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Unions' inflation aversion and international competitiveness

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Abstract

The paper explores the consequences of economic integration on wage and monetary policy management. It studies the possibility that openness may discipline labor unions through potential losses created by the worsening in terms of trade (international competitiveness) associated with high wage claims. We find that, contrary to some recent literature, a monetary expansion fails to affect real outcomes and only results in higher inflation, since the claimed wage-moderation mechanism does not work when it is properly modeled. Hence, recent policy recommendations for an expansionary monetary policy in open economies result to be counterproductive, whereas low-inflation targeting remains a first best policy.

JEL classification: J51; E24; E31; E58; J58

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1. Introduction

The recent processes of globalization and economic integration have strong implications on economic policy management, welfare state institutions, and reform designs because of

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the international positive and negative externalities they generate (see, e.g., Calmfors, 2001; Grüner & Hefeker, 1999; Jerger, 2002a).

The aspects that need to be inspected are many, e.g., whether the "old policies" based on closed-economy schemes are still useful in the new highly integrated contexts. Among these aspects, one crucial issue is how integration affects labor union behavior and, therefore, fiscal and monetary policy management. Some economists have recently studied this issue by implicitly or explicitly assuming that labor unions are inflation averse as a shortcut for taking into account the effects of international competitiveness on unions' choices.[1] By using the inflation-aversion assumption many non-conventional results have been achieved (e.g. Cukierman & Lippi, 1999; Grüner & Hefeker, 1999; Gylfason & Lindbeck, 1994; Lawler, 2000, 2001).[2]

More in detail, in the field of monetary and exchange rate policy management, the inflation aversion assumption supports expansionary monetary policy by implying a Phillips curve trade-off between employment and inflation (Gylfason & Lindbeck, 1994).[3] The underlying idea is that in integrated economies labor unions' adverse reaction to the worsening of the terms of trade via inflation implies real effects for active-demand policy. This should occur because in such a context monetary policy is not fully translated into inflation by private expectations, as it happens in the traditional Barro–Gordon framework, since labor unions take account of inflation and hence moderate their wage claims.

International competitiveness may thus discipline unions and allow monetary policy to affect real outcomes. The policy implication is that by supporting a higher inflation target (or a lower inflation weight in the central bank's preference) higher output levels can be achieved at the cost, of course, of higher inflation. Differently from the traditional conservative central banker's case, strong inflation targeting may result counterproductive as it succeeds in reducing inflation but at the cost of higher unemployment.

The above policy indications are strongly based on a modeling shortcut: unions are inflation averse because inflation worsens the terms of trade and, therefore, the real wage/employment trade-off faced by unions. In this paper, we show that, by explicitly modeling the adverse terms of trade effects on unions' preferences, equilibrium output and inflation are independent of the terms of trade effect and no wage moderation is observed. Hence, inflation aversion cannot be considered as a shortcut to model the effect of international competition on union behavior. Therefore, policy claims for monetary activism based on international competitiveness effects on unions only generates higher inflation without

[1] Unions' inflation-aversion may be justified on other grounds (Gylfason & Lindbeck, 1994). However, these alternative justifications, which imply that workers' organisations are interested—besides real wages and employment—in inflation per se, are rather weak (see, e.g., Ciccarone and Marchetti (2002) and Soskice and Iversen (2000)).

[2] All these results are based on the direct inclusion of inflation into unions' preferences (Ciccarone & Marchetti, 2002), which implies that demand policies have real effects. The inflation-aversion assumption was first introduced by Gylfason and Lindbeck (1994), but it has then become popular in order to derive non-conventional results. However, notwithstanding its importance, this assumption has not been studied in detail from both the methodological and the consistency points of view (see Acocella and Di Bartolomeo (2004) and Jerger (2002b)). For a different and more robust channel of monetary transmission, see, among others Acocella, Di Bartolomeo and Hibbs (2003), Coricelli, Cukierman and Dalmazzo (2000) and Soskice and Iversen (2000).

[3] See also Grüner and Hefeker (1999) and Lawler (2000, 2001).