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PRESS RELEASE

Wages, labor or prices: How do firms react to shocks?

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Survey results in 15 European countries reveal that, compared with the "average" European firm, Belgian firms prefer to adjust permanent and temporary employment when they are hit by adverse shocks. This paper investigates what factors explain this difference, by testing the adjustment channel used by firms in reaction to two cost-push shocks, namely an increase in the cost of intermediate inputs and a general rise in labor costs, and to a negative demand shock. Do they adjust prices? Costs? Or a mixture of both? In the case of a cost adjustment, the choice between a reduction of (base or flexible) wages, permanent employment, temporary employment, hours worked or non-labor costs is investigated.

Firstly, our analysis reveals that, in response to cost-push shocks, 65 p.c. of European firms will adjust both prices and costs. 14 p.c. of firms will only adjust prices, 11 p.c. of them will only reduce costs, while the remaining 10 p.c. will use another strategy. A pure price-adjustment strategy is more likely, and therefore a pure cost reduction is in most cases less likely, if the labor cost share is high, in firms employing many (low-skilled) blue-collar workers, in small companies and when wages are rigid. On the contrary, firms are less inclined to adopt a pure price-adjustment strategy, and more likely to reduce prices and costs, if they face high competition. Belgian firms behave more or less the same. Overall, European and Belgian survey findings suggest that flexible wages reduce the likelihood that (cost) shocks will be passed on to prices.

Secondly, firms that respond to a shock by adjusting costs do so mostly by reducing non-labor costs. The survey analysis reveals that 27 p.c. of European firms will reduce employment, while the remaining 17 p.c. will cut flexible wages or working time. An employment reaction is more likely in firms facing (real) wage rigidities linked to the existence of wage-setting institutions, such as collective wage agreements signed outside the firm, policies that adapt changes in wages to indexation (only for a demand shock), and a high share of employees covered by collective agreements, as well as in firms active in a highly competitive and labor-intensive environment and employing many low-skilled blue collars. Besides, a high share of temporary employees increases the likelihood of a reduction in temporary employment, while it protects permanent employment. Jobs are also safeguarded by a large share of flexible pay in total wages. Firms operating in construction, trade and market services, as well as small firms, are also less likely to cut back on temporary employment. These results are of course conditional on the fact that the shock is not so large that it would push the firm out of the market.

Most of these findings go some way towards explaining the stronger employment reaction of Belgian firms (37 p.c. of firms will cut employment) compared to the average of countries participating in the survey (27 p.c.). Belgian companies are indeed characterized by a larger share of above-firm-level collective wage agreements, an automatic system of index-linking wages to past inflation, a high share of employees covered by collective agreements, a low share of flexible wages, slightly higher labor intensity and many low-skilled blue collars in their workforce, compared to the average of the 15 countries. As for the blue-collar workers, a reduction in the number of hours worked is also more likely, because the system of temporary unemployment protects workers against dismissal in the initial phase of the shock. Even though the share of temporary employment is low in Belgium, its use is widespread and adjustment costs are low compared to permanent employment. Therefore, many firms use flexible employment as a buffer to absorb unexpected shocks. The presence of many small firms in Belgium also tends to safeguard employment. A test of some country-specific control variables reveals that employment is further protected by the presence of a wage cushion, i.e. the difference between wages actually paid and the scales fixed by the collective wage agreements.

After controlling for the impact of the variables mentioned above, the difference between the employment response to shocks of firms in Belgium and that of other countries remains significant. In order to explain the remaining cross-country differences, the probability of adjusting wages, permanent employment or temporary employment is regressed on a set of variables observed at the national level. The results reveal that the more stringent the legislation with respect to the protection against dismissals, the more firms adjust wages and the less they tend to adjust permanent employment, with temporary employment contracts acting as a buffer in response to an adverse shock. As the legislation is less strict in Belgium, it helps to explain the larger reaction of permanent employment to shocks in Belgian firms.

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