

# Can structural reforms help Europe?

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Magyar Nemzeti Bank

Budapest, 19-20 September 2013

# A bird's-eye view

Research question: *Can structural reforms help Europe?*

- Europe is facing a protracted stagnation period.
- Periphery was hit due to mounting “macroeconomic imbalances”.
- **Not surprisingly** structural reforms are at the centre stage of the policy debate.

How do structural reforms work?

- **Increase competition** in labour and NT goods markets
  - trigger a “**real devaluation**” (competitiveness effect);
  - **boost** expectations about **future growth** (wealth effect).

*“... we model structural reforms ... as a permanent reduction in product and labour market markups.” (page 4)*

# A bird's-eye view

## Open-economy New Keynesian DSGE model of monetary union

- **2-country:** core and periphery.
- **2-sector:** tradables and non-tradables.
- Labour is the only productive factor (implicitly **fixed K stock**).
- **Monopolistic competition** in intermediate goods production.
- Government follows a **balanced budget fiscal rule**.

## Structural reforms

- **Subsidies** to NT sector wages & prices  
⇒ supply goods & hours closer to perfect competition.
- **Price and wage markups remain unchanged!**

# A bird's-eye view

## On the impact of the structural reforms (full credibility)

- **Long run** impacts unambiguously **positive** in output.
- **Short run** impacts depend on monetary policy & credibility:
  - “**Normal**” times: central bank cuts policy rate  
⇒ Prices decline, real interest rate falls & output booms on impact.
  - “**Crisis**” times: zero lower bound is binding  
⇒ Prices decline, real interest rate rises & output falls on impact.

## On the impact of the structural reforms (no credibility)

- “Crisis” times + reform is reverted due to political tensions.
- Very **large output fall** on impact (no wealth effect).
- **No long-run impact**.

# A bird's-eye view

Alternative policies may alleviate short run perverse effects.

*“New Deal”* (builds on Eggertson, 2012)

- Grant firms and unions temporarily higher monopoly power.
- **Temporary higher inflation** eliminates real interest rate rise.
- **Limits output decline** on impact.

*“Delay”* (builds on Fernandez-Villaverde, 2012)

- Credibly commit to reforms, when ZLB is not binding.
- Future reforms **boosts demand today** (wealth effect).
- **Boosts output** on impact.

## Conclusions

- Structural reforms **may help to regain competitiveness.**
- **Timing** of implementation is **crucial**:
  - Under **ZLB**, deflation can deepen the recession;
  - **Even worse if reform is unwind** due to political tensions.
- Assess “*New Deal*” and “*Delay*”:
  - **Creates stimulus** by creating inflation or boosting demand;
  - **Can be combined** to maximize impact on output.

# Research question: *Can structural reforms help Europe?*

## Structural reforms always help!

- **Better resource allocation**  $\Rightarrow$  welfare improving.
- Under ZLB, induce output losses in the short-run.
- **Impact on welfare?** Output  $\neq$  welfare.
- **Small euro area countries** are always in a ZLB.
  - Shouldn't adopt structural reforms? Sure, they need it!
  - **Policy coordination** matters to optimize impact.
- Article is **too focused in the short-run** impacts.
- **Long-run impacts are key** in structural reforms.

$\therefore$  Title should refer explicitly to short-run issues or article should address long-run benefits and welfare.

# Some DSGE model features may affect results

## What is a structural reform?

- Legislative changes that **improve resource allocation**.
  - Remove barriers to entry, increase #players.
  - Fight competition harming practices, improve regulation.
  - **Eliminate rents** in monopolistic sectors.
  - **Parameters**: EoS in monopolistic sectors, eventually TFP.
- **In this paper**, subsidies to labour and production:

$$P_k = \left( \frac{1}{1 - \tau_k^p} \right) \left( \frac{\theta_k}{\theta_k - 1} \right) MC_k \quad \text{where} \quad \frac{\theta_k}{\theta_k - 1} \quad \text{is the markup.}$$

- Induce workers and NT firms to supply closer to competitive level;
- Distortionary subsidies financed through lump-sum taxes.

**Question: Markups unchanged!** Is this a structural reform?

# Some DSGE model features may affect results

## No role for K and investment

- **Structural reforms aim at increase investment**
  - Reforms induce cuts in prices and wages  $\Rightarrow$  inflation declines.
  - Under ZLB, real interest rate increases.
  - L-intensity & **marginal productivity of K** increase  
 $\Rightarrow$  **higher return on K**
  - Under K adjustment costs, **firms invest more.**
- **In this paper**, no K channel:
  - Higher real interest rate brings consumption down.

**Question: K channel plays a key role. Why is it absent?**

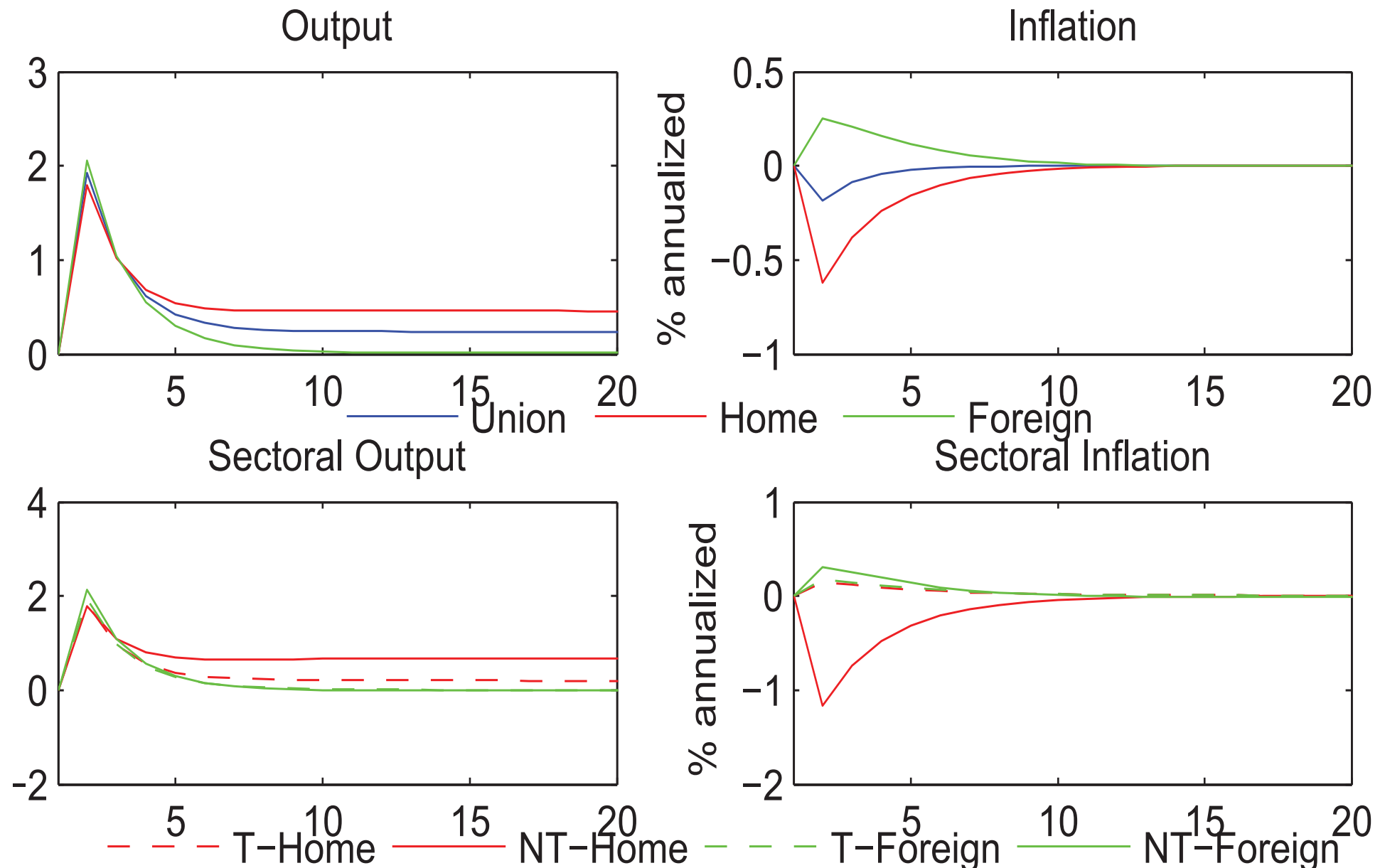
# Some DSGE model features may affect results

## Limited impact in trade balance and NFA

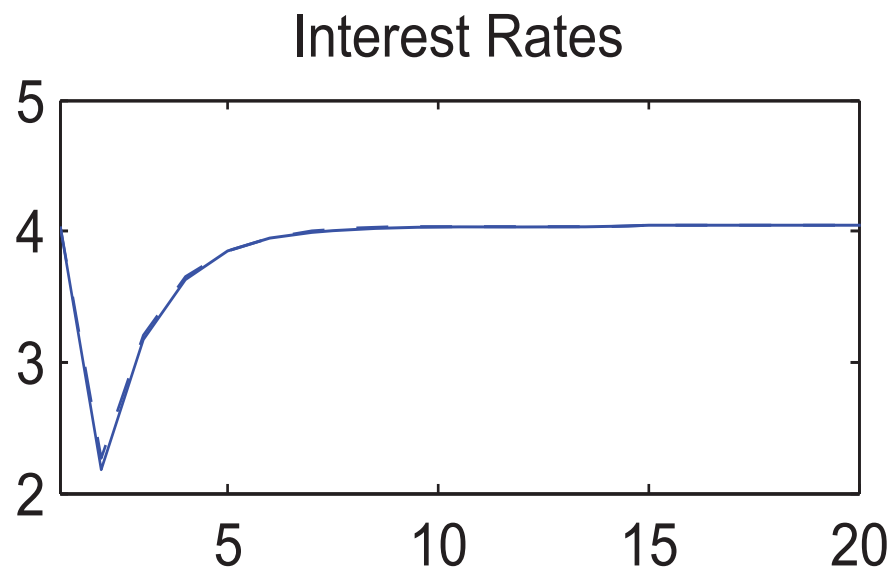
- Structural reforms aim at **re-balancing the economy**:
  - Reduction in NT wage and price markups brings prices down.
  - Resources reallocated towards tradables:  
⇒ **Improvement in competitiveness** and in trade balance;
  - **Strong positive impact in the long-run.**
- **In this paper**, structural reforms barely affect trade balance.
  - **No resource reallocation between sectors (figure 5);**
  - Tradables prices increase & competitiveness gains (?);
  - **What is the real exchange rate?** Relative price of tradables?
  - **Competitiveness impacts are minor.**

**Question: What drives competitiveness in the model?**

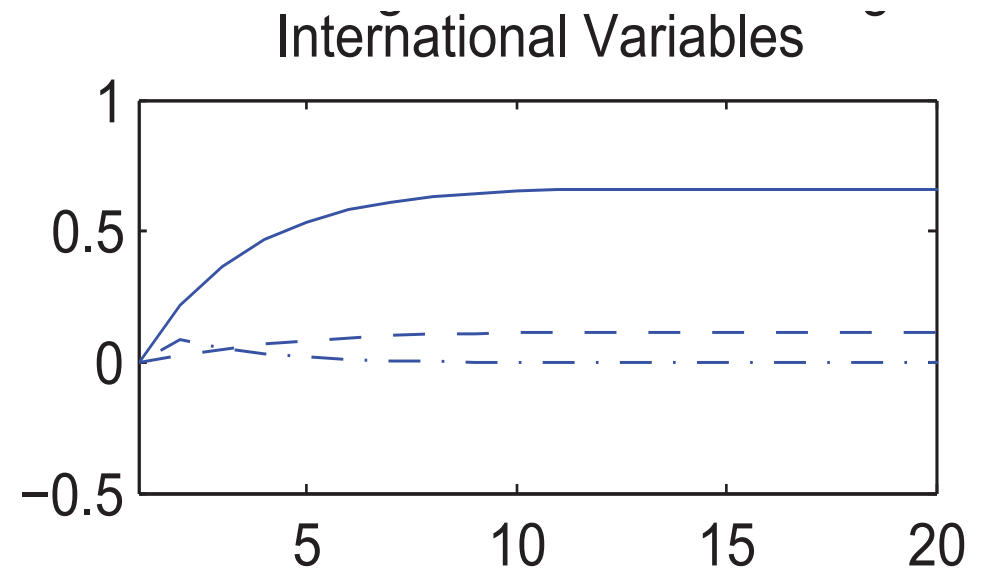
# Some DSGE model features may affect results



# Some DSGE model features may affect results



— Nominal    - - - Real



— RER    - - - TOT    · - · - · CA

# Assessing the impact of credibility

## This paper: full credibility vs. failed structural reform

- **Shock:** temporary reform (higher subsidies)
  - Government announces a reform;
  - Agents *correctly* anticipate reform reversion (political tension);
  - Only pain (recession), no gain (no wealth effect).

## My suggestion: full credibility vs. imperfect credibility

- **Shock:** temporary reform + **permanent**
  - Government announces a reform;
  - Agents *incorrectly* anticipate reform reversion (political tension);
  - Reform **becomes credible** after some period;
  - **Protracted initial pain** (recession), long-run gain.

# Alternative reform policies

*“New Deal”*: generate inflation to move away from ZLB

- Structural reforms in the model are subsidies;
- Generate inflation by increasing taxes that revert the subsidy?!
- **Essentially, not doing the structural reform.**

*“Delay”*: commit to do reforms when ZLB is not binding

- Credibility bring forward wealth effects;
- How to commit credibly? Requires bulletproof credibility;
- **Misses political economy of reforms (Rodrik 2000,2008):**
  - Deeper reforms easier to implemented in crisis times;
  - Crisis reduces rents and so vested interests resistance!

**Question: Is the short-lived recession important? Welfare?**

# Comments and suggestions

- Good paper on a very important topic.
- The paper is very well motivated!
- Mickey-model is very useful to get some intuition.
- **Long-run impacts should be emphasised.** Overly focused in the short-run.
- Production block should **accommodate K accumulation.**
- Reforms should be implemented through **EoS, not as a subsidy.**
- Assess impact of **imperfect credibility** vs. full credibility.
- **Alternative policies**, are they necessary?
  - Are **reforms welfare improving**? Hopefully yes.
  - Can alternative policies improve further? Not clear!