Institutional quality and sustainable economic convergence

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Has convergence been taken for granted?

Real convergence, PPS, Germany=100

Source: AMECO

EU periphery – Italy, Spain, Portugal, Greece

Source: AMECO

CROATIAN NATIONAL BANK
What do we know about the TFP?

Net capital stock per person employed, 2000 = 100

Total factor productivity, 2000 = 100

EU periphery – Italy, Spain, Portugal, Greece
Source: AMECO
Total factor productivity – is the truth out there?

Institutions quality vs growth

Human capital vs growth

Institutions quality and EU funds withdrawal

Sources: World Bank; OECD; EC

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Large room for improvement but progress has been slow

Quality of institutions – no convergence

Human capital – still below frontier

Note: Estimate of governance performance ranges from -2.5 (weak) to 2.5 (strong).
Source: World Bank

Source: OECD
Potential gains from structural reforms are significant but...

Potential efficiency gains from structural reforms (Percent)

Macroeconomic impact of structural reforms
(Stand-alone reforms, difference from baseline)

Source: IMF, CEESEE Economic Issues, May 2016

Source: EC (2014) The potential growth impact of structural reforms in the EU
...how to get them right?

- Two dimensions of structural reforms:
  - Moving closer to the efficiency frontier – reallocation of resources, more efficient usage of inputs.
  - Potential growth rate – expanding the efficiency frontier.

- But many policies:
  - Product market reforms, Competition policy, Labour market reforms, Public finance and taxation (including Social security system), Human capital development, Innovation policy, ...

- Do economist really understand all the mechanisms at play:
  - synergies and complementarities of reforms;
  - diminishing marginal effects of reforms?
No guarantees, but reforms remain the safest bet

- No guarantees that convergence will gain momentum again
- Closest thing to a recipe for reducing probability of being caught in middle income trap:
  - High quality of human capital - education reform
  - Facilitate private sector investment in physical capital and know-how
  - Adequate access to finance for SMEs
  - Friendly business environment
- Keep in mind that political economy also matters
Limited political inclusiveness might hinder support for the reforms

**Market economy**  
(percentage of respondents who prefer market economy over any other form of economic system)

**Democracy vs. authocracy**  
(percentage of respondents who prefer democracy over any other form of political system)

**Fair justice system**  
(percentage of respondents who agree that the country has fair justice system)

**Law and order**  
(percentage of respondents who agree that law and order exist in their country)

Thank you!