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Monetary institutions, imperfect competition and employment outcomes

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ABSTRACT

This paper explores the employment effects of strategic interactions between firms, trade unions and monetary institutions in the context of an imperfectly competitive macroeconomic model with right-to-manage bargaining. The results suggest that the employment effect of joining a monetary union is conditional upon the degree of monetary accommodation of the union-wide central bank, the degree of product market competition, and the relative bargaining power in wage-setting. In addition, the employment effect of a change in the degree of monetary accommodation of the domestic or the union-wide central bank is conditional upon the degree of product market competition and the distribution of bargaining power.

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1. Introduction

It is widely accepted that the set of incentives and constraints that policy makers face when setting monetary policy has a significant effect on nominal variables such as mean inflation. In two famous papers, Kydland and Prescott (1977) and Barro and Gordon (1983) show that, under a discretionary

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regime, the inability of policy makers to commit themselves to a low inflation rate leads to high average inflation with no gain in terms of employment. Furthermore, Rogoff (1985) demonstrates that the delegation of monetary policy to a conservative central banker can reduce the discretionary bias while Lohmann (1992) shows that the dynamic-inconsistency problem can be best resolved through an institutional arrangement in which the government grants partial independence to a conservative central banker while retaining the option to override the central bank's decisions at a strictly positive but finite cost. The relevance of the design of monetary policy institutions for nominal variables, such as mean inflation, has been borne out by a number of empirical studies and, to a good extent, is beyond dispute.[1]

Yet relatively new and evolving research shows that the effect of monetary policy institutions is not confined to nominal variables. Building upon the insights of Bruno and Sachs (1985), Calmfors and Driffill (1988) and Soskice (1990) on the importance of wage-setting institutions on macroeconomic outcomes, a relatively new strand of the literature shows that, once one allows for strategic interactions between firms, trade unions and monetary policy institutions, a change in the degree of monetary policy accommodation, or the degree of central bank conservatism, or the delegation of monetary policy to a common central bank in the context of a monetary union, will have significant effects on *real* economic variables, such as equilibrium employment and output, too.

In a seminal paper, Iversen (1998) shows that the relationship between the degree of centralization of wage bargaining and equilibrium unemployment is contingent upon the type of monetary regime. Cukierman and Lippi (1999) explore the macroeconomic effects of the interaction between the degree of central bank independence and the degree of centralization of wage bargaining in a framework in which sectoral unions are inflation averse and show that the relationship between real wages and the degree of centralization of wage bargaining depends upon the degree of central bank independence. Cukierman and Lippi (2001) argue that the creation of a monetary union may aggravate collective action problems in wage-setting as, due to the smaller weight that each union wage has in the determination of the union-wide inflation rate, trade unions become less aware of the inflationary consequences of their individual wage strategies. The aggravation of the collective action problem renders unions more aggressive in their nominal wage demands and, other things being equal, leads to higher inflation and higher unemployment. Coricelli, Cukierman and Dalmazzo (2001) examine the macroeconomic implications of the interaction between the degree of conservatism of the monetary policy maker and wage-setters. A more conservative central bank, which reacts to individual wage increases by tightening, induces wage restraint and increases employment. A straightforward implication of this result is that if the creation of a monetary union leads to an increase in the degree of central bank conservatism, joining the monetary union will reduce the country-level unemployment rate. Coricelli et al. (2001) have shown that the strength of this effect depends critically on the degree of centralization of wage bargaining as well as on country size. Hall and Franzese (1998) and Franzese and Hall (2000) show that an independent central bank can elicit wage moderation from trade unions only when collective action problems in wage bargaining are mitigated through union coordination. In the absence of union coordination, the signaling mechanism, through which an independent central bank conveys its anti-inflation commitment, fails to operate and the real economic costs of low inflation can be high. Soskice and Iversen (2000) show that, in the presence of a finite number of sectoral monopoly unions, a lower degree of monetary accommodation increases equilibrium employment. More particularly, a shift to a less accommodating policy on the part of the central bank, and the concomitant decline in real money supply, elicits wage restraint from wage-setters who dislike a fall in actual employment. Wage restraint in turn delivers a higher level of equilibrium employment. More recently, Holden (2005) explores the effects on equilibrium unemployment of the interaction between the monetary policy rule and the degree of coordination in wage-setting. Holden (2005) shows that a strict monetary policy rule disciplines the uncoordinated wage-setters as the central bank may react to excessive wages by reducing the nominal money stock. As a result, the strict monetary policy stance combined with uncoordinated wage-setting delivers lower equilibrium unemployment and reduces the wage-setters' incentives to coordinate. In addition, Holden (2005) shows that an accom-

[1] See, among others, Alesina and Summers (1993) and Cukierman, Webb, and Neyapti (1992).

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