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Dinner Speech: Deepening EMU – Political Integration and Economic Convergence

Dear Ladies and Gentleman,
Allow me first of all to thank Oesterreichische Nationalbank and the Austrian Federal Economic Chamber for organizing this excellent conference and giving me the opportunity to share my thoughts at this event and in this beautiful surroundings.

We all know that Europe has gone a long way in terms of monetary and economic integration and that the path to the point where we stand today was not an easy one. From a perspective of a person who was deeply involved in Croatia's negotiation process towards the EU membership, bringing so many countries under one "roof" is an achievement in itself. But, as we have discussed today, formidable challenges still lie ahead if we want to achieve deeper integration and boost economic convergence.

Being here in Austria tonight, it is only natural to think about Habsburg Empire as one example of a challenging nature of integration and convergence processes. Vienna Institute for International Economic Studies recently argued that some similarities exist between the Habsburg Empire and the EU, both representing complex state structures, involving various nations and autonomous regional authorities. However, the Habsburg Empire was characterized by the very low "strength" of the convergence process. According to the authors of the study, reduction of the income gap by half was supposed to happen over the period of 238 years – apparently a too long period from that particular union's perspective. This is not to say that economic divergence was solely responsible for what happened, but protracted economic hardship provides a breeding ground for destructive ideas. Same can be witnessed in today's post-crisis European landscape.

In the last couple of years, convergence processes in the EU were not in the focus of policy makers as most EU countries have been preoccupied with more serious issues – financial sector crisis and sovereign debt crisis. Rightfully so, as these were threatening the very existence of the euro area and possibly even the EU. While we are still not entirely out of the woods, great progress was achieved in these areas. Government deficits were substantially reduced and in most of the EU Member States public debt has been put on a downward path. Even more importantly, we now have the mechanisms in place that better equip us to deal with the next crisis. The Stability and Growth Pact was strengthened, ESM was established, creating the first serious European financial firepower, and the SSM and the SRM, the first two pillars of the banking union, are now in place.

However, with the negative effects of the financial crisis being gradually overcome, focus of policy makers has turned back towards one of EU's main policy objectives – economic and institutional convergence of its Member States.

Central and Eastern European countries have made large progress since the 1990s and in many countries transition towards market based economies is now largely completed. Nonetheless, their economic convergence is far from over and it was severely shaken by the recent economic crisis. Since the onset of the crisis positive income convergence trends were first reversed in many of the countries in the region and, when convergence reappeared, its pace was significantly slower than at the beginning of 2000s. At the current pace of convergence, some countries in the region would need many decades to come closer to Austrian or German levels of income.

These trends clearly show us that further convergence of standards of living is not a sure thing, and should not be taken for granted. The CEE countries will have to find new and more flexible drivers to support the relaunch of the catching-up process and to build more efficient and productive economic systems in the years to come.

So, the question arises what policy tools are available to lift potential growth and convergence?

In the pre-crisis period the growth in CEE countries was to a large extent based on strong investment growth supported by huge inflow of foreign capital. In post-crisis period net foreign direct investment inflows fell in most countries of the region and, while we can expect a rebound of capital investment growth in CEE countries, I am quite certain that growth rates that we have witnessed in 2000s, will not be seen again in the near future.

Fiscal policy might give some impetus to growth but only to a very limited extent. Most countries still have no or very limited fiscal space. Although large progress has been made to stabilize public finances after surge of deficits in the wake of global crisis, in some countries debt ratios are still above prudent levels and most countries have not yet reached their medium-term objectives. In order to increase public investment without making strong pressure on public finances the key will be to use EU funds more efficiently and effectively which in some countries, like my own, is still far from optimal.

On top of the mentioned challenges, CEE countries are also facing very unfavorable demographic trends. The share of the elderly population in total population is increasing while the share of the working age population is declining, resulting in a significant rise in the old-age dependency ratio. These unfavorable demographic trends are in some countries further aggravated by strong migration outflows (of mostly young and relatively educated labor force) which, in turn, puts a pressure on domestic wage growth and might weigh negatively on countries' cost competitiveness. This might not only work as a drag on real and potential output growth but might also create additional pressure on the fiscal positions. As pension system reforms have been rolled back in many countries, improvement in current fiscal positions are hiding higher fiscal pressures in the years to come.

With these constraints in place, the key of lifting potential growth will be to increase the efficiency with which factors of production are used, that is total factor productivity (TFP). We know that in the long run, when it comes to rising living standards, it is all about productivity. Much has been said about TFP growth in the context of the discussions on the slowdown in productivity growth, or discussions of convergence in Europe. For us, policy makers, understanding the determinants of TFP growth, is the key, as this gives us the channel to act through. There is an increasing number of theoretical and empirical papers linking both the development and the adoption of technologies to the quality of institutions defined in a very broad way. And data seem to be supportive of the link – there is a strong positive relationship between quality of institutions on one side, and growth on the other. This is why labor and product market liberalization, or business friendly environments and quality of institutions in general are so important in communication with government and broader public.

Moreover, as I mentioned earlier, catch-up growth in CEE countries in pre-crisis period relied largely on importing foreign capital which resulted in transfer of knowledge and know-how

via massive amounts of foreign direct investment. But with these inflows subsiding, it seems that more domestic innovation and investment in non-material assets will be required to maintain growth and to avoid the middle-income trap. And for this, increasing level of human capital will be crucial.

But, when it comes to the quality of institutions or human capital, there has been only modest convergence of the CEE. If quality of institutions is proxied by World Bank's Worldwide Governance Indicator there has been hardly any convergence of the CEE region towards Germany (notable exceptions are the Baltic countries where we have seen positive developments also in the aftermath of global financial crisis). Very similar conclusion can be drawn when looking at the human capital quality – not only that CEE countries lag substantially behind the EU countries that achieve the best results in PISA tests in Math and Science, but the developments over time are also not encouraging as in many countries the results actually worsened, rather than improved during the last decade.

On one hand, such developments are worrisome, but, on the other, they provide the opportunity to streamline reforms and make substantial gains from these same reforms. European Commission estimated that structural reforms that would close only half the gap with best performers in different areas (market competition and regulation, R&D expenditure, skill structure, tax structure, labor market participation, unemployment benefit 'generosity' and active labor market policies) could have significant macroeconomic effects. The level of GDP in 10 years after the reform would be around 7% higher in the CEE countries and around 12% after 20 years compared to the "no reform" scenario, and effects on employment are of similar magnitude. The OECD, or the IMF, also point to significant benefits of structural reforms in terms of TFP improvements. Notwithstanding the uncertainty around these estimates, welfare advances would most probably be substantial.

But the question is how to get structural reforms right? There are in general two dimensions of structural reforms. First, and in principle the easier ones, are the reforms that bring us closer to the efficiency frontier. That said, it is possible that easy productivity gains from sectoral reallocation and imports of foreign technology have to a large extent been exhausted. The second are the reforms that expand the efficiency frontier with many different policies to follow: research and innovation policy and strategy, product market reforms, competition policy, labor market reforms, public finance and taxation (including social security system), human capital development, etc. Can we, and should we, act on all, or most of these different fronts simultaneously? Probably yes. Do we as economists and policymakers truly understand all the synergies, complementarities and marginal effects of different reforms? Do we understand political economy of moving individually or in parallel on all these fronts? Probably not.

Another question is what should we use as a benchmark of good practices? We could, and in my opinion should, go beyond EU best performers and look at other, better, countries. Namely, what is also worrisome is that not only convergence within EU has slowed down, but also EU as a whole started to lag behind U.S.A., and this trend of divergence started long before the recent crisis. Europe's convergence process towards U.S.A. actually stopped in the mid-1990s and in the early 2000s U.S. productivity growth re-accelerated and the U.S.-EU gap widened indicating structural and institutional weaknesses that need to be addressed. So should the goal for CEE countries be to converge towards EU style labor, product and financial markets, or maybe towards more efficient ones? Converging towards the structures that are themselves underperforming might not be a good choice.

For example, integration of CEE banking markets with the West European ones, through entry of banks into the CEE region at an early stage of the transition, was certainly beneficial in bringing better technology and banking culture, as well as facilitating the capital transfer. However, today, when it is clear that bank-based financial systems are inferior to more diversified ones, the goal should probably be to turn towards developing more efficient structures.

At the same time, we need to keep in mind the political economy dimension of the process. We need to ensure broad support for the reform agenda especially since there might be some short-term costs of certain reforms. However, according to the EBRD data, not only the difference between shares of people who support and those who oppose market economy in the CEE region is only half of that in Germany, but it actually declined over the last ten years. Moreover, the same applies to the support of democracy as a political system. This is where policy design of inclusiveness, policy transparency and communication will play a tremendously important role.

So, the bottom line is that hard work awaits us and that there are no guaranties that levels of income in CEE countries are going to converge towards those of the developed Western economies. However, it is our job to dare to introduce reforms even if we are not entirely sure about the appropriate timing and the scale of their effects, as these are often not under our direct control and are notoriously hard to predict. But if history teaches us anything, and if we follow the best practices from around the world, then the path we have to follow becomes much clearer. And the closest thing to a recipe for reducing probability of being caught in middle income trap (of low growth and slow or no convergence) would be to dare to reform. Be it the education system with an aim to increase the quality of human capital, more advanced research and innovation, further liberalizing product and labor markets controls, reform of justice or public administrations systems, or any other thing that is proven to enhance the business environment in the country. And clearly, not everything we do will always get full support from the broad public, especially in the case of structural reforms with long-term gains and short-term costs, but, believe me, boldness is often rewarded beyond our expectations.

Let me end here by saying that exhibits of Schlossmuseum Linz warn us that the course of natural and societal development is indeed a long, winding and hard to follow road, but also allows us to be optimistic about our future prospects. We only need to make sure that the convergence process this time takes somewhat less than 238 years. Thank you!

References

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