Can social pacts spur inflation?

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Claire Jones, *The Financial Times*, December 2019

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In the era of the superstar central banker, there was a whiff of the great and powerful Oz in the way monetary policymakers behaved.

Markets are often portrayed as the bad guys, the ones asking for more and more cheap money to enrich themselves as others suffer. But during the Great Moderation of the 1990s and early noughties officials themselves were complicit in the construction of a universe in which they, and only they, could provide the answer. That answer being that if they could keep inflation tepid at, say, 2 per cent everything would work out just fine.

We've moved on since then. In a speech packed full of parting shots, the European Central Bank's soon-to-be ex- executive board member Benoît Cœuré last week kept his sharpest arrow for the idea of "the omnipotent central banker that can mechanically steer inflation". From the speech:

> If we communicate that we aim to maintain inflation at, say, 1.9 per cent, then we should not be surprised if the public expects us to control inflation up to the first decimal point. It significantly raises the bar for maintaining the credibility of monetary policy, particularly given how little the public actually knows about inflation and monetary policy.

Zing.

He’s gone further than most here. But after ten years of below-par inflation (and its corollary — lacklustre growth), many policymakers are now calling on governments and other social partners to support them in their fight to lift price pressures to a level that would signal all is well in the economy.

A few have explicitly called for trade unions and businesses to help out by raising wages. And it is these interactions between wage-setters and policymakers that are the focus of a paper published by the Bank for International Settlements, the so-called central bankers’ bank, last week. Here’s an excerpt:

> As of today, monetary policy has been more or less left to stabilise inflation on its own. Central banks have put in place an extremely accommodative stance for an extended period of time. As political economy conditions evolve, this role should be progressively substituted by rebalancing the macro policy mix with a more expansionary fiscal policy. More importantly, social partners and governments control an extremely powerful lever, ie the setting of wages at least in the public sector and potentially in the private sector, to re-anchor inflation expectations near 2 per cent.

The paper’s a good round-up of how several countries each overcame high inflation (mostly during the 1970s and 1980s) through what former ECB president Jean-Claude Trichet called “consensus packages” between various social partners that all cut wages.

But can these packages work this time around when we need wages to rise? We have our doubts.

Take the case of Finland, which we want to focus on as it has recently seen wages both stagnate and then rise (a little) again.

The BIS covers a central bank-approved tripartite agreement between the government, trade unions and employer unions signed in June 2016 (mostly to enhance competitiveness, inflation wasn’t actually that high).

> The plan included an increase in employees’ working time by 24 hours per annum without any increase in pay; a cut in public sector employee bonuses of 30 per cent between 2017 and 2019; a shift of social security contributions from employers to employees of nearly 4 per cent over four years; and the freezing of all wages in 2017.

The plan did indeed help to lower inflation -- though it put enormous pressure on the social fabric.

Finland’s 2016 competitiveness pact

In per cent Graph 7

The shaded region represents the year of the plan. The dotted lines are the four-year historical average before and after the year of the plan for each of the series. Wage inflation definition may vary for each country.

Sources: National data; BIS calculations.

The recent uptick may well be down to an improved deal agreed in 2018:

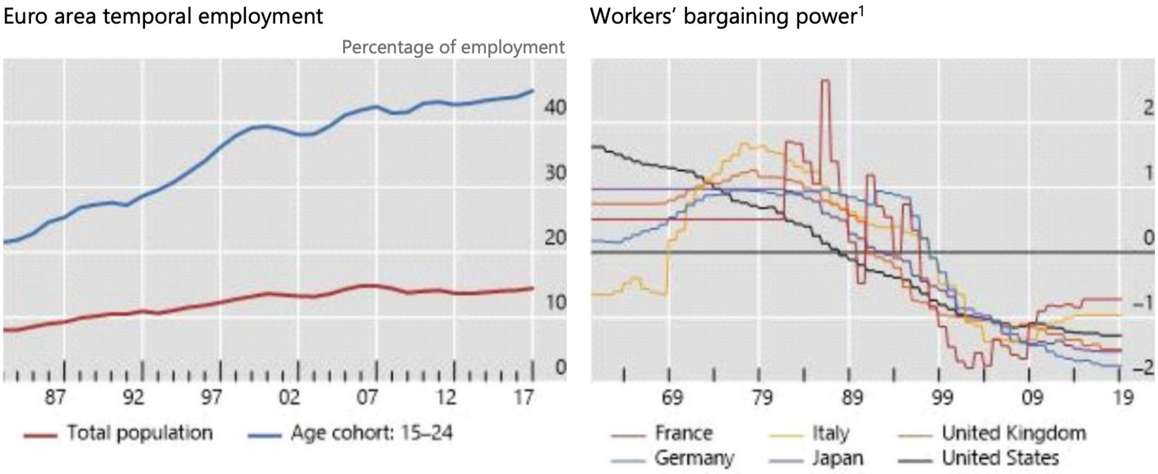
> As Mario Draghi prepares to ditch some of his crisis-era stimulus for the eurozone, the European Central Bank’s president has become increasingly reliant on people such as Ismo Kokko.
>
> Mr Kokko, an adviser on collective bargaining for Finland’s SAK trade union confederation, has helped seal a 3.2 per cent pay rise spread over the next two years for about 90 per cent of the country’s workers. The deal was a marked improvement on the previous wage round — when workers received no pay increase at all. “It’s not a big rise,” Mr Kokko told the Financial Times. “No one is getting rich. But after many lean years, it helps.”

Clearly higher wages will do no harm to price pressures. But will they do as much economic “good” as cuts did in earlier decades? Looking at the Finnish case, we would sound two notes of scepticism. The first is that a 3.2 per cent deal over two years represents a hike that is substantially lower than the ECB goal for inflation, and overall price pressures remain well below par. The second is that Finland is pretty unique in having enough of a social compact that 90 per cent of workers are covered by a pay deal — and you would therefore expect the impact here to be much stronger than elsewhere.

As the BIS paper points out, union membership in advanced economies is in decline. And that has, we suspect, cast a long shadow on the relationship between wage growth and productivity. At the same time temporary work has become more commonplace, as have older workers most interested in keeping hold of pension rights than hiking their wages.

We think all of these trends lessen the chances that powerful social compacts of sharp pay rises can be agreed in many advanced economies. We also believe that precarity and ageing will mean people will want to save more — blunting the impact of wages on price pressures.

Temporary employment and workers' bargaining power Graph 9



[1] A measure of pricing power is constructed by applying the method of principal components to changes in four indicators of relevant labour market conditions: collective bargaining coverage, employment protection, union coverage and union density.

Sources: OECD; BIS calculations.

Something else is at play here too. Beyond the walls of the central bank, the public clearly has a sense that all is not well in the economy. Yet this is not the 1970s and 1980s, when double-digit inflation was most definitely a big problem in most people's eyes. Grievances this time around focus on issues such as inequality and the retrenchment from globalisation towards economic nationalism.

As far as most people are concerned, there is more than enough inflation. Cœuré noted in his speech that most households think the average rate in the eurozone between 2004 and last year has been 9 per cent (in fact it was 1.6 per cent). That's partly down to higher housing costs (which are not wholly included in central banks' measurement of inflation). We think this gulf between real and imagined inflation also signals that it just isn't on people's radar to the degree it was when Grandmaster Flash was checking it back in 1982 (@ 2.15 here).

We've believed in the omnipotent great-and-powerful wizard for so long that when the curtain is pulled back to reveal an old man, it is difficult to know what the solution is. Social contracts could work, but society looks more torn to us now than we can ever remember.

We're still a long way from home, Toto. And we fear it'll take more than a pair of ruby slippers clicking and hoping for a pact to bring us back.