# Floor Discussion of the Hrnčíř Paper

## The Reliability of Official Figures and Catching Up with the EU

A spirited discussion of the reliability of official figures followed from a comment by Zdeněk Drábek on the investment rates in the Czech Republic and Slovakia. "I think that we should be a little bit sceptical about the numbers, because if Slovakia's investment rate is 34 per cent and their GDP growth rate is 45 per cent, then some of us or our international finance institutions should wake up and realise that there is something wrong."

Ricardo Lago agreed and cited the current US example. "In December, there was an article in the *Financial Times* reviewing US economic statistics. These statistics indicate that over the last two decades, the US consumer price index averaged 3 per cent per year. But by updating the index each year by increasing the basket of consumer goods to reflect consumer preferences, it was, in fact, only 1.9 per cent. This overestimation of the CPI led to an overestimation of inflation in the United States cumulative over two decades of 25 per cent and – accordingly – a cumulative underestimation of GDP growth and productivity growth of 25 per cent. In Latin America, we refer to national accounts as national tales because what you read is rarely what you get. Given that most of the countries in transition do not have consistent methodologies and a reliable tax system, I think figures on savings rates and investment must be viewed cautiously. While the EBRD's experience in giving credit to Slovakia for their macroeconomic performance is better than we originally expected, at the micro level the investment partnership has not been the best. I would be surprised if Slovakia is at the forefront in 2013 or 2105 unless some of the micropolicies and micro interventions are changed."

"I agree with this attitude of suspicion toward numbers, having worked in the region and being Latin American by origin," added Robert Rocha. He continued with an explanation of the underestimation of the US consumer price index, "It occurred primarily because of the shift from industry toward services. Productivity growth in the service sector is measured by hours worked instead of types of service per hour worked, so the growth slow down in the United States in recent years has been overestimated, and there has been more GDP growth than the figures show. We have more reason to be sceptical of statistics in transition economies. Having lived in Budapest for the last three years, I think, for instance, that the Hungarian national accounts are not reliable.



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Also, why were the Czech Republic and Slovakia able to avoid this investment collapse that Slovenia, Croatia, Hungary and Poland experienced? I do not have a good answer, but I have been told that it had to do with the 1991 stabilisation programme. There was much less concern in the Czech Republic and Slovakia about protecting consumption standards during that period and as a result, real wages fell more quickly and enterprise losses were much smaller. When you look at enterprise data in 1992 in all countries except Poland – which had a stabilisation programme in 1990 – then 1992 was the worst year in the region. Enterprise losses in Slovenia and Croatia were around 14 per cent of GDP while the Czech and Slovak rates were 3 to 5 per cent. Perhaps enterprise growth loses to GDP. The situation has since improved tremendously in Slovenia and Hungary, and Slovakia and the Czech Republic have improved moderately because they started from a better position. My question is: Was the 1991 stabilisation programme in the Czech Republic and Slovakia – which was considered too drastic by many – the cause of the later benefits? Perhaps that adjustment actually protected investment ratios in these countries, and now these two countries are reaping the benefits. This is more a question than a statement, and I would be interested in hearing more on this."

Jan Klacek confirmed that investment data in the Czech Republic are unreliable, especially 1991-1992 data. "The economy was in steep decline even if we account for the underestimation of shadow economy activity. Investment decline was in line with decline of consumption, so in this respect, I see little difference with the other countries. The growth period occurred after the split of Czechoslovakia began in 1994. In 1994, there was a dramatic increase in public investment after a lengthy debate on whether the decline in economic activity should be allowed to continue or whether some major activity in the economic sphere should not be encouraged in order to reverse the trend. The high investment rate was initiated by massive public investment, primarily infrastructural investment, and private investment followed later. So far, growth in the Czech Republic has been more investment-led than export-led. It is true that a combination of investment and export would be almost ideal. The question now is whether it can be sustained given the national savings rate, which is much lower than the national investment rate, and also given the erosion of confidence among foreign investors."

András Inotai expressed embarrassment about the data. "I am embarrassed about the figures themselves and even more embarrassed about their reliability. We should strive to develop the proper understanding of figures, and if we only focus on macroeconomic figures without any criticism, then we will be surprised in the coming year."

Inotai continued with two comments on the interpretation of data.



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"First, we should be careful in describing CEFTA as open since part of CEFTA's openness is the result of the separation of countries. Also, there is a tremendous discrepancy in the level of per capita exports and imports between EU and CEE countries due to our lower level of development. The real question is: How do we increase our GDP growth to Western rates?

Second, CEFTA trade is higher than what is officially registered because a large part of intra-CEFTA trade is carried out by Western intermediaries. In the case of Hungary and Poland, about 30 per cent of intra-CEFTA trade is conducted by Germany, Switzerland and Austria, which are listed in the figures as German-Hungarian, etc. and not as Hungarian-Polish. The same holds true for other bilateral relations. Another point about CEFTA is that the discrepancy between the pattern of trade within CEFTA and with the EU is interesting. Logically and theoretically, we should have a much more technologically developed trade or a higher value-added trade in our intra-regional contacts, but in fact the opposite is true. More than 80 per cent of machinery exports are going to the European Union while intra-CEFTA trade is primarily in raw materials, agricultural products and semi-finished products. This is changing and will continue to change with higher import demand and higher growth rates.

I am sceptical about the World Competitiveness Report. It would be much more revealing to examine the *change* in CEFTA's import shares in the EU, and thereby determine the pattern. This tells us substantially more than the figures alone. Also, the growth rate of CEFTA countries as a share of EU extra-regional imports was by far the highest in the last six years. We have outpaced everyone, even the very successful Asian countries, including China, which have gained tremendous relative market shares in the EU market. The CEFTA-4 and the CEFTA-5 were even more successful, not in the global market, but in the EU market."

Ricardo Lago also commented on the interpretation of the available data. "Exports and imports related to GDP are meaningless unless they are adjusted for the size of the country. Other factors being equal, the larger the size of the domestic market, the lower the ratio of exports and imports to GDP. The higher the driving force and the scope of the domestic market, the larger the size of the non-tradable sector. This has implications for the real exchange rate. A small appreciation of say 10 per cent in Slovenia vis-à-vis a 10 per cent appreciation in Poland would be a disaster in Slovenia but not in Poland. The real exchange rate index has to be adjusted for the size of the domestic market.

Further on real exchange rates, when I was studying economics in Spain in the late 1960s, the third or the fourth development plan of General Franco was to achieve \$1500 or \$2000 per capita. Today it is \$12,000 or



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$13,000 per capita, but of course the real growth in Spain has not been sixfold. The real exchange rate in most of the countries in transition should be understood as a discount factor on the stock of capital and the lack of mobility of the labour force. So we would normally expect a path of real appreciation, and as transition progresses, systemic risks decline and this discount factor should decline along with it.

More specifically, if we take the four Visegrad countries plus Romania and Bulgaria, we have a total of 100 million people. For comparative purposes, Spain has 42 million inhabitants and a GDP of 0.6 trillion while the GDP of the 100 million inhabitants of the Visegrad-4 is not any higher that 0.5 trillion. But I don't believe that the standard of living in Spain is three times what it is, on average, in the region. The indicators which suggest that the CEECs make up 4 per cent of European Union GDP are understating the size of CEE economies. Here we have the statistical aberration of using the wrong exchange rate for the comparison. I would be more optimistic in terms of convergence because there is likely to be a combination of one-third real growth – outpacing the growth in the EU – and two-thirds real appreciation of the exchange rate. This was the case in Argentina in 1989-1990 and Spain from the early 1970s until now.

On current account deficits, the CEECs are now having a tough time, but I think they have a promising future. Consumption is not only going to depend on current income but also on the prospect of future income. This means that domestic savings are going to be small. On the other hand, because the capital stock has to be renewed, it is profitable to have relatively high investment. The financing for this investment will come from abroad. However, the issue is that these foreign investments should be sustainable; authorities should guard against becoming too vulnerable."

András Inotai concluded this part of the discussion with a comment on the exchange rate and currency appreciation for the speed of the catching-up process. "The calculations on how much time the CEE countries need to catch up with the EU – 10 to 15 years – have not taken currency appreciation into account. If a currency appreciation can occur without endangering competitiveness, then the appreciation might become important as an element of catching up in ECU, German mark or Euro terms. What kind of appreciation would this be? If there is a difference in the inflation rate between the main trading partners, then you should depreciate at the same rate in order to maintain the real exchange rate. However, if there is a difference in productivity rates, which is in fact the case, then you may depreciate at a lower rate because part of the depreciation will be practically compensated by productive gains."


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## EU Criteria of Price and Exchange Rate Stability

Joan Pearce dwelled on the relationship of the EU to the Central and European countries. "The EU is not just a regional organisation of market economies – it is a very specific model of market economy. If the Czech Republic or any other applicant country is not committed to that model, then they are going to cause themselves and the other members of the EU a great deal of grief which could be avoided. Perhaps I could, in turn, provoke Miroslav Hrnčíř by asking: Why not join EFTA which is a perfectly respectable European organisation of market economies? This would require much less by way of adjustment of domestic policies.

My second comment concerns some of the implications for the acceding countries being in economic and monetary union. They will come in as so-called pre-ins, and they will not immediately be expected to be part of the single currency. Incidentally, this means that the Maastricht criterion which relates to a single currency will be not be a criterion for their membership. But even as pre-ins, a number of requirements will be imposed. If anyone is interested, these are discussed in some detail in a paper that two colleagues of mine presented at the European Economic Association annual meeting in Istanbul. The acceding countries will have to accept membership of the EMU as part of taking on the *acquis communautaire*. They can, however, request and negotiate derogations. We have given some thought to the type of derogations that one might want to contemplate given that these countries will still be in transition, in all probability, when they join the EU. These relate in particular to the question of catching up. It is clear that if these countries are catching up and have growth rates of productivity that are faster than those of other members of the EU, their currencies will be undergoing real appreciation as against the rest of the EU. This means that they will not be able to meet both criteria of price stability and exchange rate stability, and there will have to be some trade-off. At present, there is no very strong view in the Commission as to which way this should go. There are some who argue that we should aim for the price stability criterion. Others argue that it might be wise to relax the price stability criterion in order to permit the continuing shift in relative prices to occur relatively smoothly and focus instead on exchange rate stability. These are certainly issues that will have to be discussed.

Other areas of discussion are the appropriate degree of fiscal tightness for these countries, given that they will still be in the process of restructuring and given that we might reasonably expect a higher return on public investment there. A further area would be the liberalisation of capital movements where we might not want to fully impose the requirements of the EMU. The distinction is between having precise quantitative criteria



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and pursuing policies that go in the direction of price stability, exchange rate stability and so on. It is the latter that will apply in the case of the acceding countries. Certainly they will not be expected to have met any precise quantitative criteria before they are allowed to join the EU and the EMU."

Albrecht von der Heyden inquired about the degree of intra-CEFTA trade. "CEFTA's past performance has been regarded as poor. While there have been some more encouraging tendencies, what are the consequences of this and what will the future development be? Is the deepening and widening of CEFTA desirable, and are there ideas about the direction in which this development should go? What kind of instruments could be developed in order to speed up intra-CEFTA trade? I agree with Mr. Altmann that cross-border and regional cooperation are important. In the end, these also contribute to stability. Poland and Germany have very intensive border cooperation, and would it not bepossible to develop CEFTA in this direction?"

Zdeněk Drábek responded by suggesting that there was no shortage of ideas regarding Central and Eastern European cooperation. "While there have been many proposals for mutual cooperation, there has been no political will to implement these proposals. This is what is needed to make a difference."

He then turned the discussion to the issue of micro versus macroeconomic policy. "Our vice-governor has said that we are currently in a situation where macroeconomic policies are no longer an issue; the issue is microeconomic policy. I find this a surprising position. According to Miroslav's table on inflation figures, growth rates and current account deficits, how can anyone say that macroeconomic policy is no longer an issue?"

Stephany Griffith-Jones concluded the discussion with a comment on exchange rate policy. "There is some conflict between the long-term objective of using the exchange rate as a mechanism for restructuring and micro-management, and the equally important objective of not letting the exchange rate get too far out of line in the short term to minimise the risk of a foreign exchange crisis which is disruptive to growth. Growth is an important policy objective particularly in these countries because one has to deliver to the population clear proof of the benefits of the economic strategy. There are no clear lessons of international experience for exchange rate policy, so it is important to be pragmatic. A fixed exchange rate may be valuable at certain points in time, for example at the beginning of stabilisation efforts, and this is true for for a number of countries internationally, but it is also true in the Czech Republic. One of the tricks may be to replace a rigid policy with a more flexible one as the situation changes."


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## Response by Miroslav Hrnčíř

"I agree that the paper lacks an elaboration of a pre-accession strategy, and it would be reasonable to describe it. There is a basis for this exercise. There was an interesting discussion on the data. In the Central Bank, we are often proud of how reasonable our monetary policy is, then with a time lag and a revision of GDP figures, it seems that the situation was not as good as we thought. We are confronted with these data problems, but I think at least some data are available and the issue is their correct interpretation.

With regard to the exchange rate issues, perhaps we should understand the exchange rate issue in the transition economies more in connection with general macroeconomic policies and the different stages of development in transition economies. The role of the exchange rate at the initial stage of transition and the potential role of the exchange rate in later stages are quite different things. The economies have now become much more open; initially, there were just official capital flows and nothing else. Now we have a reasonable amount of private capital flows as well so the possibilities of coping with different exchange rate regimes in different stages should be distinguished. I wouldn't discuss the exchange rate regime per se, but in combination with the macroeconomic framework. The extent to which the acceding countries should be committed to the fixed rate or to price stability depends on the different preferences in different stages of development.

The issue of the Czech current account deficit is crucial at this particular stage of our development. At the same time, these macro-developments are the reflection of what is going on in the micro-sphere, i.e. the institutional sphere – the issue of restructuring the financial position of companies, developments in the capital market and developments in the banking sphere. These are the issues which have a direct impact on the macroeconomic figures, with some time lags.

I certainly think that there are various options of how to cope with this ultimate goal of becoming a standard European market. Joan Pearce has suggested that we join EFTA, and I think this would be a good interim solution. The looser environment of EFTA would allow our countries to go through some adjustment and gather some ideas on how to adjust to the demanding positions of the EU. I would not view it as an alternative, but as a complementary step."



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