Understanding the Gains from Wage Flexibility in a Currency Union: The Fiscal Policy Connection

OKANO, Eiji

Abstract

I investigate two findings in Gali and Monacelli (2016, *American Economic Review*) which are (i) the effectiveness of labor cost adjustments on employment is much smaller in a currency union and (ii) an increase in wage flexibility often reduces welfare, more likely so in an economy that is part of a currency union. First, I introduce a distorted steady state in the small open economy model of GM, in which employment subsidies to make the steady state efficient are not available, and replicate their two findings. Second, an endogenous fiscal policy rule similar to the rule in Bohn (1998, *Quarterly Journal of Economics*) was introduced with a government budget constraint into the model. The results suggest that while the first finding of Gali and Monacelli is still applicable, their second finding is not necessarily applicable. It is, therefore, possible that an increase in wage flexibility reduces welfare loss in an economy that is part of a currency union as long as wage rigidity is high enough. Thus, there is still scope to discuss how wage flexibility is beneficial in a currency union.