Financial Policy Challenges on the Horizon

Abstract: This chapter examines the financial policy challenges facing South East Europe (SEE) countries in the near term focusing on the possible impact of changes to the regulatory, supervisory, and market structures especially in the euro area (e.g., banking union, and deleveraging) on SEE economies. The implementation of the Basel III supervisory standards will likely increase bank credit spreads and reduce bank lending, particularly for trade finance and long-term investment. Of special interest to SEE economies is the evolving EU financial architecture. Given open capital markets, the effectiveness of new regulations will often be dependent upon help from foreign (EU) supervisors, or on the use of capital flow measures by SEE authorities.

All SEE countries regardless of EU status or aspirations must contend with the uncertainties of the global markets and policies beyond the euro area. Downside risks, for example, emanate from the political and security disputes between Ukraine, Russia and Europe/US, plus the region’s proximity to the turmoil in the Middle East and, more distantly, Asian vulnerabilities. More positively, the lower oil prices that emerged in late-2014 provide at least temporarily a needed income boost for oil importing countries. The prospect of the normalisation of interest rates in the USA (and UK) brings with it new uncertainties, especially as it runs in parallel with quantitative easing policies by the ECB and, again more distantly, the Bank of Japan. As memories of the global crisis fade, and the Euro-area architecture is reformed toward a more stress-proof system, it is reasonable to ask how much further the deleveraging process has to run, and what this means for capital flows to SEE. While most would acknowledge that the growth model of SEE must become more export oriented and less dependent on capital inflows, it remains a sine qua non that the region will require foreign inward investment if it is to realise the dream of convergence with the advanced economies of the EU.

The evolving EU architecture in the wake of the global and (especially) Euro-area crises has created a plethora of new EU structures that new member states, as well as prospective members of the EU, will have to contend with and adapt to. Coordination of macroprudential policies (as discussed in Chapter 4) is just one of these initiatives. There is also the revised monitoring and policing of fiscal policies, as encapsulated in the so-called “six pack” and “two pack” sets of regulations and directives that are discussed, inter alia, in Chapter 3. In addition, there is the Macroeconomic Imbalances Procedure and, most importantly of all for financial market policies, the overarching EU Banking Union, which is also must be viewed within the broader context of the regulatory and supervisory responses to the global financial crisis, in particular Basel III.

The external financial environment and policy implications for SEE

Key factors are identified that will influence in a lasting manner the external financial environment for SEE countries over the next several years. Special attention is paid to developments in the EU because of its