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FINANCIAL INTEGRATION IN NEW EUROPE – OVERVIEW AND IMPLICATIONS FOR FURTHER GROWTH POLICIES IN SERBIA

Finansijska integracija u "Novoj Evropi" – pregled i implikacije za buduće politike rasta u Srbiji

Abstract

Besides the incontestable benefits of financial development for output growth and increase of living standard across the region of so called Emerging Europe, many of underlying risks have been manifested during past two years, since the global financial crisis breakout. The aim of this paper is to overview the last two decades of financial integration with its impact on growth and income convergence of these economies. Moreover, in the perspective of change in global financial system and lower availability of foreign finance for emerging Europe, we also overview all risks stemming from the achieved level of financial integration for the macroeconomic stability. We document all identifies risks using the data for Serbia. Finally, after identifying all challenges for macroeconomic stability, we stress the importance of sustainable growth policies in the future which should aim to increase productivity and competitiveness.
JEL classification: E44, F15, F59, G32, O16,

Key words: *financial integration, New Europe, European integration, growth model, global economic crisis, income convergence, competitiveness, macroeconomic stability.*

Sažetak

Osim neospornih koristi od finansijskog razvoja za provredni rast, kao i za rast životnog standarda širom regiona, mnogi skriveni rizici su se manifestovali u području tzv. "Nove Evrope" tokom poslednje dve godine, odnosno od izbijanja globalne finansijske krize. Cilj ovog članka je da da pregled poslednje dve decenije finansijske integracije sa uticajem na rast i konvergenciju prihoda ovih privreda. Šta više, u perspektivi promena u globalnom finansijskom sistemu i smanjene dostupnosti stranih izvora finansiranja, dajemo pregled svih rizika za makroekonomsku stabilnost koji proizilaze iz trenutnog stepena finansijske integracije u zemljama tzv."Nove Evrope". U tom smislu, iznosimo sve identifikovane rizike koristeći podatke za Srbiju. Konačno, pošto identifikujemo sve izazove za makroekonomsku stabilnost, dajemo poseban značaj budućim politikama održivog rasta, čiji bi cilj trebalo da bude povećanje produktivnosti i konkurentnosti.
JEL klasifikacija: E44, F15, F59, G32, O16,

Ključne reči: *finansijska integracija, Nova Evropa, evropske integracije, model rasta, svetska ekonomska kriza, konvergencija prihoda, konkurentnost, makroekonomska stabilnost.*

Introduction

A lot has been written since the crisis spread out over the region, about the need of transforming the existing financial integration driven growth model in New Europe to a more sustainable one, relying on export and investments from local savings instead on foreign debt funded consumption growth. Financial integration of New Europe is also responsible for financial development defined as improvement in quantity, quality, and efficiency of financial intermediary services. Aside from unquestionable benefits of financial development for output growth and increase of living standard across the region, many of underlying risks have been manifesting during past two years, emerging also across old EU-members, this time qualified as EU periphery. These risks are due to (in particular foreign) debt overhang (both private and public) that is exposed by inability to repay loans when interest rate rise (risk spreads), coupled with negative growth outlook (accelerated by sudden stop in debt inflows and even deleveraging in some cases) and resulting fall in asset prices and net wealth as well as still large foreign financing needs resulting from high fiscal deficits. Post Lehman-crisis difficulties to restore a steady growth path together with regulatory

restrictions imposed to financial markets and banks in developed economies of Europe imply that, after a decade of intensive financial integration, this trend will certainly lose pace in the coming period. This change in trend will be particularly felt in so called Emerging Europe, where financial inflows from rich Western-European economies fuelled income convergence turning into an example of and represented a counterexample of global pattern in financial integration (where capital flows from poor to rich countries and faster growth is financed by own savings). In other words, we may see a future where foreign debt inflows being one of the main economic integration and growth driver in Emerging Europe, become scarce and more expensive or even stop.

In such a changing economic environment, we find it appropriate to overview and in some way to evaluate the previous decade of financial integration in Serbia and also to set it in a broader context of European integration. Under financial integration we consider all foreign financial and capital inflows and outflows. Combining cross country approach with use of some detailed insight from macroeconomic statistics for Serbia, we elaborate here both benefits and negative consequences from financial integration. In parallel, we summarize the main findings from the relevant cross-country studies in order to deepen some aspects of the subject. As the previous few years lasting debate on the economic policy priorities for bringing Serbia to the sustainable growth trend, as well as the recent literature by development-concerned community have brought out almost all necessary policy solutions[1] in the future, we restrain from analyzing specific policy solutions in this paper. We rather use systematical review of financial integration in order to point to the importance of investment in productive export oriented industries, of promoting domestic savings and efforts to improve competitiveness for future economic growth. Finally, a broader conclusion can be made from this – valid both for EU periphery as for New member states, candidates and future candidates. That is, as political integration perspective of these countries represented a significant levy for intensive financial integration one or two decades ago, the stock of accumulated cross country debt and direct investments received mainly by capital poorer countries from capital richer ones, reflecting the fact that economic integration has far outpaced the political one, is likely to represent at the present time a significant levy for further strengthening in the political ties across Europe.

The paper is composed as follows. In the first section we overview the income convergence as the specific European phenomena, supported by equally specific capital flows from rich to poor countries, both enjoying the catalytic role of explicit or implicit political integration in sense of institutional convergence on the first place. In the second section, we shed more light on the relation between financial integration and macroeconomic risks and vulnerabilities, while in the third section, we present the main insights on the relationship between financial integration and competitiveness of domestic manufacturing industry through local currency fx rate, increase in nominal wage and unit labour costs, as well as relative cost of financing.

Financial integration, income convergence and European integration process in Emerging Europe – overview and empirical findings

At the beginning of 1990s, the economic transition has started in the ex communist countries of the Central and Eastern Europe in parallel with their "political transition". The main ideology behind economic reforms has relied on the neo-liberalist proposition. It consisted of liberalization, privatization, macroeconomic stabilization (so called Washington consensus) and establishment of market institutions and policies. The specific reforms have been undertaken.

The past two decades in European transition economies have been marked by an unprecedented level of integration. Formerly centrally planned economies politically belonging to the Soviet bloc have moved into the community of Western European market economies with democratic political traditions. The economic and political integration did happen in parallel. The two may be observed as strongly interrelated processes resulting in relatively fast convergence of income and living

1 Republic of Serbia: Country Economic Memorandum "The road to prosperity: Productivity and Exports", December 2011, by World bank, represents an excellent study with strategic and policy recommendations.

conditions of poorer European countries' citizens to the level much closer of even equal to their Western European co-habitants, Figure 1.

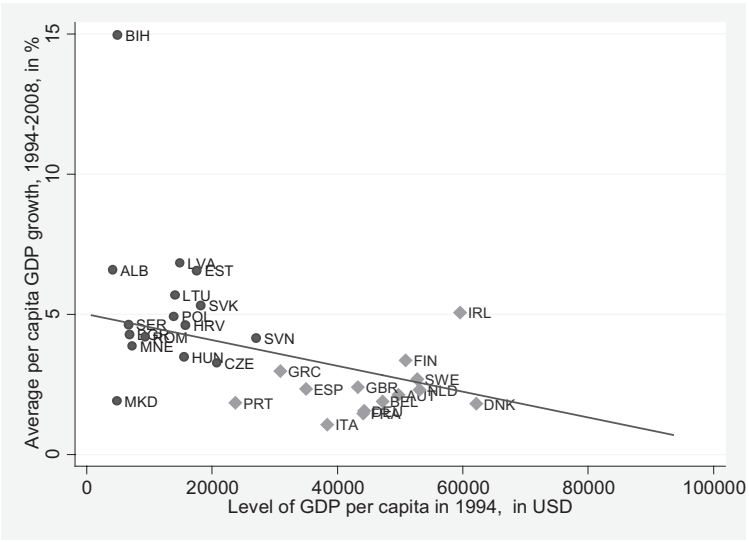
The economic integration took place on several main horizons – trade, financial, labour, knowledge where the financial integration, together with trade integration, had a prominent place.

It is however important noting that the financial integration within Europe including that of developing (Emerging) Central and Eastern European countries, took place during the worldwide trend of financial globalization. Financial globalization has started since 1980s resulting from large wave of deregulation of capital markets, opening of borders for capital flows and securitization.

And unlike global trade integration, where there is a consensus on clear positive outcome for developing countries welfare and growth (resulting from specialization, price reduction, diversification etc.), views on financial globalization are rather mixed. Financial globalization is seen as growth supporting thanks to capital accumulation and enhanced access to financing (Fischer, 1998, Summers, 2000). Nevertheless, it is associated with higher income volatility and exposure to crisis due to the sudden stops (Rodrik, 1998, Bhagwati, 1998, Stiglitz, 2002). Namely, wide range of literature on the direct net benefits from financial globalization for developing countries on the world wide scale is, however, inconclusive. An excellent literature survey by Kose et al. (2006) sum up that there is little robust evidence for the direct casual relation between financial integration and growth, but when accounting for thresholds like level of financial market development, institutional quality, governance, macroeconomic policies and trade integration, there is a positive effect of financial integration on growth for the countries above thresholds. Moreover, the benefits from financial integration seem to be rather indirect in way that financial integration plays a catalytic role in generating an array of collateral benefits that may help boosting long-run growth. These benefits are, similar to financial market development, better institutional environment, better governance and macroeconomic discipline.

When the international capital flows between developed and developing countries are concerned, there are several patterns observed on a world scale along the past two decades marked by financial globalization. The first is that capital usually goes 'uphill', that is from poor to rich countries, unlike the proposition of the neoclassical growth theory that capital goes where it is scarce and where its marginal product is thus higher, leading to the income equalization. This is known as Lucas' puzzle in international economics (Lucas, 1990). Second, global level economic evidence shows that there is a correlation between national level of savings and investment. This particularly mean that countries are growing based on their own savings and that there is a preference for investing at home even when there is a lower marginal return on investment than elsewhere. This finding has been puzzling from the point of view of the permanent income hypothesis, since high-growth countries should borrow abroad against future income to finance a higher level of investment and consumption. It represents another famous puzzle in international economics, called Feldstein-Horioka puzzle (1980). Finally, Gourinchas and Jeanne (2006) have observed on a large sample of non-OECD countries a negative correlation between productivity growth and net capital inflows over the period 1980-2000.

Figure 1. Convergence of income in Europe : 1994-2008



Source: World bank databank

This is known as "allocation puzzle" again contrasting the traditional view of neoclassical growth model where capital is directed toward more productive investment. The typical example for these three puzzles is that of China and United States capital flows.

Unlike the previously described global pattern, the European case of financial integration and capital flows between 'old' and 'new' Europe over the last two decades offer a completely opposite picture. The European case is thus more corresponding to the theoretical model. In Europe, capital has been flowing 'downhill' – from rich to poorer countries. Poorer members of European Union were net receivers of capital during last two decades. Also European transition economies have been net receivers of capital from rich Western European countries since their liberalization with the end of Cold war.

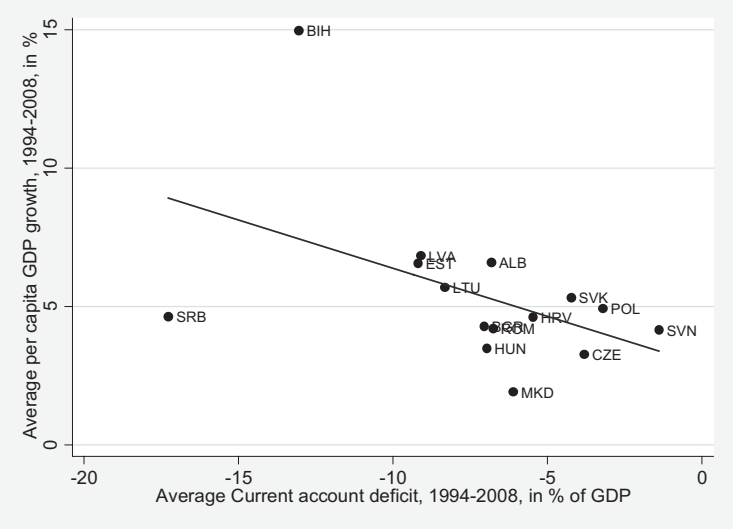
Moreover, the financial integration has had a positive effect on growth in capital receiving countries of Europe, and a dimension of impact could not be explained by threshold effects (institutional quality, financial development etc.). A large study by Friedrich et al. (2010) uses industry level data for 1998-2005 for 25 middle-income countries of which twelve from emerging Europe, suggests that it is political integration which causes financial integration to impact growth in Europe to a larger extent than elsewhere. They account for the four dimensions of political integration being: institutions, policy coordination, attitudes and political stability. This finding suggests that financial and political integration are complementary and that the political integration can considerably increase the benefits of financial integration.

Another European particularity is a phenomenon of income convergence. The term β-convergence was invented by Barro and Sala-i-Martin (1992) and refers to the negative correlation between initial levels of real GDP per capita and its average yearly growth rate, either after conditioning for certain control variables (conditional β-convergence) or without conditioning (unconditional β-convergence). Together with the concept of β-convergence, Barro and Sala-i-Martin (1992) introduce the concept of s-convergence. It refers to the decrease of the dispersion of real GDP per capita across economic units through time. It should be noted that β-convergence is a necessary but not sufficient condition for σ-convergence.

While in other parts of the world, there is no sign of convergence and in some parts of the world it has been 'a big divergence time', Europe offers again a counterexample. Catching up by new entering countries has been impressive (Figure 1). Intuitively, financial integration and income convergence in Europe are tightly related. What is more, it seems that financial flows from rich to poor countries have played a crucial role in income convergence of the last ones. And this link can be particularly well observed in the empirical analysis of determinants of current account deficits (as difference between national savings and investments) across Europe. In a large cross country study by Abiad et al. 2009, explain the increased dispersion of current account deficit in Europe by the financial integration while the direction of that relationship depends on a country's income. In other words, while poorer countries that are more financially integrated run larger deficits, richer countries that are more financially integrated run larger surpluses.

Following from the previous analysis, the negative correlation between size of current account deficit and GDP growth is registered in Europe (Figure 2), and not at all on the global scale.

Figure 2. Current account deficit and income growth in Emerging Europe



Source: World bank data

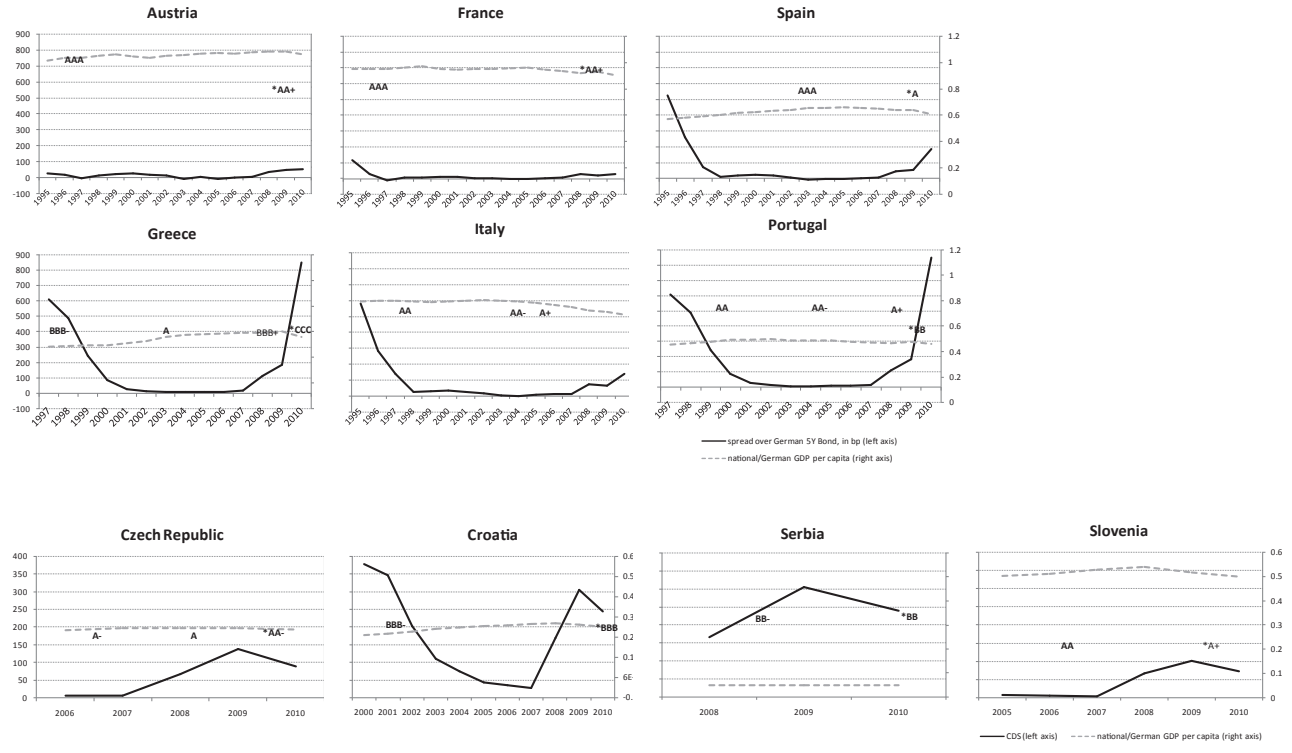
But once we look at the relative cost of borrowing and income convergence across Europe over the previous decade or two, we see that the price of borrowing for poorer (but converging) European economies had reduced very fast and much faster than their per capita income has converged, Figure 3. This observation points to at least two trends. One is the abundance of financial funds willing to take a risk of investing in poorer European economies, thus reflected in high supply and lowering spread (price). Other trend is that a part of much faster decrease in spread than improvement in fundamentals (measured by relative GDP per capita to German GDP per capita) may be attributed to pricing of credibility of future alignments and convergence to richer part of Europe. The reversal in terms of spread, during last three years, after the Lehman crisis, is another proof for that assumption.

Up to this point we have depicted the big picture explaining economic processes during two decades of European integration as well as the interrelations between capital lows, financial integration, income growth and political integration. Further on, we have shown that financial integration in terms of capital price had much faster pace that economic convergence. Namely, price of foreign capital has been reduced much faster than simple improvement in fundamentals in emerging Europe as the financial markets have priced the credibility of future integration and convergence in income of these countries.

Since Lehman crisis and even more with the sovereign crisis within the EU economies, the risk of reversal of capital flows is increased due to more regulation of financial markets, more risk aversion and less liquidity. Even more, it is widely recognized that a radical change in global development agenda is in place with these last to severe crisis episodes (Birdsall and Fukuyama, 2011). These changes will most likely include (1) the end of 'foreign financing fetish' meaning that there will be no more cheap and abundant foreign funding of development in the future, and (2) more place for and interest in industrial policies (never criticized from theory point of view but always by the fact that economic decision-making in developing countries could not be shielded from political pressure).

In the next section we are going to focus on risks and challenges from the financial globalization that happened in Europe, which are all relevant for managing

Figure 3. Price of debt, income convergence and S&P Rating evolution in selected European countries



Source: Bloomberg

future economic policy and for dealing with risks linked to the financial integration. These issues are as more relevant as the changes in global economic environment seem inevitable. In that context, and having in mind the explained genesis of financial integration and growth nexus in Europe, in the following section we are going to focus more on Serbian example all keeping the cross-country view. Also, we are going to illustrate the relevant macroeconomic imbalances and to give idea of their relative importance.

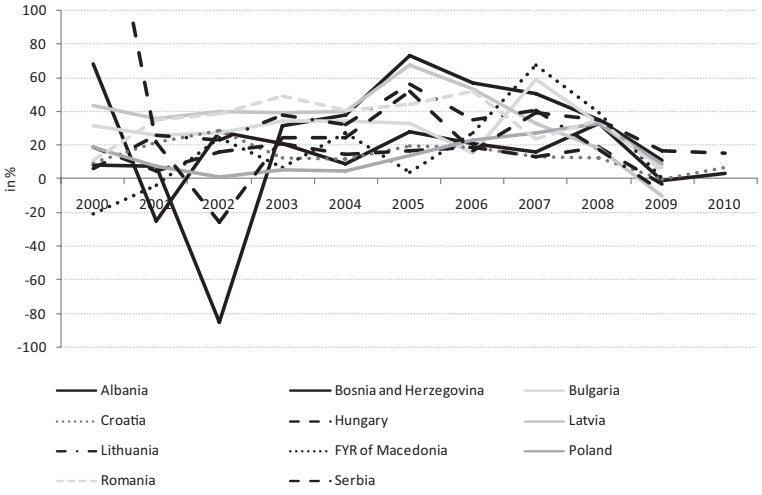
Macroeconomic challenges and vulnerabilities from financial integration

The increased level of financial integration, despite its incontestable income growth benefits, has opened a field for certain macroeconomic instabilities – short term volatility as well as long term structural imbalances. For the purpose of this overview, we classify all these main macroeconomic risks as follows: (1) demand boom impact to price and wage inflation and competitiveness; (2) risk of output fall due to sudden stops and reversals in foreign inflows; (3) exchange rate volatility and related monetary policy constraints; (4) debt sustainability risk and (5) risk of deepening of structural imbalances including fall in domestic savings rate, rise in fiscal deficit and underdevelopment of tradable (export oriented) sectors.

The long period of financial inflows has resulted in a demand boom, pushed in particular by bank credit expansion. Average annual credit growth across the region was of about 40% in the period 2003-2008, Figure 4. Some of this expansion can be attributed to the caching up due to the start from a low base once credit and consumption constrains were eliminated. However, the demand boom has been a principal cost push factor raising general price level and wages and consequently reducing overall competitiveness.

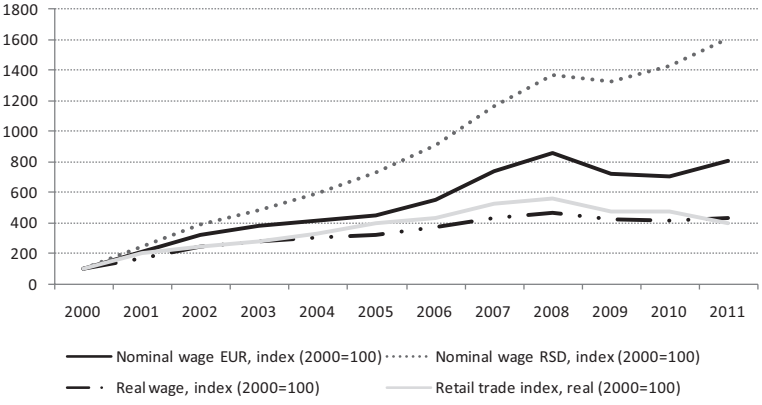
Serbian example reveals that over the 10-years period from 2001-2011, consumer prices level has increased four times (same as real volume in retail trade), average nominal

Figure 4. Domestic credit expansion, 2000-2010



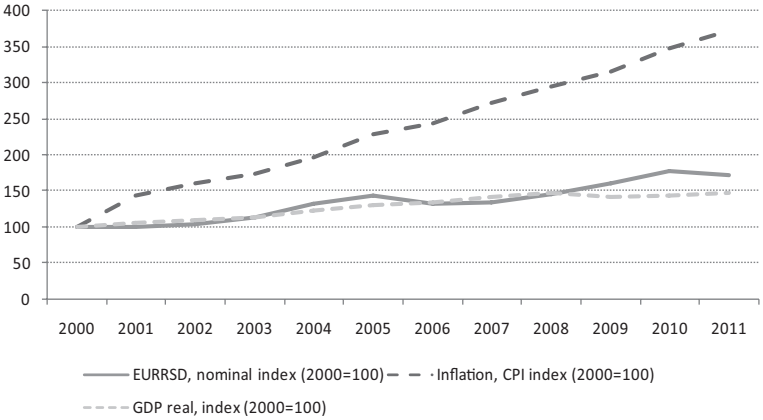
Source: EBRD; Hypo Research

Figure 5. Average wage index, Serbia: 2000-2011



Source: Statistical office of Serbia; Hypo Research

Figure 6. Prices, exchange rate and output, Serbia: 2000-2011



Source: Statistical office of Serbia; National bank of Serbia; Hypo Research

wage has boosted 16 times and real wage somewhat above four times. In the same time, real output has only doubled, Figure 5. During the same period, the exchange rate of dinar vs. euro has lost a half of its value in nominal terms, while it has almost doubled in real terms. Consequently, nominal wage translated into euro terms has increased 8 times, far less from the rise in value of production resulting in rise in unit labour costs, and therefore in fall in export competitiveness. Moreover, the trend in exchange rate and prices i.e. real appreciation of dinar has also resulted in reduction in export competitiveness since import became relatively cheaper and export relatively more expensive.

For better capturing the level of financial integration in Serbia during the previous decade, one should look at the balance of financial inflows and their "destination" in absolute terms, Figure 7.

A high dependance of output growth on foreign inflows is particularly uncomfortable once the flows suddenly reversed, and curent account deficit consequently contracts, Figure 8. That happened in Serbia, like elswere in the region of South-Eastern Europe, in last quarter of 2008. Although moderated by the arrangement with the IMF agreed in 2009, the output droped by 3% in 2009, and dinar lost about 20% of its value during last quarter of 2008 and first quarter of 2009. Since that time, the stock of cross border loans to companies, has started to melt down from the level of almost EUR 11bn at end-2009 with constant net repayments all over 2009, 2010 and 2011. However, Vienna agreement and relatively solid shape of European banks at the time of Lehman crisis have enabled localy present foreign banks' headquarters to compensate for the decrease of their direct exposure to companies with increase in ref-lines from headquarters to local subsidiaries. The trend of lack of foreign financial inflows was borken since end-2010 and all over 2011 when strong portfolio inflows destinated to government T-bills, and recently sold Eurobond outvalued the outflows from deleveraging by companies on cross-border loans, banking sector foreign liabilities remaining pretty stable. Serbian economy has registered somewhat accelerated growth in first half of 2011, and dinar has remained nominaly stable, appreciating 7% in real terms. One thing has, however, radicaly changed recently. Over last year the financial position of European banks have been deteoriating on sovereign debt crisis in EU periphery and fall in asset prices. New capital requirements in combination with increase in risk and fall in market value of assets have imposed much higher nominal capital needs[2], and many banks encounter difficulties to raise additional equity. On the other hand, improvements in capital adequacy may be reached as well by cutting banks' assets. The last would mean to reduce exposure to countries with lower investment rating. Translated into Serbian perspective, there is a

2 Estimated lack of capital by the EU banks after stress test in October 2011 was at EUR 105 bn at the time; however, due to the fall in government bond prices since, the capital requirement has increased significantly, UBS, 2011.

Figure 7. Serbian financial integration balance: 2000-2011

Investment destination of inflows, form of assets (contracts), stock at end-2011 - large part of the stock financed from flows listed in right column		Foreign financial inflows (net), cumulative for the period 2000-2011	
• Equity (privatization, greenfield investment, stock market)	~ EUR 10 bn	• Foreign direct investments	~ EUR 15 bn
• Domestic banking sector credit to companies and households (a part is financed from locally collected deposits)	a part of ~EUR 17 bn	• Foreign banks loans to local banks (mostly ref-lines from headquarters)	~ EUR 4.3 bn
• Government debt (Eurobond, stock of locally issued T-bills and bonds, other Gvt.debt net increase over the period, IFIs etc.)	~ EUR 3.8 bn	• Foreign banks direct cross-border loans to companies in Serbia	~ EUR 9 bn
• Short term liquidity, RSD reverse repo 2-week contracts with NBS	~ EUR 1.7 bn	• Portfolio inflows	~ EUR 2.6 bn
		Total	**~ EUR 30.3 bn**

Source: Hypo Research

high risk of net outflows of foreign funds in the following period. In that case, foreign financing channel may harm Serbian output growth and much effort should be put in mitigating such risks. In times of financial deleveraging, the necessity of FDI inflows for increasing investment and for balancing foreign currency flows in Serbia is particularly important. Also, in such circumstances, the arangement with the IMF plays as a buffer for external shocks. Moreover, other growth drivers, like productivity growth and support to export and competitivness should become high priority.

Although larger scale deleveraging of European bank may imacts each of host countries macroeconomic conditions, the coordination in a form of recently launched "Vienna 2.0" innitiative is a good example of political integration within Europe. It may help to avoid serious damages of sudden and uncoordinated deleveraging to output growth and exchange rate stability of host countries of South Eastern Europe and further deteoriation of the quality of banks' claims on these economies.

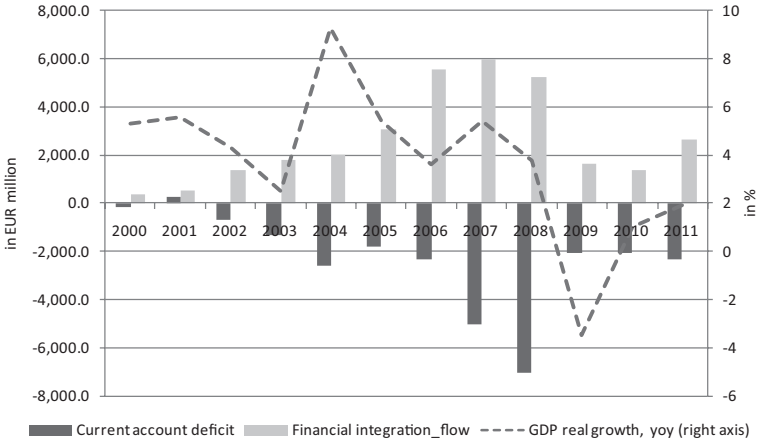
Foreign currency stability is an important element of stable business environment. It is also an important element of price stability, especially in small open economy with the hystory of inflation. However, a price to pay in order to have an independent monetary policy (instead of adopting a currency board and import price stability from the chosen hard currency country) is a floating exchange rate. It is known in economic theory as so called impossible or unholy trinity of fixed exchange rate, open capital account and stable prices where one has to be abandoned.

However, exchange rate flexibility happens to be very destabilizing in open economies with relatively shallow foreign currency markets. In such circumstances, during a wave of high foreign currency inflows, particularly in 2003-2007 period, countries deciding for floating exchange rates opted for so called sterilized interventions in order to manage the appreciation pressures. The intervention on foreign exchange market by the central bank would only mitigate the local currency volatility, in this case – appreciation. On the other hand, additionally created local currency liquidity would be absorbed through reverse repo operations by the central bank.

On the other hand, when condition reversed, with two last episodes of stress on the global financial market, all emerging European currencies went under strong depreciation pressures, Figure 9.

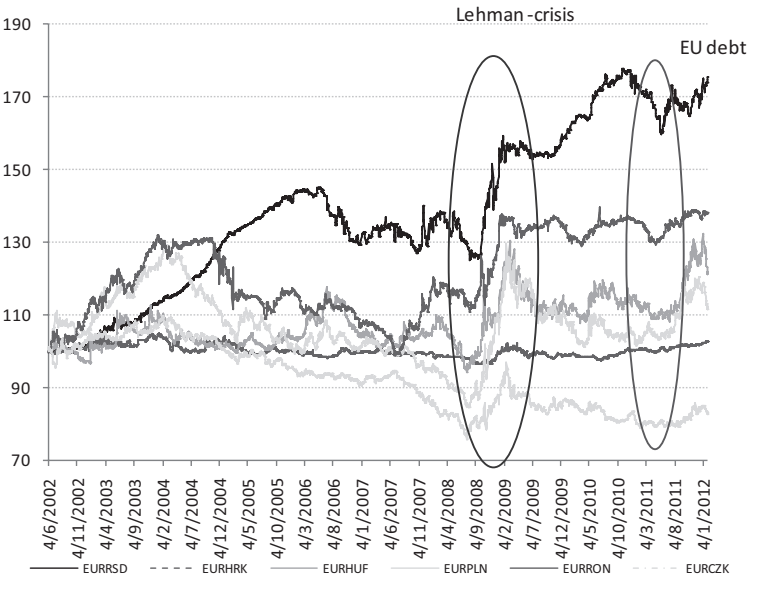
Although price stabilizing through direct impact on prices of imported goods and indirectly by anchoring inflation expectations, appreciation is reinforcing current

Figure 8 : Financial integration, current account deficit and growth, Serbia, 2000-2011



Source: NBS, Statistical office of Serbia, Hypo Research

Figure 9. Exchange rate of emerging European currencies vs. Euro, index 2002=100



Source: Bloomberg; Hypo Research

account gap and worsens export competitiveness. Dinar depreciation is acting in right the opposite direction and is happening in absence of inflows from abroad in the economy with current account deficit. It is even stronger in circumstances of net outflows of foreign financing from the country. Dinar appreciation was likewise happening during the episodes of intensive foreign inflows, in 2006 and 2007 and in 2011, Figure 10. It depreciated in times of outflows in last quarter of 2008 and first quarter of 2009 and all over 2010. All these episodes were partly mitigated by NBS interventions against the exchange rate volatility.

All central banks that opted for exchange rate flexibility have also chosen the inflation targeting framework as monetary policy regime, as Czech Republic, Hungary, Poland, Romania, Serbia. On the other hand, some countries have chosen to keep pegging their currencies (or adopted currency boards) and provide the exchange rate stability as price stabilizer. These were Croatia with currency peg and Bulgaria, Montenegro, Bosnia and Herzegovina, Estonia with currency boards.

The positive differential between interest rate on the local money market (repo rate and Government T-bills rate) and interest rate from international money market rates (e.g. Euribor) joinlly with local currency exchange rate movements (or stability) have offered a space for international arbitrage or for so called carry trade.

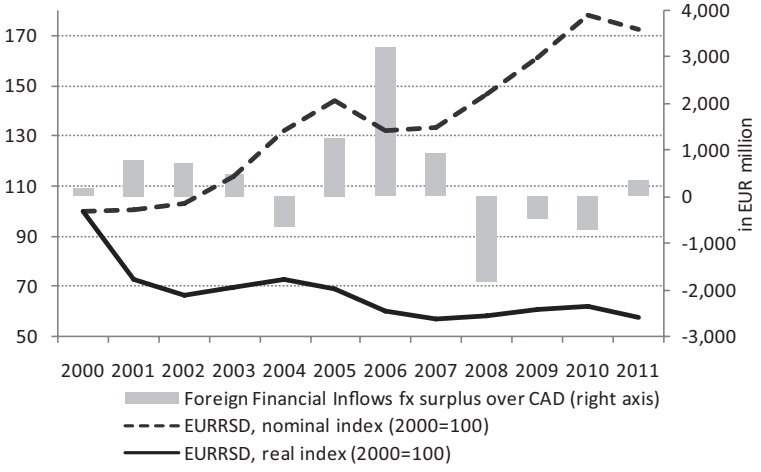
In that respect, we may observe that in Serbia, over the period 2006-2012, since the dinar repo and T-bills market have been in place, absolute value of inflows into these markets is highly correlated with the yield on dinar placements converted to euro after certain time[3] rather than to the level of nominal or real dinar interest rate, Figure 11.

Another characteristic of the financial system of emerging European economies, in some way directly linked to the achieved level of financial integration is a high proportion of total loans by banking sector with indexation clause to foreign currency, varying from about 35% in Poland over 60% level in Hungary, Bulgaria, Romania, to above 70% in Serbia, Croatia to even 90% in Lithuania.

What the previously exposed specifics – flexible exchange rate, presence of carry trade flows and high level of indexation to euro, imply for te efficiency of the local monetary policy in inflation targeting regime (inlation as a single goal, flexible exchange rate, local currency short term reference rate as the main instrument, high transmission of exchange rate movements to prices) in small open economies in emerging Europe?

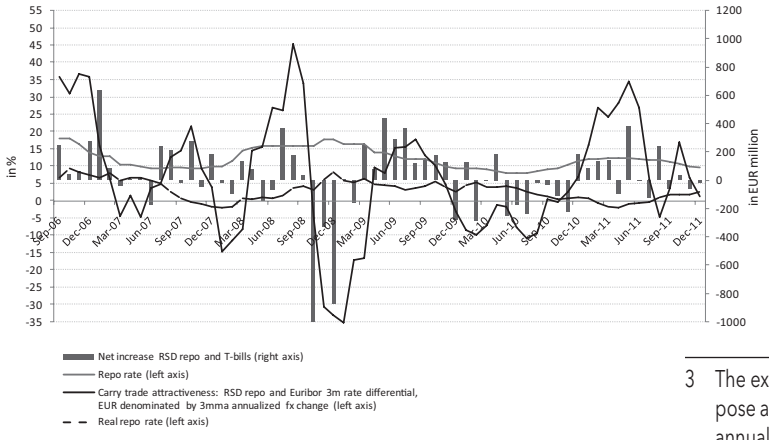
First of all, classical monetary policy channel of influencing real flows via interest rate impact on consumption, investment and saving decisions is theoreticaly limited to the local currency denominated part of monetary

Figure 10. Foreign currency surpluses and EURRSD rate



Source: NBS; Hypo Research

Figure 11. Carry trade attractiveness



Source: NBS; Statistical Office of Serbia; Hypo Research

3 The expected change in foreign exchange should be used for this purpose as an element of uncovered interest parity equation. Here, we use annualized change of exchange rate in the preceding three months as a proxy for the expected change in exchange rate.

sector assets, which is 30-40% in average. The remaining part is rather influenced by the interest rate from the international financial market and the courty risk spread (evolving not only in line with fundamentals, but also in line with market participants risk aversion and market liquidity, Figure 3).

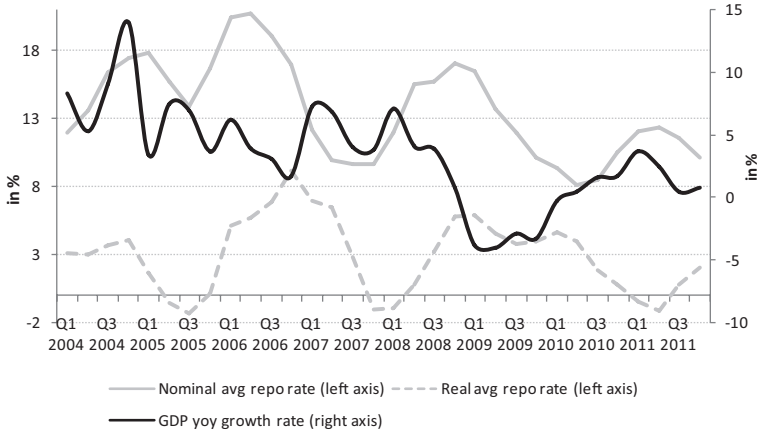
Secondly, within the local currency interest rate channel, central bank has to be always aware of the indirect impact of its reference rate on exchange rate movements. More precisely, if central bank decides to lower a local benchmark interest rate, lowering thus the return on money market placements of foreign funded market players, the central bank risks the outflow of funds temporarily parked in local currency contracts. That operation could then trigger a wave of outflows and induce local currency exchange rate depreciation. And vice versa. And once this mechanism is activated by an exogenous shock and foreign inflows suddenly reverse caousing depreciation of local currency (like with the Lehman crisis), even though the real activity is in danger of recession, central bank has an inherent limit in relaxing reference interest rate. Namely, lowering the interest rate together with exchange rate depreciation would lower the yield on carry trade and would risk additional foreign currency outflows. Even more, central bank, in these circumstances may be forced to increase its reference rate to induce some additional foreign currency liquidity inflows in order to stabilize the currency. This local interest rate – exchange rate link combined with high transmission of exchange rate movements to local prices is representing a second large limitation for the local monetary policy.

Following from the last set of observations, we may notice that reference dinar interest rate level was in a way pro-cyclical as a monetary policy instrument in Serbia, Figure 12. Contractions in output are coupled by high (restrictive) level of both nominal and real interest rate, and vice versa. Consequently, credit in local currency was relatively cheaper in good times and more expensive in bad times.

One more legacy of lasting financial integration and related foreign debt availability is a high level of accumulated foreign debt with emerging European countries. This was also the feature of poorer EU countries (so called EU-periphery) which have experienced the same financial integration – convergence model. Depending of the countries' fiscal discipline, this debt is in some of these countries more directed to public and in others to private entities. Anyhow, with the raise in debt price (sovereign risk spread), and recession in the real sector, and persistent foreign financing needs (for covering of the maturing part of the existing debt stock and new deficits of public finances, or private sector needs), new debt inflows and debt sustainability in that way come under question. From the simple debt sustainability equation, it simply follows that in the reduction of debt weight over GDP is possible with reduction in deficit, reduction of interest rate on the existing debt[4], and by raise in output growth. In the absence of foreign financial inflows as fuel for local output growth, it implies that new growth sources have to be prioritized, such as productivity improvements.

Last but not the least, we arrive to the more structural and long lasting risk in terms of genesis and in terms of necessary time and effort for correction, which is a risk of structural imbalances resulting from longer lasting pattern of investment decisions in certain industries. Namely, as with soaring financial inflows, current account deficit have persisted (though contracted significantly), the underdevelopment

Figure 12. Real output growth and reference interest rate movements, Serbia, 2004 - 2011



Source: NBS; Statistical Office of Serbia; Hypo Research

4 Important component of the interest rate on foreign debt is the country risk spread.

of export oriented (tradable) sectors has become an issue since during the financial integration process, the major contributors to overall growth were in services sectors, real estate, trade and communications.

Some of reasons for underinvestment and lower productivity in tradable sectors relative to non –tradable ones, as discussed in Cupic, Atanasijevic (2010), may rely in less available financing for productive investments in terms of maturity (lack of necessary long term funding), and interest rate (country risk spread and local monetary policy cost components built in final interest rate result in unbearable or uncompetitive financing costs for local producers in manufacturing industries, traditionally needing higher fixed investment, longer period to reach full productivity and with lower profitability rate than services business).

Conclusion

The pattern of global capital flows during the last two decades of financial integration, characterized by three well known puzzles in international macroeconomics contesting the neoclassical theory propositions, consisted in: (1) capital moving from poorer to richer countries (Lucas puzzle), (2) countries growing based on their own savings and preference for investing at home even when there is a lower marginal return on investment than elsewhere (Felshtein Horioka puzzle), and (3) "allocation puzzle" by Gournichas and Jeanne, 2007. All these pattern were completely opposed by the pattern of financial flows within Europe.

The perspective of implicit and explicit integration into the European Union has represented a significant leverage for the economic integration and for financial integration in particular. On the other hand, financial integration spurred a financial development, both having the incontestable role in economic growth. The contribution of financial integration to economic performance has been so crucial that the overall growth pattern in European transition economies has been qualified in the literature as "financial integration driven growth model". The role of financial integration and rapid financial development was also central for transmission of the recent global financial crisis to the New Europe. The last has pointed to the risks inherent to the growth model despite incontestable benefits for growth and welfare.

The lack of financial inflows will stress the importance of (1) competitiveness enhancing: institutional reforms, public sector reform, infrastructure PPP as financing pattern for infrastructure, business environment improvement (public administration, bureaucracy etc.), (2) structural reforms via investments in productive capacities – import substitution and export increase. State policies could here mitigate the problem of maturity transformation of short term savings to long term investment and of price for investment financing. (3) fostering domestic savings. This structural transformation is not particularly job creating so there is a place for particular policies to mitigate this problem. Increasing competitiveness in services sector could provide job creation. Education policy should also support these developments – higher demand of engineering and technical skilled staff unlike for commercial. Industrial policy directed toward industries with comparative advantage (WB CEM identified).

Besides the exposed review of risks and challenges stemming from the financial integration, further integration should not be in question for a small open economy like Serbia. Better understanding of risks should serve for policymakers to be able to react and try to lead the integration process in more comfortable way from the local stability perspective. The alignment of regulation, elimination of administrative barriers, and institutional convergence all represent a proven benefit for development and reforms in that respect should be pursued until the complete harmonization.

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