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The Trouble with Wage Flexibility in a Currency Union

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Wage flexibility is often considered a substitute for exchange rate flexibility in countries that joined a currency union, but a paper by Monacelli and Gali shows that its effects could be negative just when a country surrenders monetary policy. The solution: an expansive fiscal policy

Asymmetric shocks are the Achilles' heel of currency unions. When an external shock unevenly hits different regions of the union, the most affected countries, having surrendered monetary policy and having accepted fiscal policy constraints, have limited options to respond. Conventional wisdom calls, then, for structural reforms and especially for wage reduction or an increase in wage flexibility, which is expected to offset the negative effects of the adverse aggregate shock on employment and output. To the extent that wage flexibility acts as a substitute for exchange rate flexibility, it is viewed as particularly desirable in economies that have joined a currency union. The Great Recession and the Sovereign Debt Crisis qualify as asymmetric shocks for the Euro area, having affected Southern Europe much more than Northern countries, and European Central Bank's calls for structural reforms have been ubiquitous for years.

A paper by Tommaso Monacelli (Department of Economics) and Jordi Galí (Universitat Pompeu Fabra) argues that the above logic can be flawed. The paper shows that an increase in wage flexibility could be even detrimental to social welfare in an economy that is part of a currency union. In Understanding the Gains from Wage Flexibility: The Exchange Rate Connection (forthcoming in American Economic Review), the scholars obtain their results using a model of a small open economy which belongs to a currency area.

Wage reduction, the authors explain, translates into output, demand and employment gains through two transmission mechanisms. The first, the competitiveness channel, is rather straightforward: lower wages mean better terms of trade and higher competitiveness: national products substitute foreign ones, stimulating aggregate demand and thus raising output, demand and employment. The second, the endogenous policy channel, is more complex: a reduction in wages lowers inflation, triggering a monetary policy response; and it's the looser monetary policy that stimulates aggregate demand. But when a country can't implement a national monetary policy, as happens in a currency union, this second channel is muted and the welfare effect of wage reduction can be nil or even negative.

"An increase in wage flexibility must be complemented by policies able to stimulate aggregate demand", summarizes Monacelli, "and in the case of a currency union only an expansive fiscal policy can reach the goal".

The implication for the Euro area is that a coordinated European fiscal policy should allow countries affected by an asymmetric shock to implement expansive fiscal policies, loosening the Maastricht constraints. "This possibility should however always go hand in hand with the implementation of the structural reforms", continues Monacelli, "because the two interventions are complementary. As the resolution of a local crisis prevents spillovers to the rest of the area, moreover, the whole Union would benefit from it".

Fiscal policies and structural reforms, though, have different timings and the financial markets could negatively respond to the risk of a free riding government that could sooner collect the benefits of an expansive fiscal policy without later paying the toll of structural reforms. "It would be crucial to devise a way to commit the government to its resolution, trough a reliable, airtight fiscal contract", Monacelli says.

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Attached files

- Tommaso Monacelli