George A Provopoulos: Economic policies, institutions, and the political-social environment that can increase and sustain potential growth

Welcome address by Mr George A Provopoulos, Governor of the Bank of Greece, at the Bank of Greece - University of Oxford (South East European Studies at Oxford, SEESOX) conference, Athens, 11 February 2011.

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I am pleased to welcome you to the Bank of Greece. This occasion marks the second conference on South East Europe jointly organised by the Bank of Greece and Oxford University. The first conference, held in October 2009, dealt with the effects of the global financial crisis on this region and the policy challenges in the light of the crisis. The focus of this conference is different. It is on the longer-term growth potential of the region. Specifically, the conference will deal with the economic policies, institutions, and the political-social environment that can both increase and sustain potential growth. We are fortunate to have with us a number of experts from the central-banking, academic and commercial-banking communities. They will share with us their views about the growth potential of the region and the policies that can help achieve that potential.

The global crisis, which halted more than a decade of sustained growth in most countries of the region, has demonstrated that economic convergence in Europe is neither an inevitable nor an automatic process. Prior to the crisis, most of South East Europe was characterized by relatively high growth, based mainly on consumption spending, private and public. The increased consumption expenditure typically reflected rapid growth in domestic credit, to a significant extent financed through foreign-capital inflows. Rising public spending often contributed to a widening of fiscal imbalances. These imbalances had adverse consequences. Among other things, they added to domestic price pressures, reduced competitiveness, and, along with rising private consumption, contributed to higher external deficits. In some countries, inflation surged to double-digit levels, wage increases far exceeded gains in labour productivity, and there were excessive increases in asset prices, especially the price of housing. These external imbalances left the economies concerned extremely vulnerable to an external shock. That shock came in the form of an eruption of a crisis in the US subprime mortgage market in August 2007.

In its early stages, the crisis was confined to advanced economies. Local and foreign banks in Central and Eastern Europe held only negligible amounts of so-called toxic assets. However, as access to international capital markets was impaired, countries in this region most in need of external financing experienced large declines in output. A number of economies in Central and Eastern Europe were only moderately affected. Output contraction, however, was especially severe in the Baltics and, to a somewhat lesser extent, in South Eastern Europe. This circumstance suggests that countries with the more serious imbalances and vulnerabilities were most at risk from external financial shocks. The lesson from this recent experience is that convergence efforts should be accompanied by stability-oriented policies that contain the build-up of imbalances, both domestic and external.

Policy efforts at the national and international levels helped contain the impact of the crisis on economic activity. The prevailing exchange-rate regimes were successfully defended and the domestic banking sectors showed considerable resilience. In many instances, fiscal and monetary policies were tightened. In some cases the tightening occurred within the context of programs supported by the IMF and the EU. As a result, financial conditions have stabilized and there are now clear signs of a recovery in economic activity in most countries in Central and Eastern Europe.

Nevertheless, the global crisis has entailed large costs for the region. There has been a sharp decline in economic activity and unemployment has risen sharply in many countries.

Moreover, the ongoing de-leveraging process, that is the need to repair household and corporate balance sheets, tighter bank-credit standards, as well as rising long-term unemployment, could slow the pace of economic recovery in many SEE countries. The South East Europe economies, like most other economies in Central and Eastern Europe, will likely experience reduced capital inflows, because investors have become more risk-averse. Consequently, foreign investment may decline compared with pre-crisis levels, leading to lower economic growth compared with the growth rates experienced in the years leading up to the crisis.

In light of the above, there will be a need to formulate and implement economic policies geared toward developing alternative sources of growth – policies that will render the economies less vulnerable to external shocks and that will allow them to better navigate their way through shocks should they occur. One such source of growth concerns the traded-goods sector. Growth based increasingly on exports will help avoid the boom-bust cycle and asset-price bubbles that have in the past been associated with non-FDI capital inflows. Such a growth will prove more sustainable. A more-diversified export base will also help protect the economies concerned from sector-specific shocks, while providing an important mechanism for limiting the build-up of external debt.

Fiscal consolidation will be an essential element for securing high growth, by crowding-in private investment and making room for much needed infrastructure investment. Such consolidation will need to be accompanied by improvements in the effectiveness and efficiency of public spending as well as of the tax system and its administration. *We look forward to a discussion of issues related to fiscal consolidation and macroeconomic adjustment in Session I of the Conference, which will be chaired by Mr. Yannis Costopoulos, Chairman of Alpha Bank.*

The desirability of establishing a more-diversified export-based growth in the region highlights the importance of improving competitiveness. In this regard, policies that encourage greater flexibility in the labour market, competitive product markets, and an improved business environment will be critical. *Issues addressing the necessary policies will be discussed in Session II of the Conference, which will be chaired by Mr. George Tavlas, Director General at the Bank of Greece*.

Policies of stabilization and reform cannot be effectively implemented without public support. In a period of falling incomes and rising unemployment, achieving that support may prove challenging. It is especially important to try to ensure that the reforms are perceived by the public to be fair and effective, so that the short-term sacrifices are considered worthwhile. *Issues related to the building of social and political support for reforms in South East Europe will be addressed in Session III of the Conference, which will be chaired by Mr. Thanos Veremis, Professor at the University of Athens.*

With reference to the financial sector in South East Europe, the presence of foreign banks in the region has increased both the efficiency of financial intermediation and the availability of credit to the real economy. Yet, it has been argued that, in some cases, financial stress originating in EU parent banks may have been transmitted to the Central and Eastern Europe region in the early stages of the crisis. It has also been argued that euro area-based parent banks helped fuel credit booms in the region and encouraged the use of unhedged foreign-currency borrowing. After the crisis erupted, the “Vienna Initiative” responded to those criticisms. The Initiative promoted a dialogue among parent banks, home and host supervisors, and governments under the umbrella of the IMF, the EBRD and the EU. It made the countries in the region less vulnerable to shocks caused by sudden stops in capital inflows by committing parent banks to maintain their exposure to these countries. However, a number of challenges lie ahead, including the financial stability risks stemming form lending in foreign currencies and the substantial build-up of currency mismatches in private sector balance sheets.

Moreover, the Basel III framework, which has recently been released, sets stricter capital and liquidity rules than those that presently exist. The new rules will encourage banks to rely more on deposit-taking, thereby rendering the banking industry of the region more stable. However, the new rules may also lead to slower credit growth, since commercial banks may have to tighten their lending practices. The Basel III framework may, therefore, affect the dynamics of the macroeconomy as well as the channels of credit that support economic activity. *Issues related to the role of the banking system in the region will be addressed by fellow Central Bank Governors in Session IV of the Conference, which I will be honored to chair.*

Before concluding, I would like to touch briefly on the role of the ECB and the Eurosystem in the crisis. The Governing Council of the ECB has moved quickly and forcibly to adapt the ECB's tools of monetary policy to the challenges of the crisis, most importantly by protecting euro area banks against liquidity shortfalls. We provided liquidity in unlimited volumes and with longer maturities to banks at an early stage. In parallel, we reduced the interest rate at which the banks can borrow from the Eurosystem to a historical low of 1%. We also launched a programme to purchase euro-denominated "covered" bonds issued in the euro area. As a result, concerns that a credit crunch might emerge have not been realised. Moreover, confronted with a serious malfunctioning of the market for sovereign debt last spring, the Governing Council of the ECB intervened in that market. This intervention was meant to ensure a smoother transmission of monetary policy in all euro-area economies.

It is now a great pleasure for me to welcome our keynote speaker, Mr. Erik Berglöf, Chief Economist of the EBRD.