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**Research Report**

## What causes the delay in reforms in Europe?

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## **DIW Roundup**

Politik im Fokus

Deutsches Institut für Wirtschaftsforschung

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# What Causes the Delay in Reforms in Europe?

Malte Rieth and Lisa Gehrt

# What Causes the Delay in Reforms in Europe?

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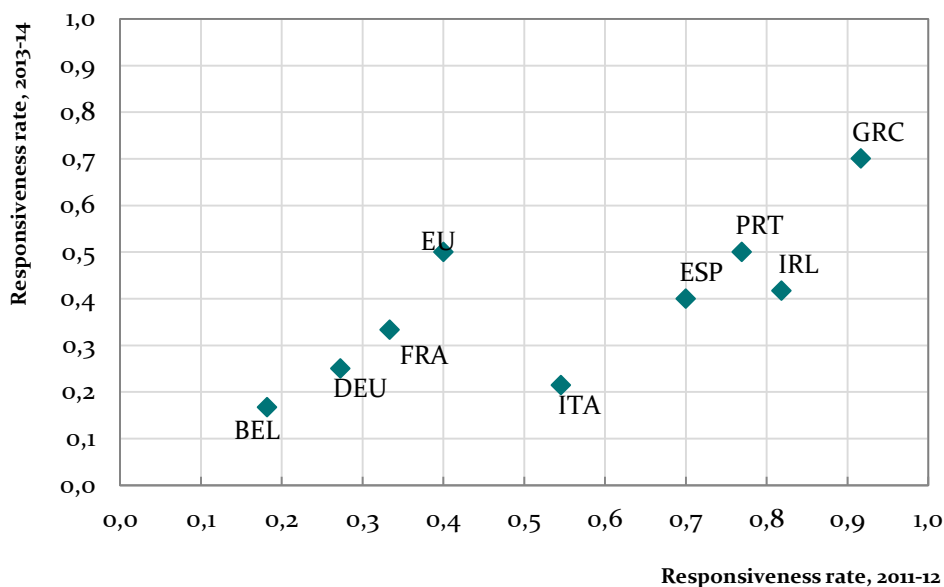
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The academic literature provides no clear answer to this question. In principle, the recent slowdown in reform activity and fiscal consolidation in the euro area may derive from several developments. Potential reasons involve the end of the economic recession, the provision of financial assistance to crisis countries, and improved financing conditions for governments as a result of unconventional monetary policy, which all reduced reform pressure. While existing studies analyse several of these causes of reform delays in general, there is only very limited evidence for such a relation in the current environment in the euro area.

## Recent slowdown in reform activity and fiscal consolidation

Descriptive statistics by the OECD and the ECB suggest a deceleration in the implementation of reforms and fiscal stabilisation throughout the last few years. The OECD “reform responsiveness rate” indicates to which extent countries have carried out structural reforms as recommended in OECD Going for Growth reports. Contrasting the years 2011/ 2012 with 2013/ 2014, Figure 1 shows that the pace of reforms has slowed down in several countries (see [OECD, 2015](#)). Above all, reform activity in Portugal, Spain, Ireland and Italy appears to have lost momentum. French, German and Belgian rates remain at unchanged low levels. An exception is Greece, whose reform responsiveness is still relatively high in 2013/ 2014.

**Figure 1: Reform responsiveness rates, 2011-12 and 2013-14**



Source: Economic Policy Reforms 2015: Going for Growth

In addition, in its monthly bulletin, the [ECB \(2015\)](#) reports country-specific annual consolidation gaps in 2015 and 2016, which are shown for Ireland, Portugal, Slovenia, Spain and France in Table 1. In both years, all of the selected countries fail to comply with their commitments. While Ireland and Portugal reduce their consolidation gaps from 2015 to 2016, the opposite applies to Slovenia, Spain and France, who report even stronger underperformance in 2016.

**Table 1: Country-specific annual consolidation gaps in 2015 and 2016**

Annual consolidation gap (difference between European Commission spring 2015 forecasted change in the structural balance and commitment; as percentage of GDP)		
Country	2015	2016
Ireland	-1.4	-0.3
Portugal	-1.3	-1.2
Slovenia	-0.4	-1.1
Spain	-1.2	-1.4
France	-0.2	-0.8

Source: ECB Economic Bulletin Issue 6/2015

### Potential reasons derive from diverse developments in the euro area economy

There are various potential sources for the slowdown in reform activity and reduced consolidation efforts. Among these, three stand out in the public discussion and academic literature. First, a number of economists suggest that unconventional monetary policy by ECB may be responsible for a slowdown in reform activity and fiscal consolidation. Second, there is academic literature suggesting a relation between the crisis episodes and the willingness to implement reforms. Third, several papers indicate that there can exist a relation between the provision of external financial aid and reduced reform activity.

The implementation of unconventional monetary policy measures in the euro area has been accompanied by an intense debate on related benefits and costs. Mario Draghi, president of the ECB, considers the central bank's policies to have been successful in improving credit and financial market conditions and to have positively influenced the euro area real economy ([Draghi, 2015](#)). Several studies provide empirical evidence supporting his claim. For example, [Altavilla, Carbono and Motto \(2015\)](#) suggest that asset purchase programs since 2014 have induced a substantial drop in euro area sovereign bond yields and the euro exchange rate while having positively affected the euro stock index and inflation expectations. Similarly, [Georgiadis & Gräß \(2015\)](#) find a broad-based depreciation of the euro and a boost of euro area and global equity prices in response to the announcement of the Expanded Asset Purchase Program. However, findings in the literature are not unanimous. [Van den End & Pattipeilohy \(2015\)](#) find no significant response of inflation expectations to policies up to December 2014. While academic findings on the effectiveness are still inconclusive, even less is known about the potential drawbacks of unconventional monetary policy measures. The literature on this matter is scarce. Yet, there is an intense public debate on the consequences on fiscal prudence and the implementation of structural reforms. [Knot \(2016\)](#), president of the Dutch National Bank, argues that governments could become less inclined to reduce debt, when faced with highly expansionary monetary policy. This position is shared by the members of the [German Council of Economic Experts \(2015\)](#), who stress the risk of favorable financing conditions to tempt governments to postpone or abandon

consolidation efforts. Similarly, [Feld \(2016\)](#) points to the risk of indebted governments choosing to increase expenditures in response to relaxed financing conditions. Furthermore, [Folkerts-Landau \(2016\)](#), chief economist at Deutsche Bank, and [Sinn \(2016\)](#), former president of the Ifo Institute, claim that broad-based monetary easing may encourage crisis countries to avoid unpopular policy steps. While Mario Draghi has been calling vigorously for structural reforms to complement monetary policy measures, he denies the supposed incentive problem. “We wouldn’t agree with this” he said. “For example, a very high unemployment rate in one country should be an incentive sufficient to undertake the necessary structural reforms, much more than a high interest rate on the financial markets”([Draghi, 2016](#)).

A second potential source of delay derives from the abating crisis in Europe. While economic downturns may facilitate the implementation of painful reforms as their need becomes obvious to the public, the reverse may hold as recessions come to an end, removing the pressure to implement structural reforms. Numerous studies have dealt with the hypothesis of crisis episodes inducing reform implementation. Theoretical explanations mostly refer to a change in the public or policymakers’ perception on the urgency of reforms as crises evolve. In an early work, [Drazen and Grilli \(1993\)](#) formalise the idea that the experience of crisis may be beneficial for an economy that has settled in a Pareto inferior equilibrium as it facilitates gaining agreement on painful but necessary policy steps. In a “war of attrition” model, they demonstrate that a deterioration of economic conditions paves the way for the implementation of structural reforms. [Lora and Olivera \(2004\)](#) use indices measuring reform progress as dependent variables in panel regressions between 1985 and 1995. They find strong support for indicators of economic crises to induce reform implementation. More recently, [Agnello et al. \(2015\)](#) investigate determinants of the likelihood of structural reforms over the period 1980 – 2005 using a logistic regression design. They show that crisis episodes tend to accelerate reform implementation and conclude that economic recessions are crucial for promoting the necessary consensus for financial, capital, banking, and trade reforms.

A third reason for reduced pressure to reform may stem from the implementation of government aid packages. Ireland, Portugal, Spain, Cyprus and Greece received extensive financial assistance within the scope of the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM) (see [EFSF, 2016](#) and [ESM, 2015](#)). Several studies analyse the impact of external financial aid on reform implementation. [Alesina and Drazen \(1991\)](#) as well as [Casella and Eichengreen \(1996\)](#) use a “war of attrition” model to analyse political decision-making on economic reforms. They show that the possibility to borrow abroad may induce governments to postpone reform activities. The latter paper additionally shows that the mere expectation of foreign aid induces a delay. [Vamvakidis \(2007\)](#) argues that while the literature has broadly focused on the effect of foreign aid, the results can be generalised to any available external financing, as low interest loans incentivise governments to avoid necessary reforms. This line of argumentation is supported by [Fernández-Villaverde, Garicano and Santos \(2013\)](#) who study why the adoption of the Euro led to delays rather than advancements of economic reforms in the euro area periphery. They conclude that the removal of exchange rate risk resulted in a substantial drop of interest rates which in turn enabled peripheral countries to access cheap money and abandon reform activity.

## Conclusion

Descriptive evidence presented by the OECD and the ECB suggests a slowdown in reform activity in Europe. Among others, three factors for this delay are discussed in the public or academic debate: unconventional monetary policy, the subsiding economic crisis in Europe, and the provision of financial assistance to specific countries through government aid packages. While according to the existing academic literature, these factors may in general change incentives for countries to implement painful reforms; there is only limited academic evidence for such a relation in the current environment in the euro area. Therefore, no firm conclusions about the most likely drivers of the reform slowdown can be drawn.

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