

# Short-Term Pain for Long-Term Gain: Market Deregulation and Monetary Policy in a Small Open Economy

Cacciatore, Duval, Fiori, and Ghironi

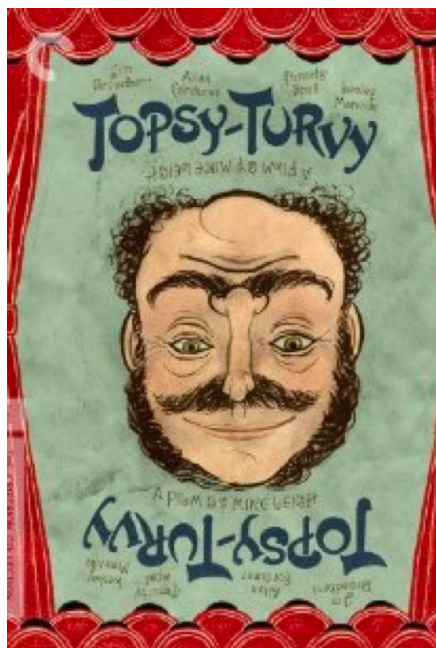
Discussion by

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“Spillovers of conventional and unconventional monetary policy: the role of real and financial linkages”

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This is not a Topsy-Turvy (TT) paper

## Introduction

A large number of contributions (by Gali Eggerston Krugman among others) have warned about the macroeconomic effects of reforms supposed to enhance the competitiveness by facilitating a sharp drop in wages or supply prices, or promote wage flexibility.

- In normal circumstances, these reforms boost employment and consumption
- With policy rates at the zero lower bound (ZLB), their effects may be (Jesus Villaverde's label) topsy turvy.
  - Main issue: they add to deflationary pressure.
  - Not that straightforward See Gali Monacelli 2013 or Cook and Devereux 2014 (or joint work with Kuester and Mueller 2012).

## Introduction

The warning from the literature is well taken, but should it be taken as a reason to avoid reforms altogether?

- In the standard NK model, the main driver of aggregate is the long-term rate

$$\hat{c} = -\frac{1}{\sigma}R_{t,\infty}$$

no wealth effects from reform

$$\hat{c} = -\frac{1}{\sigma}R_{t,\infty} + \tilde{c}_\infty$$

no sectoral-employment reallocation ( $\tilde{y}_t = \alpha\tilde{y}_{t-1}$ ) and other plausible consequences of reforms.

## What does this paper do?

- Tractable model for assessing institutionally-consistent reforms in the labor and product markets (drawing on previous work)
  - Multiple frictions: search in unemployment; nominal rigidities in the product markets; firm dynamic
  - Separated along vertical production chains
- Quantitative assessment stressing at least two notable results:
  - possible short-run costs in terms of unemployment, but no deflationary pressure
  - long-run reforms in the labor and product markets substitute (not complement)

## Outline

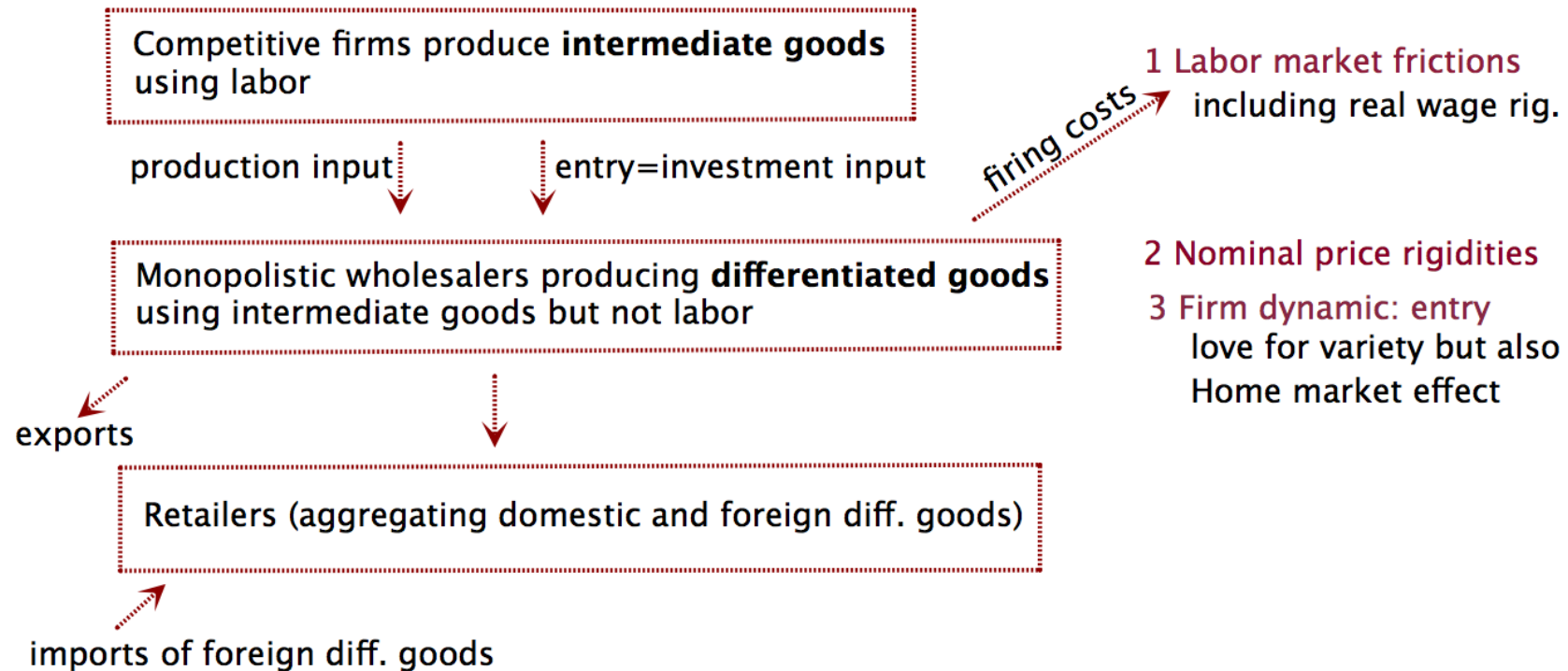
- Map of the model
- Monetary
- Topsy Turvy again?
- Questions and suggestions

## Map of the model: coexisting effects

- Standard NK Demand
  - Real rates drive consumption
- Wealth effects
  - Reforms change steady state
- Home market effects
  - Firms entry=investment tends to raise the price of fixed factors gains from love of variety and saving on trade costs (production 'relocation')

The model in a nutshell





## Monetary policy

- Why CPI target? With PCP?
  - strong response to exchange rate
- Flex price equilibrium (price stability) benchmark
  - clean comparison with alternative monetary policy/regimes

## TT again? Focus on GDP

In units of intermediate goods

$$\begin{aligned} & \text{productivity*employment} \\ & Z_t \bar{z}_t L_t = \\ = & \text{production of differentiated goods} \quad + \quad \text{entry=investment in differentiated g. firms} \\ & N_t \cdot (y_{d,t} + \tau y_{x,t}) \quad + \quad N_{E,t} \cdot f_{E,t} \end{aligned}$$

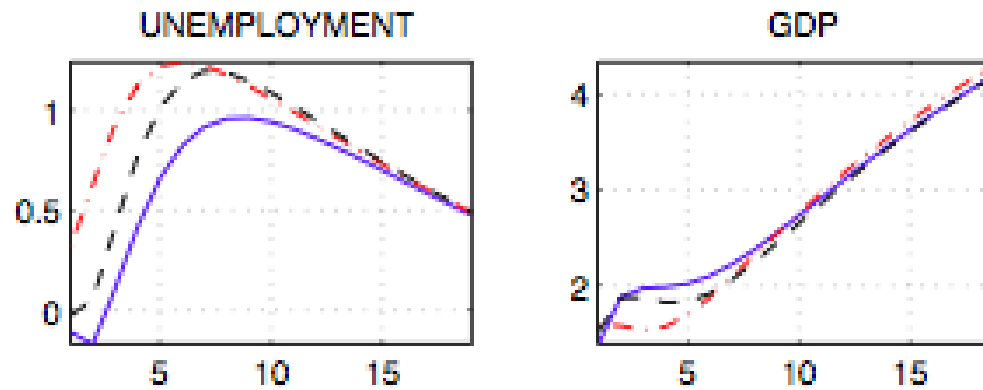
in units of consumption

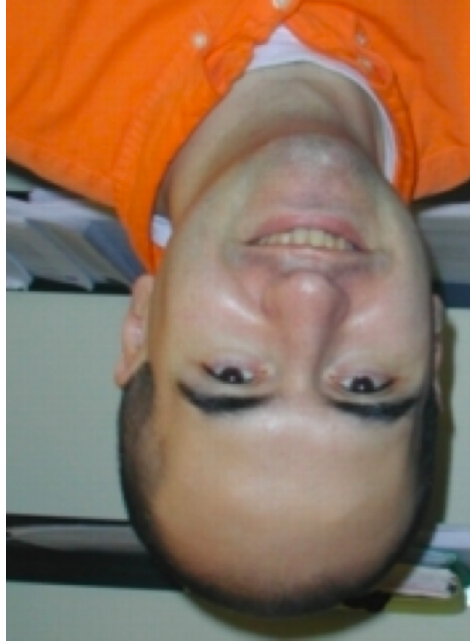
$$GDP = \rho_{d,t} Z_t \bar{z}_t L_t$$

so GDP changes with CPI inflation?

Here is the puzzling (TT) result

**Figure 4. Product market reforms**





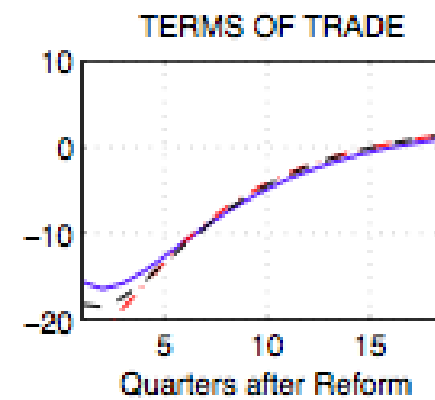
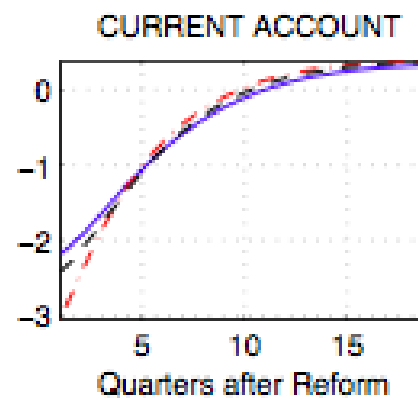
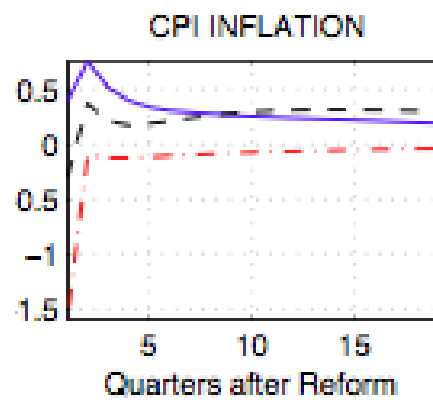
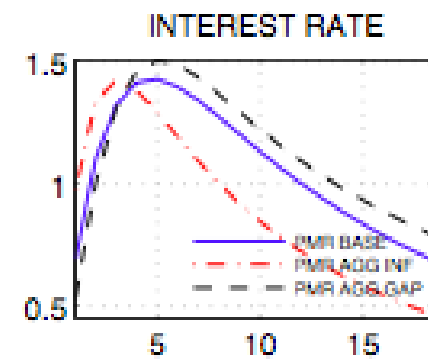
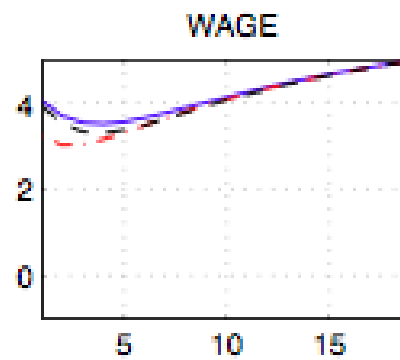
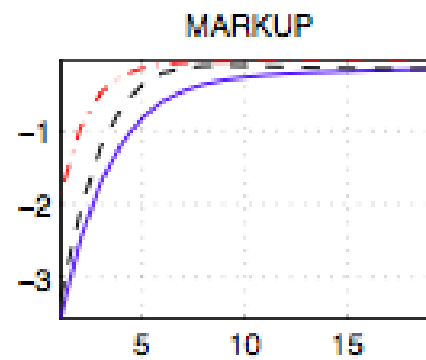
This is not the kind of guy who can accept topsy-turvy stuff!

## Product market reforms

- Good time for creating new firms
  - Investment up, Consumption down, CA deficits
  - Appreciation: intermediate goods absorbed by entry rather than production of C and Export goods
  - Wages up: home market effects
- All this is great: but why unemployment?

$$Z_t \bar{z}_t L_t = N_t (y_{d,t} + \tau y_{x,t}) + \overset{\text{entry=investment in differentiated g. firms}}{N_{E,t} \cdot (f_{E,t} \Downarrow)}$$

# Product market reforms



## Some questions

- Wealth effects and the labor market
  - Without frictions, higher steady state output and consumption may affect labor supply
  - In this model?
- Uncertainty
  - In the paper, lowering unemployment benefits boost job creation, lowering firing costs boost job destruction
  - Option value: more symmetric effects



## Some questions

- Early literature (e.g., Ghironi Melitz, my work with Martin and Pesenti, Zappada') frame distortions in multisector economy: traded non traded.
  - easier to relate to current debate on adjustment

## Conclusions

- Beautiful and complex paper bringing theory closer to policy debate
  - good economics and attention to institutional detail
- Potential framework for developing policy models
  - need to make transmission crystal clear
  - which frictions do what