

# On the Incentives for Structural Reform in the European Monetary Union

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## 1 The project

The issue of structural reform has become the leading economic issue in Europe since the last enlargement half a decade ago. And it will become an even greater issue with the next enlargement following the Copenhagen Summit. In previous research on this topic, we focussed explicitly on two central themes: the incentives for the current "outsiders" to join EMU; and the incentives to reform within the EMU and among the candidate countries. That research yielded some new insights into both questions, including some "orders of magnitude" evidence on the size of and balance between the incentives to join and to allow oneself to be joined; and also on the desirability to reform, whether in or out of the present union.<sup>1</sup>

However, our analytic framework has so far been restricted by two important factors:

a) The incentive structures, particularly with respect to market flexibility reforms, were limited to exogenously imposed structural reforms. That is, we assumed these incentives to be unrelated to the development of the model's endogenous variables. This is not realistic. Indeed, one might expect that structural reforms to strengthen trade relationships, create more flexible price and wage responses, lower the natural rate of unemployment, give rise to more stable growth prospects, etc.

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<sup>1</sup>See Hughes Hallett and Jensen (2001, 2002, 2003a,b).

The present project is designed to show how the incentives to reform depend on the development of those variables.

b) The previous analysis had been conducted within a comparative statics framework. As a result, we have been unable to capture the effects of the fact that the costs of structural reform would typically appear before the benefits. And the fact that those costs might be large, might then explain why most countries have been so reluctant to actually undertake such reforms in practice - despite admitting the importance of making such reforms. Among the costs we might expect to see losses in the ability to conduct short-run stabilisations, losses in job security, and a possible worsening in the distribution of incomes or in public services. There may also be increased short-term pressures on public finances and debt, a greater desire to use fiscal policy or labour market regulation. But the long run gains would be in increased output capacity, enhanced growth, increased competitiveness and/or lower natural rates of unemployment, increased volumes of trade, etc.

The project would therefore extend our previous work in two directions: First, structural reforms are defined in terms of the model's endogenous variables. Second, we make our analytic model dynamic, so that we are able to analyse the timing and size of the costs and benefits of reforms. This will enable us to see if the apparent lack of progress on the reform agenda is due to the benefits being small, or whether it is because the short run costs appear large compared to benefits which are rather uncertain and only accrue in the long run.

The analysis itself can best be carried out in a theoretical model to get at the issue of what happens when the reform process is endogenised. We propose to use a linearised Obstfeld-Rogoff type model, but modified to provide the kind of asymmetries of flexibility which we have already introduced into Bayoumi's (1994) original model of gains from joining a monetary union. However, given the complexity of the problem, straightforward closed form results are not usually possible in this set-up, even in simple cases. We need therefore to resort to numerical simulations. To do this we merge our previous analysis, which allows different degrees of rigidity of wage bargaining or labour mobility with asymmetric supply shocks and asymmetric trade links, into the Obstfeld-Rogoff model to give proper foundations for the consumption, investment, wage and price setting decisions.

As these numerical simulations can only produce model-specific "stylised fact" results, we will have to supplement them in a second stage with a corresponding set of simulations run through a multicountry econometric model with similar characteristics, such as IMF's multicountry model MULTIMOD. That would give an idea how realistic our results could be expected to be. As a research strategy, it follows

the standard approach of using smaller theory based models as a tool for teaching us what the important features of the solution are; and then using econometric (model) simulations to show what are likely to be the quantitative importance of the results in practice.

## 2 Visibility/dissemination

We have already accepted two invitations to present papers from this project. First, a conference on "Fiscal Aspects of the EMU", organised by Prof Rick van der Ploeg on behalf of the Robert Schuman Centre at the European University Institute in Florence, Italy, on April 4-5, 2003. Second, we have been invited to present a paper at a session on "The euro and enlargement", at the Annual Meeting of the American Economic Association, to be held in San Diego, CA, on January 2-5, 2004.

## 3 Time schedule

The work will be carried out during February 2003 - February 2004. We intend to work in two stages. The econometric work, since it is based on an existing model with only limited modifications, will be completed after six months. The theoretical modelling, and analytical model solution, is more complicated and will take the full year to complete.

## 4 Budget

Forskningsassistance	DKK 50,000
Rejse- og opholdsudgifter	DKK 25,000
Frikøb, 2 måneder (professor) <sup>2</sup>	DKK 108,104
Total	DKK 183,104

## References

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——— (2002): "EMU, Enlargement, and Structural Reform," mimeo, Centre for Economic and Business Research, Copenhagen.

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<sup>2</sup>See <http://www.ku.dk/pers/>

- (2003a): “On the Enlargement of Currency Unions: Incentives to Join and Incentives to Reform,” in *European Macroeconomic Policies After Monetary Unification: Fiscal Policies, Monetary Policies and Labour Markets*, ed. by R. Beetsma, C. Favero, A. Missale, V. A. Muscatelli, P. Natale, and P. Tirelli. Cambridge University Press, Cambridge, UK, to appear.
- (2003b): “On the Role of Labour Market Reform for the Enlargement of a Monetary Union,” *CESifo Economic Studies*, to appear.