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Structural Reforms and Macroeconomic Policy

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Introduction

When growth declines most economists tend to demand structural reforms to ensure a return to a stable growth pattern. The European economy currently most affected by this line of thought is beyond a doubt Germany. Almost every day sees suggestions for some new reform allegedly required to improve growth prospects. Last summer longer working hours were the reform of the day. The current preference is for corporate tax reductions.

Interestingly enough, many of these ideas have actually been put into practice. A federal commission (the Hartz Commission) proposed fundamental reforms for the labour market that were duly implemented. There have also been reforms of the health care system and the pension arrangements – with more to come in both these fields. Other European countries have also entered a phase of structural reform but to a lesser extent, the main focus being on pension reform. They aim to reduce the financial burden represented by pension schemes in the presence of an ageing society. Notable exceptions are the UK, Denmark and Sweden, where, as in Germany, labour market reforms have been conducted on a large scale.

The basic hypothesis underlying all these efforts is that the growth path of an economy can be improved by structural reforms alone. Labour market reforms designed to increase the flexibility of labour supply are regarded as particularly appropriate for fostering growth. In the following I will outline the connection between structural reforms and macroeconomic policy and my conclusion will be that these are interdependent rather than separate issues. By way of example, I will present a simulation that reinforces this point. At the end I will state the hypothesis that, if negative side effects are to be avoided, structural reforms should be embedded in a favourable macroeconomic policy framework. Otherwise these reforms may actually prove self-destructive in growth terms. In the light of these findings the reform process in Germany is seen as having been severely marred by neglect of the macroeconomic context. And the present dismal situation in that country, and by extension in a number of other European countries, is at least partly attributable to this neglect which, moreover, places in jeopardy all further attempts at reform.

Structural reforms and macroeconomics

What is a structural reform? Usually one understands by structural reform an institutional change that alters individual behavioural incentives in a growth-promoting manner. One example would be unemployment benefits in Germany. In the past unemployment benefits have been granted in Germany for an unlimited period, albeit decreasing after one or, at the most, two years. With the recent labour market reforms in place, unemployment benefit will cease to be payable after one year, after which those who have failed to find jobs will be entitled to receive only the much lower social security benefits. This significant reduction in benefit levels may be expected to increase the incentive for unemployed workers to seek work. In addition, a change in behaviour is induced by an intensified counselling process and a tightening of the rules on acceptable reasons for declining a job offer.

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Given that employment may be expected to increase insofar as people will now accept the lower paid jobs that they previously used to decline, the reservation wage – the minimum for which unemployed persons on benefit are prepared to take up paid employment – will effectively have been lowered as a result of these measures. Since all or at least most of the unemployed are likely to alter their behaviour in this manner, a general reduction of wages is to be expected. The resulting cheaper labour supply will, so the argument runs, in turn increase labour demand, and thus employment. With higher employment, earned income will also be higher. Consumption and investment will be boosted in their turn and, in the end, the economy will be on a higher growth path.

This optimistic picture of structural reform effects has not, up to now, been reflected in the data in Germany. And the same applies to many other countries. Some argue that these reforms need more time in order to prove effective. This may be true to some extent, since people do need time to adjust. But on closer inspection some scepticism is nonetheless in order, as the situation does not appear quite so simple. In particular, if people do not adjust quickly to such a changed environment, those who are unemployed face a loss of income. Furthermore, even if wages – one is speaking here in the first instance of nominal wages – decline, it remains doubtful, for several reasons, whether the expected increase in jobs will occur, at least in the short run.

The first and most important reason is that there may simply be no labour cost problem. If the high unemployment were caused not by excessive labour costs but rather by a lack of income and demand, a reduction in labour costs will be of no help. On the contrary, incomes will be lower than before the reform. Wages may decline also for those already employed, but this does not mean that firms will necessarily increase their workforces. As a result, income and demand will fall even further and the unemployment problem will become even worse. Therefore, before expecting a positive impact from such a reform, one should check whether labour costs are indeed the real problem and, in the case of Germany, there are substantial doubts as to whether this is the case, since wage developments have for many years been more moderate than in all the other major countries except Japan.

The second reason why only a limited impact should be expected is that a decline in nominal wages is not the same as a decline in real wages, which are the relevant wage variable for employment. While the former type of decline will be a likely consequence of the reforms, the latter is likely to happen to only a limited extent. Competition will prompt firms that have lowered their wage costs to reduce their prices too. Accordingly, real wages will not decline to the same extent as nominal wages. With perfect competition they would not even change at all.

These arguments need to be modified somewhat when applied to open economies. When prices decline, compared to a situation without reforms, international competitiveness increases via real currency depreciation, as long as similar reforms are not implemented in other countries. Hence it can be expected that exports will increase and thus growth also. If labour costs are at the root of the employment problems, this will enhance the employment-creating effects of wage moderation. If demand is the problem, the outcome will depend on the relative size of the domestic market compared to exports. In a small open economy where domestic demand is of minor importance compared to foreign markets, employment will rise due to the real depreciation. But if the domestic market is relatively large the negative impact on domestic demand will prevail. Clearly the degree of openness (which is linked to the size) of an economy is an important variable determining the impact of reforms that depress nominal wages. Even so, whatever the degree of openness, proper identification of the causes of unemployment remains important in order to assess the employment effects of structural reforms.

The example shows that the macroeconomic impact of a structural reform is not necessarily positive. If the change of incentives increases labour market flexibility, people may step up their job search efforts. In times of economic upturn this may lead to a faster build-up of employment. Moreover, the labour supply constraint is shifted outwards, leaving more room for growth. But this will happen only with an economic upturn and not at times of economic slack. So one should not expect structural reforms to lead to a turn-around and to trigger an economic upturn. This can be achieved only by an appropriate macroeconomic policy.

These considerations lead to an obvious relationship between structural reforms and macroeconomic policy. Macroeconomic policy has to be such that the side effects of structural reforms are compensated. If negative impacts on domestic demand are expected, as in the above example, macroeconomic policy has to be correspondingly more expansionary to stimulate demand in order to make up for the losses caused by reforms. In the past many countries have reacted by implementing a more expansionary monetary policy. In smaller countries like Sweden and Finland structural reforms have been accompanied by sometimes massive devaluation of their currencies; higher exports were then able to compensate for the lack of domestic demand. In a currency union like the EMU neither of these strategies may be possible. Monetary policy would have a chance to react only if these reforms were to constitute a Euro-area-wide phenomenon. This is highly unlikely, at least during the same period of time. And, of course, the exchange rate is fixed vis-à-vis the most important trading partners and, for the currency area, will not necessarily be pushed in the 'right' direction vis-à-vis the rest of the world.

Therefore the problem must be dealt with on a national level by means of fiscal policy. The recommendation is that structural reforms that place a burden on domestic demand should be accompanied by a correspondingly more expansionary fiscal policy. Only if demand is no problem can macroeconomic policy considerations be dispensed with.

Most of the reforms in Germany and elsewhere are designed to cut social security spending. They place a greater burden on private households. Such measures will not even create an incentive to save. They will merely serve to redirect money from the usual forms of household spending into channels such as healthcare spending. This hampers demand. So basically the same reasoning applies as above. But unlike the case of an improvement of incentives, social security systems will not become more effective, even in the event of an economic upturn. As such, this is mere redistribution at the expense of private households and in favour of firms.

The German example: a simulation

When, in 2003, the German government decided upon the so-called agenda 2010 – a programme including a whole range of labour market reform measures – a debate started up as to whether this programme should be accompanied by a more expansionary fiscal policy stance. Several measures were suggested. The first was a tax reform to lower income taxes. It was part of a longer-term tax reform designed primarily to reduce tax rates at the high and at the low ends of the income scale. The second measure was a public investment programme involving about the same amount of money. Using the macroeconomic multi-country business cycle model of the Euro area (EBC) of the German Institute for Economic Research (DIW, Berlin), these measures were simulated separately.[1] The model used shows supply-side as well as demand-side features. Employment depends on real wages (real total labour costs per hour) as well as on growth. Hence, *ceteris paribus* a decline in social contributions of firms that reduces labour costs will lead to higher employment as will an increase in competitiveness. If, on the other hand, domestic demand declines, and thereby growth, employment will decrease, too. If, as is the case with most structural reforms, one gets both effects, the overall outcome depends on the empirically estimated model parameters. The model is regularly used by the DIW for the purposes of short-term forecasting and has shown a good forecasting performance.

For the structural reforms the Agenda 2010 measures, as planned during late spring 2003, were considered. Though some of these ultimately failed to gain majority support in the parliamentary process, nonetheless, all in all, the simulations outlined roughly reflect the structural reforms that have since then actually been implemented in Germany.[2] In any case, they provide an example of a set of structural reforms and thus supply information on the impact of such a reform package with and without a compensatory macroeconomic policy. The results are shown in the following table and figures.

Macroeconomic Effects of Structural Reforms

Deviations in % against baseline

	Szenario I Tax Reform			Szenario II Structural Reform			Szenario III Higher Investment		
	2004	2005	2006	2004	2005	2006	2004	2005	2006
Real GDP	0,3	0,4	0,0	-0,6	-0,9	-0,6	0,9	0,9	0,4
Real private Consumption	0,4	0,7	0,1	-0,5	-1,1	-0,9	0,1	0,5	0,4
Real Investment	0,3	0,5	-0,1	-0,6	-0,8	-0,3	6,0	1,5	1,0
Real Exports	0,0	0,0	-0,1	0,0	0,1	0,4	0,0	0,0	-0,2
Unit labour costs	-0,2	0,1	0,5	-0,5	-1,2	-1,7	-0,4	0,4	0,9
Consumption Deflator	0,0	0,0	0,1	0,0	-0,3	-0,7	-0,1	0,1	0,3
Available Income	0,9	0,7	0,1	-1,1	-1,6	-1,8	0,3	0,6	0,7
Employees	0,0	0,1	0,1	-0,1	-0,3	-0,4	0,1	0,3	0,2
Public Expenditure	0,1	0,2	0,2	-0,9	-0,9	-1,1	1,4	1,0	1,1
Public Revenues	-1,6	-0,1	0,5	0,4	-0,4	-1,0	0,2	0,8	1,1
add:									
Employees [1]	10	40	20	-30	-90	-130	40	90	80
Public deficit Ratio [2]	-0,7	-0,1	0,2	0,6	0,2	0,1	-0,6	-0,1	0,0

1 in 1000 persons.

2 in percentage points of nominal GDP, + lower deficit, - higher deficit

DIW Berlin 2003

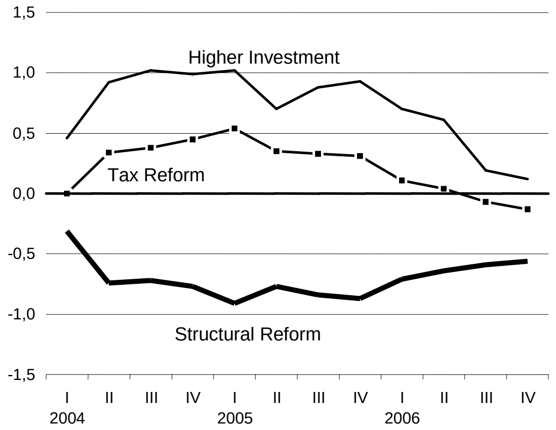
Source: Simulation with the Germany module of the EBC-model of the DIW Berlin

[1] Cf Horn, Meinhardt, Zwiener: Konjunkturelle Effekte aktueller finanzpolitischer Maßnahmen, Manuskript 2003.

[2] Details are discussed in Horn, Meinhardt, Zwiener (2003).

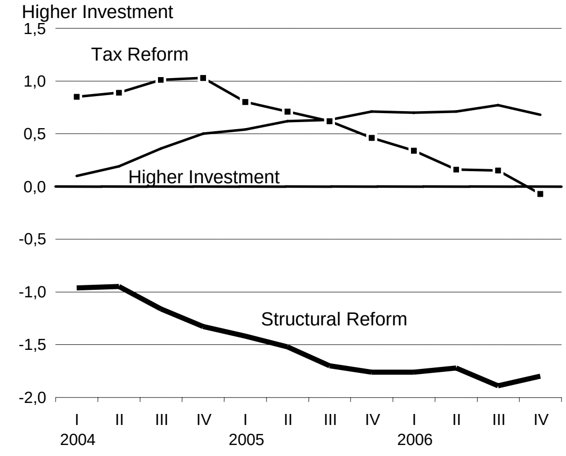
Real GDP

Deviations in % against baseline



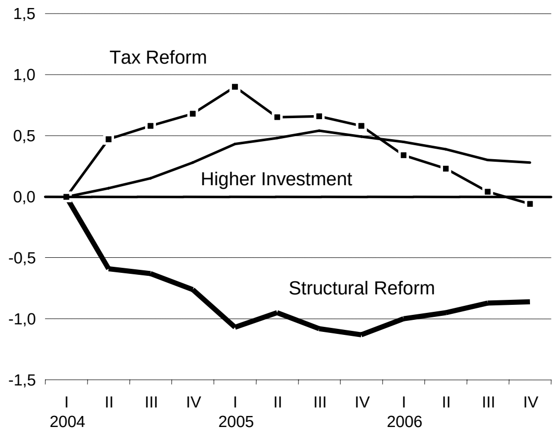
Available Income

Deviations in % against baseline



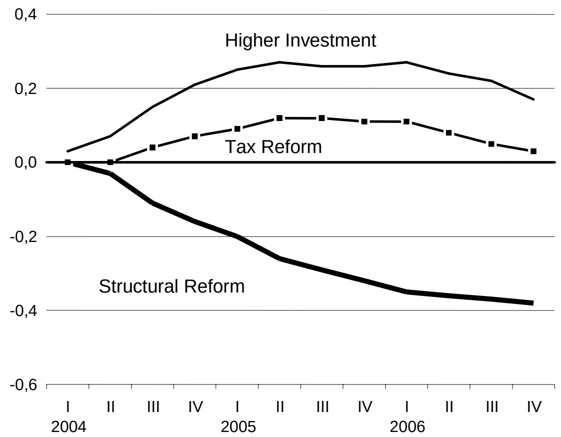
Real private Consumption

Deviations in % against baseline



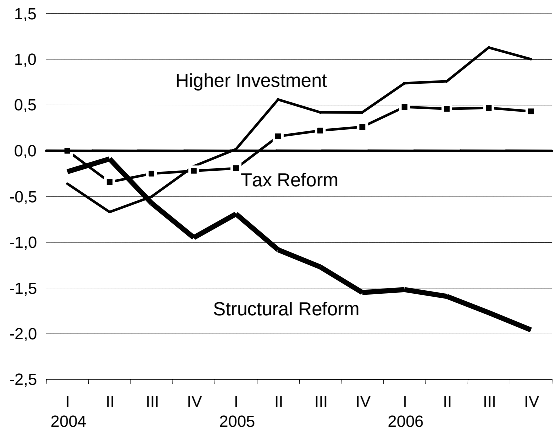
Employees

Deviations in % against baseline



Unit labour Costs

Deviations in % against baseline



Source: Simulation with the Germany module of the EBC-model of the DIW Berlin

DIW Berlin 2003

The results show that structural reforms, as planned in the Agenda 2010, taken by themselves, did indeed impose a macroeconomic burden. GDP would be below baseline up to almost one percentage point after 2 years, recovering only gradually thereafter. Private consumption, in particular, is well below its baseline throughout. Even in the third year after the start of the reform it recovers only slightly. The reason for this pattern is the significant reduction of disposable income caused by higher social security payments on the part of private households, thereby reducing the leeway for consumption spending. Disposable incomes do not recover until the end of the simulation period, and even so remain almost 2 percentage points below baseline.

The only macroeconomic variable on which structural reforms have a unanimously positive impact is exports. The reason is increased competitiveness on foreign markets, as discussed earlier. As a result of the reduction in firms' social security spending, unit labour costs decrease. Consequently firms can offer their products at lower prices on global markets, thereby increasing their market share and fostering exports. It takes time for these effects to feed into the market because firms are reluctant to reduce their prices and will seek rather to raise profits by keeping them constant. Competition however prompts them in due course to transfer the cost reduction, at least to some extent, to their customers. This time lag determines the development of GDP. Since exports show positive impacts only gradually, GDP also will move back only gradually in the direction of the baseline without reaching it. Investment is influenced from both sides, i.e. the negative domestic demand and the positive exports. Since the domestic economy effect prevails, output remains below baseline. Importantly, the same applies to employment: although lower wage costs might lead to expectations of higher employment, this effect is more than offset by employment losses resulting from the drop in domestic demand.

The simulation is then repeated with the two compensatory fiscal programmes. The figures suggest that the investment programme is clearly superior to the tax reduction programme in its effects. The reason for this is that the investment spending affects production by 100% of the amount spent. Tax reductions flow, via consumption and investment, only partly into production, since some of the money is saved. This applies especially to high income earners. Having said that, the amounts debated in 2003 were generally too low to offset the relatively high negative impacts of the structural reforms.

Growth, disposable income and consumption are initially somewhat above baseline, but subsequently decline to just above (investment) and below (tax) baseline. Despite higher unit labour costs and lower exports, employment performance is above baseline.

Conclusions

The simulation was conducted and the results obtained before structural reforms were put in place in Germany. In the meantime, real economic developments have shown that the basic findings of the simulation exercise were correct. Structural reforms of the kind debated in Germany and other countries impose a burden on domestic demand and thus require compensation in the form of an expansionary macroeconomic policy (or external stimulus) if they are to have positive effects. In Germany this did not happen. The result was an ongoing stagnation of domestic demand. Meanwhile, the positive impacts on exports indeed materialised. German firms achieved a remarkable export performance in relation to other major economies. But exports are quantitatively too small to offset the domestic demand impact: overall the economy stagnates. That is clearly the pattern indicated by the simulations. These findings reinforce the point that structural reforms must be embedded in an appropriate macroeconomic environment.

These findings must also be seen in a European context. There are two points here. One is that small countries, where the export channel is larger in relative terms, may experience somewhat more favourable trends than a large country like Germany, since higher exports have a bigger impact on growth there. This is also in accordance with experience in recent years. Secondly, however, the European economy must increasingly be seen as an entity. Not all countries can expand their exports at the cost of production in other countries. To this extent, a strategy of structural reform relying on positive effects via the export channel cannot be a solution for Europe as a whole. In particular, its effects will not be permanent since other countries will be forced to react with similar measures.

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