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EUROSYSTEM

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"Achieving Balanced Growth in the CESEE Countries"
Opening Remarks

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Good morning, ladies and gentlemen,

Let me reflect, first of all, on the title of this conference: **Why is balanced growth an important issue?**

We are now already in the fifth year of the crisis and the storm is not over yet. The crisis has taught us that the economic difficulties of many countries in Europe reflect long-term problems inherent in economic and political institutions. There are no quick fixes for these long-term issues, but it is crucial to take the right measures now.

On the one hand, it is important to contribute effectively to business cycle stabilization and to support a smooth recovery in Europe. For instance, the reduction of both public and private sector indebtedness is necessary for regaining the trust of international investors. At the same time, however, a vicious circle of consolidation measures which erode domestic demand and therefore delay the recovery has to be avoided.

On the other hand, from a medium-term perspective, the right measures have to be taken to avoid a renewed build-up of unsustainable economic positions. Achieving sustainable economic growth and thereby rethinking the appropriate growth model is of utmost importance in solving the current economic challenges.

This especially holds true for the countries in Central, Eastern and Southeastern Europe (CESEE), where the boom-bust cycle has been extraordinarily pronounced and the catching-up of income levels to those in Western Europe has been set back for several years since the outbreak of the crisis.

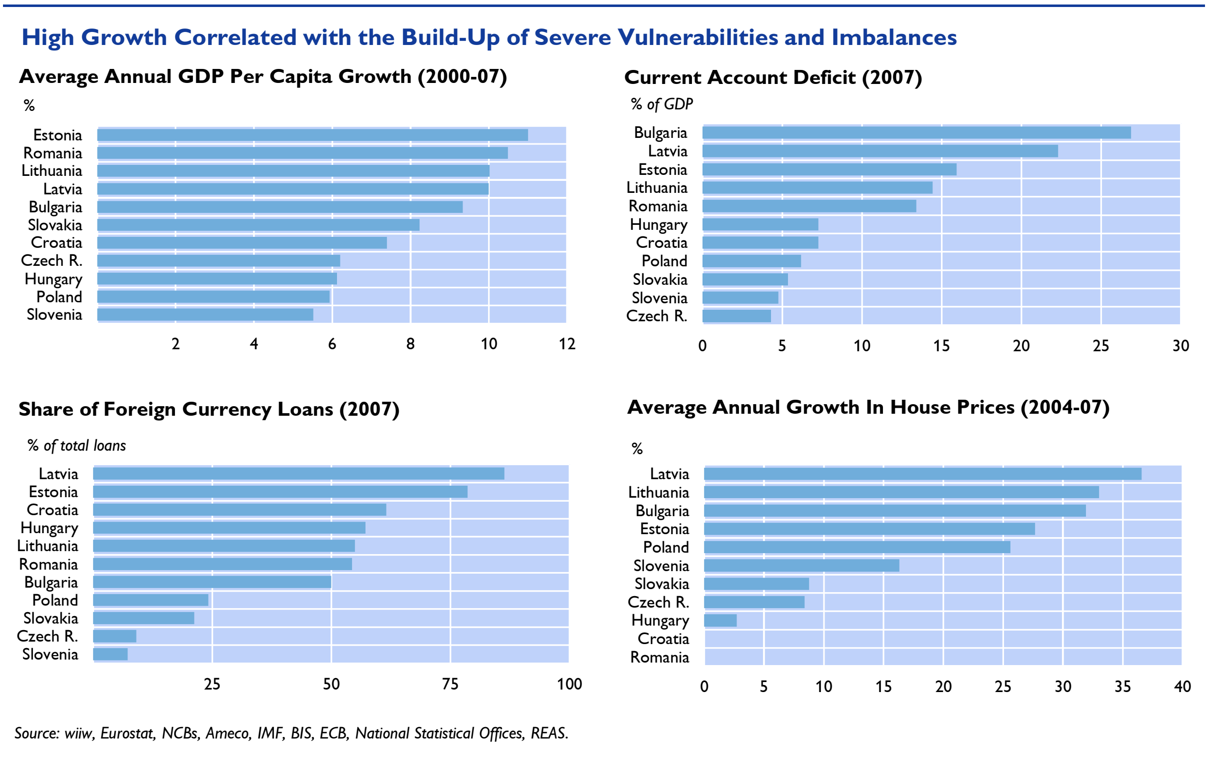
From my point of view, one of the most relevant questions in this context is the following: **How can we implement a sustainable growth model that remains crisis-resilient and promotes the catching-up process in CESEE?** Let me look into both issues – sustainability and convergence – in more detail now.

Sustainability

What is our **understanding of balanced or sustainable growth**? It means – first and foremost – that we aim to avoid large business cycle fluctuations as the frequent occurrence of sizable boom-bust cycles is associated with significant economic costs, affecting the long-run growth potential of an economy. Second, sustainable growth also implies that economic growth is diversified as much as possible to avoid the economy's dependence on the performance of a few sectors, which makes the economy more vulnerable in the case of asymmetric shocks. Last, but not least, I also want to point out the social dimension of growth – every group in society should benefit from the growth process such that the build-up of social inequalities and the resulting pressure on political economic institutions can be contained.

With these considerations of balanced growth in mind, let us briefly look back on the **pre-crisis economic developments** in CESEE in order to have a reference for the intensity of the recession in 2009 and the related adjustment process since then.

Chart 1



Between 2000 and 2007, the CESEE countries were – besides China and India – one of the fastest growing regions in the world (average real GDP per capita growth: 8.2%). This **outstanding growth performance** was mainly driven by large foreign capital inflows, which fuelled domestic credit growth, led to a surge in asset prices (in particular house prices) and considerably boosted domestic demand.

However, as you can see in chart 1, the sizable GDP growth was generated **on the back of rising vulnerabilities**. Soaring prices and wages were one of the consequences of sharply rising domestic demand. As a matter of fact, double-digit inflation rates were not unusual during the boom years. On top of very strong lending growth in the years preceding the crisis, a large part of domestic loans to households and companies was – and in some countries still is – denominated in foreign currency.

Growing internal imbalances were also reflected by the development of the external sector. Increasing internal demand led to an appreciation of the exchange rates in countries with floating exchange rate regimes, which made exports more expensive and led to the build-up of substantial current account deficits.

Several institutions, including the OeNB, pointed out the macrofinancial risks associated with these widening imbalances. However, during the boom years it was admittedly hard to predict whether these developments were actually unsustainable and a threat to growth or just the outcome of a brisk catching-up process, which would eventually reach an equilibrium point. In other words, the borderline between a buoyant convergence process and an overheated economy is a very narrow one – at least for real-time assessments.

In the end the **capital inflow-based growth model proved to be unsustainable**. As a matter of fact, up to 2008 nobody could imagine, first, that advanced economies will be confronted with such a severe recession and, second, that a shock originating from Western economies would spill over to such a strong extent to the countries in CESEE. But the accumulated vulnerabilities fully materialized when capital flows into the CESEE countries dropped sharply after the default of Lehman Brothers in September 2008. This situation, combined with the collapse of global trade and limited room for maneuver for countercyclical policy measures, led to a deep recession in 2009. It has been widely acknowledged (for example by the EBRD in its transition report[1] or a recent book by the IMF's European Department[2]) that the countries that had the largest imbalances before the crisis were hit hardest afterwards.

[1] EBRD (2009). Transition Report 2009 – Transition in Crisis? European Bank for Reconstruction and Development. London.

[2] Bakker, B. and C. Klingen (eds.) (2012). How Emerging Europe Came Through the 2008/09 Crisis – An Account by the Staff of the IMF's European Department. International Monetary Fund. Washington, D.C.

Chart 2

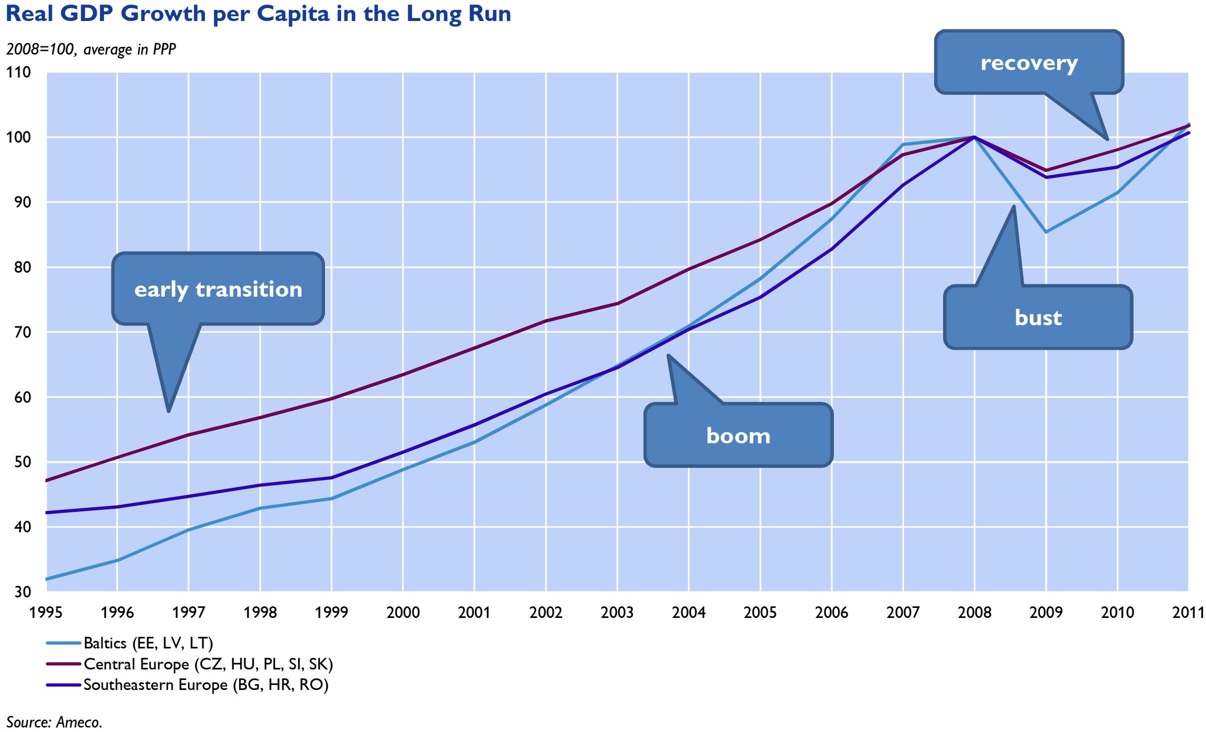


Chart 2 shows that the output loss related to the 2009 recession was extraordinarily large in the Baltics, followed by Southeastern Europe and Central Europe. It took at least until the end of 2011 to reach again the 2008 per capital real GDP levels. While this also holds true for Western European EU Member States, it becomes clear from chart 2 that the catching-up of income levels in CESEE to those in Western Europe has lost considerable momentum.

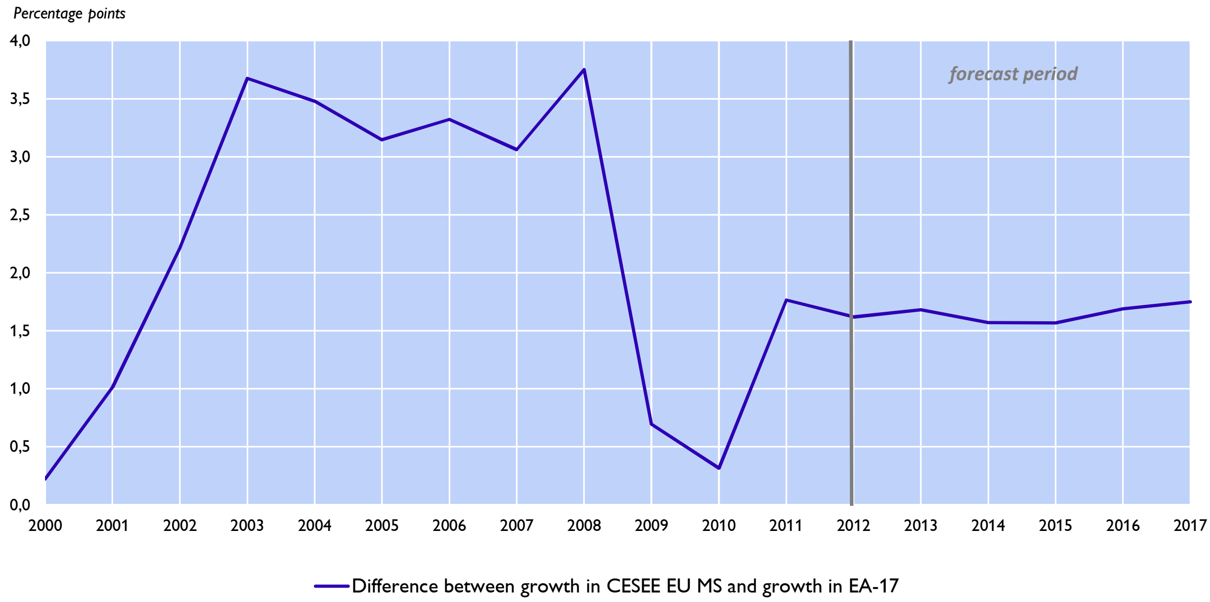
Convergence

This brings me to the second part of my remarks: convergence.

Since the fall of the Iron Curtain more than 20 years ago, the CESEE countries have undergone an impressive catching-up process. Europe has grown together in many ways: increased trade and FDI integration, improved infrastructure, greater regulatory and legal homogeneity and the adoption of best practices with respect to the setup of institutions and corporate governance. All these factors led to a substantial narrowing of income differences during the last two decades.

Chart 3

Growth Differential of CESEE EU Member States vis-à-vis the Euro Area



Note: 2012–2017 IMF forecast (World Economic Outlook) from October 2012: Estonia, Slovakia and Slovenia are included in both aggregates.
Source: Eurostat, IMF.

The 2008–09 crisis had a significant negative impact on this convergence process. Chart 3 shows that the medium-term **growth differential** between the CESEE EU Member States and the euro area has decreased from 3-4 percentage points before the crisis to less than 2 percentage points now. The positive growth margin of the CESEE EU Member States was reduced to 0.5 percentage points in 2010 and remained positive only thanks to the robust performance of Poland. As a result, the catching-up process will take more time than expected during the pre-crisis boom years. In fact, OeNB simulations show that if the growth differential remains below 2 percentage points, it will take more than 50 years for the CESEE region to reach the income level of the euro area (compared with only 37 years if the growth differential would regain its pre-crisis level of 3 percentage points)[3]. Also, the catching-up is less smooth due to large swings in CESEE cycles, particularly for small countries, as will be discussed tomorrow in a presentation of the OeNB[4].

A **delayed catching-up process poses serious challenges** to further economic and institutional reforms in CESEE and might affect the people's support for European integration. A continuous reduction of regional inequalities in Europe is also in the

[3] See also Ritzberger-Grünwald, D. and J. Wörz (2009). Macroconvergence in CESEE. In: Twenty Years of East-West Integration: Hopes and Achievements. Focus on European Economic Integration – Special Issue 2009. OeNB. 56–65.

[4] Gächter, M., A. Riedl and D. Ritzberger-Grünwald (2012). Business Cycle Convergence or Decoupling? Economic Adjustment within the European Union. OeNB. Mimeo.

interest of Western Europe, given that – according to recent studies – a reduction of income inequality has beneficial effects on the long-run growth potential of an economy.

Conclusion

Let me conclude:

Pronounced boom-bust cycles not only lead to high output volatility but also hurt the long-term growth prospects of an economy. This is especially valid for the CESEE economies that experienced a sharp output decline in 2009 and – according to our latest OeNB-BOFIT projections – there might even be a second recession phase in the wings in several countries of the region.

The main lesson from the 2008–09 crisis is that the foreign capital inflow-based growth model is not sustainable in the long run and cross-country contagion via trade and financial channels from Western to Eastern Europe can be quick and substantial.

Many countries undertook severe restructuring programs during the last years which aimed at reducing their public and private sector indebtedness and increasing their external competitiveness. However, we will have to watch the success of these programs very closely in the upcoming years.

We also saw that the economic adjustment costs caused by high output volatility are substantial, as they have a direct impact on the speed of the catching-up of Eastern European income levels to those in Western Europe. A substantial delay in the convergence process cannot be in our interest.

Therefore, ladies and gentlemen, **we have to find new growth models that prove to be sustainable and crisis-resilient and continue to promote the convergence process** – and this is one of the goals of this year's CEEI. Ladies and gentlemen, I once again welcome you to this year's CEEI, I wish you a stimulating and productive conference and thank you for your attention.