# Automatic Wage Indexation

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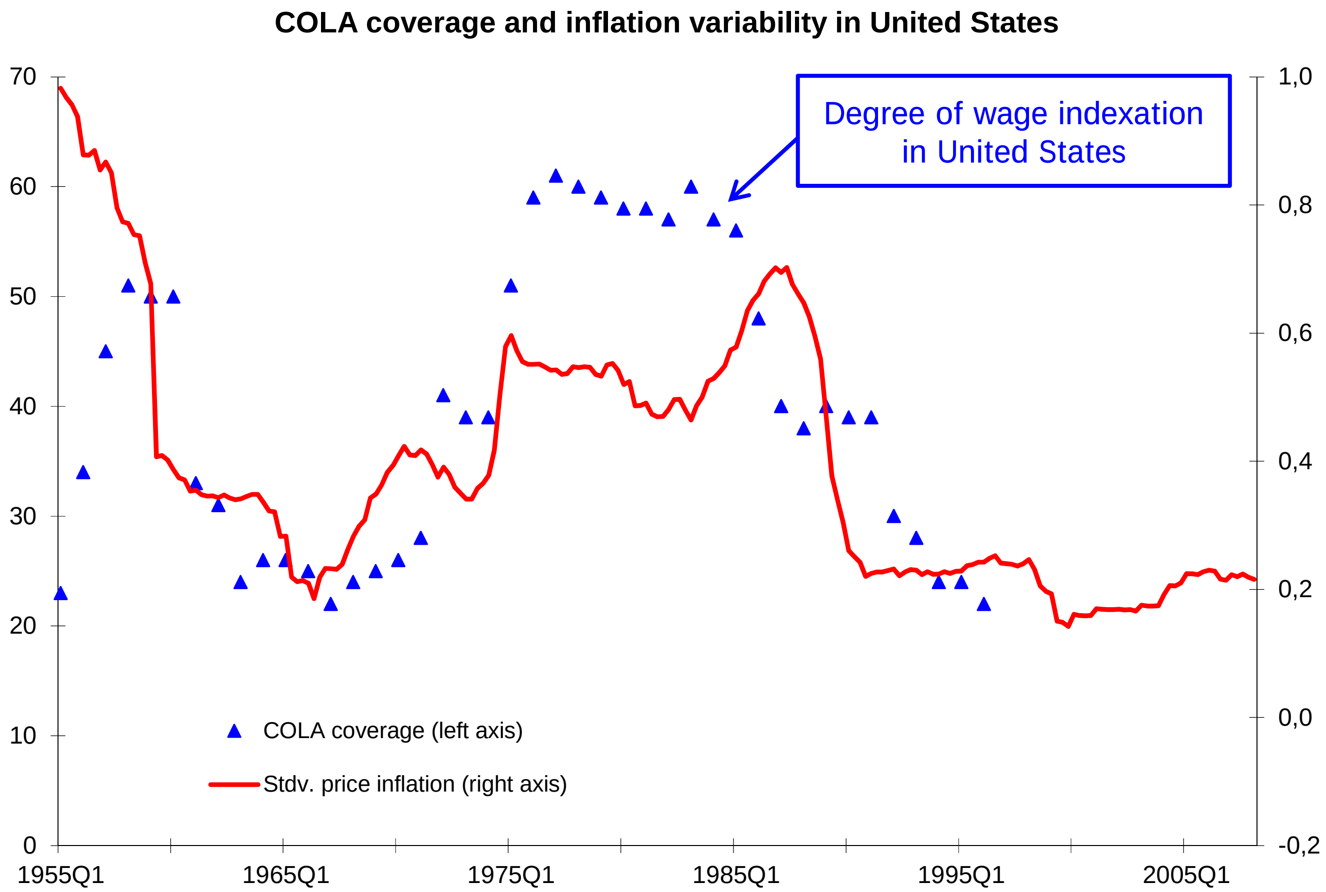
# What is it?

- Systematic (ex-post) adjustment of nominal wages to realized inflation
  - According to “health” index: consumer prices excluding tobacco, alcohol and transport fuel
  - Implementation different across sectors: timing, threshold (2%), ...
- Still bargaining about real wages (every two years)
  - Should be in line with major trading partners (FR, DE & NL): wage norm ceiling
  - Means that wage developments can only take place within range defined by indexation floor and the wage norm ceiling (if range is positive...)
- Explicit wage indexation also in Luxemburg, Malta, Cyprus & Spain
  - Partly in other countries (e.g. France): minimum wages, social benefits
  - Implicitly also present in wage bargaining of several other Euro area countries (e.g. Italy): creates difficulties for single monetary policy stance of ECB

# Where does it come from?

- Popular in 1970s due to inflation uncertainty created by monetary policy



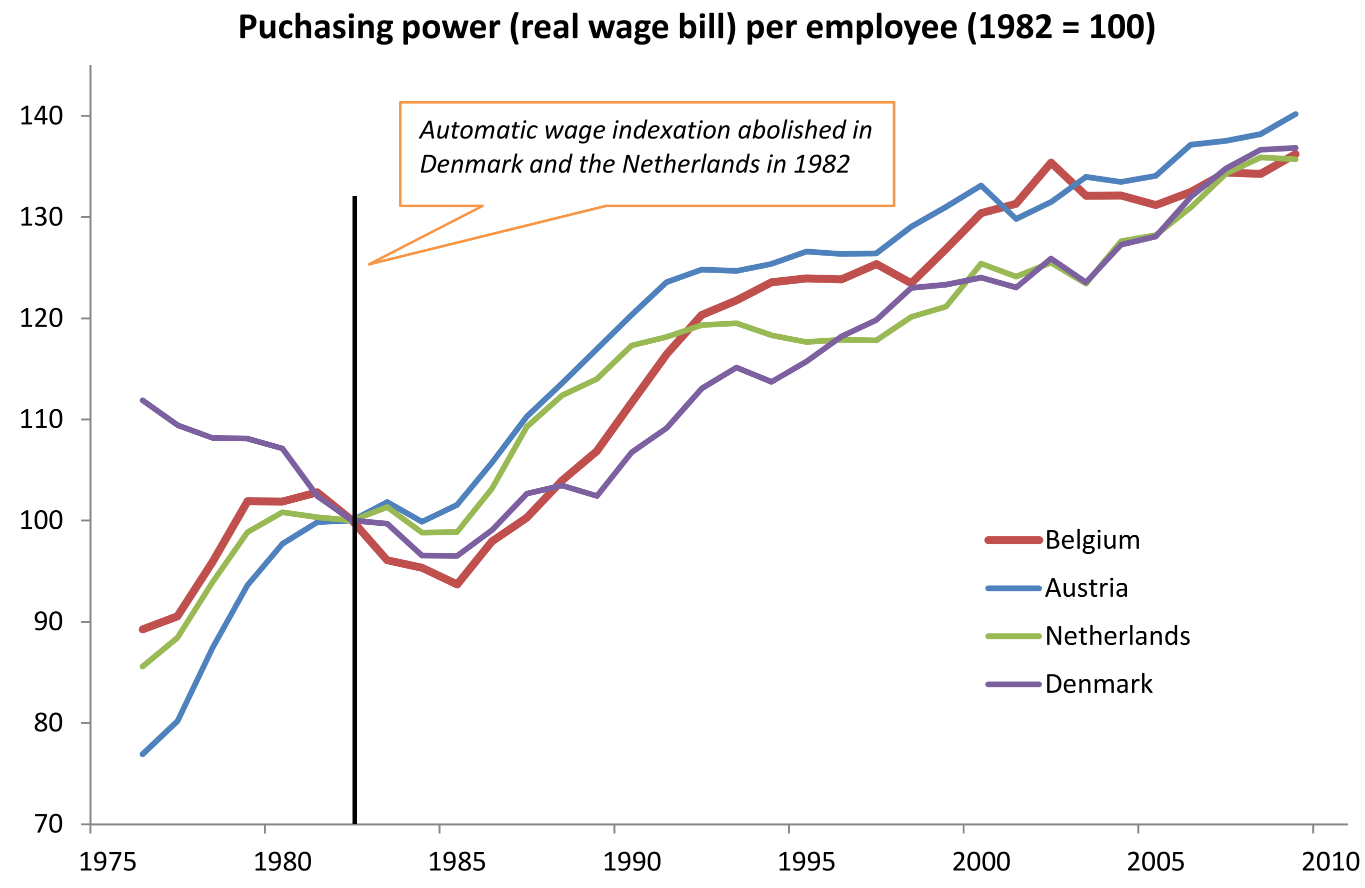

*Note: COLA = cost-of-living adjustment clauses included in major collective bargaining agreements (i.e. contracts covering more than 1,000 workers). Figures refer to end of preceding year. Source: Hendricks and Kahn (1985), Weiner (1986) and Bureau of Labor Statistics. The observation for 1956 is interpolated, and the series has been discontinued in 1996. Standard deviation of price inflation is calculated as an 8-year moving window.*

# Where does it come from?

- Abolished in several countries since early 1980s
  - E.g. the Netherlands (1982), Denmark (1982), France (1983), Italy (1993)
  - System too costly (loose of jobs)
  - Substantial reduction in inflation uncertainty
  - Central banks have explicit inflation targets: anchor for inflation expectations which is very useful for wage bargaining
    - ECB inflation target: annual (HICP) inflation “below but close to 2 percent”

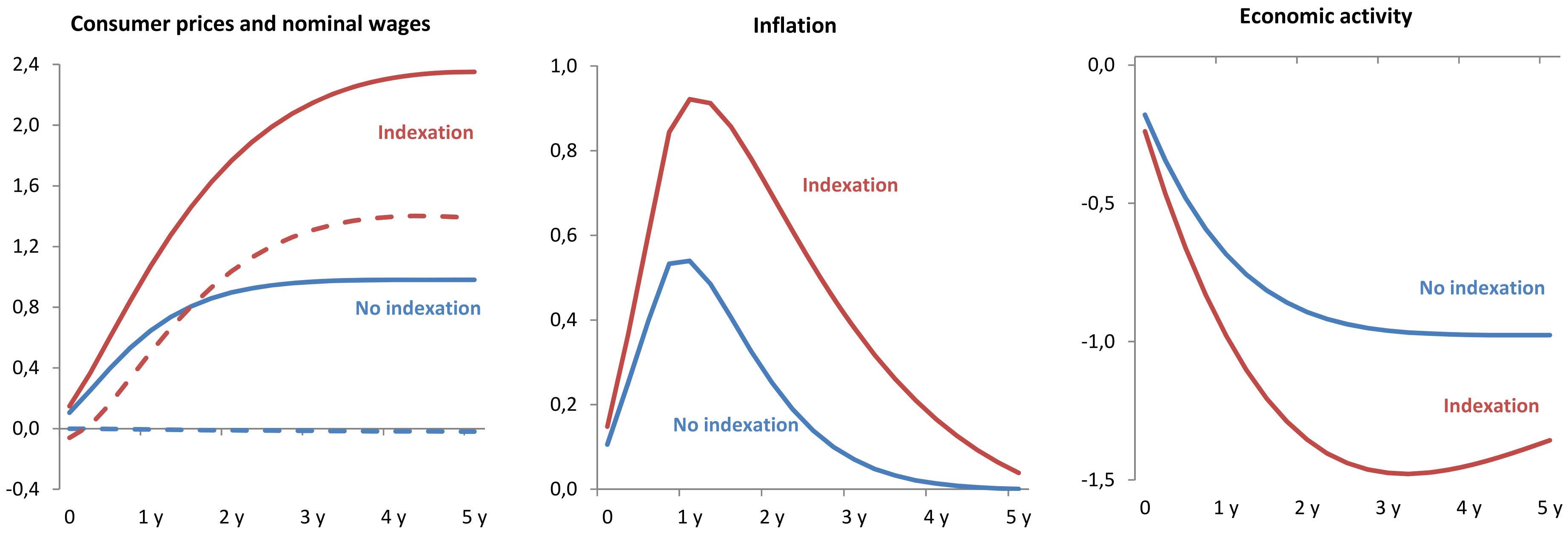
# Benefits

- Academic literature: contributes to peace in industrial relations (less strikes)
- A lot of misunderstandings: “erosion of purchasing power over time”, “countercyclical domestic demand effect in recessions (crisis)”, ...



# Costs

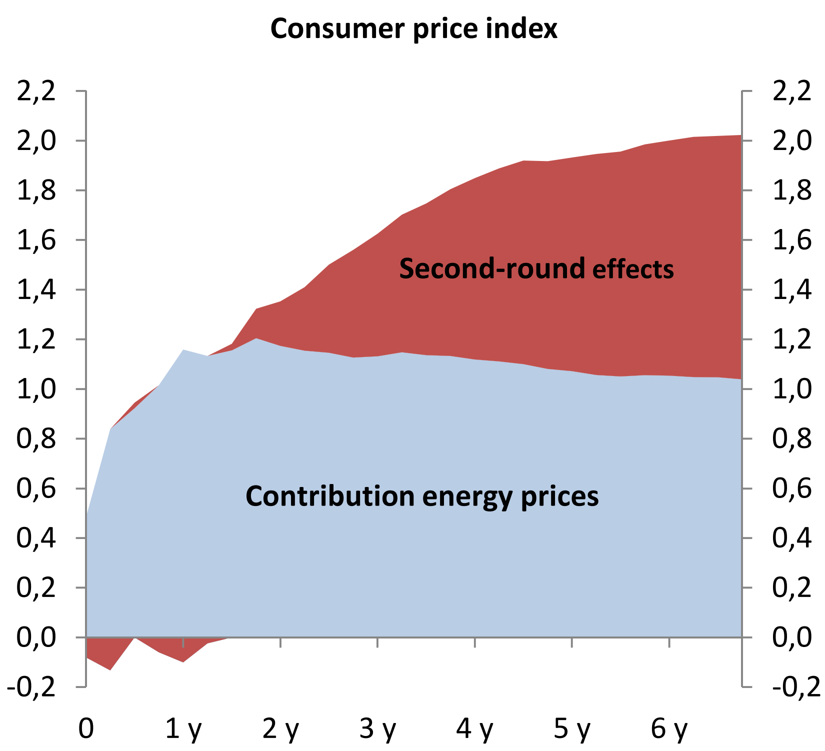
- Second-round effects and inflation: harmful wage-price spirals
  - Simulation of 1% decline in productivity or rise in costs for firms at time 0 for 2 economies that are identical in every respect, except for wage indexation

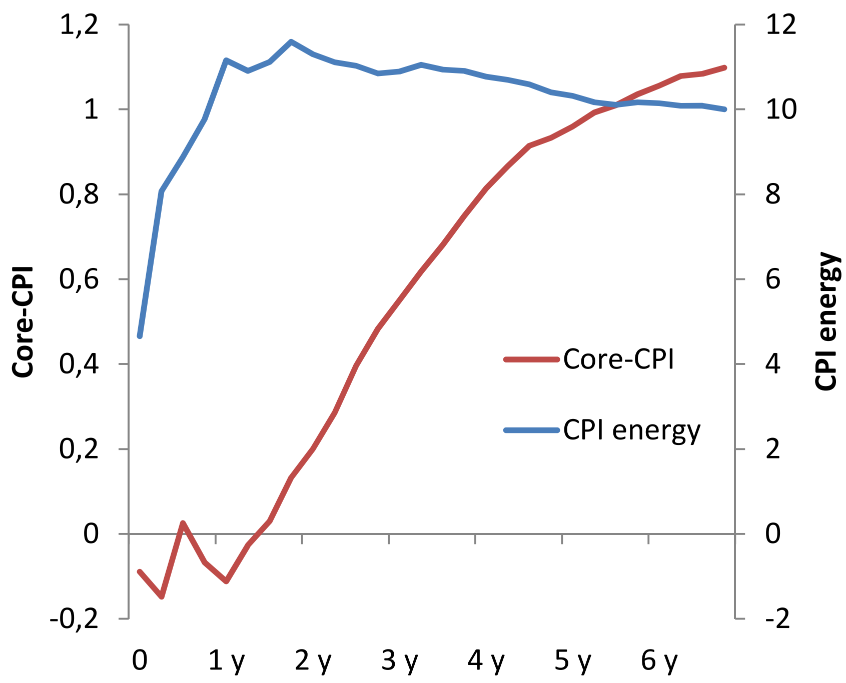



  - Stronger output consequences: unemployment increases more with indexation
    - More aggressive monetary policy response to deviation of inflation from target
    - Indexation adversely affects competitiveness

# Costs

- Second-round effects and inflation: harmful wage-price spirals
  - Estimated dynamic effects over time of an oil shock which raises Belgian energy prices with 10% at time 0: long-run multiplier on consumer prices is x2

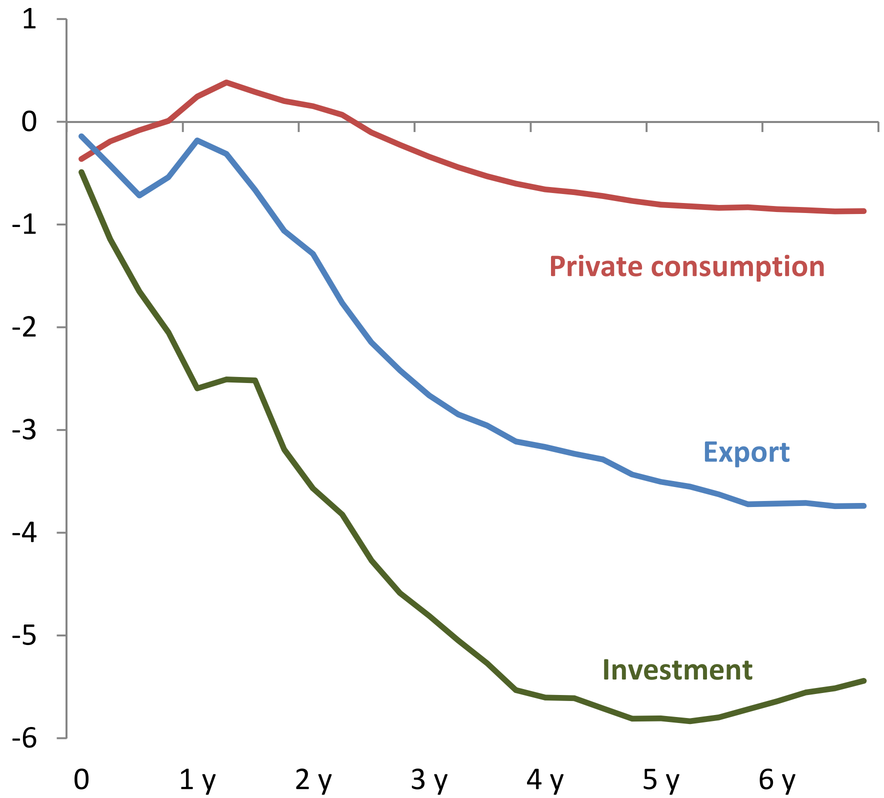



Source: Peersman and Van Robays (2009)

# Costs

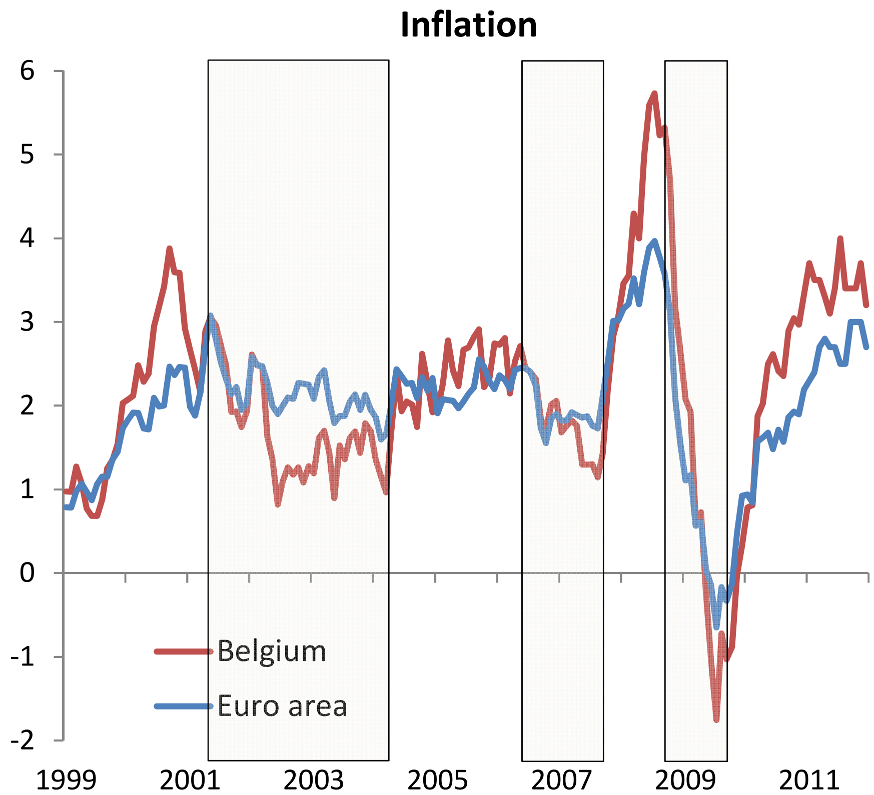
- Second-round effects and inflation: harmful wage-price spirals
  - Estimated dynamic effects over time of an oil shock which raises Belgian energy prices with 10% at time 0 (monetary policy and competitiveness effect)

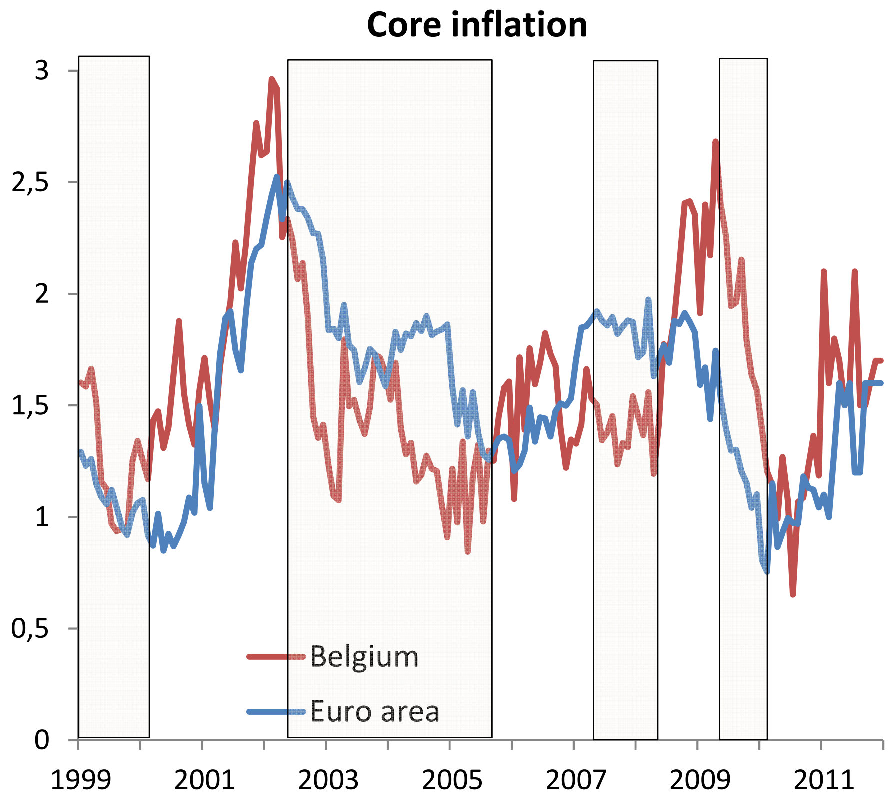



Source: Peersman and Van Robays (2009)

# Costs

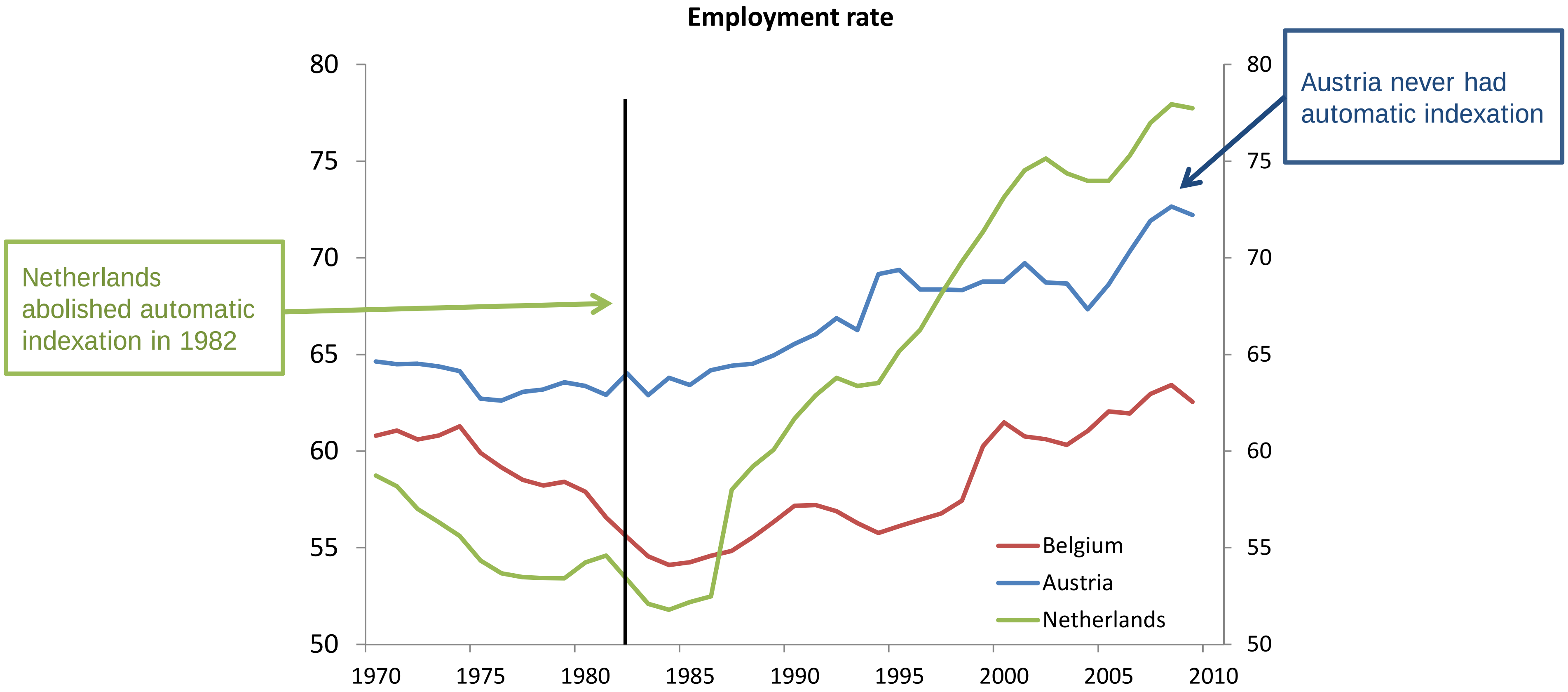
- Second-round effects are symmetric for inflation (is not well known)
  - Inflation is higher in Belgium when European inflation is rising but also lower when inflation is falling (because wage growth is more moderate)



# Costs

- But second-round effects are not symmetric for employment!
  - less productive workers loose their job in upward inflation spiral, but not all of them regain their job in downward spiral: bridge pension, LT-unemployment, ...




  - Has hence a gradual downward impact on the employment rate over time

# American Chamber of Commerce proposal

- Limit the percentage of salary paid that is adjusted automatically
  - Guarantees purchasing power of low incomes
  - Second-round effects partly reduced due to more limited impact on wage bill
  - But: low income jobs become relative more expensive than high income jobs
    - This is exactly the category which suffers the most from the system (they are the first to loose their job when the economy becomes less competitive)
    - Boomerang for those you want to protect
    - High income employees could decide to leave
  - There are better alternatives to “redistribute” income (e.g. taxes)

# My proposal

- If you really want to keep it: **index wages to the target of the ECB**
  - Is welfare maximizing of all alternative (systematic) systems if target is credible
  - Below but close to 2% per year in medium term
- No need to increase frequency of wage bargaining: good for social peace
- Preserves purchasing power (inflation has been 1.98% since start euro)
- Competitiveness in lock step with European average
- Eliminates externalities of second-round effects
  - Improves employment rate over time
  - Easier for ECB to reach inflation target (self-reinforcing) and focus on output stabilization
- More benefits: less risk for deflation spiral, disciplines price setters, ...