

conference report

South East European Studies  
*at Oxford*

# Current economic challenges and regional co-operation in South-East Europe

*February 2012*



St Antony's College  
University of Oxford

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South East European Studies at Oxford

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# Current economic challenges and regional co-operation in South-East Europe

Bank of Albania – SEESOX High-Level Seminar



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*This report draws on discussions from a conference organized by the Bank of Albania, in association with South East European Studies at Oxford (SEESOX), in Tirana on 21st June, 2011. The participants were academics and analysts from the UK, South East Europe and elsewhere. The report represents SEESOX's interpretation of discussions in the conference and does not purport to reflect the views of any of the participants.*

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## Overview

A new and sustainable pattern of growth in Southeast Europe depends critically on deeper regional co-operation. This was the consensus among senior officials and academics at a seminar that Bank of Albania Governor Ardian Fullani and SEESOX co-hosted in Tirana on June 21st.

The seminar brought together participants from Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Germany, Greece, Kosovo, FYR Macedonia, Slovenia and Turkey. It was the third event organised in the framework of a Co-operation Agreement between the Bank of Albania and SEESOX.

Speakers drew a number of political-economic lessons for Southeast Europe as they assessed challenges in the wake of the global crisis, while noting that financial stresses in the euro area had yet to subside. Across a range of detailed presentations on the sources, challenges and opportunities for countries in the region, several key messages stood out:

- The phase of fire-fighting is over, in the words of Governor Fullani, and it is time for economic architects to design a new pattern of growth: one that is based on productivity and competitiveness, and less dependent on debt.
- The economies in the region are, with few exceptions, simply too small to serve as a magnet for the critical mass of direct investment that is needed to reorient growth patterns towards more export-based expansion. In a keynote address, Marko Skreb from Croatia underscored that infrastructure gaps and business environment weaknesses across Southeast Europe must be addressed to foster market opportunities and economies of scale that would make the region a serious competitor in the European and global economy.
- These new cross-border flows are also needed to fill a foreign savings gap as - along the lines of Adalbert

Winkler's analysis – de-leveraging among euro area banks will continue to dampen credit growth in their East European networks.

- 'Roads are not enough,' in Governor Fullani's lapidary phrase. All regional networks need to be enhanced, and continuing structural reforms are essential to make the region's economies more productive and attractive to investment. Sound fiscal policies will be needed to redirect expenditure towards infrastructure and skill development while rebuilding fiscal space to buffer future shocks.
- There is a much greater scope for regional co-operation in policy analysis, which the Bank of Albania and the Bank of Greece, among others, have been active in highlighting and supporting. Peer pressure within the region can help catalyse reforms. And, as Max Watson noted, there is important scope for cross-border capacity-building efforts of the kind that the Ljubljana-based CEF has been promoting across the region, with continuing encouragement from the Bank of Albania.
- Europe will remain a key anchor, as evidenced by imminence of accession in Croatia, and progress in Serbia. Moreover, the EU has been a strong proponent of regional co-operation. But - as several speakers observed - the countries in the region are 'in the same boat together' and they need to work with each other as they make themselves more attractive economically, taking account also of the fact that the EU and the euro area may remain for some time preoccupied with internal dilemmas.
- The region is already benefiting from what Dimitar Bechev termed 'overlapping spheres' of economic and social co-operation. Terms such

as 'the Yugosphere' cease (20 years on) no longer carry negative connotations. And Turkey's economic development is helping to buffer regional trade in a period when the Greek economy is undergoing the stress of deep-rooted reforms.

- However, the goal of self-propelled and externally anchored regional co-operation is not going to be achieved in a day. Many speakers warned that it will be a hard and sometimes uphill grind. Minister Ridvan Bode of Albania called on policy-makers across the region to 'roll up their sleeves' for the task.

Against this backdrop of challenges and opportunities, participants noted that it would be important to bring new analysis to the table and to 'think outside the box' in addressing the region's issues.

During the seminar, participants offered reflections on many issues relating to reform challenges in Southeast Europe, and the role that enhanced regional co-operation can play in addressing these. Three main themes can be distilled from their remarks. These concern the experience so far with financial integration and related lessons from the crisis; the role of the central banks in the region; and key challenges and opportunities ahead, including for greater regional co-operation. The main ideas emerging on these themes are summarised below.

### **Experience with financial integration, and lessons from the crisis**

In emerging Europe there has been a strong tendency to open up financial institutions and financial markets. Financial liberalization can be analysed in its three dimensions: *de jure* openness (formal legislative liberalization); *de facto* openness

(measured by the total amount of assets and liabilities of residents toward non-residents of the country; and the role of foreign banks in the domestic banking sector. In all of these dimensions, emerging Europe has opened up a great deal, and an especially striking feature is the major influence of foreign banks operating in the countries. The pace and extent of opening up contrasts to some degree with other emerging markets, and especially emerging markets in the East Asia and South-East Asia, which were more cautious with regard to financial liberalization at comparable stages of development.

In Southeast Europe specifically, financial liberalization and integration with EU financial markets began in the early nineties, and it speeded up in the first half of last decade. Countries of the Western Balkans had almost completed financial liberalization by the end of 2002. Since 2007 Bulgaria and Romania have been members of the EU and thus of the single European financial market. Measured by the share of foreign ownership, the banking sectors in all countries in the region have been majority-owned by banks from Austria, Italy, France, Greece and Turkey since 2005.

A very rapid expansion of credit activity in the region has been related to the easy access of the banks in SEE region to financing from parent banks. The pre-crisis period in global markets was characterised by a glut of liquidity and easy financial conditions, including in the euro area. This can be demonstrated by extremely low long-term real interest rates the eurozone, during a very strong boom and broad money accelerating much faster than GDP in the major countries. The same phenomenon was evident in Southeast Europe. For example, in Croatia, during the period 2004 -2008, credit to the private sector

increased by 87% and GDP by 38%; in Serbia credit rose by 238% and GDP by 93%; and in Albania the corresponding increases were 445% and 45%, respectively.

Economic growth in the region was strong in the five years preceding the crisis. However, strong growth was frequently associated with rapidly increasing foreign debt as a consequence of the sharp increase in current account deficits. In the post crisis period, growth rates have become much lower and the convergence of these countries has slowed down severely. The parent-subsidiary relationships of foreign banks alleviated a sudden stop in capital flows to emerging Europe during the crisis. On the other hand, there is no firm evidence that foreign banks have contributed much to recovery. In other emerging market regions recovery has been more notable. Overall, empirical evidence suggests that the stability of credit growth is not much dependent on the share of assets held by foreign banks.

In the literature, the advantages of financial integration are seen as relating to the benefits of financial deepening. However, there is no statistically significant and robust evidence of positive effects on sustainable growth. The benefits of integration have much to deal with institutional strengthening, rather than a direct impact on growth. Financial liberalization is also seen as a buffer against domestic economic shocks, but the current crisis was caused by a global shock, and financial markets were a key transmission channel. On the other hand, Turkey experienced a major shock due to its trade integration, rather than a financial shock. Overall, it needs to be borne in mind that economic integration is associated with growth, but in all forms it can increase vulnerability. One of the key questions arising from the debate on

financial liberalization in general, and in Southeast Europe in particular, is whether emerging Europe has 'bet on the wrong horse' by adopting full and rapid financial liberalization in the early stages of transition. The answer to this question is not an easy one, and more research is needed.

Turning to the current outlook, the financial sector in emerging Europe is strongly tied to mature economies, and recovery in the region is thus highly dependent on their recovery. To the extent credit and capital flows are constrained, emerging Europe has to find other ways to strengthen and recover from the crisis. Whatever the final judgement will be on policies pursued in the past, the situation today seems clear. It demands a shift in the pattern of growth in the region towards one that is less dependent on credit and on external debt, and is thus more focused on an export-oriented traded goods sector as well as foreign direct investment as a source of financing.

### **The role of the central banks in the region**

The seminar was an occasion for the senior central bankers present to reflect together on some of the lessons to be drawn from their experience. The broad messages that emerged were as follows:

- Preventative measures adopted by central banks before the crisis, while at times unpopular, had proved fully warranted. For the future, this illustrated the broader case for ensuring that adequate fiscal and financial buffers are built up in the medium term.
- Co-operation among the central banks of the region had been strong, and was a major positive factor in handling the operational

aspects of the crisis as it broke on the region. This co-operation needed to be strengthened in the future, in areas such as cross-border bank supervision; and it deserved to be emulated in other aspects of inter-country relations.

- There were limits to what the central banks of the region could achieve unaided. Ongoing support from fiscal authorities was crucial, and in terms of broader economic goals it was also critical that structural policies in the region be upgraded.

At a more technical level, it was noted that central banks in SEE region have applied different monetary and foreign exchange regimes. Romania, Croatia and Serbia have adopted managed float regime, Albania has a free float, Bulgaria and Bosnia and Herzegovina have currency board regimes, FYR Macedonia has a de facto peg to the euro, and Montenegro and Kosovo have introduced the euro as a means of payment, as a successor to the DM. A general characteristic of the region in the post-crisis period has been a significant reduction of current account deficits, and Bulgaria and Croatia have been the most successful in that. On the other hand, the only country in the region that had a positive growth rate in 2009 was Albania.

Turning to the country-specific experience of central banks, the following points were made.

Being a small open economy in transition with an independent central bank and with high investment needs *Albania* needed to be careful and it needed structural reforms. Prudential regulation was the first step. The Bank of Albania changed the law on

banking sector, while drafting some future changes on other laws. These changes in the banking law included reforms on governance, supervision, risk reduction, transparency, and internal control. The Bank of Albania sought to establish its monetary anchors in the form of inflation targeting under a floating exchange rate regime. It also pressed for a fiscal policy framework that would foster financial stability. The Bank set up a credit information bureau and a financial stability department. Before the crisis, when the Bank was undertaking these reforms, there was a large inflow of liquidity. Strengthening vigilance, transparency and monetary policy helped the Albanian economy when the crisis hit. During the crisis the Bank took the necessary measures to provide liquidity to the market, when the banks were afraid to provide this liquidity. This ambiguity in the market only lasted for a week, and then banks restarted operating regularly.

Experience in *Bulgaria* in the post-crisis period shows that being conservative in good times helps in bad times. Counter-cyclical policies are required in the legislative framework such as maintenance of increased capital requirements by banks. This and other measures prevented unexpected losses during the crisis. The Bulgarian Central Bank undertook analyses and banking sector stress tests as a supervisory tool to assess the fragility of the banking sector. Cross-border cooperation has proved very important in trying to maintain financial stability in the region. Cooperation can take many forms, including memoranda and other agreements. The most efficient tool for cooperation remains the

supervisory colleges. These institutions depend on building good capacity, and on the quality of staff involved.

Although *FYR Macedonia* was hit badly by the crisis, recovery took shape in the last quarter of 2009 and in 2010. Investors, fearing devaluation, shifted from domestic to foreign currency which caused serious losses to the National Bank. The National Bank started implementing a series of reforms as a result. It had already started implementing restrictive measures before the crisis, and had to face harsh criticism from the public. But the National Bank has succeeded in keeping inflation in check. Inflation expectations of the private sector remain stable. As for longer-term policy challenges, since the beginning of the fixed exchange rate regime, there have been lively discussions on an exit policy and the implementation of inflation targeting. Such discussions continue to be a topic in the country and will be cautiously examined by the National Bank.

Kosovo is flooded with liquidity, and net foreign assets of the banking sector are around 10 percent of GDP, despite a 10 percent minimum reserve requirement. The capital adequacy ratio is far above Basel III requirements. The loan-to-deposit ratio is set around 80 percent, as a recommendation of the supervisory authority. Thus the financial sector of Kosovo entered the crisis armed with strong prudential measures. Despite high financial returns, foreign investment is low because of a lack of good institutional set-up to attract foreign direct investors. Transport and infrastructure networks have been developing, but they are still

insufficient. Remittances in Kosovo still constitute one of the strongest pillars of the current economic model.

### **Key challenges and opportunities, and the role of regional co-operation**

The global and euro area crises offer some lessons for both developed and developing countries. In terms of experience in Southeast Europe, some of the important lessons learned from the ongoing crisis were seen to be as follows.

First, the key challenge for the region is to create an alternative, sustainable growth model that is less vulnerable to shocks. For a country which is a candidate or potential candidate for EU membership it is important not to wait for membership and then start structural reforms. There is a risk of losing precious time and momentum in this way. SEE countries cannot be competitive on the basis of economies of scale: they should focus on products that suit their specialisation and find their own niches. All countries in the region are small and regional cooperation is key to attract investors. A favourable business environment, greater labour market flexibility, competitiveness, and investments in physical infrastructure will help establish this environment. Reorientation to the tradables sector, export led growth, research and development, and stronger total factor productivity is key in creating these dynamics. Economic laws are very important, but practical implementation is also crucial.

Second, a number of major lessons concerning fiscal policy have emerged. One of the lessons from the current crisis concerns the Maastricht deficit and debt levels. These have been misinterpreted as an average, but should have been thought of as an

upper bound. SEE countries should be cautious of running large fiscal deficits and increasing public debts. Policymakers should be ready for external and domestic shocks, and for a continuing reorientation of the economy, and must be prepared for negative outcomes. So it is important to have buffers which they can rely on at times of distress. Over time, fiscal policy can play a significant counter-cyclical role, but this requires the formation of fiscal buffers during times of stability, which is difficult to achieve. For an efficient counter-cyclical economic policy, it is very important to have excellent macroeconomic statistics. Across Southeast Europe during the boom period of 2000-2007, fiscal deficits decreased. On the other hand, if we compare this with the balances of households and firms (current account deficit-fiscal deficit), we observe that the scope of fiscal consolidation was not ambitious. Fiscal consolidation needs to be complemented by an increase in the efficiency and effectiveness of public spending and tax administration. In the post-crisis period it has been realised that expenditures have been on the wrong items, such as transfers and wages. Now, there is a need not only to cut, but also to reorient public expenditures toward infrastructure investment. This means that the crisis has brought with it a double fiscal challenge for the countries in the region to deal with.

Third, a number of current challenges relate to the presence of foreign banks in the region. Empirical data shows that the presence of foreign banks has contributed to financial deepening and the overall efficiency of the sector. On the other hand, the euro area-based parent banks have had a significant role in aggravating credit booms and

exposure to unhedged foreign currency borrowing. Financial stress, originating in foreign banks, has been transmitted to the banks in the region. Therefore, one of the priorities is to increase the share of domestic currency lending.

Fourth, and cutting across all these issues, regional cooperation can be seen as an opportunity for Southeast Europe. Regional cooperation matter for a wide range of reasons, and the high-level seminar played a valuable role in highlighting these and spelling them out. Some of the key points to emerge included the following:

- Network industries such as trade, transport, energy and environment are key in stimulating investments and growth. The old model of the growth in the region was based on „hub-and-spoke“ financing rather than the formulation of a regional market and this needs to change. Cooperation can help in facilitating regional specialisation, formulation of a regional industrial policy, horizontal policies in research and development, and innovation; and it can thus help enhance growth in the region.
- The old 'model' ignored monetary spillovers, but we need strong cooperation for a stable banking system. Prudential measures to control credit growth are more likely to be successful if they are coordinated by home and host supervisors. The European Coordination Initiative (the “Vienna Initiative“) is an exemplary forum which fostered dialogue between key stakeholders, including the banks. Such initiatives are vital to prevent severe exchange rate pressures or bank failures in the region during the crisis.
- There is a need to secure commitment of governments to create adequate fiscal space. Information sharing, institution-building, and legal reform are crucial for the successful implementation of counter-cyclical policy. Movement in this direction can be fostered in part by cross-country learning – as part of a wider synergy in all capacity-building.
- The countries in the region have a lot to learn from each other, as they have specific strengths and weaknesses. Each country needs to be examined, and obstacles to reform need to be identified. Corruption, quasi fiscal-budget distortions, state firms linked to interest groups, local politics and unemployment risks as a voter hazard are among the varying factors blocking reform in the countries in the region. Peer group comparisons for the region can help in diagnosing country-specific obstacles and in the formulation of tailored solutions.

Finally, it was noted by a number of participants that the EU as a regional macroeconomic policy anchor – and also as an anchor for targeted structural reforms – has been insufficiently strong. Hopefully there will be scope in the future to use the EU dialogue as a greater support for fiscal policy, including by buttressing domestic anchors. It is also to be hoped that the EBRD and the Commission together can focus on more targeted structural advice. This said, however, participants emphasised that the region needed to show greater self reliance. It was more and more clear that the countries of the region are 'all in one boat'. This should be a stimulus to closer co-operation.

# Current economic challenges and regional co-operation in South East Europe

Tirana, June 21<sup>st</sup>, 2011

## PROGRAMME

8:30 – 9:00	REGISTRATION
9:00 -9:45	<b>Welcome addresses by</b> <b>Ardian Fullani</b> , Governor, Bank of Albania <b>Othon Anastasakis</b> , Director of SEESOX, Oxford. <b>Ridvan Bode</b> , Minister of Finance
9:45 – 11:15	FIRST SESSION: Diagnosing the economic challenges
Chair:	<b>Max Watson</b> , Fellow, St Antony's College, University of Oxford
Speakers:*	<b>Dimitar Bechev</b> , Head of ECFR' Office in Sofia, and Research Associate at SEESOX <b>Marko Škreb</b> , Chief Economist, Office for Economic Analysis and Strategic Planning, Privredna Banka Zagreb <b>Adalbert Winkler</b> , Professor for International and Development Finance, Academic Head of Centre for Development Finance, Frankfurt School of Finance & Management
11:45 – 13:00	SECOND SESSION: Current challenges and the potential scope and goals of regional cooperation
Chair:	<b>Othon Anastasakis</b> , Director of SEESOX, Oxford
Speakers:*	<b>Eleni Dendrinou-Louri</b> , Deputy Governor, Bank of Greece <b>Ardian Fullani</b> , Governor, Bank of Albania <b>Rumen Simeonov</b> , Deputy Governor, Bulgarian National Bank
14:30 – 16:00	THIRD SESSION: Policy priorities for the future
Chair:	<b>Dimitar Bechev</b> , Head of ECFR' Office in Sofia, and Research Associate at SEESOX
Speakers:*	<b>Gani Gërguri</b> , Governor, Central Bank of Kosovo <b>Amir Hadziomeragić</b> , Head of the Department for Economic Research, Statistics and Publication, Central Bank of Bosnia and Herzegovina <b>Goran Petrevski</b> , Member of the Council of the National Bank of the Republic of Macedonia <b>Max Watson</b> , Fellow, St Antony's College, University of Oxford
16:15 – 17:00	CLOSING PANEL: The way forward in regional cooperation
Chair:	<b>Ardian Fullani</b> , Governor, Bank of Albania
Speakers:*	<b>Dimitar Bechev</b> , Head of ECFR' Office in Sofia, and Research Associate at SEESOX <b>Gerwin Bell</b> , Deputy Division Chief, European Department, and IMF Mission Chief for Albania & Montenegro <b>Marko Škreb</b> , Chief Economist, Privredna Banka Zagreb <b>Max Watson</b> , Fellow, St Antony's College, University of Oxford <b>Adalbert Winkler</b> , Professor, Academic Head of Centre for Development Finance, Frankfurt School of Finance & Management

\* In alphabetical order.

# ABOUT SEESOX

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South East European Studies at Oxford

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South East European Studies at Oxford (SEESOX) is part of the European Studies Centre at St Antony's College, Oxford. It focuses on the interdisciplinary study 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 teaching and research on South East Europe;
- To organise conferences, workshops and research seminars;
- To promote the multi-disciplinary study of the region within the University of Oxford (e.g. politics, international relations, anthropology, 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.

[www.sant.ox.ac.uk/esc/seesox](http://www.sant.ox.ac.uk/esc/seesox)