Conference on European Economic Integration 2020

CESEE in the COVID-19 crisis – the role of the EU and global spillovers

Compiled by Julia Wörz[1]

The Conference on European Economic Integration (CEEI) held in November 2020 was the first fully virtual conference in the longstanding tradition of this OeNB conference series. Around 300 participants from 30 countries took in and discussed the issues and challenges arising from the COVID-19 crisis and the role of EU policies and global spillovers. In his opening remarks, *OeNB Governor Robert Holzmann* recalled the fact that the year 2020 marks the year with the deepest recession in the Central, Eastern and Southeastern European (CESEE) region since the transformation recession almost three decades ago. The truly global nature of the crisis implies that especially small, open and strongly integrated economies – like the CESEE countries – are strongly affected even though they have been able to cushion some of the adverse economic impact thanks to the swift policy reaction in all countries and international support. With respect to the latter, Governor Holzmann referred to liquidity arrangements between the ECB and many CESEE countries, among other factors. Focusing on the role of the EU and the role of global spillovers, he pointed out that the region's deep integration in global value chains has been a stabilizing factor despite initial disruptions in supply chains. The stabilizing effect arises from long-term and highly specialized trade relationships and the important role of FDI financing within international production networks. Tight financial and trade linkages with the euro area have further allowed positive spillovers of ECB monetary policy to the region, as has been demonstrated by recent research. Finally, Governor Holzmann underlined the role of EU funds in the recovery and their role in promoting convergence and growth in CESEE. He concluded by saying that the main near-term challenge will be to use the available policy space in an efficient way that puts quality over quantity. At the same time, he recalled the sizable structural challenges faced by the economies in the region, with special emphasis on the green and digital transformation.

Keynote speech by Marcel Fratzscher: Europe's crisis response and its implications for CESEE countries

In his keynote speech, *Marcel Fratzscher, President of the German Institute for Economic Research (DIW Berlin)*, gave an overview of Europe's crisis response and its implications for CESEE countries. He focused on the mechanisms that explain why specific countries have been more affected by the crisis than others, on risks stemming from the second wave and on policies implemented in response to the crisis. He then went on to address how the structural transformation can be managed after the crisis. Fratzscher pointed out that a social welfare state is a strength in the crisis and that short-time work schemes have been a success. In this respect it is worth

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noting that the highly welcome EU Support to mitigate Unemployment Risks in an Emergency (SURE) supports these schemes. In Fratzscher's view, the monetary policy reaction has been strong, and he emphasized that it was essential that monetary policy continue to respond to extreme market conditions. According to Fratzscher, it is appropriate to allow for rising fiscal deficits and to boost public investment as a prerequisite for private investment. He also explained that both public investment and social policy are key for mastering structural transformation to address climate change. But there is a risk that current stabilization policies will make the transformation more difficult by supporting existing structures and by restricting fiscal policy after the crisis. While inequality and social polarization are rising due to the pandemic, the good news is that trust and support for change have been rising as well. At this point, policy responses to the pandemic have been strong but still insufficient. In the subsequent discussion, the following issues were addressed: the trade-off between a quick and a targeted policy response, the risk that fiscal support measures will be withdrawn too quickly and the procyclicality of EU fiscal rules.

Monetary policy spillovers to CESEE: what do we know and what can we do?

Doris Ritzberger-Grünwald, Director of the OeNB's Economic Analysis and Research Department, opened the first session of the CEEI by saying that euro area monetary spillovers to the CESEE region depend on the degree of regional economic integration in both trade and financial markets but also on country-specific factors, such as exchange rate regime and degree of euroization.

Martin Feldkircher, Vienna School of International Studies, reviewed the theory and existing literature on monetary policy spillovers and presented his own ongoing research on euro area monetary policy spillovers to CESEE countries. In line with previous findings, Feldkircher showed that ECB monetary policy has had positive effects on output, consumer prices and asset prices in the ten CESEE countries he has reviewed. He further noted that the spillover effects are similar in size compared to the domestic effects in the euro area and that interest rates in CESEE countries also tend to follow euro area monetary policy. According to Feldkircher, the main contribution of his research to the existing literature is that it makes it possible to disentangle some of the main transmission channels through which spillovers occur. While the theory predicts the exchange rate channel of monetary policy to cause expenditure switching between domestic and foreign goods, monetary policy also has an effect on domestic demand that affects the amount of imports regardless of currency movements (through the income absorption or demand channel). Since the two mechanisms have opposite effects, it is a priori unclear which one dominates. Moreover, several studies show that expenditure switching might be less important due to a series of factors, e.g. the use of the euro as regionally dominant currency. Martin Feldkircher showed that the positive spillovers of euro area monetary policy to CESEE mainly stem from the income absorption channel and additional second-round effects arising from CESEE trading partners, while the exchange rate channel has a minor role. This is due to, among other factors, the use of the euro as a regionally dominant currency, which dampens expenditure switching. Finally, he also pointed to the existence of spillbacks of monetary policy to the euro area economy from CESEE economies.

Livio Stracca, Deputy Director General, European Central Bank, noted that the interest in monetary policy spillovers had been renewed due to the response to the COVID-19 shock. He presented a comprehensive literature review on spillovers of both conventional and unconventional monetary policy by the ECB and the Federal Reserve (Fed). He argued that not only a sudden (discretionary) monetary policy shock should be considered but also the systematic (endogenous) response of monetary policy to various shocks to the economy. Stracca presented results from a recent ECB discussion paper that compares the spillovers of Fed and ECB monetary policy, showing that both affect foreign activity and prices in the foreign economy, with the Fed's shocks having large effects on euro area financial conditions but not vice versa. Both ECB and Fed monetary policy shocks were found to affect activity in emerging economies, but US monetary policy appeared to cause larger spillovers. Stracca claimed that, when looking at ECB monetary policy spillovers to CESEE economies, results are heterogeneous and model dependent and that, different from Martin Feldkircher's research, there had been little evidence about the relevance of different transmission channels. Stracca showed evidence of spillovers from ECB unconventional monetary policy to CESEE output, inflation and CESEE financial conditions. While CESEE countries are affected by ECB monetary policy measures, they also respond to the economic conditions prompting these monetary policy decisions. Therefore, the underlying economic (demand) shock affecting the euro area might more than offset the positive effect of the ECB's monetary policy, and the ex ante impact of (total) euro area spillovers on CESEE countries is ambiguous. Finally, looking at CESEE bond yields and stock market indicators after the pandemic hit, Stracca showed that ECB monetary policy announcements – especially after the March 18 announcement of the pandemic emergency purchase programme (PEPP) – have had a sizable impact on CESEE financial markets and played a role in stabilizing financial conditions and market sentiments during the first wave of the pandemic.

Monetary policy to the rescue: central bankers' views on the COVID-19 crisis

Robert Holzmann, Governor of the Oesterreichische Nationalbank, chaired the discussion in panel 1 on central bankers' views on the role of monetary policy in the COVID-19 crisis. Governor Holzmann came straight to the point by addressing pertinent questions to his colleagues from several CESEE partner central banks, namely from Estonia, Croatia, North Macedonia and Romania. The questions covered a broad array of topics ranging from spillovers from the ECB's monetary policy to the respective countries (or effects in the case of Estonia), and recent and prospective inflation developments, to the available room for maneuver for monetary, fiscal and macroprudential policies in case of a further deterioration of the pandemic situation, as well as the impact of the EU recovery instrument *Next Generation EU (NGEU)* and the *multiannual financial framework (MFF)*.

Anita Angelovska Bezhoska, Governor of the National Bank of the Republic of North Macedonia, focused on the ECB's accommodative monetary stance. She stated that, amidst comfortable foreign reserves and in the absence of economic imbalances in North Macedonia, the ECB's monetary policy creates space for growth-supporting policy by the North Macedonian central bank. Furthermore, she pointed out that the repo line established with the ECB provides assurance for swift access to foreign currency liquidity for her country. In her opinion, the repo line is an important signal and might be a tremendously important backstop facility when risks and uncertainty are very high.

The second panelist, *Leonardo Badea, Deputy Governor of the National Bank of Romania*, discussed inflationary developments in Romania. According to the Romanian central bank's inflation forecast, the annual inflation rate in Romania is expected to be around 2.1% at the end of 2020, i.e. a little below the central bank's 2.5% target and well in line with the target corridor. For the first months of 2021, the inflation rate is expected to remain at similar levels. Badea thinks that the NGEU as well as the MFF will have a very positive cumulative effect on economic growth in Romania, amounting to 0.7 percentage points in 2021 and 1.8 percentage points in 2022. However, these figures assume an improved absorption of EU funds compared to previous periods.

In presenting his view on the issue, *Madis Müller, Governor of the Bank of Estonia*, argued that the impact of the ECB's monetary policy can be particularly strong for small European economies with a high degree of trade openness. In that case it is very important to have countercyclical fiscal policy in place. Regarding inflation, Müller argued that inflation in Estonia is expected to be higher than in the euro area due to the country's ongoing convergence process. Turning to the question of policy space in case of a further deterioration of the COVID-19 situation, Müller explained that, thanks to prudent fiscal policies in the past, the country is now able to provide ample support for the economy. He specified, however, that economic support measures have to be well targeted, as efficient public investments are key during the current crisis.

Boris Vujčić, Governor of the Croatian National Bank, stated that he considers the monetary policy of the ECB and of the Croatian National Bank as complements: The ECB has preserved favorable financing conditions in Europe and hence supports national monetary policy that aims at stabilizing domestic markets and supporting the domestic economy. Addressing the question of policy space in case of a worsening of the COVID-19 situation, Vujčić argued that ample international reserves are boosting policy space for the Croatian central bank, allowing it to stabilize domestic markets. In addition, a toolkit of standard as well as nonstandard policy measures is available for continuing to support the Croatian economy.

In the follow-up discussion, panelists were asked whether they considered it better to be inside or outside the euro area. In addressing this question, Müller compared the current COVID-19 crisis with the global financial crisis of 2008 and welcomed being part of the euro area, as the former crisis had put Estonia's currency at risk and had made it more difficult to receive outside payments. Also Vujčić expressed a preference for being part of the euro area in order to be able to fully participate in and benefit from the ECB's monetary policy. Badea pointed out that it would also be an advantage for Romania to be a member of the euro area, but the country needs to be well prepared before entering the currency union. Prompted on the Vienna Initiative, panelists emphasized that the initiative is very important and works well as it brings together various financial market stakeholders. Müller pointed out that Estonia is less involved in the Vienna Initiative but has a forum of its own bringing together Nordic banks.

Keynote speech by Linda Goldberg: global liquidity flows – macro and micro phenomena

Gottfried Haber, Vice Governor of the Oesterreichische Nationalbank, opened the second conference day by highlighting the role of the banking sector as part of the solution in this crisis. He emphasized the stark difference between the banking sector situation in CESEE prior to the global financial crisis and the situation prior to the global COVID-19 crisis: In the years leading up to the global financial crisis, CESEE banking sectors had strongly relied on funding from abroad. Meanwhile, refinancing structures have transformed significantly as indicated by a marked decline in banks' net foreign liabilities in % of GDP in various CESEE countries. This development has been largely driven by rising domestic deposits, inter alia supported by the Austrian banking sector sustainability package aimed at strengthening foreign subsidiaries' local stable funding base and avoiding excessive credit growth.

Linda Goldberg, Senior Vice President of the Federal Reserve Bank of New York, delivered the keynote speech on "Global liquidity flows: macro and micro phenomena." With regard to cross-border flows, Goldberg highlighted the shift away from bank-based finance toward more market-based finance and the shift from more weakly capitalized toward better-capitalized global banks prior to COVID-19 crisis. She stressed that global liquidity flows are driven by macro factors like monetary policy and risk sentiment, including safe haven perceptions; but also bank characteristics such as cross-border liabilities, affiliates abroad and bank capitalization influence the extent of flows. Faced with an adverse funding or balance sheet shock, banks tend to contract lending, with cross-border direct lending reacting in a more volatile way than lending via foreign branches and subsidiaries. Yet, foreign affiliates that are less important to parent banks are usually confronted with sharper adjustments. During the COVID-19 crisis, better bank capitalization and liquidity facilities, including central bank swap lines, reduced the contraction of global bank lending to small advanced and emerging market economies. Moreover, US Fed swap lines with other central banks also helped the US economy. It is worth noting that foreign parent banks' USD funding strains stemmed also from their US branches facing corporate credit draws. Thus, these banks sent a large share of swap dollars obtained to their US branches, with branches meeting committed credit draws without an excessive tightening of new credit. The general discussion following the keynote speech centered on issues such as the importance of swap lines, the role of macroprudential policies in attenuating capital flow dynamics, different patterns of capital flows in the COVID-19 crisis compared to the global financial crisis, lasting effects of the COVID-19 crisis on capital flows and the necessity to bolster financial institutions' resilience.

European production chains under the strain of COVID-19: what is the impact on CESEE?

The second session of the conference provided an opportunity to discuss the impact of COVID-19 on production chains in CESEE. The session's chair *Reinhilde Veugelers, KU Leuven*, started out by stressing that it is important to look beyond the emergency support in the current crisis. This implies, inter alia, the need to find the right mixture between the preservation of old economic structures and creative destruction, as well as answers to questions about strategic autonomy, (de)globalization and the role of European firms in global value chains. *Carlo Altomonte, Bocconi University*, argued that global value chains (GVCs) had been under scrutiny for a while even before the COVID-19 shock. This is because GVC integration did not recover to previous levels after the global financial crisis. Altomonte postulated that while trade tensions do not significantly affect global production patterns, new technologies do. Yet their impact on GVCs is ambiguous. When it comes to the current crisis, Altomonte expects it to cause a (temporary) negative shock for GVCs as it has interrupted supply chains and increased costs of physical meetings. Nonetheless, Altomonte's research suggests that the longer-term impact on CESEE might end up being relatively benign since CESEE countries are mostly integrated in European value chains. Their exposure to non-EU shocks is limited, even when controlling for their production structure. Picking up where Altomonte had left off, *Robert Stehrer, Scientific Director at The Vienna Institute for International Economic Studies*, warned that despite the so far less severe impact of the pandemic on CESEE economies (as compared to many Western European countries) and their deep integration in GVCs there are other looming long-term challenges. In particular, the GVC integration of CESEE – strongly related to FDI flows – seems to have lost steam. In addition, many countries and industries in the region are locked in activities that generate relatively low value added, such as production rather than higher-value added R&D, logistics, headquarters or support services. That is, CESEE countries serve primarily as "factory economies" while Western countries take the role of "headquarter economies." Such a specialization is a drag on economic growth and is tightly connected to the notion of a functional middle-income trap. However, Stehrer closed the session on a positive note by voicing hopes that structural changes in specific, particularly automotive, industries might break up patterns of functional specialization and spark new FDI boosted by European green deal and investment funds.

How has CESEE navigated the crisis from a global perspective? Which lessons can emerging Europe draw from other emerging economies?

The final panel of the CEEI 2020 was also chaired by OeNB Governor Holzmann. By way of introduction, Governor Holzmann highlighted the main differences between the global financial crisis (GFC) and the COVID-19 crisis: In contrast to the run-up to the GFC, when many countries in the region had reported twin deficits in the external and public sector accounts, the CESEE countries entered the COVID-19 crisis with overall strong economic fundamentals and a generally low level of macrofinancial risks. However, the GFC hit the CESEE economies in varying degrees and the same can be expected for the current crisis.

Cristian Popa, Senior Advisor of the Vienna Initiative Steering Committee, confirmed that the CESEE economies entered the COVID-19 pandemic with lower levels of macroeconomic vulnerabilities than observed prior to the GFC. He also emphasized that when the pandemic hit, CESEE banking systems were in better shape, and highlighted that central banks in emerging economies have implemented monetary policy instruments that provided ample liquidity and positively influenced investor sentiment. However, challenges are now rising with increasing nonperforming loans. Referring to the Vienna Initiative, he concluded that participation in the Vienna Initiative is more broad-based compared to the previous crisis, i.e. more market participants are involved, but that a better understanding of capital flows is urgently needed.

Adam Tooze, Columbia University, focused on political and geopolitical aspects of recent crises. Tooze referred to the 2020 crisis as an exogenous shock and argued that the ability to react to the COVID-19 crisis is dependent on preexisting conditions and previous crises in the CESEE countries. In this regard, he reviewed critical events such as the GFC and the diplomatic crisis between Georgia and Russia in 2008. But also since the GFC, the EU has faced additional profound geopolitical and political challenges such as politics in Hungary under Viktor Orbán, Ukraine struggling with economic problems, the Russian-Ukrainian war, the Greek financial crisis or the refugee crisis starting in 2013. Tooze spoke of a polycrisis that challenged the EU to a large extent but also resulted in some coordinated action. He mentioned the Vienna Initiative (where the OeNB has played a key role) as an outcome of the coordination work. Tooze noted the benefits of integration in terms of economic convergence but questioned if convergence will be delivered to all parts of Europe. Turning to the current crisis, he pointed out that the EU had navigated the first coronavirus wave quite well but that all countries were seeing a strong economic slump. However, compared to the GFC, the financial systems are more robust, and the structure of funding and macroprudential measures implemented after the GFC have helped to manage the current crisis quite well in terms of financial flows. Also, the ECB with its swap and repo lines and with the provision of extra liquidity as well as a historic fiscal deal (which he called Marshall Plan Plus) have the potential to combat the crisis. Tooze called the negotiations painful. They were surrounded by the discussion about the rule of law and revealed substantial disagreements between individual countries on this issue. He also mentioned major political disruptions within countries, for instance in Bulgaria, Serbia or Belarus, which flag the dissatisfaction with the political elites. Tooze concluded that, overall, the COVID-19 crisis is characterized by financial de-risking compared to the GFC but persistent political risks.

The last speaker, *Petia Topalova, Deputy Division Chief at the IMF*, recalled the latest World Economic Outlook of the IMF for the CESEE region. Economic activity is projected to contract strongly in 2020 with a partial rebound in 2021. However, the outlook may already have been rendered somewhat obsolete by the second wave of COVID-19 infections. She discussed the automotive sector in greater detail, as it plays a significant role in many CESEE countries, explaining that this sector was not only hit by the lockdown but moreover suffered from negative spillovers due to the disruption of supply chains. Topalova then discussed policy responses in the CESEE region. Fiscal policy has prevented large-scale bankruptcies and job dislocations so far, and monetary policy and macroprudential policies have supported favorable funding conditions. She called for a continuation of strong policy support to minimize immediate damages from the pandemic but polices should also focus on long-term challenges in the post-pandemic world.

The discussion that followed centered around the interconnectedness of politics and economics. In this respect, Adam Tooze raised the question if and how political factors of concern, in particular the issue of corruption, are part of economic analyses. Cristian Popa highlighted that the Vienna Initiative certainly has to deal with issues of political economy as well and that the fight against corruption is gaining more and more attention. Petia Topalova added that the IMF takes good governance and the fight against corruption very seriously.

Summing up, many speakers agreed that the relatively good starting position at the outset of the COVID-19 crisis, the swift and decisive policy response and international support have helped the CESEE countries to master the first wave of the pandemic relatively well. Yet, as the crisis is unfolding, risks are mounting in many areas, and the focus will have to shift from immediate crisis response to addressing long-term challenges. Technological progress, changes in global production chains and negative lock-in effects from functional specialization patterns within these production chains were prominently mentioned in the discussion. But also the future role and scope of fiscal and monetary policy were subject to a lively discussion, along with the importance of good governance, rule of law and political stability.