

FINANCIAL SECTOR AND GROWTH PROCESS IN SOUTH-EASTERN EUROPE'S FORMER SOCIALIST COUNTRIES: COULD A KALDORIAN CUMULATIVE CAUSATION APPROACH HELP TO BETTER UNDERSTAND THE LINKS BETWEEN THEM?

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Abstract: *The reform and development of the financial sector was one of the most significant challenges that the former socialist countries faced during their transition to a market economy. At the start of this transition, their financial system was underdeveloped and centralised (monobank), where the central bank of each economy also functioned as a commercial bank. The restructuring, integration and development of the financial sector to enhance viability and enable it to respond to new demands was imperative, particularly for economic growth and the convergence of these economies with the developed economies of the region. This process of financial integration suffered a powerful shock with the economic crisis transmitted to the region in 2009. The initial aim of this paper is to highlight the problems created after the global economic crisis affecting the financial institutions of the former socialist countries of South-eastern Europe, as well as the problems that already existed, though not apparent, and were nevertheless exacerbated by the outbreak of the crisis. An attempt to investigate the role of the financial sector, dominated by the banking sector, follows, with regard to achieving macroeconomic equilibrium among the economies of the countries in the region and the potential for sustaining it in future as part of a path to growth. To fully satisfy this goal, we propose that it is preferable to avoid a linear approach to the issue, abandoning equilibrium theory to adopt an analysis inspired by the method of cumulative causation, based on the work of Nicholas Kaldor. Our analysis allows us to postulate that, in a post-crisis period, conditions prevail for the potential appearance of future structural impasses of a cumulative nature, which could lead to a systemic crisis and leave the development process of the region's economies exposed.*

Keywords: Financial sector, Economic crisis, Southeast Europe, Transition Economies, Cumulative Causation Approach.

JEL Classification Codes: P34, G01, F36.

1. INTRODUCTION

It is commonly known, according to neoclassical economic theory, that the relationship between the development of the financial sector and long-term economic growth is not linear. Nevertheless, though this theory assumes that financial sector development contributes to



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optimal distribution of resources, resulting in higher savings and thus investment, it posits that this can only happen in the short term, since according to Solow's model (1956), given exogenous technological progress, the long-term rate of growth of national income is determined by the growth rate of the labour force. In this case, the increased volume of savings does not play any role at all. The basic hypothesis for why this happens is the conviction that the law of diminishing marginal returns on capital applies. When the economy achieves long-term steady-state growth, the capital-labour ratio remains stable, all of the aggregates are increased along with the exogenously determined population growth rate, while the per capita figures remain steady. Stronger economic growth can only occur if a higher level of technological progress is integrated into the economy, though it always remains exogenous. This is where Levine (1997) introduces the importance of developing the financial sector which, through the enhanced propensity to save, capital accumulation and the funding of innovative entrepreneurial activities, can reinforce the integration of new technologies in the production process and promote economic growth.

The relation between financial integration and economic growth can be further approached through endogenous growth models which later followed the neoclassical model and rendered long-term growth an endogenous variable, while taking into account the diffusion of technologies, income distribution and institutional factors. Among these, the work of Romer (1989, 1990) and Pagano (1993) focus on the importance of the financial sector and financial intermediation to economic development in particular, adopting the hypothesis of constant returns to scale.

Opinions on the impact of financial integration are hardly unanimous. The prevailing position is that countries with more integrated financial sectors are more resilient in times of crisis. Although numerous more recent studies arrive at this conclusion, some authors argue that there is no evidence to support a strong relationship between financial integration within the globalised framework and economic growth. Prasad et al. (2003) conclude that it has not been clearly proven that financial integration enhances economic development in developing countries and moreover, it increases the volatility of consumption. In fact, they suggest that different financial integration strategies must be found, and that in the interim, goals such as "transparency, control of corruption, the rule of law and financial supervisory capacity" must be achieved (Prasad et al. 2003, p. 34).

Nevertheless, financial liberalisation, which has been linked to the expansion of the financial sphere in recent decades, could lead to a reduction in savings deposits due to the rise in interest rates caused by greater demand in capital markets, as well as the problems caused by asymmetric information, with negative effects on savings formation and, by extension, on economic growth (Arestis and Demetriades, 1997). Even more so, after periods of prosperity, financial liberalisation can potentially destabilise the financial system and render it more fragile, such as what happened with the global financial crisis of 2007 and thereafter (Wray, 2011)². Indeed, as already demonstrated - and counter to the widely held belief - financial shocks have an increasingly powerful impact on the real economy to the degree that reinforces the deepening of the financial sector (Kroszner et al., 2007). The diversification and continued integration of this sector entails increasingly greater systemic risk (Wagner, 2010).

The large majority of studies on the relation between financial integration and economic growth in general terms examine the response of macroeconomic equilibria to external shock.

² One fundamental approach to this issue can be found in the article by Hyman Minsky, "The Financial Instability Hypothesis", Levy Economic Institute of Bard College, Working Paper No 74, May 1992.

The question we pose here is whether there are endogenous mechanisms that could activate procedures responsible for disrupting this relationship.

The approach we propose in order to achieve this objective is to address this relationship through the perspective of the Kaldorian cumulative causation model and to apply it to the problem of the role the financial sector plays in the growth of the post-crisis, emerging SEE economies. The first part will review the issue of macroeconomic equilibria during the transition process of the countries concerned. The second part will examine the financial integration in the region's economies. The theory of cumulative causation is presented in the third part, while the last part looks at the role of the financial sector in the region under examination in the context of cumulative dynamics. Finally, the paper ends with conclusions and suggested topics for future research.

2. MACROECONOMIC EQUILIBRIA DURING THE TRANSITION PROCESS

After more than 25 years of experience with the transition of the former socialist countries of Southeastern Europe (SEE)³ towards a market economy and their integration into the global economy, it is possible to discern three distinct periods with regard to the progress of the undertaking and the course of development of their economies in general.

The first period extends from the start of economic and political reform to about the end of the conflict in Kosovo. The SEE countries present a less successful picture in comparison to the other countries of Central and Eastern Europe and the Baltics. The "initial conditions"⁴, the policy of uniformly applying measures and reforms proposed as part of the "Washington Consensus", in an environment of minimally developed institutions and delays in reforms, led to disappointing results with regard to expectations. Extremely high inflation, recession and growing unemployment were the key characteristics brought on by the rupturing of the structural links of the old system.

The second decade of transition was marked by a seemingly more successful period for SEE, as considerable progress was noted in implementing economic policies with a European orientation and in the development of institutions and regulatory frameworks, though the distance from the other countries in transition was still apparent. The macroeconomic indicators showed marked improvement, as the rate of increase of the real GDP accelerated. However, the rate slowed after 2004 and deficits in fiscal balances and domestic government debt were reduced, while the results were negative for the external debt of some countries, particularly as a percentage of total exports. Meanwhile, although inflation remained at high levels compared to the EU average, it showed signs of dropping, as did unemployment.

One significant weakness has to do with the structural change by the productive fabric of these economies, and specifically the decline of the primary sector in production of goods, the spectacular growth of the service sector, along with phenomena of deindustrialisation (UNCTAD, 2009). This factor explains the inability of domestic production to adequately respond to domestic demand. In terms of participation of investments in aggregate expenditure,

³ The former socialist economies in transition in the Balkans include Albania, Bosnia and Herzegovina, FYROM, Montenegro and Serbia, as well as Croatia, Bulgaria and Romania which are now Member States of the European Union.

⁴ Aside from the common characteristics of countries in transition (protectionism, super-industrialisation, low productivity and competitiveness, energy dependence on the Soviet Union), "initial conditions" are also the differences between them, such as participation of the secondary sector in domestic production, geographical distance from the markets of Western Europe, the degree of price liberalisation under the previous regime and the participation of COMECON in each country's foreign trade.

all countries more or less saw an increase, except Bulgaria and Romania. According to the same data, SEE countries present marked growth tendencies in aggregate expenditures for the period just before the transmission of the crisis to the region, where, according to EBRD data (2009), in many cases the annual growth rate exceeded that of the GDP. Regardless, the increase in bank lending and improved wages fuelled this development. External trade, which is marked by low value-added exports and high value-added imports (Jazbec and Kastrati, 2010), reflects the structure of the production potential of the country while at the same time countering the implications for employment. Specifically, the concentration of exports mainly in the consumer sector, particularly in a few problematic sectors that tend to shift on a global level based on lowest cost, could pose risks in the future due to the expected increase of standard of living and the cost of labour (Petraikos and Tsiapa, 2009). The balance deficits followed an increasingly expanding trend, except in Croatia, comprising up to 32.9% of national expenditures for Bosnia and Herzegovina in 2008. Therefore, the inability of domestic savings to fund essential investments and expanding deficits in current accounts, as well as the servicing of foreign debt, are directly related to the needs for external funding, meaning external lending to both private and public sector, in tandem with efforts to attract direct foreign investments and to implement an appropriate foreign exchange policy.

Capital flowing to the economies in the region gradually created inflationary pressure and, in combination with the Balassa-Samuelson effect⁵, in many cases led to loss of competitiveness. Moreover, the massive inflows of FDI capital increased imports of intermediate goods and mechanical equipment, and helped to further expand trade deficits. Another inflationary factor relates to countries which, in endeavouring to gain credibility for their economic policy, chose to fix exchange rates or to tie to a powerful currency (euro), which led to a convergence of real interest rates (reduction) through capital inflows. This reduction in lending costs and in many cases of lending in foreign currency, led to an additional increase in demand, further fuelling inflation.

The rapid increase in bank credit, aside from the associated risk of accumulating non-performing loans for emerging economies (Kaminsky and Reinhart, 1999) as borne out in the case of SEE, combined with inflows of foreign capital encompassed a more substantive risk for the sectors towards which the financed investments were directed. Specifically, if this capital is invested primarily in consumption and in the sector of non-tradable goods and home construction, the impact is negative for external balances, since competitiveness and exports are not enhanced and the real exchange rate is revalued. Since, according to Sorsa et al. (2007) p. 12, "in most of SEE, only about one-third or less of the stock of FDI, foreign debt, and domestic foreign currency credit is in the tradables sector," the risk of worsening external balances and competitiveness is clear.

The involvement of politics in funnelling available domestic and mainly external financial resources towards the economy created price distortions, inflationary pressures, fiscal and external deficits and excessive growth of certain sectors (construction), while it encouraged private consumption (Anastasakis and Watson, 2011).

This is the general picture presented by the transition of SEE countries during the transmission of the global financial and economic crisis. The economies of this region were hit harder than others in the post-socialist area. Even though an initial period of severe recession was followed by recovery, the rates of GDP growth cannot be compared to pre-crisis levels. The channels through which the crisis was transmitted fall under two major categories of internationalised markets of which the countries in the region are a part, each to a differing

⁵ See: Egert et al. (2006).

degree, with negative effects on internal and external balances. These are: a) the goods and services market, which is highly dependent on the EU (Bartlett and Monastiriotis, 2010) and suffered from a drop in demand, resulting in a drastic reduction in exports; and b) the capital market, where restrictions on credit from foreign and domestic banks and the increased interest on loans, combined with the large exposure of countries to foreign currency debt and a reversal in the flow of foreign direct investments, further complicated the funding of the real economy and in many cases led to devaluations of fluctuating currencies. In addition, the crisis necessitated the deleveraging of both banks and businesses, further limiting liquidity margins.

3. FINANCIAL INTEGRATION IN POST-SOCIALIST SEE

The development and reform of the financial sector was one of the most important issues to be addressed during the transition process. The financial system in this region at the start of the transition was underdeveloped and centralised (monobank). In other words, the central bank of each country also functioned as a commercial bank.

Even in the first two phases of transition, there were banking crises in all of these countries, though they differed in magnitude and duration. Although most of the economies in the region established stock markets quite early on, their operation and supervision by the exchange commissions only came into effect later in the transition. The restructuring of the financial sector to render it viable and able to respond to the new requirements is imperative. Nevertheless, the process of financial liberalisation in these SEE countries came to an abrupt halt as a result of the global financial crisis of 2008-09.

What follows is an overview of the problems that were created during the global crisis of 2008-09 for the financial institutions of the region concerned, as well as the problems that existed prior to the crisis; these had not been apparent but were highlighted by the outbreak of the crisis.

The financial system of the SEE countries can be described as bank-centric, since the capital markets are not developed and it simply specialises in traditional banking activities. Therefore, an analysis of the weak points of the financial sector focuses on the banking sector of the region. This fact protected these economies from high levels of exposure to toxic financial assets during the crisis.

A key attribute of the countries under examination is that with the onset of transition, most of their banking institutions passed into foreign hands. The wave of bank privatisation was completed with dramatically high rates of foreign ownership in all of the economies in transition. But this complementary relationship helped these countries gain a more stable and reliable banking sector.

In addition, though, as foreign banks entered the market, the number of loans to the private sector sky-rocketed (Ćetković, 2011), while all banks became involved in risky lending practices. Another significant problem typical of the pre-crisis period was that the increase in local loans exceeded the rate of growth in deposits⁶. The rapid rate of credit expansion led to an inability to properly assess the risk that lenders would default on their obligations.

As the global crisis broke out, the foreign banks attempted to contain the negative impacts by reducing or even terminating their activities in the region. The foreign banks stabilised lending during the crises of the host countries, while domestic banks reduced their lending activity (De Haas & Van Lelyveld, 2006). As it happened, the parent banks were not a

⁶ The Economist, 'Eastern European banks: The ties that bind', 21 February 2009, p. 73.

significant source of strength for their subsidiaries. Thus, domestic banks will have to find new ways to develop local sources of funding, since access to external financing has become increasingly more limited. Using an aggregate of data, De Haas and Van Lelyveld (2011) concluded that the subsidiaries of the multinational banks restricted their credit growth in the region more abruptly than the domestic banks. As domestic banks relied on funding from domestic deposits, they were better positioned to continue lending.

It quickly became clear that the withdrawal of capital from the region would have adverse consequences, since a large share of the banks are foreign-owned. Thus, the banks active in the region in cooperation with the governments of these countries launched the "Vienna Initiative" in January 2009 for the purpose of ensuring the macroeconomic stability of emerging Europe⁷. The specific initiative was included by the IMF and the EU into their macroeconomic financial support programs for these countries through various development organisations, while also providing assurance by private lenders. In exchange, a number of multinational banks present in the region committed to maintaining cross-border banking with countries in transition and to lending to businesses and households while recapitalising their subsidiaries.

According to De Haas et al. (2012), although a large-scale withdrawal of capital never materialised, there are no indications as to the role being played by the banks which were part of the initiative, as compared to those which were not. Similarly, no comparison has been made of lending behaviour of the multinational banks that were part of the initiative between countries where these banks signed the commitment and countries where they have not. Finally, the authors argue that it is not clear whether signing the Vienna Initiative could lead to negative secondary effects in other countries.

In early 2011, the economies gradually began to recover from the great recession; but the crisis in certain European countries, particularly in the south, has not been overcome. Fearing the transmission of the crisis to emerging economies that were already more vulnerable, the creators of the first initiative moved ahead with "Vienna Initiative 2". The primary objective was to avoid a large-scale withdrawal of capital from the region, ensuring that the European parent banks would not reduce cross-border funding. However, it could not prevent the sizeable deleveraging, whereby capital equivalent to about 20% of the GDP (2013) of Southeastern Europe was lost by 2014 (Bank for International Settlements, Locational Banking Statistics 2014).

The inflated real property sector suffered a major blow and property prices dropped significantly. The banking sector did not remain unaffected, since loans - particularly housing loans - could not be serviced and the number of non-performing loans grew dramatically, fuelling a climate of uncertainty. As a result, the low demand for credit arising from the high related cost led to an extended period of low credit expansion - essentially an extended credit crisis. As we can see in figure 1 that comes from CEIC (2017) all countries of the region experienced a sharp reduction of the rate of domestic credit growth starting from 2008-09, trend that has been going increasingly - and even become clearly negative - in most cases in 2013-14.

⁷ <http://vienna-initiative.com/vienna-initiative-part-2/mission-statement/>

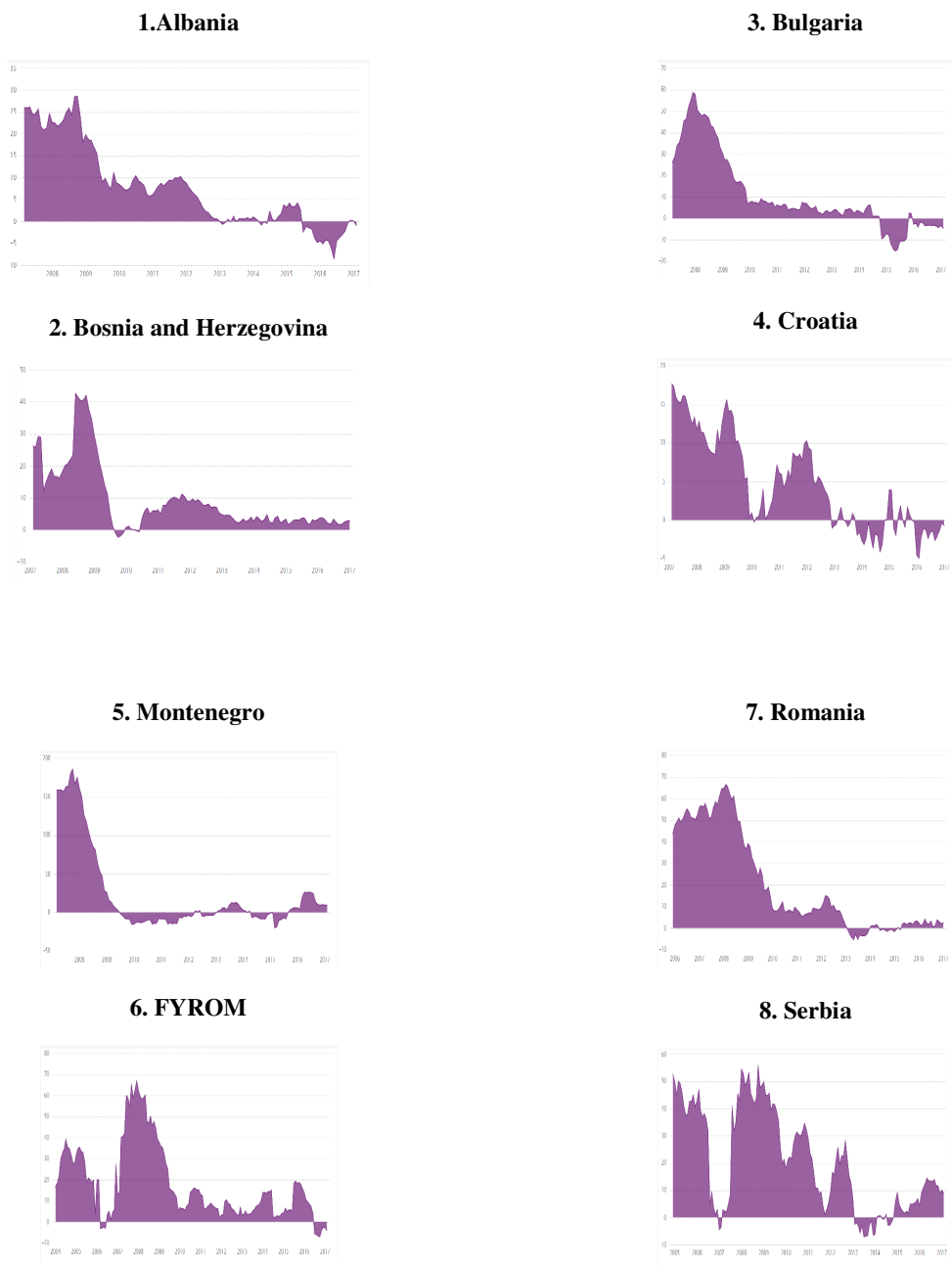


Figure 1: Domestic Credit Growth in SEE 2008-2017

Another reason for the challenges faced by the banking system was the collapse of small- and medium-sized enterprises, which had been the banking system's main investors. As capital inflows diminished, the national currencies of these countries in many cases underwent significant devaluation. Consequently, those citizens who had received loans in foreign currency found themselves in an even more dire situation, since the value of their loans increased in relation to the local currency. Loans in foreign currency were mainly being given by foreign banks (Epstein, 2013).

The weak institutional and legal infrastructure is one of the leading problems that each of the countries in transition has faced since the process began. Legislation should have been enacted to ensure their effective operation and to make it possible for markets to develop and perform their particular functions. There was no protection of creditor rights or provision for effective and modernised financial mediation. However, important steps have been taken to date. There has been compliance with EU directives, state-run banks have been contained and an IMF program of monetary discipline has been adopted. Nevertheless, the banks had concealed or ignored deep-seated problems in their balance sheet which inevitably surfaced, worsening the quality of their assets.

Continuing structural reforms are vitally important in order to guide the economy towards gaining a viable banking sector, with the ultimate goal being macroeconomic stability. Market discipline must also be strengthened, and there should be diverse sources of funding, accounting standards, regulatory responsibility, and proper supervisors and experts in order to eliminate practices that favour state banks without always meeting requirements while the main commercial banks are deprived of capital.

Finally, financial markets are characterised by an asymmetry of information between lenders and borrowers. Asymmetric information can be divided into two types: *ex ante* and *ex post* asymmetrical information (Capasso, 2003). In *ex ante* asymmetric information, lenders cannot accurately delineate the type and characteristics of borrowers. In the second category, lenders cannot monitor the results of borrower activities. The problems generated by both types of asymmetric information are quite different. The consequences of financial agreements differ in each case, with significant implications for financial development. Therefore, from the point of view of asymmetric information, operating costs affect the distribution of investments, diverting their flow towards the less productive activities and ultimately impacting on the rate of growth.

4. THE CUMULATIVE CAUSATION THEORY

In view of the above analysis, we believe that there are reasonable grounds to deepen the question of the role of financial integration in the process of economic growth of post-socialist countries. The answer to this issue could be found in the approach used by Nicholas Kaldor for certain economic issues. This post-Keynesian approach, which differs radically from the "new growth theories"⁸, is referred to as "cumulative causation", or "circular cumulative causation", and originates from the work of Thorstein Veblen (1915) on the evolution of institutions. It was used by Gunnar Myrdal (Myrdal, 1939) and later by N. Kaldor (1966, 1970, 1981). According to this approach, it not assumed that the economy functions in a state of equilibrium, nor that it lies on a production capacity curve; the variables are interconnected in a complex and diverse manner; they act and react with combined aggregate results and lead the system to a state of non-equilibrium through dependencies and hysteresis. However, they also present endogenous contradictions which are incorporated into their dynamic. And while Myrdal applies the principle of cumulative causation to the broader social context, Kaldor's approach was more economic in nature, as it explains the economic growth of a region or nation as dependent on a cumulative process in industrial production, linking increased production to aggregate demand, particularly of exports. At the same time, the increase in output (independent variable) and growth in

⁸ Although these theories (mainly developed by P.M. Romer, R. Lucas, G.M. Grossman and E. Helpman) differ from the earlier Solow model, they still fall under the neoclassical approach, assuming that income distribution is based on marginal productivity of factors of production and that the economy functions in a state of equilibrium along the production function curve.

productivity (dependent variable) were correlated by Verdoorn's Law. The result is a reduction in labour costs due to economies of scale and thus an increase in the economy's competitiveness, followed by a new growth in exports, thus introducing a new cumulative growth process.

Kaldor's approach was formalised by Dixon and Thirlwall (1975)⁹. This model implies that the phenomenon of circular and cumulative causation is due to the correlation described by Verdoorn's Law (coefficient λ). However, the differences between the rates of growth of regions/countries can only be interpreted if there are differences in λ or differences in the other model parameters from the outset; in other words, structural differences that determine the growth in aggregate demand (Léon-Ledesma, 2000). Setterfield (1997) examines the possibility in which the model could interpret a case where the growth rate is dependent on the initial conditions and the historical point in time of the system, or when it becomes path-dependent. This potentially happens when the coefficient λ and income elasticity of demand for exports, ε , become endogenous when some regions/countries become trapped in production techniques and specialisations which impede their adaptation to new development conditions. In this case, "lock-in" has occurred and institutional changes, including government policy, play an important role in its outcome. In this particular case, all equilibria that may occur are hypothetical, since endogenous forces within the system are at work. However, according to Thirlwall (2013, p. 7), "Even with 'lock-in', the economy ultimately settles down to an equilibrium".

Although the model demonstrates that differences in growth rates are maintained, more recent treatments, mainly by Amable (1992), De Benedictis (1998), Palley (1997) and Setterfield (1997) prove that it is possible for phenomena of convergence or divergence to also exist. These authors focus on the factors that influence the competitiveness of an economy aside from prices, namely technological progress and innovation. Nevertheless, with regard to the latter "technological catch-up", the integration of more advanced technological methods into the production process depends on the social capability of a nation to absorb them (Abramovitz, 1986).

Other interesting extensions of the canonical model by Dixon and Thirlwall relate to taking income distribution into account as well as capital deepening and the integration of technological progress. These two analyses are of particular relevance to the goals of this paper, namely establishing a link between the role of the financial sector of the countries concerned and the problems of economic development through the prism of the theory of cumulative causation. This is important because it leads us to see what directions economic policy should follow in order to address the structural deadlocks faced by the region. As to the first extension, Palley (1996, 1997), and Boyer and Petit (1991) demonstrate that it is possible to introduce income

⁹ The Dixon-Thirlwall model formalises the Kaldor's demand-led cumulative growth approach and is composed of four basic relationships:

$$\begin{aligned} \text{git} &= \gamma \text{xit} & (1) \\ \text{xit} &= \eta(\text{pit}-\text{pft}) + \varepsilon \text{zft} & (2) \\ \text{pit} &= \text{wit}-\text{rit} + \tau \text{it} & (3) \\ \text{rit} &= \text{rai} + \lambda \text{igit} & (4) \end{aligned}$$

Equation (1) states that the rate of real output growth in the home economy is a function of export growth (x), where γ is the income elasticity to exports. Equation (2) relates the rate of growth of the regional exports to the relative price competitiveness of the region (where pit is the rate of growth of prices of home exports and pft is the rate of growth of prices of exports produced by competitors and η is the own price elasticity of demand for exports) and the growth of income in its main export markets z, (where ε is the income elasticity of exports). Equation (3) postulates that the rate of growth of regional prices is determined by the rate of growth of domestic nominal wages (wit), the labor productivity growth (rit) and the rate of mark-up growth (τ it). Lastly (equation 4), labor productivity growth (rit) is determined by the rate of an exogenous labor productivity growth (rai) and the real output growth λ igit, where λ i is the Verdoorn's coefficient and renders the growth mechanism cumulative.

distribution between wages and profits into the model, a fact that allows for easier determination of aggregate demand. As to the second extension, in attempting to combine the endogenous theory of growth with neo-Keynesian tradition, Palley (1997) develops a closed economy model where he correlates the increase in productivity to capital deepening and the integration of technological progress to the production process. His analysis manages to prove the potential for multiple states of equilibrium as well as instability.

5. A CRUCIAL ROLE FOR THE FINANCIAL SECTOR IN CUMULATIVE DYNAMICS

Based on what has been analysed so far, we are in a position to argue that the financial sector could serve as a nodal point in detecting cumulative phenomena in the economies of SEE countries as they make progress in recovering from the crisis. Based on the basic principles of the Kaldorian model of cumulative causation, as enriched by the contribution of valuable scientific input, we believe that demand-led growth, where export trade plays a leading role, and the path-dependence phenomena which relate to both "initial conditions" and to the manner in which the transition took place, are capable of helping achieve this goal. In light of this approach, it is possible to identify mechanisms that will allow us to ascertain whether these economies possess endogenous cumulative dynamics to achieve recovery while avoiding the model which emerged de facto during the pre-crisis period and created structural distortions.

The high rates of GDP growth the region experienced during the second decade of transitional period relied to a large extent on external private and public funding - mainly borrowing and FDI inflows - and the support of liquidity by the domestic banking system, a fact that may allow to perceive this growth as "financialised". However, this encouraging picture was accompanied by an increase in income inequality¹⁰, by worsening external balances and by pathologies in the financial sector, characteristics which had been masked by optimism regarding the progress of growth. The productive base of the economies in the region underwent significant modifications, as it concentrated on a few low- and medium-technology sectors with intersectoral export performance and was dependent on demand mainly from developed EU countries. At the same time, a large portion of investments was directed to the non-tradable sector and construction.

The transmission of the global crisis to the real economy highlighted the structural weaknesses of the region's economies, which were much harder hit than those of other countries. Thus, we find ourselves before a combination of both of the above-mentioned principles of the Kaldorian model, documenting its negative dynamic: the recession which caused a decline in demand for exports and the role of path dependence, meaning the manner in which the transition was implemented. In this context, the economy's shrinking funding by the financial sector played a definite role, as it combined with the volume of internal and external debt, the poor fiscal situation, volatile capital outflows and the reversal in FDI to bring these countries to an unfavourable liquidity position. The response of economic policy applied with the intent of restoring macroeconomic equilibria was similar, a fact that entails economic cost for both the state and private sectors.

As already known and without ignoring the significance of the other parameters, the critical factor for the function of the Kaldorian model of cumulative causation lies in the Verdoorn coefficient λ , which links the rate of increase of productivity to the growth rate of production. It is just at this point that the factors which directly or indirectly influence this

¹⁰ Source: Index Mundi, World Bank estimate.

relationship in the economies of the region should be investigated to determine whether a case can be made for the existence of cumulative phenomena that lead to growth, or whether the opposite is true.

As an IMF study (2016) found, total factor productivity (TFP) in the region is low and dropped further after the crisis. The use of available technologies is less effective than in more advanced EU countries and this is due to structural and institutional obstacles. Specifically, the aforementioned study notes that the relatively small participation of the tertiary sector and, in many cases, the still large participation of the primary sector in the total GDP are factors responsible for the gap that separates these countries from the technological frontier. According to this study, other reasons for technological inefficiency include the quality of institutions¹¹, conventions, standards and formal rules, and stringent regulations (IMF, 2016, p. 38). However, this same IMF study concludes that any improvement in productivity that had been achieved pre-crisis was due to the effect of the main trading partners of the countries being examined, specifically those whose technological level had placed them closer to the technological frontier. According to the same study, the post-crisis recession is due to the decline in the potential growth and demand for exports of the above main trading partners, as well as, in many cases, their distancing from the technological frontier.

International literature on the improvement of technological levels and increased productivity highlights the importance of human capital reserves (Nelson and Phelps, 1966), (Romer, 1990). Specifically, it proposes an increase in spending on primary, secondary or higher education, depending on distance from the technological frontier (Aghion and Cohen, 2004), combined with an increase in expenditures for R&D by businesses (Hanushek and Kimko, 2000).

A fundamental question that emerges is the ability to increase funding for education and create margins for supporting R&D. This essential response to the problem of technological inefficiency is for the long term, but requires intense efforts which are difficult to implement at a time when the economies of the countries in this region are facing such difficulties. The role of the financial sector is, therefore, of key significance in securing the required liquidity in the economies of the countries concerned so that reforms that will reinforce the relationship between production and productivity can be funded. Otherwise, these economies are at risk of not activating the mechanisms of cumulative causation, as detailed in the Kaldorian model, and of becoming trapped in stagnation.

6. CONCLUSION

The relationship between the financial sector and economic growth is not a simple one. Both theoretical reservations and the recent global financial crisis, which dealt the real economy a severe blow, proved that. As this was no ordinary external financial shock for SEE economies, but rather a contagious crisis which highlighted the structural weaknesses accumulated during the transition process, the role of the financial sector must be examined carefully as part of efforts to ensure the safe recovery of the region. In this paper, we argued that the search for a theoretical solution to this question could be found by approaching the issue from the perspective of the Kaldorian cumulative causation model. By placing the development problem essentially in the relation between output and productivity - but without overlooking the importance of other parameters - this model and its extensions highlights the significance of reforms in the financial

¹¹ According to Setterfield (2010), the institutional framework must be viewed in the broad sense, meaning it should include conventions, standards and formal rules that impact on the ability of productivity to respond to growth in production, as expressed by the Verdoorn coefficient.

sector in funding essential actions in the region's economies. These reforms, however, should not be included in the generalised framework of guidelines that emerge from equilibrium theory; in other words, to be aimed at restoring balances and other variables with measures routinely recommended in such situations. They should aim to ensure the adequate financing of the private and public sectors with the goal of increasing technological effectiveness, education and research for the purpose of integrating new technologies in the production process and developing the export sector in particular. At the same time, the restructuring, recovery and improvement of the supervision of the financial system - mainly banks - as well as reforms that will re-establish the use of money to achieve real development goals should be completed, while avoiding following the same path to financial growth. At this level, upgrading and reinforcing the institutional environmental could constitute a valuable tool in achieving this goal.

Two objectives for further research could include: the policy of continuing the integration of the financial sectors of emerging SEE economies as part of the aforementioned theoretical framework; and the analysis of tools to bolster productivity by assimilating new technologies, developing innovations and promoting research in business and in higher education.

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