Understanding the Gains from Wage Flexibility

Discussion

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Motivation

- Wage flexibility?
- Dependence on:
  - characteristics of economy
  - monetary policy

Setup

- Small-open economy
- Sticky price and wages: a la Calvo θ_p, θ_w
- Policy: extended Talyor rule $i_t = \rho + \phi_\pi \pi_{H,t} + \frac{\phi_e}{1-\phi_e} e_t$
- Demand (discount factor) and supply (productivity) shocks
- Welfare loss:
  $(1+\phi) Var(n_t) + \frac{\varepsilon_p}{\lambda_p(1-\alpha)} Var(\pi_{H,t}) + \frac{\varepsilon_w}{\lambda_w} Var(\pi_{w,t})$
- Central experiment: change in θ_w

Main Results

- Focus on demand shocks
- Welfare loss hump-shaped in wage flexibility
- Marginal increases in wage flexibility can decrease welfare (more likely if exchange rate less flexible)
- Going from fully rigid to fully flexible wages can decrease welfare

Intuition

- Welfare loss:
  $(1+\phi) Var(n_t) + \frac{\varepsilon_p}{\lambda_p(1-\alpha)} Var(\pi_{H,t}) + \frac{\varepsilon_w}{\lambda_w} Var(\pi_{w,t})$
- Marginal increase in wage flexibility:
  - employment component improves
  - price inflation component worsens
  - wage inflation component...depends (higher wage inflation variance vs. lower cost of given variance)
- From fully rigid to fully flexible wages:
  - employment component improves
  - price inflation component worsens
  - wage inflation component unchanged (zero)

Role of Exchange Rate Flexibility

- Pass-through of wages to terms of trade
- Price or exchange rate adjustments
- Exchange rate adjustment:
  - faster...output stabilization
  - coordinated...saves on inflation cost

Some Comments

- Different from other arguments for destabilizing effects (on employment) of price or wage flexibility
- Here wage flexibility:
  - stabilizes employment (good)
  - creates more price and wage inflation (can be bad)
- Key: relative importance of employment vs. inflation components

Some Comments

- Here inflation cost is price dispersion (staggered price setting)
- Key determinants (apart from price stickiness): elasticity of substitution between varieties
- Usually calibrated to match aggregate markups and profits
- Fixed costs?
- More generally, relative cost of employment vs. inflation fluctuations?