

## **Kristina Persson: Monetary policy and the labour market**

Speech by Ms Kristina Persson, Deputy Governor of the Sveriges Riksbank, at LO region's annual general meeting, LO Västmanland, Västerås, 12 May 2006.

*The Diagrams to the speech can be found on the website of the Sveriges Riksbank.*

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Thank you for the invitation to participate in this LO region's annual general meeting! My speech will concern developments in the labour market and the significance of monetary policy for unemployment and employment.

### **Introduction**

There is a common fallacy that there is a tradeoff between inflation and unemployment; that one can buy slightly lower unemployment at the cost of a higher inflation rate. I would argue instead that it is quite the reverse: Stable prices provide a good foundation for the economy. Low inflation reduces uncertainty for consumers and firms; it becomes easier to predict the outcome of a decision to buy or sell and to compare different prices. Economic agreements can be signed for longer periods, which reduce uncertainty. When people make better-informed decisions, the economy is more efficient.

The task that the Riksdag (the Swedish Parliament) and the Government have given to the Riksbank is to maintain price stability. The Riksbank has then defined this statutory target as an inflation rate of 2 per cent (measured as CPI inflation) and with a margin of 1 percentage points. This means that the focus is on inflation when the Executive Board of the Riksbank makes its monetary policy decision. However, this does not prevent giving consideration to the real economy – growth and employment – when this can be done without jeopardising the inflation target. This is also clearly stated in the preparatory work on the Sveriges Riksbank Act.

The Riksbank uses the repo rate – the rate at which the banks can borrow or deposit funds in the Riksbank - as its monetary policy instrument. When interest rates are low, demand is usually high - households save less and companies invest more - which leads to a gradual increase in prices. The reverse applies when interest rates are high.

However, the interest rate should not be higher than it needs to be to guarantee that the Riksbank's inflation target can be met. With hindsight, we can note that inflation was below target in 2004-2005 and that the interest rate was therefore too high. The main explanation for this is that productivity growth was higher than expected and international price developments were weaker. Competition has also become stiffer in many different markets and has contributed to low inflation. It is very difficult to predict at an early stage what is happening in the economy and the Riksbank was far from alone in being mistaken in its forecasts. Almost all other analysts made similar, or larger, forecasting errors during this period.

At the previous monetary policy meeting, the Executive Board unanimously decided to hold the repo rate unchanged. At the same time, we signalled that there would probably be a need to increase the rate later in the year. Growth in the world economy and in the Swedish economy is robust and our assessment is therefore that inflation will increase gradually towards the 2 per cent target, reaching it a couple of years from now (see Figures 1 and 2). However, this development assumes that the repo rate will be increased, as otherwise inflation will exceed the target.

### **Current monetary policy**

Despite the fact that inflation has been clearly below target for some time, the Riksbank increased its key rate twice during the winter, by a total of 0.5 percentage points. Perhaps some people may wonder if this was really necessary; we are still in a situation with high unemployment and we cannot as yet see any inflationary pressures stemming from wages – one of the most important factors behind rising costs/prices in the economy.

However, it is not today's inflation that determines whether we shall increase or decrease the interest rate; it is the future inflation rate. The Riksbank's forecasts and decisions refer in particular to inflation

a couple of years ahead. We assume that it will take roughly this long before interest rate changes have a full impact on demand and thus on inflation.

The Riksbank does not wish to achieve an inflation rate of 2 per cent at all costs. This is neither possible nor desirable. There are always disturbances in the economy that cause inflation to deviate from the target level. If we were then to rapidly bring it back to 2 per cent, we would sometimes be forced to change the interest rate to unreasonable levels. This would also lead to undesirable fluctuations in production and employment. We therefore consider carefully what is a reasonable period of time within which to bring inflation back on target. This is what is known as flexible inflation targeting.

At present, our forecasts also indicate a fairly rapid growth in employment – the number of redundancies is declining and the number of new vacancies reported is increasing. The number of persons employed increased by just over 70 000 between the last quarter of 2005 and the first quarter of 2006. Assuming that economic developments are as favourable as we and most other analysts predict, open unemployment will fall to around 4.6 per cent in 2008. The reason why this will not happen more quickly is because the supply of jobs will increase. So, all in all, prospects look much brighter now than they did one year ago.

As inflation will probably be low for some time to come it would have been possible for the Riksbank to wait a few more months before increasing the interest rate, without jeopardising the inflation target. One can regard it as a choice between beginning to increase the interest rate relatively early in small steps, compared with waiting and then increasing in larger steps later on. And it is in this assessment of the timing of the increase that the Riksbank, like several other central banks, has taken into consideration developments in the asset market. Rising prices for household assets in the form of property and shares contribute to increasing household consumption and corporate investment. This effect is partly because monetary policy has been, and still is, expansionary.

Property prices – and also share prices – have now risen much more than the general price level (see Figure 3). History shows that both property prices and share prices can fall rapidly and heavily – which many of us remember from the crises in the early 1990s or from the IT crash a few years ago. We also know that these prices are sensitive to interest rate changes. There is thus a risk that property prices and share prices may fall too quickly in connection with an increase in interest rates. Household consumption and corporate investment would then risk declining more than is desirable and contributing to poorer growth in employment. The recent interest rate increases in small stages are aimed at reducing the risk of this occurring.

### **The earlier policy**

Before I go more deeply into the role of monetary policy with regard to the labour market, I would like to make a brief review of how things worked prior to the introduction of inflation targeting in 1993. During the 1970s and 1980s there were often cost crises and deficits in foreign trade. Sweden had no inflation target; it had a fixed exchange rate that was defended through changes in interest rates. The exchange rate, rather than inflation in Sweden, acted as the anchor for monetary policy. The Swedish krona was pegged to currencies in countries with low inflation.

However, it was not possible to generate confidence in this policy. The krona was devalued five times between 1976 and 1982, partly as a result of recurring cost crises. The large devaluation in 1982 was an offensive devaluation aimed at stimulating growth in the competitive sector. It assumed a tight fiscal policy to restrain domestic demand. During the 1980s both the credit and foreign exchange markets were deregulated, partly as a result of international developments. This was done gradually, but the credit market was formally deregulated in 1985 and the final parts of the foreign exchange regulations were abolished in 1989. Demand was high during the second half of the 1980s and the economy became overheated, resulting in high inflation, large wage increases and very large increases in property and share prices. Sweden's competitiveness was undermined and finally the Riksbank could no longer withstand the speculation against the krona. In November 1992 the krona was allowed to float and it depreciated around 30 per cent in just a few months.

The 1990s crisis was not merely a consequence of stabilisation policy failures. The situation was aggravated at the beginning of the 1990s by the tax reform – which stimulated increased saving – and an international slowdown in economic activity. It was difficult to predict the large fall in share prices and property prices. The decline in demand was substantial in any case and production and employment fell considerably. Unemployment reached the highest level of the post-war period. The

budget deficit and government debt (as a percentage of GDP) also increased to all-time highs as a result of the crisis.

Sweden and Finland were the European countries that suffered the most from the crisis, but other countries also experienced serious problems (see Figure 4). For most countries, this proved to be a dearly-bought experience. Monetary policy was reformed to inflation-targeting policy, the exchange rate was allowed to float and a deficit target and an expenditure ceiling were introduced as norms for fiscal policy. We have had this new policy in Sweden for around 10 years now, and many other countries have chosen a similar policy.

### **The labour market situation**

Most people would probably agree that the period from the mid-1990s, when inflation targeting was introduced, has been a relatively successful time in macroeconomic terms. Inflation fell fairly quickly from levels close to 10 per cent to around the inflation target of 2 per cent. Inflation has remained at a low level since then, albeit slightly too low in recent years (see Figure 1). Annual GDP growth has on average been twice as high over the past ten years as during the period 1980-1993. Employment growth has also been higher (see Figure 5). Real wages almost stood still during the period 1980-1993, but over the past ten years they have increased by an average of almost 3 per cent a year (see Figure 6). The foreign trade deficit transformed into a surplus and the same had happened with the government deficit.

Open unemployment increased in connection with the crisis of the 1990s, from levels around 2.5 per cent to around 9 per cent. Since then, unemployment has fallen to a lowest level of just over 4 per cent in 2001. At present, unemployment is at a higher level than it was prior to the 1990s crisis.

Out of a working-age population (20-64 years) of just over 5.3 million, around 900,000 persons are outside of the labour force. 245,000 are unemployed. This means that just over 4.1 million people are employed and that just under 1.2 million have no job.<sup>1</sup> The biggest problem in the Swedish labour market is thus, in my opinion, not open unemployment, but the fact that the number of those outside the labour force, that is, the number of people of working age who are not employed, has increased substantially since the 1990s crisis. In connection with the crisis, this share increased by 8-9 percentage points. It has since fallen by around 4 percentage points between 1995 and 2002, to increase once again in recent years (see Figure 7).

Do this increase in unemployment and the decline in the employment rate have anything to do with monetary policy and the introduction of an inflation target or are there other explanations?

### **Unemployment and the employment rate**

When a large shock like the 1990s crisis occurs, there are tremendous demands on both policy and flexibility among firms and individuals. If one looks at the developments in employment (or unemployment) since the 1990s crisis, one may wonder whether the labour market has really recovered, despite the fact that 13 years have passed (see Figure 5). There may also have been structural changes in the economy that make it difficult to return to the low unemployment levels we had prior to the crisis, for instance, as a result of the strong competitive pressure that globalisation entails. In the long term, it is the way the labour market functions (structural factors) that determines unemployment and the employment rate.

How quickly an unemployed person can return to work depends on several factors. Some people may find that their skills have become obsolete when one technique has been abandoned in favour of a more modern technique, such as typographers being replaced by IT people. In this case, training is one opportunity that can lead to a new job after some time. Hopefully, it will also lead to a job with a real wage that is at least equally as high as the previous wage. The greater this possibility, the more probable it is that the employee will return to work. It becomes increasingly attractive to take a job rather than to be unemployed and receive benefit, the higher the wage in the new job compared with unemployment benefit. Compensation levels are a central factor in the economists' explanation of the long-term rate of unemployment. However, studies carried out for the Nordic countries show that

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<sup>1</sup> According to Statistics Sweden's labour force surveys.

compensation levels may in practice have less effects than they do in theory.<sup>2</sup> In recent years, the replacement ratios (the ratios between unemployment benefits and wages) have fallen somewhat and application of the rules has been sharpened. This could contribute to lower unemployment in future.

Over the past decade, the number of people studying, taking early retirements and on sick leave has increased. The number of people on sick leave has almost doubled and the number of people taking early retirement has increased by around 30 per cent over the past ten years (see Figure 8). The increased amount of sick leave may, of course, be due to increased demands in working life and that labour intensity and stress have increased. Labour productivity has increased more quickly in Sweden than in other European countries over the past 10-15 years. If the increased productivity is an expression of a higher work tempo (which is not certain), one result could be increased ill-health due to stress-related illnesses, such as burnout.

Another explanation for the increased sick leave could be that social norms have changed.<sup>3</sup> When one has had an increased degree of sick leave for a period of time, the norms are affected and it may become more acceptable to take sick leave. In connection with the 1990s crisis, it could be noted that sick leave declined significantly when the problems in the labour market increased. This may have been because people were more worried about losing their jobs and therefore avoided taking sick leave.

### **Demographic changes**

Employment and unemployment may also be affected by demographic changes. It is known that unemployment is higher in certain groups of the population than others, for instance, it is higher among those born abroad and among young people (see Figure 9).

Unemployment among young people (aged 16-24) is more than twice as high as unemployment in other groups. Unemployment among young people has shown a rising trend since the 1970s. Breaking this trend must be one of the most important domestic policy tasks of our time.

Unemployment is also around twice as high among persons born in another country than among those born in Sweden. A period of increased immigration or reception of refugees can thus increase unemployment. Of course, this is not one of the main explanations for the changes in unemployment, but it can have more than a marginal effect when the demographic changes are substantial. This was the case during 1994-2000 when the number of persons of working age born abroad declined by 25 000. Since then the number of persons born abroad has increased by just over 15 000.

Demographic changes and changes in the demand for labour are examples of structural changes that may affect employment in the long term, which monetary policy cannot do.

### **Globalisation**

Another long-term change that has been under way for some time but has recently achieved a higher level of intensity can be summarised in the concept of globalisation. The question is how the increased economic integration of the trade in goods, services, capital and financial markets will affect the Swedish labour market. Will jobs disappear and wages have to adjust downwards?

Globalisation could certainly entail downward pressure on Swedish real wages, but both data and historical experiences so far indicate that this will not happen. In the long term, Swedish and, for instance, Chinese wages will probably converge, but this does not necessarily mean falling real wages in Sweden.

However, it is likely that the distribution of income has already been affected in terms of growing gaps between those with and without higher education. The main explanation is usually considered to be technological developments, particularly the increased use of computers, which have led to increased

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<sup>2</sup> See Forslund A, N. Gottfries and A. Westermark, "Real and Nominal Wage Adjustment in Open Economies", Working Paper 2005:23, IFAU, p. 28.

<sup>3</sup> See Lindbeck, A., The welfare state and social norms. In: B. Swedenborg (ed.) Why are the Swedes so sick?, SNS Förlag, Stockholm 2003, pp. 78-87.

demand for highly-qualified labour in relation to less qualified. However, the possibility that increased competition from low-wage countries is also part of the explanation cannot be entirely ruled out.

So far, it appears as though Sweden has managed the structural transformation well. The Swedish Institute for Growth Policy Studies (ITPS) demonstrates in a study that Swedish-owned industrial companies which increased the number of their employees in low-wage countries during the 1990s at the same time increased their demand for labour with higher education in Sweden. This is in line with the development that has taken place in the United States and the United Kingdom. According to the Swedish Labour Market Administration's figures on redundancy notification and ITPS's media monitoring, few jobs moved abroad as a result of companies transferring their operations abroad during 2005.<sup>4</sup> In total, the number of jobs was 2 000-4 000, of which 1 500 involved a move to another EU country.

The major challenge for the future probably does not lie in the number of jobs moving abroad, but in managing the transition required to make it possible to create new jobs as new employment is created mainly in other countries/regions/sectors. This demands a good corporate climate and a good capacity to attract knowledge and capital. It requires flexibility in the labour market so that employees can retrain as smoothly as possible, and move to new sectors and new regions. If this is not successful, then structural unemployment could become entrenched at high levels. The labour markets in Europe – including Sweden – have shown clearer tendencies towards this than in the United States.

During the period 1960-1999 employment increased substantially in the public sector. Since then it has stagnated and it is not likely that it will be the same engine for employment growth in future as it was previously. At the same time, employment in industry is continuing to decline. Instead, employment has increased most in the private service sector (see Figure 10). The capacity of the labour market to adapt to these changes in demand is of course important. In future, a large part of employment growth will probably be in the private service sector. It will be very important that the labour market functions in a way that enables a smooth transfer to growth sectors. This concerns retraining, localisation of new production and also wage formation.

Something that one can feel apprehensive about is how the Swedish economy will manage an international recession. We are strongly dependent on exports. Investment is also increasingly made abroad. I therefore believe that it is important to make it attractive to invest in Sweden so that the domestic economy is strengthened. The current account surplus also shows that there would be scope to increase domestic demand, which could increase employment in Sweden and alleviate the effect of an international downswing.

### **Wage formation**

Normally, increased competition in the goods and labour markets leads to lower profit shares and in the long term to lower unemployment and higher welfare. Wage shares rose during the period 1995-2002, when globalisation and deregulation contributed to increased competition. However, the wage share has fallen over the past three years. The reason for this could be the poorer labour market. Another possible explanation is that the unexpectedly strong productivity growth has not immediately led to higher real wages.

Wage formation has become more decentralised over the past decade, which can contribute to increased flexibility in relative wages. This is probably beneficial in a period with increased globalisation and demands for change.

Wage formation is also affected by monetary policy now being aimed at an inflation target of 2 per cent. Inflation expectations, including those of the labour market partners, are now measured on a regular basis, and it is possible to see that they have long been close to the Riksbank's target. Now that the inflation target has become anchored in this way, partners can sign more long-term agreements, which will contribute to labour market stability. We have also been able to avoid the cost crises we had in earlier periods due to more efficient wage formation. This of course requires that inflation is actually in line with the target over a longer period of time.

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<sup>4</sup> See also Ekholm, K., *Ordning och reda om outsourcing. Hur påverkar globaliseringen svensk ekonomi? (About outsourcing. How does globalisation affect the Swedish economy?)*, SNS Förlag, 2006.

## The importance of monetary policy

Monetary policy cannot affect long-term developments in the potential to produce and compete in the Swedish economy. Technological developments, investment levels, entrepreneurship and the ability of the labour market to adapt all determine the long-term growth rate and employment. The Riksbank can only affect the short-term cyclical variations around the trends in real economic developments (see Figure 11).

How do these cyclical variations actually look? Diagram 11 – which should be regarded as an arithmetic example – provides a calculation of the trend unemployment. The difference between actual and trend unemployment is cyclical unemployment – which is higher in a recession and lower in a boom. The trend is determined by factors such as those I just mentioned – i.e. demography, technological developments, labour market policy, wage formation – while cyclical unemployment is determined by transient shocks and can be affected by monetary policy.<sup>5</sup> The diagram shows that – if we disregard the 1990s crisis – cyclical unemployment was 1 percentage point at most (corresponding to 45 000 persons). According to this example, cyclical unemployment varies by an average of 0.6 per cent. This is the margin that monetary policy can affect. However, it is not realistic to believe that this can become zero. We will always have to live with cyclical fluctuations.

This is the whole point of stabilisation policy, as Keynes pointed out back in the 1930s; to even out fluctuations between booms and recessions. However, the Riksbank cannot affect the trend or the average for unemployment in the longer term. The fact that unemployment is higher now than it was prior to the 1990s crisis is essentially due to the factors I mentioned earlier, and not to monetary policy.

However, the importance of monetary policy lies not merely in the possibility to influence through temporary changes in the repo rate. An essential part of monetary policy's ability to stabilise lies in influencing inflation expectations so that they come close to the inflation target. A firmly anchored 2 per cent inflation target will affect price-setting and wage formation so that shocks - such as those we had during the "bridging over" policy years 1973-74 can be avoided.

Once again: With regard to employment and unemployment, the most important measures must be taken outside of the Riksbank. What we can contribute is to conduct well-balanced monetary policy in line with the intentions of the Sveriges Riksbank Act, so that economic agents know what money will be worth in future.

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<sup>5</sup> These calculations can be made in different ways. Here the Riksbank has used an HP filter to calculate the trend.