The "East Jour Fixe" of the Oesterreichische Nationalbank

60th East Jour Fixe

Central and Eastern Europe: Is Economic Convergence on Track?

The East Jour Fixe of the Oesterreichische Nationalbank (OeNB) was initiated in 1991 as a forum in which central bankers, government officials, members of academia and other experts on Central and Eastern Europe meet to discuss specific transition issues. On June 22, 2007, the OeNB hosted the 60th East Jour Fixe in this series on the topic of "Central and Eastern Europe: Is Economic Convergence on Track?" The jour fixe was organized as a joint event with this year's SUERF Annual Lecture given by Paul De Grauwe and entitled "Problems and Prospects for Enlargement of the Eurozone."

In the introduction, Peter Mooslechner, Director of the OeNB's Economic Analysis and Research Department, stated that economic convergence was key to spreading prosperity across countries and societies. Convergence has, moreover, gained added prominence in the European debate in the context of monetary integration, as according to the Treaty establishing the European Community euro area entry presupposes a high degree of sustainable convergence.

Peter Mooslechner recalled that the concept of convergence had a number of well-known – but not always precisely defined – dimensions. Real convergence is often understood as per capita income convergence, which is one of the most common measures of living standards around the world. Structural convergence is usually associated with a congruence of the broad economic structures of countries and some degree of business cycle synchronization. It is also closely related to competitiveness, as a country's resources are shifted to their most productive uses in the process of convergence. Accordingly, total structural convergence is neither feasible nor desirable. In contrast, nominal convergence tends to be understood – especially in the European debate – as the fulfilment of the Maastricht convergence criteria on prices, interest rates, exchange rates and public finances. Finally, institutional and legal convergence should be mentioned as further dimensions of convergence, as they are also prerequisites for joining the European Union and subsequently the single currency area.

In concluding, Peter Mooslechner pointed out that the EU had been a "convergence club" for income convergence progress in the EU's youngest Member States since the mid-1990s, especially following their accession to the EU; and more recently also for progress in Southeastern European candidate and potential candidate countries. However, some differences between Member States remain, mostly because of persisting differences in economic structures and in fiscal policies.

The topic of "Real Convergence in Central and Eastern Europe" was presented by Gábor Oblath, Member of the Monetary Council of Magyar Nemzeti Bank and Professor at Budapest's Corvinus University. Reviewing various interpretations of real convergence, Oblath indicated that the Central and Eastern European countries (CEECs) had shown absolute convergence to the real GDP per capita level of the EU-15 since the mid-1990s. However, the question whether developing countries are indeed catching up with more advanced economies depends on the method of measurement employed. Using the measures of "GDP per total hours worked" or "GDP per person employed" rather than "GDP per capita" (at PPS) makes it possible to take account of the differences in labor intensity and utilization, which appear to be significant. Furthermore, Oblath proposes to use real gross domestic income (RGDI), which corrects output for the impact of changes in the terms of trade (implicit income transfers to/from the rest of the world). Differences between RGDI and GDP growth have been observed especially in the case of Romania, Bulgaria, the Czech Republic, and Lithuania – in other words, the GDP measure underestimates the extent of the convergence progress especially in their case.

Oblath summed up the convergence process of Central and Eastern Europe as follows: After a decline of performance between 1989 and 1994 (transformation recession), the second half of the decade brought clear progress in catching up especially for small countries, thanks to well-timed stabilization and liberalization measures, which in turn fostered FDI and export-led growth.

However, as Gábor Oblath argued, there is no unique real convergence path for CEECs. As developments have so far shown, countries can be successful in catching up despite differences in macroeconomic or structural policies and/or a different behavior in the private sector. In respect to macroeconomic policies, Poland experienced excessive monetary tightening, while Hungary witnessed excessive fiscal loosening in the first decade of the new millennium. Both developments harmed real convergence. In the Baltic countries, continuously high credit growth increased vulnerability. Regarding reforms, Slovakia implemented significant tax cuts (in the context of introducing a flat tax regime) combined with substantial structural reforms in other areas, while Slovenia kept high taxes and undertook only piecemeal and gradual reforms. Concerning wages and prices, Slovakia, unlike Slovenia, had a very low relative price and wage level, but both countries' recent performance and their outlooks are sound. Oblath concluded by calling for further examinations of "stylized facts" in order to better understand recent developments in real convergence.

The second lecture was held by Michael Landesmann, Director of Research at the Vienna Institute for International Economic Studies (wiiw) and Professor at the University of Linz, on the topic of "Competitiveness and the Structural Convergence in Central and Eastern Europe." The aggregate picture for the EU-27 he sketched shows a progressive development toward absolute convergence, implying productivity level convergence (supply side) and convergence of demand structures. However, the analysis of real convergence inevitably directs the attention to the structural features of catching up, e.g. to changes in output and employment structures. A U-shaped curve of employment shows that during the catching-up process, the employment rate seemed to decline, due to the strong presence of sectors with declining output shares and strong productivity catching up. But over time this trend was reversed through the increasing weight of sectors with strong output growth and lower catching up in productivity. Indeed, it is noticeable that employment in the agricultural sector progressively declined between 1995 and 2005, while the service sector substantially gained in employment. Convergence is also observable through increased wage productivity dynamics and hence changing patterns of international specialization along comparative advantage patterns. The dynamic of productivity growth is uneven across industries, whereas wages grow much more uniformly across industries.

To a large extent, structural changes are also the result of FDI inflows, which have raised the prominence of CEECs in international trade. Employment also shifted from low-skill sectors to medium-high- and high-skill sectors, which in turn puts pressure on catching-up economies to upgrade skills. Demand for high-skill labor thus rises, resulting in labor supply adjustments in terms of educational choices, and international and national migration flows. The risk for the EU-15 is that education and skill levels stagnate, thus exposing "old" Member States increasingly to competition from new Member States.

Landesmann concluded that regional homogeneity and thus full structural convergence could not be expected in the future.

Andrzej Slawinski, Member of the Monetary Policy Council (MPC) of Narodowy Bank Polski (NBP) and Professor at the Warsaw School of Economics, provided an analysis of nominal convergence, focusing on the case of Poland from the angle of monetary policymaking.

As seen by Andrzej Slawinski, monetary policy is essentially about central banks meeting their own commitments. Between 1990 and 1991, the NBP made the commitment to achieve a stable exchange rate; from 1992–1998 it used a crawling peg and then a crawling band; in 1999, it shifted toward inflation targeting; and in 2000, it eventually floated the złoty. The sustainability of the initial exchange rate-based monetary policy strategy was undermined by financial market developments (the emergence of a derivatives market). Soon after the move toward a looser exchange rate regime the economy faced negative supply shocks (a sharp rise in oil and food prices), so monetary policy was tightened in order to preserve the central bank's credibility. The rise in interest rates triggered a sharp appreciation of the złoty, though, which in turn exacerbated the economic slowdown that had already set in. Yet the floating rate confirmed its reputation of being a shock provider rather than a shock absorber. In the years following the introduction of a floating currency, inflation was reduced through the economic slowdown and positive supply shocks. In 2003, the NBP introduced a permanent inflation target. In 2004, a sharp rise in oil prices and EU accession caused the CPI to bounce back, forcing the MPC to raise interest rates in order to prevent second round effects – despite a significant level of unemployment. Between 1999 and 2004 the złoty fluctuated strongly and was largely disconnected from fundamentals. The volatility of the złoty's exchange rate to the euro to a considerable extent reflected movements in USD/EUR exchange rates before foreign exchange dealers started using the euro instead of U.S. dollars as the transaction currency. When they switched to the euro, the złoty's volatility against the euro moderated significantly. The moderation was also the result of nominal convergence, i.e. shrinking interest rate differentials, which reduced incentives for short-term capital inflows. After 2004, the złoty moderately appreciated in line with the Balassa-Samuelson effect, because of the reduced country risk thanks to EU membership and due to the increased demand for Polish exports. This moderate appreciation, in turn, helped control inflation.

Slawinski concluded that the disinflation process in Poland was over, thanks to a committed central bank and thanks to the damping effects of globalization. In his opinion, nominal convergence should not be challenging for the Czech Republic, Hungary and Poland; furthermore he argued that the Baltic states should have been allowed to join the euro area since they had disinflated their economies and fulfilled the fiscal criteria. Moreover, as Slawinski argued, hard peg regimes had turned out to be a "long and risky shortcut" to the euro area, due to the Balassa-Samuelson effect but also due to the procyclical properties of such exchange rate regimes. The threats to preserving nominal convergence are credit booms and expansive fiscal policies, while the task to fulfil the Maastricht long-term interest rate criterion has effectively been "outsourced" to the bond markets.

In the following SUERF Annual Lecture, Professor Paul De Grauwe, Katholieke Universiteit Leuven, spoke about "Problems and Prospects for Enlargement of the Eurozone." Building upon arguments from the theory of Optimal Currency Areas (OCA), De Grauwe argued that in terms of trade integration, many of the new Member States fitted better into the euro area than some of the existing euro area countries; by contrast, they were subject to more asymmetric shocks. Since the EU-27 does currently not form an OCA, widening the euro area to 27 member countries would amplify already existing economic divergence within the euro area and thus create tensions within the euro area which cannot be solved by the ECB's single monetary policy. Already among the present group of euro area countries, there are persistent economic imbalances, which, according to De Grauwe, call for monetary union eventually to be supplemented with political union. At the same time, the larger the EU, the more difficult political union will be to achieve. In the vivid ensuing discussion, this rather bleak view was challenged by some, pointing out, for instance, that Germany's current recovery showed that adjustment of the real exchange rate through wages and prices, while being slow, could work effectively over the medium run. Contrary to De Grauwe, Executive Director Josef Christl from the OeNB argued that the Maastricht convergence criteria were a suitable proxy for assessing a country's readiness to join the euro area.