South Eastern European Challenges and Prospects

Keynote speech by Jean-Claude Trichet, President of the European Central Bank, Vienna, 29 November 2004

Ladies and Gentlemen,

I am delighted to talk here in Vienna to this distinguished audience at the conference on South Eastern Europe, the first of its kind organised by the Österreichische Nationalbank. Let me also warmly congratulate the OeNB and Governor Liebscher for the initiative.

When I think of the recent enlargement of the EU in central banking terms I cannot do so without thinking of the contribution of the OeNB, which has been involved in enlargement issues from the very beginning. This was thanks to its long-standing expertise on central and eastern Europe. With this event, the OeNB clearly demonstrates once more that it is, inside the Eurosystem, at the forefront of the analysis of European integration.

The topic that we have for today – South Eastern European challenges and prospects – is indeed a broad one.[1]

[1] Within the context of this conference South Eastern Europe is understood to comprise the following countries: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR of Macedonia, Romania and Serbia and Montenegro.

Challenges refer mainly to those that arise in the process of transition from a centrally planned to a market economy. In this respect, they are similar to the ones that those eight countries faced that joined the EU earlier in the year. But, as our friend and coparticipant in this conference Governor Nicholl of the Central Bank of Bosnia and Herzegovina puts it, for countries in the former Yugoslavia there are also two other transitions with their own particular challenges: the transition from being part of a larger state to being independent democratic countries and the transition from war to peace. I do not intend to dwell on these issues but they are indeed important when thinking about South Eastern Europe.

In setting the stage for the discussions today and tomorrow, I will focus my remarks on three aspects. I will first make some remarks on the economic and monetary performance of the region; I will then touch upon the process of economic and financial integration into the EU and, lastly, I will briefly discuss the use of the euro in the region. As I will explain in more detail, economic and monetary performance has improved over the last years, although much remains to be done. Economic links with the EU have been strengthening. These links are also based on a widespread use of the euro.

Economic and monetary performance in South Eastern Europe

South Eastern Europe is a diverse and complex region, characterised by a relatively low level of income compared to that of Western Europe. The seven countries considered here as South Eastern Europe have a combined population of around 53 million people, while the combined GDP in 2003, at nominal exchange rates, amounted to around 120 billion euro. This gives an average GDP per capita of around 2,300 euro. Even when one adjusts for purchasing power standards, income per capita across the region stood in 2003 at only 26% of the EU average (compared to the equivalent figure for the new Member States of around 48% of the EU average).

Another feature common to the countries in the region is the relatively fast growth that has been experienced in recent years. Annual real GDP growth in the region has been above 4% since 2001 and catching up in real incomes is taking place. In 2003, for a third year in a row, the economies of the countries of South Eastern Europe grew faster, on average, than the countries in central Eastern Europe and the Baltics that joined the EU last May

However, estimates suggest that, in real GDP terms, the economies from South Eastern European countries are still below from where they stood fifteen years ago, reflecting slow progress in transition in the early 1990s and economic disruptions due to wars and political turmoil. Thus, in order to catch up with living standards in the EU strong growth is needed to foster real convergence.

Monetary performance across the region has also seen significant improvements in the recent past. Up until 1998 no fewer than four countries in the region (out of 7) had inflation rates that exceeded 20% annually. After 1998 disinflation has proceeded and the median inflation rate among the countries in the region has remained in the single digits ever since. This is not to say that there are no challenges ahead on the disinflation front. In some cases inflation remains high and the challenge remains to continue bringing inflation down. In other cases, adjustments to administered prices and indirect prices may still cause a pick up in inflation. In those circumstances, the challenge is to avoid that temporary spikes in the inflation rate translate into increases in inflationary expectations.

Progress in bringing inflation down is being accomplished through a variety of monetary and exchange rate frameworks. One can classify the regimes in place in three different groups: (i) euro-based currency boards

(Bosnia and Herzegovina and Bulgaria); (ii) pegs or managed floating with the euro as a reference currency (Croatia, FYR of Macedonia, Romania and Serbia); and, (iii) independent floating (Albania). In addition, there are two territories within Serbia and Montenegro (Kosovo and Montenegro) where the monetary and exchange rate policy is determined by their unilateral euroisation – an issue to which I will return to later in my remarks. As the title of the panel discussion that will take place this afternoon highlights, country specific circumstances have called for different choices of monetary and exchange rate policy and changing circumstances may have called for changes in the approaches to be followed. I will not expand on this issue further than to emphasise that regardless of the actual monetary and exchange rate framework chosen, it is crucial to consolidate a culture of price stability, buttressed by independent central banks.

Outside the realm of monetary and exchange rate policy I would like to briefly touch upon fiscal and external developments. In the area of fiscal developments, it is fair to recognise that the fiscal deficit for the region as a whole stands at its lowest level, in terms of GDP, since the beginning of transition. Nevertheless, this should be interpreted with caution,

particularly in light of the very positive output developments that have been observed recently. The more positive side of the economic cycle provides in fact a fitting opportunity to procede further with fiscal consolidation, as well as with the necessary reforms of the structure of fiscal expenditures and revenues.

Developments in the external balances of the countries in the region provide a sobering reading. Current account deficits have increased over the last three years, and stood, for the region as a whole above 8% of GDP in 2003. While these deficits may partly stem from a natural and welcome recapitalisation of the economies in the region, fast credit growth may have contributed to exacerbate the current account deficits in a number of countries. Of course, given the low levels of financial intermediation that characterise the economies in the region, the increase in lending activity is to some extent a welcome sign of a financial sector that is performing its role within the economy as a whole. However, given the links that have often been identified between lending booms and banking and currency crisis, it is clear that authorities in the region had in a number of cases to take steps to avoid credit growth that may be too fast.

More broadly, countries in the region still lag behind those in central Eastern Europe and the Baltics, as measured by indicators such as the

EBRD's transition indicators. Improvements in the quality of the judiciary, the overall business environment and, generally, institutional reform are needed. On the positive side, it is noteworthy that, among all transition countries, it is precisely in the South Eastern European region where one have seen most progress in the last year or so. One cannot help but to associate this progress with the pull that enlargement of the EU may provide.

Economic and financial integration with the EU

In recent years we have observed a number of developments that are testament of the ongoing process of economic and financial integration between the South Eastern European region and the EU.

The EU is by far the most important trading partner for the countries in the region, accounting for between half and three quarters of the foreign trade of the countries in the region. Moreover, export performance of these countries has remained positive regardless of economic conditions in their main export markets. At the same time, the old trading patterns within the regions are long gone, leaving trading integration among South Eastern European countries at a very low level. More needs to be done,

for example through the implementation of bilateral free trade agreements already signed, in this area.

Another element pointing towards economic and financial integration between the region and the EU is the recent increase in inflows of foreign direct investment. While precise figures are hard to come by, such FDI inflows often come from the euro area. This is well known here in Austria – which ranks among the top five leading investors in no less than four countries in the region. In addition to the financial sector, FDI has typically concentrated in manufacturing industry as well as transport and telecommunications. Often, manufacturing activity in the region is well integrated into the production structures of Western European economies, which have been attracted by the comparatively low costs in South Eastern Europe and a relative geographic proximity. For the region as a whole, FDI as a percentage of GDP was close to 5% in 2003. It is to be noted that this level is low compared to the central Eastern Europe and the Baltic countries. The cumulative FDI inflows into the countries of South Eastern Europe over the period 1989 to 2003 has been on average less than USD 700 per capita, approximately one third of the comparable figure for central Eastern European and Baltic countries.

I mentioned briefly investment in financial intermediaries as an area where euro area investors have been particularly active. In fact, euro area

banks and financial institutions have been the most important investors in the respective banking sectors, contributing to financial development in the region. Let me now turn my attention to the use of the euro in the region.

Use of the euro in South Eastern Europe

South Eastern Europe is a region where one can see the use of the euro in all its dimensions. The OeNB has done much work to document this. The ECB also monitors regularly developments in the role of the euro, including its use South Eastern Europe.

As you all know, the Eurosystem takes a neutral position regarding the internationalisation of the euro. In this regard, it is also worth recalling the position adopted, already by the Ecofin in November 2000, that countries aiming at EU accession cannot use unilateral euroisation as a way of circumventing the stages foreseen by the Treaty establishing the European Community for the adoption of the euro.[2]

[2] Report by the (ECOFIN) Council to the European Council in Nice on the exchange rate aspects of enlargement, Brussels, 8 November 2000, Council of the European Union press release no. 13055/00. Also reiterated in "Policy position of the Governing Council of the European Central Bank on exchange rate issues relating to the acceding countries," Frankfurt, 18 December 2003, www.ecb.int.

As a financing currency, euro denominated debt is regularly issued by the countries of the region, which also, as I noted above, often make use of the euro as an anchor, reserve and intervention currency for their monetary and exchange rate frameworks. The euro is also being increasingly used as an invoicing currency in the international trade of the countries in the region. In the case of Bulgaria, for which a longer span of data is available, we have seen that while 37% of Bulgarian exports were invoiced in euro in 2000, the figure had risen to 61% in 2003. The increase is particularly notable given the fact that Bulgarian exports to the euro area accounted for only 51% of total Bulgarian exports in 2003, compared to 42% back in 2000. That is, while in 2000 Bulgarian exports to the euro area were greater than its exports invoiced in euro, by 2003 the opposite was true.

Euro cash inherited the role of a store of value that some legacy currencies, principally the D-mark and also the Austrian schilling, had played in some countries in the region. But the introduction of the euro also coincided with an interesting development in the region. In a nutshell, the euro cash changeover was accompanied in many South Eastern European countries by a strong increase in euro-denominated banking deposits. In many countries, particularly in the former Yugoslav republics, households deposited cash in legacy currencies – previously

kept “under the mattress” – with banks rather than exchange them directly for new euro banknotes, reflecting increased confidence in the respective banking systems.

Concluding remarks

Let me conclude by focusing on the prospects. To a large extent, these prospects can be summarised in just a few words: progress towards EU membership. Of course, countries in the region are at very different stages in their path towards EU membership, which is reflected in their different status as candidate and potential candidate countries. Indeed, Bulgaria and Romania are expected to sign the accession treaty next year whereas other countries are still preparing negotiations on stabilisation and association agreements. Moreover, there are not only economic, but also political criteria countries have to pass to transform the current EU perspective into real progress towards association or accession.

Let me also emphasise that the ECB and the Eurosystem as a whole is a contributor to this process, not least through the provision of technical assistance. Cooperation among central banks has involved twinning projects – led by some Eurosystem National Central Banks in particular Banque de France, Banca d’Italia and De Nederlandsche Bank – with the Bulgarian National Bank and the National Bank of Romania, as well as

visits and training, all geared towards sharing information and know-how. It has taken place in a large number of areas, such as payment systems, supervision and financial stability, statistics, central bank operations, etc. Looking ahead, such technical assistance will continue to intensify as countries progress towards aligning themselves with EU regulations and directives. Also the Joint Vienna Institute, co-sponsored by the OeNB, has played a crucial role in offering training opportunities to staff of the central banks of the region.

The recent enlargement to ten new Member States, as well as the progress in the accession negotiations with Bulgaria and Romania and the decision to begin negotiations with Croatia serve as powerful reminders that the enlargement of the EU remains an ongoing process.

However, for all countries in the region, no matter how far they have already travelled on the road towards the EU, there is no time for complacency. Clearly, the speed at which South Eastern European countries progress towards accession to the EU depends on the policies followed. It is the culture of stability and the exercise of responsibility in economic policy-making that are the crucial ingredients to achieve the bright prospects that lie ahead for the region.