# Ewald Nowotny: Financial cycles and the real economy – lessons for CESEE

Opening remarks by Prof Dr Ewald Nowotny, Governor of the Central Bank of the Republic of Austria, 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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Good morning, ladies and gentlemen,

It is a great pleasure for me to welcome you to this year’s Conference on European Economic Integration, which will be dealing with the topic of “Financial Cycles and the Real Economy: Lessons for CESEE.”

Let me start by sharing some general observations and thoughts with you. The economic situation in Europe in general and in the euro area in particular has started to improve over the last few months. At the same time, unemployment rates have stabilized in most economies of the European Union (with the exception of Cyprus, where macroeconomic adjustments are in full swing) and sentiment indicators point toward a soft recovery in the next few quarters and beyond. Although the heterogeneity of economic performance across the euro area remains a cause for concern, recent forecasts expect some rebalancing in 2014 on the back of a rather broad-based improvement in the macroeconomic outlook. As a consequence, of course, perceptions have started to change: During the Annual Meetings of the IMF and the World Bank this fall, Europe was no longer the focal point of concern. While this is encouraging, the situation remains greatly diverse across individual countries, and efforts now need to focus on completing ongoing adjustments. Likewise, the institutional changes in progress or envisaged at EU level need to be successfully implemented and put into practice. In a similar vein, Central, Eastern and Southeastern Europe (CESEE) is also gradually recovering. There, as in Western Europe, economic performance varies substantially between individual countries, and efforts to move toward a balanced growth model, which were at the center of attention at last year’s CEEI, need to be continued.

The recent recovery in the real economy is also supported by the decrease in financial market tensions which began in late 2012 not least because of a very accommodative monetary policy response. However, the institutional reforms that are currently being carried out in response to the crisis will have to remain a top priority for policymakers across Europe. At the moment, one of the key institutional reform efforts in the EU is the creation of a banking union. With the establishment of the single supervisory mechanism, the SSM, we have made a major effort to help this banking union to get on its way. The SSM is designed to be as open and as appealing to non-euro area EU Member States as possible, and we do hope that as many non-euro area countries as possible will participate. Given the high degree of financial integration and interdependence in Europe, it is certainly in our common interest that the SSM cover as broad a set of countries as possible.

To reap the full benefits of the single financial market in Europe, it is important to avoid measures that would have unintended side effects, e.g. in terms of market fragmentation. It is my conviction that ringfencing will not help us move forward. Regulatory and supervisory measures with regard to capital and liquidity in individual countries should be taken in a European spirit, for the better of Europe as a whole. The reversal in European financial integration, which we have seen over the past few years, needs to be stopped and in fact reversed again, so that cross-border finance in the EU can play out its full role in the common market.

Those banks in Europe which operate in more than one country should no longer be considered Austrian, German or Italian banks and so forth. They are European banks. Not only will they be supervised by the ECB as soon as the SSM takes effect (if they are headquartered in Member States that participate in the SSM), they are also European in the way they operate. For instance, the top management at their subsidiaries across Europe is no longer mainly composed of members that come from what we still call the "home" countries. In fact, the subsidiaries show a continuous trend toward multinational set-ups. To be more specific: Less than one-third of the top management of Austrian banks' subsidiaries in CESEE are from Austria. That said, the vast majority of board members comes from either the respective host countries or other third countries. The same is essentially true for the subsidiaries of other European parent banks. In my view, this diversity is a big asset as it brings a greater variety of views and thus improves the decision-making process.

All of this points toward a scenario in which the European perspective will be attributed an ever greater weight. Strengthening the European perspective may be a lengthy and, at times, an arduous process, but it is certainly the way to go – and will make an important contribution to reviving Europe and making it flourish again. One challenge along the way is that of gaining a more comprehensive understanding of the financial cycle – which is the topic of our conference. The global financial crisis and subsequently the sovereign debt crisis have (once again) strongly highlighted the key role financial developments play for economic activity and, at the same time, the necessity to review our understanding of the finance-growth nexus.

Let me briefly spell out what I mean by that. Prior to the crisis, most economists believed that financial deepening strengthens long-term growth as it improves the allocation of resources by facilitating the collection of information, the monitoring of projects, the trading, diversifying and managing of risks, the mobilization and pooling of capital and, finally, the exchange of goods and services within the economy.[1] Consequently, most observers did not consider the strong growth of private sector credit and house prices in several euro area economies (like e.g. Spain or Ireland) prior to the global financial crisis to be overly problematic but were of the opinion that it was – at least largely – sustainable.

In a similar vein, the credit boom in CESEE (which started around 2003) and the substantial increase in house prices in many CESEE economies before the global financial crisis were conceived as part and parcel of the catching-up process these economies went through – at least during the first years of the boom. Given the low starting levels of credit-to-GDP ratios and of house prices in the early phases of the transition process (as compared with fundamentals), there was general agreement that there was a need – and indeed room – for further financial deepening in CESEE. Aptly reflecting these considerations, the CEEI 2005, for example, dealt with the topic of "Financial Development, Integration and Stability." While most of the contributions at the time emphasized the considerable potential for further financial deepening in CESEE, which would increase growth and foster economic convergence in the region, several discussants aired concerns that rapid credit growth and soaring house prices, if they continued unchecked, could breed instability further down the road. OeNB research at the time suggested that credit-to-GDP levels had surpassed equilibrium values (as given by fundamentals) in some, but not in all, CESEE countries by 2005/06 – while the credit boom went on until late 2007 in the Baltic countries and until the fall of 2008 in most other CESEE economies. However, the tendency to think that "this time is different"[2] – a well-known phenomenon in late-boom episodes – caused these concerns to be widely ignored, and even those who acknowledged them hoped for a soft landing (rather than a deep and painful correction). Now – five years later – it is undeniable that several CESEE economies (as well as some peripheral euro area countries) experienced a severe

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1 ***Levine, R. 2005***. Finance and Growth: Theory and Evidence, in P. Aghion and S. Durlauf (eds.). Handbook of Economic Growth. Elseview. Chapter 12. 865–934.

2 ***Reinhart, C. M. and K. S. Rogoff. 2011***. This Time is Different: Eight Centuries of Financial Folly. Princeton University Press.

and rather protracted financial bust that is weighing on their recovery and also slowing down the convergence process – a topic we also discussed at the CEEI 2012 in Helsinki.

Thus, the crisis has recalled a key point: The finance-growth nexus is not just a long-term phenomenon but has an important cyclical component that was widely underestimated prior to the crisis. In other words, sustainable output was systematically overestimated during the boom years, as too much of the upturn was attributed to improvements in the underlying trend component and (much) too little to cyclical factors. This happened because the financial cycle at work was not appropriately taken into account. This, in turn, led to (or at least contributed to) overly optimistic expectations and the build-up of excessive leverage – as expressed in strong credit and house price growth. The magnitude of the risks involved was widely underestimated and, consequently, inappropriate policies and policy responses resulted in a high degree of vulnerability in quite a few countries as soon as the financial cycle went into reverse.

Clearly, pre-crisis failures in regulation and supervision further aggravated the situation that has developed since 2008, making it more difficult to deal with banking sector problems without either risking a financial sector meltdown or tainting public sector solvency. In the euro area, these developments led to substantial euro area-wide frictions, which we are currently addressing and need to continue to tackle until the crisis is fully solved and a sustainable new growth model as well as a complete and robust institutional set-up for Economic and Monetary Union are in place. On the global level, the regulatory agenda that emerged from the crisis is still unfinished business – and probably always will be, to some extent. Continuous efforts are therefore needed to bridge existing regulatory gaps, e.g. as regards the resolution of large multinational banks, and – equally important – to address future regulatory challenges arising from ongoing financial innovation.

Of course, the interaction between finance and growth depends on the time dimension. In the long run, financial deepening still helps growth. This finding has not been altered by the experience of the financial crisis. The positive impact of further financial deepening, however, may be smaller than we still thought a few years ago, and it may be much more conditional on the regulatory framework and the overall policy compound. This is an empirical question, and it is certainly important to revisit this debate. Even more crucial, however, is our understanding of short- to medium-term developments. Within the short- to medium-term horizon, the relation between finance and growth has become much more uncertain, given the risk that finance adds to or even causes boom-bust developments which can (and often do) entail substantial welfare costs. Both the IT revolution and global financial integration – or financial globalization if you prefer – have added to financial sector dynamics and thus reinforced the impact financial developments can have on the real economy.

Against this background, the CEEI 2013 focuses on the following questions:

- Have we changed the way we think about the finance-growth nexus? How do we measure the financial cycle and its impact on sustainable output and cyclical fluctuations? In other words: How do we assess whether financial deepening and thus the level of economic output is sustainable?
- What is the "nature" of real estate bubbles, and why should we care about their pro-cyclical interactions with finance and economic activity?
- What are the lessons to be drawn for economic policy? How should we deal with the financial cycle on the national, the European and the global level – both with regard to financial upturns and downturns? Do we have to rethink our policy rules?
- At the current juncture, how should we overcome the legacies of the crisis (and improve the resolution and/or recovery of nonperforming loans) and how should we lay the foundations for a better handling of future boom episodes? Is the necessary policy toolkit already in place? What do we know and what do we still need to know

about the functioning and the effectiveness of our new policy instruments, like e.g. many new macroprudential measures?

As the CEEI series concentrates on CESEE, we are particularly interested in the lessons that will have to be drawn for this region. To what extent did the financial cycle aggravate the crisis and slow down recovery in these countries? Are there lessons to be learned from crises in other countries – for example from the euro area periphery? Given the fairly heterogeneous performance of CESEE economies since 2007/08, did policymakers in some CESEE countries anticipate the financial cycle better than their counterparts in other countries? And, most importantly, what can we gain from these successful country experiences?

I really do hope that this year's CEEI, which will discuss all these questions (and many others I had no time to mention), will help us shed new light on several of these issues and, at the same time, strengthen the case for dealing with them from a European rather than from a national perspective. I am looking forward to a fruitful exchange of views and ideas with academics, policymakers and financial experts and, of course, with the audience.

Ladies and gentlemen, it is now a great pleasure for me to welcome, our first keynote speaker, Claudio Borio, Head of the Monetary and Economic Department at the Bank for International Settlements. He is an early contributor to the literature on the challenges that arise for monetary policy from global financial markets, cycles and crises, and I am truly obliged to him for being prepared to share his insights with us. Claudio, the floor is yours.