72nd East Jour Fixe: External Imbalances and Adjustment to the Crisis in CESEE[1]

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Introduction

The 72nd East Jour Fixe, hosted by the OeNB on February 18, 2013, discussed the evolution of macroeconomic imbalances in Central, Eastern and Southeastern Europe (CESEE) before and after the 2008–09 crisis and their underlying drivers. The topic was approached from different viewpoints, as the individual speakers touched on a great number of aspects related to both trade and financial flows as well as external debt. Apart from highlighting the role that such imbalances played in aggravating the region's downturn during the global crisis, the workshop also took a forward-looking view and provided for a discussion of whether external and internal adjustment processes have been sufficient to date and whether individual policy responses have proven to be appropriate and effective.

In her introductory remarks, *Doris Ritzberger-Grünwald,* head of the Foreign Research Division at the OeNB, pointed out that external imbalances have become a prominent topic in the euro area in recent years and a range of additional tools to monitor macroeconomic developments have been developed as a response to the crisis developments in some euro area countries. However, the topic is also of great relevance for the emerging economies in CESEE. In this respect, Ritzberger-Grünwald particularly emphasized the heterogeneity in the region in terms of both the buildup of external imbalances prior to the crisis and the reactions in individual countries during the crisis.

Keynote on "Imbalances in CESEE: Past and Future"

In his keynote address, *Boštjan Jazbec* from the University of Ljubljana reviewed the transition process from its very onset and analyzed factors which had supported the buildup of large imbalances, and hence vulnerability to the crisis, in the CESEE region. He pointed out that in many CESEE countries capital mobility had largely preceded trade liberalization, thus creating distortions in the financial and real sectors of these countries. He also postulated that capital flows had often been wasteful rather than useful as banks mostly invested in collateralizable sectors given weak institutions in the recipient countries. Thus, instead of fostering investment to build repayable capacities, capital flows were primarily directed toward consumption, construction and the trade sector and therefore did not sufficiently support new ventures and greenfield investment. Despite past and current institutional weaknesses, Jazbec identified clear progress in investor protection and contract enforcement in the region. In addition to improvements in the institutional setting, he outlined the following policy options to unlock the region's growth potential: fiscal consolidation, internal devaluation (while cautioning that the initial cost advantage has largely been taken away by competition from Asia), structural policies aimed at increasing productivity, stricter prudential standards and supervisory cooperation and coordination between home and host countries. Jazbec concluded with the observation that the countries are moving in the right direction but that it will take longer to reach convergence than expected at the outset of the transition process.

[1] *The presentations and the workshop program are available at http://ceec.oenb.at (Events).*

In the discussion, Jazbec agreed that his analysis referred particularly to the situation in the countries of former Yugoslavia and other Southeastern European countries and stressed the example of Slovenia, where institutional weakness has been painfully revealed recently despite the economy's comparatively advanced stage according to per capita income levels.

Determinants of Crisis Severity in CESEE

The first session provided an overview of pre- versus post-crisis imbalances in CESEE, focusing in particular on external imbalances and related external and internal adjustment processes. Furthermore, determinants of vulnerability and their explanatory power for the severity of the downturn in individual countries were analyzed.

Martin Feldkircher, economist in the OeNB's Foreign Research Division, presented evidence on macrofinancial determinants that indicate vulnerability to the global financial crisis based on a country sample of 63 emerging and advanced economies. The main results revealed that pre-crisis growth in domestic credit had amplified the real downturn. This holds true for several measures of crisis severity including those that assess the impact of the crisis on the growth cycle (long-term perspective) as well as on the business cycle (short-run perspective). Feldkircher furthermore stressed the detrimental effect of funding from foreign banks given excessive domestic credit growth in the years preceding the crisis. In other words, the simultaneous risk of overheating in the credit market and dependence on foreign funding makes a country particularly vulnerable to a global shock.

Irina Bunda, economist at the Joint Vienna Institute, supported the view that a credit-fueled pre-crisis boom had led to a more severe crisis reaction. Hence, external indebtedness and gross external financing needs were high in countries hit hard by the crisis. She guided the audience through a detailed presentation of the most important elements of the IMF's External Debt Sustainability Analysis, which identified, on a country-by-country basis, different factors as the most important drivers of the increase in external debt during the crisis. While the sudden growth reversal played a major role in the Baltic countries, price and exchange rate developments exerted a strong influence in Poland, Romania, Russia and Ukraine. In turn, persistent current account deficits had a substantial impact in many Balkan countries. Although adjustments are under way, vulnerabilities remain and external financing needs continue to hover around their 2007 levels. Further current account adjustments and the projected pickup in growth should, however, put the high external debt on a declining path.

The third speaker in this session, *Ettore Dorrucci,* Head of the Convergence and Structural Analysis Unit in the ECB's EU Countries Division, focused on rebalancing in the non-euro area CESEE EU countries. He started by analyzing current account drivers from an exchange rate-regime perspective and illustrated the cushioning effects of a flexible exchange rate, which were, however, not without pain: Exchange rate adjustments also led to currency mismatches in the balance sheets (particularly in Hungary). In contrast, countries with a fixed exchange rate achieved substantial internal devaluation during the crisis, which was supported further by fiscal consolidation, external factors (such as commodity price developments) and the fact that all CESEE countries are small and highly open economies and hence price takers. Turning to debt drivers in the region, Dorrucci analyzed them from a (de)leveraging perspective. In line with the previous speakers, he also noted the role of pre-crisis credit growth financed by external borrowing in creating a demand boom. He pointed out strong deleveraging in Latvia, Lithuania, Hungary and Bulgaria during the crisis and added that in the two Baltic countries, high net savings in the private sector had driven the correction of imbalances. Exchange rate targeters had pursued more prudent fiscal policies prior to the crisis compared with inflation targeters. According to Dorrucci's analysis, the question whether rebalancing has been temporary or permanent is still open. There have been gains in export market shares for most countries in the region (except Hungary), but the debt levels are persistent. The high debt burden of the private sector and vis-à-vis nonresidents implies a need for balance sheet repair with negative consequences for the growth outlook. Despite improvements in flow variables, there is still a legacy of debt overhang in some countries. He concluded by alluding to persistent bottlenecks in labor markets and lacking flexibility in product markets in the region and stressed the need for structural reforms to enhance competitiveness.

The subsequent discussion centered on the particular experience of the Baltic countries, the type of structural reforms necessary and the role of economic policy in the adjustment process. Feldkircher pointed out that his results are robust to excluding the Baltic countries from the sample. With respect to structural reforms, Dorrucci emphasized the need for implementing improvements in the judicial system, cutting red tape further and fighting corruption. He also pointed out the policy leverage inherent in EU accession and ERM II entry but at the same time stressed the importance of national ownership of reforms.

Policy Responses to the Crisis – Case Studies

The second session, chaired by *Peter Backé,* Deputy Head of the OeNB's Foreign Research Division, started with insights into country experiences, namely those of Latvia and Slovakia.

Uldis Rutkaste, Head of the Monetary Policy Department at Latvijas Banka, gave a comprehensive presentation on Latvia's road to recovery. He explained that Latvia was more successful in overcoming the crisis than in preventing imbalances before the crisis. As a starting point, he recalled the fact that Latvia had entered the crisis as the EU's most overheated economy. Moreover, he argued that policy mistakes (procyclical fiscal policy, shortcomings in financial sector regulation) contributed to the economy's vulnerability. As a reaction to the strong impact of the crisis, Latvia implemented a large and frontloaded fiscal consolidation package, which was underpinned by structural reforms. The implementation of fiscal consolidation measures was followed by the resumption of growth, as confidence in the Latvian financial markets and in the real economy was restored. Growth has also been supported by regained competitiveness. In particular, Latvia's quality-adjusted relative export prices have declined notably in recent years, which helped regain external sustainability, as shown by a small current account deficit. Rutkaste concluded by stating that Latvia aimed to adopt the euro in 2014 and went on to outline the progress with respect to convergence from this angle.

Ján Tóth, Deputy Governor of Národná banka Slovenska, focused his presentation on the Slovak experience in comparison with five other Central European economies. Tóth pointed out that Slovakia underwent the biggest structural reforms during the 2003–2006 period. These reforms helped Slovakia attract considerable volumes of FDI. Moreover, the overall impact of the reforms on the economy helped dampen the effects of the crisis in Slovakia. The adoption of the euro, according to Tóth, was "the only big thing" happening in the Slovak economy since 2006. He emphasized that the crisis reached Slovakia mainly through a trade shock. Even though exports from the Czech Republic, Poland and Hungary benefited from depreciating currencies, Slovakia – as a euro area country – nevertheless managed to keep pace with the export recovery of the countries with floating exchange rates and to regain the initial loss in export market shares relatively quickly. The crisis had, however, a larger impact on employment and total hours worked in the manufacturing sector in Slovakia than in countries with floating exchange rate regimes.

Questions coming from the audience in the ensuing discussion addressed the role of EU funds in Latvia and the partial dilution of reforms in Slovakia over the last year. Rutkaste explained that Latvia improved the absorption and use of such funds during the crisis and that these funds have played an important role in financing the needed adjustment in several areas. Tóth called for measures to increase the flexibility of the Slovak economy and for more fiscal space in order to decrease the vulnerability to future shocks.

Policy Lessons Learned?

In the second part of session 2, *Gillian Edgeworth,* Chief EEMEA Economist at UniCredit Research, dealt with policy lessons learned and challenges that lie ahead in CESEE. As a way of introduction, she argued that the crisis has improved policymakers' understanding of fiscal and external risks. She then took a closer look at capital flow dynamics before and during the crisis. Edgeworth underscored that the composition of pre-crisis capital flows to CESEE was "better" than that of flows to other regions (for example the euro area periphery), "but not perfect." According to Edgeworth, the new EU Member States saw strong net FDI inflows, a considerable part of which went to the tradable sector. She also argued that the high share of foreign ownership in the banking sector helped smooth output in CESEE in 2008–09. Turning to the most recent years, Edgeworth expressed concerns about the changing composition of capital flows to CESEE. In this respect, she pointed to a higher share of portfolio inflows and the generally shorter-term nature of capital inflows. Risks would also stem from the still-high level of external debt and low global interest rates. Against this background, she questioned whether all CESEE countries were prepared in case another shock hit the region. In her concluding statement, Edgeworth called for a more ambitious approach to integrating the newer EU states into the European banking union that is currently being set up.

Subsequently, the floor was taken over by *João Nogueira Martins* from the European Commission, who heads the DG ECFIN unit that coordinates the implementation of the EU's Macroeconomic Imbalances Procedure (MIP), a new component in the toolbox of European economic governance. As Nogueira Martins highlighted, the MIP aims at identifying elements that could lead to boom-bust cycles. The analytical part of the MIP relies on an alert system that uses a scoreboard of indicators that are benchmarked against threshold values as well as in-depth country studies. He stressed that the scoreboard is not designed to be applied mechanically. Instead, it has an indicative function, and Nogueira Martins pointed out that there is clearly a need to take a holistic look when assessing indicators that exceed threshold values. Asked whether country-specific thresholds in the scoreboard would be more appropriate, he argued that such an approach would be too complex to implement. Reflecting on the situation in the EU, he admitted that the Commission's concerns are currently more in the west than in the east. This year, the Commission is carrying out an in-depth review for 14 EU Member States, of which only three are located in the CESEE region. In general, Nogueira Martins mentioned three fields of major concern: high private sector debt, losses in competitiveness and external imbalances, both with respect to the current account and/or the net international investment position of several Member States.