DO CRISES CHANGE ECONOMIC FUNDAMENTALS IN SEE?

Proceedings of the annual International Conference organized by the Bank of Albania in cooperation with the South East European Studies at Oxford

Tirana, 30 October 2015
## OPENING ADDRESS

**Gent Sejko, Governor, Bank of Albania**

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## OPENING ADDRESS

**Edi Rama, Prime Minister of Albania**

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## OPENING ADDRESS

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## SESSION I:

**HAS THE ECONOMY CHANGED IN THE POST-CRISIS PERIOD?**

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## POST-CRISIS ADJUSTMENT AND CHALLENGES IN SOUTHEAST EUROPE

**Anita Tuladhar, Mission Chief for Albania, IMF**

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## FROM CRISIS TO CRISIS: THE UNCERTAIN STATE OF THE EUROPEAN UNION

**Othon Anastasakis, Director of South East European Studies at Oxford (SEESOX), St Antony’s College**
REMAKING THE BALKAN ECONOMY
Adam Bennett, Deputy Director of PEFM & Associate of SEESOX, St Antony’s College

THE NEW NORMAL AND THE CHALLENGES FOR BANK OF ALBANIA MONETARY POLICY
Altin Tanku, Director of Research Department, Bank of Albania

SESSION II:
HAS THE FINANCIAL INTERMEDIATION MODEL CHANGED? HOW SHOULD FINANCIAL STABILITY AND SUPERVISION POLICIES RESPOND?
Charles Enoch, Deputy Director, Western Hemisphere Department, IMF, and SEESOX

ANCHORING CAPITAL FLOWS AMIDST GLOBAL UNCERTAINTY
Gillian Edgeworth, Senior Member of St Antony’s College, PFEM, & Wellington Management

FINANCIAL INTERMEDIATION: WHAT HAS CHANGED DURING THE CRISIS?
Aneta Krstevska, Chief Economist, National Bank of the Republic of Macedonia

CHANGING FINANCIAL INTERMEDIATION, AND IMPLICATIONS FOR FINANCIAL STABILITY AND SUPERVISION
Natasha Ahmetaj, Second Deputy Governor, Bank of Albania
GOVERNORS’ PANEL:
MISUNDERSTANDING/MISJUDGMENT VS. REALITY  109

SUMMARY OF PANEL QUESTIONS:  111

Moderator: Charles Enoch, Deputy Director, Western Hemisphere Department, IMF and SEE.SOX  112

SUMMARY OF CONTRIBUTIONS TO THE GOVERNORS’ PANEL  113
Gent Sejko, Governor, Bank of Albania

SUMMARY OF CONTRIBUTIONS TO THE GOVERNORS’ PANEL  125
Bedri Hamza, Governor, Central Bank of the Republic of Kosovo

SUMMARY OF CONTRIBUTIONS TO THE GOVERNORS’ PANEL  133
Turalay Kenç, Deputy Governor, Central Bank of the Republic of Turkey

SUMMARY OF CONTRIBUTIONS TO THE GOVERNORS’ PANEL  139
Giuseppe Parigi, Head of the International Relations Directorate, Banca d’Italia

CLOSING SESSION  145
Adam Bennett
OPENING ADDRESSES
OPENING ADDRESS

Gent Sejko*

Your Excellency Prime Minister,
Dear Governor Hamza and senior central bank representatives,
Your excellencies ambassadors,
Dear guests, friends and colleagues,

I am delighted to welcome you to the annual conference of the Bank of Albania organised in cooperation with the South East European Studies at Oxford. It is a pleasure to see that this cooperation brings together old and new partners.

This has been a tough year full of challenges for the Albanian economy, consequently for the work of the Bank of Albania. The full recovery of economic growth and its further improvement in the future are and remain one of the top priorities of our work for the year.

The prolonged crisis has impelled us and homologous institutions across the world to review many of the economic axioms, which we had taken for granted for a long time.

It is not by accident that the main topic of the conference focuses on the causality and solutions for long-term problems we are facing during this period.
Over the five year period, the Albanian economy has been growing in positive territory, yet, below its potential. This is a global phenomenon in the post-crisis period, extending across South East European economies, which have experienced even lower growth rates.

I hope that during this conference we will have the opportunity to analyse in depth the reasons behind this situation, sources that feed it and the difficulties it imposes on the business model and financial intermediation. Furthermore, it would be useful to discuss on the options available to policymakers and the way out of this situation, which, I believe, is a temporary situation rather than a long-term economic equilibrium.

The Bank of Albania has been actively using two main instruments, the monetary policy and the macro-prudential policy, to give its contribution for a swift and systematic closure of the negative output gap in Albania. The Bank has continued to implement an accommodative monetary policy lowering the key interest rate to the historic 2% level.

Notwithstanding the scepticism that has accompanied this process, the lowering of the key interest rate is reflected in a wide range of interest rates in the financial market, including those on loans and government securities. The fact that the economy continues to grow below its potential does not necessarily reflect the absence of an effective transmission channel for the monetary policy. We are more and more convinced that, above all, we have a weak aggregate demand, which is not generating the much needed stimuli for the recovery of the economic activity.

Recent data, however, render us more optimistic. The real sector is showing signs of constant recovery, corroborated by some positive developments in the external economy. I would like to underline that a clearer prospect of the political and economic situation in Greece will have a positive impact over the upcoming period. The Bank of Albania has been continuously monitoring the developments in our Southern neighbour, aware of the various risks that could spill over in the Albanian economy. But, thanks to the precise and duly
interventions, especially in the banking sector, these risks never materialised.

The constant easing of the monetary policy seems to be reflected especially in investment indicators, with the domestic and foreign ones showing significant improvement over the first half of the year. On our side, we are happy that these investments were not made only due to public sector interventions. There was also a substantial component by the private sector. This leads us to believe that well-studied projects by the investors, coupled with an increasingly sound and pro-investment business climate, will serve as main drivers for the economy towards not only higher but also more sustainable growth in the near future.

In accordance with the best contemporary practices, the Bank of Albania has endeavoured to enhance the transparency in its communication with the public, not only about the actual decisions but also about our forecasts. The Bank of Albania has constantly conveyed to the economic agents the idea that the monetary policy will remain accommodative and will sustain the revitalisation of the economy. As a result, we hope that the forward guidance on the monetary policy stance of the Bank of Albania will be adequately understood by all market agents and the public.

Banks and entrepreneurs should use this opportunity to boost their activity, assured that the central bank will continue to sustain and support their activity.

In addition to the monetary policy easing, the Bank of Albania has paid special attention to the reform in the financial sector and the prudent supervision of the banking sector. The Chair of the Board of Governors of the Federal Reserve System, Ms. Yellen, in a statement not long ago leaves no doubt about the necessity of reforms in the financial sector, I quote “... a sine qua non for sustained economic recovery following a financial crisis is a thoroughgoing repair of the financial system.”

From that perspective, in cooperation with the Parliament, government and other public regulatory entities, we have undertaken
a series of legislative and regulatory initiatives, aimed at creating incentives for the recovery and assurance in lending.

Thanks to the reforms we have undertaken during this year, we have started to reap the first positive results regarding the situation of the non-performing loans.

As a result, the ratio of the non-performing loans fell for the first time after almost seven years of continuous rise. The write off of loss loans, as I have explained in previous statements, was the finalisation of joint inter-institutional efforts. During this process, we have been assisted and overseen also by important international financial institutions such as the World Bank and the International Monetary Fund.

Beyond the non-performing loans issue, the banking system continued to be well capitalised, liquid and financially sound. The issue of non-performing loans will require some more time to resolve, but this should not keep us from the recovery of the credit activity at home. For as long as the positive performance of the other above-mentioned indicators continues, the banking sector has room and the potential to credit convincing projects and investments. In my judgement, it is important to administer with courage and persistence the prevalent perception that non-performing loan have forced banks to adopt a very conservative approach to lending.

To permanently address this problem, additional measures have been taken and will be taken in the future. I would like to briefly focus on the latest initiative in this regard: a coordinated plan between the Bank of Albania, Government of Albania, Association of Banks, and International Monetary Fund, consisting in two main pillars:

The first pillar relates to the drafting and completing the legislation that regulates lending from the moment of concluding a contract until the final repayment, including disputes among the parties. These changes aim at making more precise in legal terms all procedures related to banking activity, bailiff services, borrowers and other relevant state institutions.
The second pillar is related to the regulatory framework of the activity of the banking system, therefore, related to the day to day activity of the Bank of Albania and the banking system. We have identified the regulations that will be subject to amendments. In addition to the objective for creating higher flexibility in relation to certain aspects of the activity in the treatment of the credit portfolio, we will aim at adopting a new concept: the “background check (biography)” of the client in relation to bank borrowing. We believe that this new element will help banks assess the borrowing potential of each client.

In addition to what I said above, it is a fact that, recently, lending in the national currency has seen positive growth over the months. This phenomenon, among others, has been accompanied with a positive side effect at a higher speed and intensity in the monetary policy pass-through in the economy.

Dear guests,

As I pointed out, at the beginning, economic activity at home remains in a positive trajectory, but it has not yet reached the level we wish it were. Research at the Bank continues to confirm that the Albanian economy has unutilised potential and that the closing of the gap remains the main challenge for policymakers. Interventions through both the monetary policy and macro-prudential elements insofar have not succeeded to definitively close the gap. I listed these facts intentionally as the conference of this year is called “Do crisis change economic fundamentals?” These interventions are the main actions central banks are allowed by the legislation, and recommended by the most modern theory.

If these interventions fail to introduce a long-term positive equilibrium for the economy, then a question arises naturally: what else should be done?

The answer is in the phrase “structural reforms”. While the phrase may have often been speculated, the truth firmly confirms: only the willingness to project and undertake courageous and visionary reforms is the golden key to success". 
This fact was strongly emphasised in the final statement of the Ministers of Finance and central bank Governors of 24 most developed nations, (Financial Committee of the IMF) in the annual meeting of the IMF organised earlier this month in Lima, Peru. A secure sustainable long-term growth requires timely-implemented and well-sequenced structural reforms which remain critical to raise productivity, potential output, and living standards; they should bolster confidence in the economy and reduce social inequality.

Concluding, I would like to underline the support of the Bank of Albania for a series of reforms undertaken recently as part of the medium-term agreement between the Government of Albania, the Bank of Albania and the International Monetary Fund.

Similarly to the rest of South East Europe, Albania needs a new path, in which investors will be able to see again profit opportunities. It is vital for all of us, for the region to detach itself as fast as possible from the perception as an irrelevant geographical area, fragmented, with insignificant human, financial and economic potentials. We should do anything it takes, at any cost, to restore once again the trend and vitality this region showed before the crisis.

Thank You!

* Gent Sejko, Governor, Bank of Albania.
Just as the birth of Christ serves as the dividing line for the two phases of human history, the same major financial crises serve as a separation line between different economic eras.

Although Nobel laureate Paul Samuelson said that what we really know about global crises is that we actually know very little, today we can say with certainty that dealing with the recent crisis tested the implementation of all possible options, policies, conventional and non-conventional ones for policy makers around the world, in countries rich or poor, in developed countries or in developing countries.

In the vocabulary of economists there is always the expression that financial crises are all the same, but no one looks like the other. The manner and speed with which the last crisis expanded, as a domino effect, has defied all traditional views on the self-correcting nature of financial markets, and has brought in the foreground, since many years now, the debate on the role of finance in economic growth.

The World Bank report on South Eastern Europe, where we are included, says that probably no other region in Europe is sensitive anymore to the Euro crisis than countries of Eastern Europe, with very serious challenge for these small economies. Growth prospects
of the region depend largely on external factors, including the recovery of external demand, particularly in Europe, and stabilization of international energy prices at current levels.

In fact, after a decade with high rates of economic growth, the region of Southeast Europe was affected severely by the economic and fiscal crisis in the Euro area. Economic activity in Eastern Europe is suffering from weak domestic demand, high unemployment rate, and from the banking systems being loaded with many non-performing loans.

The World Bank report also says that structural challenges continue to be the answer to finding growth in Eastern European countries. In this almost vicious circle lies in a new model of growth based primarily on regional economic integration, on a comprehensive and intelligent economy beyond the boundaries that separate today the region, by defining and even condemning them as economies too small to be self-sufficient. Beyond the way how it was born and spread, the crisis induced also the implementation of some specific policies that were unprecedented in the national and international level.

Monetary authorities in developed countries were the first to apply aggressive monetary incentives, by reducing interest rates and then using unconventionally their own balance sheets in order to inject liquidity. At the same time, decline in production due to the crisis brought the need for countercyclical fiscal policies of such dimensions that could not even be imagined prior to the crisis.

Nowadays, the developed world is dealing with the analysis of the success of unconventional instrument, such as quantitative easing. The Federal Reserve, Bank of England and the European Central Bank recently are trumpeting the success of this instrument, in a world that is still troubled financially, and whose cycles mark both large growth and loss. The crisis showed that market players were not prepared to manage the system that they themselves created. It taught us that the financial market cannot correct itself by market forces, and that central banks should play an even more important role in overseeing the health of the financial system.
National authorities should be aware that in an integrated financial system the power of their local policies is marginal. Therefore, coordination of financial supervision across countries and between different sectors of the economy is very important in maintaining financial stability in an integrated global system which, as indicated by the latest crisis of refugees, puts us face to face with developments that were unpredictable and unimaginable until a short time ago. The crisis has highlighted the fact that international economic cooperation and integration have become necessary since no country has been able to handle the new challenges in isolation from other countries, given the nature of contamination that all these challenges have.

For the first time at the Vienna Conference on 27 and 28 August, the one that followed the Berlin last year, the countries of this region made a common step to show up with joint plans, in view of the internal integration of their economies, and in view of their integration to the wider European region.

This first step is expression of both the awareness being shaped in the region that this is a situation that cannot be overcome partially, and no country can afford it isolated from the other, and of the conviction that is being created in the European Union that the concerns of countries in our region are necessarily linked to the fate of the region as a whole, and that the performance of each of our countries is very important to the performance of all countries together.

I believe that in this regard, the Government has a merit and its role to play because this is a new approach with an aim at making this region a much more attractive destination for investments where, when someone takes up to invest, they don’t just invest in Albania or in another country in the region, but in a wider economy than the economy of each of the countries.

We are all witnesses to the extraordinary transformation that has occurred in the past two decades from every aspect both in the region and in Albania, as well as to a very deep restructuring process of the economies of the region in view of an organic transformation across the continent, and simultaneously under the inevitable pressure of globalization.
The road to EU membership has contributed as a unique attraction to target reforms and structural transformation that couldn’t be targeted without this path, and which would even be seen as unnecessary, not only to promote economic growth by opening and expanding markets, but also by creating the basis in terms of legislation and drafting of special economic policies in view of a goal that is as aware as it is an inevitable pressure of the transformation process that globalization imposes.

Foreign investment in the first quarter of this year, as the Bank of Albania has certified, have reached 258 million Euros, thus making a jump of 90 million Euros compared with the same period last year. Only foreign companies are 30% more recorded in 2014 than a year earlier. In the first half of this year exports marked an increase of 11.9% compared with the same period a year ago. But these encouraging signs are not enough. We are aware that although Albania withstood the financial crisis and, as the governor underlined, withstood successfully also the threat coming from an escalation of the crisis in the neighbouring country, providing positive growth rates and financial stability, the crisis has highlighted the physiological weaknesses of a system that had actually exhausted the space for further growth.

The overall economic growth rate, before the first stages and after the crisis, was halved thus reflecting the situation in the Eurozone and the difficulties in the energy sector. What we are observing constantly, and which should make us all not just reflect - because I believe that the phase of reflection is guaranteed, - but act in a more unified way, is the fact that the crisis actually brought fully to light the businesses of domestic production with all their weakness as non-formalized structures that do not guarantee a normal ongoing and ambitious accreditation of the banking sector.

In fact, today we are at a time when despite the substantial progress made in relation to bad loans – we should not forget that bad loans have only increased for 7 years in a row and touched the ceiling of 25%, which constituted both a serious threat and the highest peak in the whole region exhausted by the crisis, today we have reached the lower level of 20%.
It is very clearly that in order to go below, a structural strengthening of the businesses in Albania is required, a transformation of the mentality and of the way businesses in Albania are structured and ready to access banks, because actually we are at a crossroads in this regard.

Banks are ready with liquidity, but domestic business is not ready to be up to the challenge of being well-structured and to motivate with credible projects their lending requirements.

In fact I believe that despite, I guess, the naturally imperfection of responses that we have chosen to answer the questions in front of which the crisis has put us, Albania has entered the process of redesigning the model of its economic development and of the transformation of its economy’s nature, aiming at an economy that is oriented by a much more sustainable domestic production and by exports.

The trade sector, as well as the manufacturing sector have consistently increased their influence on credit for businesses, while it is very clear that there are two sectors that are regarded as attractive to the financial sector; agriculture and electricity.

Despite major structural changes that have happened in all these years, it is still clear to everyone that agriculture is one of the most important sectors of the Albanian economy, and actually the sector with the largest contribution to the national economy by 22%. Therefore, seeing this sector as a strategic sector, as a sector with great potential of internal transformation and for transforming the country’s economy, we are focused on promoting systematic and aggressive growth, production development and formalization of businesses in the agricultural sector, and the increase of production capacities through financial investment, as well as through training and development of human capital.

In fact we are on the eve of opening a new innovative program in agriculture, thanks to the support, not only moral, of the governor and of BoA, but also to the understanding with second level banks to create the conditions for a much broader access to credit for
investment in agriculture starting from next year, by establishing a state guarantee fund for them.

However it is clear that economies are very complex and very dynamic systems developed by social systems and behaviours of people who populate these systems, and if we want to give an example, we can see this clearly in this new transformative phase determined by the operation against informality. Figures of only 45 days are impressive, not in terms of success, but in terms of a large quantity of data in order to analyse in depth in what social system and system of behaviours we have lived for years in relation to the economy, and what transformation can bring to the economy the social transformation of this behaviour system, in relation to the obligation of everyone to contribute according to what the law has established, in relation to their income.

On the other hand it is very clear that the financial crisis has taught us how important it is for a country to focus on policies aimed at sustainable and long-term growth based on reliable sources of growth. Our economic model of many years was based on two sources, although it was clear that they would not be there for a long time, remittances and the boom in construction. Meanwhile, reliable sources of growth remain largely unaddressed and unused by long-term development policies.

However, today it is clear that wherever we look, the convergence towards the EU remains the main subject of every model and every method to ensure long-term growth and sustainable economic growth.

On the other hand we believe that today, since it is BoA’s annual conference, is the day to say that BoA continues to play successfully an extremely important role. It continues to be a very strong guarantor of a financial stability that, despite threats, has proved to be stable and on the other hand continues to be a very reliable reference point, which is not very common in a country like ours.

Finally I want to emphasize that as a government, we support and will support on an ongoing basis every effort that would lead to
further lowering the level of bad loans, as a need to repair the defects and deficiencies in the system of lending.

But at the same time, as I said, other factors also need to act harmoniously, primarily businesses, in order to modernize and to restructure in view of more demanding requirements of banks when it comes to crediting.

However reforms take time, and visible results require hard work, sacrifices and a challenging level of patience over time. We have started an operation in a broad front, and I believe that we are still at a time when the operation continues, and we cannot ask the patient to run.

But what is certainly true is that we are creating conditions to address the high potentials of growth that our country has, not merely as a country but as a key point in the region, and in view of the awareness that it is such not only here but also in other countries of the region, for an integrated market, in order to not only increase the welfare level of our nation but also to be tomorrow much more protected from threats of openness and globalization which, as the recent financial crisis showed, are much stronger - though not immediate, but escalating in time - for the most vulnerable areas in terms of their structure and in terms of their economy as it is the area of our region.

*Many thanks for the invitation!*
Governor and friends, thank you very much for having us here again. This is the fifth Conference that we are jointly organizing with the Bank of Albania and naturally, it is a great pleasure for us to be here, from Oxford. We feel that this is a very welcoming and familiar environment to which we always like to come back.

I would like to start by pointing out that that our partnership between SEESOX and the Bank of Albania has been really rewarding; it has been fruitful and rich in output, in discussions, in thinking about issues such as growth and reform, the role of Albania in the region and Europe, and in addressing wider political economy themes. I have to add here that our “cousin” programme in Oxford, the Political Economy of Financial Markets (PEFM) plays a vital role in this partnership. Indeed, many of our speakers today are associated also with PEFM.

For SEESOX, it is essential to link with a major institution such as the Bank of Albania, a most prominent financial actor who has an outward focus and matters in the region. This is also the central institution of a country that has a meaning in international politics today, a world of global powers and multilateralism. Small European states, such as Albania, have a real impact, not just in the regional or European setting but in the global context. At SEESOX, we have
been involved in a big project on Global Balkans, touching on issues such as diasporas, energy, migration or the influence of global players such as China or Russia. Albania is an open economy, an open society, a democracy with a special geopolitical significance and, as such, it has a lot to say about our current world architecture, and this is something which we, at SEESOX, are very keen to explore.

I would also like to add that through cooperation with the Bank of Albania, SEESOX has become a true friend of Albania, in that we really care about the image of the country in the UK and in Europe and aim at contributing to the understanding of your country abroad. The Albanian Prime Minister, Edi Rama, was one of our keynote speakers having delivered the SEESOX Annual Lecture two years ago, where he engaged spontaneously with our students and scholars in a full amphitheatre at St Antony’s College.

Our mission is also about educating and interacting with young scholars and students, the elites of tomorrow. And in that sense, I would like to stress how pleased I have been this time in Tirana because I had the opportunity to deliver a lecture at the University of Tirana, the Faculty of Economics. I was very fortunate to connect with young students of this country who were very bright and well informed and showed a keen interest on current affairs and the scholarly debate. I could see that they were really committed to seeing Albania being a firm part of Europe, to becoming a better society and to engaging with the academia abroad. This left me with a very positive image of students in Tirana who can contribute to the country’s progress, if there are enough opportunities for them to show what they can do here.

Finally, I would like to express my gratitude to the Governor Sejko for hosting us here. I am sure that this is going to be an excellent conference. This has been the experience of our past joint events so far in Tirana and Oxford. I expect that this conference will produce original and important insights on the current thinking about economic policies. I would like to wish us all good luck and a very good conference.

Thank you!

* Othon Anastasakis, Director of South East European Studies at Oxford (SEESOX), St Antony’s College
SESSION I:

HAS THE ECONOMY CHANGED IN THE POST-CRISIS PERIOD?

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

Moderator: Gent SEJKO
Governor, Bank of Albania
Good morning everyone,
Thank you Governor!

Thank you Bank of Albania for inviting me to this conference to present views on this important topic of the post crisis challenges in South East Europe. It is a great privilege.

Seven years after the crisis, the recovery in the region has still been very uneven and growth prospects have not been very strong, thus creating a lot of challenges for convergence to the euro area levels. Even as the economies are adjusting, there are lots of shocks that emerging economies are once again facing. Under these circumstances, I think it is very important that we are able to focus on this issue. I would like to focus my presentation today on adjustments that have been taking place in the South East European countries, in the region, with a bit more focus on the Western Balkan economies and to discuss the medium-term challenges and policy priorities.

As I just mentioned, growth in the region has been much lower compared to the pre-crisis era.
In Chart 1 we see the growth rates in the Western Balkans as well as the new EU member states in the pre-crisis period versus the post-crisis. Whereas in the pre-crisis period, we have had very strong growth reflecting growing integration and strong capital flows in the region, in the post-crisis period we see that growth is lower. In particular for Western Balkan countries, it has been underperforming.

This is also worrying because the prospects for recovery in the near term, in general, are really limited because the potential growth has been revised down and the medium-term prospect for growth is now much lower than what we had in the pre-crisis period. This
is partly to be expected given that, in the pre-crisis period, the capital flows, the drivers of growth, were not sustainable. But, this underscores the challenges that are being faced.

The capital flows, now in the post-crisis period, have been much lower. In particular, bank lending in the region has declined and there is a circular decline in the capital flows in the region. The region as a whole has performed relatively well to withstand the shocks from the Greek crisis and spillovers from there. Nevertheless, I think, more recently, with the shocks and the volatility in the emerging markets, once again the pressures for outflows are evident.
So, how has the economy been adjusting? Let me first focus on the external adjustment. What we see is that, with external financing drying up, the current account has adjusted very sharply, in particular in the Baltics and in Central and Eastern Europe. The Western Balkans, in comparison, have adjusted relatively, I mean they have higher current account deficits, which largely reflects the fact that the savings in this region have been lower than in the rest of new member states.

What is the composition of the adjustment in the external accounts? This has been through: reduction in consumption or the increase in savings which is given by the blue bars in this chart and reduction in investments.

Source: WEO; and IMF staff calculation.
So, there has been a sharp drop in private investments as well as increase in savings. Now the way of looking at this is also through looking at the decomposition of growth. In this chart, we see a comparison of the new member states versus the Western Balkans. As I just mentioned, on the right side we can see that reduction in investment growth in particular has been much stronger in the Western Balkan states. This reduction is also the main factor contributing to the lower potential growth. On the relative scale, we can see that net exports have given a much larger, positive contribution. However, if you look at this further down, you see that growth in general is still weaker in the Western Balkans relative to new member states. This is partly a reflection of the fact that for other new member states supply chains are probably better integrated, so the exports' performance has been better, which is not the case for Western Balkans. The other factor that actually results in this positive contribution is that imports are actually contributing positively. There is a big decline in imports as well.

One of the reasons why investments are not declining as sharply in the new member states is the absorption of the EU funds, the EU structural funds that have helped to offset some of these pressures.

One of the reasons we believe that exports have not been able to do as well and have not been able to adjust in the post-crisis period is that the structure of investment was less favorable to the tradable
sector. A lot of capital flowed in in the form of FDIs in the pre-crisis period. But, these flows went, to a large extent, to the non-tradable sector.

Basically, where do we stand now? What is the indicator that we use? At the IMF, we have an external debt sustainability analysis that looks at the current account balance and compares it to a level that is stabilizing for external debt. When we compare the two, what we see is that the red bar shows the countries where, there is still a gap with the debt-stabilizing level. Whereas in the pre-crisis, or at the height of the crisis, a lot of countries still have this gap, more recently we see that this has corrected.

So, the external adjustment for most of the region has been completed. On the other hand, the quality of the structure of this can still be improved with higher savings and higher investment, in order to facilitate longer-term growth.

Let me now turn to the domestic side. Here, what we see is that on the fiscal aspect there was a lot of pressure, while fiscal vulnerability has increased, as growth decreased, the revenues dropped, and deficits and debt rose rapidly. This is not obviously to see that the adjustments do take place. Given the financing constraints, there was a lot of structural adjustment that took place on the fiscal side as well. What we see is that the adjustment was hampered by some inflexible
budgets. In the pre-crisis period, particularly in the Western Balkan states, there was a lot of increase in expenditures that were linked to pensions, items that are basically pre-committed, that are mandatory expenditures that give them less flexibility. As a result, what happened is that most of adjustments burden fell on investment.

There is a forthcoming paper from the IMF that looks at the composition of the budget structures and adjustments that took place since the crisis. In particular, I want to focus on South East Europe on the right side that shows that large part of the adjustment took place on the expenditure side and also large burden of this fell on investment.

**Chart 10 Gap between Debt-Stabilizing and Actual Primary Balance**

(Per cent of GDP)

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- Baltic: EST, LVA, LTU
- SEE: BGR, HRV, MKD, ROM, SRB, ALB
- CEE: CZE, HUN, POL, SVK, SVN
- CIS: BLR, RUS, UKR

Blue bars indicate further adjustment needed!
Generally, more effort is still needed on the fiscal positions. We have used our public sector debt sustainability analysis tool to see where the debt is, where the fiscal balances are relative to the debt stabilizing level.

Here again similar analyses show the countries where adjustments needs are still there. It shows that this is still an incomplete process. I think the policy implication is there, fiscal space is limited, adjustment is needed, but it should pay more to the growth and enhancing the efficiency of adjustment.

Turning to the private sector balance sheet. Looking at the debt overhang in the private sector, we see that there is a recent analysis that was done to also look at the gap between what is the private sector actual debt ratio versus a more optimal level of fundamentals consisting private debt ratio. What was shown by this research is that in the post-crisis period there is still a significant private sector debt overhang in the balance sheets. A flip side of these is that you can see it in the banking system as well. The NPLs ratio in South East Europe is particularly very high, which calls for more action to address this challenge through structural reforms, aimed at, for example, bankruptcy law, contract enforcement, debt resolution mechanism, in order to facilitate higher investment.
Lastly, in order for adjustment to be less painful, it requires institutions to be more flexible. One of the reasons perhaps recovery has been more prolonged in the region is that the transition process is still incomplete and a lot more institutional reforms are still needed relative to other new member states.

Just to summarize, I think there are still adjustment needs on the public balance sheet as well as on the private balance sheet. Policy should be addressing crisis legacies, where the focus should be on the efficiency of public fiscal adjustment as well as balance sheet repair and addressing NPLs.
Finally, to boost potential growth, even though the external adjustment is more or less complete, the structure is improved through greater savings as well as through more formalization of savings instruments, which can then facilitate greater investment.

*Thank you very much!*

*Anita Tuladhar, Mission Chief for Albania, IMF*
My brief presentation deals with the diagnosis of the present situation in Europe and how the region of South East Europe is affected by the current climate. Today’s European Union is a more unstable environment than in the past, and is tormented by multiple crises. To start with, the impact of the eurozone crisis years is still felt across Europe, despite the recent return to growth rates. On top of this, the increasing waves of migration threaten to set European disintegration into motion. The migration issue is, at the moment, the most risky crisis in Europe threatening to hurt major EU achievements, as well as the unity and solidarity of the European project. We are watching daily the waves of migrants in different parts of Europe from the Aegean sea to the Western Balkans and Central Europe and knocking on the doors of Western Europe -Germany, Austria and Sweden. To complicate matters more, Europe is confronting a further danger in its neighbourhood to the east and the south, in Ukraine, Syria and North Africa, a geopolitical crisis that threatens the security of the continent and brings back memories of cold war with Russia. So, just as Europe seems to be coming out of the longest economic crisis in its history, it is confronted with additional risks to its existence.

But is the eurozone crisis completely over? While it may seem that the euro has survived and is irreversible, it is not necessarily
unbreakable. A reminder of the euro vulnerability came with the July 2015 near exit of Greece from the eurozone, pointing to the difficulties that Greece still faces in its effort to remain within the euro, and the potential ramifications for the rest of the club. Without doubt, the most positive news, following a long period of eurozone vulnerability, is that we are seeing a slow recovery, which varies from country to country. With the exception of Greece which is still the only country trapped in recession, all the other European countries are back to growth. Some favourable conditions have helped, including the fall of oil prices, the quantitative easing, or the very important role of the European Central Bank as a security mechanism, all of which have, in their ways, contributed to this economic recovery.

But, we cannot claim with certainty that the period of economic susceptibility is over as shown by the persistent high unemployment in the countries of the southern economic periphery. In fact, there is an unequal picture between the dynamic economies of the advanced north and the weaker economies of the South. In addition in the whole of Europe, there is a concern with deflation which reminds us of how Japan in the 1990s was fighting with persistent low inflation and low rates of growth. And while the devaluations and the fiscal consolidations may have corrected some micro-economic imbalances in many countries of Europe, the sustainable growth potential is still missing. Limited fiscal expansion is affecting the growth potential negatively. This economic pattern has its political ramifications in national politics. Mainstream parties are being threatened by the rise of alternative political formations and the dangers that populism places to the political centre. The parties of the nationalist right are becoming increasingly prominent in post-eurozone crisis environment, to which the new migration complexity is adding further strain and where far right parties are the ones that are actually benefitting more from the environment of unsustainable growth and rising migration.

Southern European politics are particularly affected by the long period of economic slowdown and the policy of “ordoliberalism” imposed by Germany on them. This raises the question as to whether Greece is the odd one out, or whether the Greek crisis
is part of a wider problem of European economic incompetence and geographic discrepancy that will continue to affect the continent. As far as Greece is concerned, I would not hold high hopes about the third memorandum that was adopted in July, because it is recessionary, and shows no prospect of an imminent return to growth. But we need to look at the cases of Spain and Portugal, because both of them have been presented to us as positive examples of how austerity and structural reforms can lead to recovery, an argument which in my opinion is not fully justified. One needs to ask whether the reform process in both of these countries has led to the diversification of their economies. Seeing that the investments, for instance which are taking place in Spain, do not go to high value added activities, but they continue to go to poorly paid sectors, basically in tourism, one cannot be hopeful that a different growth model has been adopted. With unemployment so persistent, emigration and brain drain are becoming regular trends, and the educated youth is moving to the better economies of the north or other parts of the world where job prospects are better. The political implications of such socio-economic outcomes are substantial and in all southern countries, the mainstream domination of centre-right and centre-left politics is being challenged by the emergence of new parties and the substantial rise of the left. Elections in Greece, Spain and Portugal are showing that new politics are emerging in these countries with potential implications for wider Europe.

In a German dominated EU, guided by a growing intergovernmentalism and less so by federalism, it seems that all countries, large or small, are beginning to matter. The outcomes of national elections or the formation of one or the other type of government in every country affect the EU as a whole. Beyond the vulnerable European South, the region of Central and Eastern Europe is having an increasingly worrying impact in Europe, seeing how the challenge of migration is being internalised by governments and societies there; the populist governments in Poland or Hungary are contributing to a more convoluted political picture of Europe.

So what are the lessons from the multiple crises which Europe is suffering from?
At first, we observe that the European Union has a difficulty predicting crises. It is a club of countries, which can be very complacent when times are good and can be in denial when the problem is approaching. This happened both with the eurozone and the migration crises. So much so, that when that problem erupts then one notices that there is very little level of preparedness.

The second point is that the EU is slow to react when the crisis comes which is a manifestation of the institutional weakness of the EU to address crises. We have seen that when the eurozone crisis erupted, the IMF was called to help. The same applied to the migration crisis, when the existing institutions are unable to reach a common approach and to convince all member states that they should share the burden.

Thirdly, the intergovernmental method is becoming prominent but in a nationalistic way, whereby countries are resorting to solving matters in a short-term and piecemeal way. It is a kind of “nationalistic inter-governmentalism” which dominates the EU, which is not able to bring together all the different national points of views. Greece and Italy are worried about continuing austerity and the rise of immigration on their territories as first entry points. Spain and Portugal are struggling with their internal coalition politics and the rise of new political formations. Central European countries are becoming very uneasy with the waves of immigrants and the threat to their cultural identities. Britain is battling its EU referendum; and northern economies are worried about how their economies are affected by the weaker eurozone states as well as how their welfare systems are affected by the rising numbers of asylum seekers. The causes and threats are common to all the countries of Europe, the answers and reactions are national and fragmented.

I believe that the problems we are seeing are here to stay. The impact of the euro area crisis will continue to affect the meagre recovery of the Eurozone and it will require careful economic management to stabilise the situation. Migration is a problem that will continue as long as Syria continues to be a war territory of different agendas of the various global players. The solution will require a European response to the issue and not fragmented
nationally competitive responses. And relations with Russia require careful handling in order to avoid a return to cold war conditions.

This is an environment which affects the less advanced Western Balkan states which have recently become importers of external crises. The Western Balkans is a region which is still the soft underbelly of Europe. It offers ground for mild competition between Russia and the EU in the energy and the FDI domains. The Western Balkans is a route for all those migrants coming from the conflict areas in the Middle East and elsewhere. And it can be a ground for jihadist infiltration. For all these reasons, the region needs to be well anchored in the EU. And that’s why it makes sense for the local elites to continue with the process of accession and eventual membership. The Western Balkans has often been referred to as “the unfinished business of the EU”, because this is the only region which is not yet part of the EU but which is an uncontested part of Europe. While we know that accession is not going to happen within the term of the current European Commission, the plan is to keep the process alive through a gradualist approach. And we have to hope that the Europe where the Western Balkans will enter eventually, will still be the Union of solidarity and integration, and that the current multiple crises will be an opportunity to strengthen the edifice.

Thank you!

* Othon Anastasakis, Director of South East European Studies at Oxford (SEESOX), St Antony’s College
As Othon has already mentioned, this seminar provides a good opportunity for me to introduce you to our latest book, which is literally hitting the streets as we speak. I have not yet obtained a copy myself, but it has just been published.¹

Given that the title of the conference is “Do crises change economic fundamentals in SEE?” I think that the answer to that is “yes, clearly they do” in the light of the global crisis both within the region as well as outside the region. This book is an attempt to re-examine what has been happening in South East Europe (SEE), starting from the beginning of the transition twenty five years ago. On the basis of this review, we draw some conclusions about how the economic model for the region needs to adapt. As Othon has mentioned, this book has four authors: Russel Kincaid who used to be at the IMF and now is associated with SEESOX, Peter Sanfey, who was with the EBRD and has come here before, the late Max Watson, who, Othon has already explained, sadly died while the book was being written, and of course myself (also a former IMF official and now an academic).

The structure of the book is as follows: the first chapter looks

at overall macroeconomic developments in SEE since the onset of transition, and explores the scope for reform in labour markets. In the second chapter, we look at progress in structural reforms in more detail and also analyse the evolution of public opinion and political support in South East Europe for economic reforms, support for the market economy and for the democratic process. The third chapter assesses the conduct of fiscal policy and progress in undertaking institutional reforms in the fiscal area, including the use of fiscal rules and fiscal councils. The fourth chapter considers the scope for the use of macro-prudential tools in South East Europe and their effectiveness in controlling and better targeting financial conditions. Finally, the fifth chapter examines the implications of the on-going changes in the EU’s institutional and regulatory architecture for SEE countries, either in or on the periphery of the European Union.

Now as I only got fifteen minutes, I am not going through the whole book because I do not have time. Plus, if I did, one wouldn’t have the incentive to buy the book.

I am going to concentrate now on what is in the first chapter, which really sets the scene for the rest of the book. This will give you a flavour of what the book is all about.

When we look at the history of transition in the book, we show it as having three distinct phases. The first phase during the 1990s, which we label as the transition phase, we also characterize as the “Valley of Tears”, reflecting the V-shaped adjustment resulting from the initial steep decline in output as the earlier communist and socialist systems were dismantled followed by the recovery in output as modern economic and political systems were put in place. This V-shape was also exacerbated by conflict in the former Yugoslavia in the first half of the 1990s. In a mathematical sense the index of output at the end of this period was not much higher than at in the beginning and therefore the average growth rate during this period was negligible. However, the quality of the output at the end of the period was in a sense much greater than it was in the beginning, because it reflected the region’s restructuring toward a modern market economy.
The second phase, which we call the boom period here, we describe as the “Sunlit Uplands” where the fruits of the sometimes painful transition process finally began to appear. This boom, as we know all too well, got out of control and led to the bust phase from which the region is still even now struggling to escape. We call this period the “Wilderness Years”. The average growth of SEE went back down to almost negligible rates during 2009-14.

Looking at the three phases, initially, a number of countries in the first phase had very high rates of inflation as they tackled monetary overhangs and old soviet bank balance sheets largely comprising non-performing loans, while at the same time getting used to running independent Western-style monetary policies, which was a new thing for these countries. By the end of the first phase, however, inflation was brought under control and kept low during the boom era. Moreover, even in the bust period that followed, inflation remained relatively low. So, inflation was not really a problem in this third phase. The problem was rather the very low growth rates. It has proved extremely difficult to bring growth back to a more appropriate pace for the region.

What we saw during the run up to the boom was a very significant savings gap. Investments rose steeply in the run up to the boom, but savings were actually falling. And this difference of course gave rise to a very large current account deficit in the external balance of payments. This investment rate exceeded 30% of GDP for the region during this period. Such a high rate of investment is normally a warning sign, because its means that investments are probably being undertaken where the marginal rates of rates of returns are likely to be getting very low or even negative because more profitable projects have already been undertaken. Such a situation usually precedes a financial crisis, because it means that many of the investments servicing the loans that are backing the deposits in the banking system may go sour. As we have already heard, a lot of these investments in SEE were not going into sustainably remunerative areas such as exports. A large share was instead going into real estate development, hotels, property and into what economists call non-tradable goods. This set the scene for a classic boom-bust scenario, because when domestic demand contracts, these non-traded sectors are the first to get hit with recession.
When the global economic crisis hit, the foreign capital that was flowing in to the region and financing a fairly large current account deficit suddenly dried up. This forced investments down and narrowed the gap in the current account deficit, but didn’t completely eliminate it.

Now, in this period during the run up to the crisis, there was quite a lot of foreign direct investment. Foreign direct investment is normally regarded as a good and benign form of foreign financing because it is stable, brings know-how with it and doesn’t reverse easily. However, quite a lot of these foreign direct investments, in parallel to those financed by bank loans, were going to real estate and other non-traded goods sectors. In that sense, it was not really creating a very stable economic development model.

Moreover, as the boom got increasingly out of control, bank loans financed by cross-border bank financing reached dangerously high levels. A lot of these foreign financed loans were going into mortgages and other consumer loans and so on. Again this was creating a very dangerous situation. Of course, when the crisis hit these short-term capital flows dried up to almost zero. And this forced a dramatic contraction of domestic demand and thereby of output in the region.

That the situation did not get much worse owes much to what became known as the Vienna initiatives, an effort to prevent a major capital retrenchment led by the major international financial institutions engaged in the region. The Vienna I Initiative involved the IMF and the EBRD sitting down with the main commercial banks that were lending in the region. The region was seriously exposed to these banks, because the banking system was (and remains) foreign owned. Therefore, the region was very sensitive to a change in sentiment in western financial markets, which occurred very, very severely in the wake of the sub-prime crisis in the USA. As a result of this change in sentiment, there was a very high risk that a lot of money would be withdrawn. The region was faced not just with a stop of capital inflows, but a wholesale reversal with money actually being pulled out of the region. So these international organizations sat down with the banks most exposed to SEE and tried to persuade
them to maintain their exposure to the region in return for a commitment from a number of countries in the region to which they were most exposed to agree to enter into IMF arrangements in order to give confidence to commercial banks that they would put their affairs in order. The Vienna I Initiative period of 2009-11, succeeded in containing outflows as banks broadly maintained their exposure.

However, by mid-2011, the region was hit by another intensification of crisis with the euro area getting into further difficulties and moving back into recession. At this point, it was being very hard to continue to persuade the banks to maintain their exposure. You can’t freeze a balance sheet indefinitely like that. These two institutions now turned to work more closely with home country supervisors to try to prevent them from making matters worse by forcing banks domiciled with them to withdraw from the region by unduly intensifying prudential requirements. The second Vienna II initiative was not surprisingly less successful than the first in preventing a net withdrawal of funds during this period. Measured in terms of GDP, a total equivalent to about 20 percent of SEE GDP was withdrawn from 2009 through 2014, mostly during this second phase.

So this is a pretty challenging environment for South East Europe to regenerate growth. The effect of this was that the domestic credit expansion crashed, all the way down to zero in the immediate aftermath of the shock in 2009. It then recovered to some extent during 2010 through 2012, as domestic deposits managed to partially make up for the loss of foreign resources. Then, with the worsening of the Eurozone crisis and the expiry of the Vienna I initiative, the stop in the supply of foreign bank resources to the region turned into a gradual withdrawal. Domestic credit growth moved back into negative territory. In such an environment when banks are not lending, it became very difficult for the region to grow.

One of the reasons why they were not lending was the serious and intensifying problem of non-performing loans. This problem was not confined to SEE. The euro area as a whole has a very serious non-performing loan situation in euro area banks’ balance sheets, especially in the euro area’s southern members. This explains why the euro area itself is struggling to grow. This is in sharp contrast
to the United States of America: even though NPLs rose sharply after the subprime crisis erupted in 2008, they were very aggressively resolved, utilizing more efficient bankruptcy law and debt write-down procedures, with the residue moved off balance sheets for debt collection agencies to deal with, and so positioned the banks to begin lending again relatively quickly. This is one of the reasons why the US economy is growing and the euro area is not, and one of the reasons why SEE is still struggling to get back anywhere near to the strong growth rates the region enjoyed prior to the crisis.

Another aspect to the story is of course the developing fiscal situation. We have already noted that the current account of the balance of payments, which was very strongly in deficit on average during the boom period, was reduced quite considerably in the ensuing bust period. This contraction in the current account deficit was wholly due to the reaction of the private sector. The deficit on the private sector financial balance (which is basically the difference between what the private sector earns (after taxes) and it spends on consumption or investments) was very, very large during the boom period—some 10 percent of GDP. But then, when capital flows stopped, the private sector deficit was reduced to practically zero as spending was slashed. The slack in demand was partially taken up by fiscal policy. By contrast to the private sector balance, the average fiscal deficit in the run up to the crisis appeared negligibly small. This impression was, however, quite misleading. One of the problems, which is discussed in more detail in the third chapter of our book, is that fiscal balances in South East Europe were flattered by unsustainably strong revenues, based on levels of domestic spending which could not be maintained. As policy makers became concerned about the strength of the boom in SEE, they began to look at fiscal positions in underlying terms. And then they began to see that the underlying balance (which corrects for abnormal effects of the economic cycle) was actually much worse than the headline balance suggested. If fiscal authorities had acted sooner to strengthen their positions during the boom period, they would have created the “fiscal space” to accommodate the inevitable downturn. But by the time they realized there was a problem, it was too late. It is fair to say that, politically, it is not always an easy task to argue the case for running fiscal surpluses, when the government is flush with funds.
But if they had done so, they would have been in a better position to deal with the crisis when it finally hit. Following the onset of the crisis, there was a significant deterioration in fiscal balances, which was more or less equal to the remaining current account deficit, given that the private sector balance had been reduced to zero (the current account balance is, by definition, the sum of the fiscal and private sector balances).

Flexibility of the exchange rate affords an additional policy instrument compared to fixed exchange rate regimes. For those countries in SEE that had flexible exchange rates—including Albania—this policy did help by making it (slightly) easier to restore international competitiveness and so help rebalance the growth model from domestic to external demand. The majority of countries in SEE were either pegged to the euro, had adopted the euro, were euroised, or were so exposed to potentially adverse balance sheet effects that significant changes in the exchange rate versus the euro would be more damaging than beneficial. But a few countries, in particular Romania, Serbia and Albania, had floating exchange rates and this did allow them to adjust during the crisis. Countries with fixed or quasi-fixed exchange rates, which saw a significant erosion in competitiveness in the run up to the crisis, were unable to restore their competitiveness after the crisis. Countries with more flexible exchange rates, by contrast, were able to achieve some improvement in competitiveness. In the case of Serbia, however, this nominal gain was largely eroded by inflation. For the other countries without flexible exchange rates, efforts to improve competitiveness had to focus on what is known as “internal devaluation, or intense downward pressure on wages and prices. This explains why there was no resurgence of inflation in SEE during the bust period.

In this environment of low growth, in the wake of the crisis, unemployment in SEE inevitably remained high, although there are quite significant differences between countries in the region. This story is true for total employment, youth unemployment and long-term unemployment. Unemployment has encouraged workers to go abroad, and is partly a reflection of the level of the unemployment, but also a reflection of the relative per capita GDP between their home country and their hosts in the EU. The countries with the lowest
per capita GDP in relation to the rest of Europe had the strongest incentive for workers to go abroad to earn money. Migration is, of course, one way of reducing unemployment domestically and it also helps to avoid the problem of the loss of skills (because workers that go abroad retain those skills in their jobs abroad). The problem for the region is to get these workers—and their skills—back to region when the time comes for their repatriation.

Sending workers abroad has brought substantial remittances in return, for a number of countries and especially for Bosnia, Montenegro, Serbia and Albania. Remittances are good for the balance of payments and they also help support people in the region with higher incomes. But they do have one important drawback, which they share with systems of welfare support. While a strong welfare system can help improve living standards for those at home, such systems can also discourage people from bothering to look for a job.

Chapter 1 of the book concludes by drawing on a study by IMF staff, who looked at the problems in the labour market in SEE, by comparison with the rest of Central and Eastern Europe, as well as with Western Europe. They looked at a whole variety of factors which could explain the relatively high unemployment rate in the Western Balkans. What they found was that the traditional “institutional” variables that could explain this, including the size of state-funded social benefits, unemployment benefits, etc., i.e., the kind of things that you might expect to cause problems for the labour market, do not in fact appear to be wholly out of line in the Western Balkans compared with the rest Central and Eastern Europe and the Baltics (CEB).

Nor are higher rates of unemployment in SEE fully explained by “labour cost” factors. While the level of minimum wage in Albania is identified as a possible problem, in general, only two countries in the region, Bosnia and Bulgaria, are shown to have significant and potentially adverse labour cost issues, by comparison to the rest of CEB.

What the IMF study identified as being the biggest problem for countries in the region relating to unemployment is what they have
called here “structural” factors, including things like the business environment and, as we have already discussed above, the effect of remittances on job search incentives. They’ve also identified what they call a relative lack of accumulated foreign direct investments (FDI) in the region. While there were quite strong FDI inflows into the region in the boom years in the run up to the crisis, much of this FDI went into the non-traded goods sector, rather than into export oriented sectors where the know-how transfer would have been most useful. Moreover, a number of countries in SEE missed out from FDI in the 1990s either because they were involved in conflict or were late starters. This meant that the accumulated know-how that comes with foreign direct investments wasn’t coming in during that first phase and was significantly lacking in the Western Balkans compared with the rest of CEB. The message here is that structural reform remains an important area for SEE to focus on, in order to regenerate growth and in particular to regenerate the labour market. Well, I’m not going any further because time is running out. But I would encourage you all to buy the book and read it carefully!

Thank you!

* Adam Bennett, Deputy Director of PEFM & Associate of SEESOX, St Antony’s College
THE NEW NORMAL AND THE CHALLENGES FOR BANK OF ALBANIA’S MONETARY POLICY

Altin Tanku*

My presentation today would focus the discussion on the impact of the post-crisis economic development trends on the Albanian economy, and to consider the impact and challenges of these developments on Bank of Albania’s monetary policy. Therefore, I will try to focus particularly on the specific developments that affect the monetary policy decision-making process.

The post-crisis period has been marked by significant disruptions to economic trends. Slower economic growth and financial intermediation, persistent low inflation, and a different composition of growth and financing sources are among the most distinguished changes. Along with exogenous shocks from abroad, these changes have imposed new challenges for the Bank of Albania and its policy. The most important challenge relates to the fact that the characteristics of past and current events is eroding the efficiency of the monetary policy transmission mechanism and therefore the beneficial impact that the continuous expansionary policies implemented by the Bank of Albania could have.

As previously mentioned, the recent economic outlook indicates that growth forecasts are on the down side. The economy seems to be stuck in a new and less desirable equilibrium. During these last couple of years, the Albanian economy has been growing at a rate of
around 2-3%. Meanwhile inflation has been persistently low around 2%. These are not satisfactory figures for the Albanian economy! It is reasonable to aspire to get back towards the growth path on which we used to be before the crisis. Therefore, it is important to understand why the economy is stuck in this new equilibrium and to explore the reasons behind the sluggish economic response to economic stimulus provided by the central bank. The rest of my discussion will focus on the analysis of few important aspects of recent changes, which can shed light on the issue.

I would like to start by drawing your attention to the drivers of economic growth before and after the crisis. Chart 1 shows how the Albanian economy and its composition of growth have changed after the crisis. It can be easily seen that consumption and investments have contracted in response to slower growth, and pessimistic expectations. The contribution of the foreign sector of the economy has grown faster and has partially offset what has been lost in consumption and investments. This is quite different from what we expected at the beginning of the crisis. It was believed at the time that economic hardships in our main trade partners would hit foreign demand and result in lower export growth. However, the foreign sector grew, in the subsequent years, supported mainly by exports of minerals and oil. Moreover traditional textile and foot wear re-exports, which were originally directed toward Italy and Greece have diversified and expanded beyond these traditional
markets. Export growth has also contributed to the increase of foreign financing for investments in the Albanian economy. These developments, however, have some important implications on the monetary policy efficiency.

These two particular trends of the external sector are welcome but simultaneously they introduce a new challenge for authorities while intensifying an old one. The first challenge relates to the larger share of minerals and oil in total exports, and therefore their significant contribution to export growth relative to the rest of commodities. This trend exposes our economy to negative effects on terms of trade. Reliance in such commodities makes our economy more vulnerable to negative global demand and supply shocks and in particular economic developments in other emerging market economies which are either large consumers or produces of these commodities. Whatever developments occur in those economies will have a significant effect on their demand and supply for commodities, in particular minerals and oil, and subsequently will affect their prices. This, in turn, will impose additional challenges not only in terms of economy's growth rate but also of the exchange rate of our local currency.

The second one is related to foreign capital inflows. Heavier reliance on foreign financing is dangerous, and will get more so, as we are now approaching the phase in which at least some of developed economies like the US will potentially engage in policy reversals. The US economy has outperformed other developed countries and the Fed is widely expected to begin raising interest rates up. The tightening monetary policy in the US is likely to reduce the availability of capital market financing for emerging economies. It is very likely that the Swedish Riksbank will also increase its rates very soon. When policy rates in advanced economies increase, they may affect the willingness of foreign financing institutions to invest in the Albanian economy.

In addition, global demand and supply for commodities and their prices are also responsive to the value of the US dollar and Fed monetary policy decisions. Global demand and, therefore, the prices of minerals and oil are very volatile in international markets and
this increases both the number and volatility of potential shocks to our economy. Altogether, these developments exert more pressure on Bank of Albania’s monetary policy and expose its policy rate to foreign sector developments more than before.

Currently, the policy rate of the Bank of Albania is at its all-time low and could see further reductions in the near future. Following the nature of its inflation targeting regime and a flexible exchange rate policy, Bank of Albania has embarked on a long period of expansionary monetary policy. In response to inflation, economic growth and declining credit growth, the policy rate has been reduced from 6.25 to 2 per cent (see Chart 2). The policy response is based not only on the theoretic and empirical research conducted internationally for developed and developing countries, but mainly on the results of empirical research conducted by the Bank of Albania itself.

Several Bank of Albania research projects have focused on the interaction between growth, inflation and interest rates. The results of this body of research is summarised in a set of empiric forecasts and macro-econometric models used by the Bank of Albania.¹ This research converges to the conclusion that there is a significant relationship between the interest rates, the monetary policy rate (the

¹ This research is also published in the Bank of Albania Working Paper Series and in several edited volumes dedicated to Bank of Albania monetary policy.
weekly REPO rate of the Bank of Albania) and other interest rates of the economy, resulting in faster credit growth, larger consumption, and new investments in the economy. In this respect, monetary policy is documented to contribute to accelerated economic activity, faster economic growth and rising inflation.

Yet, despite the persistent stimulus of the current expansionary monetary policy, the economy is still stuck into this new, less desirable equilibrium. Although our economy is growing, the growth rate is not close to the pre-crisis levels. The real growth has been on a falling trend and a portfolio of Bank of Albania models indicate the presence of a negative and deepening output gap for the period 2010-2014.

Growth analysis based on several studies including Kota (2007), Çeliku (2014), Çela & Skufi (2014) and Yzeiraj & Abazaj (2014), indicate that the Albanian economy is under performing. All studies converge to the conclusion that the output gap in the recent years has been negative and growing (referring to 2014 data). Chart 3 shows the output gap as a weighted estimate of the models referred above. Data

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2 It is worth mentioning that in addition to monetary policy measures, BoA has also implemented a set of macro-prudential policies and introduced macro-prudential regulation to increase the growth of credit in the Albanian economy. However, this would be discussed extensively in the following session.

3 These models include simple trends, filters, and more structural models looking at the production function. Celiku et. al. 2016, provides a comprehensive summary of these studies and estimations based on their methodologies.
for the 2015-2016 period represent forecasts of the Bank of Albania based on the same models. It shows that the output gap will continue to be negative this current year and in 2016. This narrative indicates that the transmission mechanism is not performing as expected or forecasted by our models. Although interest rates in all maturities have tracked the reduction of the monetary policy rate, this has not been very helpful in reviving optimism and increasing spending in consumption and investments in the economy. Eventually, charts 2 and 3 suggest that the effectiveness of the transmission mechanism has somehow decreased.

In my opinion, the main problem with the reduced efficiency of the transmission mechanism relates to the potential balance sheet effects and low consumer confidence on economic developments. Currently, both enterprises and households feel the burden of outstanding debts (close to 1/5 of which is rated as underperforming loans), and do not plan to take on additional debt in the near term future. This fact is confirmed by Bank of Albania’s monetary policy and financial stability surveys, indicating problems with the demand side of the economy. On the other hand, despite a favourable liquidity position and abundant domestic financing resources (as shown by bank deposits data), the supply side remains constrained as well. Even the supportive macro prudential regulation introduced by the Bank of Albania has not eased supply side restrictions.

The supply side problems reflect not only problems related to the large share of non-performing loans on outstanding assets but also potential regulatory and macro-prudential regulations originating mainly from the home authorities. The latter factor and the reduced interest from EU-based financial groups in the region (as indicated by European Investment Bank Surveys) have become indirect obstacles that prevent the efficient functioning of the interbank and money markets. Due to all of the reasons mentioned above, the effect of lower interest rates has not been fully transmitted to the economy and has thus impaired the efficiency of the transmission mechanism.

Additional and indirect evidence of this inefficiency is obtained from Bank of Albania’s empiric analysis with regard to money and exchange rate. We observe that the growth of monetary aggregates
in response to these low interest rates is not as fast as it is predicted by our money demand models. The same could be said for the exchange rate. Despite the fact that the current exchange rate is in line with observed fundamentals including relative growth, inflation, and interest rate differential, and monetary aggregate developments, the stability of the exchange rate in the face of persistent trade and current account deficits, is potentially reflecting the observed gap in money expansion as concluded by the Bank of Albania macro-econometric models.

Both these gaps (in money and the exchange rate) are not direct objectives of monetary policy per se, but we know that they are very much related to inflation, which is the primary objective of the Bank of Albania. Faster money growth or depreciation could have potentially contributed to higher inflation. In the absence of this, the weak reaction of aggregate demand to falling interest rates has been driving prices down. Headline inflation has suffered a persistent drop from its 3 per cent objective, but even sharper effects are found in the core inflation data. The core inflation indicator dropped to an average of less than 0.5 per cent in 2013 and is expected to fall near 0 in 2015, despite a slight increase in 2014. At this moment, the Bank of Albania forecasts expect an increase in headline inflation for 2015 reflecting higher inflationary pressures from cost push factors. Aggregate demand developments will bear small impact on inflation as reflected by the general trend of core inflation forecasted for the 2015-2016 period in Chart 4.

![Chart 4 Inflation Developments](chart.png)

*Figures for 2015 and 2016 are forecasts. Source: Bank of Albania Calculations and INSTAT.*
The upward trend of headline inflation in the short term remains below the BoA target. Despite Bank of Albania estimates for inflation returning to its objective in the mid-term period, inflation is forecasted to be below the objective in 2016. These results are in line with the previously-discussed analysis that challenges are emanating from two main sources, the lack of optimism in the Albanian economy and the balance-sheet problems for households and enterprises. The lack of activity on the demand side, coupled with the “passive” approach undertaken by the banking system in the post-crisis period, is preventing financial and money markets from operating fully and efficiently.

However, it would be incorrect to conclude that monetary policy has been unsuccessful. Despite of the low inflation and the presence of positive output gap, it is very important to observe that market rates have followed and reflected monetary policy rate changes. This is expected to yield additional effects in the future given the time lags in the transmission mechanism. But, the above-mentioned problems have prevented this from producing higher credit growth, faster consumption and investments as the origin of current problems lies beyond the current level of interest rates.
In fact, credit growth has reduced sharply following the crisis, as shown by Chart 6. However I would like point out a positive development. Credit in the domestic currency, the Albanian Lek, has seen its share growing consistently and considerably by almost 20 per cent since 2008. The reduction of interest rates has encouraged a shift of the preference for credit away from foreign currencies. This indicator has grown at a satisfactory pace vis-à-vis the pre-crisis period, and as such is contributing to a much needed rebalancing in the composition of credit in economy. Despite the positive impact from the financial stability point of view, this is in itself an achievement for the monetary policy since it increases the base of influence of Bank of Albania’s policy rate.

Source: Bank of Albania.
Until the last point, the discussion has focused on the potential change in elasticities due to the impact of changes in agents’ behaviour and expectations. But, there are additional developments which impose an indirect impact on monetary policy and the transmission mechanism. One of these aspects is the persistence of the crisis and the on-going pessimistic expectations that relate to it. This is another problem that must concern the Bank of Albania and its policy decision making. A long lasting crisis can bear negative implications by shifting problems from the aggregate demand to the aggregate supply side. Persistence can cause an unwanted reduction of the output gap, due to the decline of potential output, which will slowly adjust to current output level rather than vice versa. Low domestic demand and pessimistic expectations have been accompanied by lower rates of capital utilization and persistent unemployment, and recently by idle financial capital (liquidity available at commercial banks which is not channelled into credit and investments). This results in idle factors of production, which if left out of the market for prolonged periods tend to deteriorate or be lost together, a process known as “hysteresis” in economic terms. This imposes a direct constrain over the long-term growth of the economy. It also means low profits and reduced income from these factors. Chart 7 shows the savings-and-investments balance. It indicates that starting from 2008 there is a persistent drop in investments in the Albanian economy. This drop is mostly due to private savings in Albania. This decrease in private savings is only partially offset by foreign savings; therefore, total savings show a clear downward trend. This is an unfortunate development and not only will it impose a challenge for future growth, but also for monetary policy. As it was mentioned above, foreign capital flows are volatile and react to exogenous shocks in global markets in response to interest rates and prices of commodities and in this respect they become a challenge for monetary policy. The performance of private investment highlights one last reason for concern. Chart 8, shows the composition of private financing. The yellow line represents total domestic financing while the red line shows the banking system portion of private investment (representing credit for investment financed by commercial bank credit). There is a gap between the two lines as portrayed by the blue bars in the respective chart.
If we look carefully in Chart 8, we notice that this gap has a general tendency to expand from 2008 to 2015. The chart indicates that private investments growth is being supported increasingly by alternative financing sources rather than the banking system. In this respect, alternative financing of private investments in the Albanian economy reveals yet another potential challenge for the Bank of Albania’s monetary policy. If more financing of private investments takes place outside the banking system than the credit channel would be less effective and the reduction of the policy rate will have a smaller impact on credit expansion. It thus makes it more difficult for the central bank to implement its monetary policy with its traditional tools. All together the increase of foreign financing, financial stability concerns, possible loss of output potential and the rise of alternative financing impose indirect threats to the efficiency of monetary policy and its ability to control economic sentiments and economic decision making of the private agents in the economy.

Faced with these challenges, the Bank of Albania has emphasised that its monetary policy will continue to support the low interest rate environment in order to bring optimism and increase consumption, investment and growth in the economy with its monetary policy. However, this commitment is not the only policy measure taken by the Bank of Albania. As you might recall this morning in the address to the Conference by the Prime Minister and the Governor, the
authorities are undertaking a set of measures, which have a positive
impact on investments and economic growth. These measures
foresee important legal and regulatory changes that address important
problems of collateral execution, legal conflict resolution and fiscal
issues related with nonperforming loans. They target mainly banking
supervision and financial stability issues, but simultaneously they
will provide additional incentives for credit growth, which in turn is
expected to improve the monetary policy transmission mechanism
and the effectiveness of the Bank of Albania monetary policy.

In conclusion, I would like to summarise that this “new normal”
has forced the economy to change and adjust to current market
conditions and, this has imposed new challenges to monetary policy.
Therefore, the Bank of Albania’s strong reaction to revive economic
activity and meet its inflation objective has been compromised by
a less efficient transmission mechanism. Our analysis indicates that
this inefficiency is caused by the economic and regulatory conditions
that define this “new normal”. The size of outstanding debt, and
in particular that of non-performing loans, in the households,
private sector and banks’ balance-sheets; pessimistic expectations;
regulatory constraints in home markets; and finally the banking
groups perception of the region, act as strong demand and supply
restrictions for credit expansion. They impact directly the efficiency
of the bank lending channel. In addition, the search for alternative
sources of financing has increased the share of alternative (nonbank)
financing in private investments. This tendency can potentially lessen
the influence of the policy rate on credit expansion and indirectly
reduce the efficiency of the transmission mechanism.

The long-term impact of the crisis represents probably the most
important consequence and the most significant challenge for
monetary policy. This impact is among the most debated issues of
our time. The main concern is the unknown effect of this prolonged
crisis on the long-term productivity and potential growth rate. The
ability to recover the lost human and physical capital is beyond
the reach of monetary policy and its instruments. Therefore it is
important to understand the reasons behind the lost efficiency of the
transmission mechanism and try to mend existing problems as soon
as possible, while maintaining monetary conditions accommodative.
In this process the central bank is studying all potential alternatives and preparing itself to introduce additional instruments to boost economic activity by the use of alternative expansionary policies, subject to a thorough understanding of current problems, and future developments.

Thank you very much.

* Altin Tanku, Director of the Research Department, Bank of Albania
SESSION II:

HAS THE FINANCIAL INTERMEDIATION MODEL CHANGED?

HOW SHOULD FINANCIAL STABILITY AND SUPERVISION POLICIES RESPOND?

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

Moderator: Othon Anastasakis, Director of South East European Studies at Oxford (SEESOX), St Antony’s College
Thank you very much Othon, for the introduction, and thank you very much to the Bank of Albania and the organizers that invited me to come here to this exciting conference.

In my presentation, I will speak on: A new business model for the banks in light of the global crises. My first point is to say that the views here are mine and not necessarily those of the IMF, its management or its Executive Board.

My topic is whether the financial intermediation model has changed since the global financial crisis (GFC), and how financial stability and supervision policies should respond. This topic raises a range of state of the art questions for which there is not necessarily yet a fully agreed view. I would draw you attention to table 1.

Table 1 Global Bank Retrenchment from Emerging Markets since 2009

<table>
<thead>
<tr>
<th>Year</th>
<th>Value (mil USD)</th>
<th>Name</th>
<th>Country</th>
<th>Selling firm</th>
<th>Country</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>N.R.</td>
<td>Credit Card Portfolio</td>
<td>Argentina</td>
<td>Citigroup Inc</td>
<td>USA</td>
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<tr>
<td>2012</td>
<td>N.R.</td>
<td>Banco Suquia SA</td>
<td>Argentina</td>
<td>Credit Agricole SA</td>
<td>France</td>
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<tr>
<td>2011</td>
<td>N.R.</td>
<td>JP Morgan Vastera Argentina SRL</td>
<td>Argentina</td>
<td>JP Morgan Chase &amp; Co</td>
<td>USA</td>
</tr>
<tr>
<td>2011</td>
<td>76.8</td>
<td>CIBC Bank &amp; Trust Co Cayman Ltd, CIBC Bank Co Bahamas Ltd</td>
<td>Bahamas</td>
<td>Canadian Imperial Bank of Commerce / Canada</td>
<td>Canada</td>
</tr>
<tr>
<td>Year</td>
<td>Value (mil USD)</td>
<td>Name</td>
<td>Country</td>
<td>Selling firm</td>
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<tr>
<td>2015</td>
<td>45.0</td>
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<td>Brazil</td>
<td>Standard Bank Group Ltd</td>
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<td>S.Africa</td>
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<tr>
<td>2009</td>
<td>18.7</td>
<td>Credit Portfolio</td>
<td>Chile</td>
<td>Banco Santander SA</td>
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<td>Spain</td>
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<tr>
<td>2010</td>
<td>N.R.</td>
<td>Corporate &amp; Commercial Bankin Operation</td>
<td>Chile</td>
<td>Royal Bank of Scotland Group PLC</td>
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<td>Britain</td>
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<tr>
<td>2010</td>
<td>N.R.</td>
<td>Scotiabank Colombia SA</td>
<td>Colombia</td>
<td>Royal Bank of Scotland Group PLC</td>
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<td>Britain</td>
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<tr>
<td>2012</td>
<td>1,229.0</td>
<td>Banco CorpBlanca Colombia SA</td>
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<td>Banco Santander SA</td>
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<td>Spain</td>
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<tr>
<td>2012</td>
<td>801.0</td>
<td>Banco Davivenda Salvadore no SA, Banco HSBC Costa Rica SA, Banco HSBC Honduras SA</td>
<td>Costa Rica, Honduras</td>
<td>HSBC Holdings PLC</td>
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<td>Britain</td>
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<tr>
<td>2010</td>
<td>25.0</td>
<td>Ecuadorian Branch Assets &amp; Liabilities</td>
<td>Ecuador</td>
<td>Lloyds Banking Group PLC</td>
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<td>Britain</td>
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<tr>
<td>2013</td>
<td>2,233.8</td>
<td>HSBC Bank Panama SA</td>
<td>Panama</td>
<td>HSBC Holdings PLC</td>
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<td>85.1</td>
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<td>Banco Santander SA</td>
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<td>N.R.</td>
<td>Credit Uruguay Banco</td>
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<td>Credit Agricole SA</td>
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<td>France</td>
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<tr>
<td>2012</td>
<td>N.R.</td>
<td>Uruguayan Operations</td>
<td>Uruguay</td>
<td>Lloyds Banking Group PLC</td>
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<td>Britain</td>
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<tr>
<td>2013</td>
<td>0.3</td>
<td>Galval Agente de Valores SA</td>
<td>Uruguay</td>
<td>Grupo Financiero Galica SA</td>
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<td>Argentina</td>
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<tr>
<td>2009</td>
<td>1,050.0</td>
<td>Banco de Venezuela SA</td>
<td>Venezuela</td>
<td>Banco Santander SA</td>
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</table>

### Middle East, Africa and the CIS

<table>
<thead>
<tr>
<th>Year</th>
<th>Value (mil USD)</th>
<th>Name</th>
<th>Country</th>
<th>Selling firm</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>N.R.</td>
<td>Egypt Loan &amp; Deposit portfolio</td>
<td>Egypt</td>
<td>Bank of Nova Scotia / The</td>
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<td></td>
<td></td>
<td>Canada</td>
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<tr>
<td>2014</td>
<td>N.R.</td>
<td>Banking Business / Jordan</td>
<td>Jordan</td>
<td>HSBC Holdings PLC</td>
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<td></td>
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<td>Britain</td>
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<tr>
<td>2009</td>
<td>324.6</td>
<td>Societe Ivorienne de Banque SA, Union Gabonaise se Banque SA, Credit du Congo, Societe Camerounaise de Banque SA, Credit du Senegal</td>
<td>Senegal</td>
<td>Credit Agricole SA</td>
</tr>
<tr>
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<tr>
<td>2013</td>
<td>2,106.4</td>
<td>Barclays Africa Ltd</td>
<td>S.Africa</td>
<td>Barclays PCL</td>
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<td>Britain</td>
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<tr>
<td>2014</td>
<td>177.0</td>
<td>United Arab Emirates retail banking operations</td>
<td>U.A.E</td>
<td>Barclays PCL</td>
</tr>
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<td>Britain</td>
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<tr>
<td>2011</td>
<td>16.5</td>
<td>Royal Bank of Scotland NB Uzbekistan CISC</td>
<td>Uzbekistan</td>
<td>Royal Bank of Scotland Group PLC</td>
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<tr>
<td></td>
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</table>

Source: Bloomberg, LLP.

#### Deal Data

**Banking operations / Assets for sale**

**Selling firm**

<table>
<thead>
<tr>
<th>Year</th>
<th>Value (mil USD)</th>
<th>Name</th>
<th>Country</th>
<th>Name</th>
<th>Country</th>
</tr>
</thead>
<tbody>
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<td>2015</td>
<td>N.R.</td>
<td>Credit Agricole Bulgaria</td>
<td>Bulgaria</td>
<td>Credit Agricole SA</td>
<td>France</td>
</tr>
<tr>
<td>2014</td>
<td>18.9</td>
<td>Banco Popolare Croatia dd</td>
<td>Croatia</td>
<td>Banco Popolare SC</td>
<td>Italy</td>
</tr>
<tr>
<td>2011</td>
<td>69.1</td>
<td>Equa Bank AS</td>
<td>Czech</td>
<td>Banco Popolare SC</td>
<td>Italy</td>
</tr>
<tr>
<td>2013</td>
<td>N.R.</td>
<td>ATF Bank JSC</td>
<td>Kazakhstan</td>
<td>UniCredit SpA</td>
<td>Italy</td>
</tr>
<tr>
<td>2011</td>
<td>N.R.</td>
<td>Banque Societe Generale Vostok, DeltaCredit Bank, Rusfians Bank</td>
<td>Russia</td>
<td>Societe Generale SA</td>
<td>France</td>
</tr>
<tr>
<td>2011</td>
<td>N.R.</td>
<td>EspoBank LLC</td>
<td>Russia</td>
<td>Barclays PCL</td>
<td>Britain</td>
</tr>
<tr>
<td>2012</td>
<td>158.0</td>
<td>Cetelem Bank LLC</td>
<td>Russia</td>
<td>BNP Paribas SA</td>
<td>France</td>
</tr>
<tr>
<td>2013</td>
<td>N.R.</td>
<td>Certain Russian Assets</td>
<td>Russia</td>
<td>Societe Generale SA</td>
<td>France</td>
</tr>
<tr>
<td>2010</td>
<td>84.9</td>
<td>Millenium Bank AS</td>
<td>Turkey</td>
<td>Banco Commercial Portugues SA</td>
<td>Portugal</td>
</tr>
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<td>2012</td>
<td>3,542.5</td>
<td>DenizBank AS</td>
<td>Turkey</td>
<td>Dexia SA</td>
<td>Belgium</td>
</tr>
<tr>
<td>2013</td>
<td>N.R.</td>
<td>Turkey Consumer Banking Business</td>
<td>Turkey</td>
<td>Citigroup Inc</td>
<td>USA</td>
</tr>
</tbody>
</table>
The picture is of a widespread global bank retrenchment from emerging markets since 2009. This goes across all emerging markets; it shows that major banks have withdrawn from emerging markets over the past six years, even from large emerging markets. The picture is of pervasive withdrawals, not just from emerging markets that are known to be particularly weak or particularly problematic but from all. So, even relatively strong emerging markets have seen withdrawals of commercial banks. And not only has this happened, but it also keeps on happening, and it is a continuing process. In the last year I have been working in Latin America. In Brazil, HSBC announced in 2015 that it is withdrawing from retail business. Around the region there is an expectation that there will be more withdrawals, including from amongst major household names. This trend of fragmentation of the international financial system has been receiving increasing attention recently: there was a study of this fragmentation of the world financial system, for instance, in the October 2014 edition of the IMF’s global financial stability report.

So, how are the banks withdrawing? There are a number of ways, as shown in the table. One way is by selling their businesses. If they can actually get out, make some money because someone wants to come in, it is a better solution than just walking away. So, the banks are selling their businesses--but that is only one part. Some
banks are withdrawing just from particular types of business, such as retail. Thus, in a number of places they stay in the wholesale market, which arguably is cherry-picking their areas of involvement and not helping the development of the host country so much, but they are withdrawing from the retail business. Or they are downsizing. It is not shown in the table, but in a number of cases there has been a deliberate contraction in the market share—or maybe not even a contraction in market share because, if the whole financial sector is contracting, then maintaining a market share involves a downsizing and reflects a view by the banks that it wishes to have less involvement in that economy.

Another element which now has become very significant in cross-border political relations is the cutting of cross-border correspondent banking relations (CBRs)—i.e. the withdrawal of banks which are not located in the country, but which have previously been providing correspondent banking facilities. Now they are no longer prepared to do this. Another extreme case of withdrawal is cutting trade lines, when the banks really have no wish to be involved in a country. There are cases being reported of such cutting of trade lines. This is normally related to the existence of uncertainty about payments from a country, perhaps because of awareness that correspondent banking relations are being cut. At the moment smaller countries are facing more withdrawals than larger countries, and are more affected. If one only has one or two banks in a country, for example, or one or two providing correspondent banking relations, then the impact of an individual foreign bank withdrawing is much greater than if it were a marginal foreign bank with a relatively small market share; however, almost all emerging market economies are, to a greater or lesser extent, being affected.

Now, why does this happen? Is it that the business model changes, or is it the cost of prudential compliance or AML/CFT (Anti-money laundering/combating the financing of terrorism) compliance that drives banks out?

Let us look at the how the business model has changed. The GFC weakened many global banks. Some of them are no longer with us, some are being absorbed by others, and some survived in a weakened
state. A number of banks were thrown into difficulties not due to problems initially in host country emerging markets but in their home countries: the US, the UK, the Netherlands, Austria, Switzerland, Italy, Spain, Greece and others as well. In each of these countries there were big problems at home, and the banks became much weaker than before. In pressing for withdrawals, the supervisors may have reinforced what might have been the banks’ intentions. Basically, good prudential supervision practice for a weakened institution is: go to your core business, maintain your core business, and preserve that. In that connection some banks considered that core business means home business, and overseas business is not core, and therefore should be downsized. Certainly, weakened banks needed to address the situation, and they chose to de-lever and reduce assets rather than expand activity. This was a route through which the shock that originated in North America and Western Europe has spread to emerging markets. It takes a long time for this process to work through, and the process is probably not yet ended.

Additionally, banks are nowadays much more aware of the risks. As it was shown in the earlier presentations in this conference, there was a rapid credit boom in Central, Eastern and South-Eastern Europe, and throughout emerging markets. The music was playing, there were new lending opportunities, growth was good, and there was not much awareness of, or attention paid to, the risks. The general feeling was that if indeed there was risk, the bank would be able to get out quickly. Nowadays, however, bank headquarters are very much aware of risk, and are not so sanguine. All major banks have compliance departments, and risk committees are inherently much more cautious than before. Also it is no longer an end in itself for a bank to be fully global. Some banks used to boast that they operated in 180 countries and 35 major regions. “Wherever you go, you will find us.” This was considered a big selling point and that is not the same now. All the major global banks now operate in fewer countries than before. Even if they maintain a presence, it is less of one than earlier.

Clearly, therefore there is a change in business model. Banks themselves are looking at where they are, and this is reinforced by external factors that impinge upon them. These external factors are not necessarily designed to get banks to withdraw from emerging
markets, but this may be an unintended consequence. There are two major factors in this regard: the reform of the regulatory agenda, and AML/CFT enforcement.

After the GFC, countries embarked on major programmes of prudential regulatory reform. For instance, in the EU there has been work that culminated in a number of directives and other outputs. Importantly also there has been work in a number of multilateral fora, such as the Financial Stability Board. They have done a lot of good work to strengthen the global financial system, to prevent or mitigate any financial crisis in the future. This work should serve to improve the resilience of the financial system, and should underpin the global recovery in due course. In the US in particular the recovery is already evident.

However, one element of the regulatory reforms is that banks incur substantial additional costs, no doubt at least in part reflecting recognition of the quasi costs hidden in explicit or implicit public sector subsidies to banks. Banks were lending, and they knew that if something went wrong, the public sector would pick up the costs. So, the regulatory reform agenda is bringing private costs and social costs closer together; this is valid, but it does imply higher costs for the banks.

In this regard, Basel III and the various associated regulations require that banks hold higher capital, and higher quality capital, and at least in the short run this has a cost. I am mainly talking about banking, but this has a similar impact also on non-banks, for instance the insurance companies. For the insurance companies the EU has, after many years of deliberation, passed an overhaul of the regulatory framework, known as Solvency 2. Other countries are following the EU framework and passing Solvency-2-type regulations. Amongst other elements, it requires more transparent accounting, so making risk transparent and again raising the cost of doing business.

In the United States the new regulatory framework was set out in the Dodd Frank bill. This incorporates elements of extraterritoriality, in that any bank that does business in the United States is subject to compliance requirements and penalties for its activities worldwide. Indeed, some of the actions in the United States have been against foreign banks which have US presence and, since every major bank
One additional element is in prospect on the prudential side. This is the concept of total loss absorbing capacity (TLAC). As the international regulatory bodies move on from prescribing higher supervisory prudential standards to looking at recovery and resolution, the principle that in the future failing banks should not receive public finance means that structures have to be devised so that failing banks are able to resolve themselves. They will need to have the ability to cover losses greater than their capital—i.e. be able to “bail in” additional assets. Thus regulators have determined required levels of loss absorbing capacity, which will be another buffer that banks need to build and that will become part of the cost of doing business. A bank’s TLAC relates to its size and its assets, and therefore again may serve to deter expansion.

AML/CFT is the other factor to which bank withdrawals from emerging markets is often ascribed. In the last few years, requirements on countries to meet AML/CFT requirements have been substantially raised. It is a higher bar than earlier, and is intended to be more risk focused. So, originally countries could comply with AML/CFT requirements by satisfying the OECD checklist on transparency. That may now not be the case. Instead, one is looking closely at the requirements of FATF. In that area there has recently been clarification. FATF is specific on what is wanted and what is not. FATF recently issued a statement that banks have to know their customers (so-called KYC). However, this does not mean banks must know their customer’s customer (KYCC). Also, insofar as banks have some AML/CFT concerns, their responses should be proportionate to the risks. It is not intended for instance that entire countries should be shut out because there are perceived problems with a very small number of the customers in that country.

Partly related to AML/CFT issues, bilateral pressures are one more element behind banks’ withdrawal from global banking: the US Department of Justice has been levying exemplary fines, frequently on issues that have little to do with banks’ prudential or AML/CFT policies—for instance there have been heavy fines for
violating sanctions on Iran. Some countries may legitimately be able to say such fines have nothing to do with business in their country. However, that is not a full answer. If one is a compliance officer in a bank and one sees that the Department of Justice has the power to levy a billion dollar fine, that has to be in a bank risk assessment.

I turn now to the impact of bank withdrawals. What happens? Bank withdrawals can potentially be bad especially for small countries because if the withdrawing bank has a significant market share, and the overall market is not very large, it is harder to quickly adapt. For countries with a small number of dominant of foreign banks, such as Albania, where at the outset of the crisis one foreign bank had more than half of the banking system, the situation can be particularly problematic. This has been the case in a number of transition economies, where there had originally been a dominant state savings bank which in the process of the transition was sold to a foreign bank. There are a huge number of benefits in such a sale that it brings in capital and new technology and management practices, but if it withdraws there is vulnerability.

Such withdrawals can have a significant macro impact. One area hit is credit growth, if the credit provided by the withdrawing bank cannot be substituted by an alternative institution. Additionally, there can be a significant impact on remittances. A number of countries are highly dependent on the flow of remittances. Remittances depend on correspondent bank relationships (CBRs). If banks withdraw from providing CBR services, this can have a major impact on the flow of remittances, and thus a significantly impact on the economy overall.

So, what is happening to address this problem? Major economies together with the international financial institutions came together in the so-called Vienna Initiative, to try to persuade the banks to dampen the withdrawals. The first stage worked fairly effectively. Banks were asked not to withdraw, or to withdraw only slowly, and to be careful from where they were withdrawing. In exchange, the banks were given assurances that the countries involved were adjusting. After time, however there was a limit as to how far this process could go. These are private banks, making private banking decisions, and one cannot ossify a banking structure of very different conditions of 5-10 years ago.
So what is the extent of withdrawals? When a bank withdraws by selling its business in a country, this is obvious. However, what has recently come to the fore now, the withdrawal of CBRs, is often a hidden but potentially very significant element in the financial relationship between a country and the rest of the world. The World Bank was mandated by the G-20 to collect information on this trend world-wide. It produced its results in November 2015. It had some interesting findings, but response rates were relatively low, so it is still hard to get a comprehensive picture.

Meanwhile, national and international bodies are being lobbied for clarificatory statements, for instance the US authorities and FATF. Thus the recent FATF statement, as a result of lobbying by various national and international bodies, clarified that banks had to KYC; they did not have to go beyond, to KYCC. It remains to be seen how much impact that statement will have.

There are difficulties for policy makers in addressing this issue. As already noted, commercial banks are making decisions based on what they see as their own commercial best interest. No national or international bodies are empowered to stop this. Also, the authorities are fragmented, whether one is looking at emerging markets, or at developed markets. The United States, for instance has, a particularly fragmented authority structure; each agency has its own autonomy. So, the Federal Reserve may not have the same position on de-risking as the US Treasury, which may operationally not have the same as the OCC, which does not have the same as the Department of Justice, which in turn has not the same as the Congress. Each of these has its own role and responsibility. Agencies have to follow their own legal mandates.

What should one do if there is withdrawal of global banks from one’s country? One solution is to try and find replacement banks. In this connection there may be a role for Chinese or Middle Eastern banks. In some places what is happening is that European and Northern American banks are withdrawing, and being replaced by banks from elsewhere. Maybe this reflects the global world as it is. Europe has a smaller share of world trade, therefore a smaller share of financial markets, and the Chinese banks are globalising. A second option would be to facilitate the expansion of domestic institutions. In some countries indeed this
conjuncture provides a positive opportunity. Earlier, foreign banks were welcomed, and domestic banks could not at that time provide much competition, but now domestic banks might have their chance. Let them expand. Whether that is feasible and desirable depends on the strength of the domestic banks and the extent of domestic competition. The risk, however, is of increasing oligopolisation; if there are only very few domestic banks and they are expanding as foreign banks withdraw, then they can solidify in an oligopoly structure. Again, referring to Brazil, which is a mega economy, when HSBC withdrew, its business was bought by the second biggest Brazilian bank, which thereby significantly increased its market share. There are now only three banks dominating the Brazilian market. As foreign banks go out, it is not clear whether this is what the Brazilian banking system needs.

Taking a regional, or sub-regional, approach may be helpful in generating economies of scale. This is an emerging trend in some regions. This present conference is perhaps an aspect of increasing focus on the region. If there are issues with a faraway country, say the UK, what about coordinating with one’s neighbour? Albania is a medium sized country. Countries around it are small, but Albania plus Kosovo plus Montenegro plus Bosnia together become a significant presence. How could this work? A long-term example could be Scandinavia. All countries in that region are very open looking. All are members of all relevant international bodies. But there is an additional bond between Sweden, Norway and Denmark, with additional banking sector MoUs between them, and even with the Baltic countries, and a high degree of cooperation—even cross-border ownership of banks in a few cases. A more recent example is from Central America. As the global banks went out from Central America, the major Columbian banks went in to the sub-region together. Also in West Africa, as international banks withdraw, Eco Bank, from Togo has expanded, and is now present in 27 countries. Also, the three major Moroccan banks have undertaken significant expansion throughout West Africa. So there is ample scope for institutions even from small countries to establish a regional presence.

Such bonding can have a number of advantages. First, it can get the financial system going, for instance to reduce the risk of a credit squeeze; Second, peer pressure can get banks to converge on a
higher standard, for instance as regards accounting practices. Indeed, a pre-condition for regional integration may well be a high degree of harmonization across the region; insofar as this is a race to the top, to reach a higher standard, this can be a significant additional benefit. Conferences like this can be very useful to foster this sort of process.

There may of course be weaknesses within the region, and integration could potentially lead to spillovers of such weaknesses. Clearly, Greek banks caused challenges for countries where Greek banks were present, while Greece itself had problems. Essentially, within a region, there is scope for diversification of risk. Additionally, regional harmonization can reduce the cost of compliance for global or regional banks. Harmonizing accounting systems for instance means that banks operating cross-border do not have to learn what for example is country X’s accounting system, because it is the same as the home system. The more one moves to the international accounting standard and other operational elements of doing business— even technical details such as operating hours—and the more these are harmonised—in the case of this region, to EU standards, accounting, and directives—the less are the costs of doing business across the region. Indeed, such harmonization may increasingly be a requirement for doing such business.

It is therefore not in a country’s interest to lag in adopting the regulatory reform agenda. Even if one does not wish to move ahead quickly, many others are. Suppose that one country intends to adopt international accounting standards by 2017, and the other in 2019. That is a big two year gap. A two year gap of doing business means everyone has to be double regulated, which doubles the cost.

Turning back to FATF, and fulfilling the FATF requirements. If FATF is enquiring about activities, prompt responses are helpful. For structural changes in the context of AML/CFT concerns, Mexico is an example. It is vulnerable because of the high share of foreign banks. Corresponding banking is also a big issue there. In this context innovations improving the domestic financial system can help. ATMs in every corner reduce the amount of cash being held. Increasing the use of credit and debit cards can further help to “de-cash” the economy, making it less vulnerable to AML/CFT
activity, and increasing the efficiency of the financial system overall. All this can add to the potential profitability of banking. It reduces the cost of banking and the risk of AML/CFT problems, because it is much easier to see if there are problems in the cash economy if not everybody is dealing with cash. If the vast majority of legitimate transactions are carried out through the ATM, or through credit and debit cards, then it is easier to identify the others. These are structural changes which are helpful to introduce anyway.

So, to continue this theme, there are domestic measures that can serve to strengthen credit growth. If a country loses banks, what can it do to get credit growth in the region in the light of new business model? There was a conference which took place last year in Slovenia for which the original thinking came from the former Governor of Bank of Albania, Mr Fullani, who came to the IMF in 2010 and told us that the dominant bank in the country was threatening to downsize or withdraw. It turned out that this was an issue across the region. A number of the countries here were also in that conference. Improving the macro stance, and improving the transparency of the country, can help to get credit going. Strengthening the banks through raising the capital levels, appropriate provisioning, and limiting NPLs show that the financial system is dramatically changing. Increasing transparency and predictability for creditor rights, and improving the ease of doing business, are also helpful. These points come up again and again when foreign investors consider activities here. The more that countries take measures in these areas, the more credit growth is likely to resume. And diversification from the banks can also help. The whole of Europe is dependent on banking. Other parts of the world encourage the development of capital markets, and that may be possible on a regional basis. Maybe each individual market is too small to really take off. London, Frankfurt, and New York are highly efficient capital markets, but they focus only on the internationals. There may be scope, in line with developments in other parts of the world, to work together within the region to bring about a second tier regional capital market to help stimulate growth in the region in the face of the changes of the business models of the banks.

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I would like to talk a little bit today about financial intermediation, financial globalization and emerging markets over the course of the last 4-5 years, how it has changed, why it has changed, the drivers behind that, and the implications for this part of the world. My first point is that the size and the nature of capital flows to emerging markets over the past few years have changed quite significantly, we think.

This is one chart, which captures that. When I think about capital flows, I tend to divide them in three of four categories. FDI's being, if
it is going to the tradable sector, the most beneficial and the stickiest form of capital, as well as the least likely form of capital to reverse. When I think about the more likely forms of capital to reverse, I think about portfolio flows. So, on aggregate, between 2001 and 2009 net portfolio close to emerging markets globally were negative. There were about USD 230 billion of outflows. That corresponded with a region of the world producing consistent current account surpluses over that period. Between 2009 and 2013, we saw inflows of USD 850 billion. Essentially, we saw much more inflows in the last few years than we have seen in the history of emerging markets. This is quite significant for financial stability.

We’ve seen similar trends in terms of foreign bank exposure. I think Charles [Enoch] has detailed extremely well how strong relationships between foreign banks and banks in emerging markets seems to be breaking down, but when you look to the BIS data there seems to be foreign banks still allocating money to banks in emerging markets, at least in some emerging markets, but probably with less ties, less commitment, less foreign ownership than was the case in the past, certainly, than was the case in Central and Eastern Europe in the lead up to 2008.

I want to make three points here. One is that part of this is a natural catching up process as emerging markets play a larger role in the global economy. It is only natural that they account for a larger
portion of global capital flows. But, the pace of that catch up I think is very important. *Second*, I think these trends are becoming a little bit more problematic to the extent that over the course of the noughties what we have was an emerging market region, which went against the textbooks.

So, what the textbook tells us should happen to the extent that the EM as a whole was running a current account surplus. If I strip out China from emerging markets right now, what we have is a very quick shift from current account surplus in the last decade back into current account deficit. That means that emerging markets as a region are much more reliant on foreign capital inflows today than was the case in the past. And I think my *third* point here is probably very obvious, the push factor, in particular for this portfolio flows, I think over the course of the last few years was the unconventional monetary policy in the developed world. So, it was QE1, QE2, QE3 and part of what the ECB is doing right now as well. There is a lesson to be learnt from that I think. If we question whether that money was well spent or not, part of analyses that I have done at least, suggests that money did find itself in the non-tradable sector, at least some of it, and did generate some imbalances in some emerging markets. Essentially, I guess what was happening was that, this is a generalization but we think that portfolio flows were financing growth in non-tradable sectors, because in particular in the course of the last couple of years, global trade growth has slowed significantly and we are not getting
growth in tradable sectors and emerging markets were doing the best to continue to post pretty decent growth rates.

This chart is designed to capture that. What you see here is a very simple metric of the size of the tradable sector relative to its five-year average versus a metric of balance of payments stress. If central banks across the emerging markets these days had to step in and use reserves to cover a year’s current account deficit and a year of reversal of portfolio flows, how much of the reserves would they need to use. What we have here is a very sharp differentiation across emerging markets right now. Thus, we have what we tend to call the low yielders or those economies which are forced to pay very low levels of interest rates to issue debt these days. Those economies have seen a large rebalancing in their tradable sector. So, despite the slumping global trade they have somehow managed to maintain higher export growth, than they have seen in the non-tradable sector. Those economies are also economies that are less vulnerable to balance of payments stress. But, if we look at the number of larger emerging markets such as Indonesia, South Africa, and Brazil, a lot of capital flows, of portfolio flows that ended up in these economies weren’t used to the most efficient extent.

What does all this mean for the Balkans? Probably the Balkans have a lesson to teach emerging markets more broadly to the extent that the risk is over the course of the next few years that emerging
markets are forced to undergo some of the deleveraging that the Balkans and the newer EU states had to undergo in the last four to five years. From that perspective, if there are negative spillovers from EM more broadly into the Balkans and into the new EU states, to the extent that bank deleveraging, at least some of it has occurred, it creates a little bit of a caution, compared to where we were back in 2008. What does that mean for the new model of financial intermediation in the Balkans going forward? This is a very personal view but I would argue strongly against a return to a model of credit growth, where it means access to deposit growth, funded by foreign financing.

In the first place, I think it’s unlikely that those capital flows materialize. If they do materialize, I think the lessons of the last five years for Central and Eastern Europe are that there needs to be a more aggressive regulatory approach this time around. When I say that I mean things like higher liquidity requirements, foreign liabilities, higher capital adequacy requirements, arguably, as foreign liabilities grow, tougher domestic measures in terms of loan to deposit ratios, loan to income ratios, a ban on fx funding if we see credit escalate again. My bias is to say that we are not going to see these flows return at least not over the next 2-3 years. If my theory is correct and my concerns surrounding capital flows to emerging markets materialize, as unconventional monetary policies around the world begin to be unwound, emerging markets enjoy much less in terms of foreign capital flows going forward.

The question that is probably the most appropriate when I think about financial intermediation in this region is: How to maximize the limited pool of foreign capital still positive that the region will be able to attract going forward. Put in another way, how do we ensure the maximum amount of capital flows to the private sector to support growth in the region? This comes down to what has been mentioned many times before and there are people who understand this much better than me, the NPLs issue in the region seems a very obvious hurdle, to credit growth. It also comes back to the fact that healthy financial intermediation requires healthy fiscal solvent balance sheets. It does require some progress and structural policies. There’s a lot of hard work being done in the region on fiscal policy
right now. I looked at the IMF’s forecast this morning. Albania is on track to bring its budget deficit within 3% of GDP for the first time that I could find in the IMF’s records, in 2017. This should bring benefits. And Albania’s not alone. There are other countries in the region with an IMF program that I think are surprising to the upside, right now, also.

But it probably needs to go beyond that and to think about the role of the SOEs, to think about the amount of population and the workforce, etc. So, for me, I guess when I think about financial intermediation in this region, I think there are considerable challenges, but there is still a lot of progress to be made. I think the risk is that the burden of the adjustment falls on domestic policy going forward rather than success or an ability to attract very large capital flows.

Thank You!

* Gillian Edgeworth, Senior Member of St Antony’s College, PFEM, & Wellington Management.
FINANCIAL INTERMEDIATION: WHAT HAS CHANGED DURING THE CRISIS?

Aneta Krstevska*

The last global crisis affected economies around the globe through different channels, in multiple ways, therefore imposing specific challenges to the policy makers. In this framework, many economies faced a weaker financial intermediation by the banking systems that in the economic literature is found to be a usual consequence of the crisis (Calvo et al. (2006), Claessens et al. (2009)). Regarding the driving factors, Bijsterbosch and Dahlhaus (2011) found that slowdown in lending after crisis period in many cases was combined with a decline in economic activity, financial stress, high private sector indebtedness or reliance on foreign capital flows.

This analysis will focus mainly on financial intermediation in the South-Eastern European countries (SEE), trying to provide answers on the questions: what has changed during the crises period and what are the reasons for these changes? Furthermore, the analysis highlights the experience of the National Bank of the Republic of Macedonia (NBRM) in dealing with these issues.

REGIONAL OVERVIEW

Starting from the regional perspective, in the last couple of years, after the acute stage of the crises, in most countries of the region there is some continuation in the financial intermediation deepening,
although on a much slower pace comparing to the previous period. In dynamic terms, regarding the credit relative to the GDP or the credit growth rates, in most of the countries (except Montenegro), there is some pick up comparing to the acute stage of the crises. But, credit growth rate in the last couple of years is not even close of what we had in the pre-crises period, although, one can argue that the credit growth rates in the pre-crises period were pointing to excessive credit growth.

What happened during the crisis period was that deterioration in the external environment was transmitted to the domestic economy resulting in declining in both supply and demand for loans. Hence, what actually changed during the crises regarding financial intermediation and generally speaking about the economies of the region? First of all, there was a slowdown in sources of financing regarding both deposits growth and the foreign liabilities of the banking sector from abroad. The slowdown in deposits was mainly related to the economic downturn, but also uncertainties during the crises period, pointing to the weakening of the other side of financial intermediation regarding mobilization of deposits. Thus, it is not only about intermediation on the side of the credits but also on the side of deposits, as well. In addition to that, there was a slowdown of liabilities from abroad pointing to the lower availability of funding mainly from the foreign parent banks. This is a kind of explicit form of deleveraging that countries of the region have experienced.
In addition to that, some of the countries in the region were facing different types of implicit form of deleveraging from banks from abroad. Currently, this is pointing to the fact that the banking system in the region should focus, especially in the current period, mainly on strengthening the funding from the local sources of financing.

What do we have as a result of these developments with regard to the sources of financing? Chart 2 shows that, in the last couple of years, in most of the countries in the region there has been an increase in the loans to deposit ratio, pointing to the better use of the available funds in the banking sector.

What do we have as a result of these developments with regard to the sources of financing? Chart 2 shows that, in the last couple of years, in most of the countries in the region there has been an increase in the loans to deposit ratio, pointing to the better use of the available funds in the banking sector.

Chart 3 What has changed during the crisis: credit risk under concern…

Source: National Central Banks.
Another important change, is that the credit risk became under very high concern for all regulatory authorities in the countries of the region, although, especially in the last year, there were some movements towards decline of the non-performing loans (NPLs) ratio. However, the NPLs ratio in the region is ranging from 11-20%, which is still relatively high.

It is worth mentioning, however, that in some of the countries like Macedonia and Serbia the NPLs are very well covered by impairments, around 100% coverage. Another important change during the crises, which is related to the previous two factors, is the deterioration of the profitability in the banking sector in most of the countries, during the crisis period, with some gradual improvements in the latest years (chart 4). Actually, this deterioration in profitability in many countries, including here Macedonia, reflected different aspects of the banks’ lending strategy.

![Chart 4 What has changed during the crisis: ...resulting with lower profitability, although quite solid CAR and liquidity of the banks](chart.png)

However, what is important to mention in this general picture is that capital adequacy ratio and liquidity position of the banking sector across the region are quite solid and stable, pointing to the soundness of the banking sector.
MACEDONIAN CASE

Overall, the Macedonian banking sector fits in this general picture for the region; however, there are some additional specifics of the banking intermediation.

At the beginning, it is important to mention the positive change regarding the currency structure of the lending that, in the last couple of years, has been mainly in favour of the local currency. This change has been primarily led by the changes on the side of deposits. Actually, during the crises period we had the process of the de-eurozation, mainly due to higher interest rates on deposits in the local currency and therefore higher return on instruments in the local currency and therefore higher return on instruments in the

Chart 5 Financial intermediation – Macedonian case: Positive change in the loans’ currency structure

Chart 6 Financial intermediation – Macedonian case: Loans’ structure by sectors in the last years changed mainly reflecting credit risk concentration by sectors

Source: NBRM.
local currency, as well as the overall uncertainties in the euro area, especially after 2011. This change in the currency structure on the side of deposits was reflected also on the side of the loans. Now we have most of the loans extended in the local currency. This is especially important for a country like Macedonia with peg exchange rate and additionally this change is in favour of the improvement of monetary policy transmission mechanism.

Another change that we have been noticing in the last couple of years, is the fact that there is a change regarding the structure of loans by sector, mainly turning in favour of the household sector. This is something that is going on in line with the concentration of the credit risk by sector, which is mainly linked to the loans to the corporate sector. On the other hand, the overall risk perceptions about households sector by the banks probably are at a much lower level, considering their granularity.

Moving towards the monetary policy, one important issue in this context would be: what is the contribution of the monetary policy regarding the improvement in financial intermediation process that was obviously impaired during the global crisis? First of all, during the crises period like in many other countries, the monetary policy of the NBRM was accommodative, with declining rates of the main policy instrument, currently set up at 3.25%, which is historically lowest level. Having in mind relatively low inflation and stable exchange
rate, there was a room to implement the accommodative monetary policy that was supportive to the credit growth. In addition to that, we have taken several steps towards relaxing of the other monetary policy instruments, including the reduction of the interest rates in the deposit facility we have available for the banks. During the crisis period we noticed that the banks showed high preference for liquid assets, not only for government instruments but also for the deposit facility of the central bank, especially on seven-days deposit, since these are risk free investments. By this gradual reduction of the interest rates on deposit facilities we sent a clear message to the banks that they should use these instruments mainly for fine-tuning purposes and not like a regular investment opportunity for them. Currently, the interest rate for this deposit facility is quite low, slightly above zero, anyway we still have interest by the banks for this instrument, still pointing to the fact of the risk aversion of the banks.

In addition, it is worth to mention that during the crises period we had a wide use of reserve requirements ratio. It was a relaxed in several steps, in a couple of ways. The first point was to make a differentiation of the ratio in favour of domestic instruments, thus we had decreased the requirements ratio for domestic liabilities and increased the requirements ratio for the foreign currency instruments, hence definitely supporting the positive trends that we had regarding the de-euroization process. Other types of changes in the reserve requirements ratio were in favour of the long-term

![Chart 8 Accommodative monetary policy](chart.png)

Chart 8 Accommodative monetary policy

- RR ratio for Denar liabilities
- RR ratio for domestic liabilities with fx clause
- RR ratio for fx liabilities
- Deposits of households over 2 years
- Deposits of households in Denars over 1 year

Source: NBRM.
savings instruments and savings by the households, somehow stimulating the intermediation on the side of deposits. Additionally, we had a kind of a non-standard use of the reserve requirements ratio during the crises period that started from 2013 and it will be valid until the end of 2015\(^1\). Thus, for limited period of time we have no reserve requirements for loans extended to the export and energy companies, thus supporting the recovery of the economy, and especially important sectors of the economy, contributing to the overall lending to corporate sector, since that is the area in which we registered some slowdown.

What are the banks saying about lending conditions to the corporate sector? Based on the answers from the bank lending survey of the NBRM, we note that after the acute period of the crises further on the banks reported for some relaxation of the lending conditions to the corporate sector, overall. This relaxation started especially in the last couple of years, after 2013. On the other hand, the relaxation for lending to households, started earlier, in the summer 2010. Importantly, this relaxation to corporates is mainly related to declining interest rate, followed by the relaxation regarding the amount and maturity of the loans and non-interest revenues, but less in collateral requirements.

It is true that banks reduced interest rate for loans to the private sector of the economy both for the corporate and households.

\(^1\) At the end of 2015, it was prolonged for two years more.
However, they have reduced the interest rate much strongly on the side of deposits, therefore, widening the interest rate spread, especially in the last couple of years, in favour of banks’ profitability. This is the issue that is raising questions regarding the efficiency of the banking sector, competition, intermediation on the side of deposits and banks’ business model.

The efforts about NPLs resolutions are necessary for probably all countries in the region. The stipulations in the new credit risk regulation of the NBRM, which came into force in mid-2013, support NPLs restructuring as well as the sale of foreclosed assets by the banks and so far there is some success regarding to restructuring
that is obviously shown on chart 11. In addition, it is important to mention that our analysis have confirmed that in most of the cases (in 60-70%) this is a successful restructuring. It is important to highlight that the NPLs of Macedonian banking sector are at quite moderate level. There was a jump at the beginning of the crises, anyway in the last couple of years they remain at stable level of around 11%. However, we already undertook some measures regarding the resolution of NPLs on a more sustainable base.

Table 1. Access to loans

<table>
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<th>Country</th>
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<th>Country</th>
<th>Ease of access to loans</th>
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Source: Global Competitiveness Report 2015-16, WEF.

Table 1 shows the ranking of the countries of the region according to the Global Competitiveness Report of the World Economic Forum, for 2015. These rankings are according to the soundness of banks and ease of access to loans. The ranking is based on the surveys of the economic agents, so it is mainly based on their perception. It is difficult to explain the differences between the countries (without information about countries’ specifics), but what is common for the region is that the ranking regarding soundness of the banking sector is much better comparing with the ranking regarding the ease of access to loans. This points to the fact that perception about the soundness of the banking sector is much better and, in general, it is a really valid conclusion considering what has been mentioned above - the capital adequacy ratio and liquidity position are generally strong, there was no systemic banking crises across the region, besides the turbulences in the external environment and besides the fact that in many banking sectors across the regions there is very high presence of foreign (especially Greek) capital. Thus, generally speaking, the
banking sector across the region is quite stable and sound, but there is a need for improvement in the quality of banking services, efficiency and competition in the banking sector.

CONCLUDING REMARKS

Some of the concluding remarks have been already mentioned above. It is necessary to add that economic recovery that is on-going in the region definitely builds support regarding further strengthening of the financial intermediation, on both deposits and credits. Also, central banks could play a proactive role in strengthening financial intermediation. At the NBRM we had positive results in this view, however it is worth mentioning that we are speaking of a period in which the monetary policy is accommodative and we can take into account that maybe sooner or later this situation can change. In addition to all these elements, there is a need of further restructuring and reform in the banking sector in view of further strengthening the financial intermediation. Anyway, we should take a look at the broader picture. In spite of many years of the transition, the financial system in Macedonia is mainly bank based (which also generally holds for the other countries of the region). Bank lending is still the main source of financing to the private sector, while the stock exchange did not undertake the role of alternative financing source of the private sector. In addition, we are still missing some important institutions in the financial infrastructure, starting with the agency for dealing and trading NPLs of the banks and other institutions that can provide alternative financing sources for the private sector. Thereby, we can speak of easing the access to loans but we need to have in mind the issue of easing the access to finance in a broader sense.
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* Aneta Krstevska, Chief Economist, National Bank of the Republic of Macedonia.
I’d like to start with a phrase that is familiar for everyone, although it may have a negative connotation, i.e. the “great depression”. It was widely used in the last decade whenever an economic downturn was experienced. But, in the last years, that phrase is highly competing with another phrase, which is becoming equally known the “great recession” referring to the last financial and economic crises. This means that the last crisis have been as important as the great depression for the financial system and the economies all around the world.

Actually, the financial crisis and economic crisis are closely correlated, as one crisis is transmitted to the other, regardless of which starts first. The same correlation was noted in the last crises, when although all the economies around the world felt signs of the crisis, its origin was actually narrower, arising from the financial system. If we go deeper down in the financial system, the crisis originated from the financial intermediation sector.

In the international economic domain, financial intermediation is actually no longer equal with the banking system. This leads to another essential difference of the last crises against the previous crises. While the origin of the crises was in financial intermediation, the source was not always a bank. So, often the crisis originated from another financial intermediator, a non-bank financial institution.
In Albania, however, we still use the two terms, financial intermediation and banking system, interchangeably, because the difference between the two is still very small. However, albeit having a very small share, we should not leave out of focus other non-bank institutions of the financial system, which, although having a small share, are becoming increasingly significant actors in the financial setting in Albania. Yet, we are in a very comfortable and safe position to approximate the financial intermediation system to the banking system, as the banks are the ones that have the largest share within this system.

Having said this, we need to bear in mind that another actual concern in the international financial world is the so-called shadow banking. Given the high stress and tight requirements for the banking system from the regulator, intermediation activities are shifted increasingly from the banking to the non-banking sector, also known as the “shadow banking”. This is becoming another global concern.

The non-banking sector has to be better regulated and controlled with the same attention and diligence as the banking sector. Albania, however, is in a favourable position in this regard, as we learnt the lesson at the cost of advanced economies. So, I think we will be better prepared in managing developments in this sector in order to prevent them from becoming a concern to the economy.

Next, I would like to focus on the Albanian intermediation system and point out some changes and developments to that system in the post-crisis period.

To describe a system that is still developing and to understand its features, we need to analyse the factors that determine its development trajectory and profile. There are many factors that influence the shape and the stage of any financial system, but I would like to focus on those groups of factors that are most representative of this system in Albania.

There are five groups of factors that are accepted as adequate perspectives in this analysis: system structure, legal and regulatory ambit in which this system operates, financial cycle and balance sheet quality of financial agents, level of integration in the international financial markets and, lastly, so-called extraordinary events.
Let us see them in greater detail.

The main indicator is the first group of factors, the structure of the financial system. The chart below briefly presents the Albanian financial system, in three blocks: type of operating institutions, markets and supporting infrastructure.

<table>
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<tr>
<th>Determinants of FINT</th>
<th>Financial system</th>
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The first, and the main block, is about the institutions within Albanian financial system. The following describes the first block in greater detail. Unlike for the first block, not much may be said for the second block. Markets in Albania have still a long way to go. In capital markets, only government securities are traded. The equity market in Albania is not functioning. We have an interbank market,
but it is not very active. Yet, trading in the foreign exchange market is competitive.

Referring to the third block, supporting infrastructure, we have good payment systems for both domestic and foreign currency payments. We have a credit registry in place that is not very advanced, but one of the current plans of the Bank of Albania is to review and replace it with a more advanced registry.

Turning to the first block, the structure of the financial intermediation shown in the table, I would say that financial intermediation in Albania continues the positive trend, as the ratio of assets of the system to GDP has always been growing. This means that this sector is becoming increasingly important for the Albanian economy. Also, the banking system within this block is evidently in a dominant position.

But, I would like to point out a change in it. Unlike the period before the crises, a new player, i.e. investment funds has entered in the system. It is expanding rapidly, so it needs to get addressed, to be in the focus of the supervisory authority. The non-banking sector in the system already has a 10% share, the highest level compared with the previous years.

Thus, this overview of the structure and development of the financial intermediation system in Albania shows a system wherein new types of financial agents are entering, with their share increasing rapidly and creating new roles in the economy. Therefore, additional attention should be paid to them by the regulators. The second important determinant of the development of our system is the legal and regulatory framework.

Under this topic we should consider the strength of the supervising authority, the power it has to interfere in the market, the power it has to impose ruling the system and the sources available to it, to play its role. We can certainly say that our central institutions are well equipped and there is no significant weakness identified in this regard.

The other aspect of this topic is the supervision power itself. How strong the supervision authority is to orderly regulate the
entry and exit of the market. In Albania, we do not face problems for entering the market; yet, we do have problems regarding the orderly exit of any distressed market agent. That is a very valid point. Importantly, the Bank of Albania has already started to address several projects with international support. We are working now to draft the resolution law, which addresses the orderly market exit. We have not suffered from these issues so far, because the crises did not put us in front of any insolvent institutions, but the world suffered a lot. Various countries managed to save the public interest only through instruments using tax payer funds. Albania, however, has the chance to reflect and draw lessons from the experience and at the cost of advanced economies. So, we are preparing in case it happens, to ensure that taxpayers will not be affected, unlike other international bodies that have been obliged to it.

Another very important point here about the legal framework of our system is how well defined the relation is between the borrower and the lender. We have to say we have a strong contract between the parties. After the crises, we have seen some positive changes in terms of increasing the transparency of the contract in light of protecting the consumer rights. We may say the situation is good, and even better than before the crises.

The last but not least issue of the regulatory framework is the reporting system: how good and reliable it is. We have a good and reliable reporting system. The Bank of Albania is one of the three agencies producing statistics, very good statistics, but we are not happy with the infrastructure. We are investing in that aspect in order to be in full compliance with the international standard of reporting.

The third determinant aspect is the financial cycle and balance sheet quality of the system. The full view of this aspect for Albania is shown in Chart 1.
Regarding the financial cycle in Chart 1, we notice that the positive trend continues. The system keeps expanding although at a lower rate of growth. Therefore, we do not have a problem in this regard, although the trend sloping up is somewhat slower than it was before the crises.

The second point, the quality of assets, is our daily concern. In other words, we have a high level of NPLs. In Albania, the NPLs have some specific characteristics. First, it is still among the highest in the region. This is not a good thing to say, but it’s true. Second, the NPLs reflect our concern for the high portion of unhedged loans. As you may see in the second graph of the chart, the NPLs in foreign currency loans are
higher than in domestic currency loans. This is a concern experienced across all the banks. That is why the trend in the system is that borrowing is increasingly more oriented toward the domestic currency than to the foreign currency, which has been heavily used before the crises.

We also have another concern to point out again; we have a different level of NPLs for corporates and households. The NPLs level is much higher for the corporate segment, and firms in Albania are in net debt to the banking system; they have more loans than deposits within the system. The opposite is true for households, which have not only lower NPLs but also a net creditor position; they have more deposits than loans in the system. The forth aspect is the level of system integration.

It is very important for the financial system working capacity to be integrated in the international markets. There are three indicators to measure the level of integration that we may use for our purpose here. The first one is the high presence of foreign banks in Albania. Around 86% of our banking assets belong to foreign investors and this is a good level of integration. Another indicator is the significant presence of the foreign currency within our balance sheet. We can see that more than 50% of both assets and liabilities are in foreign currency. Our position to non-residents is another indicator that is slowly having a different shape now. We can see in Chart 4 that, in the last year post crises, the assets that we have with non-residents are increasing continually versus liabilities that we have to non-residents and the gap between the two is expanding.
The last group of determinant factors is usually called extraordinary events.

What are the extraordinary events marking the Albanian system after the crises? First, the crises itself and second, the implementation of the Single Supervisory Mechanism in November 2014. Both of them are very important events, because they introduce many changes in our system.

1. Global Financial crises of 2007, with ongoing implications for:
   - Banking and financial sector activity;
   - The role of central banks and regulatory authorities;
   - The relationship between banks and the sovereign.

2. Given globalization, financial (and political) integration processes, all countries are feeling the impact!
The crises have changed the authority’s role. Now the central bank is talking about systemic risk, systemically important banks, financial stability, which were not the concern before the crises. It has also introduced significant change in the system itself, in the market. For example, in the period after 2004, we always agreed to say that foreign banks used to be the source of know-how, of growth for Albania, and that was the case. But now we are talking about potential deleveraging, about risk strategy of parent banks that may create a problem in our market, contingency plans from parent banks, etc. The role of foreign banks now in Albania is not the same as it used to be before the crises taking into account that what is a significant for a bank in Albania is not equally significant for the parent group.

The other extraordinary event is the implementation of the Single Supervisory Mechanism (SSM). What will its impact be on Albania? Around 53% of the assets of our banking system will fall under the jurisdiction of that mechanism, which might have some consequences or challenges for our market, for our system; however, I’m sure there will be positive effects. For example, positive spillovers, because the implementation of the Single Supervisory Mechanism (SSM) on the EU banking system means more or better financial stability for that country, thus only positive effects may spill over from them.

The second and very important effect: lately we signed the memorandum of understanding with the European Banking Authority, which will allow our people to be part of colleges of supervisors. This will be a very good and important development for two reasons: it will be a training school for our staff; and, it will be a very good source of good and timely information. Last summer, during Greek uncertainties, we suffered from this lack of information and, by taking part in these colleges; we will not have this problem anymore.

Last but not least is that being part of the SSM jurisdiction for at least seven of the banks in our system, means that those banks will have better reporting and will be more in compliance with the rest of the group, which means less cost of operation and reporting for at least seven banks in Albania. One of the main concerns that
continues to be present for Albania is deleveraging. The strategy of any of Albanian parent banks may happen not to be in line with our national economy interests. This is what needs to be under the focus of our central authorities and addressed in case it happens to come true.

Lastly, all we said today was related to the post crises effects. Yet, the crisis is on our table and I’m sure the professors are still thinking the same question: why did the economies fail? Everybody may have answers, we have our answers, or at least I believe that the answer for Albania, and this it is my personal belief, maybe because we forgot to control the growth rate for credit and maybe this is the mistake that other countries with lower NPLs did not. Or, maybe it is time to think about so-called malinvestment. My belief is that we are not in the position of overinvestments. I am saying this because I know very well that the part of NPLs stock is composed by not-yet-finished investments, so I may call them malinvestments.

Thank you!

* Natasha Ahmetaj, Second Deputy Governor, Bank of Albania.
Emerging Europe seems to have lost its attractiveness and confidence in the post crisis period. Have recent regional and global developments altered the fundamentals of the business in emerging Europe or the fundamentals in the foreign partners? What is the correct policy response?

Moderator: Charles ENOCH,
Deputy Director, Western Hemisphere Department, IMF
and SEE.SOX

* Summary of contributions to the Governors’ panel discussions on Misunderstanding/misjudgment vs. reality.
Ladies and gentlemen, I am very privileged to be here chairing a very-high level panel of very eminent colleagues here: Gent Sejko, Governor of the Bank of Albania, Turalay Kenç, Deputy Governor, Central Bank of the Republic of Turkey, Giuseppe Parigi, Head of International Relations Directorate of the Banca d'Italia and on Bedri Hamza, Governor of the Central Bank of the Republic of Kosovo.

I think it could be very exiting from all these countries of the region to hear their prospective.

The title of this session itself raises a lot of questions; it is quite a leading one: “Misunderstanding/misjudgment vs. reality”. Are people here over-depressed? Has the region over lost its confidence? We have heard a lot about the fall of direct investments, slower growth etc. this morning. Is that the new reality which we want to adjust, or is it that the fundamentals are stronger, the good things which are going on, that one should adopt, one should stress the positive that people see in the new reality.

I think we will have one or two rounds of discussions of my colleagues in the panel, and then there should be the opportunity for questions from the floor, either to individual panelists or to everybody. To start my first question is: Do you have any initial
comments on “is there a misunderstanding of the reality”? Or are we unnecessary depressed? What are the greatest things going on here, some of the positive elements for the region? Is there that more could be said about these positive elements?

I have a second question for the panellists. Each of them is a central banker, and I was myself a central banker before I went to the Fund. I was at a conference some years ago, where the Fund actually had a group of Europeans talking to Arab central bankers about the role of central banking in the modern world. I was explaining how the Bank of England had closed department after department. Since I arrived, we had an exchange control department, we had a registrar’s department and basically in the end it became very narrow. It’s just basically a monetary policy committee deciding on the interest rates. That has changed since the global financial crises for a number of reasons the central banks have, in some ways, been able to do more than other agencies, and monetary policy has more of a role than might have been expected. Quantitative easing is not everything.

I would be interested to hear from each of the four panellists - has there been a rethinking of the role of central banks? What is the role of central banks? We are talking here about health reform, education reform, which is excellent, but the central bank is not a health agency. As you just mentioned, it is a PR, it is to lobby for it, to explain it. What is the role of central banks in each of the countries now in taking progress forward?

* Charles Enoch, Deputy Director, Western Hemisphere Department, IMF and SEESOX
I would like to start with a positive note and emphasize that the Albanian economy has weathered the global crisis well and withstood it successfully. Despite negative developments in the global environment and in our immediate trading partners, the Albanian economy did not experience recession or large price fluctuations during the global economic downturn. Yet, developments had a significant effect in terms of growth rates, which shrank from 6-7% to below 1.5%.

The global economic downturn was preceded by a period of sustained and high growth rates supported by credit and fast expansion of financial intermediation and development of the nontradable sector. Following the crisis, both factors shrank and so did economic activity. Growth has picked up, however, and last year it stood at 2%, while we seek to reach the level of 2.5 - 2.7% growth in 2015. Most important, nonetheless, is the upward positive trend of growth. Our analysis indicates that to boost further economic activity, we need to attract more foreign direct investments (FDIs). The domestic market does not provide enough capacities to support the higher growth rates that we really need to have. The expansion of economic activity would largely benefit from foreign investments in new industries, in particular in the tradable sector. The alternative financing that would boost growth would be FDIs. Albania received significant FDIs.
inflows, especially in the financial and banking services, in the pre-crisis period. The banks that operate in Albania today gave a successful impetus to growth, and had a positive impact on the development of the domestic market. Apart from aiding financial market with know-how and capital, foreign banks contributed positively to the entire economy by providing strong financial support to economic activity. When foreign banks entered the Albanian market more than 10 years ago, they started a process of rapid financial intermediation, and provided the economy with ample credit. Soon everybody was following suit, resulting in increased market competition and fast credit growth. This, in turn, caused faster increase in consumption and investments in other sectors. Other industries were growing as well and as a result FDIIs flowed in telecommunication and other sectors of the economy.

That was a development that spanned the entire region. At that time, investors, especially the large European and international ones, considered the entire Southeast European region as a whole and assessed it to be a profitable and attractive market. Investors were much more focused on the region, its EU integration perspective and the perception of economic prospects was very positive.

Although it was not generated in the region, the crisis would make its presence felt. It was an imported crisis of course, but it took advantage of the already existing vulnerabilities that our model of growth had created. It burst in 2008 in the US and through its spillovers effect started to spread, becoming a sensitive issue for every market worldwide. The impact of the shock would not be felt right way, and the economy glided peacefully for another couple of years on the support of higher fiscal expansion. It was generally believed that our economies were probably not sufficiently integrated with the international markets and were, therefore, immune to the crisis. We used to believe that it was likely the crisis would spare the region. Unfortunately this proved not to be true. The effects of the crisis eventually would be felt and, because of it, our economy is still suffering in terms of low investments, consumption and credit and economic growth, as well as in terms of undershooting inflation, which during the last three years has been below Bank of Albania’s target. However, there is significant potential for faster economic
growth. Several sectors, especially the tradable ones, can benefit from faster credit expansion, increased productivity and overall structural reform. Growth potentials remain high in the region. Southeast European economies possess the same comparative advantages as before, and across the same sectors.

In terms of the financial market, I would like to emphasise what was mentioned earlier today, that the banking system and the financing sector have remained stable and sound in face of the global crisis. Banks have adequate capital, and ample liquidity to run their business profitably and to support the economy. The money is there, the potential is there, the capacities to support growth are there. What is missing is the aggregate demand from the real economy. Demand for investments and consumption has been weak. Demand for credit is very low as well, due to the heavy burden of existing debt, unperforming loans and pessimistic expectations in the economy. Though there are some ongoing projects, the expansion of credit remains slow as the financial sector is facing difficulties in identifying serious and healthy investment projects. We hope that the positive effect of the recent structural reforms undertaken by the government and several legislative and regulative amendments with regard to the resolution of non-performing loans will help to overcome most of the existing problems and will introduce the much needed optimism and increase confidence in the Albanian economy.

The central bank has been pursuing active monetary and macroprudential policies– by following a very accommodative monetary policy and by trying to incentivize bank lending. There have been clearly positive results, though not always at the desired level. We need higher than 3% growth, in order to have a prosperous and converging economy. Are we going to reach that growth? Are the reforms going to have the expected results?

Bank of Albania’s monetary policy has been successfully and fully transmitted to all market rates in the economy, including bank lending rates. The speed and the extent of policy intervention reflect several factors beyond developments in the real economic activity and inflation. One should also keep in mind that the Bank of Albania is also in charge of preserving financial stability. In this respect, the high
level of NPLs remains a problem that needs careful consideration and its resolution has to be managed properly. We need to find an equilibrium situation between credit expansion and the resolution of non-performing loans. However, credit expansion and credit quality reflect neither price nor bank stability problems. On the one side, we have a very good, very robust financial system, with ample liquidity and adequate capital; on the other side, we currently face a very weak demand for financial intermediation. The situation reflects first and foremost pessimistic expectations and outstanding debt burden in the households and private sector balance sheets.

The crisis revealed a fundamental problem in the domestic economies of the region, which increased the probability of contagion: the unbalanced path of the absorption growth model on which the region had relied on. Fast credit expansion, especially unhedged foreign exchange loans in support of consumption and investments in the nontradable sectors, were simply unsustainable. In Albania, this became evident even before the crisis, leading to a countercyclical policy response. When the crisis hit, we had already begun to undertake certain reforms in financial markets to curb the fast growth of foreign currency lending, and increased the policy rate to cool down excess demand. Following the crisis, and financial market developments, the central bank lowered the policy rate, implementing a very active accommodative monetary policy. In the meantime we undertook several macro- and micro-prudential measures to incentivize lending and encourage economic growth. However, there is a significant hangover, which prevents the revitalization of credit investments and growth.

Therefore, in order to incentivise serious business projects, it is important to increase foreign direct investment inflows. This is why we consider structural reforms as vital to insure continued economic growth. Albania has undertaken several structural reforms, such as the pension reform, energy reform, and fight against informality in addition to some legal reforms related to the financial sector, including the Deposit Insurance Agency. These reforms are undertaken simultaneously and sometimes, when they are all carried at once, especially during a crisis period, they are even more painful and harm economic optimism. This is why we need to be able to prioritize the
reforms that are more crucial for providing growth and attracting foreign direct investments. We are well aware that we need to improve swiftly the legal system, fight corruption, formalize the economy, and so on. I fully agree with the colleagues that some reforms take time to materialise and yield the expected positive effects. But, if we manage to prioritize our goals, I am sure that results will follow.

It is important at this stage to have a continued communication with the public. This is very crucial not only to the successful implementation of the reform but also to lessen or contain potential negative side effects in the short run. For example, we are currently undertaking reforms to reduce informality in our economy. I believe we should explain to the public why high informality is harmful not only to the society overall, but also to individuals and businesses that operate in it. In order to build proper expectations, the public should be well informed that these reforms yield longer-term results.

However, as Governor Hamza also underlined, the success of reforms depends largely on political consensus and political stability. Whatever reforms we undertake, whatever progress we seek, would be nullified unless we have political stability. The political stability in the region is very fragile and this stability is an advantage for the countries where foreign direct investors are really counting.

The bottom line is that we need to boost growth, and reforms are necessary to achieve and sustain faster growth. The potential is there, but remains unexploited due to the lack of confidence, which influences negatively investors’ sentiment and private consumption. We all know economic developments are correlated to each other. This has the potential to build into a falling spiral of growing unemployment, reduced personal income and private consumption and investments, leading eventually to further pessimistic expectations. Alternatively, in a very optimistic economic environment, higher income expectations boost consumptions and investments, which generate additional economic optimism. So, I would say that all the reforms should aim to change this mentality, to change this environment, and to bring back renewed optimism. This is what the Bank of Albania is doing and this is why our monetary policy and macro-prudential measures have been expansionary and supportive of credit expansion.
Before moving on to the question regarding the role of central banking I would like to stress that the country cannot be viewed as a separate entity. We live, we operate and we interact economically in the entire Southeast European region. We share the same development trends, the same investors and have many other economic synergies in the region. We must exploit and further increase these synergies with the neighbouring countries. Smarter and better coordination will expand economic potential of the region. Synergies in markets, products and reforms will generate and spur better and faster economic growth in the region. This will make the entire region more attractive for FDIs from our traditional partners and beyond, and will increase investment opportunities. In the near future, it is crucial for the region to coordinate efforts, create an increased synergy, and adopt a common approach.

We can turn to the banking sector for a very vivid example of regional cooperation. The crisis has changed the perception of the region and has challenged the business model of some banks, which are currently finding it not very profitable to operate in the region and would like to benefit from mergers or acquisition with larger institutional partners. This is a crucial problem faced by all countries in the region, which would be addressed optimally through continued cooperation. What we have observed nowadays is that large financial institutions are pursuing deleveraging policies as there is simply not enough interest to invest in the region anymore. Previously, our financial markets benefited from the entry of large financial groups. In Albania, we were lucky that large financial groups chose to invest in our financial system via green field investments, privatizations or mergers and acquisitions. We conducted a successful transformation of the banking system before the crisis and were satisfied of their presence in the country. These investments gave a positive and significant impact on the expansion of financial intermediation and the development of the financial market in Albania. They played a crucial role in fuelling the fast growth in the pre-crisis period.

However, now that these banks are challenged by economic and financial developments in their home markets as the euro area is confronting economic and financial stability problems, large banks are under deleveraging policies in our region. Banks are still lending,
but not as much as is required for economies to keep on growth. Their focus has shifted and this is reflected in their business model. The region needs a different business model, one that is focused on common cooperation and that can make good use of domestic savings by converting them in domestic financing. In the open market, if a corporation’s business model does not guarantee long-run profitability, it is best that a reasonable and orderly strategy, well arranged with the supervisory authorities in the country, is found so as to allow a stronger focus on core business and operations. Mergers and acquisitions will be a possible strategy on which the sector will rely in the future.

On the one hand, we have financial institutions, which have lost interest in the region and see benefits of unloading their business to other interested parties. The central bank, as a regulator, would certainly prefer this process to bring in well-established credible and reputable institutions, with clear business and developments plans for the region. As regulators and supervisors, we must make sure that this process contributes to the development and the stability of our financial markets and the economy itself. However, the interest of such institutions in the region is low for the moment, and is expected to remain so until growth rates recover their pre-crisis level, and private sector demand for credit improves. On the other hand, this is not going to happen unless new and willing financial institutions enter the market. The question faced by authorities is whether we should wait until such reputable institutions show an interest to enter our markets, or progress as soon as possible and letting less well-known financial foundations that might have expressed the interest in the financial system but do not have the expertise and the proven credibility of traditional banking groups. Recently, some financial foundations have shown an interest in entering the banking system, but we do not have enough information to judge efficiently, and we are not 100% convinced whether they will be able to play the role of banks; or whether they have the professional capabilities, the experience, the financial capacity, the willingness and the determination to fulfil their business plans in order to support economic activity and simultaneously preserve the stability of the institution and the financial system in general.
In addition, we must consider the stability, the seriousness, or the professionalism of these institutions in line with our goals. Can they deliver on their promises, are they transparent? These are questions we are facing every day.

There are also other institutions that do not face strategic decisions about leaving the region but are not really willing to play their role and comply with their stated objectives and business plans. In this case, as regulators, we would prefer to find a similar solution by sales or acquisitions. In my opinion, there is no easy and unique answer to this dilemma. Given the diversity in size, market share and balance sheet structure, profitability and systemic importance of banks in our markets, the best solution would be to adopt and consider a case by case scenario.

Last but not least, this does not depend only on domestic developments. Developments in EU, the home market of financial groups that operate in our region can have dire consequences for our financial systems as well. They might force the central banks of the SEE region to face the prospect of bankruptcy financial groups operating in their countries. This leads to a third, and more difficult, decision of dealing with a dysfunctional financial institution. A very recent example is the Greek crisis during the summer. During the period, we were faced with a difficult situation with banks with Greek capital and as one would expect, this was creating a very stressful situation not only for us but the entire region as well. We were communicating daily with the Macedonian governor, the Greek governor, the Serbian governor; practically with all the governors of countries that have Greek direct investments in their banking sector. The question was whether there would be a Greek exit from the euro or not. And if there had been a Greek exit, we might have to face a situation where we would have to take these banks under administration. The problem at that moment was such that we had to take a decision. We were also having doubts on when the correct moment to take this decision was. If we waited patiently, then it might have been too late and the situation might have deteriorated. If we took it too early, we might have created some other negative consequences in terms of transparency. We had discussions with Mr Mario Blejer, our adviser and someone with a large experience, on
what indicators and triggers would tell us the right moment when we need to act. His opinion was that there are no triggers, and that we simply had to sense it. We had to judge institution by institution and we only had our judgement to rely on.

Finally, let me turn to the debate on the role that modern central banks occupy in a country, I believe that sometimes the expectations of the public are much higher than real competencies and powers of this institution. They expect the central bank to achieve objectives and take on duties that are not under its responsibility. According to our law, achieving and maintain price stability in the country is the responsibility of the central bank. In line with this objective, we have lowered the policy rate and have injected ample liquidity in the market. The policy rate is actually at its minimum historic level and we might ease further our monetary policy if that is deemed as necessary. This policy has contributed to reducing interest rates in financial markets across all instruments.

However, our efforts go beyond these traditional central banking instruments. As I mentioned earlier, we have prepared a package of macroprudential regulations in order to incentivize banks to increase credit to the economy.

As a responsible and accountable institution, we are reconsidering and rethinking our role in the current economic situation, and we are continuously studying and discussing the use of innovative policies and instruments. We are well aware of our limitations. In our weekly monetary policy committee meetings, we have been rethinking our role over and over.

We have thought about additional instruments and opportunities to inject liquidity in the economy and provide additional funding for investment projects, in particular for the competitive sectors. We have also considered adapting changes to our regulatory framework to allow for this to happen. Above of all, we have to cooperate with the government and other authorities to bring necessary changes in the legal framework and remove institutional obstacles that prevent the resolution of nonperforming loans and collateral execution. Last but not least, we have to analyse all the structural reforms undertaken
so far and try to evaluate their appropriateness, their results and their potential social costs.

This current prolonged global recession has challenged the traditional consensus of economic principles. Traditional policies are not proving very helpful in reviving economic activity therefore flexibility is crucial in the process of reform implementation. We have to be flexible and smart enough to evaluate what is efficient and what is not. We may initiate something and continue with it as long as it is efficient. Once a reform or an initiative, being it an institutional, legal, regulatory, or economic one, is assessed as inefficient, we need to quickly adapt and seek other opportunities. The most important thing is to achieve the results and fulfil the objective. From the central banking point of view, there continues to be space we can operate in and this is what we are discussing and currently thinking about.

Concluding my speech, I would like to re-emphasise the important role of foreign direct investments for our economy and our region. This new equilibrium in my opinion remains a challenge for us because the current equilibrium of low growth and low inflation does not provide the best incentives for FDIs. Foreign direct investments bring fresh capital and provide new opportunities to exploit our unutilised resources, and they trigger new optimism in the economy. The central banks are working hard and doing everything they can in terms of monetary policy and financial stability. They are relying on traditional policy tools as well as innovative tools, and simultaneously have initiated legal and regulatory reforms that are deemed as necessary to secure well-functioning markets and increase the efficiency of and market resolution mechanisms. However, it must be understood that our role, as the central bank, goes toward the establishment of an environment, which supports economic growth and increases welfare of the country. The fundamental sources of the long-term growth and prosperity lie on the successful implementation of structural reforms. We are well aware that we have a lot of hard work in front of us in this direction. We do hope that our policies will provide the right incentives for the banking system to provide more loans and for the private sector to increase their investments and consumption. At the same time we hope to contribute to optimistic expectations and at the same time guaranty a healthy and stable financial system. We
will pursue our price stability objective and we will also be careful to preserve financial stability. We believe in this specific moment of time, under the current developments, financial stability has to be considered as a primary responsibility of the central bank on par with its price stability objective. In this respect, we have to be very careful and very keen on monitoring and managing the stability of the financial system in general but, mainly of the banking system, because 95% of the financial system in Albania consists of banks.
CONCLUDING REMARKS

It seems that we are at the end of the conference. After a long working day, I hope each panel was interesting. For me it was the first conference in the position of the Governor. I have followed all the conferences of the Central Bank before and I have always found them very well tailored. Today we have contributed to enriching these past experiences with new information, additional analyses, new experiences and innovative ideas. I would like to thank all the distinguished participants. First of all, the colleagues from the University of Oxford, that came here to help and direct this one day conference of the Bank of Albania. We have had a very good cooperation with the University of Oxford and we witnessed even today it has been a fruitful one. I would also like to thank the esteemed participants from the central banks of Italy, Turkey, Kosovo and Macedonia and all the other friends, colleagues and participants. As central bankers, we share here our concerns, the headaches that we face every day and I personally believe that in such occasions we refresh our ideas and draw helpful suggestions for our future decisions. It is a good recap that helps us to continue working in the future and will help us in the decision-making process. This is especially true since we had the privilege to share the experiences with precious colleagues coming from much larger countries with experiences that are often much more difficult than ours. I can guarantee you that our discussions today will be very helpful for our work at the Bank of Albania. I would really thank everybody for participating and for their significant contribution to this conference. Personally, I feel very satisfied with today’s proceedings. Thank you!

* Gent Sejko, Governor, Bank of Albania.
SUMMARY OF CONTRIBUTIONS TO THE GOVERNORS’ PANEL

Bedri Hamza*  

In the period before 2008, when the financial crisis started, which later developed in an economic crisis, the region’s countries were in a situation of relatively satisfactory political stability, developing structural reforms and experienced a relevant economic growth. After this period, despite the fact that not all the countries of the region are entirely integrated in the economy of the euro area, in the same way we shared the good experiences, we had to share the difficulties that the economies of the euro area were facing too, which are the primary partners of all the countries of the region. It would have been implausible that while these countries and developed economies have a financial and economic crisis, we do have a growth of investments from potential investors in our region.

Despite the many similarities that the economies of the countries of the region have, there are some distinctions between them as well, which were highlighted during the last crisis too. Kosovo, as a small country, with a young economy, suffered less during the crisis compared with other countries, including those of the region.

The banking sector in Kosovo remains stable with a good quality of the credit portfolio, well capitalized, liquid and profitable. Non-performing loans are at a relative low, representing only 6.8% of the overall credit. They are well provisioned, covered at 116%. According
to the last data in September, this year lending activity grew by 7.8%,
the greatest growth of the last years, which was financed from a
steady growth of the deposits collected inside the country. All banks
exceed the normative request as far as capital adequacy and the
financial leverage are concerned. Overall, we can say that in Kosovo
the banking system is healthy. This is also determined by reports
from respectable and trustworthy institutions in this field, such as
the International Monetary Fund and the World Bank. Kosovo has
marked an important progress at access to credit, where according to
the report “Doing Business” of the World Bank, Kosovo is ranked
28th for this indicator.

However, the banking sector faces difficulties; thus to have a
greater financial intermediation with more favorable conditions
from the banks, as well as a more adequate climate for economic
growth, I consider that we should treat these segments:

The institutions of Kosovo must perform their duties to support
the further development of financial intermediation, which are mostly
related to the legal infrastructure, like the contract implementation,
the growth of the numbers of private executors, as well as the
issues related with property rights, which represent a segment quite
challenging to resolve. Apart from the legal aspect, the cultural aspect
is important as well, since people hesitate to buy foreign properties
so the banks are faced with a number of non-liquid mortgages, which
are hard to sell thus to compensate for overdue loans.

Enterprises need to improve as well, in the sense that they need
to have financial statements correctly disclosed so that it will serve
the banks as a trustworthy source of information about the financial
performance of the enterprises. They need to improve the aspects
of corporative governance as well, so that they may transform in
serious partners of the banks.

Interest rates in Kosovo have been relatively high. Three, four
years ago, the average interest rate was around 14%. Luckily,
with competition growing in the banking system, the interest
rate has decreased. Currently the average interest rate in Kosovo
is somewhere around 7.9%, which is the average for the region’s
countries. Most of the banks in Kosovo are from European Union countries, from Austria, Germany and Slovenia. In the past, these banks have carried the brunt of the market, but with competition growth and the introduction of new banks, the leverage of these banks has been diminished. From 77% in 2010, currently these banks cover 66% of the market, which speaks for a competition growth and an improvement of the credit standards.

As far as the macro-fiscal sector is concerned, we may truly say there have been positive developments. Kosovo’s budget in the last years was a balanced budget. In the last period, budget deficit has always been smaller than 2%. It’s relevant that the public debt in Kosovo continues to be low, at 12% of the Gross Domestic Product (GDP), which is the lowest in the region.

However, Kosovo faces difficulties as well. Trade deficit is relatively high and stays above 35% in relation with the GDP. Unemployment is high, somewhere around 30%. These two indicators show the responsibility that we must continue with structural reforms: in particular, we must move to endorse more those enterprises that deal with merchandise production in Kosovo, with the goal of substituting imports and creating the possibility of exports’ growth.

Kosovo’s economy is very dependent on remittances. It has been lucky that even with a crisis in the euro area, Kosovo’s diaspora have been concentrated in economies that have shown more stability, such as Germany, Austria, Switzerland and the Scandinavian countries. As a consequence, we haven’t had a decrease in remittances in these years; instead we have had a continuous growing trend. However, as Pm Rama rightly said, in the future we must think for those to be replaced and at one point or the other, we must consider that we will have a decrease of these remittances.

Have we dealt with these issues correctly? In most of the region’s countries, related with the factors that have affected the decrease of economic growth, which have represented difficulties for the economic development in our countries, I think there is the possibility to do more. Especially, we must be careful about the stability. I mentioned the credit growth in Kosovo at 7.8%. It as a relatively
positive indicator, however, it doesn’t tell us enough about the state and the dynamic of the financial sector, in which loans not only must grow, but they must grow healthily. Apart from non-performing loans, which represent a risk for the financial stability, the public debt in most of the region’s countries has reached the point where realistically it may be required a higher economic growth to generate enough revenue so that we may cover debt payments. Therefore, I am a proponent that nations should be more careful as far as public debt financing is concerned and that they must keep the public debt at manageable levels.

In collaboration with the International Monetary Fund, as a result of the stand-by agreements, in Kosovo we have approved the fiscal regulation. This with the goal to protect the budget equilibrium, since we don’t have a traditional monetary policy as a consequence of having unilaterally adopted the euro as our official currency. To safeguard the nation’s liquidity, it is necessary that the budget deficit has to be affordable. To safeguard the nation’s liquidity, the government’s banking balance has remained on average over 4% in the last years.

In the future I think that we should not wait just the overcoming of the crisis by the developed countries. In any case, we as well must perform the duties that are in front of us. In this sense, we need to create preconditions and favorable policies to attract investments, especially in the fields where we have comparative advantages, such as the energy and mining sectors in Kosovo, and then to support small and medium-sized enterprises, which lately have seen progress also through concrete actions for the fondation of the guarantee fund for loans that will become functional next year, so that these sectors may be drivers of economic growth.

I think that the region must ensure political stability, national and international. It’s a fact that the region in the last years is more characterized with political themes than economic growth themes. Rule of the law continues to be one of the central points that need further improvements. An important factor is the infrastructure as well, which although has shown extraordinary improvements in the region overall and in Kosovo and Albania especially, still has
space for further advancement. This shows that investments in infrastructure must continue for in the near future this investments may serve as a continuous support of economic growth and of international collaboration between our countries.

The human capital quality and work productivity represent another important segment. We are talking about a great number of youths, but realistically we need for the quality to grow, for reforms in the education system and for producing cadres that match the needs of the market economy. We don’t need an overproduction of degrees, we need a production of cadres that are ready to work and contribute especially in the private sector, which must be everyone’s focus, where workplaces are generated and where economic growth is created. I want to say that the volume of the human capital is not enough to generate economic growth, instead it is needed a higher attention to grow the quality of the human capital as a precondition for growing work productivity.

All that said, the issue of structural reforms remains as much as important as the other issues discussed. Kosovo, as a young country, and starting from 2009 when it became a member of the International Monetary Fund (IMF), has conducted three programs with the IMF and we are now at the fourth. I believe that being in a program with IMF offers many advantages. Thus, fiscal discipline and the continuation of the reforms’ process are safeguarded. However, the IMF, and also others donors and countries included in one way or another in the reforms’ process, sometimes with their projections, with their propositions, they don’t have a complete picture of the events and developments that must happen or are already happening in the region. Let’s take the case of the highway in Kosovo, the Nation’s road. Apart from the governmental aspect, the national one, I wanted to talk about the economic aspect as well. Many of the experts I met expressed the position that this was a project without feasibility, which the practice has argued as wrong. I want to say that, the countries’ governments, the countries’ appropriate institutions must have the responsibility and ownership upon the reforms and there must be an adequate decision-making. We in Kosovo, when we have had to take the decisions, we had the appropriate analyses and estimates, and we acted by taking the decisions which turned out to
be the right decisions at the right time. Today, the trade exchange Kosovo – Albania has grown more than 100%. That means that the road, a part of the already mentioned aspects, is also very important for the economic growth of Kosovo and for a very easy access of Kosovo’s businesses to the sea ports of Durrës and Shëngjin. However, there have been cases when we have not been careful and decisive enough and as a consequence we’ve not acted right by, as it is the case of the energy sector. We are talking about a major project for the economic growth of Kosovo, as it is the building of power plants. We can’t talk about a stable economic growth if we don’t have an adequate electric energy supply. Apart for the need to supply the country’s economy adequately with electric energy we’ll have the advantage to build these electric energy capabilities also for export, which would improve our trade balance. We consulted with many partners, took advices from many of them, and today after eight years, we are still almost at the starting point. We have not started to build the new energetic capabilities. Therefore, we need to understand that reforms are a necessity for us, to have ownership upon the reforms, to have adequate analyzes and consultations from the experts, as well as to be careful to safeguard the macro-fiscal stability of the country. In a meeting with the representative of the relevant institutions when it came to the negotiations’ developments, I said it clearly that against several factors including the political ones, the road will be made. There, I highlighted that the road will be made with our money, that the country will not go bankrupt and that we will safeguard the macro-fiscal stability. I believe still today that if we don’t feel the need to have structural reforms and if we don’t feel ownership on those reforms is hard to move forward.

In the framework of the engagements to ensure a stable macro-economic climate and to be able to ensure the economic growth of the country, undoubtedly the Central Bank has a very important place. Since we are restricted, as far as the traditional instruments of the monetary policy are concerned, this as a consequence of using the euro as official currency, our main focus is to have a stable financial system, which we have achieved through the approval of qualitative laws and regulations, process in which our international partners have given an extraordinary contribution as well, especially the International Monetary Fund.
Our first objective has been the licensing of banks in Kosovo, thus creating the possibility that new banks may enter to develop the competition in this sector. Meaning, that may enter those banks that actually have a good reputation, juridical subjects that don’t put at risk the financial stability and don’t risk depositors’ trust in the banking system. In addition to the licensing process, we have dedicated great attention to the supervising role of the banking system as well. Together with the International Monetary Fund we have developed the supervising manual based on risk and we have started implementing with success this new supervisory methodology. All this has been oriented so that we have banks that are healthy, but at the same time able to support the economic growth of the country. Thus our focus is to have a strong banking system, healthy, to grow competition, but competition with healthy banks and then this to be positioned in support of the real sector, the private sector where economic growth is really generated.

Right now, in Kosovo’s banking system operate ten banks, of which 8 are of foreign ownership and 2 of local ownership. We remain open to create the possibility for other banks to enter, but always respecting the principle to license only banks able to safeguard the financial stability and to support economic growth. While licensing new banks or while reviewing requests for merging, we must be careful about the proposed management as well, including here aspects such as structures, qualifications, credibility, experience in the banking system, trustworthiness, their business plan, financial strength, capital provenience etc. These are complex issues that really must be analysed in detail. We have had a case in Kosovo where a foreign bank bought two smaller banks. And that bank that bought the two smaller banks developed well, and nowadays is the third bank in Kosovo as far as size goes, so it’s a positive story. We must keep in mind competition’s reduction as well, because, if one of the biggest banks in one of the economies of our countries declares that it wants to buy two or three other banks, then we have a reduction in competition and this reduction may bring a situation where a bank dominates the market, dictates the conditions of the market, interest rates and so on. In all our activity as a Central Bank, we respect meticulously the principles of the free market, hence we have an open licensing policy, through which we offer the opportunity to
new actors to enter in the market and the constant development of competition. However, we must not forget that our primary objective is the safeguarding of the financial stability. In this context, the licensing policy must be careful so that banks that do not meet the conditions of being healthy and trustworthy in the market may not enter, since they may bring much more harm than benefit to the financial system and to the economy.

In conclusion of this discussion, I want to underline again that we should continue with the reforms. Reforms are very necessary. We need to strengthen law enforcement. Of course the stability of the financial system has a special importance. I think all the countries of the region need balanced budgets. They need to keep the budget deficit under control. Possibly to keep the public debt under control, and in fact some of them need to decrease it. To protect the budget’s structure because if we analyze the budget’s structure, in most of our countries most of the budget goes for operating costs and that has made the governments expensive while the participation of capital investments is relatively low. We need a higher and more stable economic growth. Let’s take the case of Kosovo, where the economic growth in the last years is somewhat over 3.4%. As a percentage it may be acceptable, but if you take into account the low base of the economic development surely not only Kosovo, but all the countries of the region need an economic growth around 7% so that they may absorb the labour force. As far as the latter is concerned it is necessary to have more investments in improving the quality of the labour force so that we can ensure a higher rate of work productivity. This way, all the institutions must do their duty with the goal to move forward toward progress. It wasn’t easy in the past, the situation isn’t easy today, but we must trust in our goals and we must work toward our primary objective, which is to create the Preconditions for a greater economic development.

* Bedri Hamza, Governor, Central Bank of the Republic of Kosovo.
I will start with a positive note, on the positive growth rate in the region, despite several problems including balance sheet issues that certain regional countries are facing.

Looking forward, a significant development for the region is going to be the economic recovery in Europe. So, for a while, for the first time, the regional countries are enjoying a sort of recovery in Europe. Let us hope that this recovery will be firm and will increase in the forthcoming quarters and years. In Turkey, we significantly benefitted from the recovery in Europe. Exports to European countries increased considerably. I think that this is the case with certain countries in this region.

It is therefore a welcomed development and let us hope that it will continue. The ECB seems to be keen on the quantitative easing programme. They will continue at least until, and perhaps beyond September 2016. That will make sure that the recovery in Europe will probably be firm and increase over the quarters and over the years.

The second welcomed development for the region is the drop in global oil prices and the global commodity prices in general.
Let us take these exogenous spillover effects. Looking ahead, what the countries in the region should realize is that there has been a strong emphasis on structural reforms, at global, regional, continental and individual level. Let me start with the global level structural reform agenda. At the G20, we have been discussing structural reforms for some time, since 2013, during the Russian presidency, and we elaborated the structural reform agenda during the Australian presidency. During the Turkish presidency, we also worked on and specified certain implementation issues. The aim is to increase the global GDP by 2% over a five-year period. So it is going to be a significant contribution to global growth over five years. Certainly, that has been the case with international organizations such as the IMF and the OECD. They also strongly advocate structural reforms for both, the global economy and individual economies.

For example, at the European Union level, there has been strong emphasis on structural reform. So, it is quite clear now that the potential growth of the European Union should be increased through structural reforms rather than through other means. This has been quite clear, and even the ECB spoke about the need for structural reforms, for stronger governance of structural reforms at the EU level. That is quite significant. We know that one of the issues of the European Union is the governance structure. The European Union has been good at introducing good measures, but when it comes to the implementation, to the governance of those issues, they lack. But this time, there is some emphasis on the governance structure of structural reforms. This is a positive development to look forward and going forward.

At the individual level, we see that several countries have already adopted extensive structural reforms, for example, Mexico, India, and China. They either adopted or will adopt them soon. In Turkey, also we have a very big structural reform agenda, which is waiting a new government to implement it. That should be the way forward for the countries in the region to adopt structural reforms, to increase their potential growth, which has been badly affected by the developments, since the outbreak of the global financial crisis.

In terms of the position of the countries in the region within the global spectrum, I would say the following: a few years ago, you
would say this region probably looked the weakest spot. Right now, however, most countries are more or less in the same situation, facing balance sheet problems, growth slowing down, and strong need for structural reforms. The picture is not much different when you look into different regions. The Latin America, for example, looked very promising a couple of years ago. Right now, they have a big issue in their hand to increase their potential growth, increase the cyclical growth. The same applies to Asian economies. They looked really promising a couple of years ago. Right now, markets talk about vulnerabilities of Asian economies. Most countries face more or less the same situation, at this point in time. Whoever is going to adopt structural reforms is going to have a government touch.

To answer the question on the ownership of structural reforms, I concur with Mr. Anastasakis. Ownership is very important when it comes to the structural reforms. After all, we are talking about not really first generation of structural reforms, but we are talking about second generation of structural reforms. The first generation of structural reforms is mainly related to providing independence to central banks and to other institutions and fiscal discipline. This sort of things mostly does not require a fiscal spending. But, the second generation of structural reforms is really related to innovation, infrastructure, and education. These are mostly domestic issues and, therefore, the ownership of structural reforms is very important.

Usually, countries should own those reform items that they like to carry out; however, there is nothing wrong with getting help from international institutions. They have the knowledge, they have the expertise, and they have exposure to countries, which have implemented those structural reforms. There is an international emphasis on structural reforms. There are institutions that have been established and will be established. So, getting some help, sharing knowledge is a good way to implement these structural reforms.

As mentioned earlier, the role of central banks in pressing ahead, has expanded drastically to include basically financial stability objective. This is something new which central banks did not address in the past. I should, however, say that if you see the history, you will see that central banks used to take care of this financial stability objective.
The financial stability objective is now very important for central banks. Central banks try to achieve this objective either by contributing within financial stability committees, like in Turkey, Germany and other countries, or individually, like in the UK through a new committee within the central bank. That means central banks are now using new instruments, new policies to achieve financial stability as well as price stability or macroeconomic stability in the case of some other countries.

This means that central banks now are dealing with regulations, which, I must say, takes them a lot of time. This is some general change within the policy making setting for central banks.

There is also some specific change for central banks in emerging market economies. Now market interest rates had been very low due to unconventional policies in advanced economies. These low market interest rates are not really in line with emerging markets economies equilibrium interest rates.

There has to be a new instrument or a new policy to fill the gap between market interest rates which are imposed on to emerging market economies and their equilibrium interest rates. This is quite interesting, time to time, countries have faced low interest rates environment due to financial repression or similar policies. For example, right after World War II most European economies and, to a certain extent the US economy, faced low interest rates. Central banks made sure that interest rates were low because of the very high debt to GDP ratio of some European and US governments. During that time, central banks implemented what are called macro prudential policies these days, but they were never called macro prudential policies then. If you look into the German or French central banking history, they used what they call quantitative measures to provide credit growth or provide credit to certain sectors or to provide less credit to certain sectors such as consumer credit growth was one of the main issues in the States. I think, time to time, the roles of central banks do differ.

Turning to the banking sector, I think that banks have been going through really uncertain times not because of deleveraging process
that we imposed on them because of the global financial crises, but especially in Europe, because public opinion is quite against banks, in Europe at least. As a result of that and as a result of the financial global crises, at the FSB, at the G20, the whole global financial system was overhauled. And the banks have implemented so far only a fraction of those reforms, so there is a long way to go for banks to complete each item of that global financial reform that FSB member countries adopted. Perhaps we need to wait on banks for having more certain times, at least from financial regulation point of view.

To sum up my thoughts, I would say that the economic recovery in Europe is visible thanks to the ECB policy. They waited for some time and in the end they had to step in perhaps to carry out quantitative easing just like, the Bank of England and the Bank of Japan had implemented. So it’s a positive development in this continent, but going forward, I think we shouldn’t overlook the importance of structural reform; that should be very forward. Other positive news would be that unfortunate geopolitical developments hopefully will finish soon.

Thank you!

*Turalay Kenç, Deputy Governor, Central Bank of the Republic of Turkey.*
As I am the last of the panellists and many things have been already said. I just wanted to recapitulate and also put it in perspective. I would like to show and discuss on the fact that if we compare the two periods, before and after the crisis, both in the region, and in other areas of the world, we can see that this region faced some fundamental problems, i.e. structural problems. In the first period, when everything was all right, such problems were not tackled in a sufficient and effective way.

In the second period, when the problems surfaced, they showed that these vulnerabilities, these structural problems were still there and were hampering, and are still hampering growth. In a sense, it is like running in a race but having used some stimulants at the beginning. Initially, you run very fast because you are under the effect of the stimulants. Then you suddenly find out that stimulants are better not to exaggerate with. So your training may not be sufficient and you have to train more. Likewise, there is this need for more structural reforms, which is also the case for countries like Italy. More structural reforms means everything broad range of things, not only economic reforms, but also that a country has to change a lot of its fundamental characteristics.

This has also to do with the legal framework. Take for instance the issue of the NPLs. How to tackle the NPLs at the legal sphere?
Italy, for instance, is a country where the NPLs ratio is about 10%, quite high. The Bank of Italy estimated that Italy had the same legal framework as, for instance France or Germany, this ratio could have been halved. This is why, last August, the Italian Parliament passed some laws in order to increase the efficiency in dealing with bankruptcy procedures, with law enforcement, and so on and so forth. It is also true that we should not be limited to the economics sphere, but also take into account the institutional setting, the legal framework. About institutions, comparisons by the World Bank show exactly the needs of every country including Italy as one of the countries that needs to move faster in this field. This is why our government is still very much involved in the business of improving our setting and enhancing a lot of reforms, also at institutional level.

This is also part of the debate at the G20 level. The structural reforms constitute a sort of a paradox, because they are probably mostly medium to long run phenomena, which produce their expected positive effects, only after some years. Actually, for most of these reforms, literature suggests that there is some evidence showing that the initial effects may be even negative for the economy as a whole.

So, in this regard, we need some support demand in the short term. This is exactly where problems arise, because, in many countries, including Italy, the fiscal rule for this support is not there, or it is very, very limited. One thing that can be done, - and this is a task of the Government, - is to devise properly combined and well-timed reforms. Take for instance public debt; it is a problem for almost all countries. Public finance has to be dealt with care, in the sense that the composition, the quality of the measure of the reforms is crucial.

One of the main issues in public expenditure is to increase efficiency. Measures that lead to the growth lending are to be preferred. This point is part of the debate at international level and it is a very highly debated. On the one hand, there are supporters of the supply-side approach that means just structural reforms. On the other, there are supporters of the demand-side approach. As a matter of fact, in this setting, the monetary policy alone cannot deliver the results. Monetary policy may help, but it has to be accompanied, a sense, by government action.
This is a medium to a longer-term process. In the meantime, we have to consider also the fiscal dimension. The social dimension is to inform, but there is one thing talking about structural reform in general, or reform being dictated from abroad. We are seeing that the stronger countries in the organization professing reforms to the weaker countries that are already doing it. The question is: How can you make the countries feel they have the ownership of reform?

The ownership is particularly important. On the ownership question, take the case of Italy for instance, which in my opinion, is a clear example. If you refer to the situation in 2011, when it had to solve the debt crises, Italy was on the verge of bankruptcy. Basically, European institutions in a sense imposed their way the market. They imposed on Italy the need of taking some steps on the reform path. So we changed the government, there was a technocratic government; we undertook some hard reforms, hard from the social point of view, pension reforms, increased taxation, etc. What we can say now is that there was no strong increase in populist movements as was the case in other countries. Some of these movements were more vigorous, but nothing so serious. What we have seen in the last months is an increase in confidence, which seems to be back and this certainly has to do with government actions and reform efforts.

At the beginning, we might have had a problem with ownership, but now the ownership is clearly an Italian issue. It is true, however, that sometimes the help of international institutions is really necessary. To add another dimension to our discussion, when we talk about growth, we should also take into account the necessity to change the growth model.

Take for instance what is happening in China. It has reached a point probably where they realize, they could not go on with the same model based on investment and export, i.e. the so called the export-led model. Therefore, they are trying to change this model. But this is not easy, it is not without costs. What we are seeing is a decrease in the growth rate and this is clear because you, a 10% growth rate cannot last forever. So we have to accept that even an economy like China’s cannot grow at such high rates forever. The growth rate will eventually be lower and consequences must be taken
into account. These consequences are clear: commodity prices are falling due to lower demand for raw materials; deflation pressure, etc.

Referring to other areas where the problem of changing the model has not been tackled yet, we can think of Latin America or Brazil for example, which are still suffering. There are different forces at work now. One is to put your house in order. Moreover, Germany has to go on along the path of reform, but when you tell this to Germans they immediately say that they have reduced their debt.

Regarding the role of central banks in taking progress forward, I may say that for Italy this is a very difficult question because Italy is part of the euro area and the Bank of Italy is part of the European System of the Central Banks. At the Bank of Italy we are also thinking about and being heedful to what other central banks in the euro area are doing. Monetary policy is part of the common decision applicable across the euro area, but now even supervision is going to be unified at European level. In a sense, we are losing our weapons, so we are rethinking the role of central banking in such situation. Of course, we are on the front line for regulations, because we take part in the meetings of the FSB. We are also engaged in trying to shape the monetary policy decision, at euro area level. We also work to apply the decision in Italy, trying to explain this decision and functioning of this unified monetary policy, to our country. From that point of view, we are trying to understand exactly what our role will be in the future and try to find out ways in order to increase the efficiency of monetary policy and of the means of the monetary policy transmission.

As we approach the end of this conference, I would like to polish off what has already been said, by emphasising that structural reforms are important, and growth is important. Again, I would like to underline, to strongly support the view also of the short term. We do not have to lose the view of this problem because the ownership question is linked to political support as well. Basically, without political support, no structural reforms can be implemented or approved. This is also very important. The other element I want to stress is cooperation. International cooperation or coordination,
if you like, at G20 level is clearly one of the main objectives and the Turkish presidency has done a lot in order to stress the importance of coordination. I hope that in the future this will be further strengthened. But cooperation is also crucial at regional level. Think about the problem we have in Europe, for instance with the migrant crises. Coordination is the other element: structural reform, growth and coordination because without any of these three elements you cannot get the results that you want.

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Thank you Governor Sejko. It’s been a tradition with the seminars with SEESOX that we summarize in generally 10 points, the thrust of findings of the seminars. This used to be done by the late Max Watson with great flair. I’m afraid I probably won’t be able to match his talent but I’ll do my best and I think I have approximately 10 points, you can count them and tell me if I got it right.

This seminar was based on the question: “Do crises change economic fundamentals”? And I think the evidence is a resounding yes. The prime minister is likening this crisis to the equivalent of the birth of Christ, at least, as regards economics and financial fundamentals, although one could argue that ethics, in particular business ethics, needs to change as well. So, what are these fundamental changes? First there has been a marked and sustained reassessment of risk. This has led to large scale deleveraging from all emerging markets including South-East Europe although the Vienna Initiatives did help lessen that in the initial phases. Secondly, a new less ambitious banking model is developing. Global banking is no longer a virtue in itself. Thirdly, there has been a wave of global regulatory reforms as well as profound changes to the global financial architecture, including what you just heard in the role of central banks. Fourthly, this is the especially case of changes in financial architecture and especially important in European Union which is the big neighbour and the future home of South-East Europe.
Another point, the political environment has worsened, the migrant crises which is a result of the chaos in the Middle East has shown a lack of consensus in Europe on strategy. Eurozone politics especially regarding Greece has become rather toxic. And there has been a rise in far right and far left politics. As the ancient philosopher, Heraclitus, said “The world is always changing” - this is true with or without crises. We just hear about the effect of the Chinese slowdown. The effects it is having on the commodity markets and the effects it is having in turn on exporters of commodities, oils and minerals and how this is going to effects the geopolitical relationship between the consumers of raw materials and the producers of raw materials.

We are in a different world now than what we were before the crises. So how must South-East Europe respond to these developments? Well first the region’s economic model needs to adapt toward a more export-oriented structure. Second, structural reform remains imperative, even though the political appetite for difficult reforms may not be strong in the climate of low growth. Third, local finance needs to bring itself off from the dependence on foreign capital but beyond growing a liquid deposit base this may also call for a more regional dimension for banking groups as well as the developments of other financial markets such as bonds and equities.

The region as well as the Eurozone must work to reduce the stock of non-performing loans, as these will weigh heavily on the credit supply and the prospect of growth until they are resolved. Finally, policy makers and political leaders must keep the show on the road, and maintain the momentum for reform and for integration with the European Union, which, however dysfunctional it may seem today, remains the only alternative for South-East Europe.

Thank you!

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