Discussion on Boeri and Jimeno

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What is the topic of this paper?

- The main focus of this paper is the interplay between the fiscal crisis and labor market reform
- The general thrust of the paper is that the current approach to EU conditionality is suboptimal
- The authors then suggest a number of reforms that the EU could promote as a substitute to the current stance

Outline of the discussion

- Using Okun’s law to distinguish shocks from institutions
- Should institutions be cyclical?
- Should institutions be set at the European level?

Measuring institutions

- Assumption: differences in the response of unemployment to output are interpreted as due to institutions (which ones?)
- Differences in the size of the output fall are interpreted as differences in shocks.
- The authors admit that is a crude methodology

Hard to see why it should work

- The first-order effect of institutions is on average unemployment which is filtered out by the methodology.
- Y and L linked by production function, how can method separate shocks from institutions?
  - dY/dL independent of institutions if demand shocks
  - dY depends on institutions for both demand and productivity shocks
  - To get away from this one needs to think about labor hoarding
  - Differences in dY/dL would then capture some institutions (EPL) but not all

How to interpret it?

- Flexibility generally preferred to rigidity
- Is a higher Okun coefficient good or bad?
- Employment more volatile in US, UK than France, but average level lower
- Here even more subtle as what is measured is volatility of labor utilization

The analysis is shaped by a number of assumptions (like many other papers)

- More Europe is better than Less Europe
- EMU is sacred. Dismantling it is out of discussion.
- Keynesian stabilization of the output gap is senior relative to other concerns
  - Employment volatility bad, as opposed to volatility in other margins
- Insurance against income shocks must be "social" instead of individual.

Example of such bias

- Germany has adjusted hours
- Spain has adjusted employment
- Means higher unemployment in a downturn
- But it also means the same insiders will keep their jobs in Germany when recovery comes
- Furthermore, if shock permanent, better to cut employment; hours cut may be inefficiently high due to EPL

Institutions and Cycles.

- The authors suggest that cyclical aspects be better taken into account
- This applies to the timing of labor reforms as well as cyclical adjustment of the parameters
- Hence the authors suggest that
  - EPL should not be reduced in recessions
  - Retirement age should not be increased in recessions
  - UB level should be countercyclical

Countercyclicality of UB may run into hysteresis

- Economic hysteresis: more generosity makes a recession last longer
- Poltical hysteresis: resistance to reducing them as recovery kicks in
- Delegating to an independent authority may not be sufficient

Cyclicality of retirement age?

- Makes little sense to me to reduce supply just because demand is low
- To be actuarially fair the early retirees in recession should earn a lower pension

EPL

- It is true that upon impact EPL reduction destroys jobs
- It does not follow that it should take place in upturns
- For example fewer jobs may be destroyed byt the reform in recession than in expansion
- How the wedge in JD margin varies along the cycle is unclear (key aspect).
- “identification effect” may make reform politically easier in recession

Is cyclically adjusting institutions and reforms a good idea?

- Institutions are costly to adjust, unlike Central Bank interest rates
- Not clear why one should stabilize along all institutional margins, in addition to monetary and fiscal policy
- Political logic leads to reforming in times of crisis, even though it is inefficient.
- If a reform is less good in bad times, it is still good…(discounting): NPV should be >0, not maximum

Current conditionality framework inadequate?

- The general message is that imposing structural reforms in a fiscal/macro crisis is a bad idea
- Instead the authors propose some alternative reforms
- These reforms do not amplify the macro crisis, contrary to the reforms imposed by EU conditionality
- Furthermore, the authors criticize basing allowed deficit on a measure of the output gap

EU framework not so contractionary

- Structural reforms are traded against postponing the fiscal adjustment ➔ authors' concerns reflected in current arrangement
- Real possibility in structural break in potential output growth ➔ ignoring it fiscally unsustainable
- Controlling for u, policy mix more expansionary than pre 2008

Welfare cuts not inevitable

- While fiscal consolidation did prompt welfare cuts, other cuts could have been chosen
- In fact in France taxes went up

Is output gap inadequate?

- The authors argue that output gap is poorly measured, almost dismissing the whole notion
- But one cannot talk about cyclicality in reforms and appropriate deficit levels without this notion
- Furthermore, unclear which side we should go under robust control approach
- “Deflation” argument empirically unclear, and is just a point about output gap measurement

The proposed framework

- Single european contract with mandatory contributions to a savings account
- Euro-wide UB system, available to countries that have “good institutions”, again with an account
- A cyclical retirement age, portable and actuarially neutral

Why this?

- These reforms make sense
- The authors do not provide a strong argument that they would increase welfare
- Nor is it clear that they would reduce equilibrium unemployment
- Unclear why they would be easier to implement at the EU level

Structural divergence need not be a problem

- Different institutions and equilibrium unemployment are not a priori inconsistent with same currency
- Could be thought of as different population levels

When does structural divergence affect monetary union?

- Discretionary use if fiscal policy to lift economy beyond inefficient natural rate
- Inflation divergence as each country moves along its own output/inflation trade-off
- Medium term tensions on real exchange rates and activity

Policy consequences

- Euro wide institutions want to promote either
- Convergence in equilibrium unemployment levels
- Or
- Credible national fiscal rules (SGP?)

Which policies matter most to Brussels?

- Structural policies that do not affect this bias should not be centralized at the European level
- Better cyclical responses of institutions may be implemented at the national level
- In contrast, policies that reduce equilibrium unemployment more relevant to central level.
- This may help explain why reforms advocated by authors not so relevant at central level