Conference on European Economic Integration 2012: Achieving Balanced Growth in the CESEE Countries

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For the second year in a row, the Oesterreichische Nationalbank (OeNB) organized its Conference on European Economic Integration (CEEI) in cooperation with Suomen Pankki – Finlands Bank, and for the first time in its history, the CEEI went abroad: Hosted by the Finnish central bank, the CEEI 2012 on "Achieving Balanced Growth in the CESEE Countries"[2] took place in Helsinki on November 26 and 27, 2012. Achieving sustainable economic growth was, in general, seen as being of utmost importance in solving the current economic problems. Conference topics thus ranged from the most recent challenges for the banking sector to the unwinding of large external imbalances.

In his welcoming address, *Erkki Liikanen,* Governor of *Suomen Pankki – Finlands Bank,* focused on financial market stability, listing strongly interconnected and complex global financial institutions, deregulation, the development of a large shadow banking sector and the implicit public guarantee for banks that were "too big to fail" as the forces behind the harmful developments that had eventually triggered the financial crisis. At the same time, regulatory and supervisory restraints had proved ineffective. Therefore, it is important to implement the necessary reforms now. For this purpose, Liikanen explained, the High-level Expert Group on reforming the structure of the EU banking sector proposed a mandatory separation of certain trading-related activities and, in addition, a more comprehensive separation of activities conditional on banks' recovery and resolution plans. Further measures would include the use of bail-in instruments for particular debt instruments and a review of capital requirements on trading assets and real estate-related instruments.

In his opening remarks, *OeNB* Governor *Ewald Nowotny* went on to stress the need to find a new growth model for the Central, Eastern and Southeastern European (CESEE) countries, which were hit hard by the financial and economic crisis of 2008 and 2009. He pointed out that their foreign capital inflow-based growth model had proved unsustainable in the long run since it led to the buildup of substantial vulnerabilities. The resulting boom-bust cycles caused significant economic costs, harmed the countries' long-run growth potential and seriously delayed the CESEE region's convergence toward the euro area. A slowdown of the catching-up process poses serious challenges to the still pending economic and institutional reforms in CESEE and to further economic integration. Nowotny concluded that a new growth model has to be found that promotes both balanced growth and the convergence process.

Balancing European Transition and Growth in a Shifting World Economy

Danny Quah, professor of economics at the *London School of Economics,* started his keynote lecture by providing a bird's eye view of the global economy, whose

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[2] *The conference proceedings will be published by Edward Elgar Publishing Ltd. in the course of 2013. Presentations and papers, information about the speakers and the conference program are available at www.suomenpankki.fi/CEEI2012.*

gravity center – while still located along the transatlantic axis – has been moving eastward. Given the rise of the emerging economies in East Asia, this shift is set to continue well into the distant future. Quah pointed out, however, that such projections are not undisputed as many opponents argue that this unsustainable Asian growth model cannot continue for three main reasons:

1. underconsumption and excessive dependence on exports to advanced economies;
2. adverse demographic developments contrasting with the stylized fact derived from economic history suggesting that it is typically young people who drive economic growth;
3. political institutions largely considered incompatible with sustainable growth.

Quah went on to refute this widespread narrative. The argument that the lion's share of Asia's economic success is driven by foreign demand in advanced economies has not been substantiated in the current crisis. Moreover, the still rather large share of poor people in Asian populations holds a huge potential for future domestic demand. Similarly, societies in Asia – while greying – are also becoming richer and will thus increasingly invest in old-age care. Finally, Quah noted that while ballot box democracy has worked well in some parts of the world, it is not a blueprint for all. According to Quah, it is rather political legitimacy that is conducive for economic growth.

Restarting Growth in Europe after the Great Recession

In the second keynote lecture, *Seppo Honkapohja,* Member of the Board of *Suomen Pankki – Finlands Bank,* took a comparative view of Central and Eastern Europe (CEE) versus the euro area and presented various stylized facts on the developments in CEE over the last two decades. After 1995, the CEE countries that went on to join the EU in 2004 and 2007 started a remarkable convergence process, which further accelerated with EU membership. Starting in 2008, the Great Recession, by contrast, was marked by nonconvergence in most cases, with some countries even experiencing divergence during the crisis. After the crisis in 2008 and 2009, however, the CEE countries recovered relatively faster than the rest of the EU.

In the pre-crisis boom phase, current account deficits widened in most CEE countries (except e.g. in Poland and the Czech Republic). During the crisis, a strong rebalancing set in, partly caused by sudden stops or reversals of capital inflows. At the same time, unemployment rates remained relatively low compared to those in some other EU countries. The comforting conclusion Honkapohja drew was that some CEE countries managed to resume growth after the Great Recession. He traced their quite pronounced crisis resilience back to lower public and private sector debt levels and to flexible labor and product markets, which facilitated economic adjustment during the crisis. At the same time, however, competitiveness and success in foreign trade remain critical factors for the CEE region, which largely depends on growth prospects in Western Europe.

Stop and Go of Capital Flows and Deleveraging

The first session of the CEEI 2012 was dedicated to the volatility of capital flows to emerging market economies and related challenges for policymakers, with a particular focus on the CESEE region. *Klaas Knot,* President of *De Nederlandsche*

Bank, gave a brief introduction into the issue of highly volatile capital flows to emerging market economies (EMEs), characterizing the "dark side of globalization."

Karolina Ekholm, Deputy Governor of *Sveriges Riksbank,* pointed out that while emerging Europe had not been the destination of large net capital inflows (in absolute terms) compared with Latin America and developing Asia before the crisis, the ongoing deleveraging by foreign banks might play a crucial role for the region's current growth prospects. However, the reduction of net capital inflows and bank lending in CEE mostly seem to be an adjustment toward fundamentals. While the CEE countries gained rather than lost competitiveness during the crisis, the reduction of FDI inflows owing to the poor performance of the rest of Europe may hamper their long-run growth potential.

Andrew Filardo, Head of Monetary Policy at the *Bank for International Settlements (BIS),* reported on the experience of emerging market economies in Asia and how they were able to manage "stop-and-go" capital flows during the last decade. On the one hand, he referred to their "good luck," namely the fact that the "wave of liquidity" from U.S. capital outflows never fully materialized, and therefore, capital inflows remained manageable. On the other hand, the resilience of emerging Asia was also attributable to "good policies" which moderated capital flows in the short run and reduced vulnerabilities during the crisis period. Related policy measures included the stress testing of policy frameworks, the smoothing of foreign exchange movements and asymmetric monetary policy responses, which served to prevent spillovers. The Chiang Mai Initiative also strengthened international cooperation across countries and offered a "multilateral backstop" to adverse developments. Nevertheless, destabilizing capital flows may remain an important concern for policymakers, while shifts in global risk aversion play a major role for capital flows and should therefore be monitored carefully.

Marek Dabrowski from the *Center for Social and Economic Research* criticized the use of traditional balance of payments analysis for assessing global imbalances. While he pointed out that net capital inflows indeed lead to an accumulation of external liabilities which cannot grow indefinitely and must be repaid at some stage, he also explained that a country may be a net capital exporter or importer for a long period of time. Therefore, in a world of free capital mobility, countries' current account balances might follow changes in their financial accounts. Hence, national macroeconomic policies have only limited control over national current account balances and real exchange rates, even when floating exchange rates or inflation targeting are in place, as domestic money supply is largely driven exogenously by capital flows. This perspective calls for a stronger coordination of global monetary policies to avoid adverse feedback loops across countries.

Debora Revoltella, Director at the *European Investment Bank (EIB),* discussed the ongoing bank deleveraging in CESEE. From a macro perspective, the external positions of BIS reporting banks in CESEE have fallen considerably since mid-2011. While stalling credit growth seems to be a development toward an increasingly self-funded banking system, the deterioration in credit quality as measured by the rate of nonperforming loans (NPLs) is still a major cause for concern. From a micro perspective, preliminary results of the EIB Bank Lending Survey show that the current deleveraging is both domestically (demand-side) and internationally (supply-side) driven. On the one hand, most banks are going through some sort of strategic restructuring, with further deleveraging expected in the near future. On the other hand, given the local market outlook and local regulation frameworks, credit demand is currently weak as well. The survey results signal a shift toward a more self-sustainable banking model, although this rebalancing might lead to strongly binding constraints as soon as credit demand recovers. From a policy perspective, the current restructuring and rebalancing of the CESEE banking model is a positive development, but it takes time and affects growth.

Growth, Institutions and Human Capital

In the third keynote lecture, *Florencio López-de-Silanes,* professor of finance at the *EDHEC Business School,* focused on the importance of human capital not only for economic development and growth, but also for the development of sound institutions. He argued that most indicators of institutional quality, except those measuring regulatory frameworks, are often inappropriate and cannot clearly explain differences in economic development across regions and countries for two reasons: They are subjective, and they rather follow than lead growth. Therefore, López-de-Silanes conducted in-depth research on the ultimate determinants of growth, i.e. geography, infrastructure, population, human capital and culture, for a sample of regions covering 110 countries. The results show that human capital (measured by years of education) proved to be the key driver of regional variation in income and labor productivity. At the firm level, the impact of managers' educational level on productivity turned out to be four to five times higher than that of workers' educational level.

In addition, López-de-Silanes raised the issue of productivity at the government level. What is the impact of human capital on government efficiency? Measures of government efficiency often take into account corruption and policy views. To generate a new indicator of government efficiency, his research team conducted an experiment testing the performance of the postal systems of 159 countries by mailing letters to fake addresses in the respective countries and waiting for them to be returned to sender. The share of letters returned and the time it took until they were returned served to measure a country's postal efficiency. Cross-country regression analysis applied to the data showed that human capital was a main determinant of efficiency in postal services. With this experiment, López-de-Silanes suggests that education matters for economic development as it fosters the development of sound institutions.

Growth Strategies of EU Neighboring Countries: Russia and Turkey

Session 2 centered on the growth strategies of Russia and Turkey, with *Ahmet Faruk Aysan,* Member of the Board of *The Central Bank of the Republic of Turkey (CBRT),* providing an overview of recent economic developments in his country. After implementing various institutional and economic reforms, Turkey grew at a quick and rather stable rate as from 2001. After 2008, in response to the collapse of Lehman Brothers, monetary policy actions were taken to stimulate the economy. However, recovery in 2009 went hand in hand with rapidly rising credit growth rates and substantial current account deficits, which threatened financial stability and the country's sustainable growth. Against this backdrop, the CBRT introduced a set of – partly unconventional – monetary and macroprudential policy measures that pushed the economy toward greater balance and enabled a "soft landing."

As Professor *Konstantin Sonin* from the *New Economic School, Moscow,* pointed out, Russia was among the countries in the region that were hit hardest by the financial crisis. Although the short-term outlook suggests a recovery of growth at rates of 3% to 4% within the next few years, in the longer run Russia will face serious challenges. According to Sonin, the previous growth drivers, namely human as well as physical capital and the high oil price, have been exhausted. Therefore, institutional reforms to achieve productivity growth are indispensable. Suggested key reforms are the privatization of state-owned companies, deregulation, the improvement of the business climate, pension reform as well as a clear shift of monetary policy to inflation targeting.

Dinner Speech

In his dinner speech, Governor *Klaas Knot (De Nederlandsche Bank)* focused on the euro area crisis and the role of competitiveness patterns and capital flows during the crisis period. He pointed out particular country-specific aspects that played an important role for the diverging developments within the euro area. Knot concluded by suggesting ways of going forward and highlighted the necessity for comprehensive solutions.

Small-Country Experiences in Economic Adjustment

The second day of the CEEI 2012 started with a session chaired by Deputy Governor *Pentti Hakkarainen (Suomen Pankki – Finlands Bank). Doris Ritzberger-Grünwald,* Head of the *OeNB's* Foreign Research Division, shed some light on income and business cycle convergence in the CESEE region. She provided evidence that on the one hand, the region became more heterogeneous during the crisis while decoupling from the euro area on the other, particularly on account of developments in small countries. Moreover, while trend growth rates declined both in the euro area and in CESEE in the wake of the crisis, the trend growth differential between these two regions halved against the pre-crisis period, causing the catching-up process to slow down significantly.

Against the background of economic developments in Southeastern Europe before the crisis, Governor *Dimitar Bogov* of the *National Bank of the Republic of Macedonia* discussed the impact of the crisis in the SEE-6 (Albania, Bosnia and Herzegovina, Croatia, FYR Macedonia, Montenegro, Serbia) and the resulting challenges lying ahead. Prior to the crisis, economic growth in the region was above potential given excessive domestic demand, which was, in turn, fueled by massive capital inflows. Despite attempts to contain the latter by means of pioneering macroprudential measures, mounting external imbalances could not be avoided. The sudden reversal of capital flows and the economic slowdown had a sharp impact on the economy in the SEE-6, including noticeable deleveraging, a dramatic increase in nonperforming loans and significantly higher fiscal deficits. Nevertheless, the banking system in the region remained rather stable and, along with due structural reforms, it should be able to catalyze the region's attempted shift to a sounder and more sustainable growth model.

The final contribution to the session was delivered by *Ardo Hansson,* Governor of *Eesti Pank,* who concentrated on developments in the Baltic countries. He started out by benchmarking their recent rapid and severe economic correction against past crises as well as against the current rather gradual and protracted adjustment process in the peripheral euro area countries. Compared to previous crisis episodes, the Baltic countries stand out in terms of their unusually high degree of volatility in most economic variables, the significant changes in domestic demand and high external and financial vulnerabilities. In contrast to the euro area periphery, the sharp V-shaped adjustment process in the Baltics was characterized by a sudden stop in capital inflows. Moreover, unlike in the EU-IMF program countries of the euro area, public debt increased only very moderately in the Baltics and private sector indebtedness even declined. Hansson concluded by weighing up the pros and cons of the different adjustment patterns.

A Practitioner's View

This year's CEEI concluded with a panel of high-level management representatives from European commercial banks operating in CESEE markets. Their brief presentations of their banks' strategies in the region served as an introduction to a discussion on challenges for banking in CESEE. The panel was chaired by *OeNB* Executive Director *Andreas Ittner,* who outlined the importance of renewing sustainability in banking market developments in the region. Numerous initiatives support this goal e.g. the Vienna Initiatives I and II, and the Austrian Sustainability Package, which was introduced at the CEEI 2012. *Iikka Korhonen,* Head of BOFIT at *Suomen Pankki – Finlands Bank,* outlined the important role of foreign banks in the CESEE region. Among the main challenges identified by the panelists remains the relatively weak credit quality, with high nonperforming loan ratios in many CESEE countries. However, *Gianfranco Bisagni* (Head of Corporate and Investment Banking CEE and Deputy Head of CEE Division at *UniCredit Bank Austria AG*) pointed to the heterogeneous developments in CESEE during the financial and economic crisis. Future loan growth, he stated, is likely to be more and more closely tied to growth in deposits – not least due to the loans-to-local funding ratio of 110% implemented by the Austrian authorities. Together with *Radovan Jelašić* (Chief Executive Officer of *Erste Bank Hungary*), Bisagni referred to the increasing supervisory challenges and regulatory pressures on banks. Jelašić consequently called for intensified cooperation between supervisors, international institutions and banks – particularly in an environment of heightened uncertainty. *Esa Tuomi* (Senior Vice President and Head of Corporate and Institutional Banking, Poland and Baltic Countries at *Nordea*) contributed to the debate by calling attention to the microeconomic level, in particular to the relationship between banks and customers, which is crucial for the quality of banks' loan portfolio. Overall, the panelists highlighted that banks need to reassess their strategies in an environment of heightened economic uncertainty.

In his concluding remarks, Director Ittner emphasized the significance of conferences such as the CEEI as they provide an opportunity for representatives of international institutions, academics and practitioners to exchange views and discuss future challenges. In an environment of raised uncertainty and diverging interests, mutual understanding of diverging interests is particularly important. He closed by inviting all participants to attend the CEEI 2013, which will take place in Vienna on November 18 and 19, 2013.