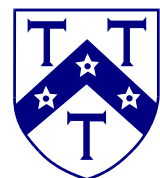


workshop report

South East European Studies
at Oxford

South East Europe: The impact of the global financial crisis

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St Antony's College
University of Oxford

S E E S O X
South East European Studies
@ OXFORD

South East Europe: The impact of the global financial crisis

Report from a workshop organized by South East European Studies at Oxford (SEESOX), in association with the Bank of Greece, and the European Bank for Reconstruction and Development (EBRD).

This report draws on discussions at a workshop on "South East Europe: The impact of the global crisis," which was held at St Antony's College, Oxford, on 15th June 2009. The participants were academics, officials from European and international agencies, and private market participants. The report represents SEESOX's interpretation of discussions in the workshop, and does not purport to reflect the views of any of the participants.

Introduction

The workshop explored the background to the crisis in the economies of the region; the question whether it should and would lead to a change in growth models; and the possible implications for external anchors – including notably the European Union and the IMF.

Participants considered that there was a common pattern of institutional weaknesses in most countries of South East Europe which, amid much diversity, had left the region quite vulnerable to an external shock. A rapid opening to foreign capital – in a setting where structural policies were still lagging, and with a history of foreign currency indexation – had exacerbated the exposure of economies to the crisis in global markets. The economic situation, indeed, had not yet touched bottom.

There was a probing discussion about what the crisis implied for future growth models. In a sense, most participants felt, the EU Accession process dictates the region's growth model. So the question must be how to trigger more sustainable expansion in the future within that paradigm. Here the challenge was uniformly seen as enhancing competitiveness – including

attracting capital flows in a world where banks, as a source of funds, were on the defensive.

To help buttress the region against the global crisis, it was noted, the IMF was being called back into a growing number of countries. But participants saw the IMF's conditionality, now largely devoid of structural elements, as less relevant over the medium term than the anchor of EU Accession. On the EU dimension, however, they were far from complacent. Only this, many felt, could overcome a relapse into past policy failures. But the strength of the anchor for candidate and potential candidate countries was weakening seriously as the EU enlargement process appeared to be stalling. A positive outcome was far from assured.

Key lessons of the crisis

The economic crisis had taken time to reach the region, and transmission channels had initially been more through conventional channels (such as trade and remittances) than through financial linkages. However, the latter effects were now being felt more strongly, with a slowdown in foreign bank lending activities, and many participants thought that the economic trends would continue to worsen

before they stabilized. There was less talk of “green shoots” of recovery in this region than elsewhere.

There was no consensus whether the pattern of integration and development in the region had made a sharp downturn inevitable at some point, even without a global crisis. However, it was noted that high levels of current account deficits fuelled by rapid credit expansion, and the prevalence of unhedged borrowing in foreign currencies, were common factors that had increased external and financial vulnerability. Indeed, there was arguably a silver lining to the crisis, as the decline in capital inflows contributed to a much needed, albeit abrupt, deceleration in credit and domestic demand growth. On the other hand, inflation had been reduced steeply over the past decade; fiscal positions had been strengthened (while remaining somewhat prone to pro-cyclicality); and structural indicators had shown a continuing impact of the EU-driven reform process in the past few years.

With regard to the reaction of domestic actors, there was agreement that governments and central banks had not reacted very strongly in the face of the crisis. The measures taken had been ad hoc and varied, often motivated by the intervention of international institutions. A number of participants thought that the low-key reaction was basically a good thing, since the situation of the public finances typically left little scope for policy. More regrettable was that there had been relatively little exchange of information, or of experience at the regional level, except among central banks in the area of banking supervision.

There was some disagreement on the past and prospective role of the euro in the region. It had proved an element of stability, both through formal currency board arrangements and through its widespread use as a vehicle currency. But several participants stressed strongly that it had, in a sense, substituted internal for external stability: inflation had been mastered and there had been continued financial deepening, but now it was hard to improve price competitiveness quickly in the presence of currency pegs and or large unhedged foreign exchange exposures.

Indeed, issues of competitiveness had emerged at several levels, although there was diversity across the region. Exports had grown, but a poor export structure was highlighted as one of the key problems in these economies. While foreign trade has made a positive contribution, it has not taken off in the way it had in the new Member States in the Baltic region and Central Europe, and it remained low in value. There was a broad agreement that structural reforms had been a weak point, compared with earlier EU joiners, and that deeper institutional changes were needed to assure sustainable growth.

A concern, in this connection, was that shadows of the past were still present in the region – both in political and in economic terms (the latter including slow structural reform, corruption, macroeconomic imbalances, and in some cases foreign-currency indexation). The worry was that the shock of the crisis might not, or not in all cases, be used as a fulcrum for accelerating reform and completing the break with the past. Economies might slip back for an extended period. If so, some participants saw risks of social unrest and even re-emerging concerns about political stability.

This was the darker side of the present situation. The crisis was in some ways an opportunity; but it had also put past progress at risk. Poverty had been reduced, but that achievement is now coming under threat. Some participants stressed the need to come to grips with this downside: after twenty years, the region could still end up being almost back where it started. The financial euphoria and then reversal in global markets unquestionably bore some share of the blame for this. Slowdown would have been likely in the absence of a global crisis, but not on the scale witnessed now. The global crisis had struck the region at a highly vulnerable point – in both political and economic terms.

When participants spoke of common features in this recent experience, a shared assessment (sometimes made explicit) was that such family resemblances were strongest among the former Yugoslav republics that have not yet become EU members. Yet the sequencing of shocks, the challenges of creeping euroization, and the issue of underlying competitiveness were features recognizable too in Albania, Bulgaria and Romania. Turkey alone, in the region, did not fit in the same matrix: it had strengthened its financial sector, having had its banking crisis earlier, in 2001; and it had faced much less radical challenges of economic transformation and institutional reform.

Re-launching growth and integration on a sustainable path

At the opening of this session, the case was made that getting the growth model for the region right was a key to its economic future, and was important more broadly in terms of Europe's credibility as a 'pole' of growth and stability in the global economy. The

premise of the original agenda concept (re-launching sustainable growth) was questioned in this connection: some participants considered that the trajectory of the past few years had been inherently unsustainable.

The growth model of the past few years had certainly left the region vulnerable to external shocks in several respects. Unlike Asia, it had not managed exchange rates in a way that preserved a wide margin of competitiveness so as to support export-led growth and build up external reserves to very high levels. Capital controls had been removed quite early; there had been a rapid expansion of lending to households, often by foreign banks and in foreign currencies; and current account deficits had widened – in some cases dramatically. This could be seen as an equilibrium process – and one of water flowing downhill from rich to poor countries. But to some observers it had also seemed somewhat unbalanced, carrying inherent risks of hitting speed limits, even before the global crisis struck.

But the question was raised starkly whether, even with the benefit of hindsight, there was really any choice in the basic growth model for the region. Globally, the alternatives could be put, in a stylized way, as either the current Asian or the earlier Latin American growth models. But neither was viable in this case. The former would be politically impossible in a region committed to rapid EU integration, while the latter (in the sense of a heavy state role and an emphasis in import substitution) had been abandoned as inefficient in the 1990s even in the countries that had earlier espoused it.

How, then, to go forwards? Most participants felt that the potential for

growth remained in place, and could only be tapped through integration with the EU and with global markets. Some felt that, by historic standards, the countries were emerging markets that displayed important strengths. All agreed, however, that their potential had not been adequately tapped. And now they would increasingly be put under a spotlight as they “competed” for foreign direct investment with Asian and other economies, in a world where the prospects for growth had dimmed and the outlook for bank-driven capital flows had reversed sharply.

A first message from the discussion was that policy-makers – however hard this was – should try to seize the crisis as an opportunity. Resources must be shifted towards more export-oriented industries, and countries must move up the value-added chain. It was suggested that the export growth documented in the New Member States of the Baltics and Central Europe might not be replicable, because starting conditions are less favourable, and governments in this region tend to be weaker. Moreover, neighbourhood trade has not (or not yet) taken off in the western Balkans.

But the policy requirements for progress were fairly clear. Structural reforms must be advanced and institutional deepening must continue. There was, again, general consensus on the emphasis needed in structural reforms. Two issues stood out in particular. First, there had to be strengthening in the input of human capital to growth. Skills were often outdated; unemployment was high; participation was weak; and demographics were adverse. Building human capital was a key to growth. Second, the business environment

had to be improved radically, to become more competitive with leading emerging markets.

A more competitive market environment would help trigger new and more balanced inflows of capital, fostering a more sustainable pattern of growth. The pattern of feast and famine in global capital markets had now removed the risks of certain types of exuberance in bank lending to households; but it also raised the stakes on implementing policies to attract capital to the productive sectors of the economy and accelerate underlying growth.

So, yes, countries across the region faced challenges that were quite diverse; and participants did not have uniform views about the specifics of the growth model to be advocated. But the common themes of enhancing competitiveness, improving economic flexibility, and strengthening institutions cut across these differences. In other words, the only recipe – and ultimately a very promising recipe – was to follow, with some handicaps and learning some lessons, the path charted by earlier EU joiners.¹

¹ Participants’ suggestions for future research focused mainly on these types of issues. They included issues of competitiveness, and a better framework of analysis for these; reasons for the relative insignificance of trade in the region - including openness and stability as issues of *longue durée*; migration questions; and challenges in structural reforms – especially relating to human capital and the functioning of labor markets. Participants agreed that the diversity in the region – in trade patterns, demographics, the role of the state, EU perspectives – makes it difficult to treat South East Europe analytically as a single area. It was argued that research of core/periphery relations suggests using a wider sample than only countries of this region.

Where participants worried deeply was not so much on the broad diagnosis of growth models as on the prospects of these becoming a reality – or happening fast enough to tip the scales decisively towards a positive political-economic dynamic: one in which the prospects for sustained growth helped to catalyse popular constituencies for reform. Especially, this question was posed concerning the candidates and potential candidates that were former Yugoslav republics. There was considerable agreement on the presence of Yugoslav legacies that inhibit reform: bloated public sectors, a preoccupation with redistribution rather than creating wealth, the role of the state still significantly larger than in the countries of East Central Europe. In fact, however, some of these considerations applied even to Turkey, different as it was from others in the broad region. Turkey's growth model had not featured the same accelerated unbalanced financial integration; but it faced very urgent problems in terms of human resource development, labour force participation, and an upgrading of skills and competitiveness that could avoid it being sidelined by Asia.

The core argument on growth models, in other words, was not about alternatives so much as about shared challenges, and a concern about loss of reform momentum. The structural and institutional factors impeding growth needed to be tackled urgently. And they might perhaps (participants worried) prove harder to tackle, not easier, following the crisis. It might be very difficult to muster domestic political support for reform. This concern led naturally to a discussion of the role that external anchors could play.

The role of the EU and international institutions

Mirroring conventional wisdom, the preponderant view in the group was that the EU remains the “only game in town.” In this discussion, however, the question posed from the outset was whether that is increasingly becoming an empty formula. Is the prospect of EU membership credible enough, and timely enough, to overcome forces that might otherwise trigger a backsliding to the desultory reforms and unfulfilled promise of the past? If not, then there were dangers, perhaps, in repeating the EU mantra too insistently as a main focus of policy efforts, to the extent this might even prove a pretext for inaction or failure. The danger in participants' minds, clearly, was that the EU would pretend to remain open and that countries would pretend to reform.

There was no deep consensus in the workshop on this core issue, albeit there was a stronger flavour of pessimism than in the past. But the discussion served useful to clarify a number of important points.

First, there was the role of “other actors” – which it would be easy to misinterpret as a pointer to future trends. In the short run, it was the IMF, not the EU, that had stood ready to respond swiftly, granting access to its resources at unprecedented levels. More IMF programmes were probably in the pipeline. In matters of commercial bank co-ordination, the EBRD had also played a prominent role. The experience of the crisis in South East Europe, indeed, was that the EU had been backward in coming forward – arguably in part because of comparative advantage in designing and monitoring adjustment programmes.

But this was seen, in some sense, as an aberration. What countries in this region needed in the medium- and long-term was above all systemic transformation – and this kind of pervasive change in structures and institutions was something that the EU anchor was best adapted to assure. Even in Turkey, the key to the future lay in a continuing deep transformation of competitiveness that was profoundly structural in nature. And participants were reminded that the IMF, from mid-2007 onwards, had set its face against structural conditionality: this was a long-haul process that other agencies were seen as championing in the triage of IFI roles. This was not to say, however, that the EU process was all-embracing: there were political and security areas where other agencies and countries could still play a helpful catalytic role.

Second, there was a question of counterfactuals. With or without the EU, no participants saw a set of positive economic choices open to the region other than to participate in the process of globalization (newly confirmed warts and all). Other strategies amounted to a recipe for backsliding into a situation with little economic promise and considerable political risks. With regard to alternative sponsors, Russia was singled out as an important actor in the region, but its engagement has been significant only in the energy sector. While it was acknowledged that Moscow can drive a hard bargain and is good at exploiting the EU's internal differences, overall it is not a formidable investor or credible anchor in the region.

Third, the picture, potentially, was thus of a steep divide in the region between those (Bulgaria and Romania) that "made it" in the 2004-7 enlargement

wave, and those left on the brink – or some way from the brink. For the EU members, the prospect of euro adoption remained a form of policy anchor and incentive, which the turbulence of the crisis perhaps made more attractive in the medium term. Even those who saw the euro as a straightjacket did not question that Bulgaria and Romania were decisively bound into the EU integration process over time. For the non-members of the EU, there was a real risk of slipping backwards (in former Yugoslavia and perhaps Albania) – or of moving sideways with reforms and slipping down the global league table (in Turkey).

Fourth, it was premature to write off the EU anchor. There was scope for political imagination in some regards. Instances offered were decisive action in the visa area, which was hugely important to citizens of the region. Another possibility was a sudden breakthrough in relations with Serbia, accelerating its membership alongside an unblocked Croatian process. This could transform the picture, and the outlook on this was viewed with less pessimism than the disturbing process in which support for Turkish accession seemed to be eroding on both sides. This set of possibilities was seen by many participants as the key route to advocate. Without some renewal and reinvigoration of the EU process, it seemed highly uncertain whether the more diffuse anchor of globalization is strong enough to trigger a sustained catch-up. Indeed, economic incentives were not enough to bring the region to address outstanding political and security issues. In former Yugoslavia particularly, the political-economic implications would be deeply worrying in the absence of renewed commitment on the EU side.

Finally, the destiny of these countries would be strongly influenced by their own actions. Things did not have to get worse to get better – indeed there was a possibility that any renewed

turmoil in the region might make EU citizens even less ready to absorb it. So reforms had to come first, if the EU was to get serious about enlargement.

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ABOUT SEESOX

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South East European Studies at Oxford (SEESOX) is part of the European Studies Centre at the University of Oxford. It focuses on the interdisciplinary study of the relationship between European integration and the politics, economics and societies of the Balkans, Greece, Turkey and Cyprus. Drawing on the academic excellence of the University and an international network of associates, it conducts policy relevant research on the multifaceted transformations of the region in the 21st century. It follows closely conflict and post-conflict situations and analyses the historical and intellectual influences which have shaped perceptions and actions in the region. In Oxford's best tradition, the SEESOX team is committed to understanding the present through the *longue durée* and reflecting on the future through high quality scholarship.

SEESOX has the following objectives:

- To support high-quality academic and policy-relevant research on South East Europe;
- To organise conferences, workshops and research seminars;
- To promote multi-disciplinary study of the region's development within Oxford University (e.g. politics, international relations, law, sociology, economics) working in collaboration with other Centres and Programmes within the University, including student societies;
- To spearhead intellectual exchanges and debate on these issues among networks of individuals and institutions beyond Oxford;
- To foster cooperation between the academic and the policy making communities.

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