OESTERREICHISCHE NATIONALBANK

Stability and Security.

WORKSHOPS

Proceedings of OeNB Workshops

Price Setting and Inflation Persistence in Austria

December 15, 2005

EUROSYSTEM

No. 8

Conclusions for Economic Policy: A Business Perspective

Panel Discussion

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The Inflation Persistence Network (IPN) has generated a great number of scientific contributions to the issue of price setting and inflation, out of which we can only tackle the most remarkable ones here, judged from the point of view of a business representative. Thus, we have selected the connections between price development and competition as well as the link of wages and prices as the topics of our contribution to this event.

1. Price Rigidity and the Case for More Competition in Austria

The IPN's research reveals that consumer prices in Austria, just like in the rest of the euro area, are relatively rigid, especially in comparison with the United States. While this general result alone is not necessarily disturbing, the sectoral breakdown yields interesting results: especially services, health care and education prices in Austria are very sticky, changing once a year or even less frequently. Strikingly, it is exactly this group of services whose prices are changed – and in this case, changes are almost always increases and hardly ever decreases – in a largely synchronous way. The authors point out that "this reflects the fact that prices of some of these products are either directly administered or strongly influenced by public authorities"[1].
The IPN has also investigated the entrepreneurs' own view of their price setting-behavior, showing that a large majority of Austrian firms normally uses time-dependent pricing rules, with 38% of all respondents using them exclusively – i.e., they do not even review their prices in the face of economic shocks. This

[1] ECB Working Paper No. 523, p. 5.

percentage is higher than in most other euro area countries, indicating again rather rigid prices in Austria.

In more general terms, the researchers find that economic reality deviates from the idealistic model of perfect competition, illustrated, for example, by the dominant use of mark-up pricing. Another result is that companies seem to be reluctant to reduce prices when their input costs fall, but also seem to dislike raising prices as a consequence of higher demand because this could be regarded as "unjust enrichment" by the customers. The latter finding suggests that many Austrians view the normal market mechanism of supply and demand as something that can lead to unfair results and that firms sometimes abstain from setting prices flexibly, according to demand fluctuations, because of "moral concerns". Finally, Europe-wide surveys reveal a clear link between competition and pricing behavior[2]: Companies that face severe competitive pressure change their prices more often, use mark-up pricing less frequently and consider underlying economic factors more in their price setting than others.

The arguments mentioned above lead to the conclusion that, while significant progress has been made in liberalizing the Austrian economy, there are still some important sectors in which competition remains weak, where public influence is omnipresent and these sectors, consequently, fail to exhibit a price dynamic that is characteristic of a free market. Therefore, we propose the following measures in order to stimulate competitive forces in those business areas that still suffer from undue public interventions:

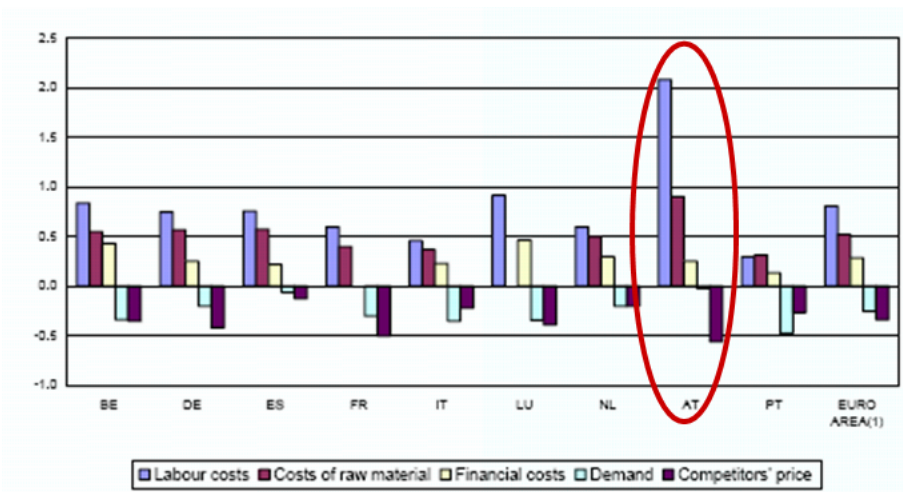
- Encourage Public Private Partnership (PPP) solutions for large public investments, combining the efficiency gains from private (instead of public) business operations with a certain security element provided by the state.
- Review whether public services, such as those that have been traditionally performed by municipalities (energy provision etc.), can be carried out more efficiently by privately-held companies.
- Create a market-oriented environment for the health care system, introducing elements of competition also for social security agencies.
- Ensure a smooth transition from formerly public monopolies to deregulated markets by establishing regulatory authorities with adequate competences. However, the ultimate goal must be to adapt these industries to completely free markets that no longer need a special regulator; i.e., the regulator's role is important, but it should not become a permanent institution.

[2] ECB Working Paper No. 535, p. 5.

2. Wage Development – the Key Factor for Price Stability

Another IPN survey that we found particularly insightful is the identification of the factors that cause price changes to be implemented. The following chart illustrates the problem very clearly:

Chart 1: Asymmetries in Price Driving Factors
(Difference between Scores Regarding Price Rises and Price Decreases)



Source: ECB Working Paper No. 535, p. 26.

The differences between Austria and the other euro area countries are striking: labor costs are the major factor responsible for price increases, while they – in contrast to other countries – give hardly ever any motivation to lower prices. Other factors, such as demand and competitors' price, play a very limited role in comparison to labor costs, giving further support to our demand to intensify competition in Austria.

Another valuable concept for a better understanding of price changes is the New Keynesian Phillips Curve, which has also been analyzed by the IPN. One important aspect tackled by this curve is the connection between labor share and the price level. Labor share can be expressed as average hourly wage divided by productivity, implying that if wages are increased stronger than productivity, the companies' marginal costs increase (ceteris paribus), which in turn forces them to raise their own sales prices.

From the above, the importance of wages for price development in general, but even more so in Austria, becomes obvious. The immense importance of labor costs as a price driving factor is not surprising in view of the dramatically high non-wage labor costs in Austria. In 2004, they amounted to 82.6% of direct wages. The figures for almost all other European economies with a comparable size are considerably lower: e.g. Finland 77.0%, Sweden 70.9%, Switzerland 51.9%, Norway 48.0%, Ireland 39.7%, Denmark 33.6%; only Belgium has even higher non-wage labor costs (90.0%)[3]. Interestingly, the Scandinavian countries, well-known for their extensive social systems, manage to finance their inhabitants' social security without laying an excessive financial burden on the production factor labor. This should serve as an example for Austria. The biggest potential to bring our non-wage labor costs more in line with the European average lies in a comprehensive reform of the social insurance system, the structure of which is obsolete and has lost its functionality in today's dynamic economic environment.

Another reason why labor costs are such an important factor for price increases in Austria is the rather inflexible labor market which prevents companies from quickly reacting to changes in demand by adjusting their wage payments. One solution, which has increasingly become popular already in the last few years, is to promote alternative types of employment, such as part-time work, temporary employment etc. Even more important to mitigate the price-driving effects of labor costs is making stronger use of flexible forms of payment. Introducing elements of performance-related remuneration on all hierarchical levels would make Austrian companies considerably more competitive: it becomes easier to survive difficult business situations, since wage payments are reduced automatically, and it makes them also more attractive as employers, since potential employees recognize that good work is financially rewarding there. The link between performance-related payment and sales prices is clear too: Wages become less of a burden for companies, they only rise strongly when business is going well and the firm can afford to pay more; therefore, they can no longer automatically force a sales price increase, as is often the case at the moment.

In his presentation, Stiglbauer cited the price trajectory of car mechanics' services as a typical example of price paths in the service sector. The researchers found out that these prices are changed exactly once a year and left constant for the remaining time.[4] This result is not surprising: the service sector is very labor-intensive, its most important input costs are wages. Wages in Austria are changed once a year, namely after termination of the negotiations for a new collective agreement, in which the annual raise is determined for the whole industry. Completely in line with the findings above, this increase in labor costs makes it inevitable for many entrepreneurs to raise the sales price, which causes the singular annual price jump observed in the analysis. Thus, a direct link between collective wage bargaining and Austrian price dynamics can be established, and has important implications for economic policy: Wage restraint is imperative to secure the competitiveness of

[3] WIFO Monatsbericht 11/2005, p.753.
[4] ECB Working Paper No. 523, p. 66.

Austrian firms; demands for raises that fully compensate for inflation and productivity gains cannot be met in an open economy with substantial unemployment. Excessive wage increases lead to cost-push inflation and, simultaneously, hamper growth and employment.

3. Central Banks and Their Responsibility for Economic Development

While the importance of containing inflation and doing research in this field in order to better understand the economic interrelations remains undisputed, we cannot turn a blind eye to the fact that in recent years, the paramount economic problem in the European Union has not been excessive inflation, but persistently weak growth and a lack of investment.

Monetary policy, which lies exclusively in the hands of the European System of Central Banks, is an important instrument that can be used to control inflation, but which has a crucial influence on investment and growth as well. Article 105 of the Treaty on the European Community reflects this thought: “Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2.” Article 2 lists, among others, the following goals: “a high level of employment” and “sustainable and non-inflationary growth”.

In view of Europe’s currently difficult situation and its pursuit to become the most dynamic economic area of the world (Lisbon Agenda), we appeal to the European System of Central Banks to take this aspect of its mandate very seriously. We hope that monetary policy will make its contribution to Europe’s growth strategy, and we are confident that the extensive research work conducted in the course of the IPN helps the ESCB to fulfil its task even more effectively and precisely.