1. European investment to support CESEE and euro area countries

Ewald Nowotny

What do we mean by ‘rebalancing’, the pivotal term of this book? 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, such as 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 chapter is structured as follows: section 1.1 assesses the challenges to the convergence process in Europe revealed by the crisis; section 1.2 elaborates on the investment gap and its solution; section 1.3 takes a historical perspective on rebalancing issues; before the final session summarizes and concludes with a general remark on policy-making.

1.1 HOW TO MAINTAIN MOMENTUM IN THE EU CONVERGENCE?

In 2014 we commemorated three anniversaries, which are crucially linked to the topic of rebalancing: 25 years since the fall of the Berlin Wall, 15 years since the creation of European Economic and Monetary Union (EMU) and 10 years since the – so far – biggest round of European Union (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 Central, Eastern and South-Eastern European (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 that started in 2008 was beneficial to the euro area. But those countries which 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 (Landesmann, 2013). The new Central European EU 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 reindustrialization. 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 tradeable industries, and have neither abundant natural resources nor tourist attractions, have difficulties in escaping the dilemma of either chronic disequilibria or contractive deleveraging.
1.2 INVESTMENT IS THE KEY

Even worse, investment, which is crucial for future growth, has been cut overproportionally. Six years after the collapse of Lehman Brothers, investment levels in the EU-28 were about 18 per cent below their peak; in some euro area economies under stress, investment was cut by about 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 small and medium-sized enterprises, 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 four to below two 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 (Oesterreichische Nationalbank, 2014). CESEE’s share in Austria’s total goods exports rose to roughly 22 per cent (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 such as 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 can the hope for convergence be maintained, as enshrined in Article 3 of the Treaty (European Union, 2007), which states that the European Union ‘shall promote economic, social and territorial cohesion’? I think that the new European Commission (2014) is setting the right priorities by proposing an investment package combined with regulatory reforms targeted toward fostering smart infrastructure, education, research and energy. This package should not only 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 (Van Rompuy, 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.

1.3 LEARNING FROM HISTORY

Some readers might have noted that an important historic event was missing from the anniversaries I listed above: 2014 also marks the centenary of World War I. This ‘great seminal catastrophe’ of the twentieth 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 confirms the view that European leaders at the time would have had better alternatives, but they made the wrong choices (Clark, 2012; Mombauer, 2013). 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 1500 kilometres 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* (Bank of Greece et al., 2014). The volume is also available electronically from the Oesterreichische Nationalbank (OeNB) website. 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 South-Eastern Europe for the period between 1830 and 1949. I am grateful to 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 South-Eastern 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.

### 1.4 CONCLUDING REMARKS

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 effective 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.

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### REFERENCES


