Villy Bergström: The labour market and wage formation

Speech by Mr Villy Bergström, Deputy Governor of Sveriges Riksbank, at the Association of Swedish Engineering Industries' HR director conference, Rimbo, 22 November 2005.

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Introduction

Thank you for your invitation to come and speak here. Today, I will not be touching upon current economic policy in Sweden or the weakening of the krona exchange rate. I will return to those issues in a couple of days in a different speech.

The shift in economic policy at the start of the 1990s has entailed better conditions for wage formation in Sweden. Among other things, the adoption of the inflation target has reduced uncertainty over future price developments. Wage-earners do not have to worry that their wage increases will be eroded by excessively fast price rises, while it is easier for employers to determine their scope for wage costs. The lower uncertainty over inflation is reflected in the fact that inflation expectations since the mid-1990s have been firmly anchored around 2 per cent.

It is important to remember that the current conditions for wage formation in Sweden – a floating exchange rate and inflation target – are considerably different from our previous regime with a fixed exchange rate. A fixed exchange rate was the norm in Sweden for some 130 years, even though the systems for maintaining it changed.

Background to the current system

During the post-war era the exchange rate norm was supervised by international agreements through Sweden’s membership of the International Monetary Fund (IMF), and the Bretton Woods system. That meant that devaluations were only allowed in the event of fundamental structural problems or imbalances. So the Bretton Woods system limited the opportunities for individual countries to devalue their way out of a cost crisis. Instead, the countries were offered loans from the IMF on tough terms.

For Swedish wage formation, this was a successful period. The Swedish Trade Union Confederation and other employee organisations/trade unions, as well as the Swedish parliament and government, were aware that the strict regulations did not permit devaluation, which had a disciplinary effect on Swedish wage formation.

The Bretton Woods system was based on an arrangement whereby the US dollar had a fixed value in terms of gold and the currencies of the other countries in turn were pegged to gold via a fixed exchange rate with the dollar. When the US was forced to abandon its dollar peg to gold in the early 1970s after having borrowed large amounts to finance the Vietnam War, the Bretton Woods system collapsed.

Thereafter, Sweden independently adopted other exchange rate regimes, all of which gave greater freedom than the Bretton Woods system. That resulted in less discipline in wage formation.

What then does it mean to have a fixed exchange rate? A fixed exchange rate means that the central bank, with the aid of currency market interventions or its policy rate, stabilises the exchange rate around a target, e.g. a price for the dollar, gold or an average of currencies, whereas under a floating exchange rate regime the exchange rate is determined by supply and demand in the currency market.

With a fixed exchange rate, you avoid some of the uncertainty in world trade when countries exchange currencies with each other. There is a limit to how much a currency’s exchange rate can vary, which is good for importers and exporters when they are forecasting income and expenditure.

The fixed exchange rate can also be seen as a way to achieve price stability. With a fixed exchange rate, inflation in the long term cannot be higher or lower than the inflation rates in the countries with which you have tied your exchange rate. For example, a fixed exchange rate against the dollar would ”force” us to maintain the same inflation rate in the long run as the US and the other countries whose currencies are pegged to the dollar. Were that to fail, our current account balance would deteriorate and we would have to devalue.

Sweden devalued five times between 1976 and 1982 under a fixed exchange rate (1976, twice in 1977, 1981 and 1982). That was because Sweden in the 1970s and 1980s had higher inflation than the other countries. Between 1975 and 1995, Swedish inflation averaged 8 per cent a year. Real wages rose by only 0.5 per cent a year. Swedish companies' competitiveness deteriorated and industrial production dropped. Sweden slipped from 4th place in the OECD's standard-of-living league to 18th place – below the average for OECD countries. We became a relatively poor country in Europe and the industrialised world.

Meanwhile, deregulation in the credit market during the 1980s resulted in a sharp expansion in credit, with an accumulation of debt among the general public as a consequence. Demand increased but supply was weak and productivity growth low. The economy overheated, inflation picked up and competitiveness was eroded. In 1990, the international economy began to weaken and prices of assets and property fell. The economic climate deteriorated dramatically and eventually the banking crisis hit the country, with large loan losses as a result.

The Riksbank defended the fixed krona exchange rate to the very last, but after large currency flows and extreme rises in interest rates the fixed exchange rate was abandoned on 19 November 1992. The outcome of the performance during the 1970s and 1980s was that we slipped down the standard-of-living league, suffered mass unemployment and saw a drop in GDP of 4-5 per cent. It was at this juncture that an explicit inflation target was introduced.

The depreciation of the krona in 1992-93 of almost thirty per cent gave the manufacturing industry a powerful boost. Since all other demand components were falling, the manufacturing sector was able to attract resources and expand. We have not had a current account deficit since 1993.

Why 2 per cent inflation and a floating exchange rate?

That two per cent is the optimal inflation target has no scientific basis. However, this level gives a reasonable trade-off between the negative consequences of high inflation and the problems entailed by deflation. Furthermore, two per cent is a common target internationally.

It is necessary, you see, to have a certain margin from zero inflation if price and wage formation are to work well. Separate prices and wages have to be able to grow at different rates if it is to be possible to allocate resources such as labour to their correct use. Since it is difficult to cut nominal wages, some inflation creates the possibility for relative changes in wages without having to reduce the nominal level for any group.

The scope for wage increases given the inflation target is around 4 per cent. (2 per cent + 2 per cent: Inflation plus productivity growth, at a given profit share.)[1] This holds if we, like the National Institute of Economic Research, assume that average productivity growth is around 2 per cent for the whole economy in the long term.

If one occupational group gets 5 per cent in order to attract labour, another group has to get less than the average increase. If the inflation target were lower, a relative increase for some might necessitate lower nominal wages for others.

So, two per cent inflation serves as an anchor for the economy. The inflation target should be the basis for wage negotiations, rent agreements, tax increases, etc. Thus, it is necessary that the target is credible, that people trust that it will be met. Before, the idea instead was that the fixed exchange rate would imply an inflation target in line with the inflation rates of our competitor countries. But this approach never worked in the same way as the inflation target.

Does monetary policy affect economic growth?

It is fairly obvious that when inflation is around 10 per cent the economy becomes unhealthy. Economic agents seek to profit from the inflation. Much depends on how the tax system is designed. In Sweden, it encouraged borrowing and speculation in real property and shares. Investment

[1] Strictly speaking it should be the price developments for output, i.e. the GDP deflator, but since the GDP deflator can be estimated to increase by around 2 per cent a year if consumer prices rise in line with the inflation target (2 per cent), this approximation works.

decisions take on a different focus than when macroeconomic conditions are stable. In Sweden, we saw a property boom in the 1980s and an overheated economy that had to be dampened.

Monetary policy is unable to affect the economy's long-term output capacity, which we judge to grow at somewhere around 2-2.5 per cent a year. But stability in the government finances and credibility for the inflation target give low interest rates and a safe investment climate, which in turn lays the foundations for a good economic performance in the long term. What monetary policy in fact can do is to stabilise demand growth in the short run and avoid a stop-go situation like in the 1980s.

Let me describe this in somewhat simplified terms. One of the variables with which the Riksbank works is the output gap, which is the difference between the economy's actual output and potential output. The output gap reflects cyclical variations in the economy.

- A negative output gap means that demand for goods, services and the factors of production is low and there are plenty of spare resources in the economy. Increases in prices and wages are small and inflation is usually below target.
- A positive gap means that actual output – demand-driven – exceeds potential output, the resource situation is tight, demand for labour exceeds supply, wages are being pushed up and inflation is normally above target.

So the output gap gives a picture of demand pressures in the economy, and demand pressures in turn influence inflation. Monetary policy is essentially about choosing an interest rate level that affects demand in such a way that the size of the gap becomes as small as possible. If actual output equals potential output so that the output gap is closed, inflation is often in line with the Riksbank's target, provided that monetary policy and the inflation target are credible.

The Riksbank and employment

That there is no negative long-term relationship between inflation and unemployment is fairly uncontroversial today, not least shown by the developments since the introduction of the inflation target – unemployment and inflation dropped in parallel during the 1990s. Since 1995, when the inflation target came into effect, CPI inflation has averaged 1.4 per cent, while real wages have grown by around 2.6 per cent. The Riksbank's formulation of monetary policy has its critics, of course – for example, at the Social Democratic Party's latest congress the inflation target's superordinate status over other targets was called into question.

Attempts to get the economy to grow at a faster pace than is sustainable in the long term through more expansionary and inflation-tolerant monetary policy would, in the long run, only result in higher inflation without any rise in output or employment. In the short term, though, monetary policy can, as I mentioned, through interest rate changes designed to stimulate or cool down economic activity, affect output and thereby also employment.

In the highly simplified output-gap world that I just described, there is a straightforward relationship between monetary policy, the output gap and employment – if the Riksbank does not hit the inflation target then employment will be affected. But reality is more complicated than that.

Firstly, monetary policy is not able to precisely fine-tune the output gap or employment. As I said earlier, it takes times for monetary policy to have an impact on inflation, which is why the Riksbank's monetary policy decisions are based on a forecast of expected price developments in the future. Furthermore, our knowledge of the output gap even now is not exact, and even less so for the coming years.

In reality, shocks to supply and demand are occurring all the time, which influence both actual and potential output. As a result, the output gap is almost never zero. In addition, each forecasting period has its events and political decisions that not only are difficult, but impossible, to foresee, a good example being the terrorist attacks on 11 September 2001. For that reason all forecasts will be more or less inaccurate, and the output gap will be positive or negative for long periods.

The important thing is that the Riksbank, in attempting to stabilise inflation, strives to achieve as small and as short-term deviations from the inflation target as possible. With a symmetric inflation target like the Riksbank's, the incentives and our efforts to avoid missing the target on the upside and the downside are equally strong. Short-term deviations from the inflation target thus will even themselves out over time and will not result in any permanent gains or losses in terms of growth or jobs. The average inflation rate over the ten years since the inflation target was introduced does not indicate any systematic deviation.

The second factor that complicates the picture of a simple relationship between monetary policy and employment is that inflation is not influenced by the output gap only but also by inflation expectations, which in turn depend on the credibility of monetary policy. If there is confidence in the Riksbank's monetary policy it is often enough to make small changes in interest rates to signal that the Riksbank is keeping a close eye on inflation tendencies. If inflation expectations instead deviate sharply from the Riksbank's target, more potent measures may be required.

Thirdly, inflation and employment are not always affected by the same factors. Many short-term factors have a strong impact on inflation but only a marginal effect on the output gap and employment (e.g. the impact of mad cow disease on meat prices or the rapid rise and fall of electricity prices due to how the weather had affected reservoir levels). Likewise, certain factors and policy decisions affect registered open unemployment more than they influence the output gap (e.g. the National Labour Market Board's decision to scale back labour market policy measures in 2003).

In addition, the relationship between monetary policy and unemployment sometimes deviates fairly sharply from previous historical patterns. The most recent episodes when inflation has been below target – at the end of the 1990s and the start of this decade – have been characterised by unexpectedly high productivity, unexpectedly low imported inflation and other more temporary supply shocks. The low inflation has not been because we have actively tightened monetary policy and dampened demand. In reality, monetary policy has been very expansionary.

With the aid of the repo rate the Riksbank can influence demand. How companies then meet this demand by varying the number of employed depends on how productivity develops, and that is nothing that monetary policy can control. Nor have we any possibility to govern how many people enter or leave labour market policy measures.

Is Swedish wage formation competitive?

When an economy is in balance, with wage and profit shares constant, companies' real wage costs increase in parallel with productivity growth. But the relationship between wage increases and competitiveness is different under a fixed and floating exchange rate. With a fixed exchange rate, competitiveness is determined first and foremost by how big wage increments in Sweden are compared with other countries. If wage costs increase too rapidly, costs crises arise that can result in higher unemployment or that force the country into devaluations with a view to restoring competitiveness, as was the case in Sweden during the 1980s. The problem with the repeated devaluations was that they eroded the fixed exchange rate's credibility. Wage-earners and employers expected to be bailed out when competitiveness was weakened by the excessively fast wage rises.

Under a floating exchange rate, however, relatively higher increases in nominal wages do not have as much significance for competitiveness, if the exchange rate adjusts. We can have higher price and cost growth than our trading partners without seeing our competitiveness deteriorate, if the krona functions as a shock absorber. So, companies do not bear the direct burden of excessive wage increases, since the exchange rate adjusts over time so that profits are maintained in the sectors exposed to competition.

Also, a floating exchange rate often dampens cyclical fluctuations. In 2001, the Swedish IT sector – including Ericsson and Telia – was hit by a deep decline. But the decline was partly compensated for by the weaker krona exchange rate, so that profits were sustained in the paper and pulp industry, the iron and steel industry, and in other parts of the manufacturing sector.

Under a floating exchange rate, the inflation target is the nominal anchor for price and wage formation, rather than the rate of wage increases abroad. Wage-earners and employers know that the Riksbank has to immediately intervene with interest rate adjustments if inflation deviates clearly from target. So, excessively high wage increments can lead to tighter monetary policy.

For an individual company or industry, developments in wage costs in other countries nonetheless have great significance, since the exchange rate in these cases can be taken as given. A Swedish company that raises wages sharply risks being driven out of business. As globalisation continues, new markets are being opened in which wage costs differ from the level in Sweden. Companies get increased opportunities to outsource their activities to countries with lower wage costs. The question is if wage growth in Sweden is competitive in relation to other countries?

The large surplus on the current account, SEK 48.1 billion during the second quarter this year, equals around 7.7 per cent of GDP and can be seen as an indication that Swedish wages and costs in general are competitive. Otherwise, Swedish goods and services would not be in such demand in other countries.

At the same time, Swedish companies have outsourced a considerable proportion of their production from Sweden to reduce costs. The stiffer competition from low-wage countries is found mainly in the manufacturing industry. However, the pace of this production outsourcing has decreased rather than increased since the end of the 1990s. One possible explanation for that is the global economic slowdown at the start of the current decade. Swedish companies give outsourcing as the reason for a lower number of employees to a lesser extent now compared with a few years ago.[2] That could also be interpreted to mean that the cost of Swedish labour has fared relatively well after all in the increasing international competition that has resulted from globalisation.

When the new regime with a floating exchange rate and inflation target was introduced in the beginning of the 1990s, it entailed new macroeconomic conditions for collective bargaining agreements. During the 1970 and 1980s, inflation averaged around 8 per cent and real wage growth was almost non-existent. The slowdown in inflation coupled with a relatively stable rate of increase in nominal wages meant that real wages rose sharply between 1995 and 2004, see Table 1.[3] Not since the 1960s has there been such a long period of regular real wage increases.

In 2004, around 450 collective bargaining agreements were concluded for some 2 million employees, most of them spanning three years. This year, approximately 70 collective bargaining agreements will be signed for just over 1.3 million employees. Municipalities and county councils account for 1.1 million of these, and an agreement covering just over two years has already been concluded for them. Recently, agreements have been signed for some 75 000 workers in the construction sector and about 60 000 employees in banking and insurance. The latter group received more than what has become the norm in the current agreement period. Worth noting is that almost the entire economy has an agreement period that runs up to some time in the middle of 2007. Given that no agreements are cancelled prematurely, 2007 will be a very busy agreement year, since the majority of the collective bargaining agreements concluded in the business sector and the central government sector in 2004, as well as the municipal sector from 2005, will be due for renegotiation.[4]

The social partners and individual companies have gradually adjusted to the low inflation rate. Wage setting also has become more decentralised, entailing increased opportunities to change relative wages within the scope of a given rate of wage increases. But despite this, we have a compressed wage structure in Sweden in comparison with many other countries.

Wage structures differ between blue-collar and white-collar workers. Blue-collar employees’ wage structure is considerably more compressed and constant across age groups.[5] The wage spread for white-collar workers is larger and increases up to 45 years of age, after which it gradually decreases. It is mainly in the higher income groups that the wage differences between blue-collar workers and white-collar employees are large. In the lower-income groups the differences are very small.[6] But on average white-collar employees have long been pulling away from blue-collar workers, which risks building up tensions in the labour market ahead of future negotiations.

Wages can also vary across different regions. But this wage spread is not especially large in Sweden either. It is mainly Stockholm, Jämtland and Gotland that have a clearly different wage situation. Stockholm has the country’s highest wage level, while Jämtland’s and Gotland’s wage level is below the national average.

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2 See Wage Formation in Sweden 2005, National Institute of Economic Research.

3 For 2004, some data in Table 1 might be changed since all agreements have not yet been concluded.

4 See Wage Formation in Sweden 2005, National Institute of Economic Research.

5 The quotient between the10th and the 90th percentile is considerably higher for white-collar employees' wages, see "Lönespridning i näringslivet 2004" (Wage spread in the business sector in 2004), Confederation of Swedish Enterprise.

6 It is primarily in the quotient between the 90th percentile and the median wage that blue-collar workers and white-collars workers' wages differ, unlike the quotient between the 10th percentile and the median wage, see "Lönespridning i näringslivet 2004" (Wage spread in the business sector in 2004), Confederation of Swedish Enterprise.

On the whole, though, the wage spread has widened in Sweden over the past 25 years, at the same time as wage formation has been decentralised. But despite the increase in the wage spread, it is still low by international standards. It is still smaller than it was in 1970 and in a comparison of 17 OECD countries the wage spread in Sweden is lowest. High minimum wages likely mean that many jobs never get created. The services sector is also affected by this, and many low-productive work duties are not performed since nobody is willing to pay what they cost, with our high minimum wages.

Table 1. Nominal and real wage growth, 1995-2004

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
BUSINESS SECTOR										
Blue-collar workers	4.7	5.4	4.7	3.4	2.6	3.3	3.8	3.6	3.1	2.6
White-collar workers	3.5	6.4	4.2	4.7	3.7	4.1	4.5	4.1	3.3	3.2
WHOLE ECONOMY										
Blue-collar and white-collar workers	3.3	6.0	4.5	3.7	3.4	3.7	4.4	4.1	3.5	3.3
CPI	2.5	0.5	0.7	-0.3	0.5	0.9	2.4	2.2	1.9	0.4
REAL WAGE GROWTH										
BUSINESS SECTOR										
Blue-collar workers	2.2	4.9	4.1	3.7	2.1	2.4	1.4	1.4	1.2	2.3
White-collar workers	1.0	5.8	3.5	5.0	3.3	3.2	2.0	1.9	1.4	2.8
WHOLE ECONOMY										
Blue-collar and white-collar workers	0.9	5.4	3.9	4.0	2.9	2.8	1.9	1.9	1.5	2.9

Sources: National Mediation Office, Statistics Sweden and Sveriges Riksbank.

Structural unemployment

Developments in the labour market have been weak despite several years' firm economic growth, historically low interest rates and strong public finances. So far, the growing economy has not managed to create enough jobs. Moreover, our current account surplus essentially means that we are exporting capital on a large scale; in somewhat more extreme terms, you could say that the jobs being created by our growth are largely ending up outside Sweden's borders.

So the low employment growth does not appear primarily to be a result of weak demand. Instead, the explanation must be sought among longer-term structural factors.

This is reflected in particular by the fact that the employment rate, in spite of historically high economic growth, has not completely recovered since its sharp fall in connection with the crisis in the early 1990s. Moreover, the fact that open unemployment did not drop more during the economic upswing in the 1990s suggests that the labour market is not functioning satisfactorily. One example of rigidities in the labour market is that unemployment has remained around 8 per cent in the construction sector, even though it is one of the few sectors where activity has risen and labour shortages have begun to appear.

Another sign that the unemployment problems are structural in nature is the large differences across regions and occupational categories. In spite of a single monetary policy for the whole of the Swedish economy, unemployment figures in some regions are twice as high as in others, while the proportion of people receiving benefit from their unemployment fund is twice as high in some occupational categories as in others. These differences seem to last over long periods, indicating that the problems are partly due to low mobility in the labour market.

In addition, the need for labour market mobility is growing as a result of structural change. The previously typical cyclical pattern, where jobs are shed during a slump and then are recreated when the economy turns around, no longer generally holds true in all industries. Jobs that are lost in a slowdown are being replaced, especially in manufacturing, by increased productivity and information technology. Growth is leading to new jobs but in different places than before. That means that more people have to change workplace or sector, and results in the need for considerable adaptability. More jobs have to be created in, for example, the services sector, perhaps in completely new companies. The structural change that occurred when farmers and forestry workers went into manufacturing was relatively easy. Now the change often entails manufacturing workers having to go into the services sector, a transition that may be more difficult.

To the extent that the weak growth in employment is due to structural change in the Swedish economy, from manufacturing jobs to services, there is reason to discuss how the functioning of the labour market can be improved and how the driving forces for new business creation can be strengthened. Several proposals have been put forward in the public debate – among other things, there have been calls for a tax deduction to subsidise certain domestic services, as well as calls for a reduction in compensation levels to increase people's willingness to take lower-paid jobs. Other solutions being discussed are lower income taxes for low-income and middle-income employees, a reduction in employers' contributions and a cut in payroll taxes. These are important political issues, but issues that we at the Riksbank do not have any obvious reason to take a stance on.

The way the whole economy functions has of necessity changed since the post-war period and it is unlikely that the current economic policy regime with a floating exchange rate and inflation target can deliver both 2 per cent inflation and an unemployment rate equivalent to the levels we had then. During the post-war period we had a unique expansion in public sector employment and very high demand pressures, something that was not sustainable in the long run and that is not possible with free movement of capital, an inflation target and an independent Riksbank.