What went wrong in Slovenia and how to get out of the mess?

Jože P. Damijan
University of Ljubljana
Institute for Economic Research
VIVES, KU Leuven

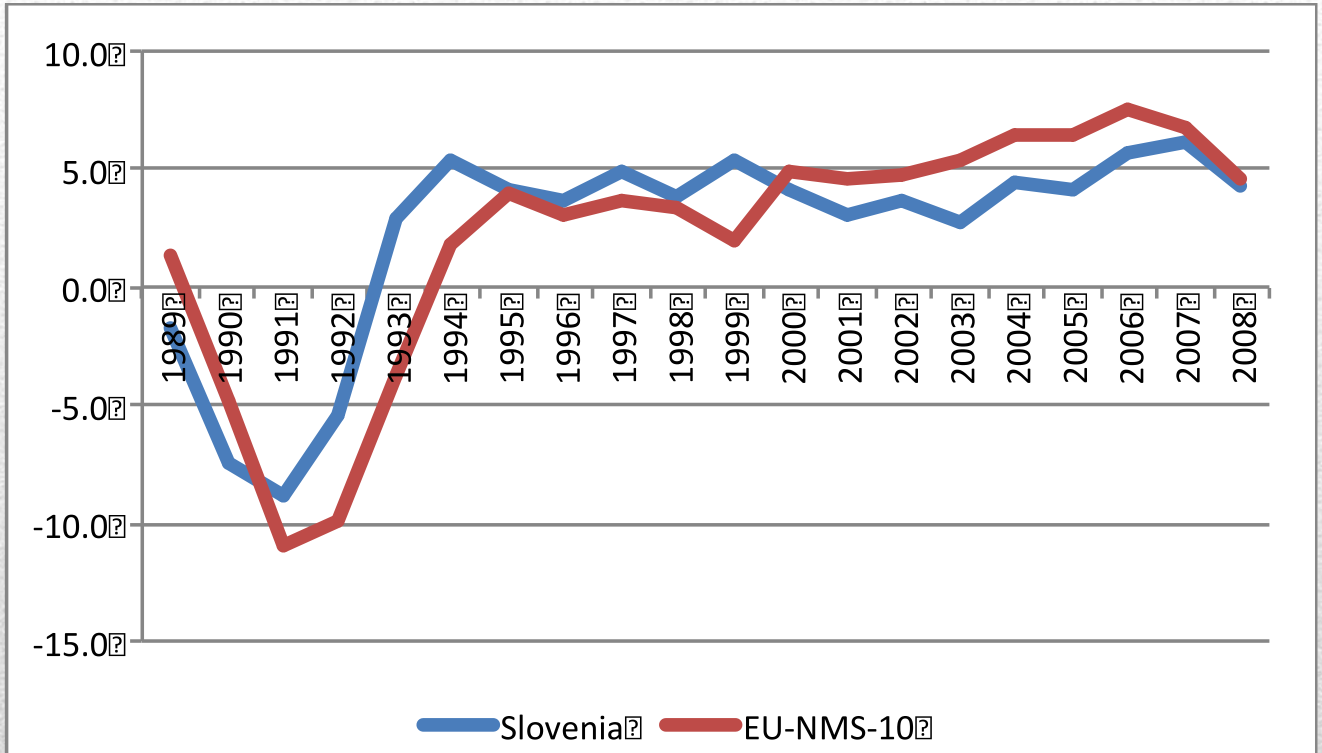
WIIW seminar, October 8, 2012

Outline

- Historical statistics (look good),
- The Fall,
- Roots of the crisis
- Mismanagement of the crisis
- How to get out of the mess?
- Can we make it?

Historical statistics

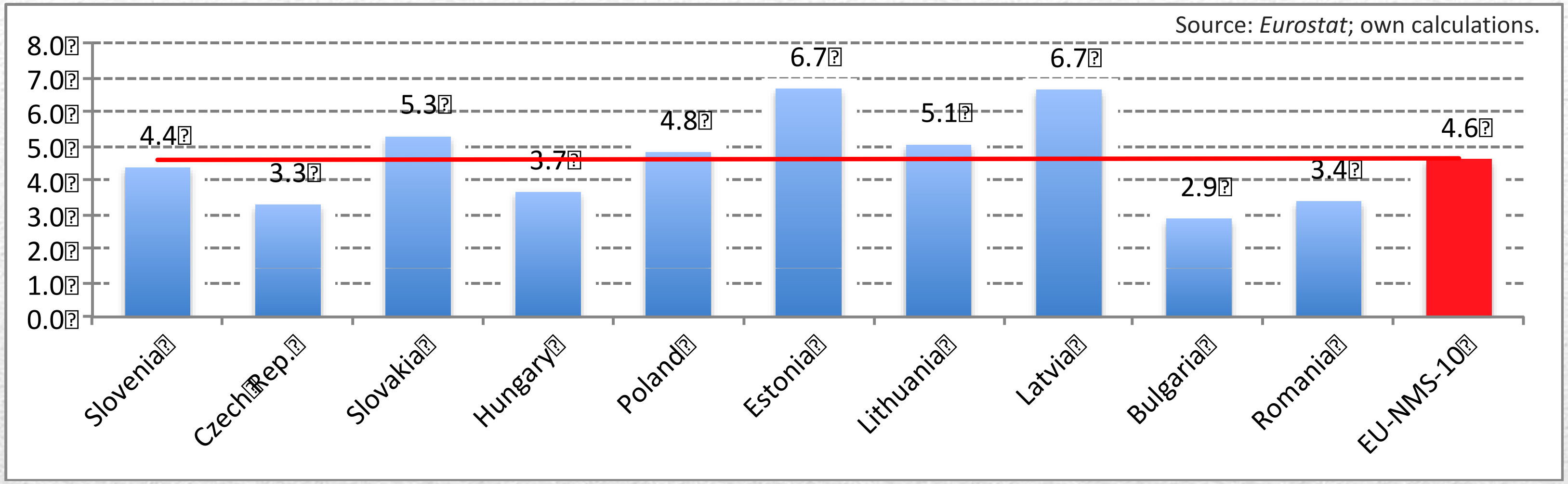
GDP growth 1989-2008 (%)



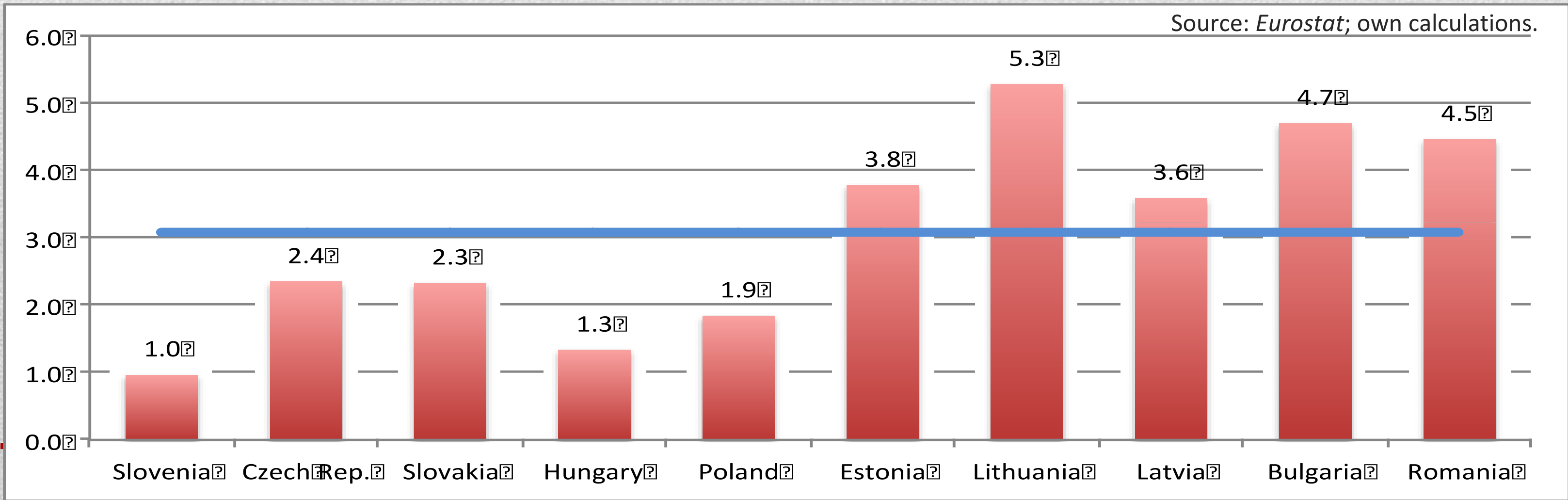
Source: *Eurostat*; own calculations.

- **Faster recovery after 1990 and more stable growth,**
- **Relative slowdown after 2000**

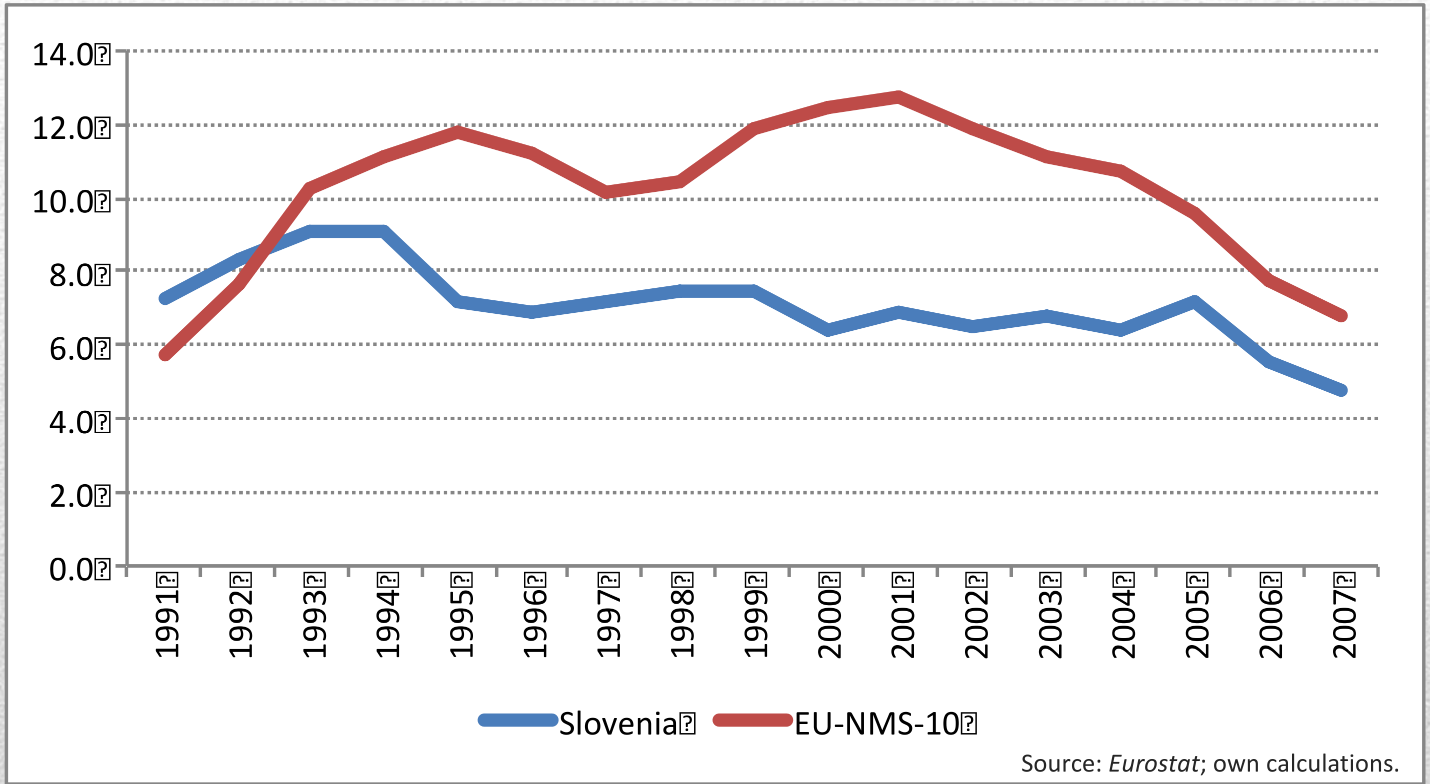
Relatively high growth 1994-2008 (%)



And very stable (low standard deviations)

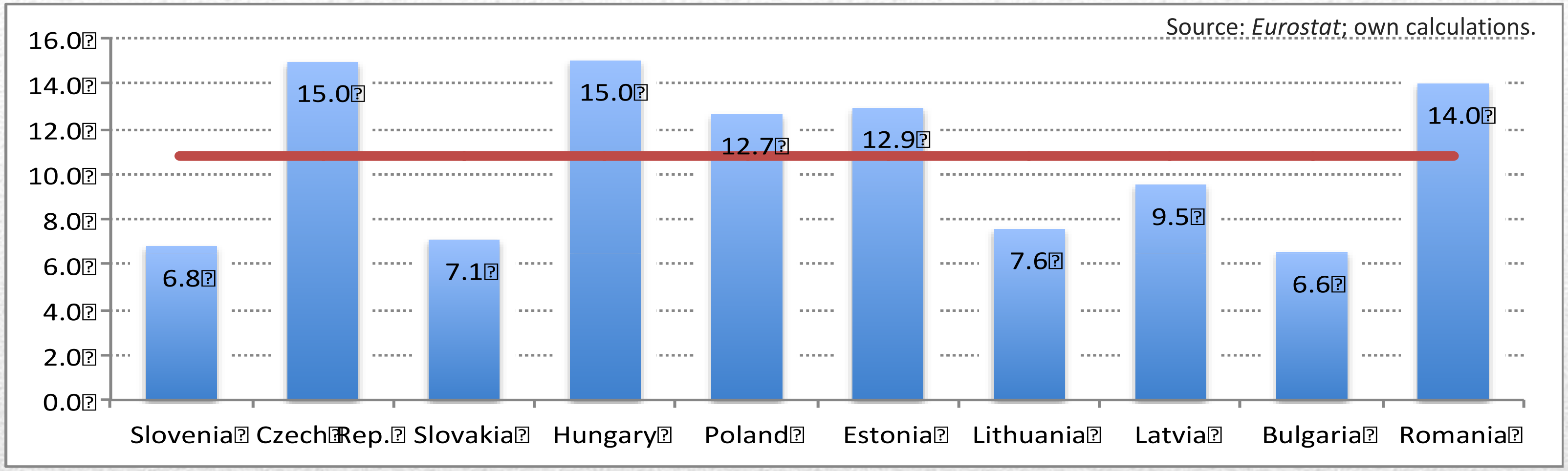


Low unemployment 1989-2007 (%)



- **Steady decreasing unemployment from already low level**

Low unemployment 1994-2008 (%)



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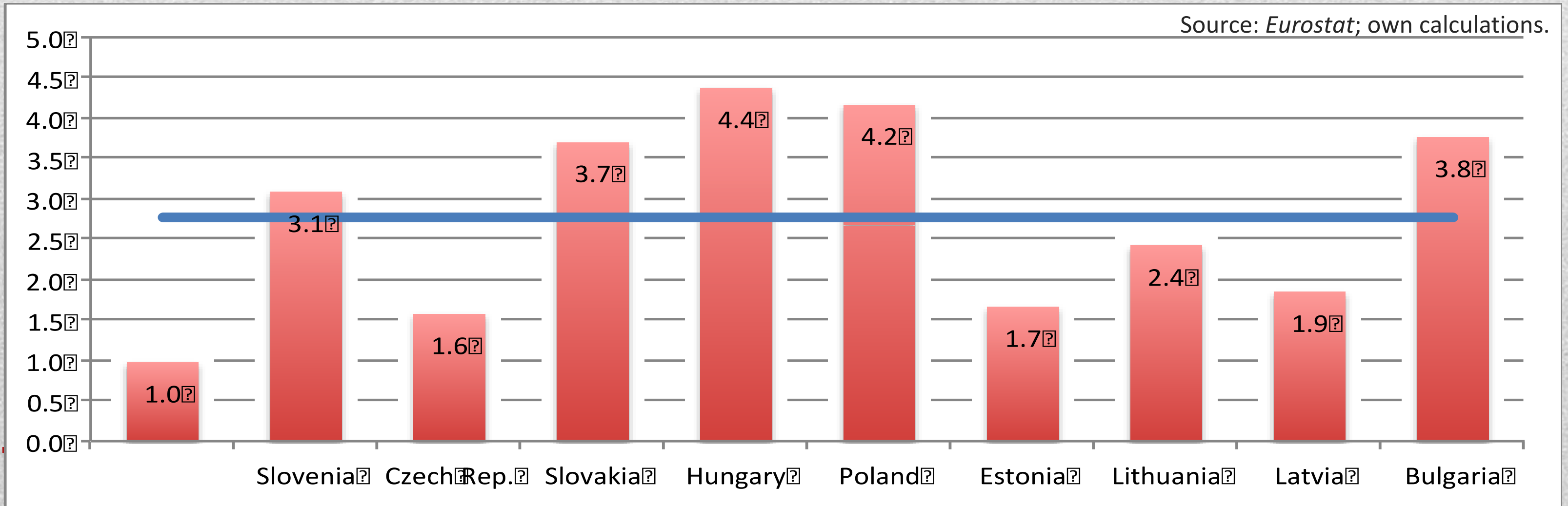
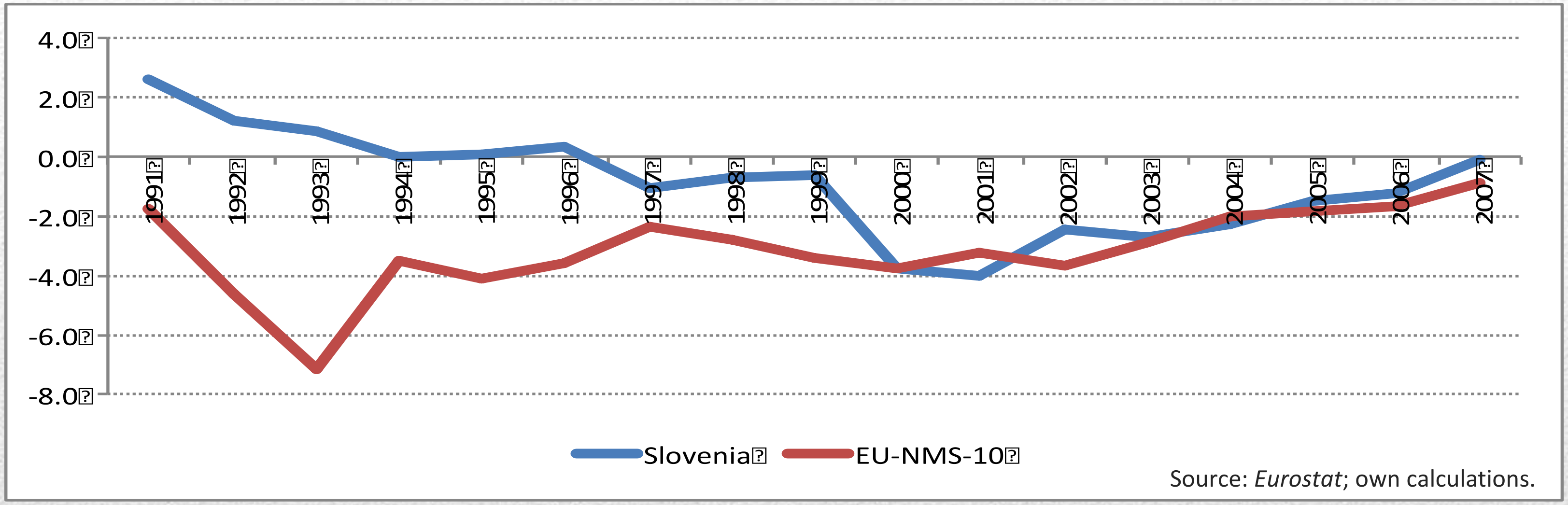
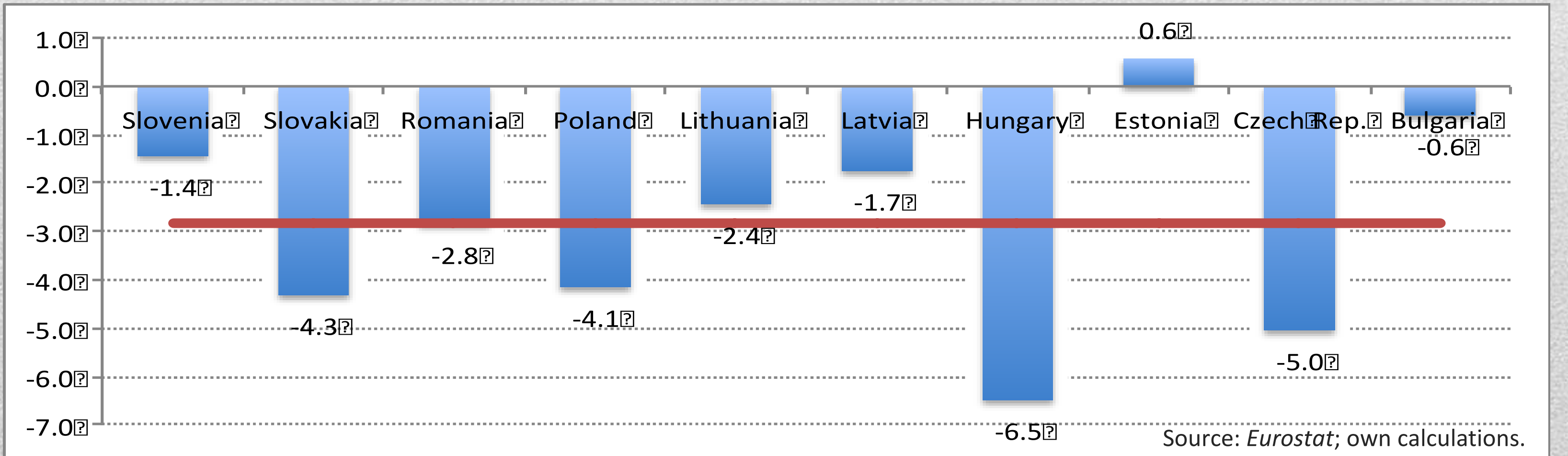


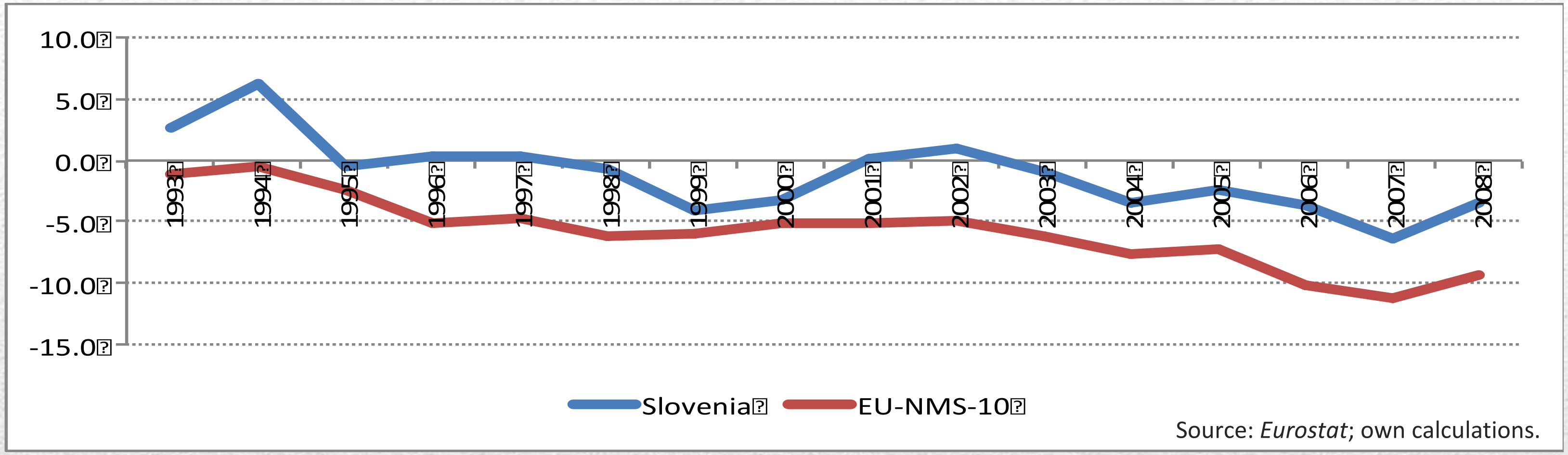
Budget balance initially positive, then deteriorating (% GDP)



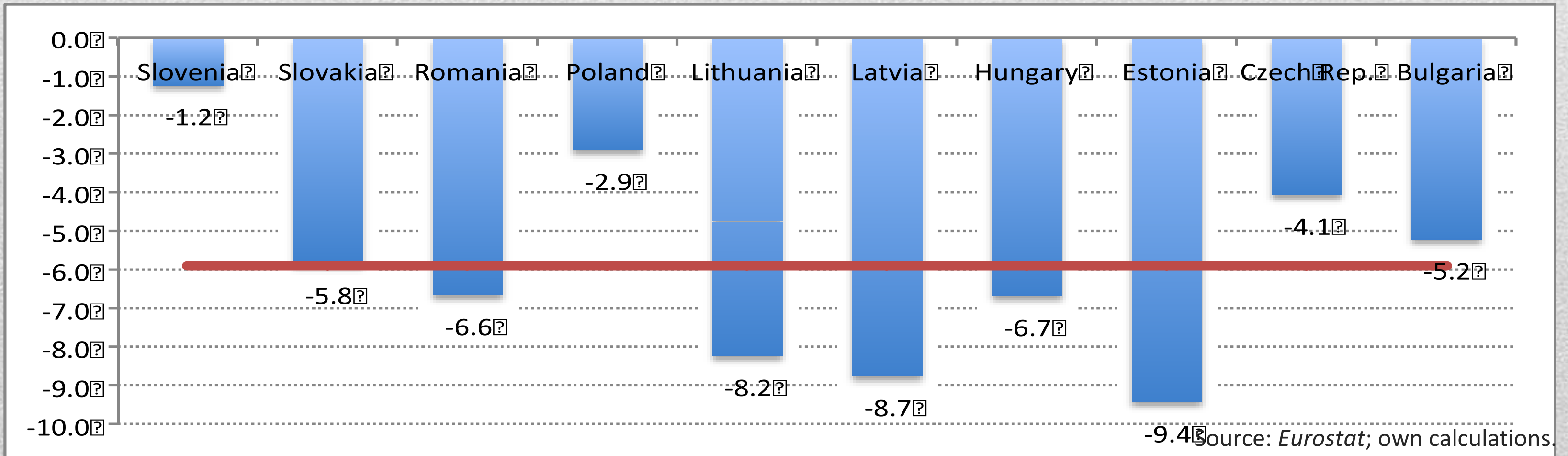
Though, deficit comparatively quite low (1994-2008)



Balanced current account until 2003 (% GDP)



But comparatively much lower deficit (1994-2008)

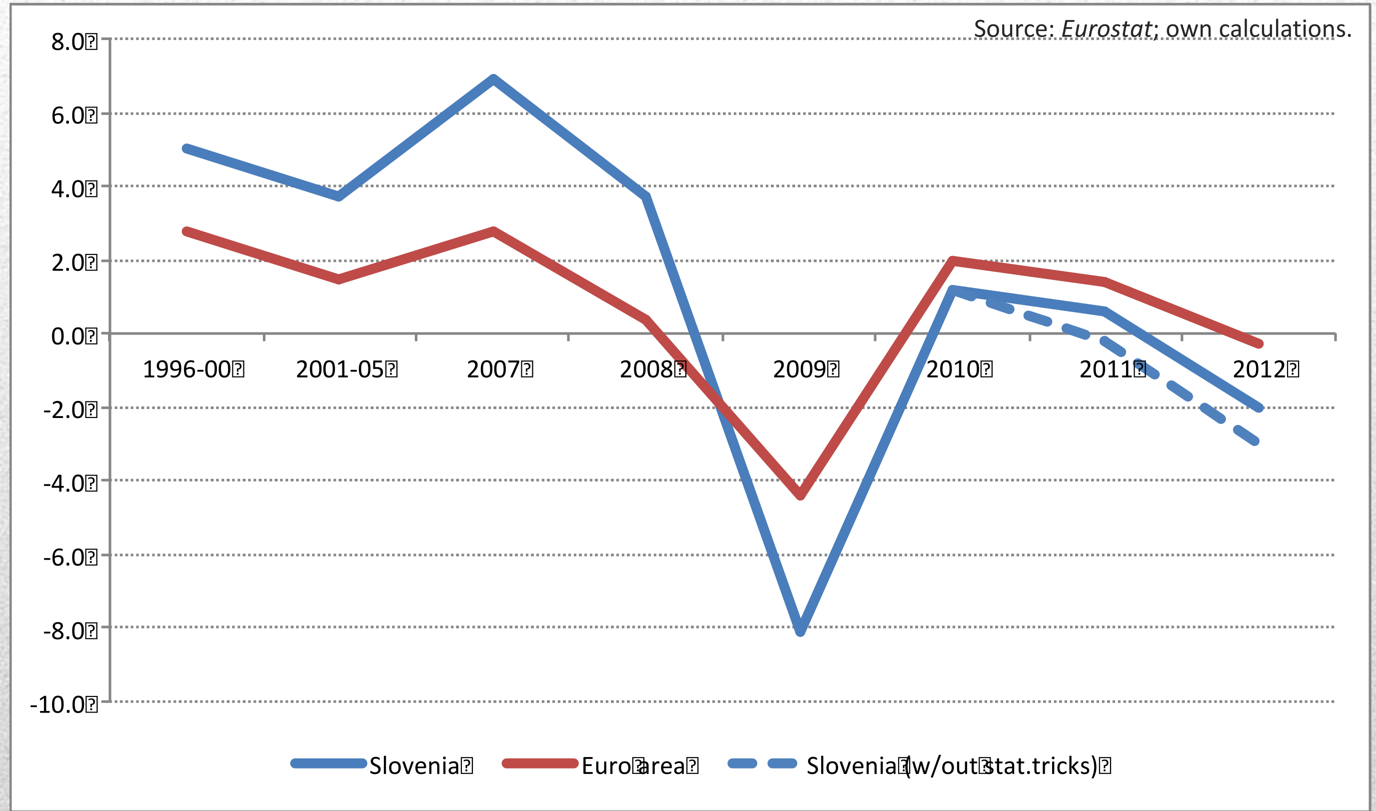


Summary

- Overall, very stable and comparatively good performance until 2008
- “Best pupil in class”, “Role model”, etc.
- Though imbalances kept piling up after 2000
- Slovenia was losing its competiveness
  - *without joining the EU (2004) and the global boom (2005-2007) the Fall might come earlier,*
- Structural reforms (2005-2006) were considered unnecessary and were delayed

The Fall

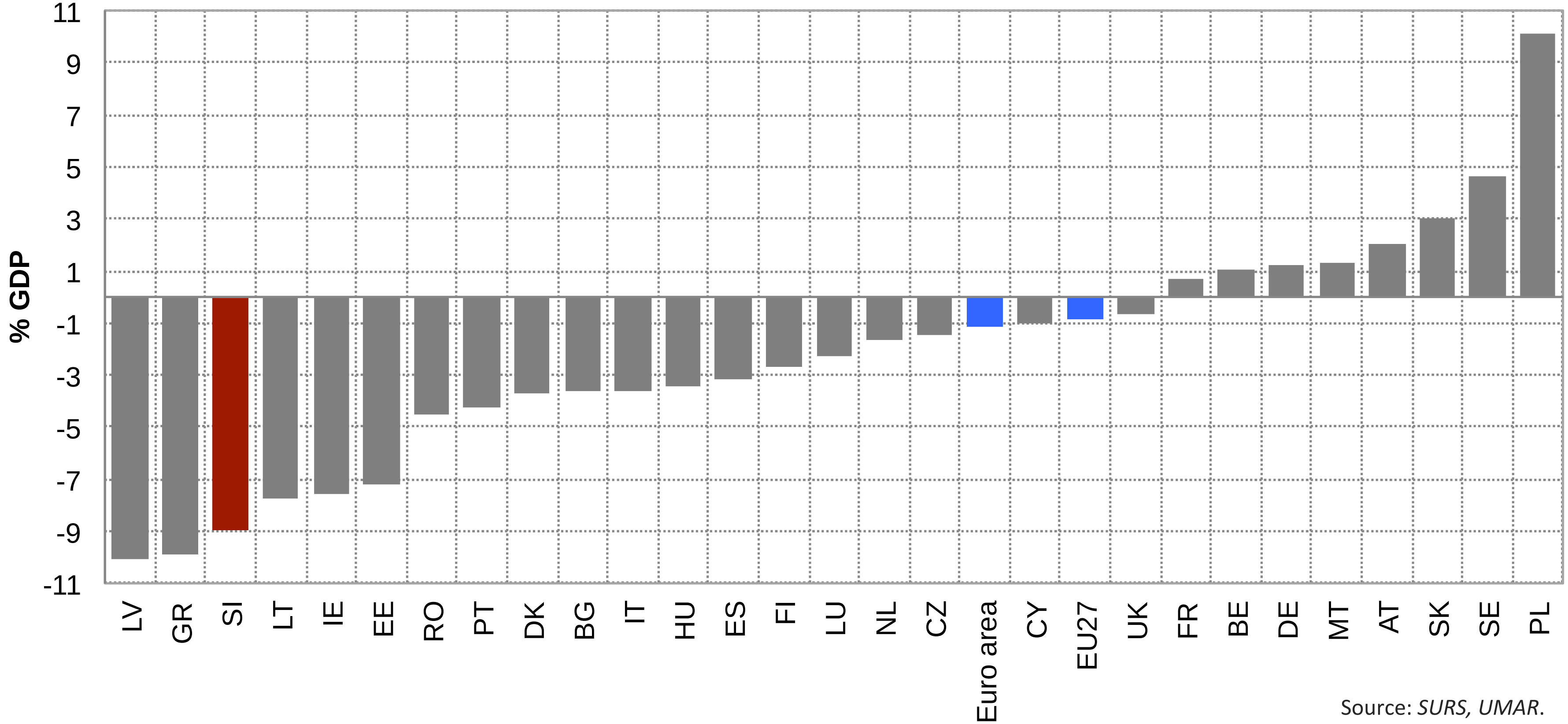
Dramatic decline of GDP in 2009



- **and slow recovery**

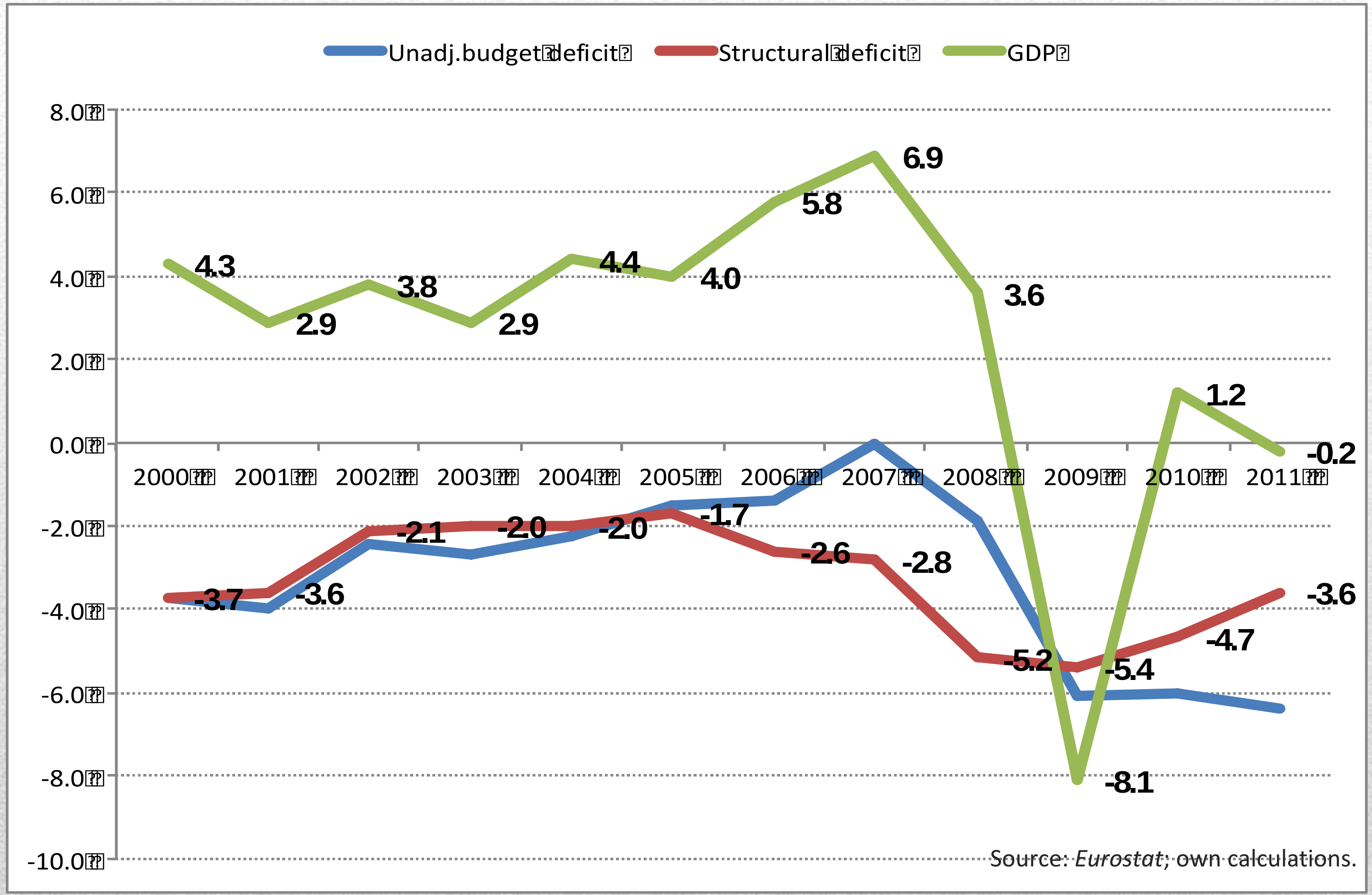
The second hardest decline of GDP in Euro area

(Q4 2011/Q3 2008; %)



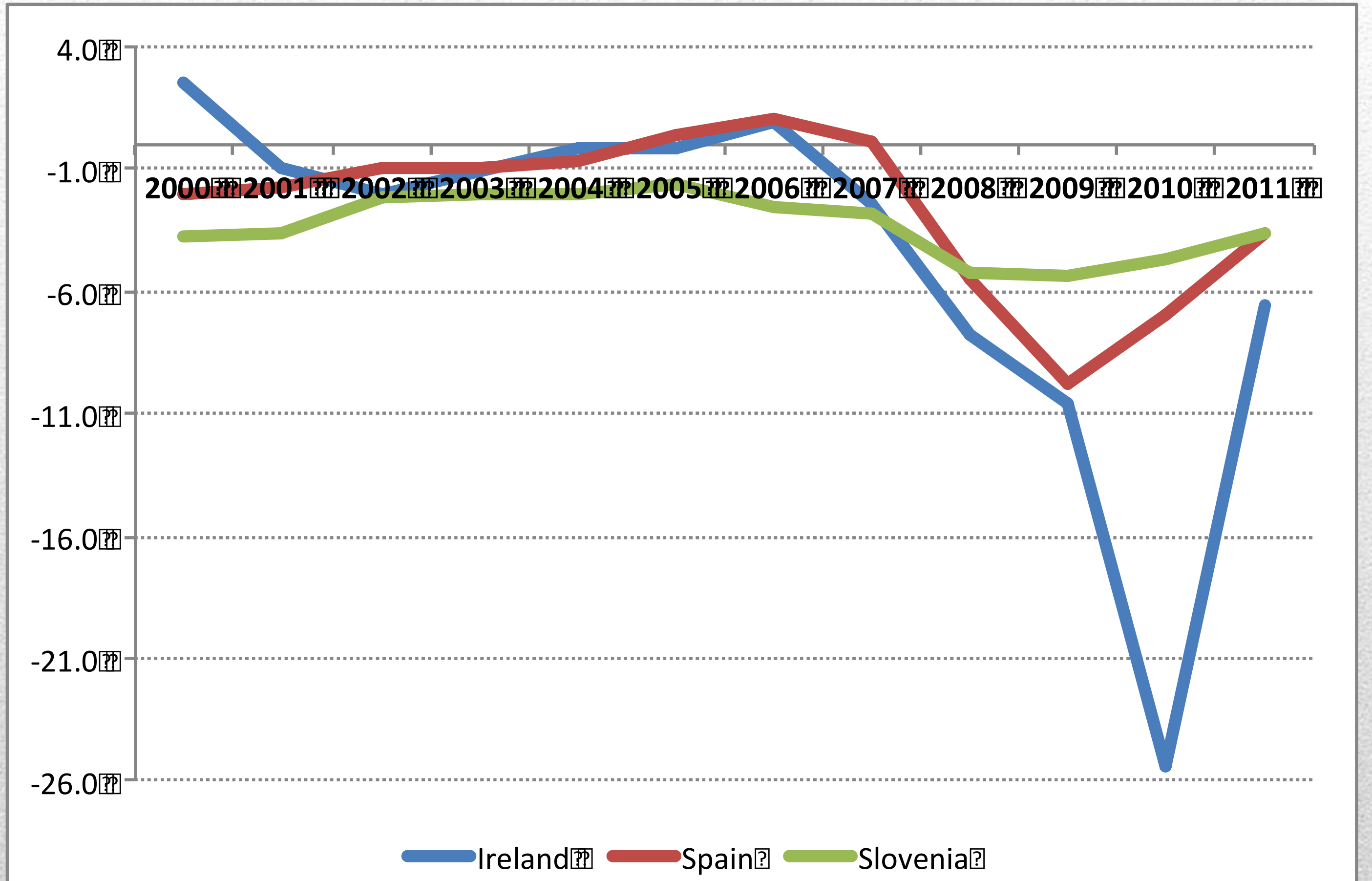
Source: *SURS, UMAR*.

Irresponsible fiscal policy



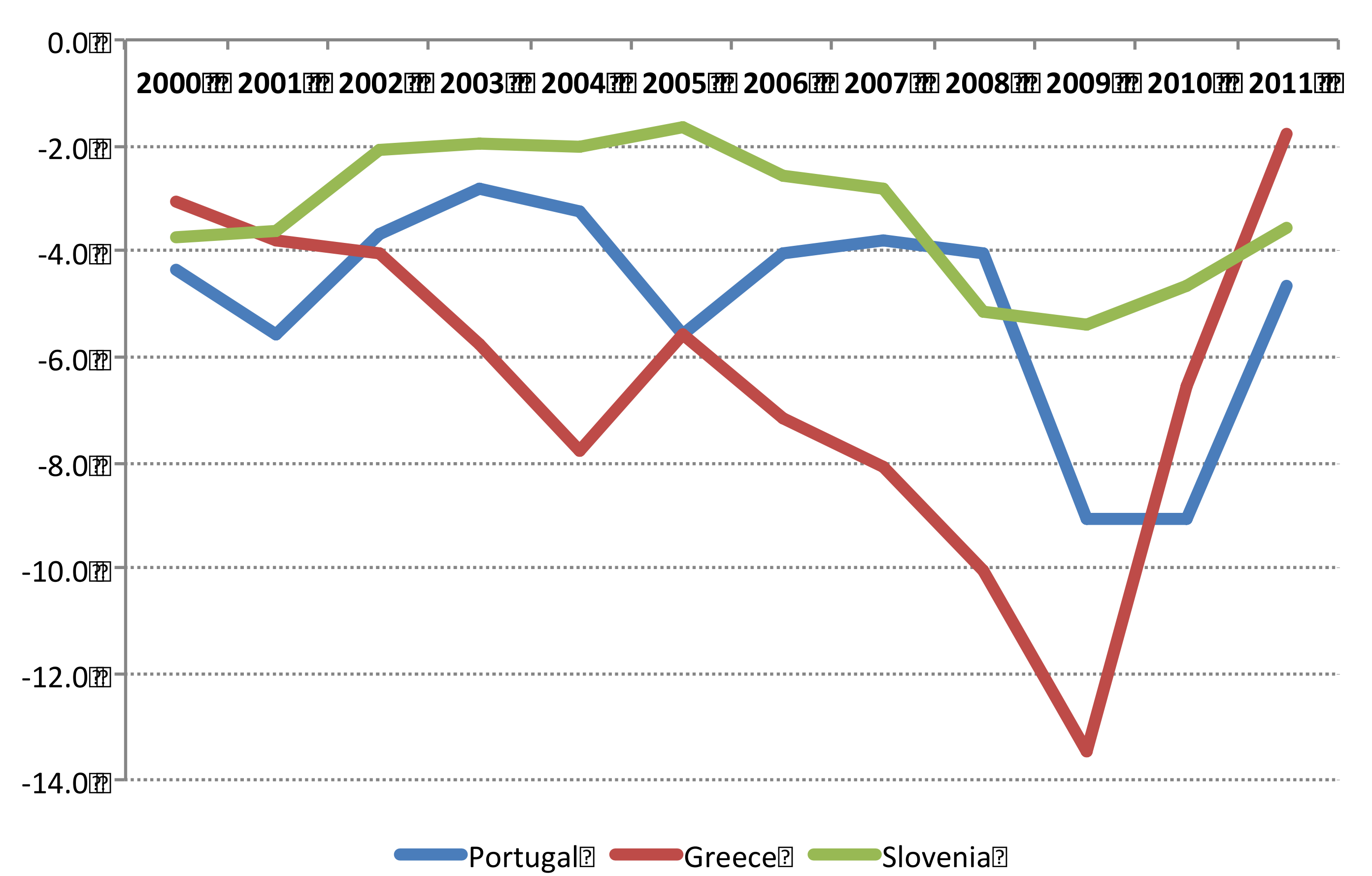
- Irresponsible fiscal policy in the run-up to the crisis,
- No savings made in the good times

Ireland and Spain more prudent
(structural deficit)



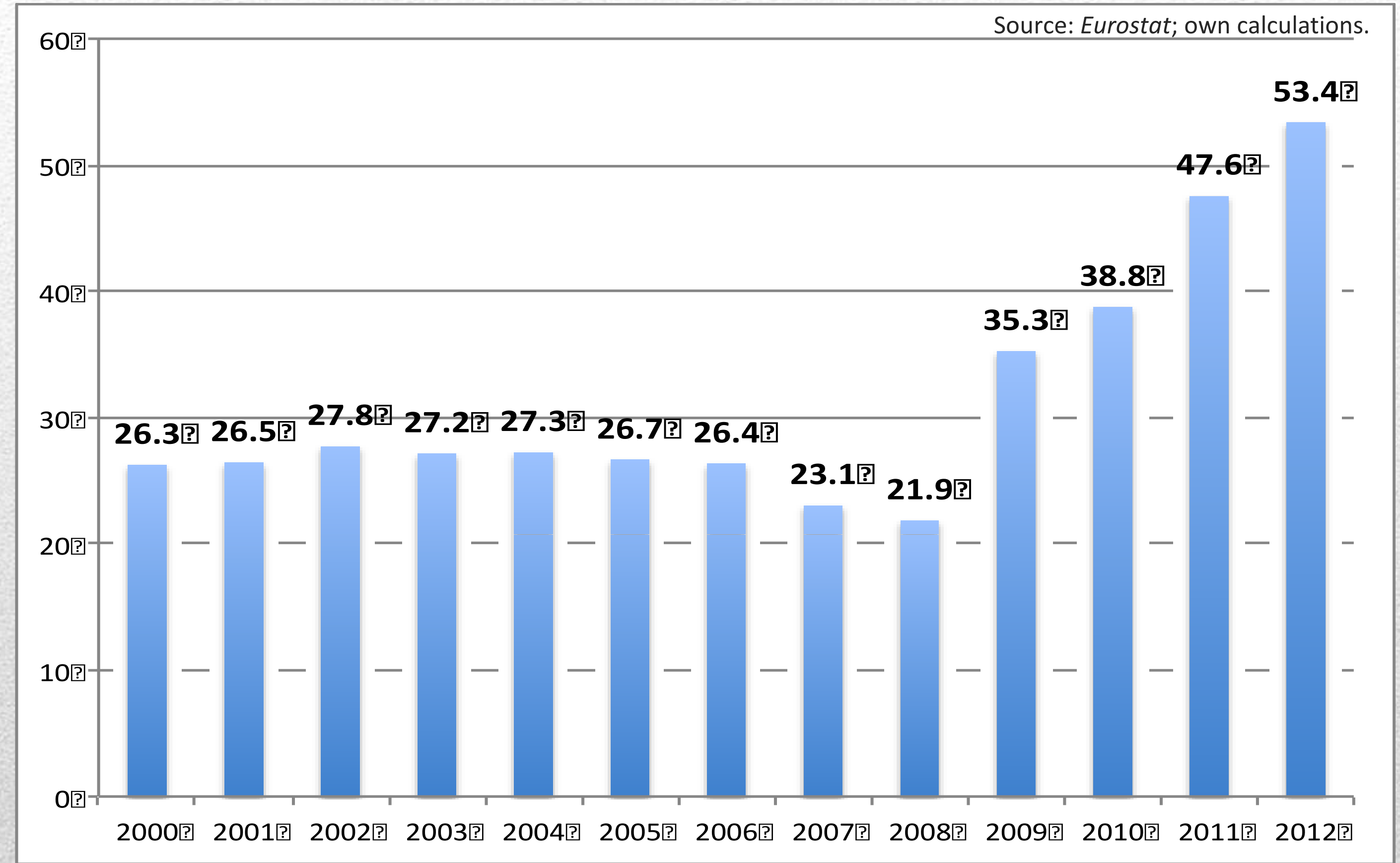
Source: *Eurostat*; own calculations.

… but not Greece and Portugal
(structural deficit)



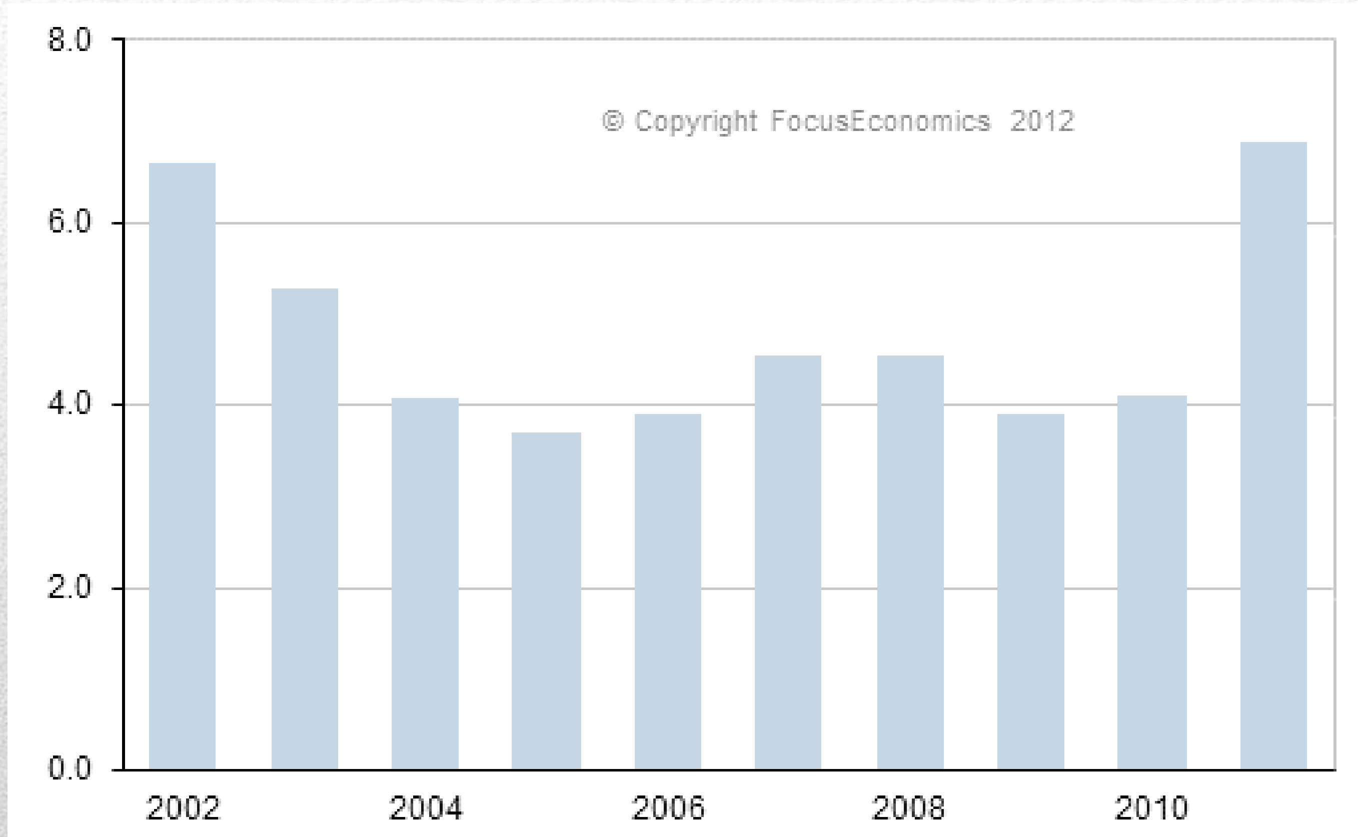
Source: *Eurostat*; own calculations.

Public debt soared (% GDP)



- **Increased public consumption,**
- **While banking problems barely tackled**

10-year bond yield (in %)



- **In 2012, 10y bond yield exceeded 7%, currently 6.2%**

Explanations

Impact of cheap money

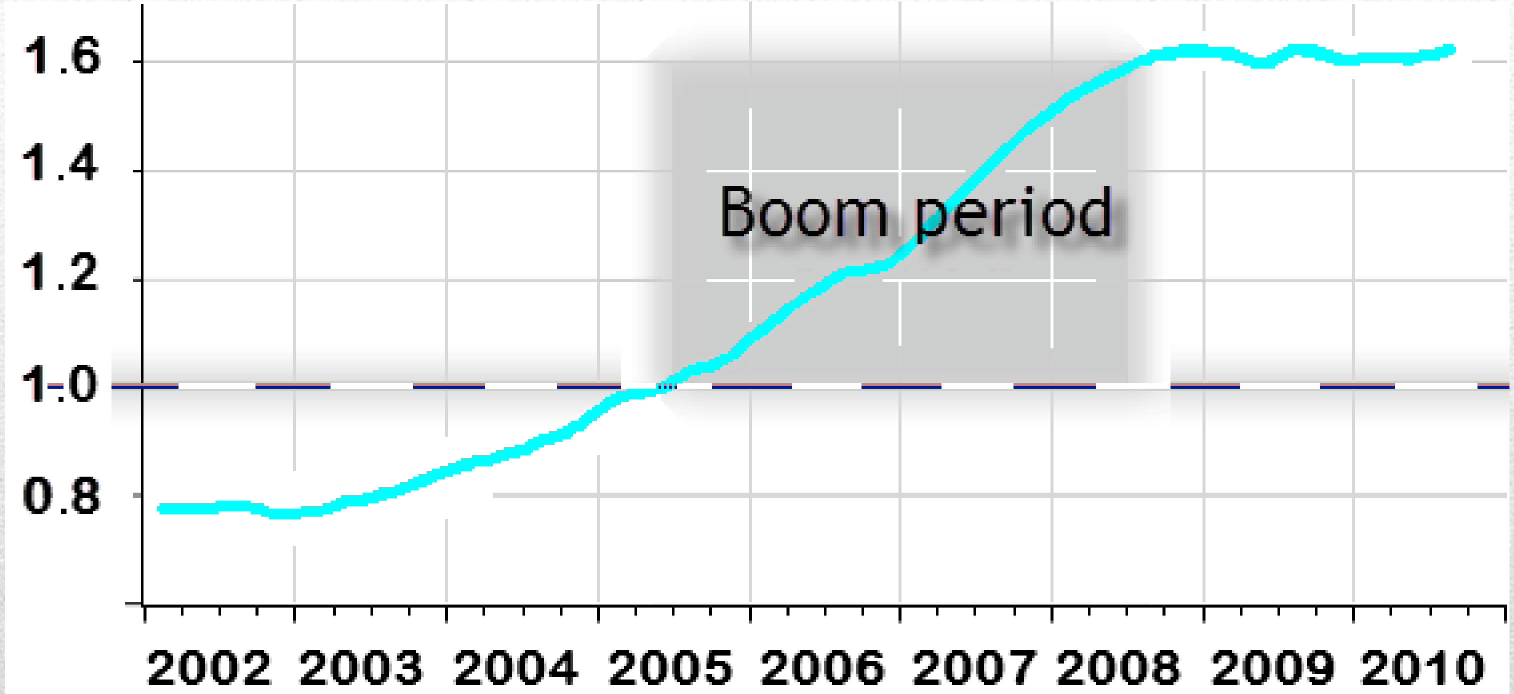
- Economic boom
- Improved stability (EU + euro)
- Liquid interbank money markets + low interest rates
- Banks borrowed short-term to issue long-term loans:
    - *for housing, real estate, M&As, MBOs,*
    - *with poor (real estate or stock-based) collateral*
- Poor regulatory supervision

Bubbles

In run-up to the crisis (2005 – 2008):

•Stock-market bubble:	+270%
•Housing prices:	+ 50%
•Construction:	+ 85%
•M&As, MBOs:	+330%
•Net foreign debt:	+ 30% GDP

Loan-deposit ratio (in %)



Source: http://en.wikipedia.org/wiki/File:Loan_to_deposit_ratio_in_Slovenia.

- **Huge, unsustainable financial leverage**

Who is to blame?

We can blame it on:

- Greedy managers and irrational bankers,
- Poor regulation and bank supervision

However,

- it only explains "*how*", but not "*why*" the country has fallen into a catastrophe,
- Roots of the crisis were systemic and were built into the system long ago,
  - *It just needed a trigger to set the things into a downward motion*

Roots of the crisis

An institutional approach

Institutional analysis as a useful tool to think about what happened in Slovenia:

- to understand the roots of the crisis
  - by taking into account the set of politically induced economic and political rules
  - that shape the motives and behavior of the groups of population

Anecdotal evidence

Acemoglu & Robinson (2001, 2012):

- Colonization strategies can explain divergent comparative economic growth of nations:
  - by setting up inclusive or extractive institutions

Spanish strategy in Latin America

Simple and brutal strategy:

- capturing a local chief of the hierarchically organized indigenous tribes or local states,
- claiming his property as theirs and then coercing the local population into producing food and wealth for the crown,
  - i.e. not changing the system of the society or the set of rules,
  - just creating similar extractive institutions and social structures designed to exploit the indigenous people.

British strategy in North America

A century later, as latecomers the British got only the leftovers (North America):

- Virginia company in early 17th century, attempting to re-create an authoritarian, “extractive” regime,
  - but failed due to hostile and superior local tribes,
  - after 2 years, changing the strategy, trying to coerce the settlers,
  - failed again, settlers ran away
- After 12 years, final change of strategy:
  - Introducing ‘headright system’ (50 acres of land + political rights)

Outcomes

Different colonization types led to divergent development paths:

- Latin America was developing into a highly hierarchical societies with little democratic right and little incentives to work
  - only elites were granted the privileges of conducting business
- Beginning of the democracy in the US,
  - politicians made accountable, preventing them from giving favors only to the elites,
  - a society where innovative ideas and hard work paid

Outcomes (2)

An example of the outcomes of differences in regulation:

- in 1914, there were 27,864 banks in the US,
- but only 42 banks in Mexico, whereby the largest two had a combined market share of 60 %.
- In a more competitive environment, money was cheap in the US calling for sound entrepreneurial ideas to be financed.

Application to Slovenia

- Under the communism before 1990, the incentives to work and to conduct a business were distorted.
  - you had to be part of the elite to be able to participate in lucrative business
- The system was not only less efficient in terms of economic development,
  - it also created a lot of frustration with the majority of less privileged

Changes after 1990, but…

- … there were three crucial "***remains***" of the old system:
- First, "***historical memory***" of the old institutional system
  - poor market regulation, lack of rule of law, etc.,
  - hostile environment for market entrants and foreign companies,
  - In order to defend the interests of the elite and of incumbent firms.

The “remains”

- Second, **undefined property**, that had to be distributed
  - mainly to internal owners (managers) and 2 state funds,
  - more than 50% of economy controlled by the state,
  - concentration of ownership through M&As, but cohabitation with politics.
- Third, after the initial defeat, successors of the old elite came back to power and stayed there for additional 12 years:
  - protecting the interests of the old/new capitalist elite and extracting rents,
  - but also creating further **frustrations** among those relegated away from the power

The trigger

- Though the system was rigid, it was a stable one.
  - the symbiosis between the old/new political elite and the managers in only partly privatized firms
  - managed to produce a stable growth with very little volatility
- The triggers:
  - flood of cheap money with the EU and global boom,
  - political change in late 2004

Run-up to the crisis

- Interaction of the three key remains that constituted the extractive institutional system,
- First, new government did not want to change the institutional system,
  - but rather taking on the Spanish colonization strategy; i.e. getting the control over the economy,
  - to make up for what they felt they were historically deprived
  - only controlled sales of state owned capital shares to “friends”,
  - extraction of rents

Run-up to the crisis, cont.

- Second, the old/new capital elite, while partly disturbed by the political elite:
  - started to make use of the cheap money to engage first in a wide process of M&As (some 20 big clusters created – holding companies),
  - followed by the MBOs (of the holding comp.)
- Some of these "primary capital accumulation" attempts were sponsored by the new government
- However
  - poor financial regulation and huge financial leverage

Outcome

Bubbles (2005 – 2008):

- Stock-market bubble: +270%
- Housing prices: + 50%
- Construction: + 85%
- M&As, MBOs: +330%
- Net foreign debt: + 30% GDP

Bubbles burst, resulting in

- Bad bank assets: +17 – 20% GDP

Bad bank assets

Non-performing loans + payments late 90 days or more

	2009	2010	2011	maj 2012	end 2012
All banks					
bill. EUR	2.7	3.7	5.5	6.5	7.0
% GDP	7.5	10.4	15.6	18.4	19.9
Domestic-owned banks					
bill. EUR	2.3	3.1	4.7	5.5	6.0
% GDP	6.4	8.9	13.2	15.6	16.9

Source: BS, Poročilo o finančni stabilnosti, maj 2012; own calculations.

- **85% of bad debt is owned by domestic-owned banks**

On top:
Mismanagement of the crisis

Political mismanagement of the crisis

A new left-wing government after 2008 (till 2011) mismanaged the crisis:

- Denying the problems of bad bank assets
  - relying on minor recapitalizations + state deposits
- No stimulus, no structural reforms
- Fatal policy mistakes:
  - *10% increase of wages in public sector,*
  - *15% increase of pensions (due to indexation on wages)*
  - *25% increase of minimum wages*

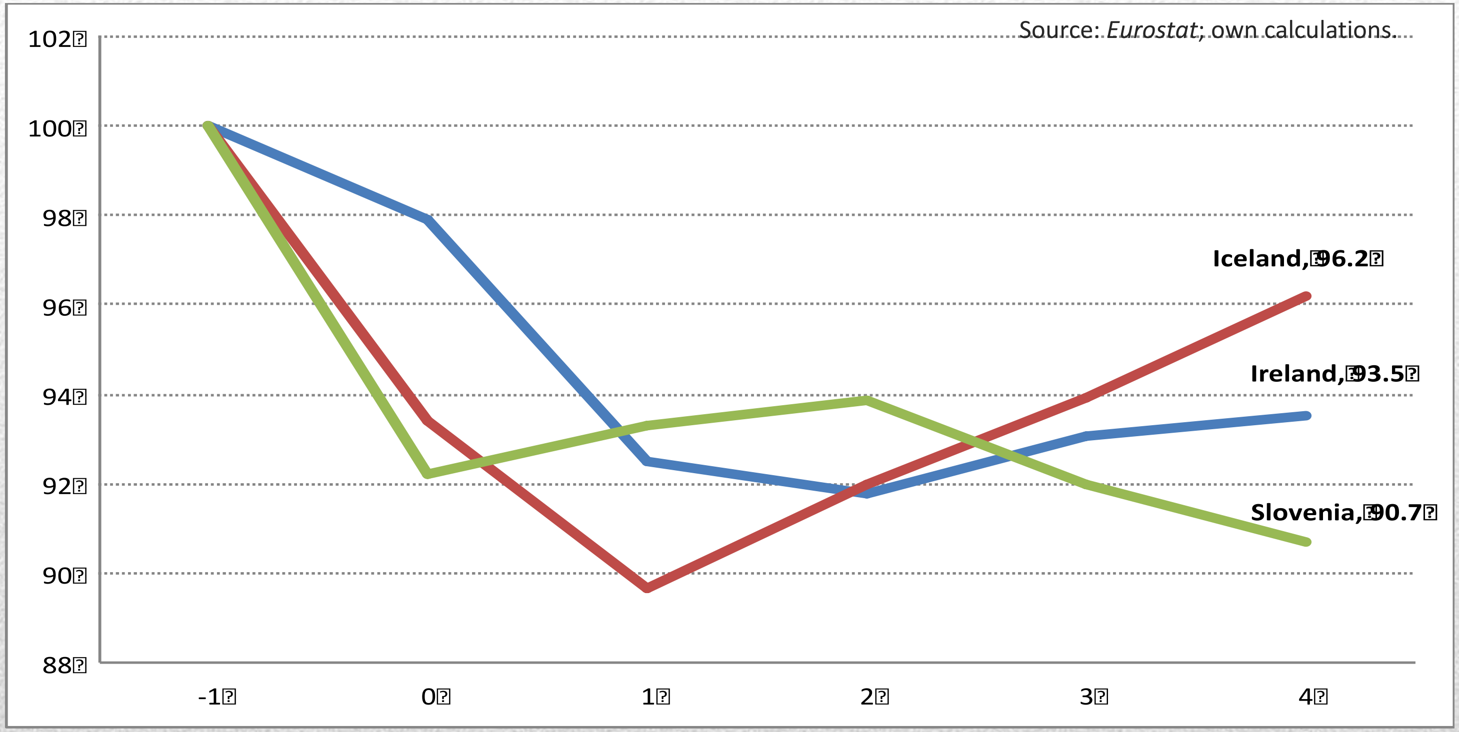
Political mismanagement of the crisis

As a result:

- Expenditures up by 10%, while revenues plummeted by 10%,
- Budget deficit soared to 6% GDP,
- In 2011, government ended its term with additional 20% public debt,
  - whereby, it did not tackle the issue of troubled banks’ bad assets,
  - nor did it provide fiscal stimulus to promote growth

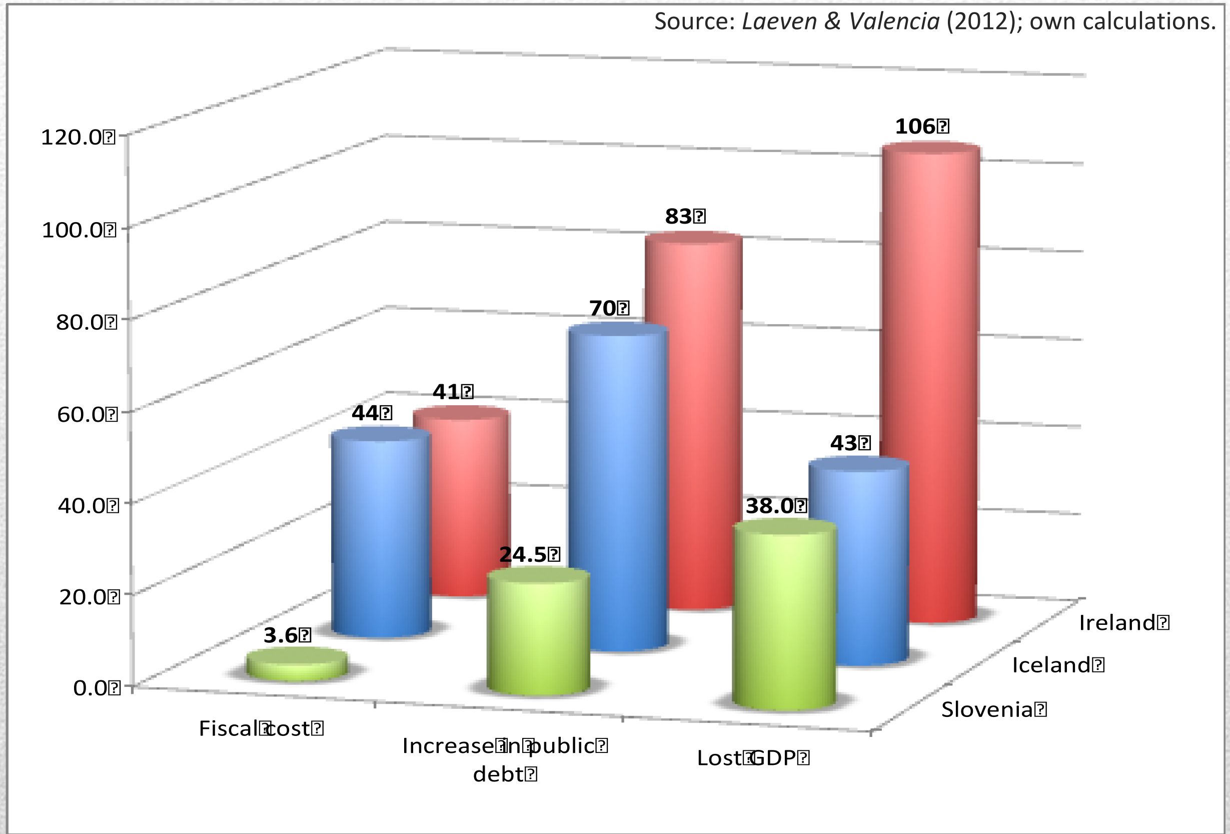
Outcome

cumulative GDP loss



- **With early bank resolution, Iceland and Ireland back to growth,**
- **While Slovenia slid back to recession**

Cost of banking crisis (% GDP)



- **Huge cost, occurred already, while banking problems barely touched**

How to get out of the mess?

Key measures

- Key structural reforms:
  - Labor market reform
  - Pension reform
- Fiscal consolidation (not too harsh)
- Bank rehabilitation (bad bank adopted)
- Fiscal stimulus
  - Public infrastructure, energy
  - Financed by PPPs, EU funds, partly state

However…

- All this might come **too late**
- We are not masters of our faith anymore
- All these efforts are hopeless
  - if unable to convince the financial markets

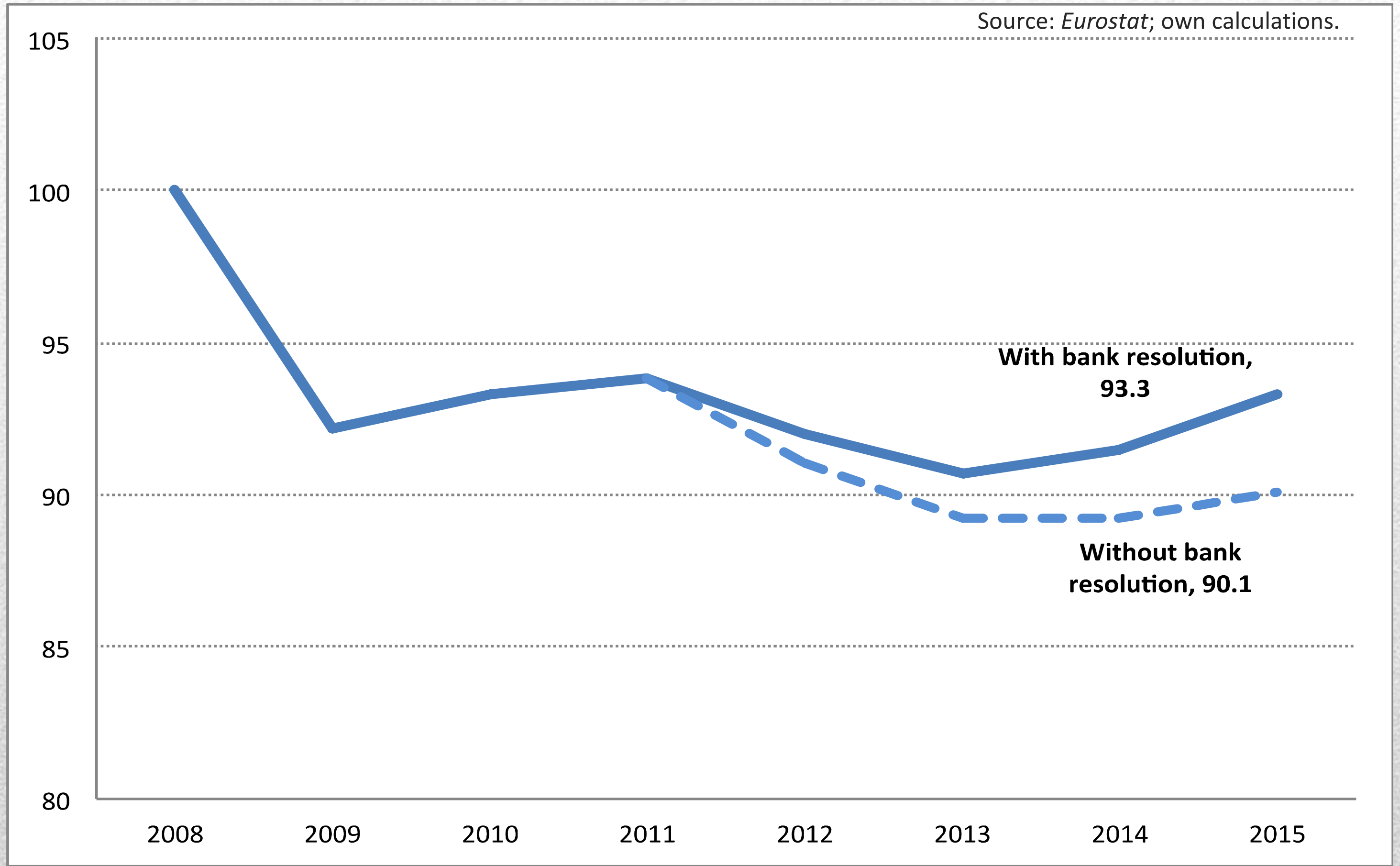
- With persisting speculations and bets against
  - Slovenia will be unable to “close” the current budget
  - And slide in a prolonged depression of a Greek type

Can we make it?

Maybe

- Yes,
  - If succeeding in convincing financial markets
  - (able to “close” the current budget and to refinance the outstanding public debt next year)
- If not,
  - Slovenia will have to ask for a bail-out (very) soon
- Things will get clearer within weeks

The future (is not optimistic)



- At best, 6 years after start of the crisis arriving at -7%

Thanks for your attention