EBRD Transition Report 2012: Integration across Borders

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On January 30, 2012, the Oesterreichische Nationalbank (OeNB) and the Austrian Ministry of Finance (BMF) for the first time jointly organized the presentation of the EBRD[1] Transition Report showcasing findings of the 2012 Transition Report and the January 2013 update of the EBRD's growth forecasts for Central, Eastern and Southeastern Europe (CESEE). The event took place at the premises of BMF and was opened by *Harald Waiglein,* Head of the BMF's Directorate General Economic Policy and Financial Markets, and OeNB Governor *Ewald Nowotny.*

In their opening remarks, both Waiglein and Nowotny underlined the importance of the EBRD Transition Report as a flagship publication for the analysis of the CESEE countries. In addition, they emphasized the strong relevance of the CESEE region for the Austrian economy, given the deep common historical roots, the geographical proximity of the CESEE region to Austria and the manifold economic and financial interlinkages. Moreover, both speakers stressed the strong CESEE commitment of both Austria and the EBRD within the framework of the Vienna initiative and its follow-up, the Vienna 2.0 initiative, with the aim of crisis management as well as crisis prevention after the outbreak of the 2008/2009 economic and financial crisis.

At the press conference, *Jeromin Zettelmeyer,* the EBRD's Deputy Chief Economist and Director of Research, summarized the EBRD's new growth forecasts for the countries in which it operates (the EBRD region)[2] and outlined the most important findings of the EBRD Transition Report 2012 "Integration across borders." The main contributions of the 2012 Transition Report are to provide a critical analysis of the European Union's plans for a banking union and possible modes of integration of the non-euro area and non-EU emerging European countries; moreover, the report presents an assessment of the recently established customs union between Russia, Belarus and Kazakhstan.

Part I: Economic Prospects in the EBRD Region – The Impact of the Euro Area Crisis on the Transition Region

The EBRD expects that GDP growth in the transition countries (including the SEMED countries) will rise moderately from about 2.6% in 2012 to 3.1% in 2013, though growth will remain slower than in the recovery year 2011. At the same time, only Hungary and Slovenia are expected to post negative growth for the second consecutive year in 2013. The general deceleration of the economic expansion in 2012, especially in many of the most exposed CESEE countries, can be attributed largely to the continued external pressures from the euro area countries. However, signs of bottoming out could be observed, as exports have started to recover and as net capital flows have slowly returned to some CESEE countries, most notably the Baltic countries. In addition, on the back of progress in key policy areas in the euro area, such as the establishment of a banking union and of medium-term fiscal frameworks, the pressure on the region's parent banks has eased. This in turn has lowered the speed of cross-border deleveraging, improving

[1] *European Bank for Reconstruction and Development.*

[2] *The EBRD recently expanded its coverage to include 30 countries ("the EBRD region") ranging from Central and Eastern Europe to Central Asia, which includes Turkey. Recently, the EBRD expanded the scope of its operations to include Egypt, Morocco and Tunisia, i.e. the southern and eastern Mediterranean countries (SEMED). Effective from 2008, the Czech Republic was the first country to graduate from the EBRD.*

funding conditions for the region's banks. However, credit growth remains negative in most new EU member countries on the back of tightened supply conditions alongside weak local demand.

Nevertheless, growth prospects in the EBRD region are still overshadowed by external and domestic macrofinancial downside risks, such as negative spillovers through both real and financial channels from a possible deepening of the euro area crisis. In particular, an analysis based on EBRD vulnerability to the euro area shows that countries in CEE (Central and Eastern Europe; in particular Hungary and the Baltic states) and SEE (Southeastern Europe; in particular Bulgaria, Romania and Croatia) are most exposed, while the most vulnerable CIS (Commonwealth of Independent States) and SEMED countries are Ukraine and to a lesser extent Russia, Morocco and Tunisia. Their vulnerability is elevated because they have high shares of nonperforming loans, a significant share of foreign currency debt, high external debt, falling capital inflows and high and rising unemployment.

Part II: The Eurasian Customs Union: An Early Empirical Assessment

In the second part of his presentation, Zettelmeyer elaborated on the benefits and challenges of the Eurasian customs union (among Russia, Kazakhstan and Belarus) effective since January 2011. The customs union could potentially have multiple benefits: (1) it might help Russia to diversify its export structure; (2) it could benefit producers within a regional integration grouping through increased market size; and (3) it could serve as a first step toward the expansion of exports from a regional area to a worldwide base. On the downside, however, one can expect trade diversion effects vis-à-vis nonmembers; this aspect must be evaluated in greater depth. Moreover, given the dominance of the Russian economy, asymmetries on account of the size of the economies in the customs union could become an obstacle to reaping benefits. Finally, it was stressed that outward-oriented commodity exporters face substantial challenges, not least due to the effort to harmonize taxation of commodity exports.

The EBRD pinpoints the following key challenges to the customs union: lowering nontariff barriers to trade, improving the cross-border infrastructure, limiting the use of tariff barriers with other countries, and extending liberalized market access to the service sector. So far, the tariff-related impact on trade has been assessed to be small, with only Russia experiencing trade creation effects, and Belarus and Kazakhstan mainly facing trade diversion effects because they have higher trade barriers to China and the EU. Zettelmeyer also outlined that in spite of the low quality of national institutions within the Eurasian Economic Community (which the participants share as a common feature), the customs union creates the potential for improvement through the strong demonstration effect of supranational institutions with good governance.

Part III: A Banking Union for the Euro Area and Beyond: Implications for Emerging Europe

In the third part of his presentation, Zettelmeyer turned his attention to possible solutions of cross-border supervision problems within the framework of the euro area banking union and outlined a practical approach to the integration in the banking union of both non-euro area EU member countries and non-EU emerging European countries. In particular, focusing on counterbalancing a "host-country"

and a "home-country" view (e.g. due to fiscal burden sharing for cross-border banks as well as supervisory responsibility problems), the report recommends that the euro area countries establish governance structures that give small euro area countries a sufficient voice. Additionally, the creation of a loss-sharing rule to mitigate moral hazard was proposed; its purpose is to ensure that the European Stability Mechanism is primarily about catastrophic loss insurance. Despite the progress made in December 2012,[3] challenges remain; they consist in finding approaches to incorporate the financially integrated non-EU countries. Possible solutions could be to confer an "associate member" status on the euro-area banking union, whereby the ECB should commit itself to providing euro liquidity for every period in return for information-sharing. Accordingly, Zettelmeyer outlined that the coordination problem should be mitigated by defining a regime in which the host country authorities and the ECB would share responsibility for subsidiaries and parent banks operating in the host countries.

The discussion that ensued after the presentation reiterated the observation that besides adverse external shocks, country-specific policy challenges remain in some CESEE and CIS countries (e.g. Hungary and Ukraine). In addition, it was pointed out that Ukraine was also under institutional reform pressure from the European Union. Finally, Zettelmeyer noted that despite the wealth of reforms implemented in the CESEE countries and their calming effect on the credit market, downside risks still prevail, not least because demand-side challenges remain.

[3] *Agreement between the European Parliament, the ECB Council and the European Commission was reached on December 12, 2012, to establish a single supervisory mechanism (SSM) within the ECB that would be open to non-euro area members.*