Reform Reversal in Former Transition Economies of the European Union: Areas, Circumstances and Motivations

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Motivations

- Why to focus on reversals?
  - Apparently wide-spread
  - No good political economy models
  - Can be particularly damaging
- Why to look into FTEs?
  - Uniquely fast-paced reforms in one generation
  - Uniquely strong role of external anchors
  - Possibly strong peer pressures, either direction
- Why now?
  - EU accession
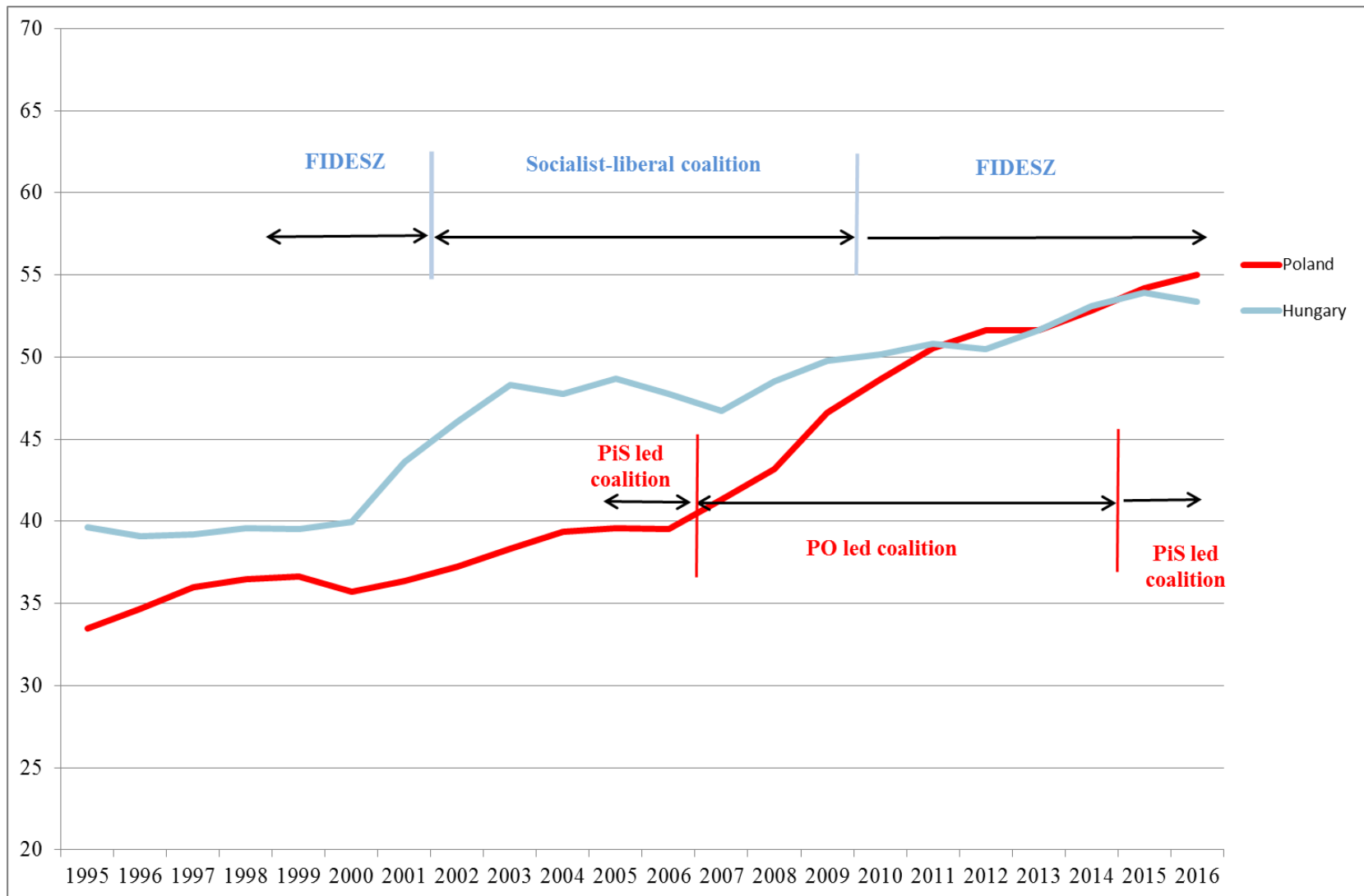 - Crisis
  - Important episodes: path dependency

Slovenia

- Interplay of behavioral reversals in banking, SOEs/corporate governance and supervision
- External anchor (MIP) →
  Reversal of reversals: behavioral and formal (privatization)
- Spill-over → central bank independence
- Strong external anchor: ECB
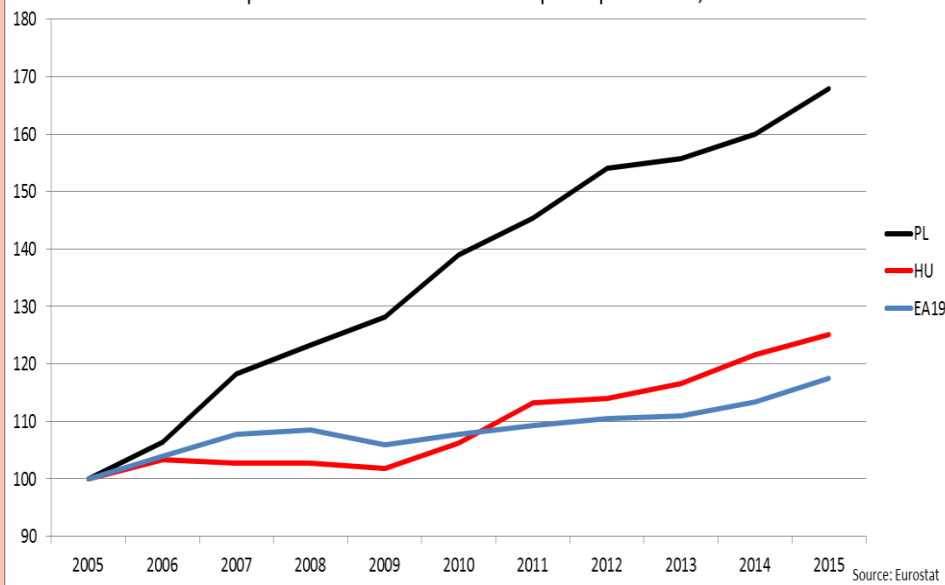- Spill-over
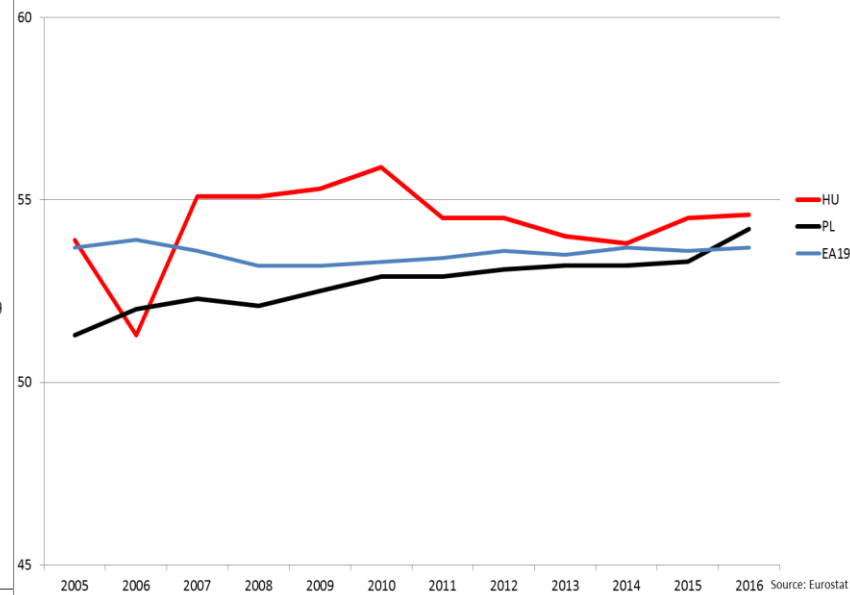 - formal → behavioral
  - CB → banking

Poland and Hungary

Polish and Hungarian middle classes

Lessons: Internal anchors

- Rapid journey stress-tested **social learning** in FTEs and left **best-practice institutions** with weak **social norms**

- Reform reversals are **wide-spread**: several countries, many areas

- Reforms reversals can be **formal** (legislation, rules) or **behavioral** (quality-behavior of an institutions)

- **Spill-overs** and **interactions** play a central role

  - From formal to behavioral and vice versa

  - From one area into other areas

  - From one institution to the other

  - Full-blown reversals are typically the result of the interplay and spill-overs among reversals in different areas

- **Inherent characteristic** of this journey

Lessons: Internal anchors

- **Partial and opportunistic reversals** can happen everywhere, even under weak governments, **major and multifaceted** reversals require strong governments

- **Asymmetries** in reversals and social norms

- **Financial system** is particularly prone to reversals

- **Best-practice fiscal frameworks** in themselves are not enough to anchor fiscal behavior.

- And when they are strong enough, reversal in fiscal behavior **transforms itself** into formal reversal in other areas (pension)

- The **crisis** made FTEs more prone to reversals, but reversals can happen in good times, too

- **Other factors** matter but do not explain reversals

Lessons: External anchors – IMF, WB

- IMF, WB dominant anchors until EU accession process started, from there on the EU gradually takes over this role

- (EU-) IMF programs:
  - Strong promoters of reforms and fend off major reversals
  - But prone to opportunistic reversals
  - Only work up to a point

- IMF surveillance (A4):
  - Very efficient in identifying formal reversals
  - Less so regarding behavioral ones
  - Overall a weak anchor

Lessons: External anchors – EU

- The EU is a strong external anchor against formal reversals in areas covered by EU law

  - Strong external anchor can shift reversal effort into other area

  - Or transform it into behavioral reversal

- Much less so against behavior reversals and areas not covered by EU law

  - MIP worked well when imbalances became excessive and the process more powerful, but weak preventive power

  - Difficult to detect behavioral reversal, especially in less transparent or legally well protected areas – perverse behavior of independent institutions

Lessons: Moving forward

- Accelerate social learning
  - EU schemes: Erasmus+, similar for mid-career, life-long
- Focus on quality and coherence of institutions and reforms
  - SSRS: help quality and coherence and accelerate social learning
- Strengthen external surveillance, also based on understanding the nature of reversals and the role of spill-overs
- The political ambition ("want") of Euro area accession
  - Can spur reforms and lock in more than before (SSM)
  - But may well remain a weak anchor in other areas