

Speech

Deputy Governor Kristina Persson

MONDAY 1 JULY 2002

On the verge of Eurosystem membership – challenges from a Swedish perspective

Introduction

Let me begin by thanking you for the invitation to come here and speak. The issue I would like to highlight is how a possible Swedish membership of Stage Three of EMU could affect the Swedish labour market. To put this issue into some kind of perspective, I shall begin by briefly describing the changeover in economic policy, followed by the recent developments on the Swedish labour market. Finally, I shall discuss the changes to the labour market that might become necessary if Sweden joins the Eurosystem.

The changeover in economic policy

Over the past two decades there has been a pronounced reorientation in Swedish economic policy. For instance, the credit market and foreign exchange market have been deregulated, the tax system has been reformed, parts of the transfer system have been changed and competitive pressure has increased. These changes have contributed to improving the way the Swedish economy functions.

Price stability has thus become a statutory objective for monetary policy. As of 1 January 1999, the Riksbank has an obligation confirmed in law to maintain price stability. The Riksbank has chosen to operationalise this objective by means of an inflation target. The inflation target is worded as the annual CPI inflation being two per cent, with a tolerated deviation interval of plus/minus one percentage

SVERIGES RIKSBANK

Telephone
+46 8 787 00 00

Fax
+46 8 21 05 31

E-mail
registratorn@riksbank.se

point. Monetary policy shall thus be conducted to ensure that the purchasing power of the krona remains stable with regard to the basket of goods bought by the average Swedish household.

Low inflation is important for many reasons. When a central bank's target is to avoid high inflation and large fluctuations in the rate of price increase, it also contributes to stabilising economic activity. Practically all of the industrial nations that have changed over to an inflation target of the type we have in Sweden have seen a reduction in variations in inflation. When a central bank stabilises the rate of price increase, it can also contribute to reducing the risk of financial crises, which is especially important because bank crises, as the experiences of for example Sweden, Finland Norway and Japan show, are often linked to a rise in unemployment and a prolonged period of poor growth.

Sweden's experiences of inflation targeting are positive. Growth in the Swedish economy has been at an average of 3.0 per cent a year since 1994, while inflation has been low over several years. At the same time, open unemployment has declined from around 8 per cent in 1993 to less than 4 per cent in 2002. This can be compared with the 1970s and 1980s, when inflation was at an average rate of around 8 per cent and growth amounted to an average level of 2 per cent. This positive development is due to a large number of factors. One factor is that there were a large number of vacant resources to begin with, but it appears likely that a more credible economic policy also has contributed.

Fiscal policy has also played an important role in giving credibility to the economic policy pursued. The value of the budget consolidation can scarcely be exaggerated.

Concerning the functioning of the labour market, the changeover from fixed exchange rates and a relatively high rate of inflation to flexible exchange rates and an inflation target implies that high inflation and devaluation, like those Sweden experienced during the 70s and 80s, will no longer take care of the effects of excessively high wage increases. In that sense one could say that the responsibility for employment to a greater extent has moved over to the social partners.

Recent developments in the Swedish labour market

During the course of 2001, growth in the Swedish economy was subdued, while inflation, excluding so-called transitory prices, rose slightly. This raises questions regarding the development of the supply side in the economy. A possible explanation as to why inflation has increased at the same time as demand has weakened is that the growth rate in potential output has been weaker than was anticipated earlier.

Both production and investment are determined by fundamental factors such as demography, households' preferences and institutions, as well as regulatory systems. These factors in turn determine the development of production factors such as labour, capital and production techniques. The long-term sustainable growth rate is also very important to households' and companies' expectations of future growth in income and profits. Willingness to consume and to produce – both supply and demand – are in the long term determined by the same

fundamental factors. It is reasonable to assume that the variations in factors such as demography and institutional conditions are relatively limited in the short term. However, demography is likely to become a constraint on economic growth to an increasing extent throughout Europe.

Deviations between actual and potential production can arise. When consumption or production exceeds the long-term sustainable growth rate, the level of resource utilisation rises, which may exert inflationary pressure in the economy.

The fact that deviations can arise between actual and potential production is due to a number of slow-moving factors in the economy. Market imperfections, such as a lack of competition and transaction costs make both prices and production factors slow-moving, and mean that it takes time for actual production and consumption to adapt to changes in supply and demand in the economy. When adapting to changes in the fundamentals that determine growth or to disturbances, the rate of price increase often increases or declines during a period of time.

A central factor in determining aggregate growth in the economy is the labour supply. The growth rate in the number of hours worked slackened from 2.5 per cent in 1999 to approximately 0.5 per cent in 2001, while employment rose by approximately 2 per cent each year. The weak development in the number of hours worked during the period 1999 to 2001 is mainly connected to an increase in absence due to illness and a decline in the average working hours.

The growth in sick leave has brought down the number of hours worked over several years. The number of persons absent due to their own illness increased by an average of 13.6 per cent per year during the period 1999 to 2001. There has also been an increase at the beginning of this year. During the first quarter, the number of persons absent due to illness rose by an average of 2.8 per cent. The rate of increase has thus declined. The question is whether the increase in sick leave is due to cyclical or structural factors. Historically, sick leave has increased, with some time lag, when the Swedish economy has been operating at high pressure (see diagram 1). If the upswing in the number of absences is due to economic reasons, it is possible that the current high level is a repercussion of the economic boom during 1999-2000. In other words, we could expect the absences due to illness to fall when the economic slowdown makes its mark on the labour market.

It is of course also possible that regulatory changes and levels of compensation have had some significance for the rise in sick leave.¹ The next diagram shows that if the figures for sick leave are divided up according to duration, it is mainly the long-term sick leave that has increased in recent years (see diagram 2). The number of persons who have received sickness benefit for one year or more increased by an average of 26.8 per cent during the period 1999 to 2001. One explanation for this development may be that the rules for qualifying for sickness

¹ See, for instance, Henrekson M. and M. Persson, The Effects on Sick Leave of Changes in the Sickness Insurance System, Forthcoming, *Journal of Labor Economics*, Vol. 22, No. 1, 2004.

pension, which is often preceded by a very prolonged period of sick leave, were made more stringent in 1997.²

There are also studies that show a connection between changes in the levels of compensation for sickness or other rules in the national insurance system, and behaviour with regard to reporting sick. For instance, when the system of no compensation on the first day of sick leave was abolished and sickness benefit was raised in the 1980s, sick leave increased, and when the rules were made stricter and the benefits less generous in the 1990s, sick leave declined. Incentives connected with the interactions of unemployment insurance with sickness insurance may also play a part in the increase in the number of persons reporting sick. In other words, one cannot rule out the possibility that the increases in sickness benefit in recent years could have contributed to the increase in those reporting sick.

Furthermore, changes in the age composition of the working population may also have had some significance. That is to say, there may be demographic elements in the recent increases in sick leave, bearing in mind that the age group 55-64 years has increased as a percentage of the working population during the greater part of the 1990s. This age group generally has a higher frequency of sick leave than the average.

Another explanation may be connected with the large savings made in the public sector during the 1990s in order to get to grips with the budget deficit. The savings may have affected both employees and, for example, users of medical and childcare facilities. If, for instance, the quality of day-care centres declines, and the strain on the personnel increases, reporting in sick may become an alternative for both parents and personnel.

The explanation for the increasing level of sick leave is probably both complex and difficult to get a grip of. The rise is probably due to both cyclical and structural reasons, with several different types of structural explanations. The government's opinion is, for example, that the working environment has great significance. If a large percentage of the sick leave is due to structural reasons, this is obviously a more fundamental problem for the Swedish labour market, which may entail an increased risk of a labour shortage in the future, with subsequent negative effects on potential growth.

Yet another factor that has made a negative contribution to the growth in hours worked in recent years is average working hours. Average working hours declined by 1.4 per cent in 2001 and continued to decline during the first quarter (see diagram 3). Variations in this can be explained by the occurrence of "labour hoarding". This entails companies choosing to retain the labour force in the initial phase of a downturn in economic activity and regulating working hours instead, for instance, by reducing overtime – a development we have seen recently. It is only at a later stage that companies start to make cuts in personnel. One of the reasons for this behaviour is that the labour force is not an entirely mobile production factor. Companies' labour costs consist not merely of wages, but also of costs for recruiting and training new personnel.

² Lindwall U. and P. Skogman Thoursie (2000), *Sjukfrånvaro och förtidspension – En beskrivning och analys av utvecklingen de senaste decennierna (Sick leave and sick pensions – A description and analysis of developments over the past decades)*, 2000:2, the Swedish National Social Insurance Board.

This is probably more common in knowledge-intensive sectors, such as some branches of the private services sector, and could thus become increasingly important in years to come. Institutional factors may also have significance for the development of average working hours. For instance, in the negotiated central wage agreements from 1998, particularly within manufacturing, working hours were adapted to economic activity, which may have contributed to the recent dampening of average working hours.

To sum up, we do not have a clear answer as to exactly how the recent developments in average working hours can be explained. The response of the labour market to changes in economic activity is one of many fields that I think should become subject to further investigation.

Another interesting research field is whether the Swedish labour market is able to deal with necessary changes in relative wages. The labour shortages in the public sector, with possible wage increases as a consequence, can have effects on inflation pressures, for instance due to wage spread between different sectors. There is a concern that groups of employees within the public sector, having a favourable labour market situation, could set the norm for up-coming wage agreement negotiations. However, studies in this field indicate that this has not been the case before, although naturally there is always a possibility that this type of pattern could arise in the future.³

EMU and the labour market

A core issue in the current EMU debate concerns whether changes will be required in the Swedish labour market to prevent the inflation rate from increasing if we join the single currency system and, if so, what these changes might comprise.

Unit labour costs, that is to say, wage costs adjusted for growth in productivity, have increased slightly more rapidly in Sweden than in the Euro area recently. The statistics in this diagram are not necessarily the best for studying developments in Sweden alone, but work well for comparisons between countries. The diagram shows that unit labour costs have increased on average by 1.6 percentage points more in Sweden than the Euro area during the period 1999 to 2001 (see diagram 4).

As the possibility to conduct an independent economic policy declines, the need for functioning adjustment mechanisms increases. In addition, increased flexibility in the labour market is most likely necessary to stabilise variations in production and employment. Generally speaking, the lack of an independent national monetary policy means that any disturbances to the Swedish economy not felt in the same way in other EMU countries, would require greater flexibility in factor and product markets in Sweden. The requirement for increased flexibility in the labour market could apply both to increased variability in nominal wage increases and to increased geographical and professional mobility of the labour force.

³ See Tägtström Sara (2000), "The wage spread between different sectors in Sweden, *Sveriges Riksbank Economic Review*, 2000:4, Stockholm.

Increased adaptation to the rate of wage increase in the Euro area and increased variability in nominal wage costs?

The design of the negotiation system probably has significance both for the adaptation of wage increases to that within the Euro area and for the degree of nominal wage flexibility. Wage formation in Sweden can be characterised by a combination of centralised and decentralised agreements. During 2001 trade and industry had a relatively high percentage of agreements with local wage formation. Almost 70 per cent of employees in the private sector had wage agreements that entailed complete or partial local wage formation. The percentage of local wage agreements in the public sector has also increased during the 1990s.

A more decentralised wage formation process could entail greater nominal wage flexibility, as wage costs could then be connected to a greater extent to the individual company's situation. On the other hand, a more co-ordinated wage formation could also entail increased flexibility, as it would make it easier for those determining wages at a central level to take the overall considerations required to enable the economy as a whole to develop favourably. It is unclear to what extent a potential Swedish participation in Stage Three of EMU would entail incentives for a more decentralised or more co-ordinated wage formation process. The existence of "social partnerships" in several EMU countries, for instance, the Netherlands and Ireland, where the social partners and sometimes even the government have worked out guidelines for wage formation, could indicate a development towards more co-ordinated wage formation in Europe. It would be interesting to hear your views on this issue - whether the experiences of the social partnerships have been positive or not.

However, a potential Swedish membership of the Eurosystem could also weaken the incentives for restraint in wage formation, which could lead to deterioration in competitiveness and eventually higher levels of unemployment.⁴ Wage formation can be seen as a "game" between the social partners and the central bank. If the wage negotiations are relatively centralised, negotiators must take into account how the agreements will affect monetary policy. It is clear that excessively high wage increases can have negative effects on growth and employment. If a central bank outside of the EMU has an inflation target, the social partners may also estimate that excessively high wage increases will entail interest rate rises, which will reinforce the negative effects. This might not be the case in the event of membership of the single currency. Particularly if the individual Member State is small, it is not likely, that the ECB will react to high wage increases in this country alone. The negative consequences of excessively high wage increases may thus appear much greater to the social partners in an individual country outside of the EMU than to a member country.

Nominal wage flexibility can also be discussed on the basis of other different points of departure.⁵ One is the length of the central wage agreement periods. This

⁴ See, for instance, Calmfors L. (2000), "EMU och arbetslösheten" (EMU and unemployment), *Ekonomisk Debatt*, Volume 28, no. 2.

⁵ See, for instance, Calmfors L. (2002), "EMU:s effekter på lönebildningen" (The effects of the EMU on wage formation), Appendix 2 to *Stabiliseringspolitik i valutaunionen (Stabilisation policy in the monetary union)*, Kommittén för stabiliseringspolitik för full sysselsättning vid ett svenskt medlemskap

reflects a balance between, on the one side, keeping down negotiating costs – including the risk of labour market conflicts – and on the other side ensuring that wages are not locked for an excessively long period, so that wage levels can be adjusted in the event of an unexpected shock. If membership of Stage Three of EMU were to give rise to greater fluctuations in economic activity than under a domestic monetary and foreign exchange policy, there may be an increased tendency to choose shorter agreement periods. If membership were to lead to more stable inflation than now, the agreement periods could instead become longer, as it would be considered easier to predict nominal wage increases.

The degree of wage flexibility is also affected by social norms – reductions in nominal wages are most often considered unacceptable. It appears that nominal wage reductions can only be implemented in extreme situations, for instance, if a company's survival is at stake. EMU membership might not comprise a sufficiently major change.

Econometric studies of how wage flexibility is affected by, for instance, ERM membership give mixed evidence. Wage formation thus represents an uncertainty factor. Some studies indicate greater wage flexibility and others show no effect at all. The conclusion reached by the stabilisation policy committee is that Swedish membership of the Eurosystem most likely will entail wages becoming more flexible, but that changes could be limited.⁶ The Riksbank has not yet taken a stand on the committee's report; we will be presenting our views on it in the autumn.

The consequences of excessively high wage increases in the event of Swedish membership of the Eurosystem can be compared to "learning the hard way", i.e. that Sweden would lose competitiveness and suffer rising unemployment. This type of development could force an adaptation in wages in the long run. However, it risks being a costly route, particularly with regard to unemployment, which could stick at higher equilibrium levels than before. In other words, it is something that we should all endeavour to avoid.

There is also a possibility that employers would resist demands for higher wage increases to a greater extent than before, as it would no longer be possible for a depreciation of the krona to help maintain competitiveness.

Increased mobility in the labour market?

If domestic prices and wages are insufficiently flexible when competitive conditions change, the labour force may instead choose to leave a country, region or sector and seek employment elsewhere. And if there is a labour shortage, overheating can to some extent be counteracted by, for instance, bringing in labour from other countries or regions with higher unemployment. An increased mobility in the

i valutaunionen (The Government Commission on Stabilisation Policy for Full Employment in the Event of Swedish Membership of the Monetary Union), SOU 2002:16.

⁶ See *Stabiliseringspolitik i valutaunionen - slutbetänkande (Stabilisation Policy in the Monetary Union - final report)*, Kommittén för stabiliseringspolitik för full sysselsättning vid ett svenskt medlemskap i valutaunionen (The Government Commission on Stabilisation Policy for Full Employment in the Event of Swedish Membership of the Monetary Union), SOU 2002:16.

labour market in terms of both geography and profession could thus compensate for sticky wages. Increased labour market flexibility also implies a better allocation of resources and thus a higher potential growth. Mobility in the labour market plays a major role in the way the labour market functions today and mobility both within and between the member states will probably take on even greater significance if Sweden joins the Eurosystem.

How mobile is the Swedish labour market? A high level of mobility in the labour market can be characterised by a good matching between job seekers and job vacancies. The Beveridge Curve, which shows the relationship between unemployment and job vacancies, can be used to illustrate matching in the labour market (see Diagram 5). An increase in the number of vacancies will lead to an increase in the number of jobs and a decline in unemployment. This means that the curve normally has a negative slope. An outward shift in the curve can be interpreted as deterioration in matching in the labour market, as the number of vacancies for each given level of unemployment is higher. Movements along the curve may depend on economic changes. When there is an improvement in the level of economic activity, the number of vacancies and recruitment rise, but at the same time the difficulties and time required to fill the vacancies increase.

The large rise in the unemployment rate in Sweden at the beginning of the 1990s was followed by a reduction in the number of vacancies, which can be interpreted as a movement along the curve. During the mid-1990s, unemployment appeared to have stabilised at a high level, but in recent years unemployment has been held back, while the vacancy ratio has risen. The Beveridge Curve appears to lie further out than before, which could indicate that the matching process has deteriorated and that the labour market has become less flexible. One reason for a possible outward shift could be that the persons who became unemployed during the crisis years of the 1990s have had difficulty in returning to the labour market. Long-term unemployment can weaken the incentives for job searching and with that matching in the labour market deteriorates.⁷ It could also be the case that demand for a professional group's skills has permanently or partly disappeared. For instance, the number of jobs in manufacturing has declined during the 1990s. However, it is still too early to comment on whether the Beveridge Curve has shifted outwards. When the Beveridge Curve is reported for monthly data, the picture is partly different. The outward shift is less clear and the curve also appears to have shown a tendency to move inwards again during 2001.

There are considerable regional differences in the level of unemployment in the Swedish labour market, which indicates that increased mobility would be desirable. During the first quarter of 2002 the difference between the county with the lowest level of unemployment, the county of Jönköping, and that with the highest level of unemployment, the county of Norrbotten, amounted to 4.2 percentage points (see Diagram 6). However, the differences have declined somewhat in recent years. Unemployment rates also vary between different professional groups. For instance, the number of unemployed trade union members in the construction sector amounted to 7.2 per cent in April, which can be compared with a figure of 2.1 per cent for the white-collar trade unions. With regard to construction workers, it is

⁷ See Björklund et al. (2000), *Arbetsmarknaden (The Labour Market)*, SNS Förlag, Kristianstad.

striking that the percentage of unemployed trade union members in April amounted to 2.0 per cent in the county of Stockholm and to a huge 16.4 per cent in the county of Norrbotten, and this was in a situation with a relatively good level of economic activity in the construction sector.

Today's Swedish economy is characterised by a rapid rate of change, there is at present both a surplus and a shortage of labour in all regions. This makes increased demands on education, labour market measures and mobility.

At the same time as a greater degree of mobility increases efficiency, there may be a conflict between geographical mobility and regional interests. Certain regions that already suffer from the problems of a diminishing population will experience even greater problems for growth when parts of the labour force move away. In addition, it is often difficult to achieve the desired geographical mobility for social reasons. The fact that two persons in a household are in gainful employment is one reason and differences in the cost of living is another. The housing situation in, for instance, the Stockholm area also makes it difficult for people to move to this region.

As you already know, mobility between the EU member states is low. According to the Commission, less than 2 per cent of EU nationals are resident in another EU member state. The mobility, on an annual basis, of EU nationals within the EU is less than 0.4 per cent of the resident population (about 1.5 million persons). In 1998, migration between states in the USA was approximately 2.4 per cent of the population. The low levels of mobility reflect various institutional differences (such as, for example, professional recognition of qualifications) as well as cultural and linguistic differences between the EU member states.⁸

A common perception in Sweden is that the mobility of the labour force will not play any major role - at least within the near future - in stabilising fluctuations in production and employment that arise from country-specific shocks within the EMU area.

Let me finally conclude by stating that wage formation is central to the development of the Swedish economy. The Riksbank's primary task is to uphold the inflation target. The Riksbank shall also, pursuant to the background to the Sveriges Riksbank Act, safeguard growth and employment if this can be attained without neglecting the price stability objective.

The challenge of maintaining price stability and a good development in employment will remain if and when Sweden takes part in the Third Stage of EMU. It is therefore important that, for instance, regulatory systems, traditions and labour market policy should lay the foundation for sustainable growth, a high level of employment and a low inflation rate. It is therefore in the interests of the Riksbank to participate in a dialogue and the development of knowledge that will facilitate this dialogue.

I have here today identified a number of areas for future study and research. They have to do with the adaptation of wages in Sweden to the rate of wage increase in the Euro area, increased variability in nominal wage costs in Sweden

⁸ Communication, *New European Labour Markets, Open to All, with Access for All*, COM (2001)116.

and increased geographical and professional mobility in the European labour market. Let me to this add the big issue of demographic change and its effects on labour supply. Another interesting question, which is of imminent importance to Sweden, has to do with what effects wage increases in the public sector will have on inflation. I hope that the trade unions in Europe will take an active part in initiating and carrying out research projects in these fields.

Thank you for listening!