Labor market imperfections, real wage rigidities and financial shocks

Di Nicola Acocella, Laura Bisio, Giovanni Di Bartolomeo, Alessandra Pelloni

The recent financial crisis has stimulated important discussions in policy and academic arenas. In particular, it has become clear that understanding the functioning of contemporary economies and formulating the proper policy responses to the shocks hitting them requires the use of a macroeconomic framework in which financial intermediation matters for the allocation of resources. One of the specific issues emerging from these debates is the way in which the design of labor market institutions of an economy affect its reaction to financial shocks. The consensus view among economists would suggest that economies with more flexible labour markets will be quicker in going back to equilibrium after being hit by a financial shock. However there is evidence concerning the fact that economies characterized by more competition in the labor markets seem to have suffered less rather than more in terms of unemployment after the recent financial crunch. In our paper we try to find an explanation for this evidence, which seems to contradict the conventional wisdom.

We explore the interaction between distortions in the labor market and financial frictions in a formal setup explicitly designed to model financial disturbances. An appropriate framework to study the financial shock transmission mechanisms has been recently developed by Gertler and Karadi (2009) and Gertler and Kiyotaki (2010). They show that if, due to an agency problem between bankers and depositors, bankers are constrained in the amount of credit they can provide to investing firms, so that a financial spread between the interest rate paid to depositors and the return on loans emerges disturbances to the quality of capital induce a credit drop and a significant downturn in economic activity by creating capital losses in the financial sector.

By using a simplified version of the above framework, we analyze the possible interactions between financial frictions and labor market institutions. In particular we consider the effects of the presence in the labor market of monopolistic competition and of strategic non-atomistic wage-setters, who may coordinate their decisions. This way a "labor wedge" appears: ie the real wage differs from the marginal rate of substitution between leisure and consumption.

We find that the presence of such wedge has no impact on the volatility of the real economy induced by a financial shock. Unionization, fiscal structure, union coordination and monopoly power have no effect on the financial crisis dynamics in our analysis. This may help in explaining the empirical evidence as regards the difference (or rather lack of any marked difference) in the performance of economies characterized by different degrees of flexibility in labour market features

By contrast, lags in the adjustment of the real wage matter in the sense that they do amplify the effects of financial shocks.

Therefore, our final message to the debate on the effects of institutional characteristics of labor markets as regards the propagation of financial shocks, is that it is important to distinguish between the different institutions and, in particular, to focus on their influence on the real wage adjustment mechanism.