Panel discussion:

Evolution of economic policies in transition countries and future challenges

Panellists (from left): Miroslav Singer – Governor of Česká národní banka (Chair), Ardo Hansson – Governor of Eesti Pank, Daniel Daianu – Professor at the National School of Political and Administrative Studies in Bucharest, Andreas Wörgötter – Head of Division at the Organisation for Economic Co-operation and Development, Michael A. Landesmann – Director of the Vienna Institute for International Economic Studies

Dr Miroslav Singer *is the Governor of Česká národní banka. He has also been a member of the Supervisory Boards/Boards of Directors at Česká pojišťovna, Expandia Finance, Expandia Banka, Expandia Holding and Chemofond, a member of the editorial boards of Finance a úvěr (Journal of Economics and Finance) and Business Central Europe. He has lectured at the Centre for Economic Research and Graduate Education at Charles University and at the University of Economics in Prague.*

Mr Daianu emphasized that it is a quite unusual period to judge transition economies; he is even reluctant to call them transition economies; because the big transition currently is not in the Central and Eastern Europe, for it is a period of huge turmoil in the euro area. Having an independent, autonomous monetary and exchange rate policy are major advantages under the circumstances because countries need not only a fiscal space but also policy space, which is a much broader concept. There is a very deep financial crisis which is not contained, a deep euro area crisis, a looming stagnation, a major shift of balance of power in the global economy.

What seems to have been missing in the policies of the last couple of decades? He pointed out several aspects. One is a relative neglect of institutions. This was highlighted in a World Bank study after the first ten years of transition. That study also emphasized there was a simplistic paradigm that had prevailed over the years neglecting structural issues. Economies are not similar, they are different, there is a lot of heterogeneity that can be seen inside the euro area too. Some of the new member states are more analogous with

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the periphery of the euro area when it comes to the ability to deal with a boom and bust cycle. Probably, the opening of the capital account was premature in some of the cases but the single market logic has prevailed. There was the episode of Asian crisis, which sent a very strong warning signal in this regard.

There are clusters of economies, Central and Eastern Europe is not homogenous. There are a few countries which seem to be much more compatible with the core of the euro area than with its periphery. It was easy to anticipate this situation. Then there are countries which were assisted financially when the crisis erupted so ferociously, including Hungary, Romania and the Baltics. So, now, euro adoption is not a goal for the immediate future for some NMSs. There are two fundamental pre-conditions for joining the euro area, in his view. One is having a well-trained economy, an economy that can withstand asymmetric shocks. Second, the euro area should be fixed. Its repair is not finished yet, and it may still take quite a while.

Now what are major challenges for Central and Eastern Europe in general? There are three, in his opinion. One is a bank credit retrenchment and even more, it is a broken transmission mechanism, as the ECB President Mario Draghi repeatedly emphasizes. Europe cannot grow without bank credit. Europe depends on bank credit much more than the United States. A second major challenge is a looming stagnation in Europe, because Central and Eastern European economies, depend overwhelmingly on the EU dynamics in general. A third challenge is a middle income trap, which some of the countries will probably face in not a distant future. A big question is whether they can turn into more entrepreneurship driven economies. The growth model should be rethought because the growth has been pretty fragile in several cases; there were episodes of a boom and bust cycle, there were very large current account deficits and so on. And finally, financial markets have become an inbuilt destabilizer to a large extent because large banking groups are more engaged in trading than in lending, so there is need for a radical reform of the regulation and supervision of financial markets, what has been emphasized in the Governor's Liikanen speech. Also the Wickers' commission report in the UK emphasizes a radical reform of regulation and supervision of financial markets as being bedly neede. Otherwise the economic situation will continue to stagnate, or get worse.

Mr Hansson congratulated Národná banka Slovenska on its anniversary and thanked it for organizing the conference and hosting the Governing council meeting. His speech covered five main points. First, the transition has been a success. It is hard to generalize, but income indicators and the rate of convergence show that over a ten, fifteen or twenty year horizon, it is clear that these countries as a group have grown relatively rapidly by any definition. Mr Hansson mentioned the risk that some of these countries may face a middle income trap, but overall this region is doing well relative to other regions. The World Bank classified some twenty plus countries as having escaped this trap, half of them in this region. This means that a lot has been accomplished and these economies are quite resilient.

Second, European integration, EU membership, and euro area membership have generally been positive factors that have created a sense of discipline and simplified decisions about which institutions to adopt in certain areas. There is no need to discuss the Japanese, American or German models, as the choice has been made. This might have been a straitjacket for some, but in general it has simplified the adoption of institutional reform. It has also led to a certain amount of indirect harmonization of countries that originally were not harmonized. Everybody was integrating bilaterally with the EU and then ten years down the road all

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the countries found themselves integrated with each other as if an invisible hand had been at work, and that was very helpful. Finally the EU has delivered convergence – the World Bank has called it a convergence machine – through the single market and through financial integration. You could question the volumes of capital that have flowed in the region in some instances and which may have flowed to the wrong sectors, but the fact that capital was flowing from richer countries to poorer countries, from the slower growing to the faster growing is a sign that financial intermediation has basically been working in the right way.

In his third point Governor Hansson argued that transition as a regional and geographical concept is becoming increasingly obsolete. It is probably still relevant for countries like Belarus or for Central Asian countries, and it makes sense in some pockets in the Balkans, but generally in the CEE region it is more or less irrelevant by now. There might be a north-south divide or an east-west divide but these are all overly simplified. Perhaps the only group that really stands out as a cohesive block is the Nordic region. There is probably a better macro outlook in terms of macro sustainability in this region, and perhaps these economies can be classified as being a bit more flexible and having the edge in terms of infrastructure, in terms of institutional development and probably also in terms of corruption. If you look at other aspects like privatization, or the degree of liberalization, there is not much variance anymore. So what you see is a lot of diversity in the EU if you look at indicators for doing business, and it is very hard to say that there is a line for this transition concept that makes a lot of sense. Probably in some sectors in some countries there are still some individual transitional issues but maybe this heterogeneity is actually a sign of normality and is a sign that national policies actually mater.

Fourth, the agenda for the future is a classical convergence process, a standard economic development agenda which is about productivity, growth, human capital, further gradual financial deepening, outstanding public sector reforms, and some infrastructure bottlenecks. Issues of migration in a single labour market may also be shared challenges. There are two other things that have to be dealt with. One is the process of convergence in the poorest parts of the continent and the other is the Ballassa-Samuelson effect which is going to affect inflation performance, but hopefully in a sustainable way.

Finally there is one element of the transition paradigm that remains relevant, and it relates a little bit to what Mr Daianu has mentioned. Transition was never a single process, it was actually at least two different processes. One was moving from planned to market-based institutions, the other encompassed huge changes in relative prices and incentives. You might have thought that planned economies were relatively undistorted, but that was not the case. The new relative prices that prevailed after the change meant that energy was too cheap, there were overly large agricultural and industrial sectors and undersized services, and trade and the tax system were distorted. A part of the transitional recession was the collapse of institutions, and part of it was this large factor reallocation. At the beginning of the transition, countries started losing potential output as productive factors were released from declining sectors and not yet employed in any alternative sector. A little later this became a driver of growth and most of the studies of growth would give a lot of weight to this factor reallocation. It links to the broader agenda in many European countries that if there is an outsized construction sector, if you want to move from the public to the private sector, if you want to move from SMEs to larger firms, then there is a whole range of reallocations that still needs to be done. And what it probably means is that some of what is happening now in many European economies in terms of stagnation, inactivity, and unemployment is probably a kind of transition 2.0 light version.

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Professor Landesmann at the beginning of his speech recalled the World Bank study which emphasized that there are worrying signals about convergence when looking forward. The other problem is the heterogeneity of convergence in the region. He also emphasized "old fashioned" issues, such as the role of manufacturing, and argued that the heterogeneity in convergence is caused by the policy instruments used by different countries.

According to Prof. Landesmann, we see a north-south divide in the euro area crisis. Analyses of the WIIW show that this divide is similar to what we see in the CEE region. The divide is both accentuated and even may be cemented in the crisis and is related to historical structural developments. Professor Landesmann stressed the weakness of the tradable sector in a range of countries, as well as external imbalances, which have been a defining feature of the disparate developments across the euro area. It is astonishing that alarm bells were not rung and policy instruments were not activated earlier against the explosive current-account imbalances. The underlying structures of current-account imbalances varied. The development of trade balances in the CEE5 was a real success story – trade deficits in the initial period, when countries built up export capacity, followed by closing the gap later on. Therefore, before the crisis erupted, these countries had either positive or balanced trade accounts.

The picture was different both in the southern EU countries, as well as throughout the rest of Eastern Europe, the Baltics, or the Western Balkan countries – with explosive trade deficits. Econometric evidence presented in the background report of the WIIW to the EU competitiveness report showed that low- and middle-income economies are much more dependent, in terms of trade performance, on manufacturing output. It is obvious that higher-income countries develop trade in export services more. In the long run the manufacturing sector is a highly important segment of the economy. What we see is a disparate development of manufacturing: the group of CEE economies with strongly developed manufacturing and the wide range of low- and middle-income countries with a steady reduction of manufacturing and a shrinking of this rather important part of the tradable sector.

There is an underlying element in this development – of industrialization and deindustrialization – which has very strong agglomeration features. We see it within countries at the regional level, but it can be seen in Europe as a whole as well as around Europe, too. Many countries suffer persistent problems in trying to link up with production networks. The problem underlying external imbalances is countries' inability to develop industrial capacities. As Prof. Landesmann mentioned, this problem has become cemented during the crises, with the exception of Baltic countries, which made some structural shift. But detailed analysis shows that a wide range of countries suffered a large negative shock to industrial capacities during the crisis, and this may have long-term consequences.

Another area is the exchange rate – not only the aggregate developments of the real exchange rate, but details of what lies behind the real exchange rate adjustments across different sectors of the economy. The main result of the analysis and overall picture so far is that real exchange rate movements have not had the intended impact on current-account adjustments. The main developments we have seen during the crisis were that adjustments went through incomes rather than through adjustments in relative prices of the tradable sector. What we see is diverse developments of the relative exchange rate of the tradable and non-tradable sector in different economies.

To conclude, Professor Landesmann stressed the fact that an element of development, which evolved during the 2000s, will have persistent features and that it is unlikely that there will be structural convergence. This is very strongly related to the build-up of the tradable sectors. We are seeing highly diverse developments and the importance of industry, which is now concentrated in the Central European hub. There is ongoing research of industrial policy, related to what Governor Nowotny mentioned in his speech – there is a slow-down in the flows of FDI. There should be supplementary policy tools to support the structural upgrade of economies and to modify current agglomerative processes.

Dr Wörgötter congratulated NBS on the occasion of its 20th anniversary. He related that period to his personal and professional life as he worked on Slovakia all that time as an economist.

Because other panellists had already mentioned many important issues, he concentrated on some supplementary points concerning experiences, challenges and some recommendations – simplified and general.

He asked to what extent we can legitimately talk about transition economies. The set of transition economies is becoming more widespread: it is not only post-communist countries that we can characterize as transition economies. This crisis has shown us that there were severe and very deep distortions within economies which have to be corrected and this process of correction is what we have to call a transition. From this point of view it is legitimate to talk about transition economies.

A transition economy is one that is not functioning according to the usual trend-cycle model, we cannot think about a transition economy as an economy which developes in a cycle around the trend, in which macroeconomic policies smooth the cycle and structural policies serve to accelerate growth. In transition economies macroeconomic policies have structural consequences and structural policies have impact on the efficiency

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and effectiveness of macroeconomic policies. So we cannot separate these two sets of policies.

Speaking about privatization, Dr Wörgötter stressed that privatization in the standard transition economies has generated less entrepreneurship and economic dynamism, but has contributed more to debt-financed consumption. That was not sufficiently taken into account by central banks. Foreign-owned financial systems contributed to this. For banks it was easier and more profitable to provide loans against collateral to households than to go through the tedious and less profitable business of providing financing to medium-sized companies, to start-ups, and to finance innovations.

One important challenge is the tension faced by countries that are already in the euro area and countries that have had a fixed exchange rate for several decades (e.g., Latvia, Bulgaria, etc.). These countries now face the challenge of achieving nominal convergence and restoring competitiveness – both going in different directions. Nominal convergence leads in the direction of higher prices, because we are talking here about lower-income countries that have a lower price level in the domestic sector, which is supposed to converge over time to the level of the other countries in the area. At the same time, they have to shift resources from the domestic sector to the export sector. But, as Prof. Landesmann showed, many of these countries have too-small export sectors. There has been over-expansion of real estate, over-expansion of retail capacity, over-expansion of infrastructure for domestic demand and domestic consumption. Redirection of the output is possible only if relative prices (domestic vs. foreign) change. This tension cannot be addressed by standard macroeconomic policies, since this is a structural feature.

Another challenge for countries like Slovakia, according to Dr Wörgötter, is how to get banks to lend to small and medium-sized enterprises and how to provide financing for innovations.

In conclusion he stressed three points (questions):

- How to make macroeconomic policies more growth-friendly. We do not have any solution, yet;
- How to remove consumption driven by the financial sector, to have more resources for employment creation;
- How to make regulatory reform create a more competition-friendly regulatory environment.

Discussion

The chairman, Governor Singer, then opened the discussion for comments from panellists and questions and comments from participants.

Prof. Daianu made a comment to Prof. Landesmann about the distribution of industrial activities in the EU. He mentioned an argument that the introduction of a common currency would lead to a specialization of economic activities according to comparative advantages and Europe would end up with an over-industrialized north and under-industrialized south. While not prophetic, it was a good economic prediction and, interestingly, this dichotomy can be extrapolated to the pains of some of the new member states. In spite of the substantial economic convergence, the prospects of stagnation are significant.

The second comment was Prof. Daianu's thesis that a major lesson from this crisis is that there should be more domestic drivers of economic growth. History of economic modernization around the world shows that domestic savings are important and, secondly, it is critical where those domestic savings go. A more entrepreneurial economy and more emphasis on tradable sectors in resource allocation is a key for economic growth.

Mr Martin Šuster *(Národná banka Slovenska) asked the entire panel about what is the most important structural reform that should be implemented in transition economies.*

According to Prof. Daianu, there are several specific structural reforms, but the most pressing one is that of reforming the education systems throughout Europe. Not enough people want to study engineering, technical sciences. Many wish to become layers, to have MBA degrees and so on. This is a comparative disadvantage against Asian economies, against the US. There are other candidates for reforms, too – e.g., the labour markets are too rigid.

Governor Hansson remarked that from the perspective of his own country (Estonia) it is education reform, probably in particular higher-education reform. Elementary and secondary levels are in a good shape, but higher education is a bit of an issue. And the other issue is the labour market. Right now, the unemployment rate is at 9.3% in Estonia and, despite this relatively high level, there are indications of inflationary pressures. So while there are elements that are quite flexible in the labour market, still the overall net result leaves something to be desired.

Prof. Landesmann stressed the importance of industrial policy. According to his econometric work exploring the successes and failures of industrial policies, one thing that emerges are highly significant interactive relations between governance indicators and the use of particular industrial policy tools, different state aid tools, etc. If one moves down the path of using a certain type of additional policy instruments, this has to be combined with improvement in governance. The use of certain industrial policy tools can be counter-productive if governance structures are not set up.

The second point, which is also strongly evidenced by the econometrics, is that vocational training is highly important for building the industrial base of the tradable sector.

The third point concerns the long-term structural problem in the current account, which of course can adjust through stagnation or lower income. But for a large number of countries there is one element that leads to real exchange rate overvaluation. That is remittance flows and the use of remittances for consumption or construction, but not for investment. So, any change in incentives that might shift the use of remittances would be a very important issue in the context of external disequilibria.

Dr Wörgötter agreed with everything that had been said and would just add one magic bullet and that is the reorientation and reprioritization in the use of structural funds. These should be used for more broadly extending innovation support and for SME financing institutions.

Prof. Issing expressed scepticism that industrial policy can be used as a substitute for the exchange rate mechanism. If several countries were to adopt such a policy, what would be the outcome? If such policies were not co-ordinated, they could run into conflicts; and if some industries were subsidized, there would be a problem with EU rules. He expressed sympathy for areas like vocational training, education, etc. In his response, Prof. Landesmann stated that industrial policies have never died. They have merely taken on a different shape. And, of course, there has been a strong emphasis towards more horizontal measures, rather than vertical measures. More recently there has been also rethinking at the European level of some vertical measures, for example on technology, on innovation policies, where the aim, similarly to many other successful economies, is to support or contain coordination failures in terms of technology implementations. Prof. Landesmann expressed support for vocational training institutions as a part of industrial policy and for successful cluster policies. He said that if countries are not willing to move towards a transfer union, it is important that every part of the union has some cluster of successful tradable activity. Several industrial policy tools are linked to its finance, specifically steering it towards SMEs, or there are export credit guarantees, which have been successful in many countries, etc. A crucial issue is the widening of European production networks. At present, they are heavily concentrated regionally in Central Europe. Support for countries linking up with such production networks is an absolutely essential ingredient. Industrial policies should not be seen as a substitute for the real exchange rate because the real exchange rate has two variables: wages and productivity and other cost factors. And, of course, the productivity variable is the one where industrial policy efforts can be directed in many indirect ways. So a singular focus that the real exchange rate would only adjust through wage adjustment would be a very incomplete perception of the long-run adjustment of the real exchange rate.

Answering a question about mistakes made during the transition, Dr Wörgötter stressed a potentially incorrect balance between policy issues in Slovakia. More emphasis was put on decreasing taxes, having a simple tax structure, and less on the regulatory environment for successful entrepreneurial activity. It could be that the advantages of the tax system were enjoyed by inappropriate income earners – by income earners that were benefiting from capital gains or activities that were not sustainable in the Slovak context.

In answering the question of what has to be done, Prof. Daianu remarked that – apart from the wisdom of judging industrial policy, due to single market logic – there should be an EU policy. Europe 2020 is, according to him, an industrial-policy strategy. It may not be effective, but it is an industrial policy. He then argued in favour of support for domestic sectors by using EU funds. Based on the experience of Asian economies, he opposed exchange rate overvaluation, argued for exchange-rate policy as an instrument for shaping resource allocation, and against premature entry into the euro area. He claimed that the euro is overvalued, it is not appropriate for some economies. We need a better understanding of the policy mix, more leeway for policy space, since fiscal policy and monetary policy are not enough, we need more tools, more instruments.

Governor Hansson remarked that the debate over gradualism versus shock therapy was not very helpful and he would prefer the creation of sound macroeconomic policy, enforcement of the rule of law and reduction of corruption.

Mr Winkler (ECB) asked for a clarification of the issue of the consumption bias in lending. He drew attention to the contrast against past warnings of the opposite, i.e. much of relationship lending, meaning the situation where bankers sat on the supervisory boards of companies. Have we moved too far? How should the current situation be viewed? Governor Singer extended the question: What is the situation in the old euro area members? Answering the question, Dr Wörgötter explained that this bias was evident not only in the CEE countries, but in the more developed EU countries, in the US and elsewhere. The question is why it was present in less developed countries and why excessive lending to households in poorer countries was allowed, predominantly in the real estate market. That bias was one aspect of the boom and bust. Prof. Daianu added in this respect that macroprudential regulation had not been present, or had been weak in the past.

(Compiled by František Hajnovič and Juraj Zeman)