Monetary policy and the transition costs of a labor market reform

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ABSTRACT

Lagged benefits relative to costs can weaken the incentives to an efficiency-enhancing labor market reform, lending support to the two-handed approach. An accommodating monetary policy, conducted alongside the reform, could help bring positive welfare effects of the reform to the fore.

In order to identify the mechanisms through which monetary policy can affect the welfare effects of a reform, we add stylized features of the labor market to a standard New-Keynesian model for monetary policy analysis. A labor market reform is modeled as a structural change inducing a permanent shift in the flexible-price unemployment and output levels. In addition to the permanent gains, the impact of the timing and magnitude of the reform-induced adjustments on the welfare of workers – employed and unemployed – is crucial to the transition welfare costs of the reform. Since the adjustments depend not only on the macroeconomic structure, but can also be influenced by monetary policy, we simulate various degrees of output persistence across different policy rules.

We find that, if inertias are present, monetary policy affects the adjustment path following reform implementation. In general, the more expansionary (or the less contractionary) the policy is, the faster the recovery to the new steady-state equilibrium is, and therefore the lower the transition costs are.

1. Introduction

Labor market reforms, like other structural reforms, are expected to deliver long-run permanent positive welfare effects, namely through permanent improvements in real wage flexibility and in potential output. However, these gains often arise with a long delay relative to transition costs (Bean, 1998; Elmeskov, 2000), which, together with uncertainty, can indeed weaken the incentives to reform labor markets.

The issue of how to enhance the sustainability of reforms has led to the development (firstly by Blanchard et al., 1986) of the two-handed approach, according to which expansionary demand-side policies, conducted alongside reforms, could help in bringing its positive effects to the fore. Demand-side policies can speed up the adjustment process towards the new long-run equilibrium, and the more sluggishly the economy adjusts, the larger the scope is for the "helping hand" of such policies (Lindbeck and Snower, 1990; Bean, 1998; Saint-Paul, 2006).

In the sequence of steady increases in unemployment rates – explained to a great extent by the presence of rigid labor market institutions (LMI) interacting with shocks – the need for labor market reforms became an important issue in the economic policy agenda in the 1990s (e.g., OECD, 1999; among many others). At the same time, the two-handed approach was also endorsed at the institutional level: demand-side policies were explicitly included as policy recommendations in the OECD Jobs Strategy in 1994; and data on the evaluation of the Jobs Strategy show that countries that shifted towards

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stabilization-oriented macroeconomic policies exhibited the highest follow through rates in implementing labor market reforms and scored significant improvements in labor market indicators (OECD, 1999). In addition, monetary authorities often advocate the necessity of reforms in the labor market, which raises the issue of whether there is room for monetary policy, particularly for helping to promote such reforms.

Theoretically, to capture the interactions between demand-side policies – monetary policy, in particular – and structural reforms, we propose a New-Keynesian rational-expectations framework with habit formation in consumption, modified with specific institutional features characterizing the labor market. As regards the latter, we assume that nominal gross wages are established in a right-to-manage process of collective bargaining, preventing labor market clearing. Once LMI are included in the model, it is possible to identify, in a stylized manner, instruments of labor market reform. In particular, we consider the reduction of the unemployment-benefit replacement ratio. Welfare effects of the reform respect both the (immediate) reduction of insurance income and of real wages, and the positive (possibly lagged) effects arising from lower unemployment levels, which in turn induce a lower tax burden (to back unemployment benefits) on firms and workers. Assuming net positive permanent effects on the welfare of the workers, the sooner net benefits show up, the lower the transition costs of the reform are.

To illustrate the welfare effects of the reform, we use a calibrated version of the model, with parameters consistent with the Euro area macroeconomic environment. The characteristics of shocks hitting the economy and relevant features of labor market institutions, namely the degree of centralized wage bargaining and the employment protection legislation, are certainly heterogeneous within the Euro area. This heterogeneity would warrant a detailed country-by-country analysis, especially if more ambitious empirical implications were to be sought. However, a simplified, standardized calibration for the Euro area – with a single monetary policy and some degree of coordination in the conduct of labor market reforms – is an interesting and useful exploratory approach to illustrate the interactions between demand-side policies and structural reforms.

After this introductory section, the paper proceeds as follows. Section 2 develops the macroeconomic model, including the definition of monetary policy rules. In Section 3, we first argue that a reduction in unemployment benefits is a meaningful stylized reform example. Then, after discussing the welfare measure, we assess, through simulations, the role of monetary policy in reducing welfare transition costs of the reform. Section 4 presents some concluding remarks.

2. A macroeconomic model with labor market institutions

In this section, we proceed with the description of a model designed to capture the interaction between labor market reform and monetary policy. We follow the New-Keynesian type of models used by Galí (2003, 2008) and McCallum and Nelson (1999) for monetary policy analysis, with the addition of non labor-market clearing features. The latter affect the non-efficient flexible-price output level and generate unemployment.

2.1. Households

Consider an infinitely lived individual (i.e., household), representative of the consumers' behavior in the economy. The individual is risk-averse and wishes to

$$\underset{C_{t+j}, GB_{i+j+1}}{\text{Max}} \ E_t \sum_{j=0}^{\infty} \beta^{t+j} U_{t+j}, \ U_t = \text{Log}\left[C_t(i) - hC_t(i)\right] \exp(g_t) - \frac{\overline{N^s}^{(1+\varphi)}}{1+\varphi}, \quad h \leqslant 1,$$

$$\text{s.t.} \qquad C_{t+j} = (1 - u_{t+j}) \overbrace{\left[\frac{W_{t+j}}{P_{t+j}}(1-\tau_{t+j})\overline{N^s}\right]}^{\text{employed}} + u_{t+j} \overbrace{\left[\frac{bW_{t+j}}{P_{t+j}}\overline{N^s}\right]}^{\text{unemployed}} + \frac{\Pi_{t+j}}{P_{t+j}} - \frac{GB_{t+j+1}}{1+rr_{t+j}} + GB_{t+j},$$

where C stands for per capita consumption of a composite final good, g defines a shock to preferences and β is a discount factor.

The utility function, U, based on Christiano et al.'s (2005), captures slowly changing habits: when h (index of habit persistence) > 0, it produces, in line with the data (see, for instance, Estrella and Fuhrer, 2002; Christiano et al., 2005; Smets and Wouters, 2003), a gradual hump-shaped response of consumption to shocks.

Regarding leisure, the individual, either employed or unemployed, is assumed to supply a fixed amount of labor, $\overline{N^s}$, normalized to 1. Besides enabling a focus on the demand-side labor market frictions, this assumption captures the empirical regularity that labor supply is relatively inelastic in the short run.[1] As a result, effective per capita hours of work, N, are taken as given by the individual, as they are determined by the demand for labor. Assuming $N \leqslant \overline{N^s}$, the unemployment rate is $u = \frac{\overline{N^s} - N}{\overline{N^s}}$.

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[1] See, for instance, Burda and Wyplosz (1997). Wage inelasticity can be due to, among other causes, the existence of labor market legislation establishing a fixed number of weekly working hours. In addition, given our definition below of the unemployment benefit rate, a variable N^s would lead to the awkward result that the amount of benefit received would increase with the amount of labor supplied.