Conference on European Economic Integration 2013 – Financial Cycles and the Real Economy: Lessons for CESEE

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The Conference on European Economic Integration (CEEI) 2013, which the Oesterreichische Nationalbank (OeNB) hosted in Vienna on November 18 and 19, 2013, focused on the topic "Financial Cycles and the Real Economy: Lessons for CESEE".[2] Following an excursion to Helsinki in 2012 upon the invitation of Suomen Pankki – Finlands Bank, which had co-organized the CEEI in 2011 and 2012, the conference was again back at its traditional venue in 2013. Following extensive discussions on issues of balanced growth and convergence in Central, Eastern and Southeastern Europe (CESEE) at the CEEI 2012, the CEEI 2013 examined the link between the financial cycle – the notion of financial booms followed by busts – and the real economy. The debate on the respective policy challenges reflected the heterogeneous recovery paths in CESEE and the question to what extent these differences mirror variations in the pattern of pre-crisis financial cycles and varying policy responses to financial busts. These issues were explored in the light of recent efforts to strengthen (macro)financial sector regulation at national and international levels. More than 330 participants from 35 countries followed the presentations and discussions of high-ranking representatives of central banks, international organizations, the business and banking sectors and academia.

In his opening remarks, *OeNB* Governor *Ewald Nowotny* pointed out that it is important to address the relationship between economic activity and financial development from different angles. While financial deepening is expected to promote economic growth in CESEE in the long run, this positive impact may be smaller than expected a few years ago and depend much more on the regulatory and overall policy framework. Over the short- to medium-term horizon, finance adds to – or even causes – cyclical swings in the real economy and, in the worst case, outright boom-bust developments, which can entail substantial welfare costs. Prior to the crisis, policymakers had failed to appropriately take into account this cyclical component of the finance-growth nexus. With hindsight, the prevalence of overly optimistic expectations and the build-up of excessive leverage in the CESEE countries can be explained by this lack of attention to the financial cycle. When the financial cycle went into reverse, several CESEE economies experienced a severe and rather protracted financial bust that is still weighing on their recovery and slowing down the convergence process. From this, Nowotny concluded that we must enhance our understanding of the financial cycle and draw appropriate lessons for economic policy, not only in the CESEE region but also at the European level. In this context, he highlighted the decision to establish the single supervisory mechanism (SSM) and reiterated the Eurosystem's invitation to non-euro area countries to broaden the reach of the SSM by participating as well.

[1] *Oesterreichische Nationalbank, Foreign Research Division. Compiled on the basis of notes taken by Elisabeth Beckmann, Markus Eller, Martin Feldkircher, Martin Gächter, Isabella Moder, Mathias Lahnsteiner, Thomas Scheiber, Maria Silgoner, Tomáš Slačík and Julia Wörz.*

[2] *The conference proceedings will be published by Edward Elgar Publishing Ltd. in the course of 2014. Presentations and papers, information about the speakers and the conference program are available at www.oenb.at.*

Given improving but still heterogeneous economic developments, Nowotny urged that financial fragmentation in Europe be reversed and a European rather than national perspective be taken in dealing with crisis-induced policy challenges.

The Financial Cycle and Macroeconomics: What Have We Learned?

In the first keynote lecture, *Claudio Borio (BIS)* emphasized the need for economists to rethink standard macroeconomic models that are unable to predict severe financial distress. He advocated analyzing the financial cycle, which can be described, in short, by credit and property prices and is characterized by both a low frequency (16–20 years) and a high amplitude. Most importantly, financial cycles are reliable leading indicators for financial crises, which historically triggered permanent losses in output and slow and protracted recoveries. Borio proposed to replace standard measures of cyclical fluctuations by "finance-neutral" output gaps, which are more reliable indicators for the current state of the economy than common measures that ascribe deviations from potential output solely to inflation. Looking ahead, he identified ill-designed policies as a key risk to global recovery. More specifically, policy measures should aim at leaning more aggressively against the buildup of imbalances in the boom phase and be less expansive during the bust phase. In this regard, he views current policy measures as being too asymmetric, running the risk of eroding the defenses of economies under stress while exhausting policymakers' ammunition. Finally, policymakers have to recognize the financial cycle as a medium-term phenomenon and therefore expand the focus of fiscal, monetary and macroprudential policy measures accordingly. In his policy recommendations for future crisis resolution, Borio argued that it is key to quickly ensure full loss recognition, recapitalize financial institutions and promote the removal of excess capacity in the financial sector. Fiscal policy should shore up private sector balance sheets by substituting private for public sector debt in a very judicious manner rather than applying across-the-board fiscal stimulus.

Credit Cycles, Central Bank Policy and the Real Economy in CESEE

The first policy panel brought together four CESEE central bank leaders who shared their countries' experiences with credit booms and their messages for macroprudential policy. In his introductory statement, OeNB Governor Ewald Nowotny recalled central lessons from the crisis, namely the need to coordinate monetary, fiscal and prudential policies, and the risks to macrofinancial stability arising from private sector indebtedness. *Marek Belka,* President of *Narodowy Bank Polski,* summarized the Polish experience as a mixture of fortunate timing and early policy awareness. He recalled that credit expansion in Poland had been moderate apart from a sectoral boom in the mortgage market. Policymakers addressed this boom early on by taking regulatory steps and restricting foreign currency lending. At the same time, Poland benefited from the fact that domestic credit growth was dampened by the global crisis. After reviewing the strengths and weaknesses of micro- and macroprudential policies geared to protect financial stability, Belka turned to the role of foreign capital and argued that foreign capital-financed growth, which is still common in the CESEE region, involves considerable risks, such as exchange rate risk and – more subtle, but also more vicious – the risk of a lopsided sectoral allocation of capital. Especially this latter phenomenon may potentially foster bubbles and has to be addressed by supervisors in a timely and appropriate manner. *Boštjan Jazbec,* Governor of *Banka Slovenije,* focused on the synchronization of business cycles between Slovenia and the euro area. He attributed improvements of the past years mainly to strengthened trade links. The more recently observed decoupling of business cycles, in his view, is a result of domestic developments and mainly related to financial sector problems. He emphasized the crucial role of institutions in general and the room for institutional improvement in the Western Balkans in particular. Especially Slovenia would need to become more efficient in dealing with state-owned companies and to clean up banks' balance sheets. He concluded by stressing the potential tension between short-term crisis management and long-term crisis resolution and the continually high need for crisis management in Slovenia. *Vedran Šošić,* Vicegovernor of *Hrvatska narodna banka,* recapitulated Croatia's long-standing experience with macroprudential policy. Being a small, open and highly euroized economy with a high degree of financial integration, Croatia has traditionally had very limited room for independent monetary policymaking. Hence, macroprudential policy has been used successfully not only to mitigate vulnerabilities but also to build up buffers and strengthen the banking system's resilience. Despite noticeable deleveraging in 2013, the external liabilities of the Croatian banking sector remain above pre-crisis levels. In conclusion, Šošić strongly spoke in favor of a holistic approach to macroprudential policy which takes into account interactions, synergies and links between individual measures. He also stressed the merits of moving early, as measures taken in good times determine the "degrees of freedom" in bad times. *Eva Zamrazilová,* Member of the Board of *Česká národní banka,* recalled that the transformation experience of the Czech Republic had initially been accompanied by the buildup of massive external imbalances and a weak monetary policy regime targeting both money supply and the exchange rate. The FDI-financed and therefore creditless recovery that started in 1999 gave way to high credit growth from 2005 to 2007 and to overheating in the housing market. The bursting of the subprime bubble in the United States spared the Czech economy from a further intensification of internal imbalances. The big puzzle in her view is the current weak performance of investments, which may reflect a stronger repatriation of profits gained from FDI than in pre-crisis times when such profits were often reinvested in the economy – developments which highlight risks related to foreign capital-financed growth. Zamrazilová concluded by pointing toward the limitations of monetary policy, with the traditional monetary framework having been stretched to the limit in the face of a weakened transmission mechanism, and underlined the importance of restoring confidence. Taking up input from the keynote lecture, the ensuing general discussion centered on the difficulties involved in obtaining reliable estimates of potential output, both from a forward-looking and a backward-looking perspective. Further topics raised included the interdependencies between monetary and fiscal policies as well as the appropriate focus of monetary policy in the euro area in view of the diverging developments across euro area countries.

Real Estate Bubbles and the Financial Crisis

In his introductory statement to session 1, OeNB Executive Director *Kurt Pribil* highlighted the crucial role house price dynamics play in gaining an understanding of economic imbalances. While real estate bubbles are hard to detect in real time, finding the right policy response is an even greater challenge, especially in the absence of robust empirical evidence on the effectiveness of various measures. With respect to Austria, Pribil outlined the initiatives taken in recent years to tackle Austrian banks' high exposure stemming from foreign currency-denominated housing loans. As the first speaker, *Dubravko Mihaljek (BIS)* sketched the incentive structures of buyers, sellers, banks and governments that may all contribute to an increasing house price bubble. The current discussion in Austria, Germany or Switzerland illustrates the difficulty of detecting real estate bubbles early on and, indeed, of fully understanding past house price bubbles – especially in Central and Eastern European countries, where credit growth played a less important role than in OECD countries. Moreover, he argued that the various regulatory, fiscal, monetary and macroprudential measures to address house price booms need to be accompanied by appropriate central bank communication, media information and financial education to influence house price expectations. *Eloísa Ortega (Banco de España)* shared the Spanish experience of recent years. A decade ago, Spain was considered a model case for prudent policies, given its sound public debt levels and the dynamic provisioning system in banking regulation. All these policies, however, turned out to be insufficient to curb house price increases and to prevent the subsequent crisis. The sharp residential property price correction during the crisis had strong repercussions on the rest of the Spanish economy, which were reinforced by malfunctioning labor markets. Spain's painful private and public sector adjustment process and the restructuring of the financial system are slow in bearing fruit. The Spanish example illustrates the key role of the housing market in generating macroeconomic and financial imbalances during upswings, but also its impact on the depth of the current crisis in Spain and on the pace of subsequent recovery. *Paul van den Noord (Autonomy Capital Research LLP),* who had been working for the OECD before moving to the private sector recently, investigated house price patterns in the G-7 countries. In the period from the 1970s to date, he observed three cycles, each longer and with a higher amplitude than the previous one. The correlation of the house price cycle with the business cycle declined over time, indicating the important role of financial deregulation and of housing as safe haven investment. He raised the provocative hypothesis that we may already be seeing the first signs of a forthcoming bubble, maybe again bigger and longer-lasting than the preceding ones, driven by current expansionary policies. As one should not take for granted the learning ability of policymakers, macroprudential policies should be given into the hands of strong and independent authorities.

The Finance-Growth Nexus: Implications for CESEE

Session 2, chaired by *Doris Ritzberger-Grünwald,* Director of the *OeNB's* Economic Analysis and Research Department, addressed the finance-growth nexus and its implications for CESEE. Previous research has established a positive nexus between financial deepening and economic growth, while more recent debates questioned the sustainability of debt-financed growth, given the deleveraging process that began after the onset of the crisis. Against this backdrop, this session analyzed whether the general link between finance and growth can be confirmed for recent years, and for CESEE in particular, and whether different stages of economic and financial development impacted the effect of finance on growth. *Martin Gächter (OeNB)* made a case for taking the financial cycle into account in business cycle measurement. He presented empirical results from an extended structural unobserved components model which explicitly considers private credit and house price developments for four advanced and four emerging economies from the CESEE region. The results show that the financial cycle has a considerable impact on business cycles and confirm that the effect of the financial crisis differs widely across countries. These findings demonstrate that traditional approaches to measuring potential output, which rely solely on the concept of nonaccelerating-inflation output, are unable to detect upswings caused by the financial cycle. In conclusion, Gächter therefore highlighted the importance of incorporating financial information in the estimation of potential output and the corresponding "finance-augmented" output gaps. *Guglielmo Maria Caporale (Brunel University)* presented long-term pre-crisis evidence on the banking system and the financial sector in CESEE EU Member States (excluding Croatia). Results from a dynamic panel model for the period from 1994 to 2007 suggested that the contribution of stock and credit markets to economic growth in these economies was limited. *Adalbert Winkler (Frankfurt School of Finance & Management)* combined the short- and long-term view by comparing the crisis experience of CESEE and euro area periphery countries. He highlighted the need to limit vulnerabilities related to strong capital inflows and emphasized that "speed can kill" the positive finance-growth nexus. He stressed the role of cross-border banking and highlighted that foreign banks in CESEE acted as a shock absorber after the crisis. In the euro area periphery countries, by contrast, shock absorption took place via public institutions. In conclusion, he argued that a multi-country currency union can only be sustainable if supported by banking and fiscal union.

Economic Convergence across CESEE: Achievements and Challenges

In his dinner speech, *Jörg Asmussen,* at that time Member of the Executive Board of the *European Central Bank,* contrasted positive and negative examples of how CESEE countries have been experiencing convergence: While benefiting from increasing living standards, deepening integration and the positive role of foreign capital flows in financing the transition process, they also experienced credit-fueled domestic demand booms, which made their growth models unsustainable. Hence, pre-crisis credit booms turned into post-crisis credit busts, and the resulting deleveraging has since complicated economic recovery. Yet, in Asmussen's view, the most worrying development is that real convergence in CESEE has virtually come to a halt. Against this backdrop, Asmussen concluded that more and – even more importantly – better European integration was needed, meaning in particular the implementation of new EU and euro area governance rules and, as regards the wider picture, the dismantling of remaining trade barriers between the Western Balkans and the EU. Moreover, he urged that policy should strive for sustainable economic and institutional convergence through a proper mixture of macroeconomic and structural policies.

Do We Need New Modeling Approaches in Macroeconomics?

The second conference day was opened by a keynote speech delivered by *Claudia Buch (Halle Institute for Economic Research),* which took its cue from numerous points of criticism voiced against macroeconomic modeling: First, economists have been blamed for failing to predict the crisis and come up with early warning exercise systems. Buch admitted that forecasters had failed to predict the crisis and that forecasting accuracy has not increased within the last decades. However, she put forth several reasons why economic forecasting cannot be more precise, e.g. because uncertainty is fundamental and not the result of bad methods. Second, Buch addressed the claim that economists fail to integrate financial markets in their models by pointing at several macroeconomic models that have incorporated issues related to the financial system and the banking sector. Last but not least, she stressed the importance of finding more links between micro- and macroeconomic developments in economic models in order to overcome unrealistic assumptions about human behavior. As a conclusion, she stated that the economics profession has responded to the crisis in many promising ways and that only time will tell which of the new approaches will be successful.

The Policy Response in Europe: How to Deal with the Financial Cycle?

Session 3, chaired by *OeNB* Executive Director *Peter Mooslechner,* dealt with the question of how policy should respond to financial cycles in Europe. The first speaker, *Katia D'Hulster,* senior financial sector specialist at the *World Bank Vienna Financial Sector Advisory Center,* explained the activities undertaken by the World Bank to make CESEE and its financial sectors more crisis resilient. The Vienna Financial Sector Advisory Center, for instance, offers tailored technical assistance, analytical output and regional conferences and workshops on topics such as nonperforming loans (NPLs) and Basel III. She highlighted NPLs as one of the major challenges in CESEE, stressed the differences in methodologies in different countries and presented a roadmap for NPL resolution. Moreover, D'Hulster noted that consumer protection and financial literacy are essential but often neglected issues. Concerning the policy response to the crisis in Europe, she underlined the importance of having a single resolution mechanism in place. Subsequently, *Bojana Mijailović (National Bank of Serbia)* focused on the business and financial cycle in Serbia as well as on measures taken to strengthen financial stability and their effectiveness. She emphasized that output growth in Serbia is currently lower but more sustainable than before the crisis and confirmed that Serbia has also seen a period of significant credit growth followed by a more recent contraction of the credit stock. The economic downturn and credit contraction have led to an increase in the country's NPL ratio. Furthermore, Mijailović reviewed the Serbian policy response to the crisis and the measures taken earlier during the boom phase to tackle the excessive growth of loan portfolios and the growing exposure to foreign currency risk and foreign currency-induced credit risk. Inter alia, she mentioned that capping lending to households by requiring banks not to exceed a maximum ratio of household loans to tier 1 capital has led to a considerable increase in banks' capitalization ratios. In general, she concluded that countercyclical prudential measures created adequate buffers for loss absorption. Efforts to support NPL resolution have had weak effects so far, however. The session was closed by *Jan Willem van den End (De Nederlandsche Bank),* who addressed financial cycles and macroprudential policies in the Netherlands, singling out the tools designed to mitigate excessive credit growth (countercyclical capital buffers) and excessive liquidity risks (maximum loan-to-deposit ratio). Van den End showed how calibrating countercyclical buffers based on the credit-to-GDP ratio would have worked in the Netherlands. He also found the loan-to-deposit ratio to be a very useful indicator for banking crises. Van den End presented countercyclical rules for upturn as well as downturn episodes. In an upturn episode, an upper bound for the loan-to-deposit ratio would result in a better coverage of loans by deposits and thus reduce liquidity risks, while in a downturn phase, a lower bound for the loan-to-deposit ratio would help avoid a credit crunch.

Macrofinancial Stability: New Challenges for Banks, Entrepreneurs and Policymakers

The CEEI 2013 concluded with a panel discussion of high-level management representatives from the *European Investment Bank,* Austrian commercial banks, and enterprises operating in CESEE markets. OeNB Vicegovernor *Andreas Ittner,* who chaired this session, invited the panelists to share their views on the crisis and to elaborate on the lessons they draw from the crisis with a view to macrofinancial stability. *Debora Revoltella,* Director of the Economics Department at the *European Investment Bank,* stressed the importance of getting a better grasp of the credit cycle. She recommended establishing an accounting regime which would force banks to base their business models on the true cost of risk over the whole credit cycle. As a lesson from crisis management over the last five years, the institutions of the designated fiscal and banking union will need clearly defined responsibilities and adequate powers in order to effectively steer against unsustainable developments. *Willibald Cernko* (CEO of *UniCredit Bank Austria AG*) and *Karl Sevelda* (CEO of *Raiffeisen Bank International AG*) outlined recent challenges for the banking sector with respect to macrofinancial stability. Although both panelists advocated stricter regulation of the financial industry, higher capital requirements and more transparency throughout the banking system, they cautioned that the transition to the new rules of Basel III will need time. A fast enforcement of the new capital and liquidity adequacy ratios risks prompting a credit crunch and depressing economic growth by overburdening the banking sector. *David C. Davies* (CFO of *OMV AG*) explained how both the sudden crash of the oil price and the collapse of the interbank market after the fall of Lehman Brothers led the OMV to fundamentally change its liquidity management in order to avoid financial distress. With banks struggling to fulfil their role as financial intermediaries given the severe problems in the interbank market, large enterprises such as the OMV started to approach financial markets directly, bypassing the banking sector. The rebound of oil prices since 2010 has prevented the OMV from undertaking a more fundamental overhaul of its business model. *Eduard Zehetner* (CEO of *Immofinanz AG*) found fault with the role banks played before and during the crisis. In particular, he criticized that prior to the crisis banks had often provided credit without sufficient assessment of counterparty risk while during the crisis they were unwilling and unable to provide sufficient financial resources when some companies (such as Immofinanz AG) needed them most. *David Hauner* (Head of CEEMEA Economics and FI/FX Strategy at the *Bank of America Merrill Lynch*) presented a rather optimistic outlook for the recovery of emerging economies. Nevertheless, he warned that emerging economies are not immune to credit cycles and stressed that capital accumulation alone does not create long-term growth.

Sustainable growth in the future will rely predominantly on countries' ability to spur productivity.

In addition to official debates, the two conference days provided a welcome opportunity for informal discussions and networking among central bankers, government officials, business and financial sector managers, researchers and journalists. Both media coverage and the positive feedback from participants confirmed the CEEI's status as one of the leading forums of discussion on economic and monetary integration in CESEE. In his concluding remarks, OeNB Governor Ewald Nowotny invited participants to come back for the next CEEI, which will be held in Vienna on November 24 and 25, 2014.