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An assessment of structural reforms in the stressed euro area countries and their relevance for growth and for EMU

Abstract:

Substantial structural reforms have been taken on labour and product markets by stressed euro area countries since 2008 – more than is generally acknowledged in Germany. These reforms have the potential to raise the growth potential in the respective countries and to improve the functioning of EMU. In the context of the optimum currency area debate it is argued that structural reforms have reduced the heterogeneity between euro area countries in terms of market rigidities. Moreover, wage and price flexibility – which are needed to better adjust to exogenous economic shocks – will be enhanced. In fact, first signs can be detected that wage flexibility has already increased in southern euro area countries.

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Contents

1. On the relevance of structural reforms for EMU and growth[1]

The global financial crisis and the euro debt crisis have revealed and intensified various economic problems of the euro area. On the one hand, these problems concern the functioning of the European Monetary Union (EMU). On the other hand, the southern European countries are suffering from structural weaknesses that impede growth and which are in large part attributable to rigid markets.

The substantial structural reforms in the stressed euro area countries, which will be documented in this paper, address these problems. The reforms increase the flexibility of wages and prices, as well as reduce the heterogeneity between euro area countries regarding the rigidity of labour and product markets. Thus, in the context of the optimum currency area (OCA) theory[2] the reforms should improve the functioning of EMU, where member states have given up their national currency and their own monetary policy. Under these conditions, euro area economies should be sufficiently similar and also have adequately flexible wages and prices in order to adjust to the divergence that can result from economic shocks. However, it is precisely in this respect that there were deficiencies before the beginning of EMU and also during its early years (Dickens et al., 2007; Heinz/Rusinova, 2011; Holden/Wulfsberg, 2007, 2014). This contributed to a significant loss of price competitiveness in many southern European countries, so that considerable current account deficits arose. In addition, there was misallocation of resources in the non-tradable goods sector (see e.g. Matthes, 2009).

The connection between the rigidity of wages and prices on the one hand and the regulation intensity of labour and product markets on the other hand – which has been proved by several analyses – is crucial for this study (Babecký et al., 2010; Heinz/Rusinova, 2011; Jaumotte/Morsy, 2012; Holden/Wulfsberg, 2014). It is through this connection that the structural reforms depicted here should improve the flexibility of wages and prices and thus the functioning of EMU.

In addition, structural reforms strengthen the potential for economic growth when they open markets, increase competition intensity, raise incentives to work and provide greater flexibility of resource allocation. This has been widely proven.[3]

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[1] This article is an abridged version of Matthes (2015).

[2] Refer to Mongelli (2008) and Matthes (2009) for a review of the roots of this theory and about the problems that are relevant to the EMU.

[3] Refer to Nicoletti/Scarpetta (2003); Bouis/Duval (2011); Bassanini et al. (2013) for general studies. For a brief survey see Kolev/Matthes (2013, 82 et seq.). For studies regarding growth effects in the the euro area refer to Varga et al. (2014); Canton et al. (2014); Anderson et al. (2014). ECB (2014a, 63 et seq.). These effects are particularly pronounced in the case of countries where markets were highly regulated formerly (ECB, 2014a, 67).

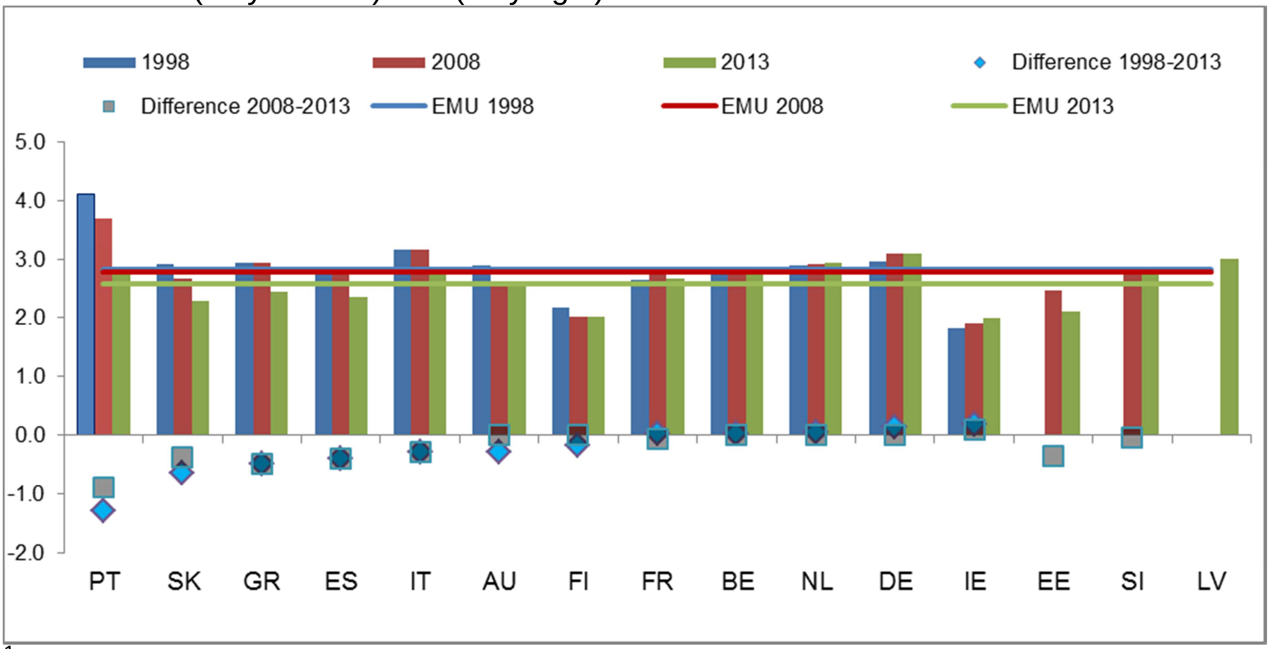
2. OECD indicators for market rigidities

The OECD has quantified the regulation intensity of labour and product markets. In order to specify the intensity of structural reforms in this regard, this chapter considers:

1. the aggregated indicator of employment protection legislation (EPL) for regular employment.[4]

2. the aggregated indicator of product market regulation (PMR).[5]

Figure 1: Employment protection legislation[1]
Scale from 0 (very flexible) to 6 (very rigid)



[1] For regular contracts of employment and in cases of individual or collective dismissals.
Sources: OECD, Cologne Institute for Economic Research

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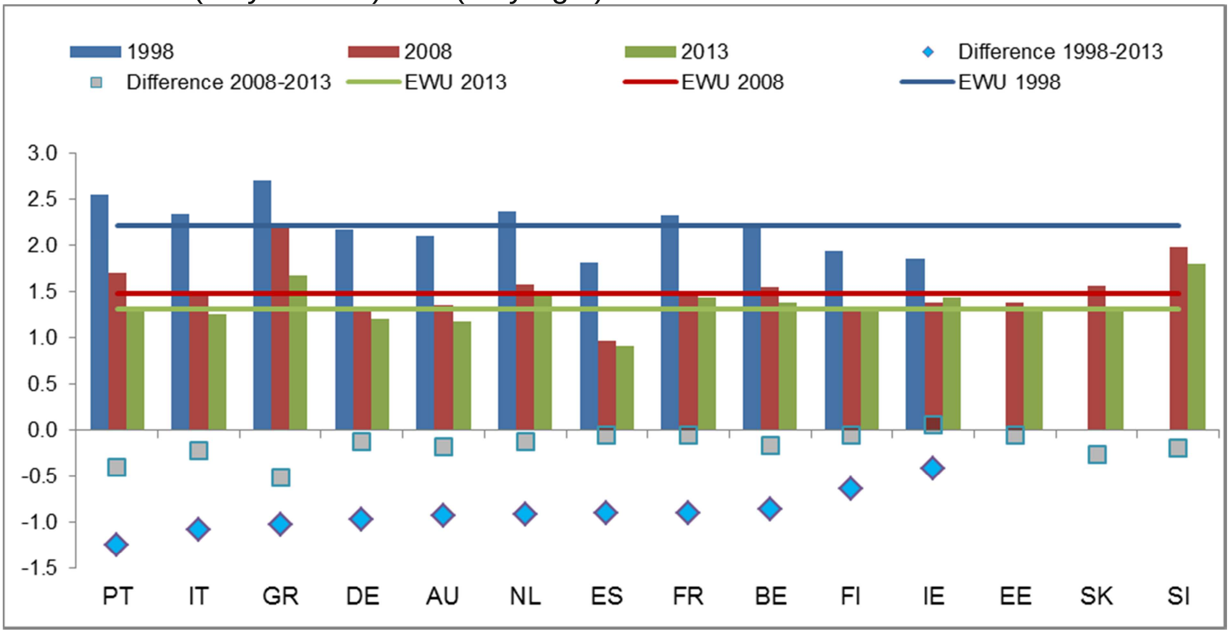
[4] Aspects covered are the difficulty of individual dismissals (e.g., severance payment, requirements for re-employment and administrative requirements) and of mass dismissals. The EPL indicator used is based upon a definition, which goes back to 1998, i.e., the time before the EMU began. Refer to OECD (2013a) and the OECD's internet site at http://www.oecd.org/employment/emp/oecdindicatorsofemploymentprotection.htm.

[5] The aggregate PMR indicator is comprised of the sub-indicators for state control of markets, barriers to entrepreneurship and barriers to trade and investment, which are subdivided in even more detail. The OECD conceptually records obstacles that limit the competitive intensity in product markets, which include regulations that limit the number of suppliers, hinder the capability (or stimulus) of companies to compete with incumbent firms, or limit the opportunities for consumers to make choices or to obtain information (i.e. measures which also tend to reduce the competitive intensity) (OECD, 2014, 67 et seq.). Refer also to the OECD's internet site at http://www.oecd.org/economy/growth/_indicatorsofproductmarketregulationhomepage.htm#Sources for further information.

Figure 2: Product market regulation
Scale from 0 (very flexible) to 6 (very rigid)



Sources: OECD, Cologne Institute for Economic Research

Figures 1 and 2 illustrate that the southern European states have in most cases reduced their labour and product market regulation since 1998 considerably more than the other EMU countries. Portugal's progress makes it stand out in both of the regulation categories but it is also one of the countries with the highest initial regulating intensity. Greece is also one of the best reforming states in both categories. As a result, individual stressed euro area countries score better in the meantime than the EMU's average with regard to some indicators, although the EMU average has also improved. This applies to employment protection in Greece and Spain, as well as to product market regulation in Spain and marginally also in Italy and Portugal.

The OECD also lists sub-indicators besides these overall indicators, which are relevant for competition intensity and for the capability of structural change in economies. Most of the southern European countries also show above-average progress since 1998 in the case of price controls, protection of incumbent firms from new competitors and the regulation of temporary employment.

This progress notwithstanding, some notable problematic areas still remain in the southern euro area countries compared with the EMU's average. For example, price controls are noticeably more intensive than average in Greece, Portugal and Spain despite the progress that has been made. This applies also to the regulation of temporary employment in Spain and Greece.

In the following structural reforms of labour market regulation, wage setting systems and product market regulation in the stressed euro area countries are depicted in more detail. The focus is laid on the time after 2008 to illustrate that the various crises considerably raised the political pressures to implement reforms that will support growth and the functioning of EMU. The evaluations that are summarized in Tables 1 to 3 should be taken as a broad assessment. They have been derived from the summary of qualitative assessments that were provided by the international organizations and other studies, as well as the quantified assessments that were made by the OECD and the World Bank.

3. Reforms of labour market regulation

Table 1 reviews the reforms that have been made in the stressed euro area countries concerning the regulation of labour markets. The categories of the reforms have been chosen regarding the objective of increasing the flexibility of wages and of the labour market in general, as well as regarding the aim of making structural changes easier by means of reallocating the production factor labour. The respective labour market regulations include high protection in the case of dismissals (e.g. by stipulating rigid conditions of dismissals or high requirements for severance payment) strict rules for fixed term employment, probation periods, and temporary work agencies as well as overly generous support for the unemployed that can limit incentives to take up work.[6]

Table 1: Reforms in labour market regulation since 2008

	PT	ES	GR	IT
Relaxing employment protection				
Relaxing conditions for dismissal	x	x	(x)	(x)[1]
Reducing severance payments	x	x	x	
Shortening notice periods	x	x	x	
Facilitating the use of fixed term employment, probation periods and temporary work agencies	x	x	x[1]	x
Unemployment insurance: reducing disincentives	x	x		

x: notable reform, (x): partial reform.
[1] Further reforms are still being implemented.
Sources: Own assessment based upon qualitative information from country surveys of the OECD and the IMF, reports by the EU and the IMF on the implementation of reforms in the programme countries, reports within the framework of the European Semester, and from the World Bank's 'Doing Business' data base as well as upon quantified information from regulation assessments of the OECD (EPL and PMR) and the World Bank's 'Doing Business' data base.

[6] Refer to Matthes (2015) for a more detailed justification of this choice of indicators.

Table 1 shows that mainly Spain and Portugal have implemented notable reforms since 2008 in the areas which are identified as relevant in this case. That also applies to a slightly lesser extent to Greece and limitedly to Italy as well. This assessment is also mirrored by assessments of the IMF, the OECD and the EU Commission, even if these institutions rightly see the necessity for further reforms in some areas. Some selected examples illustrate this assessment:

Portugal

- Reduction of previously very high employment protection in case of individual dismissals (e.g. more scope in the case of the employee's deficient suitability or performance; dismissal choice according to performance and qualification instead of according to the length of service with the company).
- Reduced severance payment and notice periods in case of dismissals.[7]
- Prolonging the maximum duration of fixed term contracts.
- Reduction of formerly very high unemployment support regarding the amount and the duration of the (redundancy) payment.

Spain

- Facilitation of individual dismissals if a company suffers from economic problems; mass dismissals now possible without state consent and without negotiations with the employees' representatives.
- Significantly reduced severance payments and notice periods.
- Introducing a new, standardized, permanent employment contract for small and medium-sized enterprises (SMEs) with a probation period of one year.
- Reduced rates of unemployment transfers and strengthened controls over whether the unemployed are sufficiently actively looking for a job and improving their capability of re-employment.

Greece[8]

- Reduced threshold values for mass dismissals.
- Significantly reduced severance payments and notice periods.
- Prolonging probation periods, more flexibility for fixed term contracts and temporary work agencies (was still being implemented until before the elections).

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7 The IMF (2014b) criticises the large difference in severance payments between justified and unjustified dismissals and sees an undue incentive for dismissed employees to litigate. Therefore, the IMF demands to more closely align these payments.

8 The Greek government that was newly elected in January 2015 initially wanted to rescind some of the reforms concerning employment protection, the wage negotiation system and product markets. With the prolongation of the Master Financial Assistance Facilty Agreement, unitlateral action by Greece should not be possible. However, it remains to be seen in which way the new government sticks to the reform course.

Italy

- Employment protection for permanent employees relaxed somewhat in 2012 (requirement for re-employment restricted if a court considers dismissal to be unjustified, especially in the case of justifiable economic reasons); protracted lawsuits shortened to some degree (introduction of obligatory mediation and accelerated court proceedings).[9] Additional significant steps to relax employment protection for permanent employees approved in December 2014.
- More flexibility for fixed term contracts (repeated prolongation possible for up to three years without a formal justification).

4. Reforms of wage negotiation systems

The relatively high rigidity of the wages in most of the southern European countries and the associated risk of longer-term appreciation of the real exchange rate depend closely upon the wage negotiation system. Various elements have in the past contributed to the fact that wage policy was oriented insufficiently towards productivity increases, competitiveness and the economic situation.[10]

There was a general lack of decentralization, of flexibility on the firm level, and of opening clauses for collective wage agreements covering the entire industry or region. In addition, incentives for renegotiations of collective wage agreements were low so that adaptation to changing cyclical conditions was hampered.[11]

Table 2 clarifies that since 2008 there have been considerable reforms of wage negotiation systems towards more decentralization in the stressed euro area countries. The underlying objective is to make wages better respond to productivity developments, competitiveness and to the economic situation.

There were particularly large reforms in Greece, as well as noticeable reforms in Spain, Portugal and Italy too (in descending order). The evaluation of considerable progress in these reforms is also shared by Marginson and Welz (2014) – with a certain limitation in the case of Italy.

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[9] This reform had been partly watered down for political reasons and it was frequently criticised as a failure (Barley, 2012). Nevertheless, *de facto* dismissals have been made easier (Cencig, 2012). This has led to increased employment flexibility, shorter proceedings in case of dismissals and a reduced number of re-employments being imposed by the courts (European Commission, 2014c).

[10] See European Commission (2011) and exemplary for Greece: European Commission (2012).

[11] Refer to Matthes (2015) for a more detailed justification of this choice of indicators.

Table 2: Reforms of the dismissal-pay systems since 2008

	PT	ES	GR	IT
Decentralization / more firm level flexibility				
Priority of firm level agreements	(x)	x	x	
Reducing extension obligations	(x)		x	(x)
(More) opening clauses		x	x	x
Increasing working time flexibility	x	x	x	x
Right of contracting with non-union workers	(x)		x	
Reduced duration of new or expired agreements	x	x	x	
Inflation indexation (repeal or reduction)		x		x
Reducing (freezing) statutory minimum wages	(x)		x	
Further elements of wage moderation	x		x	x

x: notable reform, (x) partial reform.
Source: Own assessments based upon qualitative information from Eurofound, country surveys of the OECD and the IMF, reports by the EU and the IMF on the implementation of reforms in the programme countries, reports within the framework of the European Semester, and from the World Bank's 'Doing Business' data base.

This summarized assessment can be supplemented by selected elements of these reforms.

Portugal

- New priority for firm level wage agreements compared to sector or regional agreements, even if the former contain lower standards.
- Eliminating the extension of collective wage agreements to firms that are not bound by collective wage agreements, if less than half of the employees of an industry work in firms that are bound to collective wage agreements. This situation has led to a noticeable decline in the extension of agreements throughout the sectors: from 48 (in 2010) to only 12 (in 2012) (Eurofound, 2013).[12]
- Permission for works councils in large firms (over 500 employees) to negotiate collective wage agreements (only with the consent of the trade unions).
- Shortening of the retrospective duration of expired collective wage agreements to 18 months as a rule.
- Introducing working-time accounts over longer periods in order to increase working time flexibility and to reduce the surcharges for overtime.

[12] The limits for extension of wage agreements have been reduced again in 2014, so that it remains to be seen how far the greater flexibility will continue to exist.

- Freezing of minimum wages.
- Reducing the surcharges for overtime, as well as abolishing three days of holiday and four public holidays.

Spain

- New explicit priority for firm level wage agreements compared to sector or regional agreements, even if the former contain lower standards.
- Introducing far-reaching opening clauses (divergence from collective wage agreements possible in terms of wages, working hours and other working conditions without negotiations with the works council; only information about the economic, technical or organizational reasons necessary). These opening clauses are being used increasingly (Kingdom of Spain, 2013).
- Making working hours significantly more flexible.
- Reducing the retrospective effect of expired collective wage agreements (ultra-activity) to twelve months as a rule.
- Inflation indexation of wages largely abolished (e.g. law on de-indexing; wage guidelines do no longer contain inflation forecasts).

Greece

- New priority for firm level wage agreements compared to sector or regional agreements, even if the former contain lower standards.
- Extension of sector-wide collective wage agreements to firms that are not bound to collective wage agreements largely abolished.
- Permission for the employees' representatives to negotiate collective wage agreements in SMEs with less than 50 employees.
- Extensive opening clauses for companies with economic problems regarding wages, working hours and other conditions of work.
- Maximum duration of the collective wage agreements shortened to three years.
- Shortening of the retrospective duration of expired collective wage agreements to only three months; after expiry wages are reduced automatically, so that the incentives to hold new negotiations are increased.
- Introduction of annual accounts of working time in order to increase working time flexibility and to reduce the surcharges for overtime (arrangements possible that are similar to the German short-time working system).
- Reducing the statutory minimum wage by more than a fifth (by about one third for employees under the age of 25).
- Lower surcharges for overtime.

Italy

- Introduction of extensive company opening clauses (proximity agreements and modifying agreements). It is now possible to diverge from collective wage agreements and even from statutory provisions in the case of economic problems.[13]
- This measure also contributed to increased working time flexibility.
- Extension of collective wage agreements to all companies in a sector limited by the legal confirmation of a major derogation by FIAT (Broughton et al., 2013).
- Reducing the implicit inflation indexing of wages by means of an agreement with industrial partners to orientate wages more closely to productivity trends and competitiveness.
- Nominal wages frozen between 2011 and 2013 in parts of the national economy.

5. Reforms of product market regulation

Product market regulations can obstruct the competition intensity, the foundation of new firms, the flexibility of prices, and the reallocation of production factors. Therefore, they can make it more difficult to adapt to changing economic conditions and external shocks. Moreover, economic rents of 'insiders' lower the real income of consumers due to higher prices than in a more competitive environment. They can also increase the costs for intermediary services which are relevant for sectors that rely on inputs from other industries. This can adversely affect the competitiveness of the input receiving industries.[14] Therefore, the regulation of important intermediate sectors – professional services and network industries (mainly electricity, gas and telecommunications) – will also be considered in the following besides the competition order of an economy and the regulation intensity for starting a business. Moreover, the regulations of retail trade will also be analysed because this industry is particularly important for the final consumer.

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[13] The government-imposed introduction of 'proximity agreements' in September 2011 met with very strong opposition from the trade unions in Italy initially (Cencig, 2012; Broughton et al., 2013). This hindered the uptake of this reform by firms. In addition, it was unclear initially which of several trade unions in a firm would be allowed to negotiate an opening clause. However, an agreement was eventually reached between the relevant trade unions in May 2013 that clarified the responsibility for so-called 'modifying agreements' on the firm level. This agreement is considered an important achievement for the industrial relations in Italy because trade unions were traditionally on very bad terms with each other (Broughton et al., 2013). However, it remains to be seen how durable this change is and how it affects wage developments in the future.

[14] Barone/Cingano (2013) show that countries with less regulation of the service sector tend to have relatively high growth of added value, productivity and exports in industries that use the services relatively intensely. Corres-López/Doménech (2014) confirm a positive effect in this respect on exports for Spanish companies.

Table 3: Reforms of product market regulations since 2008

	PT	ES	GR	IT
Competition order	x	x[1]	x	x
Starting a business	x	(x)	x	x
Professional services	x[1]	(x)	x[1]	x
Network Industries	x	x	(x)[1]	(x)
Retail trade	(x)	(x)	x	x

x: notable reform, (x): partial reform.
[1] Further reforms are still being implemented.
Sources: Own assessment based upon qualitative information from country surveys of the OECD and the IMF, reports by the EU and the IMF on the implementation of reforms in the programme countries, reports within the framework of the European Semester, and from the World Bank's 'Doing Business' data base as well as upon quantified information from regulation assessments of the OECD (EPL and PMR) and the World Bank's 'Doing Business' data base.

The overview in table 3 focuses again on the period after 2008 and confirms that all stressed euro area countries (with the marginal exception of Spain) have implemented significant product market reforms. This is illustrated by the following examples:

Portugal

- Competition order strengthened by improving the independence and increasing the autonomy of competition authorities and by introducing a new court that specializes in competition matters, as well as by further aligning the competition framework to the guidelines of the EU.
- Facilitation of procedures for starting a business by means of several sub-steps (e.g. significantly reducing the minimum capital to be paid in).
- Business related bureaucracy reduced by means of simplified licensing according to the principles of 'zero authorization', 'online points of single contact','one-in-one-out rule'; analysis of bureaucracy costs of new laws and regulations.
- Reforming professional services (reform only began in 2014 and still has to be completed). Comprehensive horizontal approach that includes dismantling unnecessary barriers to entry and the simplification of exercising guidelines.
- Extensive reform agenda in the services sector by implementing the EU's Service Directive in 70 specific sectors (67 of which were completed by early 2014 when the programme was finished).
- Several network industries liberalised and being further opened up to competition (postal service, telecommunications, railways, gas and electricity).
- Retail trade: Licensing procedures simplified and the administrative burden continues to be dismantled.

Spain

The requirements for reform were somewhat less pressing because Spain already had a relatively good assessment by the OECD in 2008 concerning product market regulation. Nevertheless, further progress can be recognized (IMF, 2014a): Starting a business was further facilitated. A competition authority was created for important sectors and for network industries, where further liberalisation is planned. In addition, Spain is implementing a large-scale reform (market-unity law), as the regulatory system is overly complex because of a threefold regulation level (state, regional, local) (European Commission, 2014b).

Greece

- Competition authority (Hellenic Competition Commission) strengthened by making it more independent and by giving it more autonomy to set own priorities; further aligning the competition framework to EU rules; these steps have resulted in positive initial effects (OECD, 2013b).
- Simplifying the procedures for starting a business (reducing costs, creating new forms of companies without paying in capital and linking the licensing ministries online)
- Generally dismantling business related bureaucracy (e.g. easier obtaining construction licences and fast-track procedures for larger investment projects).
- Liberalisation of professional services: About three-quarters of roughly 350 regulated professional orders opened up for more competition by means of extensively dismantling unnecessarily restrictive regulations; process continuing until recently but with partial delays in implementation.
- Network industries: gradual fundamental liberalisation of the inefficient electricity sector (e.g. continuing privatization of the electricity monopolies) and planned liberalization of the gas sector.
- Retail trade liberalised, especially by means of simplified licensing and shortening leasing terms of retail shops. The result has been a noticeable decline in mark-ups already between 2007 and 2011 (OECD, 2013b).

Italy

- Competition order strengthened by making the competition authority more competent (e.g. allowing lawsuits against resolutions that have been made by the regional authorities).
- Facilitation of procedures of starting a business in several steps (e.g. by means of simplifying the bureaucracy and factually abolishing the requirements for minimum capital).
- Liberalisation of professional services especially by reducing strict regulations for access, training and advertising, by abolishing the minimum remuneration, and by increasing the number of notaries and pharmacies; issuing licences for shops that

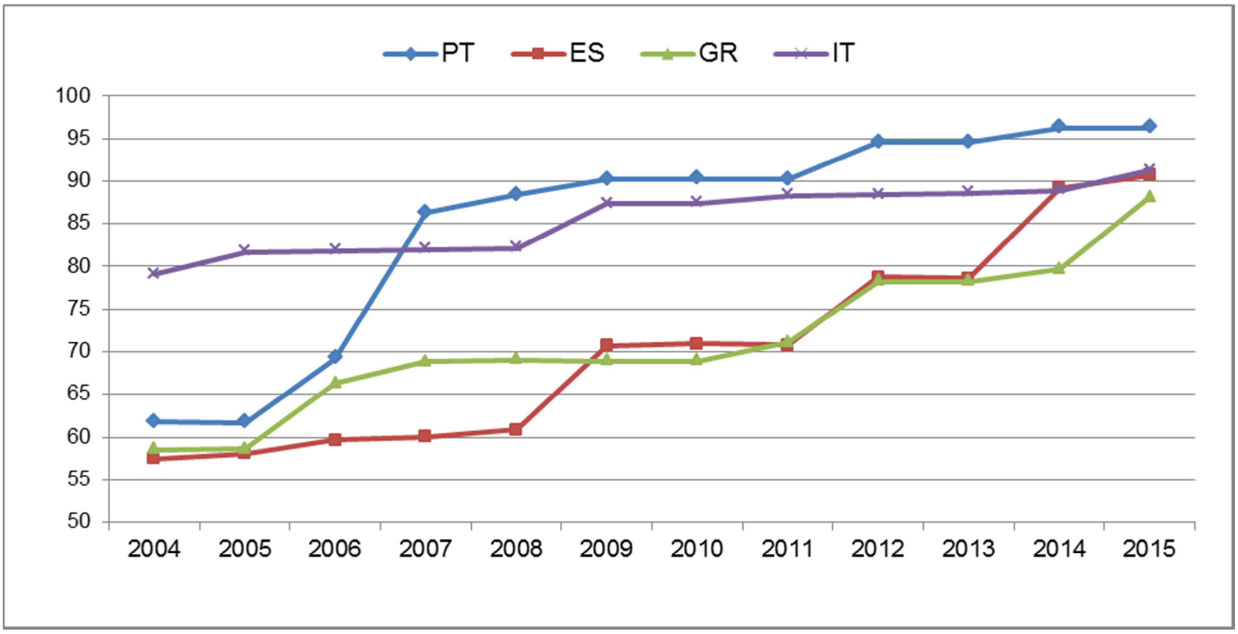
are similar to pharmacies to sell certain medicines for which prescriptions are required
- Liberalisation of network industries and introducing more competition by means of new competition authorities for these specific sectors, by decoupling production and distribution in the gas sector and by decoupling the price of gas from the price of oil.
- Retail trade: liberalizing shop opening hours (with continued high regulating intensity).

Focus: Reform of procedures for starting a business

A brief focus (in the context of product market regulation) is laid on the procedures for starting a business. On the basis of data provided by the World Bank's Doing Business database, figure 3 shows that the stressed euro area countries have achieved particular progress in this respect relative to the best performing countries - already after 2005 but particularly in the time after 2008 in most cases.

Figure 3: Regulatory intensity for starting up a business

Scale von 0 (worst performing country) up to 100 (best performing country)

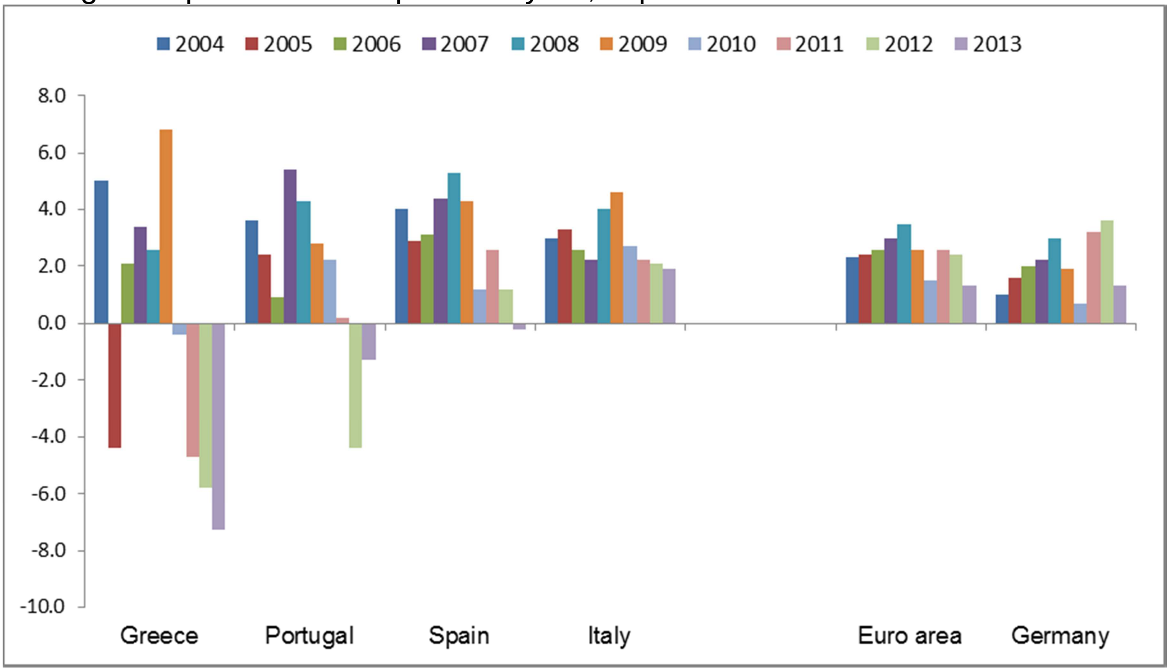


Source: World Bank Doing Business database

6. Reform effects on wages and employment

A look at recent wage trends supports the notion that the important structural reforms listed above are starting to result in more flexible wage policies.[15] This flexibility is important in the context of the OCA theory as explained above. Figure 4 shows that considerable wage adjustments have been made particularly in Greece and Portugal (see also Deutsche Bundesbank, 2014b). Also in Spain, wages have risen noticeably below the EMU average since 2010. This trend only applies limitedly to Italy until the end of 2013 but wage increases weakened noticeably (to below the EMU average) on the basis of quarterly data for 2014.

Figure 4: Wages and salaries in the commercial economy
Change compared with the previous year, in per cent



Source: Eurostat

In addition, several studies infer a direct connection between the structural reforms taken and the performance of wages and employment (see also Deutsche Bundesbank, 2014b, 23 et seq.).

- For Portugal this connection applies to the trend in unit labour cost and to the rise in employment since 2013 which also extends particularly to permanent contracts (IMF, 2014b; European Commission, 2014a). Remarkably, the (seasonally

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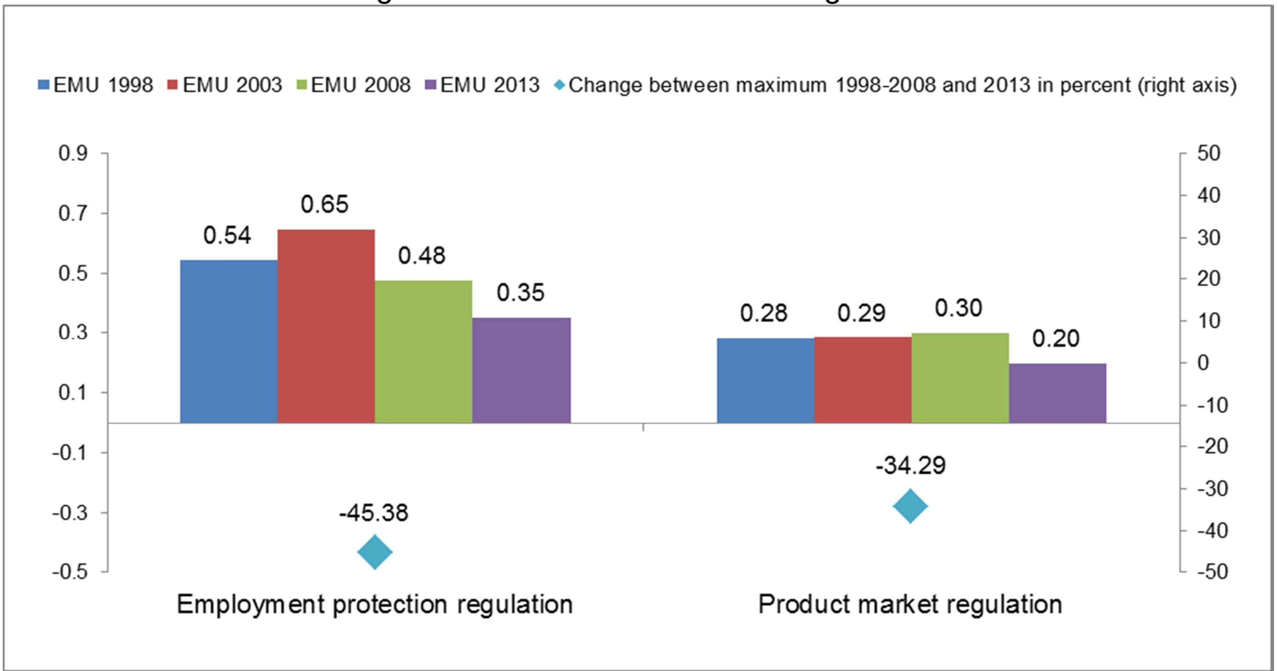
[15] The Deutsche Bundesbank (2014b, 26) points out that wages might have developed even more modestly than is evident from the available data, since mainly less qualified and relatively low-earning employees are likely to have been dismissed. This results in a structural effect on average wages: The reported aggregated trend in wages could therefore exceed the change of individual wages. Orsini (2014) also emphasized this effect for Spain.

adjusted) unemployment rate declined considerably from a maximum of 17.6 percent in the first quarter of 2013 to 13.6 percent in the third quarter of 2014.

- In Spain, search intensity of the unemployed and wage flexibility at the firm level have increased. The resulting stronger orientation of wage policy to the economic situation appears to have contributed to a notable recent employment increase, mainly in SMEs (IMF, 2013; Orsini/Vila Nuňez, 2014). Moreover, the IMF (2013) finds that the reforms appear to have reduced the growth threshold of employment.
- In Greece, wage adjustments and a more flexible wage policy have led to an improvement of cost competitiveness (European Commission, 2012). More recently, the reforms have also contributed to a relatively dynamic trend in new recruitment, despite the negative overall economic trend (European Commission, 2014e).

Figure 5: Heterogeneity of the regulation intensity in EMU
Standard deviations among EMU countries and their changes[1]



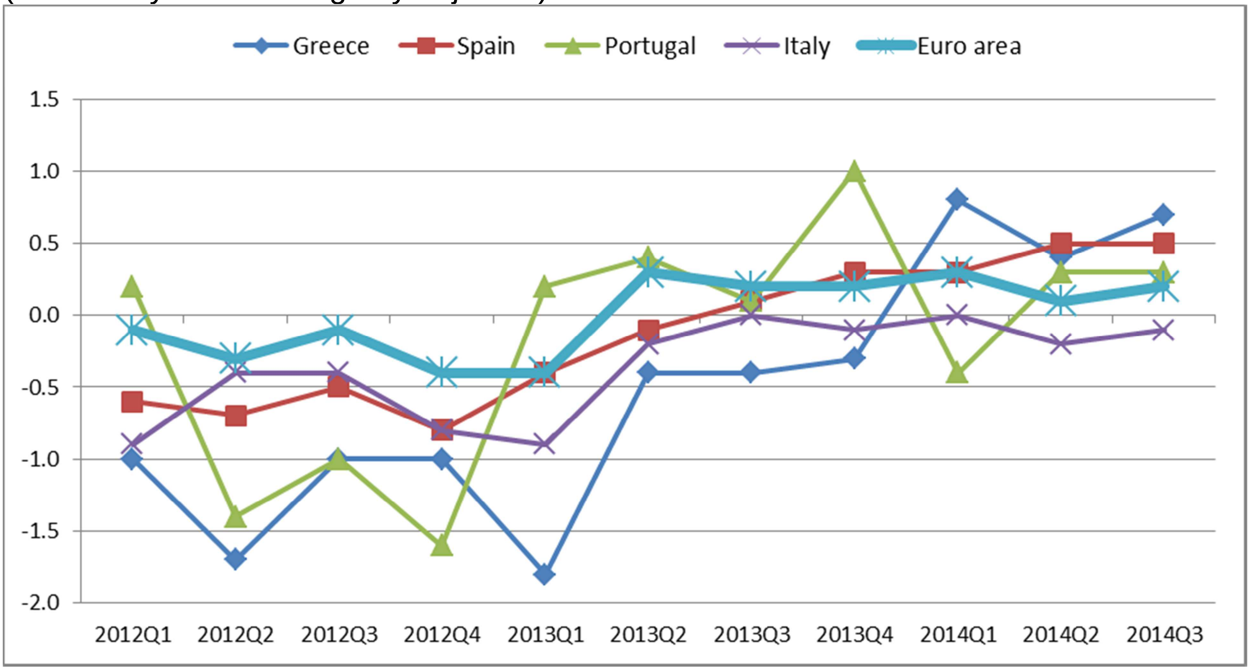
[1] Calculated on the basis of dates from Figures 1 and 2.
Sources: OECD, Cologne Institute for Economic Research

7. Reduced heterogeneity among EMU countries

In addition, it is important in the context of the OCA theory that the heterogeneity between EMU countries has declined in terms of the rigidity of labour and product market regulation. As a result, EMU countries have become more similar, which should improve the functioning of EMU via the influence of these regulations on the flexibility of wages and price. Figure 5 shows that the standard deviation (as a measure of heterogeneity) has been reduced by almost half in the case of employment protection and by about one-third in the case of product market regulation.

The standard deviation has declined noticeably also in the case of sub-indicators of product market regulation – compared with the maximum between 1998 and 2008. This reduction applies particularly to the protection of incumbent companies (-62 percent), the regulation of professional services (-46 percent) and price controls (-43 percent).

Figure 6: Recent economic growth
Change of real GDP compared with the previous quarter in per cent
(seasonally and working day adjusted)



Source: Eurostat

8. Conclusion and Outlook

8.1. Conclusion

Structural reforms in the stressed euro area countries directly address the problems which were mentioned at the beginning of this study. They reduce the heterogeneity of the Euro countries, increase the flexibility of wages and prices and facilitate structural change. Therefore, they should improve the functioning of EMU. Moreover, they increase the prospects for growth and employment.

It has been shown that the southern European countries have achieved considerable progress in structural reforms (despite the remaining needs for reforms). The available evidence up to now indicates that the structural reforms have contributed to greater flexibility of wages and to improved labour market performance. Moreover, heterogeneity between EMU countries has been noticeably improved in terms of the regulation of labour and product markets.

Finally, it appears that the reforms are also beginning to yield the aspired growth dividend. Figure 6 shows that Greece, Spain and Portugal have grown noticeably above average in 2014 compared with the euro area.[16]

This positive trend is expected to continue. According the most recent medium term forecast of the IMF (October 2014), the stressed euro area countries (apart from Italy) are expected to continuously benefit from above average economic growth between 2015 and 2019. This is highly relevant for the debate about economic convergence among euro area countries which (while having considerably progressed before the crisis) had stopped and worsened after the crisis (Goecke, 2013). However, if the IMF forecast proves right, Greece, Spain and also Portugal (to a more moderate extent) will reduce the gap towards Germany after 2014 in terms of living standards.[17] Thus, the above average implementation of structural reforms in these countries should pay off in renewed convergence.

For this to happen, ongoing reforms need to be solidly implemented and reform efforts have to continue, particularly in areas where relevant remaining reform needs have been identified.

8.2. Barriers to reform

However, despite the appearance of first positive reform effects, a discussion has taken hold whether postponing reforms would be reasonable **for economic reasons**. For example, Eggertson et al. (2014) point to possible dampening short term effects of structural reforms on economic activity in times of very low interest rates. With key interest rates at the zero lower bound – so the argument goes – product market reforms could lead (via to lower prices) to higher real interest rates and thus to a drag on domestic demand economic activity. This discussion could unduly dampen the impetus of euro countries for further reforms.

However, the fear of substantial negative short term effects of structural reforms – which Eggertson et al. derive from a fairly basic DSGE-model – can be qualified in several respects from a theoretical viewpoint. In fact, Eggertson et al. do not sufficiently consider that

- the ECB has (and applies) alternative instruments of monetary policy than only lower interest rate,

[16] However, that positive trend does not yet apply to Italy. A certain push for reforms was discernable under the administration of the previous Prime-Minister Mario Monti. The present Prime-Minister Matteo Renzi has started to tackle the remaining considerable need for reform. Much hinges, however, still on the implementation of his reform agenda.

[17] Living standard measured as the level of GDP per head based on purchasing power adjustment.

- structural reforms support economic activity because they tend to raise the profitability of investment and because lower prices increase disposable incomes and competitiveness in the short term (Vogel, 2014),
- expectations about a future increase in wealth due to today's reforms can lead to an expansion of economic activity in the short term (Fernandez-Villaverde/Rubio-Ramirez, 2011).

Thus, it is not much of a surprise that alternative DSGE-models do not or only hardly find negative short term effects of structural reforms (Bouis/Duval, 2011; Annicchiarico et al, 2013; Varga et al, 2013). This consoling result is mirrored by empirical evidence based on cross-country econometrics (Bouis et al., 2012). Therefore, reforms should not be postponed with reference to possible negative short term effects. While such effects cannot be completely precluded, they will most likely be rather limited, if they occur. In this respect, it is all the more important to design an encompassing package of structural reforms where certain limited negative short term effects of individual reforms can be compensated by positive short term effects of other reform items and of synergy effects of the package as a whole.

In addition, reform barriers can also be of **political nature**. If positive effects from structural reforms in the form of higher growth and lower unemployment take too long to materialise, substantial resistance against reforms can arise. Voters need to realise that their reform efforts were worth their struggle in due time. Greece is a prominent example of such a development. However, criticism of the reform course is also relevant in Spain (where general elections take place in November 2015) in the form of the new and rising party Podemos. Morevover, Matteo Renzi also anxiously waits for reform benefits to materialize in order to support his reform course and to keep his fragile governing coalition together.

8.3. Outlook

For structural reforms to yield tangible economic success, a sufficiently strong economic upswing is needed. Experience tells that only then the full reform effects materialise. If economic activity remains anemic for too long, the reform strategy of the euro area (which relies on broad structural reforms and moderate fiscal consolidation in the stressed countries) could be endangered. Moreover, an ongoing demand weakness could limit the reform benefits, as the growth potential can be impeded by a continuing lack of investment (and the negative effect on the capital stock) and by a possible loss in labour quality due to the negative effects of long term unemployment on workers' qualifications (Rawdanowicz et al. 2014). Therefore, it is highly important that a self-sustained upswing soon takes hold in the euro area and particularly in the stressed countries.

It is deplorable in this respect, that early business cycle indicators (that had risen considerably since 2012 particularly in the stressed countries) weakened and that growth in euro area was subdued again in the course of 2014. This was potentially mainly due to renewed economic uncertainty from geopolitical risks and in several euro area countries also to private deleveraging and restrictions on credit supply (IW-Forschungsgruppe Konjunktur, 2014). Moreover, the ongoing weakness in private investment in large parts of the euro area is a cause for concern, because this weakness appears to be relatively strong compared to other phases of recovery after economic and financial crises (ECB, 2014b, 69 ff.).

However, in early 2015 the economic picture has become somewhat brighter again, so that the prospects of a self-sustained upswing have become better. Early indicators of economic activity have risen again and economic forecasts have been revised upwards for 2015 – also in the stressed euro area countries (apart from Greece). This renewed cautious optimism is supported by several important drivers: lower oil prices, the falling external value of the euro, the redoubled expansionary monetary policy efforts of the ECB and the welcome plans of the large investment program of the EU. Thus, there is hope that the positive effects of the broad based structural reforms depicted in this paper can better materialize in the near future.

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