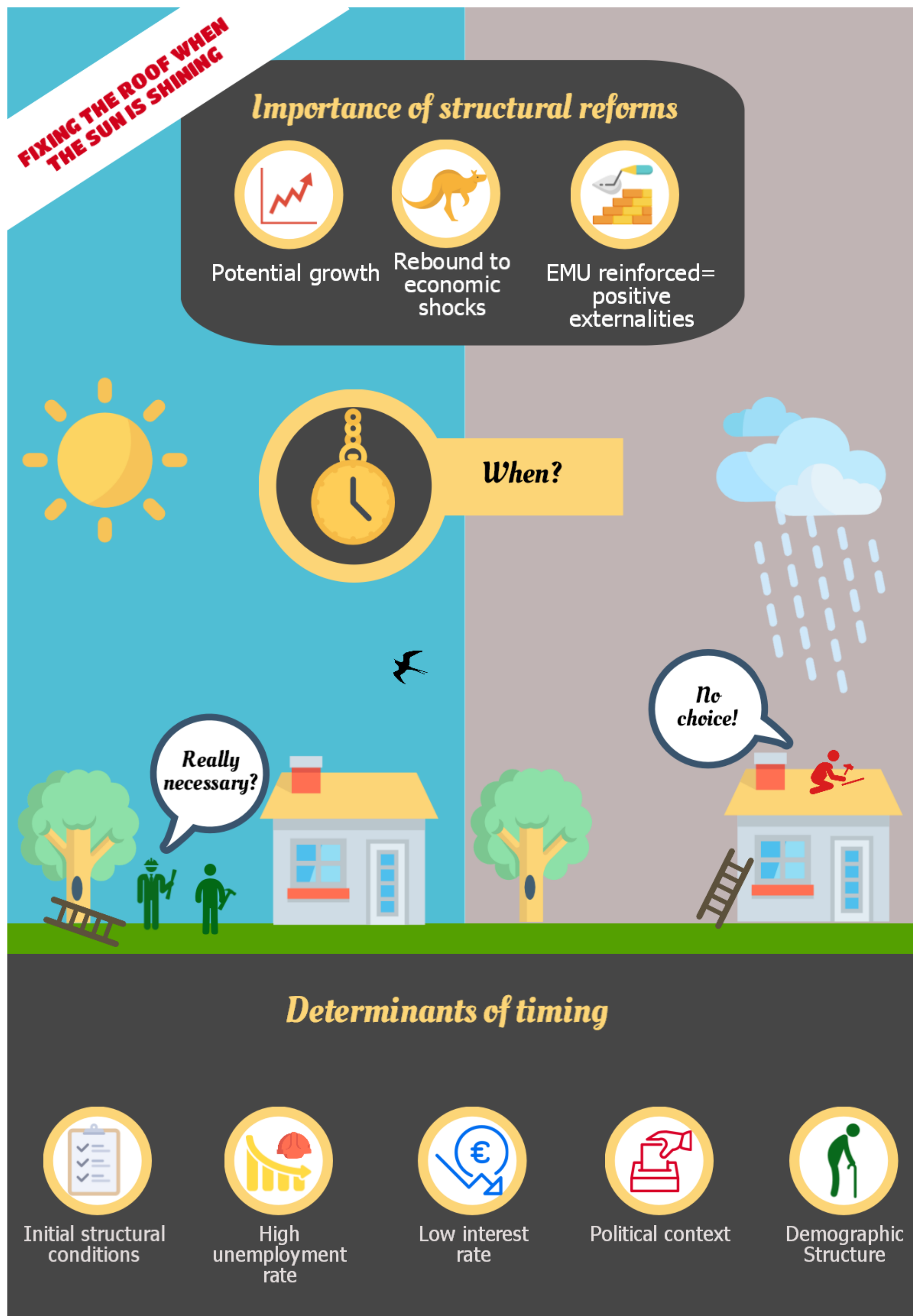
## Recommended reading

# Fixing the roof when the sun is shining: on the timing of structural reforms



**■ Structural reform is important but often seems to be undertaken reluctantly which would explain why it tends to occur when economic times are tough or when there is external pressure ■ Reforms would benefit from a favourable cyclical environment and low interest rates**

Structural policy, which aims to "permanently and positively alter the supply-side of the economy" is important yet complex. The range of factors influencing structural performance is huge - the OECD in its annual Going for Growth report produces charts on 31 indicators - and so is the list of possible measures.In addition, the short run effects may be different from the long term ones and the effects may differ whether measures are taken in isolation or as part of a broader package.

Nevertheless, the importance of structural policy is unquestionable.This was clearly explained by Mario Draghi at the ECB Conference in Sintra in 2015: *"Structural reforms… lift the path of potential output, either by raising the inputs to production… or by ensuring that those inputs are used more efficiently, i.e. by raising total factor productivity (TFP)… they make economies more resilient to economic shocks by facilitating price and wage flexibility and the swift reallocation of resources within and across sectors"*. The importance is even bigger in a monetary union: it avoids an increase in economic divergence, which ultimately could become destabilising, and by adopting the right measures, it creates positive externalities by making the union more solid for all of its members.

## The appropriate timing

Another element of complexity concerns the appropriate timing for structural reform. Common sense would dictate that when the roof of a house needs fixing, it is better to do it when the sun is shining rather than waiting until it starts to rain. Does this apply to reform policy as well? An often heard argument is that in good economic times, the willingness to reform will be low because of the perception there is no need to. Convincing the voters of the need may be difficult and put in jeopardy the chances of being re-elected. However, research by Buti, Turrini and van den Noord covering 21 OECD countries over the period of 1985-2004 shows that the *"odds of re-election are larger for reformist than non-reformist governments"* if there is an effectively working financial system and an efficient social safety net: risk-sharing and consumption smoothing will allow voters to cope more easily with the possible negative short-term consequences of reform policies.

Reform may also be resisted because of a perception that costs and benefits are unevenly distributed[1]. Reforming when the economy is weak raises the concern that it would be counterproductive by weighing on the effectiveness of an expansionary monetary policy[2]: reform measures seeking to increase aggregate supply could lower inflation expectations and increase real interest rates. This would call for combining product market reforms with labour market reforms[3].

Certain measures could increase job insecurity and weigh on consumer confidence and spending. According to Draghi (2015) "*there is some empirical foundation to these concerns. For example, research suggests that reforms that increase employment flexibility, such as reducing employment protection, are more likely to depress demand during downturns*." However, the impact of reforms not only depends on the timing but also on the types of measures, the credibility and the interaction with other policy measures. "*If structural reforms are well-designed along these parameters, they can, in fact, have a largely neutral, if not positive impact on short-term demand – even in adverse cyclical conditions*."

## Domestic and external determinants

In a recent ECB paper Antonio Dias Da Silva, Audrey Givone and David Sondermann (2017) analyse possible determinants of structural reform.

On the domestic side, they consider:

- Initial structural conditions: how far away is a country from best practices
- Macroeconomic conditions: a high level of unemployment may create a sense of urgency and reduce the resistance to change
- Fiscal and monetary policies. Lower interest rates could facilitate reform but also reduce the (market) pressure for reform
- The general political environment (distance to the next elections)
- The demographic structure (a high old-age dependency ratio could weigh on the reform efforts).

External pressures could come from

- Financial markets
- Inter-governmental agreements (think of EU governance)
- Being under a financial assistance programme

Small and very open economies could face more external pressure (via international trade).

## Structural reforms tend to occur in crisis times

Covering 40 OECD countries over three decades, they conclude that structural reforms happen more often when economic conditions are difficult, when a country is far away from best practices or when it is subject to a financial assistance programme. Low interest rates tend to promote structural reforms. Financial markets did not seem to create significant pressure for reform and there is no clear correlation between fiscal consolidation and structural reform. Having one party with majority in all houses increases the likelihood of reform implementation. The proximity to national elections or the political orientation of the government does not appear to influence reform implementation. Unsurprisingly, the European Single Market has facilitated product market reforms. In euro area countries, the drivers of reforms are broadly similar to those obtained for the entire sample. However the unemployment rate and lower interest rates seem even more important triggers of reform.

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[1] Antonio Dias Da Silva, Audrey Givone and David Sondermann, *When do countries implement structural reforms?*, ECB Working Paper 2078, June 2017

[2] What follows is based on Draghi (2015)

[3] Luc Everaert and Werner Schule, *Why it pays to synchronize structural reforms in the euro area across markets and countries*, IMF Staff Papers, Vol. 55, No. 2, 2008

Christian Ebeke[4] summarises the empirical literature as follows: "*most structural reforms tend to occur in crisis times; associated costs are frontloaded but the gains come later; the environment prevailing at the start of reforms matters – reforms implemented in good times and/or with additional support from demand policies (fiscal and monetary) lead to superior economic outcomes.*"

He then analyses the reaction of investors to structural reform. Over time reform reduces bond yields and improves the credit rating, in particular in stressed countries, where reform is needed most, and when it is launched in good times. Some fiscal stimulus helps in lowering yields provided debt levels are low. As expected, reforms followed by social discontent cause a short-run overshooting of yields.

To summarise, structural reform is important but often seems to be undertaken reluctantly which would explain why it tends to occur when economic times are tough or when there is external pressure (programme countries). Reforms would benefit from a favourable cyclical environment and low interest rates. The reform effort should be rewarded by financial markets and could under certain conditions increase the odds of re-election.

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[4] Christian Ebeke, *Who Dares, Wins: Labor Market Reforms and Sovereign Yields*, IMF Working Paper, June 2017