

Report on “Inflation targeting is a success, so far: 100 years of evidence from Swedish wage contracts” by Klas Fregert and Lars Jonung, May 26, 2008

This paper contains important evidence about the success of inflation targeting in Sweden. The paper uses 100 years of data on the details of wage contracts in Sweden in order to learn how economic uncertainty affects the terms of the wage contract. The authors appeal to Gray (1978) for a theory of wage contract length that makes the contract length a specific function of fixed contracting costs and uncertainty about the future equilibrium wage. They show that in the most recent period inflation targeting, nominal wages have been predictable and the contracts have been long (3 years) and stable.

The authors use a two-step procedure to make the argument that inflation targeting reduces macroeconomic uncertainty. In the first step they examine the low frequency relationship between contract length and the variance of one-year wage inflation. They divide the past 100 years of wage contracting into 8 policy regimes, compute regime averages and run a regression of contract length on the variance of wage inflation. In the regression, they include a dummy for periods when contracts include specific inflation indexation clauses and another for the introduction of centralized wage contracting. They omit the WW I period because they find that it is an outlier. The resulting equation has three estimated parameters and 7 observations. There is no information in the regression that cannot be understood more easily by looking at the two panels in figure 3. I recommend deleting the regression and the deviation of the regression model (equations 2 and 3 in the paper). The regressions are based on an incomplete model and too few observations.

In footnote 10, the authors mention (and dismiss) work by Danziger (1988) that is based on the implicit contracting theory of Azariadis (1975). Implicit contracting theory explains why risk-averse workers will accept (and risk-neutral firms will offer) long term contracts with a slightly lower wage in order to smooth household consumption in the face of real shocks. Uncertainty about business cycle shocks calls for longer-term contracts. At first blush, the theory complicates the easy interpretation of Gray; but it actually makes nominal wage uncertainty a better measure of the cost of having long contracts. In Gray, the only benefit of long contracts is to reduce the average cost of contracting. In Azariadis, the benefit comes from smoothing consumption in the face of real shocks. Inflation (or deflation) is the main source of uncertainty that makes the optimal contract shorter. Although this argument complicates Gray, it also justifies the authors decision to ignore real output uncertainty in the empirical analysis.

Note that it might also be useful to measure nominal wage inflation uncertainty relative real GDP growth uncertainty. We know that there was a secular decline in volatility of both output and prices, partly due to the composition of output and partly due to advances in measuring activity and prices.

The second objective is to provide evidence about the sources of short-run variation in expected wage rates. Here they take the within period variation of the wage contract

length as a proxy for the uncertainty about nominal wages. They abandon the formal regression structure and take a narrative approach. The focus could be improved by defining the concept of a monetary policy regime in terms of how well it anchors the price level. The gold standard (classic and modified as at Bretton Woods), an exchange rate target procedure and an inflation targeting procedure are all examples of strategies that may provide an anchor for monetary policy. What the authors call the full employment standard, by itself, is not a monetary policy regime. A floating exchange rate is not, but itself, a monetary policy regime. In both these cases, the lack of a policy to pin down the path for the price level leads to great uncertainty about future wage inflation.

They should also clearly describe the relationship between wage contracting policy and monetary policy. The finding that coefficient on centralized wage bargaining was negative may be due to the fact that centralized bargaining solves a conflict problem that arises in the labor market under high inflation. Without going into cause and effect, we know that the marginal product of labor fell in most countries as inflation rose. Accounting systems did less well measuring anything accurately and the acrimony surround labor negotiations often overwhelmed the process in other countries. The use of centralized bargaining may have made it easier for Swedish workers to come to any agreement in such an environment. And in such an environment, we expect contracts to be shorter.

In the last section, the narrative and the data portray a history of poorly formulated monetary policy and variable contract lengths. The overall impression one gets is of a society looking for a substitute for the classic gold standard. The convergence to inflation targeting was led by politicians and non-economists. It was only after such inflation targeting policies had been adopted that economists such as Mike Woodford and Bob King developed models to explain why it is a good thing. To date, the best evidence for the effective performance of inflation targeting regimes is in the recorded success of high inflation countries to converge quickly to low and stable inflation. We have also seen that, in inflation targeting countries, inflation forecasts tend to become concentrated around the inflation target. This paper presents further evidence that inflation targeting helps to anchor the price level.