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ScienceDirect
Economic Modelling 25 (2008) 740 – 771
Economic Modelling
www.elsevier.com/locate/econbase

Heterogenous wage formation under a common monetary policy ☆

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Accepted 23 November 2007

Abstract

How does a monetary union work when labour markets are heterogeneous? Since shocks are transmitted via both trade links and the common monetary policy and propagated via labour market responses, it follows that labour market institutions may have not only national but also union-wide implications. These issues are analysed in an intertemporal general equilibrium model for a currency union in which labour markets are heterogenous and where the monetary policy targets expected inflation. More flexibility in adjustment means more stable aggregate output, but inflation control becomes more difficult. Heterogeneity in adjustment plays a large role, in particular if country sizes are also asymmetric. This also holds in the case of aggregate shocks, and heterogeneity is potentially of large importance for aggregate volatility when countries are of asymmetric size. Considering the effects on country specific output variability, it is seen that there are important spill-over effects between labour market structures, and it is not necessarily beneficial to take a unilateral move to make labour markets more flexible.
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JEL classification: E30; E52; F41

Keywords: Wage formation; Monetary policy; Monetary union; Business cycles; Shocks

1. Introduction

Across European countries there are substantial differences in labour market performance as well as in labour market institutions (see e.g. OECD, 2004). This is a concern in its own right, but the creation of the Economic and Monetary Union has added to the importance of these differences since member countries share the same monetary policy. According to the traditional literature on optimal currency areas, a necessary condition for a well-functioning currency area is that labour markets are flexible either in terms of high labour mobility or wage flexibility (see e.g. De Grauwe, 2003). However, none of these assumptions seem to hold for the EMU-area (see Section 2). This raises the important question of how a monetary union works in the presence of heterogenous labour markets as well as the issue

☆ Comments and suggestions from an anonymous referee and seminar participants at the University Paris X (Nanterre), the Danish Central Bank and the CEBR/CEPR conference *Labour Markets*, *Fiscal Policy and Structural Reform* are gratefully acknowledged.
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doi:10.1016/j.econmod.2007.11.003

of the incentives member countries have to undertake structural reforms. Surprisingly little research has considered how a currency union with heterogenous wage setting institutions works.[1]

This paper takes a positive approach in its analysis of the consequences of labour market heterogeneity in a monetary union in which the monetary authority targets inflation. The focus is on responses to shocks addressing the role of heterogeneity in both nominal and real wage flexibility. When monetary policy is credible and the objective is overall price stability, the interesting question becomes how differences in labour market institutions affect the stability of inflation (around the level targeted by the central bank) as well as its implications for the adjustment of activity and employment to various types of shocks. It is well-known that rigidities in adjustment of wages (nominal and real) tend to imply that employment and activity become more volatile; that is, when wages take a lower burden of adjustment, a larger burden comes to rest on employment and activity. However, the interdependencies are more complicated in a currency union due to the sharing of a common monetary policy. Labour market heterogeneity may therefore have real consequences both at the national and the union-wide level since shocks are transmitted both via trade links and the common monetary policy, and propagated differently in national labour markets. Accordingly, there may be important spill-over effects from differences in labour market institutions. The issue of how labour market structures in one country affect other countries in a currency union is particularly important for the incentive to undertake policy reforms changing labour market structures. To address this issue, it is necessary first to chart the externalities arising from different labour market institutions. In particular, do countries with inflexible labour markets exert a negative externality on countries with more flexible labour markets? Are there any gains to be made by having the most flexible labour market? To what extent do countries with more flexible labour markets perform better than countries with less flexible labour markets?

This paper presents an intertemporal general equilibrium model of a currency union in which the monetary authority credibly targets inflation, and in which there may be asymmetries across unequal sized member countries with respect to both real and nominal wage flexibility. The response of inflation, aggregate and country-specific output is analysed in the presence of supply shocks for both the case of aggregate and country-specific shocks. The model structure builds on recent open economy macro models (see e.g. Obstfeld and Rogoff, 1996) and has imperfectly competitive labour markets to model wage setting and account for rigidities. The way of approaching the labour market explicitly takes its outset in the fact that wage formation in European countries is affected by institutions, implying that markets are non-competitive, but also heterogenous across countries. The model is cast in such a way that it is possible to find an analytical solution to the intertemporal general equilibrium model for a currency union with labour markets which are heterogeneous in size and structure.

Despite the frequent reference to asymmetries and heterogeneity across European labour markets, there are very few studies addressing their implications. Benigno (2002) analyses from a normative point of view how monetary policy should be designed when member countries have different degrees of nominal rigidities, and it is shown that the central bank should attach more weight to inflation in countries characterized by more nominal inertia. Beetsma and Jensen (2004a,b) also allow for labour market asymmetries in their analysis of the interactions between monetary and fiscal policy in a monetary union. Dellas and Tavlas (2002) present a three-country model allowing for asymmetries in nominal wage flexibility, and find that countries with a high degree of nominal wage rigidity are better off in a monetary union. The incentive to undertake structural reforms is addressed by Spange (2004) in a two-country model with real shocks, and he shows that a country with a rigid labour market may not have an incentive to reform its labour market to match the more flexible country.

Several authors have addressed the issue of whether membership of EMU would lead to endogenous structural changes or reforms changing rigidities in the labour market. This line of research has taken its outset in the observation that loss of a national monetary policy will increase the need for nominal flexibility to cope with asymmetric shocks (see e.g. Calmfors (2001) for a survey and references). The present paper takes a step in addressing the need for reforms and the direction in which such reforms should go by considering the implications of various labour market rigidities (real and nominal) for business cycle fluctuations.

This paper is organized as follows: Section 2 offers some key indicators on the labour market heterogeneities prevailing across EU countries. The theoretical model is set up in Section 3, and the equilibrium processes for inflation

[1] There is an important literature addressing strategic issues in wage formation when entering a monetary union, see e.g. Calmfors (2001) for a survey and references.

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