SESSION 4

SHORT-TERM IMPACT OF STRUCTURAL REFORMS

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Banque de France
SEMINAR ON ASSESSING THE IMPACT OF STRUCTURAL REFORMS
Paris, 1 June, 2015
Roadmap

Set of reforms and how they are modelled
- Model-based (DSGE) and reduced-form empirical analysis
- Differences in how reforms are captured in models

How reforms influence the components of demand
- Main channels of transmission

How the relative strength of channels is influenced by macro conditions
- Weak demand
- ZLB and Monetary union
Product Market Regulation and Taxation

Reforms to boost product market competition

• Reduction in regulatory barriers to competition
  • => Decrease in mark-ups
  • => Reduction in firm entry costs
  • => Increase in labour productivity

Reforms to enhance productive capacity and efficiency

• Shift in the tax structure
  • => Increase in consumption taxes offset by reduction in labour or corporate income tax
  • => In EMU: Fiscal devaluation

• Incentives for investment in innovation
  • => Increase in public subsidies to private R&D
Labour Market and Social Policies

Reforms to raise wage flexibility and facilitate labour resource reallocation

- Wage bargaining arrangements, minimum wages
- => Lower wage mark-up

- Employment protection legislation
- => Lower wage mark-up and firing costs
- => Increase in labour productivity

Reforms to stimulate labour supply and improve matching

- Unemployment benefits
- => Cut in reservation wage and reduction in transfers

- Pensions
- => Increase in labour supply, with or without reduction in transfers

- Job-search assistance, training programmes
- => Increase in job matching efficiency, increase in public spending
The main channels of impacts on domestic demand

**Wealth channel (positive confidence channel)**
- Life cycle or permanent income effects
- Bring forward future reform-induced income or profit gains

**Disposable income and cash-flow channels**
- Liquidity-constrained households (relative speed of employment/wage changes)
- Firms with limited access to external lending

**Uncertainty channel (negative confidence channel)**
- Perception of heightened income/profit uncertainty or instability
- Precautionary motive for saving

**Real interest rate channel**
- Inter-temporal substitution effects
- Current consumption reduced to raise financial wealth
Reforming in different macroeconomic contexts

**Normal time**
- Economy operating close to potential
- Ample room for supporting monetary and fiscal policies

**Weak demand**
- Large output and unemployment gaps
- Support from macro policies available

**Weak demand with constrained macro policies**
- (Zero Lower Bound, Monetary Union)
Little evidence of adverse effects from SR introduced in normal time

- Gains from pro-growth reforms generally exceed the costs
  - Investment increases in nearly all cases (exc. pension benefits)
  - Negative impact on consumption found in the case of price mark-up reduction, shift in taxation and cuts in pension benefits (or rise in contributions).
  - Generally small effects in the case of net exports: Positive impact found in the cases of price mark-up reduction and cuts in pension benefits.

- Reforms that tend to have a larger positive impact:
  - Unemployment benefits, job-search assistance, retirement age

- Reforms that tend to have weaker impact:
  - Employment protection, tax composition, pension benefits/contr.
Reforming under weak demand conditions changes the relative strength of channels

**Disposable income and cash-flow channel** => *More important*

- Proportion of households and firms facing liquidity constraints expected to rise
- Efficiency of job matching may deteriorate with rising unemployment rate and falling housing prices => slower reallocation

**Positive wealth channel** => *Likely to be weaker*

- Especially if the downturn is associated with dysfunctions in financial markets

**Negative confidence channel** => *Likely to be stronger*

- Heightened macro-economic uncertainty can lead households and firms to postpone spending and investment decisions
- Higher precautionary saving
Some reforms can have an adverse short-run impacts in context of weak demand

- **Reforms putting downward pressures on wages and mark-ups are more likely to further depress demand**
  - Product market reforms that enhance competition in formerly protected sectors. => reduced rents => firms exit, displaced resource.
  - Reforms of wage bargaining institutions, minimum wage or EPL => employment gains take more time to materialise and offset wage fall.

- **Reforms increasing labour supply are also less effective**
  - Need to distinguish the reform component from the fiscal stimulus or contraction => higher multiplier effects in downturns
  - Reforms reducing unemployment benefits (replacement rate or duration) or pension benefits

- **Reforms whose impact may be equal or even stronger**
  - Increase in retirement age
  - Spending on job-search assistance, training childcare support
  - Investment in KBC, including through infrastructure (broadband network) => low opportunity cost of borrowing
The gains in employment from reforming UI benefits can turn negative in a downturn

Impact of reduction in the initial benefit replacement rate in different economic conditions

Reforming under weak demand conditions and constrained macro-policies: Zero Lower Bound

**Real interest rate channel => Plays a key role**

- Reforms that boost aggregate supply can in a weak demand environment put downward pressures on price levels which lead to lower inflation expectations.
- At the ZLB, real interest rates are pushed up by difficulty to adjust nominal rates.

**Factors conditioning the importance of this channel**

- Maybe an issue mainly for reforms to enhance competitiveness through lower production costs and prices.
- Outward supply shift less clear in the case of productivity enhancing reforms given limited incentives to invest in weak demand => If supply shifts, raises neutral rate.
- LC households less sensitive to real interest rate increases.
- Effectiveness on unconventional monetary policy tools.
Reforming under weak demand conditions and constrained macro-policies: *Monetary Union*

**Real interest rate channel** => *Plays a role even in normal times*

- Reforms undertaken by one member to reduce relative wages and prices
- *Internal devaluations* raise real interest rate => can be contractionary
- Makes the case for coordinated reforms
- ZLB or near-zero inflation raises the output cost of relative wage and price adjustments

**Additional channel operating** => *competitiveness channel*

- Fiscal devaluations – A shift in the composition of taxation from labour taxes to value-added taxes -- have more traction in a monetary union due to the additional competitiveness channel
- Make fiscal devaluations potentially more effective than in normal times – as long as not too many members pursue it at the same time.
Reforms to be promoted in a context of weak demand

**Shift in the composition of public spending towards investment**

- Public infrastructure investment with high growth impact (broadband network)
- Regulatory harmonisation

**Product market reforms in specific service sectors**

- Removing restrictions on the entry of new suppliers in services characterised by low entry costs – and in some cases – latent demand (professions, taxis, etc).

**Reforms of benefit entitlements in the areas of pensions and/or health**

- Improve sustainability of public finances and create space for fiscal stimulus
- Effective/credible back-loaded consolidation

**Reforms easing frictions in the reallocation of resources**

- Reducing barriers to geographical or jobs mobility
- Housing market policies and job-search assistance
Product market reforms that can ease supply constraint can bring benefits even in a difficult context.

Regulatory barriers to competition in regulated professions (legal services, engineering, architecture and accounting)

Reducing entry barriers in service sectors with large pent-up demand and low entry costs can unleash the entry of new firms.

*2008 data.*
Reforms least likely to succeed in a context of weak demand

Reforms that initially put downward pressures on wages or mark-ups

- Employment protection legislation, minimum wages or product market regulation (network industries)

Factors mitigating the impacts of such reforms

- **Packaging**: Simultaneous reforms of labour and product markets reduce risks or extent of contractionary effects.
- **Synchronisation**: In euro area, help to reduce transition costs by giving greater scope to monetary policy.
- **Boldness**: Once and for all price level adjustment vs lower inflation expectations.

Measures to shift the relative strength of channels

- Addressing financial sector dysfunctions to improve credit flow
- Reducing policy uncertainty to boost the positive confidence channel