

Accepted Manuscript

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PII: S0022-1996(15)00156-7
DOI: doi: [10.1016/j.jinteco.2015.11.002](https://doi.org/10.1016/j.jinteco.2015.11.002)
Reference: INEC 2904

To appear in: *Journal of International Economics*

Received date: 20 August 2014
Revised date: 26 July 2015
Accepted date: 5 November 2015

Please cite this article as: Cacciatore, Matteo, Fiori, Giuseppe, Ghironi, Fabio, Market Deregulation and Optimal Monetary Policy in a Monetary Union, *Journal of International Economics* (2015), doi: [10.1016/j.jinteco.2015.11.002](https://doi.org/10.1016/j.jinteco.2015.11.002)

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Market Deregulation and Optimal Monetary Policy in a Monetary Union*

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November 16, 2015

Abstract

This paper addresses the consequences of product and labor market deregulation for monetary policy in a two-country monetary union with endogenous product creation and labor market frictions. We show that when regulation is high in both countries, optimal policy requires significant departures from price stability both in the long run and over the business cycle. The adjustment to market reform requires expansionary policy to reduce transition costs, but deregulation reduces static and dynamic inefficiencies, making price stability more desirable once the transition is complete. International synchronization of reforms can eliminate policy tradeoffs generated by asymmetric deregulation.

JEL Codes: E24; E32; E52; F41; J64; L51.

Keywords: Market deregulation; Monetary union; Optimal monetary policy.

*For helpful comments, we thank Giancarlo Corsetti, two anonymous referees, Javier Bianchi, Betty Daniel, Antonia Díaz, Andrea Ferrero, Francesco Giavazzi, Alexandre Jeanneret, Athanasios Orphanides, Paolo Pesenti, Alex Twist, and participants in seminars and conferences at Banco de España-Banque de France Conference on “Structural Reforms in the Wake of Recovery: Where Do We Stand?”, Board of Governors of the Federal Reserve System, Boğaziçi University-CEE 2012 Annual Conference, CEPR ESSIM 2013, Deutsche Bundesbank, European Central Bank, Federal Reserve Bank of Boston, Florida State University, Johns Hopkins University-SAIS, Magyar Nemzeti Bank, NBER IFM November 2012, NBER SI 2013 “Macroeconomics Within and Across Borders,” North Carolina State University, Rutgers University, SED 2012, Shanghai Macroeconomics Workshop 2014, Société Canadienne de Science Économique, University of Bonn, University of California-Riverside, University of Oxford, UQAM, University of Surrey, University of Virginia, University of Washington, and West Coast Workshop on International Finance and Open Economy Macroeconomics 2013. We are grateful to Jonathan Hoddenbagh and Tristan Potter for outstanding research assistance. Remaining errors are our responsibility. Ghironi thanks the NSF for financial support through a grant to the NBER. Work on this paper was done while Ghironi was a Visiting Scholar at the Federal Reserve Bank of Boston. The support of this institution is also acknowledged with gratitude. The views expressed in this paper are those of the authors and do not necessarily reflect those of the CEPR, the NBER, the Federal Reserve Bank of Boston, or Federal Reserve policy.

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