Svante Öberg: The financial crisis and wage formation

Speech by Mr Svante Öberg, First Deputy Governor of the Sveriges Riksbank, at the National Mediation Office, Stockholm, 29 January 2010.

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Why is the Riksbank interested in wage formation?

Wage formation and monetary policy are interrelated. The development of wages affects inflation and inflation affects the development of wages. The target for monetary policy is to maintain a low and stable level of inflation. This job is made easier if wage formation works well. Consequently, it is important for the Riksbank to follow this year's comprehensive wage bargaining rounds.

I will not make any recommendations to the social partners regarding the outcome of this year's collective bargaining. Instead, I will describe the economic setting for this collective bargaining. This may seem to be an extremely subtle distinction, but it is an important one, nevertheless. We make no normative pronouncements regarding which rate of wage increase may be most appropriate. However, considering the drawn-out recovery and the weak labour market, the scope for wage increases seems to be highly restricted.

I would also like to make two points during this introduction. Firstly: I will not be reporting any new view of economic developments beyond that presented in the monetary policy update of 16 December, although a few figures will be updated with the latest statistics. Secondly: The assessments and valuations I make here are not necessarily shared by all of my colleagues on the Executive Board of the Riksbank.

I will start with the financial markets and international developments, before turning to economic developments and monetary policy in Sweden, with particular attention paid to the development of prices and wages.

The functioning of the financial markets continues to improve, but they have not recovered completely

The functioning of the financial markets is continuing to improve, both in Sweden and abroad. One sign of this is that various risk premia in the money and credit markets continued to decrease during the second half of 2009. The levels of a number of risk premia now seem to have stabilised within a historically normal interval. Possibilities for various market participants to acquire funding at longer durations through the securities market have improved. Moreover, the Riksbank's risk survey shows that access to funding without government support has increased. The developments on the financial markets can be illustrated by the so-called TED spread, the difference between the three-month interbank rate and treasury bill rates (Figure 1).

However, despite this, the situation has still not completely normalised. There are still markets that have not recovered. There also exists some uncertainty regarding the extent of as-yet unrealised loan losses, particularly in European banks, leading to negative consequences for confidence among financial market agents. Furthermore, it must also be expected that bank lending in the United States and a number of other countries will be restrained for some time to come. As far as Sweden is concerned, it can also be added that developments in the Baltic countries represent an ongoing problem for the Swedish banks.

In addition, the financial markets are still dependent upon the measures adopted by central banks and authorities to deal with the crisis (Figure 2). However, these extraordinary measures will be successively phased out when central banks and governments deem that the time is right. For example, we have ceased to issue dollar loans and have started to increase margins on variable interest rate lending in Swedish kronor.

The lowest point of the international recession has now been passed, but uncertainty remains regarding the strength of the recovery

The lowest point of the international recession has now been passed. World trade has made a partial recovery following the steep decline of almost 20 per cent from the summer of 2008 to the start of 2009. The total trade volume, measured in terms of the *World Trade Monitor Index*, rose by almost 9 per cent between January and October 2009 (Figure 3). GDP has started to increase in both the United States and the euro area after a number of quarters with negative growth.

In our December forecast, we expect the world economy to have declined by around 1 per cent during 2009, followed by an annual average growth rate of approximately 4 per cent for the next three years (Figure 4).

For the United States, we predict a relatively good growth rate (for a developed country), this year and in the following years (Figure 5). GDP is expected to increase by an average annual rate of just below 3 per cent for the years 2010–2012. Growth is expected to be slower for the euro area. The annual growth rate in the euro area is expected to amount to just below 2 per cent for the years 2010–2012.

Although GDP growth is now underway and is expected to continue during the forecast period in both the United States and the euro area, it will be a long time until GDP returns to pre-recession levels. This means that resource utilisation will be low for an extended period of time. This applies not least to the labour market, which normally lags behind the development of GDP. In turn, this will restrain price and wage developments abroad for the next few years. I will return to this issue later on.

There is also considerable uncertainty about the strength of the recovery. The upturn in the period immediately ahead will partly be driven by temporary factors such as the effects of highly expansionary fiscal and monetary policies and an inventory cycle. There is therefore a risk that growth will be dampened again when the stimulating effect of these temporary factors declines. Experiences from previous financial crises, as reported by Reinhart and Rogoff, the International Monetary Fund (IMF) and others, also indicate that the recovery following a financial crisis will be drawn out.[1] The differences between various forecasters' views of future GDP growth are now unusually wide. This can be illustrated by the range of their GDP forecasts (Figure 6).

Asia, however, is a part of the world experiencing strong growth. China and India have also been impacted by the financial crisis, but to nowhere near the same extent as the more developed countries. GDP growth declined somewhat in Asia in 2009, but was still high by western standards (Figure 7). It is first and foremost China's increasing domestic demand and imports that are stimulating growth in the region. The OECD's indicators also show that GDP in Brazil and Russia has bottomed out and is now on the way up.

Low resource utilisation is restraining international price and wage development

Even if the international recession's lowest point has now been passed and the world economy is improving, price and wage developments are being restrained by low resource utilisation. Inflation is unusually low in both the United States and the euro area. In the United

[1] See Carmen M. Reinhart & Kenneth S. Rogoff, 2009. "The Aftermath of Financial Crises", American Economic Review, American Economic Association, vol. 99(2), pages 466–72, May.

States, inflation measured as annual percentage change has been negative since last spring (Figure 8). In the euro area, inflation was negative during the summer and autumn of last year, but rose to 0.6 per cent in November (Figure 9). Underlying inflation has fallen in both geographical areas since the middle of 2008.

One contributing cause of this low and, for a period, negative inflation is the weak development of the labour market. In the United States, employment levels have continued to decline during the autumn, with unemployment rising to approximately 10 per cent. Likewise, in the euro area, the situation in the labour market has continued to deteriorate and unemployment has increased to approximately 10 per cent. An expected weak growth in wages together with low inflation expectations is contributing towards dampening inflation.

Falling market expectations for the policy rate during the autumn may also be compatible with lower expected inflationary pressure. Both survey results and implied forward rate curves indicate that market participants' monetary policy expectations in the United States and euro area have fallen somewhat during the autumn.

Sweden also experiences recovery but low resource utilisation

Developments in the rest of the world have impacted small, open, export-dependent countries such as Sweden hard. However, even in Sweden, the lowest point of the recession has been passed and recovery has started. GDP increased slightly during both the second and third quarters of 2009, after having previously fallen four quarters in a row. The National Institute of Economic Research's Economic Tendency Survey and Swedbank's Purchasing Managers' Index have also reached levels indicating growth in the Swedish economy (Figure 10).

In the most recent monetary policy update, from December, we saw ahead of us fairly strong GDP growth for this year and the next two years (Figure 11). GDP is expected to increase by an average of just over 3 per cent per year during the years 2010–2012. Swedish exports will also increase at the same rate as economic conditions in the rest of the world improve. Despite the weak development of incomes, private consumption is expected to continue to rise over the forecast period, due to increased optimism regarding the future. Investment is also expected to contribute towards GDP growth during the forecast period – first housing investment and public investment, and then also investment in the business sector.

However, despite this growth in GDP, the economy will take a long time to recover. GDP is not expected to return to its pre-crisis level until 2011 (Figure 12). As a consequence, resource utilisation will be low during the forecast period. The labour market will also remain weak during the entire forecast period. Employment is expected to continue to fall this year, but to increase again next year (Figure 13). Unemployment will amount to approximately 10 per cent by the end of the year, but will then decrease over the following two years (Figure 14). The most recent Labour Force Surveys indicate a slightly better development than we expected in December. The manner in which this may affect the forecasts is a matter we will return to at our next monetary policy meeting on 10 February.

Two factors give Sweden an advantage: the surplus in the public finances and the current account before the start of the crisis (Figure 15). The public surplus has made it possible to conduct an expansionary fiscal policy during the crisis without jeopardising the long-term sustainable development of central government finances, which has mitigated the decline of economic activity. Even in the period ahead, the basically strong public finances will contribute towards a situation in which Sweden will not need to increase taxes and/or decrease expenditure to the same extent as, for example, the United States and United Kingdom in order to achieve the long-term sustainable development of public finances.

Significant uncertainty also as regards the strength of the recovery in Sweden

There also exists significant uncertainty as regards the strength of the recovery in Sweden. The lowest point of the recession has undoubtedly been passed, but there is, as yet, no strength in the recovery. Following a decline of over 6 per cent between the first quarters of 2008 and 2009, GDP has only increased by a total of 0.5 per cent during the second and third quarters of 2009. Production in industry and the private service sector has not started to increase as yet (Figure 16).

We expect to see fairly strong growth in GDP in the coming years. However, this expectation may turn out to be overly optimistic – the risk of weaker development is also present. As in the rest of the world, the upturn in Sweden in the period ahead will partly be driven by temporary factors such as highly expansionary fiscal and monetary policies and an inventory cycle. The forecast assumes that the world market will grow strongly, that private consumption will increase at a good rate despite the fact that the development of household incomes will be weak, that public consumption will increase and that investments will increase despite a low level of capacity utilisation and weak profitability.

Naturally, there also exists the possibility that GDP growth will be stronger than we have estimated. However, even with a higher rate of GDP growth, resource utilisation will be low – and it is resource utilisation that is significant for inflation, not GDP growth. Resource utilisation can be measured in different ways, but I will not address this issue today. I will restrict myself to stating that resource utilisation can be measured by the GDP gap – that is to say, the difference between the GDP level and what can be considered a normal level. Even with a higher rate of GDP growth, the GDP gap will be negative and resource utilisation low for an extended period (Figure 17).

The low resource utilisation does not only signify that inflationary pressures are low, but is also a reason in itself to conduct a looser monetary policy. Through our monetary policy, we are attempting not only to keep inflation at a low and stable level, but also to support production and employment in the current recession.

A divided economy

The Swedish economy is divided, with a significantly worse situation in export-dependent industries than in the private service sector. Even though the lowest point of the recession has passed, we are still experiencing the effects of the crisis on world trade. The Swedish export market has experienced a significant decline. At the same time, the expansionary fiscal and monetary policies have enabled the activity level of those areas of the economy focused on the domestic market to be maintained. This is clearly reflected in the development of different sectors during the economic downturn. While industrial production fell by over 20 per cent during the year leading up to the start of 2009, the production of private services only declined by approximately 5 per cent during this period.

This divided economy has also been visible in the labour market. The labour market in export industry dependent areas outside the major cities is far bleaker than it is in the service-dominated major cities. While industrial employment decreased by approximately 100 000 between the autumn of 2008 and the autumn of 2009, employment within the service sector remained largely unchanged (Figure 18).

Low inflation during the forecast period

We expect low inflation during the forecast period (Figure 19). The underlying inflation measured as the CPIF (CPI with a fixed mortgage interest rate) is expected to be just below 2 per cent during the greater part of the forecast period. CPI inflation, on the other hand, will vary significantly, as CPI also considers changes in interest rates on mortgages, which are affected by the decisions we take regarding the repo rate.

Inflation measured in terms of the EU harmonised index, the HICP, has recently been higher in Sweden than in the euro area (Figure 20). During the autumn, this was just below 2 per cent in Sweden, while it was negative in the euro area. HICP does not include prices of owner-occupied housing, and thus inflation measured in terms of HICP and CPIF are largely the same.

The relatively high HICP inflation in Sweden is primarily due to the heavy increase of unit labour costs in Sweden over the last three years, averaging approximately 5 per cent per year (Figure 21). In addition, the Swedish krona weakened during the financial crisis, pushing up import prices. In turn, the rapid increase of unit labour costs over the last three years is primarily due to the fact that productivity fell for three years in a row, in addition to which hourly wages increased more during that three-year period than during the immediately preceding three-year period.

This development will be reversed during the forecast period. We expect largely unchanged unit labour costs over the next three years due to low wage increases and rising productivity. We also expect the Swedish krona to continue to strengthen (Figure 22). This will mean that inflationary pressure will be low during the forecast period.

Repo rate at all-time low

At the monetary policy meeting in December, the Riksbank decided to maintain the repo rate at the all-time low of 0.25 per cent, standing fast by its previous assessment that it will not be necessary to raise the repo rate until the autumn of 2010 (Figure 23).

The background to this decision is that a low level of resource utilisation, together with a slow development of prices and wages, is expected over the next three years. In order to meet the inflation target and to support economic recovery, the repo rate must remain low for a long time. This is the same repo rate path that we adopted as long ago as July. Since then, the forecasts for GDP growth and employment have certainly been revised upwards. The forecast for resource utilisation has accordingly been revised upwards. However, at the same time, the forecasts for inflation have been revised downwards. These two changes largely cancel each other out as regards their effect on monetary policy.

Wage formation has functioned well for more than a decade

Wage formation has functioned well over the last ten to fifteen years. The development of wages has been compatible with low and stable inflation. Since the inflation target was adopted in 1995, CPIF inflation has averaged 1.7 per cent per year, seldom dropping below 1 per cent or rising above 3 per cent. This is a significant change when compared with the high and sharply fluctuating inflation we experienced in the 1970s and 1980s.

The changes made to the frameworks for wage formation are an important factor behind the lower and more stable inflation we see today. I am primarily thinking of the Industrial Agreement implemented in 1997, but also of similar but less far-reaching agreements in other areas of the labour market. I am also thinking of certain changes to the legislation and the establishment of the National Mediation Office. Another factor should be that resource utilisation has been kept at a lower level than previously, a level that is compatible with low and stable inflation. The increased credibility of monetary policy in terms of keeping inflation close to the inflation target of 2 per cent has probably also contributed. Inflation expectations over the longer term now lie close to the inflation target (Figure 24).

Low wage increases during the forecast period

This year, social partners will negotiate just over 550 collective agreements covering just over 3.3 million employees. The results of these negotiations will affect the wages of the majority of the country's wage-earners, thereby being of great significance for economic development.

The developments we see ahead of us, with a drawn-out recovery and weak labour market, make it difficult to imagine anything other than that there will be low wage increases in the period ahead. In December's monetary policy update, we expect wages to increase by an average of approximately 2.5 per cent per year during the period 2010–2012, this figure being slightly lower towards the start or the period and slightly higher towards the end (Figure 25). However, this should not be interpreted as a recommendation, but rather as a forecast based on developments in the economy and other available information. Naturally, developments in this area may take a course deviating from our expectations, just as in other areas. Wage increases include not just contractual wage increases but also wage increases over and above central wage agreements.

Wage development forecasts form a part of the overall forecast for the Swedish economy. We base our wage forecasts on the short-term wage statistics of the National Mediation Office, with adjustments made to the preliminary statistics for estimated retroactive wage payments. Following this, a forecast is made in two stages. The first stage covers the next six months, considering previously agreed wage increases, the situation on the labour market and inflation expectations. The second stage covers the next two to three years and considers unemployment, corporate profits and inflation expectations. As in other forecast areas, a final assessment of wage developments is made in consideration of model results and other information not included in the models.

The financial crisis and wage formation

The financial crisis has affected the Swedish economy in two ways. Firstly, the financial markets and the financial sector have been impacted negatively. However, in principle, this problem has now been addressed. Central banks and authorities have adopted extraordinary measures which have succeeded in getting the financial markets to function better again. The remaining areas to be addressed are that the financial sector is still dependent upon government support, that there exists a risk that new problems will arise and that a new regulatory framework is needed for the financial sector.

Secondly, the financial crisis has led to a decline in world GDP and world trade. As regards Sweden, this has primarily impacted the Swedish export industry and has led to a deep recession from which it will take the country a long time to emerge. Other parts of the economy that are focused on the domestic market have coped better, due to the expansive fiscal and monetary policies being conducted, among other factors. This has led to a clear division of the Swedish economy.

This is the economic background against which the social partners are to conclude wage agreements during the year. This will not be an easy task. It will require a variety of deliberations to be undertaken.

As I have previously stated, against the background of the drawn-out recovery and the weak labour market, we at the Riksbank expect a wage increase rate for 2010–2012 of approximately 2.5 per cent per year, lower at the start and higher towards the end of the period. This is a very low rate of increase, historically. Our forecast will no doubt be considered to be too high by many on the employer side and, likewise, too low for many on the union side.

The wage development we expect is consistent with an underlying inflation rate reaching 2 per cent by the end of the forecast period. All other factors being equal, higher wage increases in this situation tend to lead to higher inflation, higher interest rates and a weaker development of production and employment. Similarly, lower wage increases tend to lead to lower inflation, an ability to maintain low interest rates for a longer period of time and a stronger development of production and employment.

One factor that will undoubtedly play a major role in the approaching rounds of wage bargaining is the division of the Swedish economy. The differences in the ability of various industries and companies to bear a certain rate of wage increases are currently unusually great. The development of wages along similar lines in different parts of the economy would lead to smaller pay differences, but also to a faster transformation of the economy. This would hit the regions impacted by the crisis hardest and the number of industrial jobs would decline more rapidly.

Another important question concerns the implications of the division of the economy for the Industrial Agreement's normative role in wage bargaining, a role which has been very important during the most recent agreement periods. The Industrial Agreement has been a restraining force, contributing towards retaining the competitiveness of that part of the Swedish economy exposed to international competition and keeping inflation at a low and stable level at the same time as real wages have risen and growth in the Swedish economy has been strong – until the financial crisis.

In the period ahead, a drawn-out recovery, weak labour markets and low price and wage increases are also expected internationally. The sector exposed to international competition is the area of the Swedish economy to be most tangibly and directly affected by these external conditions for wage developments within Sweden. This suggests that this sector should also play a normative role in this year's collective bargaining. The service sector is not as sensitive to cost increases, but finds it easier to pass these on to prices. If the service sector plays a normative role in this year's collective bargaining, it is likely that wage increases, and thereby inflation, will be greater than would be the case if the sector exposed to competition were to be normative.

Another issue that may play a major role is uncertainty concerning the future. Under normal circumstances, agreements covering several years are an advantage, as these reduce uncertainty regarding future price and wage developments. However, the current situation is not normal. This means that making contractual commitments in respect of agreements for longer periods of time may be difficult.

As I mentioned in my introduction, I have no advice regarding the outcome of this year's collective bargaining. Instead, I have tried to describe the economic setting for this collective bargaining. The necessary deliberations must be undertaken by the social partners together.

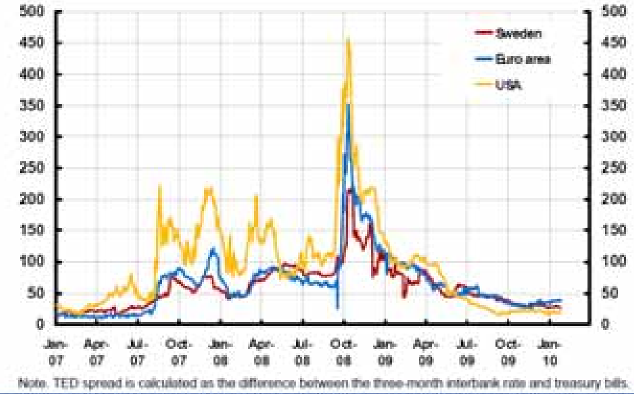
Concluding remarks

Wage formation has functioned well over the last ten to fifteen years. It has contributed to our success in maintaining inflation on a low and stable level, at the same time as real wages and growth have developed strongly. My hopes are that this year's collective bargaining will contribute towards Sweden's continued positive economic development, once the effects of the financial crisis have ebbed away.

Figures

1. The functioning of the financial markets is continuing to improve

TED spread, basis points

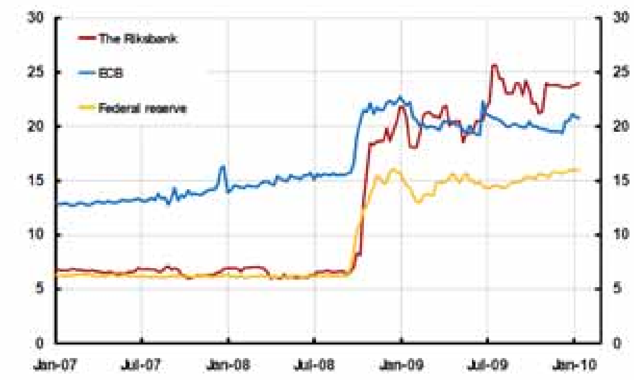


Note. TED spread is calculated as the difference between the three-month interbank rate and treasury bills.

Sources: Reuters EcoWin and the Riksbank

2. Central banks' total assets

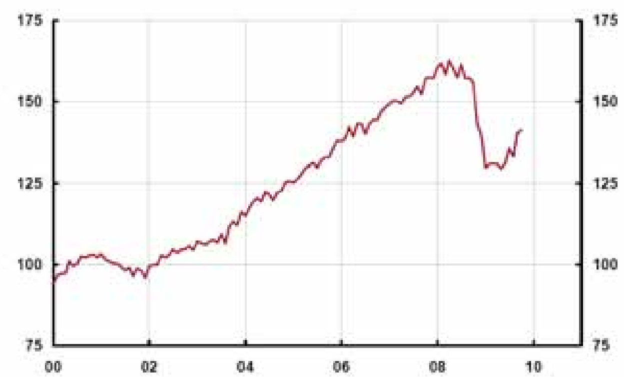
Percentage of GDP



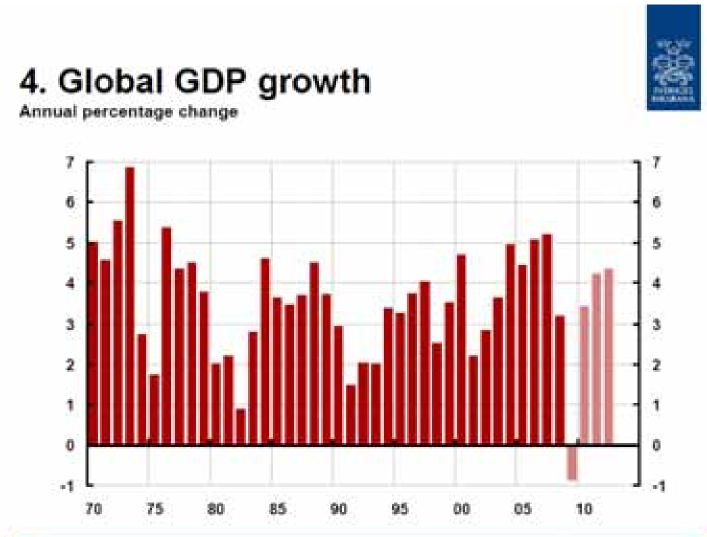
Sources: Bureau of Economic Analysis, Eurostat, Statistics Sweden and respective central banks

3. Volume of world trade

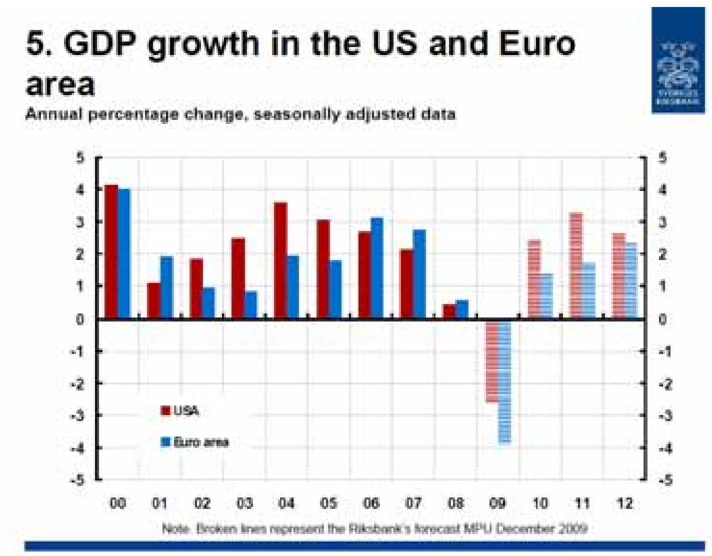
World trade monitor index, year 2000 = 100, seasonally adjusted data



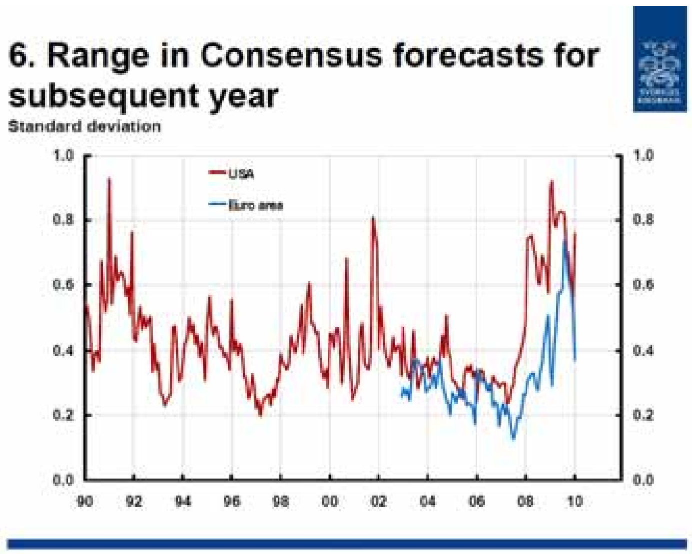
Source: Netherlands Bureau for Economic Policy Analysis



Note. Striped bars represent the Riksbank's forecast MPU December 2009. Sources: IMF and the Riksbank



Sources: Bureau of Economic Analysis, Eurostat, and the Riksbank



Source: Copyright Consensus Economics Inc.

7. GDP in the BRIC countries

Annual percentage change

	2007	2008	2009*	2010*	2011*
Brazil	5.7	5.1	-0.4	4.7	3.7
Russia	8.1	5.6	-9.0	3.6	3.4
India	9.4	7.3	5.6	7.7	7.8
China	13.0	9.0	8.7	10.0	9.7

* IMF forecast January 2010

Source: IMF

8. Consumer prices, USA

Annual percentage change

Sources: Bureau of Labor Statistics and OECD

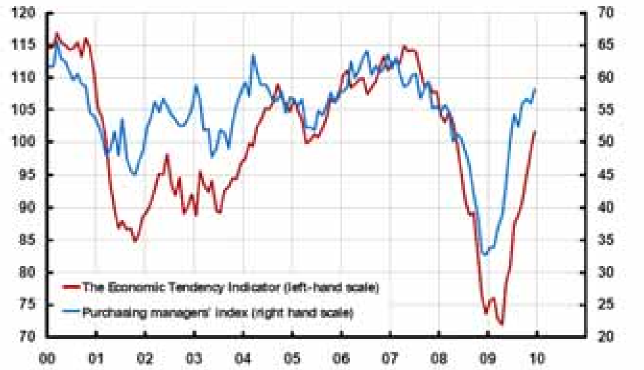
9. Consumer prices, euro area

Annual percentage change

Sources: Eurostat and OECD

10. Economic Tendency Indicator and Purchasing Manager Index

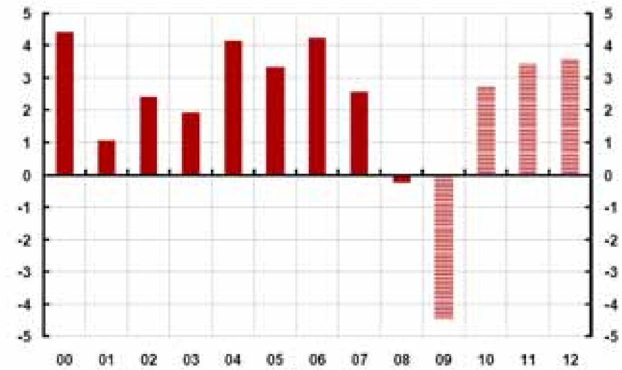
Index, average value = 100 respective net figures



Source: National Institute of Economic Research

11. GDP growth in Sweden

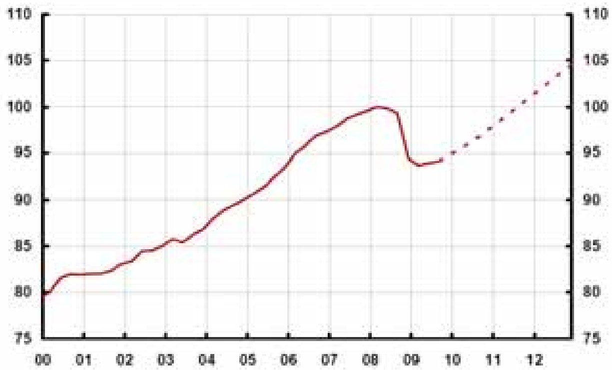
Annual percentage change, fixed prices



Note. Striped bars represent the Riksbank's forecast MPU December 2009 Sources: Statistics Sweden and the Riksbank

12. GDP level in Sweden

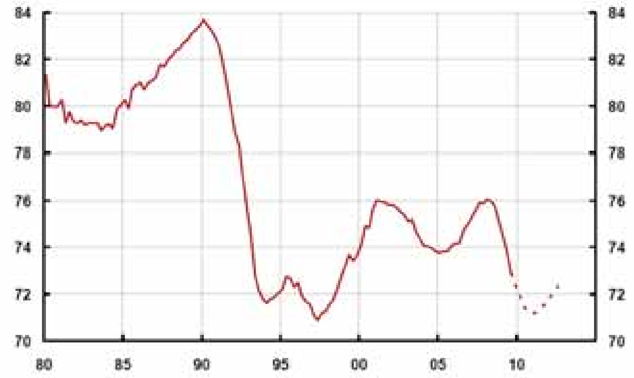
Index 2008 Q2=100



Note. Broken lines represent the Riksbank's forecast MPU December 2009 Sources: Statistics Sweden and the Riksbank

13. Employment rate

Employment as a percentage of population, 16-64 years, seasonally adjusted data

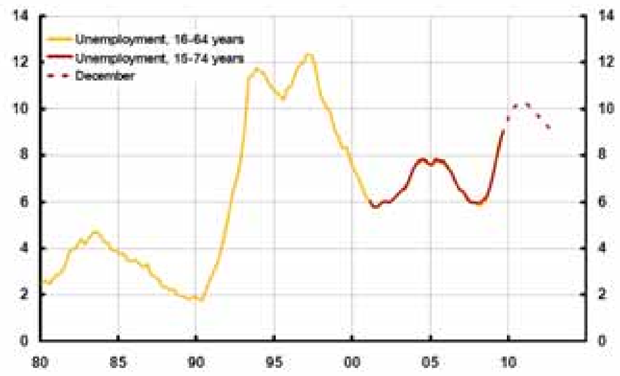


Note: Broken lines represent the Riksbank's forecast MPU December.

Source: Statistics Sweden and the Riksbank

14. Unemployment

Percentage of the labour force, seasonally adjusted data

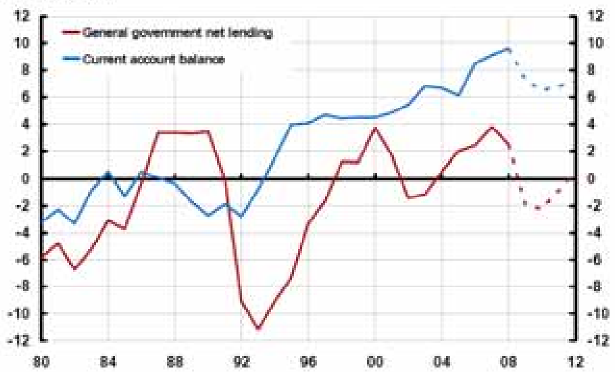


Note: Broken lines represent the Riksbank's forecast, 15-74 years

Sources: Statistics Sweden and the Riksbank

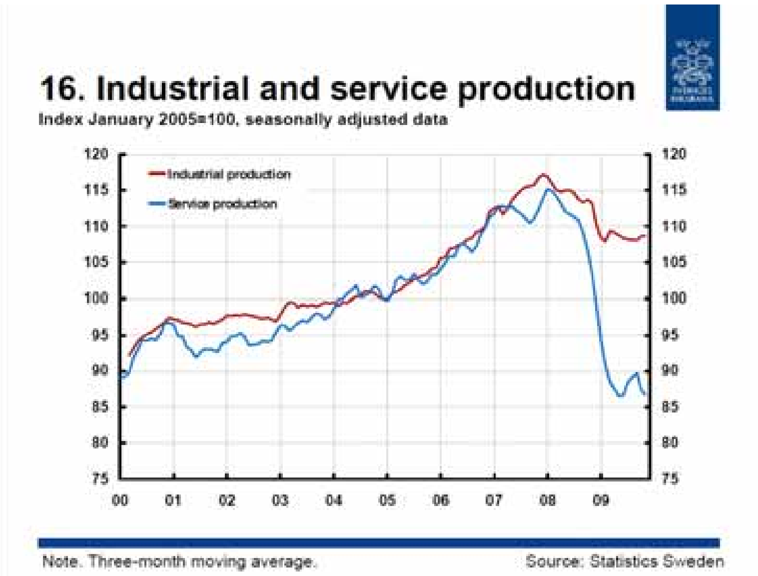
15. Current account balance and public finances

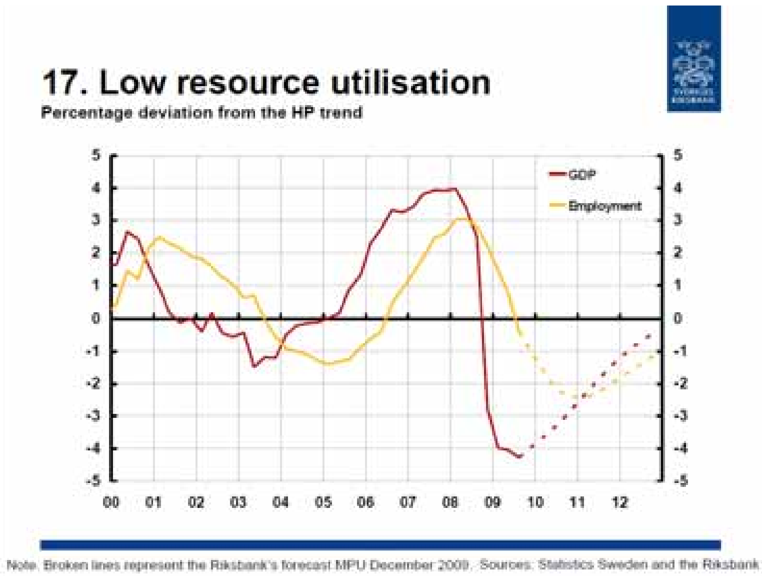
Percentage of GDP

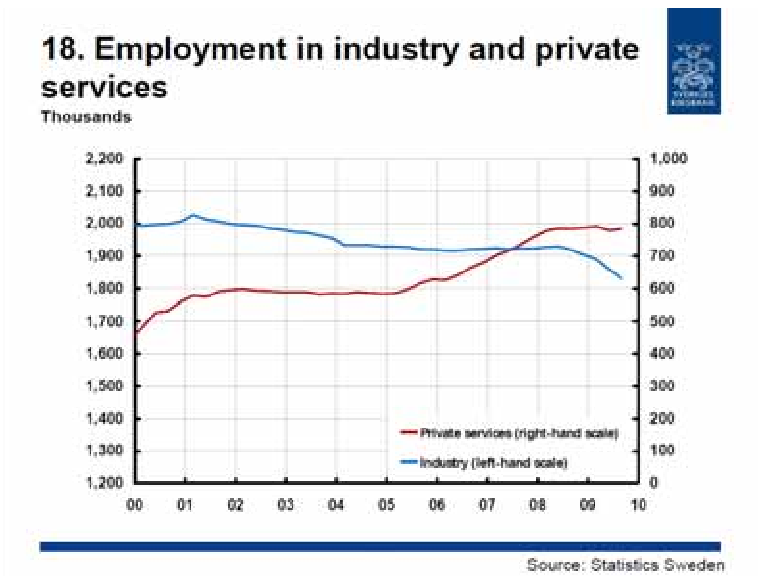


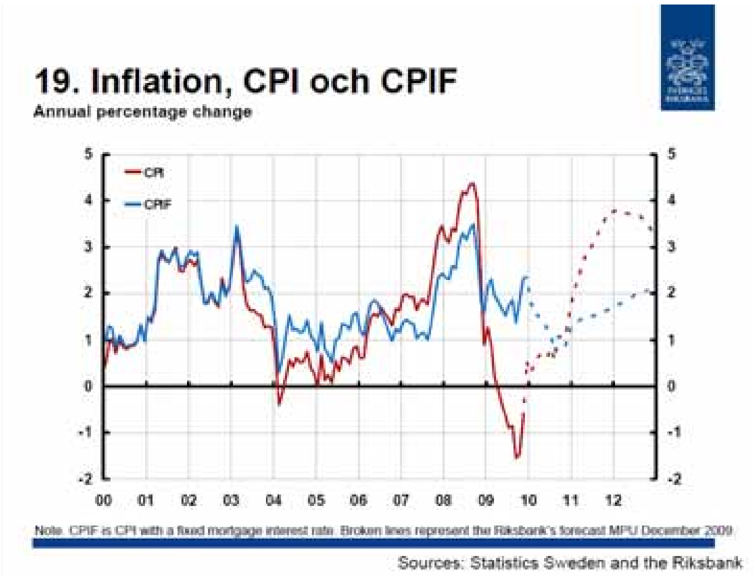
Note: Broken lines represent the Riksbank's forecast MPU December 200

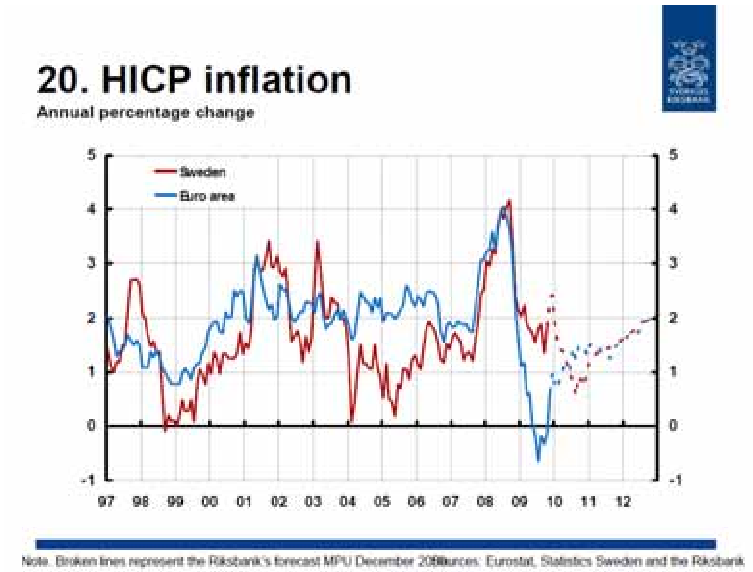
Sources: Statistics Sweden and the Riksbank

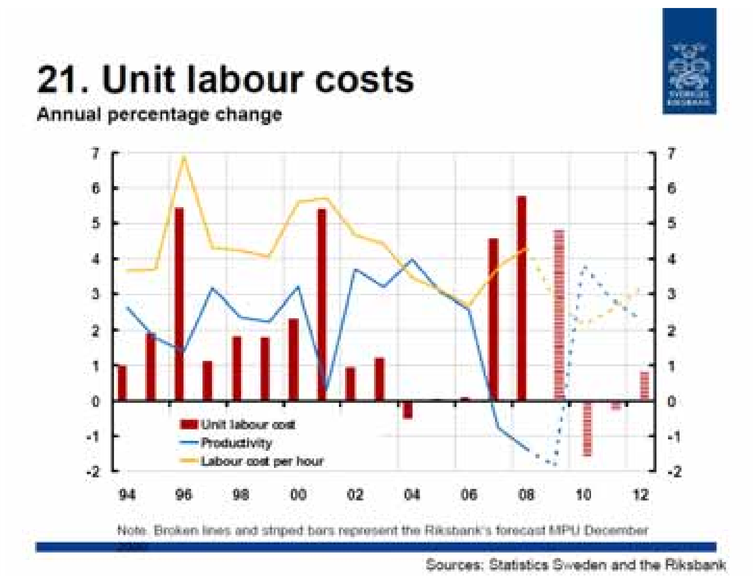

16. Industrial and service production
Index January 2005=100, seasonally adjusted data
Industrial production
Service production
Note. Three-month moving average.
Source: Statistics Sweden


17. Low resource utilisation
Percentage deviation from the HP trend
GDP
Employment
Note. Broken lines represent the Riksbank's forecast MPU December 2009. Sources: Statistics Sweden and the Riksbank


18. Employment in industry and private services
Thousands
Private services (right-hand scale)
Industry (left-hand scale)
Source: Statistics Sweden

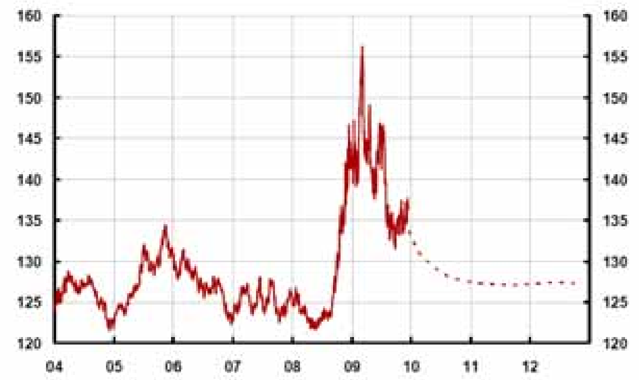

19. Inflation, CPI och CPIF
Annual percentage change
CPI
CPIF
Note. CPIF is CPI with a fixed mortgage interest rate. Broken lines represent the Riksbank's forecast MPU December 2009.
Sources: Statistics Sweden and the Riksbank


20. HICP inflation
Annual percentage change
Sweden
Euro area
Note. Broken lines represent the Riksbank's forecast MPU December
Sources: Eurostat, Statistics Sweden and the Riksbank


21. Unit labour costs
Annual percentage change
Unit labour cost
Productivity
Labour cost per hour
Note. Broken lines and striped bars represent the Riksbank's forecast MPU December
Sources: Statistics Sweden and the Riksbank

22. TCW exchange rate

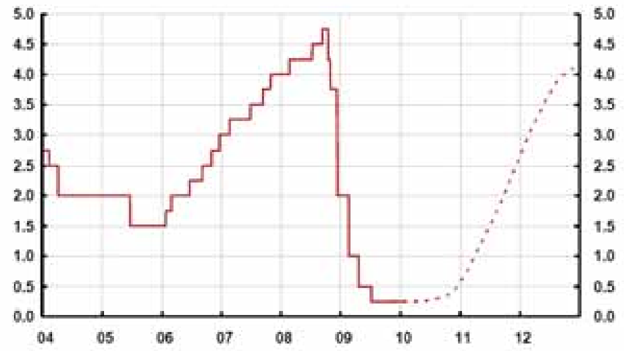
Index, 18 Nov 1992 = 100



Note. Broken lines represent the Riksbank's forecast MPU December Source: The Riksbank

23. Repo rate

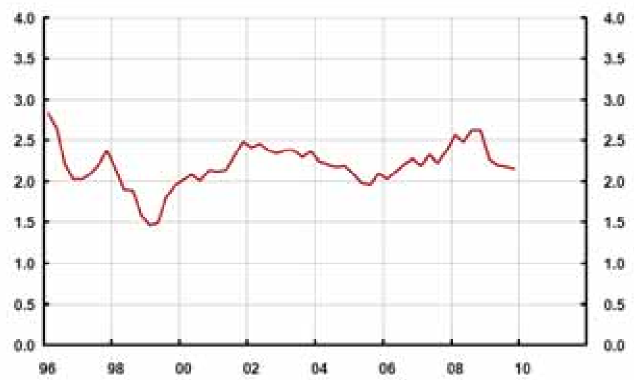
Percent



Note. Broken lines represent the Riksbank's forecast MPU December 2009; quarterly averages. Source: The Riksbank

24. Inflation expectations, 5 years ahead

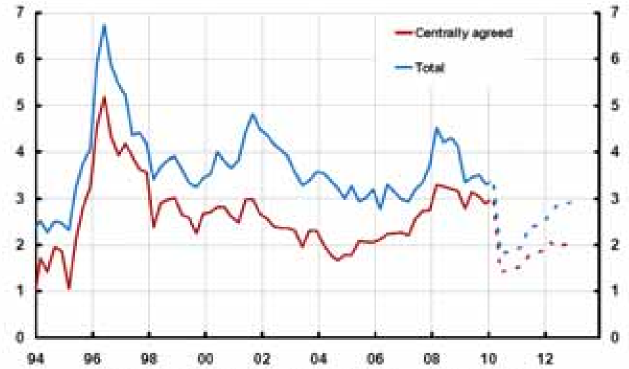
Percent



Source: TNS SIFO Prospera

25. Low wage increases

Annual percentage change



Note. Broken lines represent the Riksbank's forecast MPU December 2009.

Sourcesr: National Mediation Office, Statistics Sweden and the Riksbank