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Monetary policy with asymmetries in the asset markets participation, counter-cyclical fiscal policy and «non-atomistic» wage setters

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ABSTRACT

The purpose of the paper is to study the monetary policy implications of unionized labor markets in a New Keynesian framework, augmented with asymmetries in the asset markets participation and counter-cyclical fiscal policy.

We show that the concern of «non-atomistic» wage setters for their members that cannot smooth consumption, the political exchange between government and unions (in the form of «Social Pacts») and the ability of monetary policy to activate fiscal policy, lead to the following results: i) the determinacy regions may be dependent on the incentive to moderate wage claims, and hence on institutional parameters, and ii) the monetary authority's policy trade-off between the variability of inflation and the output gap, induced by cost-push shocks, is endogenized and hence contingent on the distortions in labor and asset markets and the degree of fiscal policy counter-cyclicality. Most importantly, in our framework, this trade-off is improved, relative to an economy with «atomistic» wage setters and when counter-cyclical fiscal policy is aggressive.

These findings suggest the stabilization role of the institutions, when the monetary authority is unable to commit to future policies.

1. Introduction

In many European countries, labor relations have been marked by longstanding social partnership. In this context, the «Social Pacts» are define as “publicly announced formal policy contracts between the government and social partners over income, labor market or welfare policies that identify explicitly policy issues and targets, means to achieve them, and tasks and responsibilities of the signatories” (Avdagic and Visser, 2011). The first generation «*Social Pacts*» wanted, after the oil shocks, to trade wage moderation for higher public expenditures/tax concessions and employment creation or lower inflation. The second generation «*Social Pacts*» was designed to reduce governments’ influence and to increase the emphasis on active labor market policies on the supply side, while wage moderation still features. Unlike corporatism in the 1970s, «*competitive corporatism*» in 1980s and 1990s, was seen as a part of a disinflation strategy in order to face the challenges of globalization, economic integration and the monetary unification in Europe (see, Hancké & Rhodes, 2005; Accocella et al., 2007a, 2007b; Hassel, 2010, p. 334; Avdagic, 2010; Avdagic and Visser, 2011). Finally, according to Regan (2017a, pp. 151–170), in selected EU countries (France, the Netherlands and Portugal) social pacts played a

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significant role, during and since the economic and financial crisis which started in 2008, while the resurgence of social pacts in Europe is primarily attributed to weak governments (Avdagic, 2010; Regan, 2017b).

Even though «*Social Pacts*», as a formula for policy making based on compromises between governments and social partners, were very popular in Europe (Appendix A), theoretical analyses of macroeconomic outcomes in corporatist economies are limited. First, the literature almost exclusively focuses on strategic interactions between «*non-atomistic*» wage setters and monetary policy (Bratsiotis & Martin, 1999; Cukierman & Lippi, 1999; Di Bartolomeo, Tirelli, & Acocella, 2013; Lippi, 2003; Soskice and Iversen, 2000). Indeed, the analysis of interactions between trade union behavior and fiscal policy is restricted. Notable exceptions are Acocella, Di Bartolomeo, and Tirelli (2007b), Cavallari (2010, 2012) and Larsson (2012). Second, only few authors incorporate the literature on strategic interactions between monetary policy and trade unions into the standard New-Keynesian model (see Gnocchi, 2005, 2006, 2009; Coricelli, Cukierman, & Dalmazzo, 2006; Cuciniello, 2007, 2011 and Acocella, Di Bartolomeo, & Tirelli, 2008, 2013), while, so far, there is no literature concerning fiscal policy interactions with labor market, in this kind of models.

This gap is linked to the «*conventional assignment*» in the standard New Keynesian model, according to which monetary policy can determine inflation, while fiscal policy prevents debt from becoming unstable (Woodford, 2011; Clarida, Gali, & Gertler, 1999, Kirsanova, Leith, & Wren-Lewis, 2009, etc). Considering fiscal policy as exogenous, and so not suitable for demand stabilization issues, can be justified on grounds of, among others, the virtue of «*Ricardian Equivalence*». As a result, the focus of the relevant literature is restricted on institutional constraints on monetary policymaking as a key ingredient in shaping macroeconomic outcomes, i.e. central bank conservatism or independence, disregarding possible interactions either between fiscal authority and trade unions or fiscal authority and monetary authority.

The purpose of this paper is to add to the literature by revealing the importance of these social partnerships, especially between fiscal authority and trade unions, for the conduct of monetary policy. Our rationale for government intervention in wage bargaining and income policy is in line with Hassel's (2010, p. 334) argument[1]: Governments prefer to seek negotiations with trade unions on wages, if the monetary authority is unable to credible commit to future policies and, therefore, in using the expectations channel to help stabilize inflation expectations. The setup of our work is closely related to Gnocchi (2005, 2006, 2009), Acocella et al. (2008, 2013), Cuciniello (2007, 2011), Coricelli et al. (2006). In contrast to the preceding literature, where fiscal policy is being considered as exogenous, we assume that fiscal policy can stabilize economy: whenever output/employment is below its target, the fiscal authority increases public expenditures.

Moreover, for fiscal policy to have impact on aggregate demand, we must break the «*Ricardian Equivalence*». An easy way to do this is to assume that a fraction of households do not have access to financial markets. Except from being simplifying, this choice for breaking the «*Ricardian Equivalence*» help us to reveal a totally new aspect in the literature on strategic interactions between labor market and the macroeconomic authorities: The concern of «*non-atomistic*» unions for their members who can't smooth consumption. With the global financial crisis spreading to the real economy, we believe that this is an interesting area for further research.

In particular, our paper describes a New Keynesian DSGE model which incorporates three main assumptions-departures from the standard model (Woodford, 2011; Clarida et al., 1999; Galí, 2015; and; Walsh, 2017). The first one is «*non-atomistic*» wage setters, who internalize the consequences of their wage decisions on aggregate variables. The second one is the incorporation of countercyclical fiscal policy, which share similar characteristics with the Taylor-rule, in monetary economics. Combining this modeling choice with the first assumption, gives us the opportunity to incorporate «*Social Pacts*» into a standard New-Keynesian model. The latter assumption is asymmetries in the asset markets participation, since a fraction of the households do not have access to asset markets (see Bilbiie, 2005, 2008; Bilbiie & Straub, 2013; Galí, López-Salido, & Vallés, 2007, 2004; Ascari, Colciago, & Rossi, 2017, 2011; Rossi, 2014; and; Di Bartolomeo & Rossi, 2005) and it is a prerequisite for the second hypothesis.

Thus, in our model, various characteristics of institutions, such as the degree of asset markets participation, central wage bargaining and counter-cyclicality of fiscal policy, form a specific labor market (labor supply): We postulate that «*non-atomistic*» unions have a motive to moderate wage increases when, the degree of fiscal policy counter-cyclicality increases (i.e. the so-called «*Social Pacts*», where governments offer fiscal expansion in exchange for wage restraint), and/or the fraction of Non-Ricardian households or the mass of unions (degree of wage setting centralization) decreases. It's worth noticing that, this dependence of the wage policy decisions from the characteristics of institutions is the corn store of our model and drives our results. Indeed, these interactions between trade unions, fiscal policy and asset markets alter both the slope of the New Keynesian IS curve (NKISC) and Phillips curve (NKPC). The latter have, beyond doubt, interesting implications for the framework for monetary policy analysis, i.e. the stability properties of simple interest rate rules, the aggregate dynamics of the economy and the inflation/output gap volatility trade-offs for the discretionary monetary policy (in the aftermath of a cost push shock).

Therefore, this paper adds to the recent literature in various ways. One strand of the literature investigates the stability properties of simple interest rate rules and relates the latter with the asymmetries in the asset markets participation hypothesis. This assumption by itself and labor market conditions (inter-temporal elasticity of labor supply, wage stickiness, etc) can change dramatically the slope of the NKISC and consequently the properties of widely used interest rate rules (see Galí, López-Salido, & Vallés, 2004; Galí, 2015; Bilbiie & Straub, 2004; Bilbiie, 2008; and; Rossi, 2014). We postulate that the determinacy region may depend on i) the incentive for aggressive wage claims-and so on institutional variables- and, ii) the degree of monetary feedback on fiscal policy stance.

Second, it is well known that, in the standard New Keynesian model, if cost-push shocks drive inflation, the «*Divine coincidence*» (Blanchard & Galí, 2007) disappears automatically, generating a meaningful policy problem in terms of the appropriate formatting of

[1] Except from the lack of credibility, Hassel (2010) emphasizes the uncertainty about monetary policy, the government's political dependence on the social partners and the sensitivity of the wage bargaining institutions as prerequisites for the government to seek direct negotiations with trade unions.