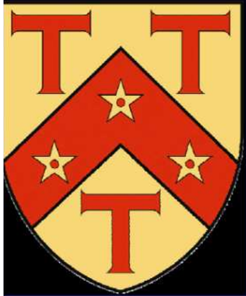

London School of Economics
European Institute
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South East Europe in the Wake of the Euro Crisis

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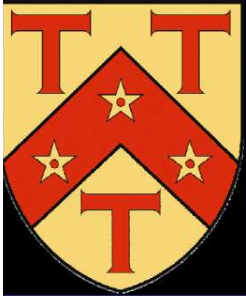


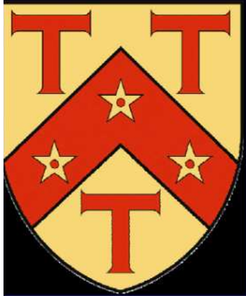
The pre-crisis vision

EU Paradigm: reconciliation + convergence
Politics and economics deeply interlinked

- Political normalisation was a precondition of the economic recovery

- Incentives from economic integration promised income – and to undercut rent-seeking elites

Bank-centred financial flows ‘delivered the goods’

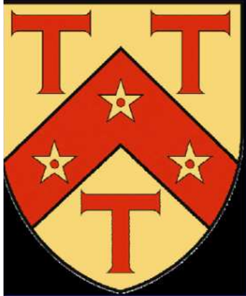


Paradigm loss?

Paradigm not lost appeal, but lost conviction

- Introspection in EU has replaced expansionism
- EU/euro anchors have lost traction
- Bank inflows stalled and in reverse
- Vulnerable groups worst affected, least helped
- Family/informality/remittances under pressure
- Region lacks linkages to German export machine

Was the EU convergence model viable in SEE?
What is the meaning of 'Greece' for the region?

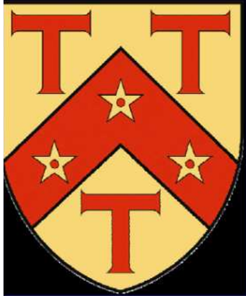


Integration & Imbalances

What went wrong with financial integration?
Meant to boost convergence & risk-sharing

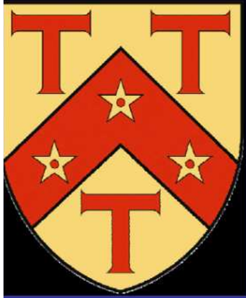
Analysis at the time featured spreads, assets, bank groups, not current account imbalances:

- Composition: equity or debt?
- Sector: traded or nontraded goods?
- Obligors: firms or banks & govt's?



Scale of Imbalances

	Net capital inflows (% GDP p.a. 2004-7)
€ Periphery	8 %
Baltic States	17 %
Central Europe & TKY	9 %
E & W Balkans	14 %



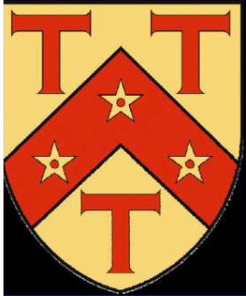
Capital Flows: € Periphery

EURbn

Other | Other investment | Portfolio | FDI | Total

350
300
250
200
150
100
50
0
-50
-100
-150

1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011



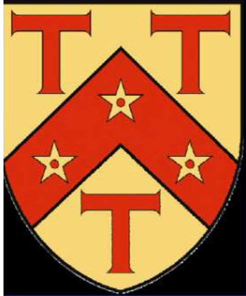
Capital Flows: Baltics

% of GDP

Capital A/C
FDI
Portfolio
Derivatives
Other invest
E&O

30.0
25.0
20.0
15.0
10.0
5.0
0.0
-5.0
-10.0

2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011



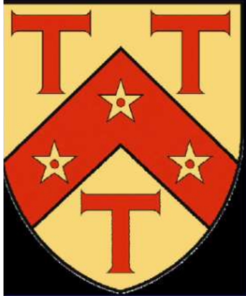
Capital Flows: CZ, PL, SK

% of GDP

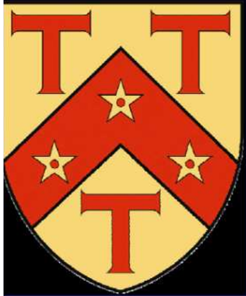
12.0
10.0
8.0
6.0
4.0
2.0
0.0
-2.0
-4.0

Capital A/C
FDI
Portfolio
Derivatives
Other invest
E&O

2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011



Capital Flows: Balkans



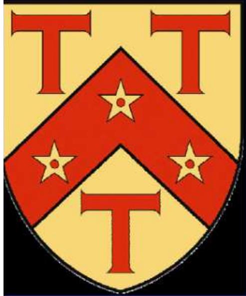
Integration,Imbalances 2

So financial integration took different forms in the various European sub-regions:

- € periphery: no net FDI (sizable FDI outflow)
- Baltics: huge; mainly banks, not FDI
- CZ, PL, SK, TK: half = FDI as ‘core’ integrates
- Balkans: huge; half = FDI, but banks, property

...So outside core Europe, net flows not mainly FDI to traded goods sector, and often huge

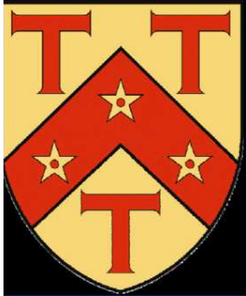
Implications for fragility and debt servicing



Macrofinancial Drivers

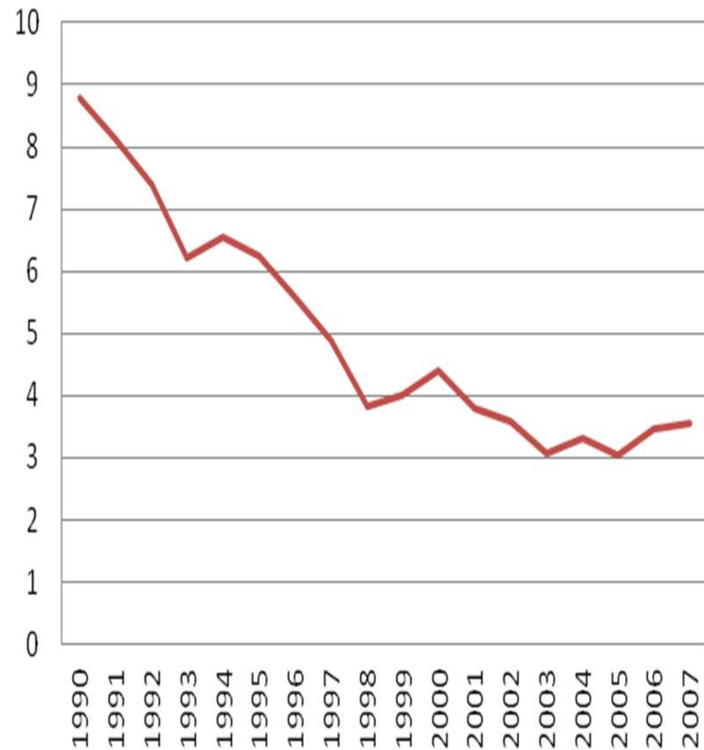
Six mutually-reinforcing framework factors:

- **Global financial ‘push’ factors**

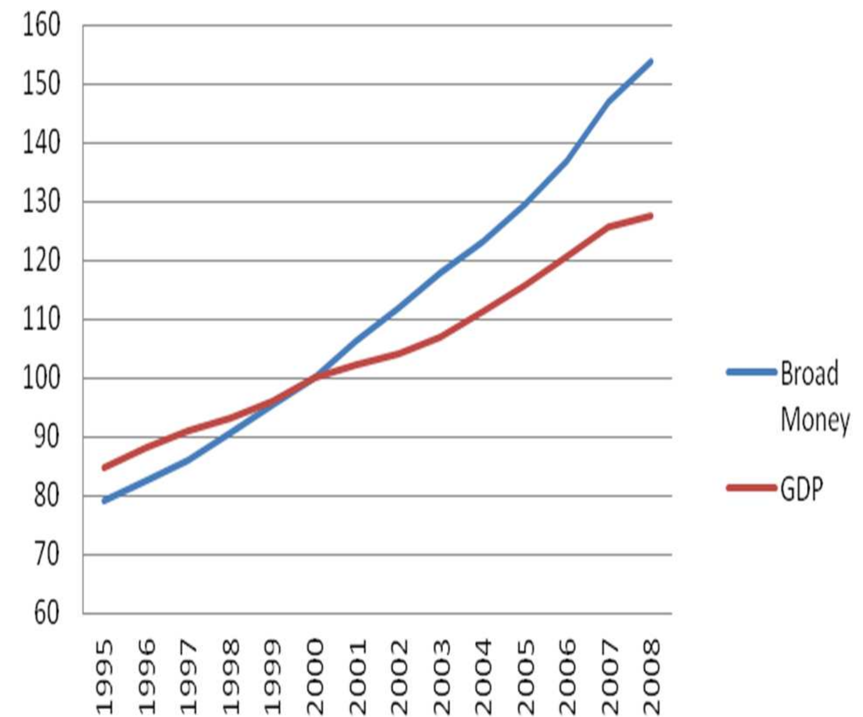


Global Conditions

Long-term interest rates in percent*



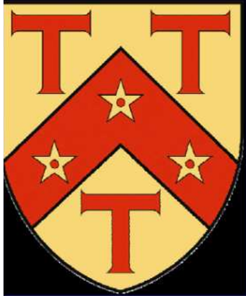
Broad money and GDP*



Source: OECD

**Long-term government bond yields (10 years).*

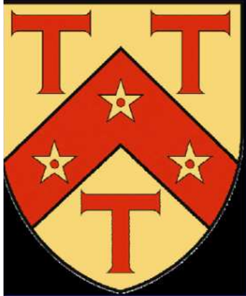
**Nominal GDP converted at constant PPP and broad*



Macrofinancial Drivers

Six mutually-reinforcing framework factors:

- Global financial ‘push’ factors
- Global trade shocks
- Real convergence play
- Currency convergence
- € area monetary conditions



Euro Area Conditions

Real short-term interest rates*

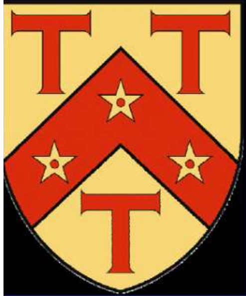
%

6.00
5.00
4.00
3.00
2.00
1.00
0.00
-1.00
-2.00

1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008

Germany
Ireland
Spain

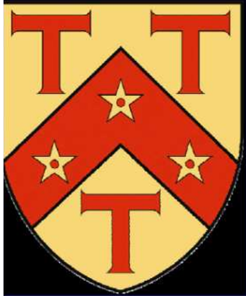
Source: OECD



Macrofinancial Drivers

Six mutually-reinforcing framework factors:

- Global financial ‘push’ factors
- Global trade shocks
- Real convergence play
- Currency convergence
- € area monetary conditions
- **National monetary, fiscal, prudential and structural policies**

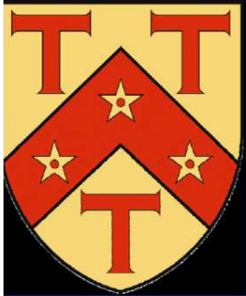


This set a high bar...

It seems currency and interest rate plays were strong drivers, as well as real convergence. Faced with this, countries that did worst:

- had a rapid growth of public spending
- failed to overlay home supervision with tough domestic macro & micro prudential actions
- mostly had little monetary policy autonomy
- experienced a high degree of euroisation
- had less advanced structural reforms

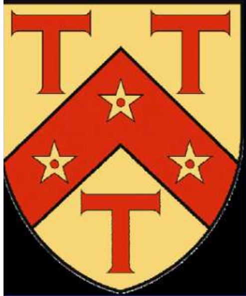
Note that Poland & Turkey score well on all



Narrow implications

Pre-crisis economic model is over
SEE more indebted, euro area overleveraged
Main trade partners also weakened...

- **Must (i) avoid repeat, and (ii) attract global FDI**
- **Better budgets for growth & ‘fiscal space’**
- **Exploit limited monetary autonomy, if exists**
- **Macropru co-ordination with home countries**
- **Targeted structural reforms, regional dimension**



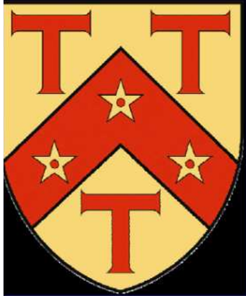
Structural reforms

At the national level:

- **Business environment – esp. tax admin. & other corruption; implementing, not just passing laws**
- **Skills gap for innovation/knowledge economy**
- **Market supporting institutions in water, energy, non-bank financial services**

Stronger regional networks and linkages

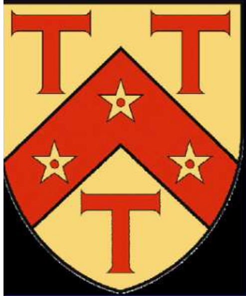
Stronger domestic anchors (eg, fiscal rules)



Crisis or impasse?

All outcomes of euro crisis pose challenge
...more integrated 'citadel' – forbidding?
...failed model hits sources of growth ?
Hard to see alternative regional architecture
So more economic self-reliance essential

Economically, a crisis of identity at regional level
If grasped, silver lining? If not, back to Balkan past
Is this the true meaning of 'Greece?'



Political risks

But this poses major political challenges/risks:

- **Gamble on ‘integration’ a second time**
- **Address key channels of rent-seeking**
- **More emphasis on bottom-up processes**
- **Avoid negatives of ‘arms length’ EU Model: reject new nationalist agenda, identity politics, poor civil rights, stability but weak reforms**

Given ethnic / border issues, this agenda still requires a credible Accession prospect