COMMENTS ON PROFESSOR CUKIERMAN'S PAPER ON "CENTRAL BANK INDEPENDENCE, GROWTH AND EMPLOYMENT"

by

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Professor Cukierman's paper, as we have come to expect of him, is dense, addresses matters of great interest and current relevance and is rich in economic policy lessons. I would like to focus on this latter aspect -the economic policy lessons- from the specific perspective of the forthcoming establishment of European Monetary Union (EMU). In particular, a question raised in this paper which seems very important to me is to what extent the central bank model chosen for EMU (highly independent) is suited to the institutions specific to European labour markets.

I would like to start by stressing a methodological caveat which is no less important for being obvious: the measurement and international comparison of institutional aspects of a qualitative nature is a difficult task prone to significant margins of error. This applies both to the measurement of central bank independence (a difficult area, in which the work of Professor Cukierman has shed light on numerous obscure aspects) and the estimation of the degree of centralisation of collective bargaining, where I suspect these difficulties are even greater.

With regard to central bank independence, there is one aspect of the work (supported, on this point, by certain literature) which I would like to qualify. I consider that the identification of central bank independence with the pursuit of relatively rigid monetary rules is overly simplistic. Indeed, some of the conclusions of the paper seem to rest excessively on the view (in my opinion debatable) that a less independent central bank has greater scope to adjust its policy in the event of unanticipated shocks to inflation. This view contradicts the recent experience of most central banks, which have gained increasing levels of independence in the last few years, while their monetary policies have been conducted with some discretionarity. In ever more complex economies, it is impossible to rely on simple monetary rules based on a single variable, such as the stock of money.

Banco de España's recent experience is a good example of what I wish to illustrate. A new statute of autonomy was approved in 1994, prompting an internal debate at the Bank which led to the establishment of a framework of direct inflation targets. This framework, as is well known, establishes a central bank reaction function containing numerous variables, real and financial, which affect inflation trends. The central bank sets its interest rates after processing and analysing this information, with its sights set on the long-term objective of price stability. In terms of the classic debate on monetary rules versus more discretionary policies, direct inflation targets would be closer to the discretionary model. In these three years of experience, Banco de España has reacted flexibly to the information received, but always with the aim of shifting the inflation rate to levels compatible with price stability. The Spanish experience has been very positive: the inflation rate has fallen by about three points since this framework was established, and is today close to 2%, an historic low.

I wish to emphasise the view that, in our experience, an independent central bank can make the discipline necessary to achieve and maintain price stability (as a medium- and long-term objective) compatible with the flexibility to adjust its monetary policy to unexpected shocks to inflation. And this in keeping with the framework of direct targets, which is at present common to a wide range of central banks, with varying degrees of independence. An independent central bank can act with discretion in the same way as a non-independent central bank. The difference is that the former, when confronted by unexpected shocks, will only agree to adjust its policy to maximise short-term output and employment if this does not involve long-term risks for price stability. In the case of a central bank subject to political power, however, this ordering of objectives and the consideration of the longer time-frame are not guaranteed. I believe that, in the long run, the overall macroeconomic results of the independence model will be better, without a loss of flexibility or capacity to adapt.

One of the most interesting and original issues addressed in Professor Cukierman's work is the relationship between central bank independence and the degree of centralisation of wage bargaining. Starting from the assumption that centralisation of wage bargaining favours the internalisation by unions of the requirements for macroeconomic equilibrium, it is argued that the anti-inflation policy of an independent central bank is less costly when wage bargaining is more centralised, while its costs, in terms of growth of output and employment, will be higher if bargaining is decentralised.

The explanation for this difference lies in the supposed aversion of unions to inflation and in the different perception of the influence of their wage demands on aggregate inflation in centralised and decentralised bargaining. In the first case, the unions would have incentives to moderate their wage demands in line with the inflation targets set by the central bank, while in the second case each union would consider aggregate inflation as extraneous to their own decisions and would have incentives to try to obtain the biggest possible wage increases.

Thus, the coexistence of central bank independence and decentralised wage bargaining would lead to the worst results in terms of inflation and unemployment. The extrapolation of this result to a monetary union formed by various countries, in which wage bargaining would necessarily be decentralised, leads to the conclusion that it may generate unemployment, via two possible routes. On the one hand, the countries with decentralised wage bargaining would, supposedly, be affected by the greater anti-inflation conservatism of the European Central Bank. On the other hand, in the countries with centralised wage bargaining structures, the unions would lose the incentive they have hitherto had to internalise the macroeconomic constraints, and would adopt more aggressive wage strategies instead.

This analysis has the merit of focussing on one of the key questions for the success of Monetary Union: on the one hand it requires the maintenance of price stability and the soundness of the new single currency, and on the other an increase in economic welfare and employment throughout the area. For this, it is essential not only to consolidate the progress made in macroeconomic stability through convergence, but to make further efficiency improvements at the microeconomic level, which requires greater liberalisation of services markets and greater flexibility of labour markets.

However, I find this approach incomplete and the conclusions may be somewhat distorted. Incomplete, because it ignores the perception unions may have of the possible link between their wage strategy and employment developments. This link exists at both the macro and microeconomic levels, albeit with certain lags which depend on the flexibility of labour market regulations, especially on the degree of job permanency and protection via severance payments.

If the unions are aware of this link, there is no reason why a decentralised framework should be conducive to more aggressive wage strategies that are detrimental to employment. A decentralised framework may lead wage bargaining to adapt to the specific productivity and demand conditions of specific companies, sectors or regions, proving as beneficial in the attainment of stability as centralised bargaining arrangements.

This standpoint has been acknowledged in part of the literature on the degree of wage-bargaining centralisation in the labour market. The strand of literature concerned appears to have found evidence that the polar models of full centralisation or full decentralisation are equally favourable to macroeconomic stability, while the intermediate decentralisation frameworks are those that would have most adverse consequences for stability and employment. This is because the latter prevent unions both from internalising aggregate macroeconomic constraints and from bargaining in accordance with the conditions of competitiveness of the various segments of the productive system. (See Calmfors and Driffill [1989], Freeman [1988] and Calmfors [1993])

From this perspective, the problem lies in the existence of rigid, protectionist regulations in European labour markets blurring the relationship between wage dynamics and employment. The creation of a monetary union with an independent central bank that targets price stability tends to make the link between wage dynamics and employment more visible. In the absence of the possibility of an adjustment via the exchange rate and with low inflation the norm, excessive wage increases will, in those areas where they are applied, tend to lead more rapidly and sharply to losses in competitiveness and a decline in employment. Perception of this should enable decentralised wage bargaining to be compatible with output and employment growth in a context of price stability. Yet for this to come about, far-reaching reforms according sufficient flexibility to national labour markets must be rapidly introduced. In any event, moves towards a greater centralisation of wage bargaining at the level of the whole area of future European Monetary Union would generate shocks on a much greater scale.

Indeed, EMU will automatically entail a move to a situation in which the degree of wage-bargaining centralisation, both EMU-wide and compared with the present situation, will be further from the maximum-concentration pole and, therefore, in a more intermediate position. This process will ensue automatically from the integration of countries that were formerly segmented. Those that were closer to the centralised model will be in a more intermediate position, such that the arrangements that might have been optimal under the old institutional framework will cease to be so. This change entails significant risks.

Underlying this problem is a far-reaching transformation inherent to EMU. Once the single currency is set in place, many European economies, which had hitherto fitted the "small and open economy" model, will become part of a single "large and closed" economy. According to the literature, the classic centralised bargaining model is better suited to the first type of country, where considerations of competitiveness abroad predominate. In larger, less open economies, competitiveness considerations, though significant, may bear less weight than the need for a sufficiently flexible mechanism for the adjustment of relative prices -and relative wages-, which may prove somewhat incompatible with centralised wage bargaining arrangements. (See Calmfors and Driffill [1989], Freeman [1988] and Calmfors [1993])

It is in fact difficult to conceive of a centralised bargaining mechanism for EMU. Such a framework would enormously hamper any consideration of the productivity differences prevailing among EMU countries. It could prompt an artificial and damaging process of wage levelling, unwarranted by the course of fundamentals. And it might, finally, introduce rigidities into labour markets, countering their necessary tendency towards greater flexibility.

I consider the need for more flexible labour markets to be of particular importance. As reiterated in the recent literature on EMU, forgoing the exchange rate as an adjustment mechanism, in a monetary union where there are very few fiscal mechanisms to soften the impact of asymmetrical shocks, requires a more active role by the labour market to absorb such shocks. More flexible labour markets, in which wages are adjusted to the productivity conditions of each sector and each firm, are hardly compatible with centralised wage bargaining arrangements, whether EMU-wide or at the national level. The conclusion from this line of reasoning is that the labour markets of EMU countries, if they must opt for one of the two extremes, should veer more to the decentralised than to the centralised model. That may seem overly bold for countries where the centralised model has had excellent results in recent years. But the move to Monetary Union entails forsaking the model of a small and open economy to become part of a large and relatively closed economy, with a flexible exchange rate against the rest of the world. And in this new situation, comparison with the United States is relevant. There, the exchange rate regime is flexible, the central bank independent and wage bargaining decentralised. And the recent, very favourable macroeconomic results are partly thanks to the great flexibility of the US economy.

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