

# THE IMPACT OF MONETARY UNION ON LABOUR MARKET BEHAVIOUR

What are the macroeconomic consequences of the establishment of a monetary union when labour markets are unionised? That is the question addressed in new research by **Alex Cukierman** and **Francesco Lippi**, published in the latest issue of the *Economic Journal*. Their analysis suggests that monetary union is likely to make unions more aggressive in their wage demands, thus increasing inflation and unemployment. This is primarily a result of each union's perception of the potential inflationary impact of its individual actions being reduced by its relatively smaller size in the whole economy.

There are a number of qualifications to the theoretical result that monetary union leads to more aggressive wage behaviour and hence to higher unemployment in the participating countries:

- First, when the degree of competition in labour markets differs across countries, the effects of monetary union on unemployment may be different in different countries. For example, the formation of a monetary union between two countries leads to a larger increase in unemployment in the country in which the labour market is less competitive, and may even decrease unemployment in the other country.
- Second, when unions are not averse to some inflation, the formation of a monetary union always increases unemployment. This increase is larger in smaller countries and at its biggest at intermediate levels of centralisation and of labour market competitiveness.

The researchers examine the robustness of their results to two alternative institutional scenarios that may be relevant to Europe. The first scenario recognises that some of the European countries in the ERM system were already committed to German monetary policy prior to joining the European economic and monetary union (EMU). Under the assumption that this commitment was credible, the analysis predicts that with the adoption of EMU, the unemployment problem may become more serious in Germany (the pre-EMU anchor country) and less serious in the satellite countries.

This is due to the fact that wage increases in a typical satellite country did not prompt a monetary policy reaction since German monetary policy reacted only to German wages under the ERM. By contrast, within EMU, monetary policy reacts to wage settlements in all EMU countries. Hence the perception of unions in the former satellite countries about the inflationary consequences of their actions is stronger in EMU than under the ERM, leading them to more wage moderation. On the other hand, German unions' perception of the inflationary consequences of their wage decisions is weaker in EMU than under the ERM, leading them to more wage aggressiveness.

In the second scenario, Cukierman and Lippi explore how wage leadership by unions in one

country alters macroeconomic performance across EMU in comparison to a case in which all unions in EMU take the nominal wages of other unions as given. Their analysis suggests that if unions' aversion to inflation is not 'too high', the wage premium in the country with the leading unions is lower than the corresponding premium where there is no wage leadership.

This happens because the leader-unions anticipate that their wage increases will be followed by similar increases on the part of the follower-unions. This induces the leader-unions to internalise the inflationary repercussion of their actions to a larger extent than under simultaneous bargaining, moderating their wage claims. Moreover, the moderating effect on average wage demands in EMU is larger when the labour market structure in the country whose unions are followers is highly decentralised.

**Notes for Editors:** 'Labour Markets and Monetary Union: A Strategic Analysis' by Alex Cukierman and Francesco Lippi is published in the July 2001 issue of the *Economic Journal*. Cukierman is at Stanford University; Lippi at the Banca d'Italia.

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