Jörg Asmussen: CEEs and the crisis – current challenges and benefits

Speech by Mr Jörg Asmussen, Member of the Executive Board of the European Central Bank, at the IIF Central and Eastern Europe CEO Conference, Berlin, 29 April 2013.

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Dear Tim,
Dear Mr. Fitschen,
Ladies and Gentlemen,

Thank you very much for the invitation to join you here today.

My initial remark today may disappoint some of you, in particular the journalists who are present: as the ECB's Governing Council will meet this week as of Wednesday, our "self-imposed one-week blackout period" applies and I will not comment on monetary policy today.

Speaking as a European Central Banker in front of an audience with first-hand experience of how the crisis in the euro area has challenged Central and Eastern Europe, I expect a lot of questions.

"Is euro area membership really a good idea for those countries?", some people may be asking, or "Should they not stay out for the time being until the euro area has sorted itself out?".

The media are full of reports about the countries of the region postponing their envisaged entry date, or dropping that goal altogether.[1]

On top of this, as the euro area tackles the crisis and reforms its policies and institutions, the "in-or-out" question has become more complex.

A country can be outside the monetary union, but still sign up for the fiscal compact, or join the soon-to-be-established Single Supervisory Mechanism (SSM). The line between helpful inclusion and potentially damaging exclusion is not so clear any longer.

But as this audience knows better than most, how these issues are resolved will have profound implications for businesses in Central and Eastern Europe. The question whether or not to join the euro has major economic consequences. The question whether or not to join SSM, and the wider Banking Union, could be decisive for financial stability.

In light of this, I would like to focus my remarks today on addressing these issues. In particular, I want to answer two questions:

First, is joining the euro area good for growth?

Second, is joining Banking Union a good idea?

1. Is joining the euro area good for growth?

Starting with my first question, 'is joining the euro good for growth'?

On the surface, the seven central and eastern EU Member States that have not yet adopted the euro seem to be doing better by being outside. Their average growth rate for 2012 was 1%, compared with a contraction of more than 0.5% in the euro area, while in 2011 it was 3.2%, compared with under 1.5% in the euro area.

Moreover, I recognise that, at present, the euro area is not an excellent advertisement for stability given the difficulties facing a number of its members.

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[1] See FT of 19 April 2013, especially Romania, Bulgaria, possibly also Poland and Hungary.

But I also think it is important not to read too much into the current situation. Its causes derive much more from policy failures – declining competitiveness, unsound fiscal policies, weak oversight of banks – than from sharing a single currency *per se*. The single currency did, for example, not harm Estonia, Slovakia or Slovenia during the crisis. To the contrary: they benefited in particular of being part of a monetary union with a stable external value of the common currency.

There are at least three reasons why euro membership can still be attractive for EU Member States in Central and Eastern Europe – which I will refer to as CEE Member States – that are currently outside.

First, countries that join the euro area from now on will be entering EMU 2.0. The euro area has, however painfully, recognised the flaws in its original design, and taken major steps to repair them. There are tougher rules for fiscal policies, stronger oversight of macroeconomic imbalances, and a lender of last resort for sovereigns in the form of the European Stability Mechanism. In other words, the euro area has gone through its difficult initial learning phase, and new members will only reap the benefits of that.

Second, the CEE Member States are already very closely connected economically to the euro area. The euro area is by far their main trading partner, accounting for more than half of exports and imports in 2012. More than two out of three euros invested in the region come from the euro area. This implies that there could be large benefits from sharing a currency, not least in lowering transaction costs and removing exchange rate risks.

Third, for these Member States, tying themselves to the euro area does not mean becoming tied to its current problems. A forthcoming ECB study shows how exporters in CEE Member States are integrated into cross-border production chains with euro area companies: they typically use machinery and components sourced from the euro area, but sell the final products around the whole globe. This means that their economic prospects can be insulated from weak demand in the euro area, should it persist or reappear in the future.

Let me also add that for EU candidate countries the benefits of EU membership remain as convincing as ever: the *acquis* is the surest path to modernisation, democracy and the rule of law.

But while the benefits of euro membership are real, like any club, the euro area has rights and it also has obligations. And during the crisis, the obligations of membership have become much more clear.

First, countries have to be ready and willing to join. By this I mean they must have internalised, in their public debate, the requirements of being part of a monetary union. Countries cannot join the euro area but continue with the same economic policies based exclusively on national considerations. And this consensus needs to be there *before* membership.

Second, while the Treaty prescribes the criteria for joining the euro, convergence means more than meeting a set of nominal criteria at a point in time. It has to involve laying the foundations to prosper in EMU over the long-term. There cannot be labour markets that protect insiders; product markets that shield closed professions; education systems that hinder innovation; public administrations that fail to collect tax or pay arrears; or judicial systems that cannot enforce contracts in reasonable time.

Countries that join the euro area in the future are in the enviable position of being fully aware of these obligations. They can prepare properly for membership and hence maximise the benefits. And indeed, many are already doing that. It is somewhat ironic that the exemplars for the right kind of policies for euro area membership are mainly found outside it.

Latvia is the leading example of how to adjust through internal devaluation, and it is a model for others in the euro area. Its "V-shaped" economic recovery illustrates what can be done with a strong consensus to undo the excesses of the past. After an initial fall in GDP of

almost 18% in 2009, GDP increased by more than 11% from 2010 to 2012, and unemployment has fallen by almost 7 percentage points from its peak.

And Poland is a case in point of how not to get into difficulties in the first place: it is a country with relatively sound macroeconomic fundamentals, which has managed to avoid recession and preserve sustainable growth in recent years.

To sum up, the case for joining the euro area for CEE Member States remains as strong as it has always been – if not stronger, because we have now learned the lessons of the first ten years. But it is not a decision that should be taken lightly. It means fundamental reform of institutions and economic models. And this can only work if the people are ready and willing to endorse it.

2. Is joining Banking Union a good idea?

But as I said at the beginning, the question for CEE Member States is no longer only whether to be in or out of the euro. Differentiated integration means joining the euro area is not the only way to deepen integration – with Banking Union being the most tangible example at the moment.

This leads me to my second question: 'is joining Banking Union a good idea'?

This is of course a question that can only be answered by the authorities in CEE countries themselves. However, the facts suggest there would be a number of benefits.

Financial interconnectedness between the east and west of Europe is extremely high. In fact, it is unique in the world. Around three quarters of bank assets in the region are foreign-owned, mostly by parent banks from other EU countries. That is three to four times higher than in Asia and Latin America.

Moreover, the crisis has shown that this interconnectedness is very risky if not properly supervised and managed.

First, in several countries lending activity in the boom years contributed to unsustainable debt dynamics in the aftermath of the global financial crisis. For example, annual growth rates of private sector credit remained well above 40 per cent in Bulgaria, Romania, Latvia, and Lithuania in the run-up to the crisis.

Second, foreign banks spread the crisis symptoms through a reduction in cross-border lending; by deleveraging from the region once the crisis started. The results were quite unfair, if that is indeed an adjective that should be used here: even those countries where excesses had not been as evident as elsewhere were hit by the drying up in cross-border capital flows.

One way to deal with these problems would be to roll back financial integration. But I think this is not a very realistic prescription. Financial interconnectedness is here to stay.

The other response is to "make interconnectedness safer". And it would seem that there are few better ways to do this than to be part of Banking Union.

Joining the SSM, which is a central pillar of Banking Union, would have concrete and tangible benefits, not just for individual banks, but also for the financial system of the region as a whole.

Let me give you an example: as you are fully aware, foreign currency lending in some of the countries of the region has been a real source of systemic risk. According to the new capital framework for banks (CRD IV), the ECB – as newly empowered macro-prudential authority – will be able, on its own initiative, to pre-emptively tighten prudential capital requirements above EU-level minimums when national systemic risks are detected.

In other words, not only will the SSM improve detection of emerging financial risks like those that caused the crisis, it will provide a stronger set of tools to counter-act them.

But Banking Union is more than just the SSM. It will also create a common approach to restructuring and resolution of banks across Europe. We need a consistent set of rules, including a clear pecking order, to create certainty for investors and reassure depositors. Fortunately, progress here is well underway.

The Bank Recovery and Resolution Directive – which applies to all 27, soon 28, EU countries – is the key first step. This framework should enter into force as soon as possible, and I would like to see the bail-in provisions advanced to 2015 to reduce the cost of bank repair for the public purse.

The next step is to establish a Single Resolution Mechanism, based on a Single Resolution Authority and a fund to be financed by the levies on the banking industry itself. This would ensure that all banks in the EU – in particular those here in CEE countries – benefit from a level playing field, as bank funding costs would not be determined by the soundness of their sovereigns, but rather the soundness of their balance sheets and business models.

However, to move ahead with Banking Union we need urgent clarity about who will actually remain outside. Many countries have given indications that they are considering to join the SSM. But as the legislative process enters the final stretch, and as our own internal preparations are gearing up, it is essential that those intentions become something more firm.

Ideally, we should know by July 2013, when the legislation is expected to be finally adopted, which countries outside the euro area are committed to join, and by when.

Conclusion

Let me conclude.

The euro area is here to stay. It will survive this crisis, it will emerge from it stronger and more countries will join the euro in the future.

But it is also unavoidable that the euro area will change. We have to move ahead with deeper integration. In a monetary union, the economic policies of each country are by definition “a matter of common concern”. It is right and legitimate that the euro area establishes much closer oversight of national decisions – for its own sake, and that of the EU as a whole.

This means that, like it or not, the euro area has become the engine of European integration. There will be a Europe of different speeds and the euro area will be the fastest.

But this process is not a threat to the idea of the European Union. As the fiscal compact and the SSM show, countries that are willing and able to fulfil the requirements are invited to join. Of course, for every Member State the timing and conditions have to be right – but personally, I would like to see this sooner rather than later.

Thank you for your attention.