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The domestic and international effects of euro area market reforms ☆

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ABSTRACT

What will be the internal and external effects of euro area market reforms? Will increased market flexibility in Europe affect incentives for the conduct of macroeconomic policy by European policymakers and their partners? We address these questions in a two-country model with heterogeneous plants, endogenous producer entry, and labor market frictions. We interpret the two countries in our model as the euro area and the U.S. We find that market reforms in the euro area will result in increased producer entry and lower unemployment on both sides of the Atlantic, but a worse European external balance, at least for some time. With high market regulation in the euro area, optimal monetary policy requires significant departures from price stability both in the long run and over the business cycle, and a higher inflation target in the euro area than in the U.S. The adjustment to market reforms requires expansionary monetary policy, and more expansion in reforming Europe than in the already flexible U.S. However, deregulation reduces static and dynamic inefficiencies, making price stability more desirable everywhere once the transition is complete.

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1. Introduction

It is frequently argued in policy circles that market reforms—or "structural" reforms—that facilitate product creation and enhance labor market flexibility would be beneficial for rigid economies, such as those of poorly performing euro area countries. The spotlight has been shining particularly bright on this argument since 2008, with the beginning of a wave of crises that rocked the world economy.[1] The argument is that more flexible markets would foster a more rapid recovery from

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[1] One only needs to read the statements by European Central Bank President Mario Draghi since 2011 for confirmation that calls for deregulation of product and labor markets have become a mantra at the highest levels of policymaking.

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recessions and, in general, would result in better economic performance. Deregulation of product markets would accomplish this by boosting business creation and enhancing competition; deregulation of labor markets would do it by facilitating reallocation of resources and speeding up the adjustment to shocks. Results in the academic literature support these arguments.[2]

In this paper, we make a start at exploring the implications of changes in the market structure of large economies, such as the euro area, for the global economy. The issue is intuitively relevant, as the implementation of market reforms that will alter important characteristics of a wide set of European countries will have effects that extend beyond the boundaries of Europe. For instance, if the euro area becomes a more favorable environment for business creation, how will this affect incentives for this activity not just in Europe, but also in its partners? What will happen to relative prices and imbalances between the euro area and the rest of the world? Moreover, if reforms in Europe have significant international effects, in addition to domestic ones, they will have consequences for the conduct of macroeconomic policy in Europe and outside. How will increased European flexibility affect macroeconomic policy incentives of European policymakers and their partners?

We address these questions by studying the consequences of market reforms in a two-country, New Keynesian model with heterogeneous firms, endogenous producer entry, and labor market frictions. The model is developed in detail in Cacciatore and Ghironi (2012). It builds on Ghironi and Melitz's (2005) model of international trade and macroeconomic dynamics with heterogeneous firms and Cacciatore's (2014) extension to incorporate search-and-matching labor market frictions as in Diamond (1982a,b) and Mortensen and Pissarides (1994)—henceforth, DMP. Cacciatore and Ghironi (2012) augment the framework by introducing sticky prices and wages—and a role for monetary policy—to study the consequences of trade integration for monetary policymaking. Here, we focus on market reforms.

We interpret the countries in our model as the euro area and the U.S., and we show that market reforms in Europe result in increased producer entry and lower unemployment on both sides of the Atlantic, but a worse European external balance, at least for some time. By putting upward pressure on labor costs, producer entry in Europe implies stronger terms of trade during much of the transition. A joint reform of both product and labor markets in the euro area causes the unemployment rate to fall on both sides of the Atlantic, but more so in Europe, and it has reallocation effects across euro area producers in line with arguments in the policy discussions: The reform implies an increase in average export productivity and a decrease in employment at less productive, non-exporting firms. Conversely, average export productivity falls in the U.S., as rising euro area imports imply that less efficient U.S. firms begin exporting, and average employment rises in the short and medium term at U.S. firms that sell only domestically.

When European markets are rigid, optimal policy requires significant departures from price stability both in the long run and over the business cycle—and more active policy and a higher inflation target in the euro area than in the U.S. The adjustment to market reforms requires expansionary policy to reduce transition costs and front-load long-run gains. Optimal policy is expansionary on both sides of the Atlantic, but more so in the euro area. Importantly, deregulation reduces static and dynamic inefficiencies in the euro area, and this makes price stability more desirable in both Europe and the U.S. once the transition is complete. Ramsey-optimal cooperative monetary policy—the model's rendering of monetary coordination between the European Central Bank (ECB) and the Federal Reserve—maximizes the benefits of European market reforms globally, with non-negligible welfare gains relative to historical monetary policy behavior.[3]

These results can be understood by considering the distortions that characterize the market world economy of our model relative to the social optimum. Optimal policy uses inflation to narrow inefficiency wedges relative to the efficient allocation along the economies' distorted margins of adjustment: product creation, job creation, labor supply, and risk sharing. For instance, positive long-run inflation pushes job creation closer to the efficient level by eroding markups and reducing worker bargaining power in the presence of sticky wages. Market reform reduces the need for inflation to accomplish this. Over time, reforms result in an endogenous increase in both the number of producers and average productivity in the euro area. Even if, depending on the type of reform, employment by the average producer may fall as more productive incumbents require less labor to produce the same amount of output, increased labor demand from a larger number of new entrants and expansion in the total number of producers imply lower aggregate unemployment. Employment is pushed toward the efficient level, and this reduces the need for average inflation to accomplish this goal.[4] The incentive to use inflation over the business cycle is similarly determined by the tradeoffs across domestic and international distortions (which imply more active monetary policy in the relatively more distorted economy).

The paper contributes to the literature on the consequences of market reforms by bringing an explicit international perspective to the topic and by studying the implications of reforms for monetary policy. The literature on the effects of deregulating product and/or labor markets has focused so far on closed-economy environments.[5] The connection between

[2] In the recent literature, see, for instance, Bertinelli et al. (2013), Blanchard and Giavazzi (2003), Cacciatore and Fiori (2010), Dawson and Seater (2011), Ebell and Haefke (2009), Felbermayr and Prat (2011), Fiori et al. (2012), Griffith et al. (2007), and Messina and Vallanti (2007).

[3] We follow Sims (2007) in considering historical behavior a more realistic benchmark for comparison than optimal, non-cooperative policies.

[4] See Pissarides and Vallanti (2007) for evidence that higher productivity is associated with lower unemployment in the long run.

[5] Cacciatore et al. (2015) study the domestic and international effects of reforms in the structure of U.S. banking, highlighting the consequences that these reforms had by creating a more favorable environment for business creation in the U.S.

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