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Wage flexibility

No wriggling out of trouble

Sep 11th 2012, 17:20 by C.O. | BERLIN

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AT THE conference of the European Economic Association (EEA) in Malaga (see here for an earlier post on this) the president of the EEA, Jordi Gali, used his presidential address to discuss the merits of "wage flexibility" over the business cycle. The implications of his presentation for Europe are worrying, to say the least.

In New Keynesian models, the dominant work horse of macro analysis in academia and central banks alike, more wage flexibility can neither magically fix an unemployment problem in a recession, as is often, if only implicitly, argued; nor does it lead to a downward spiral into an economic abyss. The crucial element, as Mr Gali showed, is the response of monetary policy. Under optimal monetary policy, the economy does gain from more wage flexibility.

Critics of New Keynesian economics will argue that these models ignore important aspects of the economy, like a high demand for safe assets that downward adjusting wages cannot fix, and may even make worse. Or the belief of consumers about their future wealth, that dropping wages may worsen, too. But here is the worrying bit: you don't even need to go there in order to come to a worrying conclusion for Europe.

The reason is that Mr Gali also added two important caveats to the argument that wage flexibility can help. First, if monetary policy cannot react appropriately for some reason, deflationary pressures through lower wages lead to higher real interest rates, hurting the economy. Germany in the early 2000s is a case in point: because of its wage adjustment, it had low inflation and consequently one of the highest real interest rates in the developed world. Second, if you have households that cannot easily borrow to bridge a period of low income—because of high debt, say—downward adjusting wages hurt consumption, and thereby the economy. Both aspects are similar to those raised in a paper by Gauti Eggertson and Paul Krugman last year.

One country with both problems is Mr Gali's home country: Spain. There is no monetary policy that can be tailored to Spain's needs, and there are many highly indebted households and firms. In the short run, downward adjusting wages will hurt the Spanish economy because there is no countervailing increase in aggregate demand—unless exports can pick up the slack, which in current circumstances is unlikely to happen. What makes it even worse, in my view, is that Spain is not in a liquidity trap, that sufficient monetary (plus fiscal?) stimulus could potentially solve. It is trapped in monetary union with a 2% inflation target that makes Spanish wage adjustment almost inevitable. Spain is truly stuck between a rock and a hard place.

All this shows how wrong it was in the 1990s to argue that "flexible labour markets" will be a stabilising force in the macroeconomy of a future euro area. The opposite is more likely to be true, in the short run. Second, it is one more, and important, reason why austerity in the current circumstances is such a bad idea: apart from exports, fiscal policy is the only source of aggregate demand that could cushion the wage adjustment.

About Free exchange

In this blog, our correspondents consider the fluctuations in the world economy and the policies intended to produce more booms than busts. Adam Smith argued that in a free exchange both parties benefit, and this blog's aim is to encourage a free exchange of views on economic matters.

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A third lesson, as Stephanie Schmitt-Grohe and Martin Uribe show in a recent paper, is that temporarily higher inflation in the euro area would go a long way to help countries adjust their wages without hurting their economies. Alas, inflation expectations in Europe remain well-anchored—at 1.3%. Some good advice for Europe's next boom economies: don't let wages rise on the back of a consumption/credit/construction boom. The way down is a nightmare.

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MrRFox Sep 12th, 04:59

Reducing wages (and even prices too) accomplishes little or nothing, and probably aggravates the situation, if debt remains level or rises.

The strong Northern states getting out of the Euro clears the way for real wages and real debt burdens of the South to correct, and does so without the need for re-denominating anyone's debts into another currency.

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Over the past five days

bampbs Sep 11th, 20:55

Austerity in a depression is insane. The rest is window-dressing.

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fundamentalist in reply to bampbs Sep 12th, 02:01

That may be the case, but you need to explain how governments can keep spending when they need to borrow to do it and no one will loan them the money.

Recommend 4 Report Permalink Reply

shaun39 in reply to bampbs Sep 12th, 02:49

Agreed. That is why we must run balanced budgets or surpluses when we are not in recession - whatever the populist incentives to do otherwise.

Once government debt has run way ahead of domestic savings and there are no gullible foreigners, the austerity hammer must strike, recession or not.

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fundamentalist Sep 11th, 20:09

Because New Keynesian econ is the workhorse doesn't mean its any good. How did we get in this mess if New Keynesians really understand the economy?

Before Keynes, economies endured scores of depressions and recovered much more quickly than anyone has recovered from the latest one. How or how did they do that without New Keynesian economists to tell them what to do?

Wage reductions don't hurt all of aggregate demand. Demand also includes demand for producer goods. Consumer goods will be hurt for a while with lower wages, but lower wages will boost production of capital goods. Increased employment in capital goods will raise demand for consumer goods. And increased production of capital goods will result in lower priced consumer goods, which in turn will spur demand.

Economies usually recover from depressions when prices fall enough that those with cash and jobs find the prices attractive and start buying.

Recommend 2 Report Permalink Reply

62Be8aZipX Sep 11th, 20:00

Portugal yesterday reduced all workers salaries by 7%. May be the process could be helped if Germany increased by decree the salaries of all German workers by 10%.
I do not see why if Portugal can reduce salaries overnight by decree Germany could no be force by its partners to increase its salaries overnight.
This might be easier than forcing Spain to lower its salaries via unemployment, etc.

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hedgefundguy Sep 11th, 19:13

It is trapped in monetary union with a 2% inflation target that makes Spanish wage adjustment almost inevitable. Spain is truly stuck between a rock and a hard place.

Which brings us back to....

" I refuse to join any club that would have me as a member."

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- Groucho Marx

NPWFTL
Regards

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shaun39 Sep 11th, 18:56

In practice, inflation is a relative concept - it is dependent on an agent's consumption bundle.

The real interest rate for an individual consumer is dependent on whether they spend their money on local non-tradable services in a rising market (corresponding to higher inflation and very low real interest rates), or on consumer electronics, computers & tech (corresponding to high deflation and very high real interest rates).

In this sense, expected real interest rates on debts also depend on future price expectations. Rapidly rising wages now might not be a good basis for modifying perceived real interest rates on a 20 year loan.

Why is this interesting?

- If the tradable share of eurozone GDP continues to increase, there will be less variation in perceived real interest rates.

- If Europeans continue to consume more across borders (Austrians living in Slovakia; French citizens getting haircuts in Spain; the Germans enjoying Italian theme parks, etc), and if that consumption takes the form of consumers chasing lower prices, there will be less variation in real interest rates

- If European consumers continue to become more mobile in working/ living across borders, they will cause less geographic dispersion in individual inflation perceptions (because their planned consumptino spans different places), reducing the variation in effective real interest rates.

- If consumers and banks were realistic about the sustainability of booms and recessions, they would perceive different real interest rates over medium to longer terms (higher during boom times; lower during recessions). Banks would adjust collateral requirements accordingly; firms would adjust their future market projections downwards during credit expansions.

All of this is just as relevant within a country as in the eurozone.

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willstewart Sep 11th, 18:16

Inflation seems necessary.

Of course this will hurt savers instead - but so do low interest rates.

Recommend 3 Report Permalink Reply

Dominique II Sep 11th, 18:06

"All this shows how wrong it was in the 1990s to argue that “flexible labour markets” will be a stabilising force in the macroeconomy of a future euro area. The opposite is more likely to be true, in the short run."

After all those years of hectoring countries with civilized labor markets to deregulate them, and of mocking those who claimed, on the basis of experience, that it did not improve anything, can we hope that this welcome epiphany will be given some publicity? After all, the overall hectoring still is pretty loud and obnoxious, not least in TE columns.

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jomiku Sep 11th, 17:31

The next to last paragraph deserves special mention.

The usual thing would be to devalue your currency to stimulate export and make imports more expensive. Can't. Next best thing would be to shift the burden of debt to others through inflation. Can't.

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