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## Structural reforms at the zero bound

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### ABSTRACT

The paper uses the a multi-region (reforming euro-area region, rest of euro area, rest of world) version of the QUEST macroeconomic model to analyse the impact of structural reforms on economic activity in a macroeconomic environment in which the zero bound on monetary policy rates is temporarily binding. Following Eggertsson et al. (2014), the simulations focus on reforms with deflationary impact, namely reforms that increase competition and reduce mark-ups and labour costs in the economy. The results suggest that the short-term output response to reforms is less positive at the zero bound compared to 'normal times' and can indeed be negative. Negative net effects are small and rather short-lived, however. Simulations that compare current and pre-announced future reforms question the idea that commitment to future reforms would improve economic conditions compared to reform implementation at the zero bound. According to political economy models, the zero bound may reduce reform intensity by increasing the short-term cost of implementation.

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### 1. Introduction

Euro-Area (EA) Member States, particularly those that have been most exposed to the EA crisis, have undertaken structural reforms of significant scale in recent years to strengthen their economies' supply side, regain competitiveness vis-à-vis trading partners and improve the situation of public finances. The reforms have been implemented in an economic environment characterised by depressed aggregate demand and EA monetary policy rates close to the zero lower bound (ZLB). Hence, the question arises how structural reforms affect economic activity in an environment with binding ZLB that rules out the standard monetary accommodation of supply-enhancing policies.

The answer to this question is relevant for the design and sequencing of economic policy at the current juncture – as illustrated, e.g., by IMF (2016). In particular, the ZLB constraint on conventional monetary policy and narrow fiscal space limit the possibility of reducing short-term costs of reforms by (temporary) macroeconomic stimulus. The paper by Eggertsson et al. (2014) argues that structural reforms can be contractionary at the ZLB and, hence, counter-productive in the current economic environment.

There is a rich theoretical and empirical literature on structural reforms with a focus on (1) the conditions for reform implementation in different areas (such as public sector reform, product market reform, labour market reform, and financial

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sector reform) and (2) the economic payoff from reforms. Key questions of the first, political economy view on structural reforms include: Why are generally beneficial reforms often delayed and difficult to implement? What facilitates the implementation of reforms? Barriers to the implementation of overall beneficial reforms include their distributional implications, with benefits spread unevenly across the population, and the intertemporal cost-benefit path, i.e. the presence of up-front costs and the discounting of long-term benefits. Drazen (2002) provides a comprehensive survey of political economy models that formalise these points. Studies on the political economy impact of distributional effects for the important case of social security (reform) include Galasso and Profeta (2002) and Conde-Ruiz and Galasso (2005).

Mainly based on case studies and panel techniques, empirical studies on the political economy of structural reforms have searched the data for factors that facilitate reform implementation. In the area of policy design, sufficient fiscal space to compensate losers or a bundling of reforms to enlarge the group of winners have been suggested as facilitating forces (Duval 2008, Grüner, 2013, Høj et al. 2006). Furthermore, severe economic crises (economic recessions, banking crises, debt crises) that question the sustainability of the status quo are associated with stronger reform activity by modifying the cost-benefit calculus and raising the pressure to reform (Agnello et al., 2015; Alesina et al., 2006; Galasso, 2014; Høj et al., 2006; Tanzi and Schuknecht, 1997). The literature on EMU and structural reforms (Alesina et al., 2008; Duval and Elmeskov, 2005) has emphasised the specific impact of monetary union on the political economy of reforms. Centralised monetary policy and tighter constraints on fiscal policy limit the possibility to accommodate structural reforms at the country level by expansionary macroeconomic policy in order to reduce short-term costs for households and firms. This constraint on the compensation of short-term costs should make reform implementation politically more difficult. But the restrictions on macroeconomic stabilisation also strengthen the importance of structural reforms to improve economic resilience and facilitate the adjustment to country-specific shocks (Duval and Vogel, 2008).

Research on macroeconomic effects (e.g., real GDP, employment, inflation, or the income distribution) of economic reforms as second line of the literature comprises econometric (e.g., Bouis and Duval, 2011; Bouis et al., 2012; Campos and Horvath, 2012; Compton et al., 2014; De Haan et al., 2006) and model-based (e.g., Cacciatore et al., 2012, 2016; Gomes et al., 2013; Lusinyan and Muir, 2012; Varga et al., 2014; Vogel, 2012) studies. This stream of work finds that the short-term impact on economic performance depends on the reform measures considered, and that it needs time for the full benefits of reform to materialise.

This paper falls in the second line of research, i.e. the analysis of (macro)economic costs and benefits from structural reform. The paper revisits and qualifies the Eggertsson et al. (2014) argument of contractionary reform effects at the ZLB in a richer model that incorporates additional transmission channels. It also discusses the related argument that credible commitment to *future* reforms is particularly powerful in stimulating economic activity at the ZLB and can reap long-term benefits without inflicting short-term costs (Eggertsson et al., 2014; Fernández-Villaverde et al., 2014). The model simulations focus on structural policies with deflationary impact, which are at the heart of the Eggertsson et al. (2014) argument, namely reforms that increase competition and reduce mark-ups and production costs in the non-tradable sector of the economy. Other major reforms or reform recommendations to EU Member States (Varga and in't Veld, 2014), which can be translated into a tax shift from labour to consumption and lower overhead (i.e. fixed) costs for firms, have less deflationary effects and do, hence, imply less differentiation between ZLB episodes and "normal times."

The results in this paper suggest that the short-term output effects of supply-side reforms can indeed become negative at the ZLB. The negative effects are small and rather short-lived, however, in a model that incorporates a larger number of transmission channels. The idea that credible commitment to future reform may raise economic activity even in pre-reform periods rests on the positive link between higher future income and current private domestic demand (wealth effect), which may be substantially weakened by financial frictions, with the result that postponing reforms does not improve economic conditions at the zero bound.

## 2. The zero bound and the transmission of reforms

The short-term effects of structural reforms depend on the accompanying macro policies. The impact of reforms that increase the economy's potential output is more favourable when monetary or fiscal policy is available to stimulate aggregate demand. Stimulating demand in order to match the shift in the aggregate supply curve accelerates the transition to the new, higher level of potential output and counteracts the deflationary impact of the supply expansion. When nominal policy rates are at, or close to, the zero bound, monetary policy lacks the traditional instruments to accommodate the supply expansion, however.

Against this background, recent contributions to academic and policy debates have questioned the benefits of structural reforms in an environment of depressed demand. While the positive impact of reforms on long-term activity and debt sustainability is not disputed, the discussion relates to the short-term effects of supply-side reforms at the current juncture.

In particular, the influential paper by Eggertsson et al. (2014) argues that structural reforms become counter-productive, namely contractionary, in the short to medium term if monetary policy is constrained at the zero lower bound (ZLB) and, hence, unable to accommodate supply expansion by the standard means of lowering policy rates. This contractionary impact of structural policies at the ZLB derives from an increase in the real interest rate. Structural reforms that increase aggregate supply in the economy put downward pressure on prices. The fall in the price level increases the real interest rate when nominal rates are stuck at zero. This real rate increase lowers interest-sensitive demand and activity.

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