ARTICLE IN PRESS

Journal of International Money and Finance ■■ (2016) ■■–■■

Contents lists available at ScienceDirect

Journal of International Money and Finance

journal homepage: www.elsevier.com/locate/jimf

Short-term pain for long-term gain: Market deregulation and monetary policy in small open economies

Matteo Cacciatore [a,*], Romain Duval [b], Giuseppe Fiori [c], Fabio Ghironi [d]

[a] Institute of Applied Economics, HEC Montréal, Chemin de la Côte-Sainte-Catherine, Montréal, Québec 3000, Canada
[b] Research Department, International Monetary Fund, 700 19th Street, N.W., Washington, DC 20431, USA
[c] Department of Economics, North Carolina State University, 2801 Founders Drive, 4102 Nelson Hall, Box 8110, Raleigh, NC 27695-8110, USA
[d] Department of Economics, University of Washington, Savery Hall, Box 353330, Seattle, WA 98195, USA

A R T I C L E   I N F O

Article history:
Available online

JEL Classification:
E24
E32
E52
F41
J64

Keywords:
Structural reforms
Employment protection
Firm entry
Product market regulation
Unemployment benefits

A B S T R A C T

This paper explores the effects of labor and product market reforms in a New Keynesian, small open economy model with labor market frictions and endogenous producer entry. We show that it takes time for reforms to pay off, typically at least a couple of years. This is partly because the benefits materialize through firm entry and increased hiring, both of which are gradual processes, while any reform-driven layoffs are immediate. Some reforms – such as reductions in employment protection – increase unemployment temporarily. Implementing a broad package of labor and product market reforms minimizes transition costs. Importantly, reforms do not have noticeable deflationary effects, suggesting that the inability of monetary policy to deliver large interest rate cuts in their aftermath – either because of the zero bound on policy rates or because of the membership in a monetary union – may not be a relevant obstacle to reform. Alternative simple monetary policy rules do not have a large effect on transition costs.

© 2016 Elsevier Ltd. All rights reserved.

* Corresponding author. Tel.: (+1) 514-340-1496.
E-mail address: matteo.cacciatore@hec.ca (M. Cacciatore).

http://dx.doi.org/10.1016/j.jimonfin.2016.02.010
0261-5606/© 2016 Elsevier Ltd. All rights reserved.

Please cite this article in press as: Matteo Cacciatore, Romain Duval, Giuseppe Fiori, Fabio Ghironi, Short-term pain for long-term gain: Market deregulation and monetary policy in small open economies, Journal of International Money and Finance (2016), doi: 10.1016/j.jimonfin.2016.02.010

ARTICLE IN PRESS

1. Introduction

Calls for market reforms to improve economic performance have become a mantra in policy discussions. One only needs to read the transcripts of ECB President Mario Draghi's speeches and press conferences over the last three years or the statements of other European policymakers to substantiate the point. Structural reforms appear to have become a crucial ingredient of the policy menu at a time when the conventional tools of demand-side macroeconomic policy are constrained and the unconventional tools are being deployed without certainty of their effectiveness. In the academic literature, a large body of economic theory points to long-term gains from reforms designed to increase the flexibility of labor and product markets. However, most of this literature provides insights into the long-term impact of such structural reforms from a static perspective.[1] Much less consensus exists on the short-run effects and transition dynamics triggered by changes in product and labor market regulation, leaving the issue of whether market reforms imply trading short-term pain for long-term gains largely unsettled. Yet this issue bears major implications for the political feasibility of reforms, as transition costs may be viewed by policymakers called upon to implement reforms as a daunting obstacle to action.

The nature of the short- and medium-term impact of reforms also matters for their desirability in the context in which they are advocated now – where traditional, demand-side macroeconomic policy cannot be used to smooth potential short-run costs and help front-load beneficial long-run effects. This issue is especially relevant at the current juncture, with monetary policies constrained by the zero lower bound (ZLB) on interest rates and/or monetary union membership, and fiscal policies tied by austerity requirements. With respect to monetary policy, a debate has emerged recently in the literature as to whether a binding ZLB could exacerbate potential short-run costs of reforms. According to this argument, in a ZLB situation, reform-driven shocks to current output supply may lower prices, raise the real interest rate, and thereby depress rather than stimulate the economy (a situation labeled as the "paradox of toil" in Eggertsson, 2010). Eggertsson et al. (2014) build on this argument in their analysis of structural reforms and monetary policy in Europe. On the other hand, market reforms may generate a positive wealth effect on consumption by increasing future income levels, and thereby stimulate current aggregate demand and output. When the ZLB is binding, this wealth effect should typically be larger as it is not dampened by the increase in interest rates that would occur in "normal times" (Fernández-Villaverde et al., 2011). Ultimately, the short-term impact of reforms, not only in a ZLB situation but also more broadly, will depend inter alia on their impact on current versus future supply and the implications for output gaps, prices, and real interest rates.

A number of recent papers have used large-scale dynamic stochastic general equilibrium (DSGE) models to assess both the short- and long-run effects of reforms (Everaert and Schule (2008), using the IMF's Global Economy Model; Gomes et al. (2011), using the ECB's EAGLE model; Arpaia et al. (2007), and Hobza and Mourre (2010), using the European Commission's QUEST model). Reforms appear to pay off only gradually – it typically takes several years for half of the long-term effects to materialize, depending on the model and the reform considered – and can even entail short-run losses due to adverse demand or terms-of-trade effects. However, these exercises differ with respect to which of labor or product market reforms are more likely to lead to short-term losses. Labor market reforms are generally modeled to weaken the bargaining position of workers and thereby initially reduce real wages. This stimulates labor demand but at the same time can weaken consumer demand, especially if – as in an individual country within a monetary union – monetary policy cannot react. Product market reforms are treated as reductions in price markups that immediately raise real wages, and quickly stimulate output and employment – although some of the associated income gain may be dampened by a decline in terms of trade associated with increased supply of domestic goods. However, if carried out in a monetary union or if implemented gradually, inducing households to expect lower prices in the future, they may raise the domestic real interest rate and thereby reduce short-term consumption and output.[2]

[1] For instance, this is the approach in an influential paper by Blanchard and Giavazzi (2003).

[2] For empirical analysis of the effects of structural reforms based on the main policy changes implemented across OECD countries over the last three decades, see Bouis et al. (2012).

Please cite this article in press as: Matteo Cacciatore, Romain Duval, Giuseppe Fiori, Fabio Ghironi, Short-term pain for long-term gain: Market deregulation and monetary policy in small open economies, Journal of International Money and Finance (2016), doi: 10.1016/j.jimonfin.2016.02.010

Download English Version:

https://daneshyari.com/en/article/7365545

Download Persian Version:

https://daneshyari.com/article/7365545

Daneshyari.com