Mario Draghi: Welcome remarks - 8th ECB conference on central, eastern and south-eastern European countries

Welcome remarks by Mr Mario Draghi, President of the European Central Bank, at the 8th ECB conference on central, eastern and south-eastern European countries, Frankfurt am Main, 12 June 2019.

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Dear guests and colleagues,

It is a great pleasure to welcome you to the eighth ECB conference on central, eastern and south-eastern European (CESEE) countries.

There are many differences between the 18 economies in the CESEE region[1], but one thing they have in common is that they have all experienced real economic convergence towards the EU average since the 1990s. Over the last two decades, in particular, real GDP per capita growth has averaged 3.8% in the region, compared with 1.4% in the European Union (EU) as a whole.

But there has been a clear difference in the pace of convergence.[2] Countries that have joined the EU, and which are hereafter referred to as the central and eastern European (CEE) economies,[3] reached GDP per capita levels of 70% of the EU average. Within this group, the countries that have joined the euro area have grown even faster, reaching almost 80% of the EU average. In contrast, catching up has been markedly slower in the economies outside the EU, with income levels below 40%[4] of the EU28 average.[5]

EU and euro area membership acted as a catalyst for convergence, creating the institutional and economic conditions for CEE economies to adopt highly effective growth strategies. Their faster convergence shows that, with high-quality institutions in place, the EU Single Market can be a powerful engine of growth, allowing not only the poorer countries to catch up, but also the richer countries to benefit from a larger market and opportunities to increase production efficiency.[6] However, in order to maintain convergence and reap lasting benefits from the Single Market and euro area membership, efforts to ensure institutional quality and good governance have become all the more important given the headwinds facing CEE economies.

The role of the Single Market and the euro in promoting convergence

How has EU membership created the preconditions for stronger growth? One of the most powerful mechanisms has been its role in promoting the deep integration of CEE countries into European value chains. This has happened in two ways.

First, accession to the Single Market led to the removal of trade barriers and the adoption of EU-wide standards, which has considerably reduced the cost of doing business across countries.[7] Firms have unbundled their production networks and relocated production and assembly in line with the relatively lower cost of production. As a result, trade flows of intermediate inputs increased almost threefold[8] from 1990 to 2015. Supply chain linkages intensified at a faster pace and were more resilient during the crisis compared with supply chain linkages with countries outside the Single Market.[9]

Second, the adoption of the *acquis communautaire* led to a more predictable legal environment and high-quality regulatory framework, which have increased investor confidence and contributed to a rapid inflow of foreign investment and technology.[10] The inflows of foreign direct investment (FDI) in the region amounted to around 6% of GDP in the pre-crisis years, compared with only 3.4% in the EU as a whole.

Countries that achieved a high level of institutional quality and governance,[11] and have been able to adopt the single currency, further benefited from the reduction of trade costs.[12] Their participation in value chains has been consistently higher than that of other EU countries and they have made most progress in catching up with the average level of GDP per capita in the EU. But more importantly, the single currency's main benefit has been to provide stability in the integration process. It has ensured that a critical mass of countries participating in the Single Market was insulated from exchange rate volatility during times of economic stress. By preventing competitive devaluations between countries within the bloc, the single currency has guaranteed the continued openness of the Single Market and strengthened the incentives for firms to increase their competitiveness through productivity gains.[13]

All economies have gained from increased trade. Since the 1990s, intra-EU trade has risen in real terms, even as emerging economies entered the global market.[14] Trade has in turn supported productivity growth.

CEE countries, in particular, have been able to accelerate the process of technology absorption from firms at the productivity frontier, which has proved to be a key ingredient in the process of convergence. ECB research shows that technology transfers have contributed to strong productivity spillovers within European value chains.[15] A 10% increase in total factor productivity (TFP) growth of western EU firms at the value chain frontier contributed to 4.8% TFP growth for CEE firms participating in value chains, which in turn fostered wage convergence in these economies.

Global headwinds: vulnerabilities to trade and financial shocks

Since the crisis, however, growth has slowed, mainly on account of a drop in TFP growth and receding FDI inflows. In the new euro area countries, TFP growth remains, unlike in other CEE countries, the main driver of growth.

But the general slowdown is being felt in all economies in the region, which suggests that, despite the ongoing benefits of the Single Market and the euro, the CEE business model has become vulnerable to shocks to international trade and financial conditions. The benefits of the Single Market for sustained convergence thus needs to be consolidated, by implementing reforms towards a more balanced growth model that is less vulnerable to changes in external conditions, such as those that have emerged recently.

Global trade has faced headwinds in recent years as trade-restrictive measures have outpaced liberalising measures.[16] CEE economies have been disproportionately affected by this for two reasons.

First, trade in CEE economies is especially responsive to cyclical developments. Since these countries have consistently been more open to trade over the past two decades, their trade elasticity is higher than in the rest of the EU. In addition, the value chains in which they participate mainly involve trade in durable goods, which have a high level of income elasticity.[17]

Second, CEE economies have increasingly specialised in certain industries, which may have made them more exposed to industry-specific shocks. In some countries, for instance, vehicle exports represent nearly 30% of total manufactured exports, making them more vulnerable to the threat of increasing car tariffs. Moreover, the effect of tariffs could be amplified, as a large share of goods cross borders multiple times during the production process.[18]

Headwinds could also result from changes in the international financial landscape. Net foreign liabilities stood at over 70% of the CEE economies' GDP in 2018, which is higher than in many other emerging economies. In particular, FDI was comparably high and accounted for 50% of total external financing up to 2010, thus providing stability. The share of FDI liabilities has declined since then and accounted for 42% of total external financing in 2018. While many countries in the region have improved their current account balances in recent years, they may remain vulnerable to changing external financial conditions due to their dependence on foreign financing.

These developments confirm that sustained policy efforts are needed to maintain a steady convergence path. The region's economies need to find new ways to boost TFP growth and deepen capital accumulation in order to "grow out" of their vulnerabilities.

The main long-term challenge is moving towards a more balanced growth and financing model, which is more reliant on domestic innovation and on higher investment spending than it has been so far. This will only be possible if domestic institutions and governance are improved.

Those countries that joined the euro area have continued improving their institutional quality, partly owing to the accession process. In the other EU countries of the region, efforts to improve institutional quality have been more mixed in recent years. Overall, institutional quality is still below the euro area average in almost all CEE economies.[19] Convergence is an ongoing process and reforms introduced over the past few years should not be rolled back. A high level of institutional quality is necessary to fully reap the benefits of the Single Market and maintain the sound economic structures necessary for the resilience of the single currency. The same applies to structural policies which were introduced to improve the competitiveness and resilience of CEE economies.

Conclusion

The Single Market created prosperity in CEE countries, especially for those in the euro area, by generating convergence in per capita income.[20] Indeed, the EU has been a source of growth and anchor of stability, allowing the region to catch up with EU living standards.

Conferences such as this one are valuable for policymakers to reflect on the region's current vulnerabilities and to discuss new avenues for growth. Today, we have with us a distinguished guest who, through her leadership of the IMF, her experience as Minister of the Economy and Finance and former Chair of the G20, will undoubtedly bring valuable ideas and new insights to this conference.

Please give a warm welcome to Christine Lagarde.

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[1] The CESEE region comprises Albania, Bosnia and Herzegovina, Bulgaria, the Czech Republic, Croatia, Estonia, Hungary, Kosovo (this designation is without prejudice to positions on status and is in line with UNSCR 1244 and the ICJ Opinion on the Kosovo Declaration of Independence), Latvia, Lithuania, Montenegro, North Macedonia, Poland, Romania, Serbia, Slovakia, Slovenia and Turkey.

[2] Zuk P., Polgar, K., Savelin, L., del Hoyo J. and König, P. (2018), "Real convergence in central, eastern and south-eastern Europe", *Economic Bulletin*, Issue 3, ECB.

[3] Estonia, Latvia, Lithuania, Slovakia, Slovenia, Bulgaria, Czech Republic, Croatia, Hungary, Poland, Romania

[4] Excluding Turkey

[5] Owing in part to historical events that have delayed countries' transition to a market economy.

[6] Jan in 't Veld (2019), "Quantifying the Economic Effects of the Single Market in a Structural Macromodel", Discussion Paper 94, Directorate-General for Economic and Financial Affairs, European Commission

[7] Blind, K., Mangelsdorf, A., Niebel, C. and Ramel, F. (2018), "Standards in the global value chains of the European Single Market", Review of International Political Economy, 25(1), pp. 28–48.

[8] Average ratio of intermediate goods exports to GDP in the EU.

[9] Schmitz, M., Fidora, M. and Gunnella, V. (2017), "The impact of global value chains on the macroeconomic analysis of the euro area", *Economic Bulletin*, Issue 8, ECB.

[10] ECB research finds that joining the EU increases inward FDI flows from other EU countries by close to 44%. See Carril-Caccia, F. and Pavlova, E. (2018), "Foreign direct investment and its drivers: a global and EU perspective", *Economic Bulletin*, Issue 4, ECB.

[11] As measured by the World Bank Worldwide Governance Indicators (WG). The WGI delivery index is a simple average of the regulatory quality, government effectiveness, control of corruption and rule of law sub-indicators.

[12] By eliminating the costs of foreign exchange payments and settlements and hedging exchange rate risk.

[13] See Draghi, M. (2018), "Europe and the euro 20 years on", speech at University of Sant'Anna, Pisa, 15 December 2018

[14] Intra-EU manufacturing trade rose from 28% of EU GDP in 1995 to 44% in2018.

[15] See Chiacchio, F., K. Gradeva and P. Lopez-Garcia (2018), "The post-crisis TFP growth slowdown in CEE countries: exploring the role of Global Value Chains", *Working Paper Series*, No 2143, ECB.

[16] See WTO (2018), "Report on G20 Trade Measures", 22 November 2018

[17] Schmitz et al. (2017), op. cit.

[18] Gunella, V., Quaglietti, L. (2019), "The economic implications of rising protectionism: a euro area and global perspective ", ECB Economic Bulletin, Issue 3/2019.

[19] As measured by the World Bank (Worldwide Governance Indicators 2018), Transparency International (Corruption Perceptions Index 2017), Global Competitiveness Report 2018–19 (World Economic Forum), and World Bank and International Finance Corporation (Doing Business 2018).

[20] See del Hoyo, J.L., Dorrucci, E., Heinz, F. and Muzikarova, S. (2017), "Real convergence in the euro area: a long-term perspective", *Occasional Paper Series*, No 203, ECB.