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Central bank conservatism and labor market regulation

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Abstract

How does central bank conservatism affect labor market regulation? In this paper, we examine the economic forces at work. An increase in conservatism triggers two opposite effects. It reduces the inflation bias of discretionary monetary policy and hence the cost of regulation. It also increases unemployment variability, making regulation more costly. In combination, the two effects produce a hump-shaped relation between conservatism and labor market regulation. To test this prediction, we use data for 19 OECD countries for the period 1980–1994. Our proxies for regulation are unemployment, different labor market institutions, and indices of labor market regulation. Conservatism is proxied by two common measures of central bank independence. We find support for the prediction of a hump-shaped relation between conservatism and labor market regulation.

JEL classification: E58; E63; J38
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1. Introduction

Monetary policymakers often express concern about structural problems in the labor market. Typically, they point out that monetary policy is not the solution to structural

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problems and that such problems therefore need to be addressed by other policy measures. This concern is easy to understand, because apart from having their own merits, policies aimed at solving structural problems would also facilitate the central bank's efforts to maintain price stability. The problem is that substantial political costs are a major impediment to labor market deregulation.

In view of this, it seems interesting to explore how the prospects of labor market regulation are influenced by monetary policy. Although monetary policy is neutral in the long run and cannot by itself reduce equilibrium unemployment, we will argue that the monetary policy regime can have real effects by influencing the government's preferred labor market policy.

The starting point of our analysis is the well-known time inconsistency problem associated with discretionary monetary policy, first analyzed by Kydland and Prescott (1977) and Barro and Gordon (1983). The basic idea is that wage setters recognize the policymaker's incentive to exploit the short run Phillips curve and foresee the inflation created by monetary policy. In equilibrium, structural unemployment is unaffected by monetary policy, but inflation is positive. By appointing a conservative central banker, the inflationary bias can be reduced at the expense of greater unemployment variability, as suggested by Rogoff (1985) and others.

In view of this trade-off, there will be two effects of increased conservatism on labor market regulation: a *credibility effect* and a *stabilization effect*. The credibility effect arises because labor market regulation, by increasing equilibrium unemployment, worsens the credibility problem and hence equilibrium inflation. Average inflation is relatively low if the central bank is very conservative and unemployment enhancing regulation is then not very costly in terms of higher inflation. Hence, there will be more labor market regulation if the central bank is more conservative. The stabilization effect works in the other direction. Conservatism increases the variability of unemployment and therefore aggravates the consequences of labor market regulation. To put it differently, if the central bank does not act to avoid bad outcomes, the government has no other alternative than to deregulate the labor market to alleviate the consequences of shocks to unemployment.

In this paper, we add a government and labor market policy to a simple Barro and Gordon (1983) model of discretionary monetary policy and analyze the interaction between the credibility and the stabilization effect. We show that in combination, the two effects give rise to a hump-shaped relation between conservatism and labor market regulation. The reason is that for very high levels of conservatism, the credibility problem is minute. At the same time, the stabilization effect is very strong because the central bank makes little effort to stabilize unemployment. At the other extreme, very low levels of conservatism give rise to a severe credibility problem, whereas the stabilization effect is negligible because the central bank puts much effort into stabilizing unemployment. From this, it follows that neither effect is negligible for medium levels of conservatism. But because each effect is relatively weak compared to the extreme cases, the model predicts more regulation for medium levels of conservatism.

We also carry out an empirical investigation of the relation between central bank independence (as a proxy for conservatism) and unemployment, labor market institutions,