



# Labor market regimes and the effects of monetary policy

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## Abstract

In this paper, we evaluate the effects of monetary policy on inflation and unemployment under different institutional arrangements in the labor market. We show that the effects of monetary policy on the real economy depend critically on the wage formation regime, and on the ways in which the restrictiveness of policy interacts with product price competition, wage setting centralization and the utility weight unions place on real wage premiums as compared to unemployment. Our analysis emphasizes how the posture of monetary policy toward inflation influences the strategic calculations driving unions' wage setting behavior in different institutional environments.

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## 1. Monetary policy, wage setting institutions and macroeconomic performance

Monetary policy neutrality means that monetary instruments are unable to affect real variables, such as output and employment.<sup>1</sup> The Barro–Gordon (1983) model and its many variants, inspired by the seminal paper of Kydland and Prescott (1977), are the main templates for modern analysis of monetary policy issues. In terms of the framework used in this paper and laid out below, the bare-bones Barro–Gordon setup corresponds to a game in which the central bank sets the money supply in order to minimize inflation and unemployment after unions set nominal wages so as to optimally trade off expected real wages and unemployment of their members. Although unions are Stackelberg leaders, the central bank's objectives and optimal policy reactions are common knowledge and union wage policies are conditioned on rational expectations of the money supply. Nominal wages are therefore adjusted to crowd-out the positive effects that monetary expansions otherwise would have on output and employment by moderating real wages. The result is a Stackelberg equilibrium characterized by monetary neutrality and excess inflation.<sup>2</sup>

A more favorable implication of this line of research is that a “conservative” central bank pursuing a stringent, non-accommodating policy is able to contain inflation without real costs in the form of systematically higher unemployment and depressed output – a view developed theoretically by Rogoff (1985) and supported to various degrees empirically by evidence in Grilli et al. (1991), Alesina and Summers (1993), Bleaney (1996) and Eijffinger et al. (1998) and others, all of which took ratings of central bank independence as good proxies for policy conservatism. Non-neutrality was shown to arise, however, if wages only partially adjust to monetary changes because of the existence of multi-period overlapping contracts – as in Fischer (1977) – or because the policy authority has an information advantage over wage and price setters – as in Canzoneri (1985) – or because unions have a pure distaste for inflation – as in Gylfason and Lindbeck (1994).

More recent contributions to the policy game literature stress new channels of monetary non-neutrality that do not depend on sticky wages, information asymmetries and direct union aversion to inflation, but instead operate through the interaction of central bank policies with wage and price setting institutions. Theoretical demonstrations by Bratsiotis and Martin (1999), Soskice and Iversen (2000), Coricelli et al. (2004, 2006), Lippi (2003), among others, implied that when there is a multiplicity of wage setting unions and product markets are monopolistically competitive, a Barro–Gordon framework may deliver policy non-

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<sup>1</sup> The classical definition of monetary neutrality implies that autonomous changes in the money supply have no influence on the level of real output (Patinkin, 1956). In the policy games literature which came a generation later, money is typically endogenous. A definition better suited to modern frameworks of analysis would be that monetary policy is neutral (non-neutral) when equilibrium output and employment do not (do) depend on the preferences of the monetary policymaker (Acocella and Di Bartolomeo, 2004).

<sup>2</sup> Union power over nominal wage setting, however, might influence the monetary authority's objectives and constraints. Fischer and Summers (1989), for example, argued that other things being equal indexation lowers the cost of inflation, which by itself gives the authorities an incentive to pursue more inflationary policies. The implication is that union coordination effectively indexing wages would tend to increase inflation. On the other hand, Waller and VanHoose (1992) pointed out that indexation steepens the aggregate supply curve, reducing the output and employment gains from (unanticipated) inflation. The incentive to pursue an inflationary policy in the first instance is therefore diminished, implying that through this channel coordinated union action to index wages might reduce an inflation bias.

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