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

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Discussion by

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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
germs from love of variety and saving on trade costs (production ‘relocation’)

The model in a nutshell
Competitive firms produce **intermediate goods** using labor

production input \rightarrow entry = investment input

Monopolistic wholesalers producing **differentiated goods** using intermediate goods but not labor

exports

Retailers (aggregating domestic and foreign diff. goods)

imports of foreign diff. goods

1. Labor market frictions including real wage rig.
2. Nominal price rigidities
3. Firm dynamic: entry love for variety but also Home market effect
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

\[ Z_t \tilde{z}_t L_t = \frac{\text{productivity} \times \text{employment}}{\text{production of differentiated goods}} = N_t \cdot \left( y_{d,t} + \tau y_{x,t} \right) + \frac{\text{entry} = \text{investment in differentiated g. firms}}{\text{units of consumption}} \]

\[ N_{E,t} \cdot f_{E,t} \]

in units of consumption

\[ GDP = \rho_{d,t} Z_t \tilde{z}_t L_t \]

so GDP changes with CPI inflation?
Here is the puzzling (TT) result
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?

\[ Z_t \tilde{Z}_t L_t = N_t \left( y_{d,t} + \tau y_{x,t} \right) + N_{E,t} \cdot \left( f_{E,t} \downarrow \right) \] entry=investment in differentiated g. firms
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