Boris Vujčić, Governor of the Croatian National Bank

Convergence: is it here to stay?

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Thank you for this opportunity, it is always a great pleasure to be in Warsaw at a NBP conference. I feel at home here, because it is not the first time I am here. But tonight this is even more so, after listening to Croatian songs in this beautiful castle. That really completes the 'feels like home' atmosphere for me.

Now, I'm the last one to speak at this year's conference, on the topic of the role of the CEE in Europe, and, some people would compare that feeling to how the seventh and the last husband of Elisabeth Taylor, Lary Fortensky felt coming back home, poor guy wondering what can I can do here that has not been done before?

Most of what I planned to say about the convergence of CEE has already been said, but let me try to put additional flavour to what has been said without keeping it too long.

The CEE has not been in focus so much, after the start of the crisis, as for the last few years most of the EU countries have been preoccupied with problems of either public finances, or the financial sector, or both. Rightfully so, as these issues have been threatening the very existence of the euro area and maybe even the future of the EU. While we are still not entirely out of the woods, great progress has been achieved in these areas. Government deficits have been substantially reduced and in most of the EU Member States public debt has been put on a downward path. Equally important, as Guntram was saying this morning, we now have the mechanisms in place to try to prevent or to deal with the next crisis more efficiently. The

Stability and Growth Pact has been strengthened, the SSM and the SRM as the first two pillars of the banking union are now in place and ESM has been established and financially loaded. With a number of other institutions (EBA, ESRB, ...) that creates ramifications of what he labelled EMU2.0

Somewhere along the way when these big issues have been resolved people have noticed that the convergence of CEE countries towards the income levels of their Western peers has, on average, slowed down. The question is why, and what can be done about that. Potential rates of growth are lower and with ageing populations, significant emigration and decreasing investment rates, focus has turned to structural reforms and institutional quality. Labour and product market liberalisation, or business friendly environments almost became mantras of central bankers in their communication with governments and the broader public. European institutions have started to stress the importance of the quality of the institutions. And not only their quality, of course. Yesterday morning I spoke in Croatia about the need to improve the efficiency of the judicial system.

It is fair to say that many reforms have already been undertaken across Europe and that many countries are now seeing the benefits of such policies. For the last couple of quarters, every new GDP data release by Eurostat has been a positive surprise, while forecasters have been raising their GDP forecast for the EA and the EU. However, while growth has resumed in all countries, medium-term growth potential in the region is insufficient to ensure pre-crisis pace of real convergence. Namely, for convergence to be sustainable, long-term potential per capita growth must be consistent with an expansion of demand. In other words, GDP growth that results from strong capital inflow, foreign demand shock, or fall in interest rates due to perhaps euro area enlargement process, could prove to be unsustainable.

So, the question is, did we take convergence for granted? Was one of the great features of the European integration process only a temporary and unsustainable phenomenon related to the initial 'low-hanging fruit' reforms that corrected vast resource misallocation problems, followed by a huge inflow of foreign capital before the crisis? Will convergence return back to a faster speed, will it continue at a slower speed, or maybe even stop or reverse?

Is convergence still here and, even more importantly, is it here to stay?

Well, as it has been shown already at this conference, convergence is still present but it has slowed down compared to the pre-crisis period. Of course, having said that, we have to keep in mind that CEE has come a long way since the beginning of the transition. Our progress has been tremendous. If we go back to 1995, the average level of income per capita in CESEE countries was below 40% of the old Europe’s income (in PPS terms). By 2008 it increased by a half and reached 60% of the EU15 level of income. And in some regions, like the Baltics, developments were even more spectacular with relative income per capita doubling in this relatively short period of time. It almost seemed that such developments were in line with so called absolute or unconditional convergence where lower-income economies grow faster than higher-income economies, simply because the marginal productivity of capital in those countries is higher.

However, today no one actually believes in absolute convergence theory which builds on the assumption that across all countries, the level of technical knowledge (and its change), the rate of savings, the rate of population growth, and the rate of depreciation are all the same. This notion is clearly rejected by the data: countries differ in many, if not all, of these features. And this is the case also for our group of countries in the CESEE region with relatively similar backgrounds. Therefore, concluding that real income developments before the onset of the crisis were in line with unconditional convergence theory would simply be spurious.

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 the 2000s. At the current pace of convergence, most countries in the region would need decades to reach German, Austrian or Swedish levels of income, countries that are often referred to as the benchmark for the CEE region. Which, in a way, brings us to the notion of conditional convergence. The theory of conditional convergence implies that if there are persistent differences across countries in preferences and other institutional features, divergence is possible in terms of both levels of income and growth rates. And the last crisis has reminded us of this quite roughly. Just take a look at the countries of Europe's periphery. The average level of income of Greece, Italy, Spain and Portugal in 2016 was only at around 67% of the German income, compared to 80% at the beginning of the millennium. Similarly, in Croatia, Slovenia or, to a lesser extent, also the Czech Republic, the relative level of income in 2016 was lower than in 2008. Therefore, growth and convergence can be held back for a protracted period of time before they reappear, or forces can even work in an opposite direction, leading to divergence. The South of the EU has actually not been converging towards the North for more than two decades.

Therefore, the convergence of standards of living is not a sure thing, and should not be taken for granted. And we all know the notion of keeping up with the Joneses, or in a more modern version – keeping up with the Kardashians, a notion that is apparently even more important today in a highly globalised world with a free flow of information. If the Joneses or the Kardashians are getting a new Mercedes, people are bound to like something similar even though just two decades ago they were driving Ladas or Trabants or Polski Fiat. So despite the progress achieved so far, citizens will continue to want more. And why shouldn't they?

Converging to what?

Since the EU stopped converging, and actually diverged, from the US in mid 1990s the question is should the goal be to converge towards the EU style labour, product and financial markets, or maybe more efficient ones? Converging towards the structures that are themselves underperforming might not be a right choice.

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

How should we, as policymakers, react to this? What are the next steps that we have to take? How much do we know?

Well, we know that when it comes to standards of living, in the long-run it is all about labour productivity. And labour productivity, in turn, depends on the amount of capital per unit of labour and something that we call total factor productivity (TFP) or multifactor productivity. The problem is that both of these components are hard, or impossible, to measure, so we have to estimate them, and that is by no means an easy task. Much has been said about the TFP growth in the context of the discussions on the slowdown in the productivity growth, or discussions of the convergence in Europe. However, if you try to decompose the data that are used in these discussions, I believe that you'll come to realise that there are serious measurement issues. For example, it is hard to believe that there has been almost no increase in capital stock per worker in Romania and at the same time, the country managed to increase its TFP by far the fastest rate compared to any other country in the region, or to believe that an almost similar situation was seen in Slovakia. In terms of data, however, this is the best we have at the moment. So, notwithstanding substantial data issues, the question is how can we, as policymakers, influence these unobservables?

While we can expect a re-launch of capital investment growth, I am quite certain that growth rate that we have witnessed in the 2000s, with strong inflow of FDIs and real estate bubbles in some countries will not be seen again in the near future. That is why so much focus is on the total factor productivity, ultimately seen as the only source of long-term growth. Of course, the TFP is an unobservable variable, usually measured by the Solow residual. What drives the TFP growth is a much trickier question. Is it innovations, technology advances? For us as policy makers, understanding the determinants of technology adoption, the TFP growth, is key, as this gives us the channel to act through. There is an increasing number of theory and empirical papers linking development and the adoption of technologies to the role of institutions defined in a very broad way. And data seem to be supportive of the link – there is a strong positive relationship between the quality of institutions and human capital on one side, and growth on the other.

But then, when it comes to the quality of institutions, or human capital, there has been little or no convergence of the CEE. If quality of institutions is proxied by the World Bank's Worldwide Governance Indicator (*which includes six broad dimensions of governance: Government Effectiveness, Regulatory Quality, Rule of Law, Control of Corruption, Voice and Accountability, and Political Stability and Absence of Violence/Terrorism*), there has hardly been any convergence of the CEE region towards Germany. Notable exception are the Baltic countries where we have seen positive developments also in the aftermath of the global financial crisis. A very similar conclusion can be drawn when looking at the human capital quality, not only that the CESEE countries lag substantially behind the EU countries that achieve the best results in PISA tests in Math and Science (Finland, Sweden, Austria, and Germany), but the developments over time are also not encouraging as in many countries the results actually worsened during the last decade. So, one can raise the question of how did we manage to converge at a relatively high pace before the crisis, or why convergence continues, with such institutions and human capital?

On one side, such developments are worrisome, but, on the other, they give us the opportunity to streamline reforms. Gains from reforms can be substantial. The European Commission estimated that structural reforms that close only half the gap with best performers in different areas (market competition and regulation, R&D expenditure, skill structure, tax structure, labour market participation, unemployment benefit 'generosity' and active labour market policies), which is not overambitious, could have significant macroeconomic effects. The level of GDP in 10 years after the reform would be around 7% higher in the CESEE 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. Even given the uncertainty around these estimates, welfare advances would most probably be substantial.

But the billion(s) dollar question is, how to get structural reforms right? There are, in general, two dimensions of structural reforms. First, and in principle the easier one, 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 been exhausted. The second are the reforms that expand the frontier. But there is so many different policies that are on the table here: Product market reforms, Competition policy, Labour market reforms, Public finance and taxation (including Social security system), Human capital development, Innovation policy, 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.

The bottom line is – there are no guarantees. There are no guaranties that levels of income in the CESEE countries are going to converge towards those of the developed Western economies. No guarantees that these countries are not going to form one, or more, of the so-called convergence clubs at a lower level of per capita income compared to their developed peers. However, it is our job to dare to introduce reforms even if we are not a 100 percent sure about the timing and the scale of the effects, as these are often not under our direct control. But if history teaches us anything, and if we follow the best practices from around the world, not only the EU, then the path we have to follow becomes much clearer. And the closest thing to a recipe for reducing the probability of being caught in the 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, be it liberalising product and labour markets controls, be it the reform of justice or public administrations systems, or anything else that is proven to enhance the business environment in the country. It is as simple or as difficult as that.

But, and this is my final thought – we have to keep in mind the political economy dimension of the process, and there things do not look encouraging.

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 is the difference in the percentage of people who support market economy approximately twice lower in our region than in Germany, but it has actually declined in the last ten years, diverged, and the same applies to the support of democracy as a political system. This is where policy transparency and communication will play a tremendously important role. 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 boldness is often rewarded beyond our expectations.

Thank you.