

Summary for non-specialists  
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## **Adjustment in the euro area and regulation of product and labour markets: An empirical assessment**

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This paper analyses how price-competitiveness (measured by both real exchange rate and inflation differentials) adjusts with the euro area and what role labour and product market regulations can play in this adjustment process. Two alternative perspectives are considered to capture the competitiveness adjustment: the reaction to the *country-specific cyclical* divergences – also called "short-term demand shocks" such as a relative slack or relative boom with respect to the euro area trade partners – and the country-specific response to *common* competitiveness *shocks*.

Results show that competitiveness in EMU moves towards easing country-specific cyclical imbalances. Although the loss of nominal exchange rate flexibility could have entailed a weaker immediate response of the real exchange rate to country-specific cyclical divergences, relative price movements seem to have partly "taken over" as an adjustment mechanism after the creation of the euro, with relative inflation reacting more strongly and more quickly to cyclical differences within the euro area.

Changes in product and labour market regulations are a natural candidate for explaining the changing behaviour of price dynamics in response to shocks and their inertia. Our analysis reveals that tight product market regulation, strict employment protection, a high minimum wage, high union density and generous unemployment benefits all appear to either reduce the immediate responsiveness of relative inflation to cyclical divergences or to raise its persistence or both.

When considering the impact response of price competitiveness to common competitiveness shocks – rather than country-specific cyclical divergences– it turns out that the presence of cross-country differences in product market regulations, minimum wages, unions, and the wage bargaining structure have influenced the extent to which price competitiveness specifically reacts in each country to common shocks.

The reduced stringency of product and labour market regulations over the past decades is then likely to have played a role in explaining the observed faster adjustment dynamics of price competitiveness after the monetary union. Moreover, regulatory reforms could help strengthen the efficiency of the adjustment mechanism.