



# THE SHORT TERM IMPACT OF STRUCTURAL REFORMS

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## Roadmap I – The questions

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### Are we asking too much from structural reforms?

- Structural reforms a substitute for demand?
- What type of reforms would best support (weak) demand in the near term?

### How best to mitigate contractionary effect?

- Is going for broader reform package better?
- Does the usual argument in favour of boldness hold in weak demand?



## Roadmap II – Looking for answers

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### **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)*



# 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



## 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

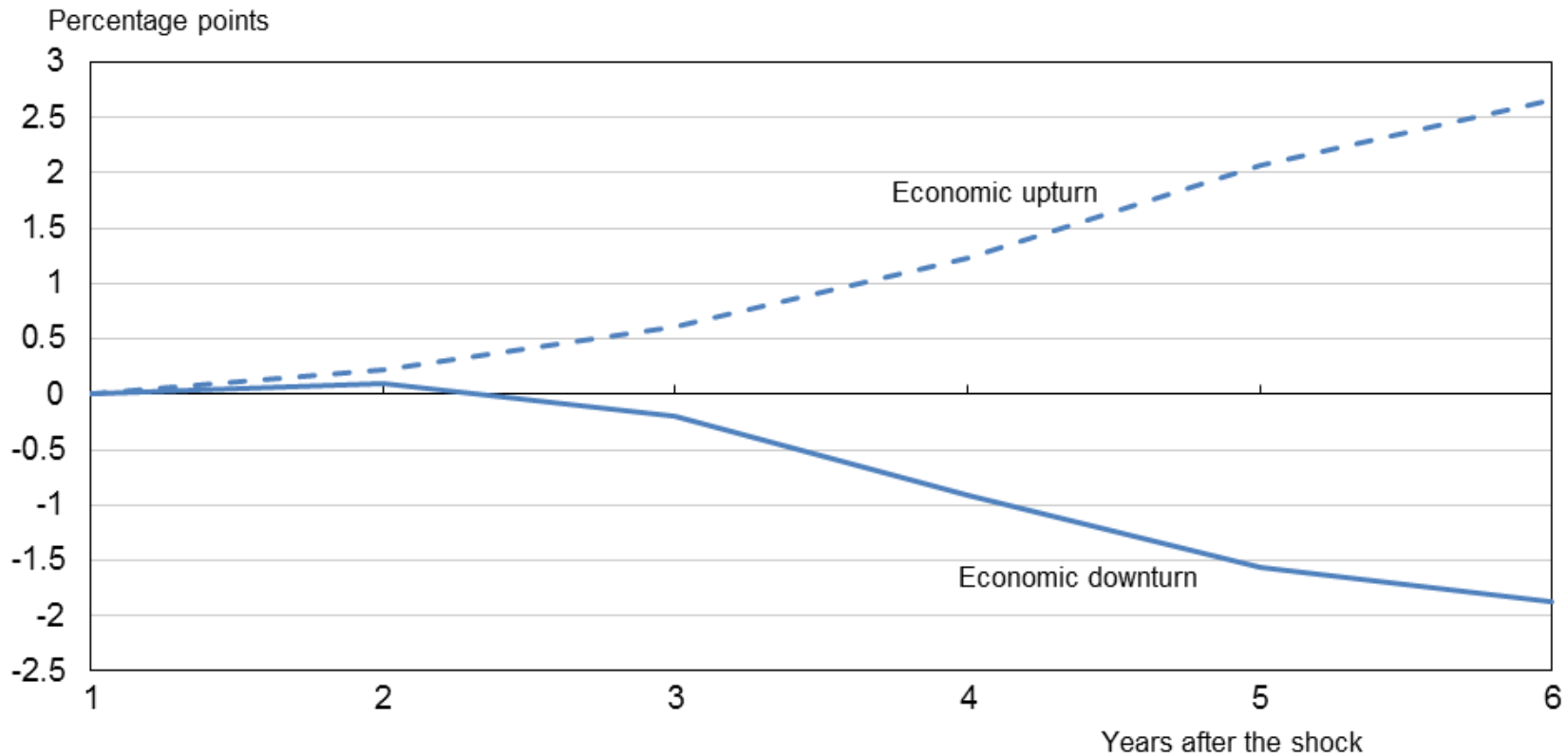
*Negative confidence channel => Likely to be stronger*

- Heightened macro-economic uncertainty can lead households and firms to postpone spending and investment decisions
- Higher precautionary saving



# 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



Source: Bouis, R., O. Causa, L. Demmou, and R. Duval (2012) "How quickly does structural reform pay off? An empirical analysis of the short-term effects of unemployment benefits reform" *IZA Journal of Labor Policy* 2012, 1:12.



## 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
- 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

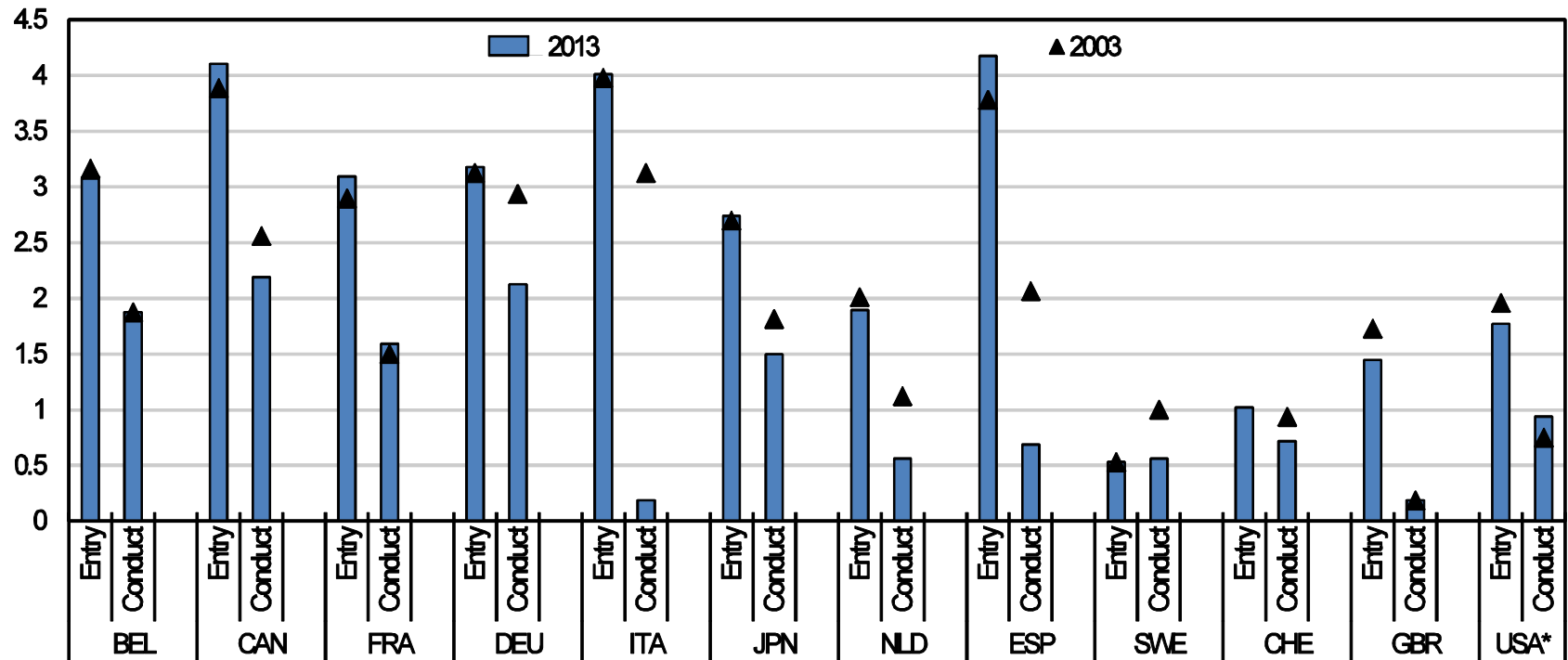
### *Reforms easing frictions in the reallocation of resources*

- 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)



\* 2008 data.

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



## 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



# Some considerations on the distributional impacts of SR

## Labour market and welfare policies

- Reducing UB replacement rates for all unemployed
- Reducing UB replacement rates for the long-term unemployed (including social assistance)
- Increasing spending on ALMPs
- Increasing the legal retirement age
- Increasing public spending on families with children (in kind family benefits)
- Reducing job protection on regular contracts
- Encouraging a decline in union density
- Reducing the legal extension of collective agreements
- Encouraging a higher degree of wage bargaining coordination
- Reducing minimum relative to median wage

## Tax policy

- Lowering labour tax wedges (unfinanced)

## Education

- Increasing public spending on education

## Innovation and Technology

- Increasing incentives for R&D spending
- Increasing incentives for patent application

## Product market regulation

- Reducing barriers to competition

### *Weak inequality aversion*

### *Strong inequality aversion*

	<i>Weak inequality aversion</i>	<i>Strong inequality aversion</i>
Reducing UB replacement rates for all unemployed	Tradeoff	Tradeoff
Reducing UB replacement rates for the long-term unemployed (including social assistance)	No tradeoff	Tradeoff
Increasing spending on ALMPs	Synergy	No tradeoff
Increasing the legal retirement age	No tradeoff	Synergy
Increasing public spending on families with children (in kind family benefits)	No tradeoff	Synergy
Reducing job protection on regular contracts	No tradeoff	Tradeoff
Encouraging a decline in union density	No tradeoff	Tradeoff
Reducing the legal extension of collective agreements	No tradeoff	Synergy
Encouraging a higher degree of wage bargaining coordination	No tradeoff	Synergy
Reducing minimum relative to median wage	No tradeoff	No tradeoff
Lowering labour tax wedges (unfinanced)	No tradeoff	Tradeoff
Increasing public spending on education	No tradeoff	Synergy
Increasing incentives for R&D spending	No tradeoff	No tradeoff
Increasing incentives for patent application	No tradeoff	Tradeoff
Reducing barriers to competition	No tradeoff	No tradeoff