Structural Reforms: Set Up for Success?

Beth Anne Wilson
Federal Reserve Board

International Monetary Fund
November 3-4, 2016
Washington, D.C.

Disclaimer

This presentation represents my own views and not necessarily those of the Federal Reserve Board of Governors or the Federal Reserve System.

In the spirit of Blanchard Duval and Furceri (2016)

- Extensive cross-country empirical work
- Brought to bear on highly relevant policy question
- Potential to have positive effects on welfare globally

Motivation

- In the face of a mediocre global recovery
- In part, related to poor productivity growth
- And with monetary and fiscal policy seen as constrained
- Attention is increasingly focused on structural reform.

Why?

- Long been thought that countries with
  - More flexible labor markets
  - Less regulated product markets
  - Stronger institutions
  - And freer cross-border flows

- Tend to perform better
  - More productive
  - Stronger, more inclusive growth
  - More resilient to shocks
  - Less corruption

But also…

- Blanchard and Wolfers (2000)
  - Interaction between shocks and institutions explains much of the rise in European unemployment since 1960
- Bayoumi, Laxton, and Pesenti (2004)
  - Lower competition in product and labor markets can account for about half of the gap in GDP per capita between the euro area and the U.S.
- Duval and Furceri (2016)
  - Impact of reforms on the level of output ranges from ¼ to almost 2 percent of GDP after 4 years.

So premise has been that…

- Countries that implement reforms which
  - Reduce rigidities
  - Deregulate industry
  - Improved institutional quality
- Would see higher growth.

Raises two key questions

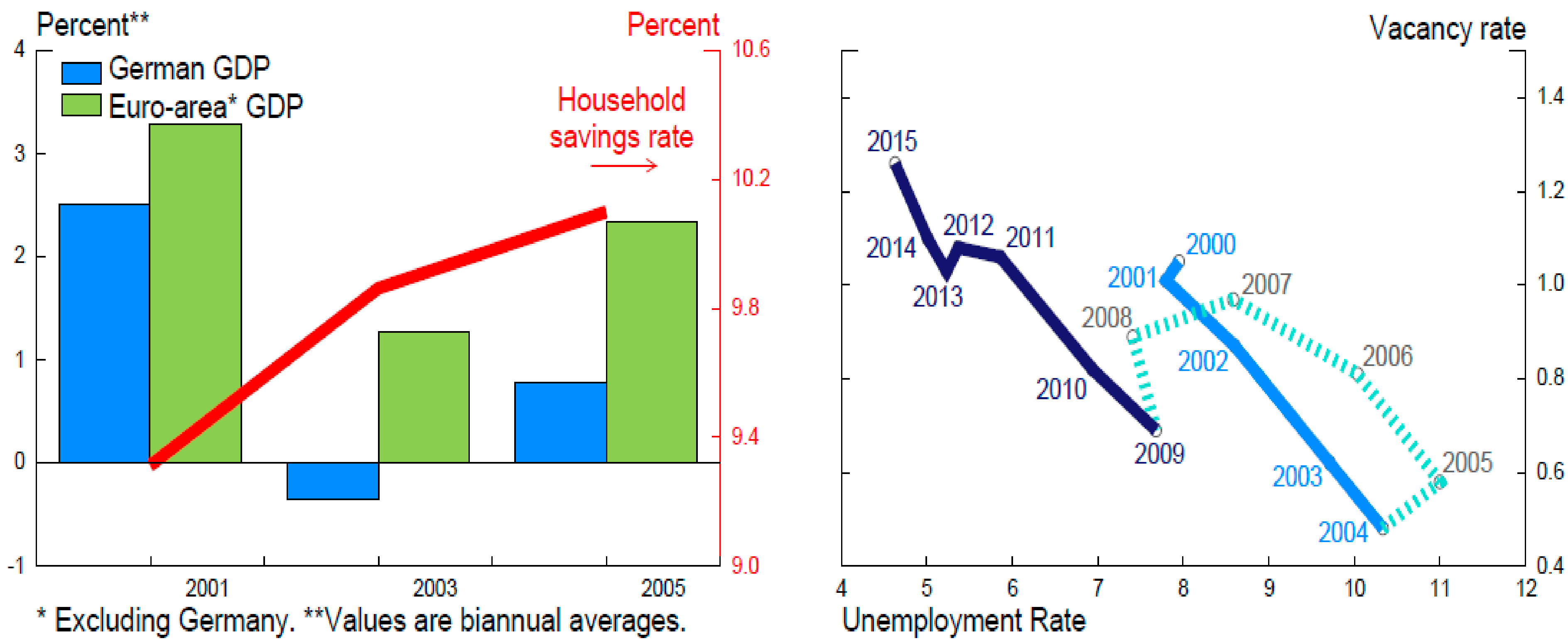
1. How is the transition?
   – Rocky.

2. How can the transition be best managed?
   – Here's where the work of Duval and Furceri and others comes in.

How is the transition?

- Initial impact can be negative and the transition long.

Labor Market Reforms in Germany



How can the transition be best managed?

- Sequencing matters.

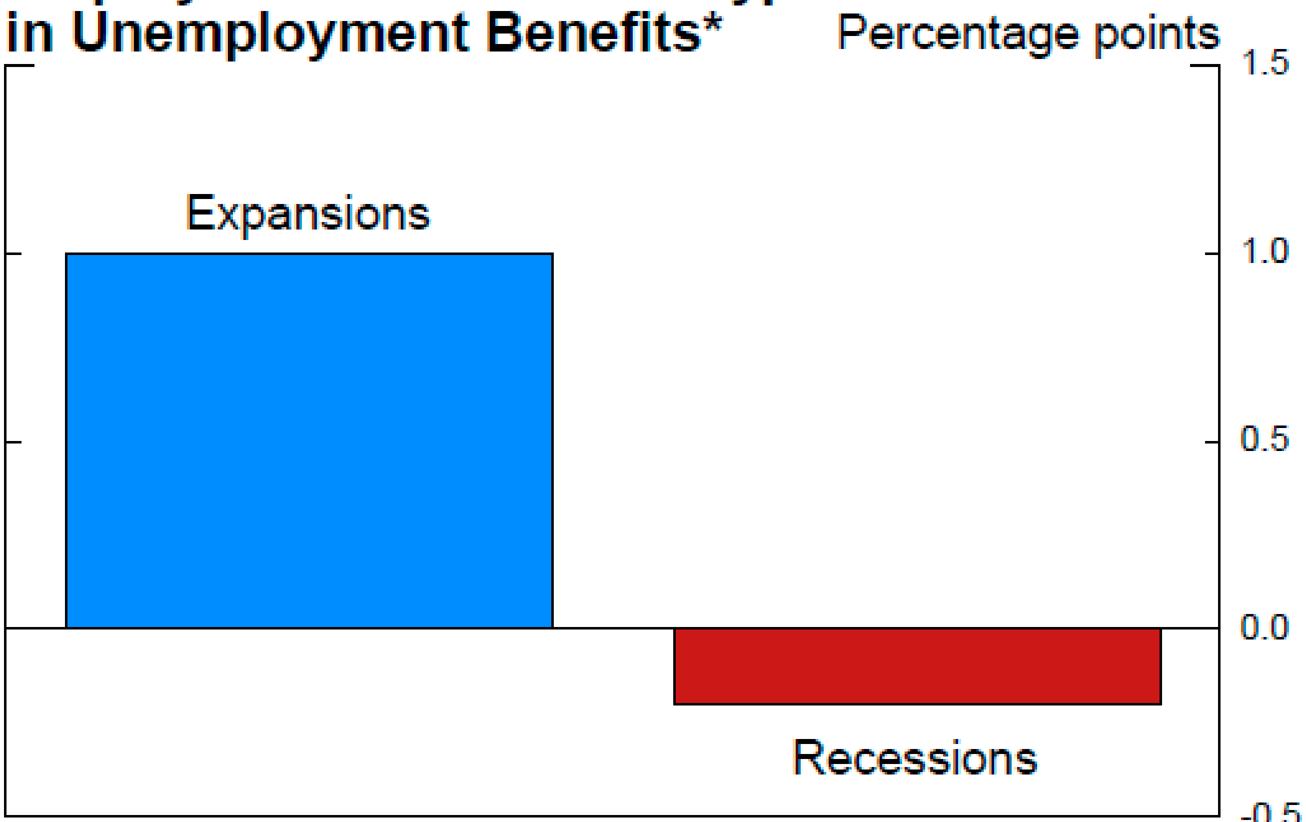
  Blanchard and Giavazzi (2003):

  - Deregulation in product market first, as it increases labor demand and real wages
  - Then turn to labor market, which typically requires lower real wages to increase employment

How can the transition be best managed?

- Be sensitive to the cyclical position

Employment Effects of a "Typical" Reduction in Unemployment Benefits*

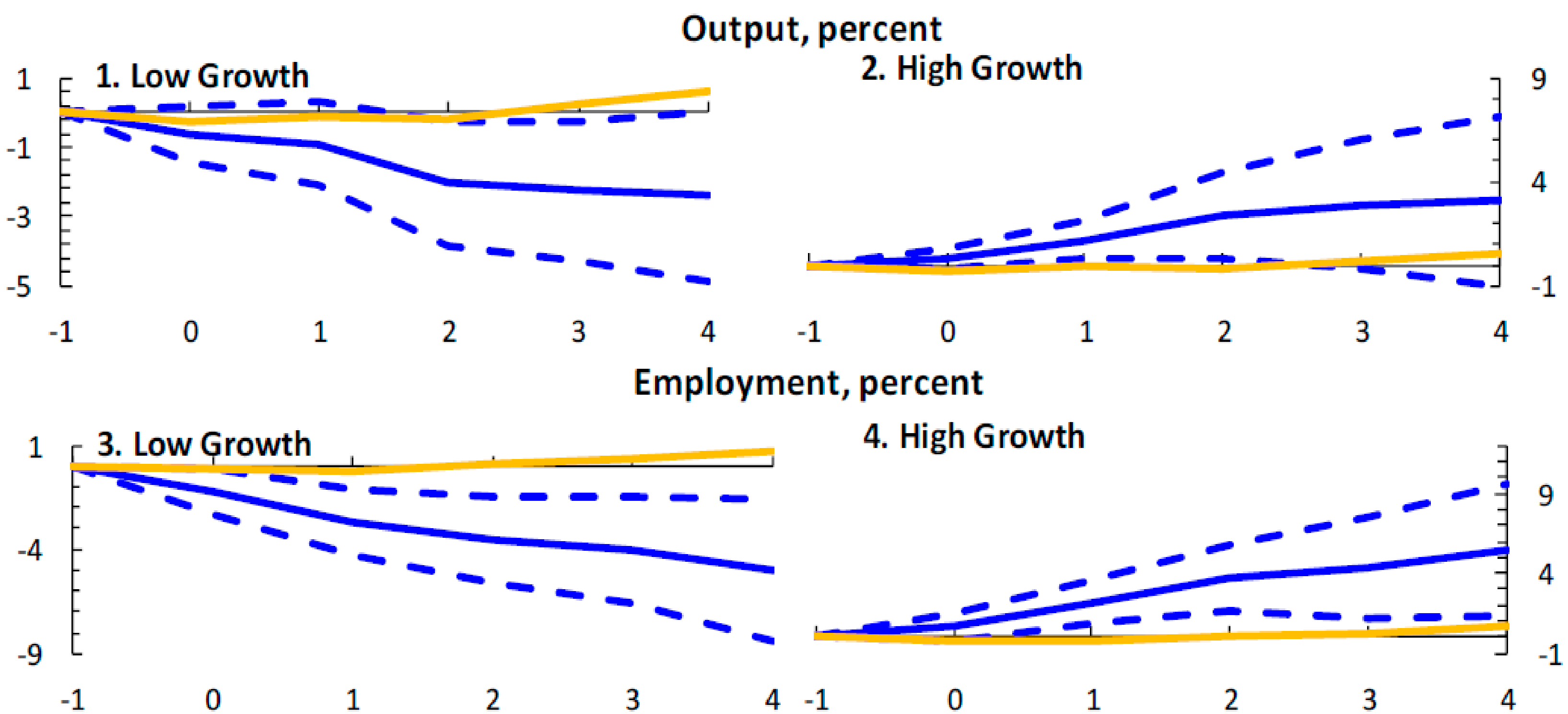


* Changes after 3 years.
Source: OECD Going for Growth (2012).

How can the transition be best managed?

- Be sensitive to the cyclical position

Figure 4. Impulse responses to regular employment protection legislation reform



How can the transition be best managed?

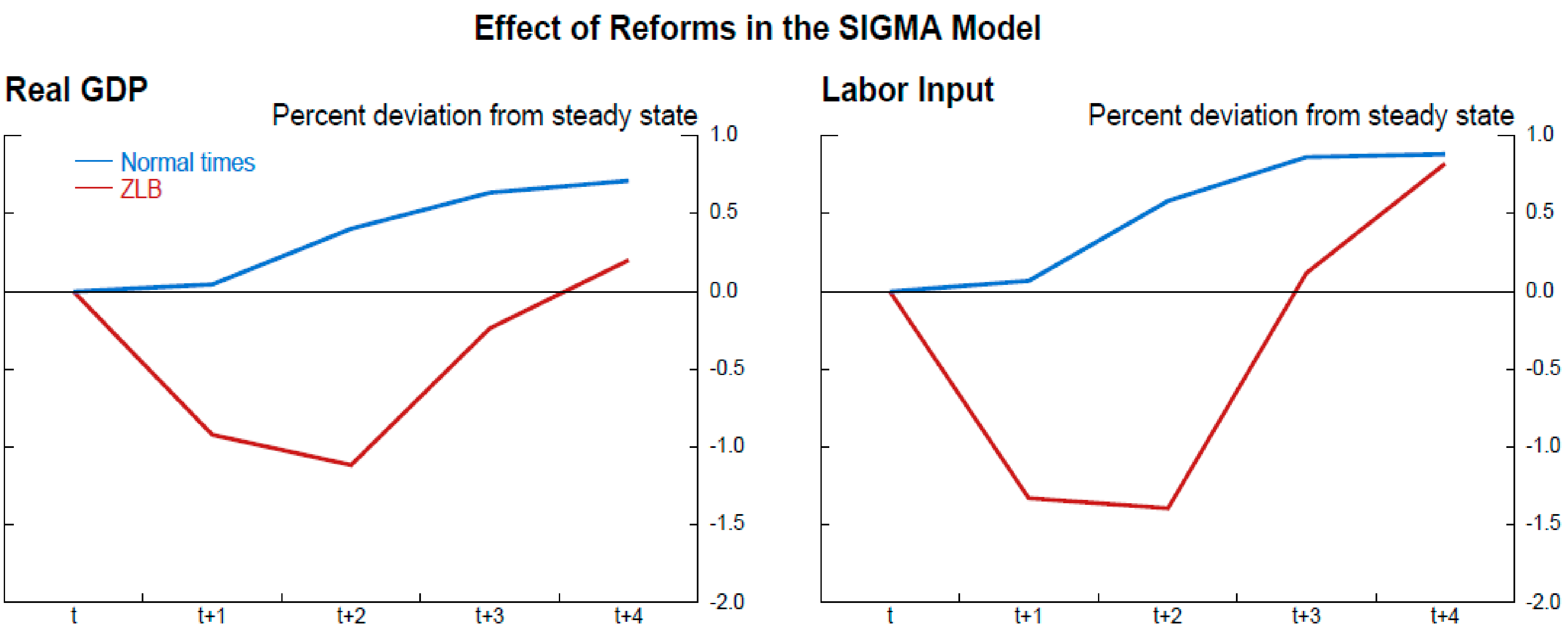
- Provide support from macroeconomic policy – Monetary policy
  - Eggertsson, Ferrero, and Raffo (2014):

- In DSGE model, absent monetary policy support…
    - Zero lower bound
    - Fixed exchange rate regime
    - Membership in a currency union

- …reforms are contractionary in the short run.

How can the transition be best managed?

- Similar results from FRB's open economy model:

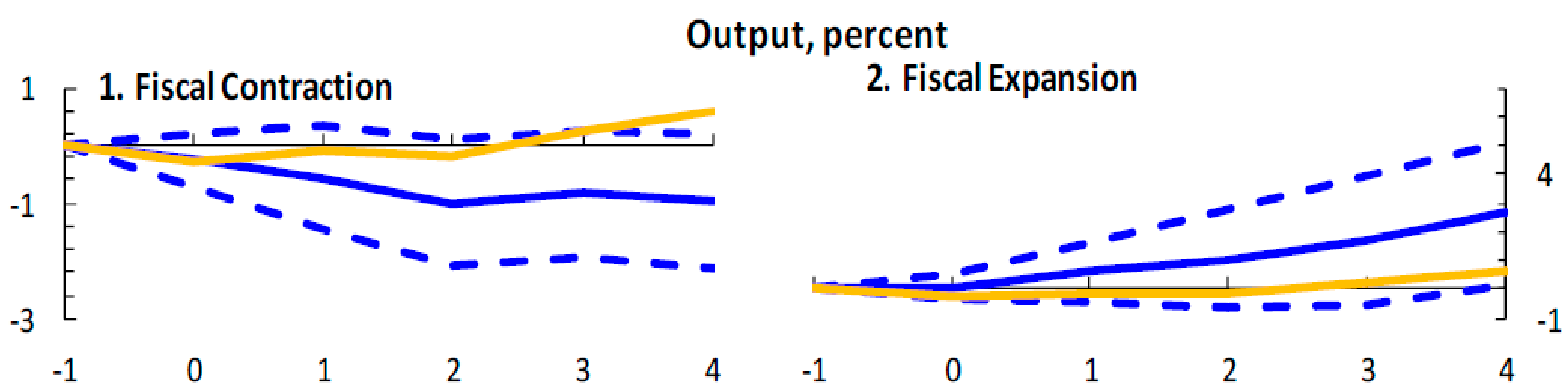


How can the transition be best managed?

- Fiscal policy
  - Duval and Furceri (2016)

Figure 8. Impulse responses to reforms under alternative fiscal policy stances

Panel A. Employment protection legislation reforms



Two Caveats
Some caution regarding the results

- We have a good sense of how to measure monetary and fiscal changes…
- …but reforms?
- Duval and Furceri take a narrative approach:
  - Analyze OECD Country Surveys to isolate "large" reforms by looking for strong reform language, frequency of this language, or large changes in OECD indicators for product and labor market regulation
- **Comment 1**: What qualifies as a large reform is judgmental and doesn't allow for comparing *size* of reforms across countries and over time

Some caution regarding the results

- **Comment 2**: Estimates are often insignificant.

Significance of Reform Coefficients Duval and Furceri (2016), Figure 1-5*	
GDP	15 out of 55
Employment	17 out of 55
Labor Productivity	3 out of 55

*Estimates refer to effects of changes in product market regulation, employment protection legislation, and unemployment benefits.

Don’t forget political economy

- Short-term pain
  - Increased unemployment, lower wages and benefits, less rents

- Can undermine support for reform efforts and lead to their reversal.

Don't forget political economy

- Long-term pain – displaced workers, rising income inequality – may lead to counterproductive backlash.

- Make sure these factors are considered when designing and implementing structural reforms.
  - "First, we need to identify for each country a set of structural reforms that provide the biggest effect on growth and productivity relative to the political capital that needs to be spent."

    [IMF Managing Director Lagarde, September 28, 2016]

Conclusions

- Structural reforms critical.
- But, successful implementation pretty tricky.
  - Sequencing, macroeconomic policy, and macroeconomic conditions all play important roles.
- Just beginning to understand.
  - Duval and Furceri represent valuable progress toward that goal.

Conclusions

- Have realistic expectations
  - Not a cure-all, perhaps the most difficult of the "three arrows" to get right.
  - Unlikely to relieve pressure on policy in the near term.
- Pay attention to timing.
  - Most successful when least urgent.
- Be willing to make tradeoffs, at least in the short run.
  - Fiscal consolidation v. structural reform.