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What determines the likelihood of structural reforms?☆

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ABSTRACT

We use data for a panel of 60 countries over the period 1980–2005 to investigate the main drivers of the likelihood of structural reforms. We find that: (i) external debt crises are the main trigger of financial and banking reforms; (ii) inflation and banking crises are the key drivers of external capital account reforms; (iii) banking crises also hasten financial reforms; and (iv) economic recessions play an important role in promoting the necessary consensus for financial, capital, banking and trade reforms, especially in the group of OECD-countries. Additionally, we also observe that the degree of globalisation is relevant for financial reforms, in particular in the group of non-OECD countries. Moreover, an increase in the income gap accelerates the implementation of structural reforms, but increased political fragmentation does not seem to have a significant impact.

1. Introduction

In the aftermath of the global financial crisis of 2008–2009, the political agenda was dominated by the need to design a response aimed at promoting the economic recovery in the short-term. As financial conditions started to improve, and general economic activity began to show signs of stabilisation, policy measures shifted towards a focus on strengthening resilience. Not surprisingly, the implementation of structural reforms is nowadays seen as an important means for dealing with the negative effects of market failures and the dangers of an opaque regulatory environment, as well as creating the necessary conditions to sustain growth in the medium-term.

In this context, the existing literature suggests that countries are typically induced to implement structural reforms when confronted with a deterioration in economic conditions, i.e. the so called "crisis-induces-reform hypothesis" (Drazen and Grilli, 1993). From a theoretical point of view, crisis episodes are seen as pre-requisites for reform efforts (Bates and Krueger, 1993) or regarded as extreme cases of policy failures (Rodrik, 1996). From a historical perspective, the number of crises experienced by

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many countries seems to support the argument that crisis episodes facilitate the implementation of structural reforms (Lora and Olivera, 2004; Drazen and Easterly, 2001).

Another strand of the literature highlights the role played by economic growth at fostering structural reforms. For instance, Aghion and Blanchard (1994) show that the restructuring of the state sector depends on labour market conditions. Campos and Horváth (2012a) also emphasize the importance of economic conditions in driving internal and external liberalisation reforms and the process of privatisation.

Additionally, a number of external, institutional and political factors have been put forward as helping to explain the incentives for reforms. For instance, external aid, whether in the form of a financial assistance program or as part of a sovereign debt restructuring, is normally conditional on the implementation of a series of structural reforms (Drazen, 2000; Fernández-Arias and Montiel, 2001). Similarly, poor quality of institutions and political fragmentation may deter the course of structural reforms either because of power to block reform legislation (Roubini and Sachs, 1989a), due to the political resistance to changes in the policy process (Alesina and Drazen, 1991; Rodrik, 2000) or even as a reflex of the distributional conflicts at the time of reforms (Rodrik, 1994).

Despite this, the empirical evidence on the "crisis-induces-reform hypothesis" is still scarce or limited to a number of works that provide, at most, some insights on the regulatory policy response to crisis episodes (Nelson, 1990; Haggard and Kaufman, 1992), rather than a full assessment of the main drivers of the likelihood of structural reforms.

In this paper, we try to fill the above-mentioned gaps in the literature while answering the following questions: (i) Do crisis episodes operate as catalysts of structural reforms? (ii) How important are economic conditions at explaining the implementation of structural reforms? (iii) Can globalisation boost the likelihood of structural reforms? (iv) What is the role played by the political setup?

Using a logistic regression and annual data for 60 countries over the period 1980–2005, we show that crisis episodes tend to accelerate the implementation of structural reforms. In particular, external debt crises are the main trigger of financial, banking and trade reforms. Inflation and banking crises are key drivers of external capital account reforms. Banking crises also exert an important effect over financial reforms.

Additionally, the empirical findings suggest that a higher degree of globalisation is positively related with most of the reforms implemented by the economies analysed in this study.

Moreover, our findings also show mixed results regarding the intensity of distributional conflicts: a higher degree of inequality pushes forward some reforms, but the fractionalisation of the political system is not relevant in the process (with the exception of product market reforms).

Our results are robust even after controlling for the GDP growth and the inflation rate, which has proven to have no significant impact on the kind of reforms analysed in this study (except the positive influence of inflation in fostering capital account restrictions).

We also find that the degree of globalization and the occurrence of crisis episodes are more relevant for the reform effort in non-OECD than in OECD countries. In this last group, recessions are a key catalyst of reforms.

Finally, the empirical evidence reveals that negative changes in the reform indices are better described as "structural reversals" and not as overshoots of the welfare-optimizing points.

The rest of the paper is organized as follows. Section 2 looks at the related literature. Section 3 presents the econometric methodology. Section 4 describes the data. Section 5 discusses the empirical results. Section 6 provides the sensitivity analysis. Finally, Section 7 concludes.

2. Literature review

A large body of empirical literature considers crisis episodes as the key drivers of policy reforms. Haggard and Maxfield (1996) argue that, in response to declining exchange rates, governments are likely to adopt liberal capital account policies to encourage foreign capital owners to resume investment. When capital inflows subsequently resume, exchange rates recover and domestic financial difficulties ease. Similarly, Simmons and Elkins (2004) find a significant and positive effect of currency crises on capital account openness. Moreover, financial liberalisation measures consisting of the relaxation of borrowing constraints and the lift of restrictions on cross-border financial transactions often strengthen financial development and contribute to stronger investment and higher long-run growth. The positive direct effect of structural reforms on growth significantly outweighs the growth loss associated with the excessive risk-taking phenomenon induced by liberalisation (Ranciere et al., 2006).[1]

Accordingly, countries are typically induced to reform when confronted with deteriorated economic conditions. Episodes of recessions, hyperinflation, and fiscal and external imbalances are likely to help removing obstacles to policy changes and to induce reform opportunities (Nelson, 1990; Grindle and Thomas, 1991; Haggard and Kaufman, 1992; Bates and Krueger, 1993; Haggard and Webb, 1994; Williamson and Haggard, 1994). Jong-A-Pin and De Haan (2007) also show that economic reforms lead to accelerations in economic growth and these are more likely when political regimes change.

From a theoretical standpoint, economic stagnation or poor economic prospects that turn into "crises" are seen as pre-requisites for reform efforts. Putting it differently, reforms are not needed when economic conditions are satisfactory (Bates and Krueger, 1993). Indeed, one of the most prominent theoretical arguments in favour of the so called "reform-induced crisis hypothesis" concentrates on the public *perception* of the need of reforms (Williamson, 1994). Only when the economic situation gets quite bad do

[1] Bekaert et al. (2005) find that stock market liberalisation leads to an increase of one percentage point on average GDP growth. Levchenko et al. (2010) also uncover positive growth effects when analysing industry level data. At the firm level, this result is confirmed by Henry (2007) who shows that that financial reforms lead to investment booms associated with declining capital costs.