

Stephen Sacht

On the Efficiency of Labor Market Reforms: How to Solve the Spanish Puzzle?

September 2015

### **Reply to the Referee No. 1**

First of all I would like to express my thanks to the referee for her/his effort, comments and suggestions which lead to an improvement of the paper. In the following I paste specific points from the referee reports (in italics) and state how I react to them. Based on the referee report, a revised version of the paper (including all changes with respect to the minor comments) will be uploaded as soon as possible to the journal's home page.

*Comment 1a): A first problem with the paper refers to the approach followed to investigate the links between the mentioned variables and the focus on the chosen determinants. If the relationship between labour market reforms, policies to support entrepreneurial activity and job creation is clear — this is chiefly a structural problem – the consideration of monetary policy may be misleading and incomplete.*

It has to be emphasized that the focus is not on monetary policy but on downward nominal wage rigidity instead. Based on the latter, expansionary monetary policy interventions might increase the possibility of market entry for unemployed people as inflation goes up. My argumentation in the paper relies on the fact that given the zero-lower-bound constraint, i.e. in a situation of a liquidity trap, even a unorthodox policy strategy (like quantitative easing) can not prevent a decline in the Spanish inflation rate. Of course, the effectiveness of such a policy depends also the degree of economic heterogeneity among the Euro Area member states as argued by the referee in her/his report (see Comment 2b)).

*Comment 1b): Of course, in the short run employment and unemployment depend also on macroeconomic policies; but why does the paper deal only with monetary policy? Fiscal policies, EU rules on the budget, austerity measures are not important?*

On page 12 (and page 7), I already state that due to the high debt-to-GDP ratio close to 100 %, fiscal policy seems to be not a valuable option as the Spanish government will stick to its own target of sustainable fiscal consolidation. As the availability of this kind of macroeconomic policy is limited, the focus is on the structural labor market reform in 2010.

*Comment 2a): Analytically, the A. uses the simple AD-AS model to investigate the mentioned links. This is helpful to easily incorporate the liquidity trap hypothesis (vertical AD curve). However, note that the AS curve might have a positive slope even without assuming downward nominal wage rigidity (page 8).*

I disagree with the referee on this point. As we assume that the nominal wage is not (down- and upward) rigid, a change in the price level leads to an one-to-one adjustment of the nominal wage. Hence, the neoclassical paradigm holds, where the rate of (un)employment does not change and the AS curve exhibits a vertical slope.

*Comment 2b): Moreover, the statement “The central bank lowers the nominal interest rate” (page 9) is unrealistic if the model refers to the Eurozone; the ECB cannot act in response to the macroeconomic situation of an individual country.*

I agree with the referee that the formulation is not entirely clear. The sentence describes the adjustments on the demand side according to the Keynes effect. In fact, the nominal interest rate declines sharply between 2008 to 2010. This is displayed by the movement from  $Q_0$  towards  $Q'_0$  under consideration of the impact of the labor market reform in 2010 (which leads to a right shift of the AS curve). Indeed, this change in the nominal interest rate mimics the global reaction of the ECB to the price dynamics in the Euro Area and not to the Spanish economic situation alone. For a better understanding I will change the sentence accordingly.

*Comment 3): Most important, the difference between the pessimistic scenario (left graph of Figure 1) and the optimistic one (right graph of Figure 1) strictly depends on the behaviour of expectations ( $E$ ), but it is not so sure that in one case they worsen and in the second case they improve.*

It goes without saying that the assumption of pessimistic and optimistic expectations is a crucial one. Pessimistic expectations are mimicked by the dramatic decline of real private expenditure as reported by the DSI Global Economic Statistics and as discussed on page 8. Over the period from 2007 to 2013 we observe negative values of this measure (except for 2010). Afterwards a reversal in investment activity occurs in 2014. This reversal can be interpreted as a change from pessimistic to optimistic expectation formation. I will include additional data on the annual changes of real investment expenditure. Furthermore note that this change resembles an important cornerstone of my analysis (with respect to entrepreneurial activity). On page 12, I state that “[o]bviously, no change (or even a decrease) in  $E$  seems to be counterintuitive since in this case an entry of a new firms goes along with an expected zero (negative) return on investment.”

*Comment 4: Concerning empirical data (table on page 5), it is strange that they do not include the wage dynamics, given the strong assumption of downward wage rigidity. In the text the A. just quotes a paper arguing for nominal hourly wage increases up to 2011; but afterwards? Some different wage measures?*

I enlarge Table 1 by including data on nominal hourly wages provided by the International Monetary Fund. The same index measure as in Schmitt-Grohé and Uribe (2013) is applied, while I report also the missing numbers up to 2014. As we allow the nominal hourly wages being a measure for the degree of downward nominal wage rigidity, the data show that nominal wages increases continuously. This holds except for 2014, where the negative inflation rate in this year resembles a strong argument for lower nominal wages in the negation process. A corresponding change in the text on page 5/6 will be made. An additional comment on the minimum wage can be also found in the recent version of the paper (see footnote 5 on page 10).

*Comment 5: Furthermore, given the positive effects coming from the 2013 Decree on entrepreneurial activity, job creation and reduction of youth unemployment, some additional data would be useful. For example data on the incidence of self-employment vs. employees among young people; or also some evidence on job creation due to start-ups. In all, the argument proposed in the paper could benefit from presenting more complete empirical data concerning the relevant relationships (although in the conclusions the A. states that econometric investigations will be made in future research).*

I totally agree with the referee on this issue. Data on the correlation between entrepreneurial activity and youth unemployment dynamics will be indeed helpful. Unfortunately, such kind of data is as far as I know not available yet. A discussion on that issue based on the literature can be found on page 12. However, in Section 4, I show that the business environment for start-up had improved, while I then argue that the Entrepreneurs Act of 2013 might account for a reduction of youth unemployment in the future.

*Comment 6: On the other hand, the AD-AS model could be moved to an Appendix and, in any case, it should be better explained.*

The AS-AS framework is the core of my theoretical analysis. On the one hand the model helps to understand on the origin of the *Spanish Puzzle*, while on the other hand it can be used to discuss the impact of the Entrepreneurs Act. Therefore, the model is essential for the discussion in the main text.