

Jean-Claude Trichet: Towards a more integrated Europe – challenges ahead for the euro area and Central and Eastern Europe

Address by Mr Jean-Claude Trichet, President of the European Central Bank, at the National Bank of Poland's conference "Towards a more integrated Europe – challenges ahead for the euro area and Central and Eastern Europe", Warsaw, 21 October 2011.

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President of the Republic of Poland,
President of the European Parliament,
President of the National Bank of Poland,
Ministers,
Governors,
Commissioner Rehn
Distinguished guests,
Ladies and gentlemen,

Let me start by thanking my dear friend and colleague, President Belka, for inviting me to address such a distinguished audience today.

Twenty years ago, the dissolution of the Soviet Union marked one of the most important events in European history – the final stage of the revolutions that began two years earlier in 1989; the end of communism in the countries of Central and Eastern Europe; and the beginning of their transition to democracy and market economies.

It is also almost 20 years since the European Council met in the city of Maastricht in the Netherlands to agree on strengthening the pillars of the European Union (EU) and laying the foundations for the transition to Europe's Economic and Monetary Union (EMU).

The changes that Europe has seen over the last two decades have been enormous

Right from the start, the countries of Central and Eastern Europe embarked on a hugely ambitious path of reform. Leaving aside differences across countries, a long and challenging process of economic transformation brought countries in the region significant improvements in incomes and living standards. Full membership of the EU – or the prospects of accession – provided an important stimulus for the process of transformation as well as an anchor of stability.

In Western Europe, completion of the three stages of EMU led to the establishment of the European Central Bank (ECB) and the introduction of the euro in January 1999. Having started originally with 11 participating countries, the euro area has since expanded to include 17 EU Member States including some previous transition economies, namely Estonia, Slovenia and Slovakia.

The *changes* Europe has seen over these past 20 years are enormous. Equally enormous have been the *challenges* along the way, not least of course due to the global financial crisis. But there have also been enormous *achievements*. In my remarks today, I would like to take stock of some of those achievements and focus on three main aspects of the process of economic convergence in Central and Eastern Europe.

Three main aspects of the process of economic convergence

1. ***Nominal and real convergence: what has been achieved?***

The *first* aspect of convergence relates to developments in terms of nominal and real convergence between the countries of Central and Eastern Europe and the euro area. Looking at the region as a whole, after some very difficult years, inflation has come down dramatically from very high levels at the beginning of transition to single-digit levels today. Long-term interest rates have also fallen substantially, reflecting the gradual anchoring of inflation expectations.

The countries of the region have also made remarkable progress in terms of institutional and structural convergence. In particular, we have witnessed the building of appropriate institutions, increased trade integration with the euro area and improvements in the business environment.

Naturally, this progress has been reflected in per capita income convergence. Over the last 20 years, per capita income has risen to an average of 63% of the EU average if adjusted in terms of Purchasing Power Parity (PPP).

But combining low inflation with real convergence has posed a serious challenge in many countries. Let me elaborate on this.

The very process of real convergence entails upward pressures on prices, which can be hard to avoid in terms of both relative prices and the overall price level. Among other things, these pressures stem from high productivity growth as well as the processes of price liberalization and tax harmonization.

Price increases related to productivity growth are usually referred to as the Balassa-Samuelson effect. But most studies have found this effect to be relatively limited.¹ Convergence in price levels, which stood on average at two thirds of the EU average in 2010, seems to have surpassed convergence in income levels in all countries of the region. This means that growth in prices has generally been higher than growth in productivity.

Potential rigidities in labour and product markets and, in some cases, an excessively loose macroeconomic stance may have complicated the delivery of low inflation rates. Indeed, while all countries have reduced inflation to moderate levels, the entrenchment of a low inflation environment still constitutes a challenge in many economies.

2. ***Importance of ensuring policies that support fast and sustainable output growth***

The *second* aspect of convergence that I would like to highlight relates to the growth model followed by some new EU Member States. Given its lower starting point in terms of real income, it could be expected that, in a world with full financial integration, large capital inflows would flow into the region.

Moreover, as people expect to be richer tomorrow than today, they may choose to smooth consumption over time by borrowing today, the more so the higher the expected gains in disposable income. A process of gradual real exchange rate appreciation, supported by strong, domestically driven output growth and temporarily accompanied by relatively large current account deficits, would seem fully in line with what the theory of convergence suggests.

¹ According to Mihaljek, D. and M. Klau (2008), over the period from the mid-1990s to the first quarter of 2008, the Balassa-Samuelson effect would explain around 24% of the CEE inflation differentials vis-à-vis the euro area. For more details, see, "Catching-up an inflation in transition economies: the Balassa-Samuelson effect revisited", BIS Working Paper.

But in several countries, the process of real convergence proved itself difficultly sustainable. During the period before the global crisis, expectations were overly optimistic, and investors and consumers engaged in economic behaviour that generated excess domestic demand, strong credit growth and inflationary pressures.

As in many other markets, risk premia were squeezed, leading to asset price misalignments (particularly in the housing market) and over-indebtedness in a context of abundant global liquidity and a strong appetite for risk. Foreign direct investment flows often focused on the non-tradable sector, for example, construction and financial sector intermediation. Furthermore, foreign currency lending grew rapidly, leading to increasing balance-sheet mismatches.

As a result a number of countries experienced notable departures from price stability and wide external imbalances that eroded competitiveness – developments that went over and above what could be justified by “equilibrium” catching-up.

Macroeconomic policies added to the risks. In countries with a fixed exchange rate, independent monetary policy was not available, resulting in monetary policy conditions that became too expansionary. In principle, this could have been compensated by very tight fiscal policy. But with the benefit of hindsight, fiscal policies were often insufficiently restrictive or even loose.

The global crisis revealed these weaknesses with particular virulence. When capital flows dried up in late 2008 and trade collapsed, real output declined sharply, in some cases leading to severe recessions. With the main and remarkable exception of Poland, the region was severely hit by the crisis. Many observers feared then that, if the crisis were allowed to run its course, it could be near catastrophic for the region and extremely dangerous for the European banking system.

But I am pleased to say that this potential “catastrophe” was avoided and I would like to devote my remaining time to the question of how this was done – the *third aspect* of the convergence process I previously mentioned. I believe answering this question may provide lessons for countries that are currently facing similar challenges in the euro area.

3. *The reaction of CEE countries to the global financial crisis: what can be learnt?*

In my view, the return to the convergence path is being achieved thanks to a combination of four main elements.

First and foremost, there are domestic policy actions to address macroeconomic imbalances at the national level. The precise policy actions differ across countries, reflecting the different country-specific challenges and policy frameworks in place. But the actions generally require a strong fiscal adjustment and/or measures to maintain confidence in the soundness of the financial sector.

Second, the reaction of the international community has been essential. Where funding challenges became more acute, international financial assistance led by the IMF – jointly with the EU in EU Member States, – has been crucial in supporting market confidence and avoiding financial crises. The balance of payments support facility available for EU Member States has been reactivated, while the World Bank, the European Bank for Reconstruction and Development and the European Investment Bank have supported several countries. Some European countries have also provided bilateral financial support.

Third, the private sector, represented by the foreign banks active in the region, has by and large maintained its exposure to the region, helped by the informal forum known as the “Vienna Initiative”. By avoiding a large-scale uncoordinated withdrawal of cross-border banking groups from Central and Eastern Europe, a systemic crisis in the region could be avoided.

Finally, the ECB is also making a key contribution. For example, by providing extensive liquidity provision to parent banks established in the euro area, the subsidiaries of those banks in Central and Eastern Europe are indirectly benefiting from this ample liquidity.

Ladies and gentlemen, let me draw to a close. I am sure that the three aspects of convergence that I have mentioned will be better understood thanks to the discussions, which will take place during this impressive conference.

Achieving sustainable convergence requires the conduct of sound economic policies, both before and after adoption of the euro. The present global crisis is demonstrating, once again, to which extent continuous resolute sound macro policies are the best way to improve economic and financial resilience in times of unexpected challenges and shocks.

Thank you very much for your attention.