ECB policy spurred economic reforms in euro area countries

The European Central Bank (ECB) has repeatedly been the focus of debate: The background are low interest rates, bond purchase programmes and other unusual measures. However, our new study shows that the ECB’s monetary policy during the euro crisis has not only helped stabilise the common currency but also led to more structural reforms.

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“Whatever it takes!” – Mario Draghi’s famous phrase may have saved the common currency in the euro crisis – jointly with extremely low interest rates and the ECB’s bond purchasing programmes. However, in recent years many commentators have criticised that these measures were taken to the detriment of economically strong member states like Germany, as they, amongst others, harm savers. In this view, the “money glut” has also
discouraged countries of the eurozone to undertake necessary reforms to make their economies and therefore the Eurozone more competitive.

Our new study finds the opposite: The ECB’s expansive monetary policy may have actually contributed to euro area countries implementing more reforms than would have been the case if monetary policy had been more restrictive. The study shows: For the period between 2006 and 2016, a moderate monetary policy easing of 25 basis points increased the average reform effort by roughly 20 percentage points within two years. Strikingly, the ECB’s positive effect on reforms was strongest in countries like Spain, Portugal, Italy and Greece. Their economies were hit especially hard by the last financial crisis – and they are again under particular pressure in the current corona crisis.

Overall, the results suggest that an expansionary monetary policy has macroeconomic effects that go beyond the direct short-term stabilisation of aggregate demand. The authors of the study conclude that ECB policy creates the necessary fiscal room for manoeuvre for reforms and can help economies to grow faster.

**ECB policy has increased countries’ reform rate, particularly in the eurozone periphery**

The study provides empirical evidence of the reforms triggered by ECB policy during the euro crisis. Using a novel approach (an event study design), the analysis shows that the ECB’s expansive monetary policy – so-called “monetary shocks” – causally increases the probability of structural reforms.

This effect is stronger for countries with weaker macroeconomic fundamentals or tight public finances. The results suggest that monetary easing has acted as a reform catalyst, especially in the South and East of the eurozone and in countries that participated in a financial assistance programme. The reform effect is particularly strong in Greece and Slovenia, but also sizeable in Spain, Ireland and Portugal during the period of investigation. At the same time, peripheral countries are also more vulnerable to surprising monetary shortages such as interest rate hikes.

Even in the euro core countries, which generally have more fiscal room for manoeuvre, the ECB’s monetary policy has spurred reform efforts, albeit not as strongly as in the periphery. The findings are consistent with the view that expansionary monetary policy drives structural reforms in crisis-hit countries by easing the short-term costs of reforms and by increasing governments’ room for manoeuvre.
There is a broad political and economic consensus that structural reforms increase countries’ growth potential, stability, and resilience in times of crises. A clear understanding of how central banks’ decisions affect the implementation of such reforms can help policymakers in designing an adequate policy mix during prolonged periods of low growth and deep recessions such as the current corona crisis.

(Un)conventional monetary policy: catalyst or hurdle for structural reforms?

Structural reforms improve the institutional and regulatory framework of an economy to increase competitiveness, employment prospects and resilience to shocks. Following many years of low (productivity) growth, calls for such reforms were very loud in the eurozone. The current corona crisis will put further pressure on the framework conditions for economic activity in the euro countries.

How do monetary policy and structural reforms interact? One view is that an expansionary monetary policy reduces countries’ reform efforts because it facilitates market access for indebted countries. According to advocates of this "moral hazard" hypothesis, it can even lead to greater risk appetite, as governments can expect a "bail-out" of the central bank in extreme cases. The opposite view is that monetary easing facilitates reforms by increasing governments’ room for manoeuvre to finance these reforms ("room for manoeuvre" hypothesis).

Many believe that the ECB’s expansive monetary policy is only a short-term solution and does not solve fundamental problems. In contrast, the study shows that it can indeed strengthen long-term competitiveness. According to the authors, it is therefore important not to draw premature conclusions in the debate. For example, the ECB’s monetary easing allows governments to push ahead with reforms by facilitating transition costs. It can also lead to job creation and facilitate negotiations with political stakeholders and trade unions that might otherwise oppose the reforms.

Yet the authors also affirm that monetary policy cannot be a panacea: The ECB is doing an excellent job – but it must do so because budgetary policy in Europe is limited. In future, therefore, there should be more room for coordinated fiscal policy to support structural reforms and create incentives. The debate on the recent verdict of the German Federal Constitutional Court is a case in point. In this way, monetary policy could again focus exclusively on its main objective – price stability in the euro area.
While an extensive body of literatures exists that studies either the drivers of structural reforms or the effects of monetary policy, the direct link between the two has not yet been subject to a thorough empirical analysis.

The key empirical challenge is to establish causal identification: While the stance of monetary policy might affect the decision of governments to undertake reforms, it also depends on broader economic conditions, which themselves are a function of reforms. To address the confounding relationship between monetary policy, government decisions and broader economic conditions, we use an event study design that focuses on the unexpected variation in euro area interest rates on ECB (un)conventional policy announcement days. These monetary policy
shocks, along with other economically and politically relevant factors, are used to explain the reform responsiveness rate.

Our main structural reform measure is the OECD's "reform responsiveness rate", which captures the extent to which countries have taken "significant action" in implementing policy reform recommendations. The indicator measures the implemented structural reforms as a share of recommended reforms in the previous year by country. It is a comprehensive metric of legislative and regulatory changes within a large number of markets and sectors.

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