

conference report

South East European Studies  
*at Oxford*

*Do crises change economic  
fundamentals in South East Europe?*

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St Antony's College  
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**seesox**  
South East European Studies at Oxford

# Do crises change economic fundamentals in South East Europe?

Tirana, 30 October, 2015

*This report draws on discussions at the conference on “Do Crises Change Economic Fundamentals in South East Europe?”, which was held in Tirana, Albania, on 30<sup>th</sup> October, 2015, jointly organised by the Bank of Albania and SEESOX, and in cooperation with PEFM (Political Economy of Financial Markets) of the European Studies Centre, Oxford. The participants included academics and officials from Albania, and others countries in South East Europe, as well as from Oxford University, the IMF, and the wider banking community. The report represents SEESOX's interpretation of discussions at the workshop and does not purport to reflect the views of any of the participants (except where specified).*

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## **Preamble**

The conference was convened by the Bank of Albania in collaboration with SEESOX. Its purpose was to explore the question as to whether crises, of the type that has been recently experienced in the context of the US subprime mortgage meltdown and Lehman failure, and then the Eurozone debt and banking problems, can affect economic fundamentals. The idea that economies can be pushed from one stable equilibrium into another (possibly less socially optimal) equilibrium by an exogenous shock is not new to economics.<sup>1</sup> The academic debate has usually made a distinction between stable equilibria, which may or may not exist in more than one form, and fundamentals, such as key parameters and structural

features of the economy which are assumed to be constant. However, it is reasonable to ask whether these economic parameters and structures (fundamentals) are themselves a form of equilibrium generated from a complementary model (or models) of microeconomic as well as social and political structures, which may themselves be subject to multiple equilibria. The purpose of this conference was not, however, to rake over these theoretical issues, but rather to pose the question about the observed variability of equilibria (and even of fundamentals) in terms of the experience of South East Europe (SEE), both in the context of the global financial environment that existed prior to the crisis, and the very different one that followed it. The key questions the conference addressed were the following: have the fundamental underpinnings of the global and regional SEE economies changed? Has the global and domestic financial intermediation model changed? And do policymakers in the region recognize what has happened?

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<sup>1</sup> For the application of multiple equilibria models to financial crises see, for example, “Models of currency crises with self-fulfilling features”, Obstfeld, M., *European Economic Review* (1996); and *Microeconomics of Banking*, Freixas, X., & Rochet, J-C., MIT Press (1997). For a debate about the theoretical possibility (or not) of such multiple equilibria, see “Rethinking Multiple Equilibria in Macroeconomic Modeling”, Morris, S., & Shin, H.S., and Comments by Rey, H. and Atkinson, A, in *NBER Macroeconomics Annual* (2000), Volume 15

The conference was opened by two keynote speeches by **Edi Rama** (Prime Minister of Albania), and by **Gent Sejko** (Governor of the Bank of Albania). Mr. Rama characterized recent events as a turning point for financial markets and for global management of the financial system. The speed of the crisis challenged traditional viewpoints, and ushered in new unorthodox and previously untried policies. But these unorthodox policies have themselves introduced a new dilemma—how to safely exit them in due course. The refugee influx from the Middle East has meanwhile compounded the region’s problems. International cooperation to deal with these problems will be essential. Despite all this, the beacon of EU membership remains a powerful guiding force for continued reform—without this goal the reform effort would have lost focus and momentum. Mr. Rama looked forward to a more diverse economy, moving beyond reliance on construction and remittances, toward (inter alia) development of agriculture and electricity production, and a more sustainable growth model overall. For his part, Mr. Sejko underlined the central bank’s determination to assist in restoring Albania’s economic growth toward its potential. The government’s pro-investment policies would help, but there was a need to clean up banks’ balance sheets and reduce the drag of non-performing loans (NPLs) if the financial system was to play its part in facilitating a recovery in growth. **Othon Anastasakis** (Director of SEESOX) concluded the opening session by stressing the importance of small nation states in the global community of nations. He noted how the Balkans were linked to the rest of the world through the extensive diaspora of its peoples, through the linkages with China and Russia in particular, and via energy corridors

between East and West. He stressed the importance that SEESOX attaches to its relationship with Albania, seeing a role for assisting in the education of young scholars.<sup>2</sup>

### **Has the economy changed in the post crisis period?**

*Changes and challenges in transmission policy mechanism and economic behaviour in the face of recent developments in European and global markets.*

The first session began with a contribution from the IMF’s mission chief to Albania, **Anita Tuladhar**, coincidentally in Tirana to undertake a review of Albania’s IMF program under the Extended Fund Facility. Delegates learned that the current growth rate in SEE was much lower than before the crisis, in part because the region’s growth rate potential has slowed. This downward estimate to potential reflected the realization that the preceding growth rate before the crisis was not sustainable. While domestic demand had been curtailed, much of this had occurred through reductions in investment (compounding the decline in potential growth) rather than consumption. The savings rate thereby remained below that of other prospective EU or new member states, resulting in current account deficits that were still difficult to finance. IMF analysis suggested that there was a need to contain external debt levels in the region, which implied continued fiscal adjustment would be required. NPLs in the region were a key impediment to the domestic financial sector’s ability to take up the slack and lend to businesses. **Adam Bennett** (SEESOX & PEFM) elaborated on this assessment by

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<sup>2</sup> Dr. Anastasakis gave a lecture entitled “From crisis to crisis: The uncertain state of the European Union” to students at the Faculty of Economics of the University of Tirana on October 29, 2015.

drawing on a recently published SEESOX book which analysed the causes and consequences of the region's altered trajectory following the onset of the global crisis.<sup>3</sup> This book traces the region's transition journey, starting in 1989 following the fall of the Berlin Wall and identifies three distinct phases: (i) early transition, with the dismantlement of old socialist or communist political and economic structures and their replacement by more market and democratic systems; (ii) the boom period that ultimately led to overheating and a skewed growth model, and (iii) stagnation following the sequence of global financial crises in the USA and then Europe. The profoundly altered global financial environment that now prevails has required a redesign of the region's growth model, away from reliance on domestic demand and development of real estate towards a more export oriented structure. The book also draws attention to way in which the post crisis stagnation and chronically high levels of unemployment (at least as recorded by the official statistics) has led to the erosion of public trust in institutions, including in the democratic process. Yet the pressure to reform, especially in the wake of the crisis, has never been greater. This makes the task for reformist politicians especially daunting. **Othon Anastasakis** drew on the public lecture he had given the preceding day to outline the political challenges facing Europe as a whole. Most immediate of these was the migrant surge from the Middle East, which was testing Europe's unity and solidarity. The Eurozone crisis has meanwhile altered the balance of power away from Brussels and the EC toward

nation states, and especially to Germany which has become the main point of reference for the EU. New political alternatives, often of a populist orientation, have proliferated across the landscape of national politics in many European countries. European demographics are meanwhile not promising, with a steady increase in the average age of Europe's citizens. The European Union and its institutions have proven complacent when times were good, and then in denial when things went wrong, with little preparedness. What does this augur for the Federal dream of the EU? Whatever the answer to this question, there remains no alternative to the EU as the goal for South East Europe. For the Bank of Albania, **Altin Tanku** (Director of the Research Department, Bank of Albania) wrapped the session with a useful review of the situation from the perspective of Albania, where, in common with other countries in South East Europe, he observed that there was a pervasive lack of optimism regarding economic prospects. Despite continuous monetary policy easing the output gap remains below potential. Post crisis developments have reduced the efficiency of monetary policy transmission mechanisms. The banking system has abundant liquidity yet credit growth is restrained by group and home supervisory authorities' policies. Moreover, the gap between the total domestic financing and banking system financing of private investments has expanded, reducing further the effectiveness of the monetary policy. In light of these developments Bank of Albania is considering alternative instruments to counteract these trends and increase the influence of monetary policy on economic activity.

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<sup>3</sup> *Remaking the Balkan Economy, Economic and Policy Foundations for Growth in South East Europe*; by Adam Bennett, Russell Kincaid, Peter Sanfey and Max Watson, Palgrave Macmillan, St Antony's series (2015)

## Has financial intermediation model changed and how should financial stability and supervision policies respond?

*Challenges of reconciling financial intermediation, financial stability, banking supervision and coordination with monetary policy.*

The second session examined more closely the evolution of the financial sector in the wake of the global crisis, including the wave of regulatory reforms being introduced in the USA and Europe. **Charles Enoch** (IMF), **Gillian Edgeworth** (Wellington Management), **Aneta Krstevska** (National Bank of the Republic of Macedonia) and **Natasha Ahmetaj** (Bank of Albania) provided a wide-ranging update of developments. Delegates were reminded of the huge extent of global bank retrenchment from emerging markets (EMs) since 2009. This retrenchment has occurred irrespective of the strength or weakness of individual EMs, and the process has been manifested in banks selling businesses, withdrawing completely from sectors (e.g., retail), downsizing, terminating correspondent banking, and cutting trade lines. This retrenchment reflects (i) a profound change in the business model of finance, (ii) strengthened prudential compliance requirements, and (iii) intensified policing of anti money-laundering (AML). “Global banking” is no longer an objective in the new business model. The retreat to the core has been intensified by the regulatory agenda.<sup>4</sup> These withdrawals have been especially difficult for small countries, such as those in SEE, with financial systems dominated by foreign banks. For these countries there is a need to find other banks willing

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<sup>4</sup> Basel 3, Solvency 2 for insurance companies, Dodd Frank, and Total Loss Absorbing Capacity (TLAC), combined with record fines by US agencies, have all increased banks’ compliance costs.

to fill the void. Banks in the Middle East or China might be able to do this, but the best option would be to develop a regionally based home grown banking system, in the same way that banks in Scandinavia have managed to do. To facilitate this, efforts should be made to harmonize accounting systems, stay current in the process of regulatory reform, fulfil the requirements of FATF (the Financial Action Task Force), and advance structural changes (such as de-cashing the economy through provision of ATMs, as in Mexico).<sup>5</sup> Looking at market trends, delegates learned how EMs outside SEE (e.g., Asia) had been running current account surpluses prior to the crisis (and were thereby better able to withstand the effects of the crisis compared to SEE), but had since been running current account deficits. In part this was the unintended consequence of Unconventional Monetary Policies (UMP) in the developed economies (USA, UK, Eurozone and Japan). What will happen to these EMs as interest rates in developed economies start to rise again (from zero) and UMP is reversed remains to be seen.

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<sup>5</sup> Delegates were reminded of the conference hosted by the Bank of Slovenia in September 2014 (see *Reinvigorating credit growth: in Central, Eastern, and Southern European economies: proceedings of a conference jointly organized by the Bank of Slovenia and the International Monetary Fund*), which recommended (i) strengthening banks’ balance sheets through raising capital and clearing out NPLs, (ii) increasing transparency and predictability for creditor rights, (iii) improving the ease of doing business, and (iv) diversifying away from banking as the dominant form of finance toward deeper capital markets.

**Central Bankers' Panel Discussion:**  
*Misunderstanding and misjudgement versus reality.*

The central bankers' panel, represented by the Governor of the Bank of Albania, **Gent Sejko**, the Governor of the Central Bank of the Republic of Kosovo, **Bedri Hamza**, the Deputy Governor of the Central Bank of the Republic of Turkey, **Turalay Kenc**, the Head of the International Relations Directorate of the Banca d'Italia, **Giuseppe Parigi**, and chaired by **Charles Enoch (IMF)** deliberated on whether recent regional and global developments altered the fundamentals of business in emerging Europe or the fundamentals in the foreign partners, or both? And if so, what is the correct policy response? There seemed to be little doubt that the world had changed profoundly either as a result of the crisis, or at any rate coincidentally because of other problems (e.g. China and (inter alia) its stock market crash). There is now a strong emphasis on structural reform globally. The USA, UK and Europe are focussing on financial sector reform, but other countries, such as China, are trying to wean themselves away from an industrial export led growth model toward one based on domestic consumption and services (ironically, moving in the opposite direction that SEE is being urged to do). Some countries, such as Germany, are shying away from similar domestic reforms that might help rebalance the Eurozone. The case for the reform of central banks was also explored. The use of UMPs and macro-prudential tools has expanded for independent central banks, although for those eager to strengthen their credentials for eventual Euro entry, the exchange rate itself has rather lost its usefulness as a tool. For central banks already absorbed into the Eurozone, conventional central banking powers

have been surrendered. With European Banking Union, central banks in the Eurozone will lose their autonomy on supervision as well. Some central banks, e.g., the Bank of England, have gone round in circles.<sup>6</sup>

### **Summing up**

The thrust of the conference's finding seemed to be that the global financial crisis had indeed led to a significant change in economic fundamentals, both in the world at large and also in SEE. There had been a marked reassessment of risk, which has contributed to a large scale deleveraging and retrenchment from all EMs, and a new banking model is emerging that no longer sees global reach as a necessary virtue. The crisis has led to a tidal wave of regulatory reform, as well as profound changes in the global financial architecture—and this was especially the case in the EU, the great neighbour and future aspirational home of SEE. The political environment has meanwhile worsened, with the rise of far left and far right nationalist parties, and the absence of a workable or harmonious pan-European consensus on key issues such as the migrant flood or the Eurozone crisis.

In light of all this, it was recognized that SEE's economic development model, as operated prior to the crisis, must change toward one less reliant on foreign (especially short term) capital. Such a reorientation of finance calls for the growth of local deposit bases, the development of regional banking groups able to benefit from economies of scale

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<sup>6</sup> The Bank of England was stripped of its supervisory role following independence in 1997 and the creation of the Financial Services Authority (FSA). In 2012, the Bank of England's supervisory authority was restored (inter alia, in light of the Northern Rock fiasco) with the establishment of the Prudential Regulatory Authority (within the Bank) and the Financial Conduct Authority (outside the Bank), and the abolition of the FSA.

yet remain dedicated to the region rather than parent banks in other parts of the world, and lastly the deepening of capital markets such as bond and equity markets. Structural reform more widely (e.g., in the labour market, business sector, commercial law, trade, and fiscal management) remains imperative, even though the political appetite for difficult reforms in these areas may not be strong in the prevailing climate of low growth

and high unemployment, and where the positive effects of such changes may take years to bear fruit. Policy makers and political leaders need to have the courage to keep the convergence show on the road and maintain the momentum for eventual integration within the EU—for however dysfunctional the EU may seem at the present time, there really is no alternative to this as the logical long run destiny of SEE.

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## Speakers

Natasha Ahmetaj	Deputy Governor, Bank of Albania
Othon Anastasakis	Director of SEESOX, St Antony's College, Oxford
Adam Bennett	Deputy Director of PEFM, St Antony's College, Oxford
Gillian Edgeworth	Economist, Central and Eastern Europe, Wellington Management
Charles Enoch	Deputy Director of Western Hemisphere Department, IMF
Bedri Hamza	Governor, Central Bank of Kosovo
Turalay Kenç	Deputy Governor, Central Bank of the Republic of Turkey
Aneta Krstevska	Chief Economist, National Bank of the Republic of Macedonia
Giuseppe Parigi	Head of the International Relations Directorate, Banca d'Italia
Edi Rama	Prime Minister of Albania
Gent Sejko	Governor, Bank of Albania
Altin Tanku	Director of Research, Bank of Albania
Anita Tuladhar	Mission Chief for Albania, IMF

# ABOUT SEESOX

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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.

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