EUROPEAN CENTRAL BANK

EUROSYSTEM

Conference on European Economic Integration (CEEI) 2017

Vienna, OeNB, 20-21 Nov. 2017.

A modern take on structural reforms: Reforming EU frameworks or EU countries?

PRELIMINARY version, please do not quote

presentation by

Klaus Masuch,

Principal Adviser, European Central Bank

The presentation reflects my personal views, not necessarily those of the ECB or the Eurosystem. I received input from B. Anderton , R. Setzer, N. Benalal, B. Di Lupidio, B. Paczek-Jarmulska and G. M. Pinna. On some topics we had very useful discussions in an ESCB Committee and Task Force.

1. The **political economy** of reforms
2. Efficiency ***and*** **fairness/inclusiveness**
3. **Good governance** and high quality institutions
4. National Responsibilities and **European Contribution**
5. Reforms and the **functioning of EMU and monetary policy**
6. **Challenges and opportunities** for reforms
7. Conclusion

Good news ….

1. Positive experiences with several **past reforms** …

2. Many **reform opportunities and options** - that can support **both growth and inclusiveness**

3. **Monetary policy** has provided very good **cyclical conditions** for reforms

… but, why so little reform progress (apart from 2011-13)?

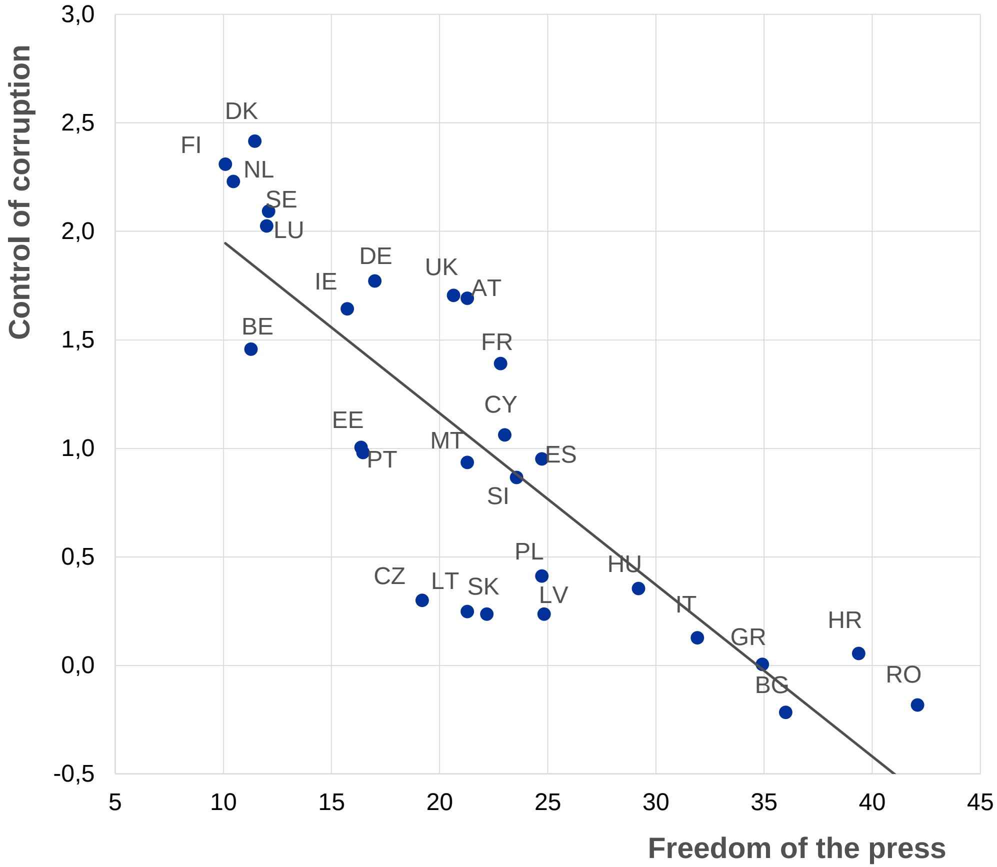
Ownership problems:

(i) Influence of **vested interests** on policy makers, media;

(ii) many **people fear to be losing out**;

(iii) weak **social trust**: difficult to implement reforms (e.g. financial crisis; perceived lack of fairness)

There may be a link between transparency and rent seeking and (in both directions). Example: Freedom of the press and control of corruption)



Sources: World Bank World Governance Indicators and Freedom House.
Notes: An increase in the "control of corruption" indicator signals a decrease in corruption; an increase in the "freedom of the press" measure signals a decrease in this freedom.

"*Corruption alone is estimated to cost the EU economy EUR 120 billion per year, just a little less than the annual budget of the European Union*" (EU Anti-corruption report, 2014)

Study mandated by the EP Research Service (2016): "The Cost of Non-Europe in the area of Organised Crime and Corruption" by RAND corporation. *Annual* costs of not fighting corruption in EU between €179bn and €900bn.

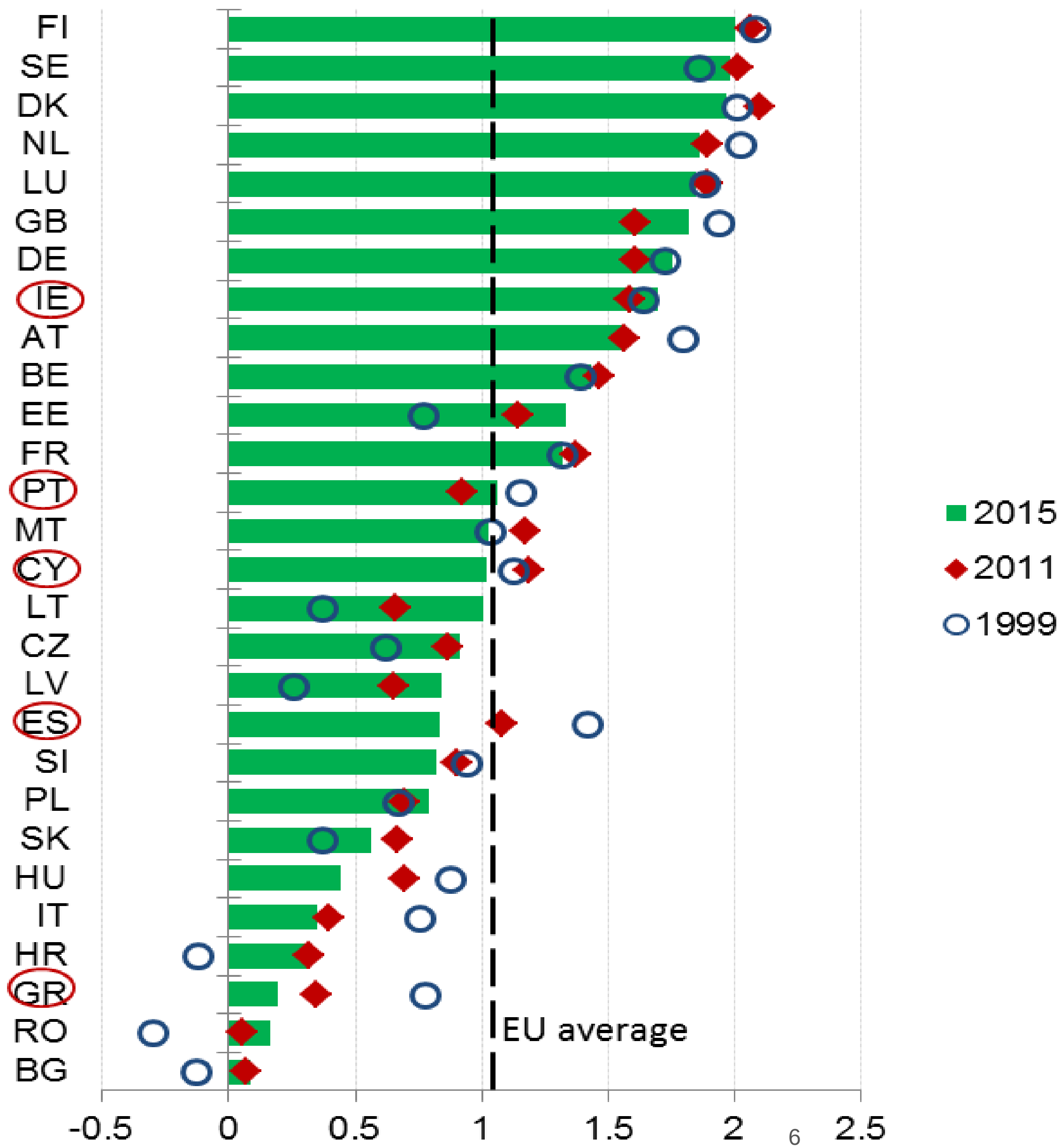
Political economy challenges:

1. **Specific reforms may** disadvantage some (e.g. workers vs. rent-seekers).
2. Governments can **hide the costs of** insufficient reforms for some time
3. **Weak transparency** of policy decisions and their costs - e.g. complex regulations, (hidden) contingent liabilities – supports rent-extraction
4. **"Brussels"** or the euro as **scapegoat** possibly made easy by complex EU processes, mixed responsibilities …
5. … distracts voters form national (regional) **responsibilities** for outcomes

➡ Risks: **delays of reforms,** weak growth and (perceptions) of lack of fairness → high political costs of reforms for future governments, **vicious "no-reform circle"?**

Possible solutions: transparency, benchmarking, access of independent research to data, clear accountability, compensation …

The importance of good governance and institutional reforms



Example:

Institutional quality

Institutional delivery indicator (1999 vs. 2011, 2015)

Chart uses a definition of economic institutions based on the aggregate of four **governance indicators from the World Bank** - World Development Indicators (rule of law, regulatory quality, government effectiveness and control of corruption).

Euro area (Post-) Programme countries are circled.

Source: World Bank Group; World Governance Indicators.

Structural policies that support BOTH efficiency and fairness/inclusiveness

Crucial for **social trust: good governance and institutions (transparency etc.)**

Support for well-being, incomes of most “ordinary” citizens by addressing …

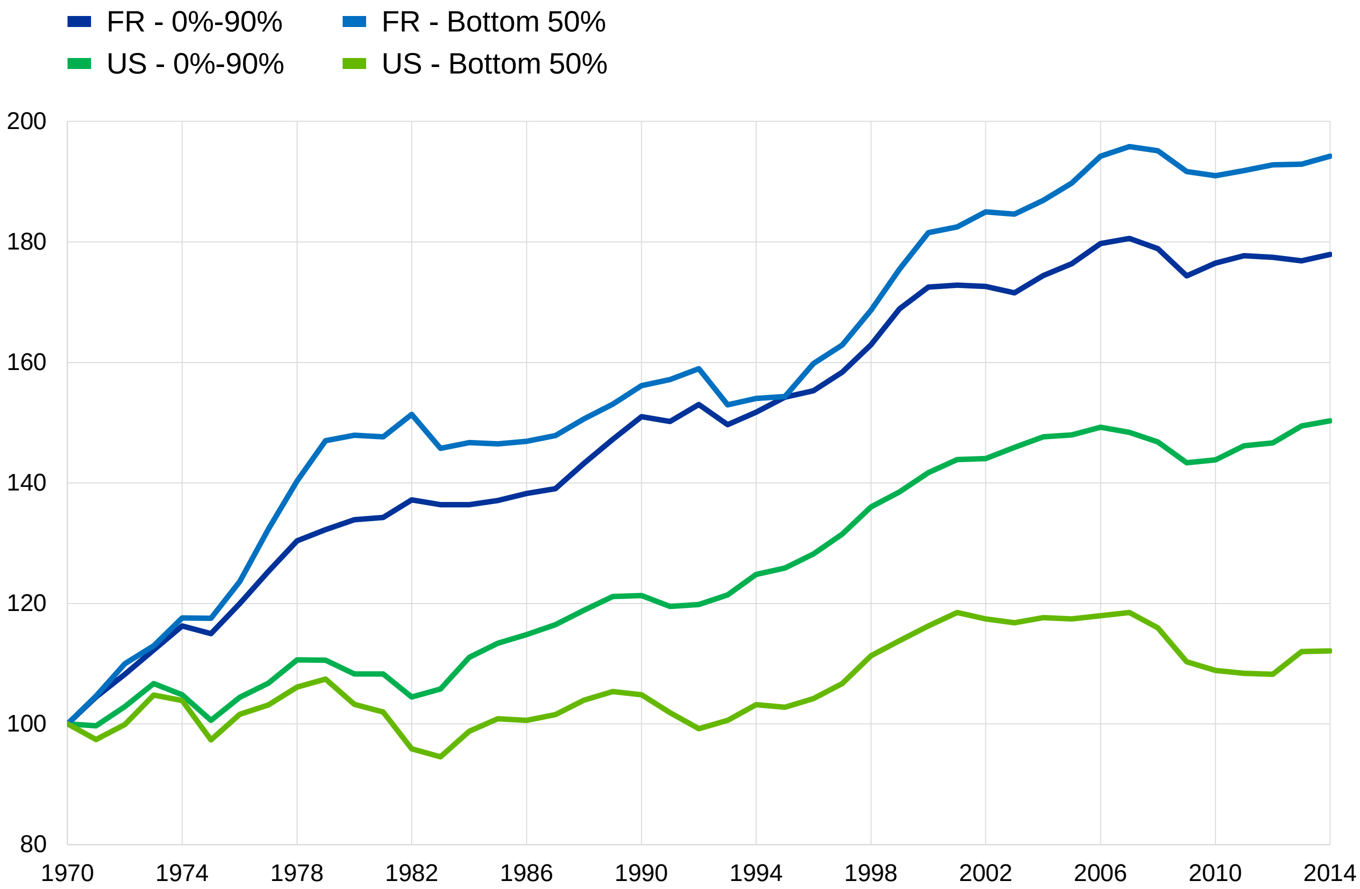
- **ineffcient and insufficiently impartial administration**
- **rent-seeking, cronyism, corruption**
- **tax evasion and tax avoidance**
- **regulations that create unfair rents (high price mark-ups) for a few firms or professions**

“Compensation” of negatively affected groups e.g. via packaging of reforms, efficient social safety net, ALMP etc.; but normally no need to specifically compensate the elimination of **rent-extraction***

Reforms with negative short-term impact on aggregate demand (and prices) can be supported by **monetary or fiscal policy**

Good institutions and reforms can contribute to significant income growth also for lower income households. Here, US model not so successful.

Average pre-tax income in different income classes in France and the US (in PPP US Dollar)

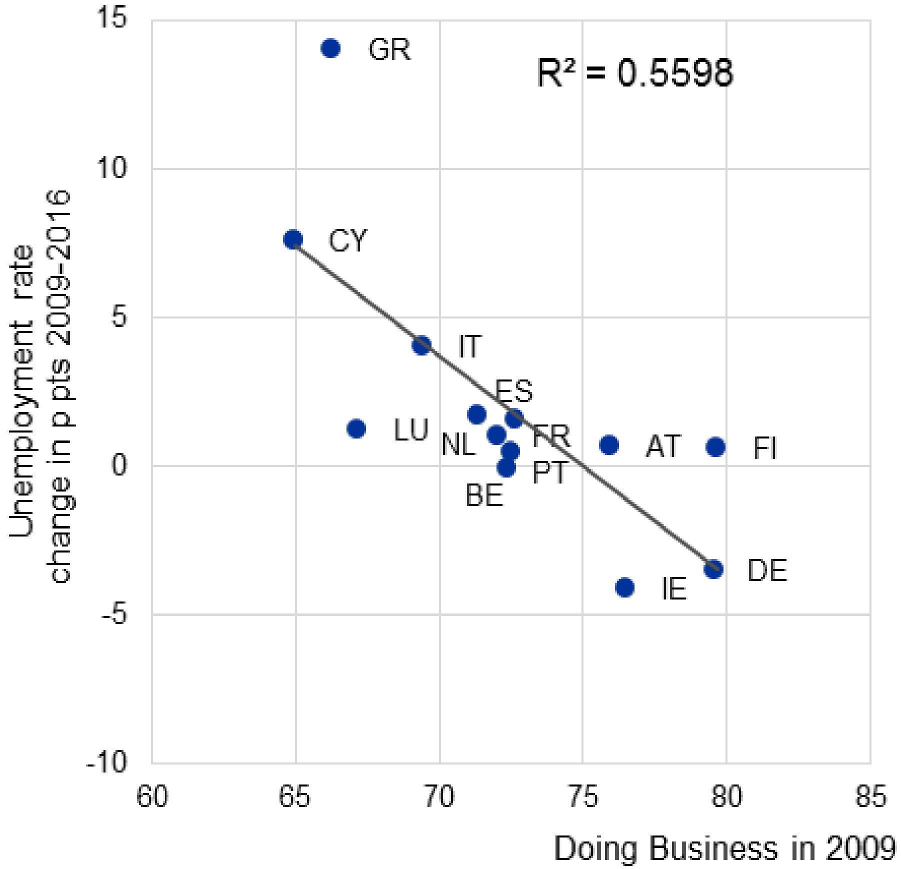


Note: Pre-tax national income is the sum of all pre-tax personal income flows accruing to the owners of the production factors, labor and capital, before taking into account the operation of the tax/transfer system, but after taking into account the operation of pension system. The population is comprised of individuals over age 20. The average is taken for equal-split adults, i.e. income is divided equally among spouses. Source: World Wealth and Income Database (WID) and ECB staff calculations.

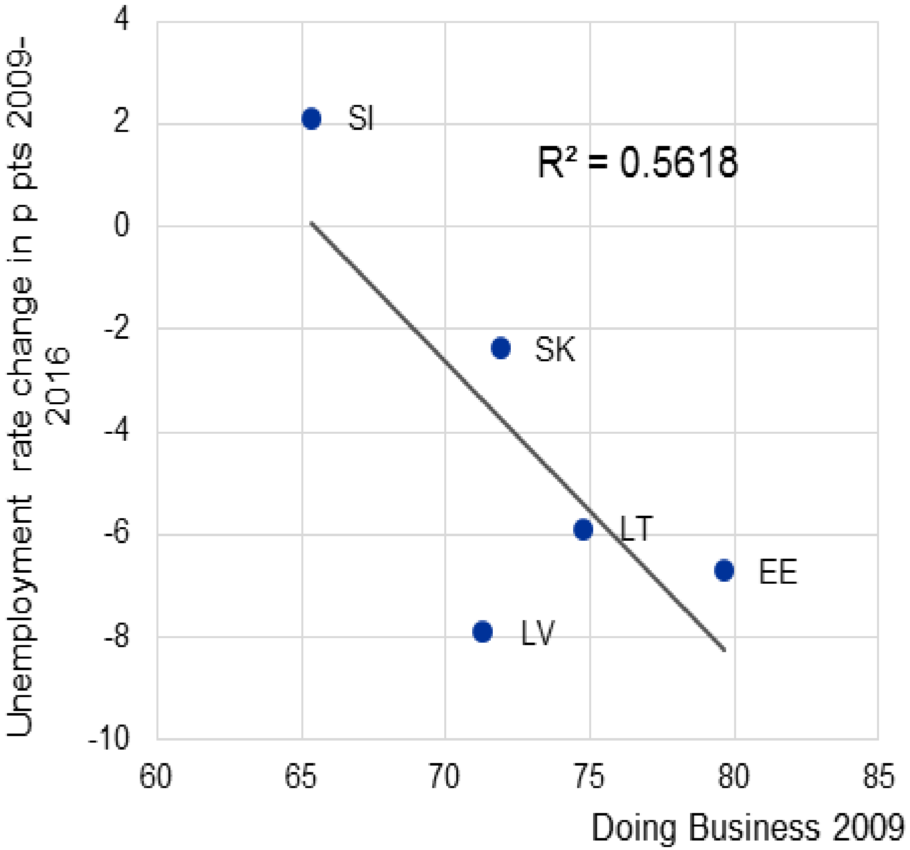
Flexibility and good business frameworks improve resilience:

Doing Business, change in unemployment after 2009

EA-11



EA-5 (Transition economies)



Sources: World Bank and Eurostat.

Successful reforms: Lessons from last (almost) two decades

National responsibility and ownership ….

1. There is **no one-size fits all** countries approach.
2. Quality of national **governance**, administrations is important,
3. but, national institutions may be partly **endogenous** to EU/EA decisions.
4. So, need to understand **political-economy processes** in EMU, **distributional** impact, and **cross-country spill-overs** etc. …
5. … "**put your house in order**", while important, is **not sufficient**.

… and a strong European contribution is needed…

1. especially in cases of truly **European common goods**,
2. **European institutions** (joint decision-making) with clear mandates, can be **more efficient** than complex common rules, without credible enforcement.

… a strong European contribution (continued) …

- **support national incentives** for reforms, e.g. by …
  - creation of **level playing fields (e.g. single market, monetary policy, supervision, BRRD etc).** for limiting of soft budget constraints,
  - **positive rewards for *implemented* reforms (**SGP, MIP, CSRs: not always very effective**)**
- clear and understandable **allocation of responsibilities: key for** transparency, accountability, ownership.
- **support of public debates in MS** by more **transparency on data and analyses** and communication (e.g. cross-country comparisons; analytical **benchmarking)**
- **Common euro area fiscal facility** can help for stabilisation, supporting monetary policy in severe downturn, but beyond this in itself may not help much to close large **productivity gaps.**

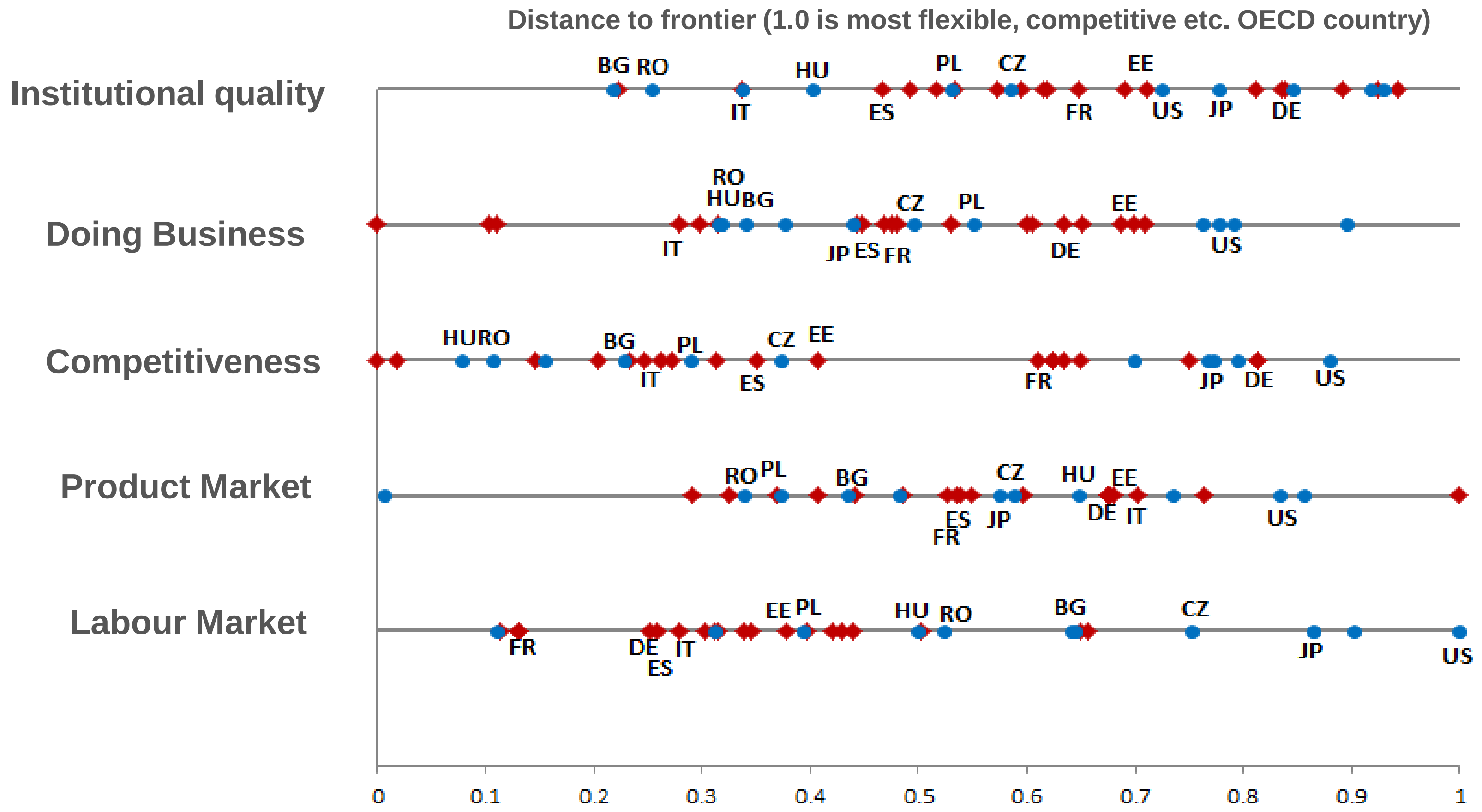
The impact of reforms for the functioning of EMU and monetary policy

Resilience of EMU and effectiveness of **monetary policy** could benefit from national and European reforms that support :

- Euro area **stabilisation** (e.g. EA fiscal capacity; buffers) and income **convergence**
- **Completion of banking, capital union,** more **cross-border financial integration** (e.g. cross-border equity and bond holdings, stronger and truly Pan-European banks, efficient **insolvency frameworks and judicial systems** allowing **banks** to ask for lower risk premia, reduce NPLs, support credit supply to productive firms).
- Increased **price, wage flexibility** limiting costs of adverse supply shocks.
- Enhanced **product market competition.**
- Reforms increasing productivity growth and thus **equilibrium interest rates** and the effectiveness of policy rates in case of large disinflationary shocks.

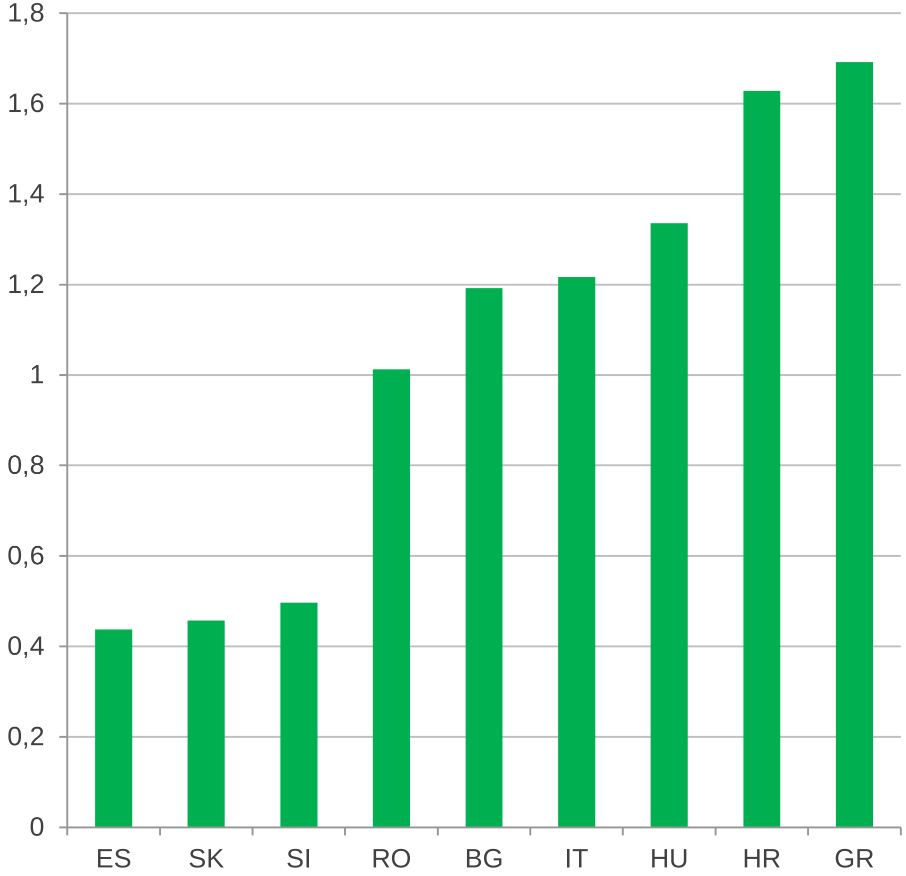
Opportunities for improvement, but one reform size does not fit all.

Structural, institutional indicators show large divergences



Note: Indicators used for operationalisation: Institutions – Average of four World Governance Indicators (source: World Bank, 2016); Doing Business Indicator (overall DTF, source: World Bank, 2017); Global Competitiveness Index (source: WEF,2016); Product Market Indicator (source: OECD, 2013); Labour Market – Index of Economic Freedom (source: Heritage Foundation & Wall Street Journal, 2016).

Counterfactual scenario: Potential future annual per-capita GDP growth impact (over up to 15 years) in case reforms had by 2015 succeeded in moving institutional quality up to the EU average (Annual average in pp)



Possible measures: enhancing transparency, law enforcement, more efficient public administration, judicial system, law enforcement, ensuring level playing fields, addressing soft budget constraints, tax evasion and corruption

Sources: Own computation. Based on WGI indicators and ECB WP by Masuch, Mooshammer, Pierluigi, et al. (2016). Based on the assessment in the paper that causality seems to run from institutions to long-term growth.

Conclusion

Reforms: Convergence towards more resilient structures: …

*… **policy progress needed …***

- ***EMU deepening** (incl. fiscal capacity)*
- *cross border **private risk-sharing**,*
- *national **ownership** & EU incentives for beneficial reforms,*
- ***institutions (transparency, impartiality, rule of law** …)*

*..**analysis (and data) needed to better understand …***

- *causes of **regional divergences** within countries,*
- ***costs of** (existing) **regulations** in changing environment (e.g. digitalisation, immigration, globalisation)*
- *how to overcome **vested interests**, rent-seeking, tax evasion etc.*

Thank you

for your attention!