Challenges of Real and Nominal Convergence

Oldrich Dedek
Vice Governor
Czech National Bank

The topic „the real versus the nominal convergence" attracts prominent policy debate in accession countries as it deals with the identification and sequencing of key economic priorities on the way towards the EU and later EMU membership. In a simplified manner, the problem can be rephrased as "Copenhagen versus Maastricht". The key question is to what extent the two sets of criteria, the real convergence of Copenhagen and the nominal convergence of Maastricht, compete with each other or rather whether they share the strong elements of complementarity. There is a number of proponents who would argue that so called exaggerated ambitions in the nominal convergence, i.e. placing emphasis on low inflation or a low public debt, will hurt economic growth and thus more time will be needed to close the performance gap between the accession countries and the EU member states. An alternative view adopted e.g. by the ECB suggests that the two processes should be followed in parallel.

In the context of this debate one should recall that the Czech economy showed very promising growth rates in 1995-96. Under the influence of good macroeconomic figures of the time the restrictions on the free movement of capital were by large abolished and the Czech currency became externally convertible. But this growth period also witnessed widening imbalances and ended with a speculative attack on the koruna, austerity packages, political crisis and protracted period of economic downturn. At present, the Czech economy has already recovered from the recession and once again embarked on a growth path, but there are rising concerns about the danger of the so called twins deficits. It has been repeatedly stressed that the current trends do contribute to the vulnerability of the economy. Therefore, a lesson should be learnt that the one-sided preference of the real convergence poses risks of a boom-bust pattern which may prolong the process of catching up with the EU and may translate itself into extra social costs.

Under the umbrella of the real and the nominal convergence one can also debate a contentious issue of the process of catching up with the EU price level. The basis for the dispute is an empirical fact that the price levels in the candidate countries lag behind those of the EU member states. This observation then tends to promote concerns whether the disinflation strategy only postpones the necessary hike in prices to bring them to the same level as that prevailing in the EU. Or is this strategy counterproductive by exposing the economy to the danger of a massive price jump upon the entry to the EU? There are even doubts about the consistency of the Maastricht criteria which require in parallel the price and exchange rate stability while candidate country supposedly needs to close the price gap either by way of higher inflation or by way of nominal appreciation.

The conduct of monetary policy in a transition country has to take account of several non-monetary factors of inflation. A particular attention is paid to the so called Balassa-Samuelson effect (BS) which is topical in its message that a higher productivity or a faster growth will inevitably lead to higher inflation. A too ambitious disinflation may thus be viewed as a hindrance to productivity growth, inhibiting real convergence. The problem with the BS effect is not to deny its logical consistency but rather to assess its empirical strength. It should not be used as an alibi for inflation generated by an overheating economy driven by an excessive growth of wages or fiscal expansion. On the contrary, the model urges the strong relationship between the converging price levels on one hand and the converging labour productivity on the other. And finally, the BS effect shows one fundamental flaw which is abstraction from the capital flows. After these flows are introduced, one can see a new set of consequences of a higher inflation rate and resulting higher interest rate differential. Adjustment mechanisms carried by the capital flows may however cause overshooting, becoming a trigger of subsequent economic turbulence.

The existing price gap also evokes the danger of a price jump due to the functioning of price arbitrage. A large potential for a price leap surely exists in the agriculture where price distortions can be attributed to the Common Agriculture Policy. Price gaps may also be attributed to lower indirect taxes and yet unfinished changes to administrative prices. Generally, pressures to increase prices may be expected in areas where the entry to the EU will lead to elimination of trade barriers or implementation of large-scale state aid programs. A statistically measured price gap may be a wrong indicator of the potential price increase if it does not capture the microeconomic details, such as transportation costs, quality of goods, varying consumer preferences, and so forth.

The policy trade-offs involved in the issue of the real versus the nominal convergence should be addressed by an efficient system of co-ordination between government and central bank policies. Several reasons exist why a monetary policy in the regime of inflation targeting creates a suitable environment for a successful co-ordination and communication between the two sets of policies. First, the inflation target allows the government to participate in setting the key parameters for the conduct of monetary policy, such as the speed of disinflation and the definition of price stability having respected the operative independence of the central bank. Paralelly it is in the interest of the central bank that the government supports the inflation target as it adds to the credibility of the monetary policy. Furthermore, the target becomes a part of the government economic policy that creates better conditions for reaching it. Simultaneously any measures taken by the central bank aimed at meeting the target should no by interpreted as a conflict with governmental policies.