Ewald Nowotny: The rebalancing challenge in Europe – perspectives for Central, Eastern and Southeastern Europe

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) 2014, Vienna, 24 November 2014.

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Your Excellences,

Dear Governors,

Ladies and gentlemen,

I am delighted to welcome you to the annual Conference on European Economic Integration (CEEI) hosted by the Oesterreichische Nationalbank. Thank you for coming to Vienna. Many of you have traveled long distances to be with us today – a fact that highlights the importance of the topic we are going to discuss over the next two days: "The Rebalancing Challenge in Europe – Perspectives for Central, Eastern and Southeastern Europe (CESEE)."

What do we mean by "rebalancing"? Obviously, the term signifies a readjustment from a state of imbalance – an economic imbalance in our case. Typically, economists distinguish between external and internal imbalances. By external imbalances, they usually mean disequilibria (mostly deficits) in the current account which, if protracted, might lead to an unsustainable net international investment position. The underlying reason for a current account deficit can differ from case to case; it can be trade-induced via export weaknesses, indicating a lack of competitiveness; it could also reflect strong import demand due to unsustainably high growth. This leads us directly to internal imbalances, which comprise accumulated private and public debt, asset price bubbles, unemployment or excessive inflation (or deflation). One could also add sectoral or distributional imbalances contributing to uneven growth. Internal and external imbalances are often interlinked, but their interrelation is not always clear-cut.

This year's CEEI coincides with three anniversaries, which are crucially linked to our conference topic: 25 years since the fall of the Berlin Wall, 15 years since the creation of Economic and Monetary Union (EMU) and 10 years since the – so far – biggest round of EU enlargement. This is not only a reason for celebration but also an occasion for honest stock-taking and thoughtful reflection. I think that the developments that followed these events have been broadly successful. For an overwhelming majority of Europeans, the last quarter of a century brought hugely improved living standards and a much higher level of freedom. The CESEE region in particular saw a period of accelerated growth rates in the years prior to the global financial crisis. This was a win-win situation not just for the acceding countries but also for the EU, in general, and for Austria with its strong trade and investment links to the CESEE region, in particular. The episode following the introduction of the euro in 1999 and up to the beginning of the financial crisis was beneficial to the euro area. But those countries who apparently profited the most had to find out that they had built their performance on the untenable foundation of private debt backed by overvalued assets.

The crisis has revealed that the previously remarkable catching-up process is neither automatic nor irreversible. The new Central European Member States fared relatively well in terms of trade performance even after the financial crisis. By contrast, a dramatic stop of private financing flows required the economies under stress in the euro area, the Baltics and the Balkans to quickly adjust their external imbalances. Even though they improved their competitiveness, external rebalancing resulted in internal imbalances such as high unemployment and overcapacities, while the development of new export capacities was hampered by financial constraints and weak European and foreign demand. Hence, a lot of the adjustment had to take place via diminished import demand caused by painful cuts in income and employment. Whether this import reduction is sustainable depends on the structural nature of the related economic slump – something we will only know with a sufficient degree of certainty at the beginning of a new cycle.

A very interesting aspect of external imbalances is their relation to the patterns of sectoral specialization in a given economy. The countries featuring the best export performance prior to and after the financial crisis are exactly those that have a large manufacturing sector. The four countries that form the Visegrad Group have been fortunate in terms of foreign direct investment, which enabled their re-industrialization. Via cross-border production networks, these economies are involved in a "new industrial core" of Europe together with Germany and Austria. Those countries, however, that have not been able to establish sufficient tradable industries and have neither abundant natural resources nor tourist attractions have difficulties to escape the dilemma of either chronic disequilibria or contractive deleveraging.

Even worse, investment, which is crucial for future growth, has been cut over proportionally. Six years after the collapse of Lehman Brothers, investment levels in the EU-28 are about 18% below their peak; in some euro area economies under stress, investment was cut by about one-half. Taking into account some necessary correction of previous overinvestment in the construction sector, a prolonged period of below-trend business investment will certainly weigh on future productivity growth. The investment gap can be partly explained by financial constraints, in particular for SMEs, start-ups and infrastructure. Another factor is demand uncertainty, triggered by private and public deleveraging – typical for balance sheet recessions.

Having said that, one should not forget that because the level of economic activity differs widely between the euro area average and the CESEE region, the latter has the best long-term growth prospects in Europe – even if convergence will, most likely, proceed more slowly than in the past (with the annual growth differential dropping from up to 4 to below 2 percentage points). Thanks to its proximity and its traditional ties to the CESEE region, Austria is in an excellent position to take advantage of this growth process. CESEE's share in Austria's total goods exports rose to 22% (2013) – with the euro area countries still accounting for half of all Austrian exports. Conversely, Austrian banks' high international exposure is concentrated with their CESEE subsidiaries despite a slight decline in the respective exposures due to reduced activities in countries like Hungary and Ukraine. While a tendency toward greater diversity is desirable, banks ought to promote a sustainable growth model in countries with adequate economic and legal conditions – in the spirit of the Vienna Initiative.

How to maintain the hope for convergence as enshrined in Article 3 of the Treaty, which states that the European Union "shall promote economic, social and territorial cohesion"? I think that the new European Commission is setting the right priorities by proposing an investment package combined with regulatory reforms targeted toward fostering smart infrastructure, education, research and energy. Not only should this package provide short-term stimulus but also improve the potential for long-term growth in Europe. At the same time, a reform of industrial policy focusing on new companies in the manufacturing sector of vulnerable Member States could help create export capacities. At the same time, the process toward a governance structure worth of a "genuine EMU" as outlined by the Presidents of the European Central Bank, the European Commission, the European Council and the Eurogroup in 2012 contributes to confidence building. While the successful creation of the banking union marked a major step toward completing the architecture of EMU, the other three pillars necessary for this completion – fiscal, economic and political union – are still in the making. To the extent that the new EMU architecture will be able to eliminate economic uncertainty, it may also contribute to economic growth in the euro area and beyond.

Ladies and gentlemen,

Some of you might have noted that an important historic event was missing from the anniversaries I listed before: 2014 also marks the centenary of the First World War. This "great seminal catastrophe" of the 20th century marked the end of an initial era of globalization and the beginning of a 30-year period of misery and barbarism. Importantly for us, in hindsight, this tragedy was by no means inevitable. Recent work by historians reconfirms the view that European leaders at the time would have had better alternatives, but they made the wrong choices. It took decades to overcome the division of post-war Europe, and in many aspects this process is still under way. The devastation brought about by the wars, however, prompted an unprecedented European peace project – a process of political and economic integration, including monetary integration. The tragic events happening these days just 1,500 kilometers east of Vienna should remind us not only of the fact that war destroys lives, but that it also destroys countless opportunities of living in prosperity.

Remembering our past helps us prepare for a better future. In this context, I am glad to advertise the publication of a data volume entitled "South-Eastern European Monetary and Economic Statistics from the Nineteenth Century to World War II." The volume will also be available electronically on the OeNB website as from December. It is the result of the work of a joint Data Collection Task Force that comprises the central banks of Albania, Austria, Bulgaria, Greece, Romania, Serbia and Turkey. The book provides the first comprehensive collection of monetary data on Southeastern Europe for the period between 1830 and 1949. Let me thank all the contributors and the entire South-Eastern European Monetary History Network (SEEMHN) for their efforts to eliminate the white spots on our map of the region's monetary history and policy. European economic history research had largely neglected Southeastern Europe, presumably because data were not readily available in the past. Remarkably, what we find today is that the countries covered in this volume already had to deal with problems of imbalances and rebalancing in the period discussed. Thus, the volume allows us to study the particular problems peripheral economies typically face after international crises: credit squeezes, capital flight and fiscal imbalances, all of which lead to strong economic contraction and often collapse.

To sum up: Internal and external rebalancing has always been a complex challenge. So far, countries at the Southern and Eastern European periphery have made good progress in improving their external competitiveness. Unfortunately, this progress entailed internal disequilibria in terms of high unemployment, contracting demand and sometimes even deflation. Eventually, their rebalancing efforts can only be successful – both externally and internally – if the macroeconomic environment improves all over Europe. Such an improvement, in turn, requires a comprehensive decision-making framework including a set of functioning monetary, fiscal and structural policy instruments. Our recent and historical experience suggests that decisions should be taken from a responsible and stability-oriented political perspective – not only for one country alone, but for the whole region concerned.

All too often, we let ourselves be guided by what a famous European leader once has said:

"There is no alternative." For an economist, there are always alternatives. What we should accept, however, is the trivial truism that any alternative has its costs or risks. There is no free lunch in economics, but we definitely have choices to make. In order to make the right ones, we must learn from each other. This conference should be a convenient opportunity.