

**Session 3:
Is the Catching-Up Process Sustainable?
- Discussion -**

**Conference on European Economic Integration
Vienna, 21-22 November 2011**

**Frank Moss
Director General International and European Relations
European Central Bank**

Overall agreement with presented assessments

OECD macroeconomic picture broadly in line with the latest ECB assessment

Crisis diagnostics for CESEE countries: economic structures, situations and policies do matter in determining outcomes

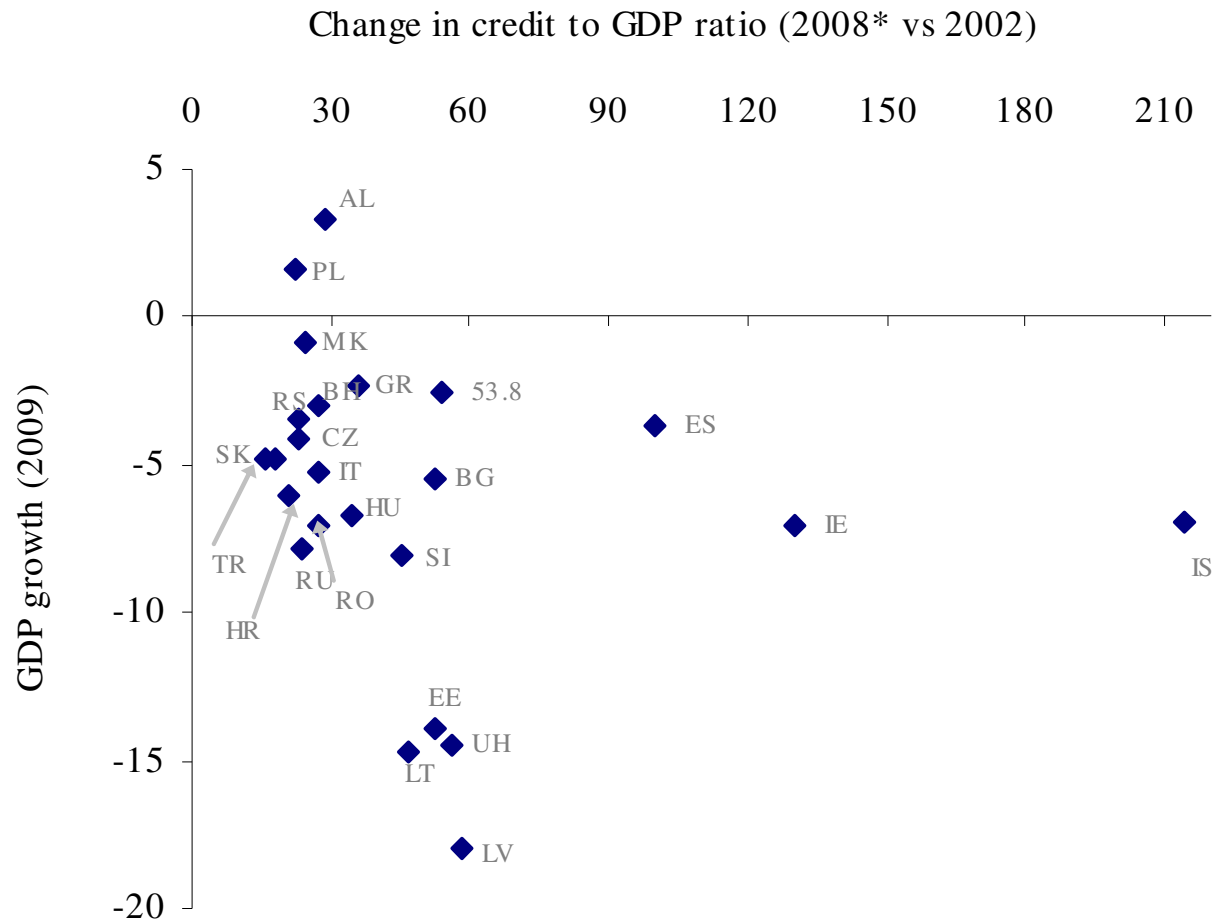
The euro area sovereign debt crisis: a major downside risk for the short-term outlook of CESEE countries

Long-term challenges for all transition countries under ‘the new normal’ of a repricing of risk and the cost of capital

Comments on selected issues raised

- 1. Credit growth, boom-bust cycles and FX lending**
- 2. Internal devaluation**
- 3. Sustainable convergence**
- 4. Lessons from the crisis for CESEE countries**

1. Credit growth and boom-bust cycles (1)



Sources: IMF and ECB calculations.

* Figures for 2006 in the case of credit / GDP used in case of Iceland.

1. Credit growth and boom-bust cycles (2)

Excessive credit growth has emerged as one of the most robust predictors of crises

- holds also in historical samples
- risks looming in China?

Many policy initiatives at the international level under way

- creation of macro-prudential bodies
- Basel III
- G20 work

Questions remain about the optimal size of the financial sector

1. Credit growth and boom-bust cycles (3)

FX lending as special risk in CESEE countries

Unhedged FX borrowing

- can amplify boom-bust cycles
- exposes borrowers to exchange rate risks and banks to credit risk
- applies to all foreign currencies

ESRB recommendations on FX lending

- Address the ‘flow problem’, i.e. will make new FX loans more expensive in order to properly reflect inherent risks
- Do not fully address the ‘stock problem’

2. Internal devaluation

Unavailability of nominal exchange as tool for adjustment can be due to:

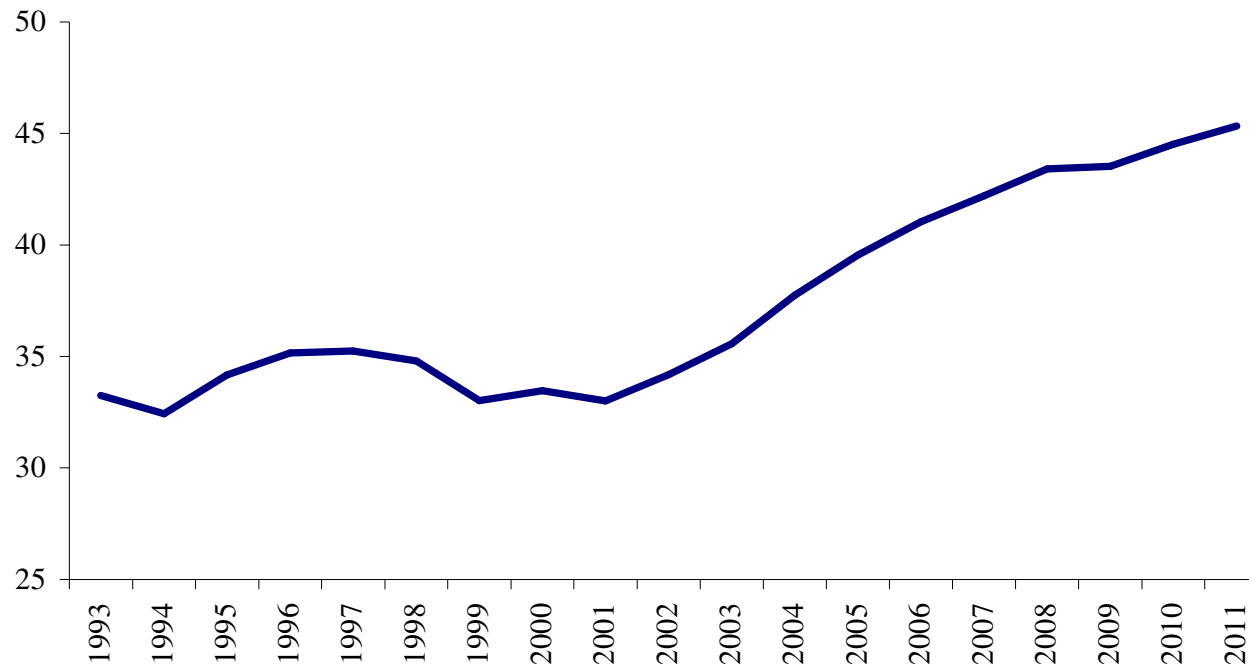
- Exchange rate policy choices (e.g. the Baltics)
- Participation in a monetary union (e.g. the euro area)

Required adjustment channels

- prices and wages; factor mobility
- fiscal or external transfers (if available) can help temporarily
- structural reforms are part and parcel of sustainable adjustment

3. Sustainable convergence (1)

GDP per capita in the CEE
(in percent of the euro area)



Sources: IMF and ECB calculations.

Note: IMF definition for the CEE: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Hungary, Kosovo, Latvia, Lithuania, Former Yugoslav Republic of Macedonia, Montenegro, Poland, Romania, Serbia, and Turkey.

3. Sustainable convergence (2)

“Good” versus “bad” convergence

Nominal versus real convergence

Convergence towards the top or (merely) the average (Jean-Luc’s definition of ‘good’ and ‘bad’)

Sustainable (‘good’) versus unsustainable (‘bad’) convergence

Main features of ‘bad’ convergence

- growth driven by domestic demand and the non-tradable sector
- large and persistent external and internal imbalances

How well have CESEE countries performed over the past decade?

How sustainable have Russia’s and China’s performances been?

3. Sustainable convergence (3)

Main elements of sustainable ('good') convergence

- External imbalances and increases in domestic demand should be matched by improvements on the supply side
- A dynamic and flexible economy requires adaptations of structural policies and improvements in institutions to improve total factor productivity, competitiveness and real GDP per capita growth
- Ultimately, 'good' convergence should lead to current account balances that are stationary in the very long run

Final lessons for CESEE countries

Lessons

- Excessive credit growth was at the root of the crisis
- Convergence takes time and constant efforts in order to be sustainable
- Maintaining competitiveness is key for sustainable convergence; internal devaluation to regain competitiveness can work, provided the accompanying conditions and policies are in place
- Economic integration with neighbours pays off (even for China)
- Entry into the euro area is no free lunch (and asset and liability euroisation no substitute for nominal or real sustainable convergence)