Growth and Finance – Motors in New Frameworks

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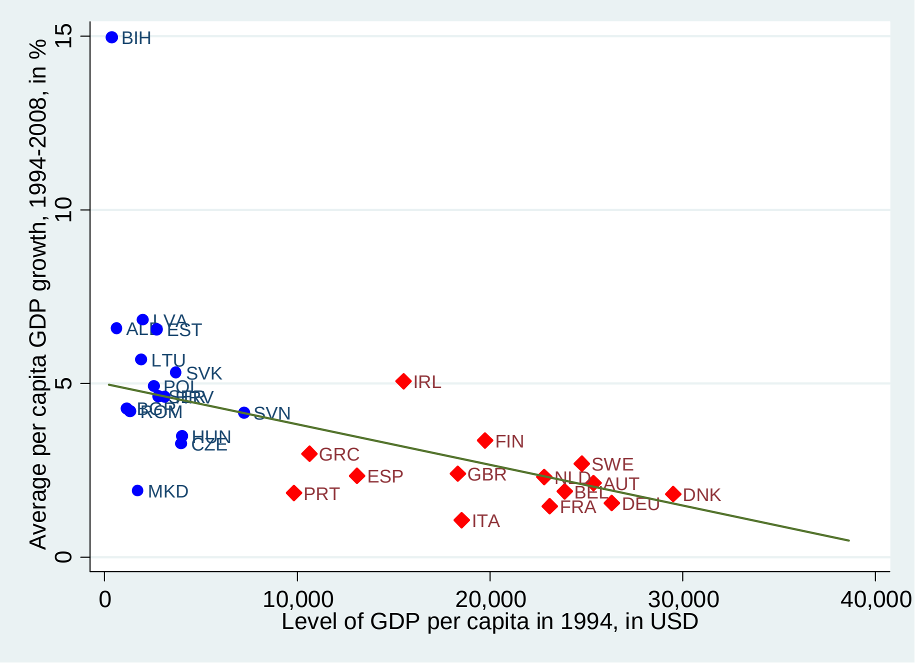
Europe is exception in terms of financial integration and convergence

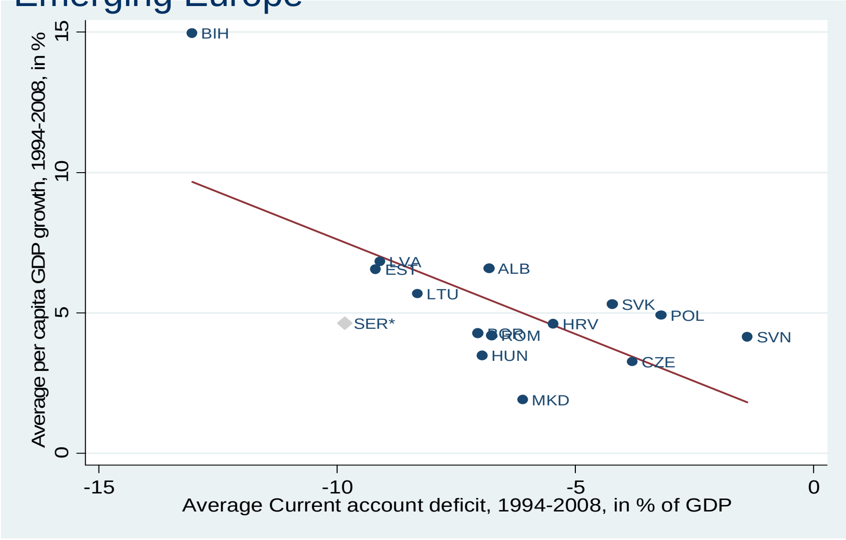
- Global context: financial globalization started since 1980s – deregulation, securitization, opening of borders for capital flows
- Neoclassical economic theory: capital goes from countries with lower return on investment to countries with higher return on investment
- On global level, financial flows to developing countries were not in line with this theoretical proposition (*Lucas puzzle, Feldstein-Horioka puzzle*)
- However, European financial flows comply with theory and contradict all previously registered puzzles on the rest of the world:
  - capital flow from richer to poorer countries
  - poor economies grow based on foreign savings
  - no preference for investing at home even if marginal returns are lower
  - capital flows from countries with lower marginal productivity of investment to those with higher productivity
- Key explanatory factor: indirect benefits of political integration (institutions, investor protection…) helping financial integration to impact growth more efficiently = European particularity

Emerging Europe: Catching up based on foreign savings/1

Convergence of income in Europe : 1994 - 2008

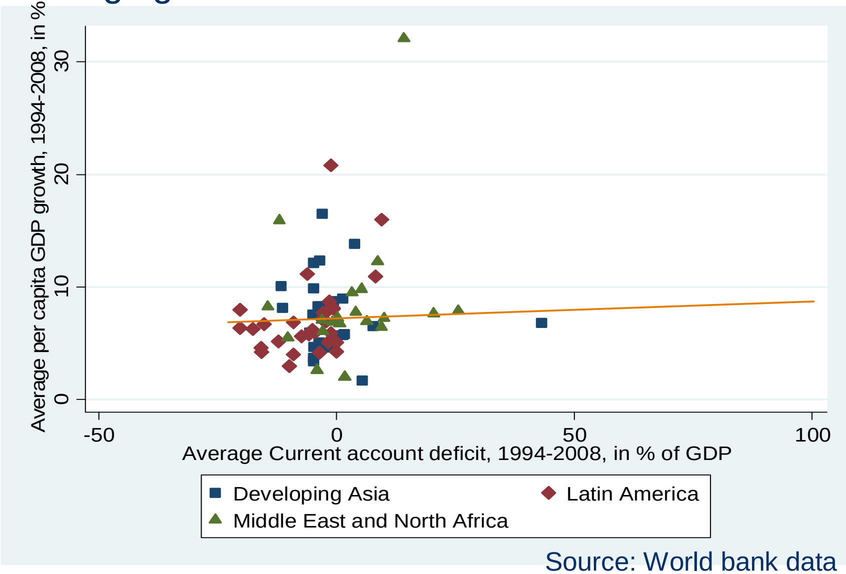


Current account deficit and income growth in Emerging Europe



Current account deficit and income growth in Emerging World

*for Serbia data refers to 2000-2008



Source: World bank data

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Financial vs. political integration in Europe

1**. Until the crisis**: **<u>Perspective of political integration acted as a leverage for much deeper financial integration at the time.</u>**

Political integration (EU integration) $\xrightarrow{1}$ **Financial integration** $\rightarrow$ **Income convergence**

Financial integration $\xrightarrow{2}$ **Political integration (EU integration)**

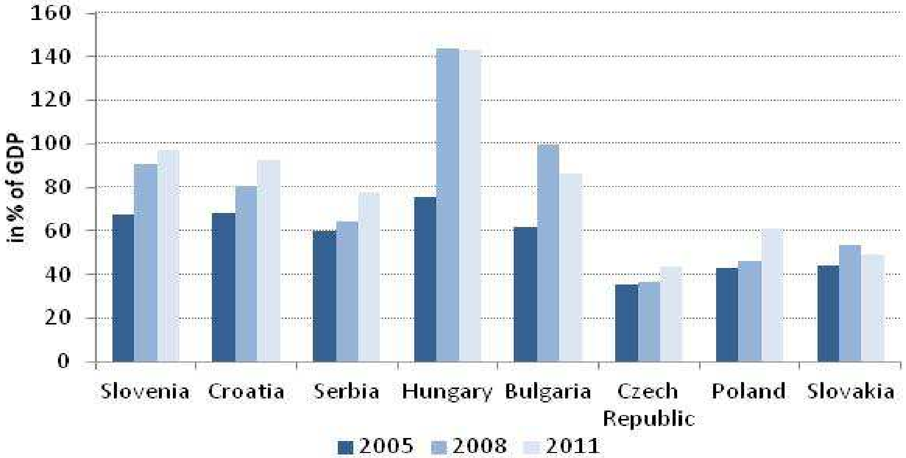
2. **Since the crisis : <u>financial integration became a leverage for continuous political / institutional integration.</u>**

Emerging Europe: Catching up based on foreign savings/2

- Foreign debt inflows to private sector intermediated through foreign banks were main growth driver until the crisis

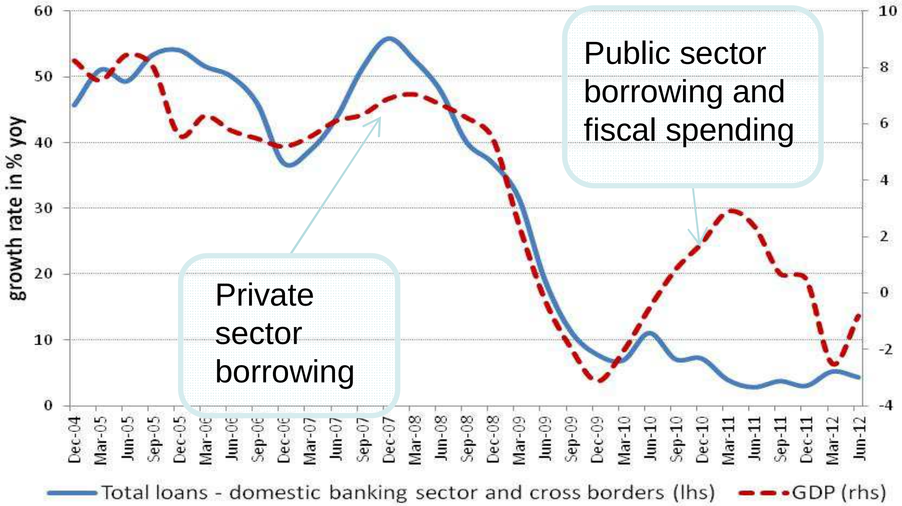
- Since crisis break out, fiscal deficits deepen throughout the region and their financing is secured mainly on the international debt market

Gross external debt, in % of GDP



Source: World bank data, Hypo Research calculations

Serbia: GDP growth and credit growth



Source: Serbian office of statistics (RZS), National bank of Serbia (NBS)

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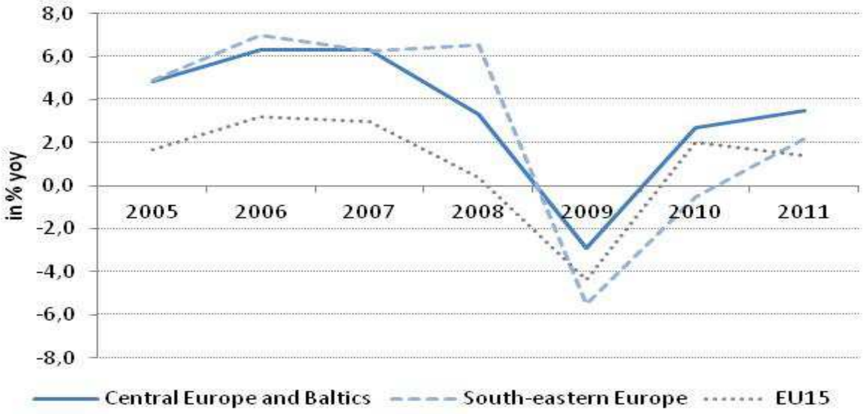
SEE: growth and finance/1

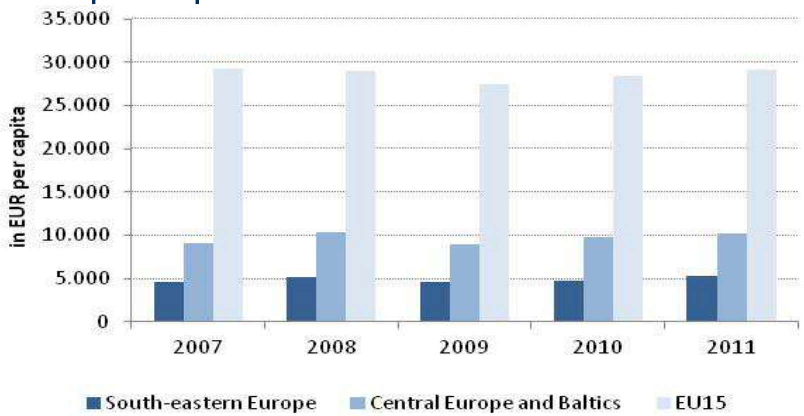
- SEE region is still behind other “Emerging” Europe regions in terms of development
- Politically the most fragile European region
- Least advanced in EU integration
- Structural and macroeconomic imbalances: fiscal deficit, foreign financing dependence, high unemployment
- High pre-crisis growth based on foreign financial inflows (consumption driven)
- Savings and radical fiscal austerity measures are hard to apply on the present level of GDP and unemployment

GDP growth*



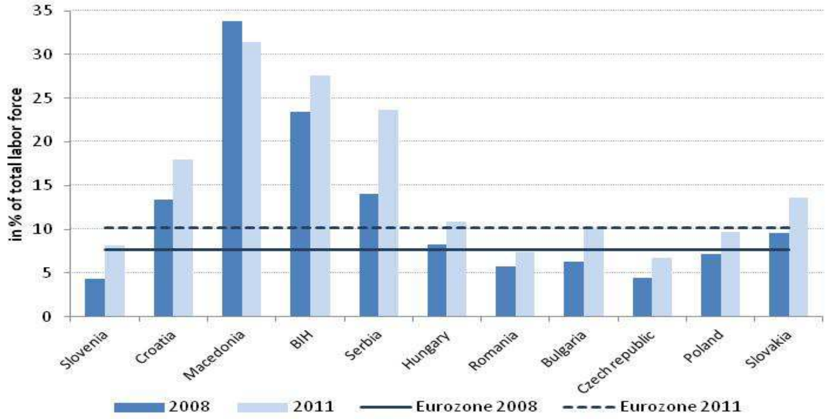
Source: EBRD, Eurostat

GDP per capita*



Source: World Bank, Eurostat, IMF, Hypo Research

Unemployment



Source: IMF World Economic Outlook, Bloomberg, Hypo Research

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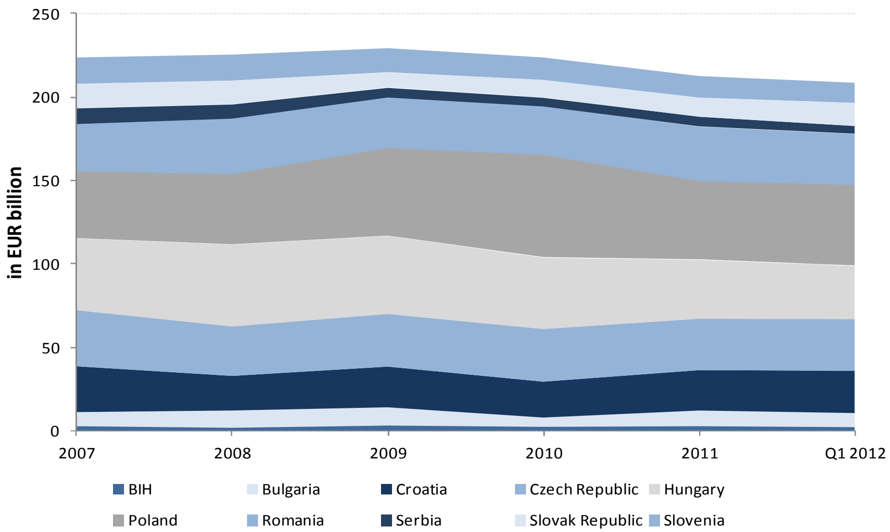
*South-eastern Europe : Albania, Bosnia&Herzegovina, Bulgaria, FYR Macedonia, Montenegro, Romania, Serbia.
Central Europe and Baltics : Croatia, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia.
EU 15 are members of EU prior to 2004 enlargement.

SEE: growth and finance/2

- ‘Vienna 1’ played a role to prevent reversal in financial flows to CESEE region following the crisis break out in 2009-2010
- Some deleveraging took place since 2011 (recently certain positive impulse comes from QE3 and ECB’s Outright Monetary Transactions OMT in Q3 2012)
- Further deleveraging could endanger both economic growth and political / institutional stability

Cross border claims of BIS reporting countries banks to Central and South-eastern Europe*



Source: Bank for international settlements

* BIS reporting countries: Austria, Australia, Belgium, Canada, Chile, Chinese Taipei, Finland, France, Germany, Greece, India, Ireland, Italy, Japan, the Netherlands, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.

SEE: growth and finance/3

- Opportunities are there in SEE region i.e. Lowest level of development = Highest potential for growth
- Local economies still lack fixed investments in order to generate sustainable growth

- In Serbia, a large cycle of investments in infrastructure, energy , public services and tradable manufacturing industries started in 2011 and shall continue over next decade:
  - **Energy** sector estimated investments of ca.EUR 1.8 billions per year
  - New transport **infrastructure** – roads, railways, estimated investments of ca.EUR 5 billions over next 5 years
  - State owned **telecommunication** company – estimated value ca. EUR 2 billion.
  - Huge potential for PPP projects: **local utilities, healthcare, education, local infrastructure** – estimated investment potential EUR 2.5 billion

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SEE: growth and finance/4

- Internal financing sources are scarce and insufficient for large capital investments
- Neither future large investments could be financed from bank credit only
- Local Institutional / legal framework in SEE should be redesigned to enable adequate matching of interests of:
  - Private investors
  - IFIs
  - Commercial banks
  - Equity investors

- Locally present financial institutions with large exposure to SEE could have a catalytic role in this process of institutional improvements

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