NationalBank OF BELGIUM
Eurosystem

2010-06-16

PRESS RELEASE

What have we learnt from the Wage Dynamics Network?

(Article published in the June 2010 Economic Review)

The Wage Dynamics Network (WDN) is a temporary research network, active from 2006 to 2009, set up by the European System of Central Banks (ESCB). It gathered researchers from the European Central Bank and 25 national central banks, together with external consultants. Its main aims were to gain a better understanding of the link between wages and prices at both microeconomic and macroeconomic level, and more generally to identify the characteristics of wage dynamics and draw conclusions for monetary policy.

For the macroeconomic side of the network, the researchers used time series and institutional data to support their analyses and to construct, calibrate and/or estimate models. This was accompanied by a major project involving the analysis of microeconomic data consisting of individual information on workers and employers. In 2007-2008, the WDN also conducted a survey covering some 15,000 firms in 16 countries, asking about their wage policy in order to supplement the existing statistics. Following the crisis, the survey was repeated in the summer of 2009 in 10 countries, polling the same sample of firms. The results of the research conducted at micro- and macroeconomic level are remarkably consistent with the survey findings, and that can be taken as a measure of credibility.

The wage structure and the institutions underlying wage setting are relatively stable over time, but they differ from one country to another. Despite those differences, the countries can be subdivided into groups sharing a set of institutional characteristics. The Belgian institutions are comparable overall to those in most euro area countries, except that the indexing of wages to price inflation is far more important. At inter-sectoral level, there are significant, persistent wage differences which can only be partly explained by composition effects (the fact that wages depend on worker characteristics, the type of occupation and the employer) and which suggest that, particularly in less competitive sectors, firms to some extent share with their workers the benefit which they gain from their dominant position by paying higher wages.

Wage rigidity was examined from various angles. First, it seems that wages are revised less often than prices, frequently at fixed intervals rather than in response to changes in the economic environment. Second, firms are very reluctant to reduce wages, and that can lead to a wage freeze. This was a particular feature of the recent economic crisis. Third, if firms suffer negative shocks, wages play only a very marginal role in cost adjustment. That finding was borne out by the recent crisis. Finally, downward adjustments rarely affect base wages, even in the case of new recruits, but tend to concern the variable component.

Regarding wage rigidity, it is important to distinguish between nominal and real rigidity. Nominal rigidity still offers some possibility of adjusting real wages via price inflation. That relative room for manœuvre disappears in the case of real rigidity. Factors which encourage real wage rigidity include the degree of worker protection, the level of replacement incomes, the centralisation of wage negotiations, the indexation of wages in line with price inflation, and the lack of competition on the goods market. The greater the downward rigidity of real wages, the more likely it is that firms facing negative shocks will react by adjusting the size of their workforce. To do that, they cut the number of permanent staff, but also make use of the scope for adjustment offered by temporary staff and reductions in working time. They made particular use of the latter in the recent crisis, with government support. The euro area in general features downward rigidity of real rather than nominal wages.

Communication | boulevard de Berlaimont 14 | phone + 32 2 221 46 28 | Company's number:
National Bank of Belgium Ltd. | 1000 Brussels | www.nbb.be | 0203.201.340 – RLP Brussels

On the basis of the results of the research conducted by the WDN, it is possible to formulate a number of monetary policy implications. First, real wage rigidity complicates the operation of monetary policy in that it results in larger fluctuations in output and employment, and is a source of inflation persistence. Next, the optimum inflation rate is lower the greater the downward rigidity of real wages. That implies a low inflation target for the euro area in general, in line with the ECB's inflation target of just above 2 p.c. Finally, the research also shows that in a monetary union, the countries with greater real wage rigidity suffer a loss of competitiveness in the event of negative productivity shocks. Generally speaking, wage institutions play a key role in the way in which firms and economies respond to shocks. Institutional differences between euro area countries therefore present a challenge for monetary policy, a problem which will grow with each future enlargement of the euro area. All this highlights the need for labour market reforms with a view to harmonisation and greater flexibility. However, those reforms will entail achieving a delicate balance between the optimum allocation of resources and social protection.

Communication
National Bank of Belgium Ltd.
boulevard de Berlaimont 14
BE-1000 BRUSSELS
phone + 32 2 221 46 28
www.nbb.be
VAT BE 0203.201.340
RLP Brussels