

Kristina Persson: Monetary policy and labour supply

Speech by Ms Kristina Persson, Deputy Governor of Sveriges Riksbank, at a meeting arranged by the municipality of Örebro, Örebro castle, 2 April 2003.

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Thank you for the invitation to participate in this conference and for the opportunity to inform you about current monetary policy and the Riksbank's objectives. I shall also take up one of the major challenges facing the Swedish economy over the coming years, namely labour supply and what consequences this may have for future growth and welfare in Sweden.

Monetary policy focuses on inflation

The monetary policy objectives are clearly stated in the Sveriges Riksbank Act - to maintain price stability and to promote a safe and efficient payment system. The Riksbank has specified the first of these objectives in an inflation target. The annual rate of change in consumer prices shall be 2 per cent, with a tolerated deviation interval of ± 1 percentage point. Monetary policy is normally directed at fulfilling this target one to two years ahead. To achieve our objective, we therefore make forecasts of price trends. If the forecasts indicate that inflation will be higher than the target level one to two years ahead, monetary policy must normally be tightened and the interest rate raised. The reverse applies if the forecast shows a lower inflation rate than the target level.

Although monetary policy is aimed at an inflation target, developments in the real economy and the labour market have considerable significance for the shaping of monetary policy. For one thing, total demand is one of the most important determining factors behind the inflation rate, and for another thing, taking the real economy into account can in certain cases mean that exceptions are made to the fundamental monetary policy rule. This applies in particular in the case of supply shocks:¹ Firstly, inflation can be allowed to be higher or lower one to two years ahead, when due to factors that are not considered to have a lasting effect on inflation, and secondly, the real economic costs of a rapid return to the target level are considered to be excessively high. For example, we had particular reason to observe certain temporary changes at the time of our most recent repo rate decision. The Riksbank believes that energy prices will fall back from their present high levels without the rise spreading to other prices. Another circumstance that affected our forecast was the crisis in Iraq, which has now become a war. The geopolitical situation overshadows the more normal inflationary risks that we usually observe. I shall return in a moment to the economic situation and give you my views of developments.

Potential growth affects the Riksbank's assessment

When the Riksbank makes its assessment of inflation in the coming one to two years, we look first and foremost at resource utilisation in the economy. The stronger the increase in demand in relation to potential production, the greater the risk of prices and wage rising too fast, and vice versa. We must therefore analyse the entire economic outlook, despite the fact that inflation is our target variable. However, the Riksbank cannot affect potential production, i.e. how quickly the economy can grow without causing inflation. This is what structural policy can do. Structural reforms can promote both investments and labour supply and thereby have a favourable effect on the long-term growth capacity of the economy.

A good structural policy can, for instance, contribute to a larger number of persons in various age groups choosing to work instead of remaining outside of the labour force. By improving the conditions for wage formation and price-setting, structural reforms can also contribute to increasing the economy's capacity to adapt to different types of shock. Structural policy can thus be seen as a complement to monetary policy. The better the long-term growth capacity of the economy, the more

¹ See the monetary policy memorandum "The Riksbank's inflation target - clarification and assessment", 4 February 1999, Reference no. 1999-00351 DIR.

quickly the actual growth rate can be without inflationary pressure arising, which would mean that the Riksbank had to react by raising the repo rate.

Structural reforms are thus important from a welfare perspective. A high growth rate in the long term increases the possibility to pay high wages, extend welfare or invest more in infrastructure and education.

The economic situation, inflation and the risk spectrum

Our most recent Inflation Report contains a sketch of the Swedish economy that anticipates a relatively slow rate of growth for this year, but then a growth rate that is sustainable in the long term. GDP growth is assessed to be 1.7 per cent in 2003 and 2.4 per cent in 2004 and 2005. This means that the resource situation in the Swedish economy will not be strained over the coming years. Thus, economic activity is not expected to put any great pressure on prices and wages in future. Our picture of resource utilisation has been affected by the revisions Statistics Sweden made to the National Accounts recently, which indicate that productivity growth in the economy has been higher during the greater part of the 1990s than we had previously assumed. This means in turn that the economy's long-term potential growth rate must have been slightly higher than we believed.

Nevertheless, inflation rose tangibly during the spring and in February was 3.4 per cent according to the annual CPI rate. This is primarily due to higher electricity prices resulting from extremely low water levels in hydroelectric power station reservoirs and to higher oil prices. As I mentioned at the start, the energy price rise is expected to cause only temporary price rises and inflation is thus expected to fall back during the spring as electricity and oil prices decline. The forecasts in the March Inflation Report indicate an average rate of increase in CPI inflation of approximately 1.0 per cent one year ahead and 2.0 per cent two years ahead.

What inflationary risks can we see ahead? There is, of course, a risk that the higher energy prices will push up costs in other parts of the economy and thus have contagion effects. They can also affect inflation expectations and thereby wage trends. We have ahead of us wage bargaining rounds in the autumn, which will affect two million employees and will play an important role in future economic developments. The main risks for inflation below target level are connected with the uncertainty regarding international economic developments. In the euro area in particular there are problems that could lead to weaker economic developments than we are currently expecting to see. The risk spectrum for inflation is thus considered to be balanced on the whole.

However, it is above all the geopolitical situation that is currently creating unease and uncertainty and poses a threat to the global economy which is very difficult to estimate. The uncertainty currently prevailing in the global economy makes it more difficult than usual to interpret various economic indicators and to predict future developments. Personally, I believe it quite possible that the consequences of the war will be both more prolonged and more costly for the global economy than is assumed in the main scenario of the Inflation Report. In addition, there was already uncertainty before the war with regard to the development of the US economy, which was connected with the large saving deficit, including a very large current account deficit. In my opinion, therefore, one cannot rule out the possibility of more interest rate reductions than that decided at the last Executive Board meeting, because of the present uncertain situation for the global economy.

Labour supply, productivity and growth in the long term

As I mentioned earlier, the economy's long-term production capacity is very important for monetary policy. It affects the rate at which the economy can grow and thereby how rapidly our prosperity can increase. Deciding factors for the speed at which the economy can grow are investment, labour supply and technology developments - e.g. machines becoming more modern or utilised more efficiently.

Labour supply, in particular, will affect the growth of the economy in future. If we use Statistics Sweden's population forecast as a starting point, we can see that the population will increase up to 2009 by an average of 0.5 per cent a year, which is slightly lower than the increase during the 1990s. Thereafter the population will decline by an average of 0.3 per cent a year. This forecast is relatively certain, compared with forecasts of economic activity. This means that population growth in the long term will undermine welfare. Most other European countries share this problem - in most of the larger EU countries the population growth is expected to be even poorer than in Sweden. However, this is no consolation - on the contrary, a poor development among our trading partners could cause further

difficulties for our own economy. Moreover, it is our own ambitions in welfare policy that should be put in relation to our growth capacity.

The future age structure has great significance for labour supply and production. This is because labour force participation varies in different age groups. It is higher in the age group 25-54 years (87 per cent) than in younger and older age groups. The age group 16-24 years studies more today than at the beginning of the 1990s. Labour force participation for the oldest age group has also fallen over the past decade. One reason is that the retirement age from the labour market has been lowered and now the actual pension age amounts to 62 years. The only group that has increased its participation in the labour force in recent years is older women. This could be because those who are reaching a more advanced age today have a higher level of education than their predecessors.

The age structure accentuates the problems. According to Statistics Sweden's forecasts, the age group 20-64 years will need to support an increasing percentage of younger and older age groups. While the number of elderly people increases, the number of those between the ages of 20 and 64 will become an ever smaller percentage of the population. From having increased by almost one million during the years 1950 to 2000, they will now increase by only 70,000 over the coming fifty years. This will increase the demands on the older population to participate in the labour force. According to a study by Statistics Sweden, half of old-age pensioners will need to work to support themselves in year 2035.

The age composition will also make tremendous demands on welfare services, which will further increase pressure on the labour market and the need for an increased supply of labour. The average costs for care and welfare increase drastically as people become older and public expenditure on pensions, medical treatment and care of the elderly can be expected to increase from approximately 18 per cent to approximately 23 per cent of GDP around the year 2030.

When the long-term growth rate receives a weak contribution, or none at all, from the labour supply, the dependence on labour productivity will increase. Compared with other countries, Sweden has managed fairly well in this respect; it is productivity growth rather than labour supply that has created growth in recent years. Labour productivity increased particularly strongly during the 1990s, which was due to several factors. One important factor was that many companies with a low level of productivity were put out of business in connection with the recession at the beginning of the 1990s, while other companies chose to cut back on unqualified employees with simple work tasks. When the economy began to grow again, there was plenty of labour available, enabling the growth rate to be high without causing inflation to accelerate. Another reason was the IT boom towards the end of the 1990s, which also contributed to productivity growth. How high can future productivity growth be? It is difficult to say for certain, but we believe that it could be somewhere mid-way between the trends of the 1980s and 1990s, i.e. around 2 per cent.

Finally, a decisive factor for growth is the number of hours we work. As we know, the amount of sick leave taken has increased dramatically recently, which means that the number of working hours per employee has declined. There are also other reasons why fewer hours are worked on average today; the amount of overtime worked has declined, part-time work has increased and absence to care for children has also increased. Three years ago the number of hours worked increased by 2.7 per cent. Last year the figure decreased by 1.2 per cent.

It is thus not sufficient that labour supply in terms of the number of persons increases. If we are to retain our level of growth, or even increase it, we need to take measures to ensure that the number of hours we work on average increases. Calculations made by the National Institute of Economic Research indicate that the growth rate could be as much as 0.4 percentage points higher per year during 2003-2008 if the government's target to halve sick leave is achieved. This means that the number of hours worked will increase by 0.8 instead of 0.4 per cent a year. Public finances would then be improved by SEK 45 billion, which could be used for reforms - or for repayments on the central government debt and thus create increased scope for future borrowing. If immigrants participated in the working force to the same extent as Swedes, it would provide a further contribution to the number of hours worked of 0.1 percentage points a year.

Monetary policy and wage formation

The labour supply thus comprises a problem both in the long term and closer to hand. If this cannot be resolved through structural measures that increase the labour supply - e.g. through less sick leave being taken, increased working hours per employee or by labour force immigration - the Riksbank may

be forced to subdue demand in the economy by raising the interest rate. The labour market's ability to manage wage formation will be tested as early as next year, when actual growth is supposed to be in line with potential growth. Of course, we do not believe that resource utilisation will put any great pressure on prices and wages so soon, but as economic activity strengthens, greater demands will be made on social partners to show restraint.

The Municipal Workers' Union's demand for relative wage changes could also entail a problem in terms of potential contagion effects. Wage costs are expected to increase this year by just over 4.5 per cent, which is higher than the Swedish economy can manage in a longer perspective. If the social partners do not succeed in accommodating the Municipal Workers' Union's wage demands, there is a risk of increased inflation.

Another challenge for wage formation is the government's employment target, which entails 80 per cent of the working population having a job. Achieving this requires reforms to increase the labour supply. Moderate wage demands could hasten the adaptation to the higher rate of employment.

The explanation for this is that in a small, open economy like Sweden, the profit share of the value added is determined by international conditions and the prevailing production technology. In the short term, the labour market situation and negotiating strength can affect the relative profit shares and wage shares in the economy, but in the long term a high rate of wage increase will only lead to lower employment and production without affecting real wages and profit shares. More moderate wage demands, on the other hand, together with measures to stimulate the labour supply, will lead to higher employment without a long-term decline in real wages.²

Conclusions

Finally, as I mentioned at the beginning, monetary policy cannot directly affect production's potential, long-term growth rate. The task of monetary policy is to stabilise the economy by changing the instrumental rate if inflation deviates from the 2 per cent target one to two years ahead. In this sense, our task is very clearly defined. However, monetary policy can indirectly lay the foundation for a good development in growth in the slightly longer term, by providing an efficient payment and price-setting system.

It is therefore within other policy areas that the solutions to the most important problems and challenges I have highlighted today must be sought. These solutions will not only make it easier for the Riksbank to safeguard price stability, they are also a necessary condition for good economic development in the future. This probably concerns many different types of input from many different forces in society. The government and the Riksdag, municipalities and county councils, public authorities, the social partners, trade and industry and individuals. Social ingenuity and a close cooperation between different parties and interests will probably be necessary for success here.

² See Wage Formation - Economic Conditions in Sweden 2002, National Institute of Economic Research.