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# Reflections on wage-setting

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## Abstract

Central banks need to be concerned about wages since they are a major driver of inflation. Rising wages are needed to signal directions for market adjustments to ensure growth. Wage growth is driven by relative scarcity, labor productivity and expectations about inflation and future growth. Migration plays a significant role to balance wages across regions and countries. Wage growth has been low in most developed economies because of underutilized labor if properly measured. Germany seems to be an exception, but the scarcity of workers has been tamed by internal flexibility resulting from more decentralized wage-setting and labor market reforms.

## 1 Introduction

Why do central banks need labor economists? When I wrote my diploma thesis forty years ago about “Rational expectations and the Phillips Curve”, there was none usable for policy – making and inflation was perfectly controlled by the size of available money. Inflation was an issue of too much money. Today, we are concerned about sluggish wage growth and measure inflation expectations by past inflation, if at all. The old Philipps Curve is rehabilitated. We do not care anymore about too much money. And central bankers like Jens Weidmann ask those bargaining for wages for a stronger wage growth. All puzzling, in particular in the face of discussions about scarce skilled labor in economies such as Germany. To what extent is this all still the consequence of the Great Recession or already the result of a new “digital economy”? Or is the lack of orientation driven by our fading ability to measure the key concepts of wages, prices, output (goods and services) and labor input effectively? In any case, since a tautology remains valid, using the definition of the labor share as wage costs divided by nominal output, we still see that inflation equals wage growth minus labor productivity growth minus growth of the labor share. All factors exposed by this decomposition are of interest for labor economists, and therefore are interesting topics for exchange between monetary economists and labor researchers.

## 2 What are wages and why should they rise?

Wages are not just simply cost factors for companies or the source of income for households. They carry important economic market signals about absolute and

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relative scarcity for the orientation of firm and household behavior. This helps to provide the best allocation of economic resources and to find the highest welfare levels. It is in particular important to deal with and properly respond to structural changes in the economy. This implies that relative wages across regions and between different occupations have to be flexible up and down.

With no wage growth, some types of wages would have to rise, others to fall. However, it is well known that wages fail to adjust downwards, even in recessions (Bewley, 1998; 1999) for current employees or new hires. Employers are afraid of damaging motivation, which wage cuts would cause. Hence, wages vary little with the business cycle. In a recent study, Hazell, Kazemi and Taska (2018) show that this also holds in the hiring process even for posted wages where employers are in a much stronger bargaining position. In a situation of posted wages, workers take the wage as given when they choose the job, while in the other situation there is wage bargaining.

In the face of this downward - inflexibility of wages, rising wages in general allow relative wages to be more flexible, since some wages can stay constant or rise only slowly, while others move up significantly in case of temporal relative scarcity or structural changes. Market signals can be conveyed more forcefully with rising wages.

However, the measurement of wages like the measurement of prices has become increasingly difficult with changes of production technology, the rise of the service sector, digitalization and the globalization of work and international collaborations. Dividing labor costs by the number of workers or hours spend at work is becoming questionable in the face of unpaid overtime work, labor hording strategies or “joint production” employing leisure on the job or working from home. Non-wage labor costs for the companies and non-wage labor benefits for the worker have to be considered.

## 3 What determinates low wage growth and should we worry?

Should we worry about the low wage growth observed? Missing clear signals of relative scarcity should eventually cause slower economic growth. The original Phillips curve connecting wage growth to unemployment as the measure of labor scarcity has been one way to measure this. Indeed, the instrument is not only back, but also this curve (as the modified replacing wage growth by inflation) has flattened strongly in most countries in recent years. (See for instance Bell and Blanchflower, 2018a; Kügler, Schönberg and Schreiner, 2018.) The natural rate of unemployment has fallen sharply since the Great Recession.

However, unemployment became fairly low in many countries and the question arises why wages would not move up. Bell and Blanchflower (2018a; 2018b) explain this by a substantially larger degree of underemployment on the job since the Great Recession. They claim that there is a lack of wage pressure in spite of comparatively low unemployment rates since those rates would understate the labor market slack. This moderates when they use a measure of underemployment replacing unemployment. In constructing such a measure they use survey data for various countries about the degree people at work would like to provide more or less. They find that since the crisis, the underemployed like to work more than they did before, and the highly employed do not want to work as much less than they did before. Underemployment has not returned to their pre-crisis levels with the exception of Germany.

Hence, Bell and Blanchflower (2018a) argue that low wage growth and low unemployment can co-exist without harm for quite a while. They also point at a historical controversy between Beveridge and Keynes. Contrary to Beveridge, Keynes doubted in 1944 that persistent levels of unemployment around 3% were feasible without substantial wage increases. In 1960 Beveridge stated an average unemployment rate of 1.5% for 1948-1959 in the United Kingdom with no sign of wage explosion.

Next to scarcity there are other factors driving (nominal) wages including productivity, innovations, price and growth expectations as well as globalization through trade, migration and internet collaborations. Digitalization reduces scarcity. Relevant are also institutional changes like labor market reforms, the decline in the role of unions and a decentralization of wage bargaining.

## 4 Why is Germany different?

That Germany has seen for long a slow wage growth as has been noted by Deutsche Bundesbank (2018), Bell and Blanchflower (2018a) and Kügler, Schönberg and Schreiner (2018) among others. This is surprising since Bell and Blanchflower (2018a, 2018b) found it the only country where underemployment has also declined significantly recently and the labor market is close to full employment with scarcity of skilled labor. Kügler, Schönberg and Schreiner (2018) largely explain this by a long-term rise in internal labor market flexibility through a decline in union power and a rise in decentralized wage bargaining.

The question remains why this had happened contrary to the developments in other European countries like France, Spain and Italy with their inflexible and sticky labor markets. Cahuc, Carcillo, Rinne and Zimmermann (2013) had studied differences in the youth labor market between France and Germany to find that the fundamental differences between both countries result from structural differences in labor policy and in the vocational training system. To generalize, wage growth remained relatively high although with high unemployment because of the lack of structural reforms in France.

The issue of the rise of internal flexibility as a cause for the large labor market success of Germany had been promoted before in a series of articles by Rinne and Zimmermann (2012, 2013) and Brenke, Rinne and Zimmermann (2013). However, they argue that such development was significantly influenced by societal pressure and interacted closely with the German labor market reforms and policy design that enforced flexible adjustments responding to structural changes and the big shock during the Great Recession.

The reform measures brought a substantial amount of low-skilled workers into work. Their low wages and small pay dynamics by definition led to a smaller increase in general wage change measurement. The reform pressure and various “employment pacts” of the government with the social partners had enforced decentralization tendencies with wage bargaining including the rise in opt-out clauses in union wage contracts in reaction to critical situations in the companies. The available political instrument to declare union wages generally binding for all companies of a certain industry or region (“Allgemeinverbindlichkeitserklärung”) orchestrated by the responsible labor ministry was less used. Governmental policies like the elaborations and public support of the short-time work instrument brought also substantial flexibility at the time of the Great Recession.

Will Germany remain different? Recent German governments including the current one have re-reformed labor policies, increased non-wage labor costs and weakened flexibility again. The general minimum wage introduced in 2017 add to those factors affecting wage growth in the future. Indeed, also union wages were already rising stronger in 2018 and consumer prices were over 2% in Mai and June 2018.

## 5 Migration for monetary policy

However, also migration across Europe is reacting to relative scarcity and affects productivity. As Deutsche Bundesbank (2018) stated, Germany managed to attract the needed workers largely from other European countries. This has weakened wage-pressures and brought jobs particularly in low-wage sectors contributing to the slow wage-growth of Germany in recent years. Migration has also affected German labor productivity.

Migration remains an important source of flexibility in particular in the eurozone. With no flexible exchange rates, mobile workers can bring adjustments, in particular in response to asymmetric shocks. A recent paper by Jauer, Liebig, Martin and Puhani (2018) has studied whether migration can be such an equilibrating force by comparing pre- and post- Great Recession migration movements at the regional level in both Europe and the United States. They found Europe today as flexible with migration than the United States. In their analysis, up to a quarter of annual asymmetric shocks can be absorbed by migration in Europe. However, the flexible migrants largely come from new member countries from Eastern Europe and from third-country nationals.

The lesson is that labor migration should be studied carefully by central banks, in particular the European Central Bank. This is even more important in the face of the rising but unfounded mistrust in the various member states about the positive contributions of migration to the functioning of the European economies.

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