Preface

After years of sharp downturns, which unfortunately were not followed by years of sharp upturns, the key question engaging European economic forums is achieving sustainable economic growth. The topics under discussion, covered by this book, range from meeting the most recent challenges for the banking sector to unwinding large external imbalances, enhancing financial stability, debating strongly interconnected and complex global financial institutions, questioning the implicit public guarantee for banks that were ‘too big to fail’, and – last but not least – how to make regulatory and supervisory restraints more effective.

With regard to the Central, Eastern and South-Eastern Europe (CESEE) countries, which were hit hard by the financial and economic crisis of 2008 and 2009, the need to find a new growth model is indeed there, as the old growth model based on the inflow of foreign capital has proved unsustainable in the long run since it led to the build-up of substantial vulnerabilities. The resulting boom–bust cycles caused significant economic costs, harmed the countries’ long-run growth potential and seriously delayed the CESEE region’s convergence towards the euro area. A slowdown of the catching-up process poses serious challenges to the still pending economic and institutional reforms in CESEE and to further economic integration. A new growth model has to be found that promotes both balanced growth and the convergence process.

In the pre-crisis boom phase, current account deficits widened in most Central and Eastern Europe (CEE) countries (except for example in Poland and the Czech Republic). During the crisis, a strong rebalancing set in, partly caused by sudden stops or reversals of capital inflows. At the same time, unemployment rates remained relatively low compared to those in some European Union (EU) countries. The comforting conclusion is that some CEE countries have been able to resume growth after the Great Recession. The quite pronounced crisis resilience (in relative terms) can be traced back to lower public and private sector debt levels and to flexible labour and product markets, which facilitated economic adjustment during the crisis. At the same time, however, competitiveness and success in foreign trade remain critical factors for the CEE region, which largely depends on growth prospects in Western Europe.
Therefore the volatility of capital flows to emerging market economies and related challenges for policy-makers is key. While emerging Europe had not been the destination of large net capital inflows (in absolute terms) compared with Latin America and developing Asia before the crisis, the ongoing deleveraging by foreign banks might play a crucial role for the region’s current growth prospects. However, the reduction of net capital inflows and bank lending in CEE mostly seems to be an adjustment towards fundamentals. While the CEE countries have gained rather than lost competitiveness during the crisis, the reduction of foreign direct investment (FDI) inflows owing to the poor performance of the rest of Europe may hamper their long-run growth potential.

Sometimes the use of traditional balance-of-payments analysis for assessing global imbalances is limited. While net capital inflows indeed lead to an accumulation of external liabilities which cannot grow indefinitely and must be repaid at some stage, a country may be a net capital exporter or importer for a long period of time. Therefore, in a world of free capital mobility, countries’ current account balances might follow changes in their financial accounts, which means that national macroeconomic policies have only limited control over national current account balances and real exchange rates, even with floating exchange rates or inflation targeting in place, as domestic money supply is largely driven exogenously by capital flows. This perspective calls for a stronger coordination of global monetary policies to avoid adverse feedback loops across countries.

A widely debated issue is the ongoing bank deleveraging in CESEE. From a macro perspective, the external positions of Bank for International Settlements (BIS)-reporting banks in CESEE have fallen since mid-2011. The assessment of this development is twofold: while stalling credit growth seems to be a development towards an increasingly self-funded banking system, the deterioration in credit quality as measured by the rate of non-performing loans is still a major cause for concern. Most recent research comes to the conclusion that current deleveraging is both domestically (demand-side) and internationally (supply-side) driven. On the one hand, most banks are going through some sort of strategic restructuring, with further deleveraging expected in the near future. On the other hand, given the local market outlook and local regulation frameworks, credit demand is also weak. From a policy perspective, the current restructuring and rebalancing of the CESEE banking model is a positive, risk-reducing development, but it takes time and affects growth.

The importance of human capital not only for economic development and growth, but also for the development of sound institutions, should not be neglected. Most indicators of institutional quality, except those measuring regulatory frameworks, are often inappropriate and cannot
clearly explain differences in economic development across regions and
countries for two reasons: they are subjective, and they follow rather than
lead growth. In-depth research on the ultimate determinants of growth,
that is, geography, infrastructure, population, human capital and culture,
shows that human capital measured by years of education proves to be the
key driver of regional variation in income and labour productivity. Also
economists should try to keep on learning, or at least, to keep on under-
standing. In this vein the growth strategies of EU neighbouring countries
Turkey and Russia, two countries having quite impressive growth rates
even after the crisis, are also covered in this book.

Surprisingly, after so many years of catching up, income and business
cycle convergence in the CESEE region is still a relevant topic. On the one
hand, the CESEE region itself became more heterogeneous during the
crisis, while on the other, it decoupled from the euro area, particularly on
account of developments in small countries. Moreover, while trend growth
rates have declined both in the euro area and in CESEE in the wake of the
crisis that emerged in 2008 and 2009, the trend growth differential between
these two regions has halved against the pre-crisis period, causing the
catching-up process to slow down significantly.

Two regions, representing several small countries, are analysed more
closely in the book: the Western Balkans and the Baltic countries. In the
Western Balkans, prior to the crisis, economic growth was above potential
given excessive domestic demand which was, in turn, fuelled by massive
capital inflows. Despite attempts to contain the latter by means of pioneer-
ing macro-prudential measures, mounting external imbalances could not
be avoided. The sudden reversal of capital flows and the economic slow-
down had a sharp impact on the economy in the Western Balkans, includ-
ing noticeable deleveraging, a sharp increase in non-performing loans and
significantly higher fiscal deficits.

In the Baltic countries a severe economic correction took place in
2008–2009. Whether this severe correction is a role model for others, or
whether this can be compared with the gradual and protracted adjustment
process in the peripheral euro area countries, is still an open question.
In fact, the Baltic countries stand out in terms of their unusually high
degree of volatility in most economic variables as well as regarding the
significant changes in domestic demand and high external and financial
vulnerabilities. In contrast to the euro area periphery, the sharp V-shaped
adjustment process in the Baltics was characterized by a sudden stop in
capital inflows. Moreover, unlike in the EU–International Monetary
Fund (EU–IMF) programme countries of the euro area, public debt has
increased only very moderately in the Baltics and private sector indebted-
ness has even declined.
Last but not least, there is the importance of renewing sustainability in banking market developments in the region. So far, numerous initiatives have been taken to this end, for example the Vienna Initiatives I and II, and the Austrian Sustainability Package. Still, the CESEE region is characterized by the important role of foreign banks. Among the main challenges remains the relatively weak credit quality, with high non-performing loan ratios in many CESEE countries. Future loan growth is likely to be more and more closely tied to growth in deposits, not least due to the loans-to-local funding ratio of 110 per cent implemented by the Austrian authorities. All in all, there are increasing supervisory and regulatory challenges for banks. Intensified cooperation between supervisors, international institutions and banks would be helpful indeed, particularly in an environment of heightened uncertainty. On a microeconomic level one has to be aware of the relationship between banks and customers, which is crucial for the quality of banks’ loan portfolios. Overall, banks, as well as policy-makers, need to reassess their strategies of going forward in an environment of heightened economic uncertainty.

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