Long-term growth prospects in Central and Eastern Europe hinge on changes in the basic paradigms of EU economic policy-making

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- CEE long-term growth depends on what happens to the West
- Catch-up to date: rather slow - and unsustainable
- Old Europe: growth anaemic since 1990: centrifugal forces now. Why?
- Paradigm change needed: for CEE more than for Old Europe
Are we all Keynesians now? Not quite

- Financial crisis of 2008: ruled out in the “mainstream” economics
- Capital market amok, euro area governments responsible?
- Pragmatic responses: Lord Keynes resurrected in practice
- Greek crisis: orthodox answers at ECB & EC
- Consolidation, Stability and Growth Pact
- Fiscal overreaction in EU, but not in USA and Japan

The single monetary policy unleashes centrifugal forces

- Long litany of objections to ECB policy
- Euro area not an “optimal currency area”
- “One size fits all”: targeting AVERAGE inflation
- Counterproductive:
  - real interest rates HIGH in low growth/low inflation countries
  - But
  - Low (even NEGATIVE) in boom countries
The other side of the (euro) coin:
Diverging unit labour costs & rising trade imbalances

- Low growth/inflation → low growth of wages → stagnant unit labour costs
- Boom → higher growth of wages → rising unit labour costs
- Common currency: no devaluation option
- Stagnant ULC countries out-compete Rising ULC countries
- Rising trade surpluses → Rising trade deficits

Germany’s response

- Not only “natural” process
- Consistent labour market and fiscal reforms
- Policy in the public sector
- Honest broker: No more
- Actively mercantilist policy: “Beggar thy neighbour"
Beggar THYSELF!

- Growth in Germany much weaker than elsewhere
- Export gains lower than losses in domestic consumption
- Tail wags the dog!
- Dependent on whims of external demand
- German trade surpluses financed by German loans!
- Bankruptcy of countries a danger to German banks?
- German government saves ITS banks

The illusion of orderly ‘rebalancing’

- Centrifugal potential long ignored in Brussels
- Recent proposals: the deficit countries must deflate wages and prices
- Counterproductive
- Alternative: excessive SURPLUS countries under corrective procedure
- Labour productivity must be properly rewarded with rising wages
Euro area accession of the NMS

- Euro area membership: advantages overestimated, risks underestimated
- Bitter lesson: from ‘cohesion countries’ to PIGS
- Maastricht inflation criterion insufficient
- Keep own depreciable currency

The EU economy needs to run budgetary deficits

- EU: fiscal deficit less than 3% by 2014
- No rush in US, Japan
- Automatic stabilisation recognized
- 3%? Why not 5%?
- Does debt burden the future generations?
- ‘Close to balance or in surplus?’ Impossible
What happens when the private sector intends to save more than it intends to invest?

- The trend: private sector saves more than invests:
- Private sector produces more than it can use:
- Solutions:
  1. Production declines
  2. Sell abroad (and credit importers)
  3. Sell to the government (who then MUST run the deficit!)
- Conclusion 1: Public sector deficit may be a secular NECESSITY
- Conclusion 2: Countries with high external surpluses need to replace external demand with INTERNAL demand

Public debt: a burden but also an asset

- Private sector seeks GOOD public debt
- Why is US and Japan’s debt ‘good’ (and not euro area’s)?
- Monetary ‘easing’ recommended
Conclusions

- Euro area and EU exposed to centrifugal forces
- ECB policy + Mercantilist Policies
- Wage deflation + Rising imbalances
- Stability and Growth Pact: shoes of lead
- Preservation of euro area, EU vital for CEE
- But the paradigms of EU policy must change