Speech

Comments on “The Effects of EMU on Structural Reforms in Labour and Product Markets” by Romain Duval and Jorgen Elemskov

Comments given by

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1. The Duval and Elmeskov Paper

The empirical results in Duval and Elmeskov (2005), (DE), indicate that structural reforms to labour and product markets are more likely to be undertaken in small countries (more open economies) than in large countries. Furthermore, in the latter countries they are more likely to be introduced if the countries have independent monetary policies. Thus, in the large countries of continental Europe, the formation of the EMU had a detrimental impact on the structural reform process. These results are ceteris paribus on other key factors which have been shown to drive the reform process, notably high unemployment, economic crisis and a strong fiscal position.

I am sympathetic to these results, based as they are on a plausible analysis of the reform process. By and large, most of the reforms discussed are "good" in the sense that they tend to raise potential output[1]. Consider the consequences of raising potential output in a closed economy that operates a standard, inflation-targeting, monetary policy regime. When potential output rises, a negative output gap develops, inflation prospects fall below target, monetary policy is loosened and aggregate demand and output rise to close the negative output gap. Output and employment both rise. Of course in a country where the monetary policy regime is credible and the citizens are highly rational and very forward looking, all this may happen without any shift in monetary policy at all. Either way, however, the incentive to undertake the reform is strengthened by the prospect that employment and output will tend to rise as a consequence.

In an open economy with a floating exchange rate, some of this adjustment will operate via net trade, depending on the extent of the exchange rate adjustment.

Now consider an economy operating within a currency union which has no control over its monetary policy. The adjustment to the reform will depend on the degree of openness. In a small open economy, the fall in inflation leads to a gain in competitiveness which translates rapidly into a net trade driven expansion. In a small open economy, output (and employment) are highly responsive to price competitiveness. The problem arises with a large economy operating in a currency union. The response of output to the lowering of inflation and hence to the improved competitiveness will tend to be very slow. With little help from monetary policy [2], the rise in potential output will translate only gradually into an increase in actual output and employment. This plainly reduces the incentive to undertake the reforms in the first place.

These arguments are both plausible and consistent with the empirical results presented in DE and lead them to their rather depressing conclusion that one of the effects of EMU is to weaken the incentives for structural reform in the larger member countries.

2. Some Ideas on the Reform Process

As DE make clear, the process of structural reform is difficult, particularly in the large countries of continental Europe where EMU has made it even harder. But this last point should not be over-stressed. In the big scheme of things it is probably not that important. So in what follows I present a few ideas on structural reforms.

a) Product Market Reforms

It is worth starting with product market reforms, in part because it is possible that they suffer less from the EMU problem than labour market reforms. The general idea driving product market reforms is to increase the intensity of competition. For example, privatisation is of little value if a public monopoly is simply replaced by a private monopoly however cleverly regulated. Real benefits start to accrue if competition can be introduced into the market. Thus the benefits to European consumers flowing from the privatisation of British Airways were probably negligible compared to those flowing from the structural changes which allowed low cost airlines to flourish.

So what consequences follow from a reform which increases product market competition? Overall prices tend to be lower and real wages tend to be higher except for those workers who were originally able to capture monopoly rents. Profits also tend to be lower. The consequences of this shift could easily be a short-run increase in real expenditure because the short-run propensity to spend is probably higher out of wages than out of profits. So output and employment may well rise even without any relaxation of monetary policy. So the EMU problem is less important.

In my view, the main sectors worth concentrating on are the big service sectors such as retail distribution and professional and financial services. This is in part because they are big, in part because there is less naturally occurring international competition and in part because the recent experience of the United States suggests there are substantial productivity gains just waiting to be picked up. Thus the dramatic productivity gains in the late 1990s in the US are concentrated in these big service sectors, driven by ICT investments alongside complementary changes in the organisation of production. Furthermore, these large productivity gains were not accompanied by substantial job losses, indeed quite the reverse. This, of course, helps significantly with the general acceptance of the process. Just as an example of how dramatic potential changes could be, in Fig. 1 we see the recent history of productivity in retail distribution which shows the extraordinary recent gains in the US relative to other countries.

A second, specialised service sector where deregulation can yield large benefits is that of job placement. Allowing private placement agencies to operate freely offers significant benefits to the efficient operation of the labour market while simultaneously enabling the public placement agencies to switch their activities to helping hard-to-place non-employed individuals into work. There is a significant public sector welfare role to be played here and the number of people who lose out from this overall change is minimal.

Finally, when it comes to structural reforms, those in the product market are more easily pushed ahead than those in the labour market because they can often be introduced initially by supra-national agencies, set up in the EU following the single market initiative. So while reforming single industries may be tricky for a national government because of significant entrenched interests, things are easier if a supra-national agency can be blamed.

b) Labour Market Reforms

Appropriate labour market reforms often appear to be very difficult to achieve and, because they are, quite rightly, in the hands of national governments, there is no supra-national body to take the blame. Indeed, there are plenty of opportunities to undertake “reforms” which make matters worse. The most obvious example of these is to be found in the sorry history of policies to reduce the effective supply of labour (eg. early retirement incentives, compulsory hours reductions etc. etc.) which have simply succeeded in reducing output and employment without improving the lot of the unemployed. More subtle, and correctly identified as a “non-reform” in DE, is the relaxation of rules governing fixed-term contracts while sustaining or enhancing rules governing permanent contracts. This combination can easily lead to a worsening of the overall employment situation, particularly if permanent contract workers have some control over pay.

It is surely best to focus on reforms which help people in a bad situation, for example, by helping the non-employed into work. It is possible to point to success stories in this area while avoiding those which can be easily dismissed as examples of Anglo-Saxon neo-liberal thinking. The reforms in the social security systems of Denmark and the Netherlands are obviously helpful examples, although it is vital to understand that these sort of carrot and stick operations cannot work unless the civil servants operating them have strong incentives to get people into work. The use of in-work benefits can also be helpful here in order to raise the desirability of employment relative to non-employment (although at the cost of introducing high effective marginal tax rates at the lower end of the earnings scale). And, as we have already noted, a thriving private job-placement sector can also be of assistance here.

Overall, however, I do not think I have much more to add here. So let me conclude by repeating that I think the analysis of Duval and Elmeskov is a fine piece of research on the particular difficulties generated by the EMU when it comes to structural reforms. The question of where we go from here, unfortunately, remains open.

Endnotes

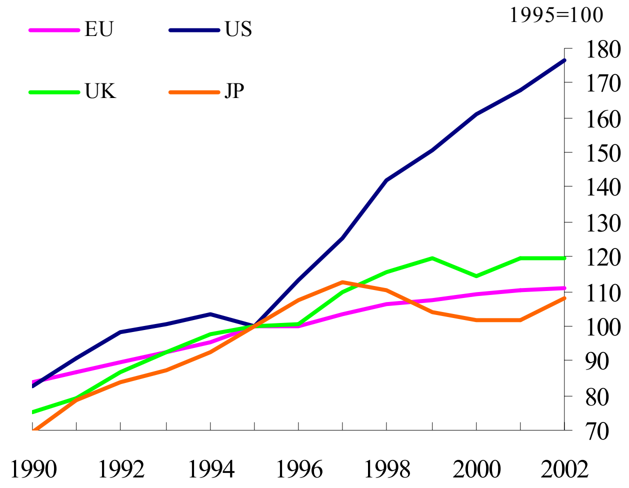
1. I do not want to get into the question as to whether all reforms which raise potential output are worth pursuing. This is obviously not correct – eg. a reform which forced all individuals aged 25 to 64 to work 60 hours per week. In my view, most of the reforms discussed in this paper are desirable.

2. Of course, the rise in potential output in a large country in a monetary union will induce some negative output gap across the union as a whole, thereby generating some monetary policy response.

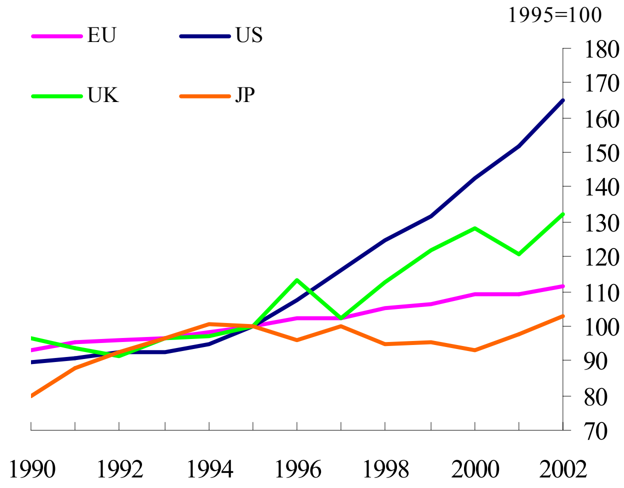
Figure 1

Productivity in the Retail Distribution Sector

Wholesale



Retail



Source: Groningen Growth and Development Centre, 60-Industry Database, February 2005, http://www.ggdc.net