Guy Quaden: Price and wage rigidities in an open economy

Opening address by Mr Guy Quaden, Governor of the National Bank of Belgium, at the fourth biennial colloquium of the National Bank of Belgium, Brussels, 12 October 2006.

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It is a great pleasure for me to open the fourth biennial colloquium of the National Bank of Belgium and to welcome you all at this conference. The topic of this year's conference is "Price and Wage Rigidities in an Open Economy".

Understanding how prices and wages are determined and how they fluctuate over the business cycle is of course a crucial issue for central banks. Nominal and real rigidities in price and wage setting have a strong impact on how the economy, and inflation in particular, reacts to all kinds of shocks. As far as these rigidities result in deviations of prices from their efficient levels, they will lead to an inefficient allocation of resources and unnecessary volatility in output and employment. Especially in a global context, with a rapidly changing external environment, flexible prices and wages can protect the economy against costly real adjustments and improve its resilience. That is the very reason why we are interested in measuring these rigidities, in understanding their nature and in assessing their welfare implications. This knowledge may eventually result in formulating deliberate policy recommendations for structural reforms in view of reducing rigidities in price and wage setting, to the extent that this is desirable from a welfare perspective.

However, as far as these rigidities are deeply rooted, monetary policymakers are faced with them as part of the environment in which they operate. Price and wage rigidities have indeed a strong impact on the monetary transmission mechanism. They also affect the way central banks will combine their pursuit of price stability with a more general concern about real economic developments and the policy trade-offs involved.

The importance of these issues induced the National Bank of Belgium to devote its 4th biennial colloquium to "Price and Wage Rigidities in an Open Economy". The aim of this conference is to promote theoretical and empirical research, both at the micro and the macro level, on the measurement, the rationale and the consequences of price and wage rigidities in an open economy.

By way of an introduction to the conference, I would like to underline the policy relevance of many of the topics that will be discussed in the presentations today and tomorrow.

In order to evaluate the relevance of the different types of rigidities, it is first of all important to document the stylised facts of price and wage setting at the micro, the sectoral and the macro level. Recently, there has been an increased research interest in studying price and wage setting at the very micro level, for instance within the scope of the Eurosystem Inflation Persistence Network and the International Wage Flexibility Project. The studies produced in these research networks constitute important contributions to our understanding of price and wage rigidities and I myself was impressed when Frank Smets presented the findings of the Inflation Persistence Network in a seminar for the Governing Council of the ECB. Frank Smets will give a similar presentation here. I am also pleased that tomorrow morning Bill Dickens from The Brookings Institute will present the results of the International Wage Flexibility Project. In addition, some other papers will provide us with new material based on micro-economic datasets of prices and wages.

Besides measuring the degree of price and wage rigidities, it is also important to understand their economic rationale. Nominal adjustment costs constitute the simplest argument to explain price and wage rigidities. However, constraints on price and wage changes may also assume a much more complicated form. Pricing decisions can be influenced by arguments that are derived from strategic interactions with competitors or with customers. Wage flexibility can be restricted by the existence of collective agreements, that avoid costly individual and frequent wage negotiations, by the existence of search costs or by the impact of wages on the employee-employer relation in terms of motivation or perception of fairness. Price and wage arrangements might also reflect distributive motives to guarantee a stable income flow to firms or households, as capital market imperfections may constrain their ability to smooth their revenue. Therefore, understanding the rationale behind the different forms of rigidities is of particular importance for analysing their welfare implications, for assessing the scope to address them with structural reforms and, finally, to derive their implications for monetary policy.

Understanding how prices and wages are set at the firm level is also a prerequisite for understanding the behaviour of the aggregate price and wage level over the business cycle and to see how they react to different types of shocks. Nominal rigidities in price and wage setting also imply that monetary policy, and nominal demand fluctuations in general, have an impact on economic activity. Knowledge about price and wage setting is therefore fundamental to understand both the monetary policy transmission process and the potential trade-offs monetary policy may be faced with.

These trade-offs come up in the debate on the optimal rate of steady state inflation, in which it is emphasised that inflation has both so-called "grease" effects, essentially because it makes the economy more flexible - particularly in the presence of specific downward rigidities -, and so-called "sand" effects, which are mainly due to the fact that inflation leads to more adjustment costs and to excess relative price and wage variability which distorts allocative decisions. The "sand" argument stresses that the existence of nominal rigidities is an important element explaining why inflation is costly and why central banks should maintain price stability. However, central banks also acknowledge the "grease" argument as they typically define price stability as a moderately positive inflation rate. Weighing both arguments was one of the reasons why the Governing Council of the ECB in May 2003 specified that, in the euro area, price stability is to be seen as an annual increase in the area-wide HICP below, but close to 2 % in the medium term.

Moreover, monetary policy may be faced with a short-run trade-off between inflation stabilisation around the target value and output stabilisation. Some contributions during the conference, for instance the keynote presentation which Jordi Galí will give this afternoon, address these issues in theoretical models. It is however obvious that this topic is also relevant for the actual conduct of monetary policy. Indeed, as in recent years we have been faced with a rather unusual clustering of shocks of the cost-push type with an upward impact on inflation in the euro area, the medium-term orientation of the monetary policy framework of the Eurosystem induced us to accommodate their first round effects on inflation and to focus on avoiding their having second-round effects in price and wage setting. Thus, the flexibility explicitly embedded in the medium term orientation of our monetary policy framework allowed us to take care, insofar as possible, of stabilising output developments, while the mere fact of having a well-specified strategy with a quantified definition of price stability helped us to anchor inflation expectations.

Another relevant question being raised is how price and wage rigidities are affected by the ongoing process of globalisation. The keynote presentation of Andrew Scott in tomorrow afternoon's session for instance focuses on how relative prices and mark-ups are influenced by trade integration. Ongoing globalisation is indeed expected to strengthen competition and to reduce mark-ups in goods and labour markets. In conjunction with other structural changes resulting from reform efforts, this should lead to a higher steady state output and employment level, and to the extent that these structural changes actually take place, monetary policy can and should accommodate this increase in potential output. This globalisation process had also an impact on inflation, and if it is a gradual and ongoing phenomenon, inflation may be affected over a fairly long period of time by a succession of impulses which, taken individually, are generally short-lived. Coping with these developments is another important challenge for monetary policy.

Many of these topics are discussed in detail in the twelve papers that will be presented during this conference. The papers are grouped in four sessions. Each session starts with a keynote lecture by an internationally distinguished researcher. Seven papers are the result of the research effort of Belgian academic teams, some of which were carried out in collaboration with our own researchers or with international experts. A selected group of outstanding economists will act as discussants of these research papers. Their comments will be the start of a discussion I would like all of you to participate in. I hope that this conference, by offering central bankers and academic researchers the opportunity to exchange ideas, will contribute to our understanding of price and wage dynamics, and improve further economic analysis on which our policy decisions are finally based.

I should like to thank all researchers who contributed a paper to this conference, the discussants for their efforts to stimulate the discussion, as well as all participants in the conference. I hope you will spend two rewarding and pleasant days at the National Bank of Belgium and I am looking forward to learn at some point in time about the outcome of your research efforts and the discussions held in the course of this conference.