Heterogeneity, Rigidity and Convergence of Labor Markets in the Euro Area

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1 What?

This paper studies the **welfare consequences** of a **convergence of labor markets** in the **Euro Area** at different levels of flexibility, deepening the analysis of previous works.

2 Why?

- The Euro Area has strongly suffered from the Great Recession: its unemployment rate remains higher than it was in 2007.
- The heterogeneity of the economic performances is very large between countries inside the Eurozone.
- Sharp **differences** exist in terms of **labor market institutions** in the EMU (unemployment insurance, minimum wage, etc.).
- Previous works have shown that **labor market flexibility** tends to cause **higher economic performances**, including in the Euro Area (e.g. Blanchard and Giavazzi (2003), Cacciatore et al. (2016)); and that some types of **labor market heterogeneity** in a monetary union leads to **negative economic consequences** (e.g. Dellas and Tavlas (2005), Poilly and Sahuc (2013)).

3 How?

I use a **DSGE model** with the following important features:

- **Two countries** (flexible/rigid) in a monetary union are asymmetric in terms of size, openness, productivity, tax rates and most labor market parameters;
- A unique central bank decides of the interest rate of the zone according to aggregate inflation;
- Union-wide financial markets are incomplete;
- Firms pay **firing costs** which brings wage heterogeneity between new and old workers;
- **Search and matching frictions** occur in the labor market which leads to a Nash-bargaining of the wages;

Then, I design models that are structurally identical but for which labor market calibration is identical for both countries in order to simulate homogenous labor markets. Those models cover convergences towards any level of flexibility between the one of the flexible country to the one of the rigid country.

I conduct two main welfare exercises:

- A **steady-state to steady-state analysis** where I look at structural and stabilization gains that are obtained when having identical labor market variables and parameters in comparison with the current labor markets;
- A **transitional path analysis** where I study short and long-term welfare gains from converging towards identical labor markets for the countries of the Euro Area.

4 Main results

The steady-state to steady-state analysis tells us that:

- **The higher the after-convergence flexibility level, the higher the structural and stabilization gains** (or the lower the losses) whichever the country as the job finding process is more efficient;
- The **rigid country** experiences **structural welfare gains for any convergence** studied and stabilization gains in almost all cases;
- The **flexible country loses in terms of structural welfare** whatever the convergence studied (negative spillover effect) but obtains stabilization welfare gains in most cases.
- Stabilization welfare gains come from the higher ability of the central bank to adopt a monetary policy benefiting both countries.

Figure 1: Welfare gains in the steady-state to steady-state analysis

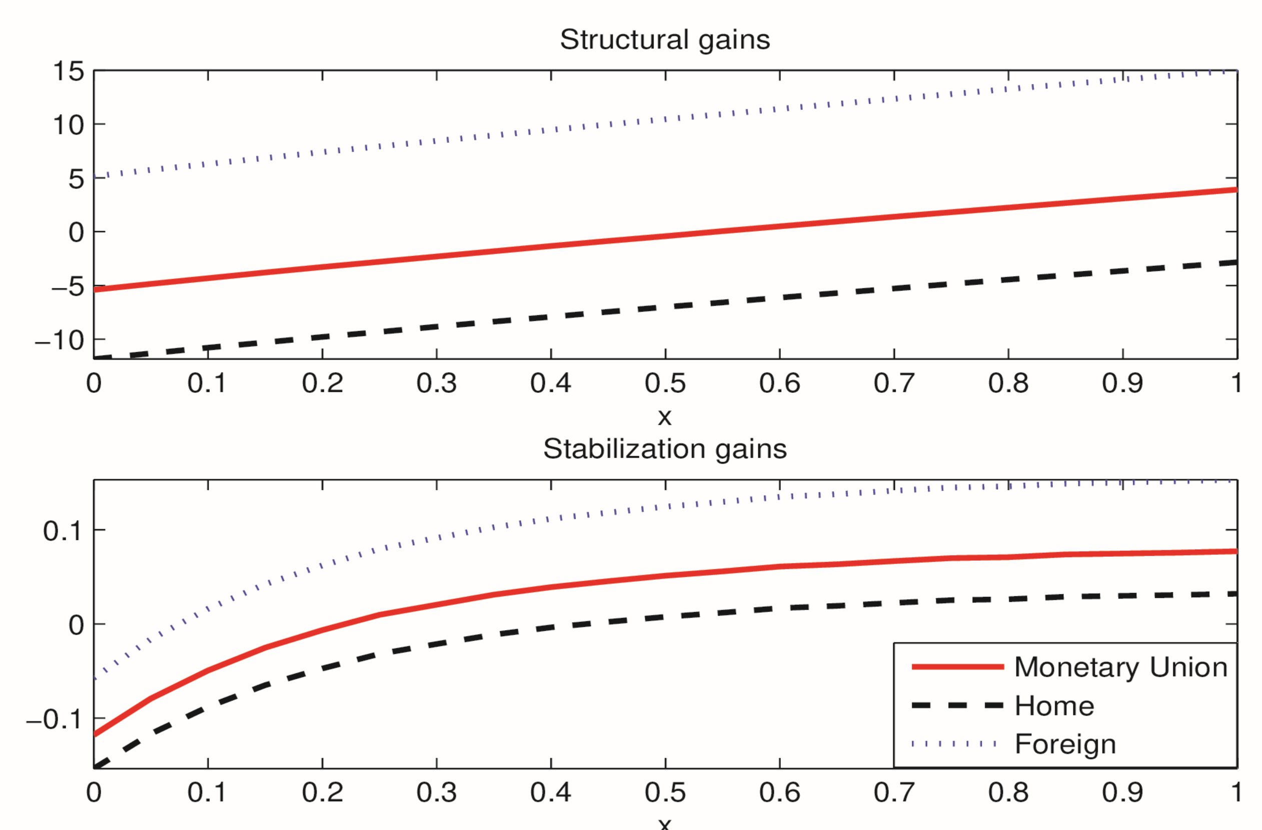
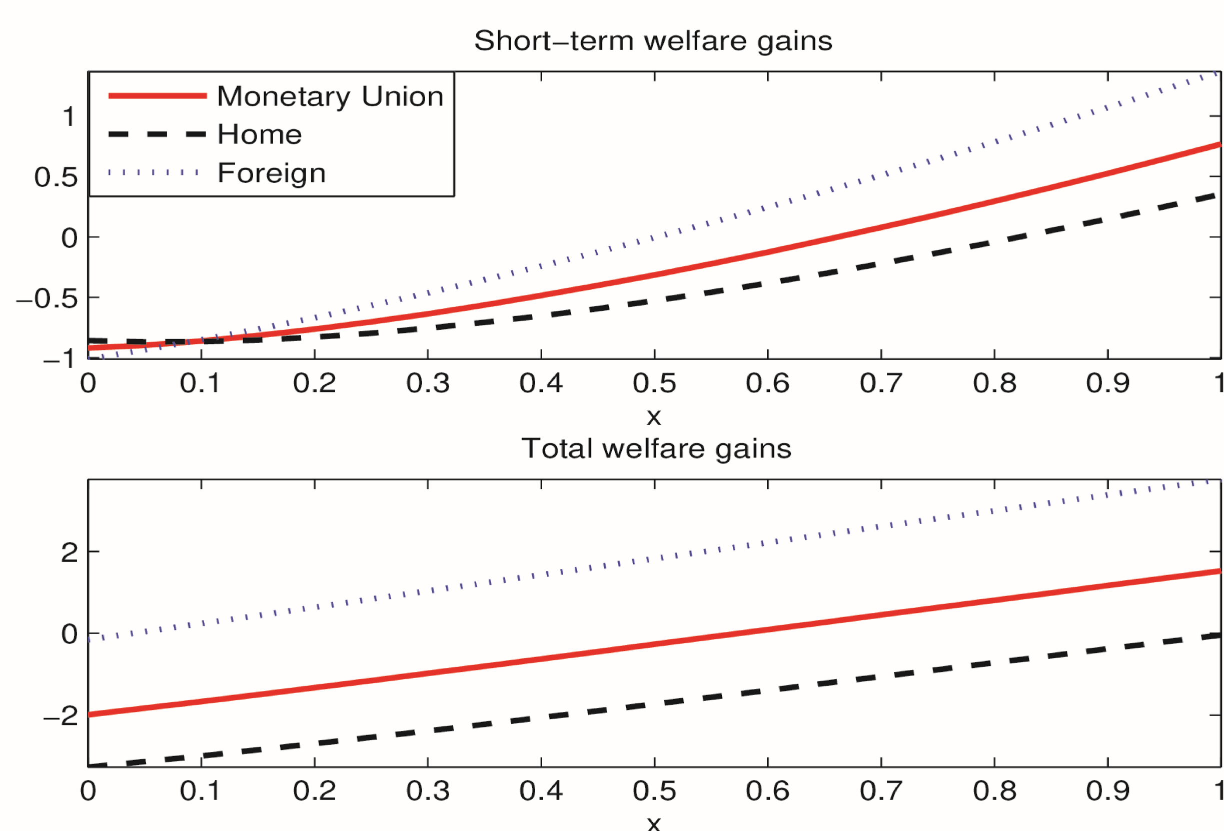


Figure 2: Welfare gains in the transition path analysis



On the long run, the transition path analysis conveys outcomes similar to the steady-state comparison exercises. But the **transition** brings additional results:

- **Welfare movements are lower** due to an opposite short-term mechanism coming from the agents' foresights of their future bargaining power;
- As a consequence, on the **short run** (4 years), the transition brings **welfare losses for most after-convergence flexibility levels**;
- The speed of convergence modifies the quantitative results: the quicker the convergence, the higher the gains (or the lower the losses) for the rigid country and the higher the losses (or the lower the gains) for the flexible country as it magnifies the long-term mechanism.

5 Conclusion

- **A convergence** of labor market institutions is likely to **increase the welfare of the rigid countries of the EMU and of the EMU as a whole**. But, it should have negative consequences for the most flexible countries.
- Such reform should be carefully implemented to limit short-term negative effects and maximize long-term gains.

6 References

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