

Discussion of paper by **Giuseppe Bertola and Anna Lo Prete**

## **“Reforms, Finance, and Current Accounts”**

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**CEPR Fourth Annual Workshop on Global Interdependence**  
**EUI - Florence, 6-7 March 2009**

**The usual disclaimers apply.**

# I. Main points of paper

- Effect of labour market “reforms” (L) on current account positions via two channels
  1. Higher productivity / expected future income: C smoothing
  2. More risk/uncertainty: precautionary S
- Role for financial constraints (F): channel 1. relatively more important when lower financial constraints
- Theoretical model linking L reforms to L mobility, productivity and risk; introducing also borrowing constraints

# Main points

- Empirical: channel 2. via risk/uncertainty dominates
  - F improvements enhance CA position
  - L reforms also improve CA position, but less for less financially constrained economies
  - Combined L-F component leads to  $C \downarrow$ ,  $Y \uparrow$ ,  $I \uparrow$ , ineq.  $\uparrow$
- Academic contribution: Insight that uncertainty has impact on decisions by consumers & investors
- Policy: L reforms may be detrimental to C (at least in short run) and may help correct external imbalances

## 2. Theoretical model

- 2-period, 2-sector model following Bertola (2004)
  - Workers need to decide about mobility in period 1: whether or not to take risk and costs to move towards productive sector in period 2
  - Uncertainty about pay-off in period 2 plus borrowing constraints affects C behaviour in period 1
  - Redistribution effects within economy: L reforms raise production  $Y$  (and  $I$ ) but also inequality/wage dispersion

### 3. Empirical test

$$CA/GDP_{j,t} = \alpha_{(j)} + \beta_L L_{j,t} + \beta_F F_{j,t} + \gamma (F_{j,t} L_{j,t}) + \varepsilon_{j,t}$$

- L three-dimensional: employment protection, union density, marginal tax rate
- F: Loan-to-value ratio
- 19 OECD countries, 1980-2003, annual data in benchmark
- Various controls, including time FE and country FE
- Null hypotheses:  $\beta_L \neq 0$ ?,  $\beta_F < 0$ ,  $\gamma < 0$

# Benchmark results (Table I)

<b>Dependent variable: Current Account/GDP</b>		
	1	2
<i>Structural Reform Variables</i>		
Employment Protection	4.1869 2.96	4.0018 3.45
Trade Union Density	2.3145 1.10	6.2827 2.41
Marginal Tax Rate	1.8438 2.24	1.4618 1.63
Main effect of Financial Development	0.3268 2.55	2.2694 7.39
<i>Financial Development interaction</i>		
Relative LTV	-0.0878 -4.48	-0.0551 -6.76
<i>Control Variables</i>		
Government Balance/GDP	0.3218 6.03	0.2622 5.22
Country effects	no	yes
Period effects	no	no
Number of observations	393	393
R2	0.1778	0.5139

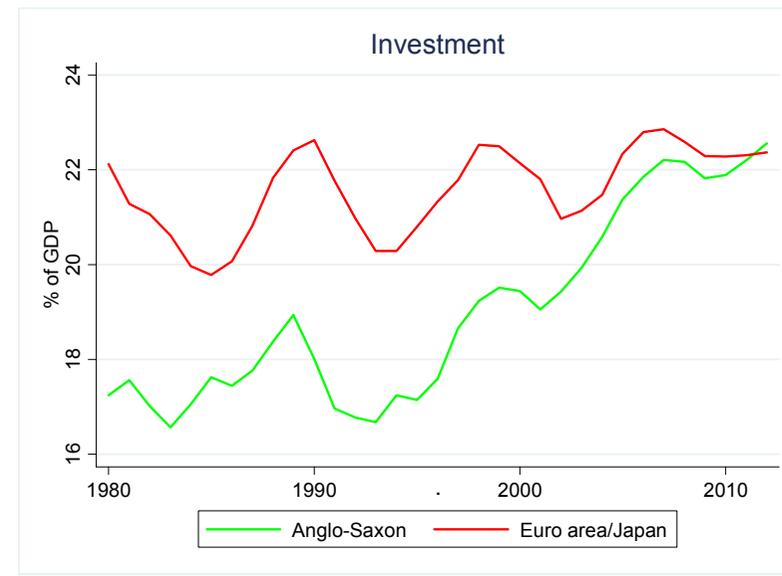
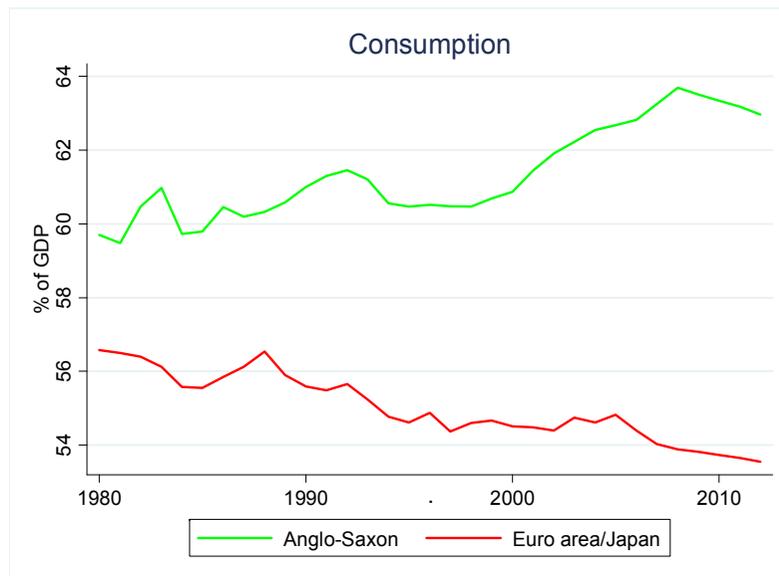
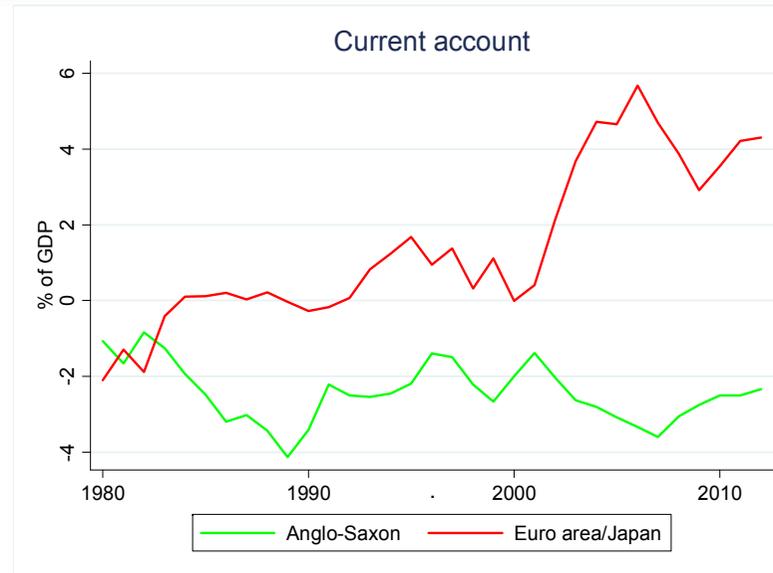
# Empirical results (Table 2)

Dependent variable: Current Account/GDP	External and demographics controls		
	1	2	3
<i>Structural Reform Variables</i>			
Employment Protection	3.0549 2.40	2.7694 2.76	1.4284 1.24
Trade Union Density	1.8948 0.95	5.3243 2.61	5.8918 2.60
Marginal Tax Rate	1.0441 1.02	0.0695 0.07	0.3384 0.34
Main effect of Financial Development	0.5467 3.80	3.3469 12.55	3.1014 6.16
<i>Financial Development interaction</i>			
Relative LTV	-0.0788 -5.04	-0.0426 -6.33	-0.0462 -5.80
Relative financial openness			
<i>Control Variables</i>			
Government Balance/GDP	0.3921 7.11	0.2089 3.94	0.2596 3.83
Terms of Trade	8.4897 2.82	6.2027 1.89	6.0258 1.81
Real Effective Exchange Rate	-2.3400 -0.79	-0.7036 -0.27	0.8315 0.32
Demographics	-0.1975 -1.89	-0.0679 -0.47	0.0940 0.64
Relative GDP level per capita			
Country effects	no	yes	yes
Period effects	no	no	yes

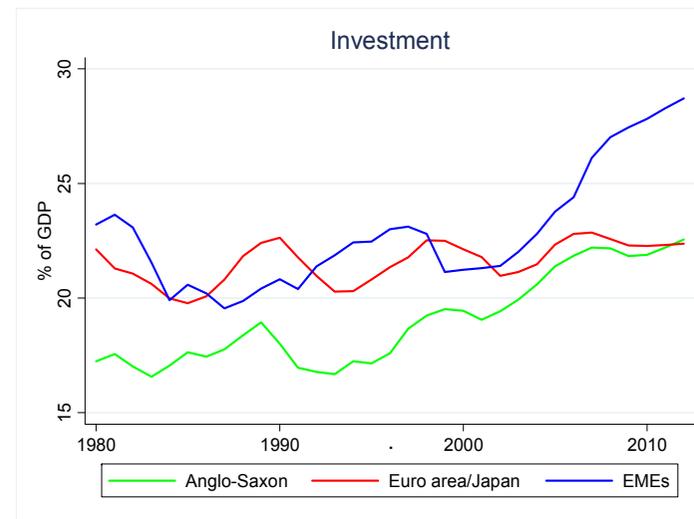
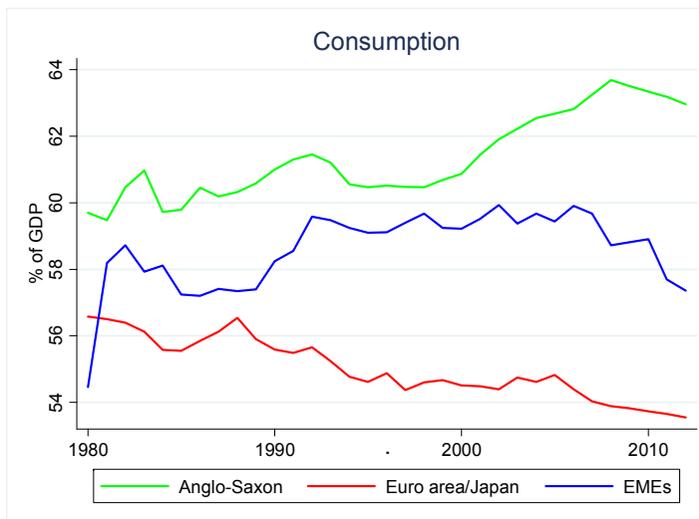
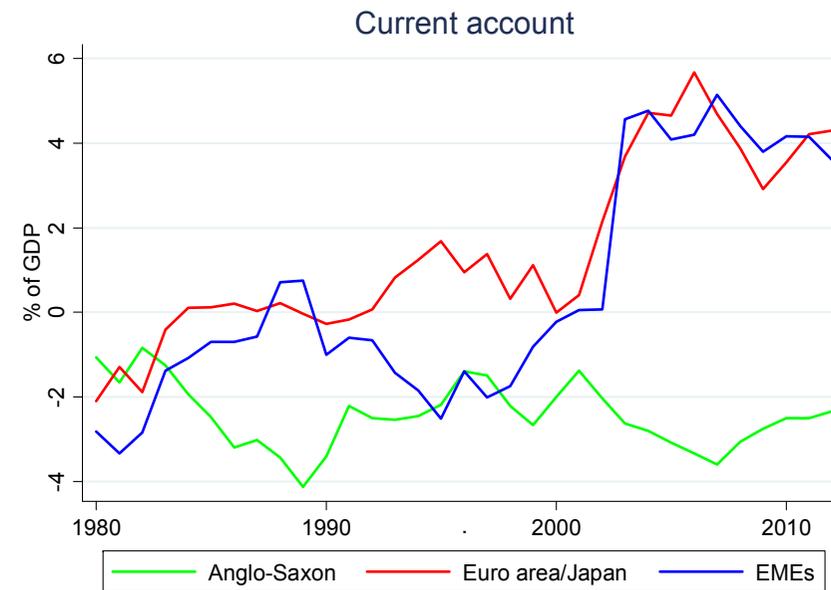
# Some queries

- $\beta_L > 0$  – is not a sufficient condition to argue that precautionary S motive dominates
- Marginal effect of L reform is  $\delta CA_{j,t} / \delta L_{j,t} = \beta_L + \gamma F_{j,t}$
- What is this marginal effect, e.g. at cross-country mean of F? Does the marginal effect differ across indiv. countries?
- Change over time: with  $F \uparrow$  over time, has directional effect of L reform on CA changed?
- Same for F:  $\beta_F > 0$  not necessarily counter-intuitive sign

# 4. Global consistency: A few stylised facts...



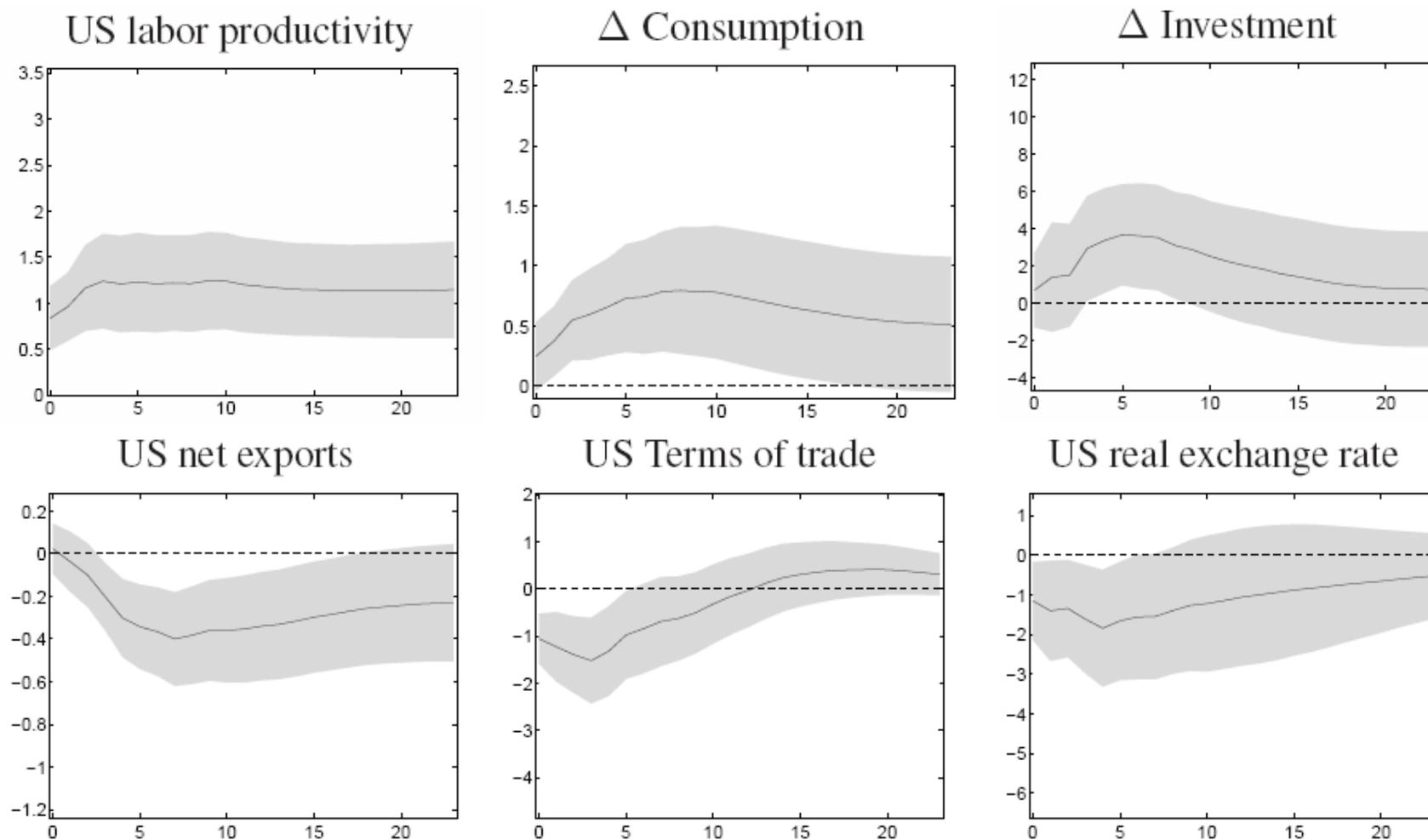
# Global consistency: A few stylised facts...



## 5. Relation to literature

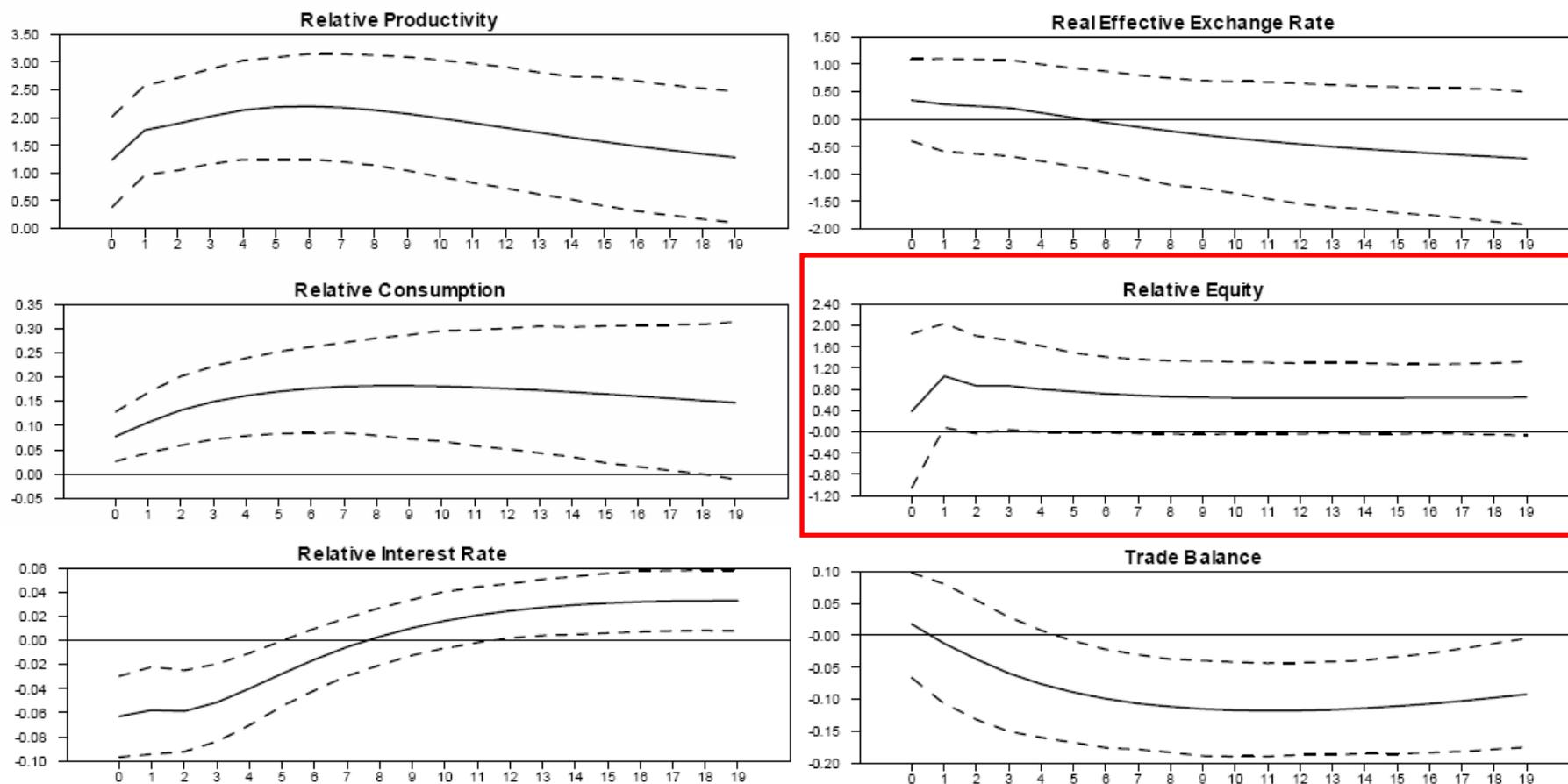
- Evidence that positive productivity shocks *worsen* net exports (Corsetti, Dedola & Leduc 2007, Enders & Müller 2008)
  - CDL 2007: Appreciation of terms of trade and RER may be rationalised through home bias, financial market incompleteness and low trade elasticity (or high shock persistence)
- link between relative prices, relative wealth and incomplete C risk sharing (Backus-Smith puzzle)
- EM 2008: financial market incompleteness is key in explaining decline in net exports, and S-shaped correlation between terms of trade and trade balance due to prod. shock (as in Backus, Kehoe & Kydland 1994)

# Productivity shocks and the trade balance: role of terms of trade and RER



Source: Enders & Müller (2008)

# Productivity shocks and the trade balance: role of wealth effects via asset prices



Source: Fratzscher, Juvenal and Sarno (2007),  
Fratzcher and Straub (2008)

## 6. A few additional queries

- Mostly static analysis of contemporaneous effects
- Relative variables for L may be useful
- Measurement of F – is to loan-to-value ratio a good proxy for financial constraints of households ?
  - Robustness with Lane – Milesi-Ferretti (EWN Mark2, 2006)
  - More standard measures in literature are Whited & Wu (RFS 2006) and Lamont, Polk and Saa-Requejo (RFS 2001)
- Second step: effect of L and F on C, I, Y, and inequality:

$$C / GDP_{j,t} = \alpha_{(j)} + \beta \text{ Fitted } LF_{j,t} + \dots + \varepsilon_{j,t}$$

- Why use of fitted component from CA equation?

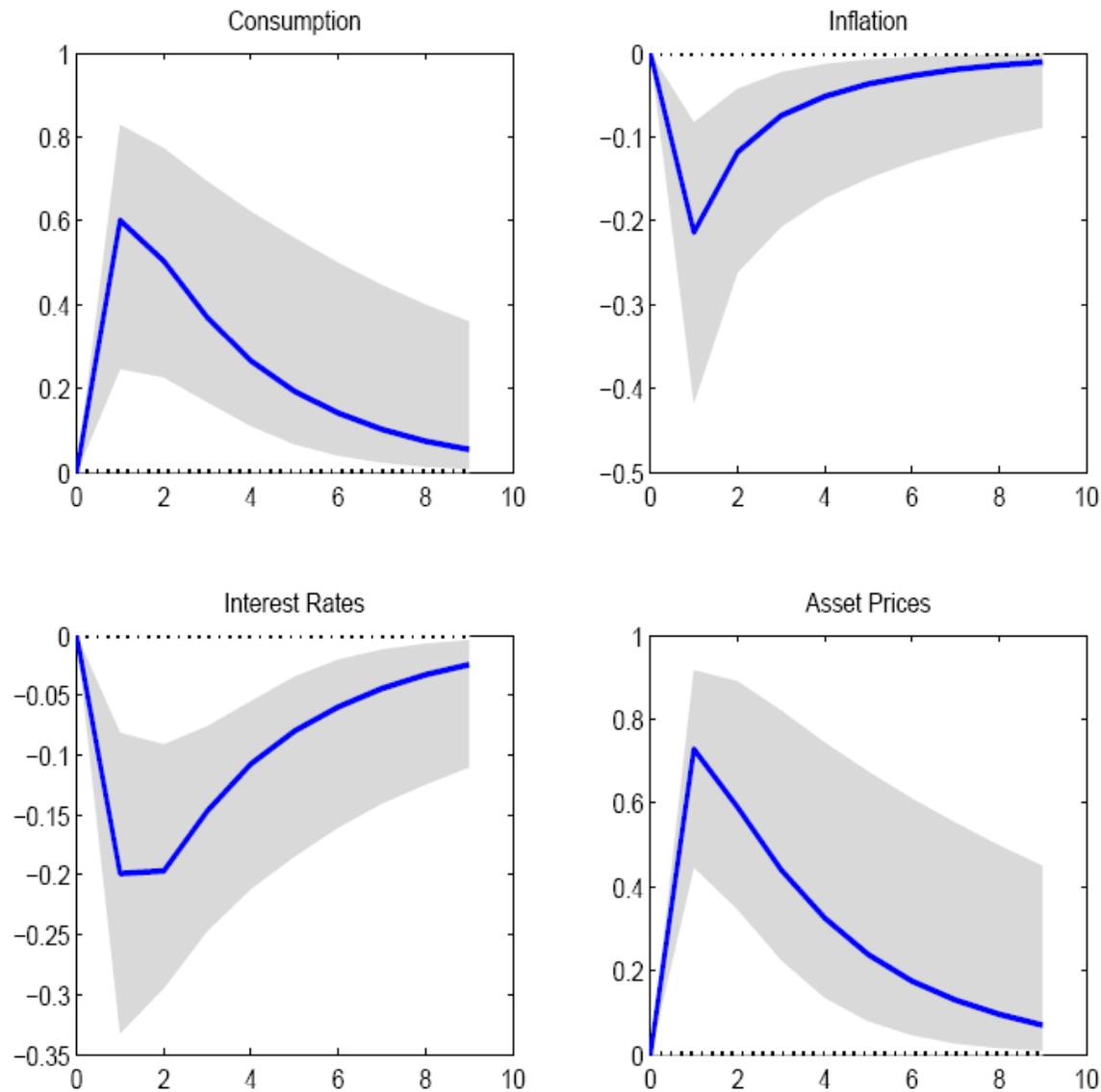
# Summing up

- Novel angle on debate of drivers of current accounts
  - Focus on uncertainty stemming from labour market reform
- Ideal would be to have a structural model
  - Identification and distinction of productivity shocks vs. shocks to uncertainty/risk stemming from labour market reforms
  - Closer anchoring to existing literature

“In our basic specification, *deregulation is associated with smaller current account deficits, and the size of this effect is larger where financial markets are less developed.* This finding can be explained by precautionary saving behavior in response to stronger labor income risk.” (page 4)

# Annex

# IR for a productivity shock in a general equilibrium framework



**Source:**  
**Fratzcher & Straub (2008)**