Jörg Asmussen: Economic convergence across Central, Eastern and South Eastern Europe – achievements and challenges

Speech by Mr Jörg Asmussen, Member of the Executive Board of the European Central Bank, at the Conference on European Economic Integration (CEEI) 2013 "Financial cycles and the real economy – lessons for CESEE", Vienna, 18 November 2013.

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Dear Ewald,

Good evening ladies and gentlemen,

It is a pleasure to be here with you tonight. I would like to thank the OeNB for the invitation to share some thoughts on the region, on which the OeNB has developed analytical excellence that is beneficial to the entire Eurosystem.

I will focus my remarks on selected experiences of countries in Central, Eastern, and South-Eastern Europe on their path of *economic and institutional convergence* towards the rest of Europe. I will argue that both the successes and the challenges associated with the convergence process point to two basic lessons. First, that we should never relax in the pursuit of domestic policies oriented towards financial stability and sustainable growth. And second, that we need not just more, but also better European integration.

In what follows, I will use the term Western Balkans to refer to the six EU candidate and potential candidate countries in the region: Albania, Bosnia and Herzegovina, Kosovo, the Former Yugoslav Republic of Macedonia, Montenegro, and Serbia]. I will use the term Central and Eastern European countries to refer to seven EU member states outside the euro area, namely Bulgaria, Croatia, the Czech Republic, Hungary, Lithuania, Poland, and Romania. And I will refer to the two groups of countries taken together as Central, Eastern and South-Eastern Europe.

I. The good experiences with convergence

If you had to pick three "good experiences" which countries in the region have made over the years in terms of convergence, what would your choice be?

1. Increasing living standards

For me, the first good experience I would bring home is the improvement in the region's living standards: between 2000 and 2012, real per-capita GDP, adjusted for differences in purchasing power, increased on average by close to 50 per cent both in Central and Eastern Europe and in the Western Balkans. In Lithuania, per capita income, measured in this way, increased from 35 per cent of the euro area average in 2000 to 65 per cent in 2012. On the other side of the spectrum, the living standard in the Former Yugoslav Republic of Macedonia increased only from 24 per cent of the euro area average in 2000 to 32 per cent in 2011. The rising living standards across the region have been a by-product of remarkable economic and institutional transformation, which has shaken off the heavy burden of half a century of central planning.

2. Offering a platform for the integration into the global economy

The second good experience I would like to highlight is the global success of pan-European production chains. This can be a win-win story for everybody in our continent.

Exports from Central and Eastern Europe grew at an average pace of over 10 per cent per year in the decade prior to the global financial crisis. Even thereafter, in many of these countries export growth has been led by significant competitiveness gains.

This export performance can to a large extent be attributed to the integration of local exporters into cross-border production chains, which at present account for half of all of their exports. What this means in practice is that local exporters typically use components sourced from the euro area to assemble intermediate goods and final products that are then sent down the value chain en route to final consumers around the globe.

Local exporters are often owned outright or operated as joint ventures by companies based in the euro area. In fact, more than two out of three euros invested in Central and Eastern Europe come from the euro area.

The win-win proposition of vertical specialisation in international trade is most visible in the European automobile industry. A recent IMF report highlights the fact that the German automobile industry embrace of this trend has allowed it to remain a leading producer and exporter of passenger cars with a global market share of around 20 per cent as of 2012. While domestic production has remained relatively constant at around 5.5 million vehicles per year between 1992 and 2011, foreign production, particularly in Czech Republic, Hungary, Poland and Slovakia, increased more than threefold, reaching 7.1 million vehicles.

Another example is that of Renault, which became the majority stakeholder in the Romanian automobile firm Dacia in 1999. In the space of a few years, Renault turned the ailing company into a driving force for the Renault Group. Specializing in robust, economical models, Dacia produces vehicles primarily for new markets.

A remarkable aspect of this production model is that, while real linkages with the euro area remain substantial, the economic prospects of countries in the region have become relatively less dependent on euro area than on world demand. I was indeed surprised when I learned that the share of Central and Eastern European exports destined to the euro area peaked already in 2001, at over 60 per cent. This share has since declined by more than 8 percentage points, as exports to partners outside the euro area have grown faster than those destined to the euro area.

3. Facilitating finance for growth

Third, country experiences with the process of EU accession suggest that new or prospective members not only benefit from an economic and institutional anchor. Over time, they have also benefited from sizeable capital inflows from the euro area that have helped finance the transformation of their economies.

True, the same capital flows were a key ingredient in the credit booms and busts in most countries of the region. While I will return to this aspect in a moment, we should not overlook the importance of financial interconnectedness between the euro area and Central, Eastern and South-Eastern Europe. Around three quarters of bank assets in the region are foreign-owned, mostly by banks from other EU countries. Their subsidiaries and branches have played *and will continue to play* a central role in improving the efficiency of financial intermediation across the region and contributing to credit availability.

II. The bad experiences with economic convergence

Moving now from the good to the bad experiences with economic convergence, we are probably all on the same ground in this room. Let me stress those aspects which, in my view, policy-makers should never forget in the future.

1. When growth models become prone to boom-bust cycles

First, in the run-up to the crisis the growth models in many Central, Eastern, and South-Eastern European countries became dominated by credit-fuelled domestic demand booms. For example, between 2003 and 2008 the average contribution of domestic demand to economic growth in Central and Eastern Europe increased by more than 2 percentage points per year.

We now all agree that this was an unsustainable development, fuelled by overly optimistic income expectations and excessive ease of financing. It led to large and persistent current account deficits. The median current account deficit peaked in 2008 at around 9 per cent of GDP across Central and Eastern European countries and 15 per cent of GDP across Western Balkan economies.

Across the region, the domestic demand booms were mainly financed by euro area banks through funding of their local subsidiaries and direct cross-border lending. The ready availability of such external financing was a contributing factor to the credit frenzy that gripped most economies in the region. The median growth rate of real bank credit to the private sector over the period 2003–2008 averaged 20 per cent per annum across Central and Eastern Europe and 25 per cent per annum in Western Balkan economies.

This experience now sounds very much as something that belongs to the past, but we have all learned the hard way that complacency is the best recipe for future disasters.

2. Impaired lending channels and bank deleveraging complicate the recovery

Second, the pre-crisis credit booms turned into post-crisis credit busts. The resulting impairment of the bank lending channel has been a stumbling block for the economic recovery ever since. Double-digit NPL ratios are now more the norm than the exception across the region. Banks have responded by setting aside provisions to cover expected losses and tightening credit eligibility standards to prevent new loans from going bad. These developments have limited banks' ability and willingness to lend.

The post-crisis behaviour of euro area banks in Central, Eastern and South-Eastern Europe has been generally cautious, but also responsible. The Vienna Initiative played an important role in preventing a "run for the exits" scenario. On the one hand, euro area parent banks kept their local subsidiaries sufficiently capitalised to avoid bank failures. On the other hand, they have been unwinding in an orderly fashion their creditor positions towards the region. This deleveraging has contributed to the tightening of credit conditions in many countries in the region. Local subsidiaries were gradually weaned off cheap parent bank funding and forced to compete for the more limited pool of domestic deposits.

A new banking business model is emerging in response to these developments, but it will still take some time before we can clearly identify a new "steady state".

3. When real convergence grinds to a halt

Finally, the most worrying development is that real convergence has come to a virtual halt in the wake of the global financial crisis in many countries in the region. The average annual growth rate of real per capita GDP, adjusted for differences in purchasing power, slowed from around 4 per cent per annum before the crisis to 0.6 per cent in its aftermath in Central and Eastern European countries – and half that in the Western Balkans. Unemployment has soared throughout the region, at times to unacceptably high levels of close to 30 per cent in Bosnia and Herzegovina and 17 per cent in Croatia.

III. Some policy lessons

Let me now draw two broad policy lessons from the good and bad experiences which I briefly outlined.

1. First, the need for more – and, even more importantly, better – European integration is for me the core policy lesson. Let me explain.

The post-crisis economic recovery, while being subdued nearly everywhere, was faster in Central and Eastern European countries than in the Western Balkan economies. Exporters from Central and Eastern Europe were in a better position to take advantage of the recovery in global demand, due in part to their tighter integration in euro-area affiliated cross-border production chains. Looking ahead, the dismantling of trade barriers between the Western Balkans and the EU should allow exporters in this region to also realise in full the advantages of vertical specialisation in international trade. This is one of the reasons why closer integration in Europe will continue to be beneficial.

Another reason is that implementing the new EU governance framework will be key to prevent future macroeconomic imbalances in the Member States. The so-called Macroeconomic Imbalance Procedure explicitly monitors the emergence of internal and external macroeconomic imbalances. Moreover, the existing Stability and Growth Pact was strengthened, introducing earlier sanctions and more automatic enforcement procedures. It now needs to be implemented vigorously.

Not least, in the context of the on-going process of building the banking union the ECB has been granted supervisory powers. As you know, this will start in November next year, and will cover not only euro area banks, but also the banks of any non-euro area Member State wishing to join the single supervisory mechanism through so-called enhanced cooperation. As part of the new powers, the ECB will monitor the financial soundness of banks and, in case of need, impose additional capital, liquidity and other prudential requirements. The completion of a comprehensive banking union with all necessary elements will be a milestone in the construction of the new European governance. It will also be of significance for countries in the entire region as in many of them the banking sector is dominated by euro area headquartered banks.

2. My second key policy lesson is that the process of economic and institutional convergence needs to be sustainable over the longer run.

The fundamental logic of the EU Treaty – with the convergence framework embedded in it – remains the right one. Existing members, as well as candidate, and potential candidate countries have to make sure that they pursue sound policies. They should first and foremost focus on establishing sound fiscal and sustainable macroeconomic developments, and complement this with the necessary structural and institutional reforms including a strong framework for central bank independence.

To support the process of institutional convergence, the ECB, together with National Central Banks of the Eurosystem, has implemented since 2007 a number of technical cooperation programmes with central banks of the Western Balkan countries to strengthen their institutional capacity and prepare them for membership in the European System of Central Banks. I visited the Former Yugoslav Republic of Macedonia and Montenegro this summer and I will travel to Serbia next month and plan visits in Kosovo and Albania next year in the context of the Eurosystem technical cooperation programmes. I find these visits on the ground always very impressive, because one gets a very concrete sense for tangible improvements through technical cooperation as well as a better understanding for the remaining challenges.

Revamping growth with the proper mix of macroeconomic and structural policies is of the essence. By now we have learned that there is no automatism in the convergence process, which should rather be seen as a by-product of relentless policy efforts – which, by the way, should occur not only before but also after the adoption of the euro.

IV. Conclusion

Let me conclude my remarks on a positive note. All in all, we at the ECB see the record of countries in Central, Eastern and South-Eastern Europe with economic and institutional convergence as a success. We have learned from the mistakes made along the way and are working at building a stronger Union.

A testament to this is that the broad momentum of euro area and EU accession has not been halted by the crisis. Since the start of the crisis three EU Member States – Slovakia, Estonia and Latvia – have adopted the euro or are about to do it. A fourth country, Lithuania has set the target of euro adoption on 1 January 2015. And three other countries have become either EU members, as was the case with Croatia in July this year, or formal candidates to join the EU, as is the case with Serbia and Montenegro. This shows that the EU and the euro are not closed shops, but rather they are open to those who are willing *and* able to join and to fulfil the respective conditions on a sustainable basis.

The EU was founded on the premise that interlocking the economic futures of participating members will free Europe from armed conflicts. This remains as true today as it was fifty-five years ago at the moment of signing the Treaty of Rome. In this regard, EU candidate and potential candidate countries in the Western Balkans stand to benefit from the promise of a prosperous and peaceful future.

I thank you for your attention.