SLOVAK MACROECONOMIC PERFORMANCE AND THE GREAT RECESSION

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Introduction and Background

The Great Recession of 2007-10 is the first major test of the Slovak market economy constructed at considerable cost and with such great expectations since 1991. The recession began in the USA in mid-2007, and initially most commentators failed to recognise its likely depth, length and global extent. European commentators were initially especially slow to understand its importance. Their first reaction was to believe that it would not have a significant impact on the European economy, and it would be especially damped inside the Euro zone. By late 2008 this view was seen as clearly false. It was always likely to have been false because from its start the recession was combined with a major financial crisis. Such combinations are invariably more destructive than the downturn parts of normal business cycles because they combine a slump in demand with a crisis in the ways demand can be financed. Thus more optimistic expectations about the future may not translate into more demand. Indeed as the desire and willingness to lend decline, this can retard and reverse any such positive development in expectations.

The trigger for the US recession was the collapse of a huge speculative bubble in the private and commercial property markets, beginning in mid 2006. The size of that bubble, and the fact that it had inflated over a long five year period, meant that a high proportion of borrowers had vastly over extended themselves in taking on mortgages which they could only hope to service never mind repay, by selling their properties on at a profit. Thus when the bubble began to deflate it deflated rapidly, leaving large debt overhangs for borrowers and for lenders. Both were left with heavy obligations, but with reduced or no assets to back them. So both began what will be a long period of debt deflation, with its consequent reduced demand and reduced willingness to lend. This suggests that the recovery in the USA will be slow, uncertain and at worst jobless.

The European economy could never have escaped the consequences of the American recession. But the European part of the world recession was more severe than originally expected because several countries had their own property market bubbles, and European banks held very large quantities of securitised assets linked to various property, credit card and automobile loans. Securitised assets were intended to shift and so disperse risk, allowing banks to raise more debt, make more loans and so increase their capital leverage. It was not immediately obvious why, when the music stopped, they were left with so many increasingly toxic assets. The initial suspicion was they were intending to sell them on, but had been too slow to spot the collapsing prises of the assets that backed them. Certainly that was true for some banks, but the consensus now is that banks held these assets mainly because they seemed to promise high returns, and so they could be used as collateral for further borrowing. The result was massive losses to European banks` capital bases, greater losses even than to US banks` capital. When this became clear it was obvious that the twin headed finance and demand recession would also severely damage the European economy.

In this short paper I want to assess Slovak macroeconomic performance by looking at the convergence of the economy with selected European economies, including other Visegrad group members. First I will look at the theoretical context of convergence. Then I will look at the empirical record. I follow that with some remarks on whether and if so how the Great Recession will alter the prospects for the Slovak economy. I conclude with a positive assessment of Slovakia`s convergence to date, and note that an even greater prize is attainable if the country is determined to grasp it by enacting positive reforms.

Theoretical Messages

Economists have puzzled about why some countries are rich and some are not at least since Adam Smith. Indeed answering that question was his prime motivation for writing *The Wealth of Nations.* But in the last fifty years, since Robert Solow`s classic paper on the theory and empirics of the neoclassical growth model, the literature has taken a more formal and rigorous direction.

Often the answer to Smith`s question is so obvious that there is apparently little point in trying to answer it. But if the question is rephrased as “why do some countries converge on others` levels of income per capita, whereas others do not?” then that is more intriguing. For example, do the same factors that determine relative income levels also drive convergence? The answer seems to be yes, but it is clear that other factors may also be important.

The neoclassical theory of growth has a very clear and systematic answer on convergence. If economies have the same steady state, then absolute convergence holds. Having the same steady state requires the same level of technology, the same rate of population growth and the same investment rate. In addition the further an economy is from its steady state, then the faster it will approach that state. This latter result will produce at least conditional convergence: as Romer (2001, p.157) has it “…countries that are poorer after controlling for the determinants of income on the balanced growth path grow faster.”

The long run fundamentals that determine the steady state include savings rates, levels of education, participation rates, incentives favouring production over rent seeking, and of course technical change. One could add to this list the way production is organised, and in particular the use of administrative and market techniques. The market option that transition countries chose after 1989 mainly reflected disappointment with the growth achievements under planning. In the case of Slovakia the pre-1989 planning system produced an industrialised modern economy, but one that by the 1980s was struggling to achieve fairly modest growth rates. Convergence with market economies was not happening indeed the reverse was increasingly true. Therefore the convergence performance is a test of whether, in Slovak circumstances, the switch to a market system has produced the hoped for improvement. A good performance would provide an important justification for the switch, and some reassurance that the sacrifice of the early transition years was justified.

The switch to a market system plus membership of the EU was clearly a huge shock to the system, but one that opened up the possibility of much faster growth, eventually driven by the technical change that the planned system achieved so poorly.
But in the short to medium run the switch brought a transformational recession, and between 1990 and 1993 Slovak real income per capita fell by 18%, using World Bank PPP data. It did not reach its 1990 relative level again until 1996. However between 1996 and 2006 the absolute level of per capita real income increased by 85%, so transition has delivered a clear success measured by absolute growth rates.

The positive shock of transition was the opening up of EU markets, the injection of EU structural funds and the spur to efficiency provided by foreign competition. Savings were encouraged by a wider range of savings products, and the greater need to save as parts of the previous welfare state were trimmed. The previous failure to innovate rapidly was partly solved by imports of advanced technology and partly by foreign direct investment. Research and development spending remains low by OECD standards, but there has been sufficient imported technology to cover this gap. Education has responded to the transition with curriculum changes and increases in the scale of tertiary education, though again the proportion of the labour force with degree level qualifications is still relatively low. But it is worth recalling that such measures of investment in human capital are very crude. It is the quality as well as the quantity of such investment that is a key determinant of productivity levels, and quality is often poorly proxied by the years of education or the highest level of education attained.

The improvement in incentives for production rather than rent seeking is hard to estimate. Different political systems and methods of economic organisation can offer quite different opportunities for both the scale and methods of rent seeking, and reliable data for a comparative evaluation is unavailable. It is clear that rent seeking behaviour is damaging to growth, but it is also clear that there are powerful interest groups opposed to its reduction. However one generalisation is possible; which is that in a competitive market system there is a direct link between rent seeking and poorer economic performance, because maintaining international competitive positions is much more important. In addition export success through improved competitiveness increases a country`s vulnerability to a later loss of competiveness through an increase in rent seeking that almost invariably involves a misallocation of resources. Finally recession makes public and private resources scarcer, and so raises the cost of their diversion through rent seeking.

The impact of the Great Recession on growth fundamentals is mostly negative, except for encouraging Slovaks to return home because of poorer prospects abroad.

Otherwise recession has reduced foreign and domestic demand for Slovak output, cut FDI and hence technological advance or catch-up.

Table 1: Slovak Income Per Capita (PPP, current international dollars) as a Proportion of other Selected Countries` Income per Capita

	GERMANY	**UK**	**FRANCE**	**AUSTRIA**	**CZECH R.**	**HUNGARY**	**POLAND**
1989	.56	.54	.51	.52	.75*	.94	1.50*
1994	.39	.40	.38	.37	.67	.87	1.17
1999	.45	.44	.43	.41	.76	.92	1.10
2006	.56	.51	.53	.50	.78	.91	1.15
2010**	.66	.59	.61	.57	.86	1.12	1.16

Source: World Bank for 1989-2006 data.
*1990
**Estimated. 2007 and 2008 overall growth rates and 2009 and 2010 estimated growth rates applied to 2006 income per capita data. Growth rates from IMF "World Economic Outlook, October 2009", Washington, IMF.

The Convergence Record

The table illustrates the Slovak record on convergence. The key results are:

a) The impact of the transformational recession on convergence is clear, and more marked than its impact on absolute living standards because the older EU comparators continued to grow while Slovakia`s output was falling.
b) 15 years after beginning its transition in 1991 Slovakia had recovered its 1989 relative real income per capita position vis-à-vis the older EU comparators. Another way of looking at this would be to say that by 2006 Slovakia had recovered from the impact of the transformational recession.
c) The incomes of those older comparators are virtually identical 1989-2006. This illustrates a key opportunity for Slovakia. Incomes per capita in western and northern Europe show a rare example of absolute convergence. In other words EU membership offers the chance of complete convergence. Whether it can seize that opportunity depends on convergence after 2006.
d) The expectation is that by the end of 2010 there will be evidence of a rapid start to that convergence. The World Bank data records growth of 17.5% for Slovakia in 2007-08, and though it expects a fall in output per capita of 1.2% in 2009-10, all of our table`s comparators do worse.

e) Slovakia`s performance relative to Poland since 1989 reflects Poland`s great success in avoiding a significant transformational recession.

Risks of the Great Recession and Conclusions

We noted above that the present recession is exceptionally widespread and severe. The question now is whether it could derail Slovakia`s golden opportunity for absolute convergence. There are several identifiable risks:

1) Because of the mixture of real and financial crises demand in Slovakia`s main export markets will remain weak into the medium run. There is no obvious other market that will take up the slack.
2) Banks will be more cautious in lending than before and will require higher returns. Securitisation markets are proving extremely slow to begin working again, and may not recover their previous prominence. It will therefore be more difficult to mobilise savings.
3) The huge legacy of debt on banks` and individuals` balance sheets in Slovakia`s export markets will take years to work through. Deleveraging will be very painful, difficult and slow.

The implication of these factors is that convergence will be more difficult to achieve than at any time in the last twenty years, not least because there will be increased competition from other countries to attract the FDI that will drive a large part of the convergence process. Therefore there is an increased need to improve physical and institutional infrastructure, to make Slovakia an even more attractive destination. The country that can offer the most smoothly working system, both administrative and market, with the lowest and least volatile cost structure, will be the most successful in attracting FDI.

Slovakia has had a successful start to the convergence process, but the real test is now and in the next twenty years. The Great Recession has made the task more difficult. But it is not impossible. It will need work, investment, sustained political commitment and continuing reforms, but the prize of full convergence is huge. There are second prizes – Greece, Portugal, Spain and Southern Italy have them – but they are less attractive. Perhaps the most important message on convergence in the EU is that countries can choose the prizes they receive, but not what they have to do to receive them.

Reference

David Romer “Advanced Macroeconomics”. (2nd Edition) New York, McGraw-Hill, 2001.