What to expect from structural reforms in the Euro area[1]

Euro area economic activity has been weak, at best, over recent quarters. The level of area-wide real GDP is still more than 2% below its 2008 pre-crisis peak. In this lacklustre growth environment, the European authorities have come under pressure to design and implement a new and more appropriate 'policy mix' that will strengthen the prospects for a real recovery. In his Jackson Hole speech in August, ECB President Mario Draghi strongly endorsed this view. Aside from looking for more support from fiscal policy to sustain area-wide demand, he also emphasised that "aggregate demand policies have to be accompanied by national structural policies" if the overall package is to be effective.

In the previous two issues of the European Economics Analyst, we reviewed the outlook for monetary and fiscal policies in the Euro area. We expect the ECB to maintain monetary policy accommodation for the foreseeable future, while broadening and deepening its credit easing measures. As for fiscal policies, we expect the area-wide stance to be broadly neutral in the coming year, albeit with important differences across countries. This represents some relief after the restrictive area-wide fiscal stance in 2011-13, which resulted from austerity and abrupt fiscal adjustment in the face of market pressure in the periphery.

This week, we present our outlook for structural policies in the Euro area over the medium term. Structural policy remains largely a national responsibility in the European Union. Nevertheless, earlier this year the European Commission issued a new set of recommendations to EU countries, encouraging reform of their economic institutions. Thus far, progress in implementing these supply-side proposals has been uneven, both across countries and over time.

We undertake a number of empirical analyses, drawing on 40 years of experience with structural policies in Europe and elsewhere, to assess: (1) the likelihood and (2) the potential economic impact of economic reforms in the Euro area. We find that:

- The current environment is conducive to structural reform. Easy monetary and fiscal policies, a large output gap, and greater peer and external pressure from European and international institutions all create a setting where economic liberalisation is more likely.
- That said, the political landscape in the Euro area suggests some countries will continue to face challenges in implementing reforms in the face of political opposition from vested interests. Progress is likely to remain patchy. In the coming quarters, we expect advances to be made in Italy, while the electoral timetable points to a weakening of reform momentum in Spain.
- Structural reforms boost investment, but their impact on employment tends to be more muted. The liberalisation of network industries (such as the telecommunication and transport sectors) has beneficial effects on economic activity and investment, whereas labour market reforms have little impact. Neither product nor labour market reforms appear to have a sizeable effect on unemployment.

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[1] This short essay appeared on the *European Economic Analyst* 14/40 of November 13, 2014 published by Goldman Sachs Global Investment Research. Due to FSA regulation, the legal authors of this piece are only permanent and FSA-certified employees of the firm (Huw Pill, Kevin Daly, Dirk Schumacher, Andrew Benito, Alain Durre, Lasse H. Nielsen, Pierre Vernet). I wish to thank the European Economics team for their helpful comments.

- Reforms take time to work through to better growth performance. Politicians who enact structural reforms need to be patient: the pass-through to stronger economic activity typically takes at least a couple of years. Our analysis suggests that the impact on investment is strongest two years after a product market liberalisation, but then abates afterwards, while GDP reacts with a longer lag.

Lessons from the past: International coordination fosters reform policies

In the Euro area, the responsibility for (and coordination of) policies varies significantly across the policy domain. While monetary policy is set by an independent ECB on an area-wide basis, fiscal policies remain the responsibility of national governments, albeit subject to European rules such as the fiscal compact and Stability and Growth Pact.

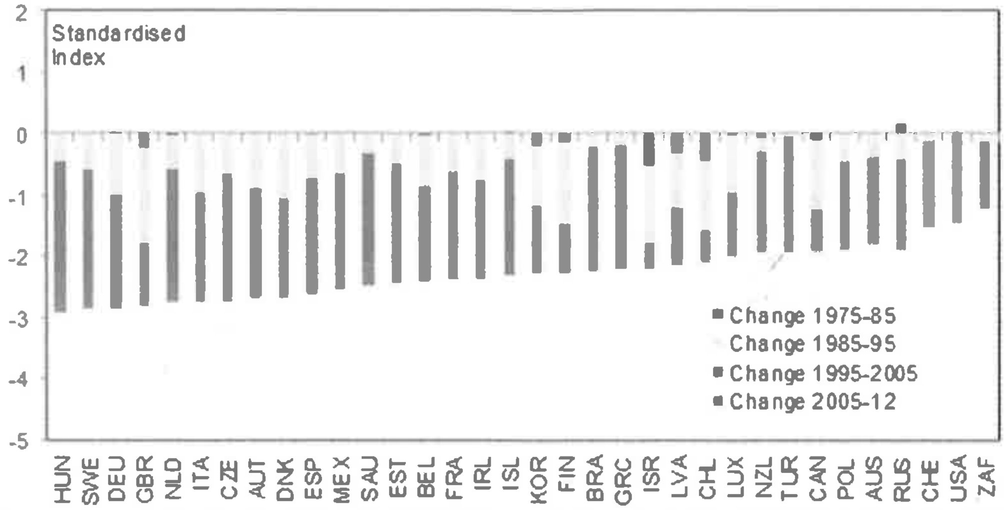
Structural policies also remain a national responsibility. Although European institutions are now attempting to exert greater influence over the design of structural policies, these remain a national affair. And, therefore, it makes sense to evaluate structural reforms on a country-by-country basis, even within the EU.

Over the past 35 years, supply-side liberalisation and reform has been implemented in many countries. In Europe, the adoption of the single market legislation played an important role. But this liberalisation impulse was not confined to the EU. By the nature of the process, the transition from centrally planned to market economies in the former Soviet Bloc entailed massive structural policy changes. Emerging market economies have also reformed economic policies and institutions in recent decades (Exhibit 1).

As individual Euro area countries are ultimately responsible for enacting structural reform, we can draw important lessons from those countries that have implemented product and labour market liberalisation in the past. In this note, we explore an OECD database that measures the degree of liberalisation in roughly 30 countries. We combine these indicators with other economic and political variables to identify the factors that foster structural reforms.

Exhibit 1: Liberalisation of network industries occurred mostly in the period 1995-2005, although some countries moved even earlier

Change in the Product Market Regulation index



Source: OECD, Goldman Sachs Global Investment Research

Macroeconomic policies matter for structural reforms

We first analyse the features of the economic and political cycle that may explain when and to what extent governments will introduce structural reforms.

Vested interest groups which stand to lose from the abolition of the protections and privileges that they have enjoyed in the past have often proved very successful at mobilising opposition to such policies. History offers many examples of governments having to backtrack from a previously announced reform plan owing to widespread political opposition.

Economic liberalisation programmes represent a classic example of the collective action problem. The benefits of structural reforms are often spread relatively widely across the population, while the costs affect specific special interests that stand to lose from the reform. Such special interest groups are often more efficient in mobilising opposition to structural policies than those who stand to benefit from the reform are in mobilising support. Caught between these two lobbies, politicians may be swayed by the stronger and more vociferous opposition of vested interests to reform, biasing policies against liberalisation and feeding the 'sclerosis' of labour market institutions.

Several hypothesis on the determinants for structural policies...

The economic literature points to a number of factors that could influence the willingness of a government to reform:

- Initial conditions. The degree of regulation in the economy could lead the government to pursue bolder structural reforms, because politicians see greater and more benefits accruing from such policies in that context and thus more room for manoeuvre in building a broad-based supporting coalition. Yet, at the same time, groups that stand to lose from any liberalisation will fight more strenuously when the stakes (and the liberalisation potential) are higher.

- Macroeconomic conditions. In ancient Greek, the word 'crisis' means 'decision'. Consistent with this etymology, some economists have suggested that crises accelerate the decision-making process towards structural reform since they act as a forcing mechanism pressuring governments to deliver.
- Tenure in office. The age of the executive may influence a government's enthusiasm for structural reforms. As the electoral term approaches its end, the government's incentive to reform may decrease. Because the short-term impact of structural reforms could be negative, the government may not be in office to reap the longer-term benefits. Others argue that a 'lame-duck' executive has nothing to lose from liberalising labour and product markets.
- Demographic factors. The demographic composition of a society could have an impact on a government's willingness to champion reforms in Parliament. In countries with a relatively higher proportion of elderly people, reforms may not garner enough support among the population as they discount more the benefits that will materialise in the future. Meanwhile, the elderly could stand ready to gain from prospects of improved growth via a more viable pension system and higher returns from their social security contributions.

... but only a few factors really matter for structural reforms

- Large economic crises spur reform. Macroeconomic conditions shape government policies. While fiscal and monetary policy can be used to counter the fluctuations of the business cycle, structural reforms are aimed at lifting the potential growth of the economy. As they alter the structure of the economy, they are rarely used as a response to an economic shock. Our evidence suggests, however, that if an economic downturn is particularly pronounced, then structural reforms in network industries are more likely to follow (as show in the second column of Exhibit 2).
- Easy fiscal policy fosters structural reform. Past experience of structural reform suggests that there is a link between aggregate demand policies and structural reforms. The empirical evidence here is clear: accommodative monetary policy and lax fiscal policy provide the environment that is most conducive to supply-side policies.
- Initial conditions matter. In 1995, Greece, Poland, Slovenia and South Africa were the countries in our sample with the tightest regulations for their product markets, with an index score very close to the maximum value (Exhibit 3). During the following 17 years after that, all of these countries enacted some forms of liberalisation, albeit to a varying degree.

Exhibit 2: International coordination and initial conditions affect a government's willingness to implement structural reforms

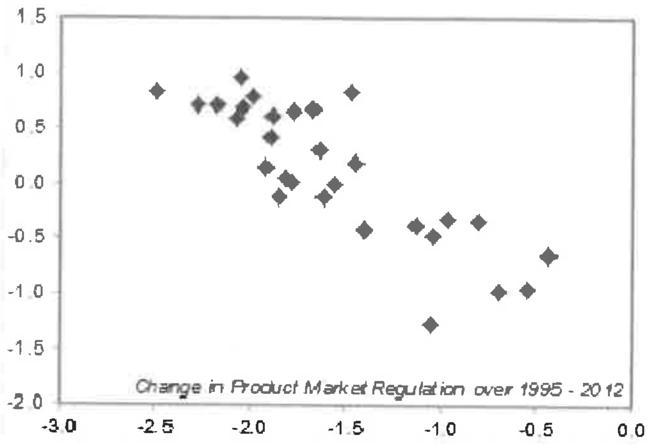
Impact of the factors listed in the first column on the degree of regulation in labour and product markets. Estimates are provided via a fixed-effect (FE) model and a system GMM (SGMM) approach.

	Dependent variable: Change in structural policy indicator for			
	Product Market*		Labour Market*	
	FE	*SGMM*	*FE*	*SGMM*
Initial structural conditions, convergence				
Lagged dependent variable	--	--	.	+
Macroeconomic conditions				
Unemployment (t-1)	.	.	.	.
Big Economic crisis (t-1, t-2, t-3)	--	--	.	.
Macroeconomic policies				
Government Budget Balance (t-1, t-2)	.	+	.	.
Change in cyclically adjusted primary balance (t-1, t-2)	.	.	.	.
Short-term interest rates	.	.	.	+
Political Institutions				
Mature government	.	.	.	.
Ideology, left-of-center government	.	.	.	.
International coordination				
EU Single Market Programme	--	--	.	.
Demography				
Old age dependency ratio (t-1)	+	.	.	+

*A negative coefficient suggests that the corresponding factor decreases the degree of regulation in the Product and Labour Market. The Regulation index for product market is a simple average of the degree of regulation in network industries (electricity, gas, telecom, post, rail, airlines and road). The Regulation index for labour market is a simple average of the employment protection indicator, generosity of unemployment benefits system and tax wedge.

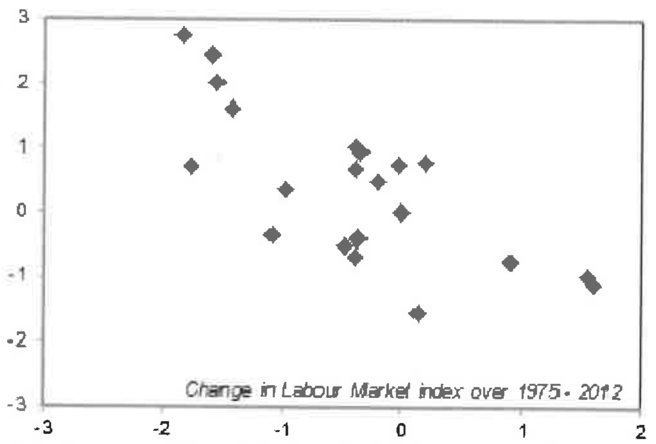
Source: OECD, Goldman Sachs Global Investment Research

Exhibit 3: Liberalisation was deeper in countries with a more rigid product market in 1995 ...
Initial value of the Product Market index, a higher value indicates tighter regulation



Source: OECD, Goldman Sachs Global Investment Research

Exhibit 4: ... while labour market reforms have proceeded in both directions since 1975
Initial value of the Labour Market index, a higher value implies stronger employment protection



Source: OECD, Goldman Sachs Global Investment Research

Exhibit 4 shows a similar picture for the labour market. In those countries with stronger employment protection laws and more generous unemployment benefit systems, liberalisations did follow. However, not all the reforms went in the same direction. Notably, some countries moved down in the ranking as they either enlarged the set of people who could benefit from unemployment protection or raised the tax wedge between the actual wage and the total labour costs that firms bear.

Not surprisingly, governments tend to liberalise their economies more when market rigidities are stronger. This is probably due to that fact that the benefits of structural reform are not the same across countries with different degrees of regulation. The social benefits for society are not enough to compensate the costs for those groups that stand to lose their privileges.

The impact of structural reform on growth, investment and employment

The Presidents of the ECB and EU Commission have stressed the need for governance of economic policies in the EU and Euro area, including in the area of structural reform. Supporters of structural reforms argue that such measures are beneficial for growth (and social welfare in general), while they downplay their potential negative effects.

Structural reforms are thought to have positive supply-side effects over the medium-to-long run. However, the economic literature has pointed out that supply-side policies can (and do) have a positive impact on growth even in the short run. While we do not aim here to review this part of the literature, it is worth mentioning that positive confidence and lifecycle-income effects can boost aggregate demand in the immediate aftermath of structural reforms being enacted.

Anticipating the positive effects of supply-side reforms for future income, households and firms are then willing to undertake some of their future spending and investment as soon as the liberalisation comes into force. Such an effect could also be compounded via the financial accelerator: as the net worth of businesses and the present value of individuals increase, they have higher collateral to offer to a bank.

At the same time, structural reforms can have a short-term negative impact: positive effects can take a long time to materialize, while other effects weigh on economic activity in the short run. Labour and product market reforms usually entail a reallocation of resources across sectors. Reducing entry barriers could stimulate capital formation driven by new entrants, while it may also induce capital scrapping in those industries that become relatively less competitive.

We do not discuss these mechanisms here, rather we examine whether the reduced-form evidence is consistent with the claims made by Euro area policy makers. A panel VAR model is well-suited to capture the average response of economic variables to structural policies. Using such a model, we investigate whether product and labour market liberalization has a positive effect on economic activity. More specifically, given the poor performance of Euro area countries in terms of employment and investment, we estimate the impact of liberalisation on GDP, investment and employment.

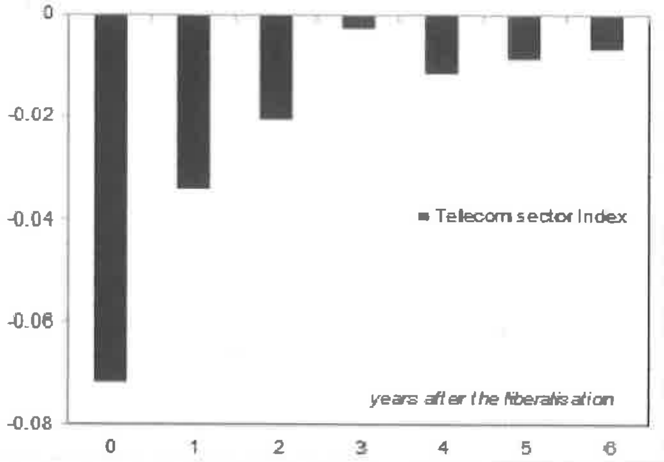
Snowball effect

Some economists have argued that bundling reforms together can help a government to gain parliamentary approval and support among the electorate. Packaged together, supply-side reforms have significant benefits for society as a whole and special interest groups will find it harder to make their case against the reforms.

Moreover, 'strategic complementarities' between reforms may reinforce the case for a more comprehensive approach. For example, some labour market regulations are more restrictive for large firms. But only large companies would benefit from a capital market reform. Combining liberalisations in capital and labour markets would amplify the effects of each reform.

Exhibit 5: Reforms in electricity sectors are followed by other reforms in telecommunications...

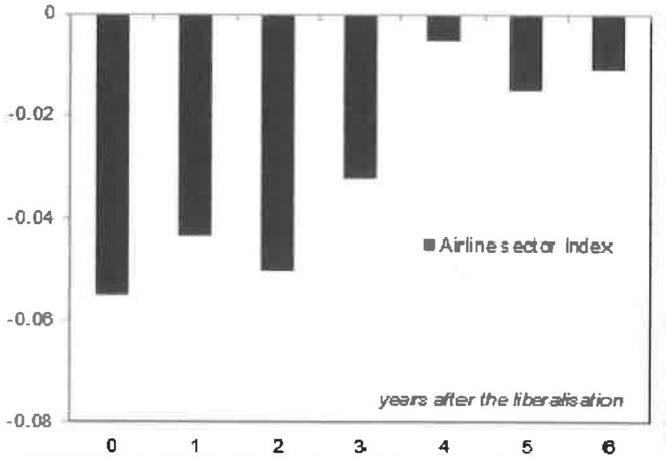
Change in the index for the telecommunications sector after a liberalisation in the electricity sector



Source: OECD, Goldman Sachs Global Investment Research

Exhibit 6: ...and liberalisation in telecommunications are followed by more reforms in the airline sector

Change in the index for the airline sector after a liberalisation in the telecommunication sector



Source: OECD, Goldman Sachs Global Investment Research

The empirical analysis suggests that governments have adopted the strategy of bundling reforms together only in closely connected sectors of the economy. The liberalisation of network services is more likely to be followed by reforms in the energy sector, rather than a reduction in unemployment benefits. Exhibit 5 and 6 show the relation between the policies that were adopted in the energy sector and those in the telecommunications sector.

Impact on investment: Significant but slow

Public and private investment has been exceptionally weak following the financial crisis and well below historical regularities in the subsequent recovery. In Germany, for example, investment in the second quarter of this year was still below the level seen before the start of the recession, more than six years ago (to be fair, it did rebound in the first half of 2011, but fell again). Even in Germany, which has outperformed other Euro area countries, there is room to stimulate investment and aggregate demand via policies that do not require higher government spending and larger fiscal deficits.

During the hearings at the European Parliament that led to the appointment of the new EU Commission, Commission President Jean-Claude Juncker announced a EUR300bn plan to stimulate investment across Europe. We argued recently that such a plan will stimulate aggregate demand and make the policy mix in Europe more accommodative, but its implementation will not be quick. Given the low level of business capital expenditure at present, the plan is unlikely to 'crowd out' private investment. Rather, it could have a positive multiplier effect via improving confidence, encouraging firms to ramp up their investment plans.

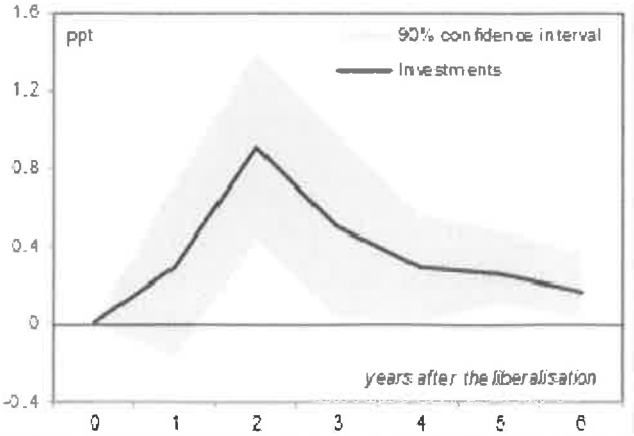
Complementing this essentially fiscal initiative, policy makers could also boost investment indirectly through a reduction in the degree of regulation in the economy, improving the business environment and thereby making firms more confident that investment projects will yield a reasonable return.

Exhibits 7 and 8 show the positive response of investment to product and labour market liberalisation. While structural policies in product and labour markets have a big impact on investment, product market liberalisation have a much bigger impact. In the second year after the reform, investment grows almost 1% more than in the baseline scenario. Although one would expect investment to respond more quickly to the announcement of a reform, our analysis suggests that more than one year is needed to witness a pick-up in investment.

The output gap responds to structural reforms in a similar way to investment. Compared with the scenario without reform, output is higher in the second and third year after the product market liberalisation (Exhibit 9-10).

Exhibit 7: Product-market liberalisation stimulates investment ...

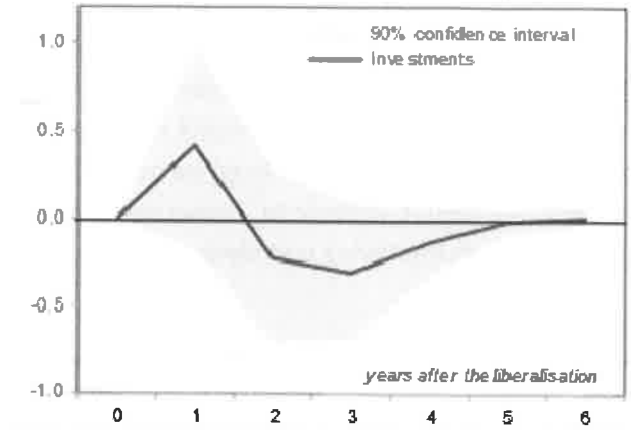
%, deviation from baseline after a liberalisation in the product market



Source: Goldman Sachs Global Investment Research

Exhibit 8: ... while labour market reforms have weaker impact

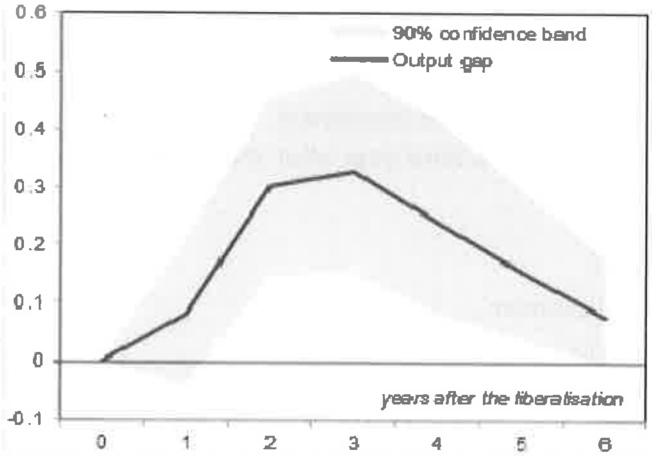
%, deviation from baseline after a liberalisation in the product market



Source: Goldman Sachs Global Investment Research

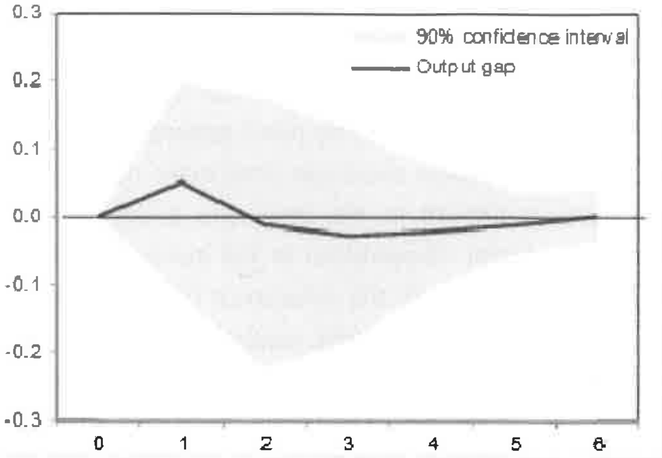
Exhibit 9: The output gap is reduced by 0.3-0.4% of GDP three years after a reform in the product market ...

%, deviation from baseline after a liberalisation in the product market



Source: OECD, Goldman Sachs Global Investment Research

Exhibit 10: ... while it is broadly unchanged after a labour market liberalisation
%, deviation from baseline after a liberalisation in the product market



Source: OECD, Goldman Sachs Global Investment Research

A more muted effect on employment

Employment reached its early-1990s highs just before the onset of the financial crisis in 2007-08. Since then, employment has stalled. Female employment, traditionally lower than male employment, has been particularly hard hit during the financial crisis. Although labour force participation has stagnated since 2008, unemployment has nonetheless increased significantly. Reducing the amount of regulation in the economy could have a direct impact on employment, if the government reduces the costs associated with hiring a new employee. In our sample, however, we do not see any sizeable impact on employment after the implementation of a structural policy.

Clear benefits, but patchy progress

Although Euro area countries have agreed to coordinate their reforms during the European Semester (i.e., the yearly mechanism according to which the Commission reviews national budgets proposed by governments), progress on supply-side measures has been patchy, at best. Euro area countries agreed to submit their annual reform programme and their budgetary plan to the European Commission in the first part of the year. The outcome of negotiations between European and national institutions is summarised in country-specific recommendations that, albeit formally endorsed by the EU Council, are not binding. ECB Board member Cœuré has suggested on more than one occasion that such a coordination process should be strengthened to encourage more reluctant countries to reform.

Spain. One of the first actions of the Rajoy administration on taking office in late 2011 was to liberalise the Spanish labour market significantly. The reform has promoted the internal flexibility of firms and reduced dismissal costs for permanent workers, thereby reducing the segmentation of a 'dual' labour market. Such policies have contributed to significant wage moderation and increased hiring on permanent contracts. Since a year ago, activity has picked up as domestic demand gained upward momentum. Although the positive performance of exports and net trade appears to be consistent with supply factors having played an important role, we see no clear separation between the effects of supply and demand policies in Spain. Rather, the financial sector reform has interacted with accommodative monetary policy to sustain the recovery. Looking at the outlook for supply-side policies in Spain, we do not expect any major reforms in the coming quarters, as the government is already in the last year of its mandate.

Germany scores highly in terms of product and labour market flexibility compared with other Euro area countries. But it still has a relatively more regulated professional services sector. This year, the government decided to introduce a national minimum wage and a slightly more generous pension system. While such policies could sustain aggregate demand in the short run, they make the labour market more rigid and are likely to slow employment growth in the long run. In its reform programme for 2015, the government has pledged to foster competition in the services sector, especially in construction and in some professional services. Given the reluctance of the German government to use some of its fiscal leeway to sustain domestic demand, supply-side policies are potentially a valid alternative to stimulate investment and, indirectly, sustain the Euro area recovery. However, we expect Chancellor Merkel's government to proceed cautiously with this type of liberalisation, since vested interests remain powerful and oppose such measures (as elsewhere in the Euro area), and the imperative to act is less powerful given the strong German labour market and positive underlying macroeconomic situation. Indeed, some of the changes being introduced by the government imply a tightening of regulations, such as its plans to impose stricter rules on temporary contracts.

France and Italy do not have stellar records in terms of structural reforms. Both countries score in the middle of ranking of OECD countries in terms of degree of regulation of their economies, and their reform patterns have fluctuated over the past decades. More reformist governments were followed by periods when either no new measures were implemented or recent liberalisation was reversed. The ECB has pledged to maintain its refinancing rates at very low levels for the years to come, and the French and Italian governments decided to adopt an easier stance on fiscal policy. Moreover, the size of the output gap is still very large in both countries (somewhat larger in Italy). Despite the favourable setting, the outlook for structural reforms in these countries is quite different.

French PM Manuel Valls has committed to reducing the cost of labour for firms, while maintaining the purchasing power of households. The government has already launched some of these measures, while others are set to be implemented soon. However, we do not expect additional bolder structural reforms by the end of 2017 . The political environment is not conducive to structural reforms as President Hollande faces growing unpopularity and the government passed the recent confidence vote with only a narrow majority.

Italy liberalised its labour market in 2012 to a very limited extent, and certainly less than Spain. The Parliament is currently debating a draft bill (the so-called 'Jobs Act'), which is aimed at decreasing dismissal costs for firms and reducing the uncertainty around them . The ruling coalition is committed to approving this law by the end of this year. If it is passed in the current form, the bill introduces a new permanent contract for all private fresh hires, which offers protection that increases gradually with tenure.

Italian PM Matteo Renzi has shown more resolve on structural policies than his predecessor. Although we have not seen much progress during the first nine months of the new government, we expect the government to deliver a package of reforms that will have a positive impact on the Italian economy over the medium run, through increased investment and more employment.

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