Monetary policy challenges and attractiveness of monetary integration for catching-up countries (by Július Horváth)

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The first speaker in Session 3, chaired by the Vice-Governor of the Národná banka Slovenska Ján Tóth, was Professor Julius Horváth from the Central European University in Budapest. He started his presentation, entitled "Attractiveness of Monetary Integration for Catching-up Countries", with a short personal reflection on a rather more subtle but ever-present division between the western and eastern parts of Europe. Next, based on theoretical and empirical findings, he discussed from a historical perspective the issue of real economic convergence between these regions. In the following part of his speech he concentrated on describing the main features of the "Central and Eastern European (CEE) growth model". Finally, in light of these characteristics, Professor Horváth touched upon the impact of the global crisis on the CEE region and its growth model.

In the introduction to his conference speech Professor Horváth implied that even though communism in the Eastern Europe ended more than 20 years ago and that since then we have been witnessing deepening interactions between west and east, some "shadow of the iron curtain" still persists. The underlying factors of the continuing division of Europe into west and east may, according to discussions in literature, be quite diverse in nature.

According to Professor Horváth some form of convergence towards core (western) countries has been an important objective of governments of CEE countries since the first of them started appearing on the map of Europe in the 19th century. In this long term, however, economic data show a rather bouncy picture. Unconditional β-convergence in a cross country setting is typically restricted to a small sample of "core" countries, i.e. older OECD countries. There appears to be a lack of support for β-convergence between Western and Eastern Europe in the period since 1820 to 1990. Economic research rather finds support for economic divergence between these regions in the long run and particularly so during the early period of transition among eastern countries from planned to market economies in the 1990s.

But, as Professor Horváth put it, "economic theory is much more optimistic". He documents this by implications of the Heckscher-Ohlin-Samuelson trade model, whereby functioning markets and a reasonably similar relative factor endowment result in productivity, goods and factor price equalisation between two countries even without free movement of labour and capital across borders. Allowing free cross-border flows of production factors speeds up the productivity, wage and price convergence. Also the implications of the New Growth Theory for real convergence of two regions that exhibit vastly different levels of initial income are optimistic. According to this theory output growth is mainly determined by technological change. As imitation of technology is less expensive than innovation, countries that are able to imitate grow faster. Big improvements in productivity are possible as long as countries are far away from the technological frontier. Once they reach it, further productivity growth is determined by new innovations that move the frontier.

Indeed, when we look at the stylised countries of the CEE region in the period from 1995

to 2007, according to Professor Horváth, we can see a historically rare success in convergence. The same positive picture for the CEE region real convergence emerges in a broader international comparison.

Professor Horváth continued his speech by looking at factors that might have played a role in the success of what he calls the "CEE Model" during the period of 1990s-2007. First, he pointed out the political factors which were very advantageous. CEE countries entered political and institutional integration with a so-called soft power. Also the EU accession talks helped guide the necessary reform process and provided credibility to these – often socially costly – policies in the eyes of citizens.

Second, macroeconomic characteristics of the "CEE Model" played an important role and Professor Horváth discussed them in a row. The CEE region saw, for instance, much higher capital inflows than both Latin America and Asia during the above mentioned period. Credit expansion in most CEE countries was to a large extent financed from these inflows, rather than domestic deposits, in contrast to most non-European emerging countries. Real interest rates were declining due to nominal rates convergence and higher inflation but borrowing costs were in many instances lowered further thanks to widespread foreign currency borrowing.

Large current account deficits and real exchange rate appreciation during the catching-up process were also among the distinctive features of the CEE region development model. These are the same features that were pretty much discredited during e.g. the Asian crisis of 1997-1998. But, as Professor Horváth put it, in case of the CEE countries these "worked"; the reason being a strong commitment to trade openness, which was rising during the whole period (until 2007) in every country of the region. At the same time these countries were increasing their world export market shares while their exchange rates appreciated. This was only possible as the region's international and domestic companies were able to raise quality and improve technological content of exports. Another important feature, mentioned by Professor Horváth, which helped mitigate the effects of the late 90s' global financial turmoil, was the ability of the region to accept dominant foreign ownership in strategic economic sectors, notably in commercial banking.

Professor Horváth also dipped into a political economy literature to characterise what this literature labels as the Dependent Market Economy of the CEE. Among these characteristics are: comparative advantage in assembly and production of relatively complex and durable consumer goods, skilled labour with medium-high level of technology, docile labour, rising income disparities, low expenditures on research and low efficiency of research. These facts again seem to support the need for more public resources to be allocated to higher education and research as the CEE countries move closer to the technological frontier.

Total expenditures on research and development as a percentage of GDP

Country	2000-2011 Average
DME	
Czech Republic	1,4
Hungary	1,0
Poland	0,6
Slovakia	0,6
LME	
UK	1,8
USA	2,7
CME	
Austria	2,4
Germany	2,6

Source: Eurostat, USA figures for 2000-2009.

In the last part of his presentation Professor Horváth elaborated on the effect of the recent global crisis on the CEE region and its growth model. As the region has been hit relatively hard by the crisis and the prestige of the underlying ideological concept (conceptualised in the Washington Consensus) has started to lose its appeal, the sustainability of the "CEE model" has come to be questioned. Other adverse factors have emerged as well – the effects of external shocks are magnified by the distributional conflicts they trigger, and social divisions in the CEE are deepening.

According to Professor Horváth the vulnerabilities of the "CEE model" evidently materialised in the recent crisis but the worst scenario did not happen. Interconnections with foreign banks softened the effect of a sudden change in capital flows. Also, thanks to the various interlinkages with Western Europe the response of policymakers in CEE was mature, i.e. populist responses were largely restrained.

(Compiled by Tomáš Tőzsér)