

Comments on
“Whither Growth in CESEE...”
A Breugel Blueprint

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A Quick Structure

- Since I agree with most that is said in Chapters 4 and 5, I will dwell mostly on Chapter 3 on exchange rate regimes and all related claims
- Chapter 3 outlines weaknesses of fixed exchange rate regimes, and strengths of flexible exchange rate regimes
- I will deal with these in turn
- And finish with a 1-slide remark on the question “Whither Growth?”

Claim 1: for CESEEs fixing is worse

- This is the main message of Chapter 3
- Catching up is more difficult under fixing
- Main reason: under fixing catching up happens through inflation, lowering real interest rates and making things bubbly by:
 - High CA deficits
 - Fast-growing external debt
 - Huge capital inflows biased in favor of debt vs FDI
 - The FDI inflows biased towards non-tradables
 - Real exchange rate appreciation decreasing competitiveness
- All this when the crisis started led to:
 - Sharper contractions for fixers
 - Faster rise in unemployment for fixers

Claim 2: for CESEEs flexing is better

- Flexers retain independent monetary policy
- If times are too good they can appreciate nominally and curb potential bubbles
- When times are bad they can depreciate and absorb shocks nominally rather than really

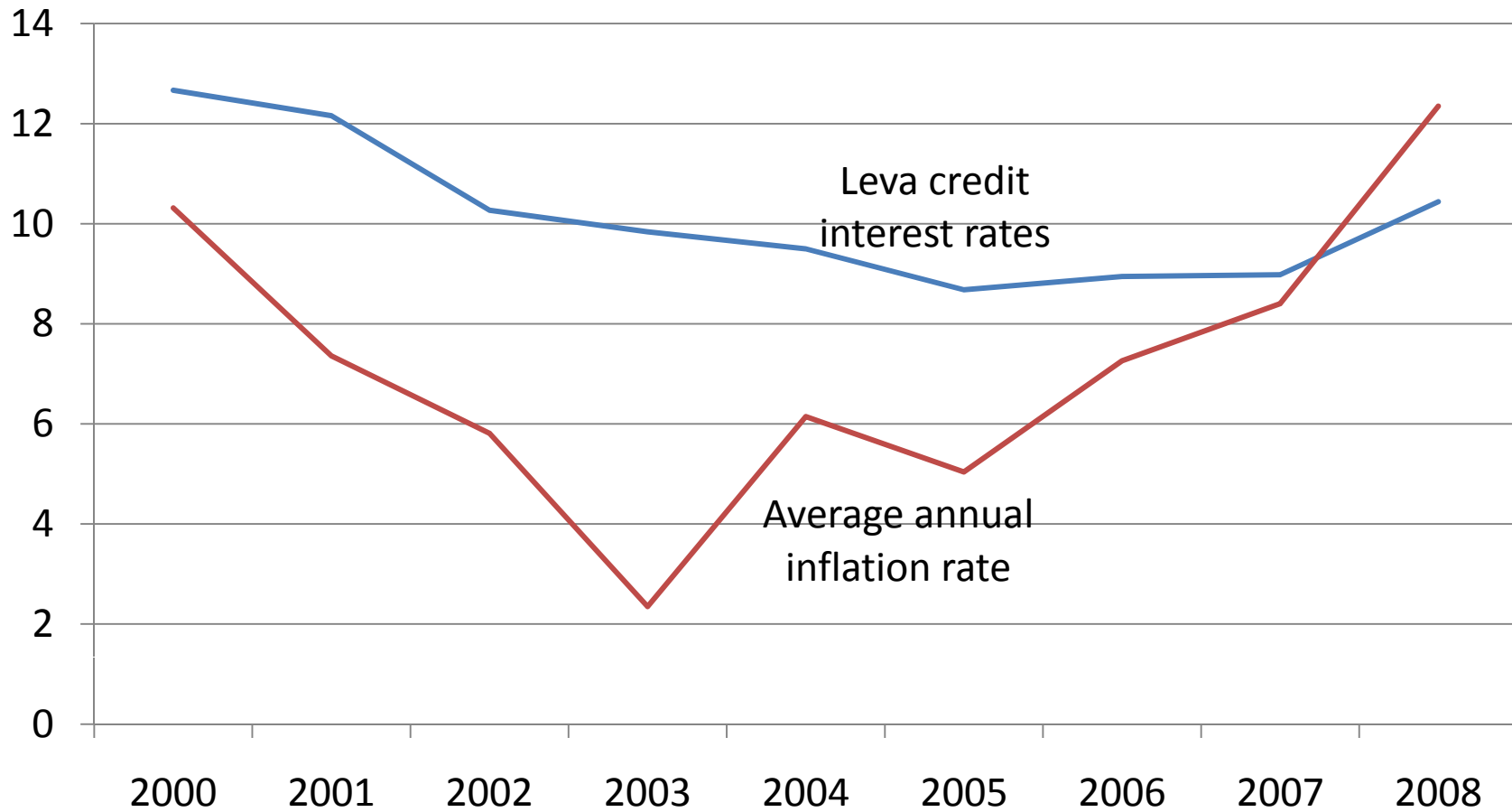
- Fine, but...

- Looking from BG both claims are problematic

Is Fixing Worse? 1

- Real interest rates being negative in fixers, attracting foreign indebtedness?
 - The implicit assumption is that for some reason the nominal interest rate is given, and higher inflation means lower real interest rate
 - Wicksell would have a problem with that
- Maybe this is true in some cases and circumstances
- But not in BG
 - on average +1.5 % in 2004-2008
 - right there with the floaters in Table 3.2, p. 51
 - so, in BG, increased foreign borrowing is NOT due to low to negative real interest rates

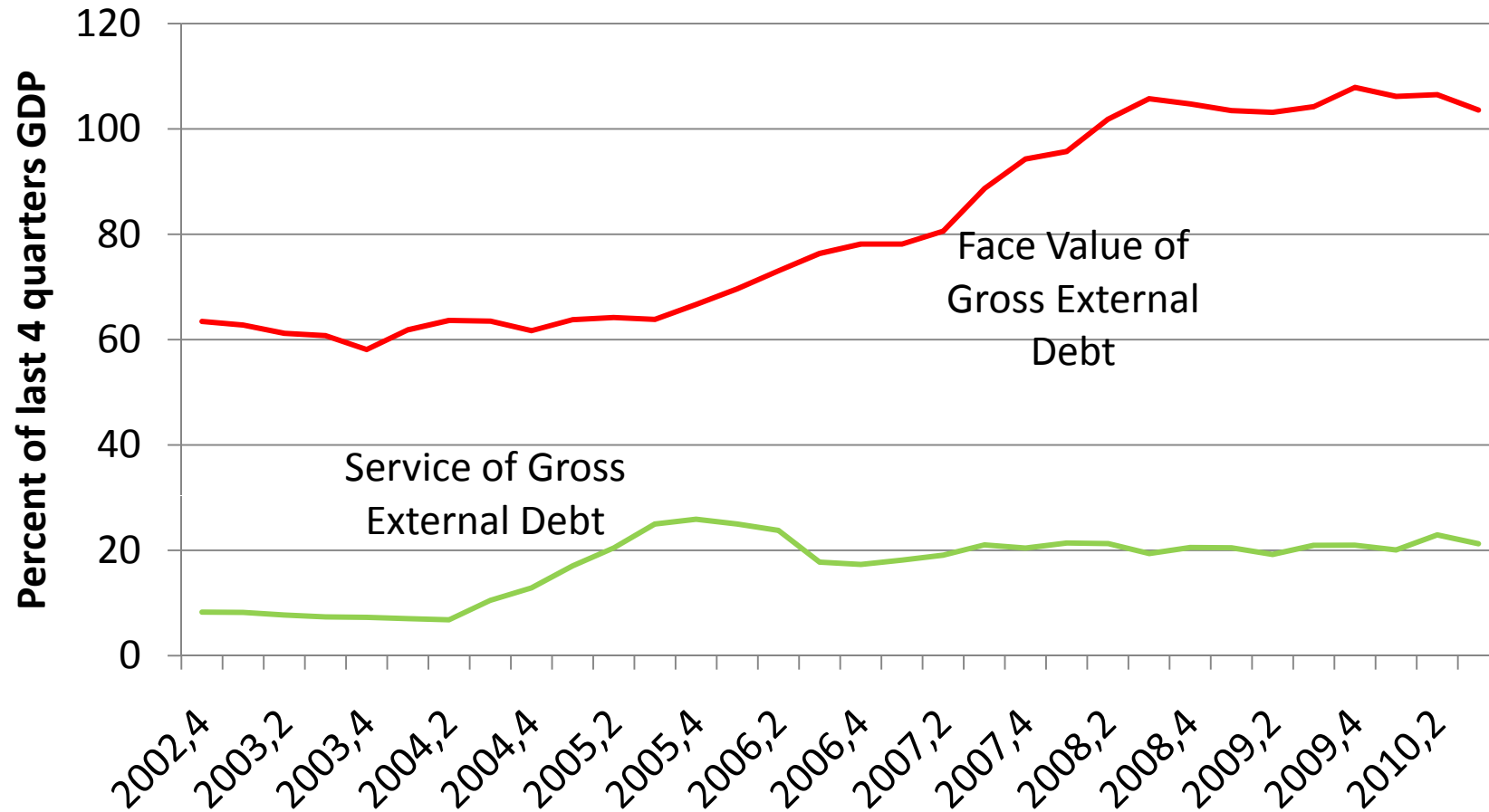
Is Fixing Worse? 1



Is Fixing Worse? 2

- It is true that CA deficits were large in the EU fixers. This may be caused by all kinds of factors other than fixing alone.
 - Size
 - Starting position
 - High domestic rates of return with risks getting lower
- The issue with debt is different.
- But to see this we need to forget about face value, and recall that a debt is as big as its service!
- And in the case of BG debt does not seem to have grown that much!

Is Fixing Worse? 2



Is Fixing Worse? 2

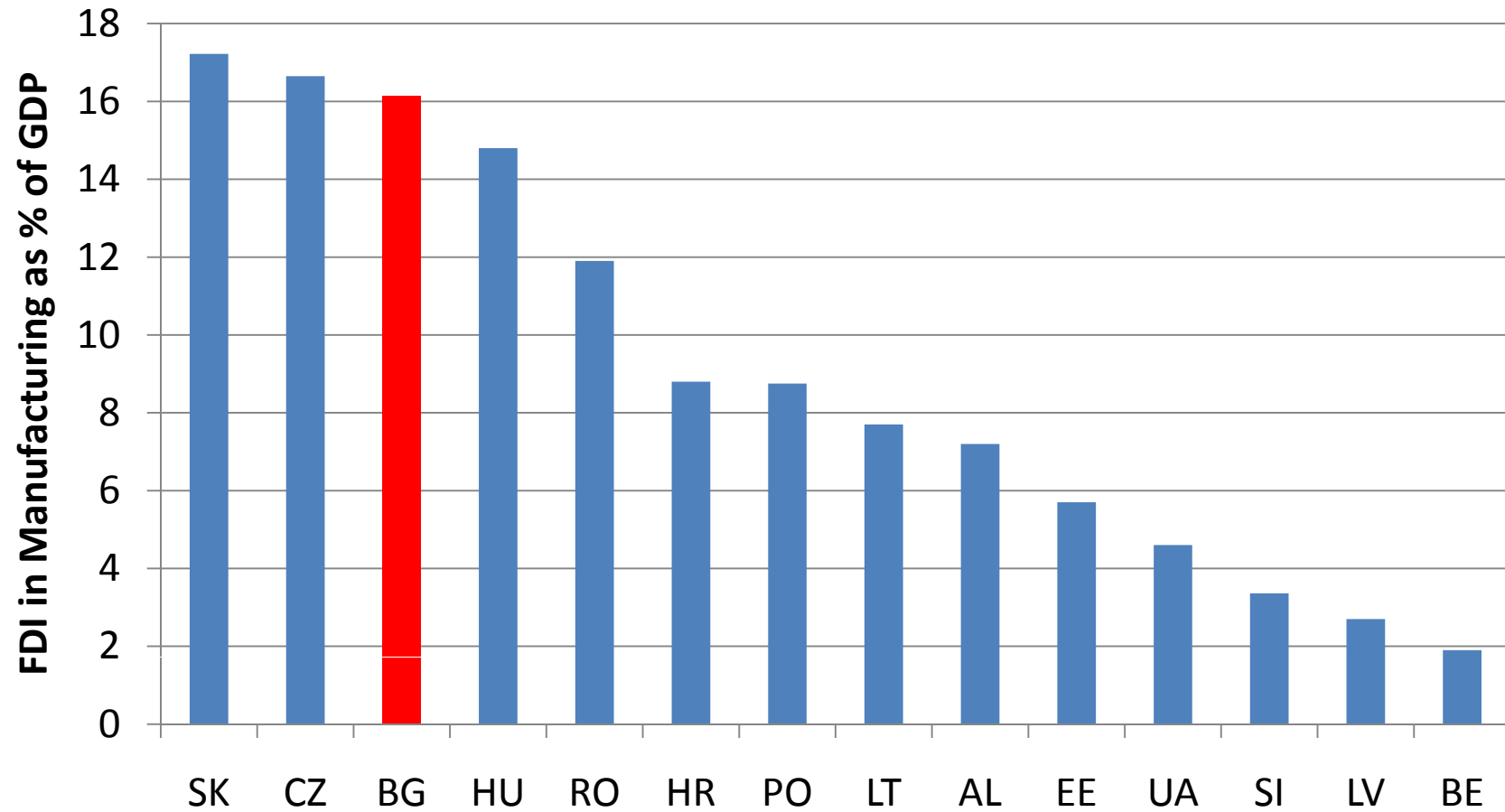
a note on saving

- Savings:
 - The implicit claim is that a sustainable model involves sufficient domestic savings. True.
 - But
 - If a foreign savings flow is downpouring, and if the public sector is saving healthily, households do not HAVE to save so much... which they can change if things change
 - It seems, that is what they are doing right now: the inflow of foreign savings decreased dramatically, the public sector stopped saving, and:
 - Eurostat projects (forecast for 2010) that BG will go from being the fifth lowest gross saver in EU in 2008 to being the second highest in 2010 (behind Estonia).
 - This is no trivial amount – an increase of 10 pp of GDP in two years.
 - Whether this is a permanent shift is unclear. But it did happen.
- General idea of these remarks: the fact that many people on Earth want to direct their savings towards your economy does not necessarily mean “problems with the effectiveness of monetary policy and capital market regulation” (p. 35)

Is Fixing Worse? 3

- Capital inflows in BG were NOT biased in favor of debt, at least not in comparison with CESEE flexers
 - Fig. 2.4: share of FDI in total capital inflows in BG was second highest among CESEEs after CZ
- FDI in BG was not biased in favor of non-tradables (esp. real estate and financials)
 - Fig. 2.5 – BG has – by far – the most sectorally balanced FDI inflow!
 - BG has a very high FDI into manufacturing – when you take the GDP point of view:

Is Fixing Worse? 3



This is an approximation based on Figures 2.5 and 2.6, p. 33

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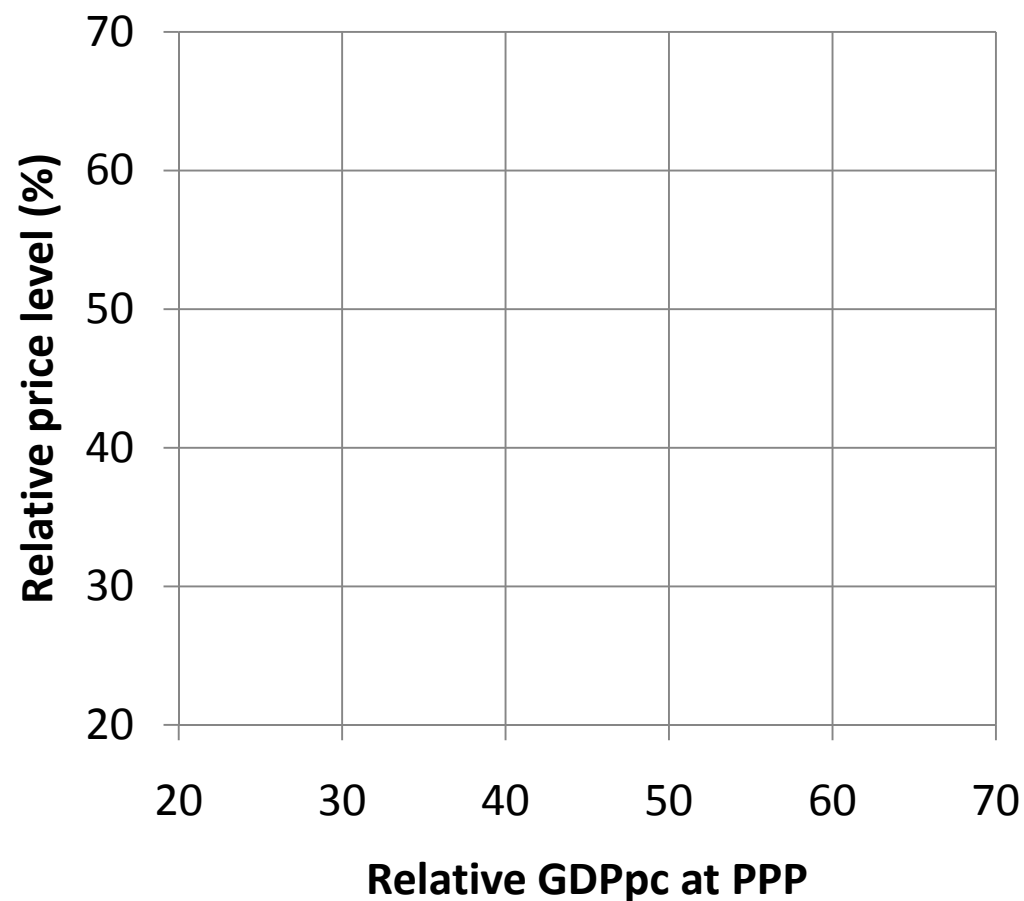
Gogi comments

Is Fixing Worse? 4

- The issue with the real appreciation is one where causes and effects have to be carefully observed
- What is “sustainable” vs “excessive” real appreciation?
- Does real appreciation cause competitiveness, or vice versa?
- The case of BG:
 - Real appreciation is along the lines deemed by the Bruegel Blueprint to be sustainable
 - Real appreciation seems to go hand in hand with rising competitiveness, properly defined

Sustainable vs Excessive real appreciation – the case of BG

This is the general framework – comparison between relative price and relative real income. After Fig. 1.6



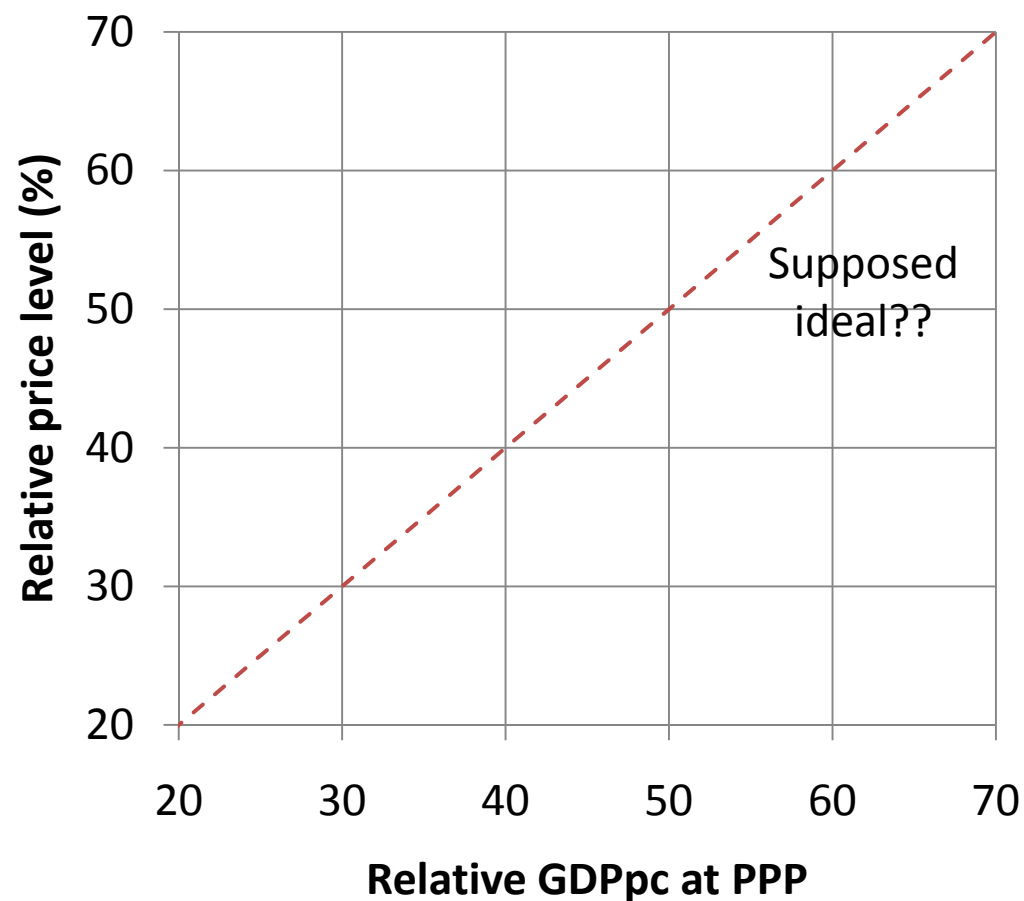
Note: EU-27 used as base. US, Canada, Australia, New Zealand, Japan much less relevant

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Gogi comments

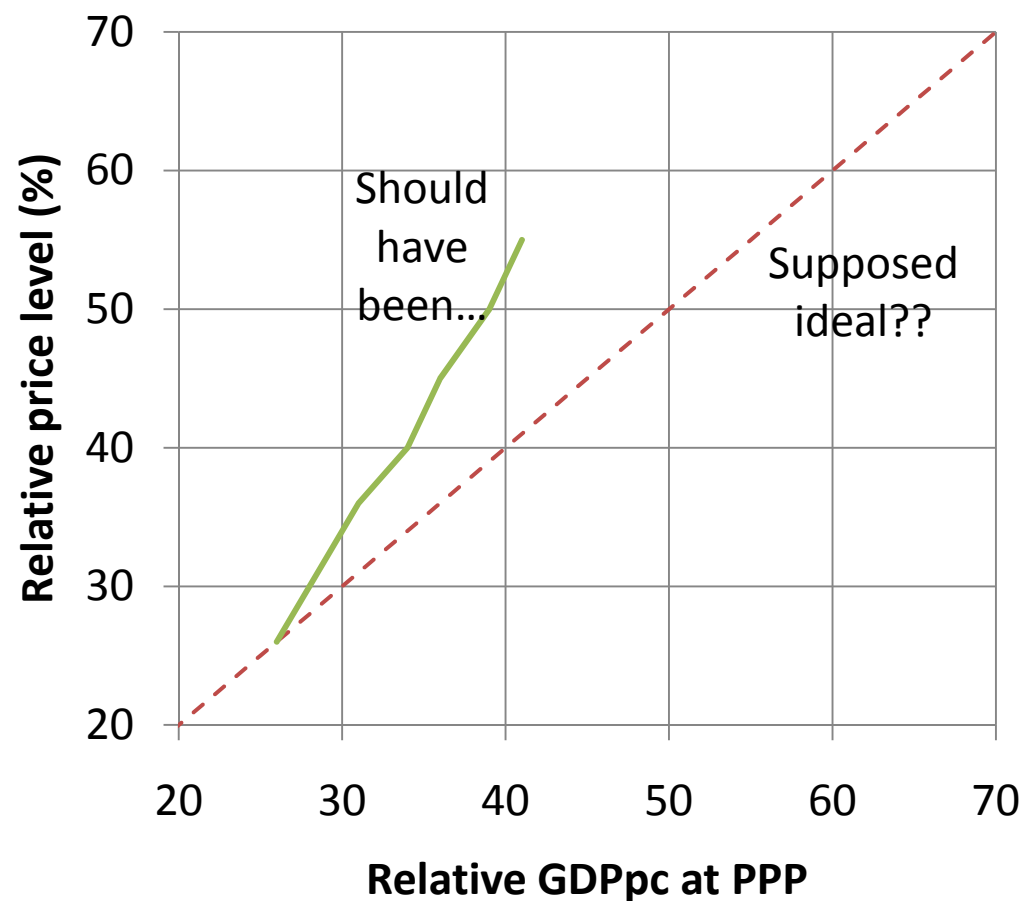
Sustainable vs Excessive real appreciation – the case of BG

For some reason, this is considered to be the “ideal”, “sustainable” convergence. Let us not dispute that.



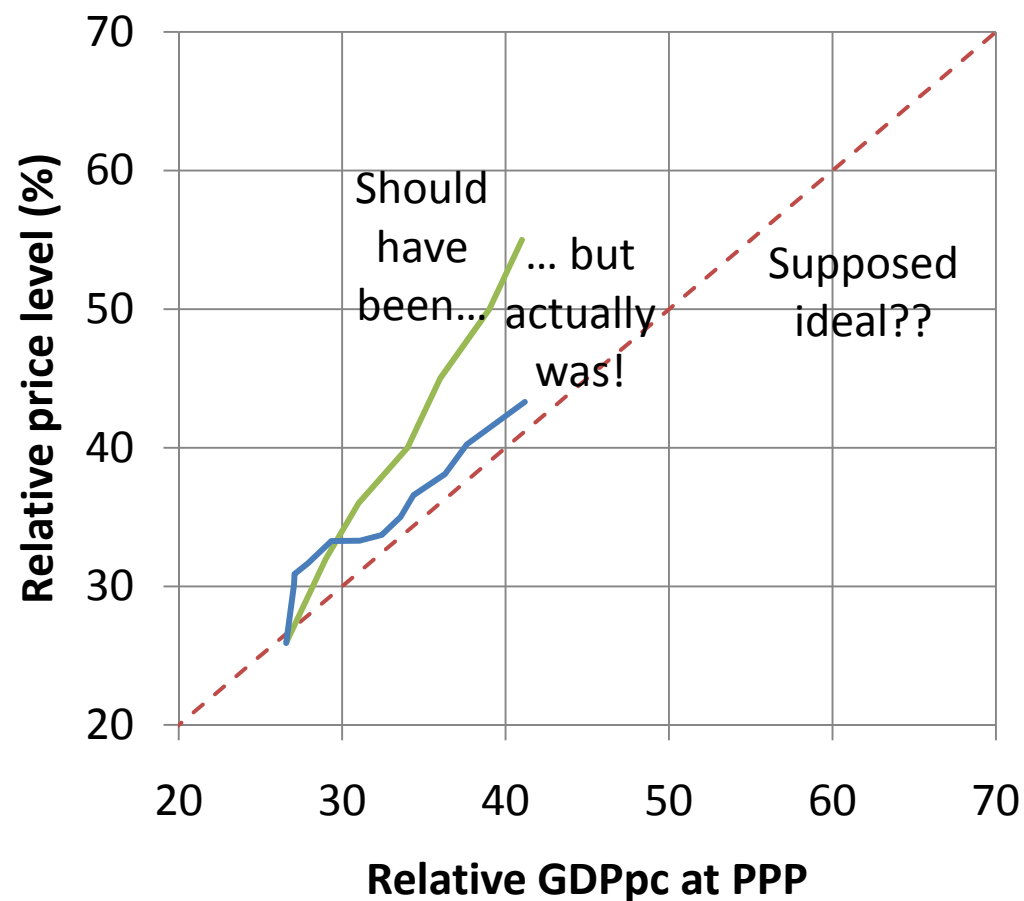
Sustainable vs Excessive real appreciation – the case of BG

“Excessive” real appreciation for BG between 1997 and 2008 (before the crisis) should have looked like this



Sustainable vs Excessive real appreciation – the case of BG

But reality was very much different!

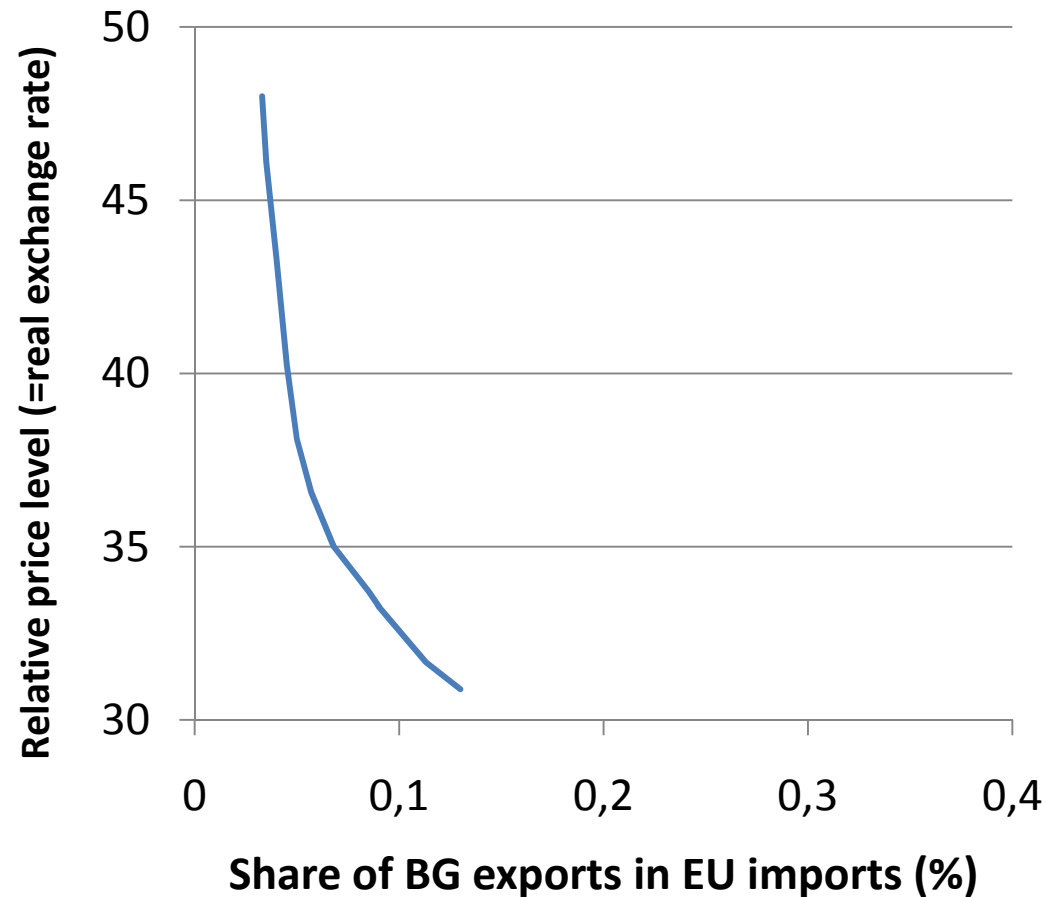


Loss of competitiveness due to real appreciation?? – the case of BG (1999-2010)

- Here is a theory:
 - Real appreciation without possibility for nominal appreciation means more expensive domestic production and from there loss of international competitiveness.
- Sometimes the real exchange rate seems to be used as “the definition” of competitiveness.
- I have another definition of competitiveness:
 - Competitiveness is being able to sell in conditions of rivalry.
 - This is basically the same as being able to add value, which is a definition of competitiveness going back at least to Michael Porter.
 - And is measured by the market share in a contested market.
- For most goods the EU is such a market. So let's see

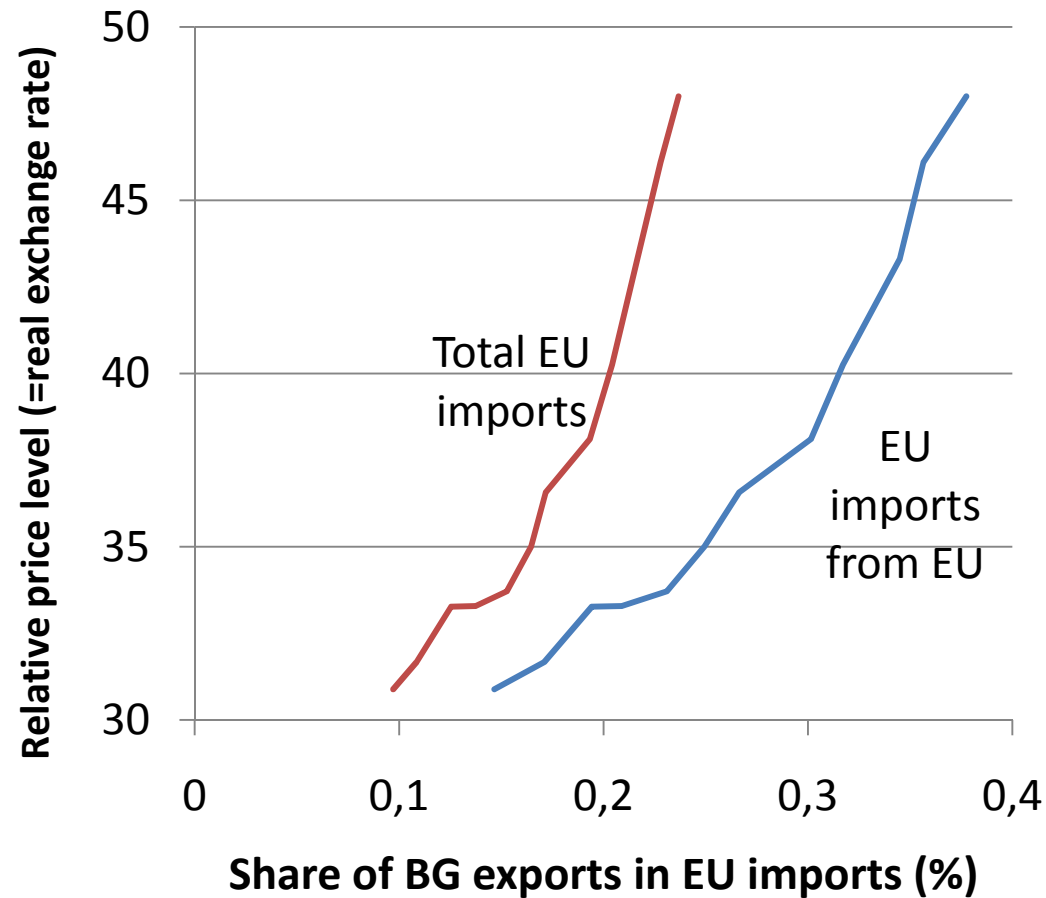
Loss of competitiveness due to real appreciation?? – the case of BG (1999-2010)

In 1999 BG exports to EU had a share of 0.10-0.15 % in EU-27 imports. Its relative price level was 32%. If it was losing competitiveness, things would have looked like this:



Loss of competitiveness due to real appreciation?? – the case of BG (1999-2010)

But in fact, things look like a mirror image of what “should” have been



Is Flexing Better? 1

- An important part of the explanatory framework of the report is the conviction that flexers fared better under the crisis than fixers. This is a highly problematic assumption for at least two reasons:
 - Some fixers did not fare worse than average
 - How a country fared during the crisis depended on a myriad of other factors besides the nature of the exchange rate regime
 - This means that the claim needs to be proven, not just assumed. Fifteen observations in total, in the case of CE5 vs BB5 they are ten, are not enough for a statistically significant test.
- As it stands now the claim is a faith-based proposition.

Is Flexing Better? 2

Independent Monetary What?

- The choice of fixing vs flexing in the case of CESEE is embedded in the following context: all these countries are
 - Small
 - Converging (catching up)
 - EU members
- This is true even for PL

Is Flexing Better? 2

Independent Monetary What?

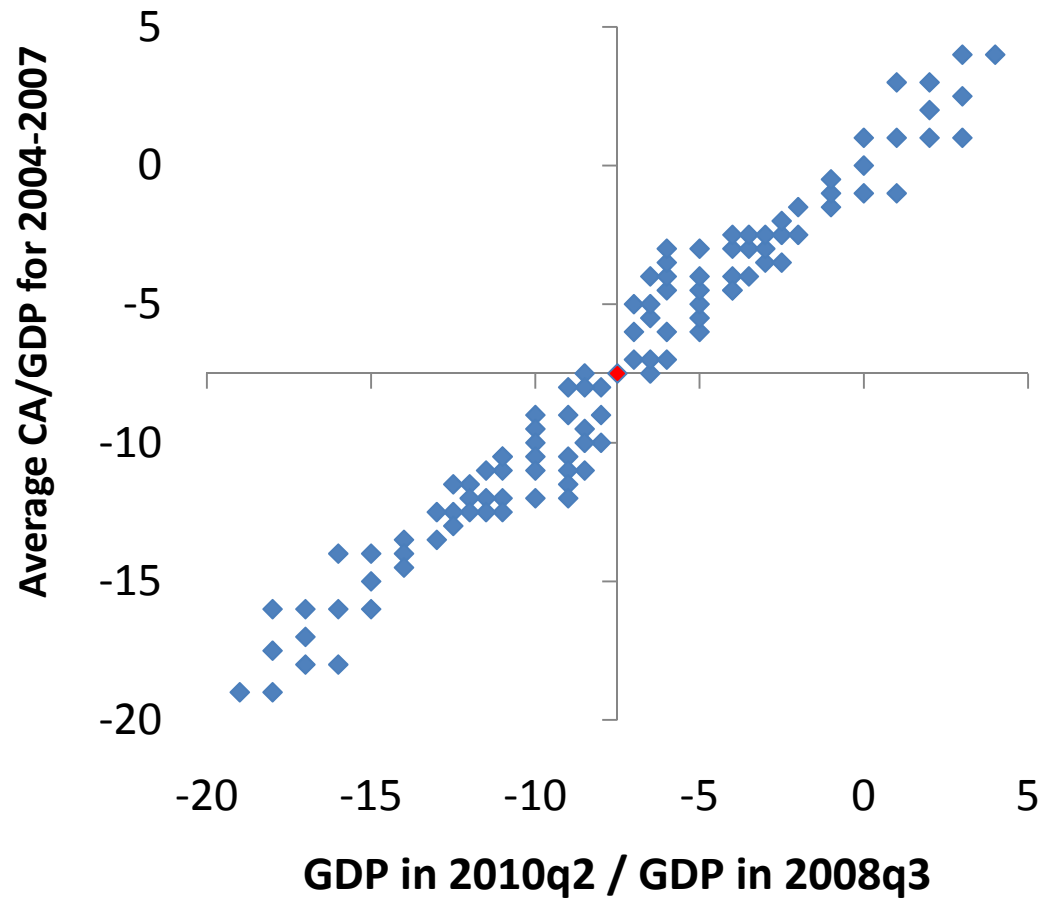
- Small, converging and members of EU means CESEEs cannot:
 - Block trade flows
 - Block financial flows
 - Control the currency denomination of these flows
- Thus their central banks control
 - A small part of the monetary base
 - A small aspect of the interest rates
 - All the rest being in Euro – a currency they do not control, thus
 - CESEE central banks' influence on monetary conditions is more a mirage than a reality
- All attempts to devalue the currency by flexers in this crisis showed that – all of them HAD to stop.

Is Flexing Better? 3

- The basic assumption of the Bruegel Bluepring is that fixing causes worse CA balance, whose adjustment is then more painful when forced by a crisis
- This should also have been the case for BG
- So things should look like this

Yes, BG is a fixer, but...

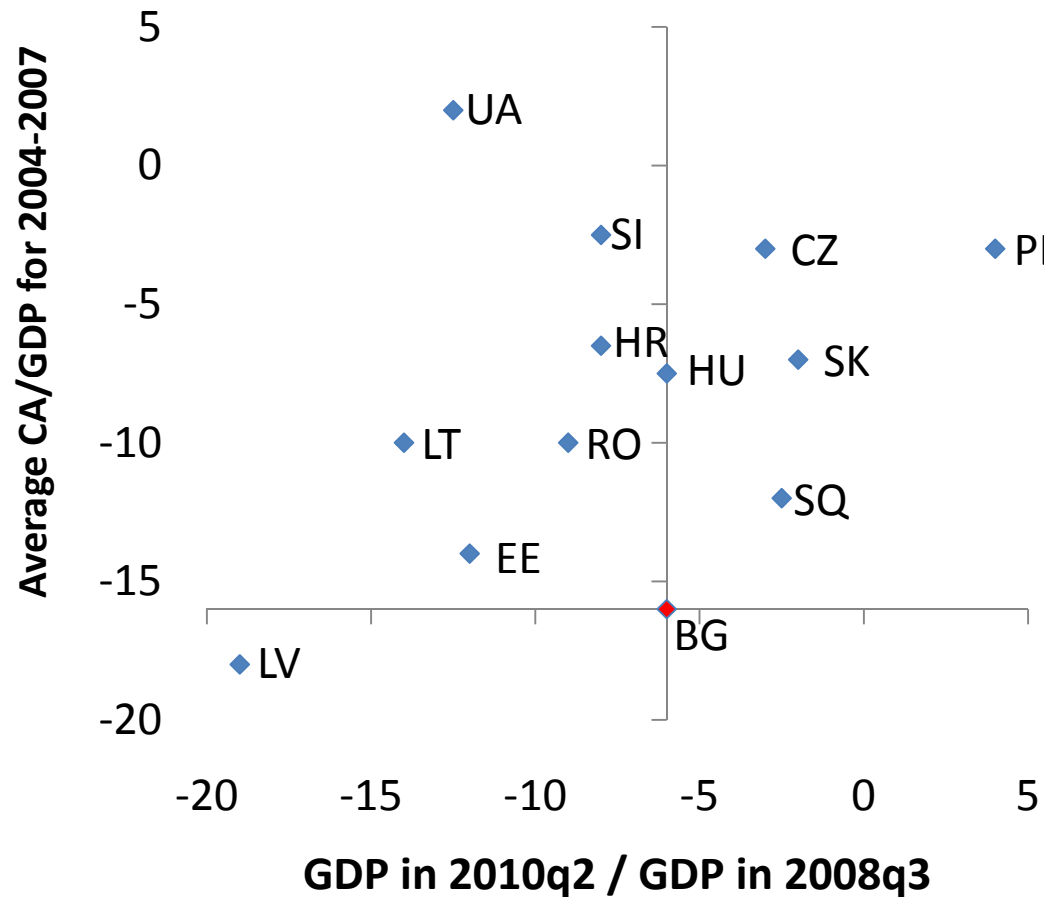
This is what things should look like in theory: the worse the pre-crisis CA (due to fixing), the worse the coping with the crisis



Yes, BG is a fixer, but... (please excuse the totally BG-centric viewpoint)

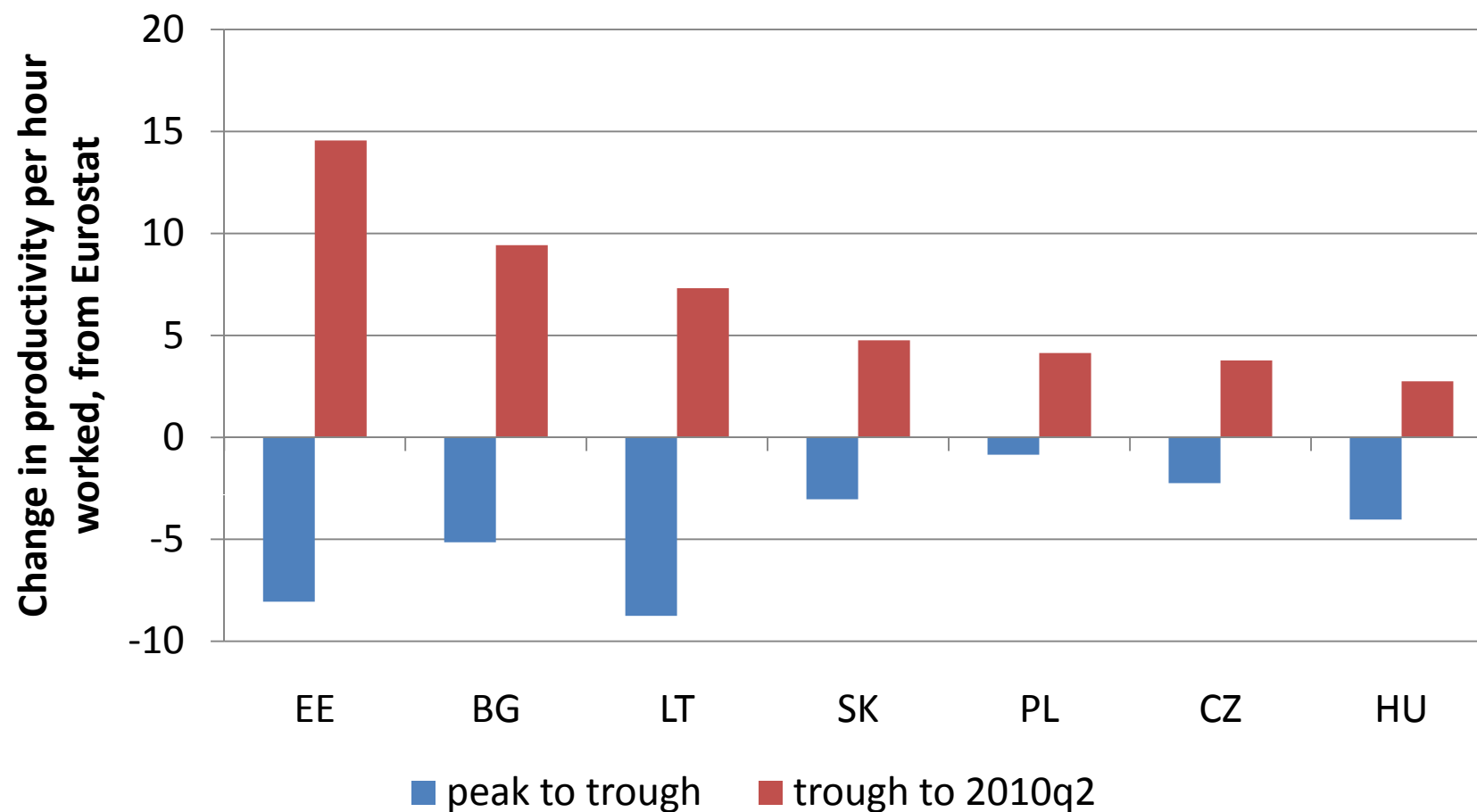
Seen from BG,
MOST of the
countries are
in the “wrong”
quadrant.

What should
we
recommend to
BG over the
next cycle –
lower CA?



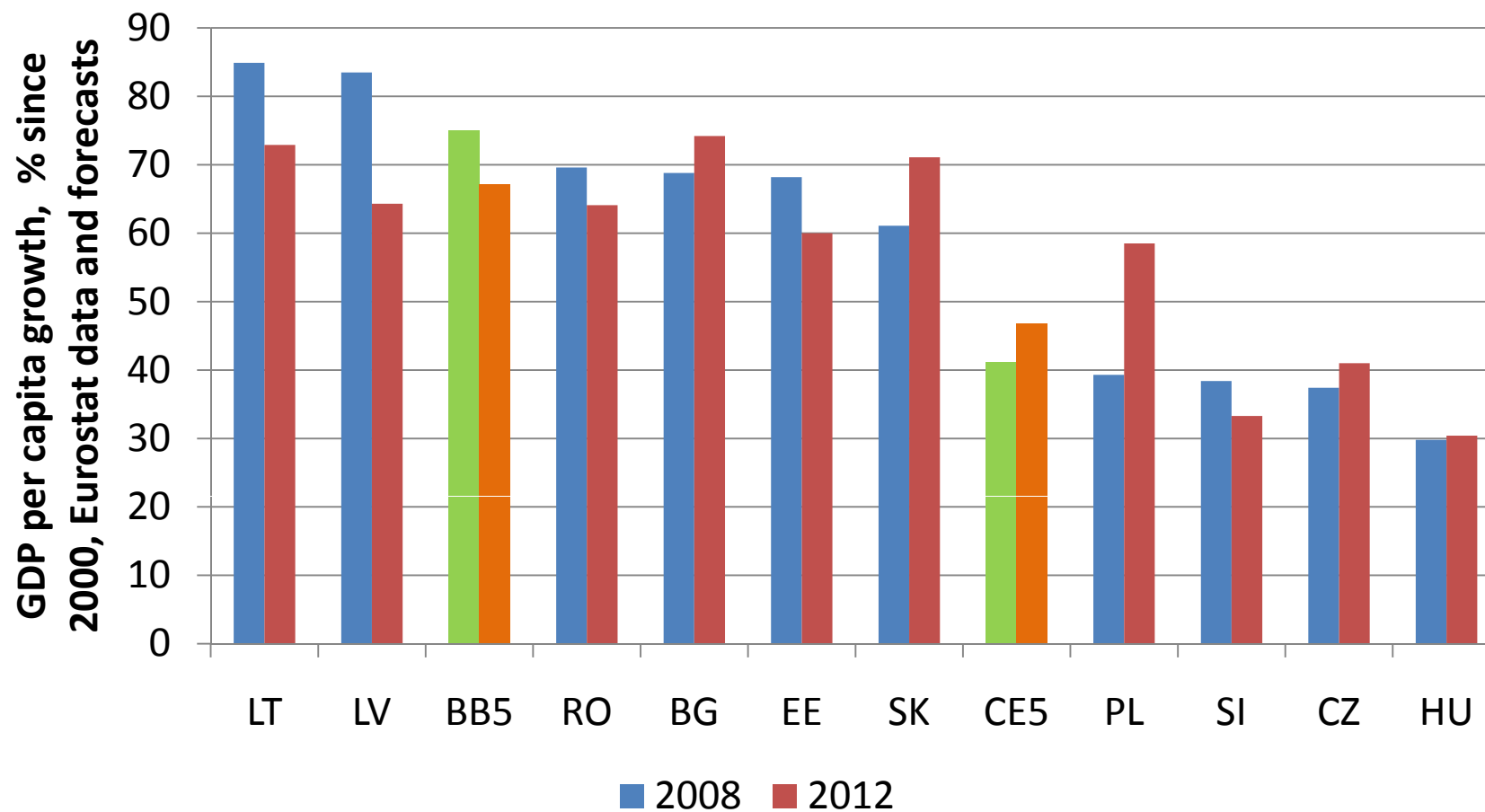
Is Flexing Better? 4

The Productivity Front



Is Flexing Better? 5

Growth since 2000 by 2008 and 2012



What About...

- The habitual long-term macro:
- $Y = Af(L,K,N) ??$
- One can easily think about policies towards:
- A
- K – all the types of K
- L,
- even N

- Just a suggestion...