Preface

Although the crisis which started in 2008 does not seem to have been over-
come yet and the economy is still struggling as this book goes to press, it
is time to make a first analysis. In this vein, this book tackles the highly
relevant question of ‘What next?’ with a special focus on the catching-up
process in Central, Eastern and South-Eastern Europe (CESEE). Do we
have to change all our conceptual frameworks, all our models and all our
forecasts, or did the crisis merely put a temporary halt to developments,
so that things will proceed in the future more or less as they did in the
past? This is not only a serious academic concern but a question of high
immediate relevance also for policy-makers and private investors, for
central bankers and commercial ones, and for regional developers and
other agents.

Specifically, the book covers four main topics, each dealing with the post-
crisis scenario from a different angle. The first part deals with the very fun-
damental question of whether post-crisis growth is going to be the same as
pre-crisis growth. Will we see structural breaks in the growth models? Or was
the crisis a mere outlier? Given the new, less favourable external environ-
ment, many economists expect recovery to be sluggish and catching-up to
slow down. In addition, consolidation necessities will dampen growth pros-
pects. Fiscal debt increased in all CESEE countries as a result of the crisis,
although public debt levels were still lower in CESEE than in the euro area.

But slightly dampened growth rates will also have some positive side-
effects. Before the crisis, current account deficits had widened as a result of
excessive consumption growth and a credit boom that was also supported
by foreign currency loans. These unfavourable and unhealthy develop-
ments have come to an end, or will at least be restricted in the future. As
a result the economies in the region will now hopefully embark on a much
more sustainable growth path.

Eastern Europe’s substantial convergence with Western Europe will
continue to be driven by total factor productivity growth. The crisis
will, however, result in lastingly lower levels of productivity growth and
reduced investment-to-GDP ratios in CESEE, thus slowing down future
convergence. By contrast, lower EU-15 growth as a result of the crisis will
partially offset this effect in the medium to longer run.

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The second part of the book deals with policy challenges in the CESEE region and beyond, with a special focus on monetary policy on the one hand and with a particular focus on three countries – Poland, Romania and Croatia – on the other hand. On these three countries readers will find an in-depth analysis by high-ranking representatives of the respective national central banks. In short, the message is that Poland benefited from its policy of flexible exchange rates, which contributed to its impressively good growth performance, whereas in Romania flexible inflation targeting failed to prevent the build-up of external imbalances. Nor was nominal appreciation successful in containing soaring prices, neither in the pre-crisis boom period nor beyond. While price stability is only a minor issue for most CESEE central banks at the time of writing, the main focus of their attention has shifted to appropriate credit growth and sound financial stability – in the region in general and in Croatia in particular.

In a historical comparison, the recent financial crisis has changed the views about central banking, bringing prudential and regulatory issues to the forefront. As outlined by Paul Wachtel for the United States in particular and for central banks in general (see Chapter 10), the role of central banks may even have broadened, and the new role for central banks foresees that financial sector stability will have more weight in policy considerations. Or, to put it differently, central banks will have to integrate financial sector stability into their price stability focus.

The third part of the book deals with the new role of financial integration, growth financing and exports. In this respect the role of capital, financial deepening (what is still to be done in this respect?) and regulatory requirements are debated. Capital inflows and exports were the two main drivers of CESEE economic growth in the past. Both factors are heavily dependent on what shape the highly advanced economies are in. Following the financial crisis, capital inflows, as well as internal and external demand, have fallen substantially, which has in turn raised the question of whether we were witnessing a possible structural decline in capital inflows and, if so, what would be its long-term growth impact. The guess is that capital will no longer flow into the CESEE region at the levels seen before the crisis, as investors are likely to have become more risk-averse in general, or they may diversify their risks more broadly and shift some of their portfolios to other emerging market regions. Exports will not fully recover as long as external demand is sluggish, and the full recovery of external demand is in turn highly dependent on the economic shape of the euro area countries.

Analytical results show that exports and the stock of foreign direct investment (FDI) in the CESEE region are positively related to industrial production, and thus to economic growth. These findings imply, first, that
the CESEE countries should make determined efforts to remain attractive locations for inward FDI and to enhance their export prospects, and, second, that the reduction of portfolio investment inflows appears to be unproblematic from a long-term growth perspective. Overall, the aim is to become more independent; as the countries become more advanced, more impetus is going to come from their domestic sectors.

The fourth and final part of the book deals with challenges for the banking sector in the CESEE region. Given Austria’s exposure this question is of special relevance from an Austrian perspective, which is also provided in this book. Interestingly, the banking sector in the CESEE region was not affected as adversely as the Western banking sector. Being less sophisticated and less deleveraged was definitely an advantage in the crisis situation. At the same time, the banking sector was and still is dominated by foreign banks in some countries, as a result of which the financial sector was affected at least indirectly in several countries.

Strengthening competitiveness and sustainability are major points. Therefore it is no surprise when international institutions are claiming that banks need to clean up their balance sheets before the revitalization of lending and any economic recovery will gain momentum. This is even more relevant as significant changes in the legal and supervisory frameworks are in the offing for banks. The new frameworks will, among other things, be better equipped to capture risks, contain more stringent capital requirements and strengthen cross-border supervisory cooperation. To stabilize and broaden the base of financial development in CESEE, the Vienna Initiative will concentrate on the establishment of local currency capital markets in which banks should participate. Yet banks themselves seem to be rather sceptical about these developments and rather hesitant to change their business model, as it was very successful in the past.

Summing up, CESEE has survived the crisis reasonably well. Growth prospects have become less favourable, but catching-up has not come to a standstill. Still, rethinking will need to occur in several economic fields and adequate policy instruments will need to be adopted. As the initial major shock has faded away relatively quickly, resistance to change has increased and persistence tendencies have resurfaced, so that it will take time for changes to be effected and to materialize. But all in all we are confident that the necessary adjustments are going to be implemented, on both the macro and the micro level, in the medium term.