Željko Rohatinski: Restoring the luster of the European economic model report

Speech by Dr Željko Rohatinski, Governor of the Croation National Bank, at the presentation "Restoring the luster of the European economic model report", World Bank, Zagreb, 4 June 2012.

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1. The transformation of the initial financial shock into the years-long recession, the shift of the heart of the problem from the banking sector to public finances and the switch of focus from the USA to Europe show the extent to which the current crisis has undermined the very foundations of the functioning of western economies in the last thirty years. Both essentially and conceptually.

2. This has not spared even "the real convergence model", which is the economic cornerstone of the projected functioning of the European Union and its monetary union in particular.

The model was based on a political consensus. It was a hybrid between American liberalism targeting primarily economic efficiency and the European tradition of social welfare states.

The model functioned relatively well "in good times" but showed all its deficiencies and weaknesses "in bad times".

This mostly refers to its considerably limited capacity to coordinate the effects of elements within the Union that are vastly heterogeneous in production, technological, social and psychological terms.

3. Therefore, with the outbreak of the crisis, the process of economic convergence among the EU member states has turned into the process of their divergence and strong polarisation of interests.

4. It follows that the model needs to be upgraded and reformed. This particularly relates to mitigating the dichotomy between uniform monetary policy and relatively autonomous fiscal, development and social policies of the member states.

5. In general and in case of EU member states in particular, it is hard to agree with the metaphor of Nobel Laureate P. Krugman about a car which is technically in good condition but stops suddenly when its battery goes dead. One has only to install a new battery (by this Krugman implies an increase in aggregate demand by expansionary fiscal policy) for the car to continue moving normally.

It would be more accurate to say that the car has serious construction errors:

(a) a volatile fuel system, where the tolerance of cyclical increases in speculative elements, both on the side of supply and demand, leads to the emergence of "balloons" and engine overheating;

(b) difficulties in the transmission of fuel to wheels as numerous institutional and noninstitutional transfers, without economic justification, result in significant fuel losses; and

(c) an untuned steering mechanism, where a combination of a liberal financial system and populist elements in national economic policy diminishes the efficiency of prevention and brake mechanisms.

6. Equally difficult is to agree with the alleged alternative "either savings or growth" or with its causally undetermined antithesis "both savings and growth". These two categories

are communicating vessels – sustainable economic growth can not be attained without the necessary level of savings.

7. How can this be achieved starting from the current situation? An economy in crisis is like an organism being eaten by poisonous substances – in this case, fundamental imbalances leading to large deficits and debt paths unsustainable in the long run.

This organism can not be treated by injecting new doses of poison (i.e. by additionally increasing imbalances) but only by injecting an antidote (savings) to dissolve existing imbalances, put a stop to their harmful effects and gradually eliminate them from the organism. This is the very essence of broadly defined "savings" and has no alternative.

8. This is the path that should be taken by Croatia – a combination of structural reforms, restrictive fiscal policy and reasonably expansionary monetary policy – so as to effect a dynamic redistribution of limited funding from consumption to investment and use this investment to initiate sustainable economic growth aided by low inflation and exchange rate stability.

Such a policy would also create a favourable environment for foreign capital inflows in the form of direct investment and not loans.

9. I believe that this line of thought closely resembles the views of the World Bank. I hope that the Croatian Government and the CNB headed by a new Governor will take that path.

I would like to express my gratitude to everyone, notably to the Croatian public for its support over the past twelve years.