Speech

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Wage formation in focus

Upplands Väsby kommun

The picture of Sweden being in a strong cyclical upturn has been confirmed recently. Growth is taking place on a broad base and is expected during the next few years to be around 3.5 per cent per year. The cyclical upturn is taking place from a favourable situation where the imbalances that previously characterised the Swedish economy have been greatly reduced. Central government debt has fallen from 80 per cent of GDP in 1995 to around 70 per cent in 1999. Sweden has been one of the most successful EU Member States with regard to tackling problems of public finances. Several years of surpluses in the current account balance have also reduced our country's foreign debt. It has now fallen to slightly over 20 per cent of GDP from having at most been 40 per cent of GDP in 1993. At the same time, inflation expectations have fallen and stabilised at a low level, close to the target for monetary policy. While unemployment is still high, both employment and new vacancies are now greatly increasing.

Practically all variables are pointing in a positive direction and it is likely that the remaining imbalances will be further reduced in the next few years. The prospects for the Swedish economy look much better than for a very long time and the prerequisites for sustainable, stable growth seem then to be very favourable.

There are therefore good reasons to assume that the first upturn of the twenty-first century will not feed inflationary impulses into the Swedish economy in the same way as during the upturns of the 1970s and 1980s. However, despite that

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we should not forget that the present low inflation regime has not been fully tested in an upturn. Not least with regard to wage formation, which I will come back to later.

Challenges for monetary policy

The challenge for the Riksbank is to balance monetary policy so that the cyclical upturn is not interrupted prematurely while, at the same time, avoiding such a great rise in demand that inflation accelerates.

If the economy is in balance and the long-term inflation expectations are low, it can be hoped that monetary policy focused on an inflation target will lead to production growth being stabilised on its long-term growth track. Inflationary pressure varies with the business cycle but when demand increases at the same rate as the increase in capacity in the economy, inflation is stabilised at a low level. When there are free resources, the central bank keeps interest rates sufficiently low so as to stimulate the economy and, when resource use is high, interest rates are kept sufficiently high to avoid overheating the economy and increased inflation. The increase and lowering of interest rates in this way also indirectly becomes a means for dampening cyclical fluctuations and stabilising production and employment. On average over a business cycle, monetary policy in an economy in balance neither needs to stimulate nor dampen growth and inflation and the real interest rate is thereby on its long-term equilibrium level. It is not possible to specify this level as it varies over time. However, according to some theories on optimality, a very rough rule of thumb is that it is close to the long-term real GDP growth. In the long run it is reasonable to assume that the real interest rate is determined internationally. In both Germany and the USA, the short real interest rates have averaged around 3.5 per cent since 1982, which, with inflation expectations at 2 per cent, would mean nominal rates of around 5.5 per cent. Resource use in the Swedish economy has been low for a long time and the repo rate has therefore been at such a low level that the economy has been stimulated. Even after last week's increase in the repo rate from 3.25 to 3.75 per cent, monetary policy acts to stimulate the economy

A weakness with regard to monetary policy considerations in practice is in a particular situation to determine how much demand can allowed to rise without exceeding the inflation target. This perhaps especially applies in economies where the low inflation regime is relatively new and not tested in all parts. As monetary policy affects inflation with a time lag, the monetary policy decisions must rest on assessment of inflationary pressure forward in time. Decisions on restraints may have to be taken before there are any visible signs of inflation. A risk that must be taken into consideration is that if an interest rate increase is too late or too little, due, for instance, to miscalculations of the strength of inflationary impulses, then inflation expectations can also rise. The consequences would be that the laboriously earned credibility for the low inflation economy would be damaged. That would then require considerably greater and long-term restraints to get inflation back on target than if it had been stopped in time.

Wage formation in focus

Monetary policy is based on forecasts of inflation in one to two years' time. These forecasts are based inter alia on assessments of the development of import prices, profits and wage costs. The pressure of demand in Sweden and internationally is an important determining factor and the cyclical upturn is just now very strong. There is a lot to indicate that large parts of the Swedish economy has adapted to a low-inflation regime. However, as I said before it cannot be disregarded that price and wage formation processes have still not been tested in such a strong cyclical upturn as that we now seem to be in. During the coming years, the focus will be on wage formation. When pay agreements for around 2.3 million employees are to be renegotiated this year and next year, the way of functioning of the labour market will be seriously put to the test.

The nominal wage cost increases must in the long term be kept within the scope permitted by productivity growth and the 2 per cent inflation target. Higher wage cost increases will either lead to reduced profit shares for businesses or higher inflation. In the short term, profit shares can, of course, fluctuate but in the longer term, the development of profits must lie in line with the surrounding world. Temporarily, low import price increases can also create some scope for higher wage cost increases without exceeding the inflation target. However, sooner or later, excessively high wage costs will lead to lower growth with higher interest rates or to a dampening of the willingness to invest in Sweden confronted with the prospect of reduced profit margins.

Challenges for wage formation

The Swedish labour market has previously had a tendency to generate wage-wage spirals. For instance, it has been difficult to change relative wages without this generating compensatory wage increases. The fact that the coming pay negotiations are taking place in a situation where there is a high demand for labour greatly increases the risk of this pattern being repeated. Since 1997, employment has increased by almost 150,000 persons. Given growth as in the Riksbank's assessment, demand for labour will continue to increase over the next few years. One indication of this is that the number of newly registered vacancies increased throughout the whole autumn last year. In some industries and regions, there are indications that a shortage of labour is developing. However, it is at the same time important to bear in mind that we are a very long way from the scarcity levels experienced at the end of the 1980s.

Another challenge to wage formation is that the first pay negotiations taking place are for public sector employees. This spring agreements expire for around 280,000 persons in the health care and education sectors. Teachers and health care staff are groups that have obviously fallen behind in their pay development leading to shortages. Consider, for instance, teachers in natural science subjects such as mathematics and physics. The student who successfully completes a university education in these subjects is probably capable of becoming a graduate engineer. The pay difference between these vocational categories is very great, however, both as regards starting pay and development opportunities. A teacher's final wage can be in the region of something over SEK 20,000 while there is no ceiling for a skilled graduate engineer. With such pay differences it is not surprising that there is a great shortage of certain categories of teachers and that it is difficult to attract people to this profession. The fact that many nurses leave the public sector in Sweden to practice their profession in, for instance, Norway and Denmark instead, has also contributed to the shortages in health care.

The Swedish labour market has not only had problems in dealing with pay balances between different occupations. It has also found it difficult to tackle regional imbalances in the same occupational category through adaptation of relative wages. Shortage of labour has, for instance, particularly affected big city areas. Lower costs of living and a higher standard of living in the provinces at the same wage have probably contributed to this. The cost of living for a senior level secondary school teacher in Falun, for instance, is considerably lower than for the same category in Stockholm. With a more flexible wage formation, the imbalances in the labour market could probably be reduced.

Low inflation expectations dampen wage increases

The starting situation for the coming pay negotiations is thus not unproblematic. However, although there are elements that cause concern, there is also a lot to indicate that the process of price formation has changed.

The most important change since the 1970s and 1980s is probably the change in the target for monetary policy and the support and credibility attained by the inflation target. I am convinced that the Riksbank's inflation target is understood and accepted by trade union members, officials and leaders. Knowledge about the inflation target and the role of monetary policy has become widespread in a quite different way to the fixed exchange rate norm. The fixed exchange rate regime basically required that wage cost increases should be adapted to the surrounding world in order not to affect employment negatively. When, despite this, wages rose more than in our competitor countries, employment was saved by recurrent devaluations. This probably contributed to reducing the pressure to adapt in the Swedish labour market. The high level of activity in the Swedish economy during the latter half of the 1980s also played an important role for action not being taken on wage formation.

The insight that excessively high wage increases rather quickly lead to growth being dampened and an increase in unemployment with a monetary policy focused on an inflation target, seem to have become generally accepted by public opinion. If the Riksbank deems that wage cost increases are pushing inflation over the target, the Riksbank will increase the interest rate and dampen demand. In the short run, lower profit shares can compensate for excessively high pay increases, although decreased profit margins reduce willingness to invest and dampen growth.

Large increases in real wages with low inflation have probably increased insight into the value of price stability. During the past four-year period, real wages have increased on average by almost 4 per cent per year despite low nominal wage increases. This is to be compared with the fact that real wages on average only increased by a half per cent per year during the period of high inflation from 1975 to 1995 despite nominal wage increases during these years totalling 8 per cent on average. This development clearly indicates that there has not been a positive correlation between high nominal wage increases and the development of real wages.

High credibility for the goals of monetary policy has led to a reduction in inflation expectations. And stable inflation expectations per se reduce the risk for pay negotiations leading to higher wage increases than there is room for. Stable inflation expectations reduce the uncertainty of the parties as to what a nominal wage demand means for the real wage. One indication that the low inflation economy has been firmly established in the Swedish economy is the result of the calculations presented in the Riksbank's inflation report from October 1999. They show that there is now another exchange relationship between the degree of capacity utilisation in the economy and the inflation it gives rise to. According to the same calculations, an increase in demand does not either lead to price increases to the same extent as previously.

Competitive pressure increases cost consciousness?

Increased competition in globalised markets could also contribute to low inflation. Globalised highly competitive commodity markets probably reduce the ability of businesses to compensate high wage costs by price increases. At the same time, it is probable that the strongly globalised capital market makes it more difficult for businesses to press down profit margins even in the short run. A conclusion is that businesses' opposition to wage cost increases that cannot be sustained by productivity increases may have increased.

Another change in the Swedish labour market is the tendency towards increased short-term employment, for instance, in the form of project employment and temporary posts. Developments are particularly clear in the expanding services sector. The total number of time-limited posts increased from 9 per cent to around 14 per cent of the total number of employees between 1990 and 1999. This development can have been reinforced by the difficult situation in the labour market during these years but many believe that the trend will continue. Also new methods of compensation are spreading. Bonus wages, profit sharing, and a 13th monthly wage are components in wage formation that increase flexibility in the labour market. Increased cost consciousness due to stiffer competition can be a factor driving on this development.

Tendencies to time-limited employment and varying compensation for work are not only positive. For the individual and households, security, predictability of income and the possibility for long-term planning, for instance, to have children and buy houses, are reduced.

Changed forms for wage formation

Although there is a broad understanding for the consequences of excessively high wage cost increases for the wage-earner collective as a whole, it may be rational for the individual organisation to demand high pay increases. Excessively large wage increases can lead to the costs for the national economy in the form of high unemployment. However, the individual organisation can at least in the short term gain by its action. This can be the introduction to a wage spiral. Various changes in the forms of wage formation have been carried out and are planned, among other thing with the end of reducing the risk of such behaviour arising.

The most important is the so-called *Industry Agreement* between 20 organisations in the labour market, 12 from SAF (Swedish Employers' Confederation) and 8 from LO (Swedish Trade Union Confederation), TCO (The Confederation of Professional Employees) and SACO (Swedish Confederation of Professional Associations). This agreement therefore affects 20 per cent of the labour force and includes an agreement that regulates bargaining procedures. The agreement states that bargaining shall be started three months before current agreements expire. There is a broad consensus among the social partners that wage formation is facilitated if new agreements are reached before the old has expired. The Industry Committee, on which the social partners are represented, appoints a group of people to serve as impartial chairpersons in negotiations. These have a number of powers, among other things, they can postpone strikes for fourteen days. This contract design should reasonably entail a considerable reduction in the risk of strike action.

The Industry Agreement has been compared with the Saltsjöbaden agreement in 1938, i.e. the agreement that introduced the long period of peace in the Swedish labour market. According to many analysts, the Industry Agreement improves the ability to cope with pay demands and relative pay adjustments within the total wage space of the economy. Flexibility in wage formation is considered to have increased and the negotiation climate improved.

With the explicit intention of facilitating wage formation compatible with economic balance, the Government introduced a bill in December last year that included proposals to create a new agency, the *Mediation Institute*. The idea is to reduce the risk for different groups in the labour market driving up wage increases in competition with one another in a way that ultimately creates a worse outcome for all. The bill includes measures that aim at new agreements being reached before the end of the previous contract period. Another important task for the institute is envisaged to be to increase knowledge and information about wage formation. The bill also includes proposed rules aiming at reducing the risk of conflict breaking out and to slow down the approach to conflict. However, the rules shall be optional, which means that they only come into effect if contractual solutions are not reached. This construction should stimulate agreements similar to the Industry Agreement being concluded.

Institutional changes have also been carried out for *state employees* that can have a restraining effect on wage formation. These changes aim, among other things, at preventing the state sector leading the way in the pay bargaining process. The so-called frame budget process makes it generally more difficult to exceed budgeted costs in the state. The appropriation norm for wage costs is designed so that wage development in the export industry shall set the level. These changes were introduced in 1997 which means that it is not yet possible to assess their efficacy.

In conclusion…

To sum up, there are elements for concern with regard to wage formation in the years to come. Bargaining is taking place in an economy with strong growth, at the same time as there is a need for pay increases in occupations where there are shortages, where pay has fallen behind. However, changes may also have taken place in the Swedish labour market that permit some optimism about developments. Above all, this concerns the support for and understanding of the inflation target and the low inflation expectations that have been established. Institutional changes in the forms for wage formation, which have been carried out or are being planned, also work in a positive direction. Finally, globalisation and competition can have increased businesses' cost consciousness.

In the Riksbank's inflation report from December last year, the assessment was made that the improved demand situation would have an effect on pay increases during the forecast period even without the effect of accentuating pay spirals. The rate of wage increases was assessed as amounting to 4-4.5 per cent in 2000 and 2001,which means that real wages continue to increase at a historically high rate. My intention here is not to make another assessment of future wage trends. However, the way of functioning of the labour market will be put to the test in the coming years and it is motivated to monitor developments closely there.

The decision of the Executive Board of the Riksbank on 3 February to increase the repo rate by 0.50 percentage points from 3.25 to 3.75 per cent means that monetary policy is now being led in a somewhat less expansive direction. This decision was based on the assessments made in the Riksbank's inflation report from December last year and the cyclical indicators obtained subsequently. The picture of a strong cyclical upswing is confirmed and most indications point to an improvement in the prospects for growth. The interest rate increase is quite simply a normal component of the present cyclical situation. When the unused resources are successively taken into use, there is reason to take into consideration increasing inflationary pressure, which reduces the scope for an expansive monetary policy. The assessments on which current monetary policy is based assume that wage formation has largely been adapted to a low inflation economy. However, the risk scenario includes demands for adjustments of relative wages that can lead to higher pay increases.