Società italiana di economia pubblica

XXIII CONFERENZA

CRISI ECONOMICA, WELFARE E CRESCITA

Pavia, Aule Storiche dell'Università, 19 - 20 settembre 2011

WHY THE REAL CONVERGENCE IS SO IMPORTANT FOR EASTERN EUROPEAN COUNTRIES?

ION LUCIAN CATRINA

Why the real convergence is so important for Eastern European countries?
(free topic)

Ion Lucian CATRINA[*]
Academy of Economic Studies, Bucharest
Postdoctoral Student[1]

ABSTRACT

The Stability and Growth Pact's (SGP) failure was strongly reflected in the high level of the budget deficit and consequently a fast growing stock of public debt for most European countries, members or willing to be member of European Monetary Union.

The nominal convergence criteria set at Maastricht, in 1992 and reinforced by SGP, in 1996, which established the thresholds of 3% of GDP for budget deficit and 60% of GDP for public debt, have been configured according to the development degree of EU 15 economies. But now, the EU has 27 members, and the twelve new members have a weaker level of development than the founders of EMU. Therefore, the initial parameters of nominal convergence, at least for the new members, should be reviewed.

The current international context has shown clearer that the less developed EU members have had more difficult restructured public expenditure and have not easy found financial support for their excessive budget deficits. A very good example is Romania, which despite many measures to reduce public sector wages and some social allowances, in the 2009 and 2010 has been recorded only a small contraction of governmental expenditure but a fast growing public debt.

This paper wants to show that a new stability pact should be written and it must include different threshold on deficit and debt for New Member States and new national tools to strengthen public finances. Even the euro adoption perspective impose a stricter management of budgetary policies and the other nominal convergence criteria, the hard core of economic policies must be the reinventing a new path to sustainable growth on long term and the achievement of real convergence objectives.

We propose to develop a new scientific model for determining the threshold of public debt for emerging countries, like Romania, different to classical one which was based on strict correlation between debt and growth. Thus we want to include in addition other determinants of public debt sustainability, like: demographic factors, political and regional circumstances, natural resources, gains in productivity brought by the IT&C, economic cycles and others.

Finally, we hope that the results of this research will be really useful to all governments in South-Eastern Europe and to European Commission too, in order to strengthen budgetary policies and reducing public debt, even if the Maastricht Treaty is expected to be changed by creating a European Mechanism for Financial Stabilization.

---

[*] E-mail: cionlucian@gmail.com, Tel: +4-0745.089.178

[1] **Acknowledgment:** *This work was cofinanced from the European Social Found through Sectorial Operational Program Human Resources Development 2007-2013; project number POSDRU/1.5/S/59184, „Performance and excellence in postdoctoral research in Romanian economic science domain"*

KEYWORDS
Convergence, deficit, public debt, stability, monetary union

JEL CLASSIFICATION CODES
E61, H61, H63

Clasical Prospects for Fiscal Behaviour Along a Bussines Cycle

Fiscal deficit and public debt were certainly the most affected nominal convergence criteria by current economic crisis. The influence of excessive deficits and debt on macroeconomic stability and the ability to resume economic growth has been a constant concern since the Second World War.

Since the '50s, James Buchanan and Richard Wagner have proposed to define the burden of public debt from its analogy with the tax burden and paying attention to the following issues: who pays, how much and when? For Buchanan and Wagner (1958: 29) the burden of public debt is nothing but "the opportunity cost of public goods, which are financed through debt". In the standard sense, the opportunity cost is measured by the value of sacrificed alternatives. With public debt, opportunity cost is the value of private goods that are given up in exchange for the public goods that debt issue makes possible.

With the same objectives, James Meade and Franco Modigliani have analyzed long-term implications of public debt on economic growth and the consequences in the field of intergenerational equity.

James Meade (1958: 163-183) believes that a clear distinction must be made between external debt and domestic debt. While external debt is a burden for the community, because it produces real goods and services transfers between debtor and creditor, domestic debt is a transfer from citizens, as taxpayers, to citizens as property owners and so nothing is lost.

Franco Modigliani (1961: 82) argued that despite the fact that government action to expand the deficit could involve a future cost for society this does not mean that action should be taken. In terms of intergenerational income gains Modigliani sees much more significant the present gains than the sacrifices in the future, and if government spending for projects that produce a yield in the future, gross debt burden could be offset by the expense and the gross yield net result would be quite positive.

Robert Barro (1979: 940-971) has demonstrated that the public debt will be, sooner or later, moved into taxation field, leading to a higher taxation and reducing the production potential. Barro approved that there are also alternative like the limitation of government spending, which will have as well contractions effect on production. Debt maturity structure is also important to note that as Robert Barro is an obvious link between inflation and real cost of debt as long-term government debt is extremely vulnerable to inflation.

In the 1988, Paul Krugman has introduced the new concept of "debt overhang" (1988: 2) referring to inheritance or accumulate a large volume of governmental debt, leading to mistrust the ability of creditors for early repayment. In other words, Krugman believes that a country has a real problem with debt if the expected present value of future potential resources transfers is less than the debt.

Reinhart and Rogoff (2010: 22) have shown that a higher public debt is generally associated with lower rates of long term growth (at a debt level over 90%). According to Reinhart and Rogoff, the EU public debt (about 88.5% in 2010) is still below the threshold at which growth is adversely affected. They suggest that the debt of many developing countries already may have a negative impact on GDP growth.

In the latest work of Iron and Bivens (2010: 6) we find the argument that a lower economic growth than the expectation of decision makers will strongly increase the deficits in developing countries. Large annual deficits, leading to a higher public debt will cause higher interest rates, lower levels of private investment and lower growth opportunity in the future.

What kind of convergence we want to reach?

The strong need to establish some nominal criteria was primarily determined by the particular structure of European economy, which requests a harmonious economic development of their members that have chosen or wish to participate to European Monetary Union (EMU). These nominal conditions are intended to remove any tensions between members, caused especially by the spread of negative effects of economic imbalances.

The nominal convergence criteria laid down in the Maastricht Treaty of the European Union, in the February 1992, were related to the introduction of common monetary policy, based on a single currency, managed by an independent central bank. Four years later, the Stability and Growth Pact aimed toward the coordination of national fiscal policies to ensure stability and prudence for budgetary climate, essential conditions for the success of EMU.

For the new member states of European Union (EU), one of the targets sets in Copenhagen, in the 1993, was the adoption of European single currency within the shortest possible time. This objective has been misunderstood by the new member states, because the adoption of the Euro currency in not the end of the complex process of convergence but rather its beginning. Entry into the Euro area does not mean removing the need to solve macroeconomic imbalances existing in the Member State wishing to join (Cristian Popa, 2009: 2).

Another illusion of emergent economies from Central and Eastern Europe has been linked to the wrong idea that macroeconomic imbalances are a natural component of the convergence process, than the result of a bad management.

Moreover, the most of new members have been misunderstood that the achievement of real convergence will be easily accomplished and that is a short time process. The harsh lessons learned from previous accession processes, such as Greece, Ireland, Spain or Portugal, have shown that the catching up process takes a very long time and continue also a long time after accession, did not end with accession.

For example, despite the fact that these four countries have had more solid economies than the new members from Eastern Europe, it is important to note that for the Greece the revenues fell soon after accession, for Ireland the revenues growth came much later than would be expected and Portugal has needed over 10 years to gain 17% GDP per capita growth.

Analyzing the evolution of the most used indicator for measuring the real convergence into EU, the GDP per capita (PPS), we can see that the catching up process of new member states was strongly influenced by the negative effects of economic crisis, turning into a *stop and go* process after the 2008.

Figure 1 - GDP per capita in Purchasing Power Standard (PPS)

Countries	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
EU 27	100	100	100	100	100	100	100	100	100	100	100	100	100
Bulgaria	26	27	27	28	30	32	34	35	37	38	40	**44**	**44**
Estonia	42	42	42	45	46	50	54	57	62	66	69	**68**	**64**
Latvia	35	36	36	37	39	41	43	46	49	52	56	**56**	**52**
Lithuania	39	40	39	39	41	44	49	50	53	55	59	61	55
Poland	47	48	49	48	48	48	49	51	51	52	54	**56**	**61**
Portugal	78	79	81	81	80	80	79	77	79	79	79	78	80
Romania	29	27	26	26	28	29	31	34	35	38	42	**47**	**46**
Slovenia	78	79	81	80	80	82	83	86	87	88	88	**91**	**88**
Slovakia	51	52	50	50	52	54	55	57	60	63	68	72	73

Source: Eurostat April 2011

It is also important to note that countries such as Romania has received a massive support of the population to join the European Union, over the 85% of population (in the 2005 Barometer), support led by the expectations that after accession the revenues and standard of living will instantly increase. In this context, Romanian policy makers have tried to respond to the huge population pressure by increasing public wages and pensions over the national budget capacity.

Many times it was considered that the process of nominal convergence has been privileged in relation to the real convergence, nominal fulfillment efforts influencing negatively the real economic variables. In fact, the two processes can not be seen but complementary. Even if nominal convergence produce a slowing of real economic performance, fulfilling all the Maastricht criteria ensure a greater economic stability and a solid economic growth.

For example, reducing inflation rate will lead to higher economic performances and an increase of real convergence of wages. Lower interest rates will also stimulate the growth of investments and the growth of real GDP.

Why the real convergence has slowed down?

The most frequently asked question that European governments have tried to respond in the last three years has been related to the optimal fiscal behavior over the business cycle and especially in the economic downturn. If we analyze the European economic recovery measures we can observe that they did not followed Keynesian model which recommend that fiscal policy should be countercyclical: in bad times the government should increase government spending and should reduce the taxes for helping production.

European decisions have not be framed nor neoclassical pattern of *tax-smoothing* (Barro, 1979: 940-971) which suggest that fiscal policy should remain essentially neutral over the business cycle and respond only to unanticipated changes that may affect the government's budget constraint.

Empirical research has shown that opposite to developed countries, the emergent markets tend to promote pro-cyclical policies even in times of recession or before to entry into recession (Gavin and Perotti, 1997: 11-72). In addition, the international credit markets do not trust the developing countries and so become more difficult for government to finance the budget deficits.

In most cases pro-cyclical temptation is due to "distortions" coming from political arena, which may engage projects and government spending over the national ability to finance them (Talvi and Vegh, 2005: 156-190).

If we look at Romanian's fiscal behavior in the last three years, the Talvi and Vegh hypothesis is verified, especially due to accelerated growth of public wages and public pensions. This action overlapped the parliamentary and local election and may repeat in 2012 and 2014, when elections will be held again in Romania.

The new Romanian agreement with International Monetary Found will aim to give not only a psychological signal to international markets, but also to impregnate continuity for fiscal reforms, without delaying or altering them by the electoral events.

In Romania, the *catching up* process was based on an economic growth rate higher than the European average, but this growth has halted abruptly in the last quarter of 2008.

Also, the process of real convergence has a strong partner in the productivity growth, more than 10% annually, led by very low initial levels, the progressive reduction of the rate of employment in agriculture and especially by the growth of foreign direct investments. This substantial increase in labor productivity has been brought forward by the accelerated growth of wages, leading to a worsening of external deficit and a further inflationary pressure.

The effects of economic crisis were felt in the most macroeconomic indicators since the beginning of 2009, on the one hand as a result of relatively low flexibility of the Romanian economy and on the other hand because of the inability of Romanian government to immediately adapt its macroeconomics policies to a radically changed economic environment.

We must redraw the main criteria for public finances stability

Main arguments to prevent the excessive budget deficits and high public debts into EMU were related to the transfers between generation and to the public investments with a large social return.

Following Blanchard and Giavazzi (2003: 2) the present condition of the European fiscal stability has been based on the estimation of nominal growth rate of potential output of 5%, without taking into account potential external shocks, but merely the cyclical economic fluctuations. For example, a deficit *d*% would lead to an increase of public debt as ratio to GDP as d=g, where g is the nominal potential output. Thus, if g will be g = 3% (real growth) + 2% (inflation) = 5% and d proposed by SGP d = 3%, the ratio of debt to GDP will be estimated as:

$$d=g$$

(d =3%) = [g = 3% (real growth) + 2% (inflation)] lead to a 60% debt ratio to GDP, level of EU Treaty.

If we will estimate this level for an emerging country like Romania, we will find out that 60% ratio is overvalued:

Figure 2 – Estimation of public debt ratio for Romania

Year	SGP deficit	Real deficit	Real growth	Inflation	Debt ratio by SGP deficit	Debt ratio by real deficit
2007	3%	3,10%	6,30%	4,90%	26,79%	27,68%
2008	3%	4,80%	7,30%	7,90%	19,74%	31,58%
2009	3%	7,40%	**-7,10%**	5,60%	15,15%	37,37%
2010	3%	6,80%	**-1,30%**	6,10%	34,48%	78,16%
2011	3%	4,40%	1,50%	**7,00%**	**35**,29%	51,76%

Data source: Eurostat April 2011

The Reinhart and Rogoff (2010: 7) estimation of debt threshold can not be tested on Eastern European countries due to missing of data for long time, especially in the communist regime. In addition, countries like Romania have not ever faced with higher rate of debt of 40%.

It seems to be too clearly that a public debt threshold of 35% of GDP for Romania is the highest limit of confidence, especially for foreign investors and credit markets too. This debt threshold is lower than the IMF estimation, 40% of GDP (Cottarelli, 2010: 7), which took into consideration the negative perspectives of aging population.

Unfortunately, Romania is not the only new Members State to which the accepted level of public debt on GDP in terms of nominal convergence should be revised. Countries with similar position are Bulgaria, Hungary, Latvia or Lithuania.

Then, it is really difficult to predict when the economies of new Members States will be able to fit into the central bank inflation targets.

For Romania, the failure to target inflation was mainly driven by the requirement to adjust the minimum European duty level, by increasing the value added tax, from 19% to 24% as a result of government failure to find alternative solutions to restrict the huge governmental expenditures and the dynamics of imported food prices and the increase of international fuel prices.

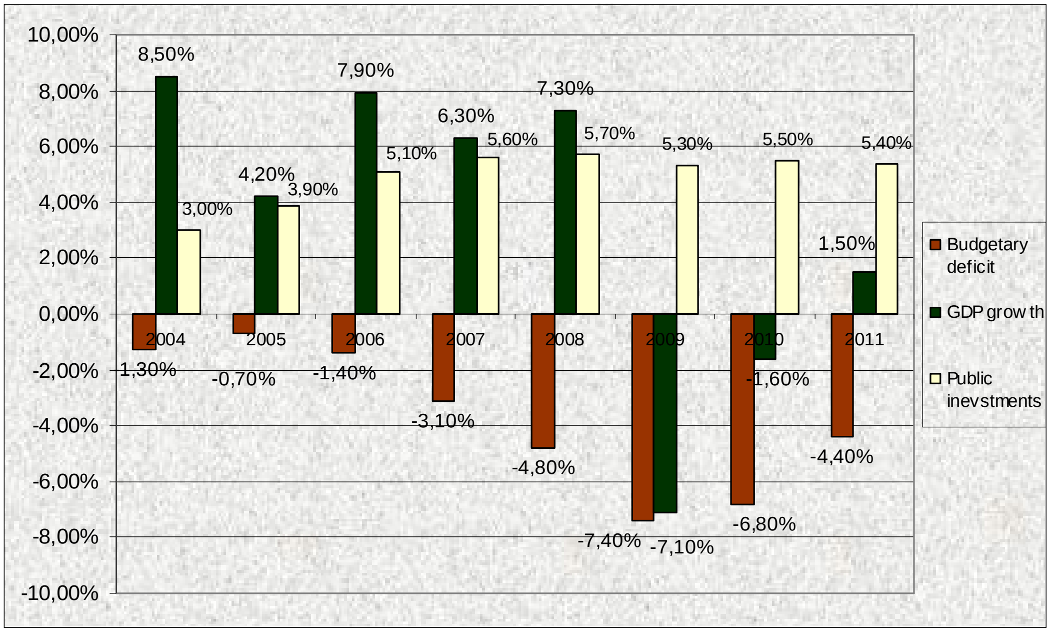
It must be said that the nominal condition of 3% of GDP sets by SGP for fiscal deficit may affects the real convergence of those economies in which the investment volume is really weak. For this reason, the governments may choose higher deficits than 3%, in order to stimulate the public investments.

The public investments have been the strongest argument used by the new Members States of EU in order to justify their excessive deficits. Unfortunately, we can not say exactly if there is a strong relationship between a higher fiscal deficit and public investment levels in the new Member States, an unconfirmed hypothesis even by the IMF research (Graeme Justice and Anca Paliu, 2006: 10).

Moreover, this kind of financial stability evaluation, used by European Commission, do not respond to other critical conditions of macroeconomic stability like structural imbalances of developing economies, exchange rate, interest rates and a huge demand for finance in the international shocks circumstance.

Recent history has shown us that there were emerging countries, especially in Latin America, that have entered into *default* at a lower level of debt ratio than 40%. For example, Romania faces the following situation: a steady decline in young people which can be involved in the labor market accompanied by a fast growing number of pensioners, the dependence degree in pay as you go system is already of 0.79 employees to one pensioner.

Figure 3 – Public investments in Romania



Data source: Romanian Ministry of Public Finance

The structural budgetary deficit created only by such negative demographic situation has already reached 2.64% of GDP and is expected to increase until 2050. Other structural difficulties are related to low capacity to collect the revenue from economy, corruption and tax evasion affecting over 12% of GDP from potential revenues.

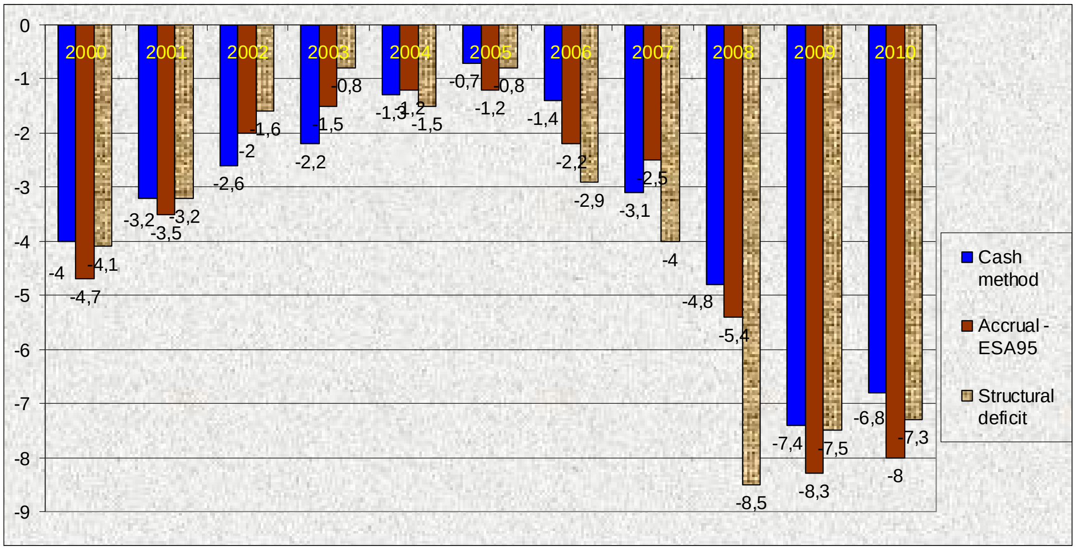
We also have to specify that there are more ways to count the fiscal deficits and public debt too. Eastern economies still holding huge enterprises and companies whose losses are not quantified neither into so-called quasi-fiscal deficit.

Currently, there is confusion between terms such as “cash” budget deficit, “accrual” deficit (ESA 95) or structural deficit. Public institutions tend to use the “cash” method (used by the IMF), which hides some payment engagements.

Unlike the “cash” method which records only actual payments, the “accrual” deficit (ESA 95) records flows on an accrual basis when economic value is created, transformed or extinguished, or when claims and obligations arise, are transformed or are cancelled. (Manual of Government Deficit and Debt, 2010)

Structural budget deficit represents the budget deficit which would appear in the absence of the business cycle influences. The most used method to establish the structural deficit remains the way that in the first step must be determined the cyclical component of the deficit and then it is removed from the actual deficit (Blanchard: 1990).

Figure 4 – Differences between methods for estimating the budget deficit



Data source: Romanian Fiscal Council

It is also important to mention what kind of public debt we are talking about. Because there is a debt contracted directly by governments and a debt contracted by other public authorities but guaranteed by same governments.

We believe that for a more accurate assessment of fiscal sustainability will have take into account the debt of state-owned companies when we estimate the fiscal deficit and must to include the debt guaranteed into total public debt.

What kind of tools we can use to reach fiscal stability?

We must admit that the Maastricht Treaty of the European Union and the Stability and Growth Pact, which aimed towards the coordination of national fiscal policies, essential conditions for the success of Monetary Union, failed to achieve these objectives from the supranational level.

In such situation, the German proposal, to establish fiscal rules into the national constitutions, has shown that fiscal consolidation should start from the Members States themselves.

The question is related to what will be limited by the constitution: the budget deficit or the level of public debt? And what threshold will be established?

Germany has already set by the constitution, until 2009, the limitation of federal budget deficit to 0.35% of GDP. Unlike the Germany, Poland has established by the constitution, until 1997, limits for the public debt level.

Can the Eastern European Countries limit the deficits by constitution? German example can not be put into practice in the new member states, because these countries have still strong centralized budgets, compared to Germany where the Landers have most of the available funds.

Moreover, the Eastern European Countries has a very inflexible structure of public expenditure, which requires an extensive process of reform in public pension system, social allowance, the efficiency of public administration and especially of public spending.

Even if, for developing countries, there is not a strong correlation between the excessive deficits and public investments as share in GDP, expanding public deficit remains the only way to achieve public investments.

Although for developing countries the multiplier of public investments is much lower compared to developed countries, public investments is the only way to stimulate the economic environment and catching up process.

The experience of current economic crisis has shown us that the budget deficits were the only way to respond to external shocks.

If we accept the limitation of deficits through the constitution, this could be done only for one year. It might be imagined during a business cycle or an electoral cycle.

If European decision will focus on fiscal consolidation by national constitution, it would be more appropriate to limit the public debt at a level estimated for each Member State, depending on the strength of each economy.

For example, the public debt threshold for Romania should be set at 40% of GDP and should be complemented with additional early warning mechanism to lower thresholds, 30% and 35% of GDP, limits which should lead to fast adjustment of public spending.

References

1. Balassone F., Franco D., Zotteri Stefania, *Public Debt: A Survey of Policy Issues,* Bank of Italy, Reseach Department, 2004.
2. Barro T.R., Oct., 1979, *On the Determination of Public Debt,* The Journal of Political Economy, Vol. 87, No. 5, Part 1, pp. 940-971.
3. Becker Torbjörn, Dăianu Daniel et al, 2010, *Whither Growth in Central and Eastern Europe?*, Bruxelles: Bruegel Blueprint Series.
4. Blanchard Olivier, Francesco Giavazzi, 2003, *Improving the SGP trough a proper accounting of public investment*, Center for Economic Policy Research, London.
5. Buchanan M. James, WAGNER E. Richard, 1958 *Public Debt in a Democratic Society* Washington: American Enterprise Institute for Public Policy Research.
6. Dinu Marin, Socol Cristian, 2006, *România în Uniunea Europeană. Potențialul de convergență*, Bucharest: AGER.
7. Gavin Michael, Perotti Roberto, 1997, *Fiscal policy in Latin America*, Cambridge: National Bureau of Economic Research, Macroeconomics Annual, Vol. 12, pp. 11-72.
8. Georgescu Florin, 2010, *Politicile economice ale României în scopul adoptării euro*, Bucharest: NBR.
9. Iancu Aurel, 2008, *Convergența nominală*, Bucharest: Romanian Academy.
10. Isărescu Mugur, 2008, *Probleme ale convergenței reale în drumul spre euro*, București: Academia Română.
11. Krugman Paul, 1988, *Financing vs. Forgiving a Debt Overhang*, Cambridge: National Bureau of Economic Research.
12. Meade J.E., Jun., 1958, *Is the National Debt a Burden?*, Oxford Economic Papers, New Series, Vol. 10, No. 2, pp. 163-183.
13. Modigliani Franco, 2005, *Long-Run Implications of Alternative Fiscal Policies and the Burden of the National Debt*, Cambridge: MIT Press.

14. Presbitero F. Andrea, 2010, *Total public debt and growth in developing countries*, Marche: MOFIR.
15. Reinhart, M. Carmen, Rogoff, S. Kenneth, 2010, *Growth in a Time of Debt*, Cambridge: National Bureau of Economic Research.
16. Talvi Ernesto, Vegh A. Carlos, 2005, *Tax base variability and procyclical fiscal policy in developing countries*, Journal of Development Economics 78, pp.156–190.