

Ewald Nowotny
Governor
Oesterreichische Nationalbank

SPEECH

Vienna, November 15, 2010

Check against delivery!

Catching-Up Strategies after the Crisis

Opening Remarks CEEI 2010

Ladies and gentlemen!

It is a great pleasure for me to welcome you to our annual Conference on European Economic Integration. The Oesterreichische Nationalbank (OeNB) has been hosting this event for many years, offering a forum for lively debates between distinguished panelists from national and international institutions, politics, banking and academia. I am glad that such a sizeable number of participants and speakers show an interest in this year's conference theme.

Implications of the Financial Crisis for CESEE Countries

As you all know, the last two years have been characterized by the global financial crisis. In its early stage, the crisis had been confined to advanced economies. Local and foreign banks in Central, Eastern and Southeastern European (CESEE) economies held only a negligible amount of so-called toxic assets. Nevertheless, excessive risk-taking put the global financial system under serious stress, which had an adverse impact on the world economy.

The CESEE economies were particularly affected by output declines. These were also caused by accumulated vulnerabilities in the region, especially the credit boom (Backé and Wójcik, 2008, Fidrmuc and Hainz, 2010) and foreign currency lending (Dvorsky et al., 2010). The output loss, with average GDP decline amounting to -3% in new EU Member States and to -6% in all CESEE countries in 2009 (IMF, 2010), was deeper than we expected. In turn, we can see slight improvements in this region this year. Therefore, as reflected in its title, this year's conference

is forward looking, dealing with catching-up strategies after the crisis. The beginning of 2010 actually featured developments which were better than expected and fueled the hope that the crisis was already passing away. Nearly all CESEE countries (with the exception of Bulgaria and Romania) are expected to grow during this year (Schreiner et al., 2010). However, the growth is fueled mainly by restocking and external demand. Moreover, the forecasts for 2011 and 2012 remain modest. The growth prospects are still fragile and there are significant downside risks. The growth path will remain below the pre-crisis trend for the coming years.

Light at the End of the Tunnel, but Challenges Remain

After the positive trend in the first half of 2010, we can now begin to see the light at the end of tunnel, but we have still much to do. The previous output declines have to be taken as an incentive to reduce vulnerabilities in the region and to continue economic and structural reforms. Fiscal stabilization will represent an extraordinary challenge for the next few years. Fiscal debt has increased in all countries during the last two years. Prior to the crisis, the new Member States had a relatively low level of public debt (37.4% of GDP), but it increased by nearly 10% of GDP on average alone in 2009 (IMF, 2010). Although this level is still lower than the public debt of the euro area (87% of GDP), we have to return to a sustainable growth path. The new Member States will have to increase their efforts in order to stabilize public finances and fulfill the Stability and Growth Pact. We have to use every possibility of financial stabilization, while at the same time keeping in mind also the global fragile growth prospects.

Exchange rate developments represent another important challenge. We can see that currently, the euro is gaining strength. This has also important implications for CESEE economies where both the euro and demand from euro area countries play an overwhelmingly important role. Exchange rate appreciations may have negative implications on Europe's external – but indirectly also on internal – trade.

The development of CESEE has important implications for the Austrian economy due to strong linkages through trade and FDI. Austria has been deeply rooted in the Central European region. We are part of the Central European family. Actually, Austria has made effective use of its geographic location during the two decades since the fall of the Iron Curtain. It has become one of the most important investors in the neighboring Central European countries. Despite the recent financial crisis, Austria increased its market shares especially in Central Europe, for

example in countries like Slovenia and Slovakia which have adopted the euro (Ritzberger-Grünwald and Wörz, 2010). During the financial crisis, Austria's links to CESEE economies have been seen as a potential source of vulnerability of the Austrian economy, especially with regard to Austrian banks investing intensively in CESEE. These concerns did not materialize.

In September 2010, the international banking regulations were revised as part of the Basel III agreement. The Oesterreichische Nationalbank and the Austrian Financial Market Authority (FMA) participated in these preparations from the beginning. The new regulations will ensure improved financial stability. However, there are also potential risks related to these regulatory changes. The banks in our region are characterized by relatively low capitalization. This may force some banks to reduce credit volumes to comply with the new regulations.

Monetary Union Contributes to Financial Stability

During the financial crisis, the euro has kept and improved its position as a global currency (ECB 2010). In addition, the euro has acted as a shelter not only for the participating countries, but also for a broader European region. This was impressively documented by the CEEI 2009 on "The Euro's Contribution to Economic Stability in CESEE" (Nowotny et al., 2010).

After the accession of Estonia in January 2011, the euro area will consist of 17 countries with an overall population of approximately 330 million. Thus, the European Union has showed its ability to make important decisions also during hard times. This also proved that the European Union is based on the equal treatment principle.

Policy Challenges for Catching-Up Countries

Several issues should be discussed during the next two days:

First, the financial crisis brought about also a liquidity trap and a credit crunch. Not only emerging economies have faced capital flights and sudden stops. These features were not unique to this financial crisis, but their impact on selected CESEE countries was much higher than before. The question is whether this will have negative implications on growth rates. In turn, countries have to introduce structural policies aiming at reducing vulnerabilities: Although the new Member States already reduced their external deficits to an estimated 1.7% of GDP in 2010, these deficits are expected to rise slightly in 2011 (IMF, 2010).

Second, the CESEE economies will most likely face lower capital inflows because investors have become more risk averse. Therefore, the CEEI 2010 should also address the question whether there will be alternative sources of growth. In turn, lower capital inflows might also have positive effects. Sustainable growth appears superior to a boom-bust cycle, which was fueled by capital inflows in the past.

Third, budget consolidation is an important issue in all CESEE. However, infrastructure needs also further investment in this region. This confronts economic policy with the old problem of squaring the circle. Some programs can be supported by the structural funds of the EU, but these funds are limited, and they also require rare domestic cofinancing funds. Possible solutions include e.g. public-private partnerships.

Finally, the fiscal crisis again underlined the importance of competitiveness (Feldkircher et al., 2010), which has to be supported especially by wage developments. However, the wage level remains above the level in CIS countries and China. This puts the CESEE region under significant pressure.

Let me conclude and stress that catching-up strategies after the crisis represent an important policy challenge for the next few years. Having successfully weathered the storms of the worst financial and economic crisis of postwar history, the euro has been and will continue to be an important anchor of growth in a broader European region. This conference demonstrates readiness to open a discussion about future growth models. We will have a unique possibility to compare views from countries that have not yet joined the EU or the euro area with the experience of EU and euro area members. I am looking very much forward to hearing, discussing and learning from the opinions of policymakers, bankers and academics over the next two days.

It is now a great pleasure for me to welcome our first keynote speaker, Vítor Constâncio, the Vice President of the European Central Bank.

Mr. Constâncio, the floor is yours!

References

- Backé, P. and C. Wójcik, (2008): “Credit Booms, Monetary Integration and the New Neoclassical Synthesis”, *Journal of Banking & Finance*, 32, 458- 470.
- Dvorsky, S., Scheiber, T. and H. Stix (2010): “Real Effects of Crisis Have Reached CESEE Households: Euro Survey Shows Dampened Savings and Changes in Borrowing Behavior.” *Focus on European Economic Integration*, Oesterreichische Nationalbank, No. 2, 79-90.
- ECB (2010): *The International Role of the Euro*. ECB, Frankfurt, <http://www.ecb.int/pub/pdf/other/euro-international-role201007en.pdf>.
- Feldkircher, M., Martin, R., and J. Wörz (2010): *Measuring Competition in CESEE: Stylized Facts and Determinants across Countries and Sectors*. *Focus on European Economic Integration* No 3, 38-62.
- Fidrmuc, J. and C. Hainz (2010): *Default Rates in the Loan Market for SMEs: Evidence from Slovakia*, *Economic Systems* 34 (2), 133-147.
- IMF (2010) *Regional Economic Outlook: Europe, Building Confidence*. IMF, Washington, <http://www.imf.org/external/pubs/ft/reo/2010/eur/eng/ereo1010.pdf>.
- Nowotny, E. (2010): “The Euro’s Contribution to Economic Stability in CESEE.” In: Nowotny, E., Mooslechner, P., Ritzberger-Grünwald, D. (eds.), *The Euro And Economic Stability, Focus on Central, Eastern and South-Eastern Europe*, Edward Elgar, Cheltenham: Edward Elgar, forthcoming.
- Ritzberger-Grünwald, D., Wörz, J. (2010) *Wechselkurse und österreichischer Außenhandel*. FIW Policy Brief Nr. 5, Research Center International Economics, Vienna.
- Schreiner, J. et al. (2010) *Developments in Selected CESEE Countries*. *Focus on European Economic Integration* No. 4, forthcoming.