

## **Essay on Fostering the reallocation of economic activities**

### **Background**

A process of market selection whereby less productive firms succumb to new and more productive entrants is a necessary component of economic development. Resource allocation plays a key role in achieving economic efficiency, and a flexible reallocation may give a substantial contribution to aggregate productivity growth. In this perspective, the economic literature has emphasized the role that factor market regulation can play in promoting reallocation, exit and entry, thereby boosting long-term growth<sup>1</sup>.

A smooth reallocation process has also relevance for the links between the economic cycle and longer-term growth. The literature on the cleansing effect of recessions<sup>2</sup> emphasizes that the exit of more inefficient firms during slowdowns sows the seeds for stronger growth afterwards, as the exit of inefficient incumbents makes easier the entry of new competitors with superior technologies and products. Empirical evidence on the US<sup>3</sup> shows that less productive plants are driven out of the market, but not only in recessions; in booms small and relative inefficient plants enter while recessions select the most productive plants.

In addition, as evidenced by the boom-bust cycle followed by a number of countries before the financial crisis, excessive growth of domestic demand during the boom phase leads to a quick and substantial reallocation between tradable and non-tradable sectors, while when the absorption boom stops and turns to bust, the sectoral adjustment process could be rather lengthy and costly because workers go through long spells of unemployment before finding a job and because of limited access to finance that hampers the creation of new activities<sup>4</sup>.

### **Aims of the essay and key questions to be tackled**

This essay should discuss, in the form of a position paper, the contribution of a different set of policies in promoting reallocation of factors, with a view of to boost productivity growth and smooth the economic cycle. In particular, the essay should:

- Review available evidence about patterns of reallocation over the business cycle and its contribution to growth;

and discuss the following issues:

- What type of labour, product, and financial market regulation is needed to promote sectoral reallocation, including via firms' entry and exit?

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<sup>1</sup> Aghion, P. and P. Howitt (2006). "Appropriate Growth Policy: A Unifying Framework", *Journal of the European Economic Association* 4, 269-314.

<sup>2</sup> Caballero, R. J. and M. L. Hammour (1994). "The Cleansing Effect of Recessions", *American Economic Review* 84, 1350-1368.

<sup>3</sup> Lee, Y and T. Mukoyama (2008). "Entry, exit and plant-level dynamics over the business cycle," *Working Paper 0718*, Federal Reserve Bank of Cleveland.

<sup>4</sup> Caballero, R. J. and M. L. Hammour (2005). "The Cost of Recessions Revisited: A Reverse-Liquidationist View," *Review of Economic Studies* 72, 313-341.

- Is there a role for active economic policies (e.g. industrial policies, tax policies...) to accelerate the reallocation process, by speeding up the destruction margin or the creative margin during recessions and/or during a recovery?
- Should policies to ease reallocation be modulated over the cycle, with a view in particular to prevent an excessive growth of the non-tradable sector during absorption booms and encourage early restructuring?