

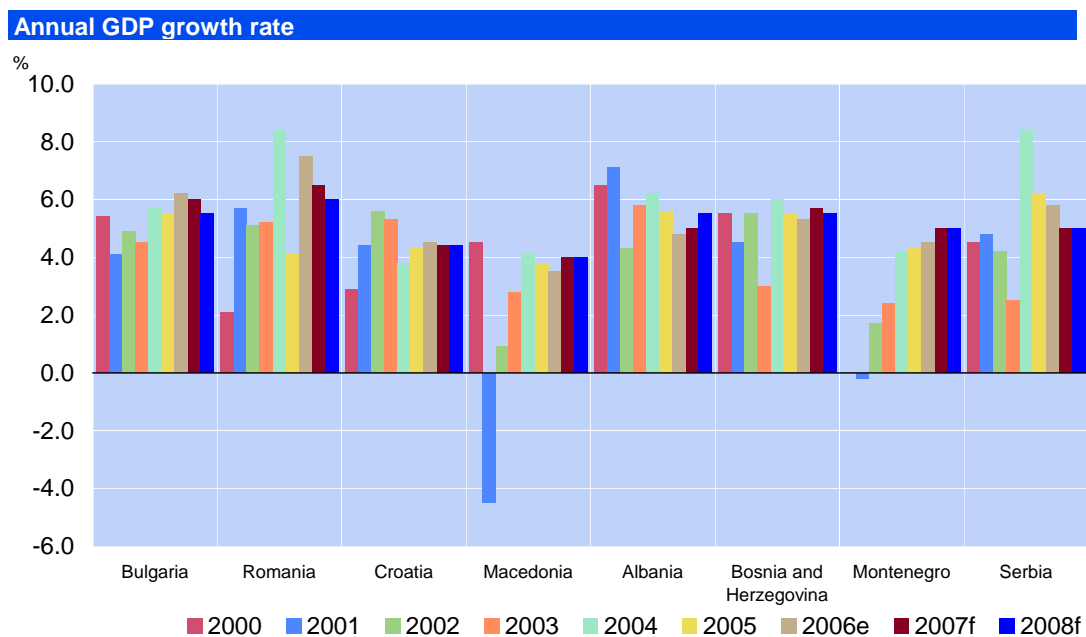
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 Economic governance and sustained growth in the Balkans  
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 Panel Statement

Economic and Monetary Governance and GDP Growth

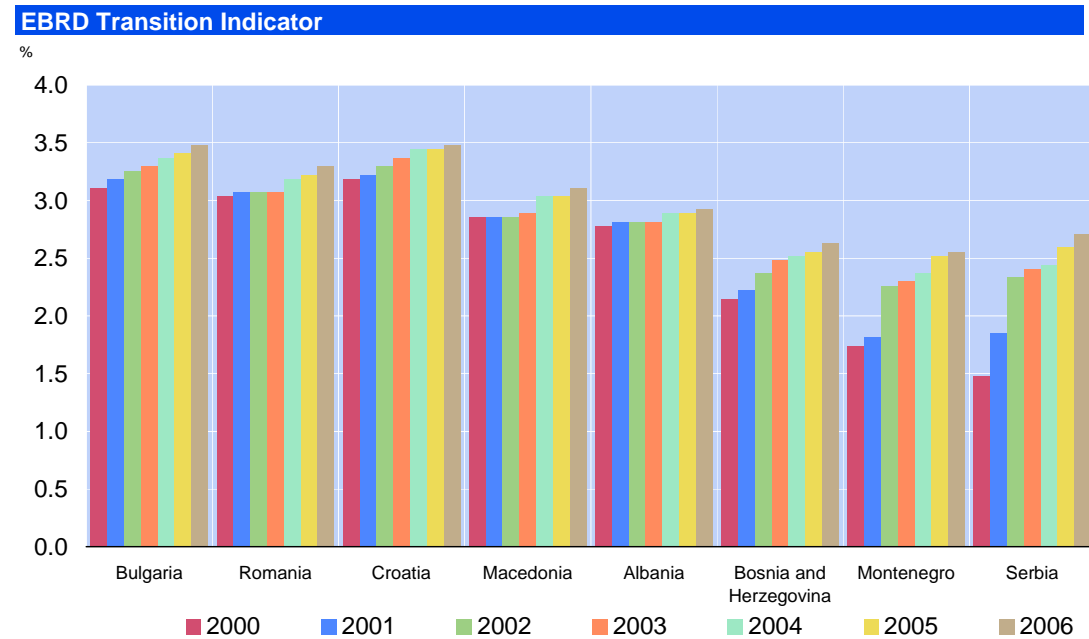
The GDP growth performance of the Balkan region (Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Republic of Macedonia, Montenegro, Romania, Serbia) has been encouraging in recent years. Annual growth rates have mostly ranged between 4% and 6% (see Chart 1), broadly comparable with GDP dynamics in the Central European countries. I would argue that the growth process in the Balkans reflects to a considerable extent a recovery after the recessions most countries of the region experienced in the later 1990s. In addition, some positive impulse has certainly come from economic reforms and improvements in the institutional framework and thus in governance since the beginning of the present decade, as captured by the EBRD transition indicators (see Chart 2).

Chart 1



Source: WIIW, OeNB Foreign Research Division.

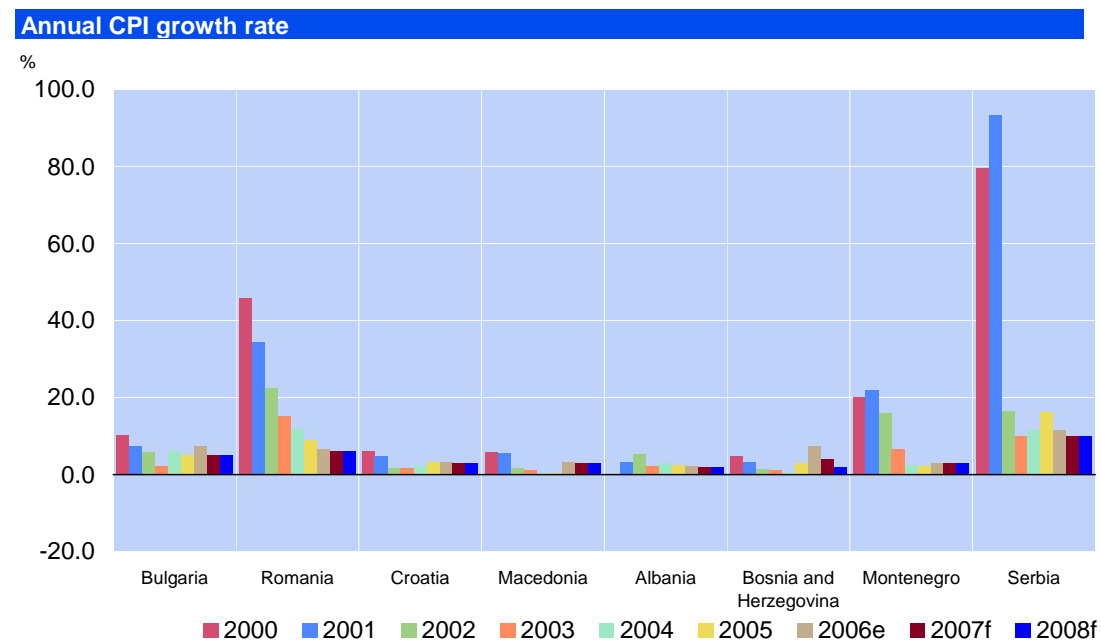
Chart 2



Source: EBRD, OeNB Foreign Research Division.

Monetary policy has supported output growth by promoting an environment of fairly moderate (or – in a few cases – even low) inflation in most countries (see Chart 3). It is noteworthy that different monetary strategies – ranging from the use of a foreign currency to pegs and inflation targeting (see Table 1) – have yielded fairly similar results.

Chart 3



Source: WIIW, OeNB Foreign Research Division.

Table 1

### Balkan countries' currencies and monetary strategies

Country/ territory	Currency (since); previous	Exchange rate regime (since); previous	Monetary policy framework (since); previous
<b>Albania</b>	Albanian lek (ALL)	Loosely managed float (early 1990s), major reference currencies: EUR (up to 1/1/1999: DEM), USD	Informal inflation targeting through money growth targeting (1998)
<b>Bosnia and Herzegovina</b>	Konvertibilna marka (BAM, June 1998); YUM (redenominating) and HRK (used regionally), DEM (country-wide) (until Dec. 1999); YUD (until early 1990s)	Currency board, peg to EUR (up to 1/1/1999: DEM) (formally introduced: August 1997, de facto since mid-1998); multiple currencies	Nominal exchange rate anchor EUR (DEM) (August 1997)
<b>Bulgaria</b>	Bulgarian lev (BGN, redenominating July 1999)	Currency board, peg to EUR (up to 1/1/1999: to DEM) (since July 1997); managed float	Nominal exchange rate anchor EUR (DEM) (July 1997); money growth targeting
<b>Croatia</b>	Croatian kuna (HRK) (May 1994); Croatian dinar (transitional); YUD	Tightly managed float, reference currency: EUR (up to 1/1/1999: DEM) (since Oct. 1993)	Nominal exchange rate anchor EUR (DEM) (Oct. 1993)
<b>Rep. of Macedonia</b>	Macedonian denar (MKD, April 1992); YUD	De facto peg to EUR (exchange rate target, up to 1/1/1999: DEM) (since Oct. 1995); managed float	Nominal exchange rate anchor EUR (Oct. 1995); money growth targeting
<b>Montenegro</b>	Unilaterally euroized/EUR (November 2000); November 1999-2000 EUR (DEM) parallel currency to YUM; before that YUM, YUD		EUR legal tender (November 1999/2000)
<b>Romania</b>	Romanian leu (RON, redenominating July 2005)	Loosely managed float (Aug. 2005); managed float (1991), reference currency: EUR (since early 2005); previously: reference basket: EUR (75%), USD (25%) (early 2004), EUR (60%), USD (40%) (early 2002); before that: reference currency: USD	Inflation targeting (August 2005); Money growth targeting (early 1990s)
<b>Serbia</b> <i>(without Kosovo/ Kosova)</i>	Serbian dinar (RSD, formerly CSD); previously called Yugoslav dinar (YUM, redenominating January 1994; YUD)	Loosely managed float (Feb. 2006); managed float (Jan. 2003), previously tightly managed float, reference currency: EUR (Dec. 2000); peg to EUR (DEM)	Informal inflation targeting through "inflation objectives" (Sept. 2006); real exchange rate anchor (Jan. 2003), previously nominal anchor EUR (DEM) (1994)

Source: OeNB, Foreign Research Division.

At the same time monetary policy tends to be constrained in Balkan countries, due to exchange rate commitments in various countries, but also – more generally – because of the wide-ranging liberalization of financial accounts across the region. Thus, other policies have to take a key role to ensure macroeconomic stability and, in particular, to keep external imbalances (especially current account deficits) in check, which are high in most Balkan countries. (The weighted average level of current account deficits in the Balkan countries reached almost 9% in 2005 and is expected to have risen somewhat further in 2006).

More policy action – strengthening of institutions and other reforms to improve the business and investment climate – is needed to underpin sustainability of growth and the catching-up process in the medium to longer run. Apart from political stability, I would argue that public-sector effectiveness, the fight against corruption, regulatory quality, the rule of law, the pace of privatization, restructuring of the enterprise sector and infrastructural modernization will (continue to) matter particularly strongly for economic growth prospects in the Balkans.

Table 2 presents a catching-up simulation for the Balkans. Of course, such simulations are highly sensitive to the underlying assumptions and should therefore be seen as scenarios that illustrate possible future developments. The simulation below is based on an assumed growth differential of 2.5 percentage points between the region and the average of the present EU-27 (assumed annual growth rate in the Balkan countries: 4.5%, assumed average annual growth rate in EU-27: 2%). In my view, bold and steadfast policies could well increase this growth differential and thus speed up the catching-up process. To be more precise, lifting the growth differential to 3% would allow the Balkans to achieve full per-capita convergence about a decade earlier than set out in the baseline scenario presented below.

Table 2

**Simulation of GDP per capita at PPP**

	in EUR, 2005	in % of EU-27, 2005	in % of EU-27, 2025	year of full catching up
Bulgaria	7,730	34.4	55.8	2050
Romania	8,010	35.6	57.8	2048
Croatia	11,270	50.1	81.3	2034
Macedonia	6,110	27.2	44.1	2059
Albania	4,420	19.6	31.9	2073
Bosnia-Herzegovina	6,150	27.3	44.4	2059
Montenegro	5,650	25.1	40.8	2063
Serbia	6,690	29.7	48.3	2056

Source: WIIW, OeNB Foreign Research Division.

Assumptions:

annual growth in the Balkan countries at 4.5%, in EU-27 at 2.0%

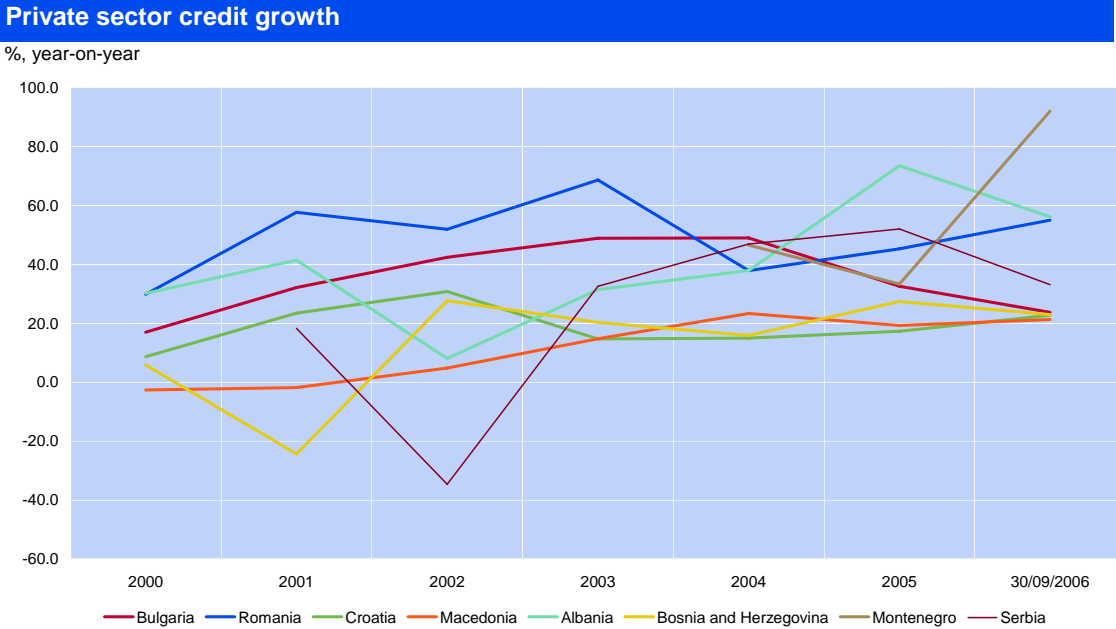
no change in the relative employment ratios

Credit growth: financial deepening or bubble?

Credit growth in most Balkan countries has been rapid in recent years and, consequently, credit/GDP ratios have risen from their initially low levels, in some cases very substantially so. It has to be pointed out that this rise is due to private sector credit

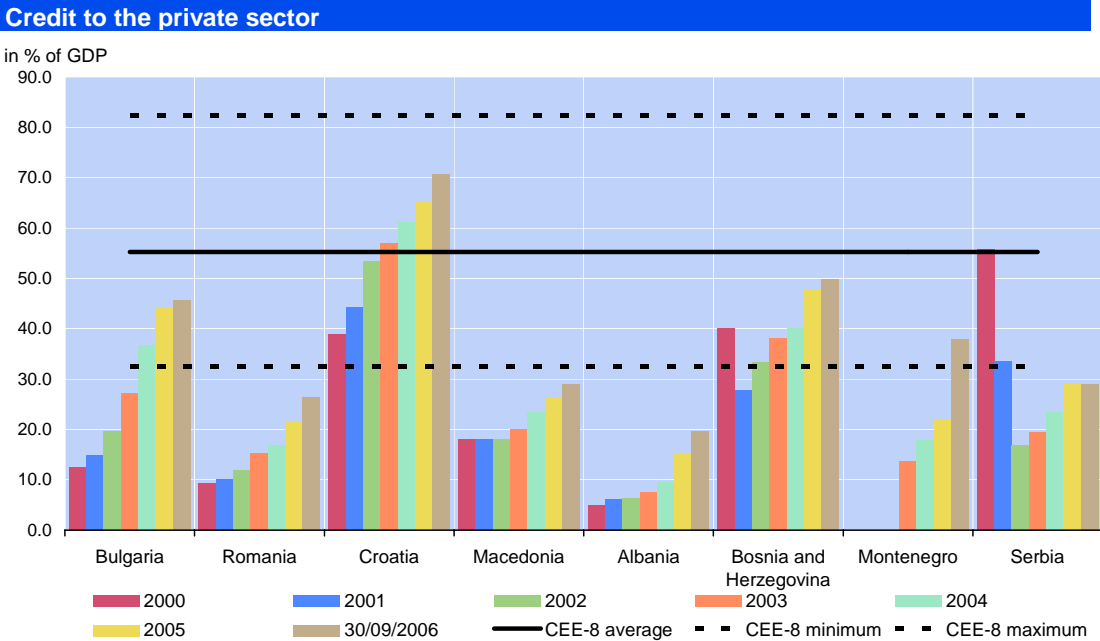
growth (see Charts 4 and 5). Public sector credit ratios have, in fact, fallen in most Balkan countries.

Chart 4



Source: National central banks, IFS, OeNB Foreign Research Division.

Chart 5



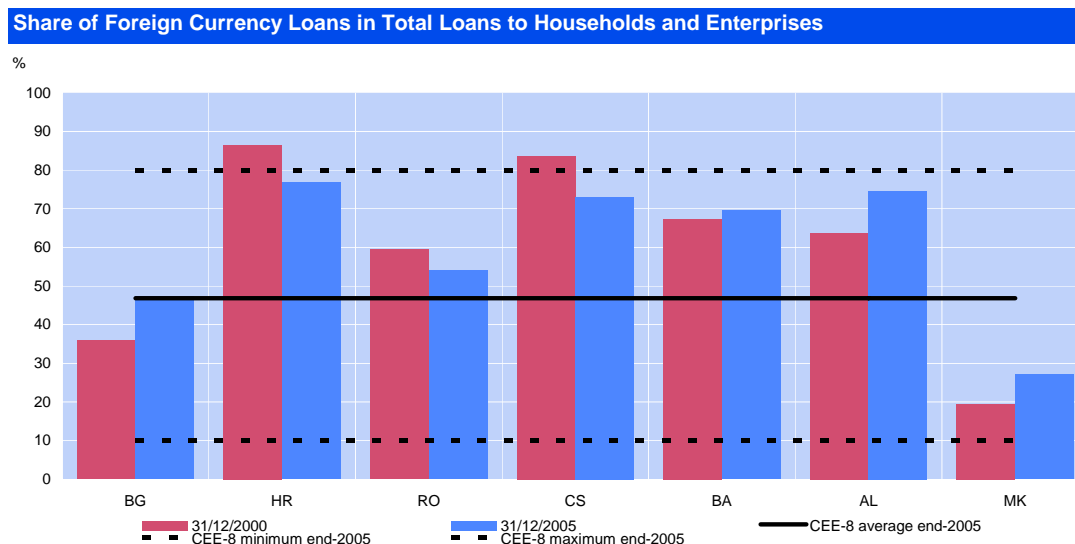
Source: National central banks, IFS, OeNB Foreign Research Division.

OeNB analyses on Bulgaria, Croatia and Romania<sup>1</sup> suggest that credit developments in these three Balkan countries up to now can be explained by fundamentals: In fact, credit ratios have approached their estimated equilibrium levels in recent years. These equilibrium levels, by the way, are themselves moving targets, as they increase in line with improvements of fundamentals. Thus, credit growth so far appears to be largely a process of financial deepening that is driven by the transformation and catching-up process.

However, due to its sheer speed, credit growth – even if driven by essentially benign factors – has posed challenges to macroeconomic management, especially as regards preserving external balance in several Balkan countries. For a number of countries, these challenges are not yet resolved, despite various policy measures that have been taken by the authorities to keep lending booms in check. In terms of the sustainability of external positions, it certainly matters whether credit is mainly used for productive purposes or for consumption.

Moreover, as credit-to-GDP levels have now come close to their equilibrium, a prolonged continuation of credit booms (e.g. spurred by a possible relaxation of credit standards) could result in lending bubbles further aggravating macroeconomic imbalances and adversely affect financial stability.

Chart 6



Source: NCBs, IMF, OeNB Foreign Research Division.

Note: Data including loans indexed to foreign currencies in Croatia. 2005 data for Serbia as at end-September 2005 and including loans indexed to foreign currencies. 2005 data for Bosnia and Herzegovina including loans indexed to foreign currencies to all sectors (as a disaggregation by sectors is not available for indexed loans). CEE-8 represents the arithmetic average of data for Estonia, the Czech Republic, Latvia, Lithuania, Hungary, Poland, Slovakia and Slovenia (2000 data excluding Slovakia).

<sup>1</sup> Balázs Égert, Peter Backé and Tina Zumer (2006), *Credit growth in Central and Eastern Europe: New (Over)Shooting Stars?*, European Central Bank Working Paper No. 687, revised version forthcoming in "Comparative Economic Studies".

Already now, foreign-currency lending to the private sector in a number of Balkan countries calls for vigilance, in particular as it implies potentially considerable indirect credit risk for banks (see Chart 6). More generally, rapid credit growth increases challenges to risk-management capabilities of banks, especially in a setting in which lending extends beyond the range of prime borrowers.

What are the policy implications of these developments? It has been argued that a combination of macro and micro measures is usually most promising, if and when a moderation of credit growth is deemed necessary. I would agree with this view: Financial and macroeconomic stability are closely interrelated and thus a combined policy response often is the route to take. Prudential measures, while fostering financial stability, can also have beneficial side-effects on macro stability. However, such measures cannot be seen as a substitute for appropriate macroeconomic policies in the longer run. Also, the risk and the implications of regulatory arbitrage should not be underestimated. Administrative measures, in turn, can potentially be useful as stop-gap measures. Their efficiency, however, declines over time – and sometimes it does so rather quickly – as circumvention increases; moreover such measures would also seem to be at odds with (future) EU membership.

### Supervision

The increasingly close economic and financial links of Balkan countries with the other parts of the world, in particular with other European countries, suggest that episodes of financial fragility would have repercussions on both the Balkans and the other European countries. This underscores the importance of good cooperation between home and host country supervisors.

Now, as Charles Goodhart has put it: "The home-host issue is a horrible complex problem" (London School of Economics, 8 April 2005).

"Horrible" means that a conflict of interest is unavoidable since the home country supervisory authority of a banking group is in charge of the consolidated supervision of the group whereas the host country authorities are in charge of supervising the subsidiaries on a solo basis as well as financial stability and deposit insurance. The host country authorities are also accountable to local tax payers and – in the case of central banks – have to implement monetary policy and stand ready to grant liquidity assistance.

Certainly, authorities should, as far as legally possible, exchange information, co-ordinate their actions and co-operate with each other. In addition, a convergence of supervisory practices should be strived at. This should lead to efficient supervisory arrangements and a level playing field for the supervised institutions.

Thus, home and host authorities face two major challenges: Trying to find (i) the optimal allocation of tasks and responsibilities (within the given legal regimes/frameworks) and (ii) the optimal balance of cost-efficiency, prudential soundness and financial stability.

Within the EU, policymakers have established a sophisticated framework for bilateral and multilateral exchange of information, co-ordination and co-operation, and for fostering supervisory convergence. And policymakers continue to expand and improve this framework, for example on the issue of host-country-based bank subsidiaries that are of systemic importance while their home-country-based parent banks are not. Moreover, whether such a framework as has evolved in Europe actually works naturally depends on a common understanding of how interaction should work and how prudential supervision should be carried out in practice; but it depends just as much on the quality of personal relations, i.e. there must be mutual trust and understanding at all levels.

Austrian authorities are very much familiar with both the home-country and the host-country role, since many of our major banks have substantially expanded their cross-border activities in recent years, inter alia to the Balkans, while Austria's largest bank was subject to a cross-border acquisition a couple of years ago.

A traditional means for co-operation are MoUs (Memoranda of Understanding). With a view to the Balkans, Austria has concluded MoUs with Bulgaria (2005), Croatia (2005) and Romania (2006), and negotiations are currently under way with other countries.<sup>2</sup>

While MoUs are not a pre-condition for a successful co-operation between home and host country authorities, they do help to establish a sound basis for future co-operation. Thus, when negotiating an MoU, the interests and possible concerns of all the authorities involved have to be taken into account and have to be addressed in a fair and balanced way.

But again, any MoU can "only" mean a framework that covers procedural aspects. Therefore, we always have to keep in mind that MoUs are "lived" by real people, and that the success of such an agreement is largely dependent on their good-will, mutual trust and understanding – in other words, a good personal relationship. Let me assure you that we, from the Austrian side, put a lot of effort into building these personal ties that are so important for facilitating mutually beneficial developments.

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<sup>2</sup> Moreover, as regards other CEE countries, Austria has concluded MoUs with the Slovak Republic (2003), Slovenia (2001), the Czech Republic (2001) and Hungary (2001).