Understanding the Gains from Wage Flexibility: The Exchange Rate Connection

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Background

- In a closed-economy New Keynesian model, the effects of a policy that reduces labor costs largely depend on monetary policy.

- Consumption Euler equation

$$c_t = E_t \left[-\left(x_{t+1} - x_t + i_t - \pi_{t+1} \right) + c_{t+1} \right]$$

- Example: Eggertsson-Woodford discount factor shock ($\Pr\{x_{t+1} = x_t\} = \mu$) and $i_t = \phi\pi_t$

$$c = x - \frac{\phi - \mu}{1 - \mu}\pi$$

Background

- Moving from a closed to an open economy model has two effects:

- "endogenous policy channel"

- "competitiveness channel"

This paper

- A small open economy New Keynesian model with a labor tax and Calvo sticky wages

- Effect of a temporary reduction in labor costs on employment is positive, but smaller the more the central bank seeks to stabilize the exchange rate.

- Increase in wage flexibility may reduce welfare, and more likely so in economies with an exchange rate-driven monetary policy.
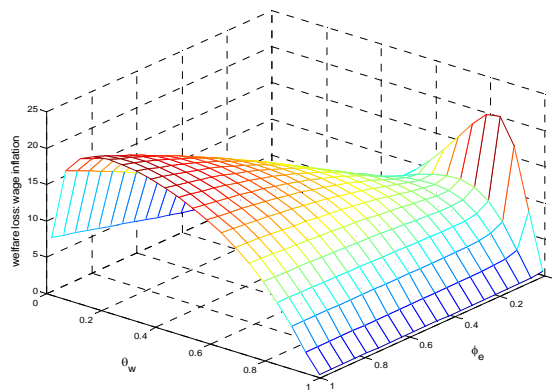
Figure 4
Welfare Loss Decomposition: Demand Shocks
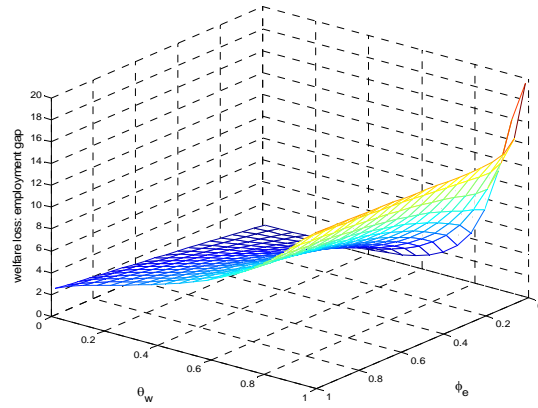
(a) Employment component
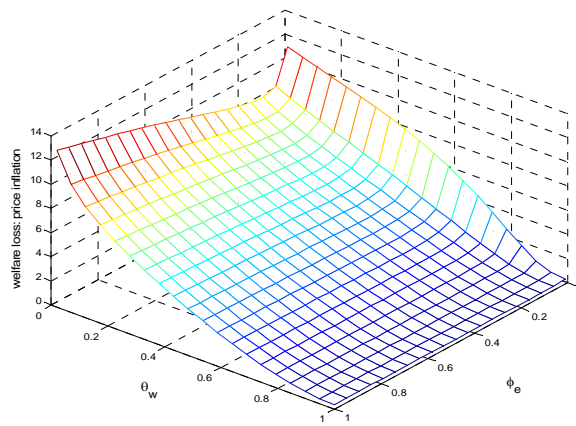
(b) Price inflation component

(c) Wage inflation component

- Great paper!

Suggestion I

- The first policy experiment looks very much like policy proposals for the euro-area, but could look even more so.

- Two country model

- To which extent does the success of a labor market reform in country B depend on the interest rate being lowered in both country A and country B?

- More generally, currently one parameter at a time is being changed. Can one make a policy a clear success by jointly moving two parameters?
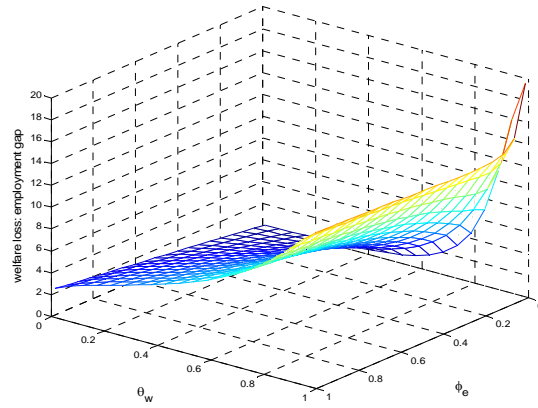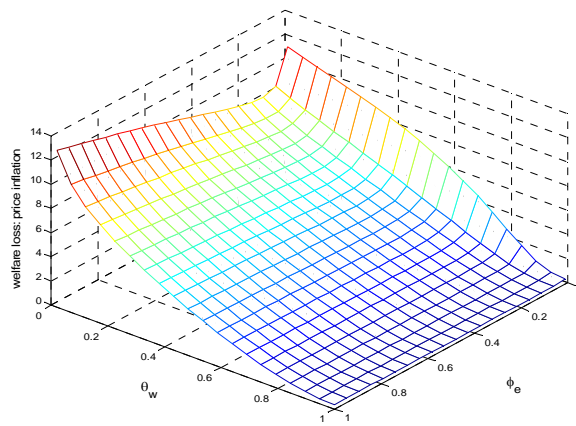
Suggestion III

- The loss function

$$L \sim (1 + \varphi)\, var\left(\tilde{n}_t\right) + \left(\frac{\epsilon_p}{\lambda_p\left(1 - \alpha\right)}\right) var\left(\pi_t^p\right) + \left(\frac{\epsilon_w}{\lambda_w}\right) var\left(\pi_t^w\right)$$

- The three components of the welfare loss have different shapes. Therefore, conclusions about the overall welfare loss will depend strongly on the values of ϵ_p and ϵ_w.

- I recommend looking at the empirical IO literature and the empirical labor literature to calibrate ϵ_p and ϵ_w.

Figure 4
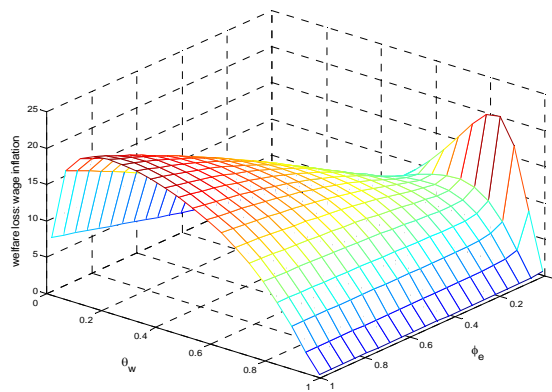**Welfare Loss Decomposition: Demand Shocks**

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