Living in the neighbourhood of the Euro Area

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Sarajevo, 22 November, 2012

This report draws on discussions at the high-level seminar on “Living in the neighbourhood of the Euro Area”, which was held in Sarajevo, Bosnia and Herzegovina on 22 November, 2012. The participants included academics, officials and political figures from Bosnia & Herzegovina, the United Kingdom, the EBRD, the ECB, and the region of South East Europe. 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 identified).

Overview

The seminar was convened to discuss the consequences and policy implications for the emerging economies in Eastern Europe of living in the neighbourhood of the Euro Area (aka Eurozone). The region's perspective on this issue had profoundly altered following the onset of the global economic crisis in 2008. The Eurozone lodestar of the region's economic and political transition was now itself being rocked by periodic and increasingly violent tremors. Shockwaves from the banking crises in the US, UK and other Atlantic states had finally exposed the fundamental flaws of the Eurozone that had seemed hitherto so blissfully hidden (at least to those in the driving seat). Cracks were opening up between the Eurozone economies of the super-productive North and the under-productive South that threatened to become permanent splits, absent urgent and far-reaching systemic design changes. Yet policy makers at the centre of the Eurozone seemed more adept at addressing the secondary symptoms of stress—fiscal deficits and debts of members—than with resolving the underlying causes—productivity differentials across a currency union without sufficient inter-member fiscal transfers. While countries in South East Europe remained determined to pursue EU accession, the appetite of the EU for absorbing new members—especially those that might further destabilize productivity imbalances in the Eurozone—had abated considerably.

At the time of the seminar in November 2012, an eerie calm prevailed over the Eurozone. A palpable feeling of relief that Greece might not (at least not yet) be destined to quit the Eurozone still permeated the markets, and held at bay renewed fears from ongoing seismic reverberations e.g., from Spain (escalating bank restructuring costs). Nevertheless, delegates at the seminar were under no illusions that the crisis was over, or even ending. The seminar focussed on three key topics. The first session looked at how the process of financial integration with the EU and the Euro Area was expected to evolve in the wake of the crisis. The second session considered the experience of new and aspiring member states in the process of EU integration and Euro adoption. The third session examined the relationship between central banks and fiscal authorities and the fiscal challenges ahead.
Welcoming address

The Chairman of the Council of Ministers of Bosnia and Herzegovina (BiH), Vjekoslav Bevanda, opened the seminar by observing that the spillover of the crisis to the transition economies had many dimensions and raised many questions. He hoped that the seminar would help provide answers to some of these questions, including how to manage the region's economic reliance on the EU, and how to run domestic policy so as to both maximize the economic benefits while minimizing the negative effect of shocks. Mr Bevanda reminded the audience that sound financial intermediation was fundamental to economic prosperity and development. The goal of integration of BiH with the EU, moreover, depended upon having a stable financial system and the rule of law. He commended the policies of the Central Bank of BiH and the government's long term planning framework for 2012-15 in furthering this objective. The Governor of the Central Bank of BiH, Kemal Kozarić, underlined that BiH was historically and culturally a core part of Europe. He recognized that the EU was currently experiencing many problems. Notwithstanding these problems, BiH’s goal of EU membership remained appropriate and would clearly be to the benefit of both BiH and the EU in the long run. While achieving membership would require BiH to overcome many reform challenges, the opportunities afforded by membership would fully justify the effort. The Director of the European Studies Centre (ESC) at Oxford University, Othon Anastasakis, underscored the role of SEESOX (and the newly established Political Economy of Financial Markets (PEFM) programme) at the ESC in furthering understanding of the issues at stake.

Financial integration with the EU and the Euro Area: Experiences and issues

The first session of the seminar covered the experiences and issues arising from financial integration with the EU and Eurozone from the varied perspective of regional central banks, commercial banks, international financial organizations, and academia. Delegates were reminded that financial integration with the EU had initially brought significant benefits—large inflows of capital to help rebuild and reorganize the economies of Eastern Europe following the collapse of the Berlin Wall in 1989 and the start of transition. The counterpart of these capital flows, of course, was a large and growing regional current account deficit. Many observers in the international community (including the IMF) welcomed the development, viewing it as a natural effect of capital flowing downhill from the developed countries of Western Europe to the developing countries in Eastern Europe.* To the extent that these deficits resulted from investment spending in tradable goods and export sectors, they should indeed have proved eventually self-correcting in a benign growth-friendly fashion. In the event, this did not happen—when the global financial crisis struck and capital stopped flowing into the region, the adjustment forced on Eastern Europe was a painful one. As we rake through the ashes of the hopes and aspirations from the great

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* Members of the academic community applauded this phenomenon as the ending of the “Feldstein-Horioka puzzle”, according to which the progressive liberalization of cross border financial flows paradoxically did not appear to be associated with a relaxation of the domestic investment-savings constraint and thereby bring about a more diverse global range of cross border current account balances.
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boom in Eastern Europe, what do we learn?

A major share of capital inflows during the boom years was in the form of foreign direct investment—. Initially, these inflows fit the classic development model—financing the retooling and reorientation of domestic industry and infrastructure toward supplying a global market. However, as the boom accelerated and domestic incomes grew, an increasing share of this direct investment was flowing into real estate and the production of non-tradable goods supplying the domestic market. This was especially the case in Southeast Europe. Such investment further fuelled the boom, as it relied heavily on domestic labour and materials (the price of which rose sharply). Foreign capital flows was starting to destabilize the host economies.

As domestic incomes rose, the demand for mortgage and consumer finance also grew. The growing demand for this type of borrowing was met to a large extent by foreign banks. Although foreign banks were initially regarded with suspicion, delegates heard that their entry was beneficial, as the existing banks—relics of the socialist era—were ill suited for modern financial intermediation. The entry of foreign banks brought new skills, better governance, and freedom from government interference. Moreover, instead of “stealing” the savings of residents, as some feared, these banks recycled them and added more from abroad. The scale of the demand for bank finance meant that these “foreign” savings assumed an increasingly large share of capital inflows as the boom matured. This heightened the risks, however, because foreign bank finance is by its nature much more fluid than foreign direct investment, and tends to be denominated in foreign currency. Many borrowers were inadequately hedged.

In the final years of the boom, the pull of investment needs in the region began to be outstripped by the push of foreign capital seeking yields superior to those available in the West, without due regard to risk. While banking institutions were trying to get a larger market share, the flow of capital into the region had become an almost uncontrollable flood. With the onset of the subprime mortgage bust in the USA, and related banking crises, risk appetite globally went sharply into reverse. Capital flows to Eastern Europe all but dried up. Construction projects halted, jobs were lost, incomes declined, and domestic suppliers found it hard to shift their products. Fortunately, while capital inflows dried up, capital reversals (with consequent liquidity problems and potential bank runs) were largely avoided. Direct investment could not easily reverse, while the so called “Vienna Initiative” persuaded foreign banks to maintain their exposure to the region notwithstanding events. In other words, the crash was bad, but it could have been worse.

The resulting economic crunch left policy makers with little room for manoeuvre. They had grossly overestimated the strength of their fiscal positions during the boom, because fiscal revenues had been unduly flattered by unsustainable incomes and spending. With the recession, rising fiscal deficits left policy makers with insufficient fiscal space to offset the fall in activity. Indeed, many countries had to tighten fiscal policy. Worse still, because so many borrowers
were exposed to foreign currency risk, policy makers could not deploy the other main adjustment instrument available—the exchange rate—for fear of triggering widespread bankruptcies and making things worse.

These experiences pointed to a number of conclusions. First, the enhanced financial integration of Eastern Europe with the EU was, on the whole, a good thing. Without it, the economic recovery (and later boom) might never have even got started. Second, while financial integration can bring rewards, it also brings risks, especially on the scale of financial flows, and their composition. These risks should be managed by sound prudential controls, including the management of credit risk and of foreign currency risk. The management of prudential controls in a countercyclical manner should also be considered. However, there is no substitute for traditional countercyclical macroeconomic policy as the last resort for controlling overheating. For countries in quasi fixed exchange rate regimes, Euroized, or members of the Eurozone, this means fiscal policy. Third, while mobile capital may loosen the private sector savings-investment constraint, it does not necessarily banish the overall balance of payments constraint—even in a common currency area. Delegates were provided with an update of the EBRD’s latest Transition Report. The report underscored how exposed Southeast Europe was to the Eurozone, not least because 40 percent of its banking system was connected to parents in the Eurozone. The exposure to Eurozone banks had nevertheless brought some benefits in diversifying the sources of bank credit and providing for a more stable system overall than might otherwise have been the case. Exposure to Eurozone banks also raised the important question of the implications of Eurozone banking system union for the region. While stability for Eurozone banks should benefit the region, there was a risk that it could tilt the competitive advantage within the region away from local banks which would not have access to the European Stability Mechanism. Cross border banking also presented a new governance issue, as regional supervisors outside the Eurozone could have less influence on activities within the region than the big central supervisor in Frankfurt. Imaginative solutions to this dilemma were required.

From the perspective of commercial bankers, the current juncture was seen as uncomfortable. New regulations were being spawned, both from outside the region (from the Eurozone), and from within, often without clarity as to what will actually be implemented. The burden of reporting was growing. Raising capital in line with the new Basle requirements would be difficult and would affect subsidiaries in the region; investors were hard to attract, even though bank shares were cheap. Bankers themselves had become political pariahs. Deleveraging was continuing. Downsizing was being extended to bank structures, as well as balance sheets, adding to the sense of retreat. To restore confidence in banks it would be necessary, inter alia, to rebuild their profitability and viability, and this would not be easy to achieve in an

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Delegates heard that countries that had experienced relatively recent systemic banking crises, e.g., Canada, Sweden and Turkey had learnt the lessons and managed to avoid their repetition. Countries with flexible exchange rates, e.g., Poland and Albania, had avoided recession.
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environment of low growth and little borrowing.

Delegates heard that banks in the region had been unable to expand their business for several years as a result of the prolonged recession, and it was unclear whether they could all continue to operate unscathed in such a low growth environment. Non-performing loans continued to weight on banks’ balance sheets and limit the supply of new credit. There had not been any serious banking crises in the region at the onset of the global downturn, because local financial systems had been relatively well prepared and safeguarded, but the strength of local banks would likely deteriorate if the economic outlook did not improve. There was tension in the attempt to marry the diverse national banking regulations in the region with those of the Eurozone. The countries in South East Europe were urged to articulate a common approach to international banking groups and Eurozone regulators.

EU integration process, adjustment and Euro adoption: Experiences from the new member states

The second session reviewed the experience of new (and aspiring) member states of integration with the EU. From the perspective of the European Central Bank (ECB), delegates heard how the design for the Eurozone had suffered from four key flaws: (i) insufficient enforcement of fiscal policy rules, (ii) the lack of a competitiveness adjustment framework, (iii) the incompatibility between a single system-wide financial market and currency with multiple national supervisory regimes, and (iv) the lack of a crisis resolution mechanism. The Eurozone was learning from these mistakes and making progress in advancing a number of systemic reforms. To deal with fiscal imbalances, (a) existing rules already applicable to all 27 EU members were to be reinforced and sanctions strengthened, (b) additional rules were to be imposed on the 17 Eurozone members, and (c) for nearly all (i.e., 25) EU members, a new “fiscal compact” treaty would be adopted. Financial oversight inconsistencies would be ironed out through unification and harmonization of financial rule books, supervision, resolution, and deposit guarantees, and by coordination of zone-wide macroprudential tools. The absence of a crisis resolution mechanism, meanwhile, had been concretely addressed by the formation of the European Financial Stability Mechanism (EFSF) and the European Stability Mechanism (ESM). The one area where the strategy remained less than convincing concerned (arguably the core problem of) competitiveness imbalances—while there were initiatives underway, including the development of national reform programs coordinated at the EU level, and procedures for reporting and correcting macroeconomic imbalances, it was unclear how these reforms would actually be implemented or whether they would deliver the desired outcomes.

As the Eurozone evolves, key questions will arise. These will cover issues such as: (i) the extent of banking and financial union, (ii) the sharing of fiscal sovereignty and debt issuance, and the possibility of a zone-wide fiscal capacity and authority, (iii) closer coordination of economic policies, as well as binding reform incentives, and (iv) steps toward fuller political union, perhaps involving a new
treaty. Delegates heard that future entrants to the Eurozone will need to be prepared to rebalance their policy toolkit away from monetary and exchange rate independence, to operate in a world of zone-wide price stability, and to expect greater scrutiny over domestic fiscal policy and its subordination to zone-agreed fiscal rules.

Participants shared their experiences of the accession process and institutional preparations. It was observed that central banks normally have to devote considerable resources for negotiating terms and seeking harmonization on issues such as central bank independence, financial sector regulation, capital movements, etc. From the perspective of the new member states of the EU and those aspiring to be members, meanwhile, the growing list of EU and Eurozone initiatives looked daunting. It was recognized that the reforms were in the right direction, and that without them “the bear that had been playing in the neighbour’s yard [i.e., the Eurozone] will soon be playing in their yard”. However, concerns were expressed about the absorptive capacity of new and (especially) aspiring member states in implementing and meeting the expectations of these new reforms in the financial sector. Notwithstanding the challenges, aspiring member states at different stages in the pipeline of accession were nevertheless making progress in implementing reforms. Many of them were preparing the ground for Euro adoption by policies of exchange rate stability (Croatia), currency board arrangements (Bosnia), or pre-empted Euroization (Montenegro).

Governors’ panel: Fiscal challenges and Central Banks—Coordination with fiscal authorities

The common thread of the discussion on the coordination between fiscal and monetary policies in the region was the need to avoid undue fiscal dominance. Fiscal accounts throughout the region had been under severe pressure because of the recession. The recession itself had been exacerbated by the region’s close economic ties with the Eurozone, so that the downturn was compounded both by the stoppage of capital inflows and the decline in European imports. Rising fiscal deficits, resulting from overoptimistic fiscal planning prior to the crisis rather than from countercyclical measures, had led to elevated risk premia on both government debt and currencies, and driven up related interest rates. This in turn robbed central banks of much scope for supportive policies, and instead required hikes in policy rates to (inter alia) protect exchange rates, compromising growth and putting pressure on non-performing loans. In addition to the problems that fiscal indiscipline had posed for monetary policy, there was also a general perception that it had damaged the hard won standing of accession countries in the eyes of the EU.

In view of this experience, central bankers in the region looked forward to much greater fiscal discipline in the future. All participants raised concerns about the rapid accumulation of public debt in the region in recent years, which would impose very limited space for fiscal manoeuvre in the future. Some recommended the more widespread use of fiscal rules. It was recognized that the mechanical nature of fiscal rules can sometimes result in their being too rigid. Innovative (and inappropriate) fiscal accounting can also
undermine their force. The art was to get the balance right between following rules, and preserving sufficient flexibility to deal with changing economic circumstances. Either way, there was no single golden rule that could be applied to all countries. The need for fiscal discipline also reinforced the argument for strong banks, and thereby a reduced likelihood for expensive bailouts in recession with resulting increases in government debt (at the very time when fiscal space was needed). Other central bankers noted the potential for more active use of macroprudential policies. The experience of Turkey during 2010-12 was cited to illustrate the potential for macroprudential policies to moderate capital inflows (and their potentially destabilizing influence) as well as outflows, without deploying damaging or potentially counterproductive changes in policy rates. It was fortunate that Turkey also benefited from an improving fiscal position at the same time. Macroprudential policies are helpful, but cannot ensure stability on their own. The region’s closeness with the Eurozone meanwhile recommended greater regional coordination with the EU toward the mitigation of negative economic shocks.

Conclusions
The discussions touched on many subjects and drew many lessons to be learnt from the ongoing crisis. Most of these issues had been debated extensively before in other fora, but matters such as these must chewed upon many times in light of ongoing developments before their full implications can be understood. If there was one clear message that emerged from the seminar, it was this: the closer countries were to the Eurozone, the greater was their determination to press ahead with the process of their continuing integration with the EU, notwithstanding the much less promising economic “neighbourhood” that now prevailed compared to when these aspirations were first conceived. The range of obstacles had increased, the burden of meeting them was heavier, and the journey overall had become longer and more turbulent. But the goal of convergence of Southeast Europe with the advanced economies of Europe remained an overarching political and economic objective.
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Speakers

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Vjekoslav Bevanda  Chairman of the Council of Ministers of Bosnia and Herzegovina
Daniela Bobeva  Director of International Relations, Bulgarian National Bank
Dimitar Bogov  Governor of the National Bank of Macedonia
Nikola Fabris  Chief Economist of the Central Bank of Montenegro
Ardian Fullani  Governor of the Bank of Albania
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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.

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- 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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