, *ibid,* p. 260.

61 Elmbrant 2005, *ibid*, p.127

62 SOU 1998: 160, 139-139. Cited by Ingvar Carlsson, 2003,*ibid,* p.212

63 Elmbrant, 2005, *ibid*, p.133

answering this final question one should bear in mind that in Sweden at that time the monetary policy was resting on the following pillars: a) the credit controls, b) the exchange controls, c) the high tax-deductions (for interest-rate payments) on loans in the existing tax-system and d) and the fixed exchange rates. With the benefit of hindsight there is nowadays a widespread belief in Sweden that the possibilities to make tax deductions in the tax-system during the 1980s made borrowers insensitive to the interest rate changes. If a tax reform putting an end to the high tax -deductions for borrowers had preceded the deregulation of the credit market, the explosion of the lending could have been averted – and the bubble in the financial and real estate sector perhaps would have been for less serious and catastrophic. The leading senior civil servants who planned and executed the abolition of the remaining credit controls have seriously underestimated the size of the insensitivity of the households to the interest rate changes because of the existing tax deductions for borrowers. In this sense, one could support the view that an inversed implementation of the two reforms, - i.e the deregulation coming about *after* the tax reform and the very generous tax deductions for payments for interest rates on loans taken having being drastically curtailed –could have averted the speculative overheating of the economy and contain the bubble within certain limits.

Whatever the results of a different sequence of the reforms implemented may have been, the fact remains that the abolition of the credit controls gave rise to a totally underestimated reckless lending opening the way for the creation of a bubble. Prepared – after hesitations and postponements – secretly by a small circle of leading experts and senior civil servants of the Riksbank, who were supposed to have a superior knowledge on matters of monetary and financial policy and to be able to predict and avert the possible destabilizing side-effects, the deregulation not only eroded a central pillar of the post-war social-democratic policy – the capacity to direct credits to priority sectors, perceived to be socially important- but also it unleashed a reckless lending by the banks, which now felt that they were not bound by any commitment to moderation and self –restraint : despite the assertions of the Riksbank Chairman that *no increase in the total size of loans was going to happen, but only a transfer of loans from the grey market to the regular market*, the lending took huge and uncontrollable dimensions. The same holds true for Feldt, who as late as 1989 refused to attribute the increase in lending to the deregulation of the credit market. As for Carlsson, at the time Prime Minister as successor to Olof Palme, he confesses that at that time he was much more preoccupied by the continuing progresses in wages during the collective negotiations than about the developments on the credit market. He admits that the effects of the deregulation had been neglected by him in favor of other work tasks and in a form of self-criticism he says that this was the most serious mistakes in the seven years as Prime Minister. [64]

Carlsson is even compelled to admit something equally important: The only ones who clearly and explicitly warned against the consequences of the deregulation in the credit market were the LO economists. It is very revealing that when the LO chairman, Stig Malm, referred – under a meeting of the executive committee of the party on April 25, 1986 - to the fact that the commercial banks were sending letters to individuals and offering loans of up to 99.000 kronor without collaterals, the reaction of Feldt, according to Carlsson , was the following:

"" Kjell-Olof Feldt replied that the increased profits in the banks were due to the fact that the interest rates had fallen and not to the deregulation. […] By deregulating we had got rid of the grey market. In the so-called open institutional market we had now better chances to follow the development of the events."[65]

How "good" and "effectively" Feldt at the Finance Ministry and Dennis at the Riksbank followed the "development of the events" is something which was going to be shown very soon- and in a dramatic way. In fact, one wonders whether their assertions were, in the best case, wishful thinking or in the worst self-inflicted blindness. In comparison to the total lack of insight into the course of events displayed by both the Ministry of Finance and the Riksbank one is equally tempted to be impressed by the far-sightedness shown by the LO economists in their warnings against the risks resulting from the deregulation of the credit controls. Unfortunately, however, for them their warnings were not paid the slightest attention and were not able to change the course of the events. The era when the models and the recommendations of the LO team of economists were taken seriously was definitely over. What counted and mattered now was the adaption to the "irresistible winds of deregulation" and the new reality shaped by them. It was the era of the *marknadsanpassningens politik*, of the market-adapted policy. And the social democracy succumbed after some resistance and hesitations to the diktats of this policy and to the winds blowing in the surrounding Western capitalist world. The fate of the exchange controls and their final abolition in 1989 was going to make it even more plain.

III. The deregulation of the currency market

64 Ingvar Carlsson, 2003, *ibid,* p.227-228 and p.260

65 Ingvar Carlsson, 2003, *ibid,* p.221

The deregulation of the credit market, accompanied by the explosion of borrowing and the consumer boom, was completed, three years later, in April 1989, by a new measure of deregulation: this time of the currency market. A year after the deregulation of the credit market the first serious relaxation of the exchange controls took place in 1986. The complete dismantlement of the exchange controls would take place in 1989. Let us take a look at the exact sequence of this second deregulation.

At the time of the deregulation of the exchange market between the years 1986-89, a similar wave was already unfolding in the major Western countries- and in most of them had already been accomplished. According to a recent, very interesting IMF Working Paper, written by Atish Ghosh and Mahvash Qureshi and which contains a brief and very illuminating historical retrospective into the past of the capital and exchange controls, the USA had abandoned its outflow capital controls already by 1974 and in Britain, where a strict control on capital outflows was in force since 1949, the advent to power of the Conservative government of Margaret Thatcher in 1979 was accompanied by their abolition. Equally important, in continental Europe, the change of policy of the French socialists and president Mitterrand in 1983, known as the *tournant de la rigueur,* meant the abandoning of the expansionary reflationary policy in favour of the policy of *franc fort* and led during 1984-86 to the lift of the outflow controls. [66] And, on top of this, the European Community, after the adoption of the Single Market Act of 1987, was entering a new period of strengthened integration, where the free circulation of capitals was an essential part.

The event of the abolition of the capital controls in Sweden should be seen and understood against this international background. The way in which the *valutaregleringen* , the regulations of the currency controls, was carried out indicates that the social democratic government proceeded to this act after hesitations, contradictions and spectacular volte-faces- and all these only in just two years between 1986-1989: it was in this span of time, that the exchange controls were abolished. The reigning deregulation *Zeitgeist* seemed to have weighted heavily on the final and sudden decision to deregulate and the final justification was that Sweden had to adapt to the new rules, i.e. to the reality of the deregulated financial markets.

The regulation of the currency market in Sweden, equally a product of the war period, was considered for many years in Sweden as a necessary condition for an autonomous economic policy, but also as an obstacle to a currency speculation. And although the internationalization of the national economy, mentioned above, circumvented the existing regulatory framework, the view, however, that

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IMF. WP/16/25, *What's is a Name? That Which We Call Capital Controls,* by Atish R.Ghosh and Mahvash S. Qureshi, pp. 23-24 an abolition of the currency regulation would provoke turbulence and would annihilate the currency reserves of the Central Bank in the case of a currency speculation was deeply rooted in many Swedish economic circles. Paradoxically, these very same circles who were warning against the destabilizing effects of an abolition of the framework regulating the currency market, began to carry out, step by step, especially after the 1988 elections (which the SAP won for a third successive time), its total abolition .

Again the abolition was a gradual process and it culminated with a sudden – though not unexpected – final volte-face. For the governing social democrats the change of attitude began to occur after 1985, while up until that point the social democrats were declaring themselves to be strongly in favor of the maintenance of the exchange controls. They saw the fixed exchange rate as the most important task of the monetary policy and its preservation was made possible by the exchange controls. . In the Budget Statement of 1985/86 one can read the following assertion: " The defense of the exchange rate stands at the center of the monetary policy and the exchange controls exist in order to make this policy more easy."[67]

The first sign of a shift in the attitude is given only some time later in the supplementary budget statement. This time the assertion is made that "*some regulations may have been outdated or have a shape that inhibits competition.*"[68] The emphasis now shifts towards a supply-side policy, to the implementation of which the exchange controls function as a hindrance. In the same text it is pointed out that "*the liberalization should be directed towards those parts of the exchange controls which can be considered to be obstacles to the evolution of the industry."*[69]

Up until 1986 the social democratic government resisted the propositions in favor of the abolition of the exchange controls. In a debate in the Riksdag, the social democratic member of Parliament (and Professor of International Economics), Bo Södersten defended the maintenance of the exchange controls by pointing out that

" A complete freedom (from currency controls) could eliminate the currency reserves up to a size of 50 billion in a night"

Only a month later Feldt and his closest collaborator, Erik Åsbrink, as well as the Chairman of the Riksbank Bengt Dennis changed their minds. The Riksbank declared that it was in favor of a gradual

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67 Government Proposal 1985/86: 143, p. 4

68 Government proposal 1985/86: 150,p.1

69 Complementary Government Proposal 1985/86: 150, p.19

but decisive phasing-out of the currency regulations. The first decisive step in the direction towards the deregulation of the exchange controls is done in the supplementary Budget Statement of 1986 when the government announced that Swedish citizens will have the permission to buy foreign shares and real estate, thus opening the way, as Elmbrant observes, for the wild buy-ups by Swedish forms in London and Brussels already from 1986 on. Swedish firms which would wish to make direct investments abroad need not take loans there but only take capital with them. [70].

However, despite this first serious relaxation of the exchange controls, the government is not willing to completely abolish the exchange controls. Feldt pointed to the necessity of maintaining from the old regulatory framework certain crucial provisions in order to resist speculative attacks:

" We must be able to prevent short -term capital investments which they are directed by differences in the interest rates and expectations about changes in the interest rate and exchange rates"[71]

The social democratic government seemed to be in a self-contradictory position: most controls should be removed, but the core should remain, as Elmbrant characteristically observes. This self-contradictory position bears witness to the fear and the awareness on the part of the government that there was a danger for speculative attacks. It is not by chance that Södersten pointed out that

" Free movement of capital, especially if they are combined with fixed exchange rates, is a very dangerous way to go."[72]

Despite all these clearly expressed misgivings and concerns for possible destabilizing speculative capital outflows, the road towards the complete abolition of the whole system of exchange controls was opened after the 1988 elections. The decision is announced in the Government's 1988/89 Budget Statement. After expressing the view that the first liberalization measures (abolition of the demand for foreign lending for carrying out direct investments abroad, possibility for Swedish citizens to invest in foreign real estate and to buy foreign shares) decided in 1987 were satisfactory and encouraging and that *no serious turbulences took place* , the government points out the necessity to abolish the remaining exchange controls (prohibition for Swedish citizens to invest in interest-yielding assets and bank deposits abroad and similar prohibitions for foreigners to make such kind of investments in Sweden). It is interesting to see on what grounds the government justifies the necessity of totally abolishing what was remaining from the old system of exchange controls. In the

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70 Elmbrant, 1993 (2005), *Ibid,* pp.171-172

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72 Elmbrant, 2005 (1993). p.172

text of the proposal one can read the following line of argument:

" The motive for the exchange controls had been the effort to increase the room for a monetary policy which was directed towards domestic goals and to protect the Swedish economy from turbulences coming from abroad and, in this way, to be a supportive means for the stabilization policy. *The protracted use of the exchange controls, the ongoing internationalization of the industry and the introduction of new financial instruments make the remaining parts of the regulation system more and more ineffective."[* **The emphasis is ours**]

The government expresses further the view that the existence of the remaining exchange controls causes distortions with serious economic costs because of the unequal consequences of the functioning of the exchange controls on different kind of firms:

"The system of exchange controls gives rise to distortions that create economic costs. The Swedish industry has been in some respects hindered in their competition with foreign competitors, not least on the financial level. To this is added the fact that the regulation do not affect in the same way different kind of firms. Limitations on the international firms' room of action are relatively limited **while smaller and medium- size firms, especially those of them which are directed towards the domestic market, are influenced far more tangibly**."

And at the same time the ongoing internationalization process and the acceleration of the process leading to an integrated European market is mentioned again and the idea that *Sweden should follow this development is clearly stated* :

" The process of internationalization is going on with full force, not least in the financial sector. In the European Community the efforts to carry out the inner market in the beginning of the 1990s means that the exchange controls of the member- states are being abolished. *It would be unhappy if Sweden would be left behind from this developments."* [**The emphasis is ours.**]

The conclusion drawn from all those developments is self- evident: the remaining parts of the exchange controls should be abolished:

" Against this background the liberalization of the exchange controls should continue. The time is ripe for phasing out the remaining parts of the exchange controls. The legislation on matters of exchange controls would be retained only for emergency reasons." [73]

The threat for destabilizing speculative attacks, which Feldt himself had indentified in the Supplementary Budget Statement of 1985/86, does not seem to be taken any longer under serious consideration. Instead, the finance committee expressed the view that rather an inflow of currencies will take place. A supplementary argument now is that Sweden should adapt to the new regulations of the European Community. Klas Eklund, a famous economist and collaborator of Feldt advanced the argument that "*the abolition of exchange controls would cause the reduction of the interest rates, that not only no outflow of currency was going to happen, but, on the contrary, an inflow of*

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73 Governmental Proposal on the 1988/89 Budget : 100:1, p 23, 24

currency was far more probable." [74] Even in the text of the Governmental Statement on the 1988/89 Budget a very optimistic stance on the prospects of the Swedish economy is taken:

" At the same time the Swedish economy was strengthened considerably since the beginning of the 1980s. The budget deficit has been eliminated, the inflation was reduced and the deficit in the current account deficit is substantially lower. The part of the industry which is exposed to the competition, especially the export industry, is far more robust and profitable today. All this has led to the fact that the trust for the Swedish economy and the economic policy has increased substantially."[75]

The volte-face in the government's whole judgment of the possible economic consequences resulting from the abolition of the exchange controls is more than evident. Not only the danger for destabilizing capital outflows and speculative attacks on the Swedish currency is now conspicuously absent, but also the trust in the robustness of the Swedish economy is such, that the whole system of exchange regulations is deemed to be useless and unnecessary- if not a hindrance to the undreamt potentialities offered to the Swedish firms in the ongoing construction of the European Single Market.

What exactly happened, however, beginning in October 1990, when the first serious destabilizing capital outflows took place, is pointed out by Elmbrant in his narrative of the turbulent 1980s:

" We know that the interests rates did not decrease, but increased and stayed at high levels, that the fluctuations in the market had been violent, that the currency outflows now are far bigger than in the past[…] We know that the "natural" capital outflow in the years 1989 and 1990 touched almost Latin-American figures, a 7% of the GDP left the country." [76]

Equally important is the fact that with the abolition of the remaining exchange controls that a *decisive change in the balance of forces in favour of the capital owners had occurred*. If the abolition of the exchange controls is an essential part of the process of the internationalization, then this practically means that the capital can move freely over the frontiers and that the capital owners can invest their capital in those lands where there are the best chances for the highest profitability. The internationalization of capital is tantamount to a strengthened position of the capital owners in relation to both the labour force and to political decision- makers (government and parliament). Even for the Swedish Model, which was built on the presence of a strongly organized working class with

74 Elmbrant, 2005 (1993), p. 173

75 Governmental Proposal on the 1988/89 Budget, *ibid*, p.24

76 Elmbrant 2005, p.174

strong organic links with the strongest social democratic party of the world, this fact could not help not having serious consequences on the whole balance of forces between labour and capital. In fact the crisis of the Model from the mid-1970s on can be fairly accurately perceived as an effort of the one social class to bring about a shift in the balance of force to the detriment of the other – for reasons of dissatisfaction with the status quo and as a consequence of the worsened economic situation. With the abolition of the credit controls firstly and with the abolition of exchange controls as an ensuing step the capital owners of the Swedish big firms could feel that they had succeeded in bringing about the shift in the balance of power most wanted by them: free capital mobility inside and outside Sweden, which grant them the possibility to exert pressure on the LO and to push the government towards a far more business-friendly economic policy.

The abolition of the credit controls was undoubtedly a crucial change in the economic policy of the late 1980s. Despite the fact that the measure did not attract - surprisingly enough, according to Göte Hansson, professor of economics and writer of a report about the globalisation of the economy and its impact on the power structure - the attention of the public opinion, those who have carried it out were, as shown by their public statements cited above, fully aware of its serious consequences on the economic policy. The idea that with the abolition of the exchange controls the room for an independent monetary policy was significantly restricted had been clearly expressed not only by the trade union Confederations (the blue collar LO and the white collar TCO) but also by Feldt himself. What finally played the most crucial role in the decision to abolish the whole of the exchange controls seem to have been -again by looking at the public statements of those involved- the *necessity for Sweden to adapt to the new rules of the European Community,* which at that time was quickly moving towards the unification of its inner market, where the free movement of capital was an essential component. Strong winds of deregulation and liberalization were blowing all over the Western world and the Swedish social- democratic government proved incapable of resisting to them. The fact that Sweden is a small and export-oriented economy was undoubtedly a fact that weighed much on the decision to phase out the exchange controls. A further argument, naturally resulting from this fact, was that the deregulation was seen to be necessary in order to enable the Swedish firms to compete on equal terms with other competitors.[77] Very characteristically, a representative of the Swedish Industry Association, made the following remark already in 1985 in an article in the Swedish newspaper *Dagens Nyheter* : *The legislator has to make a choice: do we wish to have firms*

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77 Niklas Andersson, 2013, *The Abolition of the exchange controls, An Analysis of the Arguments and the Motives.* Master work submitted to the Department of Political Sciemce, Göteborg University,

which work on a level playing field with firms from our advanced competitor countries or do we wish to have firms which are obstructed by decisions not taken on the market but which are taken on the Brunkenberg Tour in Stockholm."[78]

As already said, with the abolition of the upper limits in the credit market the ideal conditions were created for the appearance of a credit bubble as a result of the reckless lending, and with the deregulation of the currency market the conditions were created for destabilizing currency turbulence. Sweden will experience both of these in a very painful way, creating in this way the conditions for the outbreak of a deep crisis in the period 1990- 1992 which was going to lead to important cut in a series of social benefits and to shake the foundations of the Swedish Welfare State. Before we look at the mechanism which triggered the burst of the bubble, it is worth examining in brief another important reform of this period, the " tax reform of the century" which was agreed upon by the social democrats and the Liberal Party and which marks a further break with the traditional Swedish Model.

IV. The "Tax Reform of the Century" 1980-1991

The majority of the observers and students of the Swedish economic policy in the late 1980s agree that, if there is a reform signaling more than any other the divergence of the social democratic policy of the 1980s from the logic underpinning the traditional Model, this reform is the tax reform announced at a public conference in November 1988, at which the leadership of the social democratic government announced the general outline of the new tax system. On the "tax reform of the century" John Stephens makes the following remark in his very informative and insightful article about the evolution of the Swedish Welfare State:

"The 1989-90 "tax reform of the century" in which the Social Democratic government in cooperation with the Liberals *reduced the rates of marginal taxation to 50 per cent for those in higher income brackets*. [**Our emphasis**] This implied less redistribution, and an acceptance that high marginal taxation reduces incentives to save and work."[79]

The Social democratic government set up in 1987 two committees to investigate the tax system. The first committee was about a reform of revenue (income or indirect taxes?] tax and the second one

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78 Lars Nasbeth, Dagens Nyheter Debat, 19-11-1985 cited by Niklas Andersson, 2013

79 John Stephens (1996), *The Scandinavian Welfare States: Achievements, Crisis and Prospects* στο Gösta Esping-Andersen, *Welfare States in Transition*, London Thousand Oaks California Sage, p 44 and footnote 14

about the reform of the corporate tax. It is very characteristic that the Chairman of both committees was Erik Åsbrink, who only a year later played a crucial role in the decision to deregulate the credit market. In fact, his role to the sketching and the implementation of the tax reform was going to be equally crucial.

It is interesting to see in detail what kind of changes with respect to the old tax system the tax reform introduced. The main proposition of the investigators was a big reduction of the tax rates together with measures to reduce loopholes in the tax system. The progressivity of the old tax system was indeed very high: the higher the incomes were, the bigger was the part of the income which was going to be paid as a tax.[80] The marginal tax rate for an income of more than 190 000 kronor was up to 1989 72%. Accordingly in the old, highly progressive tax system there were many tax scales (tax layers, *skattskikt* in Swedish) – fourteen in the beginnin of the 1980s. After the full development of the tax reform in 1991 there should be only two tax scales (layers) . Incomes lower than 180 00 kronor were charged only with municipal tax, 30% approximately, and moreover with state income tax with a fixed amount at 100 kronor. In this way, the marginal taxes would be no more than 50 per cent. For incomes between 58 000 and 90 000 kronor the basic tax deduction was raised, something which brought about a reduction of the marginal tax in this income scale down to 22,5%. [81]. These measures were tantamount to a strong reduction of the progressivity of the tax system.

At the same time the tax rates were reduced, the tax base was broadened. A series of benefits which up until then were tax-free (car benefit, house benefit etc) were in the new system charged with tax. In this way it was hoped that loopholes in the tax system were going to be covered. Apart from it, the tax base was broadened by raising the VAT on energy, hotels, food and restaurants. Subsidies to housing and to food were at the same time reduced. [82]

What is more: the kind of revenues were reduced to three: incomes from services, capital and industry activities. The tax rate for incomes from capital was reduced to a flat rate of 30 per cent independently of size (earlier there were many separate tax rates for different kinds of income).

The social democratic government justified the necessity to carry out a fundamental revision and

80 Finansdepartmentet, 1990, *Århundratets skattereform – en populär sammafattning [* Ministry of Finance, 1990, The Tax Reform of the Century- a Popular synopsis], p.19

81 Finansdepartementet, 1990:20

82 Stig Hadenius, 2000, *Svensk politik under 1990-talet, [Swedish Politics in the 20th Century]* , Stockhol, Hjalmarsson och Högber,

reform of the old tax system by pointing out that the old system's lack of uniformity permitted extensive tax avoidance. As a consequence, there was a contradiction between the formal progressivity of the old system and the real progressivity. Finance Minister Feldt underlines, in particular, the fact that there were many dysfunctions in the old system because of the existence of loopholes, which were exploited more and more. He writes also that "*our tax system was both reducing the supply of work and was keeping low savings and productive investments.*.[83] Carlsson attributes the high inflation to the high progressivity of the tax system, which was pushing the wage levels upwards." [84]On the other hand, an additional aspect was pointed out: concerning the taxation of the housing, the full tax deductions for interest expenses represented a very significant subsidyJohn Stephens, commenting further on the philosophy of the tax reform and how it was perceived by the broader public opinion, makes the following remark:

"Along with lowering marginal tax rates, the reform eliminated many deductions and thus tax loopholes and child allowances were increased at the same time. An independent simulation study (Schwarz and Gustafson, 1991) confirmed government simulations that the reform was distributionally neutral. *The public perception, though, particularly among the Social Democrats' supporters, was different*.[85] (**The emphasis is ours**)

The government was, however, fully conscious of the fact that the proposed reform of the tax system was deviating from the traditional redistributive philosophy of the social democratic policy of the post- war periods and that the attempt at reform was a political undertaking full of risks: the possibility that the reform project would strongly dissatisfy the blue-collar working class base of the party and would lead to loss of electoral support was thought to be strong from the very beginning and Feldt in his *Memoirs* expresses his surprise that the reform was possible to be carried out[86]. Ingvar Carlsson writes in his Memoirs that "*the proposition was meaning that we would break with the principles which for decades were in force for taxation.*[…] *After the first meeting with Feldt, we*

83 Kjell-OLof Feldt, 1991, *ibid*, p.382.

84 Ingvar Carlsson och Anne-Marie Lindgren, 1996, *Vad är socialdemokrati- en bok om socialdemokrati*, Stockholm: Socialdemokraterna, p.251

85 John Stephens (1996), *The Scandinavian Welfare States: Achievements, Crisis and Prospects* στο Gösta Esping-Andersen, *Welfare States in Transition*, London Thousand Oaks California Sage, p 44 and footnote 14.

86 Kjell- Olof Feldt, 1991, *ibid,* p.442.

reached the conclusion that we had before us a politically high-risk project." [87]

It was for this reason that the party leadership tried to gain the consent and the support of the LO and of its Chairman Stig Malm to the proposed tax reform. The LO Chairman was present at the sensational press conference in November 1988 at which the general orientation of the new tax system was presented to the public opinion. He even declared the old tax system to be " rotten"[88]. However, during the process of the investigation and while the more concrete content of the tax reform was being determined, the LO chairman was getting more and more dissatisfied with the final provisions of the tax reform. Not only did the LO was practically excluded by the investigation procedure (which determined the orientation of the tax reform under the direction of Erik Åsbrink) and strongly irritated by the co-operation with the Liberal Party during the preparation of the reform. Even the final draft of the reform was far from satisfying for the LO- despite some concessions and compromises obtained by the LO.

In fact the LO had some serious reasons to be dissatisfied with the final outcome Elmbrant points out what has changed with the abolition of the old tax system:

"They declared dead the old, particularly progressive tax system with the generous tax allowances, which were one of the preconditions for financing the Welfare policy in the post-war period, but also for giving to the wage-earners and to the lower white collar workers an opportunity of living in a villa." [89]

And referring to the impressions created among the common people by the announcement of the new tax system he observes:

"While the right-wing press was praising Feld and Malm for their unanimous stance on the tax reform, under the surface the rage was boiling in Sweden."[90]

And judging the results of the tax reform he draws the following conclusion:

" Today we can see that the tax reform did not exactly fulfill its stated purposes. A part of the quickly increasing budget deficit – a deficit which was advanced as an argument in favor of cuts in the system of welfare- was due to the fact that the tax reform did not yield the revenues it had promised.

[….] Some more independent observers support that the state lost almost 40 billion per year as a consequence of the tax

87 Ingvar Carlsson, 2003, *ibid*, p. 250.

88 Jan Elmbrabt, 1993 [2005], *ibid,* p.186

89 Elmbrant 2005, *ibid,* p.186

90 Elmbrant 2005, *ibid,*p.187

reform. One can not rule-out that the losses were even bigger than the official estimates state. There is no doubt, in any case, that the tax reform was underfinanced." [91]

The LO Chairman Stig Malm went as far as to say that *a great part of today's [i.e 1993] budget deficit, which the Swedish people is obliged to pay for in form of cuts in the various transfer systems, is an effect of the fact that the tax reform was under- financed.*"[92]

And referring to the expectation of the architects of the tax reform for "dynamic effects" amounting to 5 billion, Elmbrant points out:

" The agreement between the social democrats and the liberal Folkpartiet had an entry in the form of "dynamic effects" of 5 billion. So much did they think that the state's revenues would increase as a consequence of the fact that the tax reform would make us work more. [..] The belief was confused with knowledge, when the tax experts from the different parties in Sweden would precise the very central question for every tax system, that is, which incomes one could collect. Most of the actors were showing wishful thinking, in exactly the same way in which many other of the great systemic changes at the end of the 1980s and the beginning of the 1990s were decided." [93]

The new social democratic government of Göran Persson undertook in 1997 an effort to assess the implementation of the tax reform of1990/1991 and its results. With respect to the " dynamic effects" even the government's own assessment is extremely cautious and reserved in the formulation of its conclusions. In the paragraph treating the "dynamic effects" it is pointed out that " the tax reform may have increased the total size of the desired working hours at an amount of two-three per cent. The crisis in the beginning of the 1990s meant probably in the most cases that this increase has not happened before much later. Results from a couple of studies indicate, nevertheless, that a part of the increase in the desired working hours *may have been realized.* [the emphasis is ours]. […] And as a conclusion the government inquiry concludes by remarking that "*relatively limited increases in the number of the working hours contributes to reduce the under-financing which the KUSK [the Committee for the Assessment of the Tax Reform of 1995] was able to establish."* [94]

The rather cautious formulations in the government's own assessment is perhaps an indication that the much promised "dynamic effects" were not so high as it was initially assumed by the initiators of

91 Elmbrant 2005, *ibid*, p.201

92 Stig Malm, 1993, *13 år*, Stockhol, Brevskola, p.151

93 Elmbrant 2005, pp201-202

94 Propostion 1997/98/: 1 Bilaga 6, *1990-91 års skattereform- en värdering* [Governmental Proposition 1997/98:1 Appendix, The Tax Reform of 1990/91- An Assessment] , p. 20

the tax reform.

Apart from the exact size of the "dynamic effects" and from the issue whether the estimates of the initiators were realistic or wishful thinking, there is no doubt that the Tax Reform was implemented at the false point of time and too late in relation to the consumption-led and loan-financed boom in the end of the 1980s. As already noticed in the section about the abolition of the credit controls, if the tax reform had been implemented *before* the deregulation of the credit market, it might have dampened the loan-financed boom and possibly limit the ensuing bubble in the real estate prices thanks to the abolition of the generous and extensive tax deductions of the old tax system. When the new tax reform was introduced, the bubble had already burst and the economy was sunk into recession. The value of the household assets had been dramatically reduced and the changed rules on tax deductions combined with the increases in interest rates to which the households were subjected contributed to a worsening of the recession." The timing of the implementation of the tax reform, of the bursting of the bubble and of the drastic fall in the inflation rate were indeed disastrous: in September 1990 burst the bubble (bankruptcy of the finance institute *Nyckel*) but nothing was indicating thus far that major banks were so much implicated in the real-estate lending. First, after the Summer 1991 when Gota banken and Nordbanken were shown to have considerable credit losses, the interest rates in Europe were raised and the inflation rate in Sweden begins to fall , the fall in the value begins to have a snowball effect. To all this was added the drastic curtailed tax deductions leading to the unprecedented real interest rate shock, which brought about the explosion of the savings rates of the households and the collapse of the demand. In the recessionary economic environment of 1991 the full implementation of the tax reform with the curtailment of the possibilities for tax-deductions reinforced the propensity of the households to save , drained further the demand and strengthened the recession. In this sense, one can say that the timing of the implementation of the tax reform was particularly unhappy: it did not prevent the loan-driven consumer and real estate boom and it came about in a recessionary post-bubble economy, where it contributed to the further collapse of the already shrunk demand.

From all the above one can draw the conclusion that the tax reform which the social democratic government had agreed upon with the liberals constituted an important deviation from the tax system of the past decades, which was characterized by marked progressivity and had been an important source of financing the policy of expanding the Welfare State. Clearly, the tax reform was a further step away from the progressive distributive philosophy of the previous tax system. Implemented at a time when the economy was experiencing the recession caused by the burst of the bubble, the tax reform contributed in the period 1991-93 to the reinforcement of the recessionary tendencies

Added to the effects of the other basic choices and measures implemented during the implementation of the policy of the "Third Road"- i.e the 16% devaluation, the deregulation of the credit and the currency market – the effects of the tax reform significantly contributed to narrow the room for an active social democratic fiscal policy based on progressive taxation as the means for financing the welfare services. One gets the impression that all those crucial policy choices, amounting, as Elmbrant observes, to a "systemic change", were strengthening the existing constraints or creating new ones, which precluded any possibility for a classic social democratic redistributive policy. Far from alleviating the pressure on the Welfare State the effects of the policy of the Third Way were in fact intensifying the pressure and preparing the ground for cuts and austerity measures as the only way out of the stalemate caused by the basic strategic choices of the economic and fiscal policy of the Third Way. In fact, the situation was even worse: the cumulative effects of the deregulation of the credit and currency markets were overheating the economy and creating a bubble in the real estate and assets markets. It was only a matter of time when this bubble would burst. And the time arrived in the autumn of 1990 signaling the start of a protracted crisis which in 1992 was going to assume explosive forms. The long-term effects of the policy of the Third Road were going to be tremendously destabilizing.

B) The short term effects of the Policy of the Third Way

I) The overheating of the economy, the current account imbalance and the austerity package of February – April 1990

As already noted in the previous sections the devaluation of the Swedish krona offered the internationalized Swedish companies an excess of liquidity, which was channeled by them to investment activities abroad- most of them buyouts of competitors and investments in real estate firstly in Sweden and then abroad- after the gradual relaxation in 1987 of the exchange rates controls. In this process these investment activities were considerably made easier by the first serious liberalization of the exchange controls decided in 1986. On the other hand, the members of the LO were exhorted to display wage moderation-which they did, but more and more reluctantly, to the extent to which it became clear that the devaluation happened at the cost of the wage-earners and amounted to a distribution of wealth from the working class to the capital . From the mid-1980s the wage earners began to demand and to achieve significant wage increases. On the other hand, the deregulation of the credit market provoked a reckless lending and a consumer boom based on borrowing. The combined effects of the excess liquidity, of the speculative activity of the Swedish companies at home and abroad and of the consumption and construction boom fueled by the deregulation of the credit market was to overheat the domestic economy and to worsen the current account of Sweden, especially when the wages began to explode mainly in the private sector. The first official estimates that the current account was going to worsen were announced in the autumn 1989. It was evident, remarks Elmbrant, that the wage increases in Sweden were far surpassing those of its most important trade partners. [95]

The worsened current account is used to be remedied by austerity measures. However, in the case of Sweden this worsening, as Elmbrant points out, was due to the fact the interest payments of the Swedish companies on loans taken abroad began to be statistically registered. And " *this problem cannot be solved with traditional austerity measures.*"[96]

This complicated situation, further compounded by rumors about a new devaluation, caused particular embarrassment to Feldt. For the past eight years Feldt succeeded in passing through the parliament and the government the main policy choices he deemed necessary and inevitable. Now he seemed to be powerless in front of the effects of his own policy choices, since the liberalization policy he implemented disarmed the finance ministry from the most important arsenal at its disposal for controlling the economic conjuncture. He was unable to use the interest rates and the credit reduction as stabilizing measures. Further tax increases were excluded, since a new tax reform had been already agreed upon and was due to be carried out in 1990 and 1991.

At the beginning of December 1989, when the new figures about the incomes and the expenditures of the budget became known, Feldt complained to Ingvar Carlsson that "*the situation was going to hell and the fiscal policy was too weak"*. Asked by an obviously irritated and surprised Carlsson what he was proposing, Feldt answered that he proposed that the election promises on holidays and the further development of the parental leave insurance should be taken back, a proposal which was rejected by Carlsson as being both inefficient and unrealistic. He subsequently rejected any proposal for further austerity measures which would necessitate changes in the draft budget[97].

Feldt wanted to take austerity measures but was unable to find what exactly these measures were going to be. In the next days, the government alarmed by the deadlock in the collective negotiations tried to get the organizations of the employers and the LO to agree on a stabilization agreement for

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95 Elmbrant 2005, *ibid,* p.212

96 Elmbrant 2005, *ibid,* p213

97 Elmbrant 2005, *ibid,* p214

the years 1990-1991. Whereas the LO was showing interest for such an agreement, the organization of the employers SAF blatantly rejected, at the outset, any central agreement by emphasizing that the wage formation should take place at the factory level. However, only few days later the president of the SAF came back with another surprising proposal: a legislated wage freeze. In exchange, SAF would accept a price freeze and a stop to the distribution of stock options. In fact, the SAF had taken stock of the fact that the government was far more attentive to their demands than to those of the LO.

On February 8 1990, the government, announced the final austerity package containing wage and price freeze, a municipal tax stop for 1991 and, most shockingly, a strike ban, reversing, as Elmbrant remarks, its commitment to non- interference in collective bargaining[98] Most of the demands of the SAF were satisfied to such an extent that Elmbrant speaks of a "jackpot for the SAF". Among the trade union members, on the contrary, the content of the austerity package provoked a wave of fierce protests, since the provisions on strike ban was perceived as a severe curtailment of the trade-union rights. The anger was particularly widespread among the members of the municipal workers' union, whose wage negotiations at that time were going on. The disappointment was so strong that in the following days and months thousands of municipal workers left, in protest against the provisions of the austerity package, the social democratic party[99].

The strike ban was, undoubtedly, the most provocative provision contained in the package presented by the Carlsson government. Apart from the strike ban during the wage-freeze period, a strong increase in the penalties for illegal strikes was proposed. The government, in fact, was signaling that it could not count on the ability of the social partners to carry out a productive wage bargaining process. In Elmbrant's opinion, such a declared suspicion about the ability of the two social partners no government so openly had showed since the Saltsjöbaden Agreement in 1938 . The whole event was a clear indication that the traditional Swedish Model based on the non-interference of government in the wage bargaining was in a process of being questioned in at least one important respect.

The whole atmosphere had been poisoned and the final vote in the Riksdag on the austerity package produced a political earthquake: with 190 votes against and only 153 in favor the package was rejected thus leading to the fall of the Carlsson government. A drastic austerity package which was concocted after hesitations and embarrassment in view of serious current and capital account

98 Elmbrant 2005, *ibid,* p.216, John Stephens 1997, *ibid* p.45

99 Elmbrant 2005, *ibid*, p.217

problems caused by the reckless borrowing of the Swedish firms abroad and loss of competitiveness because of wage increases was the latest effect of the policy of the Third Road. After having been successful in the short and medium run in reducing the budget deficit and in postponing the most pressing structural strains by securing considerable liquidity for the big Swedish companies, the Policy of the Third Way resulted in a deadlock- and in the fall of the government. Not surprisingly, the chief architect of this policy, the finance minister Kjell-Olof Feldt, who during the last six months preceding the austerity package had reached the point of total exhaustion, -according the evidence of Ingvar Carlsson in his Memoirs- announced the day after the vote in the Riksdag his resignation from the post of finance minister- and he was replaced by Alan Larsson.

That the government of Ingvar Carlsson was reconstituted three months later (in April 1990) and with the support of the Liberal party of Bengt Westerberg succeeded in pushing through a new revised austerity package (albeit with the most provocative provisions on strike ban and on penalties for illegal strike action removed) and thus terminate the governmental instability could not conceal the fact that the price – both political and social - of the new austerity package (which, it should be reminded was concocted as a ‘way out” from the stalemate to which the policy of the Third Road had led) was exorbitant. The new, “moderate”, austerity package reduced the replacement rate for sick pay from 90 per cent to 65 per cent for the first three days and to 80 per cent for days 4 to 90[100]. During the negotiations with Westerberg and Anne Wibble from the Liberal party the following *quid-pro –quo* was agreed: the social democrats accepted higher personal charges for the unemployment funds, an unemployment period in sick pay with full compensation, reformed insurance for work injury and a municipal tax freeze for two years , while the liberals accepted an increase in the value-added tax. The Liberal party, Elmbrant points out, succeeded in pushing through what Feldt did not succeed half a year ago: the postponement of the electoral pledge of the social democrats to extend the parental insurance. Apart from the breaking on the electoral pledge to extend the parental insurance, the most important (according to Elmbrant) system-changing provision contained in the new austerity package was the municipal tax freeze, which at the time had escaped the public attention:

“ Such a freeze had been rejected by the social democrats during the consultation talks on the tax system and it had not been considered before the great tax reform. From 1991 on , when the tax freeze was enacted, the local governments were under greater pressure for changes.”

Various municipalities were in a procedure of revising their organization. But, when the tax freeze was prolonged this led,

100 John Stephens 1997, *ibid*, p. 45

after some time, to a drastic reduction of the municipal employment. In 1993, with three years of municipal tax freeze, 80 000 jobs are expected to vanish in the municipalities . This happens in a labour market, where the situation has never been so troublesome since the 1920s and 1930s."[101]

The afternoon of the day when the new, revised (and purportedly, moderate) austerity package was presented to the social democratic Riksdag group, the meeting was stormy and the package was accepted with the greatest reluctance. Anna- Greta Leijon - a prominent left-wing social democrat and member of the parliamentary finance committee, refused to be present. She would leave the Riksdag later as an act protest against the fact that the extension of the parental insurance was sent *ad calendas grecas*, but also because she felt generally betrayed. Very characteristically, Elmbrant makes the following comment on the fatal dilemma faced by Ingvar Carlsson in those days of the negotiations for the painful package:

"When Ingvar Carlsson became again Prime Minister and continued to govern after the February crisis in 1990, he made also a choice. This can be described as a choice between leaving the power and keep his soul *or* keeping the power but in exchange being obliged to sell out a part of the old precious family objects."[102]

In our opinion the very vivid description by Elmbrant of the dilemma faced by Carlsson can be considered to be in fact the dilemma faced by the Social democracy now that the long-term consequences of the Policy of the Third Way became apparent and inescapable. The dilemma for the actual leadership of the Swedish social democratic party could be best expressed in this way: *leave the power and remain loyal to traditional social democratic beliefs (such as the non- intervention in the wage bargaining, the financial viability of the municipal sector as a means for full employment and high quality social services, the loyalty to essential electoral pledges) or hold on to the power (trying at the same time to "manage" in a "social democratic" way an un-social-democratic austerity package) and abandon the previously mentioned central and cardinal social democratic values underpinning the traditional Swedish Model?* It was a very painful dilemma indeed but the following intriguing question arises: *Did the social democratic party do its best to avoid the emergence of such a painful existential dilemma?* Since the answer to this question is very important and cannot be given light-heartedly, we shall abstain, at this particular point, from giving a final answer, and we shall go one with the other, equally serious side effect of the Third way economic policy: the *burst of the bubble in the credit market*

II. The bursting of the credit bubble and the beginning of the financial crisis

101 Jan Elmbrant 2005, *ibid,* p.228

102 Jan Elmbrant, *ibid*, p.226

By all accounts, the deregulation of the credit market and the destabilizing effects it gave rise to was the most important policy change of the turbulent 1980s. Among the crucial policy decision taken during the social democratic rule in Sweden it was this particular one which absolutely deserves the name " system- changing" measure. When the decision was taken, under circumstances which remain even today obscure and with the two main decision makers, President of the Riksbank Bengt Dennis and finance minister Kjell- Olof Feldt, blaming each other for having failed to foresee and warn about the consequences of this major policy change, the increase of lending by banks, financial institutions and real- estate institutes and the ensuing loan-fueled consumption and real estate and asset speculation took explosive forms which defied the public perception in Sweden. Even Ingvar Carlsson in his memoirs describes the explosion of lending in the most emphatic way and does not shy away from giving concrete figures about the size and the extend of the "financial galas" resulting from the époque making decision to deregulate the credit market:

" In combination with improved real incomes, increasing fortunes and optimistic expectations about the future the deregulation resulted in a strong credit expansion. The net lending from banks, financial firms and real estate institutes to households is estimated to have increased with more than 160 billion kronor during the years 1986-1988." [103]

For Carlsson the tectonic change of the credit market deregulation was going to be particularly important. Not only because it undermined the efforts of his government to cool down the economy and to avert an overheating –which, by the way, was achieved at the cost of unprecedented cuts and austerity measures unseen since the 1960s –but also because the practical consequences of the deregulation were going to oblige his government to take back its basic 1988 electoral promises: the expansion of the parental leave insurance, thus annihilating his government's political credibility and delegitimizing the mandate he won in the 1988 election- the first elections he won as new social democratic party leader after the assassination of Olof Palme (at the last months of whose rule, namely in November 1985, the decision of the deregulation was taken).

In one and a half years after the reelection of the new social democratic government in the 1988 elections (with a slightly reduced percentage, 43,2%), the bubble burst and the whole event was triggered by the bankruptcy in September 1990 of the financial firm *Nyckel* which had registered huge capital losses in loans to real estate Swedish companies.

The bankruptcy of this financial firm sew doubts about the solvency of three more financial

103 Ingvar Carlsson 2003, *Så tänkte jag. Politik och dramatic,* [So I thought. Politics and the dramatic art], Hjalmarson & Högberg Bokförlag, p. 257-258

companies- and from there the growing sense of insecurity and doubt was spread to the real estate institutes, which were recording in the previous period huge profits on the basis of the assumption that the real estate values would continue their upward trend. When, finally, the returns of the real estate proved to be insufficient for paying back interests and principal on loans and it became evident that the real estate values could fall, the problems of the real estate institutes was worsened and a domino of bankruptcies was set in motion which was spread from the real estate companies to the financial firms – with the banks following suit:

" First was hit the Nordbanken by huge credit losses, and then followed the Första Sparbanken, the Östgota Enskilda Banken, the Gota, Föreningsbanken and, finally, much to the general surprise, the Skandinaviska Enskilda Banken."[104]

Of course, the bankruptcy of the *Nyckel*, although sensational and spectacular, by Swedish standards, was going to be only the first incident of a long and protracted financial crisis which almost shipwrecked the banking system and brought the Swedish Model to its most dramatic crisis. At the time no one, according to Elmbrand, could imagine or realize what extent the disaster would assume. The general perception then was that it was about some special cases which ended up there and after that everything was going to be good again. "*Only few knew how intertwined the business between banks and financial firms were.* "[105]

The conditions leading to the creation of the bubble in the credit market and the total incapacity to predict it, let alone take measures to avert the disaster, was a case –study of systemic blindness – and systemic failure. After having justified the deregulation on the totally absurd assumption that *" on the aftermath of a deregulation the financial firms would lose terrain and afterwards disappear*, those responsible for this époque-making change of the monetary policy failed dramatically to assess previous international experiences which clearly showed that the deregulation of the credit market provoked a strong increase of the lending volume. "*Sweden did not want this way, but the credit market formally exploded."* points out Elmbrant. And very sarcastically he concludes:

" It was not necessary to have a röntgen sight to be able to see that the increase in the lending volume was attributable mainly to the real estate companies. Among other, foreign real estate of 100 billion were bought in few years *That the real estate companies were building their activities on huge borrowing*, and that this, on its turn, rested on the assumption of upward real estate values did not dawn upon the government, the Riksbank and the bank inspection because of lack of

104 Embrant 2005, *ibid,* pp237-238

105 Elmbrant 2005, *ibid*, p.238

awareness."[106]

But in this general atmosphere of self- imposed blindness there were some economists who very clearly saw the dangers of the reckless credit expansion- and warned that the deregulation was leading to an uncontrollable loan- financed consumption : the chief economists of the LO. They were ignored- despite the fact that the economists of the LO were, historically, held in general high esteem: let us not forget the essential role of the LO economists in drafting the theoretical framework of the active labour market policy of the 1950s, which secured full employment and low inflation. Unfortunately for them, the Zeitgeist in the 1980s, even in the social democratic Sweden, had been dramatically altered in favor of those who had espoused the belief that there was no alternative to the presumed self-regulating financial markets.

III. The currency crisis in October 1990 and the new crisis package

In the section dedicated to the abolition of the exchange controls we pointed out that the social democratic government proceeded to the total liberalization of the exchange controls by emphasizing, among other things, the strength of the Swedish economy, which made more and more improbable the danger of destabilizing capital outflows and speculative attacks on the Swedish krona. In fact, some advisors of Kjell- Olof Feldt went, at the time of the total liberalization of the exchange controls, as far as to support that contrary to the (earlier by the very same government) professed fears, capital inflows in Sweden were far more probable to occur than capital flights. The things were going to refute those optimistic predictions. Even after the reconstitution of the Carlsson government and the revised crisis package with the support of the Liberal Folkpartiet in April 1990 the political situation remained precarious and the government was more and more strained in its effort to handle the difficult economic situation. When the huge bubble burst in September 1990, the situation began to get out of control: extensive capital outflows began to take place in October 1990 provoking the response of the Riksbank with successive increase of its overnight interest rate between 12 and 18 October. On October 12th the Riksbank raised short-term interest rates by 2 per cent, and by another 3 per cent six days later. On October 18 the Riksbank raised its leading rate up to 17%. The same day the government was forced to announce yet another crisis package, and the cabinet spent the following week composing it."[107] Carlsson and his new finance minister Allan Larsson decided to submit on October 21th a five- point official letter with proposed measures

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106 Elmbrant 2005., *ibid*, p.239

107 Aylott, 1999, *ibid*, p.126

aiming at calming down the turbulences in the currency market. The official letter addressed to the Swedish parliament was going to be one of the most important in the modern political history of Sweden, not so much because of the new cuts amounting 15 billion kronor, but because of a paragraph stating for the first time officially and publicly the intention of the Swedish government to apply for Sweden's entry into the European Community. According to the exact formulation of this paragraph, the Swedish government expressed its intention "*to strive for a new decision of the Riksdag on European policy which in a more clear way and in more positive words makes clear Sweden's ambition to become member of the EC.*" [108]. The fact that the Swedish government up until the summer 1990 was refusing that it was considering seriously the possibility to join the EU. In an article in the influential Swedish liberal newspaper *Dagens Nyheter* under the title " *EG medlemskap omöjliggörs* " (the EC membership made impossible ") in April 1990 Carlsson insisted that neutrality was still indispensable for Sweden[109]. Now in the midst of the first serious capital flight after the abolition of the exchange controls and after the burst of the bubble the Swedish government made an impressive and sensational volte- face, which – and this is even more important and remarkable- is contained in an official letter aiming at coping with the then ongoing financial turbulence and at calming down the markets. Inevitably the impression arose that this volte- face on the question of Sweden's entry in the European Community was by no means *accidental and that it was included in the official letter exactly in order to calm down the currency markets and as a further measure, among the other emergency measures taken in the direction of reversing the previous social democratic policy.* Carlsson may in his Memoirs of 2003 refute the argument the change of attitude was dictated by the financial crisis and emphatically assert that the decision was taken as a part of a process, which was taking place during many years, and that he has made many statements, some months before the controversial official letter of October 26, which were showing a more positive attitude towards the entry into the EC, he does not sound, however, very convincing. Since we cannot in the framework of this work go into details about the controversial issue of Sweden's decision to apply for entry in the EC, we shall abstain from further comment on this issue. Turning our attention to the other emergency measures contained in the official letter to the Riksdag, it is interesting to point out the government's own conclusions and arguments about the ongoing financial turmoil and

108 Official Letter of the Government 1990/91: 50 on measures aiming at stabilizing the economy and reducer the growth of public expenditures

109 Cited by Nicholas Aylott in: Aylott, (1999) *Swedish Social Democracy and European Integration. The People's home on the Market.* Ashgate, Aldershot. , p.117

the necessity of the measures proposed in the document.

Already in the introduction to the document the government immediately states that the spiral of prices and wage costs of the Swedish economy has to be broken and that the struggle against inflation had to be put above any other ambition and demand. Only two paragraphs further below the government points out that during the autumn an extensive outflow of Swedish currency had taken place and as a consequence of the turmoil which was reigning on the currency markets the interest rates in Sweden had risen and the interest rate spread with foreign countries had increased. This worrying situation brings about a drastic reduction of investment and threatens the full employment and the well- being of the country.

Against this background the government declares its decision to present a comprehensive program containing measures aiming at stabilizing the economy, improving its functioning and reducing the growth of the public expenditure[110].

It is highly revealing that the government attributes the high inflation solely and exclusively to cost increases brought about by wage increases and avoids the slightest reference to the speculation and the bubble caused by the deregulation of the credit market and any reference to the inflation bias caused by the speculative frenzy caused by the abolition of the credit controls. It points out the fact that the Swedish wage formation system did not function well in the last years and it makes reference to institutional arrangement on the labour market which played a role in the unsatisfactory functioning of the wage formation system. Explicit mentions are made to the insufficient competition in the Swedish economy – especially in the food provisions sector.

The measures proposed by the government in order to curb the inflationary spiral fall into four main categories: 1) A reduction of public expenditures (with particular emphasis on wage and price formation and with the stated goal to achieve an inflation lower than the 4%, 2) The European policy- (the most sensational measure and the one which attracted most the Swedish public opinion)- , 3) a framework for a new industrial policy (with emphasis on infrastructure, energy, education and food provision policy), and 4) measures aiming at reducing the expenditure in the public sector (the emphasis is put on the reform and on a 10% reduction of the public administration, a reform of the health insurance with a reduction of the replacement rates in case of illness to 75% for the first two days and to a maximum of 90 per cent for the next days- with the employers paying 10 per cent of it, a coordination of the health insurance with the insurance against injury at work aiming at accelerating the rehabilitation and the return to working activity, on measures for a more effective health care

110 Official Letter of the Government 1990/91: 50, p. 2

system and health insurance system and on measures on the system of the education and of the child care system with the municipalities becoming the sole employer and provider of the education and child care services)

The whole of the measures amounted, according the government, to a sum of cuts of around 15 billion kronors. But far more than the exact size of the total sum what matters more is that the October package was the first crisis package which was dictated by turbulence on the capital market and by destabilizing capital flights. The abolition of the exchange controls not only was not accompanied by capital inflows but on the contrary, under the new economic conditions reigning in the economy after the burst of the bubble in the real estate sector and the eruption of the financial crisis, the first massive capital flight had hit Sweden hard. Whether – and to what extent- the exchange controls would have averted or kept within limits the currency turbulence, had they not been totally abolished in 1989, is a highly hypothetical question, but we think that Nicholas Aylott has a point when he remarks about the crisis that

"“Finally, there seems little doubt that the abolition of controls on capital movements in 1989 was crucial, if only in amplifying the effects of deeper- seated problems [in the Swedish economy]. It seems that controls were being increasingly circumvented anyway, but the liberalization greatly expanded the scope for Swedish firms to exploit a new option, that of “exit”. If they did not like the economic climate in Sweden they could freely relocate abroad- which, judging by the immediate outflow of capital , they did,”[111]

In the after- the -bubble economic reality the Swedish government found itself confronted with an unprecedented capital flight and no defensive instruments were at hand in order to cope with the currency turbulence. Inevitably, the government responded to it by presenting a second crisis package -only a few months after the first one in April- containing further restrictive measures, cuts and commitments to a change of policy in a much more business- friendly way and in accordance with the wishes of the deregulated and uncontrollable financial markets. The policy of the Third Way had ended in a deadlock and the deregulated credit and currency markets, worsened the instability, thus pushing the government to announce crisis packages and cuts which were weakening and undermining the existing welfare provisions of the Swedish Model. Clearly, Sweden had entered a new phase of its modern economic history: an era where the liberalized markets were able to demand from the social democratic government cuts and further tightening of the fiscal policy as the sole means of their appeasement. The social democrats may have deregulated the credit market as a consequence of their effort to find new ways for financing the growing budget deficit and in order to maintain a high public spending and preserve the full employment , as Torsten Svensson has pointed

111 Nicholas Aylott, 1999, *ibid*. p. 108

out in his 1996 report about the deregulation of the credit market, but in the long run the deregulated markets would inevitably be in a sovereign position to dictate even the appropriate size of the public expenditure and to signal their disapproval, if they deemed their size "inappropriate" or "exuberant". Is it accidental that the Swedish government included in the October package the pledge to apply for entry in the European Community? Wasn't even this pledge meant as a further gesture addressed to the markets and signaling the government's determination to a radical change of policy and a compliance with the European Community economic policy ? One is tempted to respond affirmatively.

Important and highly revealing as the October crisis and the ensuing "crisis package" may have been, they were only the beginning. The worst turbulence was lying ahead and was going to come later- in fact, far earlier than any one could expect. The social democrats tried for the remaining part of their tenure in 1991 to manage the bubble economy and to stabilize it. The two crisis packages- with the second coming about a month after the eruption of the financial crisis- were meant as a desperate effort to cool down an overheated economy. But it was the coalition of the center-right parties who was going to handle the hot potato of the post-bubble economy and the systemic fragility of the Swedish financial sector after the September 1991 elections. Undoubtedly, they inherited a fragile economy from the social democrats, but their excess confidence in their mission to accomplish a prompt systemic change of the Swedish Model by big tax reductions were making them blind to the growing budget deficit and to the warnings sent by an institution held to be sacrosanct by every center-right government: the financial markets. The price for their blindness and for their insistence on the fixed exchange rate of the Swedish krona – an insistence which ran across the whole political system, one should point out – was going to provoke an unprecedented currency crisis, compared to which the October 1990 crisis was only a minor episode.

CHAPTER 3

The " *annus mirabilis* 1991"- " swan song" of the Swedish social democratic economic policy of the 1980s ? Assessing the economic policy of the "Third Way"

In the last year of the social-democratic tenure of power some significant changes occurred, which were going to leave their imprint on the further course of events. Some of them were initiating a major turn in the direction of the economic policy and were bringing the social democratic party further away from the anti- crisis policy of the 1930s- which with some revisions, refinements and necessary adaptations remained valid until the 1980s. Some of them had to do with the international economic environment (and especially with the interest rates policy in the re-unified Germany, the exchange rate of the US- dollar and the interest rates policy of the American FED in the second half of the year). And some of them had to do with evolutions inside the Swedish labour market- which , unexpectedly enough, was stabilized after an agreement for modest wage increases between the social partners. The combined effects of those changes were going to have a very serious impact in the Swedish economy and to radically transform the conditions under which the new center –right coalition government of Carl Bildt was going to act.

The first major development, which was going to have both symbolic and real significance, was the *re-orientation of the economic policy and the shift of emphasis from the full employment to the fight* *against inflation as the primary goal of the social democratic government policy*. The fact that this shift of emphasis occurred under a serious inflation upsurge causing costs explosions for the Swedish economy in comparison with the outside world- a fact which was making all the more urgent to combat inflation- does not reduce the symbolic importance of this change: for the first time since the early 1930s, when the social democrats conceived and implemented a proto-keynesian government putting the emphasis on the fight against the unemployment by means of emergency public works, the order of priorities appears to be- and in fact, is – changed and reversed: the fight against inflation is now clearly stated as the main and primary goal of the economic policy. In the government budget statement for 1991, under the heading *The Direction of the economic policy* one can read the following declaration, which immediately attracted attention:

"It is no more feasible to secure employment in an economy with price increases, which are greater than in the outside world. In order to defend the employment and the welfare the economic policy must in the following years directed with full force towards bringing down permanently the inflation. *This task must be put before any other ambition and demand [* **The emphasis is ours**] . This implies that very strong restrictions must be put on the expenses of the central government, of the municipalities and of the regions at the same time as the sector exposed to foreign competition must be strengthened.[112] "

The way in which this change of priorities is expressed may be very careful and couched in terms of traditional social democratic political language emphasizing the fight against the inflation as a means of securing employment and welfare, but a careful reader of the government proposal was perfectly in position to perceive the clear change in the order of priorities – which the government was not hesitating, after all, to spell clearly in the sentence emphasized by us above. In the annual meeting of the National Economic Association about the budget, two economists belonging to different economic schools of thought, the social democrat Villy Bergström and the moderate monetarist Hans Tson Söderström, head of the SNS Group of Studies on the Business Cycle, were unanimous in their judgment that the statement on the direction of the economic policy contained in the Government Budget Statement was highly probable to have far-reaching consequences on the direction of the economic policy from now on. According to Bergström, it was very possible that the change of policy was implying that *we put an end to what had started in 1933* [i.e the year in which the then social democratic finance minister Ernst Wigforss in his speech in the very same Association declared the decision of the government to combat actively the unemployment by means of public works paid at wages of the open market, thus opening the era of the proto-Keynesian economic policy]. Bergström pointed to the very low number in emergency public works (in Swedish the term

112 Government Proposal on the Budget 1990/91: 100, Part 1. P4

is *beredskapsarbeten*) in the budget of 1990/ 91 , despite the fact that the unemployment rate had just surpassed the 100 000- something which was signaling that the defense of the employment was not as important as it was in the past[113]. And confirming the assessment made by his colleague, Söderström in his speech declared that the Budget Proposal 1991 is an epoch-making document. He expressed also the view that an economic- political *change of model* was under way in Sweden. And in a highly lyric way he stated that *this is of course sweet music in the ears for those of us who had supported this view for many years.*[114] By saying "us" Söderström was referring to the cycle of economists at the SNS Council on the Study of the Conjuncture , who already in 1993 advocated the need of a *an inflation norm- based policy* and of putting an end to the Keynesian short term stabilization policy. What those economists first formulated in the middle of the 1980s was becoming now government top priority- at least on the level of the economic policy priorities. In fact, the advocates of a policy based on an inflation norm were demanding far more sharp things, which were going to be put on the agenda for the first time only some time later, when the conservative coalition government assumed the government. For the time being, Allan Larsson was conceding to them the fight against inflation as the primary aim of the economic policy. At the time of the 1990/ 91 Budget the inflation rate was at about 8 per cent and one year ago, at the end of the year 1989, the government was already pointing to the fact that the *overheating of the economy has now gone so far and that the price and wage increases were lying so high that a further tightening of the economic policy was necessary. Before the government takes these measures aiming at this, the government is ready together with the social partners to try to examine whether there is a way to bring down the inflation without raising the unemployment by combining a tight economic policy and sense of responsibility.* [115]

What followed between the 1989/90 Budget (putting the inflation and the unemployment on equal footing) and that of 1990/91 (proclaiming the fight against inflation as the first priority since **1933** is this: in the first months of 1990 the social partners were unable to come to agreement about the evolution of the wages in the next three years. Then the government presented the first emergency package containing a wage and price freeze, a strike ban and a two- years freeze on the municipal taxes. The package was rejected in the parliament, Feldt resigned from his post as Finance minister, the government was reconstituted in April with Allan Larsson as Feldt's successor and a new more

113 Jan Elmbrant, 2005, (1993), *ibid,* p. 267-268

114 Jan Elmbrant, 2005, *ibid,* p.268

115 Government Proposal on the Budget, 1989/90: 100. P14

modest package with the support of the Liberal Party was voted. In the meantime, the real estate company Nyckel went bankrupt in September and triggered the beginning of the financial and bank crisis, the first serious capital flight took place in October prompting the government to present the second crisis package- the one containing further cuts of 15 billion kronor – and, significantly enough, the first official statement about the intention of the government to apply for the entry in the European Community .

The new European policy announced in the turbulent October was going to be accompanied by a further spectacular move - the second important development in the last year of the social democratic government of Carlsson/ Larsson. *In May 1991, the Swedish Riksbank announced that the Swedish krona was tied to the ECU, the European Currency Unit, without adjustments in the exchange rate,* i.e, it would continue being pegged at the existing exchange rate of the krona to the other currencies contained in the basket of currencies, to which up until then the krona was tied. In fact, Sweden by tying its currency to the European Currency Unit was changing its "currency basket": the American dollar was no more present in it.. The Riksbank announced that it was the first of the three steps leading to the full participation of Sweden to the exchange rate mechanism of the EC. It was a sensational decision, with both symbolic and real importance and which was committing the Swedish economic policy to the European one and was meant as a signal that the fight against the inflation that was now top priority for the government. According to the economist and commentator Carl Hamilton, behind this one-sided tying to the ECU there was a shrewd calculation: both the Minister of Finance and the Riksbank were expecting that the American dollar was going to continue its upward trend – in the spring the dollar went up by 5 per cent in relation to the krona. If this upward trend of the dollar would continue and the American economy would continue its positive course, then the Swedish krona would be indirectly devalued without a humiliating officially decided devaluation. In combination with the fact that an unexpected agreement between the social partners for modest wage increases (the so –called "Rehnberg Agreement") was reached a little earlier, by virtue of which the cost increases in Sweden for the next three years would be 10 per cent lower than in other countries, this calculation at that time seemed to be well-founded[116].

However, the hope for a continuing upward trend of the US- dollar did not materialize. Developments in the USA and the Germany were going to cancel the scenario most wanted by the Swedish government and the Riksbank: upswing of the American economy and European interest rates reductions. The central banks of the G7 countries decided to take a coordinated action in order to

116 Carl Hamilton, Dag Rolander, 1993, *Att leda Sverige in i krisen. Moral och politik i nedgångstid [Leading Sweden in the crisis. Moral and politics in times of decline],* Bonniers, Stockholm,

bring down the value of the US-dollar. At the same time the American Federal Reserve reduced the USA interest rates and the US- inflation rate fell. In the reunified Germany, the Bundesbank was firmly decided to break the rising inflation caused by the boom after the German Unification and was willing to raise the interest rates- a decision which was affecting negatively the other European currencies.

In the domestic labour market the Rehnberg agreement and its unexpected positive outcome was one further major event of the last year of the social democratic government. Appointed in 1990 by the new finance minister Allan Larsson with the goal of bringing employers and employees' organizations to reach an agreement on the wage developments in the years 1991-1992, the Rehnberg Commission was facing a very difficult task: nothing was indicating that such an agreement was possible, since the SAF and the LO were only one year earlier, in 1990, unable to agree on modest wage increases in order to cope with the shrinking competitiveness of the economy at the end of the year 1989. Unexpectedly, the Rehnberg Commission did it: the social partners agreed modest wage increases for the following three years and, if implemented, this would imply that the wage costs in Sweden would be lower in relation to other competing countries- trade partners. Despite signs of disintegration and failure, the Swedish system of collective negotiations finally worked- and gave results. After the Rehnberg Agreement the wage costs could be expected to be brought under control and the inflation would begin to be gradually reduced reaching already in the first month of 1992 the remarkable two per cent. It was a significant development.

All the above mentioned developments were going to change radically the picture of the Swedish economy in the second half of 1991- the time in which the centre- right coalition government was going to assume power. From being an inflationary overheated economy Sweden was now turned into a cooled- down economy displaying signs of serious recession. The decline of the value of the dollar, the high European interest rates, the beginning of the downward trend of the domestic inflation rate (a result of both the change in the economic policy and of the implementation of the Rehnberg agreement on the labour market), the burst of the bubble in the real estate sector and – last but not least – the implementation of the tax reform in the period 1990-91 with the drastic curtailment of tax deductions for interest payments on loans (and the ensuing drastic change in the saving attitude of the households) were bringing the economy deeper into a recession. In the summer of 1991 the Institute of the Conjuncture (Konjunkturinstitutet) reported that the incoming orders from both abroad and from the domestic market were continuing to be extremely low, the number of the planned new jobs for qualified workforce was the lowest ever recorded and 40 per cent of the firms had the intention of reducing their personnel in the next half year. The industrial production showed the most dramatic fall since 1940. [117] . In just one year, a confluence of various factors (changes in the economic policy, the results of previously decided reforms, the fragility of banks and financial companies after the burst of the bubble, and unexpected international economic developments (reduction of the value of the US/dollar, extremely high European interest rates) transformed cumulatively the Swedish economy into an economy on the verge of a depression. The centre- right coalition government of Carl Bildt, which came to power after the September election, were assuming not an overheated economy but instead an economy in a serious recession, in which the negative real interest rates were giving their place to more and more high real interest rates provoking an “interest rates shock” on the indebted households, which was now obliged to strengthen its savings, to radically reduce their indebtedness and shrink their consumption. The “party” of the reckless lending of the second half of the 1980s caused by the credit deregulation and the overheated economy quickly evaporated and was giving its place to an economy in recession with a drastically shrinking demand. A year which in its first half seemed promising, despite the difficulties, ended with an economy in a severe recession. That was the legacy of the social democratic government to the fragile centre right coalition government which succeeded it. The question was how the center – right coalition government was going to respond to the challenge.

How should one assess the social democratic economic policy of the “Third Way” in the period examined (1982-1991)? A policy which was conceived and implemented with the aim of strengthening the squeezed profitability of the Swedish industry and of cutting the budget deficit while striving to avoid serious cuts in the welfare state arrangements and preserving the traditional social democratic goal of full employment ended up with a serious recession in the last year of the social democratic government. The deregulation of the credit market giving rise to an unprecedented loan- driven financial, consumer and construction boom and bubble, the abolition of the exchange controls which opened the door for destabilizing currency outflows and a monumental tax reform in the period 1990-91 (occurring *after the abolition of the credit controls,*) which raised the VAT and greatly reduced the progressivity and the equalizing effects of the old tax system in the hope of strengthening the incentive to work and of achieving much promised “dynamic effects” were important events punctuating the policy of the Third Way. The first one, by far the most important, led to a reckless orgy of bank lending to households and real estate companies and to an unprecedented overheating of the economy which, combined with the wage explosion after 1988, fueled the inflation and led to loss of competitiveness at the end of the decade. The effort to cope

117 Carl Hamilton, Dag Rolander, 1993, *ibid,* p. 28

with the inflationary tendencies, intensified just before the burst of the bubble in 1990 and the ensuing banking crisis, led to two crisis-packages aiming at coping with the inflationary conflagration caused by the mismanaged credit liberalization and. in 1991, to the a monumental budget proposal which explicitly gave up the traditional social democratic goal of the full employment in favor of fighting against the inflation. The most sacred and the most cherished social democratic goal, the full employment (and the active labour market policy, this cardinal feature of the Swedish Model, as the main instrument of achieving it), the major achievement of the 1930s crisis policy, had been given up. Nothing indicated more the change order of priorities and the monumental policy change undertaken than the decision to tie the krona to the European ECU: it was a decision of tremendous symbolical and real importance and it was the most clear sign that the fight against inflation was seriously meant.

What conclusion can one draw from the way of the implementation of the policy of the Third road. from its final outcome and of the strategy and logic underpinning it? If judged by the radical policy reorientation contained in the budget proposal of 1991 and if the full employment is considered as the cornerstone of the Swedish social democracy, the outcomes of the Third Way policy testify to an undoubted failure: despite its efforts to avoid the demolition of the full employment regime, the social democratic party ended up accepting what the continental conservative parties were seeing as the top priority: the fight against the inflation. There is no doubt that the social democratic economic policy of the 1980s unfolded under dramatically changed conditions: the high growth rates of the first three decades were a past history, traditional sectors of the Swedish industry (coal mining, paper industry and shipbuilding industry) were in a serious crisis and under pressure for rationalization or downsizing and the task of reconciling the full employment with price stability had become a far more complicated issue. On the other hand, the Swedish firms, as we have already pointed out, were becoming more and more internationalized and far less interested in indulging in the class compromise underpinning the traditional "Swedish Model". They had greatly profited from the investment opportunities afforded to them and, thanks to the Rehn Meidner Model and the strong bias towards capital concentration built- in in it, they acquired a critical size, power and international expansion which they used in order to undermine the positions held by the organized labour movement- especially when the latter began to complain about the growing capital and fortune concentration from which its members were being excluded and started to submit reports pointing to the necessity of a more equitable distribution of the wealth by means of gradual changes in the property relations of the bigger firms. The problem is that the strategy finally chosen by the social democratic party leadership , the policy of the Third Way, by aiming at strengthening immediately the profitability of the Swedish companies by means of an aggressive devaluation,- and thus by giving up the fundamental demand of the Rehn- Meidner Model, further came to be in the interests of those internationalized big exporting firms- those ones which were less interested in the domestic market and in the preservation of the social compromise sustaining the Swedish Model. The liquidity thus created was not invested in productive activities: instead they were channeled to real estate and speculative dealings, which, after the abolition of the credit controls, were ran out of control and led directly to the emergence of a bubble – primarily in the construction and real estate sector. In fact, the very same deregulation of the credit market can be seen as an unavoidable outcome of the devaluation: having opted for strengthening the profitability of the firms, it would be inconsistent to deny them the possibility to invest their excessive liquidity in the most profitable financial activities: the real estate market. After the devaluation the pressure for totally lifting the credit controls can be plausibly enough considered to have been particularly strong. In this context, the abandonment of the “Rehn- Meidner”model, the very heart of the Swedish Model, was complete- and was going to have far-reaching consequences: While the Rehn – Meidner Model was pointing to the importance of keeping the profits reduced in order to reduce the inflationary tendencies and to stimulate the industrial restructuring, the basic priority since 1982 was to increase the profits. Denying the firms the much wished financial services was appearing more and more contradictory: the road had been opened for the deregulation of both the credit and the exchange market. The party with the borrowed money, the construction and the consumer boom coupled with the further reduction of the employment at a rate between 1-2% – in fact in the period 1988-89 Sweden was in full employment – and the inflationary conflagration created by the abnormally full employment and the wage increases led to an unusual overheating and a cost explosion undermining finally the competitiveness of the economy: the advantages obtained by the 1982 devaluation evaporated at the end of the decade by a mismanaged, badly planned and ill- timed deregulation of the credit market. The fact that Kjell- Olof Feldt and the social democratic party leadership failed to assess the serious side-effects of the deregulation and proceeded to the total liberalization without even a serious discussion of the whole issue inside the government and the party leading discussion and decision-making organs makes this major event of the monetary policy all the more serious and indicative of how serious matters, with potentially heavy consequences on the social democratic status quo, had been removed from the public discussion agenda and had been exclusively reserved for a few initiated people and a closed inner circle endowed with the power of final decision . The decision to deregulate was a classic example of what Torsten Svensson in his very thorough report calls “ government by experts”: a handful of experts at the Riksbank, which were thought to possess the technical knowledge to take and to implement such a serious decision, were in fact those who practically prepared the ground for the deregulation. The secrecy – and perhaps, the quasi-conspiratorial way – in which the decision was taken were thought necessary for such a serious and complicated questions of monetary policy. That the supposedly superior in financial expertise senior civil servants greatly underestimated the risks for an uncontrollable lending, greatly overestimated the capacities of the Riksbank to control an explosion of the lending and failed to perceive that a deregulation without prior reform of the tax system putting an end to the tax deductions for interest payments on mortgages was opening the gates for such an explosion raises serious questions about the way in which the reform was both decided and carried out- but also about the wisdom and the supposedly superior knowledge of those very same experts. In fact, the whole incident seems to be a case- study of one- sided corporatism- in fact of lobbyism: only the private banks were in position to influence the whole process and to lobby for the total lifting of the credit controls. Far more important is the fact that the social democracy by giving its consent to this epoch-making change of the monetary policy practically lost one basic instrument for carrying out the selective supply-side policy of channeling credits to sectors of high priority. Not only the social democratic government was totally unable to influence the way in which the excess liquidity of the firms was being invested , but also they granted them the possibility to participate in the "party" of lending after the abolition of the credit controls by channeling their profits to the booming real estate market in order to secure the much desired profitability resulting from lending and speculative investment operations

Under such conditions it was scarcely realistic to expect from the trade unions to be capable of convincing their members about the necessities of wage moderation. In the first half of the social democratic decade, the LO had been able to deliver on a policy of wage moderation and its leadership, despite being in a very delicate position, had been successful in committing its constituent to the desired policy of wage moderation. Despite the highly centralized nature of the Swedish trade union movement and the corporatist character of the bargaining system, the hope that the trade union movement would accomplish price stability by means of wage moderation in an economy with excess demand on the labour market, inflationary expectations and a basically accommodating monetary policy was totally unfounded. [118] Even a highly effective centralized system of collective bargaining and corporatist consultation was unable to cope with a combination of factors extremely favorable to an inflationary conflagration**.** In this context, the social democratic government should

118 Ton Notemans, 1993, *Varför överges arbetarrörelsens vörderingar i den ekonomiska politiken [Why the values of the working class movement are abandoned in the economic policy]* , in: Villy Bergström, 1993, *Varför överge den svenska modellen,. 12 Uppsatser om arbetslöshet och stabiliseringspolitik [Why abandon the Swedish Model. 12 Essays on the unemployment and the stabilization policy*], Tiden Förlag, Stockholm, pp. 261

have been aware of the fact, as Ton Notemans correctly points out in a very informative essay, that by abandoning the Rehn- Meidner Modell as a means for stimulating growth, this was implying that the centralized wage negotiations as a policy instrument was made ineffective[119].

Confronted with an inflationary flare- up caused by an overheated economy in the second half of the 1980s and which could not be handled by the institutional arrangements of the Swedish Model (centralized wage bargaining and corporatist consultation) and pressed by destabilizing capital outflows in 1990, the Swedish social democracy decided in the period 1990-91, in the final years of its tenure of power, (when the policy of the Third Way was finally derailed and the efforts were concentrated on managing the unwanted side-effects of some strategic options), to change the nature, the priorities and the general direction of the economic policy: the fight against inflation now became the top priority substituting the goal of the full employment. The decision to tie the Swedish krona to the ECU in May 1991 was a further clear indication that the Swedish government was bent on giving credibility to the fight against inflation by following a policy of fixed exchange rate. Despite the serious indications that the situation on the labour market after the burst of the bubble and the beginning of the fall in the real estate values was becoming critical, the measures announced in the 1991 budget proposal about the active labour market policy were glaringly insufficient: in the economic debate the attention was concentrated on how high the unemployment should be in order to bring down the inflation and not how the full employment could be preserved. Finally and after serious hesitations and improvisations, the social democratic government was converted to the already established paradigm of new economic policy: an economic policy which was concentrated around the priority of fighting against inflation by means of fixed exchanged rate securing external balance and disciplining the wage demands by giving up the goal of full employment. The policy of the “Third Way”, initially conceived as a third way between traditional Keynesian reflation and monetarist austerity at the end of the decade ended up accepting the premises and the priorities of a monetarist inspired “norm- based policy” – in fact, the Swedish variance of monetarism- directed at combating inflation and securing external balance. The institutional apparatus of the old Swedish Model, the centralized wage bargaining system, the corporatist policy- making and the active labour market policy were being proven unable to cope with the inflationary tensions, which have been unleashed by the excess liquidity of the big companies – secured after the big devaluation - and the total liberalization of the credit market.

This very same process of centralized wage- bargaining suffered in the 1980s serious blows, which

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119 Ton Notemans, 1993, *ibid*, p. 262

were going to undermine its efficiency and make it far less useful in the fight against inflationary tensions. Developed as a necessary supplement of the Rehn- Mediner model the centralized Swedish wage bargaining system was assigned the task of co-opting the social partners in consensual and coordinated negotiations, whose final outcome would secure stability and social peace and thus stable economic growth- essential to the capital owners for securing constant expansion and for the wage earners for benefiting for rising living standards and gradual expansion of the services of the " social citizenship state" (to use the expression of Gösta Esping- Andersen). On the other hand, this very same system had as a goal to strengthen the equalizing tendencies in the wage formation of the different segments of the collective of the wage earners. The solidaristic principle " equal pay for equal work" was the founding stone upon which was built and refined a solidaristic wage policy which succeeded in reducing the wage differentials inside the working class and in promoting, at the same time, the structural change of the economy by moving manpower and resources from the less dynamic the most dynamic sectors of the economy. However, in the first years of the 1980s this largely successful and efficient system of wage negotiations, which had been able to contribute its fair share to the preservation of full employment with (relative) price stability, was seriously eroded- if not partially demolished (while already in the 1970s the solidaristic wage policy between the different sectors of the wage earners was experiencing serious tensions and difficulties in coordinating the wage demands). The success of the employers' union of the engineering industry in 1983 in striking a separate wage agreement with the trade union of the Metaal Workers (, the most important constituent trade union inside the LO) was the first serious blow to the centralized wage bargaining: for the first time the most important trade union inside the LO indulged in striking a separate deal with its employers' union and, as Douglas Hibbs and Håkan Locking point out in a very illuminating article on the solidaristic wage policy, after this year, the central agreements which had been obtained, were of a different character, since the central social partners were no more in a position to impose the central agreements. [120]

Given that the centralized grip of the LO on its constituent members after 1983 was practically weakened, the situation became even more difficult to be effectively handled in the second half of the 1980s- when the "party with the borrowed money" got completely out of control: the Swedish wage bargaining system could not be used as a means of successfully coordinating the social partners and of committing them to a policy of co-ordinated wage moderation. The economic environment created

120 Douglas Hibbs, Håkan Locking, *Löneutjämning och löneökningstakt under den solidariska lönepolitiken [Wage Equalization and Rate of Wage Increase during the solidaristic Wage Policy]* in: Villy Bergström, 1993, *ibid*, pp.113.

by the unconstrained credit expansion seem to have given the final and most fatal blow to the wage bargaining system as the central mechanism of managing the inflationary As Ton Notemans points out in his already mentioned article about the change of the macro-economic policy in the two most powerful strongholds of social democracy (Sweden and Norway), the overheating on the labour market was a far more serious threat against the internal unity and cohesion of the LO than the much discussed structural shifts in the composition of the workforce which wiped out the frontiers between blue and white collar workers. [121]. The conclusion drawn from Notemans, was that the decision of the Swedish social democratic government in 1991 to change the orientation of the macro-economic policy by prioritizing inflation and by tying the krona to the ECU was the final outcome of its choice to import price stability by giving up the institutional possibility to deviate from the policy inside the EMU. It was, in a sense, the way-out from the inflationary pressure after the main institutional arrangement of the old social democratic order, the centralized wage bargaining (with the policy of the equalization of the wage differences among the different wage strata) and the corporatist consultation, were proven insufficient to contain inflation.

A picture like the one depicted above leaves one with the impression that the social democratic policy of the 1980s was a complete and inevitable failure. Was it really? Is it justified to draw a conclusion of utter failure by judging the whole efforts of the Swedish social democracy by the fact in the budget proposal of 1991 the goal of full employment was abandoned? Even if the answer is yes, this affirmative answer does, in no way, proves that Sweden in the 1980s was an abject failure. According to the opinion of Richard Layard, Professor of the London School of Economics, at the Department of Economic Performance –an opinion which is presented in an interesting article contained in the already mentioned book of Villy Bergström-, *no country did it better than Sweden during the 1980s.* He points out that the rate of employment increased (the unemployment was only 2,1 per cent, compared to the 9 % of the OECD Europe), the GDP increased as much as in Europe (Sweden: 116, 8 and Europe: 113,2 with 1970 as year of reference= 100), while inflation in Sweden was a little above the European average (Sweden: 8.6 per cent, OECD Europe: 7.5 per cent)[122] . Layard calls the above figures " a remarkable achievement" . He does not deny that mistakes had been made, but they were *minor mistakes*: the effort to bring the unemployment rate below the 2 per cent (it was a kind of arrogance, according to him) led inevitably to a demand-driven inflation. But

121 Ton Niotemans, *ibid,* p-261+262, in : Villy Bergström, 1993

122 Richard Layard, 1993, *Varför överge den svenska modellen ? [Why abandon the Swedish Model?]* in: Villy Bergström, 1993, *ibid,*pp.29-33.All the above figures given by Layard are taken from OECD Economic Outlook, December 1990 and OECD Employment Outlook, July, 1989. The figures for the 1980s are the average for the years 1983, 1986, 1987, 1988.

he express his conviction that there was not any reason for Sweden to abandon the goal of securing the full employment. Layard attributes the Swedish exceptional performance to two basic policies, which according to him constitute the unique distinguishing mark of the Swedish Model: the *active labour market policy* (Sweden had been on the forefront of intermediation of jobs, of adult education and of the creation of accidental jobs) and *the centralized wage bargaining*. He expresses also his conviction that the difficulties which Sweden came up against in the 1980s do not justify an abandonment of a policy, which, on the whole, was obviously successful. The final conclusion of Layard deserve, in this context, to be directly quoted:

" Sweden made serious mistakes. The demand was excessively expanded and the wages were compressed in a too high degree. But these mistakes where of minor character and they can be corrected. But if Sweden loses its faith in the active labour market policy and in the wage moderation, then one is on the road towards double-digit unemployment. A glance at what happened in Great Britain, in France, Germany and Spain is sending two explicit messages to Sweden. For the first, keep safe the active labour market policy and use it as a counter-cyclical measure for avoiding a long unemployment. For the second, keep up with the efforts for a coordinated wage formation, which avoids the course for private advantages running counter to the common interest."

And after having defended the two major institutional arrangements of the Swedish Model and urged the Swedes to defend these arrangements, he concludes in the following way:

" Seen from abroad, Sweden should be proud of having avoided during the 1980s the most serious mistakes made by the others. It would be tragic if one repeated during the 1990s exactly the same mistakes." [123]

The assessment made by Layard is a strong case for the social democratic policy during the 1980s: it points out some crucial and remarkable achievements, which were accomplished despite the difficult and pressing conditions of the 1980s. Sweden was by no means a failure in this period. The fact that in the second half of the decade, some mistakes were done cannot be cited as an argument in favor of abandoning a Model, which was a remarkable working and viable reality for four successive decades- and even under the new adverse conditions. *When times are difficult, then it is very easy to believe that a totally different way of doing things would be better than what one has at hand. But the things point to the opposite direction,* points out Layard. We think, he has a point- despite the fact he does not analyze in his article some important events in Sweden which exposed the original Model to considerable strains and undermined its inherent consistency (abandonment of central premises of the Rehn - Meidner Model, boost to the liquidity of the firms with a super- devaluation, which triggered the process of the credit deregulation and of the speculative demand-driven boom, a tax reform with reduced income progressivity and curtailed interest rate deductions and was implemented at a bad point when the demand had contracted and the households began to save and

123 Richard Layard, 1993, *ibid*, p.33

to pay off past loans). Layard seems to firmly believe that the destabilization in the end of the 1980s does not constitute a serious reason for giving up the two mentioned policy- institutional instruments of the Swedish Model: the active labour market policy and the centralized wage coordination. We saw that during the 1980s both of these instruments have lost part of their efficacy: especially the centralized wage bargaining, after the crucial year 1983, loses its traditionally centralized character and the efforts aiming at wage negotiation and coordination were exposed to increasing difficulties. Despite these difficulties, Layard is firmly convinced that there was no need to believe that these instruments were useless. The temptation to abandon them was strong- a fact very common in times of crisis, according to him – but the price of their abandonment would be, according to this view far higher: Sweden would inevitably sink into mass and enduring unemployment.

Whatever one may think about the arguments of Layard, one thing is certain: Sweden of the Third Way social democracy was far from a failure: the social democrats succeeded in redressing the economy- and this fact cannot be negated by saying that it was merely achieved by means of a super-devaluation. That said, one must point out that the policy of the Third Way was fraught with dangers and its architects seriously underestimated the fact that by granting to the industry such an excess liquidity this would irresistible lead to further pressures for further relaxations in order to secure more profits. The Swedish social democracy lost sight of the fact that the export oriented Swedish firms were no more interested in preserving the Swedish Model: they had been made independent of it, they no longer needed it. They profited from the devaluation, but this only pushed them to demand more and more: credit deregulation, exchange rate deregulation, tax reform, membership of the EC- and radical reorientation of the macroeconomic policy by abandoning the full employment and by resorting to the fight against inflation. The Swedish social democracy in the turning point to the new decade finally surrendered: they abandoned the full employment, they opted for external stability and price stability. The policy change began- and was initiated by the social democrats themselves. Before surrendering, the Swedish social democrats tried to implement a policy different from the traditional social democratic of the Keynesian period, while preserving its most precious goal: the full employment. At the end of the decade and the beginning of the 1990s even this goal was abandoned. In this sense, the social democracy failed. But this does not mean that Sweden in the 1980s was a lamentable failure. And no one could know what would have happened, if the social democrats had remained devoted to their traditional goal and to the two institutional arrangement of the Swedish Model: the active labour market policy and the centralized wage bargaining- or what had remained from it.

The case for the Swedish Model made by Layard leaves, nevertheless, one with a peculiar feeling.

Knowing what happened only shortly afterwards (in the period 1991-1993) and the fall of the social democratic party from power (but also after the social democratic policy in the second half of the 1990s). The things during the 1990s did not go according to the prescriptions of Layard: in fact the Swedish Model was exposed to the shocks which the radical change of the economic policy provoked. Every policy change, every transition, no matter how important and necessary may have been, is fraught with the danger of destabilization. And if a government thinks that this change must be accelerated *à marche forcée* even reaching the point of giving no attention to objective limitations and constraints or of discarding the possibility of a more gradual and soft transformation, then the turbulence can be devastating. The Bildt government acted, as we shall try to show in the next section, in exactly this way. It is high time to see it in more details in the next section the crisis of the Swedish Model during the dramatic years 1991-1994- the years when it found itself in the abyss and on the verge of complete disintegration.

CHAPTER 4

The "Swedish Model" under conservative rule- and on the verge of collapse, 1991-1994. The "successful failure" of the Bildt government

I. The general economic context, the economic program and intentions of the centre- right coalition government of Carl Bildt- Early measures in a contracting economy

The years 1991-1994 are the period when the Swedish Model underwent the most serious crisis in its history. In fact, when we speak of the *strictu sensu* crisis of the Swedish Model, we refer exactly to this period and to the dramatic events that took place during these three years. We dedicated the previous chapters to outlining the direction and the strategic choices of the economic policy of the social democratic government in the 1980s because the crisis of the period 1991-1994 would be impossible to be understood without a previous knowledge of the new economic policy pursued by the social democrats after 1982. The consumption and construction boom which followed the deregulation of the credit market led, as already explained, to a bubble, which burst in 1990, and to a creeping recession. The social democratic government alarmed by the cost of the crisis reoriented the economy policy at a time where the real estate values were reversed into a downward direction. Indeed, after the real estate bubble burst in 1990- real estate prices began to fall, the banking sector's exposure to the real estate lending was becoming more and more manifest and the economy entered into recession (which was strengthened by the implementation of the tax reform and the growing burden of interest rates payments on the indebted households). But important and serious as the social democratic economic policy choices in the second half of the 1980s they may have been, they cannot explain the unprecedented depth of the crisis that hit the Swedish economy in the period 1991-94 and brought the "Swedish Model" to the verge of disintegration. The crisis of the years 1991-94- in comparison to which the crisis in the 1930s appear to be less serious- could not have been so serious, if the right- of -centre coalition government in office had not shown a reluctance to take notice of the changed nature of the crisis facing the Swedish economy in the late 1991.

When the fragile bourgeois coalition government under the leadership of Carl Bildt came to power after the September 1991 elections, the landscape of the Swedish economy was already presenting striking differences with the overheated economy of the 1985-1990 period. After the burst of the bubble in the financial and real- estate sector and the onset of the financial crisis, after the change in the fiscal policy, at first presented in the government statement on the budget of 1991- the last of the social democratic party before handing over power to the bourgeois coalition- and the pegging of the Swedish krona to the ECU in May 1991, after the unexpected agreement between the social partners as a result of the efforts undertaken by the Rehnberg Commission, but also -and especially- after the fall of the value of the US dollar and the reduction of the American interest rates by the Federal Reserve in the summer 1991, the Swedish economy was sinking more and more in a deep recession. The Swedish krona was overvalued, the inflation of the period 1989-1990 quickly slowed down, the real interest rates were increasing at alarmingly high levels (at about 8 per cent) , the industrial production registered in the second half of 1991 a sharp decline, the unemployment rate was rising fast. The implementation of the tax Reform in the years 1990 and 1991 was beginning to bring about serious changes on the economic behavior of the households: the drastic cuts in the tax deductions for interest rates on real estate loans was now dampening demand and the indebtedness of the households was prompting them to save and to start paying off past loans, thus further draining an already weak domestic demand.

The government of Carl Bildt, despite being a fragile four- party minority government, was obliged to strike deals in parliament either with the social democrats or to the rightist- populist party *Ny Demokrati* of Ian Wachtmeister. The new government came to power with great ambitions and big plans for bringing about a *systemskifte* i.e a " system change" (or, to say it better, to continue and deepen the *systemskifte* already begun by the social democrats in the two last years of their government). That his government was the first centre- right coalition led by the rightist party *Moderaterna* (the Swedish equivalent to the British Conservative party) since 1930, (when the Conservative Arvid Lindman became Prime Minister) , and the fact that the last bourgeois coalition governments of the period 1976-1982 (under the leadership of the Center party leader Thorbjörn Fälldin) did not pursue a right- wing policy, but they continued the previous social democratic one, seems to have strengthened the determination and the impatience of Carl Bildt and of his new finance minister Anne Wibble (daughter to the legendary Swedish Keynesian economist Bertil Ohlin, but herself member of the neo-liberal faction of the Liberal Folkspartiet, the main coalition partner of the Conservatives) to implement this time a radically different economic policy, invested with a proudly proclaimed neo-liberal ideological credo. Already in the programmatic declaration of his government on October 4, 1991, Bildt declared: " *The era of collectivism in Sweden is now over. In our Sweden the society is going to be always greater than the state. We are fighting for making the decade of the 1990s the decade of changes and of renewal for Sweden.*"[124]. And Anne Wibble pointed out what was the "collectivist system" and its failed policy which caused the serious economic troubles of Sweden and which the new centre- right coalition government was intent on radically tackling by carrying out the *systemskifte* : an industrial structure prevented from being renewed by the devaluation of 1982, a policy of overheating especially after 1987 which had not been counteracted, the bad conditions for entrepreneurship created by the social democrats, a tax and social security system which was making work unattractive, the existence of public monopolies inhibiting efficiency, discouraged private savings and neglected growth. [125] In its manifest ideological fervor the new coalition government seemed to lose of sight of some crucial realities which were making the implementation of such a drastic neo-liberal program unsuitable for the situation at hand: the economic theses contained in the pre-election manifesto of the centre- right coalition parties *Ny Start för Sverige [A New Start for Sweden]* were formulated on the basis of the need to combat the overheating of the economy. But, as already shown in the previous section,

124 Jan Elmbrant, 1993 (2005), *ibid*, p.280

125 Christer Isaksson, 1994, "*Världens bästa regering...." Tusen dagar som förändrade Sverige. ["The Wolrd's best Government...." Thousand Days which changed Sweden]* , Norstedts, Stockholm, p.143.

when the government took over, the cooling of the economy had already occured. At that time the economy had entered a phase of deep recession, the industrial production was in severe retraction, the banking sector was in serious crisis and its exposure to illiquid real estate assets was becoming more and more obvious. The credit losses were in 1990 20 billion, in 1991 they amounted to 50 billion and the estimates for 1992 were of the same magnitude[126]. Furthermore, the real estate market was in free fall. and inflation was falling fast In other words, the economy was sliding into a disinflation spiral- while the economic measures contained in the pre-election manifesto of the centre- right coalition government were most adapted to an overheated economy. In fact, Bildt and Wibble were so firmly convinced that for the present mess in the economy the only culprits were the over- extension of the public welfare provisions in the 1970s and the social democratic devaluation and accommodating policy in the 1980s that they hardly took notice of the changed economic realities and the fact that the social democratic government already in the biennium 1990-91 took important measures that brought about a considerable "cooling" of the overheated economy\. The burst of the bubble, the reorientation of the economic policy towards the reduction of inflation, the pegging of the krona to the ECU in May 1991, the three year agreement of the social partners on moderate wage increases: all those measures were more than enough for putting an end to the unsustainable inflationary conflagration. The *systemskifte* , so cherished to Bildt and Wibble, had been already initiated, to a great degree, by the social democrats. The surrounding international economy with the fall of the dollar and the European interest rates lying at alarmingly high levels – because of the determination of the Bundesbank to break the inflationary tensions provoked by the German Unification- were further negative factors for the Swedish economy and contributed to a further deepening of the recession.

However, this was not the way Bildt and Wibble were seeing the whole matter. They thought that the recession, far from deterring them from their effort to radically transform the Swedish economy, in fact was pushing them to speed up the whole process of rolling back the decadent social democratic regime. The fact that the "change of system" had already been initiated by the social democrats in their last years in power was not enough for them: in fact, they may have felt that the latter had stolen them the glory of beginning it and they were determined, now back in power -for so long held by the most powerful social democratic party of Europe- to continue, speed up and intensify the process. Bildt was overconfident that he had an urgent and special mission to accomplish: to administer to the social democratic welfare state the final blow, to submit the

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Carl Hamilton Jan Rolander, 1994, *ibid*, p.63

Swedish economy (trapped in the inefficient regulations and bureaucratic procedures of its oversized welfare state) to a *short term* severe, but to *a long term* regenerating re- structuring. Economist and public commentator Carl Hamilton, an eloquent critic of the economic policy of the Bildt- Wibble, speaks of *stålbad*, (literally translated into English as " steel bath". Their intention was to carry out so radical and irreversible changes that the social democrats, even back in power in the near or more remote future, they would be unable to undo them and to bring the country back to the social democratic *status quo ante*. Bildt wanted the creation of a constellation of social, political- institutional and deep economic changes, where any *retour en arriere* would be impossible to be accomplished. Bildt- Wibble and their associates meant *business*: the *systemskifte* had to be sped up- immediately and without delay.

What kind of an economic policy the new coalition government was determined to carry out ceased very soon to be anyone's guess and Bildt made it plain from the very beginning. By arriving in power the *Moderaterna* of Carl Bildt were going to build on the changes in the direction of the economic policy, already initiated by the social democrats and to extend and intensify them. What had to be eliminated was the accommodating fiscal policy, the policy of postponing *ad infinitum* the tormenting but necessary for the economy "steel-bath". What counted was the long- term credibility of the economy policy of the government- and in no way the stimulation of an economy in recession by means of an accommodating policy. The best way to achieve it for the government was *to be tied to a policy of zero accommodation*. No retreat in the battle against the inflation was permissible - and the best means to accomplish it was by sticking to the fixed exchange rate of the krona. Thus, Bildt came to power and tied himself, Wibble and Riksbank chairman Bengt Dennis to an over-valued currency, which demanded sky- high interest rates in order to be defended, in an economy in serious contraction which could not withstand high interest rates. For the new government what mattered more was the establishment of a new paradigm of economic policy based on non- accommodation and on the credibility conferred by the determination to stay firm and not to succumb to the temptation of a Keynesian short-term stabilization and stimulation of the economy by an expansive fiscal and /or monetary policy. The new government was greatly influenced by – and was intending to carry out in full- the recommendations of the group of economists and experts at the SNS Konjunkturråd (Hans Tson Söderström, Johan Myhrman, Lars Jonung, Ingemar Hansson), which already since the mid-1980s actively preached the necessity of putting an end to the interventionist Keynesian stabilization policy. In a recent book on the Swedish economic policy, Professor Lars Jonung, one of the most prominent members of the Council and economic advisor to the new Prime Minister Carl Bildt, makes the following retrospective remark about the intellectual activities and recommendations of the SNS Council of Economic Experts in 1985, the year when the group produced a memorable Report, the 1985 SNS Report, which was proposing many of the reforms later implemented by both the social democratic government and the new centre- right coalition government:

" The introductory chapter [of the 1985 Report of the Council] had the title " A declaration of Principles". The Swedish economic policy is in front of a choice between two views: the interventionist and the non-interventionist . The first named, associated with the Keynesianism, sees the stabilization- political problem as an outcome of the instability inside the private sector. The task of the public sector is to correct the imbalances which are created there by well thought-out measures. Form the point of view of the non-interventionist viewpoint, what matters instead is to direct the public sector in a way that opportunist, vote-maximizing and short-sighted politicians do not contribute to inflation and unemployment."

And after having exposed the fundamental principles of the two different economic schools of thought, Jonung exposes the basic recommendations of the policy change which the Council was supporting with strong conviction – and with considerable success as it was going to be become evident only few years later:

" The Council turned itself against the so-called " policy of accommodation" with a string of arguments. By preserving in the short run the full employment this policy had contributed to high inflation and to many devaluations without some positive long- term effects. The Council was recommending another strategy, that is, a norm- based policy with constant inflation as the first goal. *The means for reaching low inflation was, in the short run, the so-called fixed exchange rate policy for the krona. The krona should, in a credible way, be tied to the German currency and thus follow the low German inflation.* [**The emphasis is ours**] . In the long ran, when the credibility for the policy of low inflation had been obtained, an independent goal of inflation would be set, meaning a domestic price stability objective. Such a domestic objective was presupposing a floating exchange rate."

And Jonung concludes his remarks by pointing to the string of reforms which should accompany such a non- accommodating policy:

"The transition to the regime of price stability should be combined with reforms of the wage formation system, of the tax system, of the credit market, of the real estate market and of the fiscal policy. The aim was to improve the supply-side of the Swedish economy. The reforms should increase the credibility for the new regime and signal a break with the earlier policy based on the "interventionist and regulating ambitions" [127]

We thought it was necessary to directly cite the presentation of Jonung in order to make obvious the program of economic reforms which the new government was aiming at implementing. At the time of their formulation, these recommendation were tending to become dominant among the majority

127 Lars Jonung, 2015, *Trettio år på vägen till ett stabilare Sverige. Var står vi nu? [Thirty years on the way to a more stable Sweden. Where are we now?],* in: Birgitta Swedeborg (red), 2015,*Svensk ekonomisk politik- då, nu och i framtiden. Festskrift tillägnad Hans Tson Söderström [Swedish Economic Policy- then, now and in the future. Essays to the honor of Hans Tson Söderström]*, p.38-41

of the academic Swedish economists. In fact, a shift in the views of the most of them was going to take place: from having been in its vast majority a Keynesian- dominated academic community, the circles of the leading Swedish economists was going to be turned into a community largely dominated by the supporters of the norm-based policy of non-accomodation. In the opinion of Carl Hamilton, it was historically proven that no Swedish government – independently of its political color – was able to pursue an economic policy against the current reigning inside the community of academic economists. The curse of Sweden, he points out, both during the time the economic policy was dominated by the Keynesians and during the era of the norm-based policy, was that this academic community was so homogeneous in its convictions- something which contrasts with the USA and Great Britain, where the government can find always advocates for whatever economic policy it wants[128]. When Bildt and his centre-right coalition government came to power in 1992, the dominance of the norms-based policy among the academic economists was (with some exceptions) total. Their views had a profound influence upon the social democratic party as well. The 1991 Budget Statement (the last one submitted by the social-democratic government) was bearing the imprint of the recommendations of the advocates of the norms-based policy.Even the social democratic economist Villy Bergström, head of the Trade Union Research Center on Economic Policy (FIEF) and opponent of the supporters of the norm-based policy congratulated in a speech about the Budget Proposal in the Economic Association Hans Tson Söderström on the systematic work of ideas accomplished by the Council- a work,.[129]

For Bildt the recommendations of the Council on the Business Cycle were going to constitute the hard core of the policy agenda he was determined to carry out. Finance minister, Anne Wibble, herself an economist, had taken notice of the influence of the advocates of the norms-based policy. The fight against inflation, even in the changed environment of the economy, where the recession and the disinflation were gaining in strength, was seen as the most appropriated means to acquire long-term credibility for the economic policy. The defense of the fixed exchange rate of the krona to the ECU was the most precious instrument in this decisive battle against accommodation and inflation.

But for the Swedish Conservative Party (*Moderaterna*) of Carl Bildt, the party of the Swedish upper class of capital owners and of the leading finance and industrial circles , the fight against

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Carl Hamilton, Jan Rolander, 1993 (1998), *ibid*, p.115

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Villy Bergström (red.), 1993, *ibid*

inflation, important as it may be, is only, a springboard for achieving a more substantial and more important remote goal: a strong and quick demolition of the public sector combined with strong tax cuts, in particular of the income and property tax. The problem for the Swedish Conservatives, as Hamilton points out, is that for the majority of the Swedish economists the privatizations are seen only as a means to make the service sector more efficient and they continue to be in support for a public financing of the core services and for a big public sector. It was of the utmost strategic importance of for Bildt to dress the more ideological objectives of his agenda in such a way so as to attract the support of the academic community. In this way, Hamilton concludes[130], the Conservative- led government succeeded in mobilizing all the leading economists behind its economic agenda which was advocating the fight against inflation and the defense of the fixed exchange rate of the krona as the sole means for putting an end to an ineffective accommodating policy and for acquiring credibility.

That was, concisely formulated, the real and the less confessed agenda of the Conservative- led coalition government. And Bildt was far more determined to carry out the program of a non-accommodating policy to the full and to the most extreme limit. Upon arriving in power, Bildt did not show the necessary caution and humility which the enormity of his task (a “change of system”) required and he did not seem to be fully aware of the serious predicament the Swedish economy was in. Bildt, to the contrary, thought that he was to accomplish his task rather easily. On December 1991,at exactly the same time his government experienced the first serious currency flight (in one day 25 billion Swedish kronor fled the country) and interest rate shock (the Riksbank increased the marginal rate by 6 per cent to 17,5 per cent) Bild felt able to state in an interview that “*We have lifted the politics from the routine of the every-day administration to the level of the creative statesmanship*” [131] . Given the serious predicament of the Swedish economy and the destabilizing nature of the first serious incident of massive capital flight, one is surprised to see Bild congratulating his own government on a supposedly “creative statesmanship.” Perhaps, no other Swedish Prime Minister had displayed such an unfounded self-confidence as Carl Bildt in view of the challenges and difficulties his government was facing, the constraints imposed on his radical ideological agenda and the limited political instruments at hand for carrying out this system-changing agenda. Coming to power with the solid purpose of carrying out a “ systemic change” , of

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Carl Hamilton, Jan Rolander, 1993 (1998), *ibid*, p.114-115

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Christer Isaksson, 1994, *ibid.* The statement of Bildt was made in an interview in the Swedish Newspaper Svenska Dagbladet in December 1991.

the social-democratic Sweden according to market-liberal prescriptions (and marketing this policy of “system-change” as “ den *enda vägens politiken* –i.e the “ policy of the single way”), Carl Bildt and his Finance minister Anne Wibble cut themselves totally off the signals which the financial markets were sending to them. Their policy, far from being judged as the “*most competent Sweden ever had*” was greeted with “successive currency crises” to which the Riksbank responded with interest- rate hikes.they proved to be ineffective. The whole process culminated in the serious currency crisis of September 1992 to which the Riksbank responded by raising its interest rates, to the incredible 500% in order to defend the fixed exchange rate of the Swedish krona against the unstoppable speculative attacks.

Bur before taking a closer look at how the spiral of the successive currency crises was set in motion, it is interesting to see some first measures which the new government announced and took.

Despite the high ambitions contained in the governmental declarations of October, it became very soon clear that the situation was very pressing and that some “system changing measures” and the flying start to which the government had hoped were not forthcoming because of lack of money. The government had promised tax cuts up to 7 billion kronor already from the first budget. Reduced value added tax was estimated to cost 1.5 billion kronor, abolished charge on wage 1.1 billion kronor, the abolition of turn-over tax on shares 3 billion , the abolition of wealth tax on working capital 300 million and the reduced tax limit 300 million. The problem with the above tax cuts were, as Isaksson pointedly remarks, that they concerned only few people and that they did not reduce the total tax burden in a decisive way for the majority of Swedes. The abolition of the wealth tax on working capital concerned a third of the entrepreneurs, but it yielded no great amounts in reduced taxes. The same held true for the turn-over tax on shares:shares were not much dispersed, but concerned a little number of people with capital. [132]

Measures, such as the selling of state enterprises and the introduction of waiting days for some benefits, would not yield immediate results. What remained was the recourse to small and trivial cuts here and there, in a desperate effort to begin somehow with the much promised “*systemskifte*”- or to what could be marketed as “systemskifte” to the core electorate of the Conservative party. The first announcements were stressing the need for the introduction of waiting days, for the abolition of part- pension, the worsening of adult education and the postponement to the future of the further expansion of the college education. The planned increase of the child benefit was taken back by minister Bengt Westerberg, the leader of the Liberal Party, already on 23 October. The decision was

132 Christer Isaksson, 1994, *ibid*, p. 139

justified with the arguments that there was not any money. When the social democrats and the Left party declared their opposition to the proposal for freeze on the increase of the child benefit and the populist-right wing party New Democracy declared that the government should implement its electoral promises, the government was found itself in a *de facto* minority position and faced the worst crisis only two months after its arrival to power.

In the beginning of November the government announced a measure indicating its will to open the way for the entry of private agents into the provision of public welfare services. The famous *Lex Pysslingen*, which was forbidding the existence of private actors in the day care of children was destined to be abolished. The proposition of the government will be accepted and enacted – and since the year 1992 the appearance of private providers in the welfare services will be expanded, slowly but constantly, in Sweden. On this domain, the centre-right coalition government indeed did pioneering work: it set the stage for the intrusion of private providers into the welfare services seeking profit maximization.

The same pioneering work, which can be seen as a very sensational reform , was done on the basic and secondary school policy. The expansion of the college education may have been frozen, but the government did not lose time in carrying out, in the name of the “free choice” of the parents, the expansion of the “free-school system” in the education of Sweden: schools which are run by individuals and profit-seeking joint-stock companies but which are financed by tax proceedings from the state. The great contribution of the new government’s proposal which was submitted in March 1992 consisted in that it introduced municipal subsidies to the free schools. The municipalities were obliged to pay to the free schools at least 85 per cent of what a pupil was costing in the municipal school. The sum paid by tax proceeding was called *skolpeng.* The expansion of the free schools after this law was greatly enhanced. Constantly and slowly, side by side with the public municipal schools, a “school market” with independent free schools emerged, which was supposed to satisfy better the need for free choice. Combined with the other major reform in the beginning of the 90s, the “municipalization of the public schools”, a reform carried out in 1989-90 by the then social democratic School minister Göran Persson (the future social democratic Prime Minister in the era of budget consolidation 1994-98) , this reform was going from the mid-1990s to radically transform the public education system of Sweden. In two decades the Swedish school system became (after having been one of the most egalitarian, regulated and centralized in Europe) the most decentralized, diversified and the most deregulated in Europe. Unfortunately, this did not prevent the equality in educational opportunities and, most disturbingly, the achievements of the Swedish schoolboys in international measurements (PISA, TIMSS) from considerably deteriorating. Sweden in the 1990s did not succeeded in creating the “world’s best school”, contrary to the high-flying declarations of the successive Swedish governments (both Conservative and social democratic)[133]. This honor was going to be destined to the neighbor country of Finland, whose educational reform went into the opposite direction: continued central-state control on the public schools and confidence in the central role played by the teacher in the learning process.

On November 6, the government presented the proposition for the privatization of 35 state companies, which was expected to yield ten billion kronors. But, as Christer Isaksson points out, the reasons for this decision was not primarily economic but ideological and fundamentalist. The Conservatives were attacking the state firms for being inefficient, bureaucratic in their management and wasteful. The reality seemed to be different: few state firms were presenting losses and the profitability was generally better than their counterparts in the private business and the most of them were well managed, even though some did have problems (like the ASSI after its expansion in Karlsborg). In the same month, a special unit for state- owned firms was set up at the Department of Trade and Industry in order to take charge of the management and the privatization of the state firms, The unit took charge of the half of the 35 companies.

On November 8, Per Westerberg presented the policy of the government for the small firms and entrepreneurship: lowered capital taxes and reduced employer charges, simplified laws and regulations, improved legal security. At the same time the tax minister Bo Lundgren presented the proposition “ *Tax Policy for Growth*” with a proposal about reduced tax on wealth and on capital, reduced tax on sales of shares and savings in capital security.

On November 12, the government confirmed the estimations that the goal of savings will amount at 15 billion kronor. [134]

Unfortunately for the government, the markets were far from satisfied with the declared ambitions and announcements. At exactly the same time the government plans for cuts and economies were presented, money began to storm out of Sweden. During the three weeks, which followed up to

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For a detailed account of the negative and disappointing effects of both the municipalization and the free school reform of the school system – both of them conducted in the name of “freedom of choice” and of “diversity”- one can read the very illuminating book of the Swedish educator Per Kornhall, 2013, *Barnexperiment. Svensk skola i fritt fall [Making experiments with the Children. The Swedish School in Free Fall.*], Leopard Förlag, Stockholm, in which the reasons for the disappointing results - after the implementation of the reforms - are clearly shown and documented in a convincing way.

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Chsrister Isaksson, 1994, *ibid,* p.145-146

December 1, 26 billion kronor disappeared from the currency fund of the Riksbank. The time of the high- flying declarations for the new government was suddenly over. The first proposals for economies and reduced taxes not only failed to provoke enthusiasm in the markets, but on the contrary a capital flight was triggered. The markets did not appreciate all that and opted to exit. The face- to- face with the prosaic and hard realities and the severe judgment of the markets about the serious situation of the economy had arrived. Surprisingly, the Bildt government took it incredibly lightly and opted for sticking to its policy agenda.

II. " *Vår regeringe bedriver ingen veckopolitik*" ("*Our government does not pursue a week policy"*) - or How the centre-right coalition government remained indifferent to capital outflows and speculative attacks on the Swedish krona

Only some weeks after the new government took over, a centrally placed bank director informed the Ministry of Finance that the banking sector was a ticking bomb. The critical situation of the banking sector (at that time only the critical condition of the state-owned Nordbanken was known to the public, a fact which permitted Bildt to deny the existence of a banking crisis, by insisting that there existed only a Nordbank crisis) was largely a consequence of its involvement in the real estate market and the crash of the *Nyckel* financial company. The downward trend in the real estate market was beginning in Autumn 1991 to turn into a free fall, when the drastic reduction of the inflation rate, the high interest rates and the drastically reduced tax allowances for mortgages gave to the fall in real estate values a snowball effect. In 1992 a quarter of the real estate firms were bankrupt and the bankruptcies in the real estate sector resulted in heavy credit losses. The credit losses during 1990 were 20 billion, during 1991 amounted to 50 billion and for 1992 a man spoke about an equally high figure. In November, a serious development took place: a Swedish bank, the Första Sparbanken (First Savings Bank) , announced that it was on the verge of bankruptcy and that its main owner was in need of state help in order to be able to fulfill its obligations towards its creditors. [135]

The bourgeois coalition government was so obsessed with reducing the taxes on wealth, inheritance, grants and stock operations, that it persisted in not paying the due attention to the impact of those tax cuts on the budget and on the increasing budget deficit, which the bad state of an economy in serious contraction was considerably worsening. Göran Persson, the future social democratic Minister of Finance and Prime Minister during the years of the "budget consolidation" is correct when he points out that the new conservative minister in charge of the tax policy, Bo Lundgren, raised some income taxes and thereby tightened the demand but at the same time lowered the capital tax and in this way he encouraged savings. A backward- looking economic policy, out of tune with the current state of the economy, led to reductions in state revenue, while the state expenditure increased in an economy in recession. [136] The markets, far from being impressed by the announced tax cuts and saving proposals, were rather beginning to be extremely worried about the state of the budget. It was not the reduced taxes that Sweden really needed but a better balance in the economy. The mistrust of the markets were going to become manifest with successive currency crises and currency outflows. In December 1991, only three months after having come to power, the first serious signal came: the Finnish currency, the marka, devalued and just few time after it the first important currency outflow from Sweden occurred:

" During the first crisis, on December 5 1991, Riksbank raised its lending interest rate with six per cent to 17.5 per cent , shockingly much according to the measures of the time. The currency outflow amounted to 42 billion. It was three times as much as the one during the crisis of October 1990. […] The next time the Swedish krona was attacked was at

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Carl Hamilton, Jan Rolander, 1993, *ibid,* p.63

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Göran Persson, 1997, *Den som är satt i skuld är icke fri. Min berättelse om hur Sverige återfick sunda statsfinanser*. [*Who is indebted is not free.My narration on who Sweden put again its public finances in order*] , Atlas, Stockhlom, p.37

the beginning of April 1992. Only in one day 22 billion fled the country."[137]

The first interest rate shock of the new government was already a fact. While the Chairman of the Riksbank, Bengt Dennis appealed to the leader of the *Ny Demokrati* to show a responsible attitude and to support the government in difficulty, Carl Bild felt confident enough to assert an December 3, "*The markets believe in me.*" And in order to draw political benefits from the political crisis which erupted after the refusal of the Ny Demokrati to support the proposal for taking back the child benefit, he very conveniently attributed the market turbulence and the interest rates hikes to the coming discussion in the financial committee of the parliament and made an appeal to the Ny Demokrati to support its government on this issue.

In a press conference the Chairman of the Riksbank, Bengt Dennis on his side stated that 26 billion kronor ran out of the country since min-November. As the main reason he identified the economic crisis and the strong devaluation in Finland. The international investors were making no distinctions between Finland and Sweden and were bundling together the Nordic countries. Other reason were the losses of Danish, Swedish and Norwegian banks and an expected interest raise increase in Germany. He pointed also to internal reasons: basically the decision of firms to move money out of the country. The government was also bearing a responsibility, but he carefully avoided to elaborate more on this point by attributing the problems to the insecurity reigning over the possibility of the government to pass its policy through the Riksdag.

The immediate reaction of the Bildt government to the first "interest rate shock" was to announce a new program of economiess and cuts amounting to seven billion kronor. Finally, on January 10, 1992, the day of the presentation of the Budget Statement by the government, the complementary package was containing an end to the state contributions to the "emergency" fund for companies in difficulties, two waiting days and raised employer charges. Nothing could hide the fact that the package was imposed by the markets and the Riksbank and that the government were pushed with the back on the wall.

What conclusions drew the new government from the first currency crisis and the ensuing interest rate shock? Bildt explained the distrust against the Swedish krona by supporting that the markets were desiring a tighter fiscal policy and that interest rate increases were necessary in order to show steadfastness. The fact that the interest rate shock happened, as Carl Hamilton correctly points out, so quickly after the arrival of the new government, although this government could not possibly be accused of underestimating the importance of the fight against inflation, should have prompted the

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Jan Elmbrant, *ibid*, p.291-292

government to more reflection and to a change of its order of priorities. Doing this would have meant that the government was showing the necessary flexibility and perceptiveness in view of the critical condition of an economy in a deep recession by adjusting its policy priorities to the changed reality. But, Bildt and Wibble drew the exactly opposite conclusion: they thought that the Finnish devaluation and the interest rate shock were clear proofs that they were far more right in their assessments than they initially thought and that the course should be kept unchanged: the norm had to be defended and the fight against inflation had to be intensified. [138]

In order to perceive what kind of consequences the interest rate shock of December on the households and the small and medium-size enterprises had, it is necessary to point out that the banks raised the margin between deposits and lending with 0.65%. Since the beginning of 1989 the banks had raised the interest rate margin for private clients by 2.5% . Estimated in pure money this meant a surplus income of 13 billion kronor. It was the huge credit loss that had now to be covered. That the banks chose exactly the households has an explanation: the competition was weakest on the private market. But also firms, especially small and medium size ones, which were unable to be financed via the market or abroad, were forced to pay: for the firms the margin had been raised with 1.7 billion since 1989. The surplus income amounted to 4 billion kronor.[139]

The picture of the interest rate burden becomes even clearer when one takes into account the various components of the bank interest rate. As Hamilton and Rolander again point out, after the pegging of the Swedish krona to the ECU and the collapse of the real estate market, the bank interest rate was consisting of four components: On the bottom, as the first component lay the *interest rate fixed by the Deutsche Bundesbank*. The second component was the *devaluation premium*, the compensation for the risk that the government might, however, devalue the krona. The third component was the *excess interest rate charge* (*överränta*) by the banks for covering the credit losses and the fourth was the *normal interest rate marginal* in the banking system. The great misfortune for Sweden was that the first three rate components were considerably rising at the same time the economy was in a deep recession. The horror-scenario for speculators on the real estate market became suddenly reality: the inflation fell and the interest rates rose- at the same time. [140]

Given the dramatic situation resulting form the real interest rate shock one could expect that the

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138 Carl Hamilton, Jan Rolander, 1993, *ibid,* p.65

139 Carl Hamilton, Jan Rolander, 1993, *ibid,* pp.65-66.

140 Carl Hamilton, Jan Rolander, 1993, *ibid*, pp.65-66

government in office would sketch and put into action a strong and coherent program aiming at bringing down the interest rates. Sweden, as Hamilton and Rolander remind us, was in its second year with negative growth rate. The real interest rate should have been zero. It was, instead, eight per cent. That the deplorable predicament of the financial sector was going to have a devastating impact on the real economy, the employment and the demand was self- evident and easy to be perceived. But for the Bildt/Wibble duo this hardly mattered: from the way they reacted to the December interest rate shock one can draw the conclusion that they had not the intention of bringing about actively a fall in the interest rate. *The interest rate would fall by itself, when everyone would perceive that the government was serious in its intentions.*[141] The fact that despite the cuts in the public sector and the economies announced in the draft budget the interest rates did not fall seemed hardly to bother them. The government was determined to keep implementing its system-changing mission by rejecting any measure which would provoke the impression that it succumbed to the temptations of an accommodating policy.

The same incapacity to correctly assess the seriousness of the economic situation was shown in the case of the estimated budget deficit. The Finance Minister estimated for the fiscal year 1992/93 the budget deficit to be at around 70 billion kronor- an estimate which was considered by circles outside the government as being far too optimistic, 180 billion being considered to be far more probable. Wibble was irritated that her own estimates were being put into doubt already before the fiscal year had begun. However, only few months later, in the critical spring months of 1992, Wibble was going to revise her initial estimates by putting the expected budget deficit at 100 billion.[142]

On December 16, the government commission on competition announced that in the municipalities and the regions free competition was going to be introduced. Two days later the government was beginning to remove the social democratic members from the directory bodies of the state companies in view of the planned privatizations. The effort to launch the privatization program was- together with the norm-based fiscal policy – the other major component of the policy agenda of the Swedish Conservatives. It was high time that this program was implemented- even under the most unfavorable economic conditions- or perhaps, exactly because of them.

On the Christmas evening of 1991 one hundred days were completed since the access to power of

141 Carl Hamilton, Jan Rolander, 1993, *ibid,* 66-67

142 Carl Hamilton, Jan Rolander, 1993 (1998), *ibid*, p.67-68

the new government. The provisional balance sheet was gloomy and did not bode well: conflicts in the government with the Center Party, a threat (which was taken back) to leave the government in case the tax scales were not corrected, a crisis with the party of *Ny Demokrati* (a crisis which was surmounted by Bild by mobilizing all of hispersuasion powers) and a capital flight accompanied by an interest rate shock.[143]

However serious the state of the economy and however unfavorable the conditions for the implementation of its policy agenda might have been, the turbulence of the last months of 1991 were only the first act of what was going to come. In the Spring the situation would deteriorate rapidly. Already in April Anne Wibble was forced to revise her prognoses about the budget deficit. It became now evident that the deficit in the state budget would be 100 billion- instead of the initially estimated 70 billion. She was going to revise her prognoses five more times in the near future. For the outside experts and commentators it became even more clear that Wibble was on the brink of losing control of the state finances.

The situation of the banking sector was becoming even more alarming. In May, the government was forced to buy out the Nordbank- in spite of an earlier capital injection in the autumn 1991- and to administer a further capital injection: this time 10 billion kronor (in the chapter about the financial and banking crisis we shall have the opportunity to take a closer look at the eruption and the evolution of the banking crisis) . Bildt, however, was adamant in his assertions that *“ we do not have a financial crisis, but only a problem with the Nordbank*”. The fact that the Nordbank was a state- owned bank – and a one which incarnated the social democratic ambition to act as a counter-weight to the two big private banks, SE- Bank and Handelsbank- was making Bildt all the more ready to stick to its assertion- clearly implying that the financial troubles were a result of the mismanagement of a state bank. Prognoses about the aggregate credit losses were varying, but no one doubted that they were big. Professor Johan Lybeck made a prognosis which estimated the total losses between 150 and 200 billion kronor. In the stock- exchange the shares of the banks were in free fall. The high interest rates policy during 1992 was demolishing even the fresh parts of the banking system. And while an orgy of rumors circulated in the markets about what would happen in case the credit system would stop functioning, the Conservative Minister in charge Bo Lundgren refused that the credit system was in risk and he did -consequently – nothing at all. [144]. When in the

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Christer Isaksson, 1993, *ibid,* pp.148-149

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Carl Hamilton, Jan Rolander, 1993, *ibid,* pp.68-69 early summer the SE- Banken announced big credit losses, it became clear that the ideologically convenient assertion that *" there is only a Nordbank* problem" was untenable and the reality of the financial crisis much more complicated and alarming.

In Spring 1992 the whole picture of the economy was the following: the industrial sector was staggering under the burden of high real interest rates, the export industry was unable to find markets for its products because of the over-valued krona, the Swedish credit system was in a serious trouble, the number of bankruptcies was rising, the open unemployment was equally rising, the prognoses made by the Labour Market Board (AMS) were pointing to mass unemployment and, as far as the international economy was concerned, some help from abroad in the form of an American economic revival or a German interest rate reduction was not in sight. And on top of this: In the beginning of April 1992 a new currency crisis took place. In just a day 22 billion fled the country[145].

This depressing picture should have prompted the government to more reflection, to a reconsideration of the policy pursued and the order of priorities. As Elmbrant observes, there were plenty of clear indications for the more than critical situation of the economy that the government should have taken under serious consideration: " *There was much in the general economic picture in the late spring and summer 1992, which should have prompted reflection and humility: the currency outflows' increasing size, the galloping budget deficit and the credit losses of the banks.*"[146] Under these conditions and given that the inflation, the primary goal of the government, were running at 2 per cent, the government was *de facto* obliged to respond to some serious questions, which inevitably arose : was it really the case that the inflation, at the rate of 2 per cent, was the great enemy to be fought? Was there a plausible trade- off between the effort to break the long-term inflation expectations and the serious damages to which the Swedish economy was now exposed to? The government refused stubbornly to put to itself these questions and to reconsider its economic policy in view of the radically changed since 1990 economic reality. Committed to the pledge of a "system-change" and clinging to a norm- based policy – in fact, Bildt tried to implement the advice given to him by his economic advisor Lars Jonung to the full by sticking to them in the most inflexible way – the government stubbornly refused to change course and to tackle pressing short- term problems which could bring about a fall in the interest rates. In fact all the measures

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145 Jan Elmbrant, 1993 (2005), *ibid*, p.292

146 Jan Elmbrant 2005, *ibid*, p.301

taken by the government and announced in the budget were further worsening the critical economic situation (tax breaks which were increasing the budget deficit) and were pushing the economy deeper in the recession.

The spring events were the last chance to take notice of the real nature of the economic situation and to revise the order of priorities. The opportunity was missed. In the summer further events were going to come about and speed up the slide: in June the Danish electorate rejected the Maasrticht Treaty and in July the Bundebank rose its interest rates. Already in August Sweden was ripe for the most dramatic currency crisis. Again the government showed itself to be out of touch with reality and to be totally unable to perceive how serious the situation really was. On the weekend 22-23 August- and while the leading liberal Newspaper *Dagens Nyheter* was urging the government to seek the help of the social democratic opposition- the government meeting at Harpsund, the summer seat of the Swedish government, not only did not decide some new emergency measures, but on the contrary, Carl Bildt announced to the surprised journalists gathered on the steps that the "*course stays firm, the economic policy stays firm"* . He went even further in an interview to the Kanal 1's emission Aktuell where he did not hesitate to show his characteristic self- assurance once again: " *We have control over the economic policy, yes we have it. There is no doubt about it. We have a far better control on the economic policy than Sweden ever had for a long time, and we see it also in the fact that the trust began to come back."*[147]

On Monday morning and while the market interest rates went upwards and the Index of the stock-exchange market fell with four per cent, the Finance Minister expressed the view that the markets were overreacting and very characteristically asserted in an interview to the *Ekot* and *Rapport* that *the government did not pursue a week policy which is adapted to the rankings of the currency market and that no crisis package was to be announced.*

The Bild government had trapped itself into a deadlock. The time of reckoning had come. And in September it was going to be transformed into an unparalleled thriller with successive capital flights and interest rate shocks, culminating in the unthinkable 500% rate decided by the Riksbank on September 16. The stubborn and desperate battle for the defense at all costs of the sacro-sanct fixed exchange rate of the Krona had began. The costs were going to be very heavy indeed.

III. "*When the Central Bank's interest rate hit the roof*": the monetary crisis of September 1990s – The "crisis agreements" between the Conservative government and social-democratic opposition and the

147 Chrsiter Isaksson, 1994, *ibid*,

end of the fixed exchange rate of the krona

The hopeless and futile defense of the exchange rate of the krona in the dramatic period September – November 1992 , undertaken at an exorbitant price and at a tremendous financial (and real) cost, was the culmination point of successive currency crises and the final point of an economic policy which was obsessed with the fixed exchange rate as the sacro-sanct means to acquire credibility for a policy aiming at demolishing the much abhorred "sclerotic" social democratic Swedish Model. The Bildt government has received in the previous years successive signals that the markets did not consider the current exchange rate of the krona to be realistic and the economic policy pursued to be in line with the fundamentals of the Swedish economy- and the currency speculators invested a great deal of money in this belief and gained enormous profits from the stubborn insistence of the Swedish government (and of the Swedish political system in its entirety) upon defending the value of the Swedish krona. That Bildt and Wibble had reached the point of believing that *"the sky is the limit*" in defending the korna cannot come as a surprise. What, on the other hand, needs to be underlined with emphasis is the fact that Bildt did not monopolize this obsession with the fixed exchange rate of the krona, but *that this obsession ran across the whole spectrum of the Swedish political system*- the social democratic party included (let us not forget that the fixed exchange rate was an accomplishment of their last year in power). That the Bildt government was decided to defend an overvalued krona was only the culmination point of a systemic conformism of opinions around an issue which assumed quasi-religious dimensions and was deemed so sacro-sanct as to treat anyone with a different opinion on this issues as a heretic. But before making the point for this view, let us take a closer look at the chain of events which inexorably led to the floating of the krona decided on November 20.

The *strictu sensu* crisis was set in motion in Summer and the triggering event was the No voted by the Danish electorate to the Maastricht Treaty and the decision of the Bundesbank to raise its leading interest rates. It was only a matter of time before the crisis would reach Sweden, which already in the nine previous months had experienced two serious currency crisis with interest rate increases: one in December 1991 and a second one in April 1992. During the summer 17 billion kronor fled Sweden and the short- term interest rates rose between three and four per cent. [148]. The September crisis began in fact on Monday, 24 August after the fruitless meeting of the Swedish

148 Bengt Sundelius, Eric Stern, Fredrik Bynanter, 1997, *Krishantering på svenska [Swedish Crisis Management]*, Nerenius och Santerius förlag, Stockholm, p 119

cabinet in Harpsund and the statement of Bildt that " *our course stays firm*" and the even more sensational statement of Wibble the next day that " *our government does not pursue a week policy which adapts itself to the quotations on the stock- exchange market*": the markets were waiting for a package of immediate crisis measures, Bildt and Wibble saw no reason to come up with such a crisis package. The reactions to this reluctance to admit the obvious did not take much time to manifest themselves.

The whole crisis process should be divided into two periods : a) the first one begins on August 26 and close with the opening of the Riksdag on October 6: it's the most dramatic one punctuated with successive European and Swedish currency crises, the explosion of the over-night interest rate of the Riksbank to 500 per cent on September 16 and the two crisis packages on Sunday 20 September and on Wednesday 30 September which were agreed upon between the Centre-right coalition government of Carl Bildt and the social democratic opposition and were meant as consensual responses to the market turbulence. The second one begins on 12 November with new massive outflows of capital and ends on Thursday 19 November, when the Swedish krona begins to float after an aborted effort on the part of the government to bring the social democratic party to agree on a third crisis package. This time the chain of events is far less dramatic, the media coverage far less sensational and the reigning mood giving the impression that both the leading circles of the Swedish industrial and financial circles and the government- Riksbank were resigned to the unavoidable end; the end of the fixed exchange rate of the krona.

The surprising refusal of the government to take emergency measures provoked already the next day, on August 26, turbulence on the markets leading the Riksbank to raise the interest rate from 13 per cent to 16 per cent. Bildt is obliged to have its first contacts with the social democratic leadership in order to explore the possibility for an agreement across the political blocks. The days before both Carlsson and Allan Larsson spoke favourably about the necessity of a political consensus under the condition that the government will give up unfunded reforms like the child care benefit and tax cuts for the self- employed businessmen. [149]

On September 8, Finland succumbs to the speculative attacks and let its currency, Marka, float. A flight from the krona begins. The Riksdag decided more than ever to defend the krona, raised again its discount rate with 8 per cent to the very high level of 24 per cent. What mattered now for the Riksbank was that the "Finnish contagion" had to be prevented from expanding to Sweden.

On the next day, on September 9, the Riksbank raises again its rates- now to the unbelievable 75 per

149 Bengt Sudelius, Eric Stern, Fredrik Bynander, 1997, *ibid*, p.111

cent. Both Bild and Wibble state publicly that *the sky is the limit for the defense of the krona.* The efforts at an understanding with the social democrats were continued and intensified.

On Monday 14 September, two major events took place: the Italian lira was devalued and the Deutsche Bundesbank announced a reduction of its leading interest rate. The Riksbank reacted with a reduction of its interest rate from 75 per cent to the 20 per cent. Bildt and Wibble speak publicly about a program of cuts and economies making it dependent on an understanding with the social democrats. When on the next day new currency outflows began to take place, the government decided on a crisis meeting to begin seriously and officially the first contacts with the social democratic opposition. The social democrats delivered their first letter stating the conditions under which a co-operation with the government would be possible.

Wednesday 16 September is the day when something surreal happened. After having raised again its rate at 75 per cent and after new outflows had began at lunch time, the Riksbank raised its rate to the unbelievable 500 per cent. Great Britain announced its exit from the European Monetary System. Unwavering in their determination to defend the krona, the representatives of the Swedish parties in a meeting reiterated their support for the defense of the krona.

The immediate political result of the 500 per cent interest rate was a communiqué released by Carlsson and Bildt which stated that *talks are under way between the government and the opposition aiming at a crisis agreement for making possible to defend in the long-ran the Swedish krona's value and to strengthen the Swedish economy. It is our common belief that such an agreement is necessary.*

The road to the first crisis agreement were full of obstacles which remained to be overcome. The second thoughts of the government and the temptation to drag the Ny Demokrati party in the negotiations and in a possible cooperation infuriated the social democrats which in a quasi-ultimative way demanded that the government should choose partner. On the other hand, the social democrats made it the previous day plain that no agreement can be reached without the government's renouncing unfunded reforms such as tax cuts and the child care benefit- a reform demanded vehemently by the small Christian democratic party of Alf Svensson. If economies and cuts were going to be decided- and the social democrats were impressively easily resigned to the fact that the coming crisis package would contain cuts in public expenditure - then the child care benefit was not going to be spared.

The negotiations seemed to have resulted in a deadlock: the personal relationship between Carlsson and Bildt during the negotiations continued to be particularly frosty and difficult, some close collaborators of Bildt went as far as to hang a label, in the midst of negotiations, on the wall of a room in the government building of Rosenbad with the inscription “ zone free of social democrats” which the social democratic delegation took notice of at it entered the room of negotiations . The whole process would have ended in failure were it not for the willingness of the Liberals of the Folkspartiet of Bengt Westerberg to overcome the obstacles put by the Conservatives and to persuade the social democrats to remain at the table of the negotiations.

Finally after having overcome the mutual distrust and found a formulation about the child care benefit acceptable to the Christian Democrats which opened the possibility of its implementation in the future under more favorable circumstances, the first crisis agreement was announced on September 22, Tuesday. It contained cuts in the public expenditures of 28 billion kronor – most of them in the health insurance and in the insurance against work accident (reduced replacement ratio) , as well as expenditures in the pension system (reduced pension level), cuts in defense and in the development aid – and tax increases at 10 billion kronor. Energetic measures on the labour market policy were also agreed. On the question of the privatization of state enterprises and of real estates a stop was announced and , as far as issues of worker rights were concerned, any move was going to be done after prior consultation and in a spirit of consensus. Planned or previously decided tax cuts (reduced tax on capital and wealth, as well as on self- employed entrepreneurs) were annulled.

On Thursday 24 September the agreement was supplemented with a guarantee for support for the banking sector and the establishment of a “bank emergency committee” which was going to take charge of the distressed banking sector. Up till then the government stubbornly refused to speak of a :banking crisis” preferring instead to speak of a crisis of the state banking sector (represented by the Nordbank) . It became evident, however, that the whole banking sector (including the main private banks, the SE- Banken and the Handelsbanken) were exposed to the red loans connected to the collapse of the real estate market.

The social democrats clearly accepted cuts in the social security system which they previously rejected. They were satisfied however that they had put a stop on system- changing measures of the government such as privatizations and tax cuts for the rich. Whether the announced crisis agreement would be able to appease the markets and to put an end to the currency outflows remained to be seen.

Already on Monday 21 September just a day before the final announcement on the crisis agreement, the Riksbank reduced its discount rate to 50 per cent. On Monday 28 September the interest rates were further reduced to 40 per cent. However, currency outflows continued to happen: it soon became clear that the first crisis agreement was not enough for appeasing the markets. Discussion began for a new agreement with the social democrats and Wibble contacted Allan Larsson in order to examine the possibility for a new emergency package.

This time the negotiations were fixed on the possibility of emergency reforms aiming at reducing the costs of the industry: the so-called ‘internal devaluation” was put on the agenda of the negotiations as the sole measure for strengthening the competitiveness of the Swedish industry- given the fixed exchange rate of the krona. The Chairman of the Riksbank Bengt Dennis was categorical in his assertion that a political effort had to be made in order to strengthen the competitive force of the export industry- and to save the value of the krona, of course. He demanded a drastic reduction of the employers’ contributions with at least five per cent, which had also be completely financed and he demanded that such a reduction should be supported by the social democrats in order to find support in the Riksbank. [150]

After a series of talks and negotiations and a tete-a – tete meeting with Bengt Dennis with the social democratic delegation in order to question him on the effectiveness of the measured demanded by him, on Wednesday, September 30, the second crisis agreement took its final shape: employers’ contributions were reduced by 4.5 per cent January 01, 1993 and two days from the paid holidays were taken back. The financing was going to happen by raising the VAT and by reducing the basic allowance in the income taxation with 2500 kronor. Commenting the impact of those reforms on the costs and the competitiveness of the industry the final document of the second crisis agreement reads as follows:

“*These decisions are going to reduce the costs of the industry with almost 4 points for the next year. This brings about a substantial improvement in the Swedish competitiveness. The improvement happens over and beyond the one which now takes place through low Swedish wage increases in relation to our main competitors and a quick improvement of the productivity.*

To this is added the fact that the competitiveness is strengthened with 3 per cent by exchange rate changes for other currencies the latest period.

On the whole this implies that the competitiveness of the Swedish industry for 1993 is improved with 11 per cent in comparison to 1990.”[151]

The aims and the nature of the second crisis agreement are crystal-clear and need hardly to be commented upon further: in order to strengthen the competitiveness of the Swedish industry and given that giving up the fixed exchange rate of the krona was, even now, unthinkable for the whole

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150 Christer Isaksson, 1994, *ibid,* p. 240

151 Christer Isaksson, 1994, *ibid,* p.p. 240-244.

of the Swedish political system, the only means possible was to carry out a drastic internal devaluation by reducing the costs of the industry and by financing this through measures directed against consumption. While in the first crisis agreement the emphasis was put on reducing the budget deficit by cutting the public expenditure and raising the state revenue, the emphasis in the second crisis package is put on strengthening the competitiveness of the industry by means of reducing its costs, i.e by means of internal devaluation. Finance minister Anne Wibble was now convinced that the markets in the turning point to October were demanding that the competitiveness of the Swedish industry had to be improved- the very same Anne Wibble, who only a month ago stubbornly refused to take notice of the market fluctuations and who assured that the government was not pursuing a "week policy" which adapted itself to the quotations of the markets, now considered herself able to know what exactly the markets wanted.

As for the social democrats, having opted, as Isaksson observes, for defending the fixed exchange rate of the krona during the 1980s and having pegged the krona to the ECU in May 1991, they were now compelled to continue the struggle. It occurred, however, to them that the second crisis agreement had a negative impact on an economy in recession: Allan Larsson expressed his opinion that the package was directed against the consumption- something which could run counter to the revival of the economy. In the social democratic press and in the trade- union circles critical comments on the content of the second agreement were made. This time the agreement was more difficult to be "swallowed" or to be presented as being in the interest of the vast majority of the working people. Having, nevertheless, been a co- architect of the second crisis package, they tried to exert all their influence on the government in order to arrange the implementation of the measures decided in a timetable which would minimize the recessionary impact of the measures and the unfavorable consequences for the consumption. The government wanted to implement the measures immediately, the social democrats tried to displace some of them into the next year.

The importance of the two crisis agreements was undoubted. After them Sweden was governed by two kinds of governments, as Christer Isaksson observes: the centre-right coalition government which was the result of the 1991 elections and a "government of national unity" which set the framework for the economic policy and took the important cross- party political decisions (only the Left Party denounced the second crisis agreement and was standing *de facto* outside the government of national unity) under the conditions of economic emergency reigning in the country. Ingvar Carlsson in his memoirs supports that the crisis package between the government and the social democrats saved practically the banks and the credit institutes from collapse. "*The state came out with significant guarantees so that the banks will fulfill their obligations. A special emergency bank* *was instituted with (the social democrat) Odd Engström as chairman.* Carlsson judges the institution of this bank as the most decisive and lasting effect of the crisis cooperation. And he concludes that "*the trust for the system of payments was reestablished quickly and the interest rates fell. The broad political support gave weight and strength to the agreement.* "[152] Undoubtedly the complementary part to the first crisis agreement concerning the measures of protection and the state guarantee for the banking sector was the most important part of the package and the most successful, as it was going to be become evident, since with the establishment of the committee for the support to the banks, the so-called *banksstödsnämnden*, the preconditions were created for putting in order the distressed banking sector. Without it neither the mess in the state-owned Nordbank nor the losses of the private banks (Gota Bank) would have been successfully handled.

The main hope, however, of the architects of the second agreement that the currency turbulence would be terminated had been short-lived. During the month of October the situation seemed to have been stabilized and the calm to have returned in the currency markets. Immediately after the agreement the Riksbank lowered its marginal rate from 40 to 24 per cent and a massive inflow of currency occurred. It remained to be seen how long and durable this calm would be and whether the stimulation of the competitiveness of the Swedish industry by means of internal devaluation would convince the currency speculators that the fixed exchange rate of the krona was viable.

The belief that the fixed exchange rate of the Swedish krona should be defended was reiterated once again at the opening of the Riksdag on October 6, for the winter period. In the declaration of the government the participation of Sweden in the European monetary union is declared to be an essential precondition for the well-being of Sweden[153].

The subsequent developments were going to make it plain that the markets were not at all convinced about the sustainability of the rate of the krona- despite the relative calmness during the whole of October. The situation began again to become alarming in November, the month when the second phase of the drama was going to unfold itself- and the final denouement to take place.

On November 12 and 13 and after a time of calm new massive currency outflows began to take place. The representatives of the Riksbank were called to an emergency meeting in order to assess the new situation. This time the mainstream media did not seem to pay serious attention to the new turbulence.

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152 Ingvar Carlsson 2003, *ibid*, p.493

153 Bengt Sundelius,Eric Stern, Fredrik Bynander, 1997, *ibid*, p.114

A request addressed to the European financial committee on 14 November to assist financially Sweden was rejected with the argument that the krona was not tied with bilateral parities to the currencies inside the EMS but was only tied to the ECU.

The channel to assistance from abroad having been closed, the government contacted on November 17, again the social democrats proposing a further lowering of the employers' contributions. Allan Larsson did not exclude it but demanded further justification and support for such a policy measure. The social democratic Riksdag group demanded specifications and that the whole government ,and not only the Ministry of Finance, should sign the proposal.

On Thursday, November 19 the government sent a preliminary proposal to the social democratic party and waited for the response. In the morning Allan Larsson informed that the parliamentary group and the Executive Committee of the party have a joint meeting in order to decide the party's attitude. An impatient and pressed government decided to make public the proposed measures and the Riksbank raised its discount rate from 11.5 to 20 per cent and carried out extensive purchases of kronor in order to support its value. The meeting of the social democratic party delayed to reach a decision and when the American markets opened at 14.00 o' clock, Carlsson had not announced yet anything. Currency run out of the country and finally Dennis called Bildt in order to announce him that the defense of the krona had failed. Some time later Carlsson called the Prime Minister to inform him that the social democratic party could not offer its support to a third crisis package. Asked by a journalist whether this development was a defeat, Bildt responds that "*of course this is a defeat, undoubtedly and I think that one can not escape it.*

What conclusions can one draw from the monetary storm in September 1992? What was at stake during it? Was it worth the price – both financially and as far as the real economy was concerned? The answer was given already by Carl Bildt: it was a failure, since the primary goal of the whole undertaking, the defense of the exchange rate of the krona, was not attained and the krona was let float on November 19, after the Riksbank was overwhelmed by the new currency outflows and no agreement with the social democrats was reached, which could put an end to the capital flight (how lasting effects such an agreement would have is a question which is impossible to answer, but it is plausible to suppose that even in the case of a third crisis agreement the exchange rate of the krona could hardly be saved)

Before giving an answer to the question above, it would be worth mentioning the treatment reserved to Nils Lundgren, Chief economist at the Nordbanken, when he dared express in an article the view that the defense of the krona should be abandoned, if the price to be paid would be to devastate the Swedish economy. Lundgren was held generally in high esteem both because of his competence and expertise and of his hard work at the distressed Nordbank. He was also an economist standing near the social democratic party. Lundgren thought, while the crisis was unfolding itself in September, that the defense of the krona was too much fixated on the interest rate instead of attacking the underlying problems. After a meeting with the vice- chairman and the executive director of the Nordbanken, Lundgren went to his office and wrote a strongly engaged article. In the article the proposal was made that the possibility should be examined to let the krona float. This as an alternative to the possibility to shipwreck the Swedish economy. As the economic reporter and journalist Ulla Reinius (who narrates the whole incident in her excellent book about the crisis and the reconstruction of the Nordbank), the thoughts expressed by Lundgren was a kind of dynamite[154]. To discuss something else than the defense of the krona at that particular point of time was tantamount to lese-majesté. Lundgren thought it necessary to inform in advance the government that an article with this content was going to be published in the leading liberal daily *Dagens Nyheter* on Monday. The article was faxed Friday evening to the undersecretary Olle Wästberg, who by telephone said to Lundgren that he took seriously the publication of the article. But speech was free, he remarked at the same time. Wibble was notified about the article during a travel abroad.

When the article was published in Dagens Nyheter on Monday the 28 September, it was given the provocative title " *The fall of the krona is near*" with the subtitle "*It is not worse to devalue than to keep today's interest rate levels, thinks Nils Lundgren*"

The reaction from the government to the article of Lundgren were strong- and indicative of the treatment reserved even to well-acclaimed economists who dared put in question the fetish of the fixed krona. Carl Bildt refused to appear together with Nils Lundgren on TV, since this could be expected to have a – further – destabilizing effect on the krona. The economist Carl B Hamilton, then expert to Wibble, refused to sit near to Lundgren in a discussion at SNS (The Association of Studies on Industry and Society) and stated that with such friends one hardly needs any enemies. Nils Lundgren became in a night "persona non grata" because of the fact, as Reinius points out, that he as an employee at Nordbanken, he was expected to say what he said only behind closed doors. When one writes discussion articles, then one is believed to be disloyal- and he is ostracized. Nils Lundgren still thinks, informs Reinius, two years after the incident that he was treated with coldness by, among others, politicians and journalists. The bitter conclusion drawn by Lundgren merits to be

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Ulla Reinius, 1996, *Stålbadet. Finanskrisen, Penscerkraschen och Nordbankens rekonstruktion [Steel bath. The Finance Crisis, the krach of Penser and the Reconstruction of the Nordbank]*, Ekerlids förlag, Stochholm. p.178-179 directly quoted: " *Sweden is in fact no open society*" [155].

We thought it necessary to cite the incident with the "heretic" article of Lundgren in order to make plain the intellectual atmosphere reigning in Sweden about the issue of the exchange rate of the krona and to make evident the most decisive factor at play in the monetary drama of September: the quasi- religious belief of the whole Swedish political and financial system in the fixed exchange rate of the krona. It was such the strength and the stubbornness in this belief that anyone who dared express the view that the defense of the krona *whatever it takes* may have serious negative consequences was reprimanded and seen as a lunatic. The chief economist of LO, Per Olof Edin, confessed- in a seminar organized twenty-two years later about the events of September 1992 that the LO- economists came up with the totally forbidden proposal to let the krona float. " *I can say that we never, I never was so much scolded and fooled as far as up to the corridors of the Parliament. They said that the LO should put a muzzle on the mouth of P-O Edin, because I dared express totally forbidden ideas.*" [156]

It is obvious: in Sweden in 1992 a total conformism of ideas around the fixed exchange rate of the krona had been built, a conformism which not only threatened those with different views on the issue to be publicly scorned and ostracized as heretics, but also led the Riksbank and the Bildt government – with the support of the Social democratic party – to such reactions as the shocking interest rate increases to incredible levels (firstly, 12 per cent, then 16 per cent, later 24 per cent, 75 per cent and finally, the astronomical 500 per cent) The totally unbelievable interest rates increases were undertaken by the leadership of the Riksbank with the support of the whole political system in a stifling atmosphere of an iron consensus and with the goal to show its determination to defend the fixed exchange rate of the krona, was the culmination point of a policy aimed at gain credibility in the fight against inflation. The problem was that *at that particular time* the inflation was already reduced at 2 per cent and the economy was tending to be caught in the downward spiral of deflation.

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Ulla Reinius, 1997, *ibid,* p. 179

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Cecilia Åse (red.) , 2014, *När räntan gick i taket. Vittnesseminarium om valutakrisen 1992 [When the interest rate hit the roof. A seminar of witnesses about the currency crisis in 1992.]* Södertörn Högskola, Institut of Modern History, p.22

experiencing a recession brought about by very high real interest rates? As former Chairman of the Riksbank during the period 1979-1982 Lars Wohlin points out in a very informative article about the origins of the banking crisis in Sweden, after the aggressive devaluation of 1982 the Swedish government invested its political prestige in the fixed exchange rate: the assurance was given that Sweden was not going to make use of the devaluation for the foreseeable future and that the economic problems were going to be treated by other means. But this alone is not sufficient to explain the quasi-religious fervor shown in the defense of the krona in the September crisis. Another important event came about which *politically* pushed the whole political spectrum to the direction of sticking to the fixed exchange rate of the krona: the deregulation of the credit market. According to Wohlin, the social democratic government saw the deregulation as a great political success and emphasized that it was the social democratic party the one which liberalized the credit market. The Conservatives were outmaneuvered by this right-wing political move of the social democrats and as a reaction to this they clung to the policy of the fixed exchange rate of the krona, a policy which became the cornerstone in their policy. The deregulation of the credit market provoked an uncontrolled credit explosion which, according to Wohlin, was possible to be kept within reasonable limits only if the interest rates were raised, thus functioning as a brake to the demand for credit. The Riksbank would need, according to this interpretation, a freedom of movement in its interest rates policy. *Under the fixed exchange rate, however, this freedom of movement was lacking.* The transition from a regulated to a free market was a fundamental change of system which should have been accompanied by a floating exchange rate. The Riksbank did not have any freedom to raise the interest rates considerably in order to counteract the strong credit expansion. As long as there were not any expectations for a devaluation the interest rates policy was locked by the fixed exchange rates policy. Under conditions of credit expansion and given the lack of possibility to make use of the weapon of interest rates under the fixed exchange rate regime the Riksbank was unable to control an inflation caused primarily by the credit expansion- an inflation which was undermining the fixed exchange rate of the krona. When the cost crisis finally became a fact, it was too late to defend the exchange rate. A fixed exchange rate, points out Wohlin, cannot function as a norm for the monetary policy. However, the social democrats as well as the Conservatives came to regard, for the reasons indicated above, the policy of the fixed exchange rate of the krona as a cornerstone of the monetary policy. Wohlin points out that it was very surprising that the academic economists had been unable to perceive the incompatibility of the policy of the fixed exchange rate with the task of the Riksbank to control the inflation and with a healthy bank system. The debates of the economists were dominated by the so-called “norm- based policy” of which the fixed exchange rate was an essential component: with a credible exchange rate goal the wage increases would adapt themselves to the inflation of the outside world. Under the ongoing credit expansion, however, the adaptation to the foreign inflation proved impossible: the inflationary overheating provoked the cost crisis and the fixed exchange rate became objectively untenable[157].

When the centre- right coalition government came to power, it was more than ever obsessed with the fixed exchange rate and more than ever decided to defend it- whatever it takes. The fact that the social democratic government in May 1991 made the further move to tie the Swedish krona to the ECU -and, by doing it, "stole" once again the glory from the Conservatives of realizing a classic right-wing demand- may have strengthened even further the willingness of the Bild government to remain committed to the fixed exchange rate of the krona. Despite the changed conditions of the Swedish economy - in one and a half year the country had switched from an overheated economy to a rapidly disinflationary economy in recession – the policy of the fixed exchange rate had acquired the weight of a dogma capable of making the whole political system totally blind to the absurdity of defending at an exorbitant price a totally unrealistic exchange rate. When on September 16 the British government let the Sterling float the British Chancellor to the Exchequer Normal Lamont was asked why he did not make use of the same weapon which the Swedish government made, i.e of raising the interest rate to chocking levels, Lamont gave the following answer " *Yes, but we have common sense*". The religious devotion to the policy of the fixed exchange rate made, one may think, the Swedish government lose the most elementary common sense in the dramatic days of September 1992. Or, on the contrary, behind this obstinacy another motive, much more "vulgar", might have lain, a motive which the government desperately tried to conceal or did not want to admit publicly? What if behind the stubborn defense of the krona, some other interests may have been in play, which the government tried to serve as well as possible in a course against the time and knowing very well that the battle for the value of the krona was lost and what now mattered was to buy time, precisely in order to serve these interests?

This question seems to receive an answer in the interview which Wibble gave to Ulla Reinius in her already mentioned remarkable book on the crisis and reconstruction of the Nordbank. Wibble cites also the fact that the whole political system of Sweden had committed itself to never again make use of the devaluation weapon as a means of coping with the structural problems of the Swedish economy. Not to betray this promise had become for Sweden a matter of credibility especially

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Lars Wohlin, 1998, *Bankkrisens upprinnelse [The Origins of the banking Crisis]* in, Ekonomisk Debatt, 1998, year 26, nr.1, pp.21-30 important now when the country was seeking for membership in the EU.

But this promise was given also to the Swedish market and firms and to Swedish individuals- and the borrowing of the Swedes abroad in foreign currencies grew relentlessly. The Swedish debts in foreign currency, especially after the abolition of the exchange controls in 1989,doubled from 300 billion in the first quarter of 1989 to 603 billion to the second quarter of 1992 . A great part of the Swedish big companies and of the credit expansion of the banks during the second half of the 1980s was thus financed by loans in foreign currency. The Nordbank had 70-80 billion kronor of its balance sheet in borrowing from foreign banks. A devaluation, points Reinius out, would have provoked not only exchange rate losses in the banks, it would have hit also the banks in an indirect way by damaging the creditworthiness of the loans of their clients. This would hit the balance sheets of the banks, which were already full of credit losses. The consequences would be rising interest rates and increasing financing problems for the banks. [158] In the words of Wibble herself : “If the exchange rate had collapsed already in August, without any crisis packages, this would have led to a catastrophe. A devaluation then would have hit straight into the balance sheets of the banks. Now there were many who took the time to convert their foreign debts to Swedish kronors, before the rate of the krona was let free in November. In this context one needs to bear in mind the fact that the Swedish government during the 1980s said that it was free of risk to borrow abroad. No devaluation was going to take place again, 1982 was the last time and after that we would take care of our problems. Both firms and banks had borrowed heavily abroad.[…] Those who support that we should have devalued when England did it, did not considered this fact very seriously.”[159]

The statement made by Wibble is very revealing: the stubbornness with which the Bild government tried to defend the exchange rate of the krona cannot be exclusively attributed to the ideological zeal of pursuing the norm-based policy and stretching it to its utter limit, but also to very material and real interests represented by the big firms and banks which in the past years, and on the assumption that the Swedish state will not devalue, had borrowed loan in foreign currency. A devaluation of the Swedish krona at an earlier phase and before finding the necessary time to reconvert these loans into loans in kronor would have entailed serious losses for both the creditworthiness of the clients of the banks and for the already exposed to serious losses balances of the banks themselves. The almost incredible discount rate increases decided and carried out by the

158 Ulla Reinius, 1997, *ibid*, pp.172-173

159 Wibble is directly cited in Reinius, 1997, p.175

Chairman and the Board of the Riksbank during the month of September in full understanding with the government, the opposition and the academic economists, cannot be solely understood as a dogmatic insistence on the norm-based policy but also rested on the perception that the Swedish industrial and banking elite were going to suffer severe losses. As Reinius observes, a giant conversion of Swedish foreign loans was carried out during the short autumn months. The Swedish Riksbank made use of its currency reserves in order to help some big firms in their process of loan conversion. Only the non-informed , the private persons, the small firms and those who refused to believe that the government would give up – or would be forced to give up – remained with their foreign loans. Exactly these groups, which differently from the big firms were the most fragile since they did not have some incomes in foreign currency, were going to pay the bill for the fall of the Swedish krona. And in a kind of rather rhetorical question, Reinius asks: " *But who dared speak open to the non –informed about that which it was forbidden to talk about?"*[160]

The price paid by this interdiction to talk about a matter which was labeled as a taboo was indeed enormous. Mass of currency went out of the country. The foreign debt of the Swedish state increased from 91 billion kronor to 300 billion kronor – something which , as Reinius reminds, was called " *the biggest socialization action in the history of the country* – the expression belonging to Anders Isaksson from the Moderna Tider in 1994. The real economic cost of this "socialization bill" was for the Swedish budget and the real economy devastating. As Carl Hamilton points out, the 500 per cent interest rate which was demanded in order that the banks will find the necessary time to cross the bridge, was not cost- free . The shock increases of the over-night interest rate brought about mass unemployment, death of small and medium size firms and budget deficit[161].

Even the two crisis packages, which hit directly the social expenditure and the consumption, can hardly be perceived as being beneficial for an economy whose main problem was the growing burden of households and their drastically curtailed demand. They may have been concocted as a means to appease to the markets and to show the determination of the government to defend the krona – even by " touching the sky", but one cannot escape the impression that not only they failed to achieve that to which they were destined – i.e the stop to the capital flight and the preservation of the krona- but they rested on a tragic misconception: that the markets and the speculators wanted cuts and economies, while it should have been obvious that what counted more for them was the

160 Ulla Reinius, 1997, *ibid*, p. 175.

161 Carl Hamilton in a column of the daily Aftonbladet, 30/10/1996

self- evident fact that the exchange rate of the krona was totally unrealistic and was doomed to be abandoned. The two crisis packages were resting on a totally unfounded assumption which perfectly fit the government's ideological agenda : that the monetary turbulence as the result of a lack in credibility in the fight against inflation or in the extravagance of social expenditure. In this sense, we think that Carl Hamilton has a point, when he points out that "*what is often described as badly-intentioned speculation can also be seen as the effort of the markets to adapt to the reality the policy of the governments and of the central bankers. The markets accommodate the politicians who refuse to accommodate."*[162] That the second crisis package resorted to the "internal devaluation" as a cure to the competitiveness of the Swedish industry was proved again to be a false medicine: the markets did not think that considerable improvement of the competitiveness of the Swedish industry could be secured without abandoning the fixed exchange rate of the krona. Clinging with dogmatic insistence to a fetish which had been undermined by a chain of mutually incompatible policy choices (deregulation, credit expansion, impossibility to raise the interest rates in order to combat the credit expansion under the regime of the fixed exchange rate, inflation and cost explosion) and trying to help the banks and the big firms in the process of loan reconversion was bound to lead to shocking interest rate hikes, which appeared so absurd, so as to give rise to the thought that the common sense had totally abandoned the policy makers in both the government and the Riksbank. Whether the effort to protect the banks and the big firms and the strong will to show determination in the effort to pursue a non –accommodating policy was worth the real economic cost is a matter of what kind of priorities one sees as most plausible in the new economic realities of the "roaring 90s". The Swedish leading political and financial circles made the choice of a policy change. They way in which this transition was brought about was far from perfect and the episode of the desperate and stubborn defense of the krona in the autumn months September- November 1992 was only the culmination point of a process which was based on fundamental policy mistakes, false sequence of reforms and false assumptions about the nature of the crisis. Even, after the fall of the krona, the monetary policy did not at all escape from the straitjacket of the non- accommodation despite the fact that a shocked country was inexorably sliding into the spiral of depression and the "Swedish model" was confronted with the first drastic cuts in the replacement rates of the social benefits and the dissolution of some basic components of its institutional construction. Before seeing what strategic option the duo Bild government- Riksbank made after the fall of the krona, it is necessary to a take a closer look at the crisis of the banking sector and the way in which it was handled and

162 Carl Hamilton, Jan Rolander, 1993, *ibid,* p.71

overcome. If there is a very interesting aspect in the crisis packages of the autumn 1992, the most successful and the most interesting one was undoubtedly the package of measures taken to put in order the distressed banks.

IV. The banking crisis in Sweden: its causes, its eruption and evolution and the way in which it was handled

From what has already be written so far about the consequences of the deregulation and the ensuing credit expansion, the causes of the crisis in which the banking sector of Sweden got involved are crystal- clear: the banking sector got involved in an unprecedented mess due to its big exposure to the real estate bubble. The orgy of lending received such a disproportional dimensions that the most elementary precautions in the lending practices were ignored, the capital reserve requirements were by-passed and the controlling and supervising organs- chief among them the Bank Inspection- had been shown totally incapable of getting a clear picture of the risks to which the banks were being exposed by lending to financial firms and to real estate institutes. Some think and say that the regulatory framework of the banking sector was out of line with the newly created deregulated credit market and unable to cope with the lending practices spontaneously created in the deregulated financial environment. According to Hans Dalborg, the new Executive Director of the Nordbank (who took over after the old board of directors had been forced out by the social democratic Finance minister Alan Larsson because of the huge credit losses) the crisis was accelerated by the explosive power which was lying in the fact that the financial firms were creditors of big loans on real estate. When the banks were lending directly to real estate institutes a capital coverage ratio of 8 per cent was demanded by the regulations established by the Riksbank and the Bank Inspection. But if the banks were lending to financial firms, which were under the surveillance of the Bank Inspection, the capital coverage ratio lay much lower, only at 1.6 per cent. In Sweden the trust of the banks was too big, because the real estate securities were seen as a full guarantee. [163]

It is remarkable that the seriousness of the financial crisis and its impact on the severely fragilized bank balances was not perceived immediately. The beginning of the financial crisis is situated chronologically in September 1990, when the financial company Nyckel went bankrupt. As Elmbrant observes, at Tuesday 25 September 1990, a bank called the finance inspection and

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163 Ulla Reinius, 1997, *ibid*, p. 68.

declared that it had not the intention of financing Nyckel: it was the beginning of the financial crisis in Sweden[164], but a beginning which conveyed only a very small idea of the worst that was lying ahead. As already said in the section about the bursting of the bubble, no one thought at that time that Nyckel was only the beginning and that the Swedish financial sector and its systemic banks was involved in an unprecedented mess due to a toxic exposure to the bubble of the real estate market. At that time the fall of the values of the real estate was only in its early phase and no one could expect the dramatic collapse of the real estate values as a consequence of the international economic downturn, the sharp reduction of the inflation and the subsequent skyrocketing of the real interest rates. In fact, as already mentioned, the first six months of 1991 were showing positive trends and created the impression that the economic situation was under control in spite of the obvious difficulties. The financial crisis became evident in all its seriousness in the summer of 1991, when the real estate market collapsed and the credit losses escalated violently. In September 1991, at a press conference the new leadership of the Nordbank (in charge since January 1991) announced that the credit losses would amount to 10 billion kronor far surpassing the initial estimates. The statement came as a shock to the market. [165]

The most obvious effect of the bankruptcy of Nyckel was that other financial firms were found themselves under severe difficulties. At 14.00 o'clock the market for the certificates of these financial firms (the so called "market certificates) collapsed. No one on the market dared invest a krona in such papers. On the other hand, not many people could perceive that the portfolios of the financial firms were containing a mass of losses which, as the time was passing by, would be thrown upon the banks.

Among those financial firms, which received loans from the banks and invested them in operations on the real estate markets was the Gamlestaden, a financial firm owned by Erik Penser, a well-known buoyant financier and gambler who was the owner of the Nobel industries and who had received huge loans for carrying out a variety of financial operations from the Nordbank , the state-owned bank- the bank which more than any other was going to be identified with the financial crisis in Sweden.

Nordbank played a crucial role in the banking crisis in Sweden. The fact that Nordbank was the first to become known for huge credit losses and it was a state-owned bank raised in the beginning the

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Jan Elmbrabt, 2005 (1993), *ibid*, p.237

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Ulla Reinius, *ibid*, p. 68.

impression that there was no banking crisis in general, but rather a limited event which bore witness to the bad quality of the state management of a bank. *"We do not have a banking crisis, we have only a Norbank problem*" was the motto repeated by Carl Bildt up until the summer of 1992, when one of the two big private banks, Skandinaviska Enskilda Bank (SE Bank) announced its first losses and especially after the events in September, when the systemic character of the banking crisis became so evident that it was impossible to be solely attributed to the bad management practices of Nordbank.

The history of the Nordbank is full of irony and drama. Irony because the social democratic government saw the bank as an essential instrument for strengthening the presence of the state in the banking sector and encouraged its vast expansion in order to constitute a counter- veiling force to the two big private banks by accepting that the bank would expand according to the conditions reigning on the banking market. Drama, because by acting as a common operator on the credit market the bank not only undermined the credit regulations but participated in the credit expansion and registered considerable losses which the tax-payers were called to pay.

Initially known as PKbank (Post and Kreditbank, from the fusion with Postbank in 1974, the bank was renamed in 1990 Nordbank after having bought up the Nordbank in December 1989. In fact, at the time of taking over the old Nordbank and, before the process of merger of the two banking entities was even accomplished, the first credit losses (amounting at 1.7 billion kronor) were going to be detected opening the process for an inquiry on the part of the Bank Inspection, which discovered further credit losses, most of them registered by the old Nordbank and, to a lesser extent, by the buyer, the PKbank.

Before acquiring the old Nordbank, (and taking over its brand name and its executive director, Rune Borneus), at the time considered as the most profitable bank in the Nordic countries, the PKbank was encouraged by the social democratic party leadership to become an important player in the banking sector by competing with the two other systemic private banks, the SE Bank and the Handelsbank. The new PKbank was an unexpectedly great player in the "voluntarily" regulated credit market by breaking often the regulations and - more aggressively than the other banks- breaking the voluntary agreements on the limits imposed on the credit suppliers[166]. As Ulla Reinius observes in the already mentioned book about the crisis and the reconstruction of the Nordbank, the PKbank was in the front line for deregulating the Swedish credit and currency market. The PKbank was in a process of strong expansion: the social democratic government was not able to socialize

166 Ulla Reinius, 1997, *ibid*, p. 15

the banks, but wanted to have insight the branch and full competition, not least with the big banks, (the SE Bank and the Svenska Handelsbank). It encouraged therefore the expansion of this bank under the conditions of the market and it saw to it that this will become the third power on the banking market. According to the statement of Kjell- Olof Feldt to the journalist Ulla Reinius, "*it was tempting for us social democrats to have a bank which was able to compete with the big capital. The leadership of the bank came to me and said that it was difficult for them to motivate the presence of the state on the banking market, if we do not become an effective competitor to the two other big banks. [..] When the leadership of the bank began to expand and to make some acquisitions, they come to the same level of profits with the Handelsbank and the SE-bank. It was also easy for the bank leadership to gain approval for the expansion in the social democratic government. […] The PKbanken would not continue to give loans only to the municipalities and to households, which was the basic activity of the old PKbank, it would become a business bank, it would become international, and for this reorientation it received the blessing of the government.* [167]

It was during this process of expansion and reorientation of its banking activities that the PKbank got embroiled into the credit expansion after the deregulation and into the real estate bubble. What finally exposed the fragility of the bank was the acquisition of the old Nordbank in December 1989. Reputed as the most profitable bank in the Northern Europe, the Nordbank surpassed SEbanken in profitability in 1989. It was a remarkable achievement, but a closer look at some basic numbers revealed that Nordbank's situation was far from idyllic: the own capital had grown much more slowly than that of the other big banks. The degree of capital coverage was acceptable, but the liquidity in 1990 lay at 2.5 per cent- which was not acceptable.

After the acquisition and before the process of the merger of the banks was accomplished, the first revelations about the credit losses began to become known. In August 1990 after an internal report had been carried out, credit losses amounting at 1.7 billion kronor were found. It was an astounding figure at the time. The Bank Inspection stepped in and took charge of the whole issue and an inquiry established that the total credit losses for the year 1990 would surpass the 1.70 billion kronor and would amount at 2.5 billion kronor. The figure in the end of the year would reach 5.2 billion kronor. [168]

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167 Ulla Reinius, 1997, *ibid*, p;16-17

168 Ulla Reinius, 1997, *ibid*, 27.

After the devastating report of the Bank Inspection the owner of the Nordbank , the Swedish state, represented by the minister of Finance Allan Larsson, decided to act promptly and decisively: the Chairman and executive director of the Nordbank, Rune Borneus, as well as the whole board of directors was forced to resign and a new Chairman, vice- Chairman and Executive Director were appointed with the mandate to radically reconstruct the bank. A process of internal reorganization and rationalization of the distressed bank was set in motion by the Chairman Björn Wahlström, a manager who was credited with the successful reconstruction of the Swedish steel industry and who was called urgently by Allan Larsson to take charge of the Nordbank in crisis despite the fact that he had not previous experience within the banking sector and did not vote for the social democratic party.

Wahlrström and his collaborators on the board of directors were immediately set themselves on the task of taking stock of the seriousness of the credit losses facing the Nordbank: the initial estimates about credit losses of 1.7 billion kronor in the report of August 1990 was revised two months later to 3 billion kronor and in the beginning of 1991, after the new vice-chairman more carefully and thoroughly, had examined the portfolio of the bank, to 5.2 billion kronor. But even this estimate was proven to be erroneous: in the beginning of September at a press conference the new leadership announced that the total credit losses would amount to 10 billion kronor.

A shock hit the new leadership, when after a very thorough examination of the credits given by the bank, the total credits offered by Nordbank to the group of the financier Erik Penser were estimated to be 11.4 billion kronor. This practically meant that in case of bankruptcy of the Penser- group the huge amount could wipe-out the bank's own capital, which at that time was at 12.3 billion kronor, and would make the task of reorganizing the bank impossible without an infusion of new capital by the owner.[169] The Penser engagement was in fact a liability by its mere size. The rules of the Finance Inspection stipulated that the engagement of a bank to a client- the so-called one-hand-engagement, must not surpass 10 per cent of the bank's own capital. The exposition to the Penser group constituted approximately 90 per cent of the capital of Nordbank in 1990. A further reason for embarrassment was that three different regional departments inside the Nordbank, without mutual coordination, gave credits to different branches of the Penser group. By a series of financial operations, which lay in a legal gray zone , Penser succeeded in interlocking the Nobel industries, an industrial complex with many workplaces and of national importance for the Swedish state (in the Nobel industries were included the arms company Bofors) with the financial firm Gamlestaden

169 Ulla Reinius, 1997, *ibid*, p.67

which was engaged in real estate operations. What outraged Björn Wahlström, an industrialist with managerial philosophy of long-term gains and hard work, was that Erik Penser linked, in a highly questionable way, – by placing in the Nobel industries 49 per cent of the ownership of the financial firm Gamlestaden. In other words, an industrial complex of vital importance (the Nobel industries) was coupled with a speculative financial firm exposed to bad loans on the real estate market. This was seen by Wahlström- according to his strictly industrial perspective- as both unacceptable and unprofessional[170].

It very soon became clear that without capital infusion by the Swedish state the Nordbank could not be saved and the whole process of rationalization was doomed to fail. The economic and legal mess with the Penser group made the situation even more dramatic and complicated. In view of the emergency situation and given that a bankruptcy of the Nobel industries would have a serious impact on Nordbank itself, and even more seriously, on the credibility of the Swedish banking system abroad, the Swedish government saw itself obliged to carry out important capital infusions into Nordbank. Two major capital infusions were undertaken in order to make possible the reorganization process of the Nordbank: in autumn 1991 with 4 billion kronor and in the spring of 1992 with 10 billion kronor. Total sum: 14 billion kronor.

But even more important than the infusion of capital by the state was an other innovation, a new model for coping with the non-performing loans of Nordbank: the establishment of a new entity, Securum, a kind of "Bad Bank" which was separated from Nordbanken and took charge of the "bad loans". According to the Proposal on May 7 1992, " Bad credits, loans with agreed interest rate concessions along with other assets which burdened Nordbank's capacity to serve its obligations were transferred to a subsidiary company formed by Nordbank, called Securum Ltd. The objective of this transfer is that Securum would have the goal to administer and liquidate these commitments. These commitments can at present be estimated to amount to size of 60 billion."[171]

In the opinion of Odd Engström, the Chairman of the Board for the financial support to the banking sector (the so-called *bankstödsnämnd*) , *" The establishment of the Securum was decisive for mastering the continued financial crisis*.". In the opinion of the Vice-Chairman of Nordbank, Jacob Palmstierna, the Securum was set up in order that the relatively few but big credit problems would not overshadow the many and the otherwise well-functioning credit and client relations. The

170 Ulla Reinius, 1997, *ibid*, p.94

171 The Government Proposal on the establishment of Securum is cited in Reinius, 1997, p.151-153.

Securum was created not only in order to save the bank. The State ensured that Securum was capitalized in such a way that it got sustainability – so that the real estate would not be excluded from the market. Here lay a great security for the whole Swedish banking system[172].

The total capital infusion to Securum by the government in the end of 1992 amounted to 24 billion. Added to the 14 billion which were injected to Nordbank the total sum of tax-payer money destined to the capitalization of the old Nordbank amounts to 38 billion.

Nordbank was not the only bank which granted bad loans. In fact it was the second worst after the private Gota bank. Gota bank was going to be bought up later (in 1993) by the recapitalized Nordbank.

As far as the two big systemic private banks are concerned, the SE Bank and the Handelsbank, their shares on the stock exchange collapsed by 95 and 85 per cent respectively . SE Bank requested state financial support but finally managed to cope with the credit losses without state support by increasing the width between borrowing and lending interest rate, which practically meant that the losses were transferred to the borrowers of the bank. SE Bank received 5.3 billion via a 1:1 capital infusion for shares, which took place in autumn 1993. This can be put into a relation to its own capital of 16.8 billion in 1992/93.SEB succeeded in registering profits for the whole 1993.

Handelsbank received in autumn 1993 2.65 billion through a 1:2 capital infusion for shares. In a way of comparison, its own capital lay at 17.1 billion in 1992/93. The bank justified the new capital infusion with the increased demand for credits arising from the recovery of the economy. In general, Handelsbank was the bank which coped more successfully with the financial crisis.

Both the SE Bank and the Handelsbank repaid the capital *after* the worst phase of the crisis was over. [173]

The exposition of the banking crisis in Sweden undertaken above is mainly focused on the Nordbank, the bank which was identified with the whole financial crisis more than any other and is based on the wealth of information offered by Reinius in her book about the crisis and the reconstruction of the Nordbank. The involvement of the banks in the real estate market through badly monitored and poorly coordinated lending to financial firms needs to be emphasized as the primary reason for the triggering of the crisis and its unprecedented depth. The establishment of an independent entity, the Securum, should be seen as the major innovation which was conceived and

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172 Ulla Reinius, 1997, *ibid*, pp. 151-152

173 Affärsvärlden, 24-02-2009, *Minnen från finanskrisen [Memories from the financial crisis]*

used as the main vehicle for overcoming the banking crisis in the case of Nordbank. Inevitably our exposition is insufficient and conveys only a small and fragmentary image of the depth of the banking crisis.

The banking crisis was a direct offspring of the deregulation of the credit market in the way in which tha latter has been initiated and carried out. The centre right coalition government of Carl Bildt was unfortunate enough to be obliged to cope with the banking crisis at the same time with the eruption of the currency crisis. The predicament of the banking sector became obvious at the same time the speculative attacks against the krona was in full progress as well as the desperate effort of the government to defend a totally unrealistic exchange rate. The effort, as we said, failed dramatically in November 1992. Let us now see how the center -right coalition government tried to handle the Swedish economy after the devaluation of the krona in the remaining time of its tenure.

V. With full speed into an economic depression. The Swedish economy after the *bataille perdue* for the defense of the krona.

The battle for the defense of the krona was lost in November and the krona was devalued 15 per cent in relation to the ECU. For the Bildt government it was a big blow and for a moment the government seemed to be confronted with a hard reality, which put in question the whole of its economic policy and the premises underpinning it. The reserves of the Riksbank were depleted in a futile battle, the real economy was shocked by the interest rate hikes and thousand small and medium size enterprises were falling victims to the interest rate shock, the unemployment increased to unprecedented levels and the budget deficit had already run out of control even before the events of September. One would expect that having lost the anchor of the fixed exchange rate and in front of an economy in free fall, the Bild government would be ready to show some flexibility, the Riksbank would make active use of its freedom to lower its leading interest rate and the government would resort to emergency measures for stimulating an economy on the brink of depression. Nothing of the sort happened: the troika Bild- Wibble-Dennis lost no time in replacing the norm of the fixed exchange rate of the krona with a new norm: an inflation rate target at 2 per cent with a margin of +/- 1 per cent. The insistence on the norm-based policy would continue and the interest rates would not be drastically lowered. In front of the hard events of September, which refuted both its strategic assumptions and its tactical choices, the Bildt government reacted in exactly the same manner in which the German Philosopher Johann Gottlieb Fichte, a prominent figure of the German Idealism, reacted, when a student of him remarked that the reality was refuting his theory of knowledge: “*Um so schlimmer fur die Tatsachen*” – i.e “*even worse for the* *events themselves* " exclaimed Fichte. The government was nevertheless confronted with the pressing necessity to find a substitute for the fixed exchange rate of the krona and a new interest rates policy. Instead of drastically reducing the interest rates, a new strategy was adopted: the strategy of the *lowering interest rates in small successive steps.* [174]. The economy may well have been in a free fall, but no effort would be undertaken to drastically reduce the short-term interest rates.

Immediately after the floating of the krona the Riksbank lowered its leading rate to 12.5 per cent. Thereafter, the interest rate was reduced step by step- and very hesitantly. What mattered more was the fight against an inflation- which practically no more existed- and the determination to gain credibility for the economic policy will be pursued. The contrast with the monetary policy practiced in Great Britain at that time could not be more obvious: while in the UK the leading interest rate was drastically reduced with 6 per cent after the floating of the pound, in Sweden the Riksbank refused to proceed to drastic interest rate reductions. According to Riksbank, further interest rate reductions would risk to weaken even more the krona and drive up the long- term interest rates. This would worsen the conditions for a *long-term* recovery of the economy. By means of decisions about measures with long-term effect aimed at stabilizing the public finances, the distrust for the economic policy pursued would be reduced. [175] Hamilton and Rolander comment on the philosophy underpinning the strategy of the successively reduced interest rates by pointing out that this strategy was based on the assumption that an abrupt reduction of the interest rates would be perceived as if the Riksbank after pressure was giving up the fight against inflation. They are summing up the arguments advanced by the government in defense of the reluctance to reduce the interest rates substantially by pointing out, with an obvious dose of irony, that in the thinking of both the government and of the Riksbank, reduced short- term interest rates reduce the value of krona, a reduced krona raises the import prices, raised import prices raise the inflation expectations and the inflation expectations raise the long-term interest rates- and this is in fact a kind of austerity policy. The long-term interest rates are more important than the short-term. A stimulation with the monetary policy in order to revive the economy had been, by this kind of reasoning, defined as an austerity policy. Stimulation becomes austerity and consequently the continuing austerity policy of

174 Carl Hamilton, Jan Rolander, 1993, *ibid,* p. 77

175 . Swedish Ministry of Finance, 1999, *Finans- och penningpolitisk bokslut för 1990-talet [Fiscal and Monetary Closing for the 1990s]* p.12

the government was in fact- stimulation. [176] That the interpretation of the way of the thinking of the government given by Hamilton/Rolander, despite its polemic nature, is on the whole correct is clearly shown by the following formulation in the Governmental Proposal on the Budget 1992/93 rejecting any idea of short- term stimulation of the economy:

" Today a fiscal expansion, through unfunded increase in expenditure or unfunded tax reductions, would increase the budget deficit and thereby strengthen the long-term inflation expectations. Credibility for the economic policy would be seriously damaged […] The disadvantages of a general fiscal expansion in the form of a higher budget deficit and, on the basis of the resulting higher interest rate, lesser credibility, fewer investments, far surpass the advantages which would have been attained by a higher level of activity in the short-term." [177]

The above lecture on the merits of securing "credibility" is given by a government which only few months before categorically rejected to take notice of what happened on the financial markets dismissing it as irrelevant and assuring *that its policy did not adapt itself to the quotation of the exchange market*. It is the very same government which now rejected the tax reductions as a means to stimulate the economy, but which only some months before was announcing tax reductions (tax on wealth and tax on capital) for its core voters without showing any concern about the impact on the budget deficit. It was a government which thought that it was possible to show "credibility" by resisting against the markets in any way possible, even if this would inflict serious damage on the economy. Now the budget deficit, to which the Bildt government itself contributed more than any other with its policy, was discovered as the ideal excuse for stubbornly rejecting any measure for short- term stimulation of the distressed real economy. Then, in September 1992, the sacro-sanct dogma to be defended at any price was the fixed exchange rate of the krona. Now the new sacro-sanct goal set by the norm-based policy was the two per cent inflation. What if the fight for the attainment of the first goal had been proven to be futile- and with a tremendous cost for an economy in a serious contraction? The "most competent government" in Sweden's political history knew better- and it knew that the new goal had to be defended with the same zeal and determination with which the first goal had been defended- for this was the only way to gain the credibility of the "markets".

However, these very same actors who actually were in action on the markets in London and Stockholm seemed rather to think that the fall of the krona was due to the perceived unsustainability of the high interest rates policy which was devastating the economy. What concerned the investors

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Carl Hamilton, Jan Rolander, 1993, *ibid,* pp 78-79

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Government Statement on the Budget 1992/93: 100, Appendix 1, p.16

was obviously not the budget deficit, which was mirroring an economy in stagnation, but the fact the economy actually was *in recession* and the government *refused to do anything to it.* [178]

What becomes evident from the way the government (pressed between the need to continue the norm-based policy and the need to relieve the real economy) reacted to the fall of the krona was the insistence on the long- term perspective. The norm-based policy, at least in its version represented by the Bild government, refused that some sort of adjustment between different goals in the economic policy can be made in the short run. A stable currency value had been erected on the pedestal, a leading star in whose light any other decision should be seen.

The Chairman of the Riksbank had been also instrumental in staking out the new course decided by the government. Despite the fact that circles of the industry now openly voiced the wish that a reduction of the short-term interest rate was desirable, Dennis and Bildt had no intention of drastically reducing the short- term interest rates. That a reasonable long- term plan for putting in order the public finances was urgent there was no doubt. But Dennis demanded, in order to proceed even to small interest rate reductions the presentation of a program of cuts and economies for the remaining 1990s *here and now*. Only under these condition Dennis was disposed to reduce the short-term interest rates.

During 1993 and up until June 1994 the Riksbank reduced its leading rate but *this was never lowered under the 7 per cent threshold.*. In the middle August 1994 the Riksbank thought that the credibility was so weak so that it decided to increase its leading rate by 0.3 per cent . The decision was motivated with reference to increasing inflation pressure and inflation expectations. The import prices were rising and according to some figures the inflation expectations of the industry in a year's perspective lay at 4 per cent. The increase came unexpectedly and the initial reaction was that the long-term interest rates rose and the krona was weakened. The Riksbank made in the autumn 1994 two further interest rate increases, so that in the end of the year its leading interest rate was 7.60 per cent.[179]

The critics of the Riksbank pointed out that the high real interest rates were pressing the asset values and pushing the indebted companies and households into a more and more bad situation. Even the famous SNS Konjunkturåd, the think-tank which more than any other contributed to the propagation and the success of the norm-based policy since the mid-1980s , pointed to the

178 Carl Hamilton, Jan Rolander, 1993, *ibid,* pp.79-80

179 Swedish Ministry of Finance, 1999, *Fiscal and Monetary Closing Book for the 1990s*, pp.24-25

possibility that a more drastic reduction of the short-term interest rates would create the preconditions for a recovery of the private sector. This would strengthen the public finances and reduce the uncertainty about the future economic policy, which in turn would yield lower long-term interest rates. The SNS Konjukturåd thought also that the weakened public finances was only a mirror image of the increase in the private savings, in its turn caused by the effort of the households to reduce their debts[180].

As expected, the result of the policy of first taking long-term decisions and then manage the critical short-term situation was disappointing. The long-term measures resulted not in supporting, but in hindering the rescue efforts. Instead of taking immediate measures, all the energy was spent on negotiations (mainly with the social democrats) about public savings programs and cuts five or six years in the future. Instead of go into action the strategy of *the successively reduced interest rates became a strategy for doing nothing in the end.* [181]

In 1993 the situation of the real economy was alarming. The GDP contracted with 1.8 per cent. The employment in the private sector reduced quickly (The AMS estimated 10 per cent open unemployment for autumn 1993 and 6 per cent in the various AMS- labour market programs.[182]) mainly in the industry and in the construction sector. The weakening of the public finances continued unabated. The deficit in the public sector's financial savings amounted to 12 per cent of the GDP. The Public Borrowing Requirements, measuring the state's need for new credits, amounted in 1993 to 242 billion kronor, which was corresponding to 17 per cent of the GDP. The public debt was amounting in the end of 1993 76 per cent of the GDP, an increase with 30 per cent since the beginning of the decade[183].

On the political level the Bildt government was absorbed during the years 1993 and 1994 in

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Swedish Ministry of Finance,1999, *Fiscal and Monetary Closing Book for the 1990s*, pp.22-23. The head of the SNS Council, Hans Tson Södeström will present again, some years later, in 1995, the year of the beginning of the social democratic program of budget consolidation, an elaborate version of the theses, defended by the Council, concerning the public deficits as a mirror of the debt reduction of the households in an article in *Ekonomisk Debat* , the leading magazine of the Association of the Swedish academic economists, under the title, *Realräntechock, skuldsanering och budget underskott. En balansräkningsanalys av den svenska depressionen [Real interest rate shock, debt clean-up and Budget deficit. A balance- sheet analysis of the Swedish Depression*] in: Ekonomisk Debat, 23/3, 1995, pp. 189-202

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Hamilton, Rolander, 1993, p. 81

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Hamilton, Rolander, 1993, *ibid,* p.97

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Swedish Ministry of Finance, 1999, *Fiscal and Monetary Closing Book for the 1990s*, pp.22-23 continuous and futile negotiations with the social democrats about proposed cuts and economies. This was of course a clear sign of the weakness of minority coalition government which was *de facto* obliged to seek parliamentary support in order to push emergency measures through the Riksdag. It was, on the other side, a sign of a self- inflicted passivity in the management of the crisis and of the reluctance to take short- term measures with immediate effect on the contracting economy: the insistence on a totally inflexible version of the norm-based policy and with the Riksbank barring any active fiscal policy.

Despite the continuous contacts with the social democratic party and the group around Alan Larsson in charge of the economic policy, the relations between government and social democratic opposition were burdened with suspicion and bad faith. The social democrats accused the government of not respecting basic provisions of the first crisis agreement which froze the selling of state companies, and the introduction of the child benefit, forbade the investment of the money of the wage- earner funds for other reasons than those agreed, postponed the abolition of the wealth tax and the reduction of the tax on capital income[184].

The fruitless cooperation with the social democrats became once more evident during the Spring 1993, when the government in the Budget Statement proposed the introduction of five waiting days in the unemployment insurance and that the replacement ratio would be reduced from 90 per cent to 80 cent. The social democrats rejected the proposed reduction in replacement rates and despite the continued meetings between the negotiating teams of the two blocks the negotiations resulted in a deadlock and failure with the government trying to gain the support of the public opinion by accusing the social democrats for intransigence.

Even the announcement by the government of 81 billion kronor economies for the next five years in the Complementary Budget Statement of 1993 and the subsequent negotiations with the social democrats aimed at strengthening the political consensus, as proposed by the Lindbeck Commission, on questions of public finances, was doomed to failure. When the social democrats put concrete questions to the representatives of the government about the intentions of the government to return to a capital taxation of 30 per cent, to withdraw the planned privatization of a state company, the answer was negative. The social democrats became aware of the fact that the government was not aiming at changing the economy policy towards more stimulation for growth and promotion of the employment and a more just redistributive policy. [185]

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Christer Isaksson, 1994, *ibid* , p.261

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Particularly squeezed was the domestically oriented parts of the economy. The high interest rates influenced both the cost of financing and the domestic demand. The private financial savings lay in 1994 around 15 per cent of the GDP, an increase from -6 per cent in 1990. The private consumption fell strongly. The rising interest rates made the way towards the recovery of the private economy for the households still longer. The high interest rates depressed also the prices of commercial real estate. Many commercial real estates were taken over by the banks. Even the putting in order of the balance sheets of the banks – and thereby the return to a normal lending– was delayed[186]. In fact, the banking crisis began to be overcome by continued high interest rate margins[187]. This was a policy which ran counter to the interests of the real economy. Expressed in the words of the Lindbeck Commission, " It would be economically destructive to reestablish the capital base of the banks with the help of continued high interest rate margins. The Bildt government may have praised the conclusions of the Lindbeck Commission- especially those which were in line with its norm-based credo- but took not the slightest notice of this remark, which may be considered as one of the most important contribution delivered by the Economy Commission.

In sharp contrast to the hard- hit domestic sector, the export- oriented sector was stimulated strongly by the weakening of the krona. This was expressed in rising profits, production, employment and investments in the industry. The companies in this sector were not so pressed by the high nominal interest rates, since they had partly access to the international credit markets and partly they had the room for raising their export prices in kronor. The export prices raised in the end of 1994 with over 20 per cent since the fall of the krona. This development was in itself favorable because of the fact that the sector which was exposed to foreign competition was strengthened after the marginalization which it suffered during the period of the too high costs[188].

It is very characteristic that despite the fact that the government in the Complementary Budget Statement 1993/1994 announced budget strengthening measures with long-term effects amounting to 91 billion kronor, the concrete measures were not specified and decided. The estimates were also based on a very optimistic forecast about the development of the GDP from1996 on: 4 per cent per year. In view of the high real interest rates, which were raising the interest rate costs of the state

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Christer Isaksson, 1994, *ibid,* pp. 271-281.

186 Swedish Ministry of Finance, 1999, *Fiscal and Monetary Closing Book for the 1990s*, pp.25-26

187 Carl Hamilton, Jan Rolander, 1993, *ibid,* p.96

188 Swedish Ministry of Finance, 1999, *ibid* , pp 25-26

and thereby was worsening the public deficit, this forecast was totally out of touch with the reality of the economy. [189]

By taking into account the passivity and the incapacity of the government to come up with a serious program for putting in order the public finances, one is inclined to accept the conclusion of Hamilton and Rolander that for the Conservatives of Bildt the deplorable state of the public finances did not at all matter. They viewed it only as a norm behind which a broad support could be secured for cuts in the public welfare . A real concern for the public finances is hardly detectable. The government may have fed the public opinion with plenty of rhetoric about fight against the inflation, successive interest rate increases and the like, but the goals of the policy pursued by the Bildt government seemed to be other: the emphasis is put on the system shift from the much disliked Swedish Model with a strong public welfare and an interventionist stabilization policy towards a pure market economy devoid of the distortions inflicted by the expansion of the Swedish Model especially during the 1970s. The real aim, even after the end of the fixed exchange rate of the krona, remained the determination to roll back the welfare state expansion recorded in the first half of the 1970s by carrying out privatizations and extensive tax reductions. The adherence to the norm-based policy was the perfect vehicle for the tandem Bildt- Wibble to carry out this ambitious system shift.

Understood from this point of view it seems plausible to infer that Carl Bildt had the intention under his mandate period to stake out such a radical course away from the big welfare state that the social democrats could not turn back in case they returned to power. The big budget deficit is the main means by which the system shift could be secured *in the long run.* The circle around Bildt was not measuring in common economic measures, but was considering everything *in the long ran* – which in their fall was an other expression for the fact that they assessed everything *ideologically*. [190]

Viewed from this point the Bildt government's economic policy may not be considered as a mere and total failure. In fact it created some constraints and preconditions which would push the social democratic party further away from the premises of a traditional social democratic policy. When on keeps in mind the record of the social democratic economic policy of *budget sanering*, i.e. of " putting in order the public finances" in the period 1994-1998, one can say that the Bildt coalition government was far more successful in this respect despite – or perhaps thanks to – the failed

189 Swedish Ministry of Finance, 1999, *ibid* , pp. 24-25

190 Carl Hamilton, Jan Rolander, 1993, *ibid,* pp. 116-117

management of the Swedish economy during 1991-1994.

A last measure taken by the center- right coalition government deserves to be mentioned: the Bildt government abolished what remained from the much hated “wage-earner funds”, which even in their totally harmless and watered-down version constituted a provocation and a thorn in the side of the bourgeois parties and the Association of the Swedish Employers. Thus, the Wage-Earner funds ceased to exist even in their moderate version. The deradicalized version in which they had been established and the tumultuous financial situation reigning in the country in 1992-93 precluded any prospect that the labour movement would react to such a symbolic measure on the part of the Bild government. With the Collective Wage-Earner Funds’ phasing out, disappeared the last trace from a remarkable strategic project, which the Swedish labour movement conceived as an answer to the erosion of the class compromise underpinning the traditional “Swedish Model”, but did not find the strength, the will and the courage to turn into reality.

CHAPTER 5

Getting out of the crisis: The Budget Consolidation Program under the Social democratic Party

I. From a “party of welfare reforms” to a “party of fiscal discipline”- Or How the Swedish Social democracy was led to the most extensive program of budget consolidation ever practiced in the OECDcountries

The way out of the tormenting crisis of the 1990s was finally carried out in the second half of the 1990s by that party which played a crucial role in bringing it into being: the Swedish Social Democratic party. The program of economic policy conceived and implemented by the Swedish social democrats by virtue of which Sweden exited the deep recession was, by all accounts, an impressive program: mainly because of its successful outcome, but also because of its scale and internal cohesion. The program was implemented by the social-democratic leadership with decisiveness under the surveillance of Göran Persson, the person who, more than anyone else, left his imprint on the budget consolidation policy (called *budgetsanering* in Sweden). At the end of this process the Swedish economy and the Swedish Model got out of the crisis but they got out deeply transformed and restructured. The Swedish economy entered a new economic-policy regime and the Swedish Model underwent deep cuts and institutional transformations, which were so important that one asks himself, if the Swedish Model survived the "Budget Consolidation Policy" or whether it was so radically transformed that one can speak of a radically different economic- institutional regime. Equally important: the political agent, which led and carried out this achievement, the Social democratic party, got out of it deeply transformed and with a new political- programmatic identity, which brings it to sharp contrast to the traditional social democratic party which emerged out of the reformist "crisis program" of the 1930s and the extension of the Welfare State in the post-war era. After 1998, the year which is widely seen as *l'annee charniere*, after which the full effects of the policy implemented asserted themselves, Sweden is – or appears to be- a different country- and the set of institutional arrangements known as the Swedish Model drastically altered, while the Swedish social democratic party itself seem to have undergone the full impact of the changes carried out by its leading circles. In a sense, the political party and initiator of the policy of consolidation is deeply transformed by it. Is it a new – and viable – social democratic party or a post- social democratic one? But an answer to that question presupposes that one is able, first, to have a clear and objective picture of the program implemented by the Swedish social democratic party under the iron leadership of Göran Persson in the period 1994-1998.

Less than half a year before the fall from power of the centre- right coalition government, let us say in spring 1994, nothing indicated that the social democratic party would propose, in the middle of the electoral period, the first concrete draft of such a vast and harsh program of putting the public finances in order. In fact, the question of the serious state of the public finances was one among many other important issues in the beginning of the pre-election campaign. That the state of the public finances was very serious and worrying and that the Bildt government was obviously unable to carry out a concrete, detailed and credible program of budget consolidation was more or less common knowledge and could hardly be concealed. The internal division inside the " bourgeois bloc" and the lack of cohesion and coordination among the government partners with each one of them pursuing its own pet issues (the Conservatives of Bildt were focused on tax cuts, the Liberals on reforms for the invalid persons, the Centre party on environmental issues and the Christian Democrats on the child care benefit) was becoming more and more manifest as the elections were approaching. In fact, everything indicated, that the coalition government was totally reluctant to present to the electorate a concrete program of budget consolidation because of the political cost which none of the political parties of the coalition was ready to assume in the beginning of the pre-electoral period.

As for the social democrats, they may have been far more inclined to propose more concrete cuts than their bourgeois opponents, especially after the new finance spokesman of the party, Göran Persson- a man with experience in the local politics and known for his remarkable achievement to carry out the municipalization of the secondary school system in 1989 – abandoned the Party's May 1993 parliamentary motion centered around proposals for strengthening the demand and lowering the VAT, and was more and more opting for tight fiscal measures. Yet, nothing was indicating that the social democrats were willing to make the issue of the public finances the core issue of their electoral manifesto. Rather, one was expecting that the social democrats were going to present a manifesto based on a mix of measures favouring primarily growth and a more just distribution of income and of more or less concrete measures for consolidating the public finances. In a word: a rather classic social democratic policy agenda adapted to the changed conditions brought about by the most serious financial crisis the country experienced since the 1930s.

Two events were going to change dramatically the pre-electoral scene and to put the issue of the public finances at the center of the pre-electoral campaign. The one came from abroad: in February 1994, the US Federal Reserve decided to raise its interest rates, a move which came as a shock to the markets and triggered a wave of a financial unrest and interest rate increases worldwide. Sweden was not spared from the interest rate increases despite the fact that the country was in a totally different point of the business cycle and in desperate need of interest rate reductions. Once again it became painfully obvious how sensitive the Swedish economy was to external developments and how integrated the domestic financial market was with the deregulated global financial markets. [191]

The other was domestic, but not unrelated to the external event of interest rate increases: The executive director of the big Swedish assurance company Scandia , Björn Wohlrath, stated that his company, a major actor on the market for state debt, had had enough with the interest rate increases on the market for state bonds and that he decided not to buy Swedish state bonds. The statement made by Wohlrath was made public by the Swedish financial newspaper *Dagens Industri* under the

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Peeter Jann Kask, 1997, *Vägen in och ut ur den ekonomiska krisen* (The Way in and out of the Economic Crisis), Stockholmp.13

sensational heading " *Buy- up Strike. Skandia rejects the government bonds*". Keeping in mind that Scandia had a portfolio of Swedish state paper amounting to 3 billion kronor, the statement was expected to have serious repercussion on the markets. In fact, the statement of Wohlrath had immediate political repercussions: his statement changed instantly the pre-electoral campaign and the agenda of the electoral issues. So the public finances, very quickly became -after Wohlrath's statement- the central issue of the campaign[192].

Surprisingly enough, it was the social democratic party the one which proved to be more sensitive to the statement of the Scandia Chief Executive and the one which tried to turn the sensation aroused by the statement to its advantage. And by virtue of its instant reaction to it and of re-adapting its electoral manifesto to the necessity of taking notice of the danger of interest rate increases, the social democratic party was going to be the political winner from a statement which was, undoubtedly, the statement with the most serious impact on the political life of Sweden. The social democrats were expecting a pre-electoral campaign centered around issues such as distribution of income, employment and social justice- i.e the cardinal and most cherished issues to the social democratic party and to its core supporters. They may have been surprised by the open declaration of distrust about the state obligations expressed by Wohlrath, but the rapidity of the reaction and the capacity to adapt to the new circumstances and changed order of priorities caused by Wohlrath's statement was impressive- and perhaps unexpected.

In fact, the statement of Wohlrath, combined with the growing skepticism of Göran Persson, about the effectiveness of a demand stimulation program, reacted as a catalyst for a radical revision of the electoral agenda of the social democratic party whose polling rating was estimated to be around 50 per cent. Despite the fact that Wohlrath statement did not in the end provoke the fiscal crisis people feared it would, the social democratic leadership under Carlsson and Persson felt that the circumstances were so dramatically different that the party was obliged to present in the last phase of the pre-electoral period a program with concrete proposals for economies and cuts aimed at improving the state of the public finances. The basis of such a program would consist in the explicit commitment that no reform was going to be undertaken which was going to have an adverse impact on the already critical state of the state finances. For the party leadership it became crucial that the revised electoral program would be cleared from any fiscally onerous welfare reform proposal. The commitments to increase the benefits for the long- term ill and the increase in the unemployment benefit to 90 per cent, (central issues for the LO leadership) were expunged. In the final text of the

192 Peeter Jaan Kask, 1997, *ibid*, pp.10-13

manifesto the exact formulation read as follows: *No increases in the compensation levels of the social security will be carried out during the period of the mandate. We promise no reforms which deteriorate the state finances.* [193] For the first time in a pre-electoral period, Peeter Jaan Kask pointedly remarks[194], the social democrats would present a vast program of significant cuts on areas deemed as very sensitive for the party.

On the other hand, the social democratic leadership tried hard to strengthen the credibility of the electoral manifesto by specifying the exact amount of the cuts contained in it and the areas where these cuts were going to take place. A total of 61 billion kronor economies were presented, all of them identified and specified. The aim of Persson and his closest collaborators was that the new electoral manifesto would be positively received by the markets. The secretariat of the party in charge of economic policy tried to make the best use of its contacts with market analysts and other actors on the marketplace in order to get a clear picture of the expectations of the markets and in order to bolster confidence to the manifesto.[195]

Remarkably, the final draft of the manifesto was received by the Executive Committee (*Verkställande utskottet)* of the party without serious objections (except on one point: *on the necessity to make the proposed cuts even more drastic if necessary).* The case for a further tightening of the already decided cuts was made by Carlsson himself and his idea led to the explicit formulation of a demand for an *open mandate* addressed to the Swedish people: " *We ask for the trust of the electorate in order to carry out our program aimed at increasing growth, bringing down the unemployment, stabilizing the economy and securing welfare."* And the final request was only a line further below: " *In case the growth does not increase, the unemployment rate is not reduced and the interest rates are not pressed down, we wish a full mandate from the Swedish people to take further measures for the state finances.* "[196] . The necessity for an open mandate was justified by pointing out that the budget deficit increased because of interest rate increases and the turbulence on the market may create a new unpredictable situation.

The content of the final draft of the electoral program was, undoubtedly, a clear indication of the

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193 Cited in Peeter Jaan Kask, 1997, *ibid*, pp 35-36

194 Peeter Jaan Kask, 1997, *ibid,* p 23

195 Peeter Jaan Kask, 1997, *ibid*. p. 34

196 Peeter Jaan Kask. 1997,*ibid*, p.36

programmatic change which the agenda of the social democratic party underwent on the aftermath of Wohlrath's statement. The rapidity and the relative ease with which the party leadership carried out a drastic reformulation of the party's priorities is indicative of the deep crisis awareness shown by the decision-making machine of the party. Bearing in mind that the cuts announced concerned central and sensitive areas for a traditional social democratic policy, one asks oneself how it was politically possible for the party to proceed to such a serious and drastic proposals for extensive cuts on these very same issues in the middle of a crucial electoral campaign . Everything indicates that the social democratic party leadership was deeply marked by the interest rates increases which took place in the second half of 1994. Persson and the other people in charge of drafting the electoral program were afraid of the possibility that the burden of the increased interest rates and of a further weakening of the krona would create an emergency situation. In case of such an emergency situation the government would have no other option than to turn to the opposition and demand its support for a new crisis package[197]. The social democratic leadership had not forgotten the 1992 currency crisis, the shock of 500% interest rate hikes and the tormenting negotiations for crisis packages with the bourgeois coalition government. In fact, everything indicates that the leading personalities in the party were haunted by the specter of a new currency crisis, this time in the form of a free fall in the value of the Swedish krona, of interest rates hikes and an explosion of the budget deficit. The image of a powerless government begging for support in order to get out of the stalemate was, as it seems, deeply rooted in the collective consciousness of the social democratic leadership. The fear that this time the roles might be reversed with the social democrats in government imploring for cross- party crisis packages and the centre- right parties in opposition posing severe conditions for negotiations was more than enough for pushing the party to preventive measures . The 1992 events seem to have been such a deep traumatic experience which haunted more or less the political system of Sweden in general and the social democratic party in particular. For the social democrats who were deeply involved in the events of the September 1992 days and in the protracted negotiations with the Bildt government a replay of successive interest rate shocks seem to have assumed the traits of a nightmare- so traumatic and paralyzing that the party did not hesitate to resort to extraordinary programmatic revisions as a means to rule-out the possibility of seeing the 1992 nightmare becoming again a harsh reality.

Whatever the real reasons for the radical formulation of the electoral manifesto may have been, one should not believe that the crucial- for a social democratic party – issues of social justice, growth

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197 Peeter Jaan Kask. 1997, *ibid*, p. 17

and just redistribution were totally absent from the party electoral manifesto. Even in the passage containing the request for an open mandate for further measures, the reference to classic social democratic issues such as the need to combat unemployment and to boost growth and investments is explicit enough. Peeter Jaan Kask observes that one can seriously doubt if the electorate got a clear picture of the true balance between austerity policy and stimulus policy in the social democratic electoral program. In the social democratic parliamentary bill of May 1993 the direction of the economy policy is expressed in the following key formulation: ” *In order to defend employment and welfare and create again sound public finances efforts to bring about high and sustainable growth have to be put above all other ambitions and demands.”* The impression is inescapable that for a new social democratic government a policy favouring growth was a necessary precondition for reducing the budget deficit and the unemployment. A growth policy existed side by side with a policy of cuts even in the new and revised electoral manifesto. The fact that after the elections that part of the program which contained the intended cut proposals was going to be considerably expanded at the cost of the growth-stimulating measures was a result of the international interest rate increases and of the impact of the Wohlrath’s statement on the Swedish government bonds. The 1993 parliamentary bill on growth-stimulating measures was premised on the assumptions that the long-term interest rates would fall. Instead, strong interest rate increases took place- which were perceived to be so strong and serious as to lead to a drastic revision and reformulation of the electoral manifesto with a great part of it being dedicated to the presentation and description of concrete measures for cuts and economies. The image of a credibility crisis for the Swedish economy dominated the thinking of the leading figures of the social democratic party and led them to rebalance the order of priorities contained in the May 1993 parliamentary motion (the party document advocating demand- stimulating measures). In the words of Peeter Jaan Kask, the previous strategy of ” both....and ” (” *both growth and cuts*”) gave its place to the strategy of ”first...then” (meaning: ”*first cuts ...then growth*”). In the new economic thinking of the governing Swedish social democracy the cuts and the budget consolidation were the absolute prerequisites for solving the ”credibility problem” of Sweden and for lowering the interest rates. This ”credibility problem” was deemed to be so severe and pressing that without remedying it by drastic cuts no sustainable growth was possible- under the new conditions of the deregulated financial markets.

For the Swedish social democracy the changed order of priorities, was only the first step towards a new social democratic – or post- social democratic, one might think- economic policy in the 1990s. A clear and obvious ”displacement of the point of gravity” had occurred. In the first instance, this displacement manifested itself with an expansion of the austerity measures. The 61 billion kronor in cuts originally proposed were –shockingly- doubled reaching (through the use of the “open mandate”) the amount of 123 billion kronor by the end of 1998. Obviously, it was a quantitative change of unseen proportions. One could legitimately wonder if the quantitative increase in austerity measures represented a qualitative change in the fundamental nature of the traditional social democratic policy. A presentation and an assessment of the social democratic ” budget consolidation policy” of the period 1994-1998 will be undertaken in the subsequent sections.

II. The Budget Consolidation Program 1994-1998

The budget goal was my own variant of norm- based policy. We established a goal towards which we directed ourselves and to which we had to be loyal[198].
Göran Persson

As already stated in the previous section, the budget consolidation program, which the leadership of the social democratic party outlined and presented in the Economic- Political statement in November 1994, was far more drastic and extensive than the electoral manifesto in which a mix of

198 Göran Persson, 1997, *Den som är satt i skuld är icke fri* [*One who is indebted is not free*], Atlas förlag, Stockholm, p. 65

cuts and demand stimulation measures could be found side- by- side. While the planned economies were estimated to be 61 billion, the Budget Consolidation Program, after the Supplementary Budget Statement in April 1995, contained more than double that amount, i.e. 125 billion kronor. The program included expenditure reduction and revenue increasing measures. Considered from the viewpoint of its total size, the time- horizon of the measures proposed and its goals, the Budget Consolidation Program was, undoubtedly, an ambitions fiscal consolidation program without parallel in Swedish modern history.

That the social democratic party had no option but to cope with the extremely difficult task of improving the public finances by balancing the budget was, of course, obvious. At the time of the social democrats' return to power, the budget deficit amounted to 11.9 percent of GDP and the public debt was, at the end of the year, at 76 percent of the GDP. A third of the expenses were interest rate payments on the public debt[199]. To make matters worse, in the second half of 1994, interest rates increases, first in the USA and then worldwide, set in motion a financial turbulence which in Sweden weakened the value of the krona and made the pursuit of expansionary policies (otherwise desperately needed by an economy which had, in the previous years, experienced a draining of the aggregate demand) very difficult.

It is absolutely clear: the social democratic party was de facto obliged to take the critical state of the public finances under consideration and to waste no time in taking emergency measures in order to tackle it. The electoral manifesto, written at the same time the interest rates increases were happening and under the huge sensation caused by Wohlrath's statement of mistrust, was already containing important measures for redressing the public finances. It was the first time the social democratic party fought an electoral campaign by abstaining from any promise for welfare expanding reforms and by committing themselves instead to drastic measures aiming at improving the state budget. The explicit demand for an open mandate giving the social democratic government the room for taking further measures in case those already decided were going to be proved insufficient was a further indication of how seriously the social democrats were taking the situation of the public finances and how determined they were to redress it immediately and without delay.

On the other hand, even the categorical assertions on the question of public finances could not permit one to expect that the new social democratic government, once in power, would proceed to such a drastic extension and intensification of the measures aimed at balancing the budget by means of cuts in expenses and tax increases and/ or raised contributions. And no one could expect that the

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199 Ministry of Finance, 1999, *ibid*, p.26

social democratic emergency fiscal policy would be so one-sidedly oriented to cuts that measures destined to stimulate the economy would practically disappear. The electorate expected a mix of economies and growth stimulating measures before the elections. They were, instead, offered a one-sided, shock- and- awe program of drastic fiscal consolidation in which every measure of demand stimulation was conspicuous by its total absence. The references to the pressing need to stimulate growth and to bring down the unemployment rate were rather cosmetic and could not conceal the changed order of priorities: what matter, in the short run, was the consolidation of the budget by means of cuts in expenses and transfers and by raised taxes and contributions. It was the sole means by virtue of which the credibility of the Swedish economy could be restored and the interest rates could be lowered in order to restart the growth process and to reduce the unemployment. For the first time since the crisis policy of the 1930s and the proto-keynesian program of emergency public works paid at wages of the open market, the social democratic party was presenting a program exclusively dedicated to economies and justified with the constant reference to the need for restoring credibility as a means to convince the all- powerful markets to bring down the interest states.

How the social democratic party was led to present and to implement such a one-sided program of budget consolidation, running counter to its traditionally Keynesian program of a stabilization policy? That the traumatic 1992 events, the unbelievable capital flight and the astronomic interest rates had taken deep roots in the collective memory of the social democratic party and made them fear that they could happen again and that they could offer the lamentable image of a social democratic government begging for support from the opposition parties is beyond any doubt. But can they in themselves explain the nature and extent of program which the social democrats decided to implement? Before looking into these questions and trying to answer them, it is important to have a clear and accurate picture of the policy of budget consolidation, which was not only limited to important quantitative measures, but was also accompanied by important institutional changes, which give the impression that Sweden, after the whole process had been accomplished in 1998, had entered a new and different economic- policy regime.

The nature of a reform or of a process of reforms can never – or can rarely- be attributed to the role and the action of a sole person, but as far as the process of budget consolidation policy in Sweden is concerned, there can be no doubt that the role and the actions of the new minister of finance, Göran Persson had been decisive. In fact, one is tempted to assert that without Göran Persson, the implementation of the whole program would have been more difficult and much more complicated. Thanks to his determination, single-mindedness and obstinacy to carry the tormenting process to its accomplishment Persson was *the person* guiding, supervising and leading the whole process. It was, in a certain way, the animator for all the members of the government and the social democratic party machine, as well of the civil servants at the Ministry of Finance, which were involved in the process of outlining and executing the policy of fiscal consolidation. The presentation of the program, undertaken in this section, will begin by a brief account of its chief architect.

Göran Persson was always defining himself as a person of action. And, no doubt, he was that. *Jag är en handligsmänniska*. *För mig är politik i första hand att nå resultat* (*I am a man of action. For me politics is, above all, obtaining results)* asserts Persson in the already cited book he wrote and he dedicated to the principal accomplishment of his long political career. Olof Palme, the most famous leader of the social democratic party (far more known to the international public opinion than leading and founding figures of the Swedish social democracy like Per Albin Hansson and Ernst Wigforss) used to assure that *Politiken är att vilja*, i.e " Politics is to will", an assertion which puts the emphasis on the *power of will* in bringing about necessary and deep changes by curbing objective difficulties and hesitations. " *Yes, but politics is also to attain results, to carry out that which the majority has put itself behind"* Persson concurs but, at the same time, adds and qualifies in the very beginning of his narration of the budget consolidation program. [200] Persson's motto put the emphasis on the practical results which must be accomplished. This, of course, does not stand to opposition to Palme's emphasis on the crucial role of the will in the political action: without a strong will, no practical results can be obtained. Far from being mutually contradicting, the two assertions expressed by the above two important leaders, are self- completing. This does not make the contrast of the two personalities smaller: Palme was a visionary politician who took over the party before the ideological and political *Zeitgeist* had changed and was able to put the emphasis on the will and desires of the people for change at the center of the social democratic day-to-day policy. Persson was a much more pedestrian and down- to the- earth politician. He took over the party and the country in the midst of unparalleled financial-economic crisis of the famous Swedish Model and after the conditions for a classical social democratic policy had been much more adverse. While Palme was pushed by the radical Zeitgeist of the 1970s to extend and broaden the Swedish Model, Persson had found himself, under a conservative- neo-liberal ideological hegemony, at the difficult position to handle an unparalleled financial- economic crisis and to preserve what was to be preserved from the already transformed and in serious crisis Swedish Model. Despite the adverse conditions and helped by his political upbringing, Persson was proved

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200 Göran Persson, 1997, *ibid*.p.22

to be the right man at the right time: as a practical man of action, politically raised and educated in the municipal policies and as a social democratic politician who acquired in 1989 under his capacity of Minister of School Education , the enormous credit of carrying out difficult and controversial reforms (the municipalization of the secondary education was one of the most difficult and controversial reforms in the end of the 1980s), Persson was the ideal person for implementing such a vast and difficult fiscal consolidation program. The fact that he was able of making use of Machiavellian tactics of ”divide- and- rule” – amply demonstrated during his handling of the fierce resistance of the teachers to his education reform in 1989- made him even more suitable for such a herculean task. He did it- and he did it because he was a man of action, a municipal politician for whom the sound finances are the condition sine- qua- non for both preserving the welfare state and adapting it to the new adverse conditions created by the deregulated financial markets.

What exactly accomplished Göran Persson and his closest associates and collaborators at the Ministry of Finance? According to Professor of Economics at the University Lennart Erixon, one of the economists who undertook a serious critical examination of the background, the philosophy, and the motives behind the policy of *budgetsanering*, Persson and the social democratic party carried out the most extensive program of drastic fiscal consolidation thus far conceived and practiced in the OECD countries. The basic goal of the program, first presented in the Governmental Statement in November 1994 (Goverrnment Proposition 1994/95: 25) was consisting in stabilizing the public debt as a percent of the GDP by 1998 at the latest. The Swedish Parliament took the decision on a program which comprised measures of 118 billion kronor, corresponding to 7.5 percent of the GDP, with permanent effects on the public finances in the year 1998, including the 18 billion kronor which were already decided during the previous mandate period. In the complementary statement of the April 1995, which was supported also by the Center Party, the fiscal ambitions were raised: The public finances, measured with the public financial savings, would be in balance by 1998 and the public debt as a percent of the GDP would be stabilized by 1996. In the Convergence Program, decided after Sweden’s entry in the EU, which was presented in June 1995 it was stated also that the budget deficit in the public sector would not be allowed to surpass the 3 percent of the GDP in 1997- which was one of the criteria for joining the EU Monetary Union. The following diagram gives an insightful picture of the whole budget consolidation program

Consolidation Program [201]	
Effects in the fiscal year 1998, in billion kronor	
	1998
Reduction in expenses	71.2
Transfers to households	34.6
Reduced subsidies	8.1
Reduced public consumption	6.8
Other	21.7
Of which reduced investments in roads and railways	2.7
Of which medicine and dental care	2.8
Of which education	4.1
Increases in revenue	*69.0*
Individual charges	23.7
Uniform capital taxation	7.5
"Defense tax" (N.B: A tax on vey high incomes)	4.2
Production taxes	6.1
Other	27.5
Reductions in the budget	*-14.7*
Lowered value added tax on food	-7.6
Other reductions in budget	-7.1
Consolidation program	**125.5**

The above table gives an insightful summary of the figures contained in the consolidation program and makes clear the exact magnitude of the whole consolidation program decided and undertaken by the incoming social democratic government. The strengthening of the budget consisted mostly of cuts in public expenditure. In the most part, they had to do with reduced transfers to households,

201 Ministry of Finance, 1999, *ibid*, p.27

while other parts of the reductions in expenses concerned public consumption and subsidies. The increases in revenue contained in the program were, mainly, successively increased charges to the sickness insurance. [202] What distinguished the measures, both the income-strengthening measures and the expenditure- reducing measures was that they were *front-loaded measures*. In fact, the program was constructed on the assumption that the whole *budgetsaneringspolitiken* was based on the necessity of obtaining quick and immediately perceptible results in order to gain credibility and convince the financial markets about the seriousness of the budget consolidation policy, thus leading to the urgently needed interest rate reductions. In the words of Göran Persson himself, *we wanted a consolidation program which was "front-loaded" – that is to say, with the majority of measures very early in the process – because, among other things, we knew that we had an upward trend in the economic cycle which gave us space enough for consolidation measures in 1994 and 1995. During the first years we practically took up the whole of the growth in the economy with the aim of consolidating the public finances. We left almost nothing for private consumption.*[203] According to the judgment of Persson and his closest associates in the Ministry of Finance, the profits recorded by the export- industry after the floating of the krona began to trickle- down onto the whole of the economy, thus creating a space for the implementation of forward- looking measures. No wonder, the new leadership of the Riksbank, with Urban Bakcström as its new chairman and successor to Bengt Dennis, shared this assessment and refused to relax the monetary policy of the Riksbank on the basis of this assumption.

The budget consolidation program was made possible because the new government made already in the first weeks at the Department of Finance, two major and of decisive importance moves: the first was to make full use of the- already mentioned- open mandate for further measures- over and above those contained in the electoral manifesto. The second, was that *no changes in the monetary policy was going to be pursued* . This second decision practically implied that the new social democratic government was giving up any effort to fight for a more accommodating monetary policy. In the social democratic law bill of May 1994 the proposal was made for a far more daring orientation of the monetary policy. The monetary policy would be oriented towards goals which concerned not only the inflation but also growth and employment. The Riksbank should act more actively in order to reduce the interest rates. The idea underpinning this proposal was that the monetary and the fiscal

202 Ministry of Finance, 2000. *Ibid*, p. 28

203 Göran Persson, 1997, *ibid*, pp.65-66

policy would go hand in hand and would stimulate the economy.

The budget consolidation program was specified through successive law bills in different economic-political statements. A commitment on the part of the government to undertake a half- year review of the program in the economic-political statements was deemed to be an important measure in order to ensure the implementation of the program and to quickly attain credibility.

It goes without saying that such an extensive and drastic budget consolidation program undertaken by a social democratic government was a very difficult and risky undertaking- both politically and technically. There was, of course, an inherent *ideological difficulty* related to the traditional ideological premises of the Swedish social democracy. For a social democratic government used for a very long time to a very different policy mix inspired by Keynesian demand-stimulus measures and with employment as its top priority, the implementation of such one-sided program based mainly on economies than on growth-favoring and demand stimulation measures was a very complicated matter.

Of course, the justifications found by Persson and his associates for the nature of the consolidation program was that the whole program would not estrange the social democratic rank- and- file. *The whole process of budget consolidation policy is about saving the Swedish welfare model*: Persson never got tired repeating at every public meeting and at every opportunity, that the consolidation program was a not a value in itself, but a set of unpleasant decisions taken under emergency conditions imposed by the tragic mismanaged of the public finances by an incoherent bourgeois coalition government which practiced a disastrous policy of tax rebates benefiting solely the well-off.. *The budget consolidation policy was aimed at preserving the sovereignty and democracy in Sweden*. Both Carlsson and Persson underlined that a serious displacement of the constellation of power had taken place in the last years: away from politics and in favour of the financial markets. Called *maktförskjutning* (meaning literally “ power displacement”) this alarming change was threatening the very foundations of the political democracy and sovereignty in Sweden and was threatening to convey to the citizens the impression that politics and the politicians were powerless. When the markets through raised interest rates dictate economic policy in an indebted country, the citizens think that the politicians do not have many options in their hands. And reminding the pathetic image of the right- of -center government of Carl Bildt inviting the opposition to negotiations he added that *the all- night crisis negotiations and the hastily concocted crisis packages seem as the incarnation of the powerlessness and the humiliation of politics*[204]. The

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204 Göran Persson, 1997, *ibid* , p.23

contrast of the consolidation program to the redistributive economic philosophy of the Swedish social democracy, upon which the Swedish Model was resting, was obvious and hard to conceal. Convincing arguments capable of justifying this ideological discrepancy had to be found and to be offered to the rank-and- file. And they were found: the state of emergency of the economy, the threats to democracy and to national sovereignty and the reference to the traumatic events of September 1992, with the tormenting negotiations and the fruitless crisis packages.

There was, further, an objective dilemma related to the side-effects of different policy choices: belated and weak budget consolidation measures, would appear as insufficiently credible and would significantly reduce the economic-political room for maneuver. On the other hand, too quick and big budget- strengthening measures, would entail the risk of a relapse into recession[205]. Trying to avert the risks of those opposite policy options the Budget Consolidation was drafted on the basis of three fundamental principles: It would, first, produce effects quickly so that the increase in the public debt would be halted early, but the measures were distributed over a number of years so that the contractionary effect on the demand would not be too big. It was shaped, secondly, from a distributional point of view, in a way that those with the highest incomes would contribute most. And, thirdly, priority was given to the preservation of public services such as schools and care and the cuts were concentrated on transfers to the households[206]. The distributional consequences of the consolidation program were assessed some years later in the budget statement for the year 1998 by the government itself. According to this statement, the conclusion was drawn that a fifth of the households which had the highest economic standard contributed with almost 43% to the total budget strengthening, while the fifth having the lowest economic standard contributed 11%. In any case, the effort made by the team drafting the budget consolidation program was to legitimize it in terms of fair distributional principles corresponding to the demands of social justice advocated by the social democracy. Göran Persson himself will point out to ten basic imperatives which should underpin an ambitious budget consolidation program standing serious chances for success. The third among them sounds as follows " *Distribute the burdens according to the strength of each one"* Persson admits that cuts in the public expenditure are the most noticeable for those who are in need of the support of the society and, thus, a fair policy should be based on a balance between

205 Ministry of Finance, 2000, p.27

206 Ministry of Finance, 2000, p. 27

reductions in public expenditure and tax and fee increases[207].

The implementation of the Budget Consolidation Program necessitated also important organizational changes- chief among them was the upgrading of the Ministry of Finance, which, according to Persson, during the years of the right-of- center minority coalition government had been seriously weakened because of the lack of coordination between the contradictory demands and divergent ambitions about the preferred measures, as already referred in the previous section. Seen from this point of view, the new social democratic government was in an obvious advantageous position: it was a minority government, but no other party was participating in it by holding positions in the cabinet. The social democratic government was not obliged to take under consideration different and mutually contradictory positions about the direction of economic policy. Furthermore, Persson demanded – and succeeded in carrying it through– to have a full control of the Ministry of Finance by acquiring the post of both the Minister of Finance and of Tax Minister. In order to be able to pursue the policy of budget consolidation with full force, he wanted to have a full grip on the whole of the activities of the Ministry of Finance – both the economic policy and the tax policy, as well as the municipal issues (the importance of which for a politician grown- up in the world of municipal policy he was well aware of). The municipalities are a great part of the economy and the municipal commissioners (*kommunalråd*) are important opinion makers in the party machine of social democracy. Their support meant practically that Persson would receive the support of the social democratic party to legitimize and implement a consolidation policy which could not but provoke cracks and protests inside the rank-and-file[208]. That Persson was able to gather around himself a competent, goal-conscious, experienced and equally single- minded group of close associates, capable of assuming a great deal of the workload demanded by the herculean task of an extensive budget consolidation, and to execute it in line with his instructions was an equally important aspect of the whole process.

But more than the organizational changes which Persson, with a *carte blanche* from prime minister Carlsson, was able to carry out, the fact which considerably made easier the difficult task of budget consolidation was that the social democrats were able to create the necessary political conditions for the successful implementation of the program by receiving the support of the Left Party of Gundrun Schyman (in the first six months of their government) and- even more important- of the

207 Göran Persson, 1997, *ibid*, p. 132.

208 Göran Persson, 1997, *ibid*, pp. 38-38 and p.48

Center Party of Olof Johansson in the spring of 1995. The Swedish social democratic party, even in the beginning of its political hegemony and in its heyday days, was obliged to seek the necessary support and tactical cooperation of other parliamentary parties. Having opted for the *reformist way to socialism,* meaning practically the implementation of gradual reforms by use of parliamentary means and by state legislation, the social democrats succeeded in the 1930s to form a historic cooperation with the Center Party, representing the interests of the peasants, and to put in place the crisis policy of the 1930s, which inaugurated their lasting political hegemony)- which was far from secure even after the Second World War period. In the radically different setting of the 1990s the party had to look for political support in order to form a viable government after the 1994 elections and carry out the budget consolidation program immediately afterwards. That the Left Party showed willingness to cooperate and lent its support to the program of *budgetsanering* immediately after the 1994 elections is indeed, something noteworthy. It indicates, as one may assume, how deep and widespread the concern about the critical state of the public finances in Sweden had been at the time. The concern was so deep and pervasive that even a party considered to be “populist” and supportive of unfunded welfare reforms in the past found itself ready to grant support to a drastic budget consolidation program. The leadership of the Left Party may have thought that it was worthwhile being present in the whole program trying to mitigate its most harsh features (and winning political credit for it) and, even more importantly, winning support among the members of the LO, the interests of which the Left Party in the new political setting of the 1990s did its best in trying to actively defend.

However, the support from the Left Party did not last long- not because the leadership of the Left Party had second thoughts and decided to put an end to it, but because a new political partner –the Center party- presented itself with constructive proposals to the social democrats. The latter considered the proposals to be so advantageous that they thought it worthwhile not only to accept them but also broaden them. The social democrats opted to form an a *allians över blockgränserna-* i.e. an alliance surpassing the two rival political blocs: the socialist and the bourgeois In fact, what tempted the social democratic leadership most was exactly this aspect of the cooperation with the Center party: the prospect of a cooperation with a defector from the bourgeois bloc would be a terrible blow to the Conservatives of Carl Bildt amounting to a serious weakening of the center-right bloc. But apart from this, another aspect weighed most in the considerations of the social democratic leadership and their willingness to form a new political coalition transgressing the limits of the two traditional political blocs: the continuing critical situation of the Swedish economy in the Spring 1995. Despite the extensive budget consolidation program, the expected interest rates reductions did not come about. Even in the 2000 document on the balance-sheet of the 1990s economic and financial policy it was recognized that the consolidation program had little effect on the interest rates and on the exchange rate of the krona. The continued lack of confidence of the financial markets after the experiences in the period 1991-1994 was deemed to be the single most important factor for the interest rates remaining in alarmingly high levels. The long-term interest rates stayed in the first half of 1995 at around 11% and the krona weakened further. Inflation had surpassed some months the 3% mark. The inflation expectations were according to some inquiries around 4 percent. Even the wage increases were high, both in relation to the inflation target and in relation to the continued high unemployment. Despite the tight fiscal policy the interest rate increases were continuing, periodically in small steps, until July 1995, when the leading interest rate of the Riksbank reached 8.91 per cent. It was thus raised with 2 per cent in just one year[209]. The economy seemed to be stuck - and even the implementation of the front- loaded measures did not seem sufficient to trigger the much needed interest rate reduction- or the beginning of a process of them being scaled down The new social democratic government was, literally, with its back on the wall.

The situation was becoming even more critical since the hopes invested in a new policy on the area of the labour market policy- traditionally a field on which the Swedish social democracy had scored brilliant results and the only area where a room for maneuver seemed to be available- had not been confirmed. The initial plans for a new ambitious and adapted to the new conditions labour market policy involved measures such as the shift from cash support to active labour market measures, productivity enhancing measures and efforts to favour new job creation in the production process. These ambitious new orientations had their seeds in the Recruitment and Employment Support These plans were initially supported by the LO leadership, whose new chairman, Bertil Johnsson, declared that the planned labour market program of the government was impressive. In the time preceding the announcement of the new labour market program, the LO's economists were deeply disappointed that the government had decided to implement such an extensive budget consolidation program, which entailed serious cuts and worsening of the living conditions of the LO members despite the efforts for a fair distribution of the burdens. The obvious disaffection of the LO economists became public even before the budget presentation in a publication about the evolution of the economic conjuncture. The conclusion drawn by the LO economists were very clear: there was a risk that the fiscal policy would be excessively strong and that the monetary policy would

209 Ministry of Finance,, 2000, *ibid.*, p.31

inhibit growth at the same time. In their view, if the government were unable to attain a strong reduction of the unemployment (unemployment was around the 10% at the time) and continued to cut the benefits, the labour movement would fall apart. In that case, they pointed-out that the social democratic party would becoming a “party among others”, a European middle-class party which manages mass unemployment[210]. The announcement of the new labour market program elicited the support of the LO chairman and led the economists of the LO to the conclusion that the labour market policy would constitute the field, in which an expansionary policy could be practiced since on the field of the fiscal policy the way to an expansionary policy was barred because of the huge budget deficit. Dan Andersson went as far as to support that that the labour market policy could play a key role in the economic policy and an increased efficiency of the labour market policy could make easier a reduction of the interest rates. A crucial precondition for this to happen –Andersson pointed out- was a supply- oriented labour market policy,[211].

However, the hopes invested in the mew labour market policy were not going to be confirmed in the first half year of 1995. The new recruitment support measures were judged to be far too expensive and they were considered to benefit only the rich companies and to increase their profits. The recruitment and employment support program did not become a success story and the same happened with the Agreements on Competence Development, which soon acquired a bad reputation among the employees’ trade unions since it was proved that the employers demanded that the unions would accept lower wages in exchange for an agreement. The new labour market policy was defying the established structures, the ideas and perceptions at the Labour Market Board and the trade union organizations. At the same time, the Labour Market Ministry was unable to mobilize the expertise which was necessary in order to see to it that the new proposals would produce effects. The expertise for such a task was to be found in the Labour Market Board and when finally it was incorporated to the outlining of the program by the Ministry, the last was subject to detailed criticism.

The new labour market policy faced serious difficulties: it run contrary to the established structures and could not take advantage of their collective experience in the field of the labour market policy. Furthermore, it became amply clear that when the demand in the economy was reduced, this led to a weak and ineffective labour market policy.

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Peeter Jaan Kask, 1997, *ibid*, pp.235- 239.

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Peeter Jaan Kask, 1997, *ibid*, pp.236-237. The remarks of Dan Andersson were contained into a memorandum submitted to the LO leadership.

The government was obliged to concentrate on more traditional measures in the Spring budget of 1995, at the same time as the supply- side policy was further developed. But despite some internal plans of the government to attain the goal of reducing the open unemployment by 100 000 in 18 months, no move towards this goal had taken place. The prognoses were pointing towards a very modest reduction in the unemployment in 1995 and 1996 [212].

It was at that particular juncture and with a serious unemployment situation that the first behind- the scenes contacts between the *eminences grises* of the two parties began to take place. It occurred to Carlsson and other members of the social democratic party leadership that a cooperation going beyond the rival political blocs might be the political development which could convey to the markets the image of a political system firmly united around an updated policy of budget consolidation and determined to implement it. That image could strengthen the credibility of the policy pursued. For the Center Party, the main motives behind the effort to reach an agreement with the social democratic government was both a demonstration of a sense of responsibility as well as an expression of their desire to protect the agricultural sector from excessive burdens which the social democratic government was intent on imposing on them. The social democratic government was namely planning to impose a tax on the agricultural real estate and a tax on agricultural fuels.

The final outcome of the negotiations, which were kept secret and were conducted among a handful of highly placed persons in the two parties (to which the leader of the National Farmers' Association was added) produced the much desired political agreement. The agreement contained, among other things, a reduction in the compensation level of the unemployment insurance to 75 percent, more expensive medication, worsening of the pension insurance and reduction in the value-added tax on food. Agreement also was reached on a system of tax equalization for the country's municipalities.

Beyond the specific measures contained in the agreement with the Center Party, what mattered most for the governing social democracy was that a more broad political support had been created for the budget consolidation program, a support offered by a party belonging to the rival political block. The obvious tactical political advantages resulting from the agreement (a considerable blow to the Conservatives, who were emboldened by the difficult position in which the social democratic government found itself in the spring of 1995 because of the persistently high interest rates) were weighing much less than the fact the Center Party threw itself behind the economic policy pursued and supported the even more ambitious fiscal goals contained in the Complementary Budget

212 Peeter Jaan Kask, 1997, *ibid,* pp.239-241

Statement of April 1995: the public finances would be in balance in 1998 and the public debt would be stabilized in 1996. The social democrats had succeeded in obtaining political support for their budget consolidation program in the midst of persistently high interest rates and financial anxiety. Göran Persson asssessed the agreement with the Center Party as being so important that he calls it in his book *the cooperation which secured the public finances*.

The importance of the agreement does not mean that it did not entail also serious political disadvantages- because of the way in which it had been reached and because of some of the measures contained in it. The Parliamentary social democratic party was not at all informed about the ongoing negotiations even in their last phase and was put in front of a *fait accompli*, having no other option but to accept it when the agreement was presented to them.

Even more serious was the negative and critical attitude of the LO leadership towards the content of the agreement with the Center Party. Not only the LO had not been consulted and kept informed about the ongoing negotiations, but also the reduction in the replacement rates in the unemployment benefit was hard to swallow. Some representatives of the constituent unions of the LO were very sharp in their reactions to the agreement. What had offended more the LO leadership was the complete negligence on the part of the government to inform in time the LO about the negotiations and their results. It was perceived as an act of contempt to the spirit of collaboration which was supposed to permeate the labour movement. In fact, one of the most significant results of the 1995 economic policy of the social democratic government was the severe weakening of this organic unity between the two wings of the labour movement, the political and the trade-union one .

The agreement with the Center party sealed the fact that the governing social democrats were able to secure the crucial political preconditions for the implementation of the budget consolidation policy. In the remaining part of 1995 and in 1996 the social democrats, having gained momentum from the first signs of a decline in the interest rates (it begun in the summer of 1995 and continued thereafter) and from the strong increase in the value of the krona, proceeded to a refinement of the budget consolidation policy and accompanied it with important institutional changes aimed at strengthening the credibility of their policy.

Already in January 1995 the government stated that the budget policy, apart from the carrying out of reductions in expenditure and increases in the public revenue, should be oriented towards structural change. The emphasis was now put on the importance of the institutional framework of the budget process. In the complementary budget statement of April 1995 the government proposed a *ceiling for the public expenditure as a means to realize the goal of stabilizing the state debt.* The ceiling for public expenditure was made more precise in the Spring statement on the budget (prop.

1995/96: 150) The ceiling on state expenditure was proposed to be nominal and of three- year duration. Thus the proposed ceiling on state expenditure was comprising the years 1997, 1998 and 1999. The decisions were to be rolled over every year and in every Spring Statement on the budget a ceiling on the public expenditure was to be announced for the next year. The ceiling comprised all expenditure in the state budget apart from interest rates on the public debt. In addition, expenses for the social security system are included which are accounted outside the state budget. The shaping of the ceiling for public expenditure was included in a greater reform of the whole budget process. Apart from it, a new budget cycle was proposed with an economic Spring Statement in April and one in the Budget Statement in Autumn. Furthermore, a description was made on how the prognosis and follow-up work could be improved. All these changes were aimed at strengthening the institutional framework of the budget process. An important starting point was that central decisions, as for example the establishment of the ceiling on public expenditure would be taken early in the process. The continued budget preparations would then happen inside the framework which had been established. In the new budget process the follow-up and of the assessment of the results would be given a central role[213].

The effort to make the budget process even more tight was made explicit with the adoption of a new model for the shaping of the budget, the so-called framework-decision model (*rambeslutmodel).* According to this decision-making process the Riksdag decides on the budget in two steps. In the first step the parliament establishes the whole budget space and distributes it on 27 expenditure areas. The Parliament establishes also an estimate of the revenue on the state budget. Once the framework for each expenditure area had been decided, the expenditure areas and the distribution in funding is treated in the different committees of the Riksdag. The frameworks which had been decided for every area of expenses in the first step constitute a binding restriction. After the preparatory discussion in the committees of the Riksdag a decision was taken about the different allocations. All allocations. within the respective expenditure area are distributed with one decision[214].

Parallel to the already mentioned ceiling on public expenditure, a further innovation underlining the decisiveness of the government in the area of the fiscal policy was the proposal for a *long-term surplus target* for the first time presented in the Spring Budget Statement of 1997. The government

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213 Ministry of Finance, 2000, *ibid,* pp.28-29.

214 Ministry of Finance, 2000 *ibid*, p.29

proposed that that there would be positive public savings to the tune of a budget surplus of 2% of the GDP on average. The main reasons invoked by the government for this surplus target were threefold:

- The public liabilities were going to be exposed to a big strain towards the beginning of 2000s mainly because of a growing number of elderly people. A surplus in the public finances plays an important role in arming the public sector with the possibility to meet this challenge.
- The ability for pursuing economic policy would be improved. With a budget surplus of 2 per cent of the GDP as a starting point there is a margin permitting to actively counteract the downswings of the business cycle without the deficit threatening to become too big.
- A surplus in the public finances favours and renders possible high private investments without Sweden's external debt increasing.

The target for the savings of the public sector comprised the whole of the public sector, i.e the central state, the social security and the local government sectors.

The financial savings of the local government sector is directed by the so-called *balance requirement*. The requirement for balance for municipalities (*kommuner*) and counties (*landsting*) means that they must draft their budget in a way that revenue surpasses costs. A possible negative result should be reestablished in two years' time.

On the basis of the 2% surplus target over an economic cycle more precise targets for each year are established in relation to the budget process. The target is defined on the basis of an assessment of the economic situation. The starting point is that the 2% surplus target ought to be reached when the capacity utilization in the Swedish economy is on its potential output (the level that can be maintained without inflationary pressures). In the low point of the business cycle the surplus target should be consequently lower than 2 per cent and on the up of the economic cycle bigger than 2 per cent[215].

The experiences with the 2% surplus goal in the four year period 1997-2000 were judged as good by the experts in the Ministry of Finance and the social democratic government. More on the nature and its effects of the 2 per cent surplus target will be said in the next section, where an assessment of the whole budget consolidation policy will be undertaken. In this context what needs to be emphasized is that after those important institutional changes in the rules governing the budget preparation and formation process, Sweden got a much tighter budget preparation process in line with other European countries. That the budget preparation in Sweden was too slackened and lax

215 Ministry of Finance, 2000, *ibid*, pp.29-31

and needed to be tightened was already one of the 113 recommendations made by the Lindbeck "economy commission". Now some years later the social democratic government was turning this recommendation into reality thus achieving an important institutional change which lent to their budget consolidation policy further credibility. In fact, some aspects of those changes were more drastic than in other European countries. We shall see in the next section that the social democrats were producing institutional changes with a remarkable zeal. The ceiling on the public expenditure and the "framework decision model", in which proposals for increases in expenditure must be financed within the expenditure area and/or within the ceiling, brought about comprehensive restrictions in the budget preparation process. As Lennart Erixon points-out, the use of a top-down budget process for central government from 1996 restricted the ability of Parliament to increase expenditure by a breakdown of the budget items[216]. The defenders of the new budget process point out the increased transparency thus attained, since a series of social security programs and labour market funds are now included in the budget. It is true that an increased long-term planning and follow-up of the expenditures and an increased budget discipline has been achieved as a result of the above described battery of institutional changes undertaken as a further aspect of the budget consolidation policy.

Over and above the quantitative targets of the Budget Consolidation Program and the ensuing institutional changes in the process of the budget preparation, an additional feature of the policy examined is the extremely tight monetary policy which a *de facto* independent Riksbank pursued having as an exclusive aim the fear for fueling inflationary expectations damaging the credibility of the monetary policy and the concern for the weakening of the krona. In fact, what made the budget consolidation policy even more tight and its impact on employment prospects adverse, at least until 1996, was that it had been carried out without the slightest accommodation by a Riksbank bent on preserving its de facto acquired exclusive control of the monetary policy. There can be no doubt that a more accommodating and flexible monetary policy, more directed towards stimulating the strained economy by means of interest rates reductions and less obsessed with the inflation and the inflationary expectations, would have made the budget consolidation policy less painful. A willingness on the part of the Riksbank leadership to coordinate and synchronize its monetary policy with the social democratic government might have reinforced the recovery of the economy. That this did not happen must, at least partially, be attributed to the fact that the social democratic

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216 Lennart Erixon, 2013, *Can fiscal austerity be expasionary in present Europe? The lessons from Sweden.* p. 4. Article based on a speech at the Madariaga College of Europe Foundation, Brussels, November 23, 2012.

government early in the process – in fact already during the electoral period- gave up any ambition and intention of fighting hard for getting Riksbank to agree to such interest rate reductions. As already observed above, one of the most important decisions taken by Persson and its associates in their first months in the Ministry of Finance were their acceptance of the general direction of the monetary policy pursued by the Riksbank leadership. As Peeter Jaan Kask in his informative book observes, it was already in Spring 1994, that is, months before the Wohlrath statement of distrust of the Swedish government bonds, when Persson decided to stop expressing the demand for a new orientation of the monetary policy. In the parliamentary bill in May the formulations had been mitigated and the part on the monetary policy had been toned down.

Persson had faced continuously questions about the position of the Chairman of the Riksbank- one went as far as to openly ask him if the social democrats had the intention to remove Urban Bäckström from office. Persson was replying with a standard answer consisting in repeating that Bäckström was in the middle of his term and deserved a chance to show what he was able to deliver. Persson and his economic advisors were becoming more and more reluctant to discuss the monetary policy in the midst of an electoral campaign. The argument was that such an attitude could have damaging consequences for Sweden. The social democrats were afraid of the risk that a controversy around the monetary policy would provoke a negative reaction from the markets – with further negative side-effects on the support of the electorate. Only weeks before the elections the decision was already taken that no new change in the monetary policy was going to happen- let alone to be fought for. In a very revealing interview a week before the election Persson stated that "*after the interest rate shocks the situation had changed . It would be a mistake to have a political controversy in the Riksdag in the autumn around a new priority of goals for the Riksbank.* He pledged that the monetary policy was going to remain the same[217].

Could a government, so determined to stabilize the economy by gaining the confidence of the financial markets by pursuing a fiscal policy of drastic cuts at the expense of a demand stimulating measures, fight for an accommodating and expansionary monetary policy? Could it risk an open conflict with the Riksbank leadership in such a fight? Could a suitable and more flexible combination of a drastic fiscal policy with a more flexible monetary policy be worth the price of a conflict with unpredictable impact on the much feared financial markets? Whatever the answer to those questions, the social democratic government quickly abandoned any intention of fight on the issue of the monetary policy. The social democrats preferred to concentrate themselves on their

217 Peeter Jaan Kask, 1997, *ibid,* pp.212-214

exclusive domain: that of the fiscal consolidation. The possible recessionary impact of such an option did not matter. Or it did not matter as much as the risk (or the fear) for a violent reaction from the markets. The crucial field of the monetary policy was abandoned to the exclusive treatment and decision-making of the Riksbank.

How the Riksbank assessed the economic situation and what direction did it give to the monetary policy in the crucial years 1994-1998? As already mentioned in the first half year 1995 the long-term (market) interest rates were on persistently high levels. The much desired reduction of the interest rated began to take place from the middle 1995 on, the krona began to gain in value and the inflation expectations in the end of the year, both in the short and in the long ran, were under the 3 per cent mark. Whether this changed nature of expectations was due to the fact that the consolidation program and the budget targets had become known or not is even today an issue open to investigation and to opposite considerations and opinions – and needs not be taken up here. What merits to be mentioned was that the Riksbank even in the positive climate of the second half of 1995 maintained unchanged its prime interest rate (repo-rate) at 8.91%- and this despite the tight fiscal policy and the slowdown of the inflation expectations because of the strengthened krona. In a report on the inflation expectations the Riksbank declared, nevertheless, that there was a risk that an increased private consumption could lead to increased costs for the imported products and that higher wages could be rolled forward and increase the consumer prices. This prognoses was going to be proved unfounded. The consumption expenditure of the households increased with o.6 per cent in 1995 and 1.4 per cent in 1994, and were thus slower than in 1994. The Riksbank made a false assessment of the process of private debt consolidation and of the correction of their asset position, which was far way from being brought to an end. This led to an overestimation of the danger for inflationary expectations. Even in November 1995 the Riksbank considered that the inflation would be near the upper limit of its target during 1996- the year which, according to the OECD estimates of cyclically adjusted budget balances was *the very year of fiscal austerity in Sweden* [218] - and even higher in 1997[219].

The first reduction in interest rates was undertaken by the over-cautious Riksbank in January 1996, the first in a series of interest rate reductions which went on up until December. On the whole, the interest rates were lowered from 5 per cent on average to 4.1 per cent. It was one of the greatest

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Cited in a footnote in Lennart Erixon, 2013, *ibid*, p.5

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Ministry of Finance, 2000,

interest rates reductions which were carried out in an industrial country with floating exchange rates. In the beginning, the long-term (market) interest rates increased somewhat, but from March up to the end of the year the ten-years- rates fell from 9 to 6.5 per cent. The value of the Swedish krona, the other crucial concern of the Riksbank in those years together with the inflation rate, was relatively stable between 115 and 120 for the main part of the year. The inflation expectations went steadily down.

As for the rate of inflation, this fell from March 1996 and at the end of 1996 was near zero, (measured with the Consumer Prices Index, that is, under the inflation target of the Riksbank. This took place in the harshest year of the budget consolidation policy, when the GDP- growth fell strongly from 3.7 per cent in 1995 to 1.1 per cent in 1996. The weakened growth rate in 1996 was a combined effect of the international economic downturn and of a weak domestic demand, as a result of the austerity measures of the consolidation policy.

In 1997, the year of the eruption of the Asian crisis, the Riksbank made equally false predictions about the risks for a rise in the rate of inflation. In its inflation report in December 1997, the Riksbank predicted that the inflation rate would surpass the 2 per cent in a year’s time. The starting point for this prediction was that the economy would grow with 3 per cent per year in 1998-1999 and would reach the full capacity utilization ceiling. This assessment led the Riksbank to an increase in the repo- interest rate with 0.25 to 4.35 per cent. It was a preventive move aimed at averting expectation about a higher inflation.

The inflation prospects were going to be considerably different from the prognosis made by the Riksbank in its report. The wage negotiations led to a much lower level than the previous ones. Taken on the whole, the risks for an inflation surge caused by domestic factors was significantly lower. The increasing confidence that the inflation would be from now on much lower and the positive developments in the Swedish labour market, where the so-called Co-operation Agreements were concluded on a mutual understanding on how the negotiations would contribute to a positive development of the Swedish economy, are pointed out by the experts at the Ministry of Finance as the main factor for the much lower rate of inflation than that initially anticipated by the Riksbank.

Under the impact of the Asian crisis since the Spring of 1997 and recognizing that the inflation rate would be lower than its target in a two year’s term, the Riksbank lowered its repo-interest rate in the June 1998 by 0.28 points to 4.1 per cent[220].

Afterwards, the conclusion can be drawn that the monetary policy during the crucial 1994-1998

220 Ministry of Finance, 2000, *ibid*, pp.31-32, 34-35.

period was tighter than that needed in order to reach the inflation target of 2 per cent during 1996-1997. The reason was that the monetary policy was made restrictive in order to overcome the credibility problem. The Riksbank chose to downplay the effects of the strengthening of the exchange rate and of the reversal in the inflation expectations during the second half of 1995. It underlined, instead, the risks for an upsurge in the private consumption in a situation where there existed few indications that the consumption would raise significantly. This is surprising since the effects of the budget consolidation policy on the consumption of the households could be easily expected to be drastic. That the Riksbank leadership chose to take no notice of the very tight fiscal policy practiced by the social democratic government and not to take into account its effect on the private consumption is indicative of the absence of any effort at synchronization or of an elementary coordination of the two branches of economic policy. In fact, the economic policy was compartmentalized: the social democratic government had made the clear decision to concentrate itself on the implementation of a drastic consolidation program and let the Riksbank to take care of the monetary policy. Obsessed, to an equal degree as the social democratic government, with the risk for an inflationary upsurge (mainly because of the weakening of the krona and the dynamism of the export-oriented industry) the Riksbank constantly overestimated the factors susceptible to fuel the inflation and kept its prime rate at a high level, thus reinforcing the recessionary effects of the budget consolidation policy.

Not only the social democratic government was reluctant to exert pressure on the Riksbank in order to influence the monetary policy, but also the appointments made to the Executive Board of the Riksbank were met with growing skepticism and were indicating that no serious change was to be expected. Taking notice of the decision of the social democratic leadership to appoint Kjell- Olof Feldt as chairman of the Board of the political representatives of the Riksbank and of the ex-Budget Minister Bengt Johansson as a member of the Board, a member of the social democratic party made the following remark : “ *Exactly those persons which in the past had the responsibility for the monetary policy and for the march into the financial crisis are now rewarded by being charged with managing the Riksbank. We have a party which really turned itself to the other side.*

The social democratic leadership very early made the strategic decision to dedicate itself to a policy of cuts and economies. No space for stimulus of the economy was thus left on the field of fiscal policy. They gave up any ambition or effort to influence the monetary policy in a more accommodating and expansive direction and to interfere with an increasingly independent Riksbank which took complete charge of the monetary policy. The whole policy area where a space for stimulating measures existed was the labour market policy, but, as above analyzed, the results were poor and far below the initial expectations. Even the most sophisticated and innovative labour market projects were unable to deliver substantial results- given the recessionary effects of the tight fiscal and restrictive monetary policy.

In the end the much expected interest rate reductions became a reality in the second half of 1995. Despite the reduced growth rate in 1996, the policy of budget consolidation began to have tangible results in 1997 on the domains deemed to be of high priority: the reduction of budget deficit, the stabilization of the public debt from 1998 on and the reductions of the interest rates. The drastic and overambitious social democratic consolidation program seemed to be crowned with success. However, the price in terms of unemployment were considerable and the impact of the program on the strategic orientation and policy profile of the Swedish social democratic party was deep and irreversible . The time has come for an effort to assess the successes and the failures of the program.

III. An austerity program for saving the “Swedish Model”? Criticisms formulated about the austerity program of the social democratic government in the period 1994-1998

Economics is actually a fairly simple issue. It is all about common sense. When the matter is about predicting the future, one can ask my aunt and (the famous economist,*) Klas Eklund . it is the same thing*
Göran Persson[221]

Watch out, Mr Persson. The market is watching you!
IFM Director Michelle Camdessus[222] during a meeting with Göran Persson in 1994

There can be no doubt that the fiscal consolidation program sketched, established and implemented by the social democratic government in the period 1994-1998 was a major, a watershed event in the economic history of Sweden. With this program, an economic policy switch (*politikomläggning* in Swedish) of primary importance took place in Sweden which marks the beginning of a new economic- policy regime with lasting effects on the traditional Swedish Model and its subsequent evolution from the mid-1990s. Lennart Erixon, Professor emeritus of Economic at the University of Stockholm and one of the researchers who took the program under close critical scrutiny, maintains (in an already cited article) that ”*disregarding the fiscal policy in Germany in 1996-1998 and the Netherlands in 1996- 1999, the Swedish fiscal policy in 1995- 1998 is the most obvious example of fiscal austerity in the OECD countries in the three and four-year perspective.”* Pointing out that the program of budget consolidation carried out in the mid- 1990s by the social democrats seems to have been more restrictive than the Thatcher policy in the UK in the period 1979-1982, Erixon asserts that the public budget consolidation policy in Sweden in the 1990s was radical from

221 Cited in Peeter Jaan Kask, 1997, *ibid*, p.190

222 Cited in Göran Persson, 1997, *ibid*, p. 46

an international perspective. [223]

More competent at implementing a big program of cuts and economies than the previous, Conservative- led government, more radical than the fiscal policy of the British Conservatives, the Swedish social democratic government produced a fiscal miracle, compared to which the radical declarations of Carl Bildt for a new era in the economic policy in Sweden in September 1992 seem to be a mere wishful thinking. Bildt, as a leader of the center – right coalition government, can only be considered as the man of ambitious programmatic declarations proclaiming the imminence of a deep structural change in the Swedish model of society, but Persson was the man who had the strength of will, the determination and the stamina to carry out the most extensive fiscal consolidation program thus far practiced in the OECD countries. Bildt will be probably remembered in history as the conservative politician who wanted to produce radical change, but was unable to deliver it, while Persson will be remembered as the one who was able to carry out and to bring to conclusion the program of radically reshaping the Swedish Model already initiated by the social democratic party in the 1980s with their ”Policy of the Third Way” . And Persson – and his closest associates – will be credited with the achievement of having got Sweden out of the traumatic crisis at the beginning of the 1990s and of having saved from its welfare model what it could be saved from the mess to which it had been led. So, one is tempted to conclude that the social democrats under Persson were the perfect political vehicle for carrying out market- oriented reforms and austerity measures which the Center- right bloc was unable to carry out. One is tempted to conclude that only the political force that founded the Swedish Model, was best suited -and had the necessary legitimacy (and political leeway) to transform it into something very different (while maintaining some of its aspects). Was the budget consolidation program a neoliberal austerity program which only a left-wing party could accomplish, thus confirming a famous and often cited motto that “*there is a Left which is capable of doing painful changes which the Right is unable to carry out*?

One has to be very cautious while trying to give an answer to the above question. One should take into account the concrete circumstance under which the budget consolidation program took place and should not, light- heartedly, consider the arguments advanced for characterizing them as mere ” propagandistic devices” aimed at legitimizing a neoliberal set of drastic cuts by couching them in the usual social democratic terminology, thus making this policy acceptable to the rank-and-file of the social democratic party and its core electorate.

Before making a balance of the positive and negative aspects of the program, let us see how Persson

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223 Lennart Erixon, 2013, *ibid*, , p 5

himself considers it and what the major achievements of the program were according to him. Persson thinks that with the program's successful implementation a negative development for Sweden was averted on four major levels: 1) the increase in public debt was halted and the deficit in the public finances was eliminated, 2) the budget consolidation process saved the welfare system, since a new sustainable foundation was laid for the Swedish welfare policy, 3) the decision-making power was taken away from the markets and the democracy was strengthened. The preeminence of politics was reestablished, 4) the pessimism created by the budget deficit was overcome and the self- confidence of the country was reinforced.[224]

A sense that something particularly difficult, but absolutely necessary had been achieved permeates the whole book of Persson, the feeling that a serious risk to the Swedish welfare system and to the Swedish democracy has been averted and that a huge challenge was successfully met is present from the very beginning up to the end of the narration of Persson. The expressions used by Persson make plain that he is proud that the Swedish social democracy was able to meet this challenge to the Swedish Model and to avert the danger for the democratic decision- making process. The achievement of the budget consolidation is considered to be even more important since the conditions under which the whole program was undertaken were particularly difficult and pressing. No matter what one may think about the arguments of Persson, one cannot deny that the new social democratic government had indeed achieved something remarkable. The social democrats came to power with an acute feeling of emergency and with a stern determination to take hold of the public finances, to get Sweden out of the "debt trap". By drafting a highly ambitious fiscal consolidation program, the social democrats set themselves the task of implementing it so as to stabilize the public debt from 1998 on - and they did it. Perhaps, the program will be recorded as an enormous collective economic achievement undertaken in a situation of high unemployment and under unfavourable conditions.

There can be no doubt that the circumstances under which the program had been sketched and implemented were indeed exceptional. Sweden was in a state of financial emergency, the real economy had shrunk for three consecutive years, 1993 was the *annus horribilis* of the crisis, the unemployment had sky-rocketed, the state of the public finances was critical, and the policy measures decided and implemented by the right- of -center coalition government were a classic example of a volontaristic and unrealistic economic policy of system change, which lacked the necessary sense of reality and the awareness that the political conditions for such a swift and deep

224 Göran Persson, 1997, *ibid*, p.21

systemic change were lacking. To make matters worse: Bildt and his cycles had tragically misinterpreted the nature of the crisis and clung to an anti-inflation policy at a time were inflation was in sharp decline.

The accumulated effects of the policy choices of the previous government, worsened by untimely and disastrous measures such as the tax rebates for the well- off and the unwillingness to take measures aimed at mitigating the depression , pushed the Swedish economy into a deep and unparalleled depression and significantly worsened the state of public finances.

At the time of their return to power in 1994 the social democrats inherited a mismanaged economy and public finances in a lamentable state- with a budget deficit at 11.3 per cent of the GDP in 1993. They had no other option but to try to present a credible, realistic and immediate emergency program of both redressing the economy and ameliorating the public finances. The situation was even more critical since the international economic environment was in the mid-1990s had changed since the 1980s: the financial markets had been internationalized and they were so tightly interconnected that free movements of capital could much more easily destabilize the national economies. The traumatic currency crisis in September 1992 had made it amply clear that in the absence of effective currency controls speculative attacks on the krona could be of such an extent that the Central Bank was unable to defend the excange rate with interest rates hikes, which were both unable to attain their aim and were pushing the economy further into the recession (while the currency reserves of the country were depleted and wasted in a fruitless effort). The margins for an autonomous monetary and fiscal policy had been further narrowed up to the point to suggest that any effort for a classic social democratic policy was doomed, if not to failure, at least to serious difficulties. The powerful winds of the deregulation, which had been blowing since the beginning of the 1980s, had in the 1990s produced a new internationalized and interconnected financial system of deregulated markets which were surveilling and scrutinizing the fiscal policies pursued by the national governments and were able to sanction them with attacks and interest rate shocks.

The new social democratic government arriving in power had to take into account all these events and changes and without wasting time, to present a credible and effective program for coping with an economy that had contracted for three consecutive years and for redressing the public finances. It was not the first time the social democrats were facing such a critical situation. In the beginning of the 1980s (see Chapter 2) the social democratic government of Palme- Feldt was facing circumstances which seemed to defy the old social democratic policy priorities and were making their implementation a far more complicated matter. But in 1994 the situation was much more alarming: the Swedish Model was on the verge of collapse because of a devastating recession and an unprecedented financial crisis, which had shipwrecked part of the banking system. Admittedly, the social democrats could not be exonerated for their serious responsibility in creating the conditions for the real interest rate shock and the collapse of demand due to the bad timing of the reforms decided and carried out in the framework of the Third Way Policy (deregulation of the credit market, overheating of the economy, cost crisis of the industry, deregulation of the exchange rate controls, tax reform reducing the interest rate tax allowances), but the handling of the crisis by the center- right government greatly worsened the predicament of the Swedish economy and it was the main reason for its plunging into an unparalleled depression. The social democrats were now called upon to get the economy out of the stalemate and the Swedish Model away from the brink of collapse and disintegration.

We saw in a previous chapter that the plunge into the abyss of the Swedish economy was provoked by the cumulative effect of the collapse of the real estate values after the burst of the bubble and of the skyrocketing of the savings rate of the Swedish households in the period 1991-1993. The incapacity of the decision- makers and of the leading economists to correctly interpret the real causes of the depression at the beginning of the crisis, to establish a link between rapidly deteriorating economic situation since the Summer 1991 and the drastically increased savings rate of the households and their willingness, instead, to point to the high taxes, to the too generous welfare compensations and to the rigidities of the labour market as the deeper reasons for the crisis led to policy measures which further aggravated an already serious economic crisis.

That the dramatically increased savings rate of the Swedish households was a factor of paramount importance in explaining the contraction of the Swedish economy began finally to dawn upon highly placed social democratic policy- makers. In June 1993, two leading members of the social democratic party, Leif Pagrotsky and Jan O Karlsson undertook a visit in the USA and met with MIT economist Martin Feldstein. When they told him that in Sweden the savings rate of the households exploded to 13 per cent, Feldstein was more than surprised and said : ” Is this true? No, it’s not possible”[225].

The realization of the fact that the Swedish economy had been exposed to serious shocks caused by the changed saving behavior of the households began finally to take hold of the two social democrats. This realization became evident in the first significant political document produced by the social democratic party while in opposition, the May 1993 parliamentary bill. In that, the social democratic party points to the contraction of the demand –produced by the explosion of the savings

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225 Peeter Jaan Kask, 1997, *ibid*, pp.130-131

rate- as the main reason for the main part of the decrease in production and employment,
as well as of the rapidly deteriorating public finances. In line with this diagnosis a recommendation is formulated to abstain from measures which further reduce the income of the households and increase the savings. In particular a reduction of the value of the tax deduction for interest rates repayments to 25 per cent was proposed, the reduction of the insecurity about the social security system's future quality and reliability and the demand was presented that the real estate market should be spared form measures which increase the insecurity or lower the prices. To all that an encompassing package of measures with VAT reduction and investment stimulus was added[226].

The May 1993 motion was going to be short-lived and incapable of having lasting effects on the economic policy of the social democratic government, once in power after the 1994 elections. While the importance of individuals for the historical developments tends often to be exaggerated, there can be no doubt that decision to appoint Göran Persson as new Economic spokesman for the party in opposition (and possible Minister of Finance of a new social democratic government) was going to be of a decisive importance for abandoning any idea of demand- stimulating measures as those contained in the May 1993 parliamentary bill. Persson was a social democratic politician grown- up in municipal politics with a deeply ingrained intuitive feeling of the necessity for sound and balanced public finances. As Kask pointedly observes, for Persson the mere fact of getting indebted had a morally repugnant dimension. Even more important: Persson's approach to the economic matters resembles the way of thinking of a municipal accountant who views the economic process from a strictly book-accounting point of view: revenues and expenses should- from both a morally and book- accountant point of view – be balanced. Persson never held the academic economists in high esteem and he openly and without reservations confessed that he felt very little confidence in the economic profession and its main representatives[227]. While he correctly points out that the economists very often are connected to various interests and act as well-paid lobbyists - while stubbornly refusing to admit it and pretending to incarnate objective scientific knowledge- his distrust for deep theoretical and systematic reflection on the macro-economic matters and his aphoristic statement that *economy is a fairly simple matter* reveals a strictly book- accounting point of view unable to take into consideration the complexities of a national economy caught in crisis.

For Persson the main line of action was clear: what mattered most was to show that the government

226 Peeter Jaan Kask, 1997, *ibid,* pp.131-132

227 Göran Persson, 1997, *ibid,* pp.34-35

had the control of the public finances[228]. Persson's limited capacity for a systematic theoretical reflection on the national economy, his strictly book-accounting point of view acquired thanks to his political upbringing in the municipal politics predestined him to a conception of an emergency economic program into which the May 1993 parliamentary bill had no place.

That the consolidation program was strongly influenced by a book- accountant point of view has been pointed out not only by Erixon, but also by other economists- even by prominent monetarists ones. During a meeting-debate in January 1995 organized by the Swedish Association of Economists on the occasion of the Budget Statement of the new government and during which the first draft of the consolidation program was discussed by Persson himself and prominent economists(among them Lars Heikenste, Ulf Jaokobson and Lars Jonung) , Lars Jonung, a member of the cycle of the economits of SNS study group, a strong advocate of a monetarist, norm-based policy and former economic advisor to Carl Bildt pointed out that the point of view of Persson was a cameral one and cited as an argument Persson´s response to the question (earlier posed by the coordinator of the discussion) where he (i.e Persson) has acquired his economic training from : Persson replied that he had acquired it from experiences with the co-operative movement, from the movement of the savings banks and from the municipal politics. " *But Sweden is not a municipality, nor a savings bank or a consumer association"* objected Jonung, who also remarked that the economic- political proposition was lacking an analysis of the dynamics of the Swedish economics, how it can be influenced in a way that favors growth and contributes thus in bringing down the budget deficit. " *Now the book-accountant point of view is prevailing".* [229] Persson did not let the comments of Jonung without response. After having reminded that Jonung under his capacity of economic advisor to Carl Bildt's government is moved by the need to justify the harmful policy pursued by the Bildt government under the years 1991-1993, he pointed out that *Jonung and his gang* (sic!) *had chased the municipalities and urged them to reduce their consumption at the same time as the costs of the central government rapidly increased*. Persson asserted that it is necessary to make use of book-accountant measures in order to know what happened with the public finances[230].

228 Peeter Jaan Kask, 1997, *ibid*, p.190

229 Förhandlingar Nationalekonomiska Föreninger 1995-01-18 (Protocols of discussions of the Swedish Economic Assotiation) in : Ekonomisk Debat 1995, Nr 1, pp 79-104

230 Nationa Economic Association, *ibid,* pp.96-97

In contrast to Jonung, Ulf Jakobsson, on other prominent economist taking part in the debate, expressed his agreement with Persson insistence on the urgent necessity to reduce the budget deficit. He points out that Persson is right when he speaks about the lack in "crisis consciousness" of the Swedish society about the dangers resulting from the vicious circle "budget deficit- interest rates payments- increasing debt". He supports that experiences from other countries show that a under big debt-to GDP-ratio analogous at that of Sweden (at the time over 80 per cent of the GDP) it is very difficult to break this vicious circle. He cites, in particular, the case of Belgium, where, despite the fact that the budget deficit was turned into a primary surplus, the too big interest rates payments had had as a consequence that the debt was continuing to grow. He, finally, expressed his belief that if- and only if- the new government would succeed in increasing the long-term growth up to 2.5 per cent, the road would open for a virtuous development for the Swedish economy. That said, he expressed also his disappointment that the part of the Government Statement on the fiscal plan was lacking in a clear-cut concept on how economic growth could be promoted. He, finally, aired his concern that the too big tax increases, which were a part of the new budget consolidation program, could pull the carpet for the whole consolidation proogram by reducing the growth rates." [231]

Ulf Jakobsson was, at that time, the Swedish economist who perhaps more than any other, came out publicly and lent support and theoretical justification to the policy of a drastic reduction in the size of the budget deficit which the new social democratic government had set out to implement. In a book published about the international experiences of other countries in the struggle to get out of the „debt trap" Jakobsson explicitly refered to the theory of rational expectations (formulated for the first time in the article of Robert Barro of 1974, "Are Government Bonds Net Wealth") in order to support the view that cuts in expenditure in order to consolidate the budget can improve the future incomes of the households, prompting them to adapt themselves to the new situation through reduced savings. He explicitly made use of the controversial concept of "expansive consolidation" in order to describe the positive effects to which a program of budget consolidation could give rise to[232].

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Ulf Jakobsson, 1995, in : örhandlingar Nationalekonomiska Föreninger 1995-01-18 (Protocols of discussions of the Swedish Economic Assotiation) in : Ekonomisk Debat 1995, Nr 1, pp.87-92

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Ulf Jakocsson, 1995 in: T. Backteman, V.Bergström, J. Frycklund, Ulf Jakobsson, S.O. Littorin, J. Herin, L. Prins, B*udgetsanering- fyra vägar ur skuldfällan (Budget consolidation- Four Ways out of the Debt Trap)* pp. 154-157

Despite the first reactions of prominent academic economist to the first version of the Budget Consolidation Program, there can be no doubt that Persson was a central figure in conceiving and implementing the budget consolidation program in its definitive version- the discussion at the Association of the Swedish Economist made it amply plain. The fact that he as School Minister had been proved capable of passing through a very difficult and controversial reform, the municipalization of the secondary education system, was a decisive factor for Carlsson for appointing Persson as Economic spokesman for the party. The redressing of the economy would be predictably a hard and very complicated process and it demanded a person with both goal awareness, single- mindedness and capacity for quick and decisive action. Seen form this point of view, *Persson* was the single most suitable *person* for such a difficult process. The role of economic experts was decisive for economic policy in Sweden since the beginning of the 1980s, as Lennart Erixon observes, but there can be no doubt that the making and the implementation of the budget consolidation policy of 1994-98 was political- and not expert- driven process: it was conceived and carried out under the constant surveillance and direction of Persson. Despite being politically-driven and despite the deep mistrust for the economic experts, Persson's approach to *what had to be done* to the Swedish economy was proved to be rather in line with what the leading experts at the Ministry of Finance proposed to the new Minister of Finance: In order to reach a balanced budget a decision had to be made for 75 more billion kronor in economies beyond those already contained (51 billion) in the social democratic electoral manifesto. That was the central conclusion of the reports made by Ingemar Hansson, one of the senior experts at the Ministry of Finance, to Göran Persson, the new Minister of Finance. No matter how mistrustful Persson and his closest associates may have been of the economic experts, the proposals made by them were taken over in their entirety by Persson, as Ingermar later confessed[233]. And the things were going to show that Persson and the technocratic experts were sharing one more concern: the importance attached to the need to *gain the confidence of the markets* as the only way to sustained recovery and growth**.**

It is important to remember how the social democratic party was led from the May 1994 bill to the first draft of the budget consolidation program. First, the proposal for a reduction in the VAT were drooped (in the first "shadow budget" of Persson in January 1994) , then came the international interest rate increases in the Spring of 1994 and the statement of mistrust of Wohlrath for the Swedish government bonds in the Summer. This led to a rewriting of the electoral manifesto with an emphasis on proposals for economies of 61 billion (although accompanied by important growth-

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233 Mentioned in Kask, 1997, p.189

stimulating measures). Then during the electoral campaign the decision was taken to accept the monetary policy practiced by the Riksbank and to abstain from any effort to oblige the Riksbank to a more expansionary monetary policy, in coordination with a demand-stimulating fiscal policy. And finally came the Economic- political Statement of November 1994, a month after taking charge of the government, which contained 58 billion economies and promises for further 20 billion in the January Bill Statement. In this Statement the measures for demand-stimulating measures were reduced to an insignificant fringe of the original plans. Kask observes that as a campaign for cuts and economies the Statement was a colossal success, but as an economic- political proposal the document was a political disaster, since it had few similarities with the social democratic policy which was presented in the electoral manifesto and in the Declaration of the Government. The basis had been laid for the fiscal consolidation program (the Crisis Agreement with the Center Party), the changes in the budget preparation process and the introduction of the ceiling on the public expenditure and the fiscal target of a 2 per cent primary surplus over the business cycle.

The basic assumptions underpinning the budget consolidation program in its first version was pretty clear:

Interest rates reductions would open the way for increased growth and employment

The interest rate reductions would be realized by winning the confidence on the markets for the economic policy through a drastic reduction of the budget deficit and the consolidation of the public finances.

Persson and his associates had established a clear connection between the budget deficit and the interest rates decreases: the last were to be achieved by drastically reducing the first. In assessing the whole budget consolidation process one should bear in mind this - more or less- straight line connecting these two factors.

At the time of its announcement the budget consolidation program attracted, as already mentioned above, the attention of the Swedish academic economists. Paradoxically enough, the basic assumption underlying the program, namely that the public debt was the primary ill which had to be addressed and that the recovery of the economy demanded an immediate and prompt reduction of the public debt, was met with skepticism from an unexpected side: the cycle of economists of the Business Cycle Council, the most fervent advocates of the norm-based policy since the mid-1980s. In an interesting article in the *Ekonomisk Debat*,[234] the chief magazine of the Swedish Association of Economists, the main representative of the cycle Hans Tson Södeström openly contested the

234 Hans Tson Södesrström, *Realräntechock, skuldsanering och budgetunderskott (Real interesr reates shock, debt consolidation and budget deficit),* in: Ekonomisk Debat, 1995, No 3, pp 189-202

wisdom of presenting the public debt as the main ill to be addressed and the policy of pushing too far in the direction of its drastic reduction. Without contesting the necessity of comprehensive cuts in the public system of public expenditure, Södeström underlined the necessity to bear in mind that the quick growth of the public debt had not been *any reason* of the crisis but instead only a symptom of the downward trend of the economy. He further pointed out that the crisis would have been substantially deeper , if the public debt had not been let expand. The growth of the public debt had been, according to his point view, accompanied by a reduction of the private indebtedness. The course of the crisis was involving a transfer of a given debt burden from the private to the public sector. After the real interest shock in the beginning of the 1990s and its negative effects on the market value of the real assets of the private sector, the private sector was forced to a a painful process of reducing its indebtedness by means of financial savings (reduced consumption for the households in relation to their disposable income, reduced investments for the firms in relation to their gross profits). Before the advent of the real interest rates shock in 1989-1990 the private financial savings were during , as Södeström reminds in his article, *minus 100 billion.* As an unavoidable reaction to the effects of the real interest rates shock a very quick debt consolidation process in the public sector was set in motion. From the following table, which is contained in the article of Hans Tson Söderström, one can see the evolution of the private savings in relation to the public financial savings and the current account balance:

Table: Evolution of the financial savings in the private and public sector and of the current account balance in billion kronors.

	1991	1992	1993	1994	1995	1996 prognosis	1:92-96
1	-3	61	162	165	179	157	724
Public sector	-17	-112	-193	-158	-136	-88	-{687
Current account	-20	-51	-31	7	44	69	38

Source: Swedish Economic Institute (Konjunkturinstitutet)- cited by Södesrström, 1995, ibid, p. 194

The conclusion drawn by Söderstöm is clear enough: If a quick change in the financial savings of the private sector takes place and given a certain level of production it is unavoidable that that the public sector enters and provisionally takes upon itself the debts which the public sector seeks to get rid of. In an economy with a big public sector as is The Swedish, Södertsröm points out, this happens in an automatic way: when the demand from the private sector falls, the tax revenue also fall and the public expenditure – mainly for the labour market policy- increases. The quick deterioration of the Swedish budget balance form a surplus to a deficit of 200 billion kronor was provoked by a process of debt reduction process in the private sector[235].

A further very interesting remark made by Södestrstöm concerns the burden of the Swedish public debt. Based on a table of the OECD (1994), Södeström points out that the *gross public debt of Sweden* seem to be really high (amounting to near 100 billion kronor and with Sweden occupying the third place with Canada at that time, after Belgium and Italy) . But if one choses instead to concentrate his attention on the, according to Södesrtröm, more relevant concept of the *net public debt*, then Sweden occupies a much better position: its net oublic debt amounts to 42 billion kronor- lower than the corresponding figure for countries like Belgium, Italy, Canada, UK and Germany. Södeström advocates the use of the net public debt as a more reliable and relevant figure by pointing out that the gross public debt would have been much greater in many other countries, if they- as it had been the case with Sweden – had chosen to fund some expenditure programs, and thereafter increased their borrowing in order to create this fund.

At the end of his remarkable article, Söderström even feels the necessity to address a warning (the last part of his article is ' *A warning and a concluding remark*') with respect to the priorities of the budget consolidation policy, which, at that time, had just been announced by the new social democratic government. Asserting, on the one side, that his arguments should not be misunderstood as implying that the size and the growth of the public debt are unimportant and that they should not be used as a means leading to the expectation that the budget deficit will disappear by itself, he, nevertheless, points out that he is against the economic-political point of view consisting in the belief that the budget deficit is the root of the evil, and that therefore the economic situation of Sweden would have been better if the growth of the public debt would have been checked in an earlier stage. Södesrtröm states that he is disappointed by the fact that the view that the deficit is the main evil is shared by the government, the parliamentary majority, the Riksbank, the IMF and the mainstream media.[236] It is important to remind, in this context, that the above 'revolt' against the established belief that the budget deficit as the main evil is held by the economist who more than any other else was in the forefront for a norm-based policy and against the social democratic accommodating policy during the 1980s. In 1995, when Person and the social democrats proclaimed the reduction of the public deficit to be their own norm directing their 'emergency program', Söderström, indirectly but clearly, revolts against it. He points out that 1) the budget deficit is a passive reflection of a process of a budget reduction undertaken by the highly indebted

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235 Hans Tson Söderström, 1995, ibid, pp.189, p191, pp.193-195,

236 Hans Tson Söderström, 1995, *ibid,* p.200.

private sector and that 2) the *net public debt* of Sweden is not so alarming for justifying an economic policy aimed one-sidedly at rolling back the budget deficit.

The critical comments of Södeström about a program focused exclusively and one-sidedly on the need to promptly and drastically reducing the public deficit were made in 1995, i.e at the first steps of the implementation of the budget consolidation program. Bearing in mind the critical comments of Söderström about the dangers of an exclusive focusing on the budget deficit as the primary ill, the above mentioned central assumptions underpinning the program and the results produced by it in the period 1995-1998, how could one asses the program with the benefit of hindsight? The first problem consists in defining by what criteria should one assess the nature of the budget process and its uniqueness. Lennart Erixon, who took the program under a close critical scrutiny, made an attempt to offer some criteria for judging its degree of severity. He points out that the rigour of the fiscal rules can be assessed in terms of 1) whether they are explicit numerical targets, 2) cover public expenditure or public budgets balance or both, 3) define the public debt or public deficit or both, 4) make exceptions for some budget items, 5) are only binding in the short, medium or long term, 6) are recommendations rather than compulsory (possibly including sanctions), 7) are national or supranational or both, 8) are fixed or time specific, 9) can they cover general government or central government and 10) they might have been in force for a long time or adapted rather recently. Examining the social democratic budget consolidation program on the basis of the above ten criteria Erixon supports that an overall evaluation of the fiscal rules introduced during its implementation indicate that they are relatively strict. They may have been, on the one hand, not sanction- based, like the rules in the US, Canada and the Stability and Growth Pact (SGP) between the EMU countries, and they may have covered the central government only, but :

1) the budget surplus targets in the medium term were *binding* , not just recommendations as in the SGP and the Fiscal Compact of 2012
2) Sweden had *both* a *budget* and an *expenditure target* (in contrast to Norway, Australia, the US and Canada today)
3) The budget target was *explicitly numerical* (which is generally not the case in Denmark, Australia Austria and Canada)
4) The restriction on the public budget balance is *fixed,* not time-specific or conditional (as in Norway, Denmark, Finland, Switzerland, the US and Japan. By including, for example, the social insurance system the *expenditure target for central government covers virtually all public expenditure in Sweden* (while the Finnish expenditure target excludes payment from this system)

5) The Swedish public budget target does not exclude borrowing for investment purposes(in contrast to Germany and the UK following the so-called Golden Rule)

6) The fiscal rules in Sweden were adopted earlier than in the bulk of OECD countries. This explains, as Erixon points out, why the SGP had a weak impact on the Swedish economic policy even before the rejection of the EMU membership in the 2003 referendum: the Swedish fiscal rules were applied earlier and were strict enough- and did not need the Stability and Growth Pact for having a serious impact on the Swedish economic policy.

By comparing the six above characteristics of the Swedish fiscal rules with the ten criteria adopted by Erixon, one can point out that the Swedish fiscal rules meet the criteria 1, 2, 4, 5, 8 and 10. They do not meet the criterion 6 (they are not sanction-based) and the criterion 9 (they do not include both central and general government). With respect to the criterion 7, they are national (but of equal strictness compared to the SGP rules)

As for the importance of the budget balance for the dramatic decline in Swedish public debt, Erixon claims that primary surpluses explained only 36 per cent of the decline in net public debt 1997-2007 *The reevaluation of debts and assets was by far the most important factor behind the decline in Swedish public debt.* Erixon claims that the conclusion in the empirical literature that the new fiscal-policy arrangements were exceptionally successful in reducing public deficits and debts must be qualified We think that the criteria proposed by Erixon and the exposition of the features of the Swedish fiscal rules in comparison to these criteria make the uniqueness and the nature of the Swedish fiscal consolidation program clear enough: it was a very strict and severe budget consolidation program. Even the assertion that these fiscal rules were a key factor to the dramatic decline of the Swedish public debt must be treated with caution, if Erixon's remark about the reevaluation of the debts and assets is considered to be true.

As for the introduction of the top-down budget process one should let Persson himself explain it in his own words: " *The essence of the budget reform is that the Riksdag first fixes a frame for the expenditure, both for the coming budget year and in the long-rum for three years forward. When the frame had been fixed it is not possible to be changed. If one wish to increase the expenditure, one must at the same time decide on how they will be financed or which cuts must be undertaken. Practically, this means that the opposition cannot go against the government with new proposals for expenses without being united on how they will be paid for.* "

And Persson justifies this top-down budget process, *which restricted the possibilities for Parliament to increase expenditure by a breakdown of the budget items*[237], by pointing out that with this

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framework it will be possible to govern Sweden without a risk for a state- financial chaos even with a minority government. The budget reform implied that the Parliament had disciplined itself in a surprising way. The possibilities for the Parliament to decide about extra expenditure is not totally closed, but in the past the door was wide open[238].

We pointed out previously that the whole process of the budget consolidation was strongly influenced by the views of Göran Persson, that the budget process was politically-driven and it should be directed by Persson himself and his associates and that the role of the economic experts was rather secondary. This does not mean, however, that the economic experts were excluded from the process of shaping the program and of providing the theoretical foundation of the consolidation program. Persson may have initiated and propelled the whole program on the basis of a rather simplistic book-accountant point of view and without sufficient and solid macroeconomic theoretical systematization, but, according to Lennart Erixon[239], the economic experts and advisors at the Ministry of Finance were indispensable in formulating some theoretical arguments in order to provide to the program the necessary macroeconomic foundation and to support the view that the fiscal rules contained in the program could have positive effects despite their contractionary impact.

The first argument advanced for supporting the program consisted in pretending that the economies and cuts in expenditure can have expansive effects by *reducing the propensity to private spending and by giving the industry more stable conditions for investments decisions.* It is the so-called *Ricardian equivalence* to which explicit reference is made, as Erixon, points out, in the already cited document of the Ministry of Finance[240]. Cuts in public expenditure today may give rise to household expectations that taxes will be reduced in the future.

Another argument, equally based on the thesis about the expansionary effects of the fiscal austerity and frequently used by the same advisors, was that private consumption and investment can be enhanced by reductions in the interest rate – in fact, the whole program is based on the assumption that growth can and should be attained by actively trying to bring down the interests rates. According to this argument, rational agents anticipate that fiscal austerity will reduce the long-term (real) interest rate. In this way fiscal austerity brings about an increase in private consumption and

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Lennart Erixon, 2012, *ibid*, p. 4

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Göran Persson, 1997, *ibid*, pp.129-130.

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Lennart Erixon, 2012, *ibid*

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Minstry of Finance, 2001, *ibid*, p.23

investment, thus enhancing the aggregate demand, the short- term GDP and employment. Erixon remarks that this theoretical argument became a crucial part of the new consensus in macroeconomics in the 1990s[241].

A third line of argument is based on the existence of a relation between fiscal and monetary policy and assumed that *a commitment to fiscal austerity is a signal to the Central Bank that it can pursue a more expansionary monetary policy*. Lower interest rates will weaken the currency and thus have a positive effect on net exports. However, as we saw in the previous section the monetary policy of the Riksbank seems hardly to have been influenced by the tight fiscal consolidation program announced and implemented by the social democratic government. The Riksbank stuck to its high prime interest rate policy during the whole 1995 and proceeded to its first interest rate reduction very hesitantly only in January 1996. A direct impact of the tight fiscal policy on a more expansionary monetary policy cannot be detected in the first crucial months of the application of the budget consolidation program. If the social democratic had indeed expected that the program would elicit a more expansionary monetary policy by the Riksbank, then this was proved to be an unfounded expectation. But there is nothing indicating that the government harbored such an expectation.

By concluding his presentation of the arguments advanced in favour of the thesis about the expansionary effects of the fiscal austerity, Erixon remarks that the majority of the arguments for fiscal rules is that *they will prevent governments from running big public deficits and by limiting the space for discretionary fiscal policy, increase macroeconomic stability*. While conceding that several studies verify that fiscal rules have been successful in reducing public deficits and debts, he points out, at the same time, that there are fewer studies of the effects of fiscal rules on economic fluctuations and growth.

The main objection of Erixon to the economic strategy based on the thesis of expansion through fiscal austerity is that *the direct deflationary impact of tax increases and reduction in public expenditure might be decisive for GDP and employment in the short run, and further that the decrease in GDP and increase in unemployment might actually reduce confidence among households and firms.*

Another weakness is equally pointed out: in supporting the idea that fiscal austerity can have positive effects on consumption and investment, the advisors at the Ministry of Finance referred to the *nominal interest rates.* Erixon remarks that a reduction in the nominal interest rates is not

241 Lennart Erixon, 2012, *ibid*, p. 7-8

necessarily connected to a reduction in the real interest rates: *the more efficient the fiscal austerity policy was in reducing expected inflation, the higher was the risk that this policy would bring about an increase in the real interest rates*[242]

Whatever the theoretical validity of the arguments advanced by the advisors or contained in the literature defending the reigning macroeconomic theory, the main assumption underpinning the budget consolidation program was that there existed a connection between the budget deficit and the interest rate levels and that, accordingly, the road to a lowering of the market interest rates passes through the drastic reduction of the budget deficit, thus inspiring confidence in the markets about the grip of the government on the public finances and the seriousness of the economic policy pursued.

But is there a direct connection between the budget deficit and interest rates levels? Already at the time of the formulation of the assumption of such a link between budget deficit and interest rates levels, the economists did not seem to be in full agreement on this point. It is logical to suppose that the most decisive factor for the interest rates in Sweden was the *international interest rates level.* The chief economist at LO, Per- Olof Edin argued that it was theoretically too difficult to see that the results of the budget would have any effect on the interest rates. If there is such an effect, then it is rather the opposite is the case, that is, the interest rates rise in case of a lowering budget deficit, because this is a sign that the activity in the economy increases. In trying to empirically support his view, PO Edin reminds that the greatest interest rate gap was recorded in 1989, the year when Sweden had a budget surplus (NB: at that time Sweden had the best public finances among the OECD countries after Japan). When the budget deficit was the greatest in the Autumn of 1993, the greatest fall in interest rates took place[243]. And another LO economist, Dan Andersson, remarks that the interest rates reflect also the inflation expectations and the inflation history, which have nothing to do with the budget deficit. The economic policy cannot, therefore, be shaped as if the whole of the interest rates differential was due to the budget deficit. An austerity policy does not give automatically a lower interest rate, if the inflation expectations or the instability in the exchange rates continue to exist[244].

But in the new social democratic government these remarks did not seem to have the slightest

242 Lennart Erixon, 2012, *ibid*, pp. 8-9

243 Peeter Jaan, Kask, 1997, *ibid*, p.201-202.

244 Peeter Jaan Kask, 1997, pp.216-217

impact or to make any impression on Persson and the circle around him. What seemed to weigh more heavily in his order of priorities? Persson replies in a way which does not leave anyone in doubt: *This is the only chance to show to the world around us that this was a deep crisis, that we have been conscious of it and that we were ready to confront it. In a situation like this sending signals that we would get out of the crisis by means of an expansive policy, this would amount to beg for an ordinary* (sic!) *crisis."*[245] The decision to sketch and implement a drastic fiscal consolidation program based on the axiomatic assumption that this would gain the confidence of the markets, thus bringing down, in a more or less direct way, the interest rates, had been taken. The government set out with the work of specifying the program by defining the concrete mix of cuts in public expenditure and tax increases. And the economic experts and advisors tried to theoretically corroborate the thesis of the "expansionary effects of a drastic fiscal policy" (by using the arguments cited above) and they were surprised that their recommendations for further cuts had been adopted by the new Minister of Finance practically in their entirety. . And it became quickly clear to the LO economists that the consensus which they had with the party in May 1993 was no longer valid. The stimulus policy had been put aside. The economic policy would be exclusively an austerity policy[246]. The open mandate from the Swedish people for further cuts was taken up from the very first day at the Ministry of Finance.

Were the fundamental assumptions of the program correct? Had the austerity program the expected positive effects on the consumption, investment and the stability of the Swedish economy? Was it a necessary precondition for the economic recovery in the short run (1994-1998) and for the positive economic performance in the long run (1998-2007) - taking into account that with the implementation of the program and with the introduction of the new fiscal rules (ceiling on the public expenditure, budget surplus target of 2 per cent, tightened budget preparation process) a new economic policy regime had been established?

Beginning with the assumption about a link between the budget deficit and the level of interest rates, Erixon – the researcher who took the whole program under the most detailed critical scrutiny-points out that in Autumn 1992, in a period of acute crisis and rising pubic debts, the Swedish interest rates started to converge with the German rates immediately after the monetary and exchange-rate mayhem in that traumatic Autumn. He, further, points out that in 1994-1995, a period

245 Peeter Jaan Kask, 1997, ibid, p.219-220

246 Peeter Jaan Kask, 1997, p.217

of interest rates increases internationally, the growing interest rates gap with Germany was not directly related the Swedish budget deficit, but they were reflecting *expectations for increases in the Riksbank's prime rate.* Those expectations were based on the 25% depreciation of the krona, the ensuing higher import prices and the overly nominal wage increases, which are to be expected after a strong depreciation. Erixon corroborates this assumption by pointing to the exactly similar pattern of interest rates on the 10 years bonds of Sweden and Finland. The pattern is strikingly similar despite the fact that Finland introduced in the early 1990s austerity measures, thus not as Sweden in the *period when the long term interest rates gap to Germany started to grow in both countries*[247]. A plausible conclusion is that it cannot be detected, at least in the 1992-1995 period, a direct relation of the interest rates to the size of the budget deficit or to the implementation of new drastic fiscal rules: Finland introduced fiscal austerity earlier, Sweden later, but the pattern of interest rates is strikingly similar, despite the different timing of the implementation of fiscal austerity measures in the two countries. No correlation seem to exist between interest rates level and fiscal austerity measures.

Secondly, Erixon supports that even the decreasing gap in long-term interest rates between Sweden and Germany in the following period 1995-1996 were not brought about the austerity policy. These expectations had their root in the improvements in the Swedish trade balance and to the belief that there was no threat to the Riksbank's inflation target because of the restrictive monetary policy. For the year 1996 Erixon disputes even the existence of a correlation between the austere fiscal policy and the monetary policy of the Riksbank (see the argument, cited above, that *the austerity fiscal policy sent a signal to the Central Bank to reduce its prime rate*) Erixon attributes the decrease in the Riksbank's prime rate to the weaker inflation through the strengthening of the krona and through to unexpected productivity increases in the Swedish economy[248].

Erixon advances a further argument in his effort to minimize the role played by the fiscal consolidation program in bringing about a convergence of the Swedish and the German interest rates since January 1996: it was nothing unique for Sweden, there was a general convergence of long- term interest rates among the OECD countries[249].

As far as the impact of the budget consolidation program on the recovery of the investment and

247 Lennart Erixon, 2012, p.11-13

248 Lennart Erixon, 2012, p.13

249 Lennart Erixon, 2012, p.13-14

consumption in Sweden during those years (1995-1997) is concerned, Erixon points out that the increase in private consumption in Sweden was weaker than in other small open Western European economies and the OECD on average (According to the OECD Economic Outlook 2004, Sweden: 1.8, Denmark : 2.2, Norway:4.5, Netherlands3.3, total OECD:2.7 %) while the recovery in total investment in the mid-1990s was modest from an internationally point of view

He attributes the modest recovery of the Swedish investment to the higher exports favoured both by an international recovery and a profit increase in manufacturing because of the depreciation of the Swedish krona. He believes that the Swedish depreciations were largely the key explanation to the higher export growth and share of the trade balance in GDP growth than in other OECD countries[250].

The balance drawn by Erixon for the short-term period (1995-1997) is twofold: a) the fiscal austerity program contributed strongly to the budget consolidation, b) it did not contribute to the recovery of the Swedish economy. *The restrictive fiscal (and monetary) policy at that time had short-term contractionary effects, thus causing a delay in the Swedish recovery after the deep economic recession in the beginning of the 1990s.*

That the budget consolidation program was far from being the single most important factor program in securing a sustainable growth rate of the Swedish economy in the short-run is pointed out not only by Erixon, but also by other economists, who tried to detect the effects of the program both in the Swedish recovery and the elimination of the deficit. In assessing the factors which were decisive for the beginning of the recovery, long before the implementation of the program, Martin Floden observes, in an informative and interesting article, that the crucial factor in producing the conditions for the recovery of the Swedish economy was the abandonment of the fixed-exchange rate in November 1992. Relative labour costs in the manufacturing sector were brought down by more than 30 per cent in the year following the floating of the krona, and both exports and the industry sector started growing in 1993, although total GDP was still falling. Already in1994 the growth in the industry sector exceeded 15 per cent in 1994 and remained at unusually high levels throughout year 2000, with a temporary dip only in 1996. Similar developments were observed for the export volume. In spite of not accounting for more than 15 percent of Swedish GDP, its share in the total GDP growth (at basic prices) in 1994 was more than the half, and a third of the growth in

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250 Lennart Erixon, 2012, pp.14-15. All the references to the detailed OECD statistics are cited by Erixon in three tables in two Appendixes at the end of his informative article in pp.26-29.

1995. The Swedish consolidation program was implemented after the banking system had been recapitalized and after the currency depreciation had generated high, export-led growth in 1994 and 1995. As for the effects of the consolidation program in the years 1996-1997, Floden points out that there was a temporary pause in the Swedish recovery in 1996-1997, i.e, the years following the most restrictive fiscal policy. GDP growth was lower than the >OECD average in 1996 and 1997, and the unemployment rate increased to a peak in 1997. The conclusion drawn by Floden is that t*here are serious indications that the Swedish consolidation had standard contractionary short-term effects*[251].

As for the role played by the consolidation program in reducing the debt Floden makes an attempt to identify what the most decisive factors for the debt reduction were. Based on data from the OECD and the Swedish National Financial Management Authority, Floden observes, firstly, that both net and gross public debt peaked around 1996- and between the end 1996to the end of 2007 began a continuous reduction of both the net and gross debt. Beginning with a mathematical illustration of the public budget constraint, Floden assess the importance of the following factors: 1) the initial debt, 2) the surplus, 3) the levels of interest rates and growth rates, and 4) a residual factor (that especially captures valuation changes on the assets and liabilities behind the net debt) According to Flodens analysis, the growth rates of the Swedish economy in the period 1997-2011, although high, had a *negligible direct effect* on the Swedish debt reduction, owing to the fact that *the net debt was close to zero in this time period*. Equally important: because of the net debt being close to zero, interest payments have therefore been small resulting in unimportant differences between total and primary surpluses. According to the table showing the *decomposition of change in net debt* made by Floden on the basis on OECD Economic Outlook December 2011, both nominal and real growth have unimportant effects on a low level of net debt, and the primary surplus that stabilizes debt is close to zero when debt is close to zero.

The conclusion at which Floden arrives is that the *residual* explains most of the debt reduction. This indicates that *valuation effects in the debt and asset portfolios have been important*. In Floden´s own words, *the analysis here casts some doubt on the importance of the fiscal framework and the growth-stimulating structural reforms for the reduction of the debt ratio since its peak in 1996. Primary surpluses account for less than a third of the Swedish debt reduction, and total budget surpluses account for less than a quarter. The direct impact from growth on the net debt ratio was*

251 Martin Floden, 2012, *A Role Model for the Conduct of Fiscal Policy? Experiences from Sweden*. pp.15-17.

negligible in Sweden during the period (after 1996), but arguably important for the reduction of gross liabilities. Most of the debt reduction instead appears to stem from valuation effects in the central government´s asset portfolio. But this analysis cannot rule out important indirect effects from the fiscal framework.[252]

Floden makes three concluding observations in his assessment of the Swedish experience: a) There is a clear evidence that the currency depreciation in 1993 in combination with rapid productivity growth and a benign development on important export markets contributed importantly to the Swedish recovery (already begun before the full implementation of the budget consolidation program), b) although there were clear efforts to consolidate public finances from 1992 and on, the substantial consolidation was implemented in 1995-1997, i.e after rapid growth had restarted in the Swedish economy. c) There are strong indications that the strict monetary and fiscal policy implemented around 1995 had contractionary effects on the Swedish economy[253].

That the reevaluation of central government assets was a factor of central importance for the reduction of the net debt is a conclusion which Floden happens to share with Erixon: as already noted, Erixon in his article attributed particular importance on this factor[254].

What about the economic performances of Sweden seen from a long-term perspective (1998-2007) and bearing in mind that the new fiscal rules introduced during the implementation of the budget consolidation program and after established a *new economic- policy regime in Sweden from the mid-1990*s ? Erixon tries in his article to shade some light on the most important factors for the economic performances of Sweden seen from a long-term perspective (1998-2007) He arrives at interesting conclusions.

First of all, Erixon suggests that the economic fluctuations in Sweden were larger in Sweden than in the other Nordic countries and larger than in the small open Western European countries, on average, in 1998-2007.

He attributes, further, the increase in the Swedish investment in this period *not to decreasing*

252 Martin Floden, 2012*, ibid,* pp. 22-28

253 Martin Floden, 2012, *ibid*, p.29

254 Lennart Erixon, 2012, *ibid,* pp. 5-7

interest rates, but to an *export recovery*, a *profit boom*, especially in manufacturing, and to *extensive inventions and the fierce competition in the ICT sectors*- a sector of specialization for Sweden. While not denying that the fiscal austerity might have provided for expansion for the export sector, he maintains that in Sweden the reduction of government budget deficits reflected a reduction in public transfers and not in public consumption.

The decisive factor for the Swedish export and profit boom of 1995-2007 was a *weak currency*. And the weakening of the krona had a favorable effect on the Swedish exports and on the profits in the Swedish manufacturing. Erixon tells us that in 2007 the trade-weighed nominal exchange rate was approximately 22 per cent lower than immediately before the depreciation in 1992. An accelerator mechanism was thus set in motion: higher profits stimulated investment (gross profits in the business sector had a strong positive effect on investments during the same quarter or with one to two-quarter lag).[255].

A further factor which according to Erixon was the key to the good economic performance of Sweden in the long-run was an *advantageous composition of exports.* Based on Reports from the tele-company Ericsson and on Statistics Sweden, Erixon points out that the tele-products more than any other contributed to the recovery of the Swedish exports rising from 9 per cent to 17 per cent in 1995-2000 (with Ericsson's share in Swedish exports being almost 20 per cent in 2000) . These increases in the export share of tele-products was even more pronounced in volume because of the fierce competition in the telecommunications industries.

Complementary to the cardinal role of the telecommunication industry to the recovery of the exports, Erixon underlines another beneficial factor: Sweden's specialization in raw materials (wood products, iron ore, iron and steel products). The low and medium tech industries inside these sectors replaced the ICT sector as export engine after the ICT crash in the early 2000s. The row material industries benefited also from the depreciation of the SEK because of their low import content.

A weak currency (leading to export recovery and to profit boom), the key- role in the export recovery of the telecommunications industry, the advantageous export composition of Sweden (with traditional raw material sectors replacing the tele-industry as export engine) were the key- factors for the extraordinary good economic performance of Sweden in the period 1998-2007. The outcome of this happy combination of advantageous factors resulted in a steady increase in export share of the Swedish GDP. Having attained a current account surplus in the mid-1990s, Sweden increased it

255 Lennart Erixon, 2012, pp. 16-17

further and steadily in 1996-2007. At the time of the outbreak of the financial crisis of 2007-2008 , Sweden had obtained a larger surplus in the current account, as a ratio of the GDP, than any other OECD country (with the exception of the oil producer Norway and Luxembourg[256])

The conclusion drawn by Erixon from the development factors of the Swedish economy in the period 1995-2007 is clear: nothing indicates that the budget consolidation policy and the new fiscal rules introduced during its implementation and on its aftermath can be considered as decisive for the “Swedish productivity miracle “. This can be best explained by taking into account other factors and their combined effect: the favourable exchange rate, the international upswing, the country’s specialization in industries with large technological opportunities, the openness of the economy and the existence and impact of cultural and historical factors.

Passing a final judgment on the policy of budget consolidation policy pursued by the social democratic government of Göran Persson, Erixon points to two different aspects , a positive and a negative one: the positive concerns the fact that the construction of a large political consensus for the implementation of a non-populist economic policy had been made possible in a democracy- even under conditions of a minority government. The negative one was that the program was based on the uncritical acceptance of the postulates of the new economic thinking or consensus and the disregard for the obvious conclusion that *fiscal austerity has contractionary deflationary effects*[257].

What conclusion one can draw about the budget consolidation program based on the arguments of Perssons and his associates, the counterarguments of other economists (mainly LO economists), the early, ex ante critic of Söderström about the dangers of an exclusive focusing on the budget deficit, the effects of the program itself on the Swedish economy and the ex post critical scrutiny of the program by Lennart Erixon and Martin Floden? Was the “austerity program the only alternative? Was it possible to get Sweden out of the crisis by a different policy mix much more focused on demand- stimulating measures, a policy- mix much more in line with the traditional social democratic policy? Or was the situation at that time so dramatic that practically *there was no alternative*? Was the Swedish social democracy doomed, by the combination of internal and external structural changes, to give up its cardinal values of defense of employment and of a demand- stimulating counter-cyclical policy? Was a policy of drastic and extensive austerity with front-loaded measures the only possible responsible and serious policy? While reflecting on the

256 Lennart Erixon, 2012, pp.17-18

257 Lennart Erixon, 2012, pp.,20-22.

budget consolidation program, so decisively implemented by Göran Persson, a series of questions like those above arises- and no doubt, this series of questions could be made even longer. For the time being let us try give an answer to them by bearing in mind some crucial aspects of the budget consolidation program.

That the program was indeed very extensive should be all too obvious. The criteria for judging a fiscal consolidation program established and proposed by Erixon make it amply clear that the new social democratic government took it upon itself to implement a program which was unusually harsh and bore little resemblance to the traditional social democratic policy. Granted: the state of public finances was critical and the unexpected interest rates increases from the Spring 1994 made the situation even more alarming. One could claim that the social democrats were aware of the worsened economic situation and, given the influence of globalized financial markets on the conduct of economic policies and the risk of capital flight, they had no other option but to rewrite their electoral manifesto and to adapt it to the new economic and financial climate of the second half of 1994. The abandonment of any intention of pursuing a demand-stimulation program in favor of a program of fiscal austerity is deemed to be an inevitable development caused by the financial turbulence and the statement of mistrust of Wohlrath for the Swedish bonds. The markets were worried and were expressing their desire for an economic policy which would focus on the public finances and the need to redress them by implementing a serious and detailed program of budget consolidation aimed at gaining confidence and bringing down the interest rates.

That Persson's strong wish to show that the state had a firm grip on the public finances was the single most important factor for the shaping of the budget consolidation program is beyond any doubt. However, one cannot avoid the question: was the state of the public finances so dire and the danger that the public debt could get out of control so serious as the social democrats came to believe? In 1995 the Swedish public debt was 10 percentage points higher than the OECD average. However, one should not take into account only the debt, but also the assets.

The assets of the Swedish public pension funds (the so-called *AP-fonder*) strengthens the public finances. When one takes into account these assets, Sweden was not the worst in class, but better than the OECD's average. Sweden's position got worryingly worse during the first years of the 1990s. But according to estimates of the Ministry of Finance and of the Institute of the Business Cycle (*Konjunkturinstitutet*) the net debt was stabilized in 1995 at a level which was better than the OECD's average.

In a few words: the Swedish public debt was high, but not so disastrously high so as to justify such a drastic program of fiscal austerity. One would expect from a social democratic government to

have a more balanced and calm view of the dynamics of the public debt and not let itself be influenced by a such pessimistic and excessively alarming perception of the public finances.
Even the statement of mistrust of the executive director of Scandia for the Swedish bonds did not provoke the interest rates increases initially feared no interest rates shock was produced as a consequence of the sensational statement. The main consequences produced were on the political level- and concerned the social democratic party. It was the party which, more than any other, took the statement under so serious consideration so as to feel compelled to rewrite its electoral program and to extend its part dedicated to cuts aiming at a radical fiscal consolidation. The international interest rates increases, the sensation aroused by the statements of the Executive Director of Scandia, a strictly book-accountant point of view on the budget deficit and on the national economy held by Persson and its closest associates seemed to be enough to tip the balance in favour of a drastic fiscal consolidation program. The policy choice made by the social democratic party leadership could not stand to a more sharp contrast to the policy choices of the past- especially those which gave the social democratic party its originality and bold strategic vision: the proto-keynesian crisis policy completed with the Rehn- Mediner Model in the early 1950s. The crisis policy of the 1930s consisting in stimulating an economy in depression by means of public works and active labour market policy was given up surprisingly quickly. This time, the situation of the economy was deemed to be radically different so that the historically determined set of social democratic economic policy measures were thought to be not only ineffective, but also potentially of high risk for the revival of the economy. Of course, Göran Persson was particularly apt in presenting the budget consolidation program as an emergency program aimed at securing the Swedish welfare state. Its survival was thought to demand a " painful march through the desert of fiscal austerity" . "*The big budget deficit was threatening not only the Swedish welfare system, but in the lung rum even our self-determination was at risk"* reassures Göran Persson in his book about the budget consolidation policy. "*For this reason the consolidation of the public finances should be done as quickly as possible. We had to take measures in order that the confidence of the outside world for the Swedish economy could be restored.*" [258] An acute awareness of the need to gain the confidence of the world - meaning: of the deregulated, interconnected financial markets and of the agents on the markets– and a conviction that the revival of the economy presupposed the reduction of the budget deficit, thus causing a decrease in the interest rates, seemed to have taken hold of the minds of the policy makers of the social democratic party. This sense of emergency became even

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258 Göran Persson, 1997, *ibid,* p. 19

more acute, since the whole situation was considered to be a real threat to the political self-determination of the country. The grip of the markets on the political decision-making process should be broken and the decision making power had to be transferred back to the political sphere. But exactly here lay the problem of the policy choice made: in order to regain from the markets the power – " to become again master in one's own house" – the social democrats had to act in absolute conformity with the conditions dictated by the markets. The choice made by the social democrats was an effort to regain the lost decision-making power according to the rules of the game dictated by the interconnected and deregulated financial markets. And it was a policy choice which was in absolute conformity with the new liberal and market-oriented consensus on economic policy. And the Swedish social democracy joined this consensus after having thrown overboard the set of policies invented by its leading figures during the 1930s. They came as far as to uncritically accept, as Erixon points out, the idea that a fiscal austerity policy could have expansionary effects. That the dramatic depression in the period 1991-1993 was caused by an impressive explosion in the savings ratio of the households and by a dramatic contraction of the aggregate demand had been finally recognized by the social democrats- but the recognition of this fact was set aside very quickly. The idea that the recovery of the economy could be accomplished not with demand- stimulating measures, but by exclusively focusing on the budget deficit and on the need to reduce it on the basis of assuming that there was a link between the size of the budget deficit and the level of the market interest rates was fully embraced by the social democratic leadership- and constituted the cornerstone upon which the budget consolidation program was built. It needs hardly to be emphasized: this thesis was a policy choice which in no way could be considered a fundamental belief of a classical social democratic policy agenda. The austerity measures were so much emphasized, developed and specified that no space remained for growth stimulating measures.

But was it right to assume as an axiom for the fiscal consolidation program the existence of a direct relation of the budget deficit to the level of the interest rates? If one takes into account the history of the Swedish interest rates in the end of the 1980s and in the beginning of 1990s, nothing seems to point to the existence of such a relation. According to Erixon , the decreases in the interest rates from the second half of 1995 seem to be much more related to expectations about the prime rate of the Riksbank than with the budget consolidation program which at that time was in full implementation. Erixon feels sure enough to assert that the consolidation program not only did not play, in the short run, a crucial role in the recovery of the Swedish economy, but on the contrary it delayed it: the recovery of consumption and investment, and other factors such as the depreciation of the Swedish krona and its positive impact on the exports was far more instrumental in provoking the recovery. So if the arguments of Erixon are to be accepted, then the role of the fiscal consolidation program in the recovery of the Swedish economy appears to be negative and cannot be given any credit for it.

There was another serious risk with the policy of the budget consolidation which could be detected from the very beginning and which should be taken into account: as long as the expected interest rates decreases do not materialize (or as long as they were far too insignificant to offset the contractionary effects of the consolidation policy), that implied that the austerity measures were slowing down growth and were keeping the unemployment on high levels, which by itself makes the public finances worse. The social democrats had been, however, lucky enough: the interest rates decreases did take place in the end of 1995- that is, near enough the Crisis Agreement with the Center Party so as to be able to attribute the decreases to the increased credibility of the economic policy – but nevertheless the unemployment rate remained high enough during the short-term period of the program- and afterwards (1998-2007).However, in November 2000- i.e, in the first two years after the implementation of the budget consolidation program- the AMS announced that the open unemployment fell under the 4 per cent: the impression arose that after the successful implementation of the program, Sweden would return to its traditionally low levels of unemployment which make it so unique among the Western industrial countries. It was, however, an achievement which was going to be short-lived. In the period 2002-2006, in the second mandate won by Persson as leader of the social democratic party, the unemployment rate began to rise again. The budget consolidation policy and the new economic policy regime established by it were not going to record an "employment miracle" As Erixon points out in another more detailed article, the unemployment rate in Sweden in the period 1998-2007 was the same as in total OECD (the average annual rate was 6.7 per cent) and in fact higher than in other Nordic countries- with the exception of Finland. Swedish unemployment was also higher than the unemployment in the small open Western economies on average (5.4 per cent) and, for example, than in the United States (4.9 per cent). In any case, it is striking that Sweden, even after the crisis of the 1990s, no longer belonged to the group of countries with the lowest rate of unemployment- and the same holds for the labour force participation[259] . The goal of the unemployment, the chief priority of the social democracy since the 1930s, had been initially sacrificed to a *first – then* policy ("f*irst we redress the public finances, then we take growth and employment -enhancing measures*") but the assurance

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Lennart Erixon, 2011, *Under the influence of traumatic events, new ideas, economic experts and the ICT revolution- the economic policy and macroeconomic performance of Sweden in the 1990s and 2000s.*, p. 61-62 was persistently given that the budget consolidation policy was aimed at securing high levels of employment. In fact, it was a necessary precondition for achieving again full employment. The events were going to refute this expectation- however sincere it may have been: With the exception of a temporary retreat, as noted above, the unemployment never fell to sustainably low levels. In the new economic policy regime established by the budget consolidation policy, a major reversal took place: Sweden was no longer the country with the lowest unemployment rate while, on the contrary, Sweden's inflation rate in the same period (1998-2007) was 1.2 per cent, that is significantly below the rate for the group of small Western European countries (1.7 per cent). [260]

Keeping in mind that the budget consolidation policy ran counter to basic priorities and assumption of the social democratic party, the question arises inevitably: was an other policy possible?

In trying to respond this question one must be fair and objective enough to admit that in the mid 1990s given the critical state of the public finances and the particularly strong impact of the deregulated financial markets on the state policies, no policy was exempt of serious risks and possible negative by-effects. By opting for a classic social democratic demand and growth-stimulating policy, the social democrats would have been exposed to the risk of interest rates increases and of mistrust from the markets. By opting, instead, for the fiscal austerity policy of cuts in public expenditures, the risk was present for recessionary effects and for a persistently high unemployment rate. No policy choice was easy and the path to its realization was fraught with dangers and destabilizing developmentsIn a word: the social democrats were confronted with a difficult dilemma. They had to make a choice.

In a discussion with Persson in January 1995, little time after the presentation of the Budget Statement, Per Olof Edin, the chief economist of the LO, who was among the first in pointing to the inconsistency of the assumption about a direct relation between interest rates and budget deficit, addressing Persson, said : " *One has to make a choice about where he takes his risks*. The social democratic party chose where to take the risk: it opted for implementing a drastic, frontloaded budget consolidation program despite the prospect that the unemployment rate might arise to high levels. In the strategic considerations of the leadership of the social democratic party, the confidence of the markets came to weight much more than the risks of high levels of unemployment. By opting for focusing exclusively on an extensive fiscal austerity program, the social democrats not only show themselves to be unable to honour their commitments and promises to their electorate, as Peeter Jaan Kask observes. They also threw overboard their long-time policy priorities and values

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Lennart Erixon, 2011, p.62

and they sacrificed the cherished goal of full employment. By implementing the harsh program of budget consolidation, the social democrats not only transformed Sweden by establishing a new economic policy regime with different institutional rules and with a different order of priorities, they transformed themselves in the process: they distanced themselves from the policies and the priorities of the past (those which contributed most to the foundation of the Swedish Model and granted to it its singularity and uniqueness). In a few words , the Swedish social democracy seemed to have undergone an *Umwertung ihrer Wert (i,e a "transvaluation of its values* – to use an expression of Nietzsche, that seems to us to be suitable for describing what happened to the Swedish social democracy during its implementation of the budget consolidation program.

One could object that such a statement is both unfair and inaccurate, that the social democratic party was continuing to cling to its values of full employment, equal distribution, general public welfare services and that only the means for obtaining these values had changed; something which is both inevitable and desirable in a constantly changing world- and which is furthermore a sign of flexibility and adaptability. Granted: one could not possibly expect from the social democratic party in the changed realities of the 1990s to replay, without the necessary adaptations, the policies and the recipies of the glorious by-gone era . On the other hand, one would expect from the Swedish social democratic party, a party famous for its bold strategic choices in the past, to be far more original in its strategic choices, far more capable of formulating alternatives to the ruling economic ideas and far more sophisticated in its approach to the problems with which the Swedish economy was confronted. Adopting a strictly book-accounting view on the ills of the Swedish economy and accepting uncritically the idea that a fiscal austerity policy could have expansionary effects, the social democrats showed that they had succumbed to the neoliberal *Zetigeist* of the time, that they were incapable of a more sophisticated and comprehensive view on the Swedish economy and that they failed in formulating alternative policies to those ones presented by the established economic theories. As Erixon correctly observes, while in the 1930s and the early post-war period, the social democrats had formulated alternatives to established economic ideas and policies, they failed to do so in the 1990s and 2000s. Swedish social democracy was an assimilator rather than initiator of new ideas about economic policy in the 1990s and 2000s[261]. The budget consolidation program offered in this respect the proof that the Swedish social democratic was in a strategic deadlock and was contenting itself to adopting alien economic ideas while trying to show that is was more competent in practicing them than the right-wing parties. And despite the plausible arguments about

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Lennart Erixon, 2011, *ibid,*

the same values and the different means for attaining them, one could remind the inexorable law of the dialectics: *when quantitative changes surpass a critical threshold, then they bring about qualitative changes.* By drafting and implementing such an extensive and one-sided austerity program with so ambitious quantitative goals and by accompanying this program with further institutional changes on the fiscal level, the Swedish social democracy inevitably produced qualitative changes on the economic policy regime, on the Swedish Model – and on its very nature, values and strategic orientation.

Closing our assessment on the budget consolidation program we might conclude that the program was a success in the sense that it attained the immediate objectives assigned to it: it restored the public finances and halted the increase in the public debt. The self- disciplined way in which it had been implemented and the broad political support it received proves that it is possible to carry out a fiscal austerity program within the framework of a parliamentary democracy and despite the unpopular measures it contained. That the realization of the program was possible must be attributed to the traumatic events of the Autumn 1992, when the currency crisis and the interest rates hikes produced the pathetic spectacle of a government and of a political system unable to tame a crisis despite successive emergency crisis packages. A sense of emergency and a crisis awareness seems to have taken hold of the whole specter of the political system in general- and of the social democratic party in particular. Despite the recognition of the fact that the dramatic contraction of the Swedish economy in the years 1991-1993 was caused by the explosion of the savings rate of the households and of the contraction of the aggregate demand [mainly investment demand], the social democrats quickly abandoned any idea of a demand - stimulating policy. The acceptance of the monetary policy of the Riksbank and the drafting of a much harsher budget consolidation program with frontloaded measures excluded any possibility for stimulating measures opened the road for the implementation of the most extensive and drastic austerity program in the OECD countries – more drastic than that of the Thatcher government, judged by all the criteria cited by Erxion in his article.

There are serious reason to question the fundamental assumption underpinning the program – that there is a relation between the size of the budget deficit and the interest rates levels. The history of the interest rates gap between Sweden and Germany in the 1980s and early 1990s shows that the relation between these two figures is far more complicated.

Equally debatable is whether the consolidation program and the fiscal rules introduced had contributed to the recovery of the Swedish economy or not. Other factors, much more important such as the international economic upswing, the depreciation of the krona, the crucial role of the IT sector and the favourable composition if the Swedish export sector played, in all probability, much more decisive role in boosting the Swedish economy- both in the short and in the long run. Erixon feels convinced enough to support that the fiscal consolidation program in fact delayed the recovery of the Swedish economy in the years of its implementation. For Erixon, the program was a success from a cameral, book-accounting point of view, but a failure from the point of view of the stabilization policy.

While it is beyond any doubt that whatever policy choice the social democrats might have made, this would entail risks and side-effects, the choice in favor of a drastic fiscal consolidation program had far- reaching consequences for the economic policy regime, the Swedish model and the social democratic party itself. Based on a narrow, strictly book-accounting point of view, the social democrats accepted uncritically the idea that an austerity program can be expansionary- and thus showed themselves unable to formulate alternative economic policed to those advocated by the established economic ideas. The social democrats seem to have abandoned central elements of their policy agenda and of their core programmatic values. Sweden entered a new period of low inflation and persistently high unemployment- in sharp contrast to the past. Clearly a new economic-policy regime had been established, the system change, of which Carl Bildt had dreamt of, was brought to completion. But the architects of this *systemomläggning* were the social democrats.

The Swedish Model seems to have undergone, as a result of the crisis of the 1990s and of the way in which the social democrats coped with it by carrying out their budget consolidation program, a deep and systemic transformation. It is high time to respond the questions put in the beginning of this work: What happened to the Swedish Model in the 1990s? Did it survived from the turmoil of the economic-financial crisis and from the budget consolidation program ? Does it exist anymore? And if yes, how different is it from the Swedish Model of the past and what are the central differences from -and the similarities with - the past? These questions will be responded in the next concluding section.

CHAPTER 6

After the earthquake of the financial crisis and the implementation of the fiscal consolidation program. A "New Swedish Model" or something different?

"If this party comes to the government position in 1982, then it is at the hands of the Swedish industry where our fate lies, we must be aware of this fact."

Kjel Olof Feldt[262]

262 Social democratic Party Direction (Partistyrelse), 19 December 1980, Documents of the Party Direction with Appendixes preserved in Archive of the Social Democratic Party at The Archive and Library of the Labour Movement,

"At the same time it is clear that we cannot surrender. If we bow to the massive propaganda campaign, then the field will be broken. Today the wage-earners funds, tomorrow the health insurance, the pensions and the working time, the day after tomorrow the co-decision and the law on the working environment, the next day maybe the right to strike and the freedom of organization on the shop floor."

Olof Palme, Speech at the Congress of the Metal Workers Union before the Law on Wage-Earners Funds was passed into Law

The whole of decade of the 1990s was a turbulent period for the "Swedish Model". Unparalleled financial -economic crisis, produced by an ill-planned sequence of policy reforms and a bad timing in their execution in the second half of the 1980s and by an explosion of the households savings rates and a serious contraction of the domestic demand, was accompanied by an unparalleled budget consolidation program in the second half of the 1990s, which succeeded in radically reducing the budget deficit and in stabilizing the public debt. At the end of this drastic consolidation policy, Sweden found itself with a new economic-policy regime with an altered order of economic policy priorities and a new fiscal and monetary institutional framework. The "Swedish Model" could not but be seriously affected by the underlying changes in the political economy underpinning it and was going to experience equally deep and changes in its basic traits and in its institutional structure. The question inevitably arises if and to what extent the "Swedish Model" survived the crisis and the fiscal consolidation process and whether a New Swedish Model emerged with important differences to that of the past.

We tried to give in this work a panoramic view of the basic economic –policy changes of the social democratic government in the 1980s and of the Centre-Right government in the beginning of the 1990s - as well as of the consolidation program carried out by the new social democratic government in the second half of the 1990s. While exposing these basic economic policy choices one cannot help not being stricken by the insight that these policy choices were proved to be of strategic nature and that they gave rise to successive events in a process of "system change" of the foundations of the economic policy in Sweden. The "Swedish Model" had founded itself caught in this dramatic process of systemic change and could not possibly remain unaffected by these radical changes. The financial – economic crisis of the 1990-1993 period can be seen as a tectonic event brought about during the implementation of those changes and the budget consolidation process as the effort to overcome the crisis in the short run and to stabilize and normalize the dramatically altered and transformed political economy of the Swedish Welfare Capitalism- and to equip it with new institutional instruments adapted to the new policy targets. Significantly, the eruption of the unprecedented crisis not only did not halt the process of systemic policy change, but acted as a catalyst for speeding it up.

During our exposition we tried to point out the role played by important social and political actors in the whole process. The amount of detail given in this work and the narration of some crucial events may have overshadowed the social and political factors which played a crucial role in the crisis and in the way in which the crisis was handled. It is a well- known fact that the detailed account of events and developments may lead to the serious pitfall of losing sight of the whole picture and of the basic overriding tendencies which were the main factors behind those changes. It is high time now to undertake in this concluding chapter an effort to convey the final and general picture of the identity of these social and political factors and to make sense of their role and their interplay in the process of policy change and in the shocks which the “Swedish Model” experienced during this dramatic process.

It is a basic conclusion of the present work that this systemic change could not have been possible if the consensus upon which the “Swedish Model” was built, that is, the consensus between the two basic social partners, the organized blue-collar working class and the leading circles of the private Swedish industry, had not been seriously shaken to its foundations. We should not forget that the “Swedish Model” was the outcome of class compromise, on both the political and the industrial level, attained in the 1930s between the labour movement (in its two wings, the political and the trade-union one) and the class of the capital owners (represented by the *Arbetsgivarföreningen* and the Swedish political Right, the precursor to the *Moderaterna* partiet of Carl Bildt). The Crisis Agreement between the Swedish Social Democracy and the Agrarian Party inaugurated the proto-Keynesian policy of public works, and the Saltsjöbaden Agreement sealed the historic compromise between the two social classes recognizing the right of the capitalists to lead, deploy and fire the workforce and the right of the workers to be collectively represented by the LO. The preservation, extension and completion of the original Swedish Model with the Rehn- Meidner Model for structural change by means of active labour market policy and the expansion of the welfare provisions and of the employment in the public welfare sector were resting on the original class consensus around an active but rather tight fiscal policy aimed at full employment and stable inflation, an active labour market policy and measures for structural change and expansion favourable to the big industry.

It should be reminded, in this context, that for the social democratic leaders (the Prime Minister Per Albin Hansson, the Finance Minister Ernst Wigforss and the Minister of Social Policy Gustav Möller) the historic compromise was thought to be a *provisional* compromise, a crucial step in the systematic and protracted effort of the labour movement to continue the process of extension of the democratization and to bring it to its conclusion by attaining the highest level of democratic participation, the economic democracy. The Swedish Model was corresponding to the second crucial wave of extension of democracy, the Social Welfare (or Social Citizenship) State. In this sense, the Swedish Model was something "provisional", a transitory constellation of political and class forces waiting for the following wave of extension of democracy – if the initial plans of the social democratic party are to be taken to their letter. Of course, no one in the then social democratic party leadership could predict when this "next leap forward", this transition towards the economic democracy, would take place or to describe in details the exact conditions under which this crucial next "step" would be undertaken. They contented themselves, for the time being, with the fact that the compromise was securing a continuous improvement of the living conditions of the wage-earners and they were striving for the refinement, completion and further expansion of the second stage of democratic participation, the Social Citizenship State.

In the post-war period the historic compromise underpinning the Swedish Model was preserved, upheld and reconfirmed. An extensive and refined system of tripartite corporatist consultation between the (social democratic) state power, the industrial capital owners and the trade unions of the wage-earners with ramifications on all levels of the decision-making process (with the Labour Market Board being the most important of them). And this while the initial pillars of the Saltjöbaden Agreement remained intact in their place: centralized wage bargaining between the two main social partners without legislation or intervention on the part of the state power in the process of wage formation and while the active labour policy and the solidaristic wage policy considerably sped up the process of rationalization, structural change and concentration- internationalization of the Swedish Industry. Fortified with the brilliant theoretical construction of the Rehn-Meidner Model the Swedish Model seemed to work very efficiently and to deliver remarkable results- in terms of capital accumulation, rising living standards, industrial and social peace and welfare provisions. The process was not, of course, frictionless and exempt from conflicts, but thanks to the political flexibility of the ruling social democrats and their ability to reinstate their political alliances or to build new ones, the results and the successes far surpassed the pitfalls and the conflicts. A spirit of a generalized and pervasive *samförstånd* , i.e. of consensus and of concordance begun to assert itself and to take deep roots on the levels of the social and political life and to shape a new political culture based on the resolution of the social conflicts after consultation and on "neutral" solutions to the problems and frictions. The historic compromise was updated and reaffirmed more and more in these new circumstances of continued and expansive economic growth and the prospect that this compromise may one day crumble and give place to something new and different – whether this new and different would be the “economic democracy” or a different social and politic-economic arrangement- was thought to be very remote and out of the order of the day. For the governing social democracy there was no need to change a Model which seemed to be well –functioning and highly effective, while the pervasive system of corporatistic consultation imbued its leadership with a spirit of risk-aversion at the political level and with a faith in the “policy of small steps “ and of piecemeal reforms. The prospect of endangering the whole existing arrangements and set of deals by adopting a policy of rupture or political and social polarization was ruled-out. The social democratic party had acquired a deeply- ingrained ethos of compromise. It was resting in the successes obtained by a Model, which was the final outcome of a policy of mutual cooperation with the trade-union movement and of the understanding with the capital owners based on a stable distribution of economic and political- state power.

The “Swedish Model” began to have the first serious problems exactly because of its undisputed successes. The process of structural change, rationalization and concentration of the Swedish industry strengthened the leading companies of the country (Volvo, Scania, ASEA, SKF to name only few) and allowed them to reach such a high degree of expansion and internationalization that they could become more and more interested in putting an end to the underlying compromise and its basic policy measures which secured them the conditions for such an expansion. The Swedish industrial capital had attained such a degree of concentration and of economic influence that, given the right circumstances, they could strive for a change in the actual constellation of class-forces underpinning the Swedish Model.

It was the growing awareness on the part of the trade union movement of the fact that the Social Citizenship State did not lead to a decrease of the income and wealth inequality, but on the contrary it seemed to reinforce the tendency towards capital and wealth concentration, that led to the first serious manifestations of growing unrest at the industrial level. Combined with the reaction to the constant labour mobility provoked by the active labour market policy and with the growing dissatisfaction with the painfully quick pace of industrial rationalization this awareness prepared the ground for the radicalization of the trade union movement. This radicalization was expresses in many ways- inside and outside the organized labour movement represented by the LO: it was expressed, unexpectedly, with a wave of wildcat strikes in the mining areas of Northern Sweden, strikes which seemed to defy the tightly regulated labour market and the iron consensus around the collectively agreed norms and regulations about the working conditions. It was also expressed with the emergence of a “new left” in the late 1960s which was highly critical of the social democratic consensus and which was able, despite its limited political influence, to point to the ugly and unpleasant side-effects of the social democratically managed "Welfare capitalism". And above all: the redicalization was favoured by the process of relentless capital and wealth concentration which refuted the social democratic rhetoric about the "equalizing effects of the Welfare State and of the so-called *Strong Society* (in Swedish: *det starka samhället*, a term highly reminiscent of the corresponding American term " The Great Society" in the Lyndon Johnson years). More importantly,this process of growing radicalization took roots even inside the organized labour movement, where the combined pressure from the wild strikes and the sharp criticism from the New Left, as well as the fact that the unabated capital concentration was leading to a strengthening of the big industry and finance, led to revitalization of forgotten issues, such as the vital role of the property relations in the process of production.

The social democratic leadership tried to respond to this radicalization and, possibly, to preempt it by taking, as already mentioned in the first chapter of this work, the initiative for measures aimed at improving the working conditions, at strengthening the employment security and at introducing elements of co-decision in the management of the Swedish firms- at least for issues impinging on the working conditions of the wage-earners. The battery of successive laws on employment security and on co-decision cannot be possibly considered as subversive or as potentially threatening to the "property relations" of the Swedish private industry in view of the fact that at the same time in West Germany similar measures for strengthening the co-decision were being taken by the social democratic-liberal governments of Wiily Brandt and Helmut Schmidt. In fact, the legislative initiatives were in line with the reformist "function socialist"[263] ideology espoused by the leading persons of the Swedish social democratic party. On the other hand, some aspects of the above mentioned reforms seemed to encroach on key provisions of the Saltjöbaden Agreement- and especially, on the right of the employers "*to freely employ, deploy and fire the workforce on the shop floor*. The social democratic legislative initiatives could not but arouse among the most

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As "function socialism" (in Swedish : Funktionssocialism) can be considered the strongest ideological current of the Swedish social democracy. Initially formulated by the social democratic theorist Nils Karleby in a 1927 book, function socialism was, ex post, discovered and used by the social democratic leaders (especially, Tage Erlander had repeatedly praised the book of Karleby) as the main theoretical foundation of the social democratic reformism. According to the functional socialist ideology, there is no need for the social democracy to contest the property relations, but instead to focus on small, step-by -step reforms, which would limit and narrow the scope of exercise of the property rights, and in this way, would render, gradually and without serious conflicts and violent convulsions , the capitalist property relations obsolete, since the various functions resulting from the property rights would be absorbed by society thanks to practical, step-by-step reforms.

conservative circles of the Swedish industry the suspicion that the social democratic party was preparing either a whole-scale attack on the managerial prerogatives which were inextricably bound up with the sacrosanct property rights- or was gradually undermining the foundations of the 1938 industrial Agreement.

But the most remarkable development and the most serious expression of growing unrest and radicalization came – unexpectedly – from within the organized LO. After having contented itself for a very long time with the role of faithfully sticking to the provisions of the Saltsjöbaden Agreement and of being dedicated to the tasks assigned to it by the Agreement,- i.e of striking collective agreements and of carefully inspecting their execution- the LO leadership found itself caught in a wave of radicalization coming from below which overwhelmed it and led it to lend support to a Report, whose implementation might put an end to decades of *samförstånd* , of consensual solution of the social conflicts and to provoke industrial and political polarization. Ironically enough, the Report was ordered by the LO leadership and was entrusted to a key investigator and co-author of the Model of active labour market policy for full employment and stable inflation: Rudolf Meidner, the German political refugee to Sweden of the 1930s who was to become with Gosta Rehn the most prominent chief economist in the history of the labour movement.

It is beyond the aims of the present work to present a thorough and detailed account of the background, of the content and of the aims of the Report on Wage- Earners Funds of 1975-1976. Suffice here to say that the Report- and the ensuing political battle to which it gave rise- seriously affected the political life of Sweden up until 1983, the year when a watered-down version of the original Report was finally adopted as a law by the Riksdag, only a year after the return of the social democratic party to power. The importance of the Meidner Report lay in the fact that for the first time a clear break with the function socialist ideology of the party took place: the Report concluded that the capital concentration could not be counteracted without a fundamental change in the property relations of big industry. The proposal for transferring to collective wage-earners funds a part of the profits of the firms in the form of shares in the firms clearly was a re-actualization of the importance of property issues for the prospect of attaining the third strategic goal of the labour movement: the economic democracy. The 1976 LO congress adopted the Report- much to the astonishment of the social democratic leadership, which never seriously believed that the LO would adopt it as a congress resolution. And so the social democratic leadership found itself in the uncomfortable position of having to define its attitude vis-a –vis a Report whose recommendations it could not possibly accept- let alone turn into a concrete policy proposal for immediate implementation. The leadership was so much accustomed to the spirit of *samförstand*, of consensus - after decades of continued compromises and corporatist consultations- that this spirit had been transformed into a deeply - rooted political ethos permeating not only the social democratic leadership but also the Swedish political system in its entirety.

With the Meidner Report the trade union movement made a crucial step towards surpassing basic provisions and assumptions of the initial Swedish Model. The step was bold enough- and although in clear contradiction to the reformist functional socialist ideology of the party leadership, it could be legitimized by pointing to the initial objective of the party: the need to attain the economic democracy. The trade union movement was gaining consciousness of the fact that the welfare capitalism, despite securing substantial improvements in living conditions and welfare provisions, despite the expansion of the public employment, despite the collective mobilization and wage equalization of the blue-collar working class, was de facto favoring an unparalleled capital and wealth concentration and that the workers on the shop floor were still effectively excluded from the possibility of influencing the work process, the conditions and the content of their work, the goals and the nature of the investment activity. The idea that the political power was held by the social democratic party, the party representing their general interests, was not sufficient to satisfy them any longer. At least, it did not satisfy the radicalized sections of the working class which in the end of the 1960s began to air their dissatisfaction in more militant ways..

The social democratic party leadership has responded to this unrest among the trade union movement with a series of laws aimed at strengthening the co-decision of the trade unions on the shop floor, but this seemed to fall short of the expectation and the new radical demands. The strengthened co-decision rights concerned the micro-level and the every-day matters of the life of the enterprise but they were touching neither the crucial strategic decisions nor the investment decisions. The new awareness that economic power and private property mattered and that capitalism had attained a crucial stage of development demanding a transformation of the property relations inside the firms was gaining ground, and was undermining fundamental assumptions of the functional socialist ideology of the social democracy. By adopting the Report on Wage- Earner Funds, the trade union movement clearly defied the basis of the 1938 agreement and was putting at the order of the day the demand of a modification or of a reinstatement of the historical compromise underpinning the Swedish Model in terms more favourable to the working class interests.

But the historic compromise was also undermined from the opposite side: the capital and big industry owners. The Swedish Model was proved to be much favorable to their policy of constant expansion on the domestic and foreign markets. The Rehn- Meidner Model and the solidaristic wage policy, mainly aimed at equalizing the wages inside the working class, produced the effect of strengthening, in a surprising way, the capital and wealth concentration of the private industry by facilitating the closure of the less efficient firms and the acceleration of rationalization. The right of freely appointing, deploying and firing explicitly inscribed in the Saltsjöbaden Agreement of 1948, was a favourable factor in the process of the international expansion of the Swedish industry. Swedish big industry, no matter how skeptical it may have been at the beginning towards the social democratic power tenure, was gaining from the Swedish Model- and gaining considerably in terms of expansion and capital concentration. But when the organized labour movement, pressed by the growing unrest of their rank-and-file, rediscovered the importance of the property relations for the balance of forces inside the firms and went so far as to question the process of capital and wealth concentration by proposing a scheme of collective profit sharing, the most militant circles of the big industry felt that they had to respond, cautiously but decisively, to the initiative of the labour movement. The previous laws on co-decision, taken by the social democratic party, now accompanied by a Report aimed at shaking the property relations, were strengthening the private industry in its conviction that the labour movement was no more interested in upholding the fragile equilibrium established by the 1938 Agreement. The reaction came- and it was expressed in various ways: through pamphlets by think-tanks controlled and financed by private industry, through coordination with the centre-right political parties (mainly the Conservative Moderate party) , through increasing pressure on the middle parties (the Liberal and |Center party) to abandon any idea of accepting a form of wage-earners funds, through active publicity campaigns against the wage-earners funds even in the pre-electoral period- and through uncooperative and openly aggressive attitude during the wage bargaining negotiations, in which the demand for a decentralized wage-bargaining system at the factory level was clearly being articultaed and was being put on the order of the day.

The most favourable factor to the efforts of the Swedish private big industry was the degree of expansion and internationalization, which in the second half of the 1970s was strengthened by the new unstable economic and financial environment emerging after the collapse of the Bretton Woods Monetary System. Having acquired a critical size permitting them to be much more aggressive and intransigent in their negotiations with their counterparts in the labour movement, the big private industry was beginning to fight its own struggle for ”reediting the Swedish Model” or for replacing it with a new mode of regulation in terms much more favorable to its own interests. It was not accidental that the first serious breach in the centralized system of wage negotiations took place in the first part of the 1980s, when the Metal Workers Union signed the first factory level wage agreement. That breach was a clear indication that the private industry was seriously bent on radically displacing the fragile equilibrium of power upon which the Swedish Model was resting.

What general picture one can get about the changes taking place in the various institutional and decision –making levels of the “Swedish Model”?

On the level of the macro-economic results and (planned or unplanned) side-effects of the developed and expanded Swedish Model of the 1970s particular attention must be concentrated on the limits of the active labour policy and labour mobility: despite its undoubted successes in securing full employment without serious inflationary surges, the labour force was in the beginning of the 1970s far less disposed to be obediently subjected to the planning procedures of an increasingly bureaucratized and oversized Labour Market Board. The active labout market policy was the most important means of macro-economic regulation and its highly sophisticated forms invented by the governing social democracy was a decisive key to the remarkable successes of the macro-economic management- *all other factors remaining equal.* But exactly those other factors began to change and to affect the effectiveness of the active labour policy.

On the level of class relations- and their impact on the political preconditions of the Swedish Model, we think that we can claim that in the second half of the 1970s the constellation of the class forces underpinning the “Swedish Model” were radically transformed and shaken : the undisturbed consensus and frictionless collaboration were giving place to a climate of creeping but growing confrontation between the private industry and the organized labour movement.

The First Oil Crisis in 1973 came to be added to those growing tensions and to function as a detonator for sharpened distributional conflicts between the organized labour movement and the owners of the private industry.

The serious erosion of the class compromise was going to quickly produce serious side-effects on other essential components of the Swedish Model, the system of the centralized wage-bargaining and of the corporatistic consultation being the most important of them. The labour movement was from the mid-1970s far less inclined to display co-operative attitude and to reach agreements in a spirit of mutual willingness to compromise. The strike in 1980 where the employers locked-out the striking workers, but finally they bowed to the injunction of the social democratic government to accept the proposal of the LO for a 7 pay increase. Far from being disappointed by this development, the new leadership of the Employers’ Association perceived it as the first stage in the battle against the plans for “fund socialism” of both the LO and the social democratic party. In the first years of the 1980s considerable efforts were dedicated, apart from the public campaign against the wage-earners funds, to a decentralization of the wage- bargaining process down to the firm-level.

The external shocks and the deteriorating economic and financial environment – collapse of the Bretton Woods fixed monetary arrangements, first Oil Crisis with the skyrocketing prices of the fuels, growing financial instability, growing deregulation of the financial markets under the impact of a paradigm shift in the economic policies practiced by the most influential Western capitalist countries were being added to the above mentioned factors, leading thus to a worsening of the macro-economic efficiency of the “Swedish Model”. Combined with the loss of competitiveness of certain important sectors of the Swedish industry (primarily, the steel and ship-building industry), a fact which only in part can be attributed to the rising wage costs, the deteriorating economic performances at the end of the 1970s were making it more and more evident the “ erosion” of the Swedish Model had reached a degree which demanded its , more or less radical, reorientation or restructuring. This “erosion” does not mean that the “Swedish Model” had failed or that it was on the brink of collapse, but only that its functioning thus far and its interaction with the international economic environment made necessary its updating and its readjustment. In fact, the acute feeling that changes had occurred which could not be addressed with the traditional means was widespread among the political class. Everyone felt that the stakes were high and the challenge had to be met to the best interest of the parties concerned.

Since the beginning of the new decade, the social democrats (who had returned to power) were de facto compelled to be the first to present their response to the “erosion” of the “Swedish Model”. The situation was particularly pressing and demanding, not only because of the alarming economic conditions of the Swedish industry, but also because the trade union wing of the labour movement adopted, as a way- out of the deadlock, a detailed plan for economic democracy, which was a reactivated demand for a change in the property relations inside the big companies. Although – formally- committed to the goal of economic democracy at some point in the future (and –at the same time- being aware of the reality that the welfare state expansion by means of progressive taxation and income redistribution had reached its limits and something new had to be invented) the social democratic party leadership were unwilling to assume such a radical proposal and to turn it into practical policy. Unable to overcome a deep-seated culture of consensus forged during years of corporatistic decision-making, the social democratic leadership made the following crucial decisions, which, on the whole, were their answer to the new pressing realities:

1) They chose to de-radicalize the radical content and potential of the Meidner Report by shifting the emphasis away from the issues of economic democracy and wealth concentration and

towards the need of strengthening the capital formation of the Swedish industry. A theoretical contruction invented for giving the wage earners increasing power over the decision-making process and the investment activity, was finally turned into a means for securing risk capital for the distressed Swedish industry and became a part of the policy of the Third Way aimed at strengthening the profitability and liquidity of the private Swedish industry. Something that was perceived as threatening the power of the capital owners became now a beneficial “emergency measure” offering them capital in a period of acute economic crisis and squeezed profitability.

Even more significant: The labour movement entered the 1980s divided on a strategic issue -the economic democracy and the means to obtain it- while the bourgeois political and social forces overcame their initial perplexity and were able to unite around a demand of radically rejecting the aims of the Report on Wage- earners funds. The social democratic party leadership may have felt relieved that such a dividing and polarizing issue was settled in the most harmless way, but it greatly underestimated the strategic importance of such a retreat and the determination of the bourgeois parties to mount a counter-offensive aiming to contest the very central pillars and arrangements of the traditional “Swedish Model”.

2) Having sacrificed the wage-earners funds for the sake of strengthening the profitability and the capital formation of the big private industry, the social democrats were led to further measures in this direction. The need to strengthen the profitability of the Swedish industry was felt as so pressing that it very early led to the idea that the only way to achieve this goal was to carry out an aggressive, “shock-and-awe” devaluation. There can be no doubt that the strong devaluation of 1982 was the main pillar of the policy of the Third Way. With the benefit of hindsight, one can equally point out that the decision to devalue and put the profits of the private industry at the first order of priorities was going to have far-reaching consequences- more far-reaching than the social democratic policy makers were able to imagine at the time of taking this decision. And this because this decision would be tantamount to the abandonment of a crucial assumption of the Rehn-Meidner Model which emphasized the need to squeeze the profit share of the firms through a tight macroeconomic policy in conjunction with a policy for full employment, as Lennart Erixon, points out in a presentation of the basic pillars Model at a seminar held in 2016.

3) The consequences of the aggressive devaluation immediately after the party’s return to power were going to be proved, in the medium run, very destabilizing. The social democratic party leadership may have achieved a respite in its effort to redress the squeezed liquidity of the private industry and to successfully manage certain short-term pressing problems (mainly, the budget deficit and the dearth of investment), but it succeeded only in postponing the final reckoning.

Having abandoned any intention of active industrial policy, it had no control over the way in which the private industry was going to make use of its excess liquidity. |Given that parts of the social democratic decision-makers were pushing for a complete liberalization while the devaluation was highly likely to lead to considerable inflationary pressures. The beneficial conditions for loan-taking were added to the speculative investment activities of the big industry bringing about an exponential rise in loan-taking and producing a huge bubble on the real estate market.

Before bursting, this real estate bubble led to a serious cost crisis which worsened the competitiveness of the Swedish industry, since the speculative activities on the construction and real estate market led to an overheating of the whole of the economy and to the fall of unemployment on a historic low level- a fact which unavoidably led to an uncontrolled growth of the wage increases.

But significant as those wage increases have been, they were not, in themselves, the first and most fundamental cause for its emergence. The responsibility lies with the decision to grant to the private industry such a degree of liquidity which demanded quick and profitable investment outlets.

It is very characteristic that the mainstream liberal interpretations of the Swedish financial and economic crisis- and this holds even for the more sophisticated interpretation of Assar Lindbeck- more or less fail to underline this aspect of the decision to devalue and avoid to point to it as the principal reason for the bubble. Instead, very comfortably, they put the whole emphasis on the expansion of the public welfare sector in the 1970s and the “rigidities” of the labour market- or to the wage explosion in the second half of the 1980s by downplaying the crucial link between the wage explosion and the capsizing of the system of central wage coordination and the side-effects of the devaluation – and of the decision to deregulate.

4) Although it would be far-fetched to establish a direct causal link between the devaluation and the decision to deregulate the credit market, it is difficult to escape the impression conclusion that the one measure- the devaluation- prepared the ground for the advent of the other – the deregulation of the credit market. Having chosen to deal with the crisis on the basis of the requirements of private industry,

the social democratic leadership entered a path – or let itself be trapped in a cycle of further deregulation measures-, on which one measure beneficial to the profitability of the big industry almost inevitably gave rise to further measures in this direction in order to produce its full and expected effects. Devaluing and granting to the private industry excess liquidity required by itself the removal of the existing credit controls in order to offer the adequate outlets for the amassed liquidity. Combined with the beneficial tax deductions for interest rates paid on mortgage loans the deregulation laid the basis for the unprecedented banking crisis in the end of the 1980s and the beginning of the 1990s – and it was a watershed event in the post-war financial history of Sweden. The mystery and the confusion around the process of the deregulation and the people implicated in this process cannot exonerate the social democrats of their responsibility for failing to assess the full scope and the consequences of such a crucial decision. Palme openly declared himself to be unable to grasp the far-reaching consequences of the credit deregulation and those with the necessary expertise knowledge were convinced – most of them members of the social democratic Economic Association (*Den Ekonomiska föreningen*- were convinced that the possible negative side-effects were going to be averted. They were proved to be blinded by a remarkable form of wishful thinking. Their conviction that the regulatory framework of the monetary policy needed a serious restructuring by letting the market mechanisms in prepared, under conditions of secrecy, the ground for the deregulation and, once its effects became painfully obvious, they preferred to play the "blame game" - with Feldt accusing Dennis for giving false reassurances and Dennis accusing Feldt for failing to tighten enough fiscal policy.

It is difficult to know whether the social democrats carried out the deregulation out of conviction about its beneficial effects or not. However, they failed to assess the correct implementation of the deregulation process and to carry it out in the most effective way by taking into account the dangers and the destabilizing side-effects. The previous experience of deregulation in Norway, where an uncontrolled expansion took place following a similar pattern, had not been studied carefully or was deemed to be irrelevant for the Swedish case.

5) The social democratic leadership opted, during the whole of the 1980s, to exclude the LO from any serious influence on the major economic issues and to put an end to the relation of cooperation and mutual coordination with the LO, which had been a decisive factor in the building and further evolution of the "Swedish Model". On the main strategic decisions about the issues of economic policy the leadership of the LO had no say during the whole of the decade. In fact, complaints and protests that the party leadership was *de facto* insulated from any influence on the part of the LO was frequently voiced by both the LO chairman and other chairmen of the constituent trade-unions. This did not prevent the social democratic leadership to demand from the unions to display wage moderation in order to hold back wage claims in the battle for redressing the economy in the time immediately after the devaluation. The LO initially complied with the injunctions, but it became evident that it was more and more difficult to convince its members on the merits of wage moderation in the midst of a reckless speculative boom caused by the excess liquidity granted to the big export industry in the aftermath of the Big-Bang of the devaluation. The process of centralized

wage- negotiations was on the verge of disintegration because of the tensions created by both the aggressive efforts of the employers to press for decentralized wage negotiations and the growing temptation of constituent unions to raise claims on the profits created by the speculative boom. In the end, it was the Metalworkers Union which already in 1983 finalized the first collective agreement at the firm level – an event which by no means must be underestimated. The Swedish Model was always based on the crucial role played by the central and coordinated wage bargaining system in setting the leading wage- norms and in containing the inflationary tendencies. But here again one should not lose sight of the decisive triggering factors of the inflationary flare-up: the combination of devaluation, increased liquidity inside the leading Swedish companies and the deregulation of the credit market. The door to an overheating of the economy was wide-open and the unusually – even by Swedish standards - low unemployment rate could not but add excessive wage increases and bring about a serious and unprecedented cost and competitiveness crisis for the Swedish industry.

6) That it was all about a cost and competitiveness crisis caused by the effects of the credit deregulation and the stubborn insistence on the fixed exchange rate of the krona by the totality of the mainstream economic experts, the social democratic government and the center-right opposition should have been obvious from the very beginning. However, having opted more or less consciously for a systemic change of crucial parts of the economic policy regime, all the central players and decision-makers were reluctant to recognize the obvious fact that the forces unleashed by the credit deregulation were provoking a cost crisis which was rendering the fixed exchange rate of the SEK more and more untenable. We think that the LO leading economist Per-Olof Edin has a point, when in a seminar about the 1992 currency crisis he points out that it was not at all difficult to see that the crisis in the end of the 1980s and the beginning of the 1990s was actually a cost crisis, but this fact was somehow transformed into a budget crisis- and that it was this budget crisis, which they strove to remedy by tightening the economy even more. Having ruled-out any idea of readjusting the exchange rate of the krona, the decision makers at the time established a paralyzing conformism of ideas which precluded the idea of an alternative policy as a solution to the cost crisis- and declared anyone proposing it -ranging from the LO economists in 1991 and Nils Lundgren in 1992 – as cranks. The harsh treatment meted out to the reputable bank economist Nils Lundgren who dared (days only before the inevitable happened in the dramatic September 1992) question the wisdom of the fixed exchange rate and pointed to the ravages done to the competitiveness of the Swedish industry is an event revealing of the dogmatic conformism displayed by the totality of the Swedish political system and of the mainstream economists. Why

was it is so difficult to recognize the cost crisis and its link to the deregulation? The paralyzing conformism reigning at the time of the currency crisis is attributed by Per – Olof Edin to the fact that the major decision-makers had opted for an agenda of low-inflation policy as a means for submitting the economy to a “steal bath”. The priorities of the economic policy had radically changed and the aim of combating inflation was raised to the new top priority of the policy to be implemented. Given this crucial development an atmosphere of stifling conformism was established leading to an irresistible psychological pressure to conform and to a lack of courage of expressing dissenting views- even at the moment where the obsession with the fixed exchange rate had lost all its rationale and was causing a great deal of damage[264].

7) The reaction to the cost crisis not only did not mitigate the problem but actually contributed to its further worsening. The social democrats opted, for the first time, to make the inflation their top priority. The decision seemed to be justified at that time: the inflation rate was 9%, which was faster to that of Sweden's main trading partners. Thus, it appeared that the time had come for a reconsideration of the top priorities of the social democratic economic policy. However, the unexpectedly quick scaling down of the inflation rate combined with the drastic effects of the tax reform (with the reduced tax allowances for interest payments on mortgages) in the period 1990-1991 contributed to an explosion of the real interest rates. Furthermore, the decision to peg the krona to the Deutschmark in May 1991 and the decision of the Bundesbank to raise its leading rate after the German Unification, led (towards the end of 1991) to a real interest rate of 8 per cent. Such a high real interest rate could practically kill any economy, let alone an economy which was already facing a recession[265].

The chain of decisions worsening the cost problem continued unabated during the years of the Center-Right coalition government. The decision to lower the compensation rate in the health insurance for the first days to 65 per cent and, above all, the stubborn defense of the fixed exchange rate of the krona (leading to the astronomic interest rates of 500%) was the most clear proof of how wrongly the Bildt- Wibble duo had assessed the nature of the Swedish disease. Blinded as they were by their ideological zeal to bring about a quick system change despite the lack of the necessary political preconditions. That Carl Bildt, only three weeks before the Riksbank “ hit the roof” by

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264 Per- Olof Edin, 2014, in : *När räntan gick i taken, (When the interest rate hit the roof),* pp. 22-24 Seminar held in September 2014 and organized by the Historical department of the Södertörn University in order to commemorate the twenty- two years of the currency crisis of September 1992.

265 Per-OLof Edin, 2014, *ibid, p.*24.

raising the interest rate to 500%, declared that "*the Swedish economy has got out of the cost* crisis *of the latest decade. This fact is preparing the ground for a favourable development in the coming year"* is a clear proof of how misplaced the diagnosis of the Bildt government about the economic situation at that time was[266].

8) Having lost power to the government of Carl Bildt in 1991, the social democrats were lucky enough to be in opposition while the cost crisis and the recession were turned into a depression in the dramatic period 1991-1993. The rapidly reduced inflation, the burst of the bubble and the ensuing collapse of the value of assets in the real estate market led to a real interest rate shock and a serious banking crisis-which became even worse after the interest rates hikes of 500% during the monetary crisis in September 1992. The Bildt government may have worsened the course and the severity of the crisis with its monetarist zeal. but there can be no doubt that the real causes of the crisis were to be found in the reforms and policy measures taken during the social democratic government tenure in the second half of the 1980s. The timing of the reforms (especially of the tax reform of the century, implemented in 1990-1991) was disastrous, but the results became painfully felt *after the social democrats had lost power to the conservative coalition government.* The two crisis packages in September 1992 was an opportunity for the social democrats to display responsible and co-operative attitude, while blaming the Conservatives for their incapacity to perceive in time the crisis, to correctly assess its nature and address it with prompt action and emergency measures. But the monetary crisis of 1992 was going to have lasting effects on the whole political spectrum- the social democrats included. The pathetic spectacle of a government helpless in the face of speculative attacks, unable to resist the forces of the deregulated financial markets and begging for cross-party support strongly impressed the social democrats, as the subsequent events were going to make it plain – especially after their return to power and their decisions about how to address the budget deficit.

9) In the period after the floating of the krona, i.e 1992-1993, the crucial decision was taken to pursue a policy of " gradual and cautious interest rate reductions"- instead of active interest rate reductions in order to lift from the depression an economy which, in Assar Lindbeck's words[267], suffered an accumulated fall in GDP of 5 percent during the three-year period 1991-1993, a decline in the industrial output of 15 percent and a total unemployment of 13 percent. In sharp contrast to the policy of active interest -rate reductions in the UK, the leaderships of the Riksbank, headed by

266 Per Olof Edin, *ibid*, pp.23-24

267 Assar Lindbeck, 1997, *The Swedish Experiment,* pp.65-66

Bengt Dennis, stubbornly resisted any suggestion or pressure to proceed to serious interest rate reductions – even when highly placed members of the Bildt government, among them Bo Lundgren, the minister in charge of tax issues, suggested that the Riksbank should proceed to cuts in its prime interest rate. A *de facto* totally independent Riksbank considered the danger of inflationary expectations and for the fall of the value of the krona   far more serious than the current fall in employment and production due to the collapse of the demand and the skyrocketing saving rate of the households (from minus 2 in 1990) to 10 percent in 1994. The question put by Lundgren how *one could speak about a threat of inflation when the prices of the real estate and of the paper assets was in free fall* [268]was deemed to be not worth being replied by a a Riksbank bent on preserving its prerogative to determine alone the monetary policy[269]. The final result had been, as Villy Bergström points out, both high interest rates *and* a 25 percent fall in the value of the Swedish krona[270].

While the policy of the "successive and cautious reductions of the interest rates" was pursued by the Riksbank, the social democrats finally came to realize that the exorbitant saving ratios of the households was seriously dampening the demand and felt able to present in May 1993 a Bill advocating a reduction of the value-added tax of 5 percent which amounted to a stimulus of consumption of 28 billion kronor. The reduction of the value-added tax was completed with a package of 10 billion public investment, active labour market measures and support to the municipalities which were refraining from laying off workers. It remained to be seen if the social democrats would have been able to stick to their expansionary program once in government, to push for its practical implementation and to try to coordinate it with a far more expansive monetary policy.

10) The appointment of Göran Persson as a new spokesman for the social democratic party was the first step in a process of gradual abandonment of the demand-stimulus program presented in the May 1993 parliamentary bill. First, came the abandonment of the idea of reducing the value-added tax, then came the reduction of the proposed public investment plan and then, during the pre-election period and after the statement of distrust for the Swedish state bonds of Wohlrath, the rewriting of the electoral manifesto with an extensive program for expenditure cuts and economies amounting to 75 billion kronor. However, although the demand-stimulating measures were sharply

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Peeter Jaan Kask, 1997, *ibid*, p.151

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Villy Bergström, 1995, in: *Budgetsanering- fyra vägar ur skuldfällan (Budget consolidation- Four Ways out of the Debt Trap)*, pp.

reduced, they were far from being absent in the final version of the electoral manifesto. At the same time, an open mandate was explicitly demanded from the Swedish people in order to proceed to further emergency measures- if necessary. It was this demand for an open mandate for further measures which was going to be instrumental in sharpening and escalating the proposed cuts. The social democrats made use of the open mandate almost immediately.

11) After the elections the electoral manifesto was turned into a extensive budget consolidation program amounting to 125 billion kronor. The measures for cuts and tax increases were vastly expanded and the expansionary measures were conspicuous by their absence. The new social democratic government considered that the drastic reduction of the budget deficit, in the first place, and of the rapid stabilization of the public debt in the second place, were top priorities and the only way of bringing down the interest rates. The road to the revival of the economy was thought to pass through a drastic budget consolidation program of expenditure cuts and tax increases, while demand-stimulus measures were thought to be highly risky and a luxury under the new conditions where the deregulated financial markets were subjecting the fiscal policies under serious scrutiny. There can be no doubt that the Persson's book-accountant point of view was important in the making of such an extensive fiscal consolidation program, but the acute feeling that speculative actors on the financial markets were able to provoke interest rates shocks, analogous to the traumatizing events of September 1992, seemed to have greatly contributed to the abandonment of any idea of sticking to expansionary measures The Swedish social democratic leadership was adapting itself to the new economic environment by throwing overboard the Keynesian emergency policy of the 1930s-with all the further refinements this policy had underwent in the post-war period. Even more important: its leadership seemed to uncritically accept the dominating economic ideas about “expansive austerity” and about the “rational expectations|” of the households which they are supposed to offset any recovery of the economy by means of an expansive fiscal policy. The pressing and alarming “state of emergency” of the public finances was perceived to dictate only one reliable solution: the elimination of the budget deficit by a program of drastic cuts and economies and by subsequent changes in the institutional framework tightening the budget preparation process, fixing ceilings on the public expenditure and a surplus target for the public finances extending over a business cycle. The budget consolidation program, extended,, updated and completed with the agreement with the Center Party, was perceived to be an “emergency solution” to a critical state of public finances and a package of measures aimed at preserving the Welfare State and averting the total disintegration of the “Swedish Model”. In fact, the reference to the alarming situation of the public finances was the main means for justifying such a drastic and

extensive fiscal consolidation program. That the budget deficit was a mirror image, according to Söderström, of a process of reducing the private debts was something lying out of the scope of Göran Persson. What mattered was to show that the new government had a firm grip on the public finances. That the net debt of Sweden was not so dramatic and was in fact better that that of other OECD countries did not weight in the decision to submit the country to a “steel-bath” of such a harsh program of cuts.

It is highly contestable if and to what extent the budget consolidation program played a crucial role in bringing about the economic recovery As already noted, already in 1994, a year before the beginning of the budget consolidation program, a substantial recovery was registered- and this recovery was particularly pronounced in the export industry. Both Floden and Erixon underline that the most decisive factor for this recovery was the floating and the depreciation of the krona in 1992 and that the short- term results of the consolidation program had a clearly contractionary impact on the economy. It is possible to argue that the reduction of the interest rates in the end of 1995 cannot be attributed to the implementation of the program. Still, no certainty can exist on this point: it is difficult to establish a clear-cut pattern of relations between the budget deficit and the market interest rates, but, nevertheless there are doubts as to whether the significant reduction of the interest rates can be seen as an unambiguous result of the budget consolidation program. The social democrats were, however, on this point very lucky: the interest rates were reduced in 1995 after the deal stricken with the Center party and this reduction could be presented as a success for the budget consolidation program.

Even the long-term high growth rates of Sweden (from 1998 on and up until 2007, i.e on the eve of the eruption of the 2008 financial meltdown) could hardly be attributed to the new monetary-financial regime initiated and established on the aftermath of the successful implementation of the budget consolidation program. There are serious indications that many other factors (the undervalued Swedish krona favouring the Swedish export industry , the favourable composition of the Swedish exports with the traditional mining, forestry and paper industry substituting the telecommunication industry as export leaders) had been of decisive importance for the remarkable growth rates of the Swedish economy in the period preceding the eruption of the last financial crisis.

On the other hand,- and beyond the role of the program in bringing about the economic revival - the implementation of the program transformed the fiscal regime and, by doing so, it was inevitable to transform central pillars of the “traditional” Swedish Model. How conscious the leading social democrats were of this fact it is impossible to know, but it is highly improbable that it escaped their attention that they were changing fundamental aspects of the Model which they had constructed in the post-War period and up until the 1980s. How extensive and deep were these changes? In what respects did the traditional Swedish Model change? What kind of changes did they bring about? What kind of political-economical and institutional configuration did they give rise to? Something radically different from the "Swedish Model"? Or the same Swedish Model with the inevitable modifications in a new era? And if yes, to what extent this new "Model" - to the extent it can be perceived as a "Model"- was different from the old one? In the Introduction to the present work we identified some important institutional characteristics and fundamental traits and goals of the "traditional Swedish Model" - from its elementary form in the 1930s up until the end of the 1970s- the years which were marked by the expansion of the public sector employment and the important changes in the labour laws. In the table below we list, in the left column, the main characteristics of the traditional Swedish Model and, on the right column the new institutional characteristic and the new goals which emerged after the 1991-3 crisis and, especially, after the implementation and the conclusion of the fiscal consolidation program. We think that the comparison between the content of the two columns is very illuminating and sheds light upon the new economic-financial and institutional configuration. Let us take a closer look at it:

"Traditional" Swedish Model (*from the 1930s to the late 1970s, including the proto-Keynesian policy of1930s, the Rehn-Meidner Model of the 1960s and the expansion of the public sector employment in the 1970s)*	**"Restructured" Swedish Model (** after the 1991-93 crisis and the implementation of the Budget Consolidation Program
Main goals and institutional characteristics	**Main goals and institutional characteristics**
1) ***Active*** *(but restrained),* ***counter-cyclical*** *fiscal policy based on* ***accommodating*** *measures in times of recession*	**1) Restrictive** and **non-accommodating** fiscal policy based on self-imposed **norms** (ceiling for public expenditure, surplus target, balanced budget requirement)
*2)****Extended*** *and* ***encompassing class-collaboration*** *-from the central level down to the firm level- carried out by* ***centralized collective bargaining*** *&* ***tripartite neo-corporatistic consultation*** *between State- employers- employees sitting on various administrative boards*	2')**Reduced** and **decentralized** class-collaboration taking place at the **firm-level** through |" industrial agreements"(*industriavtalen*) – Demolition of the tripartite corporatistic consultation (after the decision of the Employers' Association in 1991 to withdraw from central administrative boards) – Both LO and Employer's Union acting as **pressure groups**
*3) A****im of the economic policy****:* ***full employmen****t (while the* ***coordinated wage negotiations*** *and the* ***self-imposed wage moderation*** *contain inflation)*	3')The aim of the economic policy: 2 percent inflation target (pursued by an independent Riksbank in charge of defining the aims of the monetary policy)
4) ***Progressive*** *system of taxation with* ***high***	4') System of taxation (after the 1990-91"Tax Reform

***marginal tax rates** on income tax and generous tax allowances*	of the Century") with **reduced top marginal tax rates**(from70 percent to 50 percent) and with **proportional taxation of capital income**
*5) Combination of **solidaristic wage policy** ("Equal Pay for Equal Work") with **active labour market** policy (emergency public works, job training, person-to-jobs matching) in harmony with the aim of the economic policy (full employment with low inflation)*	5") Gradual abandonment of the solidaristic wage policy (since the separate collective bargaining of the Metalworkers Union in 1993- Continued active labour market policy -with reduced emergency public work after 1991 Difficulties of coordination of the (ambitious) active labour market policy with the (restrictive) fiscal policy
*6) **Regulation** of the **domestic credit market** and of the **currency market***	6')Total **deregulation** of both the domestic credit and of the currency market
*7) A **two tier- pension system** consisting of a **flat-rate basic pension** (folkpension), perceived as a right of "social citizenship", and an **earnings-related supplementary** pensions with relative high income-replacement ratio. A pension system based on **defined benefits***	7') A reformed pension system with strengthened individual incentives to postpone retirement, a system based on **defined contributions**

We think that a comparison of the main institutional characteristics of the "old" and of the "new Swedish Model", as it is illustrated in the table above, renders clear enough some very important differences of the political economy and of the institutional configuration of the "restructured" Swedish Model after the completion of the budget consolidation program. The main difference is undoubtedly the emergence of a new fiscal policy regime characterized by the transition from an accommodating, counter-cyclical (but rather restrained) fiscal policy to a restrictive policy based on norms aimed at tightening the budget process and keeping the public expenditure in severely outlined limits. The independence of the Riksbank and its exclusive responsibility for monetary policy is worth underlining. Equally important is the change of priorities in the general economy policy: the shift of emphasis from the full employment to the 2 percent inflation target (a change appearing in the social democratic government's Statement on the 1991 Budget). We should not lose sight of the fact that the two major events which opened the gate for the "great transformation" of the Swedish Models were the aggressive devaluation of the krona in 1982 and the deregulation of the credit market in 1985 (which inevitably led to a relaxation, in 1987, and then to a total abolition of the controls on the currency market in 1989). These central events set in motion a process of further changes completing each other and deepening the ongoing "change of system" (*systemskifte)* . The tax reform of 1990-1991 was undoubtedly underfunded: it overestimated the so-called “dynamic effects” and the reduction of allowances for interest rate payments on past mortgages deepened the recession and contributed to a further draining of the economy’s demand. At this critical point, the social democratic government in the 1991 Governmental Statement on the Budget reduced the “emergency public works” (*beredskapsarbeten*) - and this in the midst of the most serious recession since the 1930s. It was the first time since the 1993 proto-Keynesian measures that this particular measure of labour market policy was drastically reduced as a means of combating the worst effects of the recession.

A crucial event, with very important political and institutional implications, was the effective termination of the Swedish tripartite neo-corporatistic consultation beginning in 1991, when the representatives of the Employers' Union decided to abandon their places in central administrative boards (with the Labour Market Board being the most prominent of them). This event should not be underestimated: In an economy in serious recession the representatives of the Employers' Union were thus signaling their reluctance to be implicated in a process of consensual administrative decision-making. They made clear that they no longer believed in the utility of corporatistic bodies as a means of finding solutions to the current economic and social problems. For the private industry the best place for seeking solutions was the firm-level and they concentrated all their efforts in bringing about the much-desired decentralization of the wage bargaining process and of bringing it on the firm-level. Their effort had been eased by a weakened LO, whose ties with the social democratic party had been (since the abandonment of the Meidner Report on Wage-Earners Funds) considerably loosened. The spirit of mutual cooperation and feed-back with the social democratic party had practically ceased to exist and the social democratic decision-making process seemed to be effectively insulated from any influence from the economists of the LO. The LO began to be perceived by the social democratic party leadership as a “pressure group” on a par with other organized groups of the Swedish society.

The extremely serious financial-economic crisis of 1991-1993 not only did not stop the process of “system change”, but in fact acted as a catalyst for further reforms in the nature, traits and goals of the fiscal and monetary policy. After the floating of the krona, a *de facto* independent Riksbank rejected any idea of a policy of active interest rate reductions and pursued a policy of “cautious and successive interest rate reductions” and went as far as to resist any pressure for a more accommodating monetary policy. But most crucially: the newly elected social democratic government quickly abandoned any idea of an expansionary policy and conceived and implemented a vast and drastic budget consolidation program accompanied by a series of very important fiscal measures (tightening of the budget preparation process, ceilings on public expenditure, surplus target, balanced budget requirement for the local government). This new fiscal regime, which is remains until today intact bears in its entirety the signature of the social democratic party. Only the *Fiscal Policy Council (Finansradet)* was established in 2007 by the new Conservative-led government.

Can we say, as a conclusion, that the traditional "Swedish Model" had been so profoundly transformed that no longer exists? Arriving at the end of this work we are far more inclined to respond this question in the affirmative: the changes which the Swedish Model underwent in the period 1985-1998 are so profound and fundamental, the new fiscal and monetary regime, the new political economy underpinning this regime, are so different, that one can safely say that the central pillars of the traditional Swedish Model have been completely abandoned.

On the other hand, this conclusion should not be misunderstood. One should not be led to believe that the Swedish Welfare State had been demolished or seriously retrenched after the introduction of the new fiscal regime- as far as the size of public social expenditure in relation to the GDP is concerned. Even after the completion of the drastic budget consolidation program, the public social expenditure of Sweden was, according to the OECD statistics, clearly above the OECD average: in 1996, a year at which the contractionary effects of the fiscal consolidation were painfully felt, the social expenditure in Sweden was at 30.1 percent, while the OECD average was at 18.8 per cent. In 1998 the figures were 28.6 per cent for Sweden and 18.5% for the OECD average. In 2000, 26.8 per cent for Sweden and 18 per cent for the average of the OECD countries, in 2002 27.6 per cent for Sweden and 18.7 per cent for the OECD average. In 2006, the last year of the social democratic government of Göran Persson, the figures were 26.6 per cent for Sweden and 18.5 per cent for the OECD average. The conclusion is clear enough: despite a marked drop in social expenditure in relation to the OECD average (from 30.1 percent in 1996 to 26.6 per cent in 2006), Sweden was substantially above the OECD average as far as the social expenditure is concerned[271]. It is remarkable that Sweden surpassed, always according the OECD SOCX Database, during all the above mentioned period the oil-producing Norway both in relation to public social spending and in relation to net social spending.

A further aspect should also been mentioned: although the social democratic government carried out in the period 1996-2006 significant deregulation even in the factor market, the provision of social welfare services remained firmly under public control and retained much of its egalitarian and universal nature. The Conservative-led coalition government of Carl Bildt may have permitted the

271 OECD, Social Expenditure Database (SOCX)

emergence of private providers in the welfare services (and especially in the primary and secondary school education) but the social democrats did not expand the provision of welfare services by private firms and providers in any significant way. Only after the new Conservative-led government of Fredrik Reinfeldt came to power in 2006, the road was opened for a substantial and without precedent expansion of private providers of social welfare services (ranging from school and pre-school education to care for the elderly and labour market services). The extent of those initiatives was such that some Swedish authors began seriously to speak of a privatized Welfare system[272]. Although the social democrats proceeded to a decentralization in the provision of welfare services by letting the municipalities take care of them (often on cost effectiveness basis), the transfer of the financing and of the operation of the provision of social services to private operators remained a marginal phenomenon. The welfare system remained under firm public control - although a dose of market logic had been undoubtedly injected to it.

But although the social democratic rule in the period 1995-2006 cannot-and should not be- perceived as a demolition of the Swedish welfare system in quantitative terms, there can be no doubt that the traditional Swedish Model underwent a serious restructuring altering central aspects of its institutional construction and basic goals of its underlying political economy. Nothing indicates this fact more convincingly than the end of the full employment regime, a fundamental characteristic of the original Swedish Model", and the serious weakening of the active labour-market policy- first because of its non-coordination with the new fiscal policy and, secondly, because of quantitative restrictions in the funds earmarked for it.

The one-sided character of the fiscal consolidation program was justified by the social democratic leadership on the grounds that the elimination of the budget deficit and the stabilization of the public debt ,by provoking a reduction of the interest rates, would open the way for the return to a full employment. |Unfortunately nothing of the sort happened: the rate of unemployment may have been reduced under the 5% mark in 2000 (thus enabling Göran Persson to present it as a fundamental success and as a proof that the "welfare is growing again") but the subsequent developments were going to make plain that the belief that a new full employment era had been established in Sweden despite the drastic fiscal consolidation was a pious hope. As pointed out by Lennart Erixon, "*the unemployment rate in Sweden in the 1998-2007 period was the same as in total OECD (the average annual rate was 6.7 per cent) and in fact higher than in other Nordic countries, except Finland. Swedish unemployment was also higher than unemployment in the small*

272 Stefan Carlen, Chtrister Persson, Daniel Suhonen, 2014, *Reinfeld-Koden. Den ädla konsten att rasera den svenska modellen (The Reinfeldt Code. The Noble Art to Erase the Swedish Model),* Stockhol, Föreningen Ordfront.

open Western economies on average (5.4 per cent), and, for example, than in the United States (4.9 per cent)" (…) *it is striking that Sweden, even after the crisis in the 1990s, no longer belonged to the group of OECD countries with the lowest rate of unemployment*. " The following table, given by Erixon in his informative article, is very revealing:

Standardized unemployment rates in OECD countries 1992-1997, 1998-2007 and 2008-2010, annual average percentage rates

	1992-97	**1998-2007**	**2008-2010**
Sweden	**8,7**	**6,7**	**7,6**
Denmark	7,4	4,7	5,6
Finland	14,5	9,0	7,7
Norway	5,6	3,5	3,0
Austria	4,0	4,3	4,3
Belgium	9,0	8,0	7,7
Netherlands	5,9	3,9	3,8
Switzerland	3,4	3,3	3,8
Total small Western European countries	7,3	5,4	5,4
Euro area	10,1	8,8	9,1
United Kingdom	8,8	5,3	7,0
United States	6,1	4,9	8,2
TotalOECD	7,4	6,7	7,7

(Source: OECD (2005b), OECD (2011), Table 14. Note: The rate of unemployment in Belgium 1992 was derived by data on unemployment 1992 and 1993 according to a national measure.)

For a "Model",which came into being with the fundamental political goal to "put the people in work in the People's Home (*Folkhem*)" and for a political party-movement, the Swedish social democracy, which drew its legitimacy by always pointing to the high employment rates, the recent unemployment rates mark both a fundamental rupture and a changed order of priorities. The new "Swedish Model, which emerged at the end of the budget consolidation process, was diverging from the old one in, at least, one very crucial aspect: full employment has not been reconquered again after the tumultuous events in the 1990s.

As far as the active labour market policy, this very distinctive element of the original Swedish

Model, is concerned, the developments after the mid-1990s were equally revealing of the substantial mutation which the Swedish Model had underwent. Firstly, in the midst of the budget consolidation process it became evident that the hopes invested in the “new labour market offensive” of the social democratic government were not confirmed. With a reduced demand because of a drastic budget consolidation program the labour market policy proved to be unable to compensate for the contractionary effects of the program and to strengthen the labour market participation-let alone to reduce the open unemployment[273]. Political scientist, Johannes Lindvall points out that the greatest decline in the expenditures for labour market policy took place when the social democrats were in government. According to a diagram given in the article of Lindvall and based on OECD 2011 data, the expenditure for labour market measures declined between 1995 and 2005 (the last year of the social democratic government) steadily from 2,8 per cent of the GDP to 1,3 per cent of the GDP. Lindvall offers two possible explanations for the steady decline of the active labour market policy in Sweden: firstly, that the faith in the effectiveness of the labour market policy declined and, secondly, the retreat of the Swedish tripartite neo-corportism since the beginning of the 1990s. Pointing to studies carried out on the field of corporatism by other researchers, Lindvall claims that that the degree of corporatism is an important explanation of the fact that some countries invest more in active labour market policy than other. The main reason is that labour market education programs, training job places and similar programs have as a necessary precondition the active participation of the private sector[274]. What changed radically in Sweden, was the fact that after the retreat of the representatives of the employers from the Labour Market Board, seems to have a very important impact on the quality, and scope of the active labour market policy.

Abandonment of the full employment goal, retreat from the active labour market policy, erosion of the institutional framework of the Swedish corporatism –all of them important pillars of the original Swedish Model- had been seriously curtailed or suffered a marked decline. If Lars Jonung a vocal critic of the social democratic Swedish Model and the main spokesman of the “norm-based economic school” is correct in pointing out that “*The Swedish Model was resting on a system of regulation of the money and capital market*”, then one can now conceive how important and heavy of consequences the decision to deregulate the credit market had been. This decision produced (combined with other internal and external factors) a serious financial and economic earthquake and

273 Peeter Jaan Kask, 1997, pp 239-241

274 Johannes Lindvall, 2011, *Vad hände med den aktiva arbetsmarkndaspolitiken ?(What happened with the active labour market policy?)* in Ekonomisk Debat, 2011, Nr 3. pp.38-44.

led to the emergence of a new fiscal regime based on self-imposed restrictive fiscal norms. One thing is clear: what in the 1970s began as an erosion of the 1938 class-compromise, upon which the original Swedish Model was resting, ended in the 1995-2005 period with the emergence of a new institutional and economic configuration, markedly different from the original Swedish Model. The organized labour-movement and its political wing, the social democratic party, were confronted with the challenge of passing to the next phase of their original political project: from the "Social Citizenship State" to the economic democracy. They were unable to meet that challenge. They opted for another strategy which resulted in a new "|Swedish Model". Whether one chooses to call this new, restructured Swedish Model "new social democratic ", "Social-liberal" or " post social democratic" is perhaps a matter of taste or a matter of words.

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