Central Banks Warm To Collective Bargaining

Ronald Janssen 30 March 2016

Something peculiar is happening. Up until recently, many central bankers were looking at robust collective bargaining and wage formation systems as a possible source for inflationary wage developments. Indeed, central banks, and the ECB in particular, have on numerous occasions called for more flexible and decentralised (read: weakened) wage bargaining systems so as to remove any inflationary threat to price stability targets coming from hikes in wages. Currently however, we seem to be observing something of a change in their thinking. This is most obvious in Japan but also noticeable in the UK and even popping up in some of the thinking of ECB policy makers.

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Japan: Lessons from 15 year deflation

Let's start with Japan which, traumatised as it is by 15 years of deflation, has been leading the way here. As long as two years ago, at the Summer 2014 Jackson Hole conference where Mario Draghi announced for the first time the (overdue) coming of quantitative easing to the Euro Area, the governor of the Japanese Central Bank, Haruhiko Kuroda, testified to the vicious interaction that took place in Japan between falling prices and falling wages. Hit by an initial negative demand shock (the bursting of the asset price bubble), business turned the squeeze on wages by, amongst other things, refusing to participate any longer in coordinated wage bargaining rounds (the so called Spring offensive) and resorting instead to company based wage bargaining where employers are able to extract substantially more concessions from workers.. Whereas this type of bargaining certainly boosted profit margins (but not business investments!), it also pushed Japan into a situation whereby falling wages and falling prices have been chasing each other over the past decade and a half.

In the same speech, Kuroda is also making a point that is crucial for the discussion in the Euro Area (see below): Strengthening wage-formation institutions is crucial in raising inflation expectations. If economic agents realise trade unions are willing and able to raise nominal wages by at least 2 or 3% a year, then they will also change their expectations about inflation. And, as we know from the monetarist counterrevolution, if inflation expectations change then so will inflation itself as every actor will start basing its pricing decisions on these changed and higher expectations.

This point is further rammed through in an article where one of the co-authors is no less than the IMF's ex-chief economist, Olivier Blanchard. The authors of that article are actually calling upon the government of Japan to, as they call it, 'force the issue' and to 'jump-start' a wage-price spiral by requiring an annual wage indexation of at least 3% in a coordinated, tripartite collective bargaining round and to delay the promised cuts in corporate taxes until companies raise wages across Japan.

Unease at the Bank of England

Shifting from Japan to the UK, Andrew Haldane, chief economist of the Bank of England, observes in a speech given to the TUC in November 2015 that the Bank has systematically over estimated the path of wages when deciding on monetary policy over the recent years.

Wages in the UK have lagged behind productivity for several years and the labour share of income has been falling. The problem Haldane alludes to in his speech is that the Bank of England is counting on a clear acceleration of wage growth when making its current economic forecasts. The assumption used in the Bank's forecasts is that wages in coming years would actually grow faster than productivity so as to enable the labour share of income to catch up the losses it suffered over the recent past. If that were not to happen, if pay growth did not experience any lift-off, the Bank's chief economist warns of a substantial *undershooting* of the price stability target over the next two years.

A novelty: Is the ECB becoming concerned about low wage dynamics?

Even at the ECB, where some of the staunchest opponents of robust collective bargaining institutions can be found, the mind-set seems to be changing somewhat, although this change of mind is only half-hearted. Take the speech Draghi made at the start of this month that was reported in the *Financial Times* of 1 February and where he confirmed that the danger of 'second-round' effects was indeed occurring. We quote:

"While the most recent wave of disinflation is mainly due to the renewed sharp fall in oil prices, weaker than anticipated growth in wages together with declining inflation expectations call for careful analysis of the channels by which surprises to realised inflation may influence future price and wage setting in our economy".

In other words, Draghi is referring to the same mechanism we described above which is that inflation expectations matter quite a lot. If the collapse in oil prices brings headline inflation down to close to zero and if expectations about future inflation react and follow this downward trend, then low inflation is no longer a temporary but a permanent phenomenon as it becomes entrenched in actual price and wage setting behaviour. This is indeed what is currently happening in the euro area and explains Draghi's concerns. Longer term euro area inflation expectations (as expressed in 10 year swaps) are, at around 1.2%, way below the ECB's price stability of 'below but close to 2%'. At the same time, recent euro area nominal wage growth has declined further and is now limited to just 1% with nominal unit wage costs even diving below 1%. Everything is of course connected since, on the one hand, such weak wage cost developments feed into corporate decisions not to (or hardly) increase prices which then cements extremely low inflation expectations.

The ECB clearly has a downward wage-price spiral on its hands, a spiral putting at risk the euro area's price stability target and entrenching the situation of close to zero inflation.

Coordinated collective bargaining: One of the ECB's best friends in the fight against price instability

If policy makers at the ECB now seem to be aware of this problem, they keep struggling with what to do about it.

Basically, Draghi's strategy to break this self-fulfilling spiral is to "talk up" inflation expectations by loudly announcing that the ECB will print and inject even more money than before into the economy. The hope is that economic agents will perceive this as a credible signal and will start incorporating higher inflation expectations in their wage and price setting. Trade unions, expecting a recovery in inflation to, let's say, 2% would then immediately scale up nominal wage demands. Business management from their side will not fight 'tooth and nail' against such wage higher demands. As business will be expecting all prices, including the prices of products from their competitors, to go up by 2%, they will consider it feasible to translate the higher wage demands of trade unions into higher prices. The miracle of self-fulfilling expectations would be once again at work but this time in the positive sense.

In the textbook of monetary economics, putting the money printing press into higher gear is enough to ensure the credibility of the central bank's commitment to higher inflation expectations. However, in today's economy of high debt, rising inequalities and banking systems plagued by non-performing loans, it is extremely unlikely that just printing more money is sufficient to get the economy moving again, hence to raise inflation expectations.

Indeed, experience thus far with the ECB's policy of quantitative easing is unconvincing. Despite having added an extra €500bn to the euro area's money stock since the beginning of 2015, euro area growth performance or inflation numbers have not substantially improved. Recently, in November 2015 and January 2016, inflation expectations have even been *falling* at the very moment the ECB was announcing its intention for further monetary policy easing (see here).

In other words, to put a halt to the downwards slide into deflation and to get the economy back to price stability, the ECB should do more than give speeches. The ECB's commitment to reaching a reasonable inflation rate needs to be backed up by delivering concrete and convincing action, action that is going beyond the act of simply printing more money that tends to end up in the balance sheets of banks and institutional investors but not in tangible demand in the real economy.

One powerful way to do this, as Japanese policy makers have come to realise, involves the process of collective bargaining. By preventing too low inflation from spilling over into extremely low wage increases, collective bargaining is able to function as a circuit breaker in this process of lower wages chasing lower prices. This has two important implications for the ECB.

The first is that the ECB has to dump its crusade to have ultra-wage flexibility by decentralising bargaining to a strict company-by-company basis. Such atomised bargaining is very difficult to coordinate. Indeed, it is almost impossible to expect of company level bargainers (both management as well worker representatives) that they depart from the individual company level point of view and regard low inflation as a serious problem and not as an opportunity for the individual company to become more competitive and save jobs while leaving the responsibility for the stabilisation of the wider economy to the others. This failure of coordination of company level agreements inevitably leads to the outcome the ECB is seeking to avoid: Low inflation becoming entrenched by extremely weak wage deals.

Calls from European central bankers to accelerate structural reforms, in particular when these concern deregulation of collective bargaining institutions are therefore highly counterproductive. How can one expect robust wage deals if at the same time the balance of power continues to be shifted by these reforms from labour to capital? Policy advice arguing in favour of an immediate 5% cut to unit wage costs in Spain and Italy, such as the one given here is simply perverse. If such advice were to be pursued, it would intensify the process of disinflation and result in real deflation.

Stopping doing the wrong things will avoid making matters worse. It is also important to start doing things that solve the problem. What the ECB could do here is to mobilise collective bargaining and wage formation institutions, not as it used to do with the intent of squeezing wages, but with the aim of keeping wage dynamics up in the face of low and falling inflation expectations. Besides issuing a general call on the need to have robust wages, the ECB should make it perfectly clear it has completely reconsidered its view on decentralised bargaining and is now stressing the value of "coordination" of collective bargaining as such coordination makes it possible to align wage bargaining rounds with the macro needs of the economy such as the need to prevent low inflation or even deflation from becoming entrenched.

To convince economic agents of the seriousness of its change in mind, the ECB could openly and publicly reach out to social partners across the euro area. Where coordinated systems of collective bargaining exist, the ECB's message would be to insist on social partners using coordination of bargaining as a way to break the ongoing spiral of disinflation. Where such systems do not exist (and in several cases, such systems have been destroyed by the policy of internal wage devaluation), the ECB could suggest reintroducing a degree of coordination in the institutional framework.

All of this may sound pretty utopic. One should however keep in mind that the conventional policies of austerity and internal wage devaluation have failed and have brought us to a situation where the unconventional action proposed above is the only effective way out. Let's hope policy makers in and outside the ECB will soon come to realise this.