Petar Goshev: South Eastern European countries' competitiveness and challenges on the road to EU

Introductory speech by Mr Petar Goshev, Governor of the National Bank of the Republic of Macedonia, at the international conference "Competitiveness of the South Eastern European countries and challenges on the road to EU", organized by the National Bank of the Republic of Macedonia, Skopje, 30 May 2008.

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Honored guests,

Dear friends,

I wish you a very warm welcome to the Conference of the National Bank of the Republic of Macedonia on the ***Competitiveness of the South Eastern European Countries and Challenges on the Road to the EU.*** Similarly to the several conferences and workshops organized by our Bank in the recent years, this one will also seek to develop a discussion on a very important topic for the countries in transition striving to reach the income level of the EU member states. Although real convergence is not directly in the focus of interest of the monetary authorities, the unbreakable tie between the nominal and real convergence makes this topic extremely important also from a viewpoint of the monetary policy. Therefore, at this Conference we will try to analyze once again the achievements of the new EU member states, particularly their experience, their successes, but also their failures regarding competitiveness of their economies on the road to EU and EMU membership. I am convinced that South Eastern European countries, that is EU candidate and potential candidate countries, will have an opportunity to broaden their knowledge about what to do and what to avoid on the road to EU. At the same time, we will also share the experiences about the challenges that the South Eastern European countries face with on their way to the real convergence.

The transformation of the Central and Eastern European countries and their final membership in the EU is one of the most remarkable events in human history. Never before had so many countries and people made so many changes in such a short time. During the 1990s, we witnessed a complete renewal of entire systems and institutions, implementation of structural reforms, but also establishing new ways of living and thinking. What is important for us here is that these changes were happening simultaneously with a huge ***rise of income*** and living standards in general. Although not a perfect indicator for the remarkable changes, the comparison of GDP per capita in the beginning of transition and now shows a clear picture of the progress. In 1993, the group of 10 new EU member states had a GDP per capita that was 37.2% of the euro-zone level at that time, but in 2007 this indicator reached 56.4%.[1] Certainly, not all transition countries were moving with the same speed, and not all of them reached the same level of income. Among this group of countries, the three Baltic countries were moving the fastest. In 2007 they had an average GDP per capita of 56.8% of the average level in the euro-zone (it was 28.2% in 1993). Although the process of income growth is present also in South Eastern Europe, its pace is slower. For the period 1996-2007, convergence was made to the income per capita in the countries of the euro-zone by 8.2 percentage points (from 20.8% to 28.9%).[2] What is clear from these

[1] Source: World Economic Outlook Database, April 2008 and NBRM calculations. The indicator is unweighted average of GDP per capita of these countries. The indicators are according to the purchasing power parity.

[2] Source: World Economic Outlook Database, April 2008 and NBRM calculations. The indicator for SEEU is unweighted average of GDP per capita of Macedonia, Albania, Croatia, Bosnia and Herzegovina and Serbia (for 2000). The indicators are according to the purchasing power parity.

comparisons is that the achievements are huge, but also that much more remains to be done in order to reach the level of old EU members.

Why the speed of real convergence of the new EU member-states and of the candidate and potential candidate countries is different, is one of the frequently discussed questions. Taking classical theory of growth as a starting point, income actually depends on the factors of production and technological growth, meaning that the reasons for the differences should be sought in these factors. According to research, the productivity rise was mostly due to what we call "total factor productivity", that is improvements that can be attributed neither to capital nor to labor, but to specific organizational, technological and institutional changes that result in productivity rises and GDP growth. In the past few years, the new EU member-states register trends of positive influence also of the labor to the economic growth, while among the SEEU countries this contribution is still mainly negative.[3] Structural and institutional reforms also had key influence on the accelerated productivity growth. Transition indicators of the EBRD that are commonly used for assessment of the reforms indicate that the new member-states have already reached the level of the developed countries in the fields of privatization, price liberalization, trade and foreign exchange systems (although they are still lagging behind with respect to the enterprises restructuring, competition protection, banking reform and liberalization of the interest rates and financial markets and institutions, as well as the overall infrastructure).[4] On the other hand, these indicators clearly point to the fact that the SEEU countries, are significantly lagging behind with the reforms in all these areas, except price liberalization and to a certain extent trade and foreign exchange systems.

The process of accelerated income increases, that is the process of real convergence, also initiated the process of nominal convergence. Nominal convergence about which we, central bankers, speak the most, is consisted mainly of convergence of price levels, but also of exchange rate changes, interest rates and budget deficits to EU levels. As an empirical fact, rises in relative CPI usually move together with rises in relative GDP, and emerging Europe was not immune to this trend. The CPI level in the new EU member states in 1995 ranged from 29.2% of the EU-15 level in Lithuania to 44.9% of the EU-15 level in Poland. In 2006, the CPI level ranged from 42.7% in Bulgaria to 71.8% in Slovenia, which clearly shows fast price rises in these countries.[5]

It is obvious that the **parallel processes of real and nominal convergence of countries in transition pose numerous challenges for their economic policies in general and particularly for their monetary policies**. The process of real convergence creates inflationary pressures through a number of channels, thus making it difficult to fulfill one of the Maastricht criteria for entering the monetary union, and also the higher inflation generates negative effects on the competitiveness of the domestic economy. The **Balassa-Samuelson** effect is one of the most frequently indicated channels through which real convergence leads to higher inflation rates. According to this concept, the faster productivity growth in the tradables sector compared to the non-tradables sector of a country will cause a positive inflation differential and afterwards real appreciation – through the rise of market-determined prices of non-tradable goods.[6] Although there are certain dilemmas regarding its importance, most estimates show that the contribution of this effect ranges between 1 and 3

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[3] *M. Morgese Borys, E.K. Polgar and A. Zlate,* "**Real Convergence in Central, Eastern and South-eastern Europe",** Background paper prepared for the Economic Conference on Central, Eastern and South-eastern Europe, 1-2 October 2007, European Central Bank, Frankfurt am Main.

[4] Source: EBRD Transition Report 2007: November update.

[5] Source: Eurostat, NBRM calculations.

[6] *Jane Bogoev, Sultanija Bojceva Terzijan, Balázs Égert, Magdalena Petrovska,* "**Real exchange rate dynamics in Macedonia: Old wisdoms and new insights",** *http://www.economics-ejournal.org/economics/discussionpapers.*

percentage points of CPI inflation. Therefore, for countries with a fixed exchange rate regime, such as almost all transition countries had in the beginning and quite a few of them now, the higher inflation is reflected directly into real effective exchange rate appreciation. On the other hand, countries with flexible exchange rate regimes also face their share of difficulties. Since they allow their currencies to fluctuate (and usually try to target inflation), their productivity growth is reflected first in higher nominal exchange rate, and consequently in real effective exchange rate appreciation as well.

Besides the Balassa-Samuelson as a supply side effect, there were also factors on the **demand side** which contributed to higher inflation in these countries during the transition process. As productivity and income grow, people start spending relatively more on non-tradables and services, which are usually considered more luxurious and are therefore more expensive. In addition, there were huge quality improvements in products and services, which also contributed to price rises. Last but not least, as these countries were establishing functional market economies, they had to allow for market rather than administrative determination of prices. As prices were previously kept artificially low, these changes caused additional inflationary pressures. The implementation of structural reforms that are prerequisite for real convergence, also creates pressures on the fiscal policy, i.e. the budget deficit and consequently inflation. Part of the costs for the economic reforms are financed from EU pre-accession funds, whose utilization, although it does not imply direct increase of the budget deficit and jeopardizing one of the nominal Maastricht criteria, still could have a significant liquidity effect, creating inflationary pressures.

The combined effect of the of these factors on the supply side and on the demand side, is reflected in the relatively high inflation in these countries, the average annual rate of which in the period 1993-2007 in the countries of Central and Eastern Europe ranged from 6% in the Czech Republic to 38.6% in Lithuania. (By mid-90s, in South Eastern Europe, and in Bulgaria and Romania, there were frequent instances of extremely high inflation. In this group, in the period 1998-2007, the average annual inflation rate ranged from 2.1% in Macedonia to 31.1% in Serbia).[7] Such movements **caused appreciation of the real exchange rate, which was especially emphasized in the new member states. Thus in the period 1994-2006, the cumulative appreciation of the real effective exchange rate ranged from 8% in Slovenia to 105.9% in Lithuania.**[8] Economic theory offers arguments that real exchange rate appreciation is not dangerous as long as it reflects changes in the equilibrium real exchange rate. However, policy makers in these countries, especially in the recent years, are not really comforted by these theoretical discussions which consider that real appreciation is only movement to equilibrium. What they are seeing in their countries are common signs of overheating of the economy and loss of competitiveness, which deepens the external imbalances. In the beginning of transition, current account deficits were understandable and not too much cause for concern, as these countries were importing technology and previously unavailable goods. However, the size of the deficits in the last several years exceeds the level that is usually deemed sustainable. Thus, the current account deficit in the new member states in the period 1996-2005 ranged from 5% to 7.7% of GDP, but in the last two years it has been reaching 10.1% and 11.3% of GDP. The average current account deficit in the SEEU countries in the same period is even higher, and it is estimated that in 2007 it will reach 16.3%.[9] Even though deficits are projected to fall in some of the countries, in general they remain a cause for concern in most of them. Besides the trade deficit which,

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[7] Source: IMF World Economic Outlook Database, April 2008.

[8] Source: Eurostat. For the SEEU countries data are available only on Croatia and Macedonia, from the IMF International Financial Statistics. Cumulatively, in this period in Croatia there was real appreciation of 9.1%, while in Macedonia there was real depreciation of 18.2%.

[9] Source: EBRD Transition report 2007: November update and NBRM calculations. Data for 2007 are estimates.

due to lower competitiveness and higher consumption, is one of the main causes for the current account deficits, some of these countries are also experiencing deficits in the income balance, which mainly reflects repatriation of profits from foreign direct investments.

Most certainly, such high current account deficits would not have been possible if there were not such large and continuous **capital inflows** in transition countries, mainly in terms of FDI, but also of portfolio and other types of investments. For example, in the period 1989-2007, total FDI amounted to around 3,600 USD per capita in the new EU member states and around 2,000 USD per capita in the SEEU countries.[10] Again, in the earlier years of transition, capital flows partially substituted for the insufficient savings in these countries and allowed for the necessary transfer of technology and expansion of production. However, there are concerns that, in the recent years, and particularly in the countries with fixed exchange rates, capital inflows are dangerously adding to domestic demand, thus putting further pressure on inflation and increasing imports.

In addition, the rise in incomes, the presence of abundant foreign capital, the expansion of the banking sector and sometimes negative real interest rates all contributed to rapid credit growth in transition countries. Again, the rates of growth were almost unprecedented before, and in 2007 they reached around 60% year on year in Bulgaria, Romania and around 40.6% in Lithuania.[11] After a previously suppressed consumption, the process of credit growth was understandable and desirable for economic growth. However, the rates of growth are only adding to demand pressures in these countries, and in combination with the other factors, adding to the rise of inflation, rise of imports and further worsening of the current account position.

Dear guests,

At the current time, these developments pose **two particular challenges** for the policy makers in transition countries, one a short-term and the other a longer term.

The short term challenge is ***how to lower the risk of high current account deficits, which can cause wider financial crisis, combined with a currency crisis in countries with pegs and currency boards***. Both the economic theory and the economic history are clear that current circumstances are not the most favorable for these countries. Worsening current account deficits are not sustainable and can not continue forever. The more they widen, the bigger the pressure becomes for real exchange rate depreciation as a way of restoring competitiveness. This of course can be a bit easier for countries with flexible exchange rates, which can achieve it by nominal depreciation (and thus risk rise in inflation). However, countries with fixed rates are sometimes forced to abandon their exchange rate regime, as they do not have any other way out of real overvaluation of their currencies. Another risk in the short term might be the contagion of financial crises from abroad, which would combine with fragilities and thus prompt financial and economic difficulties in these countries.

The long-run challenges for transition countries are related to the ***simultaneous maintenance of competitiveness and nominal convergence***. What is next for the new EU member states is certainly achieving EMU membership and all of them agree that the stability and opportunities of the single currency are their goal. While achieving this seemed easier a few years ago, the prospects are somewhat worsened in the light of the recent developments. The record high oil prices and the high food prices additionally augmented the inflationary pressures in these countries. The high inflation in most of the transition countries makes them breach the first of the four Maastricht criteria. What is even worse, the forecasts for the next several years for most of the countries show they will probably not meet the

[10] Source: EBRD Transition report 2007: November update and NBRM calculations. Data for 2007 are estimates.

[11] Source: EBRD Transition report 2007: November update. Data for 2007 are estimates.

inflation criterion. This is particularly troubling for the countries on a fixed exchange rate regime or currency board, which do not have the exchange rate flexibility as an instrument for handling inflation.

Another part where there might be trouble is the exchange rate criterion. Now it is the floaters that could have bigger difficulties, particularly if the current developments continue and capital keeps to flow in these countries, thus making pressures for nominal appreciation. As far as the budget deficit criterion and the interest rate criterion are concerned, it appears that in these areas there will be less difficulties in fulfilling the Maastricht criteria, under the assumption there will be maintenance and strengthening of fiscal discipline.

Of course, not all is bad and unreachable as far as Maastricht criteria are concerned. These countries are not giving up and they stand ready to increase their efforts in order to achieve their goals. While it appears that most transition countries have postponed their euro-zone entry a little bit due to the abovementioned difficulties, there are also two remarkable success stories from the transition countries. We already have Slovenia which has been in the euro-zone since last year. In addition, we have Slovakia which got a positive opinion by the European Commission on fulfillment of criteria and is getting ready to adopt the euro in the beginning of next year.

The remarkable success of the Central and Eastern European countries of achieving EU membership after a thorough transformation and rapid growth of living standards undoubtedly holds a lot of recommendations and lessons for the South Eastern European countries. These countries had similar, maybe even more advanced starting positions than the other transition countries, but South Eastern Europe is now lagging far more behind in terms of progress towards the EU. However, we should bear in mind that the main reason for this is definitively the political instability and war conflicts in the region, which understandably prevented faster economic transformation and reforms. Luckily, it appears that political support for EU accession and the determination to pursue EU membership, including all the necessary economic and political reforms, are strengthening.

In analyzing the economic developments in the region of **South Eastern Europe,** some notable differences with the CEE countries appear. South Eastern Europe has much lower pace of reforms and lower growth rates. Related to this, capital inflows in the region have been much smaller and have shown a much bigger dispersion among countries, ranging from 834 USD per capita in Albania to 3,932 USD per capita in Croatia, cumulatively in the period 1989-2007.[12] Credit expansion has been high, but has still to reach rates and length of the one seen in more advanced transition countries. Consequently, there have been less demand pressures as well as comparatively lower inflation than in the other countries, although inflation has been rising recently. Exchange rate regimes in the region are various, ranging from currency board in Bosnia and Herzegovina to almost free float within inflation targeting in Serbia. What is common is that during the transition process all these countries dedicated particular attention to their exchange rate regimes and they were mostly using fixed rates, which reflects their high trade openness and their efforts to establish strong monetary authority.

Regardless of the exchange rate regime, the real exchange rate appreciation in the countries in the region has been considerable, although maybe a bit lower when compared to the new EU member states. As a result, these countries have been suffering from competitiveness loss as well. This can be clearly seen in the movement of their current account deficits, which are considerable in all of these countries. For instance, current account deficits in 2007 range from 3.1% of GDP in Macedonia to 36.2% of GDP in Montenegro.[13] However, SEEU

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[12] Source: EBRD Transition report 2007: November update and NBRM calculations. Data pertain to FDI. Data for 2007 are estimates.

[13] Source: EBRD Transition report 2007: November update.

contains two distinct patterns of the structure of the balance of payments. The first is the conventional one for the transition countries, where the current account deficit is covered mostly with FDI and portfolio investments (e.g. Croatia). On the other hand, the second pattern is consisted of huge trade deficits, which are covered much more by remittances from abroad than by foreign investments (e.g. Macedonia, Albania). However, the dilemma appears whether these high current account deficits are sustainable.

Regarding the economic history, despite the fact that in certain areas Macedonia was a pioneer in the implementation of reforms in South Eastern Europe, under the influence of negative external and domestic shocks it had relatively low rate of economic growth of averagely 2.7% in the 1997-2007 period. This resulted in a relatively low level of real convergence of 25.7% of GDP per capita in the euro-zone (23.6% in 1996). The use of the exchange rate as an anchor for inflation expectations has been effective until now, producing low and stable inflation rates. In circumstances of high import dependence and relatively slow implementation of structural reforms aimed at increasing the export potential, contributed to the maintenance of high trade deficit, which was mainly financed by high private transfers.

However, the transition process in Macedonia is specific because of the relatively slower process of real convergence and the **continuous real depreciation of the Macedonian Denar.** Namely, according to some research,[14] there has been an absence of the Balassa-Samuelson effect in Macedonia, that is the productivity in the tradable sector compared to foreign partners rises with relatively lower rates. This was a result of the absence of big foreign companies and the loss of important foreign markets, particularly after the independence. In such circumstances, the only way to maintain the competitiveness of the Macedonian producers was the specialization and exports of lower quality products. These developments did not generate inflationary pressures, which caused absence of real appreciation that was evident in the other transition countries.

In the past several years, Macedonia is quickly moving closer to the more advanced transition economies. Several years in a row we have achieved positive and stable growth rates, equaling 5.1% in 2007, which is the highest growth rate since independence. Even though economic growth rates are lower than the ones in Baltic countries as well as some of the countries in the region, this is a sure sign for the acceleration of the process of real convergence. This process is also supported by the foreign direct and portfolio investments (6.3% of GDP in 2007) and the faster credit expansion, with annual growth rate of 39% in 2007. As far as nominal convergence is concerned, Macedonia is facing challenges that are common for most of the economies in the region and elsewhere. Since the last quarter of 2007, we are having an acceleration of the inflation rate, which is mostly caused by the global rise of food and energy prices. Therefore, the uncertainty regarding the movement of these prices, as well as the expectations for pressures initiated by the process of real convergence are the main challenges for monetary policy in the medium term.

Dear guests,

I hope that with my introductory speech I have identified issues that are in the focus of interest of the economic policy-makers in the transition countries, and which I expect to be further elaborated by the participants in the conference. Today we have with us guests with diverse backgrounds. We have presenters from EU institutions, from old and more advanced new EU new member states, as well as from the South Eastern European countries, which

[14] Loko B. and Tuladhar A. (2005), **"Labor Productivity and Real Exchange Rate: The Balassa-Samuelson Disconnect in the former Yugoslav Republic of Macedonia"** *IMF Working Paper* No. 113 and *Jane Bogoev, Sultanija Bojceva Terzijan, Balázs Égert, Magdalena Petrovska, "***Real exchange rate dynamics in Macedonia: Old wisdoms and new insights",** *http://www.economics-ejournal.org/economics/discussionpapers.*

are determined to work hard for European integration. I hope that we can share the experience of the existing EU member states, including the more advanced transition countries, in the process of EU and later EMU integration. I am sure that South Eastern European countries have a lot to learn, both in terms of successful strategies and steps and mistakes to avoid. I am also sure that our capability as central bankers to successfully face the challenges of faster accession towards the EU and EMU will be enhanced by this and similar conferences. The high quality of the speakers and the guests and the diversity of their background make me an optimist that we will have a fruitful Conference, which will broaden our knowledge with new experiences. I wish you a successful work in the Conference and to the representatives from abroad I wish a very pleasant stay in Macedonia.

Thank you for your attention!