South East European Studies
at Oxford

workshop report

South East Europe in an environment of volatile capital flows

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seesox
South East European Studies at Oxford

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This report draws on discussions at the seminar on "South East Europe in an Environment of Volatile Capital flows", held in Sarajevo, Bosnia and Herzegovina, on 6th June, 2014. The participants included academics, officials and financiers, from the University of Oxford, the International Monetary Fund, Bosnia and Herzegovina (host), other countries in South East Europe, and Italy. The report represents SEESOX's interpretation of discussions at the seminar and does not purport to reflect the views of any of the participants (except where specified).

Preamble

The seminar was convened by the Central Bank of Bosnia and Herzegovina (CBBH) in collaboration with SEESOX. With the economies of South East Europe (SEE) growing again in 2014, after the double whammy of the US subprime crisis in 2008-9 and the onset of the Eurozone crisis in 2009-10, the seminar was tasked with examining how the region could sustain this hesitant recovery in an environment of volatile capital flows. Already swimming against a tide of deleveraging by European banks with interests in SEE, and stalled by near-zero growth in the neighbouring Eurozone, the region's recovery was also faced with the possibility of renewed stresses in global financial markets emerging from the opposing currents of the Federal Reserve's QE tapering and the prospect of rising interest rates in the USA and UK, and new unconventional monetary policy (UMP) initiatives (and negative interest rates) by the ECB plus massive QE in Japan. What were the options available to policy makers in SEE to help them chart a safe course through these turbulent waters?

The seminar was opened by H.E. Bakir Izetbegović (Chairman of the Presidency of Bosnia and Herzegovina), followed by welcoming remarks by Kemal Kozarić (Governor of the CBBH) and Othon Anastasakis (Director of the European Studies Centre, Oxford University).

Volatile capital flows in SEE: their evolution, and the policy tools available to ride them

The first session of the seminar focussed on the prospects for capital flows and on policies that could help the region manage sustainable growth in this environment. Delegates heard that the cumulative deleveraging by foreign banks from the region since 2008 represented the equivalent of about 10 percent of the region's GDP. There were, however, some signs that this deleveraging was slowing down, and a few countries, e.g., Macedonia and Montenegro, seemed to have avoided significant capital reversals. Given this withdrawal of foreign financing, it was not surprising that bank credit to the private sector in SEE remained subdued, with banks were forced to rely on the less elastic supply of domestic deposits for loanable resources. Efforts to strengthen the operation of the Eurozone and of banking resilience in general were, at least in the first instance, likely to spur deleveraging further. Portfolio flows, meanwhile, had reacted visibly and negatively first to the talk about, and then the fact of, tapering. Negative interest rates at the ECB might counter this influence, but by driving a wedge between the dollar and the euro, could infuse renewed tensions in financial markets that would increase uncertainty and lower risk appetite.

European Banking Union is an important step forward in the effort to prevent future financial crises, though elements remain to be fully worked out. Above all, it should help raise the standard of banking supervision both within the Eurozone and in neighbouring countries (especially those in the accession process). Nevertheless, this architecture can only go so far in avoiding financial system volatility. With many countries in SEE either pegged to the euro, using the euro, or so euroized that significant exchange rate changes are not possible without severe balance sheet effects, what are the options open to policy makers to insulate their economies from global financial turbulence? Could macro-prudential tools offer a way out of the Trilemma?[1] Macro-prudential tools have generally been proposed as financial stability devices targeted at the control of sector specific bubbles, such as asset price booms, excessive credit growth, or even surges in capital flows, enabling traditional macroeconomic levers (e.g., interest rates, or the fiscal stance) to be prioritized on securing broader macroeconomic stability objectives (such as inflation and growth). But if some of these traditional macroeconomic policy levers (e.g., an independent monetary policy) are not available for macroeconomic management, then some macro-prudential tools may be selectively deployed to serve this purpose instead. Macro-prudential tools are not, however, without their limitations in a global world. Foreign bank branches in the region are not

[1] The "Trilemma", or "Impossible, Unholy, Trinity", is the putative impossibility of having all of the following at the same time: (a) fixed exchange rate, (b) free movement of capital, and (c) independent monetary policy.

generally governed by the rules of the host country but by those of the parent. Even if host country rules did apply, clients in the host country wishing to avoid regulatory control could simply be referred to the parent. Jurisdictional reciprocity has been proposed as a means for enforcing compliance consistency, but such arrangements (to date at any rate) only apply to capital rules, and could not (for example) as yet be used to enforce host loan/deposit ratios on foreign owned bank branches. Thus, capital flow measures may be required to help manage such volatile capital flows and buttress the effectiveness of macroprudential measures.

Delegates were briefed on the experience with macro-prudential measures in a number of countries in SEE. Reflecting the dual-purpose scope of these tools noted above, many such measures were in fact implemented in a macroeconomic, rather than financial, stabilization role.[2] However, it seems that they may have served as substitutes rather than complements to conventional macroeconomic policies, and allowed monetary and fiscal policies to be looser than they should have been in the run up to the crisis. There is also evidence of circumvention and leakage from macro-prudential measures. On balance, evidence of the effectiveness of such measures is mixed, though mixed effectiveness is better than no effectiveness in a world where policy tools always seem to be outnumbered by targets.

Volatile capital flows in SEE: the implications for the real economy of SEE and for intra-regional trade and finance

In the second session speakers explored a number of issues related to capital flows to SEE. The evolution of the overarching global environment was chronicled, underlining the thesis of Hyman Minsky, that as economies grow so their financial systems become more unstable. At the same time, financial systems and markets were seen as becoming more interconnected and correlated, reinforcing the "trilemma" facing policy makers in small open economies. Delegates were treated to a discussion of ways to monitor and measure systemic risk in this financially interconnected world. The soundness of individual financial institutions was a necessary but not sufficient condition for financial stability. What mattered was the covariance between the system and individual institutions, pointing to a new measure ("SRISK") of risk calibrating the "expected capital shortfall" of a financial institution when tested against an

[2] Macro-prudential measures fall into a number of categories, apply across different structures and economic cross sections, can be time varying, and can include, inter alia, price or quantity controls (e.g., on credit or capital flows), limits or ceilings on ratios (e.g., capital or liquidity ratios), varying risk weights, and a variety of other prudential measures amenable to discretionary adjustment.

average of different crisis scenarios. Arguably the least risky form of capital flow, at least for the recipient, is foreign direct investment (FDI); this equity flow can reduce leveraging in contrast to other—debt-creating—capital inflows. Moreover, DFI unlike portfolio equity, is not as liquid and therefore is less likely to flow out in a crisis. A large share of SEE capital inflows in the run up to the crisis was FDI, and this no doubt softened the scale of the crisis when the sudden stop occurred at the end of 2008. The share of FDI was especially high in Montenegro. However, this feature did not fully insulate that country from recession when inflows stopped because investment activity was so dependent, directly or indirectly, on FDI financing. Foreign direct investment (and thereby foreign influence and control), moreover, is not a substitute for sound domestic corporate governance as the basis for sustainable growth in SEE, and under the general rubric of good governance the region has been found wanting. Policy formulation in a democratic market driven sense is still nascent, and appears to lack effective and well developed policy networks. Policy making is overly dependent on informal, unstructured and opportunistic policy coalitions made up of small groups of policy elites, and tends to be reactive (rather than proactive) to internal and external stimuli.[3] Here the EU enlargement process was seen as having an important role to play in, for example, strengthening the professionalism of the public sector and in the quality of regulatory governance.

Volatile capital flows in SEE: the central bankers' perspective

The central bankers' panel discussed different country experiences and lessons from the recent evolution of capital flows to SEE. The panel acknowledged the important role that FDI played in the run up to the crisis in the region, financing large current account deficits but helping protect against the sudden stop becoming a wholesale capital reversal. It was noteworthy, however, that Slovenia was unique in having almost no inward FDI, possibly in part reflecting its status as EU member and also member of the euro.[4] Its dependence on portfolio and banking flows made it the most severely affected by the deleveraging of foreign credit when this began after the crisis hit. A rise in official borrowing, both in Eurobond markets and also from foreign and international

[3] It was noted that countries in SEE still fell short in a number of key governance indicators, especially in the rule of law, but also in specifics like the ease of securing construction permits, enforcing contracts, and registering property. All these things were very relevant for the region's efforts to attract foreign capital, and especially FDI.

[4] Peripheral members of the Eurozone generally shared a common and puzzling feature of zero or even negative net FDI, including those that got into serious trouble, like Ireland. Possibly this is because the zero currency risk within the Eurozone made debt creating finance appear to be a less risky substitute.

official creditors had served to offset in part the deleveraging of bank credit but had also led to a worrying rise in official external debt. The focus on the sudden stop in capital flows should not be allowed to obscure the fact that the region was also hit hard by a sharp decline in exports to the EU, and also by a decline in remittances from workers employed in the EU. The possibility of expanding the policy toolkit through greater use of macro-prudential measures was welcomed, but it was noted that the effects on the real economy of widespread use of such measures was not yet fully understood. There was also some concern that over-regulation (both structurally and through the cyclical use of macro-prudential measures) might impair the long run performance of financial intermediaries.

Summing up

The following points seemed to emerge from the seminar:

- Global financial conditions are still evolving, and considerable uncertainty remains, particularly at the juncture where different parts of the world are moving out of policy synchronization (e.g. prospective interest rate increases in US/UK versus new UMP in the Eurozone and Japan).
- Capital flows will remain volatile and pose a problem for policy makers in SEE. Deleveraging of banks especially those based in euro area, is continuing, partly in consequence of weak risk appetite, but also as a result of a tightening regulatory environment (e.g., Basle III, EU banking union).
- Countries in SEE (many of which lack effective monetary policies because of exchange rate arrangements or high euroization) could make greater use of macro-prudential measures which can be directed at both macroeconomic and financial stability objectives.
- It remains important to monitor systemic risk in financial institutions. European Banking Union should help lessen and better manage such risk within the Eurozone; this will have positive spillovers for neighbouring countries in SEE, particularly in the long run but these reforms could have short-term adverse implications—e.g., continued deleveraging.
- There is a need to strengthen governance and the policy making architecture in SEE, to build capacity in government, academia, the private sector and civil society, so that technically sound analysis can be undertaken and better policies be implemented.

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Panellists

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Ruben Atoyan	International Monetary Fund
Ernadina Bajrovic	Vice Governor, Central Bank of Bosnia and Herzegovina
Adam Bennett	St Antony’s College, Oxford
Vesna Bojicic-Dzelilovic	London School of Economics
Fikret Causevic	Central Bank of Bosnia and Herzegovina
Ales Delakorda	Central Bank of Slovenia
Nikola Fabris	Vice Governor, Central Bank of Montenegro
Michael Faulend	Vice Governor, National Bank of Croatia
Giampiero Gallo	University of Florence
Amir Hadziomeragic	Central Bank of Bosnia and Herzegovina
Bakir Izetbekovic	Chairman, Presidency of Bosnia and Herzegovina
Radovan Jelasic	ERSTE Bank, Hungary
Maja Kadievska-Volnovikj	Vice Governor, National Bank of Macedonia
Russell Kincaid	St Antony’s College, Oxford
Kemal Kozaric	Governor, Central Bank of Bosnia and Herzegovina
Sead Kreso	School of Economics and Business, University of Sarajevo
Slavica Penev	Institute of Economic Sciences of Serbia
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ABOUT SEESOX

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South East European Studies at Oxford (SEESOX) is part of the European Studies Centre at 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.