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Can structural reforms help Europe? ☆

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ABSTRACT

Structural reforms that increase competition in product and labor markets are often indicated as the main policy option available for peripheral Europe to regain competitiveness and boost output. We show that, in a crisis that pushes the nominal interest rate to its lower bound, these reforms do not support economic activity in the short run, and may well be contractionary. In the absence of the appropriate monetary stimulus, reforms fuel expectations of prolonged deflation, increase the real interest rate, and depress aggregate demand. Our findings carry important implications for the current debate on the timing and the design of structural reforms in Europe.

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1. Introduction

As the European Monetary Union (EMU) struggles to recover from the global financial crisis and the European debt crisis, conventional wisdom among academics and policymakers suggests that structural reforms that increase competition in product and labor markets are the main policy option to foster growth in the region. For instance, in his closing remarks following the 2012 State of the Union, the President of the European Commission J.M. Barroso stated:

> "*...the biggest problem we have for growth in Europe is the problem of lack of competitiveness that has been accumulated in some of our Member States, and we need to make the reforms for that competitiveness.*
> *…to get out of this situation requires...structural reforms, because there is an underlying problem of lack of competitiveness in some of our Member States.*"

This paper is bad news: in a standard dynamic stochastic general equilibrium model calibrated to match salient features of the EMU economy, we show that structural reforms do not improve output during a crisis. In fact, these reforms may entail near-term contractionary effects when monetary policy is constrained by the zero lower bound (ZLB). Even more disappointingly, if agents foresee that such reforms may be reversed (which may quite likely be the case, as several interest groups have strong incentives to oppose wide-ranging liberalizations), these policies can generate large short-term output losses, further deepening the ongoing recession.

The 2008–2009 global financial crisis hit the EMU hard, resulting in large and widespread output contractions (Fig. 1). While core EMU countries, such as Germany, have mostly recovered their output losses, the aftermath has been particularly difficult for peripheral countries (Greece, Ireland, Italy, Portugal, and Spain). These countries have remained in severe recessions ever since

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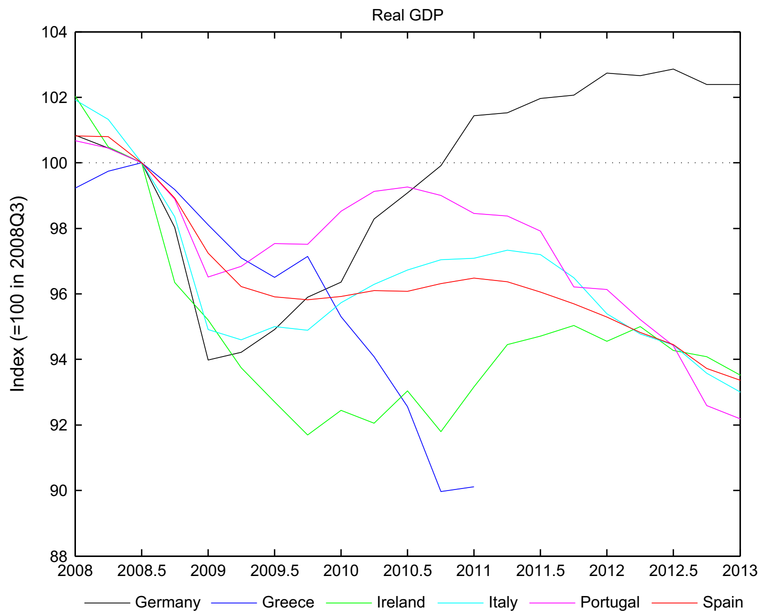

Fig. 1. Real GDP (=100 in 2008Q3) in Germany (black), Greece (blue), Ireland (green), Italy (cyan), Portugal (magenta) and Spain (red). (For interpretation of the references to color in this figure caption, the reader is referred to the web version of this paper.)

2008, eventually triggering doubts about the sustainability of their public finances and putting in danger the entire Euro project. Understanding the reasons for this asymmetric response between the core and the periphery of the EMU and what kind of policies can address this situation are thus questions of first-order importance in the current debate.

A popular narrative for the poor performance of the European periphery is that this reflects the accumulation of “macroeconomic imbalances” since the introduction of the common currency (see, among others, Eichengreen, 2010; Chen et al., 2012). As shown in the left panel of Fig. 2, peripheral euro-area countries persistently maintained current account deficits over the past decade, whereas core countries (represented in the chart by Germany, but Austria and the Netherlands followed a similar pattern) ran current account surpluses. This steep deterioration in the periphery's external borrowing position was associated with sizeable competitiveness losses. As shown in the right panel of Fig. 2, the real exchange rate of peripheral countries appreciated, relative to Germany, between 6% (Italy) and 15% (Greece) over the period 2000–2008.[1] Importantly, these appreciations largely reflect outsized increases in non-tradable good prices, such as housing and other services (see, for instance, Gaulier and Vicard, 2012).

Amid limited policy options, including the impossibility of devaluing the currency, a broad consensus has emerged: peripheral euro-area countries need to urgently adopt structural reforms that increase competition in product and labor markets. Such reforms would directly aim at the source of these macroeconomic imbalances, trying to achieve two complementary objectives in the context of the current crisis. First, reforms would effectively trigger a “real devaluation” of the periphery relative to the core, contributing to a reduction in the competitiveness gap accumulated over the past decade. Second, reforms would boost expectations about future growth prospects and stimulate current demand via wealth effects. This view is supported by the extensive empirical and survey-based evidence pointing to significantly higher economic rigidities in the periphery. Fig. 3, for instance, presents indexes of economic flexibility obtained from the World Economic Forum (2012) that capture the degree of competition in product and labor markets.[2] Indeed, peripheral countries score poorly along both dimensions.[3] In light of these arguments—and evidence—it is perhaps not surprising that structural reforms are the cornerstone of both academics and international agencies' policy advice, as exemplified in the quote by the President of the European Commission Jose M.D. Barroso, reported above.

[1] Corsetti and Pesaran (2012) note how inflation differentials between EMU members and Germany—effectively the rate of change of the real exchange rate—are a much more reliable proxy for interest rate differentials than sovereign debt-to-GDP differentials. To the extent that current account deficits are correlated with real exchange rate appreciations, the external balance of periphery countries is also tightly related to sovereign yield spreads. In sum, according to this view, fiscal and external imbalances, as well as the relative competitive position, are different sides of the same underlying problem (Eichengreen, 2010).

[2] The product market efficiency index is an average of the scores in the categories related to market competition, such as “Extent of market dominance” and “Effectiveness of anti-monopoly policy.” The labor market efficiency index is an average of the scores in the categories related to wage flexibility, such as “Flexibility in wage determination” and “Redundancy costs in weeks of salary.” See World Economic Forum (2012) for more details.

[3] OECD estimates of business markups and regulations burden paint a similar picture. We make explicit use of these estimates in our quantitative exercises.