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Is European Integration Speeding up the Economic Convergence Process of Central and South-Eastern European Countries? A Shock Perspective

Igor Veličkovski[a,b] and Aleksandar Stojkov[c]

Non-Technical Summary

The objective of this research is to obtain new insights into the factors that determine the synchronisation of shocks in the Central and South-Eastern European countries (CSEEC) vis-à-vis the euro area. From a methodological point of view, this is conducted in several stages. First, a structural VAR is employed to estimate supply and demand shocks for the CSEEC. Second, Kalman filter technique is used to obtain a time-varying measure of the shocks similarity between CSEEC and the euro area over time. In the last step, a set of variables are employed in a panel framework to explain the shock convergence process in the CSEEC towards the euro area. Thus, the research contributes to the previous work in this area in several ways:

i) the model that investigates determinants of shock synchronisation is extended by adding several important omitted variables - those related to the trade structure (vertical versus horizontal intra-industry trade) and policy coordination;
ii) in contrast to previous researches that were done in a static panel regression setting, the research relies on different and novel econometric technique - an error correction model in a dynamic panel context;
iii) the research also accounts for the effects of the recent economic turmoil on shock convergence process.

The findings indicate that:

i) an increase in trade intensity, intra-industry trade and financial integration leads to less frequent asymmetric shocks;
ii) divergent fiscal policies are estimated in some model specifications to increase the shock divergence process, although the estimated impact is rather small to counteract the positive effects associated with trade and financial integration;
iii) the identified relationships in this research are affected by the significant trade and growth slowdown in the crisis period, but are not its statistical artefacts.

Taken together, this paper provides empirical evidence suggesting that the European integration supports the economic convergence process of the CSEEC. This implies that further growth of the volume of trade, intra-industry trade and the level of financial integration is expected to bring substantial benefits of the current and potential CSEEC members of the euro area in terms of higher shock symmetry and consequently leads to smaller need for an independent monetary policy. If this process is not counteracted by divergent fiscal policies which have not been very challenging issue in the past for the CSEEC according to our empirical results, the euro could again continue in the future its historical journey to conquer the independent monetary space of the Central and South-Eastern Europe.

Keywords: Shock synchronisation; Trade; Structural VAR; Dynamic panel models.

Affiliations: [a] National Bank of the Republic of Macedonia, [b] University American College Skopje, [c] Ss. Cyril and Methodius University in Skopje