

Comments on  
"Wage, price and unemployment dynamics in the Spanish transition to the EMU  
membership"

This is an empirical study of changes in wages, prices and unemployment in Spain. One important idea is that the Spanish experiences may give useful information (e.g., for forecasting purposes) about changes that new entrants into the European monetary union will experience in the future.

The paper contains a brief overview of the different stages in the Spanish development (section 2, about one page), a theoretical background/framework (section 3, about five pages), and three sections with empirical analyses (sections 4 – 6, in total around 16 pages).

The strength of the paper is the careful empirical analyses which without doubt are useful for understanding what has happened in Spain. The main weakness is the theoretical basis for the study, which makes it difficult to interpret the empirical results. This weakness also makes it hard to draw more general conclusions that may help us predict to what will happen in new EMU member states.

The following sentences from page 3 provide an example of the problems with the paper's weak theoretical foundations:

"Thus, we would expect the transition dynamics to be strongly influenced by the persistent movements in the real exchange rates as well as the long-term interest rate. The empirical challenge is, therefore, to identify the Balassa-Samuelson effect, the increased product market competition, and the effect of imperfect knowledge in the foreign exchange market on the wage-, price- and unemployment dynamics in Spain and how these have interacted to secure the path towards a common European purchasing power parity level."

Which economic theory should we use to understand these arguments? At a very general level, one could very well think of reasons why entrance into a monetary union may be associated with many kinds of regime shifts (e.g., "increased product market competition", changes in the degree of "imperfect knowledge in the foreign exchange market"). But how would this "influence" the "transition dynamics"? Will this be captured by shocks to stochastic trends, changes in intercepts/dummies, or estimated parameters (of cointegration relations and/or dynamic interactions)? And what is the role of the "persistent movements in the real exchange rates as well as the long-term interest rate"? These are presumably endogenous phenomena which hardly can explain changes in "transition dynamics". And what does it mean, formally, "to identify the Balassa-Samuelson effect"?

Perhaps it is a bit unfair to go into such detailed criticism of a sentence that appears very early in the paper. The problem is, however, that this type of "implicit theorizing" appears in my places throughout the paper, giving rise to very much confusion.

My advice is to

- (i) keep the theoretical reasoning to a minimum;
- (ii) focus on presenting the empirical results;
- (iii) look for signs of regime shifts or shocks that may be intuitively related to EMU membership. (To provide a coherent theoretical explanation of the empirical findings is beyond the scope of the paper.)

In a number of places the paper contains statements that make perfect sense but that deserve more attention and support in the empirical analyses. Changes in the “wage, price and unemployment dynamics” may be related to

- the decision to join the EMS in 1986 (p. 4);
- removal of trade barriers, financial deregulation (p. 5), capital liberalization (p. 23);
- labour market reforms of 1994 and 1997 (p. 5);
- shocks to productivity and to the internal price wedge (p. 15);
- competitive pressure (p. 24).

Such regime shifts (and/or shocks to stochastic trends) could very well be related to preparations for EMU membership, but it is not easy to see exactly what empirical result that show the effects of these changes – nor why all these changes should be related to EMU (rather than EU) membership.

My suggestion is, therefore, to go more directly to a presentation of the empirical result and to skip most of the rest. This would probably bring us to a paper of about 15 pages.

To provide some suggestions on arguments that are confusing and could be deleted, I present a list of more detailed comments below. Please note that I do not expect the authors to develop and clarify each of these arguments in a revision of the paper, since I rather suggest that the paper should be shortened.

Detailed comments:

- “secure the path towards a common European purchasing parity level” (p. 3 – 4). The real exchange rate (in Figure 1) is not obviously non-stationary, and in addition it is difficult to understand why membership in the *monetary* union would effect the long run equilibrium real exchange rate (in contrast to membership in the *European* union which may have such an effect, e.g., through liberalisation of trade and financial flows).
- “pulling and pushing properties” (p. 4). These concepts are not part of economists’ standard tool box.
- Spain’s commitment towards the EMU initiated an adjustment of the productivity level. Again, it is difficult to see the connection between a shift in the monetary policy regime and a persistent change in productivity. The authors apparently do not believe in monetary neutrality, but they do not explain why.
- The derivation of the labor demand function on p. 6 is unclear, e.g. why the variable  $Z$  appears only through the domestic output price.
- “standard models need to be modified to be able to account for these empirically strong features of the data” (p. 7). What models and features, more exactly?
- What is the connection between the “bargaining model” in equations (1) and (2) and the labor demand function on p. 6? Why do import prices and  $Z$  affect labor demand but not bargaining?
- “important question about where in the system the adjustment takes place” (p. 8). Presumably adjustment takes place simultaneously in the whole system, or?
- The inflation rate is obviously treated as  $I(1)$  (p. 9). But this can hardly be consistent with membership in a monetary union, can it?
- What behavioural or equilibrium relation does the unemployment equation on p. 10 represent?

- Similarly, the inflation equation (7) seems totally unrelated to anything that has been presented earlier in the paper.
- “Has the previous classification into endogenous and weakly exogenous variables changed?” (p. 14) Why would the process towards the EMU affect such properties?
- “demand for labor is low” (p. 17). It is not obvious that the unemployment equation represents labor demand (rather than supply, or a mix of both).
- “government need to finance the raising unemployment” (p. 25). This argument is totally unrelated to anything that has been presented in the paper so far (theoretical arguments or empirical evidence).