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Research Report

Reform momentum and its impact on Greek growth

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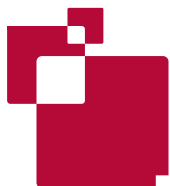
REFORM MOMENTUM AND ITS IMPACT ON GREEK GROWTH

ALESSIO TERZI

Highlights

- Greece has an imperfect track-record of structural reform implementation. However, the poor growth outcome of the Greek programmes is also a consequence of the timing and composition of reforms, which were not optimally geared towards a speedy transition to a new growth model based on the private sector. While the main responsibility for this lies with the Greek authorities, international institutions share the responsibility for the poor growth-enhancing effect of reforms.
- In the current context, further structural reform efforts should be mainly targeted at supporting Greece's speedy return to solid growth rates. This is not only because poverty and unemployment have reached very high levels, but also for political economy reasons: reforms must quickly be seen to be working in order to buttress the consensus in favour of reform.
- Further efforts should be made to improve Greece's business environment and to liberalise product markets, in addition to shifting taxation away from labour and towards consumption. Reforms to improve the quality of institutions should continue and are very much needed in the Greek setting, while taking into account that their demanding implementation might use up administrative capacity and their impact on growth will only be seen over long time horizons.

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REFORM MOMENTUM AND ITS IMPACT ON GREEK GROWTH

ALESSIO TERZI, JULY 2015

1 INTRODUCTION

Following the unexpected revelation of large shortfalls in its public accounts, Greece had no choice but to apply for an International Monetary Fund/European Union macroeconomic adjustment programme in May 2010, because financial markets were no longer willing to refinance its debt.

In general, IMF-led adjustment programmes operate on the basis of three core principles: (i) securing external financing, (ii) adopting domestic demand-restraining measures consistent with available financing, and (iii) proceeding with structural reforms to promote growth and adjust in the medium term (Mussa and Savastano, 1999). To prevent moral hazard, lending is provided in tranches, which are disbursed only following periodic reviews that confirm that the conditions attached are being respected.

Given the multiplicity of objectives, it is hard to take a clear-cut position on whether programmes are successful or not (see Sapir *et al*, 2014). The ultimate objective, however, is growth – former IMF managing director Michel Camdessus said in the 1990s that “*it is towards growth that our programmes and their conditionality are aimed*”¹. From this standpoint, after five years of assistance, it is safe to conclude that the Greek programmes have not delivered anywhere close to a satisfactory outcome. There are differences of opinion, however, over the causes of this failure. Some of the reasons most frequently given include:

1 **The ‘Original sin’ argument:** Given the size of the Greek economy and the imbalances it accumulated, the degree of macroeconomic adjustment needed was daunting. This translated into debt projections (and hence a programme) that the IMF staff even in 2010 considered largely unsustainable (and hence unrealistic), only to

be over-ruled by the IMF Executive Board on political grounds (Schadler, 2013). The first programme foresaw a GDP fall of 7.5 percent and financing was calibrated to this scenario. When the economy contracted sharply, Greece had to undertake more fiscal consolidation, because financing was provided in nominal terms (see Darvas, 2012). This connects us to points 2 and 3, below.

2 **Austerity:** Because of its public finance origin, the Greek crisis was mainly tackled with fiscal austerity measures, which weighed on growth more than initially foreseen because fiscal multipliers were underestimated (Blanchard and Leigh, 2013) and led to a deflationary spiral (Mazzolini and Mody, 2014).

3 **Delay in debt restructuring:** The pretence that the Greek public debt was sustainable, while it was widely acknowledged not to be, led to a highly uncertain situation in 2010-12. The uncertainty meant that the private sector held back from investing and caused capital outflows, undermining the financial sector and, ultimately, the recovery.

4 **Institutional gap:** Connected to point 3 above; Greece was the first euro-area country to apply for a bailout, meaning that there was a high degree of uncertainty in the early stages of the Greek crisis. No crisis management or lending facility was in place at European level and the fear of a default and euro-exit was prevalent. This again acted as a drag on investment and ultimately growth (Pisani-Ferry *et al*, 2013).

5 **Common currency trap:** Greece’s low productivity was so misaligned with prices that only a significant devaluation could have helped to restore its competitiveness and kick-start the economy. And indeed when intervening in countries with a fixed exchange rate, the IMF

1. ‘Our primary objective is growth,’ Michael Camdessus, former IMF Managing Director, Statement before the United Nations Economic and Social Council in Geneva, 11 July 1990, cited in Przeworski and Vreeland (2000).

more often than not advocates a de-anchoring². However, this was not possible within a monetary union and required a very sharp and protracted internal devaluation that will continue to weigh on growth.

More recently, a sixth reason has been put forward: **the degree of implementation of structural reform**. Aslund (2015), for example, claims that it is not austerity that explains Greece's poor growth performance, but rather the lack of progress on reform implementation. This point was echoed by Blanchard (2015). Terzi (2015), on the other hand, uses World Bank and Organisation for Economic Cooperation and Development (OECD) indicators to show that significant steps were taken to improve the country's non-price competitiveness during the programme years, a finding confirmed by Darvas (2015).

The time is therefore ripe to analyse in fine detail the conditions attached to the Greek programmes and to look in particular at the degree of structural reform implementation under the first and second programmes, the speed at which implementation took place, and the headings under which reforms were enacted, especially compared to the other euro-area programme countries: Portugal and Ireland³. Greece has implemented significant reforms. However, both in terms of timing and composition, they have not been optimally geared towards a swift transition to a new growth model based on the private sector.

1.1 Literature on the impact of structural reforms

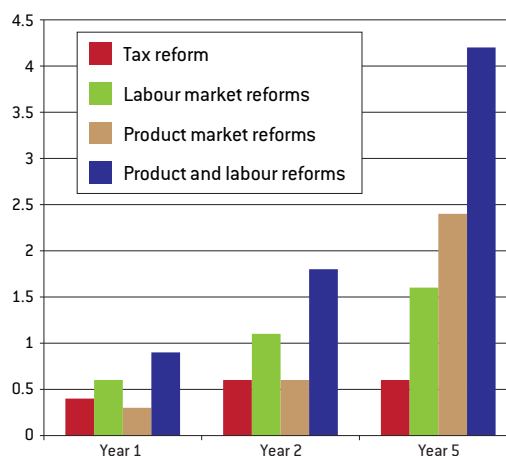
The literature on the growth impact of structural reforms is very broad. However, selected key findings of relevance for the Greek case include:

1. Product market reforms⁴ are those most likely to have the greatest positive impact over the short- to medium-run, particularly in the tradable sector. This is a finding corroborated by various papers for industrialised countries (see IMF WEO, 2004; Cacciatore *et al*, 2012), for the euro area (Barkbu *et al*, 2012), for the euro-area periphery (see Anderson *et al*, 2013) and for Greece (see Varga *et al*, 2013). However, as Figure 1 shows, most of these effects take at

least four to five years to materialise. This is not the case for all reforms: tax reforms⁵, for example, are expected to have a significant positive impact on output in the short run (Barkbu *et al*, 2012, IMF WEO, 2004). Similarly, restoring the soundness of the financial sector is likely to benefit growth already over a shorter-term horizon by lifting credit constraints.

2. Synergies exist between product and labour market reforms. As shown by Bassanini and Duval (2009), the impact of individual structural reforms will be greater the more market-friendly the institutional environment. As such, well-designed reform packages are likely to yield stronger results than piecemeal reforms. This result is corroborated by Anderson *et al* (2013) who show (also see Figure 1) how the effect of joint product and labour market reforms is greater, particularly over a five-year horizon, than the sum of the individual impacts. This result is in line with ECB (2014)⁶.
3. Institutional reforms take time to implement and are not a *sine qua non* for a swift return to growth. The fact that a strong correlation exists between high quality institutions and economic prosperity is unchallenged (see Appendix). However, building on the findings of Hausmann *et al* (2005), Rodrik (2007) details how growth accelerations have been possible over the past decades with minimal institutional change. This is echoed by Haggard

Figure 1: GDP effect of selected structural reforms in the euro-area periphery, percentage point deviation from baseline



Source: Anderson *et al*, 2013.

2. A similar argument was made for Latvia, which however chose, on political grounds, to keep the peg to the euro and face a sharp internal devaluation.

3. Cyprus and Spain also went through assistance programmes, but are excluded for the analysis for different reasons. The Spanish programme was focussed on the banking sector and did not involve the IMF. As such, it is not contained in the MONA database. The Cypriot programme is contained in MONA but, is still at an early stage of its implementation, and is largely centred on the banking sector (as Ireland).

4. Usually modelled as a reduction in final goods' price mark-ups.

5. Usually intended as a shift of taxation away from labour and towards consumption.

6. Although most of the literature suggests there is a clear complementarity between product and labour market reforms, it should be mentioned that selected theoretical papers, such as Amable and Gatti (2004), suggest a potential substitutability over the long run.

(2000) who underlines how changes in organisational routines, the creation of new institutions (such as regulatory agencies or tax-collection agencies), or fundamental changes in existing bureaucratic organisations take a long time to reach fruition even if initiated quickly. If administrative and reform implementation capacity is constrained, and if a quick return to growth is considered crucial, priority should be given to other structural reforms that are likely to be growth-enhancing already in the short- and medium-term.

2 GREECE'S REFORM EFFORTS IN PERSPECTIVE

Quantifying structural reform efforts and consequentially determining the degree of implementation of IMF adjustment programmes are notoriously problematic (Dreher, 2009). In line with Ivanova *et al* (2003), this Policy Contribution makes use of the IMF's *Monitoring of Fund Arrangements* (MONA) database, which contains detailed information on all measures taken as part of programme conditionality and, in particular, tracks whether structural reform targets were met, partially met, met with a delay, waived, or not met, by the time of each programme review. This allows calculation of the percentage of structural conditionality that was implemented. This approach is in line with work carried out on the topic by the European Commission (see Deroose and Griesse, 2014) and the OECD (see OECD, 2012).

Making use of MONA-based indicators of reform implementation has clear pros and cons. On the positive side, the granular nature of MONA allows the types of reforms that were implemented at each stage of the programme to be tracked in detail. On the negative side, all reforms are weighed equally, whereas some measures are surely qualitatively and quantitatively more important than others. To alleviate this concern, we also cross-check the MONA-based findings with alternative indicators of structural reform timing and effort (Box 1 on page 9).

2.1 Structure of the programme

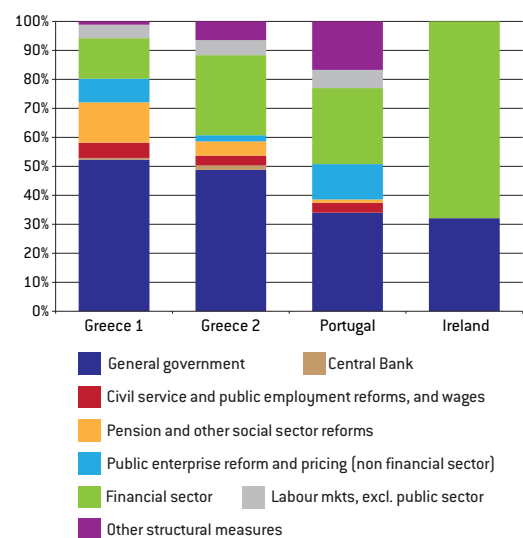
Before looking at reforms that have been implemented, it is interesting to look at how programme conditionality differed in different euro-area pro-

gramme countries. Figure 2 shows the composition of reforms under the IMF's structural benchmarks heading for the first and second Greek programmes, Ireland and Portugal. At this stage no account is taken of whether reforms were implemented or not.

Compared to Ireland and Portugal, both Greek programmes significantly emphasised the restructuring of the government's operations. This is unsurprising given the public-sector origin of the crisis in Greece. Public enterprise reforms were less at the centre of the Greek programmes than in Portugal. The Irish programme was (unsurprisingly) very focussed on financial sector restructuring.

There were also sharp differences between the first and second Greek programmes. The former was less focussed on the financial sector and more on pensions, the civil service and public enterprises than the latter. Moreover, other structural measures (which includes reforms aimed at improving the business environment) gained more importance in the second programme. This is something already documented by Terzi and Wolff (2014) using a term-frequency methodology to examine programme documents in order to grasp the general direction of conditionality.

Figure 2: Conditionality by reform headings, euro-area country programmes



Source: Bruegel based on IMF MONA database. Note: categories used in the chart (eg general government, central bank) are the original headings used in the IMF's MONA database. No filtering has been done for implemented or non-implemented measures.

2.2 Implementation of structural reforms

Although programme design and tailoring to a country's economic situation is important, success will ultimately depend on whether structural reforms are implemented. In order to assess the degree of programme implementation, Figure 3 shows the breakdown of the MONA-based implementation index described in the introduction to this section and in Ivanova *et al* (2003)⁷.

From this analysis, Ireland comes out as the clear best performer with a close to perfect implementation record. Interestingly, however, Portugal and Greece (taking the first and second programmes together) do not differ much in the share of programme conditionality fully implemented, both hovering around the 80 percent mark. But differences emerge in terms of non-implementation. Portugal experienced a large share of delays but implemented almost the full (non-waived) set of conditions in the end. Greece did not implement roughly 10 percent of the structural reforms discussed with the creditors under the first and second programme, and delayed just as many.

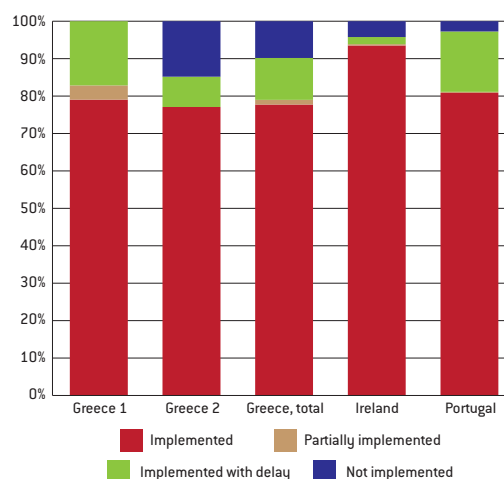
It is worth noting a difference between the first and second Greek programmes. The first saw a high share of delays, but most of the reforms were ultimately implemented. This is in line with the expert survey-based findings of Pisani-Ferry *et al* (2012). The bulk of Greek non-implemented measures are to be found in the second programme.

This indicates that the time dimension might be of relevance. Figure 4 shows the pace of reform implementation, displaying the number of new reform measures implemented in Greece, Ireland and Portugal between each review. Note that because each programme had a different starting date, each review had a different date, and Figure 4 shows the order of reviews for each country.

As can be seen, the pace of reform implementation started slowly in Greece and picked up after the first review. This is a common trend in all programmes, because reforms require time to be designed and implemented. Although systematically below the pace of implementation of Portugal (except for the fourth review), Greece was broadly in line with the other countries during the first pro-

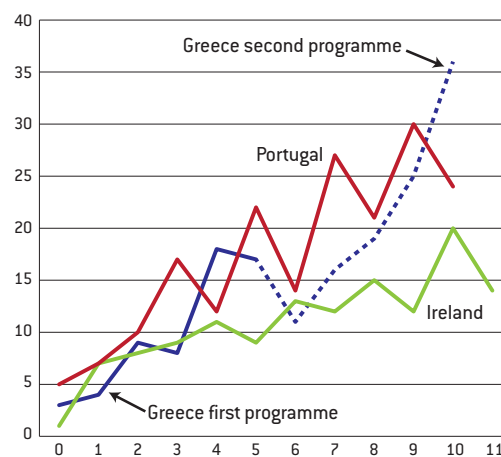
gramme. However, implementation of reforms by Greece lost momentum towards the end of the first programme (5th review) and in the transition to the second Greek programme, as noted by Pisani-Ferry *et al* (2012). As the new programme slowly phased in, reforms under new headings had to enter the legislative pipeline. As such, we observe a slow down in the number of reforms implemented under the first review of the second Greek programme. It must be noted that the pace of reform implementation picked up steadily until the last review, by when Greece was implementing more reforms (in absolute terms) than Portugal. However, by this point the reform gap, measured as the area between the Portuguese

Figure 3: Breakdown of conditionality by implementation record



Source: Bruegel based on IMF MONA database.

Figure 4: Number of reforms implemented by each review



Source: Bruegel based on IMF MONA database. Note: The x-axis uses ordinal numbers to underline that each review took place at different points in time for each programme country.

7. Waived conditions are not considered when assessing the degree of implementation.

and Greek line, was wide: over the course of two programmes and five years, Greece implemented (also partially and with delays) a total of 166 reform measures. For Portugal, this number stood at 189 over three years.

Figure 5 shows a timeline of concluded programme reviews for Greece, Ireland, and Portugal. This is particularly important because another quantitative indicator of implementation is whether reviews are broadly equally phased (see Dreher, 2009) – ideally, reviews should take place periodically (generally every quarter), with delays indicating faltering programme implementation that holds up the disbursement of subsequent loan tranches. Once again, Ireland (and to a great extent Portugal) offer two examples of programmes on track, with broadly equally phased reviews. Greece experienced two big implementation delays. The first, identified also in Figure 5, took place during 2012, when political instability following the call for a referendum on the bailout programme by Greek prime minister George Papandreou led to two consecutive elections, in May and June. The second setback took place towards the end of 2013 and the first half of 2014 when, as acknowledged by IMF (2014), adjustment fatigue had kicked in and the government majority in parliament was thinning. This also puts into perspective the Greek implementation surge identified in Figure 4: although Greece was indeed implementing more reforms than Portugal by the time of its last review, these were achieved over a one year period while the Portuguese reviews were repeated every two to three months. All in all, it is fair to conclude that Greece’s implementation was far from perfect.

2.3 Timing and composition of reforms

Exploiting the granularity of the IMF MONA database to its fullest extent, Figures 6-8 detail the timing and composition of reforms implemented⁸ in Greece under the first and second programmes, and in Portugal, as a comparison. MONA identifies whether reforms have been implemented and also tracks them over time to verify that they are not reversed later in the programme. This implies that in Figures 6-8, the last review available will effectively offer an overview of the composition of all reform measures implemented (and not reversed) during the whole programme.

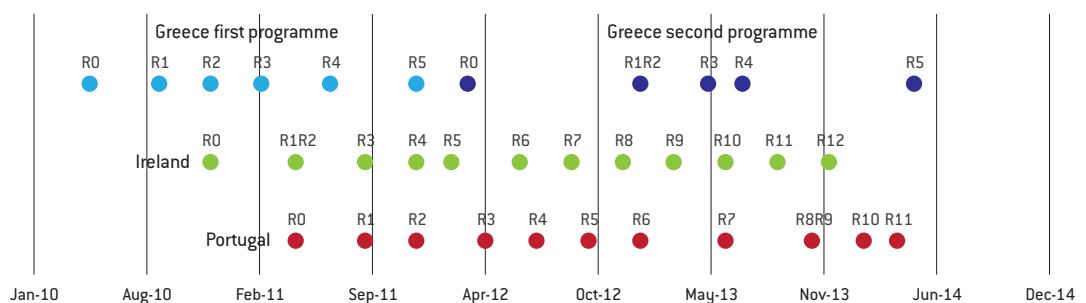
In line with the findings of Pisani-Ferry *et al* (2013), Figure 6 shows how at its inception the Greek programme was almost entirely focussed on restructuring the public sector: redesigning the tax system and increasing transparency (under general government), reducing the public wage bill (under civil service reforms), preparing privatisation plans (under public enterprise reforms) and containing pension spending. Reforms targeted at restoring confidence in the financial sector started to take effect from September 2010 (R1) but were clearly not a main component of the implementation effort, especially when compared to Portugal (see discussion below). Labour market reforms can be observed only from early 2011 onwards (R3).

As a consequence, and perhaps unsurprisingly, almost two years into the Greek programme, in March 2012, the memorandum attached to the request for an extended arrangement⁹ included an unambiguous recognition that what could be observed was “a good deal of primary fiscal adjustment” but only “some improvements in unit

8. Throughout this section, attention is only paid to whether reforms were implemented and when. No distinction is made between reform measures that were implemented, or implemented with delay.

9. The first Greek programme was replaced by a second under the IMF Extended Fund Facility in March 2012. See <http://www.imf.org/external/np/sec/pr/2012/pr1285.htm>.

Figure 5: Timeline of programme reviews



Source: Bruegel based on IMF MONA database.

Figure 6: Composition of implemented reforms in the first Greek programme, breakdown by review

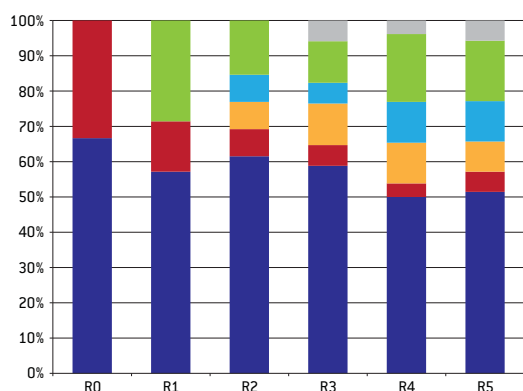


Figure 7: Composition of implemented reforms in the 2nd Greek programme, breakdown by review

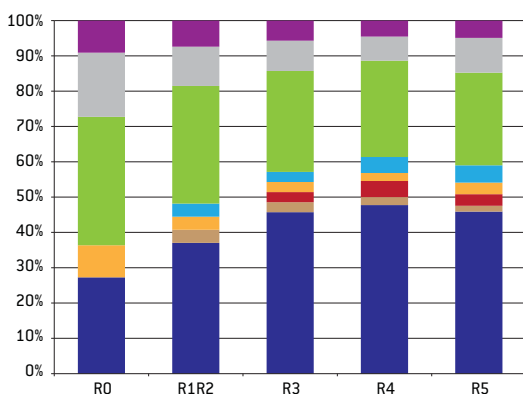
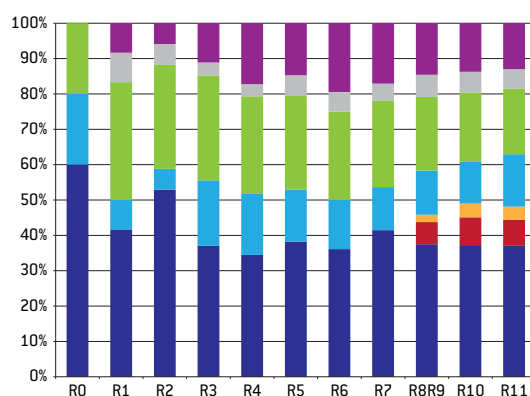


Figure 8: Composition of implemented reforms in the Portuguese programme, breakdown by review



Key for Figures 6-8:

- General government
- Civil service and public employment reforms, and wages
- Pension and other social sector reforms
- Public enterprise reform and pricing (non financial sector)
- Financial sector
- Labour mkt, ex. public sector
- Other structural measures
- Central Bank

Source for Figures 6-8: Bruegel based on IMF MONA database.
Note: R1 = first review, R2 = second review, etc.

labour costs". The European Commission (in line with the IMF) concluded that there was a need to recalibrate the programme strategy towards a growth-enhancing structural agenda, reducing the focus on fiscal adjustment (European Commission, 2012).

By comparing Figures 6 and 7, we see a change in the headline composition of structural reforms implemented under the second programme for Greece. The share of general government-related reforms dropped to less than 30 percent of the overall implementation envelope in R0 (only to return to high levels at later reviews).

After being a big omission from the first programme, measures falling under a new category of 'other structural reforms' (under which reforms improving the business environment and promoting competition are grouped¹⁰) started to be implemented from the start of the second programme, although to a limited extent. Within this category, efforts focussed on improving the business environment rather than liberalising product and service markets (Box 1). This is in line with the findings of IMF (2014) which noted in its last Greek review (R5) that progress on product and service market reforms had until then lagged behind.

Labour market reforms, on which rather slow and limited progress was made under the first programme, were a more important component of the second programme from the outset. Finally, restructuring the financial sector was straight away a more significant component compared to the first programme, and stayed significant throughout.

Figure 8 shows the composition of reforms implemented in Portugal, to provide a comparison with a country in the euro area that, like Greece, had to restore its competitiveness while dealing with unstable public finances. Apart from the first review, the Portuguese programme was characterised by less focus on reforming the government's operations compared to the Greek programmes. For Portugal, restructuring the financial sector took a central role from the inception of the programme and remained an ongoing priority. Reforms aimed at improving the labour market began to be implemented very early on (R1) in the

10. Examples of reforms falling under this heading are liberalising closed professions, liberalising product markets, removing barriers to competition in the tourism/retail sector.

programme. Reforms strictly aimed at restructuring the pension system¹¹ and civil service¹² kicked in only at a later stage in the programme.

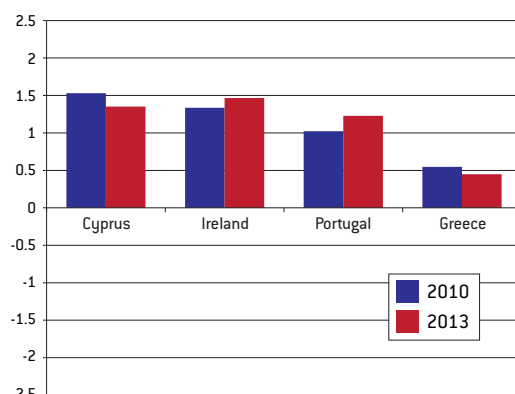
Finally, compared to both the first and the second Greek programmes, a larger share of Portugal's implementation effort was devoted from the outset to improving the business environment and promoting competition (under 'other structural measures'). In Greece, product/business environment reforms were delayed until late 2012.

2.4 Structural reforms and growth in Greece

The preceding sections have shown that neither the timing nor the composition of reform implementation in Greece was optimally geared towards a swift and strong return to growth. Under the first Greek programme, the priority was given to measures aimed at restructuring the government's operations, reorganising the civil service, streamlining the budgeting procedures and increasing fiscal transparency. These are all positive measures aimed at improving the quality and effectiveness of decision-making but very demanding in terms of implementation over the relatively short horizon of a programme, and likely to benefit growth only over the longer term.

This is particularly problematic in a country that, already at the inception of the programme, displayed very low levels of administrative capacity, bureaucratic quality, and hence implementation capacity. To substantiate this claim, Figure 9 shows a World Bank expert-survey-based indicator aimed at capturing a country's quality of civil

Figure 9: Government effectiveness indicator, -2.5 (min) to 2.5 (max)



Source: World Bank Governance Indicators.

service, degree of independence from political pressures, quality of policy formulation and implementation. Two interesting remarks: first, Greece's administrative capacity was much lower than all the other programme countries: less than half of Portugal's before the crisis. Second, notwithstanding all the effort put into improving institutional quality, Greece has suffered a deterioration (if at all a change) in its administrative capacity. As explained above, institutions are hard to change and improve over the relatively short duration of a programme. This would suggest that when dealing with limited administrative capacity, it is better to focus reform efforts on growth-enhancing measures, rather than first trying to improve institutional capacity in the hope that a more wide-ranging economic programme can subsequently be implemented.

Of course, some of these 'government-related' reforms, if not most, were considered necessary not for growth-enhancing considerations, but for fiscal consolidation purposes. However, as Rodrik (2007) put it, institutional reforms, as well as a consolidation of fiscal accounts, "can be much easier to undertake in an environment of growth rather than stagnation" or depression.

Reforms associated with a beneficial effect on output only over long time horizons, such as institutional reforms, were a large part of the Greek structural reform conditionality relative to other euro-area programmes, such as Portugal's. Tax reforms, intended as a shift of tax burden from labour to consumption, were not really observed. VAT rates increased, but this was not coupled with a reduction in the tax wedge, which remains one of the highest in the OECD (IMF, 2014). Moreover, measures aimed at improving the business environment and promoting competition were to a great extent lacking, while labour market reforms progressed independently, hence failing to exploit the synergies between the two.

Some of these shortcomings were reversed only two years down the road, in the transition to the second Greek programme, which emphasised business environment reforms more, included some continued effort on labour market reforms and aimed to restore confidence in the financial sector.

11. For example, introducing a legislative proposal that would align the rules and benefits of the public sector pension fund with the general pension regime (MEFP ¶18). Done (with delay) at R8R9.

12. For example passing a public administration labour law aimed at aligning the public employment regime with private sector rules, including for working hours and holiday time, and termination of tenure (MEFP ¶18). Partially implemented at R8R9 and then implemented (with delay) at R10.

BOX 1: Alternative indicators of reform timing and effort

International organisations have assembled a wide variety of competitiveness indicators that, in some cases, can be used to gauge structural reform efforts. However, like the MONA-based method employed in this paper, their use has significant limitations.

First, only a few of these indicators are based on legislative changes and not cyclical elements that are beyond the direct control of a government. For example, the World Economic Forum produces a Global Competitiveness Indicator which, among its sub-components, includes a measure of product market efficiency. This might at first sight look like a good indicator to measure effort and progress in product market reform. However, this pillar is constituted by elements such as imports (as a % of GDP), which are likely to fluctuate due to a number of cyclical factors, particularly during sharp recessions.

Second, assembling regulatory-based indicators of competitiveness is particularly burdensome and, as such, these are often not produced on a yearly basis. For example, the OECD's indicator of Product Market Regulation (PMR) is only published every five years (the last vintages being 2008 and 2013). This makes its use problematic in this setting, because it does not allow the timing of reforms to be gauged.

Third, these indicators are usually very specific and enable the zooming in on one specific characteristic of a policy field. For example, the OECD's Employment Protection Legislation (EPL) index focusses on flexibility of labour markets but is not well equipped to capture all reforms taking place under the labour-market heading. For example, changes to the minimum wage legislation or active labour market policies would not alter its score. As such, even a combined reading of these competitiveness indicators hardly gives a better overall assessment of wide-ranging reform packages, such as those implemented by a country under an IMF/Troika programme.

With these caveats in mind, Table 1 below illustrates the change in score of the available yearly regulatory-based competitiveness indicators as a proxy for reform progress¹³ in Greece and Portugal.

Table 1: Change in selected competitiveness indicators

		2010	2011	2012	2013	2014	total
World Bank Doing Business index	Greece	-2.0	0.5	2.0	2.4	1.7	4.6
	Portugal	2.4	1.0	1.4	-0.2	0.0	4.6
Employment Protection Legislation (EPL)	Greece	-0.6	0.0	0.0			-0.6
	Portugal	0.0	-0.6	-0.3			-0.9
Energy, Transport, and Communication Regulation (ETCR)	Greece	-0.06	-0.02	0.00			-0.08
	Portugal	-0.06	0.00	-0.13			-0.19

Source: Bruegel based on World Bank, OECD.

The first indicator analysed is the World Bank's Doing Business index, which captures the quality of the business environment. This is a particularly good indicator for our purposes as it is a wide-ranging composite index, meaning that countries could experience similar improvements while crafting reform programmes that target country-specific bottlenecks. Interestingly, Portugal and Greece experienced exactly the same improvement in their DB index over the last five years, but with a difference: Portugal concentrated its reform efforts in the early years of the crisis, whereas substantial improvements in Greece started materialising only from 2012 onwards (under the Second Greek Programme). This chimes well with our MONA-based assessment that reforms aimed at improving the business environment in Greece were delayed and, consequentially, their beneficial impact on growth was delayed.

The OECD's EPL shows how both Portugal and Greece liberalised their labour markets to a comparable extent in the first year of their respective programmes (in December 2010 in the case of Greece, which is why in MONA this is recorded under the third review in February 2011). However, unlike in Greece, in Portugal a strong reform momentum was carried through to the second year of the programme. In 2012, the EPL index for Greece marks a small improvement, which might seem to contrast with our MONA-based assessment. This is however because, rather than liberalising its labour market, Greece was reforming its minimum wage legislation, hence slipping under the EPL's radar. Unfortunately data for 2013 and 2014 is not available, because of the OECD's publication calendar and by virtue of the way EPL-based reform effort is computed.

The third indicator shown in Table 1 is the OECD's Index of Regulation in energy, transport, and communication. We see how after a comparable liberalisation effort in 2010, reforms under this heading broadly came to a halt in Greece, whereas Portugal made significant progress in 2012. Once again, unfortunately, data limitations do not allow us to capture the extent to which reform momentum sped up under the second Greek programme.

13. The associated years are not those of publication but rather, depending on the methodology of construction of each indicator, the ones in which reforms took place. For example, the OECD's EPL assesses the state of labour market regulation on 1 January each year. The change between 2012 and 2013 are hence marked as reform effort in 2012.

However, the timing and composition of reforms has led to a sharp adjustment of labour costs but less so of prices (Manasse, 2015). As Manasse (2015) explains, a fall in nominal wages (which is what matters for competitiveness purposes) that was not matched by a reduction in prices also implied a sharp contraction of real wages, which aggravated the recession rather than promoting growth. Synergies between labour and product market reforms went largely unexploited in Greece, with adverse effects on growth.

Portugal, on the other hand, adopted a timing and composition of reforms more in line with the three principles outlined in section 1.1. First, short- and medium-term growth enhancing reforms started already to be put in place from the first review (R1) onward. Second, labour market and product market reforms proceeded hand-in-hand (Figure 8 and Box 1). Third, reforms aimed at restructuring the operations of the government, including improving the civil service, did not occupy a predominant role or were phased in at a later stage in the programme. All in all, from a strictly growth perspective, this was a good recipe, which partially explains why reforms in Portugal started producing earlier and better results than in Greece.

3 CONCLUSIONS

After five years of financial assistance to Greece, exports are not yet picking up significantly, public debt hovers above the 170 percent of GDP mark, unemployment remains above 25 percent, and GDP remains some 25 percent below its pre-crisis level. Against this background, and compared to the experiences of other countries going through Troika adjustment programmes, few would define the Greek programmes as successes. However, opinions differ on the causes of the failure. In relation to one possible cause – the relatively slow implementation of reforms in Greece, and the composition of those reforms – this Policy Contribution has shown that:

- Reform efforts under the first Greek programme were very much focussed on restoring confidence in the country's fiscal accounts. This was to be achieved through both fiscal consolidation and institutional changes aimed at increasing fiscal transparency and accountability. At

least at the beginning, too few measures were taken to reorient Greece swiftly towards a new growth model based on the private sector.

- This shortcoming was to a certain extent reversed in the second Greek programme, which put somewhat more emphasis on product markets, competitiveness, and growth. However, at this stage, amid a deep recession and political instability, implementation slipped.
- In terms of the pace of reform, Greece started at the same speed as other euro-area countries but experienced significant delays in 2012 and late 2013, and a significant reform gap (in absolute terms) developed, in particular, between Greece and Portugal.
- By comparison, reforms in Portugal experienced some delays but there was ultimately a better overall implementation rate, which was more balanced between consolidation and growth and, within the latter, between product and labour market reforms. This implies that reforms implemented in Portugal would more quickly and strongly take effect than those in Greece.

Concluding that the Greek programme failed only or mostly because reforms were not implemented would be unfair to the Greek authorities. The analysis above suggests instead that implementation was broadly on track in the early stages of the first Greek programme. However, it was not focussed enough on short- and medium-term growth-enhancing reforms, as admitted by European Commission (2012). This initial design failure was then coupled with a limited administrative capacity, government instability and (at times) limited ownership of the reform agenda by national authorities. All these elements are associated in the literature with faltering implementation of conditionality during adjustment programmes (Bird and Rowlands, 2001; Dollar and Svensson, 2000; Ivanova *et al*, 2003; Kahn and Sharma, 2001; Nsouli, Atoian and Mourmouras, 2004) and placed limits on the amount of reform that could credibly be asked from Greece. One can conclude that while the main responsibility lays with the Greek national authorities, international institutions

have to a certain extent a shared responsibility for the poor growth-enhancing impact of structural reforms in Greece.

At the current juncture, the challenge for Greece and its creditors will be to strike the appropriate balance between the necessary fiscal consolidation, also dictated by the political or market constraints on the external financing that can be granted to Greece, the desire to prevent blatant injustice, and the need to return the country to growth. Growth should be prioritised not only on the ground that poverty has reached unacceptably high levels, but also on political economy grounds. As explained by Williamson (1994), there is a need to demonstrate at least one area in which a reform programme has succeeded (and an important one would be a return to strong growth) in order to sustain the reform process. And everyone seems to agree that Greece still needs substantial reform.

In terms of composition of structural reforms to achieve the goal of a speedy and solid return to growth while waiting for past reforms to bear fruit, some key takeaways are:

- 1 Product market liberalisation and efforts to improve Greece's business environment will be beneficial to growth, whereas labour markets have been liberalised quite substantially and are now broadly in line with the OECD's average, as shown by Darvas (2015).
- 2 Institutional reforms should continue but bearing in mind that administrative (and hence reform implementation) capacity is low and constrained in the short-run. As such, short-run

growth enhancing measures should be given priority.

- 3 Tax reforms, intended as a shift in the tax burden away from labour and towards consumption, can boost output already in the short run. Within this framework, an increase in the VAT rate could very well be beneficial for growth, but only if coupled with a reduction in the tax wedge, which has not so far materialised in Greece.

Clearly, an underlying crucial caveat of this analysis is its partial nature. It focusses only on growth as the objective of an adjustment programme, whereas programmes need to take account of multiple realities, ranging from the fiscal situation, to market sentiment and political feasibility in both the creditor and programme countries, especially within a monetary union.

Moreover, within the growth target, this Policy Contribution isolated and focussed only on structural reforms. It is likely that all the factors given in the introduction, from large fiscal multipliers to heightened uncertainty, contributed to the failure of the Greek programmes. To a certain extent, these factors most likely mutually negatively affected each other, for example with austerity weighing on growth and social cohesion, political stability, and ultimately structural reform implementation. Isolating and analysing these intricacies should be a matter of great interest for future research, especially as, for good or for bad, conditionality and financial assistance have been ingrained in the European crisis management framework and it cannot be excluded that they will have to be activated again.

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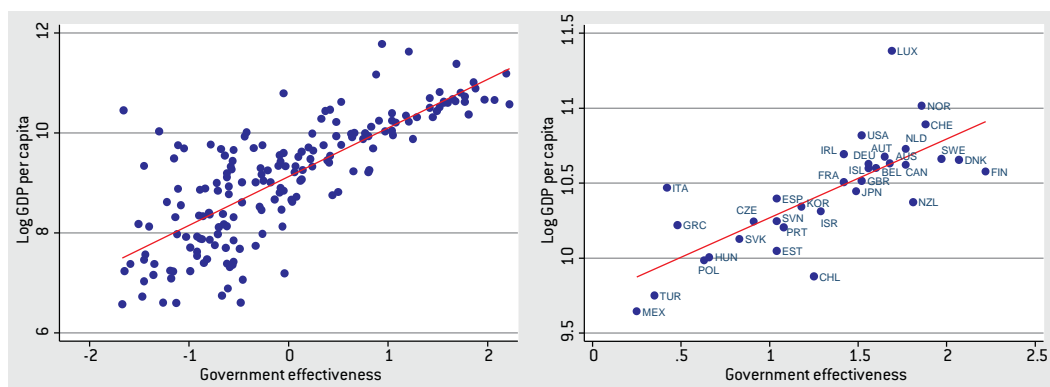
APPENDIX: THE RELATIONSHIP BETWEEN INSTITUTIONS AND GROWTH

One of the most established correlations in growth (or development) economics is that between quality of institutions and wealth (North, 1990). As shown in Figure A1, richer countries are better governed. The voluminous literature on the topic has gone to great length in trying to disentangle the two and detect the direction of causality. Perhaps the most influential contribution to the field since North (1990) is by Acemoglu, Johnson, and Robinson (2001) who, making use of an ingenious instrumental variable approach, show how it is high quality institutions that cater for sustained growth and wealth.

However, as recognised by Acemoglu and Robinson (2012), whereas high quality institutions are necessary in order to experience sustained periods of growth over long time frames, growth acceleration episodes are possible also in poor institutional environments. This message is echoed by Rodrik (2007) who argued that igniting growth is also possible with minimal institutional changes, whereas sustaining it over long periods is more challenging and requires extensive institutional reforms.

To illustrate the point, Figure A2 on the next page shows the correlation between average post-global financial crisis real GDP growth, and governance effectiveness – one of the World Bank's most widely used indicators of institutional quality. As can be seen, the correlation coefficient is minimal, suggesting that high growth is possible over relatively short time horizons (four years in this case) also in poor institutional settings. In a way, this shows that poor institutions are not an unsurmountable brake to economic activity, at least over a medium term horizon.

Figure A1: Correlation between quality of institutions and GDP per capita, world (LHS) and OECD (RHS)

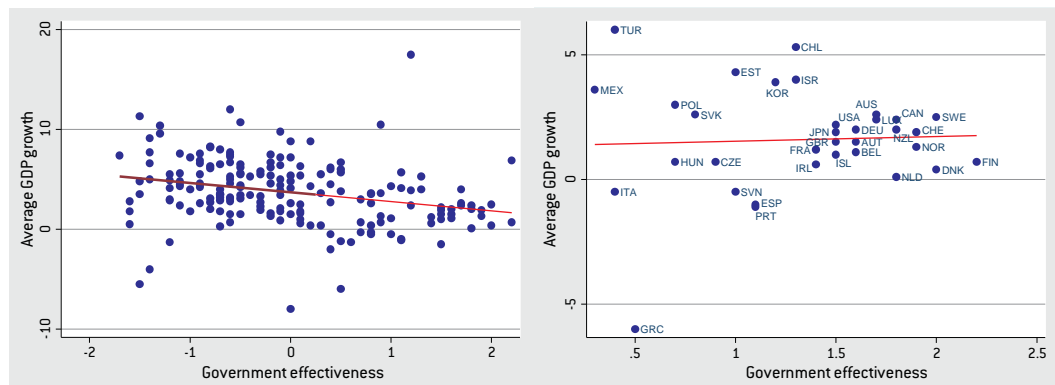


Source: Bruegel based on World Bank. Note: Average over the period 2009-13.

These findings are confirmed by more thorough quantitative studies, which also control for the initial level of income, hence taking into account the possibility that what the correlation plots in Figure 3 capture is simple economic convergence. Once again, no statistically significant correlation between institutional quality and (short- to medium-term) growth is observed (OECD, 2013). Similarly, more case-based studies have tried at length to explain the 'East Asian paradox': high corruption levels did not prevent countries such as China, Thailand, and Indonesia from experiencing strong output growth during the 1980s through into the mid-1990s.

Extrapolating these findings to a macroeconomic adjustment programme setting suggests that if the objective is to bring swiftly a country back to growth in order to improve its debt sustainability, reforms overhauling the institutional setting are neither a necessary nor sufficient condition for success. Once growth momentum is restored, however, improving the institutions will help to solidify and sustain it.

Figure A2: Correlation between quality of institutions and growth acceleration, world (LHS) and OECD only (RHS)



Source: Bruegel based on World Bank. Note: Average over the period 2009-13.