

Threats to The “Convergence” of the CESEE

By William White

I am very pleased to have been invited to speak at this 2019 Lamfalussy Lecture Conference. I met Alexander Lamfalussy in the mid 1980's, when I first started attending meetings at the BIS in Basel, and was impressed by his great wisdom, analytical capacities and his personal kindness. Accordingly, I was particularly honored to accept the position of Economic Adviser at the BIS in 1995, a position he had previously occupied. Yet, it was only last year, when I did a review¹ of a book of his essays², that I really came to appreciate the greatness of this quintessentially modest man. Reflecting a lifetime of rich experience, and of constantly having to adapt his beliefs and policy recommendations to changing circumstances, his essays remain well worth reading by those charged with dealing with contemporary problems.

My comments today will be in three parts. First, I will take a brief overview of the convergence process between the CESEE countries and the rest of the EU since the demise of the communist system in the CESEE in the early 1990's. Second, I will hazard some thoughts on the future of the convergence process, stressing the importance of the need to ensure that the CESEE economies are sufficiently resilient to inevitable economic downturns. Hoping for the best is not a strategy. Third, I will identify some current threats to both growth and convergence, some economic and some political, and will also suggest some policy remedies.

Convergence to Date

The Nobel prize winner Daniel Kahneman (2013) stresses that how a problem is “framed” has an important effect on the solutions ultimately suggested. The organizers of this conference have defined the problem in terms of “catching up” or “convergence” with Western Europe. This implies either a belief in the inevitability of this process or a belief that there is something inherently good in achieving such a **relative** objective. It seems to put aside a possible alternative objective, of simply raising in a sustainable way the **absolute** quality of life for the

¹ White (2018a)

² Maes (2017). The book was commissioned jointly by the Magyar Nemzeti Bank and the National Bank of Belgium

citizens of the CESEE. This focus on “convergence” also threatens to draw attention away from remaining problems within individual countries in the CESEE, not least the question of inclusiveness and the adequate sharing of the fruits of progress. If convergence for the average citizen comes at the expense of growing regional inequality, or a growing rural-urban divide, is this a good thing to do or not?

Even accepting “convergence” as a goal, the literature indicates that many questions remain³. How to measure convergence? Most commentators seem to focus on the convergence of real GDP per capita, but this ignores exchange rate issues (market rates or purchasing power parity) and also different demographic trends that might create cross country differences in the relative size of the working age populations. Another contentious issue is, convergence with whom? Should the benchmark be the original EU5, the average of the “core” European countries, the average of the current membership, or simply the nearest rich neighbour? These different measures can give quite different estimates of how near, or far, the objective appears.

Looking back, however, there can be little question of how far the CESEE countries have advanced from what Rostowski (2007) has described as a “quite abominable” starting point. In terms of real GDP per capita, the Baltic states, Poland and Slovakia have converged the most. The Czech Republic, Slovenia and Hungary have also made great progress, albeit less in convergence terms because their initial levels of GDP per capita were significantly higher than some other CESEE countries. Broader measures of well-being, for example the OECD indices indicating a “Better Life”, have also improved significantly, with declining infant mortality and rising life expectancy playing an important role. Importantly, there seems to have been relatively little increase in income inequality, as measured by Gini coefficients⁴. Admittedly, such measures do not include income gains from the “black economy” or corruption, and can give a quite different impression of inequality than measures of the distribution of wealth.

Broadly put, the increased rate of growth in the CESEE seems to have resulted from a marriage between inflows of foreign direct investment, mainly in the form

³ Mihaljek (2018)

⁴ Ritzberger-Grunwald (2018)

of “green field” investments based on modern technology, and an educated and flexible domestic work force. The fact that wage levels were initially low by Western European standards contributed materially to inducing those foreign inflows. Yet another, and more fundamental motivating factor, was an incredible array of legal and institutional reforms. In particular, legal reforms led to wholesale privatisation of previously state-owned enterprises and deregulation that encouraged private enterprise. New institutions were also introduced to enforce the new laws and to protect the rights given by the law⁵. It was generally recognized that, without the protection of property rights and the consistent and equal enforcement of the law, there would be little investment⁶. Nor would there be much of the related entrepreneurship and innovation which is at the heart of a process of dynamic growth.⁷

The organizers of this conference have also drawn attention to the fact that the convergence process of the CESEE seems to have slowed since the onslaught of the Great Financial Crisis (GFC) in 2008⁸. Whether this is a permanent trend is hard to determine since it depends on the differential rate of slowing of two different series and an evaluation of the factors affecting each. The recent literature⁹ seems to indicate that large economic downturns have hysteretic effects, though it is not clear whether it is a negative effect on the level of “potential” output, or its growth rate or both. Post crisis estimates of potential, in virtually all regions of the world, have clearly been revised down from pre-crisis estimates. However, this has largely been based on a simple extrapolation of post crisis trends. This falls short of a careful evaluation of the underlying causal factors, and falls well short of whether they might exert a permanent influence or not.

There can be little doubt that the CESEE were affected more than the “core” European countries by the retrenchment of the Western European banks after the GFC, and particular after the beginnings of the subsequent crisis which affected

⁵ See Rostowski (2007) and also Balcerowicz (2015) for an intriguing description of such developments by those who participated in them.

⁶ Balcerowicz (2019)

⁷ Phelps (2013) and Janeway (2018).

⁸ Ritzenberger-Grunwad (2018) confirm this, noting that the most important driver has been a sharp reduction in fixed investment.

⁹ Saxena and Cerra (2008)

the “peripheral” European countries. Whether under the influence of perceived self-interest, or regulatory imperatives, previous capital inflows to the peripheral countries and to CESEE were sharply reversed. The expected negative effects on growth were amplified in some countries where a preceding “boom” turned to “bust”. In effect, in those countries the crisis revealed that some part of the observed pre-crisis growth was not sustainable.¹⁰ Hopefully, these kinds of influences on growth will dissipate with time.

The OECD has also noted a slowing in the pace of structural reforms in CESEE in the post crisis period. It would not be unreasonable to link this fact to **absolutely** poorer economic performance over the same period. However, it is harder to link this to **relatively** poorer performance since the OECD has observed a similar slowing in the pace of structural reforms in many countries. Economic difficulties always constrain the government’s capacity to buy off the vested interests that oppose structural reforms. In the CESEE, the slowdown might have been accentuated by “reform fatigue”, unique to them after such a long period of massive structural change. Again, there are no grounds for belief that this will be a permanent force impeding growth, and convergence, in the future.

The Future of Convergence

Expectations about future growth and convergence in CESEE, as well as the policies needed to support this objective, depend on the growth model we assume. As noted above, how a problem is “framed” can have a significant effect on the solutions proposed.

A traditional neoclassical growth model (of the Solow-Swan type) links growth to factor inputs assumed to have diminishing returns. Assuming that labour and capital can move freely to jurisdictions where returns are higher, convergence is inevitable. In this model, the efficiency of allocation is crucial, and all other policies and institutional developments are irrelevant. A crucial shortcoming of the neoclassical approach is that all the other forces driving growth are assigned to the growth of Total Factor Productivity (TFP) – in effect a residual in the econometric estimation of the production function.

¹⁰ Borio et al (2013) provide a new methodology for estimating “potential” in the context of a non-inflationary financial boom.

More modern approaches to explaining growth and the possibility of convergence (e.g. endogenous growth theory and complexity economics) make different assumptions¹¹. They admit to the possibility of increasing returns to scale, the importance of investment in human capital (education and training), the relevance of research/development and innovation, and concentration effects among others. Under these alternative approaches, convergence is not inevitable but depends on the policies being followed in the nation in question. Cases in point are those African and Latin American countries which have failed to converge to richer neighbours over many decades. Moreover, what is crucial is not just getting on a good growth path, but staying on it through the adoption of policies which adjust to changing circumstances. Cases in point are those Asian countries which initially had investment and export driven growth models, but which are increasingly being forced to turn to domestic consumption to support demand.

While most of the narrative about growth and convergence focuses on policies to promote positive growth, increasing attention is now being focussed on policies that reduce the potential for negative growth. Economic history indicates that all economies have their ups and downs. Moreover, complexity theory predicts that all complex systems break down regularly according to a Power Law. This suggests that all economies will have periods of slower or even negative growth.

This fact is crucially important. Recent research by Broadberry and Wallis (2017), based on European data going back to the fourteenth century, shows that eighty percent of the difference in the longer-term growth rates of richer and poorer countries can be explained by the former economies not shrinking as much in downturns as the latter economies. Broadberry and Wallis attribute this to stronger institutions in the richer countries that maintain trust during downturns. This allows an orderly and cooperative adjustment that minimizes the potential for positive feedback effects to aggravate the downturn.

In a separate strand of literature, Funke, Schularick and Trebesch (2015) suggest that financial crises play a particularly important role in this regard. Such crises commonly lead to political polarisation, with nationalist and socialist extremists

¹¹ See for example Beinhocker (2006) and Kirman (2010)

benefiting in particular. The authors state “ These developments likely hinder crisis resolution and contribute to political deadlock. The resulting policy uncertainty may contribute to the much-debated slow economic recoveries from financial crises”.

Focussing on the potential harm done to longer term growth and convergence by downturns has another implication. Much more attention needs to be paid to crisis prevention, to crisis management and to policy measures which actually resolve underlying problems rather than disguise them or “kick the can further down the road”. I will return to this issue at the end of this presentation.

Current Threats to Both Growth and Convergence

Many such threats can be identified. Some of these are internal to the CESEE and merit a domestic policy response. In effect, these are efforts directed to crisis prevention. However, many of the identified threats arise from developments outside the CESEE. Since there is nothing the CESEE can do to prevent such shocks, the emphasis must be on ex ante preparations to manage and resolve problems when and if the shocks materialize. Note that such preparations are also important for dealing with internally generated problems. It would be naïve to assume that preventive measures will always prove adequate.

Internal threats

A first problem is rapidly rising wages, reflecting unfavourable demographics accompanied by a significant degree of emigration from many CESEE countries. The concern is less that of rising inflation, which seems everywhere to be held down by global developments, than a loss of external competitiveness¹². This has raised concerns about emerging balance of payments problems and the possibility that firms (especially foreign ones) might move to lower cost jurisdictions¹³. This latter concern might, however, be mitigated by the natural advantages of the CESEE countries; their proximity to Western Europe, the large sunk costs of existing investments and stronger institutional foundations than countries further to the east or south¹⁴.

¹² Johnson (2018)

¹³ For a broader discussion of this problem and what to do about it, see Grieveson (2018)

¹⁴ Hille (2018)

While some countries (like Poland) have addressed the underlying labour market problem with increased immigration, there is wide spread political resistance to this solution in much of the region. Providing better domestic working conditions, to restrain or reverse emigration would be helpful. So too would be improved education to increase the supply of skilled workers. Perhaps most important are policy measures that will facilitate the productivity increases required to justify higher real wages¹⁵. Finding ways to accelerate the spread of technological innovations from “frontier” to “laggard” companies is a challenge throughout the OECD.¹⁶

A second problem has to do with excessive levels of private sector debt, which create “headwinds” to spending and could also prove a threat to financial stability. This does not seem to be a current problem, given the slowdown in credit growth in recent years¹⁷, though the level of non-performing loans in some countries indicates some unresolved issues from the past¹⁸. Yet, I would flag private sector debt as a future concern, since debt driven crises seem increasingly endemic. Not only should the authorities keep a watchful eye, but they should not take too much solace from the availability of new macroprudential instruments of control. These instruments have many shortcomings¹⁹. Not least, they seem less effective in resisting a credit boom than in making the financial system more resilient to the subsequent bust.²⁰

A third prospective problem is the level of sovereign debt. While it is true²¹ that only a few CESEE countries have ratios of debt to GNE greater than 60 percent (the Maastricht requirement), and the duration of that debt has lengthened, developing and transitional economies generally have lower thresholds for losing market access. Moreover, looking forward, the poor demographics in many CESEE countries will imply a significant degree of tightening to get on a

¹⁵ Measures might include more investment in technology and innovation, and less investment in labour intensive (and low productivity growth) sectors like construction.

¹⁶ Anderson et al (2015)

¹⁷ See Komunina et al (2018), Fessler et al (2017) and Allinger et al (2018)

¹⁸ Hildebrandt and Lahnsteiner (2017)

¹⁹ White (2018c)

²⁰ In many countries, macroprudential tightening has occurred against the backdrop of ultra-easy monetary policies which encourage regulatory evasion. This combination is totally different from how the implementation of macroprudential policies was originally conceived, as a complement to tightening monetary policies. See Group of Thirty (2015)

²¹ Beer (2018) and Eller and Holler (2018)

sustainable path. The sooner a medium term target framework can be developed, the better. In this regard, the need to run larger surpluses in good times is imperative. The tendency for sovereign debt stocks to ratchet up, in virtually all countries, is because fiscal stimulus in downturns is never adequately offset by restraint in good times.

A fourth issue has to do with the proportion of sovereign debt held by foreign entities with relatively short investment horizons, and/or denominated in foreign currency²². This raises the possibility of sudden outflows and currency mismatch problems²³. Further efforts to develop domestic financial markets, especially in domestic currency, would be helpful. So too would derivative markets that might help governments trying to hedge their foreign currency exposure.

A final and crucial issue is possible backsliding (or even reversal) of previous legal and institutional reforms. In a number of countries, the independence of the judiciary from the political process has been called into question. This could have important implications for the business environment, for investment in general and for foreign investment in particular. Foreigners are particularly aware, from painful historical experience, that deviations from the “rule of law” commonly act to their disadvantage.

External threats

As small, open economies, the CESEE are subject to the vagaries of events elsewhere. I present here a limited list of things to worry about. However, a central point to note is that, in a highly globalized world, problems anywhere are likely to trigger problems elsewhere. Put otherwise, some of these external shocks might be highly correlated. This increases the dangers they pose for the CESEE and raises the importance of ensuring resilience.

Global trade tensions, particularly between the US and China but also between the US and Europe, are a major threat to growth going forward. Such tensions raise uncertainty and sap confidence, both of which lower investment. Threats to trade in cars could be particularly harmful, coming on top of sharp, recent

²² See Barisitz et al (2016)

²³ Regling (2018) raises the related possibility of capital flight by resident deposit holders, and notes how cross euro deposit insurance might play a helpful role.

slowdowns in demand for cars in both the United States and China. Given the importance of the automobile sector in CESEE, changes in the structure of global production could have an important negative effect.

Brexit is another issue²⁴, with a no-deal Brexit looking increasingly possible. One set of negative effects would be similar to those from rising trade tensions. Around 20 percent of the cars made by German automobile companies in Europe are sold in the United Kingdom. EU budgetary problems will also be hit by Brexit, with negative implications for structural funding in CESEE in particular. More positively, Brexit will reduce the opportunities for younger workers in the CESEE to move to the UK. What is more ambiguous are the implications for Brexit for internal developments within the European Union²⁵. On the one hand, it might show that leaving the EU is possible and so encourage others to do the same. On the other hand, the costs of a chaotic UK departure, to the citizens of the UK, might encourage efforts to make the EU work better than it currently does.

Issues internal to the EU also raise threats that might affect CESEE. Veron (2012) asserts that the institutional structures of the EU suffer from serious “analytical, executive and democratic deficits” that make it prone to breakup²⁶. To this must be added ongoing disputes about where (national or international) power should be exercised, about immigration, budget issues and how to deal with rising nationalist (populist?) sentiments. Short of breakup, attempts to refigure the EU to make it more manageable could conceivably leave some CESEE as second or even third tier participants²⁷.

Finally, there is the issue of global growth prospects in the next few years. Alternative, plausible scenarios all indicate some risks for the global economy and the CESEE. A more optimistic growth scenario, starting from low levels of excess capacity in many countries (not least the US), threatens inflation and higher interest rates. However, higher rates of interest lower the capacity of many highly indebted companies to service their debts,²⁸ which could then lead to slower growth and financial instability in turn. A less optimistic growth outlook also leads

²⁴ Barber (2018a)

²⁵ Barber (2018b)

²⁶ See also White (2017)

²⁷ Barber (2018c)

²⁸ See White (2018b)

to slower growth and the risks arising from financial instability, but more directly. As Warren Buffet remarked "It's only when the tide goes out that we see who has been swimming naked".

What could CESEE do to prepare for downturns arising from whatever source? Steps can be taken ex ante to allow the downturn to be better managed. Ensure that domestic deposit insurance arrangements are adequate. Build up fiscal buffers to allow sovereign deficits to rise without losing market access. Similarly, raise the duration of sovereign debt to reduce rollover problems. Also raise the capital and liquidity buffers of banks to make them more resilient to a downturn. Negotiate with foreign providers of liquidity in foreign currency to ensure liquidity support when needed. Finally, keep the lines of communication open between "home" and "host" supervisors in cases where foreign banks play a big role domestically. More generally, it is always good to be able to count on the support of friends in tough times.

In many downturns, it quickly becomes apparent that attempts to service existing debt levels are having negative feedback effects on the whole economy. This is what Keynes described as the "paradox of thrift". It is instructive that, in Greece since the crisis, massive bouts of fiscal restraint actually led to the sovereign debt ratio rising sharply as GDP fell even faster. To avoid such outcomes, it is important to take ex ante steps to allow private sector debt to be more easily and quickly restructured or even written off. This involves, not only passing the appropriate laws, but also ensuring that an adequate administrative structure exists (of courts, judges, mediators etc) to give effect to the laws. Similar measures should be in place to ensure the orderly resolution of financial institutions, perhaps even over a weekend as has often been necessary historically.

The broadest requirement of all, to support an orderly and resilient recovery from bad shocks, is a willingness to cooperate between private sector participants and between the private sector and the government. If this is replaced by an ethos of "every man for himself" the resulting disorder will prove highly costly. Cooperation, however, must rest on a sense of trust in the integrity of other parties. Most importantly, it rests on the belief that the government is acting in the best interests of all its citizens and not just a favoured few.

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