Looking ahead through the Rear-View Mirror

Swedish Stabilisation Policy as a Learning Process, 1970-1995

A Summary

By Lars Jonung

Introductory remarks

The stabilisation policy record of Sweden during the period 1970-1995 is unique. No other OECD-country experimented with as many policy switches or policy reversals as Sweden or did it so drastically. As a response to OPEC I, Sweden tried a policy of ”bridging over” in 1974-76 based on an expansionary domestic fiscal policy. The aim was to counteract the contractionary effects of OPEC I. In the aftermath of OPEC II Sweden carried out an offensive ”super-devaluation” of 16 per cent, originally planned to be 20 per cent, designed to give Sweden a competitive advantage for several years and to ”jump-start” the Swedish economy. In the early 1990s Sweden stubbornly defended the fixed exchange rate of the Krona, using large central bank interventions and high overnight rates which for a brief period stood at 500 per cent. (The manager of the Riksbank was considering still higher rates.) The Swedish budget deficit displayed the largest volatility of all OECD-countries during this period. The Swedish economics profession has been involved in the policy formation process as advisers, commentators and policy-brokers to a larger extent than in most OECD-countries.

The purpose of this summary is to analyse and explain the evolution of Swedish stabilisation policies during this period. Specifically it seeks to account for the policy switches by applying recent research on policy learning as developed within the field of political science to the Swedish experience.

Sweden is well suited for such a study for several reasons. First, the Swedish political system has allowed the government to directly control the instruments of fiscal and monetary policies, and in particular to influence the central bank for most of the period studied here. Second, the prevalent Keynesian traditions and views have given the government many instruments and much discretion to use when framing policies. Finally, the Swedish tradition of openness and debate concerning public affairs has induced policy makers to publish their memoirs and views. This literature represents an extremely fruitful source for this report. Here policy makers reveal, sometimes surprisingly frankly, their thinking and their views on the proper conduct of fiscal and monetary policies, thus illustrating much of the learning process of policy makers.

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Contents

1 Introduction

The aim of this study is to explain the sequence of policy switches that characterises Swedish stabilisation policy during the period 1970-95. During these years, the goals, instruments and restrictions of stabilisation policy underwent a series of changes. In rough outline, the process can be described as follows. In the beginning of the 1970s, stabilisation policy had a number of goals: a fixed exchange rate for the krona, external balance, full employment, low inflation, high growth and "low" interest rates. The arsenal of policy instruments included, apart from general measures, a number of selective ones. The scope of policy action was determined by Sweden's adherence to the Bretton Woods-system, that is by the fixed exchange rate for the krona. Capital and exchange controls shielded the Swedish capital market from the rest of world allowing the policy authorities far-reaching powers to regulate domestic economic activity. Behind this financial wall domestic financial markets were strictly controlled by the Riksbank and the ministry of finance.

Optimism regarding the potency of economic policy was widespread and shared by the political parties and by the economics profession. There was a firm belief that the Swedish economy could be successfully managed by the political system.[1] Stabilisation policy was seen as a guarantee for a high level of demand and thus of full employment, more or less independent of the business cycle and the character of disturbances impinging on the domestic economy. The favourable economic performance during the 1950s and 1960s – the golden years of high growth, low inflation and full employment – was regarded as proving the efficiency of "active" stabilisation policies. As a consequence, the level of ambition for stabilisation policy was "high", inspired by both the macroeconomic outcome and by the development of theories regarding fiscal and monetary policy. Included in this optimism was the belief in "fine tuning" with the help of selective instruments.

The dominating approach to stabilisation policy, or "the policy paradigm", was based on Keynesian theory. During the post-war

[1] Optimism concerning the power of policy extended beyond economic policies to include all areas of political control within Swedish society.

period, this emerged as the prevailing theory, reinforced by ideas from the Stockholm School of Economics. This theory provided the basis for the actual framing of stabilisation policy – it was “the policy model” adopted by policy makers - as well as the foundation for academic research on stabilisation policy, being “the theory model” used by university economists.[2]

Over the course of the last 25 years, this picture has been erased. A new view regarding the strategy for stabilisation policy has replaced the view that prevailed around 1970. The goals for stabilisation policy have changed, as have the priorities between goals. The fixed exchange rate has been replaced with a floating exchange rate for the krona. The monetary policy goal – more or less the only goal for the Riksbank – has, since 1993, been set as a target of 2 per cent inflation per annum within an interval of one percentage point. At present, the primary goal of fiscal policy is to create a surplus in the central government budget over the course of the business cycle and, in the long run, to reduce public debt as a share of GDP. The counter-cyclical aspect of fiscal policy has been pushed aside.

The old set of instruments has been replaced with a new one. The selective instruments and regulations have more or less disappeared. The system of investment funds that once received international praise has been buried. The framework for stabilisation policy has changed significantly, mainly through the deregulation of financial markets. Monetary policy now focuses solely on setting the short-term interest rate on “deregulated” financial markets. The Riksbank has recently been granted a more independent position from the government and the parliament. The budget process in the Swedish parliament is managed with the help of new budget legislation restricting the scope of fiscal policy.

The earlier optimism regarding the possibilities to “fine-tune” the economy has given way to a sceptical attitude towards an “active” and selective policy. This new view has found support from new theories regarding stabilisation policy and from the policy experiences during the last quarter of the century. Macroeconomic events since the beginning of the 1970s have been a source of disappointment. Growth in the Swedish economy has fallen during the last twenty-five years compared with the 1950s and 1960s as well as with growth rates in other OECD countries. The 1970s and 1980s was a period of extensive and

[2] The concepts of the “policy model” and the “theory model” are discussed by Pekkarinen (1989). In Sweden, economists at the universities and the framers of fiscal policy were probably more in agreement with each other than in most other OECD countries. See for example Lundberg (1968), who commends the “economically enlightened” Swedish politicians.

volatile inflation. During the 1990s, unemployment has reached a high and seemingly lasting level. Sweden has been marred by three devaluation cycles during the last twenty-five years.

How should this process of changes in the goals, instruments and restrictions, in short, in the strategy for stabilisation policy, be explained? The theoretical literature regarding economic policy gives little guidance as traditional theories are based on the analysis of policy behaviour within given structures and with given policy preferences. Thus it has little to say about a course of events in which those responsible for stabilisation policy have changed strategy or paradigm for their policy.

The empirical literature regarding policy changes provides some assistance. It emphasises a number of driving forces behind policy switches, such as a serious crisis, which undermines the credibility for the old approach, the existence of a promising alternative to established policy and decision-makers with exceptional will-power and ability to enforce a new policy. As a rule, this literature highlights single episodes such as changes in the stabilisation policy in Sweden and the USA during the depression in the 1930s, in the USA and the United Kingdom during the 1980s, in Latin America in connection with different stabilisation programs and, in later years, the conversion from a planned economy to a market economy in the former Soviet Union.

Because of this strong focus on *single* episodes, the literature is not systematic. It does not seek to explain a *sequence* of switches similar to that occurring in Sweden during the last quarter of the century and make generalisations based on such a course of events. Overall, economists have not expressed much interest in policy switches.[3] This field of research has mainly been the domain of economic historians, historians and political scientists.[4]

A striking feature of the evolution of Swedish stabilisation policy, at least since the beginning of the 1970s, is the close relationship between the policy of the past and the present: changes in policy represent reactions to earlier policies. This perspective invites studies of processes that link the behaviour of policy makers over time. An

[3] The fields of economic history and of economic thought are exceptions. Switches in stabilisation policy provide a fertile field for studies of how new theories and ideas force the retirement of old ones. The 1930s in Sweden are an example of this. The emergence of the Stockholm School of Economics, the fiscal activism of the 1930s and the Riksbank’s price stabilisation program of 1931 have been examined in several contributions.

[4] Lately, economists have developed more formalised “rigorous” studies of policy switches. See, for example, Alesina and Drazen (1991), Johnson (1997) and Rodrik (1993). Rodrik (1993, p. 356) argues that policy switches are “too interesting to leave to political scientists”, that is economists should devote more attention to this phenomenon.

approach has recently been developed based on the concept of "policy learning" or "lesson-learning", mainly by American political scientists. They have focused primarily on changes in US defence and foreign policies.[5] Studies of stabilisation policies have hitherto been very few.[6]

The literature on policy learning is adopted in this study as a framework for the analysis of the Swedish record. Policy learning is defined in the following manner. Those responsible for the framing of stabilisation policy, the policy makers, learn as they consciously adjust their goals and instruments by taking into consideration earlier experiences and new information.[7] This definition of "learning" does not claim to be exact and precise. The approach is used here as a method to structure the analysis of the sequence of stabilisation policy switches between 1970 and 1995.

From this perspective, policy switches become the result of learning or, to be more precise, of relearning, i.e. revising old notions regarding the choice of suitable goals, instruments, priorities, strategies and institutions for stabilisation policy. This approach has not been applied systematically to the study of Swedish stabilisation policy – nor to the study of stabilisation policy of other countries.

This study focuses on two groups that have had the predominant influence over the framing of Swedish monetary and fiscal policy: first and foremost, on politicians responsible for the direct conduct of policy, both in power and in opposition, and second, on economists who have interpreted the effects of actual policies and who have produced advice regarding present and future measures. Economists have influenced policy "indirectly" as advisors, commentators, debaters, experts on public and private commissions and as researchers. They have functioned as "policy entrepreneurs" or "policy brokers" by formulating alternatives to the old policies.[8] It is extremely difficult to measure the extent of influence exerted by the economics profession. However, we are content with establishing that economists and politicians have continuously been involved in debate and discussion with

[5] The policy learning literature usually deals with the lessons from Munich, Pearl Harbour, the Korean War, the Vietnam War and other "traumatic" events. See for example Bennet and Howlett (1992), Levy (1994), May (1973) and Stenelo (1980).

[6] Two studies of Thatcher's economic policy are explicitly based on "social learning", see Hall (1993) and Oliver (1997).

[7] There are a large number of definitions of "learning". The definition chosen above is in agreement with the main body of the literature on policy learning.

[8] These terms are taken from Levy (1994, p. 300).

each other regarding stabilisation policy and that economists have influenced policy.[9]

For several reasons, the Swedish experience is exceptionally well suited to examine from a policy learning perspective.[10] First, participants in the stabilisation policy process have frequently documented their experiences and views. This is the case for both politicians and economists.[11] In other words, the traditional openness of Swedish society facilitates the analysis of policy learning.

Second, the structure of the political system has allowed Swedish politicians to test different stabilisation strategies more immediately and more consistently than their fellow politicians in other countries. The power over fiscal and monetary policy has been strongly concentrated to the central government during the major part of the period studied here. As a rule, the government has been able to count on support from the legislative assembly, the parliament, for its measures. The scope for action regarding stabilisation policy has been strikingly large. During the years 1970-95, there were no restrictions on fiscal policy in the form of, for example, limits on the budget deficit or on public debt.[12] The Riksbank has been subject to close political control.[13] This institutional setup is part of the reason why policy activism

[9] The actual influence of economists on policy during the 1980s and 1990s is discussed by, among others, Feldt (1996), Jakobsson (1996), Söderström (1996) and Wibble (1996). Lundberg (1968) believed that the role and influence of Swedish economists has been strong from an international perspective.

[10] Several researchers have noted that empirical research regarding learning processes is faced with the difficult problem of finding relevant observations. This also applies to Swedish stabilisation policy, although to a lesser extent than is the case for other countries and other policy areas.

[11] The memoirs of Kjell-Olof Feldt, minister of finance 1982-1990, provide the most prominent example of the openness in the Swedish stabilisation policy debate. His book is an important source for understanding the conduct of economic policy during the 1980s. See also the memoirs of Bengt Dennis (1998), head of the Riksbank 1982-1994, of Bo Lundgren (1998), minister of taxation 1991-1994, and of Anne Wibble (1994), minister of finance 1991-1994.

[12] Erik Lundberg (1968) considered such restrictions to be a sign of superstition and ignorance in the field of stabilisation policy. Assar Lindbeck furthered similar thoughts in the debate regarding the budget deficit in the beginning of the 1970s. Today, restrictions of this kind form part of the main body of the conventional view.

[13] The devaluation in October 1982 is an excellent example of the power of the government. Immediately after the election but before taking any other steps, the new social democratic government was able to order the Riksbank to carry out a devaluation that originally had been planned at 20 per cent. The devaluation was formally carried out by the Riksbank Governor, Lars Wohlin, who had been appointed by the non-socialist government. After the outcome of the 1982 election, he considered himself to be a “non-political official”.

became so extensive in Sweden during the years 1970-95 compared with the international pattern.

Third, the dominating “activist” Keynesian philosophy contributed to Sweden becoming a laboratory for stabilisation policy experiments during the last quarter of the century. This laboratory produced a rich harvest of experiments.[14] The outcome and interpretation of these experiments became the central part of the learning process.

[14] The literature about policy learning emphasises the connection between experiments and learning processes.

2 The learning process: an overview

The different elements of the learning process during the years 1970-95 are summarised in Figure 1. The figure is based on separating the course of events into four stages. The first stage consists of a macroeconomic disturbance, see column (1), which - with a time lag - triggers a policy reaction aimed at counteracting the original disturbance – see column (2). In this second stage, the policy reaction is determined by the lessons obtained from the period/crisis immediately preceding in time. Gradually the policy response affects the macro-economy in stage 3 – see column (3). Eventually, and in this case the time lag can be considerable, economists and politicians evaluate the effects of the policy measures. In this process they learn the lessons of the past, i.e. they revise their opinion concerning the proper policy response. This learning determines the policy reaction when the next macroeconomic disturbance hits the economy.[15] Learning is a continuous process, as indicated in the lower part of Figure 1. When the next crisis hits the Swedish economy in the future, the policy reaction will be determined by the lessons gained from the crisis in the beginning of the 1990s. Stabilisation policy is "event-driven" according to Figure 1, driven by exogenous macroeconomic disturbances.

The learning process can be described in more detail in the following way; see Figure 1 summarising the process in four episodes. These episodes are: (1) the policy of restraint and "the lost years" between 1970 and 1973, (2) the OPEC I crisis with the policy of bridging-over and of devaluations between 1973 and 1979, (3) the OPEC II crisis with the "super-devaluation" between 1979 and 1985, and (4) the crisis in the 1990s preceded by deregulation and overheating between 1985 and 1995. The policy during each episode is strongly influenced by the lesson from the preceding one. Each episode triggers new learning which affects policy behaviour during the next episode or stage.

[15] Is the generally accepted view of the actual policy effects the "correct" one from a scientific point of view? We do not address this issue. For our study it suffices to establish that in time a common interpretation or "learning" crystallises from each economic crisis.

The process commences during the years 1970-72. At that time, the then social democratic government introduced a tight fiscal and monetary policy aimed at reducing the outflow of foreign reserves, holding down inflation, improving the current account and limiting the expansion of the public sector. This policy reaction was based on the lessons from the Bretton Woods system. Within this institutional framework, a currency outflow required domestic tightening.

The contractionary policy gives rise to heated criticism from the opposition and economists – the debate about what is commonly referred to as the "lost years". The opposition bases its arguments on a Keynesian perspective. They assert that fiscal policy should be more expansionary in order to counteract the rise in unemployment registered in 1971-72. The views held by the minister of finance are considered outdated. The criticism, which undermines the credibility of the government, in combination with a fall in its poll ratings, contributes to a move towards expansion from the end of 1972. The prime minister Olof Palme forces the minister of finance to abandon the policy of restraint. (This is the first episode illustrated in Figure 1.)

The next major macroeconomic disturbance is the first oil price shock 1973-74, OPEC I. The lesson from the "lost years" now influences the policy response of the government. It is reluctant to counteract the OPEC I crisis with a tight policy stance.[16] Instead, the Swedish reaction is determined by the belief that it is possible to avoid, to "bridge over", the expected international downturn by expansionary fiscal policy. All parties support the policy of "bridging-over" – possibly the most pronounced Keynesian experiment in any of the OECD-countries during the 1970s. The influential SNS Economic Policy Group, established by a private think-tank in 1974, initially supports the bridging-over strategy.

The policy of bridging-over turns eventually into a failure. After an initial positive effect, it results in a growing budget deficit, an increased tax burden, a deficit in the current account and a serious "cost crisis", that is a severe loss of competitiveness of Swedish exports, which breaks out in 1977. The acute crisis is arrested by two "defensive" devaluations in 1977 and a policy of fiscal restraint during 1978. Prior to the 1979 election, however, stabilisation policy again becomes expansionary. (See the second episode illustrated in Figure 1.)

[16] See for example Hans Bergström (1984, p. 105): "The experience of the "lost years" of 1971-72 were too close in time to allow for any possibility of liberation from the one-sided Keynesian thinking that had been rendered inadequate by the oil crisis. This was in particular true for the country's collective body of economists who keenly applauded a more expansionary fiscal policy."

The next macroeconomic shock has its origins in the second oil price shock (the OPEC II crisis) of 1979-80. The lessons from the OPEC I crisis and the cost crisis triggers a different policy reaction than during the OPEC I crisis. Fiscal policy is tightened and various austerity packages are introduced. At an earlier stage than during the OPEC I crisis, the krona rate is changed. In September 1981, the krona is devalued by 9 per cent. The non-socialist government goes to the polls on a program of restraint in the autumn of 1982.

The social democratic opposition campaigns against the policy of restraint, against the "belt-tightening". Back in power after winning the 1982 election, the new social democratic government carries out a large devaluation of 16 per cent in October 1982. This "aggressive" super-devaluation, planned during the years of opposition, summarises the lessons from the OPEC I crisis and from the depreciations of the krona of 1931 and 1949, which were regarded as successful. The devaluation of 1982 can be described as an "offensive" devaluation with the aim of "kick-starting" the Swedish economy; a plan without parallel in the history of Swedish stabilisation policy.

The policy of bridging-over in the years 1974-76 was based on fiscal expansion and a fixed exchange rate for the krona. In October 1982, the idea is to make use of an expansionary monetary policy and a tight fiscal policy. The policy mix changes, but not so the basic idea that Sweden can diverge from or "avoid" international economic developments. The belief in domestic expansionism – in a Swedish approach different from the international pattern - is still strong.

The devaluations in 1981 and 1982 contribute to rapidly increasing prices, wages and profits, which become major problems for stabilisation policy during the years to follow. These inflationary impulses are met by the use of price controls, attempts at income policies and the introduction of the system of collective wage-earner funds.

The experience of the devaluation policy contributes in time to a new majority view on stabilisation policy. Economists with increasing conviction recommend a fixed exchange-rate policy or a hard currency strategy, i.e. a policy that does not accommodate negative disturbances through exchange-rate adjustments. Sweden should convert to a low inflation strategy by a credible commitment to a fixed exchange rate. In this way, Swedish inflation will follow the lower rate of inflation which is assumed to prevail among its trading partners, in particular Germany. Further, a number of institutional reforms are proposed in order to strengthen the credibility of the hard currency approach. The fixed exchange rate for the krona should function as a nominal anchor with which low Swedish inflation can be achieved. This new lesson, proposing a rule-based macroeconomic policy, is mainly brought out in a number of reports from the SNS Economic Policy Group in the mid

1980s. It will eventually be embraced by both political camps. (See episode 3 in Figure 1.)

The course of events leading to the next deep macroeconomic crisis can be traced back to November 1985, shortly after the general election, when the Riksbank decides to deregulate the domestic credit market.[17] At this point, the Riksbank changes the instruments for its policy but retains a fixed exchange rate as its most important intermediary goal. During the following years, the demand for and the supply of credit increase markedly. The real rate of interest - adjusted for taxes, inflation and inflationary expectations - becomes negative for many borrowers. The prices of assets, such as shares and real estate, rise drastically without any counteractive measures being taken through monetary and fiscal policy during the years 1986-89. The scope of action of the Riksbank is limited because of its commitment to maintain the fixed exchange rate for the krona. Due to political reasons, the minister of finance feels prevented from tightening fiscal policy. Initially, the rapid expansion of lending does not cause undue concern.

Prices and wages rise sharply, particularly during 1988 and 1989. Registered unemployment stands at less than two per cent during 1989-90. The competitiveness of the Swedish export industry is undermined. The Swedish economy enters into what is classified as the "over-heating", an economy with high inflation from an international perspective, with exceptionally low unemployment and with a disadvantageous cost development. The over-heating contributes to speculation ("interest rate crisis") against the fixed exchange rate for the krona at the end of the 1980s and in the beginning of the 1990s.

Around 1991, the boom turns into a deep recession, the most severe in the post-war era, different from the OPEC I and II crises. It is basically a financial crisis due to a rapid rise in the real rate of interest caused by a set of impulses; the international increase in the real rate of interest due to the German reunion in 1989-90, "the tax reform of the century" which makes household borrowing more expensive, and a decline in Swedish inflation. Private sector savings increase markedly, demanding an adjustment via reduced public savings and/or via the exchange rate of the krona, i.e. through a depreciated exchange rate.

The sharp rise in the real rate of interest, "the real rate shock", undermines the stability of the financial system. Asset inflation turns into

[17] The financial deregulation during the 1980s is sometimes singled out as the cause behind the financial crisis in the 1990s. This is a misleading causal analysis, however, as the crisis in the beginning of the 1990s was not the result of the decision taken in November 1985 to deregulate. A large number of other decisions had to be taken in order for the crisis in the 1990s to occur, of which the deregulation was an important initial decision.

asset deflation. Investment activities, in particular within the construction sector, collapse while unemployment increases. The budget deficit accelerates. In real terms, national income declines three years in a row – a unique pattern without parallel in Sweden during the 20th century.

The lessons from the devaluations undertaken between 1977 and 1982 determine initially the reactions of the political establishment to the course of the crisis of the 1990s. Stabilisation policy is rigidly committed to maintaining a fixed exchange rate for the krona, the idea being that Sweden shall move from being a high inflation country to becoming a low inflation country. The commitment to the fixed exchange rate for the krona is demonstrated in the Budget Bill of 1991 presented by the social democratic government, and by the decision to link the krona to the ECU in May 1991. The super-devaluation of 1982 had been trumpeted as a once-and-for-fall devaluation, the last of its kind. According to political will and rhetoric, devaluation is supposed to be a thing of the past.

Politicians, the ministry of finance and the Riksbank as well as the main body of economists initially lack a proper diagnosis of the 1990s crisis, and subsequently lack an appropriate recipe for how it should be dealt with. Official forecasts show significant errors. Decision-makers - both within the social democratic government up until the election defeat in September 1991, and within the incoming non-socialist government – note how they are caught unaware and how surprised they are at the speed and depth of the crisis. Kjell-Olof Feldt, minister of finance during the latter half of the 1980s, writes that “there was not enough insight into the severity of the situation until it was too late and the catastrophe was a fact” (Feldt (1994, p. 52)).[18] The acute crisis is resolved when the Riksbank is forced to abandon its defence of the fixed exchange rate of the krona in November 1992 by allowing the krona to float.

The 1990s crisis contributes to a revision of the lessons gained in the 1980s. A new and fundamental lesson regarding monetary policy after the failed defence of the krona is that a fixed exchange rate for the krona is difficult to uphold in a world of internationally well integrated financial markets and when other countries have converted to floating exchange rates. The Riksbank did not imagine such an international environment when it carried out its deregulation in 1985-89. The old goal of the monetary policy, the fixed exchange rate for the krona, is replaced with a new one in January 1993, i.e. that of a low inflation norm or a price stability rule. Another lesson gained from the high inflation of the 1980s is that the Riksbank is granted a more independ-

[18] This is apparent in several accounts by policy makers. See Dennis (1998), Lundgren (1998) and Wibble (1994).

ent position from January 1, 1999. This legislation is also part of the Swedish convergence to the rules of the European Monetary Union.[19]

After the acute crisis of the 1990s and the large budget deficits following in its wake, fiscal policy is focused on budgetary consolidation. Balancing the budget becomes the primary target for fiscal policy against the background of the extreme rise in public debt in the early 1990s, the largest of its kind among OECD countries. In order to create a more stringent budget discipline, new legislation regarding the budget is introduced during 1996, allowing a ceiling on government expenditures. (See episode 4 in Figure 1.)

According to Figure 1, the different policy switches can be described as a series of interconnected experiments where the interpretation of the outcome of the experiments form the core of the learning process. Each episode is an experiment that, with time, results in new lessons demonstrating a feedback between the present policy and the policy of the past. Thus, stabilisation policy is characterised by a strong "path dependency" as policies are related over time through the backward-looking behaviour of the policy makers.

[19] A lesson gained from the financial crisis was that a similar crisis should properly be counteracted with a floating exchange rate and temporary government assumption of parts of the debt burden of the private sector. This insight was forced upon the policy makers by the acute crisis.

3 The learning process among policy makers

So far the evolution of stabilisation policies during the years 1970-95 is interpreted as a process where the policy makers learned to redefine their goals, instruments and restrictions in light of the perceived successes and failures of their policies, that is, in light of new lessons. In short, they were learning from experience.

The analysis can be taken further as a number of more specific conclusions regarding the learning process of politicians and economists can be identified. These are described below in terms of five central aspects: (1) the driving force behind the learning process, (2) the timing of learning, (3) the sources of information, (4) the character of the lessons, and (5) the macroeconomic consequences of the learning process. These aspects have been selected from the literature on policy learning.[20] In addition, the issue whether Swedish policy makers learned to learn is also examined.[21] Table 1 provides a summary of the conclusions.

3.1 The driving force behind the learning process

The fundamental driving force which initiated policy learning was the negative disturbances or shocks that struck the Swedish economy beginning in the 1970s. These impulses should be viewed in the context of macroeconomic developments during the Bretton Woods period. After the Korea boom, the 1950s and 1960s were a “calm” period, where the cyclical swings in economic activity were fairly small and anticipated. With this experience, the established approach

[20] See for example Bennett and Howlett (1992), Levy (1994) and Oliver (1997).

[21] The learning process extended not only to leading politicians in government and the opposition. The lessons became part of the interpretation of macroeconomic developments among the media, voters and general public. How these lessons were spread among the political elite and voters is not treated in this report. On this issue see for example Blendon et al (1997), Becker and Jonung (1998) and Colander and Coats (1989).

towards macroeconomic shocks became one where these could and should be dealt with by a countercyclical policy focused on controlling demand at an aggregate as well as at a regional level. The purpose was to keep the Swedish economy within the “narrow band” of full employment, avoiding high inflation and unemployment.

The new features of the macroeconomic disturbances of the 1970s and 1980s were their strength and nature. The strength of the impulses was greater than earlier, creating larger cyclical amplitude than during the 1950s and 1960s. The disturbances did not originate from the demand side, instead they came mainly from the supply side, primarily in the form of significant and unexpected changes in relative prices. The OPEC I and OPEC II crises had their origin in oil price increases. The deep crisis of the 1990s can be traced to a sharp rise in the real rate of interest during the “boom-and-bust” cycle in the late 1980s and the early 1990s.

Another source of disturbances was the framing of stabilisation policy, which in some cases had a destabilising effect. The policy of bridging-over put the Swedish economy onto an unsustainable course. The super-devaluation of 1982 probably took place when the economy may be described as being in “equilibrium“, thereby setting the stage for a strong inflationary stimulus. Stabilisation policies created the overheating of the latter half of the 1980s and the financial crisis at the beginning of the 1990s. The ambitious attempts to stabilise the Swedish economy thus contributed to the macroeconomic imbalances.

The macroeconomic disturbances were unexpected and unknown to contemporary politicians and economists. In their efforts to understand and to stabilise the course of events, they became part of a learning process. Thus the learning process was “endogenous”, mainly determined by the interpretation of the results of previous policies. The shocks to the domestic economy became the exogenous factor in the learning process. The behaviour of politicians and the analyses of economists were primarily reactive, a reaction to previous external events, crises or developments.

3.2 The timing of learning

The learning by the policy makers took place primarily during and after acute economic crises. The following examples illustrate how crises brought about the acceptance of alternative strategies. The OPEC I crisis served as a justification for the policy of bridging-over. However, as Swedish exports declined due to loss of competitiveness, the Riksbank was forced to devalue the krona in 1977. The OPEC II crisis led to a relearning, where devaluations and a tightening of fiscal policy were implemented at an earlier stage than during the OPEC I crisis. During the government crisis in February 1990, the social democratic government proposed a series of measures that had not been previously openly considered within the party, like restrictions on strikes. The fall of the Swedish krona in 1992 contributed to the Riksbank decision not to return to a fixed exchange rate for the krona but to accept a flexible exchange rate.

In some cases the crises eliminated the established strategy for stabilisation policy and resulted in new alternatives. The devaluation in August 1977 forced the krona to be withdrawn from the European exchange rate co-operation, commonly known as “the snake”. The fall of the krona in November 1992 meant that a fixed exchange rate no longer remained a credible alternative for monetary policy. The rapid increase in public debt during the crisis of the 1990s made it difficult to continue a policy of large budget deficits.

On several occasions, the planning for parliamentary elections gave rise to a new strategy for stabilisation policy. The social democratic internal planning for the election in September 1982 included an “offensive” devaluation that was implemented in October 1982. The conservative and liberal parties set up a program for economic growth and structural change prior to the 1991 election, *A New Start for Sweden*. This served as the basis for the policy of the Carl Bildt government following the election victory of the non-socialist parties in September 1991.

The crises functioned as important dividing lines or catalysts for the stabilisation policy learning process in different ways. First, an acute crisis forced the policy makers to evaluate the existing policy and alternatives to it. Secondly, a crisis could eliminate a policy alternative and in that way force a new policy choice. Thirdly, a crisis often provided strong incentives to subsequently appoint investigations and commissions, both within the public and private sectors.[22] These evaluations could break ground for new ideas and in time contribute to a policy switch.

The above results regarding the timing for learning coincide well with the established views in the literature on policy learning. As a rule, it emphasises that some form of major event, a national crisis or a substantial shock, triggers policy learning. When all is quiet on the

[22] The Bjurel report (Ds Ju 1979:1) and the Lindbeck commission (SOU 1993:16) are two examples of evaluations made by the central government. The SNS Economic Policy Group reports were often inspired by crises in the Swedish economy.

policy front, the incentives to learn and implement new ideas are significantly weaker.[23]

3.3 The sources of information

Every learning process is based on the processing of information. From where did the policy makers collect their information? Four conclusions can be discerned regarding the sources of information for learning.

Firstly, politicians responsible for policy framing based their learning primarily on the interpretation of the *latest* crisis, i.e. they obtained their information from the most recent experiences. When Anne Wibble, minister of finance 1991-94, describes the arguments used by the non-socialist government to a support the fixed exchange rate for the krona, she refers to her own experience of the devaluation policy of the 1970s and 1980s (Wibble (1994, p. 23)):

> "From my time as a political staffer in the earlier non-socialist governments, I had my own experience that recurrent devaluations did not solve any problems. After the huge devaluation in 1982, the social democratic government had made it clear that this was enough. New devaluations would erode the credibility of Sweden."

Bergström (1993, p. 197) emphasises the following pattern in his analysis of the preparations by the Bildt government to assume office in 1990-91:

> "There is a strong tendency in all human thinking to act in accordance with the most recent significant experience. The failure of the devaluation strategy and the high inflation economy were the major experiences of the 1980s. Out of that came the definite intention among all responsible parties not to undertake a further devaluation, to eliminate inflation from the Swedish system at all costs…. This political psychology is very common."

Secondly, politicians responsible for policy also obtained information, inspiration and arguments from the economics profession, i.e. from economists active at universities and research institutes. Policy makers were influenced directly or indirectly on a number of occasions by the

[23] This argument is well illustrated by Feldt's (1993) conclusions concerning the politically possible.

proposals and analyses of economists.[24] Economists were called in, for example, to serve as experts in various capacities. The Bjurel report of 1979 and the Lindbeck commission of 1993 are prominent examples. Several economists participated in the seminar activities involving the economic programs of the liberal party and the conservatives prior to the 1991 election. Economists would visit the government on their own initiative and present proposals and recommendations.[25] At times, contacts and consultations were close between economists and government representatives as well as members of the opposition.

Politicians were admittedly influenced by economists, but they seldom implemented their specific recommendations, which were often part of a larger package of proposed measures. They adopted elements which agreed with the party program and with public opinion and they ignored or opposed other elements. To put it more concisely, they used the analyses of economists when it was to their advantage.[26]

Thirdly, analyses and proposals from international organisations have served as another source of information. The Swedish stabilisation policy establishment maintained an ongoing relationship with its international counterparts. The OECD and the IMF regularly visited Sweden. The OECD published surveys of the Swedish economy approximately every other year in close collaboration with the ministry of finance. The missions to Sweden by IMF ended with the presentation of a confidential report to the government and the Riksbank.[27] The

[24] An example can illustrate this. The government announced a change in the priorities concerning unemployment and inflation in the 1991 budget bill, which was in line with the rule-bound macro-economic policy view launched by the SNS economists in the mid-1980s. However, the new emphasis on low inflation in the budget bill came after several years of overheating and expansionary policy.

[25] One prominent example is the visit by Assar Lindbeck, Erik Lundberg and Bertil Ohlin to the Fälldin government in August 1978, which contributed to a more expansionary fiscal policy than otherwise.

[26] There is one major area where the advice of economists was hardly followed by reforms or measures, namely in regards to wage formation in the labour market. A recurrent theme among economists has been that a poorly functioning wage formation has contributed to Sweden's macroeconomic difficulties: to cost crises, to devaluations, to the expansion of the public sector and to the low rate of economic growth. See, for example, Söderström (1996, p. 197) commenting on the proposals for labour market reform of the SNS group: “All the analyses and advice of the Economic Policy Group appear to have been cast on the rocks.” Similar arguments can be found in Calmfors (1996) and others.

[27] The IMF missions did not express any severe criticism of Swedish stabilisation policy during the 1980s and contained hardly any warnings of the coming financial crisis.

Riksbank had access to a significant international network through BIS and IMF.[28]

It is difficult to obtain a clear picture of the significance of the import of international information for Swedish stabilisation policy. The ongoing contacts between Swedish and international authorities appear not to have had any immediate and significant effects on Swedish stabilisation policy, judging from available public sources and the biographical literature. However, the international policy influence has probably been underestimated here. Several policy makers such as Carl Bildt, Bengt Dennis, Lars Heikensten and Lars Wohlin have emphasised that they were influenced by information from outside Sweden.[29] Representatives from the ministry of finance have stressed the role of the OECD in advocating new ideas concerning supply-side and growth policies in the 1980s.[30] These were implemented in American and British economic policies and thereby yielded an influence on Sweden by means of a demonstration effect. [31]

One reason for the lack of a clear foreign influence on Swedish policies is the strong domestic support for the Swedish model and hence, also for a "nationalistic" stabilisation policy. There was a common belief, mainly during the 1970s and 1980s, that Sweden had chosen a better way than the rest of the world to maintain full employment. On several occasions, Swedish politicians were inclined to criticise the international community when it did not implement a stabilisation policy that resembled the Swedish one.[32] [33]

[28] It is possible that foreign influence was greater concerning the framing of supply-side policies, especially during the end of the 1980s. The OECD's Sweden report has contained for quite some time a repeated message of deregulation, primarily in regards to the labour market, without this having had any noticeable effect on Swedish economic policy. A closer examination of Swedish "policy imports" remains as an exciting research task.

[29] These comments have been made directly to the author.

[30] The official sources and the biographical literature probably underestimate the influence of international policy. Both Carl Bildt and Bengt Dennis emphasise foreign models in their comments to the author.

[31] Another example: after the fall of the Swedish krona in 1992, the Riksbank sought information about the conduct of monetary policy under flexible exchange rates and invited representatives from the Canadian central bank to Stockholm.

[32] Feldt (1994, p. 55) explains the phenomenon in the following way: "Sweden maintained as long as possible an independent, or one could say nationalistic, economic policy."

[33] The social democrats were strongly opposed to the foreign models of Ronald Reagan and Margaret Thatcher. Carlsson (1994, p. 59) criticises the non-socialist government in the years 1991-94 for using "ideas of the 1980s from the USA and the United Kingdom" when framing "practical policies".

Fourthly, policy makers used economic forecasts as an important source of information. However, the official forecasts from the National Institute of Economic Research often turned out unsuitable as a basis for policy-decisions during the years 1970-95 as they consistently painted an excessively bright and optimistic picture of the future.[34] Above all, they were unable to capture the occasionally very rapid course of events during crises. The deficiencies of the forecasts became significant, especially during the crisis of the 1990s. When the forecasts were most needed, their reliability was at their poorest. Several politicians have also remarked that the forecasts were incorrect and that this posed a problem for them.

Even if the four sources of information discussed above were primarily the same for all politicians, there was occasionally a dispute on the correct lessons to be drawn. Politicians learned in some cases different lessons from the same experiences and developments. Several examples can illustrate this. Leading social democratic politicians first denied that Sweden had entered into a cost crisis in 1976-77 and that a devaluation was a suitable solution. Regarding the crisis of the 1990s, the non-socialist interpretation indicated that there were serious structural deficiencies in the Swedish economy. From a social democratic perspective, the crisis of 1990s was understood as primarily the result of severe policy mistakes made by the Bildt government.[35] In itself, the crisis was not an indication of any structural deficiency. The return of the social democrats to power after the 1994 election revealed differences in learning. The earlier policy based on deregulation and supply policy, tax reforms, etc., that was introduced at the end of the 1980s during Ingvar Carlsson’s office as prime minister and continued by the Bildt government, found little acceptance by the new social democratic government formed by Ingvar Carlsson in 1994. The lesson was not to repeat the mistakes that leading social democrats believed had contributed to their loss in the 1991 election.

These results regarding the sources of information agree with the results from international research, demonstrating that the most recent domestic events, especially those personally experienced, are the predominant sources of information in the learning process. For every policy arena, there is also an establishment of more or less recognised

[34] The same criticism must be also made regarding the long-term forecasts. These systematically provided an unduely bright picture of the medium-term and long-term development of the Swedish economy. See Jakobsson (1996, pp. 180-186).

[35] Ingvar Carlsson (1994, p. 58) describes the results of the non-socialist government's policy as from the fall of 1991 in the following manner: “the recession became worse and prolonged. The Bildt government is singularly responsible for this.”

experts associated with the university world, research institutions and think tanks which produce policy information. The economics profession performed this function in Swedish stabilisation policy.

3.4 The character of the learning process

The learning process was based on an analogy where the new crisis or new situation was compared to the most recent crisis or the most recent development that was considered relevant for the formulation of the current policy stance. There was a tendency to push the analogy so that the new crisis was made fully comparable to the old one. In other words, the analogy was developed into an identity, i.e. the current crisis was described as identical with the previous crisis. This had consequences for the policy framing as the policy judged to be the correct or proper one was based on the policy that was perceived as having been most suitable one during the previous crisis.

Since the policy makers based their learning from the most recent crisis (see the above discussion on the sources of information) and less from crises that were further away in time, the learning process was as a rule *short-sighted*. The lesson became not to repeat the perceived error made during the previous crisis. Thus, the learning process was primarily *negative* in character, that is focused on creating a policy different from that which had been tried during the previous crisis. The learning process can be described as a form of "error-learning". Adjustments were made in accordance with what was perceived as wrong with the previous policy stance.[36]

These characteristics of the learning process, error-learning and its short-term nature, are highlighted by the following four episodes. [37]

[36] See the discussion by Heymann and Leijonhufvud (1995, p. 8) on modelling behavior: "We may think of economic models as arrayed on a spectrum of behavior representations. At the 'adaptive' extreme of this spectrum lie models of behavior governed exclusively by feedback. Behavior is backward-looking and, in the simplest case, reacts only to the immediate past experience." At the 'pre-calculating' extreme we find the inifinite horizon dynamic programming models of recent vintage." Our account of Swedish policy behavior is consistent with the adaptive approach to modelling decision-making.

[37] Feldt (1994, pp. 71-72) criticises what he considers as short-sightedness in the economic policy debate by describing first how "a choir of experts, economists and people in business and politics have in unison criticised and condemned the depreciation of the krona as an instrument of economic policy for some time now. The 1982 devaluation is especially seen as having destroyed Sweden's economy, driven up wage demands, and created a generally irresponsible attitude in business and in parliament as a result of the economic upswing it created." In the mid-1990s following several years of a strong depreciation

1 The expansionary policy of bridging-over in 1974-76 was a reaction to the contractionary policy in 1970-72. The lesson here was *not* to repeat “the lost years”. This episode, which has been described as successful by more recent critics, was perceived as a failure during the first half of the 1970s.

2 The fiscal policy tightening and the devaluations of 1980-82 were a reaction to the policy of bridging-over. The lesson was *not* to repeat the policy of bridging-over from OPEC I and to adjust the exchange rate of the krona at an earlier stage in the crisis. The super-devaluation of 1982 was an attempt to use the devaluation instrument “offensively” in contrast to the “defensive” devaluations of 1977.

3 The determined defence of the fixed krona rate in 1991-92 was a reaction to the devaluation policy of 1977-82, especially the super-devaluation of 1982 which was presented as a once-and-for-all devaluation. The lesson was *not* to fall back into a devaluation pattern again.

4 The introduction of a flexible krona rate in November 1992 and the announcement in January 1993 by the Riksbank of an inflation target of 2 per cent was a reaction to the failed attempt of trying to achieve low inflation by maintaining a fixed exchange rate for the krona. A fixed exchange rate was found *not* to be a suitable arrangement in a financially integrated world

The analysis of the Swedish stabilisation policy learning process on this point is also in agreement with the international analyses of learning in foreign policy and defence policy showing that policy response is based on a retrospective analogy thinking of the type “Do not forget Munich, Pearl Harbour, Vietnam”, etc. The collective memory is limited to the most recent crisis or trauma. The analogy is extended so that decision-makers perceive the current crisis as nearly identical to the previous crisis and thus current policy becomes a reflection of the lessons of yesterday.

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of the krona and rising share prices, “this seems to have all been forgotten, at least for the moment.”

3.5 The macroeconomic consequences of the learning process

The nature of the macroeconomic disturbances varied from crisis to crisis. Some of the shocks were unknown to the policy makers at the outset, such as the first oil price shock during the 1970s, and the real interest rate shock in the beginning of the 1990s. In principle, every shock should have been met by a policy adapted to the character of the particular shock, given that this knowledge was available from the start. However, decision-makers do not to possess that kind of knowledge, they do to have a clear picture of the current macroeconomic situation, they are not able to identify the driving forces underlying economic developments, and they do not have access to exact forecasts of the future.

Given these circumstances, which were the macroeconomic consequences brought about by the learning process? It is reasonable to differentiate between two cases. The first one is when the new crisis displays great similarities to the previous one. Here policy makers have most likely learned to avoid the mistakes made earlier, since their learning is built on a backward-looking analogy with the old crisis. We should then expect the policy reaction to be more successful than was the case during the previous crisis.

The second case is when the new crisis differs "markedly" from the previous crisis. The use of analogy reasoning then creates an erroneous basis for forecasts for the new policy. Under these conditions, the learning process runs the risk of producing a stabilisation policy that is not adapted properly to the prevailing situation since some important condition has been added or has disappeared. Policy makers risk fighting a crisis on the basis of an incorrect conception and forecast of the current economic situation. The learning process and thus the policy design may then become a source of instability. The argument can be expressed in more general terms. Systems with "short memories", i.e. with a short historical perspective, have a tendency to become unstable and to show signs of "overshooting".[38] [39]

[38] Calmfors (1996) emphasises this feature of "overshooting" where the policy makers pushed their policy too "far" and too "hard". See also Jervis (1976, p. 275) who notes that, "Those who remember the past are condemned to make the opposite mistakes."

[39] See also Hans Bergström's (1993, p. 197) analysis regarding the consequences of "taking actions based on the most recent major experience": "There is a danger of repressing the risk in order not to commit an earlier type of

The following three episodes illustrate these conclusions regarding the macroeconomic consequences of the learning process.

1 The OPEC I crisis was basically caused by a strong surge in global energy prices. This was a disturbance on the supply side of the economy and should have been met by supply-oriented measures that increased flexibility and hastened the impact of changed relative prices for energy on the Swedish price structure. Such a policy would have facilitated the adjustment of the Swedish economy.

   Instead, the stabilisation policy reaction was to emphasise demand policies by raising Swedish domestic demand by the policy of bridging-over and by counteracting changing relative prices with such measures as price controls and the rationing of petrol. This was the lesson from the "lost years" and from the dominant Keynesian outlook in which control of demand and selective interference in the price mechanism were central elements.

   The Swedish version of Keynesianism in the early 1970s was developed to deal with "small" demand disturbances; it was not designed to counteract the major supply shocks of the 1970s. Therefore, stagflation was a surprise for many policy makers; they had not previously faced a situation with both rising inflation and rising unemployment. Moreover, the Keynesian analysis covered a relatively short horizon, lacking insights into the long-term effects of large budget deficits and high inflation.

2 The OPEC II crisis was met with the lessons from the OPEC I crisis. The policy reaction was also more successful than during OPEC I. In an international perspective, Swedish economic performance was "better" during OPEC II than during OPEC I. Swedish GDP and industrial output diverged negatively from the path in OECD-Europe during OPEC I, but basically traced the same path during OPEC II.

3 The lessons from the devaluation and accommodation policy of the 1970s and 1980s determined the policy reaction to the crisis in the early 1990s. In the beginning, the crisis was met by support for the fixed exchange rate for the krona. However, the economic policy of the latter half of the 1980s had created an initial position from which it was extremely difficult to credibly defend a fixed exchange rate in the early 1990s. The overheating and the asset inflation had produced a real appreciation of the krona. In addition, the deregulation of financial markets at the end of the 1980s had seriously im-

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mistake, for example, by allowing a deflationary process to turn into a depression, or by supporting an overvalued currency for too long a period."

paired the ability of the Riksbank to defend a fixed krona rate. Speculation had become a much more powerful force than previously when financial markets were regulated. When countries as Great Britain and Italy abandoned fixed exchange rates in autumn 1992, the defence of the Swedish krona became even more difficult to maintain.

The crisis of the 1990s revealed itself to have a different character than that of the two energy crises. The driving force was a strong rise in domestic real interest rates, not a surge in international oil prices. In a world with free capital mobility, it was found that meeting the crisis of the 1990s with a policy derived from the lessons of the devaluation policies of the 1970s and 1980s was not a successful strategy.

How do these conclusions regarding the consequences of the learning process for Swedish stabilisation policy agree with international results? Essentially the same picture emerges here. There is a risk that the learning process leads to mistakes when current policy is based on an incorrect analogy with earlier episodes. This feature of the policy decision process is emphasised by Jervis (1976, p. 228):

> "Decision-makers usually fail to strip away from the past event those facets that depend on the ephemeral context. They often mistake things that are highly specific and situation-bound for more general characteristics because they assume that the most salient aspects of the results were caused by the most salient aspects of the preceding situation. People pay more attention to *what* has happened than to *why* it has happened."

Policy makers have a tendency to base their learning on a static conception of society. Thus they extend the chosen analogy too far. They are unable to adjust their use of "history" to the new circumstances, which render the analogy with the past less relevant for current decisions. The consequence turns out to be an unexpected result.

3.6 Did policy makers learn to learn?

Policy switches created new conditions for economic policy. This is clear from the following schematic list. The devaluation policy established expectations of future devaluations, which made it difficult to defend the fixed exchange rate for the krona. The large increase in public debt in the 1980s and 1990s restricted the use of fiscal policy in the longer run. The deregulation of 1985-89, designed to give the Riksbank increased control and greater influence on financial markets, meant that the ability of the Riksbank to maintain a fixed exchange rate for the krona were eliminated over time. Financial deregulation, which was primarily the result of the large budget deficits at the end of the 1970s and the start of the 1980s, allowed for a budget deficit at the beginning of the 1990s that was much greater than previously. This list can be extended.

Were the policy makers able to "learn to learn", i.e. did they take into consideration the changed conditions of the type described above in their policy reactions? Did they grasp the advantages of continually revising their view of the goals and instruments of stabilisation policy and of developing the capacity to look forward? The answer must be a negative one.

Decision-makers were generally "surprised" by the long-term effects of earlier policy decisions, which in turn had been made to handle more or less acute crises. Politicians were mainly retrospective, they did not learn to learn from current developments. They did not anticipate that policy changes in themselves would change the preconditions for policy. Politicians revealed themselves to be not only short-sighted "retrospectively", but also short-sighted "prospectively".

Ingvar Carlsson, social democratic prime minister 1986-91 and 1994-96, describes the difficulties of understanding the implications of the growth of the financial sector: "But what we did not anticipate was the rapid development of financial markets with increased internationalisation and new forms of trade."[40] Similar conclusions are found in the economic policy memoirs discussed in this study.[41]

[40] Färm (1991, p. 85)

[41] Such thoughts can be found in the policy recollections of Wibble (1994) and Feldt (1991, 1994).

Thus, Swedish politicians scarcely learned to observe the long-run effects of their policy measures.[42] Similar conclusions are found in international research. The task of politicians is to handle crises.[43] After the handling of an acute crisis, it is up to the future to show what should be done with the long-term effects of the crisis policy.

As noted frequently above, the conclusions regarding the stabilisation policy learning process in Sweden are in agreement with international research on policy learning. The latter are almost exclusively based on studies of American security policy, defence policy and foreign policy. At first glance, it may appear surprising that the similarities are so striking. However, those responsible for stabilisation policy, like those responsible for foreign policy and defence policy, are regularly faced with sudden and often unexpected crises that require immediate reaction. This similarity in the decision-making situations is probably the main reason why the Swedish results agree with the American results even though they are obtained from two different policy areas.

[42] There was a significant rotation within the group of politicians responsible for policy. This also made it difficult to retain experience and knowledge of lessons learned within the Cabinet Office.

[43] Gunnar Myrdal has emphasised this aspect in his statement that a government deals with two things: crises and appointments.

4 The learning process among economists

As previously mentioned, economists assumed a central role in the discussion of stabilisation policy choices.[44] They followed economic developments, interpreted them and made their diagnoses and prescriptions known. They participated regularly in debates with the minister of finance on new budgets, they met with governments and representatives of the opposition in different forums. They expressed their views in the media and published articles in the daily press.

As indicated earlier, the economists did not comprise a homogeneous group. There were many views within the body of economists. Some were quicker than others to absorb and propose new ideas, perspectives and interpretations. Others lagged behind or remained faithful to the macroeconomic outlook of their youth. In addition, the majority of economists did not work with macroeconomic issues, and remained therefore generally silent in the stabilisation policy debate. However, it is possible to detect a main stream that formed the most influential alternative to the official view on stabilisation policy. The changes of the main stream reflect the learning process of the economists. Their learning is summarised below with the aid of some elements of the schedule used above in analysing learning among the politicians responsible for policy.

4.1 The timing of learning

Economists entered public debate primarily when they perceived that the outcome of present or of expected policies were or threatened to be “worse” than the outcome they expected of a “better” policy design. The economics profession became sceptical of the tight policy of 1971-72 as unemployment grew. Initially the majority of economists sup-

[44] Hardly any other social scientists participated in the stabilisation policy debates during the period 1970-95. Admittedly, there were individual contributions made by political scientists, sociologists, economic historians and business economists. But these did not deal with the central questions regarding stabilisation policy.

ported the expansionary policy of bridging-over of 1974-76. As the expected results of this policy failed to materialise, criticism grew in strength and took the form of advice to devalue the krona and eventually the recommendation to change to a rule-based macroeconomic policy.

Many economists were initially positive toward the devaluations of 1981 and 1982. They were surprised by the positive effects of these measures, but criticism gradually grew from their side. When the 1982 devaluation was evaluated at the start of the 1990s, the final marks given were low.[45] The policy makers did not have the capacity to follow up the devaluation with a sufficiently tight policy to make it successful in the long run.

Mainstream economists supported the fixed exchange rate policy at the start of the 1990s, but after its failure they became openly critical. Some maintained that the adherence to the fixed krona rate and the defence of the krona went too far.[46] They rapidly changed to a positive attitude to a floating exchange rate once the krona was floating.[47]

In this process of criticism, debate and research, the "disappointment" over what was perceived as failed policies contributed to a search for alternatives. The time for learning took place primarily *after* the acute crisis when the policy results were identified. This was the case for OPEC I and OPEC II. These crises undermined the established stabilisation policy strategy based on activism, fine-tuning, demand management and devaluations. A new learning process took place during and after the 1990s crisis. The crisis brought a focus on the portfolios of the private and the public sector and on the balance between private and public indebtedness; a move away from the traditional Keynesian aggregates.[48] The crisis illustrated how the growth of financial markets undermined the sustainability of a fixed exchange rate.

[45] See the contributions in Jonung, ed., (1991).

[46] See, for example, Söderström (1993) and Calmfors (1996).

[47] The transition could be very rapid to the outsider. At least two economists, namely Villy Bergström and Assar Lindbeck, changed from a defence of the fixed exchange rate to an understanding of floating exchange rates during interviews on November 19, 1992, when the news of the fall in the krona came. It should be mentioned that they considered that they could not openly criticise the fixed exchange-rate policy as long as the "defence of the krona" continued, although they had private doubts about the hard currency policy.

[48] Söderström learned to analyse the Swedish crisis of the 1990s from his experiences from a study of the Finnish depression: "During my work on the Finnish study, I gradually understood that a reasonable analysis of the causes of the crisis as well as a suitable economic policy must begin with the balance sheets in the private sector." See Söderström (1996, p. 201).

The time of learning for economists was *prior* to the comparable point in time for the political system. There were two reasons why economists were generally the first to formulate new alternatives. First, they were not bound by political obligations and political programs. They could present their viewpoints more freely than politicians. Secondly, university economists participated in the traditional academic learning process constantly testing and questioning established theories and interpretations. Provisional hypotheses and criticism constitute the working environment of the researcher. This spirit, driven by the flood of new international research results, brought Swedish economists to learn more quickly than the political establishment, making them ready to issue new prescriptions when the old ones appeared to have failed. On the other hand, economists were sometimes perceived as opportunistic and unreliable by politicians and the media for just this reason.

4.2 The sources of information

Economists critical of the conduct of stabilisation polices during the years 1970-95 based their critique primarily on data describing the performance of the Swedish economy, relying upon the most recent events or episodes as support for their message. Their empiricism very rarely consisted of econometric tests of explicit models or theories. This method is well illustrated by two books where the authors of different sections of a selection of SNS reports evaluate their analyses in retrospect.[49] Here they view their advice in the light of actual developments, where the difference between expected and actual outcome contributes to reflection and learning. Their comments are based primarily on statistical data pertaining to macroeconomic outcomes:

> "But the Economic Policy Group as well as the government ignored the more long-term results of rapidly rising general government expenditures and an increasing private consumption during those years." (Lundberg and Rydén (1980, p. 32)).
>
> "Considering recent experiences, I would today place more weight on the instability-creating effects of inflation,…." (Lundberg and Rydén (1980, p. 47)).
>
> "First, it should be noted that we did not grasp then just how effective the 1977 devaluations actually were" … "At the time we were ignorant of the poor state of public finances as from 1977 onward." (Lundberg and Rydén (1980, pp. 66-67)).

[49] See Lundberg and Rydén (1980,1985).

The above quotations easily give the impression that the SNS economists only made incorrect assessments. This is misleading as they were able to point to threats and problems in many areas which subsequently materialised.

The SNS economists were not the only economists who revised their views. Quotations can be gathered from many areas. See, for example, Carl-Johan Åberg (1997, p. 92) who writes:

> "We all make mistakes, including myself. In the debate of the Swedish Economic Association regarding the 1977 budget proposal, referred to in *Ekonomisk Debatt* no. 1, 1977, I questioned whether Sweden had a cost problem."

The actual macroeconomic record was thus the primary source of information for the learning process of economists. When arguing for new policies, economists commonly referred to "experience" and "lessons". This is demonstrated in Table 2 which lists publications dealing with Swedish stabilisation policy during the period 1970-97 where the word "lesson" is contained in the main titles or in the subtitles. In these cases, the contribution evaluates actual policies and gives advice on how stabilisation policy should be framed.

International research, which in turn partially reflected the foreign experiences of stabilisation policies, were an essential source of information and inspiration for Swedish economists. Many of them sought to apply and test new macroeconomic theories and models on Swedish data. The economists thus served as a bridge between foreign theoretical developments and the Swedish environment. The SNS reports tried to build their arguments on the basis of Swedish and international research. Various government commissions dealing with the Swedish economy relied on recent international results. References to the research frontier, to "theory", are certainly many, but they do not appear to play as prominent a role as references to "experience" to legitimise policy proposals

A primary task of new research was to provide support for the policy proposals of the economists. They functioned as a "filter" to organise the arguments for new policies and to reinforce the empirical arguments. This was a rational behaviour by the economists. It is easier to win an audience in public debate by referring to concrete problems than to abstract theoretical advances, the relevance of which is easier to criticise.

4.3 The character of the learning process

The learning process of the economists was primarily based on the most recent previous experience, similar to the learning within the political system. The most recent policy mistake became the basis for proposals of changes in the policy stance. During the 1970s advice had a short-term cyclical perspective; that is during the "lost years" 1971-72 and during the policy of bridging-over 1974-76. The recommendations were designed for the most immediate future; there were little considerations of the long-run effects of the policy recommendations.

The perspective eventually shifted to the long-run as the consequences of the stabilisation policies of the 1970s gradually became clear. The lesson was to abandon the strategy based on devaluations and on accommodation and to adopt a long-term strategy based on fixed exchange rates in order to achieve low inflation and high credibility.

As with politicians, economists had great difficulties in foreseeing the new macroeconomic environment arising in the 1970s and 1980s. They were repeatedly surprised by "reality". A quotation from Lundberg and Rydén (1985, p. 120) illustrates this reaction:

> "But I could not ever have dreamt of the rapid consolidation which, despite everything, occurred between 1982-1984. It was a question of two unforeseen changes …"

Hans Tson Söderström, the driving spirit behind a rule-bound non-accommodating policy based on a fixed exchange rate for the krona, learnt from his study of the Finnish crisis that the fixed exchange rate must be abandoned under certain exceptional conditions. He formulates this idea as a lesson.[50]

> "Shortly after I had finished my work for the Bank of Finland (June 1993), I consequently began to try to apply my lessons from Finland to economic policy in Sweden…. In a column in *Dagens Nyheter* in the summer of 1993, I developed the argument for why a rule-based macroeconomic policy was not advisable in an extraordinary situation such as the Swedish one. (Söderström (1996, p. 172)).

[50] Söderström (1996, p. 201) rejects "active" stabilization policy except in cases of major disturbances: "an active stabilization policy must be employed if the economy, despite everything, should be struck by unexpected internal or external macroeconomic disturbances in the magnitude of 10 percent of GDP or greater."

However, according to Söderström, under normal circumstances stabilisation policy should follow a rule or a norm. His view on this point remains unchanged. In his review of the macroeconomic experience of the 1990s, he sees a rule-bound policy as “a good basis for future policy”.[51]

To sum up, Swedish economists learned, as politicians did, generally after the macroeconomic crises, and then primarily from the actual macroeconomic events. Their comparative advantage was their ability to analyse the historical course of events and to use this analysis as a basis for identifying and warning of future problems.

[51] See Söderström (1996, pp. 10-11): “My belief in a rule-based policy as a major strategy in economic policy remains totally unbroken. But only a fool can imagine that there are economic policy recommendations which are always valid, regardless of the economic conditions in which policy is applied.”

5 Conclusions

The goals, instruments and restrictions for Swedish stabilisation policy underwent fundamental changes during the period 1970-95. This was the result of a series of strong negative shocks that struck the global economy and thus the Swedish economy. When politicians responsible for policy sought suitable measures to counteract these disturbances, they were drawn into a sequence of decisions, which over the years resulted in a new strategy for stabilisation policy.

The fundamental idea of this study is that the evolving sequence of policy switches should be analysed as a learning process.[52] The process involved both the policy makers, the "politicians", and the economists who participated in research and debate concerning stabilisation policy.[53]

[52] The evolution of stabilisation policy in 1970-95 has been examined in this study as a learning process. The question arises whether this period is exceptional. The answer must be no. Similar learning processes can be documented for earlier phases of Swedish stabilisation policy.

Several examples can be presented in support of this conclusion. The development of the legislation from 1668 to the present for the Riksbank can be interpreted as one long attempt to include various lessons into the regulatory framework. See Fregert and Jonung (1996). The return to the gold standard at the beginning of the 1920s was based on the experience of the pre-war gold standard and of the inflationary process during World War I. The return to the pre-war gold parity created a severe depression in the Swedish economy, which became part of the lessons of the past that influenced the policy response during the crisis of the 1930s. Economists and politicians learned that a deflationary policy like that of the 1920s was an unsuitable strategy. A new course was chosen based on price stability, floating exchange rates and greater reliance on fiscal policy. At the end of World War II, the framing of economic policy after the war was examined on basis of the lessons from World War I and from the first years of the 1920s.

[53] The fundamental idea in this study is that stabilisation policy evolved as part of a learning process. This view invites questions of a normative character: should the learning process be improved or facilitated? Similar normative questions are raised in American studies on policy learning. One possibility would be to set up an institution whose task would be to continually present alternative diagnoses and prescriptions of monetary and fiscal policy. However, it is doubtful whether such a new addition would have much to contribute. Such institutions already exist in the form of universities and research institutions.

Even if a new institution or organisation was created for "stabilisation policy learning", there is no guarantee that it will be able to learn the right lessons, nor that Swedish politicians and economists would learn from such an organisa-

Presently there is common support for a new model or paradigm for stabilisation policy and for a new institutional arrangement based on an independent Riksbank, a "tighter" budgetary process and an internationally integrated Swedish financial market. The support, however, does not appear to be as complete and stable as that established during the 1950s and 1960s for the Keynesian view.

Have Swedish politicians and economists now learnt the correct stabilisation policy lesson from history and the development of theory? We will not know the answer until some time in the future after the next major macroeconomic disturbance has hit the Swedish economy. Then we will have the opportunity to investigate whether the policy reaction proved suitable for dealing with this future crisis. (See episode 5 in Figure 1.) It cannot be ruled out that the prevailing view will reinforce and deepen the future crisis, i.e. the lesson of today will prove to be the "wrong" lesson in the future.[54]

Can we begin to see the end of the history of stabilisation policy and thus of the learning process? Judging from this study, there is nothing that indicates this. The learning process will continue as a consequence of new macroeconomic disturbances, new conditions and new research results. We should expect future policy switches. Therefore, a final conclusion of this study should be that the lessons which determine contemporary policy and institutions should not be regarded as definitive and ultimate ones and should not be allowed to constrain policies and institutions under all conditions in the future.

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tion. Pluralism and multiplicity in research and debate are probably the best methods for facilitating learning.

Admittedly, economists could become better as advisers if they indicated more clearly under what circumstances their advice should be followed and under what circumstances it is not applicable. Many economists issue prescriptions without declaring under which circumstances they should *not* be followed.

[54] The currently prevailing idea is to limit the field of discretionary action by a "restrictive" institutional framework. The former wider scope of action constituted the basis for the Swedish policy experiments and thus for the lessons of today. The new institutional constraints now in place have reduced the area for experiments. However, the possibility to experiment has a value in itself that should be balanced against the cost of "risky" experiments.

Table 1. The policy learning process 1970-95. Major conclusions.

1 The driving force behind the learning process
The driving force was the major macroeconomic disturbances that hit the Swedish economy. They triggered economic crises which forced the policy makers to start to evaluate different policy options and thus to search for lessons from the past.

2. The timing of the learning process
The learning by the policy makers took place primarily in connection with acute economic crises and in the years following the crises when the effects of the policy response were identified.

3. The sources of information for the learning process
The main source of information was the interpretation of the most recent previous domestic economic crisis and its policy outcome, considered relevant as a basis for decisions and forecasts.

4. The character of the learning process

a) Learning was built on analogy reasoning between the current crisis and the previous crisis. Learning was therefore backward-looking and of a short-run character: it excluded episodes, that is, information from events further back in time.

b) Learning was primarily of a negative character: the lesson was to avoid repeating what was perceived as policy mistakes during the previous crisis (”error-learning”).

5. The macroeconomic consequences of the learning process
Learning determined the policy response and thus influenced the path of the macro-economy. Two cases should be distinguished:

a) When the new crisis was similar to the old crisis, the “mistakes” from the previous crisis were avoided.

b) When the new crisis differed significantly from the old crisis, the learning process risked creating instability. In this case, policy makers met the new crisis with the support of misleading lessons. The learning process then became a potential source of instability.

6. Did policy makers learn to learn?
It was difficult for policy makers to learn to learn. Their learning was backward-looking, but hardly forward-looking. They seldom considered the long-run consequences of their measures and were subsequently surprised by them. Thus, policy-making contained a strong element of reaction to the course of events, created by exogenous shocks as well as earlier stabilisation policy measures.

Comment: The above results are basically in agreement with international research on policy learning. Most of the conclusions regarding the learning by policy makers also pertain to the learning by economists. Economists revealed the same tendency as policy makers to condense the lessons from the most recent crisis and to limit their retrospective vision.

Table 2. The use of the term lessons ("lärdomar" in Swedish) by economists. A selection of titles from the literature on Swedish stabilisation policy, 1970-97.

Swedish titles:

Calmfors, L. (1979), "Lärdomar av kostnadskrisen" (Lessons of the cost crisis).

Lundberg, E. (1984, p. 131), "70-talets stabiliseringspolitiska debatt – nya lärdomar" (The stabilisation policy debate of the 1970s - new lessons).

Lundberg, E. and B. Rydén (1980), "Svensk ekonomisk politik. Lärdomar från 70-talet" (Swedish economic policy. Lessons from the 1970s).

Lundberg, E. and B. Rydén (1985), "Ekonomisk politik i förvandling. Hur stabil är stabiliseringspolitiken? Lärdomar från 80-talet" (Economic policy in transition. How stable is stabilisation policy? Lessons from the 1980s).

Söderström, H. Tson (1990), "Stabiliseringspolitiska lärdomar och framtidsperspektiv" (Stabilisation policy lessons and future perspectives), contribution in B. Södersten, ed. (1990).

Söderström, H. Tson (1996), "Slutord: Lärdomar av depressionen" (Concluding words: Lessons of the depression), pp. 196-201 in Söderström (1996). (Subtitle).

Wihlborg, C. (1993), "Slutsatser och lärdomar" (Conclusions and lessons), pp. 285-286 in Wihlborg (1993). (Subtitle).

Bergström, V. (1996, p. 169), "Lärdomar för vårt land" (Lessons for our country). (Subtitle).

English titles:

Jonung, L. (1983), "Lessons from Swedish Stabilisation Policy in the 1970s".

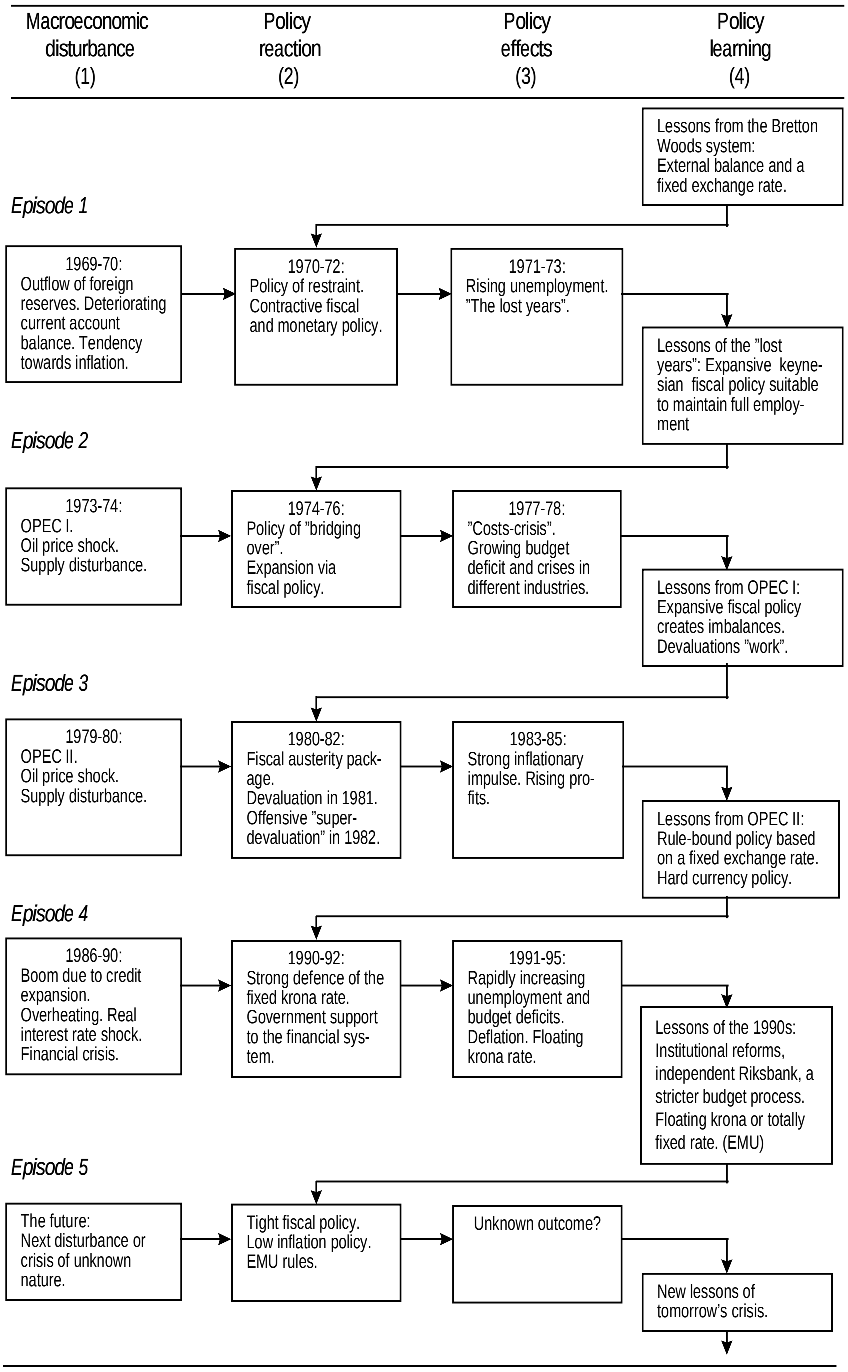
Calmfors, L. (1993), "Lessons from the Swedish Macroeconomic Experience".

Svensson, L. (1994), "Fixed exchange rates as a means to price stability: What have we learned?"

Lindbeck, A. (1997, pp. 69-72), "Lessons from the Macroeconomic Experience". (Subtitle).

Comment: The table includes only references where the term "lessons" (lärdomar) or "learned" are part of the title or a subtitle.

Figure 1. The policy learning process. A stylized picture.



Appendix Alternative explanations for the stabilisation policy switches 1970-95

In this study, the switches in the strategy for stabilisation policy are interpreted as the results of active experimentation and learning during a 25-year period. However, there are other competing interpretations of the Swedish record. Two are discussed here. One places emphasis on ideological factors, the other views the macroeconomic course of events as determined by weak and sluggish political institutions.

The ideological explanation

Several analysts have explained the evolution of stabilisation policy since the 1970s as mainly the result of general political and ideological changes, caused by “right-wing forces”, neo-liberalism and/or the idiosyncratic character of some decision-makers. Bengt Dennis and Kjell-Olof Feldt are on the receiving end of this criticism.[55] Demonstration effects from the economic policies of Reagan and Thatcher are also emphasised. According to this interpretation, the framing of stabilisation policy was determined primarily by ideological forces; policy is the outcome of a struggle between different ideologies and classes.

There are reasons to doubt this approach. A major theme in this study is that the macroeconomic disturbances of the last quarter of a century created strong incentives for a different type of policy than the previous one. The “old” policy, based on demand measures, met with unexpected difficulties, thus not functioning as expected. The politicians responsible for policy learned that in a world with greater mobility in financial markets and with well-developed inflationary expectations among wage earners and employers, the prescriptions from the 1960s and 1970s could not be applied successfully. The old approach

[55] See for example Elmbrant (1993, chapter 35) and Lönnroth (1988) for contributions that emphasise changes in prevailing ideology as the driving force behind the new views on stabilization policy.

lost out in competition primarily because it stood out as failing, not because of ideological reasons. Politicians and economists learned this lesson at different rates in different countries.

There are, admittedly, ideological elements in the process since stabilisation policy, as well as its institutions, are created by politically elected bodies. During the entire 1970-95 period, no radical measures were adopted to change the structure of the labour market toward greater flexibility in Sweden. The political power of the trade union movement limited the scope for political action here. However, it was possible to make policy switches in other sectors, especially in the financial sector, while maintaining a basically unchanged structure on the labour market. A similarly strong trade union influence did not exist in other countries, which contributed to a more rapid transition to a low inflation policy and structural reform in countries such as Great Britain and New Zealand.

Regarding the behaviour of economists, Lönnroth (1988) emphasises that the change in outlook among economists was essentially due to effects of ideology and conformity. In my opinion, Lönnroth does not give sufficient attention to the lessons which economists could draw from actual macroeconomic developments. If economists are assumed to live in a world where they are unable to learn from macroeconomic developments and from new research, then their changing views are most easily understood as caused by ideological and/or psychological factors.

Explanations based on institutional weakness

An alternative interpretation of the policy switches during the last 25 years can be found in the Lindbeck commission (SOU 1993:16):

> "The economic crisis cannot be explained without an understanding of the deficiencies in the political system. The weak institutions in monetary and fiscal policy explain the inflationary tendencies of the 1970s and 1980s, the development toward the cost crises, and the current high unemployment. Unstable rules of the game in the areas of taxation and regulation, as established by the political system, explain the financial crisis." (p. 149).

> "Institutional sluggishness during conditions of change is, in our opinion, an important explanation for the macroeconomic problems of the last two decades." (p. 33).

The stabilisation policy problems facing Sweden during the last quarter-century are viewed here as primarily caused by weaknesses and sluggishness in the political or the institutional framework. The argument is built on the implicit hypothesis that in case Sweden had been equipped with “strong” institutions, the macroeconomic course of events would have been more favourable.[56]

The interpretation of the commission does not find strong support in this study which analyses the economic record as the outcome of a learning process by focusing on the ideas, models and expectations influencing fiscal and monetary policy-making. The line of causation in this study can briefly be summarised in the following manner. Swedish politicians, both within the social democratic and non-socialists camps, as well as the main body of economists basically embraced the same stabilisation policy view at the beginning of the 1970s. This view or paradigm, that is the Swedish version of Keynesianism, determined their policy reaction and policy analysis. Moreover, the existing institutional framework reflected this paradigm.

The Keynesian prescription of increasing demand, ignoring the long run effects of budget deficits, raising government expenditures, etc., revealed itself over time to be less successful in counteracting the shocks that hit the Swedish economy in the 1970s and 1980s. The discrepancy between expected and actual results triggered eventually a learning process.

Following the above argument, the proper conclusion should be that the source of weak economic performance should be primarily sought in the policy model which the politicians and economists originally supported. The institutions were hardly the source of macroeconomic problems; they do not stand out as “weak” or “sluggish”. Rather, they should be treated as evidence of “strong” and “effective” institutions, not inhibited by orthodox, pre-Keynesian taboos regarding the scope of stabilisation policy actions.[57] These institutions transformed policy advice and policy measures relatively quickly.

The learning process itself with its many experiments should not be perceived as a sign of “weak” institutions. The Swedish political system demonstrated actually a significant flexibility in the long run by testing and learning new policy strategies. Admittedly, it was a “cumbersome” process with many mistakes and errors before a new paradigm emerged and became consolidated by the mid-1990s.

[56] The view of the Lindbeck commission inspires to a counterfactual thought experiment. What would have been the macroeconomic outcome for 1970-95 if Sweden had been equipped in 1970 with the institutional system recommended by the Lindbeck commission while simultaneously embracing a stabilisation policy paradigm based on contemporary Keynesianism? Would such a system been more capable of learning and adapting itself than the institutional framework that actually existed?

[57] This type of praise and appreciation of the institutions of Swedish stabilisation policy is expressed by Lundberg (1968).

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