Klaus Liebscher: Southeastern Europe – chances and challenges of European integration

Speech by Dr Klaus Liebscher, Governor of the Austrian National Bank, at the Southeastern European Financial Forum, Bucharest, 17 May 2007.

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Ladies and Gentlemen!

It is a great honor for me to address this distinguished audience here at the Southeastern European Financial Forum. I am pleased to discuss the success the Southeastern European countries have achieved so far during their catching-up and European integration process and the challenges they face. But first of all, let me congratulate Romania and Bulgaria on their accession to the European Union on January 1, 2007. Both countries are now fully participating in the further progress of European integration.

I think it is fair to say that Southeastern Europe is a rather heterogeneous region, which means that it is important to adopt a differentiated approach to analyzing developments within this region. Yet given my short time slot here, a certain degree of generalization is inevitable.

Overall, Southeastern Europe has performed well in economic terms in the recent years. Output growth has been solid in 2005 and 2006 at average rates of around 5%. Inflation decreased considerably and the renewal of some inflationary pressures in 2005 and early 2006 has apparently been temporary. Noticeable progress has also been achieved in fiscal consolidation, and fiscal balances in Southeastern Europe show moderate deficits or surpluses.

Furthermore, the privatization process is now well advanced in most countries, with the share of the private sector in GDP coming to between 55 and 75%.

At the same time, challenges remain in several areas.

- First, despite strong economic growth, unemployment has remained pronounced across the region, reaching levels as high as around 40% in some countries. Thus, reducing unemployment and increasing employment levels remains a significant challenge, especially in a number of the smaller countries of the region.
- Success in this area would not only bring improvement to the everyday life of citizens and thus contribute to political and social stability, but help raise potential and actual output in these countries.
- Second, external imbalances remain large throughout most of Southeastern Europe, with current account deficits at higher single-digit or even at double digit levels. Although these deficits are to a significant degree financed by foreign direct investment inflows, the region remains heavily reliant on external finance. This exposes the countries to interest rate developments in industrial countries and to changes in investor sentiment.
- Third, notwithstanding progress in privatization in recent years, the share of the private sector in GDP remains lower in the region than in those Member States that joined the EU in 2004.
- Last but not least, progress with structural reforms in the area of factor markets and in the judiciary has remained uneven.

I have no doubt that the EU association and accession process will continue to have a significant beneficial impact on reform efforts in the region. In the case of Bulgaria and Romania, EU accession has contributed to an improvement of indicators of economic reform, governance and the business environment. I am optimistic that the integration process will lead to similar benefits for the other countries in Southeastern Europe. In addition, the new Member States as well as Bulgaria and Romania have achieved a high degree of integration with the EU-15 over the past decade. Trade links deepened in both directions following the start of the transition process, owing – among other things – to the gradual dismantling of trade barriers in the framework of Association Agreements. The EU-15 is today not only the most important trading partner in the region, but also its biggest foreign investor. As a result, the EU-15 countries account for approximately two thirds of the total FDI stock in the region. This is particularly true for the banking sector, where foreign-owned banks have gained an average market share of around 80%.

Austrian companies in general, and Austrian banks in particular, identified market opportunities in Central and Eastern Europe at a relatively early stage and have established a considerable presence in the region by now.

With an average market share in banking sector assets of almost 25%, Austria's banks are market leaders in Central and Eastern Europe.[1] More than one-third of the profits of the six largest Austrian banks already come from this region.

As Austrian banks continue to move into the southeast and east, their exposure is broadly diversified, which is intended to contain risks. At the same time, the Austrian authorities closely monitor potential challenges involved. Stress tests indicate that the banks' exposure is manageable and potential contagion effects on Austrian banks should be very limited.

The broadly favorable economic developments I sketched earlier have provided a solid background for financial sector developments in Southeastern Europe over the past few years.

With respect to the institutional framework and reforms, as measured by the EBRD's transition indicators, Southeastern Europe has advanced substantially in terms of overall banking system transformation. Like in other countries of Central and Eastern Europe, the privatization of large parts of the banking sectors was a characteristic feature in the region, although in most of Southeastern Europe (apart from Croatia and the Republic of Macedonia) privatization took place more recently.

Institutional reforms and ownership transformation contributed significantly to the deepening of financial intermediation in the region, which has advanced steadily and dynamically, in particular in Bulgaria, Croatia, and Bosnia and Herzegovina. In Albania, Serbia and the Republic of Macedonia, this process has been less even, and bank assets started to expand somewhat later.

The growth of credit to the private sector, in particular to households, has been fairly strong, while credit to the public sector has remained steady or even declined.

In the majority of countries in the region (apart from Bulgaria, Croatia and Romania), credit growth has essentially been financed by deposit growth, and changes in banks' net foreign asset positions appear to be associated, to an important extent, with rising net claims on central banks.

This development distinguishes Southeastern Europe from Central Europe, where foreign financing has – especially recently – played a bigger role.

Despite the dynamic developments of the past few years, the degree of intermediation in Southeastern Europe, with the exception of Croatia, is below the average level observed in the CEE-8 countries and well below the average of the euro area. This is, however, not surprising, given that the GDP-per-capita levels in most countries of the region are also

[1] Central-, Eastern- and Southeastern Europe, excluding CIS-countries.

substantially lower, and there is an empirical regularity that financial depth increases with rising GDP-per-capita levels.

Anticipating a catching-up in income levels, prospects of further financial deepening in Southeastern Europe are certainly intact.

Let me also point out that prudential indicators of banks in the region have remained broadly solid and have in some cases improved. Despite falling moderately in recent years, capital adequacy ratios in Southeastern Europe remain at double-digit levels and are higher than in the Central European and Baltic countries and certainly much above the Basel minimum threshold of 8%. Certainly, retaining a solid capital buffer against risks is highly appropriate and advisable.

In most countries of the region, the share of nonperforming loans has fallen in the first half of this decade. Romania and Serbia are exceptions in this respect, but in both countries, the rise in the share of NPLs is attributable to the tightening of classification rules. At the same time, it should be borne in mind that NPL ratios are lagging indicators.

An important feature of bank intermediation in Southeastern Europe is the large role of foreign currencies both on banks' asset and liability sides. It goes without saying that this currency substitution involves risks.

This is particularly true for foreign currency lending to unhedged borrowers, especially households. The resulting foreign currency exposure of their clients increases banks' indirect foreign exchange risk and thus their credit risk.

Finally, in most SEE countries, bank profitability has improved substantially during the first half of the current decade. Notwithstanding this improvement, the return on equity levels in 2005 were – with the exception of Albania – below the average recorded in the Central European and Baltic countries.

Let me now turn to the monetary integration process of candidate and potential candidate countries[2] before and after their accession to the European Union.

On their way into the EU, the countries in Southeastern Europe are free in choosing their monetary and exchange rate policy strategies. This is clearly reflected in the variety of exchange rate regimes in place across the region, which range from currency boards to lightly managed floats.

Moreover, Montenegro and Kosovo are unilaterally euroized and use the euro as their sole legal tender. Let me stress that these two cases are very special, originating from a post-war crisis resolution setting, and definitely do not constitute a precedent for other countries.

EU accession represents the first of three stages in the monetary integration process of EU Member States. Upon accession to the European Union, new Member States are required to treat their exchange rate policies as a matter of common interest and to pursue price stability as the primary objective of monetary policy.

However, beyond these obligations, the choice of the respective monetary and exchange rate strategy remains, in the first instance, a responsibility and prerogative of the individual Member States. At the same time, EU Member States (with the notable exception of Denmark and the United Kingdom) are committed to striving for the eventual adoption of the euro.

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[2] Croatia and Turkey are candidate countries. They started accession negotiations on 3 October 2005. In December 2005, the European Council granted the former Yugoslav Republic of Macedonia the status of a candidate country; accession negotiations have not started. All the other Western Balkan countries are potential candidate countries: Albania, Bosnia and Herzegovina, Montenegro, and Serbia including Kosovo under UN Security Council Resolution 1244.

According to the economic reasoning underlying Economic and Monetary Union (EMU), the eventual adoption of the euro is envisaged as the endpoint of a structured convergence process within a multilateral framework.

Participation in the Exchange Rate Mechanism (ERM II)[3] represents the second stage in the monetary integration process of non-euro area Member States. The basic idea behind ERM II is that this mechanism should help to ensure that participating Member States orient their policies toward stability; it should foster sustainable nominal and real convergence and thereby help them in their efforts to adopt the euro.

Participation in ERM II is voluntary. However, as participation in ERM II is a precondition for the eventual adoption of the euro, Member States are expected to join the mechanism at some stage. ERM II membership can take place any time after EU accession. However, to ensure smooth participation in ERM II, major policy adjustments – for example with regard to price liberalization and fiscal policy – would need to be undertaken before entering the mechanism. And an agreement among all parties involved in ERM II must be achieved on the central rate and the width of the fluctuation band.

Moreover, participation in ERM II requires sound monetary, fiscal, wage and structural policies. The importance of this statement cannot be overstressed, as a sustainable catching-up process and in particular investor confidence – and subsequently financial market and exchange rate stability – rest on a stability-orientated macroeconomic policy mix and flexible and efficient economic structures.

Euro adoption and full participation in EMU represent the third and final stage in the monetary convergence process. Euro adoption requires the achievement of a high degree of sustainable convergence, measured by the fulfillment of the conditions set out in the Treaty and its Protocols.

Every two years, or upon request by a Member State, the European Commission and the European Central Bank prepare Convergence Reports to assess the progress achieved in terms of economic and legal convergence. I would like to emphasize that this assessment is based on the principle of equal treatment both among non-euro area members and in comparison with current euro area countries. The application of the convergence criteria for new EU Member States must be no more, but also no less strict than for the current euro area countries.

A key factor in examining the fulfillment of the convergence criteria is sustainability, as convergence must be achieved on a lasting basis and not just at a given point in time. Let me emphasize that in this process of adopting the euro, quality must not be compromised for the sake of speed!

Let me conclude by taking a step back, in order to get a broader view of what all this and also this conference are about. I am aware that for many people the European integration process has, unfortunately, become synonymous mainly for regulations, markets, trade, profits and losses. However, the EU is much more than that: The European Union is the most important and successful peace project Europe has ever seen.

Today, the European Union not only comprises countries from the western part of Europe, but also free and democratic countries from Central, Eastern and Southeastern Europe. And the integration process of the Southeastern European candidate and potential candidate countries is moving on. Some 15 years ago, such a development appeared highly unrealistic, if not impossible. Yet, visionaries, determined policymakers and the people of Europe have translated this project into reality.

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[3] ERM II is a multilateral arrangement of fixed, but adjustable, exchange rates with a central rate and a standard fluctuation band of +/–15% against the euro.

This success reminds us not to lose sight of our long-term goals and visions. Yet, a sustainable catching-up and integration process requires strenuous preparations, hard work and a lot of discipline. As a consequence, the Southeastern European countries which have gone through this process will be in better shape and in a stronger position than before. And not only the people in these countries, but all Europeans are going to gain as integration is advancing and thus stability and prosperity are progressing in Europe!