



OESTERREICHISCHE NATIONALBANK  
EUROSYSTEM

# What is the appropriate role of structural reforms in E(M)U deepening?

Andreas Breitenfellner (coauthored with Kurt Bayer)  
83rd East Jour Fixe, OeNB  
Vienna, 18 September 2018

Foreign Research Division  
[www.oenb.at](http://www.oenb.at)



## Outline

1. Motivation & Definition
2. Shifts in the meaning of structural reforms & related evidence
3. The link between structural and macroeconomic policies
4. Structural reform and E(M)U reform
5. Concluding remarks

## Motivation

### No day without plea for structural reforms...

The implementation of structural reforms in euro area countries needs to be substantially stepped up...

*M. Draghi  
13 Sept. 2018*

Structural reforms are crucial to modernise our economies, strengthen their performance and resilience, and foster real convergence within and across Member States.

*V. Dombrovskis,  
10. Sept. 2018*

### Three questions

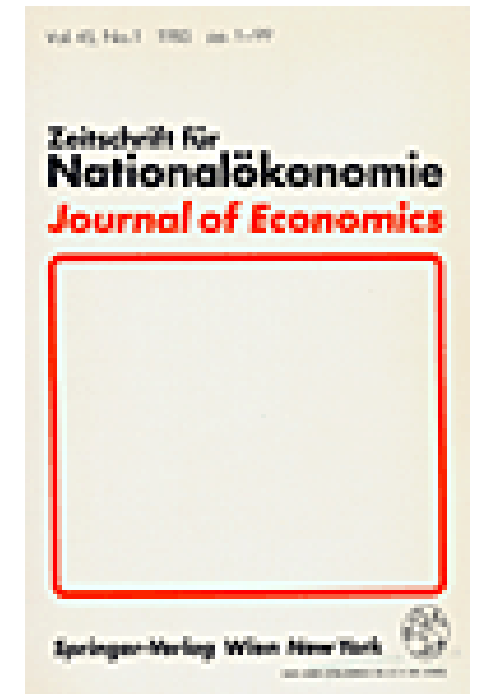
1. **Why** are structural reforms necessary in EU and EMU?
2. **How:** Should reforms rather enhance flexibility or more directly productivity and well-being?
3. **Who:** Should reforms originate from the EU or the national level?

## Semantics of “structure” in economics: hopelessly vague?

**“Structure, I am afraid, is often a weaselword used to avoid commitment to a definite and clear thought.” (Fritz Machlup, 1958)**



**Structure and Structural Change:  
Weaselwords and Jargon**  
Von  
**Fritz Machlup**  
The Johns Hopkins University, Baltimore, Maryland, USA



## The typical definition in economics

### Structure

- Long term
- Supply side
- Segments / sectors / factors
- Microeconomics
- Potential growth
- Structural reforms
- Many actors: ministries, international, regional & local authorities, social partners, etc.

### Cycle

- Short term
- Demand side
- Aggregate
- Macroeconomics
- Actual growth / output gap
- Fiscal & monetary policy
- Finance ministry & central banks

### Interaction

- Macro environment of reforms,
- Hysteresis (impact of macro on structure)
- Macro impact of reforms

# Myriades of policy areas

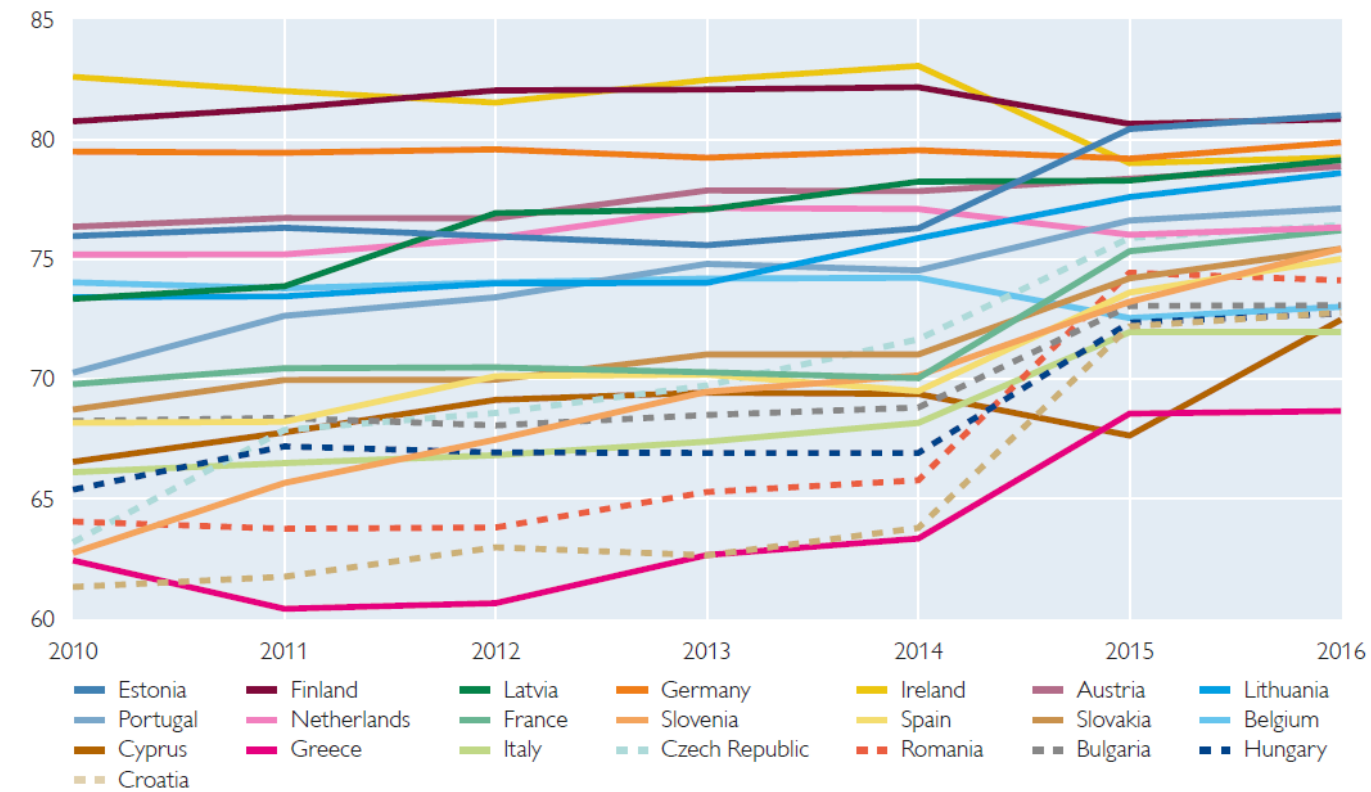
Governance and public administration	Tax revenue and public financial management	Growth and business environment	Labour market, health and social services	Financial sector and access to finance
<ul style="list-style-type: none"> <li>• Governance</li> <li>• Central &amp; local administration</li> <li>• e-Government</li> <li>• Management of human resources</li> <li>• Better regulation</li> <li>• Anti-corruption &amp; anti-fraud strategies</li> <li>• Anti-money-laundering strategies</li> <li>• Judicial reform</li> </ul>	<ul style="list-style-type: none"> <li>• Revenue administration</li> <li>• Budget preparation</li> <li>• Spending reviews</li> <li>• Fiscal strategies &amp; tax policy</li> <li>• Supreme audit institutions/ independent fiscal institutions</li> </ul>	<ul style="list-style-type: none"> <li>• Investment licensing</li> <li>• Competition policy</li> <li>• Trade issues</li> <li>• Digital society</li> <li>• Land registry</li> <li>• Energy Union</li> <li>• Better Regulation</li> <li>• Management of State-owned enterprises (SOEs)</li> <li>• Sectoral expertise: transport, environment, water, agriculture, etc.</li> </ul>	<ul style="list-style-type: none"> <li>• Labour market, policies &amp; laws</li> <li>• Welfare system</li> <li>• Pension system</li> <li>• Healthcare system</li> <li>• Education &amp; vocational training</li> </ul>	<ul style="list-style-type: none"> <li>• Access to finance</li> <li>• Capital Markets Union</li> <li>• Bank supervision &amp; resolution</li> <li>• Non-performing loans</li> <li>• Insolvency &amp; financial literacy</li> <li>• Insurance &amp; pensions</li> <li>• Competition issues</li> </ul>

Source: European Commission

# Structural convergence happens

## Doing Business indicator – distance to frontier, for selected euro area and EU countries (2010–2016)

Distance to frontier score<sup>1</sup>



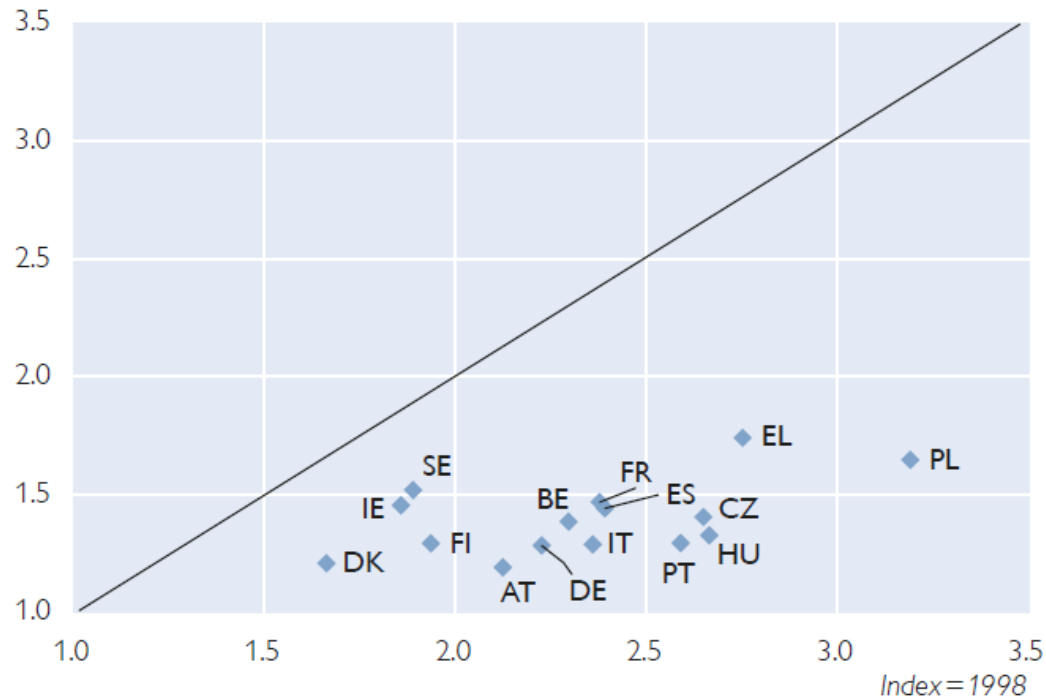
Source: World Bank.

## ...convergence towards more flexibility (long-term view)

### Competition and innovation

#### Product market regulation of the whole economy

Index=2013

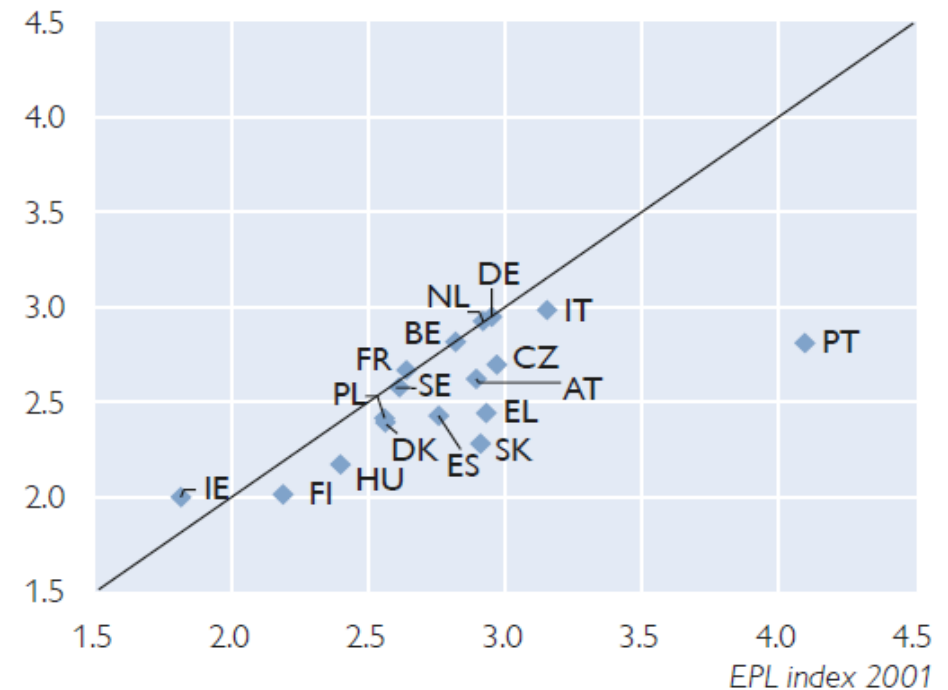


Source: OECD, European Commission.

### Labor market institutions over time (I)

#### Strictness of employment protection legislation

EPL index 2013

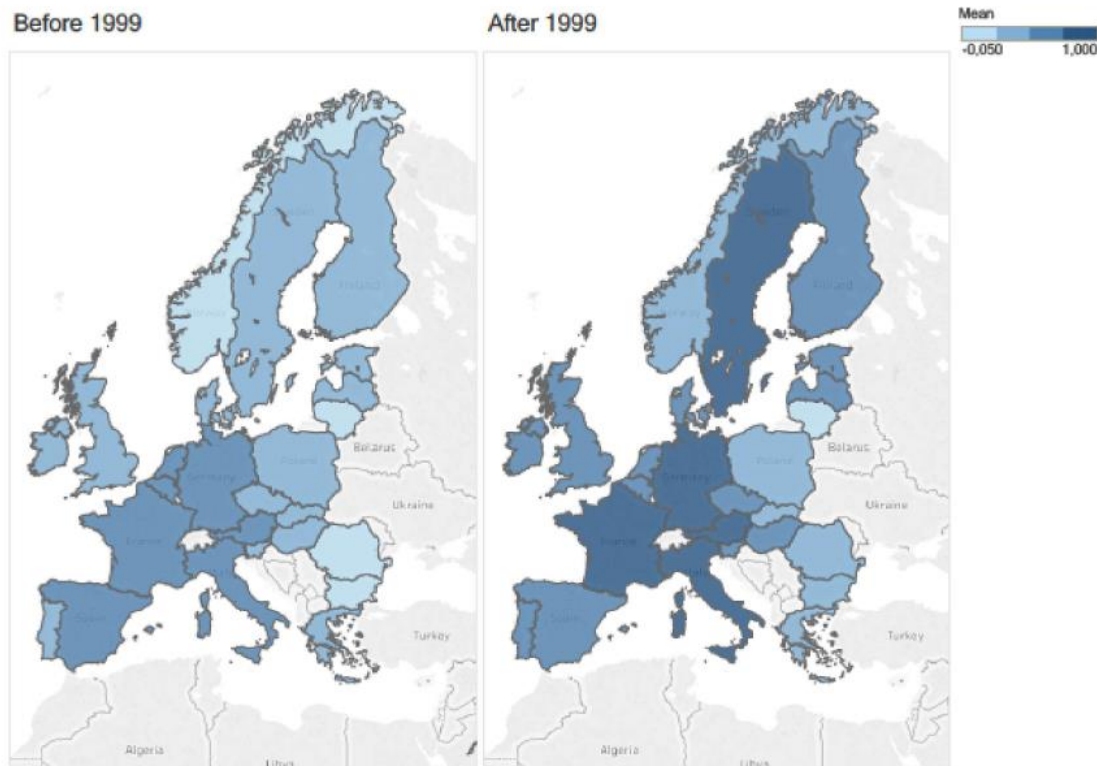


Source: OECD.



# Output convergence: Cycles more synchronized but incomes diverging in EMU

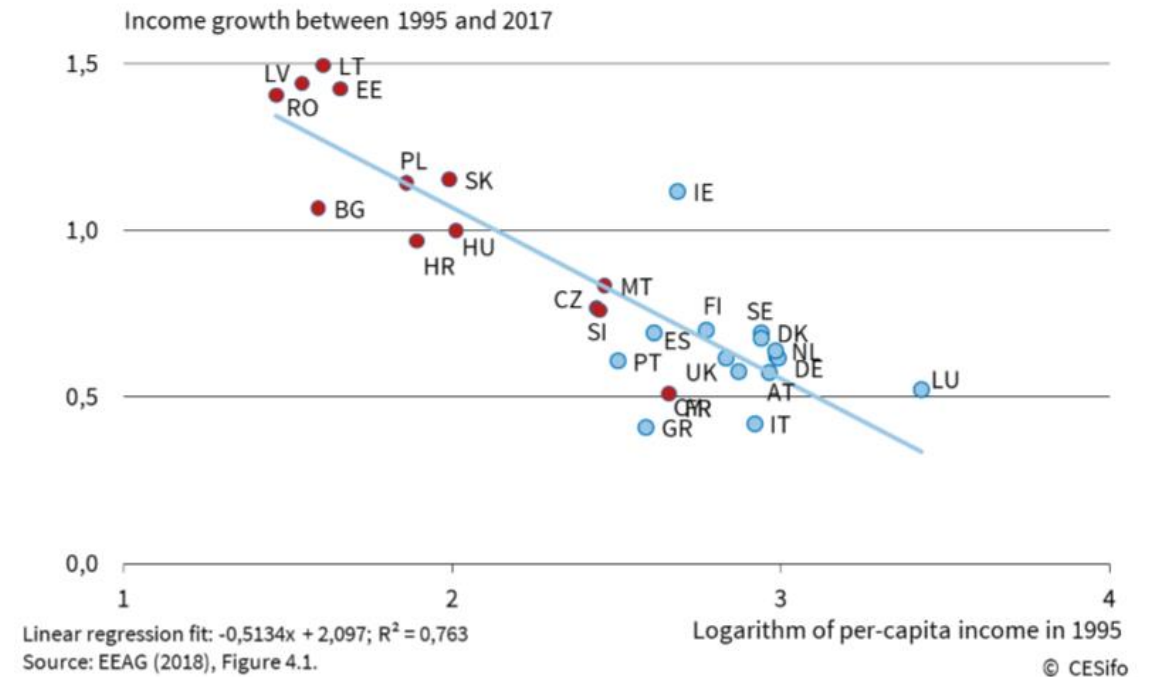
**Figure 1** Business cycle synchronisation in Europe before and after the euro



Source: Campos et al. (2017).

**Figure 2**

Income Convergence between 1995 and 2017 for EU-28



## Shift in the meaning of structural reforms

### Pre-crisis

Code word for cost-cutting, deregulation, liberalization & privatization

- Advanced economies: supply-side strategies after stagflation and Keynesian consensus (led by OECD and IMF).
- emerging economies: Washington Consensus (export-led development strategies)

### Post-crisis

OECD:

- “New Approaches to Economic Challenges” (NAEC): focus on inequality, wellbeing, etc.

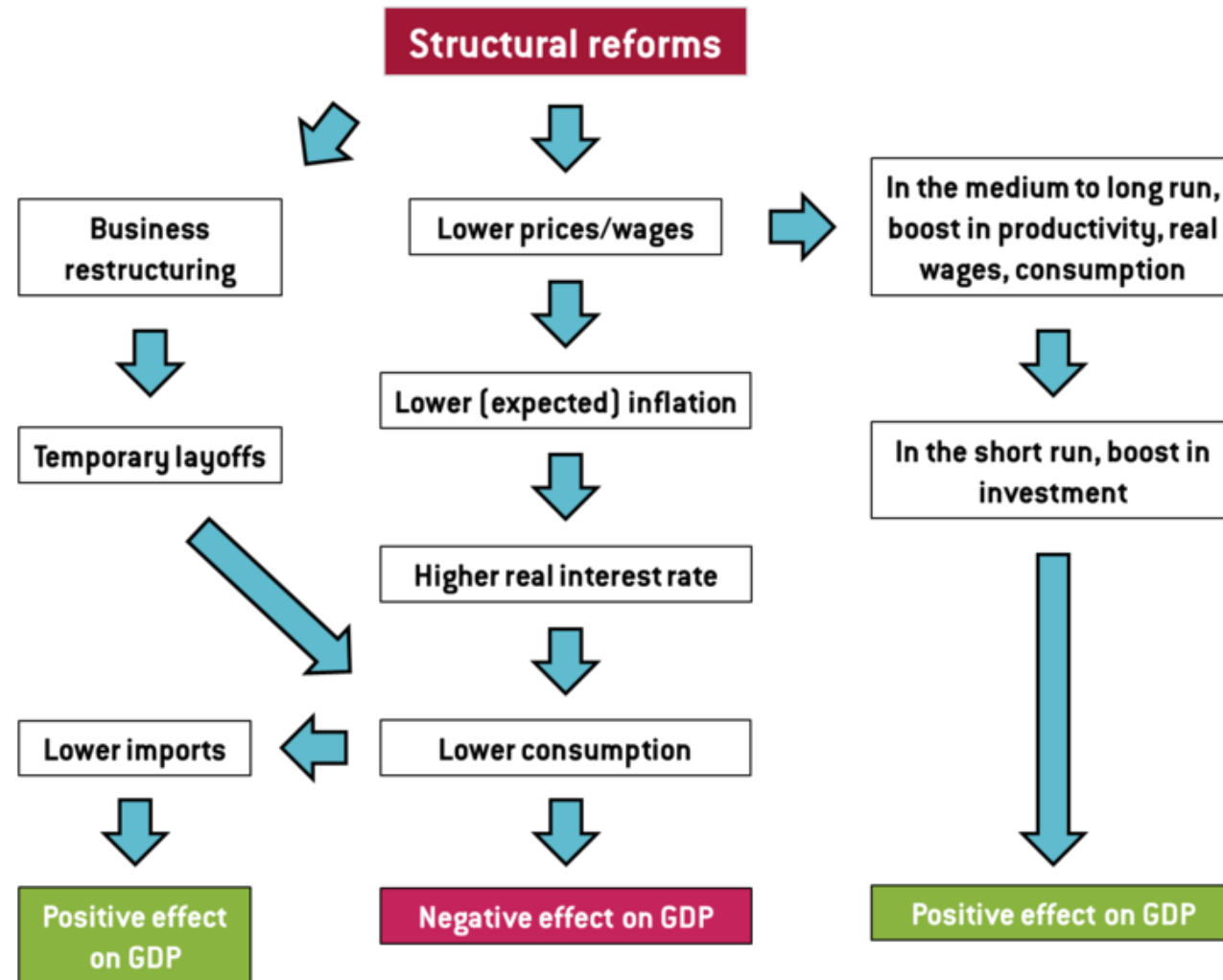
IMF:

- Watch out macro conditions → careful prioritization and sequencing of reforms
- Inclusive growth, reversal in pension policies

EU:

- Egalitarian considerations & efficiency
- supporting macro policies

## Long-run Gains vs. short-run pains: balance of deflationary and expansionary forces



## Economic debate on structural & macroeconomic policy interaction

### Old supply/demand debate:

- Neoclassic vs. Keynesianism

### New Keynesian / DSGE models:

- reforms boost competition → reduce mark-ups
- initially deflationary → gradually expansionary through reallocation

### Galí (2012) or Eggertsson et al. (2014):

- Short-run transmission of reforms depends on monetary policy accommodation.
- At zero lower bound (ZLB): Flexible wages/prices cannot offset shock

### Vogel (2014), Fernández Villaverde et al. (2014), Cacciatore et al. (2017):

- Deflationary effects low
- Wealth effects boost consumption & labour supply

### McAdam and Stracca (2015): Empirical evidence OECD 1980-2014:

- Growth impact of labor market reforms depends on saving response
- Depends on recession or ZLB, especially for euro area countries

## Policy debate before and after the crisis

### Van Riet (2006):

- Structural reforms → lower inflation outlook → **monetary policy** more effective
- smoothing transmission mechanism → more efficient
- monetary policy → price stability → price transparency → reveals need for reforms.

### Draghi (2017):

- monetary policy → support economic activity
- structural reforms → raise the effectiveness of monetary accommodation

### OECD (2006):

- limited scope for **fiscal** expansion → only structural reforms.

### Beetsma and Debrun (2004):

- fiscal rules erode incentives for structural reforms (no compensation of losers)

### Buti et al. (2009):

- reforms and fiscal discipline: either trade-off or complement
- depending on short-term costs of reform and time horizon of government.

## Timing of structural reform matters (IMF 2016)

### Effect of Product and Labor Market Reforms on Macroeconomic Outcomes

The effects of structural reforms depend on the type of reform, overall economic conditions, and the horizon considered.

Area of Reforms	Normal Economic Conditions		Weak Economic Conditions		Strong Economic Conditions	
	Short Term	Medium Term	Short Term	Medium Term	Short Term	Medium Term
Product Market	+	++		+	+	++
Employment Protection Legislation			-	--	+	++
Unemployment Benefits	+	++	-		+	++
Labor Tax Wedge	++	++	++	++		
Active Labor Market Policies	++	++	++	++		

Source: IMF staff estimates.

Note: The macroeconomic outcomes are output and/or employment; + (-) indicates positive (negative) effect; the number of + (-) signs denotes the strength of the effect. The effect of labor tax wedge decreases and spending increases on active labor market policies is smaller but remains positive when these measures are implemented in a budget-neutral way.

*Sample: 20 advanced economies over the period 1998–2013*

# The political economy of structural reforms

## Determinants of structural reforms

	Labour market reforms	Product market reforms	Reforms on framework conditions	Reforms on FDI barriers
Depth of recession	+			+
Unemployment rate	+			
Potential growth	-	-	-	
Chg. structural balance	+		-	-
Short-term interest rate	-		-	-
Programme dummy	+		+	+
Majority in all houses	+	+	+	
Single market dummy		+		
EPL initial conditions	+			
ETCR initial conditions		+		
DBI initial conditions			+	
FDI initial conditions				+
Past product market reforms	+			

- Governments rather undertake reforms in dire economic times.
- A strong government seems to be conducive to more reforms.
- Monetary loosening helps reforms
- Reforms happen both in times of fiscal tightening and loosening.
- EU-Institutions promote reforms

Source: A. Dias da Silva, A. Givone, D. Sondermann (2017) „When do countries implement structural reforms?”, ECB WP.

## Structural reform and E(M)U reform: three views

### Substitutes:

- everybody should do homework (“Ordoliberal view”); no EMU reform needed
- “New Hanseatic League”

### Complements:

- first homework → E(M)U deepening feasible (“Brussels/Frankfurt view”).
- Five-President’s report

### Integral part:

- EMU reform → precondition for other reforms
- “Anglo-Saxon economists’ view”: any currency needs a state or fiscal center
- Meseberg declaration

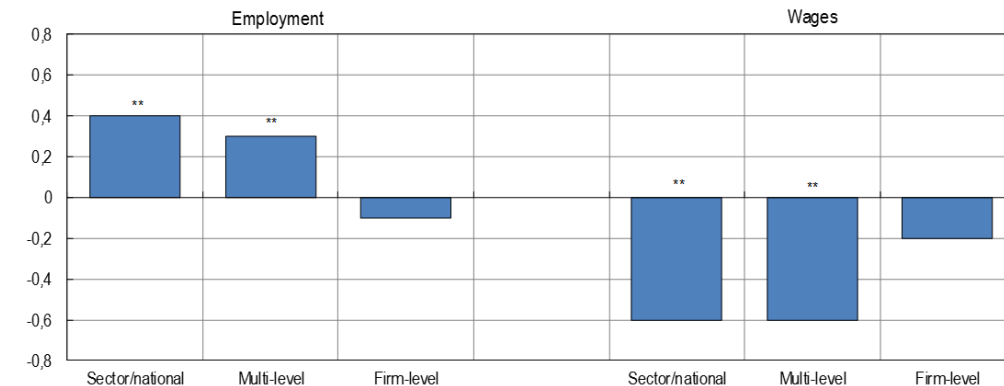


## Flexibility vs. Productivity?

- **Optimal currency theory:** Flexible wages/prices replace exchange rate mechanism → adjustment to asymmetric shocks
- **Flexibility** not necessarily **de-centralization** (OECD, 2017); social partnership more flexible outcome.
- Little employment protection → less knowledge accumulated → lower investment → lower **productivity** (Kleindienst, 2014)

Figure 2.7. The role of collective bargaining arrangements for firm-level adjustments to the Great Recession

Percentage point difference between post- and pre-crisis growth due to a 10-percentage point increase in collective bargaining coverage relative to no collective bargaining



Note: \*\*\*, \*\*, \* statistically significant at 1%, 5% and 10% levels respectively, based on standard errors that are clustered by country and industry.

Source: OECD calculations based on ORBIS (2000-12) and the Structure of Earnings Survey (2006).

## Proposals to foster the link between EMU & structural reforms

### **Five Presidents' Report (2015):** Completing EMU

- achieve similarly resilient economic structures throughout the euro area
- should become more binding → condition to access macroeconomic stabilisation function

### **Commission's roadmap (6-12-2017):** Reform delivery tool

- Structural Reform Support Programme (€ 25 bn in EU-Budget MMF 2021-27)
- In Context of European Semester or in preparation for euro area membership
- Compensate for short-term costs

### **Already in place:**

- Country specific recommendations in European Semester
- Structural reform clause in Stability and Growth Pact (up to 0.5% temporary deviations)

## Subsidiarity: When should EU get involved in national reforms?

1. Excessive external or internal imbalances  
→ negative spillovers to other Member States
2. Reforms have positive externalities for productivity growth (but negative on competitiveness of other MS)
3. To improve the functioning of the Single Market
4. To prevent regulatory arbitrage (“race to the bottom”)
5. To promote risk sharing (solidarity)

Even more so for **euro area members**:

1. Dampening inflation – easing ECB’s job
2. Increasing potential growth
3. Transmission mechanism of monetary policy
4. Business cycle synchronization
5. Wage & price flexibility → adjustment

## Issues for discussion

1. EU **bias** towards consolidation and internal devaluation → more upgrading reforms productivity, human capital, well-being etc. (EU Pillar of Social Rights)
2. Relation **Macroeconomic Imbalances** & structural reforms unclear: German current account surplus – result of wage restraint or structural demand?
  - Commission: “boost competition in the service sector” (ibid., p. 12) but “service sector wages are the lowest in the EU relative to manufacturing wages” (ibid., p. 28)
3. Measurement: implied **optimal level of rigidity** = 0 → one size fits all, some degree of market imperfection help to create markets or embed it in society
4. Should the EU apply **negative sanctions**? EU budget conditionality (structural funds)
5. Optimal division of labor between **EU and member states**
  - EU diagnosis & policy objectives
  - MS implementation
  - Subsidiarity may even imply more centralization of some tasks

## Concluding remarks

- Beware of the structural reforms mantra (Gros, 2017)
- Structural conditions interact with macroeconomic policy
- **Long-term gains vs short-term costs** (economy, society)
  - Policies to compensate losers & minimize costs
- „defensive“ reforms (cost cutting, flexibility) → „upgrading“ reforms (productivity, technological frontier, inclusiveness)
- **No “one size fits all”**
- National policy preferences ≠ simply rigidities
- Comprehensive reform packages vs. concentration on binding constraint (Rodrik, 2016)
- Minimum conditions for markets: rule of law, etc.
- **Local ownership & consensus** of reforms essential
- Reform incentives from EU level only where externalities

**Danke für Ihre Aufmerksamkeit**

**Thank you for your attention**

[www.oenb.at](http://www.oenb.at)

[oenb.info@oenb.at](mailto:oenb.info@oenb.at)

 [@OeNB](https://twitter.com/OeNB)

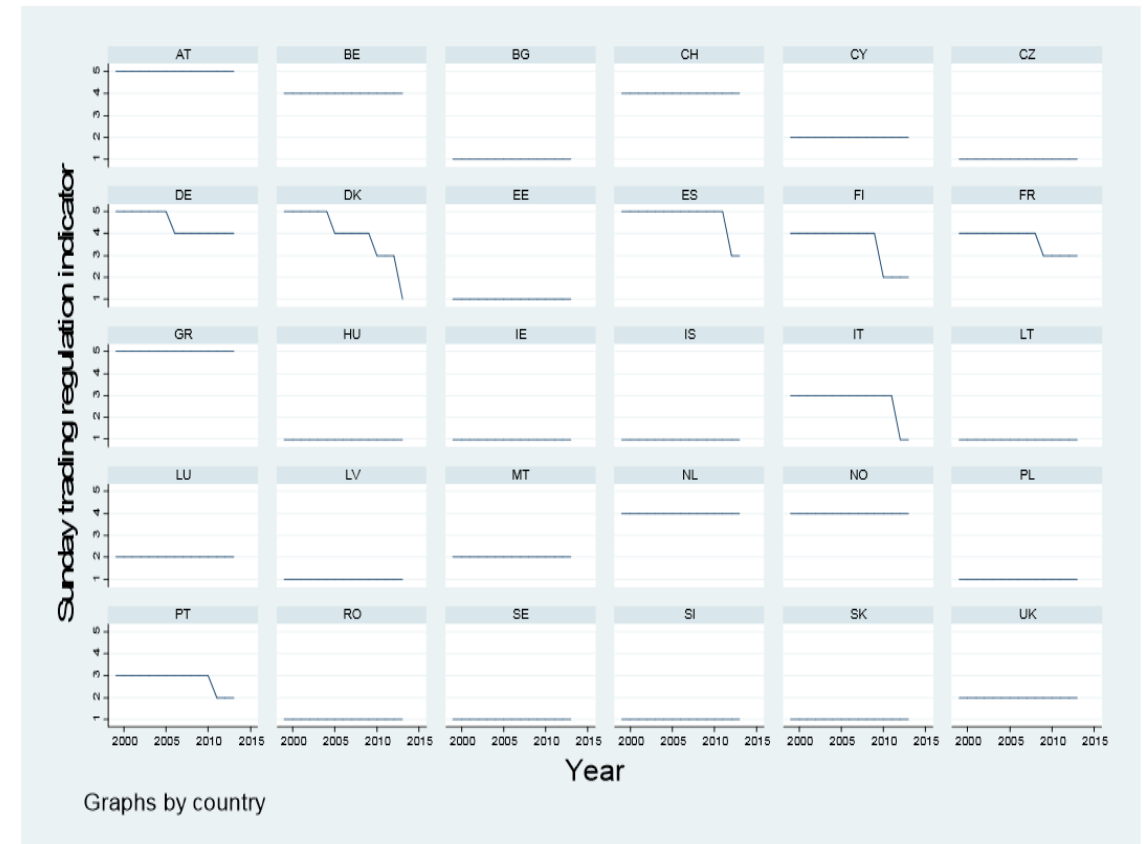
 [OeNB](https://www.youtube.com/OeNB)



## Example 1: Italian government to reverse the opening of Sunday shopping

- AT: strictest Sunday shopping regulation;  
DE & GR: recent liberalization
- IT: very liberal after Monti reform in 2011 -  
new government to undo reform
- All structural changes → short-term costs  
(40,000 job losses reported) But no long-  
term gains from old restrictions
- Symbol for religion, family values, workers'  
rights.
- Empirical Evidence : 12 years reform in 30  
countries: +50,000 jobs (Genakos &  
Danchev, 2014, OECD); +7-9% of  
employment in retail in reforming countries

FIGURE 1: THE EVOLUTION OF SUNDAY TRADING REGULATION INDICATOR



Notes: The figure presents information on the evolution of Sunday trading regulation indicator across 30 European countries.

Source: Authors' estimates based on the Sunday trading regulation indicator constructed using information from the OECD PMR indicator on regulation of shop opening hours and legislation search in secondary sources on timing and extent of reforms.

## Example 2: Minimal effects of German minimum wages

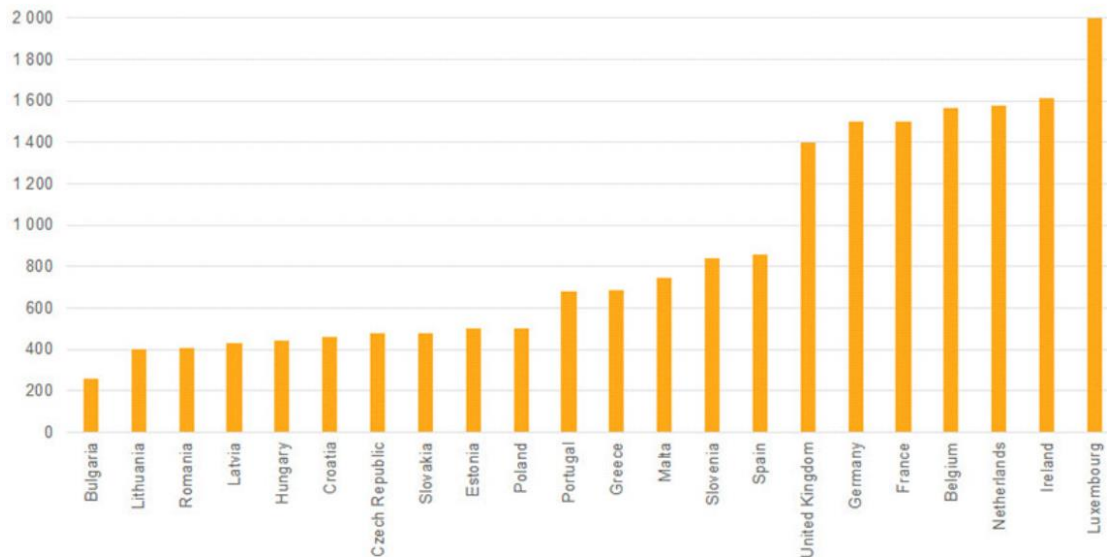
Herzog-Stein et al (2018)

- Minimum wage has tended to stimulate economic growth
- Low savings rate of low income earners → strong increase in real private consumption

Bonin et al (2018):

- Negative effects of minimum wage on employment statistically significant but marginal magnitude

Minimum wages in the EU Member States, as of 1 January 2018, in € per month



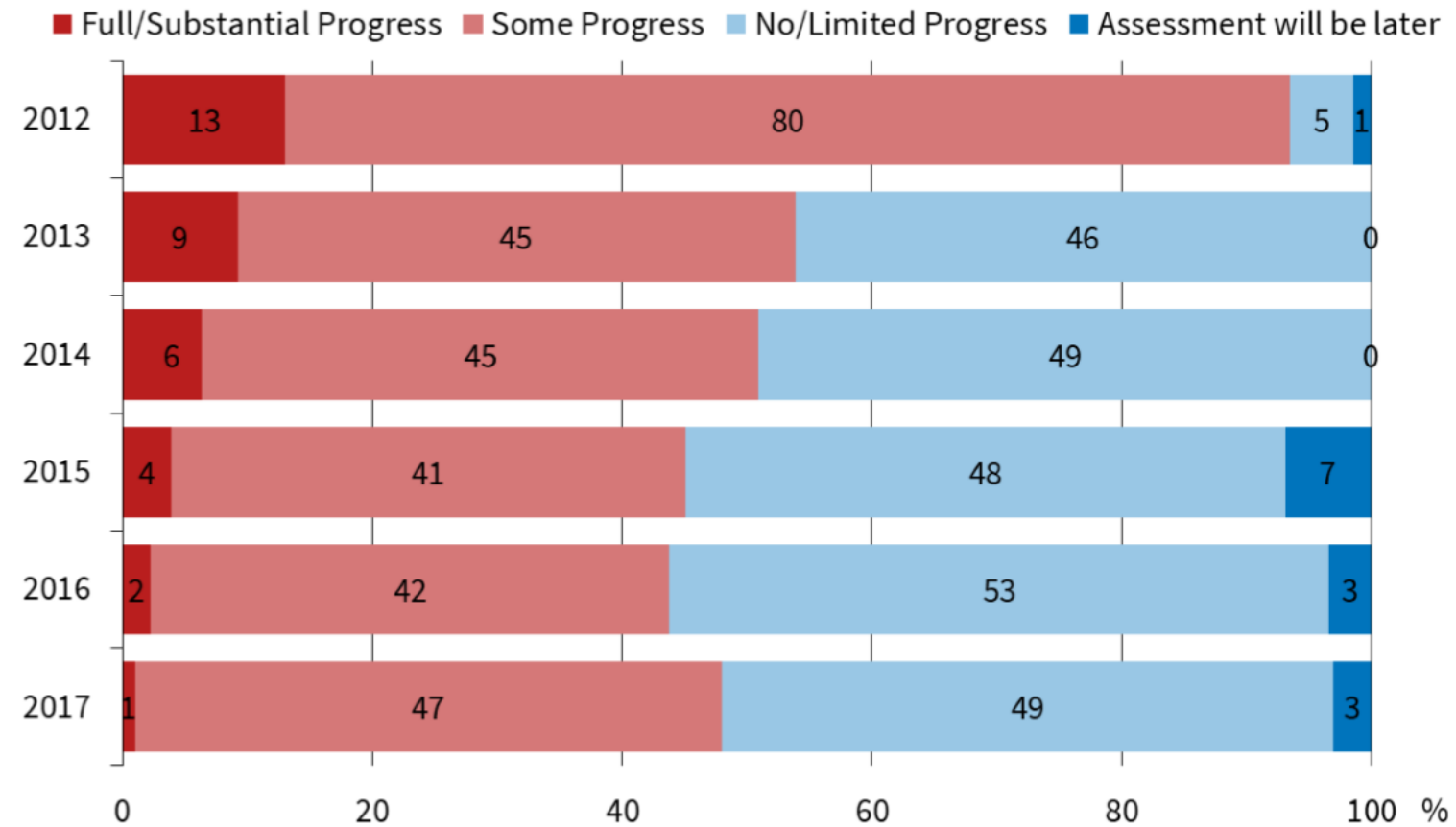
Note: Denmark, Italy, Cyprus, Austria, Finland and Sweden do not have minimum wages

[ec.europa.eu/eurostat](https://ec.europa.eu/eurostat) 



# Reform fatigue?

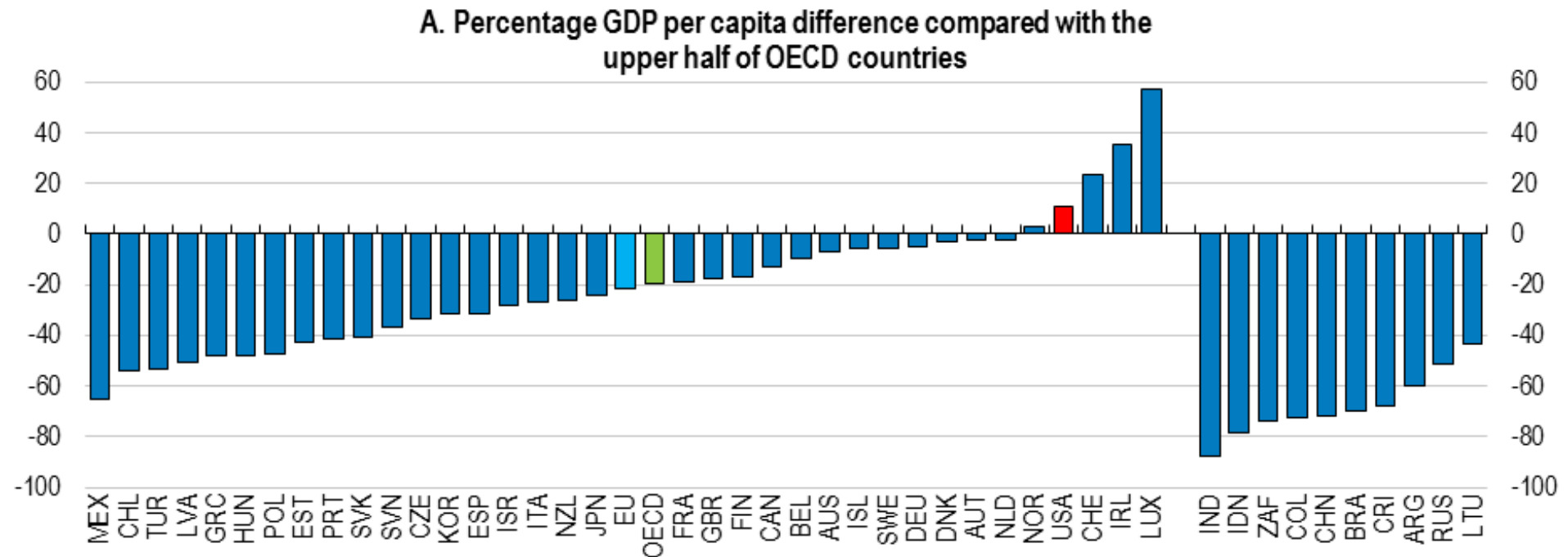
## European Semester: Implementation of Country-Specific Recommendations



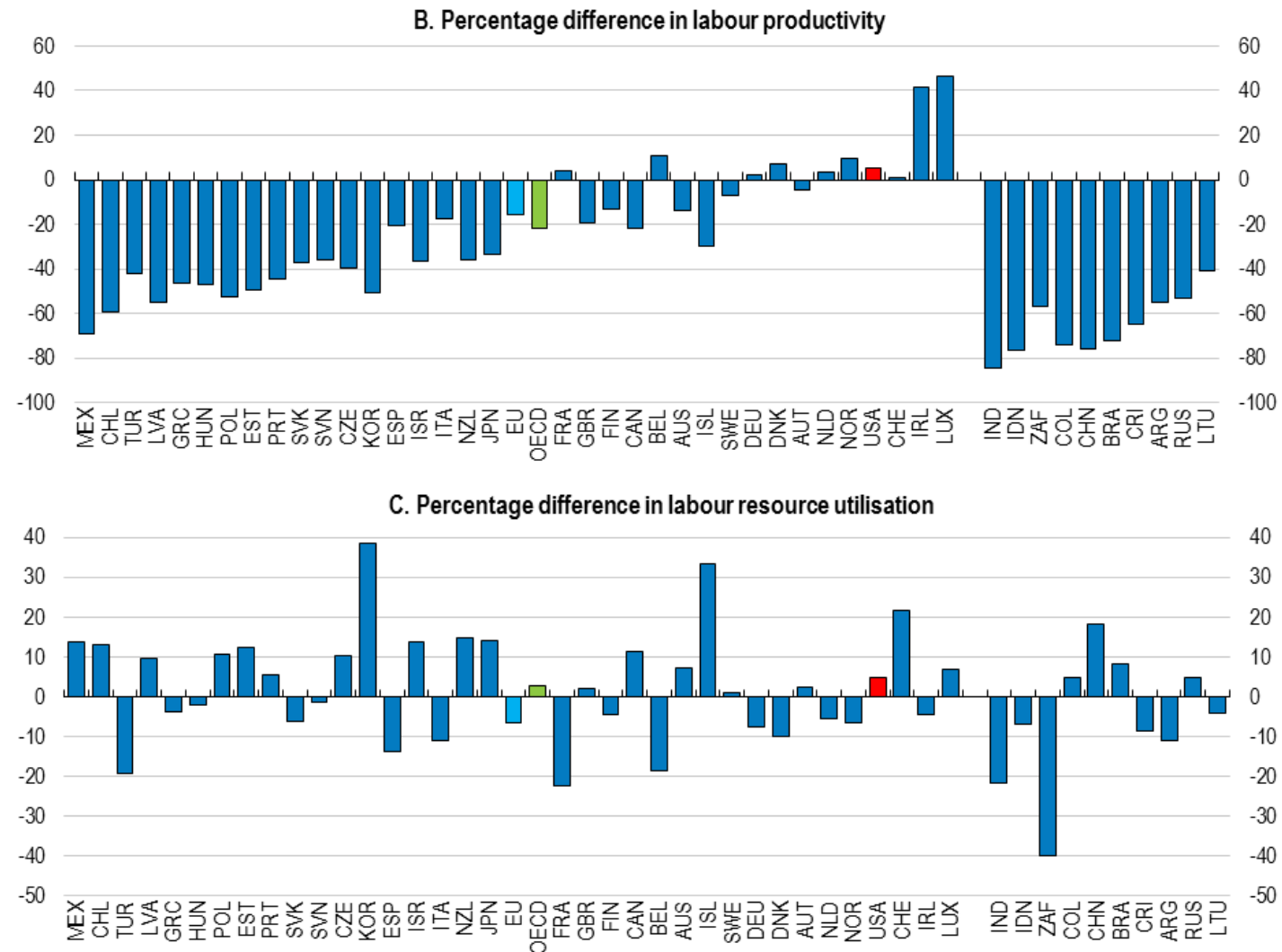
Source: European Commission. Based on EEAG (2018), Figure 4.23.

© CESifo

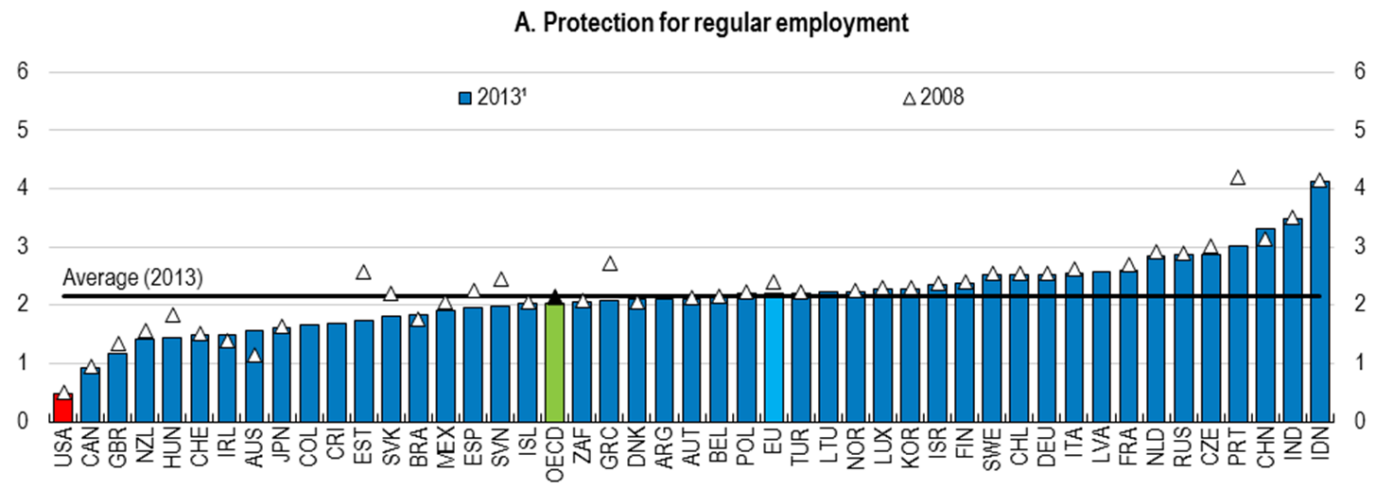
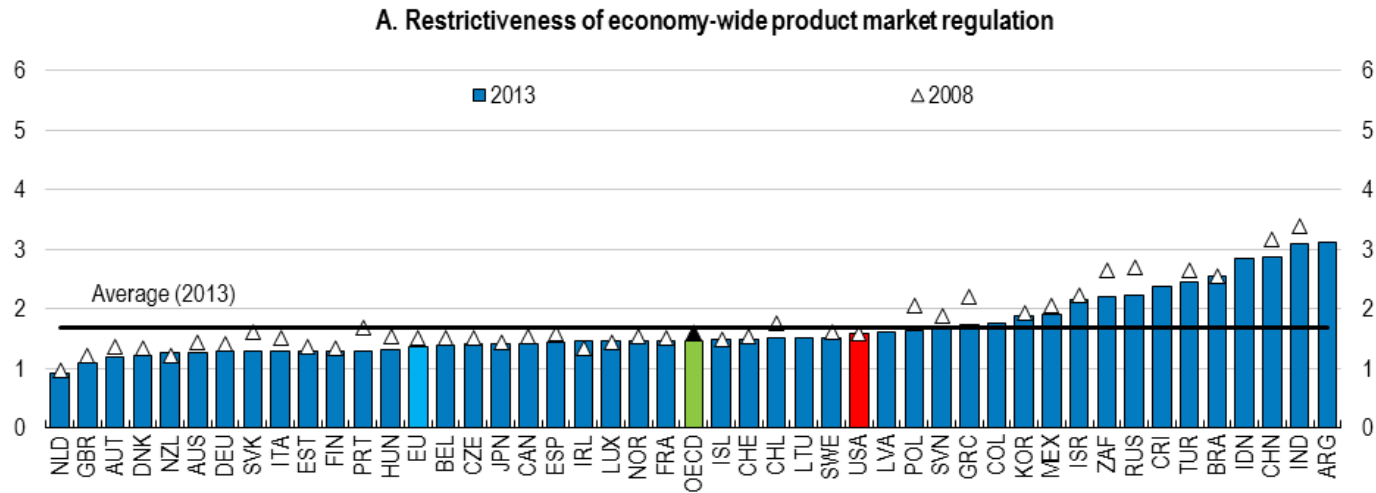
## OECD approach: Differences in GDP per capita 2015



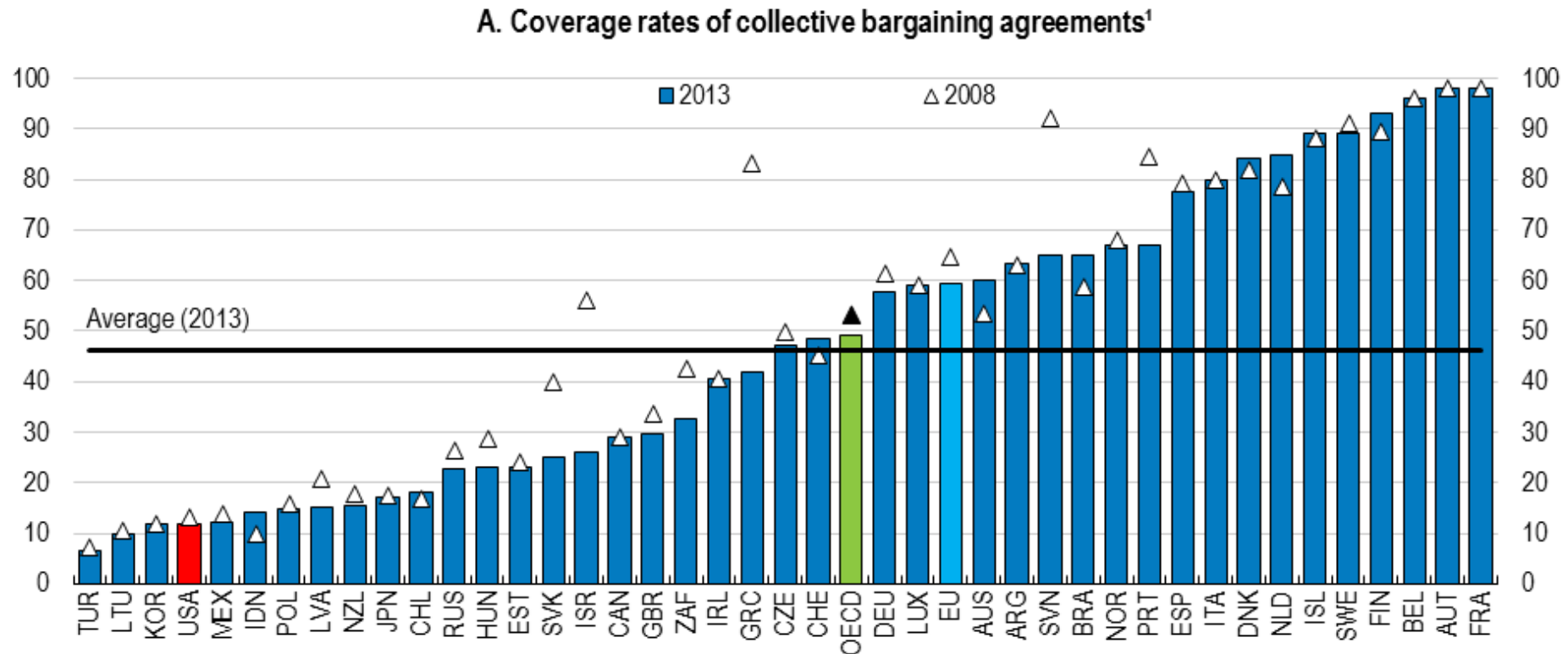
...mostly accounted for by productivity gaps...

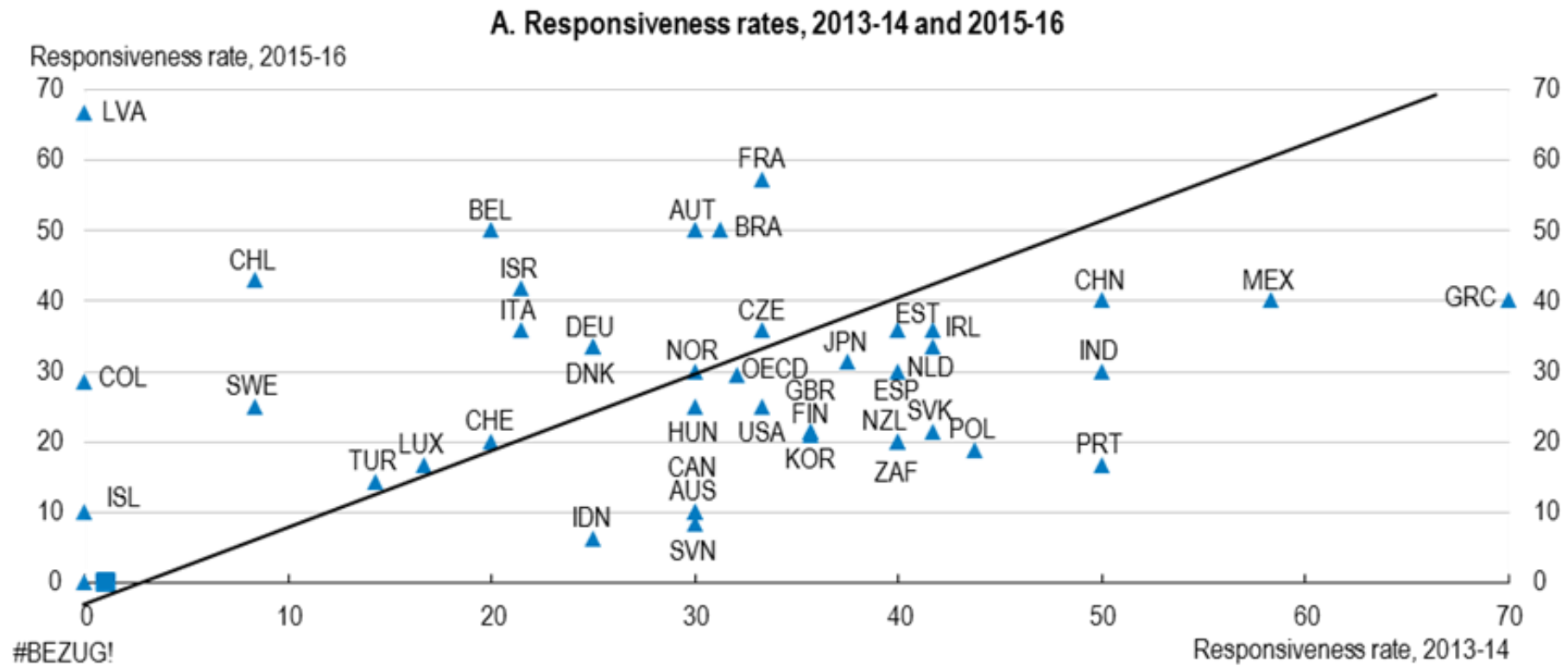


...yet EU has rather liberal product markets

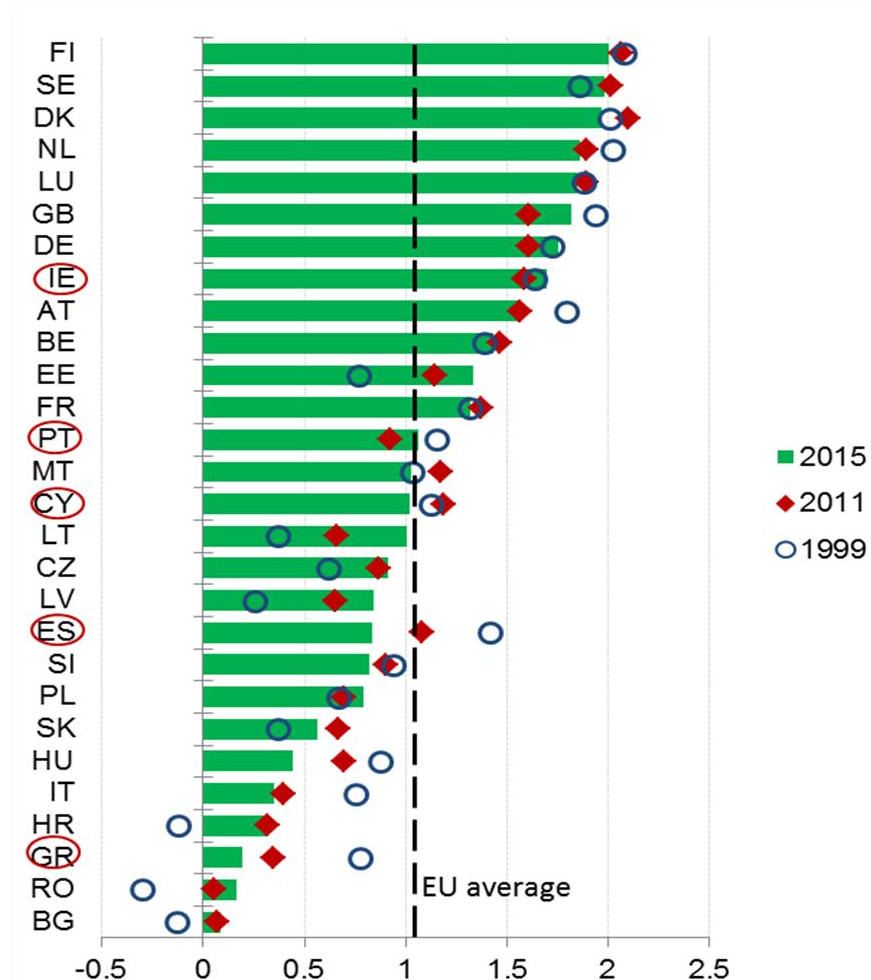


## Puzzle: firm level wage setting considered more growth friendly...





## Crisis has deteriorated institutional quality



Economic institutions based on four governance indicators from the World Bank - World Development Indicators:

- rule of law
- regulatory quality
- government effectiveness
- control of corruption

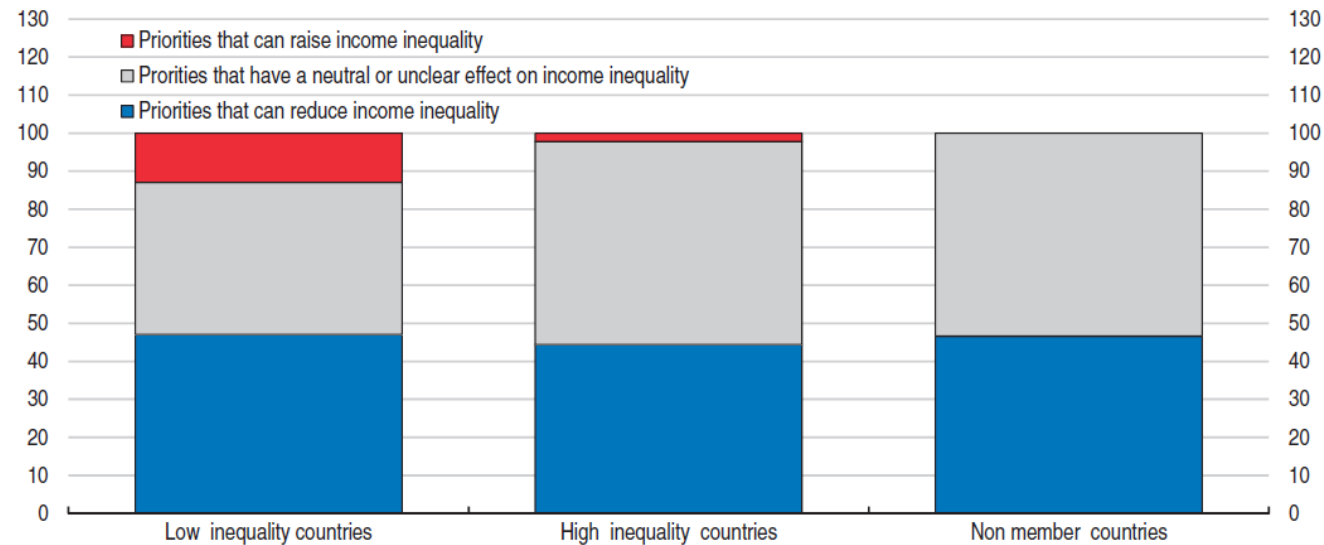
Source: World Bank Group; World Governance Indicators.

## Trade-off between growth and inequality

Growing inequality undermines growth: Significant negative impact in OECD countries (1% increase in inequality lowers GDP by 0.6% to 1.1%)

Structural reforms affect long-run income inequality

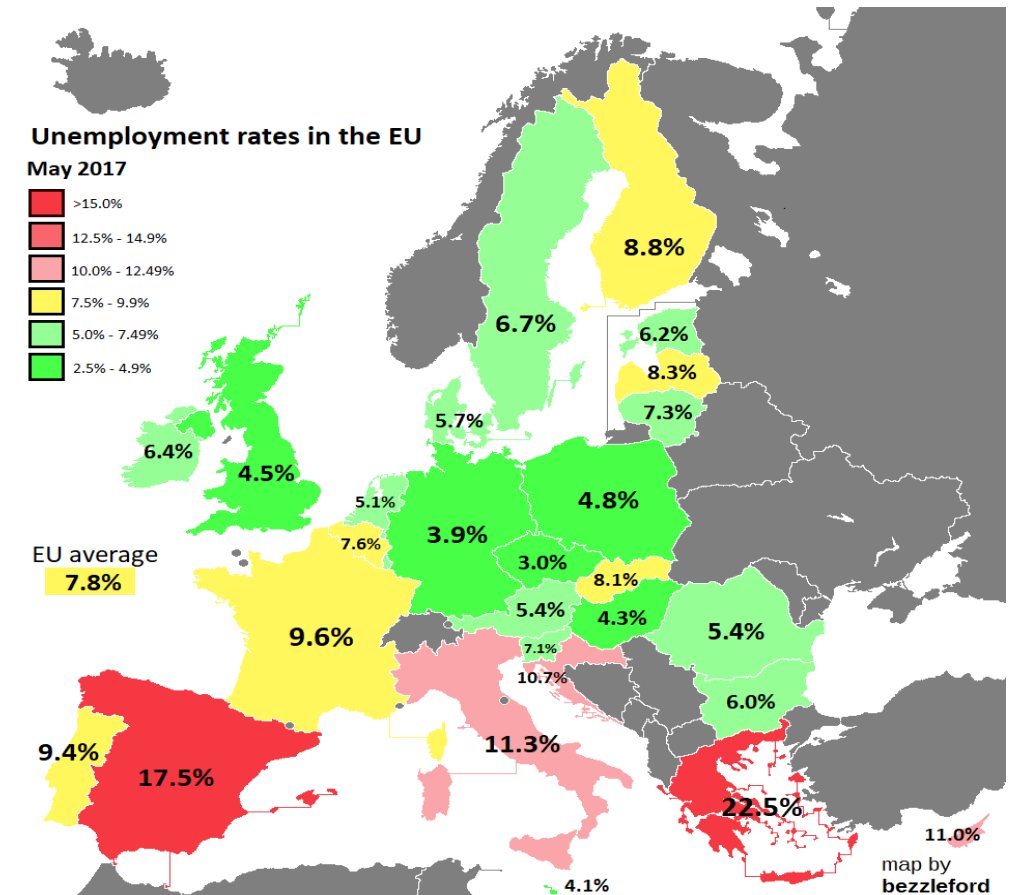
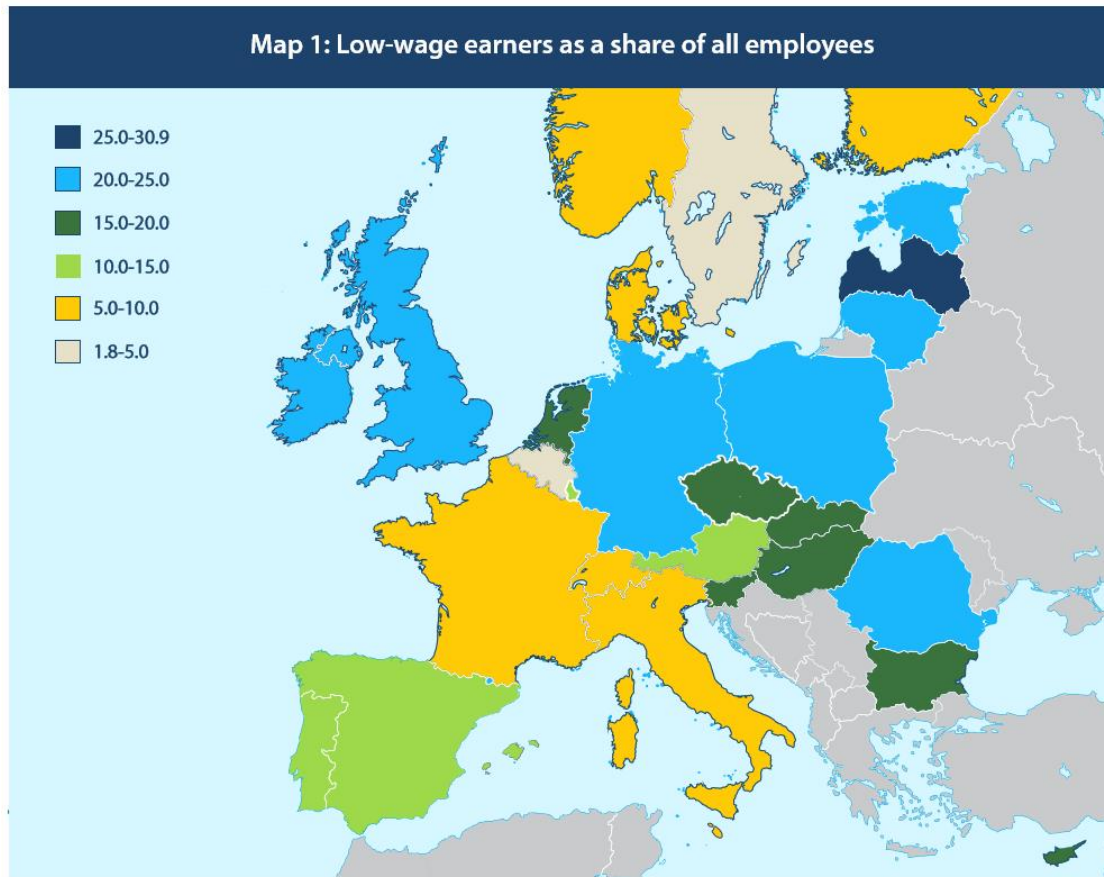
Figure 1.14. *Going for Growth* priorities and their impact on inequality<sup>1</sup>  
As a percentage of priorities, 2017



1. This figure shows the share of *Going for Growth* priorities that could reduce (increase) income inequality for countries (OECD, non-OECD) with Gini coefficient below (lower inequality) or above (upper inequality) the median. For low (high) inequality countries the share is computed taking as denominator the total number of priorities for low (high) inequality countries.



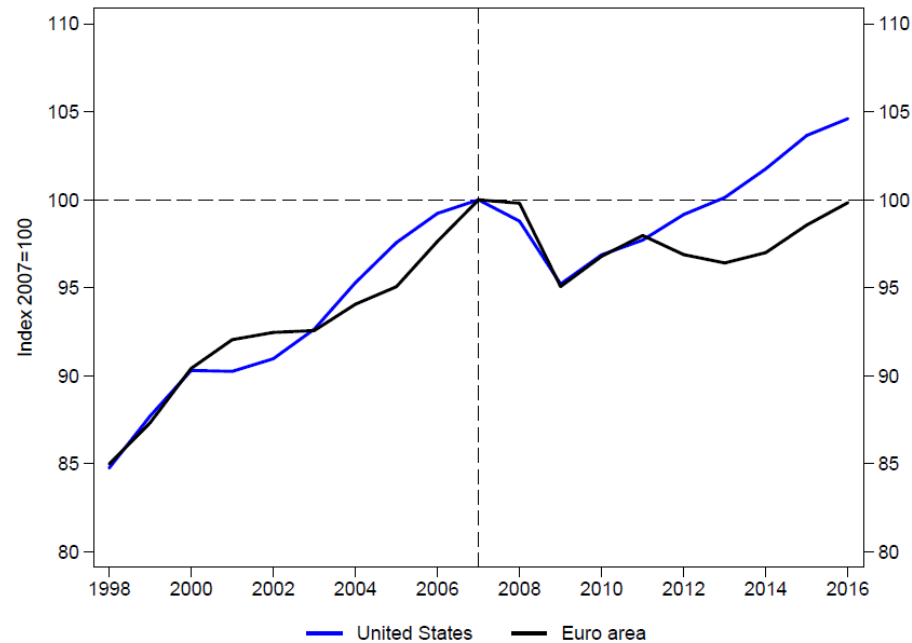
# Working poor vs. low unemployment?



# Growth gap USA vs. EU – just a structural issue?

Real GDP per person

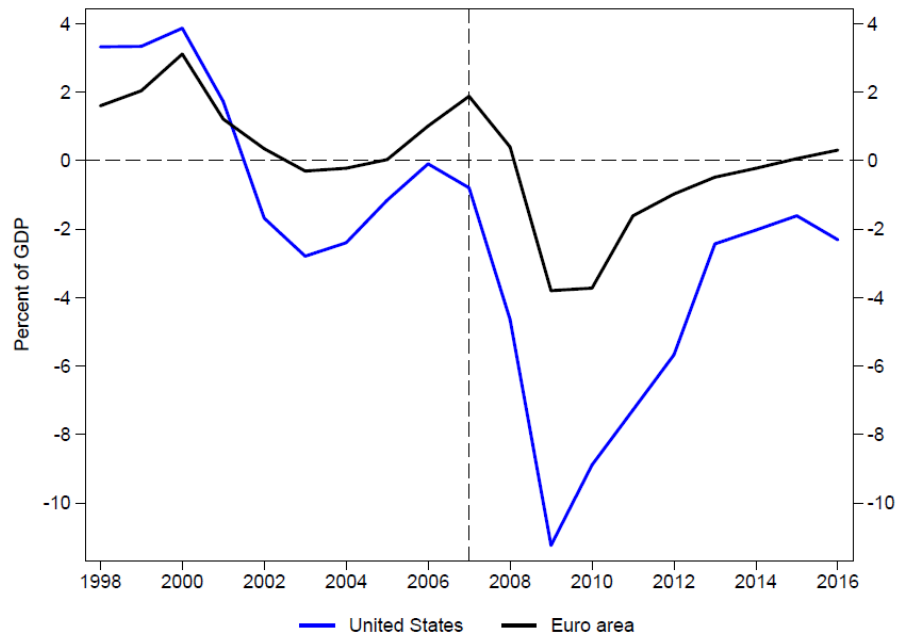
(Euro area = EA12)



Compared to the US, Europe has structural strengths and weaknesses. (De Grauwe)

# Fiscal and monetary policy is decisive

## Primary balance ratio to GDP



Source: IMF WEO, April 2017.

Size of balance sheet, in USD & EUR, respectively.

