South East European Studies
at Oxford

workshop report

South-East Europe: Investing in the future

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South East Europe: Investing in the future

St. Antony's College, 2nd December, 2011

This report draws on discussions at the workshop on "South East Europe: Investing in the future", which was held in Oxford on 2nd December, 2011. The participants were academics, officials, and market participants from the United Kingdom and from 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.

Overview

The workshop took place against the backdrop of serious financial stress in the euro area. There was marked concern about negative spillover effects from this crisis to South East European banking systems, and to the real economy of the region. Participants also mentioned some risks of a 'mega shock' from the euro area. It was noted that South East Europe was the region, outside the euro area itself, that appeared most vulnerable to these risks at the present time. Unlike the situation in 2008-9, there was relatively little latitude for a macroeconomic policy response to buffer the impact of these stresses.

Participants emphasized the need to find viable ways of making the region more attractive to investment from the core area of Europe, which was faring best in the current crisis. This would require a more diagnostic approach to identify, target, and address key obstacles to progress – which very often might lie in a few crucial areas such as human skills and attitudes of mind. While governments should not 'pick winners', some participants suggested the need for a broad industrial strategy – analysing what skills and network facilities (for example) were needed, and in which sectors the need for reforms was most pressing, to attract inflows of investment, given the potential of the region. Such approaches must be driven from within the region, including through cross-border co-operation: the EU was in a weaker position than formerly to catalyse and anchor reforms.

During the sessions of the workshop, participants focused in turn on three broad questions. The first concerned the political-economic context of the workshop, with an emphasis on the renewed vulnerability of the region. The second issue was how to diagnose correctly the nature of the challenge in enhancing investment levels. The third topic of discussion was the policy implications of this analysis at the national and regional level.

The political-economic context

Despite the sharp external adjustment achieved across the region in the wake of the 2008-9 shock from global markets, the ongoing impact of the euro area crisis had opened up new and in some ways more serious vulnerabilities in South East Europe.

The main spill-over channels of the euro area crisis have been trade and finance. In both respects, SEE countries are highly dependent on euro area members, and they are all directly or indirectly linked to the euro. Moreover, the current crisis is not only about sovereign debt: it is also a political crisis of the euro area and the wider EU. This too has inevitable implications for the region.

The adjustment of the region to the 2008-2009 global financial and economic crisis was evident in sharply reduced external imbalances. Croatia saw its current account deficit shrink from 15% of GDP in 2008 to only 1% in 2010. Bulgaria's experience was even more striking, with the virtual elimination of the current account deficit, which had been 22% of GDP in 2008. Serbia and Bosnia and Herzegovina have also seen major reductions in this regard. Foreign exchange overvaluation was also addressed, to differing degrees. Despite this external adjustment, the response of countries in the region to the first phase of the crisis still left financial vulnerabilities to be addressed over the medium term. One vulnerability lies in levels of external debt, which rose markedly in the private sector during the run-up to the crisis. In Bulgaria, Croatia and Montenegro external debt is on the order of 100% of GDP. In Romania and Serbia, the level of external debt is greater than 70% of GDP. The aftermath of the crisis also left vulnerabilities in the banking system. One of the most serious threats in the current crisis is that profitability of banks has gone down, non-performing loans have gone up, and the credit and funding environment has deteriorated. According to the data of the central banks in the region, non-performing loans have risen significantly since the onset of the global crisis. This situation in the region – even without the added dimension of the euro area crisis – was causing some foreign banks to ask whether it was sensible to stay in the region, or at least whether to rationalise their networks there.

At a deeper level, a key vulnerability – or, more positively, a key challenge – for South East Europe after the first phase of the crisis lay in the need for a 'make-over' in the pattern of growth in the region. Real GDP contraction in SEE was at almost 6% in 2009. Then, even in 2010, growth was mildly negative in real terms. From a growth theory perspective, SEE economic expansion in the first decade of the century was seen to have been driven mainly by the accumulation of physical capital rather than human capital. These investments were mainly based on foreign savings as domestic savings were low. Saving rates were far below investment rates by 2009, and this was reflected in high current account deficits of SEE countries. Productivity has also been low, and the growth that we have seen so far has not been based on increased efficiency. Thus, in the wake of the global shocks, policy-makers became concerned whether the incentives and institutions were in place to foster a strong return to growth in a setting of much less ample banking inflows.

The need for such a deep adjustment over the medium term also highlights an underlying concern of a political-economic nature: the region's 'new and inexperienced institutions'. The public sector in the region is inefficient and it incurs relatively high costs to the societies in SEE countries. Evidence for the weakness of institutions in the region can be found in international reports such as: Economic freedom, Business Survey, Doing Business, the EBRD Transition Indicators, and the Global Competitiveness Report. Almost all SEE countries are ranked low relative to western European countries, for example. Regarding political and civil freedoms, the Gastil index for political and civil freedom is an indication of the region lagging well behind Europe. At one level this underscores the difficulty of pressing through difficult reforms. At another level it recalls the inevitable risk that severe economic stress could trigger political and social unrest.

This then was state of the region – its political-economic balance sheet, so to speak – when the euro area crisis started to gather force. Participants in the workshop considered that the risks and challenges posed the euro area crisis seem if anything greater than the earlier round of shocks. Key indicators of vulnerability are exports to the euro area, the flow of FDI from the euro area, and the role of euro area bank subsidiaries. The Economist Intelligence Unit vulnerability index shows that all countries in the region are exposed.

Foreign trade is an important link for all countries in the region (in this case including Turkey). All countries in the region are highly dependent on the euro area markets, and notably on Germany, Italy, Austria and Greece. Trade among the Western Balkan countries, and with central Europe, is lower than most models would predict. Albania has had the lowest share of trade with CEFTA (4.7%), as opposed to Serbia, Croatia, Bosnia and Herzegovina, Macedonia and Montenegro, which have had an average market share in trade with the CEFTA region of approximately 33%. Croatia and Serbia have both a large trade surpluses in intra-regional trade, which is primarily due to their large trade surpluses with Bosnia and Herzegovina.

Financial linkages with the euro area have become increasingly prominent, in terms of vulnerability, and were a key focus of discussion. An important dimension of the challenge lay in the issue of common lenders. Albania, Croatia and Serbia are highly vulnerable to the euro area problems, and they – along with a number of other countries – are dependent on a fairly small number of banking groups that are headquartered in a very few euro area economies. In Albania, half of the industry is owned by one Austrian and three Greek banks. The two largest banks in Croatia, with a combined market share of 42%, are owned by Italian banks. The combined market share of Italian banks in Serbia is 21%, and of Greek banks it is 15%. In Bosnia and Herzegovina, Austrian and Italian banks account for 59 percent of the market.

With the deepening of the euro area crisis, parent banks from Western Europe, for example, were considered less likely to give full support to their subsidiaries. The ability of parent banks to extend new credit lines to SEE establishments is constrained by the decision of the European Banking Administration to increase of European banks' capital ratio from 6% to 9% by the end of June 2012; by new prudential liquidity requirements; and by the acute funding stress experienced by banks in related parts of the euro area. Domestic banks will have to rely on local funds much more. External funds are going to be scarce and depositors have been withdrawing their money from banks in some countries. In short, foreign banks have so far been regarded as a good strategic investors in the banking systems of SEE countries. But concerns have arisen whether their presence has now started to work against ability of SEE countries to buffer cyclical risks.

Prospects for investment – is the region ready?

The dominant theme in this section of the workshop concerned the differing patterns of integration that link emerging Europe with the mainstream EU economy – and especially with the core bloc of countries in the EU that have fared relatively well during the ongoing crisis. In terms of industrial structure, the former transition economies of Central Europe are notably integrated with the economies of Austria and Germany. There is involvement of some sectors that are producer-driven, and some which are buyer-driven. There are weaker examples too, in Central Europe (such as Hungary). But overall the pattern of integration has tended to promote the growth of the traded goods sector to a fair extent. In South East Europe this is less the case. The robustness of differing patterns of growth in the 'periphery', it was suggested, seem linked to the way in which countries have integrated; and this in turn may reflect the quality of national policies.

Participants thus saw what might be termed an industrial policy challenge in the region. For most participants this did not mean 'picking winners', or a call for 'state capitalism'. The question was rather how the state could do better at diagnosing the key prerequisites to facilitate the right kind of outward integration, and notably an expansion of sectors that can provide a basis for sustainable growth. Thus the issue was not one of grandiose industrial plans, but of production capabilities and competitive pressures. Policy-makers do not necessarily understand yet the drivers of potential productivity increases. One view was that production capability actually drives growth today (and production capability can be proxied by ISO-9000 standards in empirical studies). This was seen as a key driver of productivity improvements. Each sector has possible paths of productivity improvement at the micro level. In this and other ways, the crisis is provoking (and must provoke) different ways of thinking and a deeper, more sector-based, analysis of the reforms needed to boost investment and productivity.

A closely related point of emphasis was the disappointing export performance of the SEE economies – well below what would be expected on the basis of their size and also in terms of their geographical links. This was traced to a number of factors, but with the question of skill deficiencies, and of institutional weaknesses, being crucial. According to World Bank research, the most problematic factors for doing business in all the Western Balkan countries lie in dealing with construction permits, registering properties, enforcing contracts and paying taxes. The position of the Western Balkan countries in the Doing Business survey published annually by the World Bank shows that the most successful countries in improving their positions and implementing reforms have been Albania and the Former Yugoslav Republic of Macedonia. By contrast, Serbia and Bosnia and Herzegovina have been the worst in the implementation of reforms - Serbia has been downgraded by six ranks, and Bosnia and Herzegovina by twenty.

It was noted that the relevance of financing constraints has changed since the onset of the global crisis. The Global Competitiveness Report (GCR), published by the World Economic Forum (and based on an Executive Business Survey), provides a distinct picture of the causes that limit investment activity in the region. Unlike Doing Business, the GCR signals that access to financing has recently become a major problematic factor for firms. Access to financing became the biggest problem in doing businesses in Albania, Bosnia and Herzegovina, FYR Macedonia and Montenegro. This is a major change since 2008, and is a direct consequence of the spillover effects of the financial crisis. Although loans to firms and households have increased slightly over the first nine months in Bosnia and Herzegovina, Croatia and Serbia, this growth is very modest and slower than the growth of non-performing loans. The problem of growing non-performing loans in the Western Balkans, combined with a large dependence of the region on Austrian and Italian banks, as well as the euro area crisis, seem set to make access to financing even more problematic for enterprises in the region in the period ahead.

The investment challenge and its policy implications

There was a high degree of agreement in the workshop on the nature of the policy challenges for South East Europe. In order to change the pattern of growth, which has so far been based on domestic-demand led expansion, countries in the region have to achieve more export-oriented growth – and to attract FDI that will help accelerate this trend. What investors worry about most when they enter a market, it was acknowledged, is institutions not working. They will be deterred by macro policies that allow sharp boom-bust cycles and draw resources into non-tradable sectors, as well as by deficiencies in areas that are crucial for the tradable sector such as competition policy, privatisation, customs regulations, and basic infrastructure.

The need to strengthen institutions was thus seen as a key issue in creating a more conducive setting for investment in the region. A wise set of investment policies must include institutions that assure a stable macroeconomic environment (low inflation and fiscal responsibility); a fair treatment of foreign and domestic investment; a friendly business environment; and an ongoing impact evaluation of existing policies. It was also noted that investment in any individual country should ideally be well-balanced. While a very high proportion of foreign investment can leave a country vulnerable to external shocks, over-dependency on domestic investment would deprive it external savings, access to foreign networks, and the import of know-how. Moreover, infrastructure investments by themselves are not enough, and they need to be put in context. Recently published research presented at the workshop concerning the development impact of transport infrastructure in Turkey suggests that capital expenditure on infrastructure should be "human resource cantered" rather than solely infrastructure or capital-oriented. This would be made possible by enabling labour spill-over effects of transport infrastructure.

It was considered that the problems posed by 'common lender' risks from the euro are very difficult to address. As some governments in Western Europe are trying to protect their sovereign ratings, some state-owned banks from these countries have already announced they would no longer approve new credit lines to their subsidiaries in the region (such as Raiffeisen Bank). That is why banks in the region could soon be left without additional resources. Although most banks in the region have been cautious over the past two years and have been in surplus in the reserve accounts with central banks, these high reserves have been an integral part of foreign reserves held by the central banks as deposits in the eurozone central banks or as government bonds of the euro area countries.

This posed a threat to all the SEE economies, and communication between the countries remained very important. The banking systems need contingency plans embracing a home and host policy. The idea of another Vienna Initiative to forestall a withdrawal from the region (which had not yet been launched at the time of the workshop) would be more difficult to make effective, given the weaker capacity of parent banks to accomplish this. Nonetheless it was important to strive for a jointly coordinated action of countries in the region in cooperation with the EU, EBRD, EIB and the World Bank.

Taking into account the serious problems of high (and increasing) external debts of SEE countries, and related problems with bank liquidity and solvency, there will be a strong pressure on central banks to step in. Central banks had played a major role in the period since 2008, including through cross-border co-operation; but there was a need to appreciate the limits to what they could do unaided. They needed to explain the importance of structural reforms and of sound public finances.

For countries that were not facing acute budgetary stress, this raised the question to what extent fiscal policy could play a role in countering recessionary pressures and supporting infrastructure. It was noted that financial markets were much more sensitive to public debt risk than at the outset of the global crisis, so the room for manoeuvre here was strictly limited. Could there be scope in some cases to engineer a short-term relaxation in budgetary consolidation to make room for the costs of structural reform? A complementary and safer option would be to cut back on current transfers and thus increase the fiscal space for other actions. To the extent there was any room for manoeuvre, this should certainly be aimed at favouring capital expenditures based on human capital development and job creation, in order to increase the tax base while maintaining policy discipline.

A possible proposal for a counter-cyclical measure was made at the workshop, based on issuance of a new financial instrument. Government securities of countries in the region would be issued with an exclusive purpose of financing the development of cross-border projects in the field of road and energy infrastructure. These securities could be called Euro-Balkan Bonds. They would be denominated in national currencies, issued by the national governments and guaranteed by the Euro-Balkan-Guarantee Fund. This proposal would not apply to the issuance of bonds which would be used for current budgetary expenditures, but for financing of capital projects, creating jobs, and in so doing broadening the tax base. The question was explored whether guarantors could be found to enhance such Euro-Balkan bonds (the EU, in cooperation with the EIB, EBRD, IBRD), and also whether such bonds could have an equity component linked to the sale of government shares in large state-owned enterprises – for example in telecoms.

Working with the EU in the Accession process has been a crucial support to countries as they have sought to build institutional capacity. However, the EU anchor is waning: the EU is not only weaker, but its authority is significantly diminished. So the central option for the region is to support itself, and to carry out reforms without relying on external anchors. In today's setting, there is both a greater interdependency between countries in the region, and a greater need for cooperation in attracting funds from abroad. Some participants spoke of 'a pooled competition' for FDI. This reflected the fact that South East Europe comprises a group of fairly small economies: it is an area in which economies of scale truly require the creation of a regional market, with overlapping layers that reflect the earlier bonds of former Yugoslavia as well as outward linkages to Central Europe, Greece and Turkey. Moreover, there is still an image problem vis-à-vis the rest of the world, and a more cooperative approach should bring long-term benefits. Efficient regional cooperation is thus a key dimension of any policy solutions, and it is essential to find effective ways of bringing together all parties that can play a role in facilitating investment in the region.

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ABOUT SEESOX

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South East European Studies at Oxford

CELEBRATING 10 YEARS 2002—2012

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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.