Conference on European Economic Integration (CEEI) 2019

Looking back on 30 years of transition – and looking 30 years ahead

Compiled by Julia Wörz[1]

The CEEI 2019 gathered around 340 participants from 30 countries to review three decades of political and economic transformation in Central, Eastern and Southeastern Europe (CESEE) and explore the challenges lying ahead.[2] In his opening remarks, *OeNB Governor Holzmann* mixed praise for the CESEE countries' truly impressive transition and integration achievements with concern. After all, unfulfilled promises and unrealistic expectations about the speed and ease of transformation have led to a social, economic and political backlash. To reach out to those who feel "lost in transition" it will be necessary to keep fostering convergence by spurring inclusive economic growth. Other challenges to be met include adverse demographic developments, the further integration and deepening of capital markets both within European monetary union (EMU) and in CESEE, remaining adjustment needs and new kinds of transition in the face of climate change. The surest path for CESEE's success story of the past decades to continue, as summed up by Governor Holzman, will be continued cooperation in the spirit of the European Union's official motto, "United in diversity."

Keynote lecture #1 by Beata Javorcik: "Achievements of the past 30 years"

Beata Javorcik (Chief Economist at the European Bank for Reconstruction and Development – EBRD) supplied key facts and figures: In terms of services-to-GDP ratios and the pace of market liberalization, the CESEE economies outperform all other emerging market economies. Central European countries now rank among "developed economies" with a per capita income level (at purchasing power parity) of about two-thirds of that of the G7 countries (with the metropolitan areas having benefited more in terms of GDP per capita than other areas).

These achievements have come at a cost, though, including deep initial recessions and structural shifts accompanying price liberalization, causing significant economic hardship. Looking ahead, she addressed demographics and migration as challenges for the region. The old-age dependency ratio is already close to that of euro area countries. Pension reforms promoting early retirement have depressed labor force participation among older people. A shift toward longer working lives will require improvements in health care. Today, 10% of people born in the EBRD regions live outside their country of birth or citizenship, contributing to fiscal imbalances and declining property values. Policies to foster re-immigration need to focus on the quality of governance, as corruption and weak institutions are primary causes for emigration.

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[2] *The conference was held on November 26 and 27, 2019. A conference volume will be published by Edward Elgar Publishing Ltd in 2020. Presentations and papers, information about the speakers and the conference program are available at www.oenb.at/en/Monetary-Policy/focus-area-central-eastern-and-southeastern-europe/events/conference-on-european-economic-integration.html.*

Javorcik concluded that given the current stage of knowledge "we could not have done things differently" but that further catching-up will require a transition to a new growth model, based on innovation, non-cost competitiveness and environmental sustainability.

A historic transformation: heterogeneity in CESEE in a changing global context

In session 1, chaired by *Vedran Dzihic* (Austrian Institute for International Affairs), *Ivan Krastev* (Institute for Human Sciences) and *Philipp Ther* (University of Vienna) emphasized the importance of psychology and expectations in understanding the transition process. As pointed out by Philipp Ther, economic progress was overshadowed by individual and collective experiences such as threats of poverty or the absence of family members for work reasons even in early transition. Over time, many people became disillusioned with the process of transition as economic modernization failed to produce the expected social outcomes. As explained by Ivan Krastev, the ensuing brain drain of young and educated people added to public dissatisfaction and darkened national perspectives. Even where people became more satisfied with their personal lives, satisfaction with public life and politics declined. Apart from this "crisis of expectation," outmigration (the loss of mostly young people, of money invested in education, of labor and of voters) created a new, rather homogenous electoral body with a hostile stance against immigration.

Both speakers saw the roots of challenges to liberal democracies in CESEE also in the initial goal of transition, namely that of modeling Western liberal democracies. Meanwhile, the global financial crisis and the social consequences of globalization and laissez-faire capitalism have raised questions about the desirability of imitating the "Western" model. Today, Ivan Krastev concluded, most CESEE economies do not want to be imitators of somebody else's model anymore and instead aspire to develop their own models and norms.

The central banker's view on monetary policy during transition

The first panel brought together central bank executives from three former Yugoslav countries and the Czech Republic. *Ana Ivković* (Vice Governor of the National Bank of Serbia) underlined the need to restore confidence in monetary policy following strong currency depreciation and hyperinflation in the 1990s, and the need to have an adequate fiscal framework in place for inflation targeting to work. With the move to a coherent economic policy in the last couple of years, the Serbian economy has been fundamentally transformed and is doing well now – which does not mean that everyone would be happy, though.

Boris Vujčić (Governor of the Croatian National Bank) recalled that, due to a badly mismanaged economy in Yugoslavia in the late 1980s, all legacy countries had to first rein in hyperinflation and stabilize the economy in the early 1990s. A decade later, Croatia faced the challenge of having to manage capital inflows to address resulting imbalances – the irony of history being that the very measures for which the Croatian authorities were criticized back then are very widespread and well-known today as "macroprudential" policies. Finally, Croatia continues to be overbanked as a result of the liberal licensing in the 1990s and may be in for more consolidation even though two-thirds of banks have disappeared from the market again.

Boštjan Vasle (Governor of the Bank of Slovenia) added that Slovenia mastered the transition process without major macroeconomic distortions. Beyond transformation, Slovenia had pursued EU integration as the only meaningful option for a small country. And the credibility of the euro and the common monetary policy had indeed helped contain domestic inflationary pressures in Slovenia during the crisis.

Jiří Rusnok (Governor of the Czech National Bank) recalled the early transition phase in which the currency, back then little more than a central-planning accounting unit, had to undergo a significant devaluation. The subsequent exchange rate peg, adopted with a view to anchoring the economy, worked well initially yet ultimately proved unsustainable given the impossible trinity of open capital markets, independent monetary policy and a fixed exchange rate. Having abandoned the fixed exchange rate under market pressure, the Czech National Bank became one of the first central banks to introduce inflation targeting. Inflation targeting was challenging particularly in the wake of the global financial crisis when inflation rates became inadequately low.

In the ensuing discussion the central bankers were asked, inter alia, to assess the exchange rate choice in their respective country and particularly to share their views of (possible) euro adoption. In principle, all speakers expressed satisfaction with their respective exchange rate arrangements and agreed that euro adoption is largely a political decision.

Financial sector developments during transition

In his introduction to panel 2, *Gottfried Haber* (Vice Governor of the OeNB) recalled the demise of the pre-crisis business model built on parent bank funding and lending in foreign currency as well as the successful Austrian Sustainability Package that addresses banks' funding and further measures taken by the Austrian authorities to contain lending in foreign currency.

Stijn Claessens (Head of Financial Stability Policy at the BIS) reminded the audience that the CESEE countries did not have a functioning banking system 30 years ago. Yet, the countries demonstrated that a financial system can be built very quickly when involving foreign banks and international financial institutions. While also expressing concerns regarding foreign funding, Claessens positively mentioned the Vienna Initiative and pointed out that the presence of foreign banks helped deal with domestic shocks.

Radovan Jelasity (CEO of Erste Bank Hungary) portrayed the difficult situation for CESEE at the start of the global financial crisis that spilled over to Austria via rising sovereign spreads and received high international media attention. Today, the situation is very different, as reflected by the favorable market valuations of banks engaged in CESEE. Moreover, banks present in Hungary today benefit from conditions absent in the euro area: robust GDP growth, positive interest rates and advantageous margins.

Francesco Mazzaferro (Head of the Secretariat of the European Systemic Risk Board – ESRB) shared some memories, particularly about the time when he worked at the EU Neighbouring Regions Division of the European Central Bank in the early 2000s. In this position, he contributed to the ECB's efforts to accompany the EU enlargement process. With regard to his current position he emphasized the importance of the ESRB recommendation on lending in foreign currency, that in his view was very successful.

In the discussion that followed, Stijn Claessens stated with respect to financial innovation and its implications for CESEE that, risks in the short run apart, fintechs might ease access to financing for SMEs and households. He warned against the possible misuse of technologies based on big data and emphasized that banks would need to act fast to adjust their business models. Radovan Jelasity emphasized the need for equal treatment with regard to regulation and costs arising for banks (e.g. special taxes for banks).

Modes of transition: the impact of different economic policy approaches

Doris Ritzberger-Grünwald (Director of the OeNB's Economic Analysis and Research Department) opened session 2 by pointing towards the variety of microeconomic reforms involving privatization and competition policies as well as institutional reforms and governance that characterized transition in the CESEE countries. *Marina Grušetvaja* (Professor at the RheinMain University of Applied Sciences) addressed the impact of different transition patterns and approaches to economic development in the CESEE EU Member States, Russia and the Ukraine. She explained that transformation in CESEE had also been inspired by the "Washington Consensus" (1989), as a strategy of economic transformation originally designed for South American countries, and the "Augmented Washington Consensus" (2000), which added measures mainly focused on institutional transformation. Analyzing the shock therapy (liberalization, privatization and deregulation) driving the move from planned to market economies, she showed the initial effects of output decline, high unemployment and inflation, followed by a steady economic recovery before and a slowdown of progress after EU accession. Russia and Ukraine showed strong similarities to the transition processes in the CESEE EU members, even though their economic recovery started later – not least because of the lack of EU accession perspectives. The main transformation challenges for Russia and Ukraine are the low quality of institutions and the decrease of FDI inflows.

Talking about "CESEE reunion with Europe," *Andrzej Sławiński* (Professor at the Warsaw School of Economics) highlighted the successful transformation of Poland and the Polish exchange rate regime in the early 1990s (initial fixing of the zloty to overcome hyperinflation, followed by a gradual floating) and the importance of currency boards for the Baltic states and Bulgaria despite their exposure to unsustainable lending booms. A lesson from the 1990s is that intervention on foreign exchange markets can be effective. Stabilizing inflation in the 2000s was easier than initially expected, supported by central banks' credibility after successful disinflations, the rising export potential of CESEE countries, the global fall in inflation and participation in European value chains, which accelerated economic convergence and facilitated the rapid reduction of trade imbalances. While the global financial crisis had made some new EU members cautious about joining the euro area, given the relative merits of floating exchange rates, Poland's increased economic and financial integration had lowered the exchange rate pass-through and stabilized the Polish zloty against the euro, reducing the value of the option to wait. Finally, Sławiński made the case for the promotion of innovations by (public) institutions, citing best practices from Israel, Taiwan, Ireland and Nordic countries.

1989: the year of great ambivalence

The dinner speech delivered by *Anton Pelinka* (former Professor at the Central European University) concluded the discussions on the first day. Pelinka stressed the all-European transnational nature of the Velvet Revolution that brought communism to an end in 1989 and the role of Gorbachev in ending the "Brezhnev Doctrine," which had vindicated Soviet military suppression in Berlin in 1953, in Budapest in 1956 and in Prague in 1968. In 1989, the post-Stalinist system surrendered peacefully, accepting its financial and intellectual bankruptcy in view of the strength of liberal democracies, i.e. multiparty systems checked by independent media and jurisdiction. National sovereignty regained in 1989 has since been relinquished for EU membership, and the integration of sovereign nation states should be pursued even further. Despite its imperfections, the "best Europe we ever had" has delivered peace, liberty and prosperity. After all, the post-national Europe implied by the "Jean Monnet Process" was a response to fascism, world wars and holocaust. The current neonationalist populism across Europe is evidently an attempt to escape the complexity of globalization.

Looking ahead, the EU as the biggest economic player worldwide still needs political tools to create a balance between America and Asia. And the EU is at a crossroads between three scenarios "between the end or the return of history": in Pelinka's view, either the principles of liberal democracies will prevail; or exclusion and European disintegration will be fostered by authoritarian movements acting on frustration behind the facade of democracy; or the EU will survive but muddle through as an unfinished federation – less democratic and weaker than the U.S.A. and China.

Keynote lecture #2 by Anders Åslund: "Ten lessons from 30 years of postcommunist economic transformation"

In his introduction to the second conference day, *Eduard Schock* (OeNB Executive Director) again highlighted the impressive speed of catching-up the CESEE countries have shown, having reached 58% of the per capita income level in the euro area by 2018, up from 36% in 2000. In this respect, *Anders Åslund* (resident senior fellow at the Eurasia Center of the Atlantic Council) emphasized the crucial role of fast and decisive reforms that need to be understood by the public but cannot always seek consensus with all players involved. In a severe crisis – such as the dismantling of communist rule in CESEE – newly appointed policymakers building on new ideas need to act fast to develop a comprehensive reform package, ideally with sufficient and timely international financial support. Other crucial factors for successful continued transition include open markets, transparency, good governance, the establishment of property rights and rule of law. Here, the EU can assert a positive influence on countries inside the EU and with or without an EU membership perspective alike. For countries without an EU perspective, more engagement in the EU's Eastern Partnership is needed with an emphasis on financial support and education.

Can Europe/CESEE learn from Asian catching-up experiences?

In opening session 3, *Michael Landesmann* (Senior Research Associate of the Vienna Institute for International Economic Studies – wiiw) highlighted above all the differences in the catching-up process between CESEE and in East Asia. While East Asian countries have built up domestic human capital and R&D bases (industrial policy), CESEE economies have largely relied on FDI inflows. While East Asia opted for gradual economic opening, CESEE went through very fast liberalization and was soon dominated by foreign banks. While in East Asia the state played a strong role in catching-up, in CESEE catching-up was driven by the EU accession process (the acquis communautaire) and EU membership. Looking ahead, East Asia may be on the path of increasing regional integration, whereas CESEE is facing the task of shifting to more innovation-oriented growth while grappling with serious demographic problems.

Khee Giap Tan (Co-Director of the Asia Competitiveness Institute at the National University of Singapore) explained the East Asian economic development (EAED) model and its experiences, which, he underlined, may be very useful for CESEE. To promote catching-up, EAED features an important role for government and industrial policy (starting with infrastructure modernization) and gradual financial integration and trade liberalization, also in countries with limited or guided democracy. Concerning the U.S. protectionist turn under president Trump, Khee Giap Tan argued that China's rise is a given because it is impossible to stop the Chinese from "thinking innovation." He made the case for more pragmatism and calmness in the EU's stance toward the Belt and Road Initiative – China's new global trade route linking Asia, Africa and Europe – since with Beijing's immense experience in infrastructure development, "China can do it cheaper, better, faster."

Ágnes Szunomár (Economist at the Hungarian Academy of Sciences) argued that CESEE offered China strategic entry points to the EU, given lower political expectations and fewer domestic protectionist barriers. In the case of Hungary, Austria, of course remains a larger trading partner than China, and 80% of Hungarian exports to China are generated by German corporations. In turn, CESEE's wish to cooperate with China may partly stem from disappointment from not catching up (more quickly) with advanced EU members. In the case of the Western Balkans – the key recipient of Belt and Road infrastructural expenditures in CESEE – the exposure to China may reflect dissatisfaction with remaining outside the European Union.

Possible further reasons for CESEE's expanding cooperation with China and other powers were discussed lively with the audience. Ágnes Szunomár pointed out that rapid EU enlargement to Central and Eastern Europe in 2004 and 2007 possibly nurtured unrealistic expectations in the Western Balkans, prompting disappointed governments to reach out to China, Russia et al. On the issue of relations between China and Russia, Khee Giap Tan pointed out that these are obviously at a high level at present and that hostile U.S. policies have helped push the two giant neighbors together.

Monetary and financial stability challenges

In session 4, *Johannes Wiegand* (Division Chief at the IMF) provided an assessment of CESEE countries' choices of monetary and exchange rate regimes. He stressed that most countries with fixed exchange rate regimes today were hit by traumatic hyperinflation in the 1990s. In such a case, pegging is arguably the right regime, consisting in prioritizing monetary stability over fine-tuning the monetary stance. Moreover, some economies may be too small to make floating worthwhile. These countries with (quasi-)fixed exchange rates have a bigger interest in adopting the euro, as this would greatly facilitate macroeconomic management, with FX deposits becoming domestic deposits and banks having direct access to euro liquidity. For them, whether inside or outside the euro area, strong use of countercyclical fiscal and macroprudential policies would be required to make convergence less bumpy despite a somewhat misaligned monetary stance. Looking at the Baltics, which adopted the euro without prior floating, wage and price pressures returned as part of real convergence, but financial imbalances have not (yet) reemerged, probably partly thanks to strong macroprudential frameworks put in place in the meantime.

Against this background, *Markus Eller* (Principal Economist at the OeNB) presented a study co-authored with the session chair *Helene Schuberth* (Head of the OeNB's Foreign Research Division) and others on the impact of macroprudential policies in CESEE countries, in view of their pronounced boom-bust cycles in capital flows and credit over time. They found that macroprudential policies could be indeed effective in containing credit growth and capital inflows in CESEE. However, the implemented macroprudential policies have apparently not yet been effective in dampening the strong recent house price increase in the region. House price growth might possibly be contained more effectively with borrower-based measures rather than capital-based measures.

Primož Dolenc (Vice Governor of the Bank of Slovenia) shared the case of a severe crisis hitting Slovenia in 2013 as a result of several structural factors, including a banking system dominated by three large state-owned banks, high dependence on foreign wholesale funding, deficiencies in banks' credit approval processes and lending to a highly indebted corporate sector and to financial holdings with no or poor collateral. This situation was further aggravated by cyclically weak domestic economic activity. Swift action by the authorities provided for the transfer of a large share of nonperforming claims to a bad bank; the recapitalization of banks via cash injections and government securities; and the write-down of subordinated instruments (bail-in). By 2019, the share of nonperforming claims had declined to 1.5% (from 18% in 2019), and the total capital ratio had increased to 19.8% (from 14.0%). Also, the largest banks have been privatized to majority foreign owners.

Keynote speech #3 by Martin Selmayr

Martin Selmayr (Ambassador of the European Commission to Austria) reflected on where Europe stands 30 years after the fall of the Iron Curtain and where the place of CESEE is in this new constellation. For one, key functions have been assigned to CESEE leaders in the new European Commission (2019–2024): Executive Vice-President Valdis Dombrovskis is responsible for an "Economy That Works For People & Financial Services," and three out of five vice-presidents are from the CESEE region: Věra Jourová (Values and Transparency), Maroš Šefčovič (Inter-institutional Relations and Foresight) and Dubravka Šuica (Democracy and Demography). The main topics of the new European Commission are closely related to CESEE, too. CESEE countries are among the digital forerunners and carbon reduction laggards alike. Building a green European economy will rely on the solidarity and responsibility of member states no less than the search for viable compromises on the protection of the EU borders, common procedures for asylum seekers, and meaningful action to address the challenges of aging, labor migration and brain drain. Finally, President von der Leyen took office with a vision of a "geopolitical Commission" that redefines the EU position in the world. This includes defining the relationship with Russia, whose biggest enemies and friends are located in CESEE.

Martin Selmayr concluded with five recommendations. First, the EU must learn the language of power to position the EU in the world (which presupposes a strong and united Europe). Second, the EU must listen carefully to its neighbors, and EU accession talks must be pursued further with all candidate countries and potential candidates. Of course, there can be no progress and no EU entry without the rule of law – recently strengthened with a landmark decision of the European Court of Justice, which ruled that the independence of national courts in the EU is essential for the functioning of the single market in the EU as the courts apply the commonly agreed EU rules directly. Likewise, since the euro is at the heart of the EU project, every EU country should seek to introduce it sooner or later. Third, the EU budget is policy and solidarity in numbers. The budget might seem small from a bird's eye perspective, nevertheless, its impact on investment and growth in the CESEE countries is beneficial – for the net contributors as well. Fourth, growth-oriented policies that foster also investment into CESEE economies are key. This strengthens domestic demand, which in turn could shield the EU from rising global trade volatility. Finally, plurality and diversity are valuable assets; hence independent EU institutions need to reflect the diversity of the societies. As such, also gender equality is not simply an ideology but a necessity for the legitimacy of European institutions.

The future of CESEE: the impact of megatrends

The concluding session of the conference was chaired by *Thomas Steiner* (OeNB Executive Director). In his introductory remarks, he highlighted the relocation of global power from the West to the East, as reflected among other things in the increasing soft power exerted by China through its Belt and Road Initiative. The subsequent speakers addressed further important megatrends such as climate and demographic changes.

Ada Ámon (Senior Associate at Third Generation Environmentalism – E3G), argued that the Iron Curtain as a former East-West divide has now been replaced by a Coal Curtain of Europe. In 2030, the same line on the map will mark the divide of the EU: In Western EU countries, the share of renewable energy will amount to around 50% while in the CESEE EU countries the share is expected to reach only 20% to 25%. She stressed that the Visegrad group of countries – the Czech Republic, Hungary, Poland – are ignoring climate threats, attempting to extend fossil fuel burning, violating air pollution limits and undermining the development of renewable energy. According to Ada Ámon, this is particularly worrisome as the Visegard group plays a significant role in setting the agenda for the rest of the CESEE EU Member States. The European Commission is currently the only active and forceful agent pushing the development of a new renewable energy generation that could prevent the emergence of a coal curtain to some extent. Ámon argued that the national energy and climate plans as well as the next EU budget (2021–2017) provide great opportunities to improve the green transition in the CESEE countries.

Alexia Fürnkranz-Prskawetz (Professor at the Vienna University of Technology) addressed another East-West divide, created by rapid population declines in many CESEE countries versus population increases in Western EU countries. Population decline in the CESEE countries is due to collapsing fertility after 1989 and its slow recovery, lower life expectancy than in the West and strong outmigration. Looking ahead, migration pressures in and migration flows from CESEE, in particular in poorer and destabilized countries, are expected to stay high. Furthermore, past migration and low fertility lead to shrinking numbers of women in reproductive age and to long-term declines in the number of births. Hence, population aging and population shrinking, especially in peripheral regions, present a major future challenge for the CESEE countries.

Mario Holzner (Executive Director of the Vienna Institute for International Economic Studies – wiiw) reported that most CESEE countries are rapidly approaching the tipping point where labor demand equals labor supply. Automation, measured as the use of multipurpose industrial robots in the automotive industry, is generally lower in the CESEE countries than in Western European countries, Japan or the U.S. The new digital economy provides the CESEE countries with a new catching-up opportunity, if it were not for the fact that most CESEE countries are digital transformation laggards.

Summing up, the transformation itself was mostly seen as having been extremely successful: per capita income levels have increased impressively, far-reaching reforms have been implemented swiftly and decisively, and macroeconomic and financial stabilization has been reached. Still, the achievements of the past 30 years have also come at a cost, including deep initial recessions and structural shifts accompanying price liberalization, which caused significant economic hardship. Looking forward, major challenges were identified for the next 30 years: the relocation of global power from the West to the East, nationalist tendencies and consequently declining support of European integration, demographic change and outmigration.