Focus: Economic policy

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A whiff of '88

The lull before the storm?

Recently a whiff of an earlier series of events in the Swedish economy has emerged. The election year 1988 was the lull before the storm that broke out in the early 1990s. At that time, a number of earlier economic problems seemed reasonably under control, and the government began speaking of new reforms – at the same time as problems were growing below the surface. In a number of respects, issues and the moods characteristic of the economic policy debate at that time are cropping up again today.

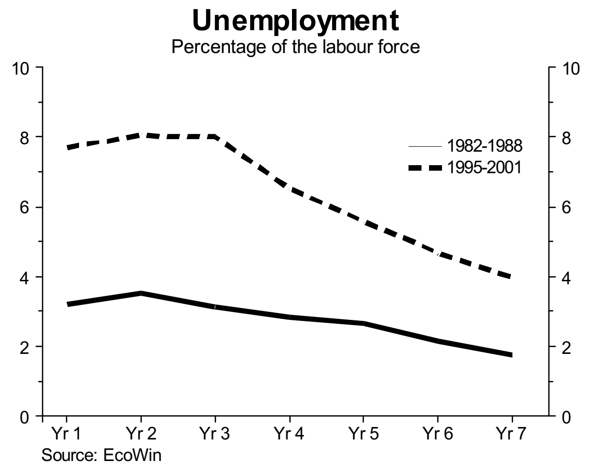
- Capacity utilisation in the economy is rising, and wage formation is being put to the test.
- Once the struggle against the budget crisis is over, new expenditure demands will arise and restructuring policy is being marginalised when it is needed the most.
- The monetary policy regime is encountering new difficulties, and goal conflicts are enticing people to hope for easier ways out of these problems.

The parallels with 1988 are important and deserve to be highlighted. The "crisis cycles" during the 1980s and 1990s show interesting similarities in terms of threat scenarios and political dynamics. Yet there are also important differences. The institutional framework today is substantially more solid, while today's leading politicians still bear the scars of the early 1990s crisis. As a result, today's problems are not growing as large and there is better ability to deal with them.

In a longer-term perspective, however, we can foresee another threat scenario. Weak growth policy, combined with international pressure on Swedish tax bases, will cut into public resources. When this coincides with increasing demographic needs, as well as political unwillingness to make any crucial decisions with regard to prioritisations or systemic changes on the expenditure side, tensions will increase. However, this time the threat is hardly a crash. Instead the threat scenario consists of tendencies towards stagnation, accompanied by persistent problems and muddling through.

On the way to overheating?

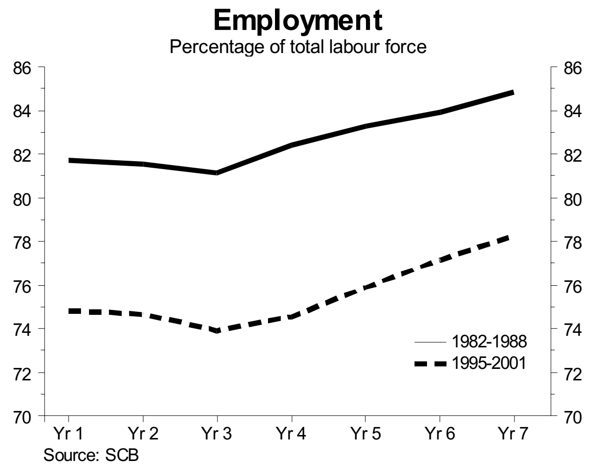
The Swedish economy has started to recover after last year's international slump. This recovery is beginning at a stage when unemployment is lower than it has been in a decade. Rapidly rising absences due to illness are helping to dim the supply situation. Under such circumstances, it is not so strange that issues centring on capacity shortages and bottlenecks are high on the agenda.



Economic Research

Focus on wage formation

At that time, Swedish wage formation was squeezed both by its inherent compensation dynamic and by a rising labour shortage. During 1987 and 1988, annual wage and salary increases nevertheless slowed from an earlier 8 per cent or so to just above 6 per cent. Wage policy initiatives on the part of the government in the form of tax cuts were one element of what tuned out to be the final death throes of 1980s wage round co-ordination. Since inflation had also slowed from two-digit annual figures in the early 1980s to about 4 per cent in 1986-87, it was possible to get the impression that Swedish price and wage formation were moving towards adjusting to developments in other countries and that the "third way" perhaps had an end station other than a steep slide in the krona. When the economy became even more obviously overheated in 1989-90, inhibitions disappeared, resulting in a feeding frenzy and two-figure pay increases.



We can see parallels to the situation of today. The downshift to lower pay increase figures after the early 90s economic crisis took time. For example, the 1995 wage round resulted in pay hikes of 5-6 per cent, despite record-breaking unemployment. The increased credibility of the official inflation target and the fact that modest nominal hikes have yielded major increases in real wages have made wage formation easier and increased acceptance of the new rules of the game. The 2001 wage round resulted in relatively modest pay increases despite a tight labour market situation, which many observers took as evidence that the Swedish wage formation process had fundamentally improved. An improved institutional framework for negotiations due to the 1997 Agreement on Industrial Development and Wage Formation (often called the "Industrial Agreement") seemed to be one of the cornerstones of this successful structure.

Over the past year, however, a number of signs have appeared which indicate that this system is beginning to lose its shine. Patience is wearing thin and there is mounting frustration inside the trade union movement that relatively high inflation in the past year is undermining real wages. The Industrial Agreement is being squeezed from different directions. Rising wage drift in various service sectors, high pay increases in large portions of the public sector and the construction workers' long-term target of a wage level 25 per cent above other workers are factors complicating the future of the Industrial Agreement. This is unpleasantly reminiscent of the 1980s wage-price spiral.

Important differences

However, there are important differences in terms of risks and the degree of overheating, as well as with regard to wage formation mechanisms.

- **The labour market is not as tight as at the end of the 1980s.** Unemployment is higher and the potential for boosting labour supply is greater, at the same time as companies are not currently announcing any obvious shortage of labour. Overall, this means a significant difference in the degree of labour market tightness.
- **Economic stabilisation policy is better equipped.** In the 1980s, the deregulation of the credit market combined with the taxation and deduction rules then in force led to overheated demand, in which a

rapid expansion in lending and an accompanying real estate bubble were central features. Economic policy offered no short-term countermeasures. Interest rate policy was trapped by the fixed krona exchange rate, and the threat of a cost crisis was too long-term and applied to an excessively small portion of the economy to have a sufficient disciplining effect. Today, however, the interest rate weapon is available to an independent Riksbank and can be activated directly on a scale that depends entirely on the severity of overheating.

- **Wage formation has become firmer.** In spite of everything, all the players in the wage formation process learned important lessons from the 1980s, and their power of resistance to wage spirals is stronger. In addition, too much is at stake, both for employers and employees, to repeat the failures of the 1980s. There is a greater awareness that the negotiation system alone is incapable of restraining pay increases in an overheated economy. This is reflected in the relative understanding the trade union side has shown for the Riksbank's interest rate hikes so far this year. This is in stark contrast to the strong trade union opposition to austerity measures in the late 1980s. The conflict between the Trade Union Confederation (LO) and the Ministry of Finance, then called the "War of the Roses", for example, culminated in the spring of 1989 in protests against the modest austerity measures being proposed. However, the fact that the wage formation process might also need support from fiscal and restructuring policy, for example by paying lower benefit levels to absentees, has so far been too difficult to swallow.

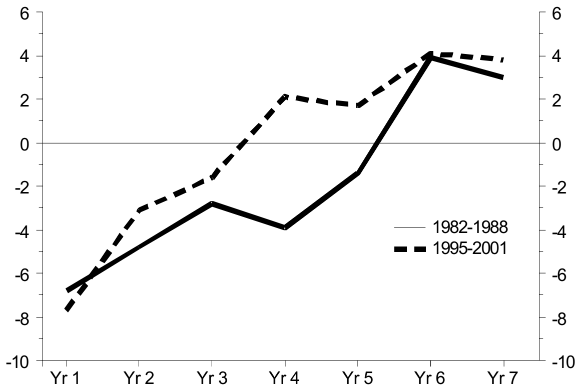
Demand for rewards when budget crises are overcome

Perhaps the most striking parallel to 1988 concerns the sea change in public finances. Deficits equivalent to 10-12 per cent of GDP a decade ago have again been replaced by sizeable surpluses. In an international comparison, these shifts of more than 15 per cent of GDP are unequalled. Such dramatic budget fluctuations seem to generate their own political dynamic, so that in a number of respects we now seem to be back in the same phase as in 1988.

The political explanations offered both during the 1980s and 1990s, when the central government budget was being restored to good health, were primarily based on bookkeeping arguments. Unsustainable deficits and galloping government debt had to be combated with great vigour; in such a battle, it is sometimes necessary to take steps that you genuinely dislike ("We were forced to do this"). Such a political tactic inevitably creates demands for the restoration of lost benefits when times improve. Today, as in 1988, when expenditure demands are being formulated they have strong legitimacy because of the earlier rhetoric. Cutbacks approved earlier, which have been more or less explicitly described as temporary, are now to be phased out. Investments in fundamental, prioritised fields that had to be sacrificed due to budget constraints must now be implemented etc. In such a situation, it is not easy to shift the arguments from a bookkeeping-based perspective to one based on restructuring or stabilisation policy.

General government financial balances

Per cent of GDP



Source: OECD

In 1988, expenditure demands were formulated on a broad front. Expanded public sector services and social welfare reforms - such as more comprehensive parental insurance, a sixth paid holiday week (an election promise that was partly buried) etc - were on the agenda. Responding to galloping absenteeism with an unpaid first day of absence was not politically possible in this environment, but instead was implemented a few years later when the crisis was in full bloom.

In these respects, we can now hear ghost-like echoes from 1988. The benefit levels in the sick pay system and the unemployment insurance system need to be raised. Investments in health care, schools and social services need to be intensified, etc. In the current situation, it is difficult to see how the government budget expenditure ceilings can be preserved. The budget margin has been used up, while costs for such items as absences due to illness show no signs of shrinking.

Once again, growth and restructuring policy seem marginalised in this climate. Indicative of how the government is minimising the role of economic incentives in people's choices between work and absences is that its planned tax cut on labour (the fourth stage in rolling back higher employee payroll fees imposed during the mid-90s pension reform) seems to be on ice, while various types of expenditures are rising.

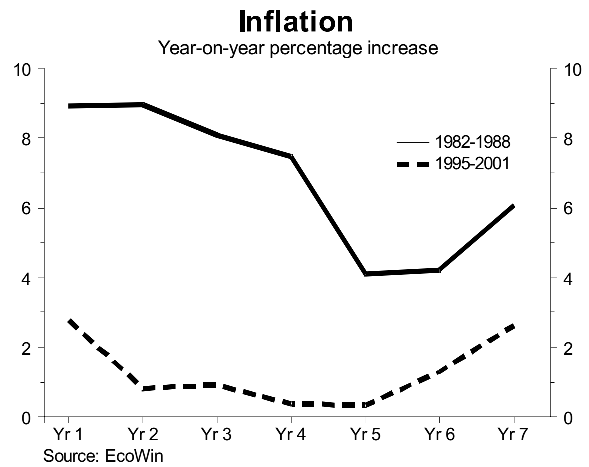
But tighter limits

However, in terms of budget policy there are also some important differences that indicate that today's situation is more favourable than 1988.

- **More robust surplus:** The budget reform policy of the 1990s was based to a larger extent on genuine rule changes concerning public sector expenditures and revenues. The surpluses of the late 1980s were instead largely an indirect consequence of the overheated economy and the fact that tax revenues benefited in the short term from galloping inflation. Today's surplus is therefore more robust than that of the late 1980s.
- **More stable framework:** Even if one may fear that the expenditure ceilings are in danger during the election year 2002, the institutional framework of budget policy operates entirely differently. Three-year budget frameworks, expenditure ceilings and the requirement that the opposition must submit a comprehensive budget alternative to be able to vote down the government budget together mean that the type of expenditure accumulation that created problems in the 1980s is no longer possible today.

Currency regime being put to the test

The year 1988 was something of a lull before the storm in terms of the credibility of the then-fixed exchange rate policy. As described above, inflation and the rate of pay increases had in fact slowed somewhat, despite increasing tightness in the labour market. Nevertheless, a public debate was under way that questioned whether the large gap in the unemployment rate in Sweden and in the then-smaller EU area (some 2 per cent and 8-10 per cent, respectively) could be preserved, given the prevailing regime. This debate received support from a number of American economists who felt that the fixed exchange rate was an unnecessary straitjacket, which would force Swedish unemployment upward.



The "Brookings Report" published in 1987 in collaboration with the Centre for Business and Policy Studies (SNS) had a relatively large impact. This report proposed that Sweden should accept somewhat higher inflation than other countries, as a highly reasonable price for its substantially lower unemployment. In order for this to be reconcilable with Sweden's exchange rate policy, the report proposed a continuous write-down of the krona's reference rate. This idea received some support in Swedish public discourse and was developed by LO economists and others a year or so later into a similar proposal.

We can trace a similar trend in today's economic policy debate. With Sweden's monetary policy regime including an inflation target facing a serious test for the first time, this is leading to various types of questioning. On the one hand, people are raising the question of whether the inflation target is on its way towards losing credibility since the Riksbank is incapable of dealing with the situation and is in the process of losing its grip on inflation-fighting. Another type of questioning that has clear echoes from the 1980s concerns analysis related to the goal conflict between inflation and unemployment. The idea that a less ambitious or less explicit inflation target might provide room for lower unemployment is being introduced from various quarters.

It is naturally not unreasonable to question the prevailing regime. After the success of inflation target policies around the world in recent years, there is perhaps an excessive faith in the possibility of controlling and forecasting inflation. In our opinion, however, today it is not justified to be overly worried that Sweden's inflation target cannot be met, given the means that the Riksbank has at its disposal. Nor is it likely that any adjustment in the formulation of its inflation target would provide any greater opportunities for lasting lower unemployment. To change the inflation target today could ruin the costly investment in credibility undertaken in recent years. The boring old recommendation that improved incentive structure is the path to lower sustainable unemployment thus remains valid.

Conclusions

We can see how the mood of economic policy, in some respects, contains a strong whiff of 1988. A pessimist will have no difficulty distinguishing the similarities. A labour market that is getting progressively tighter, with discernible threats of overheating and with rising absences due to illness worsening the situation. A wage formation system that shows some signs of losing its grip after a period of hopeful improvements. A budget policy that is facing demands for restoration of lost benefits and traditional rewards to those who have waited, just when structural improvements are needed the most. A gnawing concern that monetary policy will not be capable of handling the situation and, concurrently, an incipient debate on whether changing the anchor of this policy might be an easy path away from the increasingly troublesome goal conflict between inflation and the labour market. Considering what happened in the years after the 1988 election – the run-up to the major economic crisis of 1991-93 – it is easy to see the writing on the wall.

At the same time, it is not difficult to identify major differences. The primary difference is that the institutional framework is much more solid today. The most important elements of this are:

- An independent Riksbank with a floating exchange rate and an inflation target.
- A transparent budget regime with expenditure ceilings and, in the background, also the framework of the Maastricht Treaty.
- A wage formation system whose players have a higher level of economic sophistication.

The fact that the generation of politicians who are now leading the country was deeply affected by the early 1990s crisis will also help ensure that the whiff of '88 remains just that - a whiff.

In a longer perspective, however, darker clouds are discernible. Weak growth policy combined with international pressure on

Swedish tax bases will limit public sector resources. When this is accompanied by increased demographic needs and by political unwillingness to make some crucial decisions related to prioritisations or systemic changes on the expenditure side, tensions will rise. In the long run, this cannot be solved only by a self-imposed technical framework, in the shape of expenditure ceilings and budget targets. Given firmer frameworks and tighter spending limits, this time a strategy-less policy will not trigger a market explosion, but it will instead contribute to gradually weaker growth and to a widening economic gap between Sweden and other countries.

What will happen this time, if official policy does not get its act together, is thus not a crescendo ending in a crash – as occurred in 1988-92 – but an increasing tendency towards stagnation, accompanied by accentuated and persistent problems.

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