Conference on European Economic Integration 2014: The Rebalancing Challenge in Europe – Perspectives for CESEE

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The Conference on European Economic Integration (CEEI) 2014, which the Oesterreichische Nationalbank (OeNB) hosted in Vienna on November 24 and 25, 2014, focused on the rebalancing challenges in Central, Eastern and Southeastern Europe (CESEE) and the euro area.[2] The presentations and debates offered interesting insights, for instance: (1) The EU convergence process has slowed down but might be revived by closing the investment gap and promoting reindustrialization. (2) Sequencing private and public balance sheet repair is critical in a balance sheet recession. Income inequality can be both the source and the consequence of macroeconomic imbalances. (3) The current external rebalancing in the euro area periphery and in CESEE may be structural rather than cyclical even if it is import and demand driven. (4) The first choice when it comes to easing the cost of rebalancing in terms of growth and employment would be fiscal policy, but fiscal policy is legally constrained. (5) Monetary policy is the second choice, but it is less effective at the zero low bound. (6) Structural reforms such as the recent advances in banking sector regulation and coordination might be less desirable in the short term than in the long term.

Around 420 participants from 35 different countries attended the CEEI 2014 to listen to presentations and discussions by high-ranking representatives of central banks, international organizations, the business and banking sectors, and academia.

In his opening remarks, *OeNB* Governor *Ewald Nowotny* referred to three important anniversaries: 25 years since the fall of the Berlin Wall, 15 years since the introduction of the euro and 10 years since the (so far) biggest round of EU enlargement. He affirmed that for an overwhelming majority of Europeans, these watershed events implied a marked rise in living standards and the level of freedom. Enlargement was a "win-win situation" for the acceding countries, the EU as a whole and Austria with its strong links to the CESEE region. As Nowotny pointed out, however, "the crisis has revealed that the previously remarkable catching-up process is neither automatic nor irreversible." In some cases, a strengthening industrial base helped economies escape the dilemma of either chronic disequilibria or contractive deleveraging. The 18% decline in investment levels across the EU-28, however, has negative consequences for present and future growth. Nowotny commended the countries at the Southern and Eastern European periphery for improving their external competitiveness but regretted that the price for this progress was high unemployment, stating that the macroeconomic environment will have to improve all over Europe to make rebalancing successful. Nowotny dismissed the popular presumption that "There is no alternative," supporting the investment package proposed by the new European Commission.

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[2] *The conference proceedings will be published by Edward Elgar Publishing Ltd. in the course of 2015. Presentations and papers, information about the speakers and the conference program are available at www.oenb.at.*

He also underlined the successful creation of the banking union as a major step toward completing the architecture of Economic and Monetary Union (EMU).

The Role of Investment in a New Growth Model for CESEE

In the first keynote lecture, *Sir Suma Chakrabarti,* President of the *European Bank for Reconstruction and Development (EBRD),* addressed the rebalancing challenges for the CESEE economies. While the EBRD has strongly supported the development of local currency and capital markets, Chakrabarti said that capital flows from advanced to emerging economies in Europe are a good business for both sides. He welcomed some rebalancing in the ownership structure of banks toward domestic ownership as long as this rebalancing was based on market principles without implying any "targets" for national ownership. He also pointed to the importance of high-quality investment, which is a key precondition for growth-enhancing high-impact infrastructural projects. In Chakrabarti's view, the CEEI 2014 addressed a crucial agenda for the coming years, namely the building of a sustainable growth model rooted in domestic productivity growth. Despite a slight slowdown in the post-crisis period, structural reforms continue to be essential for growth and convergence. In this context, Chakrabarti pointed out four challenges: First, dealing with the post-crisis overhang of nonperforming loans (NPLs), which has become a renewed priority under the Vienna Initiative; second, addressing corporate debt distress, which underlines the need for a legal environment that encourages financial restructuring as promoted in the Austrian parent bank groups' initiative; third, mitigating the precipitous decline in both public and private investment; and fourth, invigorating innovation, given the exceptionally low levels of public and private R&D spending in CESEE. In the future, growth will need to be more balanced, Chakrabarti concluded – between different sectors, between domestic and external demand, and between different forms of funding.

Risk Aversion Disturbs European and Global Economy

J. Bradford DeLong (University of California) started the second keynote lecture with an appraisal on what has been achieved in Europe over the centuries, focusing in particular on the unprecedented success of economic integration and growth in post-World War II Europe and pointing out that current problems, by comparison, were relatively small. The major problem today, according to DeLong, is the shock triggered by the 2008 collapse of Lehman Brothers and its aftereffects. The 2008 shock is best viewed as a collapse in risk tolerance on both sides of the North Atlantic. The shock was good, on the one hand, because savers have become more cautious, and bad, on the other, because savers are less willing to bear risk. But in an economy, someone must assume the risk-bearing function. Prior to the crisis, when both perceived return and risk tolerance were high (and probably too high), the European convergence model employed "peripheral" labor in extremely risky enterprises at high equilibrium wages. To properly rebalance the European economies, wage levels in the euro area periphery must adjust to match productivity levels – given the resistance of core euro area taxpayers against permanent fiscal transfers. Countries outside the euro area can use exchange rate policy to restore competitiveness, although this can lead to high inflation. Within the euro area, where devaluation is not a possibility, there are other options to replace missing

risk tolerance: (1) large-scale loan guarantees, asset purchases or public spending programs to save "peripheral" firms; (2) structural reform to boost "peripheral" firms' productivity; (3) "peripheral" euro area deflation or core euro area inflation. DeLong suggested to attempt all these and to remain flexible enough to reverse course if one of these options appears too costly to implement.

Difficult Monetary Policy Trade-Offs in CESEE

The panel discussion among high-level CESEE central bank representatives was opened by *Lars E.O. Svensson,* Professor at the *Stockholm School of Economics.* He claimed that in normal times, monetary policy and financial stability policy should be conducted independently, whereby each policy should be fully informed of, and take into account, the conduct of the other. However, in instances where one policy fails to achieve its objective, the other policy must be able react to this failure as a last line of defense. Hence, full cooperation between both types of policy is needed in times of crisis. Svensson said that the current euro area situation, with inflation below the target, was problematic and advocated quantitative easing as an effective tool at the zero lower bound.

Daniel Dăianu, Member of the Board of *Banca Naţională a României,* recalled that some challenges to monetary policy arise from older dilemmas – such as constraints caused by unlimited capital flows, persistent high inflation and the transition crisis. He mentioned the painful adjustment of huge current account deficits in Romania that were coupled with the misallocation of resources into nontradable sectors. New dilemmas for many CESEE economies derive from substantial capital in- and outflows, the impact of EU sanctions against Russia and a general lack of policy coordination. *Nikola Fabris,* Vice-Governor of the *Central Bank of Montenegro,* outlined the experience of a small country whose policy space is extremely limited due to euroization. The main objective of the Central Bank of Montenegro is financial stability, with reserve requirements serving as the only effective macroprudential policy instrument. *Raimondas Kuodis,* Deputy Chairman of *Lietuvos bankas,* observed that the conventional policy mix has reached its limits in the current crisis and that therefore unorthodox policies are to be used. He pointed out that distributional aspects of monetary policy have not received enough attention and pleaded for the use of macroprudential policy to address business cycle fluctuations caused by credit growth. He also referred to the functional finance argument, which states that increasing public debt can be tolerated as long as unemployment and inflation are kept low. *Miroslav Singer,* Governor of *Česká národní banka (CNB),* explained how the CNB had recently been able to reconcile both inflation and exchange rate targeting and hence use its full policy space despite pressure from international capital markets.

The general discussion first centered around the Czech policy experiment, which was generally judged as being successful even if other factors (e.g. reviving domestic demand) were also seen as having been instrumental. Prompted to comment on the prospects for euro adoption, both Singer and Dăianu confirmed their countries' commitment. Dăianu also stressed the need to further improve EMU in a pragmatic way. Panelists agreed that it remains key to preserve ample room for monetary policy and to have as many policy instruments as possible at one's disposal. OeNB Governor Nowotny concluded the panel discussion by highlighting that an evaluation of the criteria for euro introduction should focus on

sustainability. It is in the interest of both the euro area and other EU Member States to make the euro a long-term success and achieve real economy convergence.

Balance Sheet Adjustments Dampen Economic Growth

OeNB Executive Director *Kurt Pribil* gave a short introduction to Session 1 on "Balance Sheet Adjustments and Economic Growth" by turning the attention to balance sheet recessions, debt overhangs and the associated question of the optimal sequencing of adjustment across institutional sectors. He highlighted two crucial policy questions, namely whether Europe is at the beginning of a stagnation period and whether current efforts of banking regulation are jeopardizing the current recovery.

Jan in 't Veld from the *European Commission* focused on current deleveraging and argued that debt overhangs and balance sheet repair are currently important drivers of the slowdown in economic growth. Furthermore, he distinguished between "passive" deleveraging, which is characterized by still positive net credit flows associated with even faster (nominal) GDP growth, and the much more painful "active" deleveraging, which is driven by negative net credit flows. With reference to model-based scenarios, he was able to show that the cost of private sector deleveraging is considerably higher when it is combined with public sector deleveraging. He proposed further unconventional monetary policy measures, a fiscal demand stimulus in public infrastructure and the implementation of structural reforms as possible policy responses.

Richard Koo, Chief Economist at *Nomura Research Institute,* addressed the issue of balance sheet recessions by comparing Europe with Japan. According to his line of argument, as a consequence of the bursting of the asset price bubble, balance sheets are currently under water and firms pay down debt despite of zero interest rates, i.e. they minimize debt instead of maximizing profits. In the euro area and many other advanced economies, the corporate sector has considerably increased its financial surplus during recent years. In such a situation, according to Koo, the government is the only sector still willing to borrow and therefore should step in to increase aggregate demand. In the euro area, Koo identified two main structural deficiencies, namely the fiscally restrictive Maastricht Treaty and the existence of procyclical and destabilizing capital flows between government bond markets.

Helene Schuberth (OeNB) took a closer look at the role the nonfinancial corporate sector plays in sluggish EU recovery. She highlighted the significance of interrelated balance sheets across institutional sectors and the massive drop in private sector demand in many EU economies following the 2008 crisis. From a micro perspective, falling capital expenditures are associated with a significant increase of cash holdings among large (listed) firms in the euro area. This indicates that large firms aim at becoming more independent from external funding sources in an environment of high uncertainty. Furthermore, the significant external rebalancing at the macro level is found to be based rather on a drop in investment than on an increase in national saving. This massive decline in investment further jeopardizes the European convergence process, as poorer countries have discontinued their investment overproportionally.

Macroeconomic Imbalances Are Related to Economic Inequality

The next session dealt with an aspect very often overlooked in discussions: the two-sided link between macroeconomic imbalances and economic inequality. As the session's chair, *OeNB* Director *Doris Ritzberger-Grünwald* pointed out that the trend of mounting external imbalances and diverging income levels was only interrupted temporarily during the crisis. In the meantime, economic research has found that these developments are important factors in hindering economic growth and reducing growth prospects in the euro area.

Michael Kumhof (IMF), who gave his presentation via video recording, focused on the U.S. case. Comparing the pre-1929 and the pre-2008 decades, he observed sharply increasing income inequality, mounting debt leverage of low- and middle-income households and wealth inequality accompanying income inequality. Households' increasing debt leverage eventually triggered a large financial and economic crash. Differentiating between top earners (top 5% of incomes) and bottom earners (the rest), his theoretical model tracks the data very well. He concludes that rising income inequality was the main driver of debt growth as top earners save the additional funds while bottom earners borrow to increase consumption. He concluded that, as crisis probability rises with debt, income inequality was also a key contributing factor to the 2008 crisis.

Till van Treeck, Professor at the *University of Duisburg-Essen,* confirmed Kumhof's finding that with top earners' rapidly rising income shares, the savings rate in the U.S.A. declined and debt increased as low income households dissaved and borrowed to increase consumption. This resulted in rising current account deficits. The German case is different as it is dominated by small and medium-sized, family-owned firms which retained profits within the company instead of distributing bonuses and dividends. Thus the top income shares hardly increased in boom years, and corporate financial balances increased strongly. Weak domestic demand in Germany and its current account surplus are hence not the result of weak equipment investment but rather of excessive retained corporate profits.

Mario Holzner, Deputy Director of *The Vienna Institute for International Economic Studies (wiiw),* focused on the countries in CESEE and the CIS. He showed that income inequality is low in the more industrialized core CESEE countries, but high in the northern and southern periphery of the region and even higher in the CIS. Just as in advanced economies, inequalities contributed to credit growth, bubble formation and imbalances, which in turn cemented inequality. In his view, industrial policy and social partnership could contribute critically to the establishment of a balanced and prosperous economy.

Future Growth Strategies in CESEE Rest on Productivity

In his dinner speech, President *Marek Belka (Narodowy Bank Polski – NBP)* discussed the mid-term growth perspectives of Poland as an example for the whole CESEE region. He started with an appraisal of the real convergence process after transition. Between 1995 and 2012, GDP per capita in Poland more than doubled in purchasing power parity (PPP) terms, reaching around 60% of the EU-15 average. The implied catching-up by an impressive 25 percentage points originated mainly from the accumulation of both physical and human capital. Belka noted, however, that the prospects for future growth stemming from traditional sources, which in turn are related to factor accumulation, are rather gloomy – both for Poland and for

many other CESEE countries. EU cohesion funds aside, foreign investment – the main productivity driver so far – tends to diminish, overinvestment is becoming a potential threat (particularly in countries with fixed exchange rates) and skill accumulation in human capital cannot last forever, given worrying demographic trends. Similarly, the growth effects from sectoral shifts gradually dry up: The reallocation of resources from agriculture to services lifted the productivity level, but continued shifts from manufacturing to services tend to lower productivity growth. "The only way to ensure rapid growth in GDP per capita in the future is to encourage ongoing increases in total factor productivity. This calls for a well-crafted policy related to the issues of R&D, technology adoption and our countries' position in the global value chain," Belka concluded. When asked about Poland's perspective of euro introduction, Belka stated that the crisis has revealed the importance of improving shock resilience before losing exchange rate flexibility. He also suggested that EMU should solve its governance problems by mimicking a state with all its essential institutions rather than relying on rules.

Quantitative Easing in the Euro Area via Synthetic Bonds

The second conference day started with a keynote lecture by *Lucrezia Reichlin,* Professor at the *London Business School.* Maintaining that the ECB's targeted inflation rate is increasingly being undershot and expected inflation has continued to decline, Reichlin expressed doubts about how the ECB will re-anchor inflation expectations without implementing a considerable quantitative easing (QE) program. Between 2008 and 2010, when the euro area was confronted primarily with a liquidity crisis in the interbank market, the ECB did not to have to resort to QE (unlike the U.S.A.). But the current situation of prolonged economic stagnation, together with policy rates that have reached the zero lower bound, is reminiscent of traditional macroeconomic crises when the central bank runs out of tools. When pursuing macroeconomic stabilization, there is therefore not really an alternative to QE. However, its implementation, according to Reichlin, is subject to fundamental difficulties. When it comes to the required size of QE, the current ECB purchases of asset-backed securities (ABS) will not be sufficient as the ABS market is rather small. Thus, sovereign bond purchases will also be necessary. To deal with the related moral hazard issues (e.g. reluctant budgetary discipline), more safe assets would be needed at the euro area level; however, such safe assets do not yet exist. Reichlin therefore proposed that for its QE operations, the ECB should exclusively use a synthetic safe bond formed by euro area national bonds combined in GDP-weighted proportions. Only the senior tranche of this synthetic bond should qualify as risk-free for regulatory purposes. According to Reichlin, this solution would eliminate incentives for misbehavior as banks would be protected from the fallout of government defaults and reduce investors' geographic bias in the flight to safety.

External Rebalancing Is Both Cyclical and Structural

The third session focused on the main determinants of the reduction in external imbalances observed since the outbreak of the crisis. *OeNB* Executive Director *Peter Mooslechner,* who chaired the session, recalled that despite significant progress in external rebalancing, many emerging economies are still vulnerable – a fact

that became obvious from the effects of the Federal Reserve's announcement that it would start to taper its bond-purchase program.

Daniel Gros, Director of the *Centre for European Policy Studies,* noted that not everything that is noncyclical is automatically structural. In particular, he referred to co-movements in both cyclically adjusted as well as unadjusted trade balances that have been observed in the euro area despite the fact that trade balance adjustment is largely attributable to import compression, which is typically considered a cyclical factor resulting from weak demand in most European economies. With respect to the large corrections that have taken place since 2008, he stressed that adjustments have been observed in deficit countries while little has changed in the current account balances of surplus countries. Hence, Gros was reluctant to label such unidirectional shifts "rebalancing." Turning to the CESEE countries, which showed a particularly strong reduction in their current account deficits, he concluded that improvements in competitiveness – as evidenced by real depreciations – were beneficial in addition to CESEE's geographical position close to the Russian market, which was dynamic until the outbreak of the Ukrainian crisis. He concluded that improvements in (price) competitiveness dominated in the recent external rebalancing of both CESEE and euro area economies. Structural factors such as targeting growing export markets were only of minor importance.

The second speaker, *Stefan Zeugner* from the *European Commission,* confirmed the view that most of the external imbalance adjustment in the euro area was noncyclical. However, he approached the topic from a supply-vs.-demand perspective rather than from a trade perspective. He recalled that adjustment in Europe resulted from declining demand in the periphery along with sluggish demand (below supply) in the core euro area. With inflation below target, the outlook for nominal GDP has started to worsen recently in the core euro area, compounding the declining trend in nominal GDP in the periphery countries and causing the debt-to-GDP ratio to worsen. This shortfall in "structural" demand arises from lower potential growth and is thus clearly not cyclical. He concluded that given this noncyclicality, the large deficits of the past are not going to reappear. But this piece of good news hides some very bad news as the underlying reasons for trade adjustment are lower demand and lower potential growth in Southern Europe. He deduced that more inflation and growth through investment in Northern Europe will be necessary.

The ensuing discussion centered on persistent surpluses in the core countries, swings in financial fragmentation within Europe as well as the impact of the financial cycle on current account imbalances and the fact that the net international investment positions of euro area economies have not seen any rebalancing so far.

Banking Sector Regulation: The Glass Is Half Full

The final panel brought together the views of bank representatives, regulators and researches. *OeNB* Vice Governor *Andreas Ittner* recalled three crucial lessons for banking regulation from the Austrian perspective: regulation should be harmonized, capital ratios should be increased and macroeconomic policies should be coordinated. *Thorsten Beck,* Professor at *City University London,* asserted that we were only midway to a successful banking union. While the Single Resolution Mechanism (SRM), the establishment of the Single Supervisory Mechanism (SSM) and the comprehensive assessment exercise were steps into the right direction, he

called for a euro area-wide insurance with back-stop funding by the European Stability Mechanism (ESM) and a European recapitalization agency.

Adrian Blundell-Wignall, Director of Financial and Enterprise Affairs at the *Organisation for Economic Co-Operation and Development (OECD),* insisted that capital ratios are an inferior indicator for institutions' propensity to default. An improved regulatory framework should therefore also focus on leverage ratios, since the risk-weighting process is polluted by banks' incentives to reduce their capital ratios as far as possible. *Irmfried Schwimann,* Director of the Directorate-General for Competition of the *European Commission,* echoed that the hike in the return generated through high leverage ratios was achieved only by implicit insurance through tax payers. Tighter regulation thus need not necessarily be detrimental to growth but might even foster competition. Based on his experience in the Netherlands, *Wim Boonstra,* Chief Economist of *Rabobank Nederland,* highlighted that regulatory capture can become a serious problem as unhealthy banks might be kept alive insensibly long. The most important feature of a regulatory system therefore was the possibility to unwind banks without causing costs for the tax payers. *Barbara Potisk-Eibensteiner,* Chief Financial Officer of *RHI AG,* who represented the nonfinancial sector on the panel, pointed to the asymmetric financing conditions nonfinancial corporations are facing. Unlike small and medium-sized enterprises, large corporations can increasingly refinance themselves and benefit from a reduction in lending costs through liquidity injections by monetary authorities. However, since firms' trust in banks has significantly decreased, relationship lending might be the business model banks will opt for in the future. Finally, *Gunter Deuber,* Director of *Raiffeisen Bank International AG,* could not confirm a credit crunch for CEESE countries. Also, he was far more cautious with regard to further banking regulation than his co-panelists. He concluded that it was time for a "regulatory pause" even if more equity in the banking sector would be useful in general.

The panel's views on the shadow banking sector varied. Beck underlined its importance for competition, and Blundell-Wignall stressed its increasing role in bypassing banks and directly providing long-term investments. Contrary to that, Boonstra was worried about the quick rise of shadow banking and argued that the next crisis might be arising in this segment.

In his concluding remarks, OeNB Governor *Nowotny* expressed his gratitude for the excellent food for thought the CEEI 2014 had provided in the current economic situation. He pointed out that many people still consider all CESEE countries emerging market economies, while the conference made it clear that several CESEE countries have a well-established and functioning market economy that is well beyond the stage of "emerging." Finally, he invited all participants to next year's conference: The CEEI 2015 will be held in a greater European format as a joint venture with the *Conference on the Future of the European Economy (CFEE)* of *Narodowy Bank Polski (NBP)* and take place in Warsaw, Poland, on October 15 and 16, 2015.