Ardian Fullani: EU integration – key challenges for CESEE countries

Speech by Mr Ardian Fullani, Governor of the Bank of Albania, at the conference "Interlinkages with the euro area and long-term convergence dynamics", hosted by the European Central Bank, Frankfurt, 17 June 2013.

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Mr. Chairman,

Ladies and Gentleman,

Dear Colleagues,

The topic of this Conference is of crucial importance for the economic and financial prospects of Western Balkan countries. These countries are fully integrated with the EU economy and the EU financial system. The European Union represents their main trading partner and banks originating in the EU dominate the financial system in our region. As amply demonstrated by our experience, prior to and during the recent crisis, developments in the EU affect immediately both the real and the financial system in the region. *The EU and Western Balkans can be considered partners and, as such, they have a legitimate interest in the policies and actions of the other. I trust this conference will try to explore the best mechanisms for mutual consultation and coordination.*

CESEE countries have chosen integration with the EU as the main vehicle to deliver sustainable and long-term economic prosperity to their citizens. I would like to point out that our countries have consciously chosen the path of EU integration: we have undertaken painful structural reforms; we have made legal and regulatory reforms around this process; we have opened our markets to goods, services and capital from the EU. *I think it is only fair for us to expect long-term commitment and solidarity from our partners.*

This integration and convergence process has certainly delivered in the past two decades. GDP growth has outpaced that of the EU and financial intermediation has rapidly improved. Common economic wisdom based on indicators such as GDP per capita, relative financial intermediation, relative cost of labour and technology indicate that this process will continue in the future. CESEE countries still offer attractive investment opportunities: they have, in general, better demographic dynamics and are geographically closer to Europe than other emerging markets. This political and economic integration has naturally led to financial integration.

However, I would like to make three remarks regarding the economic and financial integration path we are pursuing.

- *First,* the main focus of national authorities in SEE should be to facilitate the allocation of capital to more productive sectors, by providing the right incentives, structural reforms, legal environment, tax policies, and economic stability. *This requires a common understanding with banks operating in the region. Banks are and will remain profit-maximizing entities. Nevertheless, they should be more attentive to long-term trends, because they have a stake in the sustainable development of the economy.*
- *Second,* we have developed a financial system and pursued a financial integration strategy based on the banks, which account for more than 90% of the financial system throughout the region. Therefore, recent suggestions about developing domestic capital markets as an alternative to a bank-based financial system are useful, but perhaps unfeasible in the short to medium term.
- *Third,* the SEE is and will remain a capital-hungry region, which should be partly intermediated through international banks. This fact should be recognized by both

EU regulators and EU parent banks. A new business model relying purely on domestically-generated deposits is a wrong answer to the previous extremes of huge capital inflows.

Currently, key challenges to financial stability in the SEE area comprise non-performing loans, slow growth of credit to the economy, the problem of fiscal finances, and the exchange rate stability. Their nature and magnitude are directly related to the growth problem and the private sector approach to consumption, savings and expectations. These problems were either created or exposed by the crisis and have exacerbated due to financial stability-related issues of our partner countries and their approach to the solution of such challenges. More directly, the banking sector has seen deleveraging due to required financial stability measures of the European banking authorities. Does this have an impact on credit and growth? The obvious answer is yes. Whether directly or indirectly and despite their origin, current financial stability problems are related to slow economic growth, which, in turn, is the result of shrinking financial intermediation. In principal, these developments have combined in a vicious circle, which is leading the economy in a slow downward spiral.

There are certain important lessons learned by the crisis. Above all, there is a substantial change in the perception of policy design and policy implementation by authorities with two defining trends. First, we are observing a new paradigm – the rethinking of the central bank policy design and policy implementation. The new model consists first in the idea that CPI-based inflation targeting might not be enough to preserve macroeconomic and financial stability, and second, in the use of macroprudential regulation in combination with traditional monetary policy measures. To be effective, these measures require a strong coordination with traditional monetary policy and banking regulation and supervision measures. Unless coordinated, they can do more harm than good. Moreover, given the strong cross-border financial links between the EU and the SEE, they have over reaching effects across the borders. In this respect, coordination becomes a multi dimensional effort.

Due to these strong financial and economic linkages of the CESEE with the euro area, European policies and regulations, macroeconomic and macro prudential intervention have authentic real-time impact on our economies giving way to new challenges. The coordination of macroeconomic and macroprudential measures within the euro area will continue to exert macro stability pressures on the CESEE. Therefore, it is important for the economies of the CESEE to know, in advance, and understand the EU’s legal, institutional and regulatory developments in the financial system and possibly have an opinion on the potential impact and unintended consequences that such developments may have on their economies.

I would invite the EU monetary and supervisory authorities to focus on the overall picture and think about long-term solutions rather than short-term adjustments, which, instead of solving the problems, recycle the old ones (problems) into new challenges, transforming the nature and the subject without really addressing the overall stability issue.

The EU Banking Union, in our view, is a very important step towards further integration and coordination between home and host authorities. We appreciate the fact that the establishment of the centralized supervisory authority will facilitate the information exchange between supervisors, creating a more efficient communication between home and host regulators by reducing the complexity of dealing with multiple national supervisors and regulatory bodies. The Bank of Albania, as a member of the Vienna Initiative Steering Committee, advocates the need for EU authorities to comprehensively assess interconnectedness issues between EU/euro area and non-EU/non-euro economies in order to design balanced and sustainable policies. In particular, macro prudential measures in the euro area should also consider the situation and the potential impact on non-EU host countries. We expect that the ECB, as a leading authority within the SSM, to play an important and constructive role, whereas non-EU supervisors must be granted the opportunity to express their views on EU financial policy decisions affecting their domestic financial stability, before the actual decisions are taken. The effective functioning of supervisory colleges is also considered a very important issue, where countries with systemic EU subsidiaries may address their supervisory concerns.

On the other hand, it would help if small countries of the region outside the Banking Union had a unified view and approach towards EU authorities and expressed their concerns as a single voice. In this regard, the Bank of Albania, assuming a coordinating role, has invited other non-EU countries to contribute in formulating a common regional approach towards the Banking Union and its effects on these countries.

We also argue that it is at the benefit of the ECB, and other monetary and supervisory authorities and EU authorities to bring the CESEE countries on board of discussions, like a responsible doctor, who, while providing a strong remedy for his patient, tries to minimize potential side effects. The ECB must consider the potential side effects of its policies in our region. This consideration concerns five important issues:

First, the ECB has a large theoretic and empiric expertise on financial stability, monetary and economic analysis; however, the CESEE countries may have a more precise and direct view of potential side effects on their economies;

Second, this discussion among the ECB and the CESEE must start early, possibly in the design process rather than after the implementation of legislation and regulation. This will allow enough time for CESEE authorities to implement legal and regulative amendments to complement EU regulation and adapt its institutional structures in timely manner.

The reforming EU deposit insurance and banking resolution mechanisms, for example, will have legislative and regulative implications for economies of the CESEE due to dominance of European banking groups in our financial sectors. However, until the ECB and the EU decide on a solution and legislation is eventually approved, we would not know what the potential implications (like regulatory arbitrage opportunities), the required legal changes, and the financial costs are for our banking system and our economies. Information is clearly in the interest of the CESEE countries as it would remove uncertainty and risk among host supervisors (non-EU and non-euro area) regarding the effective resolution (including burden-sharing) of multinational European banks;

Third, establishing “Resolution colleges”, similar to “colleges of supervisors”, might be an intelligent and efficient way to prepare for extreme situations. These colleges would allow home and host supervisors to discuss ex-ante regarding possible resolution of multinational European banks, with the purpose of bridging differences in the process and burden sharing as much as possible. In principle, some form of supervision could be designed to allow the ECB to share the responsibility of supervising multinational European banks with the host supervisors (particularly in case of their systemic importance in host countries).

Fourth, establishing swap lines of liquidity in euro, between the ECB and the host countries’ central banks (or supervisory authorities) – non-EU countries, managing and overcoming unexpected liquidity risk and other potential constrains faced by multinational European banks, which might rise directly or as unintended consequences in response to decisions taken by supervision and financial stability authorities in the euro area. This could be the case only for those (non-euro area, non-EU) host countries, where the European banks have a systemic importance. In return, the host countries’ supervisors will provide the ECB with information on the financial situation of the systemic subsidiaries and their respective supervisory policies;

Fifth, it is about the role of international financial organizations. The IMF, the World Bank, and the Basel Committee have had and continue to play an important role in shaping the financial system and building its resilience in our economies. The EFSAP is an excellent example to illustrate this point, and they have vast expertise in dealing with related issues in developed and emerging countries. Therefore, I believe that involvement of these institutions in the discussion process would benefit both EU and CESEE economies.

The euro area and the CESEE economies will be ultimately part of the same political economic and monetary union. Despite current hardships, the EU political and economic integration agenda remains committed in this goal. One might even say that despite potential political, social setbacks caused by the crisis, it (the crisis) is pushing the integration agenda faster and stronger than before. In this respect, it is necessary to connect the political and economic integration process together and continue developing both processes at the same speed. Under current circumstances, regional cooperation and communication becomes a necessary objective of the CESEE integration process, at least for the banking and financial market reform. It would be much easier for the EU authorities to adopt and address the concerns of the CESEE as a single group rather than individually.

In conclusion, it is so important to establish a significant level of communication and coordination among the central banks and EU institutions, their legal and regulative framework. Finally, I would recommend complementing it with a similar level of coordination among other institutions, which play a significant role in macroeconomic and financial stability in our economies. In particular, there is more need for communication and coordination among the ministers of finance in the region because fiscal policy is essential for the macrofinancial stability of the economy and plays a significant role in the successful implementation of the macroprudential tools. The coordination is not an easy task, especially when benefits come at the cost of one's partners, but, if we aspire to have far-reaching results, this is the right manner and the appropriate moment to react.

Thank you!