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Influential price and wage setters, monetary policy and real effects

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Abstract

Using a microfounded general equilibrium model, this paper shows that when large monopolistic firms or unions perceive even a small influence on aggregate nominal variables, price targeting results in a higher equilibrium output than monetary accommodation. This is because price targeting increases, whereas monetary accommodation decreases, (i) the price elasticity of demand, (ii) the labour elasticity of demand and (iii) the elasticity of the wage with respect to the household's total income. Within this framework, we also show that (a) price targeting combined with wage centralization raise welfare, (b) the standard approximation that no single price or wage setter can affect nominal aggregates is appropriate only when (a) at least a few hundreds of such large firms exist and (b) wage centralization is low.
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1. Introduction

It is widely accepted in macroeconomic modelling that in economies where a very large number, N, of competitors exist, effects of the order $1/N$ are 'negligible' in relation to the aggregate economy. This practice is a useful simplifying approximation that is based on the assumption of an 'infinitely large' number of firms and unions, in which case no single price or wage setter is large enough to perceive an influence on aggregate nominal variables, (see Dixit and Stiglitz, 1977). More recently, a few attempts have been made to examine the qualitative implications of relaxing this standard approximation. For example, in computing the price elasticity of demand of monopolistic competitors, Yang and Heijdra (1993), allow each firm to perceive some influence on the average price index. This results in a lower price elasticity of demand than that derived in the Dixit–Stiglitz model. D'Aspremont et al. (1996) show that in addition to the above effects, individual price decisions can also take into account income effects. Both of these models are focused on product diversity and the optimal degree of entry and so they are confined at the micro level. They show that the inclusion of such effects increases the monopolistic power of price setters, reduces the price elasticity of demand and raises the optimal price.

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At the macro level, the presence of large price or wage setters has been shown to have significant qualitative implications that are dependent on monetary policy. When firms or unions are large enough to perceive even a small influence on aggregate nominal variables, monetary accommodation is shown to raise equilibrium unemployment by lowering the labour and price elasticities of demand, (Bratsiotis and Martin, 1999; Iversen and Soskice, 2000; Holden, 2003, 2005).[1] Indeed, as a number of more recent papers show, considering the effects of large monopolistic competitors on aggregate nominal variables can produce some challenging qualitative results about policy implications and the structure of labour markets, (i.e. Guzzo and Velasco, 1999; Coricelli et al., 2006, 2004; Holden, 2003, 2005; Lippi, 2003; Benassi et al., 2002; Vartiainen, 2002; Knell, 2002; Acocella and Di Bartolomeo, 2004; Lawler, 2000, forthcoming). These result are demonstrated to be robust even under the assumption of national expectations or in the absence of nominal rigidities. However, skepticism may still remain as to whether, or the extent to which, any individual price or wage setter can perceive an influence on aggregate nominal variables.

This paper builds a microfounded general equilibrium model where workers, organised into unions, receive wages from the firms they work for, as well as a share of aggregate profits by *all* the firms in the economy. This overcomes the restrictions often imposed on earlier models, that either lacked of microfoundations or were based on the simplified yeoman farmer model (i.e. Bratsiotis and Martin, 1999; Iversen and Soskice, 2000). This fully general equilibrium model enables us to examine thoroughly the conditions under which influential monopolistic industries and unions can generate real effects through their potential influence on nominal aggregates. In particular, the model contributes to the recent literature in three non-negligible ways.

First, it introduces a new source through which influential wage setters can interact with aggregate demand, namely through the effects that wages have on households' *non-wage income*. The paper argues that given the standard assumption in general equilibrium models, that money transfers and profits of firms are distributed to households, (i.e. that households are share owners), influential unions should set wages in relation to the household's *total real income*. The latter consists of (i) the gains from being employed, (ii) money transfers and (iii) aggregate profits.[2] We show that the inclusion of the *non-wage income* effect (ii and iii), result in higher wage claim moderations by 'large' monopolistic competitors than shown in the recent related literature, while contradicts the suggestion in the traditional literature that more powerful unions imply less welfare. According to the traditional literature, wage setting by powerful monopoly unions implies additional distortions in the labour markets that result in higher equilibrium real wages and unemployment (or lower equilibrium output). This for example is true for most efficiency wage or insider–outsider wage bargaining models, where firms or unions aim to secure high real wages for their workers or union members at the expense of the "outsiders". In this model, high wage centralization (particularly in conjunction with price targeting), moves the economy closer to the competitive equilibrium output. This is for two reasons; first, because higher wage centralization embraces a larger part of the total active labour force, (hence of the average economy-wide wage) and this has been shown to moderate wages (i.e. Calmfors and Driffill, 1988).[3] Second, as a few recent papers have shown, when large unions anticipate an effect on aggregate nominal variables, they internalise the adverse effects of their wage claims on their members' real wage income and this results in a moderation of their wage claims. This model shows that in a general equilibrium framework, large unions must incorporate the effect of their wage decisions on both the wage-income and non-wage income of their members. The inclusion of the *non-wage income* makes the role of monetary policy even more important as it provides another channel of interaction between price and wage setting and aggregate demand and this, under high wage centralization and price targeting, is shown to move the economy closer to the competitive equilibrium output. In this sense, and contrary to the effects of the traditional literature, more powerful (in the sense of larger) unions may be desirable since greater centralization of wage bargaining leads to better coordination of wage decisions.

Second, the paper shows that the presence of influential price and wage setters strengthens the case for price targeting. Price targeting is shown to result in higher levels of equilibrium output than those implied by monetary

[1] For an earlier literature see also, Driffill (1985), Calmfors and Horn (1985), Iversen (1998).

[2] The recent literature of large monopolistic competitors focuses mainly on (i), the wage income effect and partly on (ii). For example, Bratsiotis and Martin (1999) and Iversen and Soskice (2000), allow for wage setting to affect real money balances but this is not done within a general equilibrium framework where unions maximizing the households' objectives and where the latter also includes profit sharing.

[3] In a similar fashion more recently, the insider-outsider theory predicts that the larger is the insider group the more wage moderation is to be expected (i.e. Lindbeck and Snower, 2002).

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